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INVESTMENT MANAGEMENT

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Why Invest in Quality?

Three key factors to building a concentrated, quality-focused portfolio

Quality is one of those words that appears to represent a simple truth—it seems self-evident that high quality is always preferable to low quality, no matter the subject at hand. Everyone wants quality, especially at a good price. But what is quality when it comes to investing?

According to researchers at AIG[1] and Lazard,[2] quality stocks outperform both "Value" and "Growth" styles. With the rise of factor investing over the last two decades, it should be a simple task to distill quality into something quantifiable that investors can seek out and invest in. However, quality investing is not that simple.

While quality has been the basis for many investment approaches since the 1930s,[3] academics have not identified a singular stock characteristic that serves as a proxy for quality. As Hsu, Kalesnik, and Kose noted in their 2019 paper, *What is Quality?*, "Unlike standard factors such as value, momentum, and size, 'quality' lacks a commonly accepted definition." These "standard" factors aim to capture either a premium associated with an economic risk that cannot be reduced through diversification or returns that appear due to a persistent investor behavioral bias.[4] Quality is more subjective. Because there is no agreed-upon single proxy for quality, investment managers use a variety of metrics and approaches to construct their quality strategies. Some of the common characteristics used to define quality include growth (e.g., earnings growth or dividend growth), profitability (e.g., return on equity), or stability (e.g., earnings variability).[5]

In their study of popular quality index factor definitions, Hsu, Kalesnik, and Kose determined that some measurements of quality were more robust than others. They broke down the individual metrics used to construct quality factor indices and analyzed whether the metrics were "robust" predictors of future excess returns and risk-adjusted returns. They determined that profitability, accounting quality, payout/dilution, and investment factors appear to be robust, while earnings stability, capital structure, and growth in profitability are not robust.[4]

Defining quality in the absence of an industry-standard definition

"Unlike standard factors such as value, momentum, and size, 'quality' lacks a commonly accepted definition."
~ "What Is Quality?" by Jason Hsu, Vitali Kalesnik and Engin Kose[4]

As there is no agreed-upon single proxy for quality, investment managers use a variety of metrics and approaches to construct their quality strategies. Some of the common characteristics used to define quality include growth and stability.

At Jensen, we start with a robust metric and refine the list of eligible securities based on additional subjective measures of quality. This approach allows us to build a concentrated, quality-focused portfolio—one that can be summed up in three factors.

[1] Pettee, Timothy. 2019. "Investing in Quality Stocks: Why Quality is Always in Style." Whitepaper Series. AIG, May. For the purposes of this paper, AIG used the S&P 500 Index as a proxy for quality, the Russell 1000 Value Index as a proxy for value, and the Russell 1000 Growth index as a proxy for growth.
[2] 2021. "Quality-Driven Growth: An Enduring Combination." Investment Focus. Lazard, April 27. https://www.lazardassetmanagement.com/us/en_us/references/international-equity/quality-driven-growth-an-enduring-combination. For the purposes of this paper, Lazard used the MSCI ACWI ex USA Quality Index as a proxy for quality, the MSCI ACWI ex USA Value Index as a proxy for value, and the MSCI ACWI ex USA Growth Index as a proxy for growth.
[3] Graham, Benjamin & Dodd, David. "Security Analysis." New York Whittlesey House, McGraw-Hill Book Co. 1934.
[4] Jason Hsu, Vitali Kalesnik & Engin Kose. 2019. "What Is Quality?" Financial Analysts Journal, 75:2, pp. 44-61.
[5] Johnson, Ben. 2016. "The What, Why, and How of Quality." Morningstar ETF Investor. https://www.morningstar.com/articles/746828/the-what-why-and-how-of-quality

Since quality is not easily defined, our belief is that it makes sense to start with a robust metric and refine the list of eligible securities based on additional subjective measures of quality. This approach allows us to build a concentrated, quality-focused portfolio. Jensen's investment strategy can be summed up in three key points:

1. **Set the bar high.** Start with a universe of companies defined by a robust measure of quality, such as return on equity (ROE).
2. **Research deeply.** Make informed judgments about whether a business possesses sustainable competitive advantages by thoroughly investigating every aspect of the company.
3. **Evaluate continuously.** Review portfolio holdings regularly to ensure that businesses are measuring up to expectations and incorporate new market information as it becomes available.

Setting the Bar High

At Jensen Investment Management, we believe that ROE can help identify companies that have the potential to provide attractive returns over long periods of time while reducing volatility and risk. ROE is calculated by taking the company's annual net income after taxes (excluding non-recurring items) divided by the average shareholder equity. This metric reveals the amount of earnings generated by each dollar of equity invested in the company and is a valuable initial screen of a company's profitability and shareholder value-add.

Our research and experience over more than thirty years suggest that we can use ROE to identify a selection of high-quality, profitable companies that can generate returns above their costs of capital in a variety of environments. First, we determine an initial universe of companies that have generated an ROE of 15% or more for at least ten consecutive years, as determined by Jensen's Investment Team.[6] We believe that this universe contains companies with sustainable competitive advantages and strong growth potential whose stocks typically have lower volatility than broad market indices. However, simply investing in the stocks that fit one characteristic, even one as demanding as 10+ years of ROE over 15%, is not enough for a strong quality investment proposition.

Research Deeply

To determine the quality of a business beyond ROE, all of its underlying elements must be examined, including:

- Reading annual reports, government filings, company websites, and relevant news items.
- Assessing the company's history, industry, business model, strategy, management, competitive advantages, barriers to entry, strengths, weaknesses, opportunities, and threats.
- Determining risks, including financial, environmental, social, and governance issues.
- Meeting with company management teams and researching the company's peers.
- Building proprietary financial models to assess profitability, financial strength, future cash flows, and ultimately the fair value of the business.

In our view, this is the only way to confidently determine quality: thoroughly researching a business, its strengths and weaknesses, and what it can offer shareholders. If screening based on consistently high ROE is the investing equivalent of reviewing a company's resume, research represents the job interview and background check. With in-depth research in hand, it becomes easier to determine whether a company has competitive advantages over other firms and can reliably generate returns on capital above capital costs. Indicators of competitive advantage typically include favored brand names, differentiated products, unique manufacturing processes, technical expertise, patents and intellectual property, a strong network effect, and economies of scale. Shareholders should feel confident that the businesses in which they invest are positioned to endure and grow rather than be potentially dethroned by a disruptor with a new product or business model. After all, why invest in a business that doesn't appear to have lasting competitive advantages?

Additionally, strong and growing free cash flow is typically an indicator of a high-quality business with competitive advantages. High profitability allows a company to reinvest in its business in an attempt to protect existing income streams and to develop innovative goods and services for future growth. Following the cost of reinvestment, a highly profitable company typically also generates considerable free cash flow: the cash that is leftover to pay out to investors in the form of share repurchases and dividends. That is, an ideal high-quality business can both invest in its future and reward shareholders.

Evaluate Continuously

After the highest-quality businesses are selected for investment, it is critical to evaluate those businesses on an ongoing basis. Due to their overall strength and market-dominant positions, quality businesses are typically poised to weather short-term market fluctuations. This disposes them to a long-term investment strategy measured over complete market cycles rather than by short-term wins or losses. Investment styles and asset classes may come into and go out of favor during market cycles due to macroeconomic changes or investor sentiment, such as in the wake of the COVID-19 pandemic of 2020-2021.[7] However, quality businesses have the potential to outperform during down-market periods due to their enduring nature, potentially benefiting investors who may be allocated to riskier asset classes in addition to a quality strategy. This strategy also has the potential to stabilize or add to returns over longer time horizons, as mitigating

[6] Calamar, Adam. 2016. "Return on Equity: A Compelling Case for Investors." Jensen Investment Management.

[7] For more information on the performance of quality strategies in the wake of COVID-19, see our recent paper Reflationary Headwinds to Quality Investing. https://www.jenseninvestment.com/insights/quality-investing-headwinds

losses during market downturns can have a positive impact on long-term returns.

That said, buy-and-hold-forever makes little sense even for long-term investors: no matter how high the quality of the company at the time of purchase, quality can deteriorate over time. Continuous analysis at the company level is crucial to understand changes that might undermine the thesis for ownership. Reasons to sell can include:

- The security reaches its full value. If a stock is acquired at a reasonable or discounted valuation, eventually the business may reach an investor's estimate of full value. Selling stocks that have reached this high-water mark and reinvesting in more attractively priced quality opportunities aim to increase expected returns and reduce price risk.
- A company's ROE falls below 15%. Should a company's ROE decline below the 15% threshold required by Jensen's investible universe, this could indicate that the company's competitive advantages are faltering. We believe removing exposure to companies that no longer meet the ROE threshold reduces risk and ensures the consistency of the strategy's execution.
- Better investment opportunities. Positions might be liquidated because there are other investment opportunities with stronger fundamentals and/or more attractive valuation.

We strive to monitor our portfolio holdings and prospective holdings continuously and respond to new information to maximize the fundamental quality of our portfolio. We believe remaining focused in this way increases our strategy's potential for superior risk-adjusted returns and helps the strategy meet investors' objectives.

Conclusion

While a standard industry definition for quality may not exist, quality has persisted as an investment objective for many strategies. Academic research now demonstrates that there are some robust, tested measures of quality that provide a starting point to build an effective quality investment approach, but in practice, this is not enough.

We believe that using a robust metric as a starting point followed by deep research at the company level provides for a long-term and stable investment strategy. Jensen has kept the faith of multiple generations of investors by taking the time to truly understand businesses and by constantly reevaluating market and business information. Even as our technology has evolved and our research process has been refined, our fundamental strategy has not changed since 1988 because we know what we own: quality businesses. And quality endures.

For more information on quality or Jensen's investment strategies, please contact us or reach out to your Client Relationship Manager directly.

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