FUND STABILITY

RATING METHODOLOGY

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 fixed-income funds are exposed, that is credit risk, liquidity risk and interest rate risk.

Contents

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PAKISTAN CREDIT RATING AGENCY

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1. INTRODUCTION

- 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 mutual fund industry has witnessed notable evolution in the overall structure. Asset management companies (AMCs) have introduced a variety of products in line with varying risk-return preferences of investors.

1.2 Recognizing the rising competition and growth potential in this industry, the asset managers 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 the funds' net asset value.

1.3 The asset management business has two distinct elements – 1) the asset manager, 2) the mutual funds. PACRA has developed separate methodologies 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, ability to generate sound fund performance and effectiveness of an AMC's systems and processes. PACRA offers three products to capture varied factors of different types of mutual funds, i) Star Ranking, ii) Stability Rating, and iii) Capital Protection Rating. The star ranking (also referred as performance 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 reflects the degree of protection offered on the original investment of the unit holders.

1.4 The Fund Stability Rating provides the 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.

1.5 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 the type and extent of risks to emanate by the implementation of the proposed investment policies. However, the absence of proper track record may lead to some prudence in the rating compared to a fund having sufficiently long operational history. A fund is eligible for fund stability ratings as soon as its mandate is finalized and offering document is approved by the Securities and Exchange Commission of Pakistan.

2. RATING PROCESS OVERVIEW

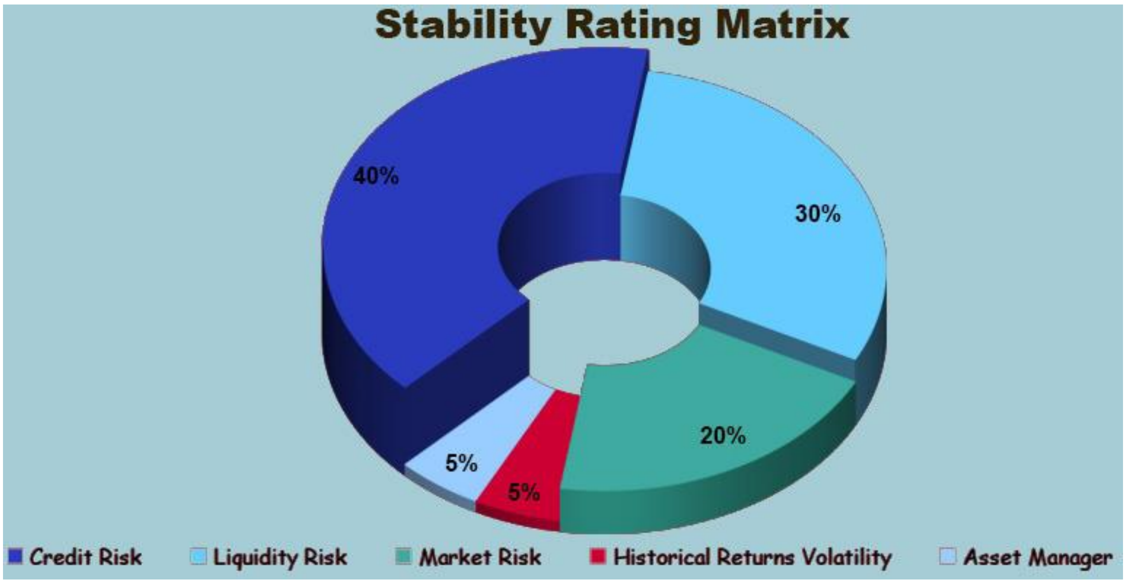
- Opinion on Prospective Stability of Returns
- Considers a mix of Quantitative and Qualitative Measures

2.1 PACRA's mutual fund stability rating is an 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 a combination of risks. 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*) to B(f) (*fund having a very low capacity to maintain stability in returns and possesses very high exposure to risks*). The suffix – (f) – distinguishes the Fund's stability ratings from PACRA's other ratings.

2.2 The stability rating is based on a detailed quantitative assessment of a fund's portfolio and 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.

2.3 In forming an opinion on a fund's price NAV volatility, PACRA will consider a variety of factors aimed at establishing the fund's exposure to credit, liquidity and interest rate risks and the quality of the fund management (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.

2.4 The foremost factor is credit risk, having the highest weight in the rating matrix. This is followed by market risk and liquidity risk. These three factors collectively have 90% of the weight. This means that the fund's stability rating would be directly governed by its policies on credit, market and liquidity risks.



3. CREDIT RISK

- Credit Quality of Assets
- Individual Concentration
- Weighted Average Maturity (WAM)
- Issuer Concentration
- Sectoral Concentration

3.1 Overall Risk Assessment: The assessment of a fund's credit risk aims at forming an opinion as to the fund's overall exposure to this risk. The opinion is based on review of various factors, including the fund's investment policies regarding credit risk exposure towards various market segments, individual and cumulative credit quality of the investment portfolio, and the diversification of assets across investment types and issuers, and weighted average maturity.

3.2 Market Segment: The fund's exposure to market segments is analyzed to estimate the risk inherent in the investment portfolio. PACRA believes that one market segment, despite belonging to the same operating environment, could have distinct independent characteristics from others due to the specific attributes of the players therein. The high rated funds will have pre dominant exposure to low risk segments (government securities, TFCs of commercial banks) and low proportion towards high risk avenues (corporate TFCs/Sukuks).

3.3 Weighted Average Credit Quality: 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. Moreover, whenever there would be a difference of opinion with reference to the assigned rating, the view of PACRA shall prevail. 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. Meanwhile, higher rating on issuers and obligations on the fund's holdings will generally mean that the probability of default and transition to lower rating is less-frequent than lower-rated issuers and obligations. Herein, both the individual rating and the weighted average rating would be the yardstick to follow. PACRA believes that an individual scrip is critically proportionate to its bearing on the cumulative credit quality of the portfolio.

3.3.1 Table 1 elaborates PACRA's view as to the computation of weighted average credit quality of the fund.

Table 1.

	Asset Allocation % of AUMs				
Credit Quality Score	**Govt. Secutiries/AAA**	**AA+**	**AA**	**AA-**	**A+**
9 to 10	Min. 75%	Max. 25%*			
8 to 9	Min. 50%		Max. 25%*		
7.5 to 8	Min. 25%			Max. 25%*	
7 to 7.5	Min. 15%				Max. 25%*
6 to 7					

*The remaining portfolio allocation should be in higher rating categories, subject to minimum specified in government securities.
Note: Actual asset allocation may vary over time as the assigned weights are indicative.

3.3.2 The table shows that a portfolio, with a minimum exposure of 75% to government securities/AAA rated investment avenues, would have the maximum score. Similarly, a minimum exposure of 50% to government securities/AAA rated investment avenues, while having 50% distributed across AA+ or AA investments/instruments subject to a maximum of 25% in the lowest mentioned rating category would carry the second high level of score.

3.4 Non-Performing Assets: The asset composition of the portfolio will be reviewed in terms of non-performing /under-restructuring assets with respect to the fund size. The presence of non-performing assets will have a diluting impact on overall credit quality of the underlying portfolio. The size of fund is critical when assessing the degree of variability in NAV in the event of default 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 peer. However, the ability of fund's performing assets to counterbalance current and future losses, ensuring stability of returns, will also be examined.

3.5 Concentration Risk: The 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. Fund portfolios are subject to additional risk when they are highly concentrated in a specific industry. For example, concentration in securities of a specific industry may expose a fund to industry risks that could deviate significantly from general market trends. High rated funds would have a diversified portfolio, minimizing exposure to any single issuer, sector, security or market segment.

3.6 Weighted Average Maturity: The weighted average maturity of the investment portfolio is analyzed to capture time horizon over which the portfolio is exposed to risk. Portfolio having longer WAM is more vulnerable to credit risk (default and transition to lower rating) in comparison to portfolio with lower WAM.

Score	WAM
9 to 10	45 Days
8 to 9	60 Days
7 to 8	90 Days
6 to 7	180 Days
4 to 6	2 Years
1 to 2	4 Years
0 to 1	Above 4 Years

4. MARKET RISK

- Market Value Fluctuation
- Interest rate risk

4.1 The more complex part of evaluating a fund's stability involves determining the fund's sensitivity to the changing market conditions. PACRA assess market risk in the nexus of variables affecting the market value of the underlying portfolio. Market value can fluctuate due to a number of variables largely including interest rate, liquidity and operating environment. Another key factor affecting the stability of returns is the volatility in prices of TFCs, conceiving the absence of a well-established bond market. However, given the difference in investment philosophy and operating characteristics of income and money market funds, the relative degree of emphasis on identified factors may vary for different categories of funds.

4.1.1 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 fund's sensitivity to shifts in the yield curve. Duration is a useful tool for quantifying a 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 interest rate movements. 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. The result of the threshold mentioned in Table 2 is considered to gauge the fund's ability to maintain market value and avoid disruption in returns.

Table 2.

Interest Rate Risk	Duration
9 to 10	45 Days
8 to 9	60 Days
7 to 8	90 Days
6 to 7	180 Days
4 to 6	2 Years
1 to 2	4 Years
0 to 1	Above 4 Years

5. Liquidity Risk

- Unit Holding Concentration
- Segment-wise Liquidity

Liquid Assets

5.1 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. 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 Redemption: 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. In case of a new fund, comfort can be drawn from sponsor's sizeable holding in the fund though it engenders concentration risk. We also examine the effectiveness of the management's policies and procedures for tracking and anticipating major redemption activity.

5.3 Moreover, PACRA considers the extent to which the fund is invested in liquid avenues as a percentage of net assets, notably short-term government securities alongwith any other sources of potential liquidity. The liquidity of the fund is gauged with reference to its underlying character, as depicted in the offering document. A fund styled as a high liquid fund would have an investor base with different characteristic as against a fund where the objective is to earn high returns.

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 in a category. 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).

7. Management Review

7.1 The ability of a fund to meet its investment objective and adhere 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

- Asset Manager Rating
- Fund Management
- Investment Process
- Risk Management Systems

assessment of management quality may also provide a basis of how the fund might respond to future opportunities or stress situations under different market conditions.

7.2 Management scoring is directly derived from the asset manager rating of the company managing the fund. During the evaluation process, PACRA reviews the policies and procedures developed by the management to meet its investment objectives and assesses the efficacy of the investment management process, the supporting organizational structure, internal controls, risk management, and reporting systems. 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.

7.3 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. The framework deployed to ensure compliance with regulatory requirements and its actual effectiveness would likewise be an important consideration.

8. SURVEILLANCE

- Bi-Annual review
- Breach to be noted

8.1 PACRA monitors key rating factors of the rated funds. The objective is to make sure that the fund's behavior is consistent to its stated mandate and disclosed investment policy. This would ensure that the rating remains current and accurate. A detailed formal review of rating will be carried out on a bi-annual basis.

8.2 In an instance where pre-defined limits are breached, PACRA attempts to understand the reason for breach. For a plausible reason, PACRA may draw an exception. Otherwise, PACRA would provide time to the fund manager to bring the portfolio within the stated framework. If the fund manager is able to cure the breach within the stipulated timeline, the rating is maintained. If the portfolio continues to breach, the stability rating is revised to reflect the change in the investment policy.

RATING SCALE & DEFINITIONS: Asset Management Industry

These ratings/rankings are not a recommendation to buy, sell, or hold any investment, in as much as they do not comment as to the yield or suitability for a particular investor. Eventually the risk/reward trade-off should be determined solely by investors

ASSET MANAGER RATINGS

AM1: Very high quality

Asset manager meets or exceeds the overall investment management industry best practices and highest benchmarks.

AM2++, AM2+, AM2: High quality

Asset manager meets high investment management industry standards and benchmarks with noted strengths in several of the rating factors.

AM3++, AM3+, AM3: Good quality

Asset manager meets investment management industry standards and benchmarks.

AM4++, AM4+, AM4: Adequate quality

Asset manager demonstrates an adequate organization that meets key investment management industry standards and benchmarks.

AM5: Weak

Asset manager does not meet the minimum investment management industry standards and benchmarks.

FUND STABILITY RATINGS

AAA(f)

An exceptionally strong capacity to maintain relative stability in returns and possesses negligible exposure to risks.

AA+(f), AA (f), AA-(f)

A very 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

A+(f), A (f), A-(f)

A fund with stable performance generally in line with its peers with strong capacity to respond to future opportunities or stress situations.

BBB+(f), BBB (f), 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.

BB+(f), BB (f), BB-(f)

A low capacity to maintain stability in returns and possesses very high exposure to risks

B(f)

A very low capacity to maintain stability in returns and possesses very high exposure to risks.

The fund stability rating scale of AAA to B is appended by the letter (f) to denote fund ratings and to differentiate it from the nomenclature used for issue and issuer ratings.

FUND PERFORMANCE RANKINGS

5-Star Very good performance

4-Star Good performance

3-Star Average performance

2-Star Below average performance

1-Star Weak performance

CAPITAL PROTECTION RATINGS

CP1

Very strong certainty of capital protection.

CP2+ CP2

Strong certainty of capital protection.

CP3+ CP3

Good certainty of capital protection.

CP4+ CP4

Adequate certainty of capital protection.

CP5

Weak capital protection.

Rating Watch: Alerts to the possibility of a rating change subsequent to, or in anticipation of some material identifiable event. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled.

Rating Outlooks: Indicates the potential and direction of a rating in response to a) trends in economic and/or fundamental business/financial conditions and/or deviation from expected trend. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

Being based on actual performance, no Outlook or Rating Watch can be assigned to fund performance rankings.

Suspension: It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, a suspended rating should be considered withdrawn.

Withdrawn:

A rating is withdrawn on a) termination of rating mandate, b) cessation of underlying entity or c) the rating remains suspended for six months or d) PACRA finds it impractical to surveil the opinion due to lack of requisite information.