Bonds: A look at credit ratings

Bonds are attractive to investors for two reasons. Presuming that the issuer remains solvent, a bond offers a reliable source of income, paying interest on a regular basis until maturity. Second, bondholders can expect to receive the full face value of the bond at maturity.

Bonds are perceived as a less risky investment than stocks. But that perception must be tempered by the fact that, because they may be bought and sold prior to maturity, bonds are subject to market fluctuation and may be worth less than the original cost upon redemption. The formula is simple: When interest rates rise, the value of existing bonds falls. If an investor needs to sell the bond in a rising interest rate environment, he or she may suffer a loss. On the other hand, falling interest rates may boost the value of an existing bond, often allowing an investor to sell the bond at a gain.

Bond quality

Because a wide variety of bonds is available to the average investor, those who want to keep their risk to a minimum—ensuring that their income stream remains predictable and that their principal is safe—should seek the guidance of credit rating agencies.

Standard & Poor’s and Moody’s are the two credit rating agencies most familiar to investors, as well as the most influential. Their role is to assess the risk of a bond under their scrutiny by studying all available information about the issuing company and then assigning a grade to the issue that accurately reflects the company’s ability to meet the promised principal and interest payments.

Standard & Poor’s and Moody’s both use letter grades to rate bonds. Although a bit different in letter usage, they both rate bonds in descending order from A to C. (See “How to Interpret Credit Ratings” below.)

A rating’s impact

A bond’s rating will have a strong influence on its pricing and interest rate. Of course, a credit rating is not a recommendation to buy, sell or hold a particular bond. Still, there is no denying the fact that a bond’s initial rating, as well as any subsequent upgrades or downgrades, will affect significantly the attractiveness of a bond to investors. (Upgrades and downgrades occur when the financial health of the issuer changes.)

As a result, ratings will affect a bond’s current yield (the annual rate of return, expressed as a percentage). Highly rated bonds typically offer a lower yield because they attract so many investors. Investors need an incentive to choose a lower-rated bond over a higher, and thus these bonds offer a higher yield.

Bonds generally are classified into two major categories—investment-grade and speculative (“high-yield” or “junk”) bonds. Investment-grade bonds are those that are assigned to the top four categories by Standard & Poor’s (AAA, AA, A, BBB) and Moody’s (Aaa, Aa, A, Baa). Although the rating agencies don’t always agree on the risk of default by a particular issuer, their assessments are usually similar to each other.

What bond is best for *you*?

Why do you hold bonds in *your* investment portfolio? If you are like most bond investors, you are looking for predictability, safety and a source of cash in troubled times. You may also hope for performance superior to stocks when stock prices are in decline.

If these are your aims, you need to limit your exposure to risk, by focusing on investment-grade issues. If you intend to hold more speculative issues, look for companies with improving earnings and remember the rule of diversification—balance your low-grade holdings with investment-grade issues. Finally, for stability, consider shorter maturities, which fluctuate less with changes in prevailing interest rates.

How to Interpret Bond Credit Ratings			
	Standard & Poor's	Moody's	
Investment Grade	AAA	Aaa	Extremely strong
	AA	Aa	Very strong
	A	A	Strong (somewhat susceptible to negative changes)
	BBB	Baa	Adequate (susceptible to adverse conditions)
Speculative	BB	Ba	Uncertain (presently adequate, but facing long-term risk)
	B	B	Somewhat vulnerable (currently adequate, but likely to encounter unfavorable conditions)
	CCC	Caa	Vulnerable (payment dependent on favorable conditions)
	CC	Ca	Highly vulnerable
	C	C	Currently vulnerable (may be filing for bankruptcy, but currently paying)
	D		In default (interest payment missed or bankruptcy declared)

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Any developments occurring after January 1, 2008, are not reflected in this article.