Less is More: The Advantages of Small and Mid-Tier Fixed Income Managers

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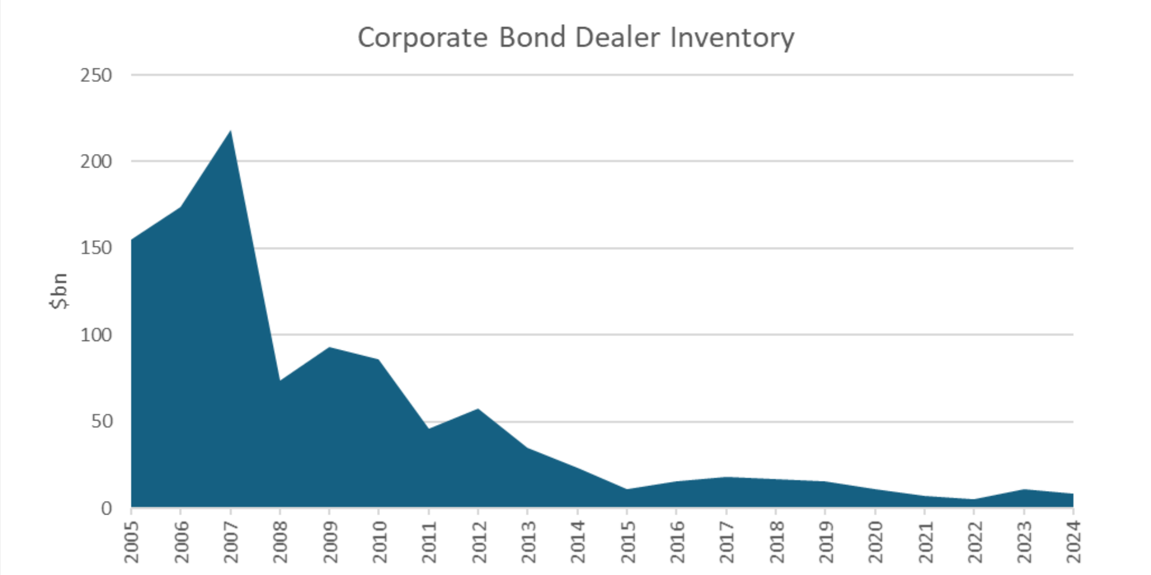
INTRODUCTION

With the presence of ever-changing headlines, volatility and higher yields in the fixed income markets can provide great opportunities to generate outsized returns. One of the key components of fixed income investing is the ability to remain active and shift the portfolio to current market dynamics. That ability can be significantly impacted by the overall size of a fixed income portfolio. Specifically in the corporate bond market, having an appropriate asset level can allow a portfolio manager to be nimble and proactively re-position the portfolio to their liking.

DEALER INVENTORY

The ability to be nimble is particularly helpful in periods of illiquidity when activeness and the capacity to quickly transact is most important. Regulations, many stemming from the Great Financial Crisis, added requirements that restricted the ability of dealers to hold inventories of corporate bonds on their balance sheet. This lowering of balance sheet holdings coincided with a rise of debt issuance in the corporate bond market, fueled by low-interest rate policies.

This dynamic of increased bond issuance and lower dealer inventories has led to decreased liquidity and higher volatility, making it more difficult to transact on larger issues of bonds.



Source: New York Fed

CORPORATE BOND FLEXIBILITY

Investing in the corporate bond space can present itself in a multitude of ways. Opportunities can range from analyzing the quality of a bond issuer, where specific bonds fall within the credit curve and the issuer's capital structure. These different issuances can vary in size and being smaller allows a manager to be flexible in how they can allocate amongst them. Smaller issue sizes, for example, may not be investable for larger managers as their exposure could make them substantial owners of the overall issue.

Liquidity, and specifically the ability to sell positions, is an important advantage for more nimble fixed income managers. Larger positions are analogous to a larger ship, and the amount of time it takes to turn one around. The sheer position size makes it more difficult to execute, especially in times of strain. In contrast, smaller managers hold less amounts of an issue and can more actively sell a position and reallocate to a potentially better opportunity.

The size of a manager's portfolio is an important factor in allowing that manager to express their investment views. A large asset base could constrict the manager from purchasing, or selling, securities in a timely matter or at all. To demonstrate the restrictions that a large manager could face, we have constructed two scenarios:

Large Bond Issuance of $1 billion, with the manager purchasing a 3% position

Asset Manager Size	$15bn	$5bn	$500mm
3% Position	450mm	$150mm	$15mm
% of issue size	45%	15%	1.5%

In this scenario, the larger manager can purchase the security but would own 45% of the issuance, and the mid-tier manager would own 15%. This could severely impact their ability to sell the security in a timely manner while achieving proper execution. This is especially important if the issuer is underperforming or at risk.

Small Bond Issuance of $100 million, with the manager purchasing a 3% position

Asset Manager Size	$15bn	$5bn	$500mm
3% Position	450mm	$150mm	$15mm
% of issue size	450%	150%	15%

In this scenario, a 3% position for both the large and mid-tier manager exceed the overall issue size of the bond. Therefore, it would be impossible for each to purchase a meaningful position of this bond for their portfolios. In contrast, a smaller manager would be able to reasonably purchase this issue without worrying about liquidity risk.

Within the investment grade universe, many times the best value can be found in the small issuer sizes as there are less players involved to drive the spreads down. At times, a limited amount of a security can also become available at a discounted price. For example, a broker might be clearing out aged inventory or a manager could be rebalancing a new account.

PERFORMANCE

The performance of a fixed income portfolio can be attributed to several different factors, including duration, yield curve, sector allocation and security selection. When it comes to providing alpha relative to one's peers, security selection is one of the most important factors and one that can be easily quantifiable when comparing the performance of one bond versus another. Smaller and more nimble managers have additional resources to source opportunities to provide better security selection and alpha, while larger funds tend to more likely mimic an index and have a higher exposure to the beta factor.

CONCLUSION

The uncertain macro environment, coupled with the existence of higher yields, have made fixed income a very attractive asset class and there are ways in which a manager can differentiate itself from its peers. One of those ways is the ability to be nimble and quickly navigate the positions within the portfolio. We expect a period of volatility to persist and for this advantage of active managers to be even more important within the fixed income space.

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22 Years of Investment Experience

13 Years with Sawgrass

Mr. Siegel is a Fixed Income Portfolio Manager at Sawgrass, responsible for credit analysis, trading, and portfolio analytics. He serves on the firm's fixed income investment committee. Prior to Sawgrass, he worked with Pioneer Alternative Investments as a fixed income research analyst, where he selected sub-advisor funds for inclusion in a $3 billion fund of hedge funds, and with Morgan Stanley as a fixed income sales analyst servicing advisors on various fixed income investments. His educational accomplishments include a B.S. in Financial Economics from Binghamton University, and earning a Chartered Financial Analyst (CFA) designation from The CFA Institute (formerly AIMR), of which he is a member.

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