Why Read About Bond Ratings?

Hildy Richelson and Stan Richelson
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If you are an AAII member or a thoughtful, inquisitive friend, you may wonder why the AAII Journal, which generally only publishes articles on stock investing, published our article entitled "What Are Bond Ratings, and Why Do They Change?" in their March 2021 edition. Charles Rotblut, AAII's Journal Editor wants to keep his readers aware of potential investing pitfalls.

Due to current low interest rates, most individual investors choose to invest in risk assets in order to maintain their lifestyle. Among the many risk assets are low quality bonds and other debt-type instruments that provide an income stream. The most frequent method of investment for individual investors is through funds.

Few investors look into the holdings of the funds they buy. Most individual investors only have one question: Which fund is yielding the most?

According to the usual fund profile, a fund is allowed to hold unlimited investment grade bonds, but may be limited to the percentages of bonds that are designated 'high yield' or 'junk,' (Ba1 or BB+ rated or lower) depending upon your viewpoint. In the event that the fund's holdings surpass the designated limits included in their prospectus, they must sell holdings to stay within their investment criteria.

All investment grade bonds are rated by one rating agency or more based broadly on two general criteria: the financial stability of the issuer, and the willingness of the issuer to repay their obligation. Junk bond issuers have questionable abilities to repay. 'Junk' bonds may or may not be rated. If they are unrated, then their relative safety is open to a subjective evaluation by the fund company. Ratings are the only guide to quality unless the investor is able to do his own research.

Mr. Rotblut wrote an editorial to accompany our article, warning his readers to be careful of low rated debt instruments. With 50 percent or more of corporate bonds now in the lowest investment grade category, an unanticipated event could tip the scale, sliding those teetering on the investment grade edge into the jaws of what we call the "junk chasm".

Wall Street calls it high yield because the interest payments are higher; We say that you have fallen into the junk chasm when you have lost between 30 and 60 percent of your principal. A fund that holds these toxic bonds is not a safe alternative to stock investing, which is Mr. Rotblut's point. Finding an exit strategy after an adverse event may prove costly to your bottom line.

Our article explains how the ratings are done and why, unlike diamonds, they are not forever. We provided insights such as why triple-A bonds never default. The rating services are very proud of this. However, the reason is that triple-A bonds that become weak credits are downgraded over the years, and their one-time superlative ratings long forgotten.

Another insight with regard to ratings is to "follow the money". As you all know, this is always a good idea. The issuer pays the rating services. As you can imagine, there is some "forum shopping". It might not surprise you to find out that the newer, and less substantial rating services are "easier markers" – imagine that.

If even one rating agency gives a bond a higher mark, the fund company can justify putting that bond into a higher rating category, ignoring the lower ratings. That justifies the issuer paying up for the extra rating and keeps the fund's yield higher.

Complications

Ratings are not equivalent across all markets. Both S&P and Moody's somewhat standardized the ratings between corporate and municipal bonds. However, structured notes and products occupy a field of their own.

This was amply exhibited in 2008 when structured investment products holding mortgage-backed securities, rated triple-A, were found to hold dicey securities that defaulted, sending the entire economy into a tailspin. Structured products started out simply. Instead of holding the mortgages they issued, banks were able to package them together and sell them, with the interest and principal passing through to the holders. They were called Collateralized Mortgage Obligations (CMOs). They were issued by a separate bank unit called a Special Purpose Vehicle (SPV)or a Special Investment

Vehicle (SIV) that walled off these investments apart from other banking assets.

That worked so well that issuers started packaging other products into Collateralized Debt Obligations (CDOs). Now the banks could package any kind of loan, credit cards, auto loans, etc. and sell it to an unsuspecting public.

Sounds simple enough! What could go wrong with that?

In a competitive market, where everyone is looking for what yields the most, banks had to keep lowering their mortgage writing standards in order to be able to sell their mortgages and other debt into competitive funds.

Remember, everyone wants to buy the funds that yield the most.

The rating agencies took the banks' word for it that they were packaging good mortgages, not ones with weak collateral backing them. Those toxic mortgages were buried underneath good mortgages and given a triple-A stamp by the big rating agencies.

That worked well, until the CMOs and the CDOs blew up because their actual value was not calculated, creating the most tremulous crisis since the Great Depression in 2007-2008. Bad money drives out good money. A good idea to package and sell debt ended up being a bad idea for buyers when they unsuspectingly bought toxic products. Creating a new high-quality product that deteriorates into a seemingly high- quality product that eventually blows up is a repeated pattern for many structured products.

What is Your Exit Strategy?

For an Individual Bond: You can follow the material events and rating changes and decide if you want to sell or hold the bonds to maturity. Even if ratings change or there are some negative material events, you can get a sense of whether your bonds will eventually return your principal. Getting the money back that you loaned to the issuer is the name of the game, isn't it? You do not incur any fees on your bond holdings unless they are in a managed account. There may be no taxes to pay.

For a Mutual Fund: The perceived advantage of a mutual fund is its ease of exit. When you sell your shares, you receive the Net Asset Value (NAV) of those shares. If you own a mutual fund that owns dicey bonds and the ratings go negative, the fund company must sell securities if you decide to leave, and there isn't enough cash on hand. They will likely sell the best

valued bonds in order to raise cash to pay you. If you instead choose to stay while others leave, the value of the portfolio may be diminished unless new money comes in. Sales may generate capital gains or losses which are passed through to you. Depending upon the fund you choose, you may have very low annual fees, or back or front-end loads and higher on-going fees.

If a fund does not perform well, the mutual fund company solution is to close the fund and open a new one, or merge it into an existing sister fund.

For an Exchange Traded Fund (ETF): You do not redeem your shares. You must sell them to another investor at whatever is the going rate. Your sales are subject to brokerage fees, just like the sale of stock. In addition, all transactions are subject to a Section 31 Transaction Fee payable to the SEC, currently 0.00221% of the net proceeds from the transaction. The ongoing fees may be very low or not, depending upon the ETF you choose. Because your purchase or sale does not trigger actual security sales, the generation of capital gains taxes may be lower than for a mutual fund.

Other than for a 3-week period in March, 2020, our very strong U.S. stock and bond markets have not subjected ETFs to any dramatic downturns. It is not clear if market prices will closely track fund prices as they currently do, or if the ETFs will behave more like their closed-end cousins with a wide disparity between the Net Asset Value (NAV) and share prices.

Fast Forward to Today

The joke goes: How low are interest rates? Answer: So low that you may have to pay the issuer of the bonds instead of being paid! No joke!

Huh! How is that possible?

In many places the world is awash with cash, and some governments are suppressing interest rates. The banks don't want to hold the money, so they charge the depositor for the privilege of keeping the money in the bank. These are the negative interest rates we see in some countries like Switzerland, Germany and Japan.

In the U.S. we have not reached this point. Yields are near historic lows. Investors hunger for higher yield. We are experiencing yield compression, where the yield difference between higher quality and lower quality bonds does not compensate you for the added risk of buying junk bonds.

As long as there are no explosions, the question still is: What yields the most?

Our Strategy

We believe in buying quality bonds because principal protection is more important than the marginal rate difference in return. If you purchase risk assets, and you guessed wrong, you may lose some or all of your principal. How difficult will it be for you to recover from sizeable losses?