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The Opportunity in Short Duration Underfollowed High Yield Bonds

Synopsis:

- The global COVID-19 pandemic and the Federal Reserve's various lending facilities to address the crisis have fundamentally changed the risk/reward structure of credit markets.
- The HY market's risk premium has experienced significant volatility brought on by extreme economic weakness and Fed intervention.
- Short duration HY bonds possess superior breakeven yields relative to longer duration bonds representing downside protection to further price decay.
- Current yield differentials across credit quality and duration reflect a move to safety leaving short duration, lower quality bonds as being oversold.
- The HY market's current valuation includes an inverted yield curve where short duration, small-cap bonds offer greater return potential than large-cap bonds.
- With the Fed's HY corporate lending program focusing on large-cap bonds and ETFs, the absence of small-cap bonds represents greater upside potential.

Why the Timing Is Right To Look At This Strategy

Unexpected exogenous shocks to financial markets have historically caused significant asset price dislocations that eventually lead to valuation mismatches and ultimately to buying opportunities. This is particularly true when the Federal Reserve enters the fray with various lending facilities and quantitative easing initiatives.

This report sets out to identify and examine one such segment of the HY market that offers attractive investment opportunities and therefore alpha possibilities, namely, small-cap, short duration and underfollowed HY bonds.

Since the Fed's various facilities are structured to focus on large cap, high quality issues, smaller issues of less than $250M are an attractive opportunity for longer term investors because of the premium being paid for their illiquidity compared to bigger issues.

This underfollowed group offers a pickup in extra yield while holding the smaller issue, offers good profit potential over time as the broad high yield market's yield premium comes back to normal levels.

Elevated High Yield Spreads Represent A Buying Opportunity

Prior to the arrival of COVID-19 many argued that the US high yield market was richly valued and that investors weren't being properly compensated for the risk. During the first two months of 2020, the median option-adjusted spread (OAS) was 361 basis points (bp). Even the short-duration segment of the HY market was trading tight with a median OAS of 410 bp. By comparison, the median historical OAS for the broad and short-duration HY market are 482 bp and 555 bp.

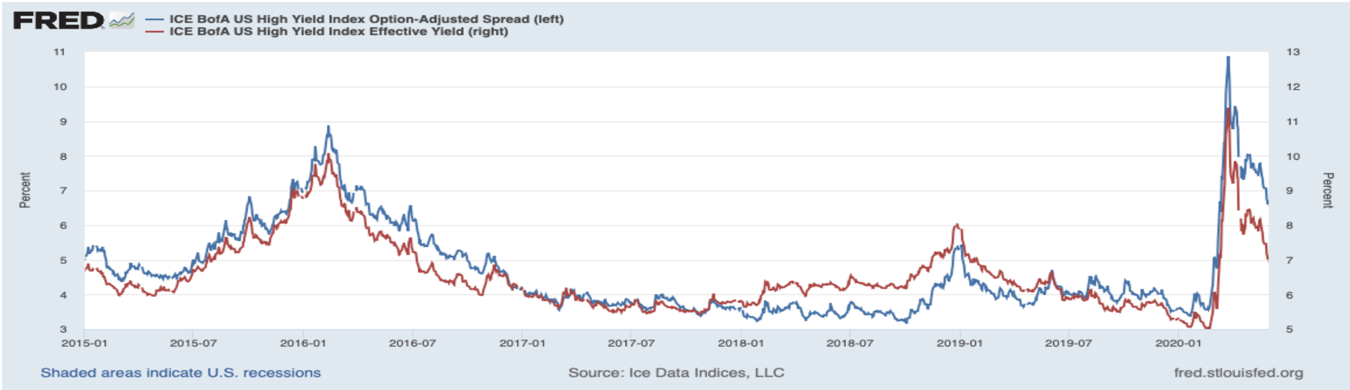
As figure 1 illustrates, the onset of COVID-19, which began showing up in credit markets during late February, resulted in a seismic repricing of credit risk. Not only did spreads push out wider than witnessed during the last dislocation in late 2015 and early 2016 when energy prices collapsed, but the speed of the repricing was incomparable to any point in history.

Over the span of 21 trading days, US HY spreads surged from 366 bp on 2/21 to 1,087 bp on 3/23. Likewise, the short-duration universe saw the spread scream higher from 416 bp to 1,328 bp over the same period. However, when the Fed threw its hat into the corporate bond space via Primary & Secondary Market Corporate Credit Facilities (PMCCF & SMCCF) on March 25th, credit markets repriced much tighter. And, when the Fed expanded these programs to include "fallen angels" and eligible high yield ETFs on April 9th, spreads continued to tighten.

Even with the implicit backing of the Fed, though not in the literal sense, broad and short-duration high yield spreads are 671 bp and 823 bp as of May 29th. At these levels these markets are 305 bp and 407 bp wider than they were during the pre-COVID-19 period. In other words, spreads are wide by historical standards, which confirms the current recessionary environment.

The current market environment favors short duration high yield bonds due to excessive spreads tied to incremental illiquidity premiums. It is this disproportionate premium that provides superior upside potential.

Figure 1: US High Yield Option-Adjusted Spread & Effective Yield



Source: St. Louis Federal Reserve, Concise Capital Management

YIELD BREAK-EVEN

During periods of market dislocation and misallocation of capital, less liquid and underfollowed segments of credit markets tend to offer the best value. This is especially true today after the Federal Reserve's support programs focus on large company capital structures with issue sizes greater than $1 billion.

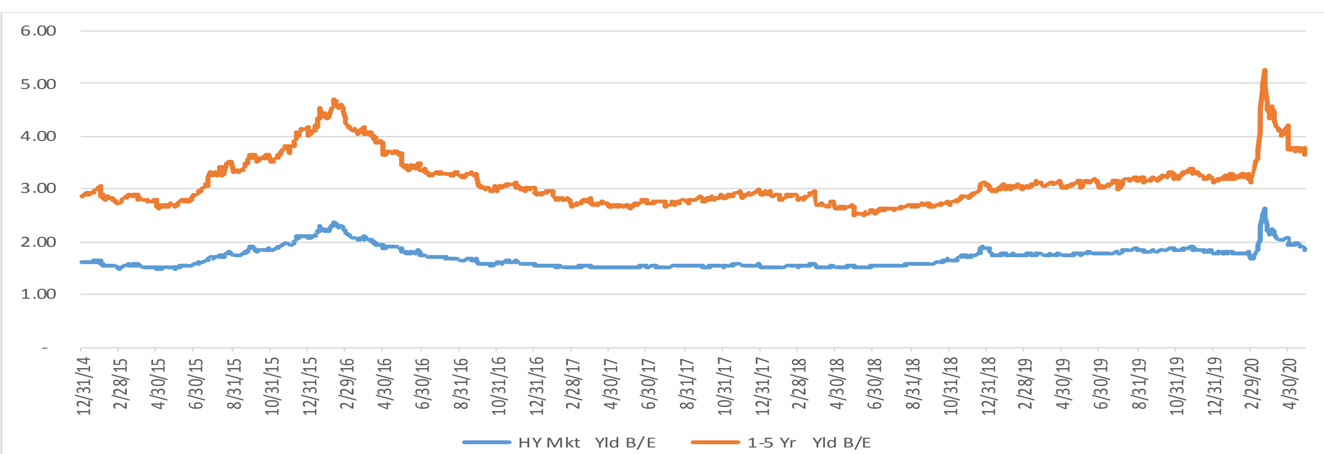
Valuation opportunities associated with small cap issues are on display when we apply a breakeven yield analysis. The breakeven yield represents the amount of downside price protection before a position registers a loss (B/E Yld = Yield/Duration). For example: consider a short duration high yield bond with a duration of 2.4 years and a yield of 11.6%. The bond's yield can rise 4.8% (11.6/2.4) in one year to 16.4%; and the breakeven (gain or loss) is still zero. This is because the high yield offsets the price decline. By comparison, a long duration bond (4.7 yrs.) that possesses a yield of 7.9% would only have a breakeven yield of 1.7%, representing far less downside protection.

Historically, during periods of distress, we often see an inversion of the credit curve by duration. Consequently, short-duration corporate bonds with high yields will possess higher breakeven yields and therefore a greater degree of downside protection.

As of May month-end, the short duration high yield market (1 – 5 yr.) possesses a break-even yield of 3.63% (see figure 2). That represents a decrease from the end of March (4.35%), due in large part to the Fed's intervention announcement that lifted prices, narrowed spreads, and dropped yields. By comparison, the broad high yield market break-even yield is 1.86% down from 2.15% at the end of March.

Bottom line: short duration high yield bonds offer potentially superior downside protection during these uncertain times while offering relatively attractive outperformance opportunities versus their large cap brethren.

Figure 2: Broad vs. Short Duration High Yield Breakeven Yields



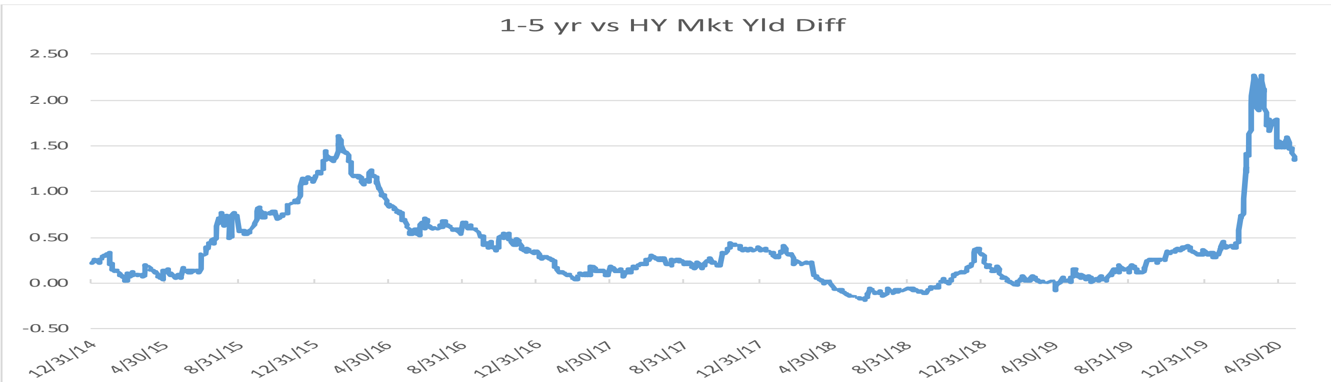
Source: Bloomberg, Concise Capital Management

US High Yield Credit Quality Yield Differentials

Yield quality differentials offer another relative value measure that in the current credit market backdrop further illustrates the attractiveness of short duration high yield bonds. When high yield investors look to defensively position their holdings quickly, they will focus on liquid larger cap issues. *That process often leads to a mispricing of smaller, less liquid short duration bonds.* The rotation into larger issues depresses the broad high yield market, which is heavily weighted by large cap names, while the yields of smaller cap issues increase.

The resulting yield differential highlights a mispricing of small issuers and a corresponding attractive risk-adjusted return profile for small issues. This reflects the current inverse credit curve. As figure 3 illustrates, the yield differential currently sits at 135 bp where the longer-term median is 25 bp.

Figure 3: Yield-to-Worse Yield Differentials – Short Duration vs Broad HY Market

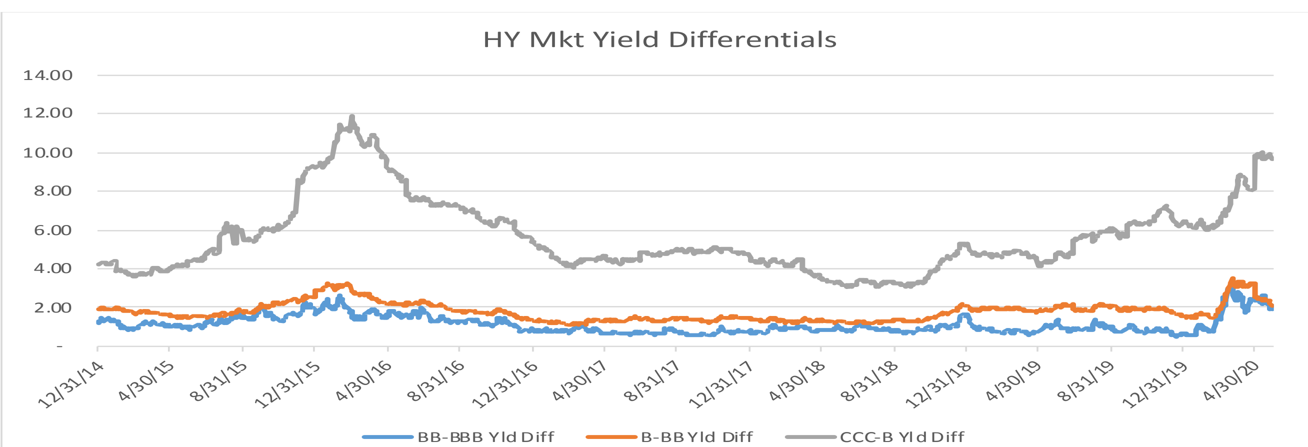


Source: Bloomberg, Concise Capital Management

The rotation toward quality and liquidity is also reflected in the yield differentials across credit rating categories. Figure 4 illustrates the yield differentials by credit quality. The CCC-B differential is the most distorted with a spread of almost 1,000 bp. That compares to the historical median differential of 492 bp. However, the comparison involving the CCC group can be misleading. After all, the CCC group represents only 13.9% of the US HY market. Of that group, only 15%-20% trades on a regular basis. As such, headline CCC index figures often do not effectively capture the credit group.

Consequently, the focus should be on the BB and B spread relationships. The differentials between BB-BBB and B-BB are basically on top of each other, (204 bp vs 211 bp), but compared to their respective median historical spreads, (96 bp vs 173 bp), it's the BB-BBB segment that is the most mispriced.

Figure 4: Yield-to-Worse Yield Differentials by Credit Quality



Source: Bloomberg, Concise Capital Management

Yet, the current environment has also impacted this relationship due to the magnitude of "fallen angels" that have moved from the BBB segment to BB. The debt of "fallen angels" totals approximately $150 billion since March 1st according to Fitch with another $200 - $300 billion still at risk.

When we account for this trend, we really must instead focus on the relative yield differentials between the BB – B credit segments.

The takeaway from this analysis suggests short duration, B rated, high yield bonds offer the best value during the current credit environment.

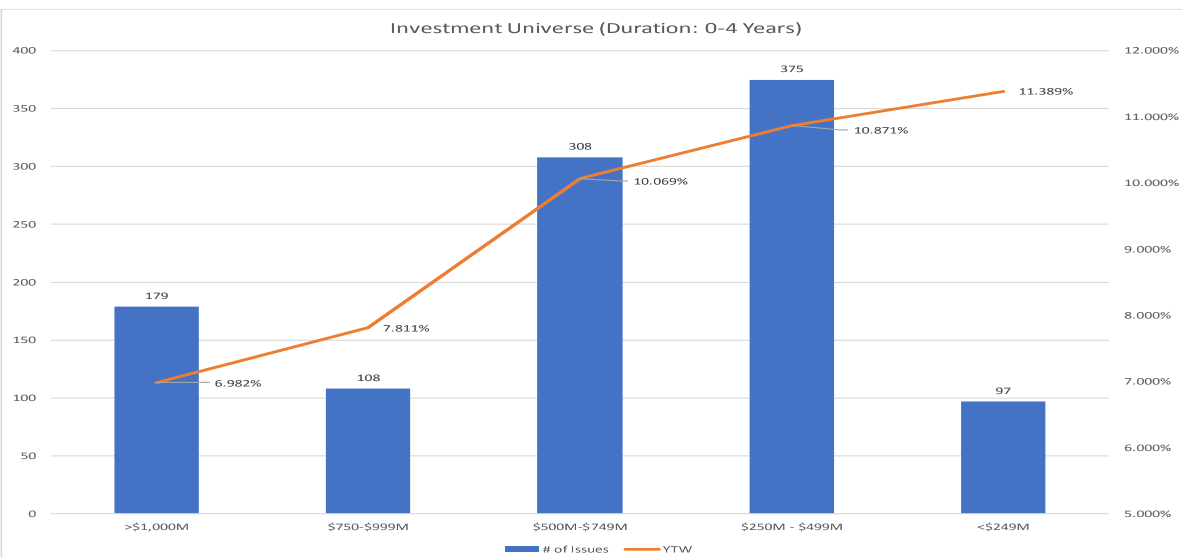
FOCUS ON SMALLER/UNDER-FOLLOWED BONDS

The significant repricing of the high yield market, which began with a significant sell-off followed by a Fed-induced strong rebound, caused the credit curve to invert. *The impact of differentiating liquidity premiums across issue size has historically contributed to inverted curves. Importantly, while the Fed's actions have exasperated the curve, the liquidity premium induced inversion is a common event and is not expected to revert post COVID-19.* Moreover, the liquidity premium associated with smaller cap issues allows investors to capture the systemic inefficiency within the HY market, which in turn leads to outperformance.

There are several ways to evaluate the market's curve and, in this case, we examine the curve of the short-duration market (1-4 years) by issue size. In particular, smaller issue size (<$500MM), short-duration paper represents attractive value by virtue of higher yields relative to comparable large issues. The higher yields and shorter duration are what drives the higher breakeven yields covered earlier.

Presently, this investible universe includes over 450 eligible bonds with yields-to-worse above 10.50%. Another contributing factor to the attractiveness of short-duration, smaller issue size bonds is that few research departments follow small issues, creating a lack of information, which promotes market inefficiency. Small purchase lots typically prevent large high yield funds from purchasing small issues, leading to a liquidity premium.

Figure 5 : Investment Universe (Duration : 0 – 1 Years)



Source: Bloomberg, Concise Capital Management

CURRENT OPPORTUNITIES IN SMALL ISSUES FOLLOWING FED INTERVENTIONS

Over the past couple of years, we have seen the BBB segment of the investment-grade market grow increasingly large as a percent of the total IG market. Indeed, as of April month-end, the BBB sector represented 46.0% of the IG market compared to 21.2% in 2010.

Worries about the size of the BBB market seemingly got the attention of the Fed with their entry into the corporate bond space via its proposed $750 billion Primary and Secondary Market Corporate Credit Facility (PMCCF & SMCCF) that included fallen angels.

The Fed's entry into the corporate market, HY in particular, clearly favors large-cap issues. According to the PMCCF term sheet, eligible fallen angels are those bonds that were investment grade as of March 22 and must be rated at least BB-/Ba3 at the time the Facility makes a purchase. The Fed will not waste its capital allocated to this program on small-cap issues but instead would focus on issuers like Ford and Occidental Petroleum, both of which fall into the fallen angel category.

Consequently, while small-cap, high quality, underfollowed HY issues initially benefited by the Fed's PMCCF & SMCCF announcement, this segment of the market offers opportunities with yields that are disproportionally higher than larger similarly rated issues. The relative mispricing of smaller-cap issues represents outperformance opportunities relative to larger-cap issues.

CONCLUSION

Throughout this report we have touched on a number of measures that suggest smaller-cap, short duration, underfollowed high yield bonds offer attractive upside potential compared to far larger and more liquid longer duration debt.

In particular, the underfollowed segment of the US high yield market possesses higher breakeven yields that speak to a degree of downside protection during a period that will certainly see a spike in defaults. At the same time, the group offers superior yields relative to longer duration bonds. This is also true with the short duration "B" credit group relative to the "BB" group.

While much has been said of the Federal Reserve's impact on the corporate bond market via its plan to purchase HY ETFs and "fallen angels," the Fed's plan does not filter down to small-cap HY paper. Furthermore, the HYG and JNK HY ETFs that are the Fed's focus represent very little overlap with small-cap names as only 0.6% of the HYG constituents are of issues with outstanding sizes less than $400M.

Finally, in addition to the attractiveness of short-duration, smaller underfollowed bonds, the current market requires active management. After all, bottoms-up credit analysis is required to select those companies that will not only make it through to the other side of the COVID crisis but will also outperform other high yield alternatives. We believe the risk/reward of this strategy merits consideration relative to passive investing.

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