When Credit Diverges from Equity

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KEY TAKEAWAYS

- Credit and equity returns can diverge significantly at the onset of event risk.
- Many shareholder-friendly actions come with increased leverage risk that could pressure bond spreads and quality ratings.
- Credit investors should be keenly aware of the factors influencing equity performance and remember a company's fiduciary responsibility to shareholders above all else.

It's a common misconception that credit and equity performance are both manifestations of a firm's underlying health and thus move in tandem.

While a robust equity cushion is typically positive for credit, equity and credit returns can diverge significantly at the onset of event risk. The origin of this divergence lies in the different risk-to-reward ratios for each investor base. A large part of fixed income investing relies on the "win by not losing" mantra. In other words, as long as a company does not default on its debt, fixed income investors should get their investment back along with a risk premium. Fixed income investors see limited additional benefit from gains in a company's profit and earnings, and upside potential is capped by coupon payments and any modest increase in par value. On the other hand, equity investors have much larger upside potential; there is no limit to stock price appreciation. Gains in a company's profit and earnings tend to directly accrue to equity investors as company managements often prioritize shareholder value over balance sheet improvement. As a result, payout for credit investors is typically skewed to the downside, whereas payout for equity investors is typically skewed to the upside.

Poor equity performance pressures a firm to look for direct and indirect ways to boost shareholder value through strategies such as cost cutting, increased dividends, share repurchases, asset sales, acquisitive strategies for growth, and increased capital expenditure to induce growth. Shareholder-friendly actions tend to pick up late in the credit cycle, when corporate profits are increasingly under pressure. Not all actions are necessarily credit negative, but most come with risk of increased leverage that could pressure bond spreads or lead to rating agency downgrades. As a result, fixed income investors should keep a keen eye toward equity performance when forecasting bond performance.

Example: CBS Corporation

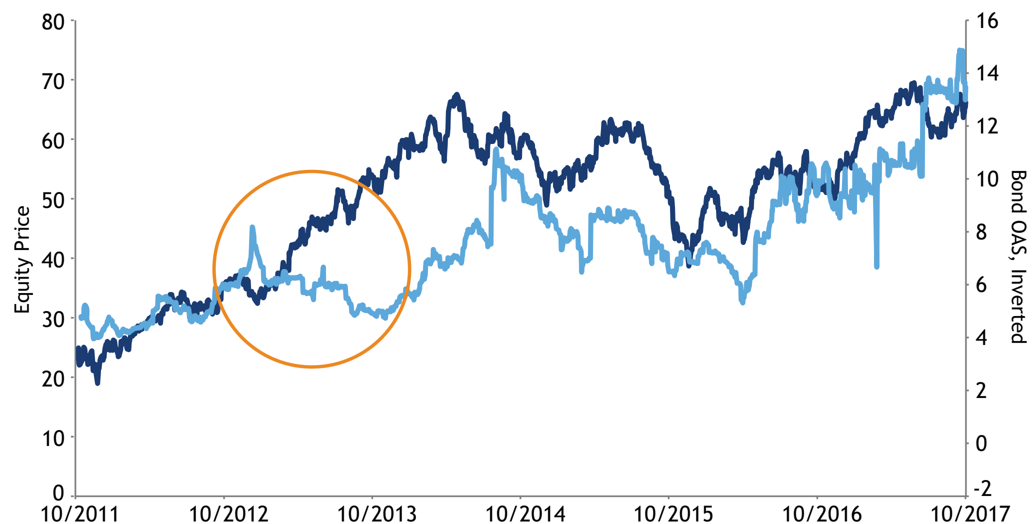
The chart below illustrates CBS Corporation equity performance (dark blue) and bond spread performance (light blue) and highlights a period when bond spreads and stock performance diverged and then reversed to become positively correlated again. Note that we are showing inverse bond spread to help illustrate the following examples. Bond spreads began widening (underperforming) in October 2012 due to repeated share buyback announcements, which implied a need to fund the transactions via the debt markets. During the same period, operating performance was generally trending upward, combining with the boost from capital returns to drive stock outperformance. So although CBS' operating performance was generally trending upward, the bonds sold off based on the market's perception that all of the value was accruing to equity shareholders through expected debt-funded share repurchases.

Bond and equity performance became positively correlated again in September 2013. Why? Because the bond market determined the debt supply headwind had passed, operating performance was still trending up, and CBS remained underlevered relative to its media peer group. After that, bond and equity performance remained largely correlated. However, the correlation has recently fallen again as equity has been showing much higher volatility than bonds due to constant-pay TV ecosystem headlines, advertising pressures and merger and acquisition rumors.

CBS CORPORATION EQUITY AND BOND SPREAD PERFORMANCE

Source: *Bloomberg Barclays, data as of August 10, 2017.*

*OAS Calculation=1/OAS*1000*



Credit Investors Should Be Keenly Aware of Equity Performance

While a company's underlying fundamental operating performance can result in a strong correlation between credit and equity performance, there are often scenarios that result in meaningful divergence. Credit investors should keep a keen eye toward equity performance when forecasting bond performance. Having a pulse on management's ambitions and a deep understanding of fundamentals, the global macroeconomic environment and the industry's position in the credit cycle can be critical to understanding the divergence between credit and equity. Remember, a company's fiduciary responsibility is to shareholders above all else.

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