GMO

MAKING MONEY IN AN OVERVALUED MARKET

Capitalizing on a Merger Arbitrage and Distressed Debt Combination

May 2022

Introduction

With the easy market gains many investors experienced over the past decade now looking increasingly like they are in the rear-view mirror, portfolio management is getting much tougher. Economic and geopolitical uncertainties are high. Inflation is eating away at everything. Many market valuations still look stretched. Equities, fixed income, privates, cash – they all seem to have their problems.

Amid these challenges, thoughtful investors can still find pockets of opportunity, and we believe that combining GMO's active merger arbitrage and distressed debt strategies offers an attractive one. Historically, this combination has provided equity-like returns with half the risk of equities, characteristics that look very appealing at any time but especially so in today's environment.

Current Opportunities in Merger Arbitrage and Distressed Debt

We believe there are attractive opportunities currently in both merger arbitrage and distressed debt. In merger, spreads are wider than normal as investors weigh the global risk of rising regulatory scrutiny. While some of this concern is fair, we believe it can be overcome by using fundamental analysis to carefully select deals. In GMO's Event-Driven Strategy, which we've managed since 2016, we leverage our deep experience to do just that, to find opportunities where expected value is wider than normal given the risks involved in each deal.

Meanwhile, within distressed debt we see bright prospects despite low defaults, particularly in mid-risk stressed credits. Some of these securities offer the dual attractions of healthy income and capital appreciation potential, supported by a compelling margin of safety. We have run the GMO Credit Opportunities Strategy since 2010. Our current portfolio's weighted average loan-to-value ratios are approximately 45%.

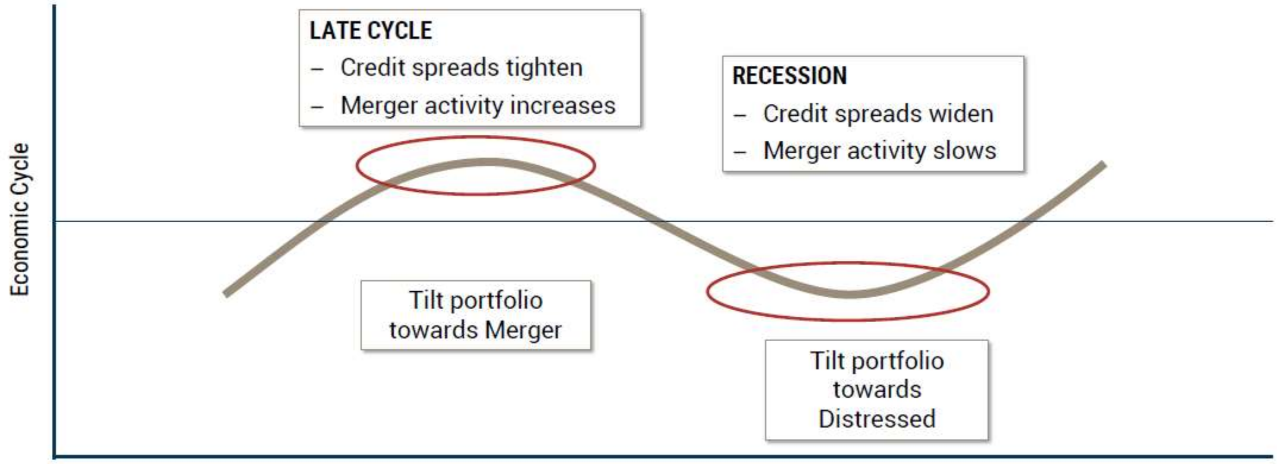
Each of these strategies on a standalone basis looks appealing and has achieved strong returns to date. Moreover, we believe there is much to be gained by holding these positions in combination and dynamically allocating between them.

The Power of a Merger and Distressed Combination

Merger arbitrage and distressed debt strategies capture returns that are fundamentally different from traditional equity and fixed income indices and risk premia. The appeal of combining the two strategies begins with their inherent countercyclicality. As the stylized example in Exhibit 1 demonstrates, in strong economic periods mergers tend to be plentiful, providing abundant opportunities for merger arbitrage investors to produce healthy returns. Conversely, as the economy slows or struggles amid a recession, credit spreads widen and bankruptcies increase, enhancing opportunities in credit and distressed debt. This countercyclicality creates significant potential to add value through an investment approach that tactically shifts portfolio allocations between merger and distressed throughout the economic cycle.

A STRATEGY FOR ALL SEASONS

Countercyclicality of merger and distressed investing



Source: GMO

Supporting our stylized concept above, a backtest of our blending GMO's Event-Driven and Credit Opportunities returns using fixed weights yields an encouraging confirmation of our hypothesis (see Exhibit 2). A fixed-weight combination produced equity-like returns with half the volatility of equities, including a drawdown in March 2020 just two-thirds that which equities experienced. This strategy has a beta of only 0.3 to equities.

On top of this, we believe we can improve on these results by dynamically shifting the allocations between Event-Driven and Credit Opportunities throughout the economic cycle, leveraging our Asset Allocation, Event-Driven, and Credit Opportunities teams to evaluate the current market environment and respond with compelling tactical tilts. Our ability to add value via dynamic allocation is supported by the deep relationships and frequent interactions of our teams, as we combine important insights about both the big picture opportunity set and bottom-up investment nuances to make allocation decisions.

For example, examining high-level data on indicators like credit spreads and merger activity is an excellent starting point. But also being able to understand the idiosyncrasies of each team's holdings adds a crucial extra layer of information that helps us make stronger allocation decisions, increasing our odds of adding value with a strategy that combines different investment disciplines.

Overall, GMO's collective knowledge and long history managing Asset Allocation portfolios gives us confidence we can offer investors an equity-like return with a smoother ride.

The result: a combined offering that harnesses GMO's expertise across multiple dimensions.

CONSISTENCY IS THIS COMBINATION'S HALLMARK

HYPOTHETICAL CHARACTERISTICS

Annualized Return	8.1%
Volatility	7.5%
Sharpe Ratio	1.01
Beta to ACWI	0.3
Drawdown	-15%

As of 12/31/21 | Source: GMO
Past performance, whether hypothetical backtested or actual, is not predictive of future results. Please see the disclosures of this paper. During the period of 2010 through 2016, the Event-Driven returns used were from a portfolio within GMO's Multi-Strategy. Drawdown period was March 2020.

A New GMO Investment Offering

We believe that by blending our merger arbitrage and distressed debt strategies, we can add significant value for our clients trying to navigate the challenging investment environment we are experiencing now and that we expect over the coming years. GMO has recently started offering such an investment strategy. We invite you to contact your GMO representative for more information.

Disclaimer: The views expressed are the views of Doug Francis, Matt Kadnar, Sam Klar, and Jon Roiter through the period ending May 2022 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.

Hypothetical back-tested performance is not predictive of future results. The results reflect performance an investor would have obtained had it invested in the manner described and do not represent returns that any investor actually attained. Hypothetical results are calculated by the retroactive application of a model constructed on the basis of historical data and based on assumptions integral to the model which may or may not be testable. The backtested performance presented is based upon the methodology described in the paper. Changes in these assumptions may have a material impact on the hypothetical returns presented. Certain assumptions have been made for modeling purposes and are unlikely to be realized. No representations and warranties are made as to the reasonableness of the assumptions. Hypothetical performance is developed with the benefit of hindsight and has inherent limitations. Specifically, hypothetical results do not reflect actual trading or the effect of material economic and market factors on the decision-making process. Since trades have not actually been executed, results may have under-or over-compensated for the impact, if any, of certain market factors, such as lack of liquidity, and may not reflect the impact that certain economic or market factors may have had on the decision-making process. Actual performance may differ significantly from hypothetical performance. Hypothetical results are adjusted to reflect the reinvestment of dividends and other income and, except where otherwise indicated, are presented gross-of fees and include the effect of hypothetical transaction costs, but not management fees, performance fees or expenses, if any. Actual fees are disclosed in Part 2 of GMO's Form ADV.