



Are Ratings Overrated? | August 2019

“I think people make way too much of ratings.”

Walter Cronkite

Last month we asked when was the last time you gave an Uber driver less than five stars. The question segued into an examination of factors that can lead ride-share users and credit agencies to inflate their assessments.

This prompted questions as to what's in a rating. For example, a 4.7 out of 5 stars sounds like a great score for your Uber driver; however, it's actually below average in most cities.

Similarly, what does it mean for a company to be AAA or BBB, and what can and cannot be deduced from these letters?

In its simplest form, a credit rating is an assessment of a borrower's ability and willingness to meet their debt obligations. Much like a personal credit score, it's an indication for lenders on the likelihood of being repaid.

The most cited rating format is that of S&P and Fitch, where the investment-grade spectrum spans from AAA to BBB-, and the high yield universe from BB+ down to D (defaulted). Although exact methodologies differ across agencies, they are essentially evaluating two key risks: financial and business.

At the heart of the financial risk analysis are accounting ratios; quantitative metrics designed to assess the financial flexibility and health of an entity. The debt burden is compared to profitability measures and forecasts, sources of funding, cash flow, and the subordination of the specific security. The business risk element is more subjective and focuses on the strength of the company's operations and competitive dynamics. Combining the quantitative with the qualitative, they arrive at a rating.

And based on historical evidence, they seem to work pretty well. Lower graded securities default more than their higher-rated peers. The hierarchy of ratings thus provides a reliable indication of relative default probabilities. For this reason, ratings are often used as a proxy for risk. But for a true evaluation of riskiness, there is one crucial piece of information missing: price.

In this way, credit ratings are akin to hotel stars. In comparing a 4-star and a 5-star hotel, an important consideration for most would be price. Is it worth paying double for a slightly better room? Similarly, a AAA bond might be overly expensive while a lower-rated security could be overcompensating for the additional risk.

Also, as seasoned travellers can attest, not all 4-star hotels are created equal. The same goes for debt. Not all BBB's are the same, and issuer and security-specific factors, such as liquidity, also need to be taken into consideration.

Having realized that quality and hotel stars aren't everything, many online booking platforms have included metrics such as value, service, cleanliness, and location into their models. And while credit ratings offer investors a good starting point, in isolation, they are incomplete. Most critically, they do not offer any indication of value. As the legendary investor Howard Marks once wrote: “no asset is so good that it can't become a bad investment if bought at too high a price and there are few assets so bad that they can't be a good investment when bought cheap enough.”



The Fund

August's market moves were dominated by interest rates. The Canadian 10-year yield dropped by an astounding 32 bps, which meant rate exposure was a tremendous tailwind for returns, as evidenced by the Bond Universe returning 1.88% on the month. Equity markets opened on a weak footing, but rallied into month-end, resulting in the TSX closing higher by 0.43% and the S&P down 1.58%. This left credit as the clear underperformer, with Canadian BBB spreads generically higher by 16 bps.

Oddly enough, while corporate bond spreads widened in response to the uncertainty and to compensate for lower all-in yields, credit derivative indices, after initially widening, staged a strong recovery to finish the month nearly unchanged. Investors on both sides of the border braced themselves for an onslaught of Fall supply. Thus, despite the late rally in stocks and derivatives at the end of the month, corporate debt buyers were content to sit on the sidelines awaiting the new deals.

There were interesting flows in the US market as funds that invest in high yield, and levered loans saw outflows, while those invested in higher-quality fixed income saw inflows. The CCC/BB spread ratio hit a 5-year high, suggesting that investors remain concerned about the possibility of a recession and are looking to improve the quality of their holdings. Thus, while the deterioration in credit was somewhat indiscriminate, higher-quality names did fare a little better than their lower-rated peers

In terms of supply, the sharp drop in interest rates last month drew the attention of banks, financials, and REITs who took advantage of attractive coupons to issue debt.

The month proved to be frustrating as short positions in derivative indices and provincial bonds failed to provide an offset to the widening in corporate spreads, resulting in a loss of 83 bps (F Class down 82 bps).

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2019	2.03%	1.15%	0.36%	1.54%	0.15%	1.04%	0.80%	(0.83%)					6.38%
2018	1.19%	(0.45%)	(0.35%)	0.77%	(0.25%)	0.26%	0.46%	0.52%	0.47%	(0.34%)	(1.57%)	(0.81%)	(0.13%)
2017	1.73%	1.30%	0.44%	1.03%	(0.22%)	0.53%	0.94%	(0.09%)	0.70%	0.83%	0.45%	0.50%	8.46%
2016	0.19%	1.49%	5.32%	3.51%	0.60%	0.54%	1.73%	1.63%	1.01%	1.86%	1.60%	1.62%	23.15%
2015	-	2.29%	2.51%	1.27%	2.46%	0.25%	0.73%	(0.25%)	1.68%	1.71%	1.37%	0.87%	15.86%

The Algonquin Debt Strategies Fund LP was launched on February 2, 2015. Monthly returns are based on 'Series 1 X Founder's Class' NAV as calculated by SGGG Fund Services Inc. and are shown in Canadian dollars, net of all fees and expenses.

Credit

August saw portfolio managers frozen by the anticipation of September supply. On occasion, a barrage of new deals can certainly create bumps along the road. The question is whether there is sufficient demand and cash in the system to smooth the path.



Strong year-to-date returns from bonds, means that solid inflows into fixed-income funds should continue. Also, with investors moving from lower to higher-quality credit, investment grade funds should see the lion's share of new capital. These factors should create a decent amount of demand for the anticipated deals.

On the other side, lower rates mean lower borrowing costs, which makes it attractive to refinance existing debt. Accordingly, we expect a wide array of issuers to tap the market, in what is typically a busy issuance season. Thus far, the stream of new deals hasn't disappointed expectations, but the early indications show that there is sufficient cash on the sidelines to meet the supply. We continue to closely monitor this balance and remain selective in our purchasing, preferring to maintain flexibility than chase shiny new issues.

The quality improvement trend also occurred within the investment-grade space, as the gap between single-A and BBB paper has grown. We are paying close attention to this differential, as in such moves, risk is often mispriced, and opportunities created.

With equities only a couple of percentage points below the highs, we are cautious that the perplexing Brexit and China-US trade negotiations could spook global markets once again. As such, we continue to hold a medium risk posture.

Rates

The escalating trade tension is having an impact on business confidence and investment, with economic data showing signs of weakness. Rising uncertainty about the durability of global growth drove sovereign yields lower, resulting in over \$16 trillion of negative-yielding government debt.

The Federal Reserve is expected to cut rates by 25 bps later this month. Many expect them to cut by another 50 or 75 bps by mid-2020. Meanwhile, the Bank of Canada has adopted a 'wait-and-see' attitude. They have left the door open to lowering rates, but are not showing any sense of urgency. We wouldn't be surprised to see an ease or two by the Bank of Canada over the next six months or so.

The inverted yield curve needs the central banks to deliver the aforementioned cuts. Should the economic data strengthen (most likely due to a US-China trade deal), the bond market could be due for a vicious move to higher yields.

On the other side of the pond, Germany issued a 30-year sovereign bond in August with a humungous coupon of zero. The security was offered at €103.61. This means investors are lending the German government money for 30-years, not receiving any interest, and locking in a loss of 3.5%. Perhaps they can feel better knowing that they own the best quality (AAA) paper that money can buy.

Contact

Algonquin Capital Corporation
1 King Street West, Suite 1502
Toronto, Ontario, M5H 1A1
www.algonquincap.com

Raj Tandon
Founding Partner
raj.tandon@algonquincap.com
+1 (416) 214-3493



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