

Tom Hancock and Kim Mayer sat down to introduce Quality investing at GMO and discuss what makes this particular strategy so compelling to equity investors. The following is an abridged transcript, which is available in full [here](#).

What does Quality mean to you?

In quality investing, we look for a **portfolio that you can hold through thick and thin without having to worry about the events of the moment**. We look for three attributes in the companies that we invest in:

1. **Relevance:** Companies that do something important now and for a long time to come.
2. **Strong competitive positions:** Companies where a rival cannot come in and take away what they do or diminish its profitability.
3. **Great management teams:** Companies with management teams that invest with a long horizon and deploy capital responsibly in a prudent way.

How do clients use Quality?

Initially, many of our investors had a tactical allocation around whether quality looked cheap to the rest of the market, or if they were concerned about market levels. Recently, many **investors have begun to rethink of quality as a good way to get core equity exposure:**

1. Our performance pattern has **provided defensive protection, but we have also done a good job of keeping up** in the strong markets over the years.
2. Our portfolio does not skew heavily toward growth or value **and tends to take a middle path. This helps protect from the extremes of either type of investing:** having to pay too much for growth that never materializes and falling into value traps.
3. Our portfolio has exhibited a **strong Sharpe ratio**.

What is the history of Quality investing at GMO?

The original incarnation of GMO in 1977 was a stock-picking, deep value strategy. The founders realized that some of the great companies like Coca-Cola beat the market consistently, and by more during downturns – so, **you were getting safer companies that outperformed**. A bias against these great, high-quality companies was not something you wanted in your deep value investment process. In the 1980s, GMO was a **pioneer in “systematizing” the**

stock-picking techniques of the founders into computer-implementable rules. A big part of that was coming up with a way of measuring these quality characteristics and was based on:

1. **high levels of profitability;**
2. **stable profitability; and**
3. **low levels of leverage**.

That was the basis of our approach in the 1990s when I joined the firm and has continued to be at the core of what we do. As you roll forward, GMO got more focused on top-down investing and that was when we launched a pure Quality strategy in 2004. **Quality is what we have been doing at GMO since our start.**

How is GMO Quality different from Quality ETFs?

We start in the same place – a quant model that looks for quality identifiers in a company's historical record. If you buy a Quality ETF, that is the portfolio you get. **We think we can do several things better that have led to significant differences in composition and performance patterns.**

1. **We vet the output of that model:** We seek to screen out the false positives (*companies that have historically screened as high quality, but for a variety of reasons may no longer be high quality*) and also the false negatives (*companies that have been unfairly punished by one of the pillars of our quant model, and thus would not make it into the portfolio*). Quant screens are helpful because it focuses your attention. But at the same time, **you must do the individual work and separate the good from the bad. We have been quite successful at that.**
2. **We pay attention to valuation:** Our approach seeks to avoid the most expensive quality companies.
3. **Portfolio construction:** Most factor portfolios are unwilling to look different from the benchmark. We are **happy to build big concentrations in sectors** where we find lots of quality companies, and we are similarly happy to have little-to-no weight in sectors that are unattractive. **In particular, we have a lot of concentration in Technology and Health Care sectors.**

If you think of their characteristics of long-term relevance – never clearer than now – you think about things like strong competitive positions where scale matters, there is a lot of intellectual capital and strong balance sheets. At the same time, you get pretty good valuations and it is the place to be.

What are some mistakes, or lessons learned, over your long history at GMO?

There are two things that stick out:

1. If you go back to the financial crisis, **we did an excellent job battering down the hatches and preserved capital during the downturn. We did a less good job of repositioning ourselves for the rebound in 2009** – we were not as nimble as we should have been to keep up, and that is **something that has informed our thinking this time around**.
2. The way we think about valuation has evolved. GMO has a heritage of being value investors and from 2013 to 2015, we made some mistakes about seeking too much value, and were not willing enough to hold our winners. We traded the portfolio more than we should have in retrospect. This is something we have adjusted to **keep the turnover low and be willing to buy and hold great companies over the long term**.

How have you reacted to the volatility this year?

It has come in a couple of phases:

1. When COVID-19 emerged in China, it was seen as on the other side of the ocean and people were pretty sanguine in the U.S. At that time, **we moved toward bulletproofing the portfolio, and it was pretty bulletproof to begin with** (i.e., we took profits from some of the higher-flying growth names).
2. As the pandemic spread, we saw a lot of indiscriminate panic. **The best companies were being sold off with the weaker ones at a similar rate and we saw that as an opportunity to buy some great companies** like Nike, Starbucks, ASML, and LVMH (a bit higher-growth names or ones we held in the past before the valuation ran).

3. As we hit the “bottom,” we felt the selling fell too far in some of the more cyclical stocks. We increased our weight in financial services and added to industrial cyclicals in a way that has served us well in the subsequent rebound.

To put this in context, **we turned over about 15% of the portfolio in the first quarter (not much for active managers generally, but high by our standards).** We typically turn over about 25% every year, half by adding new positions and half by rebalancing what we hold.

These moves point out the benefits of an adaptable, adept active management team – **to be able to take advantage of the dislocations and to think about valuations more purely than what the lagging, stale financials tell you today.**

Why are you adding to Financials right now? And why not Energy?

You have to be careful – both sectors have long-term relevance but there is concern about the strength of their balance sheets. **Energy we are much more cautious about:** there is a lot more overcapacity, there is the threat of new entrants with alternative energy, and it is a sector where capital deployment has suffered. **Financials were the victims and beneficiaries of the financial crisis: they have become much more conservative, their balance sheets are much stronger, and they are great, long-term relevant businesses with clear economies to scale.** When we think about the banks we own or added to, these are companies trading at materially lower price-to-tangible book than in the financial crisis, where they were at ground zero. We think they are priced for the bad outcomes to last for an extremely long time and provide great optionality to a continued recovery.

Why Quality today in these highly uncertain markets?

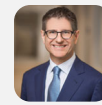
The range of outcomes today is about as wide as we have seen and is driven by any number of factors including the pandemic itself, the economic reaction to the pandemic, and policymaker reactions to that economic impact. The shape of the

recovery is anybody’s guess. Will it be a V-shaped recovery? Will it be some kind of a long U-shaped recovery? The danger investors can get into is building a portfolio that is optimized for a certain scenario. **The advantage of a quality portfolio is that it gives you the flexibility to last through a long downturn thanks to strong liquidity profiles and balance sheets. And yet it will do well as the recovery begins because these companies are market leaders** that are likely in a position to thrive at the hands of weaker competitors. The final uncertainty today is around inflation, which is linked to the massive reaction of policymakers around the world. **A quality portfolio can offer inflation protection down the road because these companies tend to be market leaders with ability to pass cost along to the consumer.**

What excites you about the portfolio today?

The portfolio is **set up to do well in a wide variety of outcomes.** We hold a balanced exposure toward the defensive end of the portfolio, but also have exposure on the more economically sensitive side of quality. To pick a specific opportunity that we see, consider **the “computerization” of everything. Every device is a computer these days and there are many companies in great positions to take advantage of that trend:** software companies like Microsoft, semiconductors like Texas Instruments or Taiwan Semiconductor. It’s a secular growth trend that **plays into the wheelhouse of some great high-quality companies that we are invested in.** So, regardless of what is happening today or next year, there are great investing opportunities out there.

BIOGRAPHIES



Tom Hancock

Dr. Hancock is the head of GMO’s Focused Equity team and the portfolio manager for the Quality Strategy. Previously at GMO, he was co-head of the Global Equity team. He is a partner of the firm. Prior to joining GMO in 1995, he was a research scientist at Siemens and a software engineer at IBM. Dr. Hancock holds a Ph.D. in Computer Science from Harvard University and B.S. and M.S. degrees from Rensselaer Polytechnic Institute.



Kim Mayer

Mr. Mayer oversees investor relations and is a research analyst within GMO’s Focused Equity team. Previously at GMO, he was a member of the Global Equity team focusing on the Quality Strategy. Prior to joining GMO in 2006, he managed the U.S. fixed income syndicate desk at Morgan Stanley. Mr. Mayer earned his B.A. in History from Princeton University.

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