

# QUARTERLY INVESTMENT REVIEW

## Quality Strategy

### RETURNS (%) (LOCAL)

	Cumulative (%)		Annualized (%)				
	QTD	YTD	1 Year	3 Years	5 Years	10 Years	ITD
Net of Fees (Composite)	-4.26	15.71	26.85	11.71	11.03	12.99	9.32
Gross of Fees (Composite)	-3.99	16.67	28.23	12.61	11.79	13.66	9.90
S&P 500	-3.27	13.07	21.62	10.16	9.92	11.92	9.11
MSCI World	-3.46	11.10	21.95	8.09	7.26	8.27	7.19
Value Added (vs. S&P 500)	-0.98	2.64	5.23	1.56	1.11	1.07	0.21
Value Added (vs. MSCI World)	-0.79	4.61	4.89	3.63	3.77	4.72	2.14

### Major Performance Drivers

In recent conversations with investors, we have noted some consistent themes, so we thought it would be helpful to structure this quarter's commentary as a Q&A session drawing on a composite of those engagements.

#### What were the drivers of performance this quarter?

Equity markets had a weak quarter, falling -3.5% from a USD perspective. Most sectors delivered negative returns. The Quality Strategy has always had favored habitats – companies with barriers to entry, long-term relevance, and capital discipline are not spread evenly across global markets. This quarter, a lot of the market action was in sectors that the Quality Strategy doesn't currently participate in.

Oil stocks were the notable exception to falling prices, ahead of broader markets by a full 15 percentage points. We have not found sufficiently high-quality names here in recent years so had no exposure to this quarter's best source of return. Balancing that, Real Estate and Utilities, where we also tend not to find distinctive business models and so were also zero weighted, were amongst the weakest returners this quarter as interest rates rose.

The portfolio couldn't escape the broader equity market malaise. The brightest spots in the portfolio came from company-specific progress for Eli Lilly, in terms of results and listings for its Mounjaro obesity treatment, and from some U.S. domestic names benefitting from dollar strength, e.g., UnitedHealth and U.S. Bancorp, both of which generate substantially all their revenues from within the U.S. The weaker returns came from growthier names in the portfolio in Technology and Health Care, and from industrial cyclicals Otis and Knorr-Bremse, which each have some exposure to continued weakness in the Chinese economy alongside their other revenues.

#### Are markets expensive and rolling over?

The U.S. market trades at 19.0x forward earnings, very close to the 10-year average and just a turn above the 25-year average of 18.0x. The MSCI World index trades on 16.7x forward earnings, a turn below the 10-year average of 17.7x and 25-year average of 17.9x. This is not obviously the backdrop for an overvalued market. Some of our GMO colleagues make the perfectly reasonable case that this wasn't a normal 25 years from a rates perspective or even a margin perspective, but we prefer not to pick that fight – our preference is to stay fully invested, allocating investment to companies that we think will deploy their capital productively. Markets will ebb and flow from here of course, and current weakness could easily continue, but the starting point is a pretty normal one in terms of multiples.

Inception Date: 6-Feb-04

**Risks:** Risks associated with investing in the Strategy may include Market Risk - Equities, Management and Operational Risk, Focused Investment Risk, Non-U.S. Investment Risk, and Currency Risk. Returns shown for periods greater than one year are on an annualized basis. To obtain performance information to the most recent month-end, visit [www.gmo.com](http://www.gmo.com). **Performance Returns:** 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 included in the Important Information section at the back of this presentation. 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. 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. These 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 and incentive fees were deducted performance would be lower. For example, if, before fees, the strategy were to achieve a 10% annual rate of return above its hurdle rate each year for ten years, and an annual advisory fee of 1% and incentive fee of 20% of net returns above the hurdle rate were charged during that period, the resulting average annual net return (after the deduction of management and incentive fees) would be approximately 7.20%.

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## ***Major Performance Drivers Cont.***

Is the growth run over?

Just because the market aggregate multiples are normal looking, we can't make assumptions about the underlying parts of the market. After a torrid 2022, Growth stocks have rebounded nicely this year, at first from the pendulum swinging back post-sell-off, and then turbocharged by excitement over AI, etc. Growth has outperformed Value globally per MSCI by almost exactly 20 percentage points in the first three quarters of 2023. Partially as a result of this, and partly due to stock selection, the Growth names in the portfolio had swelled to a little over 40% of the total weight. Naturally the strong market for these names has made the valuations for Growth stocks a little less compelling on average, given that our fundamental expectations for most stocks haven't changed dramatically. We therefore have taken the opportunity to sell some stock at these levels. The portfolio's Tech holdings remain reasonably valued, consistent with rewarding shareholders, but just a bit less enticingly priced than they were at times in 2022.

Where do you see buying opportunities?

If part of the market has won by a lot, that ought to create relatively more attractive valuations elsewhere. Traditionally, Consumer Staples companies have been a key part of our portfolio – for decades they were able to deploy capital at a high rate of return due to competitive advantages in distribution and branding. In recent years there have been some concerns as to whether digital marketing would enable upstart products to eat into the larger Staples companies brand advantage. While this has happened to a degree, in practice, the FMCG giants have had to develop digital marketing muscles of their own, and their distribution advantage remains largely in place. However, we reduced the strategy's exposure to Consumer Staples several years ago largely because their multiples had crept higher, and for their prospective fundamentals, the stock pricing was on average simply less compelling than for alternatives, for example, in software.

The last couple of years of supply chain havoc and inflationary pressure on raw materials has created some opportunities in Consumer Staples today. This quarter we added to Diageo, a global leader in the drinks segment, where we believe that a valuation opportunity has been created by a change in leadership (forced by ill health), some margin pressure, and concerns about softening demand in some of its major spirits markets. Aside from Staples, we also made additions to several Health Care positions that are priced more attractively than they had been.

But you're selling Eli Lilly though?

Eli Lilly has been something of a special case in our Health Care holdings and has performed extraordinarily well over the last couple of years. We bought Eli Lilly after a short bout of stock weakness in 2019, on an unexceptional multiple for a pharmaceutical company. The logic was that Lilly had a promising looking pipeline for diabetes treatment but was far behind market leader Novo Nordisk in terms of diabetes revenues. It now has the most efficacious GLP-1 drug for treating not only diabetes, but obesity also. And promising trials are in place to treat related cardiovascular, kidney, and liver diseases. As a result, Eli Lilly's stock has been comprehensively rerated. The company must now execute well on capturing the much wider TAM to deserve its lofty rating – we have no reason to think it cannot but believe that we can reduce portfolio risk by reallocating some of those gains and thus took some profits this quarter.

How do you think about the impact of macroeconomics on the strategy?

We do not spend much time trying to forecast rates, currencies, or other macroeconomic parameters – we lean heavily on diversification, and rather than try to forecast developments in that space, we seek to react to the valuation opportunities that they can create.

The U.S. dollar had a strong quarter, with the DXY dollar index retracing about half of the ground lost since Q4 2022. There was some correlation between portfolio stock performance and the dollar – given that many of the names in the portfolio are multi-national, global businesses, it was notable that the weakest three performers, Amadeus, Knorr-Bremse, and LVMH each had only around 25% of revenues from the U.S. The effect also manifested in the consumer space, where the portfolio's more domestic U.S. holdings (Constellation Brands and TJX) were among the best returns while the more global holdings struggled. The portfolio has diversified sources of revenue generation (as does the S&P 500, frankly) and while there will be times when exposure to the dollar is helpful, we do not seek to maximize it.

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## **Major Performance Drivers Cont.**

Long rates rose steeply this quarter, at a similar pace to the first three quarters of 2022 that caused havoc to (the perception of) Growth stocks. Growth stocks also underperformed this time, too. So did the more interest rate sensitive sectors – Utilities, Telecoms, Consumer Staples. Financials, which – to oversimplify – benefit from rising rates, outperformed and we think they are a helpful addition to our portfolio in that regard.

At the margins, we prefer to lean into stock price weakness related to macro effects and this takes us back to the Consumer Staples. Diageo, for example, generated only 36% of sales in the U.S. last year (and so has been swimming against the currency tide) and has a bond proxy characteristic due the relative stability of its revenues (thereby not helped by rising bond yields), further explaining the undemanding share price, and hopefully strong prospective returns, for Diageo today.

What is the outlook from here?

While we don't attempt to forecast the market, we believe that the portfolio is priced to deliver reasonable returns from here. We would expect returns to tend toward the superior long-term fundamentals of the companies in the portfolio. Historically quality stocks have held their own in terms of inflation. Furthermore, the portfolio has typically offered a certain amount of protection in the face of falling markets, owing to the strategy's twin assessments of valuation and quality that differentiate it from many of its peers.

Portfolio weights, as a percent of equity, for the positions mentioned were: Eli Lilly (2.5%) UnitedHealth (5.4%), U.S. Bancorp (1.9%), Otis (1.9%), Knorr-Bremse (0.4%), Diageo (1.1%), Amadeus (0.7%), LVMH (1.2%), Constellation Brands (1.4%), and TJX (2.6%)

## 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.

## IMPORTANT INFORMATION

**Comparator Index(es):** The S&P 500 Index is an independently maintained and widely published index comprised of U.S. large capitalization stocks. S&P does not guarantee the accuracy, adequacy, completeness or availability of any data or information and is not responsible for any errors or omissions from the use of such data or information. Reproduction of the data or information in any form is prohibited except with the prior written permission of S&P or its third party licensors. The MSCI World Index (MSCI Standard Index Series, net of withholding tax) is an independently maintained and widely published index comprised of global developed markets. 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.

**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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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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