QUALITY TRUST

Quarter Ending March 31, 2021

OVERVIEW

The GMO Quality Trust seeks to deliver total return by investing in equities of companies that the GMO Focused Equity team believes to be of high quality.

PERFORMANCE (%)

Net of Fees, AUD	+7.86
Gross of Fees, AUD	+8.02
MSCI World [1]	+6.30
Value Added	**+1.72**

Major Performance Drivers

Markets continue to climb the wall of fear erected by the Covid-19 pandemic. Despite worsening epidemiological data across much of the world, forward-looking markets deemed improvement in the outlook to have continued. Promising results from aggressive vaccine programs in the United States and United Kingdom added to the sense that the world has a route out of its recent malaise.

The tone of equity markets reflected this increasing optimism with the strongest performance coming from Energy and Financials, two of the sectors that saw the worst of it last year, while more defensive ones such as Health Care, Utilities, and Consumer Staples were left behind. Bond markets reacted to the change in sentiment too, with long rates rising around the world but notably so in the key U.S. Treasuries market. This change in long-term rates put pressure on equities of higher duration, with many growth stocks, especially in Tech, stumbling in Q1. The overall result was a quarter with the highest spread in performance between winning value stocks and struggling growth stocks in more than a decade.

We believe that GMO's portfolio offers a "third way" of investing, aiming to capitalize on the ability of well-managed and competitively advantaged businesses to navigate economic and geopolitical gyrations and generate strong returns on investment over time. The portfolio aims to benefit from superior long-term revenue growth and resilient margins – thus sipping, rather than gulping, at the same font as the growth-investing crowd – while paying attention to valuation (not by insisting on the low multiples beloved of many on the value scene, but by seeking appropriate prices for better businesses). By aiming between the value and growth poles, the portfolio generated above-market returns this quarter in an environment that was not especially friendly.

The most significant contributions to return came from the portfolio's "back to normal" and Technology holdings while the small allocation to classic defensives was weak.

We created the back-to-normal grouping last year as a way to think about and allocate to market opportunities as economies reopen. This quarter, the best performing names in this group included Lyft, one half of the nascent ride-sharing duopoly in the U.S., and Financials such as U.S. Bancorp and Wells Fargo. Lyft's passenger numbers are showing meaningful recovery; the company's challenge is now to reactivate drivers who stepped away last year. The banks appear to have avoided serious mishaps this go around and simply got too cheap – this quarter they benefited from the perceived advantages of a steepening yield curve too as banks tend to borrow short and lend long.

Opportunities remain in the back-to-normal group. This quarter we added two such investments here. The first, Safran, is the leading player in the manufacture and maintenance of jet engines for narrow body aircrafts. Safran's stock price was shunted downward during the pandemic as demand for air travel fell, but the company's razor-blade model, alongside the long development time for new engines, means that a significant portion of the company's growth model is assured for years to come.

Our second new back-to-normal investment was Global Payments, a financial technology company that offers payment processing services to merchants. The pandemic put a short-term brake on growth for Global Payments, but given the secular tailwind behind increasing card usage, we believe that the company's stock trades at an alluring price today.

We also made a back-to-normal change in the portfolio's Health Care bucket to initiate a position in Cigna, diversifying the long-term holdings in health insurers UNH and Anthem. Cigna is more focused on commercial rather than government payers so this asset-light business comes with a little more cyclical exposure than the others.

The portfolio's stock selection within Technology has been negatively correlated with the performance of Tech stocks in recent years. This is because we emphasize the higher-quality names with proven businesses over the more speculative areas of Tech. Your portfolio's Technology holdings comfortably bested the broader Tech space this quarter, with the strongest contributions coming from 2020 portfolio addition Lam Research – a leading maker of semiconductor manufacturing equipment – and long-term holding and analog specialist Texas Instruments. We initiated a position in semiconductor equipment maker KLA too. KLA leads the market in tools for error detection and measurement along the chip manufacturing process and is positioned to benefit from investment at leading-edge fabrication facilities. Semiconductor companies have demonstrated their importance recently as supply chains have been tested amid chip shortages in some areas. We expect growth, with some cyclicality, and strong returns on capital from here.

We believe that the outlook for your portfolio remains positive and that the noise around high aggregate multiples across markets today is largely a distraction; the majority of the jump in measured aggregate multiples in the U.S. market in particular is a result of the increasing share of the market's profits that are derived from strongly growing businesses. In any case, your portfolio is not the market – we continue to seek high quality businesses trading at attractive prices on your behalf.

Portfolio weights, as a percent of equity, for the positions mentioned were: Lyft (1.4%), U.S. Bancorp (4.1%), Wells Fargo (3.4%), Safran (2.3%), Global Payments (1.0%), Cigna (1.0%), UNH (4.6%), Anthem (3.1%), Lam Research (3.2%), Texas Instruments (3.0%), and KLA (0.6%).

[1] 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.

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