



**LET'S TALK ABOUT...**

FINANCIAL LEXICON EDITED BY THE SWISS ASSOCIATION OF ASSET MANAGERS

## Rating

(Part One) Rating agencies, that we already discussed in the previous basic series of our Financial Lexicon, specialize in assessing financial strength and reliability of governmental and corporate issuers, so evaluating their capacity in complying with financial commitments. The scale of their judgements spreads from top ratings, down to average ones until the threshold of the so called "investment grade" (which is pretty relevant for portfolio management, as we will discuss further down), until negative ratings which find their bottom in the default grade, that is current or perspective insolvency, being the faulted payments of periodical interests and/or principals at duly expirations). Rating agencies act through upgrades and downgrades moves, outlook statements about a certain issuers and also putting them in or our "watching lists", should the issuers be facing some sort of financial problems. For portfolio managers and investors such ratings are just a tool to be used together with others, such as the analysts' views and the levels of the CDS (Credit Default Swaps), the latter being the premiums to be paid in order to insure the duly payments at expirations by a certain bond issuer. All these topics are part of current financial news and also fuel polemics. Rating agencies are particularly blamed, on one side for having been unable to forecast the degrading financial fundamentals of many troubled institutions, just judging them after the critical outcomes had already revealed themselves; on the other hand their downgrading and negative judgements strongly could have contributed in exacerbating and dramatizing already turbulent market conditions, so further fuelling volatility and speculative pressures. We are not going to take part in the quarrel. However suffice it to say that politicians and administrators often look for scapegoats when debating problems that neither rating agencies nor institutional investors or speculators have created themselves, just rather having taken note of them and adapting their actions and strategies accordingly. However it is all the same undoubted that for some rating and analyzing institutions, relations with their "targets" may be particularly diversified and complex, so to make their judgements and comments less objective, timely and transparent than they should be expected to be. But we are now more interested in the rating issues themselves and their outcomes for portfolio management, as carried on by different actors, including the independent asset managers, whose activities are marked by some specific features in this area too. *(to be continued) - GLT*

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(Part Two) The issuers' ratings are important factors in setting and managing fixed income portfolios, despite the many uncertainties, delays and contradictions which have marked the agencies' outcomes, so to even fuel controversial comments and quarrels. It is worth noting that some kinds of investors, e.g. pension funds, insurance companies, fiduciary trusts and similar institutions, often are not allowed to hold less than "investment rate" graded instruments, in terms of such agencies' assessments.

Should a certain issuer's downgrading take place, it may then happen that the manager has to sell the related held securities not just for a strategy choice, but because he is so obliged by the institution's rules. That is the reason why during some critical market phases, an issuer's downgrading beyond the investment grade level often fuels selling flows which add up with the ones already created by uncertainties and default worries. That was the recent case for Greek and other European sovereign bonds. However the "rating factor" is not equally important for all kinds of managers. In very general terms it looks some more relevant for major managers, like banks, mutual funds, pension institutions and so on, where the models employed in selecting the portfolios' components attach more importance to rating scales and segmentations. For other managers, often smaller ones in terms of size but all the same structured and benefiting from great competences and experiences, as is the case for the Swiss independent portfolio managers, factual features, direct knowledge, historical evaluations and outlooks, together with some feelings and old good sense may be often more relevant than rating itself. Not to say that such independent managers also enjoy a full unconstraintness in evaluating and selecting the investment instruments for their clients, pretty away from the conflicts of interests and biases that may affect the issues of big institutions, including rating agencies too. *(to be continued) - GLT*

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(Part Three) The practical consequences of a downgrading, that are an issuer's assessment of its lower financial reliability, as stated by specializing agencies, despite the many related problems and even polemics, are not at all negligible. Not only because stepping down beyond the "investment grade" obliges many conservative institutions, such as pension funds, insurance companies, and so on, to put the involved securities out of their portfolios, but also as, in more general terms, such downgraded issuers will have to borrow from the capital markets at higher costs, so paying higher risk premiums to investors. Their spreads with (theoretically) no-risk issuers becomes them wider and wider. The matter may be particular sensitive when the downgrading involves a government, which could be already faced with pressing financial problems, so making its charges even heavier, opening the way towards prospective debt restructurings or even defaults. Such situations are also reflected in higher CDS levels for those issuers, that is the premiums investors have to pay so to insure the regular repayment of debt principal at expiration. The problem of a sovereign debt's downgrading and related skyrocketing CDS level has fuelled debates, as the question may arise about the institution/s which could actually repay the debt in place of a defaulted state. It is a good question indeed, which has taken many to doubt about the real validity of such tools when applied to public issuers. And what can we say of those unrated companies, many of which Swiss ones, often big and glamorous, which are not interested in asking for an assessment of their financial conditions by specializing agencies? One may think that they act that way because, having troubled conditions, they do not want to have them publicly disclosed, but that may be very far from true. On the contrary unrated companies, according to standardized patterns, often enjoy very good financial conditions and do not just see an official rating "declaration" as necessary for their businesses, also because they know to be able to easily borrow from the capital market and informed investors. These companies may also think that rating process is too ritual and standardised, or not so transparent and valid if applied to their conditions. Whatever their motivation for going unrated, that is not a negative mark, but it may often prove just as the contrary. Moreover, such unrated issuers may be particularly interesting for those managers who are less constrained by rigid and highly structured models, as is the case for big banks and other major institutions, which may also see conflict of interests within such models. For independent portfolio managers, who are fully free in their strategies of allocation and management, rating may be not always be seen as a mark of quality and reliability, so becoming less relevant in selecting instruments for their clients' portfolios. *(end) - GLT*

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