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FridsonVision HIGH YIELD STRATEGY

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Market's Agreement with Rating Agency Opinions

High yield managers tend to downplay the influence of credit rating agencies on the market and on their valuation decisions. They have an understandable commercial incentive to justify prospective clients' fees that reflect the cost of employing teams of credit analysts. It can therefore serve their purposes to undermine the credibility of Moody's, Standard & Poor's, and Fitch Ratings. Underwriters, seeking to persuade investors that the bonds they are trying to sell are actually higher-quality than their ratings suggest, sometimes cite bizarre outliers in the historical record of ratings to "prove" that the agencies' methods are systematically flawed.

Martin Fridson, CFA
Publisher

We certainly do not believe that a high yield portfolio can be managed satisfactorily by relying on nothing more than ratings for bond selection. Neither do the rating agencies claim anything of the kind. Indeed, they specifically state that their ratings are not investment opinions. Their analysis considers only default risk (default probability and loss given default) and, to some extent, covenants. A bond's relative risk premium (spread-versus-Treasuries), as the agencies readily acknowledge, also reflects its duration and secondary market liquidity, as well as various supply-demand factors and general market conditions.

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FridsonVision High Yield Strategy is a bi-weekly research service produced by FridsonVision LLC and geared to finance professionals. Its publisher is Martin Fridson, CFA, who was the #1 Institutional Investor All America Research High Yield Strategist while at a leading investment bank and is an inductee to the Fixed Income Analysts Society Hall of Fame.

Market's Agreement with Rating Agency Opinions

Notwithstanding all of the above, close examination of rating and spread data reveals that high yield ratings and valuations are not as disconnected as might be inferred from the simple observation of instances in which a bond trades at a wider spread than lesser-rated issues. This report examines links between ratings and issuer fundamentals and spreads, while also documenting an association between rating outlooks and spreads. Throughout, we define a bond's rating as the Composite Rating reported by ICE Indices, LLC and its spread as the same source's calculated option-adjusted spread (OAS).

Ratings and Interest Coverage

With a bit of effort, readers can find an example of two bonds issued by different companies in the same industry, with identical ratings from all major rating agencies, identical capital structure priority, and closely similar coupons and maturities, displaying the supposed proof of rating agencies' incompetence whereby the one with the higher EBITDA/Interest ratio is rated *lower* than the one with the lower ratio—as if the agencies lack access to or ignore rudimentary financial reporting data. In reality, interest coverage is just one of several key ratios that credit analysts, whether employed at buy-side shop, a sell-side firm, or a rating agency, take into account. Furthermore, a company's reported EBITDA and interest expense are backward-looking numbers that analysts in all three of those employment locales deemphasize if they have reason to believe the company's future will look very different from its past.

EXHIBIT 1:
Coverage Ratio by Rating
Twelve Months Ending March 31, 2025

Composite Rating	Median EBITDA/Interest (x)	Count
BB1	7.46	35
BB2	6.87	70
BB3	6.84	59
B1	5.75	45
B2	5.32	33
B3	3.11	11
Total	**6.23**	**253**

Based on issuers of nonfinancial senior unsecured bonds within the ICE BofA US Nondistressed High Yield Index on June 30, 2025. Calculations are by issuer. Issuers for which either coverage or leverage is unavailable are excluded.

In short, there are several valid reasons why a particular company's bonds may be rated lower than those of a company with lower coverage ratio. As **Exhibit 1** demonstrates, however, aggregate statistics most definitely show a correspondence between rating and coverage. Median EBITDA/Interest decreases with each step down the rating scale. (Sample sizes are too small to extend this analysis to the CCC+ and lower rating categories. All of the displayed categories other than B3 satisfy the rule-of-thumb minimum count of 30 to qualify as a statistically valid sample.)

Ratings and Spreads

Another way practitioners sometimes try to discredit the credit rating agencies is to point to instances in which a bond has a wider spread than a bond in the same industry, the same capital structure priority, a similar coupon, and a similar maturity, but has a lower rating. There is nothing demonstrating ratings' irrelevance in this situation, for as noted above, the rating agencies specifically refrain from addressing certain factors that influence a bond's valuation, e.g., depth of the secondary market for the issue and scarcity value. Close examination of the data, however, confirms that it overstates the case to claim that there is no correspondence between ratings and market-determined spreads.

Market's Agreement with Rating Agency Opinions

EXHIBIT 2:
Rating versus Spread
June 30, 2025

Composite Rating	Median OAS (bps)	Count
BB1	130	35
BB2	127	70
BB3	135	59
B1	171	45
B2	201	33
B3	205	11
Total		**253**

Note: Sample consists of nonfinancial, senior secured bonds, one bond per issuer, drawn from the ICE BofA US Non-Distressed High Yield Index. Source: ICE Indices, LLC

Exhibit 2 confirms that ratings and spreads do not exist in separate universes. Median spreads on all gradations of B are wider than on all gradations of BB. Although the progression is not perfectly monotonic within the BB range, there are sharp breaks from BB3 to B1 and from B1 to B2. This is not to say that investors determine their bids and offers on the basis of ratings. The evidence does indicate, however, that:

(a) The factors that the rating agencies do consider (primarily default probability and loss given default) play a major if not dominant role in spread determination.

(b) To a considerable extent, the assessments of default risk that high yield investors independently reach concur with the rating agencies' conclusions.

Rating Outlooks and Spread Differentials

This study's final investigation involves rating outlooks. The rating agencies supplement their letter-grade designation for a bond with opinions about the likely direction of the rating over the coming, not precisely quantified period. STABLE is the outlook provided for most issues, with smaller numbers of issues receiving POSITIVE or NEGATIVE designations. In instances in which there is uncertainty about the outcome of a pending event with major credit quality implications, such as a proposed merger or litigation involving a massive potential liability, the agencies replace outlooks with watchlistings that indicate whether the rating will potentially be upgraded or downgraded, or whether it could go either way, depending on the outcome. Critics' cherrypicked examples of supposed rating-spread discrepancies that fail to take into account outlooks and watchlistings can be misleading, unintentionally or otherwise.

EXHIBIT 3:
Rating Outlooks and Valuation

	Spread Direction Versus Rating Median		
Outlook Type	**Correct**	**Incorrect**	**% Correct**
Positive	12	4	75.0*
Negative	19	6	76.0*
Total	**31**	**10**	**75.6***

**Statistically different from 50% at 99% confidence level. Sources: FridsonVision calculations, ICE Indices, LLC*

Exhibit 3 provides further evidence of market/rating concurrence on valuation. From our larger sample of 253 issuers we identified 41 with outlooks other than STABLE. In 31 of these cases, the market agreed with the rating agencies' assessment in the sense that it assigned a spread narrower than the median for the rating if the outlook was POSITIVE and a spread wider than the media for the rating if the outlook was NEGATIVE. That is, the market factored into its spread some percentage probability that the rating would move in the indicated direction rather than remain in place. Leaving ratings aside, it would be irrational for the market to assign a spread based solely on the issuer's past record and circumstances while ignoring signs that its fortunes were likely to improve or worsen in the relatively near term.

Market's Agreement with Rating Agency Opinions

The market's bias toward "Correct" (concurring with the rating agencies' outlook) assessments is not a chance outcome. With 99% statistical confidence, the 75.6% summary figure for "Correct" judgments by the market is statistically different from a 50/50 distribution. That same level of statistical significance applies to the Positive-Outlook and Negative-Outlook subsamples, which have essentially the same percentage breakdown between "Correct" and "Incorrect" market assessments.

Conclusion

Practitioners have commercial incentives in some instances to denigrate the usefulness and accuracy of credit ratings. No knowledgeable person would suggest that high yield managers could run their portfolios effectively without the help of analysts who formulate independent opinions on credit risk while also assessing pricing factors that the rating agencies explicitly exclude from their analysis. It exaggerates matters, however, to assert that the rating agencies ignore important fundamental information or that the market invariably disagrees with the rating agencies' conclusions. On those points, we have presented evidence involving financial data, spreads, and rating outlooks.

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FAIR VALUE MODEL UPDATE

At midyear, June 30, 2025, the high yield market was extremely overvalued. Minor narrowing later in the month did not reverse that conclusion. Read below the factors we use for calculating fair value, followed by our latest update.

These independent variables represent the key determinants of the high yield risk premium.

Credit Tightness

The percentage of banks tightening credit for medium- and large-sized companies minus the percentage of banks easing credit for those borrowers, as reported in the Federal Reserve Board of Governors in its quarterly Senior Loan Officer Opinion Survey on Bank Lending Practices.

Industrial Production

Month-over-month change reported by the Federal Reserve Board of Governors.

Five-Year Treasury Rate

Effective yield on the ICE BofA Current 5-Year US Treasury Index

CCC & Lower Percentage

Percentage of the total face amount of the ICE BofA US High Yield Index with a Composite Rating of CCC or Lower.

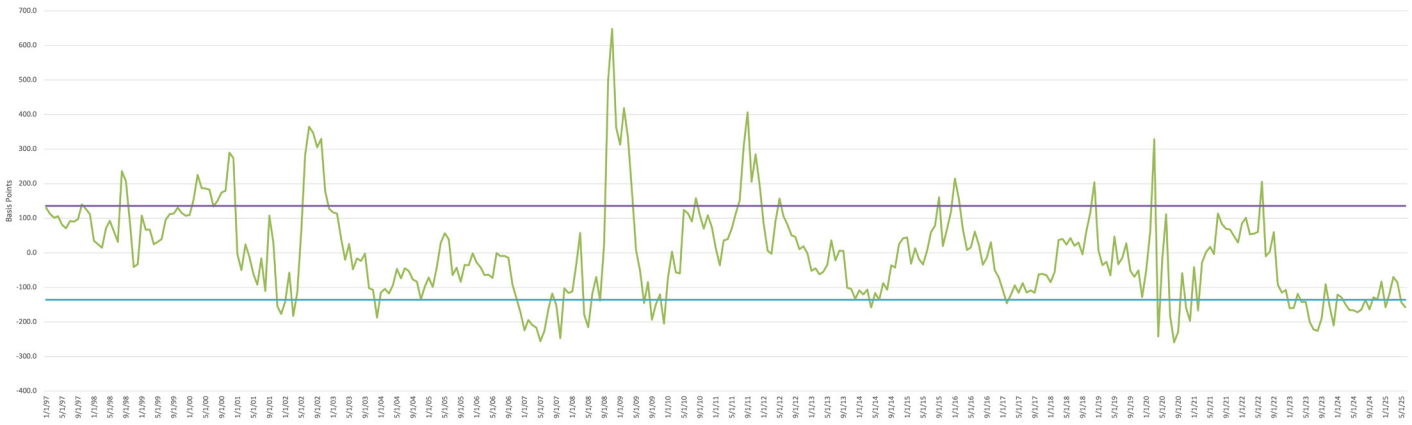
For portfolios that include high yield bonds along with other asset classes, we recommend underweighting (overweighting) high yield when the actual OAS exceeds (falls short of) the model-estimated value by one standard error or more.

Fair Value Model Update

Between May 31 and June 30, our fair value estimate declined from +475 bps to +454 bps. Pushing in the direction of a narrower required spread were a drop in the CCC & Lower Percentage from 13.10% to 12.69% and an improvement in Industrial Production from -0.2% to 0.3%. Partly offsetting those effects was a decrease in the Five-Year Treasury Rate, which is inversely correlated with the spread, from 3.96% to 3.72%. Our Credit Tightness measure, which is reported quarterly, was unchanged at 18.4%.

While the required spread declined by 21 bps, the actual OAS dropped by 36 bps, from +332 bps to +296 bps. On June 30, consequently, the high yield index was overvalued by 158 bps (296 – 454). That located it in extreme overvaluation territory, as determined by our threshold of a disparity of one standard error, i.e., 136 bps. On July 18, the actual spread stood at +293 bps, putting the high yield overvaluation at 161 bps.

High Yield Spread: Actual minus Estimated
Monthly, January 1997- June 2025



*As of June 30, 2025
Sources: Federal Reserve Board of Governors; ICE Data Indices, LLC; Leveraged Commentary & Data (LCD)