Understanding Investments

Credit Ratings: 10 Things You Need to Know

Individuals, companies, and countries rely on ratings that are issued by credit agencies. The opinions of the "big three" – Standard and Poor's, Moody's and Fitch – are still valued, even though their reputations took a beating when they failed to predict the global financial crisis in 2008. Here are some fundamental facts:

1. Credit ratings are letter grades of safety

They examine several fundamental questions. Will investors get their money back with interest? Or is the issuer likely to default, leaving investors with little? The more A's an issuer has, the better the bond. Conversely, the more C's or D's, the lower its credit quality. (Figure 1)

2. Default rates jump as ratings decrease

The chance of an issuer going into default rises significantly with each step down the rating scale. Default rates are two to three times higher for an A-rated company than an AA/Aa-rated one. The difference is largest within B-class ratings. Nearly four times as many high-yield companies (BB/Ba) default, compared to the nearest investment grade ones, which are rated BBB/Baa. (Figure 2)

Figure 1: Credit Rating Scale

	S&P's Rating*	Moody's Rating
Investment grade	AAA	Aaa
	AA	Aa
	A	A
	BBB	Baa
Non-investment grade / Speculative / "junk"	BB	Ba
	B	B
	CCC	Caa
	CC	Ca
	C	
	D	C

Highest quality, lowest credit risk

Credit quality diminishes down scale.

Issuer in default

* Method developed by Fitch Ratings, but later purchased and licensed by S&P

Source: DBS CIO Office, S&P, Moody's

Figure 2: Annual average corporate default rates by letter rating

	S&P		Moody's	
	Credit Rating	Ave. Default	Credit Rating	Ave. Default
Investment grade	AAA	0.00%	Aaa	0.00%
	AA	0.02%	Aa	0.06%
	A	0.06%	A	0.10%
	BBB	0.23%	Baa	0.27%
High Yield	BB	0.98%	Ba	1.07%
	B	4.61%	B	3.41%
	CCC-C	23.76%	Caa-C	13.86%

Annual corporate default rates. S&P data from 1981-2013, Moody's data from 1920-2010

3. Better credit ratings = cheaper funds

Higher-rated countries and companies are able to borrow more cheaply, because the risk of holding their debt is judged to be lower. It's the age-old rule behind borrowing and lending.

4. Better credit ratings = more capital inflows

Most of the world's bond funds can only invest in a country if it has an investment grade rating from at least two of the "Big 3". Some equity funds face a similar restriction. As such, a status upgrade – or even the promise of one – can attract more inflows. For example: Moody's raised Indonesia's credit rating to Baa3, or investment-grade, in mid January 2012, joining Fitch. The Jakarta Composite Index jumped by 1.1% the next day, and inflows into Indonesia-focused equity funds were at the highest in over a year, according to funds flow tracker EPFR Global.

5. Credit ratings go beyond hard numbers

The determination of credit ratings is not an exact science. Yes, credit analysts pore over balance sheets, cash flows, and the reliability of future revenue (e.g. toll road fees compared to home sales). But they also consider factors like political stability, industry norms, market share, and clauses in the bond's structure that could provide added protection against default.

6. Credit ratings are not buy/hold/sell recommendations

Credit analysts calculate the odds of investors getting their money back at the end of the day. Investors should consider their risk profile, financial goals, and time horizon before deciding whether to buy, hold, or sell any investment. A recent example: Singapore has a coveted AAA-rating. But its citizens bought only a third of the SGD1.2 billion Singapore Savings Bond available for sale late in September 2015.

7. Credit ratings are not guarantees of future value

Before the 2008 global financial crisis, subprime mortgages were bundled and sold as very safe AAA-rated investments, because analysts saw a slim chance of all of them defaulting at the same time. But we now know the story. When the crisis hit, these bundles were swiftly downgraded, and the value of these AAA-rated investments plunged.

8. Credit ratings aren't absolute predictors of default

Credit ratings do not have 100% accuracy, and unexpected events can be devastating. For example: Analysts at the 'Big 3' gave Lehman Brothers a positive investment-grade rating of AA up until mid-September 2008, fully expecting a government or company rescue. Lehman Brothers declared bankruptcy on 15 September 2008. Major insurance company AIG took a US government bailout the next day, despite it having a top-notch AAA rating from Moody's, S&P and Fitch.

9. Credit ratings do not indicate liquidity risk

Liquidity risk arises when investors are unable to sell an asset quickly enough to avoid a loss. When Lehman Brothers collapsed, financial markets froze. Buying and selling simply stopped in debt markets, and even companies with solid cash balances found no takers for their new bond issues.

10. Credit ratings are not a pre-requisite for creditworthiness

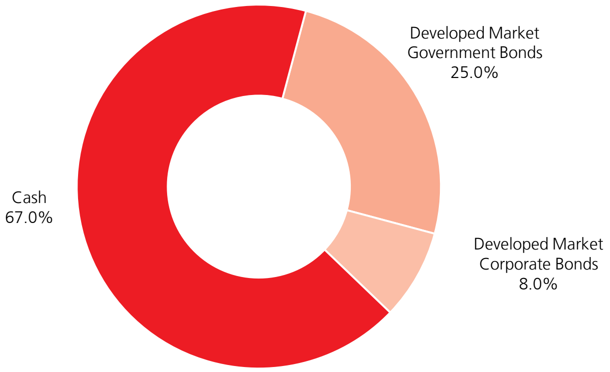
Bonds issued by companies with no credit ratings typically offer higher yields, but not all of them have cash problems. Some issuers rely on another party's rating, for instance Singapore statutory boards, which rely on the government's AAA rating. Others may not see value in paying for a rating.

Asset Allocation

DBS 3-Month Tactical Model Portfolio – Q4 2015

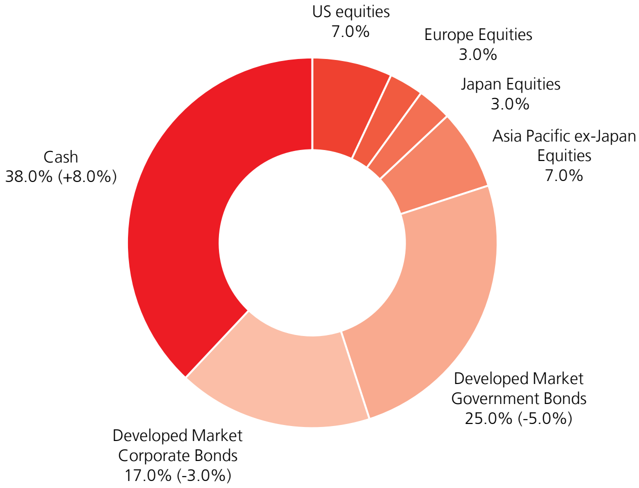
1. Defensive

Capital preservation with minimal risk exposure



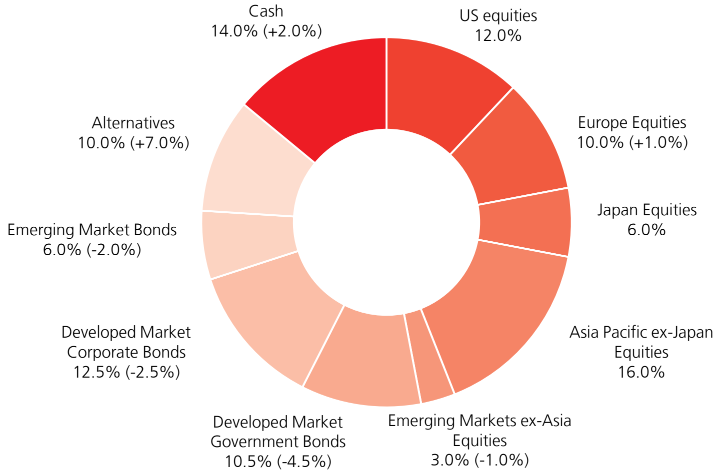
2. Conservative

Capturing some capital growth with low risk exposure



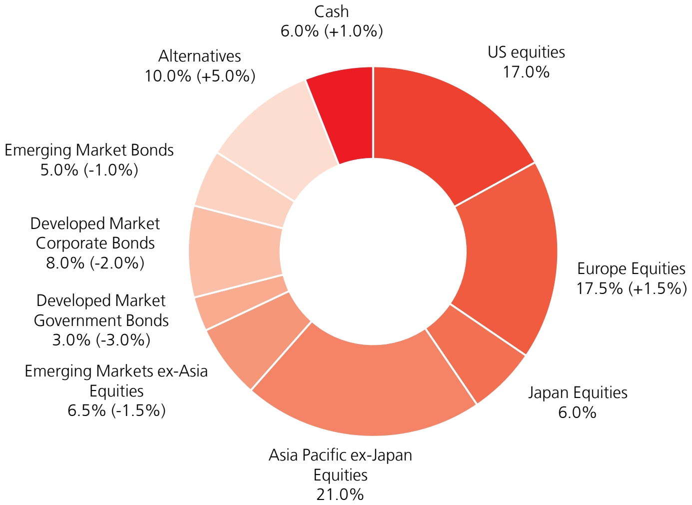
3. Balanced

Capturing modest capital growth through a balanced risk-and-return approach



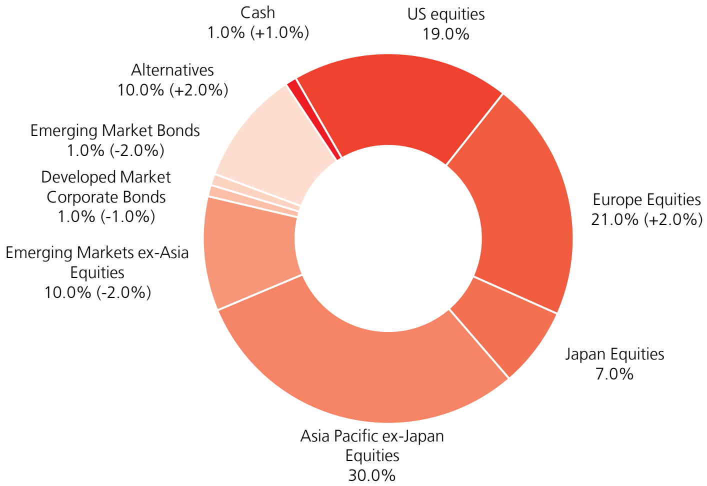
4. Growth

Higher wealth enhancement through greater exposure to risky assets



5. Aggressive

Maximising capital growth potential through exposure to a large portion in risky assets



Notes:
Percentages denote actual tactical asset allocation weights for a 3 month time horizon.
Figures in brackets refer to the tactical weight shifts versus the strategic allocation. Taking the Balanced model as an example, "Europe equities 10.0% (+1.0%)" represents an overweight of 1.0% compared to the neutral weight of 9%.

Tactical Asset Allocation – Q4 2015

Asset Class	Region	3m view	12m view	Rationale
Equities	US	Neutral	Neutral	Maintain 3M and 12M Neutral. Medium-term headwinds include: (1) Valuation concerns; (2) Operating margins and earnings concerns; (3) US dollar strength; and (4) Monetary tightening concerns. The peaking of operating margins and the negative impact from dollar strength will continue to weigh on US equities. US equities currently trade at 16.4x forward P/E and consensus forecasts earnings growth at 4.8% in 2015.
	Europe	Overweight	Overweight	Maintain 3M and 12M Overweight given monetary accommodation on the back of ECB QE. Benefits of ECB QE: (1) EUR depreciation boosts export competitiveness; (2) Low real rates support property prices; (3) Portfolio re-allocation, with banks re-investing funds in riskier assets; and (4) Boost to banks securitisation. Europe trades at 14.8x forward P/E – a 9.8% discount relative to the US. Based on consensus forecast, Europe is forecast to register 8.9% EBITDA growth in 2015.
	Japan	Neutral	Neutral	Maintain both 3M and 12M Neutral. Medium-term headwinds include: (1) China growth risks; and (2) Fed policy normalisation risks. However, the following medium-term factors should support the Japanese equities market in the event of a broad-based correction: (1) Rebound in economic fundamentals; (2) Subdued oil prices; and (3) Support from government pension fund. At 13.5x forward P/E, MSCI Japan trades at a discount to Developed Markets while consensus forecasts EBITDA growth of 11.5% in 2015.
	Asia Pacific ex- Japan	Neutral	Neutral	Maintain 3M and 12M Neutral. Medium-term challenges include: (1) Imminence of Fed policy lift-off impacting Asia Pacific ex-Japan (APxJ) emerging economies; (2) Sell-down in Chinese equities; and (3) Regional economic growth concerns. APxJ trades at 12.1x forward P/E and market consensus forecasts earnings to fall 12.0% this year.
	Emerging Markets (EM) ex-Asia	Underweight	Underweight	Maintain 3M and 12M Underweight. We expect EM ex-Asia (especially those with large current account imbalances) to face renewed selling pressure as the US moves towards policy normalisation. The downtrend in commodity prices will also be negative for commodity producers in the region. EM (ex-Asia) equities trades at 12.0x forward P/E. Market consensus expects earnings to plunge 24.4% in 2015.
Bonds	Developed Markets (DM)	Underweight	Underweight	• Maintain 3M and 12M Underweight. On a cross-asset basis, equities remain more attractive than bonds. • Government Bonds (3M and 12M Underweight) – Maintain Underweight given: (1) UST 10-yr yield trading below fair value; (2) Rising wages and strengthening economy translating into stronger 'core' inflation; and (3) Prevailing market complacency on US interest rate risks. UST 10-yr yield expected at 2.4% in 3Q15 and 2.6% in 4Q15 for the UST 10-yr yield. • Corporate Bonds (3M and 12M Underweight) – Maintain Underweight given likelihood of funds outflow and further spreads widening as the Fed moves towards policy normalisation. Stay cautious on US high yield bonds as spreads have not become sufficiently wide at 5.9%.
	Emerging Markets (EM)	Underweight	Underweight	Maintain 3M and 12M Underweight despite current "carry-friendly" environment of moderate growth, weak inflation, and still accommodative monetary policy. Risks for EM bonds remain on the downside given: (1) Imminent US policy normalisation; and (2) Potential rise in default rates.
Alternatives	N/A	Overweight	Overweight	• Commodities (3M and 12M Neutral) – Despite massive destruction of prices across the commodities complex from mid-2011, the declines continue. Commodities are struggling with downside pressures amid: (1) Weak Chinese growth; (2) Dollar strength; and (3) Continued oversupply and excess inventories in a range of commodities. • Gold (3M and 12M Overweight) – Maintain 3M and 12M Overweight amid rising volatility posed by (1) The undeclared "currency war" between China and other emerging markets; and (2) Imminence of Fed policy normalisation. • Hedge Funds (3M and 12M Overweight) – Maintain 3M and 12M Overweight. Volatility expected to rise should the Fed tighten monetary policy. Increase hedge funds exposure to protect against downside risks.
Cash	N/A	Overweight	Overweight	Maintain at 3M and 12M Overweight amid rising volatility and in anticipation of broad-based portfolio de-risking.

Figures and estimates are as of 2 October 2015.

Strategic Asset Allocation Models

Investment Objectives of the Model Portfolios

The DBS Strategic Model Portfolios have been developed in consultation with Morningstar Associates, LLC based on a set of capital market assumptions. Morningstar Associates, LLC, the industry leader in fund of funds management, investment consulting and retirement advisory services, has developed five portfolios for DBS Bank.

Each portfolio is diversified across many types of asset classes and investment styles in order to benefit from the top performing asset classes and reduce the impact of lower performing asset classes.

- Defensive - This model is ideally suited for investors who are seeking to preserve their capital and are uncomfortable sustaining losses. Its 0% allocation to equities means the portfolio will have lower returns while striving to reduce risk exposure over the medium to long term. To help minimize risk; this model has a sizeable allocation to cash and Developed Market bonds.

- Conservative - This model is ideally suited for investors who are fairly risk adverse and are seeking more stable returns. Its 20% allocation to equities strives to capture some growth potential, without assuming too much risk over the medium to long term.

- Balanced - This portfolio is ideally suited for investors who are seeking to strike a balance between risk and returns. Although the 47% allocation to equities and 3% allocation to alternative investments give this model a riskier profile than either the Defensive or Conservative models, it is better positioned for modest growth over the medium-to-long term.

- Growth - This model is ideally suited for investors seeking to grow their capital and who can tolerate higher risk and considerable market volatility over the medium-to-long term. Although its 68% allocation to equities (with a bias to Asian equities) and 5% exposure to alternative investments position the model for growth, it also exposes the investor to potentially high losses.

- Aggressive - This model is ideally suited for investors who are seeking to maximize growth and can tolerate losses and market fluctuations over the medium-to-long term. Its 87% allocation to equities and 8% exposure to alternative investments position the investor to capture the upside of the market, but also expose them to the potential of sustaining extensive losses on the downside. This model has the highest allocation to Asia Pacific ex-Japan, US and Europe equities, while still maintaining some exposure to bonds and cash.

The target investment horizon of a Strategic Asset Allocation Model portfolio is five years.

Strategic Asset Allocation Models for 2015

		Defensive	Conservative	Balanced	Growth	Aggressive
Equities	US	0%	7%	12%	17%	19%
	Europe	0%	3%	9%	16%	19%
	Japan	0%	3%	6%	6%	7%
	Asia Pacific ex Japan	0%	7%	16%	21%	30%
	Emerging Markets ex Asia	0%	0%	4%	8%	12%
	Equities	0%	20%	47%	68%	87%
Bonds	Developed Market – Government Bonds	25%	30%	15%	6%	0%
	Developed Market – Corporate Bonds	8%	20%	15%	10%	2%
	Emerging Markets (EM) Bonds	0%	0%	8%	6%	3%
	Bonds	33%	50%	38%	22%	5%
Alternatives		0%	0%	3%	5%	8%
Cash		67%	30%	12%	5%	0%
Expected Return (%)		1.7%	4.0%	6.8%	8.6%	10.2%
Expected Risk (%)		3.0%	6.1%	11.0%	15.0%	19.0%

To find out more, talk to any of our Relationship Managers now!

Notes:

- The expected annual return of the strategic portfolio is based on capital market assumptions derived from Morningstar's econometric model that relies on historic, current and forecasted data on the indices highlighted below. The information is for reference only.
- The expected risk (or annual standard deviation) of the strategic portfolio represents the expected risk level of the portfolio based on historical asset class relationships (correlations) and volatility, using monthly returns from 2004 to 2015 based on the indices highlighted below. The information is for reference only.
- Morningstar Associates' model portfolios started on 1 October 2010. Morningstar reviews the strategic asset allocation on an annual basis. The current Strategic Asset Allocation (SAA) is as of end November 2014.
- Based on the model portfolios, the Aggressive model has the highest risk, followed by Growth, Balanced and Conservative, with Defensive being the least risky. The risk consideration that was used in formulating the Strategic Asset Allocation was the annualized quarterly average drawdown. A maximum annualized average quarterly drawdown constraint is in place for the different portfolios, with the defensive portfolio having the most restrictive and the aggressive portfolio having the most accommodative risk constraints.
- The investor type classification for the portfolio has no direct relationship with the Financial Needs Analysis customer risk profile types and the portfolios are not assigned any product risk rating based on the bank's proprietary risk rating methodology.
- The above model portfolios are effective from January to December 2015 and are subject to change.
- The expected return and expected risk are based on the following indices for calculation:
  - o Equity: US – MSCI USA GR; Europe – MSCI Europe GR; Japan MSCI Japan GR; Asia Pacific ex Japan – MSCI AC Asia Pacific ex –Japan GR; Emerging Market (EM) ex Asia - MSCI EM-ex Asia GR
  - o Bond: Developed Markets (DM) Government Bonds – Citigroup WGBI All Maturities USD; Developed Markets (DM) Corporate Bonds – Citigroup WorldBIG Corporate A USD; Emerging Markets (EM) Bonds – JPMorgan EMBI Global Diversified
  - o Alternatives: Commodities – Bloomberg Commodity Index Total Return; Gold – S&P GSCI Gold Official Close TR; Hedge Funds – Credit Suisse Hedge Fund
  - o Cash: Bank of America Merrill Lynch USD LIBOR 3 Month Constant Maturity

Morningstar Associates' Asset Allocation Approach:
A hallmark of Morningstar Associates' asset allocation approach is to diversify the models across investment styles, sectors, sub-asset classes, market caps, and regions. This approach aims to ensure that some part of the portfolio will be performing well in most markets while limit the downside risks.

In determining the asset allocation targets, Morningstar Associates uses a multifaceted approach that features of a number of sophisticated mathematical models to forecast returns on various asset classes. The modelling process is designed to provide asset targets appropriately aligned with current market conditions and investor expectations. Morningstar Associates also subjects the asset allocation models to 10,000 simulations to determine how well or poorly they stand up to different market conditions over a five-year period and then make any necessary adjustments.

Morningstar Associates refines the asset allocation targets based on local market characteristics and behaviours. This results in significant overweight to the Asian markets, both equity and fixed income, in the DBS Strategic Asset Allocation Models, although each model retains varying degrees of exposure to the global markets.

There are five DBS Strategic Asset Allocation Models, namely Defensive, Conservative, Balanced, Growth and Aggressive. These are risk-based asset allocation models, where expected risks are agreed upon with DBS. In determining the most efficient asset targets for the DBS Strategic Asset Allocation Models, Morningstar Associates factored in a number of constraints imposed by DBS. First, DBS stipulates that there should be no allocation to Emerging Market bonds and no allocation to Alternative asset classes for the Global Defensive and Conservative Models. Second, there should be no allocation to Equity asset classes for the Defensive Model.

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