DODGE & COX®

Investment Perspectives

Finding Value in BBB Debt: Not All Corporate Bonds Are Created Equal

OCTOBER 2019

KEY TAKEAWAYS

- Despite the significant expansion of the BBB-rated[a] corporate bond market over more than a decade, and the systemic risk concerns associated with potential downgrades of large BBB issuer complexes into high yield territory, corporate fundamentals remain solid and downgrade risks appear manageable.
- These trends underscore the importance of carefully examining the fundamental opportunities and risk factors associated with investing in corporate bonds.
- Our active, bottom-up approach—with an emphasis on price discipline and issuer-level research—gives us confidence in the BBB securities held in the Dodge & Cox Income and Global Bond Funds.

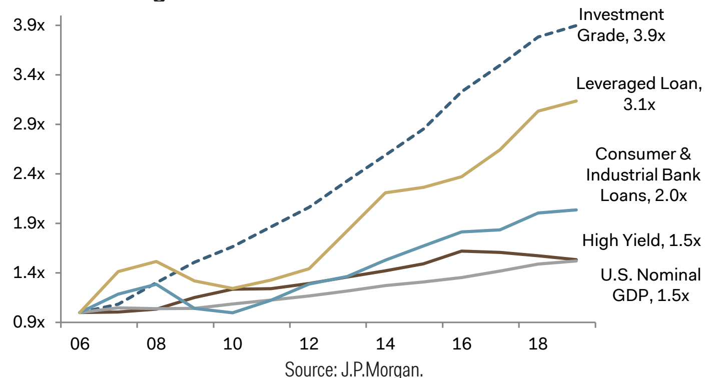
EVOLUTION OF CORPORATE CREDIT AND THE GROWTH OF BBB DEBT

The investment-grade (IG) fixed income market has experienced transformative growth since 2006, with a significant increase in BBB-rated corporate debt since the global financial crisis in particular. BBB bonds, the lowest tier of the IG market, now comprise over half of the IG corporate universe.

Several interrelated factors are driving this growth: an evolving banking sector, a more aggressive management approach to capital allocation (in part reflected in an increase in debt-financed corporate activity), and an increase in investor demand for yield. In addition, increases in leverage and changes in credit rating agency methodology have exerted downward pressure on ratings at the sector level—especially for banks and commodity-related issuers.

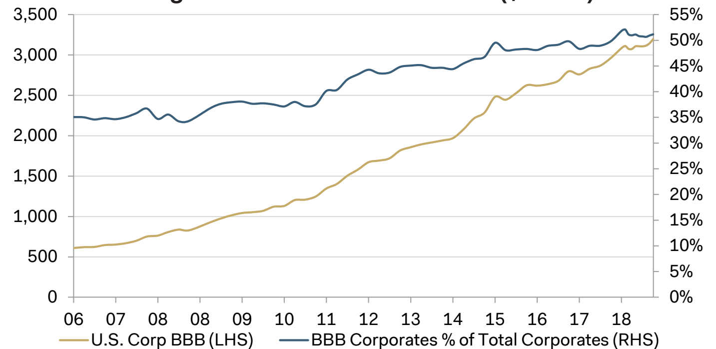
The IG market has grown faster than the below investment-grade—or high yield (HY)—market, as non-bank lenders have offered an attractive alternative funding source for lower-rated companies and rating agencies have upgraded a number of HY issuers to IG over the prolonged macroeconomic expansion.

Figure 1: Market Growth vs. Nominal GDP[b]



Source: J.P.Morgan.

Figure 2: Growth of BBB Market ($billion)[c]



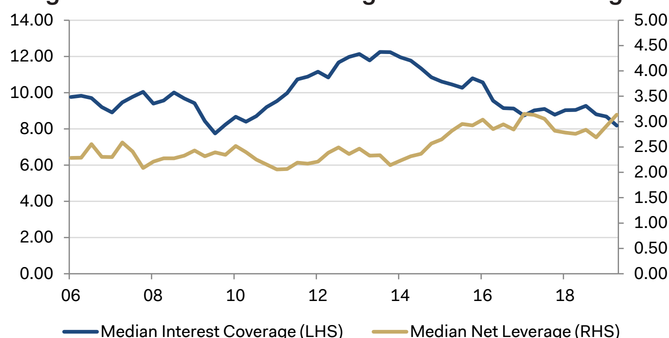
Source: Bloomberg Index Services.

The growth in BBB bonds has triggered concerns among some investors and market analysts that a potential recession-driven wave of ratings downgrades could lead to a supply/demand imbalance and a significant downward price adjustment. **So why are the Dodge & Cox Income and Global Bond Funds overweight corporate bonds at the lower-rated end of the IG spectrum?**

BBB Market Fundamentals Remain Strong

Improvement in the cost of capital has spurred management teams to increase leverage over the last five-plus years. However, we believe these higher debt levels are well supported by the cash flows, earnings power, and maturity profile of the median BBB-rated company.

Figure 3: Industrial BBB Leverage and Interest Coverage[c]



Source: FactSet, Bloomberg Index Services.

Note: In the first quarter of 2019, the uptick in net leverage is primarily driven by an accounting standard change, which brings operating leases onto the balance sheet, and is not considered a true leveraging event.

Importantly, much of the increase in the BBB market has occurred in sectors with greater capacity for leverage, such as:

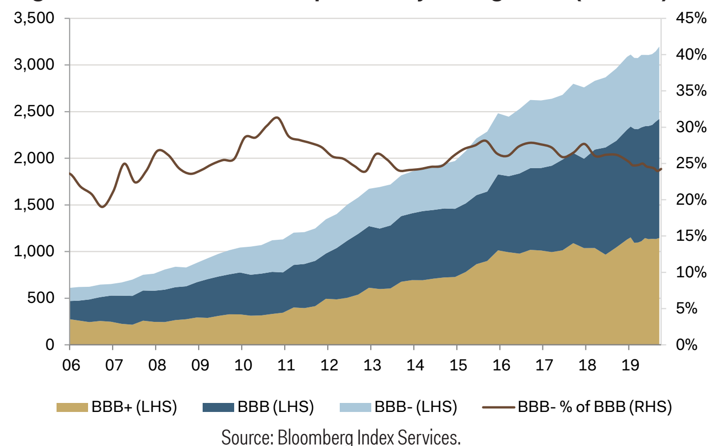
- **Consumer Non-Cyclicals:** companies with stable revenue streams, cash flows, and high debt-service capacity.
- **Banking:** well-capitalized, liquid, and highly regulated entities, with BBB-rated portions of large bank capital structures primarily comprised of the subordinated securities of large, A-rated institutions.
- **Communications**: issuers with predominantly subscription-based, recurring revenues, stable cash flows, and high debt-service capacity.
- **Energy, specifically Midstream and Refining**: sub-sectors with manageable commodity price exposure and significant financial flexibility compared to their upstream peers.

Many formerly A-rated companies have added incremental financial risk through mergers and acquisitions (M&A), taking advantage of low interest rates to bolster their competitive positions. In fact, Standard & Poor's ("S&P") recently found that two-thirds of the downgrades of non-financial corporates to BBB from 2010 through the first quarter of 2019 were M&A related.[d] A number of these transactions have created significantly larger companies with leading franchises, diverse revenue sources, and viable deleveraging plans. Many of the largest M&A borrowers have strong incentives to maintain IG market access and significant degrees of freedom to delever and strengthen their liquidity profiles (e.g., separable assets, cost/dividend cuts, durable equity market sponsorship). S&P also notes that 67% of these issuers have either an "excellent" or "strong" business risk profile, compared to 44% of the BBB category as a whole.[d]

Downgrade Risks Appear To Be Contained

The share of BBB debt rated at the lowest tier (Baa3/BBB-)—the most susceptible to downgrade to HY in an economic downturn—has grown less than the BBB market overall. If all the BBB- issuers on "negative outlook" or "credit watch" were downgraded, they would comprise less than 10 percent of the HY market. We believe this is an unlikely outcome, but one that the market could absorb.

Figure 4: Growth in BBB Corporates by Rating Level ($billion)[c]



Source: Bloomberg Index Services.

In our opinion, downgrade risk does not pose a systemic issue, even when taking into account a potential recessionary environment. For example, S&P calculates that $200 to $250 billion of debt is at risk of a downgrade to below investment-grade in a 2008-style scenario, over a period of multiple years.[e] Though significant, at roughly 5 to 7 percent of the HY market on an annualized basis, downgrades would be in line with past cycles. Moody's comes to similar conclusions based on a reasonable set of assumptions, noting that the "fallen angel" (downgrade from IG to HY) rate is more highly correlated with industry-specific challenges than with macroeconomic cycles.[f] Specifically, below investment-grade downgrades exceeded $100 billion in only three time periods over the last two decades: 2002 (Telecommunications and Utilities), 2005 (Ford and General Motors), and 2016 (commodity-related

sectors). Downgrades in these years represented more than 30 percent, 15 percent, and 5 percent of the HY market, respectively.[f] Though corporate index spreads were volatile, each transition to HY was ultimately achieved without systemic implications. Furthermore, market volatility resulted in buying opportunities for credit selectors and set Dodge & Cox up for excellent subsequent returns in the Funds.

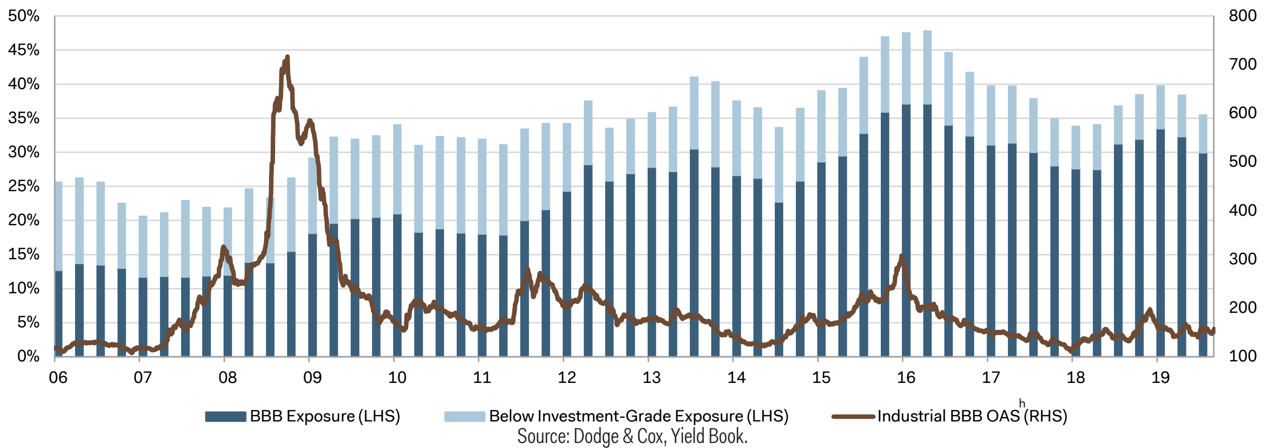
WHERE WE ARE FINDING VALUE IN BBB BONDS

Dodge & Cox's BBB exposure is the result of our active, bottom-up security selection process, valuation discipline, and emphasis on the opportunities and risks at the issuer level. We do not construct portfolios pursuant to a broad macro view, ratings, or an index-driven strategy. Portfolios are comprised of highly vetted issuers and differ from their primary benchmarks. Our BBB exposures evolve when valuations and return opportunities change (see the charts below for an illustration of the Funds' BBB and below investment-grade exposure over time). We incrementally lean into individual issuers and securities when we believe they offer a compelling risk-reward opportunity. Conversely, we trim or exit exposures as spreads tighten or when circumstances cause our fundamental view of a particular issuer to decline.

As investment opportunities have grown within the IG market, we have found notable value in debt financings related to strategic M&A issuance. Lending at a point of elevated financial leverage increases alignment with management and can lead to interesting opportunities when priced appropriately. When selecting among various M&A-related debt funding opportunities, we closely examine both issuer and security-level attributes.

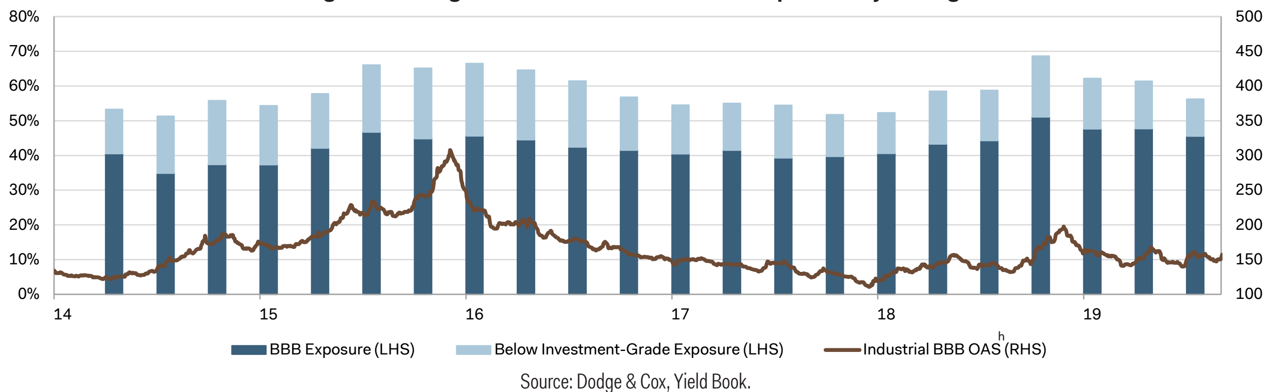
At the issuer level, we emphasize business combinations underpinned by a compelling strategic rationale, with achievable synergies and management commitment to deleveraging (preferably accompanied by a demonstrated track record). We seek companies with leading franchises, increasing scale and diversification, and multiple sources of operating and financial flexibility, including cost cutting, capital expenditure reduction, asset sales, and untapped sources of capital. Since we seek companies with the capability to generate durable cash flows across a range of macroeconomic scenarios, we often find M&A opportunities in less cyclical industries, such as Health Care and Consumer Staples.

Figure 5: Dodge & Cox Income Fund Exposure by Rating[g]



Source: Dodge & Cox, Yield Book.

Figure 6: Dodge & Cox Global Bond Fund Exposure by Rating[g]



Source: Dodge & Cox, Yield Book.

At the security level, we require a level of spread compensation that offers a margin of safety to mitigate the impact of potential integration challenges and/or delays along the deleveraging path. We also make targeted investments along the credit curve where we view the risk-reward dynamic to be most compelling. Finally, we seek additional downside protection via security terms (e.g., coupon step-ups) when appropriate to provide an additional layer of compensation in the event of credit ratings downgrades.

However, strategic corporate activity is not the only source of our recent BBB investment ideas. Our global industry analysts look across the entire capital structure, which gives them a broad view of the risk and reward of various investment opportunities. Our unique model for research coverage helps us identify relative value and unearth interesting additions to the Funds, regardless of their genesis, as explained in the case studies shown.

THE DODGE & COX INTEGRATED APPROACH TO CREDIT RESEARCH

Sound credit research, when coupled with valuation discipline and a long-term investment horizon, has rewarded investors through market cycles. Our integrated and tenured research team—comprised of 34 global industry analysts (whose research serves both fixed income and equity portfolios), 5 dedicated credit analysts, and 3 macroeconomic analysts—is responsible for the credit research underpinning all of our credit investments. We carefully examine each investment's fundamental risks and opportunities. Through this process, we have reaffirmed our conviction in Fund holdings in BBB issuers and other lower-rated borrowers across sectors and believe their issuer-specific risk-reward profiles offer compelling long-term value.

Downside risk analysis is at the heart of our credit research effort, with the primary emphasis on assessing the potential for permanent impairment (i.e., default, liability management). The potential drivers of financial distress at the issuer level are many and varied, but typically involve some combination of unexpected deterioration in operating fundamentals (for structural, cyclical, or company-specific reasons) combined with an inability to access capital markets or otherwise source funds to meet obligations as they come due. Prior to making any new investment, we conduct extensive scenario analysis to examine a variety of downside outcomes, and we assess each issuer's sources of financial flexibility, including cash balances, access to bank and capital markets funding, asset

Case Study: Price Discipline in Action

Anheuser Busch-Inbev (ABI; Baa1/A-/BBB) issued $46 billion of capital markets debt in January 2016 to fund its acquisition of SABMiller. We established positions in the Income and Global Bond Funds based on our favorable view of the company's franchise, its deleveraging capability, and attractive valuation. Following strong performance over the course of just a few months, the valuation became less attractive in relation to our view of the company's risk profile and we exited these positions held in the Funds. Though we maintained a positive view of ABI's long-term fundamentals, we believed the issuer's spread levels no longer provided an adequate margin of safety to compensate for the risks associated with integrating the acquired businesses and meeting the aggressive deleveraging timeline reflected in market expectations.

As time passed, the company did, in fact, fail to meet its stated leverage targets, and market participants became increasingly concerned with the potential for credit rating downgrades. ABI debt spreads underperformed and Moody's downgraded its credit rating from A3 to Baa1. When the company issued new bonds to extend its maturity profile in January 2019—a time of both heightened issuer-specific anxiety and broader capital markets volatility—we were prepared and re-established positions at spreads that were, in our view, more reflective of the underlying risks.

Our investment thesis is underpinned by the company's scale, geographic diversification, leading portfolio of brands across the pricing spectrum, and significant degrees of freedom to facilitate debt reduction to protect the now-lower ratings. The latter point has been illustrated by a sequence of events in the summer of 2019 whereby the company shelved plans to IPO its Asian business, then quickly followed with an asset sale that will generate even greater proceeds to accelerate debt reduction. This action is in addition to a previously announced dividend cut. The rating agencies have commented positively, and bond spreads have tightened in response.

sales, or reductions in dividends, costs, and capital expenditures. At times of stress, we have found that maintaining conviction—a direct result of the rigorous liquidity analysis we engage in prior to making any credit investment—can be additive to long-term results.

IN CLOSING

While the growth in the corporate bond market and deterioration in credit ratings quality certainly warrant ongoing monitoring, we believe that the risk-reward profiles of many BBB issuers remain attractive. Our forecast for continued economic growth—which we expect to be sustainable over the long term at the pre-2018 trend of roughly 2%—combines with healthy corporate fundamentals to support current portfolio positioning. Downside scenarios are mitigated by supportive monetary policy (domestically and abroad), a well-capitalized, well-funded, and vigorously regulated banking sector, and, for the select securities held in the Funds, a margin of safety priced into the individual securities.

Case Study: Benefits of Integrated Global Research

Ultrapar Participaceos SA (Ultrapar; Ba1/BB+/NR), a Brazilian fuel distributor, is one of the many opportunistic investments we have made in issuers that are less well known in the U.S. bond market. These more unique positions often are identified in the context of global equity research for the Dodge & Cox Stock, International Stock, and Global Stock Funds.

We held Ultrapar equity in the Dodge & Cox International Stock Fund from 2001 to 2012, and have continued to follow the company closely. As a result, our equity and fixed income research teams have developed substantial knowledge of this company's long-term business profile and the operating and financial strategy pursuant to which it is governed. Thus, when attractive opportunities have arisen, we have been able to apply our comprehensive knowledge of its creditworthiness and our conviction in its long-term prospects to an investment decision independent of the company's below investment-grade credit ratings.

For example, in the third quarter of 2016, we initiated a position in Ultrapar in the Income and Global Bond Funds when the company issued a new 10-year U.S. dollar bond at a 400 basis points spread— almost three times the spread on the Bloomberg Barclays U.S. Corporate Bond Index at the time. Despite the volatility of oil prices and geopolitical risks, we remain attracted by the company's market-leading position, high-quality assets, strong management team, and conservatively capitalized balance sheet, but have adjusted exposure—downward and upward—as relative value dynamics have shifted over time. Most recently, in the first half of 2019, we added to fixed income positions in Ultrapar at another new issuance opportunity.

Appendix: Credit Ratings Scale by Rating Agency

		Moody's	Standard & Poor's	Fitch
Investment-Grade	**AAA**	Aaa	AAA	AAA
	AA	Aa1 Aa2 Aa3	AA+ AA AA-	AA+ AA AA-
	A	A1 A2 A3	A+ A A-	A+ A A-
	BBB	Baa1 Baa2 Baa3	BBB+ BBB BBB-	BBB+ BBB BBB-
Below Investment-Grade (High Yield)	**BB**	Ba1 Ba2 Ba3	BB+ BB BB-	BB+ BB BB-
	B	B1 B2 B3	B+ B B-	B+ B B-
	CCC	Caa1 Caa2 Caa3	CCC+ CCC CCC-	CCC+ CCC CCC-
	CC	Ca	CC	CC
	C or below	C	C/D	C/RD/D
Not Rated	**NR**	NR	NR	NR

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a A rating by Moody's, Standard & Poor's, or Fitch of Baa3, BBB-, BBB- or above, respectively, constitutes an investment-grade (IG) rating. See Appendix for additional detail on the three agencies' credit ratings scales and naming conventions.

b Chang, Joyce, Jan Loeys, and Kimberly Harano. "The Rise of the Corporates: Is a Triple-B Cliff on the Horizon?" J.P. Morgan, October 1, 2019.

c Chart data is based on Bloomberg Barclays U.S. Corporate Bond Index.

d Kraemer, Nick W., and Evan M. Gunter. "To 'BBB', Or Not to 'BBB': Management Decisions Spur Most U.S. Corporate Downgrades to 'BBB'." S&P Global, September 5, 2019.

e Altberg, Michael P. "When The Cycle Turns: 'BBB' Downgrade Risks May Be Overstated." S&P Global, December 3, 2018.

f Emery, Kenneth, Daniel Gates, and Anne Van Praagh. "Fallen Angels: High-Yield Market Buffers Potential Transitions Amid Wider Risks." Moody's Investors Service, May 13, 2009.

g The credit quality distributions shown for the Fund is based on the middle of Moody's, Standard & Poor's, and Fitch ratings, which is the methodology used by Bloomberg in constructing its indices. If a security is rated by only two agencies, the lower of the two ratings is used. Please note the Fund applies the highest of Moody's, Standard & Poor's, and Fitch ratings to determine compliance with the quality requirements stated in its prospectus. The credit quality of the investments in the portfolio does not apply to the stability or safety of the Fund or its shares.

h OAS (option-adjusted spread) is the option-adjusted yield differential between stated index and comparable U.S. Treasuries. OAS does not translate into a return.