Schroders

Talking Point

Unholy Trinity

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The bad news is that if you thought 2008 was tough for corporate credit, 2009 will turn the screws even harder. We see three threats to corporate credit quality: **liquidity**, **operational leverage** and **accounting malpractice**. The first is already terrorising major parts of the world's financial system but the latter two will cause further shocks to a wider set of issuers and sectors. The good news is, for investors who analyse the threats in order to negotiate these hazards, there are some extremely cheap valuations in credit with below-market risk.

The 2008 liquidity and demand shocks remain important into 2009…

We base our entire framework of analysis on one old-fashioned principle: bond issuers get into trouble when they can't pay their interest or they can't repay the principal. Sounds straightforward, we know, but it is surprising how many investors have been led into blind alleys over the last year when this simple principle is forgotten. And from this, the two mains strands of our credit research effort flow…

Liquidity

Will we be repaid from internal company resources or are we relying upon goodwill from the issuer's bankers to roll over debt? Can they repay the money we have lent them? In 2008, Continental AG and Ineos are examples of how spreads can blow wider when this becomes a concern.

Operational leverage in a downturn

How sensitive is the company's profit generation to sales declines? If sales fall 5...10…20%, is the company so rigid that it can't adjust to maintain profits and pay the interest owed to us? Examples of this high sensitivity to the economic cycle in 2008 included Kingfisher and ITV, falling from investment grade to junk.

…but an old ghost returns to haunt us

Accounting fears

During a long bull market of the sort we experienced from 2003-2007, we believe the requirement for companies to 'make the numbers' leads to increasing pressure to take an assertive approach to accounting. Only when the economy begins to contract does the accounting 'spin' become unsustainable, leading to accounting revisions and a collapse in confidence in the company. This clearly has ramifications for the company's bankers, suppliers and customers, with consequences for liquidity and operational leverage.

We are unable to access communications between a company and its auditors. Instead, Schroders Credit Research screens major European corporate issuers and their subsidiaries for some of the identifying characteristics of aggressive accounting. Essentially, we aim to identify major divergences between net income growth and cash flow generation. All else being equal, these should run in parallel. If not, we investigate why not. If there isn't a good reason, it seems logical to us that the risk of an unwind of an aggressive accounting practice appears to be higher than normal and the company is best left out of portfolios.

I stress that we are attempting to identify companies with imprudent accounting , rather than fraudulent accounting. The latter, based upon deception, leaves fewer fingerprints. Nonetheless, I believe our systematic stress on cash flow analysis does pick up some of the signs of corporate malfeasance too. It certainly gives us an advantage versus our competitors who approach matters with a greater stress on the P&L, with its greater opportunities for obfuscation and sleight-of-hand.

Summary

Evaporating liquidity, collapsing demand and accounting ambushes; the conjunction of this unholy trinity in 2009 is making fundamental credit analysis more important than ever. Yet this intense environment should play to our strengths. . We have always considered fundamental credit analysis as a necessity, not a luxury.. If we are aware of the threats coming, we can be prepared to avoid the dangerous securities – and invest in solid companies at extremely cheap, even once-in-a-lifetime, prices. Living in interesting times isn't a curse. Happy New Year!