momentum

weekly digest

Week ending 12 November 2017

global investment management

Why Quality is up our Street

The awareness of value and (to a lesser extent) momentum factors within equity markets is undeniable, with a huge amount of academic research and publications dedicated to both, and with many famous investors following these styles. As a result, they are typically well understood and well defined. In short, value investors seek stocks they believe to be under-priced by the market, focusing on low valuation multiples, for example, price to earnings or price to book. On the other hand, momentum investors seek stocks with positive price momentum over the previous six or twelve month periods.

In contrast, there has been far less research written about (high) quality as an investment factor or style. Unlike value and momentum styles, any risk premium associated with quality stocks is not widely understood or accepted. Despite this, quality investing has risen hugely in popularity in recent years due to strong outperformance during risk-off periods, particularly during the global financial crisis and European debt crisis, and due to investors' elevated levels of risk aversion.

Quality is often a very subjective concept; few investors would argue that they invest in anything but high quality businesses and yet resultant portfolios across similar managers can vary wildly! At Momentum we use a focused definition in order to evaluate quality strategies and to help us construct robust portfolios. Simply put, we define quality businesses as those that have demonstrated a high and stable level of profitability over the long term. These businesses typically benefit from strong economic 'moats' (defendable competitive advantages) which enable them to sustain above average returns over longer periods. Our focus on stability generally excludes stocks in highly cyclical or competitive industries, focusing instead on genuinely resilient businesses which are more often found in industries with low sensitivity to business and economic cycles. These attributes must be assessed over a long time period, preferably a couple of business cycles, as profitability is more likely to be maintained going forward if it has been achieved persistently across different economic environments.

The businesses that fit these criteria typically demonstrate low leverage with strong cash flow generation, high margins, a stable and growing dividend and usually an asset-light model with low reinvestment requirements. While these are all characteristics of quality companies, screening for these attributes alone can easily lead to the inclusion of lower quality businesses, especially if one only looks at the recent history.

Unsurprisingly, focused portfolios of genuinely high quality and high return businesses have generated strong excess returns over the long term. Much of their outperformance versus market indices has come during market or economic downturns; but the quality style has often kept up with the market or even outperformed in strong equity markets, including recently. This has led many investors to conclude that quality stocks are overvalued. Indeed the holdings of a global quality ETF trades at an aggregate forward price earnings multiple of approximately 18x, compared to the broad market at 16x next years projected earnings. However, the quality portfolio has a much higher return on equity of 28% versus 13% for the broad market. This difference in returns more than justifies the valuation difference (and then some) as the portfolio can compound profits at a much higher rate. This discrepancy has long been observed across global markets, due to a wide number of reasons that are beyond the scope of this blog! Suffice to say that our long term modelling indicates that the majority of quality stocks remain reasonably priced at current levels and offer good potential returns for long term investors.

Despite this, it is important to recognise the risk of overpaying for quality stocks as valuation is critical in determining expected returns, whatever the quality. In addition, there are risks of quality deterioration, demonstrated by declining profitability; potentially due to a weakening economic moat, a lack of innovation or management changes. Due to these inherent risks, investors should be cognisant of the investment vehicle they utilise to gain quality stock exposures. Investors interested in quality stocks can typically gain exposure by investing with certain focused active managers, a quality index ETF or a smart-beta fund. Either way, risks such as the above should be carefully considered on an ongoing basis.

At Momentum, we have invested in quality strategies for many years and believe it plays a key role in all our portfolios, particularly as a complement to other styles within portfolios. Quality strategies are a valuable tool for our Outcome Based Investing approach as the stable returns profile and defensive qualities ensure a more steady growth path to achieving investor aims without sacrificing returns.

The Marketplace

- US, UK and European stocks sell off
- Investor concerns over US tax reform plans
- Saudi Arabia continues anti-corruption reforms
- EU Commission downgrades UK GDP growth forecasts
- Brent crude oil hits two and a half year highs

Market Focus

US

- The Senate released their draft version of the tax bill, including some notable differences to the House's draft. In particular, the one year delay for corporate tax cuts and the retention of seven tax brackets rather than the consolidated four. This, in addition to the controversial suggested revenue sources proposed by the House, weighed on investors' confidence around meaningful tax reforms.
- OPEC expects North American shale output to increase to 7.5 million barrels in 2021, almost 56% higher than estimates made last year. OPEC's output cuts have facilitated an oil price recovery that has supported US shale producers.
- Tax reform concerns and weaker than expected earnings reports contributed to the 0.2% fall in US equities and the 0.6% fall in the US Dollar on a trade weighted basis. Meanwhile, US Treasuries fell 0.3%.

UK

- The European Commission cut 2017 GDP growth forecasts for the UK to 1.5% down from estimates in the spring of 1.8%. 2018 growth is forecasted to be 1.3%.
- Reports suggest 40 Conservative MPs have agreed to sign a letter of no confidence in Prime Minister Theresa May.
- International development secretary Priti Patel resigned after admitting to holding several unauthorised meetings with Israeli officials. This is the second ministerial resignation in a week following the resignation of Sir Michael Fallon last Wednesday.
- During the week, Sterling rose 1.7% on a trade weighted basis, while retail stocks declined amidst slowing consumer spending. Both partially contributed to the 1.6% fall in UK equities.

Europe

- Euro area GDP growth forecasts were raised by the European Commission to 2.2% in 2017 and 2.1% in 2018, up from estimates in the spring of 1.7% in 2017 and 1.8% in 2018.
- Germany's September trade surplus beat expectations at USD 24.1 billion, versus USD 22.3 billion expected.
- The final PMI reading for the Eurozone in October was revised up 0.1 points to 55.0, suggesting Q4 GDP growth could beat current expectations.
- Brent crude oil rose 2.3% during the week, to close at $63.52. Mid-week price highs were the highest since June 2015. This follows Saudi Arabia's anti-corruption program, and their current tensions with Iran.
- European stocks declined 2.1%, partially driven by declines in mining shares and investors taking profit on recent strong performing stocks.

Rest of the world

- Saudi Arabia has continued to step up its anti-corruption program, ordering banks to freeze personal bank accounts of many individuals who have not yet been arrested.

Source: Bloomberg. Returns in local currency unless otherwise stated.

Stephen Nguyen (CFA) & Oliver Cooper

Asset class/region	Currency	Currency returns			
		Week ending 10 November	Month to date	YTD 2017	12 months
Developed markets equities					
United States	USD	-0.2%	0.3%	16.7%	20.8%
United Kingdom	GBP	-1.6%	-0.7%	7.6%	12.8%
Continental Europe	EUR	-2.1%	-1.7%	12.4%	20.1%
Japan	JPY	0.4%	2.0%	20.9%	33.6%
Asia Pacific (ex Japan)	USD	0.7%	1.7%	34.3%	31.4%
Australia	AUD	1.4%	2.3%	10.5%	18.2%
Global	USD	-0.2%	0.2%	18.5%	22.2%
Emerging markets equities					
Emerging Europe	USD	2.0%	1.3%	15.9%	27.4%
Emerging Asia	USD	0.3%	1.4%	40.8%	36.2%
Emerging Latin America	USD	-0.6%	-1.8%	19.9%	21.5%
BRICs	USD	1.2%	1.9%	39.6%	37.5%
MENA countries	USD	-1.4%	-1.3%	-2.6%	4.8%
South Africa	USD	-0.2%	0.1%	15.0%	17.8%
India	USD	-2.3%	-1.2%	32.8%	25.8%
Global emerging markets	USD	0.2%	0.9%	33.4%	31.8%
Bonds					
US Treasuries	USD	-0.3%	-0.1%	2.1%	0.8%
US Treasuries (inflation protected)	USD	-0.1%	0.1%	2.2%	1.0%
US Corporate (investment grade)	USD	-0.7%	-0.6%	5.0%	4.5%
US High Yield	USD	-0.8%	-0.8%	6.6%	9.1%
UK Gilts	GBP	-0.5%	0.0%	0.1%	2.0%
UK Corporate (investment grade)	GBP	-0.7%	-0.1%	3.0%	5.0%
Euro Government Bonds	EUR	-0.4%	-0.3%	0.4%	0.7%
Euro Corporate (investment grade)	EUR	-0.3%	-0.2%	2.7%	2.8%
Euro High Yield	EUR	-0.7%	-0.4%	6.9%	8.4%
Japanese Government	JPY	0.2%	0.3%	0.1%	-1.3%
Australian Government	AUD	-0.2%	0.4%	3.7%	2.3%
Global Government Bonds	USD	0.1%	0.0%	5.3%	1.6%
Global Bonds	USD	0.0%	-0.1%	5.9%	3.0%
Global Convertible Bonds	USD	-0.1%	-0.1%	9.8%	9.2%
Emerging Market Bonds	USD	-0.8%	-1.8%	6.5%	5.9%

Source: Bloomberg. **Past performance is not indicative of future returns**

Asset class/region	Currency	Currency returns Week ending 10 November	Month to date	YTD 2017	12 months
Property					
US Property Securities	USD	2.1%	3.2%	4.8%	12.8%
Australian Property Securities	AUD	4.3%	4.6%	1.3%	10.4%
Asia Property Securities	USD	0.8%	2.0%	26.0%	20.6%
Global Property Securities	USD	1.2%	2.0%	13.8%	17.7%
Currencies					
Euro	USD	0.5%	0.1%	10.8%	7.0%
UK Pound Sterling	USD	1.0%	-0.6%	6.8%	5.1%
Japanese Yen	USD	0.7%	0.2%	3.1%	-5.9%
Australian Dollar	USD	0.2%	0.0%	6.4%	0.6%
South African Rand	USD	-1.1%	-1.7%	-4.8%	-2.3%
Swiss Franc	USD	0.6%	0.1%	2.4%	-0.9%
Chinese Yuan	USD	-0.3%	-0.3%	4.6%	2.4%
Commodities & Alternatives					
Commodities	USD	1.1%	2.3%	3.0%	9.2%
Agricultural Commodities	USD	0.3%	0.7%	-2.8%	-2.5%
Oil	USD	2.3%	3.5%	11.8%	38.6%
Gold	USD	0.6%	0.5%	10.7%	1.4%
Hedge funds	USD	-0.3%	-0.3%	4.8%	6.3%

Source: Bloomberg. **Past performance is not indicative of future returns**

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