GMO
FOCUSED EQUITY INSIGHTS

GMO QUALITY FOR THE LONG TERM AND TODAY

Tom Hancock | November 2023

There are many ways to define quality companies. GMO's focus in quality investing for 40+ years has been on companies that have a consistent and enduring ability to deliver high returns on their investments. This requires a business with continued growth and relevance, tight control to replicate assets, and strict capital discipline on management's part. These companies often identify themselves by delivering a track record of high profitability, stable profitability, and a strong balance sheet.

Why GMO Quality?

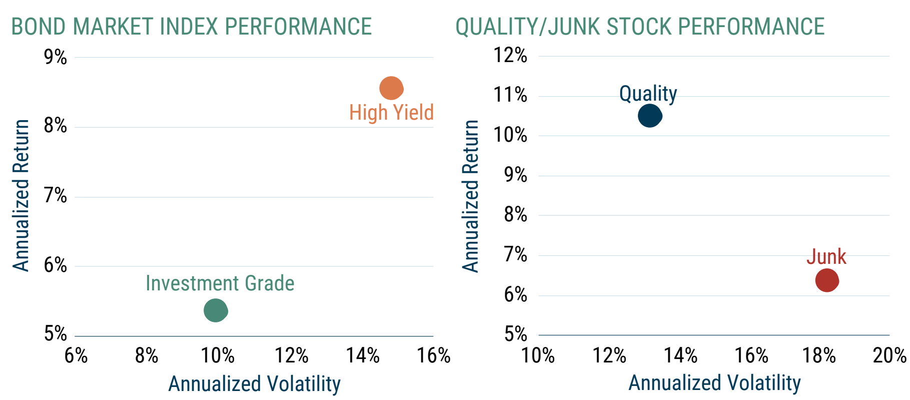
- Valuation matters. While we believe quality companies are worth a premium, an attention to valuation provides a margin of safety against the risk of overpaying for unrealistic or unsustainable growth expectations. And our valuation focus helps to ensure that we are buying stocks with muted – not over-hyped – market expectations.
- When it comes to growth, we look forward – not back. Our attention to valuation does not mean we can't participate in the upside – high ROI growth is worth a big premium! A quality valuation approach can find great opportunities – even during growth periods like the one we're in today.

Why invest now?

- Finance theory tells us that achieving higher returns requires taking more risk. But in equity markets, higher quality stocks have outperformed lower quality stocks by a considerable margin despite being much less risky (Exhibit 1).

EXHIBIT 1: THE BOND MARKET PRICES RISK RATIONALLY, BUT THE STOCK MARKET GETS IT BACKWARDS

Finance theory tell us that high risk stocks should win…but they don't



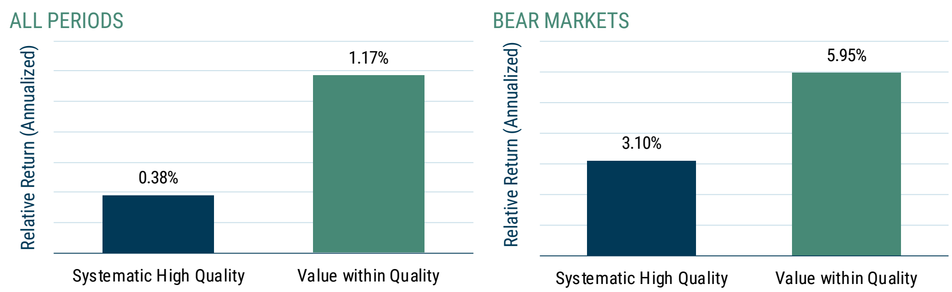
As of 12/31/2022 | Source: S&P, MSCI, GMO
Bond Indices are the S&P 500 High Yield Corporate Bond Index and the S&P 500 Investment Grade Corporate Bond Index. The S&P 500 Investment Grade and High Yield Index return data starts in 1995. The Quality and Junk portfolios are based off the MSCI ACWI Index returns that starts in 1988. GMO defines quality companies as those with high profitability, low profit volatility, and minimal use of leverage. Junk companies are the inverse. High and low risk groups are based off quartiles within the MSCI ACWI Index.

- The GMO U.S. Quality ETF (QLTY) presents investors with what we believe is an ideal core equity holding that seeks to both deliver strong returns and mitigate risk. Even so, in today's environment we believe there are a few notable reasons that make investing in quality particularly worthwhile:

- High rates are bad for asset prices, but in our view the impact of a changing discount rate on growth stocks seems overstated. We expect our results to primarily be driven by the ability of our quality companies to allocate capital successfully over time.
- Similarly, we note that quality stocks have tended to fare well compared to the broader markets in times of rising prices, and that paying attention to valuation alongside quality delivered even better results.
- During bear markets, cheap high-quality stocks have outperformed on a relative basis (Exhibit 2). That doesn't mean they don't go down, but rather that they go down much less than the market – the weakest businesses are revealed when times get tough.
- Quality-at-a-reasonable-price investing can benefit from innovation trends like AI and the GLP-1 class of drugs. Even if the most high-profile stocks have stretched valuations, there is often a broad ecosystem providing many investment opportunities and high-quality incumbents get their share (or more) of the profits.

■ Given quality tends to trail in up markets, it's easy to see why some may hesitate to allocate to quality when focused on relative performance. But as our research shows, quality keeps up well enough on the upside and more than compensates on the downside to compound over the cycle and outperform over time.

EXHIBIT 2: HIGH-QUALITY WINS OVER TIME WITH LOWER RISK



April 1928 – December 2022 | Source: GMO
Bear market is the drop in prices of at least 20% from any peak over a period of at least 3 months. GMO Quality is the highest quality 1/3 of the U.S. market. Value within Quality is the low valuation half of that, relative to the broader U.S. market.

An investor should consider the fund's investment objectives, risks, charges and expenses before investing. This and other important information can be found in the fund's prospectus. To obtain a prospectus please visit www.gmo.com. Read the prospectus carefully before investing.

Risks associated with investing in the Fund may include: (1) Market Risk - Equities: The market price of an equity may decline due to factors affecting the issuer or its industry or the economy and equity markets generally. Declines in stock market prices generally are likely to reduce the net asset value of the Fund's shares. (2) Management and Operational Risk: The risk that GMO's investment techniques will fail to produce desired results. (3) Focused Investment Risk: The Fund invests its assets in the securities of a limited number of issuers, and a decline in the market price of a particular security held by the Fund may affect the Fund's performance more than if the Fund invested in the securities of a larger number of issuers. For a more complete discussion of these risks and others, please consult the Fund's prospectus.

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Tom Hancock
Dr. Hancock is the head of the Focused Equity team, a portfolio manager for GMO's Quality Strategies and a partner of the firm. Previously at GMO, he was co-head of the Global Equity team. Prior to joining GMO in 1995, he was a research scientist at Siemens and a software engineer at IBM. Dr. Hancock holds BS and MS degrees from Rensselaer Polytechnic Institute and a PhD in Computer Science from Harvard University.

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