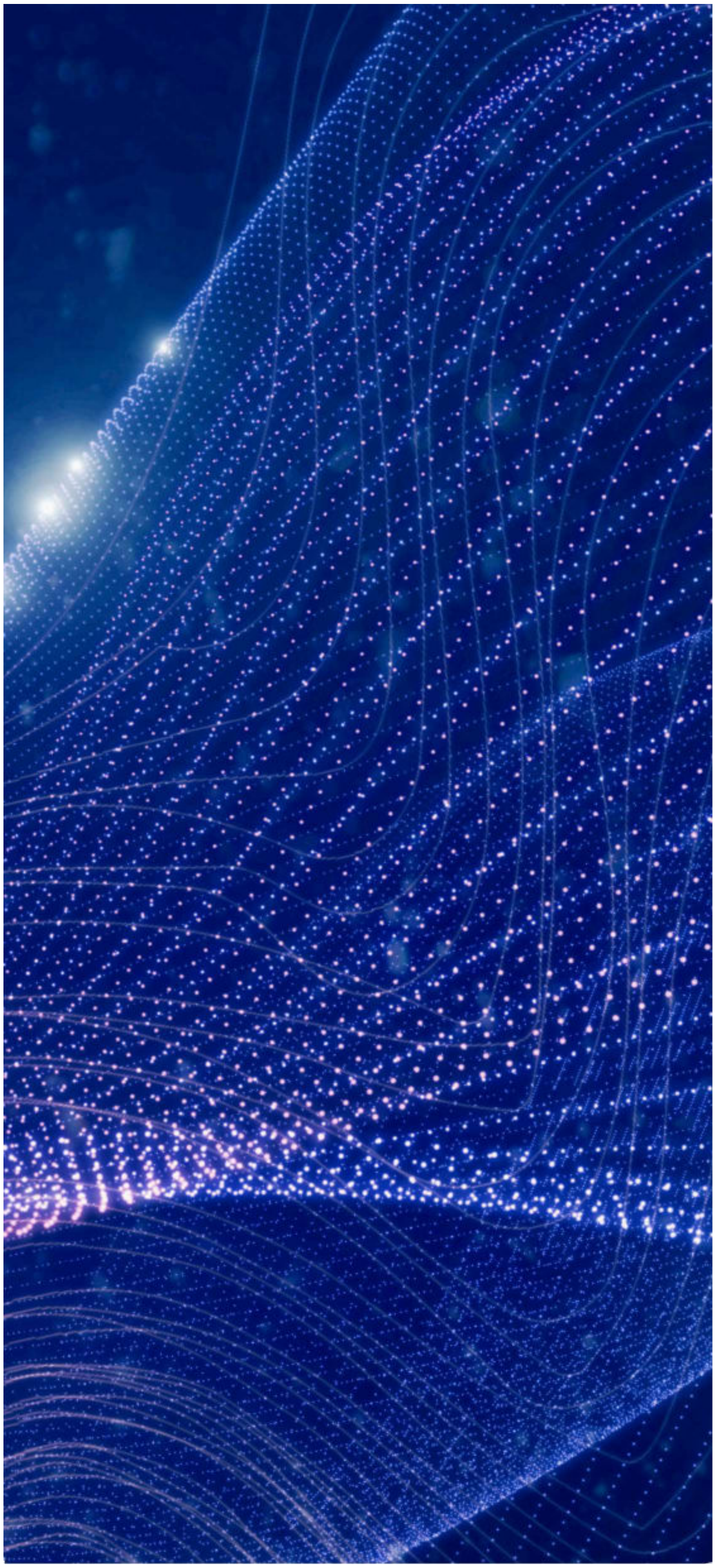
Strategic value of BBB-rated bonds in investment-grade portfolios

Ed Goard, Jim Kelts, and Sam Gilbert of Yousif Capital Management explain how integrating BBB-rated bonds into captive insurance portfolios can deliver resilient returns, enhance diversification, and boost yield without materially increasing default risk



Excluding BBB-rated bonds is a common strategy for managing risk within captive insurance portfolios, primarily driven by concerns over credit risk and potential downgrades to high-yield status. However, a deeper analysis reveals that BBB-rated bonds — while representing the lower tier of the investment-grade spectrum — exhibit a risk profile more akin to their higher-rated peers than to speculative-grade debt.

Historically, BBB-rated bonds have delivered attractive risk-adjusted returns and demonstrated resilience across varying market conditions.

Their inclusion in captive insurance portfolios therefore offers a valuable opportunity to broaden the investable universe, enhance yields and improve portfolio flexibility — without materially increasing default risk. For captive insurers that have traditionally excluded (or limited) exposure to this segment, an allocation to BBB-rated bonds can strengthen diversification, boost return potential and remain aligned with risk management objectives.

Low default risk

Credit ratings are issued by major credit rating agencies such as Moody's, S&P and Fitch to assess the creditworthiness of fixed-income issuers and their securities. These ratings range from investment grade to speculative grade, depending on the issuer's perceived ability to meet financial commitments and their exposure to economic conditions.

Investment grade bonds — rated 'AAA', 'AA', 'A' and 'BBB' — generally reflect a strong capacity to meet financial obligations and are traditionally associated with lower levels of risk. BBB-rated bonds represent the lowest tier within the investment grade category, positioned just above speculative grade (or high-yield) bonds. While frequently perceived as riskier than their higher-rated peers, historical evidence challenges this assumption: BBB-rated bonds have exhibited relatively low default rates and delivered attractive risk-adjusted returns over time.

Credit Rating Scale

Investment Grade	AAA
	AA
	A
	BBB
Speculative Grade (High Yield)	BB
	B
	CCC
	DD
	C
	D

When assessing bonds' perceived risk, historical default rates are a key indicator. As expected, default rates across the investment-grade spectrum have remained consistently low over time.

More revealing, however, is how narrow the gap is between BBB-rated issuers and their higher-rated peers: the long-term average one-year global default rate for BBB-rated corporates is just 0.14 per cent, compared with 0.05 per cent for A-rated issuers and 0.02 per cent for AA-rated issuers — each figure well below one quarter of one per cent, underscoring the stability and reliability of investment-grade debt.

In addition to low annual default probabilities, the average time to default for bonds initially rated BBB is 9.6 years, providing investors and managers with ample runway to monitor credit developments, adjust exposures, and manage risk proactively, thereby reducing the likelihood of sudden losses.

Expanded investable universe

Excluding BBB-rated bonds from a captive investment portfolio significantly narrows the opportunity set within the investment-grade universe.

As at year end 2024, BBB-rated bonds represent just under 50 per cent of the total market value of the investment-grade corporate bond index, a share that has steadily grown over the past two decades.

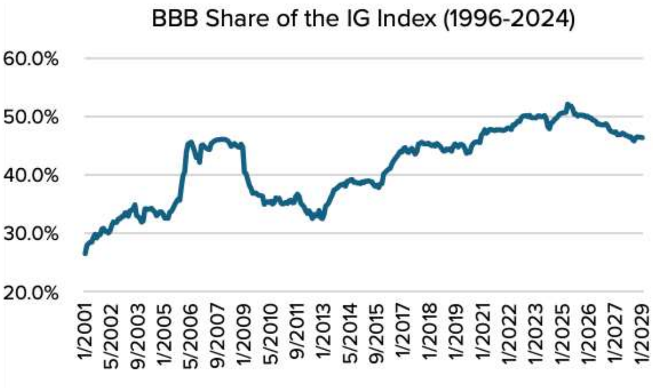
Beyond their sheer market value, BBB-rated securities also account for most individual issuers in the investment-grade space. Omitting this segment not only limits yield potential but also constrains sector exposure and issuer selection, hindering the construction of resilient, dynamic portfolios.

In contrast, the considered inclusion of BBB-rated bonds broadens the investable universe and enables more robust portfolio design without materially increasing risk.

Default Rates (%)

	AAA	AA	A	BBB	BB	B	CCC/C
Latest four quarters	0.00%	0.00%	0.00%	0.11%	0.17%	1.24%	30.89%
Weighted long-term average	0.00%	0.02%	0.05%	0.14%	0.57%	2.98%	25.98%
2008 default rates	0.00%	0.38%	0.38%	0.49%	0.81%	4.09%	27.27%
Number of defaults	8	33	101	234	686	1885	462
Average time to default	18	17.2	14.4	9.6	7.2	5.1	2.1

Sources: S&P Global one-year global default rate for 1981-2023



Source: ICE Investment Grade Index, 1996-2024

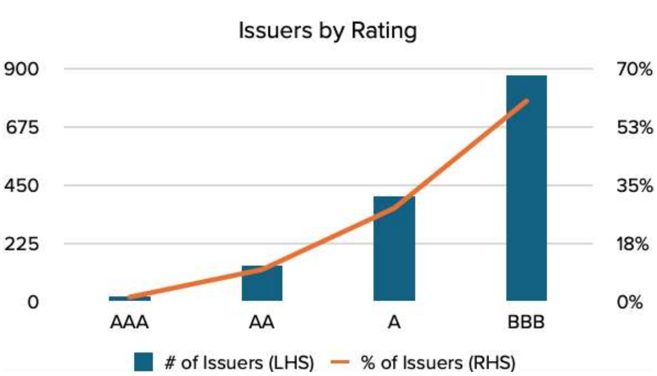
Incentives and issuer behavior within the BBB segment

While the proximity of BBB-rated bonds to high-yield status raises concerns for some investors, there are additional factors worth considering.

BBB-rated companies often adopt capital-allocation strategies specifically aimed at preserving their investment-grade status, in contrast to 'AA'- and A-rated companies, which can absorb a downgrade while remaining investment-grade.

Moreover, BBB-rated issuers have a stronger incentive to pursue credit upgrades to reduce borrowing costs, unlike their higher-rated counterparts.

The size and depth of the investment-grade universe, particularly when compared to high-yield markets, further encourage issuers to maintain their ratings, thereby reducing funding costs and enhancing capital flexibility.



Source: ICE Investment Grade Index as of 12/31/2024

While downgrades have outpaced upgrades over the past 40 years, BBB-rated corporate bonds have an average downgrade rate of 4.26 per cent, the lowest among all rating categories, and are the only segment of the fixed-income universe in which upgrades have been almost as likely as downgrades over that period.

Average one-year corporate transition rates, 1981-2023

Rating	% Upgraded	% Downgraded	Downgrade/ Upgrade Ratio
AAA	-	9.39%	-
AA	0.48%	7.96%	16.58
A	1.59%	5.67%	3.57
BBB	3.34%	4.26%	1.28
BB	4.83%	8.66%	1.79
B	4.43%	8.17%	1.84
CCC/C	13.43%	27.83%	2.07

Sources: S&P Global, 1981-2023

Downgrades can occur, but we believe a robust credit research process can help investors to identify and avoid potential downgrade risks.

This approach enables investors to capture the return potential of BBB-rated bonds while mitigating downside risk.

Attractive risk-return profile

In addition to low default rates, attractive upgrade prospects and increased flexibility, we believe BBB-rated bonds offer compelling risk-adjusted return potential.

Historically, they have outperformed higher-rated investment-grade bonds on a risk-adjusted basis, delivering superior excess returns while maintaining relatively low levels of volatility.

Investors prepared to accept slightly greater volatility in exchange for enhanced returns have often found BBB-rated bonds to be an effective means of improving portfolio performance.

The additional yield offered by BBB-rated securities has more than compensated for their incremental risk, as evidenced by higher Sharpe ratios and improved capital efficiency over time.

Return statistics by credit rating (2004-2024)

	AAA	AA	A	BBB
Avg 12-month excess return	0.33%	0.69%	0.82%	1.74%
Standard deviation	3.38%	4.14%	5.99%	7.66%
Sharpe Ratio	0.10	0.17	0.14	0.23
Worst 12 months	-14.39%	-15.94%	-24.55%	-24.93%
Worst date	10/31/2008	10/31/2008	10/31/2008	11/28/2008
% of Negative periods	35.00%	30.83%	35.00%	37.50%

Source: Bloomberg, 12/31/2004-12/31/2024

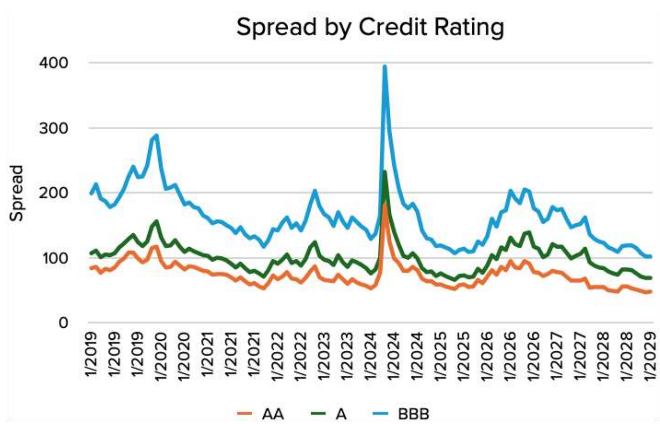
Including BBB-rated bonds — still within the investment-grade spectrum — can support this goal by boosting returns without unduly increasing overall portfolio risk.

BBB-rated bonds typically offer a wider spread — the difference between the yield on a corporate bond and that of an equivalent US Treasury bond — than A-rated or higher-rated issues.

This spread represents a risk premium, compensating investors for holding securities that carry greater risk relative to a 'risk-free' asset, usually US Treasuries.

Our analysis indicates that BBB-rated bonds do not exhibit materially higher risk than A-rated bonds, making the extra spread particularly attractive.

BBB-rated bonds can form part of a long-term allocation to enhance portfolio returns, while also being deployed tactically to adjust risk — guided by fundamental credit analysis and relative-value considerations — to capitalise on market dislocations and opportunities within the investment-grade universe.



Source: ICE Investment Grade Index of as 12/31/2024

Portfolio flexibility

When analysing BBB-rated bonds, investors must determine whether the additional yield adequately compensates for the incremental risk assumed.

Capital in a captive investment portfolio is finite and should be allocated efficiently to maximise return potential within defined risk parameters.

The final piece

BBB-rated bonds are a valuable addition to a captive insurance portfolio, offering an attractive return profile, relatively low default risk, an expanded investable universe and the potential to enhance portfolio flexibility.

Despite sitting at the lower end of the investment-grade spectrum, investors are duly compensated for the incremental increase in risk.

Historical data supports the case for BBB-rated bonds as a critical component of a well-diversified portfolio, demonstrating a favourable balance of risk and return.

To maximise the potential of BBB-rated bonds, a disciplined and robust investment approach is essential.

Captive managers seeking exposure to this segment should appoint an investment manager with deep expertise and a rigorous process to navigate its complexities.

A credit-selection model that incorporates fundamental analysis, default probability and valuations, uncovering undervalued opportunities while mitigating potential risks such as ratings downgrades, is paramount.

The objective is a disciplined process that delivers targeted exposure to the BBB-rated segment, optimising the balance between risk and reward. ■

Yousif Capital Management, LLC is an SEC registered investment adviser based in Bloomfield Hills, MI. A more detailed description of YCM, its management team and practices can be found in the firm's brochure, Form ADV Part 2A which can be found on our website www.yousifcapital.com or at https://adviserinfo.sec.gov.

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