GMO

YEAR-END LETTER FOR 2024

Focused Equity Team: Resources Strategy

Dear Client,

The GMO Resources Strategy fell 17.9% net of fees last year, its worst performance in almost a decade. For perspective, our official benchmark, the MSCI ACWI Commodity Producers Index, dropped 5.6%. While we aim to outperform our benchmark over the long term and have done so since inception, substantial strategic differences between our approach and the benchmark can create meaningful differences in performance over shorter periods.[1]

Approach

Over the last 15 years, we've built a proprietary investment universe of companies that provide direct or indirect exposure to commodity prices. Commodity producers, such as oil companies and miners, provide fairly direct exposure to commodity prices, while those that service commodity producers (e.g., oilfield services, farm machinery) and those that compete with commodities (e.g., wind, solar, biofuels) provide indirect exposure. Since our benchmark is comprised almost exclusively of commodity producers, we're investing in several industries that are not incorporated in the benchmark. There are also industries in the benchmark that we generally avoid (e.g., steel, aluminum).[2] Thus, our investment universe has overlap with the benchmark, but there are substantial differences.

We also set strategic allocation targets for various industries to produce a much more diversified portfolio than the benchmark, which is typically 60-70% fossil fuels. Our strategic allocation target for fossil fuels is 35%, and our exposure has averaged around that level since inception. Diversification has long-term benefits, but clearly there will be periods where a large underweight to fossil fuels will hurt relative performance.

When selecting investments from our custom universe, we seek companies trading at significant discounts to their peers. These discounts are often due to lower growth prospects, poor commodity performance, or some perceived risk. Smaller-cap stocks, companies with emerging market operations, and companies higher on the cost curve are generally priced as riskier. A significant discount is also typically applied to pre-production companies, as the market has a healthy skepticism about unproven projects. Our job is to determine where the market has overreacted to these factors and build a portfolio of attractively priced companies.

Performance

Commodities were mixed in 2024. With the Fed focused on fighting inflation, oil dropped about 5%, iron ore tumbled 25%, lithium cratered over 40%, and agricultural commodities generally fell. Copper, aluminum, and zinc rose a bit.

Stock selection has generally been strong since inception, but strategic differences versus our benchmark, which over the longer term haven't been major factors, have had a large impact on relative returns in recent years. In particular, our underweight to fossil fuels and out-of-index exposure to clean energy have hurt. In 2024, these two factors reared their heads again with clean energy alone explaining almost all our underperformance versus our benchmark.

Stock selection was mixed last year. Our largest fossil fuel position, Kosmos Energy, fell almost 50%, as the market punished the small cap severely for some short-term operating issues and a slight delay in a new asset coming online. Not owning Exxon, which makes up around 15% of the benchmark, was almost as painful, as Exxon rose about 11% in an otherwise down oil & gas industry. We generally don't expect to own companies like Exxon and Chevron, as they typically trade at richer

[1] From inception through the end of 2024, the Resources Strategy outperformed the MSCI ACWI Commodity Producers Index by 2.7% per annum.

[2] Steel and aluminum companies are generally smelters, not commodity producers.

valuations than many peers. However, the Exxons and Chevrons of the world are natural trading vehicles for oil exposure, and they win from time to time despite their rich valuation.

We look far beyond Exxon and Chevron, of course, and were rewarded last year for digging deep into Argentina to invest in YPF and Vista Energy, two oil & gas companies expected to generate much higher free cash flow yields than the U.S. oil majors. YPF rose over 150% last year, and Vista Energy rose around 80%, as both continued to execute well and conditions in Argentina improved. These positions had large positive impacts on the portfolio.

Mining companies struggled last year given the drop in iron ore prices, so our overweight to mining and large exposure to iron ore producer Vale dragged on performance. Our out-of-index exposure to lithium hurt as well.[3] Our copper positions performed well, so our overweight to copper and strong stock selection contributed positively.

The performance impact of our investments in agriculture, timber, and water was muted but positive overall.

Positioning & Outlook

After a big run amid Covid on the back of low interest rates and a weak dollar, commodity prices have fallen back in the higher interest rate, strong dollar environment of the last couple years and now generally sit at or below their five-year averages. While we don't endeavor to predict commodity prices, the supply/demand dynamics are compelling.

Barring an edge case scenario where we'll have bigger problems on our hands – think nuclear war, zombie apocalypse, and the like – commodity demand will continue its inexorable growth. In recent decades, demand growth has generally been driven by global population growth and the development of the emerging markets, but the U.S. is set to join the party. After a couple decades of flat electricity demand in the U.S., industry experts expect a big boost in the years to come, driven largely by data centers and electrification.[4]

The supply side is generally challenged. We continue to chew through our highest quality, cheapest resources and push into more expensive assets and more challenging locations (e.g., ultra deepwater oil & gas, underground mining, agricultural land in central Brazil). In addition, capital investment across the energy and metals complex continues to hover around 20-year lows, ensuring that new supply won't hit the market in a substantive way for years to come given the 10+ year lead times on many projects.

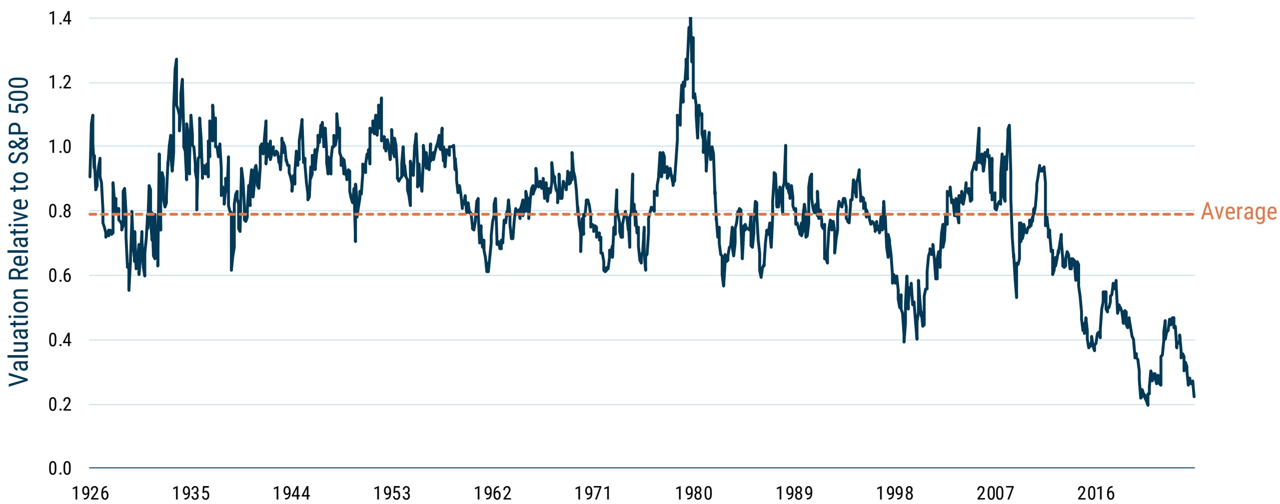
Though the supply/demand dynamics are conducive to high commodity prices, the market certainly isn't pricing in any optimism. As of the end of 2024, energy and metals companies traded at nearly the most attractive valuations we've ever seen relative to the broad market (see exhibit below). The only time commodity producers have traded at similar levels historically was during the Covid pandemic, when the global economy floundered, oil prices crashed to $10 per barrel, and there were real questions about the future of daily life. That's a far cry from today, with oil in the mid-$70s, the global economy humming along, and life having returned to some semblance of normal. On a risk-adjusted basis, the current opportunity seems much more attractive than the one a few years ago, and that opportunity worked out well for investors who took advantage of the attractive valuations. While market commentary would lead one to believe that AI is the only thing that matters these days, the energy sector more than doubled the return of the S&P 500 over the last four years.

[3] MSCI considers the lithium producers we invest in to be specialty chemicals companies, not commodity producers.

[4] Grid Strategies, a power and transmission consultant, projects ~16% growth in U.S. electricity demand over the next few years, a jarring amount of growth after a long period of stagnancy.

VALUATIONS ARE HISTORICALLY ATTRACTIVE

Valuation of Energy/Metals Companies Relative to the S&P 500



As of 12/31/24 | Source: S&P, MSCI, Moody's, GMO

Valuation metric is a combination of Price to Earnings (Normalized Historical Earnings), Price to Book Value, and Dividend Yield.

We also see a large dislocation in the clean energy sector, where sentiment has driven prices to levels that are disconnected from the strong long-term prospects for the companies. Clean energy companies are growing significantly faster than the broad market, yet many trade at steep discounts. Though there are risks to the sector and concerns about the prospects for the Inflation Reduction Act, we believe these risks have been more than priced in by the market.[5]

Last year, we took advantage of the weakness in the fossil fuel, mining, and clean energy sectors. We added to Kosmos Energy amid its 2024 struggles. As Kosmos ramps up production over the next few years, we see free cash flow yields rising from 20% this year to over 40% by the end of the decade. Compare this to the 7-10% free cash flow yields projected for Exxon, and you can understand both why some investors like Exxon – after all, 7-10% isn't bad at all! – and why we have a strong preference for Kosmos. In mining, iron ore's fall last year hit Vale, allowing us to scoop up shares at lower prices. Within clean energy, we saw strong opportunities in solar and biofuels, in particular, and added to a basket of these names as we believed the industries were oversold.

Business & Team Update

On the business front, net flows have been flat over the past two years. Many clients have added to their positions in recognition of the unique opportunity and our strong long-term track record. As of the end of last year, assets in the strategy stood at around $2.7 billion.[6]

From a team perspective, we continued to add talent with Alec Newell joining 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. His initial focus has been on fossil fuel companies, and we're excited to have him back on board.

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

[6] Strategy assets include assets in the Resources, Resource Transition, and Metals & Mining Strategies.

Final Thoughts

Entering 2025, our portfolio is comprised of what we believe are high-upside names. Valuations are deeply depressed across the traditional energy, clean energy, and mining sectors, yet the long-term prospects are strong for each. While volatility is a fact of life in these sectors, the expected returns are very high for those committed to the ride.

We value your confidence in us and patience. While the road has its ups and downs, the current opportunities are extraordinary.

Sincerely,

Lucas White
Lead Portfolio Manager, Resources Strategy

Annualized Returns as of 12/31/2024 (Net, USD)	*Inception*	*1-Year*	*3-Year*	*5-Year*	*10-Year*	*ITD*
Resources Composite	12/31/2011	-17.90%	-6.89%	3.95%	6.98%	4.90%
MSCI ACWI Commodity Producers		-5.56%	5.82%	5.89%	4.02%	2.24%

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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