Rating Agencies

By Michael E. Chadwick, CFP®

No matter what ride you have, it's been rated by some agency or firm, and perhaps by a lot more than one of them. Some of the rating agencies include the Insurance Institute for Highway Safety, the National Highway Traffic Safety Administration, the Environmental Protection Agency (yes, they rate cars now too, they'll tell you how "green" your car is or isn't) Car & Driver, Autoweek, Edmunds, JD Powers & Associates, Kelley Blue Book, Motor trend, Carfax, Consumer Reports, etc. There is a plethora of rating agencies all doing their due diligence so the consumer is informed and doesn't have to do all of the groundwork him or herself. We all assume the rating agencies are doing their jobs and that is never questioned. If you're looking for a safe car you'll focus on the crash test results from IIHS or NHTSA, if you seek reliability you'll focus your search on Consumer Reports, if you seek a fun to drive ride with personality you'll tune into Car & Driver and Autoweek – each and every aspect of automobiles can be rated and listed from best to worst, most desirable to least desirable. The reviews from firms are for the most part fair and unbiased. There can be some bias if a publication gets advertising from a manufacturer, they'll be inclined to say good things about the products because they wish to continue to get the advertising business. Some test vehicles aren't the ones you and I can buy, they're special "test mules" given to certain publications – clearly not fair or unbiased. Overall, I think the automotive industry is relatively fair and the consumer gets a reasonable report on what is what with all of the options we have for rides out there.

In the financial world we also have rating agencies that function in a similar matter. Their job is to do the intimate and detailed field research on investments and tell the investor what quality this investment is. The financial rating agencies include Standard & Poors, Moody's Investor Services, AM Best Ratings, Weiss Ratings, etc. The rating agencies typically rate investments based on safety, with a AAA (triple A) rating indicating this investment is the safest one out there, as safe as US Government Treasuries. The ratings then begin to go downhill as the financial stability of the investment declines, from AAA, it goes down to AA, A, BBB, BB, B, CCC, CC, C, etc. Investors typically view anything rated BBB or above as "investment grade" which means pretty good and stable companies with a very small risk of going belly up. Anything under the BBB rating is considered "junk" investments, hence the term junk bonds. Ironically, the auto giants GM & Ford are today considered junk bond investments. The lower quality ratings will need to pay a higher interest rate than the higher quality investments to compensate the investor for the increased risk, or at least perceived increased risk, of the investment. As a company, it's always best to have the highest rating so you can get capital at the lowest rates. Just like with your personal credit, the higher your score the lower interest rate you'll have on any loan you take out and if your score is low, you'll be forced to pay a very high interest rate or will be denied the loan. In the financial world the rating agencies haven't been so reliable – they rated many junk bonds AAA and didn't do the type of research they should have. It's much more complicated rating bonds and structured financial products because they can be layered. The mortgage fiasco we now face is because of these structured products, many of which have over 40 layers of investments within them. One product, if fully researched could be 2.5 million pages long! That's a lot of reading and it's not fun reading like a novel, its lawyers writing on financial products. Many physicians have told me the best sedative they know of if financial literature, far more powerful than any drug on the market. The bottom line is now the financial markets are working through re-rating all investments and it'll take a while. In the interim, the credit markets have somewhat dried up because investors aren't sure if they can bank on the ratings as they're applied to various debt instruments. Over time, the ratings will all be accurate and correct, but the price paid was a heavy one and now the rating agencies will face lawsuits from attorneys general. The best advice is not to rely too much on any one firm and do your own research and come to your own conclusions both about your investments and your rides. What rating systems are you paying attention to?

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