Perpetual

Perpetual knowledge bank series: Credit Risk

By Perpetual Asset Management

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Credit risk is the possibility that a borrower or counterparty does not meet its payment obligations as they fall due. A borrower defaulting by failing to meet interest or capital repayments is one of the most significant risks faced by any lender. Consumers, companies or countries posing higher credit risks usually end up paying higher interest rates on loans. Taking

on more credit risk can lead to higher yields for lenders but it also increases the chance the borrower will not fully repay the loan.

Although it is difficult to know exactly who will default on obligations, properly assessing and managing credit risk can lessen the severity of a loss. There are many contributors to credit risk, such as profitability and cash generation of the borrower, the industry in which they operate, whether the loan is secured by assets or unsecured, and whether the loan is senior or subordinated to other creditors.

The least risky borrowers are typically governments and the best sovereign debt is almost risk free. For example, lending to the Australian government. However, there is an extremely large universe of other borrowers from high quality through to those considered higher risk, such as high-yield borrowers who issue sub-investment grade debt. Generally, if a bond has a low rating (below BBB), the issuer has a relatively high risk of default but stronger ratings (BBB, A, AA, or AAA), mean the risk of default is progressively less likely.

Unrated securities are also becoming increasingly common and refer to assets issued by borrowers without an established credit rating from a rating agency such as Standard & Poor's (S&P), Moody's Investor Services or Fitch. If a company is unrated, it does not necessarily mean that the debt it issues are high risk, but it does mean that investors will need to undertake more extensive due diligence to evaluate the borrower's financial strength and the security's complexity.

PCI's investment strategy provides flexibility to invest across the broad spectrum of fixed income and credit assets and means we can take advantage of opportunities where quality issuers who do not meet the criteria for investment grade ratings can offer more attractive returns. The broad range of assets also means we can actively manage the portfolio to adapt to changing market conditions.

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