DAVY

DAVY GLOBAL FUND MANAGEMENT

Quality investing

How to outperform growth and value long term

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Executive summary

- Quality has outperformed growth and value over the long term but is less commonly used as a basis for investment.
- High-quality stocks are more resilient and capture less of the downside in down markets.
- Our proprietary measure of quality has outperformed the MSCI World Quality Index over the long term.

Introduction

Many investors favour the concepts of growth and value in their investment strategies. The concepts are well defined, researched and familiar. The concept of quality is increasingly used as a basis for investment and there are many views as to how quality can be defined. Our analysis of quality suggests that certain companies - irrespective of their value or growth orientation - exhibit numerous common factors, such as high returns and margins, appropriate leverage, and consistent dividends and payout ratios.

These types of metrics are traditionally used to define quality as they capture different aspects of it. Our research shows that a more accurate picture of a company's quality can be found by using a broader range of elements to create a bespoke definition of quality.

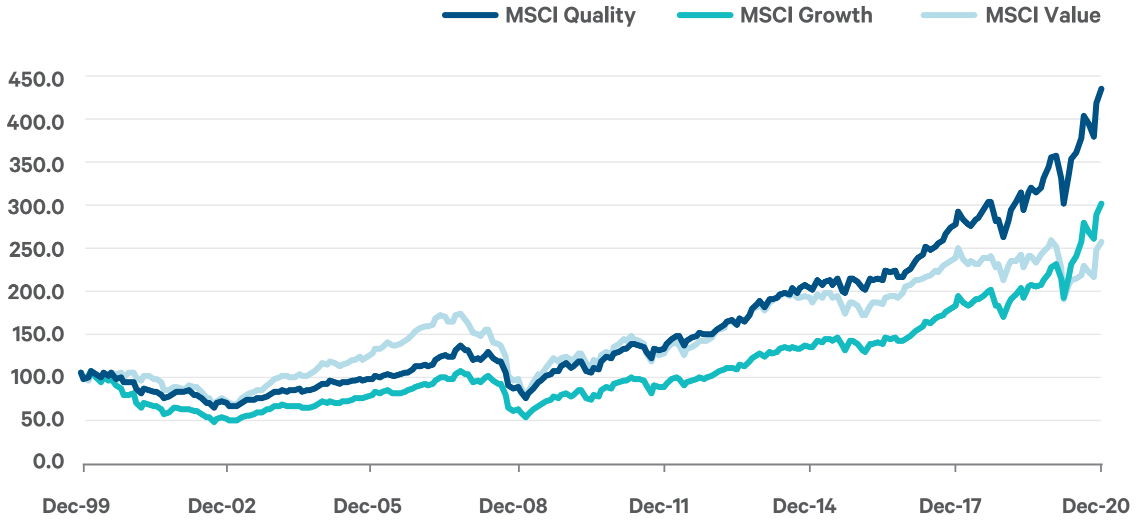
In addition to accounting metrics, other measures we can use to assess a firm's quality include environmental, social and governance ('ESG') measures such as staff turnover, board diversity/independence and overall ESG performance. Having said that, these metrics may be harder to find and measure reliably for a broad universe of stocks. This is why we have created a specific platform for their incorporation within our investment process.

Also, we have observed that quality correlates with growth and value at different times in the economic cycle. As a result, we complement our understanding of quality by using additional models of growth and value.

Better long-term performance

In our analysis of performance, quality stocks have consistently outperformed both growth stocks and value stocks over the long term.

Fig 1: Quality outperforms growth and value long term



MSCI Indices, cumulative net daily total returns, USD: 2000 to 2020

Y-axis represents cumulative % return of:

MSCI World Quality Index (USD)

MSCI World Growth Index (USD)

MSCI World Value Index (USD))

Source: Davy Global Fund Management, MSCI

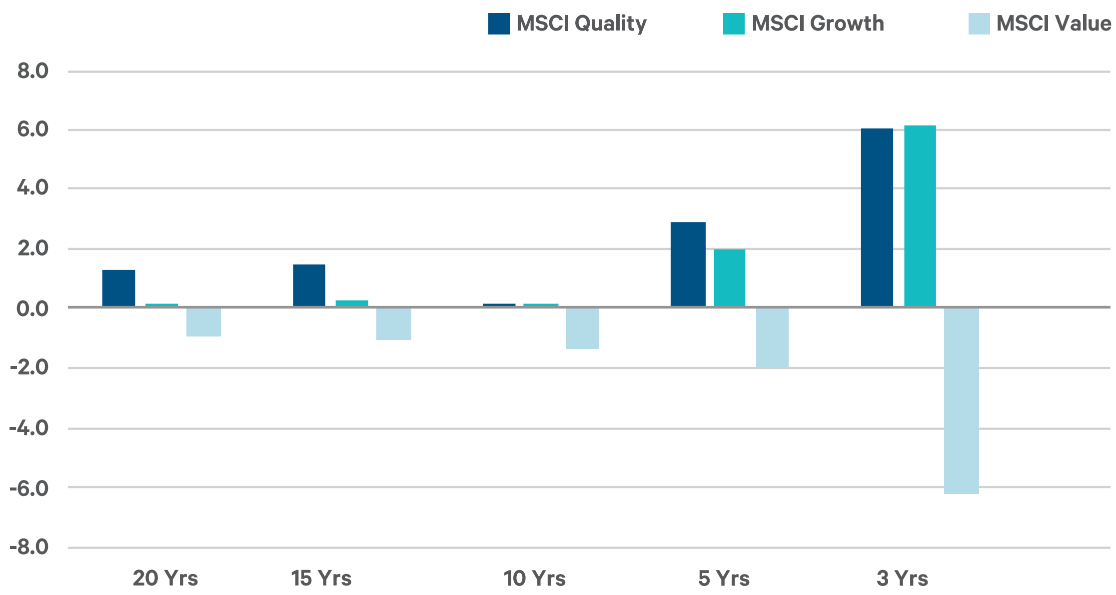
More resilient in down markets

Moreover, quality exhibits defensive characteristics that may be valuable to investors in periods of heightened volatility. In particular, our research highlights that high-quality companies capture less of the downside in down markets than growth and value companies and that this trend has persisted across multiple periods.

> *our research highlights that high-quality companies capture less of the downside in down markets than growth and value companies*

The outperformance of quality in such periods clearly demonstrates investors' 'flight to quality' when markets are volatile.

Fig 2: Quality is more resilient in down markets



MSCI Indices, cumulative net daily total returns, USD: 2000 to 2020

Y-axis represents % return during periods of negative performance of the MSCI World Index:

MSCI World Quality Index (USD)

MSCI World Growth Index (USD)

MSCI World Value Index (USD)

Source: Davy Global Fund Management, MSCI

Excellence re-defined

Given quality has been shown to outperform over the long term, why do many investors still focus on growth and value?

One of the reasons for investors' preference for growth and value may be that these concepts are better understood and appreciated by investors and that there is consensus as to how to define and measure these factors.

It is a different matter with quality. While it is relatively easy to recognise companies at the extremes of the quality spectrum, there is no single definition of "quality" in academic literature. Different investors define quality differently.

Creating a quality-based investment strategy

We base our investment philosophy on quality due to its better long-term performance compared with other investment styles such as growth and value. We focus on the overarching characteristics of high-quality companies, notably:

- High returns and margins
- Appropriate leverage
- Consistent dividends and payout ratios

Our research shows that high-quality companies exhibit these characteristics irrespective of their value or growth orientation.

We believe high-quality investments can be found across the market capitalisation spectrum because companies with high and stable profits, low volatility and conservative capital practices are less likely to go bankrupt.

Such high-quality stocks typically command a higher premium over low-quality stocks, but they do so in reflection of their better and more sustainable business models. Low-quality stocks are cheap for a reason. Our task as investors is to filter out lower-quality stocks and identify true quality.

> *"Our task as investors is to identify true quality*

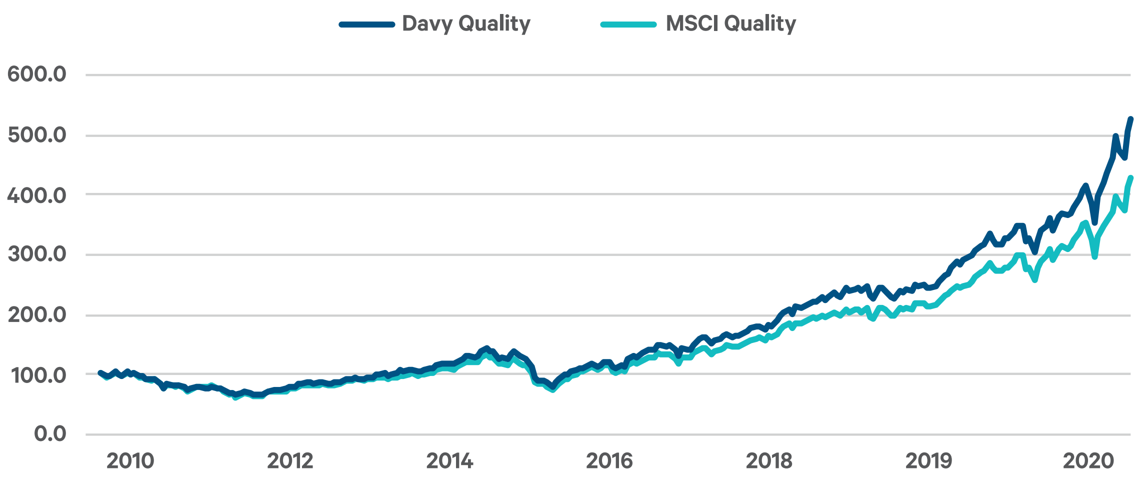
To help us do that, we created our own definition of quality that we apply using both quantitative and fundamental investment techniques (we describe this approach as 'quantamental').

Quality investing in practice

Throughout the investment process, our analysis is supported by rigorous in-depth investigation and is underpinned by academic research. This approach provides a consistent lens through which we analyse investments and ensures we focus on investing in safe, profitable and well-managed companies.

The validity of our quality investing strategy can be tested by comparing the performance of our approach with the MSCI World Quality Index (USD). This comparison shows that our proprietary quality index has consistently outperformed the MSCI quality benchmark over a 20-year period.

Fig 3: Our measure of quality outperforms the MSCI benchmark



MSCI Indices, cumulative net daily total returns, USD: 2000 to 2020

Y-axis represents cumulative % return of:

Proprietary Model of Quality Index & MSCI World Quality Index (USD) over 20-year period

Returns since 2016 represent actual returns of Davy Quality Index

Returns 2000-2016 represent back tested returns of Davy Quality Index (inception date 31 Dec 1999)

Source: Davy Global Fund Management, MSCI

Our index-beating approach to quality investing

To help us rank companies by quality, we have deconstructed quality into four factors: profitability, persistence, protection and people.

Profitability

Profitability is crucial to a firm's success. We analyse metrics such as operating margin, return on assets and return on equity to separate high-quality companies from their lower-quality counterparts. Measures such as these assess the efficiency with which a firm can generate profits from its equity and assets, while operating margin measures how effectively firms convert revenues to profits.

Persistence

Our research shows that measures such as operating margin, return on assets and return on equity of high-quality companies are greater, more predictable and remain more stable over time. This suggests these firms have some form of sustainable competitive advantage over the long-term. What's more, we find that the highest-quality companies tend to remain high quality.

Protection

The conventional view of a firm's capital structure suggests that companies achieve higher returns for investors by taking higher risk in the form of leverage. In reality, the opposite is true. Our research shows high-quality companies tend to have appropriate leverage for their business model. They consistently outperform companies with inappropriate levels of debt. Our research shows that high-quality companies use these excess cash flows to invest in the business to fuel growth, fund acquisitions, pay down debt and return excess capital to shareholders.

People

The capital structure of a business is an important determinant of quality since management directly controls decisions relating to dividends, stock buybacks and rights issues.

Research shows dividends are a reliable and consistent form of investment return as they are paid from real cash earnings and cannot be manipulated through creative accounting. While stock buybacks are popular among companies as a more flexible way to return capital to shareholders, research shows that a regular dividend is a good indicator of consistent cash generation.

The academic case for quality

Explore our first paper on this topic, 'Quality Matters, 2016' which provides background on the academic research that supports the investment case for quality.

WARNING: Past performance is not a reliable guide to future performance. Investments may go down as well as up. Some figures are forecasts, which are only estimates. They should not be relied upon to make investment decisions. The value of investments may fall as well as rise.

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