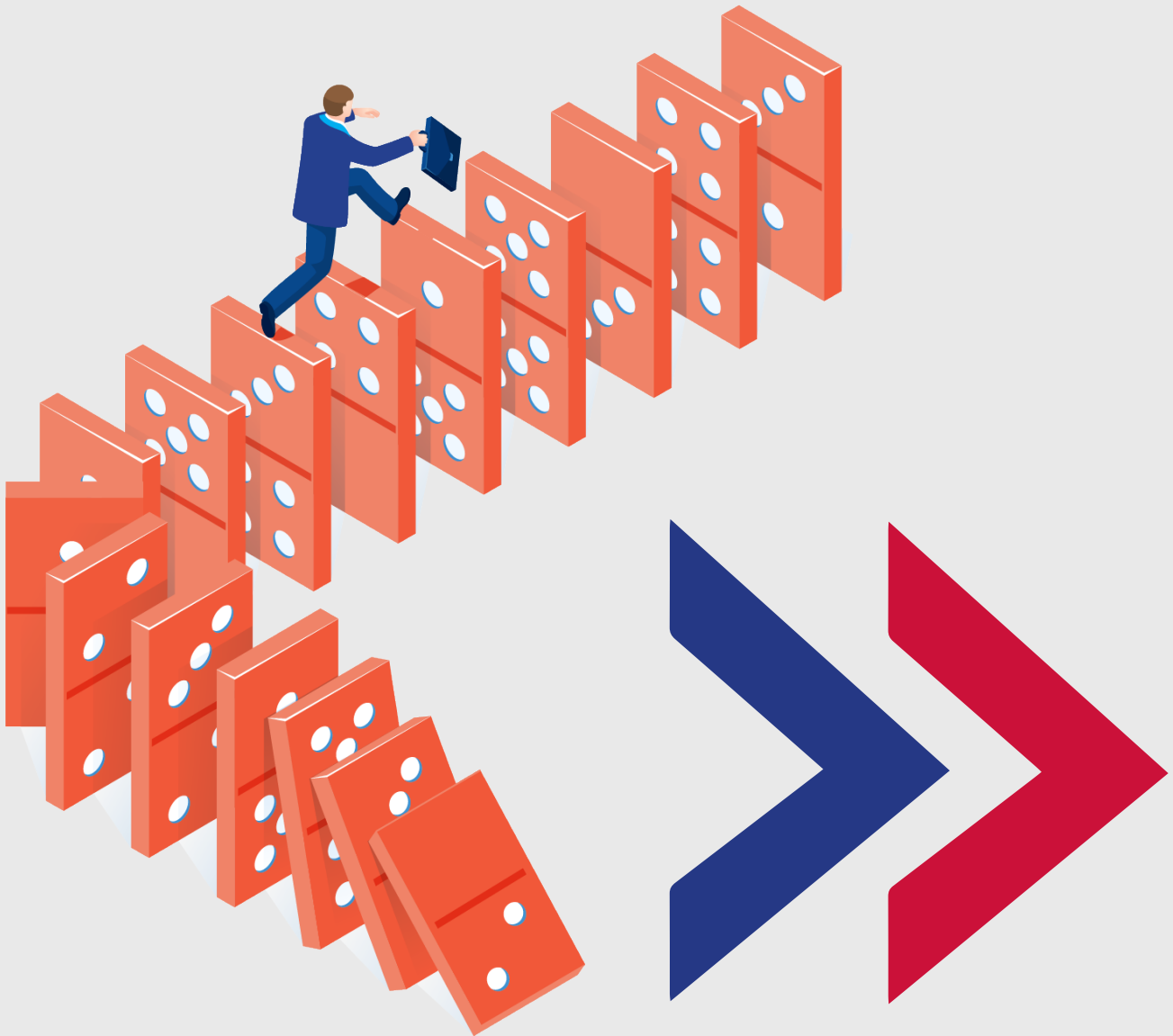


SELECTING QUALITY EQUITIES AND ADAPTING PORTFOLIOS

AMIDST GLOBAL VOLATILITY & UNCERTAINTY





In a recent Thought Leadership event in Bangkok co-hosted by Hubbis and global asset management group GMO, experts from GMO offered some fascinating views on high-quality equity portfolios aligned to appealing valuations through the firm's Focused Equity Team. The team oversees several key strategies at the firm, including the roughly US\$22 billion flagship Quality Strategy that was launched in 2004. The event was attended by gatekeepers and other decisionmakers at wealth management firms in Thailand and further afield in Asia. All guest comments are off-the-record and Hubbis has summarised the insights and observations from GMO in this review.

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GMO was created in 1977, remains privately held, and oversees some US\$66 billion of AUM. For more than 45 years, GMO has partnered with a broad range of sophisticated institutions, financial intermediaries, and families to provide the investment expertise they need to meet their goals and fulfil their missions.

GMO's sole focus is investing on behalf of their clients. Investment teams identify and exploit long-term opportunities, developing solutions that anticipate and respond to client needs. GMO's clients benefit from the firm's diverse investment expertise, intellectual curiosity, and open culture of debate. GMO reports that it prides itself on the ability to take advantage of contrarian market opportunities, and clients receive access to all of their industry-leading, insightful investment research and commentary.

The central speaker was Gunwoo Lim, Portfolio Strategist for GMO's Focused Equity team. Gunwoo joined GMO full-time in 2011 and was formerly an emerging markets specialist before taking up his current role at GMO. He earned his bachelor's degree in Industrial Engineering from Purdue University and his master's degree in Financial Engineering from the University of California, Berkeley.

Cindy Tan, CEO of the GMO Singapore office, co-hosted and represented GMO in Asia at the event. Cindy is responsible for operational, compliance, and governance matters for GMO's Singapore office and is also involved in business development efforts for GMO's Global Client Relations team in Asia. Prior to joining GMO in 2004, she worked at Ernst & Young in Singapore, where she was involved in advisory and assurance services for financial institutions in the local market. Ms. Tan currently sits on the Board of CFA Society Singapore, where she is also a member of the Investment Committee. She is also a member of the CFA Institute's Capital Markets Policy Council. Ms. Tan earned a bachelor's degree in Accounting from Nanyang Technological University in Singapore. She is a CFA charterholder and a CFA ESG Investing certificate holder. Ms Tan is also a Chartered Accountant of Singapore.



KEY TAKEAWAYS AT A GLANCE

INTRODUCTION TO GMO FROM SINGAPORE
CEO CINDY TAN

Cindy Tan highlighted GMO's extensive history, noting the firm's 47 years in the industry, including nearly 20 years in Asia. She explained GMO's shift from focusing primarily on institutional clients to diversifying and extending the firm's clientele coverage to include serving private wealth investors. Tan explained that GMO focuses intently on understanding investor needs and providing tailored solutions, leveraging the firm's distinctive long-term, valuation-focused investment strategies and supported by their publicly available and widely read 7-Year Asset Class Forecast.



GMO'S EQUITY ALLOCATION VIEWS

Tan discussed significant valuation dislocations in equity markets not seen in the past decade, highlighting current opportunities in the US deep value market and the international deep value market. She stressed the importance of incorporating a core quality component in equities for stability and security in uncertain market environments. She also emphasized GMO's consistent valuation caution, even for high-quality companies. GMO's long-term, valuation-focused investment philosophy helps to provide a margin of safety against the risk of overpaying.

SEEKING QUALITY IN
EVERY NOOK AND CRANNY

Tan discussed GMO's Quality Strategy. GMO is constantly identifying bright spots in undervalued segments of the market that are often overlooked. Despite market participants being excited about innovations like AI, GMO focuses on the sustainability of future growth based on the long-term and stable profitability of a company, which is not dependent on any hyped market trend. This approach allowed GMO's Quality Strategy to outperform in various market cycles in the last decade.

GMO'S FOCUSED EQUITY TEAM AND THEIR
INVESTMENT PHILOSOPHY

Tan shared that the GMO Focused Equity team manages more than \$30 billion in AUM, focusing on long-horizon, high-conviction quality investments with a blend of fundamental and quantitative techniques. Gunwoo Lim highlighted that their \$25 billion flagship Quality Strategy was launched in 2004 and has achieved strong and stable returns in different types of market conditions. In the last 10 years to end-June 2024, the strategy returned 14.2% annualized (net), outstripping the MSCI World Index by 5.1% annually.



QUALITY DEFINED AND QUALITY SOUGHT

Lim defined the common traits of the 'quality' companies they hold, emphasizing their ability to generate high and sustainable returns on capital. This is achieved through identifiable high-returning assets, durable business models, and the capital discipline of management. The strategy is concentrated, currently holding slightly more than 40 names, each meeting the team's quality criteria such as high profitability, high stability, and strong balance sheets. For instance, they appreciate TSMC for its high entry barriers backed by technological leadership and production capacity, and Apple for its economic moat founded on a closed ecosystem serving around 1.5 billion iPhone users worldwide.



THE GMO APPROACH TO VALUATION AND SELECTION

Lim detailed the Focused Equity team's disciplined valuation approach. As long-term investors, the team focuses on forecasting long-term cash flows and avoids overpaying for quality businesses, especially those with over-hyped growth expectations. He cited Microsoft, a company they have held for nearly two decades, to illustrate equity return drivers. He also discussed why they avoided Nvidia due to valuation risks. Instead, they're investing in companies like TSMC and Lam Research in the semiconductor space. These companies, not solely dependent on rising AI demand, trade at more attractive multiples, highlighting the team's conservative valuation approach.



MANAGING HIGH-PERFORMANCE STOCKS IN THE QUALITY EQUITY PORTFOLIO

Lim discussed managing high-performing stocks and disciplined selling based on valuation targets. The GMO Quality Strategy holds investments for a long period of time to capture the fundamental growth of companies. However, portfolio positions are fully liquidated if the market price significantly surpasses the intrinsic value of the business based on the team's assessment. He cited the liquidation of Adobe from the portfolio late last year as an example. The team believes that Adobe is a high-quality company, but could not justify the stock's valuation, which appreciated over 70% last year because of the stock's perceived benefit from AI.



RISK MANAGEMENT, PORTFOLIO ADAPTATION AND NAVIGATING MARKET VOLATILITY

Lim addressed the impact of market conditions on volatility, emphasizing the team's investment process that has historically delivered higher returns with lower volatility over the past two decades. He noted that quality companies with strong fundamentals tend to be less volatile in down markets. He stressed the importance of diversification and a valuation-focused approach, particularly at crucial market inflection points. Lim compared the current market concentration to the dot-com bubble, even though today's underlying composition is of a much higher quality. He emphasized that the GMO Quality Strategy is well diversified among attractively valued high-quality companies while avoiding exposure to the most overvalued companies in this highly concentrated market.

THE KEY INSIGHTS IN MORE DETAIL

Introduction to GMO from Singapore CEO Cindy Tan

Cindy Tan, CEO of GMO's Singapore office, addressed the select group of gatekeepers and decisionmakers from the private wealth management community in Asia. She provided a brief overview of GMO, focusing on the firm's extensive history and expertise. Notably, GMO has been in the industry for over 40 years and in Asia for almost 20 years, focusing mostly on institutional clients and increasingly on private wealth investors.

Recognising the evolving market in Asia, she explained that the region's private wealth had grown rapidly in recent years, and GMO has been leveraging its institutional expertise to introduce solutions tailored for wealth management clients. "Our goal is to understand investor needs and provide the right solutions tailored to their objectives," she said.

Tan highlighted GMO's distinctive investment approach, saying, "We are a long-term, valuation-focused investment manager. Our hallmark is our asset allocation views, which we showcase through our 7-Year Asset Class Forecast. This forecast is publicly available on our website (www.gmo.com) and offers deep insights into how we price expected returns across all asset classes over a full market cycle."

GMO's Equity Allocation Views

Tan also discussed the broader asset allocation strategies at

GMO, emphasising the current opportunities they see in both equity and fixed income markets. She noted significant valuation dislocations in equity markets that haven't been seen in the past decade. Specifically, she highlighted opportunities in the US and international deep value markets, where GMO has recently introduced strategies.

Addressing the question of global equity exposure, Tan stressed the importance of having a core equity component that allows investors to "sleep at night." She acknowledged the appeal of thematic plays in tech growth, but advised clients to focus on core portfolios that offer stability and security.

Tan pointed to GMO's common investment philosophy of being valuation-focused to avoid overpaying and thereby ensuring a margin of safety. This disciplined approach is crucial for managing client investments effectively. She cautioned somewhat about valuations and the lack of liquidity in private markets.

Addressing a question about GMO's suite of offerings, Tan stressed the firm's consistent caution around valuations. Despite client pressure to participate in booms like the AI trend, GMO prefers to focus intently on the primary drivers of return (for a stock), including long-term earnings growth, dividends, and changes in price multiples, which are based on the core tenets of their well-liked and publicly available GMO 7-Year Asset Class Forecasts.



CINDY TAN
CEO
GMO Singapore

Tan recounted instances where GMO returned capital to clients during overvalued market periods, highlighting their commitment to protecting client wealth over the long term. Clients adhering to GMO's valuation-focused philosophy benefited during market corrections.

She highlighted GMO's unique blend of quantitative methods and fundamental insights, enhancing their discipline in buying and selling decisions. She cited Jeremy Grantham's paper from March 20, which emphasised the importance of investing when others are fearful and stepping out when necessary. This disciplined approach is central to GMO's risk control metrics and investment strategies.

On the fixed income side, Tan mentioned that GMO aims to be



GUNWOO LIM
GMO

duration-neutral and is exploring areas like structured finance using a specific strategy that focuses on disruptive finance, providing exposure to credit despite the narrow spreads currently seen in credit markets. She also pointed out emerging markets, particularly local currencies, as areas of growing interest for diversification of fixed income exposures.

Seeking Quality in Every Nook and Cranny

Tan elaborated on GMO's approach to managing quality investments, emphasising the importance of identifying overlooked segments. This aligns with their philosophy of taking care of fundamentals by focusing on quality while controlling valuation risk by focusing on valuation and the price paid for investments.

Addressing a question about their suite of offerings, Tan stressed GMO's consistent valuation caution. Despite market participants being excited about innovations like AI, GMO

remains focused on long-term earnings growth, dividends, and changes in multiples. This approach is reflected in their 7-Year Asset Class Forecasts. Tan recounted instances where GMO returned capital to clients during overvalued market periods, like the tech bubble, highlighting their commitment to protecting client wealth over the long term. Clients who adhered to GMO's valuation-focused philosophy benefited during market corrections.

GMO's Focused Equity Team and Their Investment Philosophy

Tan introduced GMO's Focused Equity team, which now manages some \$30 billion of AUM in equity strategies primarily focused on quality and real assets. They target long-horizon, high-conviction investing with a blend of fundamental and quantitative techniques.

Gunwoo Lim from GMO's Focused Equity team then highlighted the team's approach and track record.

He explained that GMO's flagship Quality Strategy is now 20 years old and is well-known for its stable performance and reliability. The portfolio has achieved remarkable returns - in the 10 years to the end of June 2024, net returns were 14.2% annualised, outstripping the MSCI World Index by 5.1% annually. The strategy ranks in the top 5% among peer managers during this period, highlighting the superiority and stability of its performance.

The Focused Equity team is primarily based in Boston, with additional members in London and Singapore. Lim, who is based in Singapore, serves as a portfolio strategist. In the Focused Equity team, members often take on multiple roles; portfolio managers also serve as research analysts, highlighting the team's strong research focus.

Quality Defined and Quality Sought

Lim explained that the team's investment philosophy is centred around identifying attractively valued, high-quality companies in the market, rather than focusing on macroeconomic factors, such as interest rate changes.

He elucidated how the team defines quality as companies that generate high and sustainable returns on capital through identifiable high-returning assets, durable business models, and the capital discipline of management. The strategy is concentrated, currently with slightly more than 40 names in the fund, each representing a significant investment. This concentration reflects their high standards for quality, as it is challenging to find numerous companies that meet their criteria.

He outlined three key factors they consider:

» **Identifiable Assets:**

Lim emphasized the importance of high-returning assets, whether tangible or intangible. He provided examples such as TSMC, which invests heavily in building semiconductor fabs to produce advanced chips, as well as Microsoft, which benefits from its widespread use of software and services in corporate environments, thereby creating high switching costs and network effects. He noted that these assets create a robust economic moat for the company.

» **Business Model:** The team looks for companies with strong, durable business models that will remain relevant in the future. Lim underscored the team's long-term investment approach, which requires a high level of confidence in the business model that safeguards its future profits from competition and reliably generates cash flows for investment valuation.

» **Capital Discipline:** Lim stressed the importance of management's capital discipline when making decisions on reinvestment, mergers and acquisitions, or returning capital to shareholders through buybacks and dividends. He explained that this quality of management is crucial in ensuring the company's growth and enhancing shareholder returns.



Lim explained that these criteria are applied to all companies in their portfolio, ensuring they meet these high-quality standards. He underscored that this rigorous quality vetting process is the primary driver of returns in the strategy, complemented by the team's conservative approach to valuation.

The GMO Approach to Valuation and Selection

Lim detailed GMO's valuation approach, which focuses on forecasting future cash flows to determine the intrinsic value of a business. Lim also explored the practical application of this valuation approach, highlighting that while their goal is to identify high-quality companies, it is crucial to acquire them at an appealing price. He mentioned that the team's approach could be summarized as taking care of fundamentals by focusing on quality, while controlling valuation risk by seeking to avoid overreach on the earnings multiple. This allows them to avoid overpaying for high-quality businesses, especially those with over-hyped growth expectations.

Lim cited Microsoft, a company they have been holding for nearly two decades, as an example to explain the drivers of equity return. Earnings growth contributed the bulk of Microsoft's total returns over the long-term, although valuation changes could drive short-term returns.

On the other hand, Nvidia is a story of racy valuations on stocks whose potential was far more difficult to assess. Addressing the sustained frenzy around Nvidia, he reported that the GMO Quality Strategy had outperformed the benchmark last year and this year, without owning any Nvidia shares, explaining that their approach is centred on avoiding valuation risks.

While acknowledging Nvidia is a great company that has performed exceptionally well in the market, Lim highlighted the valuation risks associated with the uncertainty of AI's ultimate use case. Instead, they're investing in companies like TSMC and Lam Research in the semiconductor space. These companies, not solely dependent on the rising demand

for AI, trade at more attractive multiples, underscoring the team's conservative valuation approach.

Managing High-Performance Stocks in the Quality Equity Portfolio

Lim also zoomed in on some of the challenges of managing high-performing stocks and the importance of valuation in their investment strategy. He said that they hold investments for a long period of time to capture the fundamental growth of companies. However, they fully liquidate positions in the portfolio if the market price significantly surpasses the intrinsic value of the business based on their assessment. For example, they liquidated Adobe late last year after the stock appreciated over 70% because the market perceived



the stock as benefiting from AI, a valuation the team couldn't justify despite their belief that Adobe is a high-quality company. They then redeployed the capital to more attractively valued opportunities.

Lim also mentioned that the team has increased their exposure to more defensive quality stocks in the consumer staples and healthcare sectors as their valuations have become increasingly attractive, while reducing some of the quality growth stocks that have performed strongly throughout the year. He stressed that the core quality stocks in the portfolio with more defensive businesses have historically provided a defensive ballast when the stock market is under stress.

Risk Management, Portfolio Adaptation and Navigating Market Volatility

Lim addressed the impact of market conditions on volatility, highlighting that over the past two decades since its inception, the GMO Quality Strategy delivered higher returns with lower volatility than the broad equity indices.

Quality companies with strong fundamentals tend to be less volatile in down markets. Additionally, the team's focus on valuation has provided additional protection at the market's inflection points as most recently demonstrated in the bear market in 2022 and in Q1 2020 when the Covid-19 pandemic hit the global economy.



Lim also stressed that diversification across different styles of high-quality companies and a valuation-focused approach have provided meaningful downside protection in every major bear market. He offered insights that the team manages portfolio risks, such as unforeseen geopolitical risks or macro risks, through diversification and position sizing at the individual stock level so that the portfolio is not overexposed to such risk factors on an aggregate level.

Lim cited that while the team sees the current market concentration growing increasingly high, nearing that of the dot-com bubble the underlying composition today is of much higher quality. He concluded the conversation by emphasizing that the GMO Quality Strategy is well diversified among attractively valued high-quality companies, while also avoiding exposure to the most over-valued companies in this highly concentrated market. ■

DISCLAIMER

The views expressed are the views of the GMO speakers through the period ending July 2024 and are subject to change at any time based on market and other conditions. This is not an offer or solicitation for the purchase or sale of any security and should not be construed as such. References to specific securities and issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities.