The BBB Advantage

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There has been no shortage of time dedicated within financial media to the growth of the BBB-rated segment, the lowest rating category of the investment grade corporate bond market. Much of the attention has been geared around the theme of a 'disaster waiting to happen' with speculation that large amounts of BBB-rated debt will be downgraded from investment grade to high yield.

Despite the plethora of negative headlines, we have a favorable view on the BBB-rated category relative to higher-rated tiers of the corporate bond market.

Credit Ratings:

There are three main credit rating agencies that assign credit ratings – Standard & Poor's (S&P), Moody's Investors Service (Moody's) and Fitch Ratings, Inc. These organizations analyze the financial health of companies that issue debt and assign them a credit rating, which reflects their view on a company's ability to pay back debt through timely interest and principal payments and the likelihood of default.

The ratings are scored using alphabetic codes. The rating AAA (or Aaa for Moody's) is the highest credit rating and implies negligible risk of default.

Corporate bond ratings are broken into two major groups: investment grade and high yield, with ratings below BBB- (Baa3 for Moody's) considered to be in the high-yield category.

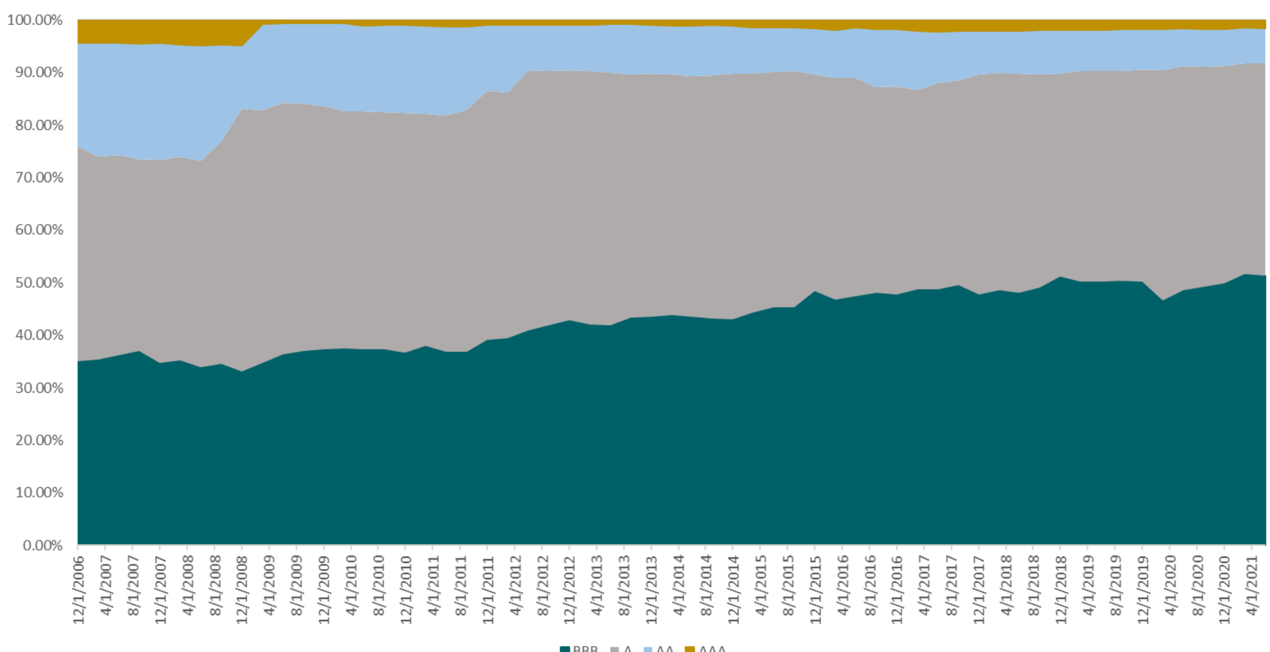
	S&P	Moodys	Fitch
Investment Grade	AAA	Aaa	AAA
	AA	Aa	AA
	A	A	A
	BBB	Baa	BBB
High Yield	BB	Ba	BB
	B	B	B
	CCC	Caa	CCC
	CC	Ca	CC
	C	C	C

Credit ratings can have a large impact on a company's funding costs. For example, a company that drops from investment grade to high yield will generally have much more expensive financing costs and a more limited buyer base for its bonds.

<u>Growth in BBB-rated tier:</u>

The U.S. BBB-rated corporate bond market has more than tripled in dollar terms since the beginning of 2009 and now represents roughly half of all investment grade debt. This growth has been the result of several factors, including:

- A low interest rate environment, which has enticed companies to increase leverage by issuing debt to fund share buybacks, dividend increases and/or mergers.
- Changes in the methodologies used by credit rating agencies that resulted in downward pressure, particularly for banks.
- Upgrades from the high-yield market.



Source: Bloomberg, July 2021.

Not your father's BBB market:

Thirty years ago, most global, multinational companies maintained AAA or AA credit ratings. However, this is no longer the case, while 60 companies were rated AAA in 1990, there are now only two (Johnson and Johnson and Microsoft).

Today, many global multinational companies in non-cyclical, defensive industries – such as Disney, General Electric, McDonald's, Thermo Fisher and Verizon – carry a BBB rating. The stability of revenue as well as the diversity and scale of these companies means they have a variety of levers to pull to stabilize and improve their balance sheets to maintain an investment grade rating, even during an economic slowdown.

Debt Profile:

Corporate management teams have taken advantage of the low interest rate environment and accommodative financial conditions to decrease funding costs as well as extend the maturity profile of their debt. A lack of near term maturities affords companies, in balance sheet repair mode, time to implement fundamental improvements.

Times are A-changing:

While the management teams of many BBB-rated companies are focused on debt repayment and reducing balance sheet leverage, the management teams of many higher-rated (AA and A-rated companies) continue to focus on prioritizing shareholder friendly and M&A activities. These actions will continue to weigh on corporate fundamentals and may actually result in a downgrade to BBB-rated.

At a fundamental level, the incentive for maintaining an A rating from a cost of capital perspective is very low. Conversely, the cost of capital increase for a company that is downgraded from BBB to high yield is very punitive. In addition, a downgrade to HY can also trigger covenants in existing debt and contracts with third parties such as suppliers and customers. Therefore, there is a large incentive for companies to remain BBB rated and in the investment grade category.

Portfolio Positioning:

In summary, we have a preference for BBB-rated companies in defensive industries, which have the ability to generate significant free cash flow through a variety of economic cycles, and have management teams that are committed to fundamentally improving the balance sheet. The combination of higher yields and, in many cases, improving balance sheets offer the prospect of attractive risk-adjusted returns relative to higher-rated segments of the market.

It is important to note that not every BBB-rated company is an attractive investment opportunity, and some will be downgraded to high yield. The ability to focus on the winners, and as – if not more importantly – avoid the losers, highlights the importance of active management.