Zeo Capital Advisors

Fundamental Fixed Income

Unreliable Credit Ratings May Be Putting You At Risk

13 May 2020

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Unreliable Credit Ratings May Be Putting You At Risk

by Venk Reddy

Why are credit ratings and credit risk still used interchangeably? In today's environment, distinguishing between credit ratings and credit risk seems more important than ever. It is not uncommon to see investment grade bonds priced-to-perfection with more downside risk than shorter-term, lower-rated bonds. After the dislocation in March 2020, you would hate to take on perceived safe, investment grade credit, only to be caught in a contagion of downgrades where pricing is wrought by indiscriminate selling. After all, is the Fed program really a reliable investment thesis?

Finding "quality" companies that may have high yield ratings could provide the most attractive opportunity for investors in fixed income. Those who own quality corporate debt despite the ratings are not forced sellers based on credit rating downgrades or the fund flows that follow them; instead they fall in the value investors' world where fundamental facts drive decisions.

But if you are going to take on credit, understanding the disconnect between ratings and risk matters. How does a company with good fundamentals (relatively low leverage and strong cashflows) get a poor credit rating?

It's a good question and one not asked enough.

Firstly, rating agencies typically make their assessments based on a current snapshot. This is why we think of them as backward-looking. They intentionally do NOT do the work a fundamental credit manager does to form a forward-looking view of a company's competitive landscape, prospects, capital structure, optionality, etc. In our experience, to the rating agencies, the future often looks like a straight-line projection of the prevailing environment at the time.

For example, oftentimes, companies that look stable with high ratings get "surprised" by technology, ultimately presenting an existential threat. It's not until that existential threat actually proves real enough to hurt their financials that the ratings agencies will react. A fundamental manager tries to anticipate such scenarios to avoid the downside surprise. Think Blackberry vs. iPhone – Research In Motion (now known as Blackberry Limited) was investment grade even after the iPhone was introduced because they had such a large installed base, but the company was at risk well before they lost recurring revenues and market share.

Even worse, when the agencies have deviated from this snapshot approach recently, it is usually to give issuers a free pass for projected but uncertain cost savings and other synergies from an acquisition. Investment grade companies with abnormally high levels of leverage have been allowed to keep their ratings with only the promise that the leverage spikes are temporary. If the synergies are not realized, these companies cannot reasonably remain investment grade, by the agencies' own standards.

So all across the board, the stage is set for downgrades as rating agencies come to grips with either their failure to consider the future or their unrequited optimism when they did.

Secondly, ratings agencies consider relative comparisons to other companies across industries. They have specific characteristics they view as disqualifying for certain ratings levels. Think of this as a checklist – a bit too rigid for all companies but good enough for the proverbial 80/20 rule (don't hold me to the percentages, but there is a point where the law of diminishing returns on their effort comes into play). This leaves babies being thrown out with the bathwater. This one-size-fits-all approach leaves the door open for meticulous fundamental analysts to find quality despite a rating label.

There are three business models we see penalized with lower ratings more than others: lower-margin businesses, cyclical industries and smaller companies.

> Low Margin Businesses: It's harder for a company with relatively low margins (i.e. commoditized business) to achieve an investment grade rating. An example of this is Hanes Brands. It has relatively low margins because it is largely a commodity product of basic apparel. However, the company has the ability to pass through cotton costs quickly. Ratings agency models are sensitive to a benign revenue drop projecting cash flow to turn negative, but the reality is Hanes Brands' margins tend to stay stable even though they are lower than you might find in a different industry. In a downturn, the company has levers to stay profitable, even if at a lower level. Meanwhile, its sheer scale generates a lot of cashflow, and its liquidity is high even in an economic downturn given the inelastic demand for its products. Hanes Brands is a BB company but arguably has a higher credit quality, in our view.
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> Cyclical Companies: Similarly, it is harder for a company whose business is inherently cyclical to achieve an investment grade rating even if the company manages through that cyclicality with ease due to liquidity. And the ratings agencies typically have hard limits on leverage, so even if a company is appropriately levered for its industry (say 3-5x in retail), that might be enough to prevent it from getting a higher rating.
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> Smaller Companies: It is also harder for a smaller company with the same credit metrics as a larger company to achieve the same rating – there is an inherent bias against smaller companies because they are viewed as having a lower level of access to capital, though we have not seen that play out in any sort of reliable pattern. There's just too many market participants at all sizes for a good credit, regardless of rating, to have trouble raising money or refinancing debt.

Thirdly, when a rating agency rates an issuer, there is often little differentiation between nearer-term and longer-term maturities. Even when there is, company-wide factors such as overall leverage and gross margins can weigh more heavily in an agency's rating decision than the impact on creditworthiness of a particular debt issue maturing within the next year or two. In this case, the distinction between ratings and risk is relatively obvious. Even so, credit ratings are a particularly notorious area in which investors fall into the trap of thinking in terms of homogenous categories rather than heterogenous securities. In reality, an issuer's creditworthiness is varied, comprising many factors, some of which may even offset others.

In our own experience managing two mutual funds focused on corporate debt, we find visibility within shorter timeframes to be much greater than looking out longer, so the ability to analyze away much of the uncertainty (and therefore to get conviction in a credit) is different. The ratings agencies don't make these distinctions UNLESS they are paid to rate individual issues by the companies themselves (conflict of interest much?), and even then, that typically only happens for new issues, so shorter maturities end up getting tagged with longer maturity ratings.

On top of it all, those longer maturities don't always get re-rated as they get shorter unless the issuer is large enough to have an audience. This brings us back to the 80/20 rule: It comes into play more than you might expect, but we should always remind ourselves that the ratings agencies are for-profit businesses that happen to offer what is viewed as a public service, not public service companies that happen to earn a profit.

So what can investors do? Recognize not all bonds in the same rating category are the same. Look for fundamental managers who take the time to analyze each individual company, regardless of rating, to identify quality issuers who can repay the debt. Any effort to minimize credit risk depends on careful analysis and the price paid, not reliance on credit ratings.

Especially now, when the Federal Reserve is inflating demand by painting all investment grade bonds with the same brush, it's more important than ever to selectively invest in companies where both the supply/demand imbalance and the underlying fundamentals are aligned in your favor. Following credit ratings without analyzing credit risk seems to be pointing the other way. From where we stand, carefully vetted high yield bonds have always presented more attractive risk/rewards than investment grade. Today, they may present a better risk profile as well.

Zeo Capital Advisors

Important Disclosure Information

Zeo Capital Advisors is a fundamental investment manager with a short-duration credit mutual fund, a sustainable high yield mutual fund and separately managed accounts. Venk is the Chief Investment Officer and founded Zeo Capital Advisors in 2009.

For more information contact Zeo directly at 415-875-5604 or visit www.zeo.com.

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