Emerging Country Debt Fund

Year Ending December 31, 2018

OVERVIEW:

The GMO Emerging Country Debt Fund seeks total return in excess of that of its benchmark, the J.P. Morgan Emerging Markets Bond Index Global primarily through instrument rather than country selection. The Fund invests primarily in external sovereign and quasi-sovereign debt instruments of emerging countries.

Performance (%)

Net of Fees, Class III, USD	-5.91
Gross of Fees, Class III, USD	-5.41
J.P. Morgan EMBI Global +[1]	-4.61
Value Added	**-0.80**

COUNTRY ALLOCATION: -1.6%

SECURITY SELECTION: +0.3%

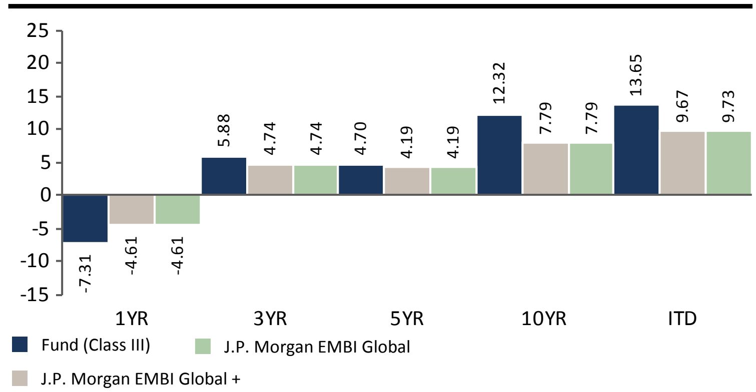
Major Performance Drivers

The benchmark spread over U.S. Treasury yields widened during the year to a level not seen since early 2016. The 10-Year Treasury yield rose 29 bps in 2018, to 2.69%. The year began in a very bullish mood for emerging debt and many other asset classes, but ended on a very bearish one. Early in the year, markets were still enjoying optimism from robust and synchronized global growth. However, by midway through the first quarter, concerns over the growth outlook emerged, largely due to an escalation in trade tensions between the US and China. These trade tensions entered a new phase as rhetoric and threats gave way to actual tit-for-tat tariff and non-tariff measures. Meanwhile, although the US economy was showing strong growth, due in part to tax cuts and fiscal stimulus, stress was appearing in other parts of the world, including the UK as it was negotiating Brexit and Italy, which was navigating its politically tricky budget process. Amid these events, many markets underwent very large swings. While the 10-Year Treasury yield began the year at 2.40% and ended the year at 2.69%, it spent part of the year well above 3% at levels not seen since 2013. The Brent crude oil price fluctuated between a high of $86 per barrel and a low of $50. The US stock markets reached an all-time high in September, only to collapse late in the year and finish sharply down for 2018.

Amid this global uncertainty, heightened risk aversion negatively affected emerging market debt. Credit spreads of every country in the benchmark widened over the year with the exception of Mozambique, which was a special case, having agreed to a debt restructuring with bondholders. Argentina and Turkey, in particular, sustained speculative attacks on their currencies and other financial markets. Argentina, in a weakened state from years of economic mismanagement, was forced to go to the IMF for a bailout. Turkey's markets were made further vulnerable by a very public spat between Presidents Trump and Erdogan over an American pastor being held in a Turkish court. Other geopolitical tensions affecting emerging countries, such as the Russia–Ukraine conflict, showed few signs of resolution. Finally, Venezuela formally went into default during the year as socioeconomic conditions worsened and inflation was estimated to have exceeded 1,000,000%.

Performance data quoted represents past performance and is not indicative of future results. The investment return and principal value of an investment will fluctuate so that an investors shares, when redeemed, may be worth more or less than their original cost. Current performance data may be lower or higher than the performance data provided herein. To obtain performance information to the most recent month-end, visit www.gmo.com. Gross Expense Ratio of 0.53% is equal to the Funds Total Annual Operating Expenses set forth in the Funds most recent prospectus dated June 30, 2018.

Annualized Return (%) as of December 31, 2018



Inception date: 04/19/1994
Chart returns include purchase premiums and redemption fees impact if applicable.

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Amid this risk aversion and in contrast to 2017, countries outperforming the index were concentrated in low-yielding, higher-rated sovereigns spread across Asia, emerging Europe, and Latin America. These included the Philippines, China, and Malaysia in Asia, the Baltics, Poland, Croatia, and Hungary in Europe, and Peru, Chile, and Panama in Latin America. Mozambique was the top performer. Brazil was also a strong performer, due in part to an election result that the market favored, bringing right-wing firebrand candidate Jair Bolsonaro to the presidency.

Countries underperforming the benchmark during the year were mostly high-yielding, weak sovereign credits, including some oil exporters. These included Venezuela, Argentina, Costa Rica, and Ecuador in Latin America, several sub-Saharan African countries, along with other high-debt countries such as Ukraine, Lebanon, and Tunisia. Despite strong support from the IMF, Argentina's spreads remained elevated due to program implementation risk and an upcoming election in October 2019.

The portfolio suffered from significant negative alpha from country selection during the year, mainly due to its overweight in Venezuela, Argentina, and Tunisia, and its underweight in China. Also detracting from country selection alpha, though much less significantly, were the portfolio's overweight in Turkey, Ukraine, and Mexico, and the portfolio's underweight in several of the low-yielding countries mentioned in the commentary above, such as the Philippines, Poland, and Malaysia. The largest positive alpha contribution to country selection was the overweight in Brazil, while smaller positive contributions came from the portfolio's overweight in Russia, Pakistan, and Belize, and underweights in Oman and Lebanon.

Alpha from security selection overall was positive. Security selection alpha from countries within the benchmark was roughly flat for the year, with positive alpha from holdings in Angola, Oman, Tunisia, and Turkey offset by negative alpha from the choice of holdings in Venezuela, the Philippines, and Argentina, among others. The portfolio garnered significant positive alpha from holdings in off-benchmark countries, which we identify as security selection. These included positions in Bahrain, Israel, Saudi Arabia, and the Bahamas, among others.

In 2019, the market enters the year at significantly higher spreads than one year ago, and valuation metrics that are much more attractive. Risks are always present, including an escalation in the trade war if negotiations between the US and China over the next few months break down. A significant development for the market in 2019 will be the gradual inclusion of five additional Gulf Cooperation Council states into the benchmark. As a group they will eventually comprise an 11% weight. The portfolio continues to have significant overweight positions in several Latin American countries, including Mexico, Argentina, Brazil, and Venezuela, and a significant underweight in China.

[1] The J.P. Morgan EMBI (Emerging Markets Bond) Index Global + is an internally maintained benchmark computed by GMO, comprised of (i) the J.P. Morgan EMBI through 8/31/1995, (ii) the J.P. Morgan EMBI+ Index through 12/31/1999, and (iii) the J.P. Morgan EMBI Index Global thereafter.