GMO
YEAR-END LETTER FOR 2023
Event-Driven Strategy

Dear Investor,

GMO's Event-Driven Strategy posted a +7.3% return, net of fees, in 2023. It was a wild, albeit profitable, year for our Strategy and the best place to begin our recap is with the headline of a Bloomberg article dated June 6, 2023: "Lina Khan Is Upending One of Wall Street's Favorite Trades." The article, written in the wake of the Federal Trade Commission's ("FTC") surprise decision to challenge Amgen's acquisition of Horizon Therapeutics, accurately paints the gloomy picture facing merger arbitrage investors in the middle of the year. Aggressive regulators like FTC Chairwoman Khan in the United States were leading a new enforcement paradigm, racing to block deals that would have been settled under prior administrations. Geopolitical tensions between the United States and China seemingly increased the chances that Chinese regulatory approvals of transactions involving U.S. companies would be withheld for political reasons. And a combination of increased regulatory scrutiny and the high-profile failures in the banking sector had just led to the cancellation of TD Bank's purchase of First Horizon. It was a challenging time to be a merger arbitrage investor, with even the most seasoned among us pondering a career with comparative docility. Skydiving? Crypto trading? Almost anything seemed preferable to what had become the drudgery of merger arbitrage.

The existence of this temptation created a fascinating backdrop. As value-focused merger arbitrage investors we appreciate that the notion of value in our asset class can be an unusual concept to explain. In merger arbitrage, value isn't about price/earnings ratios or discounted cash flow models. Yet our value-based approach is actually quite straightforward. Two of the critical inputs required to tell if a merger is a good investment or not are largely provided to you by the market. The first is the return in a deal close. Deals trade at a spread that compensates you for the time value of money and the risk that the transaction will fail to complete. This spread is a merger arbitrage investor's potential profit if the transaction completes successfully. Conversely, by examining where a given spread traded before the transaction announcement and adjusting for changes post-announcement, merger arbitrage investors can make a high-quality estimate of the potential loss if a deal breaks. As a result, the question of whether any particular merger arbitrage transaction is an attractive investment revolves around the probability of each potential outcome. As we noted in our inaugural investor letter back in 2018, probability is the active investor's pricing mechanism.

Value Investing in Merger Arbitrage

Merger arbitrage is an asset class uniquely suited for a probabilistic approach because in any given year there are dozens of merger transactions to evaluate. As a result, we are able to look back over time and see how accurate our probabilities have been over a large sample size. Our own historical accuracy has been very good. In practice, that has meant that deals we estimate as having, for example, a 90% probability of closing, do indeed close nine times out of ten. This accuracy allows us to rely on our probability estimates to find value opportunities in merger arbitrage – those deals where we have a different view from the market's regarding the likelihood of deal closure.

Following a probabilistic approach to merger arbitrage investing is straightforward but not easy. Particularly in dynamic environments like we saw in 2023, it can be very tempting to fall into the age-old investment trap of thinking "this time it's different." This line of thinking is a trap not because the world isn't ever different, but because sometimes it is and sometimes it is not. An investor, therefore, must balance long-held truths with an acknowledgement that past assumptions often need to be challenged. The trick for an analyst, therefore, is to move from binary statements to probabilistic ones. This time may indeed be different, but HOW different?

This was the core challenge faced by merger arbitrage investors in early-June when the Bloomberg article was written. The changes – U.S. antitrust enforcement, trouble in the U.S.-China relationship, volatility in the banking sector – were undeniable. The questions of where and by how much they would impact merger arbitrage investors were far less clear. Our approach to investing your capital in such environments rests on two fundamental components: analysis and temperament.

Analytically, we endeavor to avoid broad judgments about the environment and focus on the specifics of each transaction. Our probabilities aren't determined by a singular model that treats all transactions similarly but, rather, by understanding the nuances specific to each deal. Are there genuine antitrust issues? If so, are they solvable and how? How committed is the buyer to the transaction? Would they be willing to go to court? How would we feel about owning the target company as a standalone business if the deal were to break? Asking and answering these questions allows us to build a mosaic of information for each deal that informs our probability estimate. The adaptability of this mosaic is particularly important in a volatile backdrop like 2023, where we could pay increased attention to, for example, a given buyer's willingness to face off with an aggressive antitrust regulator in court. By starting with a sound analytical framework and leaving room for adjustment, we give ourselves a tool that is both time-tested and flexible, firm but not fragile.

We pair our analytical assessments with a long-term temperament. One of the most challenging parts of following a probabilistic approach to merger arbitrage investing is the knowledge that, in expectation, some deals will break, and yet in the aftermath of a given broken deal it is very tempting to want to throw the whole framework out the window and run for the hills. Our long-term temperament has been critical to our long-term success. We have lived through countless failed transactions and have ample experience viewing the outcome of a particular transaction with an emphasis on analysis rather than emotion. The emotion part of a broken deal is straightforward – they aren't much fun! The test for a merger arbitrage investor is to separate the emotion from the analysis. We look for lessons in any particular broken deal that might apply to future transactions, but we also try not to over-learn from the facts of a given situation that may have gone wrong for reasons that don't have much applicability to future transactions.

Balancing our flexible, time-tested analytical framework with a long-term temperament has allowed us to deliver strong short and long-term results, with the relative lack of correlation and volatility that makes the merger arbitrage asset class so unique and useful for investors. Consistency of approach and results is a hallmark of our Strategy – the names and facts will change each year, but even amid volatile backdrops like 2023, we press on and maintain faith in our approach. With that, let's dive deeper into some of the individual names that were particularly impactful for 2023 returns.

U.S. REGULATORY CHALLENGES AND OPPORTUNITIES

The headline story for merger arbitrage investing in 2023 was the continued aggression of global antitrust regulators. As detailed above, this presented ample analytical challenges and a higher-than-average number of failures. Increased hostility toward mergers paired with banking sector volatility contributed to our biggest losing position during this year, First Horizon. First Horizon's acquisition by TD Bank was derailed by regulatory objections in the U.S. and TD Bank's decision to abandon the deal rather than go through the long process of overcoming regulatory objections. While we were generally bullish on the regulatory facts in First Horizon as well as TD's commitment to the transaction, ultimately this was a case where the world changed, and this transaction bore the brunt. This was not a particularly large position for us given our concerns about valuations in the banking sector, but the magnitude of the break was large enough (First Horizon fell nearly 60% peak-to-trough) that the impact on the portfolio was significant.

It would have been tempting in the wake of the First Horizon break to declare U.S. regulatory risk a new paradigm and throw in the proverbial towel. But our analytical approach, paired with a general view that terrible sentiment in our space was more than accounted for in spread pricing, gave us the confidence to continue to engage in situations involving antitrust risk. It proved a profitable decision. Several of our best-performing positions during the year – Activision, Seagen, VMware, and Black Knight – were transactions where U.S. regulatory reviews were a key risk. In each case, our willingness to own was based on a belief that, while some transactions might indeed be challenged and fail to consummate, as a group they represented compelling value to bear this risk.

Activision was perhaps the mascot for arb sentiment during the year. Regulatory obstacles in the U.S. and UK early in the year caused many merger arbitrage investors to declare this deal nearly dead. We agreed that sentiment was poor, but two major factors kept us involved. First, Activision's fundamentals were robust, and we viewed the stock as having minimal downside if the deal broke. Second, despite what appeared to be insurmountable regulatory objections, the buyer, Microsoft seemed committed to the fight. This buyer commitment proved to be a critical factor as, over the course of the year, Microsoft defeated the U.S. Federal Trade Commission in court and then reached a settlement with UK regulators to allow the transaction to close. For investors like us who were willing to bear the short-term pain, Activision proved to be

an especially profitable position. At year end it represented one of our top performing names not only in 2023 but in our Strategy's history.

Black Knight and VMware were both transactions viewed early in the year as likely targets of U.S. antitrust lawsuits, resulting in very wide spreads early in the year. In each case, we thought antitrust issues were resolvable and that buyer commitment was high. In each case, we were proven right after a long and volatile ride. U.S. regulators did indeed sue to block Black Knight's acquisition by Intercontinental Exchange, but an increased divestiture package was enough to get regulators to drop their suit in a settlement before trial. VMware's acquisition by Broadcom was marked by the fear that the involvement of Broadcom CEO Hock Tan, who in the past had drawn the ire of U.S. regulators, would lead to a lawsuit. However, to the surprise of those who had predicted doom earlier in the year, the transaction worked its way through contentious U.S. and European regulatory reviews by late summer, avoiding a lawsuit entirely. Hock Tan then played a key role in helping the company secure Chinese antitrust approval this Fall, allowing the transaction to close in late-November.

Finally, our position in Seagen, the Strategy's third-best performing name during 2023, reflects both our analytical rigor and attention paid to market sentiment. When Seagen's acquisition by Pfizer was announced in early-March, we initially pegged the transaction as potentially problematic given U.S. regulators' increased focus on the pharmaceutical sector. We therefore viewed the spread as too tight to compensate for a potentially rocky ride and initiated a short position. When the FTC sued the Horizon-Amgen transaction, Seagen stock fell in sympathy, allowing us to profitably cover our short. As the year evolved and the FTC settled the Horizon-Amgen suit without a trial, we recognized that the environment had improved for Seagen and yet the spread remained wide. We initiated a long position that paid off when the transaction received FTC approval and closed in December.

The China Challenge

Balancing analysis and temperament was similarly challenging in transactions in sensitive sectors requiring Chinese antitrust approval. Dating back to their decision to withhold antitrust approval of NXP Semiconductors' acquisition by Qualcomm in 2018, Chinese regulators have proven willing to use antitrust approvals as a retaliatory weapon in their ongoing tense relationship with the United States. As we mentioned above, we saw considerable spread volatility in the VMware-Broadcom spread late in the year as reports emerged that Chinese approval may be withheld. While that transaction received approval and closed, it was a good window into the analytical and behavioral challenges associated with owning merger arbitrage positions where Chinese regulatory approval is a key risk.

We saw both sides of this proverbial coin during the year with our positions in Tower Semiconductor and Silicon Motion. While neither deal presented traditional antitrust concerns in China, semiconductors' importance in the ongoing U.S.-China tensions made these spreads ripe for volatility. In both cases we focused on understanding the downside and did considerable work examining the history of Chinese antitrust approvals in recent years. Our general finding was that while both transactions posed risks, the spreads were very wide, and it seemed unlikely that both deals would break. This analysis turned out to be correct, albeit with considerable volatility along the way. China indeed withheld approval of Intel's acquisition of Tower Semiconductor, despite considerable effort by Intel executives to get the deal over the finish line. Tower represented our second-largest losing position during the year. The case of Silicon Motion was far more interesting and, fortunately, far more profitable. Silicon Motion's acquirer, MaxLinear, had successfully navigated the Chinese regulatory process in past deals, giving reason for optimism about their odds this time around. However, MaxLinear's poor stock price reaction to the deal, worsened by a down cycle in the semiconductor industry, caused some to question the transaction's strategic rationale. While we shared many of the concerns, we reasoned that there was a price for everything, and coming into the summer Silicon Motion stock traded at a massive discount to the deal terms, suggesting near-zero odds of approval. As a result, we were delighted to be holding a position in Silicon Motion on July 26th when China approved the transaction. The stock soared more than 70% and we spent the day unwinding our position at a considerable profit, joking that we were selling our position to investors who wouldn't have dreamed of owning it just 24 hours ago. Our humor proved prescient later that day when MaxLinear announced that it was terminating the transaction, leading Silicon Motion to give up a large portion of its gains. Having locked in our profits by selling earlier in the day, we were in the fortuitous position of surveying the wreckage from the sidelines in the following weeks, as Silicon Motion and MaxLinear swapped lawsuits. Our due diligence on Silicon Motion and the prospect of a future significant settlement gave us the confidence to re-enter Silicon Motion stock in the weeks following the unexpected broken deal and we still held a small position at year end.

The juxtaposition of Tower Semiconductor and Silicon Motion provides an interesting window into our investing style. In each case we followed a value approach rooted in deep research, understanding that wide spreads don't always work out favorably, but can have a large positive impact when they do. Each transaction also required a level-headed temperament, in particular in the case of Silicon Motion where our quick action to move on after the bulk of our expected profit had been made left us in a favorable position when the facts changed. It is rare to go one for two in merger arbitrage and make a profit, but at year end Silicon Motion was our best-performing name during the year (and as mentioned the second-best in our Strategy's history) and we earned twice as much on Silicon Motion as we lost on Tower Semiconductor. As we noted to our internal investors on the day of the Silicon Motion approval: value investing lives!

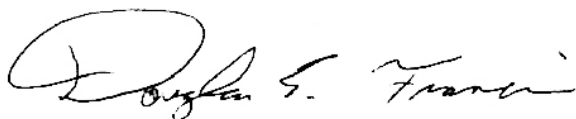## Conclusion: Looking Backward and Forward

Our +7.3% return in 2023 outperformed cash (T-Bills +5.3%), fixed income (Bloomberg Agg +5.5%), and our merger arbitrage peers (HFRX Merger Index +3.0%) during the year. And while our Strategy trailed the Magnificent Seven-led equity indices (MSCI ACWI +22.2% in 2023), we view this as a side effect of our Strategy's low correlation to equity indices. Indeed, we need look back only a further 12 months to 2022's returns to witness the diversifying benefit of an event-driven strategy. As we detailed in our 2022 letter, our Strategy's +6.2% return in 2022 was achieved amidst a terrible year for most risk assets, with major equity indexes declining more than 20% for the year and fixed income indices nearly as bad.

Delivering such consistency during a volatile two-year period didn't come without its share of bumps in the road. But in an investment landscape that seems more focused than ever on consistency, we have found that the best path to achieving comparatively consistent outcomes is by focusing on the process required to generate them. In preparing our annual letter we often re-read our past commentary and marvel at how much the names change while the process remains the same. As such, as we end this letter, we thought it appropriate to include a section from the closing of our 2018 Annual Letter, the first we wrote after the launch of our standalone strategy.

"We're often asked what type of market environment we "need" to succeed in a given year. While ample corporate deal-making activity is certainly preferable, we're cognizant that more deals do not always equal a better opportunity set. Similarly, a decline in deal volume doesn't mean tumbleweeds for event-driven investors. As long as companies face key strategic decisions with uncertain outcomes and as long as markets aren't always efficient in pricing that uncertainty, there will be opportunities in the event-driven world. One of the benefits of our approach is its repeatability: even though specific opportunities change from year to year, our investment process and philosophy don't."

In the five years since that letter was written we have held over 250 positions, making money on ~80% of them. Merger arbitrage is an asymmetric business, it can be tempting to focus on the losers, the ~20% that caused all the headaches. And yet by treating winners and losers with similar equanimity, trying to avoid getting too positive in periods of success or too low in periods of failure, we've generated results of the magnitude and consistency that have eluded many in our space. Our 5-year annualized return at year end 2023 stood at 5.4%, net of fees, exceeding our benchmark by nearly 400 bps per annum and our peers (as measured by the HFRX Merger Arbitrage Index) by a similar amount. While we don't know what specifically to expect in 2024, we are confident we have the team, approach, and process to navigate whatever comes our way.

Yours sincerely,

Doug Francis
Head of Event-Driven Team, Portfolio Manager

Sam Klar
Portfolio Manager

Annualized Returns as of 12/31/2023 (Net, USD)	Inception	1-Year	3-Year	5-Year	ITD
GMO Event-Driven Strategy	7/31/2016	7.27	3.94	5.37	5.00
FTSE 3-Month T-Bill		5.26	2.25	1.91	1.67

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. 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.

Disclaimer
The views expressed are the views of Doug Francis and Sam Klar and the GMO Event-Driven team through the period ending January 2024 and are subject to change at any time based on market and other conditions. This is not an offer or solicitation for the purchase or sale of any security and should not be construed as such. References to specific securities and issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities.