UPS AND DOWNS OF CREDIT RATINGS

WHICH CAME FIRST - RATINGS OR PRICES?

By MICHAEL COLE and HUGH DOUGHERTY

A study of the effect on security prices of credit re-ratings produces a chicken-and-egg question. Have the markets already absorbed the information before a ratings announcement?

In the course of developing a disciplined approach to equity market recommendations we have considered the value of alternative company ranking techniques. Before producing an "in-house" system, our attention was captured by the thought that publicly available *debt market* ranking systems may already yield some ranking information for *equity market* analysis. This paper summarises our research into the question of whether a change in the debt rating of a given listed company signals a change in its future relative share-price performance.

The use of debt ranking data for this purpose would appear to have a plausible basis. Credit-rating agencies rank companies using a broadly similar methodology to a disciplined equity market analyst. Detailed information on operations, finances and strategy—past and prospective, audited or not—is consistently combined in an assessment of the total picture.

A more specific focus of the credit-rating process is prospective cashflow and its variance, which is in common with equity market analysis. One key divergence of emphasis, however, concerns the greater weight accorded to such things as asset protection, indenture provisions, etc. in the credit-rating process.

Before presenting our results, however, it must be noted that this intuitive approach is inconsistent with the official stance of the rating agencies toward the interpretation of their ratings scale. In a recent interview with Personal Investment magazine, Paul Coughlin, director of Australian Ratings, said: "The ratings are not recommendations to buy or sell securities . . . Nor are they judgments about the relative performance of various investments. We are concerned with asset quality rather than performance." In this light we accept that our use of the Australian Ratings data here is not necessarily recommended by people closer to actual compilation.

Table 1 documents the most important rating changes announced by Australian Ratings since early 1989 from an equity market perspective. The data has been split into upgradings and downgradings, with some companies recording more than one re-rating over the period.

The columns headed "Relative Performance" reveal relative market pricing both three months before and three months after the rating change shown. Specifically, the numbers shown in any cell represent the percentage growth in the company share price (on a fully diluted basis) minus the percentage growth in the All Ordinaries Index. On this definition, a negative number is interpreted as underperformance of the company share price vis-a-vis the overall equity market while a

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positive number represents outperformance.

The results are best interpreted by comparing the two Relative Performance columns; ie, the change in relative performance after a re-rating. This approach is summarised in the column to the far right of the table where the re-rating was classified into one of five categories:

- **Strong fail.** For a downgrading, these are instances where the stock underperformed before the announcement and outperformed thereafter. For an upgrading, these are instances where the stock outperformed before the announcement and underperformed afterwards. In essence, this category suggests that the credit-rating announcement acts as a contrariant indicator of market pricing. In such cases there is a presumption that the equity market prices had already fully discounted the information which prompted the re-rating in the first instance.
- **Fail.** For a downgrading, these are instances where the stock outperformed before the announcement and continued to do so thereafter. For an upgrading, these are instances where the stock underperformed before the announcement and continued to do so afterwards. This category picks up cases where there appears to be no correlation at all between the rating change and market pricing.
- **Neutral.** For a downgrading, these are instances where the stock underperformed before the announcement and continued to do so afterwards to a broadly similar degree. For an upgrading, these are instances where the stock outperformed before the announcement and continued to do so afterwards to a broadly similar degree. This category reflects the difficulty of differentiating between the effect of the rating change per se and the mere continuation of an already established trend.
- **Success.** For a downgrading, these are instances where the stock underperformed before the announcement and significantly accelerated this underperformance after the announcement. For an upgrading, these are instances where the stock outperformed before to the announcement and significantly accelerated this outperformance afterwards. This category picks up cases where there appears to be some correlation between the rating

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Table 1:
Major company downgradings

Code	Date of Re-rating	From:	To:	Relative Price Performance* Before	After	Comment
SMI	Jan-89	BBB	BBB-	-2	26	Strong Fail
NCP	Feb-89	BBB	BBB-	2	34	Fail
SFG	Feb-89	BBB+	BBB	-4	-4*	neutral
BEL	Mar-89	BB	B	-12	-35	Success
PSL	Mar-89	BBB-	BB+	6	7	Fail
HKR	Mar-89	BBB-	BB-	-12	-81	Success
GMF	Apr-89	A-	BBB	22	-16	Strong Success
AGL	May-89	A+	A-	-8	-5	neutral
JOD	May-89	BBB-	BB+	5	-3	Strong Success
NCL	May-89	BBB-	BB+	-5	-4	neutral
ANI	Jun-89	A+	BBB+	-13	-12	neutral
HKR	Jun-89	BB-	B	-81	-14*	neutral
MSA	Jul-89	BBB-	BB+	-19	-1	neutral
AAL	Aug-89	AA-	A	-8	1	Strong Fail
QTX	Oct-89	BB-	CCC	-65	0*	Strong Fail
EXL	Nov-89	A-	BB	-4	16	Strong Fail
FAI	Nov-89	BBB	BBB-	-19	-5	neutral
NCP	Dec-89	BBB-	BB+	-7	-13	Success
TNT	Dec-89	A-	BBB+	-12	-6	neutral
QTX	Dec-89	CCC	C	-56	7*	Strong Fail
BLL	Dec-89	CCC	c	-17	-46	Success
BOND	Dec-89	CCC	c	-56	7*	Strong Fail
BEL	Dec-89	CCC	c	-60	-10	neutral
WBC	Jun-90	AA+	AA	-6	-5	neutral
MCP	Jun-90	BBB	BBB-	-3	-26	Success
AST	Nov-90	BB+	CCC	-78	34*	Strong Fail
TTH	Nov-90	BB+	B-	-71	0*	Strong Fail
PSL	Nov-90	BB+	B-	-51	6*	Strong Fail
NCL	Nov-90	BB+	B-	-71	-5*	neutral
JOD	Nov-90	BB+	B-	-28	1*	Strong Fail
NCP	Dec-90	BB+	B-	-28	1*	Strong Fail

Major company upgradings

Code	Date Of Re-rating	From:	To:	Relative Price Performance* Before	After	Comment
BLL	Mar-89	B-	B	-17	-62	Fail
QTX	Mar-89	B	BB-	1	-6	Strong Fail
RGC	Dec-89	A-	A	5	11	Success
BRY	Dec-89	BBB	BBB+	-10	-16	Fail
BIL	Feb-90	A	A+	11	4	neutral
CNA	Feb-90	BB-	BB+	0	14	Success
SMI	Feb-90	BBB-	BBB	-11	18	Strong Success
IEL	May-90	BB+	BBB	0	1	neutral
WOI	May-90	B+	BBB	16	3	neutral

***Note:** Stocks marked with an asterisk are calculated using the latest available data; a full three-month period may not have been possible either because of a subsequent delisting or the relatively recent occurrence of the re-rating.

change and market pricing.

- **Strong success.** For a downgrading, these are instances where the stock outperformed before the announcement and underperformed afterwards. For an upgrading, these are instances where the stock underperformed before the announcement and outperformed afterwards. This category covers cases where the rating change appeared to alter dramatically equity-market perceptions of relative pricing, the presumption being that the equity market had not even considered the information which prompted the re-rating.

The mechanics of this approach are best explained by taking the first stock shown on the list of downgradings as an example. Howard Smith (SMI) was downgraded in January 1989 from BBB to BBB-. Over the three months preceding this announcement SMI had lagged the growth in the All Ordinaries Index by 2 per cent. Subsequent to the announcement, however, the stock reversed this relative performance by outpacing the growth in the All Ordinaries Index by 26 per cent. We consider this to be a "strong fail" because the prior underperformance was replaced by subsequent outperformance, suggesting that the unfavourable information contained in the downward re-rating was already fully priced into the stock before the Australian Ratings announcement.

Using these definitions, our results clearly indicate that the information content of Australian Ratings announcements are in large part already factored into market pricing beforehand. The results by category are shown in Table 2.

On only seven of thirty-one downgradings (ie, less than 25 per cent of the time) did the company's share price subsequently and significantly underperform. Even if all the neutral readings for the downgradings were reallocated as successes the very best the credit ratings could do was a 58 per cent success rate.

The result suggested that equity market pricing tends to move ahead of credit rating changes, rather than after, is not too surprising.

There is a much smaller number of upgradings with three of the nine instances yielding subsequent outperfomance (six if the neutral is included as a success).

The result suggested—that equity market pricing tends to move ahead of credit rating changes, rather than after—is not too surprising when one considers the differing disciplines equity-holders and debt-holders face in the investment process.

Table 2: Results summary

	Downgradings		Upgradings	
	No.	(%)	No.	(%)
Strong Failure	11	(36)	1	(11)
Failure	2	(6)	2	(22)
Neutral	11	(36)	3	(34)
Success	5	(16)	2	(22)
Strong Success	2	(6)	1	(11)
Total	31	(100)	9	(100)

First, the former tend to have high levels of liquidity and the latter do not, while the order is reversed when it comes to security. In this light, shareholders have both the incentive and, more important, the capacity to attempt to alter their shareholdings in response to the arrival of frequent information regarding the fortunes of a particular company.

The sharemarket is more likely to move, for example, on the basis of daily anecdotal evidence rather than await confirmation in the less-frequently available published accounts. In contrast, corporate creditors (and hence the credit rating agencies which act as their major information source) may have the incentive to move this quickly but do not have the liquidity to do so; these entities are virtually locked into "infrequent" behaviour, whereas the equity-holder is free to exercise his desires well in advance.

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Second, credit assessment tends to be an "absolute" concept while equity investment is more akin to a "relative" concept. Credit ratings may change only slowly because the probability of non-repayment versus repayment for a specific company may alter infrequently. On the other hand, equity investment considers the probability of one company outperforming other companies and "the baton may change hands" frequently from this perspective.

This is not to say that the credit ratings cannot play a significant role in the process of equity-market analysis. We shall be exploring this avenue in future research with the most obvious application appearing to be as an input to the determination of the various equity risk premia concepts which abound either at the level of individual stock selection or broad asset-class allocation. □