The Case for Quality – The Danger of Junk

“You can’t make a silk purse out of a sow’s ear.”

It has been the cornerstone of finance for decades: Rational investors should demand higher returns whenever higher risk is assumed. And, while this relationship generally holds true at the asset class level, rather astonishingly, it completely breaks down at the stock level. In fact, it appears that investors overpay for higher risk stocks and underpay for less risky stocks. This pattern of high return for low risk exists both in small and large caps and in global equity markets alike.

A quick glance at the world around us provides ample circumstantial evidence as to why investors might overpay for risky stocks. For example, if people are risk-averse, why do casinos exist and how do lottery tickets sell? In both of these cases the expected return on “investment” is negative, yet business for both is booming.

Mispricing of Risk

As a result of a casino mentality in the stock market, risky stocks are generally overpriced because investors are trying to own the next big thing, be it a Starbucks or an EBay. The tantalizing prospect of generating stratospheric returns from a small investment seems to blind people to the overwhelming probability of loss. Similarly, investors tend to underpay for less risky stocks because these companies do not offer the theoretical possibility to shoot the lights out with one great stock selection.

Quality as a Strategic Investment

Most high quality companies tend to be stable profit generators and as a result are less risky. Surprisingly, even though many of these corporations tend to generate high profits year after year, they are systematically underpriced because they lack volatility. Instead of overpaying for these companies, as finance theory would suggest – given their low risk profile – shareholders in fact do just the opposite: they underpay. The result is that investors in high quality companies get to forge ahead with 15+% returns year after year without overpaying. Of course, in any given year, low quality stocks can and do stage rallies and high quality stocks can underperform. But the high quality stocks have always won over longer holding periods. No matter what metric is used to identify quality stocks – leverage, profitability, earnings volatility, or beta – high quality stocks have beaten out low quality stocks (see Exhibit 1).

Exhibit 1: Relative Performance of High Quality U.S. Stocks vs. Low Quality

<table>
<thead>
<tr>
<th>High Quality</th>
<th>S&amp;P 500</th>
<th>Leverage</th>
<th>Profit Margin</th>
<th>Earnings Volatility</th>
<th>Beta</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lo</td>
<td>1.0%</td>
<td>Lo -1.0%</td>
<td>Hi 1.0%</td>
<td>Lo 1.7%</td>
<td>Lo 0.5%</td>
</tr>
<tr>
<td>Hi</td>
<td>-1.0%</td>
<td>Hi -2.0%</td>
<td>Lo -2.0%</td>
<td>Hi -2.0%</td>
<td>Hi -2.6%</td>
</tr>
</tbody>
</table>


Finally, high quality stocks, given their inherent characteristics of low leverage and high and stable profitability, are more likely to be able to survive a financial crisis. The fact that stocks of these companies tend to outperform the market means that this insurance against a financial crisis is available “free of cost.”

Quality as a Tactical Investment in 2004

Insurance against economic downturns is especially important today because corporate leverage is higher than it has ever been, leaving American corporations in a delicate position as depicted in Exhibit 2.

Interest rates are at an all-time low and any increase in these rates could cause a financial catastrophe. In case of such a meltdown, high quality companies should help shelter investors from losses.

From a valuation standpoint, low quality stocks look unappealing as we enter into 2004. The recent run up in these stocks has left them significantly overpriced compared to their historical average. What happens when
GMO has decided to focus primarily on large cap U.S. equities. The benefit of owning a large cap portfolio in any financial crisis is evident: the government is much more likely to bail out large companies which employ thousands of people than a small manufacturer.

How does GMO define quality companies? A company must meet all of the following three criteria:
- low leverage
- high profitability
- low earnings volatility

Failure to meet any one of these criteria excludes a stock from the investable universe. To select stocks from this quality universe, GMO uses the stock selection approach that it has used since 1982 in U.S. equity portfolios. The methodology identifies companies that are able to maintain high levels of profitability over longer time periods than the market in general, thus mitigating the tendency for profits to regress to mean levels. In addition, this stock selection approach has the added benefit of differentiating between “good” and “bad” growth: only companies that can deliver returns in excess of their cost of capital should be rewarded for growth.

Conclusion

High quality companies are excellent investments today, but surprisingly are not being discussed much in the financial or academic press. This is probably due in large part to the ingrained focus in the investment management business: value and growth strategies are prolific, as are large and small cap funds. But high quality funds are uncommon.

For 22 years, GMO has successfully incorporated a measure of quality into its strategies. Given that a critical component of our stock selection approach is our ability to distinguish good growth from bad growth, GMO has an edge in selecting the most attractive quality stocks. In other words, we understand when it is good for a company to increase its debt in order to grow and we understand the sustainable level of debt that a quality company may carry.

In the current economic environment where forecasts for U.S. equities do not bode well over the next few years, GMO believes that the U.S. Quality Strategy provides some relief – another “where to hide” – for investors in U.S. equities.