QUALITY INVESTMENT FUND

Investment Review: Quarter Ending December 31, 2022

OVERVIEW

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

PERFORMANCE (%)

Net of Fees, USD	+9.44
Gross of Fees, USD	+9.58
MSCI World [1]	+9.77
Value Added	**-0.18**

Major Performance Drivers

2022 was a tough year as investors had to process an ugly combination of geopolitical and related macroeconomic stresses in the form of rates, inflation, FX, and increased risk of recession. This quarter saw some respite; the S&P 500 returned 7.6% and the MSCI World 9.8%.

Your industrial holdings shone in the quarter with Safran, the French manufacturer and servicer of narrow-bodied jet engines, Otis, the U.S.-listed global elevator manufacturer and servicer and Knorr-Bremse, the German rail component duopolist all contributing. These disparate sounding companies are linked by their exposure to China. As the Chinese government finally lifted its draconian Covid lockdowns, beneficiaries were repriced across quite a spectrum of different types. Chinese customers represent around a fifth of revenues for both Otis and Knorr-Bremse, while travel-adjacent companies such as Safran were lifted by the potential rush of millions of Chinese tourists across the world over the next year or two.

Overall sector allocation detracted from returns while stock selection helped. Energy was the best performing sector once more and your portfolio continues to hold no investments in this capital-intensive sector. Your portfolio's overweight to Health Care was a bright spot, at least from an allocation perspective, with the best performing portfolio position found here was Intuitive Surgical, which rebounded after suffering in the poor run for growth stocks that characterized the first nine months of 2022. The impact of overweight positioning in relative sector laggards IT and Consumer Discretionary, was outweighed by solid stock selection here. For example, Oracle pleasantly surprised the market with strong revenue growth in the wake of its acquisition of Cerner, a leader in health care software, and continued signs of strength in its portfolio of cloud enterprise products. TJX also had a strong quarter with analysts upgrading their expectations for profits in 2024. TJX has some countercyclical tendencies - historically it has been able to source supply more easily in tough times and also benefits from downtrading by consumers.

We think your portfolio is best described in three parts: Core Quality, a more cyclical Quality Value piece, and a Quality Growth allocation. Each plays a specific role.

1. Core Quality brings defensive characteristics to the portfolio. Your holdings are spread across software businesses with well-entrenched clients that are likely to continue paying irrespective of the cycle, e.g., Oracle; mature, stable health care businesses principally in pharmaceuticals like Johnson & Johnson; and in consumers staples such as Nestle. Collectively these names tend to be less impacted by changing market sentiment than most parts of the market and deliver lower absolute volatility over time. This defensive core is a microcosm of what the Quality portfolio was in its first years in the mid-2000s when the principal concern of the team was the risk to equity markets in the face of raging animal spirits in the credit markets.
2. The Quality Value piece of our portfolio is where our more contrarian ideas tend to land. Here we hold, for example, an allocation to U.S. Health Insurers that we like to describe as being "under a permanent cloud" – the political overhang associated with their business model has meant that they have traded far below where they should have given their profitability and opportunity for reinvestment at high rates of return. We also hold companies that even now bear the scars of the pandemic, especially in travel-adjacent areas. Safran, the leading maker of engines for narrow-bodied jets, is available at a price that we believe underestimates the many years of servicing ahead for their dominant installed base.
3. Finally, the Quality Growth part of the portfolio generally contains companies whose futures we believe to be underpinned by a "stronger for longer" period of business growth. These companies may trade at a premium, possibly a substantial one, but all have in common that we believe that there is a good chance that the share price underappreciates future prospects.

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 investor's 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. Attribution figures reflect that of the base currency of the portfolio which may differ from that of the hedged currency share class.

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The attraction or otherwise of a company's stock is especially dynamic in the growth arena. The fall in high-priced growth stocks this year has been widely attributed to the rise in investors' discount rates alongside central bank determined rates, but we think that the role of rates is limited. As we discussed in a note published this quarter, (See *Growth Investing Ain't About the Rates* on www.gmo.com) we are more sympathetic to the role of rising discount rates in tormenting equity markets in general than in driving the relative performance of growth stocks. While growth stocks are longer duration assets, reflecting their growing future cash flows, we calculate that - unless you are willing to credit a growth window lasting for decades – the cross-sectional impact on changing discount rates is not that significant, certainly less so than the differentiation made by recent, twitchy markets. As a result, we oriented our purchases this year toward the growthier end of the market, with purchases of ASML, the Dutch manufacturer of advanced lithography equipment required for the manufacture of high-end semi-conductors; Intuitive Surgical, maker of the most accepted robotic surgery products; and Amazon and other existing growthier holdings.

The quarter saw several liquidations across your portfolio. While selling after a company's qualities have become fully recognized by the market is our preferred exit route from a position, it is clearly not the only way out. There is a balancing act necessary in portfolio management between trading too often based on the news du jour vs. sticking stubbornly to an investment thesis and holding a position for too long. In this spirit, we took the decision to remove three holdings where our conviction had deteriorated. Thus Lyft, Global Payments, and Cisco limped out of the portfolio this quarter. We believe, however, that you finish the year with a more compelling portfolio, at better prices, than the holdings at the start of the year.

Markets had a lot to worry about in 2022. We started this commentary with a list of concerns. To close it, we do believe that markets have the tendency to "climb a wall of worry." Most of the old saws pertaining to market behavior are rooted in common sense and as some of the worries are alleviated, one might expect markets to react accordingly. In that case we would hope that the Quality Value and Quality Growth parts of your portfolio would do the heavy lifting. After a brutal year, stocks are cheaper than they were, and are thus better set for the future. In the case of another tough year, however, we hope that your portfolio's Core Quality brings some reassurance.

Portfolio weights, as a percent of equity, for the positions mentioned were: Safran (3.2%), Otis (2.1%), Knorr-Bremse (0.4%), Intuitive Surgical (1.3%), Oracle (3.0%), Cerner(0.0%), TJX (3.2%), Johnson & Johnson (4.3%), Nestle (1.4%), ASML (0.0%), Amazon (3.1%), Lyft (0.0%), Global Payments (0.0%), and Cisco (0.0%).

Important Information

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[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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