

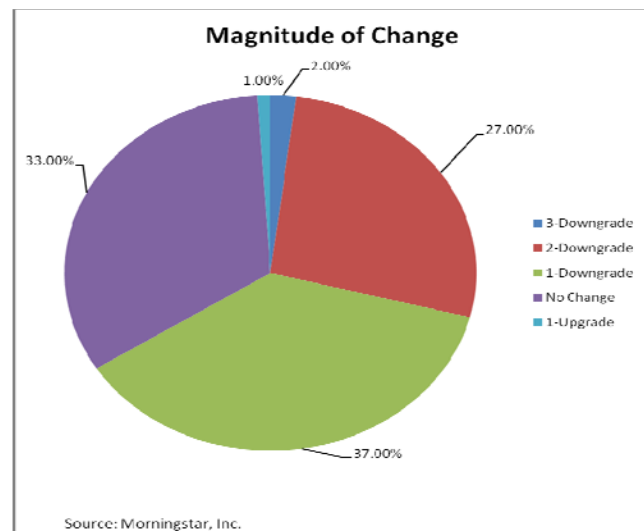
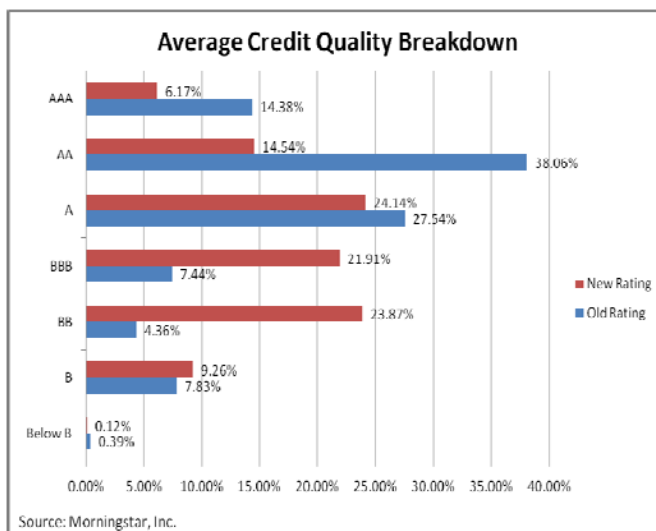
Portfolio Credit Quality Measurement

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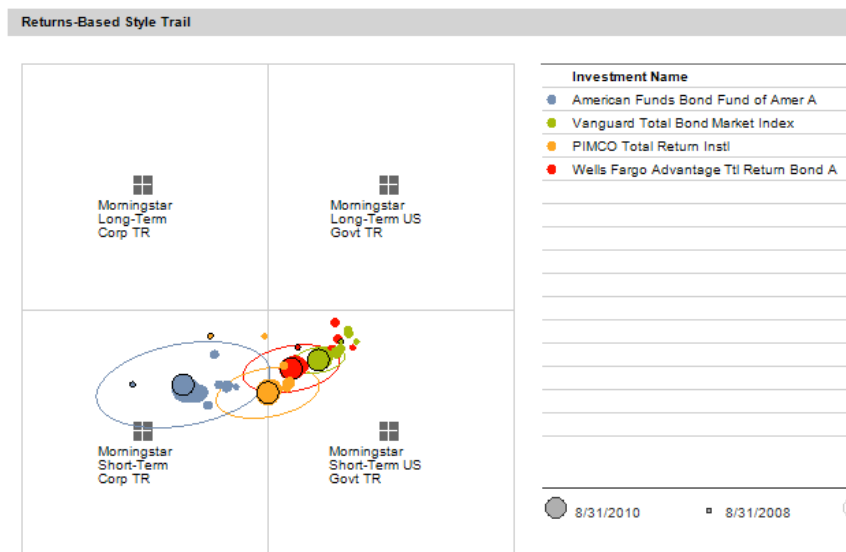
Improvements in Reporting Standards

Tightening regulation prompted by the recent financial crisis has caused mutual fund and reporting companies to rethink how they calculate the average credit quality of a portfolio. This change was spurred by the Financial Industry Regulatory Authority (FINRA), which recently decreed that the traditional method of calculating average portfolio credit quality does not properly reflect its true credit risk. The calculation assumed that the rate at which underlying securities defaulted was constant, when, in fact, these rates rise exponentially across the credit scale. FINRA's recognition of this difference, thanks in part to research conducted by the Securities Litigation & Consulting Group, translated to a decision that marketing materials and reports can no longer publish the average credit quality information using the old methodology.

Mutual fund and reporting companies are responding to this news by adopting a new methodology that better reflects the actual credit risk of a portfolio. At first glance this may seem like a fairly innocuous change, but its ramifications are actually quite significant. An example of the magnitude of change can be seen in statistics received from Morningstar, Inc. According to their initial review, 62% of previously AA rated fixed income mutual funds are now rated A or lower using the new methodology (see charts).



To illustrate that this change represents an improvement compared to the previous calculation methodology, the returns-based style chart to the right depicts four fixed-income funds that previously had an average credit quality rating of AA. As you can see from the chart, the American Funds Bond Fund of America plots considerably further to the left, indicating it has greater exposure to lower quality bonds. The Vanguard Total Bond Market Index and the Wells Fargo Advantage Total Return Bond, which both plot further to the right, have historically had more of a high quality tilt. Under the updated methodology, these two funds still carry a AA credit quality rating, while PIMCO Total Return is now rated A and American Funds Bond Fund of America is rated BBB.



Impact on Plan Fiduciaries

The change in the credit quality calculation has several different implications for plan fiduciaries. First, although fiduciaries may already be aware of the added credit risk a given bond fund manager tends to take on due to their strategy, this updated statistic offers a means to better evaluate the fixed income portion of their plans and ensure proper diversification from a credit quality perspective. This is an opportunity for committee members to take a step back and determine what the objective for the investment was originally and confirm that it continues to fulfill this objective. Also, given this new measure, how does the investment fit in with the overall structure of the plan?

As an example, a bond fund that had its credit quality rating changed from AA to BBB under the new methodology may likely have been unsuitable as a core-plus fixed income investment within a portfolio. On the other hand, this fund may be a strong complement to go alongside a more conservative option that retained its higher rating, providing broader exposure from a credit risk perspective. However, if the plan already utilizes a high yield bond fund, this may actually result in unnecessary overlap, creating overexposure to lower quality issues, depending on the extent of the credit risk that the manager is taking on. These different scenarios demonstrate why it is important for plan fiduciaries to carefully review their fixed income investments and confirm that their plans remain properly diversified from a credit perspective in the context of the new credit quality measures. This analysis should be followed by the implementation of any adjustments needed to ensure proper plan diversification.

Another implication of the calculation change is with regard to performance monitoring and peer group construction, especially within the context of an Investment Policy Statement. The two main factors in determining fixed income peer group construction are typically credit quality and duration. While the duration calculation has remained constant, the change in the credit quality calculation will likely have a significant impact on peer group membership. 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 the performance comparisons for any given investment relative to its Investment Policy-defined peer group.

To illustrate the degree of variation found across the fixed income market's credit quality tiers, note that the Barclays U.S. Aggregate Bond Index, which has an average credit quality rating of AA, produced positive returns of 5.24% in 2008 and 5.93% in 2009. On the other hand, the Barclays U.S. Corporate High Yield Index, which has an average credit quality rating of B, produced equity-like returns of negative 26.1% in 2008, followed by a positive return of 58.21% in 2009. Managers who were investing in a greater percentage of lower quality bonds than their AA rating would have suggested over this time likely had returns that fell somewhere within this range, depending on the extent of the credit risk within their portfolio. The updated credit quality statistics should result in more homogenous fixed income peer groups that account for these types of differences. Therefore, it is important that committee members reassess their Investment Policy Statements to ensure that their fixed income managers are being compared to the most appropriate peer groups, while still taking into consideration any strategy differences that will continue to exist relative to the updated peer group.

In summary, the change in the average credit quality calculation methodology provides investors with a better representation of the level of credit risk inherent in a bond manager's strategy. It is important for plan fiduciaries to reassess their fixed income investments to ensure that, given this updated data, their plans remain properly diversified from a credit risk perspective. Fiduciaries should also take into consideration the impact that this change will have in relation to their Investment Policy Statements, specifically with regard to how any resulting change in peer group membership will affect manager performance evaluation.

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