

# CREDIT MATTERS

TAKE IT AS SERIOUSLY AS THE MONEY MARKET FUND INDUSTRY DOES, SAYS DENNIS GEPP

Money market funds (MMFs) are becoming an increasingly important tool for corporate treasurers to have at their disposal when considering how and where to invest short-term cash. The benefits of security, liquidity and yield performance enjoyed by MMF investors are well documented, but perhaps less attention has been paid to the crucial role of credit analysis in the management of MMF portfolios.

Best practice in MMF portfolio construction does not merely involve assembling a portfolio of short-term instruments that meet credit rating agency minimum ratings. Rather, it calls for the rigorous testing of each instrument for robustness of credit quality before an investment is considered.

This article examines MMFs' credit processes in detail and attempts to shed some light on aspects of credit management that are often overlooked or taken for granted.

Managing MMFs requires attentiveness to many factors, including daily cash flows, longer-term cash flow trends in various rate environments, and overall market dynamics. The cornerstone of all this effort, however, has always been a sound portfolio structure and a thorough credit review process.

The objective of proper credit research is simple: to determine whether a security presents minimal credit risk. But evaluating the credit risk requires experience, diligence and attention to detail. Both a commitment of resources

to strong credit work and an environment that fosters teamwork and mentorship are key attributes in MMF management success.

## The people behind the process

To undertake proper credit analysis, you need dedicated research teams comprised of experienced and knowledgeable investment professionals. Each analyst should be assigned to a particular sector or product area, as well as specific types of credit or industries available within that sector/area. This structure gives every analyst an in-depth understanding of the companies in a given sector, the impact of monetary and fiscal policy on an industry, and the behaviour of each sector within a credit cycle. It also allows team members to develop relationships within



the industry that facilitate an understanding of company management. The combination of the analysts' focus on sector with the overarching work of the credit committee creates an environment in which analysts have the freedom to do their own research, but are compelled to present only their best ideas to their peers and to senior management. This ensures the integrity and quality of the research process.

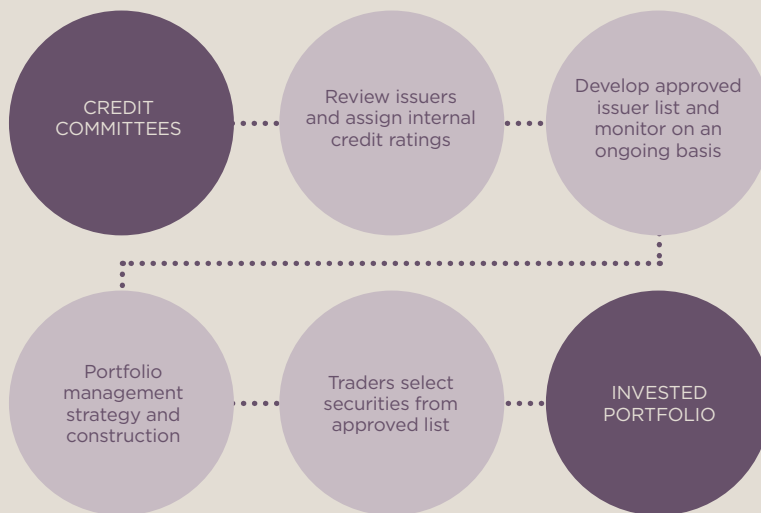
Working closely together, portfolio managers, analysts and traders should support

and implement the intensive credit research process with an objective of successfully managing cash across all market cycles.

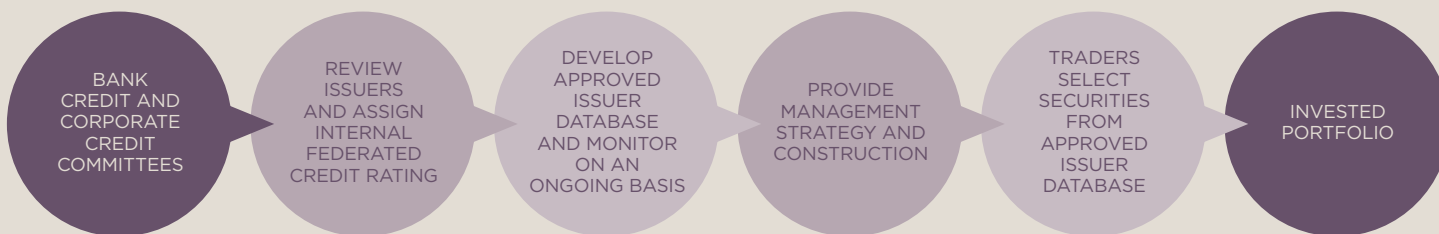
Credit research is really the backbone of the security selection process, and requires experienced individuals, led by a director of research. While the analyst makes a recommendation for rating an issuer, the credit committee ultimately decides whether to approve and assign a rating and to put the issuer on the approved list of securities for purchase and trade. For example, Federated's money market operations have several credit committees, including bank credit and corporate credit, each of which is chaired by a director of investment research and includes two to three portfolio managers and senior analysts.

In formal credit analysis, the committees are charged with reviewing each issuer and assigning an internal rating. They also ensure the continuity and thoroughness of the research process and confirm that the securities in question are acceptable for use in portfolios governed by the Institutional Money Market Funds Association's

## EXAMPLE OF A CREDIT REVIEW PROCESS



## MANAGEMENT OF CASH ACROSS ALL MARKET CYCLES



- ◆ Committees chaired by director of investment research
- ◆ Voting members include portfolio managers, senior analysts and a dedicated team of money market investment analysts

- ◆ Quantitative and qualitative analysts
- ◆ Internal rating scale applied

**Key input:**

- ◆ Financial analysts
- ◆ Industry conferences, publications
- ◆ Wall Street and other third-party information
- ◆ Due diligence meetings

- ◆ Relative value analysts
- ◆ Compliance with CRA, IMMFA and ESMA requirements
- ◆ Average duration of 20-60 days

ratings standards and the European Securities and Markets Authority's criteria for classification as a short-term MMF. In addition to initial ratings and ongoing review of the approved list, the credit committee also reviews any recommendations that a security be upgraded within the rating system.

While the process is formalised in terms of the steps covered, analysts should not be forced to apply a 'cookie-cutter' approach or model to their fundamental analytical process. The methodology outlined above affords each analyst the flexibility to establish an independent thesis on an issuer and, ultimately, a rating.

Initially, an analyst assesses whether or not an issuer warrants an approved recommendation, but the analysis is then refined and an internal rating should be recommended. The money market selection process should ideally be marked by a conservative bias. A notable element of this conservatism is an analyst's ability to downgrade an issuer without committee approval. This is so that negative credit events are immediately reflected in the database of approved

issuers. Also, in most cases, an issuer should be rated by two credit rating agencies in order to be considered for investment – another layer in the conservative approach.

### Technological support

Although the credit research team provides the foundation of the fund selection and management process, its work is integrated and supported through a trading and portfolio management system. This management system is a vital tool to the portfolio manager and provides a powerful compliance screen and audit trail. Any portfolio constraints can be programmed into the proprietary system by product and portfolio. The system flags all questionable trades relative to investment policy and prevents trades that would render the portfolio out of compliance. This approach focuses not only on generating competitive returns, but also on managing risk and providing transparency to the entire investment process.

This intensive, proprietary credit review process, combined with a highly defined and disciplined process of portfolio construction to maximise liquidity and yield, provides

the structure for a business model that is able to adapt to the credit markets during good times and bad.

### Monitoring

Critical as initial coverage of a security is, analysts must also spend a great deal of their time in ongoing analysis and coverage of an issuer. This surveillance should take place through the coverage of major credit events, such as mergers/acquisitions, management changes and credit rating changes.

In addition, quarterly earnings reports and annual reports must be analysed. In terms of work product and communication, analysts should release notes on credit events and quarterly earnings updates to the money market team (other analysts, portfolio managers, traders and senior management), as well as writing industry updates, discussing all companies in a given sector, and outlining major issues facing a group and highlighting trends.

### Flexible friends

MMFs are an exceptionally flexible tool, aiming to provide investors with AAA-rated security, same-day or next-day access, and a good yield.

Accounts should be easy to open, easy to operate and return cash when needed. Among these benefits, however, the first and most important consideration in corporate treasury risk management is security.

When considering investing in MMFs, corporate treasurers can take comfort from the intensive effort applied by MMF managers to ensure that credit risk in their portfolios is kept to a minimum.

Indeed, before opening an account with an MMF, potential investors should examine the manager's credit process as part of their own due diligence.

While a number of factors go into the management of MMFs, it is the arduous preparation of proper credit analysis that provides the foundation for continued long-term success. ↕



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