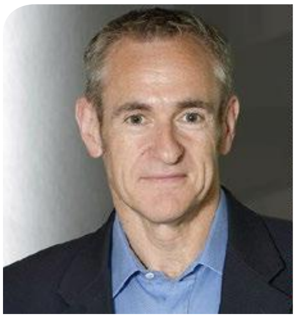

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Selling CDS protection could be the most effective way of capturing excess premiums in investment grade credit

The market might not offer free lunches, but there is one rather generous meal deal that is worth a look. The investment grade credit risk premium (CRP) — the excess return offered by investment grade credit over risk-free securities — nearly always over-compensates investors for the default risk that it represents. While the CRP has fluctuated over the past 15 years, it has always provided break-even compensation to investors for more than the historical average default rate — currently almost five times more. Are investors getting something for nothing?

Explanations for the CRP abound. Some view it through a behavioural prism, seeing investors as prone to negativity bias and dread-aversion, which leads them to demand an excessive premium for default risk (effectively tail-risk protection) as a result of unfavourable experiences during prior market or economic dislocations.

However, since the evidence demonstrates that the CRP consistently overcompensates for such bad outcomes, such action, if conscious (as a cognitive bias suggests), would be perverse. It seems more likely that such dread-aversion is the result of a feeling, rather than experience of a negative tail event, in which case we would need to turn to the unconscious and the paradigm of emotional finance to understand it. But before paging Dr Freud, there are other more prosaic explanations we can consider.

Causes of the credit risk premium

The CRP could be ascribed in part to supply/demand dynamics, as Bank of America highlighted in a recent research piece. The cost impact of macro-prudential regulatory changes in the wake of the global financial crisis has seen dealer inventories of bonds dwindle, while the outstanding stock of corporate bonds has ballooned, exposing investors to severe, illiquidity-induced price corrections during sell-offs. They have reacted by buying CDS protection as a hedge (rather than selling bonds), forcing CDS spreads out and inflating the CRP. However, while the 'more-buyers-than-sellers' argument may explain the CRP in the post-financial crisis environment of tighter regulation and easy money, it does not account for its existence in the years before the crisis.

Management structure matters

The 'theory of the firm' offers another lens. Either de jure or de facto, it is the role of senior management to maximise shareholder value. One way to achieve this (especially in a low-growth environment) is to minimise and appropriate returns due to other stakeholders, notably creditors. That credit quality will migrate negatively over time is implicit in this dynamic. Thus, as a credit investor, you would demand a high ex-ante CRP to compensate for potential negative migration, the extreme manifestation of which is default.

Fortunately, not all managements are created equal. Risk appetites differ (appropriating too much from creditors may jeopardise the firm — and shareholder value — over the long term) as do management incentive structures. Moreover, an independent board and rigorous governance to channel senior management motivations will affect outcomes. This allows an informed, active credit investor to select those single-name credits where the risk of management-led migration is lowest, thereby retaining much of the CRP.

Any or all of these models for understanding the CRP may have explanatory value. Who knows and, to a degree, who cares? To paraphrase Karl Marx, analysts have hitherto only interpreted the CRP in various ways; the point is to harvest it.

Effective harvesting argues for use of CDS, which isolate the CRP from rate risk, enjoy superior liquidity to bonds and may be levered at zero cost on margin, enabling investors to apply leverage to a persistent premium from a safe asset class.

The combination of levered investment-grade CRP with the capital gain from roll-down (again, always present while credit curves are positively sloping) can deliver returns that will give equities a run for their money. A free lunch? No. But more appetising and easier to digest than a lot of the competing offerings on the menu.

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