Ratings Drift and Credit Quality

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Anytime our economy enters a period of contraction, credit stresses will undoubtedly occur. Earnings, and thus cash flow, decrease and leverage increases. In the aggregate, this is a normal expectation of economic weakness. Where this becomes most difficult is at the moment of impact ? that point at which analysts and portfolio managers must make a decision on which security to buy or not buy. Compounding this level of difficulty even further is that, even though the decline in credit quality is obvious from quarter to quarter in the numbers, the rating agencies are sometimes seemingly random in their reaction as far as downgrading or even upgrading particular companies is concerned. In other words, even though financial weakness is a normal and expected part of economic contraction, no one ever really knows if the rating agencies will, in fact, downgrade a particular credit. Given the natural smoothing effect this has on the credit markets, this is likely a positive that the rating agencies take a longer-term view. However, it makes picking individual bonds more challenging.

As part of our credit research process we analyze long-term trends in credit quality in the aggregate, looking at several financial ratios that the agencies have defined as a critical component in the quantitative part of their rating function. The agencies are typically circumspect as to the degree that qualitative (not numbers) factors influence their final rating determination. At the end of the day, however, financial health is determined by (short of fraud) the ability of a company to pay interest and principal, not the degree of relative circumspection implied to lend credence to some proprietary rating methodology. I'll let the reader decide which is more important.

Throw into this mix the idea "ratings drift" and the challenge becomes more complex. Ratings drift occurs simply due to the fact that the financial condition of companies on the whole is not static. This is particularly true during periods of economic contraction. The bottom line to this phenomenon of ratings drift as it exists currently is that the overall aggregate credit quality during the last year or so has decreased by about a "plus", or "+", in ratings terminology, for any given rating category excepting AAA. What I mean by that is this: based on their underlying financial condition currently, a company that a year or so ago was rated single-A, now should be rated about single-A-minus. I say "about", because this is not an exact science.
The reality, however, is that the real world doesn't work like this. All single-A credits are not magically downgraded to single-A-minus because of ratings drift. Instead, the average financial metric in each rating category slips by an amount enough that each "should" be downgraded. In fact, they are not. The underlying average financial ratios of each rating category simply slip. Actual credit quality declines, but relative credit quality is unchanged on the whole, while remaining much different from specific company to specific company.

We try to guard against both ratings drift and credit quality declines by what, on the surface, seems to be a very simple idea. We try to buy credits whose underlying numbers either look like their actual ratings or those whose underlying numbers look better than their rating would imply. We try to avoid those credits where the numbers are materially weaker than the current rating. Without explaining how to build a watch when you probably only want to know what time it is, let me get right to the point.

The companies, in the aggregate, on our approved list have an average "actual" rating of something slightly weaker than single-A, but not fully single-A-minus. The underlying fundamentals of these same credits are single-A, on average.

The companies not on our approved list that we have reviewed over the last few months also have an average "actual" rating, on average, of slightly weaker than single-A. The underlying fundamentals of these companies, however, look like something in the BBB-minus range, teetering on the verge of junk-bond status (BB+ and below), a much different credit metric indeed. You would recognize most of the names from this universe. Some of these companies may, in fact, never be downgraded and we may well miss some investing opportunities. We will continue to err on the side of evaluating the numbers.