Looking beyond the ratings

Federated Hermes

How Federated Hermes' high-yield team values bonds

When Federated Hermes uses the term quality, we are referring to an issuer's underlying business. Business quality and rating-agency quality are fundamentally different, and Federated Hermes' experience in the former has played an important role in our success as a high-yield asset manager.

Rating agency perspective of quality

The first thing most investors think of when they hear about a bond's quality is a rating agency's grade issued by the three Nationally Recognized Statistical Rating Organizations (NRSROs). In high yield (i.e., bonds rated BB, B, CCC or lower), an NRSRO's methodology includes:

- A bias toward quantitative metrics associated with leverage and coverage ratios that often miss the big picture, such as industries that have strong current free cash flow but are in secular decline.
- A tendency to lag market conditions. Underlying business fundamentals may improve or deteriorate dramatically with no resulting change in quality rating; in some cases, the initial rating at issuance may not change for years.

Federated Hermes' perspective of quality

We hold a fundamentally different view of quality, and our approach includes:

- A forward-looking view of company financials, with a qualitative emphasis on franchise value, industry and competitive profile and strength of management.
- A premium on a company's ability to service debt through consistent and predictable free cash-flow generation.
- A definition of quality that normally leads us to invest in less-volatile sectors such as packaging, media, food/beverage and health care, and to underweight volatile, cyclical sectors like metals/mining, energy, homebuilding and airlines.

We believe not all CCC-rated bonds are created equal

The market provides an implied quality rating of a bond via its effective spread-to-Treasuries. We view this market-based valuation to be more indicative of a bond's inherent risks than a static bond rating from an issuer.

Many high-yield investors avoid CCC-rated bonds entirely due to their perceived riskiness. A closer look reveals that the CCC sector is comprised of a highly disparate group of bonds as measured by effective spread-to-Treasuries. A comparison of CCC bond spreads demonstrates that the market views some CCC bonds as having higher quality than the rating agencies suggest.

Comparison of spread breakouts for Federated Hermes Institutional High Yield Bond Fund (FIHYBF)

Rating agency breakout (as of 12/31/23)

	FIHYBF	Index	Variance
Credit quality	Weight (%)	Weight (%)	Weight (%)
Cash	3.27	–	3.27
BBB	5.63	–	5.63
BB	27.07	46.04	-18.97
B	38.53	41.11	-2.58
CCC/and Below	25.17	12.83	12.34
NR	0.33	0.02	0.31
Total	**100.00**	**100.00**	**–**

Rating agency: Bloomberg Ratings

Index: Bloomberg US Corporate High Yield 2% Issuer Capped

Effective spread breakout (as of 12/31/23)

	FIHYBF	Index	Variance
Credit quality	Weight (%)	Weight (%)	Weight (%)
Low spread (high quality)			
<1.00 - 2.16	47.70	46.04	1.66
Mid spread (mid quality)			
2.16 - 5.58	39.56	41.11	-1.55
High spread (low quality)			
>5.58	12.74	12.85	-0.11
Total	**100.00**	**100.00**	**–**

Index: Bloomberg US Corporate High Yield 2% Issuer Capped

Effective spread breakouts are calibrated to rating agency index quality weights (BB = Low spread, B = Mid spread, CCC = High spread). According to rating agencies, Institutional High Yield Bond Fund appears to be low quality—overweight CCC, while underweight BB.

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Federated Hermes' view

Despite overweights to CCC-rated bonds, we believe Federated Hermes' market-based, spread-driven quality analysis can help identify performance characteristics beyond the rating-agency quality definitions.

We believe divergent views of quality create an inefficient market and provide an opportunity for Federated Hermes to generate attractive excess and risk-adjusted returns.

Bloomberg US Corporate High Yield 2% Issuer Capped Index: Is an issuer-constrained version of the flagship US Corporate High Yield Index, which measures the USD-denominated, high yield, fixed-rate corporate bond market. The index follows the same rules as the uncapped version, but limits the exposure of each issuer to 2% of the total market value and redistributes any excess market value index wide on a pro-rata basis. The index was created in 2002, with history backfilled to January 1, 1993.

The ratings agencies that provided the ratings are Standard & Poor's, Moody's and Fitch. When ratings vary, the lowest rating is used. Credit ratings of A or better are considered to be high credit quality; credit ratings of B are good credit quality and the lowest category of investment grade; credit ratings B and below are lower-rated securities ("junk bonds"); and credit ratings of C or below have high default risk. The credit quality breakdown does not give effect to the impact of any credit derivative investments made by the fund.

Effective spread is the difference in yield between high yield bonds and treasury bonds of comparable maturities.

A word about risk

Mutual funds are subject to risks and fluctuate in value.

High-yield, lower-rated securities generally entail greater market, credit/default and liquidity risks, and may be more volatile than investment-grade securities.

Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

Past performance is no guarantee of future results. Ratings are subject to change and do not remove market risk.

This material must be preceded or accompanied by a prospectus.

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