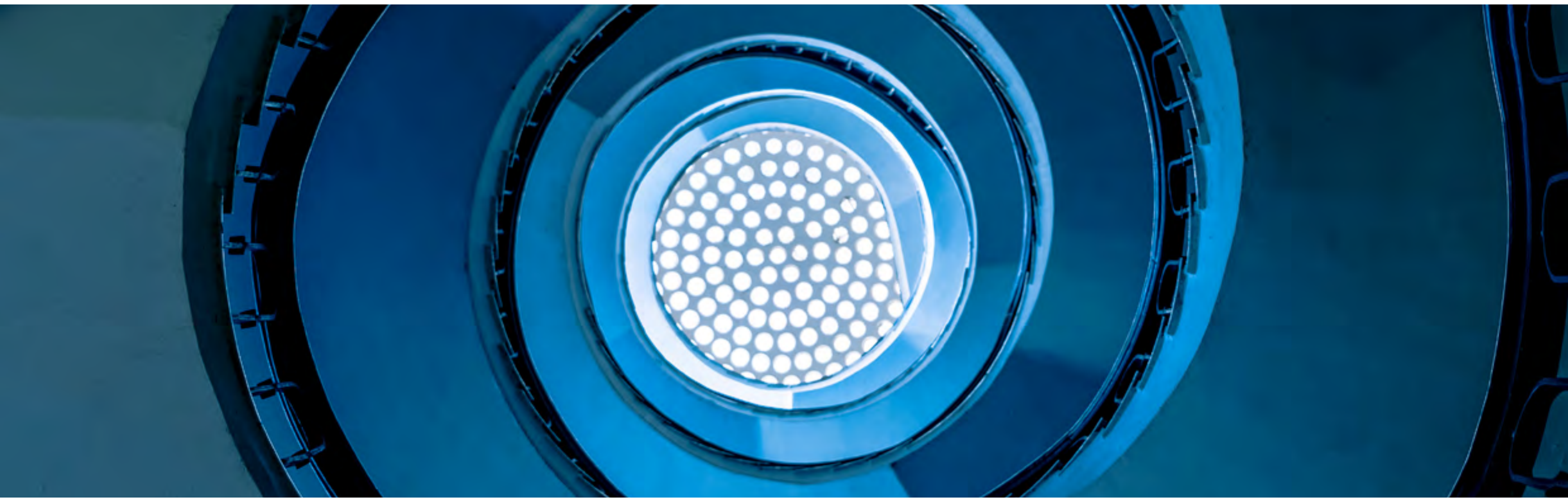
Allianz Global Investors

FIXED INCOME
ADVANCED INSIGHTS

The art of avoiding defaults

Why credit risk is crucial for bond investors



In the first in a new series on fixed income investing techniques, we examine how bond investors can minimise the risk of defaults. In our experience, this approach not only protects value but allows investors to strengthen conviction in their portfolio – and potentially achieve better investment outcomes.

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Defaults and other credit events, in which issuers fail to pay bondholders what they are owed, are a fact of life in financial markets. Affecting both sovereign and corporate issuers, they have occurred in developed and emerging markets – ranging, for example, from the collapse of Lehman Brothers to Ethiopia's international default in 2023.

These events can be damaging to fixed income investors. But most defaults do not come out of the blue: the signs of an impending default are visible. In this article, we explore our approach to spotting the warning signs and protecting value for investors.

Key takeaways

- Key to successful fixed income investing is a thorough credit assessment to identify and blacklist issuers at risk of default.
- Investors must take politics into account and assess not only an issuer's ability to repay but its willingness to do so.
- Rather than encouraging an excessively cautious approach, a laser focus on default risk can build the conviction that supports superior risk-adjusted returns.

Conduct a sophisticated credit assessment

Protection against defaults starts with a thorough credit assessment of every issuer we consider investing in. We examine quantitative factors – such as financial strength – using our global research tool, Advanced Analytics, while also considering qualitative factors. We review assessments frequently and debate them between analysts and portfolio managers.

It is important not only to trust the data, but to question established truths. For example, there used to be a belief that the protections offered by the European Central Bank (ECB) meant that sovereign issuers in the eurozone either could not or would not default. Yet the Private Sector Involvement (PSI) implemented by Greece in 2012, during that country's debt crisis, led to a default in all but name – 97% of eligible privately held Greek bonds were restructured, writing off 53.5% of their nominal face value.

The troubles of the Greek public finances were plain to see, yet many investors chose to continue holding Greek bonds, possibly betting that the ECB would step in to ensure they received the bonds' full face value. In our view, a better strategy would have been to act on the warning signs and divest from Greek debt while there was still time.

Play the long game – defaults may be years in the making

Ernest Hemingway wrote that one goes bankrupt "gradually, then suddenly". So it is with defaults, which may develop over many years before reaching crisis point.

Let's examine some recent high-profile recent defaults. Concerns over French retailer Casino surfaced in 2019 when its parent company was placed under creditor protection because of high debts. Casino issued a statement that the procedure would not affect its operations, employees or strategic plan, which included an asset disposal scheme to reduce debt. However, in July 2023 Casino missed the interest payment on a EUR 400 million bond and defaulted after the 30-day grace period in August 2023. As a consequence, the rating agency S&P changed the rating to "D".

In retrospect, the governance concerns at the parent company were a signal that Casino itself faced overwhelming challenges, but in this case, it took four years for the drama to reach its climax. This example demonstrates how investors must take a long-term view, considering how default risks develop over years.

Consider how politics influences defaults

As well as governance issues, our investment teams examine the broad landscape in which issuers operate. Inevitably this means considering political risk – both for corporate as well as sovereign issuers.

The exclusion of Russian banks from the international payments system Swift in 2022 following the invasion of Ukraine, coming on top of an existing programme of financial sanctions, stranded various Russian assets and made it effectively impossible for many Russian issuers to pay their bondholders.

Russian issuers do not necessarily lack the means to pay. But that is little consolation for bondholders who face drawn-out legal procedures and a high likelihood of significant losses.

We believe fixed income investors must examine not only an issuer's ability to pay, but its willingness to do so. There are many cases in history where an issuer had the resources to satisfy bondholders but failed to do so for political reasons.

Monitor credit agencies, but question them

Credit ratings agencies such as S&P, Moody's and Fitch aim to guide bond investors about default risks. Their ratings are useful inputs to the investment process, but we do not treat the agencies' views as the final word. The process followed by the agencies can be seen as backward-looking, and this has sometimes caused them to overlook key risks. One example is the assigning of triple-A ratings to collateralised debt obligations (CDOs), which suffered severe losses in the 2007-08 financial crisis.

Our approach takes the views of the agencies seriously but also interrogates them. What underlying metrics explain the decision to upgrade or downgrade an issuer? By studying the past decisions of the agencies, it is possible to gain insights into their decision frameworks – insights that are valuable for active managers.

Identifying potential defaults gives investors confidence to take calculated risks

It may seem that a laser focus on default risk could lead to a highly cautious approach to fixed income investing – one that would imply steady but low yields. But this is not true. By identifying and blacklisting issuers that are at risk to default, we strengthen our conviction in those remaining issuers that may offer attractive features. Indeed, the same thorough credit assessment that can identify a deteriorating profile may reveal a "rising star" – an issuer with a "junk" rating with an improving credit profile that could be poised to enter the investment grade universe.

Our view, as active managers, is that the market consensus is often wrong, and that by doing our own research, we can identify and avoid risks that others have not seen and benefit from the market inefficiencies. The best approach to fixed income requires us to do our homework, challenge bias and take nothing for granted.

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