DIAMOND QUALITY

The Benefits of Identifying Quality

In baseball, the appeal of the power hitter is undeniable. Having one in the batter’s box means that you are one pitch away from scoring runs in a hurry and turning the game around, while the spectacle of watching tape-measure home runs can draw the attention of even the most casual fans.

The positives of leading the league in homers, however, typically come with pretty sizeable trade-offs. By being aggressive and swinging for the fences on every pitch these players generally have a high probability making contact with nothing but air, resulting in strikeouts coming at a high frequency — it is not just random chance that New York Yankees’ star Giancarlo Stanton has been in the league’s top 10 for both home runs and strike outs in each of the last two seasons (with the latter outnumbering the former by nearly 4-to-1 in those years).

And while you definitely want these prototypical sluggers in your line up when they are in a groove and hitting well, it is often the case that they are streaky — the homers come in bunches, but slumps also happen with some regularity that leave a gaping hole in the middle of your lineup.

In the investing world, the power hitters are the aggressive growth stocks. These securities have the potential for stronger-than-average returns, attracting a premium in the marketplace and capturing the attention of financial media and the imagination of investors looking to turn a small investment into a fortune in short order.

But much like the home run hitters, the risk of strikeouts with aggressive growth stocks is high; in other words, the potential for higher reward comes with higher implicit risk. Growth stocks are typically levered to the economic cycle, outperforming the broad market in periods of strong economic growth, but also being subject to significant downside risk when growth rolls over or if sentiment swings negative.

Much like managers in baseball try to balance their lineups with contact hitters, equity portfolio managers can make complementary investments in dividend stocks which can generally offer up more moderate but stable performance and regular cash flows that can help mute the downside. Of course, these income-generating investments offer comparatively less upside than their growth counterparts that can leave investors feeling as though they are on the outside looking in during market bull runs.

In baseball, the truly elite players are those that can consistently hit for both power and average, maintaining a high upside while also limiting slumps and steadily providing value even when they are not able to hit the ball out of the park. There is an equivalent for the well-rounded hitter comparison in financial markets: quality stocks.

A generally accepted definition of a “quality” stock is the equity of a company that has high profitability, low volatility in earnings growth and low leverage. A company that scores high in these three categories is typically more mature (and as such has strong management and corporate governance structures in place) and a dominant player in its industry with a sustainable advantage over competitors and a focus on secular growth trends rather than cyclical ones.
Benefits of Quality

These quality companies are able to see consistent and sustainable organic growth and tend to be fairly sheltered from the ebbs and flows of the business and interest rate cycle.

The fact that these companies are able to typically generate stable profits makes them inherently less risky investments, but also means that their stocks may be limited in their future growth rates relative to their more aggressive peers. With that in mind, though, note that over the last 10 years that cover this global economic expansion and bull market, it is the quality stocks (defined by the MSCI World Style Index as stocks that achieve high scores based on high return on equity, stable year-to-year earnings growth and low financial leverage) that have managed to outperform other investment strategies as well as the broad market.

Moreover, extending the range to the last 30 years (and capturing the previous full market cycles rather than just the current expansionary period) the relative outperformance of Quality stocks versus other strategies, and growth in particular, becomes even more stark.

While this relatively unheralded top-tier performance of quality investing strategies is noteworthy in general, what is more interesting (and carries significant implications given the expected market backdrop going forward) is what has been the driving force.
The Best Offense is a Good Defense

As mentioned, growth strategies typically do best in positive market and economic environments. Unsurprisingly, the MSCI World Growth index has the highest up-market capture ratio among its peers over the last 30 years, meaning it outperforms the broad market and other strategies when the stocks in aggregate rise.

Of course, market performance is not strictly one-directional; instead it is a two-way street on which the course sometimes changes abruptly without clear signs.

When global stock markets decline, growth strategies fall more than the broad market and by considerably more than the other investment styles — particularly quality stocks, which see materially more muted downside performance.

This latter point is the key. While catching the upside moves is clearly important in terms of generating positive investment performance, mitigating the downside is equally, if not more, important. By their nature, stocks of quality companies are designed to weather the storms in financial markets and the economy as a whole since their ability to generate consistently solid earnings growth with low leverage means that can survive systematic financial crises and recessionary conditions — and this is a key factor in the potential longer-term outperformance of quality strategies.
Volatility in the Macro Picture

More to this point, quality stocks have outperformed the global benchmark over the last three decades in periods of heightened equity market volatility, and by a significant degree.

CHART 5: SHELTER FROM THE STORM

MSCI World Total Return by Style Versus Overall Index In Above-Average* Volatility
(basis point difference in the average annualized rate)

*Based on monthly data from January 1989 to February 2019 when the VIX (VXO prior to 1990) is above its average level.
Source: Bloomberg, Guardian Capital. The MSCI World Index, which is part of The Modern Index Strategy, is a broad global equity index that represents large and mid-cap equity performance across 23 developed markets countries.

In the same vein, the characteristics of quality stocks typically make them able to outperform no matter what interest rates are doing. Low leverage leaves these companies in better shape than others when interest rates (and costs of capital) rise, while their stability and strength permit them to be able to manage in weaker economic conditions that are associated with generally declining interest rates.

CHART 6: RATE INSENSITIVE PERFORMANCE

MSCI World 12-Month Total Return by Style Versus Overall Index
(basis point difference in the average annualized rate)

Based on monthly data from January 1989 to February 2019 using changes in 10-Year US Treasury Note Yields.
Source: Bloomberg, Guardian Capital.
By seeing a comparatively smaller decline amidst volatile and down market conditions, quality stock strategies do not typically see the impairment of their capital which means that subsequent rebounds are applied to a larger base. The downside protection combined with market-like exposure to upswings is why quality has been able to consistently outperform throughout market cycles — and the fact that all of this has historically come with comparatively low volatility means that the outperformance is especially noteworthy on a risk-adjusted basis.

**Strength in the lineup**

One of the by-products of a quality-focused discipline is the fact that some companies will be avoided due to either their market environment or their balance sheet management. Firms that operate in commodity-related sectors (industries where companies are “price takers” rather than “price makers” and are overly levered to the economic cycle) as well as those that are capital (and with that debt) intensive are often avoided. For example, the MSCI World Quality Index is virtually unexposed to Energy, Materials, Utilities and Real Estate and materially underweight Financials relative to the overall benchmark index.
Bottom Line

In the short-term, any style or factor can be the hot performer, hitting home runs on a regular basis. Streaks of spectacular performance, however, are not sustainable and the risks implicit in those gains become more evident; ultimately slumps happen and can turn what was once a promising season into a forgettable one.

The potential to hit a home run with an investment is a highly desirable prospect. But with the big swings come the potential for big misses. If the pressure is on, you want to have a player in your lineup that you know can consistently make high quality contact, because while the occasional home run is great, the ability to consistently hit singles and doubles means that you are going to be in position to score more often than not and in the end, hopefully help you win the game.

Investments in foreign securities involve certain risks that differ from the risks of investing in domestic securities. Adverse political, economic, social or other conditions in a foreign country may make the stocks of that country difficult or impossible to sell. It is more difficult to obtain reliable information about some foreign securities. The costs of investing in some foreign markets may be higher than investing in domestic markets. Investments in foreign securities also are subject to currency fluctuations. The information and statistics contained in this report have been obtained from sources we believe to be reliable but cannot be guaranteed. Any projections, market outlooks or estimates in this letter are forward-looking statements and are based upon certain assumptions. Other events which were not taken into account may occur and may significantly affect the returns or performance of these investments. Any projections, outlooks or assumptions should not be construed to be indicative of the actual events which will occur. These projections, market outlooks or estimates are subject to change without notice. Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. All indexes are unmanaged and you cannot invest directly in an index. Index returns do not include fees or expenses. Actual client portfolio returns may vary due to the timing of portfolio inception and/or client-imposed restrictions or guidelines. Actual client portfolio returns would be reduced by any applicable investment advisory fees and other expenses incurred in the management of an advisory account. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from Alta Capital Management, LLC. To the extent that a reader has any questions regarding the applicability above to his/her individual situation of any specific issue discussed, he/she is encouraged to consult with the professional advisor of his/her choosing. Alta Capital Management, LLC claims compliance with the Global Investment Performance Standards (GIPS®). The GIPS firm is defined as Alta Capital Management, LLC which is an independent money management firm that focuses on identifying high quality growth companies through fundamental analysis and a sound valuation methodology. To receive a complete list and description of composites and/or a compliant presentation that adheres to GIPS standards, please contact Alta Capital Management at 801-274-6010 or Compliance@altacapital.com.