

Looking beyond the ratings

How the US Federated Hermes' high yield team values bonds

The first thing most investors think of when they hear about a bond's quality is a rating agency's grade. The letter grades agencies assign to an issuance's creditworthiness remain the most pervasive means of valuing it. But this is not the only way to define quality. When Federated Hermes uses the term, we are referring to the quality of an issuer's underlying business. Business quality and rating-agency quality are fundamentally different, and Federated Hermes' experience in the former has played a large role in our success as a firm.



Rating agency perspective of quality

Investors are familiar with credit quality ratings issued by the three Nationally Recognized Statistical Rating Organizations (NRSROs): Moody's, Standard & Poor's and Fitch. In high yield (i.e., below investment grade), bonds are rated BB, B, CCC or lower. The NRSRO's methodology includes:

- Heavy reliance on quantitative metrics associated with leverage and coverage ratios.
- An emphasis on the current financial position of the business, with limited focus on future prospects.
- 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.
- A bias toward quantitative metrics that often miss the big picture, such as industries that have strong current free cash flow but that are in secular decline, like newspapers and wireline telecommunications.

Federated Hermes' perspective of quality

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

- A forward-looking view of company financials.
- A qualitative emphasis focused on franchise value, industry profile, competitive profile and strength of management.
- A premium placed 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 healthcare, and to lower our exposure to volatile, cyclical sectors like metals/mining, energy, homebuilding and airlines.

Market's perspective of quality

Separate from the rating agencies, but equally if not more important, 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 one of the NRSROs.

We believe not all CCC-rated bonds are created equal

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 bonds as of 3/31/20 shows that the market will pay as little as <1% over Treasuries for some issues while it demands significantly higher spreads for others, even greater than 100% over treasuries. This demonstrates that the market views some CCC bonds as having higher quality than rating agencies suggest.

Federated Hermes' edge

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

Federated Hermes is adept at investing across the entire credit-quality spectrum. Our analysts combine extensive industry experience with bottom-up analysis that seeks to identify superior operating companies. It is this comprehensive, fundamental credit work that can uncover relative value opportunities that would be missed by relying solely on rating agency assessments. This in-depth combination of qualitative and quantitative analysis is designed to identify strong operating companies that can service an aggressive capital structure. This security selection process has generated consistent results across various market environments and credit cycles.

Exhibit 1: Analysis of portfolio quality — rating agency versus effective spread

The table below compares portfolio "quality" as defined by a rating agency versus a market-based view of quality as measured by effective spread-to-Treasuries. It reveals how a portfolio credit agency quality allocation may not always be indicative of its risk as reflected in its underlying bond valuations, or spreads.

Rating agency breakout (as of 3/31/20)

	Strategy	Index	Variance
Credit quality	Weight (%)	Weight (%)	Weight (%)
Cash	2.38	-	2.38
BBB	1.20	-	1.20
BB	33.31	49.25	-15.94
B	38.79	36.96	1.83
CCC/and below	24.24	13.48	10.76
NR	0.08	0.31	-0.23
Total	100.00	100.00	

Rating agency: Bloomberg Barclays Ratings

Index: Bloomberg Barclays U.S. High Yield 2% Issuer Capped

Effective spread breakout (as of 3/31/20)

	Strategy	Index	Variance
Credit quality	Weight (%)	Weight (%)	Weight (%)
Low spread (high quality)			
<1.00 - 6.12	45.31	49.25	-3.94
Mid spread (mid quality)			
6.12 - 12.29	45.42	36.96	8.46
High spread (low quality)			
> 12.29	9.27	13.79	-4.52
Total	100.00	100.00	

Index: Bloomberg Barclays U.S. 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, Federated Hermes' High-Yield Strategy appears to be low quality—overweight CCC, while underweight BB.

Exhibit 2: Federated Hermes' performance profile — demonstrating our thesis through realized results

At first glance, The Federated High Yield Fixed Income Strategy would appear to be an aggressive, low-quality, high-beta strategy that underperforms when the market sells off. But our realized performance profile reveals the opposite, i.e., lower beta, lower yield, lower volatility in down markets.

Despite being overweight CCC-rated bonds, Federated Hermes' market based, spread driven quality analysis has been more predictive of performance characteristics than rating-agency quality definitions.

2016				2017				2018				2019				2020
1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q

■ BB quality and higher ■ B quality ■ CCC quality and lower

Bloomberg Barclays U.S. High Yield 2% Issuer Capped Index — performance by quality

BB 3.86	CCC 11.83	CCC 8.20	CCC 4.70	CCC 4.66	BB 2.68	CCC 2.50	CCC 1.02	CCC 0.30	CCC 2.87	CCC 2.73	BB -2.91	BB 7.21	BB 3.08	BB 2.03	CCC 3.74	BB -10.15
CCC 3.76	B 4.83	B 5.70	B 2.01	B 2.52	CCC 1.85	BB 2.01	BB 0.39	B -0.55	B 1.42	BB 2.32	B -4.35	B 7.21	B 2.66	B 1.65	B 2.61	B -12.97
B 2.46	BB 3.60	BB 4.36	BB 0.43	BB 2.06	B 1.70	B 1.75	B 0.37	BB -1.60	BB -0.17	B 2.29	CCC -9.28	CCC 7.15	CCC 0.29	CCC -1.76	BB 2.45	CCC -20.55

Portfolio quality breakdown versus index

-22.13	-20.10	-21.35	-20.43	-19.98	-20.77	-20.73	-20.76	-20.02	-20.22	-19.79	-21.44	-20.98	-22.06	-21.72	-22.15	-23.31
5.06	3.86	6.72	5.99	7.55	8.03	8.09	7.13	4.76	6.05	3.37	6.84	6.21	7.56	5.66	5.13	5.29
14.50	13.19	12.85	11.39	9.81	8.53	9.27	8.94	11.96	11.56	12.02	12.25	11.66	11.35	12.11	11.88	13.88

Federated High Yield Fixed Income Composite — quarterly performance (%) (gross)

3.68	4.53	5.30	1.30	2.79	2.44	2.00	0.22	-1.11	0.96	2.49	-4.54	7.79	2.56	1.48	2.95	-12.02
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Federated High Yield Fixed Income Composite — quarterly performance (%) (net)

3.55	4.40	5.16	1.17	2.66	2.31	1.87	0.09	-1.24	0.84	2.36	-4.66	7.66	2.43	1.36	2.82	-12.13
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Bloomberg Barclays U.S. High Yield 2% Issuer Cap Index — quarterly performance (%)

3.35	5.52	5.55	1.75	2.70	2.17	1.98	0.47	-0.86	1.03	2.40	-4.54	7.26	2.50	1.33	2.61	-12.68
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Federated High Yield Fixed Income Composite vs. Index (%)

0.33	-0.99	-0.25	-0.45	0.09	0.27	0.02	-0.25	-0.25	-0.07	0.09	0.00	0.53	0.06	0.15	0.34	0.66
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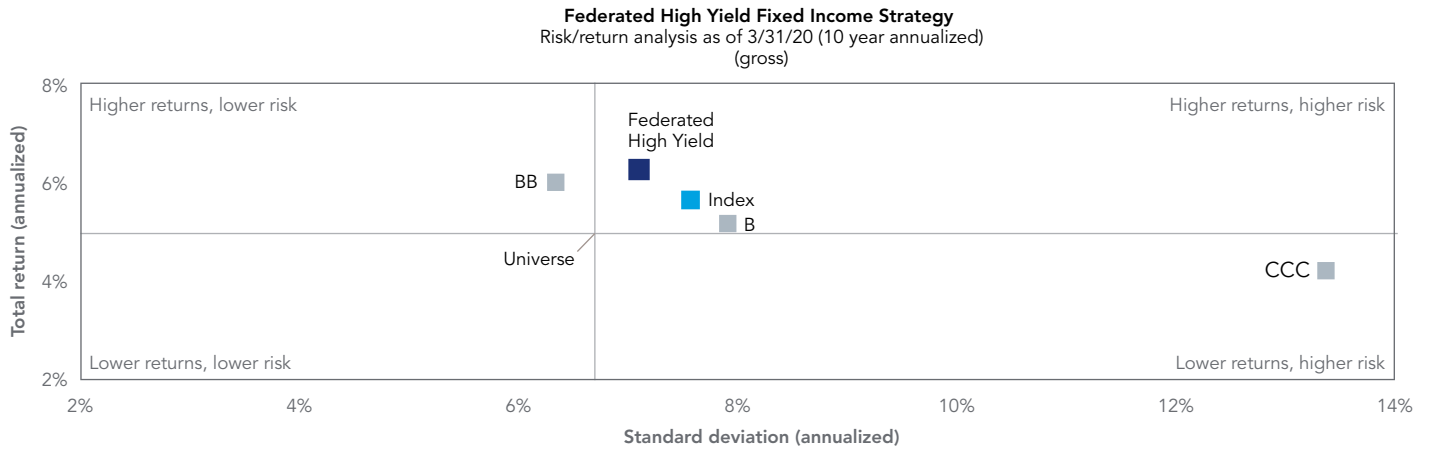
■ Down markets are noted in orange.

Past performance is no guarantee of future results.

Supplemental information to the attached GIPS report.

Exhibit 3: The Federated High Yield Fixed Income Strategy 10-year risk/return analysis as of March 31, 2020

When looking at Federated's High-Yield Fixed Income Strategy from a risk/return standpoint, we see that, over a 10-year period, the portfolio has outperformed its benchmark. Additionally, we see again that though the strategy tends to have a greater allocation to CCC-rated securities than the benchmark, the strategy's risk characteristics are more closely correlated to BB- and B-rated high-yield bonds. In fact, the lowest correlation is to that of CCCs.



Source: Federated Hermes, eVestment Alliance, LLC
 Federated High-Yield = Federated Hermes, Inc.: High-Yield Fixed Income Composite
 Index = Bloomberg Barclays U.S. High Yield 2% Issuer Capped
 B = ICE BofAML Single-B U.S. High Yield
 BB = ICE BofAML BB U.S. High Yield
 CCC = ICE BofAML CCC & Lower U.S. High Yield
 Universe = eVestment U.S. High Yield Fixed Income

Past performance is no guarantee of future results.

Results displayed in USD.

For a comparison of gross to net returns, see chart on next page. "Pure" gross-of-fees returns do not reflect the deduction of any expenses, including trading costs. "Pure" gross-of-fees returns are supplemental to net returns. This information is supplemental to the attached GIPS report, which should be referred to for the current performance, including the net figures.

Schedule of rates of return and statistics

Composite	High Yield Fixed Income Composite
Index	Bbg Bar US High Yld 2% Issuer Capped (6/05) from US High Yield
Periods ending	3/31/2020

Annualized returns (%)

	Composite gross return	Index	Net composite return (assuming maximum fee)
Q1 20	-12.02	-12.68	-12.13
YTD	-12.02	-12.68	-12.13
1 Year	-5.74	-6.94	-6.21
3 Years (Annlzd)	1.29	0.76	0.79
5 Years (Annlzd)	3.35	2.78	2.83
10 Years (Annlzd)	6.26	5.64	5.72
15 Years (Annlzd)	6.81	6.35	6.12
20 Years (Annlzd)	6.66	6.54	5.88
Jan 78 - Mar 20 (Annlzd)^	9.10	N/A	8.20

Annual returns (%)

	Composite gross return	Composite net return	Benchmark return	Composite* 3-yr st dev	Benchmark* 3-yr st dev	Number of portfolios	Composite assets (\$mil)	Firm assets (\$bil)
2010	15.16	14.59	14.94	15.24	16.76	8	4,579.0	354.3
2011	5.97	5.44	4.96	9.70	11.00	8	4,664.2	363.9
2012	15.55	14.97	15.78	6.38	7.07	8	6,844.1	371.3
2013	7.87	7.33	7.44	5.98	6.42	8	7,890.4	366.8
2014	3.55	3.03	2.46	4.38	4.50	8	8,391.3	349.3
2015	-1.71	-2.20	-4.43	5.05	5.25	10	9,492.4	343.4
2016	15.59	15.01	17.13	5.36	5.99	10	10,967.9	342.3
2017	7.64	7.10	7.50	4.89	5.56	14	12,369.5	354.7
2018	-2.32	-2.81	-2.08	4.17	4.59	14	10,401.6	377.2
2019	15.49	14.91	14.32	4.34	4.02	14	11,920.0	503.1

^^Represents composite inception period. See page 4 for additional notes to the schedule of rates of return and statistics.

*Represents the 3-year annualized standard deviation for both the composite and index returns. The statistic is used to measure the volatility of composite returns.

**Standard deviation is calculated using gross returns. Standard deviation is not applicable ("N/A") for any period if fewer than five accounts are in the composite for that period. (See footnote 5)

This composite is comprised of high yield portfolios managed by utilizing Federated's high yield fixed income strategy that focuses on fundamental bottom-up security selection techniques to create broadly diversified portfolios of securities with non-investment grade credit ratings. High yield bonds carry increased levels of credit and default risk and are generally less liquid than government and investment-grade bonds. Effective June 2005, the benchmark was changed to the Bloomberg Barclays US High Yld 2% Issuer Capped Index as it is more representative of the strategy of the composite. Portfolios eligible for this composite may include portfolios managed on behalf of registered investment companies (mutual funds) or separate account portfolios, both taxable and tax-exempt. From 1988 to 1991, this composite was comprised of a dollar-weighted composite of Federated's two largest high yield mutual funds. This composite was created in March 2001. Federated Investors has managed portfolios in this investment style since January 1978. The High Yield Fixed Income Composite represents the combination of the mutual fund and separate account composites which were originally created in November 1998. Federated Investors claims compliance with the Global Investment Performance Standards ("GIPS®") and has prepared and presented this report in compliance with the GIPS® standards. Federated Investors has been independently verified for the period of January 1, 1992, through December 31, 2019. A firm that claims compliance with the GIPS® standards must establish policies and procedures for complying with all the applicable requirements of the GIPS® standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS® standards and have been implemented on a firm-wide basis. The High Yield Fixed Income Composite had a performance examination for the periods January 1, 1992 through December 31, 2019. The verification and performance examination reports are available upon request. The firm's separately managed account fee schedule for this product is 0.50% on the first \$50 million; 0.35% on \$50 - \$100 million; 0.25% on assets greater than \$100 million. Currently, all composite net-of-fee returns are calculated using highest fee. See disclosure notes for any appropriate historical fee calculations. Actual fees may vary by client.

Notes to the schedule of rates of return and statistics

1. Federated Investors is a global, independent, multi-strategy investment management firm with offices in Pittsburgh, New York, Boston, Cleveland and London. For GIPS® purposes, Federated Investors is defined to include the assets of registered investment companies, separate (or private) accounts, managed accounts (including wrap accounts) and commingled or collective trusts that are advised or sub-advised by the following subsidiaries: Federated Equity Management Co. of PA; Federated Investment Counseling; Federated Investment Management Co.; Federated Global Investment Management Corp., to include effective December 2008, (the date of acquisition) the institutional assets of Federated Clover Investment Advisors, and effective September 2009, (the date the assets were brought into compliance) the SMA/Wrap assets of Federated Clover Investment Advisors; Federated International Management Limited; MDT Advisers; and effective April, 2012 (the date of acquisition) Federated Investors (UK) LLP. Firm assets on this report exclude the advisory-only, model-based assets that may be included in other reports providing total firm assets.
2. Interest income and dividends are recognized on an accrual basis. Returns include the reinvestment of all income.
3. All market values and performance information are valued in U.S. dollars unless currency is denoted in composite title.
4. With the exception of the Federated Clover Investment Advisors composites, annual composite dispersion is measured and presented using the asset weighted standard deviation of the returns of all of the portfolios included in the composite over the entire year. Quarterly dispersion is measured using all portfolios included in the composite for that quarter. With regard to Federated Clover Investment Advisors composites, annual dispersion is measured using the equal weighted standard deviation of the returns of all the portfolios included in the composite over the entire year.
5. Composite dispersion does not measure the risk of the product presented, it simply measures the return variance among portfolios managed in a similar fashion. This variance can be affected by variations in cash flow or specific client parameters among the portfolios comprising the composites, as well as by Federated's execution of strategy across accounts.
6. See the composite description language on the prior page for a discussion on appropriate fees currently applied to calculate composite performance. With regard to the institutional composites not managed by the Federated Clover or MDT Advisers teams, for the period July 1, 1992 through September 30, 2009, net of fee performance was calculated monthly by reducing the gross composite return by the highest actual fee of any account in the composite for that month, regardless of investment vehicle. Prior to this, the maximum management fee charged for the period July 1, 1992 through September 30, 1992 was used to calculate net of fee performance back to inception of the composite. In addition, further fee information can be obtained from Federated's respective Forms ADV Part 2 Brochure Item 5.
7. Additional information regarding the policies for valuing investments, calculating performance, and preparing GIPS reports, as well as a complete list and description of the firm's composites and pooled funds is available upon request.
8. Past performance is not indicative of future results.
9. GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein.
10. See disclosures on the Schedule of Rates of Return and Statistics Reports for additional information.

The value of investments and income from them may go down as well as up, and you may not get back the original amount invested.

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