GMO

YEAR-END LETTER FOR 2024

Developed Rates & FX Team: Systematic Investment Grade Credit Strategy

Dear Client,

As we enter 2025, we extend our gratitude for your continued confidence in GMO and your partnership in our systematic approach to investment-grade corporate credit. We remain committed to delivering a rules-based, data-driven strategy designed to navigate the complexities of the investment-grade corporate credit markets and are confident that our disciplined approach has the potential to deliver strong, reliable results for investors.

Strategy Overview

Before jumping into our analysis of the year, we think it's important to start by providing a brief refresher on our process and strategy. The GMO Systematic Investment Grade Credit Strategy seeks to generate total returns in excess of its benchmark, the Bloomberg U.S. Corporate Index, through a disciplined and objective factor-based approach. Bonds are evaluated using proprietary signals across key dimensions, including:

- Value: Identifying bonds with attractive credit spreads
- Momentum: Leveraging trends in public equity markets to inform credit allocations
- Quality: Emphasizing issuers with positive developments in credit profiles
- Company Fundamentals: Signaling drawn from research from GMO's Systematic Equity team

We manage interest-rate, spread, and key-rate duration exposures closely to the index, seeking to ensure that credit bond selection remains the primary driver of active returns. Sector allocations are capped to mitigate unintended risks, and liquidity screening coupled with turnover management enhances portfolio efficiency.

2024 Market Review

U.S. investment-grade corporate bonds delivered a total return of 2.1% in 2024, as measured by the Bloomberg U.S. Corporate Index. Despite modest total returns, the asset class delivered a strong excess return of 2.5% over duration-matched Treasuries, reflecting the risk appetite for credit.

The Federal Reserve moved towards funds rate normalization, cutting 50 basis points in September and another 25 basis points in December. Economic data in the second half of the year offered a fruitful environment for credit. The U.S. growth story remained, and third quarter GDP registered 3.1% annualized. Inflation moderated, albeit unevenly, and the final reading of Core CPI was 3.3% for November, down from 4.0% a year earlier.

Corporate earnings growth was strong, and a wave of upgrades coupled with robust solvency ratios helped justify valuations. Spreads compressed across rating cohorts and within sectors. Bonds with the lowest ratings in the asset class, BBB credits, outperformed both in spread and excess return terms, followed by A-rated debt. The belly of the curve, namely the seven-to-ten-year maturity sector, drove credit curve flattening. From a sector perspective, Financials provided healthy performance, namely from Finance companies and REITs, while Capital Goods and Technology companies on average lagged the broader investment-grade market. Within factors, value-based indicators benefited greatly from the compression in credit spreads, while momentum, quality, and company fundamental pillars exhibited mixed results during the year.

Strategy Performance

Our strategy generated 1.1% alpha (net) in 2024, reflecting the strength of our systematic approach. Credit selection was the primary driver of outperformance, while sector tilts also contributed positively. Overweight positions in REITs, Consumer Non-Cyclicals, and Energy enhanced returns, though an underweight to the Electric industry detracted. Bond selection within Capital Goods, Technology, and Banking delivered strong results.

Viewed through a factor lens, the narrowing of credit spreads highlighted the strength of our valuation pillar, delivering alpha for much of the year. While momentum struggled in the first half, it rebounded in the second half, ending the year with a modest drag on alpha. Quality and company fundamentals-based signals had a very small impact over the period.

2025 Outlook

As we look ahead, the investment-grade market presents a mixed landscape. After a stellar two-year run, valuations within the investment-grade corporate sector look expensive. Credit spreads are tight, hovering near post-GFC lows at 80 basis points, tempering expectations for prospective excess return potential. However, the Bloomberg U.S. Corporate Index's 5.3% all-in yield may provide income opportunity for total return investors, who should view stable corporate fundamentals and the macroeconomic environment as supportive.

Compressed risk premia will make it challenging to uncover large dislocations through our valuation framework, but we expect other factors within our model to offer defensiveness should credit fundamentals, or sentiment, deteriorate in 2025. As such, we believe our systematic, multi-factor approach is well suited to navigate challenging markets, and leveraging a disciplined, systematic bond selection process gives us confidence our strategy has the potential to deliver strong results in the coming year.

Yours sincerely,

Jason Hotra
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Portfolio Manager

Annualized Returns as of 12/31/2024 (Net, USD)	*Inception*	*1-Year*	*3-Year*	*ITD*
Systematic Investment Grade Credit Composite	09/30/2020	3.27	-1.54	-0.20
Bloomberg U.S. Corporate Index		2.13	-2.26	-1.15

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**.

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