Dan Nigro

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EXTRA CREDIT: When AAA Ratings Make Investors Cringe

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By **Anusha Shrivastava**

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NEW YORK (Dow Jones)--Are they ratable?

The ratings agencies seem to think so. They have been frantically updating their models to better measure the creditworthiness of complex securities that many have come to dread: residential mortgage bonds and collateralized debt obligations.

But the deluge of ratings downgrades and stunning write-downs from big banks holding these securities have undermined confidence in what ratings mean.

When a security loses its AAA crown and falls into a kingdom of junk in the span of six months - which was the case of a smattering of deals downgraded last month by Moody's - it's going to tarnish the shine of what had been stellar status that conservative investors sought when picking securities for their portfolios.

It's also going to leave investors like pension funds, insurance companies and big banks stuck with securities once considered gold and now considered toxic.

"Investors have lost faith in ratings across the entire spectrum due to the speed and depth of the cuts," said Dan Nigro, an asset-backed securities portfolio manager at Dynamic Credit Partners LLC, a hedge fund in New York. "Their current mindset and historical data set may not be sufficient to rate these products."

All three ratings agencies insist they are changing their ratings methodology to try to keep in step with the

significant changes in the market.

The swift and widespread deterioration in the housing market, coupled with lax lending and underwriting standards as well as instances of outright fraud that have led to higher delinquencies and the poor performance of these bonds, has thrown the agencies off-kilter, they say.

"We are tightening our criteria and increasing the frequency of our reviews," said Chris Atkins, vice president of communications at Standard & Poor's. "We are modifying our analytical tools and models to incorporate changes in our assumptions."

Spate Of Downgrades Unnerves Investors

Moody's Investors Service is in the process of cutting credit ratings and warning of potential downgrades on billions of dollars worth of collateralized debt obligations, while Fitch Ratings said in late October that $23.9 billion of AAA-rated CDOs face steep downgrades that could push some of them into speculative, or junk, territory within a month.

There has been plenty of blame put on the ratings agencies, which critics say were too slow to recognize the negative impact a slowing housing market would have on securities backed by shaky subprime loans taken out during the peak of lax lending in 2006.

Many are also angry that it is only now that the ratings agencies are changing the criteria used to judge these securities, which in hindsight seemed extremely vulnerable to falling home prices and higher interest rates.

"It is very difficult to play the game without knowing the rules," said Michael Youngblood, portfolio manager and director of research at FBR Investment Management in Virginia. "The rules keep changing. Clearly, one could fairly criticize the agencies for not having paid attention to the magnitude of layered risk," he said.

With debt rated below AAA in some subprime bonds possibly getting wiped out and even some AAAs getting hit, there was "something fundamentally wrong with the analysis of portfolios," said Jeff Nabi, managing director with Assured Guaranty, which provides AAA-rated credit enhancement products for asset-backed and mortgage-backed securities, speaking at a panel on subprime markets at a conference on such securities in Orlando, Fla.

Some investors with a longer investment horizon are still hoping that the bonds will eventually snap back.

"There are some obvious advantages to long-term capital that can withstand short-term retrenchments in markets," said Russell Read, chief investment officer at the California Public Employees' Retirement System, or CalPers.

CalPers allocates 15% of its real-estate portfolio to investments related to residential housing. "In a $250 billion fund, we're not easily rattled by market reversals that may knock smaller investors," he said.

CalPers owns about $2.5 billion in securities that are backed by subprime loans, "but they are all AAA-rated, unlike other bonds that are subordinated," Clark McKinley, an information officer for CalPers, wrote in an email. "We are well protected in this case and not at risk."

This high level of confidence in the ratings agencies' work isn't widespread, however, and many now hammer home a basic tenet of investing: do your own homework or get a second, informed opinion before you buy anything.

Independent Research May Be One Solution

"Recent events underscore the need for independent research," said Derrick Wulf, portfolio manager at Dwight Asset Management in Burlington, Vt. "Unfortunately, not all investors have the depth of resources to perform the necessary research to make informed, independent decisions on certain types of complex securities."

This is one of the reasons why investors rely on ratings agencies to pronounce their verdict on a bond in the first place. Then, when the ratings are downgraded, they feel betrayed.

"It goes to the heart of what an investor wants ratings to mean, not what the ratings agencies want ratings to mean," said Mark Adelson, a consultant with Adelson & Jacob Consulting LLC in New York, who worked at Moody's for nine years, until 2001. "People want ratings to mean something, but the real world is not that smooth. A rating is a one-dimensional summary of risk in a credit, not the total amount of risk in a credit."

The misconception is that a AAA rating means the investor won't lose any money, he said.

Investors are now learning how painful such an assumption can be.

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