



## FIXED INCOME

---

### Asset Reliability and Security Prices Evidence From Credit Markets

March 3, 2014

This paper explores the relation between the reliability of an enterprise's accounting and its security prices. We focus on how inaccurate accounting can affect a firm's credit spreads, for several reasons. For one thing, each company can have multiple debt instruments of different terms trading in the markets; this permits sharper tests to determine where the effect of reliability is greatest. Second, using multiple instruments for a single company reduces the influence of potentially correlated omitted variables (e.g., earnings expectations), since they are likely to be common across these instruments.

Our work follows a seminal paper by Duffie and Lando (2001) that presented a theoretical model in which a hypothetical firm is owned by equity holders who were fully informed about its assets. However, the firm's creditors received only incomplete information through periodic accounting statements.

In this model, the precision — or lack thereof — of accounting information is an additional source of credit risk, and is most relevant for short-term credit spreads. (Over the longer term, the uncertainty around the evolution of asset value will dominate the lack of precision in information available to creditors. Thus the effect of noise in accounting information will decrease with horizon of debt.)

For two companies with different precision of accounting information, but which are otherwise identical, the credit spread term structures will be farther apart at the short end than at the long end. The firm with noisier accounting information will have proportionately higher default risk in the short run, at least as perceived by its creditors.

This document is not intended to, and does not relate specifically to any investment strategy or product that AQR offers. It is being provided merely to provide a framework to assist in the implementation of an investor's own analysis and an investor's own view on the topic discussed herein.

This document has been provided to you solely for information purposes and does not constitute an offer or solicitation of an offer or any advice or recommendation to purchase any securities or other financial instruments and may not be construed as such. The factual information set forth herein has been obtained or derived from sources believed by the author and AQR Capital Management, LLC ("AQR") to be reliable but it is not necessarily all-inclusive and is not guaranteed as to its accuracy and is not to be regarded as a representation or warranty, express or implied, as to the information's accuracy or completeness, nor should the attached information serve as the basis of any investment decision. This document is not to be reproduced or redistributed to any other person. The information set forth herein has been provided to you as secondary information and should not be the primary source for any investment or allocation decision. Past performance is not a guarantee of future performance. Diversification does not eliminate the risk of experiencing investment losses.

This material is not research and should not be treated as research. This paper does not represent valuation judgments with respect to any financial instrument, issuer, security or sector that may be described or referenced herein and does not represent a formal or official view of AQR. The views expressed reflect the current views as of the date hereof and neither the author nor AQR undertakes to advise you of any changes in the views expressed herein.

The information contained herein is only as current as of the date indicated, and may be superseded by subsequent market events or for other reasons. Charts and graphs provided herein are for illustrative purposes only. The information in this presentation has been developed internally and/or obtained from sources believed to be reliable; however, neither AQR nor the author guarantees the accuracy, adequacy or completeness of such information. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to

be relied on in making an investment or other decision. There can be no assurance that an investment strategy will be successful. Historic market trends are not reliable indicators of actual future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. Diversification does not eliminate the risk of experiencing investment losses.

The information in this paper may contain projections or other forward-looking statements regarding future events, targets, forecasts or expectations regarding the strategies described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this document, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons.