WILSONS

Feel the Quality

Our weekly view on asset allocation.

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Quality: A Rewarding Investment Strategy

Last week, we discussed the debate surrounding the outlook for growth versus value investment styles in equity portfolios.

Read Signs of Life after the Growth Stock De-rate?

We also highlighted "quality" as an important factor to consider both in the context of constructing growth or value orientated portfolios, and as a strategy in its own right.

This week, we explore a "quality" investment strategy in more depth.

Quality Has Strategic and Tactical Appeal

We see the "quality factor" as having strong long-term investment performance credentials and believe the outlook for quality is particularly attractive at the current juncture in the global business cycle. We expect global economic growth and earnings growth to slow significantly over the coming year. As a result, companies with high quality, resilient earnings streams should be increasingly sought after by the market.

Quality focussed investment strategies arguably receive less attention than growth and value investing, yet the quality factor has an impressive long-term track record. A quality tilt is also complementary to most other investment styles.

Figure 1: Long term relative performance of quality

Source: Refinitiv, Wilsons.

Defining Quality

Although there is no universally agreed upon definition of what constitutes a quality company, there are some fairly well accepted rules of thumb.

Quality businesses generally earn a high return on equity (ROE) or return on invested capital (ROIC). Quality growth companies can also typically re-invest back into their own business (using retained earnings) at a high marginal return on capital invested. It is this organic growth characteristic that gives quality growth companies a rising and very valuable earnings profile.

Quality companies typically have fairly defensive or resilient earnings streams. This is typically measured by low variability of earnings from year to year.

Quality companies typically have **strong balance sheets with relatively modest gearing.** Indeed, high quality mega caps such as Microsoft and Apple are literally sitting on billions of dollars of excess cash, which gives them considerable optionality.

The widely followed Quality Performance Index run by Morgan Stanley Capital International (MSCI) uses 3 characteristics - ROE, low variability in earnings per share (EPS), and low leverage - to construct a passive or quantitative quality index.

More active fundamental strategies may consider other quality inputs. **Management quality** is an important albeit more subjective consideration, which is typically highly prized by fundamentally based quality focussed investors.

Industry positioning is often an additional consideration. A high-quality business typically has an identifiable 'moat' or set of competitive advantages. These competitive strengths can include: superior product or service quality, a strong brand, superior scalability, distribution strength, or proprietary technology.

While this is not an exhaustive list of quality attributes (strong generation of free cash flow and high operating margins are frequently cited as additional quality attributes) the range of factors outlined above tend to describe quality companies fairly well.

Figure 2: MSCI World Quality Index top 10 constituents

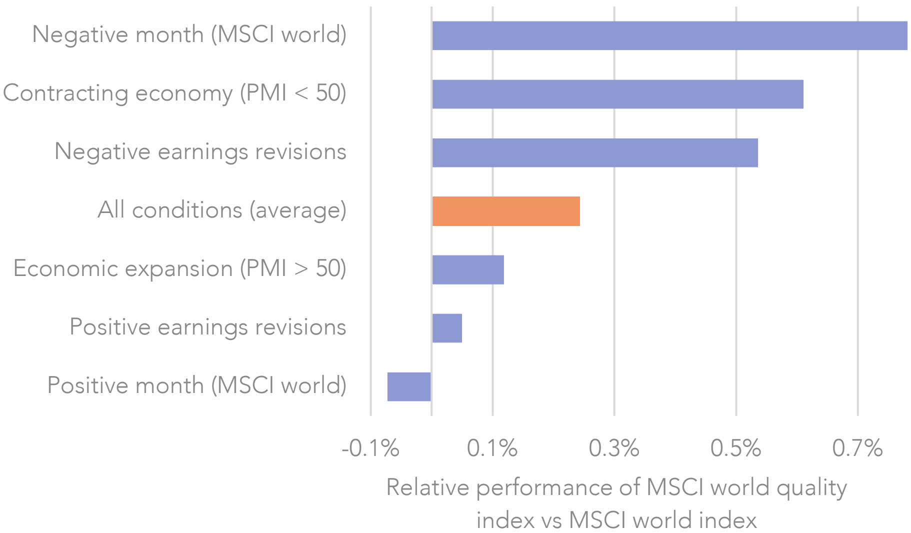
	12mth fwd PE	ROE (FY1)	EPS CAGR % (FY1-FY3)
Apple	24.3	157%	6%
Microsoft	25.5	40%	17%
Alphabet (A&C class)	19.9	26%	16%
Amazon	70.4	10%	153%
Tesla	55.1	34%	26%
Nvidia	30.7	40%	18%
Meta	13.7	26%	14%
Nestle	23.7	25%	8%
Visa	25.5	42%	16%

Source: MSCI, Refinitiv, Wilsons.

How Investors Use the Quality Factor

How the quality factor is utilised in investment processes tends to vary. Quality may be a consideration in a broader range of stock selection criteria, with valuation typically being pivotal. Quality can influence or dominate stock selection, depending on the exact investment strategy, be it quantitative or more fundamental.

Figure 3: Average relative performance of quality in different market settings - monthly since 1990



Source: Refinitiv, Wilsons. * Earnings revisions refer to the month-on-month % change in MSCI World Weighted 12 month forward EPS forecasts

Highly active strategies with a heavy emphasis on quality often exclude whole sectors (e.g., resources and financials) on the basis of quality thresholds, particularly in relation to earnings volatility.

Looking at passive quant-based indices over a long period of time suggests quality titled portfolios perform well over the long run. As discussed, they also tend to do particularly well in times of moderate to low economic growth. Quality often performs better in drawdown phases or bear markets, albeit outperformance is not confined to bear markets.

It is this risk asymmetry, with decent performance in rising markets but superior performance in falling or sluggish markets, that gives quality its outperformance trend over the long-term. From this perspective, there is a large body of academic evidence suggesting that low volatility, high quality portfolios outperform high volatility, low quality portfolios. This perhaps flies in the face of traditional portfolio theory, which holds that higher risk portfolios will generate higher returns in the long run.

Re-thinking Risk and Return

The apparent existence of a long-term global premium for quality suggests quality could represent a 'free lunch' for investors. Of course, these are long-term tendencies, not ironclad outcomes for every year. Over the past 2 years, quality has actually underperformed.

We see 2 key drivers behind the underperformance of quality. Firstly, the growth stock rally entered a speculative phase last year with many high-growth (pre-earnings) stocks being bid up aggressively. More recently, a big first quarter commodity rally, led by energy in particular, saw quality indices lag again.

As both the high-growth and commodity rallies have faded, quality has begun to show signs of outperformance. With earnings slower and downgrades increasing, resilient high-quality companies look set to outperform in our view.

Investors can access quality through deliberate quality focussed strategies or through growth and value managers with a material quality component to their investment process. We tend to favour equity managers with quality either at the forefront or well incorporated into their investment processes, across both international and Australian equities.

Figure 4: Recent relative performance of quality (short term performance)

Source: Refinitiv, Wilsons.

Disclaimer and Disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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