

Why Quality is the cornerstone of what we do

In the ever-evolving landscape of equity investing, the concept of quality has undergone a remarkable transformation. What was once relegated to the sidelines as a niche strategy has since emerged as a powerful and distinct approach. Investors worldwide are increasingly drawn to quality-based investment strategies, and for good reason: they work.

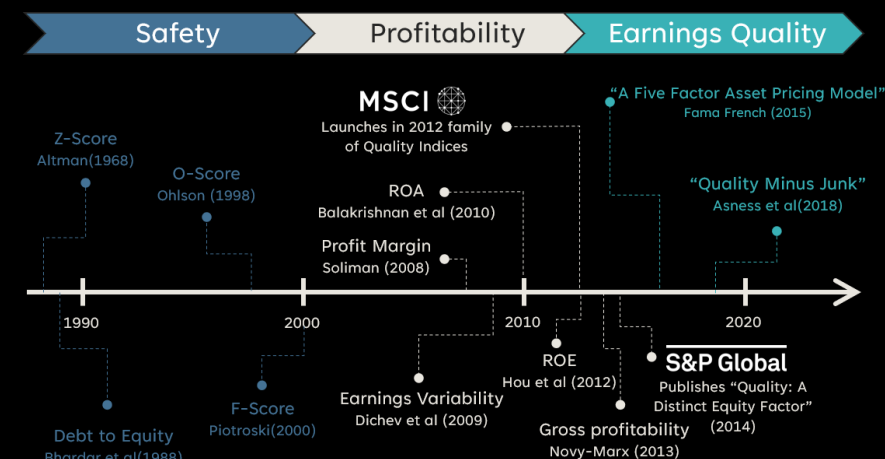
Back in the 1980s, equity managers were neatly categorized into two camps: growth or value. These traditional approaches dominated investment discussions, leaving little room for other strategies. Quality, if mentioned at all, was often an afterthought—a footnote in the grand narrative of stock picking.

Fast forward to today, and the landscape has shifted dramatically. The concept of quality in financial analysis has evolved significantly over time, as depicted in the timeline on the right. Starting with financial strength and later giving way to focussing on profitability and earnings quality. This evolution reflects the growing recognition of quality's impact on investment outcomes. Most of the academic research only started to see the light of day since the global financial crisis in 2008.

Quality investing has shed its niche status and taken centre stage. Why? Because it delivers results. Investors have witnessed the resilience of quality stocks during market turbulence, economic downturns, and global uncertainties. The allure lies in their ability to weather storms while maintaining steady performance. Chart 1 depicts this in actual numbers since 1990. The chart shows the excess returns of the most familiar factor indices of the MSCI relative to the broad market in various market regimes*. Among the three factors, it is true that momentum performs well in all regimes, but in those where quality performs well, it does markedly better. It is impossible to know in which regime we might end up in next, hence quality is a good all-weather bet, and why we favour it as our core strategy.

Quality, however isn't a one-size-fits-all concept. Its interpretation varies across industries, sectors, and market conditions. What constitutes quality in a technology company may differ from what's valued in a consumer staples firm. This is why it is extremely important to hold the best quality companies within each respective sector.

Quality investing has come a long way—from a niche corner of the market to a mainstream strategy. As investors seek stability and long-term growth, quality remains a beacon of promise. Whether you're a seasoned portfolio manager or a novice investor, understanding the nuances of quality will be essential in navigating the complex investment landscape of 2024.



Excess return of factor indices relative to broad market since 1990
Chart 1



Source: FactSet Research Systems.

The past performance of an index is not a guarantee of future results.

*Proprietary economic model that classifies each month into four distinct regimes based on ensemble of signals (Slowdown, Contraction, Recovery or Expansion)

Quality standing the test of time

At its core, quality investing focuses on identifying companies that consistently generate high returns on invested capital (ROIC). ROIC measures how efficiently a company utilizes its capital to generate profits. But why does quality matter?

McKinsey, a global consulting firm, conducted a study to understand the sustainability of company returns on invested capital (ROIC). The results were both fascinating as well as obvious in hindsight. Traditionally, high ROIC was believed to attract competition and eventually revert to average levels, or that is at least what we were taught in economics class. However, McKinsey's findings revealed a more nuanced reality.

McKinsey divided the market into quintiles based on historical ROIC. Each quintile represented a different performance group, ranging from the highest to the lowest ROIC. McKinsey then tracked the median ROIC for each quintile over the next fifteen years.

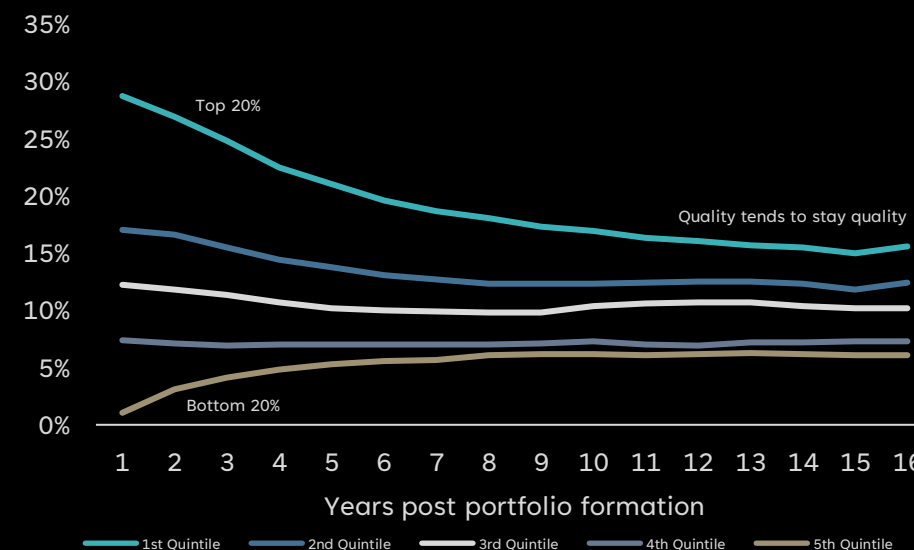
While mean reversion does occur, a significant number of companies manage to sustain high ROIC over extended periods. These exceptional companies defy the traditional model by maintaining profitability due to various factors:

- **Innovation:** Pioneering products or services create enduring advantages.
- **Brand Strength:** Recognizable brands wield pricing power.
- **Regulatory Advantages:** Some industries benefit from protective regulations.
- **Network Effects:** Companies with strong network effects thrive.
- **Cost Efficiency:** Streamlined operations lead to consistent profits.

High-performing companies didn't maintain sky-high ROIC indefinitely. However, the companies with historically exceptional ROICs continued to outshine the rest of the market. Historic profitability acted as a reliable predictor of future profitability. Again, in hindsight, this outcome makes intuitive sense. Take a company like Visa – the chances that we will see a company being replaced that accounts for close to 40% of global payments are basically zero or close to zero.

The key takeaways from the study is reflected in the findings in numerous quality academic research papers. Researching historically successful companies pays off. Patience and a long-term perspective are essential for quality investing. Quality endures, and understanding the persistence of high ROIC can guide your investment decisions toward lasting success.

ROIC decay over time





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