

SMALL CAP QUALITY STRATEGY

The Opportunity

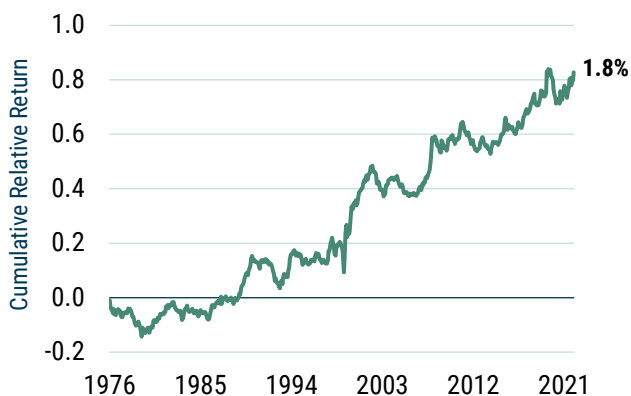
Quality stocks, the equity securities of companies with durable, resilient business models and high returns on capital, have historically provided superior risk-adjusted returns. Quality investing is an approach well suited to small cap equity. High-quality small cap companies have delivered stronger returns than the small cap universe, with lower volatility. Since 1976, small cap quality has outperformed the small cap asset class in the U.S. by 1.8% annualized and has also outperformed the all-cap U.S. market by 2.9% annualized (Exhibit 1). These more predictable, long-term winners are often undervalued by the market, buried under the buzz of stocks long on narrative but short on fundamental stability. We believe that because of the prevalence of junk companies in small cap, a quality-focused investment approach can deliver superior and meaningfully differentiated results.

Furthermore, an attractive valuation opportunity has opened up as small cap stocks have undergone a significant derating in recent years. We believe small cap quality offers a way to take advantage of attractive valuations while reducing downside risk.

U.S. SMALL CAP QUALITY PERFORMANCE

Outperforming both other small caps and the broader market

U.S. SMALL QUALITY VS. U.S. SMALL RELATIVE RETURN



U.S. SMALL QUALITY VS. U.S. RELATIVE RETURN



Data from December 1976 to November 2022 | Source: Worldscope, GMO

Performance data quoted represents past performance and is not predictive of future performance.

The GMO Solution

The GMO Small Cap Quality Strategy seeks to generate total return by investing primarily in equities of U.S. small cap companies that fit our quality criteria. GMO's Focused Equity team defines quality companies as those with durable business models, high returns on capital, and secular growth drivers. Our strategy is highly focused on ensuring that we only invest in companies that can sustain their edge and performance over time, using fundamental research to identify long-term winners within a quantitatively defined quality universe. These longer-term investments also help to minimize trading costs, which can be high in small cap.

Before leveraging fundamental analysis, our portfolio construction process begins with applying our proprietary systematic quality screens to the small cap asset class. Within this remaining universe, we fundamentally examine every name, testing whether each company possesses the sorts of strong competitive advantages that lead to sustained outperformance.

The final GMO Small Cap Quality Strategy is a high-conviction portfolio of about 40 names, selected for their attractive valuations and especially high-quality business models, within a risk management framework designed to avoid excess exposure to any one sector or economic trend.

SMALL CAP QUALITY INVESTMENT THESIS



GMO's Quality approach can add significant value in Small Cap



Fundamental research identifies the businesses with highly sustainable competitive advantages



We avoid the lottery tickets and long-term losers pervasive in Small Cap

GMO brings three key competitive advantages to small cap quality investing:

- **EXPERIENCE** – GMO is a pioneer in Quality investing with more than 40 years of experience and a real track record in down markets.
- **"BEST OF THE BEST" BLENDED APPROACH** – Finding small cap companies that will remain relevant, strong, and growing is a challenge that can yield significant rewards. GMO combines the discipline and consistency of its quantitative framework with a forward-looking, fundamental vetting process that assesses the long-term relevance of each company's business model.
- **LONG TRACK RECORD OF STRONG, RISK-ADJUSTED RETURNS** – GMO's flagship Quality Strategy has a history of providing strong returns with less risk than broad equity markets. It has also provided meaningful downside protection since its inception in 2004.

The Client Fit

We believe the Small Cap Quality Strategy is a prudent way for investors to get small cap equity exposure. Small cap quality equities have historically delivered strong equity returns with a more defensive profile than broad small cap equities. Clients may also use the Strategy in more specific roles within their investment programs.

- **Core small cap U.S. Equity Holding:** The GMO approach balances growth and value without tilting heavily toward either style. The best fit is for clients who are more concerned with absolute risk than relative tracking error.
- **Defensive/Low Volatility Small Cap Exposure:** The Strategy's focus on durable business models with resilient fundamentals significantly reduces exposure to low quality business models prevalent in the small cap universe. Quality within small cap has historically delivered strong equity returns with lower volatility than small cap indices.
- **Tactically a Good Place to Hide:** Small cap quality has outperformed small cap during down markets. When the recovery comes, only a small portion of the down market outperformance is given back, resulting in strong through-cycle performance.

Who We Are

Founded in 1977, GMO is a private partnership whose sole business is investment management. The firm manages global portfolios with offices and clients around the world. Investment offerings include equity, fixed income, multi-asset class, and alternative strategies. GMO is known for blended fundamental and quantitative investment research expertise and a long-term orientation toward value investing.

The Team

The GMO Small Cap Quality Strategy is managed by the Focused Equity team. The experienced team includes 13 investment professionals, with members located in Boston and London. Tom Hancock, Hassan Chowdhry, and James Mendelson, portfolio managers for the Small Cap Quality Strategy, oversee idea generation, research, and portfolio positioning.

RISK

Risks associated with investing in the Strategy may include: Management and Operational Risk, Market Risk - Equities, Smaller Company Risk, Focused Investment Risk, and Illiquidity Risk.