IN AN UNCERTAIN WORLD MIGHT FLOATING RATE ASSETS BE A PENSION FUND'S BEST FRIEND? ASKS M&G'S LLOYD

- ***Ultra-loose monetary policy now looking "long in the tooth"***
- ***Lloyd suggests stepping back from high yield in favour of bonds with a yield pegged to interest rates***

London, 9 April 2014 – The UK's economic recovery may be looking healthier by the day, says **David Lloyd, head of institutional portfolio management at M&G Investments**, but many uncertainties remain. The best thing that pension funds could do in fixed income right now is re-evaluate their allocations to high yield and look for cheap floating rate assets.

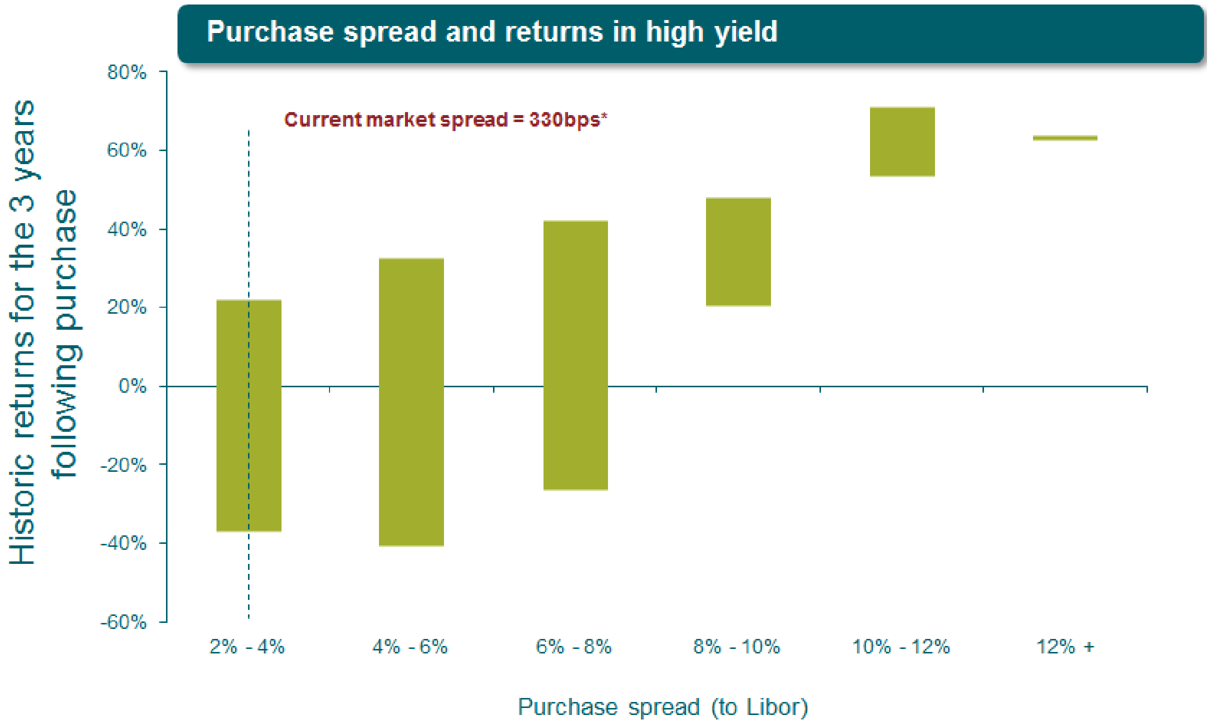
Lloyd says, "The UK economy has been growing for five years now, measured from the absolute bottom, and while that's good news for just about everyone it does mean the upturn is relatively long in the tooth.

"I'm optimistic, but I am conscious that if things take a turn for the worse then the Governor of the Bank of England has few weapons left. Interest rates have been at emergency levels for five years and my view is that the need to "reload the gun" is becoming ever more pressing. It would be a major headache for policy makers were we to enter a renewed downturn with no ammunition in either monetary or fiscal policy."

M&G's institutional fixed income fund managers tend to eschew large macro calls or forecast based views on markets, focusing instead on spotting and exploiting value – in essence, buying cheap bonds.

On that basis, they believe high yield is starting to look expensive. **Lloyd** explains, "History says that when spreads on high yield are where they are at the moment, the range of absolute returns over the following three years is from plus 20% to minus 40% (see below chart). There will always be some good value bonds but a wholesale move into high yield now looks more a punt than a fundamental investment decision to me.

Chart: historic returns in high yield



Source: M&G, BofA Merrill Lynch European High Yield non-Financial 2% Issuer constrained Index (HPIC), M&G Calculations
*Asset swap spread. Data set: 31 December 1997 to 31 March 2014

"Anecdotal evidence bears this out. A Greek bank recently issued a CCC-rated bond with a yield of little more than 5%. That's what a UK or German government ten year bond yielded about a decade ago. Even in a world of super low interest rates, that looks pretty far from being OK to us. We would rather take profits from high yield and put pension fund client money to work in securities that compensate us more generously for the risks."

While M&G's fund managers are still finding value in some mis-priced high yield bonds they are finding more compelling opportunities in floating rate assets. **Lloyd** continues, "The 'fixed to floating' conversation is the one we are having most frequently with clients about their bond allocations. First because there remain some attractive opportunities there and second because some want to build in more protection against the possibility that interest rates might rise.

"To give you an example, a 1% rise in gilt yields will erode about 8% of value from an index of sterling, investment grade corporate bonds. A basket of floating rate securities offers much greater protection in such a scenario."

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If you require any further information, please contact:

Irene Chambers

Corporate Communications

M&G Press Office

Tel: 020 7004 4132

irene.chambers@mandg.co.uk

Notes to Editors

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Headquartered in London, M&G employs over 1,500 people worldwide operating from offices across Europe and Asia.

M&G's history is a story of investment firsts, from the UK's first mutual fund in 1931 to the Inflation Linked Corporate Bond Fund in 2010.

M&G is the investment arm of Prudential Plc in the UK and Europe.

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