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INVESTMENT MANAGEMENT

The Case for Middle Market High-Yield Investing

FIXED INCOME | GLOBAL FIXED INCOME TEAM | INVESTMENT INSIGHT | 2018

Like many sectors of the global fixed income markets, high-yield bonds have generated strong returns for investors in recent years.[1] With the risk of additional rate hikes, however, investors are searching for the best place to be in the bond market. We believe the answer is high-yield now more than ever, and within that, middle market issuers.

Although U.S. high-yield bonds feel the impact of rising rates like other higher-quality bonds, the impact is usually significantly lower. When the Federal Reserve hikes rates, it's the lower-quality bonds that tend to perform better, albeit with greater risks, largely because they generally have less duration and are more influenced by the equity markets.

We feel that high-yield bonds remain one of the most appealing investment options available in fixed income, and that an actively managed portfolio of high-yield bonds can be a sensible part of a client's overall portfolio. Although yields tightened significantly in 2017, we expect continued risk on sentiment and the global backdrop to support moderate spread compression. Additionally, we expect default rates to continue to decline as reduced stress in the commodity sectors has led to a decline in overall default volume and issuers have few near-term liquidity pressures.

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[1] Source: Morgan Stanley Investment Management (MSIM). **Past performance is not indicative of future results.**

DISPLAY 1

Higher sharpe ratio, lower beta, lower downside capture, shorter duration and shorter maturities—what's not to like?

	MIDDLE MARKET BONDS	TRADITIONAL HIGH-YIELD	BLOOMBERG BARCLAYS U.S. CORPORATE HIGH-YIELD INDEX
Bonds Outstanding	$150 million to $1 billion	≥ $1 billion	–
Number of issuers in Category	595	339	934
Total Category Par Amount	$289 billion	$1,018 billion	$1,307 billion
Average Duration	3.31	4.01	3.86
Median Years to Maturity	5.72	6.39	6.24
5-Year Sharpe Ratio	1.17	0.88	0.96
5-Year Beta	0.89	1.04	1.00
Downside Capture Ratio	0.84	1.08	1.00

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Source: MSIM. Bloomberg Barclays. As at June 30, 2018.

In particular, we believe that a high-yield portfolio focused on middle market issuers can potentially offer investors an attractive means of accessing high yields due to certain characteristics of these borrowers. This belief is based on our proprietary research that demonstrates middle market high-yield bonds can offer a significant yield advantage relative to the broader high-yield market, have less sensitivity to interest rates and demonstrate lower volatility than larger issuers, as seen in *Display 1*.

This paper explores these points in more detail to better understand the potential benefits and some of the risks to investing in middle market high-yield bonds.

Asset Class Overview

The high-yield market is well over $1 trillion in size and consists of corporate bonds rated BB+ and below by the major credit rating agencies.[2] In return for their increased credit risk, high-yield bonds typically offer higher yields than U.S. Treasury bonds and investment-grade corporate bonds. As evidenced by its size, the high-yield market is a mature sector of the fixed income markets and has developed significantly since its start in the 1980s.

Typically, the high-yield market has financed both fallen angels, meaning credits that have lost their investment-grade ratings, or more growth-oriented companies that require large amounts of capital to help fund their expansion. A good example of this is the build-out of wireless cell phone networks in the 1980s and early 1990s, as well as local casinos and cable television. In exchange for the more speculative nature of these credits and industries, investors typically received shorter maturities and bigger coupons than larger investment-grade credits. Additionally, investors have typically maintained a structurally senior position in the capital structure (e.g., liens on assets) and have had more of a voice in what the issuer can and cannot do in the form of covenants. These typically will limit how much debt the issuer can assume, and cap the amount of fixed charge liabilities[3] and dividends they can offer. Typical for this asset class, the majority of new issue high-yield bonds are also callable at a premium, usually at half of their coupon (a new issue 10-year bond is typically callable in five years).[4] This helps limit the interest rate risk of these securities, giving high-yield bonds one of the lowest durations of any part of the fixed income market.

State of the Market: High-Yield Bonds in Rising Rates

A combination of gradual tightening of monetary policy, the threat of escalating trade wars, equity volatility and a pickup in idiosyncratic news flow has left investors looking for the best way to position their portfolios. However, investors may find it in an unlikely place: high yield. And within the high-yield market, it's the bonds on the lowest rung of the rating ladder—the B and CCC names—that tend to perform the best in a rising rate environment.

While high-yield bonds feel the impact of rising rates like other high-quality bonds, the impact tends to be less dramatic. That is in large part due to the fact that high-yield companies generally have shorter maturities than their high-quality competitors. Additionally, many high-yield bonds have the ability to be called at a premium, which helps provide high-yield bonds with some of the lowest durations found in the fixed income market. For example, the duration of the Bloomberg Barclays U.S. Corporate High-Yield Index is 3.94 years, compared with 7.17 years for the Bloomberg Barclays Investment-Grade Corporate Index.[5] With rate hikes likely to continue

[2] Source: Barclays. As of December 31, 2017.

[3] A type of fixed expense that recurs on a regular basis.

[4] Source: MSIM. Data as of December 31, 2016.

DISPLAY 2
Size of the high-yield middle market

	BLOOMBERG BARCLAYS U.S. CORPORATE HIGH-YIELD INDEX	
	NO. OF ISSUERS	PAR AMOUNT ($ BILLIONS)
Total unique issuers	926	1,269
Unique issuers with bonds < $1bn bonds outstanding	611	304
Percentage of Index	66	24

Source: Bloomberg Barclays, MSIM. Data as of June 30, 2018.

in 2018 and into 2019, we tend to believe that middle market credits and the B and CCC segments of the market are most appealing as they tend to have even less duration than the broader high-yield market and will likely be the most sensitive to the new pro-growth agenda.

Middle Market—What Is It?

As we sit near all-time lows in yield for global high-yield indexes, and face potential rake hikes, an interesting and often overlooked way to approach high-yield investing is to focus on middle market credits. There are various ways to define the middle market portion of the U.S. high-yield universe. Revenue, EBITDA and enterprise value[6] are all valid metrics, but we find total outstanding debt to be the most appropriate gauge. Our definition has evolved over the years, but the characteristics have not. For the purposes of this paper, we define the middle market as companies with $150 million to $1 billion of total bonds outstanding. We believe that by using a disciplined and diversified approach, investing in this segment can potentially provide investors with increased yields with limited volatility throughout market cycles and less duration risk than the broader high-yield market.

Currently, middle market companies can typically offer a 100 to 150 basis points (bps) yield advantage over larger companies with similar ratings and credit statistics, which, in our opinion, is not due to their bonds being inherently more risky, but rather because of their size and market participants' regard for them.[7] It is important to note that middle market companies are smaller credits, not necessarily worse credits. The yield advantage is largely a function of this market segment being overlooked by larger market participants. Though generally assumed to be less liquid, as shown in *Display 2*, as of June 30, 2018, these issuers made up 66 percent of the U.S. high-yield market in terms of their sheer number and a quarter percent based on par amount outstanding.

Why We Think the Middle Market Is Attractive

Given the relatively small middle market issuance size, large asset managers generally tend to exclude middle market names from their focus lists because they are unable to buy enough of them to satisfy their internal portfolio allocation requirements. Furthermore, brokers and investment houses tend to overlook these issues because their larger client bases do not actively trade them.

On the primary issuance side, large dealers who underwrite bonds focus less on these issuers because they come to market much less often than bigger companies with larger and more complex capital structures. Additionally, since middle market companies issue new bonds much less frequently than larger named companies, rating agencies tend to be less focused on them. Their ratings, therefore, are often not reflective of their most recent credit profiles compared to their larger peers. In the absence of up-to-date information, rigorous bottom-up research can help uncover opportunities in any mis-rated securities.

As noted earlier, middle market issuers have typically offered a yield advantage of 100 to 150 bps versus larger high-yield borrowers, in large part because they receive less scrutiny from market participants including credit rating agencies, underwriters and asset managers. We believe one of the most attractive features of middle market bonds is derived from an investment manager's ability to use diligent fundamental research to identify issuers with the strongest credit metrics and then look to benefit from the additional yield they can provide.

Increased Dialogue With Management, Not With Investor Relations

Middle market companies also provide some advantages with respect to the research process. Credit research analysts can often speak directly with a company's chief executive officer or chief financial officer at least on a quarterly basis. This direct dialogue helps in the credit evaluation process and leads to a better understanding of management's focus on their business plan. This dynamic is much less common in larger cap issuers, as they are far more likely to have investor relations teams, who often tend to be more focused on their equity holders rather than bondholders. Management at middle market companies is usually

[5] Source: Barclays. As of June 30, 2018.

[6] EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) is a free cash flow metric. Enterprise value is a measure of a company's value, often used as an alternative to straightforward market capitalization.

[7] Source: MSIM. Data as of December 31, 2017.

interested in knowing who their bondholders are, and also engage in ongoing dialogue with them.

Structural Simplicity

Capital structures of middle market issuers tend to be simple and easy to analyze as they typically have a single tranche of bank debt and one or two tranches of bonds. Additionally, when a middle market company brings out a new issue, investors can often demand greater protections be placed in the structure, security and covenants of the new issue because of the issuer's relatively unknown quality in the overall marketplace. This can lead to increased secured bond issuance, preferable to the typical senior unsecured bond that is common in the high-yield market.

The opposite is true when you look at some of the larger issuers. The largest capital structures in the high-yield market are often an intricate web of entities that are interconnected in complicated ways. It is not uncommon to see a company move its assets from one legal entity to another internal entity, which may not guarantee the bonds that were originally issued. Assets can also be transferred to foreign subsidiaries, or dropped into a tax-advantaged structure like a master limited partnership or real estate investment trust. Inter-company loans to finance-related entities can be put in place, often at the expense of bondholders. Additionally, holding company issuance has been increasing, which are usually highly levered transactions that offer little or no asset coverage to investors. These structures can present opportunities for investors, but, given their structural complexity, they often require more legal astuteness than fundamental credit research can provide.

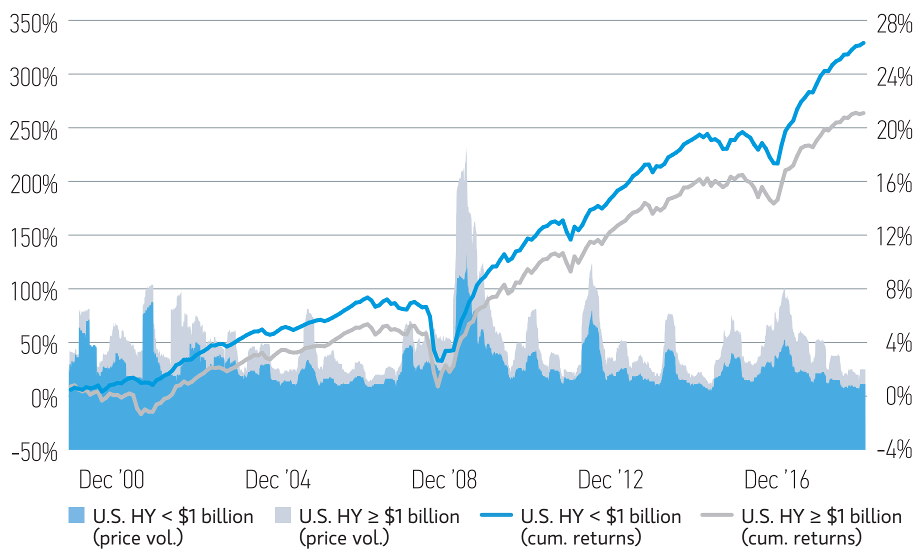
It is important to note, however, that the relative structural simplicity of middle market high-yield bonds is not a defense against their defaults, and that intensive fundamental research is still needed. For example, in 2013, a middle market issuer with a single senior secured bond and a small unsecured convertible bond defaulted on its bonds as a result of the closure of one of its key facilities in response to unexpected regulatory actions. The closed facility was instrumental to the issuer's overall operations and underscores one of the downsides to investing in smaller companies, as they may have limited operations compared to larger companies. This example helps demonstrate the need for diligent and thorough research to fully understand the credit quality and potential risks of middle market issuers.

Avoiding Volatility

A key feature that makes middle market high-yield bonds attractive is their historically lower level of volatility as compared to the larger high-yield issuers. *Display 3* compares the price volatility of middle market issuers to that of larger high-yield issuers. As there is no index of middle market credits, we have partitioned the Bloomberg Barclays U.S. Corporate High-Yield Index into two buckets, one with issuers with less than $1 billion in bonds outstanding and one with issuers with bonds equal to and greater than $1 billion. As the chart shows, volatility has been lower for the smaller middle market issuers in the Index. This is generally true, but even more so in times of market stress, like the financial crisis in 2008 and 2009, when volatility spiked dramatically. This differential becomes more pronounced in times of market distress and, at times, may exceed twice the level of the broader high yield market.

DISPLAY 3

Middle market: higher returns with lower volatility—an overlooked market segment



Source: MSIM. Bloomberg Barclays. As of June 30, 2018.

We define "middle market" as companies with $150 million to $1 billion in total bonds outstanding at the time of investment.

Before 2001, the total number of unique large-market tickers compared to the total number of unique tickers in the index was very low. Due to sample size, we chose to start at December 31, 2000. Price volatility shown in annualized rolling three month daily price volume.

Past performance is not indicative of future results. The index performance is provided for informational purposes only and is not intended to predict or represent the performance of any Morgan Stanley investment or strategy.

When markets experience periods of stress, as in 2008, investors often want to reduce holdings of risky assets such as equities or high-yield bonds and move to safer, more liquid alternatives such as cash. High-yield funds and high-yield exchange-traded funds may experience significant redemption requests, requiring managers to liquidate holdings. These funds will typically sell their largest bonds, as they are often the most liquid holdings. Investment managers also know that they will most likely be able to buy back these positions should they want to reinvest in these issues. This can lead to undesirable excess volatility and underperformance in their portfolios. In contrast, middle market bonds tend to trade more on their intrinsic fundamentals rather than on broader market technicals, like interest rate volatility or fund/capital flows.

Sharpe ratios, a measure of excess returns per unit of risk, are considerably higher in the middle market, while beta—a commonly used volatility metric—is noticeably lower, implying lower risk, as shown in *Display 1*.

Conclusion

In our experience, there are a number of reasons to consider investing in the high-yield middle market. These reasons become more pronounced when rates are rising, as they now are. Their demonstrated decreased volatility in the past is a key feature to consider, along with their associated capital structures, which tend to be relatively simple to analyze. The ability to be called at a premium, one of the common features for many, new issue high-yield bonds, helps provide these bonds with some of the lowest durations found in the fixed income market. Finally, middle market companies, with their more accessible management teams, may provide advantages to investors when analyzing their associated businesses.

For investors, fixed income investments have been a strong generator of positive returns for some time, and the U.S. high yield market is no exception.[8] However, with rate hikes likely to continue in 2018, and potential policy changes from the Trump administration, investors are left wondering what to expect next. Our view is that default rates are likely to remain contained and that high-yield issuers are the best place to be within fixed income. Furthermore, based on our analysis, we believe that the middle market of the high-yield universe, specifically, can potentially provide that sweet spot for investors—a higher yield, less correlation to interest rates and lower volatility than larger issuers for those investors comfortable with the risks of investing in the high yield sector.

[8] Bloomberg Barclays U.S. Corporate High-Yield Index as of December 31, 2017.

About the Team

RICHARD LINDQUIST, CFA®

Managing Director

Richard is Global Head of the High-Yield Fixed Income team at Morgan Stanley Investment Management. He joined the firm in 2011 and has 36 years of investment experience. Prior to joining Morgan Stanley, Richard was a managing director and co-head of U.S. High-Yield at Guggenheim Partners, responsible for portfolio management, asset gathering, client service and overseeing all high-yield trading. Previously, he was a managing director and head of the U.S. and Global High-Yield Fixed Income team responsible for managing the firm's high-yield assets for pension funds, mutual funds and insurance companies, as well as globally marketing the strategy and servicing existing high yield clients at both HSBC Halbis Partners (HSBC Global Asset Management) and Credit Suisse Asset Management. Richard received a B.S. in finance from Boston College and an MBA in finance from the University of Chicago. He holds the Chartered Financial Analyst® designation.

JACK CIMAROSA

Executive Director

Jack is a Portfolio Manager on the High-Yield Fixed Income team. He joined Morgan Stanley in 2012 and has 13 years of investment experience. Prior to joining the firm, Jack was a trader at Guggenheim Partners focused on leveraged debt. Previously, he worked in high yield at Maple Stone Capital Advisors and The Airlie Group. He began his career at UBS, where he worked on a sales desk focusing on non-dollar rates and currencies. Jack received a B.A. in media studies from New School university.

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[9] Source: Assets under management as of June 30, 2018. Morgan Stanley Investment Management is the asset management division of Morgan Stanley. Assets are managed by teams representing different Morgan Stanley Investment Management legal entities; portfolio management teams are primarily located in New York, Philadelphia, London, Amsterdam, Singapore and Mumbai offices. Figure represents Morgan Stanley Investment Management's total assets under management/supervision.

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DEFINITIONS

Credit risk is the risk of loss of principal or loss of a financial reward stemming from a borrower's failure to repay a loan or otherwise meet a contractual obligation.

Interest rate risk is the risk that an investment's value will change due to a change in the absolute level of interest rates, in the spread between two rates, in the shape of the yield curve or in any other interest rate relationship.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates.

Callable indicates that a security contains an embedded call provision that allows the issuer to repurchase or redeem the security by a specified date.

Par amount outstanding is the total dollar value of bonds issued for a specific bond issue.

Beta is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole.

The **Sharpe ratio** is calculated by subtracting the risk-free rate from the rate of return for a portfolio and dividing the result by the standard deviation of the portfolio returns.

INDEX DEFINITIONS

The **Bloomberg Barclays U.S. Corporate High Yield Index** measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The Index excludes emerging market debt.

The **Bloomberg Barclays U.S. Corporate Index** is a broad-based benchmark that measures the investment grade, fixed-rate, taxable, corporate bond market.

The indices are unmanaged and it is not possible to invest directly in an index.

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