

Quality Series Fund

Year Ending December 31, 2018

OVERVIEW:

The GMO Quality Series 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, Class R6, Fair Value, USD	+0.01
Gross of Fees, Class III, Local Close, USD	+0.89
S&P 500 ¹	-4.38
Value Added	+5.27

Major Performance Drivers

From a relative performance perspective, the year was a successful one; the portfolio beat the S&P 500 and MSCI World by a meaningful margin, net of fees. At the dawn of another New Year, we feel it is appropriate to reiterate what we are trying to achieve with the Quality portfolio by discussing some of the changes made to the portfolio over the course of the last year while also considering aspects of the outlook today.

Our goal remains simple: to invest in businesses with demonstrable competitive advantage that have growth options to redeploy capital productively. In an ideal world, we initiate these investments at a price that has been dampened by a “temporary cloud” – a negative development that we believe will have only limited impact on the company’s long-term prospects – and sell them only if their valuation becomes unsustainable.

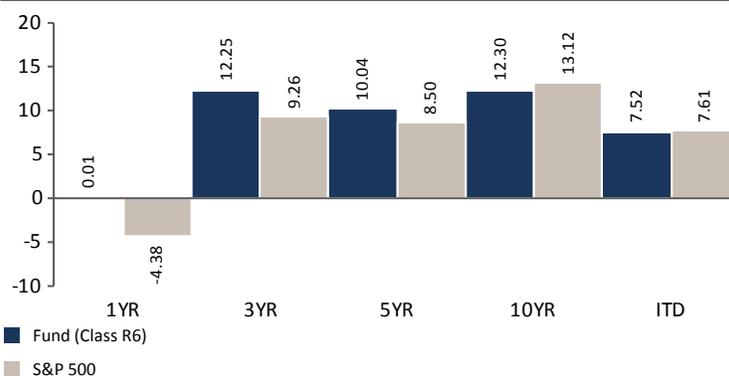
2018 saw a handful of additions to your portfolio. We bought three names under what we believe are new temporary clouds:

We initiated a position in Facebook in the first quarter, as the company struggled with a series of missteps with regard to user privacy. The drumbeat in Washington is rising, and Facebook will have to invest many billions of dollars in data privacy and content clean-up. We believe that the company’s competitive advantage in online advertising is such that it can comfortably make these investments while generating enviable profits and continued growth. Uncertainty over how long this process will take plays to our long investment horizon, and we believe that the sell-off has been overdone. We acquired a stake in Merck, also during the first quarter, after several years of underperformance from pharmaceuticals stocks caused in part by concerns about regulatory and legislative pressures on the pharmaceutical industry. We believe the current price of Merck overstates these concerns and underappreciates Merck’s growth potential given its excellent position within the attractive oncology space.

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. Gross Expense Ratio Class R6 0.54% is equal to the Funds Total Annual Operating Expenses set forth in the Funds most recent prospectus dated June 30, 2018.

The inception date refers to that of the GMO Trust Fund. Class R6 shares were first offered on January 1, 2012. Performance data quoted for each GMO Series Trust Fund reflects the performance data of the corresponding GMO Trust Fund restated to reflect the fees and expenses associated with the GMO Series Fund.

Annualized Return (%) as of December 31, 2018



Inception date: 02/06/2004

Chart returns include purchase premiums and redemption fees impact if applicable.

We took advantage of weakness in growth stocks towards the end of the year to open a position in Booking Holdings. Its booking.com platform has powerful network incumbency in Europe allied with growth options elsewhere. The shares also became available at a forward multiple in the teens for the first time in several years.

We also participated in the IPO of Knorr-Bremse. Knorr-Bremse is one-half of a global duopoly in railway braking – a spectacularly well-insulated business without a successful new entrant for a century (seriously!) – and an innovative player in truck braking. We believe that Knorr-Bremse fits the profile of an archetypal long-term holding for the portfolio based on its competitive advantage.

We typically sell names for one of two reasons. In the first and preferred category, we reduce the weight in businesses that we like when they sell for high prices. We were able to reduce the exposure to higher quality but more cyclically exposed Industrials at relatively high valuations early in 2018. We sold Emerson after owning the company for five years and significantly reduced the position in 3M that we have held for well over a decade. We then bought back 3M at more reasonable prices as it slipped during the year. We also liquidated positions in Humana and Teradata for this reason, albeit the main motivation was that other positions offered similar exposure at more attractive valuations.

In the second and less happy category, we also liquidate positions that no longer pass muster in terms of quality via our vetting process. This year we sold Schlumberger, where we grew increasingly uncomfortable with its risk-sharing revenues on inherently uncertain projects. We also removed CVS, whose “transformative” acquisition of Aetna raised the intensity of an alarm that was already sounding about its pharmacy and retail businesses.

Looking to the future, we believe that the portfolio has the potential to deliver a satisfactory equity return at current valuations. We estimate that the portfolio’s economic yield for 2019 – reflecting profits available after reinvestment to sustain the existing business – stands comfortably above 5%, using year-end prices. Assuming we have correctly identified companies that can redeploy some of that economic profit at high rates of return, this yield should give some guidance to prospective long-term real returns. We certainly view the portfolio’s emphasis on company quality, capital deployment, and stock valuation as part of the answer to navigating equity market uncertainty.

Year-ending weights, as a percent of equity, for the positions mentioned were: Facebook (1.4%), Merck (2.2%), Booking Holdings (1.45%), Knorr-Bremse (0.8%), Emerson (0.0%), 3M (3.7%), Humana (0.0%), Teradata (0.0%), Schlumberger (0.0%), CVS (0.0%), and Aetna (0.0%).

An investor should consider the fund's investment objectives, risks, charges and expenses before investing. This and other important information can be found in the fund's prospectus. To obtain a prospectus please visit www.gmo.com. Read the prospectus carefully before investing.

Risks associated with investing in the Fund may include Market Risk - Equities, Management and Operational Risk, Non-U.S. Investment Risk, Liquidity Risk, and Derivatives Risk. For a more complete discussion of these risks and others, please consult the Fund's prospectus. Distributor: Funds Distributor LLC. GMO and Funds Distributor LLC are not affiliated.

Each GMO Series Trust Fund is a feeder fund investing substantially all of its assets in shares of a corresponding GMO Trust Fund (i.e., a master fund). Each Series Trust Fund's sole portfolio holding, other than cash, is shares of the corresponding Trust Fund.

¹ 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.