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THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Investing in the Lesser Known Leads to Advantages in High Yield

ROBERT SYDOW runs the Mesirow High Yield and Leveraged Loan group at Mesirow Financial. In his 32 years in the business, he has been also been a senior high yield portfolio manager at First Interstate Bancorp, SunAmerica, and his own firm, Grandview Capital. He has managed high-yield debt for the largest foundation in the world and presently manages for one of the three largest sovereign wealth funds. Before his investment career, Mr. Sydow held several positions at Atlantic Richfield Company, now part of BP, and was the Treasurer of First Interstate Bancorp. Mr. Sydow holds dual degrees in economics and history from UCLA, a Juris Doctor from UCLA Law School, and an MBA from UCLA Graduate School of Management.

SECTOR — GENERAL INVESTING

TWST: Could you tell me about the firm?

Mr. Sydow: Mesirow is an independent financial services firm that has been in business for 83 years. We're based in Chicago, with 19 offices located around the world. We are an entrepreneurial firm — and with 100% of voting shares held by employees, our interests are aligned with those of our clients. We would like to think we do a pretty darn good job of sustainable investing, and we have a strong commitment to corporate responsibility, with particular focus on sustainability and community engagement. I joined the firm three years ago, and those are the reasons I joined.

TWST: And is there an overarching investment philosophy at the firm?

Mr. Sydow: Well, each of the different asset groups is given a lot of latitude. I would say the most overarching thing about all of our strategies is that we do attempt to be very distinguishable from the very, very large managers. We kind of have to be, and that's how we choose to be.

Most of the strategies, I would say, have a preference for small- and mid-cap issuers. I know we certainly do within the high-yield and leveraged loan department, where I am the chief investment officer.

TWST: Do you target mostly institutional investors?

Mr. Sydow: As for the firm as a whole, 95% of our assets under management are institutional and in our group — the high-yield group — that number is 100%.

TWST: Maybe you could discuss your focus and describe your approach to investments?

Mr. Sydow: Well, a little bit of a background. I've done this for 32 years and my senior colleagues on my team have done it for at least 25 years, all of them working together. And we've all evolved to have a fairly consistent and common theme. We like investing in relatively unknown situations. And a situation could be unknown because it is a small industry or a small company and something that does not attract a lot of attention, for example, by equity research analysts on Wall Street who publish massively on very big companies.

We tend to be involved in situations where there's no Street coverage, where information is not cheap and where you have to spend quite a bit of time and effort to really get to know the company. And the payoff for us is that that type of company tends to have a relatively high coupon.

For a high-yield portfolio, our coupon advantage over the index traditionally has been about 100 basis points. It's much, much wider than that today, on purpose. But what we find is there are much higher yields paid for these companies as if they are riskier. And all of our work is dedicated to finding companies that bear that very high coupon, but, in our view, are not at great risk of defaulting.

TWST: And how important is volatility to the people who invest in this area?

Mr. Sydow: Well, we are blessed to have pretty sophisticated investors who do not panic at volatility, and we've certainly seen a lot of volatility, for example, in 2020. Volatility is not a terribly well-understood thing. In many cases, the biggest opportunities emerge out of volatile markets, and I'll refer again to 2020. At the tail end of past recessions in 2003 and 2009, same situation — when there's great disruption in the market, we tend to find a lot of pretty good companies. Their bonds trade down too much because people have a generalized fear that temporarily high default rates in the market are going to persist. That actually never happens, and so volatility, we kind of regard as our friend. We don't really worry too much about month-to-month volatility and neither do our sophisticated investors. The type of volatility that is truly damaging is having a really bad year, for example. And that can certainly happen in our market.

TWST: And has most of the volatility from this past year been related to COVID? Has COVID been impacting on this area and in other ways too?

Mr. Sydow: Yes. First of all, just to talk a little bit about the volatility, we had about a three-week period in March where the market went down about 1 point per day. It's gone down by more — back in 2008 it did — but it never has gone down 20 points in 20 days like we had here. And then it flipped for a number of reasons and the market has stormed back much faster than most people thought. And so I would say, yes, COVID drove a lot of volatility. And the steps taken to combat COVID, both in the real world in vaccine therapy, for example, were a big change and that's turned out to be a big success, but also the unprecedented steps taken by the monetary authorities back in late March and early April, where for the first time ever, they intervened directly in our market by purchasing specific bonds and also ETFs. So there was the fastest sharp decline ever and the fastest sharp recovery ever during this period.

Obviously, when you have a government-mandated shutdown of the economy, which has never occurred before, nobody can really say they ever prepare for that. Yes, you're going to have a tremendous amount of volatility. But a lot of those industries we think will fully recover; some of them basically already have fully recovered. There are other industries that were permanently changed by COVID. A number of those had some negative secular trends already in existence before COVID hit. And in our view, COVID accelerated some of the bad news all into 2020.

A very obvious example, for example, would be the movie theater business. For a long time, the number of people actually going to the theater has been flat to slightly declining and the industry has survived by raising ticket prices and spending massively to improve the viewer experience, spending a lot of money to do it. And when your theater shuts down and people embrace **Netflix** (NASDAQ:NFLX) even more than they already were, that's certainly irreversible. Some segment of people is just not going to return to the theaters if they open.

And there's a new thing that was accelerated there and that is that one of the remaining advantages in the movie theaters for quite a while has been that you had to go to a theater if you wanted to see a blockbuster movie on an opening night. And we've always thought at some point, the movie studios are going to make those movies available to streaming services on the same day they open in the theaters. You now see a couple major studios have done that. They claim that that only covers the 2021 product slate, but we think that's a permanent change. So obviously, we do not own any movie theaters; we've been highly negative on them for quite a while.

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Highlights

Robert Sydow discusses investing in high yield for Mesirow Financial. He has a preference for small- and mid-cap issuers that are not well covered by Wall Street analysts, finding they provide much higher yields without added risk. He also places less focus on interest rates, stating that in high yield, the most important thing by far is the ability of the company to pay you back. Mr. Sydow is not worried by short-term volatility, noting that often the biggest opportunities emerge out of volatile markets like we had in 2020. He believes that many of the industries negatively affected by COVID will recover fully, if they haven't already, but also points to instances where the pandemic accelerated loses in industries where there were pre-existing negative trends.

Companies discussed: Netflix (NASDAQ:NFLX) and Carnival Corp. (NYSE:CCL).

Others that have been hurt a lot are traditional retail for obvious reasons. Even dinosaurs like myself that didn't engage in a lot of e-commerce before, we do it pretty enthusiastically now. There were in the migration of advertising away from print media and away from radio and in the direction of the tech platforms. That's accelerated because people are not in their cars, not listening to the radio, and so the radio ratings are terrible — and obviously those folks are impacted. Office space is not really a high-yield industry. We think that there is some permanent impact there.

And probably a really big one everybody noticed was that gasoline prices and oil prices have been way, way down. That actually started in February ahead of COVID because there was a price war between Russia and OPEC, but the destruction of a lot of demand, roughly 9%, I think, of world oil demand went away this year, has kept prices very low and put increasing stress, in particular, on the exploration and production sector of the energy business.

TWST: And are some of these sectors that you just brought up included in the high-yield strategy? Or did you want to highlight some others that are noteworthy?

Mr. Sydow: Sure. Those are all sectors in which we were underweighted and mostly zero weighted. In a few cases, we were lucky we had no holdings there for other structural reasons, and then COVID came along and we doubled down on owning nothing there.

I mentioned before that there were a lot of opportunities created during 2020. And one of those would be in what is called the midstream sector of the energy business. And you can think of that as all the processing, all the machinery, all the pipelines between the wellhead where oil and gas are produced and the refinery or the distribution point for natural gas and for crude oil. And that is a segment of the energy business that is not directly exposed to the very bad decrease in oil price.

Those businesses are principally driven by the amount of oil and gas being produced. And what kills the energy companies has been the decline in price, not the decline in volumes. The decline in volume is actually fairly modest, and you can think of this intuitively. Natural gas — the biggest two uses are to create electricity and to heat homes and heat businesses. And those are two things even in a COVID-19 environment that people will continue to do. And so, the volume of natural gas we need, therefore the volume of natural gas produced, pretty much stays constant in the short run despite lower prices. And if you're making money by just transporting that in a pipeline and charging a fixed fee per barrel of oil or per million cubic feet of gas, your business is probably going to be pretty resilient.

1-Year Daily Chart of Netflix Inc.

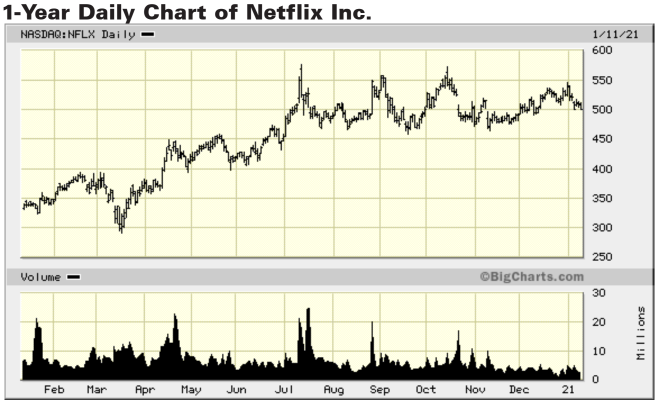

Chart provided by www.BigCharts.com

TWST: And when we talk about institutional investors, some of them, if they're government agencies, might be concerned about pensions for their employees. Others, they're in a situation where they might want liquidity so that they can get payments made to non-profits, if they're foundations. Are these some issues that you're seeing with your clients?

Mr. Sydow: Yes, but that's not really new. Pensions have been underfunded and getting more so for a long, long time now. And COVID obviously impacted them to the extent they held equities or high-yield debt or a lot of other things. Their underfunding position was suddenly greatly aggravated. It's come storming back. The securities markets have come back even faster than the real economy, so we're kind of back to where we were. But yes, they're always worried about being underfunded. They're always worried about what their asset allocation should be.

In my view, what they should be worried about right now is that the real returns on investment-grade bonds for the next three, five, 10 years are going to struggle to be a positive number. And we think they probably ought to be conscious of inflation. Now, inflation hawks have been warning about this for at least 10 years, and it hasn't happened. But I would also say that with the amount of monetary expansion we've had in the last year in particular, i.e., money printing, I think that there is a real basis for worrying about higher inflation, and that's going to hurt most fixed income. I don't think it will hurt high yield very much and I don't think it'll hurt equities either.

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But we noticed bonds in the midstream space during March declined almost as much as the oil producers. We are very enthusiastic about midstream — we doubled pretty much all of our existing positions in that industry. We have a big overweight on it now and it's been our most successful area for the last eight months.

There have been other opportunities created as well, and I would say most of those were companies that we were already quite familiar with. And when their bonds dropped by what we thought was too much, we added positions there. There have been a few other one-off situations. Like at the start of the year, the cruise business, as you can imagine, has been absolutely hammered. And those were, in fact, high-grade bonds at the start of the year, yielding as low as 3%. But these companies do have a viable business.

If you look at the loyalty of cruise customers, it's very, very high. We do think that business is going to be salvaged by the vaccine. And these companies have been paying extremely high coupons, and I'm thinking now of **Carnival Corporation** (NYSE:CCL), for example, which issued very high coupon bonds secured by its very newest and best ships. So we think even if 50% of the cruise customers never come back, these ships that we have a lien on will be operating profitably. So those are some of the opportunities. I could go on at length about that — there have been very, very many of them.

1-Year Daily Chart of Carnival Corp.

Chart provided by www.BigCharts.com

TWST: And are your clients watching what happens with interest rates closely as to what the Federal Reserve might do?

Mr. Sydow: Yes, they do that all the time. I honestly think that the influence of the Fed on high-yield issuers is a bit exaggerated. But yes, everybody worries about interest rates all of the time. I would say that in our strategy, honestly, we don't. In high yield, the most important thing by far is the ability of the company to pay you back. And the Fed has some impact on that, but I think it's usually overrated.

TWST: What about the outlook for 2021? What are you telling your investors who are interested in the high-yield strategy about anything that's on the horizon that might be particularly noteworthy?

Mr. Sydow: Well, we told people really since March that we were believers that the miracle of modern medicine was going to make the COVID vaccines work, and this is true. Even though the so-called messenger RNA technology has never before resulted in the actual production of a successful vaccine, the advances in genomic science in the last decades have been so great that we were pretty confident they would. And therefore, we told people that that was going to be a game changer and that 2021 was going to see a strong recovery. A lot of that's already happened, but we would continue to be of that view.

The vaccines, obviously, are a spectacular success. There are remaining logistical challenges, but I think those are going to be solved quicker and more easily than people fear. And so we've always been pretty optimistic about 2021; we remain that way.

Back in March, the consensus view was that market-wide default rates would be 10%, maybe higher. I believe the forecast made by one of the rating agencies was 12.5%. Our view was that 2020 would be better than that and we're going to be right about that. I think the default rate for the entire market is going to be only about 7%; our portfolio is going to be half of that. And I think that default rates in 2021 are going to fall substantially below 7%.

If we have a recovery like we had, for example, after the Great Recession, we then had five years when net default losses averaged about 100 basis points per year in the market. If we get that now, if we get that in 2022, 2023, 2024, I think that even at the low yields we see in the high-yield market, you will make a net credit spread that is comparable or even slightly better than we have historically.

TWST: In the high-yield environment, do you see the same interest you sometimes see from institutional investors in terms of looking for companies that might avoid investing in certain sectors because of environmental or governance issues, or isn't it as much of an issue as you might see with maybe some other type of strategies?

Mr. Sydow: I would say there's a lot of talk and lip service given to that. What I would say is that people articulate that they want that, and then at the end of the policy statement, they will say, "Naturally, we do not expect any policy responses in your portfolio to actually cost us anything." And so, what we do basically is, we will ask our large clients: if there are particular industries that you don't want us to invest in, please just tell us that. We don't really want to be guessing and substituting our judgment for theirs. And at the end of the day, our institutional investors place very, very few restrictions on the industries that we go into.

TWST: So many times, they're more concerned about the actual yield than maybe some of these other concerns that have been voiced in other areas?

Mr. Sydow: Yes, they're concerned about both. And people, they don't really want to prioritize. And that kind of throws the ball to us, and we really don't want to be in the position of guessing how they would make that trade off. So if there's an industry they didn't want us to invest in, for example, such as the coal business, we would easily apply that rule within their portfolio, and our institutional investors have chosen not to do that.

Also, what we have noticed is in investments, in general, there's a sort of activism in which investment managers or their pension fund clients seek to actually influence corporate policy. And what people don't really think about clearly is that is something that a shareholder can do and really mostly a large shareholder can do because he can vote his shares and he can elect the board. And people sometimes forget that bondholders are not in that position at all. We do not vote for the board. The board really doesn't pay much attention to what we think. Their duty is to obey the covenants and pay us our coupons, and that's basically it. So it's really not terribly realistic to expect a debt investor to be influencing the company. And in practice, you don't really see that happening.

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TWST: And anything we haven't talked about you care to bring up?

Mr. Sydow: I would just add, what is appealing to us and why we have spent our careers in this asset class, and frankly, why we think others should be long high yield, is that we think it's basically a fairly analytically solvable problem. If we can hold high-coupon bonds and use powers of analysis and judgment to have a pretty good idea about which companies are able to pay us back and we can repeat that, then you're going to do pretty well over a business cycle.

Now, you cannot say that about an asset like equities or real estate in which investor sentiment and euphoria and psychology plays a big role. You can see equities become under- or over-valued, and that can be sustained for a very, very long time. In the bond market, if we buy a seven-year bond we're going to know, probably, three years or four years on whether that bet has worked out or not. And that bond price is going to converge toward a definite 100 bid on the day it reaches maturity.

And so this is really one of the fundamental lessons that Michael Milken taught us at the start of the high-yield bond market history, that if you can be right on credit calls — and that is really a fairly analytically solvable problem — then you can be very successful in this asset class. And over time, the risk that we take has been amply rewarded, and there's a lot of value to be added there.

TWST: Do you consider yourself a boutique firm or is the firm larger than that?

Mr. Sydow: In the realm of high yield, we're definitely a boutique firm.

TWST: Why would an institutional client want to choose a boutique firm over, let's say, one of the mega firms?

Mr. Sydow: Well, just to put some numbers on it, some of these mega firms will have a single mutual fund that's got $20 billion in it, and we only manage $1.3 billion. Some of those very large firms, if you look at their performance, they are extremely highly correlated with each other and with the market, and there's a reason for that. Their portfolios may have 400, 500 bonds in them, and there are only 1,000 issuers in the entire index. And so you get a very, very large portfolio that's pretty much going to act like the index.

We only hold 100 bonds in ours. We are definitely a boutique, and what we're striving for is to have a portfolio that will be not highly correlated with some of the big players. So the institutions that hire us are frequently doing so specifically because our portfolio is going to act differently, particularly in times of stress, and we can show that that's happened historically.

So we are a boutique, and I would say that we're investing in a lot of boutique-type companies. And what I mean by that is, it could be a company that's only got $100 million of cash flow, a relatively small company, and it may only have $300 million of bonds outstanding. A really big firm would have $10 billion of bonds outstanding. So a small firm that's got $300 million in bonds outstanding, what we find is that the very large managers will simply ignore that company; they don't want to own a bond unless they can have $100 million of it and that creates opportunities for firms like us. We would only be interested in buying $15 million or $20 million of that.

And for that company, we're actually a fairly important investor. And so, when we call them up and say, we would like to come and visit your plant, they greet us with open arms, and we can develop really pretty intimate relationships with these companies — we can visit them every year. And if that company is not being followed by the equity markets and it's not being followed by the very smart guys running the big firms, we can get a pretty systematic information and judgment advantage with respect to that issuer, and that's what we're trying to recreate in as many names as we can.

TWST: Thank you. (ES)

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