Risk Premium Fund

Year Ending December 31, 2018

OVERVIEW:

The GMO Risk Premium Fund aims to achieve a long-term total return commensurate with that of global equity markets by selling put options on major global equity indices.

Performance (%)

Net of Fees, Class III, Fair Value, USD	-7.41
Gross of Fees, Class III, Local Close, USD	-6.99
CBOE S&P 500 PutWrite Index	-5.93
Value Added	**-1.06**

Major Performance Drivers

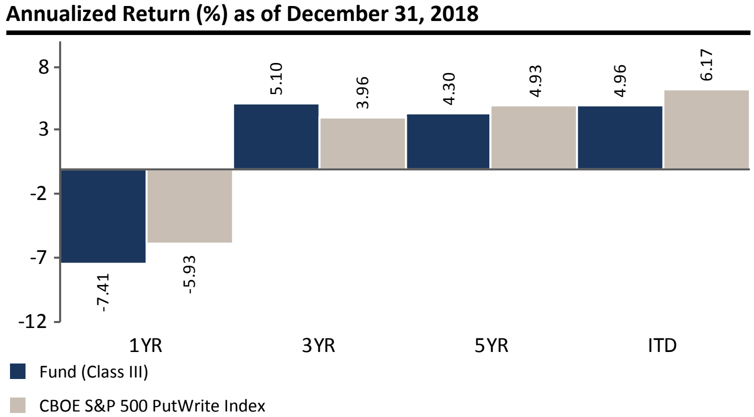
The portfolio underperformed the CBOE S&P 500 PutWrite Index in 2018 as a result of a challenging first quarter, but went on to recover some of the shortfall with improved performance in the balance of the year. On a longer-term horizon, we also consider performance relative to the MSCI World Index given the expectation of harvesting the global equity risk premium. When compared to the broader equity benchmark, the portfolio performed as expected. It experienced a shallower drawdown than the equity index as we recovered some losses by selling options at elevated premiums.

This year marked an inflection point for financial markets and the global economy. Synchronized growth in the context of still-accommodative global monetary policy and positive returns across risk assets with record low volatility characterized 2017. In contrast, 2018 saw volatility return with a vengeance, monetary tightening from G3 central banks, higher front-end rates, wider financing spreads for corporates and households, an Italian BTP flash crash, and negative returns across virtually all asset classes including emerging market bonds and currencies, US and European corporate credit, global equities, and commodities. In fact, the trade-weighted US dollar and US T-bills were the best performing assets in 2018.

If 2018 provided a stark reminder against the complacency of the previous year, it was not uniform. The first quarter of 2018 marked a sharp departure from the exceptionally low levels of volatility seen in 2017 with a spectacular rise in US equity index implied volatility. The second and third quarter saw a decline of US equity volatility as sentiment improved and some recovery in risk assets, with the notable exception of Europe and emerging market equities. Finally, in the fourth quarter, volatility returned, and broad risk assets dramatically underperformed cash. We briefly recap the performance of Risk Premium through these three distinct periods of 2018.

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 0.48% is equal to the Funds Total Annual Operating Expenses set forth in the Funds most recent prospectus dated June 30, 2018 as amended.

Annualized Return (%) as of December 31, 2018



Inception date: 12/14/2012
Chart returns include purchase premiums and redemption fees impact if applicable.

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In the first quarter, the volatility regime shifted rapidly, with equity volatility and correlations rising and normalizing towards historical averages, especially after a year of exceptionally low volatility. To illustrate the contrast, in 2017 the S&P 500 returned 22% on an annualized volatility of 7% while over 2018 the index returned about -4% on an annualized volatility of 17%. More to the point, over the first quarter, the S&P 500 delivered 20% volatility. While there were a number of shifting market drivers, the ostensible catalyst for the volatility regime shift was the short volatility ETP blow up on February 5. The market selloff was precipitated by indiscriminate end-of-day short covering on the behalf of two levered short VIX ETPs, which resulted in the largest one-day rise of the VIX Index in history. The selloff affected not only the VIX complex, but also the most liquid segments of the market[1]. The portfolio performed incrementally better than the broad S&P 500 from peak to trough due to the premium collected, in line with our expectations for a variance risk premium strategy. However, the portfolio underperformed the CBOE's S&P 500 Put Write Index by about 3%. About half of this is attributable to the portfolio's global allocation, and the other half is attributable to the use of short tenor options in the US at a time when markets delivered a high level of realized volatility.

The next two quarters witnessed a gradual decline in volatility with the S&P 500 delivering about 10% realized annualized volatility. US equities, and Technology stocks in particular, delivered strong performance. Other major asset classes did not fare as well: European stocks reeled from Italian deficit concerns and an Italian BTP flash crash, and emerging market assets struggled with a resurgent US dollar as the Fed predictably raised interest rates while shrinking its balance sheet. The portfolio outperformed the CBOE S&P 500 PutWrite Index over this period. Most of the outperformance is attributable to to selling FTSE, and to a lesser extent, S&P/ASX 200 volatility, which delivered strong performances. Perhaps more importantly, we eliminated our exposure to Euro Stoxx in May and June, thus avoiding the sharp re-pricing of the risk premium on European assets(for example, the Italian BTP to German Bund sovereign spread repriced by more than 100 basis points from trough to peak in late May).

Equity volatility returned during the last quarter of 2018. The sanguine market conditions during the second and third quarter were displaced by equity volatility more reminiscent of the first quarter. Implied and realized equity volatility rose, domestic and international equities swooned, sovereign yields declined, oil re-entered a bear market, and credit spreads widened. Worries about trade tensions and a China slowdown negatively affected investor sentiment. Pricing of these market risk factors also occurred in the context of thin market liquidity and little depth. This naturally led to more days of large market moves. On the positive side of the ledger, the Federal Reserve began communicating a more flexible path forward for rates, economic fundamentals in the US remain sound, and the US dollar traded sideways for most of the last quarter. Given that these crosscurrents drove volatility higher, this was a challenging period for volatility carry strategies. US and Asian short variance positions were punished, whereas European equity short volatility fared better in relative terms. The portfolio benefited from exposure to the FTSE, which led to outperformance during the quarter, especially in December.

[1] For more on this event and our view of risk premium strategies, see Constable and Le, "The Value of Short Volatility Strategies," 2018.

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