QUARTERLY INVESTMENT REVIEW

U.S. Quality Strategy

Performance returns (USD)

ANNUALIZED RETURNS (QUARTER-END)	Quarter-End	YTD	1-Year	3-Year	5-Year	10-Year	Since Inception
U.S. Quality Strategy (net)	6.10	13.84	12.15	-	-	-	19.69
U.S. Quality Strategy (gross)	6.20	14.16	12.56	-	-	-	20.13
S&P 500	8.12	14.83	17.60	-	-	-	21.50
Value Add	-2.02	-0.99	-5.45	-	-	-	-1.82

MAJOR PERFORMANCE DRIVERS

Absolute returns were strong in Q3, but the market environment was challenging for the U.S. Quality portfolio in a relative sense; many of the more speculative corners of the market rose sharply. The portfolio underperformed the S&P 500.

The best performers were mainly found in the technology space, where the prospects for AI continue to tantalize markets. The growth allocation was therefore the strongest performing part of the portfolio. In particular, Alphabet, Lam Research, and Oracle were all up strongly, buoyed by AI, albeit in rather different ways. Oracle clinched a $300bn monster of a deal with OpenAI, causing investors to boost their assumptions for the company's cloud business. This deal intensified excitement over AI-related capex more generally, helping the stock prices of a swath of data center suppliers from semis to hardware to electrical equipment and beyond. Beneficiaries in the portfolio also included Lam Research, critical in semiconductor manufacturing, and Broadcom, the designer of custom silicon chips. Alphabet also delivered strong returns. Despite operating at the forefront of AI, the main boost for the quarter came from a more lenient than expected regulatory ruling recognizing that AI has potentially loosened the company's grip on search going forward.

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.

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MAJOR PERFORMANCE DRIVERS CONT.

We have noted in the past that there is a counterintuitive consequence of the portfolio's relatively conservative stock selection in the significant allocation to the Tech sector; strength in the sector tends to be better for the portfolio's absolute returns than its relative returns, as we saw this quarter. This is because the most exciting tech stocks tend to exhibit wilder volatility, both in good times and bad. This is a contributing factor to the portfolio's long-term return signature – tending towards reasonable upside capture when markets are rising (though lagging the surges) and a certain amount of capital protection when markets turn south. We are taking a similar, conservative approach to stock selection as we invest around AI today.

LLMs are a truly astounding technological leap forward, and AI has the potential to change the world. However, there is so much hyperbole on the subject that we think it is useful to reduce this complex topic into manageable pieces, and hopefully in doing so, to better understand the opportunities and risks ahead. So let's take a deep breath.

We think one can usefully think of AI businesses as four distinct activities or layers. At the top sits the "App Layer," by which users, both consumer and corporate, can access AI insights. Live examples are subscriptions to Microsoft's Copilot or the Cursor coding support tools, while future use cases are imagined by thousands of start-ups across the world. Next comes the "LLM Layer" – ChatGPT, Claude, Gemini, and the rest, covering text but also images, driving data, whale song, and everything in between. These LLMs all rely on the "Compute Layer" both in their training stage and to generate answers after they have been unleashed. This layer is dominated by the hyperscalers – Microsoft's Azure, Amazon's AWS, Google Cloud – who have been joined by newer participants such as Oracle and CoreWeave. The Compute Layer is in turn built on top of the "Supply Layer" of semiconductor companies – Nvidia, Broadcom, TSMC – and data center builders.

While many companies participate in multiple layers (e.g., Alphabet has built LLMs and provides compute), the economics of the different layers are distinct, though each is inextricably bound to those directly above and below it.

- Revenues generated by the App layer must, in part, be used to pay for the LLM layer. There is an open question as to which will have a greater ability to price for their services. Will it be Apps, with barriers to entry derived from their specific context (e.g., Salesforce's relationship with its customers' data)? Or will it be specialized LLMs that others cannot replicate easily?
- The LLM layer's intangible capex is in the form of training. That training comprises the dominant part of AI spend with the Compute layer today. LLM layer revenue generated in the future from inference - i.e., the use of the LLMs – is necessary to justify the Compute layer's ongoing splurge on capex.
- The Compute layer's capex can be thought of as a mix of maintenance and growth capex. The share of growth in that mix has never been higher. That growth capex therefore dominates the revenues of the Supply layer, perhaps making the Supply Layer's AI revenue streams the most sensitive to changing assumptions as events unfold.

To navigate our way in AI, we have attempted to understand where the most and least defensible business models are to be found (and we continue to do so more or less continuously, as the rate of change is exhausting). We try to avoid forecasting the specific shape of the future, i.e., which model will dominate or where adoption will progress fastest. It is clear that inference revenues are growing at an impressive clip, but the ultimate run rate is inherently unknowable. We therefore aim to invest where we see strength from a financial perspective and a greater ability to press on the accelerator or the brake, depending on how things develop. We are also trying to keep an open mind as to where the strongest business models will emerge – markets have a tendency to overconfidence, and that can be dangerous in the early stages of a new technology. As Alisdair Nairn points out in *Engines That Move Markets,* his excellent book on prior waves of innovation, the winners often emerge quite late in the story, and even the winners can shed their equity base a time or two before coming out on top. Henry Ford's early backers learned about that the hard way!

The U.S. Quality portfolio's AI exposure is therefore centered around a) well-financed businesses with strong compute capabilities, e.g., the hyperscalers, and b) some of the more diversified businesses in the Supply layer, such as Broadcom. In addition, the portfolio has exposure to several businesses where the market has turned up its nose about their potential in the App layer, but where we believe the jury is still out, for example, Salesforce. We hope that this group will be able to generate strong incremental fundamental returns from AI in aggregate, without compromising our well-entrenched quality criteria. In short, the exposure to relatively conservative stock selection in Technology continues.

Although readers of financial news might not believe it, global markets are mainly comprised of companies where AI is not the driving force today. In the post-April rebound, these companies have tended to lag the broader markets, and the core and value parts of your portfolio have generated weaker returns. Consumer Staples, which sits in the core bucket, was the laggard with alcohol stocks especially in focus. Constellation Brands has import rights for Mexican beer brands in the United States and has been under duress since the presidential election. We suspect that these rights will prove valuable once the dust settles.

QUARTERLY INVESTMENT REVIEW

MAJOR PERFORMANCE DRIVERS CONT.

The portfolio's Health Care returns were slightly better, but more impactful from an attribution perspective due to their higher weight. July was rough for the sector broadly, and the portfolio's exposure suffered another down leg in UnitedHealth Group, which had peaked in early April. We sat on our hands in the second quarter – although the valuation case was strengthening, we hesitated over the risk that public sentiment towards the managed health companies could stimulate flashy action from the politicians. The risk remains, but we think it is becoming less acute, and we added to the position in UnitedHealth at the end of July. The stock is up a little over 50% since its nadir around then, and we bought some more in August as part of a basket of Health Care purchases across managed health, pharma, medical devices, and other healthcare. Although the near term may well be choppy, over the longer term we believe that the secular outlook for Health Care remains positive in the main, that innovation and efficiency will continue to be sought after and rewarded, and that valuations remain quite reasonable. More generally, we find that valuations outside of the stocks most directly entwined with AI are trading at levels broadly in line with history, and we therefore retain a constructive view of the portfolio's long-term return potential from here.

Portfolio weights as a percentage of equity for the securities mentioned are as follows: Alphabet (4.9%), Lam Research (5.1%), Oracle (4.4%), Broadcom (4.6%), Microsoft (8.2%), Amazon (2.2%), CoreWeave (0%), Nvidia (0%), TSMC (0%), Constellation Brands (1.7%), UnitedHealth Group (2.7%).

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PRODUCT OVERVIEW

The GMO U.S. Quality Strategy seeks to generate total return by investing primarily in U.S. 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 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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