M&G Alternatives Investment Management

M&G Credit Income Investment Trust

1 April 2020

Investment Manager's Update

- The Company's portfolio is well-diversified with 122 individual holdings, mostly in assets with high credit-quality from across the fixed income universe.
- The Company has maintained a defensive strategy for some time given generally tight credit spreads so the portfolio was cautiously positioned entering into the Coronavirus (COVID-19) pandemic.
- Patience and flexibility has, to date, prevented the Company from becoming a forced buyer or seller of mispriced assets.
- Mark-to-market volatility is expected in public assets due to changes in market credit spreads, and such volatility should present opportunities for the Company to add assets at attractive yields. During periods of uncertainty private asset deal flow tends to dry up, and so our focus for the time being is on managing the credit risk of the existing private assets that we intend to hold to maturity.
- The Company remains well positioned to deliver on its primary objective which is income generation. We will continue deploying into higher yielding assets that we deem offer the best risk-adjusted return.

The reality of the COVID-19 pandemic is starting to hit home across the world as governments and policymakers alike implement their containment action plans and take measure of the problem at large. It may be too early to predict the shape of things to come and what it will ultimately mean for the global economy, but uncertainty in the short term remains high as newsflow drives volatility in markets and short-term travel restrictions and self-isolation policies cause economic disruption.

Whilst the situation is everchanging and fluid, we would like to take this opportunity to reassure you that M&G has taken all steps necessary to ensure the continuation of business during the coming weeks and months.

M&G has implemented contingency plans to ensure all business services can be maintained with all staff now working from home. We have the requisite operational connectivity and equipment to allow all critical services to be maintained.

Portfolio and market overview:

From a portfolio perspective, we are keeping a watchful eye on developments and our Investment Team continue to closely monitor underlying positions. The Company has a diversified portfolio which invests across a broad range of public and private assets across the liquidity spectrum. The portfolio benefits from a degree of protection through its diversified construction, with 122 individual holdings, mostly in assets of high credit quality from across the fixed income universe.

There has been significant price volatility in many of the assets that have a tradable market value in the portfolio, particularly in the high yield and ABS holdings. In the short to medium term this volatility will undoubtedly have an impact on the NAV, until such time as markets stabilise. In addition, our Valuations Committee is revisiting pricing policies for those assets that do not have observable market prices to ensure they are appropriately valued to reflect current conditions*. This process will take time but it is also likely to have a negative impact on the valuation of the private portion of the portfolio.

As long term value investors we have seen areas of value in recent weeks, and have selectively purchased small amounts of investment grade corporate issues at particularly attractive spreads. We will continue to reposition the portfolio over the coming weeks as market liquidity allows.

Assessing the impact of market dislocation to date:

- In terms of credit spread dynamics, all public credit markets have been extremely volatile and have widened significantly since the end of February. For example, spreads on the Sterling investment grade index have widened by 114 basis points[1]. The most remarkable thing about this was not the levels reached but the speed with which it happened which was faster even than during the Global Financial Crisis. It is important to stress that liquidity is generally poor, with bids difficult to find even in the flow credit market at present.
- The High Yield market index widened by as much as 350 bps at the height of its volatility on 23rd March[2]. At present we see better value in Investment Grade credit which has widened by a relatively wider margin and is much less likely to suffer defaults.
- High quality ABS has not been immune to the market volatility despite its secured nature and the downside protection that exists within these structures. Liquidity in the market remains thin and we are not seeing much volume traded at current levels.
- European leveraged loans are sitting at their post crisis wides with credit spreads sitting at around 700bps from recent averages of 300 – 400bps. The increased volatility has impacted the Company's holding in the M&G European Loan Fund which has decreased in value by c.13.8% over the last month.
- In terms of private debt assets, the pervading uncertainty has also impacted deal flow and broader activity. This is largely unsurprising, and is common in periods of market disruption, given the reduced appetite from borrowers who are reluctant to pay higher margins for financings in periods of uncertainty. When markets stabilise, then we anticipate that there will be a pent up supply of deals needing to be done, which should offer attractive opportunities.

What about credit risks?

The portfolio comprised high-quality assets entering this crisis, with many of the private holdings benefiting from robust balance sheets and/or strong security enhancements. If the disruption lasts for a relatively short period of time, we would not anticipate material credit issues for the majority of our assets. A more prolonged global downturn will start to have more varied effects which are much harder to predict at this stage.

When we directly invest in any company, we perform significant stress-testing, including scenarios of severe cashflow reduction. Financial covenants are typically a feature of our assets, which allow us to engage with the investee company and their owners should performance start to deteriorate. Embedded within the business we have a large restructuring team, comprising 17 legal, credit and accounting specialists. The team has undertaken more than 300 European restructurings to date, which enables us to work with companies and their owners in the event of covenant breaches to optimise the outcome for our clients.

If a global recession were to emerge, we would expect to see an increase in credit impairments and defaults. We have begun a rigorous process to re-assess every credit in light of the current circumstances (across all our portfolios). In this process each of the private assets is subjected to specific scenarios to determine its risk as high, medium or low. The purpose of this is to focus our resource to the assets that are more likely to require the use of our restructuring team and problem credit committees.

Looking further ahead – being prepared for all scenarios:

The COVID-19 pandemic has undoubtedly caused fear and panic in global financial markets and a consequence of this is volatility. A prolonged and protracted crisis could have a broader macro-economic impact that would have ramifications for all areas of investment, publicly listed giants and privately-owned companies. In every scenario, we remain alert to both the risks and opportunities that such a fast-moving situation can bring and continue to ensure a high level of diversification in our portfolios.

Source: M&G, [1]ICE BoA Sterling & Collateralised Index (UC00), as at 27 March 2020.
[2]ICE BoA European Currency Non-Financial High Yield 2% Constrained Index (HPIC), as at 23 March 2020.
*Pricing decisions will be made in conjunction with the third party administrator 'State Street' who is ultimately accountable to the Board for portfolio valuations

Glossary

This glossary provides an explanation of terms used in this manager review and in our literature

Asset
Anything having commercial or exchange value that is owned by a business, institution or individual.

Asset Backed Security (ABS)
A security whose income payments and value are derived from and collateralized by a specified pool of underlying assets.

Asset class
Category of assets, such as cash, company shares, fixed income securities and their sub-categories, as well as tangible assets such as real estate.

Association of Investment Companies (AIC):
The UK trade body that represents investment managers. It works with investment managers, liaising with government on matters of taxation and regulation, and also aims to help investors understand the industry and the investment options available to them.

Basis points (bps)
A common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%, or 0.0001, and is used to denote the percentage change in a financial instrument.

Bond
A loan in the form of a security, usually issued by a government or company, which normally pays a fixed rate of interest over a given time period, at the end of which the initial amount borrowed is repaid.

Callable Bond
A bond that can be redeemed (in other words, called) by the issuer before its maturity date. The price at which the issuer buys back the bond is normally higher than its issue price. A bond is usually called when interest rates fall, so that the issuer can refinance its debt at the new, lower interest rates.

Capital
Refers to the financial assets, or resources, that a company has to fund its business operations.

Capitalisation
The total market value of all of a company's outstanding shares.

CTA
Corporation Tax Act.

Closed-ended
A term used to describe an investment company whose capital is fixed and whose shares are not generally redeemable at the option of a holder.

Comparative sector
A group of funds with similar investment objectives and/or types of investment, as classified by bodies such as the Investment Association (IA) or Morningstar™. Sector definitions are mostly based on the main assets a fund should invest in, and may also have a geographic focus. Sectors can be the basis for comparing the different characteristics of similar funds, such as their performance or charging structure.

Consumer Prices Index (CPI)
An index used to measure inflation, which is the rate of change in prices for a basket of goods and services. The contents of the basket are meant to be representative of products and services we typically spend our money on.

Convertible bonds
Fixed income securities that can be exchanged for predetermined amounts of company shares at certain times during their life.

Corporate bonds
Fixed income securities issued by a company. They are also known as bonds and can offer higher interest payments than bonds issued by governments as they are often considered more risky.

Credit
The borrowing capacity of an individual, company or government. More narrowly, the term is often used as a synonym for fixed income securities issued by companies.

Credit Default Swaps (CDS)
Are a type of derivative, namely financial instruments whose value, and price, are dependent on one or more underlying assets. CDS are insurance-like contracts that allow investors to transfer the risk of a fixed income security defaulting to another investor.

Credit rating
An independent assessment of a borrower's ability to repay its debts. A high rating indicates that the credit rating agency considers the issuer to be at low risk of default; likewise, a low rating indicates high risk of default. Standard & Poor's, Fitch and Moody's are the three most prominent credit rating agencies. Default means that a company or government is unable to meet interest payments or repay the initial investment amount at the end of security's life.

Credit spread
The difference between the yield of a corporate bond, a fixed income security issued by a company, and a government bond of the same life span. Yield refers to the income received from an investment and is expressed as a percentage of the investment's current market value.

Debt instrument
A formal contract that a government, a business or an individual can use to borrow money. Debt instruments outline the detailed conditions of the loan, such as the amount and schedule of payment of interest, the length of time before the principal is paid back, or any guarantees (collateral) that the borrower offers. Any type of debt can be a debt instrument - from bonds and loans to credit cards.

Default
When a borrower does not maintain interest payments or repay the amount borrowed when due.

Derivatives
Financial instruments whose value, and price, are dependent on one or more underlying assets. Derivatives can be used to gain exposure to, or to help protect against, expected changes in the value of the underlying investments. Derivatives may be traded on a regulated exchange or traded over the counter.

Developed economy / market
Well-established economies with a high degree of industrialisation, standard of living and security.

Dividend
Dividends represent a share in the profits of the company and are paid out to a company's shareholders at set times of the year.

Emerging economy or market
Economies in the process of rapid growth and increasing industrialisation. Investments in emerging markets are generally considered to be riskier than those in developed markets.

Episode
A phase during which investors allow their emotions to affect their decision making, which can cause financial markets to move irrationally.

Equities
Shares of ownership in a company.

Ex-dividend, ex-distribution or XD date
The date on which declared distributions officially belong to underlying investors.

Exposure
The proportion of a fund invested in a particular share/fixed income security, sector/region, usually expressed as a percentage of the overall portfolio.

Fixed income security
A loan in the form of a security, usually issued by a government or company, which normally pays a fixed rate of interest over a given time period, at the end of which the initial amount borrowed is repaid.

Floating rate notes (FRNs)
Securities whose interest (income) payments are periodically adjusted depending on the change in a reference interest rate.

Gearing
Is a measure of financial leverage that demonstrates the degree to which the Investment Trust's operations are funded by equity capital versus creditor financing.

Gilts
Fixed income securities issued by the UK Government.

Government bonds
Fixed income securities issued by governments, that normally pay a fixed rate of interest over a given time period, at the end of which the initial investment is repaid.

Hard currency (bonds)
Refers to bonds denominated in a highly traded, relatively stable international currency, rather than in the bond issuer's local currency. Bonds issued in a more stable hard currency, such as the US dollar, can be more attractive to investors where there are concerns that the local currency could lose value over time, eroding the value of bonds and their income.

Hedging
A method of reducing unnecessary or unintended risk.

High yield bonds
Fixed income securities issued by companies with a low credit rating from a recognised credit rating agency. They are considered to be at higher risk of default than better quality, i.e. higher-rated fixed income securities but have the potential for higher rewards. Default means that a company or government is unable to meet interest payments or repay the initial investment amount at the end of security's life.

Index
An index represents a particular market or a portion of it, serving as a performance indicator for that market.

Index-linked bonds
Fixed income securities where both the value of the loan and the interest payments are adjusted in line with inflation over the life of the security. Also referred to as inflation-linked bonds.

Inflation
The rate of increase in the cost of living. Inflation is usually quoted as an annual percentage, comparing the average price this month with the same month a year earlier.

Investment grade bonds
Fixed income securities issued by a company with a medium or high credit rating from a recognised credit rating agency. They are considered to be at lower risk from default than those issued by companies with lower credit ratings. Default means that a company or government is unable to meet interest payments or repay the initial investment amount at the end of a security's life.

Investment trust
An investment trust is a form of collective investment found mostly in the United Kingdom. Investment trusts are closed-end funds and are constituted as public limited companies.

IRR
Internal Rate of Return

IPO
Initial Public Offering. The process of offering shares of a private corporation to the public.

Issuer
An entity that sells securities, such as fixed income securities and company shares.

Leverage
When referring to a company, leverage is the level of a company's debt in relation to its assets. A company with significantly more debt than capital is considered to be leveraged. It can also refer to an investment company that borrows money or uses derivatives to magnify an investment position.

LIBOR
The three-month GBP London Interbank Borrowing Rate is the rate at which banks borrow money from each other (in UK pounds) for a three-month period.

Liquidity
A company is considered highly liquid if it has plenty of cash at its disposal. A company's shares are considered highly liquid if they can be easily bought or sold since large amounts are regularly traded.

Local currency (bonds)
Refers to bonds denominated in the currency of the issuer's country, rather than in a highly traded international currency, such as the US dollar. The value of local currency bonds tends to fluctuate more than bonds issued in a hard currency, as these currencies tend to be less stable.

Long position
Refers to ownership of a security held in the expectation that the security will rise in value.

Macroeconomic
Refers to the performance and behaviour of an economy at the regional or national level. Macroeconomic factors such as economic output, unemployment, inflation and investment are key indicators of economic performance. Sometimes abbreviated to 'macro'.

Maturity
The length of time until the initial investment amount of a fixed income security is due to be repaid to the holder of the security.

Mezzanine tranche
A generally small layer of corporate debt positioned between the senior tranche (mostly AAA) and a junior tranche (unrated, typically called equity tranche).

Modified duration
A measure of the sensitivity of a fixed income security, also called a bond, or bond fund to changes in interest rates. The higher a bond or bond fund's modified duration, the more sensitive it is to interest rate movements.

Monetary policy
A central bank's regulation of money in circulation and interest rates.
Morningstar™
A provider of independent investment research, including performance statistics and independent fund ratings.
Near cash
Deposits or investments with similar characteristics to cash.
Net Asset Value (NAV)
A fund's net asset value is calculated by taking the current value of the fund's assets and subtracting its liabilities.
NAV total return
A measure showing how the net asset value (NAV) per share has performed over a period of time, taking into account both capital returns and dividends paid to shareholders.
The AIC shows NAV total return as a percentage change from the start of the period. It assumes that dividends paid to shareholders are reinvested at NAV at the time the shares are quoted ex-dividend.
NAV total return shows performance which isn't affected by movements in discounts and premiums. It also takes into account the fact that different investment companies pay out different levels of dividends.
Non-Executive Director (NED)
A non-executive director is a member of a company's board of directors who is not part of the executive team. A non-executive director typically does not engage in the day-to-day management of the organization, but is involved in policymaking and planning exercises.
Official List
The Official List (or UKLA Official List) is the list maintained by the Financial Conduct Authority (acting in its capacity as the UK Listing Authority) in accordance with Section 74(1) of the Financial Services and Markets Act 2000 (the Act) for the purposes of Part VI of the Act.
Ongoing charges figure
The ongoing charges figure includes charges for management of the fund; administration services; and services provided by external parties, which include depository, custody and audit, as well as incorporating the ongoing charge figure from funds held in the portfolio (taking into account any rebates). The ongoing charges figure (as a percentage of shareholders' funds) is an annualised rate calculated using average net assets over the period in accordance with the Association of Investment Companies' (AIC) recommended methodology.
Options
Financial contracts that offer the right, but not the obligation, to buy or sell an asset at a given price on or before a given date in the future.
Overweight
If a fund is 'overweight' in a stock, it holds a larger proportion of that stock than the comparable index or sector.
Payment date
The date on which dividends will be paid by the investment company to investors.
Private debt instruments
These instruments not traded on a stock exchange and typically issued to small groups of institutional investors.
Public debt instruments
These instruments refers to assets that are listed on a recognised exchange.
REIT (Real Estate Investment Trust)
A REIT is a company that owns, operates or finances income-producing real estate.
Retail Prices Index (RPI)
A UK inflation index that measures the rate of change of prices for a basket of goods and services in the UK, including mortgage payments and council tax.
Securitise/Securitisation
The creation and issuance of tradable securities, such as bonds, that are backed by the income generated by an illiquid asset or group of assets. By pooling a collection of illiquid assets, such as mortgages, securities backed by the mortgages' income payments can be packaged and sold to a wider range of investors.
Senior tranche
The highest tranche of a debt security, i.e. the one deemed least risky. Any losses on the value of the security are only experienced in the senior tranche once all other tranches have lost all their value. For this relative safety, the senior tranche pays the lowest rate of interest.
Short position
A way for a fund manager to express his or her view that the market might fall in value.
Short-dated corporate bonds
Fixed income securities issued by companies and repaid over relatively short periods.
Short-dated government bonds
Fixed income securities issued by governments and repaid over relatively short periods.
Spread duration
A measure of the portfolio's sensitivity to changes in credit spreads.
Sub-investment grade bonds
Fixed income securities issued by a company with a low rating from a recognised credit rating agency. They are considered to be at higher risk from default than those issued by companies with higher credit ratings. Default means that a company or government is unable to meet interest payments or repay the initial investment amount at the end of a security's life.
Swap
A swap is a derivative contract where two parties agree to exchange separate streams of cashflows. A common type of swap is an interest rate swap to hedge against interest rate risk.
Synthetic inflation-linked bonds
Refers to securities created using a combination of assets to simulate the characteristics of inflation-linked bonds. By buying inflation-linked government bonds and selling protection against companies defaulting on their debts, using credit default swaps, the combined synthetic investment will behave similarly to a physical inflation-linked bond, had one had been issued. Synthetic inflation-linked bonds are usually created where a company does not have any inflation-linked bonds in issue.
Tap issuance programme
A method of share issuance whereby the Company issues shares over a period of time, rather than in one sale. A tap issue allows the Company to make its shares available to investors when market conditions are most favourable.
Total return
The term for the gain or loss derived from an investment over a particular period. Total return includes income (in the form of interest or dividend payments) and capital gains.

Valuation

The worth of an asset or company based on its current price.

Volatility

The degree to which a given security, investment company, fund, or index rapidly changes. It is calculated as the degree of deviation from the norm for that type of investment over a given time period. The higher the volatility, the riskier the security tends to be.

Weighted Average Life (WAL)

The asset-weighted average number of years to final maturity of the portfolio, based on the final maturity for all assets/exposures.

Yield

This refers to either the interest received from a fixed income security or to the dividends received from a share. It is usually expressed as a percentage based on the investment's costs, its current market value or its face value. Dividends represent a share in the profits of a company and are paid out to the company’s shareholders at set times of the year.

Yield to maturity

The total return anticipated on the portfolio if the underlying bonds are held until maturity

Important information

M&G INVESTMENTS