Perpetual knowledge bank series: Credit Spreads

By Perpetual Asset Management
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Nothing is more confusing for the uninitiated bond investor than to hear about the movement of "credit spreads". Aren't bonds all about interest rates? They are but there's more to it ...

Credit spreads refer to the compensation or return provided for accepting credit risk, which is the risk that a borrower or counterparty does not meet its principle and/or interest payment obligations as they fall due. Credit spreads provide implied default rates of borrowers of debt securities, as priced by the fixed and floating rate markets.

Traditionally, credit spreads are measured by the difference in yield between corporate debt and government debt of the same maturity. For example, the US Treasury 10-year bond.

In Australia, the Bank Bill Swap Rate (BBSW) is commonly used as the reference rate to evaluate floating rate securities. In this context, **credit spreads represent the risk premium added to the base interest rate (e.g. BBSW) when pricing corporate securities**.

Generally, the higher the credit risk, the higher the "spread" or extra interest that investors are willing to pay for owning the debt. We often hear two sayings:

1. "Credit spread widening"
   This means compensation or return provided for accepting credit risk has increased. Credit spread widening typically occurs in times of uncertainty or when economic conditions are expected to deteriorate. Credit spreads may also widen to indicate the creditworthiness of a borrower has deteriorated. Therefore, when you invest in assets at wider credit spreads, the return provided is higher as compensation for accepting the higher risk. Conversely, existing assets in your portfolio will decrease in value as a result of credit spreads widening.

2. "Credit spread tightening"
   This means compensation or return provided for accepting credit risk has lowered. Credit spreads may tighten as an indication of improving market conditions and/or a more positive view on the risk profile of borrowers. Therefore, when you invest in assets at tighter credit spreads, the return provided is lower as there is less risk to be compensated for. For existing assets in your portfolio, the value of the asset will increase as a result of credit spreads tightening.

At Perpetual, we employ a robust, active and risk aware investment process to determine the most attractive credit investment opportunities on a risk-adjusted basis at any point in time. This includes conducting rigorous relative value opportunities. For example, we may seek to identify opportunities where credit spreads are wide for certain securities and therefore the compensation received from investing is more attractive. We then seek to generate profit for our investment portfolio when credit spreads tighten on the same asset and we exit the position.

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