Research Insights

QUALITY INVESTING

Volume 10

Jarislowsky Fraser

Introduction

Quality Investing Beyond The Numbers

Every investor wants to invest in “quality” companies—but what exactly defines quality, and can it be measured? In this edition of Research Insights, Kelly Patrick, Christopher Knapp, and Adam Bomers discuss the strengths and limitations of quality factor investing—a popular quantitative strategy increasingly available through various factor-based products—and how Jarislowsky Fraser (JFL) takes a differentiated, qualitative and active approach to fulfilling its commitment to buying high-quality businesses.

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Q. Investors often associate "quality" investing with quantitative "quality factor" strategies. Can you provide some context on factor investing and where quality fits within it?

Adam: Factor investing can get pretty esoteric, but at its core, it seeks to go beyond the typical sector classifications by identifying quantifiable company characteristics that help explain and—ideally predict—differences in returns. It dates back to the 1960s with the development of the Capital Asset Pricing Model (CAPM), based on the premise that asset returns are driven by a combination of market return (beta) and asset-specific return.

However, modern factor investing took shape in the 1990s with the work of academics Eugene Fama and Kenneth French. Their *Three-Factor Model* expanded on CAPM by including market capitalization and book-to-market value, showing that small-cap stocks tend to outperform large-cap stocks, and value stocks tend to outperform growth stocks. This introduced two key factor strategies—size and value—into the framework.

Kelly: Other market researchers began analyzing vast amounts of market data using regression analysis and identified additional factors. These included momentum – the idea that stocks that have recently performed well tend to continue performing well, while recent underperformers tend to keep lagging; low-volatility – the premise that stocks with lower volatility tend to outperform over time; and the third factor was quality – typically defined by characteristics such as high return on equity, low earnings volatility, low leverage ratios, and high margins.

Adam: It's important to note that factor investing is not just about data mining or finding correlations. For example, one could hypothetically check if companies starting with the letter "C" have a performance pattern, but meaningful factors typically have some connection to behavioural finance theory. For instance, momentum tries to take advantage of investors' herding behaviour and confirmation bias. Low-vol and quality, at least in part, try to counter the "lottery effect," where investors tend to favour stocks with the potential for very large short-term gains over those that may offer smaller short-term returns but greater long-term rewards.

Q. How has the quality factor performed historically?

Kelly: Over time, the quality factor has performed well, outperforming most other factors going back to 2001. It has typically demonstrated good upside capture—meaning quality stocks tend to perform well when the overall market does well—while minimizing downside capture in weaker market environments.

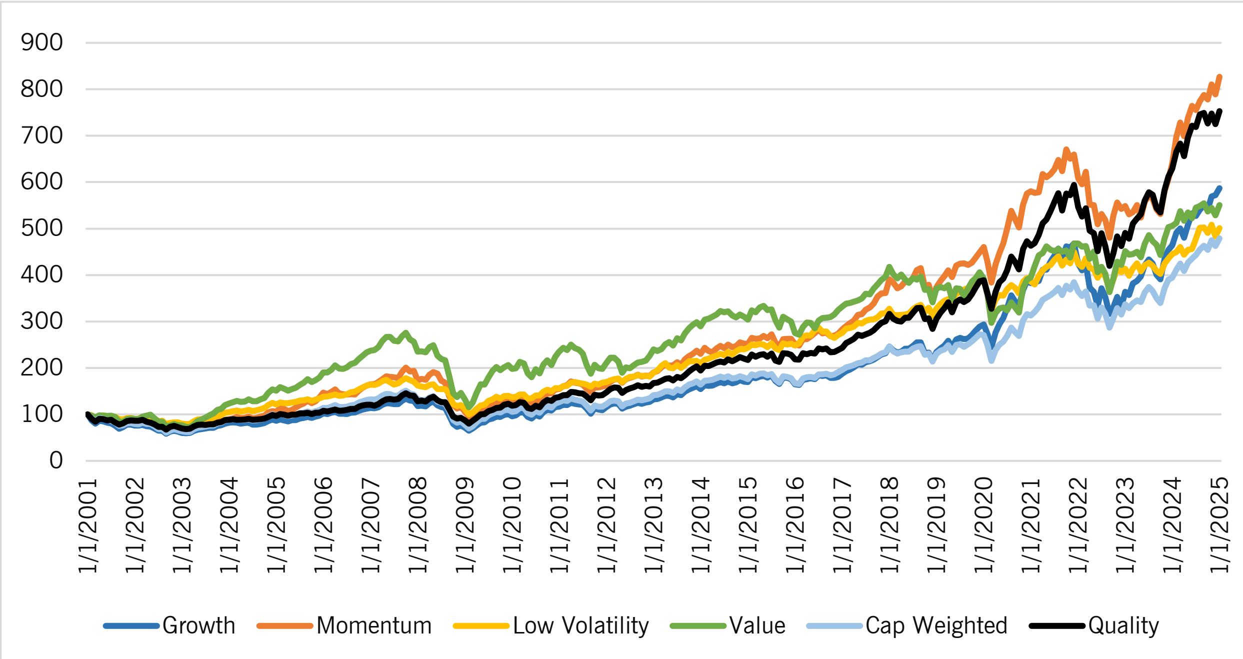
That being said, there are a few important considerations. One is that the quality factor has become more commercialized, particularly with the rise of quality factor ETFs. Additionally, during recent periods of very low interest rates, companies aligned with the quality factor strategy have often traded at a meaningful premium to the market, as low rates inflate the value of these high-quality, long-duration assets. This has, at times, made the quality factor relatively expensive.

Christopher: It is important to note that performance depends highly on the market environment. It is not as simple as saying, 'Quality is better.' While the quality factor typically limits downside, this is not always the case. For example, in 2022, when rates were rising, quality stocks experienced more downside than usual and underperformed in a down market, behaving very differently than what we've seen in the past.

Kelly: The 2022 period was unique because interest rates had been exceptionally low during the pandemic, and as rates began to rise, quality-factor stocks had further to fall due to their higher valuations. It was a distinct market environment.

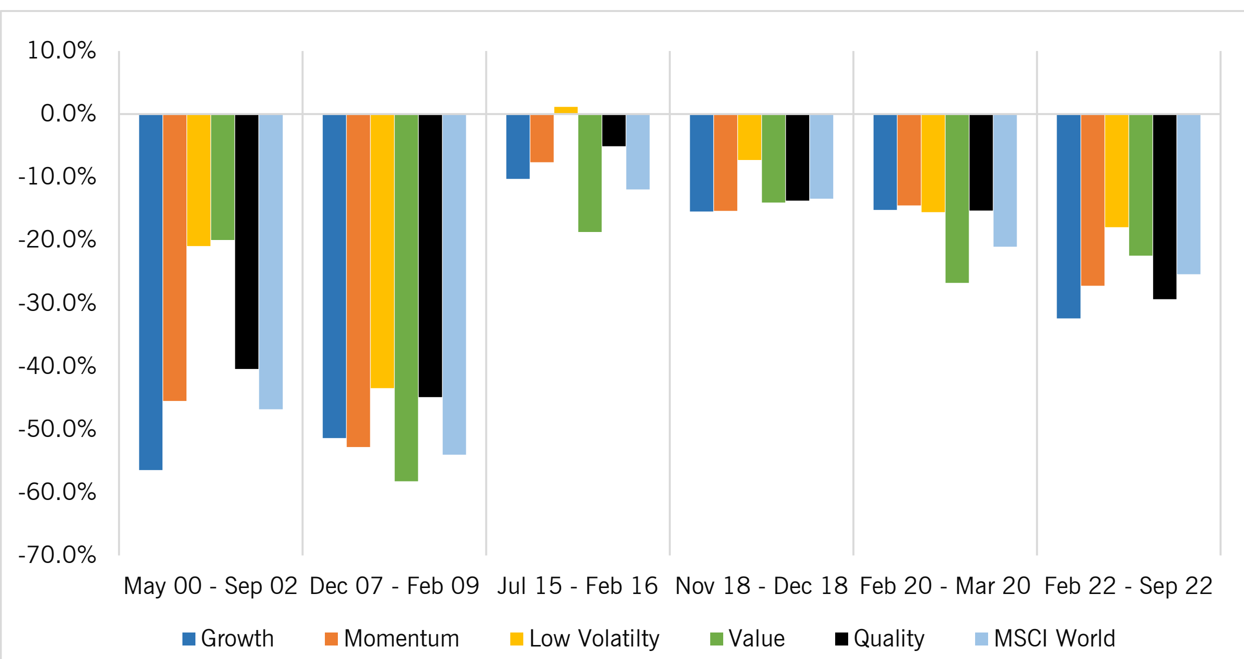
Adam: Another contributing factor to the quality factor's underperformance in 2022 was the rise in commodity prices due to the war in Ukraine. Typically, quality factor investors avoid commodity industries such as energy and materials—two sectors that performed very well in 2022.

Figure 1: Historical MSCI Factor Performance



Source: Bloomberg

Figure 2: Factor Performance – For Periods Where MSCI World Index Declined by > 10%



Source: Bloomberg

Q. **The quality factor has performed well overall, but what are its limitations, if any?**

Kelly: Let's consider how the quality factor, or any factor, works in a commercial product. When an ETF provider creates or rebalances a quality factor fund, they typically screen the index for criteria like return on equity, leverage and earnings variability—though the exact criteria can vary. The top quartile of companies according to these metrics is then selected. The process is just mathematical: companies are ranked, often with equal criteria weighting, and the top ones are bought. In some cases, funds will even short lower ranked companies.

However, there are several limitations to this approach:

1. **Valuation is ignored:** There may not be any consideration of a company's valuation, meaning expensive companies can be included in the fund.
2. **Backward-looking data:** The data used in factor screening is often inherently historical, making no assessment of a company's prospects. This means potential changes in a business or its fundamentals may be overlooked.
3. **Lack of qualitative assessment:** A quantitative approach does not evaluate qualitative factors such as a company's competitive position, management quality, or the sustainability of the metrics it uses to inform investment decisions. For instance, it won't evaluate whether a company's return on equity will likely remain stable over time.

Adam: One other limitation to consider is from a portfolio construction perspective. When companies are selected solely based on factor metrics, it can lead to highly concentrated portfolios, especially in terms of countries or sectors.

Q. **How does JFL's approach to quality differ from the quantitative factor approach?**

Kelly: What fundamentally sets our approach apart is that we *always* start with the business itself. Our goal is to invest in the most sound and resilient companies, and we evaluate their quality using three core criteria.

> ***"Our goal is to invest in the most sound and resilient companies, and we evaluate their quality using three core criteria: competitive position, management and governance, and financial strength."***

First, we assess the company's competitive position—its "moat." We examine whether the business has high barriers to entry, a sustainable competitive advantage, and the potential to strengthen that advantage. This is the most important single criterion in determining whether a company is a strong investment. While we consider the data when we look at competitive position, our analysis certainly goes far beyond static, moment-in-time numbers. That's a key differentiator for us.

Second, we conduct a thorough evaluation of the management team and governance framework. This is an ongoing, in-depth assessment of leadership's ability and commitment to driving business success, recognizing that both management and governance can evolve over time.

Third, we analyze financial strength. We look for companies with strong balance sheets, low long-term leverage, and stock valuations that are attractive relative to our long-term cash flow model.

Ultimately, our approach allows us to develop a clear understanding of a company's cost of capital by assessing and understanding the business more deeply—going beyond backward-looking data to make informed, forward-thinking investment decisions.

Adam: Historically, our style has been described as "GARP" or growth at a reasonable price. However, a more accurate description is "QARP," which is quality at a reasonable price. While we prefer companies that grow faster than GDP, growth itself is not our primary criterion. To be more precise, we focus on identifying high-quality businesses that are growing, ensuring our investments are both resilient and well-positioned for long-term success.

As fundamental investors, we seek to own stakes and high-quality businesses that we believe will build and grow their value and wealth over time.

Chris: Another key differentiator in our approach is our more thoughtful consideration of cyclicality. Some companies may meet our quality criteria but would not be considered strictly 'quality' stocks due to their cyclical nature. However, we don't automatically equate cyclicality with lower quality.

For example, a hotel management business may experience cyclical fluctuations in its earnings, but its asset light business model is highly resilient in downturns and drives outstanding returns on capital over the long-term. Our approach recognizes that quality isn't solely about earnings stability—it's also about structural resilience and the ability to generate value over time.

Kelly: A business with some cyclicality can still be a great investment if it trades at a reasonable multiple and demonstrates a positive long-term trend despite short-term fluctuations. Traditional quality factor ETFs often exclude companies with higher earnings variability, but as long-term investors, we take a different approach. We recognize that some cyclical businesses can still be high quality, and we are willing to embrace that cyclicality when the fundamentals and long-term outlook remain strong.

Q. Can you expand on the way you approach valuation?

Kelly: As I mentioned, our approach to valuation is rooted in our fundamental belief that the business itself comes first. We do not start with valuation metrics and work backward to justify an investment. Instead, our core competency lies in deeply understanding and identifying great companies. Once we achieve that, we can assess whether a company's valuation presents an anomaly or an opportunity. Since we are long-term investors, we focus on extended trends in the business rather than short-term price movements. For instance, we look at a company's ability to maintain or expand its competitive position over time.

That is where our opportunity typically comes from. We are willing to hold stocks longer than other investors. Valuation inefficiencies can arise over that longer time horizon because markets typically, in our view, tend to fade high-quality businesses into more normalized businesses—they assume regression to the mean.

In essence, our approach creates a form of time arbitrage. We take a longer-term view, making calculated decisions about whether a company can maintain or expand its competitive advantage. This patience allows us to invest in businesses that will continue to generate high returns for years to come.

Chris: This approach is built on the extensive research and analysis conducted by our team to develop watch lists of companies and cover them continuously. We are always looking for opportunities to invest in certain companies at the right time. This deep, ongoing coverage allows us to stay well-informed, giving us the flexibility to adjust our portfolio and tilt it toward companies presenting attractive opportunities as they arise.

> *"We take a longer-term view, making calculated decisions about whether a company can maintain or expand its competitive advantage. This patience allows us to invest in businesses that will continue to generate high returns for years to come."*

Q. Under what conditions might JFL invest in companies that do not meet the quantitative definition of 'quality'? Can you give some examples?

Kelly: Let's consider leverage. We typically seek companies with strong free cash flow, but some businesses use leverage strategically. If a company has a sustainable business model and has made value-accretive acquisitions with strong long-term payback, we may still invest—even if it gets screened out of traditional quality factors due to leverage. Examples include growth-oriented, utility-like businesses such as CN Rail and TransCanada Pipeline, as well as Diploma PLC, a UK-based supplier of specialized technical products and services.

Cyclicality is another factor that typically excludes businesses from traditional quality screens.

For us, if a company has high earnings variability but strong long-term fundamentals, we may still invest. Intercontinental Hotels Group is a good example. While operating in a cyclical industry, its asset-light model and strong cash generation make it highly resilient. Even during the pandemic—arguably the worst-case scenario for a hospitality company—it did not need to raise equity. With minimal debt, high margins, and the ability to withstand economic cycles, we consider it a "durable cyclical"—one that can ride out short-term turbulence and reliably benefit from long-term secular trends.

Q. Beyond leverage and cyclicality, what other aspects of a business might you look at differently?

Kelly: A key aspect of our approach to quality investing is looking beyond traditional metrics like return on equity (ROE). While ROE is a common quality indicator, some exceptional companies may not exhibit high ROE due to significant reinvestment in growth. Amazon is a prime example—at certain points in its history, its financial metrics did not fit the conventional definition of a quality company. Its margins were low, it was aggressively reinvesting in its business, and profitability was intentionally compressed to support long-term goals. Despite this, we recognized its deep competitive advantages and long-term potential, which is why we've been investors for many years.

Margins are another key consideration. While many focus on high-margin businesses, some companies generate strong returns through high asset turnover instead. Suppose a company has solid management, a strong competitive position, and a reasonable valuation. In that case, we see no reason why it cannot be considered a quality business, even with lower margins. The food services industry provides some interesting examples of this. Companies like Bidcorp in South Africa and Compass Group in the UK provide catering and food supply services to the restaurant industry. Industry margins are slim, but asset turnover is high, return on invested capital (ROIC) is attractive, customer relationships are sticky, and these companies benefit from resilient and steady growth trends.

Q. Does JFL ever use quality factor screens to assess potential investments?

Kelly: We typically avoid quantitative assessments of our businesses, as we believe they do not lead to the best outcomes. We avoid screening methods since they are widely used by others. Instead, we focus on identifying quality companies before their strength is reflected in financial metrics or appears on investor screens.

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