Small Cap High Yield Bonds Can Defy Expectations

Investors may be misperceiving risk and missing out on opportunities.

With bond investors looking far and wide for stronger returns, they may be missing an opportunity that is hiding in plain sight. For decades, small cap high yield bonds have outperformed other high yield bonds. Robert Sydow, portfolio manager at MetLife Investment Management, has a hunch why this asset class has been overlooked: Investors are misperceiving the risk of these bonds.

“Small cap high yield bonds always trade at a significant spread to large cap high yield bonds — and we think that’s just a mistake,” Sydow says. “People intuitively assume large companies must be safer, in the way a large boat is harder to sink than a small one, but the data shows a different picture.”

Premium Rates, Lower Risk

Small cap high yield bonds have offered an average of 121 basis points of excess yield compared to large cap high yield bonds, according to the Credit Suisse High Yield Index.[1] The market typically demands higher yields to compensate for more risk, but when it comes to high yield bonds,

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research shows that small cap bonds have lower default rates and lower volatility than their large cap peers.

Small cap high yield bonds defaulted at an annual average rate of 3.8% of par while large cap bonds defaulted at 4.5% from 2011 through 2024 — a 16% difference.[2] During 2002 and 2009, which were difficult years for high yield issuers, the large cap default rate was more than double the rate for small cap bonds.

At the same time, large cap high yield bond prices saw more week-to-week price volatility, with return standard deviations of 1.14% versus 0.68% for small cap. Those results show that small cap high yields have been less volatile and carry a lower default risk than large cap high yield bonds.

Assumptions and Overlooked Opportunities

If small cap high yield offers the opportunity for greater returns and lower default risk, why aren't more investors taking advantage?

Sydow believes there are a few factors involved. For one, investors believe that small cap companies may have less access to financing and top management talent. "While directionally it may be true that larger companies have more levers to pull and better management, our data shows that the market is overvaluing those minor advantages," Sydow says. "We invest in companies that can withstand those challenges and reap the additional income as reward."

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Sydow says there are other challenges that can lead to premium yields. Researching small companies and niche industries can be difficult, with limited access to company data and poor visibility into companies' business models.

Companies in the shale industry, for example, produce huge quantities of polluted water that have had to be trucked out for disposal. A few small companies started building dedicated pipeline networks to lower the cost of transporting the contaminated water. The water treatment niche is small, with just a handful of companies, and relatively new, so there was little research or expertise on these businesses. "Most investors couldn't send an analyst out to the Permian Basin to do the legwork on a small company, or they preferred to watch from the sidelines until the results were proven," Sydow says. "But for agile investors who could do the research, and didn't wait for the company to become big, there was a first-mover advantage."

The small size of the issues itself can also change the market dynamics. Large mutual funds and institutional managers often eliminate consideration of small issuances because they choose not to devote research to small positions. "When most investors ignore issues, it creates mispricing and opportunities," Sydow says.

Finally, liquidity concerns can keep some investors out of the small cap space. Indeed, small cap high yield issues trade 14% less than large cap bonds.[3] However, Sydow says the spread more than compensates investors for the additional liquidity costs.

Finding Winners

While the historic data shows the relative performance and risk advantages of small cap high yield overall, security selection is the most important part of MetLife's process. That involves getting familiar with intriguing market areas such as the water treatment operators in the shale industry. It also involves looking deep into a company's finances. Sydow says his fund eliminates well over half of issuers based on one key factor: free cash flow.

"We look for companies that generate strong and consistent free cash flow — ideally enough to repay 10% of their debt per year," Sydow says. "Free cash flow, which we measure as EBITDA minus interest and maintenance capital expenditures, gives companies the ability to withstand stress." Sydow adds he finds large cap high yield companies tend to lever their finances further, and rarely meet his cash flow criteria.

While most institutional investors have a traditional high yield strategy in their portfolio, an allocation focused on small cap high yield has the potential to boost returns and may be less risky than some investors assume. "We are hired to provide excess returns, and we have those available due to our small cap focus," Sydow says. "The liquidity costs are manageable, the default data shows risk is lower and the extra income is there for those sophisticated enough to see it."

Get more insights about opportunities in the fixed income market.

Sources

1. Credit Suisse, HY Index Weekly Data, 2011-June 30, 2024. Bond issue size used as a proxy for the size of the issuing firm. This is commonly done because firm size, measured by sales, profits or market capitalization, is dynamic; what is a small firm one year may become a mid-size firm in the near future. And the market capitalization of private companies cannot be observed. Issue sizes, on the other hand, remain constant, so averages across long periods have meaning.

2. Credit Suisse, HY Index Weekly Data, 2011-June 30, 2024.

3. Trade Reporting and Compliance Engine (TRACE). Based on daily turnover as a percentage of issue size. Past performance is not indicative of future results.

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