Diamonds are Forever – Bond Ratings, Not so Much

Hildy & Stan Richelson
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Currently we are in a low interest rate environment. This is wonderful for people buying houses because mortgage rates are so low. However, if you are a retiree or someone planning to retire, this is not good news. How can you generate enough income to support your life style? The usual way for investors to generate more return is to take on more risk. By maintaining low rates, the Federal government is forcing investors to take more risk. It you are at or near retirement, this might not be advisable.

To generate more income using bonds, you can extend out the yield curve to generate a higher return, or you can purchase lower rated bonds that might yield more.

This article addresses the evaluation of the credit risk of bonds, and suggests that purchasing lower rated bonds is not a good strategy, despite the potentially higher returns.

The two major risks of bonds are the liquidity risk and the credit risk. The liquidity risk is that the bonds you wish to sell cannot be sold reasonably quickly at a fair price. The liquidity risk may be caused by market factors that are unrelated to the actual credit quality, or by the deterioration of credit quality. The credit risk is when the ability of the issuer to pay interest and principal deteriorates.

Credit Quality and the Rating Agencies

What is credit quality? This is a catch-all phrase referring to current financial strength. It also encompasses future financial strength. Depending on the time horizon of the investment, this can be interpreted differently. The issuer may be financially stable near term, but the long-term credit quality may be questionable.

One principal way that investors evaluate credit quality and credit risk is to focus on the bond rating of the issuer. If the credit quality of the issuer is questionable, then the rating agencies will put the credit on "negative credit watch." That can eventually result in an actual downgrade of a rating. The credit watch can also be positive for a potential

upgrade in ratings, or removed from credit watch, in the same way that a patient's medical condition can deteriorate or improve.

The "big three" bond rating agencies are Moody's Investor Service (Moody's), Standard & Poor's Global Ratings (S&P), and Fitch Ratings (Fitch). These agencies have been rating bonds for more than a century. The newcomer to the block is Kroll Bond Rating Agency, founded in 2010. Though the agencies all look at ratings over a range of scenarios, their interpretation and evaluations may differ.

One important factor that neither the bond rating agencies nor the bond sellers (brokers) highlight, is that bond ratings are merely a current evaluation of risk based on the ratings criteria the agencies establish. Bond ratings are not forever. The bond ratings are generally designed to be a good faith evaluation of the issuer's current credit quality. The criteria may change as significant new developments emerge. For example, Moody's purchased Four Twenty Seven, Inc. in July 2019. According to Moody's press release, it is a company that evaluates physical climate risks.[i] It quantifies information regarding environmental, social and governmental risks (ESG) and provides risk metrics to further enhance Moody's rating evaluations. This signals a change in how climate risk will be incorporated into the ratings. The risks of climate change have been focused on reputational and ethical challenges, rather than the physical and financial impact of those changes which will now be incorporated into Moody's ratings. [ii]

Frequent issuers have their ratings updated every time they come to market. Unlike the stock market valuations which tend to jump around, bond ratings on municipal bonds tend to shift glacially. Corporate ratings may be more subject to change, and may be updated after quarterly earnings reports.

In order to understand the rating business, keep in mind that all rating services are paid by the issuers, not the investors. One explanation of the difference in ratings is that each of the four rating agencies are competitors and are in a price war with each other. The issuers know this and often do what is called "forum shopping" to get the highest rating at the lowest price. In the municipal bond markets, issuers understand that investors value the ratings of Moody's and Standard and Poor's the most.

Inexperienced investors may be unaware that ratings are not forever. When the rating agencies see that a Aaa or Aa1 credit is deteriorating, they downgrade the issue well in advance of a possible default. Moody's downgraded New York City (NYC) to Aa from Aa1 in October 2020. The 2021 budget in NYC was supposed to include productivity gains – but no such luck. The increase in the NYC payroll that took place during Mayor DeBlasio' tenure resulted in 38,219 new jobs, but not productivity increases. NYC needed to issue new bonds in October 2020 because it had to maintain its payroll rather than stimulate the economic engine of the City. The impact of Covid-19 has decimated NYC businesses. Will state and local revenues recover? Will NYC need to restructure as it did in the 1970's? This remains to be seen.

Thus, there have been no defaults on double-A credits because they are downgraded to junk, or default, or their ratings have been withdrawn prior to default. Bond issues may also be refunded to improve their credit quality.

There is a saying: Don't buy triple-A bonds because the ratings can only go down. That may be the case, but if the issuer weakens, the ratings will decline at a slower pace because the triple-A issuer has shown that it is fiscally responsible and the investors have a better chance of keeping their principal safe.

There is more competition among the 4 rating agencies for rating distressed credits. Here is a statement on the heath of the New York City Metropolitan Transit Authority on September 24th 2020: "The MTA faces an existential threat where enfeeblement is the short-term risk and extinction the worst-case scenario," Chairman of the MTA Patrick Foye said after the issuance of a new MTA bond issue.[iii]

On September 15, 2020 the New York Metropolitan Transit Authority (MTA) came to market with the following ratings:

Moody's A3   S&P BBB+   Fitch A+   Kroll AA+

The MTA sold $900 million Series 2020D transportation revenue climate bonds, certified as green bonds in three distinct issues. Looking at the same data, why is there such a wide disparity in ratings? The rating agency may evaluate data differently, or chose different data to evaluate.

Kroll provided the highest rating; while the ratings from Fitch, Moody's and S&P declined to the lower investment grade ratings. What entities that hold bonds benefit from an AA+ rating, even though all the other ratings are lower? On October 6th, 2020, less than a month after the MTA came to market, Kroll downgraded MTA to AA from AA+ with a negative credit watch as a result of the expected continuing bad MTA financial news.

Material Events

If you purchase individual bonds, you know that "material events" are posted fairly regularly. Material events are notices of any changes or events that might affect the health of an issuer. Frequent posts state whether or not an issuer has filed their financial report in a timely manner. Less frequent postings are about rating changes. Many issuers are posting that there has been an occurrence of a financial obligation as a result of Covid-19. We may soon see material events regarding climate issues.

Conclusion

Credit quality is not something that should be taken lightly when purchasing municipal or any other kind of bonds. If bonds lose their investment grade rating – lower than

triple-B minus, then mutual funds, ETFs and other bond consolidating entities may have to divest their portfolios of such high-yield (junk) bonds. If the bonds are in an index, they may be deleted. Liquidity may dry up, meaning you won't be able to sell at a fair price, if you want to sell.

If bonds are to add a sleep quotient to your feelings of wellbeing, seeing them descend into junk territory with the risk of losing principal will do the opposite.

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[i] "Moody's Acquires Majority Stake in Four Twenty Seven, Inc., a Leader in Climate Data and Risk Analysis," Press Release. July 24, 2019.
[ii] Leonid Bershedsky. "Moody's Catches on to Climate Risk Mispricing," Bloomberg Opinion. July 25, 2019, 7:17 AM.
[iii] Paul Burton. "New York MTA's woes prompt call to max out on Fed MLF (Municipal Liquidity Facility) program." The Bond Buyer. Sept 24, 2020.