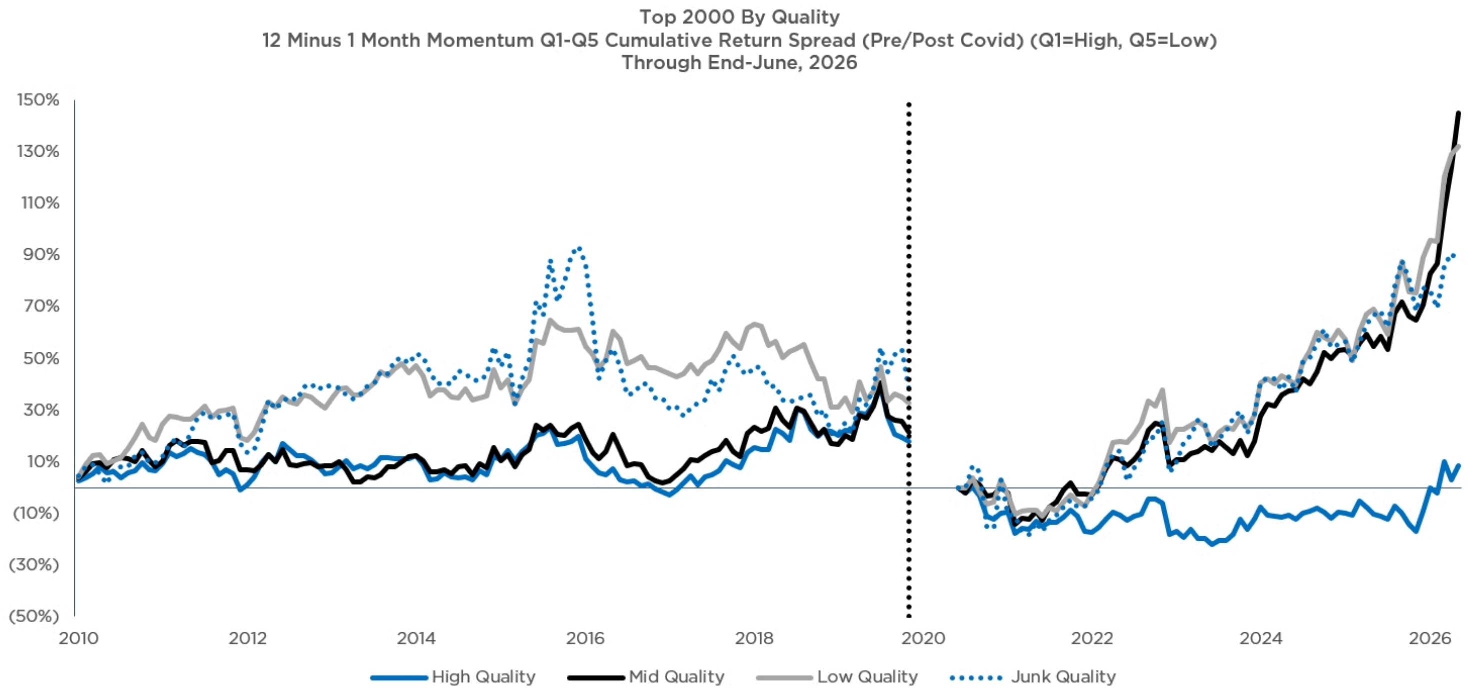
Level Set - The High Quality Pushback from our High-Quality Work

Last Tuesday we published our second half 2026 outlook (LINK HERE) and hosted a webcast with live Q&A (REPLAY HERE, Password: 15e!t+E@). As is customary after our year-ahead and mid-year outlooks, we use the following Sunday's Level Set to address the areas where we received the most investor commentary, feedback, and pushback.

The area where we received the most follow-up was on our new work on quality. We have been writing for some time that we don't think buying high-quality stocks and shorting junk stocks generates any excess return. We have shown that strategy has cumulatively failed for six years now, and that the signals used to buy high-quality stocks effectively have markedly changed over the past few years. We were asked by our clients several times this spring to analyze two things:

1. What to avoid among high-quality stocks
2. What about companies that are improving in quality

We analyzed these questions as part of the second half outlook, and the results weren't particularly encouraging. One observation we thought was quite telling was that momentum, which has been incredibly effective as a factor over the last few years, has not worked among high-quality stocks (see below).



Source: Trivariate Research,LP

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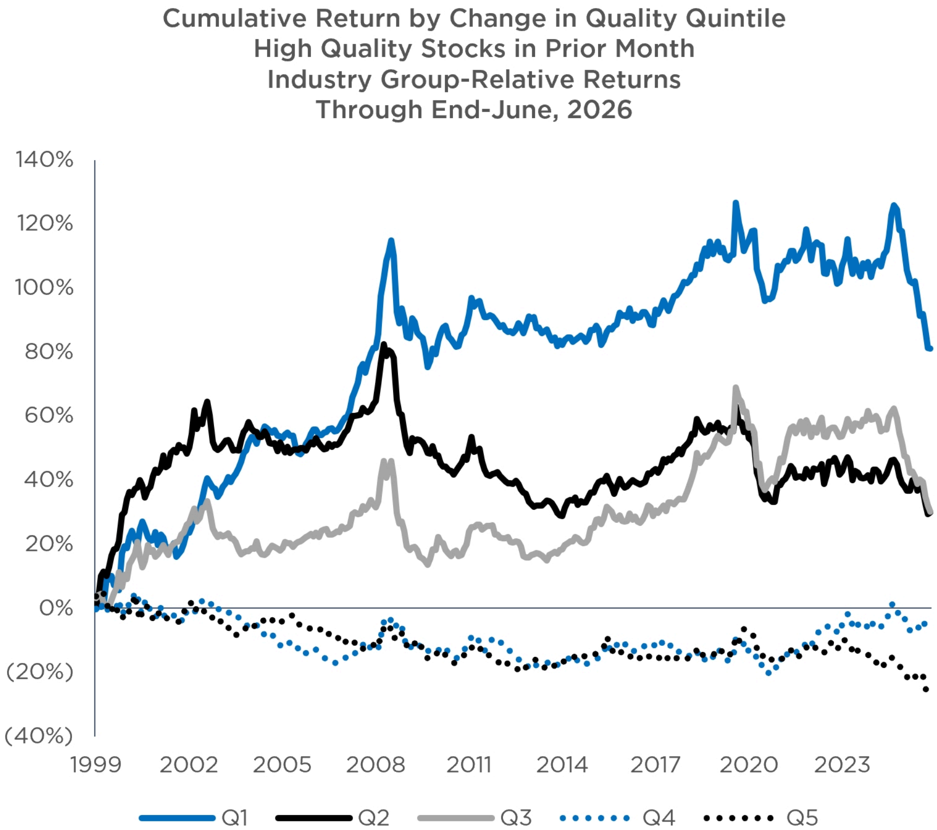
Today, there are many mega- and large-cap. high-quality stocks that have had poor 12-month price momentum, including MSFT, META, NFLX, TMUS, and ABT, among others (see below). However, high-quality not working isn't because of the recent weakness of parts of the Great 8. In fact, the failure of momentum among high-quality above is computed equally-weighted, and represents "high-quality" the weakness among the diverse group of stocks below.

Mega-Large Cap. High-Quality Stocks with Poor Price Momentum
Through July 8th, 2026

Tickers	Stocks	Industry	Market Cap.	12-Month Momentum
MSFT	Microsoft Corporation	Software	2888.5	(21.4%)
META	Meta Platforms, Inc.	Interactive Media & Services	1562.6	(14.1%)
NFLX	Netflix, Inc.	Entertainment	320.8	(41.3%)
TMUS	T-Mobile US, Inc.	Wireless Telecommunication Services	199.9	(21.8%)
ABT	Abbott Laboratories	Health Care Equipment & Supplies	166.9	(27.3%)
ISRG	Intuitive Surgical, Inc.	Health Care Equipment & Supplies	151.3	(21.5%)
UBER	Uber Technologies, Inc.	Ground Transportation	151.3	(20.6%)
BKNG	Booking Holdings Inc.	Hotels, Restaurants & Leisure	141.0	(19.8%)
SPGI	S&P Global Inc.	Capital Markets	131.3	(11.4%)
SYK	Stryker Corporation	Health Care Equipment & Supplies	126.4	(15.7%)
NOW	ServiceNow, Inc.	Software	114.2	(47.0%)
ADP	Automatic Data Processing, Inc.	Professional Services	98.2	(18.4%)
MELI	MercadoLibre, Inc.	Broadline Retail	91.9	(27.9%)
ADBE	Adobe Inc.	Software	88.1	(41.6%)
MRSH	Marsh & McLennan Companies, Inc.	Insurance	86.0	(15.7%)
SNPS	Synopsys, Inc.	Software	83.6	(20.4%)
CTAS	Cintas Corporation	Commercial Services & Supplies	72.7	(16.3%)
AZO	AutoZone, Inc.	Specialty Retail	50.2	(18.4%)
ADSK	Autodesk, Inc.	Software	44.8	(32.9%)
RBLX	Roblox Corporation	Entertainment	40.6	(45.3%)

Source: Trivariate Research, LP

We looked only among high-quality stocks and ranked them on the change in quality score on a month-over-month basis (see below). It turns out there are two key observations. Firstly, high-quality stocks where fundamentals are getting worse, consistently perform poorly relative to their industry average. The bottom two quintiles (4 and 5) have never cumulatively gotten above zero. Secondly, the high-quality stocks with the most improving scores have also lagged. While this latter point is somewhat surprising, we conclude that high-quality companies where quality is eroding are worth avoiding.



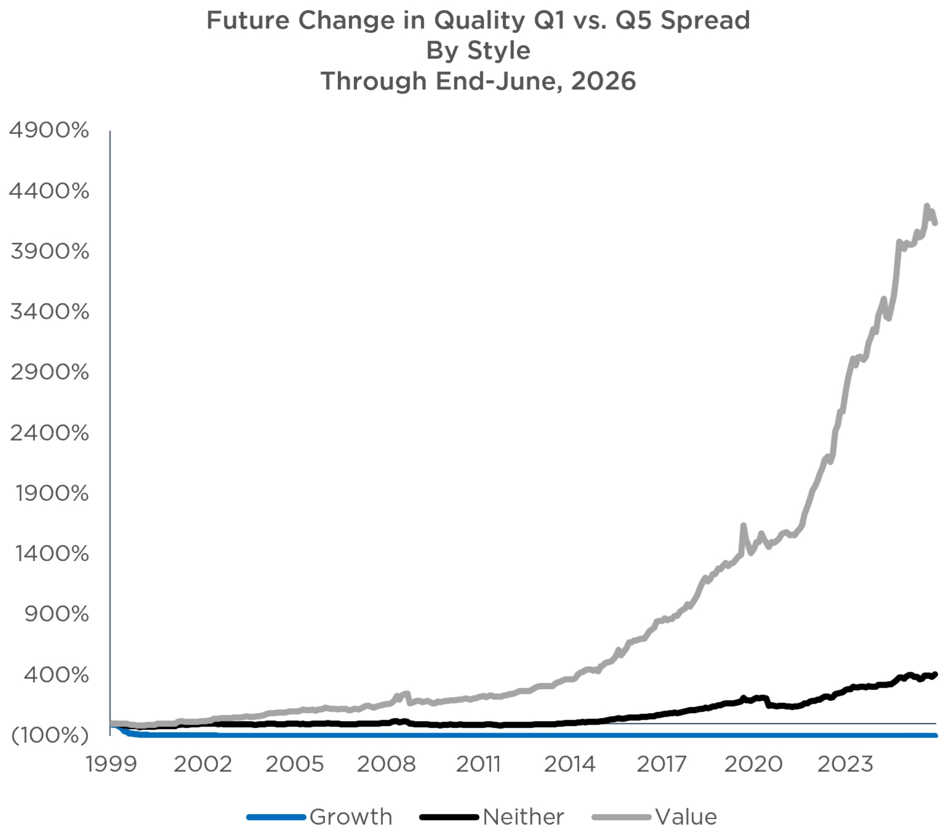
Source: Trivariate Research, LP

Below we show mega- and large-cap. stocks in the high-quality bucket, but most recently in the declining quality 40% per below. This includes three of the Great 8 stocks, interestingly.

High-Quality Mega- and Large-Cap. Stocks in Bottom Two Quintiles of Change in Quality Through July 8th, 2026			
Ticker	**Company**	**Industry**	**Market Cap ($US Bil.)**
MSFT	Microsoft Corporation	Software	2770.95
AVGO	Broadcom Inc.	Semiconductors & Semiconductor Equipment	1797.18
META	Meta Platforms, Inc.	Interactive Media & Services	1429.87
BRK.B	Berkshire Hathaway Inc.	Financial Services	1078.39
V	Visa Inc.	Financial Services	646.35
AMAT	Applied Materials, Inc.	Semiconductors & Semiconductor Equipment	574.03
LRCX	Lam Research Corporation	Semiconductors & Semiconductor Equipment	541.91
CSCO	Cisco Systems, Inc.	Communications Equipment	462.96
MA	Mastercard Incorporated	Financial Services	453.81
KLAC	KLA Corporation	Semiconductors & Semiconductor Equipment	394.12
MS	Morgan Stanley	Capital Markets	329.72
GEV	GE Vernova Inc.	Electrical Equipment	315.71
PANW	Palo Alto Networks, Inc.	Software	277.93
ADI	Analog Devices, Inc.	Semiconductors & Semiconductor Equipment	193.46
MCD	McDonald's Corporation	Hotels, Restaurants & Leisure	192.06
TMUS	T-Mobile US, Inc.	Wireless Telecommunication Services	181.52
VZ	Verizon Communications Inc.	Diversified Telecommunication Services	176.79
SCHW	The Charles Schwab Corporation	Capital Markets	160.47
ABT	Abbott Laboratories	Health Care Equipment & Supplies	158.05
CB	Chubb Limited	Insurance	132.16
CRM	Salesforce, Inc.	Software	128.30
PGR	The Progressive Corporation	Insurance	127.65
PLD	Prologis, Inc.	Industrial REITs	126.39
SYK	Stryker Corporation	Health Care Equipment & Supplies	120.70
SPGI	S&P Global Inc.	Capital Markets	120.54
FTNT	Fortinet, Inc.	Software	112.55
TT	Trane Technologies plc	Building Products	108.57
SO	The Southern Company	Electric Utilities	107.89
HWM	Howmet Aerospace Inc.	Aerospace & Defense	107.57
CDNS	Cadence Design Systems, Inc.	Software	103.52
NOW	ServiceNow, Inc.	Software	102.39
MDT	Medtronic plc	Health Care Equipment & Supplies	100.14
NEM	Newmont Corporation	Metals & Mining	99.30
BNY	The Bank of New York Mellon Corp	Capital Markets	99.26
GD	General Dynamics Corporation	Aerospace & Defense	95.65
MNST	Monster Beverage Corporation	Beverages	94.01
SNOW	Snowflake Inc.	IT Services	88.21
HCA	HCA Healthcare, Inc.	Health Care Providers & Services	86.49
ADBE	Adobe Inc.	Software	81.50
MRSH	Marsh & McLennan Companies, Inc.	Insurance	80.52
DASH	DoorDash, Inc.	Hotels, Restaurants & Leisure	80.40
CME	CME Group Inc.	Capital Markets	80.02
AEM	Agnico Eagle Mines Limited	Metals & Mining	77.57
TDG	TransDigm Group Incorporated	Aerospace & Defense	74.51
INTU	Intuit Inc.	Software	71.39
TRV	The Travelers Companies, Inc.	Insurance	70.20
MPWR	Monolithic Power Systems, Inc.	Semiconductors & Semiconductor Equipment	67.92
REGN	Regeneron Pharmaceuticals, Inc.	Biotechnology	63.44
ALL	The Allstate Corporation	Insurance	61.25
KEYS	Keysight Technologies, Inc.	Electronic Equipment, Instruments & Components	59.83
AFL	Aflac Incorporated	Insurance	59.68
YUM	Yum! Brands, Inc.	Hotels, Restaurants & Leisure	44.06
RBLX	Roblox Corporation	Entertainment	38.93

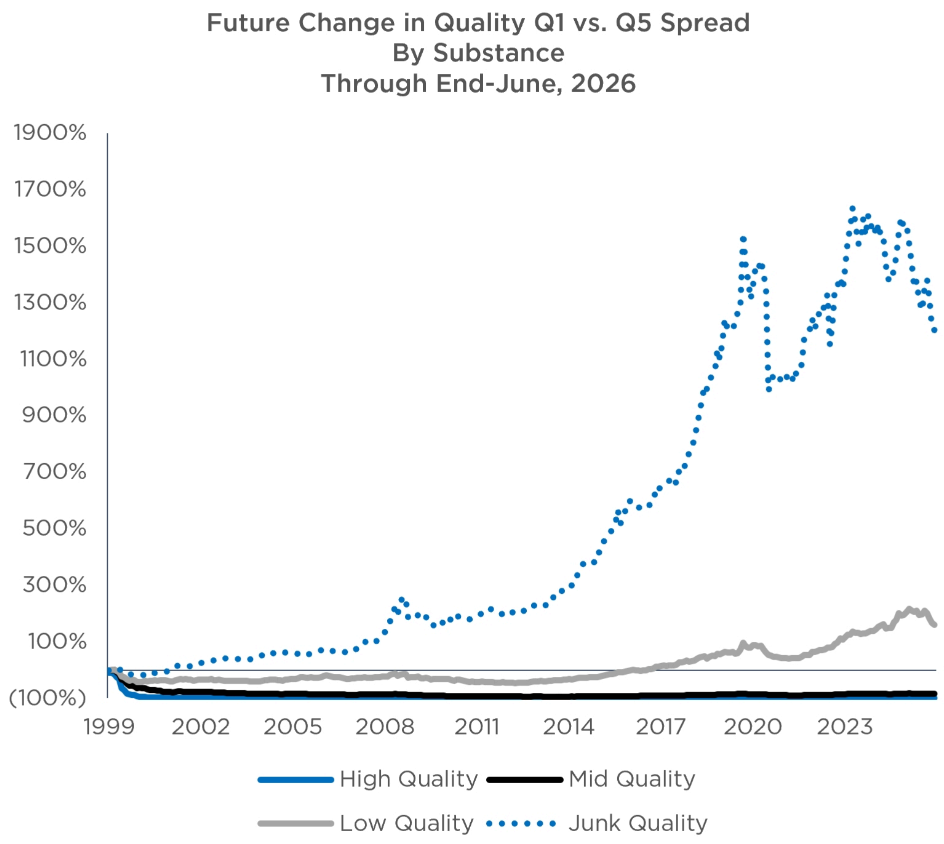
Source: Trivariate Research, LP

Given the interest level from investors, and our analysis that improving quality scores did not have predictive value, we wondered if the reason was that the stock outperformance occurred contemporaneously with the improvement. The answer - is yes - but only for value stocks (see below). It turns out that growth stocks with improving quality not only don't work after the quality improvement, but also not contemporaneously. That has some important implications for how investors need to select growth stocks - and avoiding over-reliance on quality metrics is key!



Source: Trivariate Research, LP

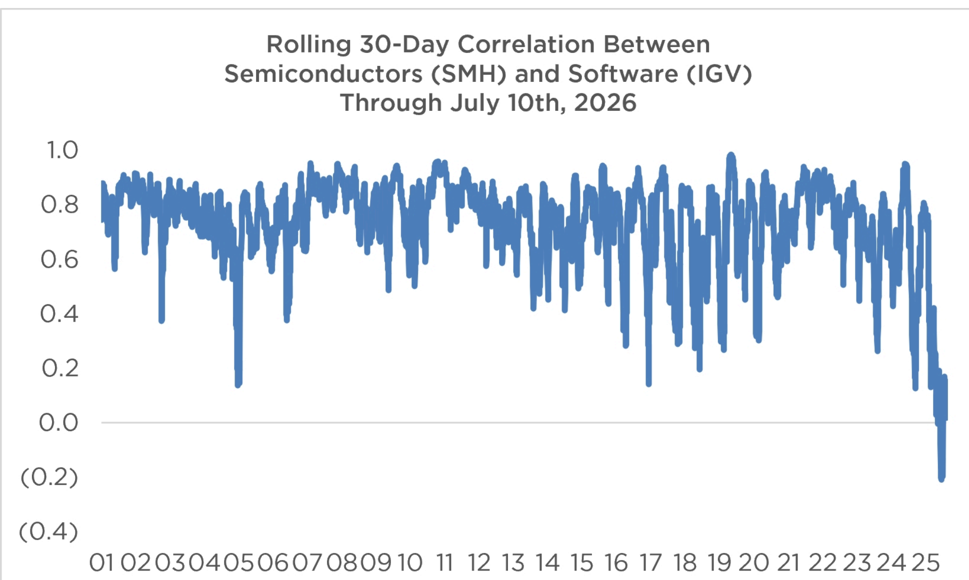
Contemporaneous quality improvement does work some for junk stocks (see below).



Source: Trivariate Research, LP

<u>In the end, we don't think investors should focus on quality - unless they are trafficking in junk stocks or value stocks, where buying companies where the quality will improve has some merit.</u>

The second area investors questioned on our outlook was on our continued overweight on Technology, and our preference for Semiconductors vs. Software. We wrote that our North Star was to own Semiconductors over Software more than two years ago, and that in aggregate has turned out to be a great call. But before we get sore patting ourselves on the back, it is worth noting that Software has performed well off of market lows, and for the first time in 25 years appears to have diversifying qualities vs. the Semiconductor industry, with current 30-day return correlations near zero (see below).



Source: Trivariate Research, LP

This means that while we are negative on Software in the longer-term view, we can see the merits of owning Software as a defensive hedge - something we would have thought as unfathomable even a year ago. We wrote in our 2H outlook that Software almost seems like it is Tobacco in the later stages, meaning it can be a true defensive and may take a longer time to collapse than we previously argued. Our conclusion is that we were impacted by some of the pushback we received from Software bulls, but more from the risk management perspective than alpha perspective. Our prior work clearly showed that more expensive and fast-growing Software outperforms cheaper and slower growing Software, and given a lot of Software is high-quality that is consistent with the signals that have been effective for security selection among high-quality stocks. Since 2020, the best two signals that have worked to identify winning high-quality stocks have been high R&D intensity and fast revenue growth. That applies to Software as well.

Best and Worst Performing Signals in High Quality Universe Since 2020
Top 2k US Equities
As of End-June, 2026

Signal	Annualized Mean Return	Annualized Std. Dev of Returns	Sharpe Ratio	Hit Rate
R&D-to-Sales	8.0%	22%	0.36	58%
Revenue Growth	7.5%	14%	0.52	56%
Net Debt to Market Cap	6.5%	13%	0.49	53%
12-Month Momentum	5.6%	15%	0.37	54%
Dividend Coverage Ratio	4.3%	9%	0.46	60%
Short Interest-to-Value Traded	4.1%	9%	0.44	58%
Buyback Yield	3.7%	11%	0.34	53%
Indicated Dividend Growth	3.7%	7%	0.55	55%
EPS Growth (Trailing 12Q)	3.0%	8%	0.39	54%
EV-to-Forecast Sales	2.8%	15%	0.19	54%
Forecast Net Margin Expansion	(0.5%)	10%	(0.05)	47%
Forecast Gross Margin	(0.8%)	18%	(0.04)	53%
Price-to-Forward Earnings	(1.2%)	21%	(0.06)	46%
Net Margin	(1.5%)	15%	(0.09)	47%
Gross Margin	(1.6%)	10%	(0.16)	47%
Quick Ratio Growth	(1.8%)	7%	(0.27)	44%
Accruals	(2.1%)	9%	(0.23)	47%
Operating Margin	(3.0%)	17%	(0.17)	44%
Indicated Annual Dividend Yield	(4.1%)	16%	(0.26)	46%
Inventory-to-Sales	(5.4%)	10%	(0.53)	45%

The current Software names that fit the bill - high R&D intensity and high forecasted revenue growth - include DDOG, TEAM, AUR, and FIG, among others (see below).

Fast-Growing, High R&D Intensity Software
As of July 10th, 2026

Ticker	Company	Market Cap (US $ Bil.)
DDOG	Datadog, Inc.	91.41
TEAM	Atlassian Corporation	22.43
AUR	Aurora Innovation, Inc.	12.38
FIG	Figma, Inc.	11.72
QBTS	D-Wave Quantum Inc.	7.80
SOUN	SoundHound AI, Inc.	2.87
AIP	Arteris, Inc.	1.45

Source: Trivariate Research, LP

Important Disclosures

Analyst Certification

The analysts, Adam Parker, Maxwell Arnold, Chang Ge, Colin Cooney, Ryan McGovern and Jesse Goodman, responsible for the preparation of this research report certifies that: all the views expressed in this research report accurately reflect the research analyst's personal views.

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