GMO

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A QUALITY STRATEGY UPDATE

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During a quarter marked by historic volatility, the GMO Quality Strategy did its job of providing downside protection. In a period in which the S&P 500 Index lost 19.6% of its value and the MSCI World Index dropped 21.1%, the GMO Quality Strategy fell 16.4%. The peak-to-trough move within the quarter was rapid and severe with each index shedding 34% in just a few weeks.

As markets processed the implications of the first global pandemic in over a century, the sheer magnitude of overall change and daily market swings has been matched just once in the last several decades during the frenetic weeks of October 2008, as the global financial system teetered on the precipice. Finance is not and should not be the world's top priority today – managing the world's health is much more important. But for those of us in financial services, it remains necessary to focus on the long-term objectives and the opportunities offered up by the markets.

The Quality Strategy remains invested in high quality businesses. We seek out companies that have identifiable high-returning assets, long-term relevance, and capital discipline. We believe that these enterprises have safer fundamental characteristics than the average business and the Strategy was able to hold up better than the broader markets as a result. In addition, we aim to own companies that are attractively priced according to our discounted cash flow calculation. Our largest sector allocation remains to Technology, where the names we hold are bolstered by the nearly essential nature of their products in today's world. This is true whether we work in the office or at home. We also continue to emphasize the Health Care and Consumer Staples sectors that are naturally defensive. Additionally, the Strategy has had its share of beneficiaries from changes wrought by the virus. For example, Roche's diagnostic machines are the mainstay of virus testing and its shares delivered positive returns. Reckitt Benckiser outperformed based on rocketing sales of Dettol and Lysol disinfectant and Mucinex cold remedies. Companies like Johnson & Johnson, Eli Lilly, Abbott Laboratories, and 3M are prominent in the fight against the virus.

We eschew leverage. That is a risk that doesn't seem to matter until it does, which with the rapid declines in revenue experienced by many businesses, is suddenly today. We are wary of more cyclical industries with undifferentiated products or with a high fixed cost base that creates operational leverage. We do not hold any positions in the Energy sector. In our long/short strategies, we are short "junk" stocks with those characteristics. The newly launched net long Quality Spectrum Strategy shone in the quarter versus the market, while the dollar neutral and negative beta Tactical Opportunities Strategy delivered a positive absolute return.

We have been more active during the quarter than is our norm for this portfolio. Swift as it has been thus far, there has been a trajectory to the market reaction to the crisis. In January and early February, the prevailing market sentiment was that Covid-19 and the bulk of its economic fallout would remain confined to China, with disruptions to supply chains and impacts on companies with sales exposure to the region. At the time, we judged this reaction to be too optimistic as we thought that the virus could spread more widely, and that even if the virus recovery were to be quick, it was a leap to assume that the economic recovery would be equally quick. In that period, we rebalanced to more defensive names (Consumer Staples, Health Care). As fears grew about the severity of the pandemic and its economic impact, selling became more indiscriminate. Companies with solid balance sheets whose long-term growth prospects remain intact were being sold down at the same rate as more levered, highly cyclical names. The portfolio benefitted from our ability to be opportunistic as stock prices moved. The portfolio turned over more than double the amount of any recent quarter, and we entered six new positions (Quest Diagnostics, Starbucks, Nike, LVMH, ASML and Schwab) while exiting two others (Booking and Mastercard).

This activity, in addition to the advantages we have long emphasized including a better view on "quality" through fundamental analysis and gaining a margin of safety through considering valuations, distinguishes our portfolio from factor portfolios such as the smart beta quality ETFs. The sharp difference in performance during the event thus far underscores the advantages that nimble active management brings to Quality investing.

Taking a longer-term perspective, we note that valuations have likely moved into more attractive territory as the market has fallen. The average stock globally trades substantially below where it started the year, and almost certainly has a higher embedded return at this point. As awful as the pandemic is, it seems rather likely that this hiatus in economic activity will not be permanent. However, the timing of a return to something approximating normality is highly uncertain. We would argue that the Quality Strategy provides a responsible starting point for investors and institutions wishing to take advantage of the more attractive valuations on offer without losing too much sleep. If normality takes a while to reassert itself, we believe that this portfolio is likely to suffer less from permanent fundamental impairment than the broader markets, and therefore ought to be well positioned to participate when the market returns to a happier state of affairs.

Furthermore, we note that within markets there has now been significant return differentiation between sectors. The worst hit parts of the market have been those that are viewed as most cyclically exposed this time around: Energy, Materials, Financials, Industrials, and some parts of Consumer Discretionary. Stocks in Consumer Staples, Health Care and Technology – the areas favored by the Quality Strategy, have fared better than the market. This constellation of returns has suited the strategy but raises the question of how we are approaching portfolio management at this point.

Jeremy Grantham wrote more than a decade ago that it is important to learn from your mistakes, but that it is equally important not to learn too much from them. The Quality Strategy went into the global financial crisis of 2007/8 with a poise of maximum armor-cladding in the form of cash and defensive industry allocation. The Strategy shone brightly, in a relative sense at least, protecting clients from the worst of the bear market. Our regret was that we remained in defensive mode all the way through the bear market, and then some way beyond it, with disappointing participation in the rebound as a result. This cycle we held a much more constructive portfolio during the last few years, keeping up with or bettering the broader indices, while providing defensive returns during this savage bear market as well as what now feels like a much milder event in the fourth quarter of 2018. As we survey opportunities, we consider which companies may participate when the rebound inevitably comes. Equally (and here is where we don't want to learn too much from last time around) there is a danger in making the portfolio too aggressive should market weakness last for a protracted period. Our goal is to take the middle path, gradually increasing the emphasis on parts of the portfolio with greater return potential over time as valuations become more attractive, yet investing in great companies that can withstand a wide range of outcomes over a wide range of time horizons and still emerge as strong survivors.

It is also important to consider what changes may become permanent. Short-term winners during the lockdown (internet retail, food retail, wireless services), and also gold miners, generated positive returns in the quarter. We are skeptical that seeking to exploit these immediate winners is anything other than a quick turn – the cash flows in the next couple of quarters, even if unusually strong, are highly unlikely to represent more than a small percentage of the net present value of any business. Yet it would be foolhardy to state that the pandemic has changed nothing. Our crystal ball may be no better than yours, but it seems reasonable to think that the adoption of e-commerce, for example, is likely to be accelerated in areas where its penetration to date has been more limited, say, in groceries. This could be seen as a boon to those benefitting from digital advertising spending (Alphabet, Facebook) or those most adept at deploying that spending (Unilever, Nestle). It seems likely that online Health Care will also be better accepted after this forced experiment, perhaps enabling Health Care companies such as UnitedHealth to do more with less. IT advisors such as Accenture and Cognizant might benefit from these and other instances of technological transformation. Equally, the staggering scale of the Health Care challenges make somewhat more likely the chances of reform to U.S. Health Care delivery with unclear results for the Strategy's Health Care names (though we maintain that the portfolio's investments in Health

Care are more part of the solution than the problem). Depending on the trajectory over the coming months, the ramifications for government finances, economies, and particularly the U.S. presidential election will be revealed, albeit not in advance. As the market reacts so will we, continuing to allocate the portfolio to what we judge to be the most attractively priced high-quality businesses.

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