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GMO High Yield's Joe Auth: Niche, Alpha-Driven, 'Pointy'

This month, ***BFI*** interviews **Joe Auth**, Head of Developed Fixed Income at Boston-based, Jeremy Grantham-founded **GMO**. **Auth is portfolio manager of both GMO High Yield Fund and GMO Opportunistic Income Fund**. He started in September 2014, coming over from the **Harvard Endowment** (HMC) to run the structured products business at GMO. He tells us "The most extensive part of my background in fixed income is in **structured products, so mortgages, CLOs, ABS**, those types of investments." **We discuss the overall bond market, the High Yield fund and the risks of *not* owning credit and bonds.**

Joe Auth

BFI: *Give us some history.*

Auth: I was one of the three people that started the GMO High Yield Fund. The strategy got going in 2017 and then became a mutual fund in the spring of 2018. **Of the two main products that I manage at GMO (High Yield and Opportunistic Income), they're very different…. One (Opportunistic Income – the structured products fund) uses a fundamental approach more, and then the other one (High Yield) uses more of a systematic, factor-based approach**…. Fixed income isn't something GMO is known for … **but we've been investing in bonds for quite a long time**.

Our flagship strategy is really our Emerging Country Debt strategy, and that's been open since 1994. We've also been doing broad-based, **core plus fixed income investing** since the 1990's…. **Since then, we've kind of established … other "pointier" or "niche-ier" strategies, including the structured products strategy, which started in 2011**. There is a local currency EM debt option as well. We have a fixed income hedge fund, the high yield strategy that I mentioned, and **we're also doing systematic investment grade credit investing**. So that's kind of an overview of **GMO fixed income**. **We're known more for the niche, alpha-driven — 'pointy' is the term that people use — strategies in fixed income than the generic broad-based kind of benchmark strategies**.

BFI: *Tell us about Boston and bonds.*

Auth: I think of Boston as being more of a long-only, credit-focused town. We're a little different…. **On the corporate credit side, overall,** … we employ **more usage of derivatives**. Much of our focus is on the macro side, top-down. **We also approach things in a factor-based way, as opposed to traditional bottom-up credit underwriting**, and we do plenty of investing on the short side in addition to what we do on the long-side. (But our high yield effort happens to be a long-only product.)

BFI: *What are you buying now?*

Auth: The goal of this fund is to try to generate high yield, beta returns. We think this fund is pretty benchmark aware. **We're not looking to time the market with this fund [and] we try not to hold cash**. We also don't lever the fund up. We're generally shooting for 100%-invested at all times…. **We're not doing traditional credit work in this fund**, not trying to pick the company or industry.

We are trying to exploit what we think are the market inefficiencies in the high yield market, and we do that on a systematic factor-based way…. We think that we're running a more liquid strategy than the average high yield mutual fund. This is [attractive] if investors want a greater ability to trade in and out of a high yield product. **We think our fund allows them to do that**.

As I said, we're not picking individual credits. **But our models and our sense of the market right now tells us that higher quality high-yield is better than lower quality … given the inverted yield curve, given where interest rates have gone and given [remaining] recession risks**. It feels like the odds of the recession certainly in the near term have come down, but **they're not gone**. We look at the gap between, for instance, double-B spreads and triple-C spreads, or even single-B's and triple-C's, and **we think those gaps are too tight**. So, **we think generally you want to be in a higher quality part of the high yield market**.

GMO

BFI: *Talk about yields in general.*

Auth: We are spread-based investors; we're total return investors. When you look at the yield, the yield consists of the **risk-free component and then the risky component**. And if much of your yield is made up of the risk-free component, well then, 'Is the yield of a risky corporate bond really attractive … or are you just harvesting a higher risk-free component with a relatively unattractive spread component?' You really do want to look at spread versus yield. **That being said, there are a lot of investors out there that do look at yield, and yields drive their decision-making process**. So, we are respectful of that. **When yields get more exciting, there is more demand for fixed income products, including credit products**. We see it in investment grade cash; we see it in high yield cash.

BFI: *What are your main challenges?*

Auth: When we think about challenges today versus historically, one of the challenges … is the fact that **financial repression has made it very difficult to find attractive investments**…. That challenge is lower now than it has been in most periods since the end of the GFC. **We don't think spreads everywhere are that interesting, but they are in some parts of the market**. Even if you don't think

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(***GMO's Joe Auth Gets Pointy*** *from p.1*)

spreads are interesting … **rates are about as high as they've been at any point during the post GFC era**.

When base interest rates were at zero and spreads were very tight … it was difficult to find investments that generated returns that were adequate for the risk. That challenge is much less now, which is a good thing. **On a nominal basis, on a relative basis, there's a lot more to do**. I would go back to the challenge that's always present for managing a mutual fund with credit instruments — **you have to balance the search for alpha with the need for diversification and liquidity**.

We need to think about when markets get really stressed. We need to make sure that … everything can look liquid when the market is trading in a balanced way and everything feels fine. **But on those days, weeks and months when liquidity really goes out, you want to make sure that you've got enough investments that hold their liquidity in your fund**.

BFI: *What about risks and rates?*
Auth: Four of the main risks that we take in fixed income are: rate/duration risk, spread risk, volatility risk and liquidity risk. **Rates and spreads** are the two most obvious ones, so **clients are always thinking about them**. You can be bearish on rates; you can be bearish on credit. I think there's reasonably good arguments for either of those…. **But you can't really argue that there's no risk or very little risk of *not* owning those risks anymore**.

When rates were at 50 basis points or zero at the front end of the curve, there was very little risk in being under-exposed or not having exposure to duration. Now when the 10-year Treasury is at 4% and 2 year yields are at 4.90%, **there is a real opportunity cost to not holding any duration if rates rally**. Rates can rally and there could be a lot of P&L from owning duration in certain parts of the credit markets…. **Customers are still worried that rates could go higher and spreads can go wider**. But they also recognize that it's a much better time to be looking now…. Yields are a lot higher…. **The cost of not being invested at all is much higher in fixed income than in credit than it was a year and a half ago**.

BFI: *Tell us about your customer base.*
Auth: In the high yield fund, it's institutional. In the structured products fund that I manage, **it is a mix**. There is definitely a private wealth advisor component in that fund as well. **For GMO as a whole there is a mix of traditional institutional, high net worth, sub-advisory, and intermediary clients**.

BFI: *What's your outlook going forward?*
Auth: If I think about the outlook for the high yield market, **obviously economic growth is by far the most important factor**…. If we go into a recession or a deep recession, that's usually very poor for high yield fundamentals and spread performance.

But I do think the rates market is going to drive fundamentals to some extent as well, in many parts of credit. The longer that interest rates stay at these higher levels and the curve remains inverted, the tougher it is for big parts of the market to obtain capital…. So to the extent that … rates rally from here [and] the curve normalizes, I think that's going to be positive for fundamentals. **But the longer we stay at levels we are now, or even go higher on rates, that's going to be problematic for parts of this economy and parts of the financial markets**. ⟐

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