Ain't No Love in the Heart of the Downgrades

Excerpted from the Alternative Investment Analyst Review, Volume 8, Issue 4

The Alternative Investment Analyst Review is the official publication of the CAIA Association. Access to the most current issue is an exclusive benefit of CAIA Membership while archived issues are available to the public in the Perspectives section at CAIA.org.

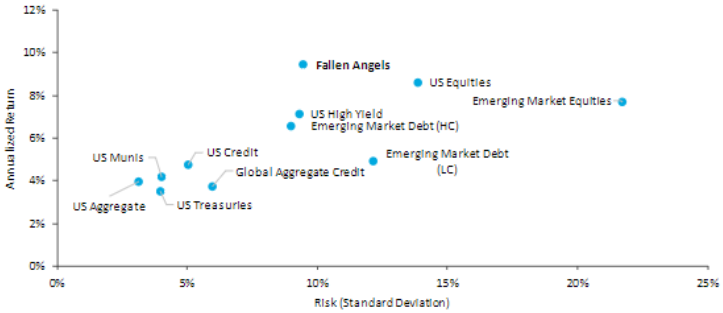
The full article may be accessed here.

Central Issue of the Paper

Arguably, there are at least three, and perhaps more, ways a manager can exploit market inefficiencies to outperform a benchmark: structural, behavioral, and informational. In "Fallen Angels: The Last Free Lunch," Paul Benson, CAIA, and Manuel Hayes introduce the concept of investing in Fallen Angels, a name for bonds that have recently been downgraded from investment grade to junk status. The paper focuses on how these three advantages (whether implicit or explicit) can lead an investment manager to earn excess returns.

Approach Employed by the Paper

The Bloomberg Barclays US High Yield Fallen Angel 3% Capped Index was first introduced in January 2005. Since then, the author's note that the index has outperformed every major asset class. In fact, the index has commanded a premium return to US High Yield, with similar risk.



In this short primer on fallen angels, Benson and Hayes first introduce the history of fallen angel investing performance, the rationale for why it works, and how it might fit into an investor's portfolio. There are a three primary reasons for why fallen angel investors have done so well for themselves: structural, behavioral, and informational.

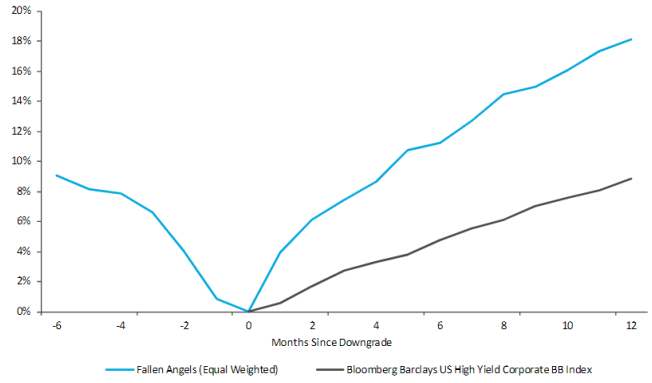
The Structural: The Players in the Market

Structurally, there is a clear divide the investors that operate in the investment grade and high yield markets. The investment grade universe is roughly twice as large as the high yield universe, and there's much larger concentration of passive investors via mutual funds and ETFs in the investment grade universe. When an individual credit is downgraded from investment grade to high yield, passive investment grade managers by mandate are no longer allowed to hold these securities. This creates downward pressure on pricing as passive managers are forced to sell indiscriminately into a market half its size.

The Behavioral: Fallen Angels Get No Love

While the structural reason has to do with passive investors, the behavioral has more to do with active investors. Some active managers can hold existing positions even if they have been recently downgraded, or even purchase recently downgraded securities if they so choose. However, large downgrades increase portfolio risk and may suddenly appear less attractive relative to other opportunities. This can either cause active managers to shed recently downgraded positions or refuse to buy newly downgraded entrants, creating even more downward pressure on prices.

The Informational: Clipped Wings, But Not Junk



Despite being recently downgraded, not all fallen angels are truly junk. Some companies may be going through a tough time, but that doesn't mean their long-term outlook is doomed. In fact, Benson and Hayes argue that fallen angels compare favorably to their high yield peers for three reasons: quality, performance, and the potential for upgrade:

- *Quality* – relative to the broad high yield universe, fallen angels are higher in credit quality as they enter the universe at a BB rating. This translate into a lower potential default rate.
- *Performance* – the price of fallen angels does fall substantially upon being downgraded, but on average they bounce back much faster
- *Potential Upgrades* – the asset class has more potential for upgrades than the high yield market, meaning they could move back into investment grade territory later on.

An active manager who understands the characteristics of the market might be able to separate the good companies from the bad and use that additional insight to select high quality companies at depressed prices.

Findings of the Paper

Benson and Hayes expect this universe to expand in the future, especially since the 50% of the investment grade market are rated BBB (the lowest possible investment grade rating). As the market grows, there is likely to be plenty of opportunity for investors to harvest differentiated, and idiosyncratic, sources of return which can be value additive to an investment grade or high yield portfolio.

Original Article: "Fallen Angels: The Last Free Lunch" by Paul Benson, CAIA and Manuel Hayes
Viewpoint Author: Aaron Filbeck, CFA, CAIA, CIPM