

# QUARTERLY INVESTMENT REVIEW

## Quality Strategy

### Preliminary\* Performance returns (USD)

ANNUALIZED RETURNS (QUARTER-END)	Quarter-End	YTD	1-Year	3-Year	5-Year	10-Year	Since Inception
Quality Strategy (net)	5.81	21.53	35.80	13.20	16.99	14.73	10.51
Quality Strategy (gross)	5.98	22.10	36.64	13.90	17.69	15.37	11.07
S&P 500	5.89	22.08	36.35	11.91	15.97	13.38	10.30
Value Add vs. S&P 500	-0.07	-0.55	-0.56	+1.29	+1.02	+1.36	+0.21
MSCI World	6.36	18.86	32.43	9.08	13.04	10.07	8.29
Value Add vs. MSCI World	-0.55	+2.67	+3.37	+4.12	+3.95	+4.66	+2.22

### MAJOR PERFORMANCE DRIVERS

For several quarters, investors have debated not whether there would be a recession, but how big it would be. The third quarter was punctuated with two broad sell-offs of a relatively minor nature and, in the case of the Japanese stock markets, a brief but significant one with the Topix down more than 20% peak to trough in local terms. Sell-offs notwithstanding, Q3 was the fourth consecutive positive quarter, with the MSCI World returning 6.4%. Markets do apparently "climb a wall of worry," to deploy an old market saw.

The Quality portfolio slightly underperformed the S&P 500 for the quarter, running its usual race, making up (relative) ground during the sell-offs while faring less well when Nvidia/the S&P 500/Growth stocks were buoyant. In other words, the Quality portfolio provided relative protection in the face of market volatility, as it has tended to do in the past.

However, continuity in market direction – up – masked a shift in terms of market drivers. For the first time in several quarters, Growth stocks underperformed. The NASDAQ's ascent slowed to a rate well below that of the broader markets. Sectors perceived as most likely to benefit from falling rates performed well with Utilities and Real Estate topping the table with honorable mentions for Financials and Industrials.

These dynamics were reflected in the subdivisions of your portfolio. Quality Growth stocks underperformed, with semiconductors being hit particularly hard. We took the opportunity to allocate on weakness to ASML, the global #1 in lithography, whose machines are critical for the manufacturing of the highest-powered semiconductors. Better returns came from the Quality Core and Quality Value parts of your portfolio.

Today we have around 40% of your portfolio invested in Quality Growth and the rest divided between Quality Core and Value. After years in which Growth stocks, especially in the U.S., have performed well, and especially after a quarter where they did not, is 40% too little or too much?

Composite Inception Date: 29-Feb-04

**Risks:** Risks associated with investing in the Strategy may include: (1) Market Risk - Equities: The market price of equities may decline due to factors affecting the issuer, its industries, 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, including annualized returns and annualized volatility. (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 offering documents. This is not a complete list of risks associated with investing in the Strategy. Please contact GMO for more information.

**\*Preliminary Performance:** Final performance numbers are generally available on GMO's website within fifteen business days after month end. Investors should not rely on preliminary numbers to make investment decisions.

**Performance Returns:** Performance for the year of inception is less than a full calendar year. Returns shown for periods greater than one year are on an annualized basis. To obtain performance information to the most recent month-end, visit [www.gmo.com](http://www.gmo.com). **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. Gross returns are presented gross of management fees and any incentive fees if applicable. These returns include transaction costs, commissions, withholding taxes on foreign income and capital gains and include the reinvestment of dividends and other income, as applicable. If management and incentive fees were deducted performance would be lower. For example, if, before fees, the strategy were to achieve a 10% annual rate of return above its hurdle rate each year for ten years, and an annual advisory fee of 1% and incentive fee of 20% of net returns above the hurdle rate were charged during that period, the resulting average annual net return (after the deduction of management and incentive fees) would be approximately 7.20%. **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.**

# QUARTERLY INVESTMENT REVIEW

## MAJOR PERFORMANCE DRIVERS CONT.

First, there is no official definition of "Quality Growth" and therefore no hard standard against which to judge the size of the allocation. In recent years we have classified and communicated our strategy via groupings that are intended to reflect the different types of Quality investments. The schema has changed over time to reflect the opportunities at hand (we called out a reopening bucket between 2020 and 2022 for example) and our classifications are ultimately judgmental. What we call Quality Growth may differ from what you call Quality Growth.

Currently, stocks expected by consensus to grow earnings by 10% p.a. or more make up 80% of the S&P 500 and 70% of MSCI EAFE by weight, neither fraction being unusual in the context of the last 20 years. Is that a good definition of a Growth stock? Probably not as the median S&P 500 growth expectation has hovered around 13.5% over the period. However, if we tighten the focus to companies expected to grow by 20% p.a. or more, we get about 20% of the S&P 500 and 15% of EAFE. These are heady growth rates and just 5.7% of the Quality portfolio sits here. So, when we talk about Quality Growth, we do so within our valuation-aware mindset and have less exposure than the market to the highest expectation areas.

Furthermore, the stocks that we classify as Quality Growth can and do change over time, reducing the comparability of the Growth allocation between periods. This quarter for example, we moved Oracle and SAP from the Quality Core group to Quality Growth. The former classification has become strained as these companies have harnessed, after several false starts, the cloud opportunity in earnest. Oracle's world class and flexible infrastructure solves security problems in the cloud while offering terrific speeds for the training of AI models. Strong results made it the largest contributor to relative returns this quarter. SAP has developed software that facilitates its clients' transition to the cloud, having re-engineered its code base for effective cloud deployment. Both companies' stocks began to walk and quack like Growth stocks as the market absorbed this change, so their reclassification was both appropriate and necessary.

Next, the portfolio's steady allocation to Quality Growth stocks has required a good deal of active portfolio management behind the scenes. To illustrate, at the end of 2016, the portfolio had a combined 18.5% in Microsoft, Alphabet, and Apple. Had we not traded the portfolio since then, that weight would today be 37.5%! Today we have around a 15% weight to these companies. Under a veneer of stability, we have lightened the allocation to big Growth, particularly when the market has offered us good incentives to do so.

Finally, it's the overall portfolio exposure that really matters. Today Quality investors face a dichotomy in valuation between defensive staples in Core Quality and the more dynamic companies in Quality Growth. Shares in the former appear to be priced in an undemanding fashion. Nestle and Diageo, for example, trade at their lowest relative multiples in a decade. Newer holding Haleon appears attractively priced and we have been buying from Pfizer as it works down its residual stake. The underlying fundamentals of these staples support a respectable return, with the potential for a boost from revaluation. Quality Growth companies, however, have the potential to generate higher levels of fundamental return over time (albeit with those higher fundamental returns required to support their higher multiples). If both groups were to stay at constant valuation over the next few years, the Quality Growth stocks ought to deliver stronger returns. Constant valuation, however, is not generally a good assumption and as Growth stocks have outperformed, we have gradually sold stock to the point that the aggregate portfolio's relative returns have been somewhat more correlated to Value indices than Growth indices this year. That said, we prefer to maintain a diversified portfolio with investments across the different categories of Quality businesses with an eye on valuation to keep the portfolio in shape.

Portfolio weights, as a percent of equity, for the positions mentioned were: ASML 1.1%, Oracle 3.6%, SAP 2.9%, Microsoft 6.1%, Alphabet 4.1%, Apple 5.2%, Nestle 1.5%, Diageo 1.1%, Haleon 1.5%

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## PRODUCT OVERVIEW

The GMO Quality Strategy seeks to generate total return by investing primarily in equities the Focused Equity team believes to be of high quality.

The team believes that companies with established track records of historical profitability and strong fundamentals – high quality companies – are able to outgrow the average company over time and are therefore worth a premium price. The Strategy's disciplined approach uses both quantitative and fundamental techniques to assess the relative quality and valuation of global companies and aims to exploit a long-term investment horizon while withstanding short-term volatility.

## IMPORTANT INFORMATION

**Comparator Index(es):** The S&P 500 Index is an independently maintained and widely published index comprised of U.S. large capitalization stocks. S&P does not guarantee the accuracy, adequacy, completeness or availability of any data or information and is not responsible for any errors or omissions from the use of such data or information. Reproduction of the data or information in any form is prohibited except with the prior written permission of S&P or its third party licensors. The MSCI World Index (MSCI Standard Index Series, net of withholding tax) is an independently maintained and widely published index comprised of global developed markets. MSCI data may not be reproduced or used for any other purpose. MSCI provides no warranties, has not prepared or approved this report, and has no liability hereunder.

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.

## ABOUT GMO

Founded in 1977, GMO is a global asset manager committed to delivering superior performance and advice to our clients. We are privately owned, which allows us to singularly focus on our sole business – achieving outstanding long-term client investment outcomes. Offering multi-asset, equity, fixed income, and alternative strategies, we invest with a long-term, valuation-based philosophical approach.

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