# MID-YEAR LETTER FOR 2021

*Asset Allocation Team: Equity Allocation Strategies*

Jul 2021

Dear Client,

We hope this mid-year letter finds you, your family, and your colleagues healthy and well. Here in Boston, GMO's headquarters, the streets are filling up with summer tourists, restaurants are crowded, our beloved Red Sox are in first place and playing to capacity-filled audiences in Fenway Park, and, in the worst backhanded compliment yet, commutes are miserable again – in other words, things look like they are getting back to normal. We hope that this is true in your cities and towns as well.

We are pleased to report that performance for GMO's Equity Allocation strategies at this mid-point in the calendar year is quite encouraging. Our Equity Allocation strategies have largely delivered solid investment results thus far in 2021. While we do not anticipate that the Value reversal is going to follow a "straight line," the first six months of 2021 are what we hope is just a small sample of the type of returns we can expect as the extreme valuation gap between global Value and global Growth starts to shrink to some semblance of normality. While U.S. equities outperformed non-U.S. stocks in the first half of 2021, we believe the record high absolute and elevated relative valuations between the U.S and the rest of the world will normalize over time.

We are confident in our current positioning, but as always we continually make adjustments as the opportunity set changes.

## *Key Points*

- **The Value vs. Growth reversal is delivering returns, with a long runway left.** The historic valuation gap between global Value and Growth stocks finally began its reversal. Our Equity Allocation portfolios have benefited from this recent phenomenon, and we hope and expect this trend to continue.

- **Growth stocks remain in a bubble.** Despite pockets of outrageously overvalued Growth stocks being de-rated in Q1 and Q2, we still believe we are in a Growth bubble. Speculative behavior is rampant.

- **Remain underweight U.S., in favor of non-U.S.** Despite headlines about positive earnings surprises for U.S.-based companies, we believe that current prices have baked in an unreasonably optimistic future, which is always dangerous. Non-U.S. stocks, in contrast, have more realistic multiples.

- **Best opportunity set in over 20 years, so there is quite a bit to do.** The valuation gap between Value and Growth, combined with the gap between U.S and non-U.S. multiples, combined with some opportunistic plays, we believe offers one of the best relative opportunity sets we have seen in over 20 years. We are taking full advantage of the risk budgets allowed in our Equity Allocation strategies.

## *The Value vs. Growth Reversal Is Delivering Returns, with a Long Runway Left*

On November 9, 2020, or "V-Day," Pfizer announced successful test results from its Covid-19 vaccine. It was a dramatic turning point for the world and for the capital markets. Value stocks, which had been perennial laggards, particularly for the months leading up to that date (2020 ended up being the worst year in history for Value stocks relative to Growth), began their reversal. From that day until June 30, 2021, the MSCI ACWI Value index outperformed the broader benchmark by 600 bps and its Growth counterpart by almost 1200 bps. We hope and expect that this reversal has legs and is, frankly, just the beginning of a potential multi-year process.

In the meantime, our portfolios benefited from this recent turn of events. In the first half of 2021, our Global All Country Equity Allocation Strategy and Global Developed Equity Allocation Strategy rallied 14.1% and 15.7%, net of fees, ahead of their MSCI ACWI and MSCI World benchmarks by 1.8% and 2.7%, respectively. While the

top-down call to be underweight the U.S. and overweight emerging tended to hurt performance, the value (and quality) biases of most, if not all, of our underlying strategies ended up more than making up for it.

Over the same period, the International All Country Equity Allocation Strategy and International Developed Equity Allocation Strategy rose 10.8% and 12.1%, net of fees, outperforming their benchmarks by 1.6% and 3.3%, respectively.

Throughout, our decision to lean into Value was certainly not predicated on a successful vaccine, nor do we believe it is dependent upon a "normalization trade." Not surprisingly, our decision is predicated upon something much more foundational – Value *deserves to win* because it is the cheapest (relative) we have seen it over the past twenty years, as the chart below illustrates. While pundits will point to economic normalization around the world, rising interest rates, rising inflation, etc., as the main drivers of this recent reversal – that is the current narrative – our argument is much more valuation-based. (We will remind the reader of the inconvenient truth that the best Value vs. Growth performance in U.S. history was from 2000 to 2003, a period of *declining* interest rates, not rising.) If you look at the valuation gap between Value and Growth in the below chart, there is still a long, long runway ahead.

## VALUE IS EXTREMELY CHEAP

As of 6/30/2021 | Source: GMO Composite Valuation Measure is composed of price/sales, prices/gross profit, price/book, and price/economic book. Value and Growth groups are both sliced over 12 months.

## *Growth Stocks Remain in a Bubble*

Despite the relative underperformance of Growth year-to-date, Growth stocks were still up in absolute terms, further stretching valuations, and signs of speculative mania only increased throughout the first half of 2021. It is true that some of the frothiest names lost some of their froth during this timeframe (Tesla's price, for example, peaked in early January at over $900 per share and ended June at around $680, a loss of a quarter of its value). Yet SPAC issuance is setting records, as is stock issuance more broadly, an indication that companies are jumping at the chance to sell more of their stock at these nosebleed valuations to an all-too-eager audience. Single-stock call options, referred to internally at GMO as lottery tickets, are seeing the highest volumes in recorded history, with the only comparable time period being at the height of the tech bubble of the late 90s. The list of scary anecdotes is long and growing – Bitcoin, meme stocks, NFTs, bidding wars at art auction houses on literal "nothingness,"[1] and on and on.

1 In May of this year, 67-year-old artist Salvatore Garau sold an "immaterial sculpture"—which is to say that it doesn't exist. The buyer went home with a certificate of authenticity and a set of instructions: the work, per Garau, must be exhibited in a private house in a roughly five-by-five-foot space free of obstruction.

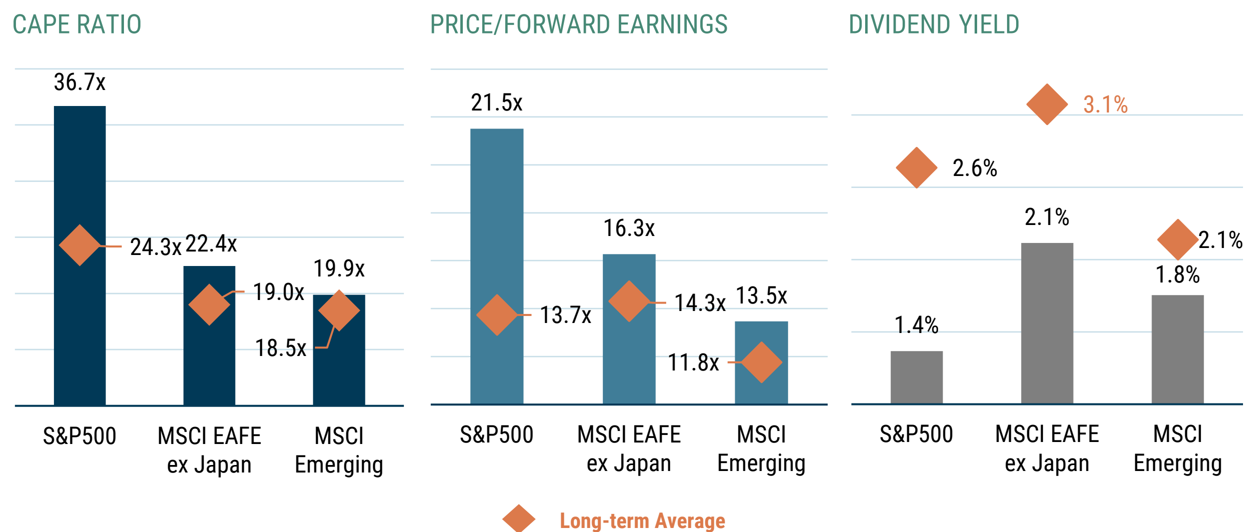
Beyond these nervous-laughter-inducing anecdotes are a litany of more traditional valuation metrics, all of which are pointing to seriously overpriced markets, particularly in Growth and the U.S. Combined, truly expensive markets *plus* evidence of manic behavior form the makings of a bubble.

## *Still Underweight U.S. in Favor of Non-U.S.*

By almost any valuation metric, U.S. stocks look expensive relative to developed countries outside of the U.S. and to emerging countries. As the chart below shows, and this is just a sample, whether we look forward or backward, the U.S. trades at a hefty premium.

### EQUITY VALUATIONS ARE 'FULL' TO EXTREME

***U.S. equities are meaningfully more expensive than the rest of the world***




As of 6/30/2021 | Source: GMO

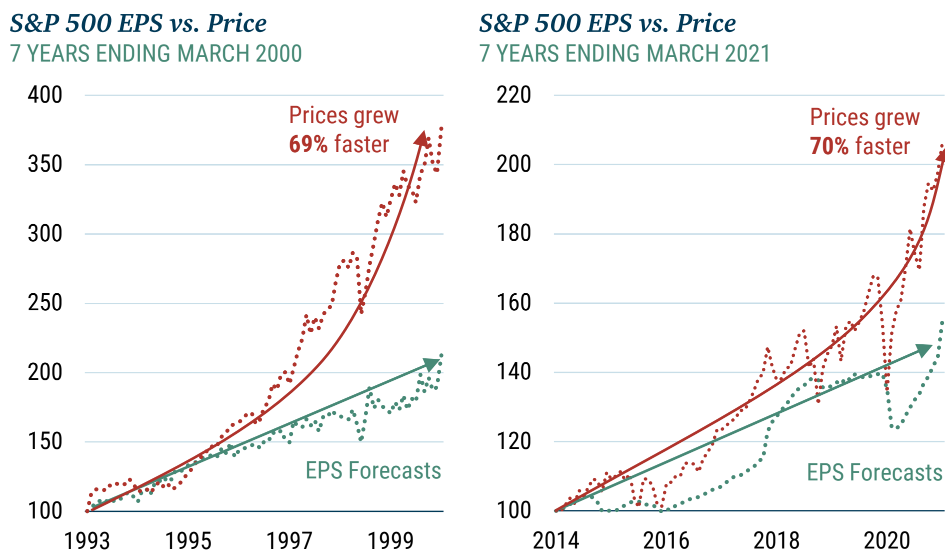
Many of you, we know, have been frustrated by the bearishness of GMO's published forecasts for U.S. stocks and suggest that we are missing the bigger picture – that the S&P 500 is chock full of great companies with great prospects. It is. We don't dispute that. But that argument is missing the point. Our concern is not about the growth prospects for some of these new dynamic companies and business models, it is about the prices you are paying for that growth. Remember, there are no such things as bad assets, just bad prices. The TMT bubble is a sobering reminder of this axiom.

We will be the first to admit that traditional valuation metrics – Price to Earnings, Price to Sales, etc. – are backward-looking. The general complaint is that they are not giving any credit to today's high-growth, high-plowback companies that are "disrupting" countless industries. Fair enough.

But what if we use EPS forecasts from the street, which try to capture all that terrific growth. (We'll forget for the moment another inconvenient truth that McKinsey has estimated that earnings estimates from the street are roughly 100% too high.[2]) The danger could still be that even today's great companies with great narratives can still experience price movements that are too great.

2 McKinsey & Company: Marc H. Goedhart, Rishi Raj, and Abhishek Saxena. *Equity Analysts: Still Too Bullish,* Spring 2010.

## REMINDER: THERE ARE NO BAD ASSETS...JUST BAD PRICES




Source: GMO, I/B/E/S
EPS forecasts are 2-year forecasts. In the first chart, EPS forecasts grew at an annualized rate of 11.1%; in the second chart, EPS forecasts grew at an annualized rate of 6.4%.

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This would not be the first time (i.e., chart above). The left graph shows the 7-year period leading up to March 2000, the height of the TMT bubble, comparing EPS forecasts with the price index of the S&P 500. Back then, the excitement of new web-based technologies and business models combined with growing confidence in the Fed had expectations running high. Wall Street EPS forecasts on the S&P 500 were rising at a healthy clip. That wasn't the issue, though. Prices were. They were increasing at an even faster rate – 69% faster. This, as you know, did not end well.

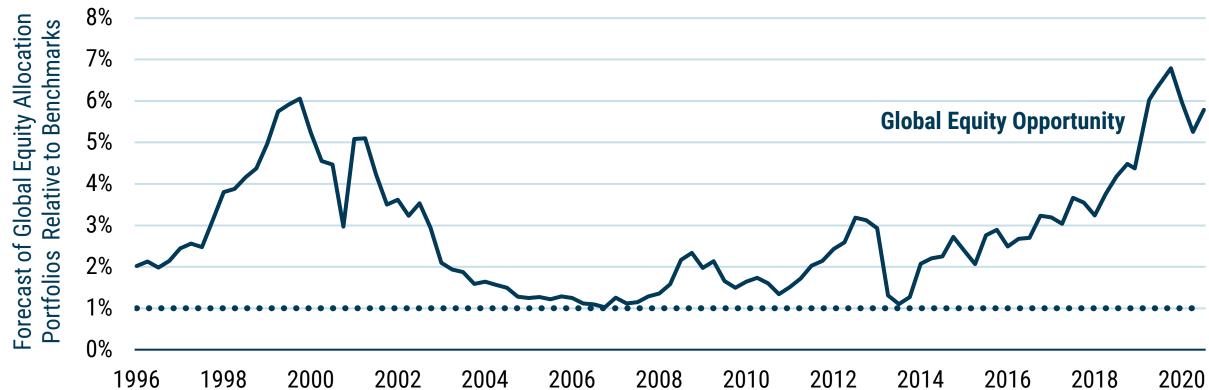
History is eerily rhyming today if you look at the picture on the right. Today's narrative about new business models is compelling – high growth, business moats, asset-light, network effects, high-switching costs, etc. Earnings forecasts from Wall Street are rising healthily, reflecting these terrific growth opportunities. The problem, yet again, is that prices are growing 70% faster. This, as you suspect, cannot end well.

## *Best Opportunity in Over 20 Years*

While our glass-is-half-empty view on Growth is sobering, there is a very different way to look at today's environment. Indeed, relative to traditional equity benchmarks, we think it is one of the *best opportunity sets in over 20 years,* as in one of the best times to look different and take active risk. For global equity investors in particular, this is actually an exciting time, due to historically wide valuation spreads across regions and styles.

## GLOBAL EQUITY OPPORTUNITY LOOKING VERY GOOD

***Best opportunity set since the TMT bubble!***




As of 6/30/2021 | Source: GMO
Opportunity is difference between forecast return of portfolio and benchmark given GMO forecasts at the time. 10-year forecasts are translated to '7-year equivalent' by multiplying by 10/7. Dotted lines are our long-term expectations of likely achievable alpha from asset allocation.

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The chart above is a thought experiment. Focus on the line, which maps our asset class forecasts over time to the positioning of our GMO Global All Country Equity Allocation Strategy to calculate an expected return. We then subtract the expected return for the MSCI ACWI portfolio. This chart measures how much additional, or excess, return we could theoretically generate by looking different from the benchmark.

Focus on the notable 1999-2000 period, for example. The difference between the expected return of our Strategy and the MSCI ACWI benchmark was 6.0%. Why so high? Because the benchmark, at the time, had a heavy weighting to U.S. Growth stocks, which were in a massive valuation bubble. Our GMO forecasts, in fact, were calling for negative returns for the S&P 500 (eerily similar to today). By dramatically underweighting the U.S. and dramatically overweighting cheaper pockets of the market, such as emerging, we expected to generate *excess* returns of 6.0% annually for the next seven years (note: the Strategy actually delivered excess returns of 7.9% annually for that seven-year period). We thought at the time that we would likely never see such a great opportunity again, given how ludicrous valuations had become.

Now, however, look at today's reading – this relative opportunity set is in line with what we saw 20 years ago. Why so high again? This time, U.S. markets are expensive. And we are in a global Growth bubble – the valuation disparity between global Growth and global Value is one of the widest we've seen in our investing careers. The benchmark, in other words, is chock full of expensive U.S stocks and expensive Growth stocks globally.

## *Quite a Bit to Do: Outlook and Positioning*

Our latest forecasts – a key component driving our asset allocation decisions – and our main positioning themes are highlighted below.

1. **We are leaning into Value across the globe.** As discussed, despite the good news on the Value vs. Growth front, the valuation gap is still at or near historic levels. And this observation is global in nature. As the valuation gap narrows, as it deserves to do, there is money to be made.

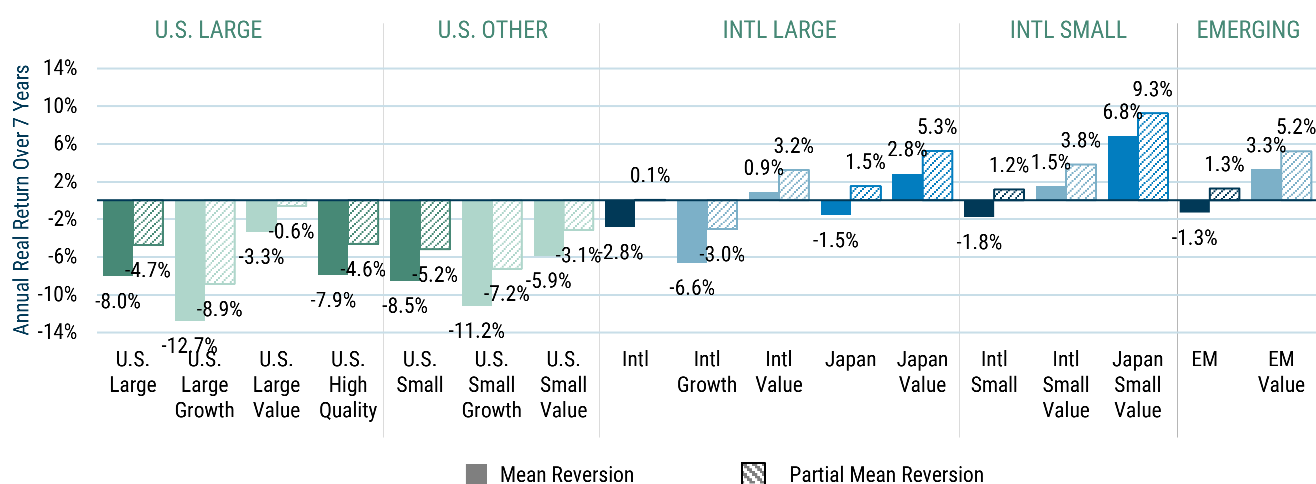
2. **We are leaning into non-U.S., where appropriate.** Stock prices not only reflect the present but also, more importantly, expectations of the future. The sad story of capital markets is that time and time again things never turn out as well as the market hoped nor as badly as the markets feared. Today, the U.S. is characterized by near-historic optimism, and that makes us – and it should make you – nervous. We are overweighting emerging markets and Japan Value, which look attractive in our latest forecasts.

3. **We are leaning into quality, explicitly and implicitly.** In the U.S. we have an explicit allocation to the GMO Quality Strategy. And implicitly, the underlying teams at GMO are, and have always been, concerned not just with naïve value – any machine can calculate a Price to Book ratio – but with a quality-adjusted way of looking at valuation.

4. **We are being opportunistic.** The allocation to a Quality Cyclicals[3] strategy in the summer of 2020 and the decision to allocate specifically to a Japan Value[4] strategy last fall are examples of how important it is to take advantage of situations when they appear, no matter how seemingly narrow and focused. While that statement is always true, it is particularly poignant in a world of generally overpriced assets.

## 7-YEAR GLOBAL REAL RETURN EQUITY FORECASTS

***7-Year Asset Class real return forecasts as of June 30, 2021***




Source: GMO
The chart represents real return forecasts for several asset classes and not for any GMO fund or strategy. These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. Forward-looking statements speak only as of the date they are made, and GMO assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual results may differ materially from those anticipated in forward-looking statements.

We firmly believe that valuation-sensitive investing will be rewarded. For those who still believe in Value, our current Equity Allocation strategies serve as a diversifying complement to long-only portfolios that have tended to tilt towards Growth in recent years. For those who have thrown in the towel on Value, our Value-leaning strategies can help hedge against the risk of cyclically poorer returns to Growth-oriented public and private equity portfolios after their decade of extraordinarily good returns. Thank you for your trust and partnership. We look forward to engaging with you in conversation in the year ahead.

Yours sincerely,

Ben Inker
*Head of GMO Asset Allocation*

3 The GMO Quality Cyclicals Strategy invests in leading cyclical businesses. Leveraging a long-term, disciplined approach to investing in high quality companies, GMO's Focused Equity team selects from a high-conviction universe of cyclical businesses that are of higher quality than their industry peers and are structurally underappreciated by the market. Times of elevated stress can create extraordinary opportunities in quality cyclicals.
4 GMO's Usonian Japan Equity team follows a disciplined, bottom-up approach using fundamental research to identify equities that are undervalued and profitable with high quality balance sheets. The team spends considerable time developing a high level of knowledge about companies and focusing on downside risk. Additionally, we engage collaboratively with corporate management to unlock shareholder value.

**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®) compliant presentation is available on GMO.com by clicking the GIPS® Compliant Presentation 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 compliant presentation. The above information is based on a representative account selected because it has the least number of restrictions and best represents the implementation of the strategy.

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