YEAR-END LETTER FOR 2024

Focused Equity Team: Climate Change Strategy

Dear Client,

In 2024, the GMO Climate Change Strategy had its toughest year since inception. After holding up reasonably well through the first three quarters, the strategy dropped over 20% in the fourth quarter amid the election of Donald Trump and Republican sweep of Congress, ending the year down 25.5% net of fees. The performance reflected sentiment surrounding politics and interest rates more than the fundamentals of the companies in which we invest. For perspective, the WilderHill Clean Energy Index fell 31.7% for the year. Sentiment-driven drawdowns create opportunities, of course, and we see a major dislocation in clean energy as we start the new year.

Approach

Let's revisit how we choose investments for the strategy before delving more deeply into performance. We start by identifying companies involved in helping the world to mitigate or adapt to climate change and therefore exposed to long-term secular growth. However, a company may be an excellent mandate fit and still not be considered for the strategy, as we also evaluate its quality. We look to invest in businesses with competitive advantages that would be difficult to replicate. In addition, we pay close attention to price and focus on companies trading at attractive levels given their fundamentals. Hence, we're not just investing in climate-linked companies and hoping for the best. We're tracking down growing, relatively high-quality businesses trading at enticing valuations.

Performance and Market Review

This approach had been highly successful prior to the last couple years. From inception in 2017 through the end of 2022, the Climate Change Strategy delivered returns of over 11% per annum net of fees, substantially better than the broad market MSCI All Country World Index (ACWI), which returned 7.1% per annum over the same period. In the last couple of years, however, cyclical headwinds have led to a slowdown in clean energy growth and poor performance in the sector.

Electric vehicle (EV) growth slowed in 2024 with commonly cited reasons revolving around cost, range anxiety, and inadequate charging infrastructure. While we haven't invested directly in any EV manufacturers, we do invest in lithium companies, EV battery manufacturers, automotive suppliers, and semiconductor companies that sell to the EV companies. All these industries performed poorly last year. The challenges for EV adoption aren't new, of course, and progress will continue. The lifecycle cost for EVs is already superior due to lower fueling and maintenance costs, and the end game for auto manufacturers is still clearly centered on EVs. We do hear increasing talk of hybrids as a bridge from internal combustion engines. Hybrid growth would drive demand for batteries, battery materials, and semiconductors as well.

There was also disappointing growth in renewables last year. The headwinds revolved around cyclical factors, such as inventory gluts, high interest rates, and changing policy dynamics. The market has been pricing these companies as if cyclical trough conditions are the new normal and the incoming Trump administration will strike a stunning blow to clean energy. Cyclical conditions appear to be easing, however, and it's far from clear that the incoming administration will be bad news.[1] As with EVs, the long-term structural case for renewable energy remains intact.

We did see strong performance last year in some areas of the portfolio, notably in electric grid, building efficiency, copper, and water.

Framing Performance

Performance has been poor the last couple of years in an absolute sense and particularly poor relative to the AI-fueled, narrowly driven broad market. However, performance has been very strong relative to clean energy. Since the peak of clean

[1] For much more on the latter topic, see The Future of the Inflation Reduction Act: Rhetoric vs. Reality (December 2024).

energy in February 2021, our strategy has outperformed the WilderHill Clean Energy Index by over 300% (Exhibit 1). Hence, our weak performance in recent years has been more about allocating to a distressed cyclical sector than poor stock selection.

EXHIBIT 1: GMO CLIMATE CHANGE STRATEGY VS. WILDERHILL CLEAN ENERGY INDEX

As of 12/31/24 | Source: GMO

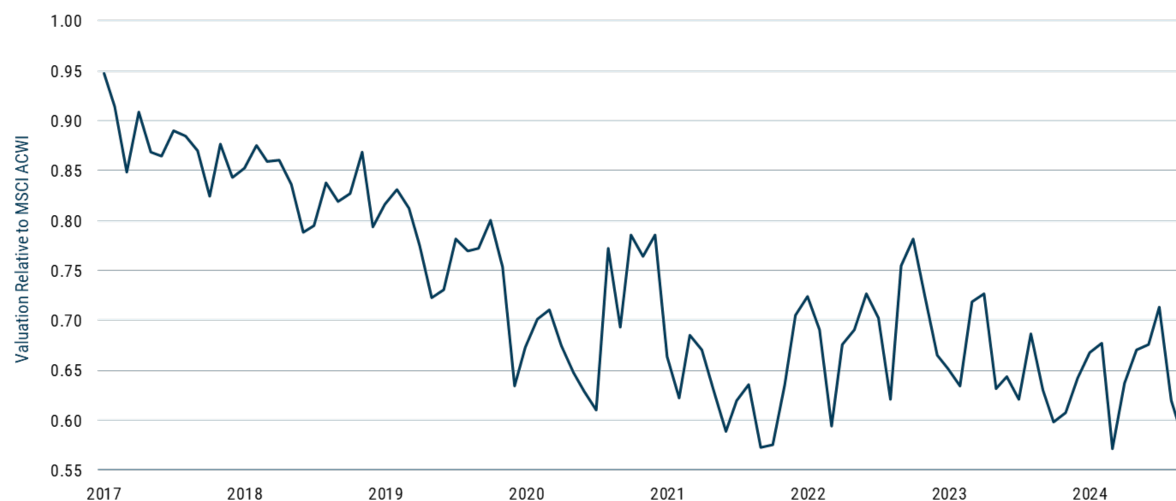
The above information is based on a representative account in the strategy selected because it has the fewest restrictions and best represents the implementation of the strategy.

Leaving the market out of it altogether and focusing on fundamentals also lends interesting perspective. Our portfolio grew earnings slightly faster than ACWI over the last two years: 3.7% vs. 3.4% per annum. While this represents a significant slowdown in growth for the portfolio, it hardly seems fair for the market to so severely punish a group of already deeply discounted stocks that grew a bit faster than the market.

Positioning & Outlook

While volatility has been high, we don't view the Climate Change Strategy as particularly risky. We invest in profitable, growing companies at attractive valuations, a strategy we expect to be quite stable for those investing for the long-term. Since inception, our portfolio has always traded at a discount to the market (Exhibit 2). At the end of last year, that discount sat at over 40%. Despite the discounted valuations, our portfolio has grown earnings faster than the broad equity market since inception with approximately 4.6% annualized earnings growth for our strategy vs. approximately 3.4% for ACWI.

EXHIBIT 2: VALUATION OF GMO CLIMATE CHANGE STRATEGY RELATIVE TO MSCI ACWI



As of 12/31/24 | Source: IBES, MSCI, GMO

Valuation metric is price/forward earnings.

The superior growth is expected to pick up substantially going forward. According to Bloomberg consensus estimates, our portfolio is expected to grow earnings approximately 5% faster per annum than the broad market over the next couple years. This strong expected earnings growth for stocks trading at depressed levels leads to the portfolio trading at around 13 times this year's estimated earnings and 11 times next year's.

A few factors drive the growth expectations. Costs continue to fall for clean energy, and interest rates are coming down. Global policy support continues to kick in, allowing companies to benefit from a variety of incentives, and concerns about energy security and fossil fuel dependence persist. In the U.S., rapid data center growth driven by climate-conscious tech companies is expected to create burgeoning clean energy demand. In addition, improvements in permitting and interconnection queues are expected to help. Obviously, there are no guarantees that growth will materialize as expected, but with sentiment in the basement, it's unlikely that much optimism has corrupted the projections.

The volatility last year provided us with opportunities to add to positions in high-quality clean energy companies at what we believe to be deeply discounted prices. Given that the pain in the sector has been widespread, we've generally reacted by investing in a basket of companies, rather than focusing on idiosyncratic opportunities. We've found particularly strong opportunities in solar, biofuels, and batteries & storage.

Risks

Clearly, there are risks to the industries we're investing in, highlighted by concerns about the impact of the upcoming Trump administration.[2] The main concerns revolve around potential Republican efforts to dismantle the Inflation Reduction Act and the impact that tariffs and immigration policies could have on inflation and, hence, interest rates. However, these risks appear to be more than priced in by the market. For example, we've stress tested the financial models for many of our largest positions for a full IRA repeal scenario and found that almost all our major positions have substantial upside even in a world without the IRA. We believe the market is currently pricing in low probability bear-case scenarios for many of our names, resulting in large potential upsides in much more likely base-case scenarios.

[2] Once again, see The Future of the Inflation Reduction Act: Rhetoric vs. Reality (December 2024) for more on this topic.

Business/Team Update

Despite the recent performance woes, net flows over the past two years have been flat. Many clients have added to their positions in recognition of the strong long-term opportunity and depressed valuations. As of the end of last year, assets in the strategy stood around $1.5 billion.

From a team perspective, we continued to add talent as Alec Newell joined the team as an analyst last summer. Alec was a standout co-op for us a few years ago and has rejoined the team after starting his career with stops at Goldman Sachs, Morgan Stanley, and a private equity firm. We're excited to have him back on board.

Final Thoughts

Though we hit an inevitable rough patch in a historically cyclical sector, the long-term prospects for our strategy continue to be bright. The market shouldn't price rapidly growing companies at a discount, yet that's exactly what's happening. We're unaware of a historical precedent where growing companies have experienced this much turmoil and traded at such deeply discounted valuations. Now is the time to take advantage of this unique opportunity, not run from pain that has already been inflicted.

We truly value the confidence you've placed in us to navigate these choppy waters and the patience that you've shown. It is our hope and belief that you will be rewarded handsomely for both.

Sincerely,

Lucas White
Lead Portfolio Manager, Climate Change Strategy

Annualized Returns as of 12/31/2024 (Net, USD)	*Inception*	*1-Year*	*3-Year*	*5-Year*	*10-Year*	*ITD*
Climate Change Composite	04/30/2017	-25.50%	-14.63%	-0.22%	N/A	3.26%
MSCI ACWI		17.49%	5.43%	10.06%	N/A	10.26%

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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