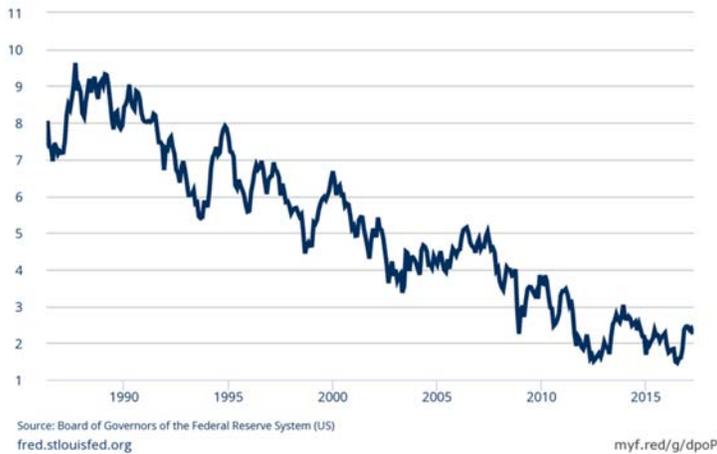


Treasury Rate: 10 Year Constant Maturity



Summary

Citing “confidence in the robustness of the economy and its resilience to shocks”, the Fed has signaled its intention to move interest rates up over at the least the next year. After a thirty year rally in bonds, a series of rate increases now appears to be underway.

Many, if not most, institutional portfolios have large weightings in investment-grade (IG) fixed income and are less exposed to high yield. This paper offers historical evidence showing that increasing the allocation to high yield can provide diversification and add return, using data from periods of rate increase from 1987 through 2017. We show that exposure through mutual funds and ETFs, while seemingly efficient, comes at the cost of lower returns; and we present a possible explanation based on an analysis of pricing differentials related to issue size, noting that the largest funds tend to overweight large issue size bonds and underweight smaller issues.

In the high yield market, there are no passive vehicles available exclusively focused on mid-sized and/or lower grade credits. This argues in favor of active management, as we show that smaller issues have tended to trade at lower prices, and in prior periods of rate increase coincident with economic growth, taking more rather than less credit risk has proven to be rewarding.

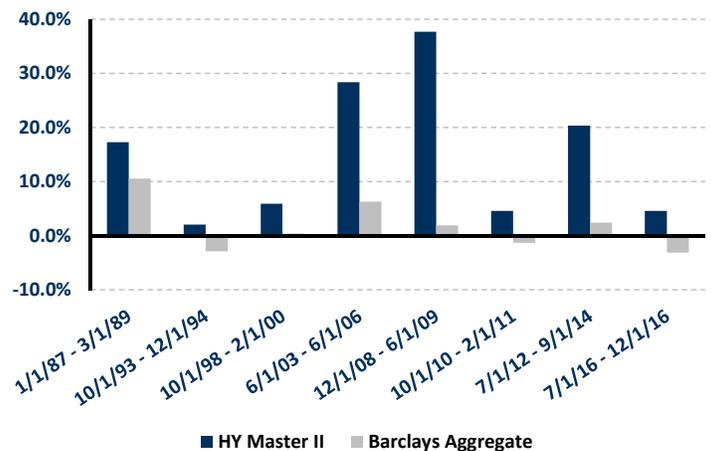
We also show that a smaller manager has a structural edge in this space, as the average amount available to trade in smaller issues makes it difficult if not impossible for larger managers to build positions large enough to materially affect returns.

Why High Yield?

The economic argument supporting high yield in a rising rate environment is straightforward: if Fed policy is guiding rates up because the economy is strong enough to justify it (as is the case today), that economic tailwind can support increasing profitability and more cash flow for high yield (i.e., leveraged) issuers. Improvements on these metrics can boost the issuer’s credit quality, which in turn leads to tighter spreads on their publicly traded debt. This directly benefits holders of their bonds through price appreciation, and can also increase market receptivity to refinancing transactions. Historically, this spread compression and the follow-on balance sheet improvements have more than offset the impact of rising rates, both at the issuer level and in aggregate for the asset class.

This effect has been remarkably consistent. Over the last thirty years, in periods when interest rates rose, high yield (as measured by the B of A Merrill Lynch High Yield Master II index) regularly outperformed investment grade bonds (as measured by the Barclays Aggregate index):

High Yield vs. Investment Grade Total Return
 during rate increases: 1987 through 2016



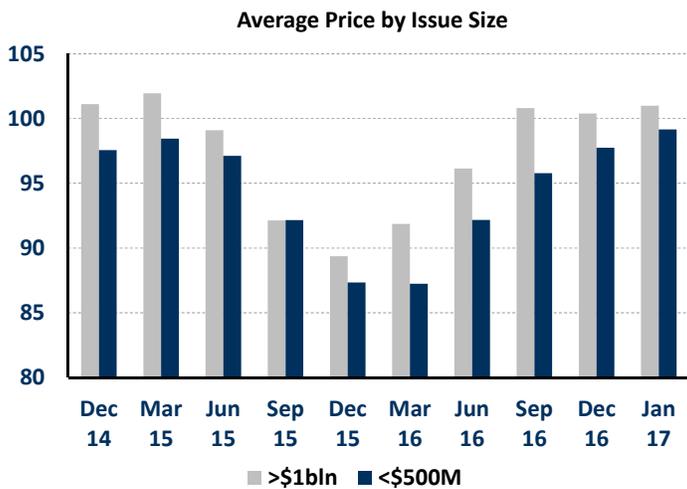
Source: Bloomberg

Price Dispersion by Issue Size

Since the financial crisis of 2008, the high yield market has more than doubled in size. Over the same period, a series of regulatory changes capped by the Volcker Rule provisions of the Dodd-Frank Act have resulted in trading desk inventories at banks and investment banks shrinking by 90% or more¹. This divergence has led to a significant drop in liquidity, most

notably in smaller and lower credit grade issues. As one example of this impact, a recently published Federal Reserve Staff paper estimated that the price impact of a downgrade from investment grade to below investment grade has increased five-fold from pre-crisis times to todayⁱⁱ.

Along with the overall decline in liquidity and increase in price volatility, a price gap between larger and smaller issues has persisted, with larger issues trading at higher prices and lower yields to maturity relative to smaller issues.

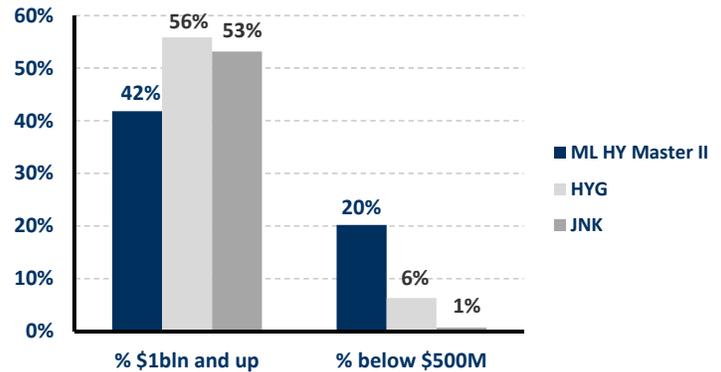


Source: Bloomberg

While the size of this price differential has varied over time, it can be enough to create a yield to maturity advantage that we estimate at 150-250bp for what we believe to be otherwise similar credits.

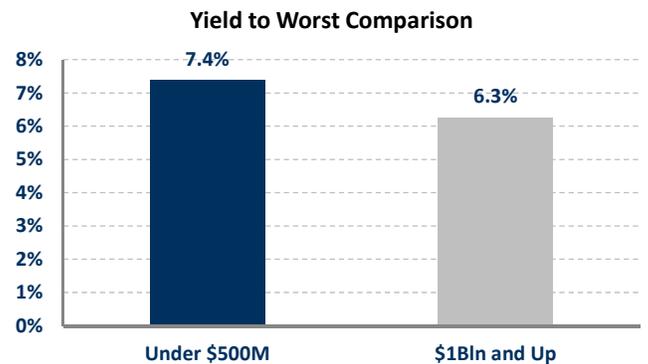
We believe this gap has been reinforced by the concentration of high yield investment dollars in larger funds. As high yield has attracted institutional and large scale retail flows, the largest managers have grown, such that by Q4 of 2016 the largest twenty managers in high yield accounted for nearly half of all assets in the strategy.ⁱⁱⁱ With an average AUM of approximately \$30 billion, establishing a 50bp position requires a \$150 million purchase, a transaction size best suited to large issues. Publicly available data on the largest high yield ETFs (HYG and JNK) suggests that these pressures have resulted in portfolio weightings that overweight bonds with issue sizes greater than \$1bn and underweight bonds with sub-\$500M issue sizes:

Small and Large Issue Size Weighting: HY Master II index vs. HYG and JNK



Data is as of 1/31/17. Source: Bloomberg

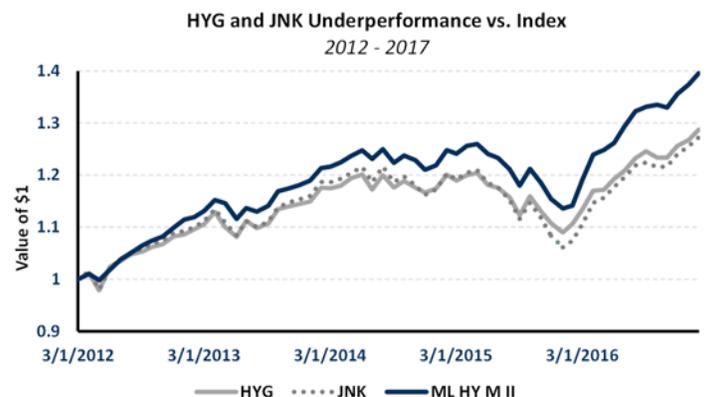
The crowding of investment flows also corresponds to a measurable disparity in yields, with sub-\$1bn issues on average trading at higher yields relative to larger issues:



Data is as of 1/31/17. Source: Bloomberg, B of A Merrill Lynch

“Low cost beta” comes at a price

The ETF capitalization bias may be a drag on performance. Unlike the equity world, passive replication of high yield indices has not provided index-level returns. This shortfall has accumulated steadily over the past few years, increasing sharply in the 2016-17 rally:



Source: Bloomberg, B of A Merrill Lynch

Mutual fund performance has lagged as well, particularly of late:

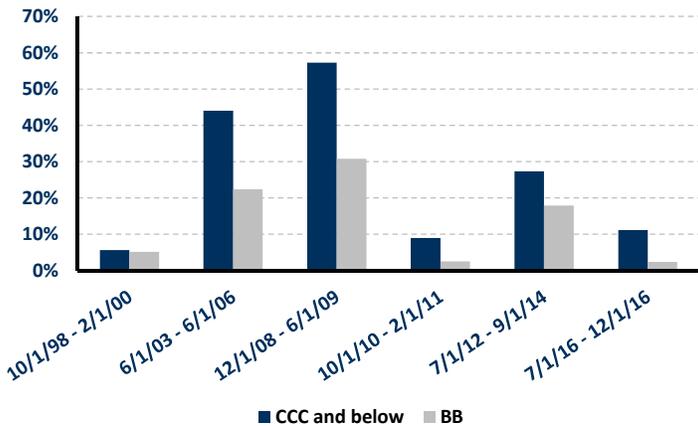
Annualized HYG and HY Mutual Funds Returns vs. ML HY Master II Index through December 2016



Source: Bloomberg, B of A Merrill Lynch

Finally, historical data suggests that dipping down in credit quality pays off in higher returns as rates move up. In the last six of the eight rate increases discussed on page 1 (the first two periods occurred before the start of the CCC and below index), lower quality high yield credits have outperformed higher quality high yield by an average of 1220 basis points per period:

CCC and Below vs. BB Total Return during rate increases: 1998 through 2016



Source: Bloomberg

Benefits of a Smaller, Specialized Manager

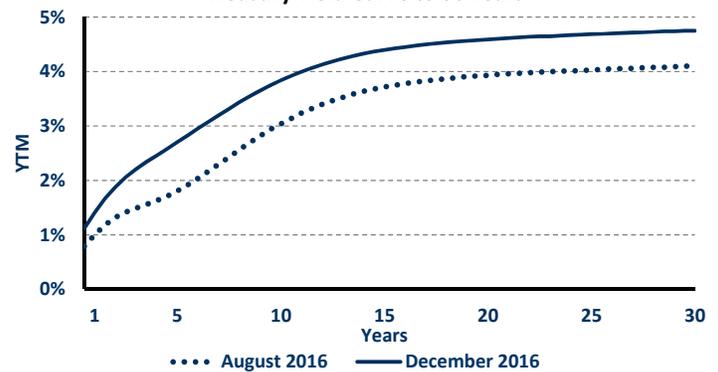
We noted above that bonds (and loans) from smaller issues are not generally available in quantities large enough to provide the exposure needed by exchange traded funds and the largest high yield managers: while \$25M (5% of a \$500M issue) can be a meaningful position for an appropriately-sized mid-cap manager, it is too small to impact the performance of a high yield ETF, mutual fund, or large institutional manager with an AUM in the tens of billions.

With sub-\$1bln issues making up more than half of the high yield market and, on average, trading at higher yields-to-maturity, smaller issues are a significant and potentially valuable segment for investors.

Beyond the broader access smaller size affords, a specialized manager may also be able to benefit from a sourcing advantage through relationships with dealers who know the manager as a potential secondary market buyer for bonds from smaller issues. In a part of the market where forced selling occurs and few buyers participate, the ability to be shown timely opportunities can add value.

Rates are rising now

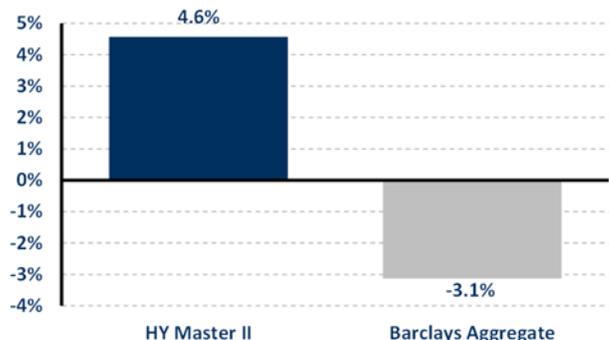
Treasury Yield Curve to 30 Years



Source: US Treasury

Following Fed Chair Yellen's speech last August in which she signaled that US economic strength was likely to push the Fed to raise rates, the yield curve started to move up. As has been true historically, high yield outperformed – in this case delivering positive returns as investment grade bonds had a negative return. This is, in our view, an important reminder of the potential risk in portfolios heavily weighted towards IG and a clear example of the diversification benefit high yield can provide.

High Yield and IG Returns August through December 2016



Source: Bloomberg

Conclusion

With the historic bond market rally now in the rear view mirror, we believe the case for high yield is timely. In addition to the well-documented negative correlation between high yield and Treasuries, market developments over the last ten years have created liquidity differentials

that provide the opportunity for significant incremental return from mid-cap and smaller high yield issues. For managers sized to participate in this part of the market and investors not constrained by a need for daily liquidity, this segment of fixed income deserves consideration for diversification and incremental return as interest rates trend back up.

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The Merrill Lynch High Yield Master II index tracks the performance of below investment grade US dollar-denominated corporate bonds publicly issued in the US domestic market.

HYG: An exchange-traded fund (ETF) that tracks the investment results of an index composed of U.S. dollar-denominated, high yield corporate bonds.

JNK: An ETF that tracks the Barclays Capital High Yield Very Liquid Index includes publicly issued U.S. dollar denominated, non-investment grade, fixed-rate, taxable corporate bonds that have a remaining maturity of at least one year, regardless of optionality, are rated high-yield (Ba1/BB+/BB+ or below) using the middle rating of Moody's, S&P, and Fitch, respectively, and have \$600 million or more of outstanding face value.

ⁱ Source: Federal Reserve Board of Governors

ⁱⁱ Bao, Jack, Maureen O'Hara, and Alex Zhou (2016). "The Volcker Rule and Market-Making in Times of Stress," Finance and Economics Discussion Series 2016-102. Washington: Board of Governors of the Federal Reserve System, <https://doi.org/10.17016/FEDS.2016.102>.

ⁱⁱⁱ Source: UBS, eVestment