GMO

# YEAR-END LETTER FOR 2024

*Focused Equity Team: Quality Strategy*

Dear Client,

2024 was another vintage year for equity investors. Absolute returns were generally positive across global markets and the Quality Strategy returned +18.9% net of fees. This was slightly ahead of the MSCI World Index but trailed the S&P 500.

We manage your portfolio in a benchmark-agnostic manner. We believe that this is the right starting point because the ultimate drivers of return are the fundamentals – earnings growth and income – and not index weights. We estimate that the fundamental return to the portfolio was a little under 20% for the year – in other words, the portfolio passed its fundamentals through as valuations held, and by this yardstick, 2024 was pleasing.

And yet returns seemed dissatisfying, nevertheless. The S&P 500 outperformed both your portfolio (net) and the MSCI World Index by more than 6%.[1] This is a wide margin indeed when one considers that the constituents of the S&P500 comprised more than two thirds of the MSCI World Index. What was going on here?

## *Nvidia and AI*

The short answer is Nvidia. This single company at the heart of artificial intelligence accounted for more than 5% of the return to the S&P 500. The stock returned 171% for the year. Its fundamental return from earnings growth was higher still.

A stock generally outperforms because the market's aggregate assessment of the future for that company has improved more than other companies. Our sense was that Nvidia started the year with high expectations baked into the stock. We believe that on average, investing in areas of searing expectations is a difficult way to generate returns. Yes, these companies tend to grow faster than the market, but there is an asymmetry to outcomes because only perfect execution will support the stock price. But this year, for this company, those high expectations were trounced, and your portfolio would obviously have been better off with an allocation to Nvidia.

AI is causing a good deal of activity across the corporate world. The list of investee companies that are generating material AI revenues is now quite long – from long-term AI leaders Meta and Alphabet on the consumer side, through Microsoft's initial success with their Copilot products in the corporate world, via TSMC and the others involved in GPU manufacturing, to Oracle's world class cloud computing infrastructure and Accenture's multi-billion revenue stream from AI consulting. Likely every other company in the portfolio is assessing and deploying AI in some shape or form, whether to assist their programmers, enhance their client offerings, or write their client letters (not this one!).

The big uncertainty is which of these activities will generate high and sustainable associated ROIs. Our investing careers began in the 1990s and the Internet bubble of the late 1990s was a formative time for us. Then, like now, it was clear that the world was changing. In hindsight, many of the early investments proved to be disappointing or worse for their (initial) shareholders. The fiber optics build-out was too rapid to support the financing. Visionary business models proved ahead of their time. Even the long-term Internet winners had gut-wrenching rides as short-term exuberance morphed into longer-term realism; Tesla and Meta hadn't been born yet and Alphabet was still unlisted, but the oldest members of the Magnificent 7 suffered drawdowns of roughly 65-90% by the time the dust had settled. GMO's skepticism in the late 1990s allowed our predecessor strategies to largely avoid these pitfalls.

We believe that this time is different (choice of words intended). Yes, we have the excitement, but we also have a different cast at a different stage of development than we did the last time around. Our sense is that we are in the frothier part of the capital cycle in terms of AI, and one has to imagine that a fair amount of the speculative capital being attracted into AI over the last year or two will ultimately be lost. But the largest sums are being deployed by the participants with a) the greatest

[1] The data shown here is for the GMO Quality Strategy. The geographically focused U.S. Quality Strategy delivered roughly 2% better.

optionality in their businesses and b) the broadest shoulders to carry the load. Alphabet, Facebook, and Microsoft, for example, have been investing in AI and its predecessors for years now with the ability to curtail expenditure should revenues disappoint and, importantly, redeploy the acquired infrastructure – largely in fungible computing power – to other useful activities if necessary.

A potential danger for investors at this stage of the cycle is to confuse a cyclical surge in activity with a secular one as capital investments are made to reposition companies for AI. One company's capex is another company's revenues, and should the AI capex phase wane, their providers should be expected to feel the pain. This brings us exactly back to where we started, with Nvidia. Nvidia has built a fabulous franchise around doing a big thing brilliantly. It has limited competition in an area that is growing with ferocity. With a $3 trillion price tag, investors in Nvidia need these dynamics to continue for some time. We prefer to allocate your capital to other businesses that participate in the same transformation but with more diversified business models and less ambitious embedded expectations. We recognize that in go-go, risk-on years, this orientation may prove a drag on returns, but over the course of the cycle, we believe this approach is likely a safer and equally rewarding path to choose.

## *The Trump Trade*

Your portfolio generated its returns in the first three quarters of the year, remaining ahead of the U.S. market until the dying days of September. Absolute returns for the portfolio were negative in the final quarter, in contrast to the broader markets' gains. Although we didn't appreciate it immediately, the strategy's relative return began to move early in the third quarter with the betting odds on Trump's chances of winning the presidency. Much of the relative sector performance in Q4 could be interpreted as responses to the Trump policy platform (for example, with respect to the potential inflationary impact of tariffs, deportations, some aspects of deregulation etc.), alongside a preference for lower interest rates.

As bond yield rose, users of leverage (Real Estate and Utilities) and bond proxies (Consumer Staples and Health Care) were weak. Payers of rates (Financials that borrow short and lend long) and "friends of Donald" in Technology and Consumer Discretionary (e.g. Tesla/Musk) did well. The relatively defensive orientation of your portfolio was an uncomfortable place to be. Overweights in Consumer Staples and Health Care were a drag, and owning the less racy plays in Technology hurt too. Non-U.S. holdings generated lower returns as the initial implications of MAGA and the potential for tariff hardball was priced in and the dollar strengthened.

Disappointing as the quarter was, the silver lining is that we have seen this movie, or one quite like it, before. In the last quarter of 2016, when Trump was elected for the first time, we saw a similar pattern of beneficiaries in terms of sectors and so on, and we also saw our strategy's YTD gain against the broader markets evaporate over a short period. That time around, most of the relative market moves were reversed as markets saw that Trump's aspirations would be hard to implement in practice. By the end of Q1, the strategy was back on track. The Trump team appears to be somewhat more cohesive in 2025, but we suspect that the path ahead will have its twists and turns. We do not presume to make a specific short-term forecast, but believe that investing in well-managed, competitively advantaged businesses with an eye on valuation should generate attractive returns going forward.

## *Health Care*

Health Care combines the growth drivers from innovation and demographics, as well as the potential benefits of applying AI, but none of these helped the group in aggregate this year. In many areas, it feels like the U.S. health care system is fighting a rearguard action against the lifestyle perils that come with the wealth of modern society, but in the last few years we have seen remarkable successes in the Covid vaccine response and the development of GLP-1 drugs. Health Care is an attractive sector for us in terms of quality and valuation and is our second largest exposure behind Information Technology. However, 2024 presented a challenging environment. There were cyclical issues from the post-Covid adjustments, decreasing research budgets, and the economic slowdown in China. And there was political headline risk both before and after the election, notably around drug pricing by pharmaceutical companies, the role of Pharmacy Benefit Managers (PBMs), and the uncertainty associated with the incoming U.S. administration. Absent the notable exceptions of Intuitive Surgical, which was riding the enthusiasm of the launch of its DaVinci 5 robotic surgery system, and Eli Lilly with its GLP-1 drugs, our positions in this sector were largely a drag on absolute, not to mention relative, performance.

Particularly notable was the Managed Care industry that provides health insurance and other services supporting the U.S. health care system. This industry was cast tragically into the spotlight with the murder of UnitedHealth Group executive Brian Thompson. While we empathize with those wrestling with the strain of health issues, all health systems must make difficult trade-offs as funding is finite. This terrible event unleashed a torrent of often misplaced vitriol against U.S. health insurers; individuals interact directly with insurers, but often people do not realize that health insurers act under the instruction of the ultimate payer – typically private corporations or the government. Looking through all the complexity, their profit margins are not excessive and the utilization management programs they implement on behalf of their clients are an essential lever to manage the growth in U.S. health care spend. Many of the corporate players have incentives to maximize the amount of spend, no matter what the benefits. We see this negative sentiment as a buying opportunity – a repeated motif in the political cycle - and, we have added to our positions in UnitedHealth as well as our other holdings, Elevance and Cigna.

## *Portfolio/Outlook*

We initiated four new positions in the portfolio this year,[2] or more precisely, added three new ones and welcomed back an old friend, ASML. Netherlands-listed ASML sits on the highest tech edge of semiconductor manufacturing and consequently got caught in geopolitical crossfire aimed at China. The resulting sell-off created our third opportunity to invest in this critically important business in just five years.

The new names were:

- Hilton, the earnings-compounding, property-light hotel chain that proved the resilience of its business model during the pandemic;
- Thermo Fisher Scientific, a leading manufacturer of scientific instruments going through what we believe will prove a temporary lull after the Covid surge was compounded by a “venture capital winter” that constrained spending in the biotech world; and
- Dassault Systèmes, the French leader in industrial simulation software that has the potential to continue its history of growth once cyclical issues among its clientele ameliorate.

We believe that this group has the potential to generate strong fundamental returns from here, acquired at valuations that to us seem reasonable or better.

Portfolio exits comprised two successes and one dud. We downgraded our quality assessment of Alibaba earlier in the year and sold at a disappointing price. GE and American Express worked out better. GE has reinvented itself in recent years to focus on its high-quality jet engine business. Given GE’s substantial rerating, we found their joint venture partner, Safran, to be a more attractively priced alternative. We liquidated Amex after almost a decade of profitable investment, also on valuation grounds. Both companies remain on our watchlist.

Your portfolio still has a substantial allocation to growth stocks, but as markets continued to build steam, we have taken the opportunity to use this allocation as a funding source for investment in core holdings (emphasizing Consumer Staples) and value positions (especially in Health Care). Thinking about how to allocate to growth stocks has been an ongoing feature of the last few years. Companies with growth opportunities and a high return on capital should generate a strong return for investors if the valuation multiples are not too stretched. Where valuations run up, we try to sell – e.g., Adobe, which we liquidated with helpful timing in late 2023 – albeit with the humility to recognize that valuation can only ever be an imprecise tool.

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[2] The comments here on securities traded relate specifically to the GMO Quality Strategy. They may not directly apply to clients with geographically focused or otherwise constrained quality portfolios, but we hope that the examples are useful, nevertheless.

The flipside of thinking about growth is how to approach some of the core stocks that have comparatively anemic revenue growth prospects. How can these companies compete with the growth stocks? Capital discipline on the part of company management becomes key; if a company can deploy some capital at a high rate of return while maintaining discipline around surplus capital, the low revenue growth can be translated to a double-digit fundamental return with the help of dividends, share buybacks, judicious inorganic growth, and perhaps some margin improvement. However, in 2024, your growth stocks outperformed core and value stocks by some margin as valuations held firm.

Where do we go from here? We read the same newspapers as you do and, as usual, the future seems much more unpredictable than the past. Indeed, there is plenty to worry about from geopolitics, debt levels, fractious domestic politics, technological change, etc. We try not to spend too much time forecasting the specific shape of things to come. We prefer to lean against detailed shorter-term views that are priced in by the market with confidence. We suspect the consensus that emerged toward the end of last year around developments in U.S. politics is one of those cases. Whether we're right or wrong on that, we believe that your portfolio of well-managed, competitively advantaged businesses trading on valuations that make sense will likely generate compelling returns in the coming quarters and years. In addition, we note that the shares in quality businesses tend to hold up better than the broader market should times turn tougher.

We sincerely thank you for the continued trust you place in us as manager of your assets and wish you all the best for the year ahead.

Sincerely Yours,

Tom Hancock
*Head of Focused Equity*

Anthony Hene
*Portfolio Manager*

Ty Cobb
*Portfolio Manager*

| *Annualized Returns as of 12/31/2024 (Net, USD)* | *Inception* | *1-Year* | *3-Year* | *5-Year* | *10-Year* | *ITD* |
|---|---|---|---|---|---|---|
| **GMO Quality Composite** | 02/29/2004 | 18.86% | 9.24% | 14.22% | 13.90% | 10.26% |
| **S&P 500** | | 25.02% | 8.94% | 14.52% | 13.10% | 10.30% |
| **MSCI World** | | 18.67% | 6.34% | 11.16% | 9.95% | 8.18% |

***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.

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