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# CIO Viewpoint

# Quality time – the case for quality stocks as recession fears rise

Investment Solutions

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**Amid tough times for equities, a tilt towards quality can add a defensive element to portfolio positioning. We examine the case for quality stocks in the current bear market.**

Equity investors are having a painful year. Major markets have fallen 10-25%, with double digit declines in the US, Europe, mainland China and much of the emerging world. Rising recessionary fears are compounding high inflation, a prolonged war in Ukraine and investors reducing risk exposures. This cycle is also unusual, with growth concerns and higher rates weighing on markets simultaneously, leaving few places for investors to hide.

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## The X Factor

Investors can try to improve performance by tilting their equity exposures towards different regions, sectors, or styles. Dispersion here can be significant, and has been high this year. Energy, for example, is the only sector to have delivered positive performance year-to-date, up 21.4% versus a 28.5% fall for consumer discretionary stocks[1]. Different 'factors', investment styles – including value, growth, quality, momentum and size (see text box on page 3) – can help explain investments' long-term risk and return performance and tend to exhibit different characteristics, e.g. volatility, rate sensitivity and performance across the cycle. In recent years, investment styles have been more important drivers of returns than sectors or regions, according to MSCI data[2].

## A tug of war – value versus growth

For much of equity market history, the value style of investing – buying stocks that look cheap versus their intrinsic value – has been a favoured strategy. Yet between the Global Financial Crisis and 2021, growth stocks outperformed their value peers, and tech stocks rose inexorably, leading many to wonder if the world had fundamentally changed. In 2021, however, value stocks staged a comeback and gradually regained the ascendancy. This year, too, rising rates have dealt a bigger blow to higher growth segments of the market, although the spread in performance between value and growth has narrowed.

### Key takeaways

- Equity investors face tough choices, as recessionary concerns and higher rates weigh on markets simultaneously; favouring different styles is one way to try and improve performance
- A tug of war between value and growth dominated the narrative last year. This year, rising rates have also dealt a bigger blow to higher growth segments of the market
- Quality stocks tend to outperform in challenging market environments, especially during slowdowns and cyclical recessions
- We have increasingly favoured a quality overlay this year, and recently upped the quality bias within our equity exposure.

[1] As of 11 July

[2] Active Management Opportunities in a Dispersed Market, MSCI, July 2021

Style investors tend to focus on the value/growth dichotomy: is the initial price we pay for an investment, or its subsequent growth, the most important driver of returns? Yet there is another, less researched dimension: the quality factor. It has no single agreed definition. A quality label can be self-serving – no one wants to tell clients they invest in low-quality stocks. We define quality stocks as having high and stable profitability (return on equity, earnings variability) and low leverage. Academic research shows that stocks sorted on this basis have generated higher risk-adjusted returns than the broader market over time, with evidence for a profitability premium especially strong, particularly for large-cap firms[3].

Crucially, quality tends to outperform in challenging market environments, especially during slowdowns and cyclical recessions, as these lead to a contraction in earnings and margins for most companies. US quality stocks have outperformed the broader market in the last three recessions (2001, 2008-2009 and early 2020 – see chart 1). Why is this the case? Quality companies tend to be those with strong business models and competitive advantages that rivals struggle to emulate. Many are multinationals, providing diversification across many economies. Their predictable earnings chug along, even as growth falls. This also allows them to continue paying dividends, providing investors with reliable income, which can be highly prized if bond yields are low. Quality firms also do better on balance in inflationary environments, since they are better able to defend their margins.

## Examining Buffett's success

Both quality and value investors seek strong earnings; the former with more emphasis on balance sheet health, the latter on valuation multiples. The two styles tend to work at slightly different points in the cycle: value in expansionary periods, when their multiples re-rate, and quality in recession. Warren Buffett is famous as a value investor, but an analysis of Berkshire Hathaway's performance from 1977-2016 suggests that quality was actually a more important factor than value in generating the firm's excess returns, contributing 3.4 percentage points of performance, versus 1.2 percentage points respectively[4]. A 2008 annual report from the investment firm generated a famous Buffett aphorism, which captures both elements: "Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down."

## A defensive tilt

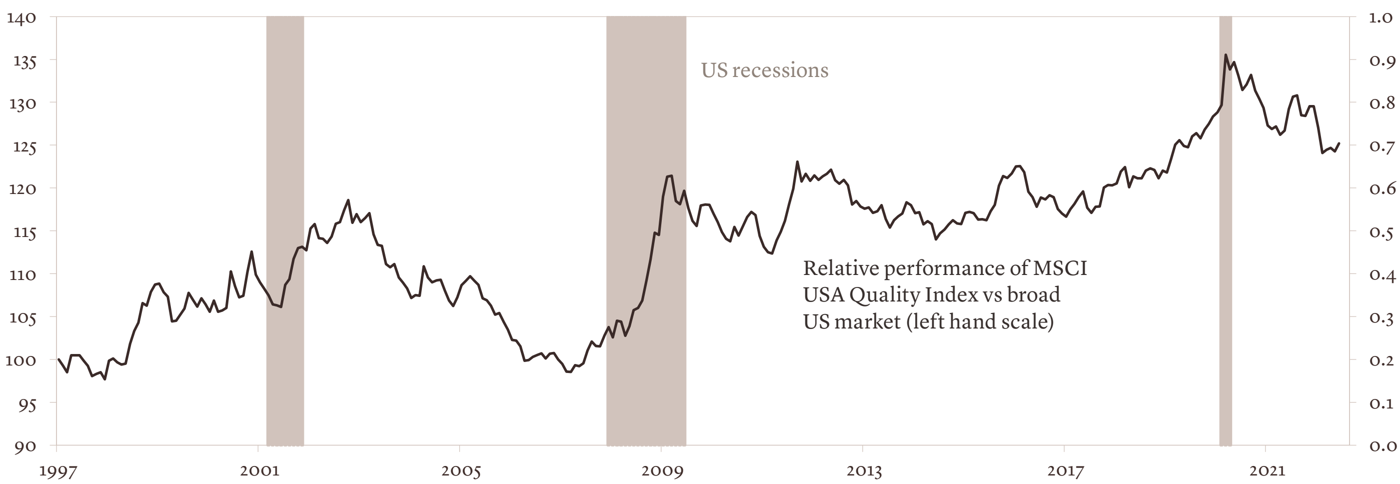
A tilt towards quality is one way to introduce a defensive element to portfolio positioning and reduce risk. Our current allocation favours value over growth, and we have increasingly applied a quality overlay to stock selection this year. While this can be achieved readily via exchange-traded products, it is also an opportunity for active managers to add value via screening and identifying quality firms and picking individual stocks. This could be an increasingly valuable strategy, given highly dispersed stock performance currently versus history. We try to find these companies using an approach that is sector and country agnostic. We have also recently increased our quality

[3] See Robert Novy-Marx, *Quality Investing* (2013)

[4] Sources: AQR, CRSP, HRF, Morningstar, Barclays

**1. Quality has outperformed in recessions**

Relative performance – US quality versus broad US stocks




Sources: Bloomberg, Lombard Odier

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bias within our US equity exposure, where the largest pool of quality stocks can be found.

Why are we doing this now? One reason is a price correction. Valuations of quality stocks have fallen back to long-term average multiples and no longer constitute a headwind. The other is timing, and the rising probability of a severe recession. Our proprietary World Economic Indicator, which tracks 74 business indicators, indicates a recent move from a slowdown to a contraction regime. It tends to lead GDP data by 6-8 months. Quality tends to outperform as markets face more restrictive financial conditions (see chart 2), and particularly 7-18 months after the US yield curve inverts (2-year yields rising above 10-year tenors), which happened in March 2022 for the first time since August 2019. Overall, our equity exposure is underweight, when taking into account our options strategies on US and European indices.

### Examining style premia

**Value** – An asset that looks cheap versus its intrinsic value will tend to outperform a more expensive one (focus on price to earnings/price to book value ratios, free cash-flow measures)

**Growth** – Favours companies expected to grow at above-average rates (focus on sales and earnings growth, profit margins, return on equity)

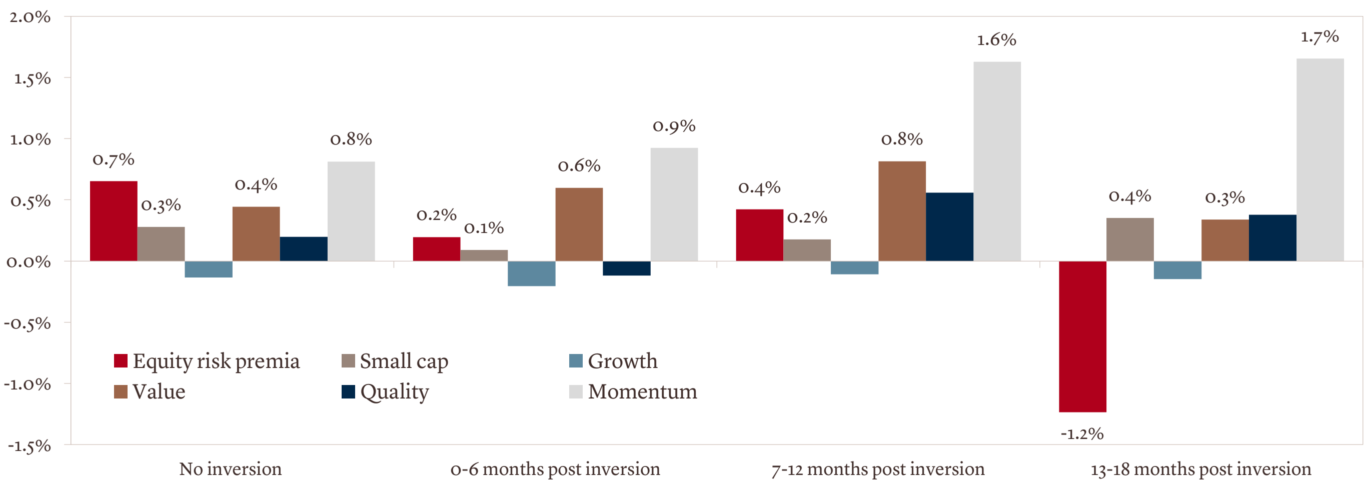
**Quality** – Companies with resilient business models and sustainable competitive advantages should outperform over time (focus on return on equity, debt to equity, earnings variability)

**Size** –Mid and small cap-stocks tend to outperform large-cap stocks over time, potentially as compensation for higher risk (see *The cross-section of expected stock returns*, Kenneth French and Eugene Fama, 1992)

**Momentum** – The idea that an asset's recent relative performance tends to persist in the near term

## 2. Quality outperforms amid more restrictive financial conditions

US yield curve inversion (2-year - 10-year) and monthly market performance




Sources: Bloomberg, Lombard Odier

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