GMO HIGH YIELD STRATEGY

Exploiting Inefficiencies to Maximize Returns

GMO's High Yield Strategy uses a top-down, systematic approach designed to exploit what we believe to be inefficiencies in the high yield asset class. We believe the resulting Strategy is a compelling investment solution that, due to our differentiated investment approach, has delivered excess returns with low (and oftentimes negative) correlations to more fundamentally oriented high yield managers.

KEY FEATURES

Strong returns

- The GMO High Yield Strategy delivered +1.0% of alpha over its benchmark (the Markit iBoxx USD Liquid High Yield index) and 1.5% of alpha over the HYG ETF, both net of fees since the strategy's inception in January 2017 through April 2023.
- Over the past one- and three-year periods, our net alpha was +3.1% and +1.1% compared to our benchmark index and 3.3% and 2.2% compared to the ETF, respectively.
- As of Q1 2023, the GMO High Yield Strategy had outperformed 85% of the eVestment U.S. High Yield Fixed Income universe net of fees since inception and over the past year.

Superior liquidity

- By using macro index products as well as on-the-run bonds, the Strategy delivers a more liquid profile than investors might typically experience from the standard, bottom-up high yield mutual fund.

Highly differentiated

- Our investment team is not made up of corporate bond analysts or credit pickers. Rather, we use a differentiated top-down, factor-based approach designed to exploit market inefficiencies. This has enabled us to deliver a high yield market beta return plus consistent, meaningful alpha.

The Need for Liquid Credit Investments That Outperform

Ben Inker
Co-Head of Asset Allocation

"GMO's Asset Allocation team manages dynamic multi-asset portfolios wherein allocation decisions are guided by valuations. When an asset class is both attractively valued and a good portfolio fit, we make an allocation.

Before GMO's High Yield Strategy was created, we used passive solutions (such as ETFs) for time-sensitive credit investments. While this approach generally worked, we determined based on an ex-post analysis that active strategies could potentially deliver even better results. Our key criteria for such an active high yield strategy were liquidity and improved overall performance.

To meet this need, GMO launched our High Yield Strategy in 2017, and the Asset Allocation team has successfully allocated to (and away from) the Strategy multiple times over the past six years. Specifically, the liquidity profile has consistently met our expectations, while the performance has surpassed what we believe could have been achieved through other vehicles."

MARKET INEFFICIENCIES THAT GMO'S STRATEGY EXPLOITS

1. Hedging demand

Misguided investor efforts to time the high yield market can lead to some of the most straightforward opportunities to deliver alpha. Shorting bonds is a cumbersome process, so investors who are trying to express the view that returns will be poor in high yield markets tend to use index and ETF products. When there is high demand to short these instruments, the borrowing costs can become quite high.

We routinely exploit this investor behavior by either buying and lending out high yield ETFs or entering total return swaps that pay the index's return plus a considerable spread. Fundamentally, we are not taking any additional risk here because we hold exactly the benchmark exposures; technical risks (such as counterparty or trading/liquidity related risks) could possibly hamper our ability to capture the full discount.

While these opportunities ebb and flow, they can offer a repeatable alpha over the index that at times can be in the 1-3% range. When we see such opportunities, we are very happy to forego other means of trying to add alpha for the repeatable win.

2. Focusing on spread carry at the expense of slide/roll-down

Another classic hedging strategy that market-timers utilize is buying protection on a credit default swap index, such as CDX HY, intending to insulate themselves from credit losses across a basket of high yield securities. These swaps can seem appealing, as the carry cost of the synthetic vehicle (CDX HY) generally looks lower than the credit spread on the high yield bond index. However, this yield advantage for the cash bonds is misleading.

Not only is CDX HY a higher quality basket of issuers than the typical high yield bond index (with fewer historical defaults), but it also has meaningfully different slide, or roll-down, characteristics. (Slide refers to the profit and loss (P&L) an investor makes when spread or yield curves are upward sloping and the simple passage of time creates price appreciation as the instrument ages into a lower discount rate.)

Hedging-focused investors prefer to buy protection linked to the on-the-run CDX series, which often has a steeper spread curve than cash high yield bonds. Thus, an investor offering protection through these securities can often earn a return higher than the high yield index despite the spread to maturity of the synthetic instrument being lower.

How the GMO High Yield Strategy Adds Value

"The high yield universe is filled with teams of fundamental credit analysts who all believe they are better than average at their jobs. Some truly are, and they will effectively deliver alpha. Many, however, are not, and investors who are overconfident about their capabilities frequently make errors that we believe a disciplined, systematic process can exploit. Similarly, many high yield investors ineffectively strive to outperform by timing the high yield market or focusing too much on strategy yield over total return. Finally, segmentation in the marketplace can cause mispricing between different derivative exposures, giving tactical investors the potential to opportunistically add value.

Joe Auth
Head of Developed Fixed Income

Rachna Ramachandran
Portfolio Manager

The GMO High Yield Strategy, which is always fully invested in U.S. high yield exposure, uses several techniques designed to exploit these inefficiencies, which are long-standing issues that we believe will continue to exist. However, beyond simply implementing this collection of strategies – with each designed to individually deliver long-term alpha against the high yield universe – we go a step further and actively shift our allocations between them when market pricing leads us to believe that doing so will be beneficial. Our disciplined, transparent, and repeatable process has allowed us to exploit these inefficiencies and outperform 85% of our peers since the Strategy's inception, while also beating our benchmark in every asset class drawdown over that same period."

In periods of high market volatility, CDX HY may at times sell off more than the cash bond market. While this creates a more attractive opportunity looking forward, there may be a near-term hit to P&L, relative to the benchmark. A keen eye on market dynamics assists us in understanding dislocations, and therefore, how to best profit from them.

There is also the risk that portfolio differences between CDX HY and the cash benchmark could lead to some idiosyncratic events (e.g., issuer defaults). This risk can be mitigated by adhering to well-defined issuer limits and having a holistic view of the Strategy's exposures, including look-through into portfolio products.

Therefore, an investor that can consider and manage the tradeoffs between spread carry and slide (i.e., roll-down) will be positioned to take advantage of this structural market inefficiency.

3. Investors not adequately compensated for call risk

Much of the high yield cash bond universe is callable – meaning issuers have the right but not the obligation to purchase the bond at a preset price prior to the bond's maturity. This call option that the investor has sold to the issuer can limit the investor's upside in a bullish scenario and has the potential to make a bond moderately or even very negatively convex.

We believe high yield investors do not always get compensated appropriately (through a higher base case spread premium) for taking on this unattractive "heads I barely win, tails I lose big" profile. Indeed, our research shows that the most negatively convex high yield profiles have, on average, worse return outcomes than the broader high yield universe. We posit that pockets of the high yield investment community (e.g., indexers) may focus on scenarios in a flat spread or interest rate environment and do not adequately account for how the durations of negatively convex bonds can move against the investor when yields move up or down, generating inferior P&L outcomes.

We actively avoid owning the most negatively convex profiles on the cash bond side, which, when combined with our exposure within CDX HY (derivative contracts are not callable), generally gives us a superior convexity profile compared to the high yield universe as a whole. This strategy results in a slightly higher duration on average than the cash benchmark, which may result in some excess volatility, particularly during moderate market moves. However, the Strategy's defensive tilt, due to the additional exposure to quality bonds, offsets this risk.

4. Yield chasing means quality is often too cheap

Investors' obsession with achieving maximum yields offers other further opportunities for us to outperform. While from the outside all junk-rated debt may seem the same, it is in fact a very heterogeneous universe. CCC bonds default at a rate of 15% or so on average across a market cycle, while BB bonds default at around one-tenth that rate. BB bonds have vastly less credit risk than their CCC counterparts and therefore yield substantially less – on average about 6% less. But given the huge disparity in credit losses between those groups, the lower-risk, lower-yield BB group has actually outperformed over time.

While this phenomenon is somewhat similar to the counterintuitively strong performance of high-quality stocks, the effect is even more striking in high yield. BB bonds have on average delivered 2.9% returns over Treasury bonds since 1988, whereas CCC bonds have delivered a mere 1%, and they have done so with a return volatility of 7.4%, just a little over half of the 14.3% volatility of the CCC cohort.

BB bonds are not always priced attractively versus the rest of the high yield universe, but when they are, they offer another attractive way to outperform, in this case with the side benefit of lower fundamental risk. While this is generally the case, in an aggressive rally, an investor who has avoided these high-beta CCC rated bonds will miss out. We analyze the valuations of different credit rating buckets to help us effectively capture this inefficiency.

ACTIVELY SHIFTING ALLOCATIONS TO IMPROVE ALPHA

None of these opportunities exists at all times, but almost all of the time more than one are offering alpha opportunities for investors who are keeping a close eye on them and who run a liquid enough portfolio that they can dynamically move their capital – as we do in GMO's High Yield Strategy. It is something extremely difficult to achieve if you are simultaneously running a strategy dedicated to fundamental credit analysis and trying to time the default cycle.

Investors getting their exposure to high yield credit through such strategies therefore miss out on this reliable alternative path to alpha from active management. And investors going the passive route to get their exposure to high yield in an effort to keep their liquidity high are, simply put, leaving money on the table.

While a willingness to take on illiquidity can be a path to higher returns within credit, GMO's High Yield Strategy is providing strong evidence that meaningful and reliable alpha can be achieved within a highly liquid credit portfolio.

ANNUALIZED RETURNS AS OF MARCH 31, 2023 (NET, USD, %)

	Inception	*1-Year*	*3-Year*	*5-Year*	*ITD*
GMO High Yield Strategy	1/31/2017	-0.45	5.98	3.91	4.02
Markit iBoxx USD Liquid High Yield		-3.25	4.76	2.92	3.03

Performance data quoted represents past performance and is not predictive of future performance. Net returns are presented after the deduction of a model advisory fee and incentive fee if applicable. These returns include transaction costs, commissions and withholding taxes on foreign income and capital gains and include the reinvestment of dividends and other income, as applicable. Fees paid by accounts within the composite may be higher or lower than the model fees used. A Global Investment Performance Standards (GIPS®) Composite Report is available on GMO.com by clicking the GIPS® Composite Report link in the documents section of the strategy page. GIPS® is a registered trademark owned by CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein. Actual fees are disclosed in Part 2 of GMO's Form ADV and are also available in each strategy's Composite Report.

Risks associated with investing in this Strategy may include Management and Operational Risk, Market Risk - Fixed Income, Credit Risk, Illiquidity Risk, and Derivatives and Short Sales Risk.

Disclaimer: The views expressed are the views of Ben Inker, Joe Auth, and Rachna Ramachandran through the period ending May 2023, and are subject to change at any time based on market and other conditions. This is not an offer or solicitation for the purchase or sale of any security and should not be construed as such. References to specific securities and issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities.

(617) 330-7500 | www.gmo.com

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