What is credit risk and why does it matter?

When I am talking about fixed interest as an asset class, I often talk about *credit risk* as being an important concept when investing.

In fact, it could be THE most important concept when investing in fixed interest and cash – particularly if you believe that these 2 asset classes are the absolutely secure part of an investment strategy.

Credit risk is the risk that the issuer of the investment (the bank/the company) will default on their commitment to return your capital and/or interest due to you at the end of the agreed investment period.

Traditionally, the higher the credit risk of a fixed interest investment, the higher the return.

It is a trade off.   You take more risk with your money, and they should pay you more to get your money from you.

Everyone understands that, when you invest money in shares, the value of the shares will go up and down and there is the potential that you will lose some money at some point.

People also understand that, if it is a general market downturn and you hold your investments, they will usually eventually increase in value.

However, if a fixed interest investment turns pear shaped, often the capital is permanently lost with no possibility of return.

The easiest way to measure *credit risk* is to look at the credit rating of the business which is offering to take your money and invest it for you.   This is not always fool proof but it is a really good place to start.

There are many large global multinational companies which offer credit risk assessments, such as Standard and Poors**,** Moodys, and Fitch.

These would be the companies that we see most often in this part of the world. They each have a system of rating the credit worthiness of the offering, and have explanations of what their ratings mean on their websites.

HOWEVER, what most people do not realise is that the scale of credit ratings is not linear, it is logarithmic.

In NZ, being a very earthquake prone country, people are often familiar with the Richter scale, where each Richter level is in fact 10 times the amplitude of the previous level. For example, a Richter level 3 earthquake is 10 times stronger than a level 2 earthquake.

With the Standards and Poors ratings, they range from AAA to D, with + and – ratings in between.

Anything above a **BBB-** is regarded as "**investment grade**".

Anything less than **BBB** is regarded as "**speculative grade**". *This includes BB and B grade*.

In an investment context, *speculative* means *high risk*.

Over a five year period, the probability of an AAA security defaulting is 0.35%.

At the bottom end of the investment grade rating, the probability of a BBB security defaulting over a 5 year period is 3.44%.

This is *10 times* more likely to default than a AAA rating.

From this point onward, the probably of default escalates at a much steeper level, as does the Richter scale.

Banks, companies and even governments have credit risk ratings.

Australia as a country has a AAA rating, while we have an AA rating.

This does place us amongst the highest rating countries in the world.

HOW WE (and you can) APPLY CREDIT RISK

With our (Smart Money Advice's) portfolio construction processes, our philosophy is that the cash and fixed interest in a portfolio should be capital secure.

Cash and fixed interest is the bedrock of a portfolio to maintain portfolio value should all else turn to custard (a technical investment term).

We therefore pay a lot of attention to underlying credit risk.

Our current portfolio construction guidelines are that around 95% of the fixed interest in a portfolio should be in the A grade investment band, and 5% can be in the B grade band.

We do not go lower than BBB- for credit risk.

It does mean that we are limited with what we can invest in, and that currently, the interest rates are moderate.

If you are looking at an offering in your local newspaper and going *“whoa, look at that – it is much better than my bank”*, hop onto interestrates.co.nz and check out the credit rating of the provider.

Then ask yourself:

> ***“how important is it that I get this money returned to me?”***

If you absolutely want that money back, stick to the high credit rating investments.

Janet Natta is a financial adviser and director of Smart Money Advice, offering investment portfolio construction and management services to clients throughout NZ, as well as comprehensive financial planning advice to assist clients to build and protect wealth to achieve their dreams.