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MAKING MONEY AND REDUCING RISK IN AN EQUITY SUPERBUBBLE*

Matt Kadnar | February 2022

Navigating the career risk associated with bubbles (especially superbubbles) has always been tricky and is one of the biggest failings in the investment management industry.[1] We at GMO dedicate ourselves to trying to get the big picture calls right. Extreme market environments, similar to the one we are experiencing currently, are where we have historically been able to add significant value to investors' portfolios. As the table shows, we have made some unconventional moves and owned some very unconventional portfolios in the face of market extremes.

Bubble	*GMO Positioning*
1989 Japanese Equity Bubble	Zero weight in Japan in International Equity portfolio
1999 TMT Bubble	Reduced equity, focus on Value stocks, REITs, and bonds
2007 Global Financial Crisis/Risk Bubble	Reduced equity, focus on U.S. Quality and long/short strategies
2022 Equity Superbubble	Reduced equity, focus on non-U.S. Value and alternative strategies; Equity Dislocation at 20% (designed to profit from Growth bubble bursting); modest fixed income, no Treasuries, and only specialized credit

As we move through the fourth "bubble era" in GMO's history, we have once again positioned our Asset Allocation portfolios to reduce risk and take advantage of what we believe will be a generational opportunity for adding alpha through asset allocation.

Equity Dislocation: Betting on the Bubble in Growth Stocks Bursting

While the overall U.S. market is in bubble territory as Jeremy Grantham recently outlined,[2] the epicenter of the bubble – both at home and abroad – is concentrated in Growth stocks. As such, the largest risk position in our flagship Benchmark-Free Allocation Strategy (as well as in our Alternative Allocation Strategy) is long a global portfolio of Value stocks and short a global portfolio of Growth stocks. To build these portfolios, we use a proprietary definition of "Value" and "Growth" that aims to assess

* This article originally appeared as an addendum to Jeremy Grantham's January 2022 Viewpoints, "Let the Wild Rumpus Begin - (Approaching the End of) The First U.S. Bubble Extravaganza: Housing, Equities, Bonds, and Commodities."

1 See "Let the Wild Rumpus Begin."

2 See Jeremy Grantham's April 2012 GMO White Paper, "My Sister's Pension Assets and Agency Problems (The Tension between Protecting Your Job or Your Clients' Money)."

Matt Kadnar
Mr. Kadnar is a member of GMO's Asset Allocation team. Prior to joining GMO in 2004, he was an investment specialist and consultant relations manager at Putnam Investments. Previously, he served as in-house counsel for LPL Financial Services and as a senior associate at Melick & Porter, LLP. Mr. Kadnar has a B.S. from Boston College majoring in Finance and Philosophy and a J.D. from St. Louis University School of Law. He is a CFA charterholder.

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the intrinsic value of companies and provides, in our view, a better lens on valuation than traditional value metrics or indices. This approach has proved to be incredibly successful: in an unusual year like 2021, where Value beat Growth by 200 bps globally, our custom approach generated alpha of approximately 1,500 bps. We believe significant room remains for this holding to continue its strong outperformance. This portfolio is available for direct investment via the Equity Dislocation Strategy. We also have worked with a client to build a pure U.S. Growth short portfolio, with a focus on the most expensive names in the Growth universe. We believe this particular type of portfolio is an excellent hedge to the significant gains many have experienced via investments in technology-focused private equity and venture capital.

Limited Equity Risk and Focus on Most Attractive Pockets (Value, Quality, Thematic)

Outside of long/short strategies, we have reduced our equity risk considerably and emphasized non-U.S. stocks, which we believe are considerably cheaper than their U.S. counterparts. We have concentrated our exposure to non-U.S. Value stocks globally, including those in Emerging Markets and Japan. To us, these stocks look very cheap relative to the U.S. and in the case of Emerging Markets and Japan Value, particularly Japanese Small Value, they are attractive in absolute terms as well. Japan also benefits from secular tailwinds related to shareholder-friendly reforms and improved profitability and return on shareholder equity.[3]

In our Global Equity and our benchmark-sensitive Global Asset Allocation portfolios, we have also maintained an allocation to our Quality Strategy, managed by our Focused Equity team and generally composed of outstanding companies with deep moats, low levels of leverage, and consistent, high, profitability. We have seen clients who still want to maintain an allocation to Growth but are cautious about overall valuations allocate to our Quality Strategy. Quality generally has growthier characteristics, but because of our focus on valuation, our Quality Strategy is now more highly correlated to Value than at any point in the last 20 years. Resource equities, which are largely a segment of Value, also look cheap relative to the rest of the world. We have also seen clients allocate to our Resources Strategy as a hedge against inflation. Finally, we've made a compelling case for owning our Climate Change Strategy, which seeks to take advantage of opportunities related to mitigating the effects of climate change.[4] The Resources and Climate Change portfolios are also managed by our Focused Equity team that, critically, maintains a significant valuation discipline in their stock selection.

Making Money While Reducing Risk

Navigating bubbles is fraught with all types of risk – absolute, relative, and career. This time is no different: when mean reversion will begin is inherently unknowable. However, there remain significant opportunities to make money and reduce risk in today's market, just as there were in 1987, 1999, and 2008. We know that selling winners and rebalancing into losers is good investment discipline but incredibly difficult to do for a whole host of behavioral reasons. That investment discipline is particularly critical given the equity superbubble we see today.

3
See "Japan Equities: Entrenched Perceptions Ignore Improving Reality," by Drew Edwards and Rick Friedman (January 2022).
4
See "Thinking Outside the Box: How and Why to Invest in a Climate Change Strategy," by Lucas White and Jeremy Grantham (April 2019).