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Managing known unknowns in the high yield market

Listing the risks in a bond issue is a relatively straightforward task since every prospectus includes an extensive compilation of disclosures. However, it is crucial to differentiate between risks that can be reasonably estimated and priced and those that, due to their inherent nature, are extremely challenging to quantify. Certain industries are particularly susceptible to "tail risks," which can result in exceptionally severe losses.

Bob Sydow
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Management

In the high yield market, some risks are less obvious than others.

One of the main reasons for our High Yield strategy's past success is that we consider multiple types of risk when we analyze an issuer's bonds, with some risks being less obvious than others. That is especially true when investing in financial issuers. In this article, we cover a partial list of risks we consider before investing, and why we always avoid the banking sector and financial intermediaries who rely on short-term funding. The rapid collapse of Silicon Valley Bank (SVB) in March of 2023 will serve as an exemplary case study of why our avoidance of the sector is justified.

Transformation risk | When a company can change its risk profile quickly. When SVB decided to "reach for (a tiny amount of) extra yield," they rapidly extended the average duration of their enormous bond portfolio to six years, vastly longer than the duration of their liabilities. This illustrates how financial firms can transform their risk faster than any industrial firm. They can sell a bond portfolio and re-invest in a very different one within a week or two, or use an interest rate derivative to do the same thing in an instant. By comparison, it took an industrial company like Enron years to make the scale of changes to its risk profile that SVB accomplished in weeks.

Transparency risk | When a firm can alter its risk profile in subtle and hard to spot ways. Within a complex (or even not so complex) bank, it can be difficult for an external investor to gain full transparency into such quick, transformative actions. In SVB's case (and thus the large increase in risk), the changes to their portfolio were disclosed without management comment or discussion, only deep in the notes to the financial statements in the bank's annual (not quarterly) reports.

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Structural risk | Bond holders are put at the back of the line. In a bank, unsecured bondholders are deeply subordinated in the debt structure much more so than in an industrial or service company. In a bankruptcy, they are paid after the vast deposits and the derivatives counterparties, which usually means they are not paid at all. Bondholders are also usually structurally subordinated because their claim is on the holding company, not the operating company.

Confidence risk and regulatory response | When a loss in confidence results in a rapid and permanent destruction of value. Unlike an industrial company, a bank's key asset during stress is a fragile intangible—confidence—whose half-life can nowadays be measured in hours. And unlike an industrial company, during the endgame a powerful player with different incentives may emerge who is not present with industrial companies. That is to say, bank regulators, usually at the federal but occasionally at the state level, may intervene to put a decisive (and perhaps premature) end to rescue measures that could have salvaged value for bondholders.

This was certainly true at SVB, where deposits were withdrawn so fast that no orchestrated rescue was possible. In a single day, the bonds issued at the bank level dropped in value by 90 percent, and they have not recovered. Regulators have declared that those bonds will be "wiped out." Signature Bank bonds now trade at two cents on the dollar. First Republic bonds trade at one cent. All three of these were rated investment grade at the time of their closures. (The holding company bonds of SVB dropped by less, because SVB had nonbank assets which were not subject to a run on deposits.)

Lessons from The Great Recession

High yield investors would do well to remember that during the Great Recession of 2008, the two most spectacular defaults were the formidable Lehman Brothers and AIG. Both, like SVB, seemed strong and sported high bond ratings just days before their sudden collapse. What is less well remembered is that almost all of Wall Street, all of which was highly levered with short-term debt, was effectively bankrupt in 2008, which is testament to the magnitude of this risk. The only other industry we can recall being subject to such an industry-wide instant calamity is the tourism industry, which was crushed by both terrorism and Covid. (We don't invest in airlines, hotels or restaurants either.)

The $700 billion Troubled Asset Relief Program (TARP) was passed to bail out the largest investment banks, but that aid was not extended to the much smaller financial institutions which had issued high yield bonds because they were not large enough to pose a systemic risk to the financial system. The banks agreeing to receive massive preferred stock investments from the Treasury included Goldman Sachs Group Inc., Morgan Stanley, J.P. Morgan Chase & Co., Bank of America Corp. (which had just agreed to purchase Merrill Lynch), Citigroup Inc., Wells Fargo & Co., Bank of New York Mellon and State Street Corp. These are the headliners that everyone remembers. What is often forgotten, though, is that 67% of the total par value of high yield bonds issued by financial intermediaries defaulted during the Great Recession. This is the highest cohort default rate for any industry in the 45-year history of the high yield market.

We believe that the prudent response to these realities is to completely avoid this industry, as we have done since our inception in 1999.

Know which risks you can estimate and price, and which ones you can't

There are structural and permanent reasons why financial issuers historically have a:

- Long-term default rate that is a multiple of the average of safer industries
- Recovery rate on bonds that default which is chronically below the market average

While many of these risks are unique to financial firms, not all of them are. Mesirow High Yield products have never invested in a financial intermediary which relies on news-sensitive deposits or wholesale funding. Likewise, we avoid investments where business economics can change readily, where transparency is difficult to obtain, and where industries are prone to improper risk analysis by those who are running the company.

We believe our careful analysis of the many different risk types allows us to invest confidently in smaller, lower-rated bonds, and thus we can reap higher-than-benchmark yields without a commensurate increase in default risk. The SVB failure, and other bank failures after SVB's downfall, simply serve as further reminders why our approach has proven prudent over time.

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