

Quality for uncertain times

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Pierre Debru

Head of Research, WisdomTree Europe.

In the last few months, market visibility has significantly declined. The Ukraine War created major geopolitical uncertainty. Inflation and Central Banks' hawkish stands weigh developed economies and growth expectations. Quite logically, volatility is back in the markets. While the 20 days historical volatility of the MSCI World hovered around 10% for most of 2021, it has now increased sharply with current levels between 20% and 25%¹. After sharply correcting in January and February, markets now appear to move sideways.

In such uncertain times, many investors are contemplating reducing risk in their portfolios. Still, a reallocation from equity to fixed income logically loses some of its appeal when interest rates may be on the verge of snapping a 40-year downtrend. Shifting equity exposures toward higher Quality, more robust equity names could help protect the downside while maintaining exposure to the upside.

Quality for lower visibility and increasing volatility in markets

Profitability as a proxy for Quality. It captures the outperformance of highly profitable firms that can continue to thrive in difficult economic and market conditions thanks to strong proven business models. Such companies tend to be in demand when investors start to worry about future outcomes and when economic visibility is reduced, leading to outperformance in high volatility and end of cycle periods.

In Figure 1, we compare the behaviour of highly profitable companies and less profitable companies in different volatility regimes. To do so, we calculate the 20day rolling historical volatility of US equities since 1963 and split the periods into five groups (quintiles) based on the level of volatility. Quintile #1 regroup the one-fifth of the periods with the lowest observed volatility (all periods with volatility below 8.1% annualised). Quintile #5 regroup one-fifth of the periods with the highest observed volatility (all periods with volatility above 17.5% annualised).

Figure 1: Behaviour of highly profitable companies and less profitable companies in different volatility regimes

Source: Kenneth French data library. Data is calculated at a daily frequency from July 1963 to February 2022. Stocks 'High Quality' represent the top 30% by operating profitability, and 'Low Quality' represent the bottom 30% by operating profitability. The portfolios are rebalanced yearly at the end of June. 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 $t-1$.

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

We observe that less profitable, low-quality companies tend to outperform in periods of low volatility (in Quintile #1), but their average underperformance increases with the volatility.

On the contrary, highly profitable, high-quality companies see their outperformance increase with the volatility. In other words, highly profitable companies tend to act as a safe haven for investors in periods of stress and high volatility, leading to the highest outperformance in those periods.

It is worth noting as well that those high-quality companies historically outperform in all five volatility regimes. This is why Quality is considered the "all-weather" factor:

- Can help investors build wealth over the long term
- Can weather the inevitable storms along the way

It is worth noting, after a long period of relatively low volatility between March 2021 and November 2021, the US markets have gone through two periods of high volatility recently: one in December 2021 and one ongoing since Jan 2022.²

Figure 2: US equity market and volatility levels since 2019

Source: Kenneth French data library. Data is calculated at a daily frequency from December 2019 to February 2022. The market represents the portfolio of all available publicly listed stocks in the US. All returns are in USD.

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Since quality companies generate high revenues, they can grow and compound wealth in the future. Thanks to their solid business models and financial strength, they can withstand unexpected events such as economic downturns or geopolitical shocks.

Quality for inflationary times

In inflationary times, companies' bottom line live or die by their pricing power, i.e., their capacity to increase prices in line with their costs. Often, pricing power and high-quality business go hand in hand. In the word of Chairman and CEO Warren Buffet, "If you've got the power to raise prices without losing business to a competitor, you've got a very good business, and if you need a prayer session before raising the price by a tenth of a cent, you've got a terrible business."³

Highly profitable companies with a high return on equities and a high return on assets tend to display such high pricing power. Using such fundamental screens tend to unearth:

- Luxury companies such as Moët Hennessy Louis Vuitton (LVMH), L'oreal or Hermes
- Companies with strong brands like Apple or Coca Cola

Let's take Apple for example, their products are often recognized as "the best" in the industry. It gives the company the right to charge a premium over its competitors. Apple's pricing power is obvious, looking at the price of a top shelf iPhone since 2008 in Figure 2. When the Consumer Prices Index ("CPI") grew by 25.6% over the period, the price of the iPhone went up by 128%. Yet Apple's sales numbers remained very high.⁴

Figure 3: Evolution of the price of iPhones versus inflation

Source: WisdomTree, Bloomberg and GSMArena.com. Date from July 2008 to September 2021.

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Quality in the Value versus Growth debate

With the beginning of the rate hiking cycle in the UK and the US, investors have started to worry about the implied duration in their equity portfolio. This led to a sharp outperformance of value stocks versus growth stocks over the last 3 to 4 months. The Quality factor ended up caught in the crosshairs.

Using fundamental filters to find quality stocks with no other considerations will often lead to a growth bias that can be detrimental to the strategy in the current market environment. The MSCI USA Sector neutral quality is a clear example of this bias at the moment. Its methodology does not control for its value or growth exposure leading to Growth being the 3rd biggest factor exposure in the portfolio after Profitability and Momentum⁵. Year to date, this led to underperformance of -3.3% versus the S&P 5006.

However, it is possible to find high-quality stocks in all parts of the market, in all sectors, in all factors. It is possible to find high-quality stocks that are cheaper than the market. Building a high-quality strategy with a value tilt is possible, for example, if the investment process is built with valuations in consideration. Quality orientated strategies that factor in value metrics in their processes have tended to do better this year.

1 MSCI, as of 2nd April, 2022

3 Andrew Frye, Daking Campbell, 'Buffett says pricing power is more important than good management,' Bloomberg, February 18, 2011

5 WisdomTree, Bloomberg. As of 28th March 2022. Analysis is run on holdings using PORT in Bloomberg. Factor definitions and calculations are explained in "US Equity Fundamental Factor Model" which is available in PORT Help in Bloomberg. **Historical performance is not an indication of future performance and any investments may go down in value.**

6 WisdomTree, Bloomberg. From 31st December 2021 to 28 March 2022. You cannot invest in an index. **Historical performance is not an indication of future performance and any investments may go down in value.**

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