Dimensional

Credit Ratings vs. Market Pricing

June 2012

The financial media treated the recent credit-ratings downgrade of fifteen major US and European banks by Moody's Investors Service as big news. But for the financial markets, it was old news.

In fact, the stocks and bonds of the fifteen institutions rallied after the announcement by Moody's on June 21. Not only had the news been widely anticipated as far back as four months ago when the agency indicated the banks would be subject to a ratings review, but for up to two years beforehand, markets had been pricing the banks' bonds as riskier than Moody's ratings would indicate.

Following downgrades of the US and euro-area sovereign borrowers in the past year, this episode demonstrates why Dimensional considers market prices—which incorporate all currently available information—as superior to potentially outdated evaluations from credit-ratings agencies.

Special Posting

BACKGROUND

News services gave notice of the downgrades last Thursday, hours ahead of Moody's official announcement. While the agency had warned of potential ratings downgrades back in February 2012, there was a degree of uncertainty about the extent of the revisions.

Reflecting this, share prices of the major banks fell sharply on Thursday pending the announcement, with Bank of America, Barclays, and Credit Suisse all down nearly 4% on the NYSE.

Moody's subsequently announced downgrades of between one and three notches to the credit ratings of fifteen companies, citing the prospect of reduced profitability and lower growth prospects due to difficult operating conditions and increased regulation.

Suffering the biggest downgrade, with a three-step adjustment to its long-term credit rating, was Credit Suisse. Two-notch downgrades were announced for Morgan Stanley, Barclays, BNP Paribas, Royal Bank of Canada, Citigroup, Goldman Sachs, JPMorgan Chase, Credit Agricole, Deutsche Bank, and UBS. Bank of America, HSBC Holdings, Royal Bank of Scotland, and Societe Generale each fell by one notch. (Moody's had already downgraded Australia's Macquarie Group and Japan's Nomura, which were on the original list of seventeen banks flagged for review.)

MARKET REACTION

For those who had not been following the story, the market reaction to the announcement might have been seen as counterintuitive. Judging the news to be not as bad as expected—or at least no worse—market participants bid up the prices of most of the bank shares and bonds in the session following the Moody's statement. In fact, share prices for ten of the downgraded firms were higher at Friday's close in New York. Strikingly, the cost of insuring Morgan Stanley's debt dropped to its lowest level in more than seven weeks, reflecting relief that the bank's downgrade was restricted to two notches rather than the previously feared three.

The market reaction was reminiscent of the behavior of security prices in the lead-up to and aftermath of Standard & Poor's downgrading of the credit ratings of nine Eurozone nations in January 2012.

In that case, the yield spread of sovereign bonds of those nine nations relative to German government debt (measuring the additional return demanded by investors for holding bonds with higher levels of risk) actually decreased in the weeks leading up to and following the downgrades.

A similar pattern was evident in mid-2011 when Standard & Poor's, after protracted warnings, lowered the credit rating of the US government. On that occasion, the yields on US Treasury bonds continued to fall while prices on those bonds continued to rise. In other words, US sovereign borrowing costs actually fell following the downgrade.

In the current case, however, the ratings agency was not playing catch-up with market pricing by just a few months. Instead, the agency's ratings were as much as two years behind the level of risk already perceived by the market and already factored into prices, as measured by implied credit ratings.

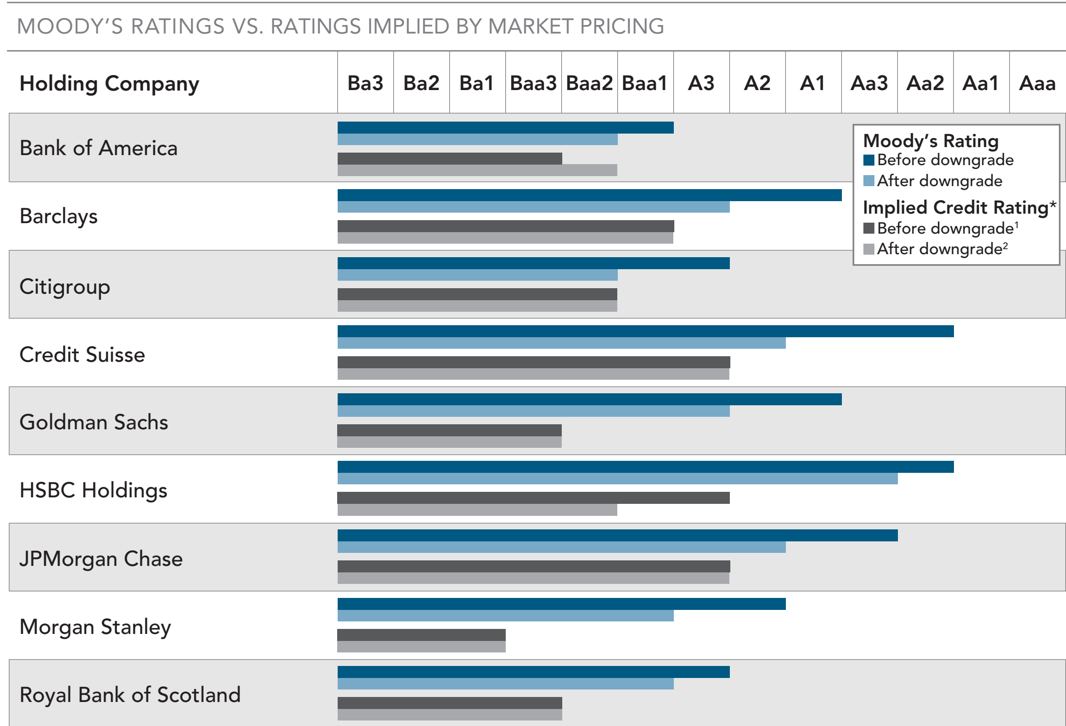
The chart below shows that for more than a year, starting in late 2011, Bank of America was being treated by the market as significantly riskier than its credit ratings from Moody's and S&P would suggest. Indeed, near the end of 2011, the company's bonds were being priced by the market as "junk," despite an investment-grade rating from the agencies.

The reason for the divergence is that the markets react to real-time news and incorporate fresh information as it comes to light. In contrast, the agencies' official ratings are often based on stale information.

CREDIT RATING VS. RATING IMPLIED BY MARKET PRICING (BANK OF AMERICA)

Source: TRACE and Dimensional.
*Implied credit rating calculated by Dimensional based on market price data.

The chart below compares the previous and current credit ratings from Moody's for several of the affected banks. It also shows Dimensional's calculation of the implied credit rating for each security, based on data from TRACE, a real-time barometer of secondary-market bond pricing. The implied ratings were generally unchanged following the announcement of the downgrades, demonstrating that market prices had already incorporated this information.



Source: Moody's, TRACE, and Dimensional.
1. Average of implied credit ratings between June 1 and June 22, 2012.
2. As of June 25, 2012.
*Implied credit rating calculated by Dimensional based on market pricing data.

It's also clear that, even after the downgrades, the market's perception of these securities' riskiness is generally higher—in some cases significantly higher—than Moody's assessments.

DIMENSIONAL'S APPROACH

In many ways, this event serves as a real-world demonstration of the advantages of Dimensional's market-driven, measured approach to risk and return in fixed income markets.

First, what is declared "news" in the media is often not news at all in highly competitive financial markets. As shown, Moody's downgrades had been widely expected and already reflected in market prices.

Second, even after ratings changes, the market may hold different views than the ratings agencies. Those views represent the combined opinions of millions of market participants and are based on all currently available information.

Third, market perceptions of risk are constantly changing as new events occur and as risk appetites wax and wane. As such, an investment strategy based on second-guessing markets or identifying "mispriced" securities is unlikely to succeed.

For the above reasons, Dimensional considers live market pricing as the best estimate of risk and does not rely only on the often-dated perceptions of ratings agencies. As we have seen, a bond may be officially sanctioned as investment grade but may behave as a much riskier credit.

This really shouldn't be a surprise, as the ratings agencies are working off the same information available to the market in aggregate. What the agencies can't do is instantly adjust ratings in response to new information, particularly when the environment is shifting rapidly.

The virtue of working with markets, rather than against them is that there is rich information available in market pricing. Our approach always is to respect the market, take only those risks worth taking, and to manage risk through broad diversification.

SUMMARY

Like the equity market, the fixed income market prices in information about credit risk instantaneously. This makes it extremely difficult for credit ratings agencies to adjust their ratings in a way that fully reflects the markets' perception of risk.

Moody's downgrade of fifteen major banks may have been presented to the general public as significant news, but the lowered ratings had been factored in by the market well in advance of the official statement. Having fallen before the announcement, bank shares and bond prices rallied afterward.

The dynamic nature of market pricing is why Dimensional always considers market prices when making its investment decisions, rather than relying on third-party assessments.

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All expressions of opinion are subject to change without notice in reaction to shifting market conditions. Diversification does not eliminate the risk of market loss. Credit risk is the risk that the issuer of a security may be unable to make interest payments and/or repay principal when due. A downgrade to a credit rating may affect a security's value.

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