Quarterly Comment – I 2014

Over the last two years there was much communication or hype about so called quality stocks or quality companies. Many investors propagated to own quality stocks but the understanding of the definition for a quality stock probably differed a lot. So was it rather a marketing strategy than a sensible investment strategy?

Let's use the very simple framework of the Price-Earnings-Ratio (PER) to showcase the principle of quality investing. Any reasonable investment strategy features the search for a cheap price of an asset that is expected to fetch a higher price for whatever reason in the future. Consequently, the performance of an investment strategy is purely determined by the "P" variable of the equation. Buy low, sell high. Yet, the concept of quality investing pertains first and foremost to the "E" variable (changes in earnings) and to a certain extent to the varying degree of the "R" variable (multiple arbitrage). Hence, the two main drivers for "P" are changes in "E" and "R" (P = E x R). Most investors will very likely agree that quality in a stock refers to resilient, recurring, sustainable, and steadily growing earnings, most often based on exceptional business models. But which metrics to use in order to measure these characteristics there is widespread dispersion in application and no common denominator in the market place.

In the most recent CFA Institute magazine, there was an article featuring some versions of quality investing. From a quantitative perspective, finance professor Robert-Novy-Marx suggested to multiply gross margins by asset turnover to receive a more powerful result in predicting relative performance among various stocks. Another version was proposed by Eduardo Repetto of DFA in form of dividing EBTDA by book value. Cliff Asness of AQR explained other measurements such as the five-year growth of return on equity, low idiosyncratic volatility or equity net issuance. Kimball Mayer of GMO associated sustainable higher profitability with minimal use of leverage while companies try to lower the volatility of its earnings. And last but not least, Vitali Kalesnik of Research Associates shared some findings by using composite signals from financial distress levels, growth consistencies, and accounting red flags and by combining these signals with perennial value measures.

While reading the article it stroke me that all investors had concentrated purely on quantitative measurements. These metrics can only show the outcomes of the underlying business models, so it's like just checking for certain symptoms. In contrast qualitative analyses revolve around economic moats or sustainable competitive advantages of business models and try to detect the root causes of economic success. Although I also perform regular quantitative screens on similar terms, it serves only as idea generation in a first step. Thereafter, I always want to understand the nature of any competitive advantages, if existing. Many companies try to sell their story of uniqueness, which are in fact irrelevant for profitability. Even in the case of some real advantages those could be imitable anytime soon by competitors. Real sustainable competitive advantages are rare. Bruce Greenwald from Columbia University and Pat Dorsey of Morningstar published their work on certain competitive structures and positioning that can be defended and subsequently enable higher profitability. Business models with economic moats have at least incorporated one of the following characteristics and the more they have incorporated the stronger the moat: intangible assets (brands, patents, etc.), switching costs, search costs, customer habits, network effects, and economies of scale. This list is not exhaustive but gives the most important factors. It is certainly easier to set up a screen and run it through a database than to talk to many stakeholders of a company to discern competitive advantages and to test their level of solidity. The discussion about a definition for quality stocks is already diverse but the perspectives on the quality of a business model get even more multifaceted. Phrased in competitive advantage jargon, investing is just an execution business, in which success depends on the manager's capability to do a better job than other managers do. Also quantitative models need constantly be revised and once a model becomes too successful, others will simply use it too.

After talking a lot about the earnings variable in the PER equation above, for which some smart models might exist to differentiate quality companies, the "R" variable or multiple arbitrage can be less controlled. In general, the PE level is just an approximation of the root cause or in other words the level of equity participation of the total investor base. There are times in which the PER (or interest in equities) is high and there are times in which the PER is low. History told us that there are inevitable mean reversion forces over time. But any concepts of historical comparisons, e.g. cyclically adjusted price earnings (CAPE) or total market cap in relation to GDP, have given poor guidance with respect to market timing. Today in the equity markets of many leading countries the long-run PERs have entered the upper bandwidths (in the US already at the very top). Consequently on a macro level, any prudent investment strategy allows for possible multiple compression these days. Apart from that, individual companies ought to be compared to their own historical PERs or to their peer groups. Quality companies usually command higher multiples, transmitting into higher prices. Hence, earnings multiples correspond to the level of quality or the sustainability of competitive advantages. But at the end of the day, any multiple level must make sense on a fundamental basis sooner or later. We have all heard about the notion of "good company, bad stock". So what does it help to own a company with an extremely strong business model but with a stock price that suggests a hopeless overvaluation? During the Nifty-Fifty period in the 1970s the quality only investment strategy proved devastating. With elevated multiple levels the risk exposure increased in form of a reversion from above-average general equity market participation rates and potentially too high expectations in the resilience and growth prospects of the underlying earnings levels.

As a result, the earnings and ratio variables play both key roles in a sensible quality investment strategy. I have encountered many outstanding business models in the last couple of years but after doing the math on valuation based on its inherent business models I couldn't reconcile my absolute required rate of return mindset with the lofty expectations for earnings growth built into the share prices. Unfortunately, by decomposing the drivers for the idiosyncratic level of multiples, most investors put too much weight on the expected growth rates and less on the sustainability of earnings. Thus, a strategy focusing on the inefficiencies in how the sustainability of earnings is reflected in a stock price seems to me more promising and worthwhile to explore. In contrast, focusing on the more elusive and often too optimistic growth rates poses much higher risks. If growth expectations cannot be met, very often not only the earnings level takes a hit but also the multiple collapses and the mutually reinforcing impact wrecks a lot of value in the short term.

Summing up, there are noteworthy opportunities to exploit in quality investing and not just marketing gimmicks by investors. Nevertheless, finding quality stocks alone is an insufficient effort. Any defined quality company needs to be evaluated with respect to its price. Only if both characteristics are favorable, outperformance will be attainable over the long run.

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