

Research Comments

Relativity Theory, Normal Distributions, and Credit Decisions

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If you're hoping this article is about physics and statistics, you may be disappointed. I'm growing weary of writing about investment risk and I don't know very much about physics. However, if you're hoping to read something about credit decisions, I'll talk to you about a few things that have been on my mind lately. Actually, the draft of this article has been bouncing around in that vast empty space between my ears for a couple of quarters, but it hadn't quite gelled until last night. Oh what a deadline can do for inspiration!

One of my primary jobs as a fixed income analyst is to find a reason not to buy something. After all, a bond is not expected to double in price. In terms of credit risk, we want predictable coupon payments and the return of our principal at maturity. This may stand in stark contrast to my equity-analyst brethren, for at these lofty levels many of them appear to be searching for a reason to buy something. The problem with this approach is that you have to buy something sometime, or as an analyst you risk alienating your primary constituencies including clients, portfolio managers and brokers. So, how do you know what to buy?

Relativity Theory

Many people are concerned today because corporate spreads are so tight. However, over the past few years as spreads have contracted, and even now as they remain compressed, corporates have continued to outperform the overall market. This scenario tells us to buy high quality corporates and not take relative credit risk. Even though spreads are tight and new issuance is low, there is still an ample supply of high quality corporates as long as you are patient. Therefore, why should we buy a single-A or double-A credit for a tight spread that we think is rated incorrectly, is doing share-repurchases that will impact credit quality, or is integrating a recent merger? We don't, because we can buy a homogenous credit without these attributes at essentially the same spread. Therefore, we avoid relative credit risk.

Normal Distributions

We also don't buy credits based on a "normal distribution." For example, if all the credits in the universe had interest coverage ratios that ranged from 0 to 2, and 1 was representative of single-A, would you buy single-A bonds? No, because a coverage of 1 is not a coverage that is typically thought of as being of single-A quality. Becca can tell you a great story of a portfolio manager who thought that there should always be some AAA utility bonds because they should be rated based on a bell curve. We don't buy credits for our clients that way. In that sense, we are also trying to avoid absolute credit risk.

Credit Decisions

Here's how we mesh this all into our credit decisions. I went back and reviewed all the credits we have purchased over the last several quarters. Combined, these 17 credits have an average rating of "A" from the agencies. Based on our internal research, we believe these credits should have an average rating of "AA." Clearly someone is wrong, but this is the side of the credit

equation we like to be on: buying homogenous credits, at attractive and comparable spreads that, based on our research, appear to be mis-rated by the agencies.

If the agencies are wrong, we may get some upgrades and spreads should continue to contract in these credits. If we are wrong, then we own some credits at good spreads that the market thought were single-A, and were priced accordingly. If we're both wrong, the agencies will most surely downgrade weaker single-A's before they get around to our credits. Under any of these scenarios, we should have both relative and absolute credit protection versus the market as a whole. This strategy has worked quite well in practice. Over the last three quarters, this group of corporates has out-performed the overall market by 65 basis points.