britannic asset management

press release

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default risk is a red herring – downgrades are what investors need to worry about, warns britannic asset management

Corporate bond default rates are at the highest level ever according to the latest figures from Moody's. But Britannic Asset Management warns that while default risk has to be taken into account, the real issue facing investors is downgrades.

Standard & Poor's statistics suggest that 29% of investment grade corporate bonds that are currently AA rated will be downgraded in three years time. The risk of downgrading is considerably higher than the risk of default.

Commenting, Frank O'Donnell, Head of Retail at Britannic Asset Management says:

"Corporate bonds remain a very attractive option to investors, particularly those looking for income or keen to avoid the ongoing stockmarket volatility. But as you would expect in the current environment, the financial strength of many companies is being severely tested and the number of corporate bond downgrades has been increasing. Investors need to be aware of this risk – not just the risk of default. Avoiding the losers and managing this risk is often more important than picking the winners in a corporate bond portfolio, and this is where active managers can have the edge over tracker funds."

Downgrades can happen to all types of corporate bonds and have a substantial negative impact on price. At the top end of the market, for example, a downgrade from AA to A results in an average fall in market price of 4.14%, while a downgrade from AA to BB results in an average fall of 29.92% (Source Bloomberg Analytics). If a portfolio holds a bond that is downgraded it suffers this loss and it increases its risk profile by holding a lower grade bond. In addition, a bond that is downgraded once often slips down further and becomes more likely to default, causing double the impact on a portfolio.

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O'Donnell continues:

"The degree of analysis that goes into an actively managed corporate bond fund is important in ensuring quality stocks can be chosen, sector themes can be followed and more importantly, that risk is not just understood and monitored, it is also managed. Unlike tracker funds, actively managed corporate bond funds have the ability to avoid transition stocks and the potential to outperform. This is becoming increasingly important in the current market environment as the benefits of picking a good stock are far outweighed by investing in a bad stock."

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Notes to editors

- **Default rates –** According to Moody's, default numbers are trending up and rates reached 3.7% for corporate bonds last year. If you look at investment grade bonds alone, however, the chance of default is only 0.17% according to Moody's .

- **Downgrades -** Standard & Poor's statistics show that 28.98% of AA rated corporate bonds are likely to be downgraded after a period of three years has passed. Corporate bonds issued by companies such as Tesco, Thames Water and Scottish Mutual are some high profile examples of AA rated bonds to have suffered a downgrade.

- **Transition cost -** The risk of transition to a lower grade over a period of time is high and a bond that has been downgraded once is more likely to be downgraded again - the average decrease in market price of a downgrade from AA to BB is 29.92% (Source Bloomberg Analytics). In addition, a bond that starts to suffer downgrades is more likely to default, thus, the risk profile of a portfolio holding a downgraded bond increases substantially.

- **Bond funds -** Britannic Asset Management manages two bond unit trusts that are available as ISAs. The Britannic Corporate Bond fund invests in investment grade corporate bonds and over five years to the end of August 2002 was the top income provider in its sector (source Lipper, offer to bid, net income withdrawn), and fifth on a total returns basis (Source: Lipper, offer to bid, net income reinvested). It also manages the Britannic High Income Bond Fund which invests in both investment grade and sub investment grade corporate bonds.

The value of investments can fall as well as rise and are not guaranteed. Past performance is not necessarily a guide to the future.

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