Solutions Exchange
from S&P Valuation and Risk Strategies

Standard & Poor's

Risk-to-Price By The Sector

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Solutions Exchange is developed by S&P Valuation and Risk Strategies, a separate and independent team at Standard & Poor's. The objective of this analysis is to gain greater insight into specific events and trends in the market using S&P Valuation and Risk Strategies data and analytics solutions.

According to Standard & Poor's new Risk-to-Price score, bonds in the health care sector do a better job, on average, of providing yield for associated market and credit risk when compared with other sectors in the U.S. scored bond universe. The consumer discretionary sector comes out at the bottom.

A New Risk Measure

A common investment strategy is to first identify attractive sectors before selecting individual bonds. The health care sector, for example, has weathered the current credit crunch better than many others. Demographic trends and the recently passed health care laws could prove favorable for strong credit performance of health care-related companies (see "A Rash Of Activity For U.S. Speculative-Grade Health Care Companies," published July 16, 2010, on the Global Credit Portal). But choosing the right sectors based on an investor's risk tolerance is not always easy. Is it possible to rank sectors according to how well they are compensating investors for risk?

Standard & Poor's Valuation and Risk Strategies has developed a new risk benchmark called Risk-to-Price (R2P). R2P scores measure how well a specific bond compensates investors, through yield, for the associated market and credit risks. The R2P formula incorporates a bond's option-adjusted spread (OAS), that same bond's price volatility, and the issuer's estimated probability of default (PD); the higher the score, the better that bond rewards investors for risk. For any given date, each bond's score is ranked against the universe of scored bonds. Bonds are also given a percentile ranking, so it's easy to see where a specific bond stacks up against all the others.

Using R2P, investors can compare scores among bonds to see how much yield their holdings offer for the underlying market and credit risks, relative to other bonds in the market (for more detail on R2P scores, see "Market Intellect: MCRS' New Risk-to-Price Score Helps Investors Assess How Well They Are Being Compensated For Risk," published Feb. 18, 2010, on RatingsDirect®, on the Global Credit Portal®). R2P also provides insight into sector performance when looking at bonds in the aggregate. We took a look at the median R2P scores and median percentiles by sector (excluding financials) over the past year and a half.

Ranking The Sectors

As shown in table 1, the top three sectors at the end of June were health care, telecommunication services, and consumer staples. Although telecom is in the top three overall, it has been the most volatile of all the sectors, bumping in and out of the top tier over the last year and a half, with a steady increase since April *(see charts 1 and 2)*. Since January 2009, health care and consumer staples have been consistently at the top, with utilities and information technology roughly tied for third.

Industrials, materials, and consumer discretionary rank as the bottom three sectors from an R2P perspective, with the median percentile of all consumer discretionary bonds averaging about 40% over the past year and a half.

Table 1

R2P Median Percentiles And Scores As Of June 30, 2010

Sector	Percentile	R2P Score
Health care	79	67
Telecommunication services	75	61
Consumer staples	73	59
Utilities	71	57
Information technology	64	51
Industrials	55	41
Energy	55	41
Materials	51	38
Consumer discretionary	41	28

Charts 1 and 2 illustrate the importance of using percentiles to track bond and sector performance. Changes in individual bond or sector R2P scores over time, when examined on a stand-alone basis, are not meaningful in assessing the relative attractiveness of that bond or sector as scores for all other bonds could potentially move in tandem. In such a case, a change in score may not be accompanied by a change in quartile or percentile rank. Looking at individual scores over time, however, is useful for highlighting trends. We would need to dig a little deeper into the individual R2P components (OAS, price volatility, and PD) to understand the forces behind the trends. The percentiles *(see chart 2)* are useful for tracking relative rankings over time.

Chart 1

Median R2P Scores By Sector

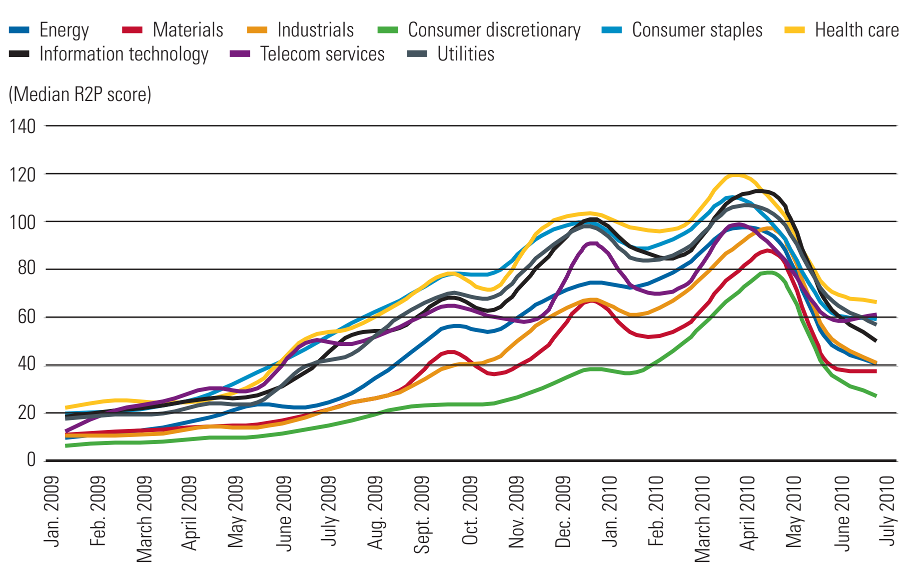
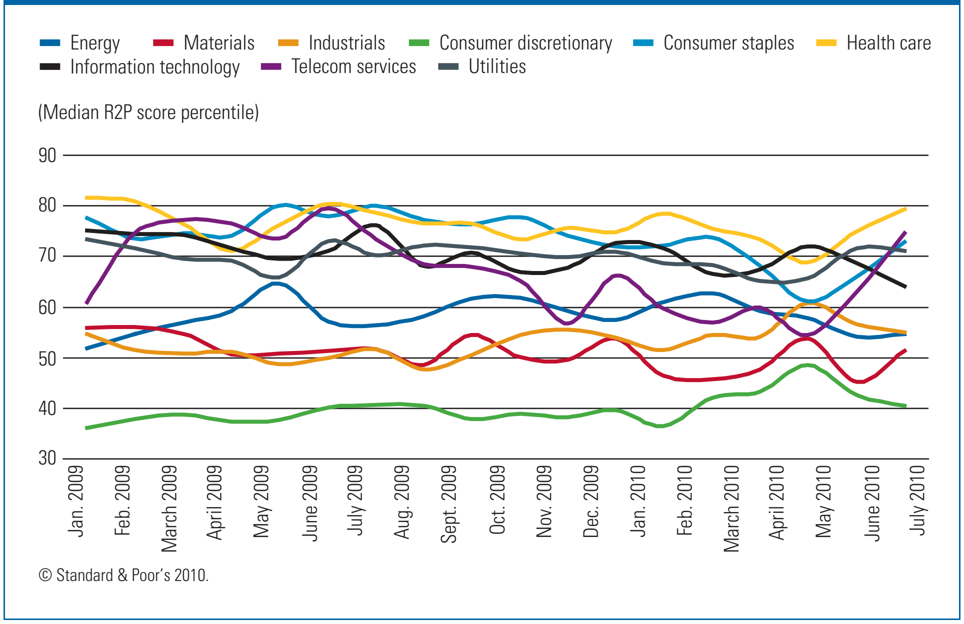


Chart 2

R2P Median Percentiles By Sector

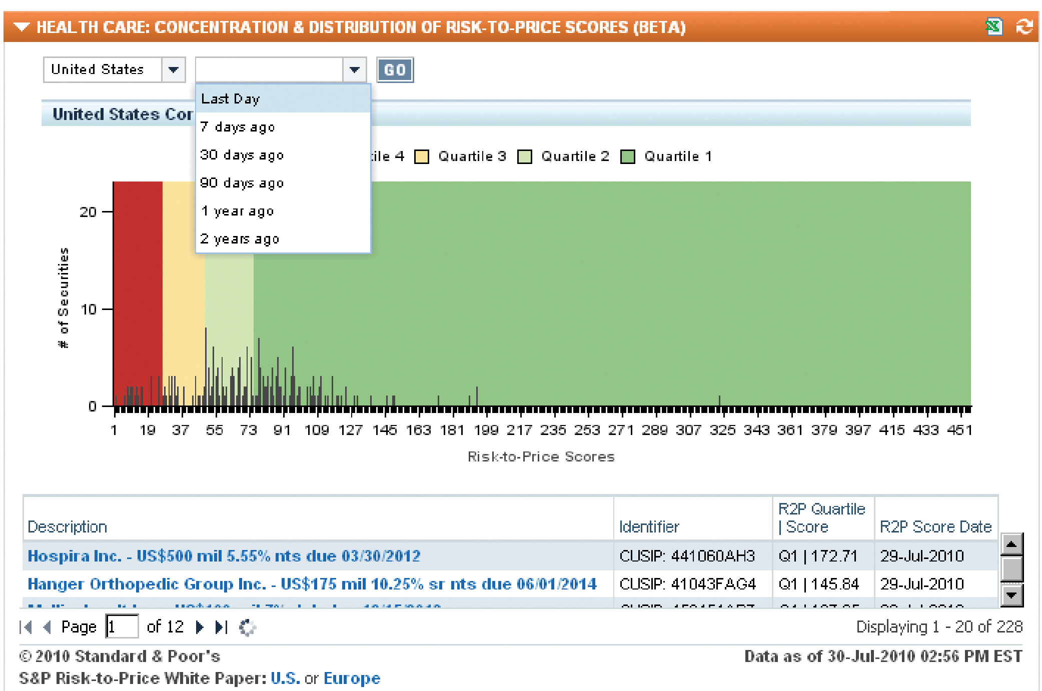


Getting At The Data

Using R2P data on Standard & Poor's Global Credit Portal, we narrowed our focus to the distribution of R2P scores in health care—the sector with the highest overall scores of the past 18 months. A strong majority of securities in our query currently rank in the first or second R2P quartiles, indicating an attractive risk-reward profile relative to the larger bond universe *(See figure 1)*. From there, we were able to compare the individual R2P inputs, as well as additional data, for sector securities.

Figure 1

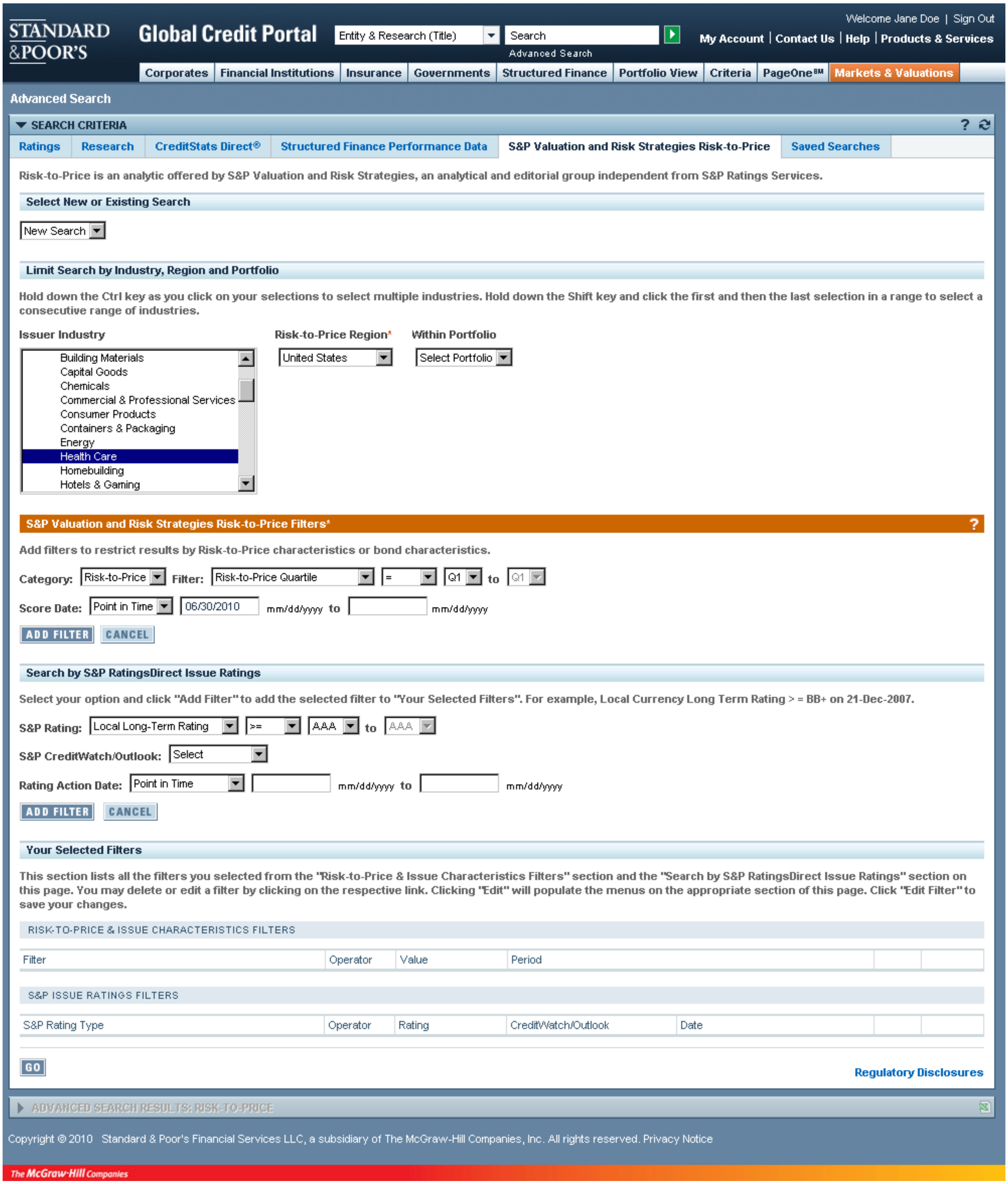
Distributions for the Health Care Sector on the Global Credit Portal



We then searched specifically for U.S. health care securities that ranked in the first quartile, those that offer the best rewards relative to their underlying risks, at the end of June 2010 *(see figure 2)*.

Figure 2

The Screening Tool on the Global Credit Portal



Digging Deeper

In terms of how bonds in the U.S. R2P universe stack up, on average, the health care sector has been a solid leader. The consumer discretionary sector, meanwhile, is a clear laggard. This provides a general first-pass screen of where investors may be getting better yield for the associated market and credit risks of their holdings. To get further detail, we could dig deeper, by extracting the bonds in a particular sector and ranking them by R2P score or the individual R2P components such as PD to get a combined market and credit view of risk and determine which individual securities may offer the best opportunities.

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