



# QUALITY IN AN AGE OF INNOVATION

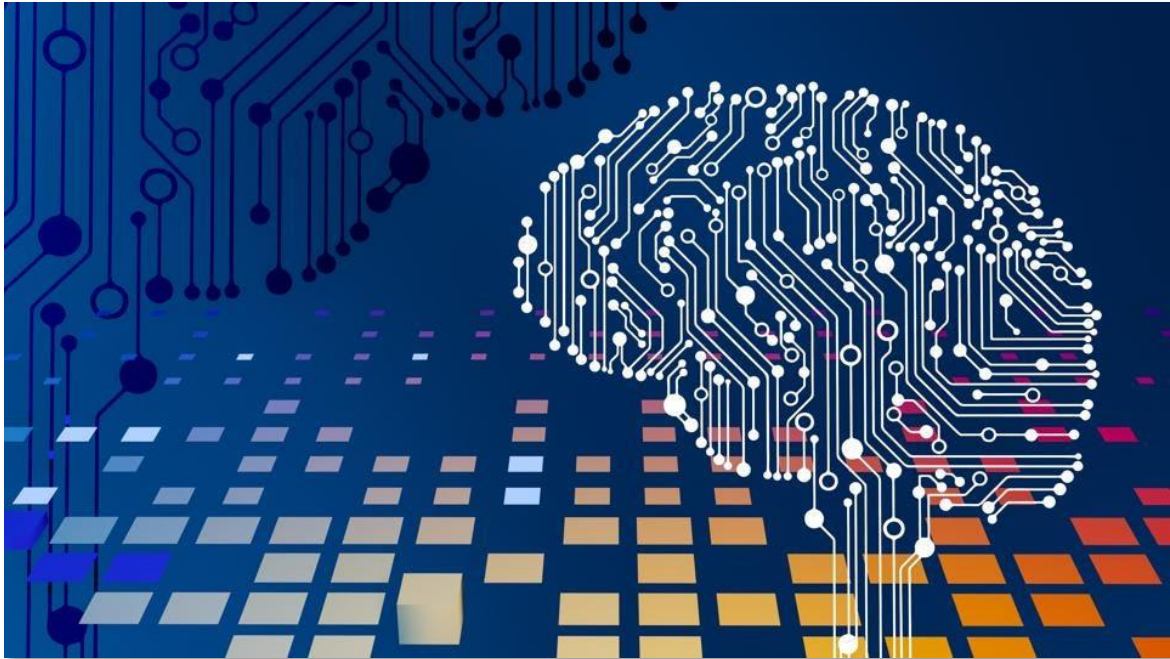
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*Anthony Hene*

**GMO**

# 2023 FEATURED TWO BIG TIPPING POINTS

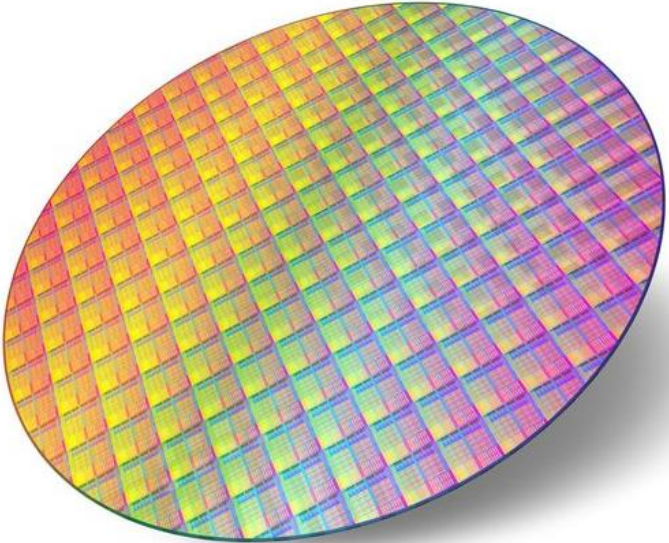
## Generative AI



## GLP-1 Drugs



# CONTINUATION OF THE 21ST CENTURY TREND



# COMPANIES HAVE BENEFITTED FROM THIS!

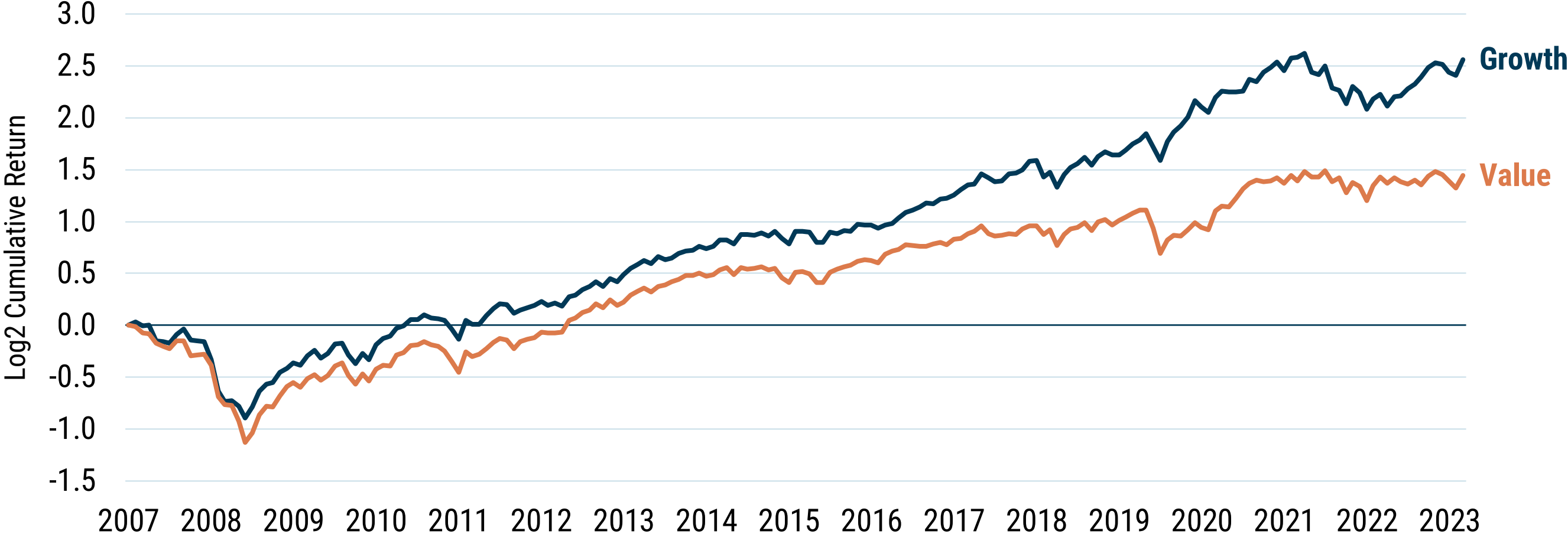
## Profit Margin of the S&P 500



As of 30/11/23 | Source: Compustat, MSCI, GMO  
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# AND IT'S BEEN A GREAT RUN FOR GROWTH INVESTING

5.1% annualised outperformance since the market peak in 2007



As of 30/11/23 | Source: Bloomberg, GMO

# HOW DOES A QUALITY INVESTOR DEAL WITH CHANGE?

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## The Perception:

- Slow to acknowledge change.
- Focus on stability and consistency biases investing toward lower growth.
- Our obsession with valuation doubles down on that bias.

## The Reality:

- Quality provides the right mindset to focus on future profitability.
- “Better late than never” works.
- The rich get richer: often better late than early.

# THE RIGHT MINDSET: WHAT IS A QUALITY BUSINESS?



## GENERATES HIGH AND SUSTAINABLE RETURN ON CAPITAL

### Identifiable High Returning Assets

Return on capital

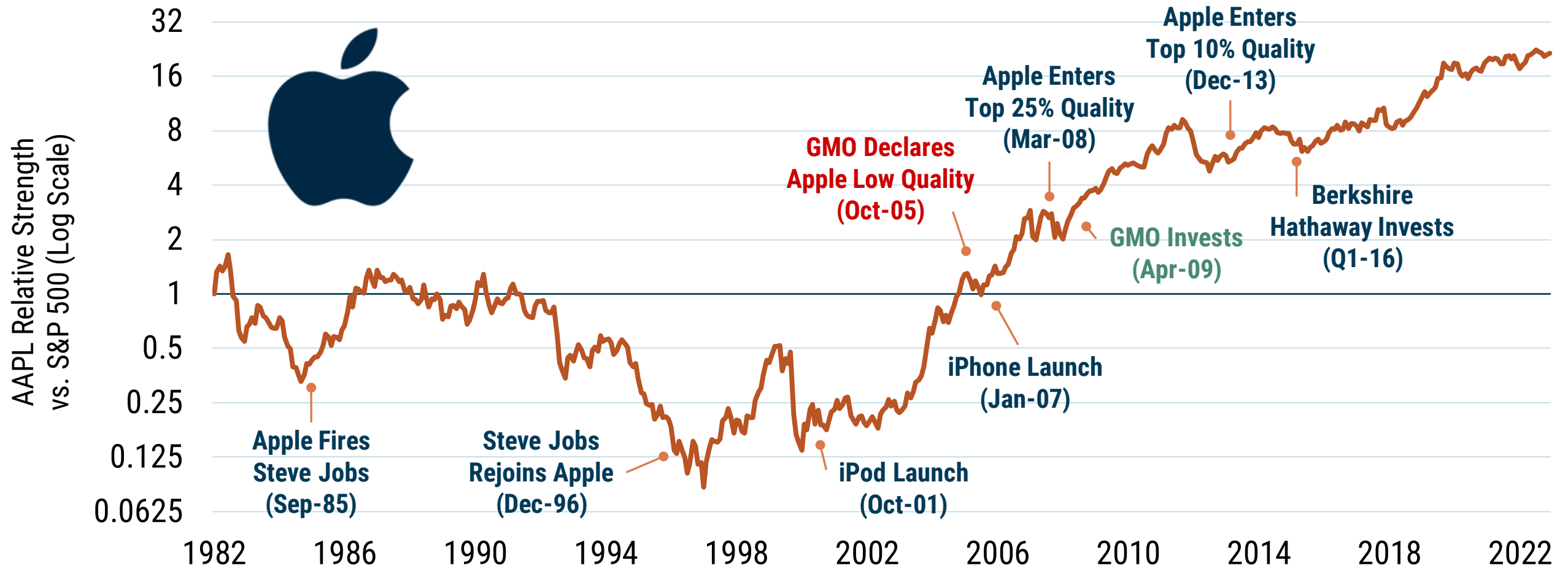
### Relevance

Long-term durability of business model

### Capital Discipline

Management invests prudently and with a long horizon

# BETTER LATE THAN NEVER – APPLE



As of 30/11/23 | Source: Bloomberg, GMO

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# BETTER LATE THAN NEVER

## Backward looking screens found the tech sector

### GMO U.S. QUALITY UNIVERSE BET ON TECH

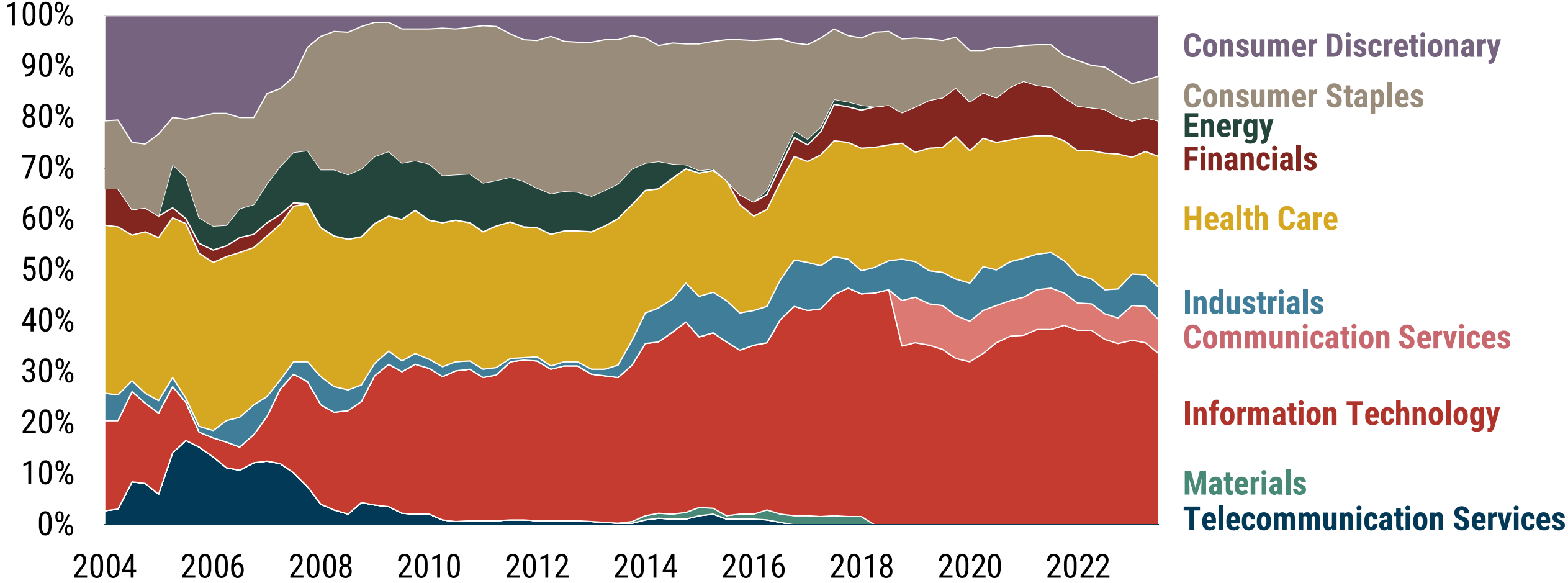


As of 30/11/23 | Source: Worldscope, Compustat, MSCI

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# EVOLUTION OF QUALITY PORTFOLIO POSITIONING

## Sector weights



As of 30/9/23 | Source: GMO  
 The above information is based on a representative account in the Strategy selected because it has the fewest restrictions and best represents the implementation of the Strategy.

# THE RICH GET RICHER – MICROSOFT

## What did Microsoft invent?

- Word processors and spreadsheets?
- Web browsers?
- Cloud computing?



Forethought, Inc.



LOTUS DEVELOPMENT CORPORATION



# CHAT GPT 3.5 HAS SPOKEN

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“What are the most important innovations of the 21st century?”

1. Smartphones
2. High-Speed Internet and Broadband
3. Social Media
4. Cloud Computing
5. Artificial Intelligence (AI) and Machine Learning
6. Electronic and Autonomous Vehicles
7. Renewable Energy
8. CRISPR-Cas9 and Gene Editing
9. Blockchain and Cryptocurrencies
10. Space Exploration
11. 3D Printing
12. Virtual Reality (VR) and Augmented Reality (AR)
13. Biotechnology and mRNA Vaccines
14. Clean Meat
15. Quantum Computing

# HOW DO WE INVEST AROUND THESE INNOVATIONS?

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## **BUY THE OBVIOUS NAMES AND COMPOUND AWAY!**

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- Smartphones
- Social Media
- Cloud Computing

## **LOOK FOR THE RIGHT BUSINESS MODEL AT THE RIGHT PRICE**

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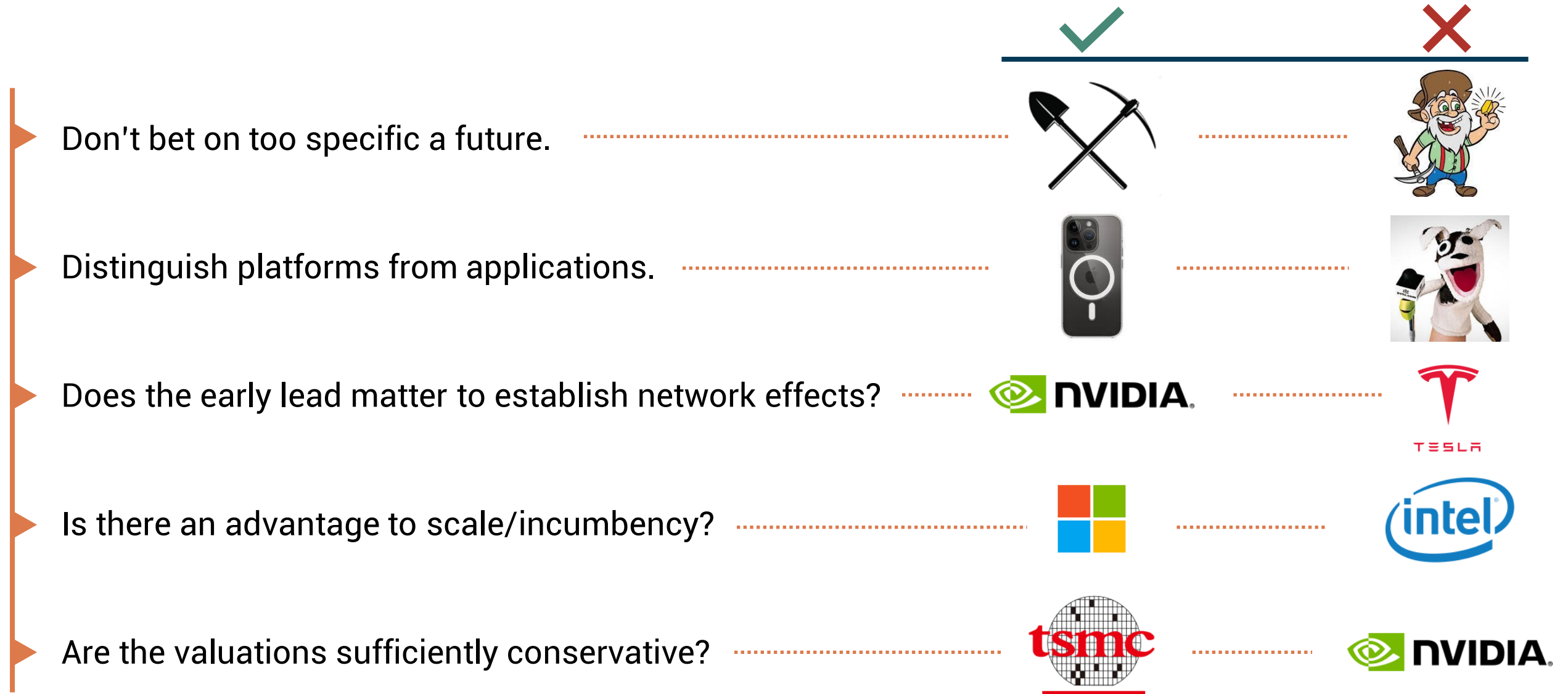
- High-Speed Internet and Broadband
- Artificial Intelligence (AI) and Machine Learning
- Electronic and Autonomous Vehicles
- Renewable Energy
- CRISPR-Cas9 and Gene Editing
- Biotechnology and mRNA Vaccines

## **NOT YET**

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- Blockchain and Cryptocurrencies
- Space Exploration
- 3D Printing
- Virtual Reality (VR) and Augmented Reality (AR)
- Clean Meat
- Quantum Computing

# FINDING THE RIGHT BUSINESS MODEL AT THE RIGHT PRICE



# THE PORTFOLIO AT TIPPING POINTS: NVIDIA'S BOMBSHELL

## NVIDIA's entourage boosted the portfolio

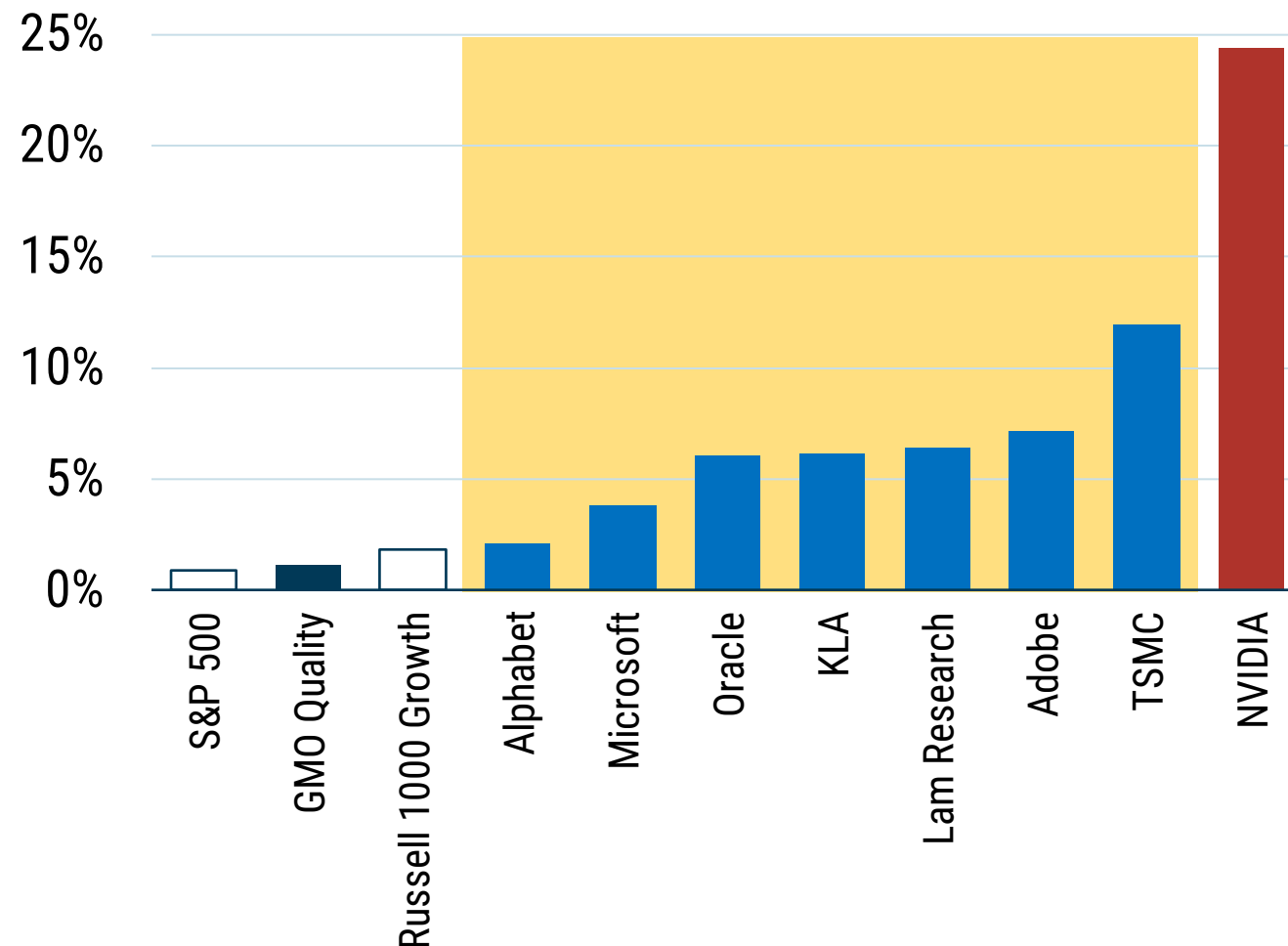
“ For FY2Q24, we model NVIDIA to report revenues of **\$7.01 billion**, up 8% q-q ”

– BMO, 21/5/23

“ Let me turn to the outlook for the second quarter of fiscal '24. Total revenue is expected to be **\$11 billion plus or minus 2%**. We expect this sequential growth to largely be driven by data center, reflecting a steep increase in demand related to generative AI and large language models. ”

– Colette Kress, NVIDIA CFO, 24/5/23

## GMO "AI" HOLDINGS 25/5/23



Source: Bloomberg, GMO

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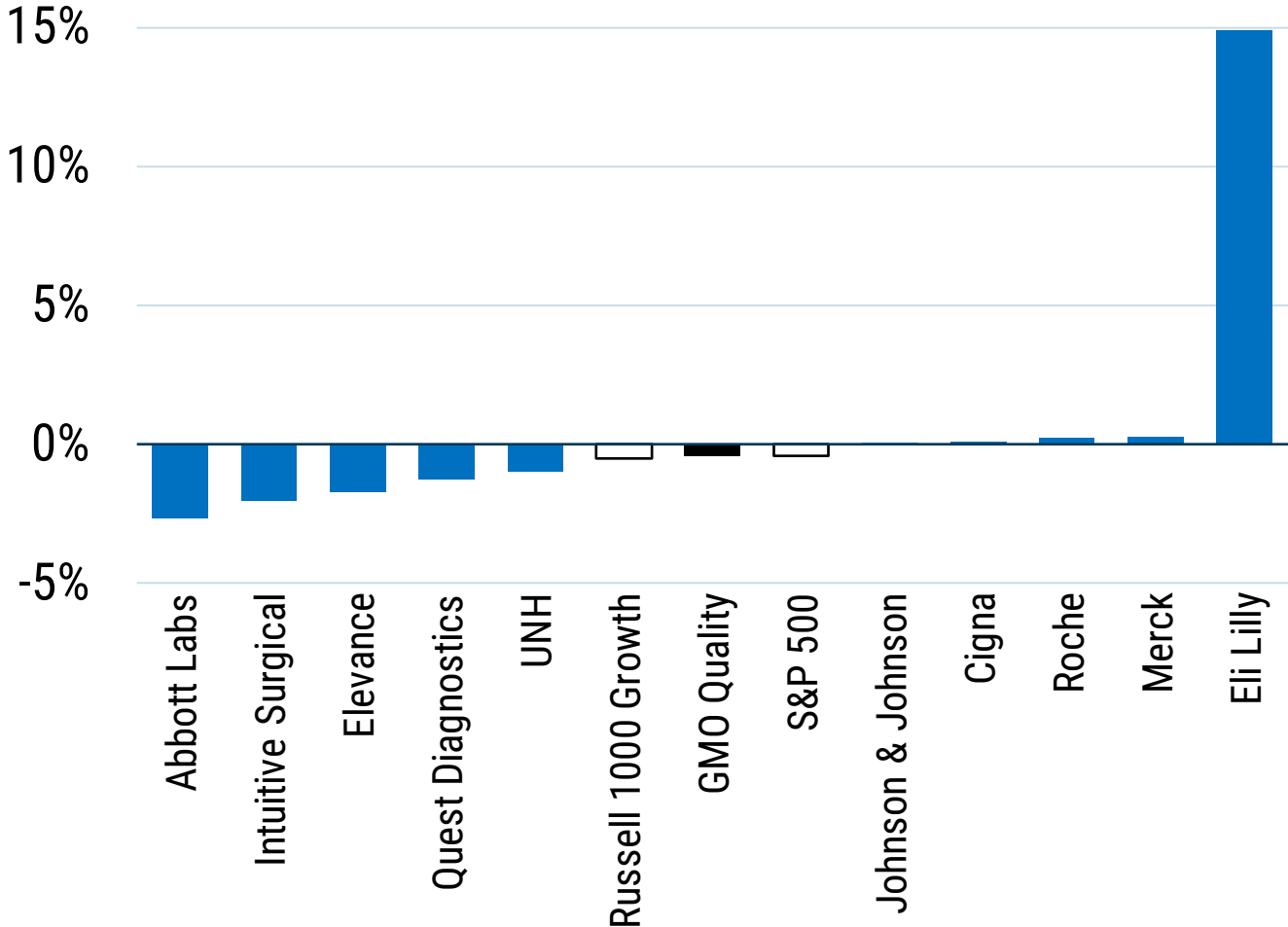
# THE PORTFOLIO AT TIPPING POINTS: NOVO NORDISK PUBLISHES “SELECT” TRIAL

## GMO benefited from direct GLP-1 exposure

“ Semaglutide 2.4mg reduces the risk of major adverse cardiovascular events by 20% in adults with overweight or obesity in the SELECT trial ”

– Novo Nordisk press release, 8/8/23

GMO HEALTHCARE HOLDINGS 8/8/23



Source: Bloomberg, GMO

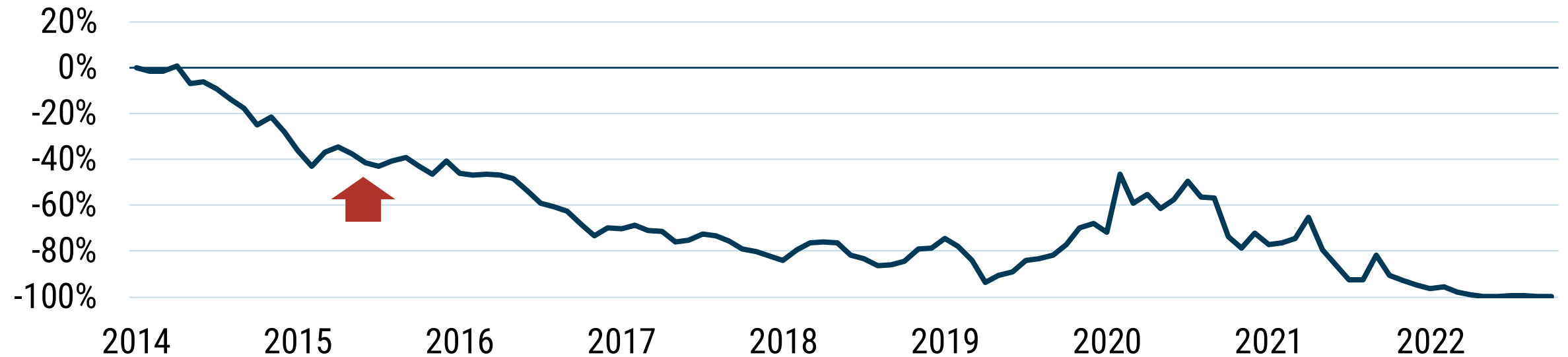
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# WIN BY NOT LOSING

Avoiding innovation's victims can be as important as finding the winners

BED BATH AND BEYOND (BBBY) CUMULATIVE RETURN



## GMO "Vet" Summary

Company has been a well-run business in unfortunately what is becoming a terrible industry due to massive growth and share penetration from e-commerce. Past success may not apply in the future.

Source: Bloomberg, GMO

# QUALITY INVESTING MAY NOT RELY ON DRAMATIC INNOVATION

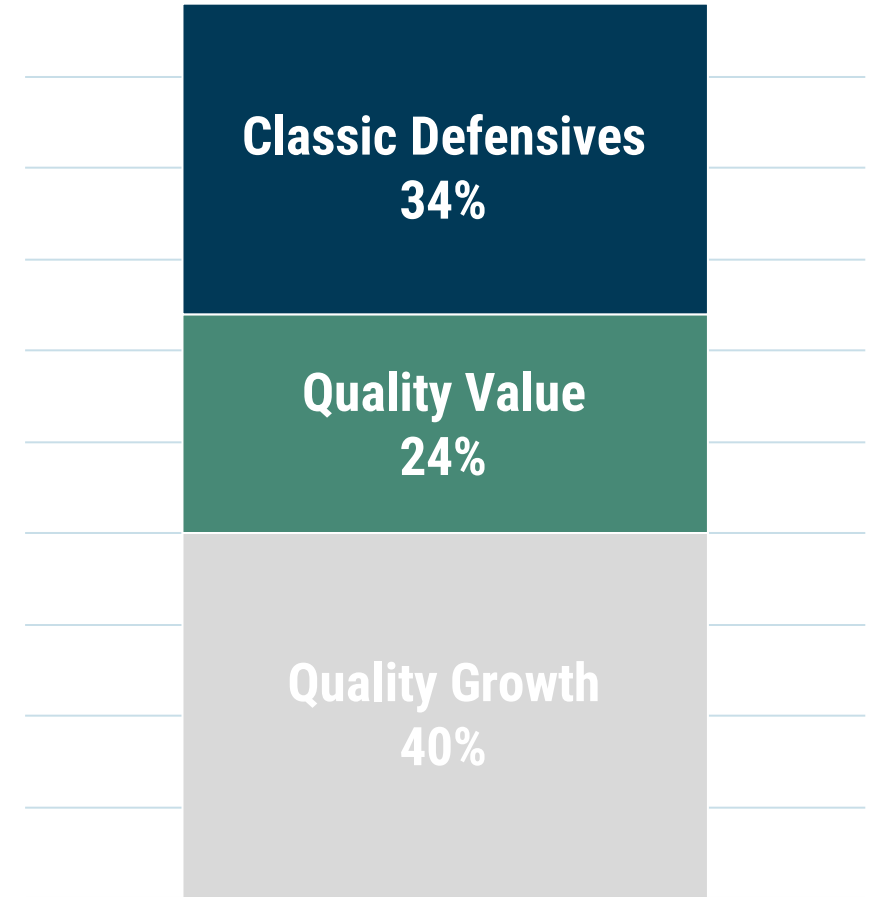
## Classic Defensives

- Innovation is incremental.
- Secular trends drive consumption.



## Quality Cyclicals

- Productive capital allocation across the cycle.
- Volatility provides trading opportunities.

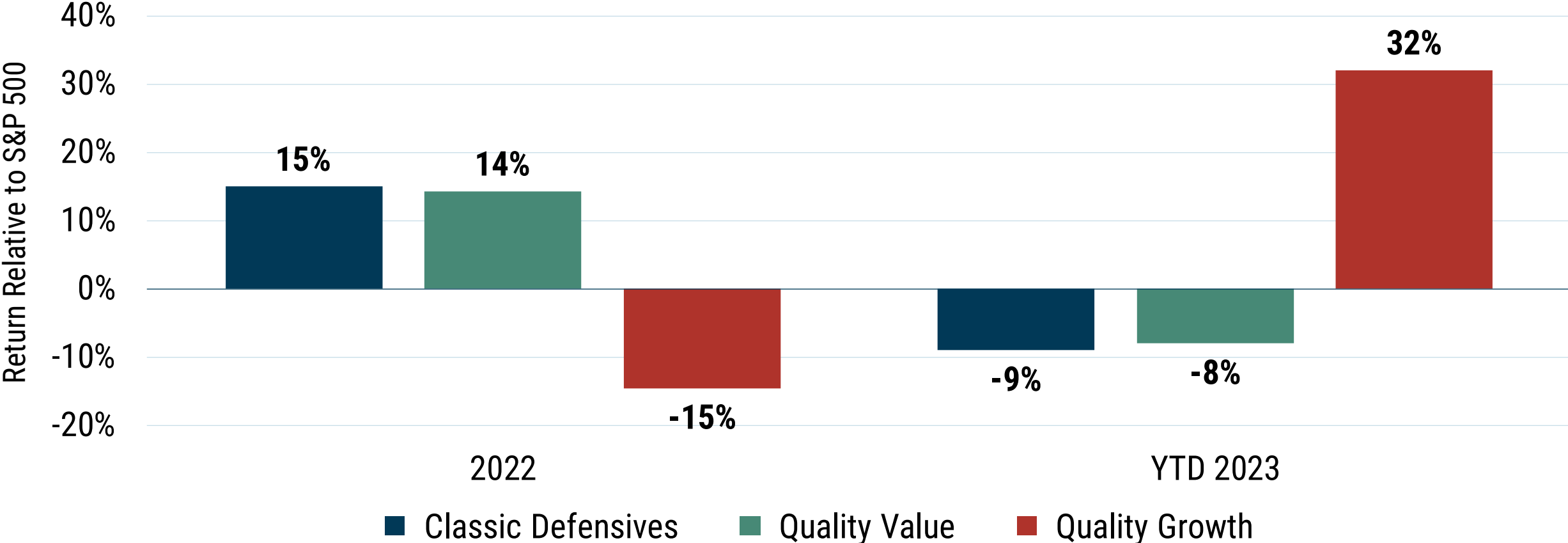


**Current (30/9/23)**

# DIVERSIFICATION AND REBALANCING HAVE PAID OFF

## GMO Quality was able to outperform in two very different environments

RELATIVE PERFORMANCE OF BUCKETS WITHIN GMO QUALITY

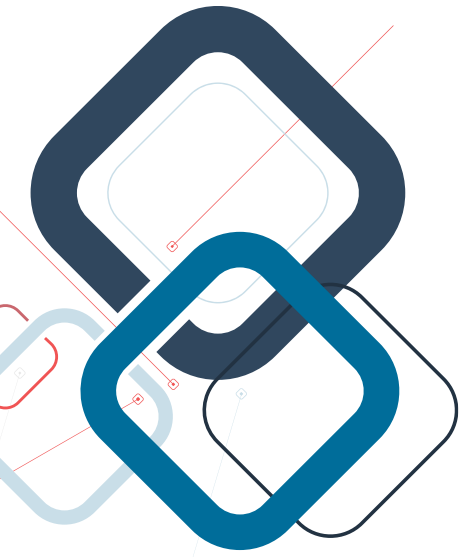


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# CONCLUSIONS

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- Quality doesn't have to be a bet against innovation.
- Investing in innovation doesn't have to be a bet against valuation (done right).
- Look backward and forward.
- Diversification and rebalancing are important (duh!).



# IMPORTANT INFORMATION

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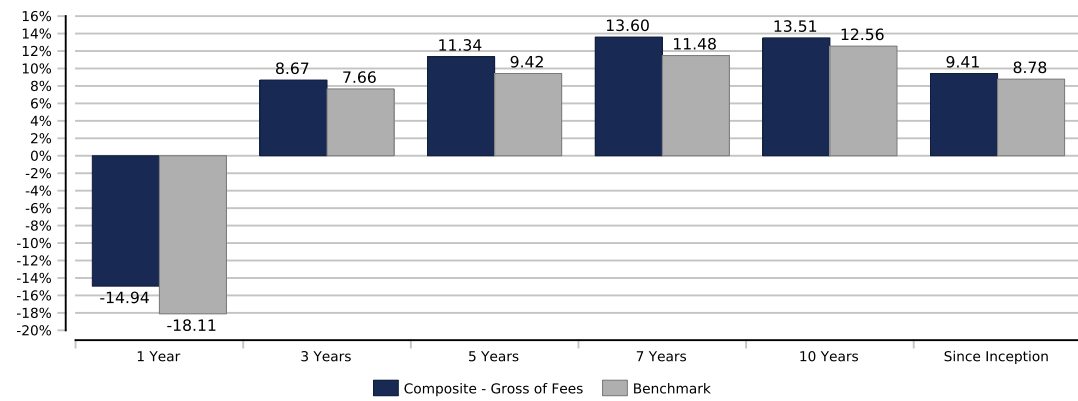
# QUALITY COMPOSITE

Reporting Date:	31 December 2022
Composite Inception Date:	29 February 2004
Reporting Currency:	USD
Benchmark:	S&P 500

## RETURNS SUMMARY

Period	Rates of Return (%)			3-Year Standard Deviation (%)		No. Of Portfolios	Dispersion	Composite AUM (million)	Firm AUM (million)
	Composite Gross of Fees	Composite Net of Fees	Benchmark	Composite	Benchmark				
2022	-14.94	-15.60	-18.11	18.92	20.87	11	0.33	11,826.08	56,057.29
2021	26.63	25.85	28.71	15.74	17.17	10	0.69	14,904.03	68,170.55
2020	19.15	18.52	18.40	16.72	18.53	8	0.48	11,318.47	62,777.74
2019	32.18	31.52	31.49	11.30	11.93	8	0.42	10,205.99	64,198.84
2018	0.87	0.37	-4.38	10.49	10.80	6	N/A	8,121.09	62,735.25
2017	29.54	28.89	21.83	9.61	9.92	<=5	N/A	9,998.68	70,352.83
2016	10.14	9.59	11.96	9.74	10.59	<=5	N/A	10,056.09	74,736.30
2015	1.94	1.40	1.38	10.01	10.47	<=5	N/A	9,714.05	98,669.31
2014	13.16	12.54	13.69	8.51	8.97	6	N/A	12,803.86	114,333.00
2013	26.06	25.47	32.39	9.46	11.94	<=5	N/A	14,583.19	114,783.17

## RETURN ANALYSIS BASED ON MOVING PERIODS\* (\*annualized returns above one year)



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GMO's policies for valuing investments, calculating performance, and preparing GIPS reports are available upon request. A complete list of composite and limited distribution pooled fund descriptions and list of broad distribution pooled funds is also available upon request.

As of 6/30/2023, the standard management fee schedule for the mutual fund in the composite is 33bps on all assets. The annual mutual fund expense ratio for share class I is 59bps. The fee schedule includes fees for shareholder services and operating expenses, in addition to the management fees. Other share classes may feature higher or lower fees. Please refer to fund documents for additional information. The standard fee schedule for the UCIT fund in the composite is 48bps for less than \$125M USD, 44bps between \$125-\$250M USD, 42bps between \$250-\$300M USD, and 39bps over \$300M USD. The annual expense ratio for the most expensive class (R) of the UCIT is 116bps. Some accounts in the composite may have fees that differ from the standard fee schedule and may or may not have performance fees. Please refer to fund documents for additional information. The standard fee schedule for the representative Australian Trust fund in the composite is 60bps on assets under 25M AUD, 55bps on assets between 25-100M AUD, 45bps on assets between 100-300M AUD, and 40bp thereafter. The standard SMA fee schedule for accounts in the composite is 50bps on the first \$50M USD, 45bps on the next \$50M, 40bps on the next \$300M, 35bps on the next \$100M, 30bps on the next \$250M, 25bps on the next \$250M, and 20bps thereafter. The standard performance-based SMA fee schedule for accounts in the composite is 30bps on the first \$50M USD, 25bps on the next \$50M, 20bps on the next \$300M, 15bps on the next \$100M, 10bps on the next \$250M, and 5bps thereafter in addition to a 10% performance fee. Or 20bps on the first \$50M, 15bps on the next \$50M, 10bps on the next \$300M, and 5bps thereafter in addition to a 15% performance fee.

The Quality Composite includes portfolios seeking to deliver total return by investing in the equity of companies that GMO believes to be of high quality. A high quality company is generally one that GMO believes has an established business that will deliver a high level of return on past investments and that will utilize cash flows in the future by making investments with potential for high levels of return on capital or by returning cash to shareholders through dividends, share buybacks, or other mechanisms. In selecting securities, GMO uses a combination of investment methods, typically considering both systematic factors and judgmental factors, and may also rely on valuation methodologies. The composite was created in March 2004.

The strategy is not limited in its use of derivatives; however the impact is typically immaterial. Both the use of derivatives and borrowing may cause a portfolio's gross investment exposure to be in excess of its net assets (i.e., leverage), which may subject a portfolio to a heightened risk of loss. During the period presented the strategy typically used none.

The internal dispersion of annual gross returns is measured by the equal-weighted standard deviation of account gross returns represented within the composite for the full year. For periods with five or fewer accounts included in the composite for the entire year, 'N/A' is noted as the dispersion is not considered meaningful. The three-year annualized standard deviation measures the variability of the gross composite and benchmark returns over the preceding 36-month period. For periods without 36 months of composite performance history, 'N/A' is provided for both the composite and its benchmark.

Performance results are presented both gross and net of investment advisory fees. The composite results are time-weighted rates of return net of commissions, transaction costs and withholding taxes on foreign income and capital gains. Returns for mutual funds included in the Composite include securities lending income, if applicable. Valuations and returns are calculated and expressed in U.S. dollars. All composite returns reflect the reinvestment of dividends and other earnings. Gross returns do not reflect the deduction of investment advisory fees or any other expenses that may be incurred in the management of this account. Effective January 1, 2014 net composite returns are calculated using a model advisory fee by applying the current highest fee to the composite's gross-of-fee returns on a monthly basis. Prior to January 1, 2014 net returns were calculated by applying the account's actual fee schedule in effect for the respective period on a monthly basis for each account in the composite. The model advisory fee is the higher of the maximum standard fee charged to separate accounts, without taking into account any applicable breakpoints, or the highest fee paid by any account in the composite. Actual fees paid may be higher or lower than model advisory fees.

Past performance is not an indicator of future results.

The S&P 500 Index is a capitalization-weighted index of 500 stocks. This unmanaged market index is provided to represent the investment environment existing during the time periods shown. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Dividend income is reinvested. The Index compared herein may be comprised of securities which differ from the securities in the accounts in the composite. The index does not reflect the deduction of advisory fees. It is not possible to invest directly in the index.

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