# Investing in quality stocks over the business cycle

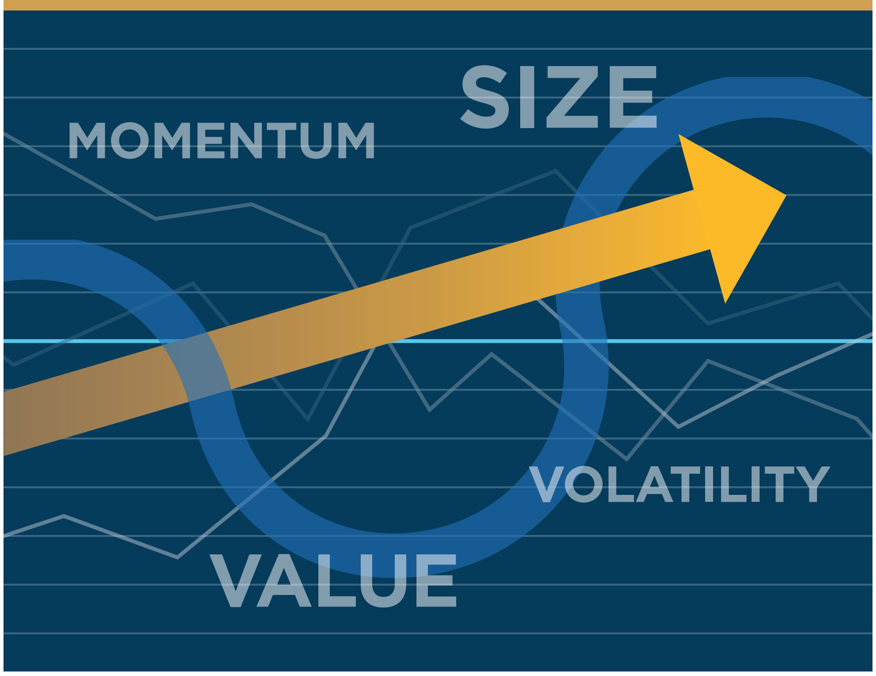
## Key highlights

- Quality refers to strong fundamental characteristics of a company that show up in actual business results
- Stable earnings, sustainable cash flow and strong balance sheets are typical characteristics of quality companies
- Quality stocks tend to outperform the broad market over a full economic cycle with less volatility

What do we really mean when we talk about “quality investing”? Shouldn’t investors always look for quality in the investments they choose for their portfolios?

The answer is “yes” when speaking about quality in a general sense. But quality is a theme all of its own in the world of factor-based investing (also known as “smart-beta”). When used as a factor, quality helps investors and investment managers identify return opportunities based on what makes a resilient, well-run company. When combined with other factors, quality can help contribute to overall portfolio performance and dampen volatility.

**Quality stocks may outperform in later stages of the economic cycle because quality companies are often in better position to manage through tough times.**



## What is "factor investing"?

Before we explore quality, let's discuss factors. Factor investing uses deep data collection and analysis to identify key drivers of investment performance and develop an investment strategy based on these drivers to seek above-market returns.

Quality is one type of factor investing; other factors include momentum, value, size, volatility and more. Quality investing involves the analysis of different fundamental characteristics of company performance—earnings, cash flow, return on equity and more—to identify companies that appear to be financially sound, well-managed and positioned to produce strong returns through different phases of the business cycle.

Investing in quality companies can be advantageous to investors during late-period phases of economic expansion and into recessionary cycles. Because quality companies are said to have strong balance sheets and firm financial controls, they possess multiple levers they can use to adjust to changes in the business climate and are able to manage through times of economic transitions.

| What are some factors? | How do they work? |
|---|---|
| **Quality** | Companies that are prudently managed and financially strong may perform well throughout the business cycle. |
| **Momentum** | Strong performance among stocks may carry forward to deliver positive near-term results. |
| **Value** | Companies with stock prices that are undervalued relative to their prospects for growth may offer strong return opportunities. |
| **Size** | Smaller companies historically have delivered stronger returns than larger companies over the long term. |
| **Volatility** | Stocks that exhibit less variance in return over long-term averages may deliver better risk-adjusted performance. |

## What to look for in a quality company

- **A history of stable earnings**
- **Sustainable cash flow**
- **A strong balance sheet with reasonable levels of leverage or debt**
- **A defensible position in their specific market**
- **Prudent management and transparent governance at the board level**

# What is a“quality” company?

Quality can be subject to different interpretations and definitions. What defines quality in one manager’s eyes may be different in another’s.

At a high level, quality as a factor refers to strong fundamental characteristics of a company that show up in actual business results. When we talk about fundamentals, we’re talking about hard financial data such as earnings, cash flow, return on equity, debt-to-equity and more. A business’s fundamentals represent the basics of business performance. Is the company profitable? Does it have positive cash flow? Does it carry excessive debt relative to ownership equity?

While quality as a factor can be subjective, the data used to define quality generally are not.

Businesses report fundamental performance in hard numbers at the end of every quarter and fiscal year. These numbers are readily apparent to any investor or portfolio manager, and they cannot easily be misrepresented (not without significant consequences).

## Where to look for quality?

**Below are some common and useful fundamental indicators that portfolio managers use as part of a quality factor analysis.**

**Return-on-equity (ROE):**
How much income a company earns on its net assets (total assets minus current debt)

**Earnings consistency:**
How strong are current earnings and how sustainable they may be for future growth.

**Free cash flow (FCF):**
How much cash a company generates to cover payables, service debt and potentially pay dividends

**Debt/equity ratio:**
How much has a company borrowed relative to the value of outstanding stock owned by the shareholders

# Quality stocks in the economic cycle

Quality companies generally experience steady growth throughout economic expansions, but they tend to outperform as the growth cycle matures. In earlier phases of the cycle, companies that are positioned for growth often get more attention from investors, as they seek to participate in their rapid earnings growth. Higher investor interest creates momentum for these stocks as the business cycle continues.

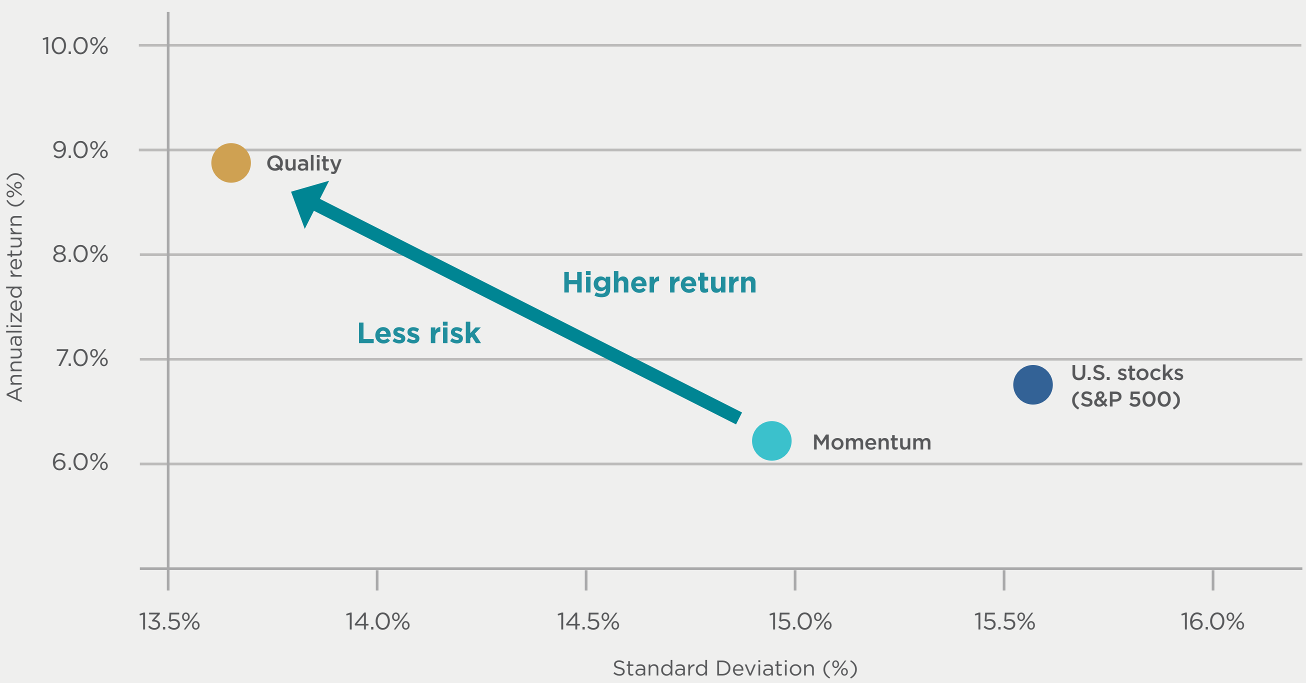
But as the cycle matures, sustaining earnings growth becomes more difficult than it was earlier in the expansion. Quality stocks, on the other hand, appear more attractive as economic growth decelerates, because investors see greater value in their consistent earnings and strong balance sheet.

As business conditions turn more difficult, companies without strong fundamentals generally lack the ability to adjust, and investors become more concerned with achieving earnings growth, not just maintaining it.

But quality companies can use their fundamental strength to remain competitive and continue to generate profits. These firms often have more ways to adapt to changing business conditions, so they can continue to remain viable and withstand economic recessions.

With this flexibility, quality companies tend to outperform the broad market over the course of a full business cycle with less volatility, as illustrated in the chart below.

**Risk and return analysis of quality, momentum and the broad U.S. stock market**
2008-2018




Quality represented by the MSCI USA Quality Index. Momentum represented by the MSCI USA Momentum Index. U.S. stock market represented by the S&P 500® Index.

Source: Factset, December 2018

# Key takeaways

1

Quality as a factor can help investors identify return opportunities based on the characteristics of well-managed and financially sound companies.

2

Quality companies tend to outperform other companies and the broad stock market over a full business cycle with less variance in returns.

3

When combined with other factors, quality can help contribute to overall portfolio performance and dampen volatility.

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**MSCI USA Quality Index:** this index is based on the MSCI USA index, its parent index, which includes large and mid cap stocks in the US equity market. The index aims to capture the performance of quality growth stocks by identifying stocks with high quality scores based on three main fundamental variables: high return on equity (ROE), stable year-over-year earnings, growth and low financial leverage.

**MSCI USA Momentum Index:** this index is based on MSCI USA index, its parent index, which captures large and mid cap stocks in the US equity market. The index is designed to reflect the performance of an equity momentum strategy by emphasizing stocks with high price momentum, while maintaining reasonably high trading liquidity, investment capacity and moderate index turnover.

**S&P 500® Index:** An unmanaged, market capitalization-weighted index of 500 stocks of leading large cap U.S. companies in leading industries; gives a broad look at the U.S. equities market and those companies' stock price performance.

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