When To Trust Bond Rating Agencies

Institutional and individual investors rely on bond rating agencies and their in-depth research to make investment decisions. Rating agencies play an integral role in the investment process and can make or break a company's success in both the primary and secondary bond market. While the rating agencies provide a robust service and are worth the fees they earn, the value of such ratings has been widely questioned after the 2008 financial crisis, and the agencies' timing and opinions have been criticized when dramatic downgrades have come very quickly. Any good investment firm, whether it's a mutual fund, bank or hedge fund will not rely solely on the bond rating agency's rating and will supplement their research with their own in-house research department. This is why it's important for an individual investor to not only question the initial bond rating, but frequently review the ratings over the life of a bond and constantly question those ratings, as well.

See: *Why Bad Bonds Get Good Ratings*

Major Players
While there are a number of rating agencies out there, the three major ones usually referred to are: Moody's, Standard & Poor's (S&P) and Fitch. These agencies assign credit ratings for issuers of debt obligations, or bonds, in addition to specific debt instruments issued by those companies. The issuers of debt can be companies, nonprofit organizations or state and local governments. In addition, the United States government issues bonds that will eventually be traded in an open market setting. Each agency has their own models by which they evaluate the credit worthiness of a company, which directly affects the rate the issuing firm will offer to purchasers of the bonds upon issue.

The credit rating, just like a personal credit rating for anyone who has ever applied for a mortgage, indicates how likely the company will be to pay interests over the life of the bond. In the company's case, it also implies indications of the potential marketability of the bonds over their life, as well as the company's ability to return the principal when the bond comes due at maturity. (For investors considering buying debt securities, a credit rating is an essential tool, learn more in *What Is A Corporate Credit Rating?*)

Each of the three major agencies have slightly different ratings, but all three have ranges from primes, which are usually reserved for the most pristine companies or the U.S. government, to bonds that are in default.

Bond Rating Grades

Credit Risk	Moody\'s	Standard & Poor\'s	Fitch Ratings
Investment Grade	--	--	--
Highest Quality	Aaa	AAA	AAA
High Quality	Aa1, Aa2, Aa3	AA+, AA, AA-	AA+, AA, AA-
Upper Medium	A1, A2, A3	A+, A, A-	A+, A, A-
Medium	Baa1, Baa2, Baa3	BBB+, BBB, BBB-	BBB+, BBB, BBB-
Not Investment Grade	Ba1	BB+	BB+
Speculative Medium	Ba2, Ba3	BB, BB-	BB, BB-
Speculative Lower Grade	B1, B2, B3	B+, B, B-	B+, B, B-
Speculative Risky	Caa1	CCC+	CCC
Speculative Poor Standing	Caa2, Caa3	CCC, CCC-	--
No Payments / Bankruptcy	Ca / C	--	--
In Default	--	D	DDD, DD, D

The Ratings
Every credit analyst will offer a slightly different approach to evaluating a company's credit worthiness; however, when comparing bonds on these types of scales, it's a good rule to look at whether the bonds are either investment grade or non-investment grade. This will provide the basic groundwork in simple, straight-forward terms. This does not mean that ratings in investment grades are safe or that non-investment grades are unsafe, the investor still needs to dig into the sub-sectors within those general ratings.

It's key to remember that these are static ratings, as a novice investor may make long-term assumptions just by looking at them. For many companies, these ratings are constantly in motion and susceptible to changes, especially in trying economic times like the economy experienced in 2008. Terms like "credit watch" need to be considered when an agency makes a statement about its evaluation; this is usually not a good sign for the company and is an indication of the direction of the next credit quality change.

Unfortunately, the path downward is much more common than upwards. This is due partly to the way the system is designed. It takes a certain quality of a company to issue bonds as part of their capital structure and the market for investment grade has historically dominated the non-investment grade. This precludes small or up-and-coming companies from ever entering the bond market and subjects the historically larger companies to constant scrutiny. (Learn more in *The Debt Ratings Debate*.)

GM Vs. Microsoft

A great example of this path is to compare two very different companies**, General Motors** and **Microsoft**. These two have been textbook examples of companies traveling down opposite paths. General Motors had been around since the turn of the 20th century, had gone through many economic cycles and used debt heavily as leverage in its balance sheet, in order to grow the business in upward economic cycles and hold its own in downward cycles.

Microsoft, on the other hand, is considered more of a growth company, which found its roots in entrepreneurial spirit, venture capital and eventually issuing common stock without using debt for leverage. Microsoft had the ability to seek capital in the bond market, but it didn't capitalize on its great credit rating to raise money until 2009. In contrast, General Motors saw its credit rating deteriorate slowly as it lost market share and battled economic cycles, eventually going bankrupt in mid-2009. For these two companies, survival may have relied on those credit ratings to keep them in the game.

How Companies Value the Rating

As important as it is for investors to review credit ratings, it's even more important to the companies. The rating affects a company by changing the cost of borrowing the money that it wants to leverage its balance sheet. The effect is a higher cost of capital due to higher interest expense, leading to lower profitability. It also affects the way the company uses the capital; although interest paid is often taxed differently than dividend payments, the basic premise is that the borrower expects to have a higher return on the borrowed money than the cost of the capital.

The ratings over time also have major effects on the marketability of the bonds in the secondary market, the ability for companies to borrow in other markets, the ability to issue stock, the way analysts view the level of debt on their balance sheet and a major psychological aspect of how a company is viewed. (Read more on a company's financial position in *Understanding The Income Statement*.)

The Bottom Line

History has taught us how to use the information provided by the credit rating agencies, as a start. Their methods are time tested and up until around 2008-2009 were rarely called into question. The value of the ratings to the companies themselves is paramount, as it can potentially determine a company's future. As the financial markets became mainstream and matured, the access to capital markets and their scrutiny have both increased. Along with the added volatility, the lending markets have seen similar risks as equity markets. With the increased speed of both financial information and market changes, the rating agencies are more important as a first step, as they are to be scrutinized for their ratings and the trend in their rating changes. If you are considering investing in specific bonds, consider these changes and use the agencies for what they are intended to be, a good place to start.

Read more: [When To Trust Bond Rating Agencies](http://www.investopedia.com/articles/bonds/09/bond-rating-agencies.asp#ixzz3qf0v6GLK)
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