Mike Salice, CFA
Director of Research
msalice@skyhcm.com
February 17, 2020

Weekly Briefing

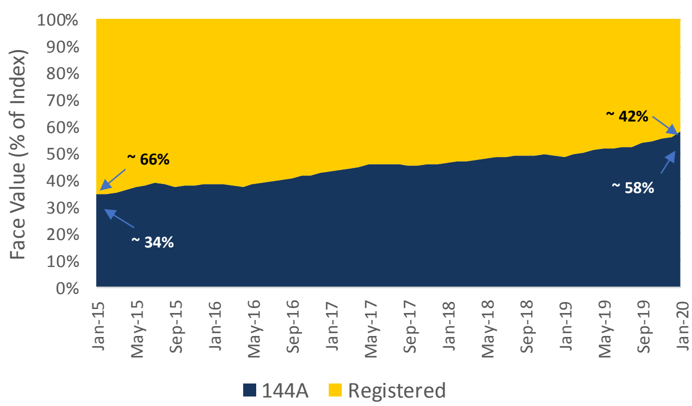
SKYView: The Rise of Unregistered Bonds under Rule 144A

In past research pieces, we have highlighted the move upward in quality that the ICE BofA US High Yield Index (ticker H0A0, our proxy for broad market high yield risk) has enjoyed in recent years, noting that the percentage of BBs are now higher (and the percentage of CCCs are now lower) than in prior spread-tight periods. A less apparent but nevertheless impactful dynamic has been the proliferation of 144A bonds, which now outnumber SEC-registered issues in the H0A0 Index. In this *Weekly Briefing*, we discuss these market changes and test the merits of the notion that 144A bonds tend to represent greater underlying risk than their registered counterparts.

Historically speaking, non-registered issues (referred to as “144A” bonds, in reference to Rule 144A promulgated under the Securities Act of 1933, as amended, that provides a safe harbor exemption from registration) made up a very small portion of the high yield index. As recently as 15 years ago (February ’05), there were only 335 bonds in H0A0 classified as 144A, or approximately 17% of all issues. These securities tended to come from smaller, sometimes private issuers and remained in the minority as public companies with listed equity made up ~ 2/3 of the index. This dynamic has rapidly changed: as demonstrated below, **144A securities have eclipsed SEC registered bonds in both face value and issue count**, even though the proportion of public companies in the index remain essentially unchanged. Note that 144A bonds (58% of the index) represented in the chart below include those with and without registration rights; through January 31, 2020, 95% of this group was 144As without registration rights.

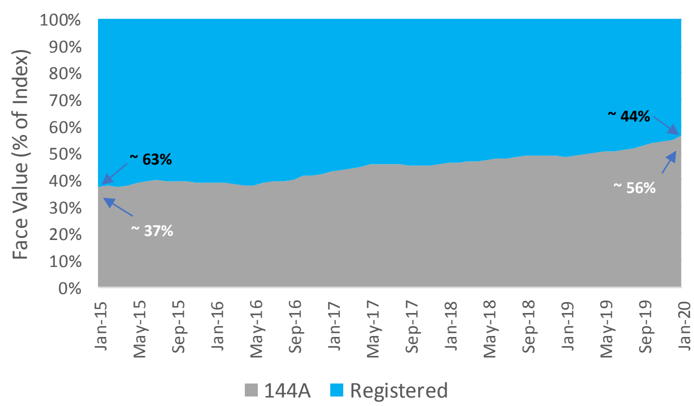
US High Yield Index Face Value by Issuance Type

face value, monthly data over the last 5 years



US High Yield Index Issue Count by Issuance Type

face value, monthly data over the last 5 years

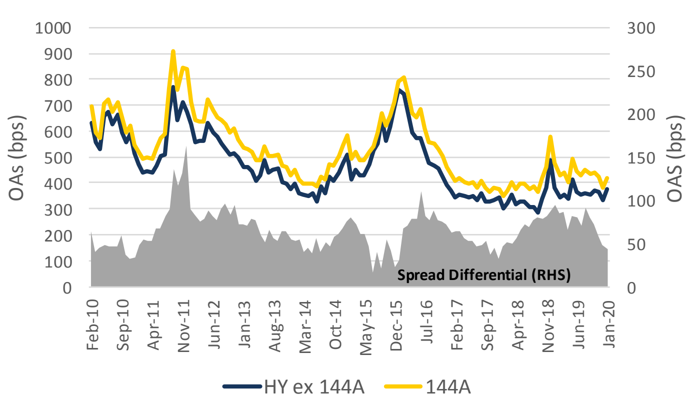


Source: SKY Harbor, ICE BofA Indices, Bloomberg

As shown below, 144A issues have traded at an average OAS spread differential of +65 bps versus registered bonds over the last 10 years, seemingly justified given a relatively lower threshold for information disclosure. As 144A issuance has proliferated – now, many companies with public equity are opting to issue unregistered bonds, and there are numerous examples of capital structures of the same issuer that contain both 144A and registered bonds – such premiums should have diminished. **After controlling for differences in ratings and duration, premiums appear to have done just that, with OAS differentials eroding over the last several years**. Put another way, on an apples-to-apples, oranges-to-oranges basis, the market views registered and unregistered bonds as virtually indistinguishable. The word “fungible” also comes to mind.

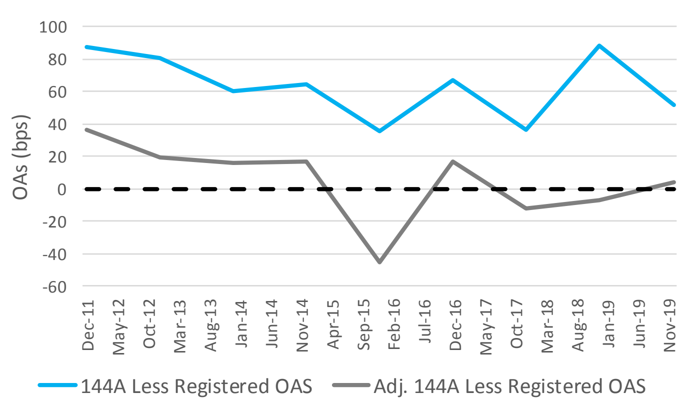
144A Bonds Have Historically Had Wider Spreads…

monthly data, trailing 10 years



…Controlling for Ratings & Duration Erodes Most of the Premium

annual data, trailing 10 years

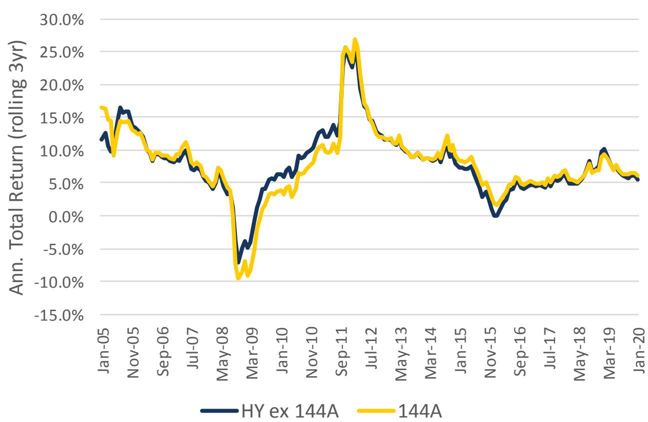


Source: SKY Harbor, ICE BofA Indices, Bloomberg

Using H0AX (the ICE BofA US High Yield Excluding 144A Index) and making some assumptions to create a 144A-only index (largely calculating the difference between H0A0 and H0AX), we then compared rolling-three-year annualized return and volatility metrics for both cohorts. Our findings show that **our 144A index had similar returns relative to the registered bond index over the last 15 years** – a dynamic that makes sense to us as the differences between registered and non-registered issues have significantly diminished, and as the 144A sample size has gotten larger and more diverse. **144A bonds, however, have demonstrated bouts of higher volatility in periods of stress**, most notably around the time of the last recession and in periods impacted by the European sovereign debt crisis. On the other hand, 144A bonds have closely paralleled registered bonds in recovering from volatile periods and in the last four or five years have actually experienced less volatility than its comparable cohort.

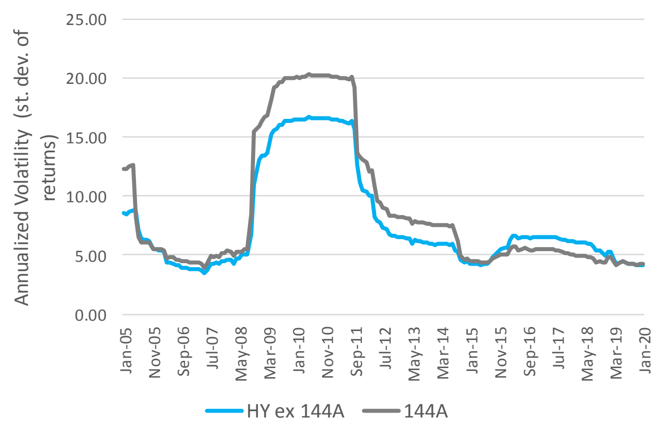
Rolling 3yr Annualized Returns

monthly data, trailing 20 years



Rolling 3yr Annualized Volatility

monthly data, trailing 20 years

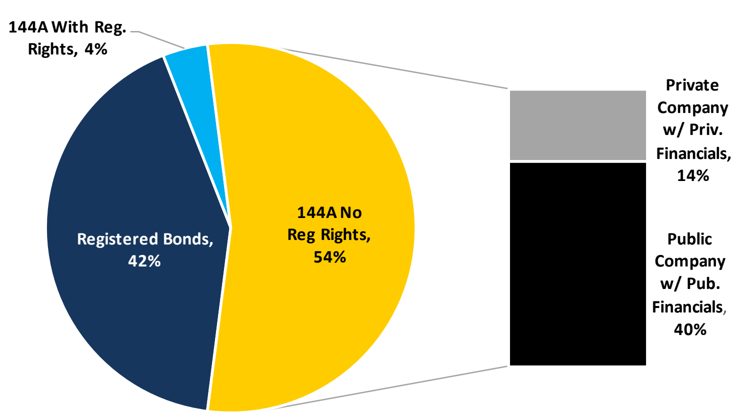


Source: SKY Harbor, ICE BofA Indices, Bloomberg

Given these findings, we would then expect a dummy variable (1=144A bond with no registration rights) to be statistically insignificant in the calculation of constituent-level OAS after controlling for items we know require compensation in the high yield market (term risk, credit risk and small issue / illiquidity risk). Upon first run, however, the variable proved significant, and implied that 144A issues with no registration rights carried a 33 bps discount to registered bonds after controlling for differences in duration, ratings and issue size. Further examining the pool of 144A securities with no registration rights, we found that a small portion (~25%) was made up of private companies with financials that were harder for investors to obtain (i.e., they were stored in password-protected data sites available only to current or prospective owners of the bonds). To account for this additional layer of opacity, we created another dummy variable (1=private company with private financials), the incorporation of which made our 144A with no registration rights designation no longer statistically significant with respect to differing OAS spreads with registered bonds. As such, **we find that premiums associated generally with 144A with no registration rights issuance can be attributed only to the subset of private issuers that limit accessibility of financial information – an intuitively logical outcome**. These issues tend to trade ~ 80 bps cheap to registered bonds.[1]

High Yield Index Constituents

data as of January 31, 2020 (most recent month end)



OAS Drivers: Regression Output Implies Private vs. Public Distinction Statistically Significant, 144A Designation is Not

HY Index (H0A0) at Jan. 31, 2020

Factor	*Coefficients*	*P-value*
Intercept	0.0	
Term Risk (Duration)	44.2	0.0000
Credit Risk (WARF)	89.4	0.0000
Small Issue (1 or 0)	55.4	0.0003
Private Financials (1 or 0)	80.6	0.0000

Source: SKY Harbor, ICE BofA Indices, Bloomberg

[1] In order to reduce noise associated with bonds trading to a very short call, trading distressed (to a recovery price), and other outliers, we limit our dataset to exclude bonds with a spread below 100 bps or above 1,000 bps, and also exclude bonds with a duration below 2.0 or above 8.0

In conclusion, 144A bonds now outnumber registered issues (in both number of issues and face value) and now make up more than half of the high yield bond market as reflected by the ICE BofA US High Yield Index (~ 58%). Furthermore, the market appears to view registered and 144A unregistered bonds as virtually indistinguishable as differences in spread have essentially disappeared, particularly when adjustments are made for variances in credit rating and duration over time. Remaining discounts in spread, in our view, are derived from the subset of 144A issues that are private in nature, with financial information restricted to current or prospective owners of the securities.

Addendum

We chose to analyze non-registered issuance in this *Weekly Briefing* because of implications Rule 144A can have on many asset managers, investors and issuers in the high yield bond market and elsewhere. One of the central conditions of Rule 144A is that the unfettered purchase and sale of such securities can only be made by and to qualified institutional buyers ("QIBs"), a definition for which the SEC has recently invited public comment (due March 15, 2020) with respect to proposals the SEC issued to amend the definition of a QIB that would expand the list of entities that are eligible to qualify as QIBs. See SEC Release 33-10734, December 18, 2019 and published in the Federal Register on January 15, 2020. While not advocating any specific suggestion for public comment here, we, nevertheless, believe our findings are highly supportive generally of expanding the current boundaries of the Rule 144 safe harbor and in our view are entirely consistent with the SEC's stated mission of protecting investors, maintaining fair, orderly & efficient markets, and facilitating capital formation.

On the Calendar

Occurred

Event	Release Date	Period	Survey	Actual	Prior
CPI MoM	13-Feb-20	Jan	0.2%	0.1%	0.2%
Import Price Index MoM	14-Feb-20	Jan	-0.2%	0.0%	0.3%
Retail Sales Advance MoM	14-Feb-20	Jan	0.3%	0.3%	0.3%

Upcoming

Event	Release Date	Period	Survey	Actual	Prior
Empire Manufacturing	18-Feb-20	Feb	5.0		4.8
Building Permits	19-Feb-20	Jan	1450k		1416k
PPI Final Demand MoM	19-Feb-20	Jan	0.1%		0.1%

Source: SKY Harbor, Bloomberg

Recommended Reading

House, Billy, et al. (2020, February 13). Sanders as Front-Runner Raises Democratic Jitters in Congress. *Bloomberg*, Retrieved from https://www.bloomberg.com/news/articles/2020-02-13/sanders-as-frontrunner-raises-democratic-jitters-in-congress

Fan, Wenxin, et al. (2020, February 13). Sharp Rise in Coronavirus Cases Raises Questions about Outbreak's Peak. *The Wall Street Journal (subs. req.)*, Retrieved from https://www.wsj.com/articles/sharp-rise-in-coronavirus-cases-raises-questions-about-outbreaks-peak-11581617783?mod=hp_lead_pos6