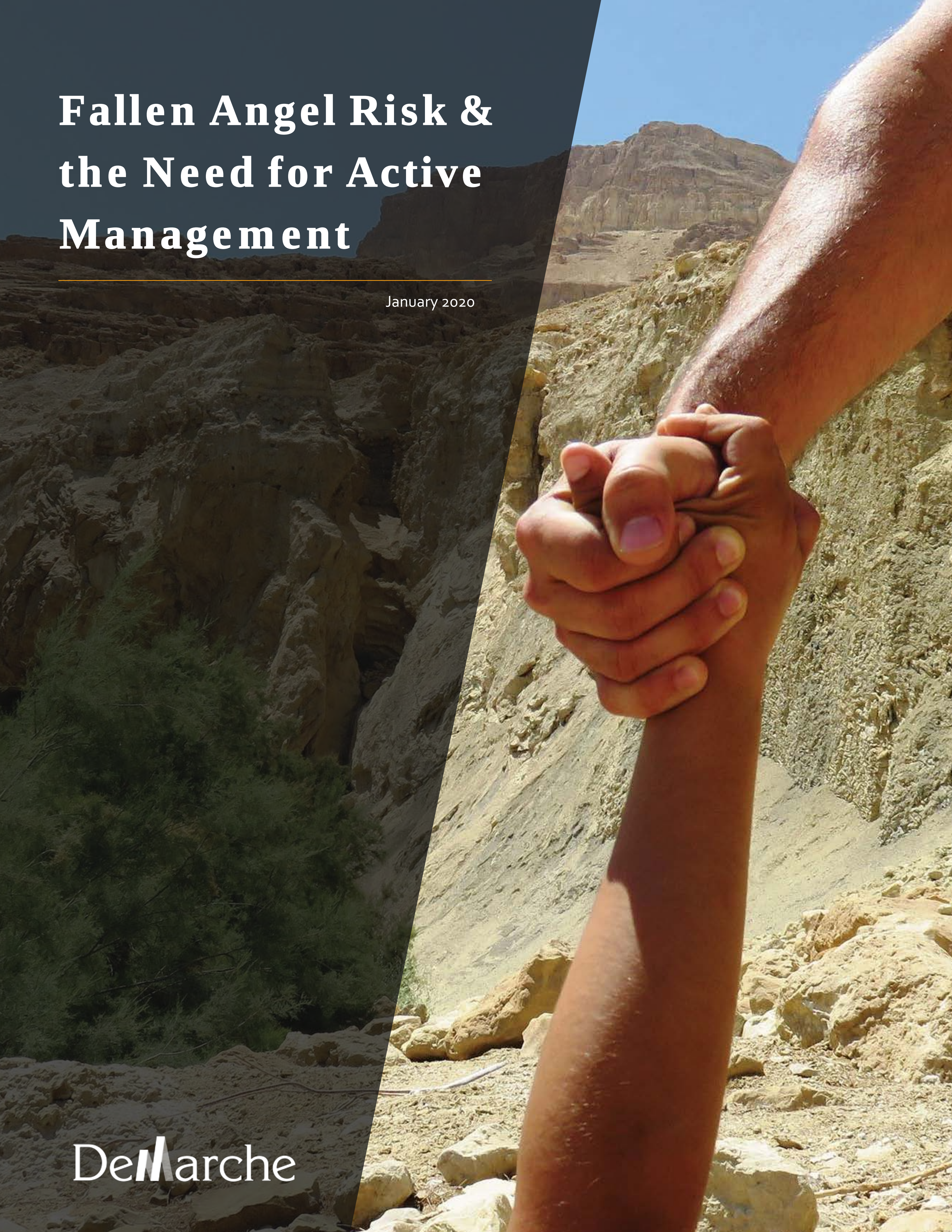
Fallen Angel Risk & the Need for Active Management

January 2020



DeMarche

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***Fallen Angel:** when an investment grade bond is relegated to the high yield universe*

Point of Discussion

01 Investment Grade Corporates & Recent Growth

02 Fallen Angel Risk & Considerations

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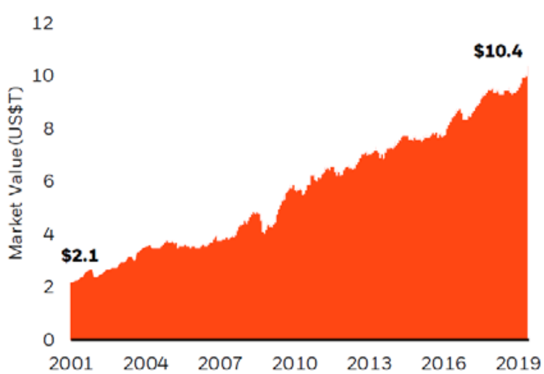
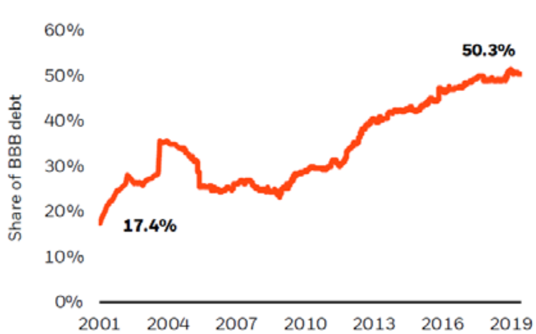
Market Value of Investment Grade Corporates



Source: Bloomberg Barclays, as 6/28/2019.

BBB-Rated Bonds as a Percentage of Corporate Debt



Source: Bloomberg Barclays, as 6/28/2019.

The recent change to the composition of investment grade debt, particularly in regard to the increase in "fallen angel risk" further points to the need for active management within fixed income.

Investment Grade Corporates & Recent Growth

Trustees overseeing institutional portfolios typically allocate a significant portion of assets to investment grade corporate bonds. Why is this? Corporates have historically offered a higher level of returns than government bonds with a similar risk profile over the course of market cycles. This contrasts with high yield bonds, which have historically offered a higher level of returns than government bonds, but with a higher level of risk often similar to equities. Additionally, corporates have offered diversification against other asset classes within portfolios, allowing for better risk-adjusted returns over time.

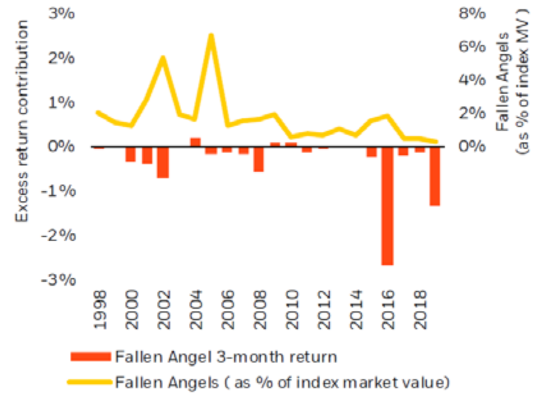
An increased appetite for corporate debt is one factor leading to the growth over time in the space. Since 2001, the global investment grade corporate debt market has grown and evolved significantly, from a total market value in 2001 of approximately $2 trillion to a market value over $10 trillion today.

Over this same period, the lowest rung of quality in the investment grade ladder has ballooned, as BBB-rated bonds currently represent over 50% of global investment grade debt versus only 17% in 2001.

Compounding the concern of heightened risk is the fact that creditworthiness of investment grade corporates has weakened by historical standards. The world's largest bond manager, BlackRock, offered their perspective on the changing bond market in a recent research report:

> *"We believe the sharp increase in the proportion of BBB-rated constituents has made the investment grade bond sector riskier than in recent years. BBB-rated bonds are typically the most vulnerable of all investment grade debt in a recession. Any downgrade of such bonds would relegate them from the investment grade to the high yield universe making them "fallen angels" and re-rate their value.*
>
> *Portfolios constrained to invest only in investment grade debt would likely be forced to sell the holdings, potentially further eroding the bonds' value."*

BlackRock further quantified the significance of downgrades by examining the price impact of “fallen angel risk” over three-month return periods. Looking back over 20 years, they found that fallen angel bonds declined sharply in the three months prior to being downgraded. This created a drag on the returns of the overall market of U.S. investment grade corporate bonds. In most years, fallen angels were only marginal detractors, while in 2016 they detracted over 2.5%. Furthermore, the potential impact of downgrades varies and the magnitude can be influenced by the stage of the credit cycle. In late-cycle credit environments such as the late 2000s, high yield default rates tend to increase and the percentage of fallen angels subsequently rises, opening the door for a period of pronounced negative performance. The performance drag can be significant for investment grade portfolios.



The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results. Source: Bloomberg, BlackRock, as of 6/30/2019. The left axis represents excess return contribution measured from every name that fell out of the Bloomberg Barclays US Credit Index 3 months prior to its rating downgrade. The right axis represents % market value of the downgraded names that fell out of the Bloomberg Barclays US Credit Index.

Fallen Angel Risk & Considerations

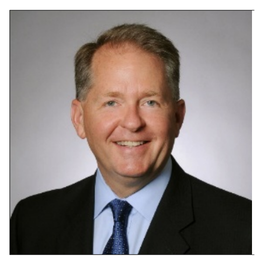
It is important to understand the composition of BBB corporates and the drivers that contributed to its rapid growth. Three main groups drove growth in the space: banks, energy and non-cyclicals. Banks compose over 20% of BBB debt and grew following the Great Financial Crisis as a result of heavier regulatory scrutiny. As a result of this increased scrutiny, many banks have taken measures to improve capital discipline and balance sheet strength. Following the energy crisis in 2016, there was a wave of downgrades, though it can be argued that energy companies have maintained financial discipline and avoided risk-taking, even following the recovery in oil prices. The final group is comprised of non-cyclical sectors like Consumer Staples, Communications and Healthcare. These are considered defensive industries due to their ability to maintain earnings stability in economic downturns. Thus, they are less likely to experience the severe deterioration in credit quality that may lead to ratings downgrades. They are also more likely to be large multi-national corporations who are heavily incentivized to maintain investment grade status. These issuers will typically not downgrade without a fight.

The Need for Active Management

The investment grade corporate bond market has experienced material change and the potential for fallen angel risk has grown substantially, underscoring the need for active management strategies designed to provide defensive characteristics even in an asset class traditionally believed to be “safe.” Managers can not only provide diversification across issuers, industries, sectors and ratings, but they may also add value through security selection and the avoidance of issuers who exhibit higher levels of risk. Credit analysis performed by active managers is essential in order to deliver downside protection in volatile markets and shifting credit and business cycles.

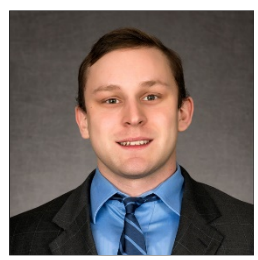
Put Research To Work

with the DeMarche Team



Thomas C. Woolwine

Vice Chairman



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Sources Utilized:

- *BlackRock, Making the grade, Assessing risks in the BBB-rated corporate bond market*
- *Columbia, Size of BBB debt market, explained in 3 charts*
- *Schroders, Why fears over the rise in triple-B corporate bonds look overdone*