

## **The Difficulty of Credit Decisions**

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We have discussed in the past how credit-related purchase decisions are made in the corporate bond market versus in the stock market. To recap briefly: because corporate bonds do not typically trade on a centralized exchange, as do stocks, you simply cannot buy a given bond when you want to. In other words, we can do all the research in the world and if the particular bond is not available our efforts are wasted. Weeks or months can pass when doing random bond research before the bond is actually available, and then it might never be available at a price you are willing to pay. Therefore, when conducting bond research, we must "take what the market will give." We must be constantly alert for which bonds are either available now or might become available in the near future and tailor our research around these potential opportunities. Due to the lack of availability at a given point in time, corporate bond research is, well, almost backwards. We attempt to be vigilant about avoiding risk, rather than seeking price appreciation.

We have found that corporate bond research must be defensive in nature. This defensive posture puts an analyst in a position of avoiding "bad" bonds rather than looking for "good" bonds. It is natural to sell a declining bond (watchlisted for a downgrade in rating), which is why our credit research approach has taken this defensive posture for the last thirteen years. After all, bonds are not designed to be "higher return" investments like stocks. Bonds are used to meet defined income needs or to match specific cash flow requirements in client portfolios. Bonds are not going to double in price. They either pay their coupon (interest rate) and you get your principal back later or they go down substantially in price. The risk (all of it) is on the downside. So, to the extent we can tailor our research to avoid weaker credits, the better we will do over the long term. We are more interested in a bond paying its coupon to its stated maturity and therefore fulfilling our clients needs.

The basic foundation of our corporate bond research is to compare what we believe the bond should be rated versus what the bond is actually rated by the rating agencies (Moody's, Standard & Poors and Fitch). Using our proprietary financial models, which are designed to assess a company's estimated "ability to pay", we purchase bonds where our ratings are equal to or better than the rating agencies and stay away from bonds where our research shows they should be rated lower than they currently are by the rating agencies. This simplified description of our purchase decision naturally assumes that all the other factors like coupon, maturity, issue size, industry sector, relative value compared to other opportunities, absolute yield, and rating, among others, are also acceptable for client portfolios. Our sell decisions are essentially driven by the reverse of this process. You can't buy bonds based on yield and rating agencies alone. It's not that simple.

To put this a little more in context, here's an interesting number. Fully 71% of the credits we have analyzed so far in calendar 2000 have not been approved for purchase, which is a little higher than recent years. Only 29% of reviewed credits year to date were added to our approved list. To me, these percentages support the appropriateness of the defensive posture of our research process. It also supports the almost universally accepted theory that portfolio managers try to sell their bad credits before the market recognizes they are declining in credit quality. To the extent we can avoid this inherent risk in the bond market, the better job we do for our clients.