Diamond Quality

In baseball, the appeal of the power hitter is undeniable. Having one in the batter's box means that you are one pitch away from scoring runs in a hurry and turning the game around, while the spectacle of watching tape-measure home runs can draw the attention of even the most casual fans. However, the positives of leading the league in homers typically come with pretty sizeable trade-offs. By being aggressive and swinging for the fences on every pitch, these players generally have a high probability of making contact with nothing but air, resulting in strikeouts coming at a high frequency. While you definitely want these prototypical sluggers in your line up when they are in a groove and hitting well, it is often the case that they are streaky — the homers come in bunches but slumps also happen with some regularity that leaves a gaping hole in the middle of your lineup.

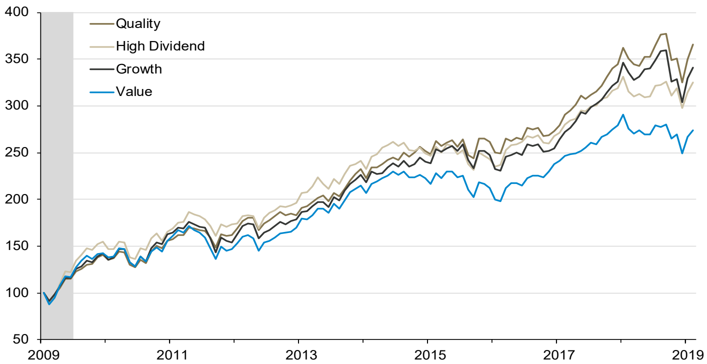
In the investing world, power hitters are aggressive growth stocks. These securities have the potential for stronger-than-average returns, attracting a premium in the marketplace and capturing the attention of financial media and the imagination of investors looking to turn a small investment into a fortune in short order. However, much like the home run hitters, the potential for higher reward comes with higher implicit risk. Growth stocks are typically levered to the economic cycle, outperforming the broad market in periods of strong economic growth, but also being subject to significant downside risk when growth rolls over or if sentiment swings negative.

Much like managers in baseball try to balance their lineups with contact hitters, your portfolio managers can make complementary investments in dividend stocks which generally offer up more moderate but stable performance and regular cash flows that can help mute the downside. Of course, these income-generating investments offer comparatively less upside than their growth counterparts that can leave investors feeling as though they are on the outside looking in during market bull runs.

In baseball, the truly elite players are those that can consistently hit for both power and average. There is an equivalent for the well-rounded hitter comparison in financial markets: quality stocks. A quality stock is one with high profitability, low volatility in earnings growth and low leverage. This type of company is typically more mature with a sustainable advantage over competitors and a focus on secular growth trends rather than cyclical ones.

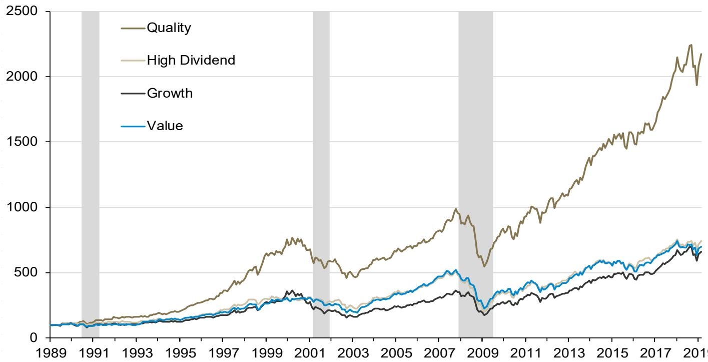
The benefits of quality stocks not only prove themselves over the latest bull market cycle but also and more prominently over the last three decades (a period that captures the previous two full market cycles rather than just the current expansionary phase).

Chart 1: Quality is the best strategy this cycle..
MSCI World Style Index Total Return
(index: January 2009 = 100)



Shaded regions represent periods of US recession
Source: Bloomberg, Guardian Capital

Chart 2: ..and in the longer-run as well
MSCI World Style Index Total Return
(index: January 1989 = 100)



Shaded regions represent periods of US recession
Source: Bloomberg, Guardian Capital

As is often the case in investing, the best offense can be a good defense, and on this score, quality stocks also provide relatively better downside protection than their higher growth peers. While catching the upside moves is important in terms of generating positive investment performance, mitigating the downside is equally, if not more, important. 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 that can survive systematic financial crises and recessionary conditions — and this is a key factor in the longer-term outperformance of quality strategies. Quality stocks have outperformed the global benchmark over the last three decades in periods of heightened equity market volatility, and by a significant degree. In the same vein, the characteristics of quality stocks make them able to outperform no matter what interest rates are doing. Low leverage leaves these companies in better shape than others when interest rates (and costs of capital) rise, while their stability and strength permit them to be able to manage in weaker economic conditions that are associated with generally declining interest rates.

The bottom line is that in the short-term, any style or factor can be the hot performer, hitting home runs regularly. But in the long run you want to have a player in your lineup that you know can consistently make high quality contact. Because while the occasional home run is great, the ability to consistently hit singles and doubles means that you are going to be in position to score more often than not, and in the end, hopefully help you win the game.

This document includes information and commentary concerning financial markets that was developed at a particular point in time. This information and commentary are subject to change at any time, without notice, and without update. This commentary may also include forward looking statements concerning anticipated results, circumstances, and expectations regarding future events. Forward-looking statements require assumptions to be made and are, therefore, subject to inherent risks and uncertainties. There is significant risk that predictions and other forward looking statements will not prove to be accurate. Investing involves risk. Equity markets are volatile and will increase and decrease in response to economic, political, regulatory and other developments. The risks and potential rewards are usually greater for small companies and companies located in emerging markets. Bond markets and fixed-income securities are sensitive to interest rate movements. Inflation, credit and default risks are also associated with fixed income securities. Diversification may not protect against market risk and loss of principal may result. This commentary is provided for educational purposes only. It is not offered as investment advice and does not account for individual investment objectives, risk tolerance, financial situation or the timing of any transaction in any specific security or asset class. Certain information contained in this document has been obtained from external parties which we believe to be reliable, however we cannot guarantee its accuracy. Guardian Capital Advisors LP provides private client investment services and is a wholly-owned subsidiary of Guardian Capital Group Limited, a publicly traded firm listed on the Toronto Stock Exchange.