

# QUARTERLY INVESTMENT REVIEW

## U.S. Quality Strategy

### Performance returns (USD)

ANNUALIZED RETURNS (QUARTER-END)	Quarter-End	YTD	1-Year	3-Year	5-Year	10-Year	Since Inception
U.S. Quality Strategy (net)	5.54	22.95	38.84	-	-	-	26.03
U.S. Quality Strategy (gross)	5.64	23.29	39.36	-	-	-	26.50
S&P 500	5.89	22.08	36.35	-	-	-	24.70
Value Add	-0.34	+0.87	+2.49	-	-	-	+1.33

### 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 S&P 500 returning 5.9% and the MSCI World returning 6.4%. Markets do apparently “climb a wall of worry,” to deploy an old market saw.

The U.S. Quality portfolio had a positive return in the third quarter but lagged slightly behind its benchmark, the S&P 500. The portfolio ran its usual race, making (relative) ground during the sell-offs, while faring less well when Nvidia/the S&P 500/growth stocks were buoyant. In other words, the U.S. 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 and 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.

Today we have around 40% of the 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 when they did not, is 40% too little or too much?

Firstly, 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 the portfolio 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.

Composite Inception Date: 30-Jun-23

**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. **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.

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## MAJOR PERFORMANCE DRIVERS CONT.

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 growth stocks? 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 only about 5% of the U.S. 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 have moved Oracle from the Quality Core group to Quality Growth. The former classification has become strained as Oracle has harnessed the cloud opportunity in earnest, after several false starts. 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. If a particular stock has begun to walk and quack like a growth stock as the market absorbed this change, its reclassification is both appropriate and necessary.

Thirdly, 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 weight in Microsoft, Alphabet, and Apple of about 18%. Had we not traded the portfolio since then, that weight would today be over 37%. Today, the portfolio has 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 is 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. 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 business, and an eye on valuation to keep the portfolio in shape.

Portfolio weights, as a percent of equity, for the positions mentioned were: Nvidia (0.0%), Oracle (4.9%), Microsoft (6.6%), Alphabet (4.2%), Apple (5.4%).

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## PRODUCT OVERVIEW

The GMO U.S. Quality Strategy seeks to generate total return by investing primarily in U.S. 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 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.

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