The Pakistan Credit Rating Agency Limited

Asset Manager Rating Methodology

An independent opinion on the quality and expertise deployed by an asset management company

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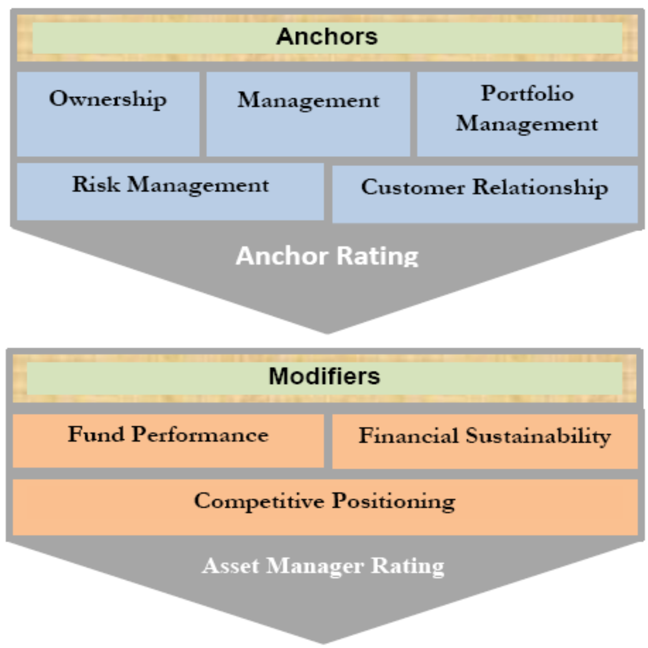
1. INTRODUCTION

- **Quality of asset management services**
- **Not a promise for future returns**
- **Multi-faceted criteria**

1.1 The primary purpose of PACRA's Asset Manager Rating is to provide users with an independent opinion on the quality and expertise deployed by an asset management company and potential vulnerability to investment management and operational challenges. It is important to understand that Asset Manager Rating differs fundamentally from the traditional credit rating, which refers to an entity/issuer's ability to meet its financial obligations. At the same time, Asset Manager Rating is not a determinant for the future performance of a fund, portfolio or other investment vehicle.

1.2 An asset management company is exposed to multiple major and minor risks. Major risks include but are not limited to **i)** inadequacy of investment decision-making body **ii)** weak investment oversight, **iii)** inconsistency in decision-making, **iv)** liquidity and asset-liability mismatches (leading to redemption delays and distressed sale of investments, which ultimately impact the value of assets under management. Other risks include **i)** poor communication **ii)** business disruption, and **iii)** operational errors in valuation, settlement and redemption processes, amongst others.

1.3 PACRA follows a comprehensive approach to form an opinion on the quality and expertise deployed by an asset management company. It attempts to analyze an AMC not only on a standalone basis but also in the relative universe. Factors underlying the methodology are grouped under two segments – Anchors and Modifiers. Anchoring factors help to understand design and objectives of an AMC. PACRA evaluates i) Ownership ii)



Management, iii) Portfolio Management, iv) Risk management Framework, and v) Customer Relationship. By this, it is easy to read the thought process of an AMC's sponsors (board) and the management team; since an AMC's design has to be reflection of the objectives conceived by the sponsoring group. Factors classified as modifiers capture an AMC's progress and achievements using its design and against its objectives. PACRA forms this view by evaluating i) Fund Performance, ii) Financial Sustainability, and iii) Competitive Positioning. Conceptually, Anchors are the attributes available to the AMC from its inception, though these continue to evolve. On the other hand, Modifiers are factors where initially a prospective view is formed. As actual performance is demonstrated, it is compared anchor view. If these are aligned, anchor opinion leads to AM rating. In case of deviation, opinion is modified.

2. MANAGEMENT

- Management team
- Key man risk
- Organizational Structure

2.1 **Management Quality:** Human expertise plays a critical role in asset management. The efficiency and reliability of processes at all levels of the organization largely rely on the effectiveness of the team set-up and experience of the people involved. An important aspect of PACRA's analysis is therefore management team's ability to conceive and execute stated strategies, ensure efficient coordination and oversight.

2.2 PACRA's evaluation of human resources is based on an objective criterion that focuses on the back ground of management and staff, both individually and collectively. Assessment is based on the years of relevant work experience, prior track record and tenure with the company. Each functional area is covered including portfolio management, risk management, investment research, sales and distribution, marketing, internal audit and compliance.

2.3 Loss of key personnel, particularly members of senior management and senior portfolio managers, can have potentially adverse effects on performance of funds under management and overall standing of the company relative to peers. Hence, HR turnover is reviewed to determine the stability of critical staff, with particular focus on key departments. In addition, company's human resource policies are also reviewed to gauge company's emphasis on retaining and recruiting vital staff and ensuring their redundancy in the structure.

2.4 **Organizational Structure:** PACRA's analysis of the organizational structure focuses on how the asset management company is organized keeping in view the scope of operations and diversity of product base. PACRA believes that departments should be structured in an AMC keeping in view segregation of duties and importance of the functions to be performed, e.g. risk function has to be separate and independent.

3. PORTFOLIO MANAGEMENT

- Composition of IC
- Investment Decision Making
- Research and Analysis

3.1 The complex nature of financial markets requires asset managers to have clearly-defined and solid investment processes and the ability to demonstrate consistency in implementation while maximizing risk adjusted performance and meeting various qualitative benchmarks. Within this framework, PACRA specifically focuses on clarity of investment styles and adherence to stated investment strategies.

3.2 **Investment Decision Making**: The investment decision making process is the pivotal stone of portfolio management. PACRA reviews the degree of clarity in investment objectives and philosophy on the part of asset managers. Adherence to the stated investment objectives and philosophy is important to ensure that investment avenues are consistent with the stated mandate of the collective investment schemes. While PACRA reviews the investment philosophy inscribed in the offering documents, these are normally generalized statements. Hence PACRA considers management approach and philosophy governing in the investment committees more relevant for the overall assessment.

3.3 The importance of having a clear investment objective was highlighted during the liquidity crises of 2008. Investors were inadvertently misled to believe that income funds were a highly liquid asset class. However, owing to evaporation of liquidity of the underlying investments (mostly TFCs) in the market and the ensuing panic redemption, some asset managers had to resort to distressed sales and /or suspend their funds altogether. This, while highlighting increased investor aversion to liquidity risk, also lead to strict regulatory guidelines that distinguished highly liquid money market funds as a separate asset class from income funds.

3.4 PACRA assesses how investment/divestment decisions are formulated, reasoned and analyzed. Structure of the Investment Committee and its functions are an integral part of the decision-making process, as the Investment Committee is the primary point of reference for any investment decisions made and implemented. The effectiveness of the Investment Committee needs to be evaluated to ensure that it is discharging its responsibilities in the best possible manner and in the best interest of the unit holders. From this perspective, the composition of Investment Committee, experience of its members, frequency of meetings and review of investment committee packages are reviewed to determine the overall effectiveness of decision making process. At the same time, dominance of any particular member is carefully scrutinized through review of Investment Committee minutes.

3.5 The overall quality and transparency of the asset management company's trading and dealing practices is important in determining consistent implementation of investment decisions across funds. Quality of trading systems and criteria for selection of brokers is evaluated to assess whether the asset manager provides fair price and best execution for investors. The quality of supervision over the trading function and extent of compliance with trading policies provides insight on the monitoring and control environment instituted by the management team on the trading function.

3.6 **Investment Advisory:** The framework installed for separately managed accounts (SMA), discretionary and non-discretionary, is assessed. The emphasis is laid on independence of decision making and fair treatment to the SMAs. Neither funds under management should suffer on behalf of SMAs nor otherwise. An AMC may be designed to focus primarily on SMAs; hence such AMC would be evaluated based on factors relevant to SMAs.

3.7 **Investment Research and Analysis:** Strong investment research and analytical frameworks are critical for prudent investment management. The degree of independence enjoyed by the research staff in its operational activities and investment recommendations, both from the fund management team and from the reference shareholder, is an important determinant in assessing its effectiveness in the investment management chain. Structure of the research department is critical in identifying the reporting lines and how the roles and responsibilities of the division have been delegated amongst various staff members comprising the research division. The experience and educational profile is considered. A mix of different skill set in the team is considered good when it is supervised by a strong Head of the department.

3.8 The quality, reliability, completeness and relevance of quantitative models and statistical techniques employed, complexity and extent of risk analysis and ratios commensurate with the investment scheme enable us to assess the overall quality and viability of the various tools used by the research department in formulating investment-related recommendations / decisions.

3.9 Likewise, the extent and quality of the research output (including the scope of the investment universe and depth of analytical input) needs to be assessed to determine the relevance and timeliness of the research to the investment process. An analysis of how research data gathered through various sources is documented for guidance and future reference is important to gauge the quality and extent of the research database for future investment-related decisions.

4. RISK MANAGEMENT

- **Risk Management Framework**
- **Investment Risk**
- **Operational Risk**
- **Risk Indicators**
- **Internal Controls**

4.1 **Risk Management Framework:** Risk management and monitoring culture and platform are the hallmark of a seasoned and mature asset management company. Evaluating the overall risk management framework of the asset management company enables to determine how various risks are identified, monitored and mitigated across the company. The efficiency of controls and risk management within an asset management company is instrumental in mitigating risks arising from operational and investment management failures. The analysis considers role of the Board in formulating risk management policies, quality and extent of such, the independence of the risk management function, and the key risk indicators and IT systems employed by the company to monitor risk. At the same time, the involvement of senior management in the overall risk management function is assessed to understand organization's emphasis on risk and its overall risk culture.

4.2 **Operational Risk:** Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. An analysis of the company's Disaster Recovery (DR) procedures, infrastructure security and monitoring of third-party activities helps to determine the viability of the operational control environment against unanticipated business disruptions, personnel slippage and inadvertent data entry errors. In addition, PACRA evaluates capacity to promote ethics and monitor enforcement thereof.

4.3 **Core Software:** Optimum portfolio management requires adequate and sufficient technological resources, whether internal, provided by the parent company or affiliate, and/or an external third party (e.g. vendors). Most critical in terms of IT resources are unquestionably the portfolio management and order management systems. Various features of the portfolio management system are explored; robustness, coverage of instruments, time delay before transactions are entered, timely and accurate portfolio pricing and ability to monitor value added indicators and order simulation. PACRA assesses the quality and reliability of the order management process in terms of systems and procedures to ensure the secure, timely and fair handling of multiple transactions. Electronic order and confirmation also clearly adds value and security, notably when trading is a risk. The integration of custodians and fund administrators within the systems is also cautioned. PACRA places high value on MIS and considers such MIS superior which are generated directly from the system

4.4 Investment Risk Management*:* Investment Risk Management permeates the entire investment management process, and consists of two pillars a) macro-economic risks, b) portfolio risks. Macro-economic risks are the risks to the operating environment of the asset management industry and overall economy of the country. Portfolio risks are risks related to the portfolio investments of the company. This may be reflected in the overall structure of the investments at AMC level, exposure to different sectors and redemption pressures. Three main categories are 1) Credit Risk, 2) Market Risk, and 3) Liquidity Risk. Each of these risks needs to be viewed separately to gauge the exact nature and source of a particular risk factor and controls in place to mitigate such risks.

4.4.1 PACRA reviews coverage and appropriateness of risk indicators used by the company, the capacity of the portfolio managers to measure such indicators and monitor exposures against explicit and meaningful limits. The extent of risk indicators used by the company depends on the scope of activities and nature of product base. Reconciliation between expected and actual risk levels is equally important and requires regular comparisons, analysis of discrepancies and correction.

4.4.2 Credit Risk*:* For Credit Risk, it is important to periodically monitor the financial strength and creditworthiness of the various counterparties and to take appropriate actions in case of any adverse changes. Credit risk can also arise from breach of internally defined allocation limits, internal rating guidelines for investment purposes and high concentration in individual investments, sectors and or groups.

4.4.3 Liquidity Risk*:* Liquidity risk management has recently emerged as a key challenge for asset managers. An evaluation of the liquidity profile of the underlying investments in particular fund, any asset / liability mismatch that could trigger a potential liquidity wipeout and availability of external sources of contingent funding (e.g. unutilized bank credit lines) are key factors. Steps taken by the company to mitigate redemption risks and related MIS are also considered. While considering the liquidity, AMC's own liquid resources may also be considered.

4.4.4 Market Risk: Market risk can arise primarily from adverse movements in interest rates and asset prices. High volatility in market conditions may result in significant losses on the investment portfolio. Therefore, it is important to assess the measures used by the asset manager to mitigate market risks (e.g. stress testing for interest rate shocks, duration analysis, beta analysis, cut-offs for exit from stock market, repositioning strategy) that can adversely impact the overall portfolio value.

4.5 Compliance & Internal Audit: An analysis of the overall Compliance and Internal Control framework (including Internal Audit procedures) of the company helps in identifying the procedures, control centers and reporting lines, in order to manage conflicts of interest, meet fiduciary responsibility, and to verify the accuracy of financial and accounting information prepared for unit-holders and other stakeholders. This analysis would assess the strength of the overall compliance and control environment beyond regulatory requirements. Well-documented and comprehensive internal policies and a structured internal control program are viewed as positive factors for the rating. The compliance function would be evaluated on an enterprise-wide basis. More value would be given to the compliance function integrated into the system of the company.

5. CUSTOMER RELATIONSHIP

- **Core Software**
- **Investor Services**
- **Investor Reporting**

5.1 Investor Services: PACRA examines the investor services platform of an asset manager for evaluating overall service quality and resource availability for investors education and facilitation. Examining client relationships focuses on the asset manager's ability to manage relations through determination of investment objectives and a thorough understanding of constraints, and then to day-to-day relationships. PACRA evaluates the asset manager's capacity to provide appropriate responses tailored to client requests, as well as keeping abreast of local regulations. Criteria are, inter alia, staffing, technical knowledge of sales people, systems such as Client Relationship Management (CRM tool), value-added services and access to information. The platform afforded to advisory clients, if any, from the stand-point of its adequacy and robustness is also evaluated.

5.2 Investor Reporting: Much of the information provided to investors is communicated through regular reporting, which PACRA examines in light of its comprehensiveness, clarity, consistency, accuracy and timing. This capacity to adapt reports to meet varied investors' requirements is also examined. Beyond mere reporting, PACRA believes that all asset managers should offer performance presentations and performance attribution reports to their clients on a widespread and timely basis. The agency, therefore, looks at accuracy of performance attribution and consistency with the investment process. PACRA also reviews the resources and the procedures used in the production of reports, particularly with respect to front-office independence and to data accuracy.

6. OWNERSHIP

- **Franchise Value**
- **Synergistic benefits**

6.1 The ownership may provide multiple benefits to the company in terms of systems, processes, policies and procedures. These benefits are accounted for in the related factor. The benefit which is analyzed in this section is the franchise value afforded to the company and other synergies made available. The strength of the franchise and synergistic benefits contribute towards asset manager rating.

7. COMPETITIVE POSITIONING

- **Size matters**
- **Diversification is important**
- **Retail AuMs**

7.1 Market Share: The size provides sustainability to the asset manager and longevity to its operations. Thus, analysis of Assets Under Management (AUM) and the product base is central to PACRA's assessment. The aim is to assess company's ability to work with clients and to provide asset management services well-suited to their needs. Market share of an asset manager and its growth over a period of time is incorporated in PACRA's assessment of an asset manager's standing and competitive positioning amongst peers.

7.2 Diversification of fund mix: PACRA considers that, apart from the sheer size, a good investment manager has a well-diversified product slate. Not only the asset manager offers a full bouquet of products, AUMs invested in each product are also well-diversified. PACRA looks at diversification from two angles: a) AUMs represented by the top fund, b) AUMs represented by single asset class. Concentration in either of these is not considered good.

7.3 Investor Concentration: Composition and concentration of unit holder base is considered. Unit holder concentration is analyzed to judge the potential redemption risk that asset manager may face in the event of crisis and probable redemption run. The yardstick is AUMs represented by Top Twenty investors. Higher the asset manager rating, lower the concentration by top twenty investor. The other yardstick is the total contribution of AUMs by the retail. While HNWs are sometimes included in retail, PACRA looks at the pure number to distinct between financial savvy and general investors. Run-rate of retail AUMs, its overall contribution in total AUMs and fee from retail are some of the important indicators in the eyes of PACRA.

7.4 Operational History: PACRA considers asset manager's experience in the industry and views favorably asset managers that have gained several years' track record, navigating through market cycles, developing sound processes and a well nurtured expertise to offer asset management services.

7.5 Distribution and Sales Network: PACRA examines the distribution and sales network of an asset manager. Particular focus is given to asset managers' association with commercial banks, third-party distributors and exclusivity of such arrangements. At the same time, asset manager's emphasis on brand management, strength of sales team, training routines for sales agents and related performance reviews is also incorporated in analysis.

8. INVESTMENT PERFORMANCE

- **Star rankings**

8.1 Achieving competitive investment results is the principal objective of an asset management company. Over the long run, poor performances lead to a poor reputation; poor reputation leads to outflows; and outflows lead to deterioration in profitability and ultimately in the standing of the asset manager.

8.2 There could be ways to evaluate fund performance. PACRA's analysis of performance focuses on the star-rankings of all eligible funds of an asset manager. Both short-term (1-Year) and long-term (3-Year and 5-Year) performances are analysed to form a consistent opinion and smoothen-out periods of unusual performances. PACRA believes that in long run, the funds of an asset manager with noted strengths in other rating factors will usually be superior or at par with peers.

9. FINANCIAL POSITION

- **Sustainability of operations**
- **Revenue from retail investors**
- **Break-even analysis**

9.1 PACRA looks at financial position of the asset management company with an objective to assess sustainability. For this, both balance sheet analysis and profit analysis is undertaken. Several aspects of the company's income statement are considered: revenue and diversification of revenue stream: revenue from fee and capital gains, expense trends, concentrations by client and product. The fee revenue from retail investors is pivotal to PACRA's comfort, especially when it provides complete coverage against the company's operating expenses. The return on equity is analyzed in conjunction with peer to make a view as to the shareholders' satisfaction with the investment.

6

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.

+ = (Plus)

++ =(Double Plus)

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 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 adequate 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.