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- U.S. Opportunistic Value Strategy

A DEEP VALUE INVESTMENT IN FINANCIALS

Attractive valuations with surprisingly sound quality

The Asset Allocation Team | March 2023

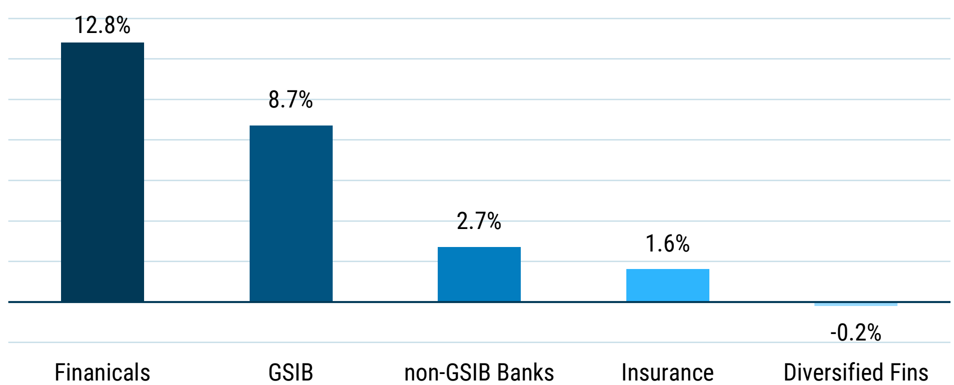
In the chaos of crisis, it is tempting to retrench into the safest assets. Following bank failures, many investors may prefer to avoid financials all together. Risks remain, but the banking sector will survive and some banks will actually benefit from current stresses.

GSIBs represent the bulk of our financials exposure

GMO's U.S. Opportunistic Value Strategy seeks to concentrate in the dislocated deep value (cheapest 20%) cohort of the U.S. equity market, based on a blend of our quantitative valuation models. At the end of February 2023, financials comprised 25% of the strategy, a roughly 13% overweight relative to the market. Exhibit 1 highlights how in the U.S. Global Systematically Important Banks (GSIBs), such as J.P. Morgan and Bank of America for example, comprise the bulk of our financials overweight. Other financials exposure includes insurance companies, some non-GSIB banks, and select diversified financials.

GSIBs dominate positioning because our valuation models factor in the strength and consistency of profitability profiles along with sound balance sheets. An objective to capture the very attractive deep value segment of the U.S. market does not require dialing into junk.

EXHIBIT 1: U.S. OPPORTUNISTIC VALUE ACTIVE FINANCIALS OVERWEIGHTS VS. S&P COMPOSITE 1500



As of 2/28/2023 | Source: GMO

GSIBs are competitively well-positioned and potential beneficiaries of disruption

GSIBs are unlikely to fall victim to the correlated deposit withdrawals and associated solvency risks that contributed to the failure of Silicon Valley Bank and others. Compared to smaller banks, GSIBs:

- are subject to higher[1] and tougher[2] regulatory capital requirements and more frequent[3] stress tests,
- have more diversified funding sources and are reported[4] to be experiencing significant deposit growth in recent days, and
- are, in the opinion of our fundamental analysts, better positioned to absorb any increased capital requirements or FDIC insurance costs that may arise.

GSIBs are cheap

Seven out of eight U.S. GSIBs[5] are sufficiently attractive that they screen as deep value on GMO's valuation models. U.S. Opportunistic Value's GSIB holdings trade at a 40-70% discount to fundamental value, based on GMO's proprietary price-to-fair-value model; this is roughly top decile relative to their own history, meaning they have rarely been cheaper on this metric.[6] Given their relative strength and competitive positioning, GSIBs offer an interesting opportunity for an investor who can bear short-term volatility, with lower potential for the permanent impairment of capital facing less sound banks. A valuation-driven approach understands the biggest bargains are usually found in times of turmoil.

Seeking deep value investments, GMO does not solely rely on traditional valuation ratios. Consequently, the U.S. Opportunistic Value Strategy has quality characteristics in line with core benchmarks despite trading at significantly more attractive levels. Even within the shaky U.S. financials sector, we're able to find banks which offer both resilience and excellent value.

Disclaimer

The views expressed are the views of the Asset Allocation team through the period ending March 21, 2023, 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.

1
GSIBs must hold up to 2.5% additional tangible loss absorbing capital relative to smaller banks.

2
AOCI, including losses on available for sale security portfolios are included in regulatory capital calculations for GSIBs but not for banks with less than $700 billion of assets.

3
Banks with less than $250 billion in assets are stress tested every other year.

4
See for example, Bloomberg.

5
https://www.fsb.org/wp-content/uploads/P211122.pdf

6
As of 2/28/2023 | Source GMO. Considers valuation data since 12/31/1990.