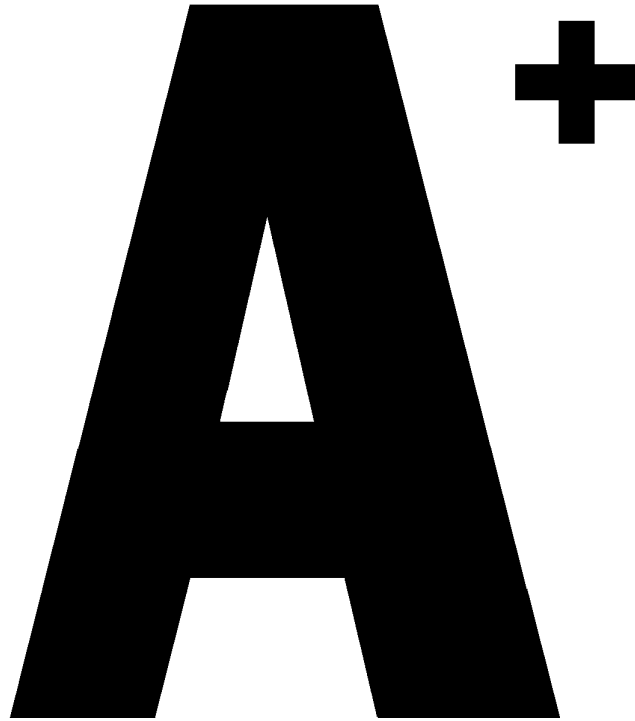


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In Caveat Emptor

By Trip Shepard

"There are two superpowers in the world today in my opinion. There's the United States and there's Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me, it's not clear sometimes who's more powerful."

*Thomas L. Friedman, author of The Lexus and the Olive Tree
On News Hour with Jim Lehrer, February 13, 1996*

In recent years, Wall Street equities analysts have come under withering fire both for being wrong far more often than right and shilling for their firms' investment banking clients. Now it's the leading credit rating agencies' turn to take the heat for misleading investors and for structural improprieties in their business practices.

I'm not going to stick up for Wall Street. In my opinion, many sell-side analysts don't do a very thorough job researching companies. Often, their biggest failing is not spending enough time reading the small print—the extensive footnotes in many companies' balance sheets and income statements that contain so much valuable information. In other instances, analysts are afraid to "tell it like it is" for fear of losing their jobs by jeopardizing their firm's highly profitable investment banking relationships. That's why at Gabelli Funds, we have always done our own homework rather than rely on Wall Street research.

The All Powerful Rating Agencies

We have been just as wary about the opinions of the leading credit rating agencies—until quite recently perceived by the investor public as astute and objective judges of the quality of corporate debt. As the quote at the lead of this article makes clear, the credit rating industry's Big Three, (Moody's Investor Services, Standard & Poor's, and Fitch), have even more power than Wall Street brokerage firms. Stocks that are downgraded by high profile equities analysts (usually after they have already declined by a substantial margin) generally come under temporary selling pressure. When any of the Big Three downgrades corporate debt, particularly from investment grade to junk bond status, the fertilizer really hits the fan. Bondholders sustain more severe and lasting damage, because a credit downgrade has an immediate and substantial impact on the cost of capital for corporations and in some instances, can force the company to immediately pay off a significant portion of its obligations. If the cash to do so isn't available, bankruptcy can be the only option.

Before we review the event that has done the most to undermine the creditability of the credit rating agencies—the Enron debacle—I'll give you a brief history and detail some of the inherent problems and potential conflicts of interest in the credit rating business.

From Railroads to Bank Deposits

The credit rating agencies got their start in the late 19th century publishing financial analyses on railroad companies. Gradually, they expanded their scope, providing investors with ratings on credit obligations ranging from corporate debt to bank deposits. Beginning in the 1930's, demand for the credit rating agencies' services increased substantially when the Office of the Comptroller of the Currency began to incorporate credit ratings into its investment restrictions for banks. Credit rating was a fragmented business until 1975, when the Securities and Exchange Commission established the Nationally Recognized Statistical Rating Organization (NRSRO) designation and named Moody's, S&P and Fitch as NRSRO's. Over the following 27 years, numerous regulations have been created to govern the level of non-investment grade debt that institutional investors (banks, insurance companies, and corporate pension funds) can own. This resulted in even greater demand for Moody's, S&P and Fitch's services and gave them even greater power over corporate America and the fixed income market.

A Ratings Primer

As part of their ratings assessment, the three rating agencies evaluate numerous qualitative and quantitative factors to determine whether or not a fixed-income issuer is likely to generate sufficient future cash flows to meet its credit obligations. The agencies review all the public information that exists on a corporate issuer and analyze factors such as the

characteristics of the issuer's industry, the strength of its management, the viability of its business strategy, its profitability, and its capital structure. Once all this information has been gathered and analyzed, a credit committee convenes to vote on the rating a debt security will receive. Table 1 presents the different ratings used by the rating agencies.

Fees = Conflicts of Interest?

Initially, the credit rating agencies charged investors for subscriptions to their rating reports, even though the actual ratings were disseminated publicly free of charge. In the 1970's, around the time that the Big Three became designated as NRSRO's, they began charging debt issuers as well. Moody's and S&P continued their practice of rating virtually all SEC-registered corporate bonds based on public information whether or not the issuer requested the rating. However, if the issuer paid a one-time fee based on the size of its offering it received the right to share non-public information with the rating agency in order to better present itself. Moody's has taken this revenue and profit generating system a step further by allowing corporations to pay a yearly fee and have all their bond issues rated. In addition, the rating agencies have started to charge companies fees for advice on what the likely credit rating effect of potential corporate actions would be.

Obviously, having issuers pay for ratings provides a potential conflict of interest for the rating agencies, in that the debt of companies paying for all these services might be given more favorable ratings. The credit rating agencies have tried to diffuse concern over this potential conflict of interest by maintaining that investor confidence in their objectiveness and independence is more critical to them than dipping into the pockets of their corporate clients—an eerie echo of Wall Street's assertion that the integrity of their analysts' research is never compromised by highly profitable investment banking relationships.

Table 1:		Credit Ratings		
Criteria	S&P^(a)	Moody's^(b)	Fitch^(c)	
INVESTMENT GRADE				
Extremely strong payment capacity	AAA	Aaa	AAA	
Very strong payment capacity	AA+	Aa1	AA+	
	AA	Aa2	AA	
	AA-	Aa3	AA-	
Strong payment capacity	A+	A1	A+	
	A	A2	A	
	A-	A3	A-	
Adequate payment capacity	BBB+	Baa1	BBB+	
	BBB	Baa2	BBB	
	BBB-	Baa3	BBB-	
<hr/>				
NON-INVESTMENT GRADE				
Uncertain payment capacity	BB+	Ba1	BB+	
	BB	Ba2	BB	
	BB-	Ba3	BB-	
High risk that payment capacity will not exist when obligations come due	B+	B1	B+	
	B	B2	B	
	B-	B3	B-	
Company is either in default or is very likely to default	CCC+		CCC+	
	CCC	Caa	CCC	
	CCC-		CCC-	
Company is in bankruptcy or default	C	Ca	C	
	D	C	D	

(a) Standard & Poors is a subsidiary of McGraw Hill.
 (b) Moody's is a stand-alone rating agency.
 (c) Fitch is a subsidiary of the French conglomerate Fimalac.

Whether credit rating agencies are swayed by cash paying corporate customers is a matter of debate. However, service arrangements that allow issuers to share some non-public information with the agencies without being required to provide all non-public information is problematic to say the least. Giving the rating agencies access to non-public good news while allowing corporations to sweep the bad news under the rug until something happens that forces them to do some public housecleaning is, as we shall see, a recipe for disaster.

The Enron Debacle

Despite the inherent problems in the credit rating business, the investor public never fully questioned the analytical capabilities or integrity of the credit rating agencies. Then came Enron.

Prior to Moody's Investor Service's downgrade of Enron debt from Baa1 from Baa2 on October 29, 2001, (just 33 days before the company filed for bankruptcy), all three credit rating agencies rated Enron's senior unsecured debt three levels

above non-investment grade. In an April 2000 report, Moody's wrote that its Baa1 rating for Enron's senior unsecured debt was based on the company's "increasing earnings from its position as North America's leading energy wholesaler, with consistently strong cash flows from its core pipeline business". The report also opined that Enron's energy services sector (including its trading operations) should increasingly contribute to operating income.

To be fair, the report also mentioned \$7 billion in off-balance sheet liabilities as a significant risk to the company. As it turned out, Enron was able to hide considerably more debt from Moody's and the other credit rating agencies. We can't blame the rating agencies for failing to uncover what looks to be a massive accounting fraud. However, if Enron was required to share all non-public information with the rating agencies, they might have detected the quiet ticking of the time bomb that was about to go off.

Although the rating agencies are aware of their power to cripple corporations by downgrading their debt, the impact of a potential downgrade is not included in their analysis. In the case of Enron, one could argue the rating agencies should have explicitly warned investors that a significant ratings downgrade could put this highly leveraged company out of business. If the agencies didn't know already, they quickly learned that if they downgraded Enron's debt to non-investment grade status, it would immediately cause an estimated \$3.9 billion in liabilities to come due, for which the company did not have enough cash to pay.

The timing of the downgrade of Enron debt to junk status was also somewhat suspicious. It wasn't until November 28, 2001, after the agencies concluded that Enron's merger attempt with Dynegy would not succeed, that they all downgraded Enron's senior unsecured debt to junk bond status. One could argue that the credit rating agencies were acting in bondholder's best interest by delaying dropping the bomb in the hope that a merger with Dynegy could save the day. Unfortunately, the merger didn't get done and many Enron bondholders were left holding an even emptier bag.

Light at the End of the Tunnel

Will something good come from this fiasco? Hopefully, we will see higher and more uniform accounting standards for public companies. We can no longer jeopardize public trust in the financial markets by allowing companies to move debt off the balance sheet and disguise losses through dummy partnerships and affiliates. We might even go so far as to allow the market rather than the credit rating agencies evaluate the creditworthiness of corporate debt for regulatory purposes. For example, if ABC Company's 10-year non-secured bond has a yield that is 300 basis points higher than the 10-year Treasury bond while comparable debt from XYZ company has a yield that is only 100 basis points higher than the same Treasury bond, the market is telling us XYZ is in better shape to honor its obligations. Regulations could be established that would prevent institutional investors from owning bonds that have yields that are on average more than 200 basis points above the yield on comparable Treasury bonds for some period of time. This may sound like a radical solution, but think about it. It's the way the stock market has always operated and while over the short-term, Mr. Market doesn't always value stocks appropriately, over the longer-term stocks generally trade at a rational relationship to their real-world economic value.

In Conclusion

What lesson can investors take from this sad tale? In Caveat Emptor—buyer beware. If your stockbroker is pitching the stock of a company that is paying his firm millions in investment banking fees, (something you won't learn unless you ask), beware. If the manager of the bond fund you own is relying solely on the research of the credit rating agencies, (something not likely to be highlighted in the prospectus), beware. Do some research or at least go for a second and third opinion before you invest.

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