

The Rating Game | July 2019

“If you’re the police, who will police the police?”

Lisa Simpson to Homer

When was the last time you gave an Uber driver less than five stars? It seems to have become the de facto rating. As per one driver’s t-shirt, ‘if you’re alive when you arrive, that’s a five.’

Uber isn’t alone when it comes to overinflated report cards. A recent study of online marketplaces concluded that not only are judgements heavily skewed to the highest bucket, but they also tend to drift higher over time (Filippas et al., 2019).

The optimistic view is that as empathetic creatures, we don’t want to inflict harm on the reputation of others, particularly in public forums. And in our desire to leave ‘above average’ appraisals, we fall into a loop of pushing the averages higher and higher.

This rating inflation increases both the cost of receiving a negative critique and the discomfort in giving one. An effect that is more pronounced when the object of our assessment is a person; it’s easier to leave a negative review for a toaster than for a plumber. And while this compassion is heartwarming, it undermines the value of the feedback and can render it meaningless.

One solution is to revert to cold-blooded experts. Why seek the opinion of random diners when you can refer to professional restaurant critics?

Such is the case in the world of fixed-income, where the Michelin stars are given out by the Credit Rating Agencies (CRA). This oligopoly of firms has been evaluating debt instruments since the early 1900s, from humble beginnings in railroad bonds to the complex structures of modern financial engineering.

But ever since 2008, these bond pundits have been scrutinized, with the integrity of their assessments in question. Like Uber passengers, they have been accused of (and even fined for) inflating ratings. But unlike rideshare users, for far less compassionate reasons.

The main contention is the inherent conflict of interest in the compensation model. The CRAs are paid by the very issuers whose securities they are evaluating. How confident would you be in a review where the critic was paid by the restaurant? And while it’s harmless for the steakhouse to give their regulars VIP treatment, there is evidence that CRAs also favour the larger, more frequent issuers (He et al., 2010; Bolton et al., 2012).

The conflict of interest is further exacerbated by ‘rating shopping’, with issuers able to select and pay for the most favourable judgements. In recent years, with the number of agencies receiving SEC regulatory blessing going from three to ten, there are even more to choose from. This has raised concerns that increased competition for market share is leading to lower standards.

The problem is more acute in structured debt and the boom in securitized pools of loans, mortgages, and other borrowings. These products are highly likely to be ‘rating shopped’, and as their market has grown, so have the revenues from grading them. In their fight for a slice of the pie, some agencies are relaxing their models and doling out generous verdicts. Furthermore, booms bring with them their own risk. Research has shown that CRAs are more prone to inflating grades during booms, which is also when investors are most willing to accept them at face value (Bolton et al., 2012).

This is not to say there is a grand conspiracy in the world of credit appraisal. The lion’s share of public companies, sovereigns, and municipalities have multiple ratings and aren’t picking which report cards to show

their parents. Also, since 2008, new regulations have increased the transparency and accountability of the evaluation process. And if these measures aren't enough, the agencies also need to worry about their reputation, as a loss of confidence could lead to business failure.

But given the systemic flaws are biased towards inflating assessments, it is wise not to take the letters assigned to securities as law. After all, we require an editorial disclaimer for a review that is paid for by the reviewed.

As always, there is no substitute for careful analysis before deciding to put your money to work. Either that, or we need rating agencies to rate the rating agencies. As per Homer Simpson's response to Lisa's "If you're the police, who will police the police?"... "I don't know, Coast Guard?"

The Fund

July saw the classic summer grind tighter in spreads. Domestic credit was generically 4 bps narrower, while the US was in 7 bps. In addition to the usual tail-wind of lower issuance, optimism on a trade agreement and the lure of monetary stimulus provided an additional boost.

Perhaps the most interesting story involved the slow-motion train wreck of SNC-Lavalin, with the stock price dropping roughly 20%. Relatively speaking, the bonds held up reasonably well, as debt holders feel reassured that the remaining stake in highway 407 is sufficient to cover all obligations. Nonetheless, the credit spread widened 50bps, and we were thankful to have sold all our holdings before the escalation of the drama.

Featured issuers included banks (Bail-In, NVCC and FRNs) as well as CI Financial and First Capital. Gibson Energy was upgraded to investment grade by S&P which will broaden their following with investors going forward.

The Fund was well-positioned to capitalize on the seasonal pattern. In June, we built up a medium exposure and maintained that for the better part of July. Because issuance usually starts up in August, we started reducing exposure towards the end of the month.

The modest performance of spreads coupled with carry lead to the month's 0.80% return (F Class 0.71%).

	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%						7.28%
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

The trick with positioning the portfolio for the summer grind is to prepare for the potential post-holiday onslaught of supply. We have already started the process of taking chips off the table and will continue to make room for new securities.

The picture for supply is mixed. Foreign jurisdictions continue to be receptive to our great domestic banks, which minimizes the risk of a deluge from them. However, the decline in yields will attract a slew of non-financial issuers looking to take advantage of cheaper funding.

Market participants see-saw between optimism based on central bank stimulus and fear due to geopolitical overhang. Since it is impossible to predict which camp will win out, we are preparing for volatility by reducing exposure and increasing hedges through short credit positions.

Rates

The Bank of Canada chose to leave rates unchanged last month, although the door is open for them to cut if forecasted inflation moves lower.

The Fed delivered the widely expected 25bps rate cut; however, investors were not enamoured with Chairman Powell's characterization of the move. The rhetoric painted it as a mid-cycle adjustment rather than the start of a prolonged easing cycle. It was either that or the fact that two of the Fed governors did not vote to ease.

With no end in sight to the trade tension between China and the US, the odds do not favour yields moving higher.

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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