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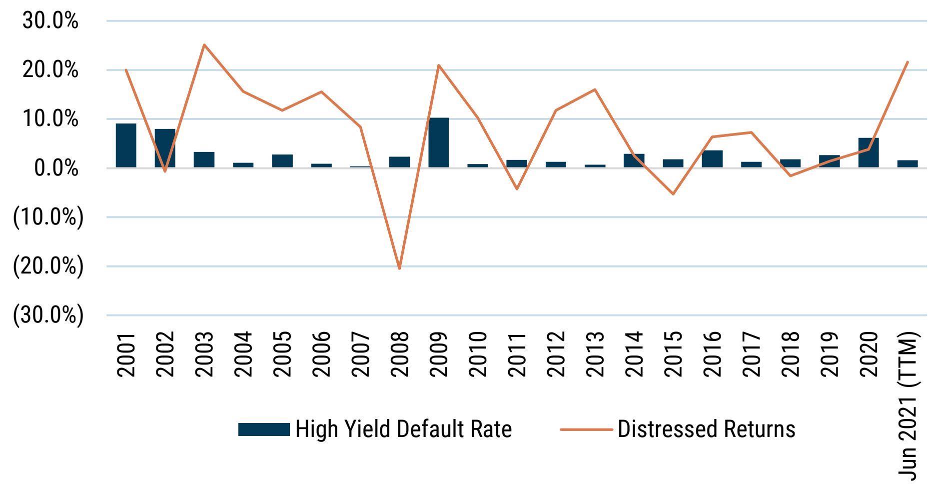
MORE THAN MEETS THE EYE

Distressed Returns in a Low Default Rate World

Credit Opportunities Team | November 2021

DISTRESSED RETURNS VS. DEFAULT RATE



Source: Bloomberg, JP Morgan, Credit Suisse Distressed Index

- While intuition might suggest low high yield corporate default rates starve distressed strategy returns, historical evidence indicates that this has not been the case.
- **Eight of the top ten double-digit return years for distressed debt featured default rates inside of 3.5%,** while recent returns suffered due to poor performance through the energy default cycle.
- Digging deeper, the explanation is not so counter-intuitive as distressed investors underwrite risky or uncertain situations that are shunned by the market and offer discounts in high and low default environments.
- GMO's Credit Opportunities Strategy seeks attractive returns through the cycle by investing across credit-linked asset classes:
  - Mini industry cycles, idiosyncratic risk events, and abrupt periods of risk-off sentiment continue to provide opportunities during lulls between major cycle downturns.
  - Over the past decade, the Strategy captured returns in a broad range of credit-linked asset classes such as structured products (2011-2013), European sovereigns, corporates, loans (2011-2015), municipal bonds (Puerto Rico from 2016-2020), dislocated investment-grade bonds (2020), and enhanced equipment trust certificates, or "EETCs" (2020-2021).

- **Despite the low current default rate, there is more to this opportunity set than meets the eye:**
  - We continue to find attractive total return investments in relatively low loan-to-value, further out the recovery curve COVID-impacted sectors such as travel, leisure, and aerospace, as well as idiosyncratic opportunities in leveraged telecom and health care capital structures.
  - Looking ahead to emerging opportunities, sources of stress are abundant. Current leading candidates include China property deleveraging, global supply chain disruption, commodity inflation, and potential shocks from inflation and associated central bank tightening.

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