Importance of Credit rating on your Debt Portfolio

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The seed of this work was laid when Sidharth (our research head) and I started debating about debt papers going bust. More specifically - debt papers in which Mutual Funds invest going bust.

There have been few instances where the underlying paper has gone bust in case of a few AMCs. However, in all the cases this loss has been absorbed by the AMC by taking a hit on it's own corporate balance-sheet.

Thus, I am outlining some of the prudent factors to be kept in mind for investment in Debt Mutual Funds:

1. Do not invest in a portfolio holding instruments which have a credit rating of below AA (i.e. AA- or below)

2. Invest only in AMCs which have a large Balance-sheet

- **Our View on the credit-ratings**

Following is the actual default rate for debt instruments under various credit rating buckets.

One-, Two-, and Three-Year CDRs, between 1988 and 2011				
Rating	Issuer-months	One-Year	Two-Year	Three-Year
Crisil AAA	11846	0.00%	0.00%	0.00%
Crisil AA	24368	0.04%	0.40%	1.09%
Crisil A	25694	0.82%	3.52%	7.66%
Crisil BBB	29366	1.89%	5.34%	12.27%
Crisil BB	22685	5.80%	12.52%	24.58%
Crisil B	11489	8.25%	17.89%	37.90%
Crisil C	2350	21.36%	37.23%	50.79%
Total	127798			

Source: Center for Investor &Education and Learning

- As can be observed from the table above, the papers rated below AA ratings have a dramatically real chances of defaulting

- Credit Risk also increases with an increase in the time-frame of the instrument. 3-year bucket has a much higher chances of defaulting compared to 1-year bucket

- It is also pertinent to point out that if you try to improve the credit rating to the hilt in your portfolio, you will still be increasing the interest rate risk. This is primarily because AAA rated instruments are dominated by government securities (see table below) which because of the longer tenures are more prone / benefit more from interest rate movements

Market Capitalization as on August 31, 2012			
Security Type	No. of Securities	Market Capitalization (in ₹ Cr)	% of Total
Government Securities	129	2,677,078.66	57.41%
PSU Bonds	1028	268,908.01	5.77%
State Loans	1430	805,046.60	17.26%
Treasury Bills	52	317,195.69	6.80%
Local Bodies	19	3,028.32	0.06%
Financial Institutions	499	162,372.98	3.48%
Bank Bonds	500	198,402.82	4.25%
Supranational Bonds	1	391.22	0.01%
Corporate Bonds	1793	230,903.50	4.95%
Total	5451	4,663,327.80	100.00%

Source: Birla Sunlife Mutual Fund

Balance-sheet of AMCs

On an examination of the financial statements of AMCs done by Prashant (our Tax & Accounts head) and me, following are some of the important observation:

- Bank backed AMCs (***except Kotak***) have a strong cushion:
  - SBI AMC
  - HDFC AMC
  - ICICI AMC

- Private Institutions that have a strong balance-sheet in our opinion:
  - Franklin
  - DSP
  - Reliance
  - IDFC
  - UTI
  - Birla