

Different ratings agencies have developed different strengths in quantitative and qualitative analysis. As the market pressures increase and investor needs change, so collaboration will make more sense, writes **Jonathan Boyd**

Rating agencies look for allies

Suppliers of funds ratings are working hard to place themselves and their brands in front of increasing numbers of investors on a pan-European basis. The growing popularity of mutual fund investments, coupled with the onward march of regulatory changes designed to foster an increase in cross-border fund sales means that competition to provide such services has significantly increased.

Rating agencies are best known for their credit ratings, a necessary requirement for those invested in the debt markets. It comes as no surprise that credit ratings should be more evolved, as the global debt market is far larger than the combined equity markets, or the universe of alternative investments such as hedge funds. It is the size and ubiquity of credit markets that make names such as Moody's Investor Service, Standard & Poor's or Fitch Group known across pretty much all markets.

Ratings of mutual funds can broadly be broken down into quantitative and qualitative assessments of the skills of the fund managers and/or products in question. The question of what types of assets can be rated can also help decide which ratings system to use.

Increasingly, the big, powerhouse credit rating agencies have moved into the mutual fund space as part of an expansionary strategy. S&P, Moody's and Fitch are

the classic examples of credit ratings agencies that have added analysis and ratings of funds or asset management companies to their books of business over time. Younger ratings businesses yet to establish a full pan-European presence, let alone a global footprint, have taken different approaches to the demand for ratings they see in the market. Examples of those with a strong presence in a home market would include Sauren Group and Feri EuroRating Services in Germany; and OBSR and Financial Express in the UK. Others ratings brands such as Lipper and Morningstar are already well-known across a larger number of European markets. All are focused intently on expanding their presence.

For example, Sauren (see box on page 41) takes the view that managers – the people, not the companies – are the key factor determining returns. Apply a qualitative analysis to the fund manager making the investment decisions on behalf of a fund and the investor stands a better chance of improving future returns, its system argues.

Feri, another German-based ratings supplier, has grown its business by focusing solely on the quantitative analysis of funds that are over a certain age. For those of a younger nature, it applies a blend of quantitative and qualitative analysis (see box opposite).

MUTUAL FUND RATING AGENCY BREAKDOWN

FERI – analyses 8,454 funds; quantitative analysis of funds with track record of over five years, and qualitative analysis of funds with less than five years' track record; uses 12 performance and risk measurements. Core markets are Germany, Switzerland and Austria.

Financial Express – quantitative analysis; offers Crown rating, a scoring system that comprises an alpha score, consistency of performance and volatility. UK-focused, but expanding into Swiss, German and Austrian markets.

Lipper – part of ThomsonReuters; offers mutual and hedge fund reviews of more than 80,000 funds; analyses consistency, capital preservation www.investopedia.com/terms/p/preservationofcapital.asp, peer performance and expense management, among other factors, to determine performance

Morningstar – offers quantitative analysis on 370,000 instruments; uses a nine-square Style Box to visually represent the investment characteristics of stock and mutual funds of fixed income, domestic equity and international equity securities.

OBSR – part of Morningstar; offers qualitative analysis of UK industry.

Sauren Group – qualitative analysis of fund managers as key to determining returns; looks at investment philosophy and track record.

S&P – analyses 1,100 funds, or the top 20% of funds in each sector; ratings are based on an evaluation of quantitative (historic performance, volatility and portfolio construction) and qualitative (management, corporate status and investment process) factors that contribute to long-term performance.

"Our driving mission is to help investors get beyond the advertising"

Christopher Traulsen, Morningstar

FERI

The overall objective of the Feri fund rating is to assess the quality of fund management with respect to the management's contribution to out-performance and risk mitigation.

Feri uses a blend of 70% performance and 30% risk indicators to produce its quantitative ratings, says Christian Michel, team leader Fund Research at Feri EuroRating Services. This is currently applied to 8,454 funds.

Feri also uses quantitative analysis to make ratings. Quantitative-only ratings are only available for funds that have a five-year or older qualifying track record. The qualifying element means the fund must have had the same mandate and manager in place over the full period.

The quantitative analysis considers 12 performance and risk

measurements to produce a rating between A (very good) to E (poor).

Feri EuroRating started providing fund ratings in Germany in 1998. In 2006, it started adding qualitatively based ratings to cover funds with fewer than five minimum qualifying years required for the quantitative ratings. The challenge with newer funds is the level of uncertainty around factors including new concepts, new managers, and possibly changes in concepts. The qualitative ratings are based on information gathered through a number of ways, including questionnaires, RFPs, and manager interviews seeking answers to questions on processes and structures.

As funds age, Feri's system introduces a sliding scale of qualitative to quantitative factors.

This means that funds approaching their fifth year will be rated more on quantitative than qualitative factors, while funds less than half a year old will be rated exclusively on qualitative factors.

The reason for this adjustable method is to enable ratings on as many funds as possible, says Michel.

"As we see rating as a first step in fund selection, it is important to cover as many funds as possible.

There are about 6,000 funds in Germany, and we rate about 3,500 of these – including all relevant share classes. We cannot rate all of these by quants alone. Therefore, we enhanced our rating methodology by using qualitative information."

<http://www.feri-fund-rating.com>

*Christian Michel,
team leader
Fund Research,
Feri EuroRating
Services*



FINANCIAL EXPRESS

Michael Holland, UK managing director at Financial Express, says his company's quantitatively based Crown ratings highlight one attribute of performance that other systems may emphasise less.

The Crown rating is broken into three constituent parts: an Alpha score, consistency of performance, and volatility. "Uniquely, we look at Alpha when others just look at performance," Holland says. The ratings run from a single Crown to three Crowns.

The consistency element is important, he says, because there is a difference between a fund that has a very good year followed by four poor ones, compared to a fund that is consistently good over five years. Both may show the same overall five-year performance, but the investor would probably prefer consistency.

Financial Express also provides data showing performance of the managers, by stitching together their performance over the past decade, regardless of which different funds they have managed. The system is also used to compare the performance of peers.



*Michael Holland,
UK managing
director,
Financial
Express*

"UNIQUELY, WE LOOK AT ALPHA WHEN OTHERS LOOK AT PERFORMANCE"

The UK has also seen different quantitative and qualitative approaches, with Financial Express putting forward a quantitative ratings system, whereas OBSR, now part of Morningstar, has pursued the qualitative analysis in its ratings.

M&A

Morningstar's decision to acquire OBSR last year followed a trend that has been on going in the ratings sector for some time. In this case, it was a US company boosting its UK presence. Similarly before that, Canadian media company Thomson bought into the funds data and ratings presence in Europe through its acquisition of Reuters in 2008.

It remains to be seen to what extent this gives the former UK company the weight to land a knockout punch against its key data rival in New York, Bloomberg. But because of the sheer size of the combined company, it suggests products such as Lipper Leaders have backing that could last many rounds against competitors if required.

What the M&A activity has shown, however, is that the activity is less about removing competition and more about tying together opportunities in different areas; where one may be better known for quantitative ratings,

88% The percentage of investment managers felt optimistic about their business prospects over the next three years, a poll of 60 C-level and senior executives at hedge funds, mutual funds, separately managed accounts, and collective investment trusts in the City of London by outsourcing firm SEI showed

there may be good synergies linking up with another better-known for qualitative analysis and ratings.

Comments from a number of ratings suppliers suggest that Europe is a place both of burgeoning opportunity, but also of challenges. Michael Holland, Financial Express's UK managing director, says he has seen research from the US suggesting that a higher proportion of investor assets do go to higher-rated funds. This is a pattern he expects to develop across Europe in future.

He also sees the possibility that ratings around asset classes, including risk scores for asset classes, could become more in demand.

Regulation such as Ucits may create the more efficient single market so long dreamt of by the Lamfalussy process, but it also throws up the possibility that different ratings systems and ratings providers may end up fighting over a smaller number of funds, which for some could stress business models.

Other changes will inevitably shift the focus of the use of ratings. The ageing population of Europe means long-term savers with a focus on income generating assets and future liability matching may become more than those investing for near-term protection or investment purposes. ■

LIPPER



Ed Moisson

The Lipper Leader system relies on purely statistical measures. There is no qualitative part to the rating, says Ed Moisson, head of UK & cross-border research, Lipper.

The system does the quantitative calculations monthly, with funds measured across a range of criteria over three, five and ten years. Ratings will be based on all funds registered for sale in a country will be scored, with the rating based on how any particular fund performs compared to other funds in its particular universe.

This also means that if a fund company is selling the same fund across different European markets, the ratings user may want to look at different universes, Moisson adds.

In Europe, the Lipper Leaders system provides four ratings for each fund relative to peers; total return, consistent returns risk adjusted, capital preservation, and fund expenses. Funds are rated between 1-5, with a score of 5 being the highest. The system will look to rate the funds against peers or groups of similar funds.

www.lipperleaders.com

MORNINGSTAR

Another of the big US analysis and ratings providers, Morningstar published its first funds related data and analysis product in 1984. Today, it claims to offer data on some 370,000 instruments, including funds and operations in 26 countries. The past half-decade has seen the company grow through considerable acquisitions, including the fund data business from S&P in 2007, and OBSR (Old Broad Street Research) in 2010.

In Europe, it has arguably pursued a market-by-market approach, for example, with separate websites for each of the UK, France, Germany, Italy, the Netherlands, Norway, Spain and Switzerland.

Morningstar's "Star" rating system awards between one and five stars on the basis of quantitative analysis of risk-adjusted performance. The process relies on breaking the fund universe up into smaller comparison groups to enable better measurement of the fund-manager skill.

Because of these smaller comparison groups, Morningstar changed its treatment of funds with multiple share classes in 2002. They are subsequently evaluated separately – although for the ratings, a single portfolio counts just once regardless of the number of shares. Provision is also made for changes to investment strategy, with historical information given less weight. Morningstar says this is to avoid incentivising companies into changing fund style to get a better rating.

The ratings are applied to three periods: trailing three, five and ten years. The process adjusts weightings for these different periods, depending on the age of the fund. A three-year-old fund will have 100% of its rating attributed to the three year period. A fund that is between five and ten years old will have a 60% of its overall rating attributed to the five-year period rating, and 40% to a three-year rating. Funds more than ten years old see their overall rating split 50%

for ten years, 30% for five years, and 20% for three years.

However, Morningstar has also moved to boost the qualitative part of its ratings business. Christopher Traulsen, director of research – Europe and Asia, explains: "Our driving mission is to help investors get beyond the advertising. Our qualitative research philosophy prioritises those funds that generate the greater portion of investor assets or interest. Morningstar qualitative fund ratings, therefore, cover not only the good funds, but the mediocre and poor ones as well."

Traulsen says the OBSR acquisition significantly boosted the company's overall research resources, particularly given OBSR's knowledge of the UK's funds industry. "The combined UK research team has since harmonized fund ratings across both systems, providing investors with strong and consistent analysis backed by the global quantitative data resources of Morningstar."

<http://corporate.morningstar.com>



Christopher Traulsen, Morningstar

"There is the possibility of consolidation in the funds universe because of Ucits"

Gokhan Saruhan, S&P

SAUREN

The Sauren Group is distinctive in that not only does its ratings system focus purely on qualitative research into fund managers, which it tracks over time, but it has also developed into a funds of funds provider.

Founded as an independent analyst by Eckhard Sauren in 1991, the company has published the qualitative Sauren fund manager rating since 2002. The rating assesses managers' own capabilities, for which they are awarded one, two or three gold medals.

A single medal is awarded for 'very good fund management'. Two medals signifies 'outexcellent fund

management', with the manager demonstrating a high level of quality in terms of his investment philosophy and the investment process. Three medals are awarded for 'outstanding fund management'.

The medals are awarded annually, with the next awards event scheduled for 8 September in Frankfurt.

The Sauren method looks at individual managers' investment philosophy and track record. Sauren believes that this is key to determining whether a fund can be successful in future, but also implies that past performance of a fund

product becomes worthless once a responsible manager leaves.

Sauren notes that this is what it sees as a weakness in a quantitative approach; that it leaves ratings intact because such ratings are based on past performance. By contrast, it argues that a new fund managed by an individual with a strong track record could be a good investment opportunity. And by not waiting for the product to gain a track record, it means funds can be rated as soon as possible, rather than, say, waiting for a three-year anniversary.

www.sauren.de/en



Eckhard Sauren

S&P

S&P's ratings are another type that focus on qualitative analysis. But before getting to the interview-based part of its process, it applies a quantitative screening that sifts out about 80% of funds, which are not eligible for further inclusion.

For example, new funds require a minimum of 12 months in the market before they would be considered for screening, while funds generally would require a minimum three-year period before being considered. Consistency of performance is the key criteria being studied at this point in the work.

Once screened, the qualitative analysis work begins by collecting as much information as possible from the provider about its own history and the background to the fund, before any interview is held. Factors considered include the composition and background of the management team, the strategy and investment disciplines used to manage the fund – including risk controls, as well as activities around the fund itself, such as whether it has changed size significantly and what instruments account for its performance.

The interview process is based on obtaining face-to-face interviews with the fund managers, says Gokhan Saruhan, head of research, S&P Fund Services. S&P relies on a core set of criteria for any interview, but supplements them depending on what the analyst team has discovered during its initial information gathering exercise. First-time interviews will take longer, Saruhan says.

"It is critical to have that interaction.

It tells a lot of things," he adds.

This process also enables

S&P to obtain a view that is forward looking, against other information that may be backward looking. Any rating suggested by an analyst is subject to a ratings committee, which makes the final rating, subject to any challenges from the provider firm.

Although the business model for the rating requires the provider firm to pay for the work to be done before it has started, Saruhan says that there is a "firewall" between the sales and business development parts of S&P and the analysts to ensure independence and objectivity.

Overall, there are about 1,100 S&P fund ratings in effect, he says. S&P uses a lettering rather than a numbering system. An 'A' rating means the fund demonstrates high standards of quality in its sector based on its investment process and management's consistency of performance as compared to funds with similar objectives. An 'AA' rating means the fund has demonstrated "very high" standards, while the top rating of 'AAA' means it demonstrates "the highest standards".

On the future of fund ratings, Saruhan says one option may be for regulators to consider introducing a required reference to ratings on mutual funds, in the same way it is applied to products in the credit market. Changes such as the Retail Distribution Review in the UK market are putting pressure on financial intermediaries to take more consideration of factors such as ratings, he believes.

"It is possible it could go in that direction, but there are a lot of dynamics. There is the possibility of consolidation in the funds universe because of Ucits." <http://www.standardandpoors.com/home/en/eu>

*Gokhan Saruhan,
head of research,
S&P Fund
Services*

