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BBB, the Rising Star of Credit

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To BBB or not to BBB

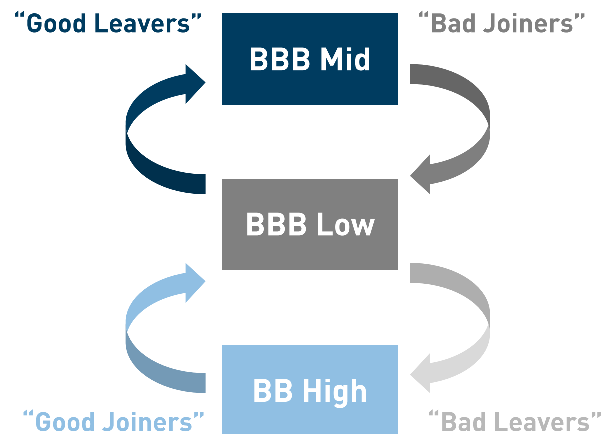
A decade ago, 25% of corporate bonds outstanding were rated BBB; today, that figure stands at 45%. The strong growth in this category of bonds rated on the lower end of the "investment grade" spectrum has been primarily driven by the ultra-low interest rate policy in the years prior to 2022. The low-rate environment incentivised companies to increase leverage by issuing more debt, and compelled management teams to add value for shareholders either by embarking on debt-funded M&A or through share buybacks. Several commentators have pointed to the growth in BBB-rated credit as a vulnerability in the financial system. However, we believe the reality is much more nuanced than that and see the BBB-rated area of the credit market as an alpha-generating opportunity we intend to continue focusing on.

Source: BarclaysLive. Data as of May 31, 2024.

The Twilight Zone

Within the BBB category are securities rated BBB-high, BBB-mid, and BBB-low. The fastest growing of these sub-categories is BBB-low, which has gone from being 11% of the bond market in 2012 to 16% of the market today. What makes them particularly interesting is their general high degree of sensitivity to the economic cycle, being just one notch away from being rated high yield. Rather than viewing BBB-low as a static bucket, we believe it's more discerning to view this category as a transitional zone between investment grade and high yield. An average of 25% of the bonds rated BBB-low at the start of the year are no longer in the category at the end of the year.

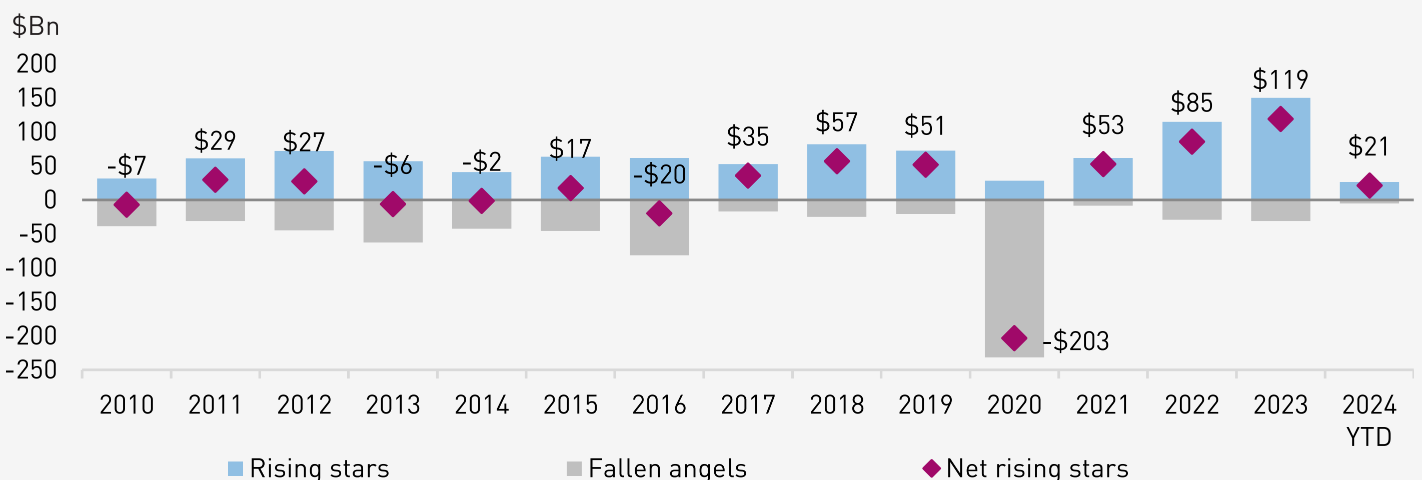
There are several answers for how and why bonds join or leave the BBB-low zone. Simply put, bonds can enter or leave this category for a good reason (ratings upgrade) or a bad reason (ratings downgrade).[1] In total, the BBB-low corporate category has grown by around 50% since 2014 (an addition of $243bn). Interestingly however, 73% of this growth has come from two sources: "good joiners" and bonds issued by energy companies that were downgraded due to the Shale Revolution.[2] We view these energy downgrades as more indicative of a technological shock rather than a broader economic issue. As a result, growth of this category has been more modest than expected if one separates out the upgraded "good joiners" and energy downgrades.



Anticipating falling angels

The BBB segment overall has been net positive in terms of growth, warranting caution at this stage of the cycle. Following the Global Financial Crisis, rising stars have been more common than falling angels, but this could change as we move along the economic cycle.

Rising Stars Have Been Outnumbering Fallen Angels



Source: Goldman Sachs. Data as of June 25, 2024.

[1] The other way bonds can leave the category is by maturing or being called.
[2] The "Shale Revolution" enabled the United States to profitably increase its production of oil and natural gas through a technique that combined hydraulic fracturing and horizontal drilling to extract shale gas.

There are some structural reasons why this fallen angels' cycle could be more difficult than previous episodes:

1. The size of the BBB category has grown much quicker than the BB category, which raises the question of where the demand for securities would come from in the event of downgrades.[3]
2. BBB companies today are on average more leveraged than in previous cycles.
3. Much depends on the rate at which the fallen angel cycle unfolds – the higher the concentration of downgrades, the more disruptive it could be for pricing as the market struggles to digest the additional supply of BB-rated securities.

Despite all this, we still believe the BBB segment is an interesting area to focus on. Investors holding BBB-rated corporate debt earn a premium and are relatively well compensated (net of expected losses from defaults) compared to both higher and lower rated debt.

Rating	Annualized Return	Default Rate	Return Volatility	Sharpe Ratio
AA	5.5%	0.0%	5.4%	0.46
A	5.8%	0.1%	5.8%	0.48
BBB	6.4%	0.1%	6.3%	0.54
BB	7.8%	0.6%	6.8%	0.70
B	6.9%	3.0%	8.5%	0.45
CCC	6.4%	26.0%	13.5%	0.25

Source: Bloomberg, S&P Global. Annualized Return, Return Volatility, and Sharpe Ratio data is calculated using monthly returns from 08/1988 - 06/2024. Default Rate data is the weighted long-term average of one-year global default rates.

Note that this analysis is simply based on investors owning the entire US BBB segment and does not reflect any security selection, active management, or other factors that can generate "alpha" in addition to the pure market return (or "beta").

The art and science of BBB credit selection

Credits rated A or above tend to be large companies that have stable credit profiles and are generally well-followed, making it difficult to find securities with a catalyst for outperformance. The nature of the BBB-low category as a transitional zone makes it an ideal area to exploit opportunities, enabling us to set either long or short positions around factors such as expected ratings actions, as an example. This segment has a diverse collection of companies, which creates room for value dislocations that we can capitalize on through active credit selection.

[3] In recent years, Asian institutional accounts have been an increasingly important holder of USD-denominated investment grade debt. These investors tend to be ratings sensitive, which could mean they are forced to sell securities that lose their investment grade ratings.

When looking at the BBB category, we either focus on credits where we believe the credit profile is on an upward trajectory, or credits where we believe the compensation we're receiving is more than adequate given credit fundamentals. In recent years, we have tilted toward sectors where the overall trend has been toward lower leverage rather than higher leverage – a clear example being Financials. We have also generally preferred to own subordinated securities issued by high quality companies rather than senior securities issued by lesser quality issuers.

As the cycle has advanced, we are increasingly establishing short positions in companies that we think are vulnerable to losing their investment grade rating. We are mindful of the fact that caution is required when investing in the BBB space, but we continue to find pockets of value here that enable us to generate alpha for our investors.

If you would like to learn more about our investment approach, feel free to reach out to a member of our team.

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