

DETAILED DESCRIPTION OF HIGH YIELD STRATEGY PILLARS

The GMO High Yield Strategy seeks to outperform its benchmark, the Markit iBoxx USD Liquid High Yield Index, by applying a factor-based approach to portfolio construction. It is designed to capture alpha from top-down sources of risk premia, taking advantage of structural market inefficiencies while maintaining a liquid portfolio. The Strategy invests in a range of high yield instruments, including cash bonds, synthetics, and portfolio products to gain exposure to these sources of risk premia. The Strategy is managed as a collection of discrete sleeves. The motivation for each and brief description of the model alpha is described below.

Carry

Carry is the return earned if market conditions remained unchanged, except for the passage of time. It is composed of spread and rolldown – the higher the spread and the steeper the curve, the greater the carry.

Our model compares the carry potential between the cash high yield market and the Markit CDX High Yield Index (“CDX HY”) and allocates to CDX HY when its projected return (i.e., carry) is attractive. The primary factors that are included in the model are two different measures of what investors refer to as the “basis,” which is the difference between high yield bond spreads and the implied spread of the index. The model also estimates the return earned from “rolldown” between CDX HY and the cash market. For CDX HY, this entails a relatively simple calculation using different spread tenors. For the cash market this calculation is more involved because high yield bond curves are not well defined at the issuer level. The rolldown is an important aspect of the overall return offered by the Carry sleeve of our model and adds value beyond that of a simple spread comparison.

Quality

High yield investors often have a minimum yield threshold, causing higher quality, and in turn, lower yielding BB bonds to be undervalued during a large portion of a typical market cycle. BB bonds default at a lower rate and are less volatile than the broader high yield market. Average historical returns for BB bonds however are commensurate with those of high yield. This is largely due to the fact that their lower losses from defaults offset their lower initial yields. As a result, our exposure to BB bonds may help to improve risk-adjusted returns without lowering absolute return relative to the benchmark.

The potential alpha of the Quality sleeve of our model is a function of various aspects of the BB cohort relative to the high yield market, including spread, weighted average rating factor (“WARF”), historical returns over different time horizons, and convexity profile. The potential alpha is typically higher when high yield spreads are tight.

Short Duration, Low Quality

Lower rated, short maturity bonds are often overlooked by investors, given their asymmetrical risk profile and low liquidity. Historically, they’ve offered better returns than longer duration bonds of a comparable rating. Our strategy takes advantage of this structural premium in the market, while idiosyncratic risk is managed through diversification and leveraging in-house expertise in screening for issuers with high near-term default risk.

The potential alpha here is modeled in the same spirit as the Quality factor. It is driven by current valuation of the Short Duration/Low Quality cohort relative to the benchmark, historical returns, and the convexity profile. Note that this is a relatively small part of the overall high yield universe and as such model estimation results are impacted by a small observation size.

Fallen Angels

This well documented premium captures the tendency of recently downgraded bonds to be oversold as they transition from the investment grade investor base to the high yield universe.

The Fallen Angel factor follows the credit cycle. During an economic contraction, when there is a high volume of fallen angel bonds, buying a diverse portfolio including all eligible bonds provides optimal results. At other times, when downgrade volumes are more limited, the potential alpha of each fallen angel bond is estimated through peer analysis, recent performance, and where applicable, the CDS-bond basis.

Volatility

There is a structural demand-supply imbalance in credit options due to hedging demand from various investors, including bank loan desks that receive capital relief for owning put protection. This results in a high implied-to-realized volatility premium in credit. The Short Volatility factor aims to monetize this premium by selling short-term (2-3 month) delta-hedged puts on the CDX HY index.

Allocation to the Short Volatility sleeve is a function of volatility premium in the credit options market, defined as the difference between implied and realized volatility. Our research has identified specific thresholds for this premium that dictate allocation in order to maximize return potential while effectively managing risk. This sleeve is a strategy overlay and managed to be market neutral.

Benchmark Arbitrage

Due to demand-supply technicals and hedging needs, markets sought by high yield portfolio products can often get dislocated. This gives us the opportunity to enhance portfolio alpha by buying risk at a discount to the benchmark and/or receiving an attractive borrow rate for lending an ETF holding.

The Strategy invests in a combination of ETFs, Total Return Swaps (TRS) on ETFs, and Standardized TRS on the iBoxx USD Liquid High Yield Index. We compare the expected return of each security, considering its discount or premium to NAV, funding cost and transaction cost, to determine the optimal way to obtain our exposure.