CORPORATE CREDIT

Does your manager have the necessary analytical skills to make the right choices for your bond portfolio?

By Maria Berlettano

Much fanfare is made about the skill required to select individual corporate securities for a stock portfolio. Yet these skills are just as important in constructing a fixed income portfolio. A poor corporate bond investment could lead to sour returns brought about by widening credit spreads or bond defaults. When this happens, it is difficult to recover the loss. In fact, unlike equities, there isn't enough upside potential in corporate bonds to make up for a bad investment.

Portfolio managers should not rely on credit rating agencies to determine the suitability of a corporate bond, as ratings often lag the performance of the bond market. Frequently, a company's performance, and how it fares relative to market expectations, will influence the price of its bonds long before an agency adjusts its ratings. This is not to say that rating agencies are irrelevant. There are times when agencies make changes that are unexpected, and these changes can have a positive or negative impact on bond prices. More importantly, agencies contribute to a fair and organized market system. They establish benchmarks of credit quality that help contribute to the relative levels of bond yields.

While ratings are important to consider, an investment counsellor should independently analyze and assess a corporate issuer's credit quality and then use its analysis to anticipate where credit ratings and credit spreads are heading.

A complete analysis encompasses three major areas: industry, company and security analysis. Each of these areas involves a number of detailed steps. At the very least, the process should involve a meeting with management to determine the depth and breadth of the team, its vision for the future and whether its growth and financial plans are reasonable.

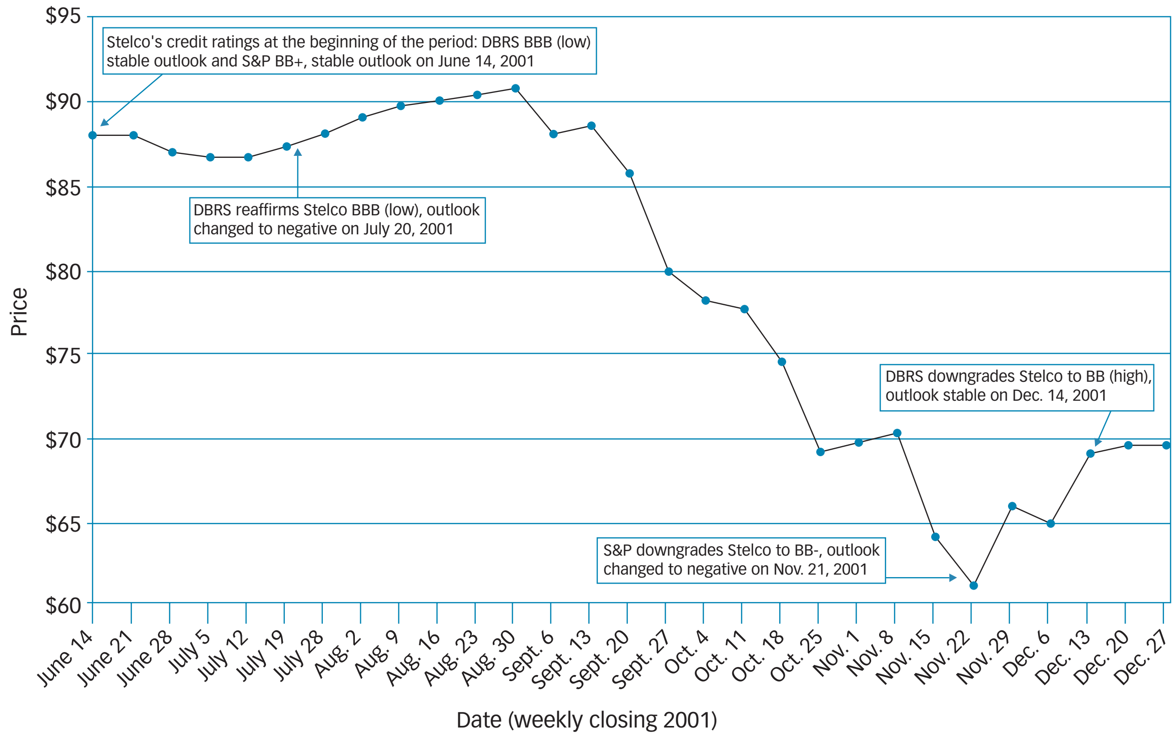
The analysis should also evaluate the strength of the company's franchise in the context of the industry structure as well as external factors that will drive its financial performance. In addition, it should examine various debt protection measures that provide important information about a company's financial performance under duress.

Portfolio managers should also take the time to build forward-looking models that can forecast how measures will change under various scenarios. This task is important when there is an economic downturn and revenues and profits are under pressure, as well as when there are fundamental changes in an industry, such as deregulation and consolidation, which could influence a company's future financial performance.

Stelco Inc., Canada's largest steel producer, is a good example of a bond investment where independent analysis, including a forward-looking model and scenario testing, would have allowed a portfolio manager to avoid a large credit-related loss. Looking at the price history of Stelco's 10.4% senior bonds maturing Nov. 30, 2009 during the second half of last year, it is evident that the price of these bonds remained relatively stable from June through August, and then there was a massive sell-off (see "Stelco's

Stelco’s bear trap

Between June and November 2001, Stelco’s 10.4% senior bonds maturing Nov. 30, 2009 decreased by about 30%. Yet rating agencies only lowered the bonds’ ratings after the bonds’ major downturn.



bear trap," left). Reliance on the rating agencies would have resulted in a poor investment decision as Stelco was downgraded only after its bond price fell sharply and went 'no bid,' meaning they were virtually impossible to sell.

During the investment holding period of June 14, 2001 to Dec. 27, 2001, the market was initially comforted by the fact that Standard & Poor's held to its stable rating outlook and Dominion Bond Service Rating reaffirmed Stelco's higher investment grade rating, although it changed the outlook from stable to negative. The market may have also had a false sense of security that the worst was over for the steel sector as July and August steel prices were firming up and the inventory correction in the manufacturing sector appeared to be advancing well.

However, overall market conditions remained poor in 2001. The economy was growing progressively weaker, the slowdown was spreading to other industries, demand for steel remained soft, industry over-capacity was persisting, excessive cheap imports continued to flood the market and steel prices were at depressed levels.

It was evident from the start of the year that Stelco's financial performance would be challenged by the difficult business environment. The company's financial flexibility would be gradually depleted as the slowdown dragged on. When it became obvious that the economy was not turning around, especially following Sept. 11, negative investor sentiment surfaced and Stelco's bond price fell like a stone.

An independent analysis of Stelco would have forewarned of a high probability of this decline. Stelco's financial performance and debt protection measures were already below the requirements for its existing ratings and relative to other similarly rated industrial companies. In addition, running scenarios on a forward-looking model would have shown that without a quick reversal of current market conditions, these financial measures would severely worsen. It was just a matter of time before the bond rating agencies would sharply downgrade Stelco.

Bonds provide an important anchor that ensure a relatively stable and minimum level of returns year-after-year, without the volatility associated with too large a position in equities. Bonds are less risky than equities, but they are not risk-free. To add value, portfolio managers need to be thorough in their credit analysis and draw on their analytical skills and knowledge of business and finance concepts with the experience they have acquired during previous economic cycles. At the same time, managers need to be forward-looking with respect to credit trends. **BC**

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