GMO

# YEAR-END LETTER FOR 2024

*Structured Products Team: Opportunistic Income Strategy*

Dear Client,

As we enter 2025, 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.

## *Performance Review*

The GMO Opportunistic Income Strategy delivered a 5.97% return (net of fees) for the 2024 calendar year, outperforming its benchmark, the Bloomberg U.S Securitized Index, by 4.51%. The strategy had the advantage of being invested in sectors that delivered on average better carry and better spread performance compared to securities that make up our benchmark during the past 12 months. Our benchmark consists almost entirely of Agency mortgage bonds, which while delivering a modest total return during the period, still lagged the performance of almost every other spread sector in 2024. The benchmark also carried materially more interest rate duration than our strategy, which hurt returns in a year when carry from Treasury positions (defined as returns over cash) were significantly negative.

All the main long risk sectors within the portfolio delivered strong excess returns over cash in 2024. The strongest performer was CMBS, which generated a 12.5% total return during the year. Traditional CMBS risk screened as being very cheap at the end of 2023, and our decision to overweight that sector going into 2024 was a tailwind for the strategy's performance. Because we believed spread reversion would be a primary source of return within CMBS, we focused our efforts on profiles with material upside (not capped out on a price basis) if spreads did in fact tighten.

Within other long sectors, total returns ranged from 7.25% to 9.75%. CLOs were at the lower end of that range as we invested very conservatively there in 2024, having found spreads more attractive in other parts of the structured product market (in 2023, CLO spreads mean-reverted to a much greater extent than CMBS, ABS, and Agency MBS, and thus began the year looking less cheap). CLO profiles also had less positive convexity at the beginning of 2023, especially at the top of the capital structure. We preferred profiles that offered more upside should spreads continue mean reverting. Our largest consumer sectors, RMBS and Student Loans, delivered returns of approximately 8.0% and 8.3%, respectively. Both sectors carried well and experienced spread tightening throughout the year. Fundamental performance in both sectors has been strong, especially within RMBS as home prices continued their upward climb, serving to de-lever existing seasoned profiles. While performance challenges could affect both RMBS (affordability concerns) and student loans (payment resumptions on the federally guaranteed side), we believe our focus on very seasoned and de-levered profiles offers protection against most types of fundamental deterioration.

Our Treasury futures positions, which we use primarily to manage the strategy's duration exposure, drew down considerably during the year. This detracted -1.22% from the strategy's total return. We started 2023 with approximately 2.0 years of rate duration but adjusted both down and up throughout the year, ending modestly higher at approximately 2.3 years. Treasury futures incurred two sources of negative return in 2024:

1. Carry was negative as the curve was inverted for most of the year, causing futures prices to roll down the curve, and
2. Most base rates sold off during the year, contributing to additional negative returns for Treasuries. The rate sell-off was more pronounced at the back end as 10-year rates increased by approximately 68 bps while 2-year rates ended the year at almost the same level they had started it.

The curve stayed inverted for most of 2024, finally disinverting in September as the Fed began their cutting cycle. By the end of the year, the 2Y/10Y curve was positively sloped at 25 bps after beginning the year inverted by approximately 45 bps. Entering 2025, the rates market was in a more optimal carry position than it had been for some time, with the curve now positively sloped (if only mildly) and yields higher than the fed funds rate for most parts of the curve.

Our credit shorts and credit relative value trades drew down as well, detracting -0.31% from the strategy's total return as corporate credit spreads ended the year meaningfully tighter and credit implied volatility ended the year at 5-year lows. Despite delivering a return of 5.35%, which would have been considered very attractive in any year since the GFC, our relatively heavy cash holdings detracted given that returns from all bond sleeves were higher than what cash delivered.

## *The Market in 2024*

Overall, 2024 was a year that delivered tighter spreads and higher base rates, resulting in strong excess returns in most sectors but more mediocre total returns in sectors with significant interest rate exposure. The market's pricing of Fed rate cuts generated plenty of volatility on the interest rate side throughout the year as expectations of the magnitude and speed of the Fed's cutting cycle fluctuated over the period, with significant cuts priced in to start the year and at the end of the summer. Interestingly, cuts were priced out only after the Fed began easing. At year-end, the market had priced in a total of one to two cuts in 2025. A stickier inflation set up, some notably hawkish commentary by the Fed, and the expectation that the incoming Trump administration might deliver policies disadvantageous to bonds were among the reasons cuts were priced out as the year progressed.

Treasuries generated much lower returns vs. cash in 2024, returning only 0.5% according to BAML. Most spread markets did much better, particularly corporate credit, which had a very strong year from an excess return perspective.

U.S. investment grade spreads, for instance, finished the year 22 bps tighter at 82 bps, returning 2.80%, and high yield spreads ended the year 47 bps tighter at 292 bps, returning 8.20%. The story was much the same on the derivative side, with both on-the-run CDX IG and CDX High Yield tightening over the year to 49 bps and 308 bps, respectively.

The securitized credit picture was mainly one of strength as well, as strong 2023 performers (CLOs, Non-Agency RMBS) continued to tighten. Some of the cheaper sectors, primarily CMBS and parts of higher quality ABS, did even better. Although fundamental issues surrounding commercial real estate continued to pop up, the "worst outcomes" started to be priced out of the market, causing loss-remote bonds to tighten significantly in 2024. At this point we believe most of the mean reversion we had expected between high-quality CMBS and other parts of credit has occurred, and that bond selection will be the main source of return going forward.

Agency MBS generated a positive but comparably weaker return in 2024 relative to corporates and other structured products. Although option-adjusted spreads did tighten over the course of the year, the sector's returns were negatively impacted by the interest rate volatility that persisted throughout the period. We continue to think Agencies represent a reasonably attractive place to invest given spreads still stand out on a relative basis. This sector should gradually inspire more sponsorship as the curve steepens and the banking regulatory situation progresses.

It remains the case that a high percentage of the American public now carry mortgage rates significantly lower than current market levels, which means obtaining a new mortgage (either by refinancing or moving) would have a considerably negative financial impact on borrowers. The net result is that the market expects individuals to remain in their current mortgages for a long period of time.

## *Our Outlook for 2025*

Early in 2024, we found that many profiles in the structured space were on the cheaper side versus history and that the environment was very attractive from a relative perspective. As we exited 2024 that was no longer the case as the cheapest sectors mean-reverted considerably. We thus find the beta in most parts of credit to be more expensive than we'd like but continue to see opportunities to generate strong risk-adjusted returns as individual profiles among many structured products remain attractive (especially given the opportunity to invest in parts of the market where we believe fundamental risk exposure is minimal). Indeed, entering the New Year, we believe bond picking offers the best alpha opportunities, especially in CMBS, RMBS, and parts of ABS, compared to broad sector calls.

We continue to think Agencies look reasonably compelling given spreads still stand out on a relative basis and we expect the sector to begin attracting more sponsorship as the curve steepens and the banking regulatory situation progresses. On the other hand, we believe adjusting our focus if and when the rate curve steepens could be key given bullet principal window bonds will become more attractive than wide window bonds in such an environment.

Although it certainly cost us some basis points in 2024, we continue to think the macro setup supports a conservative fund posture: overweighting the safest profiles, maintaining a healthy exposure on the short side to what we see as the most overvalued credit sectors, and retaining an ample amount of dry powder.

Thank you for your confidence in GMO and the Opportunistic Income Strategy. We look forward to working with you in 2025.

Sincerely,

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

Ben Nabet
*Portfolio Manager*

| *Annualized Returns as of 12/31/2024 (Net, USD)* | *Inception* | *1-Year* | *3-Year* | *5-Year* | *10-Year* | *ITD* |
|---|---|---|---|---|---|---|
| **Opportunistic Income Composite** | 10/31/2011 | 5.97% | 3.53% | 3.32% | 3.71% | 4.48% |
| **Bloomberg U.S. Securitized+** | | 1.46% | -1.98% | -0.59% | 0.83% | 0.76% |

***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 Ben Nabet 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.