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Finding opportunity with taxable bond rising stars

Alexandre (Alex) Christensen, CFA
Portfolio Manager

Kris Moreton, CFA
Senior Vice President,
Client Portfolio Manager

Katherine Nuss, CFA
Vice President,
Client Portfolio Manager

Multisector fixed-income investing requires flexibility and unbiased asset allocation. But to be successful doing this, you need a team of research analysts scouring all corners of the credit markets to find the opportunities that drive alpha, no matter the market environment.

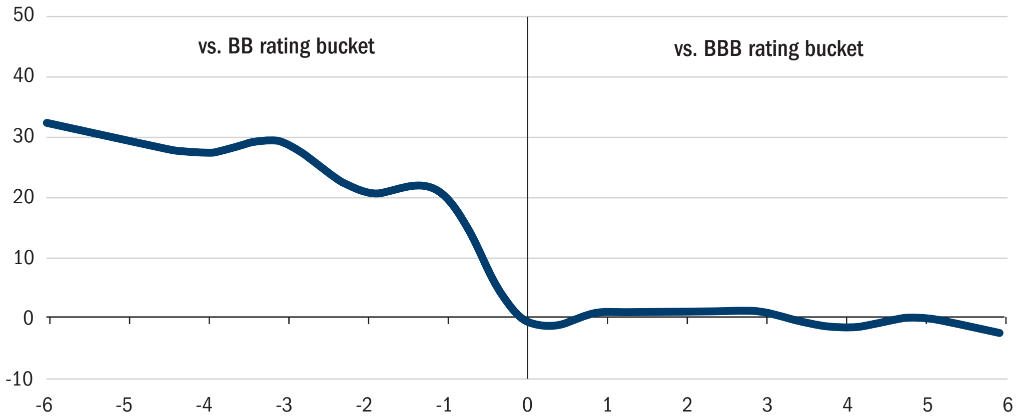
It's even more important when prices are high, like they are now given the astounding recovery from the COVID market crisis. When we survey fixed-income markets, we still see a handful of good risk-adjusted return opportunities. At the top of the list are high yield rising stars.

Corporate financial health follows a typical pattern through the economic cycle: during a recession, credit quality falls as profitability and leverage get worse. Some companies barely holding onto investment-grade ratings are downgraded to high yield — we call these "fallen angels." As the economy heals and balance sheets improve, some companies regain their investment-grade rating — these are known as "rising stars."

Historically, rising stars have mainly outperformed the greater high-yield market while on their path to ratings upgrades. A main reason for this is technical: the investment-grade market is significantly larger than the high-yield market and provides a much bigger buyer base. Often times, rising stars experience price support as they simultaneously expand their universe of investors and reduce their debt loads by paying down existing or issuing fewer bonds.

The chart below illustrates this phenomenon. In the six months leading to upgrade, the risk premium (option adjusted spread, or OAS) of rising stars declines: investors demand less incremental yield cushion, which pushes prices higher. At the point of upgrade, illustrated as "0" below, the risk premium of rising stars are generally trading on par with their BBB-rated counterparts. Bond ratings are divided into categories ranging from AAA (highest) to D (lowest). The opportunity for price appreciation has largely passed, which means that getting ahead of the rating agencies is critical.

Exhibit 1: Rising Star outperformance occurs primarily prior to the upgrade
Median OAS change relative to ratings bucket (bp)*

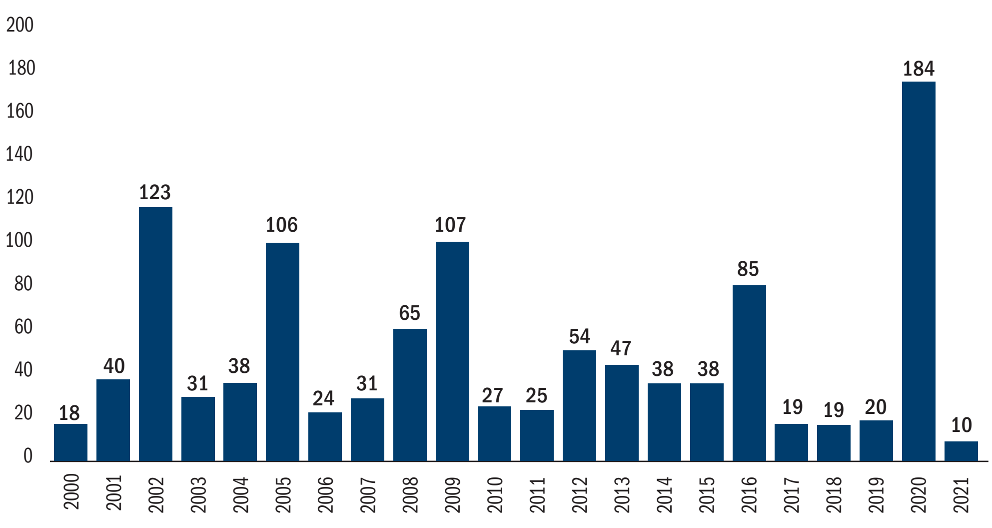


* A basis point is 1/100 of a percent.
Source: Barclays research.

But the benefits to owning this targeted segment of the corporate bond market may continue after ratings upgrades as well. Most rising stars ultimately achieve a BBB rating, which, as the lowest rated rung of the investment-grade market, carries a higher yield than other ratings cohorts. This yield advantage has historically translated into higher returns, allowing BBB rated bonds to consistently outperform the broader investment-grade market. As a result, simply buying full-spectrum high-yield or investment-grade exposure will not capture the opportunity in the same way that overweighting these select bonds can in an active portfolio.

The current economic cycle and transition of fallen angels to rising stars presents opportunities for active managers. There were more fallen angels in 2020 than any year prior. Some of these companies made ill-timed acquisitions, some experienced unprecedented businesses disruptions and others had lackluster business models for some time. The downgrades occurred across industries but were especially pronounced in energy, auto producers and consumer goods.

Exhibit 2: Fallen angel volumes, annual ($b)



Source: Barclays, 2021.

But what a difference a year makes. 2021 had the fewest fallen angels in 20 years as the economy — and corporate credit metrics — improved. Today, a large number of companies are in sights of investment-grade investors as potential rising star candidates. Our credit analysts project that as much as 15% of the High-Yield market by market value could be on a path to higher credit ratings.

Ratings agencies move slowly, however. With solid understanding of each of these businesses, their credit trajectories, and their management's intentions, our research analysts can identify rising star candidates before agencies make their move. This first-mover advantage has real payoff for investors: when most spreads are already tight, rising stars have a clear catalyst to continue to tighten and may exhibit less downside volatility.

Rising stars continue to be an area of focus in our multisector portfolios because of these concrete catalysts. Upgrades may come in a few months or even next year, but a total return higher than just a bond's coupon is rare when risk premiums are as tight as they are now.

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