FIXED INCOME 101

BAJAJ MUTUAL FUND

# UNDERSTANDING CREDIT RISK AND CREDIT RATINGS

**EVERY BOND STARTS WITH A PROMISE**

The issuer borrows money and promises to pay interest and return the principal on time.

**CREDIT RISK**

The possibility that this promise may not be fully met or may be met late.

## HOW CREDIT RISK REACHES THE INVESTOR

**1**
**ISSUER STRENGTH**

Cash flows and balance-sheet strength determine repayment capacity.

**2**
**RISK ASSESSMENT**

Investors assess the chance of delay, downgrade or default.

**3**
**YIELD DEMANDED**

Higher perceived risk generally requires a higher yield.

**4**
**PRICE AND RETURN**

A change in risk can move the bond price and fund NAV.

## CREDIT RATINGS A SIMPLE READING GUIDE

A credit rating is an independent opinion on an issuer's ability to meet its debt obligations. It is a starting point for analysis, not a guarantee.

| RATING | BASIC READING | WHAT THE INVESTOR SHOULD UNDERSTAND |
|---|---|---|
| AAA | Highest safety | Very strong ability to meet obligations; it is still not risk-free. |
| AA | High safety | Strong ability, but somewhat more exposed to changing conditions. |
| A | Adequate safety | Greater sensitivity to business and economic stress. |
| BBB | Moderate safety | Payment capacity may weaken under adverse conditions. |
| BB and below | Higher credit risk | Greater vulnerability and a higher probability of loss. |
| D | Default | The issuer has defaulted or is expected to default. |

## WHY CAN A LOWER RATED BOND OFFER MORE YIELD

**BOND 'A' HIGHER QUALITY**

Illustrative yield: 7%
Lower perceived probability of default.

**BOND 'B' LOWER QUALITY**

Illustrative yield: 9%
Extra yield compensates for additional credit risk.

**THE IMPORTANT PART**

The extra 2% is not free return. A downgrade, price fall, delayed payment or low recovery can offset it.

## WHAT CAN CHANGE A CREDIT RATING

**BUSINESS**



Sales, profitability and competitive position

**BORROWING**



Debt levels, interest burden and cash flows

**LIQUIDITY**



Cash available and ability to refinance

**EVENTS**



Governance, regulation or sector-specific stress

## WHEN CREDIT QUALITY CHANGES

| EVENT | WHAT CHANGES | BOND IMPACT | INVESTOR IMPACT |
|---|---|---|---|
| UPGRADE | Repayment capacity is viewed more favourably. | Yield or credit spread may fall; price may rise. | The fund may benefit, depending on its holding. |
| DOWNGRADE | Credit quality is reassessed lower. | Yield or spread may rise; price may fall. | Fund NAV may be affected before any default. |
| DEFAULT OR DELAY | Interest or principal is not paid on time. | Liquidity may fall and recovery becomes important. | Losses may arise; segregation may apply under regulations. |

## HOW TO READ CREDIT RISK IN A DEBT FUND

**1. RATING MIX**

Check how much is held in sovereign, AAA, AA and lower-rated securities.

**2. ISSUER CONCENTRATION**

A high exposure to one issuer or business group can increase the impact of a credit event.

**3. SECTOR CONCENTRATION**

Stress in one industry can affect several issuers at the same time.

**4. LIQUIDITY**

A bond may be difficult to sell at a reasonable price during market stress or heavy redemptions.

## SAME YTM DOES NOT MEAN SAME RISK

| | PORTFOLIO 'A' | PORTFOLIO 'B' |
|---|---|---|
| CREDIT MIX | Mostly sovereign and AAA | More AA and lower-rated issuers |
| RETURN DRIVER | More dependent on accrual and rate movement | More dependent on credit selection and spread movement |
| KEY QUESTION | Is the yield adequate for duration risk? | Is the extra yield adequate for credit risk? |

## RATING IS USEFUL BUT IT IS NOT THE FULL ANSWER

**NOT A GUARANTEE**

Even a highly rated bond can be affected by changing business, market or liquidity conditions.

**NOT PERMANENT**

Ratings can be upgraded or downgraded as the issuer's financial position changes.

**NOT A SUBSTITUTE FOR RESEARCH**

Fund managers also assess cash flows, leverage, covenants, concentration and liquidity.

## KEY TAKEAWAY

**Do not judge a debt fund only by its YTM. Understand where the yield comes from and whether the additional credit risk is suitable for the investor.**

Illustrations are simplified and not investment advice. Rating symbols and definitions may vary by rating agency and instrument type.

**Mutual Fund investments are subject to market risks, read all scheme related documents carefully.**