OPINION

Ellen Carr

Only Special Investors Get to Buy These Bonds. They Make Up More Than Half of the High-Yield Bond Market.

The case for liberating a growing market

February 21, 2020

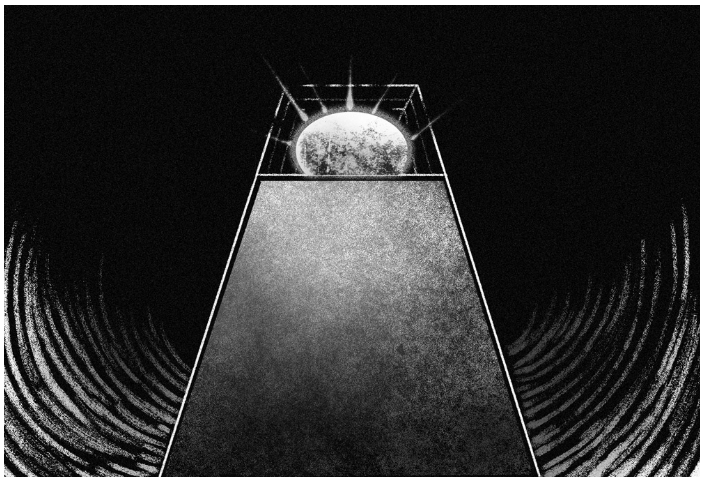

Illustration by II

Imagine if you were the CIO of a small liberal arts college with an endowment of $65 million. With students agitating for fossil fuel divestment, you initiate a search for an investment manager to construct a portfolio that accomplishes this goal. You find exactly what you're looking for — a boutique firm that specializes in customized accounts for small institutions like yours, with fees only modestly higher than those of the index fund you're currently invested in. You are ready to liquidate your index fund position and transfer the proceeds to this new manager — when the firm's chief compliance officer tells you that your account will be eligible to own only *half* of the securities in the index.

If this sounds like hyperbole, look no further than the high-yield bond market.

144A securities — that is, unregistered bonds available only to qualified institutional buyers, or QIBs — now make up just over half of the high-yield bond market. This is a substantial increase from even a few years ago; 144As were only 19 percent of the market in 2012. Even more significant, 144A bonds made up more than three quarters of new high-yield issuance in 2019. At this rate, the entire high-yield bond market is going to be 144A by the middle of the decade.

If you're wondering what a QIB is, it's defined as an institution with more than $100 million in investable assets. In practice, the QIB designation process varies: Some compliance officers at investment management firms take a by-the-book approach, which means that even if a firm manages in excess of $100 million, any institutional client below that threshold in investable assets doesn't get designated as a QIB. This applies to a larger group of institutions than you might imagine; for example, *U.S. News & World Report* says that the median college endowment was $65 million in 2018. And according to Candid (formerly the Foundation Center), the average assets under management of U.S. foundations is $10 million.

The murky rules about who can, and who can't, buy 144As invite deliberate misinterpretation. Brokers generally won't sell unregistered securities to "unsophisticated" (non-QIB) investors, as they can be sued for doing so. But there are ways around this; some brokers, for example, market the Regulation S tranche of a 144A issue (which is supposedly designated for non-U.S. investors) to non-QIBs as a backdoor way to offer their clients access to this category of bonds. And some investment managers take a "don't ask, don't tell" approach with institutional clients, and hope that their broker counterparties don't ask for more specific certification.

By this point, you're likely thinking of 144A bonds as obscure securities issued by private companies no one has ever heard of — like, say, a tiny oil and gas driller with a few wells, or a private equity–owned fertilizer manufacturer — without enough publicly available information on which to base an investment decision. It's true that companies like these have accessed the high-yield market via 144A issuance.

But you would be wrong to view these as the typical 144A issuers.

Many 144As are issued by public companies and Securities and Exchange Commission filers, sometimes with other registered bonds and exchange-traded common stock. Companies issue 144As to decrease origination fees, documentation, and time to market relative to SEC-registered bonds. Of the top-ten issuers in the Barclays high-yield index, there are only two with *no* 144As in their capital structures, whereas more than half of the top ten have minimal registered debt outstanding. One top-ten issuer, Bausch Health, has *only* 144A bonds. On the other hand, all but one of the top-ten high-yield issuers have publicly traded stocks. So "unsophisticated" investors can load up on the highest-risk security in the capital structure — but the SEC deems the layer above this (and in some cases several layers above) too risky.

I'll use a real-life example to illustrate the unintended consequences of 144A buyer restrictions. Transdigm Group is a publicly traded aircraft component manufacturer (and No. 11 in the index referenced above). Let's say you're a high-yield portfolio manager with a new mandate for a small endowment client. Using publicly available information and filings (10Ks, 10Qs, earnings call transcripts), your credit analyst has built a cash flow model and calculated ratios to measure credit quality (e.g., debt/EBITDA, fixed charge coverage) for the company. You get comfortable with Transdigm's balance sheet and trajectory, although you are a little leery of the management team, which regularly issues debt to finance large acquisitions. And most of Transdigm's bonds are rated low-single-B, only one notch above CCC. As your client's guidelines don't permit CCC-rated securities — a typical restriction in the institutional universe — you are sensitive to downgrade risk; you don't want to be a forced seller.

Your analyst informs you that Transdigm has two types of bonds: secured and unsecured. *Great*, you think — i. Secured bonds provide investors with an added layer of protection in the form of collateral. Additionally, they often have better covenant protection against incremental debt issuance collateralized by the same security. In the (unlikely) event of Transdigm's bankruptcy, you'd get a much better recovery in the secured bond. The ratings agencies know this; the secured bond is rated two to three notches higher than the unsecured bond by both Moody's and S&P (Ba3/B+ versus B3/B–). Investors know this; the secured bond has a lower yield and spread than a comparable-maturity unsecured bond. The only entity that doesn't know this is the SEC; because Transdigm's secured bond is 144A, it's off limits to non-QIBs. You can invest your client's account in Transdigm 's unsecured debt or publicly traded stock — but you cannot purchase the safest security in the capital structure, which is the most appropriate for your client's account.

The impact of this shift to private issuance has a couple of negative consequences.

For one, it funnels small institutions into an investment vehicle that may be ill-suited to their needs. High-yield funds subject investors to the whims of bear credit markets, as managers are forced to sell securities into frozen markets. They promise liquidity that the underlying securities don't enjoy in stressed markets. High-yield bonds have T+2 settlement dates; good luck matching these up with the typical T+1 settlement date of a mutual fund experiencing panicky redemptions. And funds don't allow for client-specific exclusions (e.g., no fossil fuels), which can be particularly important to endowments and foundations.

Two, it exacerbates diversity issues. Minority- and woman-owned investment firms manage only about 1 percent of assets under management across the industry. Happily, some clients are starting to focus on hiring MWBE investment managers. But imagine trying to raise $50 million in seed capital to launch a high-yield bond fund while telling your clients you can invest in only half the market.

This new accessibility challenge in the high-yield market is particularly ironic because it bucks the overall trend of better access for smaller investors. Limited trading liquidity outside of large "block" trades used to make it difficult to get adequate diversification in high-yield in accounts below $10 million. A decade ago trading in sub–$1 million lots ("odd lots") generally meant wider bid-ask spreads, limited liquidity, and poor execution. But since the credit crisis, trading has gotten easier for small high-yield investors. MarketAxess (an electronic trading platform for bonds that also happened to be one of the best-performing Nasdaq stocks in 2019) and other e-trading ventures, as well as a new class of broker-dealers that specialize in algorithmic and matched trades without prop desks, are providing liquidity in odd-lot trading. Price transparency has increased with Trace, the bond pricing service available on Bloomberg, which as of 2014 includes trading levels and volumes for 144A bonds. Bid-ask spreads (the difference between the prices at which you can buy and sell a given bond) have declined for odd-lot trades. These are welcome developments that have made high-yield more attractive both to investors (by reducing trading costs) and issuers (by reducing funding costs). But so long as half the market is off-limits to non-QIBs, these advantages don't accrue to some of the small institutions that could most benefit from them. The Gates Foundation and Harvard University have always had access to customized, adequately diversified separate high-yield accounts; the small liberal arts college with a $65 million endowment continues to be excluded from this investment opportunity.

I'm neither a securities lawyer nor a regulator, so I don't have a solution to this issue other than the obvious: Relax restrictions for 144A trading, and relax registration documentation for well-known issuers. Perhaps the best place to start would be to differentiate between 144As issued by "reporting" and "nonreporting" issuers (this distinction is exactly what it sounds like — companies that file public financials with the SEC versus those that don't). Another approach might be to create a streamlined or fast-track, low-cost registration process if the issuer already has other registered securities, or if the bond is guaranteed by an entity with registered securities.

There is plenty of public information available to analyze these companies and their 144A bonds. The protection offered by the QIB buyer restriction is mostly protecting the market share (and fees) of large mutual fund managers.

Related Content

SPONSORED

Citadel May Make History With Bond Issue

November 28, 2006

SPONSORED

U.S. Legal Issues For Non-U.S. Equity Derivative Market Participants: A Primer - Part 2

March 10, 2006

SPONSORED

Adapting to Rapid Change and Finding Opportunities in Fixed Income

Sponsored by iShares December 04, 2019

PORTFOLIO

Julie Segal

How Private Equity Became a Beta Play

All the numbers point to private equity and venture capital being at a peak. But it's not for the reasons many think, according to McKinsey.

February 21, 2020

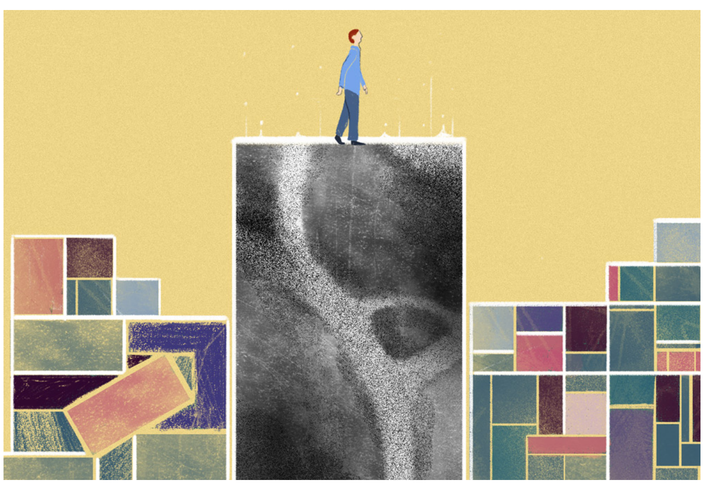

Illustration by II

Institutions once invested in private equity for the potential to earn higher returns than other asset classes, and the persistence of the outperformance, among other things. But pensions, sovereign wealth funds, endowments, and other institutions are now allocating increasing amounts to private markets because they don't have a choice, according to a McKinsey & Co. report expected to be released Friday.

Institutional investors "used allocate to PE for three reasons: outperformance versus public markets, predictability as there was strong persistency of top quartile managers, and the belief that PE was fairly uncorrelated," said Bryce Klempner, a partner at McKinsey and one of the authors of the report.

"Uncorrelation was a myth to begin with," he went on. "The extent of outperformance and persistency have declined but have not disappeared. Both are still valid reasons for investors to look to PE. However, there's another reason to be in the asset class now, which is exposure." The number of private equity-owned companies has doubled since 10 years ago, Klempner pointed out, and the number of publicly traded companies is half that of 20 years ago. "Institutions need to be in private equity if they want exposure to growth companies, regardless of whether they can pick the top managers."

[*II* Deep Dive: Private Equity Changes Everything]

Private equity still has the potential to outperform, but it's not as easy for investors to choose the top managers, as their persistence has declined, according to McKinsey's report.

"Although persistency of outperformance by PE firms has declined over time, making it harder to consistently predict winners, new academic research suggests that greater persistency may be found at the level of individual deal partners," the report's authors wrote. "In buyouts, the deal decision-maker is about four times as predictive as the PE firm in explaining differences in performance." However, the McKinsey report stressed that it is difficult for institutions to make funding decisions based on individuals.

"Most LPs think they are above average at picking the winners," Klempner said. "But only half of them can beat the median." As a result, many investors' performance expectations may be too high.

Klempner explained that investor demand for broad-based exposure to private equity is what has driven fundraising and other metrics to records.

Assets in private markets increased by $700 billion in 2019, and $4 trillion over the past decade, according to McKinsey. The number of private equity firms grew in tandem, more than doubling during the time period. Meanwhile, the number of private equity-backed companies in the U.S. increased by 60 percent, according to the consulting firm.

Fundraising has also been strong. McKinsey reported that by the end of 2019, the industry had raised $919 billion, a little less than what was gathered in 2018. Despite that, 2019 was the second best year for fundraising ever, according to the report. The consulting firm expects 2020 to be another healthy year for fundraising, as large private equity firms have said they are targeting an aggregate intake of about $350 billion.

Dry powder, or cash on hand to invest, also hit records last year. Uninvested capital reached $2.3 trillion in the first half of 2019, up from $2.1 trillion the year before.

Kempner sees both fundraising and dry powder as in line with the growth of the industry overall.

“Dry powder is not just a keg of powder getting bigger,” Kempner said. “It’s inventory. When you’re a small business, you need less inventory than when you're larger. So it's much more about how many years of capital do you want to have on hand. If it were zero, the industry wouldn’t have any money for a rainy day. And that’s when you can buy low.”

According to the report, dry powder is at a “record in absolute terms, though the roughly two ‘turns’ of annual deal volume that this represents is within the range of historical norms.”

While institutional investors are allocating more to private equity and venture capital, McKinsey said that, compared to targets, investors are under-allocated by more than $500 billion in private equity alone.

The sizes of private market funds are growing along with the amount of assets. When it comes to buyout funds, half of the total amount of money raised in 2019 was pulled in by funds of $5 billion or more. The market share of smaller funds, those below $1 billion, is at a fifteen-year low as well.

“Yet paradoxically there is little evidence of any consolidation at the top of the industry,” the report found. “And even as the number of active PE firms continues to grow (it’s now nearly 7,000), more managers are calling it quits than ever. Most of those raised just one fund, suggesting that attrition is mainly a result of one-and-done managers.”

Filed Under: Portfolio

Related Content

CORNER OFFICE

McKinsey: Mounting Dry Powder Is Nothing to Worry About

Staff February 23, 2017

PORTFOLIO

The Power of Private Equity

Gary Pinkus and Conor Kehoe November 13, 2009