The Effect of Credit Rating Changes on Asset Prices

Master Thesis

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Executive Summary

The price reaction of common stocks of publicly traded companies to Standard and Poor's credit rating changes is investigated during 2003 to 2012. A unique feature of this thesis is the use of different perspectives in studied analyses. Previous studies have difficulties to find reliable abnormal return following upgrades while downgrades produce statistically significant abnormal returns. I presume that the absence of reliable effects following upgrades is due to the perspective used by previous studies. They analyze the effect of downgrades and upgrades at a country level without taking into consideration different characteristics of companies. Therefore, I introduce different perspectives such as an analysis of rating changes by observing the impact of downgrades and upgrades on different rating categories, "small caps", "large caps", value and growth firms, cheap and expensive stocks and finally different sectors. These diverse angles have been studied thanks to my comprehensive sample size of 3'733 non-contaminated observations from 1'780 firms domiciled in the Euro-zone countries or in the USA.

As expected, the thesis presents reliable abnormal returns following upgrades. Concerning the Euro-zone market, this is thanks to the analyses of the effect of credit rating changes on different rating categories. In fact, there is statistically significant cumulative abnormal return following upgrades from non-investment to investment grades. Regarding the US market, there are consistencies in findings for most of analyses following upgrades. In search for explanations, I find a link between stronger reactions of rating changes with the period after the introduction of Regulation Fair Disclosure (Reg FD) in 2000. As documented by Jorion, Liu and Shi (2005), post-FD period (2000 – 2002) leads to significant impacts on stock prices compared with the period pre-FD (1998 – 2000). Therefore, the thesis also contributes to confirm findings of this study with a larger period of observation.

An interesting pattern that emerges from this thesis and other studies is the heterogeneity across firms in the effect of rating change announcements. My empirical findings suggest that companies with diverse characteristics produce different effects. Expectations regarding different behaviors are verified with more pronounced impact of downgrades on "large caps" compared to upgrades where the impact on "small caps" is the inverse. This observation holds for both the Euro-zone and the US markets. Additionally, only for the US market, value firms indicate higher abnormal returns following upgrades where growth firms are more affected by downgrades. Furthermore, expensive stocks in the US market are more impacted by rating changes compared to cheap stocks. Finally, diverse sectors, from the Euro-zone countries and the USA, behave differently to rating changes and interestingly, statistically significant results are produced by same sectors in the Euro-zone and the US markets.

Moreover, the thesis provides an investment strategy based on the observation of credit rating changes with different buy-and-hold periods. By entering the market the day after the rating change, investors that are unable to predict rating changes could realize consistent returns. The maximum is indicated following upgrades on value firms in the US market with a reliable cumulative abnormal return of 5.84% on average with a holding period of twenty days.