Credit Ratings Are Size-Dependent

If you find yourself with a little extra time on your hands this holiday week, seek out some self-congratulatory economic literature from the 1990s boom discussing why the U.S. was a special place to start and nurture new businesses.

No, this is not another tendentious screed on Sarbanes-Oxley; please keep reading.

The list always included American firms' direct access to capital markets; this stood in stark contrast to both Japan and Continental Europe where commercial banks acted as gatekeepers to credit. Commercial bankers may be fine people on all counts, but their primary functions are lending money and providing services, not engaging in venture capital. The old joke about bankers only lending money to those who can prove they do not need it has a good measure of truth.

Capital markets come in three flavors, debt, equity and hybrids thereof such as convertible bonds. If we may generalize, startup ventures should prefer issuing debt as opposed to equity if they are confident about their business prospects. Counterbalancing this desire is a simple reality: Younger and smaller firms, even those destined to succeed, may appear less creditworthy than their older and larger cousins. Venture capitalists exist to take a risk in exchange for an equity stake in such firms.

Given this background, we should expect to see significant differences between the credit ratings of firms as a function of their size. And as different industries have different credit demands, we can extend the analysis to each of the ten economic sectors defined by Standard & Poor's; a topic last visited in the context of sector-specific credit default swap costs in June.

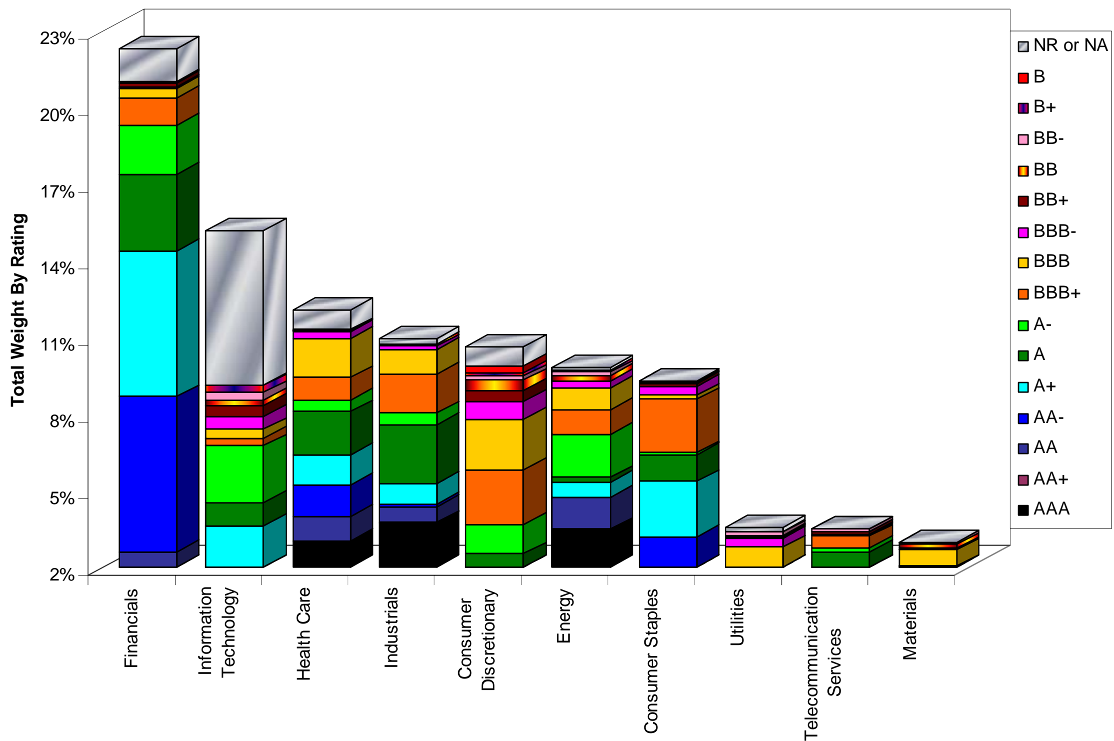
Sector Credit Rating Breakdown

Each of the three charts below contains ten stacked columns. The height of each column corresponds to an economic sector's weight in the designated index, the S&P 500 for large-capitalization issues, the S&P 400 for middle-capitalization issues and the S&P 600 for small-capitalization issues. The columns are sorted by each sector's weight in the designated index.

The blocks within each column correspond to various long-term credit ratings using the S&P credit-rating methodology. This system designates the very best credits as AAA and moves on down through various investment-grade ratings to BBB-. In each column, the best credit ratings are on the bottom and the lesser ratings are on top in ascending order. Issues whose bonds do not have an S&P credit rating are on the top of the stack.

In the realm of fun facts, the S&P 500 is home to America's last six AAA credits. These are ExxonMobil, Pfizer, Johnson & Johnson, General Electric, UPS and Automatic Data Processing. And while we are at it, UPS is the second largest stock by market capitalization in the S&P 500 Industrial sector. That's right, those people running around in the brown trucks stand next to the venerable General Electric in the AAA club and just behind it in the Industrial sector. This says something profound about the landscape of modern American business; what I am not sure.

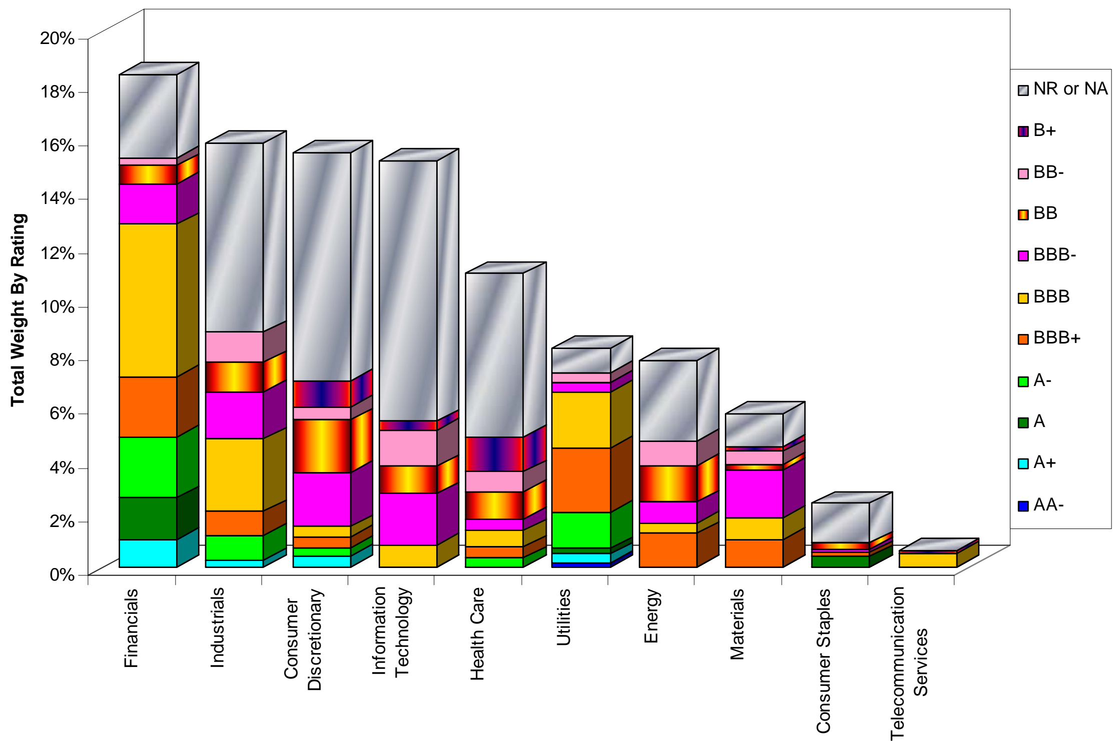
Within the S&P 500, the Financials are not only the largest sector but the one most dominated by A- or higher credits. If any of you are worried about that perennial concern of the perennially concerned, a global derivatives meltdown, please note your anxieties are not shared by S&P. This is a tribute to modern financial engineering and risk management, and if that sounds like a trip down Hubris Lane, so be it. When Long Term Capital Management bit the dust in 1998, it rocked the world. Amaranth Advisors lost more money in a shorter period of time and in a narrower trading zone and the most notable outcome was the hiring en masse by Goldman Sachs of much of its trading team. Yes, we can and will have financial accidents in the future; that's a given. But we appear better equipped than ever to quarantine these developments as they happen.



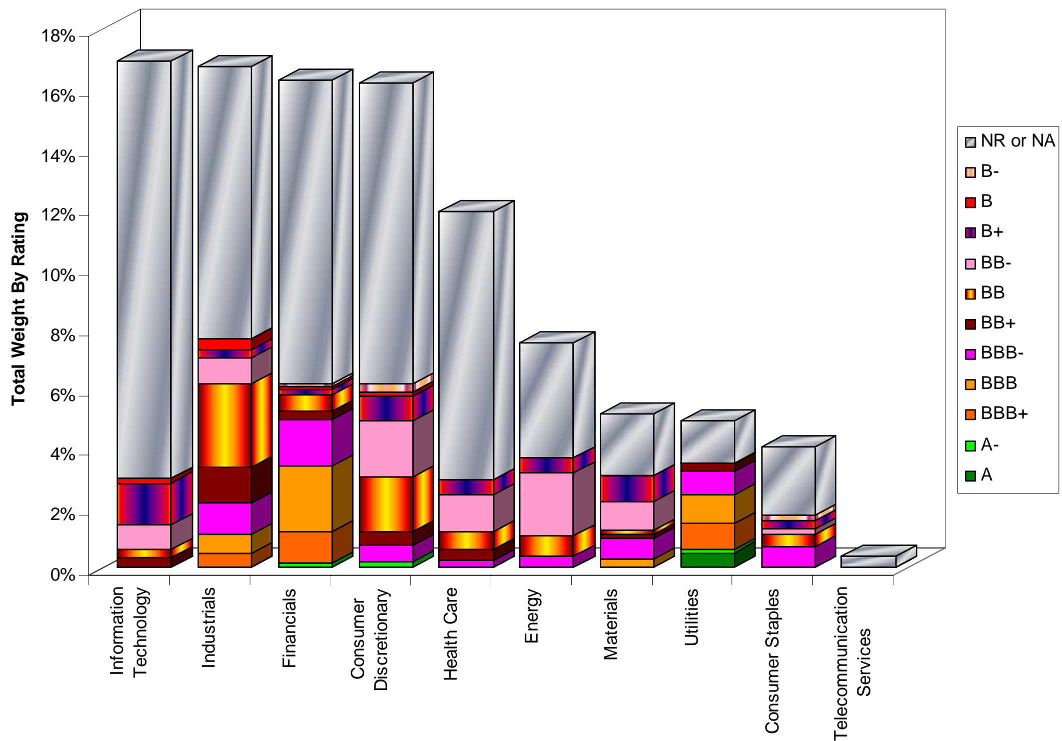
The second notable aspect of the S&P 500's credit breakdown is the large non-rated allocation in the Information Technology sector. We will return to this below.

Middle And Smaller-Capitalization Firms

Now let's take a look at the S&P 400. Here only one firm, WGL Holdings, a gas utility in the Washington, D.C., area, has a rating as high as AA-. A significant number of firms in the Consumer Discretionary, Information Technology and Health Care sectors are below investment grade, and a large number of firms across sectors are non-rated. The credit landscape of middle-capitalization firms is considerably lower than that of the S&P 500.



This trend continues as we get into the S&P 600. Here the highest credit ratings, A's, also go to Utilities, Laclede Group and Piedmont Natural Gas. But the real story is not only the large number of non-investment grade issues but the huge weighting of non-rated bonds across all sectors. The Information Technology sector typically is financed with equity and venture capital, but the Industrial, Health Care and especially Financial sectors elsewhere can tap the corporate bond markets. Size is a gatekeeper to American corporate bond markets.



Finally, does any of this matter to shareholders in aggregate? The total returns year to-date for the three market indices in descending order are 15.1%, 10.0% and 14.2%. These results, for 2006 at least, are inconclusive. We cannot say whether investors systematically have been rewarded for taking on greater credit risk or for fleeing it. All we can say is size matters in the corporate bond market.