STYLE TRENDS: DEFINING QUALITY AND WHY IT MATTERS

KEY POINTS

- Quality style trends rotate in and out of favour, creating opportunities for investors who understand its leadership drivers.
- We use quantitative and qualitative analysis including market cycle, macroeconomic and fundamental research to assess quality leadership trends.
- "Quality" as an investment characteristic is more subjective than other styles and this paper provides an in-depth analysis of how Fisher Investments (FI) examines quality.

INTRODUCTION

Unlike other equity styles such as value, momentum, and size, there is a vigorous debate occurring in the investing community on how to define quality. Investment managers typically use a wide range of qualitative and quantitative measures to capture quality in their portfolios. At FI, we believe interpreting and integrating quality differently than others may produce capital markets technology with actionable portfolio management implications across a variety of investment strategies. Additionally, markets favour different characteristics at different points in the market cycle and we think quality is no different (Exhibit 1). In this paper, we will examine the various ways in which quality is defined, demonstrate how FI defines and utilises quality when managing portfolios, study how quality behaves over market cycles as well as how it interacts with other market factors.

Exhibit 1: No One Category Is Best For All Time

Best	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Performing	Small Cap 51.3%	Small Cap 26.7%	Quality 2.1%	Small Cap 18.6%	Small Cap 29.2%	Quality 8.8%	Quality 2.0%	Value 13.4%	Growth 30.5%	Quality -7.0%	Quality 35.7%	Growth 33.9%	Quality 22.5%	Value -6.9%	Growth 33.5%
	Mid Cap 43.7%	Mid Cap 21.1%	Large Cap -6.4%	Mid Cap 17.4%	Mid Cap 24.9%	Growth 5.8%	Growth 1.9%	Small Cap 12.1%	Quality 29.0%	Growth -7.8%	Growth 33.2%	Quality 25.4%	Value 20.4%	Large Cap -17.9%	Quality 33.0%
	Growth 38.1%	Growth 15.5%	Value -6.7%	Growth 17.2%	Quality 23.9%	Mid Cap 4.8%	Small Cap -0.6%	Large Cap 8.7%	Mid Cap 25.0%	Large Cap -8.1%	Large Cap 27.4%	Large Cap 17.0%	Large Cap 19.5%	ACWI -18.0%	Large Cap 24.1%
	Quality 36.8%	ACWI 13.2%	ACWI -6.9%	ACWI 16.8%	Growth 23.6%	ACWI 4.7%	Mid Cap -1.2%	ACWI 8.5%	ACWI 24.6%	ACWI -8.9%	ACWI 27.3%	Small Cap 16.8%	ACWI 19.0%	Small Cap -18.3%	ACWI 22.8%
	ACWI 35.4%	Quality 12.1%	Growth -7.0%	Large Cap 16.7%	ACWI 23.4%	Large Cap 4.7%	ACWI -1.8%	Mid Cap 7.7%	Large Cap 24.5%	Value -10.1%	Mid Cap 26.6%	ACWI 16.8%	Growth 17.3%	Mid Cap -18.4%	Small Cap 17.4%
	Large Cap 33.9%	Large Cap 11.7%	Mid Cap -9.2%	Value 16.4%	Value 23.3%	Value 3.6%	Large Cap -2.0%	Quality 6.1%	Small Cap 24.3%	Mid Cap -12.9%	Small Cap 25.2%	Mid Cap 15.6%	Mid Cap 16.8%	Quality -23.4%	Mid Cap 15.9%
Worst Performing	Value 32.7%	Value 10.9%	Small Cap -11.0%	Quality 15.5%	Large Cap 23.1%	Small Cap 2.2%	Value -5.6%	Growth 3.7%	Value 19.1%	Small Cap -14.0%	Value 21.5%	Value 0.4%	Small Cap 16.5%	Growth -28.4%	Value 12.7%

Source: FactSet. MSCI ACWI, MSCI ACWI Small Cap, MSCI ACWI Mid Cap, MSCI ACWI Large Cap, MSCI ACWI Growth, MSCI ACWI Value and MSCI ACWI Quality Indices yearly returns from 2009 - 2023. All returns presented are in USD and inclusive of gross dividends.

WHAT IS QUALITY?

Quality as defined by the Merriam-Webster dictionary is a "degree of excellence".[1] Given how abstract and subjective the interpretation of what excellence means, it is not surprising that investors find it challenging to arrive at a common definition of quality. There are various ways to assess a company's excellence based on either its operations, management, financials, or other aspects. Typically, common traits of a high quality company refers to its earnings stability, profitability and lower financial risk compared to a definable peer group. This is measured by both quantitative and qualitative metrics. (Exhibit 2)

Exhibit 2: Examples of Quantitative & Qualitative Quality Metrics

Quantitative	Qualitative
ROE	Management Pedigree
Earnings Variability	Economic Moats
Debt to Equity	Strategic Supplier Diversification
Gross Margin	Corporate Structure
Net Margin	Ownership Structure
Long Term Debt	Geography
Net Debt	Brand name vs Generic
EBITDA	Leadership Pipeline Age
Accounting Standards	Leadership Pipeline Concentration
Debt to Asset	ESG Score
Return on Asset	
Asset Turnover	
Gross Profit	
Net Profit	
Quality Indices	

Source: Fisher Investments Research.

An example of a quantitative metric used by the industry is return on equity (ROE). It is the amount of net income returned as a percentage of shareholders' equity. It illustrates how effective the company is at turning the cash put into the business into greater earnings and growth for the investors. The higher the ROE, the more efficient the company's operations are making use of those funds therefore higher quality.

Additionally, prominent index data providers such as MSCI, FTSE Russell, and S&P have all created indices to capture the quality factor which are widely used by the industry as benchmarks. However, the definition of quality varies from one index provider to another which is different than factors such as value or growth which are defined consistently across the index data providers. Further, index methodology in defining quality is based on backward-looking data (e.g. historical profit margins) whereas equities are forward-looking. So, *only* using indices' quality definition limits our understanding to which companies are defined as high quality by focusing only on historical data as opposed to historical data *and* forward-looking measures.

There are also qualitative attributes of quality that are more subjective and abstract which can help a company maintain a competitive advantage and deliver long-term growth. For example, some investors look at management pedigree because the calibre of key decision-makers can determine the trajectory of a company's progression. Visionary leaders, such as the late Steve Jobs and Warren Buffett, have stood at the core of some of the biggest corporate transformations.

HOW DOES FI DEFINE AND UTILISE QUALITY?

Quality research complements our existing top-down investment process. Depending on the market environment, quality can act as a primary stylistic driver and other times it can act as a residual factor. Both

[1] *Merriam-Webster. (n.d.). Quality. In Merriam-Webster.com dictionary. Retrieved March 5, 2024, from https://www.merriam-webster.com/dictionary/quality*

quantitative and qualitative metrics are incorporated in our red flag security analysis when we make initial buys and are reviewed regularly. We use these widely broad available metrics to calculate our own in-house quality Z-score. This allows us to identify uniquely positioned companies with higher quality characteristics in the investable universe. There are three primary quality metrics used in calculating the Z-score. The combination of these three quality characteristics creates a compounding effect that drives our quality approach:

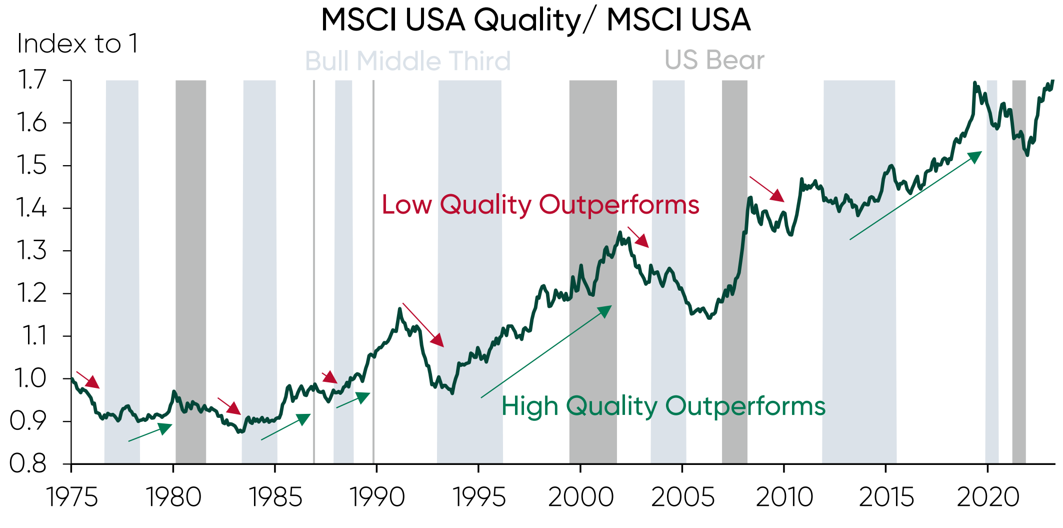
- **ROE**—Companies with a high ROE suggest it is a highly profitable business that are more likely to maintain good earnings growth and hold up better when margins are under pressure.
- **Earnings Variability**—Earnings variability is measured by the standard deviation of earnings per share growth over the past 5 years. A low earnings variability implies higher earnings predictability and therefore high quality.
- **Debt to Equity**—Cash-rich businesses with lower financial leverage have more financial flexibility which allows for increased research and development, share buybacks, dividends, and strategic acquisitions.

The first step of the calculation is winsorising (a mathematical averaging method that limits extreme values) the three chosen quality metrics at the 5th and 95th percentile of the MSCI ACWI IMI universe to avoid extreme outliers. Then, we obtain a Z-score by standardising them relative to the MSCI ACWI IMI Index. Lastly, we average the three quality variables Z-scores to achieve the final quality Z-Score. We utilise the final quality Z-score to rank companies within the investable universe. The higher the quality Z-score, the higher the quality of the company. Based on where we are in the market cycle and our outlook on whether quality is primary driver or residual factor of returns, we will adjust portfolios accordingly.

QUALITY AND MARKET CYCLE STAGES

Exhibit 3 shows historically MSCI USA Quality equities have outperformed the broad US equity universe. While survivorship bias may influence this trend (low quality companies are more likely to fail), leadership still rotates between high and low quality equities. Understanding cyclicality is important to help ensure most of the outperformance periods are captured in portfolio positioning. We have found equity style trends are typically driven by economic and market cycles. Our prior studies on quality—utilising MSCI's definition of quality—indicate investors prefer lower-quality securities early in bull markets and higher quality as bull markets mature.

Exhibit 3: Quality Leadership Depends on Nature of Business Cycle



Source: Refinitiv Eikon. MSCI USA Quality and MSCI USA monthly returns from November 1975 – February 2024. All returns presented are in USD and inclusive of gross dividends. Index to 1 on November 1975.

Early bull cycles are characterised by: Rapidly increasing economic growth; steepening yield curves facilitating access to capital; low sentiment/pessimism about the market recovery; low inflation and low capacity utilisation. This backdrop tends to favour lower quality companies, which typically often lag in downturns and beat irrationally dour expectations during the recovery. Low quality equities outperform off market bottoms and when economic output rapidly increases.

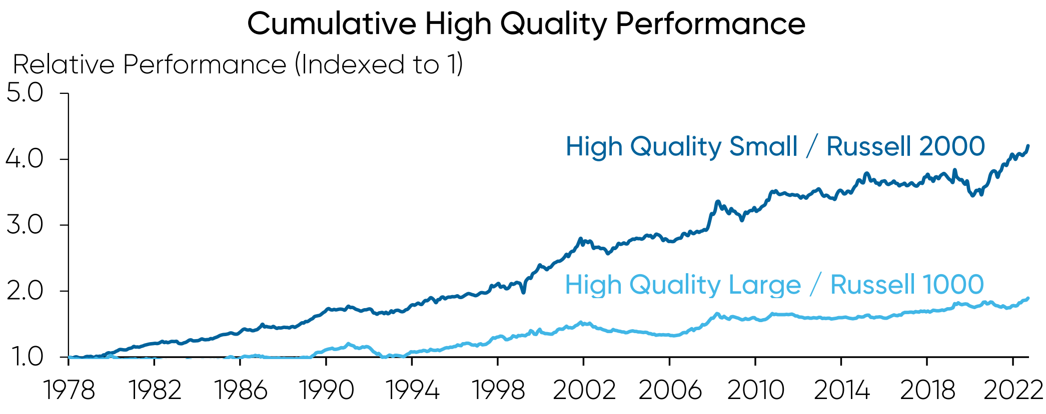
Mid-to-late bull cycles are characterised by moderating economic growth; flattening yield curves that inhibit access to capital; high sentiment/optimism about the market; higher inflation and high capacity utilisation. This backdrop favours high quality equities which rewards the companies best able to maintain earnings. High quality equities, with their large global footprint and diverse revenue streams, fit the bill. These companies typically have innovative products, higher margins, more cash on hand and are less debt heavy. Typically, during late bull cycle, there is also a very tight labour market which favours large companies that have the advantage to recruit when competing for talent.

Bear market cycles are characterised by slowing or sluggish economic growth; negative sentiment/scepticism about the market; low disposable income and weak productivity levels. This backdrop favours high quality equities as well because they can maintain earnings in a torpid global economy. Companies with a "margin of safety"—high and consistent earnings with low leverage—thrive in a market environment full of uncertainty and volatility. Attributes of quality companies that are more subjective and abstract may matter more during this part of the market cycle which can help a company maintain a competitive advantage and deliver long-term growth (e.g. brand recognition). In summary, understanding the key drivers that could lead to a shift in leadership from lower-quality to higher-quality companies during market cycles aids in our pursuit of achieving excess return.

QUALITY INTERACTION WITH OTHER FACTORS

Studying how the quality factors interact with other factors provides investors with more options and opportunities, which we think is invaluable for helping to achieve long-term success. It can be a powerful complement during small/large or value/growth leadership shifts in the market cycle and/or when managing specific mandates. For example, we have found that quality tends to matter more in driving outperformance in small cap companies compared to large cap companies. Exhibit 4 shows when we compared historical performance of the high quality companies in Russell 2000 versus Russell 1000 (represented by the top 30% of the quality Z-score ranking), spreads between high- and low-quality companies are wider in small-cap than in large caps.

Exhibit 4: Performance Differences in High Quality Small-Caps vs Large-Caps



*Source: ClariFi - Russell 1000 and Russell 2000. Total Monthly Returns in USD from December 1978 – August 2023. Quality portfolios use a composite equal-weighted Quality score of (ROE, 5Y Variance in Earnings, Debt-to-Equity). Quality portfolios are rebalanced semi-annually in June and December, taking the top/bottom 30% of Quality names in the parent index. Issuer weights are determined using (market cap * quality score), and weights are capped at 5%.*

Overall, we conduct various other studies between quality and other factors. We customise our quality Z-score to what is more applicable to the factor whether that is style, index, or sector. This dynamic approach allows for a more comprehensive understanding of quality.

CURRENT OUTLOOK & CONCLUSION

Global equities ended 2023 positively—erasing the 2022 downturn. This early bull started unusually, with high quality growth equities leading the market. Slow growth and an inverted yield curve have funnelled more capital to high quality firms that can use their pristine balance sheets and size to their advantage. We believe the new bull market cycle likely continues in 2024—favouring higher-quality equities. In a slower-growth and falling inflation environments, high quality, all-weather growth equities should lead markets. FI portfolios were overweight high quality equities since the 2022 downturn and we have since added more names in late 2023. Some examples of these new positions in Consumer Staples are listed below. (Exhibit 5)

Exhibit 5: 2023 Sample Quality Trades Summary in Global Strategies

Name	Buy Rationale
Nestlé S.A.	We added to Nestlé, the world's largest packaged food products company, to increase exposure to high quality companies. Not only is Nestlé a market leader in the fastest-growing categories of coffee, pet food and infant nutrition, but nearly 85% of total company sales hold number one or two market share in their categories. Going forward, the company's focus on premium brands as well as high free cash flow should allow it to keep growing its market share and profitability through acquisitions and innovation.
Walmart Inc.	We added to Walmart, the world's largest retailer, to increase high quality exposure. The company should benefit as it continues to leverage its size and market share advantages to drive store traffic. In addition, a robust e-commerce operation provides an important growth avenue moving forward.
The Procter & Gamble Company	We added to Procter & Gamble, the leading household products company, to increase exposure to high quality companies. Procter & Gamble should benefit from its mega-cap characteristics, including economies of scale and superior pricing power from its innovative and premium product offerings.
Unilever PLC	We added to Unilever, the British-Dutch household and personal care manufacturer, to increase high quality exposure. The company's strong brand names and diversified offerings should generate superior growth relative to peers. Unilever should also benefit from its diverse geographic end markets, including high exposure to Asia's and the Americas' consumption growth.

Source: Fisher Investments Research, as of November 2023. Please note, not all strategies or clients received these trades.

In conclusion, at FI we dedicate a sizeable research resource to identifying and monitoring the quality factor across markets and strategies. We remain flexible in our definition of quality and diligent in conducting various studies on how to capture it.

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