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EXECUTIVE SUMMARY

Everyone loves high quality! How could they not? The word “quality” is synonymous with “good,” and in almost all fields of human endeavor, high quality is viewed in a more favorable light than low quality. High quality companies tend to have higher profitability, stronger balance sheets, higher earnings growth, and consistent dividend growth.

In today’s unpredictable markets, it is important to focus on the quality of your investments. The reason is simple: research shows that portfolios tilted toward high-quality investments tend to offer consistent returns that outperform benchmarks over the long term, as well as offer downside protection over a full market cycle.

We believe high quality outperforms. A large amount of empirical evidence and many academic studies emphasize the benefits of quality investments.

WHY HIGH-QUALITY

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ACADEMIC SUPPORT

The "quality" equity factor has received tremendous academic support in recent years. Investment firms and investors are now starting to embrace this factor, and empirical evidence is available that emphasizes the benefits of quality investments.

Robert Novy-Marx's June 2012 paper "The Other Side of Value: The Gross Profitability Premium" states the following:

- "Profitability, as measured by gross profits-to-assets, had roughly the same power as book-to-market (a value measure) in predicting the cross section of average returns.
- "Profitable firms generated significantly higher returns than unprofitable firms, despite having significantly higher valuation ratios (higher price-to-book ratios).
- "Gross profitability was a powerful predictor of future growth in gross profitability, earnings, free cash flow and payouts.
- "Because both gross profits-to-assets and book-to-market were highly persistent, turnover of the strategies was relatively low.
- "Because strategies based on profitability are growth strategies, they provided an excellent hedge for value strategies – adding profitability on top of a value strategy reduced overall volatility."

Max Kozlov and Antti Petajisto, the authors of a January 2013 paper "Global Return Premiums on Earnings Quality, Value, and Size," investigated whether the return premium on stocks with high earnings quality was a global, rather than just a U.S., phenomenon. Their study covered the period from July 1998 to June 2012 and found the following:

- "A simple strategy consisting of long stocks with high earnings quality and short stocks with low earnings quality produced a higher risk adjusted return ratio than the overall market and similar strategies betting on value or small stocks.
- "The aforementioned result held both in the overall sample as well as in the more recent time period since 2005.
- "Because the global earnings-quality portfolio had a negative correlation with a value portfolio, an investor wishing to invest in both exposures could have achieved significant diversification benefits.
- "The results weren't driven by hard-to-implement trades. Simple cap-weighted long-only portfolios with a combined value-quality tilt beat the broad market by 3.9 percentage points per year among large cap stocks and 5.8 percentage points among small cap stocks. Compared with a pure value tilt, the combined value-quality tilt added 1.2 percentage points per year among large caps and 1.8 percentage points among small caps."

“Quality Minus Junk,” published in October 2013 by Cliff Asness, Andrea Frazzini, and Lasse Pederson, supports that, over time, a portfolio of high-quality names has beaten the market – even though the stocks have typically been more expensive than the overall market – and offered lower risk. Their research states as follows:

- “A quality security is defined as one with characteristics for which – all else equal – an investor should be willing to pay a higher price: those that are safe, profitable, growing, and well-managed.
- “High quality stocks do have higher prices on average, but not by a large margin. Perhaps because of this puzzlingly modest impact of quality on price, high quality stocks have high risk-adjusted returns.
- “A quality-minus-junk (QMJ) factor that goes long high quality stocks and shorts low quality stocks earns significant risk-adjusted returns in the U.S. and globally across 24 countries.
- “The price of quality – i.e., how much investors pay extra for higher quality stocks – varies over time, and reached a low during the internet bubble in the late 1990s. Further, a low price of quality predicts a high future return of QMJ.
- “Controlling for quality resurrects the otherwise waning size effect.”

Jeremy Grantham, legendary co-founder of Boston fund firm GMO, published “Playing With Fire” in April 2010, which observed that quality has historically outperformed:

- GMO’s own data, which tracks high-quality companies, finds they have outperformed the Standard & Poor’s 500 stock index by a cumulative 50 percent since 1965.
- Since 1925, Standard & Poor’s has tracked its own index of quality companies, the High Grade Index, and it has outperformed the rest of the market over the stretch – particularly during recessionary periods such as the Great Depression.
- Historically, high-quality stocks have produced superior returns with far lower risk. They can be, in other words, a “free lunch” for investors.

Published in July 2010 by Aye M. Soe of S&P Indices Global Research and Design, “Is High Quality Always Better?” states: During down markets and periods of high volatility, widening credit spreads, and a steepening yield curve, the quality premium tends to be positive. Here are the paper’s key points:

- In most fields of human enterprise, high quality is viewed in a more favorable light than low quality.
- The quality premium, or difference in return of high quality versus low quality, is positive in down markets. This validates the commonly held belief that high quality provides a cushion in market downturns.
- The quality premium is a function of risk aversion, credit spread, and changes in the slope of the yield curve.

PIMCO takes a more international look at quality with the December 2013 paper, "The Profitability Premium in EM Equities." It found profitability tends to be persistent and underpriced:

- More and more research shows profitable companies, defined by returns on equity or similar measures, are "persistently" profitable, maintaining their profitability over long-term investment horizons.
- The significance of profitability is an international phenomenon; identifying countries, industries and companies that have characteristics suggesting future growth is critically important.
- High-profitability strategies tend to outperform, supporting the investment approach of identifying strong, profitable companies that deliver outperformance over time. Over the last 15 years, the size of the profitability premium (excess return) has been roughly 9 percent per year.

In the August 2008 research paper "Asset Growth and the Cross-Section of Stock Returns," Michael Cooper, Huseyin Gulen, and Michael Schill discovered asset growth rates are strong predictors of future abnormal returns:

- A firm's annual asset growth rate emerges as an economically and statistically significant predictor of U.S. stock returns.
- High-growth firms tend to have higher earnings-to-price ratios (EP) and tend to be more profitable in return on assets (ROA) than low-growth firms.
- From a stock performance standpoint, high-growth firms earn trailing 36-month returns that are very high compared to other firms.

The March 2010 white paper, "The Third Dimension: An Investor's Guide to Understanding the Impact of 'Quality' on Portfolio Performance" by Brian Smith of Atlanta Capital, discusses the classifications used by investment managers, including market capitalization, investment style, and quality:

- Quality can significantly influence a portfolio's risk and return characteristics, as well as distort the influences of size and style.
- From 1979-2009, high-quality stocks outperformed large cap and small cap, as well as growth and value stocks, with substantially less volatility.
- Contrary to efficient market theory, superior risk-adjusted returns are available to high-quality investors.

Another GMO white paper, published by Chuck Joyce and Kimball Mayer in June 2012 and titled "Profits for the Long Run: Affirming the Case for Quality," describes profitability as the ultimate source of investment returns:

- Contrary to popular belief, profitability can be forecasted, and superior profitability persists.

- Returns earned by stock investors are entirely a function of the underlying corporate profits of stocks held in a portfolio.
- Investors systematically undervalue the stability of quality stocks, which leads to their consistently higher returns over the long term.
- A fundamental focus on profitability remains the best way to minimize the risk of permanent loss of capital.
- Because companies with superior earnings ability provide insurance during market drawdowns, a portfolio of quality stocks can be expected to do very well during these events.

David Swensen discusses the benefits of high-quality, fixed income in his August 2005 book "Unconventional Success":

- Investors insulate portfolios from deflationary conditions and financial crises by holding long-term, non-callable, full-faith-and-credit obligations of the U.S. government.
- While standard U.S. Treasury bonds provide the most powerful deflationary hedge, the return of principal guaranteed by U.S. Treasury Inflation-Protected Securities (TIPS) affords investors a measure of deflation protection.
- Financial market crises often lead to extreme investor preference for safe investments.
- During flight-to-quality episodes, U.S. Treasury securities benefit from the demand of fearful investors, leading government bonds to appreciate while nearly all other security types fail.
- Unfortunately for investors, corporate bonds contain a variety of unattractive characteristics, which include credit risk, illiquidity, and callability. Even if bond investors receive fair compensation for these unattractive characteristics, astute investors recognize that the credit risk and callability of corporate obligations undermine the fundamental diversifying power expected from fixed-income holdings.

CHARACTERISTICS OF HIGH QUALITY

FOR EQUITIES

High quality has several specific, identifiable characteristics that can all be tied to the general concept of consistent and stable company growth over the long term.

Higher Profitability – High-quality companies tend to have above-average profitability measures, such as return on equity (ROE), return on assets (ROA), and net profit margin (NPM). Higher returns can allow companies to reward their shareholders through internal growth, dividends, or share repurchases.

Stronger Balance Sheets – A company's balance sheet strength (i.e., lower relative debt levels) can be measured in a variety of ways, but debt to capital (DTC) is a leading statistic used to measure quality. Lower debt levels allow a company more freedom to grow in the future.

Earnings Growth – Companies with higher and more stable earnings growth are able to support stronger dividend growth. The average long-term earnings growth estimates are higher for companies with superior historic ROE and ROA figures.

Dividend Growth – Managers in stable corporations with confidence in the future are better able to consistently grow dividends. ROE is a key attribute of such companies.

FOR FIXED INCOME

High quality can be defined as low credit risk* when talking about fixed income. The best asset class to exemplify this classification is long-term, non-callable, full-faith-and-credit obligations of the U.S. government; in other words, U.S. Treasury securities. In order to achieve a more inflation-neutral investment, U.S. Treasuries are typically paired with equally high-quality TIPS.

HIGH-QUALITY PERFORMANCE

There is an argument to consistently emphasize high-quality stocks in portfolios as they have outperformed the overall market on a total return and risk-adjusted basis for the last 25 years. In fact, the global evidence for high quality is fairly compelling. Quality has outperformed both large-cap and small-cap stocks for not only the global market but consistently across all regions, such as North American, Europe, Japan, and Asia.

Historic performance of the MSCI USA Quality Index versus the MSCI USA Index shows quality's total return outperforming over five-, 10-, and 15-year periods while exhibiting significantly lower volatility, which leads to superior risk-adjusted return.

DIVIDEND GROWER PERFORMANCE

Dividend-growing companies, which are typically associated with high quality, have also outperformed over time. Even if the economic backdrop didn't favor dividend-growing stocks,

*Credit risk describes the borrower's general ability to repay the debt. From a bond holder perspective, it can be associated with the risk of losing principal.

dividend growers have still provided the best returns over the last 40-plus years – including the majority of the last two decades when investors clearly put more emphasis on price appreciation than dividend income.

Furthermore, dividend growers and initiators – those companies able to raise or begin to pay dividends – had higher total returns coupled with lower volatility than the broader dividend-paying group. Dividend stocks have outperformed since 1972 with an 8.8 percent annualized return versus 7.0 percent for the broad stock market. Dividend stocks that initiated and grew dividends outperformed all stocks with a 9.6 percent annualized return.

Further, using a strategy focused on securities with high and growing dividends alleviates the stress of income generation while improving sustainability. When thinking about performance, investors should focus on total return and not just capital appreciation or dividend income singularly.

The S&P 500 has had an annualized total return of about 9.0 percent from 1871 to 2010. The income component made up more than half of that return — it was not only greater than capital appreciation but less volatile — and ranged from about 2.0 percent to 6.0 percent annualized, while the price appreciation was as high as 15.0 percent and as low as negative 3.0 percent annualized. Also, dividends grew consistently throughout those years.

BEAR MARKET PERFORMANCE

High-quality stocks' earnings are less variable than those of low-quality stocks and are therefore better able to weather market turmoil. This validates the commonly held belief that high quality can provide a cushion in market downturns. The quality premium (difference in return of high quality versus low quality) is a function of risk aversion and tends to be positive during periods of high volatility and down markets.

In sluggish environments where economic growth is likely to be below average and interest rates are more likely to rise than fall, we believe higher quality companies should outperform. These companies tend to have higher dividend growth, which should reduce overall price volatility, and thus have historically tended to outperform after market peaks.

CONCLUSION

In conclusion, research shows high quality investments behave just like any high quality consumer products, in that they tend to provide consistent results for the long run. High quality securities are those with greater profitability, rising historic and forecasted earnings, as well as dividend growth. The merits of high quality are submerged in heavy academic research that helps provide proof they have greater long term returns when compared to the overall market.

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Return on equity (ROE) is an indicator used to measure the profitability of a company in terms of shareholder equity. It is calculated by dividing net income by shareholder equity. Return on assets (ROA) is an indicator used to measure the profitability of a company in relation to the company's total assets. The return is calculated by dividing the net income by the total assets. The net profit margin (NPM) is the ratio of net profits to revenues for a company that shows how much of each dollar earned by the company is translated into profits. It is calculated by dividing net profit by revenue.

The MSCI USA Quality Index is based on the MSCI USA Index, its parent index, which includes large and mid cap stocks in the US equity market. The index aims to capture the performance of quality growth stocks by identifying stocks with high quality scores based on three main fundamental variables: high return on equity (ROE), stable year-over-year earnings growth and low financial leverage. The MSCI USA Index is designed to measure the performance of the large and mid cap segments of the US market. With 627 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in the US

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