QUARTERLY INVESTMENT REVIEW

Quality Cyclicals Fund

RETURNS (%) (USD)

	Cumulative (%)		Annualized (%)				
	QTD	YTD	1 Year	3 Years	5 Years	10 Years	ITD
Net of Fees (Class VI)	4.04	15.16	20.98	16.46	–	–	18.86
Gross of Fees (Class VI)	4.15	15.39	21.47	16.92	–	–	19.33
MSCI ACWI	6.18	13.93	16.53	11.00	–	–	13.48
Value Added (vs. MSCI ACWI)	-2.14	1.22	4.45	5.46	–	–	5.37

Major Performance Drivers

The Quality Cyclicals portfolio generated a solid return this quarter but lagged the MSCI ACWI.

This was not an environment in which one would expect a cyclicals portfolio to prosper. Market returns were concentrated in three GICS sectors and were driven by a handful of star performers, each with a technology angle. Information Technology was the leader, with Apple, Microsoft, and Nvidia making the largest contributions to the sector's returns. Next came Consumer Discretionary, propelled by Amazon and Tesla. In third place was Communication Services with Meta and Alphabet making outsized returns. These seven highlighted companies also happen to comprise the top seven slots in the MSCI ACWI index, and the portfolio's positioning in these names accounted for approximately three quarters of the relative performance shortfall.

The biggest corporate news story of the quarter concerned Nvidia and the extraordinary demand for its artificial intelligence (AI)-oriented GPU chips from datacenter customers as markets processed the rapid improvement in Large Language Models (LLMs) and AI. As a result, consensus estimates for this year's revenues jumped by more than 40%, a seriously unusual leap for a company of Nvidia's scale. Nvidia was the strongest large cap globally over the quarter as a result.

The portfolio's exposure to AI comes mainly from Meta and Alphabet. Neither are held with this as an explicit rationale, although the purchase of Meta in Q4 2022 was motivated by our perception that Meta's investment in AI was likely to pay off in terms of better targeting within its advertising business (alongside the perceived cyclical issues in digital advertising affecting both Meta and Alphabet). Subsequent events have vindicated this view and while Meta's prospects have become clearer, with greater optionality from AI than we had envisaged, the share price has moved forward rapidly since and we took some profits this quarter. Alphabet has leading AI capabilities having invested in the area over many years, and their data centers are likely to benefit from increased use of LLMs, given the enormous processing power required.
We would expect that companies such as holding Lam Research, involved in the manufacturing of the chips required to build the LLMs and to generate the inferences that are needed as they are deployed, will likely benefit from increased use of AI too. Elsewhere in the semiconductor space, the portfolio holds memory chip specialist Micron, and this quarter we added exposure to Texas Instruments. We regard Texas Instruments as an archetypal quality cyclical with a market leading position in analog semiconductor manufacture and a track record of strong and, when necessary, counter-cyclical discipline in capital allocation.

Performance data quoted represents past performance and is not indicative of future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance data may be lower or higher than the performance data provided herein.

Major Performance Drivers Cont.

We continue to view your portfolio through the lens of three classes of holdings. This quarter the core and reopening classes performed approximately in line with the broader markets, while the China basket performed poorly. The thesis behind your Chinese positions was partly based on an expectation of a rebound in China's animal spirits post-lockdown. This effect has been slower to materialize than in the developed countries and, after a burst last year and in January, Chinese assets have been weak. In hindsight, that is perhaps understandable as developing countries had less scope to prop up consumer balance sheets during the lockdowns and, as a result, Chinese consumers are still in the mode of rebuilding their savings.

Progress is still discernible, however. Macau gaming revenue, for example, continues to rebound rapidly, now approaching two-thirds of the corresponding 2019 quarterly rate, up from less than half in the first quarter, supporting your investments in Las Vegas Sands and Galaxy Entertainment.

International airline passenger data from IATA demonstrated continued improvement in the Asia Pacific region as a whole, which, like Macau activity, tracked back to around two-thirds of 2019 levels in May (far behind the other regions). We initiated a position in General Electric – no longer a conglomerate but increasingly focused on jet engines. GE has a joint venture with portfolio company Safran but in addition plays a key role in the wide-bodied jet engines used for long-haul flying and is thus more indexed to Asian aviation developments.

We also added to quality U.S. positions that have been under cyclical stress. We began to buy back U.S. Bancorp, having been in selling mode over prior quarters. We believe that the market's connection of U.S. Bancorp to recent regional banking issues was overdone and were able to purchase some stock in this well-run bank at close to book value – a deep discount to recent norms. We added to Micron in the semi-conductor space at what we suspect is closer to the bottom of its inventory cycle. We added to CarMax, the leading American used car dealer. CarMax has some commonality with your holding in Intercontinental Exchange, despite the rather different industry, in building a leading tech platform that enables other companies to participate in transactions with their customer base, as ICE is doing in the mortgage market. The used car business is in the doldrums, but CarMax has managed its way through cycles in the past and pleased the market at results time by signaling that its technology investment requirements have likely peaked.

Major Performance Drivers Cont.

We continue to believe that your portfolio offers the opportunity to participate in the long-term fundamental returns of leading cyclical businesses, and to benefit from the valuation gaps that can arise as the market reappraises their prospects in the light of cyclical hopes and fears.

Portfolio weights, as a percent of equity, for the positions mentioned were: Meta (2.2%), Alphabet (2.3%), GE (1.0%), U.S. Bancorp (1.8%), Texas Instruments (1.3%), Lam Research (2.6%), Micron (2.1%), Intercontinental Exchange (3.1%) and Carmax (1.4%).

PRODUCT OVERVIEW

The GMO Quality Cyclicals Fund seeks to generate total return by investing in leading cyclical businesses. Leveraging their 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. The team believes that quality cyclical businesses are structurally underappreciated by the market and that times of elevated stress can create extraordinary opportunities in quality cyclicals.

ABOUT GMO

Founded in 1977, GMO is a global asset manager committed to delivering superior performance and advice to our clients. We are privately owned, which allows us to singularly focus on our sole business – achieving outstanding long-term client investment outcomes. Offering multi-asset, equity, fixed income, and alternative strategies, we invest with a long-term, valuation-based philosophical approach.

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