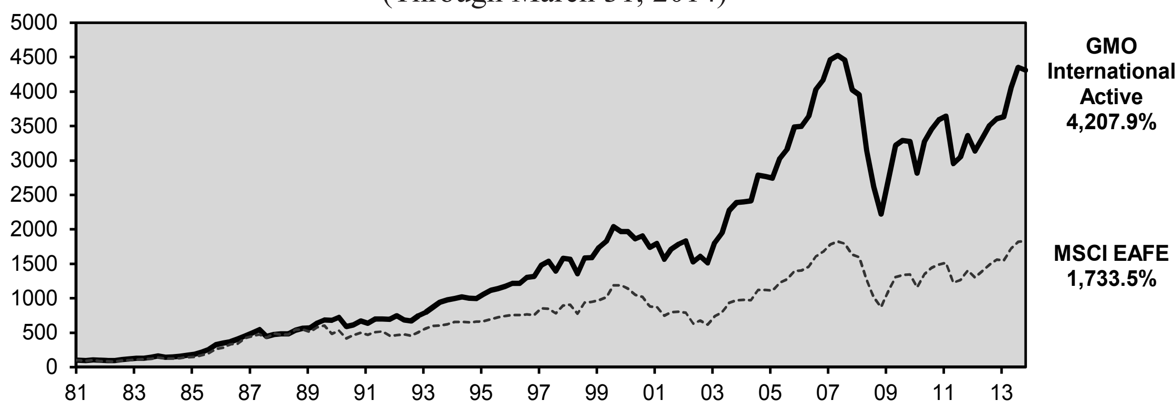
International Active Update
First Quarter 2014

Performance

The International Active EAFE Strategy underperformed the MSCI EAFE index by 1.7 percentage points in the first quarter; the strategy fell 1.0% net of fees and the benchmark rose 0.7%. Negative stock selection was somewhat offset by positive country selection.

GMO International Active Performance
(Through March 31, 2014)



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
YTD 2014		-1.0	+0.7	-1.7	+1.8	+5.7
Compound Annual Rate of Return (32 Years, 10 Months)						
		+12.1	+9.3	+2.9	+11.3	+10.2

Region Commentary

Perhaps the most disappointing asset class of the past few years has been emerging market equities, which was a splash of cold water for those hoping this 15-year market darling would provide solid performance relative to stocks in the slow-growing, post-crisis West. Indeed, since the end of 2012, the MSCI Emerging Markets index has underperformed its developed market peer, the MSCI World, by 24.5% annualized. While some smaller markets within emerging have performed fairly well over this time period, the malaise has been broad-based, and some of the larger countries, such as the much-hyped BRIC markets, have fallen the most. This is a startling contrast to the 13.6% per year outperformance that EM equities afforded over their developed market peers for the decade from 2001 through 2010.

Frustratingly, the recent underperformance occurred at a time when it is hardly clear that emerging market equities were expensive. The GMO 7-year asset class forecasts have consistently placed emerging markets near the top of their expected return ranking during this period. What happened and what do we think going forward?

To understand where we are, we must go back to the catastrophic end of the last emerging markets cycle in 1998, when overheated emerging economies fell victim to capital flight, deflationary recessions, and currency devaluations. While the economic dislocation was severe, the equity and currency falls combined with internal restructuring left most of these economies extremely competitive and priced to outperform by the time the world started to recover from the TMT bubble. The September 30, 2003 GMO 7-year forecasts put returns for emerging equity at 6.9% real,[1] and the MSCI Emerging Markets index returned 18.9% per year over the next 7 years. Value was obvious, and it more than delivered.

We would argue that the initial upturn in emerging market economies, from 2003 through perhaps 2007, was on sound footing. From that point onwards, however, a confluence of events created the conditions for an unsustainable increase in economic activity and equity market valuations, although conditions varied from country to country. One major feature of emerging markets, particularly those in Asia, is their tendency to manipulate exchange rates and accumulate foreign exchange reserves. This boosts domestic money supply and underpins the inflationary boom that is the hallmark of the emerging market economic and credit cycle. The weak U.S. dollar throughout the first part of the last decade provided fertile soil for this cycle to assert itself once more. This pattern, however, was put into overdrive by two factors. One was the China bubble, which put upward pressure on commodity prices and significantly improved the terms of trade for emerging economies like Russia (oil), Brazil (iron ore), and Indonesia (palm oil and coal), to name a few. The second was unconventional monetary policy in the West after its financial crisis. These policies caused a global search for investment yield, commonly in the form of carry trades. Both of these trends forced huge amounts of capital into emerging markets, and this predictably inflated local economies, boosted exchange rates, goosed economic growth rates, and pushed equity and debt valuations to nosebleed levels. It is the reversal of these two factors that is responsible for the recent downturn in emerging markets, and there is ample reason to believe it could continue.

GMO has written at length on the Chinese economy and the issues that we believe exist there. In short, we believe that an epic credit bubble is in the early stages of unwinding. If we are right, there should be major downward pressure on industrial commodity prices in particular, negatively affecting the economies of the many emerging market exporters. This would probably also raise the EM risk premium in general. Combined with a possible rise in nominal yields globally, there would be the potential for a significant repricing of discount rates across most emerging market assets. The past decade saw the price of risk in emerging markets decline. The J.P. Morgan EMBI+ sovereign nominal yield, one measure of the cost of capital in emerging markets, went from levels over 12% in 2002 to half of that by 2010.

As we described, however, emerging market equities have already underperformed substantially. Is there any value? A defining feature of these markets is the spread of value available. EM contains a far greater range of valuations than the whole of developed markets, from Russian oil companies at 2x earnings to Chinese consumer plays on 8x price to book. The markets are definitely discounting a portion of the factors we discussed above, some to a substantial degree. We are watching the asset class closely and are now finding opportunities in some names that we feel have fallen too far.

[1] The inflation assumption used was 2.2%, and a range of + 10.5% annualized return was given.

Country Selection and Market Update

Country selection was 0.2 percentage points ahead of the benchmark. Our positioning in Continental Europe added to returns, particularly an overweight position in Italy, which outperformed in the quarter. An underweight position in Switzerland partially offset the gain.[2]

While the news in the quarter was dominated by Putin and the Ukraine, the European macro outlook continued to improve. This was reflected in the declining bond yields of the peripheral countries. However, worries linger about potential deflationary issues, and we continue to watch carefully for signs of deflation risk.

The U.S. Federal Reserve moved to taper another $10 billion to $55 billion. Worries that low interest rates would be raised made the market skittish, but Fed Chair Janet Yellen made it clear that, due to conditions in the labor market, the Fed would not be raising short-term interest rates anytime soon. This news gave markets a boost at the end of March.

In Japan, creeping concerns over fiscal issues in China sent Asia's largest and most liquid market into a tailspin. Putin's antics in the Ukraine, malaise in the emerging markets, and taper tantrums in the U.S. were also factors in the decline.

We continue to focus on individual companies and their valuations. We still find many opportunities in Europe and have increased our overweight position in the region. We believe that limited growth has been priced into the equity markets, and anything over that will be well rewarded. We have funded our overweight in Europe by taking our weight down in Japan. We believe much of the value has been wrung out of the Japanese market after the 2013 outperformance, but we still find interesting pockets of value driven mainly by restructuring stories and companies that remain on trough margins and trough multiples. We have begun to buy select companies in emerging markets that we feel have been oversold as those indexes fell.

Stock Selection

Stock selection lagged the benchmark by 1.9 percentage points in the first quarter. Holdings in Japan, Australia, Continental Europe, and the emerging markets underperformed.[2]

Stock selection in Japan was hurt by our position in banks. We have three separate holdings in the Japanese banking sector given their respective exposures to credit growth as the Japanese economy slowly emerges from a decade of deflation and deleveraging. In oversimplified terms, owning the banks is a bet on the success of the Bank of Japan's commitment to quantitative easing and the resulting 2% inflation it aims to produce. In periods of deflation, capital is rewarded by sitting still while prices drop, thereby generating a real rate of return without taking any risk. This is why deflationary expectations are often hard to break. Inflation, on the other hand, eliminates the risk-free option of sitting still and compels capital to seek a return in riskier assets. Banks are the conduit and potential profit center for this transition in Japan. Our holdings in each bank serve a different means of accessing potential credit growth in Japan. For example, Sumitomo Mitsui gives us exposure to credit growth in small- and medium-sized enterprises in domestic Japan; Mitsubishi UFJ provides exposure to overseas loan growth with the kicker of dollar-based earnings from interest held in Morgan Stanley and Union Bank; Shinsei Bank is largely exposure to Japanese consumer credit. While reported earnings have been largely positive, the market appeared to fret over the contraction of net interest margins (NIMs), a function of the Bank of Japan's lowering the JGB yield curve. While it is true that NIMs did contract, the lower margins were largely offset by the increase in loan growth – a nascent sign of the credit growth central to our thesis. Given the low valuations and solid dividends, we feel well paid to wait for the market to realize that the glass is more than half full and filling.

We have had substantial positions in the Australian names Toll and Asciano for quite a while, the premise being that these two logistics companies are bumping along a cyclical trough in volume while taking costs out of the business. Should any sort of economic growth return to Australia, these two should show strong profit and cash flow growth. In the meantime, with Toll, we collect a 5% dividend yield (2% for Asciano) while we wait. Valuations for both are reasonable and expectations are low. The issue for both stocks has been that the cyclical upturn never seems to come, despite signals in the rest of the economy that growth is picking up. For now, we are willing to wait to see if the green shoots elsewhere will finally feed into increased profits for these two cyclicals. For Toll in particular, there is frustration that management has not moved more swiftly in shedding

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

underperforming assets. We believe that should any deals be announced, the stock could move positively.

In Continental Europe, holdings in ArcelorMittal and Television Francaisse 1 (TF1) hurt performance. Arcelor underperformed last quarter as the positive news flow around nascent recovery in Europe was offset by tough trading conditions in emerging markets. Being the largest steel and one of the largest iron ore players globally, the company also suffered from iron ore and steel price movements. We have exited our position in the stock. Our rationale for buying this name was that the recovery in European industrial and construction industry will offset any uncertainty emanating from China. However, we didn't anticipate the extent of the downward pressure on global steel and iron ore prices. A severe slowdown in China will cause a decline in iron ore profitability that will completely wipe out any positive impact from steel industry recovery in Europe or the United States. Hence, we sold our position. TF1 is the largest TV broadcaster in France. After a +60% run in 2013, investors took some profits off the table in early 2014. As it derives most of its revenues from advertising, TF1 is a pure play on the macro environment and has to deal with a weak economy combined with a challenging competitive landscape. At the same time, costs are under control, the company has no debt, strong cash flows are being generated, and significant capital is slated to be returned to the shareholders in the near future. TF1 still remains one of the cheapest broadcasters in Europe.

Our position in emerging markets subtracted from returns, particularly holdings in Russia. The two names we own, TCS Group and Sberbank, were casualties, along with most of the market, of the sanctions imposed on Russia due to the Ukraine crisis. We are closely watching the developments, and at this point we believe both companies are discounting in escalation of the crisis.

Currency and Hedging

Benchmark currencies in the Pacific region climbed relative to the U.S. dollar, with the Japanese yen gaining 2.0% and the Australian dollar rising 3.6%. Elsewhere in the world currencies were relatively neutral for the quarter. The euro was flat against the dollar, and the U.K. pound gained 0.7%.

The strategy was unhedged in the quarter.

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First Quarter 2014

GMO

Sector Weights and Performance
March 31, 2014

Sector	MSCI EAFE Sector Performance		Sector Weight March 31, 2014	
	First Quarter	*YTD 2014*	*GMO Int'l Active**	*MSCI EAFE*
Consumer Discretionary	-2.0%	-2.0%	13.8%	11.8%
Consumer Staples	0.6%	0.6%	8.4%	11.0%
Energy	1.7%	1.7%	7.6%	6.9%
Financials	-0.4%	-0.4%	25.1%	25.6%
Healthcare	5.7%	5.7%	5.1%	10.4%
Industrials	0.4%	0.4%	15.8%	12.9%
Information Technology	-0.4%	-0.4%	5.2%	4.5%
Materials	0.7%	0.7%	6.4%	8.1%
Telecommunication Services	-2.1%	-2.1%	4.4%	5.0%
Utilities	7.1%	7.1%	5.4%	3.8%

GMO Parameter Profile
Actual P/BK, P/E, P/CF, and Yield
March 31, 2014

Region/Country	Price-to-Book	Price-to-Earnings (weighted median)	Price-to-Cash Flow (weighted median)	Yield
GMO*	**1.5**	**16.4**	**9.9**	**2.9%**
MSCI EAFE	1.7	17.0	10.8	3.1%
GMO Premium/(Discount) to MSCI EAFE	-12%	-4%	-8%	-6%

*Data is based on a representative account selected because it has the fewest restrictions and best represents the implementation of the Strategy. This information is supplemental to the GIPS compliant presentation of the strategy that has preceded this report in the last 12 months or accompanies it. GIPS compliant presentations of composite performance are also available at www.gmo.com.

International Active Update
First Quarter 2014

GMO

MSCI EAFE Country and Currency Returns

	March 31, 2014		2014 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
Israel	0.5%	0.0%	19.1%	-0.5%	18.5%
New Zealand	0.1%	0.0%	10.4%	5.5%	16.4%
Denmark	1.4%	0.4%	16.1%	-0.1%	16.0%
Italy	2.6%	8.1%	14.6%	0.0%	14.6%
Ireland	0.3%	0.4%	14.0%	0.0%	14.0%
Portugal	0.2%	0.4%	9.7%	0.0%	9.7%
Australia	7.9%	4.9%	2.2%	3.6%	5.9%
Spain	3.6%	4.1%	4.8%	0.0%	4.8%
Switzerland	9.3%	4.9%	4.0%	0.6%	4.7%
France	10.4%	18.6%	2.9%	0.0%	2.9%
Sweden	3.3%	1.7%	3.5%	-0.9%	2.6%
Belgium	1.2%	1.1%	2.4%	0.0%	2.4%
Norway	0.8%	1.2%	0.8%	1.3%	2.2%
Netherlands	2.7%	1.3%	1.0%	0.0%	1.1%
MSCI EAFE			**-0.3%**	**0.9%**	**0.7%**
Finland	0.9%	1.1%	-0.1%	0.0%	0.0%
Germany	9.5%	7.4%	-0.4%	0.0%	-0.3%
United Kingdom	21.1%	20.0%	-1.5%	0.7%	-0.8%
Singapore	1.4%	0.0%	-1.2%	0.4%	-0.8%
Austria	0.3%	0.4%	-2.8%	0.0%	-2.8%
Hong Kong	2.8%	1.3%	-3.3%	0.0%	-3.4%
Japan	19.7%	15.4%	-7.5%	2.0%	-5.6%
Emerging Markets	0.0%	4.5%			
Cash	0.0%	2.9%			

Performance data quoted represents past performance and is not predictive of future performance. Returns are shown after the deduction of management fees, transaction costs, and other expenses. The returns assume the reinvestment of dividends and other income. Fees are disclosed in Part II of GMO's Form ADV and are also available in each strategy's compliant presentation. Composite performance is supplemental to the GIPS compliant presentation for the strategy that was made available on GMO's website in September of 2013.

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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