



Fisher Funds

Investor Education Centre

*Making investing enjoyable, understandable
and profitable...*

The role for ratings agencies

01/05/11

It's hard to know how to feel about ratings agencies. They have failed investors in the past by assigning AAA ratings to sub-prime mortgage backed securities which, with hindsight, should have been given junk status. They also failed to assess the debt situation of European countries until after a credit crisis had emerged. And then they exacerbated these credit crises by threatening further downgrades if solutions weren't quickly developed. Enron was considered by ratings agencies to be world-class, just before it collapsed.

Closer to home, finance companies were given ratings that led investors to believe they were putting their money with quasi-bank organisations, but they were far from it.

The main criticism levelled at ratings agencies is that they are too slow to act, and that because their fees are paid by the very organisations they are rating, they cannot be considered objective.

Regardless of how we feel about ratings agencies, they continue to wield a lot of power. Recently Standard & Poors reduced its outlook on America's AAA debt rating from stable to negative. Share markets immediately fell, interest rates rose and money flowed out of stocks and other 'risk' assets.

The chance of the US losing its AAA status should not have been a huge surprise – we all know that the US government has been printing money and has yet to manoeuvre its way into a convincing economic recovery. But although we all know about possible outcomes, an official warning from a ratings agency is a shot across the bow and makes a downgrade seem somehow more likely. S&P explains that when they revise an outlook, it means a 33% chance of a rating change within two years.

What does it matter if the US gets downgraded to AA? A debt downgrade would raise the cost of interest payments for the US government, as well as the borrowing costs for American consumers and businesses. Higher interest rates would hurt the already debt-laden US economy, potentially killing any chance of a recovery.

Some suggest that the ratings agencies are a waste of space and should be done away with. Problem is, there needs to be some benchmarking system so that investors can get a steer on which investments and countries are riskier than others.

It's all very well thinking investors can make our own assessments, but as regulators and authorities have discovered when picking over the carcasses of failed finance organisations, a lot can be hidden from view and discovered only after it's too late.

Rather than doing away with ratings agencies altogether, we should learn how to treat their opinions, because that's all their ratings are. Somebody described a ratings agency as an outsider that can only ever assess the cut of the clothes being worn, not the strength and integrity of the body within. Perhaps ratings agencies can play a role in pointing out obvious dangers and risks, but hopefully investors will come to realize in time that the final responsibility for determining the risk and appropriateness of any investment lies with themselves.

Making investing enjoyable, understandable and profitable...