IR+M
INCOME RESEARCH + MANAGEMENT

IR+M UPDATE
Choose Your BBBs Wisely

December 20, 2018

Since 2008, the size of the BBB corporate market has risen from $670 billion to over $2.5 trillion, and today represents almost half of the total investment-grade universe. At its current market size, overly cautious investors who avoid investing in BBB credits could be missing out on opportunities. We believe through careful, bottom-up analysis, investors can still find attractive credits while avoiding companies that are overly levered. In this piece, we explore the growth of BBBs, the potential impacts and how IR+M is navigating this evolution.

THE GROWING BBB MARKET

During a prolonged period of low interest rates and an improving economy, corporate issuers have frequently accessed debt markets for capital. Although this is not a new development, the size of the BBB market, and the potential risks that it poses, has made investors increasingly wary. Historically, 7-15% of investment grade corporates were downgraded to high yield during periods of economic stress. Today, that would be equivalent to $175 to $350 billion of debt, which could be difficult for the $1.2 trillion high yield market to absorb. Despite this, we believe investors can still find attractive BBB credits with low risk of being downgraded to high yield.

BBB ISSUANCE AND LEVERAGE HAS INCREASED…

In 10 years, the BBB segment of the corporate market has increased over 250%. This growth was largely driven by a rise in merger and acquisition (M&A) deals to help offset the lack of organic growth, as well as downgrade action by the rating agencies. Despite the run-up in debt, rating agencies have been more accommodative, particularly to companies with scale. This additional flexibility resulted in over 30% of investment-grade corporates having debt/EBITDA in excess 4x. If credit ratings were based on that metric alone, over half of BBB debt would be considered high yield.

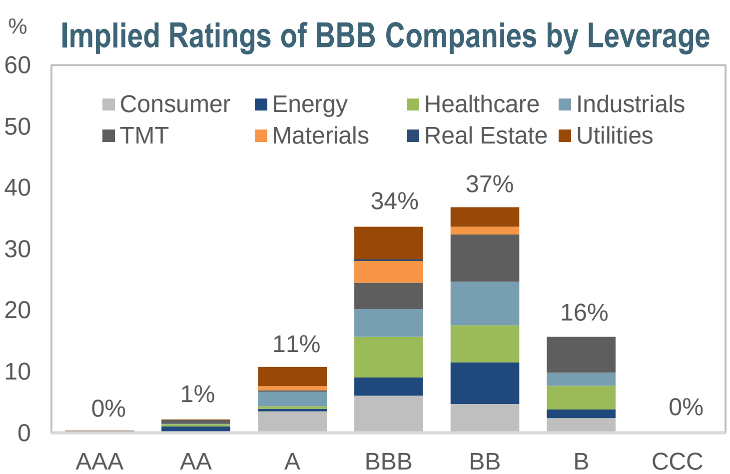
The proliferation of BBB-rated issuers is not likely to slow down in the near-term. Not only are companies being downgraded to BBB after engaging in M&A, but existing BBB companies are leaning heavily on the new issue market for funds. In 2018 alone, 70% of investment-grade debt issuance was from BBB issuers. The growth was focused in a few sectors – Energy, Healthcare, and Consumer.

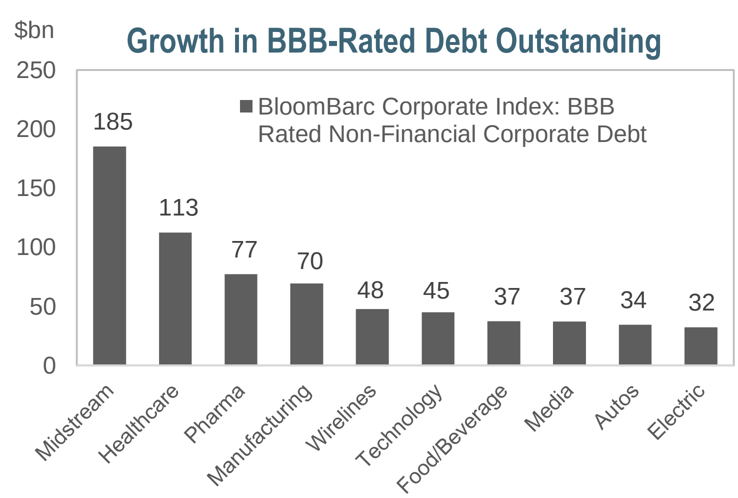
BUT GROWTH IS CONCENTRATED IN A FEW SECTORS

Energy: Many issuers were downgraded in 2015 and 2016 due to commodity-cycle weakness, and ultimately $82 billion of energy debt was downgraded to BBB-. Since then, Energy companies have dramatically improved their balance sheets and restructured to withstand lower oil prices.

Healthcare and Consumer: Issuers in these sectors have engaged in debt-funded M&A to help spur growth. Following their M&A transactions, CVS and Anheuser-Busch tapped the new issue markets, issuing $40 billion and $46 billion, respectively.

The size of the BBB market now dwarfs that of the BB market, at over four times the size. The risk is that an economic downturn triggers a rash of downgrades to BBB-rated issuers, flooding the high yield market.





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BE CAUTIOUS OF POTENTIAL FALLEN ANGELS

From 2014 to 2018, debt rated BBB- grew from $240 billion to $575 billion. Investing in these potential fallen angels could be costly for investors. Historically, in the six to twelve months preceding a downgrade, spreads widened by 300bps on average, placing them in line with those for BB-rated issuers. Once corporates enter the BB category, the buyer base – and demand – changes.

Unlike investment-grade corporates, there are only a few natural buyers for BBs. Insurance companies and foreign buyers typically have high-quality mandates, which preclude them from purchasing securities rated below investment grade. Also, mutual funds and exchange-traded funds (ETFs), which are buying an increasing number of bonds, are governed by strict guidelines that may force them to sell securities that fall below BBB.

Top 10 BBB-Rated Issuers by Debt Outstanding

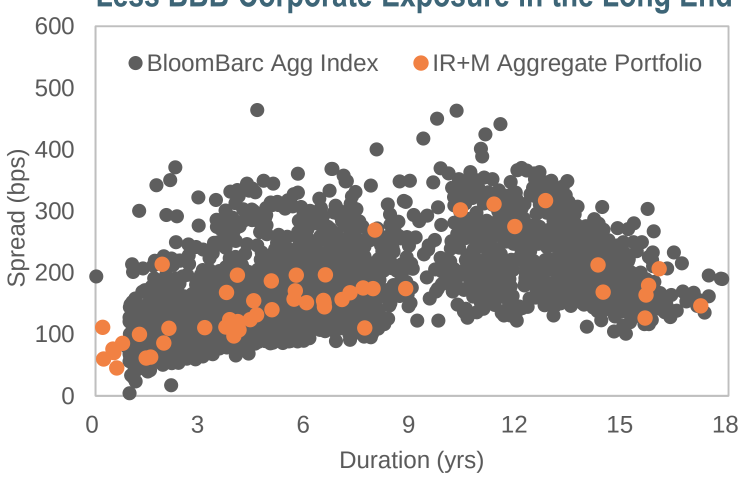
Issuer	Weight (%)	Index Debt Outstanding ($bn)
AT&T Inc	1.8	90.4
Citigroup	1.5	77.4
Verizon Communications Inc	1.4	71.7
CVS Health Corp	1.3	65.3
General Electric Co	0.9	43.7
General Motors Co	0.8	38.2
United Technologies Corp	0.7	33.8
Ford Motor	0.6	32.0
AbbVie Inc	0.6	31.2
Kinder Morgan Inc.	0.6	29.4

While active investors may have the ability to traverse the low BBB-rated landscape, passive investors may have less flexibility to do so. The composition of indices – in particular, the Bloomberg Barclays Corporate Index – is becoming more weighted towards issuers with higher outstanding debt, which often carries a lower rating. This is exasperated in long indices due to most BBB debt being longer in duration. As such, passive investors who track the index may be unknowingly exposed to lower-rated bonds. At IR+M, we believe that each security has a precise purpose in the construction of a portfolio.

IR+M APPROACH + POSITIONING

Although there may be heightened risk overall, not all BBBs are created equal. At IR+M, we rely on our bottom-up security selection skills to find attractive relative value opportunities. To avoid the potential risks of fallen angels, we believe it is prudent to remain cautious when investing in BBB rated credits.

Less BBB Corporate Exposure in the Long End



- **Proceed with caution**. Due diligence is prudent for sectors that are susceptible to M&A activities. Post M&A, management may have a credible de-levering plan going forward. Avoiding too much exposure in the long-end can help insulate the portfolio from any long term deviations from such plan.
- **There are benefits to being active.** The passive holding of the entire corporate index can be risky. The majority of M&A and issuance is dominated by a handful of sectors, and active management can reduce event and concentration risk through fundamental research.
- **Careful security selection.** Although the market value of BBB corporates has increased, the number of issuers has also grown. This gives our experienced Credit Team a larger universe for security selection possibilities.

At IR+M, we are well aware of the potential risks associated with the growing BBB corporate market. However, through extensive bottom-up research, we believe that investors can still navigate the uncertain environment and find attractive relative value opportunities. By leaning on our experience as security selectors, avoiding credits prone to potential leveraging events, and steering clear of the temptation to reach for yield, we believe we are well-positioned to take advantage of any potential volatility and dislocations going forward.

Sources: Bloomberg, Bloomberg Barclays and Barclays POINT® as of 11/30/18. Index is the Bloomberg Barclays Corporate Index as of 11/30/18. Fallen angels were investment-grade bonds that were downgraded to high yield. Representative portfolio characteristics. A similar analysis can be provided for any portfolio or composite we manage. The views contained in this report are those of IR+M and are based on information obtained by IR+M from sources that are believed to be reliable. This report is for informational purposes only and is not intended to provide specific advice, recommendations for, or projected returns of any particular IR+M product.