GMO ALTERNATIVE ALLOCATION STRATEGY

In the face of the recent extreme turbulence in the market as a result of the COVID-19 pandemic, we believe liquid alternatives remain a critical component of a diversified investment strategy. This is particularly true given the decline in the yields on bonds and their subsequent difficulty in generating good returns from such low yields. GMO's Asset Allocation team has had a significant allocation to liquid alternatives over the past several years, and they remain integral to today's portfolios. We like liquid alternatives in our portfolio as a unique source of portfolio of return and diversification due to the following characteristics:

- Low beta to stock and bonds
- Low duration
- Low to moderate volatility relative to risk assets
- Steady, persistent source of returns

But not all liquid alternatives are created equally. We have taken a very differentiated approach in building a stand-alone offering, the GMO Alternative Allocation Strategy, to deliver strong, consistent returns for clients. As we celebrate the Strategy's one-year anniversary, the following provides an overview of the attractive opportunities the GMO Asset Allocation team sees for liquid alternatives in portfolios today.

Bonds: The Return-Free Risk

Bonds are generally owned in a portfolio for at least one of two reasons: income and/or protection against a deflationary event such as a significant recession or a depression. While prognosticators have been calling for the end of the "Great Bond Bull Market" for what seems like decades, what is clear is that the yield or the income you receive by owning bonds today is miniscule. The yield on the U.S. 10-year Treasury bond hit an all-time low of 32 basis points (bps) on March 10, 2020, this is the lowest yield we have seen in the history of the Republic. Additionally, the negative yields we have seen from Japanese and European government bonds are the lowest in recorded history. And bond math is quite exacting: if you hold a 10-year bond to maturity, you will eventually receive the indicated yield assuming you are paid par at the end. Trying to generate a return of 5% real or 7% nominal is going to be exceptionally difficult with those levels of yields. Assuming a yield on government bonds of 75 bps, you would need your equity portfolio to deliver more than 11% in order to generate a 7% nominal return for a traditional balanced portfolio.[1] And if you own the Bloomberg Barclay U.S. Aggregate ("Agg"), you do get a higher yield (on the order of 2.5%), but your equities would still need to generate a return of 10%.[2] Of course, that higher yield on the Agg does not come for free as it is related to owning mortgage and investment grade credit. We have recently seen some of the risks that COVID-19 has inflicted on credit markets particularly in the BBB-laden investment grade market.

A significant risk to owning bonds for income purposes is not only the measly income you receive, it is the asymmetric risk of the yields on those bonds rising. With a duration of approximately 9, a measly 16 basis point increase in yields wipes out your entire years' worth of income from your U.S. 10-year government bond.[3] As venerable market observer Jim Grant calls it, this is your proverbial "return-free risk".

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[1] Assuming a -.50 bps real yield would require a return of almost 9% real for equities to achieve a return of 5% real in a traditional 60/40 portfolio.
[2] For the potential perils of investing in the Agg today, please see Pete Chiappinelli's piece "The Passive Aggressive Agg, Revsited".
[3] This assumes a current 10-year U.S. treasury bond with a coupon of 1.5%. If you held the bond for a year, a 6 bp increase in yield would wipe out your cash flow for the year as the price of your bond also declines over the course of time as it gets pulled to lower to par.

The real yield and real return on bonds will depend on inflation over that time period. While we are experiencing a significant deflationary shock with the COVID-19 pandemic, there are seeds being sewn for the possible return of inflation over the medium term. The significant fiscal stimulus we are seeing globally has the potential to create inflationary bottlenecks in the system. Further, to the extent the pandemic causes companies to rethink international supply routes, requiring more costly supplies, decreased productivity, and an increase in total manufacturing costs (including labor), we could start seeing higher prices and inflation creep into the economy here as well. Bonds, being as expensive as they are, would be vulnerable to significant shifts in pricing should we get an inflation shock in the intermediate term. Levered bonds, as is typical in risk parity strategies, would get hit especially hard. But it is not only bonds but stocks which would be hurt by a repricing from inflation as well. Equities actually have the most duration of any asset and are vulnerable to a shift in discount rates, which typically rise after inflation increases and the Fed steps in to bolster cash rates to fend off the inflationary forces.[4]

One of the fantastic virtues of bonds through the last several crises has been its anti-correlation with equities. Basically, as deflationary shocks have hit the economy in the TMT bust, GFC, and now the COVID-19 crisis, bonds have been a fantastic hedge to your portfolio. If we continue to get deflationary shocks to our economy, bonds likely will do less well simply because the starting yield is so low. And if the shocks are inflationary, bonds will do quite poorly (even TIPS may go down in price as real yields rise, although likely significantly outperforming nominals). While recent history has been very kind to bonds, particularly in hedging equities, we believe the cost to that hedge today is inordinately high with a lower-than-normal payoff. There is good reason to believe that the best days of bonds as an equity hedge are behind us.

Against this backdrop, we have a much higher than normal allocation to liquid alternatives or hedge fund-like strategies today. We like the characteristics of liquid alts as they are primarily long/short in nature eliminating the duration risk from long positions in stocks or bonds. Additionally, liquid alternatives are a good way to generate returns in an environment where bond yields have reached all-time lows. Liquid alternatives performed much better than equities during March, although we did see extreme liquidation events in numerous markets. They did not keep pace with government bonds because there is some embedded equity risk in most liquid alternative strategies, but as a source of return going forward, we like the returns and portfolio characteristics of liquid alternatives much better than bonds.

GMO's Differentiated Approach

GMO's product development effort is not about trying to divine what the marketplace is demanding but more about trying to put together portfolios that will actually make money for clients. In this vein, we launched the GMO Alternative Allocation Strategy ("ALTA") in May of 2019 to take advantage of the benefits of liquid alternatives in our own Asset Allocation strategies. While recently many investors have focused on alternative risk premia ("ARP") strategies in the liquid alts space, we have chosen a different direction.[5] Given the proliferation of ARP strategies, we view many of these strategies as being commoditized, or certainly possessing less potential return than any well-devised back test would suggest. Rather than anchoring to simple, well-known factors with good back tests, we have focused ALTA on a

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[4] Equities (both public and private) actually have the most duration as the majority of their value is derived from cash flows more than twenty years in the future.
[5] Alternative risk premia strategies are generally long/short strategies for stocks, bonds, commodities, and currencies using return factors such as value, momentum and carry.

combination of long-tenured, alpha-oriented strategies and fundamental risk premium ("FRP") or insurance-like activities.

We use our Systematic Global Macro Major Markets, Fixed Income Absolute Return, and Asset Allocation Long/Short strategies as our core alpha strategies and combine them with two of our fundamental risk premium strategies, the Merger Arbitrage (Event-Driven) and Put Selling strategies. We refer to these strategies as "fundamental risk premium" as in both instances, we are being compensated for a risk others do not want to bear. For Merger Arbitrage, we are underwriting the risk that a merger may not close. Because of the downside associated with deal breaks, historically there is a premium associated with underwriting definitive agreement merger deals. Similarly, in Put Selling, we are selling unlevered equity index puts, or insuring against downside equity risk, which we believe is systematically misvalued by investors. If you are bearing the downside risk of equity markets, you should be compensated for such an activity and lo and behold, you have been.[6] The unlevered nature of this strategy is key in that allows you to survive months like March and write more premium at elevated levels of implied volatility. In both FRP strategies, we also attempt to add alpha via security selection. We like this combination of alpha and FRP strategies because we believe it will provide a unique and more enduring pattern of returns than just focusing on ARP.

March of 2020 was not kind to our FRP strategies. Our Merger Arbitrage portfolio was down 5.7% on the month as we saw median spreads move from 200 bps to 1,400 bps before settling in around 600 bps. We were able to actively rebalance the strategy and tactically increase our position in definitive agreement mergers because of the extreme move in the markets. At the end of March, the spread of our fundamentally selected Merger Arbitrage portfolio was approximately 900 bps. We view this as an excellent risk/return investment. Our Put Selling strategy was down 13.8% on the month in March and was basically flat to global equities. While months when a portfolio is down 14% are always tough to swallow, we have been able to continue to sell puts at historically very wide levels of implied volatility. Importantly, these two portfolios did not differ dramatically from how we modeled their behavior in an adverse scenario, and March of 2020 certainly would qualify as an adverse scenario on many levels. However, adverse scenarios do eventually pass. We also rotated into very attractively priced high yield bonds and bank loans in late March and early April, ahead of the Fed's latest "bazooka" bond-buying announcement. By maintaining our discipline and actively reallocating during times of stress, we believe we will generate excess returns over time.

Capital Efficiency and Fees: More Exposure Without Additional Fees

One of the advantages of building a liquid alternatives portfolio "in-house" is that we can run our derivatives-based strategies as overlays without committing the capital associated with the stand-alone products.[7] The overlays allow us to efficiently increase exposure in a way that is not possible in a fund-of-funds or any other type of "do-it-yourself model". We take an extremely conservative view when implementing these types of overlays where we keep our cash balances very high to withstand even the most adverse of circumstances. This ultimately allows us to responsibly concentrate our exposures and have more assets working for us.

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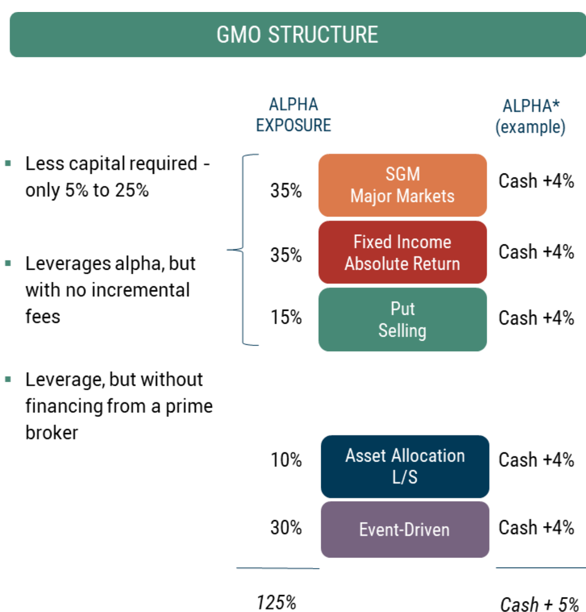
[6] In the long run, we believe put selling should deliver equity-like returns because you are bearing equity-like risk although the pattern of returns is different than the underlying equities.

[7] One of the keys in using derivatives and gaining exposure via margin investment is that our margin requirements are protected by Regulation T from the SEC. It is not subject to changes based on the capital requirements of a prime broker which can change based on the health of the underlying broker-dealer. This type of leverage can be called away at inopportune points in time whereas leverage provided margin and Reg T is much more stable.

CAPITAL EFFICIENCY

Efficient use of capital without the additional fees



While this efficiency of our use of capital is very helpful in getting more assets working for us, our structure is not entirely unique to GMO. Others can, and do, use this structure (although it is more difficult and expensive to do this in a fund-of-funds capacity). What is unique about our approach is that we purposefully do not increase our fees in proportion to the leverage we are engaging. We manage the portfolio with the increased exposures but only charge as if there was no leverage to the alphas in the strategy. The ultimate effect is a more manageable fee arrangement than many of our competitors. Why do we do this? We want to make sure that the fees we charge in proportion to the alpha we aim to deliver are reasonable. This enhances our ability to meet our investment objective of cash plus 4%. If we were charging more and taking more of the alpha away in fees, our ability to meet our objective would be critically compromised. And that is something we are categorically unwilling to do.

Conclusion

We were excited to launch the GMO Alternative Allocation Strategy a year ago and are eager to introduce our Strategy, especially in today's market environment:

- Liquid alternatives are an incredibly important tool for an allocator today to combat the high valuations, particularly of bonds, and the increased duration of all portfolios.
- We combine long-tenured, alpha strategies with fundamental risk premium strategies to produce a more consistent pattern of returns.
- We focus on efficiently implementing our strategies to get more assets working for us without simultaneously increasing fees.

The views expressed are the views of the GMO Asset Allocation team through the period ending May 2020, 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.

Risks associated with investing in the Strategy may include: Management and Operational Risk, Leveraging Risk, Derivatives and Short Sales Risk, Market Risk - Equities, and Market Risk - Fixed Income.