# International Active Update
## First Quarter 2015

GMO
North America | Europe | Asia-Pacific

### PERFORMANCE

The International Active EAFE Strategy outperformed the MSCI EAFE index in the first quarter; the strategy rose 5.7% net of fees and the benchmark gained 4.9%. Country and stock selection were both positive.

**Performance** (Year by Year %)

| | | GMO Int'l Active | MSCI EAFE | GMO Value Added | S&P 500 | Bonds AAA/AA |
|---|---|---|---|---|---|---|
| **1981** | **(Jun-Dec)** | 5.8 | -1.0 | 6.8 | -4.6 | 2.0 |
| **1982** | | 2.4 | -1.9 | 4.3 | 20.3 | 42.5 |
| **1983** | | 32.1 | 23.7 | 8.4 | 22.6 | 6.3 |
| **1984** | | 8.7 | 7.4 | 1.3 | 6.3 | 16.9 |
| **1985** | | 65.1 | 56.2 | 8.9 | 31.8 | 30.1 |
| **1986** | | 57.4 | 69.4 | -12.0 | 18.7 | 19.8 |
| **1987** | | 9.7 | 24.6 | -14.9 | 5.3 | -0.2 |
| **1988** | | 21.2 | 28.3 | -7.1 | 16.6 | 10.7 |
| **1989** | | 27.4 | 10.5 | 16.9 | 31.7 | 16.2 |
| **1990** | | -10.7 | -23.4 | 12.7 | -3.1 | 6.8 |
| **1991** | | 13.9 | 12.1 | 1.8 | 30.5 | 19.9 |
| **1992** | | -4.0 | -12.2 | 8.2 | 7.6 | 9.4 |
| **1993** | | 41.2 | 32.6 | 8.6 | 10.1 | 13.2 |
| **1994** | | 5.9 | 7.8 | -1.9 | 1.3 | -5.7 |
| **1995** | | 13.8 | 11.2 | 2.6 | 37.6 | 27.2 |
| **1996** | | 14.6 | 6.0 | 8.6 | 23.0 | 1.4 |
| **1997** | | 6.8 | 1.8 | 5.0 | 33.4 | 13.0 |
| **1998** | | 13.9 | 20.0 | -6.1 | 28.6 | 10.8 |
| **1999** | | 28.6 | 27.0 | 1.6 | 21.0 | -7.4 |
| **2000** | | -6.5 | -14.2 | 7.7 | -9.1 | 12.9 |
| **2001** | | -10.1 | -21.4 | 11.3 | -11.9 | 10.6 |
| **2002** | | -6.1 | -15.9 | 9.8 | -22.1 | 16.3 |
| **2003** | | 41.4 | 38.6 | 2.8 | 28.7 | 5.3 |
| **2004** | | 22.4 | 20.2 | 2.1 | 10.9 | 7.9 |
| **2005** | | 13.5 | 13.5 | 0.0 | 4.9 | 5.9 |
| **2006** | | 27.6 | 26.3 | 1.2 | 15.8 | 3.2 |
| **2007** | | 10.5 | 11.2 | -0.6 | 5.5 | 2.6 |
| **2008** | | -41.2 | -43.4 | 2.1 | -37.0 | 8.8 |
| **2009** | | 25.5 | 31.8 | -6.2 | 26.5 | 3.0 |
| **2010** | | 5.0 | 7.8 | -2.7 | 15.1 | 12.4 |
| **2011** | | -11.7 | -12.1 | 0.5 | 2.1 | 18.0 |
| **2012** | | 14.9 | 17.3 | -2.4 | 16.0 | 10.7 |
| **2013** | | 24.1 | 22.8 | 1.3 | 32.4 | -7.1 |
| **2014** | | -11.0 | -4.9 | -6.1 | 13.7 | 17.3 |
| **YTD 2015** | | 5.7 | 4.9 | 0.8 | 1.0 | 3.2 |
| ***Compound Annual Rate of Return (33 Years, 10 Months)*** | | | | | | |
| | | 11.6 | 8.9 | 2.7 | 11.3 | 10.3 |

## REGIONAL COMMENTARY

On the global menu of asset classes, European equities are the flavor du jour. A more generous QE package from the ECB than discounted by the markets coupled with tentative signs of economic improvement in the eurozone have been enough to send the MSCI Europe index 11.6% higher in local terms in the first quarter. In contrast, the S&P 500 is only marginally above where it began the year.

The bullish case on European equities centers on cyclical recovery potential in the eurozone with earnings in the region still 30% below their 2007 peak, while other areas of the world have recovered, for example, U.S. aggregate earnings are 25% higher than 2007. Given that EU equities remain cheaper than their U.S. counterparts (at least on measures less prone to cyclicality, such as price to book and cyclically adjusted P/Es), the case for buying Europe seems compelling.

While not denying the relative appeal of European equities over the U.S., the argument that European equities represent an attractive investment on absolute grounds is far less strong. In 2012, trough valuations on (hopefully) trough earnings in the eurozone were commonplace. This is not the case today. Draghi's reassurance on the durability of the faltering eurozone saw risk premiums diminish and powered a strong rally in 2013. Unfortunately, the eurozone then failed to deliver on the earnings upside the bulls envisaged. The economic outlook remained poor and earnings momentum weak. Hence, the disappointments of 2014.

There are better hopes on the macro front today. Whether QE can boost economic growth remains a question, but there is little doubt that it can weaken currencies and hence boost a country – or a region's – export sector. Thanks in part to euro weakness Mario Draghi has been able, without facing derision, to raise growth forecasts for the eurozone to 1.5% for 2015 and to 1.9% for 2016. This has been the first material upward revision in the one-year forward GDP forecast by the ECB since 2011. And, the market needs earnings to improve to generate upside. Since March 2009, 94% of the rise in eurozone equities can be attributed to multiple expansion, meaning only 6% can be accounted for by earnings growth.

There are also reasons for caution. The case for demand in many European industries being structurally, rather than cyclically, weak remains potent. Autos are a prime example. Western European auto sales peaked in 1999 at 15.1m units. In 2014 they were 12.1m units, up from the 11.6m trough in 2013. Certainly this suggests some cyclical recovery potential (though far less than in the U.S. market, where sales plummeted 50% in 2008). But, it could be argued equally that it bears similarities to the Japanese market, where sales have been falling for 20 years as factors such as poor demographics take their toll. It is notable that auto sales in Europe now are only 1.5m units (11%) below their 25-year average. It seems unclear where a V-shaped recovery will come from. The European working age population is declining, and on a country basis, only Spain and Italy appear to offer meaningful recovery potential compared to long-term trends (auto sales in both countries are close to 30% below their 25-year averages; in contrast France is only 10% below its long-term average and Germany 5%). Yet, unemployment and, importantly, youth unemployment, remains stubbornly high in both Spain and Italy. Perhaps Draghi's QE package will end this malaise, but given this backdrop it seems very optimistic to expect a major Europe-wide rebound in auto sales in the short term. Even if such a rebound does materialize, it is worth noting that among the car makers only Peugeot really offers significant gearing to European markets. Most other European car makers have diversified away from dependence on Europe into emerging markets, where growth is slowing.

Autos are not alone in failing to offer significant cyclical recovery potential. Utilities look to have structurally impaired earnings compared to their 2007 levels thanks to the huge growth in renewables. Elsewhere, European banks look highly unlikely to see strong improvements in their returns on equity, thanks to higher capital ratio requirements and less tolerance for leverage within the sector.



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Finally, the lumbering edifice of the European state and the straitjacket of the euro remain burdensome. Despite these problems, the market seems to have swung from extreme skepticism regarding the durability of the euro project to unjustified optimism in its resilience. The euro remains a remarkable test bed in the acceptance of democratic states of economic adjustments via deflation rather than letting a country's currency take the strain. The benefits of low oil and a depressed euro – though undeniably potent in the short term – could prove ephemeral.

In a world of assets offering low returns, European equities undeniably look to be a less bad place to invest. Some European sectors – building materials, for example – do appear to offer notable cyclical recovery potential. But, these are more the exception than the norm. Those who argue for blanket cyclical upside throughout Europe are likely to be disappointed.

## COUNTRY ALLOCATION AND MARKET UPDATE

Country and currency allocation was 0.5% ahead of the benchmark. Our positioning in Europe added to returns, particularly due to being less exposed to the United Kingdom than the benchmark. In addition, while our weight in Europe is slightly lower than that of benchmark, we have an overweight position in the eurozone. In January we hedged the account such that the exposure of the portfolio to the euro was closer to that of the benchmark, and the hedge against the euro was positive in the quarter.[1]

The Pacific was the best performing region in the quarter, with Japan leading the way. "Shunto" is a Japanese term for the "spring offensive," a period in which labor and management conduct wage negotiations. This year's Shunto has garnered particular focus due to Prime Minister Abe's conviction that extracting the Japanese economy from deflation requires real wage growth. The contracted wage concessions to the large unions have been largely ahead of expectations, with headline wage growth of 2.3%. Formal union negotiations cover only one in five workers in Japan, the majority of workers are employed by companies with fewer than three hundred employees, or small- and medium-sized enterprises (SME), where the news is equally good. SME wage increases appear to be on target for 2.1% YoY growth. These are strong numbers for a workforce that has not seen much improvement in wages in over a decade. Rather than being taken as corporate largesse, there are signs that the Japanese labor market is tightening in several service sectors. While wages are up, inflation appears to be rolling over given the decline of oil prices and less expensive imports due to the stabilization of the yen. An important part of any domestic economic recovery is capex, which remains muted. All of these factors taken together have kept the BoJ on the sidelines with regard to incremental stimulus. Meanwhile, in the private sector, Japanese management teams are delivering on earnest efforts to improve ROE and dispose of low return assets, cash being the most immediate example. Dividends are going up and shares are actively being bought back, which has provided support to a market revisiting a 15-year high.

Despite a falling euro, Europe performed well in the quarter, as it began its quantitative easing program and has managed to diffuse the Greek crisis, at least for now. Inflation, or lack thereof, remains a concern, but while still negative, numbers improved over the quarter. In the U.K., the election continues to draw closer.

During the first quarter, the U.S. market has struggled to find direction with the backdrop of a strengthening dollar, declining earnings estimates (mostly due to energy companies), and valuation levels, which are not particularly cheap. However, an improving job market and the prospect of increased consumer spending given the decline in fuel prices have continued to give support to the market. Record cash balances and strong cash flow generation are fuelling share repurchases and M&A activity, and will likely limit some of

[1] Data is that of a representative account from within the Composite.



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the downside risk posed by elevated valuation levels.

## STOCK SELECTION

Stock selection beat the benchmark by 0.3% in the first quarter. Holdings in Europe, Australia, and Hong Kong outperformed. On the negative side, stock selection in Japan hurt returns.[1]

In Europe, outperformance came from companies across the region: Peugeot in France, Banca Popolare di Milano in Italy, and Deutsche Telekom in Germany. Peugeot enjoyed a very strong run in the first quarter on the back of signs of a recovery in European automotive volumes (Peugeot is the quoted auto manufacturer most exposed to the eurozone market) and a strong set of 2014 results. The company saw a significant improvement in free cash flow generation and solid progress toward the group aim of an operating margin of 2% for its automotive division (this is targeted for 2018 at the latest, and likely to arrive far earlier based on current trends). Banca Popolare di Milano outperformed after the Italian government approved a decree that forces co-operative banks like Milano to transform into joint-stock companies. Co-operative banks currently allow a shareholder one vote, irrespective of his/her investment position, effectively preventing any major reforms/takeovers from happening in these banks. The passage of this law will take power away from local foundations and trade unions that exert more than their share of influence and prevent the banks from merging or becoming more efficient. The passage of this law will allow Milano to improve its return on equity, bringing it closer to large banks, thus allowing the bank to re-rate. Finally, European telecom companies did well, especially Deutsche Telekom. There are several reasons we like these names, among them that the consolidation of the industry within markets has started, and their regulatory environment has finally become a tailwind after many years of holding them back. These companies stand to benefit from a "market repair" scenario, where a data consumption boom drives a rebound in the ARPU.

Stock selection in Australia was positive. Logistics company Toll received a buyout offer from Japan Post at a 50% premium to its previous value, vindicating our long-held position in the company. We sold our entire position given the very aggressive re-rating of the shares. In addition, Incitec Pivot, a mining explosives maker and fertilizer merchant performed well; mostly on higher prices for fertilizer DAP. While formerly a cheap stock, the strong returns have increasingly discounted the company's future cash flows.

Hong Kong listed Cheung Kong Holdings and China Unicom outperformed. Cheung Kong, historically a holding company for the operating assets of famed investor Li Ka Shing, announced a reorganization that will consolidate all of the property assets into one listed company, and all non-property into a separate listing. This could mean a narrowing of the large discount to NAV at which the stock has traditionally traded. China Unicom, China's second largest mobile phone operator, rallied along with its peers China Mobile and China Telecom as cheap valuations and very fast adoption of 3G and 4G handsets spurred hopes that mobile data revenues will bring growth back to a market that has seen surprising competitiveness despite its consolidated nature. We have since switched to holding China Mobile.

In Japan, Hitachi Ltd. fell on news that it would buy Italian company Finmeccanica's rail and signal assets. While the market had anticipated the transaction, the price was a negative surprise.

## CURRENCY AND HEDGING

Currency was an important part of returns for the quarter as most benchmark currencies fell against the U.S. dollar. The most significant was the euro, which dropped 11.3% as that region began its QE program. The U.K. pound fell 4.8%. The Japanese yen was one of the few currencies that held up, declining only 0.1% while the Australian dollar lost 6.6%.



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As mentioned above, in January we hedged the account such that, despite more exposure to eurozone markets than the benchmark, the exposure of the portfolio to the euro was roughly in line with that of the benchmark. As of March 31, 9.0% of the account was hedged. The hedge against the euro was positive in the quarter.

**Sector Weights and Performance** March 31, 2015

| | MSCI EAFE Sector Performance | | Sector Weight March 31, 2015 | |
|---|---|---|---|---|
| Sector | First Quarter | 2015 | GMO Int'l Active | MSCI EAFE |
| **Consumer Discretionary** | 8.4% | 8.4% | 14.2% | 13.1% |
| **Consumer Staples** | 4.7% | 4.7% | 6.3% | 11.0% |
| **Energy** | -4.8% | -4.8% | 3.8% | 5.1% |
| **Financials** | 4.8% | 4.8% | 36.0% | 26.0% |
| **Healthcare** | 9.6% | 9.6% | 2.8% | 11.4% |
| **Industrials** | 6.0% | 6.0% | 8.2% | 12.7% |
| **Information Technology** | 7.1% | 7.1% | 9.4% | 4.9% |
| **Materials** | 3.3% | 3.3% | 2.9% | 7.5% |
| **Telecommunication Services** | 2.2% | 2.2% | 10.9% | 4.7% |
| **Utilities** | -4.8% | -4.8% | 5.5% | 3.6% |

The above information is based on a representative account within the strategy selected because it has the fewest restrictions and best represents the implementation of the strategy. The information above is supplemental to the GIPS compliant presentation that was made available on GMO's website in September of 2014.



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## GMO Parameter Profile Actual P/BK, P/E, P/CF, and Yield March 31, 2015

| Region/Country | Price-to-Book | Price-to-Earnings (weighted median) | Price-to-Cash Flow (weighted median) | Yield |
|---|---|---|---|---|
| **GMO** | **1.4** | **16.4** | **8.3** | **2.9%** |
| MSCI EAFE | 1.8 | 19.3 | 12.2 | 2.9% |
| GMO Premium/(Discount) to MSCI EAFE | -23% | -15% | -31% | 1% |

## MSCI EAFE Country and Currency Returns

| | March 31, 2015 | | 2015 Q1 | | |
|---|---|---|---|---|---|
| Country | MSCI EAFE Weight | GMO Int'l Active Weight | MSCI EAFE Return in Local Currency | MSCI EAFE Currency Return | MSCI EAFE Return in $US |
| Denmark | 1.6% | 0.0% | 30.9% | -11.6% | 15.8% |
| Japan | 22.2% | 21.1% | 10.2% | -0.1% | 10.2% |
| Israel | 0.6% | 0.0% | 11.3% | -2.2% | 8.9% |
| Germany | 9.5% | 8.7% | 22.0% | -11.3% | 8.3% |
| Portugal | 0.2% | 0.5% | 20.9% | -11.3% | 7.3% |
| Italy | 2.3% | 9.6% | 20.4% | -11.3% | 6.8% |
| Hong Kong | 3.1% | 1.9% | 6.0% | 0.0% | 6.0% |
| Belgium | 1.3% | 1.5% | 19.4% | -11.3% | 5.9% |
| Sweden | 3.1% | 0.5% | 15.9% | -9.3% | 5.2% |
| Netherlands | 2.7% | 0.0% | 18.2% | -11.3% | 4.9% |
| **MSCI EAFE** | | | **10.8%** | **-5.4%** | **4.9%** |
| Switzerland | 9.3% | 3.9% | 2.4% | 0.7% | 4.7% |
| France | 9.7% | 13.5% | 18.0% | -11.3% | 4.7% |
| Ireland | 0.3% | 0.0% | 16.7% | -11.3% | 3.6% |
| Austria | 0.2% | 0.0% | 16.2% | -11.3% | 3.1% |
| Australia | 7.3% | 4.3% | 10.4% | -6.6% | 3.1% |
| Finland | 0.9% | 0.9% | 15.5% | -11.3% | 2.5% |
| Norway | 0.6% | 0.0% | 9.9% | -6.8% | 2.3% |
| Spain | 3.6% | 5.3% | 12.0% | -11.3% | -0.6% |
| United Kingdom | 19.8% | 16.9% | 4.0% | -4.8% | -1.0% |
| New Zealand | 0.1% | 0.0% | 2.4% | -4.0% | -1.8% |
| Singapore | 1.4% | 0.0% | 1.4% | -3.3% | -1.9% |
| | | | | | |
| Emerging Markets | 0.0% | 7.1% | | | |
| Cash | 0.0% | 4.3% | | | |



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Performance data quoted represents past performance and is not predictive of future performance. Returns are presented after the deduction of a model advisory fee and a model incentive fee if applicable.  Net returns include transaction costs, commissions and withholding taxes on foreign income and capital gains and include the reinvestment of dividends and other income, as applicable. A GIPS compliant presentation of composite performance has preceded this presentation in the past 12 months or accompanies this presentation, and is also available at www.gmo.com. Actual fees are disclosed in Part 2 of GMO's Form ADV and are also available in each strategy's compliant presentation. Fees paid by accounts within the composite may be higher or lower than the model fees used. The attribution information above is based on a representative account within the strategy selected because it has the fewest restrictions and best represents the implementation of the strategy. The information above is supplemental to the GIPS compliant presentation that was made available on GMO's website in September of 2014.

Performance is shown compared to the MSCI EAFE Index, a broad-based securities market index that measures large capitalization international stocks. Broad-based indices are unmanaged and are not subject to fees and expenses typically associated with managed accounts or investment funds. Investments cannot be made directly into an index.

Information about the composite is as of the period-end noted above, subject to change without notice and not intended as investment advice.

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