The “Buffett Factor” Revisited

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Berkshire Hathaway Inc. Acquisition Criteria[1]

Demonstrated consistent earnings power

Businesses earning good return on equity (ROE) while employing little or no debt

The key phrase is “businesses earning good returns on equity while employing little or no debt.” However, the quality discussion within equity investing has a long history, and Warren Buffett certainly isn’t the only one to mention it.

Benjamin Graham’s Quality Criteria One of Warren Buffett’s teachers, Benjamin Graham, who is known as one of the fathers of value investing, also had a rigorous focus on quality traits. Many focus on Graham’s criteria for finding inexpensive companies, but he was at least equally focused on attributes of quality, if not more so.

Benjamin Graham’s Attributes of Quality[2]

“Adequate” enterprise size, as insulation against the “vicissitudes” of the economy

Strong financial condition, measured by current ratios that exceed 2 and net current assets that exceed long-term debt.

Earnings stability, measured by 10 consecutive years of positive earnings

A dividend record of uninterrupted payments for at least 20 years

Earnings-per-share growth of at least one-third over the last 10 years

Fama-FrenchOperating ProfitabilityFactor

Research done by Kenneth French and Eugene Fama arrives at a similar place. In their research piece “A Five-Factor Asset Pricing Model” from September 2014, they cite operating profitability, defined as annual revenues minus cost of goods sold, interest expense and selling, general and administrative (SG&A) expenses, all divided by book value of equity. Note, this is similar to Buffett’s criteria above: a company earning a good return (profits) on its equity (book value)—in other words, a high ROE. Arranging the U.S. market into quintiles based on operating profitability further emphasizes that high-quality stocks have won over longer holding periods.

The Spectrum of Operating Profitability Quintiles from June 30, 1963, to June 30, 2015

- **Top Two Quintiles Outperformed the Market:**We saw the top two quintiles outperform the market on two fronts—average annual returns andSharpe ratio. In other words, this outperformance was not achieved with a significant increase in risk.

Grantham on Why Quality May Outperform over Long Periods One of the long-standing investment practitioners of quality investing has been Jeremy Grantham's firm, GMO. In a paper written in 2004[3], GMO wrote of quality firms:

- WisdomTree Europe SmallCap Dividend UCITS ETF (DFE)
- WisdomTree US SmallCap Dividend UCITS ETF (DESE)
- WisdomTree Emerging Markets SmallCap Dividend UCITS ETF (DGSE)

All data is sourced from WisdomTree Europe and Bloomberg, unless otherwise stated.

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