

Fund Quality Ratings Criteria

Assessing Funds' Investment Processes and Operational Attributes

Master Criteria

Forward Looking Analysis: Fund Quality Ratings (FQRs) provide investors with insights into a fund's investment process and forward-looking drivers of performance. While useful, purely quantitative risk/return performance rankings have inherent limitations due to their reliance on historical return data.

Greater Fund Transparency: FQRs provide transparency for investors through an in-depth assessment of a fund's key attributes and consistency of longer-term returns relative to its peer group and/or benchmarks. Fund Quality Ratings are assigned globally to registered funds and separately-managed mandates.

Three-Pillar Approach: The FQR has three pillars: (1) an assessment of the investment process, its resources and the management company; (2) an operational 'pass/fail' analysis; and (3) a 'reality check' of the qualitative assessment against the manager's historical risk-adjusted performance.

Qualitative Assessment: The Qualitative Assessment focuses on the manager's investment philosophy and processes — including risk management — that drive investment results, the depth and quality of staffing and technology infrastructure supporting the investment process, the management company's experience, financial resources and strategic commitment to the fund. Additionally, the Qualitative Assessment includes an operational analysis as described below.

Operational Pass/Fail Analysis: The operational analysis focuses on the fund's legal, regulatory and operational setup, including pricing, asset segregation, auditor, governance, and transparency. Only funds that are able to pass this review can be rated.

Track-Record Identifies Outliers: For established funds, the historical risk/return performance track record is analysed relative to peers, primarily to identify performance outliers. Fitch uses Consistent Return rankings from Lipper (known as the Lipper Leaders) or comparable performance metrics.

Six Tier Scale: FQRs are presented on a six-tier scale. FQRs of 'Excellent' are assigned to funds with the highest proficiency and strongest resource commitments in key areas of the investment management process, coupled with high, consistent long-term risk-adjusted returns relative to peers and/or relevant benchmarks. Conversely, FQRs of 'Inadequate' are assigned to funds with poor, inconsistent track records and an investment management platform with low proficiency and inadequate resource commitments. Between these two extremes, funds may be rated 'Strong,' 'Satisfactory,' 'Weak,' or 'Qualifying'.

Rating Newer Funds: For funds with a track record less than three years, Fitch Ratings will consider the track record of comparable funds managed by the same team, if the investment strategy is substantially similar. Even so, the ratings may be constrained absent an established track record. For funds without a relevant three-year history (direct or proxy), Fitch may assign an FQR based solely on a Qualitative Assessment of the investment processes and operational set-up, until a full track record is established. Such funds would be denoted as "Qualifying".

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Fund Quality Ratings: A Summary of the Methodology

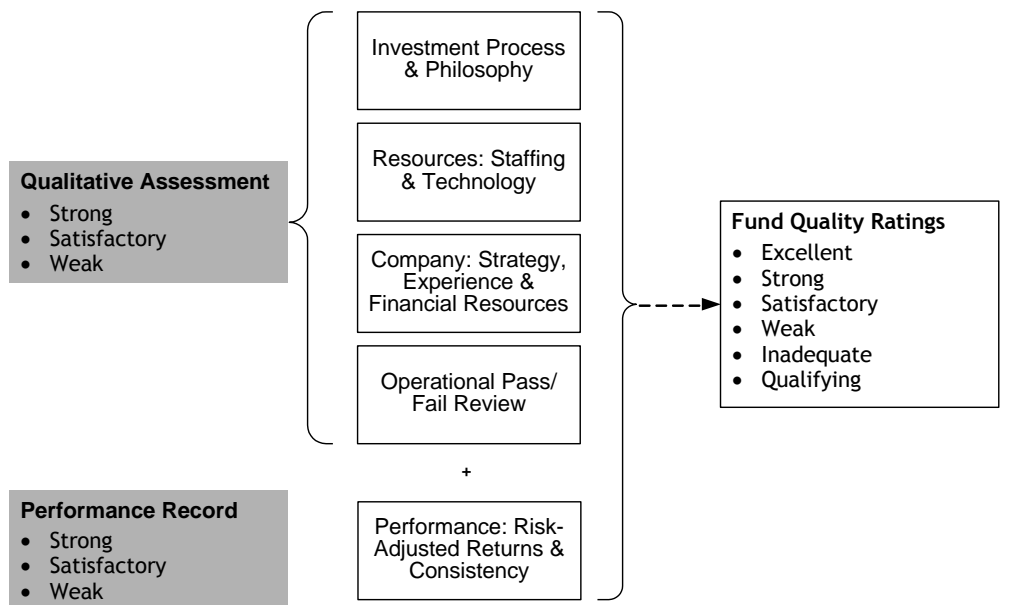
When assigning Fund Quality Ratings, Fitch analyses the core identifiable qualitative drivers that support a fund's performance: 1) investment process (including risk management); 2) the fund manager's staffing and technology, and 3) the fund manager's experience, resources and strategic commitment. When assigning Fund Quality Ratings, the agency analyses fundamental components both individually and collectively.

After conducting its review of the three critical drivers — (i) investment process, (ii) fund manager's staffing and technology, and (iii) the fund manager's experience, strategic commitment and financial resources — Fitch provides a Qualitative Assessment of each individual area and the fund overall as either 'Strong', 'Satisfactory' or 'Weak'. This Qualitative Assessment forms the foundation of the final Fund Quality Rating Fitch assigns (and provides a standalone analysis for newly-established funds).

- The key determinant of a Fund Quality Rating is the Qualitative Assessment of performance drivers.
- The Fund Quality Rating also factors in historical performance, specifically in the case of outliers.
- Fitch's highest Fund Quality Rating is reserved for funds with 'Strong' Qualitative Assessments confirmed by a strong track record relative to its peer group.
- For funds lacking a three-year track-record, Fitch will provide an FQR based only on the Qualitative Assessment, in which case funds are assigned an FQR of 'Qualifying' if they meet minimum operational and qualitative criteria.

Figure 1

Fund Quality Rating Process



Source: Fitch

While the Qualitative Assessment is the key determinant of the Fund Quality Rating, the FQR also factors in the long-term risk-adjusted performance of the fund, specifically in the case of performance outliers.

Funds that have consistently outperformed their peers, benchmarks or target returns over the longer-term and carry a Qualitative Assessment of 'Strong' generally would be rated 'Excellent,' the highest rating available, and those with a Qualitative Assessment of 'Satisfactory' would typically be rated 'Strong.' For funds that have performed closer to the mid-range or average for their peer group, Fund Quality Ratings would reflect the outcome of the Qualitative Assessment and the funds would be rated 'Strong', 'Satisfactory' or 'Weak'.

Conversely, funds that have exhibited poor long-term performance relative to their peers, benchmarks or target returns, are likely to be rated 'Inadequate' or 'Weak'. In cases where substantial, measurable positive change has occurred in the investment processes, even in the face of sub-par performance, the fund may occasionally achieve a 'Satisfactory' rating. (For more information, see Figure 12 on page 12.)

Related Criteria

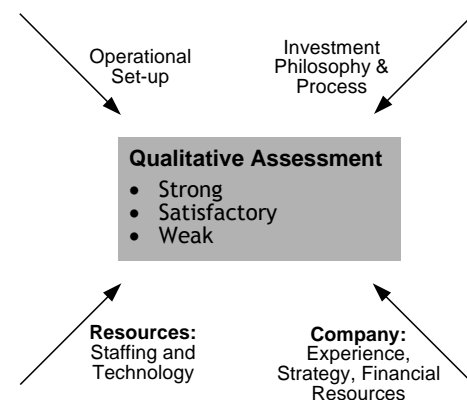
[Reviewing and Rating Asset Managers \(August 2010\)](#)

[National Scale Asset Manager Rating Criteria \(July 2010\)](#)

Whenever available, Fitch will rely primarily on Consistent Return rankings provided by Lipper, a Thomson Reuters company (see www.lipperleaders.com) for purposes of the performance assessment. These rankings, known as the Lipper Leaders, rank funds on a scale of one to five based on their history of providing relatively superior consistency and risk-adjusted returns when compared to a group of similar funds. Fitch may use other information sources as well as internally-calculated measures of risk and returns, when Lipper peer group analysis is unavailable and/or when helpful analytically.

Figure 2

Qualitative Assessment



Source: Fitch

The Qualitative Assessment – Drilling Down to the Details

When analysing the core drivers that support a fund's performance — investment process, resources (staffing and technology) and the management company— Fitch uses a scorecard (see *Appendix D*). The Qualitative Assessment scorecard considers a blend of factors that have been identified as fundamental drivers of fund performance, with an emphasis on the investment processes and resources. The aim is to provide investors with an objective, informed view of the capacity of the fund management company to support the fund's ability to deliver consistent performance relative to peers and/or benchmarks over the longer term. Each category and sub-category is ranked on the three-tier Qualitative Assessment scale of 'Strong', 'Satisfactory' or 'Weak'. These individual component rankings are then combined to arrive at the overall Qualitative Assessment.

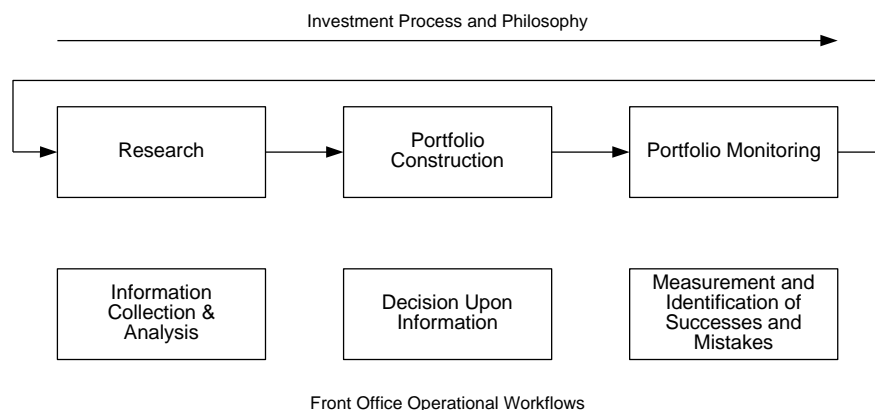
Investment Process

Fitch assesses the discipline, competitive advantages, repeatability and adaptability of the investment process. The primary objective is twofold:

- to determine the consistency with the fund's stated objectives; and
- to identify the key factors driving the fund's performance relative to its peers.

Figure 3

Investment Process Overview



Source: Fitch

As part of its assessment, Fitch meets with senior management and investment professionals — in particular, the fund's portfolio manager (PM) — and reviews investment documentation. The principal areas of focus are:

- the investment process/philosophy;
- research and informational competitive advantages, if any;
- investment decision-making and portfolio construction;
- portfolio monitoring;
- front-office workflow.

Investment Process and Philosophy

Fitch reviews the transparency and consistency over time of investment style and philosophy, and how this reconciles with performance results and performance attribution. Information is derived from interviews with key portfolio management functions as well as process presentations, answers to requests for proposal or reporting to investors and other fund-related documentation. When considering the investment process, Fitch takes into consideration any drift in the investment style or approach.

Fitch seeks to understand whether the investment approach has been tested in one or more market cycles, particularly more volatile environments or in periods of high fund inflows/outflows. Changing market conditions may require a modified strategy and focus. When such modifications occur, the degree to which they are the result of a well-articulated reasoned decision-making process is considered.

Figure 4

Investment Process and Philosophy Attributes

Strong	Clearly defined and consistently executed investment philosophy and process that have identifiable competitive advantages and have been tested and refined through one or more market cycles. Sources of performances are clear and consistent with stated strategy with minimal style drift.
Satisfactory	Reasonably well-defined and consistent investment philosophy and process, but may not have been fully tested through one or more market cycles. Acceptable, occasional style drift away from core stated investment philosophy.
Weak	Poorly defined investment philosophy and process and/or recent material changes to philosophy and process that remain untested over time and market cycles. Sources of performance unclear or highly opportunistic with significant style drift over time.

Source: Fitch

Research and Analysis

Fitch assesses the quality and relevance of the research inputs and outputs, the breadth of the investment universe and the depth and timeliness of the analytical approach — quantitative or qualitative, micro or macro — to understand how they fit within the general investment process of the fund.

Research capabilities are assessed in relation to the fund's investment focus. For instance, Fitch expects an equity fund managing concentrated portfolios of "best ideas" to clearly emphasise the depth of its analysis on stocks. By contrast, an equity fund that is managed as a benchmarked portfolio is expected to have extensive coverage — through quantitative modelling, for example — of the stocks included in the relevant index.

Regardless of the form that analytical opinions and recommendations may take, Fitch seeks to understand the extent to which these are based on clearly established methodologies as opposed to more ad hoc decision-making, and are consistently documented and communicated. The quality of the information flows between the research and portfolio management functions, when they are separated, is also a critical area of focus.

Investment process and philosophy is assessed for:

- Transparency and clarity;
- Consistency with fund's stated objectives;
- Style drift.

Figure 5

Research Attributes

Strong	Very disciplined research process supported by a documented methodology with deep analysis using multiple and original information sources. Full coverage of investment universe. Cross-asset research or high integration between available research resources with focused idea generation and consistent outputs. High integration between research and portfolio management.
Satisfactory	Reasonable well-disciplined research process that is adequately documented. Adequate coverage of investment universe. Research and analysis judged to be satisfactory as evidenced by information sources, processes and outputs. Interaction between research and portfolio management is effective, although not highly integrated.
Weak	Research not properly identified as a core function in the investment process, with lack of formalisation as evidenced by outputs or organisational structure. Gaps in investment universe coverage. Analysis is superficial, relying on standard information sources and with some coverage limitations. Research process ad hoc or poorly linked to portfolio construction and investment execution.

Source: Fitch

Portfolio Construction and Decision-Making

The portfolio construction and decision-making process is assessed by four main aspects as follows.

- The portfolio construction and decision-making process is defined by four main aspects.
- The Qualitative Assessment of the portfolio construction process focuses on sources of risk and return.

- Incorporation of research outputs: Investment decisions should be effectively supported and in line with research opinions. Clearly structured and documented processes allow repeatability, consistency over time and an effective investment review feedback loop.
- Discipline for buy and sell decisions: Investment decisions should be well formulated, reasoned, disciplined and challenged. Investment approval and portfolio review processes should adhere to policies and demonstrate well identified, rational drivers to buy and sell decisions.
- Portfolio construction and risk considerations: Diversification and risk management considerations may be instrumental to buy and sell decisions, position sizing, asset allocation and the resulting portfolio risk profile. Fitch considers the diversification of sources of risk and return and whether the portfolio offers attractive risk-adjusted returns with controlled exposure to downside risk.
- Trading: Focus on access to market, trading (best) execution and strategies as a source of return for the fund.

Figure 6

Portfolio Construction and Decision-Making Attributes

Strong	Very disciplined decision-making process balancing the need to take all inputs into account with the need for strong decision-making and leadership. Strong ownership of decisions at all levels as well as adaptability to changing market conditions. Strong ability to execute portfolio decisions clearly based on portfolio construction rules that incorporate risk targets. Very good access to market and strong trading capacities.
Satisfactory	Disciplined decision-making process with occasional leadership issues such as weak forms of consensus decision-making or reliance on one or two people. Reasonable adaptability to changing market conditions. Risk management and portfolio monitoring processes suitable for managing risk in more volatile markets but may lack some reactivity. Standard access to market and fair trading capacities.
Weak	Some inconsistency in decision-making process and/or frequent leadership issues in the form of weak consensus decision-making or excessive reliance on one or two key people. Portfolio construction philosophy often challenged by changing market conditions, and portfolio construction rules and limits are judged to be fairly simplistic.

Source: Fitch

Portfolio Monitoring and Measurement

Fitch assesses the timeliness, scope, depth and effectiveness of portfolio monitoring, and whether adjustments or adaptations to portfolio construction are made in a timely fashion. The evaluation focuses to the extent relevant for a particular fund on:

- profit and loss (P&L) and performance (versus peers, market indices and objectives);
- exposure and concentrations;
- sensitivity to market risk factors;
- risk estimation techniques (value-at-risk, scenario analysis and stress testing);
- risk budgeting;
- liquidity (asset and liability) risk;
- credit and counterparty risk; and
- other risks (forex, optionality, prepayment/extension risk, basis risk).

For each of these areas, Fitch considers the coverage and appropriateness of the indicators followed by the manager, the adequacy of measurement techniques, and whether explicit and meaningful limits are in place. An important consideration is the level of discipline in risk taking and monitoring in comparison with the fund's stated risk appetite.

The frequency and depth of reviews and follow-up actions are evaluated to determine the degree to which they facilitate proactive portfolio adjustments in response to changing market conditions. Fitch looks for a robust risk management framework that is integrated with the investment process and controlled by risk managers or other senior executives that are sufficiently independent from the investment function and influential at the organisational and decision-making levels.

Figure 7

Portfolio Monitoring Attributes

Strong	Frequent and formalised monitoring process, distinct from decision-making process with proper and independent oversight. Holistic coverage of portfolio performance drivers and risk factors with numerous indicators and dynamic analysis in absolute and relative terms. Key metrics and analysis available on-demand. Disciplined follow-up process.
Satisfactory	Monitoring process based on formalised reports and incorporated into decision-making process (eg in investment committee). Good oversight by head of desk with focus on main performance and risk indicators. Coverage of most of the important risk and performance parameters in absolute and relative terms with regular production of key metrics and analysis. Less formalised but effective follow-up process.
Weak	Monitoring process concentrated at portfolio manager level without formalised oversight. Oversight process may not allow for monitoring of key performance and risk indicators by limiting coverage to performance and hard dollar exposures. Insufficient follow-up processes.

Source: Fitch

Operational Front-Office Workflows

Fitch reviews the robustness and efficiencies of front-office operational processes, including the effectiveness of controls associated with the execution of a fund's investment process. For example:

- order entry and management;
- portfolio rebalancing;
- replication of model portfolio (if any) in real portfolios;
- cash and currency management;
- systematic hedging; and
- net asset value (NAV) and P&L validation.

As part of this assessment, Fitch considers the extent to which investment professionals are able to remain focused on their primary objective — effective portfolio management — while ensuring full operational security.

Figure 8

Operational Front-Office Workflow Attributes

Strong	Front office operational processes are highly streamlined given the fund's core asset class and strategy. Manual interventions are kept to a minimum. Key front office processes have automated controls embedded.
Satisfactory	Core front office operational processes are well automated, although manual interventions exist for non-core processes or certain assets. Automated controls cover critical processes and coverage is not exhaustive, requiring manual or semi-manual checks.
Weak	Core front office operational processes are not streamlined and impose administrative burden on investment professionals. Manual interventions are the norm and controls are mostly manual.

Source: Fitch

The Qualitative Assessment of staffing resources focuses on:

- The team's organisation;
- People skills and experience;
- The team's capacity;
- Staff turnover.

Resources — Staffing and Technology

Fitch reviews the depth and breadth of resources to determine whether they are adequate to support the fund's stated investment process. The focus is on the front-office staffing and technology platform.

Staffing

In a people-driven business such as investment management, a key determinant of performance is the skill level, experience and organisation of staff relative to the fund's management requirements. The main areas of focus are as follows.

- **Team organisation:** Fitch assesses whether the team's functional organisation allows it to effectively implement the investment process, promotes efficient coordination and oversight, and maintains accountability and clear segregation of tasks. The agency reviews the various structures, roles and responsibilities of investment teams and their interactions, whether any key person dependencies exist and back-up arrangements. Overall, Fitch views positively clearly structured organisations that find a balance between specialisation of staff and flexibility.
- **Individual skill sets and experience:** Fitch evaluates objective measures, by reviewing the backgrounds and previous roles of relevant staff. Specifically, the agency assesses how much relevant experience they have, individually and collectively, their length of tenure with the company, the range and relevance of available skill sets and their prior track records. This assessment covers each functional group involved in the fund's management, with a particular focus on portfolio managers and analysts to determine the match between their expertise and experience with the fund's management profile. Fitch's evaluation of investment experience is based on its depth (ie across the cycle) and relevance to the fund (ie sector/ market coverage and type of portfolios/ strategies previously managed).
- **Turnover:** Staff turnover is reviewed to determine the level of staffing stability, with a particular focus on the stability of the investment team, as this is key to the investment process and performance continuity over time. Fitch also explores the organisation's strategies to recruit, retain, incentivise and develop its personnel, particularly for rapidly expanding businesses or through downturns.
- **Capacity:** Depending on the organisational structure and how duties are distributed among staff, workload indicators — such as the number of names per analyst or accounts per portfolio manager, and trading or transaction volumes — can be useful in assessing the adequacy of staffing resources.

Technology

Fitch assesses an organisation's technology resources to determine how closely they match the fund's needs, as determined by its objectives and constraints, types of underlying assets and investment universe, and whether this allows for efficiency/security in portfolio

Fitch's Qualitative Assessment of technology resources focuses on:

- Systems functionality and coverage;
- Access to data;
- Automation and integration;
- Development and maintenance.

management activities. The focus is on technology that directly supports the investment process.

The main areas of focus are as follows.

- **Functionality and coverage:** The systems are assessed on how they help support the fund's investment process, given current and projected volumes. As such, the focus is on the flexibility, adequacy and scalability of systems that are central to the fund management function: portfolio management and trading systems, analytics (monitoring, performance and risk) and research models. Often, a demonstration of these key systems will help shown how much the capabilities are actually being used and what gaps may exist in their coverage.
- **Access to internal and external data:** Fitch considers the coverage, centralisation and scalability of the databases used in the organisation, as well as the procedures in place to collect, analyse, control and report portfolio and market data. Reporting and data accessibility will also be evaluated, with a particular focus on how flexibly they can be used in the fund's management.
- **Automation and integration:** Beyond the quality of individual systems and databases, Fitch focuses on the level of integration achieved between components and external applications. The degree of manual interfacing and the capacity to properly and effectively manage workflows are good indicators of the level of integration achieved. Integration can take many forms but, in all cases, it should minimise operational risks while maximising efficiency.
- **Development and maintenance:** Fitch reviews the systems maintenance, development and replacement procedures to assess the capacity of the fund house to continuously enhance the IT environment offered to investment professionals.

Figure 9

Resources Attributes (Staffing and Technology)

Strong	The fund is supported by a very clear and stable organisation. Investment professionals are particularly experienced in the relevant asset class and investment strategy. Lead PMs demonstrate a very long tenure in the management of the rated fund. The overall staff supporting the fund exhibit particularly high stability (minimal turnover), depth and the management company shows a strong ability to attract, retain and train staff. Front-office systems (order management, portfolio management) offer high flexibility and scalability and match current and future needs. Analytical systems (risk management, performance or style analysis) provide investment professionals with on-demand and rich information on an integrated, easy to access basis.
Satisfactory	The fund is supported by a clear organisation with well-identified areas of responsibilities. Key investment professionals are adequately experienced in the relevant asset class and investment strategy. Lead PMs demonstrate an adequate tenure in the management of the rated fund. The overall staff supporting the fund exhibit adequate depth and stability at a senior level, albeit with some moderate levels of turnover among investment staff. The management company shows an average ability to attract and retain staff. Front-office systems offer adequate flexibility and scalability and match current needs, while analytical systems offer adequate coverage.
Weak	The organisation behind the fund lacks clarity and/or exhibited recent instability. Investment professionals' experience lacks depth in the relevant asset class and investment strategy or lead PMs have recently taken over management of the rated fund. The overall staff supporting the fund lack depth and / or have suffered from particularly high turnover and/or the management company fails to attract, retain and train staff. Front-office systems lack flexibility and/or scalability and analytical systems are inadequate.

Source: Fitch

Company — Experience, Strategic Commitment and Financial Standing

Fitch evaluates the organisation's stability, sustainability and ability to provide a favourable environment to meet the stated performance objectives of the fund. For management companies that maintain a Fitch Asset Manager Rating (see *Appendix B* for a comparison of

Company stability and sustainability is assessed through:

- Ownership and organisational structure;
- Financial strength;
- Institutional experience;
- Strategy and commitment to maintain market presence.

Fund Quality Ratings and Asset Manager Ratings), Fitch will place heavy reliance on the Asset Manager Rating and its underlying analysis when assessing the management company.

For the purpose of the Fund Quality Rating, the main areas of focus are as follows.

- **Ownership and organisational structure:** The relationship between the company, its sponsoring entity (if any) and the fund's business unit is examined to understand the interrelationships of the fund, the manager management company and the parent. The agency reviews the history of support provided by the shareholders to the asset manager and/ or the asset manager to the fund's business line. Fitch views positively shareholding and organisational structures that have demonstrated they can adapt to changing environmental and business priorities while preserving overall stability over time.
- **Financial strength:** Fitch reviews the financial statements of the company to assess its long-term viability. The focus is on evaluating the working capital requirements and profitability of the organisation. The agency aims to understand whether the company can afford to maintain resources and to make investments for the ultimate benefit of the fund.
- **Company's investment experience:** Fitch determines the tenure of the company in asset management, management of the fund's underlying asset class, strategy and vehicles, relative to its peers. Length of experience is complemented by a review of its quality in breadth, depth and relevance for the fund. Fitch views positively companies that witnessed a full market cycle and that have incorporated in the fund management process lessons from investment experience.
- **Market presence, strategy and commitment:** The importance of a fund to an organisation is largely a function of the company's presence in and strategic commitment to the fund's markets. Fitch evaluates the significance of the fund for the company, as indicated by its market share as well as the share of the firm's AUM and revenues represented by the fund's asset class. It also examines the nature of, and ability to retain and develop the targeted investor base of the fund.
- Finally, the above factors are considered in connection with clarity, adequacy and execution of the firm's strategy and recent and foreseeable changes.

Figure 10

Fund Management Company Attributes

Strong	The management company and its parent/sponsor (if any) demonstrate a strong commitment to the asset management business. Their financial resources are solid, allowing it to invest in the business and fund key initiatives. The management company has a long, established tenure in the investment management business and with respect to the fund's asset class. The management company and its parent/sponsor have weathered market cycles and proven to be resilient and adaptive to challenges. They demonstrate a strategic commitment to the fund and have a strong market presence in the asset class.
Satisfactory	The management company and its parent/sponsor (if any) have a reasonably well-established track record in the asset management business. Their financial resources are sufficiently stable to support critical investments in the business. The management company manager's tenure in the investment management business is reasonably well established with respect to the fund's asset class. The tenure of the management company may be somewhat shorter and therefore they may not have been tested through a full market cycle. They appear to be strategically committed to the fund and the asset class.
Weak	The management company and its parent/sponsor (if any) have a limited track record in the investment management business or exhibit corporate instability with respect to organisation or strategy. Their financial resources are uncertain or insufficiently stable to ensure critical investments in the business. The management company's tenure in the fund's asset class is short or non-existent, making it difficult to assess investment acumen and strategic commitment.

Source: Fitch

- The legal, regulatory and operational set-up involves an analysis of the fund's main service providers, its regulatory framework and oversight, governance practices, control processes and transparency.
- Funds whose operational platforms are deemed to be "inadequate" are not assigned a Fund Quality Rating.

- The analysis of historical risk-adjusted performance serves as a Fund Quality Rating input, particularly to adjust for performance outliers.
- Historical performance is evaluated using Lipper Leaders for Consistent Returns or comparable performance metrics of risk-adjusted returns relative to peers or investment benchmarks.
- The analysis is meant to identify funds with strong consistent long-term track records as well as those with weak or inconsistent track records.

Pass/Fail — Operational, Legal and Regulatory Analysis

The legal, regulatory and operational environments in which funds operate are not uniform. Depending on the jurisdiction, funds may operate with very different levels of investment regulations, governance and investor protection. Within a particular jurisdiction, funds may also operate under different standards. Before assigning a Fund Quality Rating, Fitch analyses each fund on a "pass/fail" basis to see if the overall legal, regulatory and operational framework is sufficiently robust. The main factors reviewed by the agency are listed figure 11.

Only funds that are able to pass this review can be rated. Should concerns arise as to the legal, regulatory and operational aspects of an already rated fund, the Fund Quality Rating could be downgraded and potentially withdrawn, if the review leads to a "fail" status.

Historical Risk-Adjusted Performance — Adjusting for Performance Outliers in the Fund Quality Rating

Funds with superior investment processes stand a better chance of meeting their objectives or outperforming peers over the long term. Consequently, Fitch's Fund Quality rating is primarily based on the assessment of the fund management company's processes and resources.

However, while having a superior investment process is desirable, Fitch also recognises that the most compelling evidence of whether a fund effectively achieves its investment strategy are the long-term risk-adjusted returns it produces relative to the risk-adjusted returns of similar funds, benchmarks or targets. Consequently, the long-term risk-adjusted performance of a fund is factored into the Fund Quality Rating as an overlay, notably filtering and adjusting for outliers (ie funds in the top or bottom performance quintile).

As mentioned in the methodology summary, whenever available, Fitch relies primarily on Consistent Return ratings provided by Lipper for its performance inputs. The Lipper Leaders rank funds on a scale of 1 to 5 based on their history of providing relatively superior consistency and risk-adjusted returns when compared to a group of similar funds.

Figure 11

Standards for Operational "Pass/Fail" Screen

Risk areas	Standards	Potential areas of concern
Administrator, custodians, prime brokers, auditors	Known entities, clear and stable relationships, clear and standard delegation framework, no or only rational changes — segregation of assets	<ul style="list-style-type: none"> • Lack of segregation of assets • Management company Fund/manager custodies its own assets (ie no independent custodian) • Fund's (master or feeder) audit firm/administrator or other third party unknown to investment community
Regulation and governance	Existence of an adequate governance structure through regulation, governing bodies of the fund, controls and/or audits	<ul style="list-style-type: none"> • Material litigation/regulatory sanctions against the fund, company or PMs • Absence of regulatory body, controls/audits
Valuation	Clear responsibility, established pricing policy, robust sources	<ul style="list-style-type: none"> • Management company Fund/manager values own assets (ie no independent pricing agent or department with proper policy and separate reporting line) • Stale pricing • Highly illiquid, difficult to value assets
Fund terms	Clear and standardised terms, avoiding conflicts of interest — adequate redemption terms given investment universe and strategy	<ul style="list-style-type: none"> • Fund purpose is not "third-party asset management" • Materially atypical fee structure (eg no management fees) or atypical redemption terms • Redemption terms inconsistent with investment strategy • Unequal or preferential treatment of certain shareholders
Conflicts of interest	Absence of conflicts or procedures to mitigate conflicts of interest with other activities and investment positions of the management company and its affiliates	<ul style="list-style-type: none"> • Management company Fund/manager trades through affiliated broker/dealer without control procedures
Transparency and reporting	Adequate content and frequent, timely delivery of investor reporting. An ability and willingness to offer transparency to investors	<ul style="list-style-type: none"> • Fund and/or management company misrepresented in marketing documentation (vs. legal documentation) • Black box investment strategies

Source: Fitch

Funds that achieve high ratings for consistent return may be the best fit for investors who value a fund's year-to-year consistency relative to other funds in a particular peer group. While Fitch looks at a fund's consistent return rating for every period available, the focus is primarily on the longer term (three to five years). The agency generally looks at the returns and rankings of the lowest fee share class (eg institutional share class).

Where a peer group is difficult to define or where otherwise considered helpful analytically, Fitch may utilise other information sources as well as internally-calculated measures of risk and returns, such as the Sharpe ratio (for funds with absolute return objectives) or information ratio (for funds benchmarked against market indexes), relative to an appropriate peer group. In all cases, the goal is to compare the fund's performance to a relevant peer group, benchmark or the fund's target absolute returns to assess how well it has been managed over the longer term relative to its investment strategy.

Figure 12

Adjustment for Performance Outliers

Qualitative Assessment ranking	Typical adjustment for strong track record ^a	Typical adjustment for weak track record ^b
Strong	To 'Excellent'	To 'Satisfactory' ^c
Satisfactory	To 'Strong'	To 'Weak'
Weak	No uplift	To 'Inadequate'

^a Strong track record: Funds with a minimum five-year track record and that are in the top quintile (top Lipper Leader Consistent Return rating or what Fitch deems as equivalent) over a cumulative period of five years

^b Weak track record: Funds in bottom Lipper Leader Consistent Return rating category or what Fitch deems as equivalent over three or five years

^c May achieve 'Satisfactory' if substantial positive change has recently occurred in the investment process

Source: Fitch

Funds with a 'Strong' track record typically will be those that have been in the top quintile (top 20%) over a cumulative period of five years or more based on their Lipper Leader Consistent Return rating, while a 'Weak' track record is assigned to funds in the bottom Lipper Leader ranking over cumulative periods of three or five years, whichever is more relevant. Notably, this adjustment for historical track record creates a conservative bias in the ratings distribution.

As part of the adjustment process, Fitch seeks to avoid placing undue emphasis on historical track records derived from materially different investment strategies or processes. To do so, the agency reviews performance analysis (eg performance attribution) and historical evolution of portfolio metrics or allocation, to identify if the historical performance exhibits any style drift or has been derived from performance drivers that are not part of the current investment strategy.

For example, an equity fund pursuing a stock-picking strategy could have historically benefited from investments in option arbitrage strategies, areas in which it is no longer investing, as per its investment strategy. In cases where the track record is deemed inconsistent with the current strategy, Fitch will discount the historical performance and apply conservative adjustments when assigning Fund Quality Ratings.

Treatment of Funds Lacking Track-Record

For a fund that does not have a three-year track record but that completely clones an existing fund, Fitch will consider the track record of the original, cloned fund.

For a newer fund which is not a clone of an existing fund with a three year track record, Fitch may also decide to consider the track record of a comparable fund. In order to do so, the fund's key investment decision makers and the decision making processes should be substantially the same as that of the comparable fund and the comparable fund should have at least a three-year track record. Nevertheless, the ability to achieve Fitch's highest rating may be constrained.

Fitch may also evaluate newly-launched funds with new or relatively unproven investment strategies. For example, a European long-only equity fund manager may launch a long-short UCITS fund or a traditional balanced investment process may expand to include a multi-asset absolute return strategy. Likewise, a hedge fund manager may launch an on-shore vehicle with an investment strategy that has been revised in a material way to meet UCITS regulations.

In the absence of a clone or comparable fund, Fitch may decide that it can assign an FQR of 'Qualifying'. In order to do so, the fund and its management company must be judged by Fitch to be at least 'Satisfactory' under Fitch's Qualitative Assessment.

The treatment of new funds is summarised in the table below.

Figure 13

Treatment of New Funds (Less than Three-Year Track Record)

Existence of a clone fund	Fitch will consider the track record of the clone fund in its analysis.
Existence of a comparable fund but no clone fund	Fitch may consider the track record of the comparable fund in its analysis but the ability to achieve Fitch's highest rating may be constrained.
Absence of either a clone fund or comparable fund	Fitch may assign an FQR of 'Qualifying' if minimum qualitative and operational criteria are met.

Source: Fitch

What Can Trigger a Rating Change?

Based on the ongoing surveillance of the fund and the organisation (see below), Fitch can take rating actions, if factors detailed in this report are materially affected. Nevertheless, before taking any action, the agency would review the changes and assess whether the capacity of the fund to achieve its objectives and outperform peers is structurally modified. During this period, funds' ratings are put "under review".

Circumstances that would generally trigger a review include:

- departure of the portfolio manager or any key investment professional;
- corporate changes (merger, spin-off);
- material change to the investment process (philosophy, models, inputs, scope);
- material style drift as measured by fund market sensitivities or allocation;
- material evolution in track record as measured by fund rankings or risk-adjusted returns; and
- material market evolution affecting a fund's asset class or strategy.
- Material event affecting the company or its staff (fraud, litigation, loss).

Rating Process Overview

Fitch's Fund Quality Rating review process is designed to assess relevant information, consistently apply criteria and uniformly disclose the agency's rating rationale. The process incorporates five stages, as illustrated in the diagram below and described in the following section.

Requested Documentation

Prior to the on-site review, the asset manager of the fund is asked to provide a set of documents — as outlined in *Appendix C* — designed to capture fund-related as well as organisational, investment process and personnel-related information. This information is reviewed to create an agenda for the on-site review.

On-Site Review

The on-site review allows Fitch to clarify and refine its understanding of the fund's drivers of performance and investment processes.

Generally lasting half a day, it consists of interviews with:

- executive management (if involved in the management of the fund being rated);
- portfolio managers and traders (including lead portfolio manager(s));
- research teams;
- risk management;
- product specialists.

In addition, the agency requests system demonstrations and assesses the environment of direct portfolio managers through an "on desk" visit.

Analysis

In an effort to apply its methodology as consistently as possible and minimise subjective variations in evaluating fund characteristics, Fitch uses a scoring approach to make its qualitative determinations. Each factor within Fitch's analysis is categorised as 'Strong', 'Satisfactory' or 'Weak'. The final overall fund-level Qualitative Assessment is derived from the average as well as the distribution of the scores assigned to the individual factors. For example, only funds with a majority of 'Strong' scores and no 'Weak' scores may be assigned a 'Strong' Qualitative Assessment. The Qualitative Assessment is then adjusted to reflect historical risk-adjusted performances as explained above.

Ratings Assignment and Monitoring

All Fund Quality Ratings are determined by a rating committee. The committee, composed of on-site visit attendees and other senior analysts, reviews and discusses the recommended rating, the scorecard results, the rating rationale and the track record.

FQRs assigned by committees are followed by rating commentary and a rating report typically published on the agency's free website, www.fitchratings.com. The reports provide a profile of the fund and personnel, processes, resources and operations and a summary of the rationale.

All Fund Quality Ratings are actively monitored. Surveillance is based on dialogue with the fund manager and analysis of third party information sources, including information on:

- relevant corporate activity (M&A, litigation, etc);
- material staffing changes, ie change of PM;
- changes in the performance of the fund or asset class; and
- material shifts in the fund's or management company assets under management.

Fitch will review the funds' key performance metrics periodically, relying on recognised data providers such as Lipper and standard investor reporting as well as summary statistics on the fund's portfolio.

Criteria Scope and Limitations

The primary focus of this criteria report is on funds that are actively managed for third-party investors and rely on a defined investment process and seek to outperform their investment peer group and/or target benchmarks.

Users of ratings should be aware of the general limitations on the nature of the information that rated entities or their agents make available to Fitch. In issuing and maintaining Fund Quality Ratings, Fitch relies on factual information it receives from fund managers or sponsors and from other sources the rating agency believes to be credible (including Lipper). When assigning

Fund Quality Ratings, Fitch does not perform due diligence but conducts a reasonable investigation of the factual information relied upon by it in accordance with its rating methodology and may obtain reasonable verification of that information from independent sources (eg. auditors or regulators), to the extent such sources are available for a given fund or in a given jurisdiction. Fund managers may choose not to share certain information with external parties, including rating agencies, at any time. While Fitch expects that each manager that has agreed to participate in the rating process will supply promptly all information relevant for evaluating the ratings of the fund, Fitch neither has, nor would it seek, the right to compel the disclosure of information by any agents of the fund.

Fund Quality Ratings may not incorporate “event risk”. Event risk is defined as an unforeseen event which, until the event is known, is not included in the existing ratings. Prominent event risks for funds include sudden, dramatic and unexpected changes in financial market prices or liquidity, adverse regulatory decisions, litigation, redemptions, fraud or other unforeseeable breakdowns in control and governance, among others.

Fund Quality Ratings involve an assessment of historical risk-adjusted performance based primarily on net returns. To limit distortion from fee levels, Fitch generally considers the lowest fee share class. As such, Fund Quality Ratings will not directly factor in the extent to which a higher fee share class’s expense structure deviates from historical norms and, therefore, may reduce future returns and distributions to a shareholder class. Differences in tax regimes may also influence the actual, after-tax returns that investors experience.

The ratings do not predict a particular investment outcome or a particular risk-adjusted return. As they are relative within a given peer group, Fund Quality Ratings are not comparable across peer groups. For example, a ‘Strong’ rated emerging market fund may be intrinsically more volatile than other sector funds at the same ratings level.

Fund Quality Ratings are not credit ratings nor are they intended as inputs to credit ratings. Therefore, any attempt to compare Fund Quality Ratings with credit ratings in their ratings levels, transition rates or other traditional “performance metrics” would not be appropriate.

The FQRs are not and should not be construed as an investment recommendation. They should be viewed as one of many potential inputs into an investor’s decision-making process. The FQRs do not opine on the fund’s liquidity or the market value of its assets.

Appendix A: Fund Quality Ratings Definitions

A Fund Quality Rating provides an in-depth assessment of a fund's key attributes and consistency of longer-term returns relative to its peer group and/or benchmarks. Key areas analysed in determining the rating include (1) investment philosophy and processes (including risk management), (2) resources supporting the investment process (staffing and technology), and (3) the investment manager's strategic commitment, experience and financial resources. In addition to this "front office" analysis, an operational "pass/fail" review of the fund's regulatory and control framework is undertaken to assess whether key aspects of the operational environment are sufficiently robust. Collectively, these qualitative factors are used to derive a Qualitative Assessment on a scale of 'Strong,' 'Satisfactory,' or 'Weak.' Fund Quality Ratings are assigned on the basis of this Qualitative Assessment and, for all FQRs other than 'Qualifying', in combination with an analysis of the fund's historical risk-adjusted performance relative to its benchmarks and/or sector peers, specifically to identify and adjust for performance outliers.

'Excellent'

'Excellent' Fund Quality Ratings are assigned to funds that demonstrate, in Fitch's opinion, the highest proficiency and strongest resource commitments in key areas of the investment management process and have delivered high, consistent long-term risk-adjusted returns relative to peers and/or relevant benchmarks. The management company's investment processes and resources strongly support the fund's ability to deliver high, consistent performance relative to peers over the longer term.

'Strong'

'Strong' Fund Quality Ratings are assigned to funds that demonstrate, in Fitch's opinion, high proficiency and strong resource commitments in most key areas of the investment management process and have delivered good, consistent long-term risk-adjusted returns relative to peers and/or relevant benchmarks (top 'quintile' typically). The management company's investment processes and resources support the fund's ability to deliver good, consistent performance relative to peers over the longer term.

'Satisfactory'

'Satisfactory' Fund Quality Ratings are assigned to funds that demonstrate, in Fitch's opinion, adequate proficiency and resource commitments in key areas of the investment management process and have delivered average long-term risk-adjusted returns relative to peers and/or relevant benchmarks. In some cases, ratings at this level may be assigned to funds with below-average track records provided the management company can demonstrate substantially revised investment processes that materially address shortcomings in historical performance. The management company's investment processes and resources support the fund's ability to deliver average risk-adjusted performance relative to peers over the longer term.

'Weak'

'Weak' Fund Quality Ratings are assigned to funds that, in Fitch's opinion, fail to demonstrate adequate proficiency and resource commitments in key areas of the investment management process and/or have delivered poor, inconsistent, or an unsubstantiated long-term risk-adjusted track record relative to peers and/or relevant benchmarks. At this time, weaknesses in the management company's investment processes and resources impair the fund's ability to deliver consistent performance relative to peers over the longer term.

'Inadequate'

'Inadequate' Fund Quality Ratings are assigned to funds that exhibit an inconsistent, weak track record (bottom 'quintile' typically) coupled with 'Weak' proficiency and resource commitments.

'Qualifying'

The 'Qualifying' designation is applied to funds that, as determined by Fitch, lack a three-year track record (or substantially similar proxy track record) but are judged to be at least 'Satisfactory' under Fitch's fund Qualitative Assessment.

Fitch may use an alternative ratings scale for Fund Quality Ratings in certain markets where regulations mandate, or the stage of fund industry development calls for a particular scale and/or ratings methodology. In such markets, Fitch will conform its ratings scale and methodology to the local market's regulatory framework and practices. For example, all funds may be rated on a numerical scale rather than the FQR six-tier qualitative scale. Fitch will fully disclose its ratings methodology and scale to the extent they differ in certain markets from this published criteria.

Appendix B: Fund Quality Ratings and Fitch Asset Manager Ratings: Complementary Analytics with Unique Perspectives

Figure 14

Differences Between Fund Quality and Asset Manager Ratings

Fund quality ratings	Asset manager ratings
Performance and process-oriented	Operational risk-oriented
Assigned at the fund level	Assigned at the asset manager level

Source: Fitch

Fitch's Asset Manager Rating (AM Rating) addresses the vulnerability of asset management organisations to operational and investment management failures (relevant criteria can be found in *"Reviewing and Rating Asset Managers"*, dated 13 August 2010 and *"National Scale Asset Manager Ratings Criteria"*, dated 2 July 2010). Through its AM Ratings, Fitch provides an independent opinion of the robustness of the asset management company's overall platform. AM Ratings do not explicitly address the relative strength of a particular strategy or fund.

Fund Quality Ratings, on the other hand, explicitly assess the drivers of a particular fund's risk-adjusted performance relative to its peers. Unlike AM Ratings, Fund Quality Ratings address operational risk at the fund level and only on a "pass/fail" basis.

As such, AM Ratings and Fund Quality Ratings are complementary. Together, they provide investors with an overall qualitative opinion on the risks from operational and investment management failures resulting from the asset management organisation, irrespective of the particular managed fund (AM Ratings). At the fund level, they provide a prospective view of the factors influencing a fund's future performance relative to its peers.

There are, of course, natural areas of overlap between AM and Fund Quality Rating analysis. For instance, the AM Rating analysis covers valuation processes, management of conflicts of interest, transparency and reporting, and corporate governance, which are addressed during the Fund Quality Rating "pass/fail" operational and legal screening. Additionally, while both criteria involve a review of the firm's experience, resources and investment process, the analytical focus differs as highlighted above. As such, Fitch would expect the Fund Quality Rating review process to be streamlined for a fund managed by a Fitch-rated asset manager.

Appendix C: Agenda and Requested Documentation

Figure 15

Typical On-Site Agenda and Requested Documentation

Topic	Requested documentation
Investment process <ul style="list-style-type: none"> Investment philosophy Research inputs and models Decision-making, authority, formalisation oversight and counter powers Portfolio construction rules and practices Portfolio monitoring tools and frequency Reactivity and adequacy to market conditions Risk management framework and mechanisms Risk metrics and limits Buy/sell discipline Implementation (trading, model portfolio, etc) Operational workflows 	<ul style="list-style-type: none"> Presentation of the investment process/fund Representative research outputs (macroeconomic research, equity/credit research, quantitative research, etc) Representative investment committee minutes Recent examples of specific quantitative model changes (if applicable) Screenshots/demonstration of monitoring and risk tools used by investment professionals (P&L, performance attribution, position-keeping, etc) List of the risk limits (regulatory, contractual or internal) and risk indicators of the fund Risk management reports covering the fund List of brokers/counterparties with last 12-month volumes for the fund
Fund <ul style="list-style-type: none"> Profile Investors Investment universe, eligible assets Sources of performance Beneficial and detrimental market regimes Past performance review Trading history 	<ul style="list-style-type: none"> Fund prospectus or legal documentation Material historical changes to terms, auditors or service providers Last three investor reportings (most comprehensive one) Last three annual reports Representative investor communication (newsletters, research, strategy) Historical data: Assets, NAV per share, calendar performances vs. benchmark and peers One- and three-year performance analysis/attribution Historical evolution of key parameters: Allocation, market sensitivities, etc Top 10 investors, breakdown of overall investor base Last year's transaction and trading volumes, last year's portfolio turnover
Staffing <ul style="list-style-type: none"> Key investment staff and support teams Roles and responsibilities Staff turnover Recruitment/sourcing and training strategy Incentive compensation structure Outsourced functions 	<ul style="list-style-type: none"> Departmental/divisional organisation charts Key personnel résumés (senior management, investment professionals and risk management) Last five years' staff turnover among investment professionals involved with the fund
Systems and analytics <ul style="list-style-type: none"> Presentation of systems for <ul style="list-style-type: none"> portfolio management and trading analytics research Demonstration on the desks Operational workflows for trading and other front-office administrative tasks 	<ul style="list-style-type: none"> Overall IT architecture and flow diagram between the front- and middle-office systems and parties Main internal database and third-party data used Functionalities of each front-office tool (tools supporting investment decision-making process, pricing, portfolio monitoring and trading)
Company background <ul style="list-style-type: none"> Overall history and experience of company Ownership and organisational structure History, experience, market presence of company in the asset class/strategy relevant to the fund Client base Financial condition Recent and foreseeable changes Strategy and business plan for the fund 	<ul style="list-style-type: none"> Corporate organisation chart (noting parent, subsidiaries and affiliates with shareholding participation breakdown) Most representative due diligence questionnaire Lists of procedures to mitigate potential conflicts of interest List of board/executive committee's members (including biographies) Breakdown of assets under management Third-party service providers Audited financial statements or key financial numbers Relevant pricing policy

Source: Fitch

Appendix D

Figure 16

Rating Scorecard for Qualitative Assessment

Investment process	
Investment process and philosophy	Definition, transparency, consistency and stability of investment process and philosophy
Research	Investment edge of the process Research discipline, depth and breadth Quality, consistency and relevance of research outputs
Portfolio construction and adjustments	Adequacy of decision-making process
Monitoring	Evaluation of risk parameters in portfolio construction Trading capabilities
F/O operational workflows	Timeliness, scope and effectiveness of fund monitoring Efficiency and reliability of F/O operational processes Effectiveness of controls on the PM value chain
Resources	
Staffing	Clarity and stability of organisational structure, roles and responsibilities Match between PM skill-set/experience and management requirements of the fund If "star manager system", talent of PM If team-based approach: Effectiveness of teamwork Match between research staff numbers and universe covered/research focus Relevance of analysts' experience relative to the fund's investment universe Support and control functions Stability/company tenure of relevant investment professionals Firm's ability to retain, proactively recruit and train relevant staff
Technology	Functionality and coverage of core PM/trading system Functionality and coverage of risk and research analytics Degree of automation/integration/reporting/access to data Evolution of the firm's technology
Management company	
Ownership	Shareholder's commitment, support and stability
Financial condition	Financial condition of the company
Client base	Diversification, stickiness of the client base
Institutional experience & market presence	Experience (length and relevance) and market presence of the company in AM industry Experience (length and relevance) and market presence of the company in the relevant asset class/strategy Strategic commitment to the business line of the fund
Stability	Expected impact of recent and/or foreseeable relevant changes

Source: Fitch

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