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Enduring Quality

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There are many ways investors try outperforming the market. Tilting the portfolio regionally, moving up and down the market capitalisation spectrum or exposing their portfolio to different investment factors (risk premia). Some factors are well known and easily defined whilst others are less so. In recent times, much has been discussed about the "great rotation" from growth to value. Growth and value companies are widely understood, however there is another factor, namely quality, that has been on the sidelines recently and is less clearly defined. With fears of a correction or pullback rising after such a strong rally in equities – is it time investors start to pay more attention to this cohort of companies which often exhibit lower volatility, and provide more defensive characteristics whilst being capable of delivering a steadier growth path?

Quality is possibly the most subjective factor you will come across and one that is likely to differ depending on who you ask. Unsurprisingly, most investors would claim that they are investing in quality businesses, yet the results can vary wildly across these strategies – so what is quality and how do we define it?

At Momentum we define quality businesses as those that have demonstrated a high and stable level of profitability over the long term. These businesses typically benefit from strong economic 'moats' (defendable competitive advantages) which enable them to sustain above average returns over longer periods. The businesses that fit these criteria generally have low capital intensity (with low reinvestment requirements), low leverage, strong cash flow generation and strong intellectual property such as brands.

The focus on stability typically excludes companies in highly cyclical industries and leads you to more resilient businesses which often have low sensitivity to the economic cycles. These businesses are known as great compounders which can generate returns persistently across different economic environments. They are not fully immune from market swings but nevertheless one can expect a quality firm to be well placed to weather periods of uncertainty.

Unsurprisingly, we have observed that portfolios of genuinely high quality businesses have generated strong excess returns over the long term.

The outperformance tends to be more pronounced during periods of heightened risk aversion, but the quality factor has proven it can keep up with the market or even outperform in rising equity markets too. Interestingly, the excess returns over the long run have not been associated with an increase in risk (as measured by volatility). This excess risk "premium" over the market is not widely understood.

So why are these stocks able to generate excess returns over the long term with less risk? This seems counterintuitive and a contradiction to the Capital Asset Pricing Model (CAPM) where extra returns should be accompanied by a higher level of risk. There are many possible explanations, of which the majority are behavioural. Firstly, overconfidence bias is one issue. Humans are generally overconfident in their ability to forecast the future, and quality (low volatility) stocks usually have more predictable cashflows which can negate this issue, leaving less scope for forecasting errors. The 'lottery effect' is another reason, as higher volatility stocks are often associated with lottery tickets (potential for a large pay-off but the probability is low) and investors are willing to overpay for this optionality. Quality businesses also tend to be less 'glamorous' and lower octane, which typically leads to lower incidence of unfavourable events compared to their counterparts (high volatility stocks). As a result, they don't tend to fall as much in market downturns relative to other companies and can compound returns at a greater rate over the course of multiple economic cycles. These possible explanations all point towards one thing: quality characteristics have been systematically undervalued by investors over time, relative to lower quality businesses, which has enabled them to outperform broad indices over the long run.

At Momentum, we have invested in quality strategies for many years and believe it plays a key role in all our portfolios, particularly as a diversifier to other style factors within the equity allocation. Quality stocks are a valuable tool for our outcome-based investing approach as their stable return profile and defensive qualities help to deliver a smoother journey for our clients.

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