M&G (Lux) Global High Yield ESG Bond Fund

Three-year investment review

Fund managers – James Tomlins and Stefan Isaacs

FOR INVESTMENT PROFESSIONALS ONLY

October 2020

- *The M&G (Lux) Global High Yield ESG Bond Fund combines M&G's long-running experience in high yield investing with a rigorous assessment of environmental, social and governance (ESG) factors.*
- *The fund applies a three-stage ESG screening process, with active company engagement forming a key part of the investment strategy.*
- *Since its launch in October 2017, the fund has achieved an average ESG score which has been consistently higher than the global high yield market.*

The value and income from the fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise. There is no guarantee that the fund will achieve its objective and you may get back less than you originally invested.

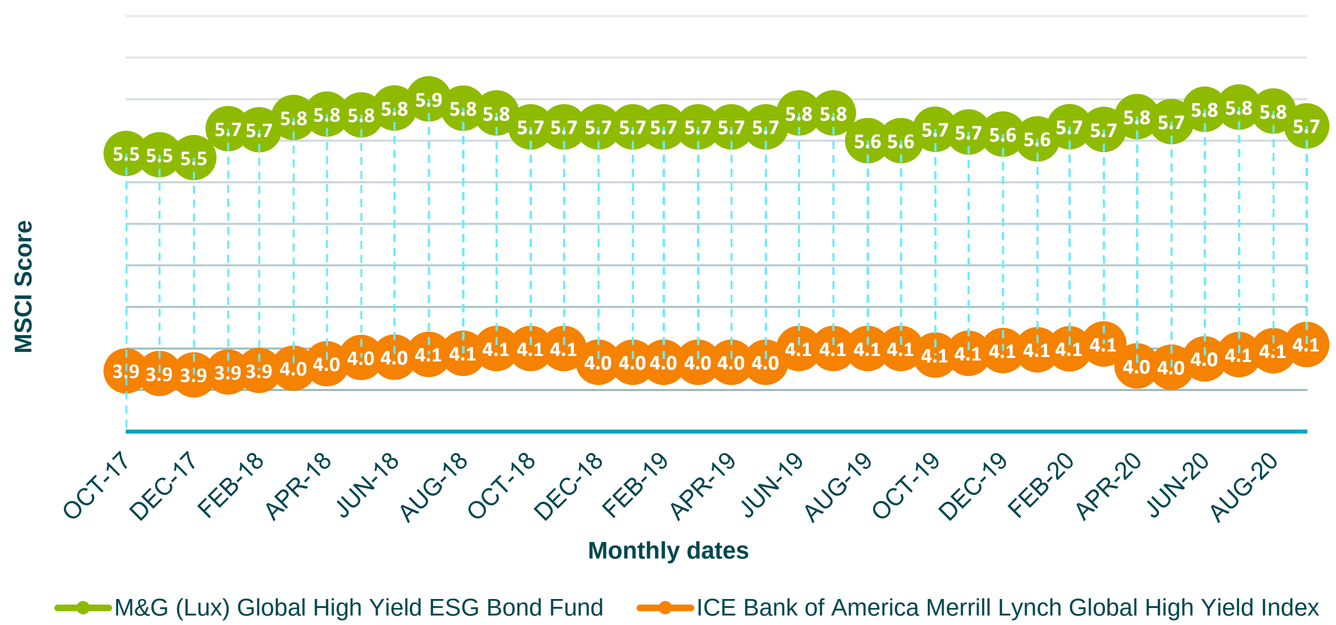
Sector-leading ESG metrics

The M&G (Lux) Global High Yield ESG Bond Fund combines M&G's long-running experience in high yield investing with a rigorous assessment of environmental, social and governance (ESG) factors. Drawing on the expertise of M&G's credit analysts, along with external ESG research from MSCI, the fund seeks to capture the best ideas across the global high yield bond market, while applying a comprehensive three-stage ESG filter.

Since its launch in October 2017, the fund has achieved an average ESG score which has been consistently higher than the global high yield market (see Figure 1). Using MSCI data, we also assessed the ESG performance of the fund against its peers in the global high yield sector and found that its ESG score was within the top 5% of funds across the data set which consists of 129 peers.

Moreover, the fund screens well on climate metrics, with a significantly lower carbon footprint compared to the global high yield index. While the fund does not have an official climate target, our rigorous ESG screening means the fund will have a natural bias towards less carbon-intensive companies and tend to exclude the most polluting businesses. Based on tonnes of carbon dioxide equivalent

Figure 1. MSCI ESG Score versus Benchmark



Source: M&G, Bloomberg, MSCI. October 2020.

(CO_2e) produced per $US million of revenues, the fund's weighted-average carbon intensity was calculated as 176 tonnes versus the index, which measures 380 tonnes.

The fund is also currently aligned with a 2-degree scenario for the full analysed period (until 2050), according to the ISS ESG Climate Impact Assessment, consistent with the objectives of the Paris Agreement (see Figure 2). Based on its current portfolio holdings, the fund is using only 55% of the allocated carbon budget to remain within the 2-degree limit through to 2050 as set by the Paris Agreement.

Figure 2. ISS Climate Impact Assessment

Portfolio Compliance with Emission Budget per Scenario

	2020	2030	2040	2050
2°	41.48%	44.58%	48.84%	55.03%
4°	40.16%	39.08%	37.5%	35.91%
6°	39.25%	37.59%	35.38%	33.7%

Source: M&G, Bloomberg, ISS, 30 September 2020.

A powerful ESG screen

The fund applies a consistent and quantifiable ESG methodology, which goes well beyond a simple exclusion-based approach. Potential investments are filtered through a three-stage ESG screen:

- **UN Global Compact** – excludes companies assessed to be in breach of the United Nations Global Compact principles on human rights, labour, environment and anti-corruption.
- **Sector screening** – this stage seeks to filter out companies that derive part of their revenues from specified activities.
- **ESG integration** – removes companies which we believe display poor ESG credentials based on an in-depth assessment of a wide range of ESG factors.

We believe this approach helps to ensure a minimum ESG quality in the fund, with a tilt towards companies which show positive ESG credentials, while avoiding companies flagged for certain frequently used social safeguards screens.

ESG integration forms the core part of the process and also accounts for the majority of the exclusions from the fund's investment universe. This stage involves an-depth analysis across a wide range of issues. Depending on the industry, this might cover everything from energy efficiency and pollution to working conditions and product safety.

We firmly believe that having a thorough understanding of ESG-related risks leads to a more comprehensive credit analysis and a better-informed investment decision. For this reason, we see ESG analysis as an important complement to traditional financial analysis, allowing us to more fully understand and assess all potential issues that could affect a company's future financial performance.

Please note that investments in bonds are affected by interest rates, inflation and credit ratings. It is possible that bond issuers will not pay interest or return the capital. All of these events can reduce the value of bonds held by the fund. High yield bonds usually carry greater risk that the bond issuers may not be able to pay interest or return the capital.

Active ESG engagement

ESG engagement forms another key part of the fund's investment approach. Engagement is a collaborative process, with the fund managers working closely with M&G's credit analysts and dedicated ESG team. Each of these areas brings different expertise to the engagement process, which together allows us to build a comprehensive understanding of a company's ESG attributes and its overall credit profile.

The engagement process will typically serve one or more of the following purposes:

- Help improve a company's ESG behaviour and performance;
- Encourage better ESG disclosure and transparency;
- Improve our understanding of a company's ESG characteristics and any ESG-related risks.

Over the past three years, we have engaged with a wide range of businesses in order to better understand their strategies for tackling ESG-related issues. High yield companies typically tend to be more dependent on capital markets as a source of their funding, and therefore can be more incentivised to maintain good relationships with their lenders. As a major bond investor, M&G can often gain extensive access to management, using our influence and specialist knowledge to help encourage further ESG progress.

Assessing Huawei risk in the telecom sector

As well as individual company engagements, we also carry out broader sector reviews. For instance, M&G's credit analysts recently initiated an in-depth review across the telecom sector due to concerns around the viability of Huawei as a supplier of telecom equipment. Huawei has come under increasing pressure from the US in recent years, leading to its equipment being banned in several countries. With further countries poised to enforce similar bans, telecom companies which use Huawei's equipment could face significant financial and operational headwinds.

Our detailed credit analysis and active company engagement, has allowed us to get a better understanding of an important risk factor currently facing the telecom sector. Following this review, we believe we now have a much clearer picture of Huawei-related risks for the sector and the telecom companies held in the fund.

Investing in emerging markets involves a greater risk of loss due to greater political, tax, economic, foreign exchange, liquidity and regulatory risks, among other factors. There may be difficulties in buying, selling, safekeeping or valuing investments in such countries.

Resilient investment performance

Since its launch on 5 October 2017, the fund has delivered resilient investment performance against a challenging market backdrop. Despite the unprecedented sell-off in high yield markets in early 2020 as the spread of the new coronavirus led to a closure of much of the global economy, the fund has generated a positive return over the past three years (annualised).

In the three years to 5 October 2020, the fund has returned 2.8% (pa), which was behind its benchmark (ICE BofAML Global High Yield Index USD Hedged Index) which returned 4.3%. However, the fund has achieved lower annualised volatility (9.0%) versus its benchmark (9.6%) over the past three years. This supports our view that an ESG-focused high yield strategy is capable of delivering attractive risk-adjusted returns and demonstrating resilience during periods of extreme market turbulence such as we have seen this year.

Performance since fund launch (%)

	Year to 5 Oct	2019	2018	2017	2016	2015	Since launch (pa)
Fund	-2.5	13.3	-2.6	n/a	n/a	n/a	2.8
BM	0.5	14.5	-1.9	n/a	n/a	n/a	4.3

Past performance is not a guide to future performance.

Benchmark (BM) = ICE BofAML Global High Yield Index USD Hedged Index

The benchmark is a comparator against which the fund's performance can be measured. The index has been chosen as the fund's benchmark as it best reflects the scope of the fund's investment policy. The benchmark is used solely to measure the fund's performance and does not constrain the fund's portfolio construction.

The fund is actively managed. The investment manager has complete freedom in choosing which investments to buy, hold and sell in the fund. The fund's holdings may deviate significantly from the benchmark's constituents.

Source: Morningstar Inc., as at 5 October 2020, USD Class A Acc, income reinvested, price-to-price. Benchmark returns stated in share class currency.

Key performance drivers

The fund's lack of exposure to more cyclical credits has weighed on returns relative to the benchmark index, as we favoured more defensive businesses, such as packaging companies and cable operators. For instance, the fund's underweight exposure, relative to the benchmark, to the auto sector has detracted in 2020. In the energy space, not holding 'fallen angel' Pemex (which failed the fund's ESG screens) also detracted, given its strong recovery since its inclusion in the global high yield index earlier this year.

The fund's bias towards European issuers also cost some relative performance, as US high yield outperformed. The US high yield market has benefited from the country's stronger economic backdrop, and more recently from the US Federal Reserve's decision to include high yield bonds within its asset-purchase programme.

On the positive side, the fund's overweight exposure to healthcare, relative to the benchmark, has helped. Within this sector, we would highlight HCA, which recently had its MSCI ESG rating upgraded to AA on the back of improvements in its corporate governance practices. We would also highlight credit selection in the transport sector, where we were able to avoid some of the more cyclical names most affected by the COVID-19 crisis.

Credit selection in the telecom sector was another contributor, in particular our overweight positions in KPN and Millicom. Both of these names have also shown good progress on ESG matters, with strong governance practices and independent board majorities. In the case of Millicom, we have been especially impressed with the experienced management team's efforts to ensure sound anti-corruption and business ethics. Millicom has also been active in the issuance of sustainability bonds to fund a number of environmental and social projects.

A distinctive ESG proposition

With high yield bonds remaining an underserved part of the ESG landscape, we believe M&G is able to offer a distinctive investment proposition, which combines our long-running expertise in high yield investing with an in-depth assessment of ESG criteria.

The depth of our resource means we are well placed to thoroughly scrutinise all aspects of a company's credit profile, and this has proved invaluable as our high yield team have navigated the COVID-19 crisis. While good ESG performance doesn't shield companies from market shocks such as COVID, it brings to light companies with a more resilient and sustainable business model over the medium and long term, factors which we believe will increasingly impact the funding costs for businesses as markets will become more sophisticated in pricing those risks.

With global interest rates likely to remain close to zero for the foreseeable future, we continue to find value in parts of the high yield market. A strong demand for income, coupled with the ongoing support of the world's central banks, should provide a solid foundation for valuations. As economic activity has picked up in recent months, we would also highlight the marked fall in credit downgrades amongst high yield issuers.

Nevertheless, given the strength of the recovery in high yield markets over the past few months, we think a more selective approach will be needed going forward. The ability to analyse the extent to which a company's revenue streams and liquidity situation may have been affected by the pandemic will be especially critical over the coming months. We believe the depth of our expertise in assessing both traditional financial and ESG factors leaves us well positioned to face the challenges ahead.

M&G
October 2020

The fund allows for the extensive use of derivatives.

Further risks associated with this fund can be found in the fund's Key Investor Information Document.

504605_SICAV_PE ex Germany & Austria_Asia

UCITS HAVE NO GUARANTEED RETURN AND PAST PERFORMANCE IS NOT A GUIDE TO FUTURE PERFORMANCE