

# A Conversation with Moody's: Investment Programs in the Rating Process



Highland Associates, Inc.  
2545 Highland Avenue, South  
Suite 200  
Birmingham, AL 35205  
205-933-8664  
[www.highlandassoc.com](http://www.highlandassoc.com)

**TOPICS:**

Thoughts on Liquidity  
The Tax-Exempt Debt Market  
Governance Structures  
Investment Portfolio Positioning & Strategy

**Introduction**

The financial crisis and ensuing recession of 2007-2009 had a dramatic impact on virtually every financial market. The particular challenges in the bond markets – including the sub-prime debt crisis and structured product defaults – caused problems beyond the investment markets. Not-for-profit institutions who issue debt were also impacted on the liability side of their balance sheet by the significant changes in the mark-to-market value of interest rate swaps, resulting collateral posting requirements and the failure of the auction rate debt market – all at a time when the operating performance for virtually every not-for-profit organization strained under the pressure of the weak U.S. economy.

As if the dual struggles within the asset (operating / investment) and liability (debt) segments of the balance sheet were not enough, third-parties such as auditors and the credit rating agencies ramped up their requirements for transparency and liquidity within the investment program.

Highland's advisory philosophy was founded on the principal that the investment program must complement and support the overall organization, its mission, and its financial structure. As a result, we have always considered the impact of our clients' auditors and their ratings partners on the investment program and the organization's financial position. However, with rising scrutiny from the ratings agencies in particular coming into 2010, Highland sent a team to New York to sit down with Moody's to discuss many of the issues impacting the investment program and Highland's advice to our clients.

The full review of this visit can be found on our website (Moody's January 2010 – [www.highlandassoc.com/insight/white-papers/](http://www.highlandassoc.com/insight/white-papers/)) in a paper entitled "Highland Associates Report on the Investment Program in the Ratings Process". The paper covers topics such as the (then) new liquidity analysis worksheet, healthcare industry outlook, tax-exempt debt market, portfolio governance and investment program structure.

We visited Moody's again in April 2012 to discuss two particular topics – the initial use of liquid alternative allocations within portfolios and the shift in governance structures to more delegation of authority to outside advisors such as Highland.

Our most recent visit to Moody's took place in April 2014 and included a review of the 2010 and 2012 topics (liquidity worksheet, tax-exempt debt market, governance and program structure) along with an update on Moody's overall portfolio positioning evaluation. The following paper summarizes the key points from this most recent visit.

## HIGHLAND'S SOLUTION - LIQUIDITY:

Highland now includes the three-tier liquidity breakdown for our clients' operating portfolios (asset class and total portfolio) in our quarterly package. This helps to keep the members of governance at our clients fully informed of their current profile and how any potential changes to investment managers or asset classes might impact this profile. All recommendations include the impact of changes to liquidity for each of our client's unique objectives and constraints – including the five specific factors outlined to the right. Additionally, we are available to help our clients categorize investments within the worksheet to allow a consistency of reporting of allocations and managers to Moody's.

## Liquidity

This discussion centered around the current state of the liquidity worksheet (with 2014 as the fifth year of its use), new findings or trends in the data, any targets for each of the three liquidity tiers (monthly, less than annual, more than annual), and how Moody's uses the data in their overall evaluation process.

- Moody's has seen a marked shift in the asset allocation of their rated portfolio. The first set of worksheets in 2010 and 2011 showed very high levels of cash and fixed income coming out of the financial / market crisis and in the midst of a very challenging operating environment. Recent reporting has included more balanced portfolios that reflect a more stable environment (for most organizations).
- The median level of monthly or better liquidity for the Moody's rated portfolio ranges from approximately 80% for Aa rated credits to nearly 100% for A and Baa credits. It is important to note that this evaluation includes not only the portfolio, but also the operating cash held on the balance sheet. Actual portfolio liquidity would be lower than the median listed above. Also, this evaluation is separate from the self-liquidity reports required for organizations with demand debt facilities.
- There is no firm target for liquidity. The tolerance for differing levels of liquidity within the tiers depends on an organization's rating along with a number of other factors:
  - Swaps and potential collateral posting;
  - Demand debt and self-liquidity programs;
  - Defined benefit plans and funding status;
  - Illiquid investments and future capital commitments; and
  - Capital spending plans.

As a general rule, lower rated credits should be more liquid but even higher rated credits may need more liquidity if a number of the factors above are also impacting a given organization.

## Tax-Exempt Debt Market

This discussion centered around the current tax-exempt structures in the market along with a discussion of federal and state-level questions surrounding tax-exempt status for debt issuers.

- Moody's has not seen an increase in the risk of current issuing debt structures (unlike the taxable markets which have shifted back in that direction). Most structures are fixed rate structures with little, if any, net new swap deals.
- Private placement issues with banks and other institutions with an internal portfolio have been fairly common but Moody's believes this will reach a saturation point and will likely slow.
- The discussion surrounding tax-exempt status for debt issuers is ongoing at both a federal and a state-level. Moody's does not believe that a change is a real possibility but it is a growing risk. Factors such as states searching for additional sources for tax dollars along with tax-exempt issuers issuing taxable debt (i.e. – Build America Bonds) has led to questions surrounding the need for tax-exempt status. Again, Moody's does not see a change happening, but the continuing discussion is somewhat of a risk long-term.

### HIGHLAND'S SOLUTION - TAX-EXEMPT DEBT

Highland is not involved in the financing side of our clients. However, we do factor in debt structures and the overall level of debt into the objectives and constraints evaluation and resulting asset allocation evaluation process.

**HIGHLAND'S  
SOLUTION -  
INVESTMENT  
PROGRAM  
GOVERNANCE:**

Highland provides detailed reasoning for initial asset allocation recommendations (or implementation for discretionary mandates), any subsequent changes and individual manager hire / fire decisions. We also participate in routine discussions with the management team to ensure the portfolio is properly aligned with the current operating profile of our clients as well as their strategic goals and objectives. These practices should provide any information our clients need for the investment portfolio segment of the rating agency discussion. At the same time, we are happy to provide any additional information necessary to aid in a ratings report or review.

## Investment Program Governance

This discussion centered around the trends of delegation (discretion) / outsourcing of the management of investment programs.

- As a general rule, Moody's has a positive view of organizations that engage an outside investment advisor in some capacity (advisory, discretion, etc.). While some organizations have the scale of operations and investment assets to build their own internal investment team, this is rare. Most organizations need some level of outside advice.
- The type of arrangement – traditional advisory vs. discretion – should be appropriate for each organization's unique situation. Interestingly, there is no broad opinion of the type of organization that should use advisory vs. discretion. While one might assume that larger, more sophisticated organizations might have the depth of staff to be more involved in the investment process, they often have very complex operations (i.e. – multiple affiliates, captive insurance programs, complicated debt structure, etc.) that requires time and focus potentially limiting their ability to play a very active role in the investment process. Either arrangement may be appropriate in the eyes of Moody's as long as the reasoning fits that organization.
- Moody's was clear that regardless of the type of outside arrangement, the management team must be able to explain (1) why the arrangement (advisory vs. discretion) makes sense for their organization and (2) the overall investment strategy and how it fits their organization. They do not expect the management team to go investment manager by investment manager through the portfolio explaining each in great detail. However, they do expect for the management team to be able to speak to:
  - The overall asset allocation positioning and philosophy;
  - The risk profile of / philosophy for the allocation;
  - The basic characteristics of / philosophy in selecting investment managers (i.e. – aggressive philosophy vs. managers with a capital preservation bias); and
  - How the allocation, risk and investment manager philosophy complements the overall strategy of the organization.

Importantly, Moody's expects the management team to be able to speak to these issues without having to refer questions to the outside advisor. Again, they do not expect granularity on every underlying investment; rather, they expect the management team to be able to speak comfortably regarding the overall philosophy and allocation relative to the strategy of the organization.

## Investment Portfolio Positioning & Strategy

This discussion centered around current thoughts on investment manager concentration, impacts of types of asset classes on concentration, and alternative investment allocations.

- As a general rule, Moody's has a tolerance of 10-12% per individual investment manager positions.
  - Cash and fixed income managers are likely to be higher, especially for more conservative organizations like healthcare, and Moody's is comfortable with that fact. They are willing to grant that there is limited diversification achieved by investing in four different core fixed income managers at 10% each – two managers at 20% likely provide sufficient firm risk control.
  - Traditional equity managers are likely to be lower than that level depending on their individual strategy (i.e. – highly concentrated managers / narrow mandates might be lower while more diversified managers with a broader mandate could more comfortably approach 10%).
  - Alternative managers should have lower individual positions. More diversified structures such as fund of funds or multi-manager funds might have higher position weightings while stand-alone managers or strategies should be lower.
- Alternative investments have always posed a challenge for Moody's in their evaluation of their rating portfolio. The more limited liquidity of alternatives relative to traditional investments and potential changes in terms (i.e. – gates, suspension of redemptions, etc.) make their liquidity profiling more difficult. In general, Moody's comfort level with alternative investments is based on the management team's ability to detail:
  - Schedule of capital commitments to private strategies;
  - The transparency an organization has to the underlying investments; and
  - The ability of the management team to explain the strategy and why it is appropriate.
- Many of our clients began investing in hedge funds through fund of funds vehicles in the late 1990's or early 2000's. As a result, after 10-15 years of experience, some of our clients are exploring the use of direct positions in hedge funds as well. All else being equal, Moody's prefers fund of funds vs. direct investments due to the diversification provided by multi-manager funds. However, as with many issues related to the investment program, they can get comfortable with a direct program if (1) the organization has the scale to sufficiently diversify exposure and (2) the management team can explain the strategy and why it is appropriate.
- The proliferation of liquid alternative vehicles in the past five years has also complicated Moody's evaluation of the risk and liquidity profile of their rating portfolio. Many hedge fund strategies that had historically been offered only in limited partnerships are now available in traditional SEC registered mutual funds:
  - Hedge fund strategies (i.e. – long / short equity, managed futures, global macro);
  - Global tactical asset allocation (i.e. – flexible allocations of cash / fixed income / equity mandates); and
  - Hybrid equity managers (i.e. – equity / convertible bond managers, etc.).

Moody's evaluation of what is, or is not, an alternative has traditionally been based on the structure and liquidity profile of the investment. A long / short equity fund in a limited partnership format would be an alternative while a long / short equity fund in a mutual fund format has the exposure of an alternative but the liquidity profile of a traditional investment.

Where does it fit?

As an example of this conflict, we discussed with Moody's a hypothetical client and how liquid alternatives could benefit their portfolio and their organization.

### **CASE STUDY: APPLICATION OF LIQUID ALTERNATIVES**

*THE CLIENT:* Not-for-profit Healthcare Operating Portfolio

*THE PROBLEM:* The organization has significant capital commitments in their strategic plan and cannot make any material less liquid investments due to the heavy expected withdrawals from their investment program to fund the commitments. However, being limited to only traditional cash, fixed income, and equity allocations (due to liquidity) leaves the investment portfolio vulnerable to a market decline close to a funding need or the limited returns available in cash and fixed income investments.

*THE SOLUTION:* Liquid alternatives. The organization can help control their downside risk, while maintaining the required liquidity, by shifting some of the long-only equity allocation to liquid alternative mutual funds. At the same time, the liquid alternative funds offer a potential return superior to the expected returns for cash and fixed income investments – helping to achieve a total portfolio return sufficient to fund the mission.

*THE OUTCOME:* Success. The client is able to match their investment program to their strategic plan, match the portfolio to the return objective and risk tolerance of the organization, and manage the liquidity profile consistent with their needs.

Following our discussions with Moody's, they agreed with the benefits some alternative allocations can provide if properly structured and implemented. They also plan to review their liquidity worksheet to determine if more or modified categories should be added to reflect the developments in the liquid alternative markets.

#### **HIGHLAND'S SOLUTION -**

#### **INVESTMENT PORTFOLIO POSITIONING & STRATEGY:**

Highland already factors in rough investment manager concentration limits, asset class specific concentration factors, and the role alternative investments play for our clients. We will continue to support our clients in any way possible to arm them with the information they need to satisfy any rating agency questions.

## ABOUT HIGHLAND:

Highland Associates, Inc. was founded in 1987 as an independent institutional investment advisor to assist not-for-profit institutions in the development, implementation, and maintenance of treasury and investment management programs.

The firm is headquartered in Birmingham, AL and, as of December 31, 2013, serves as investment consultant on approximately \$18 billion in assets.

*The information provided herein is not intended to be, nor shall it be construed as, investment advice or a recommendation of any kind. To the extent that this communication contains information as to the historical performance of a particular investment or strategy, no representation is being made that an investor will or is likely to achieve any results shown or will make any profit at all or will not suffer losses, including loss of principal. Past performance is not indicative of future results. The information provided is furnished as of the date shown, and no representation is being made with respect to its accuracy on any future date.*

## Conclusion

The key takeaways from our discussions include:

- 1) The appropriateness of a number of factors related to the investment program depends on the organization and its objectives and constraints:
  - a. Governance structure;
  - b. Asset allocation; and
  - c. Liquidity profile.
- 2) Communication is key, including:
  - a. Management's ability to communicate philosophy and strategy during routine reviews; and
  - b. Management's willingness to provide notice and reasoning (prior to a regular rating review) if there is a material change in the allocation or strategy.

Routine discussions with Moody's allow Highland to ensure our recommendations for asset allocation, investment structure, and manager positions are reasonable in the eyes of Moody's. While we are charged with making the best decisions or recommendations possible for our clients from an investment perspective, we cannot be ignorant to the thoughts of third-parties, like auditors and the rating agencies, that have a material impact on our client's overall organization and mission. This routine dialogue allows us to reconcile any disconnects between the realities in the investment markets and what Moody's expects from our clients in the rating process.

We have also found that Moody's has been very open to hearing about new trends in the investment markets and how they impact their rated portfolio. This is reflected in their pending review of the liquidity worksheet to ensure it remains relevant in today's investment markets. They have expressed gratitude to Highland for taking the time to visit with them and they view our efforts to understand Moody's perspective in relation to our clients' investment portfolios as a positive for each individual client in their rating evaluation.

We plan to continue this routine dialogue with Moody's and welcome any questions or issues you may have that we can address in our discussions.

### References & Additional Resources:

Highland Associates: Moody's January 2010: Highland Associates Report on the Investment Program in the Rating Process  
<http://www.highlandassoc.com/insight/white-papers/>



**Bill A. Terry, CFA****Co-founder | Principal | [bterry@highlandassoc.com](mailto:bterry@highlandassoc.com) | 205.933.8664**

Mr. Terry is an original founder of Highland Associates. He is a principal of the firm and a shareholder. Prior to forming Highland Associates, Mr. Terry co-founded and co-managed the Investment Management Consulting Group of Interstate/Johnson Lane securities. Mr. Terry is a member of the Board of Directors for Protective Life Corporation, a NYSE listed company, where he serves on both the Finance and Investment, and Audit Committees. In addition he serves as immediate past Chairman of the Executive Board of the Greater Alabama Council of Boy Scouts of America and on the Finance Committee of the Birmingham Museum of Art. Mr. Terry holds a Bachelor's of Arts degree from Davidson College and is a CFA Charterholder. Mr. Terry has 31 years of investment experience.

**Charlie D. Perry****Co-founder | Principal | President | [cperry@highlandassoc.com](mailto:cperry@highlandassoc.com) | 205.933.8664**

Mr. Perry is an original founder of Highland Associates. He is a principal of the firm and a shareholder. Prior to forming Highland Associates, Mr. Perry co-founded and co-managed the Investment Management Consulting Group at Interstate/Johnson Lane Securities (a New York Stock Exchange Listed Company). Mr. Perry currently serves as the chair of the Investment Committee for the University of Alabama at Birmingham Health Services Foundation and sits on the Board of the Health Services Foundation, the University of Alabama Health System, the UAB Medical Leadership Committee and the Comprehensive Cancer Center of the University of Alabama at Birmingham. He is the current Vice Chairman and past President of the Alabama Symphony Orchestra and is Chair of the Alabama Symphony Endowment. He earned his Bachelors of Arts in Economics from Washington and Lee University. Mr. Perry has 37 years of investment experience.

**Michael T. Lytle, CFA****Consultant | [mlytle@highlandassoc.com](mailto:mlytle@highlandassoc.com) | 205.933.8664**

Mr. Lytle joined Highland Associates in 2006 as a consultant to the firm's institutional client base. He is a shareholder in the firm. Prior to joining Highland Associates, he worked as a fixed income portfolio manager in AmSouth Bank's Asset Management Department. Mr. Lytle is the Chairman of the Investment Committee of the Greater Alabama Council of Boy Scouts of America, serves on the advisory board for the Department of Economics, Finance and Quantitative Analysis at Samford University and is a past president of the Vestavia Hills Library Foundation. He is also the Chairman of the Finance Committee and Vice-Chair of the Deacon Board at Dawson Memorial Baptist Church. Mr. Lytle earned his Bachelors of Science from Berry College. He is a CFA Charterholder and past board member and president of the CFA Society of Alabama. Mr. Lytle has 15 years of investment experience.

**Paige B. Daniel****Consultant | [pdaniel@highlandassoc.com](mailto:pdaniel@highlandassoc.com) | 205.933.8664**

Ms. Daniel joined Highland Associates in 2006 as a consultant to the firm's institutional group. She is a shareholder in the firm. Prior to joining Highland Associates, she was director of alternative strategies with AmSouth Bank's Wealth Management Group. Ms. Daniel also worked for CIBC Oppenheimer and with Quick and Reilly. She is a member of the YWCA of Central Alabama's Board of Directors and Endowment Committee. She is also on the Executive Committee and Board of the Parkinson's Association of Alabama. Ms. Daniel serves on the Board of the Girl Scouts of North Central Alabama and chairs their Finance Committee. She earned her Bachelors of Arts in Economics from Vanderbilt University and her Masters of Business Administration from Georgia State University. Ms. Daniel has 19 years of investment experience.

**R. Scott Graham, CFA****Consultant | [sgraham@highlandassoc.com](mailto:sgraham@highlandassoc.com) | 205.933.8664**

Mr. Graham joined Highland Associates in 2006 as a consultant to the firm's institutional client base. He is a shareholder in the firm. Prior to joining Highland Associates, he worked at Vulcan Materials Company as a senior financial analyst. Mr. Graham previously worked at CNHI and NCP Solutions in an analyst role. Mr. Graham earned his Bachelors of Science in Finance from Troy University and his Masters of Business Administration from the University of Alabama at Birmingham. He is a CFA Charterholder and a member of the CFA Society of Alabama. Mr. Graham has 11 years of investment experience.