3-D Investing[1]

Most investment management approaches are categorized along two dimensions: market capitalization and investment style. Has the impact of a third dimension—quality—been overlooked?

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For many years, investors have diversified their equity portfolios by both market capitalization (large, mid-, or small) and investment style (value, core, or growth), hence the popular nine-square style box. The basis of this approach is the theory that large- and small-cap, and growth and value stocks explain most of the variation in equity returns. Although individually risky, these various capitalization and style approaches dampen risk when combined in a portfolio. At Atlanta Capital Management, our research indicates that ignoring quality and investing solely by capitalization and style dimensions is unwise. In fact, the performance of high- and low-quality stocks can have a significant influence on an investor's risk and return characteristics, in many cases overwhelming the influence of either size or style.

In general, most investors deem high-quality stocks to be those with steady, consistent earnings growth, modest debt to equity ratios, and above-average returns on invested capital. It's not surprising that companies with these financial characteristics typically have seasoned management teams and strong competitive positions in their key markets. Low-quality stocks, on the other hand, are those with erratic or highly cyclical earnings, heavy debt burdens, and poor returns on capital. Typically these companies have less experienced managers, less dominant market positions, and are (on average) smaller in size and have shorter records as public companies.

The Standard and Poor's Earnings and Dividend rankings (also known as "quality rankings") score the financial quality of several thousand U.S. stocks from A+ through D, with data going back to 1956. The company rankings are based on the most recent 10 years (40 quarters) of earnings and dividend data. The better the growth and stability of earnings and dividends, the higher the ranking.

1 This article has been adapted from a longer report. The complete report is available through the Atlanta Capital Management website (www.atlcap.com).

S&P quality rankings provide investors with a useful time series for measuring trends in the performance of high- and low-quality stocks. The rankings are not infallible, but they are unbiased and empirical and have been calculated the same way for a lengthy period of time. Atlanta Capital Management uses these rankings along with several other proprietary and non-proprietary analytical tools to evaluate the financial quality of companies in which we invest.

For the purpose of this study, we have constructed a custom set of quality indices. The universe includes all Russell 3000 Index constituents that have S&P quality rankings and prices greater than US$1. These high- and low-quality indices are provided to compare the performance of stocks with above-average S&P quality rankings (B+ or better) to those with below-average S&P quality rankings (B or below and not rated). Each index is formed and rebalanced monthly, and returns are calculated using a market capitalization-weighted methodology. At year-end 2009, approximately 60 percent of the market capitalization of the Russell 3000 was ranked "B+ or better," and 40 percent was ranked "B or below" and "not rated."

In addition to the pair of custom quality indices, other Russell indices are used as reliable proxies for market capitalization and style categories. These indices are also used to depict how most investors structure their U.S. equity manager lineup. The Russell 1000 and Russell 2000 indices measure the performance of stocks with large and small market capitalizations, and the Russell 1000 Growth and Value indices measure the performance of the growth and value investment styles. The Russell 3000 measures the performance of a broadly diversified portfolio of U.S. common stocks.

Table 1 depicts the 2009 calendar-year return of Atlanta Capital's size, style, and quality indices in comparison with the Russell 3000. As indicated, low-quality stocks outperformed the broad market by 17.3 percent in 2009. This result was substantially greater than the 8.9 percent premium generated by growth stocks and the mere 0.1 percent premium generated by large-cap stocks.

TABLE 1

2009 RETURNS BY SIZE, STYLE, AND QUALITY

		Size		Style		Quality	
	Russell 3000	Russell 1000	Russell 2000	Russell 1000 Growth	Russell 1000 Value	Russell High Quality	Russell Low Quality
Total Return of Index	28.3%	28.4%	27.2%	37.2%	19.7%	18.8%	45.1%
Premium / Deficit vs. R3000	—	0.1%	(1.1%)	8.9%	(8.6%)	(9.4%)	17.3%

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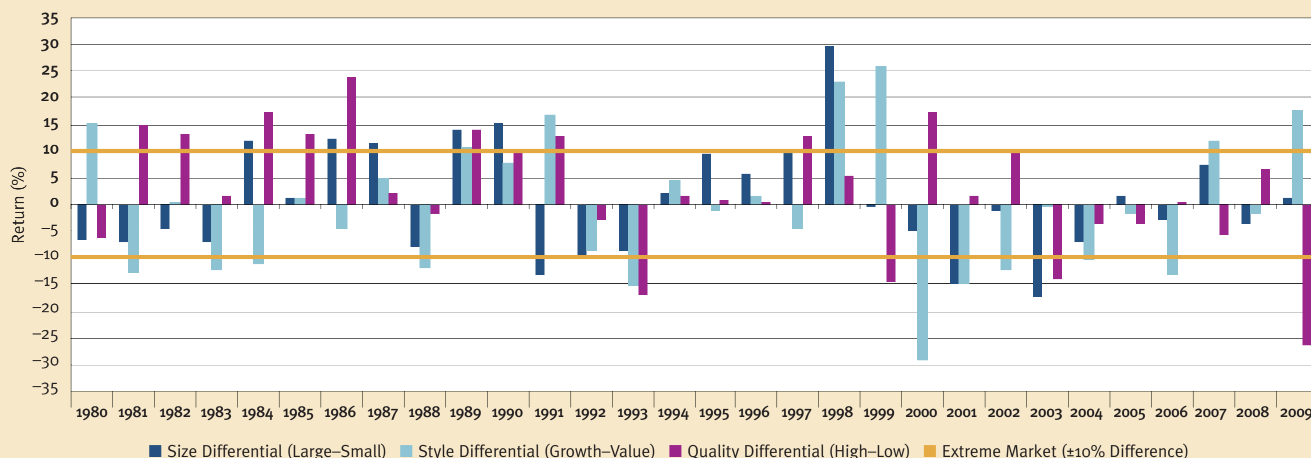
FIGURE 1

PERIODS OF EXTREME MARKET PERFORMANCE: SIZE, STYLE, AND QUALITY DIFFERENTIALS (1980–2009)



Clearly, each size, style, and quality index responded differently to the same economic stimuli applied throughout the year. Knowledge of this differential behavior can help investors manage the volatility of their equity portfolios and, ultimately, enhance their total rate of return.

The "Quality Cycle" and the Economic/Market Cycle

The amount of exposure to high- and low-quality stocks can have a more important impact on return than exposure to large- and small-cap stocks as well as growth and value stocks. In addition, fluctuations in the performance between high- and low-quality stocks are not random or totally unpredictable events. In fact, a "quality cycle" appears to exist that is closely related to the economic and stock market cycle.

Figure 1 shows the annual difference in return between each pair of our size, style, and quality indices for the 30 years ending in 2009. The magnitude and frequency of the quality differentials are comparable to those of size and style. For example, quality is the single largest influence on performance in 10 of the 30 years shown.

Also, there are only six periods when low-quality stocks outperformed high-quality stocks by 500 bps or more—1980, 1993, 1999, 2003, 2007, and 2009. In the other 24 periods (80 percent of the observations), high quality dominated low quality or lagged it by only a modest amount. The economic and capital market conditions that existed during each of the six years of low-quality domination reveal important patterns, as shown in **Table 2**.

TABLE 2

ENVIRONMENTAL CONDITIONS DURING STRONG "LOW QUALITY" YEARS

	Economic Conditions	Monetary Conditions	The Stock Market
1980	Brief recession in 1980, followed by a second in 1981–82.	Fed tightened early in 1980, then eased.	Last year of 1975–80 bull market led by energy.
1993	Long expansion between recessions of 1990–91 and 2001.	Fed easing since 1990, followed by abrupt tightening in 1994.	Near beginning of 1991–99 bull market led by technology.
1999	Strong U.S. economy led by technology spending, slows in 2000 with dot-com bust, recession begins in 2001.	Fed eased in mid-1998 in response to emerging market debt crisis and Long-Term Capital Management rescue, then tightened in late 1999.	Last year of 1991–99 bull market led by technology.
2003	Synchronized global economic expansion from 2002–07.	Fed easing.	First year of 2003–07 bull market led by energy, metals & mining, and housing related stocks.
2007	U.S. growth slowing, real estate deteriorating rapidly.	Fed tightening, yield curve flat.	Last year of 2003–07 bull market.
2009	Severe recession in 2008, signs of recovery in 2009.	Fed easing since subprime crisis of 2007.	First year of 2009–? bull market.

Performance of low-quality stocks tends to dominate high-quality stocks at the beginning and end of a stock market cycle. Low-quality outperformance during the middle of an economic or stock market cycle is rare. These occurrences are not random. The relatively brief spurts of low-quality outperformance make intuitive sense when analyzed in the context of the economic, monetary, and stock market conditions.

By their nature, low-quality stocks are usually more economically sensitive than high-quality stocks. In addition, they tend to be more reliant on the debt markets because they are usually more capital intensive and less able to finance growth through internal resources. When the economy slides into recession following a period of monetary tightening, low-quality stocks tend to fall farther than high-quality issues because low-quality company profits are more vulnerable to deteriorating economic and credit market conditions.

Typically, once policymakers become sufficiently concerned about recession, the U.S. Federal Reserve aggressively eases credit market conditions, and Congress and the president cut taxes and raise spending in an effort to turn the economy around. Low-quality stocks, which tend to fall the most during a bear market, tend to lead the initial phases of a new bull market because these bear market laggards have the most to gain from improving credit market and economic conditions.

Why do low-quality stocks also tend to outperform high-quality stocks at the end of a bull market? After all, economic and credit market conditions are much different at the beginning of a stock market cycle than at the end. The primary reason that low-quality stocks outperform as the market nears a cyclical peak is that investor speculation is often widespread near stock market tops. In the late stage of a bull market, stock prices have been rising for a sustained period of time, luring more and more unsophisticated investors into the market. In the latter stages of a bull market, a widely recognized market leader has developed—for example, oil stocks in the late 1970s, consumer growth stocks in the 1980s, internet stocks in the late 1990s, and energy and housing stocks in the past decade. As more investors chase the same investment theme, they become less quality conscious and buy stocks of secondary companies and/or new issues with inexperienced management teams. As a result, low-quality stocks outperform the broad market right up until the market peaks and turns down.

Figure 2 depicts the rolling 36-month annualized performance differentials between each pair of our size, style and quality indices. As illustrated, the variation in each performance differential ebbs and flows over time and does not appear to be random. A cyclical performance pattern clearly exists between each pair of our size, style and quality indices.

The Outlook for High-Quality Stocks

If history is a guide, high-quality stocks should post stronger relative returns in 2010 and 2011 following their lackluster showing versus low quality during 2009. The drivers of this expected outperformance should be (1) attractive valuations relative to low-quality issues, (2) a less stimulative fiscal and monetary policy environment, and (3) a likely moderation in the pace of earnings growth and investors' appetite for risk.

Attractive Valuations. In retrospect, 2009 seems to have been a fairly typical period for strong performance by low-quality stocks. The economy was in its second year of recession, and government was aggressively applying fiscal and monetary stimulus to lift the economy out of the abyss. Credit spreads in the bond market began to narrow early in the year as investors' appetite for risk slowly returned. Equities, with investors sensing that an economic recovery was three to nine months away, began to rise in March. After sharply underperforming high-quality stocks during 2008, low-quality stocks sprang back to life.

FIGURE 2

(ROLLING 36-MONTH EXCESS RETURNS) SIZE, STYLE, AND QUALITY RETURN DIFFERENTIALS (1983–2009)

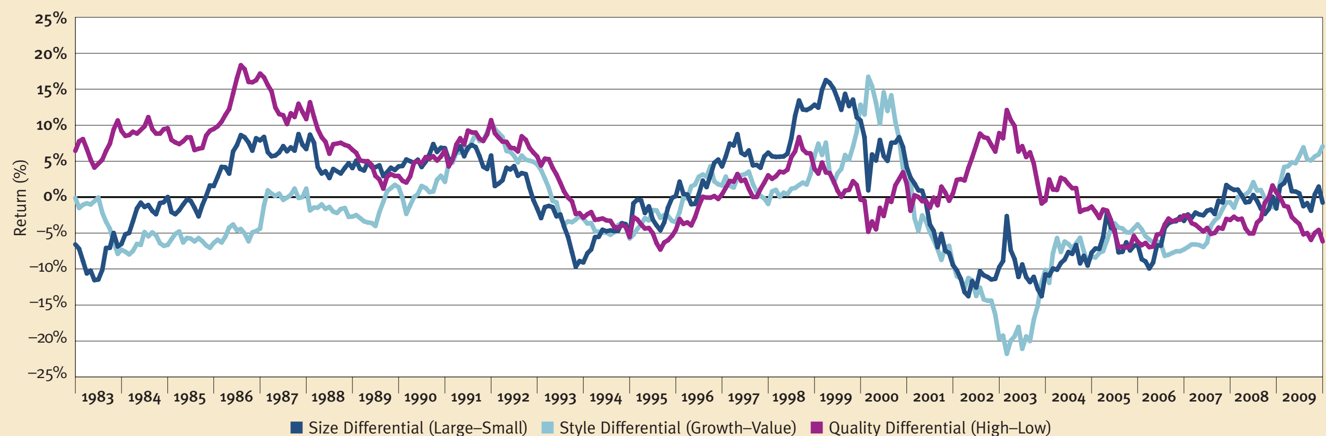


TABLE 3

RUSSELL 1000 INDEX AS OF 26 FEBRUARY 2010	Price/Earnings 2010	Dividend Yield	Debt to Capital	Return on Equity	Earnings Stability (20 Quarter R^2)
Russell High Quality	17.1x	1.8%	31%	19.1%	0.60
Russell Low Quality	20.1x	1.1%	34%	14.2%	0.48

What was unusual about 2009 was the extremely large gap between high-quality and low-quality performance. Low-quality stocks outperformed high-quality stocks by 26.7 percent in 2009, a gap far wider than the 17.5 percent gap in favor of growth over value and the 1.2 percent gap in favor of large cap over small cap.

The strong relative performance of low quality in 2009 completely erased the valuation premium normally accorded to high-quality issues. **Table 3** shows recent valuation and financial metrics for high-quality and low-quality nonfinancial stocks in the Russell 1000 Index. (Financials are excluded because the huge write-offs and losses in this sector can distort the data.) Each quality sample contains about 320 equally weighted names.

Note that high-quality stocks sell at a price/earnings discount to low-quality issues while providing a higher dividend yield.

The poor relative showing of high-quality stocks in 2009 coupled with their low relative valuations is one reason why high-quality issues may outperform low-quality issues during 2010 and 2011.

Monetary and Fiscal Policy. Another important reason is that monetary and fiscal conditions are likely to become less stimulative in 2010 and 2011. Several major countries, such as China, Australia, India, Brazil, and Canada have already begun to tighten monetary policy as inflation pressures emerge in East Asia and in natural resources-based economies. In the United States, short-term interest rates, near zero, can't fall any lower and are likely to rise in 2011 as the economic recovery begins to mature. Tax rates on income, dividends, and capital gains are likely to rise in 2011 with the expiration of the Bush tax cuts and the need to finance health care reform. A more restrictive monetary and fiscal policy generally favors high-quality companies, which are less sensitive to the economic cycle and less dependent on credit markets.

Earnings Growth and Risk Appetite. The third reason that high-quality stocks may post stronger relative performance in the months ahead is that the sharp reacceleration in earnings and economic growth in 2010 should start to dissipate in 2011 as the economic recovery matures. In an environment of tighter monetary conditions, higher taxes, and slower economic growth, investors typically become more risk averse and favor high- over low-quality stocks.

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ADDITIONAL CONSIDERATIONS

Other considerations may be of interest to various investors—quality's correlation with size/style, relative potential of low/ high-quality stocks to enhance total portfolio return, and risk-adjusted returns. These questions were evaluated, and a few general conclusions follow.

Correlation with Size/Style. The returns derived by investing in our pair of quality indices appear to be influenced by factors other than size and style. The size, style, and quality indices described in this article exhibit weak correlates relative to each other. Thus, quality, as a third dimension of portfolio classification, provides diversification benefits when combined with the two traditional dimensions of size and style.

Enhancing Total Return. Over the past 30 years, the 12.4 percent compound annual return generated by the Atlanta Capital high-quality index represents the highest absolute return in comparison with the other size, style, and quality indices. Given the performance advantage inherent in high-quality stocks, a strategic allocation to "high quality" could reasonably be expected to enhance an equity portfolio's total return. Although the performance advantage of high-quality stocks appears to hold over the long term, deviations are certainly possible in the short term. A strategy of holding low-quality stocks over the past five years would have produced significantly superior returns relative to a strategy of holding high-quality stocks. Historically, mean reversion has forced these relationships back into equilibrium and in line with their long-term averages. Therefore, a substantial rebound in favor of high-quality stocks may be near.

Risk-Adjusted Returns. Atlanta Capital's research indicates that high-quality investing is a superior strategy on both an absolute-return and risk-adjusted basis relative to size and style-based investing. Over the past three decades, high-quality stocks have offered the highest return per unit of risk taken. When we plotted the behavior of high- and low-quality indices in both rising and declining periods, the portfolio of high-quality stocks preserved the most capital while the portfolio of low-quality stocks fully participated in the market's decline. This preservation of capital combined with the power of compounding is the basis of high-quality stocks' superior risk-adjusted results.