

Insights

Thoughts about the liquidity of small issue high yield bonds

The true liquidity costs of small cap high yield bonds are often exaggerated. In fact, small cap bonds are just slightly less liquid over all but the shortest run, and a small cap portfolio can be run with lower total liquidity costs than a large cap portfolio.

Summary

1. Over time and especially today, small cap bonds pay higher than average yields, with the so-called but mis-named “liquidity premium” being in excess of their historical incremental default risk. They also exhibit greater dispersion in realized returns, and are thus attractive to active managers with the requisite skill seeking to exploit these sources of value. Such a strategy must trade off these benefits against the possible cost of illiquidity.
2. Under real world conditions captured in the TRACE database of trades, portfolios of small cap bonds (under \$500 million outstanding) are only slightly less liquid than portfolios of large bonds (over \$1 billion outstanding.) The true incremental cost of the excess illiquidity is far smaller than the higher incremental yield available in the small cap segment of the market.
3. Measured correctly by comparing the daily trading volume relative to the total issue size outstanding, small cap bonds trade only 14% less often than large bonds.
4. Large managers tend to hold very large issues, and a large manager liquidating a large (e.g., \$100 million) position in a large cap bond generates a higher percentage liquidity cost than a small manager liquidating a \$10 million position in a small bond.
5. Some volatile periods often described as “illiquid” are in truth experiencing a conceptually different phenomenon – price discovery.
6. At times of marketwide panic selling, as in 2020, illiquidity is inevitable and is one of the unhedgeable risks that investors must accept in exchange for the historically high promised (and delivered) returns in the high yield market. But those who stay the course have historically recovered losses from market selloffs at an astoundingly fast rate.

Thoughts about the liquidity of small issue high yield bonds

The true liquidity costs of small cap high yield bonds are often exaggerated. In fact, small cap bonds are just slightly less liquid than A-1 but the short run, and a small cap portfolio can be run with lower total liquidity costs than a larger cap portfolio.



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Summary

1. Over time and especially today, small cap bonds are higher than average yields, with the 10-year bid-ask spread liquidity premium being a source of their historical excessive default risk. They also exhibit greater dispersion in realized returns, and are thus attractive to active managers with the requisite skill set and strategy that seek to exploit their source of value. Such a strategy must trade off these benefits against the liquidity cost of illiquidity.
2. Under real world conditions captured in the TRACE database of trades, conditions of small cap bonds (under \$100 million outstanding) are only slightly less liquid than conditions of large bonds (over \$1 billion outstanding). The true incremental cost of the excess illiquidity is far smaller than the higher liquidity cost available in the small cap segment of the market.
3. Historical records for comparing the early trading volume relative to the total issue size outstanding, small cap bonds trade only 3.4% less than large bonds.
4. Large managers tend to hold very large issues, and a large manager holding a large (e.g., \$100 million) position in a large cap bond generates a higher percentage liquidity cost than a small manager holding a \$100 million position in a small bond.
5. Some specific periods often discussed as "illiquid" are in fact experiencing a counterparty efficient phenomenon – price discounts.
6. As a result of marketplace participants, as in 2010, liquidity is available and is one of the uncorrelated risks that investors must account in exchange for the historically high (and not just abnormal) returns in the high yield market. But those who shy the search for historically abnormal yields from market activity at an extraordinary bid rate.

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