GMO

YEAR-END LETTER FOR 2023

Focused Equity Team: Quality Strategy

Dear Client,

Twenty twenty-three was quite a year in the markets. The Quality Strategy returned 29% (net),[1] its second-best result since inception almost 20 years ago, as inflation subsided alongside economic concerns and investors processed positive developments on various fronts.

Returns to technology investors were extraordinary. The NASDAQ 100 returned 54% for the year, beating every major geographic index worldwide. Returns to investors outside of technology were more normal (for a good year) at 16.3% for the S&P 500 ex-Tech and 17.1% for the MSCI World equivalent.

In developed markets, 78 stocks returned more than 70%, and portfolio exposure to those played a role in determining outcomes in 2023. The Quality Strategy owned five members of the 70%+ club: Meta, Salesforce, Amazon, Adobe, and Lam Research, and comfortably beat the S&P 500 and MSCI World indices.[2]

The magnitude of returns for technology companies seems mind-boggling at first glance and the sustainability of those returns is likely the most important question for equity market investors as we begin 2024. Our starting point in addressing this is to break those returns into a) a component deriving from business fundamentals, e.g., earnings per share (EPS) growth and any return from dividends, and b) a part deriving from a change in valuation as measured by price-to-earnings (P/E) multiples. This lens keeps our focus on companies generating strong fundamental returns while remaining mindful of valuation.

If the fundamental returns are self-funded (as ought to be the case with quality businesses), total returns will converge with the fundamentals over time, and so valuation will exert less of a pull over the longer term. In the shorter term, however, valuation changes are often dominant. This year, we estimate that the weighted median EPS growth for U.S. technology companies was around 13% (and dividend returns were about 1%). Though not a vintage year by recent standards, this isn't bad, but leaves valuation change to explain a large chunk of total return.

Does this mean that the headline 54% return for the Nasdaq 100 was largely driven by shifting sentiment and is therefore at high risk of mean reversion? Perhaps, but not necessarily. Return decomposition algebra doesn't lie per se, but it doesn't tell the whole story either. What else was going on?

A year of innovation

On May 25, Nvidia shocked the markets with next-quarter revenue projections 60% ahead of market expectations. Demand for the company's GPU chips was snowballing as businesses scrambled to explore opportunities in large language models (e.g., ChatGPT) and generative AI.

On August 8, Novo Nordisk announced their GLP-1 treatment could cut the risk of cardiovascular events in overweight or obese adults by 20% with serious revenue implications. Further announcements from Eli Lilly compounded the excitement around the use of GLP-1 in weight loss and even in slowing Alzheimer's Disease.

The implications for company profits from innovation are multi-dimensional and, in these cases, will likely crystallize over several years. At the simplest level, if earnings prospects for the largest tech names have been improved by generative AI, then markets will reflect that, and whether that gain can be chalked up to a multi-year improvement in EPS (i.e., fundamental return) or a one-year shift in valuation is a bit theoretical; the associated benefits from these innovations justified a bonus in terms of returns as intrinsic values have probably risen.

1 Preliminary data.

2 The team's Quality Spectrum Strategy returned 25.3% (net), owning the same names on the long side while shorting expensive junk names on the short side, and beat its MSCI ACWI benchmark by 3.1%. Our Quality Cyclicals Strategy returned 22.6% (net), owning Meta, Lam Research, and Booking Holdings, but was light on tech. It edged ahead of its MSCI ACWI benchmark.

The practical question that we must answer as investors is where are those benefits most likely to land, and do valuations accurately reflect them? We try to start with some humility. No one knows for sure how the cookie will crumble. We aim to invest the Quality Strategy in companies that use capital productively and trade on valuations that are consistent with attractive investor returns. Many of the strategy's investments are in the technology arena, and on "Nvidia Day" the strategy performed quite well, despite owning not a single share in Nvidia. The strategy's semiconductor and software businesses are seen as beneficiaries of AI and many have performed well since. In the case of Adobe, we believe that the market has overestimated the benefits of AI to the company and therefore took the opportunity to liquidate the position. For Accenture, on the other hand, we believe that pressure on IT spending this year is masking what is a significant multi-year opportunity to assist major corporations to prepare their data for a different world and added to the position.

The strategy's healthcare positions also outperformed on "GLP-1 Day," all down to an investment in Eli Lilly. This was pleasing as the strength of their pipeline in GLP-1s was a strong part of our 2019 buy thesis for Eli Lilly, back when the stock traded at a very normal kind of multiple for a pharmaceutical company. By contrast to the buzz around the armada of companies carried in ChatGPT's wake, the market has fretted about businesses that could be dampened by widespread GLP-1 take-up, from sleep apnea specialists to food and beverage producers. This created buying opportunities. For example, the shares of robotic surgery leader Intuitive Surgical came under pressure from concerns over potential consequences for its bariatric (weight loss) surgery offering – in our view not material to their long-term prospects – and we added to your holding in Q4.

Whether we have positioned the portfolio correctly for these innovations will be revealed over years, not months or quarters, but it seems reasonable that the market has indeed upgraded the assessment of fundamental returns. Nvidia, Novo Nordisk, and Eli Lilly have almost certainly made some truly spectacularly high return on investment decisions in recent years, but we believe that originality isn't the only way to exploit changes in the commercial landscape. What has Microsoft truly invented over time? Not spreadsheets, not web browsing, not cloud computing…but it has profited from all these innovations by canny capital allocation and a deeply embedded installed base. Your portfolio is built around the idea that strong returns on investment for a range of beneficiaries of innovation – both as creators and incumbents – will be a propellant from here.

Interest Rates

Could rates have supported the tech stocks and rising equity market valuations? Although U.S. policy rates were hiked four times this year[3] and the first cut is yet to be seen, the forward rates that affect many valuation models took a marked step downward in the fourth quarter, perhaps providing some year-end market support.

To the extent that bond markets are a proxy for rate expectations, the 2-, 10- and 30-year bond rates all finished the year close to where they started it, so rates don't explain the aggregate shift in equity valuations in a very satisfactory manner. Inflation did end the year much lower than it started, so perhaps that was a more important factor. In any case, as we have noted previously, discount rates probably shouldn't be used to explain cross-sectional moves in equity markets (e.g., growth vs. the rest[4]), and we believe that reacting to macroeconomic developments is a more productive use of time than trying to predict them.

A rebound

If improved fundamentals can partially explain market moves, and rates probably cannot, perhaps the sprint upward for tech stocks simply reflected too low a starting point in January. Given that the previous year was characterized by a powerful sell off in growth stocks, this argument is worth investigating. While the S&P technology sector returned 55% in 2023, the annualized return since the end of 2021 is a rather more pedestrian 5% per annum. Over the same period, U.S. CPI was – wait for it – 5% per annum! In fact, most other S&P sectors were actually down in nominal terms over the two-year period, with the glaring exception of energy (+24% per annum) which was recovering from an earlier, different mishap.

3 Rising rates did have consequences elsewhere in your portfolio. The mini banking crisis – now relegated to footnote status – that felled Silicon Valley Bank and a couple of others captured attention in the first half of the year. Aside from some ill-advised balance sheet management around private equity and crypto exposures at specific institutions, the main concern for financials emanated from rising interest rates. Deposit flight to higher returning money market funds sharpened focus on the potential for capital losses on balance sheet assets with duration, even those expected to be held to maturity. Thankfully, we had reduced the strategy's exposure to banking stocks in the first quarter based on valuation, and the noise around the mini crisis created some trading opportunities. Having down-weighted further in March and April, we added to conservatively managed USB at lower prices in the middle of the year.
4 See Growth Investing Ain't About the Rates (October 2022).

In aggregate, the S&P 500 excluding technology stocks returned approximately nothing over the last two years and less than nothing after inflation.

Although this sounds somewhat reassuring in justifying the lurch upward in tech stocks, to be convincing we would have to believe not just that growth stocks got relatively cheap in the intervening period (they did), but that they were attractively positioned two years ago. Unfortunately, growth/tech stocks looked peaky to us from a bottom-up perspective at the end of 2021 and we reduced our allocation to technology around then for that reason. While tech earnings have progressed since, they have not done so at a rate that would make them obviously attractive today.

So where are we now?

In aggregate, we find ourselves somewhat sympathetic to the idea that innovation has contributed to returns in 2023, and pretty unsympathetic to reasoning based on discount rates or a fully justifiable rebound.

And so we have once more trimmed the strategy's technology-related exposure. It's not that we find all tech stocks overpriced. There are high-quality software businesses, such as Alphabet and Meta, trading close to Benjamin Graham-approved 20x P/E multiples. We see interesting opportunities in critical parts of the semiconductor supply chain. The prospects for certain strands of enterprise software look enticing. The strategy still owns a substantial allocation to tech. On balance, however, we have found incremental opportunities to put capital to work with other productive users of capital, some trading at more subdued valuations, in the industrial, healthcare, and consumer spaces.

In healthcare, we added to your position in UnitedHealth on weakness during the year. The largest U.S.-managed healthcare company is return on capital focused and has been able to exploit its scale to propel earnings power over time. We view this year's share price pause after a strong 2022 as an opportunity, while recognizing that political posturing on healthcare is a regular feature of U.S. election years.

As mentioned above, consumer staples companies, long a mainstay for quality investors, have been under pressure for a while now, and we have begun to increase allocations there. The staples companies were affected by inflation more than most – the costs of the commodities required for production, packaging, and distribution soared just as consumer balance sheets were stressed by rounds of price increases and rising borrowing costs. To add insult to injury, the potential for GLP-1 prescription has cast a cloud over potential consumption, and therefore revenues, for many of the food and beverage businesses too. Fundamental returns were weak, and valuations were cut. These new valuations are intriguing; reduced expectations for the staples businesses reduces investor risk. Current share prices give little credit for potential margin expansion should commodity prices ease or other concerns prove overblown.

In addition to the list of challenges for staples, Diageo was one of several companies hit by inventory issues this year. For many food and beverage products, short shelf lives and low values per unit limit the risk of overstocking in distribution channels. However, for Diageo – perhaps best known as the maker of Johnnie Walker whiskies – rising consumer prices and a shortage of supply during the pandemic resulted in higher-than-normal inventories at their customers in Latin America. As these factors began to abate, Diageo's revenues from the region fell, surprising investors. Assuming the competitiveness of Diageo's product remains approximately stable, the destocking issue should shrink into the rearview mirror over time while the shares now trade at their lowest valuation in years, and we would expect total returns at least in line with potentially double-digit fundamentals from here.

We also initiated a position in Haleon toward the end of the year. Haleon was formerly the consumer health business of Glaxo and Pfizer, and its portfolio of products sits at the intersection of consumer staples and healthcare. You will likely know their products – e.g., Sensodyne for your teeth, Advil for your head – even if you're not familiar with the business. Haleon trades at a similar valuation to Diageo, with a similar level of revenue growth anticipated too. The point of interest is that Haleon was spun out of Glaxo in 2022 and still bears many of the "big pharma" costs inherited during the carve out. If the company is successful in rationalizing some of these costs as planned, the impact on margin will be material in driving fundamental returns.

We thank you for entrusting your assets to our management for another year. This has been an exciting one for our team. In addition to strong returns across our broad market strategies, our U.S. Small Cap Quality Strategy returned a net 32.9%, trouncing the S&P 600 Index.[5] We also launched new vehicles to allow access to more investors, most notably GMO's first ETF.[6] For 2024, we will do our utmost to repay the trust of old and new clients alike with our continued focus on quality businesses trading at prices that make sense for the long-term.

Sincerely Yours,

Tom Hancock
Head of GMO Focused Equity Team

Ty Cobb
Portfolio Manager

Anthony Hene
Portfolio Manager

5 For more, see our Small Cap Quality Year-End Letter.
6 GMO Launches Its First ETF, the Actively Managed GMO U.S. Quality ETF (NYSE: QLTY) (November 2023).

Preliminary Annualized Returns as of 12/31/2023 (Net, USD)	*Inception*	*1-Year*	*3-Year*	*5-Year*	*10-Year*	*ITD*
GMO Quality Strategy	2/29/2004	29.13%	11.11%	16.41%	13.21%	9.81%
S&P 500 Index		26.29%	10.01%	15.69%	12.03%	9.60%
MSCI World Index		23.79%	7.28%	12.81%	8.60%	7.68%

Annualized Returns as of 12/31/2023 (Net, USD)	*Inception*	*1-Year*	*3-Year*	*5-Year*	*10-Year*	*ITD*
GMO Quality Spectrum Strategy	11/30/2019	25.34%	20.64%	N/A	N/A	14.61%
50% MSCI ACWI/50% 3-Month T-Bill Blend		13.75%	4.33%	N/A	N/A	5.83%
MSCI ACWI		22.20%	5.75%	N/A	N/A	9.02%

Annualized Returns as of 12/31/2023 (Net, USD)	*Inception*	*1-Year*	*3-Year*	*5-Year*	*10-Year*	*ITD*
GMO Quality Cyclicals Strategy	4/30/2020	22.61%	7.16%	N/A	N/A	16.69%
MSCI ACWI		22.20%	5.75%	N/A	N/A	13.26%

Annualized Returns as of 12/31/2023 (Net, USD)	*Inception*	*1-Year*	*3-Year*	*5-Year*	*10-Year*	*ITD*
GMO Small Cap Quality Strategy	8/31/2022	32.88%	N/A	N/A	N/A	27.46%
S&P 600 Index		16.05%	N/A	N/A	N/A	10.47%

Final performance numbers are generally available on GMO's website five to ten business days after month end. Investors should not rely on preliminary numbers to make investment decisions.

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. The portfolio is not managed relative to a benchmark. References to an index are for informational purposes only.

Disclaimer

The views expressed are the views of Tom Hancock, Ty Cobb, and Anthony Hene 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