

Quality Control

A rocky start to global stock markets in 2022 makes for a good time to remember the helpful attributes of diversification and downside protection within a portfolio. One key element to consider is the importance of owning quality companies: entities with unique products, services or business approach that allow for consistently healthy economics regardless of the market environment. While it is often easy to get swept up in the day-to-day price movement of stocks, it is important to understand that, fundamentally, a portfolio of stocks is simply a collection of underlying businesses. Subject to valuation, diversification and other risk parameters, identifying a subset of superior quality businesses makes for an ideal universe from which to select investments.

The intuitive appeal for a high-quality bias is strong, as these businesses exhibit financial stability regardless of geopolitical tensions and economic trends. For example, even during difficult times, people tend to keep current on their auto insurance with Intact Financial, eat Häagen-Dazs from Nestlé and renew their annual home subscription for Microsoft Office. As evidence, witness the net profit margins earned by Pepsi's collection of brands, which include Gatorade, Frito Lay and Quaker, over five years as shown in the table below. Is it even possible to see a recession?

Year 1	Year 2	Year 3	Year 4	Year 5
16.1%	14.3%	11.9%	13.8%	10.9%

**Answer: Year 3 and Year 4 comprise the 2008/2009 recession, one of the worst since the Great Depression.*

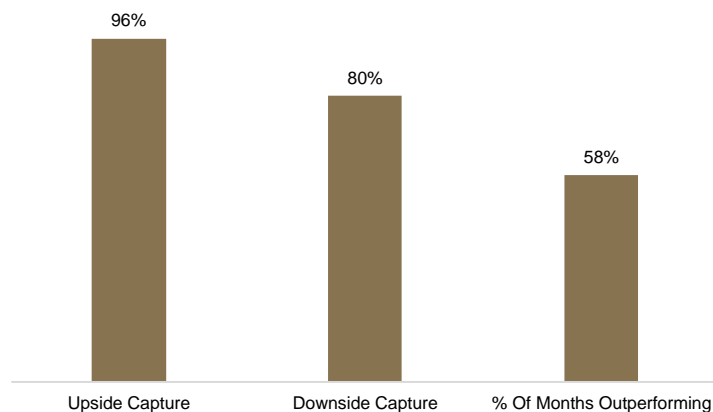
Source: FactSet, 2006-2010

There is also empirical support for a high-quality preference as well. A recent report from Credit Suisse HOLT¹ examined the performance of the top tier of companies in each sector as measured by quality – in this case, as determined by companies showing a consistently high return on capital. Since 1995, these stocks have shown an 80% “Downside Capture”, meaning that in a 10.0% market decline, they have declined only 8.0%. They have also shown a 96% “Upside Capture”, meaning that in a 10.0% market rise, they have gained 9.6%. In other words, these high-quality stocks historically fared quite well during market declines, while almost fully participating when markets rise. Additionally, these stocks generated market beating performance in 58% of all months over this lengthy span, an interval, which includes the 1990’s technology boom and bust, the Financial Crisis of 2008 and 2009, and much more.

¹Burns, S., D. Rones and J. Pecora, HOLT Global Market Overview – February 2022, A Bad Stretch for Good Companies Offers a Chance to Selectively Upgrade Quality, Credit Suisse Group AG, February 2022.

Many inputs are involved as part of prudent portfolio construction, with one being a consideration of quality. Owning businesses capable of capturing excellent economics, regardless of the environment, can be an effective quality control system that aims to help investors achieve their long-term investment objectives, despite the inevitable periods of market turbulence that will occur along the way.

Performance Of Highest Quality Stocks



Source: CS HOLT. Performance of top quintile of 2000 largest global equities, as ranked by consistently high returns on capital, from 1995 to 2021.

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