

The Case for Quality

By: Arman Gevorgyan, CFA, and Amy Orr

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Investment

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Early in April 2009, Rogerscasey published a research brief in which we argued that clients should patiently and methodically rebalance into U.S. equities throughout 2009. Within broader equities, we urged clients to invest in high quality strategies and avoid deep value managers. In this piece, we will expand our analysis of high quality companies and portfolios.

Defining Quality

One common definition of quality is Standard & Poor's (S&P) Earnings and Dividend Rankings, commonly known as quality rankings (not to be confused with credit ratings). The rankings are based on per share earnings and dividend records for trailing 10 years, adjusted for change in the rate of growth, stability with long-term trend, and cyclicity.¹

Simply put, S&P's rankings are primarily based on the growth and consistency of earnings and dividends.

Money managers who run quality-oriented investment strategies oftentimes have their own, more broad criteria of what constitutes a quality company. From our manager due diligence experience, the quality criteria most frequently used by investment managers are:

- Consistent earnings;
- High and recurring free cash flows;
- High returns-on-capital;
- Low financial leverage;
- Dominant competitive position; and
- Strong and shareholder-friendly management.

All metrics previously cited ultimately tie back to the earnings and dividends criteria used by S&P. Without high and recurring free cash flows, it would be difficult, if not impossible to grow dividends. Likewise, without returns-on-capital consistently in excess of the weighted average cost of capital, a company cannot enjoy long-term earnings growth. As a result of the effects of financial leverage, companies with high debt burden tend to have more volatile earnings than debt-free companies. Finally, without a dominant competitive position and competent management, a corporation would struggle to grow consistently.

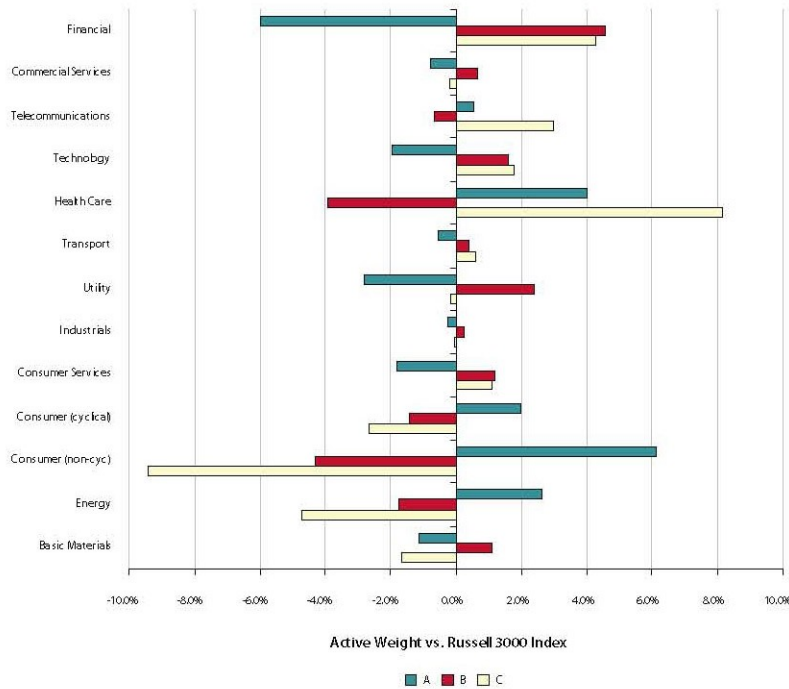
Quality Characteristics

To provide a better understanding of the composition and characteristics of the high quality universe, we ran holdings-based analytics using the components of the Russell 3000 Index as of December 31, 2008. We divided the index portfolio into four segments:

- companies with S&P quality ranking of A+, A, or A- (A-rated companies)
- companies with S&P quality ranking of B+, B, or B- (B-rated companies)
- companies rated C+ or below (C-rated companies)
- companies that did not have quality ratings due to size or other reasons.

We focused on the first three segments and excluded the unrated companies from our analysis. Examining sector exposures in *Figure 1*, we would like to highlight the underweight to financials among A-rated companies with the corresponding overweight among C-rated companies. As many financial companies have leveraged balance sheets due to the nature of their business, they are less likely to maintain consistent earnings. The few A-rated financials include large insurers (Hartford Financial, MetLife) and certain banks with fee-oriented business models (State Street Corp, Northern Trust).

Figure 1: S&P Quality Ranking Breakdown by Sector Weight



Source: S&P, Barra, Rogerscasey

The consumer staples sector presents a mirror opposite to financials; quality companies have an outsized presence among staples in contrast to lower quality companies. Staples, also known as consumer non-cyclicals, by definition enjoy relatively stable demand for their products which is conducive to generating consistent earnings.

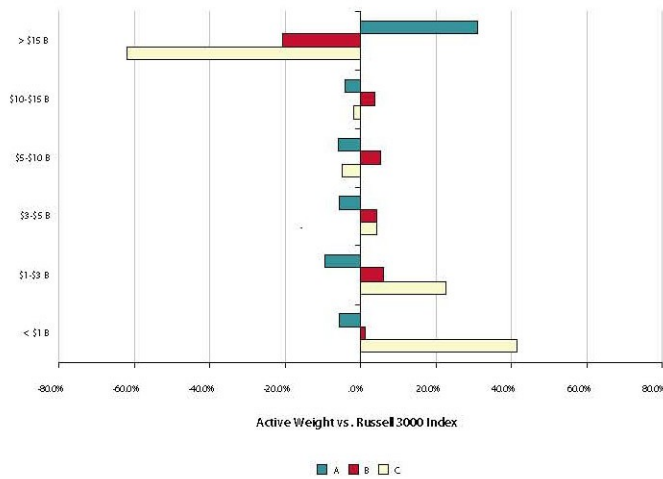
Finally, we would like to highlight the healthcare sector, to which both A-rated and C-rated companies have outsized exposure. Large pharmaceuticals, medical device and managed care companies make up the majority of the high quality healthcare companies. Similar to staples, these firms benefit from the relatively stable demand for their products and services. On the other hand, lower quality healthcare companies mainly consist of small biotechnology and medical device companies whose fortunes are tied to one or two products which may still be in development.

The outcome for these companies is often binary: if the product in development gets approved and successfully launched, the company will likely prosper; if not, it will likely fail.

To summarize, because of the differences in sector weightings between the high quality universe and the broad market, high quality portfolios will likely perform well when defensive healthcare names and consumer staples lead the market; they will likely perform poorly when the market is led by financials and small biotech or medical device companies.

In *Figure 2*, we show the S&P quality ranking breakdown by market cap. As one would expect, the more established, larger capitalization companies are better represented in the high quality segment.

Figure 2: S&P Quality Ranking Breakdown by Market Cap



Source: S&P, Barra, Rogerscasey

Given the strong correlation of quality with size, high quality portfolios tend to perform well when mega-caps lead the market.

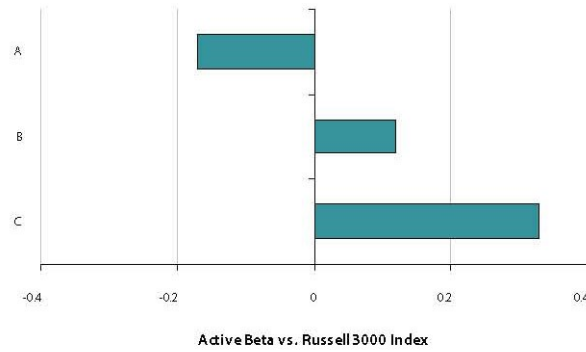
We also would like to note that because S&P requires 10 years of data before issuing a quality ranking, small cap companies which do not have a 10-year operating history but otherwise fit the quality criteria will remain unrated; as a result, the mega-cap bias that we see in *Figure 2* is somewhat inflated. From our experience, there are a number of investment managers that run successful quality-oriented strategies in the small cap segment of the market. In their due diligence process, these managers focus less on formal quality rankings and more on the inherent characteristics of the underlying investment candidates.

In addition, we note that many lower quality companies can become small caps because investors do not reward companies that are not able to grow earnings and dividends consistently.

As an example, of the 939 C-rated Russell 3000 constituents, 359 experienced share price declines of 60 per cent or greater during 2008.

Similarly, it is intuitive that higher rated companies, which by definition have more consistent earnings and dividends, will be less volatile than the market. *Figure 3* shows that A-rated companies have Barrapredicted market beta of well below one, in sharp contrast with C-rated names whose average beta exceeds 1.3. The beta exposure implies that, on a relative basis, high quality portfolios will tend to perform better in down markets than in up markets.

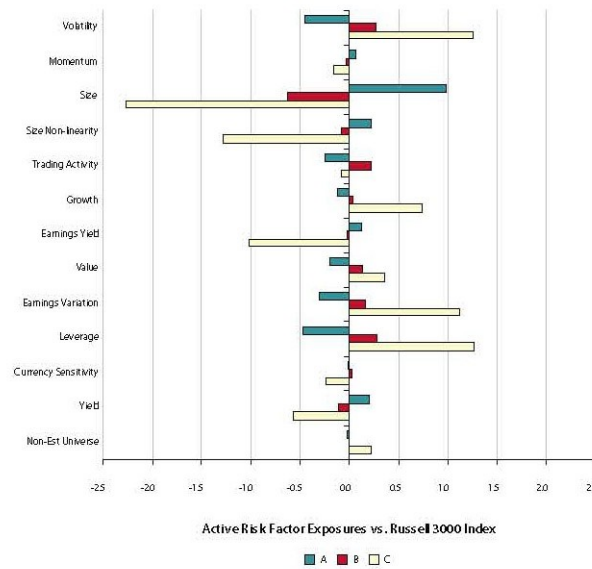
Figure 3: S&P Quality Ranking Breakdown by Beta



Source: S&P, Barra, Rogerscasey

In *Figure 4*, we show Barra active risk factor exposures by S&P quality ranking. Consistent with our observations about the market capitalization distribution by quality, A-rated stocks have positive exposures while C-rated stocks have negative exposures to size and size non-linearity factors.

Figure 4: S&P Quality Ranking Risk Factor Breakdown



Further, A-rated companies have negative exposures to volatility, leverage, and earnings variation; this is in contrast with C-rated companies which have positive exposures to all three of these factors. The leverage, volatility, and earnings variation exposures are all consistent with the definition of quality used by investment managers.

We also would like to highlight that over time, the share of high quality companies in the universe of ranked companies has declined dramatically. A-rated companies accounted for roughly 31 per cent of all ratings in 1985, but only 13 per cent in 2004. At the same time, the weight of C-rated companies increased from 12 per cent to 30 per cent (see *Table 1*). We have observed a similar trend in the corporate bond market, where credit quality has also been deteriorating over time. We would attribute this secular decline in quality across equities and fixed income to the increased utilization of financial leverage in corporate capital structures.

Table 1: S&P Quality Ranking Distribution Over Time

	1985	1990	1995	2004
A	30.8%	22.5%	15.0%	13.4%
B	56.9%	59.4%	64.7%	56.4%
C	12.3%	18.0%	20.2%	30.2%

Source: S&P, Rogerscasey

Quality Performance

In this section, we will examine the return patterns of high and low quality stocks and portfolios. In *Table 2*, we calculate returns-based statistics using annual returns of capitalization-weighted portfolios defined by S&P quality rankings. The portfolios included all companies for which S&P provided a ranking. In the spirit of fair disclosure, we should point out that while we use a 23-year returns history in our calculations, the annual return strings limit the number of independent observations and may distort some of the statistics.

Table 2: S&P Quality Ranking Statistics, 1986-2008

	A+	A	A-	B+	B	B-	C & D
Return (%)	9.90	8.40	10.60	8.90	10.30	8.20	4.70
Risk (%)	18.20	17.80	16.30	18.50	19.40	18.90	34.20
Sharpe Ratio	0.39	0.31	0.46	0.33	0.39	0.28	0.16
Up Market Capture	0.94	0.88	1.00	1.03	1.16	1.02	1.26
Down Market Capture	0.51	0.69	0.59	1.07	1.17	1.18	2.12

Source: S&P, Rogerscasey

Below are a few takeaways from our analysis:

Low Quality Stocks Posted Lower Returns and Higher Risk

For the past 23 years, C and D-rated companies had vastly inferior returns and much higher risk than companies rated A and B. The C rating implies a serious deficiency in financial health; as an example, if a company skips a preferred dividend payment, it is automatically downgraded to C or lower. The D ranking is reserved for companies in reorganization. Intuitively, one can see why companies in bankruptcy, or close to being in bankruptcy, do not offer a great return potential for common shareholders. Likewise, the binary nature of long-term outcomes for C and D-rated companies (reversion to mean or total wipeout of common shareholders) provides intuition as to why this category of stocks is much more volatile than the rest of the universe.

Highest Quality Stocks Provided Superior Risk/Reward Characteristics

A-rated stocks (including A+, A, and A- ratings) displayed higher returns and lower volatility than B or C-rated stocks.

As a result, A-rated stocks collectively had higher Sharpe ratios than their lower quality counterparts.

Highest Quality Stock Provided the Best Downside Protection

A-rated companies provided far superior protection to their shareholders in down markets. At the other extreme, C and D-rated names were the worst area in which to be invested during market declines. Intuitively, in tough markets, lower quality companies which are oftentimes highly levered and must rely on capital markets for the financing of their operations, are in greater danger of going out of business. That said, only five of the 23 years incorporated in our analysis featured down markets. This limited data set may have distorted our analysis.

To supplement the returns-based analysis of S&P quality rankings, we examined the characteristics of a small sample of institutional-caliber, quality-oriented strategies. *Table 3* shows the 10 strategies that we selected for this illustration; for the purposes of our analysis, we divided these 10 strategies into two sub-groups by style, growth, and value.

Table 3: Sampling of Quality Focused Strategies

Growth-Oriented Strategies	Value-Oriented Strategies
Atlanta Capital High Quality Growth Plus	Crawford Investment Counsel Dividend Growth
GE Asset Management U.S. Premier Growth	Davis Advisors Large Cap Value
GSAM U.S. Strategic Growth	Eagle Capital Equity
Sustainable Growth Advisers U.S. Large Cap Growth	GMO U.S. Quality
Walter Scott USA Equity	Lazard Asset Management U.S. Equity Select

We aggregated the strategies within each sub-group into hybrids.² Because we used quarterly return strings in our calculations, we were able to get much higher statistical confidence levels in our results than when using annual returns.

As *Table 4* demonstrates, the results of our hybrid analysis are consistent with our findings from the analysis of S&P returns. Specifically, both on the value and growth side, the managers generated higher returns while maintaining lower volatility than that of their respective benchmarks. In addition, both value and growth hybrids provided very effective downside protection, with down capture figures in the 70 per cent range. The up capture figures were also impressive, with growth hybrid up capture of roughly 90 per cent and value hybrid up capture of roughly 100 per cent.

Table 4: Growth and Value Quality Hybrid Historical Statistics

	10 Years Ended December 31, 2008					20 Years Ended December 31, 2008				
	Return	Std. Dev.	Info. Ratio	Up Capture	Down Capture	Return	Std. Dev.	Info. Ratio	Up Capture	Down Capture
Quality Growth Hybrid	-0.66	17.36	0.37	89.67	73.55	9.39	16.47	0.20	92.49	73.48
Russell 1000 Growth Index	-4.27	20.96	N/A	100.00	100.00	7.43	19.20	N/A	100.00	100.00
Quality Value Hybrid	4.44	14.58	0.57	101.16	76.84	11.36	14.31	0.43	104.03	81.55
Russell 1000 Value Index	1.36	16.10	N/A	100.00	100.00	9.08	14.71	N/A	100.00	100.00

Source: Rogerscasey

Why is Quality Attractive Now?

We will be making two arguments as to why, in our opinion, quality-oriented strategies are tactically an attractive investment option at this time. First, we believe that in today's volatile market environment quality strategies offer downside protection. Second, we believe that valuations of high quality stocks are compelling, relative to historical averages and the overall market.

In our brief published in April 2009, 'Deep Value Revisited,' we argued that 2009 will be a choppy year for equities since market volatility, despite subsiding in recent weeks, continued to be at extreme levels. Empirically, our argument was supported by a spirited market rally in March 2009, after severe declines in January and February.

As we demonstrated in *Table 2* and *Table 4*, quality companies and portfolios offer excellent downside protection, while allowing for the capture of most of the market gains, should investor sentiment turn positive. In today's volatile market environment, we believe that these characteristics should be very appealing to investors worried about capital preservation.

We also believe that despite their recent outperformance, dating to the start of the bear market in October 2007, high quality companies are still attractively valued today. Because high quality companies are superior businesses, one would expect them to trade at a sizeable premium to lower quality companies and the broad market. However, our analysis in *Table 5* on the following page demonstrates that A-rated companies traded at modest premiums versus the Russell 3000 Index on price-to-book and price-to-earnings basis while providing a superior dividend yield vis-à-vis the benchmark.

Table 5: S&P Quality Ranking Valuation

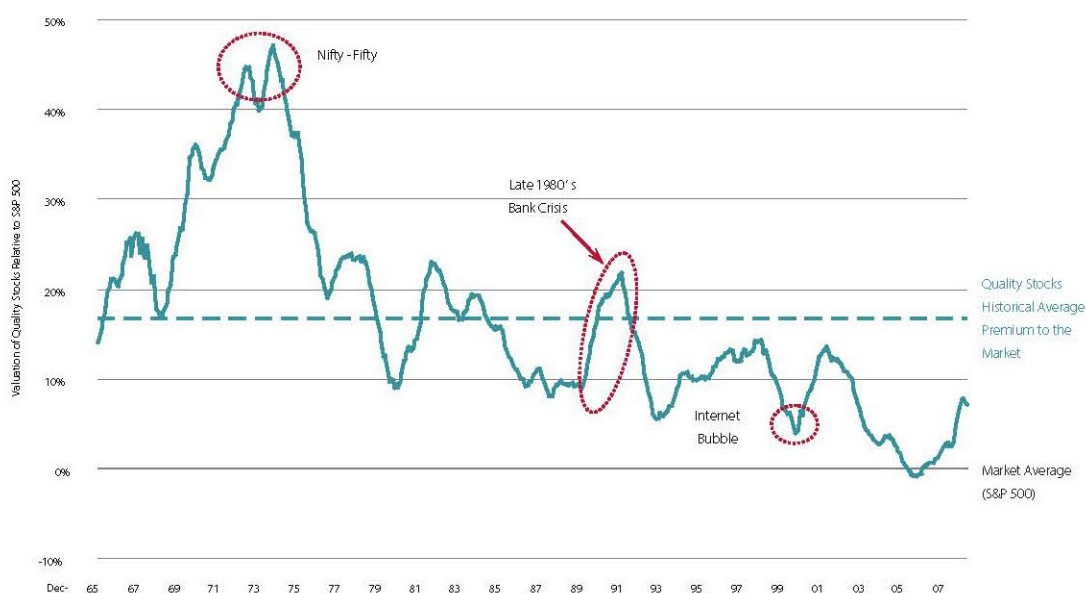
	A	B	C & D	Index
P/E (LTM)	11.0x	10.6x	12.2x	10.8x
P/B	2.4x	2.1x	2.2x	2.2x
Dividend Yield	3.6%	2.7%	1.2%	3.0%

Note: Data as of 12/31/08

Source: S&P, Barra, Rogerscasey

Our analysis is corroborated by GMO's historical valuation analysis of its internal quality universe, defined by the firm's proprietary intrinsic valuation measure (see *Insert Figure 5*). GMO's data demonstrates that since 1965, high quality companies exhibited average valuation premium in the high teens versus the S&P 500 Index. Remarkably, at the peak of the leverage bubble around 2005-2006, high quality companies traded at parity and, momentarily, even for a discount to the broad market. Since then, the valuation of high quality companies has recovered somewhat, but still remains well below the historical average.

Figure 5: Historical Valuation of Quality Stocks versus the S&P 500 Index



Note: Analysis current through 2/28/09

Source: GMO

In summary, our main takeaways from this research brief are as follows:

- We believe that when rebalancing into equities in 2009, clients should emphasize strategies that invest in high quality companies.
- High quality companies are commonly defined as those with consistent earnings and dividends, high and recurring free cash flows, and low financial leverage.
- In our opinion, quality-oriented strategies are appealing in today's volatile market environment as they provide downside protection while allowing for upside participation. We also believe that high quality companies are attractively valued relative to historical averages and the overall market.
- Historically, high quality stocks displayed superior risk/reward characteristics relative to the broad market. Strategies that invest in high quality stocks exhibited similar traits.

- Consistent with their definition, high quality companies and portfolios generally have lower beta and negative exposures to volatility, leverage, and earnings variation risk factors.
- High quality companies and portfolios will likely perform well on a relative basis when:
 - ❑ mega-cap stocks lead the market
 - ❑ consumer staples and defensive healthcare names are in favor
 - ❑ the financials sector struggles.

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1 S&P's Quality Rankings, October 2005

2 The hybrids are equal-weighted and rebalanced on a quarterly basis. The hybrids use the full returns history for each underlying strategy. When historical returns for an underlying strategy are no longer available, the hybrids are reinstated by equal-weighting the remaining strategies.