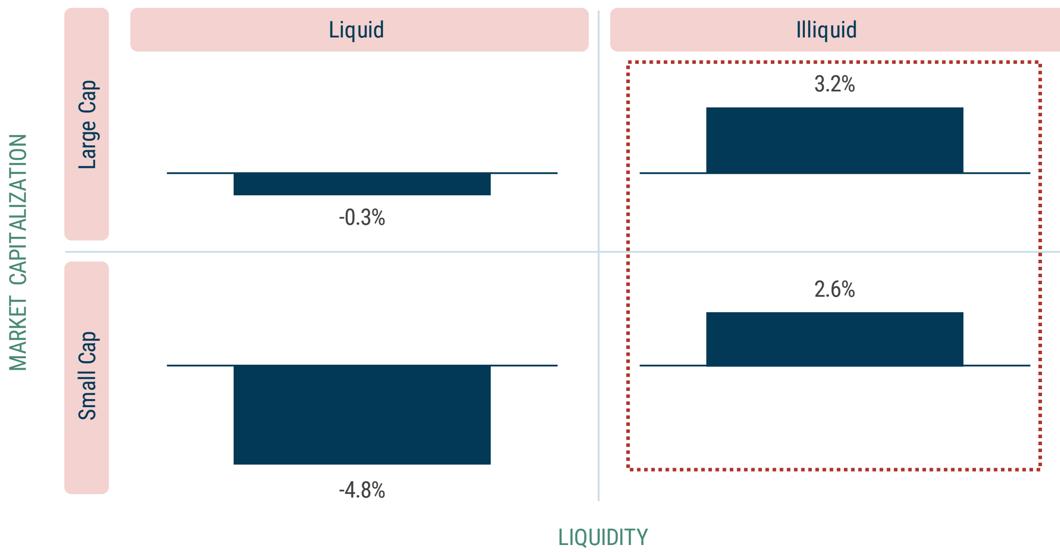
EMERGING LIQUIDITY PREMIUM STRATEGY

The Opportunity

There is no free lunch. An investor purchasing something illiquid has, by definition, just given up on the ability to quickly dispose of the asset. This illiquidity premium, a very enticing 3% per year since 2000, is related to, but *not* the same as, the small cap premium. In fact, the overlap between the illiquid and small cap universes is less than 50%. The matrix in Exhibit 1 below makes the contrast clear. The return premium has been in illiquid (right column) and not in small cap (bottom row). Investing in the liquid part of small cap (bottom left) has actually detracted approximately 4.8% relative to the MSCI Emerging Markets Index annualized since 2000.

EXHIBIT 1: PERFORMANCE RELATIVE TO MSCI EM (1/31/00 – 9/30/18)



The GMO Solution

Not surprisingly, attempts to capture the illiquidity premium by industry standard investing/trading structures cost so much that it effectively cancels the premium offered. Our solution allows us to extract this premium, leading to a unique investment opportunity in illiquid, publicly traded names while avoiding the long lock up of private equity.

Get the penny right and the pound will take care of itself:

Each of our illiquid strategy components - product structure, alpha signals, and trading style - is designed to leave as light a footprint on the liquidity surface as possible.

We have strict controls on capacity and require advance notification for purchases and redemptions. The alpha signals used (more detail is provided below) have a long horizon, low turnover, and encompass many names. The traders, a high touch team focused on hard to trade securities, are given a long list of buys/sells and have flexibility along both dimensions: time to completion and which names to trade. This allows them to exploit all sources of liquidity (which could vary by stock) and play the waiting game to the limit.

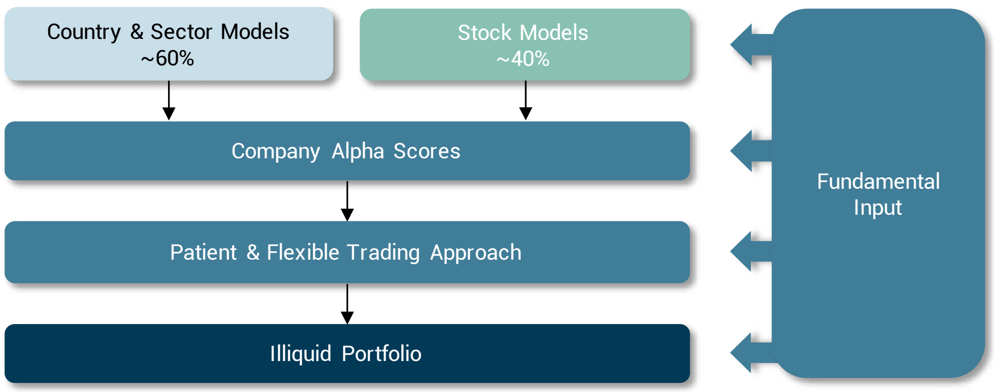
Be Not Afraid of Illiquidity:

Emerging markets small cap is at the periphery of equity investing for most clients. Emerging Liquidity Premium is a step further removed in awareness and comfort. But, illiquidity is not a proxy for factors such as size or value or momentum or beta to the market. We adjusted for these factors in our analysis and found that the return accruing to illiquidity is essentially unchanged.

Another comforting aspect is that the worst drawdown associated with illiquid stocks since 2000 was no worse than that suffered by the liquid part of the market.

Value Is the Heart of Everything We Do:
Our alpha models begin with detailed, company-level data and then distill the financial information into what really matters, the discounted sum of sustainable, distributable cash flows. We incorporate country and sector specific signals and give them a greater weight than stock selection. We believe that a quantitative approach to modeling minimizes emotion and leads to more consistent returns. Collaboration with the fundamental team, refined over 20 years, ensures that these models are based on economics rather than econometrics.

EXHIBIT 2: INVESTMENT PROCESS



The Client Fit

As an emerging equity portfolio combining fully active signals with a secular underlying premium, the GMO Emerging Liquidity Premium Strategy is a unique approach with the potential to diversify existing core emerging market and global equity portfolios. Our research has shown that exposure to illiquid names is underrepresented in many investment portfolios, even those with dedicated emerging small cap allocations.

Who We Are

Founded in 1977, GMO is a private partnership whose sole business is investment management. The firm manages global portfolios with offices and clients around the world. Investment offerings include equity, fixed income, multi-asset class, and alternative strategies. GMO is known for blended fundamental and quantitative investment research expertise and a long-term orientation toward value opportunities.

The Team

Warren Chiang and Arjun Divecha are the portfolio managers for GMO's Emerging Liquidity Premium Strategy. Warren Chiang, a firm partner, has over 20 years of industry experience and heads the quantitative division of the broader 25+ member GMO Emerging Markets Equity team. Arjun Divecha, a firm partner and Board member, founded the team in 1993 and is widely considered a pioneer of fundamentally based, quantitative portfolio management. GMO's emerging markets quantitative effort encompasses a wide array of disciplines including quantitative modeling, portfolio optimization, and data science. The team has a global footprint, with investors in GMO's San Francisco, Singapore, and Boston offices.

RISK

Risks associated with an investment in the Strategy may include Market Risk - Equities, Non-U.S. Investment Risk, Currency Risk, Management and Operational Risk, and Illiquidity Risk.

40 Rowes Wharf | Boston, Massachusetts 02110
(617) 330-7500 | www.gmo.com