

## **ICRA LANKA- FUND MANAGEMENT QUALITY RATING METHODOLOGY**

A **Fund Management Quality Rating** from ICRA Lanka provides investors with an independent opinion on the overall quality, governance process, and fund management expertise of the Asset Management Company (AMC) rated. For AMCs, ICRA Lanka ratings are a credible means that can be used to highlight their investment management characteristics. The ratings also provide investors with a useful benchmark to differentiate among AMCs. ICRA Lanka ratings however are not intended to comment on the future performance of the schemes or funds being managed by the AMCs rated.

### **ANALYTICAL FRAMEWORK**

The methodology for rating Fund Management Quality emphasises qualitative factors over quantitative factors and considers the following key parameters:

- Ownership
- Organisational Structure and Management Quality
- Governance Structure and Fiduciary Responsibility
- Transparency and Investor Service
- Investment Performance
- Financial Soundness

The weighting of the parameters would vary from case to case, given that every AMC has its own unique characteristics.

### **Ownership**

ICRA Lanka evaluates the ownership structure of an AMC with a view to understanding the business objective of its owners, their financial strength, the extent of their commitment to the business, and any potential conflict of interest between the AMC and their other businesses. The owners' ability to infuse capital to address any business or growth requirements is viewed as critical.

### **Organisational Structure and Management Quality**

Organisational structure is an important consideration in determining an AMC's overall ability to meet its investment objectives while at the same time exercising adequate control over various activities involved in the execution, delivery and performance of its obligations. A structure that facilitates timely decision making and provides for adequate staffing in key function areas, besides ensuring use of sound risk management processes and efficient customer service, is viewed positively. Further, the evaluation would consider whether the structure is commensurate with the size of the Assets under Management (AUM). ICRA Lanka also assesses the AMC's ability to retain its key employees, its succession planning for the key positions, and the potential impact of employee turnover on its stability and performance. ICRA Lanka would examine whether performance expectations and the employee compensation structure are appropriately designed and communicated across the organisation to ensure avoidance of any conflict between investor interest and the interest of other stakeholders.

The track record of the AMC and the depth of experience of its investment managers and other senior

management personnel are important starting points in the exercise. ICRA Lanka assesses the AMC's ability to support and sustain investment management activity by focusing on its investment decision making process, depth of research, risk management practices, and investment infrastructure. AMCs in which the investment decision making process mitigates any undue risks to investors and also strives to consistently align investment decisions with the stated investment objectives and policies are viewed favourably.

Among the issues evaluated are the composition and role of the investment committee, the basis on which investment decisions are made, the quality of the in-house research team, and the systems followed to access external research and services. Also evaluated are the processes by which portfolio policies, investment objectives, preferences and constraints are established and monitored over time. In ICRA Lanka's view, a well-defined backup process is necessary to deal with crises like large redemption pressures and unexpected market volatility. Of particular relevance is the actual investment process vis-à-vis the guidelines, besides the adequacy of checks to ensure that decisions are not taken in an ad hoc manner without adequate due diligence.

### **Governance Structure and Fiduciary Responsibility**

An AMC holds in trust and manages investors' money and has an important fiduciary responsibility towards them. ICRA Lanka would examine whether the AMC's risk management structure is robust enough to ensure adequate oversight of investment policies, guidelines, strategies, and adequate accountability at all levels. Regulatory compliance by the AMC's risk management structure is an essential, from ICRA Lanka's perspective. In ICRA Lanka's view, a strong internal audit function helps in ensuring integrity of an AMC's risk management structure.

ICRA Lanka considers a strong governance structure that goes beyond mere statutory compliance and actually facilitates adherence to high ethical and fiduciary standards across the AMC in all its day-to-day activities as a rating positive.

### **Transparency and Investor Service**

Disclosure of investment management philosophy, cost structure, entry/exit policy, portfolio composition and method for computing net asset value (NAV) are important aspects that help AMCs achieve transparency and communicate effectively with investors. NAV is perhaps the single most important statistic for communicating performance. In this regard, ICRA Lanka would assess the valuation method used to compute NAV; the method should not only be consistent with the regulatory guidelines, but should also be in line with the best practices in the industry.

Transparent disclosures also help AMCs bridge any gap that may emerge between investor expectations and fund performance. The quality of investor service is assessed by examining aspects such as promptness in processing sale/repurchase requests and in responding to investor grievances, besides by the efficacy of the systems put in place to ensure proper crediting of investment benefits like dividends and bonuses.

## **Investment Performance**

Achieving competitive investment performance is the principal objective of an AMC. Investors' risk appetite and market expectations, on the other hand, are widely divergent. As a result, one finds a large number of individual schemes tailored to meet such objectives. ICRA Lanka segregates the schemes within the mutual fund universe into categories on the basis of portfolio composition and investment objectives. The historical risk adjusted returns of individual schemes of the AMC being rated are compared over various time frames with peer group schemes or with an appropriate benchmark that evaluates the relative performance of the schemes of the AMC being rated. In particular, ICRA Lanka looks for significant aberrations in relative performance to check for possible deficiencies in management quality or investment process.

## **Financial Soundness**

An AMC's ability to fund its operations and also meet its future capital requirements from internal accruals holds critical importance, from the perspective of ICRA Lanka's rating methodology. An AMC's ability to fund its business activities is a function of its earning power, as determined by its AUM and skill in managing expenses. The AMC must be in a position to hire and retain professional talent, and have adequate systems to support its activities. ICRA Lanka also evaluates the cost structure of the AMC being rated and the extent to which the structure is in line with industry standards so that the AMC concerned can offer services at competitive costs.

## **ICRA Lanka Fund Management Quality Ratings: Scale and Definitions**

**AMC Quality 1 (AMC1):** Entities rated AMC1 are adjudged to provide the highest assurance on management quality. ICRA Lanka's opinion is not a comment on statutory compliance, financial performance or future performance of schemes managed by the Asset Management Company.

**AMC Quality 2 (AMC2):** Entities rated AMC2 are adjudged to provide high assurance on management quality. ICRA Lanka's opinion is not a comment on statutory compliance, financial performance or future performance of schemes managed by the Asset Management Company.

**AMC Quality 3 (AMC3):** Entities rated AMC3 are adjudged to provide adequate assurance on management quality. ICRA Lanka's opinion is not a comment on statutory compliance, financial performance or future performance of schemes managed by the Asset Management Company.

**AMC Quality 4 (AMC4):** Entities rated AMC4 are adjudged to provide inadequate assurance on management quality. ICRA Lanka's opinion is not a comment on statutory compliance, financial performance or future performance of schemes managed by the Asset Management Company.

**AMC Quality 5 (AMC5):** Entities rated AMC5 are adjudged to provide poor assurance on management quality. ICRA Lanka's opinion is not a comment on statutory compliance, financial performance or future performance of schemes managed by the Asset Management Company.