



The Quality Conundrum

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We are witnessing the end of a remarkable and confounding era for stocks, best described by the “quality conundrum” investors faced for much of the last two years. During that time the combined *outperformance* of low-quality stocks alongside the *underperformance* of high-quality stocks was unprecedented in the last 30 years.

Now, we are embarking on an era where high-quality stocks will likely significantly outperform low-quality stocks, resolving this conundrum. Regardless of how you manage money for your clients, understanding this impending regime change will be critical to delivering superior performance.

The resolution of the quality conundrum will proceed independent of the overall market’s direction. This is important because the third, and perhaps final, painful decline of the current secular bear market remains ahead. Against that backdrop the renewed outperformance of high-quality stocks may begin as a flight to safety, but can continue as the seedlings of a new secular bull market, eventually driving market indexes higher. Attractive absolute valuations of many high-quality companies – those trading at single-digit P/E and cash-flow multiples, around tangible book value, and with respectable 3-6% dividend yields – will be the foundation for those eventual gains.

By reviewing the nature and magnitude of the quality conundrum investors have faced of late, we can begin to understand how it will resolve and how to take advantage of the looming shift.

A conundrum among many

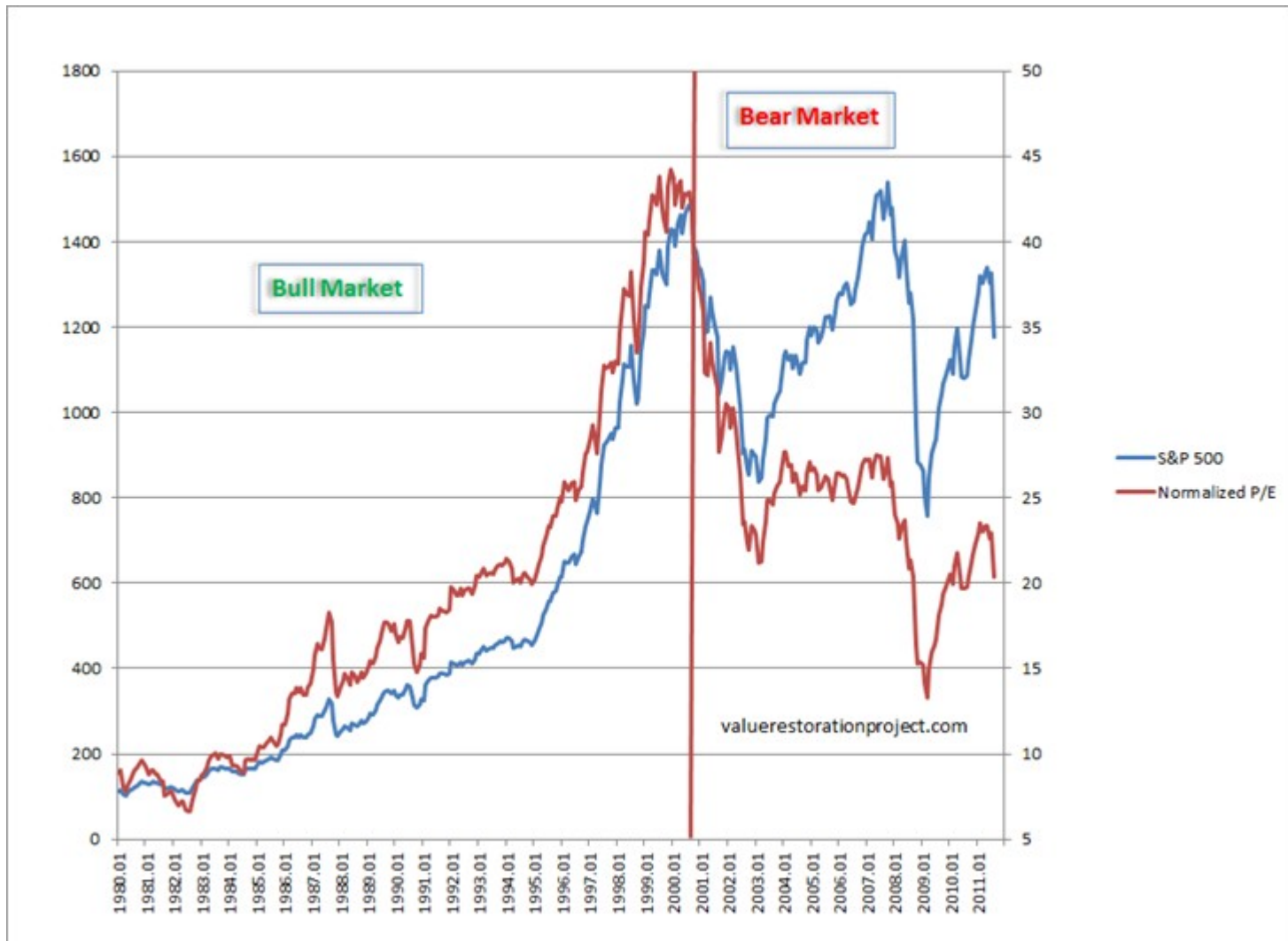
The market has a way of frustrating even the most patient investors. Value investors who correctly identified the expensive valuations of large-cap equities in the late 1990s spent several years watching those overvalued markets become even more so. Investors who correctly identified the nominal lows in stock prices in 1974 had to wait another seven years for their investments to begin compounding at meaningful real rates of return. In November 1979, investors who watched gold appreciate over 1,100% in less than 10 years – and were sure that, at \$400/oz, its pricing was unmistakably speculative – must have been shocked to see prices double once more to over \$850/oz over the course of the next few months. As the eminently quotable John Maynard Keynes noted, the market can



stay irrational longer than most investors can stay solvent. This, no doubt, is a lesson learned and relearned throughout history.

Fortunately, for those investors who aim to stay solvent *and* generate a meaningful return along the way, the occasional irrationality of market prices has a counter-force – mean reversion. This phenomenon is driven by valuation, which as James Montier points out, is the closest thing we have to a law of gravity in finance. . In the [Seven Immutable Laws of Investing](#), he identifies valuation as the primary determinant of long-term returns, and countless academic studies back up that assertion.

Those focused on valuations were pleased to see stocks trading around 700 on the S&P 500 in March of 2009. At a normalized P/E of 13, the market was priced to deliver decent returns for the foreseeable future, approximately 8-10% annualized. Investors of nearly all types, in nearly every risky asset class, saw tremendous value. Only those paralyzed by fear or a lack of liquid capital were unable to benefit from the cheapest market we had seen since the mid 1980s.



Source: Sitka Pacific Capital Management

The joy of inexpensive markets faded rather quickly, however, as the S&P 500 rallied more than 40% over the subsequent six months and went on to appreciate by more than 75% from its March 2009 low by the end of 2010. In essence, the promise of 5-10 years of 8-10% annualized returns was compressed into just a handful of quarters.

Skeptics have observed that more than just fundamentals have been driving stock prices over the last few years. Whether it was crisis-induced fiscal and monetary policy, rampant global liquidity from expanding central bank balance sheets, or greed's influence on "animal spirits" – something just didn't *feel* right about the nature of the stock market's rally from the March 2009 lows.

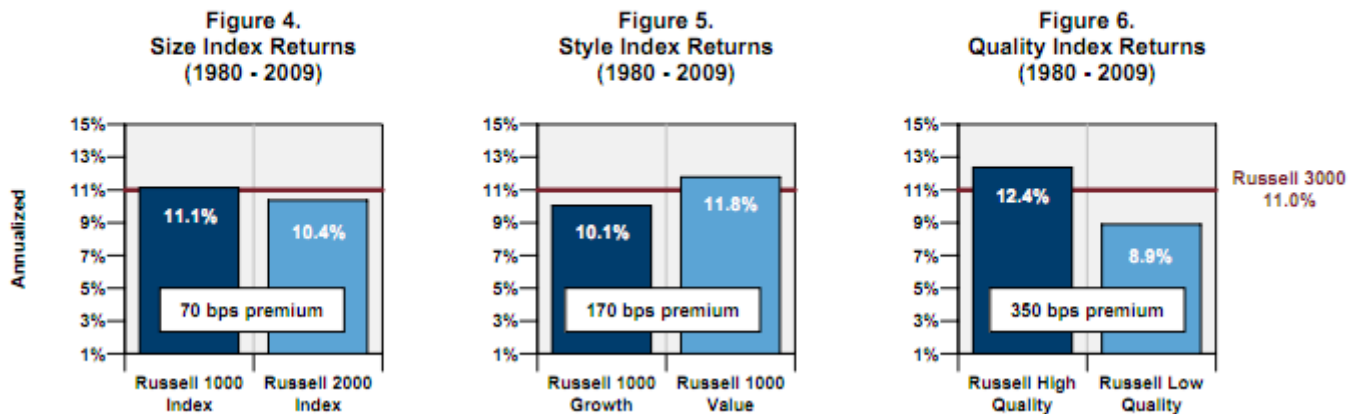
The quality conundrum and the dash for trash

During the market rout of late 2008 and early 2009, the market punished the stocks of the weakest companies the most. This made sense. We were not only in a recession, which meant declining revenues, but many companies had taken on a tremendous amount of debt over the previous 5-10 years and were vulnerable as a result. As [Russell Napier of CLSA reminded us at the CFA annual conference](#), “equities are the fine sliver of hope between assets and liabilities.” The prospect for increased bankruptcy risk rightly drove prices of the stocks with the most financial and operating leverage down the most. High-quality stocks were outperforming their lower-quality brethren.

Once it became clear, however, that the Federal Reserve and the U.S. Government would be the lender of last resort, committed to a policy of extend-and-pretend to minimize the near-term pain of failed businesses, the dash for trash was on.

In 2010, Brian Smith, CFA, of Atlanta Capital Management, published [The Third Dimension: An Investor’s Guide to Understanding the Impact of “Quality” on Portfolio Performance](#). The article makes a compelling case for the long-term, risk-adjusted return advantage of high-quality stocks, which Smith defined as those rated B+ or better by Standard and Poor’s.

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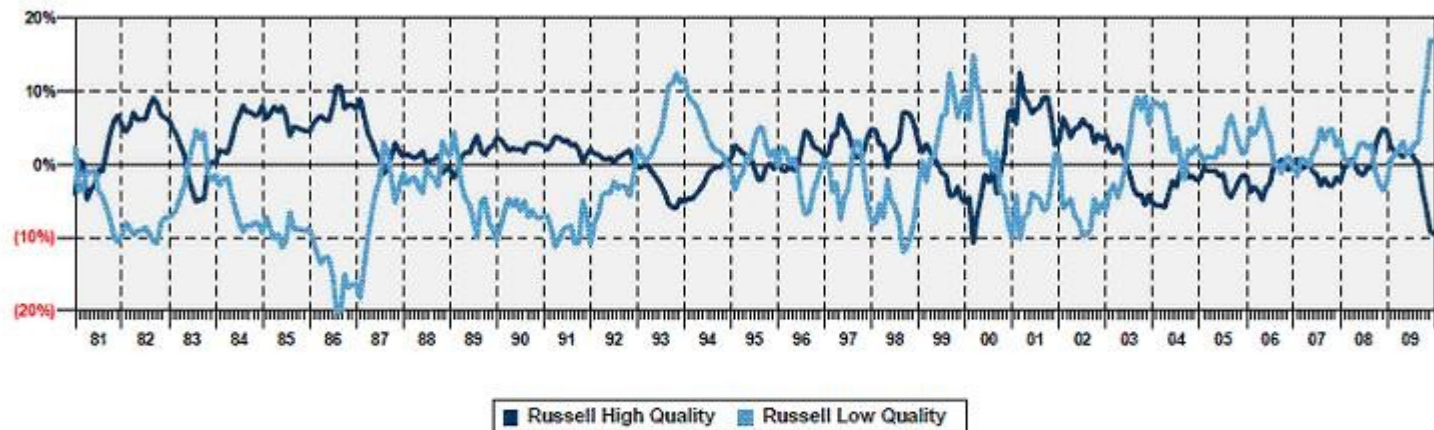


Source: Atlanta Capital Management

Unfortunately, similar to the excess returns that can be found with value stocks, the relative returns on these investments can be choppy – there can be long periods when low-quality stocks outperform. Witness the chart below, which shows the rolling 12-month returns for high- and low-quality stocks (in excess of the Russell 3000 broad stock index) from 1980 to 2009. As noted above, during 2008, high-quality stocks delivered over

4% excess returns versus the Russell 3000, while the lowest-quality stocks offered an excess loss of over -2%.

Figure 3. Rolling 12-Month Excess Returns vs. Russell 3000 Index



Source: Atlanta Capital Management

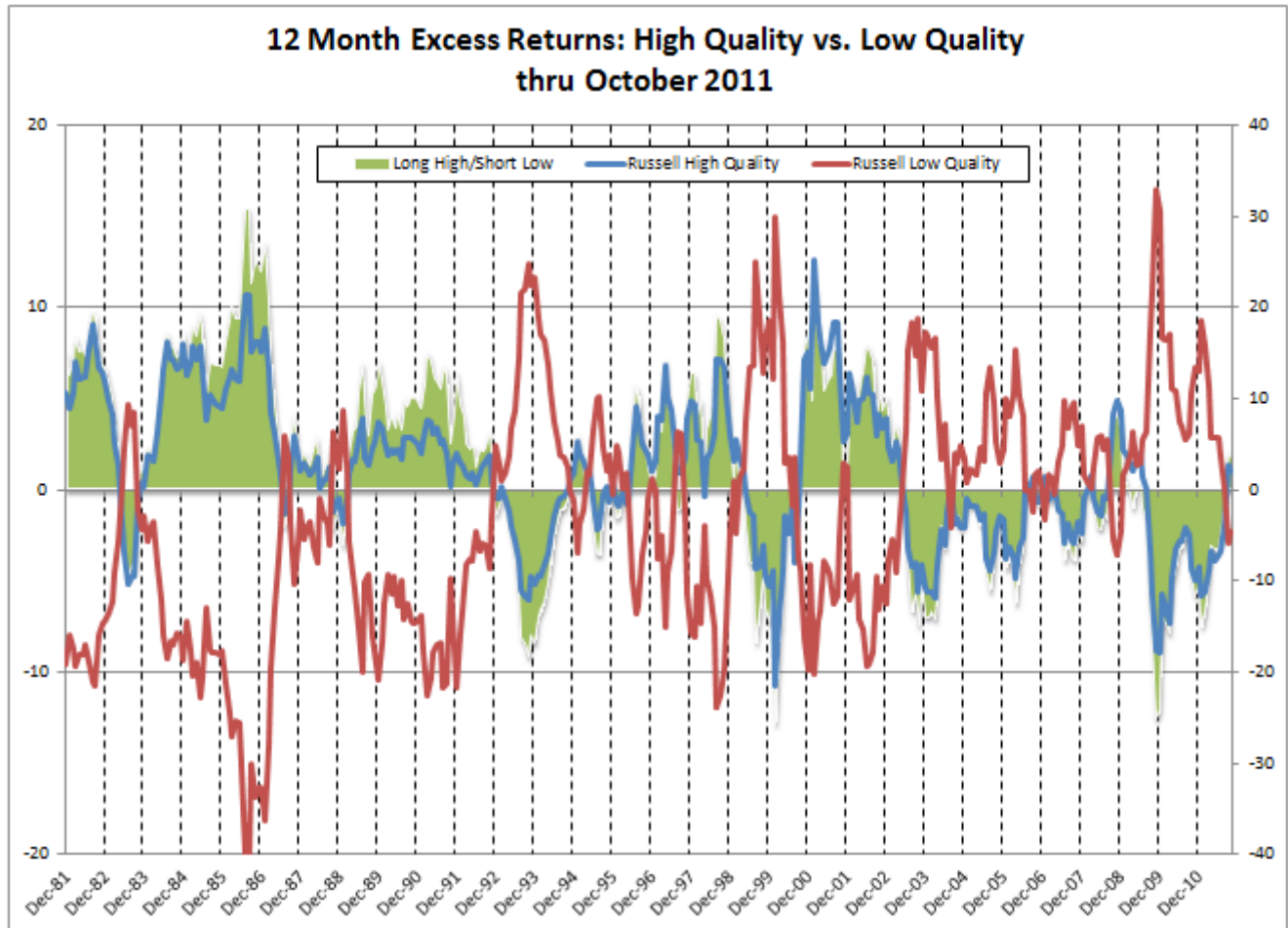
The outperformance of high-quality stocks, however, was short-lived. In 2009, the lowest-quality stocks outperformed the broad market by more than 15%, the largest margin in at least the last 30 years.

But that doesn't even tell the whole story. Over the same period, the highest-quality stocks *underperformed* the broad market by nearly 9%, also among the largest such discrepancies in over 30 years. By the end of 2009, the *spread* between the excess returns of the highest-quality stocks and the lowest over the preceding 12 months, over -24%, was the most extreme it has been over the last 30 years, on par with the spread that existed when the market peaked in early 2000.

The law of gravity at work

The extreme divergence between the returns of high-quality and low-quality stocks threw the relative valuations of the two groups out of whack. Normally, high-quality stocks get premium valuations relative to their low quality-counterparts. This makes both intuitive and theoretical sense, since high-quality stocks tend to have higher returns-on-equity and more stable earnings. As Brian Smith of Atlanta Capital showed, however, at the end of 2009 high-quality stocks actually traded at a 15% discount to low-quality stocks on current earnings and sported a dividend yield more than 60% higher.

The anomalous performance moderated some in 2010, but investors who focused on taking advantage of the mismatch continued to be frustrated. High-quality stocks lost over 4%, and low-quality stocks gained more than 6% in excess of the broad market. The low-quality skew of the market was particularly evident in the rally sparked by the second round of Quantitative Easing in the fourth quarter of 2010.



Source: Atlanta Capital Management; Sitka Pacific Capital Management

So far in 2011, we've seen a clarifying of the quality conundrum. Much in the same way the markets for risky assets have broadly reassessed the sustainability of stimulus-driven returns, the outperformance of low-quality stocks has reversed course. This reversal has been confirmed by a commensurate positive excess return to high-quality stocks. In the 12 months ending October 31st, high-quality stocks have generated nearly 1% excess returns, while low-quality stocks have lost over 2%, for a spread of over 3%. This trend likely grew stronger in November.



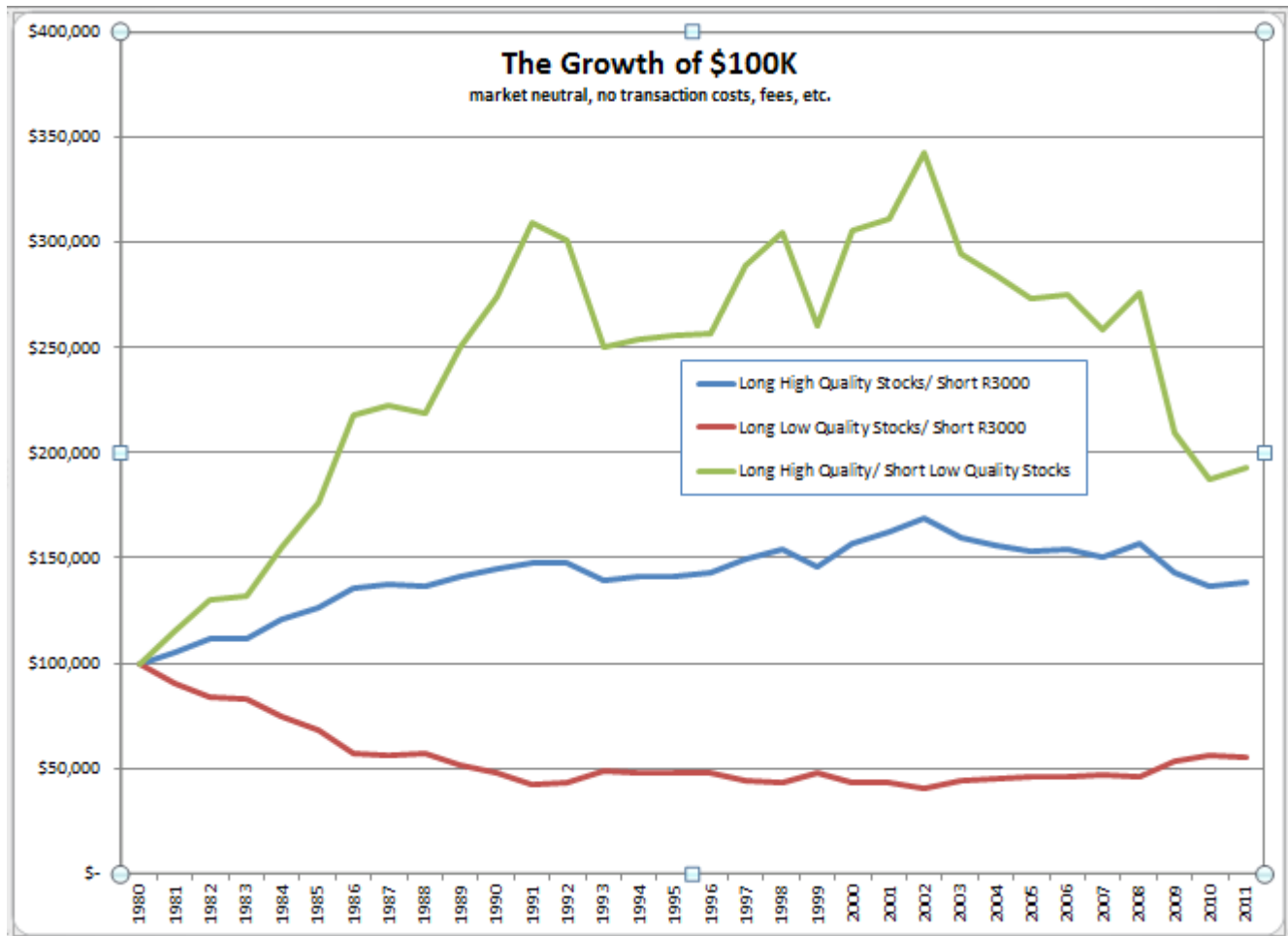
Agreeing to agree. And disagree.

It is difficult to say what exactly drives returns to high- or low-quality stocks over various time periods. Certainly valuation is important. At the peak of the market in 2000, larger, high-quality, “blue-chip” stocks carried excessive premium valuations – just as the “Nifty Fifty” did in the late 1960s. The laws of valuation ensured poor subsequent returns. What we label quality is also subject to error – many large-capitalization investment banks, commercial banks, insurance companies, and the like have all been inappropriately highly rated by S&P recently.

We can also measure quality in different ways. An analysis of factor returns, for example, shows that stocks that rank highly on certain quality factors, like earnings stability, inventory turnover, debt/assets, ROE and the like have generated meaningful long-term excess returns, though in varying amounts for different sectors.

Furthermore, it is difficult to generalize about the propensity for high- or low-quality stocks to outperform in up- or down-market environments, which gives market bulls and bears something on which to agree. During the secular bull market of the 1980s and 1990s, high-quality outperformance was the norm, with low-quality surges only appearing briefly, typically during speculative periods preceding the short corrections of the era. In contrast, during the secular bear market of the last 12 years or so, high-quality stocks have delivered excess returns only during market declines. Perhaps the sustainable and ongoing outperformance of high-quality stocks is a necessary marker of durable broad market gains.

This gives the long high-quality/ short low-quality trade an unusual and extraordinarily valuable distinction: It can generate meaningful returns regardless of whether one expects a cyclical broad market decline or whether one expects that we are in the early stages of a multi-year bull market. As long as relative valuations for high-quality stocks remain attractive, the relative returns can be robust. Indeed, in [GMO's monthly forecast](#) of 7-year asset class returns, U.S. high-quality stocks are priced to deliver 5.4% annualized real returns, which far exceeds the 1.8% forecast for the U.S. large-cap space and -0.4% forecast for the U.S. small-cap class.



Source: Atlanta Capital Management; Sitka Pacific Capital Management

At Sitka Pacific, we currently favor global high-quality stocks with inexpensive valuations in the equity portion of our Absolute Return strategy, while hedging that exposure with positions that move against various broad market indexes. In our long/short equity strategy, Hedged Growth, we are further able to take advantage of expensive, low-quality stocks on the short side – leading to a more direct manifestation of this theme and an opportunity to generate meaningful returns in a variety of market environments.

Bringing it all home

Understanding the returns to high- versus low-quality stocks is as important today as understanding the relationship between growth and value stocks. Whether you are picking stocks or evaluating outside managers, it is essential to understand the drivers of future returns. The quality conundrum has created tremendous opportunity, and some investors will capture these returns better than others. A flexible long/short approach, emphasizing high-quality stocks with low valuations, will generate meaningful positive returns – in a world in which such returns will continue to be hard to come by.



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