QUALITY STRATEGY

Quarterly Investment Review

PRODUCT OVERVIEW

The GMO Quality Strategy seeks to generate total return by investing primarily in equities the Focused Equity team believes to be of high quality.

The team believes that companies with established track records of historical profitability and strong fundamentals – high quality companies – are able to outgrow the average company over time and are therefore worth a premium price. The Strategy's disciplined approach uses both quantitative and fundamental techniques to assess the relative quality and valuation of global companies and aims to exploit a long-term investment horizon while withstanding short-term volatility.

MAJOR PERFORMANCE DRIVERS

Despite a worrisome drumbeat of gloom from AI and geopolitics, this quarter turned out to be a pretty normal sort of quarter for global stock markets, with markets returning 2.3% per the S&P 500 and 1.9% per the MSCI World.

The GMO Quality portfolio outperformed the broader markets, and the portfolio's defensiveness reasserted itself. The portfolio returned a little less than the benchmarks during the strong spell that began in the last few days of July and more than made up for it in the soggy patches. This was in line with the experience of the last decade or so, but in contrast with the first half of 2026, when investors focused intensely on Energy (in Q1) and AI winners (in Q2).

Leveraged market participants had been amongst the most enthusiastic backers of the AI winners – long the semi-conductors and data center-focused capital goods companies – often funded by shorting software businesses and no doubt contributing to H1's "SaaS-pocalyse". The portfolio took the other side, trimming semis gradually until July, while diversifying and adding new positions in software and software-related businesses.

The subsequent sell-off in AI winners that began this quarter pressured those hedge fund long/short positions – most notably in the case of the Situational Awareness fund, which was rescued/decapitated by Citadel after its book appeared to have spun out of control. All this led to some intense reversals in performance by market segment.

Software stocks were the standout - far outperforming other industries - with Salesforce and Accenture leading the pack, each up approaching 50%. We trimmed both, with the proceeds partially spread across other software names.

The reversal in the direction of relative performance was not limited to Technology. Health Care stocks also saw their fortunes change after a limp first half. The biotech industry appears to be turning upwards, finally, benefiting the portfolio's holding in Thermo Fisher, a provider of life science tools and services that enable drug development. While pharmaceutical stocks generally outperformed too, Merck's gains were more idiosyncratic, coming from promising clinical results from their work with Moderna, which uses mRNA technology to create an individualized cancer vaccine. Our sense was that the market rushed to price in the still rather uncertain future cash flows from this project, and we pared back the portfolio's exposure.

We liquidated the portfolio's position in Haleon, where neither margins nor growth have lived up to expectations post-carveout from GSK, allocating instead to medical equipment company Stryker. Stryker's comprehensive portfolio of hospital products and its installed base of robotic joint replacement systems give it a deliciously unfair sales advantage that has potentially been overlooked as the company deals with a cyberattack and manufacturing issues at a recent acquisition, neither of which we expect to have a long-lasting impact.

A pattern is evident in the trades noted above – portfolio rebalancing generally skews towards the reactive. Although the team's number one priority is quality, we regard valuation as an important consideration, and as a result, we prefer to give the market what it wants in terms of liquidity when we trade – we tend to do our selling when others are buying, and vice versa. There is a tension here between riding winners/cutting losers (long-term correct) and keeping an eye on valuation (also long-term correct). We try to resolve the conflict by selecting companies that we hope to hold for the long-term and thus keeping overall turnover relatively low (c. 20% a year over time, with some variation according to the opportunity set and cross-sectional volatility across the market), while using significant changes in valuation to reshape the portfolio, either incrementally or in terms of liquidations and additions.

We made three additions to the portfolio in this vein over the quarter. We already mentioned Stryker. Our valuation antennae also began to jingle this quarter around Home Depot and Martin Marietta. We have followed these businesses for some time, having owned each in offshoots of the Quality portfolio at times over the last few years.

Home improvement retailer Home Depot had a good lockdown, growing rapidly for a couple of years, but has been suffering a hangover since. Home Depot has a scale-driven business model that increasingly emphasizes professional supplies, services, and trade distribution alongside its better-known retail front end. Rising mortgage rates have weighed on the company's shares this year, and we believe the stock represents good value, anchored by a structural desire for homeownership and the perpetual proclivity of those homeowners to maintain and upgrade their primary asset. When a great business trades at a good price, we are inclined to let the cycle take care of itself (to a point – we could allocate more in a more marked downturn).

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Quarterly Investment Review

MAJOR PERFORMANCE DRIVERS CONT.

Martin Marietta is the largest supplier of building aggregates - crushed stone, gravel, etc. - in the United States. This is the first Quality portfolio investment in the Materials sector in over a decade. Quarries are capital intensive, and it can be hard to get the environmental permits to start a new one. Aggregates are low-value per unit of weight and tend to be purchased locally to reduce transport costs. Martin Marietta's business is therefore built around natural local oligopolies and substantial mineral reserves, with solid pricing power alongside occasionally erratic volume. This year, the company agreed to acquire the U.S.'s largest lime producer, a deal with interesting possibilities for synergies as lime production creates aggregates as a waste product, one that Martin Marietta can deploy thoughtfully. The market reacted negatively to the deal, which will close at full price (if you ignore the synergies, that is), but we believe that both the combination and the stock look compelling.

Both of these purchases increase the cyclicality of the portfolio at the margin. We continue to build your portfolio from the bottom up, but note that the portfolio's allocation to each of energy, materials, real estate, autos, banks, insurance, and industrials – i.e., nearly all the most cyclical parts of the market - is relatively low. There is thus further room to allocate to a select group of quality cyclical businesses should they become more attractively priced. In the meantime, your portfolio remains allocated to high-quality business models that are inherently defensible and continues to represent a constructive way to invest across equity markets – this quality should be a welcome characteristic if that worrisome drumbeat continues to get louder.

Portfolio weights, as a percent of equity, for the positions mentioned were: Salesforce (1.0%), Accenture (1.1%), Thermo Fisher (4.7%), Merck (1.6%), Haleon (0%), Stryker (0.9%), Home Depot (0.5%), and Martin Marietta (0.5%)

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PRELIMINARY ANNUALIZED RETURNS (USD, %) (QUARTER-END)

	Quarter-End	YTD	1-Year	3-Year	5-Year	10-Year	Since Inception
Quality Strategy (net)	4.32	9.88	16.79	20.32	13.23	15.72	10.75
Quality Strategy (gross)	4.49	10.39	17.52	21.07	13.93	16.39	11.32
S&P 500	2.30	12.75	15.74	22.88	13.79	15.33	10.85
Value Add vs. S&P 500	+2.02	-2.86	+1.05	-2.57	-0.57	+0.39	-0.10
MSCI World	1.88	11.75	15.24	21.40	11.89	12.81	8.97
Value Add vs. MSCI World	+2.45	-1.87	+1.55	-1.08	+1.34	+2.91	+1.78

RISKS

Risks associated with investing in the Strategy may include: (1) Market Risk - Equities: the market price of equities may decline due to factors affecting the issuer, its industries, or the economy and equity markets generally. Declines in stock market prices generally are likely to reduce the net asset value of the Fund's shares; (2) Management and Operational Risk: the risk that GMO's investment techniques will fail to produce desired results, including annualized returns and annualized volatility; and (3) Focused Investment Risk: the Fund invests its assets in the securities of a limited number of issuers, and a decline in the market price of a particular security held by the Fund may affect the Fund's performance more than if the Fund invested in the securities of a larger number of issuers. This is not a complete list of risks associated with investing in the Strategy. Please contact GMO for more information.

Composite Inception Date: 29-Feb-04

***Preliminary Performance: Final performance numbers are generally available on GMO's website within fifteen business days after month end. Investors should not rely on preliminary numbers to make investment decisions.**

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IMPORTANT INFORMATION

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The above information is based on a representative account in the Strategy selected because it has the fewest restrictions and best represents the implementation of the Strategy.

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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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*GMO's West Coast Hub is comprised of members of Investment, Global Client Relations, and other teams located in and around the Greater San Francisco area
**Representative Office