



## YEAR-END LETTER FOR 2023

### High Yield Strategy

Dear Client,

Twenty twenty-three ended up being a stellar year for high yield credit, as it was for most risk-assets. As we noted in our letter last year, valuations had pointed toward a high single-digit return and the HY market more than delivered, gaining 13% over the calendar year 2023. Our HY strategy essentially kept pace with the market over this period, with a return of 12.93% (net of fees) compared to its benchmark, the Markit iBoxx USD Liquid High Yield Index (IBOXHY), which returned 12.89%, and better than iShares iBoxx \$ High Yield Corporate Bond ETF (HYG), the largest high yield ETF, which delivered 11.53%.

While performance over any one calendar year can vary, the strategy continues to deliver on its goal of generating a consistent alpha through the cycle by investing through a unique top-down factor approach and maintaining a liquid portfolio. With a 6-year track record now, the strategy has outperformed its benchmark by 0.9% per annum (net of fees) since its inception. A detailed grid outlining net performance vs. peers and our index is outlined below.

### ANNUALIZED RETURNS (NET, %)

	<i>GMO High Yield</i>	<i>IBOXHY Index</i>	<i>HYG ETF</i>	<i>Peer Group</i>	<i>GMO HY Percentile rank among peers</i>
<b>1 Yr</b>	12.93	12.89	11.56	12.08	30
<b>3 Yr</b>	2.96	1.73	1.01	1.88	22
<b>5 Yr</b>	5.65	4.79	4.20	4.7	17

Category: High Yield Bond as of 12/31/2023 | Source: Morningstar

The above information is based on a representative account within the strategy selected because it has the fewest restrictions and best represents the implementation of the Strategy. Exchange Traded Funds (ETFs) are bought and sold through exchange trading at market price (not NAV), and are not individually redeemed from the fund. Shares may trade at a premium or discount to their NAV in the secondary market. Brokerage commissions will reduce returns.

### Strategy Overview

GMO's High Yield Strategy aims to deliver HY beta return plus consistent alpha over its benchmark by employing a quantitative, 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. Our top-down, data-driven approach allows us to allocate capital across a range of HY instruments to seek the best possible risk-adjusted returns over a full market cycle. The factors we employ and our allocations to certain HY portfolio products usually lend the strategy a high-quality tilt. Broadly, this has helped the strategy to outperform during market drawdowns as well as in periods of moderate spread tightening. We expect to lag the benchmark during widespread rallies that compress spreads even in the lowest quality HY cohorts.

**As was the case in the previous year, the main contributors to the strategy's performance in 2023 were credit portfolio products.** This includes exposure to total return swaps (TRS) on the IBOXHY, which often traded at a discount to its fair value, allowing us to capture alpha over the benchmark without any added tracking error. The decrease in hedging activity this year meant that the magnitude of discounts available was less than in the prior year. That said, we relentlessly monitor this market and have been extremely nimble in adjusting allocations proportionally to the potential alpha we assess, enabling us to successfully harvest a return premium. The TRS had the added advantage of a downward-sloping term structure (longer dated contracts traded at larger discounts), allowing us to roll expiring contracts at attractive valuations.

The strategy's exposure to CDX HY (an index of HY credit default swaps) to harvest HY carry was also advantageous. CDX HY traded wider than the cash market through the year, offering a better spread carry while also often outperforming cash bonds in market rallies. Our allocation to CDX HY is based on our measure of the spread basis between cash bonds and synthetic credit, and the relative roll-down between the two. The portfolio particularly benefitted from the addition of CDX HY exposure when the basis was at stretched valuations, as captured by our model.

Finally, the credit volatility selling overlay once again contributed positively as the spread between implied credit volatility and realized volatility remained wide.

The main detractor to the strategy's performance was the portfolio's exposure to the quality factor via BB bonds. We increased exposure to this factor in February following the swift spread rally that occurred at the beginning of the year. Quality bonds generally outperformed the broad HY market over the next month as spreads widened. However, our sample of BB bonds lagged the broad BB universe. The underperformance was due to a few larger idiosyncratic exposures that our bottom-up bond model liked but ended up bucking the overall BB trend. In response, we tightened our risk bands to align more closely to the BB index. Since the introduction of these risk controls in October, the performance of our BB bond holdings has been closer to the return of the BB index, improving the likelihood of top-down BB decisions generating the expected result.

One surprise through the year was the lack of fallen angel bonds that the strategy could participate in. Credit rating trends were very positive through the year. While HY lost several issuers to the investment-grade market this year through rating upgrades, barely a handful made the reverse transition. We expect this dynamic to eventually reverse as either economic growth and inflation slow (high yield credits are particularly exposed to these risks), or the negative impact of higher rates start to impact HY capital structures more fully.

## Outlook

Looking forward, it is unlikely that this year's returns will prove as exciting as the last year's as valuations have normalized relative to last December. All-in yield for the market was at 7.6% at year end, 136 bps lower than at the end of 2022. That change is almost entirely due to compressed credit spreads, which ended 2023 at 322 bps (145 bps tighter than at the beginning of the year), while 2-year, 5-year, and 10-year Treasury rates all ended the year within 15-20 bps of where they began 2023. While not at absolute lows, this is not far from the lowest spread compensation for HY credit risk in the post-GFC period. **We believe that the still reasonably healthy yield of 7.6% is masking the poor spread valuation metrics to some extent, and that there is little in the way to compensate for unexpected negative scenarios on an excess return basis. While we're much less sanguine about valuations this year, the technical picture continues to be supportive.**

Primary issuance remains muted as companies reassess their funding costs and optimal leverage. Corporate balance sheets remain in good shape, though there is perhaps a wide dispersion between the haves and have-nots. The risk to HY comes mainly from the prospect of a recession or a weakening in U.S. consumer strength.

For the strategy, valuations point to a continued allocation to the quality factor (BB bonds). This may impede performance if spreads continue to tighten, but given the limited upside to spreads, this presents a small cost. We expect this factor to contribute positively in the event of spread widening or increasing defaults.

Also, with the lower spreads and lower yields that 2023 has brought, the HY market has become more negatively convex again (i.e., a lot more bonds offer limited price appreciation at this point because they're constrained by their call price). If this trend continues, we'd expect to increase our allocation to CDX HY, which offers a better convexity and roll-down profile than the HY bond market as a whole.

Our research efforts are focused on exploring new drivers of alpha, honing our existing factor suite and allocation models, and improving execution. The top-down factor allocation approach remains the primary driver of the strategy. At the same time, we also leverage broader bottom-up factor-based credit work that is enhancing our bond selection process through proprietary bond alpha scores. Research in this space continues, with a view to improving alpha even further and adding flexibility to the portfolio construction process.

We look forward to discussing GMO's High Yield Strategy and investment philosophy with you in the coming year. We think it offers an ideal complement to more traditionally managed HY portfolios, bringing a unique perspective to investing in the asset class.

Yours sincerely,



Joe Auth  
*Head of Developed Fixed Income*



Rachna Ramachandran  
*Portfolio Manager*

---

<i>Annualized Returns as of 12/31/2023 (Net, USD)</i>	<i>Inception</i>	<i>1-Year</i>	<i>3-Year</i>	<i>5-Year</i>	<i>ITD</i>
<b>GMO High Yield Strategy</b>	1/31/2017	12.93%	2.96%	5.65%	4.86%
<b>Markit iBoxx USD Liquid High Yield Index</b>		12.89%	1.73%	4.79%	3.97%

---

***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. **GMO LLC claims compliance with the Global Investment Performance Standards (GIPS®).** 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. The portfolio is not managed relative to a benchmark. References to an index are for informational purposes only.

***Disclaimer***

The views expressed are the views of Joe Auth and Rachna Ramachandran through the period ending January 2024 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.

Copyright © 2024 by GMO LLC. All rights reserved.