Virtues and Constraints of High Quality Stock Ownership

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It is rare to meet an investor who openly admits a desire to invest in low quality stocks. Most clients are attracted to the idea of investing in "high quality common stocks." Sometimes they are then perplexed that they do not always provide higher than market returns. Intuitively, one could assume that the highest quality stocks would provide outstanding relative performance in all market climates. In this paper we will define high quality and provide our perspective on appropriate return expectations for these types of companies.

First, let's define high quality common stocks. The quality of a business is in direct proportion to the consistency of the company's earnings and cash flows, and the financial strength as measured by the balance sheet. In our experience, the single best window into quality is a company's historical dividend record. This stands to reason since dividends are paid from cash flow, and on a longer-term basis a rising stream of dividend payments will be a reflection of rising earnings per share. Thus, the highest quality companies typically not only have a record of consistent dividend payments, but also exhibit a pattern of annual dividend increases. Companies that raise their dividend each year are generally considered to be high quality.

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Standard and Poor's produces quality rankings on most large capitalization stocks. Consistency of earnings and dividends has the heaviest influence on the ratings. As an example, Coca Cola would be an A+ rated quality, whereas a highly cyclical stock such as Alcoa would be rated B-. While Coca Cola provides some degree of assurance on the future, Alcoa provides very little in the way of predictability, and is considered more speculative since their business is cyclical and heavily influenced by the price of aluminum, a volatile commodity.

The success or failure of any investment depends on one's investment parameters and how performance is defined. Over time, we would expect Coca-Cola to provide superior returns to Alcoa, but not every year. Over the shorter-term, the price or valuation of any investment will be a more primary determinant of the return. Over the longer-term, however, the fundamentals of the company and growth of the business, along with the dividends received, will be the more primary influences on the return. As investor expectations ebb and flow, valuations expand and contract, leading to return differences, but we believe that over the longer run the high quality characteristics should be the driving factors in superior performance.

High cost is not synonymous with high quality, although ordinarily, one might expect to pay a premium for the perceived quality of an item. Applying this thinking to common stocks, higher-quality companies are typically afforded a higher valuation as measured by the price-to-earnings ratio (P/E), price to sales, and price to cash flow (EV/EBITDA). The consistency and predictability of the business increases the probability of a positive return, reduces risk, and as a result investors are typically willing to pay more for the perceived certainty and quality.

Further perspective on high quality stocks may be gained by thinking of them in relation to U.S. Treasury securities. The highest quality investment in the world is generally considered to be U.S. Treasury bills. An investment is always about the future, the assurance one has that the assets will be returned, and the relative certainty of return. In the case of Treasury bills, there is absolute assurance that the investment will be returned at maturity, and there is no doubt that the interest will be paid on the instrument. The investor has perfect visibility on the future result.

Because Treasury securities are considered the highest quality, safest and most liquid security, all investments are priced relative to Treasury securities. For instance, the next step down in quality is the category of high quality corporate bonds. On very rare occasions a corporate issue will be priced at a yield lower than a Treasury of the same maturity, but almost always there is a premium yield over the Treasury, in order to compensate the holder of the corporate issue for perceived additional risk. This is called the default premium, and over time high quality corporate bonds have rewarded their holders with a slightly higher total investment return.

The same order of relationships can be applied to a common stock investment. High quality common stocks can be thought of as somewhat analogous to Treasury securities, but in the equity market. Even though stocks are much more "risky" in terms of their volatility, and the shareholder is far below the bondholder in the capital structure for claims on the assets of the company, one can think of high quality stocks as being priced in their market in somewhat the same way as the Treasury security in the bond market. The parallel is not always exact, for the pricing on high quality stocks fluctuates much more relative to other categories than do bonds. Like Treasuries, we believe the stocks of the highest quality companies are safer in the long run. For investors who want to take more risk, they should be compensated for their risk with higher returns over long periods of time. Smaller capitalization stocks, for instance, which are riskier than large stocks, have materially outperformed over long periods of time. Taking more risk is the upside, but there is always the downside to consider.

Looking at return histories of individual stocks in the high quality category, we know that they have done well over time. We also know that there can be periods of relative underperformance over the short-to-intermediate term, or even for a matter of years. We encourage our investors to think about high quality investments in a longer-term context and relative to the risk assumed. Our preference is to invest where there is the most visibility on the future, the highest assurance that in fact there will be a return, and therefore we focus on sustainable investments in companies where there is little doubt about their long-term viability. This means going into high quality and being careful about valuation for a variety of investment reasons, not just immediate return. It means being willing to earn a less-than-market return over some period of time, especially in periods when risk is being rewarded, in order to have the potential that in more difficult economic or financial times, high quality stocks will protect capital and outperform by a good margin. Lastly, we think our clients, and investors in general, will be best served to evaluate investment returns over a full market cycle and doing this will give them the best chance for success in their investment program.

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