Credit Ratings Aren't "Quality" When It Comes To Forecasting Stock Returns

November 2011

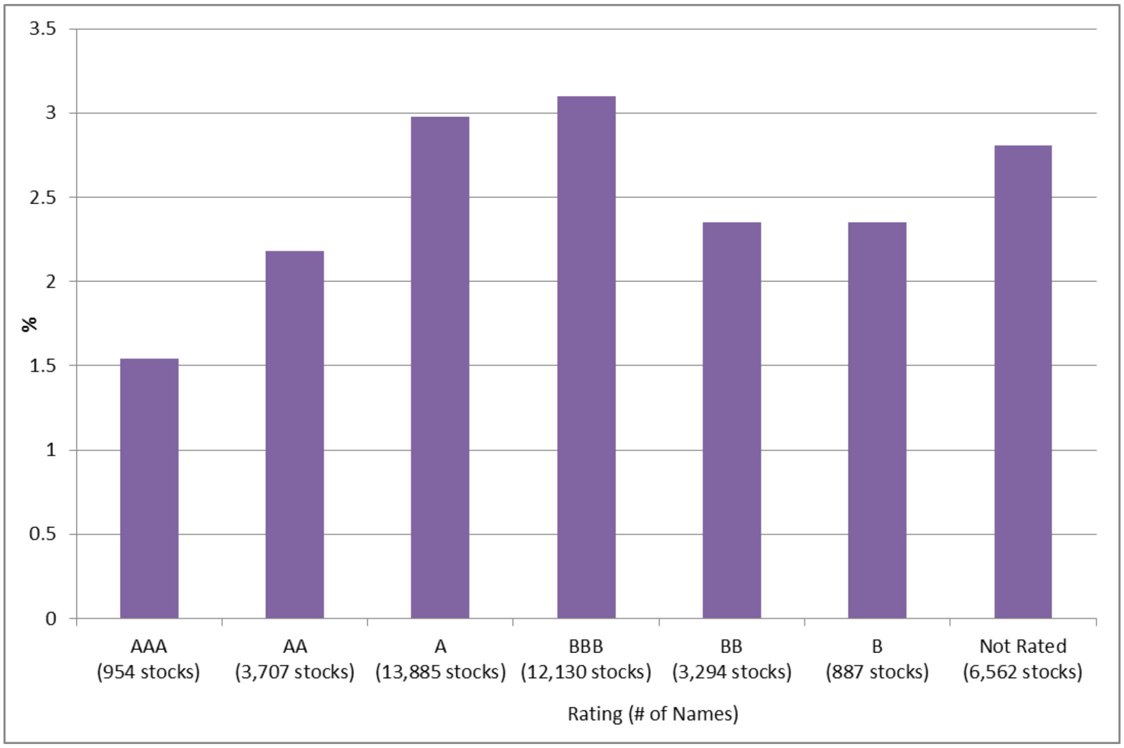
During the 3rd quarter of 2011, when the S&P 500 Index fell by over 13%, opportunities for stock picking appeared to be distinguished by quality. Based on S&P Debt Ratings, companies that were rated AA and AAA were down 8%, companies that were rated BBB and A were down 15% , and BB and below were down 24%.

This raises the question, "Do high quality stocks tend to outperform in general?". The answer depends upon your definition of "quality." Is it dividend paying companies? Is it companies that generate cash flow? One indicator that actually isn't predictive of stock returns through time is debt ratings, such as those described above. Indeed, S&P's goal with its debt ratings is to guide investors with regard to the chances of a company defaulting on its bonds, not to offer a guide with regard to future stock price performance.

Companies that have earned high debt ratings tend to be mega-cap companies for the most part, so any investment strategy that's focused on investing in companies with higher ratings is taking on a big size bias. When smaller companies are favored, companies that are rated AA and AAA will tend to underperform. Furthermore, investments which focus on companies with higher debt ratings are completely excluding those companies which have no debt at all. These unrated companies may be even higher quality than those with debt that is rated AA or AAA, and indeed, they have tended to outperform the highly rated companies through time. (See the group of stocks categorized as "Not Rated" in the table below.) Finally, from a behavioral standpoint, buying the highest rated stocks is usually the more "comfortable" position, and often the more successful investment strategies tend to be those which are well-considered but "uncomfortable."

To specifically measure the predictive ability of S&P Debt Ratings with regard to stock price performance, we gathered data on all of the stocks that were in the S&P 500 Index at the end of each quarter going back to 1990. As you can see in the table, the stocks with debt that is rated AAA actually tended to underperform the S&P 500 Index over time. (Part of this underperformance was due to dramatic declines in Fannie Mae and Freddie Mac, which were both down about 90% during the third quarter of 2008.)

Quarterly Returns by S&P Rating , 1990-Present[1]



[1]Source: Compustat