ASSESSING THE RISKS AND RETURNS OF BBB CREDIT

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There has been a great deal of commentary recently about the risks posed by BBB rated corporate bonds. Warnings abound of a 'bond catastrophe' caused by quantitative tightening and, specifically, a meltdown in BBB credit as issuers are downgraded to high yield status or default. Should credit investors be worried?

Since the global financial crisis, there has been a proliferation of BBB issuance, prompted by the prevailing monetary conditions of ultra-low interest rates and quantitative easing. It is argued that, as these conditions reverse, the receding tide will reveal companies that have borrowed excessively or over-engineered their balance sheets. As they either default or are downgraded, investors will suffer mark-to-market losses at best or capital destruction at worst.

While there are some reasons for concern and a prudent approach is sensible, we feel these arguments are extreme and investors shouldn't be spooked. A key reason for our more positive outlook, however, is our active investment approach. Through a strong investment philosophy and process, we aim to avoid bonds with an unfavourable risk/return trade-off and focus on assets with much more attractive risk/return profiles.

We would be more concerned by the growth in BBB credit if we were passively invested across the whole rating band. Indeed, we would be concerned by passive investments across the entire ratings spectrum, as investing purely on the basis of index or rating ignores the potential benefits that non-benchmark or unrated bonds can offer.

BBB fears

Commentators have been highlighting the growing proportion of BBB bonds for some time (figures 1 and 2). The argument goes that BBB is only one notch above 'junk' or high yield bonds and that many issuers have taken advantage of very low interest rates to issue bonds. This means that there has been a deterioration in credit quality that will only become apparent in the next recession. In some cases the proceeds have been used to buy back equity, which is portrayed as unhealthy financial engineering.

By implication, the day of reckoning is coming. When UK interest rates eventually increase, yields will rise across fixed income markets, but the BBB category of investment grade credit will be especially affected as it contains a number of 'accidents waiting to happen' i.e. companies that have taken advantage of low interest rates and are now more highly leveraged. Furthermore, as this category lies on a significant investment threshold, the weight of BBB downgrades from investment grade could overwhelm the high yield market, resulting in significant losses there too.

Was last autumn a taster?

We apparently had a foretaste of a bond market meltdown in the autumn as the outlook for US interest rates became cloudier. With the Federal Reserve (Fed) seemingly committing to faster increases than the market had expected, the US bond market cracked with the yield on the 10-year benchmark rising from around 2.80% to nearly 3.25%.

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When S&P downgraded GE and GE Capital bonds two notches from A to BBB+ on 2 October, it seemed the doomsters were right. The fourth-largest company in the world in 2012, GE had now been exposed as a 'zombie' – one of the living dead, surviving only on cheap money. This is what happens to over-extended companies when interest rates rise. It was surely just a matter of time until the BBB dominoes started to fall.

So far, so depressing. However, we feel that while the factual basis for these fears isn't wrong, the conclusions reached seem extreme and, while possible, investors shouldn't be spooked by the dire predictions. Last year's falls in government bonds and GE aren't necessarily an augury of meltdowns in bond markets or a wave of corporate downgrades. Furthermore, active investors with a disciplined and thorough investment process can largely avoid such landmines.

Our view

Others have written extensive analyses of credit markets and empirically shown that investment grade credit and, BBB in particular, is no more risky today than in 2008. We agree with much of the analysis. **In particular, we see no evidence to suggest that:**

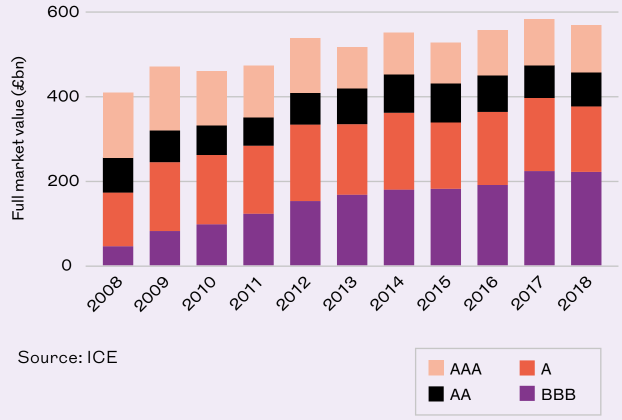
- Ratings agencies have lowered their standards to let issuers with questionable profiles cross over from high yield to BBB investment grade – if anything, the opposite seems likely given the reputational damage suffered by ratings agencies in the aftermath of the financial crisis.
- Issuers are more leveraged or less able to service their debt – there may be some companies or sub-sectors that look vulnerable if economic conditions or industry dynamics were to deteriorate significantly, but active investors can avoid such higher risk areas.
- BBB issuers are more likely to be downgraded or default than in previous cycles.

Why buy BBB credit?

For sterling investment grade credit, our models suggest investors require a yield premium to gilts of around 40 basis points (bps) to compensate for the risk of default. With credit spreads at around 130bps (at 31 March 2019), they are receiving c. 90bps for other risks, such as lower liquidity or ratings migration. This seems generous, given that investment grade defaults are relatively rare and our assessment of the risk premium remains steady at c. 40bps. With the 10-year gilt yielding only c. 1.00%, the extra 130bps of yield on credit is a significant return. BBB investors are paid even more handsomely for the additional risk of default with a BBB credit spread of c. 200bps.

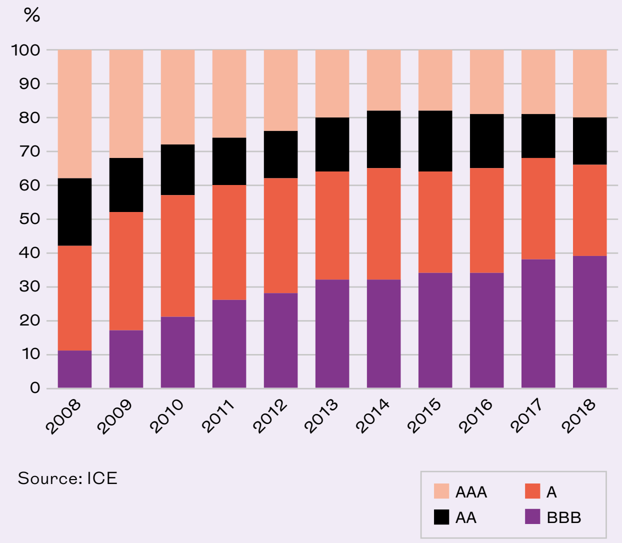
Over recent years, BBB rated bonds have consistently outperformed, with lower volatility of returns, compared to the broader market. In particular, returns have been better and smoother than those of A rated bonds (figure 3).

Figure 1: The size of the BBB sector of the sterling investment grade credit market has increased both in absolute terms (from £45bn at the end of 2008 to £221bn at the end of 2018) and as a proportion of the market (from 11% at the end of 2008 to 39% at the end of 2018).



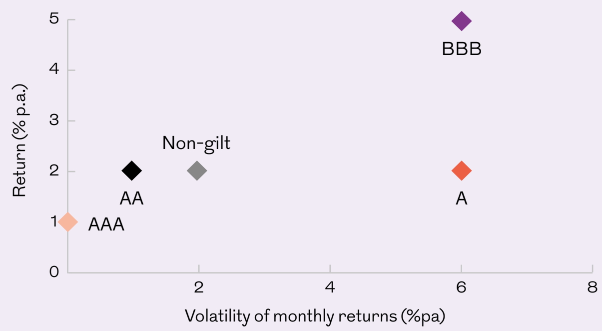
Source: ICE

Figure 2: The proportion of the sterling investment grade credit market made up of BBB rated bonds has steadily increased since the global financial crisis.



Source: ICE

Figure 3: Over the 10 years to the end of 2018, annualised monthly excess returns for BBB rated bonds have exceeded those of all other individual rating bands and of the broader market as a whole. Over the same period, the annualised volatility of monthly excess returns from BBB rated bonds has been marginally than that for A rated bonds, itself higher than that for higher rating bands and the broader market as a whole.



Source: ICE

The reasons for the increase in their share of the market size are partly performance-related, but also due to migration from higher ratings to lower ratings as well as strong issuance of BBB rated bonds in the sterling market. It should be noted, however, that the sterling market is not the only one to see such a development.

Not all BBB bonds are equal – the benefits of active investing

RLAM funds have always had a material exposure to BBB bonds; this is not because we like BBB as a distinct area – we feel that ratings are a source of inefficiency in the market, and would therefore never buy a bond on that basis. Rather we always look at the particular bond to assess whether we are being adequately compensated for the risk taken – and have found that many of these bonds have been rated BBB.

This exposure predates by far the global financial crisis and subsequent boom in BBB issuance – it is a key element in how we generate returns as active investors. Going back to 2008, while BBB bonds accounted for 11% of the sterling credit market, they comprised 35% of the Royal London Corporate Bond Fund (figure 4). Our holdings remain above benchmark today.

Over many years we have evolved our investment process to identify and exploit inefficiencies in credit markets. The most important consideration is whether a bond offers investors a favourable balance between risk and return. The yield on more obscure or complex issues can be materially higher than on more mainstream issues – one reason for this can be whether the issue is included in the bond indices or benchmarks. Many investors rule out off-benchmark bonds as they haven't got the expertise and experience to analyse them. A focused, thorough and enquiring research team is a major advantage.

A key factor for credit investors is the likelihood of default, yet far less attention is paid to recovery. Just because a company defaults on its debt doesn't mean investors end up with nothing – this is a key difference between credit and equities. To improve the risk profile of a particular issue, we assess the covenants that protect investors, whether the debt is secured against the borrowers' assets and the levels of collateral. The rates of recovery for similarly-rated bonds can be very different. It is interesting to note that while the market has a greater proportion of BBB bonds than it did 10 years ago, the proportion of these secured bonds has not kept pace – as issuers have generally borrowed on an unsecured basis. This contrasts with our approach (figure 4).

Another important element of our investment process is to manage the downside by emphasising bonds with a favourable risk/return trade-off. The ratings process is imperfect, grouping together issuers with dissimilar risk-return profiles and making arbitrary distinctions on other factors. We would be more concerned by the growth in BBB credit if we were passively invested across the whole rating band as this approach fails to differentiate effectively between the quality of issuers.

What if we're wrong?

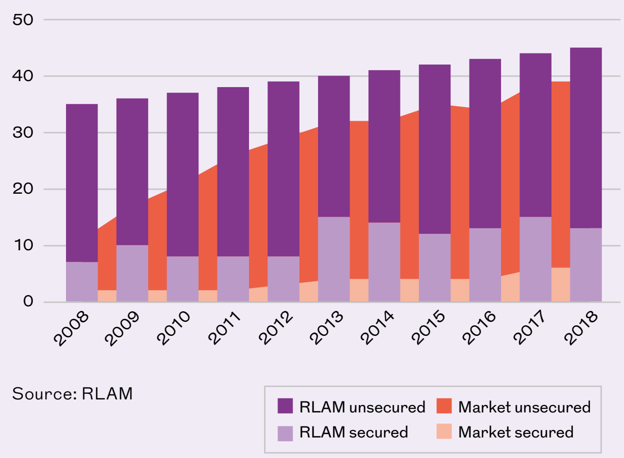
Of course, we cannot be complacent about any investment risk, let alone systemic market failings, so it's healthy to consider what the impact might be if we're wrong about the risks of BBB. For example, given the lengthy of the US growth cycle, it's possible that the US economy will roll over into recession next year. Policy mistakes by the Fed in terms of higher-than-necessary interest rates might bring this forward and/or make the recession deeper, but for now it seems that the central bank has learned from its overly hawkish comments in the autumn. Furthermore, various factors have seemingly taken the edge off growth and lightened the pressure on the Fed to get ahead of inflation.

If the US goes into a more pronounced recession, however, credit markets will suffer and there will be some defaults and downgrades – it's unlikely that BBB issuers will be immune to this. Will downgrades from BBB overwhelm the high yield market? We think not. Looking at BBB and high yield globally, we believe there's plenty of leeway and cashflow in stable sectors to absorb downgrades, particularly in the US.

Europe is slightly more of a concern. The European Central Bank's quantitative easing programme has run on far longer than those of the Fed or Bank of England. More issuers took advantage of this cheap funding with some new investment grade issuers making their debut in the BBB space. This could be a sign of problems to come. However, while Europe is a little worrying, we believe investors are being fully compensated for the risks in BBB and an active approach can avoid the more likely accidents.

A risk that active investors can't mitigate is illiquidity. In the event of a collapse in the price of a particular issuer or the wider market, it is possible that there are no buyers – particularly given the reduction in the market-making capacity of investment banks. This could impact investors in two

Figure 4: Since 2008, the proportion of the sterling investment grade credit market made up by BBB rated bonds has steadily increased. Over the same period, the proportion of the RL Corporate Bond Fund made up by BBB rated bonds has also increased, but to a lesser degree. The proportion of BBB rated exposure in the fund that is 'secured' has remained significantly higher than that of the market.



Source: RLAM

ways: as forced sellers they would have to accept prices far below the fair value of the bonds or they could suffer mark-to market losses. Illiquidity is likely to be worse for off-benchmark bonds, which is why some managers don't invest in them.

We believe these risks are overstated, however, and anyway we're more than compensated for them by higher yields – this is the illiquidity premium. Besides, we carefully manage this risk by only investing in bonds that we're prepared to hold to maturity.

Summary

Despite the possible negative economic scenarios, we believe BBB rated credit bonds continue to offer attractive risk-adjusted returns; even factoring in the higher default rates expected for lower-rated bonds, they should still deliver more attractive returns than other sectors. Although rising interest rates could pose some challenges, we believe BBB credit can continue to outperform. Switching to higher rated credit or even government bonds is likely to have a negative impact on long-term investment returns.

Moreover, our approach to credit investment, which places an emphasis on security regardless of rating but in a way that is particularly meaningful for lower-rated (or even unrated) bonds, further enhances the returns available from the BBB sector. We will continue to seek to generate excess returns over the medium term, thanks to our strategy of effectively managing the downside, seeking out value in credit markets and building well-diversified portfolios.

Not all BBB bonds are equal and neither are all credit fund managers. Investors can mitigate downside risk by selecting those managers with an active approach and strong track record, backed up by a strong investment process and high-quality credit research.

Contact us

For more information about our range of products and services, please contact us.

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