

Insights

High yield investing

We are often asked why our portfolio contains a high concentration of relatively small bond issues (which tend to be issued by commensurately smaller companies – firms having enterprise values between \$1 billion and \$5 billion). We believe that 1) such issues tend, for a variety of reasons, to offer more yield per unit of default risk, 2) such excess return is of greater value to almost all investors than the foregone value of the allegedly higher liquidity of very large issues, and 3) the information dynamics of small issues provide an opportunity for an active manager to add security-specific alpha above the simple “liquidity premium” observed in the high yield market.

Dispersion – the active manager’s friend

Large issues attract attention and coverage by both the underwriters and such private research firms as Gimme Credit and CreditSights. Issuers of large bonds also tend to have publicly traded equity, which is a “free” resource to allow a bondholder to quickly read the latest Street thinking on a company. Large issues tend to be widely owned and, thus, followed by enough smart investors to be efficiently priced.

What this creates is a relative information vacuum in less widely owned names, where investors must utilize their own information and judgments. In truth, some do not try, particularly if they are simply attempting to capture liquidity premia indiscriminately or managing their portfolios strictly from their desks without visiting their issuers. The presence of so many uninformed holders allows individual bonds to diverge from their true value, creating opportunities for investors who work hard to acquire proprietary information and judgments. The high cost of proprietary information causes more dispersion – more bonds that are undervalued, and more that are overvalued too. This dispersion is observable in simple credit metrics, too – for example, leverage statistics, and especially yield per unit of leverage, are more heterogeneous in this cohort than in larger cap bonds.

We believe the dispersion to be found in our preferred niche allows us to gain value both on offense (higher yield) and on defense (lower default losses.) Counterintuitively, these allegedly illiquid bonds actually trade with lower volatility too.

It’s not size that matters – it’s stability

We soundly disagree with the thinking that the resilience of a credit is related to its absolute size. (Caveat: we do believe that of the very small bond issues of under \$100 million, which are a different class of company entirely). Logically, what really matters to a business’ survivability is its skill and cost position relative to its competitors, the stability of the economics of the industry, and the stability of the supply-demand balance within the industry. None of those are related to company size. Rating agencies, on the other hand, do have a bias in favor of absolute size (despite the painful lessons of WorldCom, GM, Fannie Mae, Enron, etc.) and to the extent those biases affect ratings and thus bond prices, they create opportunities to invest in solid but undiscovered companies at high yields.

What we seek are the structural indicia of stability: the classic “barriers to entry,” an indispensable product or service with few substitutes, a product with little obsolescence risk, a product with low exposure to volatile exchange rates, and a product with high switching costs so that its customers will be “sticky.”

In fact, absolute size can be a disadvantage in a rapidly growing industry precisely because of the easy access to capital it provides. An industry with many competitors and large scale, well followed by the research community and having a clientele of investors comfortable with the sector, can more easily develop overcapacity courtesy of the capital raising option provided by the high yield market.

The advantage of simple capital structure

Another feature of smaller issuers is that they tend to have simple capital structures. Smaller companies tend to have just two layers of debt – a secured bank facility (probably including a revolving line of credit for seasonal needs) and a single unsecured high yield bond issue. In the event of a distressed reorganization, either in or out of bankruptcy, the critical inter-creditor negotiation process necessary to preserve the company’s value is made much easier than in the case of a larger company, where multiple layers of holding companies, multiple collateral pools, and multiple creditor groups are all immobilized by the scourge of multiple law firms that are paid by the hour. Complex capital structures are almost always created by financial engineers to benefit the equity holders or the secured creditors, not the unsecured bondholders.

The mirage of liquidity - and why it is overvalued

The most frequent objection to our thesis is that our approach entails liquidity costs that are not captured adequately, in either the statistics cited thus far in this report or in our results. In “normal times” when security prices are exhibiting a normal level of volatility, we believe our trading costs are no higher per trade than a large cap high yield bond manager and, given our low turnover, we are actually able to capture the excess yield offered by small issues with lower total trading costs than most competitors. In times of higher market-wide volatility, large cap names frequently trade down more because holders seeking cash want to liquidate their big positions, not their small ones, and they all become sellers of the same bonds at the same time. In the special case of issuer-specific bad news which affects one bond, we find that the hoped-for ability to shift losses to others vanishes. It turns out that secondary market buyers of large issues are just as risk-averse as anyone else. This is why we refer to liquidity as a mirage. Just when it is most needed, it is most absent.

We would argue that the extreme scarcity of liquidity in the wake of company-specific bad news offers a major opportunity for superior credit analysts. In the aftermath of the bad news, as investors arrive at their new estimates of fair value, the presence of non-analytical sellers or even merely mistaken sellers is good news for those who follow a small issue well and can more rapidly and confidently decide whether the bad news is terminal or survivable for the issuer. It is at times like this that providers of liquidity to “stressed” issues can make extraordinary profits. Those profits are available to players who have already developed a niche of knowing small companies well, so that they can assess the new data without having to re-underwrite the entire credit file. It is at that moment that superior judgment, information and nerve matter. Recall that in the realm of small issues, there are few truly knowledgeable holders – such issues tend to be held in small lots within very large portfolios, and are essentially placeholders in a closet indexation strategy. So, the conditions for smart provision of liquidity are at hand: scarce and costly information, a relatively large number of holders whose positions are considered minor and not really

worth knowing well, a significant difference in the information sets of the holders and, above all, fear. In fact, our strategy when buying new issues is never to own a “full” position at the outset. During the life of each credit, it is likely that there will at some time(s) be negative news that moves the bond price down by several points and, at those times, we want to be able to provide the liquidity the market demands (and pays for) in those situations where we believe the news is temporary and survivable.

All else being equal, the more liquidity the better – it is why exchanges and market makers exist. But it is important to recognize that liquidity is not free, and carries with it opportunity costs. To confine oneself only to securities whose liquidity is high in “normal” times would mean to forego the value-additive features of less liquid securities.

Why aren’t the advantages of small issues arbitrated away?

The extra value in small issues persists in a highly researched, trillion-plus dollar market. Why?

Some mutual funds, by charter, will not look at small issues. They have adopted what we believe is an extreme position on the liquidity continuum, believing that more is always better. The most extreme of all are exchange traded funds, which hold only large issues...and have historically underperformed the high yield market by over 150 bps despite having very low trading costs.

Some managers seem to operate on a consensus model: they derive comfort from the presence of other large players in a large issue that has seemingly earned the imprimatur of the market, and they pay attention to Wall Street’s “buy” recommendations and the size-biased pronouncements of the ratings agencies.

There persists the myth of the “core” holding. The idea that a bond is so large that some of it “must” be held is really a manifestation of closet indexation (or even overt indexation). This is the antithesis of what an active manager is paid to do. But enough managers invest this way to have kept exploitable liquidity premia in existence for the entire history of the high yield market.

Summary

We believe our strategy that includes investing in small issues is the most direct way to capitalize on local informational advantages in the very lucrative realm of credit (where a disciplined approach can systematically add value) while simultaneously “selling” liquidity to parties who systematically overvalue it.

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* Data is as of 12/31/17. Currency also advises internally on another \$1.15 billion of client funds.

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