High Quality Stock Performance Held Back by Limited Earnings Visibility

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Little did we know 2020 would punch the ticket for an unexpected roller-coaster ride. After six weeks of relative tranquility, investors endured a record-setting descent into bear market territory, culminating in a 34% market decline from February 19th to March 23rd, followed by a whiplash-inducing rebound in the subsequent two months. Rather than suffering from nausea, however, many market participants now appear euphoric as equity markets march ever closer to regaining their early-2020 peaks.

While perhaps a welcome respite from the panic-stricken early stage reaction to the abrupt realization of COVID-19 related economic implications, recent elation appears inconsistent with nagging concerns associated with pandemic mitigation efforts. These worries include the long-term repercussions of social distancing measures as well as the efficacy of the healthcare response. From an investment perspective, such misgivings coalesce into uncertainty about the trajectory and magnitude of the expected earnings decline and subsequent rebound.

For quality investors, such as ourselves, additional questions surround the recent underperformance of high-quality stocks,[1] as shown in the table below.

Total Return

Period	High Quality	Low Quality	S&P 500 Index
Peak-to-Trough: 2/19/20 – 3/23/20	-33.73%	-33.80%	-33.79%
Tough-to-Present: 3/23/20 – 6/12/20	34.67%	37.95%	36.61%
Peak-to-Present: 2/19/20 – 6/12/20	-10.85%	-8.72%	-9.55%

Not all market behavior in this period is perplexing. Low quality outperformance in the 'trough-to-present' period is consistent with the rapid change in market sentiment that typically favors traditional value stocks. However, the lack of high-quality superiority

1 Source: S&P Quality Rankings. S&P ranks index constituents from A+ though C based on trailing earnings and dividend consistency. We consider stocks rated A- and above as high quality and those rated B+ and below as low quality.

during the 'peak-to-trough' period is puzzling. Definitionally, high-quality businesses demonstrate relatively consistent earnings and dividends. It stands to reason that investors would gravitate towards such stocks during a period in which 70% of S&P 500 Index companies have reduced or withdrawn earnings guidance.[2]

Instead, we are witnessing just the opposite. This conundrum appears linked in part to a lack of earnings visibility. Earnings stability is a key differentiator for high quality businesses. However, thus far, high quality companies have not fared much better than the overall market in terms of maintaining financial outlooks. In The Jensen Quality Growth Fund, (70% of which is invested in stocks rated A- or better) nearly 60% of the companies have withdrawn or reduced earnings predictions since the start of the year.

A lack of reliable earnings and earnings forecasts causes investors to speculate. In recent months, such conjecture has taken the form of optimism over fiscal and monetary stimulus and a continuation of momentum trading, with little apparent concern for underlying business prospects.

These trends suggest that market participants are willing to overlook expectations of both a precipitous decline in 2020 earnings (-30%) and a rosy 2021 recovery scenario (+48%),[3] despite both assumptions resting upon an arguably flimsier-than-normal foundation due to limited corporate forecasts and a plethora of risks that could easily upset a fragile economy.

Perhaps our metaphorical rollercoaster ride is nearly over. Or, maybe we are in store for a few more high-speed twists and turns. Regardless, looking forward, we foresee an improved environment for high quality stocks. Earnings visibility should naturally improve as the economy adjusts to post-pandemic norms, thereby illuminating differentiated, more sustainable business models and setting a more meaningful baseline for future expectations. We are optimistic that tangible—as opposed to speculative—financial results will remind investors to refocus their attention on long-term business fundamentals and the importance of knowing what they own.

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2 Source: https://www.gartner.com/en/newsroom/press-releases/2020-05-15-gartner-analysis-of-s-and-p-500-company-earnings-shows-70-percent-have-revised-or-withdrawn-guidance-due-to-covid-19-disruption

3 Source: S&P Dow Jones Indices: 6/3/20