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## New Fixed Income Classifications

A recent FINRA announcement that the traditional method of calculating average portfolio credit quality does not properly reflect true credit risk is having a noteworthy impact on fund companies and reporting firms alike. However, it should also be drawing the attention of plan sponsors.

The traditional calculation assumed that the rate at which underlying securities defaulted was constant, when, in fact, these rates rise exponentially across the credit scale. The new methodology incorporates the non-linear nature of credit risk and has resulted in a lower average credit quality measure for a substantial percentage of fixed income funds. As an example, Morningstar, Inc. has reported that 62% of previously AA rated fixed income mutual funds are now rated A or lower using the new methodology.

The revised statistic offers a better means for fiduciaries to evaluate the fixed income portion of their plans and portfolios, and ensure proper diversification from a credit quality perspective. The change should trigger a review of fixed income investments' original purpose and confirm that they continue to make sense within the overall framework of the portfolio or plan.

The revised measure also impacts performance monitoring and peer group construction, especially within the context of an Investment Policy Statement. Given the general downward movement of the average credit quality measure for most investments, higher quality peer groups will now likely have fewer members and lower quality peer groups will likely have increased membership. Furthermore, better distinction now exists between peer groups that are defined, at least in part, by quality tiers. This may significantly alter performance comparisons for any given investment relative to its Investment Policy-defined peer group, given the dramatic differences in performance that may exist between differing quality-based segments of the market.

It is important that Committees review their Investment Policy Statements to ensure that their fixed income managers are compared to the most appropriate peer groups. The improved-upon measure should provide impetus for fiduciaries to review their fixed income investments with greater transparency than in the past.



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