THE STAN CLARK FINANCIAL TEAM'S

PERSPECTIVES

An Excerpt from Volume 13 | Issue 4 **June 2022**

Investing

QUALITY IS KEY

By Michael Chu, Senior Wealth Advisor

Warren Buffett, one of the world's greatest investors, once said, "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

Companies that are consistently profitable and growing, and have solid balance sheets, sound like wonderful companies to invest in. In 2013, Cliff Asness of AQR Capital Management put out a study called *Quality Minus Junk*, which demonstrated that stocks fitting the quality mold produced better-than-average returns in the U.S. and 24 other stock markets around the world. This study covered companies between 1958 through 2018, i.e., 60 years' worth of data.

The fathers of *factor investing*, Eugene Fama and Kenneth French, originally identified two factors that seemed to produce higher-than-average returns: value and size. In the early 1990s, other researchers, including Asness, documented a third factor: momentum. Then there's quality, a newer-generation factor that includes things like profitability, accounting quality, earnings stability and growth. In this article, we'll quickly review value and momentum and spend more time on quality.

Good value stocks are those with low prices compared to underlying company fundamentals, such as price-to-earnings or price-to-book value. *Good momentum* stocks are those that surprise investors by doing better than expected, with analysts raising earnings estimates, reported earnings higher than expected and positive price movement.

How to measure quality?

Quality stocks are those with strong profitability, growth and safety. Such stocks justify higher prices, but their positive qualities are often underappreciated by the market and therefore mispriced. Some examples of quality measures are:

1. High return on equity, high profit margins, strong cash flows
2. Growing earnings, margins and cash flows
3. Low price volatility, low earnings variability, low debt to equity.

Intuitively, one would think that higher-quality stocks are more expensive than low-quality stocks – after all, they deserve to be higher priced. But the reason they're attractive investments is that the price premium tends not to reflect the full benefit of their quality. In other words, they're not expensive enough! Despite seeming more "expensive" than average to begin with, investing in high-quality stocks yields better returns over the long term.

Why would such stocks exist? Perhaps it's that investors assume high-quality stocks are already efficiently priced, so they naively look elsewhere for opportunities.

Back to the Asness study mentioned above. As noted, the *Quality Minus Junk* authors looked at 40,000 stocks over 60 years in the U.S. and 24 other developed countries. Quality stocks delivered higher returns in the U.S. and in 23 out of the 24 other countries (only New Zealand fell ever-so-slightly short).

In addition to higher returns, quality stocks provided a safety net during crises. This is because historically, such stocks command a higher premium as a result of a flight to quality after a crisis. So, returns from quality are extra-high during downturns.

The *Quality Minus Junk* authors also noted that, for the market to rationally put a price on quality characteristics, the characteristics need to be persistent. The study found that profitable, growing and safe stocks tend to retain these characteristics over the next five to 10 years.

In summary, quality stocks tend to earn higher returns and yet appear safer as well. What does this mean for us? The stock strategies created by the Stan Clark Financial Team use all three types of factors: value, momentum and quality. As we've mentioned before, each factor works well on its own, but when combined with the other factors, the results are even better. Some strategies lean towards one type while others are a blend of factors.

The end result for our clients is a portfolio of stocks covering the full spectrum of factors that have provided above-average performance. We'll talk about this more in our next article on quality.

Michael Chu is a Portfolio Manager and Senior Wealth Advisor for The Stan Clark Financial Team at CIBC Wood Gundy. Michael is a specialist in investment research and information technology.

CIBC WOOD GUNDY | The Stan Clark Financial Team
Where planning, investing and behavioral finance meet

Phone: 604 641-4361 | Toll-free: 1 800 661-9442 | Fax: 604 608-5211 | Email: stanclarkfinancialteam@cibc.ca | www.stanclark.ca