GMO
COMMENTARY

EQUITY DISLOCATION STRATEGY: REVIEW

Asset Allocation Team | August 2021

EXECUTIVE SUMMARY

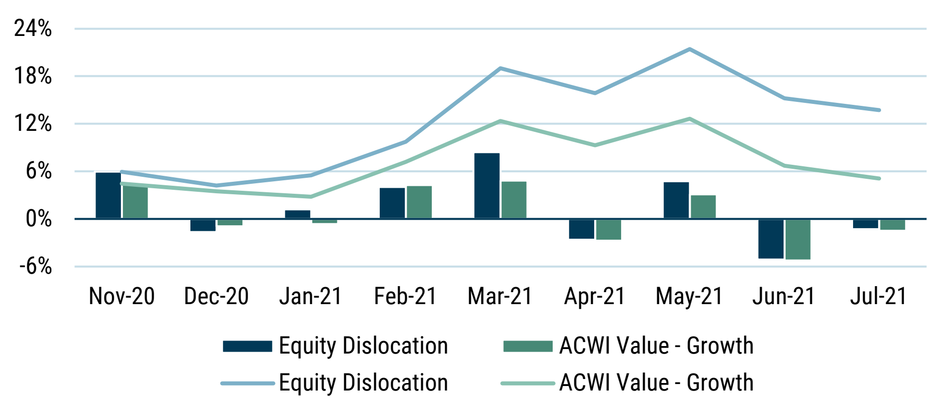
Since we launched the Equity Dislocation Strategy at the end of October 2020, the GMO Asset Allocation team has been delighted that many of our clients seem as genuinely excited about it as we are. Given the high ongoing level of interest, we felt that the nine-month anniversary of launch was an opportune time to share our current thoughts.

A Fantastic Start

The Irish phrase "Go n-éirí an bóthar leat," popularly mis-translated as "May the road rise to meet you," seeks to capture the sentiment of a successful, trouble-free journey where everything just falls smoothly into place. The first seven months in the life of the Equity Dislocation Strategy certainly felt a bit like that.

The main thesis of the Strategy is that the valuation spread between Value stocks and Growth stocks is absurdly wide. As the spread closes, this extreme dislocation in the market should provide one of the most exciting investment opportunities that we have seen in decades, and we believe it can deliver strong absolute return with little to no sensitivity to market movements. The green bars in Exhibit 1 show the monthly performance of the MSCI ACWI Value Index versus the MSCI ACWI Growth Index, and the strong relative returns from Value did indeed provide an extremely useful tailwind for our Equity Dislocation Strategy.

EXHIBIT 1: STRATEGY PERFORMANCE (NET OF FEES)



As of 7/31/2021 | Source: GMO

Encouragingly, strong security selection has been just as helpful as the backdrop of Value outperformance. Towards the end of 2020, the cheap long book drove relative outperformance, as many stocks that had suffered disproportionally at the hands of Covid-19 bounced back on the news of positive vaccine developments. In the spring of 2021, the short book added significant alpha, as egregiously expensive speculative names showed signs of cracking. Putting this together, the Equity Dislocation Strategy has had the very nice profile of capturing an average of 1.4 times the outperformance of Value versus Growth in the four positive months to date, while only suffering an average of 0.9 of the downside in the five months where Value lagged.

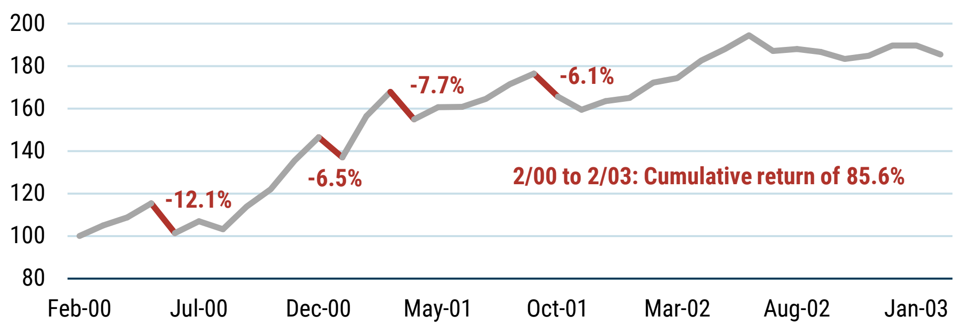
A Bump in the Road

The resurgence of Value appeared to grind to an unceremonious halt in June 2021. The inevitable speculation followed – that Value can only win if interest rates go up; that Value can only win if there is a seamless post-Covid reopening; or perhaps even that Value can't ever win again and it was all just a false dawn. We are a lot more sanguine than that. Quite simply, as much as we would love a trouble-free journey, an unwinding of a dislocation of this magnitude is going to come with bumps in the road. We have seen it all before.

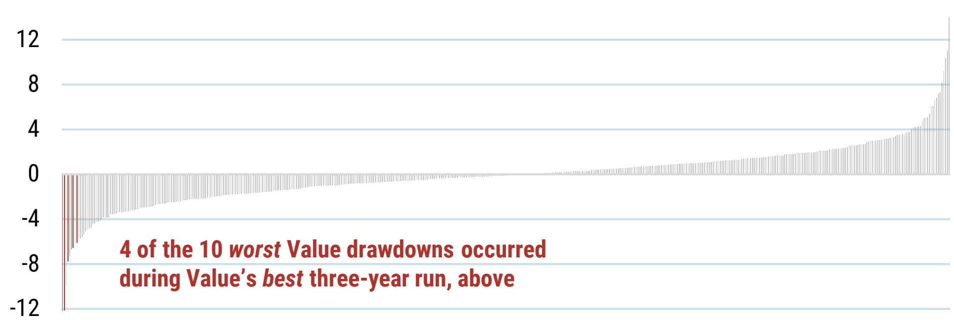
Exhibit 2 shows the three-year reversal of Value versus Growth in the U.S. from 2000 to 2003. Just as now, the valuation gap between Value and Growth had reached absurd levels by 1999 and mean reversion was inevitable. Not only would a long Value/short Growth portfolio have generated returns of around 86% in this timeframe, but it would have continued to be profitable for several years afterwards. However, it was not a straight line. When we look at the entire 40-year history of the Value versus Growth relationship in the U.S., four of the ten worst monthly drawdowns occurred during this period.

EXHIBIT 2: THE BEST 3-YEAR PERIOD FOR VALUE VS. GROWTH…ALSO SUFFERED SOME OF ITS WORST DRAWDOWNS

Value vs. Growth: The Best 3-Year Period in History (U.S.), 2000 to 2003



Value vs. Growth: Monthly Returns, Worst to Best, 1979 to 2021



Source: GMO
Value and Growth represented by the Russell 1000 indices, respectively.

A Little More Detail

The Strategy's 12.0% return, inception to July 31st, 2021, net of fees, remains nicely ahead of the 5.1% excess return of the MSCI ACWI Value Index over the MSCI ACWI Growth Index.[1]

This outperformance has predominantly been driven by excellent security selection in the long book, particularly within Consumer Discretionary and Financials. Selection in the short book has been broadly flat, with alpha generated in Industrials being offset by a challenging return in Consumer Discretionary. Interestingly, the securities in the short book markedly outperformed MSCI ACWI Growth for the first few months as speculative stocks continued to do well, but thankfully that has reversed recently as these stocks have come under pressure.

We are aware that there can be a reticence to short Growth stocks in case one ends up betting against "the next Amazon." Indeed, we have no quarrel with Growth stocks provided that they are priced sensibly, though this does appear to be the exception in today's markets. The short side of the Strategy is really trying to capture stocks where valuations are reflective of completely implausible growth expectations. For example, we have not been short any of the FAANGs since inception, as we do not consider them to be outrageously expensive, particularly relative to many other stocks in the universe.

Importantly, we are also broadly diversified, so performance is not unduly influenced by a handful of winning or losing securities. To give some context here, no less than eight of the short positions more than doubled in price over the period and, further, the biggest average short, Tesla, has seen performance just shy of 80%. Despite being short these very strong performers, our risk-aware approach towards portfolio construction has enabled the Strategy to post an absolute return of almost 14%. This focus on risk management will continue to be a key part of the process.

While we only have modest net country exposures, we allow net sector positions of up to 10% long or short. We don't want the Strategy to be simply a concentrated "Banks versus Information Technology" play, but at the same time we do want to recognize that there can be sizeable discrepancies in the valuations of different sectors. Inception to date, sector positioning has added some modest value, with a positive contribution from being overweight Financials mostly offset by being underweight Information Technology, which also performed well.

Current Opportunity

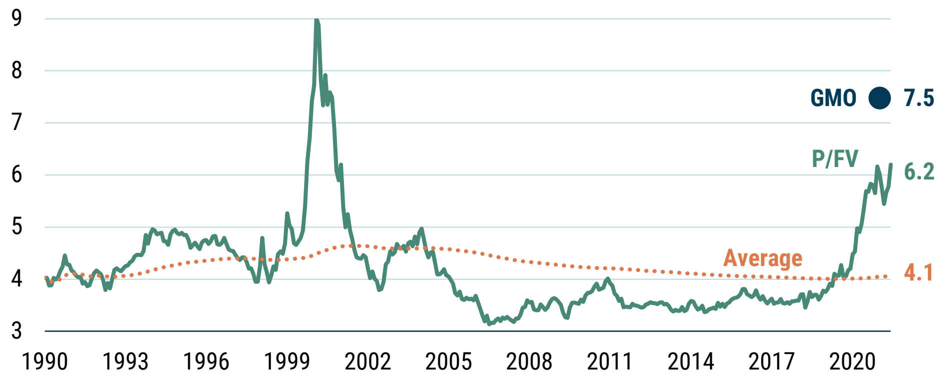
Although we are pleased by the very solid start the Equity Dislocation Strategy has enjoyed since inception, we believe that the opportunity set remains extremely compelling. Exhibit 3 shows the evolution over time of our Price to Fair Value metric, the ratio of the most expensive quintile of the MSCI ACWI universe to the least expensive quintile of the MSCI ACWI universe.

1
The excess return of MSCI ACWI Value versus Growth is calculated by compounding the monthly differences.

Final performance numbers are generally available on GMO's website five to ten business days after month end. Investors should not rely on preliminary numbers to make investment decisions. 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.

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®) 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.**

EXHIBIT 3: PRICE TO FAIR VALUE THROUGH TIME



As of 6/30/2021 | Source: MSCI, GMO
The P/FV ratio, shown as of 5/31/2021, is the P/FV of the most expensive quintile of the ACWI index divided by the P/FV of the cheapest quintile of the ACWI index, with P/FV calculated relative to country and weighted by the square root of market cap. As of 6/9/2021, the ratio of the P/FV of the short side of the Equity Dislocation Strategy over the long side of the Equity Dislocation Strategy was 7.5. Averages are calculated using harmonic means.

The outperformance of Growth over the last couple of months has just served to push the broad opportunity back to the levels we saw at the time we launched the Strategy at the end of 2020. Although we are running a very diversified portfolio with roughly 200 securities on both the long side and the short side, our Strategy is still more concentrated than the quintiles we have used to represent the broad opportunity, allowing us to focus on the cheapest stocks for the long book and the most expensive for the short book. The blue dot shows the significantly higher ratio of the Price to Fair Value of the short book to the long book of the Strategy.

We continue to have extremely high conviction in our investment thesis, which is why Equity Dislocation remains a key 20% position within our Asset Allocation team's flagship, unconstrained Benchmark-Free Allocation Strategy.

We would be delighted to speak with you further if you have any questions. Please do not hesitate to reach out to your GMO relationship manager or a member of our Asset Allocation team, or contact us for more information.

Disclaimer

The views expressed are the views of the GMO Asset Allocation team through the period ending August 2021 and are subject to change at any time based on market and other conditions. This is not an offer or solicitation for the purchase or sale of any security and should not be construed as such. References to specific securities and issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities.