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Unrated bonds are an expert's domain

Some years ago, 'bond king' Jeffrey Gundlach, the founder of DoubleLine Capital said: "Fear and loathing" best describes market sentiment toward risky assets. Today, the era of ultra-low-yields has somewhat reversed this sentiment.

In times of negative yields, the hunt for yield has led some investors into the unchartered territory of unrated bonds; this is a risky business. Bond ratings provide an assessment of the issuer's ability to pay coupons and return the principal in a timely manner. These are normally issued by one or more of the three independent rating agencies: Standard & Poor's, Moody's or Fitch. Ratings also provide a point of comparison across the 'graded bond' universe, allowing investors to assess whether a bond is over or undervalued relative to others.

Lately, more investors have been happy to venture into unrated bonds, taking fundamental analysis into their own hands, or ignoring the need for this entirely; in some cases at their peril. It is not to say that unrated bonds are, by default, a bad investment: this is a space that savvy, professional investors can navigate, scoping out good opportunities which offer a premium to compensate investors for the lack of rating or for having less liquidity, which is often the case in this market.

Issuers which are considered 'household names' have been able to take advantage of their status amongst retail investors and tap into the unrated bond market. Renowned companies do so to avoid the cost, in terms of money and time, involved with obtaining a rating. Adidas, Ferrari and Air France-KLM, have all issued unrated bonds.

However, this is a space where amateur investors can get burnt. An example of this is when in 2014/15, a series of defaults and insolvencies hit Germany's Mittelstand bond market, which was predominantly made up of unrated bonds issued by small and medium-sized enterprises (SME). According to the Financial Times, of 192 Mittelstand bonds issued between 2010 and 2014, there were 26 corporate defaults. Retail investors - enticed by 7% coupons and the 'famously reliable German SME sector' - suffered great losses and complain they were let down by a lack of transparency about the risk of their investments. Unfortunately, another wave of defaults could be likely when €1.6bn of Mittelstand debt matures this year.

Unrated bonds can allow companies to raise capital whilst masking ailing financials. Going unrated can also avoid the negative image associated with a low public rating, or sell-offs that could occur if their rating was to be downgraded. Unrated bonds have lighter covenant packages, meaning the issuer enjoys more flexibility than it would from bank loans. However, this means less protection for investors.

A 'red hot bond' market

In Europe where the European Central Bank (ECB) has been buying €80bn worth of assets per month (slowed to €60bn in April) under their Quantitative Easing program, prices were kept high and yields, artificially low. Yield-starved investors became more willing to move out of quality or graded bonds in pursuit of returns.

"If the market is really hot, and at the moment it's red hot, you don't always need a rating", said Roman Schmidt, head of corporate finance at Commerzbank speaking in the Financial Times.

As an example, in March, Fromageries Bel, the French cheese-maker who owns Babybel and La Vache Qui Rit (the laughing cow), issued its first Eurobond, absent of a rating. The issue was substantially over-subscribed; more than €2.3bn of orders were received for a €500m seven-year bond yielding 1.59% (coupon 3%).

In January, Louis Dreyfus, a Dutch commodity trader, issued an unrated 5-year Eurobond with a 4% coupon. There was strong demand with orders in excess of €1.7 billion. The transaction was upsized from €300 million to €400 million to accommodate investor interest.

We cite these examples, not to opine on whether these were good investments or not, but to highlight the extreme levels of demand that an unrated bonds can command in the current climate if the returns are right. The Federal Reserve (Fed) published a research paper in October 2016, concerned with herding in bond markets (this can cause large unsubstantiated rallies or sell-offs based on seemingly little fundamental evidence to justify either). It found that herding in unrated bonds is considerably higher than in investment grade bonds and even high-yield.

Fundamentals are key

Nonetheless, not all unrated bonds are low quality and can offer a slight premium. According to the rating agency Fitch, quite a few of the larger issues of unrated bonds display credit profiles that could be classified as investment, or near-investment grade. Unicredit, the investment bank, presents Prada as an example of this. In 2013, they issued a 5-year unrated bond with a nominal amount of €130m and a 2.75% coupon. They note that at this time, Prada's strong credit metrics compared well to large competitors, such as LVMH (Rating: A+).

In this opaque market, the challenge for investors lies in separating out the few high quality, unrated bonds from those which may not even be worth the paper they are printed on. To do so, in-depth fundamental analysis is required and inexperienced investors should beware of relying on false queues such as brand name or image. We also note that if 'fear and loathing' returns to riskier assets, it is likely that unrated and junk bonds will suffer the most, given their vulnerability to herding and often fragile fundamentals. In brief: Unrated bonds are an expert's domain!

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