Global Fund Rating Methodology

Version V2

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Overview

Egan-Jones Ratings Company, Inc. (“Egan-Jones” or “EJR”) is a credit rating agency established in 1995. Privately owned and operated without affiliation to any financial institution, Egan-Jones is respected for its timely, accurate evaluations of credit quality. Egan-Jones ratings and research are available via e-mail, its website, and other distribution platforms. EJR is committed to continuously refining its expertise in the analysis of credit quality and is dedicated to maintaining objective and credible opinions within the global financial marketplace.

SEC Requirements

A general description of the procedures and methodologies used to determine credit ratings. The description must be sufficiently detailed to provide users of credit ratings with an understanding of the processes employed in determining credit ratings, including, as applicable, descriptions of: policies for determining whether to initiate a credit rating; a description of the public and non-public sources of information used in determining credit ratings, including information and analysis provided by third-party vendors; whether and, if so, how information about verification performed on assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction is relied on in determining credit ratings; the quantitative and qualitative models and metrics used to determine credit ratings, including whether and, if so, how assessments of the quality of originators of assets underlying or referenced by a security or money market instrument issued by an asset pool or as part of any asset-backed or mortgage-backed securities transaction factor into the determination of credit ratings; the methodologies by which credit ratings of other credit rating agencies are treated to determine credit ratings for securities or money market instruments issued by an asset pool or as part of any asset-backed or mortgaged-backed securities transaction; the procedures for interacting with the management of a rated obligor or issuer of rated securities or money market instruments; the structure and voting process of committees that review or approve credit ratings; procedures for informing rated obligors or issuers of rated securities or money market instruments about credit rating decisions and for appeals of final or pending credit rating decisions; procedures for monitoring, reviewing, and updating credit ratings, including how frequently credit ratings are reviewed, whether different models or criteria are used for ratings surveillance than for determining initial ratings, whether changes made to models and criteria for determining initial ratings are applied retroactively to existing ratings, and whether changes made to models and criteria for performing ratings surveillance are incorporated into the models and criteria for determining initial ratings; and procedures to withdraw, or suspend the maintenance of, a credit rating. Market participants are provided the opportunity to comment on the methodologies through the EJR’s website (publicly available) for EJR’s consideration.

Executive Summary

In this document, Egan-Jones Ratings Co. ("EJR") presents its methodology for rating funds. This document shall be used in conjunction with EJR's main Methodologies (https://egan-jones.com/), in which other rating approaches and methodologies, such as "COLLATERAL, SECURITY AND OTHER SURPPORT" including Loan to Value ("LTV") approach, and "HIERARCHY PRINCIPLE" may be considered in rating funds and related instruments.

The universe includes all types of investment vehicles including but not limited to pools, trusts, special purpose vehicles, closed-end funds, money market funds, prime funds, exchange-traded funds, model-driven funds, short and long duration funds, and portfolios, warehouses, and other similar vehicles (collectively "Funds" or "Fund"). This methodology provides an overview of EJR's general approach to analyzing Funds and evaluating quantitative and qualitative risks. This methodology explains how these factors are combined to form EJR's rating. In rating reports for specific investment funds, EJR will elaborate on its method for analyzing industry-specific investment guidelines and structural-specific factors, as necessary. In the future, EJR may publish sector-specific and structure-specific investment fund rating methodologies.

Funds are distinct from long-term fixed income financial instruments in several respects. From a strictly legal perspective, fund equity investors own limited partnership interests or shares (collectively "Equity Interests") and such Equity Interests represent an interest in the portfolio assets.

EJR's rating is meant to indicate the quality of a fund's underlying portfolio, quality of the management team deploying that fund's investment strategy, as well as the likelihood of maintaining that credit quality prospectively. EJR's rating does not provide an indication of performance as it relates to returns as measured versus peers, volatility, or yield. For information on EJR's rating scales, please see EJR's Rating Scales and Definitions.

The Rating Approach

EJR’s Fund ratings are based on quantitative and qualitative aspects and aim to reflect our best judgement concerning current and prospective credit quality. The quantitative analysis (“QuantScore”) is based on the credit quality of the fund’s portfolio using EJR’s credit matrix; the methodology provides information on the credit quality/support of assets targeted for investment by funds, measured in the context of the portfolio’s Weighted Average Life (“WAL”), which is the key duration benchmark used to determine the portfolio’s expected loss. EJR's rating addresses the composite expected losses from various assets in the fund.

The QuantScore is adjusted via a qualitative analysis (the “QualScore”) based on a review of management and operational /administrative aspects of running the fund, with a focus on whether those aspects might impact the credit quality of the fund. An assessment that results in a strong QualScore can lead to an overlay that could ultimately result in a higher rating than a fund with a weak QualScore. Generally, a management assessment that results in a weak QualScore will result in a lower final rating. However, in certain instances, it could indicate EJR was unable to develop sufficient comfort with a fund’s management practices to assign a rating to that fund. The methodology provides information on the credit quality/support of assets targeted for investment by funds, measured in the context of the portfolio’s Weighted Average Life (“WAL”), which is the key duration benchmark used to determine the portfolio’s expected loss. EJR's rating process aims to address the composite expected losses from an investment in the fund. Qualitative considerations may affect the rating, such as the strength of the fund manager or sponsor, or a material and persistent deviation from the fund’s strategy. In determining whether a fund can be rated, Egan-Jones considers the availability and quality of information regarding the financial instruments held in the fund. Note, the QualScore will be implemented after the effective date of this methodology and initially will be lightly weighted (i.e., one notch up, no change or one notch down) during the first year. QualScore will be used for new rating but in the case of existing ratings, will be conducted at the time of surveillance. (Note, EJR considers one notch to be immaterial.) After the first year of the effective date of this methodology, the notching will be a maximum of two notches (i.e., up to two notches up or down).

Additional items which might impact the final rating include asset/liability management, liquidity considerations, characteristics of assets held, and leverage.

QuantScore

Credit Matrix Weighted Average Life and Portfolio Expected Loss

A specified amount of expected loss is derived using a Credit Matrix, which compiles: 1) a sampling of the portfolio assets and an identification of the actual, estimated or derived long-term rating, 2) the calculation of the weighted average credit quality for the sampled assets, and 3) the expected loss associated with that rating based on a comparison of the expected loss for such rating given the financial instrument's maturity using Egan-Jones expected loss table. The expected loss of the portfolio's assets is then aggregated to determine "Portfolio Expected Loss". The Weighted Average Life ("WAL") is derived based on the remaining lives of the underlying financial instruments. If all the Fund assets are not known, a sampling or judgement might be utilized for determining the WAL. Ultimately, the level of WAL is a matter of judgement.

The ratings of the underlying fund assets are subject to review by a rating committee. Financial instruments that are not rated by Egan-Jones' are assessed based on other sources of information and through the use of other analytic techniques. In those cases where EJR derives a rating for a financial instrument, EJR typically derives the senior unsecured rating and then makes adjustments for the seniority and other characteristics. For example, in the case of senior secured debt, EJR would typically up-notched from the senior unsecured level. Conversely, in the case of subordinated debt and preferred stock, there would be down-notching. In the case of common stock, there would typically be an additional down-notching. In assessing these financial instruments, EJR considers the Fund manager's internal credit assessment of such financial instruments as well as the process used to arrive at the assessments. A random sampling of the portfolio will be conducted for existing Funds; for de novo Funds, analysts may weigh prior experience of the Fund manager and expected results for the Fund. The sampling should be at least 15% of Fund assets. Analysts may consult the Rating Review and Policies Committee for further guidance as needed.

Adjustment for Portfolio Diversification

Fund diversification may allow Fund investors to realize yields from some Fund holdings as an offset to possible losses from other holdings. For example, if a Fund holds investments in only a single firm, and there is a default, the investor normally could not expect to realize any coupon income and would be left with an expected loss. In a diversified Fund, by contrast, a Fund investor may benefit from yields from other holdings, which may offset at least in part the default loss. The level of diversification of a Fund is a matter of judgment. For example, analysts may consider that the Fund diversification after the "ramp-up" period for a de novo portfolio or Fund or similar vehicle. Additionally, in some cases, a look through to the underlying assets might be appropriate.

The possible levels of Fund diversification are expressed over four categories: high, medium, low, and no-diversified based on the following guidelines:

- Maximum single issuer holding 2% or less – high
- Maximum single issuer holding > 2% to 4% – medium
- Maximum single issuer holding > 4% to 6% – low
- Other – Non-diversified

Adjusting for Expected Losses to arrive at the Fund Rating

The portfolio yield is adjusted to reflect diversification to take account of expected portfolio losses by the following approach:

1. Factors of 75% for high diversification, 50% for medium diversification, 25% for low diversification and 20% for Non-diversified are applied against the Fund expected return to arrive at the Adjusted Portfolio Return. For example, if the composite yield of a Fund is 10% and the diversification is low, the Adjusted Portfolio Yield is 2.5%.
2. Estimated Losses are then reduced by the Adjusted Portfolio Return. For example, if the Estimated Loss is 4% and the Adjusted Portfolio Return is 2.5%, the Adjusted Expected Losses would be 1.5%.
3. Compare the Adjusted Expected Losses to the Expected Loss in view of the WAL using the Credit Matrix to arrive at the Fund rating. If the Adjusted Portfolio Return equals or exceeds the Adjusted Expected Losses, the rating is generally 4 rating notches above the weighted average rating of the bond Fund's holdings, although if the ratio of Adjusted Portfolio Return divided by Estimated Loss is greater than two, an additional notch up should be included.

QualScore

Quantitative measures are helpful in the above analysis but via the addition of qualitative factors we aim to further enhance the accuracy of the credit assessment. Factors which we believe are relevant include:

I. Management

An assessment of the asset management firm provides insight into whether the firm has the resources to support the operation of the Fund. In particular what resources may or may not be available, expertise, ability to attract talent, how it might compare to peers in the industry in terms of market share and reputation. The assessment of the firm's management, with a focus on the investment team of the fund being assigned a rating and its structure and culture, typically results in an understanding of the strength of the team involved in the management of the fund and its experience in the asset class to be focused on. The assessment should provide expectations regarding future performance of the fund.

	Strong	Average	Weak
Parent Organization	The parent is well-known and well-regarded in the industry. "Bench strength" is high such that if needed, parent can easily supplement current activities of investment group.	The parent is known and in the industry. "Bench strength" is such that if needed, parent can easily supplement current activities of investment group.	The parent is unknown and/or not well-regarded in the industry. "Bench strength" is low such that if needed, parent would have difficulty supplementing activities of investment group.
Organization	Fulsome staffing among the various functional areas, well-established internal controls, robust compliance function.	Adequate staffing among the various functional areas, established internal controls, compliance function.	Inadequate staffing among the various functional areas, sparse internal controls, anemic compliance function.
Investment Teams	Investment teams have deep experience in their respective areas. Evidence of backup managers in most areas.	Investment teams have experience in their respective areas. Backup managers in some areas.	Investment teams have modest experience in their respective areas. No evidence of backup managers in most areas.

II. Investment Process

A sound investment process is integral to assessing management's ability and to ensure investor protection. In our view, the investment process entails all activities undertaken by the management firm as well as structural and organizational issues that lead to building a successful investment platform including staffing; policies and procedures; reporting lines; analysis, including approval and surveillance; and technology and systems.

	Strong	Average	Weak
Staffing	The investment staff is a dedicated, independent, well-educated, and well-trained team which has evidenced regular success in the investment process.	The investment staff is a dedicated, independent, educated, and trained team which has evidenced some success in the investment process.	The investment staff is inexperienced and has evidenced modest success in the investment process.
Policies/ Procedures	Written policies and procedures addressing the roles and responsibilities of staff members, the analytical process, investment initiation and monitoring process, and investment guideline compliance.	Some written policies and procedures addressing the roles and responsibilities of staff members, the analytical process, investment initiation and monitoring process, and investment guideline compliance.	Few policies and procedures addressing the roles and responsibilities of staff members, the analytical process, investment initiation and monitoring process, and investment guideline compliance.
Analytical Tools	Robust, comprehensive insightful analyses for making investment decisions.	Adequate analyses for making investment decisions.	Weak analyses for making investment decisions.
Technology/Systems	Sophisticated systems used throughout the investment management process.	Adequate systems used throughout the investment management process.	Weak systems used throughout the investment management process.

III. Portfolio Management Process

Portfolio guidelines provide the characteristics of the targeted portfolio assts including eligible assets, diversification, and concentration limits, and hedging and leverage constraints. EJR expects clear investment guidelines, a well-documented investment processes, independent investment committees, transaction execution and portfolio monitoring. Technology and systems are also analyzed with a focus on stability, scalability, and customization with regards to the various strategies employed by the manager.

Regarding Investment guidelines, while diverse, we expect the manager will have exhibited and ability to comply with such guidelines. Diversification of the portfolio constitutes an important element of both portfolio quality and credit risk, but that in some areas, such diversification is impractical.

	Strong	Average	Weak
Investment Policy and Portfolio Guidelines	The investment policy and portfolio guidelines are clear and cogent.	The investment policy and portfolio guidelines generally clear.	The investment policy and portfolio guidelines are unclear and confusing.
Investment Policy and Portfolio Guideline (collectively "Guidelines") Compliance	Regular review and monitoring of compliance with Guidelines.	Periodic review and monitoring of compliance with Guidelines.	Little review and monitoring of compliance with Guidelines.
Technology/Systems	Sophisticated systems used throughout the portfolio management process.	Adequate systems used throughout the portfolio management process.	Weak systems used throughout the portfolio management process.

IV. Risk Management

Risk management is a critical area the application of which varies depending on the type of investments undertaken (e.g., a fund holding short term U.S. treasuries is expected to have nearly no losses whereas an early stage venture capital fund typically has significant losses and significant gains). The issue is whether management is undertaking the appropriate precautions to manage risks at the expected levels. The ideal combination enhances the probability of below average risk combined with above average returns for a particular investment approach.

	Strong	Average	Weak
Risk Management Policies and Procedures	Robust written risk management policies and procedures (P&Ps) and, regular testing of such P&Ps, and regular training re. P&Ps.	Some risk management policies and procedures (P&Ps) and, testing of such P&Ps, and training re. P&Ps.	Few risk management policies and procedures (P&Ps) and, little or no testing of such P&Ps, and little or no training re. P&Ps.
Risk Management Oversight	Regular review and monitoring of compliance with P&Ps.	Periodic review and monitoring of compliance with P&Ps.	Little review and monitoring of compliance with P&Ps.
Technology/Systems	Sophisticated systems used throughout the risk management process.	Adequate systems used throughout the risk management process.	Weak systems used throughout the risk management process.

Interest and Debt Coverage

If we are rating the debt and/or preferred capital associated with the Fund (collectively the “Fund Capital”), after deriving a rating for the Fund, we will make a determination of whether the expected return on the assets is sufficient to cover the interest and/or dividends (collectively the “Yield”) on the Fund Capital. If the Fund assets include a material portion of equity-like instruments, we might consider the return on equity, asset appreciation, or similar measures as indicators of the expected yield on Fund assets, such as Capital Asset Pricing Model (“CAPM”). Provided the expected return on the Fund assets exceed the yield on the Fund Capital, the difference shall be referred to as the “Excess Yield”. (The estimated loss on the Fund assets shall be adjusted by considering the Excess Yield (such as subtracting Excess Yield from the estimated loss on the Fund assets, or other adjustment as appropriate). In assigning a rating to the various capital components of the Fund, we might also consider the amount and composition of capital subordinate to the instrument being rated. The adjusted estimated loss shall then be compared to the corresponding rating levels for various estimated loss and considered in deriving the Fund Capital ratings. Note, in cases where the expected total return on the Fund assets is less than the debt costs for the Fund (i.e., there is a shortfall "Shortfall"), generally a Loan to Value approach will be used (see EJR's Main Methodology, "Collateral, Security and Other Support"), but with any shortfall reducing the value of the assets or alternatively, increasing the expected debt level.

Asset/Liability Management and Liquidity

An evaluation of the Fund's structure of the Fund's asset base might be needed particularly if cash requirements stemming from the capital side cannot be met from ordinary asset returns, but instead might necessitate a liquidation of a portion of Fund assets. Considerations regarding this aspect might include the levels and timing of cash demands stemming from the capital side, the marketability of the Fund's assets, alternative funding sources, and capabilities, and resources of the manager/sponsor of the Fund. Our experience is that most Funds have made accommodations for risks deriving in this area, but for Funds targeting short-term investments such as money market or prime funds, this area typically required greater attention.

A Closed-end fund ("CE Fund") is a fund which issues a fixed number of shares which are not redeemable from the fund. Unlike open-end funds, new shares in a closed-end fund are typically not created by managers to meet demand from investors. Since redemptions by investors are affected by shareholders selling shares on the exchange rather than liquidating fund assets, the liquidity demands on the Fund are typically ameliorated.

The measurement of LTV applied to the closed end fund and fund investment instruments rating will be used by: (1) Net Asset Value, which the value of all fund assets less liabilities. (2) Adjustment of NAV (i.e. benchmark volatilities, beta). (3) "L" is fund share holders' investment instruments (i.e. preferred share).

The selection of adjustment (allowed under EJR methodology) factor is from observable market based on elements, such as market volatilities.

Money market funds, prime funds, and other short-term funds (collectively, "ST Funds") have particularly acute considerations regarding asset/liability management and liquidity. In addition to the analysis mentioned above, an evaluation is needed regarding the Fund's ability to meet liquidity demands from cashflow or asset sales. Extreme examples of problems facing ST Funds were during the 2008 credit crisis whereby the commercial paper market froze (i.e., there was little buying or selling of paper) and investors demanded redemptions. Therefore, while a matching of the durations of assets and liabilities is important, the real risk is a freezing or severe curtailing of the liquidity on the asset side and whether the Fund has the ability to manage through such stressful periods. We believe the optimal way for addressing such low probability, high risk events is via qualitative analysis. Considerations might be gating terms (to provide the Fund time for orderly liquidations), credit lines, and other forms of liquidity a Fund might draw upon.

Validation/ Check

EJR aims to reflect the benefits of diversification in this Methodology. However, if using a simple Loan to Value (LTV) approach (addressed in EJR's core Methodology), indicates a greater level of credit quality, EJR will typically primarily use the LTV approach. Note, EJR may adjust the value mentioned above based on volatility, marketability, and general liquidity of the assets from which value is derived.

Appendix

Derivatives

Funds may use derivative products for a variety of purposes, including hedging interest rate, currency, and other market risks; substituting for a direct investment in an underlying instrument; or seeking to increase returns. Adjustments to the Credit Matrix may be made if the use of derivatives for hedging purposes is material. The analysis of hedging derivatives only evaluates for potential added credit risk and does not attempt to take into account elements of market risk, which may be inherent to these derivatives. Certain derivative instruments, such as credit default swaps (CDS) and forward purchase contracts, can create direct credit exposure to a referenced security. For these types of derivatives, EJR considers the notional amount of the referenced security in its assessment of portfolio credit quality through the use of Egan-Jones' Credit Matrix.

Monitoring Practices

To support its published rating opinions, Egan-Jones' analysts rely on information flows from the Fund company, independent third-party administrators, and publicly available sources. Such information, including portfolio data, is updated, and reviewed at least annually to ensure that the Fund's portfolio and management approach remain consistent with the Fund strategy and rating. At the discretion of EJR more frequent than annual surveillance might be required.

Limitations and Disclaimers

All EJR credit ratings and published methods are subject to certain limitations and disclaimers.

Information: Adequate information must be available to reach a view on the creditworthiness of the issuer, entity, or transaction in question. This includes publicly available information on the issuer, such as company financial and operational statistics, reports filed with regulatory agencies, and industry and economic reports. In addition, the rating process may incorporate data and insight gathered by EJR. If the available information appears insufficient to form a rating opinion, EJR may decide not to assign or maintain a credit rating.

Audit: Egan-Jones does not perform an audit in connection with any credit rating and may rely on unaudited financial information.

Usage: EJR's ratings remain its property at all times, and EJR has full discretion to determine if and when to withdraw a rating. Thus, EJR can choose to withdraw a rating at any time and for any reason, for example, due to a lack of information or a lack of market interest.

Methods: EJR does not intend to assume, and is not assuming, any responsibility or liability to any party arising out of, or with respect to, its published ratings methodology. Its ratings methodology documents are not intended to and do not form a part of any contract with anyone and no one shall have any right (contractual or otherwise) to enforce any of their provisions, either directly or indirectly. At its sole discretion, EJR may amend its ratings methodology documents and the processes described therein in any way and at any time as EJR may elect.

Disclosure of Ratings: Egan-Jones follows the applicable regulatory rules and requirements for the disclosure of ratings. Rating definitions and the terms of use of such ratings are available on the firm's website at www.EGAN-JONES.com. Published ratings, criteria, and methodologies are available from this site. Policies and procedures concerning conflicts of interest and other relevant topics are also available from this site.

Market participants are provided the opportunity to comment on the methodologies through the EJR's website (publicly available) for EJR's consideration.