# M&G (Lux) Emerging Markets Corporate ESG Bond Fund

## Applying ESG criteria to EM corporate bonds

### Fund Manager – Charles de Quinsonas

FOR INVESTMENT PROFESSIONALS ONLY

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- *The M&G (Lux) Emerging Markets Corporate ESG Bond Fund combines M&G's long-running expertise in emerging market investing with a rigorous assessment of environmental, social and governance (ESG) factors.*
- *The fund draws on the well-established investment process followed by the M&G (Lux) Emerging Markets Bond Fund, complemented by extensive ESG screening.*
- *Enhancing M&G's internal credit analysis capabilities with external ESG research from multiple leading providers, this actively-managed fund represents a genuinely distinctive proposition for investors looking to gain exposure to the ever-growing and diversified emerging market corporate bond universe.*

*Please note that 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.*

## Adding ESG criteria: the benefits

The rise of responsible investing over the past decade represents a major shift in the investment industry. Growing awareness of a range of environmental and social issues has seen an ever-larger number of investors shift their focus beyond traditional financial considerations towards an approach that also looks at an investment's wider impact on society.

Over the past few years, these changing attitudes have helped to drive a steady increase in the number of responsible investment and ESG-related strategies. Growth has been especially strong in the fixed income space -- although these strategies have tended to focus on investment grade issuers within developed bond markets. Only a limited number of funds are operating in the emerging markets bond space. But as we have seen in cases involving Brazilian natural resource companies Vale and Petrobras, emerging market corporate bond issuers may face elevated ESG-related risks, which can have a material impact on their financial performance. Furthermore, the riskier nature of the asset class means that any positive or negative ESG developments can have a significant impact on asset prices.

We therefore regard ESG-related factors as critical considerations when assessing the creditworthiness of a corporate issuer in emerging markets. A thorough ESG analysis can help to flag companies whose ESG shortcomings may ultimately lead to a deterioration in their credit profile. Conversely, ESG analysis can help us to identify potential outperformers in a way that traditional credit analysis may fail to capture, in our opinion.

Investing in EM corporate bonds will typically involve additional political and jurisdictional risks compared to developed markets. We believe it is vital to understand and fully assess all potential issues that could affect a company's credit profile. In this respect, we see ESG analysis as an important complement to traditional financial analysis, helping to ensure a more comprehensive credit analysis and a better-informed investment decision.

The EM corporate bond market has seen rapid growth over the past 15 years, driven by the strong economic expansion across developing economies. Nevertheless, we believe this remains an under-researched market, creating a wealth of opportunities for active credit selectors with the expertise to assess the specific risks that are a feature of EM investing.

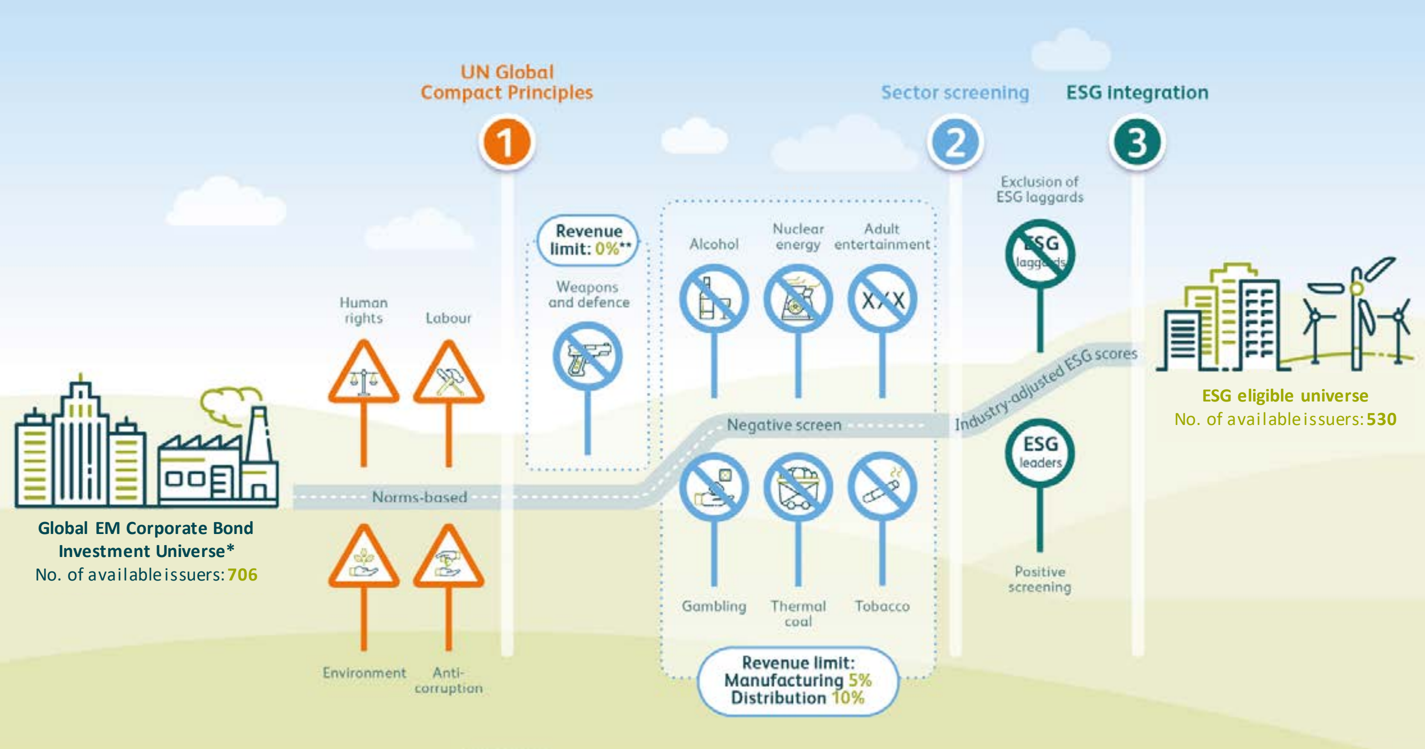
You should be aware that investments in bonds are affected by interest rates, inflation and credit ratings. It is possible that bond issuers will not pay interest or return the capital. All of these events can reduce the value of bonds held by the fund. Investors should also be aware that investing in 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.

## Overview of the strategy

The M&G (Lux) Emerging Markets Corporate ESG Bond Fund seeks to capture the best ideas across the emerging markets corporate bond market, while applying a formal responsible investment screen and a special focus on environmental, social and governance (ESG) factors. The fund invests mainly in emerging market corporate bonds issued in hard currency, although the fund manager also has the flexibility to invest in other securities, such as sovereign EM bonds and local currency EM bonds.

The fund takes an active, high-conviction approach that combines our long-running experience of investing in emerging market bonds with external ESG research from

**Figure 1. ESG screening process**




*Source: Source: M&G. 31 July 2020 . *JP Morgan CEMBI Broad Diversified Index. ** On a best-efforts basis subject to our data providers*

three leading providers. In-depth credit research forms the core of the fund's investment process, with ESG factors closely integrated into our credit analysis. The fund manager also closely assesses the global macroeconomic outlook, helping to determine with this analysis the fund's regional, country and sector allocations.

Our credit research process involves both a quantitative and a qualitative assessment. Alongside traditional credit and financial metrics, we therefore put a strong emphasis on assessing the quality of management and we regularly meet with companies to get a better understanding of their strategy and business model. Sovereign analysis also forms a key part of our research process; it allows us to better understand any external threats or opportunities that companies may face.

## The three-stage screening process

In order to identify securities that meet the fund's ESG criteria, potential investments undergo a three-stage screening process, which excludes certain types of organisations (see Figure 1). We believe the approach outlined below strikes the right balance between maintaining a large and diverse selection of emerging market credits and achieving a favourable ESG outcome.

Companies that are not eliminated by the three-stage filter will then be assessed using traditional credit analysis and according to their ESG merits, drawing on both internal and external ESG research.

### 1. UN Global Compact

The first stage excludes any companies that are assessed to be in breach of the United Nations Global Compact principles on human rights, labour, environment and anti-corruption. Any company that has been deemed by any of our external ESG research providers to have inflicted serious large-scale harm in relation to these principles will be excluded.

### 2. Sector screening

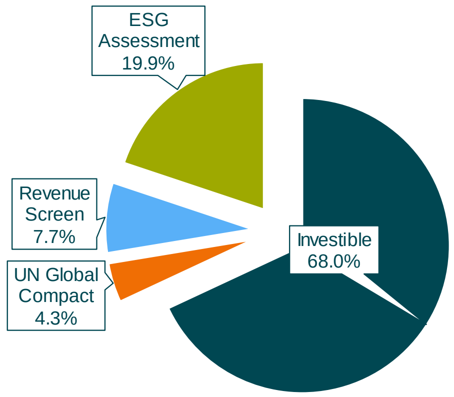
The second stage implements a sector screen seeking to filter out companies that derive more than 5% of their revenue for producers, or 10% of their revenue for distributors, from the following sectors or sub-sectors: tobacco, alcohol, adult entertainment, gambling, thermal coal or nuclear energy. We also seek to exclude companies that derive any of their revenue from defence and weapons. Please note that sector exclusions are implemented on a best-efforts basis and subject to source data.

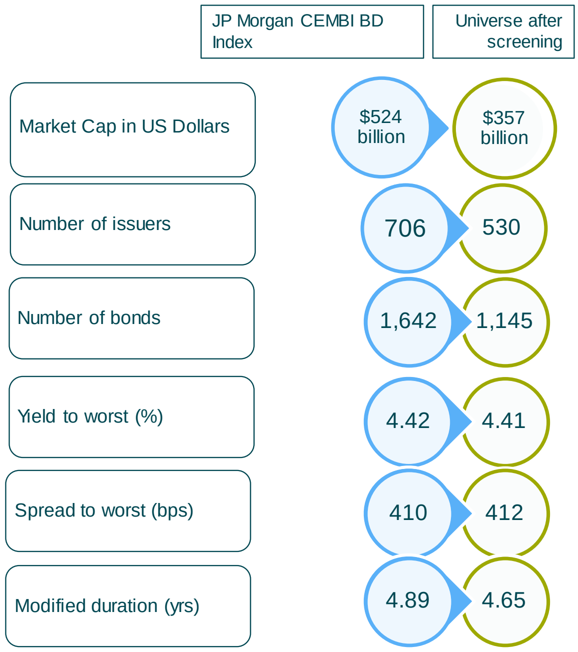
### 3. ESG integration

The third stage filters companies according to their overall ESG credentials. The fund seeks to exclude companies that we consider to be ESG laggards based on the analysis of our external research providers and our in-house ESG assessment. We typically exclude any company that is classified as an ESG laggard by two or more of the three external providers (eg, MSCI defines laggards as issuers with an ESG score below 3.0). By using multiple ESG

## Figure 2. The results from responsible screening

| | |
|---|---|
| **Exclusion of JP Morgan CEMBI Broad Diversified index by security weight*:** | **31.95%** |
| **Exclusion of JP Morgan CEMBI Broad Diversified index by issuers count*:** | **24.93%** |




*Source: M&G, Bloomberg, JPMorgan indices, *MSCI ESG Research, Sustainanalytics, RepRisk 31 July 2020. Based on model portfolio data, for illustrative purposes only.*

research providers we are able to cover 99% of the fund's investable universe.

Where M&G produces an internal ESG rating, this will prevail over the assessment of the external providers. Therefore, we will exclude an issuer that M&G considers to be a laggard, even if external providers believe it has sound ESG qualities. Conversely, an issuer that M&G considers to have positive ESG qualities may be included in the portfolio, even if the external providers class it as an ESG industry laggard.

Positive screening is also performed. The fund will typically favour issuers with strong ESG credentials, providing that valuations are comparable with issuers that have a weaker ESG profile.

The fund may also hold up to 10% of its NAV in securities with no external ESG ratings. This flexibility is expected to be primarily used for new issues, which have yet to have been assigned an external ESG rating. In such instances, our ESG assessment will be based on the research of our in-house team of credit analysts and any such transactions will be documented with our investment oversight team.

Compared to the narrower focus of the first two screens, ESG integration involves a sophisticated analysis of a wide range of complex issues, which might cover everything from energy efficiency and pollution to working conditions and product safety. Companies are assessed on an industry-adjusted basis, taking into account the key issues relevant for that sector and with comparison to the standards and performance of their industry peers.

## EM universe: large, well-diversified

The fund's investment universe is large and rapidly growing. The emerging markets hard-currency corporate bond market (including quasi-sovereign bonds) was worth US$2.4 trillion as at the end of December 2019. This compares to US$0.6 trillion just a decade ago, and means it is now significantly larger than the US high yield bond market. It is also a highly diversified market, consisting of more than 700 individual issuers from more than 50 countries and covering a wide range of sectors. In terms of credit rating, around 60% of the universe is made up of investment grade issuers. The EM corporate bond market currently offers a yield of around 4.4%. Given the underlying credit quality of many of the issuers, we regard this as attractive, both in absolute terms and compared to other areas of the fixed income market.

In total, approximately 32% of the EM corporate bond market is excluded from the fund's investable universe once we have applied the three-stage filters (Figure 2). Around 4% is excluded due to non-compliance with the United Nations Global Compact principles, while sector screening accounts for a further 8% exclusion. An additional 20% of the market is then excluded due to poor ESG metrics, outlining the importance of a comprehensive ESG analysis to capture the industry laggards.

**Figure 3. Screening impact – country and sector weighting**

Top 5 changes in country weight - increase

| | CEMBI BD INDEX | Universe after screening | Difference |
|---|---|---|---|
| Saudi Arabia | 3.57% | 4.56% | 0.99% |
| Turkey | 3.67% | 4.61% | 0.94% |
| Mexico | 4.31% | 5.25% | 0.94% |
| Singapore | 3.85% | 4.74% | 0.89% |
| Colombia | 3.84% | 4.71% | 0.87% |

Top 5 changes in sector weight - increase

| | CEMBI BD INDEX | Universe after screening | Difference |
|---|---|---|---|
| Banking | 21.96% | 28.11% | 6.15% |
| Real Estate | 5.22% | 6.20% | 0.98% |
| Telecommunications | 6.79% | 7.76% | 0.98% |
| Financial Services* | 4.26% | 5.15% | 0.89% |
| Technology & Electronics | 2.68% | 3.41% | 0.73% |

Top 5 changes in country weight - decrease

| | CEMBI BD INDEX | Universe after screening | Difference |
|---|---|---|---|
| Israel | 3.38% | 0.88% | -2.50% |
| Macau | 2.12% | 0.00% | -2.12% |
| Brazil | 4.51% | 3.02% | -1.48% |
| India | 4.07% | 3.38% | -0.69% |
| Indonesia | 2.63% | 2.01% | -0.61% |

Top 5 changes in sector weight - decrease

| | CEMBI BD INDEX | Universe after screening | Difference |
|---|---|---|---|
| Leisure | 3.43% | 0.00% | -3.43% |
| Healthcare | 2.47% | 0.31% | -2.17% |
| Utility | 8.16% | 6.12% | -2.04% |
| Basic Industry | 11.90% | 11.32% | -0.58% |
| Transportation | 1.37% | 0.96% | -0.41% |

*Source: M&G, 31 July 2020. Based on model portfolio data, for illustrative purposes only. *Financial services excludes banking, which is a separate sector. ESG providers used in the screening process are MSCI, Sustainalytics and RepRisk*

The resulting emerging market corporate bond universe remains both large and well-diversified from a country and sector perspective, providing access to a broad range of investment opportunities.

In terms of sector breakdown, the most notable differences are a reduced exposure to utility, leisure and energy companies, and a higher exposure to banking, telecoms and financial services.

## A distinctive EM proposition

With emerging market corporate bonds remaining an underserved part of the ESG landscape, we believe the fund provides a distinctive investment opportunity, which combines M&G's long-running expertise in emerging market credit analysis with an in-depth assessment of ESG criteria.

With the right approach and sufficient expertise, we think it is possible to construct a well-diversified emerging market portfolio offering favourable ESG characteristics. Considerations around responsible investing are likely to play an increasingly important role in all forms of investing over the coming years, and we see significant potential in an ESG-focused global emerging market corporate bond strategy.

**M&G**
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The fund allows for the extensive use of derivatives.

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

do Mercado de Valores Mobiliários, the “CMVM”) has received a passporting notification under Directive 2009/65/EC of the European Parliament and of the Council and the Commission Regulation (EU) 584/2010 enabling the fund to be distributed to the public in Portugal.

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

M&G INVESTMENTS