GMO

MID-YEAR UPDATE: EQUITY DISLOCATION STRATEGY

Investing with Conviction amid Speculative Fervor

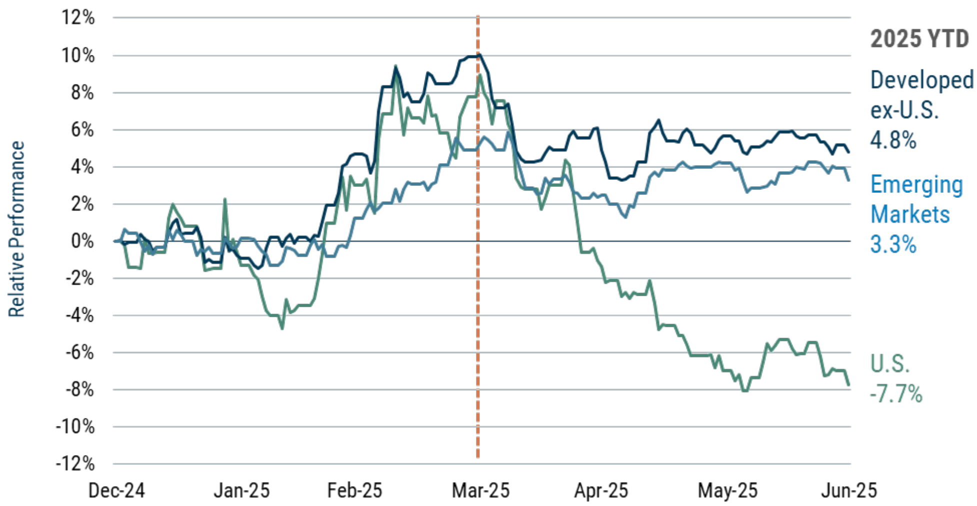
July 2025

Introduction

Value enjoyed a strong start to 2025, until a whiplash in investor sentiment, buying the dip in growth equities and then chasing momentum in expensive names, dramatically reversed the performance advantage.

For the six months ending June 30, 2025, MSCI ACWI Value beat MSCI ACWI Growth by a modest 1.6%, although value was considerably farther ahead until growth won by 11.5% in the second quarter. This speculative rally ignored several higher-quality mega-cap names (Apple and Alphabet were down -17.9% and -6.7% respectively for the period) and, without them hampering returns, growth beat value by 1.0% YTD on an equally weighted basis.

DEEP VALUE – EXTREME GROWTH



As of 6/30/25 | Source: GMO

Square root market-cap-based groups. Deep Value is the cheapest 20% on Composite Value. Extreme growth is the most expensive 20% on Composite Value. MSCI data may not be reproduced or used for any other purpose. MSCI provides no warranties, has not prepared or approved this report, and has no liability hereunder. Please visit https://www.gmo.com/americas/benchmark-disclaimers/ to review the complete benchmark disclaimer notice.

Equity Dislocation's Short Book Cost Performance in the Speculative Rally

Equity Dislocation is a long/short strategy designed to profit from the ongoing extraordinary dislocation between value and growth equities. An environment in which extremely speculative, expensive growth (the very stocks that Equity Dislocation is targeting for short positions) does well will always be challenging for performance. In the first half of 2025, Equity Dislocation's short book returned 17.5% versus the MSCI ACWI Growth return of 9.3%.

We recognize a certain appeal to "buying the dip," particularly when some of these companies, like Roblox and Carvana, delivered solid earnings and optimistic guidance. However, the stock price reaction of many of these names appears bizarrely optimistic in our view. The ten biggest individual detractors from performance in the short book had a somewhat staggering average return of 104% for the period. This seems to be the very definition of a speculative rally.

Exploring this a bit further, the biggest individual detractor, Palantir Technologies, was up 80.2% YTD, leaving it with broadly the same market capitalization as Bank of America or Coca-Cola. Palantir now trades at a remarkable price-to-sales ratio of 110x. To put this in context, in the craze of the dot-com bubble, Amazon traded at a high of 43x sales, Microsoft reached a high of 30x sales, and Sun Microsystems hit a much less extreme (but still elevated) 10x sales.

We included Sun in that exalted group because a couple of years later, then-CEO Scott McNealy threw out one of our favorite investment-related quotes:

> *"At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?"*

Of course, we don't talk about Sun Microsystems anymore because it was just one of the many darlings of the tech bubble that never really recovered once the bubble burst and was acquired by Oracle in 2010.

It is much harder to find cautionary tales about companies that trade at 100x sales because they are rarer than hen's teeth. However, Zoom did just about hit a valuation of 100x sales during the pandemic, and the stock is now down about 90% from that peak despite significant growth in the business.

Some of the names that have run up inordinately so far this year are in diverse industries such as IT Services, Software, Entertainment (Communication Services), Specialty Retail (Consumer Discretionary), Biotech (Health Care), Utilities, and Electrical Equipment (Industrials).

Equity Dislocation's meaningful net short position in **Aerospace and Defense** was a meaningful detractor, costing about 2% of performance for the first six months of the year. Although we believe the performance is overly exuberant, dismissing it as part of the speculative rally would be too convenient. Given fraught geopolitics around the globe over the last number of years, Aerospace and Defense companies had been bid to very high valuations, hence our sizeable short position.

Outside of the U.S., these companies enjoyed another surge in share prices in 2025 as many governments committed to increased defense spending. Although this commitment undoubtedly increases the fair valuation of defense companies, our model still believes that many are trading at extremely stretched valuations.

Equity Dislocation's Long Book Performed Pretty Well, Actually

The Equity Dislocation long book returned 13.8% for the period, nicely ahead of the MSCI ACWI Value return of 10.9%. In a disappointing period for performance, we don't want to dwell too much on successes, but:

- **Banks.** The industry group that was the most additive in the first six months of 2025 was Banks, a textbook deep value position. Our 8% net long exposure to this group and strong stock selection added a little over 3% for the period.
- **Tariffs.** The Equity Dislocation long portfolio is more exposed to tariffs than the short portfolio, but we are comforted by the valuation discount to fair value. Indeed, after a tough time earlier in the year, it is heartening that our net long positions in areas like Automobiles and Marine Transportation rallied and contributed positively to YTD performance.

Strong Return Potential Ahead

Equity Dislocation remains the biggest single exposure in Benchmark-Free Allocation, our flagship unconstrained multi-asset strategy. We believe the current turmoil and volatility in markets will eventually, and inevitably, cause investors to question the high, "priced for perfection" valuations that many growth stocks are trading at. Conversely, many of the stocks in the long portfolio are priced very favorably and only need modest outcomes to deliver on their potential. Identifying the timing or catalyst for a normalization in value spreads remains elusive, but we firmly believe we will be paid to be patient. Valuation spreads remain historically wide: globally, value still needs to outperform growth by more than 60% for relative valuations to return to long-term averages. While Equity Dislocation stands to benefit handsomely from a narrowing of relative valuations, we believe the portfolio can still deliver attractive returns as long as spreads do not widen due to rebalancing (the continual reconstitution of the groups favors value).

Annualized Returns as of 6/30/2025 (Net, USD)	*Inception*	*1-Year*	*3-Year*	*5-Year*	*10-Year*	*ITD*
GMO Equity Dislocation Composite	10/31/2020	-10.11	-1.86	N/A	N/A	5.56
FTSE 3-Month T-Bill		4.88	4.75	N/A	N/A	3.08

Performance data quoted represents past performance and is not predictive of future performance.
Gross returns are presented gross of management fees and any incentive fees if applicable. Gross returns include transaction costs, commissions, withholding taxes on foreign income and capital gains and include the reinvestment of dividends and other income, as applicable. If management fees were deducted performance would be lower. Net returns are presented after the deduction of a model advisory fee. Net 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. MSCI data may not be reproduced or used for any other purpose. MSCI provides no warranties, has not prepared or approved this report, and has no liability hereunder. Please visit https://www.gmo.com/americas/benchmark-disclaimers/ to review the complete benchmark disclaimer notice.

Disclaimer
The views expressed are the views of the GMO Asset Allocation team through the period ending July 2025 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.