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# TRIVARIATE RESEARCH

## IF HIGH QUALITY DOESN'T WORK, DOES IMPROVING QUALITY WORK?

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## BACKGROUND AND RESEARCH SUMMARY

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**Background:** It has now become increasingly accepted that high-quality has not been working as an investment factor. The median high-quality stock has a price-to-forward earnings four turns **lower** today than pre-COVID, whereas the median junk stock has seen no multiple contraction. The result is that stock pickers need to utilize different signals to pick high-quality stocks. Recently, price momentum has failed among high-quality stocks, even while it has been a key signal elsewhere. 83% of the S&P500's market capitalization is now top-half quality, fueling our judgment that S&P500-indexed investors should have approximately 70% of their portfolio in top half quality, enabling them to accurately tell their investors that they are quality-biased at the same time they are actively underweight. As this dynamic has become more well understood, many investors have asked us if they should focus on **IMPROVING** quality – i.e., change in the quality ranking – as opposed to level.

**Testing change in quality:** We ranked all stocks on our “raw” quality score and looked for the performance of those that improved quality the most vs. those where it deteriorated the most. That strategy worked well from 2005-2008 but has sharply failed since 2011 and even recently. This also hasn't added value looking at relative-to-industry-group returns. **Buying stocks following an improvement in their quality score is not an effective strategy.**

**Does type of stock matter?:** We wondered if there was something confounding happening where buying improving quality worked in some parts of the market, but not in others. We looked at absolute and relative-to-industry group returns for improving quality scores among Financials, Dividend payers, and the rest of the market. Among Financials, the strategy cumulatively generates less than 2% per year, though that mostly was into the Financial Crisis. For all the Dividend paying non-Financials, the strategy has never worked. The non-Financials / non-Dividend paying – like a lot of Technology – this worked until 2011 or so and has failed since. **Hence, buying high-quality stocks, or stocks where quality just improved, doesn't result in outperformance.**

## RESEARCH SUMMARY

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Change in quality has no predictive power: We analyzed the performance of stocks within the starting quality bucket (high, mid, low, junk) to see if change in quality mattered. We found it was somewhat helpful to own the high-quality stocks with improving quality and avoid the high-quality stocks with deteriorating quality (Q1 minus Q5) on change in quality from 1999-2009, and from 2015 until a year ago, though this has sharply failed over the last twelve months. Isolating it to just high-quality stocks, we found that improving quality among the highest-quality bucket was a decent strategy until the last year. Avoiding high-quality stocks in the bottom two quintiles – i.e., quality is getting worse- has consistently been a good investment strategy. Our conclusion is to look for high-quality stocks where quality is not getting worse. It is unclear why there has been a recent sharp failure.

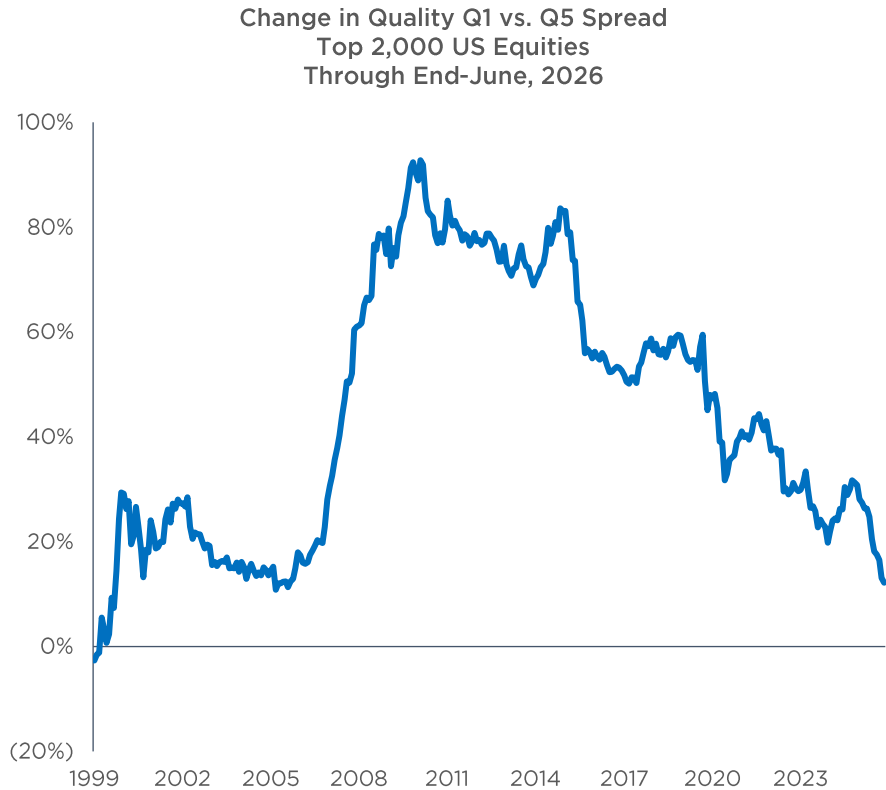
But it has some contemporaneous efficacy: Given quality improvement has little predictive power over future equity returns, we wanted to see if the change in quality was being priced in before the change occurs. Quality improvement has worked historically for value stocks and junk stocks – contemporaneously but doesn't work for growth or higher quality even as a coincident metric.

CONCLUSION: A strategy of buying stocks that are high-quality or buying stocks where the quality has already demonstrably improved bears no fruit. Investors looking to play the quality game are best suited to either:

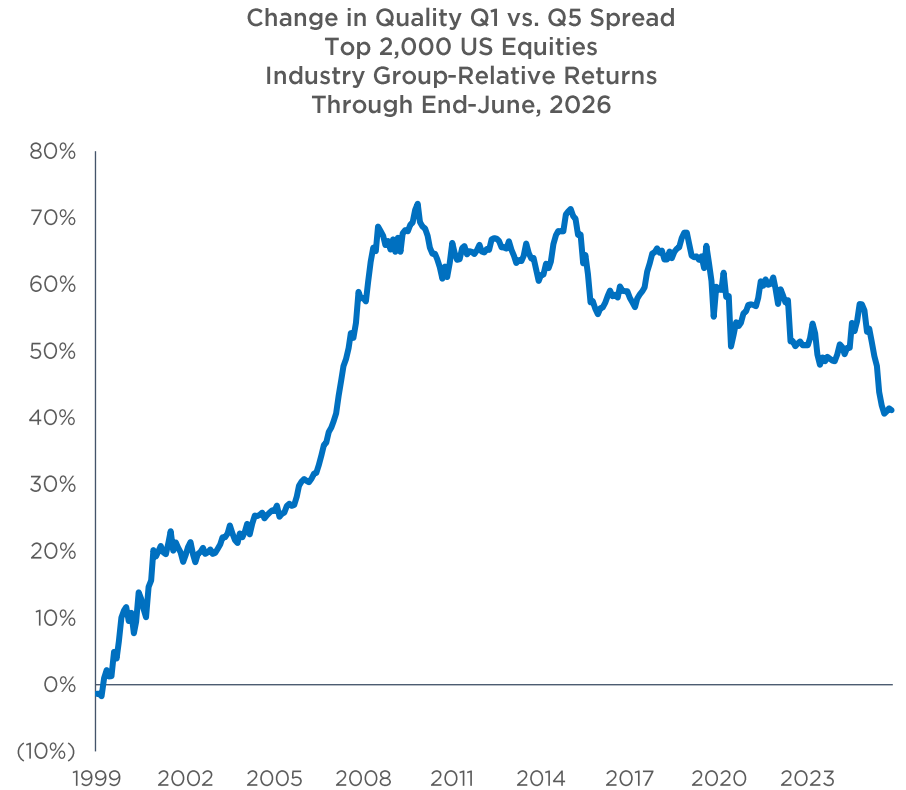
- 1) Own high-quality stocks where revenue is growing fast, and where the quality is not deteriorating.
- 2) Own companies that they think will improve quality, but where it is not yet in evidence.

# BUYING STOCKS THAT ARE IMPROVING QUALITY DOESN'T WORK

We believed this approach was logical, and some of our clients were inquiring whether they should focus on improving quality, given that high-quality strategies have not been working as expected. It seemed to us that buying low-quality or junk stocks that migrate to higher quality would be a productive strategy. We ranked all stocks on our “raw” quality score and looked for the performance of those that improved quality the most vs. those where it deteriorated the most (left). That strategy worked well from 2005-2008 but has sharply failed since 2011 and even recently. This also hasn't added value looking at relative-to-industry-group returns. Buying stocks following an improvement in their quality score is not an effective strategy.



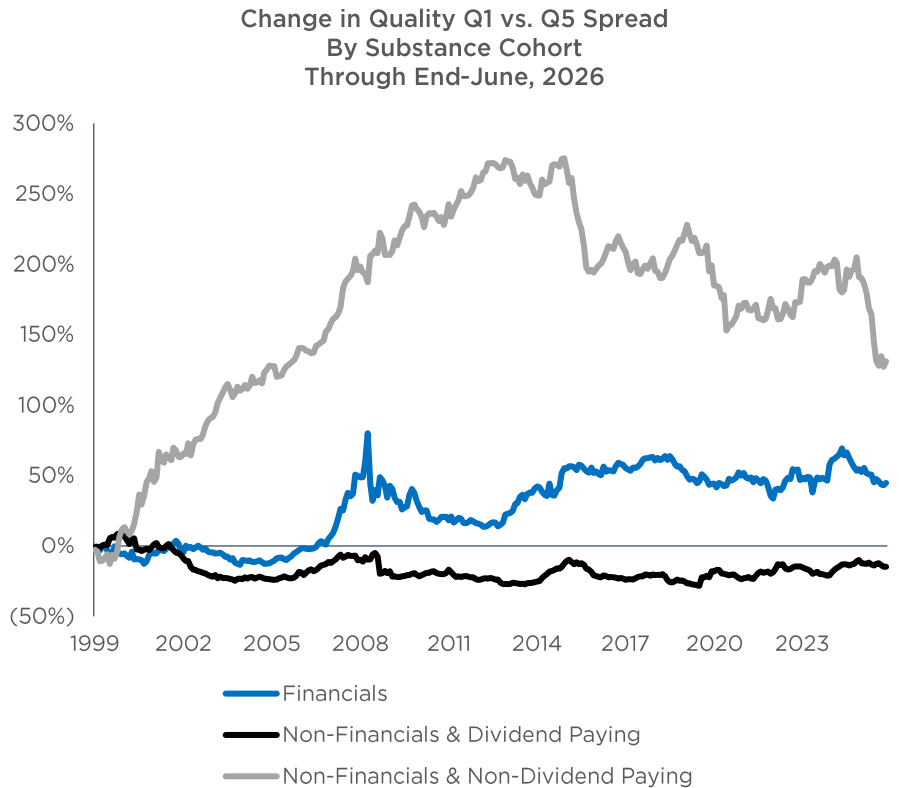
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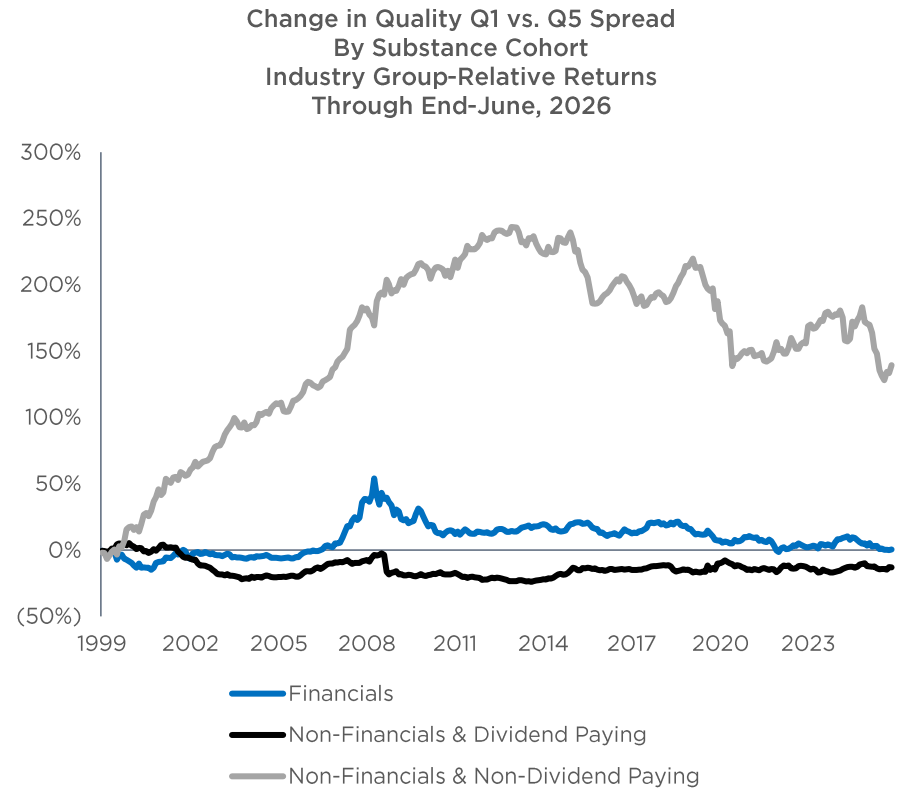
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# IT NEVER WORKED EXCEPT UNTIL 2011 IN PARTS OF THE MARKET

We wondered if there was something confounding happening where buying improving quality worked in some parts of the market, but not in others, given the premise seems so logical. We looked at absolute (left) and relative-to-industry group returns (right) for improving quality scores among Financials, Dividend payers, and the rest of the market. Among Financials, the strategy cumulatively generates less than 2% per year, though that mostly was into the Financial Crisis. For all the Dividend paying non-Financials, the strategy has never worked. The non-Financials / non-Dividend paying - like a lot of Technology - this worked until 2011 or so and has failed since.



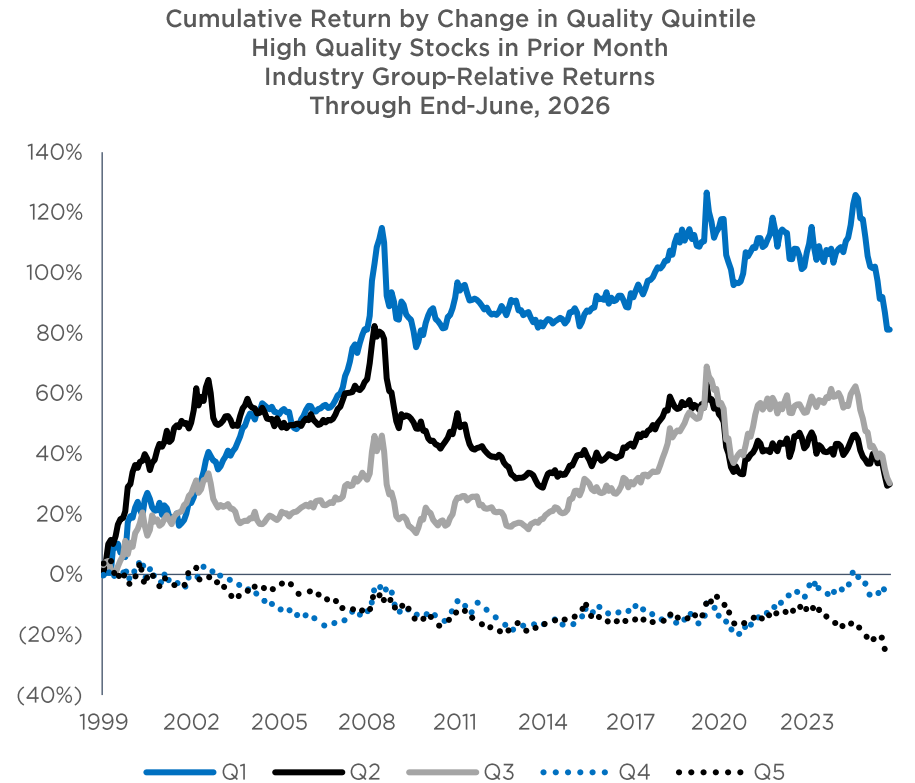
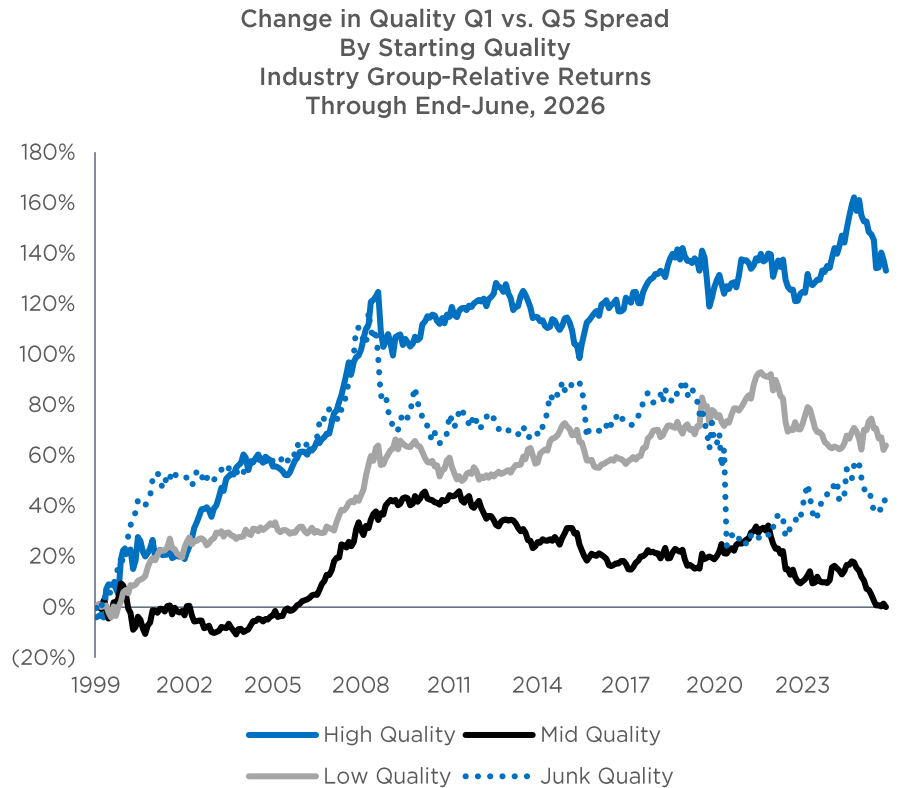
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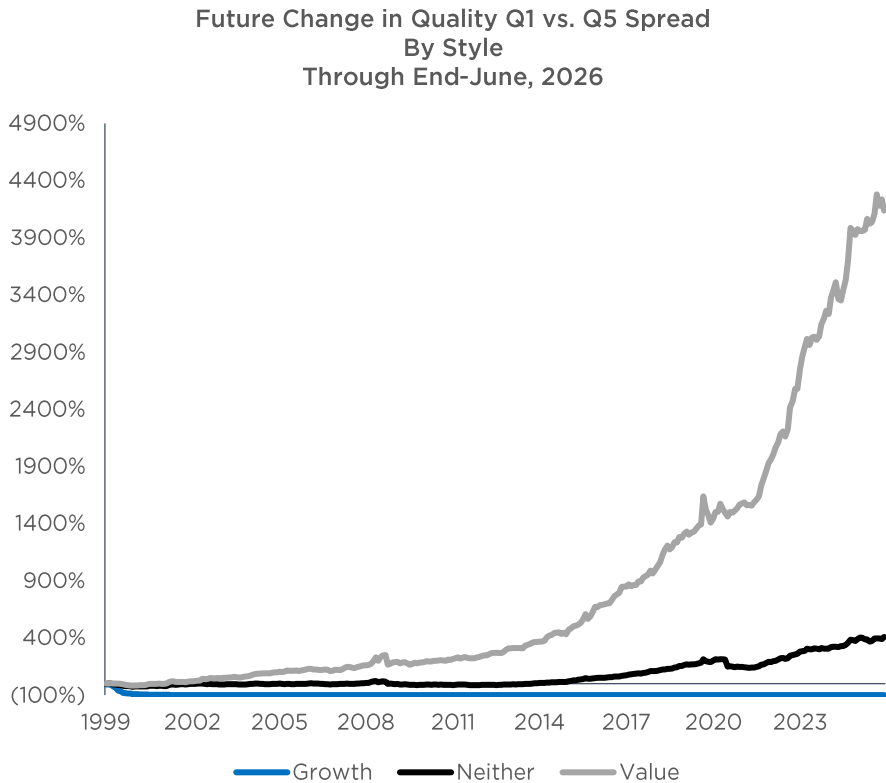
# RECENTLY HIGH-QUALITY STOCKS WITH IMPROVING QUALITY FAILED

We analyzed the performance of stocks within starting quality bucket (high, mid, low, junk) to see if change in quality mattered. We found it was somewhat helpful to own the high-quality stocks with improving quality and avoid the high-quality stocks with deteriorating quality (Q1 minus Q5) on change in quality from 1999-2009, and from 2015 until a year ago, though this has sharply failed over the last twelve months (left). Isolating it to just high-quality stocks (right), we found that improving quality among the highest-quality bucket was a decent strategy until the last year. Avoiding high-quality stocks in the bottom two quintiles – i.e., quality is getting worse- has consistently been a good idea. Our conclusion is to look for high-quality stocks where quality is not getting worse. We don't have a great logical explanation for the recent sharp failure.

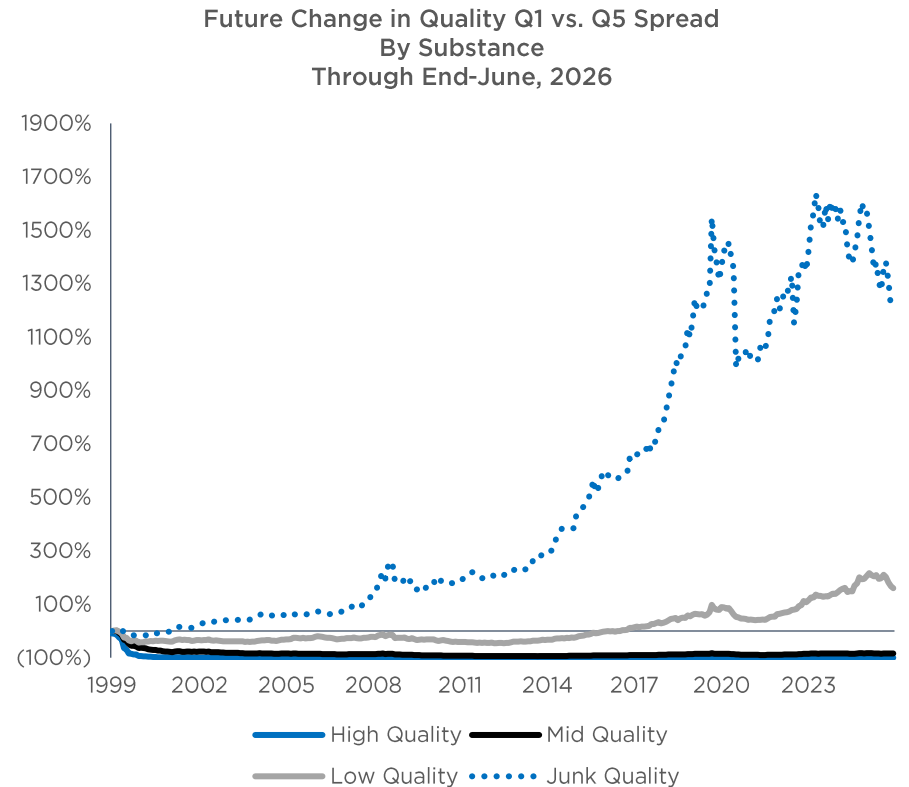


# IMPROVING QUALITY WORKS CONTEMPORANEOUSLY

Given quality improvement has little predictive power over future equity returns, we wanted to see if the change in quality was being priced in **after** it occurs. Below we show the Q1 vs. Q5 spread using quintiles of the *future* 1-month change in quality. Quality improvement works particularly well among Value stocks (left) and Junk stocks (right).



Source: Trivariate Research



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