

Optimal Factors in High Yield Portfolio Construction

Introduction

The publicly traded U.S. high yield bond market is large at roughly \$1.5 trillion, and it is very diverse. Enormous companies, with enterprise values in the hundreds of billions, sit in the high yield index alongside smaller companies with enterprise values in the hundreds of millions. Relatively high quality, near investment grade ‘crossover’ issuers sit alongside lower quality ‘distressed’ and practically bankrupt issuers. Within high yield, it is widely known that quality has been a strong factor over long time periods, with BB’s and B’s historically generating higher returns than CCC’s, and doing so with less volatility. While less scrutinized, issue size also appears to be a strong factor historically, with a tendency for smaller issues to generate stronger income and total return.

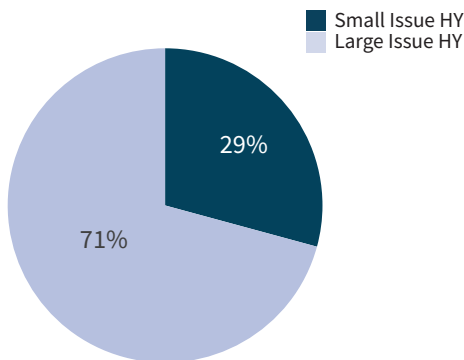
We believe a high yield portfolio that captures both factors, higher quality and smaller issue size, can consistently outperform the broad high yield market.

Observation #1: There is a broad and investable opportunity set of smaller high yield issues.

The median issue size in the ICE BofA US High Yield Index is \$600 million. For our purposes, and because the index segregates the market here, we will consider smaller issues as those below the market median (currently \$600 million) and larger issues as those above the median. By market value, smaller issues represent 29% of the high yield market.

High Yield by Market Value

As of 03.31.2025

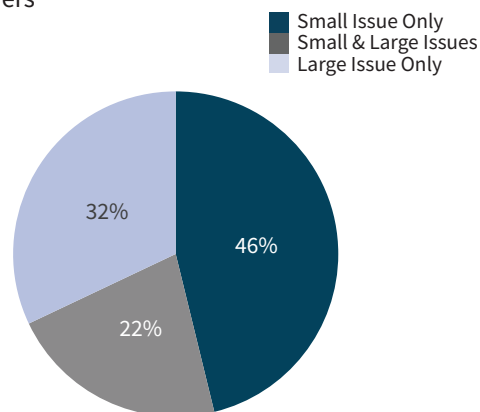


Source: ICE BofA Indices. ICE BofA Small Cap by Par Cash Pay High Yield Index. ICE BofA Large Cap by Par Cash Pay High Yield Index.

Most smaller issues are from issuers that are generally smaller in size. However, some are from larger companies that have both smaller and larger issues in their capital structures. The smaller issues in these cases are often the result of corporate actions like mergers, acquisitions, and partial tenders. As of Q1 2025, 596 issuers, representing 68% of the market have a smaller issue in their capital structure. We see this as a broad range of companies from which to research and select potential investments.

High Yield Issuers

As of 03.31.2025



Source: ICE BofA Indices. ICE BofA Small Cap by Par Cash Pay High Yield Index. ICE BofA Large Cap by Par Cash Pay High Yield Index.

The issuer quality distribution is similar among smaller and larger issues, as seen in the following chart.

Quality Distribution

As of 03.31.2025

	Small Issue	Large Issue
BB-rated	57%	55%
B-rated	32%	35%
CCC-rated	11%	10%

Source: ICE BofA Indices. ICE BofA Small Cap by Par Cash Pay High Yield Index. ICE BofA Large Cap by Par Cash Pay High Yield Index.

Sector composition differs somewhat between smaller and larger issues, with the Basic Industry and Energy sectors currently comprising larger weights among smaller issues. The following chart shows the top 10 sector weights for each and suggests adequate sector diversity is achievable in the smaller issue market.

Top 10 Sector Weights
As of 03.31.2025

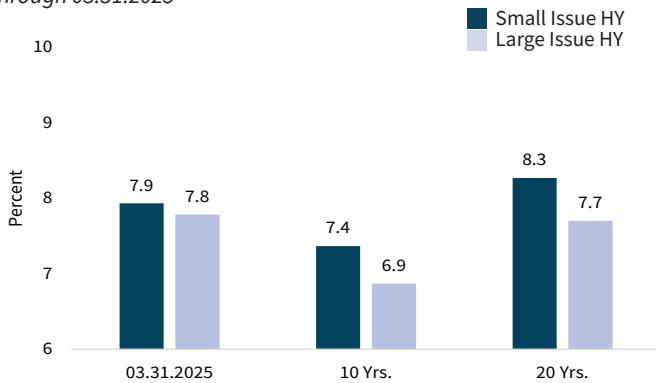
Small Issue	Weight (%)	Large Issue	Weight (%)
Basic Industry	14%	Energy	11%
Energy	12%	Media	11%
Financials	8%	Healthcare	9%
Real Estate	7%	Basic Industry	8%
Services	7%	Telecommunications	7%
Capital Goods	7%	Capital Goods	6%
Retail	7%	Services	6%
Leisure	6%	Financials	5%
Technology	5%	Retail	5%
Healthcare	5%	Technology	5%

Source: ICE BofA Indices. ICE BofA Small Cap by Par Cash Pay High Yield Index. ICE BofA Large Cap by Par Cash Pay High Yield Index.

Observation #2: Smaller issues yield more and have a wider range of coupon options.

Smaller high yield issues typically yield more, on average, than larger issues. High yield ETFs predominantly own larger issues in their effort to replicate the broad market. It may be difficult for the largest ETFs and fund complexes to own small issues in sufficient size to have a meaningful impact on their portfolios, and consequently it makes little sense for them to focus significant research resources here.

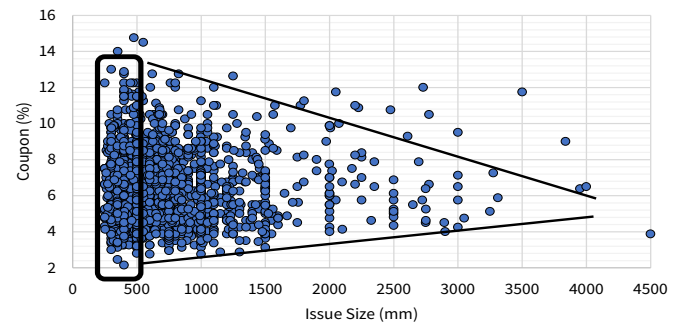
Average Yield to Maturity
Through 03.31.2025



Data as of 03.31.2025
Source: ICE BofA Indices. ICE BofA Small Cap by Par Cash Pay High Yield Index. ICE BofA Large Cap by Par Cash Pay High Yield Index.

We believe this dynamic adds pricing inefficiencies to the cohort of smaller issues, resulting in a wider range of new issue coupons. Greater coupon diversity among smaller issues is helpful in constructing a portfolio focused on income.

Coupons by Issue Size
As of 03.31.2025

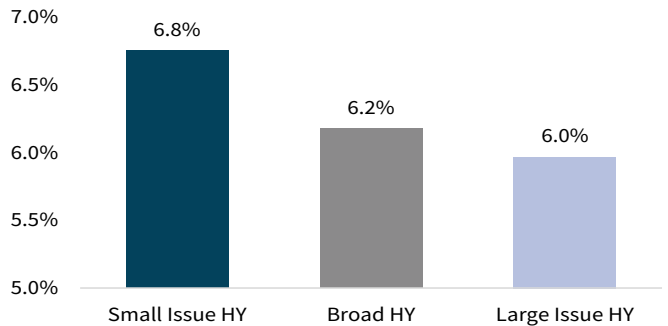


Source: ICE BofA Indices. ICE BofA US Cash Pay High Yield Index.

Observation #3: Smaller high yield issues have historically outperformed with lower volatility.

With a quality distribution like the larger issues, and typically higher yields, smaller issues tend to outperform over long time periods. The outperformance holds when looking at averages of rolling 3-year and rolling 5-year time periods.

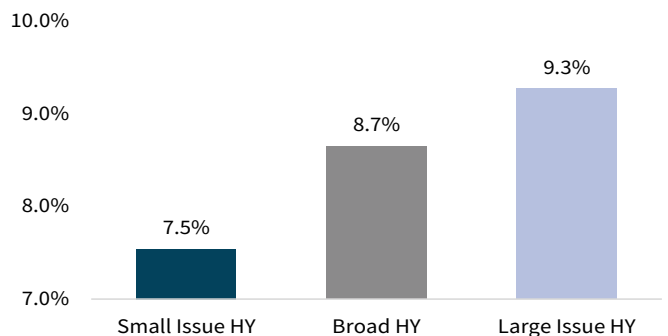
Annualized Returns
1998 - Q1 2025



Data as of 03.31.2025
Source: ICE BofA Indices. ICE BofA Cash Pay High Yield Index. ICE BofA Small Cap by Par Cash Pay High Yield Index. ICE BofA Large Cap by Par Cash Pay High Yield Index.

Given that smaller issues are generally not heavily owned by ETFs and large mutual funds, they are less susceptible to short term trading swings caused by retail inflows and outflows. This may partially explain why smaller issues typically exhibit lower return volatility. Relative volatility also holds when looking at the averages of rolling 3-year and rolling 5-year time periods.

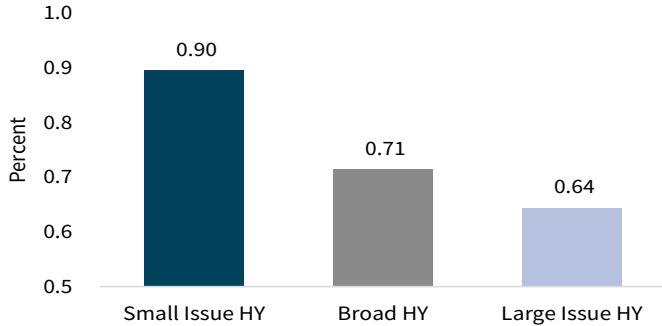
Standard Deviation
1998 - Q1 2025



Data as of 03.31.2025
Source: ICE BofA Indices. ICE BofA Cash Pay High Yield Index. ICE BofA Small Cap by Par Cash Pay High Yield Index. ICE BofA Large Cap by Par Cash Pay High Yield Index.

When one considers relative return and relative volatility in unison, smaller issue high yield bonds look like a sweet spot for striving to generate attractive risk-adjusted returns within the broader high yield market.

Simple Sharpe
1998 - Q1 2025

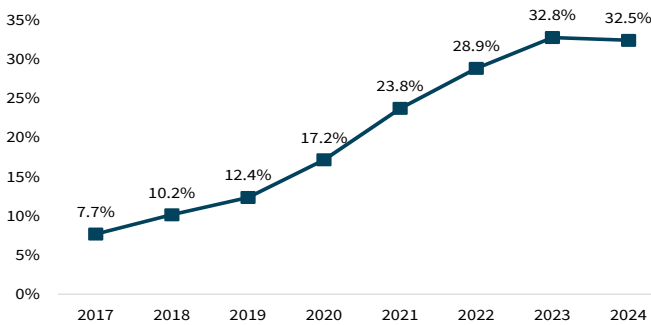


Data as of 03.31.2025.
Source: ICE BofA Indices, ICE BofA Cash Pay High Yield Index, ICE BofA Small Cap by Par Cash Pay High Yield Index, ICE BofA Large Cap by Par Cash Pay High Yield Index.

Observation #4: Liquidity is improving.

The emergence of electronic trading for corporate bonds has been a significant market development over the last ten years. Electronic trading platforms bring together additional market makers and more competitive pricing for any given trade than the traditional ‘over the counter’ trading protocol. Furthermore, with an electronic platform intermediating, buy-side accounts can trade directly with one another, which is a relatively new source of additional liquidity. The advent and growth of electronic trading platforms for corporate bonds, high yield bonds in particular, enhances liquidity for smaller high yield issues.

Market Share of the Four Largest High Yield Electronic Trading Platforms
2017 - 2024

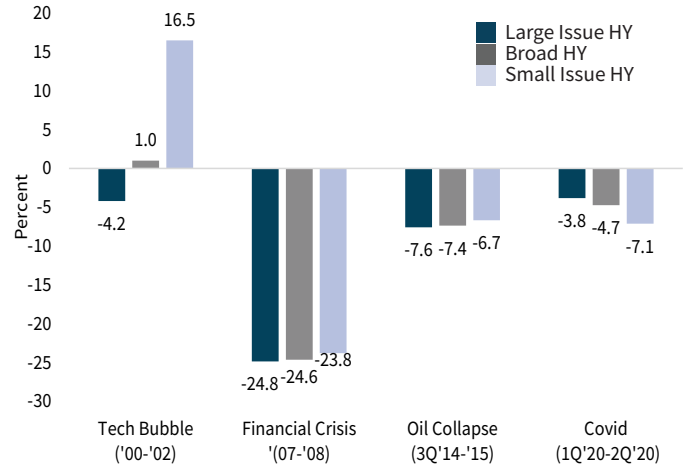


Data as of 12.31.2024.
Source: Chartwell Investment Partners; MarketAxess and Tradeweb; Trumid; Bloomberg

Another way to consider liquidity is to look at performance during periods of acute market stress. Smaller issues underperformed somewhat at the immediate onset of the Covid-19 pandemic, though we note smaller issues have since outperformed over the entirety of the post pandemic recovery. During the Financial Crisis of 2008 and the Oil Collapse of 2015, smaller issues outperformed, but only marginally. Interestingly, smaller issues outperformed handily during the Tech Bubble of '01-'02. This was likely due to heavier concentrations in the Basic Industry and

Energy sectors at the time and significant under-exposure to Technology and Telecommunications. In our experience, performance during periods of market stress has been highly influenced by quality and sector concentrations and has had little to do with issue size.

Performance During Market Stress

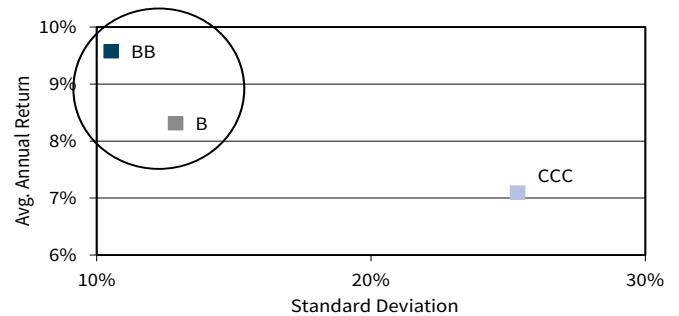


Data as of 12.31.2024.
Source: ICE BofA Indices, ICE BofA Cash Pay High Yield Index, ICE BofA Small Cap by Par Cash Pay High Yield Index, ICE BofA Large Cap by Par Cash Pay High Yield Index.

Observation #5: Like quality, smaller issue size is a winning factor in high yield.

The market has long known that strategic allocations to high yield are best served focusing on the higher quality tiers of the market (BB-rated and B-rated) based on historical returns and volatility. We believe CCC-rated allocations should be thought of as more tactical, as we see little reason for a CCC-rated allocation over a complete economic cycle.

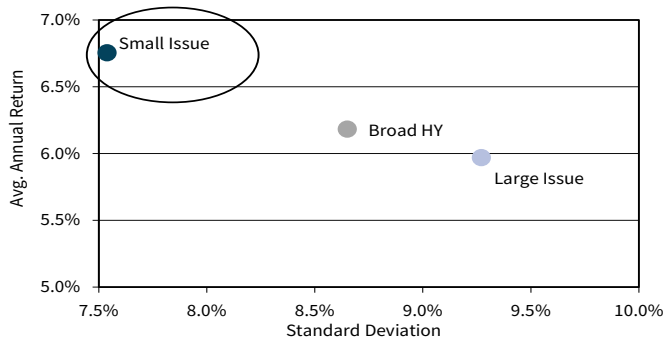
HY Returns and Standard Deviation by Rating
1984 - 2024



Source: Bloomberg US High Yield Indices
Data as of 12.31.2024. The chart indices are subsets of the ICE BofA US High Yield Index and are the ICE BofA BB US High Yield Index; ICE BofA B US High Yield Index and the ICE BofA CCC US High Yield Index.

Perhaps not as well known, a strategic allocation to the smaller issue portion of the high yield market may also be prudent based on historical returns and volatility. Larger issue exposure, perhaps via an ETF or large fund complex, appears more tactically suited in this framework.

HY Returns and Standard Deviation by Issue Size
1998 - Q1 2025



Data as of 03.31.2025
Source: ICE BofA Indices, ICE BofA Cash Pay High Yield Index, ICE BofA Small Cap by Par Cash Pay High Yield Index, ICE BofA Large Cap by Par Cash Pay High Yield Index.

Summary

Smaller high yield issues have historically outperformed the broad high yield market in both absolute and risk-adjusted terms. In the cohort of smaller issues, experienced managers with strong fundamental credit research capabilities have a wide opportunity set to continually look for interesting and potentially alpha-generating ideas. Focused managers can look to this space to harvest incremental income compared with the broad high yield market without sacrificing quality. Inefficiencies around smaller high yield issues allow a manager to construct a portfolio of equal or better quality *and* equal or greater income than the broad high yield market. In an efficient market, these portfolio qualities ought to be mutually exclusive, but a focus on smaller high yield issues appears to make both achievable. In our view, quality paired with smaller issue size is a winning combination and portfolios exhibiting both factors in unison can be part of the solution to help investors meet their income needs.

Definitions

ICE Bank of America (ICE BofA) US Cash Pay High Yield Index is an unmanaged index used as a general measure of market performance consisting of fixed-rate, coupon-bearing bonds with an outstanding par which is greater than or equal to \$50 million, a maturity range greater than or equal to one year and must be less than BBB/Baa3 rated but not in default.

The Broad HY refers to the **ICE BofA US Cash Pay High Yield Index** defined above.

The Small Issue HY refers to the **ICE BofA US Small Cap by par Cash Pay High Yield Index** which is comprised of the smallest 50% of issues by par value within the ICE BofA US Cash Pay High Yield Index.

The Large Issue HY refers to the **ICE BofA US Large Cap by par Cash pay High Yield Index** which is comprised of the largest 50% of issues by par value within the ICE BofA US Cash Pay High Yield Index.

Index returns have been taken from published sources. Indices are unmanaged, and one cannot invest directly in an index. Market index results shown are not reduced by any fees as an index is unmanaged.

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Risk Considerations: Historically, bonds have indeed provided less volatility and less risk of loss of capital than has equity investing. However, there are many factors which may affect the risk and return profile of a fixed income portfolio. The two most prominent factors are interest-rate movements and the creditworthiness of the bond issuer. Generally, when interest rates rise, bond prices fall and when interest rates fall, bond prices generally rise. The risk of a change in the market value of the investment due to changes in interest rates is known as interest rate risk. Interest-rate risk is subject to many variables but may be analyzed based on various data (e.g., effective duration).

The risk that the issuer may default on interest and/or principal payments is often referred to as credit risk. Credit risk is typically measured by ratings issued by ratings agencies such as Moody's and Standard & Poor's. A credit rating of a security is not a recommendation to buy, sell or hold the security and may be subject to review, revision, suspension, reduction or withdrawal at any time by the assigning Rating Agency. Ratings and insurance do not remove market risk since they do not guarantee the market value of the bond. Bonds issued by the U.S. Government have significantly less risk of default than those issued by corporations and municipalities. However, the overall return on Government bonds tends to be less than these other types of fixed-income securities. Finally, reinvestment risk is the possibility that the proceeds of a maturing investment must be invested in a lower yielding security, all other things held constant, due to changes in the interest-rate environment. Investors should pay careful attention to the types of fixed-income securities which comprise their portfolio, and remember that, as with all investments, there is the risk of the loss of capital.

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