4 reasons to consider quality stocks as core, long-term holdings

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Building a house on weak foundations is a recipe for disaster. This is also true for equity portfolios. While the core holdings may not be the most exciting, a portfolio's success will often hinge on its quality. Investors should look for four main characteristics in an asset they choose for the core of the portfolio:

- Reliable outperformance over the long term anchored in known and proven investment principles
- Resilient behaviour across the business cycle
- Defensiveness in crises
- Asymmetric risk profile (that is, capturing more of the upside than the downside)

Highly profitable companies are often regarded as great core holdings, as they tend to tick all four of the boxes above. At WisdomTree, we believe that a High-Quality strategy is the cornerstone of an equity portfolio. It is the key to building resilient portfolios that can help investors build wealth over the long term and weather the inevitable storms along the way.

Reliable outperformance with the Quality factor

Among practitioners, selecting stocks based on their Quality attributes has a long track record. Warren Buffet does not stand alone in his focus on High-Quality stocks. His mentor, Benjamin Graham, a founding father of value investing, recognised the value of High-Quality companies as early as 1934 (Graham and Dodd 1934).

More recently, academics have also recognised the long-term outperformance of Quality stocks. In 2014, Fama-French extended their three-factors model (Market, Size, Value) to a five factors model that includes two Quality factors[1].

Figure 1: High-Quality stocks historically outperformed the market with less volatility

Source: Kenneth French data library. Data is at a monthly frequency and as of 30 November 2022. Stocks are selected as above the median market cap, with "high" representing the top 30% by operating profitability and "low" representing the bottom 30% by operating profitability. The market represents the portfolio of all available publicly listed stocks globally. All returns are in USD. Operating profitability for year t is annual revenues minus cost of goods sold, interest expense, and selling, general, and administrative expenses divided by book equity for the last fiscal year end in t-1. You cannot invest directly in an index.

Historical performance is not an indication of future performance and any investments may go down in value.

In Figure 1, the High-Quality portfolio, which includes the 30% stocks with the highest operating profitability in the Global Developed Equities universe, outperforms the Low-Quality Portfolio (which includes the 30% stocks with the lowest operating profitability) by more than 4.5% per annum since 1990. The High-Quality Portfolio also outperforms the market by 1.4% per annum while delivering lower volatility, demonstrating its credentials as a recognised equity factor. Historically, Quality stocks have exhibited higher long-term returns and lower volatility, which creates a very attractive risk-return profile for core holdings in investors' portfolios.

Steady as Quality goes

Quality stocks benefit from strong business models and steady financial results over time. Their financial performance is, therefore, more consistent and predictable from one period to the next. When building investment strategies focused on Quality stocks, this translates into steady, robust returns in a large array of market scenarios. When compared with other equity factors, the Quality factor tends to deliver more consistent periods of outperformance.

Figure 2: Rolling 10Y annualised performance of US factors versus US equities as a whole

Sources: WisdomTree, Ken French, data as of 31 July 2022 and represents the latest date of available data. Value: High 30% Book to Price portfolio. Size: Low 30% portfolio. Quality: High 30% portfolio. Low Vol: Low 20% portfolio. High Div: High 30 portfolio. Market: all CRSP firms incorporated in the US and listed on the NYSE, AMEX or NASDAQ.

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In Figure 2, we show the rolling outperformance of different equity factors versus the US equity markets over periods of 10 years. We observe that Size outperforms in 61% of the period. In other words, an investor holding a small-cap investment for ten years (at any point between 1960 and 2022) would have had six chances out of 10 to outperform. Other factors exhibit outperformance around 70% of the time. Quality stands out with a historical occurrence of outperformance of 88%.

While the Quality factor in many years may feel more like the Tortoise than the Hare, let's not forget La Fontaine's old adage, "slow and steady wins the race".

Weathering uncertainty and market drawdowns by focusing on highly profitable stocks

When investing strategically in equities, investors should look for strategies that can weather unexpected and unpredictable events. Core holdings need to be able to withstand drawdowns as they do not have a vocation to be traded in and out of the portfolio at every sign of trouble.

Quality is not the only defensive factor, of course. It is not, in fact, the most defensive factor, a mantel that Min Volatility claims easily. It is a defensive factor nonetheless, and it has demonstrated time and time

again that it can protect investors' portfolios when equity markets turn south. Looking at the last 60 years, we can see that in 12 out of the 15 worst months in US equities, the Quality factor cushioned the drop and lowered the drawdown. In April 2022, for example, US equities lost -9.45% when the Quality factor lost only -7.73%, an improvement of 1.72%. Or in March 2020, US equities lost -13.26% when the Quality factor lost only -10.62%, an improvement of 2.64%

Figure 3: Performance of the Quality factors in the worst 15 months for US equities since 1963

Source: Kenneth French data library. Data is at a monthly frequency and as of 31 December 2022. Stocks are selected as above the median market cap, with quality representing the top 30% by operating profitability. The market represents the portfolio of all available publicly listed stocks in the US. All returns are in USD. Operating profitability for year t is annual revenues minus cost of goods sold, interest expense, and selling, general, and administrative expenses divided by book equity for the last fiscal year end in t-1. You cannot invest directly in an index.

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This is also the case over longer time periods. During the Covid Crisis (between February and March 2020), the MSCI world lost -34% when Quality lost -30.2%[2] cushioning the blow by 3.8%. In 2008, Quality reduced the drawdown by 5.9%[2], and in 2022, it reduced it by 4.27%[2].

Overall, the Quality factor delivers outperformance in most crises, providing well-needed respite to investors when they need it the most. However, contrary to other defensive factors, they can also participate in the upside, making them an ideal candidate for long-term investments.

The all-weather factor

Over the long term, the key to a successful investment is to capture more of the upside than of the downside. A strategy that demonstrates such an asymmetric profile will thrive over the long run. Figure 4 shows the upside capture and downside capture ratio of the Quality factor versus other strategies calculated on monthly returns. The upside capture ratio is the percentage of market gain captured by a strategy when markets go up, and the downside capture ratio is similarly the percentage of market losses endured by a strategy when markets go down.

Figure 4: Upside and downside capture ratio of various equity factors and peer

Source: WisdomTree, Bloomberg. Period September 2002 to December 2022. Calculations are based on monthly returns in USD. Quality is proxied by WisdomTree Global Quality Dividend Growth UCITS net TR Index. Min Vol is proxied by MSCI World Min Vol net TR Index. Value is proxied by MSCI World Enhanced Value net TR Index. Size is proxied by MSCI World Small Cap net TR Index. You cannot invest directly in an index. Above numbers include backtested data.

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Strategies that sit above the grey line have a strong advantage over the ones sitting below the line. Their Upside Capture ratio is bigger than their Downside Capture Ratio, which means that they capture more of the upside when the market is up than they lose when the market is down.

Quality is the strategy furthest above the line, so it benefits from having a very asymmetric profile with an upside capture ratio of 95% and a downside capture ratio of only 87%. In other words, it is a factor that can both grow and defend.

Looking at our list of 4 characteristics, Quality investments tick all the boxes. Anchored in academic research, Quality strategies have the strength to grow over the long term and also to weather any temporary storm. This makes Quality a worthy candidate for a strategic, long-term, core investment in equities.

[1] Source: (Fama and French, A Five-Factor Asset Pricing Model 2014).

[2] Source: WisdomTree, Bloomberg. Periods of 12 February 2020 to 13 March 2020, 31 December 2007 to 31 December 2008 and 31 December 2021 to 31 December 2022. Calculations are in USD. Quality is proxied by the WisdomTree Global Quality Dividend Growth UCITS net TR Index. **You cannot invest in an index. Above numbers include backtested data. Historical performance is not an indication of future performance and any investments may go down in value.**

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