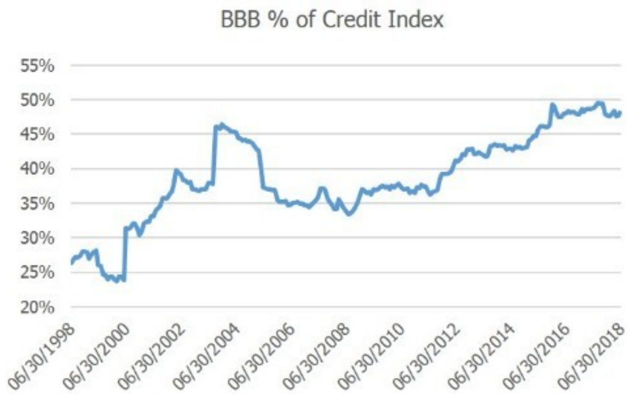
Bond iQ
Intra Quarter Update

Will Investment Grade Credit Get Stung by BBB's

Lured by the temptation of low interest rates, companies have embraced more leverage. As a result, the average credit rating of investment grade corporate bonds has been quietly deteriorating for decades. In fact, AAA rated companies have nearly become extinct. In 1981 there were 61 companies rated AAA. Today there are just two! As highly rated companies have become scarcer, the number of BBB rated companies has been growing rapidly. Since 1998, BBB rated bonds have nearly doubled as a proportion of the Barclays Investment Grade Corporate Bond Index and now make up nearly 50% of the index. We believe this has increased the risk of the investment grade corporate bond market, and poses significant risk to passive fixed income investors.



This doesn't necessarily mean that we view all BBB rated bonds as risky, however. In fact, we continue to believe that high quality, non-cyclical BBB rated bonds offer attractive relative value without adding much risk versus comparable A rated peers. The trouble is, much of the growth of the BBB market has come from highly cyclical industries and the very lowest notch of BBB rated bonds – two areas of the market that we have always strictly avoided. Not only are the lowest tier of BBB rated bonds significantly more volatile, but they teeter just one notch above junk. In the event of economic or market turbulence these bonds are far more likely to be downgraded into junk territory – an event that typically leads to adverse price volatility. 2016 was a notable example of this. Falling commodity prices caused acute stress within energy and commodity related credits leading to widening spreads and vast downgrades. According to a study by Moody's, over 17% of bonds rated Baa3 (the lowest BBB tier) were downgraded into junk territory that year, while less than 1% of bonds rated Baa1 (the highest BBB tier) transitioned to high yield ratings – a true testament to the quality disparity between the highest and lowest tiers of BBB's.

For passive fixed income investors, there is simply nowhere to hide. Unlike active managers who can scale the size and the composition of their credit exposure, passive investors are forced to go along with changes in the composition of the credit markets. After all, the more debt a company issues the larger that company becomes as a proportion of bond indices. In effect, passive bond investing rewards companies who degrade their balance sheet and borrow lots of money and punish higher quality companies with less risky financial profiles – a phenomenon that no active manager would ever willingly go along with. In closing, it's important for bond investors to consider how the credit landscape has changed. As active managers we enjoy the freedom to select only corporate bonds that fit within our rigorous "Quality Yield" discipline, while passive investors are stuck owning even the lowest quality issuers.

Brandon Zureick, CFA
Portfolio Manager & Strategist

Dale Coates, CFA
Vice President & Portfolio Manager