Smith Group
ASSET MANAGEMENT

Market Perspectives Excerpt

Quality Considerations

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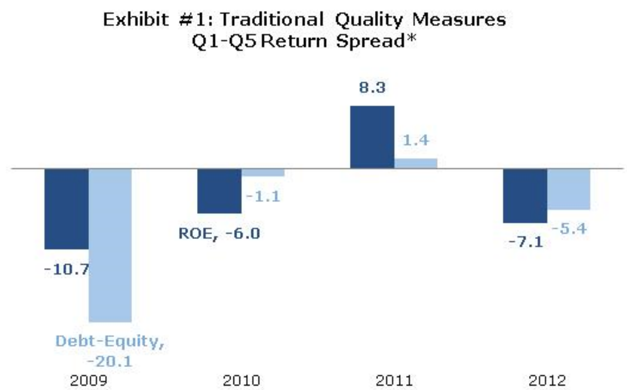
Two years ago in the aftermath of the 2009-2010 junk rally, active managers lamented the irrationality of lower quality companies outperforming their higher quality brethren. In the first quarter of 2011, we wrote an article discussing the difference between how the Smith Group looks at quality compared to the quality bias of many active managers. In 2012, quality was once again a headwind for active managers. Although, less so for the Smith Group leading us to refresh our article.

Active managers' quality bias justifiably comes from a belief that high quality companies can deliver higher, more consistent earnings growth than those that have to deal with the ancillary issues of low quality. Two common quality measures often used as filters by active managers are return-on-equity (ROE) and leverage (debt-to-equity). In the case of ROE, the logic would be that companies generating high returns on equity can deploy investment intelligently to create higher earnings, while companies with low returns do not have the same opportunity. Leverage then acts as an enabler of taking advantage of opportunities. Reasonable leverage enables companies to invest in projects and lowers the cost of capital, as opposed to over levered companies that have high capital costs and have a more difficult time raising the funding for good projects. In theory, this desire for high quality companies makes sense.

In practice, the case for traditional quality measures is less consistent than proponents would like. Exhibit #1 above right, illustrates the contemporary issue that traditional quality investors are contending with. The chart shows that the lowest quintile (worst 20%) stocks of the Russell 1000 universe ranked by ROE and leverage have been better performers than the highest quintile (best 20%) in three of the last four years. One could postulate about a variety of specifics to explain why low quality is beating high quality. It could be that with interest rates so low generating a high return on equity is not as important. Or with so much liquidity in the system and so little corporate investment taking place that leverage was not an inhibitor to capital needs. There are a multitude of potential explanations but the thrust of this article is not to explain the whys so much at to discuss the return associated with the factors.



At the Smith Group we are also quality investors, but our focus is on metrics supporting the sustainability of earnings trends. We are most interested in determining if a company with accelerating growth can sustain that pace. Conversely, is slowing growth a pause that refreshes instead of a fundamental change in business prospects? Metrics like balance sheet accruals, change in inventories, and asset efficiency give hints of how much management is stretching to meet market expectations and thus how likely they are to meet expectations in the future. These are some of the measures that make up our Earnings Quality (EQ) factor inputs. Exhibit #2 applies a similar quintile 1 minus quintile 5 calculation to the universe and indicates that in each of the last four years selecting the highest ranked stocks using our EQ factor was more profitable than owning the worst ranked. Comparing the first two exhibits it is not hard to imagine that many high quality managers are currently bemoaning the irrationality of the market, while the Smith Group has been less effected.

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* Average annual difference between 1st and 5th quintile returns for Russell 1000 stocks sorted into quintiles by noted factor

Quality Considerations

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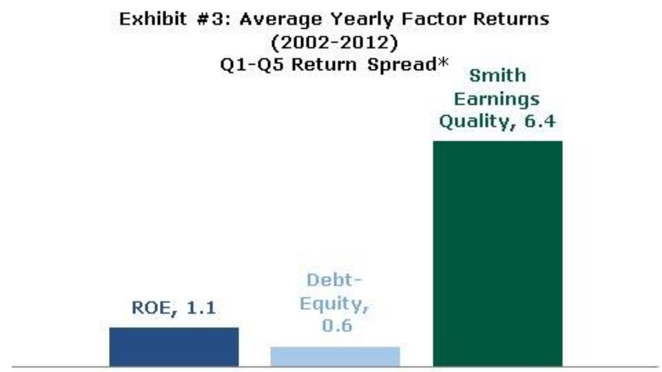
But is traditional quality suffering a temporary setback or is it really as good of a stock selection criteria as supporters would like to believe? Applying the same Q1 minus Q5 calculation to the 2002-2012 period in exhibit #3 yields a clear advantage to earnings quality compared to more traditional quality measures. While ROE and leverage ratios were on balance a positive factor they lagged substantially below the 6.4% return spread associated with EQ over time. But not only is the spread larger, the signal is also more consistent. In the eleven years in exhibit #3, EQ produced a positive spread in all 11 of them, while ROE only yielded a positive spread in 5 years and debt-to-equity in 7 years.

Earnings quality is a significant input to the Smith Group process as opposed to traditional quality. With our goal of identifying companies growing faster than expectations, sustainability of that growth is critical to our success.



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