Title: **THE MYTH OF THE CREDIT SPREAD PUZZLE**

Speaker: **STEPHEN SCHAEFER**
London Business School

Importance: Why this matters:

The credit spread puzzle is that many studies using Merton-type structural models of credit spreads find spreads that are lower than actual spreads, particularly for investment grade bonds. By using a longer history they are able to resolve the puzzle. They find the model is able to capture the level and the time series variation of investment grade credit spreads.

Investigation: "Speaker analyzed XXX data to address the questions yyy, zzz, etc."

They calibrated their structural model using default rates from the 1970 to 2001 and the 1920 to 2001 period. By calibrating the model to higher default rate observed over the longer period (e.g. post 1920 rather than post 1970), the model spreads are generally in line with observed spreads.
Repeating the analysis using individual bonds, they find the model fits empirical data reasonably well for investment grade bonds of medium to long maturity. The model does not fit shorter time or speculative grade bonds very well.

Innovation: Are there new techniques of interest in the data or approach to the problem?

The authors used simulations to estimate default rates, and demonstrated that the distribution is likely to be highly skewed. As a result, any single draw is more likely to closer to the mode than the mean, producing a downward bias estimate of the underlying default rate.

Insights: 1-2-3, what are the three most important things the speaker offered?

1. Do not calibrate Merton Models to observed default rates over a shorter period. One needs to use post 1920 data to produce model spreads that are in line with observed. Observed defaults are just one draw from a larger distribution.
2. Default probabilities may be higher than we think.
3. The model also is able to fit the time series of spreads.
4. The model underpredicts spreads for high yield bonds. Probably due to not incorporating a premium for illiquidity.

Audience rating: 3.67