M&G Fixed Income

Opportunities in high yield bonds

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FOR INVESTMENT PROFESSIONALS ONLY

April 2020

- *The sell-off in high yield markets has been unprecedented in terms of both magnitude and pace, with spreads now indicating a worst-case scenario. While we expect high yield markets to remain volatile in the short term, on a medium to long-term basis, we think the asset class now offers the potential for strong returns.*
- *We believe that M&G, with long-running expertise in high yield investing and relying on an in-house team of credit analysts, is well positioned to capture the compelling opportunities that are emerging across high yield bonds.*

Please note that the value and income from the funds' assets will go down as well as up. This will cause the value of your investment to fall as well as rise, and you may get back less than you originally invested. 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. In addition, high yield bonds usually carry greater risk that the bond issuers may not be able to pay interest or return the capital.

Opportunities in high yield?

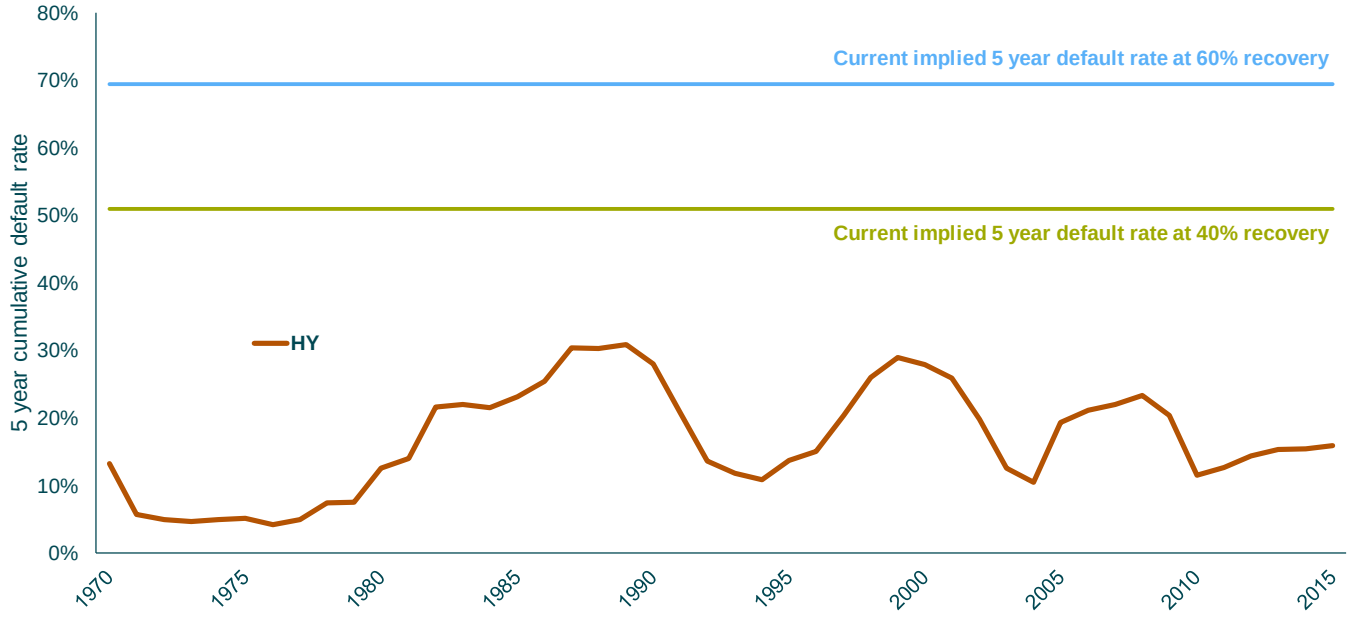
As countries across the globe battened down the hatches and imposed national lockdowns in a bid to curb the outbreak of Covid-19, many risk asset classes sold off, not least high yield bonds. High yield spreads widened nearly 500 basis points (bps) during the height of the turbulence in March and are now currently hovering at just under 1,000 bps. The huge decline in oil prices exacerbated problems, given that the energy sector makes up more than 10% of the global high yield market. The pandemic also prompted income-hungry investors to quickly abandon the asset class, accelerating the selling pressure and removing much-needed liquidity.

Amid ongoing coronavirus-related volatility, high yield valuations are now looking cheap on a historic basis, potentially generating some very attractive medium to long-term opportunities for investors willing to take on the risk:

- The global high yield market fell -13.6% in Q1 2020. Looking back, the last six occasions when the global high yield market had a quarterly drawdown of at least 4%, it resulted in returns in excess of 20% over the following two

Figure 1. Implied levels of default

Historical 5-year cumulative default rate vs what is currently priced in



Source: M&G, Deutsche Bank, 2020.

years. Furthermore, buying high yield with spreads over 900 bps has never lost money over a 12-month holding period historically, and the median 12-month return has been 28%. The last time the high yield market sold off this hard (2008), the subsequent return from the asset class in the following year was 60.7%.

- Spreads in the global high yield market are pricing in a cumulative 5-year default rate of 51% (assuming a 40% recovery). The floating rate high yield market is pricing in a cumulative 5-year default rate of 70% (assuming an average recovery of 60%).The prior record default rate was 31% and the average default rate during recessions is 17% using data all the way back to 1980.

These are certainly compelling numbers to us. But the risks are still very prevalent too; spreads topped out at more than 2,000 bps after the Lehman Brothers bankruptcy, and investors should brace for downgrades and higher default rates over the coming months, particularly in hard-hit sectors.

However, nothing is stopping us from expecting default rates to be consistent with previous recession cycles. We should also remember that the level of stimulus provided by central banks and governments has been nothing short of extraordinary. Measures to support businesses and consumers have been quick and robust compared to 2008/09. Central banks have been willing to grow balance sheets and put swap lines in place, even buying corporate bonds as part of their bond-buying programmes.

There will also be some winners too. Food retailers, packaging businesses, technology, media, and communications companies, pharmaceutical and healthcare operators (all significant areas of the high yield market), are likely to either experience relatively limited impact or in fact see an upturn in revenues. The ability to carefully select high-quality, attractively priced credit exposure will be crucial in the coming weeks and months. Having access to one of the leading in-house credit analyst teams will help us to identify those companies which can preserve liquidity and continue to serve their debt liabilities.

While we expect high yield markets to remain volatile in the short term, on a medium to long-term basis we think high yield markets offer the potential for strong returns, based on a combination of income and significant capital upside as spreads return to more normal levels.

The world of high yield at M&G

As one of the largest and most experienced high yield investors in Europe, M&G boasts impressive expertise in this highly specialised asset class. M&G offers four distinct high yield strategies, designed to cater for a variety of investor needs (**Figure 2**).

M&G (Lux) Global High Yield Bond Fund[1] – Our long-running global high yield strategy, with a track record of more than 20 years. The fund seeks to capture the best relative value ideas across the global high yield universe.

M&G (Lux) Global High Yield ESG Bond Fund – A global high yield bond fund, which combines our expertise in high yield investing with a rigorous assessment of environmental, social and governance (ESG) factors. The fund offers a formal and measurable ESG screening process that goes beyond a simple exclusion approach.

Figure 2. The world of high yield at M&G

Funds		M&G (Lux) Global High Yield Bond Fund	M&G (Lux) Global High Yield ESG Bond Fund	M&G (Lux) Global Floating Rate High Yield Fund	M&G (Lux) Floating Rate High Yield Solution
Strategy Focus		Best ideas global HY bond fund	ESG-focused global HY	High yield FRNs	Synthetic high yield FRNs
Outcome	Interest rate risk (duration)	c. 3 years	c. 3 years	c. 0 years	c. 0 years
	Income/yield	✓	✓	✓	✓
	Responsible screen	✗	✓	✗	✗
Performance drivers	Geographical allocation	✓	✓	✓	✓
	Stock selection & sector rotation	✓	✓	✓	✗
	Credit exposure scaling/leverage	✗	✗	✗	✓
	Management of credit spread duration	✓	✓	✓	✓
	Security – capital structure	Typically a blend of senior secured and senior unsecured instruments	Typically a blend of senior secured and senior unsecured instruments	Typically senior secured instruments	Typically senior unsecured instruments

Source: M&G, March 2020.

1. On 9 November 2018, the non-sterling share classes of the M&G Global High Yield Bond Fund, a UK-authorised OEIC, merged into the M&G (Lux) Global High Yield Bond Fund, a Luxembourg-authorised SICAV, which launched on 9 November 2018. The SICAV is run by the same fund managers, applying the same investment strategy, as the UK-authorised OEIC.

M&G (Lux) Global Floating Rate High Yield Fund[2] – Focusing on global high yield floating rate notes (FRNs), this innovative strategy is designed to provide a more defensive approach to high yield investing by focusing predominantly on senior-secured high yield bonds, while offering protection against interest rate risk at the same time.

M&G (Lux) Floating Rate High Yield Solution – A synthetic floating rate high yield strategy with minimal levels of interest rate risk. The fund gains its high yield exposure exclusively through CDS indices, providing a cost-effective, well diversified and highly liquid way to access this market.

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2. On 7 December 2018, the non-sterling share classes of the M&G Global Floating Rate High Yield Fund, a UK-authorised OEIC which launched on 11 September 2014, merged into the M&G (Lux) Global Floating Rate High Yield Fund, a Luxembourg-authorised SICAV, which launched on 13 September 2018. The SICAV is run by the same fund manager, applying the same investment strategy, as the UK-authorised OEIC.

Please note, not all funds mentioned above may be available in your jurisdiction.

The funds allows for the extensive use of derivatives.

The funds may invest more than 35% in securities issued by any one or more of the governments listed in the fund prospectus. Such exposure may be combined with the use of derivatives in pursuit of the fund objective. It is currently envisaged that the funds' exposure to such securities may exceed 35% in the governments of Germany, Japan, UK, USA although these may vary subject only to those listed in the prospectus.

Further risks associated with the funds can be found in the funds' Key Investor Information Document**.**

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