BE WARY OF BOND RATINGS:
Look Beyond Ratings When Considering Investing in Bonds

Bonds are part of many investors' portfolios, held either as individual securities or through funds (such as mutual funds). A key consideration for bond investments is the rating given to a bond by a nationally recognized bond rating company. Investors consider these ratings in evaluating possible investments, but it is important to look beyond the mere rating when considering an investment in a specific bond or bond fund portfolio.

Following the 2008 financial crisis, companies that provide bond ratings were criticized for a rating process that failed to adequately assess the risk of certain investments as part of the rating process. As a result, some high-risk bonds were given inflated ratings to appear more creditworthy and appealing to investors. While corrective steps were taken following the financial crisis, there are concerns that inflated ratings continue. For this reason and others set out below investors should look beyond the rating when considering an investment in one or more bond or bond funds.

What is a Bond Rating Company?

Bond rating companies (sometimes called agencies) are for-profit companies (not to be mistaken with government agencies) that assess the creditworthiness of both debt securities and their issuers. These companies provide investors with reliable information on the riskiness of various kinds of debt. But this may not always be the case.

In the best situations, rating companies provide investors with an evaluation of the risks associated with debt securities. These securities include government bonds, corporate bonds, certificates of deposit (CDs), municipal bonds and others. The risk of investing in these securities is determined by the likelihood that the debt issuer — be it a corporation, or local government — will fail to make timely interest payments on the debt.

What is a Bond Rating?

Bonds are rated at the time they are issued. The rating is important not only for its role in informing investors, but also because it affects the interest rate that companies and government agencies pay on their bonds. Ratings are usually characterized by a letter grade, with the highest-rated bonds given a “AAA” (or similar) rating and the lowest-rated given a “C” or “D” rating. These ratings can have significant implications for issuers, bond investors and the capital markets. Most directly, ratings drive bond pricing: AAA bonds generally are the priciest (and hence have the lowest yields) while the progressively lower-rated bonds are less and less sought after (and have higher yields). And, if a rating

(over)

Issued: December 2019

Continued from the front:

company “downgrades” its rating on a bond due to some negative news released by the issuer or a market moving event, the bond will tend to lose value in the marketplace.

During the 2008 financial crisis, for example, when rating companies rated structured debt products whose value was tied to mortgages, the rating companies looked at recent trends in housing. They based their worst-case analysis on a 10% decline in the housing market. But home prices fell by more than that during the recession, demonstrating the models used by ratings companies were too conservative.

What to Watch For to Protect Yourself

Be wary of complex rating models. Bond rating companies have been accused of exacerbating the financial crisis and defrauding investors by offering overly favorable evaluations of insolvent financial institutions and approving extremely risky mortgage-related securities. Companies sometimes use complex and unreliable models to calculate the probability of default. This may cause the agency to give a product a high rating, putting investors at risk while the agency makes its profit from the very company it is evaluating.

Over-reliance on ratings (Do your due diligence) - Many debt products are so complicated only the bond-rating companies have access to the details about the individual loans in the portfolios. As a result, investors fall into the trap of overly relying on the bond rating instead of doing their own due diligence.

Rating companies have a profit incentive to be uncritical. Bond rating companies are being paid by the companies issuing the debt, so they have a big incentive to give favorable ratings so the company or underwriters will continue to come back.

Conflict of interest. Investors should be aware of the possible conflict of interest between the rating companies and the bond issuers; issuers pay the companies for the service of providing ratings. Because of these and other shortcomings, ratings should not be the only factor investors rely on when assessing the risk of a particular bond investment.

Rating companies rely too much on the recent past. Bond rating companies often make the classic mistake of thinking recent financial history is likely to repeat, and only look at the last two years or fail to account for the greater systemic risks associated with certain products. Investors should use caution when considering bond offerings and not take a rating company's grade at face value without doing their own homework.

The Bottom Line

If you have interest in purchasing bonds as part of your portfolio, before making any decisions, ask questions, and do your due diligence.

NASAA has provided this information as a service to investors. It is neither a legal interpretation nor an indication of a policy position by NASAA or any of its members, the state and provincial securities regulators. If you have questions concerning the meaning or application of a particular state law or rule or regulation, or a NASAA model rule, statement of policy or other materials, please consult with an attorney who specializes in securities law. For more investor alerts and advisories, visit www.nasaa.org.

NASAA