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# Global Fund Manager GMO Highlights the Avenues to High-Quality, Sustainable Investing

**Hubbis and our co-host, the global asset management firm GMO, welcomed a group of Asia-based investment specialists from wealth management firms to a discussion on the outlook for the global financial markets, and the quest for investments that are both high quality and sustainable. The guests heard of GMO's quest for optimal defensive strategies, concept of quality, investment protocol, and listened to GMO's ideas on identifying the corporate winners that are climate change positive. They also found out more about why GMO believes that the very high valuations in major markets will revert to a more normalised level if long-term averages are re-discovered, but that the new 'norm' to emerge will be at lower sustainable returns than in recent decades.**

# The key takeaways

### Quality seldom comes cheap

The GMO Quality Strategy, which on November 1st held assets totalling USD9.4 billion, invests in about 40 stocks, the top 10 of which account for roughly 40% of the portfolio. Lead fund manager Dr. Tom Hancock told guests that buying quality businesses that maintain a sustainable business model for the longer-term does not come cheap.

### Quality and quantity

GMO explained that the team's approach is to buy quality assessed quantitatively, but also filtered by fundamentals. The team runs a concentrated portfolio and tends towards the US, and to key sectors such as technology and healthcare.

### The 'bond-alternative' psychology drives up prices

They observed that many stocks, such as consumer staples, are now expensive on a historical basis, because with interest rates so low, people have been gravitating towards those names as bond type alternatives.

### The US now offers better dynamics

The US markets offer the best combination of quality stocks combined with acceptable valuations, largely because growth is stronger in the US. Elsewhere, many stocks outside the US market are so highly priced because their local investors flock to the big, leading stocks, but the underlying economic growth is less supportive.

### To be defensive you do not need to be negative

Cash is a defensive strategy, but you cannot participate in the upside phases of the markets. Global, high-quality equities are a very good way to participate in the upside while preserving some downside protection.

### Quality, for GMO, is defined as...

'Quality' to GMO means screening related to historical return on capital, the stability of the return on capital, strong balance sheets, and of course relevance of the business and sustainability of the model.

### What is not so important...

Dividends are far less important than the growth potential of the business. The GMO team prefer stocks that reinvest their money in growth, much as Microsoft did for several decades.

### Be prepared to get off the high horse...

GMO will always change its views in the face of fresh evidence. He explained that some of the trades he is most fond of are decisions where businesses selected for the portfolio are sold if the business model proves to be compromised.

### Be reasonable...

In the quest for true quality, there is little chance of buying at low valuations. A mistake of investing generally is to be greedy, both growth greed and cheap pricing greed. GMO prefers to take the middle ground and avoid value traps, avoid growth traps, perhaps missing some of the more spectacular returns too, but having more modest gains over a larger number of shorter runs.

### You can play EM growth through the MNCs

When asked about value and quality in emerging markets, GMO explained that the preference is to play emerging market growth through the multinationals that are selling into the emerging markets, largely because they are safer, and the domestic equivalents are very highly priced.

### Climate change is a peg for future-proofing portfolios

Climate change, where activism as well as investment money is increasing apace, is a key area of focus for GMO, from both a corporate and from an investment perspective. GMO's preference is to analyse companies whose businesses will materially benefit from efforts to mitigate or adapt to climate change, but GMO's investment team takes a pragmatic approach, preferring supply chain assets rather than exposure to electric vehicle makers, or perhaps to solar power companies.

### ESG plays a major and growing role

The climate change and clean energy initiatives involve a very ESG oriented approach, but climate change investments cannot always fit all the E, S or G criteria. And there are some stocks that offer quality as well as one key feature of ESG, for example Accenture, the major IT consulting company that is making great strides forward in human capital, in other words especially boosting the 'S' and 'G' of ESG.

### China embracing ESG as well

Some see China as the emerging villain of the environmental crisis, but the Chinese government has been promoting ESG; starting from last year they require quarterly reporting by companies to Beijing regarding their ESG practices. Reducing pollution and driving towards reduced fossil fuel usage will help the country attract capital and improve national security.

### Look downstream, look at the true picture

The biggest individual 'clean energy' stock for GMO's strategy is currently semiconductor firm SolarEdge, which supplies technologies for the alternating current and power in the electrical systems. The copper content required for clean energy is very high compared to regular industrialisation, but it is hard to get new high-grade copper out of the ground, so that offers another opportunity. And in the agriculture space, there are more fertilisers used to enhance land yields, but phosphates and potassium are mined and are finite. Demand for fish farming will rise as fish are less carbon intense than pork or cattle to raise, hence it is a cleaner source of protein.

### Resources should play a key role in portfolios

GMO believes that there should be a core focus on resource stocks, which should be selected by disciplined, bottom-up fundamental analysis.

### Be unconstrained

GMO's team at the event explained that they pay no attention to the benchmark, with all selection rigorously determined by their search for all the key attributes they had outlined earlier in the talk.

### Pay little attention to reputation

When investing in quality, the buyer should not be focussed on the reputation of stocks, but on the actual fundamentals of the business. Focus on the play on the field, not the name on the back of the jersey, was a telling comment.

**THE DISCUSSION WAS HEADED BY DR. TOM HANCOCK, THE BOSTON-BASED FUND MANAGER LEADING THE 'GMO QUALITY' STRATEGY,** a USD9.4 billion global equities fund that has delivered 9% annual returns since inception in 2004, considerably higher than the 6.8% that the MSCI World index has returned.

Hancock is the head of GMO's Focused Equity team as well as the portfolio manager for the Quality Strategy. Previously at GMO, he was co-Head of the Global Equity team. He is also a partner of the firm. Prior to joining GMO in 1995, he was a research scientist at Siemens and a software engineer at IBM. Hancock holds a Ph.D. in Computer Science from Harvard University and B.S. and M.S. degrees from Rensselaer Polytechnic Institute.

GMO is a USD66 billion Boston-headquartered global asset management firm founded in 1977, with offices at six locations around the globe. One of the co-founders is Jeremy Grantham, a well-regarded value investor.

"We are a private partnership and this structure means our sole business is investment management," Mehak Dua, Client Coverage & Business Development at GMO. "As an independently owned private partnership, we are designed and built to invest the way we believe will deliver the best results over the long-term for our clients. At GMO, we are willing and able to take and hold significant and unconventional positions when we see markets move to extreme valuations.

She added that GMO takes a contrarian value investment approach to identify and exploit opportunities and the rationale behind this approach is that economic reality and investor behaviour cause securities and markets to overshoot their fair value. "We focus on compounding wealth for our clients by identifying mispriced opportunities and then exploiting them in a systematic and disciplined way," she explained.

The firm boasts a client base of prestigious and sophisticated investors globally and works diligently to partner with them, Dua reported. "We are well known for our candid, academically rigorous market insights and advice that underpin the research that we undertake."

Dua introduced Hancock, explaining that the suite of strategies that Dr Hancock manages represents roughly USD9 billion of money, focusing on what is called 'quality' investing long before it became a buzzword in the industry. "We also opened the resource equity strategy fairly early in 2011 and then the climate change strategy three years ago, although GMO from a research viewpoint has been engaged with this area for more than 15 years."

She also introduced her colleague Mark Wu from Singapore, GMO's lead China analyst who spends a lot of time in China and Taiwan and would offer his perspectives later in the event.

Hancock opened the main proceedings, explaining that his bottom-up approach takes a very long horizon, focusing on buying great businesses, which sometimes

means paying a premium for them, for example, the biggest position in the GMO quality strategy right now is in Alphabet.

"And we are not just quantitative," he reported. "We are very much fundamental as well and run relatively concentrated portfolios. Our flagship strategy comprises of about 40 names. While we are global, we tend to have a little bit more of a US focus, and tend to like tech and healthcare stocks."

## The best things do not come cheap

He then observed that there is a perception that quality investing is a style that is expensive. "An issue," he said, "is for example that consumer staples stocks are expensive, names such as Procter & Gamble or Nestlé, partly because with interest rates so low, people have been gravitating towards these "safe haven" names as bond type alternatives. Sometimes, when alluding to expensive, people tend to be talking about non-US markets - for example, in many EM countries, partly because of regulation, investors tend to invest mostly domestically and buy multinationals. There is scarcity value associated with high quality technology companies in emerging markets for instance. At the moment, the GMO Quality team believes they can get exposure to similar business models in the US for more attractive valuations than, say, in the emerging markets..."

He turned the discussion toward defensive strategies. Cash is best, he stated, but noted that in markets there is always something to worry about and you can run around scared of your own shadow, meaning you are protected during the downturns, but don't join in the upturns. Somewhat shamelessly talking my own book, I would say quality equities are a very good way to kind of balance that, to participate in the upside while preserving some downside protection.

"Our strategy went down in 2008 but it went down 20 percentage points less than the MSCI World Index," he reported. "Then it outperformed by 15% in 2011, and at the same time kept up with or beat equity markets over the last 15 years in aggregate."

## Screening for quality

He articulated his views on what the word 'quality' means to GMO. "Our screening is related to historical return on capital, the stability of the return on capital, strong balance sheets, and of course relevance of the business and sustainability of the model. But we pay little attention to dividends, although we like them, we like it even more if a company reinvests the money into a business with a high return on capital and growth. That of course is why we were buying stocks like Microsoft in the 1980s."

He added that quality is not about stock price volatility per se, as high-quality businesses tend to be more stable because the fundamentals are stronger. "Moreover," he remarked, "quality is not a sector-neutral concept, and we are unapologetic about not having very much commodity exposure, not having very much energy exposure, and always being underweight financial stocks."

## Be prepared to adjust core assessments

He also noted that GMO will change its views in the face of fresh evidence. "Actually, the trades we are sometimes most proud of is abandoning stocks that have underperformed and where we decided that the business is more broken," he reported. "For example, a British American Tobacco, Qualcomm, IBM, Bed Bath & Beyond, those are all stocks where we sold well before the bottom, even if not at the top."

Hancock noted that, naturally, in the quest for quality, there is little chance of buying at low valuations. "A mistake of investing generally is to be greedy; both growth greed or cheap pricing greed," he explained. "We tend to hug the middle ground and avoid value traps, avoid growth traps, perhaps missing some of the more spectacular returns too, but having more modest gains over a lot of short runs, that is our general approach."

He then reported that at the core of the framework in which GMO does its top-down forecast is mean reversion, not just in valuation terms but also the profitability that drives the earnings underneath the multiples. "We do not believe stocks should be priced relative to bond yields. However, overall equities are too safe an asset over meaningful periods to deliver a 6% historical real return. We also have to consider if profits are up because of low interest rates, or if the profitability is more permanent."

When asked about value and quality in emerging markets, he explained that his preference is to play emerging market growth through the multinationals that are selling into the emerging markets, largely because they are safer, and the domestic equivalents are very highly priced.

MARK WU
GMO

Moreover, Mark Wu added that many Chinese companies, for example, have had corporate governance issues in the past, and while things are improving, they also suffer from the need for fresh capital, while multinationals are cash generative for future investment. "In short, we share the view that MNCs are a good way to indirectly play China in addition to obviously holding direct China stocks."

## Climate change and the supply chain

Hancock shifted the conversation to climate change, where activism as well as investment is increasing. "Jeremy Grantham, our founder, devotes his personal wealth and philanthropic energies to education efforts around climate change," he remarked, "and he is one of the most high-profile spokespeople on that issue."

"From our side," he elucidated, "we manage a strategy that is oriented toward companies whose business will materially benefit from efforts to mitigate or adapt to climate change, but it also involves the clean energy supply chain. We are pragmatic in our approach to buying copper mining, lithium mining, as well as semiconductors or other things in the supply chain, and much more likely to buy companies like that than buy the end product companies such as Tesla."

Hancock added more insights on the climate change strategy, which he said is obviously very ESG oriented on a specific dimension, but noted that to truly focus on climate change the investor may have to give up some other ESG criteria.

"More generally on ESG," he elucidated, "we have focused on this for many years and always integrated specific considerations we care about in our valuations, for example the 'S' in ESG for Accenture, which is an IT consulting company, they have put in a huge effort on re-training their staff and boosting human capital. As an investor, we are investor first, but incorporate key ESG considerations and have longer term horizons. So, for example with ESG, we avoid the Teslas of this world

and express our ESG and climate change views better in the supply chain and away from certain corporate governance issues you might see in a firm such as Tesla."

When quizzed on energy, Hancock remarked that he personally has a view that nuclear energy can be part of the solution. "It may be clean in the broader sense of the word," he commented, "so for example low greenhouse gas emission and relatively safe. We don't currently hold any nuclear players in the climate change strategy, but we would if the right opportunities come around."

reduce, and it is also a key part of their national security."

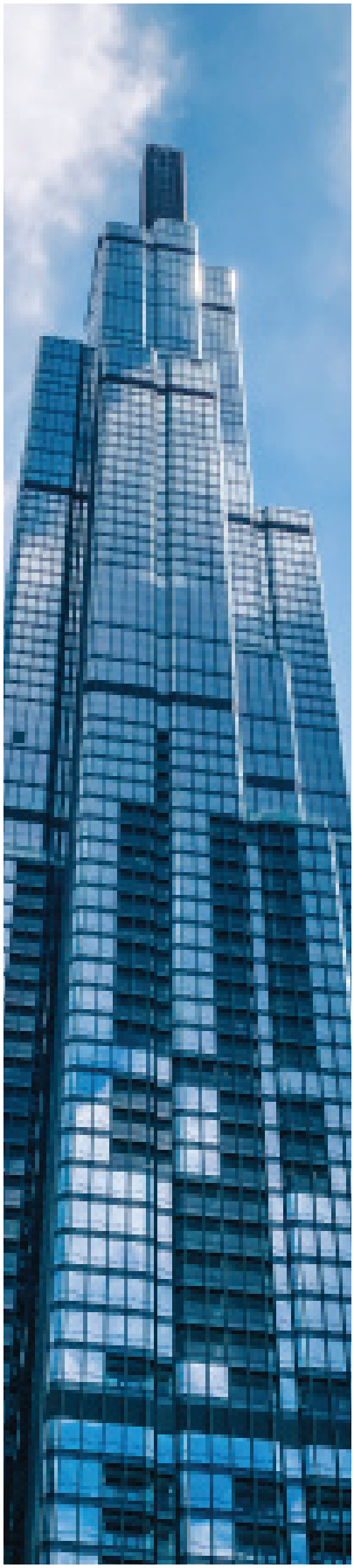
Hancock told guests that the biggest individual 'clean energy' stock for his strategy currently is semiconductor firm SolarEdge, which supplies technologies for the alternating current and power in the electrical systems. "From an investing point of view, solar panels are kind of a commoditised industry, you can't really make money there. And looking at alternatives, the copper content required for clean energy is very high compared to regular industrialisation, but it is hard to get new high-grade copper out of the ground, so that is another opportunity."

**"We actually have our own work in progress on developing a proprietary scoring, but it is not yet rolled out. Currently, the way I invest is to use scores and then overlay fundamentals. GMO does manage a lot of assets on more of a purely quantitative basis though, and as a group we are more energetic about really quantifying things than putting them in a score."**

### Experience counts

Wu also commented on ESG and China. "The Chinese government has been promoting ESG, so starting from last year they require quarterly reporting by companies to Beijing regarding their ESG practice. China wants foreign capital and they know that will be a key issue. I expect the pace of ESG adoption to accelerate there. Moreover, industries that might appear 'clean' such as solar panels, where China is the leader, are actually heavily polluting and will require more ESG-style adoption in the future. In general, my comment is that China's use of fossil fuels will

In the agriculture space, Hancock reported the largest holding is fertiliser company Mosaic. "As climate change concerns expand, the land must work harder, so fertiliser use is increasing," he explained. "In the supply chain, nitrogen is kind of commoditised, but phosphates and potassium are mined and finite, so the entities that control those are going to be advantaged. Demand through healthy eating trends, as well as through climate change, will result in more fish farming, as fish are less carbon intense than pork or



DR. TOM HANCOCK
GMO

cattle to raise, hence it is a cleaner source of protein."

## Score and then assess

His closing comment on ESG was that his strategy uses MSCI Sustainalytics for its ESG scoring. "We actually have our own work in progress on developing a proprietary scoring, but it is not yet rolled out. Currently, the way I invest is to use scores and then overlay fundamentals. GMO does manage a lot of assets on more of a purely quantitative basis though, and as a group we are more energetic about really quantifying things than putting them in a score."

Wu added some final views on ESG from his perspective. "We use MSCI, but also, we have our internal research," he explained. "We have a dedicated ESG manager, and then for some stocks we will have our own scores, especially for larger stocks, so we have a gatekeeping system to block us out of stocks that do not comply."

Hancock then focused more on resource stocks, noting that he believes an allocation of 20% of the portfolio to be realistic and appropriate. "We are doing things that other people aren't really doing," he said. "Most resource managers have a much more top-down focus of saying, 'this is going to be the year for nickel or this is going to be the year for gold or oil', 'oil versus industrial metals' but the reality is there is a very bad track record of forecasting any of that stuff. But there are so few people doing bottom-up fundamental work, like us, and we've had the highest alpha in that segment versus any other segment, whereas a lot of the best active managers just shy away from commodity equities because they can't forecast commodity prices. But if you are willing to take a fundamental value approach, there is a great opportunity in resource equities."

## Benchmark agnostic

Hancock was then quizzed on whether the fund is driven by benchmark or completely unconstrained. "We are completely unconstrained in the sense a benchmark plays no role in the portfolio construction process," he stated. "for the quality strategy, we are concentrated in around 40 stocks, of which the top 10 are about 40% of the portfolio. The other two strategies are more diversified, with over 100 stocks and more exposure to smaller cap names whereas the quality strategy is focussed on larger cap stocks."

His final comment went to the quality strategy, remarking that when investing in quality, the buyer should not be focussed on the reputation of stocks, but on the actual fundamentals of the business. "Focus on the play on the field, not the name on the back of the jersey," he remarked. "And the best companies' relative at the most attractive valuations we think are concentrated in the tech sector and it is that feature that gives you the downside protection. We have stuck to our basic premises and approach for some years, and the only thing that really changed is better upside capture, so the data is now more supportive of us continuing on these trends."

The discussion closed with some of the guests probing further on some of the specifics, and then with Hancock, Dua and Wu thanking the attendees and inviting them to maintain an active dialogue in the future. ■