Morgan Stanley

INVESTMENT MANAGEMENT

MIDDLE MARKET HIGH YIELD INVESTING

Middle market corporate bond issuers are one of the last underappreciated areas of the U.S. credit market. Issues are often overlooked despite their advantages, for those comfortable with the risks associated with this sector. Bonds from mid-size issuers can offer lower volatility, shorter duration, better-than-expected fundamentals and a significant premium to the yield offered by their larger peers.

"The middle market represents just under one-quarter of the total U.S. high yield market as measured by par amount outstanding , but it makes up the majority of our portfolio exposure," says Richard Lindquist, head of High Yield Fixed Income at Morgan Stanley Investment Management. He oversees the Morgan Stanley U.S. High Yield strategy, which invests in high yield bonds issued by companies with $150 million to $1 billion or less in total debt outstanding.

"Middle market issuers offer 100-150 basis points in additional yield over their larger competitors," says Lindquist. A smaller issuer may share the same (or better) fundamentals and outlook, but pays a premium merely for being small.

That differential has been fairly consistent. It is also more important in a low-yielding world where every extra bit of yield can make a larger difference in performance when compounded over time. Investors get a lot of choice too, with more than 600 issuers across all major economic sectors.

Nevertheless, for some investors the $1 billion limit on outstanding debt is just too small an amount to consider. When big institutional managers run portfolios of $50 billion or more, small issuers and their bonds have a built-in barrier to entry: they really are just too small for managers to take a big enough position to make a difference to overall returns.

When larger investors deliberately avoid the middle market, however, they also lose out on other useful volatility, liquidity and duration features.

Global allocation flows tend to hit the big index bond names hardest as billions of dollars shift from one asset class to the next. When investors grow nervous, liquidity becomes an increasingly pressing problem and it is not helped by the withdrawal of investment banks from market making. Banks no longer provide a backstop when trading is intense.

Although middle markets are not immune to liquidity concerns, they generally exhibit less price volatility than larger issuers. "Middle market bonds tend to trade more in-line with the underlying fundamentals of the issuing names," says Lindquist."

The lower volatility may also be connected to changes on the sell side. Wall Street has cut back its fixed income research capabilities as regulatory and profitability issues have come to the fore, and the occasional nature of middle market issuance means that they are not a big fee generator. So middle-market bond buyers have to put in the legwork themselves when it comes to bottom-up analysis, thinks Lindquist.

That can be time consuming and expensive, "Many managers simply do not have the credit analyst staff to tackle the middle market," he says. "Those focusing on middle market credits have to be committed to fundamental research.

Frequency and pricing also come into play. Smaller issuers tend to have simple structures and simpler financing needs. One loan, one bond is common.

"Middle market issuers will not be back to market for four or five years. They are not frequent customers," says Lindquist.

In contrast, large companies are juicier prospects for repeated fee generation. The biggest issuers have also come to market more frequently of late, lured by the prospect of refinancing at very low cost.

Middle market players often come with fuller covenant packages, but still have to be price takers. Even when loaded with extras concerning dividends, restricted payments and call protection, smaller issuers are not always judged kindly by ratings agencies. The ratings agencies tend to see size as a detriment, expecting smaller firms to default more often. Single B and CCC ratings are more common, so issues are priced accordingly.

"Even when the companies are performing just as well, middle market issuers are generally rated lower," says Lindquist. "Even though their fundamentals can be just as robust, they are not targets for insurance buyers because of their lower ratings."

In a low-growth world, well-run middle market companies are often acquisition targets. When larger, higher-rated companies buy smaller competitors, the middle market bonds of the company being acquired tend to benefit from an immediate uplift. That positive event risk typically runs only one way, however. The larger acquirer may be downgraded by taking on more debt.

"The acquisition market is quite healthy," says Lindquist. "Companies have been buying other companies for a while across a range of sectors." Whatever their rating, middle market issues tend to be shorter duration. Most come to market with five to seven years to maturity, often because their management thinks they have to pay too high a coupon on their bonds.

Big issuers think differently. They want to lock into lower-for-longer and are more than happy to launch issues for ten years, or more if they can get away with it, thinks Lindquist. "For the potential 100-150 basis points more yield, you get durations that are three-quarters of a year shorter than the index," he says. "More yield and shorter duration can be a strong hedge against rising rates."

Lindquist's own Morgan Stanley Institutional Fund Trust High Yield Portfolio (MSYIX) uses a value-oriented fixed income approach and seeks to achieve attractive total returns. The fund typically holds a well-diversified portfolio of U.S. high yield issues in each fund or managed account strategy. Sectors can be zero-weighted, although they have caps on overweight exposures. The team can overweight by a maximum three times for sectors that are 4 percent or less of the index. For larger sectors, the overweight can be double.

Positions are generally held until the yield advantage pulls in. Much of the work done by the team is on relative credit, so positions will be swapped out if a better opportunity comes along. Turnover is typically around 40 percent, somewhat lower than that of peers.

Lindquist calculates that up to 85 percent of the returns of their fund comes from bottom-up selection, but with significant alpha harvested from top-down allocations. Defaults tend to be concentrated in certain sectors and avoiding them is key to outperformance, so the team overweights the good sectors and avoids the ones that that look stressed.

The recent commodity rout highlights the concentration issue well, says Lindquist. Of all defaults in U.S. high yield, 87 percent were in energy and metals and mining last year. Typically it takes any sector two or three years to work through its debt problems. When investors remain wary, that is generally a good point to re-evaluate the sector. In the case of oil-related issuers, the turnaround has come far quicker because the price of oil has rebounded and underlying assets are doing well. Default rates recently spiked at 6% but have started to decline, and recovery rates have also risen.

"The commodity issues were well telegraphed," explains Lindquist. "Energy has been one of the best performing sectors this year. We are not interested in defaulted bonds, but some of the stressed issues are worth looking at."

He remains cautious as the oil price could reverse again. Yet markets are relatively sanguine. There has also been little volatility in the run-up to the U.S. elections, while worries over slowing growth in China appear to have dipped below the radar. Monetary policy is not a big concern either.

"The biggest risk is a leg-down in commodities if oil dips below $40," concludes Lindquist. "Markets are not concerned about a possible Fed hike in December. Rate rises have been well telegraphed, too."