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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

For High Yield Investors, Free Cash Flow Is Key to Weathering Recession

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SECTOR — GENERAL INVESTING

TWST: Please introduce Mesirow, its history, and your role there.

Mr. Sydow: Mesirow is a financial services company that has been in business for 85 years. We are headquartered in Chicago, with 17 offices around the world. We have a number of major businesses with about 500 employees, and we're entirely employee owned. Some of Mesirow's main businesses are investment banking, capital markets, structured finance, sale/leaseback capital, public finance, and asset management — both alternative and traditional. And we have a big advisory business as well. I am the CIO of the High Yield and Bank Loan group at Mesirow. We are headquartered in Manhattan Beach, California.

TWST: What type of client is best served at a boutique firm? And why is Mesirow considered a boutique firm?

Mr. Sydow: From the point of view of a client, and specifically a client of our group, we see the boutique as favorable in the sense that we are not encumbered by managing an overly large portfolio. We own only about 100 bonds in our portfolio out of 2,000 in the index — so we own 5% of the bonds in the high yield index, while some of our very large competitors own hundreds of bonds, 400, 500 bonds. We've seen a couple that own 800 bonds. So for a firm like us that is fairly aggressively trying to beat the market, the ability to do that on a relatively small scale is a big advantage. And that kind of shows up in our returns.

We can also be a lot quicker to respond to situations because if we need to move in or out of a position, we may be trading 10 million or 20 million bonds instead of 200 million or 300 million bonds. So we're nimble.

From the point of view of an employee, a boutique firm is the right fit for us because we were lifted into Mesirow about five years ago and we are left alone to run our business pretty much as we see fit. We do not have to worry about the views of a corporate chief economist because there isn't one. So it's a very appealing structure for us because the mode of investing that we have developed over 28 years has been left completely intact.

TWST: Give us a closer look at your funds under management, and clients served. Is that portfolio of 100 names in every fund?

Mr. Sydow: We have some institutional clients for whom we manage large separate accounts. We have a retail mutual fund, and we also have another commingled fund called a collective investment trust. Those are all managed in exactly the same way. From time to time, a separate account owner may want to customize that a little bit, may want us to avoid certain industries, or to hold only 60 or 80 names, and other variations like that. But all the portfolios are managed in the same manner with a substantially complete overlap in the names.

We do not try to be a manager for everybody. We tend to attract clients who are aggressive investors. So, for example, we serve a couple of sovereign wealth funds and they are intensely focused on high risk adjusted returns. And we've demonstrated that a boutique strategy like ours that only has about 100 names in it has the capacity to produce that type of return.

TWST: What's your current view of the market now? How are headwinds like inflation and rising interest rates impacting your strategy?

Mr. Sydow: Well, the dominant force on the high-yield market is the same as in all other fixed-income markets right now,

which is the new presence of significant inflation. And that's actually something that we had forecast when the money supply was increased by 42% in response to COVID. For many years, actually for about 30 years now, when Treasury rates have moved up, and by that I mean intermediate- and long-term Treasuries, it's been because we've been in a strong economy. And so even rising rates for the last 30 years have not really hurt the high-yield market. In fact, the last 13 times that the 10-year Treasury went up 100 basis points, all 13 of those rises resulted in positive returns in the high-yield market. But that has all changed dramatically now.

The reason Treasury rates have gone up, and they've gone up a lot — the most in 40 years — has nothing to do with a strong economy now, but rather the presence of inflation and the fear that it's going to be long-lived and that the Fed is going to have to respond very, very vigorously to knock it down. People do not want to earn negative real rates of return, so rates have risen and will continue to do so.

And so high yield does respond to Treasuries, and high yield is down almost 14% year to date. About 10 points of that 14 point decline is strictly due to the increase in Treasury rates. And that means that only 4% of the decline is due to fears of a recession or of stagflation.

Historically that is actually a very, very mild response. Typically, if the market is really concerned about a recession, you will see it go down 10, 20 or 30 points. And now the fear of recession has only knocked it down four points. The average spread on the index right now is 515 basis points. That's actually less than the historical average. So what I'm seeing right now is the high-yield market is way, way down, but it is not in fear of a recession — or at least not acting that way yet.

TWST: So you saw this downturn coming. What were the signs you saw then, and what are you seeing now as you look ahead?

Mr. Sydow: Yes, you're right about that. I published a paper a couple of years ago in which I said that inflation is coming and we're going to see a relinking of high yield to other debt. And sure enough, the investment-grade Bloomberg Aggregate is down just a couple of points more than us, down by 16%. And long-term Treasuries year to date are down by 33%. So we did call that a couple of years ago, because of the massive increase in the money supply that happened with all of the COVID spending.

We responded to that in part by buying more loans in our portfolios. And by that, I mean floating rate, senior secured leveraged corporate loans. We have the latitude to do that in most of our accounts. Loan prices are far less responsive to changes in interest rates. And in fact, it's a floating rate instrument. The coupon will rise as the Fed brings up short-term rates.

So the presence of those loans in our portfolios has made our portfolio a full year shorter in duration than its index. That means we are less sensitive to changes in intermediate-term rates. And for that reason, among others, we are substantially ahead of the index year to date. And in 2021, we beat the index by about 700 basis points. So adapting to that big change in the markets has been very, very important.

TWST: How have any other of the headwinds that we're seeing impacted your portfolio — possibly the stronger dollar, COVID concerns now receding, or the war in Ukraine?

Mr. Sydow: Yes. Well, those are all big macro themes. But the strong dollar doesn't terribly affect our portfolio. We tend to be involved in industries that produce goods or sell services in the comparatively strong U.S. economy. We always have a strong bias in favor of that exposure. We never want exposure to emerging markets.

And just as an anecdote, for example, there is a single, large property developer in China called **Evergrande** (OTCMKTS:EGRNF) which has $300 billion of dollar-denominated bonds. And that is 20% of the entire size of the U.S. high-yield market. We want no exposure to anything like that. We think there will be much, much slower growth in China. We think there will be a very severe European recession, because Europe has made policy choices that leave it short of reliable energy. So we've always favored U.S. exposure and we continue to do that.

The big headwinds that are going to hit our portfolio are: first of all, continued high inflation. We think we're in just the third or fourth inning of inflation. We think it's going to take years, not months, to knock it down to 2% again. And we think that there may or may not be a recession. There is certainly stagflation at the moment, which is the call we made at the end of 2021.

If recession comes, we see that the U.S. market — high-yield market — is actually fairly well positioned, with companies' finances in comparatively good shape. Average leverage is lower than its historical average. Average interest coverage is at a record high level right now. Free cash flow is strong. And there are not a lot of early maturities. So we think that if there is a recession, the high-yield market won't go down another ten points, rather maybe another five. We think that our portfolio is pretty well positioned for that. We tend to invest in fairly old economy companies that generate a lot of free

Highlights

Robert Sydow discusses investing in the high-yield market for Mesirow. He says that inflation is the dominant force on the high-yield market right now. He believes that in the event of a recession, the U.S. high-yield market is fairly well positioned, with companies' finances in comparatively good shape, with strong free cash flow and average leverage below its historical average. Mr. Sydow says Mesirow tends to invest in fairly old-economy U.S. companies that generate a lot of free cash flow and that they currently favor companies that process, refine, and market natural gas and oil and produce related equipment. They also like some manufacturing and services companies, but they are avoiding many consumer-sensitive and interest-sensitive sectors. Mr. Sydow recommends that investors who fear recession look to leveraged loans rather than high yield, saying they are paying a higher spread right now for less risk, and their coupons readjust in real time.
Companies discussed: China Evergrande Group (OTCMKTS:EGRNF) and Tesla (NASDAQ:TSLA).

cash flow. And in a recession, having free cash flow becomes even more important than in normal times.

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TWST: Can you share some specific names that are best cushioned against market decline? And anything that you're monitoring now for a better buying opportunity?

Mr. Sydow: Well, we don't really like to talk about individual names for a couple of reasons. But more to the point, we invest mostly in relatively small companies that don't have publicly traded equities. So most of your readers are probably not going to be familiar with these names. We do feel comfortable talking about industry weightings though. And for the last two years, our biggest holding has been the midstream part of the energy complex, and the oil services part — not the ownership of the hydrocarbons themselves. The exploration and production companies are very volatile and tend to have pretty high default rates, whereas midstream companies are exposed to much steadier volumes, not prices.

What you're seeing now, in both the U.S. and in Europe, and really everywhere, is the critical importance of energy infrastructure, which means the capacity to process, store, and transport oil and gas. That's really come to the fore nowadays. And you'll see that in the fact that Europe has been paying about 10 times the historical price for its delivered natural gas. So we've always liked that industry. There was an unusual opportunity to buy those bonds at very low prices back in 2020, and we did that quite heavily. And that's been a major tailwind within our portfolio for the last couple of years.

We think that non-energy infrastructure spending is also going to be quite strong. We see that companies that process and, in some cases, produce commodities are going to have a strong tailwind in the coming years. So we're pretty heavily involved in that.

We think that consumer spending, which has held up actually very well with all that printed money that was mailed out to people's mailboxes — as the recession gets closer, if that's indeed where we're headed, that is going to subside. Right now people are drawing down their credit cards again, but that can't be sustained. And so that's a long-winded way of saying that we are avoiding a lot of consumer-sensitive businesses. We are avoiding consumer durables. We are avoiding the auto sector. And we are avoiding interest-sensitive sectors like housing.

TWST: How important is ESG to your evaluation of a holding? Do you consider clean energy and climate warming concerns in evaluation of your investment choices?

Mr. Sydow: We do that if the client requests it. Different clients have different views about, for example, whether natural gas is a good or bad thing. In particular, we're hearing that a lot of Europeans who've had a very negative view on hydrocarbons in recent years have a newfound appreciation for them. So the short answer is that we do invest in the processing, movement, and marketing of oil and gas. We avoid ownership of the hydrocarbons, not because we think they're a bad thing, but rather because we think the prices are too volatile to sustain a capital structure through a recession in those industries.

We really ask our clients what their view is on industries and companies. If there's an industry or a company that they just don't want us to own, we ask them to tell us what that is. We put that on a no-buy list and we respect their wishes. Other than that, what we look at is whether the ESG factor in question — whether it's a carbon footprint, or a social policy, or the composition of the board — we ask whether that is sufficiently important to the company's customers, to the legislature, to the courts, and to regulators that some action on their part would threaten the ability of that company to ultimately pay us back.

So there are industries that we have not invested in for that essentially fiduciary, economic reason. And there are about five or six of them, but I would say that energy broadly is not one of them. We haven't owned a thermal coal producing company in 23 years. And that's because we foresaw that natural gas was going to get much, much cheaper because of the fracking revolution, and steam coal would be driven out of the U.S. electrical generating sector. And that has been an ongoing process. There have been a lot of coal company bankruptcies that we've missed for that reason.

TWST: It sounds like your strategy and approach is very risk averse. That said, what are your top worries as you look into 2023? Any other advice on how investors can mitigate against risk?

Mr. Sydow: Well, yes. Every high-yield investor should be risk averse. Unlike equities, the best thing that can happen to us is that we get our coupons and then we get our principal back at the end. And the worst thing that could happen is we experience a default and we lose 60% of our money, maybe even all of our money. So that's what we call an asymmetric payoff. And when you face that, you need to be risk averse. It's all about figuring out who can't pay you back and avoiding those companies. The key to that is to have a very single-minded focus on what is the resiliency of an industry and a company within that industry. And we rely particularly on the generation of a lot of free cash flow.

Over the years, the high-yield market has become more open to companies that don't have free cash flow today, so that company would need to do what they call "grow into the capital structure." In other words, they've got to greatly increase, not maintain, their cash flow over the next five years in order to meet the maturity. A very good example of that would be **Tesla** (NASDAQ:TSLA), which faced existential risk just a couple of years ago and now seems to be doing well. But we would not invest in a company that is a new venture, and that starts out with substantially negative free cash flow because, as I said, the best that can happen to us is that we just get back our interest and our coupon. And if you're facing that type of risk in a risky growth story, you really should own the equity of the company.

TWST: Anything else you can share about the most resilient industries that you see as you look into 2023?

Mr. Sydow: The most resilient are so safe that they have very low yields, and we're not interested in owning those. What we're really looking for is a combination of high yield and high resiliency, and we find those in the small- and mid-cap sectors. And we think that the best opportunities we saw in 2020 still remain today. These are a lot of the companies that process, refine, market natural gas and oil and produce the equipment that's necessary to develop that. We also like a lot of manufacturing and services companies.

TWST: For an investor who is negative on investing in fuel oil— any other choice more related to clean energy that you like?

Mr. Sydow: There really are not a lot of high-yield issuers that are in, for example, the wind turbine business, or that produce biodiesel or things like that. Those just tend not to be a big presence in the high-yield market. So the short answer is no, we don't have any investment in those. And we don't think that there's a lot of opportunity there either.

TWST: Do you like Tesla? Especially as related to the upcoming mandate for all electric cars by 2035?

Mr. Sydow: No. We think electric cars are going to face a very difficult future. There are a lot of mandates and a lot of plans announced by the manufacturers. But there is a significant problem with the batteries. If you look at the amount of raw materials that is needed to electrify the car fleet — and by that I mean the lithium, the copper, the rare earths, the nickel, the magnesium, all the things that you need to electrify the car fleet — it would require the world mining industry to increase by a factor of 10. We just think that people vastly underestimate how difficult and how costly that's going to be.

So we think that the transition to electric cars, which is actually quite slow, about 1% of the cars in the United States are currently electric, is going to be extremely slow. And in our portfolio, we're basically concerned about the next five years, not like the stock market. We are concerned with whether our companies will be able to pay us back by refinancing our debt five years from now. So it's a much shorter investment horizon than people think about when they talk about the energy transition.

TWST: What are your concluding thoughts as you look into 2023?

Mr. Sydow: We're a bit agnostic on whether we will have continued stagflation or an actual recession in 2023. We recommend that for investors who really think there's going to be a recession and fear it, now is not a good time to go into high yield. But we do think it's probably a good time to go into leveraged loans. They are paying a higher spread right now for less risk than we see in the high-yield market, and their coupons readjust in real time. And that's why we participate in that market as well.

TWST: Thank you. (VSB)

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