GMO

YEAR-END LETTER FOR 2024

Focused Equity Team: Small Cap Quality Strategy

Dear Client,

In 2024, the Small Cap Quality Strategy returned 9.7% (net), outperforming our benchmark, the small cap S&P 600 Index, by 1.0%. Our outperformance was driven entirely by stock selection, with our sector allocation a modest negative. Our underweight in Financials was a notable headwind, as regional banks recovered from their weakness in the aftermath of Silicon Valley Bank's collapse. And our overweight in IT was actually a drag as small cap tech did not benefit meaningfully from the AI-related outperformance that benefited mega cap tech companies. Our underweights in Energy and our overweight position in Industrials largely offset these headwinds, however. From a stock selection perspective, among our largest positive contributors to relative returns were Ciena, Stepstone, and Globus Medical; our largest detractors were Axcelis Technologies, Neogen, and Arcbest.

Though we seek to deliver greater outperformance than we delivered in 2024, we take comfort in having beaten our benchmark despite a difficult year for quality investing overall. Our strategy's investment approach begins with our quantitatively defined small cap quality universe, which selects small cap stocks with high returns on capital, stable fundamentals, and low levels of leverage. From this universe – which typically includes 150-200 stocks – we select our portfolio of approximately 40 companies that we believe, from a fundamental perspective, represent the best balance of high-quality business models, attractive valuations, and diversified economic risks. Our analysis indicates our fundamentally selected portfolio outperformed our quantitative small cap quality universe by over 6%, turning a rough year for quantitative quality into an acceptable one for the strategy.

Throughout the year, shifts in narratives around inflation risk, recession risk, geopolitics, and the potential policies of a Trump administration had dramatic impacts on the performance of various groupings of stocks, such as small vs. large caps, various sectors or subsectors such as regional banks, and quantitative factors such as value or quality. The strategy's performance suffered as expectations for cuts in the fed funds rate ramped up in June. A falling rate environment is often more favorable for speculative businesses. Furthermore, as in 2016, Trump's election victory proved to be another headwind for quality stocks. While the Small Cap Quality Strategy underperformed sharply in November as risk assets outperformed, the strategy recovered some of those lost gains in December.

In general, we do not try to predict short-term shifts in market sentiment or make bold macro calls. Where sentiment shifts appear extreme and valuations unusually cheap or expensive, we will rebalance toward or away from the affected market segments, respectively. For instance, post-election, we concluded that some policy-related narratives had been excessively priced into stocks and rebalanced from winners into losers. Most of the time, however, our strategy is to diversify the economic exposures of our holdings to control our various investment risks, but with the important constraint that we will not dilute the quality of our portfolio. This constraint means some portfolio risks cannot be diversified, and our relative returns will be vulnerable to rallies in cyclical or lower-quality businesses, as occurred after Trump's re-election.

Our best and worst contributors this year, Ciena and Axcelis, respectively, are in some thematic ways quite similar, and both are useful examples of how our quality-oriented and valuation-sensitive investment approach can add value in small caps. Both companies are cyclical, with revenues driven by their customers' capex cycles: Ciena sells networking equipment to telecom companies and cloud service providers, while Axcelis sells semiconductor capital equipment (ion implantation devices) to chip makers. Both companies are highly focused on a key technological niche where they have a commanding lead, and both will benefit from tremendous secular demand for their respective niches over time. In Ciena's case, rising demand for bandwidth related to AI applications will fuel demand for their networking equipment, whereas in Axcelis' case, rising demand for energy-efficient silicon carbide chips will drive purchases of their ion implantation devices.

This year, Ciena benefited from improving sentiment around their products' ability to address AI-related use cases, as well as the resolution of an inventory overhang. Axcelis was punished by the market as demand for their equipment was hurt by slowing demand for EVs and signs of near-term over-investment in silicon carbide capacity after a period of enthusiasm that ran into mid-2023. In 2023, we were selling Axcelis as it rose, limiting our downside as it fell. This year, as sentiment on Ciena has improved, we are trimming our weight. Both companies remain attractively valued with bright futures, but we believe the right move is to shift weight toward the more out-of-favor name.

Small cap stocks are particularly prone to large swings in sentiment driven by near-term trends, even as long-term trends and opportunities remain largely unchanged. These swings create opportunities for a strategy that focuses on investing in the best businesses – those least likely to face permanent impairment of capital – at attractive valuations. Taking advantage of such opportunities has been a key contributor to our outperformance. We believe that focusing on high-quality businesses is an effective and highly differentiated way to invest in small caps. Over time, we believe the strong performance of these businesses will continue to drive healthy returns for our investors.

Sincerely,

Hassan Chowdhry
Portfolio Manager

Tom Hancock
Head of Focused Equity,
Portfolio Manager

James Mendelson
Portfolio Manager

Annualized Returns as of 12/31/2024 (Net, USD)	*Inception*	*1-Year*	*3-Year*	*5-Year*	*10-Year*	*ITD*
Small Cap Quality Composite	8/31/2022	9.66%	N/A	N/A	N/A	19.48%
S&P 600		8.70%	N/A	N/A	N/A	9.70%

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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