# Quality Series Fund

Quarter Ending March 31, 2019

**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 | +12.97 |
| Gross of Fees, Class III, Local Close, USD | +13.38 |
| S&P 500 [1] | +13.65 |
| **Value Added** | **-0.27** |

## Major Performance Drivers

The majority of GMO's strategies operate on a long-term time frame measured in years. This allows us to seek profit from investing when prices are reduced by some short-term market concern. Weakness in American Express's share price a couple of years ago, for example, resulted from the company's loss of a large contract for a co-branded credit card. This particular business loss actually reinforced our positive view of Amex's capital management (management refused to match a rival's overaggressive bid) and allowed us to initiate our first Financials position in years. The market has subsequently been persuaded by Amex's results.

It is easy to demonstrate that problems are temporary in nature once they've been resolved. The practicalities tend to be murkier in real time. This quarter we allocated an additional portion of the portfolio to Facebook and believe it's an opportune time to dig deeper into our thinking about the position. The case against Facebook, on the surface, sounds convincing and coalesces around three core arguments:

1) The value of Facebook's offering is threatened by governments and regulators. The regulatory threat argument, in turn, rests on at least three planks. First, Facebook has developed a near monopoly position in social media via Instagram, WhatsApp, Messenger and its eponymous platform. Conventional wisdom tells us monopolies are intrinsically bad and serve as regulatory shark bait. Second, Facebook has repeatedly demonstrated its inability to manage data privacy issues. Third, the company has antagonized both the political left and right with its apparently insincere PR campaigns of contrition, partisan censorship of its platforms, and its heavily loaded plea for government regulation.

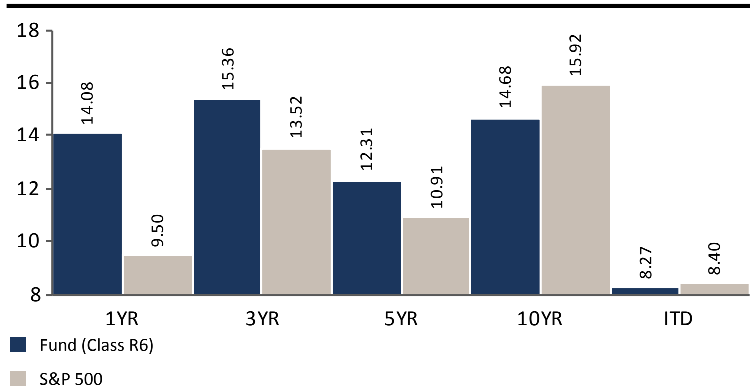
2) There are risks to the ongoing relevance of the Facebook platform. The average age of a Facebook user is on the rise as teens ditch the platform for alternative networks such as Snapchat.

3) The efficacy of the digital advertising revolution is questionable amid mutterings from Procter & Gamble and others about fake clicks, poor viewability, and so on. The primary appeal of digital advertising is its alleged ability to identify the effectiveness of ad spending – therefore a 2014 Google study concluding that more than 50% of digital ads never reached human eyes raised some eyebrows.

**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 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 March 31, 2019**




Inception date: 02/06/2004
Chart returns include purchase premiums and redemption fees impact if applicable.

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Starting with the latter first, we believe the “digital advertising is dead” argument is weak. We’ve seen the enthusiastic adoption of digital advertising across our portfolio, with positive effects for Facebook and mixed effects for others. The challenge for some consumer names is that internet-based advertising can create competitive beachheads for new brands, but this hasn’t put established brands off digital advertising. New CEO Alan Jope of Unilever noted in 2018 that adding to their digital advertising effort (already 35% of the advertising budget) was not constrained by money, but the arms race over staff with the right digital advertising credentials! Advertising dollar trends follow media consumption trends – on that basis alone, digital advertising is not only here to stay, but has many years of growth ahead.

In terms of declining platform relevance, it is true that Facebook user growth amongst North American and European youths has reversed. However, Facebook comprises four reasonably distinct platforms. Facebook-owned Instagram appears to be winning the war with Snapchat. WhatsApp, as disclosed by the company and confirmed by panel surveys, is becoming more popular. Growth on the Messenger platform fells this argument on three of four of Facebook’s platforms.

With respect to Facebook’s regulatory travails, the rebuttal is less robust but worth considering. Facebook has done a phenomenal job of building a sustainable ecosystem. Not all monopolies are bad – in this case the network effects for, say, WhatsApp users (and advertisers) are powerfully enhanced as more join. While dismembering Facebook might please certain political constituencies, it’s unlikely to be in the best interest of the community of participants and risks displeasing at least some voters. Increased regulatory scrutiny does mean that enhancing the monopoly by buying competitors is off the table, perhaps forever, but Facebook’s strong balance sheet means it can respond to competitive threats. Paradoxically, were Facebook to fall under a new regulatory regime such as the European Union’s GDPR privacy code, the cost of compliance would diminish the likelihood of new entrants.

Facebook has not done as good of a job on data and content management, and a truly atrocious job on corporate communications in recent years. We believe the company is genuinely attempting to remediate its privacy and content shortcomings and that this will help address both regulatory and user concerns. Facebook has been adding extensively to its resources and expenses, which would be hard to maintain at current levels even if it wanted to. We believe actions are more important than words and that concerns will fade over time as Facebook ups its game.

Are we 100% sure? No one can be. We aimed to manage the digital regulatory risk to the portfolio by funding the increase in Facebook from our position in still attractively priced Alphabet. We have high confidence that Facebook’s share price is discounting a poor outcome. It is rare that the market presents an opportunity to buy into a business that continues to grow its revenues at a 30% annualized clip with a price tag less than 20x last year’s earnings. We model declining margins from here, but note that Facebook retains an enviable share of the mobile internet advertising market, the fastest growing piece of the global ad business. The company is only part way through the monetization of its user base. We expect WhatsApp to be the basis of a powerful peer-to-peer payment system (already live and scaling rapidly in India). Facebook’s fortress balance sheet is consistent with a patient approach denied by many of its peers. In summary, Facebook appears to be an attractive risk-adjusted opportunity.

Quarter-ending weights, as a percent of equity, for the positions mentioned were: Facebook (2.2%), American Express (2.9%), Unilever (2.1%), and Alphabet (6.8%).



[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.

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