FORTIFYING INVESTMENT PORTFOLIOS WITH INDEPENDENT RESEARCH

Seven Frequently Asked Credit Process Questions

INTRODUCTION:

In its most basic form, investing is all about understanding and managing risk. For fixed income securities, it's more about managing credit and interest rate risk. And, understanding credit is of particular importance for corporate cash investors whose primary concerns are principal stability and liquidity, while attractive yield potential is often a secondary concern. Understandably, virtually every bond manager professes to be a conservative at heart when it comes to credit risk.

Regrettably, the subprime credit crisis has painted us a very different picture and revealed many false claims. It is now apparent that investment firms large or small, well-known or obscure, were investing in securities with credit quality that was inconsistent with the risk tolerance of their conservative claims of credit philosophy. In retrospect, it was quite clear that some firms had fallen into the all too familiar trap of investing in securities with unproven credit quality, having been temped by the lure of incremental yield.

Lately, the research department at Capital Advisors Group has been fielding a number of questions on our credit philosophy, process, and credit selection criteria. Of course, we cannot claim that "our mouse traps are better", or that "we are smarter". What we are committed to is choosing credits the old-fashioned way, even when it was out of fashion as the credit paradigm perilously shifted to structured finance, credit derivatives, and dynamic hedging.

Without further ado, below are the seven most asked questions we've seen in recent months:

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FREQUENTLY ASKED QUESTIONS

1. What are the objectives of the credit function?

The main credit objective at Capital Advisors is to look for credits with strong credit fundamentals compatible with corporate cash investors. Aside from evaluating an issuer's fundamental credit metrics, we place greater emphasis on assessing its event risk and market risk.

In addition to avoiding credit defaults, we seek credits that provide effective headline risk management, enhanced portfolio liquidity, better risk diversification, minimized market-driven credit losses, and lastly, risk-adjusted yield potential.

Simply stated, "money good" is not good enough.

2. What is your overall credit process?

As "fundamental" credit investors, we use a bottom-up process to identify issuers with strong operating results and financial flexibility. We have a multi-faceted credit research process with an institutional "buy-side" focus, a robust risk management system, specialization in financial institutions, and an objective to manage separate accounts. This is in contrast to cash management units at major financial institutions that rely on credit functions elsewhere in the organization that serve investment banking, pension or money market fund needs.

The process starts with the construction of a strong "buy list" consisting of highly rated issuers which are market leaders with sound financial profiles. We proactively monitor and evaluate these credits through a variety of means that include an early warning system of stock alerts and corporate news, daily tracking of credit rating changes, periodic credit reviews, a maturity scoring system, and a formal committee that is made up of senior managers, traders and the Director of Research. Each corporate name must be recommended by a credit analyst and approved by the credit committee before being allowed in a portfolio. A weekly newsletter communicates to the portfolio managers and traders all relevant credit events in the previous week.

3. How does credit research fit in the firm's investment decisions?

At Capital Advisors, credit research, trading and portfolio management form the "triumvirate" of investment decision making. As portfolio managers work with individual clients according to their investment guidelines, traders search for investments competitively that satisfy portfolio managers' maturity targets with pre-approved credits available in the marketplace.

The discipline of research is about making explicit and timely credit recommendations. Unlike in certain large organizations where analysts are organized by silos and have limited interactions with other investment professionals, the credit research team at Capital Advisors Group works intimately with the other two groups to provide independent, on-the-ground assessments of various investments.

4. What are the research criteria in individual credit selections?

Not relying on broker research, we build our own earnings models and cash flow projections. The results are combined with our secular views of economic and industry trends to reach investment decisions. We establish maturity limits to differentiate our exposure to individual issuers. We also supplement our own research with ratings agencies analysis, third-party research and industry publications.

As we seek to identify investment opportunities, we consider a number of

factors about a given issuer that include:

- industry trends and peer group performance
- market position and product leadership
- profitability, liquidity, leverage and capital investments
- management strength and credibility
- external factors (economic, regulatory, demographic and geopolitical)

Subsequently, we employ a proprietary credit model called LYRICS to address these key fundamental characteristics. The model includes assessment on an issuer's:

- L - prudent financial **Leverage**
- Y - risk-adjusted **Yield** potential
- R - strong brand **Recognition**
- I - consistent **Income** generation
- C - management **Credibility**
- S - strong and defensible market **Share**

5. How do we stay ahead of the credit rating agencies?

We rely primarily on our own credit analysis to reach credit decisions, supplemented by fundamental research from outside sources, including Wall Street firms and rating agencies. We use ratings to establish minimum credit floors and to gauge agencies' credit bias; however, they are only incidental to our credit opinions.

We stay ahead of the rating agencies by being skeptics at heart, examining issuers' projected financial conditions with close scrutiny, monitoring their equity and bond prices as important leading indicators, participating in their earnings calls, attending investor conferences, and playing the "devils advocate" against rating agencies' rating actions and key trends.

6. What type of securities do we try to avoid?

There is a popular saying that there are no bad investments, only bad prices. We believe, however, that there are no wrong investments, only wrong investors. For institutional cash investors with crucial principal preservation and liquidity needs, some investments present greater uncertainty than acceptable regardless of price. We believe many securities that are otherwise sound investments elsewhere are inappropriate for our portfolios.

We take a cautious view toward issuers in cyclical industries with unforeseen liabilities. We are also wary of the so-called “structured finance” issuers, or bonds with derivative features that rely on legal structures or asset collateral to achieve high ratings. We steer clear of new instruments until they are “cycle tested” by economic recessions or market liquidity shocks. Securities with leverage features, including hidden leverages, are also on our list of those to avoid.

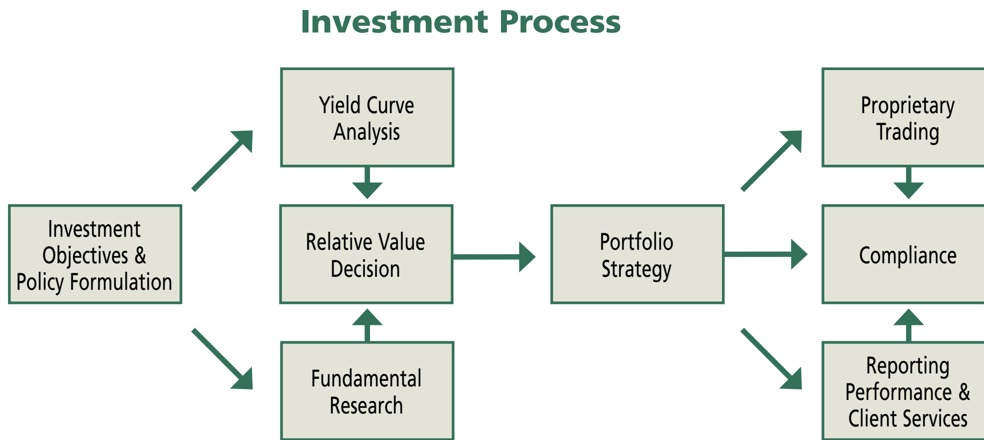
These securities may include subprime mortgage lenders and asset-backed securities backed by subprime mortgages, airline trust certificates, auction rate securities, extendible commercial paper, collateralized debt obligations (CDOs), structured investment vehicles (SIVs), and structured notes.

7. How do we deal with a rating downgrade or an out-of-compliance credit?

Due to credit markets’ dynamic nature, credit events may occur that result in downgrades. In most cases, we fully anticipate a ratings action and will have taken necessary steps to limit or reduce our exposures prior to the events. Rating agencies may downgrade insurers unexpectedly on rare occasions in reaction to sudden events. Our practice is to look to the actual credit events that caused the rating actions reaching a portfolio decision.

Compliance with client portfolio guidelines is our first priority. In rare instances when investments fall out of compliance, we do not hesitate to sell the positions if we deem the situation may worsen before it improves. On other occasions, we may choose to hold the positions until maturity after careful evaluation of the issuers’ fundamentals and the overall credit environment.

Investment Process



Conclusions

The liquid funds industry encountered an unprecedented subprime/SIV crisis last year when problems in the securities they held started to surface. As asset values began to decline and more investors requested redemptions, more than 20 large fund families either sustained heavy losses in their enhanced cash funds, or purchased problem assets from money market funds to prevent them from breaking the psychologically important $1 net asset price.

The perceived high-quality and short-maturity nature of cash investments may have contributed to investors' crisis of confidence. Ironically, a firm's "conservative" philosophy and "sophisticated" credit capabilities were often the selling points in glossy pamphlets used by many large firms. Furthermore, many cash management divisions at large firms that sold to corporate investors did not and do not have dedicated credit research staff of their own.

As we present our responses as to how we analyze credits, we need to stress that these techniques are neither extraordinarily advanced nor complicated. In fact, we believe it is not the techniques that set one firm apart from another in research capabilities, but the commitment to risk aversion which is the true hallmark of conservative credit investing. Since the market's pendulum will perpetually swing between greed and fear, the commitment to a conservative risk culture does not come without a price when the market turns a blind eye to risk. Ultimately, strong credit research cannot be borne from short-term fixes, but from a long-term risk view that what goes around, indeed, comes around.

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