Peak Quality?

The message below is quite compelling:

> *"We have a quality-focused investment philosophy, and own the best companies for the long term."*

Tough to argue with that one, right? Basically, it is the polar opposite of what must be the worst pitch of all time:

> *"We focus on horrible management teams and low quality businesses, and like to own the lousiest company for as short a period as possible, and then turn our portfolio over by selling one miserable business model and buying an even worse one."*

Well, fuelled by some excellent academic research over the last five years, as well as the ever-intensifying canonization of Warren Buffett, Mr. Market has been increasingly attracted to and enamoured by the concept of "quality" investing. So, let's explore it.

What is Quality?

Wikipedia tells us that:

> *"Quality Investing is an investment strategy based on a set of clearly-defined fundamental criteria that seeks to identify companies with outstanding quality characteristics."*

So far, that tells us exactly nothing.

They continue, however, with:

> *"The quality assessment is made based on soft (e.g. management credibility" and hard criteria (balance sheet stability)."*

This is a little less amorphous, but one of our peers has written an excellent book *Quality Investing: Owning the best companies for the long term,* and have done an even better job than Wikipedia.[1]

Hurry up guys, there might be a storm headed our way.

In it, they write that there are three broad characteristics that indicate quality; "strong, predictable cash generation", "sustainably high returns on capital", and "attractive growth opportunities". They do not mention anything about value as a condition, however they do (rightly) suggest that the combination of the three factors above are "particularly powerful, enabling a virtuous circle of cash flow generation, which can be reinvested at high rates of return, begetting more cash, which can be reinvested again."

They also highlight some other features that help them to determine the three key characteristics above, and they include "an appealing industry structure", "multiple sources of prospective growth", "high-value customer benefits", "various forms of competitive advantage", and "good management."[i]

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[1] *And in a stroke of marketing genius, they were able to convince Lawrence Cunningham (of Berkshire Beyond Buffett and The Essays of Warren Buffet fame) to co-author the book alongside two members of their investment team.*

In it, they also quote Warren Buffett who stated:

> *"Leaving the question of price aside, the best business to own is one that over an extended period can employ large amounts of incremental capital at very high rates of return."*[ii]

And we can learn even more about "quality investing" by reading Benjamin Graham, Buffett's teacher and mentor. In *The Intelligent Investor*, the term "quality" shows up 77 times. In it, he highlights "general long-term prospects", "management", "dividend record", and "current dividend rate" as indicators of quality. Later he mentions "past (fundamental) performance" and "current financial position" as determinants of quality.

He clarifies the former with notions of "earnings stability", "earnings growth", and reiterates the importance of "dividend record"; and for the latter he suggests that "current assets should be at least twice current liabilities" and that "long-term debt should not exceed the net current assets". He also suggests a "moderate ratio of price to assets". He clarifies that the "current price should not be more than 1 ½ times the book value last reported" although that with a "multiplier of earnings below 15 (it) could justify a correspondingly higher multiplier of assets."[iii]

Fast forward to the 21st century, and the academics started weighing in with more concrete (and testable) notions of quality. Chan, Chan, Jegadeesh and Lakonishok (2001) discussed the notion of "earnings quality" and suggested that "earnings increases accompanied by high accruals" suggested "low-quality earnings" which were "associated with poor future returns."[iv]

A decade later, Novy-Marx has emerged as a leader in honing in, understanding, and communicating what he thinks "quality" is. He compares a lot of other peoples' definitions,[v] and has ultimately concluded that gross profitability tells us nearly everything we need to know.[vi]

Cliff Asness and his crew at AQR have done further work in the area, concluding that – everything else being equal – an investor should be willing to pay a higher price for "stocks that are safe, profitable, growing, and well-managed."[vii] In their conclusion, they explain how this is a "puzzle for asset pricing" as it is unlikely that the excess returns to quality stocks are because they are risker than junkier stocks. They even suggest the opposite, that "quality stocks are low beta and, rather than exhibiting crash risk, if anything they benefit from a 'flight to quality', that is, they have a tendency to perform well during periods of extreme market distress."

Even Eugene Fama himself has somewhat validated things, and has added "quality" variables to the Fama-French three factor model[viii] (profitability and investment).[2] The results were robust[ix], with positive factor loadings on these quality factors – at least historically – although no risk story was offered why this might be the case.[x]

What Price, Quality?

So "quality" certainly isn't an area that has been ignored by academics, nor by practitioners. Given the attention it receives today, surely the question has become whether or not high quality stocks are still underpriced. If even Gene Fama can't come up with a risk explanation why "quality" is riskier than "junk" and the boys at AQR (and GMO and DFA and Blackrock and elsewhere) are pouring literally tens of billions of dollars into "high quality" assets, is it at least possible that we shouldn't blindly go out and buy more "quality" without considering the valuation as implied by the biases of the consensus investor who is making the price for the stock?

In the book *Quality Investing*, cited above, the authors mention 19 case studies on companies on companies that they felt displayed some positive aspect of quality. While we don't disagree that all of them are of high quality (and we own one of them today), we'd also point out that the average P/E ratio of this bunch is markedly higher than the market P/E, and some names in particular are up in nosebleed territory. Great companies? Yes. But would I have rather purchased then four years ago when they were on 12x forward earnings? Absolutely.

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[2] *And upon the inclusion of profitability and investment, the "value factor" (HML), interestingly, disappeared. Moreover, the authors stated that none of these five factors were portfolio mimicking state-variables in the spirit of Merton (1973) but were just "diversified portfolios that provide different combinations of exposures to the unknown state variables". Fair enough, but if the bar was that low, then why didn't they acknowledge momentum as the sixth factor?*

In the authors' defence, they do somewhat address the valuation issue in the very last chapter of their book where they state that their "quality investing strategy emphasizes quality first, and valuation second", and then go on to "highlight some drawbacks of traditional valuation approaches". They also claim (and it sounds right to us) that "quality companies tend to exceed estimates, meeting or beating forecasts far more frequently than inferior rivals"; but then go on to claim (which doesn't sound right to us) that when investors don't participate in obviously "great companies" because they are expensive, and wait for these "tomorrow stocks" to get a little bit cheaper, that "the day seldom comes".

Our view is that the best investing opportunities are not only higher quality than realised by Mr. Market, but that this feature is simultaneously accompanied by an unsustainably low valuation ascribed to it by that same Mr. Market. We also wonder about the investing masses that now claim to be "quality" investors profligately refusing to consider valuation in their allocation of capital. This is not only reckless investing, in our view, but it shouldn't surprise anyone that the host of "quality investors" (both fundamental and quantitative) might be crowding things out, and taking the juice out of future returns.

And this isn't the first time Mr. Market has become smitten by quality. It happened in the early 70's, when investors en masse decided that it was okay to pay any price for a defensible business with high returns on capital, strong long-term growth prospects, and an excellent management team. It was called "The Nifty Fifty", and we all know how that turned out.

Here is an interesting fact, and one that you won't find on the cover of Forbes Magazine or on the first page of The Wall Street Journal. Since December 31, 2002 through the end of last year (15 years of data), Berkshire Hathaway shares have underperformed the S&P 500.

Dec 31, 2002 - Dec 31, 2017	Cumulative Returns	Annulised Vol	Annualised Returns
Berkshire Hathaway	308%	18%	17.6%
S&P 500	314%	16%	17.8%

And in the most recent nine years, Berkshire Hathaway shares have actually underperformed by nearly 200 bps annually, and over 50% cumulatively.[3]

Dec 31, 2008 - Dec 31, 2017	Cumulative Returns	Annulised Vol	Annualised Returns
Berkshire Hathaway	208%	15%	14.1%
S&P 500	259%	10%	16.0%

The point here is not to detract from Buffett's aura, or from quality investing, or from his excellent, steadfast wisdom; the point is that routinely investing in quality without regard for price is no panacea. In Berkshire's case, they have so much capital now that the best days of deploying it opportunistically are behind them. However, it is also possible – if not likely - that for the rest of us, many quality names have been bid up too high, and the market environment hasn't been conducive to finding high-quality bargains? After all, it was Warren Buffett who wrote:

> *"Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down."*[xi]

Our view is that the intersection of quality and value is where things get interesting. That could mean owning an extremely high quality company that the consensus investor only believes to be good quality, or owning the mediocre quality company that Mr. Market has left for dead.

The aforementioned Robert Novy Marx, in fact, hit the nail on the head.[xii]

> *"Buying high quality assets without paying premium prices is just as much value investing as buying average quality assets at discount prices."*

[3] *Even the change in book value as reported by the company has underperformed by 2.2% per annum in this 9 year window.*

And he adds:

> *"…the real benefits of value investing accrue to investors that pay attention to both price and quality."*

And the father of it all, Benjamin Graham has himself implicitly stated that high "quality" companies aren't a buy at any price, and in fact can become overpriced:

> *"Nearly every issue (i.e. stock) might conceivably be cheap in one price range and dear in another."*

And he has even suggested that high quality stocks don't always stay that way.

> *"Most businesses change in character and quality over the years, sometimes for the better, perhaps more often for the worse. The investor need not watch his companies' performance like a hawk; but he should give it a good, hard look from time to time."*

So, as we go out, meet management teams, speak to their competitors, customers, and suppliers, and build a general view about the dynamics and characteristics of the company and the sector in which it competes, and then decide if the reward of ownership more than compensates us for the risks of ownership, let's remember our golden rule "we buy stocks, not companies."

A high quality company does not necessarily make a high quality stock.

Maybe they built this one a bit too high?

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[i] Cunningham, Lawrence A., T. Eide, P. Hargreaves. 2015. "Quality Investing: Owning the best companies for the long term". Harriman House. London.

[ii] Buffett, Warren. 1992. Berkshire Hathaway Annual Letter.

[iii] Graham, Benjamin. 1973. The Intelligent Investor (4th Rev. ed.) Harpers & Row, New York, New York

[iv] Chan, K., L. K. C. Chan, N. Jegadeesh, & J. Lakonishok (2006). "Earnings quality and stock returns". Journal of Business, 79(3), 1041-1082.

[v] Novy-Marx, Robert, 2014. "Quality Investing." Working paper, 1-28

[vi] Novy-Marx, Robert. 2013. "The Other Side of Value: The Gross Profitability Premium." Journal of Financial Economics 108, 1-28

[vii] Asness, C, A. Frazzini, and L. H. Pedersen. 2013. "Quality Minus Junk". Working paper, 1-26.

[viii] Fama, E., K. French. 1993. Common risk factors in the returns on stocks and bonds. Journal of Financial Economics 33, 3-56.

[ix] Fama, E., K. French. 2014. A Five-Factor Asset Pricing Model. Working Paper, 1-29.

[x] Merton, Robert. 1973. An intertemporal capital asset pricing model. Econometrica 41, 867-887.

[xi] Buffett, Warren. 2008. Berkshire Hathaway Annual Letter.

[xii] Novy-Marx, Robert, 2013. The Quality Dimension of Value Investing. Working paper, 1-40.

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