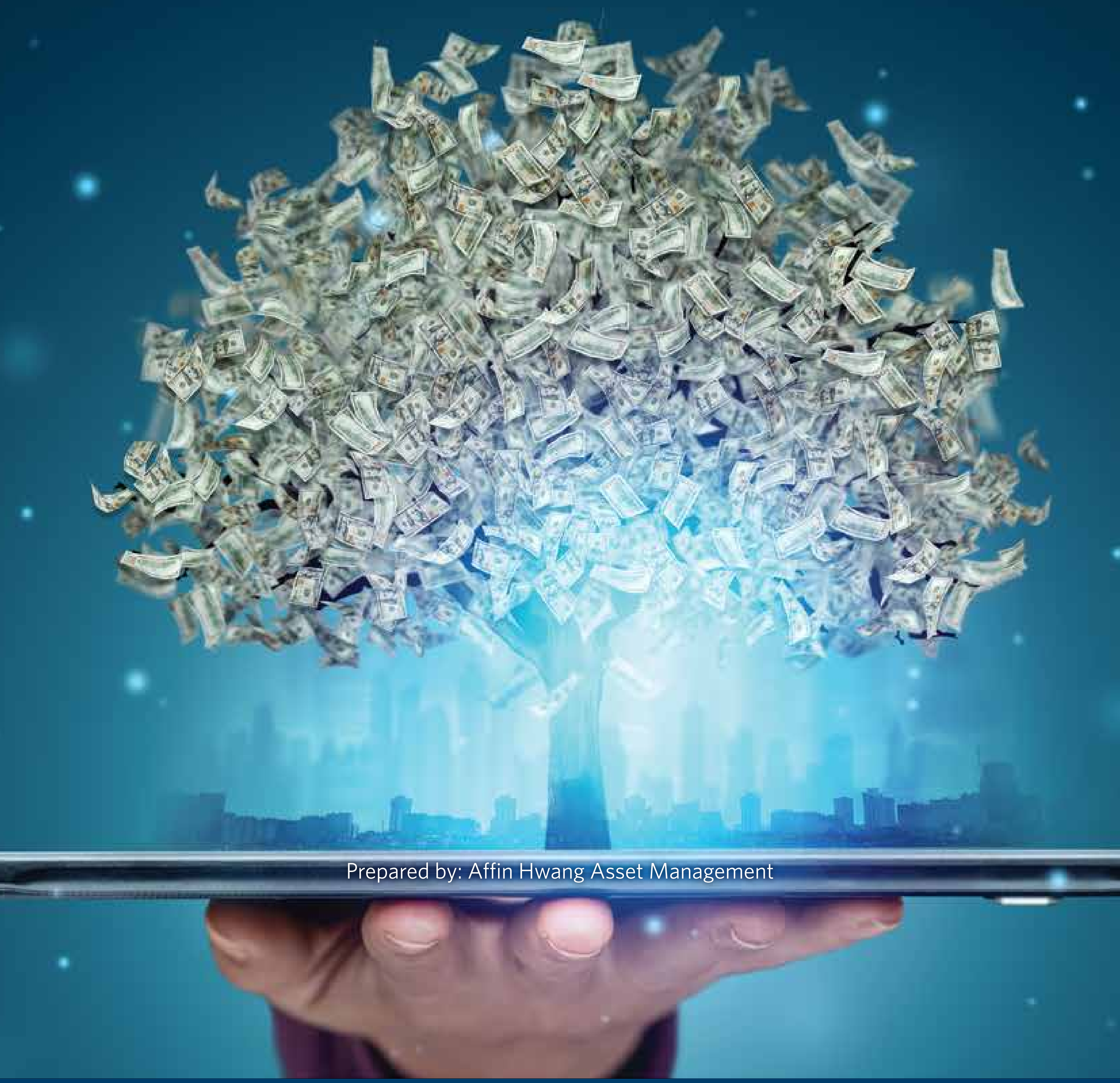
Fixed Income
for **Freshies**

(Part 2/2)



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In the second and final part of our educational series on fixed income, we learn more about why credit ratings matter as well as what narrowing/widening spreads signal to investors.

< What Is A Credit Rating? >

Bonds can be rated by a credit rating agency to determine the issuer's creditworthiness. This is usually through an assessment of various financial factors including its liquidity, gearing and other non-financial metrics.

Standard and Poor's (S&P), Moody's Investors Service (Moody's) and Fitch Ratings are the three main providers of credit ratings, also known as the Big 3. Locally, we have Ratings Agency Malaysia (RAM) and Malaysia Rating Corporation Berhad (MARC).

Table 1: International Rating Agency's Long-Term and Short-Term Rating

Moody's		Standard & Poor's		Fitch Ratings		Rating Description
Long-term	Short-term	Long-term	Short-term	Long-term	Short-term	
Aaa	P-1	AAA	A-1+	AAA	F1+	Prime
Aa1		AA+		AA+		Hi Grade
Aa2		AA		AA		
Aa3		AA-		AA-		
A1		A+	A-1	A+	F1	Upper Medium Grade
A2		A		A		
A3	P-2	A-	A-2	A-	F2	
Baa1		BBB+		BBB+		Lower Medium Grade
Baa2	P-3	BBB		BBB	F3	
Baa3		BBB-	A-3	BBB-		
Ba1	Not Prime	BB+	B	BB+	B	Non-Investment Grade Speculative
Ba2		BB		BB		
Ba3		BB-		BB-		
B1		B+		B+		Highly Speculative
B2		B		B		
B3		B-		B-		
Caa1		CCC+	C	CCC+	C	Substantial Risks
Caa2		CCC		CCC		
Caa3		CCC-		CCC-		
Ca		CC		CC		Extremely Speculative
		C		C		Default Imminent
C		RD	D	RD	D	In Default
/		SD		SD		
/		D		D		

In general, a time horizon of one year or under is considered short term, and anything above that is considered long term. In the past institutional investors preferred to consider long-term ratings.

Source: Bond and Sukuk Information Exchange (BIX) Malaysia.

Table 2: Malaysia's Rating Agency Indicators

RAM Ratings		MARC Malaysian Rating Corporation Berhad		
Long-term	Short-term	Long-term	Short-term	Definition
AAA	P1	AAA	MARC-1	Extremely strong capacity to meet financial obligations
AA1		AA+		Very strong capacity to meet financial obligations
AA2		AA		
AA3		AA-		
A1	P2	A+	MARC-2	Strong capacity to meet financial obligations, but somewhat susceptible to adverse economic conditions and changes in circumstances
A2		A		
A3		A-		
BBB1	P3	BBB+	MARC-3	Moderate capacity to meet financial commitments, but more vulnerable to adverse developments and economic conditions
BBB2		BBB		
BBB3		BBB-		

Source: Bond and Sukuk Information Exchange (BIX) Malaysia.

A credit rating is important because it is a reflection of the issuer's financial strength and ability to repay. This helps investors in making decisions on which bonds to invest.

Credit ratings also play a part in determining the price or yield of the bond. A higher-rated bond may offer a lower yield, compared to a lower-rated bond because it is deemed less risky or susceptible to a default. Conversely, a low-rated bond would offer a higher yield to compensate the higher risk taken by the lender.

< Investment Grade (IG) Bonds >

An Investment Grade rating indicates that a particular bond possesses a relatively lower risk of default. Hence, making it an attractive investment option for conservative investors. The yields are lower compared to high yield bonds.

High Yield (HY) Bonds

Also known as 'Junk' bonds. These are higher paying interest rate instruments as they have a lower rating relative to Investment Grade bonds. A higher yield is to compensate investors for the additional risk taken. Certain high yield bonds are also called 'fallen angels' after losing their IG status.

Treasuries

Treasury securities (Treasuries) are deemed to be the safest investment instrument. It is also known as the risk-free rate. The guarantor behind these instruments is the full faith and credit of the US government.

Investors are guaranteed the return of both their interest and principal that they are due. Treasuries are also vulnerable to both inflation and changes in interest rates, just like any other bond instrument.

Malaysian Government Securities (MGS)

MGS are coupon-bearing, long-term bonds issued by Malaysia's government to raise funds for development expenditures. It typically constitutes the most actively traded bonds in the country. Bank Negara Malaysia (BNM) regularly issues 3-year, 5-year, 7-year, and 10-year MGS as benchmark securities for the development of a benchmark yield curve.

In addition, 15-year and 20-year have also been issued to lengthen the yield curve. (Source: Bond and Sukuk Information Exchange (BIX) Malaysia)

Government Investment Issue (GII)

GII is a long-term non-interest-bearing Government securities based on Islamic principles issued by the government of Malaysia for funding developmental expenditure. GII are issued through competitive auction by BNM on behalf of the government. GIIs are issued with original maturities of 3-year, 5-year, 7-year, and 10-year. (Source: Bond and Sukuk Information Exchange (BIX) Malaysia)

What is a Credit Spread?

The credit spread is the difference in yield between bonds that have a similar maturity, but different credit quality. It is an indication of the risk premium taken by a bond investor. It is typically measured against the US Treasury or a government bond as it is considered the risk-free rate.

For example, a AA-rated bond will have a narrower spread compared to a BB-rated bond because it is less risky due to a higher credit quality. Spreads are usually measured in basis points (bps), where 1 bps equals to 0.01%.

What does it mean when credit spreads widen or narrow?

Credit spreads **widening** can be a signal of:-

- Potential distress in the bond issuer and its creditworthiness or;
- Markets turning more cautious due to the macro environment and investors becoming more risk-averse.

Hence, investors are being compensated with higher yields which is causing spreads to widen.

Credit spreads **narrowing** can be a signal of:-

- Potential improvements in the bond issuer and its creditworthiness or;
- Markets turning more ebullient because of improvements in the macro environment and sentiment

A healthy economic environment where demand for bonds remain strong will cause spreads to narrow or tighten.

Invest in Fixed Income

To learn more about our fixed income solutions and how you can build a diversified portfolio with bonds, book an appointment with us via the link below:-

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