

Market Risk (Volatility) Ratings (1995)

Background. State and local governments have long relied on credit ratings as an independent analytical source to gauge the credit risk of an investment option. However, credit risk analysis alone is not sufficient to safeguard against the assumption of other risk components, including market, interest rate, and liquidity risks. Through the securitization and structuring process, AAA rated securities and funds also may carry extreme market and other risks that are wholly unaddressed by credit ratings. Rating agencies now provide market risk ratings that evaluate the volatility of the security under a wide range of potential interest rate and mortgage prepayment scenarios.

Risk components, such as interest rate, prepayment, credit, spread and liquidity, and currency risks are analyzed to assess how aggressively a fund uses derivatives and leveraging, and what risks their use presents to fund managers and investors in the fund. Results indicate the degree of potential variability in the prospective fund performance. Historical performance and volatility of fund returns relative to appropriate benchmarks also are evaluated.

When applied to individual collateralized mortgage obligations (CMOs), market risk ratings provide a useful benchmark to governmental entities as they establish guidelines for prudent management of derivative investments.

Recommendation. The Government Finance Officers Association (GFOA) encourages state and local governments to augment information they receive from brokers, dealers, or advisors with independent research when conducting due diligence of potential investments. Information sources include historical trading ranges, trend and volume data, brokerage firm research, cash flow and present value analysis, and credit ratings and research.

- GFOA encourages investment in only those CMOs and funds that seek market risk ratings from rating agencies to provide comprehensive disclosure of risks to public investors. Although volatility ratings currently are not mandatory, public investors may wish to consider limiting their investments to CMOs and funds that have received favorable volatility ratings from a nationally recognized rating agency.