YEAR-END LETTER FOR 2023

Structured Products Team: Opportunistic Income Strategy

Dear Client,

As we enter 2024, we want to thank you for your investment with GMO and your continued confidence in the Opportunistic Income Strategy. Below is a review of the last 12 months and our outlook for the new year.

The GMO Opportunistic Income Strategy delivered a 7.03% return (net of fees) for the 2023 calendar year, outperforming its benchmark, the Bloomberg U.S. Securitized+ Index, by 1.96%. Compared to our benchmark, our strategy had the advantage of being invested in sectors that delivered on average better carry, better spread performance, and lower interest rate duration than the securities that make up our benchmark. Our benchmark consists almost entirely of agency mortgage bonds, which delivered a poor 2023 return compared to most other spread sectors.

At a high level, our floating rate sector holdings, CLOs and student loans, delivered the strongest net returns at 10.17% and 9.31%, respectively, during 2023. These sectors had the advantage of generating coupons benchmarked to LIBOR/SOFR in a year when the interest rate curve stayed inverted and floating rate base rates were significantly higher than those farther out the curve. Our real estate sectors delivered lower but still solid net returns at 7.14% for RMBS, 8.07% for CMBS, and 7.93% and 8.97% for the smaller exposures within small balance commercial and single family rentals, respectively. These sectors in some instances suffered from spread underperformance (e.g., MBS and CMBS) and delivered interest rate volatility that eroded returns for profiles with variable maturity schedules. However, the benefits of elevated carry and several opportunistic portfolio additions we made at or close to the YTD wide levels in MBS and CMBS sectors helped to deliver solid return contributions from these areas of the market.

Our Treasury futures positions, which we use primarily to manage the strategy's duration exposure, contributed a small positive net performance of 0.17% during the year. We started and ended 2023 with approximately 2.0 years of rate duration but adjusted through the year – taking rate duration down to 1.4 years following the post regional bank crisis bond rally, and up toward our max position of 2.5 years when rates touched their peaks in late October. Our tactical trading generated some PNL which helped offset Treasury futures' negative carry in a year when the curve was inverted (causing futures prices to roll down the curve). Interestingly, rates and the shape of the curve (as measured by 2s and 10s rate differential) ended the year at levels very close to where they started, despite a significant amount of realized volatility during the year. In some periods, the volatility was even extreme on a daily basis (for instance, between March 7 and April 7 during the regional banking crisis, the 2-Year Treasury yield changed by an average of 17 bps per day).

Our credit shorts and credit relative value trades drew down by approximately 0.30% (net) in 2023 as corporate credit spreads ended the year meaningfully tighter and implied volatility on credit spreads ended the year at 5-year low levels. Our elevated cash holdings detracted from returns despite delivering a net return of 5.22%, which would have been considered very attractive in any year since the financial crisis, given that returns from all our bond sleeves were higher than the cash return.

Below we discuss the market in 2023 and provide a brief outlook for the year to come.

The Market in 2023

Overall, 2023 was a year of significant volatility for fixed income investors, but one that certainly ended on a higher note than 2021 and especially 2022. On the base rate side, bond yields ended the year in approximately the same place they began. Despite that, the year did generate a significant amount of volatility for Treasury investors, with 2- and 10-year rates increasing to around 5.25% and 5.0% at the end of October. Following that point, a combination of a relatively benign CPI report as well as a very dovish FOMC meeting in December helped support a furious bond rally that brought yields down to slightly below 4% for 5s and 10s and around 4.35% for 2s. Despite very little if any decline in yields and having to incur negative rolldown return due to the shape of the curve, Treasury investors still ended the year with absolute returns well above zero, demonstrating how a much higher starting yield helped to set up a more positive return profile.

While Treasury bonds generated carry-like returns in 2023, parts of the credit markets enjoyed significantly more capital PNL. Most specifically, corporate credit enjoyed a very strong year from both total and excess return perspectives.

For instance, according to BAML data, U.S. investment-grade spreads finished the year at about 98 bps, 33 bps tighter than their year-end level of 131, while U.S. high yield ended the year 139 bps tighter at 320. The IG Index finished the year with a return of 10.73%, whereas high yield was at 13.44%. On the derivative side the story was much the same, with on-the-run CDX IG starting the year at 80 bps and finishing 23 bps tighter at 57, and with CDX High Yield starting the year at 478 bps and finishing 122 bps tighter at 356.

Within the securitized markets, the picture was much more of a mixed bag, with CLO and non-agency RMBS sectors enjoying material spread tightening (like corporate bonds). Meanwhile other sectors, including agency MBS, CMBS, and parts of the ABS market did less well. CLOs and non-agencies had the advantage of strong (non-agencies) or better-than-feared (CLOs) fundamental performance along with supportive technical conditions. Agency MBS and parts of the ABS market (auto and credit card bonds) dealt with much weaker technicals as 2023 progressed. The Fed's continued program of quantitative tightening combined with the withdrawal of the bank bid in light of the rate selloff and regional bank crisis that emerged in the spring, together, contributed to the poor technicals. CMBS suffered from a similarly poor technical as well as significant fundamental weakness in parts of the commercial real estate sectors. **We currently find valuations in these sectors compelling, especially relative to spread levels in corporate bonds.**

In the fall, mortgage rates briefly touched 8% – a level not seen for over 20 years. Despite the end-of-year rally, which brought rates closer to 7%, a high percentage of Americans now carry mortgage rates that are significantly lower than current market levels. This means that obtaining a new mortgage (either by refinancing or moving) will have a considerably negative financial impact for those borrowers. The net result is that the market expects individuals to remain in their current mortgages for a long period of time.

Despite participating somewhat in November and December's rally, CMBS spreads materially underperformed those in most other credit sectors in 2023. We believe this had much more to do with fundamental rather than technical concerns. More datapoints (sale prices significantly lower than loan balances and previous sales prints) emerged, continuing to lend support to the ongoing office market decline. Furthermore, other sectors whose fundamentals previously supported very aggressive valuation assumptions (e.g., apartments) saw much larger-than-expected valuation declines due to softening performance and interest rate spikes.

Our Outlook for 2024

At the beginning of 2023, the market looked as attractive overall as it has in most periods since the end of the GFC. Given the spread rally over the course of the year, we no longer see it that way from a nominal perspective as we enter 2024. However, we still find that many profiles among structured products remain on the cheaper side versus history, and from a relative perspective, the environment is still very attractive.

Compared to corporate credit, many high-quality parts of the structured market have lagged, setting up compelling long/short profiles as we enter 2024. These include, but aren't limited to, much of the senior parts of CMBS, agency MBS, and higher quality portions of the ABS market. For instance, the valuation relationship between top of the capital structure AAA conduit CMBS and investment grade corporate bonds remains very dislocated in favor of CMBS, even though we believe (as does the market) that the risk of principal impairment on these highly rated CMBS bonds is exceptionally low.

We do find one part of the structured market significantly less attractive now than we did at the beginning of the year: CLOs. From a spread perspective, CLOs have had a very strong year, with AAAs tightening by approximately 34 bps with subordinate tranches rated BBB doing even better – tighter by between 100 bps and 150 bps. And just as important as the spread tightening is the fact that the sector's convexity profile looks significantly worse than it did, especially at or near the top of the capital structure with dollar prices at or very close to par.

Beyond CLOs, the convexity story in most of the market remains compelling. Wider spreads and higher interest rates compared to when much of the existing product was originated means that dollar prices are below par and extension potential/call risk in stories like floating rate CMBS, single family rentals and parts of non-agency are attractive historically.

Thank you for your confidence in GMO and the Opportunistic Income Strategy. We look forward to working with you in 2024.

Sincerely,

Joe Auth
Head of GMO Developed Fixed Income

Ben Nabet
Portfolio Manager

Annualized Returns as of 12/31/2023 (Net, USD)	*Inception*	*1-Year*	*3-Year*	*5-Year*	*10-Year*	*ITD*
GMO Opportunistic Income Strategy	10/31/2011	7.03%	2.47%	2.88%	3.56%	4.36%
Bloomberg U.S. Securitized +		5.08%	-2.80%	0.37%	0.72%	0.70%

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.

Net returns for individual components, such as sectors and countries, are calculated by applying the same fee rate that is used in the top level (total portfolio) net return calculation. Net contribution to return figures for individual components are calculated by netting down the gross contribution to return by the net vs. gross return differential, multiplied by the average weight during the period. Fees and expenses are not charged to individual investments, and net performance of individual components is provided for illustrative purposes only to meet regulatory requirements. Different calculation methodologies can result in materially different net returns for individual components. Please refer to the net performance of the Strategy, which best represents the net performance an investor would have received if they had been invested during the periods shown.

Disclaimer
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