

Can including fallen angels enhance returns?

What is a fallen angel? In theological terms, a fallen angel is one who has rebelled and been exiled from heaven. In financial markets, it's a bond or issuer that has been expelled from the investment grade universe.



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In this article we focus on the design of a sterling fallen angel index as well as highlighting the benefits of combining it with investment grade indices.

In many cases these bonds are issued by very well-known companies who you may not necessarily associate with high yield issuers (e.g. Tesco, Telecom Italia).

When a bond is downgraded (either by S&P/Moody's/Fitch¹) it often implies that the business is suffering in some shape or form, either from a weakening financial position, or a loss in revenues and/or market share that could have an impact on the issuer's ability to service their debt. When a company's debt is downgraded below investment grade, it no longer remains a constituent of investment grade benchmarks.

Over the medium-to-long term, the fallen angel issuer has the opportunity to recover from the downgrade by regaining financial strength and being upgraded. The fallen angel may improve its ability to navigate balance sheet challenges or its assets may become more valuable. The bottom line is that these issuers have a high incentive to regain their investment grade status in order to maintain a low cost of capital over the longer term.

¹ Ratings agencies, such as Standard & Poor's and Moody's Investors Service, assign ratings to bonds based on an issuer's ability to repay its debt. Bonds rated from AAA down to BBB- are considered investment grade (Figure 1). Those rated BB+ and below are considered high yield.

Figure 1. Credit Rating and LGIM Index Fallen Angel Definition

	Rating	LGIM fallen angel index definition
Investment grade	AAA	Investment Grade
	AA+	
	AA	
	AA-	
	A	
	A-	
	BBB+	
	BBB	
	BBB-	
	High yield	
BB-		
B+		
B		
B-		
High yield	CCC+	High Yield
	CCC	
	CCC-	
	CC	
	D	

Note: LGIM Index have defined a fallen angel to be high yield bonds rated from BB+ to B-. However, others may include the entire high yield rating spectrum.

For companies who can successfully regain investment grade ratings, the pick-up in the performance of their debt can be significant. For investors who can maintain exposure to fallen angels through this period, there is an opportunity to potentially generate returns above that of investment grade indices, with measured levels of risk.

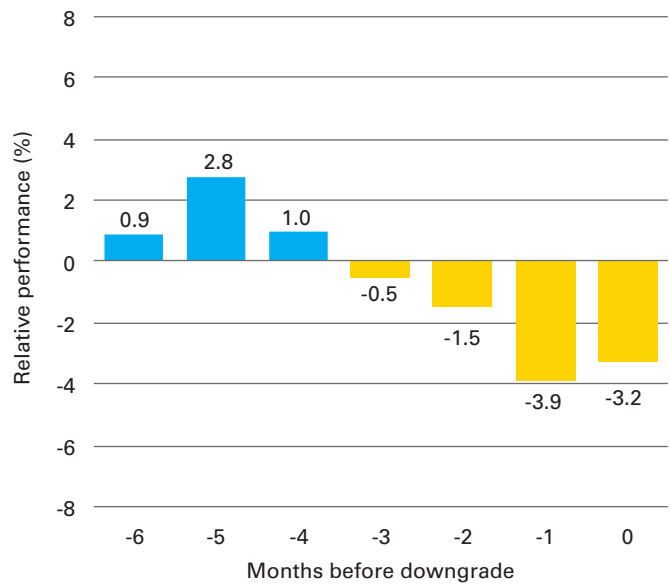
FALLEN ANGELS IN UK CORPORATE BONDS

In this article we focus on the sterling fallen angel market, and on how investors who are willing to extend their sterling index investment grade exposure to include a fallen angel component can implement the change most effectively.

The current size of the sterling fallen angel market, as defined by the LGIM index, is around £22bn, compared to the investment grade market size of £565bn. Sterling fallen angels represents 42% of the sterling high yield universe. Unsurprisingly, the vast majority of the fallen angel universe is the highest quality within the high yield universe, with 79% of the index rated as BB+, as shown in Figure 2 (ii).

Investors who choose to add fallen angel exposure to existing mandates (investment grade and BBB index funds) still retain the majority of their exposure to investment grade assets. The current weight of LGIM index fallen angels, as a proportion of investment grade plus fallen angels, or BBB plus fallen angels indices, is 3.6% and 9.9% respectively (Figure 2, i and iii).

Figure 3. FA-6 months before downgrade relative performance versus IG index (Compounded)

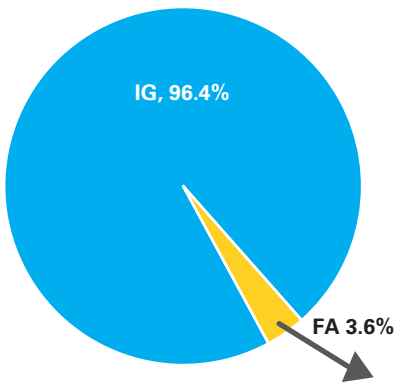


Source: LGIM, Bloomberg LP, iBoxx
For illustrative purposes only. Past performance is not a guide to future performance.

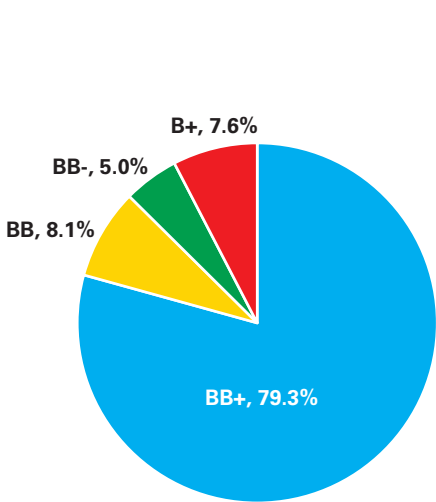
Prior to a fallen angel downgrade, the bond or the issuer may be placed on negative 'credit watch'. As individual rating agencies issue downgrades, this can lead to selling pressure that makes the underlying bond prices fall. Historically, the price of a fallen angel bond starts to underperform the investment grade universe in the months before the downgrade (Figure 3). Investors that cannot hold the bonds following a downgrade, typically due to investment policy restrictions, are often selling where prices are artificially low.

Figure 2. Sterling investment grade and fallen angel market overview by rating and size

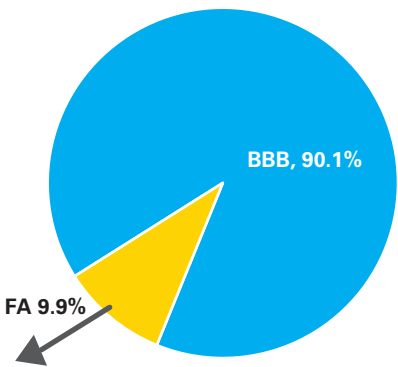
i. Investment grade and fallen angels index



ii. Fallen angels



iii. BBB and fallen angels



Source: LGIM, iBoxx

As selling pressure dissipates, the price of the fallen angels typically recovers partially or fully within three- to-six months post downgrade (Figure 4). Thus, by continuing to hold fallen angel bonds after the downgrade, investors have the opportunity to benefit from price reversion and outperformance versus the wider investment grade universe.

DESIGNING A FALLEN ANGELS INDEX

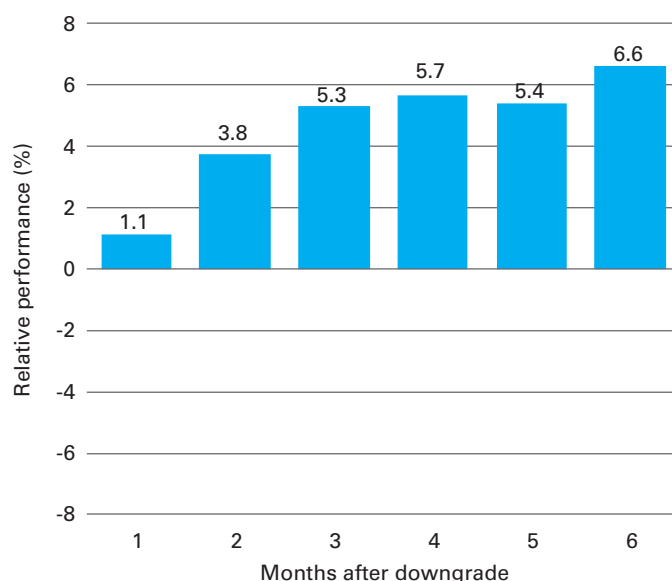
LGIM has worked in conjunction with iBoxx to design an index which includes fallen angel bonds. iBoxx are responsible for the index methodology and performance calculation, and the index has been calculated back to 2012, giving five years of historical returns.

LGIM are now offering investors exposure to fallen angels as part of an extension to our existing GBP Investment Grade Index Fund range.

LGIM clients now have a choice of the following additional funds:

- Markit iBoxx £ Non-Gilts All Stocks (IG) plus Markit iBoxx GBP Non-Gilts Fallen Angels
- Markit iBoxx £ Non-Gilts BBB plus Markit iBoxx GBP Non-Gilts Fallen Angels

Figure 4. FA-6 months after downgrade relative performance versus IG index (Compounded)

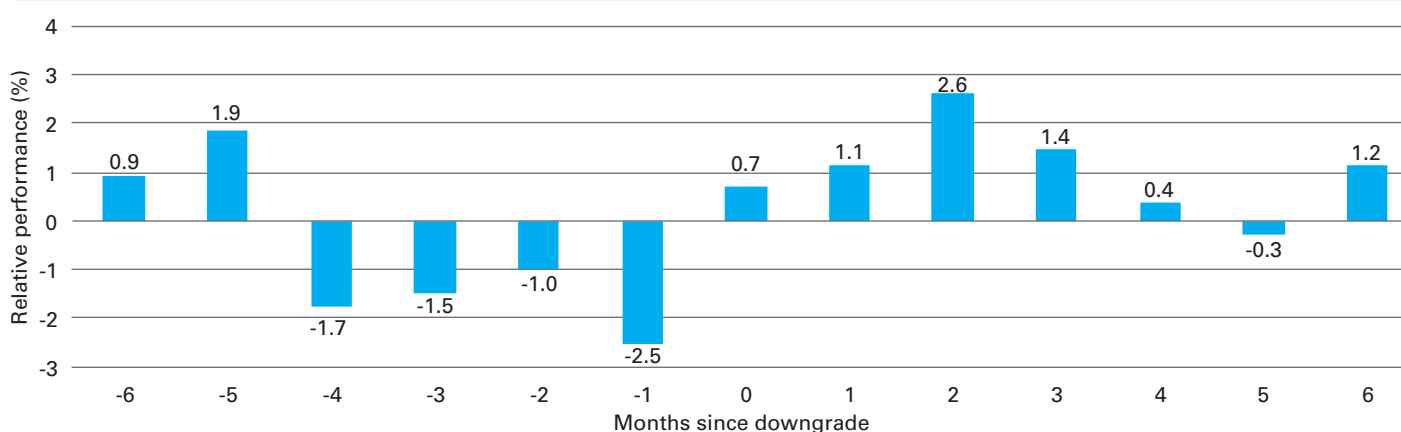


Source: LGIM, Markit, iBoxx
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To ensure the new indices fit seamlessly with existing iBoxx non-gilt indices, iBoxx index rules are maintained. In addition, two custom rules have been created for the fallen angel component.

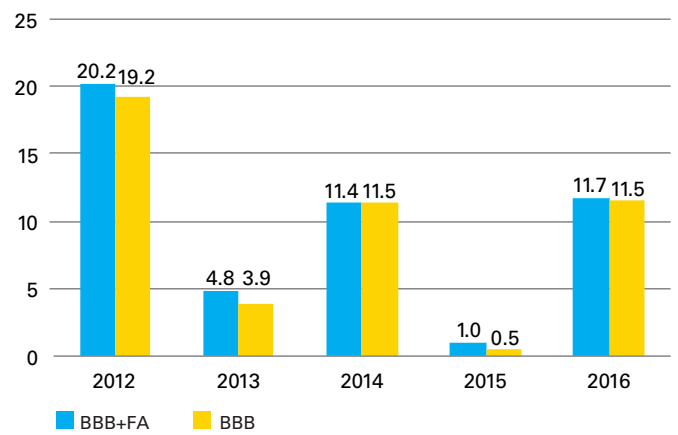
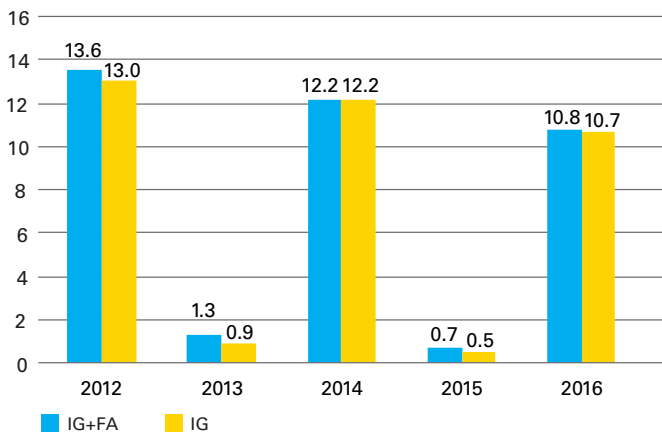
First, the maximum inclusion time for bonds classified as fallen angels is five years.

Figure 5. Fallen angel performance relative to investment grade index pre and post downgrade



Note: Price changes are calculated based on the average of all prices for the 64 fallen angels that entered the index between January 2012 and February 2017. The cumulative chart is the com. Source: LGIM, Markit, iBoxx, Bloomberg LP. For illustrative purposes only. Past performance is not a guide to future performance.

Figure 6. Total return of fallen angels combined with investment grade and BBB indices (%)



Source: LGIM, iBoxx, Bloomberg LP. Note: the consolidation of the contribution to the IG and BBB is weighted according to the market value of the FA, IG and BBB universe. For illustrative purposes only. Past performance is not a guide to future performance.

This allows sufficient time for issuers to regain their investment grade rating and removes issuers that perhaps should no longer be considered fallen angels after this period.

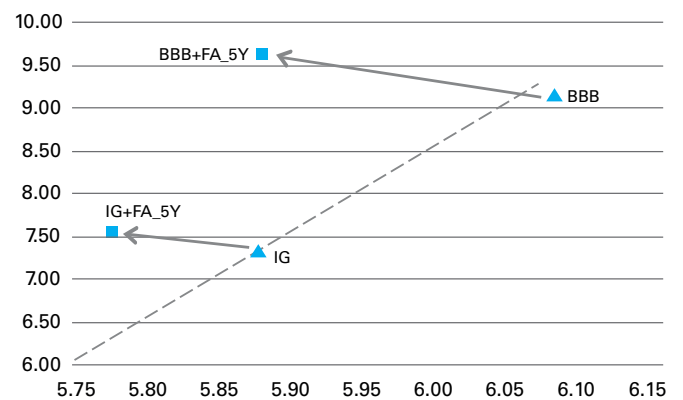
The second rule is to include a conservative minimum credit rating into the fallen angel component which we have designated as B-. Issuers that continue to fall down the credit scale to CCC+ or below would be removed from the index.

Historically, there have been 109 fallen angels in total in the index since 2012. Over this five year period, 25% of the fallen angels have been upgraded back to investment grade, while 8% continued their downward trend and experienced a credit rating downgrade to CCC or below. Since the inception of the index no bonds have jumped to default.

Moreover, bonds that were upgraded back to investment grade, on average, spent two and a half years as a fallen angel, while those that suffered further downgrades to CCC/CC did so within a year.

Based on the constructed fallen angel index, we analyse the historical price reaction of the bonds pre- and post- the downgrade relative investment grade universe (Figure 5). The average fallen angel tends to underperform in the four months leading up to a downgrade, and then outperform in five out of six months following the event.

Figure 7. Five years risk and return



Note: IG+FA_5Y is the combined IG and FA return (annualized) and volatility over the past five years (February 2012 - February 2017). BBB + FA is the combined BBB and FA Source: LGIM, iBoxx. For illustrative purposes only. Past performance is not a guide to future performance.

Our analysis shows that six months prior to the downgrade, fallen angel bonds underperformed -3.2% on average and in the six months after, they outperformed by 6.6%.


The addition of fallen angels to the investment grade index over the last five years has increased the cumulative return by 1.2% over this period (Figure 6). When the fallen angel component was added to the investment grade (BBB) index, performance increased cumulatively by 2.6% over the same period.

When we view the risk/return profile of the investment grade and BBB indices compared to the same indices with the fallen angel component included, the addition of the fallen angel has historically provided a higher return with a lower level of risk (Figure 7).

As we have covered in this article we believe the benefits to investors to be two-fold when incorporating fallen angels as part of a wider fund solution. Firstly, the fallen angel bond price tends to overreact to the downgrade in the short term and recover partially or fully within six months of the downgrade. Secondly, a small addition of fallen angel bonds into investment grade and BBB indices could improve the risk-adjusted returns compared to the standalone indices. LGIM now offers practical ways to take advantage of these benefits through these new funds, which are available through segregated mandate and unit linked life policy. Capital is at risk.

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