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# Effect of Being a Fallen Angel on Bond Ratings and Yields

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## Abstract

This article investigates whether bond ratings serve as a basis for market prices of bonds. Unlike most previous work, which focused on rating changes, the author uses a new sample to consider bond ratings at issue. The author compares the yield spread of general high-yield bonds and high-yield bonds issued by fallen angels (firms that no longer carry an investment-grade rating). If investors totally depend on ratings, equally rated bonds should have the same yield spreads. This study finds, however, that bonds of identical ratings have different yield spreads. Specifically, for the BB/Ba rating

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category, yields of high-yield bonds issued by fallen angels are higher than the yields of similarly rated bonds issued by firms that have a speculative rate from the beginning. These findings suggest that bond ratings do not perfectly capture information related to bond characteristics in general. Results also suggest that rating agencies are too optimistic when rating high-yield bonds issued by fallen angels.

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