GMO

# YEAR-END LETTER FOR 2024

*High Yield Strategy*

Dear Client,

2024 marked another solid year for credit returns, as corporate bond spreads reached lows not seen since the lead-up to the Global Financial Crisis 17 years ago. The spread tightening itself felt well justified, bolstered by a strong economy, healthy corporate balance sheets (for the most part), and the tailwind of Fed rate cuts as inflation fell toward their target. But it is notable that the bulk of the performance was realized in the fourth quarter after several false starts earlier in the year – a testament to the prevailing uncertainty about the macroeconomic outlook.

Among the notable performance-related credit trends last year was the firm re-establishment of the negative correlation between Treasury yields and spreads. When inflation is stable, spreads – especially in the highly consumer-sensitive High Yield (HY) sector – are more sensitive to economic growth and thereby the outlook for defaults. The bullish sentiment around both was apparent in the 2-month 77-bp rally that brought us to the spread lows in mid-November, completely offsetting the increase in Treasury yields.

Which brings us to a second notable (and related) point – the HY spread rally to 253 bps wouldn't have been possible without a turn in sentiment around CCC bonds. For much of last year, even as higher quality bond spreads marched lower, CCC valuations stood stubbornly wide; through mid-July the Bloomberg U.S. HY Index had tightened by 27 bps, while the CCC cohort was 46 bps *wider*. Remarkably, these low-rated bonds ended the year tightening by a whopping 200 bps, delivering 11.7% in excess return versus government bonds. While CCCs represent just about 12% of the index, the outsized move boosted the broad HY market to do better than both BB and B bonds.

## *Strategy Overview*

GMO's High Yield Strategy returned 7.88% (net of fees) in the calendar year 2024 compared to 7.95% for its benchmark, the Markit iBoxx USD Liquid High Yield Index (IBOXHY).

Recall that the 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.

That last scenario describes the state of affairs toward the end of the year, as highlighted by the notes on CCC performance above. It is no surprise then, that the strategy's allocation to the Quality factor, via BB bonds, was the biggest detractor from overall performance. As we mentioned in our letter last year, we had expected to increase allocation to this factor as HY spreads tightened, in line with our research and quantitative signals. Cognizant of the risk of underperformance, especially if the laggard CCC cohort staged a comeback (which it did!), we implemented the increase in a staggered, valuation-aware manner. While this factor absorbed some underperformance in 2024, we believe it is well-positioned to deliver alpha in an adverse market scenario going forward.

Highlighting the diversification benefit offered by our slate of factors, the allocation to Carry (via CDX HY, a tradable index of credit default swaps, or CDS) and Benchmark Replication (via Total Return Swaps, or TRS, on the IBOXHY index) handily overcame the deficit from the Quality factor to bring strategy performance on par with the high-yield benchmark.

The Carry factor is implemented through a long position in CDX HY that offers a superior way to harvest the roll-down in high-yield credit. CDX HY broadly outperformed the cash HY market in 2024. The portfolio enhanced this alpha by varying the factor allocation throughout the year in accordance with our research model signals, which incorporate the basis between CDX HY and cash bond spreads, and the relative roll-down between them, among other quantitative metrics.

Among the surprising alpha sources available in 2024 was the TRS on IBOXHY, which also outperformed the HY benchmark by virtue of trading below its fair value for much of the year. This was an unexpected opportunity, given it tends to occur in weak rather than strong markets. The portfolio was able to harvest this alpha opportunistically based on TRS valuations relative to other factors. This alpha comes with zero tracking error, making it particularly attractive.

The Short Volatility overlay had a difficult year and made a small negative contribution to portfolio returns. A positively trending market punctuated by periodic shocks was not an ideal environment for this strategy.

Finally, for yet another consecutive year, there were barely any downgrades from investment grade into HY, leading to almost no activity for our Fallen Angel factor.

## *Outlook*

The HY market ended 2024 at an all-in yield of 7.6%. Very rarely has this valuation not resulted in a positive total return for the subsequent year. But it's becoming increasingly hard to ignore the fact that credit spreads make a minimal contribution to this yield. Their contribution, at 38%, is in fact nearing an all-time low. There is little to no room for error at this spread level, making credit-based allocations to HY much more challenging.

The GMO High Yield Strategy is always fully invested; we do not try to time the HY market. That said, these valuation levels do affect the relative attractiveness of our top-down factors in different ways. We've recently increased our allocation to Quality (via BB bonds) because our quantitative signals suggest an alpha opportunity if the market sells off and a relatively low carry give-up if it doesn't. Returns in a low spread environment are dominated by carry over mark-to-market changes on the upside, given the lower limit on spreads. This will likely entail opportunistic increases in our allocation to Carry (via CDX HY), which has the added benefit of a better convexity profile than the cash market. The outlook for Fallen Angels is uncertain and quite dependent on the economic cycle. We suspect we may still have a while to go before a broad-based downgrade cycle, but we expect more idiosyncratic events to provide some opportunity.

Among the bottom-up factors employed in our bond selection process, Value trumped Momentum and other defensive signals last year. At current spread levels, this trend is likely to continue. Spreads don't have much room to go tighter, making Momentum more effective in avoiding bad apples than picking up upside alpha. Credit selection at the right price, i.e., Value, has the potential to perform in either direction.

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. We've made several enhancements in this area over the past year, including sharpening certain regression models to better reflect the economics of HY bonds, improving the accuracy of our issuer mapping methodology, and fine-tuning effective factor exposures to have a more balanced risk profile, among other endeavors. Research in this space continues, with a view to improving alpha even further and adding flexibility to the portfolio construction process.

Thank you for your confidence in GMO. We value your partnership and look forward to discussing GMO's High Yield Strategy and investment philosophy with you in the coming year. We believe it offers an ideal complement to more traditionally managed HY portfolios, bringing a differentiated perspective to investing in the asset class.

Yours sincerely,

Joe Auth
*Head of Developed Fixed Income and Portfolio Manager*

Rachna Ramachandran
*Portfolio Manager*

| *Annualized Returns as of 12/31/2024 (Net, USD)* | *Inception* | *1-Year* | *3-Year* | *5-Year* | *10-Year* | *ITD* |
|---|---|---|---|---|---|---|
| **High Yield Composite** | 1/31/2017 | 7.88% | 3.89% | 4.43% | N/A | 5.24% |
| **Markit iBoxx USD Liquid High Yield** | | 7.95% | 2.84% | 3.53% | N/A | 4.46% |

***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.

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