Where Credit Is Due: A Look at the Ratings

An educational review of basic investment concepts and techniques—in easy-to-understand terms.

There are many factors that individuals must consider when making investments in fixed-income securities. Current bond yields, current bond prices, and current as well as future interest rates all may have a big impact on the return of a fixed-income investment.

One other factor investors need to evaluate is the credit quality of the issuer and the particular bond. Individuals investing in fixed-income securities typically have two major concerns:

- How likely am I to get my money back at maturity? and
- How likely am I to get my interest payments on time?

Treasury securities, backed by the credit of the U.S. government, are regarded by most investors as "safe" in terms of these two questions, with no credit risk. But what about the credit risk of other issues and issuers?

Credit ratings offer one tool investors can use to help answer these questions.

Credit ratings and the agencies that issue them have come under heavy criticism for not properly assessing the creditworthiness of many recent securitized issues, as well as the banks and other financial entities holding these issues. However, credit ratings do provide investors with some basic information on the relative credit quality of an issue or issuer. In addition, the ratings have an impact on an issue's yield and price. Thus, even if you have doubts about the ratings themselves, it is important to understand what they are and what they mean if you are investing in fixed-income securities.

What Is a Credit Rating?

Credit ratings are evaluations of credit risk—the relative ability of a particular issuer to meet its financial obligations in full and on time, as well as the credit quality of a specific bond issue and the relative likelihood that it may default.

The ratings are not buy or sell recommendations, guarantees of credit quality, or exact measures of the probability of default. Instead, they express an agency's opinion of relative creditworthiness, from strongest to weakest, within a universe of credit risk—in other words, a higher-rated bond is deemed less likely to default than one with a lower rating.

A rating can be assigned to an issuer, such as a corporation, municipality, or even a sovereign government; ratings can also be assigned to individual issues, such as short-term and long-term debt obligations, securities, loans, structured finance instruments and preferred stock.

The ratings are provided by rating agencies that specialize in evaluating credit quality. The best-known rating agencies are Moody's Investors Service, Standard & Poor's (S&P), and Fitch Ratings. Each agency uses its own methodology to evaluate creditworthiness and its own scale to represent its opinions. The three major rating agencies use scaled letter grades to indicate the relative creditworthiness of the issuer or issue.

How Bonds and Issuers Are Rated

Ratings are assigned based on extensive analysis by the rating agencies of the issuer's financial condition, operating performance, policies and risk management strategies, primarily in an effort to evaluate revenue sources available to the issuer to cover debt service. This typically includes an analysis of current and historical information, but it also evaluates the potential impact of foreseeable future events. For example, in rating a corporate issuer, the agency may factor in anticipated ups and downs in the business that could affect the firm's creditworthiness.

To assess the creditworthiness of an issuer, an agency typically reviews a range of financial and business attributes that may influence the issuer's repayment. This analysis typically includes both financial and non-financial factors, including the issuer's financial condition, economic, regulatory and geopolitical influences, and for corporations, management and competitive positions. In rating governments, the analysis may concentrate on political risk, monetary stability and the country's debt position.

To assess an individual bond issue, an agency will review the creditworthiness of the issuer, as well as evaluate

Table 1. Credit Quality Ratings and What They Mean*

Investment-Grade Ratings

Moody's	S&P	Fitch	Interpretation
Aaa	AAA	AAA	Highest quality.
Aa	AA	AA	High quality; very strong capacity to meet financial commitments.
A	A	A	Upper medium grade; strong capacity to meet financial commitments.
Baa	BBB	BBB	Medium grade; the lowest investment grade. Adequate capacity to meet financial commitments, but more subject to adverse changes in circumstances and economic conditions.

Speculative-Grade Ratings

Moody's	S&P	Fitch	Interpretation
Ba	BB	BB	Lower medium grade; highest speculative grade. There is the possibility of credit risk developing over time.
B	B	B	Low grade; highly speculative. Current obligations being met, but capacity to meet financial obligations dependent on favorable business or economic conditions.
Caa, Ca	CCC, CC	CCC, CC	Poor quality; obligation is highly vulnerable to nonpayment; default is probable or imminent.
	C	C	No interest being paid or bankruptcy petition filed.
C	D	D	In default.

**The ratings from Aa to Ca by Moody's may be modified by the addition of a 1, 2 or 3 to show relative standing within the category; the ratings from AA to CC by S&P and Fitch may be modified by the addition of a plus or minus sign to show relative standing within the category.*

Sources: InvestinginBonds.com, Standard & Poor's, Moody's & Fitch Ratings.

the specific terms and conditions of the debt security, including its position with regard to other debt obligations of the issuer, as well as other external credit supports such as guarantees, insurance and collateral.

Ratings Over Time

Forecasting future financial and economic conditions can be tricky, particularly if it is for a longer time period—the further the agency predicts into the future, the more imprecise and unreliable their forecasts become.

To keep the ratings current, agencies typically track changing conditions that may affect the creditworthiness of an issuer or a debt issue, particularly changes that could hurt earnings or revenues, or issuer performance. This could include shifts in the economy, credit markets or business environment, or changes in more specific circumstances affecting a particular industry, issuer or an individual issue. For example, if a corporation buys another company with debt, the amount of outstanding debt owed by an issuer may increase sharply virtually overnight.

If a rating is under review, most agencies will signal this possibility by placing the issue or issuer on a "watchlist": for Moody's, the list is called Watchlist; for S&P it is CreditWatch; and for Fitch Ratings it is Rating Watch.

Appearance on a watchlist does not mean a ratings change is inevitable, but rather that a change is possible. And while a rating may be under review for a possible downgrade, it could also be under review for an upgrade. In addition, a rating change may occur immediately, without the issuer or issue first appearing on a watchlist, if the agency feels it has all of the information it needs to make an immediate assessment.

Once a rating has been reviewed and either changed or affirmed (no change to current rating), it is removed from the watchlist.

A ratings change can have an impact on the price of an issue. The change in price corresponds to the amount necessary to bring the current yield of the bond (its coupon rate divided by its current price) in line with other bonds rated at the same, new level.

Certain ratings changes affect prices more than others. For example, a highly rated bond that is downgraded one level may produce little noticeable difference in the price. However, certain downgrades are more significant than others and should be viewed as red flags, including:

- A downgrade that drops a bond rating to below investment grade;
- A downgrade of more than one rating notch (say from AA to A–);
- A string of downgrades in close succession.

Note that occasionally the price of some bonds drops in advance of a rating change if the market is ahead of the rating agencies in sniffing out potential problems.

Ratings Scales

Table 1 provides an abbreviated explanation of the various bond ratings offered by the three major rating agencies.

Typically, bond issues are considered either investment grade or speculative grade. Investment-grade bonds typically have a fair margin of safety, provide the highest degree of principal and interest payment protection, and are the least likely to default.

Speculative bonds are often referred to as "high-yield bonds" or "junk bonds," because of their greater degree of credit risk, and higher risk of default. The yields on these bonds are typically higher than investment-grade bonds to compensate investors for the additional risk; they also tend to be more volatile in price.

In order to protect their investments, many individual investors limit their purchases to bonds that are rated investment grade. In addition, many fiduciary institutions, such as banks and pension funds, are permitted by law to invest only in securities rated investment grade.

While the rating scales presented in Table 1 offer general definitions for each letter symbol, agencies typically rate issuers and issues relative to a specific universe. For example, a corporate bond issue is rated relative to other corporate bond issues, and a municipal issue is rated relative to other municipal issues. Despite the fact that the same letter symbols are used to rate the various issuers and issues, a letter rating for one type of issue is not comparable to the same letter rating for a different grouping—in other words, a municipal bond with an A rating does not have the same default risk as a corporate bond with an A rating.

Currently, the ratings of municipals are in flux due to the problems of several insurance companies that insure municipal bond issues. A municipal bond issue that is insured typically receives a rating based on the insurer's capital and claims-paying resources. In the current financial crisis, the downgrading of several municipal bond insurers' ratings has affected the municipal bond issues they insure, regardless of the creditworthiness of the municipal issue. At the present time, the rating agencies are still grappling with how they will handle ratings in the event more insurers are downgraded. Moody's, for example, has stated it would publish the underlying rating, but for an additional fee.

What Ratings Do—and Don't—Reveal

While a rating may provide you with some guidance on the relative safety of a bond issue or issuer, it is important to keep these points in mind:

- A rating is a credit rating agency's opinion of the ability of an issuer to make timely payments of principal and interest; it is not an opinion on the investment merits of either the issue or the issuer.
- A rating is a forecast based on conditions that may change.
- The rating is relative to other issues and issuers, and not an absolute assessment of the likelihood of default.
- A change in the rating may affect the price of an issue. However, other factors—in particular changes in interest rates—can have a greater impact on price (when interest rates rise, the price of a bond will fall, and when interest rates fall, the price of a bond will rise).
- When analyzing a bond issue, be sure that you understand the main reasons for the rating: What sources of revenue will pay debt? What is the credit history of the issuer? Has it been upgraded or downgraded and if so, why?

For More Information

Where can you get information on ratings, and see the ratings for individual issues?

The best sources are the three rating agencies:

Moody's Investor Services: www.moodys.com (ratings are available for free if you register).

Fitch Ratings: www.fitchratings.com (ratings are available for free).

Standard & Poor's: www.standardandpoors.com (ratings are available for free if you register). ▲