Understanding Credit Spreads

– By Prof. *Simply* Simple

Courtesy: Tata Mutual Fund

August, 2020

- A credit spread refers to the difference in interest rates between a corporate bond and a comparable Government bond.
- Suppose interest rate on a five-year corporate bond is 6 per cent and that on a similar five-year Government bond is 5 per cent.
- This means that the interest on a corporate bond consists of a risk-free rate of 5 per cent plus a credit spread of 1 per cent.

WAY2WEALTH

- Different securities in the market have different risk profiles.
- Therefore, compensation is paid to investors proportionately according to the risk taken by the investor in selecting a particular security.

For Example

- Lets say there is a paper issued by the Govt. at 10% coupon. This means if person A subscribes to it, he will earn 10% after one year. So a Rs 100 investment will give him Rs 110 at the end of the year.
- Now suppose the Govt. decides to issue papers at 9% a week later.
- At the same time, person A has a desperate need to get cash and wishes to sell his paper.

TATA MUTUAL FUND

- So he goes to the market to sell the paper.

- Now had the Govt. not reduced the coupon rate, he would have probably sold the paper at Rs 100 to some one, say person B, in the secondary market.

- But since person B today can earn only 9% coupon for a fresh paper (i.e. Rs 9 for investment of Rs 100) and person A understands this, he tries to sell his paper at approximately Rs 100.5 and make a profit of Rs 0.50.

However why would B agree to this? Let see further…

- The buyer, person B, too agrees to buy it at Rs 100.5 because the new rate being offered by the Govt. is 9% whereas at Rs 100.5 he is now earning a better return. How?
- Rs 110 (Value of the paper at the end of the tenure of one year) – Rs 100.5 (Investment) = Rs 9.5 (Absolute Gain)
- Because B chose to buy an old paper (10% coupon) from A from the secondary market, he is better off by making Rs 109.5 at the end of the tenure as against Rs 109 which he would make by investing in a fresh paper from the primary market.
- So as against the 9% return that fresh papers are offering, let us see what return did B manage to get…

- The return that B will make will be 9.5/100.5 = 9.4% which is better than the market rate of 9%.
- This new rate based on the market price is what is popularly known as “yield”.
- **Thus we have seen that when the market price (NAV of MF scheme) goes up the yield actually comes down (from 10% to 9.4%).**

There will be a spread between two different kinds of papers due to the following reason:

- **Credit quality** – Lending money to the Govt. against its papers is any day safer than lending money to a corporate because the Govt. will never ever default. Hence, one is willing to park one's money at a lower yield.

- But unusually high spread between papers as seen in the markets these days is due to available money chasing the Govt. papers, a situation that is not likely to be sustained in the long term.

- The difference in yields between two different kinds of debt papers in the market is known as credit spread.
- For example, if the Govt. security is giving an yield of5% while a corporate paper is giving an yield of 8%, the difference between them is 3% - which is the credit spread.
- However, the spread between a Govt. and good quality corporate papers isn't normally 3%. It is usually around 1.5%.
- What this means is that the probability of the value of a corporate paper going up in the market is quite high due to the additional spread seen.
- So if you buy corporate papers in the current depressed situation, there are good chances that you could make a profit when the spreads reduce as expected.

- The Yield is the income return on an investment.
- A credit spread is the yield spread, or difference in yield between different securities.
- When the yield actually comes down, the market price (the NAV of a MF scheme) actually goes up.

Registered Office Address

Rukmini Towers, 3rd & 4th Floor, # 3/1, Platform Road, Sheshadripuram, Bangalore - 560 020. Tel.: (080) 43676869, (080) 22121512 / 22121952

Corporate Office Address

EFC LTD, 14th Floor 'A' Wing, Empire Tower, Reliable Cloudcity, Airoli, Thane Belapur Road, Navi Mumbai - 400708. Tel.: (+91 22) 40192900 / 61462900

Way2Wealth Securities Private Limited - ARN: 0009. | Way2Wealth Brokers Private Limited – NSE: INB 11502, BSE: INB 3117, MCCI: 5100 SEBI Reg. No: INZ000178638, RA: INH200002739 | PMS: INP000000829 | AMFI Regn. No.: ARN 77558 DP SEBI Regn. No. IN-DP-CDSL-526-2009 | CIN: U67120KA2000PTC027628. | Way2Wealth Commodities Private Limited - SEBI: INZ000049130, MCX Member ID: 40040. NCDEX Member ID: 00908, CIN: U51229KA2006PTC039880. | Way2Wealth Insurance Brokers Private Limited - IRDA License No - 222, CIN: U66010KA2003PTC032003 | Way2Wealth Capital Private Limited - RBI License No : 02.00034, CIN:U65921KA995PTC018960