Fallen Angels: A window for forward-looking investors

*Today’s economic environment has prompted credit rating agencies to downgrade a substantial amount of debt from companies. However, with the right fundamentals, some bonds may offer compelling valuation opportunities, according to Paul Benson, head of fixed income efficient beta at Mellon.*

Fallen angels, or investment grade bonds downgraded to high yield, can create attractive entry points for bonds with equity-like returns and fixed income-level risk. However, when these bonds are downgraded, some portfolio managers end up selling them.

**Why do they sell?**

As a company’s financial performance deteriorates, whether it’s due a black swan event or mismanagement of funds, rating agencies will downgrade its bonds. This can create a forced-selling scenario among investors who can no longer continue to hold these bonds.

“On the active side, portfolio managers may sell if their strategy’s investment guidelines, which often have a high-yield threshold, limits them from holding additional below-investment grade debt,” says Manuel Hayes, senior portfolio manager of the Mellon Efficient Beta Fallen Angel Strategy.

Passive managers, who focus on managing tracking error, naturally sell out of these bonds during monthly rebalancing, leading to steep discounts, according to Hayes.

**So where’s the alpha?**

The investment grade bond market is roughly US$6 trillion in size and nearly five times the size of the high-yield market. ¹ Forced selling can send ripples of disruption through the high yield market, creating a supply-demand imbalance.

“There’s a large component of investment grade managers who have to sell these bonds, which have been downgraded to a market smaller in size,” Benson says. “When you have this influx of downgraded fallen angel bonds, entering the high yield market at a very fast pace because of forced selling, there tends to be a technical indigestion.”

This ‘technical indigestion’ results in about 200 basis points (bps) of discount relative to where fair value should be for these bonds, according to Benson. ² The key is to identify those fallen angels that are underpriced relative to the broad high yield market.

“If you can systematically invest at the time of the peak discount, we believe you’re able to harvest this structural alpha component,” Benson says.

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² Data from Mellon Efficient Beta team
Aside from valuation opportunities, fallen angel bonds can also offer an attractive risk-return profile. For instance, about 85% of fallen angels have a BB rating while only 50% of the broad high yield market is comprised of BB-rated bonds. The other 50% of the broad high yield market is mainly comprised of B and CCC-rated bonds. This means the sub universe of fallen angels has lower default risk than the broader high yield universe.

Why now?

According to Hayes, there are three reasons why the time could be right to invest in fallen angels:

- Increased pace of downgrades leads to large opportunity set
- It’s an attractive entry point from a spread/yield perspective
- The Federal Reserve (the Fed) is buying fallen angels now

The fallen angel space is only growing, which means more opportunity to invest in downgraded bonds at a discount. Over the last 10 years, rates have been low so companies have continued to issue more and more debt, according Hayes. However, the pandemic has caused lower corporate earnings and a weaker economic outlook. Now, some companies, which may not have been cautious enough, are being downgraded by rating agencies.

“A higher amount of downgrades means more investors are forced selling, which means larger discounts and potentially high returns,” Hayes says. “Over US$150bn has been downgraded year-to-date and we’re four months into it. That number has exceeded every full calendar year.”

“On the sell-side, we hear analysts projecting anywhere from another US$200bn to US$700bn in fallen angel downgrades taking place from now until the end of this year.”

Secondly, wider option-adjusted spreads (OAS) during March offer a wider entry point, which should be more compelling to investors. At the moment, OAS spreads are at roughly 750 bps, which Hayes says is still an attractive entry point, at levels not seen since the Great Financial Crisis.

Lastly, the Fed is currently buying fallen angel bonds, which Hayes says is supportive of valuations. On April 9, the Fed announced it would expand its primary and secondary market corporate credit facility to include fallen angels, which impacts both bonds and ETFs.

On the bond side, US$500bn will be supported on the primary market and US$250bn on the secondary market. On the ETF side, it announced it would buy broad-based corporate bond ETFs.

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3 Data from Mellon Strategic Beta team
4 Data from Mellon Strategic Beta team
5 Bloomberg: Federal Reserve’s fallen angel bond buying won’t catch them all. April 9, 2020.
On May 4, the New York Fed provided more insight into the program, stating if a recently downgraded company wants to opt into the primary credit market and have the Fed purchase its debt, there is compliance criteria that must be met—but if met, it would step in as last resort lender. It also announced it would start buying broad-based corporate bond ETFs in early May if they meet certain valuation criteria.

“This is very supportive of valuations. On the bond side, the high-yield market rallied 86 bps on the back of this initial announcement. That’s one of the largest single-day moves in high-yield market history,” Hayes says.

“On the ETF side, we saw 6% returns intraday into broad high yield ETFs. From a valuation perspective, this only further reinforces why we think the time is now to invest in fallen angels.”

Fallen angels may be a way for investors looking beyond the horizon to navigate today’s market environment and tap into fundamentally-sound bonds at a discount.

**Definitions:**

**Alpha:** Then excess return of an investment relative to the return of a benchmark index. **BB rating:** A credit rating just below the investment grade threshold. **Beta:** The measure of relative volatility. **Black Swan Event:** An unpredictable event, beyond what is normally expected and has potentially severe consequences. **CCC rating:** A credit rating, which represents an extremely high risk bond or investment. **Fair Value:** An assets sale price agreed upon by the buyer and seller. **Option Adjusted Spreads:** The measurement of the spread of a fixed income security rate and the risk-free rate of return, which is then adjusted to take into account the embedded option. **Spread:** The difference between two comparable measures. **Yield:** Earnings generated and realized on an investment over a particular period of time.

No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.

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