GMO

YEAR-END LETTER FOR 2025

Developed Fixed Income Team: High Yield

Dear Client,

GMO's High Yield Strategy returned 9.3% (net of fees) in the calendar year 2025 compared to 8.8% for its benchmark, the Markit iBoxx USD Liquid High Yield Index (IBOXHY). This marks the seventh year of outperforming the benchmark, since the strategy began nine years ago.

Our strategy aims to deliver HY beta return plus consistent alpha over its benchmark by employing a quantitative, factor-based approach to portfolio construction. It is designed to capture alpha from top-down sources of risk premia, taking advantage of structural market inefficiencies while maintaining a liquid portfolio.

Our top-down, data-driven approach allows us to allocate capital across a range of HY instruments to seek the best possible risk-adjusted returns over a full market cycle. The factors we employ and our allocations to certain HY portfolio products lend the strategy a high-quality tilt. Broadly, this has helped the strategy outperform during market drawdowns as well as in periods of moderate spread tightening. We expect to lag the benchmark during broad-based rallies that compress spreads even in the lowest-quality HY cohorts.

Performance Overview

The major top-down factor allocations in the portfolio, namely, Quality (via BB bonds), Carry (via CDX High Yield), and Benchmark Arbitrage (via Total Return swaps or TRS), all made positive contributions to portfolio alpha for 2025, as each factor outperformed the broad market. The Fallen Angel sleeve and the Short Volatility overlay were both detractors to performance; their share of the overall portfolio allocation was quite small and therefore didn't detract much from total alpha.

The strategy began the year with a near-maximum allocation to the Quality sleeve, owing to tight market spreads and reduced dispersion between rating cohorts, given the stellar performance of CCCs over the preceding months. This cost the strategy some alpha in the first two months of the year. Once the rally faltered in March, and especially during the tariff-policy-induced market turmoil in April, this allocation to BB bonds was instrumental to the strategy's alpha. In fact, we were able to monetize this outperformance and move part of the Quality allocation into Benchmark Arbitrage, which offered better value in the aftermath of the spread widening. Over the second half of the year, we brought this allocation back up to its maximum allowed 30%, as HY spreads neared multi-year lows and other factor sleeves appeared to offer limited value. BB bonds outperformed lower-rated bonds over the year, making the Quality sleeve allocation highly beneficial to the portfolio.

Among the bottom-up factors that drive security selection within the Quality sleeve, Value and Issuer Fundamentals contributed positively, while Momentum and Quality underperformed.

In absolute terms, the Carry sleeve, implemented via a fully funded long in CDX High Yield, was the best performer over the last 12 months. Our allocation to this sleeve, however, was only about half of its maximum allowable limit of 40% through most of the year. The reason for our caution was the diverging spread duration between the cash bond and synthetic high yield market (with the former trending lower) and the persistent right tail (distressed, widespread names) in the CDX HY portfolio. In hindsight, perhaps our allocation was too conservative. We ended the year with a 20% allocation to Carry.

The Benchmark Arbitrage sleeve seeks to generate alpha by harvesting the discount to NAV available in cash portfolio products, such as the standardized IBOXHY Total Return Swap (TRS). This discount was larger and more compelling to start the year, but steadily dwindled to near zero over the fall. Allocation to this sleeve made a steady positive contribution to alpha over 2025.

After a multi-year drought, there were a handful of Fallen Angel candidates this year. Only two made it past our valuation screen that compares their spread to their new HY peers. Performance was mixed among the issuers we bought; overall, the sleeve made a small negative contribution to portfolio returns.

Finally, it was a challenging year for the Short Volatility overlay. The premium between implied and realized volatility, though positive, was a tad lower than in past years. The occurrence of short-lived but sharp market shocks, followed by trending markets, led to a negative contribution to strategy alpha.

Market Recap

On the face of it, the HY market posted a solid performance in 2025, as evidenced by the benchmark return. Much of this, however, was owed to a decrease in Treasury rates, particularly at the front-end, which rallied on the expectation (and eventual realization) of Fed rate cuts. The HY market's excess return over Treasuries was a more modest 2.6%.

This isn't particularly surprising. As we noted in our last year-end letter, with the all-in yield in the high single digits, it was highly likely that the market would deliver sound overall performance, but that the credit contribution would necessarily be limited. Excess returns for the market were reflective of a supportive macro environment with reasonably healthy corporate balance sheets, balanced supply-demand conditions, and consequent low default rate (1.2% for the year). But with limited ability for spreads to compress beyond their 2024-end level of 287 bps, they did the best they could, which was to simply deliver carry – still respectable, but a far cry from the last two years.

One of the more remarkable aspects of the past year was the underwhelming performance of low-quality bonds. Consider that BBs, single-Bs, and CCCs, respectively, had an excess return over Treasuries of 2.9%, 2.6%, and 2.4% - not only are these numbers near uniform, indicating no differentiation by credit rating, but they also increase with credit quality!

A related trend in the market has been the increasing dominance of the highest-quality HY bonds. From representing about 46% of the market two years ago, they now make up 55%. This has come almost entirely at the expense of a shrinking middle cohort, i.e., single-B bonds.

Outlook

It is a fact of credit markets that periods of high positive returns are followed by muted performance – there is only so much more spreads can tighten. HY spreads ended the year at 266 bps. Consider that even in the heyday of 2007, with the credit bubble in its late stages, the market was only about 33 bps tighter than this level. There is an argument to be made that the current make-up of HY is much better in credit quality – that 55% BB weight mentioned earlier compares to only about 35% back in 2007 – and perhaps deserves to be even tighter. As it happens, though, BBs have already passed the 2007 lows; for the market to tighten from here in any significant measure requires a rally in lower quality bonds.

Given our maximum allocation to the Quality sleeve, this scenario presents a risk. But it is a calculated one, in two respects. One, we think our other top-down factors work as diversifying forces, making up for some of the underperformance from this allocation in a high-beta rally. And two, our goal is to outperform the market through the cycle – the Quality sleeve will act as a bulwark when the inevitable sell-off occurs, with a relatively low cost to bear if the market continues in its current vein.

As a quantitative strategy, robust research and analysis form the backbone of our investment process. Over the past year, we re-examined the case for a top-down factor designed to harvest the premium in short-duration bonds and made progress on a more flexible form of alpha calculation to enhance the bottom-up security selection process. We hope to begin implementing some of these ideas in the portfolio over the coming year.

Thank you for your confidence in GMO. We value your partnership and look forward to discussing GMO's High Yield Strategy and investment philosophy with you in the coming year. We believe it offers an ideal complement to more traditionally managed HY portfolios, bringing a differentiated perspective to investing in the asset class.

Yours sincerely,

Joe Auth
Head of Developed Fixed Income, Portfolio Manager

Rachna Ramachandran
Portfolio Manager

Annualized Returns as of 12/31/2025 (Net, USD)	***Inception***	***1-Year***	***3-Year***	***5-Year***	***10-Year***	***ITD***
High Yield Composite	1/31/2017	9.30%	10.02%	5.17%	N/A	5.68%
Markit iBoxx USD Liquid High Yield		8.83%	9.87%	4.34%	N/A	4.95%

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
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Appendix

TOP-DOWN STRATEGY FACTORS

Top-down factors capture well-established sources of high yield risk premia

CARRY	Return earned from spread and rolldown across cash and synthetic instruments if market conditions remain unchanged.
QUALITY	Harvests premium in high quality i.e., BB bonds. Factor provides better risk-adjusted returns through lower default rate and less volatility
FALLEN ANGELS	Recently downgraded bonds tend to get oversold as they transition from IG to high yield
SHORT DURATION, LOW RATED	Lower rated, short maturity bonds are often overlooked, given asymmetrical risk profile and illiquidity. Default risk mitigated through diversification and issuer risk limits
VOLATILITY	Demand-supply imbalance in the credit options market keeps implied volatility elevated vs. realized
BENCHMARK ARBITRAGE	Portfolio products can often trade at a discount to fair value, presenting the opportunity to harvest alpha with a low tracking error