TRIVARIATE RESEARCH

QUALITY IS LIKE VALUATION: AVOID EXTREMES

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BACKGROUND AND RESEARCH CONCLUSIONS

Background: We have written extensively in the last 18 months about quality investing. Here is what we have concluded so far: High-quality has lagged junk since 2019. The signals used to pick stocks within the high-quality cohort have changed dramatically, and what worked from 1999-2018 has not worked since then. Price momentum has not worked among high-quality stocks but has worked everywhere else over the last few years. Stocks where quality has improved have not done well, as investors generally need to buy stocks before the quality demonstrably improves. High-quality stocks that have gotten worse on quality underperform the rest of high-quality. Exposure to quality has clearly changed, and we studied the optimal quality-related portfolio in today's work.

Methodology: We simulated 100 portfolios each month from 1999 through June 2026, analyzing 1999–2018 and 2019–2026 separately. Each simulation randomly selected 60 stocks from different quality deciles and calculated their cap-weighted one-month forward returns. Quality is measured using Trivariate's point-in-time continuous substance score. The score combines ranked balance-sheet, profitability, cash-flow or dividend, and risk measures, with inputs tailored to Financials, dividend-paying non-Financials, and non-dividend-paying non-Financials. Higher scores indicate higher quality. D1 is the highest-quality decile, D2 the second highest, and so forth, with D10 the lowest quality decile. Among the Top 500 stocks by market cap, each decile contains approximately 50 stocks. We compared D1-D10 portfolios with D2-D9, D3-D8, D4-D7, D5-D6, the broader four-decile combinations, and each individual quality decile.

S&P500 results: From 1999-2018 it was clear that the higher the quality, the better the overall performance. On the contrary, since 2019, the highest quality decile has been the worst performing, with the 6th through 9th quality buckets the best. It has remained true that the lower the quality, the more volatility that has occurred, both from 1999-2018, and more recently.

INVESTMENT CONCLUSIONS

Avoid extreme quality: Because returns were so strong recently, we looked at the T-statistic of performance during both time frames. Adjusting for regime and volatility, it seems that, historically, the higher the quality the better the returns. But since 2019, it seems like extreme quality is worse than central quality. We then selected portfolios only from a range of deciles, from extreme (D1 and D10 meaning the highest and lowest deciles) through D5 and D6 (middle quality). **The worst performing portfolios were extreme quality. Running quality-neutral from the middle of the quality distribution generally yields better risk adjusted returns since 2019, whereas the distribution mattered less before 2019.**

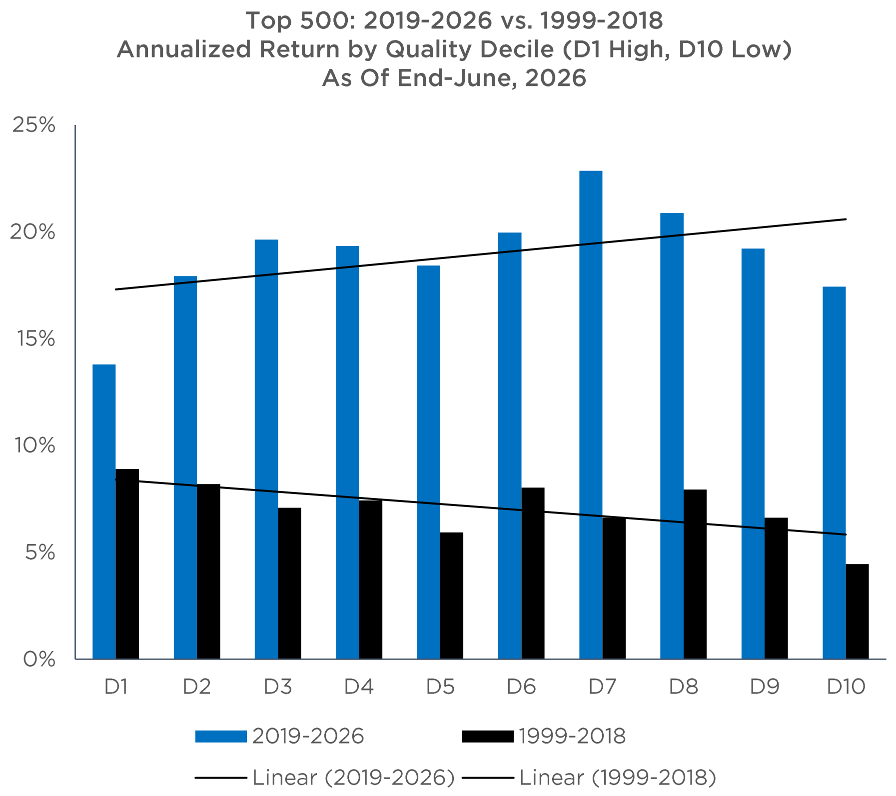
Growth: We analyzed the growth universe and generally found similar results to the overall SP500. The higher the quality the better from 1999-2018, but the highest quality decile of stocks was the weakest performing since 2019. Lower quality stocks got more volatile recently than higher quality, though more consistent with history.

Value: Quality has not mattered as much among value stocks historically, as from 1999-2018 it appeared extreme quality (high and low) lagged. More recently, the 8^{th} and 9^{th} highest quality deciles were best. Volatility was similar recently to history among value stocks, with lower quality generally correlated to higher volatility. We would not conclude that owning high-quality stocks matters in the value universe.

In summary, for S&P500 focused long-only portfolio managers, owning average quality today that will improve its quality in the future but is not yet in evidence is a better idea than owning very high or very low quality. We don't see a near-term reason why that would change. **We think about using quality to pick stocks the same way we think about using valuation to pick stocks. Generally, it isn't a great factor, but avoiding extreme quality (very high and very low) seems prudent.**

SINCE 2019, THE HIGHEST QUALITY DECILE HAS BEEN THE WORST

Among the top 500 stocks, we simulated 100 portfolios each month from 1999 through June 2026, analyzing 1999–2018 and 2019–2026 separately. Each simulation randomly selected 60 stocks from different quality deciles and calculated their cap-weighted one-month forward returns. Quality is measured using Trivariate's continuous point-in-time score. From 1999-2018 (left), it was clear (black bars) that the higher the quality the better the overall performance. On the contrary, since 2019, the highest quality decile has been the worst performing, with the 6th through 9th quality buckets the best (blue bars). The 2nd worst performing decile is the lowest quality one. It has remained true that the lower the quality, the more volatility that has occurred, both from 1999-2018, and more recently (right).



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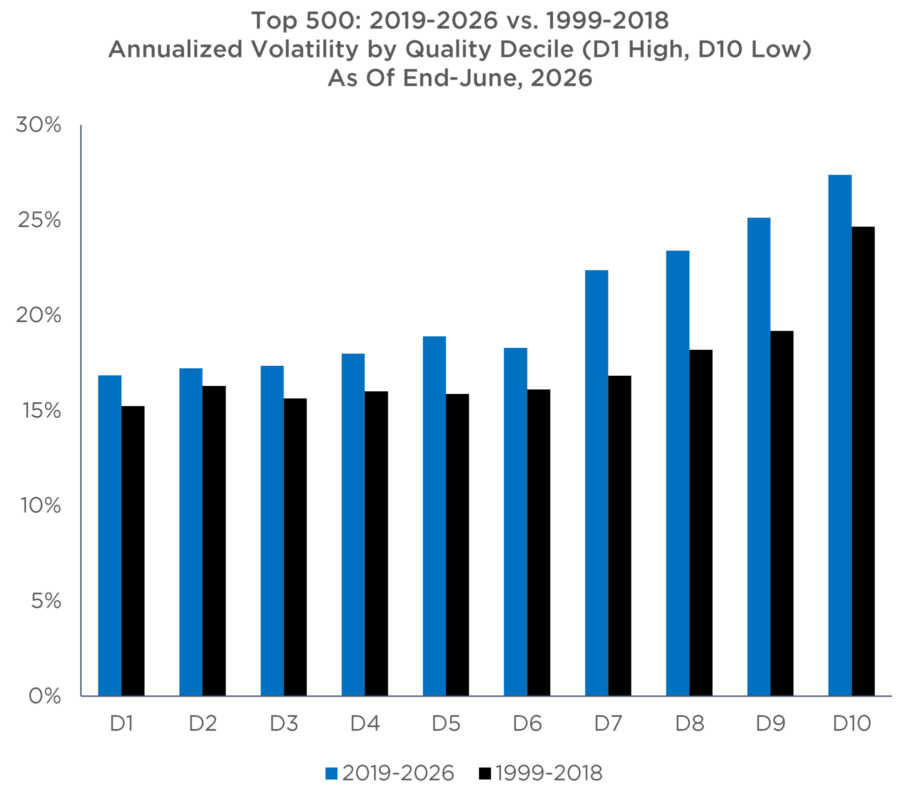

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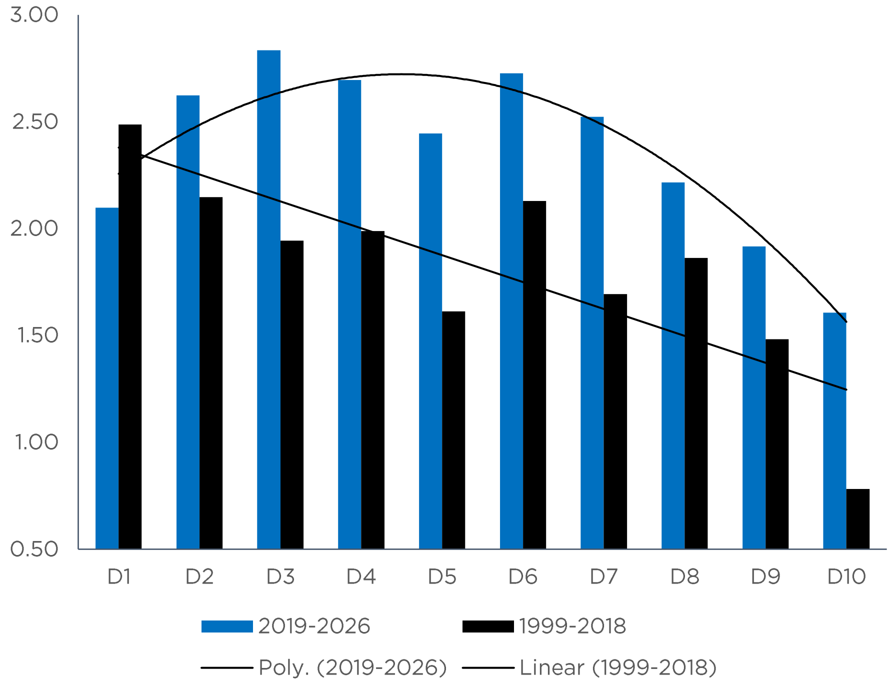
DISTANCE FROM AVG. QUALITY HAS BEEN PENALIZED SINCE 2019

Because returns were so strong recently, we looked at the T-statistic of performance during both time frames. Adjusting for regime and volatility, it seems that historically the higher the quality the better the returns, but since 2019, it seems like extreme quality is worse than central quality (left).   We then selected portfolios only from a range of deciles, from extreme (D1 and D10 meaning the highest and lowest deciles) through D5 and D6 (middle quality). The worst performing portfolios were extreme quality (right). Running quality-neutral from the middle of the quality distribution generally yields better risk adjusted returns since 2019, whereas the distribution mattered less before 2019.

Top 500: 2019-2026 vs. 1999-2018
T-Stat by Quality Decile (D1 High, D10 Low)
As Of End-June, 2026



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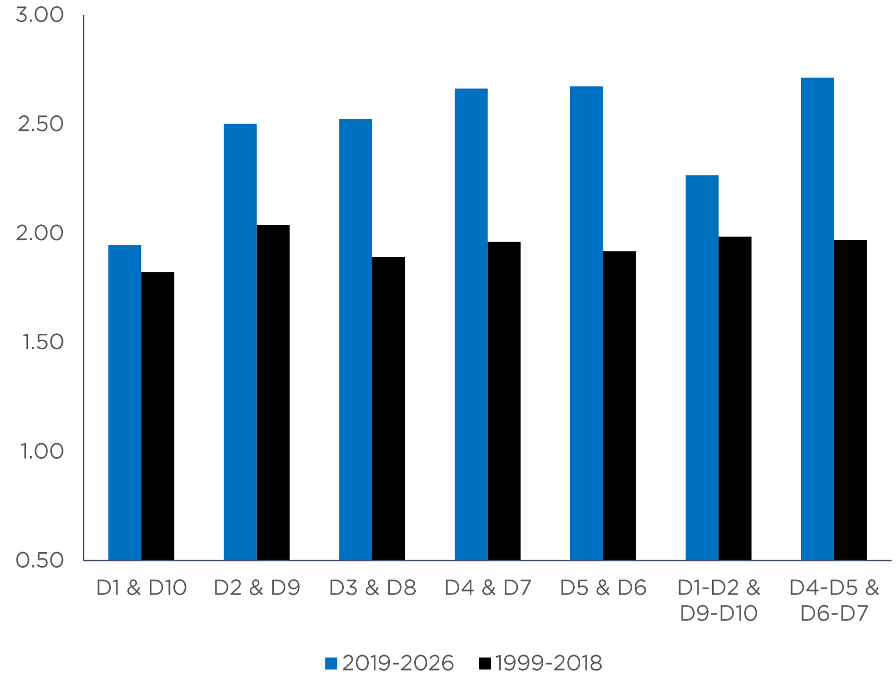
Top 500: 2019-2026 vs. 1999-2018
T-Stat by “Quality Neutral” Portfolios
As Of End-June, 2026



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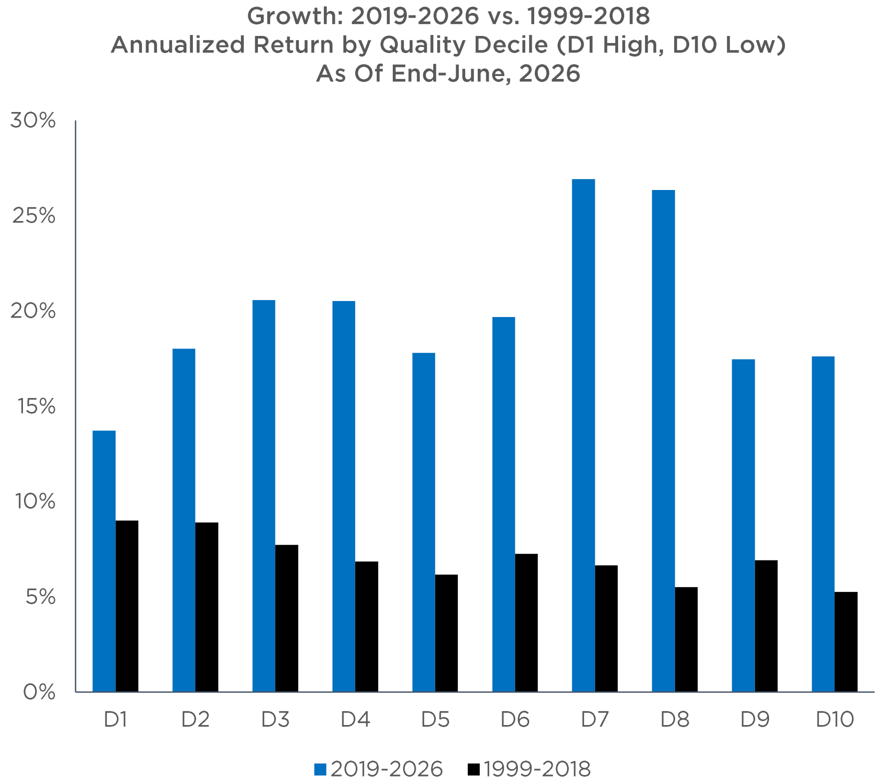
THE STORY IS SIMILAR AMONG GROWTH STOCKS

We analyzed the growth universe and generally found similar results to the overall S&P 500. The higher the quality the better from 1999-2018, but the highest quality decile of stocks was the weakest performing since 2019 (left). Lower quality stocks got more volatile recently than higher quality, though more consistent with history (right).



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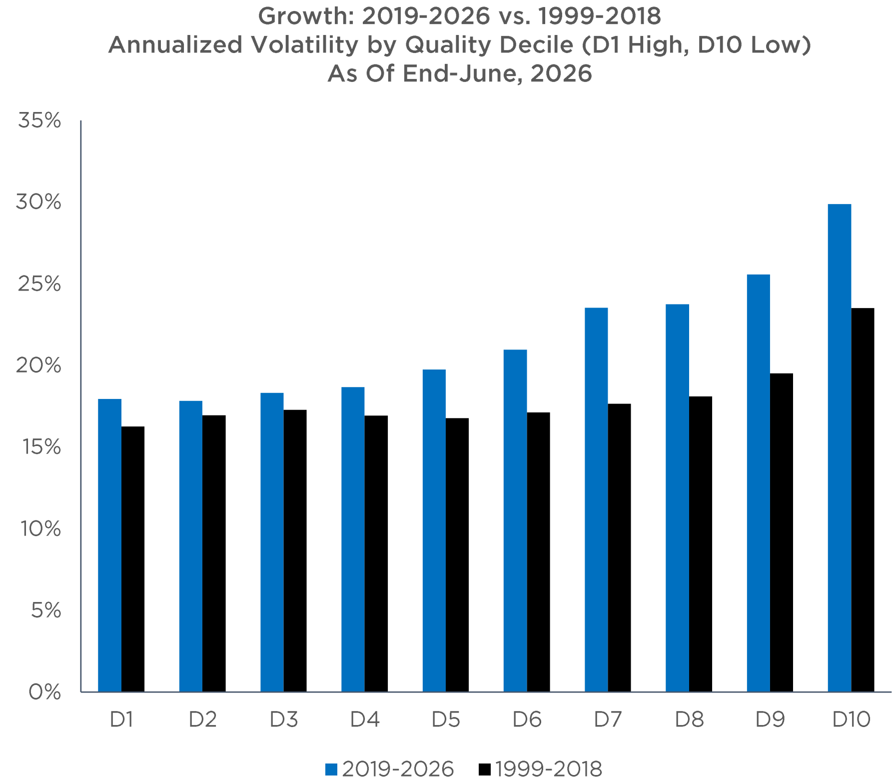

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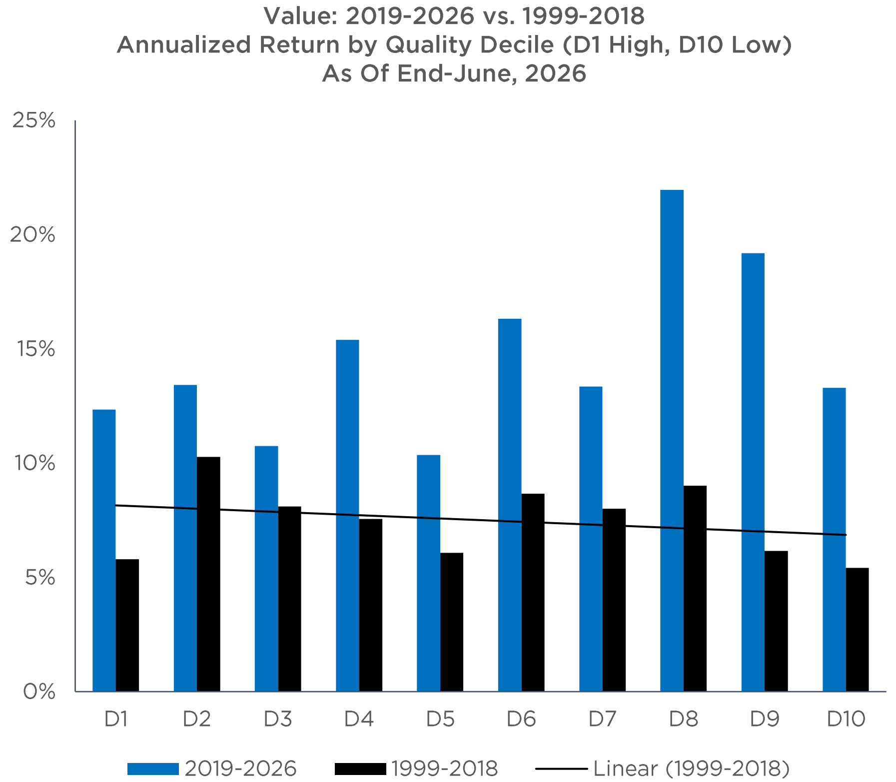
QUALITY MATTERS LESS IN VALUE THAN GROWTH

Quality has not mattered as much among value stocks historically (left), as from 1999-2018 it appeared extreme quality (high and low) lagged. More recently, the 8th and 9th highest quality deciles were best. Volatility was similar recently to history among value stocks, with lower quality generally correlated to higher volatility (right). We would not conclude that owning high-quality stocks matters in the value universe.



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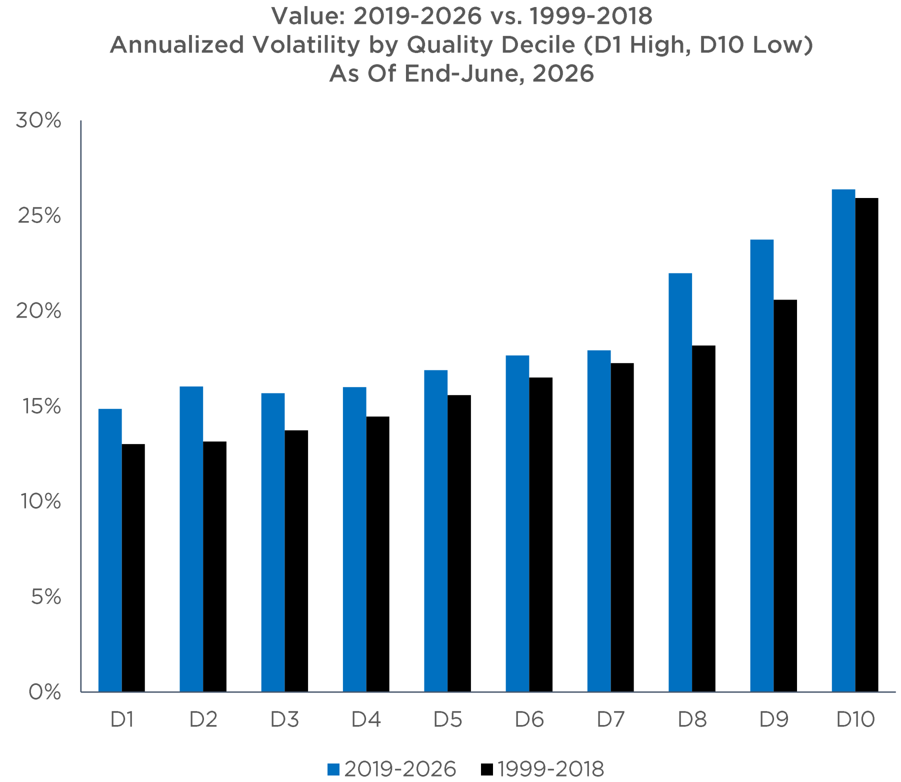

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