M&G Global High Yield ESG Bond Fund

Applying ESG criteria

Fund managers – James Tomlins and Stefan Isaacs

FOR INVESTMENT PROFESSIONALS ONLY

September 2020

The M&G Global High Yield ESG Bond Fund combines M&G's long-running expertise in high yield 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 Global High Yield Bond Fund, complemented by an extensive ESG screening process. Combining M&G's internal credit analysis capabilities with leading ESG research from MSCI, the fund provides investors with a measurable assessment of its overall ESG impact and we believe represents a genuinely distinctive proposition in the high yield fund space.

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.

An ESG-focused high yield strategy

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 move their focus beyond traditional financial considerations towards an approach that also looks at an investment's wider impact on society.

Changing attitudes have helped to drive a steady increase in the number of responsible investment and ESG-related strategies over the past few years. Growth has been especially strong in the fixed income space, although these strategies have tended to focus on investment grade issuers, with high yield bond funds so far making up only a small part of the ESG universe.

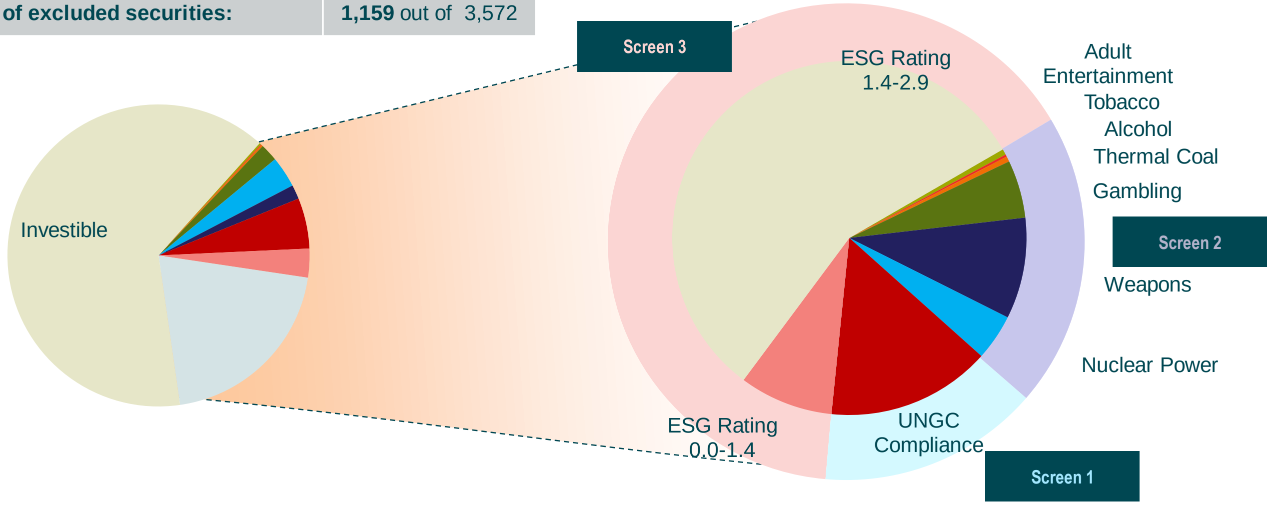
However, although the high yield bond market contains a relatively small number of companies that display the very strongest of ESG credentials (the so-called 'industry leaders'), we firmly believe that ESG considerations can play an important role in high yield investing.

A thorough consideration of ESG factors can, in our view, help ensure a more comprehensive credit analysis, which should ultimately lead to a more informed investment decision. With the right approach and sufficient expertise, we believe that constructing a well-diversified high yield portfolio, which displays positive ESG credentials, is eminently achievable.

Figure 1. The results of ESG screening

Exclusion of Merrill Lynch Global High Yield Index (by security weight):	**36.06%**
Number of excluded securities:	**1,159** out of 3,572

Reason for exclusion (by security weighting)



Source: M&G, Bloomberg, ICE Bank of America Merrill Lynch indices, MSCI ESG Research, 30 June 2020. For illustrative purposes only.

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.

Three-stage ESG screening

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 2). We believe the approach outlined below strikes the right balance between maintaining a large and diverse selection of high yield credits and achieving a favourable ESG outcome.

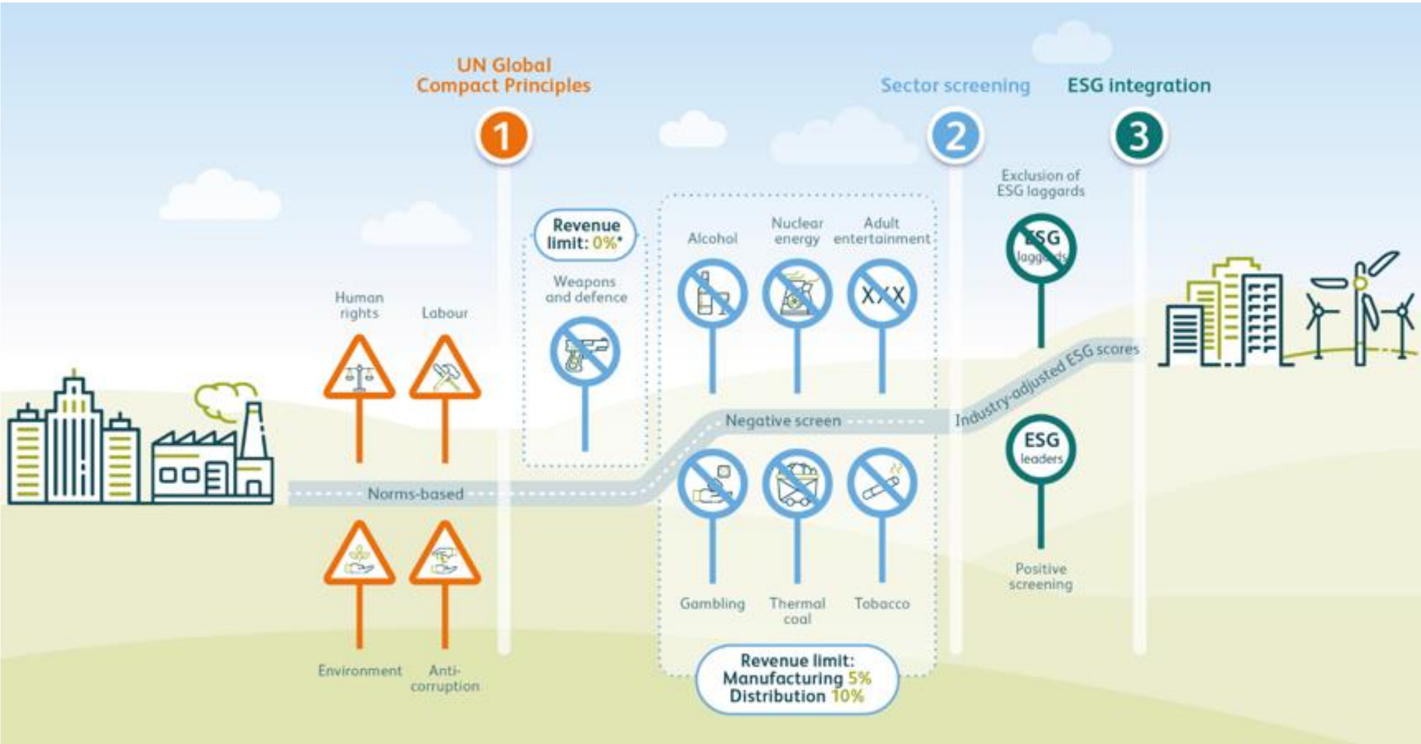
- **Sector screening**

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.

- **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 MSCI and our in-house ESG assessment. We typically exclude any company that is classified as an ESG laggard by MSCI (ESG rating 2.9 or lower).

Figure 2. Three-stage ESG screening

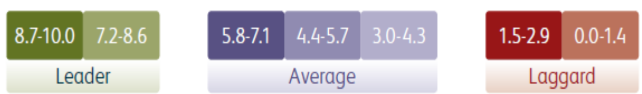


*Source: M&G. *On a best-efforts basis, subject to our source/s and MSCI data.*

- **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 protection and anti-corruption. Companies in breach are defined as institutions that have been involved in one or more controversial cases (both ongoing cases, as well as those concluded within the last three years) and have been judged to have inflicted serious large-scale harm.

MSCI ESG Rating Scale



Source: MSCI

However, since ESG assessment is a highly complex and subjective process, there may be occasions when our credit analysts disagree with the assessment of our external provider. In such instances, the fund managers may retain a limited exposure to a company with an ESG rating below 2.9. Any such decision is subject to a formal and documented approval and review process.

The fund may also hold up to 10% of its NAV in securities that do not have an MSCI ESG rating. 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 that are relevant for that sector and by comparison to the standards and performance of their industry peers.

A large and well-diversified universe

In total, around a third of the global high yield market is excluded from the fund's investable universe once we have applied the three-stage filters.

As can be seen from Figure 1, ESG integration has the greatest impact, with more than 20% of global high yield issuers excluded because of their poor ESG ratings (2.9 or below). In contrast, less than 10% of issuers are removed as a result of sector screening, outlining the importance of a more comprehensive ESG analysis to capture the industry laggards.

The resulting EGS high yield universe remains well-diversified from both a geographic and a sector perspective, and offers the fund managers access to a wide range of The fund allows for the extensive use of derivatives. investment opportunities, allowing them to express their core investment views through sector positioning and individual credit selection.

As well as investing in physical bonds, the fund can also use derivatives to gain exposure to individual credits. The fund is permitted to hold single-name credit default swaps (CDS), provided the underlying securities can be screened and meet the fund's ESG criteria as outlined above. However, the fund is not able to invest in CDS indices, due to the fact that some of the underlying securities may conflict with the fund's ESG criteria.

Investors should be aware that the hedging process seeks to minimise, but cannot eliminate, the effect of movements in exchange rates on the performance of the hedged share class. Hedging also limits the ability to gain from favourable movements in exchange rates.

A distinctive high yield proposition

With high yield bonds remaining an underserved part of the ESG landscape, the fund provides a distinctive opportunity for investors to gain access to M&G's long-running expertise in high yield credit analysis alongside leading ESG research from MSCI.

By providing investors with a measurable assessment of its overall ESG impact, we believe the fund represents a genuinely distinctive proposition in the high yield fund space.

With the right approach and sufficient expertise, we think it is possible to construct a well-diversified high yield portfolio, which offers favourable ESG characteristics. With considerations around responsible investing likely to play an increasingly important role in all forms of investing over the coming years, we see significant potential in an ESG-focused global high yield strategy.

M&G
September 2020

M&G INVESTMENTS