June 2022

Top Quality

The last two years have been tumultuous to say the least, with a seemingly unending onslaught of challenges (COVID-19 chief among them) impacting economic activity and general daily life.

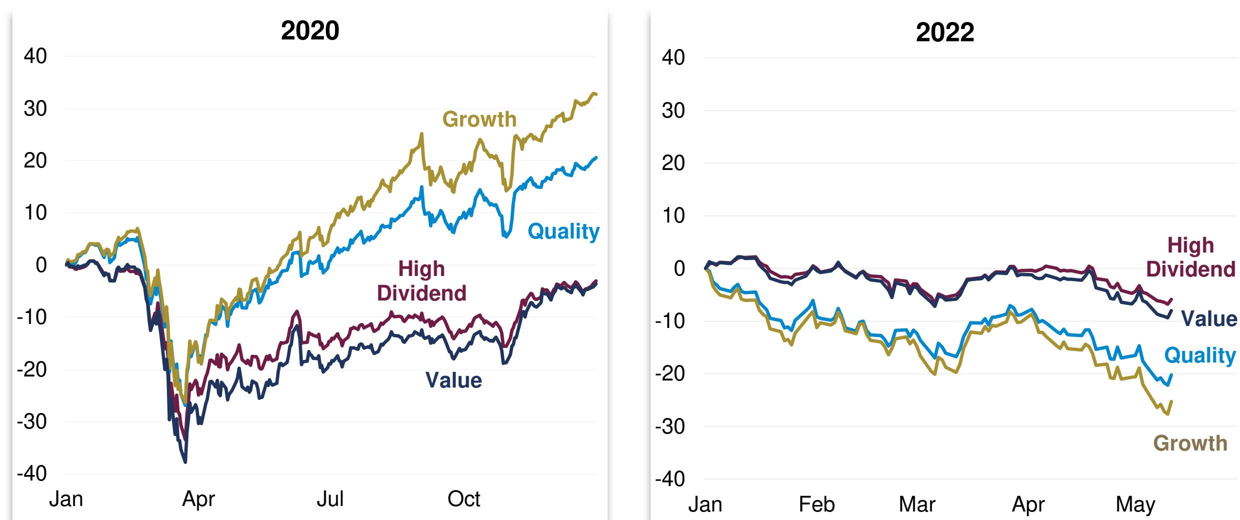
Interestingly, however, forward-looking financial markets have largely been able to take the events in stride and, after a brief detour in early 2020, remained on the path of strong performance laid in the aftermath of the financial crisis more than a decade ago as investors focused on the better days ahead.

The start of 2022, however, has seen the mood in the markets change notably, with the combination of rising inflationary pressures, the aggressive turn by global central banks, the Russian invasion of Ukraine and the ongoing negative impacts of the ongoing pandemic seemingly becoming too much, ratcheting up the risks to the outlook and souring investor sentiment.

While macroeconomic data has remained resilient to this point, risk asset prices have come under significant pressure — and the current equity market sell-off stands in stark contrast to the last major one two years ago. That event occurred against a seismic shift in the outlook, with the segments that fared best amid the onset of the public health crisis (and over the subsequent two years) significantly underperforming.

A tale of two sell-offs

(MSCI World Style Index performance; percent change since 1 January)



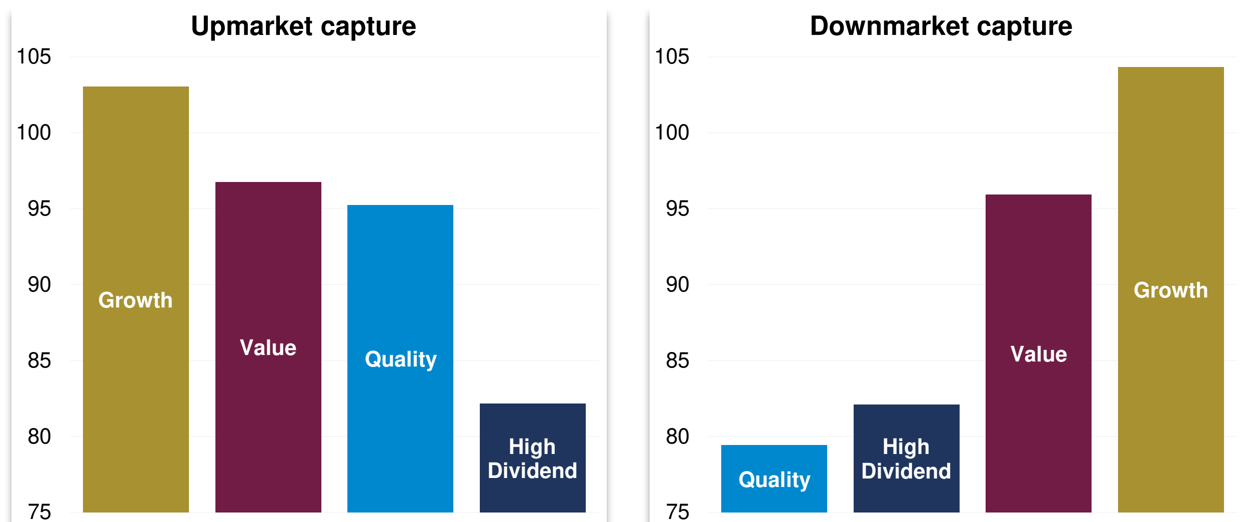
Data to 13 May 2022; source: Bloomberg, Guardian Capital

Moreover, the fact that "quality" strategies — those that focus on equity of companies that have high profitability, low volatility in earnings growth and low leverage — have been among the worst performers represents a pretty notable difference during this period.

Looking at the available history back to 1982 (so, spanning the last four decades and all of the economic cycles therein), what has differentiated the performance of quality global equity strategies (and why they have consistently outperformed over long horizons) has been their ability to keep their head above water among more turbulent tides. Quality strategies typically are not necessarily the best performing when markets are buoyant, however they register materially more muted declines when broad markets weaken versus other strategies; by their nature, stocks of quality companies are designed to weather the storms in financial markets and the economy as a whole since their ability to generate consistently solid earnings growth with low leverage means they can survive systematic financial crises and recessionary conditions.

This time is different

(percent, relative to MSCI World Index)



Based on monthly data from January 1982 to April 2022; source: Bloomberg, Guardian Capital

More to this point, quality stocks typically serve as a safe haven amid periods of crisis, outperforming the global benchmark over the last four decades in above-average volatility, and by a significant degree.

Shelter in the storm

(MSCI World Style Index performance by volatility regime; basis points relative to MSCI World Index, annualised)

**Average in the CBOE US Equity Volatility Index (VIX) from January 1990 to April 2022; source: Bloomberg, Guardian Capital*

This raises an obvious question: what has been driving the current underperformance in quality and is it likely to be sustained, or is there good reason to anticipate a reversal of fortune?

As mentioned, economic momentum has continued to prove resilient, and despite the growing list of headwinds that are weighing on the macro outlook, earnings have come in better than anticipated (especially for the "value" strategies and their relatively heavy exposure to commodity markets). Consensus earnings expectations for the coming 12 months have moved higher — deconstructing market performance year-to-date shows that a downgrade in valuations has been the driver of declines.

Earnings their keep

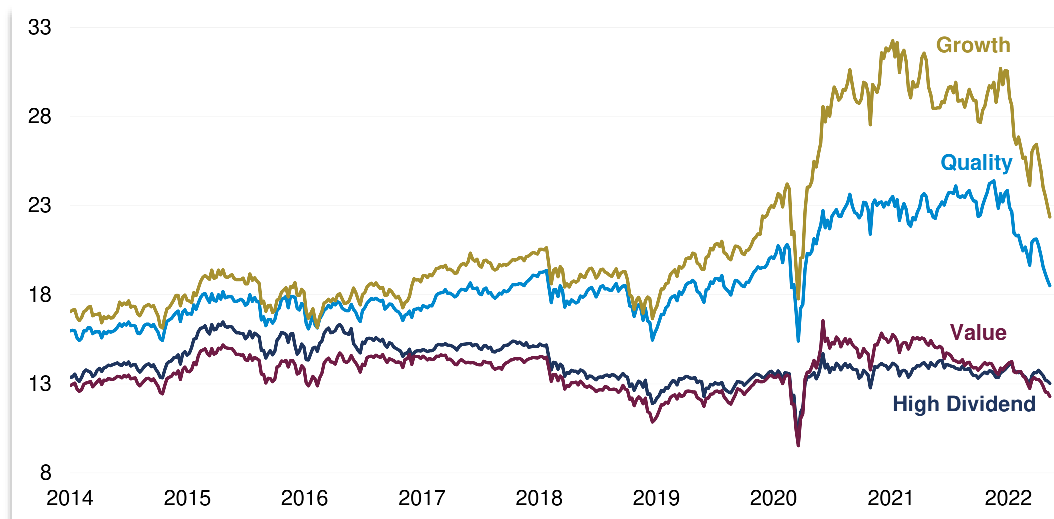
(MSCI World style index year-to-date* performance decomposition; percent)

** 1 January 2022 to 13 May 2022; source: Bloomberg, Guardian Capital*

The compression of valuation multiples is consistent with rising pessimism over the current outlook — the increased uncertainty and downgraded views imply expected lower earnings growth over the medium term. Additionally, valuations have come under pressure due to the impact of higher market interest rates, which serve to reduce the present value of future earnings — and given that stocks that carry higher relative valuations are typically those that derive their value from their expected ability to generate above-average earnings growth in the years ahead, these areas of the market have underperformed.

Go forth and multiple

(MSCI World Style Index forward price-to-earnings ratio)



Data to 13 May 2022; source: Bloomberg, Guardian Capital

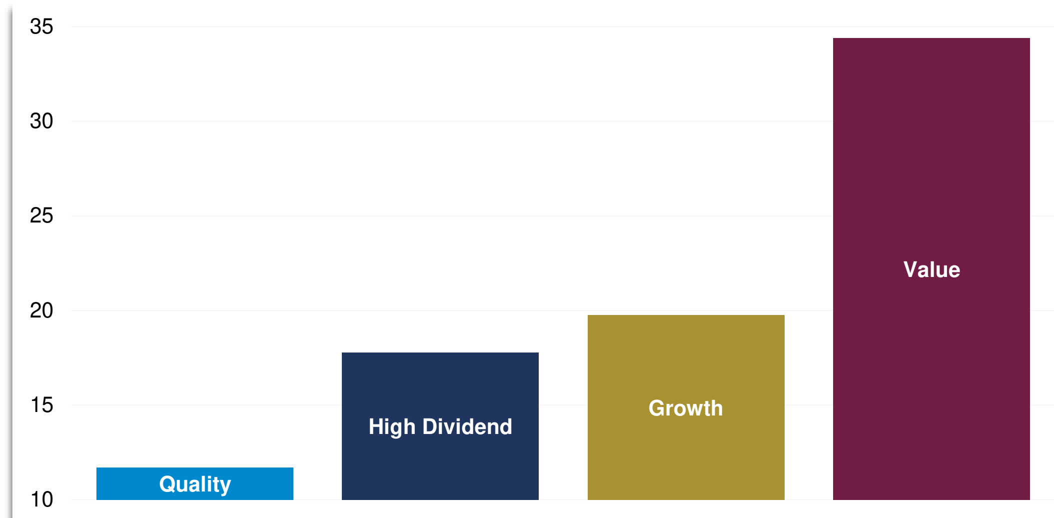
The extent of the selling pressure among quality stocks, however, provides some indication that the baby is maybe being dumped with the bathwater right now — not everything with an above-average valuation multiple is created equally and warrants being sold.

For starters, while both "growth" and "value" companies tend to be highly susceptible to changes in the economic environment, quality companies, which typically are more mature (and as such have strong management), tend to be sheltered from the ebbs and flows of the business cycle. The same is true for dominant players in their industries with sustainable advantages over competitors and that focus on secular trends rather than cyclical ones.

The volatility of "quality" companies' earnings growth has been lower than peers — a factor underpinning quality strategies' outperformance amid higher volatility environments, where a premium is put on certainty.

More certainty, less volatility

(MSCI World Style Index standard deviation of trailing 12-month earnings growth*)

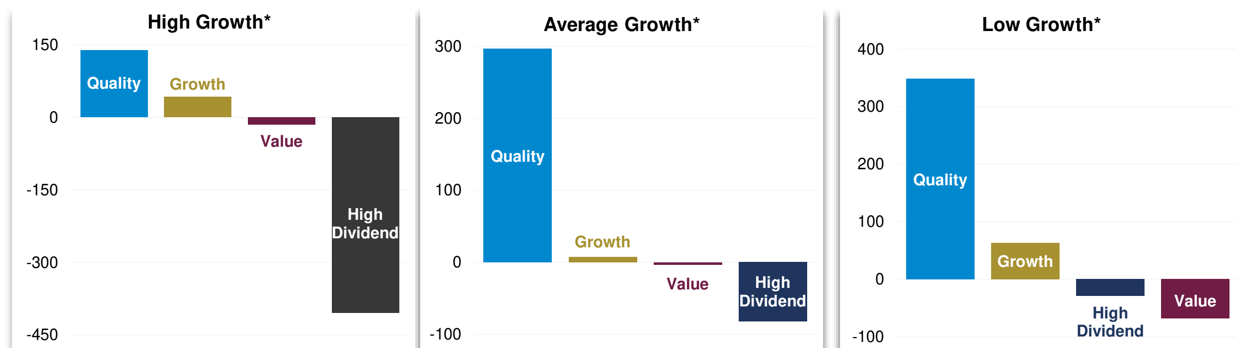


**Based on data from January 2014 to April 2022; source: Bloomberg, Guardian Capital*

Furthermore, it has historically been the case that stocks of quality companies have been able to outperform the broad market no matter the global economic growth backdrop. In fact, the best relative performance over the last four decades has actually come when growth across developed market economies has been below average as investors placed an added premium on companies that can consistently expand their profits in these environments.

Room for growth

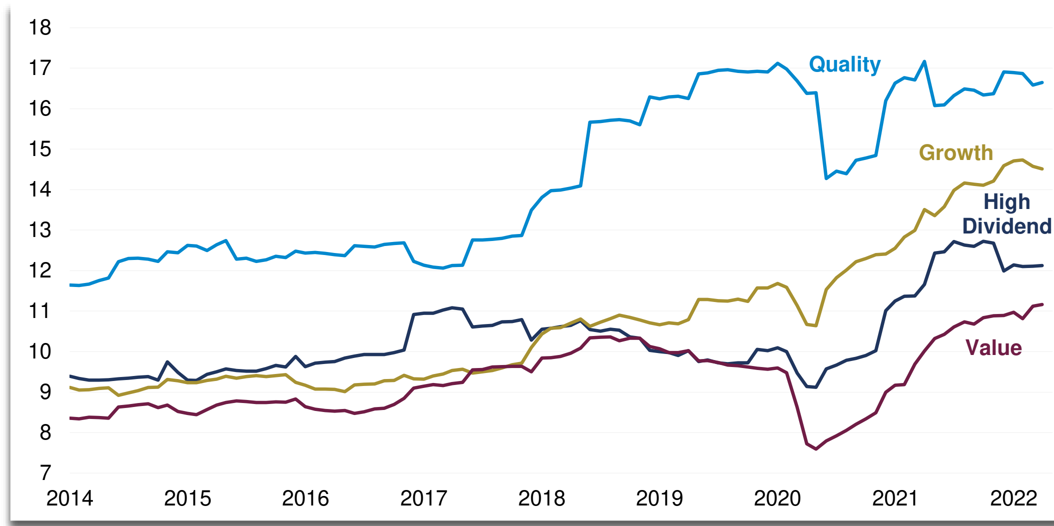
(MSCI World Style Index performance by economic growth regime*; basis points relative to MSCI World Index, annualised)



**Based on OECD quarterly real GDP growth data since Q1/1982; "high"=top third; "low"=bottom third; "average"=middle third; source: Bloomberg, Organisation for Economic Co-operation and Development, Guardian Capital*

A key contributor to the consistency and stability in earnings of quality companies is the fact that they typically have the ability to exert pricing power on their end customers thanks to their dominance in their industry and differentiated product offerings that result in lower elasticity of demand (demand does not change much with changes in prices). Quality companies tend to be "price makers" rather than "price takers," with companies that operate in commodity-related sectors generally sparse among their ranks. These characteristics allow quality companies to operate at higher profit margins.

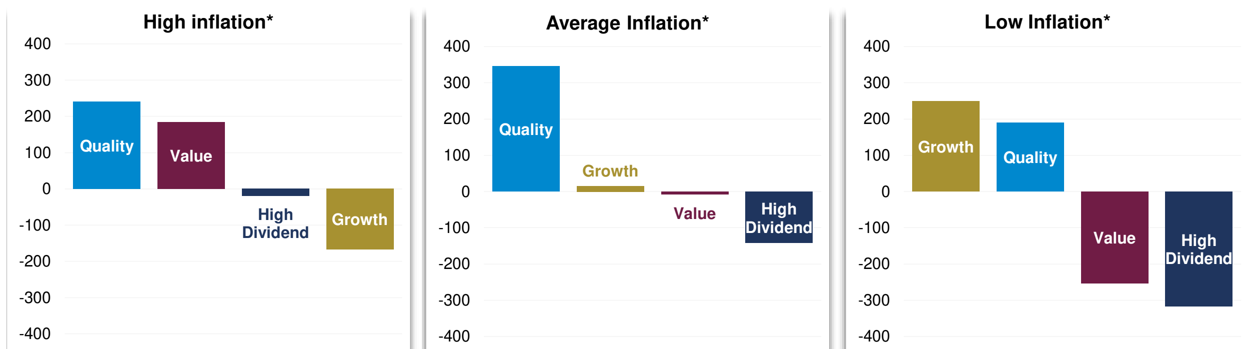
At the margin
(MSCI World style index profit margins; percent)



Data to 29 April 2022; source: Bloomberg, Guardian Capital

High margins and the ability to influence pricing also mean that quality companies tend to be well-insulated from the impact of rising prices — these companies are able to pass through increases in input costs and sustain margins and earnings. As such, quality stocks have managed to outperform the broad market over the last 40 years during periods of elevated inflation — another notable contrast from more recent events.

Inflated sense of self-worth
(MSCI World Style Index performance by inflation regime*; basis points relative to MSCI World Index, annualised)

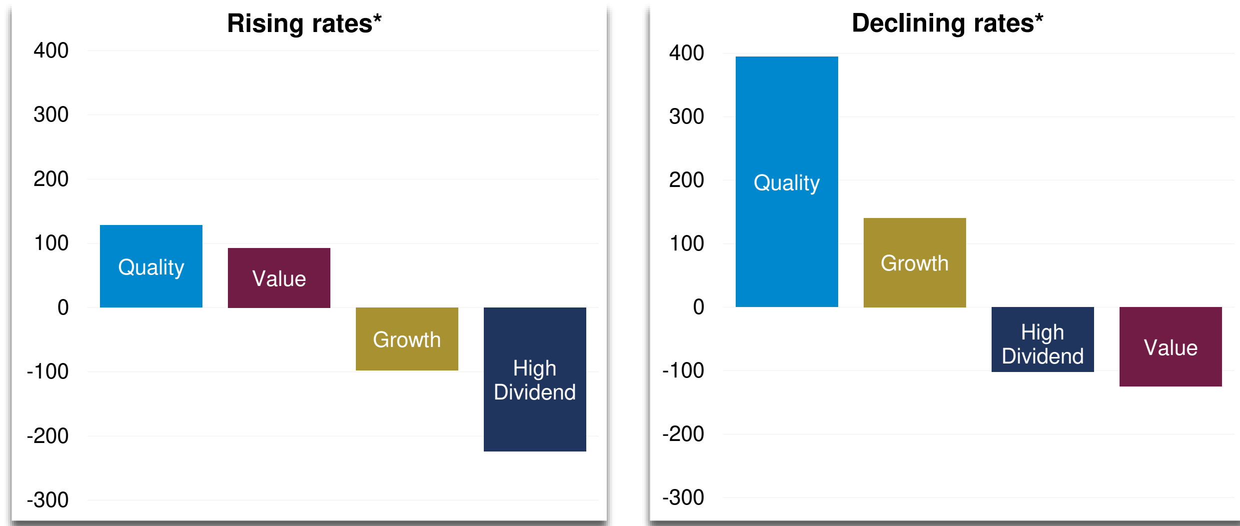


**Based on US consumer price inflation; "high"=top third; "low"=bottom third; "average"=middle third; based on data since January 1982 to April 2022; source: Bloomberg, Guardian Capital*

On a related note given global central banks' focus on maintaining price stability, it is also worth highlighting that the fundamental nature of quality stocks leaves them relatively insulated from changes in market interest rates as well. Low leverage leaves these companies in better shape than others when interest rates (and costs of capital) rise and historically has led to outperformance in such regimes. Additionally, their stability and strength permit them to be able to manage in weaker economic conditions that are associated with generally declining interest rates.

At any rate

(MSCI World style index performance by interest rate regime*; basis points relative to MSCI World Index, annualised)



**Based on two-month change in 10-year US Treasury Yield from January 1982 to April 2022; source: Bloomberg, Guardian Capital*

In other words, the material underperformance of quality stocks so far this year seems inconsistent with both history and the fundamental characteristics that differentiate the companies included in the group from other style factors.

A more challenging outlook for growth, with higher interest rates, heightened volatility and the potential for persistently elevated inflation are definitely less than favourable for growth-oriented investment strategies that have flourished over the last decade. However, such environments have traditionally supported the relative performance of strategies that focus on the quality companies that score highly with respect to profitability, earnings growth stability and leverage.

The seeming lack of discrimination in the selling of anything that trades with an above-average valuation multiple and limited exposure to commodities would therefore appear to provide opportunities for more active investors with a longer-term focus. Stocks in many high-quality companies are nowhere near “worthless,” just “worth less” at the moment, and history suggests that mispricings do not tend to last long once volatility subsides.

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