

Insights

Hidden gems: The compelling case for small cap high yield

The small cap high yield market is not as well known or closely followed as the “traditional” market of bigger high yield issues — that’s exactly why small issues may offer high yield investors much more of what they are looking for: overcompensated credit risk, diversification and lower default rates.

Below, we make the case as to why every high yield investor should focus on small cap over traditional or large cap high yield. We will also share our research findings, some of which surprised us.¹

What does small cap high yield offer investors? Quite a lot.

- **More income** | Small cap bonds trade on average 128bp wide vs large cap bonds²
- **Lower default rate** | Small cap bonds have experienced a 16% lower average annual default rate than large bonds over the last two decades (3.8% vs 4.5%)³
- **Lower volatility** | Large cap bonds are much more volatile on a week-to-week basis vs small cap bonds (the respective standard deviations of returns are 1.17% and 0.70%)⁴
- **Lower correlations** | Lower correlation to the S&P 500 and Bloomberg Aggregate⁵

Small cap high yield investors have benefitted from all these factors for many years. So why is no one paying attention? We have our theories. But first, let’s see if the data backs up our assertions.

More income

As shown in Chart 1 below, small cap bonds trade on average 128bp wide vs large cap bonds (Credit Suisse, HY Index Weekly Data 2011-2022), which is not all that surprising.

Large vs Small Spread



Source: Credit Suisse, HY Index Weekly Data 2011-2022. Past performance is not necessarily indicative of future results.

Large household names are generally associated with more data transparency via equity research, news coverage and research from industry consultants. Such transparency applies to large issuers’ high yield bonds, too — analysts have access to a wealth of standardized data that makes pricing them much easier.

Conversely, a small issuer from a small industry will be much less known, and reliable data will be harder to come by. An analyst

must do a lot more work to form an estimate of value and may lack confidence in that estimate once it has been made. When investors are not confident of their valuations, they rationally build in an extra margin of safety or an extra margin of yield.

Hidden gems: The compelling case for small cap high yield

The small cap high yield market is not as well known or closely followed as the "traditional" market of bigger high yield bonds – that's exactly why small cap bonds may offer higher yields. However, much more of what they are looking for as compensation comes from risk diversification and lower default rates.

Below, we make the case as to why many high yield investors should focus on small cap high yield or large cap high yield, the all star bond or research findings, some of which support it.

What does small cap high yield offer investors? Quite a lot.

- **More income:** Small cap bonds look on average 150bps wider in high cap bonds.
- **Lower default rate:** Small cap bonds have experienced a 10% default average, about half that of large cap bonds, and the low default rate is a 10%.
- **Lower volatility:** Large cap bonds are more volatile and in 2015, the average return on small cap bonds was 10.5% and 10.5%.
- **Lower correlation:** Lower correlation to the S&P 500 and Bloomberg Aggregate.

Small cap high yield investors have benefited from all these factors for many years. So, it's no surprise that the high yield market is a hot topic. But it's not just the high yield market that's hot.

More income

As shown in Chart 1 below, small cap bonds have an average 150bps wider in high cap bonds. Credit Suisse HY Index Weekly Data 2011-2022, which is a small cap bond.

Large financial firms are generally associated with more risk. Companies in which investors invest, such as research, have coverage and research that investors consider. Some companies apply to large cap high yield bonds, but a small cap bond is a small cap bond, and that makes pricing more difficult.

Chart 1: LARGE VS SMALL SPREAD

Chart 2: LARGE VS SMALL DEFAULT

Chart 3: LARGE VS SMALL VOLATILITY

Chart 4: LARGE VS SMALL CORRELATION

Chart 5: LARGE VS SMALL RETURN

Chart 6: LARGE VS SMALL CREDIT RISK

Chart 7: LARGE VS SMALL LIQUIDITY

Chart 8: LARGE VS SMALL CREDIT RISK

Chart 9: LARGE VS SMALL LIQUIDITY

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