



The Pakistan Credit Rating Agency Limited

# Fund Stability Rating

A current opinion on the prospective relative stability in a fund's return, the rating provides an objective measure as to the main areas of risk to which the income funds are exposed, that is credit risk, liquidity risk and interest rate risk.

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**1. INTRODUCTION**

- Evolving Nature of Industry
- PACRA’s Products
- Stability Rating – A yardstick for measuring capacity to maintain stability in returns

**1.1** Mutual fund is an effective tool for mobilizing resources from a large pool of investors, and in turn, providing them access to a variety of assets, which might otherwise be difficult. Pakistan’s asset management industry, which is still in initial development phase, has witnessed notable evolution in overall structure during the years. The asset management companies (AMCs) have, intermittently, introduced a variety of products in line with varying risk-return preferences of investors. Equity funds have remained mainstay of the industry for long. However, lately, income funds (including money market and aggressive income funds) have gained an increasing attention of investors. With the advent of commercial banks in the asset management industry through their subsidiaries, the asset management industry has gained significant momentum. These companies, with established franchise and financial backing of the parent, are helping in expanding the outreach of industry in the retail segment. Their share in the overall growth of the industry has risen sharply, and currently, bank backed AMCs constitute around half of the total assets under management of the industry.

**1.2** Recognizing the rising competition and growth potential in this segment, the asset managers, while offering a variety of funds, are using varying investment styles and techniques to offer competitive returns. All these developments have necessitated the need for an independent opinion as to the risk exposure of these funds, which, in turn, has an impact on stability in future returns.

**1.3** The asset management business has two distinct elements – 1) the asset manager, 2) the mutual funds. PACRA has developed different products to capture distinct components of the industry. Asset Manager Rating is an opinion on the quality of fund management, capability to manage risks inherent in asset management business and effectiveness of an AMC’s systems and processes. PACRA offers three products to capture varied factors of different types of mutual funds. The performance ranking (also referred as Star Ranking) is purely a quantitative measure, comparing historical returns of a fund relative to other funds in the same category of classification. Capital protection rating is a view as to the relative strength of a particular fund to offer protection of invested amount.

**1.4** The Fund Stability Rating is the latest addition to PACRA’s rating spectrum. It provides investors with an objective measure as to the main areas of risk to which the income funds are exposed, that is credit risk, liquidity risk and interest rate risk. The stability rating could provide investors with a useful yardstick in comparing their individual risk-return matrix, while making investment decisions. Lately, fund stability rating has been made the mandatory rating for all income and money market funds by Securities and Exchange Commission of Pakistan (SECP).

**2. PROCESS OVERVIEW**

- Current Opinion on Prospective Stability in Returns
- Considers a Mix of Qualitative and

**2.1 THE RATING PROCESS:** PACRA’s mutual fund stability rating is a current opinion on the prospective relative stability in a fund’s return. The rating is designed to provide investors with a simple to use indicator for evaluating the sensitivity of a fund’s NAV to changing market conditions. The rating categories range from AAA(f) (fund having an exceptionally strong capacity to maintain relative stability in returns and possesses negligible exposure to risks, including credit, market, and/or liquidity risks) to BB(f) (fund having a low capacity to

**Quantitative Measures**

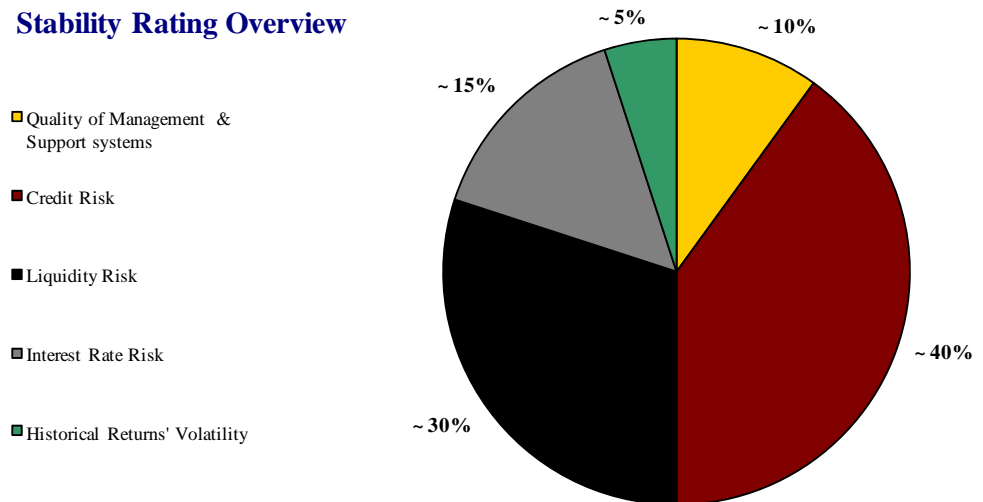
maintain stability in returns and possesses high exposure to risks). The (f) distinguishes the Fund’s stability ratings from PACRA’s other ratings.

**2.2** There is no requirement of any minimum operational history of the fund to be eligible for the rating. Thus, a fund proposed to be launched in the near future could also be assigned a rating, based on assessment of the quality of the fund management team, the types and extent of risks to emanate by the implementation of the proposed investments policies and strategies, and effectiveness of the controls and risk management systems. However, the absence of proper track record could lead to some discount in the rating compared to a fund having sufficiently long operational history.

**2.3** The stability rating is based on detailed quantitative assessment of a fund’s portfolio and an in-depth qualitative assessment of fund management. The rating is current as to the date it is assigned, and any significant changes in fund’s portfolio or investment philosophy of the fund manager may lead to deviation from the assigned rating. PACRA will continuously monitor the rated funds, usually on quarterly basis, to ensure that the rating remains current and accurate. However, a detailed formal review of a rating will be carried out on annual basis.

**2.4** In forming an opinion on a fund’s price volatility and potential for loss, PACRA will consider a variety of factors aimed at establishing the quality of the fund management, and the fund’s exposure to credit, liquidity and interest rate risks (mentioned in the following diagram and discussed in detail below). These factors are assessed within the broad context of a fund’s investment objectives and policies to determine how they may affect the fund’s risk profile and relative price volatility under different market conditions.

**Stability Rating Overview**



**3. MANAGEMENT REVIEW**

- Asset Manager Rating
- Fund Management

**3.1** The ability of a fund to meet its investment objective and adherence to stated policies ultimately depends on the management’s experience and quality of support systems. Therefore, an assessment of the fund manager’s qualification and experience, and the asset management company’s capabilities and track record are an integral part to the fund rating process. The assessment of management quality may also provide a basis of how the fund might respond to future opportunities or

- Investment Process
- Risk Management Systems

stress situations under different market conditions.

**3.2** During the evaluation process, PACRA will review the policies and procedures developed by the management to meet its investment objectives, and will assess the efficacy of the investment management process, the supporting organizational structure, internal controls, risk management, and reporting systems. The asset manager rating of the fund management company will provide a useful reference point in forming an opinion as to the quality of the management. A detailed description of the key factors that contribute to an assessment of the fund management qualities is reflected in our methodology for rating asset managers.

**3.3** To determine fund's level of risk tolerance and confirming harmony in fund's stated objectives and fund manager's investment philosophy in future course of action, discussions with the fund manager regarding the prospective asset mix and investment strategy will be vital during the rating process. At the same time, investment management experience of the fund manager and his/her association with the AMC will also be considered as a part of overall process in forming an opinion.

#### 4. CREDIT RISK

- Credit Quality of Assets
- Individual Concentration
- Sectoral Concentration

**4.1** The assessment of a fund's credit risk aims at forming an opinion as to the fund's overall exposure to risk. The opinion is based on review of various factors, including the fund's investment policies regarding credit risk exposure, credit quality of the investment portfolio and counterparties, the diversification of assets across investment types and issuers, and the management's overall credit risk management process.

**4.2** The fund's investment policies, as to exposure to specific segments and securities, approved list of counter parties, rating limitations to be considered while making investment decisions are analyzed to form a broad assessment of the probable risk inherent in the investment portfolio. Rating of the securities and the counterparties, where available, will be used to form an objective opinion as to credit quality. For securities or investment segments, where ratings are not available, PACRA will form its own opinion as to the credit risk involved, and will also look at the fund management's assessment of the credit risk considered at the time of making the investment decision. The overall opinion as to the credit quality of the underlying portfolio will be based on the weighted average rating of individual securities in the portfolio, and PACRA's assessment of the underlying risk where ratings are not available.

**4.3** Meanwhile, the overall concentration risk in the portfolio is established by analyzing the diversification across investment types and issuers. Well-managed funds would have clearly articulated and documented policies and procedures to ensure compliance with its stated portfolio diversification objective. High rated funds would have a diversified portfolio, minimizing exposure to any single issuer, security or market segment. The historical data, where available, regarding asset composition will also be reviewed to determine the credit risk appetite of the management, and adherence to its stated policies.

**4.4** The review of credit risk management process is an important element in overall assessment of the credit risk of the fund. This involves review of the in-house credit and research analysis, security evaluation process, and ongoing surveillance procedures. The investment proposals and minutes of the Investment Committee meetings will also be reviewed to examine the depth and quality of

analysis, and consistency of approach to understand the manager's credit risk tolerance.

## 5. MARKET RISK

- Liquidity Risk
- Unit Holding Concentration
- Sectoral Concentration
- Fund Size
- Interest Rate Risk

**5.1** By far the more complex part of evaluating a fund's stability is judging a fund's sensitivity to changing market conditions. The review of the fund's policies and management's investment strategies provides a useful insight into the potential volatility in the returns of the portfolio. The fund's historical performance, where available, is an important ingredient when used as part of the overall analysis of a fund's quality and volatility. However, it is important to stress that the past management behavior may not always reflect current or future management styles. Hence, the fund manager's view about the prospective composition of the fund is critical when forming an opinion on the stability of fund's returns.

**5.2** The key factors to be considered while analyzing the fund's market risk exposure are the liquidity risk, the portfolio diversification, fund size, unit holders' concentration and interest rate risk. Given the difference in investment philosophy and operating characteristics of income and money market funds, the relative degree of emphasis on these factors may vary for different categories of funds.

**5.2.1 Liquidity Risk:** Liquidity of a fund's portfolio is critical for maintaining a stable NAV. The liquidity of a security refers to the speed at which that security can be sold for approximately the price at which the fund has it valued or priced. Securities which are less liquid are subject to greater price variability, and can significantly impact the NAVs at times of major redemptions. More liquid investments present lower risk, as these are more amenable to accurate pricing on a daily basis and support the fund's ability to correctly measure NAV. While analyzing the liquidity of investment portfolio, we consider the types of investments in the portfolio, the maturity structure, and secondary market liquidity.

**5.2.2** The counterpart to managing the liquidity of investments is the necessity to accurately monitor and anticipate subscription/redemption activity. Unexpected large redemptions have a direct influence on the fund's market risk exposure, as they could lead to liquidation of investments at below their fair value to meet redemption requests. Redemption volatility also adds to the complexity in managing a fund, as the uncertainty created by the instant liquidity requirements can make it difficult to employ a consistent investment strategy. Therefore, PACRA carefully reviews the characteristics of each fund's unit holders base, including the proportion of top investors in total net assets of the fund. However, comfort can be drawn from sponsor's sizeable holding in the unit holding structure. We also examine the effectiveness of the management's policies and procedures for tracking and anticipating major redemption activity. This may include constant communication with the fund's largest investors to get an early indication of redemptions.

**5.2.3** The diversified portfolio of assets can better protect a fund from changing market conditions than a fund that is not well diversified. Portfolios are subject to additional risk when they are highly concentrated in a specific currency, industry, or security type. For example, concentrations in securities of a specific industry may expose a fund to industry risks that could deviate significantly from general market trends. In a similar manner, significant concentration in specific security types may expose a fund to greater market price risk because of interest rate

movements or other market conditions. The size of fund is also critical when assessing the degree of variability in NAV in the event of default of a counterparty or non-performance of an instrument. Generally, an equal sized infection in portfolio will have greater effect on a smaller fund's NAV than its larger counterpart.

**5.2.4 Interest Rate Risk:** Movement in interest rates is the principal determinant of a fund's price and these represent one of the most important factors contributing to a fund's risk profile. The interest rate risk measures the funds sensitivity to shifts in the yield curve. Duration is a useful tool for quantifying an income fund's exposure to interest rate risk. It is defined as the rate of change of fund's NAV with respect to change in interest rates. In general, the longer the duration, the more susceptible the fund is to rising interest rates. The analysis of duration for gauging interest rate risk is more relevant in case of fixed rate instruments. As the majority of the corporate bonds issued in the country are based on floating interest rates, PACRA would also consider the terms of re-pricing while evaluating interest rate risk.

## **6. HISTORICAL RETURNS' VOLATILITY**

- Coefficient of Variation

**6.1** For funds having operational history of six-months or more, the variability in returns is gauged on standardized basis through coefficient of variation for each fund respectively. The coefficient of variation is calculated by dividing standard deviation of fund's monthly returns by average monthly return (SD of Monthly Returns/Average Monthly Return).

### **INFORMATION REQUIREMENT FOR FUND STABILITY RATING**

The following section illustrates the general set of information requirement for the fund stability rating process. Depending on the historical performance, operational characteristics, and investment policies and strategies, some additional information may also be sought for specific funds.

#### **MANAGEMENT'S REVIEW**

- Information pertaining to asset management company's sponsors, financial condition, track record, funds/assets under management, key employees, staffing, organizational structure, support systems including technology infrastructure, investment management process, research function, risk management, compliance and internal control systems.
- Fund manager's comprehensive profile and experience.

#### **THE FUND**

- The most recent prospectus/offering document, trust deed and marketing material.
- Copies of the quarterly financial statements (maximum for the latest 12 quarters).
- Record of daily NAVs.
- Fund specific investment policies, including policies concerning asset eligibility, selection, and evaluation process.

#### **CREDIT RISK**

- The fund's policies regarding credit risk exposure.
- Policies regarding repurchase agreements, and investment in any type of financing arrangements involving stock markets including CFS and futures market.
- Details of the credit evaluation systems.
- Institution wise break-up of the assets, where details are not specifically available in the quarterly financial statements
- Information pertaining to the Internal credit and research analysis, security evaluation process, and ongoing surveillance procedures.

#### **MARKET RISK**

- Latest maturity profile of assets.
- Weighted average maturity and duration of the portfolio on monthly basis.
- Explanation for any major deviation in the NAV during a given period.
- The fund's specific policies for liquidity management.
- Unit holder mix and proportion of holding by top 10 investors.
- Redemption history on a monthly basis (maximum for the latest 12 quarters), reflecting gross purchases and gross redemptions and policies for managing large redemption requests.

**RATING SYMBOLS & DEFINITIONS**

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**AAA(f)** An exceptionally strong capacity to maintain relative stability in returns and possesses negligible exposure to risks.

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**AA(f)** A very strong capacity to maintain relative stability in returns and possesses very low exposure to risks.

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**A(f)** A strong capacity to maintain relative stability in returns and possesses low exposure to risks. This capacity may, nevertheless, be more vulnerable to changes in circumstances or in economic conditions.

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**BBB(f)** An adequate capacity to maintain relative stability in returns and possesses high exposure to risks. This capacity may be impacted adversely by changes in circumstances or in economic conditions.

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**BB(f)** A low capacity to maintain stability in returns and possesses very high exposure to risks.

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**B(f)** A very low capacity to maintain stability in returns and possesses very high exposure to risks.

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**Notes:** A plus (+) or minus (-) may be appended to a rating to denote relative status within major rating categories except for AAA(f) and B(f) ratings.

**Disclaimer:**

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