Methodology

Rating Canadian Mutual Fund Companies

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Insight beyond the rating.

CONTACT INFORMATION

Brenda Lum
Managing Director, Canadian Financial Institutions
+1 416 597 7569
blum@dbrs.com

Kent Wideman
Chief Credit Officer
+1 416 597 7535
kwideman@dbrs.com

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Introduction to DBRS Methodologies

- In general terms, DBRS ratings are opinions that reflect the creditworthiness of an issuer, a security or an obligation. They are opinions based on an analysis of historic trends and forward-looking measurements that assess an issuer's ability and willingness to make timely payments on outstanding obligations (whether principal, interest, dividend or distributions) with respect to the terms of an obligation.
- DBRS rating methodologies include consideration of general business and financial risk factors applicable to most industries in the corporate sector as well as industry-specific issues and more subjective factors, nuances and intangible considerations. Our approach is not based solely on statistical analysis but includes a combination of both quantitative and qualitative considerations.
- The considerations outlined in DBRS methodologies are not intended to be exhaustive. In certain cases, a major strength can compensate for a weakness and, conversely, there are cases where one weakness is so critical that it overrides the fact that the company may be strong in most other areas.
- DBRS rating methodologies are underpinned by a stable rating philosophy, which means that in order to minimize the rating changes due primarily to economic changes, DBRS strives to factor the impact of a cyclical economic environment into its rating as applicable. Rating revisions do occur, however, when it is clear that a structural change, either positive or negative, has transpired or appears likely to transpire in the near future.
- As a framework, DBRS rating methodologies consist of several components that together form the basis of the ultimate ratings assigned to individual securities. Assessments typically include the industry's business risk profile, the company's general business risk profile, the company's financial risk profile and considerations related to the specific security.
- To some extent, the business risk and financial risk profiles are interrelated. The financial risk for a company must be considered along with the business risks that it faces. In most cases, an entity's business risk will carry more weight in the final issuer rating than will its financial risk.

Business and Financial Risk Overview

- On a high-level macro basis, DBRS has a consistent approach to determining the issuer rating of an entity that is common across many industries. (See the appendix for the definition of "issuer rating.") Our high-level approach can be broken into three stages, as shown on the opposite page.
- Where applicable, DBRS uses the concept of business risk ratings (BRRs) as a tool in assessing the business strength of both industries and individual companies within many methodologies across the corporate finance area. DBRS typically assesses five areas to establish the overall BRR for an industry:
  – Profitability and cash flow.
  – Competitive landscape.
  – Stability.
  – Regulation.
  – Other inherent industry considerations.
- Although there is an overlap in some instances (to some degree, in the long term, all five factors tend to relate to profitability and stability), DBRS has found that considering these five measures in a separate fashion is a useful way of approaching this analysis.
- Using the same factors across different industries provides a common base with which to compare the business risks of various industries, even when they are distinctly different. In all cases, DBRS uses historic performance and our experience to determine an opinion on the future, which is the primary focus. For additional discussion on industry BRRs, please refer to the Industry Business Risk Ratings and Industry Business Risk Rating Definitions sections in the appendix.

DBRS

- It is important to note that the ratings for company-specific business and financial risks as provided under Stage 2 of this document should not be taken as final issuer ratings. For example, an individual company may fit into the "A" range with respect to the analysis of its business risk, but its financial metrics could be more in the BB category. It would be incorrect to believe that the final issuer rating in this case would be either "A" or BB. In determining the final issuer rating, both of these two major areas must be considered. For additional discussion on this topic, please refer to the Interrelationship between Business and Financial Risk section in the appendix.

Three Stages of DBRS Rating Analysis

Stage 1: Industry Business Risk Rating
Consider the overall business risk rating (BRR) for the industry.

Industry Business Risk Rating

↓

Stage 2: Issuer Rating
Consider the strength of the individual issuer:
(a) First assessing how the company's BRR compares with the industry BRR.
(b) Then assessing the company's financial risk.
Taken together, these factors will determine the company's issuer rating.

Company Business Risk + Company Financial Risk = **Issuer Rating**

The **long-term rating** puts more emphasis on business risk than the short-term rating does.

The **short-term rating** stresses financial risk as well as business risk, but places more emphasis on financial risk and liquidity than the long-term rating does.

Stage 3: Rating the Security
Consider covenant and ranking issues that exist for specific securities, using the issuer rating to determine specific security ratings.

Rating on the Security

Level of collateral and ranking of collateral and recovery methodology

Holding company debt versus operating company debt and notching principles

DBRS

Stage 1: Industry Business Risk Rating for the Mutual Fund Industry

INDUSTRY STRUCTURE AND DEFINITIONS

- According to the Investment Funds Institute of Canada (IFIC), the Canadian mutual fund industry consists of over 60 mutual fund manufacturing companies. Of estimated total assets under management (AUM) of more than $700 billion as of the end of 2010, of in excess of $600 billion, just under $300 billion or 41% are managed by 7 Canadian chartered banks and the Groupe Desjardins. An additional $54.6 billion or 7.8% is being managed by recently acquired affiliates of these same deposit taking institutions (e.g., PHN, DundeeWealth (Dynamic), Northwest and Ethical).
- Ten years ago, banks accounted for just 23% of AUM held by retail investors in the form of mutual funds. The banks have largely picked up market share through the promotion of wealth management products through their branch networks.
- Life insurance companies are also increasingly involved in manufacturing mutual funds as opposed to segregated fund products. Segregated funds are sold through licensed insurance agents and brokers while mutual funds are sold through MFDA (Mutual Fund Dealer Association)-licensed representatives and financial advisors, though any one advisor can have licenses to sell both kinds of products. The life insurance industry currently represents another 4.4% of AUM held in the form of mutual funds.
- The top five so-called independent mutual fund manufacturers which are not integrated into larger Canadian financial institutions account for 39% of industry AUM. The remainder is accounted for by a large number of small fund managers. These independent mutual fund companies are highly dependent on distribution arrangements and relationships generally focused on independent financial advisors and planners.
- For the purpose of assigning a rating to the mutual fund industry in Canada, the DBRS universe is therefore restricted to less than half of the AUM which is accounted for by the major independent mutual fund companies.
- The natural saving/investing/consumption cycle of the broader economy gives rise to demand for mutual funds and other retail wealth management products and services. The drivers of retirement savings and the general increase in financial wealth are therefore both demographic and economic. Government policies have a role to play in creating incentives, often tax-based, to encourage the accumulation of wealth to meet expected costs of retirement, education, and health care. The target market for mutual fund companies tends to be middle-aged, middle-income earners who are saving for their retirement. Client balances tend not to be large. Institutional AUM is similarly largely driven by pension savings, with each client account being relatively large.

For the Canadian mutual fund industry, DBRS views the industry business risk rating as being within the A (low) to BBB (high) range, based on the following industry business risk factors.

INDUSTRY PROFITABILITY AND CASH FLOW

- The major revenue line for a Canadian mutual fund company is the fees earned on the average market value of (AUM) and/or assets under administration (AUA), where the mutual fund company also houses an independent distribution arm. The offsetting expense base consists of both variable and fixed costs.
- A degree of scale economies is important to achieve profitability inasmuch as there is good operating leverage to be achieved in investment management and marketing and sales, and back office operations. Nevertheless, most expenses relate to human capital, with very little in the way of fixed assets. Correspondingly, much of the expense base is generally scalable to the size of the AUM and the volume of sales.
- Because the product is largely sold through financial agents such as advisors and planners who trade on their relationships with retail investors, there is a general absence of price competition in the industry, which makes it inherently profitable. As a fee-generating business with few requirements for working capital and investment capital, cash flows are stable, varying with the level of AUM and AUA.

INDUSTRY COMPETITIVE LANDSCAPE

- The Canadian mutual fund industry is competitive between individual Canadian mutual fund companies and among alternative consumer wealth management options such as full-service brokers, direct investing options, savings deposits and similar wealth accumulation products offered by banks and life insurance companies.
- In all wealth management entities, potential operating leverage is substantial, making the gathering of AUM and AUA in sufficient quantity a key success factor in achieving profitability. While the product being marketed may appear to be a commodity (investment management services) and should be characterized by price competition, each competitor has a vested interest in differentiating itself based on its promotion of investment performance or customer relationships with either the distribution agent or the ultimate customer. Pricing, therefore, tends to follow an oligopolistic model.
- While the potential for scale economies are significant, the effective break-even point can be lowered if a competitor has effectively positioned itself as offering a unique value-added product or service which can warrant higher fees.
- Mutual fund companies compete on a non-price basis for shelf space with individual investment advisors, which have the potential to direct the investments of client funds according to a number of factors and considerations that ultimately determine the success of each company's asset-gathering initiatives. Among these considerations may be service quality to the advisor and the ultimate client, ease of doing business in terms of technical interconnectivity and paperwork, product breadth and depth and relative fund performance.
- In the institutional market, the client is generally much more sophisticated than in the retail market. Competition is still based on investment performance and customer service, but achievement also has to be demonstrated.
- While the retention of retail funds depends largely on the company relationship with the advisor, the retention of institutional funds is more directly a function of performance. Given the large sums involved, movements in institutional funds under management can be volatile.

INDUSTRY STABILITY

- A successful mutual fund can generate several years of stable revenues for the fund company since there is little competitive pressure on management fees. Revenue stability is similarly enhanced by new product sales efforts and disincentives to withdraw funds, both through redemption charges and through the persuasive impact of the financial advisors who are largely compensated to minimize redemption rates. With respect to mutual funds, therefore, both the AUM and the associated revenues are considered to be "sticky." Institutional AUM (including pension funds and sub-advised AUM) are considered to be less "sticky" and significantly less vulnerable to persuasive marketing and more vulnerable to identifiable investment management performance.
- Nevertheless, revenues are driven by movements in broad investment markets, which are influenced by such factors as the perception of broad macroeconomic health and general investor confidence in the economic outlook. Stock market levels feed back in terms of retail investment activity, affecting the mix of such products between fixed income and more speculative equity investments, which has an impact on revenues.

INDUSTRY REGULATION

- The financial products sold to consumers in most jurisdictions are highly regulated through the prospectus-filing process. The sales process is also monitored for fairness to consumers in terms of the required amount and timing of disclosures regarding an advisor's conflicts of interest and the related costs of owning the selected funds. While the compliance with associated rules and regulations is an additional cost for the industry, such a regulatory framework can also save the industry from reputational damage and, in the extreme, expensive litigation.

- Governments regularly make assumptions about the need and ability of the general population to save for retirement, education and health-care costs. Government-authorized savings schemes such as registered retirement savings plans (RRSPs) and Tax-Free Savings Accounts (TFSAs) have a large impact on the ability of Canadian mutual fund companies to grow by attracting additional AUM. Government-sponsored financial literacy campaigns and heightened awareness of longer-term financial needs can deepen the retail investor's understanding of the investment process and raise awareness of the need to save, resulting in additional savings, which is potentially favourable for the mutual fund industry.
- Alternatively, higher financial literacy, facilitated by access to alternative information sources (many of which are available online), can result in more independent retail clients not relying on financial advisors for investment and financial education, which would not be positive for mutual fund companies that are structured to sell through financial advisors.
- Industry bodies also have a role to play in enforcing compliance by Canadian mutual fund companies as well as providing an effective political lobbying platform. However, the cost of compliance with all of the rules and regulations creates another expense hurdle, which only the largest companies can efficiently absorb. As such, regulatory change has played a part in encouraging industry consolidation.
- Where a Canadian mutual fund company includes a deposit-taking operation, government regulation takes the form of oversight of required capital and liquidity levels similar to the regulation of a bank. DBRS regards the regulatory framework for the mutual fund business as supportive.

OTHER INHERENT INDUSTRY CONSIDERATIONS

- The primary technological requirement for a successful Canadian mutual fund business is to have in place an effect information technology (IT) platform that allows for the reliable calculation and reporting of unit values to unitholders. IT is also used by Canadian mutual fund companies to effectively manage investment funds in terms of attribution analysis.
- Since the IT platform for a successful Canadian mutual fund business is not especially proprietary or specialized, technology tends not to be an important competitive factor. However, the cost of technology has played a role in encouraging the consolidation of the industry, resulting in a lower number of competitors operating with more effective scale.
- However, related to technology risk is the advent of more online capabilities (including investment information, investor education and transactional capability), which generally works against the financial advisor distribution channel. New products such as electronically-traded funds (ETFs) are an example of how technological change can threaten the traditional mutual fund product.
- On the other hand, technological change is also responsible for growth of alternative fund categories such as the fund of funds, which cater to the financial planning market rather than to the traditional investment management market through product designs focused on specific life stages and horizon dates.

Stage 2: Issuer Rating

To move from the generic industry BRR toward the issuer rating for a specific company, two tasks must be performed. Specifically, we must determine the business risk and the financial risk for the individual company.

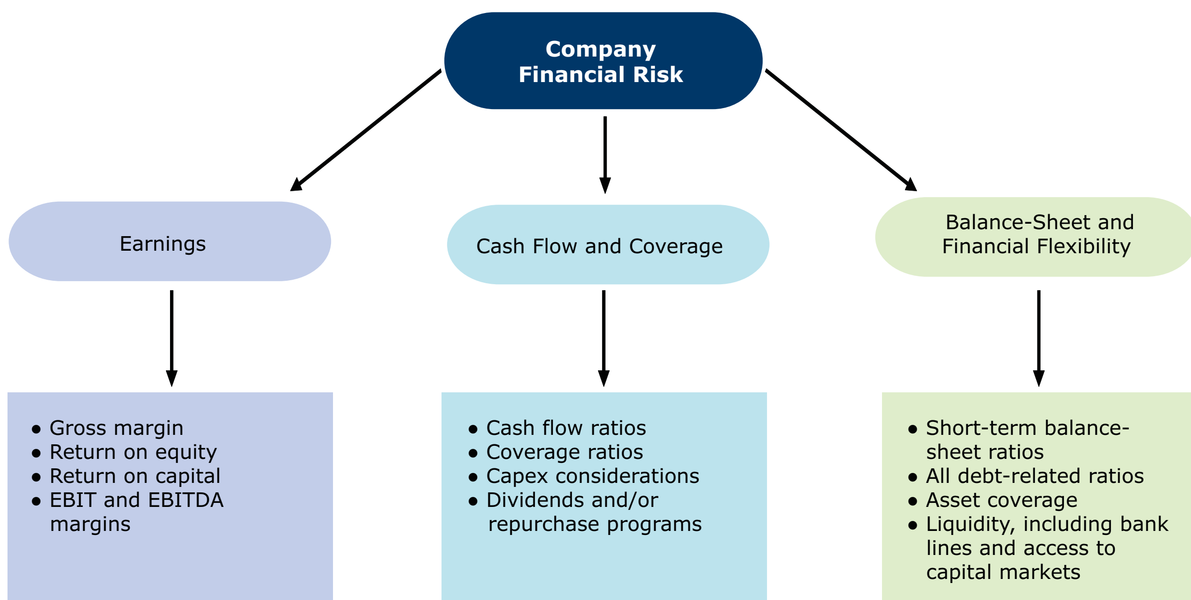
BUSINESS RISK PROFILE

- The business risk profile of the issuer may be better or worse than the industry average due to the presence of unique attributes or challenges that exist at the issuing entity. While not exhaustive, the list of critical factors outlined in the previous section could result in a specific issuer rating being different from the industry BRR.
- This methodology also provides some guidance on which factors are considered the most critical for the industry in question. Issuers may also have meaningful business lines in addition to the base business that extend beyond their most prominent industry, which could add significant attributes or challenges.

FINANCIAL RISK PROFILE

- The graphic below is a visual display of the key financial risk profile considerations that are discussed in the Company-Specific Financial Risk Factors section of this methodology, although even the detail provided there is not meant to be exhaustive.
- The discussion will note that DBRS often makes calculation adjustments in key ratios for risks related to a variety of areas. In some cases, a relationship with a parent or associated company will also be important.

Key Financial Risk Metrics



Company-Specific Business Risk Factors

- We now consider if an individual company in the mutual fund industry would be better, worse or the same as the industry BRR. Our focus here is on the critical business risk factors that relate to this industry in particular. The five critical factors used to determine the industry BRR are applied by DBRS to compare numerous industries and are thus more general in nature.
- By analyzing these key drivers (which will vary on an industry-by-industry basis), the essential strengths and challenges of each industry are captured in an accurate fashion, and transparency is provided. The analysis below is connected to the industry BRR in that the industry BRR establishes where an average company would be considered to score on the matrix. For example, an industry with a BRR of BBB would mean that the following matrix describes the scoring of an average company within the BBB column.

Company-Specific Business Risks – Critical Factors

Rating	AA	A	BBB	BB
Business Strength	Exceptional	Superior	Adequate	Weak
Scale	• Enjoys a dominant position in the industry, which maximizes all potential economies of scale. • Probably a long-time competitor in the industry, which has grown to its current scale by following disciplined and proven business practices. • Substantial earnings capacity, which allows for the internal generation of growth capital. • Characterized by having a large and growing share of the mutual fund market.	• A significant competitor, with good market presence but with some deficiencies in terms of maximizing its scale economies. • Effectively, the business is limited in scope and scale which just allows it to maintain market share with fewer advantages with which to increase share.	• Scale is sufficient to generate reasonable profitability, but the company's market share is vulnerable, with signs of shrinkage or inconsistent growth.	• A small economically inefficient operation, suffering from shrinking market share.
Distribution	• Multichannel distribution, including some captive and direct distribution, where the company can directly control the sale of its own products. • Sufficient brand strength such that even independent advisors are forced by their customers to offer the company's products or risk being seen as having a deficient product line. • Dominant shelf presence. • Makes available a number of complementary financial products and services to its distribution channels and is "easy" to do business with.	• A significant presence in the major third-party distribution channels, though not dominant. • Demonstrated ability to maintain and grow market share through successful wholesaling to distribution channels.	• Limited to a few main distribution channels but constantly trying to win additional shelf space and market penetration. • Has some marketing strengths and advantages, not least of which is a certain amount of history in the business and long-standing relationships with selling agents and advisors.	• No real market advantages to promote, so it relies largely on cultivating relationships with individual advisors through intensive and expensive recruitment.

Company-Specific Business Risks – Critical Factors

Rating Business Strength	AA Exceptional	A Superior	BBB Adequate	BB Weak
Product Mix	• A well-diversified portfolio of AUM and AUA, with a suite of complementary financial products and services, largely developed organically through disciplined product design and execution capabilities. • Strong offering of financial planning products, including horizon funds or fund of funds. • Few celebrity portfolio managers or several who have long tenure with the company. • Diversification by customer, including broadly distributed retail and institutional funds; by products, including equities and fixed income; by portfolio management style (growth, value or growth at a reasonable price (GARP)); and by geography, including both domestic and international assets. • In addition to funds, a whole suite of complementary products and services that help bind the customer and the advisor to the company.	• Well-diversified product offerings subject to certain limits, such as effective scale in certain product lines or gaps in the product portfolio that can only be filled by acquiring talent and expertise. • Certain concentrations by asset class or portfolio management style. • Lacks full suite of complementary products and services.	• One or two funds account for a disproportionate share of AUM, often tied to the success of a specific manager or management style.	• No particularly successful funds and few complementary products.
Brand	• A highly recognized brand built over many years of successful operations and being continually restored and refreshed. A brand which customers favour	• A recognized brand which is acceptable to customers but not a selling point	• A slightly tarnished brand stemming from inconsistent performance and reputation	• No brand profile to speak of outside of its small distribution platform
Fund Performance	• Consistent majority of four- and five-star funds.	• Good representation of four- and five-star funds.	• Less than half of AUM represented by four- and five-star funds.	• Few four- and five-star funds and absence of a track record.

PRIMARY COMPANY-SPECIFIC FACTORS

Scale

- Critical scale can provide competitive advantages in areas such as cost and operational efficiency, supply discounts, market profile and customer perception. A large equity base can provide additional comfort from one-time earnings hits, and larger firms often have more funding options in times of financial stress. (Key metrics to provide ranges: AUM and market share, share of gross and net sales.)

Distribution

- Mutual fund companies approach the market in a variety of ways, but control over distribution is becoming increasingly important as consolidation continues among independent advisors. Certain companies have their own distribution operations to sell proprietary products. While these distribution operations may not be profitable on a stand-alone basis, they are a potential source of revenue and expense synergies with the more profitable investment management business.
- Other fund companies sell through independent brokers for whom mutual fund companies compete on a number of relationship considerations. Direct sales channels such as banks and direct online investing represent a threat to traditional mutual fund companies as they bypass the financial advisor on whom mutual fund companies largely depend.
- The ability to access multiple distribution channels should enable a firm to maximize its sales potential and reduce its dependence on any single channel for new sales. Captive sales distribution channels are generally regarded as a positive for the mutual fund company credit rating as there is evidence that they give rise to higher levels of net sales (lower redemption rates) of the company's own funds. The conversion of AUA into AUM is a consistent theme where distribution channels are housed by mutual fund companies. (Key metrics: asset redemption rates, diversification of sales by channel, stability of fee income.)

Product Mix

- Breadth and diversification of a firm's products and services contribute to growth and sustainability of fee revenue. A company with limited diversification in terms of a specific fund, type of fund (equity or fixed income) or investment style or manager, risks losing AUM when such focused funds are less favoured by the market. A diversified product offering, therefore, allows for product switching rather than outright redemptions and maintenance of AUM.
- Complementary products such as savings deposits and investment loans are also a potential source of earnings diversification as well as a competitive advantage in serving the distribution channel. Part of a mutual fund company's attraction may be celebrity-type investment managers. Providing an appreciation and understanding of these managers to the client appears to be part of the perceived value added by investment advisors, giving rise to volatility when such managers depart.
- Many mutual fund companies have been seriously wounded by first trumpeting the performance of individual portfolio managers and subsequently suffering redemptions following that manager's departure. Either diversification by manager or a team-based approach with no specific manager focus is considered more sustainable than a marketing focus on a single manager.

Brand

- Most mutual fund companies will acknowledge that their primary customer is not the retail investor but rather the financial advisor or planner. Over the years the industry has vacillated between targeting marketing materials to retail investors but have found that it has been generally ineffective. Nevertheless, retail investors are more likely to accept the purchase of products where he/she is familiar with the brand which makes the selling job easier for the advisor. Such brand awareness is therefore considered a critical business risk.

Fund Performance

- Maintaining competitive fund performance is important inasmuch as advisors and retail investors frequently chase top-performing funds and managers. DBRS does not consider this a critical key business risk as long as investment fund performance is neither consistently below nor above the median performance for the asset class. Investment fund performance statistics suggest that no fund or manager consistently outperforms the fund universe on a risk-adjusted basis.

COMMON BUSINESS CONSIDERATIONS

- There are two major considerations that were not included with the prior analysis but can have a meaningful impact on an individual company in any industry: country risk and corporate governance (which includes management). These areas tend to be regarded more as potential negative issues that could result in a lower rating than otherwise would be the case, although DBRS would certainly consider exceptional strength in corporate governance as a rating attribute.
- In most cases, our focus on the two areas is to ensure that the company in question does not have any meaningful challenges that are not readily identifiable when reviewing the other business risk considerations and financial metrics outlined in this methodology.

Country Risk

- Governments often intervene in their economies and occasionally make substantial changes that can significantly affect a company's ability to meet its financial obligations; therefore, considerations include the company's main location or country of operation, the extent of government intervention and support and the degree of economic and political stability.
- As such, the sovereign rating itself may in some cases become a limiting factor in an entity's rating, particularly when the sovereign has a lower rating and the entity does not have meaningful diversification outside its domestic economy.

Corporate Governance

- Effective corporate governance requires a healthy tension between management, the board of directors and the public. There is no single approach that will be optimal for all companies.
- A good board will have a profound impact on a company, particularly when there are significant changes, challenges or major decisions facing the company. DBRS will typically assess factors such as the appropriateness of board composition and structure, opportunities for management self-interest, the extent of financial and non-financial disclosure and the strength or weakness of control functions. For more detail on this subject, please refer to the DBRS criteria *Evaluating Corporate Governance*.
- With respect to the pivotal area of management, an objective profile can be obtained by assessing the following: the appropriateness of core strategies; the rigour of key policies, processes and practices; management's reaction to problem situations; the integrity of company business and regulatory dealings; the entity's appetite for growth, either organically by adding new segments or through acquisition; its ability to smoothly integrate acquisitions without business disruption; and its track record in achieving financial results. Retention strategies and succession planning for senior roles can also be considerations.

Company-Specific Financial Risk Factors

KEY METRICS

- Recognizing that any analysis of financial metrics may be prone to misplaced precision, we have limited our key metrics to a small universe of critical ratios. For each of these ratios, DBRS provides a range within which the issuer's financial strength would be considered as supportive for the same level of business risk as the mutual fund industry. For example, a company where the outlook for both business risk and financial risk metrics falls within the BBB category would, all else being equal, be expected to have an issuer rating in the BBB range.
- To be clear, the ratings in the matrix below should not be understood as the final rating for an entity with matching metrics. This would only be the case to the extent that the business risk of the company and a wide range of other financial metrics were also supportive. The final rating is a blend of both the business risk and financial risk considerations in their entirety.

Mutual Fund Industry Financial Metrics

Key Ratio	AA	A	BBB	BB
Return on equity	> 20%	12% to 20%	7% to 12%	< 7%
EBITDA-to-average AUM	> 1%	0.75% to 1.0%	0.50% to 0.75%	< 0.50%
EBIT fixed charge coverage	> 10.0x	7.0x to 10.0x	5.0x to 7.0x	3.0x to 5.0x
Cash flow-to-commissions	> 4.0x	2.5x to 4.0x	1.0x to 2.5x	< 1.0x
Debt plus preferreds-to-EBITDA	< 1.0x	1.0x to 1.5x	1.5x to 2.5x	> 2.5x

- While the data in the above table are recognized as key factors, they should not be expected to be fully adequate to provide a final financial risk rating for any company. The nature of credit analysis is such that it must incorporate a broad range of financial considerations, and this cannot be limited to a finite number of metrics, regardless of how critical these may be.
- DBRS ratings are based heavily on future performance expectations, so while past metrics are important, any final rating will incorporate DBRS's opinion on future metrics, a subjective but critical consideration.
- It is also not uncommon for a company's key ratios to move in and out of the ranges noted in the ratio matrix above, particularly for cyclical industries. In the application of this matrix, however, DBRS is typically focusing on multi-year ratio averages.
- Notwithstanding these potential limitations, the key ratios are very useful in providing a good starting point in assessing a company's financial risk.
- It is important to note that actual financial ratios for an entity can and will be influenced by both accounting and accounting choices. In Canada, this will include the shift to International Financial Reporting Standards (IFRS). DBRS acknowledges that IFRS and other accounting choices will have an impact on the financial metrics of the companies that it covers. The financial risk factors include ratios based on data from company financial statements that are based on Canadian Generally Accepted Accounting Principles (GAAP) and U.S. GAAP, for the most part. When company financial statements are based on GAAP in other countries, including IFRS, the ratios and ranges may need to be redefined.
- Recognizing that the metrics in the table above do not represent the entire universe of considerations that DBRS examines when evaluating the financial risk profile of a company, the following provides a general overview that encompasses a broader range of metrics and considerations that could be meaningful in some cases.

DBRS

Overall Considerations in Evaluating a Company's Financial Risk Profile

In addition to the information already provided with respect to key financial metrics, the following financial considerations and ratios are typically part of the analysis for the Canadian mutual fund industry.

EARNINGS

- DBRS earnings analysis focuses on core or normalized earnings and in doing so considers issues such as the sources, mix and quality of revenue; the volatility or stability of revenue; the underlying cost base (e.g., company is a low-cost producer); optimal product pricing; and potential growth opportunities. Accordingly, earnings as presented in the company's financial statements are often adjusted for non-recurring items or items not considered part of ongoing operations. DBRS generally reviews company budgets and forecasts. Segmented breakdowns by division are also typically part of DBRS analysis.
- The earnings profile of a Canadian mutual fund company is a measure of the overall effectiveness of the rated company's operations. Canadian mutual fund revenues may vary across companies in reflection of the mix of business (e.g., whether retail or institutional, equity or fixed income). Assuming that each company's revenue stream in terms of fees per AUM is a constant, being a low-cost manufacturer and distributor is a key consideration as competition intensifies and the threat of lower management fees could potentially put downward pressure on revenues for all players.
- A well-contained cost structure should usually result in increasing margins with growth in AUM, all other things being the same. Non-mutual fund activities, such as intermediary, insurance and trust operations, can have a significant impact on intercompany comparisons. Incremental earnings from these related operations will contribute to returns and margins provided that they are efficiently managed. A positive trend in profit margins, subject to changes in business mix, is regarded favourably.

Typical Earnings Ratios

- Return on equity.
- EBIT margin.
- EBIT-to-average AUM.
- EBITDA margin.
- EBITDA-to-average AUM.
- Management fees-to-AUM.
- Trailer fees-to-average mutual fund assets.
- Operating expenses-to-operating revenues.
- Operating expenses-to-average AUM.

LIQUIDITY

- The rated company's available liquidity and its ability to generate new liquidity are a measure of financial flexibility. Short-term operating cash flow deficiencies may be accommodated with short-term working capital credit lines, but the company must be able to pay off such lines on a regular basis.
- The ability to access capital markets or the availability of committed bank facilities for longer-term or permanent capital needs is a function of the issuer's ability to service such debt on a timely basis. Additional sources of funding may include investments in securities, which act as a store of liquidity as well as a store of hidden capital in the form of unrealized gains.
- Asset securitization is also a potential source of financial flexibility. Loan balances such as mortgages or investment loans may also be sold into structure investment conduits, thereby enhancing liquidity. DBRS also notes each company's commitments under operating leases.
- The relative size of a company's intangible assets is a function of how much acquisition activity has occurred in the past. To the degree that most balance sheet growth is the result of the purchase of illiquid intangible assets, the rated company is vulnerable to goodwill impairments. The exposure of each company to the risk of having overpaid for intangible assets is the ratio of intangible assets-to-total assets.

- Depending on the relative size of the mutual fund company and the growth of gross mutual fund sales, lenders may be secured by future management fees to fund deferred sales commissions, which create a payment priority over any unsecured creditors.
- As mutual fund companies grow and mature in terms of AUM, they will inevitably reach a point where the new sales commissions can more easily be funded through organically generated cash flow from operations before sales commissions are paid.
- In assigning a rating to a mutual fund company, the incremental financial flexibility created by being able to internally fund sales commissions is significant. A consistent ratio of free cash flow (funds from operations before working capital changes and sales commissions)-to-sales commissions in excess of 1.0 times coverage is important in assessing this self-funding capability.

Typical Cash Flow Ratios
- Interest coverage ratios.
- Free cash flow.
- Cash from operations-to-sales commissions.

CAPITALIZATION
- Since the Canadian mutual fund business is not capital-intensive, financial leverage is generally employed to finance acquisitions, fund front-end sales commissions or fund peripheral operations such as capitalizing a regulated deposit-taking/lending affiliate. As a result, Canadian mutual fund companies can optimize their capital structure to maximize returns to common shareholders.
- The ability of a company's operations to service its debt and preferred share obligations is a function of both financial leverage and earnings.

Typical Balance-Sheet Ratios
- Liquid assets-to-total debt plus preferreds.
- Debt-to-capitalization.
- Debt plus preferreds-to-EBITDA.
- Dividend payout ratio (net income).
- Dividend payout ratio (free cash flow).
- Dividend and share buyback payout ratio (free cash flow).
- Internal capital growth.

Stage 3: Rating the Security

With respect to Stage 3, the following comments describe how the issuer rating is used to determine ratings on individual securities:
- DBRS uses a hierarchy in rating long-term debt that affects issuers that have classes of debt that do not rank equally. In most cases, lower-ranking classes would receive a lower DBRS rating. For more detail on this subject, please refer to DBRS rating policy entitled "Underlying Principles."
- In some cases, issued debt is secured by collateral. This is more typical in the non-investment-grade spectrum. For more detail on this subject, please refer to *DBRS Rating Methodology for Leveraged Finance*.
- The existence of holding companies can have a meaningful impact on individual security ratings. For more detail on this subject, please refer to the criteria *Rating Parent/Holding Companies and Their Subsidiaries*.

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Appendix

INDUSTRY BUSINESS RISK RATINGS

- DBRS uses the concept of business risk ratings (BRRs) as a tool in assessing the business strength of both industries and individual companies within many methodologies across the corporate finance area. (DBRS does not typically use this approach for most financial, government and public finance sectors, where the industry is more challenging to define and this approach is not as useful.)
- The BRR is assessed independently of financial risk, although in some cases there are subtle but important links. As an example, the very low business risk profile of many regulated utilities has historically allowed this sector to operate with debt levels that would not be acceptable for most other industry sectors. Given this reality, it is difficult to consider the utility industry's BRR without acknowledging to some degree that the industry operates with sizable debt levels. This type of relationship exists with many industries, although typically to a much lesser degree.
- When a BRR is applied to an industry, there is an acknowledgment that this is a general assessment and there may in fact be a wide disbursement in the business strength of individual entities within the industry. Nonetheless, this assessment is beneficial to enabling DBRS to clearly delineate our industry opinion and is a useful tool when comparing different industries. An industry BRR is defined as being representative of those entities that the market would consider as "established," meaning that the group of companies being considered would have at least reasonable critical mass and track records. As such, the BRR for an industry does not consider very small players, start-up operations or entities that have unusual strengths or weaknesses relative to the base industry.
- DBRS methodologies note whether they apply to global industries or more specific countries or regions. When analyzing individual credits, DBRS considers the degree to which regional considerations may differ from the geographic area applicable within the industry methodology. Many entities have business units that transcend industries and in these cases, more than one BRR would be considered, including the possible benefits or challenges that may exist when all businesses are analyzed as part of a combined group.
- The BRR is a tool that provides additional clarity regarding the business risk of the industry overall, but it should be viewed as just one aspect in the complex analysis of setting ratings and should by no means be seen as either a floor or ceiling for issuers within a given industry. Although DBRS does not anticipate volatility in an industry's BRR, changes are possible over time if there are meaningful structural developments in the industry. When such a change does occur, DBRS will make this clear and note any impact on related individual ratings within the industry as applicable.
- DBRS assesses five areas to establish the overall BRR for an industry. Although there is an overlap in some instances (to some degree, in the long term, all five factors tend to relate to profitability and stability), DBRS has found that considering these five measures in a separate fashion is a useful way of approaching its analysis. In all cases, DBRS uses historic performance and our experience to determine an opinion on the future, which is the primary focus.

Industry Profitability and Cash Flow

- When ratios such as return on equity, return on capital and a variety of cash flow metrics are considered, some industries are simply more profitable than others. While standard economics would suggest a reversion to the mean through new competitors, this often occurs at a very slow pace over a long time horizon and in some cases may not occur at all because of barriers to entry.
- The benefits from above-average profits and/or cash flow are substantial and include internal capital growth, easier access to external capital and an additional buffer to unexpected adversity from both liquidity and capital perspectives.
- Some industries and their participants have challenges or strengths in areas such as research and development (R&D), brand recognition, marketing, distribution, cost levels and a potentially wide variety of other tangibles and intangibles that affect their ability in the area of profitability.

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Industry Competitive Landscape

- The competitive landscape provides information regarding future profitability for the industry and thus somewhat crosses over into the profitability and cash flow assessment, but competition is deemed worthy of separate consideration because of its critical nature.
- Participants in industries that lack discipline, produce commodity-like products or services, have low barriers to entry and exhibit ongoing pricing war strategies generally have difficulty attaining high profitability levels in the longer term. Certain industries benefit from a monopoly or oligopoly situation, which may relate to regulation.

Industry Stability

- This factor relates primarily to the degree of stability in cash flow and earnings, measuring the degree to which the industry and its participants are affected by economic or industry cycles. Stability is considered critical as industries with high peaks and troughs have to deal with higher risk at the bottom of a cycle. As such, to some degree, industries with lower but stable profitability are considered more highly than industries with higher average profitability that is more cyclical.
- Some of the key factors in considering stability include the nature of the cost structure (fixed or variable), diversification that provides counter-cyclicality and the degree to which the industry interrelates with the overall economy. Depending on the industry, economic factors could include inflation or deflation, supply and demand, interest rates, currency swings and future demographics.

Industry Regulation

- Where applicable, regulation can provide support through stability and a barrier to entry, but it can also cause challenges and change the risk profile of an industry and its participants in a negative way, including the reality of additional costs and complications in enacting new strategies or other changes.
- As part of its analysis of regulation, DBRS also considers the likelihood of deregulation for a regulated industry, noting the many examples where this transition has proven to be a major challenge in the past.

Other Inherent Industry Considerations

- Each industry has its own set of unique potential risks that, even if managed well, cannot be totally eliminated. Specific risks, the ability to manage them and the range of potential outcomes vary industry by industry. Two of the most common risks are changing technology and operational risks.
- Some of the other more common risks are in the areas of legal, product tampering, weather, natural disasters, labour relations, currency, energy prices, emerging markets and pensions.

INDUSTRY BUSINESS RISK RATING DEFINITIONS

DBRS specifies the BRR for an industry in terms of our Long-Term Obligations rating scale. When discussing industry BRRs for an industry, DBRS typically provides either one specific rating or a limited range (such as BBB (high)/BBB). Using a range recognizes the fact that, by their nature, industry BRRs are less precise than a specific corporate or security rating as they represent an overall industry. In addition to relating to the industry level, these definitions also apply to the business risk of individual companies, which will fall more often in the very high and low categories (AA/AAA and B) than would be the case for an entire industry.

Industry Business Risk Ratings (BRRs)

Rating	Business Strength	Comment
AA/AAA	Exceptional	An industry BRR of AA/AAA is considered unusually strong, with no meaningful weakness in any individual area. It may include pure monopolies that are deemed essential (the primary case being regulated utilities, where the risk of deregulation is believed to be very low). Common attributes include product differentiation, high barriers to entry and meaningful cost advantages over other industries or entities. These and other strengths provide exceptional stability and high profitability. It would be quite rare for an industry to have a BRR in this category.
A	Superior	Industry BRRs at the "A" level are considered well above average in terms of stability and profitability and typically have some barriers to entry related to capital, technology or scale. Industries that have, by their nature, inherent challenges in terms of cyclicality, a high degree of competition and technology risks would be unlikely to attain this rating category.
BBB	Adequate	Industry BRRs at the BBB level include many cyclical industries where other positive considerations are somewhat offset by challenges related to areas such as commodity products, labour issues, low barriers to entry, high fixed costs and exposure to energy costs. This rating category is considered average and many industries fall within it, with key considerations such as overall profitability and stability typically considered as neither above or below average.
BB	Weak	An industry at the BB level has some meaningful challenges. In addition to high cyclicality, challenges could include the existence of high technology or other risks. Long-standing industries that may have lost their key strengths through factors such as new competition, obsolescence or the inability to meet changing purchaser demands may fit here. The culmination of such factors results in an industry that does not generally score well in terms of stability and profitability. For an entire industry, this is typically the lowest BRR level.
B	Poor	While not common, there are cases where an industry can have a BRR of B. Such industries would typically be characterized by below-average strength in all or virtually all major areas.

INTERRELATIONSHIP BETWEEN FINANCIAL AND BUSINESS RISK

Having in mind the prior discussion on the typical importance that DBRS places on certain financial metrics and business strengths for the mutual fund industry, we provide some guiding principles pertaining to the application of DBRS methodologies, the first one being that, in most cases, an entity's business risk will carry more weight in the final rating than its financial risk.

Based on this underlying concept, we provide the additional guidance for individual companies with varying business risks:

- **For an Entity with a Business Risk of AA (Exceptional):** A company with a business risk of AA will almost always be able to obtain an investment-grade issuer rating. When financial metrics are in the BBB range, an entity with a business risk of AA would typically be able to attain an "A"-range issuer rating.
- **For an Entity with a Business Risk of "A" (Superior):** Unless financial strength fails to exceed the B range, superior business strength will typically allow the final issuer rating to be investment grade. Very conservative financial risk may in some cases allow the final issuer rating to be within the AA range, but this should not be considered the norm.
- **For an Entity with a Business Risk of BBB (Adequate):** At this average level of business risk, the level of financial risk typically has the ability to result in a final issuer rating from as high as "A" to as low as B.
- **For an Entity with a Business Risk of BB (Weak):** At this weak level of business risk, conservative financial risk can, in some cases, take the final issuer rating into the BBB investment-grade range.
- **For an Entity with a Business Risk of B (Poor):** It is not typically possible for a company with a business risk of B to achieve a final investment-grade issuer rating.

DEFINITION OF ISSUER RATING

- DBRS Corporate rating analysis begins with an evaluation of the fundamental creditworthiness of the issuer, which is reflected in an "issuer rating". Issuer ratings address the overall credit strength of the issuer. Unlike ratings on individual securities or classes of securities, issuer ratings are based on the entity itself and do not include consideration for security or ranking. Ratings that apply to actual securities (secured or unsecured) may be higher, lower or equal to the issuer rating for a given entity.
- Given the lack of impact from security or ranking considerations, issuer ratings generally provide an opinion of default risk for all industry sectors. As such, issuer ratings in the banking sector relate to the final credit opinion on a bank that incorporates both the intrinsic rating and support considerations, if any.
- DBRS typically assigns issuer ratings on a long-term basis using its Long Term Obligations Rating Scale; however, on occasion, DBRS may assign a "short-term issuer rating" using its Commercial Paper and Short Term Debt Rating Scale to reflect the issuer's overall creditworthiness over a short-term time horizon.

SHORT-TERM AND LONG-TERM RATINGS

- For a discussion on the relationship between short- and long-term ratings and more detail on liquidity factors, please refer to the DBRS policy entitled "Short-Term and Long-Term Rating Relationships" and the criteria *DBRS Commercial Paper Liquidity Support Criteria for Corporate Non-Bank Issuers*.

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Insight beyond the rating.

www.dbrs.com

Corporate Headquarters

DBRS Tower
181 University Avenue
Suite 700
Toronto, ON M5H 3M7
TEL +1 416 593 5577