The Opportunities and Risks of Investing in Fallen Angels for Insurance Companies

Insurance companies have historically allocated toward higher quality yield instruments. Over the past decade, amid a persistent low interest rate environment, insurance companies have gradually increased their allocations outside of investment grade bonds into primarily the higher quality end of the high yield corporate bonds. As insurance companies grow in size, their allocations to high yield have tended to increase, resulting in insurance companies making up an increasing segment of the high yield market. One trend we have observed is more insurance companies opting to adjust or customize their high yield allocations. Given their strong empirical performance, Fallen Angels have become an alternative option for high yield investors looking to allocate primarily to the higher ratings cohort of the market. In this paper, we plan on comparing a Fallen Angels strategy to upper-tier high yield strategies consistent with how insurance companies are currently allocated within the high yield space. Since we see a difference between smaller and larger insurance companies on their high yield investments, we distinguish between “smaller insurers” and “larger insurers” by ratings-based allocation mixes shown in Figure 1. For Fallen Angels, this paper will highlight the composition, performance, and characteristics of the ICE BofA Fallen Angel High Yield Index cohort of the ICE BofA U.S. High Yield index.

Empirical risk and returns

Since 1996, the inception of the ICE BofA Fallen Angel High Yield Index, Fallen Angels have generated favorable absolute and risk-adjusted returns, especially as compared with how small and large insurance companies invest in high yield. Fallen Angels were able to generate roughly 3% excess returns per annum over allocations consistent with smaller and larger insurers over this period with modestly higher volatility (see Figure 2). As with its other corporate bond indices, the ICE BofA Fallen Angel High Yield Index rebalances at the end of each month, adding in recently downgraded names based on composite rating as well as removing defaulted securities from its constituents.

When looking at calendar-year returns Figure 3, shows that Fallen Angels outperformed small and large insurance companies in 16 and 17 of the 24 years (including 2020 through the end of May), respectively, and generated a higher Sharpe ratio than both small and large insurers in 15 of the 24 years.

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<th>FIGURE 1</th>
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<td>Large Insurers</td>
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Source: SNL database based on 2019 data.

1 Index constituent composite ratings are updated once a month as part of the rebalancing process. Composite rating changes take effect on the last calendar day of the month based on information available up to and including the rebalancing lock-out date (the third business day prior to the last business day of the month). Rating upgrades or downgrades occurring after that day will not be considered in the current month rebalancing and will get incorporated at the following month’s rebalancing. For example, assuming there are no Global Holidays in between, if August 31 fell on a Friday the rebalancing lock-out date would occur on August 28. Therefore, a bond that was downgraded to below investment grade on August 28 would transition from the investment grade Index to the high yield Index at the August 31 rebalancing. Conversely, if the bond was downgraded on August 29, it would remain in the investment grade Index for the month of September and transition to high yield at the September 30 rebalancing. Composite ratings are the simple averages of ratings from Moody’s, S&P and Fitch.

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As illustrated in Figure 4, in calmer markets, Fallen Angels are historically comparable to spreads on ratings-based allocations of insurance companies. The average OAS over this period for the Fallen Angels index was 490bps as compared to 466bps and 485bps for small and larger insurers, respectively. As with insurance companies’ generally higher-rated bias within their high yield allocations, Fallen Angels is predominantly BB-rated (roughly ¾ of the index market value on average), having been downgraded from Investment Grade (see Figure 12).

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However, during periods of turmoil, Fallen Angels spreads have, at times, widened to levels higher than small and large insurers. Figure 5 and Figure 6 show the historical differential in OAS between the Fallen Angels index and small and large insurers. As noted, while Fallen Angels on average trades in line with small and large insurers, Fallen Angels OAS has widened beyond them on a few occasions over the past 24 years, most notably in 2000 (tech bubble) 2002 (telecoms) and 2008 (global financial crisis).

Another way of explaining these spikes in relative risk is to look at rolling spread volatility. Figure 7 shows higher levels of spread volatility for U.S., Fallen Angels in periods of idiosyncratic industry stress such as 2002, 2006, 2008, and 2016.

What exacerbates these moves is the fact that Fallen Angels issues, due to having been issued with investment grade ratings, are typically longer dated maturity and therefore longer duration credits than are bonds issued with High Yield ratings. Figure 8 illustrates the historical modified duration of Fallen Angels as compared to small and large insurers and U.S. Investment Grade Corporates. Historically, the index duration of the index has shortened during periods of strong credit fundamentals due to the lack of new "issues" (downgrades, in this case) and the increasing number of bonds trading to call as prices rise. During periods of market stress, however, the index duration has, at times, extended as a function of significant downgrade activity (see Figure 8). During these periods, heightened levels of spread volatility, combined with this spread duration extension risk, can subject the Fallen Angels universe to outsized downside price risk at times.

Historical characteristics of Fallen Angels

As shown in Figure 9, Fallen Angels have, on average, accounted for roughly 15–20% of the U.S. High Yield market over the past 25 years. Throughout the early and mid-2000s, Fallen Angels grew to make up nearly 30% of the aggregate high yield market. The number of Fallen Angels issues can be rather chunky (see Figure 11), although absent a significant pickup in defaults, the average longer maturity of these credits means that the market value of the index tends to be more stable following significant downgrade cycles.

The clustered nature of Fallen Angels downgrades results in more dynamic shifts in the industry composition of the Fallen Angels universe, as shown in Figure 10. Increases in issuance have typically coincided with either significant macroeconomic events such as the tech bubble (2000) and the global financial crisis (2008) or idiosyncratic sector-specific headwinds such as automotive (2005) and energy (2016). Investors looking to purchase the Fallen Angels index in its entirety should be aware of this industry concentration risk that has historically been exacerbated in periods of credit stress.
As mentioned previously, by virtue of Fallen Angels being downgraded legacy Investment Grade issues, the characteristics of the index will vary from a more static ratings-weighted approach in a few noticeable ways. Most obviously, the average credit rating for the Fallen Angels Index will skew heavily toward upper tier high yield as a function of migration from investment grade. As a result of investment grade issuance, the average duration of a Fallen Angel typically sits somewhere between U.S. High Yield and U.S. IG.

Is there an arbitrage opportunity?

Perhaps a sign of behavioural biases or forced-selling by stricter investment mandates, the month preceding downgrade on average fare very poorly for Fallen Angels corporate bonds.

Figure 13 shows the average spread activity in the 6 months prior to and 6 months immediately following downgrade to High Yield. As the figure illustrates, average spread widening for an issuer in this period leading up to downgrade was 384bps. For investors willing to either hold or buy recently downgraded issues, recovery in Fallen Angel OAS was sharpest in the first month following index inclusion at roughly 110bps. This suggests that despite spread widening leading up to the downgrade, ratings-agnostic, opportunistic buyers of credit are quick to step into the market.

Also, the date when a fallen angel enters high yield index varies between providers. For example, the Markit iBoxx USD High Yield Index, bonds downgraded to high yield are held in a 3 month ratings stabilization period before entering the index. Some of the other indexes wait one month. This may be part of the reason for the big drop off in OAS after one month in Figure 13.
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As with any asset experiencing significant price pressure and fundamental weakness, buying Fallen Angels does not come without its own risks. While the average spread recovery immediately following downgrade has been general positive for buyers, the potential for buying “falling knives” remains a risk for indiscriminate buyers of these credits. This can be demonstrated through the dispersion in spread activity across the universe of Fallen Angels issuers. Figure 14 shows the spread behaviour of the top and bottom quartiles as ranked based on the change in spread from 6 months prior to downgrade until the time of downgrade. As shown, there is a significant differential in spread activity for top quartile versus bottom quartile issuers. While the average spread action has generally been positive, the bottom quartile, which is a significant portion of the underlying issuers, experienced continuing weakness in spreads, culminating in average spread widening of about 500bps.

Conclusion

Insurance companies appear to already be investing in high-yield akin to a fallen angel approach. Our observation is that investing in Fallen Angels, in many cases, can outweigh the risks of investing in a broader high-yield despite an average higher overall credit rating. Opportunistic buyers of the asset class have been, on average, rewarded by strong spread rallying post-downgrade. Given the nature of purchasing downgraded securities, which often demonstrates a strong negative momentum bias in fundamentals and in price terms, indiscriminate purchasing of Fallen Angels can result in the ownership of fundamentally impaired credits. As such, avoiding exposure to deteriorating credits—either through fundamental investing or through a more systematic approach—can help opportunistic investors invest in Fallen Angels while potentially mitigating the risk of significant drawdown risk and default loss potential.
Risk disclosure

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond’s maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate. Investing in high yield bonds, which tend to be more volatile than investment grade fixed income securities, is speculative. These bonds are affected by interest rate changes and the creditworthiness of the issuers, and investing in high yield bonds poses additional credit risk, as well as greater risk of default.

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