THE STAN CLARK FINANCIAL TEAM'S

PERSPECTIVES

An Excerpt from Volume 13 | Issue 6 **September 2022**

Investing

QUALITY IS KEY (PART 2)

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In our previous article on Quality factors we discussed how selecting companies that fit the quality mold produced higher than average investment returns. Now let's look at some of those factors we use to select stocks for your portfolio.

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.

Most measures have been tested by researchers over several decades across various countries. This gives us confidence that the factors in each measure are sound and should continue to work in the future.

Further, the sophisticated back-testing system we use for our models can test the effectiveness of each variable, using realistic assumptions, going back to 1996 or longer. For example, a portfolio of stocks that we choose based just on return on equity (ROE) will have outperformed the market by 3.7% per year, on average. Of course, to properly evaluate a variable, we look at more than just one number. But that's a good starting point.

One consideration is how a portfolio does in different types of markets. For example, does its ROE do better in up markets or down markets? Ideally a portfolio will do well in both. However, it's also acceptable for a portfolio to be stronger in certain types of markets. In the above example, the portfolio's ROE does very well in down markets and okay in up markets. You can think of its ROE as being more the defensive type.

We also look at performance consistency over the years. In the 26 years since 1996, did the portfolio massively outperform over just a few sporadic years, or moderately over the majority of years? A more powerful variable will be one that performs more consistently. In this case, on a calendar-year basis, the ROE outperformed in 18 of 26 years, or 2/3 of the time, which is pretty good.

Let's look at another variable. The 5 Year Earnings Growth (5YEPS) is, as its name suggests, the growth in earnings over the previous five years. If we picked stocks just based on this variable, over the last 26 years the portfolio would have outperformed the market by 2.9% per year, on average. As before, it's important also to look at other results. 5YEPS outperforms 59% of the time in up markets and 52% of the time in down markets. On a calendar-year basis, this variable outperformed in 16 of the 26 years.

As we can see, the stocks did well when we used ROE; also when we used 5YEPS. But what happens if we pick stocks using both variables? Based on both, the portfolio returns 4.4% better than the market – higher than each variable on its own.

At first glance that may seem counterintuitive. But basically what's happening is that we're getting better results because the variables are un-correlated. For example, if one variable is not doing well for a certain period, it could be the case that the other variable compensates. So, overall, better results.

Some of the consistency metrics are better, too. Both variables combined outperform in 58% of up markets and 61% of down markets. On a calendar-year basis, the combined strategy outperformed in 20 of 26 years. Again, the variables work better together than each on its own.

Our Quality Strategy uses several more variables – each making the strategy better with more performance or better consistency metrics.

How do we use the Quality Strategy in our investment process? It's one of several strategies we use to help create our portfolios. Each strategy focuses on a distinctive combination of value, momentum and quality factors. And each strategy, on its own, has produced better-than-average results in the past.

Our unique approach to portfolio construction is that we combine top-ranked stocks from all the various strategies into each efficiently diversified portfolio. This design helps reduce risk – while maintaining our expectations of outperforming.

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