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Rising Debt and Deteriorating Credit Quality Expose Potential Risks of Index Investing

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GLOBAL FIXED INCOME

JOHN LOVITO
Co-Chief Investment Officer

CHARLES TAN
Co-Chief Investment Officer

As the global economic cycle matures, certain risks inherent in fixed-income investing will become more apparent. And, given the passive nature of index investing, those risks likely will be more pronounced within portfolios that mimic broad fixed-income indices. Active managers, on the other hand, have the flexibility to alter their portfolios as the economic cycle churns to potentially avoid many of the pitfalls facing their passive peers.

CORPORATE DEBT ON THE RISE, CORPORATE CREDIT QUALITY ON THE DECLINE

Against a multi-year backdrop of historically low interest rates, corporate debt has grown significantly. For example, between 2008 and 2018, Evercore ISI reports that global nonfinancial corporate debt grew 54%, from $46 trillion to $71 trillion. At the end of 2018, this debt represented 92% of global GDP; in mid-2008, nonfinancial corporate debt represented 78% of GDP.[1]

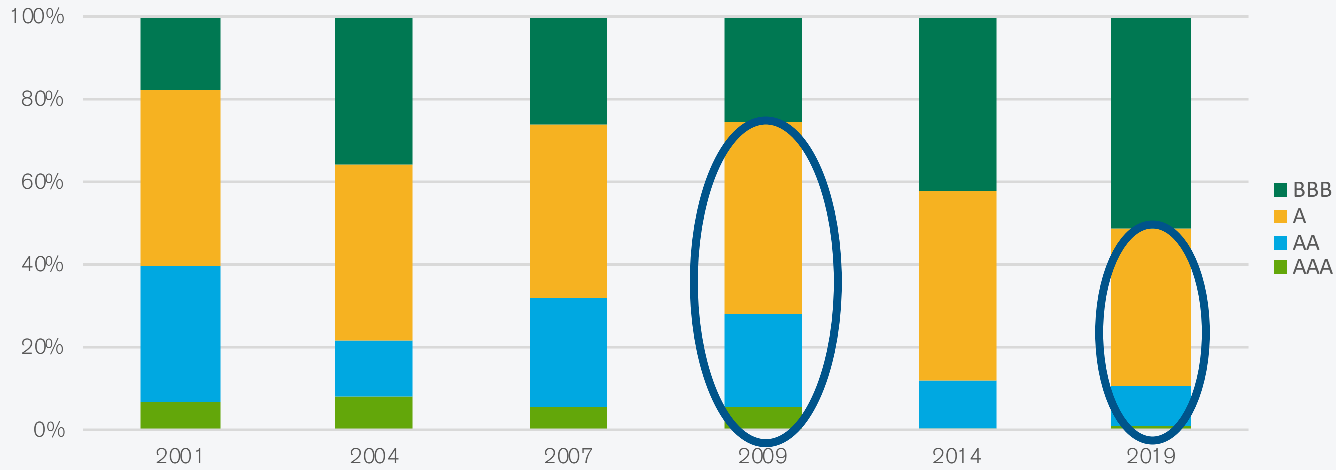
Meanwhile, as debt levels have escalated, the economic cycle has edged closer toward a downward shift, adding to the challenges for global fixed-income investors. Corporate credit quality tends to improve in the early stages of an economic cycle and deteriorate as that cycle matures. We've seen this historical trend play out throughout the 2000s. At the start of the current economic expansion in 2009, 75% of bonds within the Bloomberg Barclays Global Corporate Bond Index were rated A or better. Ten years later, only 49% of the index's bonds were rated A or better. See **Figure 1**.

[1]Evercore ISI: Perspectives on Global Debt, June 19, 2019.

FIGURE 1

As Economic Cycle Matures, Lower-Quality Bonds Gain Market Share

Credit Rating Composition of Global Bond Market



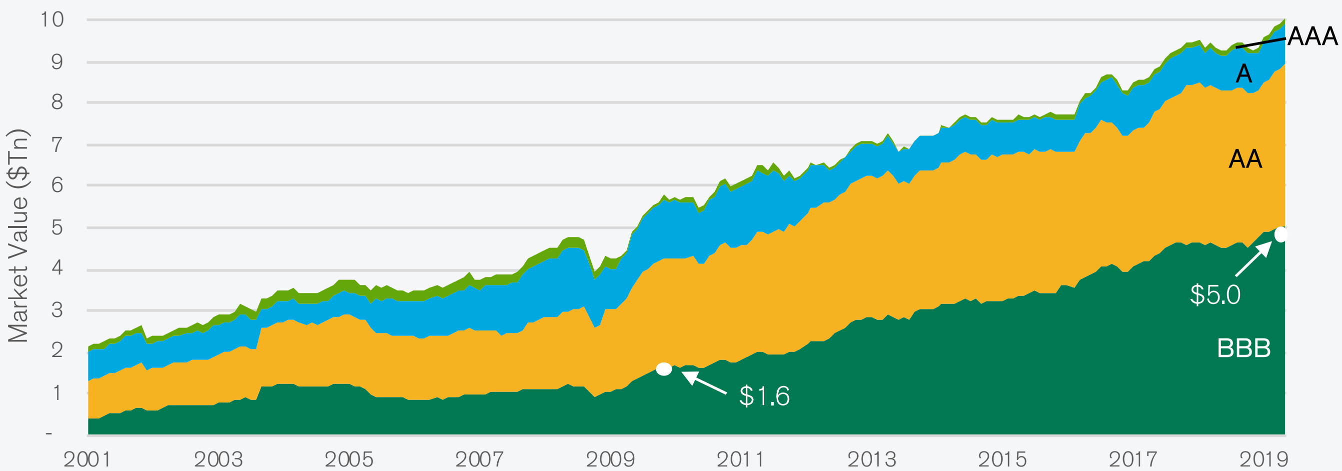
Source: FactSet.
Global bond market represented by the Bloomberg Barclays Global Corporate Bond Index. Data from 1/1/2001-5/31/2019.

At the same time, the percentage of global bonds with BBB credit ratings jumped from 25% to 51%. The market value of that debt increased from $1.6 trillion at the end of 2009 to $5.0 trillion as of May 31, 2019. See **Figure 2**.

FIGURE 2

Bonds with BBB Ratings Dominate Investment-Grade Indices

Global Corporate Bond Market Growth by Credit Rating



Source: FactSet, Morgan Stanley Research, Bloomberg.
Global bond market represented by the Bloomberg Barclays Global Corporate Bond Index. Data from 1/1/2001-5/31/2019.

Two main factors are driving the recent rise in debt with BBB credit ratings:

- **Financial sector downgrades.** Before the financial crisis of 2008, the debt of most big U.S. and global banks was rated AA or better. During the crisis, many financial companies struggled to finance their debt, and a wave of credit-quality deterioration hit the industry. Credit agencies downgraded many financial sector bonds to A and BBB. Since then, the industry's credit ratings have broadly improved but not to their pre-financial crisis levels.
- **Low interest rates.** Outside the financial sector, corporations have taken advantage of historically low interest rates to issue debt. Some have used debt to buy back shares and pay shareholder dividends, while others have issued debt to fund mergers and acquisitions (M&A). Coinciding with this boost in M&A activity have been increases in leverage and credit-rating downgrades from A to BBB.

DEBT LEVELS RISING

We believe growth in corporate leverage is a troubling trend. Gross leverage among all U.S. investment-grade debt issuers, for example, has generally been increasing since the end of 2011. At year-end 2011, the gross leverage for all U.S. companies with BBB credit ratings was 1.99x capital levels. As of March 2019, the gross leverage had climbed to 2.51x capital levels.[2]

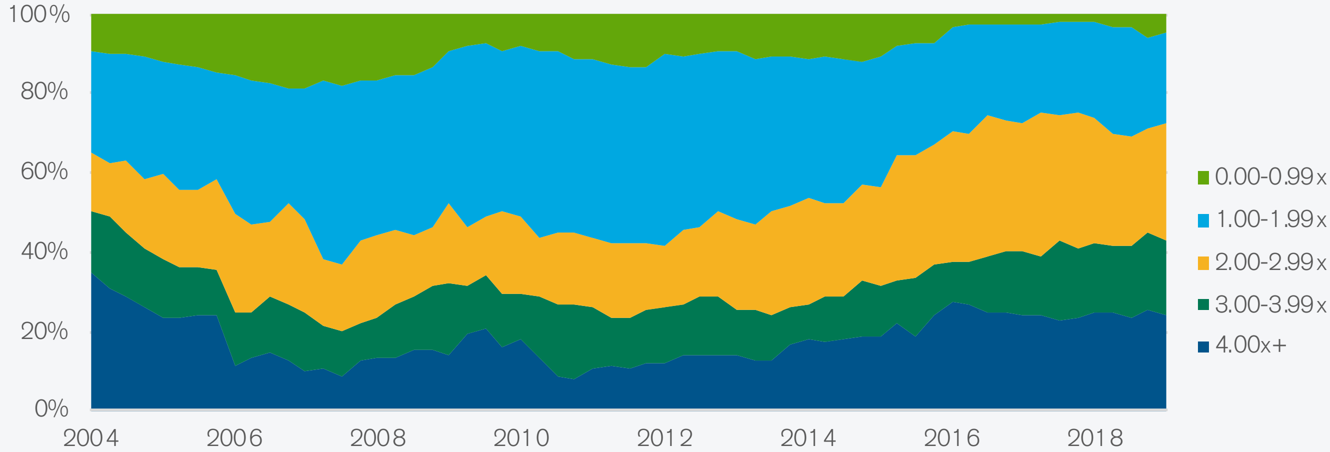
Furthermore, most investment-grade corporate bond issuers have debt loads that are at least twice as large as their capital levels. What's more, **Figure 3** shows a growing percentage of U.S. investment-grade debt issuers with debt-to-capital ratios of 4.00x and higher. Historically, this leverage bucket was associated with high-yield credits. But in recent years, bond ratings agencies have relaxed their ratings standards, highlighting another worrisome trend.

For companies with significant debt-to-capital ratios, the path to deleveraging likely will be a long one, raising concerns that many won't be able to improve their balance sheets before the next downturn. Accordingly, many companies may fall out of the investment-grade debt market and land in the high-yield universe.

FIGURE 3

Many U.S. Investment-Grade Debt Issuers Have High Debt-to-Capital Ratios

Percent of Investment-Grade Debt in Each Leverage Bucket



Source: Morgan Stanley Research, Bloomberg Finance LP, FTSE Fixed Income LLC.
Data from 3/31/2004-3/31/2019.

GOVERNMENT BONDS AREN'T IMMUNE FROM DOWNTURN IMPACTS

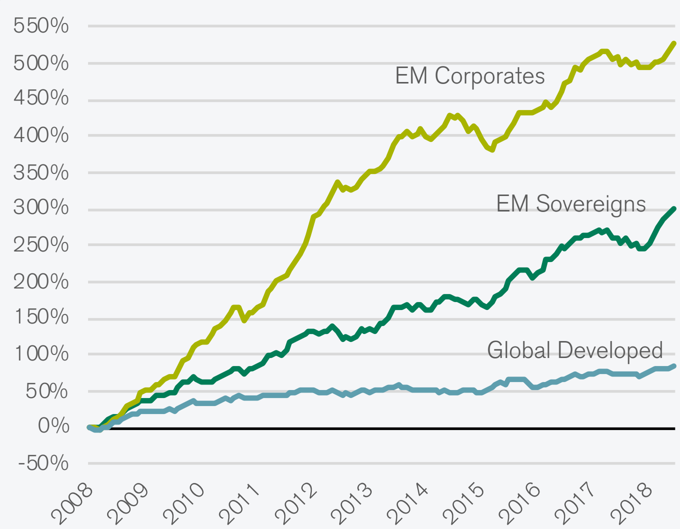
Escalating fiscal deficits throughout developed and emerging markets likely will hurt governments' ability to repay their debts. As economic growth slows, so will the volume of government tax receipts, and servicing an expanding level of debt will grow more difficult.

This trend likely will pose a bigger problem for governments in emerging markets (EM), where external sovereign debt has grown more than 300% since 2008. Growth in EM corporate debt has been even greater, as **Figure 4** demonstrates. In addition, policies, processes and politics in emerging markets may not be as stable as those in developed markets, increasing the risk. But we think trends in developed markets are troubling, too. Many nations face escalating debt-to-GDP ratios and little political will to stem the spending with rising populism spreading across the developed world.

FIGURE 4

EM Debt Growth Has Been Explosive

Growth of External EM Debt Market



EM Corporates: JPM CEMBI Broad; EM Sovereign: JPM EMBI Global; Global Developed: Bloomberg Barclays Global Aggregate Bond. Data from 12/1/2008-6/30/2019.
Source: FactSet.

[2]Morgan Stanley Research, Bloomberg. Uses average S&P/Moody's rating at each quarter.

PASSIVE PORTFOLIOS MAY NOT BE POSITIONED TO MANAGE MOUNTING RISKS

While index investing may be an efficient way to invest in the broad equity market, it may not offer the same benefits to investors seeking core bond exposure, particularly as the economy slows and credit quality suffers. Key differences include:

- **Composition.** Equity indices are mostly market-capitalization weighted, so companies with the greatest historical success generally represent larger pieces of the index. But among the widely used U.S. and global core fixed-income indices,[3] the issuers with the most debt have the largest index weightings. This means investors may be overexposed to issuers with heavy debt loads and potentially weakening creditworthiness.

  Unlike active managers, market indices don't consider a company's declining credit quality or rising default risk. This characteristic of index investing may not present problems while the economic cycle is positive, and the higher-risk component of the index is small. But if the cycle turned, the economy slowed and recession hit, credit risk would increase within broad market indices. Passive strategies with investment-grade mandates would be forced to sell securities with deteriorating credit qualities as prices fell.

- **Market Exposure.** Core bond indices offer exposure to government-backed, government agency and investment-grade corporate securities only. In the U.S., they exclude more than one-half of the total fixed-income universe. Investors passively tracking the U.S. core bond index miss out on nearly $21 trillion of investment opportunities,[4] including commercial mortgage-backed securities, asset-backed securities, collateralized loan obligations, and high-yield corporate debt.

- **Rebalancing/Turnover.** Unlike broad equity market indices, which typically rebalance quarterly or annually, the widely used U.S. and global core bond indices rebalance monthly, reflecting the ongoing cycle of securities maturing and entities issuing new debt. Therefore, turnover is typically much higher for a portfolio tracking a core bond index than a portfolio tracking a broad equity index.

These factors are inherent to fixed-income index investing, regardless of the current stage in the economic cycle. But, as the economic cycle slows, the composition and market exposure factors likely will become more pronounced, highlighting the hidden dangers of passively investing in bonds.

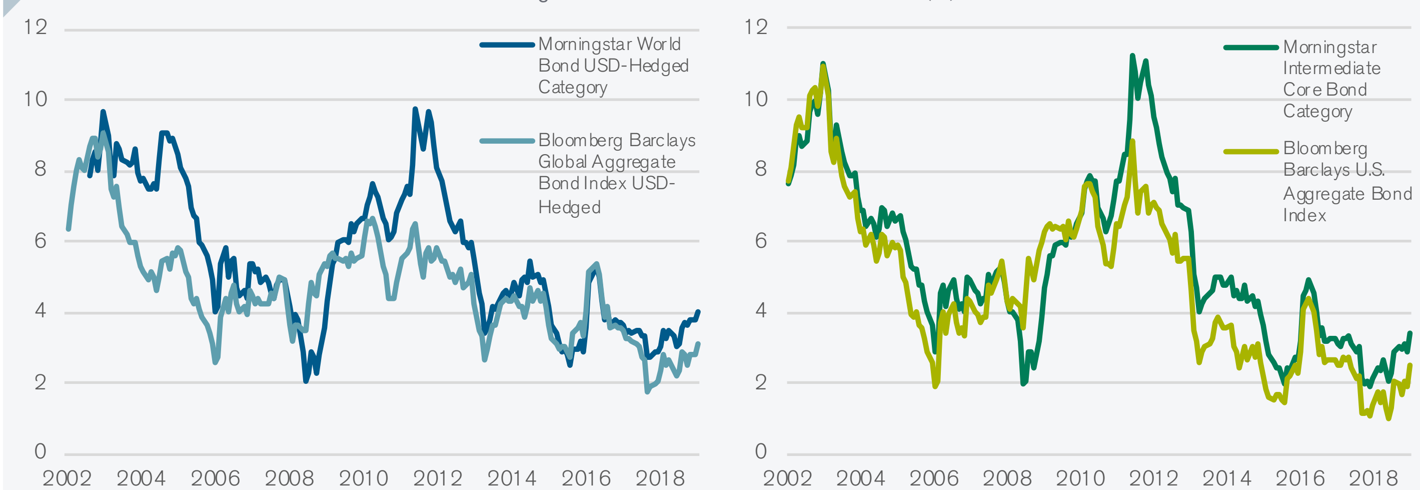
ACTIVE MANAGERS MONITOR, RESPOND TO ECONOMIC CYCLE

Unlike their passive peers, active managers can adjust their exposure to various risk factors to take advantage of opportunities as the economic cycle churns. Because of this capability, active managers, collectively, have a history of outperforming the broad bond market, as **Figure 5** illustrates.

FIGURE 5

Global and U.S. Active Bond Managers Have Outperformed Indices

Rolling 3-Year Annualized Return Gross of Fees (%)



Source: FactSet.
Data from 5/31/2002-5/31/2019.

[3]Bloomberg Barclays U.S. Aggregate Bond Index and Bloomberg Barclays Global Aggregate Bond Index
[4]*Investment News*, "Active Fixed-Income Management Makes Sense Now More Than Ever," September 7, 2018.

The ability of active managers to monitor and respond to credit market trends may provide a key advantage over passive portfolios as the economic cycle changes. Active managers rely on proprietary research and analysis to help them proactively sell securities with weakening credit quality before the actual credit-rating downgrade. In addition to potentially avoiding these “fallen angels,” active managers have the flexibility to purchase “rising stars,” or bonds poised for a credit-rating upgrade from high-yield to investment-grade.

Additionally, those investing globally can avoid government-issued bonds with negative yields. Within the global bond market, government-related securities comprise 73% of the broad market index.[5] Ongoing central bank stimulus in Europe and Japan has pushed certain government bond yields to record lows, meaning a notable share of the global bond market index includes government bonds with negative yields. Index investors can’t avoid these securities, but active managers can.

Furthermore, because they don’t have to mimic an index’s specific composition, active managers generally are free to rotate between bond market sectors according to market and economic conditions and value opportunities. Most have the flexibility to purchase out-of-index securities, which may enhance performance potential and help reduce certain risks. In addition, active managers can adjust their exposure to interest rate risk (duration), which may aid performance potential in rising- and falling-rate environments.

TRENDS TRUMP TIMING

All economic cycles eventually take a turn for the worst, but the exact timing of the next shift remains unclear. That’s why it’s important to note the market trends historically indicative of an economic downturn and react accordingly. Those trends include rising debt levels and a deterioration in the quality of that debt worldwide.

These developments present challenges for all fixed-income investors, but we believe passive portfolios are particularly vulnerable to the adverse effects. Active portfolios, on the other hand, feature the insight and experience of professional, seasoned investors attuned to market opportunities and risks. They have the flexibility to respond to changing market and economic conditions and explore investment opportunities beyond those of a broad market index. We believe these characteristics may enhance performance potential and curtail risk throughout the economic cycle, and they remain particularly important as the cycle downshifts.

[5]Bloomberg.

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Suite 4345
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