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English Version

Insigneo Weekly Dispatch

The Quest for Quality in Equity Markets

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The Quest for Quality in Equity Markets

> "Quality" in equity markets refers to an investment style focused on a company's financial health, sustainability of earnings, and a strong competitive position. This includes factors like low debt levels, strong cash flow, and predictable operating margins.

> Traditionally, Quality companies were found in sectors like Consumer Staples, Healthcare, Utilities, and Financials. However, in recent years, the Technology sector has also gained prominence in Quality-oriented investments.

> It is important to diversify within the Quality investment style, especially given the relatively high valuations of U.S. Quality stocks. International equities, which may offer Quality at more attractive valuations, offer a reasonable complement to existing portfolios.

Stick with Quality. Equity investors have heard this mantra repeatedly over the past few years. But what exactly is Quality? And how do you "stick with it"?

Notice that we have spelled the word Quality with a capital "Q", implying that, in this case, Quality is a noun, not an adjective. This is because in the world of investing, Quality is an investment style, or factor, much like Growth or Value. **In broad terms, the definition of Quality as a factor tends to be centered around a company's financial health, sustainability of earnings, and strong competitive position, among others.** From a financial health perspective, Quality tends to involve factors such as relatively low levels of debt and strong cash flow generation. In a similar manner, earnings sustainability is tied to factors that highlight a company's resiliency, such as strong, predictable operating and EBITDA margins, as well as healthy, sustainable Return on Equity (ROE) metrics. Unlike the previous two descriptors of Quality, which

are more precise and quantitatively oriented, a company's competitive position tends to be more subjective in nature. Components of a company's strong competitive position may range from business models with entrenched market leadership operating in industries with high barriers to entry, to highly experienced management teams. Unsurprisingly, financial health, earnings sustainability, and competitive position are all interrelated. For example, a company with a leading competitive position in its industry may be able to charge higher prices than its competitors, leading to strong operating margins and cash flow generation, which could in turn lead to a lower need to issue debt, resulting in a healthy balance sheet. However these components may be linked, there is one over-arching theme across all of them: a sustainable business model.

Traditionally, companies meeting the parameters of the Quality factor were found mostly in the Consumer Staples, Healthcare, Utilities and Financials sectors. Think of household names such as Procter & Gamble, Coca-Cola, Johnson & Johnson, and J.P. Morgan Chase. However, over the past five years, the Technology sector has also entered the mix. In fact, Technology companies now comprise between 40% and 50% of the holdings in some of the most prominent Quality-oriented ETFs on the market. If we think about it, this makes perfect sense. Some of the companies in the S&P 500 that today fit the bill are not just the slow-growing, value-oriented companies of years past. **Some of the companies that now have fortress-like balance sheets, are cash flow generation machines, and have nearly impenetrable moats are the growth-oriented tech giants, including many of the Magnificent Seven corporations.**

A case in point is Microsoft. A company as deeply entrenched in its industry as Microsoft, offering cutting edge solutions, and led by a highly experienced management team, can generate industry leading Operating Margin and ROE metrics, resulting in high levels of cash flow. Generating over $130 billion in Cash Flow from Operations alone, the amount of cash generated by Microsoft is larger than the total value of Goldman Sachs or energy giant ConocoPhillips, measured on a market capitalization basis. In fact, with close to $80 billion currently in cash on its balance sheet, the company's cash position is larger than the GDP of Croatia. At the same time, the company's leverage position, measured on a Net Debt/Equity basis, is a tenth of that of its competitors. These are the underpinnings of the new Quality companies.

However, trading at 34x forward earnings, Microsoft is not exactly cheap. In fact, most Quality-oriented companies in the United States currently trade at a premium to the S&P 500. This makes sense, as investors have bid up these stocks over the past few years in their search for Quality. So, given the relatively expensive valuations of some of these companies in the U.S., how are investors supposed to "stick with Quality"? **The answer is diversifying within the Quality investment style**. Although the Quality factor is far more pervasive in the United States, it is not exclusive to this country. Many other countries and regions around the world are also home to companies that exhibit this factor yet are trading at more attractive valuations. Let us look at Europe.

Trading at roughly 14x earnings, the Eurozone is trading slightly above its 20-year average valuation of 13x. At first glance, the current 8% premium embedded in Eurozone markets does not seem like a bargain. However, when we consider that U.S. equity markets are currently trading at nearly a 40% premium to their 20-year average, we can then appreciate the relative discount in European markets. In fact, according to a recent report from J.P. Morgan, international equities in general are currently trading

at a 35% discount to U.S. equities, compared to a 20-year average discount of 18%. Granted, U.S. equities should trade at a premium relative to the rest of the world, given the higher earnings growth rate in this country. However, the current wider-than-average valuation gap should narrow as other countries begin to catch up. Additionally, over the past 30 years, international equities have proven more likely to outperform the U.S. only when the U.S. Dollar weakened, as we saw in the period from 2002 through 2008. Given the current environment, in which we are already experiencing weakness in the U.S. Dollar, a tailwind for stronger international equity market performance could be in the making. **With Quality available at discounted rates in other parts of the world, investors have an avenue through which to diversify their exposure to this factor.**

There are several mutual funds and ETFs through which exposure to the international Quality factor could be considered, such as the iShares MSCI International Quality Factor ETF (IQLT). However, it is important to highlight that this does not mean that investors should eliminate U.S. quality stocks from their portfolios. It just means that investors with existing positions in U.S. quality equities, who want to continue to gain exposure to this factor, could consider international equities as a complement. ■

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