SKY HARBOR
CAPITAL MANAGEMENT
Responsible Investing for a Sustainable Future

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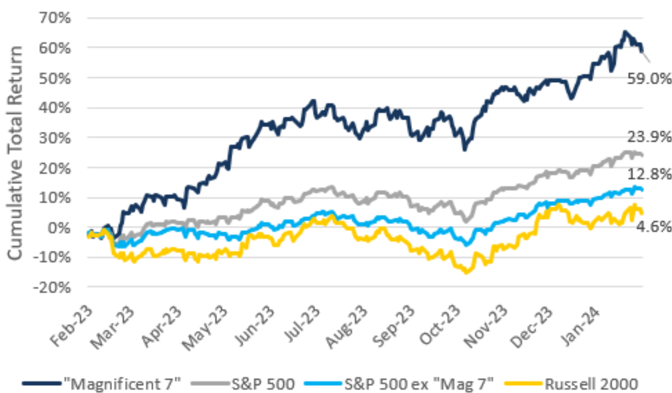
SKY Harbor Weekly Briefing

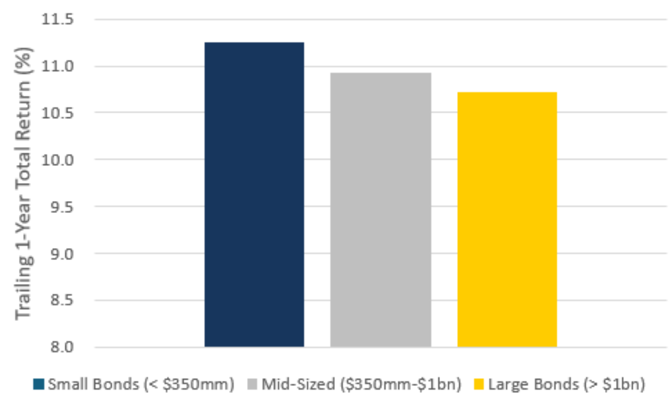
Time to Sweat the Small Stuff?

Much has been made about small cap stock underperformance over the last several years, with assumed drivers that include reduced availability of capital, higher interest rates, persistent labor competition, and a lack of M&A activity, to name a few. Though this dynamic is evident by simply viewing trailing returns of the Russell 2000 Index relative to the S&P 500, a seemingly opposite trend has emerged in US high yield bond markets. In this *Weekly Briefing*, we compare recent "small" vs. "large" bond performance, noting fundamental and technical reasons for the recent divergence, and outlining our rationale for a potential inflection on the horizon.

The "Magnificent 7"

Coined the "Magnificent 7" by Bank of America strategist Michael Hartnett, this group of mega-cap tech stocks (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla) has significantly outperformed the market over the last year. The magnitude of their outperformance and disproportionate impact on the S&P 500 (now ~ 30% by market cap) has somewhat distorted performance for the index as a whole. As demonstrated below (left side), **exclusion of the "Magnificent 7" from our proxy of large cap stocks closes a significant portion – though not all – of the outperformance relative to the Russell 2000 Index, our small cap proxy**. In US high yield bond markets, however, performance divergence has been far less notable, even skewing in the opposite direction. In the chart below (right side), we note that "small" bonds ($350mm outstanding and lower) have outperformed "large" bonds ($1bn in size or greater) by over 50 bps on a trailing 12-month basis.

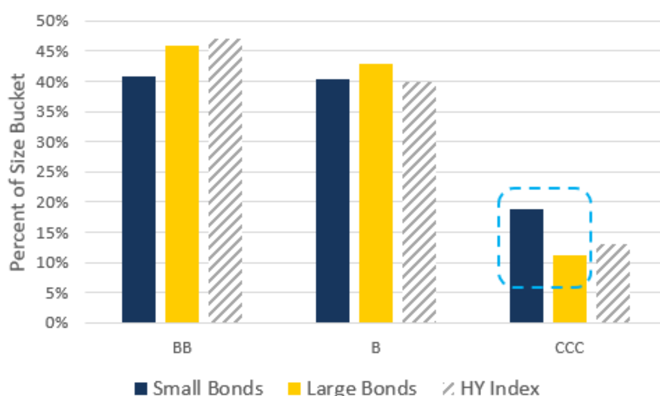


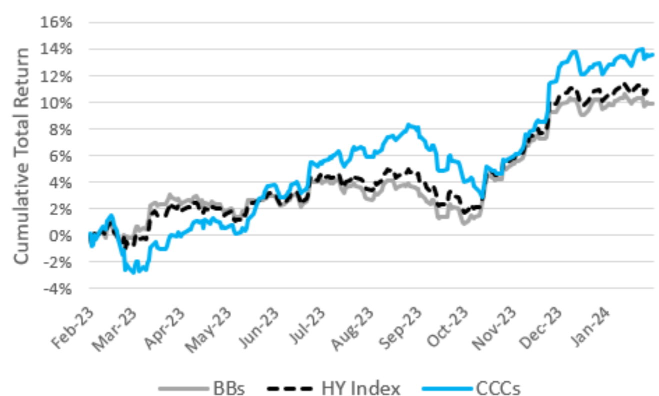


Source: SKY Harbor, UBS, Bloomberg, ICE Data Indices

Rewarding of Risk

As noted in a prior *Weekly Briefing* entitled "Christmas Came Early," CCC-rated debt outperformed other rating buckets in 2023, largely a function of disinflation progress and "soft landing" enthusiasm, which displaced a base case recession outlook that was so prevalent in 2022. **CCC-rated debt makes up ~ 19% of the "small" bond cohort, nearly twice the relative magnitude found among "large" bonds** (~ 11%). As such, we think part of small issue outperformance over the last year is a function of ratings skew – not dissimilar to the role the "Magnificent 7" played in pulling up the performance of large cap equities relative to their small cap peers – albeit less concentrated.

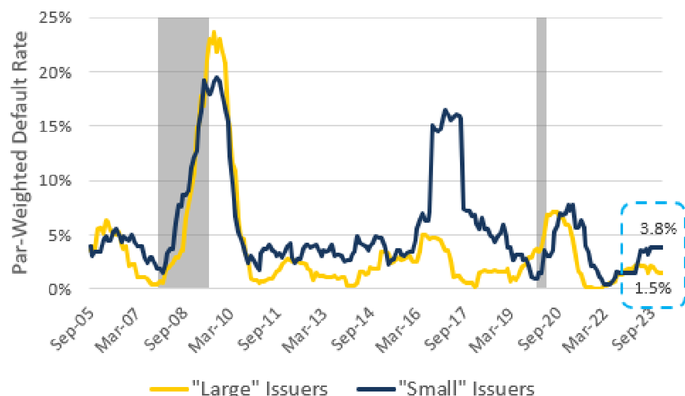


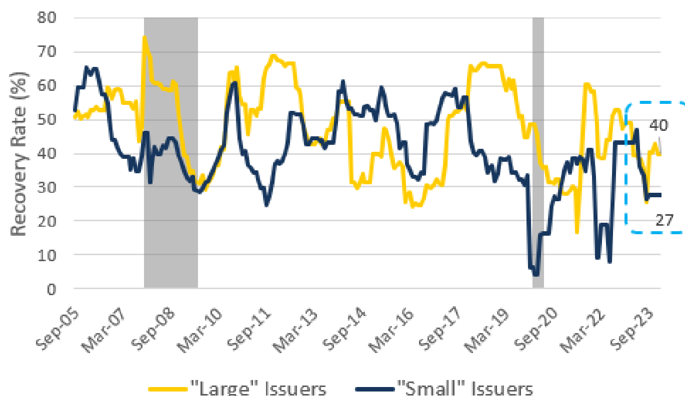


Source: SKY Harbor, ICE Data Indices

Stronger Fundamentals in Large Structures

From a fundamental perspective, does small issue outperformance appear warranted? To address this question, we present below a time series of default and recovery rates, which show moderate dispersion at present based on data collected since 2005. For simplicity, and to account for issuer size evolution and distortion stemming from large capital structures at times issuing small bonds, we utilize BofA Merrill Lynch's framework, defining "large" and "small" cohorts by face value of bonds outstanding (top and bottom quartiles, respectively). As demonstrated below, **default rates for "small" issuers are running at a level more than twice that of "large" issuers**, while recovery rates on those defaulted bonds have similarly diverged. Despite this, "small" performance has not suffered.

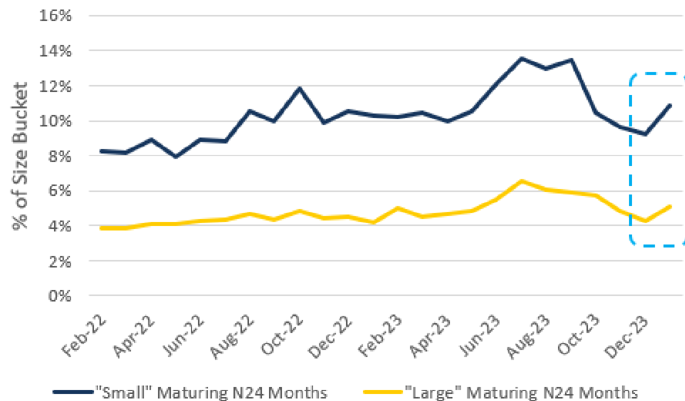


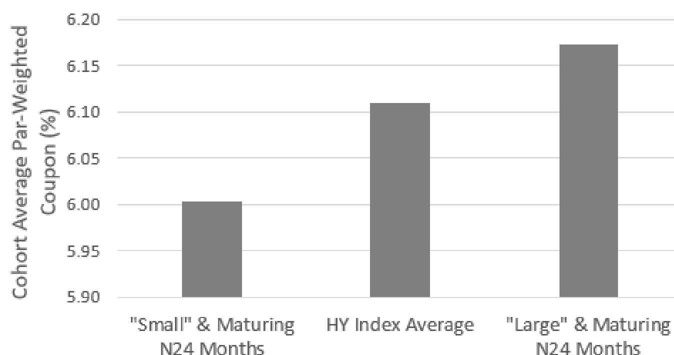


Source: SKY Harbor, BofA Merrill Lynch, The National Bureau of Economic Research, Bloomberg

Small Issuers Face Greater Refi Hurdle

Additionally, and as noted in an October '23 *Weekly Briefing* entitled "Not Yet Up Against a Wall," par-weighted coupons are set to ratchet up from bottom decile levels as issuers are forced to address upcoming maturities, causing concern among some market participants that this repricing will negatively impact fundamental credit ratios on a go-forward basis, which ultimately drive future default rates. As highlighted below, **a greater proportion of "small" bonds are set to mature in the next 24 months, implying greater upward pressure on issuer interest expense relative to the "large" subset**. With existing coupons modestly lower than the index average, "small" issuers appear at greater risk of interest coverage erosion in the coming quarters, all else being equal.



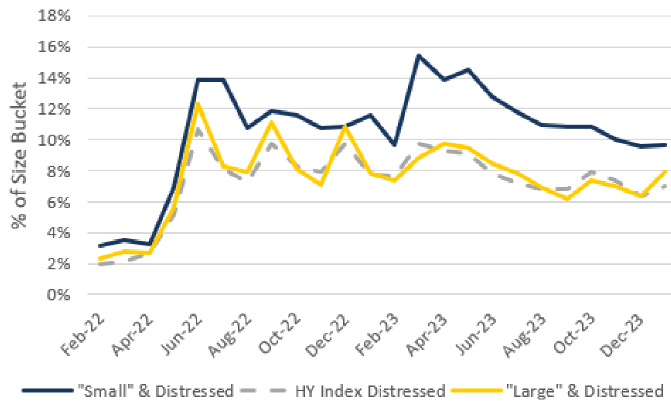


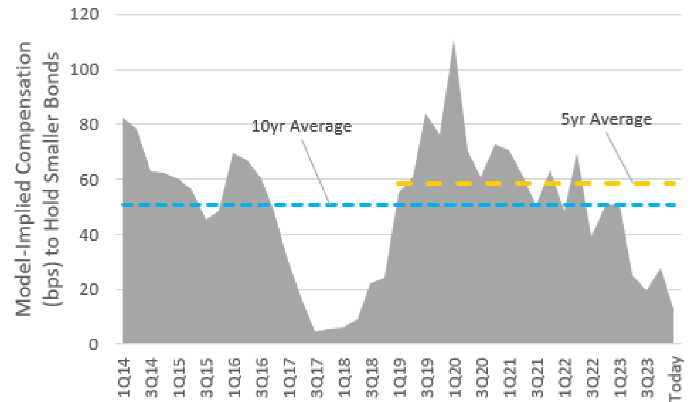
Source: SKY Harbor, ICE Data Indices

More Stress, Less Pay

We would also highlight that **"small" issues disproportionately fall into the "distressed" category**, commonly defined as bonds with an option-adjusted spread in excess of 1,000 basis points. While the distressed cohort has recently outperformed the balance of the index, likely contributing to "small" bond outperformance, a turn in sentiment may negatively impact this group, which tends to trade with greater volatility than non-distressed bonds.

Finally, in a *Weekly Briefing* from nearly a year ago entitled "Recalculating Factor Compensation," we noted our aim to generate, on a monthly basis, a regression-derived estimation of compensation per unit risk factor, with differences in credit quality (via weighted average rating factor), tenor (via duration), and liquidity (via bond issue size) constituting ~ 90% of index option-adjusted spread variability over time, in our view. At the onset of the pandemic, we estimated the illiquidity premium was running at nearly 2x the long-run average, and normalization of that metric led to small issues outperforming large issues and the index in general by over 2,100 bps and 1,450 bps, respectively, in the 35 months ended February 28, 2023**. At present, illiquidity compensation, after adjusting for differences in credit rating and duration, is well below historical norms**. As such, we view smaller issues as generically "rich" in the current market environment.





Source: SKY Harbor, ICE Data Indices

Adjusting our Bias

Higher defaults, lower recoveries, and incremental refi pressure appear at odds with small issue outperformance within US high yield bonds over the last 12-month period, a trend that stands in stark contrast to large cap dominance on the equity side. Though we have historically been willing to overweight the "small" issuer subset – in part due to perceived pricing inefficiencies given a limited buyer base and absence of sell-side coverage – the lack of meaningful illiquidity premiums (in aggregate) continue to dampen our enthusiasm for such securities in the current market environment. As such, we anticipate a continued portfolio shift toward larger and more liquid exposure in the coming months.

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