

Qualifying Quality:

**How Each Manager's
Definition of Quality has
Differentiated Their Portfolio
Returns**

March 2021



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Points of Discussion

- 01** Definitions of Quality
- 02** Does the Market Identify Different Variations of Quality?
- 03** How Does the Efficacy of Quality Change in Different Economic Cycles
- 04** Call To Action: Verify Important Quality-Oriented Drivers of Performance in Your Portfolio

How Each Manager's Definition of Quality Differentiates Their Portfolio Returns

Following a turbulent market in 2020 that experienced shifts in leadership among growth, value and market capitalization, clients may be wondering if their managers' quality orientation is positioned to outperform as we enter 2021. Quality as a factor can stand on its own, but is often defined differently when approached from a growth or value-oriented perspective. While research is ongoing about what "quality" actually is, today we'll seek to frame how different managers define quality, as well as incorporate key findings from published academic research on quality and how it performs in different environments.

"Exposure to quality is viewed as a means of generating superior return."

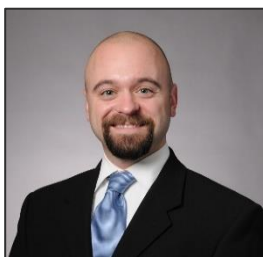
- Jason Hsu, Vitali Kalesnik and Engin Kose

Abstract

Academic research has identified profitability and investment as effective quality factors that provide the best chance of producing a return premium.

Put Research To Work

with the DeMarche Team



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Sources Utilized:

- Research Affiliates
- CFA Institute

Definitions of Quality

Quality is different from most indicators of corporate success due to the wide range of definitions used in the industry. Other well-known indicators of corporate success such as valuation and size have well-documented and widely used specific definitions. The definition of quality as a performance indicator can vary significantly based on the investor's perspective. Some investment managers define quality as those companies that maintain strong balance sheets with solid free cash flow generation. Others define quality as companies with a high return on invested capital (EDITDA/Invested Capital) and are experiencing positive earnings revisions. While other managers define quality as those companies with high to rising returns on investment capital (ROIC) in excess of their cost of capital, with low to no debt, high to rising operating margins and a history of sustainable growth. In addition, both growth- and value-oriented managers utilize quality considerations upon determining the optimal portfolio.

According to the Financial Analyst Journal article "What is Quality?" written by the 2019 Graham and Dodd Award winners Jason Hsu, Vitali Kalesnik and Engin Kose, the definition of quality is a collection of metrics designed to capture the indicators of higher-quality financials in companies. Their research identifies seven categories most utilized in the investment industry. These seven categories include profitability,

earnings stability, capital structure, growth in earnings, accounting quality, payout/dilution and investment (including Capex) trends.

Quality Checklist

Which factors are most often used when defining quality equity investments? There is no broadly excepted definition, but market research frequently cite these common attributes.

Profitability	Return on Equity (ROE), Return on Assets (ROA), Return on Invested Capital (ROIC), and Gross Profitability.
Earnings Stability	Growth variability in Earnings Per Share, Earnings Per Share Stability and Dividends Per Share Stability.
Capital Structure	Debt to Equity, Total Leverage and Debt to Cash Flow ratios.
Growth in Earnings	Gross Profitability, Gross Margins, Change in Asset Turnover, Return on Equity (ROE) and Return on Assets (ROA).
Accounting Quality	Accruals, Short-Term Change in Accruals, and Net Operating Assets
Payout/Dilution	Equity Issuance, Debt Issuance, Total Payout and Net Payout Trends.
Investment	Investment Trends within Asset Growth, Capital Expenditures Growth, and Fixed Asset Growth.

Does the Market Identify Different Variations of Quality?

While considering the seven categories of quality, various factors are used to measure each quality category. The **profitability category** is most often measured by a company's return on equity, return on assets, return on invested capital, and its gross profitability. Followed by the **earnings stability category** most often measured by a company's growth variability in earnings per share, its earnings per share stability and its dividends per share stability. Additionally, the **capital structure category** is most often measured in terms of a company's debt to equity, total leverage and debt to cash flow ratios. The **growth in earnings category** is often measured by a change in a company's gross profitability, gross margins, change in asset turnover, return on equity and return on assets. The **accounting quality category** is often measured in terms of accruals, short-term change in accruals, net operating assets and how aggressively a company books sales that may never translate into actual cash flows. The **payout/dilution category** is most often measured by a company's equity issuance, debt issuance, total payout and net payout trends. Finally, the **investment category** is often measured by a company's investment trends within asset growth, capital expenditures growth, and fixed asset growth. Academic research including Titman, Wei, and Xie (2004) and Cooper, Gulen, and Schill (2008) found that companies with a conservative level of investment (asset growth) tend to achieve superior returns. Fama and French (2008, 2016) confirmed their finding.

Each of the seven quality categories have been tested in numerous academic studies, including Fama and French's five-factor model research in 2015, to determine how successful each has been in predicting future returns in various market environments. A good amount of historical research has been conducted regarding the efficacy and robust nature of profitability, accounting quality, payout/dilution and investment including the previously discussed "What is Quality?" article written by Jason Hsu, Vitali

Kalesnik and Engin Kose. Academic research on earnings stability and capital structure as quality categories have received mixed evidence of their efficacy of predicting future returns. While profitability, investment, accounting quality, and payout/dilution have been identified as predictors of higher return in quality portfolios. In addition, Messrs. Hsu, Kalesnik and Kose's research confirmed that profitability and investment quality categories capture most of the quality related premiums in predicting positive returns as an indicator on their own, in a four-factor model (including market, size, value and momentum) and successful in producing a risk-adjusted portfolio. Furthermore, academic research has shown that profitability and investment quality were also successful in predicting positive returns in the geographic regions including the U.S. and Europe but less so in Japan.

How Does the Efficacy of Quality change in Different Economic Cycles?

Academic research has determined the efficacy of profitability and investment quality factors have historically not added value (or as much value) to portfolio returns during bear market periods due to various reasons including 1) market bubbles bursting as witnessed during the technology bubble in 2000 and 2) in periods associated with a shock to a company's fundamentals as witnessed in 2020 due to the COVID-19 pandemic. Although the two quality factors' performance were not as effective during the onset of a bear market, their efficacy historically has picked up in the subsequent two years following the bear market as the economic uncertainty is resolved.

During the second quarter of 2020, quality oriented investment performance had not yet experienced the rebound in efficacy for profitability and investment due to lingering economic uncertainty from COVID-19 related issues. Some concerns still causing market uncertainty include whether another wave of COVID-19 could send global economies back into a shutdown, and questions remain about the ability of a few industries such as the airline industry to survive additional economic shocks.

Another time period that exemplified a challenging environment for quality occurred in the late 1960s and early 1970s when investors were enamored with the Nifty Fifty, which included 50 of the largest and historically most aggressively growing companies in the U.S. So much interest in these companies caused investors to exclude the consideration of valuation relative to future growth prospects. Because of their strong record of growth, valuation ratios seemed irrelevant and investors still found the Nifty Fifty stocks attractive at 50, 80, and even 100 times earnings. At the end of 1972, when the S&P 500 Index traded at a P/E of 20, the Nifty Fifty were trading at a P/E of 40. It has been said during this period, value investing gave way to growth at a reasonable price (GARP). As a result of the valuation bubble, the Nifty Fifty stocks fell by 47% when the broader S&P 500 Index contracted by 39% in 1973-1974. The key point here is that these companies were considered to be "high quality" at the time but buying "high quality" companies at high prices may not be the best investment decision.

Q: What should prudent investors do?

A: Verify their Portfolio's Implementation of Quality-Oriented Drivers of Performance

Because the use of quality factors can be included in both growth and value strategies and across market capitalization ranges, we recommend clients discuss their portfolios with their DeMarche consultant in order to better understand in what environments their specific quality orientation will outperform, or potentially lag the benchmark. DeMarche has been researching managers since 1974, and our robust process leads to an unparalleled understanding of how managers perform in different markets. Our historical manager recommendations have led to, on average, a large majority of recommended managers beating their benchmarks after they are hired, resulting in an outperformance of 133 basis points versus their respective benchmarks¹. Be sure to contact DeMarche to learn how we can help you gain a better understanding of your managers and ensure an efficient portfolio.

¹ Results for all manager searches in traditional asset classes since 1979. Average success rate of 71% captures the search finalists who outperformed or performed in line with their style benchmark over the subsequent five years. 5-Yr excess returns of 133 bps average for search finalists vs relative objectives.