



## Credit Stability

by Glenn E. Atkins, CFA

It is dangerous to purchase corporate bonds based solely on the ratings provided by the agencies. We work from an approved list based on our own ratings and other financial and non-financial criteria.

The problem with relying strictly on the agencies is that they tend to rate bonds “through the cycle,” which means that even as fundamentals deteriorate, the ratings remain the same. This is great for lending stability to the credit markets, but can wreak havoc when “headline” risk emerges. As soon as the company makes the front page of the Wall Street Journal for any reason it is suddenly downgraded, when based on fundamentals it should have been downgraded long ago. I do not know how to fully guard against this phenomenon of headline risk, so we try to avoid bonds where our rating is lower than that of the agencies.

There is an interesting phenomenon occurring within the corporate bond world – at least in my corporate bond world. It’s too early to call it a discernable trend, but it is interesting nonetheless.

Given the widespread and widely known difficulties experienced by the U.S. economy during the last few years, one might expect corporate credit quality to have declined considerably. In many cases that has actually been true, as evidenced by the significant number of downgrades and the highly publicized nature of many of the more recent corporate “blow-ups.” However, in at least one case(our approved list), credit did decline slightly, but more recently we have seen a firming of credit metrics and even an improvement when compared to the credit metrics of four years ago.

Take for example the 24 industrial companies on our corporate bond approved list. As we do with all our credits, we analyze these companies based on a large number of fundamental financial characteristics. These numbers are then combined into an aggregate number which is then converted to an estimated alphabetic rating similar to that of the rating agencies.

Looking at the average credit numbers from these companies back in 1998 would have revealed an average number of 6.10

(lower is better), which would roughly equal a solid single-A rating. This number declined to a low of 6.35 during 2000, which is not surprising given the dynamics of that year. More recently, during 2002, this number improved to 5.72. On a percentage basis, this is an improvement of about 6% from 1998 and about 10% from the lows of 2000. Both the 6.35 and the 5.72 are each indicative of a single-A rating, but it’s a shift in credit quality that might indicate we are bouncing off the lows of credit quality, at least among the names on our approved list. When you evaluate credit scores to two decimal places it’s hard to read too much into such a minor change, but even so, it’s an encouraging development.

**“...credit quality across the board may be beginning to improve...”**

In a broader sense, a few things come to mind. First, this improvement suggests to me that credit quality across the board may be beginning to improve, because the companies on our list represent a large cross section of industrial America. Second, it suggests that certain companies have absorbed the recent economic weakness quite well and that those that can, have used this opportunity to strengthen their balance sheets and improve their competitive position relative to those companies who are incapable of improving their financial positions. Third, it appears to me that much of this improvement has come through the maintenance of margins, operating cost reductions, and debt reduction through largely internally generated cash flow. In the credit world, this would lead to a further division between the haves and the have-nots.

Again, I don’t want to jump up and pound the table, but I do think it is an interesting observation.

If this is a trend, I don’t think it’s being widely recognized. And if it’s not a trend, then I’m wrong, but we still have some good companies. In either case, I’m happy with the names on our list. ■