NEWPERSPECTIVES

Commentary from New Century Advisors
April 2017

Looking for the Fat Pitch

- ‘Fat pitches’ are rare, but the market occasionally throws smaller, chubby pitches
- Major index rule changes cause dislocations
- 15% of the investment grade utilities sector dropping out of the index
- Catch high quality credits at discounts

Index Rule Changes Present Chubby Pitches

As active bond managers we are always looking for the proverbial ‘fat pitch’; the market opportunity where the reward to risk ratio is heavily skewed in one’s favor. In truth, ‘fat pitches’ are few and far between and are usually only obvious in hindsight. Market dislocations that cause prices to stray from value are accompanied by the uncertain probability of loss or in other words, risk. However, from time to time the market throws smaller, chubby pitches. The recent rule changes to the US Broad Index provided managers with one such opportunity to take a swing.

On April 1st, the Bloomberg Barclays US Aggregate Index changed its minimum issue size from $250mm to $300mm. The rule change impacted 985 individual issues totaling $272 billion or 1.4% of the Index. Of the $272bn, 67% or $182bn is Corporate debt and the remaining $90 billion is Government Related. The following table shows the distribution of debt impacted by sector.

($ Billions)	Market Value	New Market Value	Change	% Change
Treasury	$ 6,959	$ 6,959	$ -	0%
Securitized	$ 5,831	$ 5,831	$ -	0%
Gov Related	$ 1,512	$ 1,422	$ (91)	-6%
Corporate	$ 4,962	$ 4,780	$ (182)	-4%
Industrial	$ 3,025	$ 2,937	$ (88)	-3%
Utility	$ 382	$ 324	$ (58)	-15%
Financial	$ 1,556	$ 1,520	$ (36)	-2%
Total	$ 19,264	$ 18,992	$ (272)	-1%

Source: Bloomberg Barclays Index as of 1/31/2017

Forced Selling of High Quality Credits

In anticipation of the rule changes, we saw index funds sell these smaller corporate issues. Not surprisingly, the selling caused spread widening in the 250-300mm issue sizes (see below) and offered very

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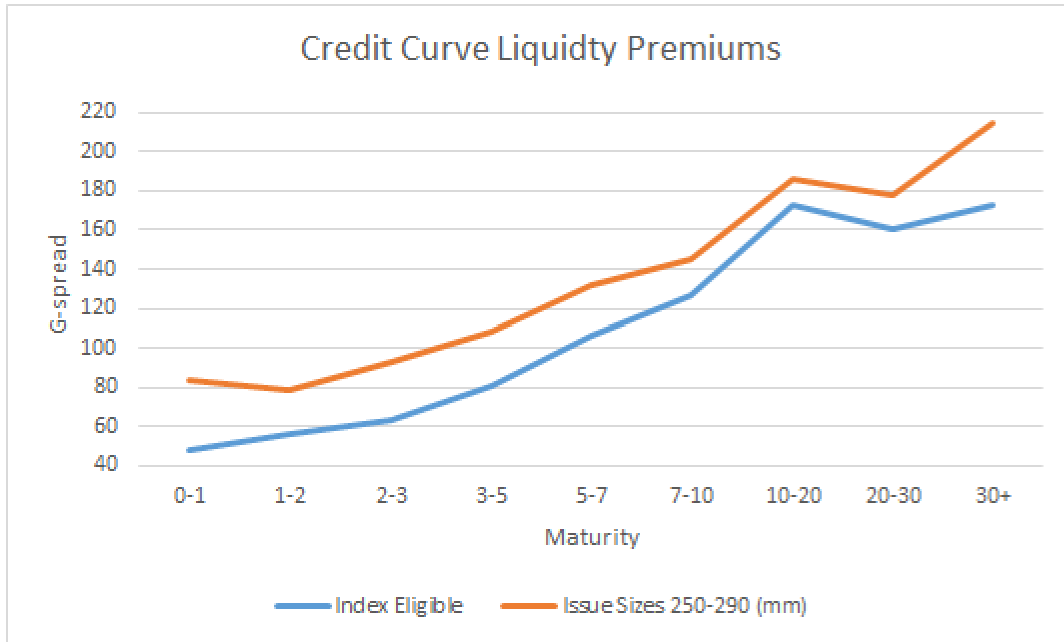
attractive liquidity premiums verses the Index eligible comparators. Liquidity premiums for non-index issues typically range from 10 to 50 basis points depending on the credit quality of the issuer, the sector, dollar price and maturity. Given the uneven distribution of small deal sizes, some corporate sectors were disproportionately impacted by these rule changes.



Within the Utility sector, approximately $57.8 billion in market value or 15% became Index ineligible. Given that these smaller Utility issues are thinly traded and quite illiquid, the selling widened spreads dramatically despite the relatively high quality and defensive nature of these credits. In much the same way that technical selling pressure occurs when a bond is downgraded to high yield, these market dislocations can ultimately prove to be a great buying opportunity for active managers.

In Closing

While it is impossible to predict the duration of this technical dislocation, past experience tells us the opportunity won't last long. We have already seen a number of issuers 'tap' outstanding deals, i.e. increase the size of their outstanding issue in order maintain an index presence. We have viewed this technical dislocation and widening in a number of these issues to as an opportunity to add high quality credits at significant discounts and take active, non-index risk verses our benchmark.

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For more information on any of the data, trends, or trading strategies in this piece, or to discuss how New Century Advisors might help you to manage your inflation risk, please contact Leigh Talbot, CFA, Director of Client Relations at 240-395-0012 and ltalbot@ncallc.com

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