

A New Rating Framework

Traditional ratings have many conflicts of interest but before now, there hasn't been a viable alternative

Christopher Miller - December 2009

- Investors expect to get un-conflicted high quality research for free
- That hasn't been possible before, but a new rating approach may help
- We have already started working on the basis that we contract with the investor, the investor pays us, and then gets reimbursed by the manager
- Advantages include: contractual responsibility to the investor, perfect alignment of interests, proactive oversight and governance

Introduction & Summary

Phase I

Up to 2008, most of our business was sell-side ratings. We performed a form of reverse due diligence on hedge funds and funds of funds, paid for by the manager and distributed to qualified investors. The work resembled that of credit rating agencies, but we showed investors much more of our methodology with fairly long, but surprisingly readable reports.

But in the credit crisis many of our clients cancelled ratings. It was a difficult time for almost everyone, and we suffered a knock-on effect, despite not being involved in the AAA scandal, or any blow-ups, and even having warned people about Madoff and Weaving.

Phase II

At the same time, we started getting calls from worried investors who wanted to know more about their managers, with lock-ups, gates, valuation issues, redemption fees and side pockets. They were prepared to pay, and compared with how much they were losing, our fees were miniscule. We have turned around our business model to grow this side of our business dramatically.

Phase III

Now, we have already started working to a new model, whereby the manager reimburses the investor for the cost of our work. After all, our fees are still small in comparison to the fees managers are earning for managing the money and the amount at stake.

We found that managers are very willing to pay a small amount for ongoing monitoring. In fact, consensus was remarkably easy to achieve. Investors like the idea, but perhaps approach it with a more conservative attitude: they are not used to asking for discounts or rebates.

Wider benefits

We think that our model has potentially very big implications. It revolutionises the "issuer-pays" rating model with a conflict-free system that benefits the investor at a reasonable cost to the manager.

Have your cake and eat it...

Allenbridge HedgeInfo specialises in hedge fund research and due diligence for a wide variety of investors. We conduct discreet background research and on-site meetings with our renowned qualitative expertise and quantitative toolset.

Why are hedge fund ratings like credit ratings?

Many parallels

The main issues are fundamentally the same, however the hedge fund rating market is not as mature as the credit ratings, the participants are more fragmented and hedge fund ratings are not as compulsory as in the credit market. Whilst this *should* result in competition to get the reputation for the most incisive and accurate ratings, in practice, that does not always happen. In fact, we suspect the market is subject to the same pressure from "shopping for ratings" whereby issuers choose ratings from the agency likely to give them the best rating. It's reverse Darwinism, and there must be a better way.

We discuss credit rating agencies in depth here because the concepts are so easily transferrable, there is much more debate and evidence on credit rating agencies and the concepts may be easier to visualise.

How most existing ratings work

In the early days of rating agencies, the idea was that a rating agency would survive only if its ratings were respected and in demand from investors. And since the ratings were paid for by subscribers (investors), that was a very reasonable assumption. But times change and technology changed. As it became so easy to communicate and copy the ratings, the agencies started to switch to the current "issuer pays" model.

Oligopolistic

Certainly today, the dynamic has changed, with the credit rating agencies forming an oligopoly around a captive market for credit ratings. In hedge funds we do not yet have the luxury of that environment. But we are still tainted by association with the credit rating agencies whose business models have demonstrably failed, and are riddled with conflicts. Probably the only things holding legislators back from imposing draconian measures on the agencies are:

- the lack of a viable alternative; and
- the threat of country downgrades.

A cynical observer might unkindly suggest that the rating agencies are so powerful that legislators are fearful of the country downgrade option.

Objectivity too precious

Agencies argue that the reputation for objectivity is too vital to risk by shady behaviour. New York University's Stern Business School¹ suggests that this is a reasonable argument. We think that there are elements of truth to it and the industry has gone to great lengths to be transparent and independent with independence at various stages of the rating process. However, there is more scope for error or bias in new or immature products, compared with "simple" credit ratings.

But the rating agencies are not so oligopolistic as to be above criticising each other. Fitch and DBRS issued studies in April 2007 on CPDO ratings, saying that AAA ratings, issued only by S&P and Moody's, were not justified by CPDOs. This is laudable, but the issues were wider than just AAA ratings on CPDOs. In the credit crisis, few were above criticism.

Issuer pays

With the mainstream rating model, the issuer pays and the investor obtains the information, usually for free. This makes practical sense, since only one report needs to be done, irrespective of the number of investors. The rating fee is often based on the size of the fund or debt issue in question. The freeness of information for investors is increasingly being taken for granted, and with the passage of time, "benefits" become seen as "rights".

Untouchable

Rating agencies are quite well protected from legal challenge by investors, as there is legal precedence characterising reliance on rating agencies as unreasonable².

¹ <http://whitepapers.stern.nyu.edu/summaries/ch03.html>

² <http://www.ft.com/cms/s/3/83059044-995b-11de-ab8c-00144feabdc0.html>

How other market participants operate

Smarter investors, including hedge funds, tend to rely on their own internal research rather than public ratings.

Buy-side

There are also rating and research agencies who are "buy-side" in other words, they work for investors rather than issuers.

Free ride

With freely traded fixed income products, the real rating can be implied from the spread. This implies a "free ride" on the research done by others, but it assumes an efficient market. As an aside, we are pragmatic about the efficient markets hypothesis: it is useful, without being either entirely true or false, and we believe that most markets are mostly efficient most of the time. Unfortunately, it is hard to tell whether the market is behaving efficiently, and even if it was, the chances are that it will be most inefficient at the least convenient time.

Known problems with the "issuer pays" model

- Issuers often ask for consulting advice from rating agencies to ensure they construct optimal structures that will achieve high ratings. This is a reasonable desire, but the conflict of interest from paying for ratings is compounded by the even greater conflict from consulting.
- There is often not enough investor engagement with the rating agencies to understand and oversee the rating methodology and practical application.
- Rating agencies are often seen as reactive rather than investigatory. Given the list of failures to spot problems such as Enron, CDOs, and other complex products, one could be forgiven for thinking that they only downgrade when they have no choice.
- Some people say that investors want consistency of ratings³ and that there are advantages to a concentrated market, by avoiding duplication, but others argue that rating agencies are consistent more than accurate, and the availability of a variety of opinions is beneficial.
- The power of self-fulfilling prophecies dictates that large and influential agencies have to be especially careful about downgrades. A prescient article⁴ from the FT says that "A downgrade can even tip countries towards recession or companies towards bankruptcy." This is relevant for systemic risk management.
- Investment rules are driven by ratings. Coupled with the oligopolistic nature of the mature credit rating industry, this creates systemic risk. This can manifest itself in different ways, such as the risk that a downgrade will result in massively disproportionate selling, or a concentration in too-good-to-be-true investments such as that seen recently in structured products.
- There is a notable lack of accountability to the end user.
- With opportunities for shopping around, there can be a clear temptation for agencies to be swayed, or at the very least, for issuers to head to the agency with the highest indicative rating.
- In the hedge fund market, issuers can choose when to have their track record assessed, or whether or not to renew a rating if it is likely to be downgraded.

Of course it is easy to say in hindsight that structured product ratings were baloney, in the same way that it was obvious that banks were over-leveraged. There were people who cried foul before the crisis hit, but they were few and far between. We suspect that even the authors of the above-mentioned article didn't imagine such a savage outcome at the time they were writing.

³ <http://www.voxeu.org/index.php?q=node/887>

⁴ http://www.ft.com/cms/s/0/595b8988-03da-11dc-a931-000b5df10621.html?ncklick_check=1

Initiatives

G30

The influential Group of Thirty published research and proposals for financial regulation and supervision⁵ in January 2009. It expressed signs of dismay that rating agencies are not held legally accountable for their work, and in the US, their work is even subject to First Amendment protection. They note that it is impractical to resume the "investor pays" model due to the difficulty of competing with the traditional issuers' "free" ratings, and because of the difficulty of protection of intellectual property.

Their recommendations concentrate on:

- the caveat emptor principle;
- encouraging the agencies to step up their methodology to include a wider range of risk factors; and
- changing payment models to align incentives better, and making the agencies more accountable.

Given their comments about the impracticality of the "investor pays" model, we are not sure if the third point was an empty challenge with the first point as backstop, or whether they actually thought something could be achieved. As you can see in *Our Approach* below, we take it the latter way.

Stern Business School

And we are not the only ones. There are bold initiatives to reform ratings by creating a central disinterested third party to commission ratings. One way it could work has been outlined by Stern Business School. It is intended to consist of a body that an issuer can approach to obtain a rating which agrees a fee and assigns an agency impartially. The idea is that the conflict of interest can be discharged this way, while still fostering competition. And the advantages of the "investor pays" model are not compromised by the "free rider" problem whereby other investors don't have to pay if they hear or guess about the ratings. We are impressed and believe this could work better than the existing framework, but we not persuaded that it is the best option or the whole story.

We like the idea of a central impartial clearing house, but believe that the end user is best placed to decide who should perform the work and that public ratings from very large agencies encourage systemic risk.

Other initiatives

Some commentators⁶ argue for a return to the "issuer-pays" model, but without presenting a complete plan. While there is also talk of preventing shopping around and paying up front⁷. But the reports do not give conclusive solutions.

Our Approach

Manager reimburses

We have already started to work for investors whereby the issuer (hedge fund manager) has agreed to reimburse the costs to the investor. In the interests of the investor, we are offering free constructive feedback to the manager. We think this is the best of all worlds.

The advantages include:

- contractual responsibility only to the investor,
- no direct cost to the investor
- level playing field with managers
- alignment of interests for the success of the investment,
- pro-active oversight and governance.

⁵ <http://www.group30.org/pubs/reformreport.pdf>

⁶ <http://www.washingtonpost.com/wp-dyn/content/article/2009/09/17/AR2009091704608.html>

⁷ <http://center.uvt.nl/sem/freixas.pdf>

We believe that most investors would rather help their managers to be the best they can be, than leave at the first sign of trouble. Admittedly, there may be limits to the scope of constructive comment, especially ex-ante, but this potentially gives the managers a competitive advantage, all in the interests of the investor.

It's really not at all complicated, and it achieves the same object, that with appropriate qualification, anyone interested can obtain a free impartial research report. Hopefully, investors will choose the rating agencies least likely to miss a serious risk, and most likely to give good consulting advice to the issuer.

When we asked some hedge fund managers for feedback they were more enthusiastic than we expected, and the investors were predictably keen, but in some cases seem shy to ask the manager. It may be that the aforementioned central clearing house could act as an escrow account for the fee to avoid the need for unnecessary transactions.

Another "manager pays" model

Another investment consultant we know has an interesting model that allows them to collect the money directly from the managers. They select managers for mainly UK local authority pension clients by getting them to agree to pay the cost of the exercise if they win the beauty parade. At over 0.3% of the amount invested, this is not a small sum, but in general, almost all fund of funds managers agree to this, and most single manager funds probably would too. Some of the criticisms that the model arouses are:

- The consultant must be conflicted because they receive money from the managers. *We think that because all managers have the same terms, they have no incentive to favour one manager over another. As such, there is no conflict... only a confusing relationship.*
- The universe of managers who are prepared to pay the fee is less than optimal. *There may be managers in mainstream investing or hedge funds who would not agree; but we have not met any. So we don't accept the universe is too limiting.*
- The beauty parade is simply data gathering with blunt measures like the Sharpe ratio. *There is some truth to this, and our approach is much more exhaustive.*
- The fee is a high one-off fee for mainly quantitative work, without due diligence, and no follow-up. *We agree this is a significant weakness.*

We can improve

Although we do not fully agree with the arguments, we think that the model can be improved by:

- avoiding receiving money directly from the manager: hair splitting perhaps, but it is simpler to say that we don't receive money from them, and that the investor appoints us;
- asking a much lower fee;
- applying our flagship qualitative and quantitative approach; and
- using an ongoing contract for oversight, so the above fee is per annum.

There will obviously be fine tuning, such as a minimum to commence coverage of a manager, a minimum for each separate client, and a minimum investment size for manager selection mandates to be included.

A disadvantage?

This works intuitively in the hedge fund market because hedge funds are not allowed to market themselves to the public, and the reports are not made public. But for credit ratings, this would mean that issuers would not make the rating public. There are increasingly powerful ways to manage the intellectual property online or through the main data providers, especially if the end user doesn't have to pay.

But is this disadvantage really an advantage? We think that the absence of public ratings will reduce the systemic risk from rating agencies.

Benefits

With this model, we also anticipate greater choice and competition for rating reports, less conflict, and better oversight with more duplication of due diligences. Yes. That is not a misprint. More eyes looking at credit, hedge funds and other things is a good idea.

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