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TRIVARIATE RESEARCH

HOW TO PICK HIGH-QUALITY STOCKS TODAY

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RESEARCH SUMMARY AND INVESTMENT CONCLUSIONS

Background: Over the past year, many investors have lamented the fall of high-quality stocks and the rise of junk stocks, making it challenging for those who don't change their investment philosophy to keep up with the market. Moreover, telling allocators you avoid high-quality stocks seems like a potentially poor marketing strategy. We have shown in our work however, that high-quality has lagged junk cumulatively over the last five years, and last week (Level Set – The Moving Parts), we showed that since 2019, the majority of high-quality stocks have seen multiple contraction, whereas the median junk stock has seen slight multiple expansion. Being an excellent, high-quality business, might mean you merit a higher multiple, but for the last six years, it has also meant modest multiple contraction. With that in mind, we investigate in today's research what has worked within the high-quality cohort alone, believing that these trends might continue for the foreseeable future.

What variables should you use to pick high-quality stocks?: We looked at our factor library to identify signals that were efficacious at predicting high-quality stock winners from high-quality stock losers since 2020. Buying stocks with **high R&D-to-sales, high revenue growth, and low debt was the best approach. Avoiding relatively higher short interest also worked. Profitability level and valuation did not matter for stock selection.**

How is this different from history?: We then compared what has worked since 2020 with what had worked from 1999 to see where history has not been helpful of late. Revenue growth is working far better today than in the past, as is forecasted revenue growth, for stock selection. From a stock perspective, you need fast growth to offset multiple contraction. Valuation metrics – whether price-to-forward earnings, EV-to-forecasted sales, or free cash flow yield are far worse today than in the past– and in some cases have been negative recently – meaning expensive stocks subsequently outperform cheap ones. Revisions - i.e., one-month changes to earnings – have worked better recently than in the past.

INVESTMENT CONCLUSIONS

Revenue growth and profit margin: Fast growers materially LAGGED from 1999-2020, as they often missed expectations or had high starting valuations. However, since 2020, and in particular over the last two years, **the best performing quintile within high-quality has been the fastest revenue growers**. While we constantly talk about margin expansion mattering for stock selection, the truth is, this has not really helped distinguish winners from losers - either for operating margin or net margin over the long-term - as nearly all five quintiles have similar performance. This is in part true because many high-quality businesses, for instance in Pharmaceuticals or Software, have very high margins, no debt, and decent cash flow, but aren't going to improve their margin profile – it is only about growth for these businesses. Finding high-quality businesses with lower margins and therefore improvement potential is prudent. Since 2020, lower net and operating margin companies have materially outperformed high-quality stocks with high net and operating margins, meaning the potential for improvement has allured investors, not the maintenance of excellence.

High inventory doesn't matter - high short interest does: Among high-quality stocks, inventory-to-sales level has been a counter-indicator, meaning buying high inventory-to-sales companies and shorting low inventory-to-sales companies has generated excess return. Perhaps this is because these businesses don't have perishable inventory, or perhaps it is because it is change in inventory, and the dream of margin expansion, that drives subsequent outperformance. While high-quality stocks typically don't draw attention from short sellers, it is true that the lowest quintile of short interest has steadily outperformed the highest quintile of short interest in the high-quality universe.

Long / short high-quality ideas: On slide 10, we show Long ideas that include those with high forecasted revenue growth, low short interest, and recent upward revisions. These include NVDA, AMD, and APH, among others. Short ideas have low relative forecasted revenue growth, higher short interest, and have not seen positive EPS revisions and include SO, AMP, and DHI, among others.

R&D INTENSITY, FAST GROWTH, LOW DEBT, AND LOW SI MATTER

We looked at our factor library to identify signals that were efficacious at predicting high-quality stock winners from high-quality stock losers since 2020. Buying stocks with high R&D-to-sales, high revenue growth, and low debt was the best approach. Avoiding relatively higher short interest also worked. Profitability level and valuation did not matter for stock selection.

Best and Worst Performing Signals in High Quality Universe Since 2020
Top 2k US Equities
As of End-December, 2025

Signal	Annualized Mean Return	Annualized Std. Dev of Returns	Sharpe Ratio	Hit Rate
R&D-to-Sales	9.2%	19%	0.48	58%
Revenue Growth	8.8%	14%	0.65	58%
Net Debt to Market Cap	7.2%	12%	0.59	53%
Beta	5.7%	21%	0.27	54%
Short Interest-to-Value Traded	5.5%	8%	0.69	60%
Buyback Yield	5.1%	11%	0.48	54%
Dividend Coverage Ratio	4.4%	10%	0.46	60%
EV-to-Forecast Sales	4.3%	15%	0.29	54%
EPS Growth (Trailing 12Q)	3.7%	8%	0.49	56%
Indicated Dividend Growth	3.7%	7%	0.55	56%
Price-to-Forward Earnings	(0.3%)	21%	(0.02)	47%
Gross Margin	(0.3%)	9%	(0.04)	49%
Dividend Growth (Trailing)	(0.5%)	7%	(0.07)	47%
Price-to-Earnings	(1.0%)	19%	(0.05)	42%
Accruals	(1.7%)	9%	(0.19)	47%
Net Margin	(3.1%)	15%	(0.21)	46%
Quick Ratio Growth	(3.5%)	6%	(0.56)	40%
Inventory-to-Sales	(3.5%)	10%	(0.37)	46%
Operating Margin	(3.8%)	16%	(0.24)	44%
Indicated Annual Dividend Yield	(5.5%)	15%	(0.38)	46%

Source: Trivariate Research

VALUATION HAS FAILED RECENTLY, GROWTH AND REVISIONS WORK

We then compared what has worked since 2020 with what had worked from 1999 to see where history has not been helpful of late. Revenue growth is working far better today than in the past, as is forecasted revenue growth for stock selection. You need fast growth to offset multiple contraction. Valuation metrics – whether price-to-forward earnings, EV-to-forecasted sales, or free cash flow yield are far worse today than in the past – and in some cases have been negative recently – meaning expensive stocks subsequently outperform cheap ones. Revisions – i.e., one-month changes to earnings – have worked better recently than in the past.

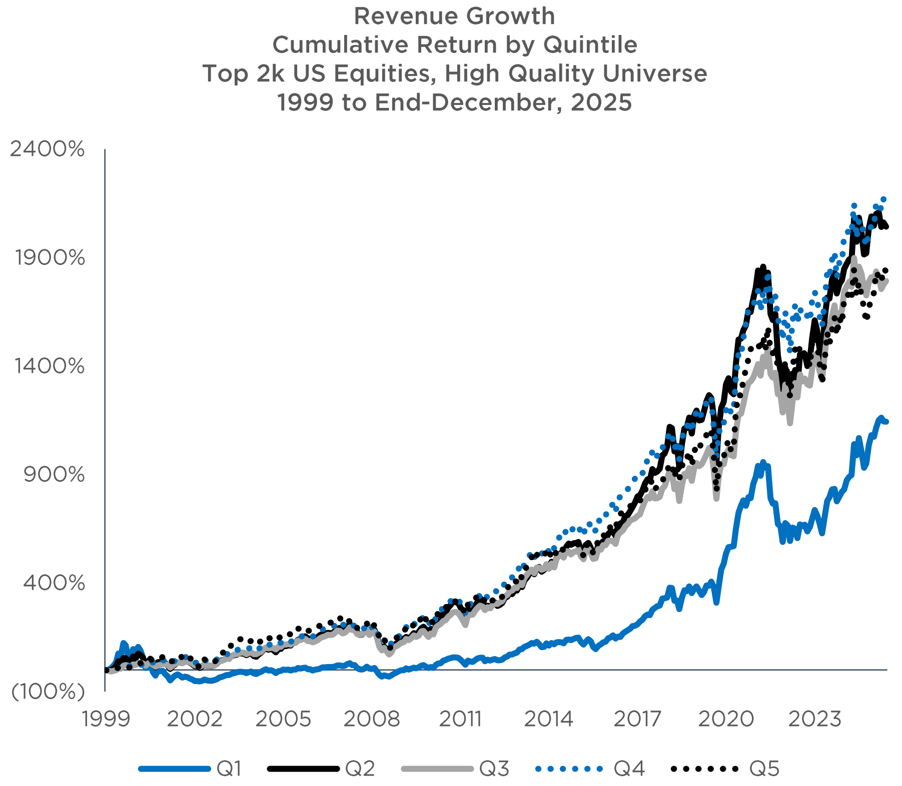
Signals with Largest Delta Between Since 2020 Mean Return and Since 1999 Mean Return
High Quality Universe, Top 2k US Equities
As of End-December, 2025

Signal	Since 2020 Sharpe Ratio	Since 1999 Sharpe Ratio	Difference In Sharpe Ratio	Since 2020 Annualized Mean Return	Since 1999 Annualized Mean Return	Difference In Mean Return
Revenue Growth	0.65	0.03	0.61	8.8%	0.7%	8.1%
Forecast Revenue Growth	0.11	(0.31)	0.42	1.7%	(5.9%)	7.6%
1-Month % Change in Fwd EPS	0.40	(0.16)	0.55	2.6%	(1.7%)	4.3%
R&D-to-Sales	0.48	0.21	0.27	9.2%	5.1%	4.2%
Beta	0.27	0.07	0.20	5.7%	1.9%	3.9%
Buyback Yield	0.48	0.09	0.39	5.1%	1.6%	3.5%
3-Month Momentum	(0.01)	(0.15)	0.15	(0.1%)	(3.1%)	3.0%
Indicated Dividend Growth	0.55	0.14	0.41	3.7%	0.9%	2.8%
252d Momentum	0.04	(0.11)	0.15	0.5%	(2.3%)	2.8%
Dividend Coverage Ratio	0.46	0.19	0.27	4.4%	1.8%	2.6%
Capital Expenditure-to-Sales	0.21	0.32	(0.12)	1.6%	2.7%	(1.1%)
Operating Margin	(0.24)	(0.13)	(0.10)	(3.8%)	(2.5%)	(1.3%)
Inventory-to-Sales	(0.37)	(0.22)	(0.15)	(3.5%)	(1.8%)	(1.8%)
Forecast Net Margin Expansion	0.11	0.42	(0.31)	1.0%	3.2%	(2.2%)
Forecast Gross Margin Growth	0.08	0.35	(0.28)	0.7%	3.2%	(2.5%)
Accruals	(0.19)	0.18	(0.36)	(1.7%)	1.4%	(3.0%)
Free Cash Flow Yield	0.28	0.58	(0.30)	3.3%	6.7%	(3.4%)
Quick Ratio Growth	(0.56)	0.04	(0.61)	(3.5%)	0.4%	(3.9%)
EV-to-Forecast Sales	0.29	0.68	(0.38)	4.3%	9.9%	(5.6%)
Price-to-Forward Earnings	(0.02)	0.21	(0.23)	(0.3%)	5.3%	(5.6%)

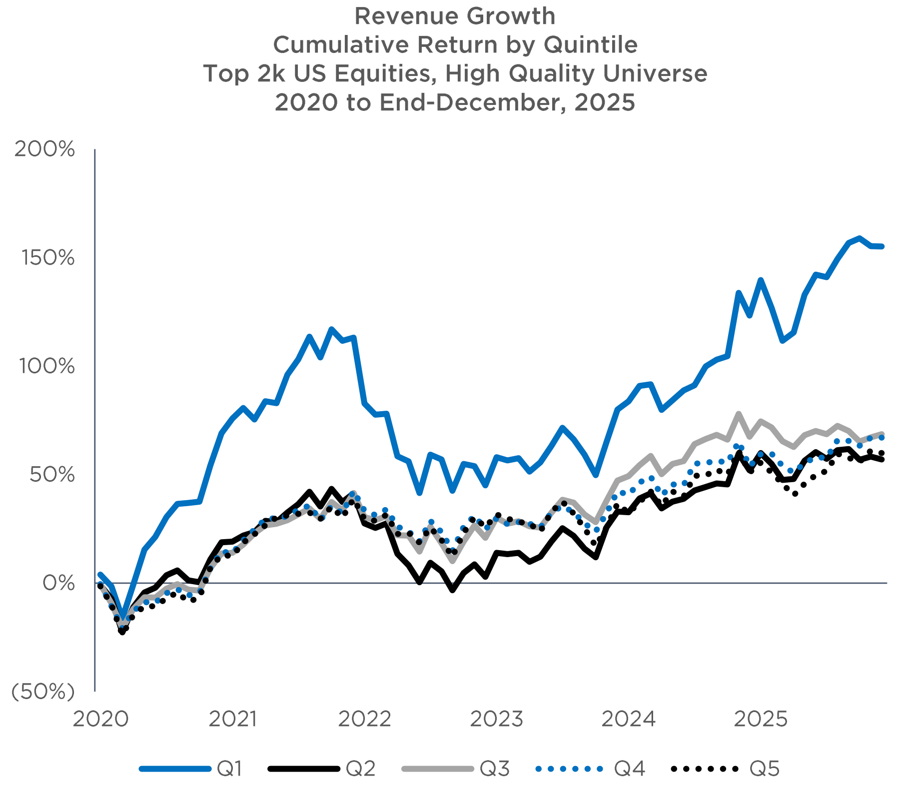
Source: Trivariate Research

HIGH REVENUE GROWTH USED TO UNDERPERFORM, NOT ANYMORE

We show the efficacy of each revenue growth quintile, among high-quality stocks, from 1999 to present (left) and since 2020 (right) to highlight further how metrics for stock selection have changed recently. Fast growers materially LAGGED from 1999-2020, as they often missed expectations or had high starting valuations. However, since 2020, and in particular over the last two years, the best performing quintile within high-quality has been the fastest revenue growers.



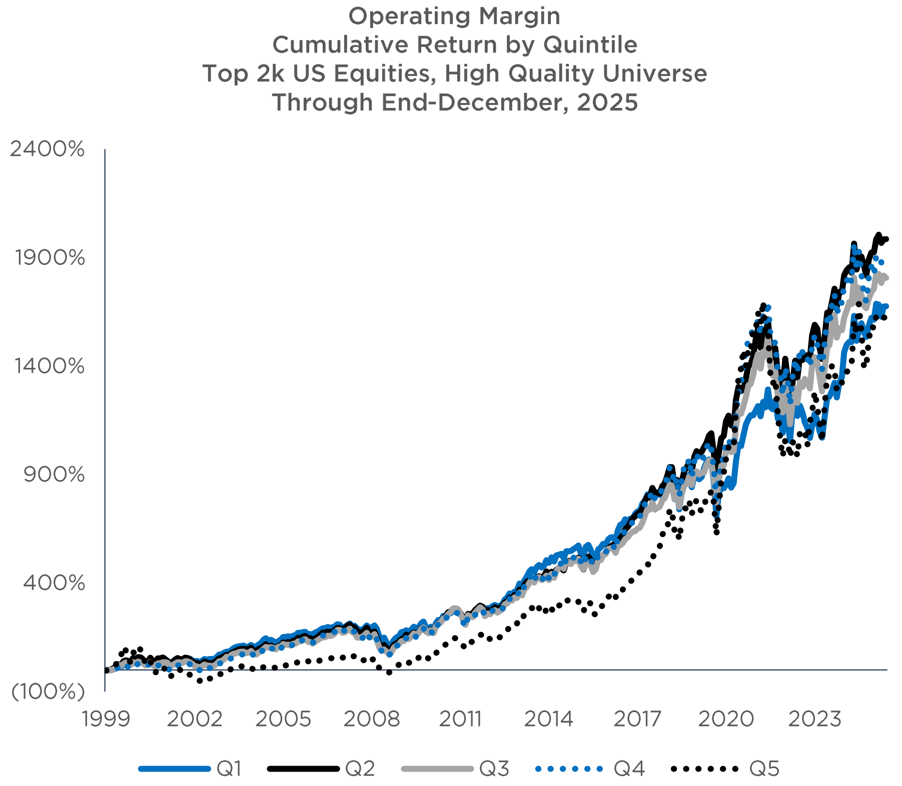
Source: Trivariate Research



Source: Trivariate Research

MARGINS HAVE NEVER MATERIALLY MATTERED FOR HIGH QUALITY

While we constantly talk about margin expansion mattering for stock selection, the truth is, this has not really helped distinguish winners from losers - either for operating margin (left) or net margin (right) over the long-term - as nearly all five quintiles have similar performance. This is in part true because many high-quality businesses, for instance in Pharmaceuticals or Software, have very high margins, no debt, and decent cash flow, but aren't going to improve their margin profile – it is only about growth for these businesses.



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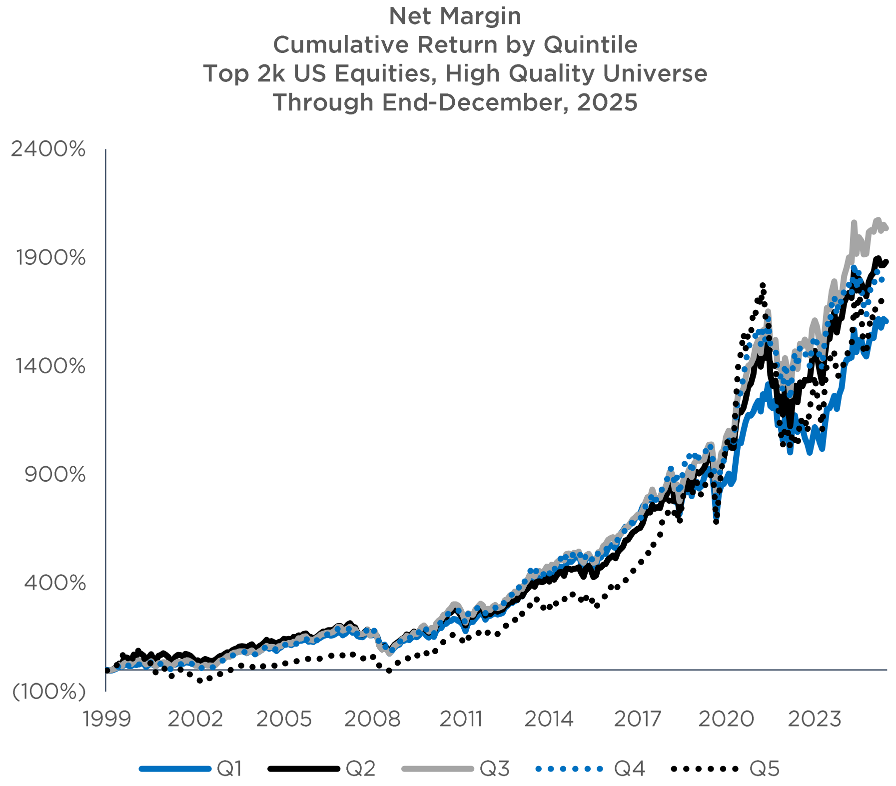


Source: Trivariate Research

LOWER MARGIN COMPANIES WITHIN HIGH-QUALITY HAVE BEEN BEST

Since 2020, lower net (left) and operating (right) margin companies have materially outperformed high-quality stocks with high net and operating margin, meaning the potential for improvement has allured investors, not the maintenance of excellence.

Net Margin
Cumulative Q1 vs. Q5 Spread Return
Top 2k US Equities, High Quality Universe
Through End-December, 2025

Source: Trivariate Research

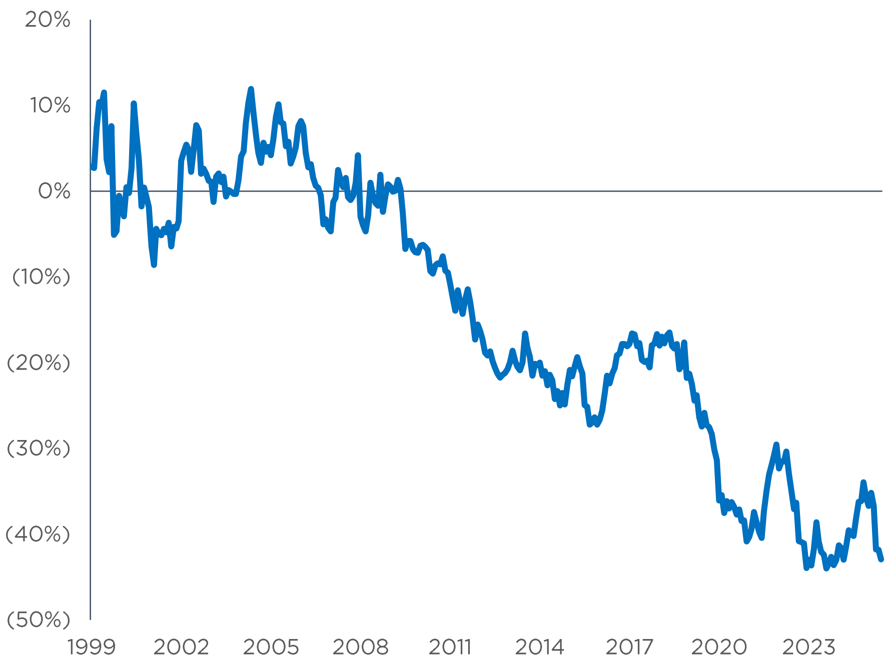
Operating Margin
Cumulative Q1 vs. Q5 Spread Return
Top 2k US Equities, High Quality Universe
Through End-December, 2025

Source: Trivariate Research

HIGH INVENTORY IS FINE, HIGH SHORT INTEREST IS NOT

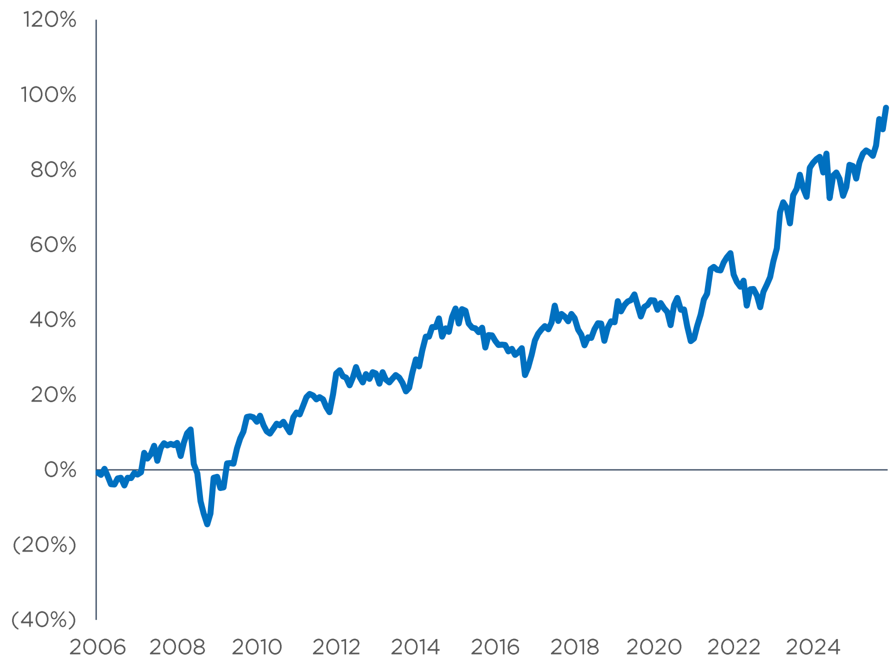
Among high-quality stocks, inventory-to-sales level has been a counter-indicator, meaning buying high inventory-to-sales companies and shorting low inventory-to-sales companies has generated excess return. Perhaps this is because these businesses don't have perishable inventory, or perhaps it is because it is change in inventory, and the dream of margin expansion, that drives subsequent outperformance (left). While high-quality stocks typically don't draw attention from short sellers, it is true that the lowest quintile of short interest has steadily outperformed the highest quintile of short interest in the high-quality universe (right).

Inventory-to-Sales
Cumulative Q1 vs. Q5 Spread Return
Top 2k US Equities, High Quality Universe
Through End-December, 2025



Source: Trivariate Research

Short Interest-to-Value Traded
Cumulative Q1 vs. Q5 Spread Return
Top 2k US Equities, High Quality Universe
Through End-December, 2025



Source: Trivariate Research

QUANTITATIVELY DERIVED LONG / SHORT HIGH-QUALITY IDEAS

Long ideas include those with high forecasted revenue growth, low short interest, and recent upward revisions (left). These include NVDA, AMD, and APH, among others. Short ideas have low relative forecasted revenue growth, higher short interest, and have not seen positive EPS revisions (right). Ideas here include SO, AMP, and DHI, among others.

High-Quality Long Ideas, Top 2k US Equities
Top Quintile of Forecast Revenue Growth, Bottom 40% Short Interest,
Top Quintile of 1-Month % Change in Fwd EPS
As of January 26sh, 2025

Ticker	Company	Sector	Market Cap. (US $Bn.)
NVDA	NVIDIA Corporation	Information Technology	4,531.03
AMD	Advanced Micro Devices, Inc.	Information Technology	409.14
APH	Amphenol Corporation	Information Technology	190.41
AEM	Agnico Eagle Mines Limited	Materials	108.15
TEAM	Atlassian Corporation	Information Technology	36.43
DT	Dynatrace, Inc.	Information Technology	12.42
ONTO	Onto Innovation Inc.	Information Technology	10.27

Source: Trivariate Research

High-Quality Short Ideas, Top 2k US Equities
Bottom Quintile of Forecast Revenue Growth, Top 40% Short Interest,
Bottom Quintile of 1-Month % Change in Fwd EPS
As of January 26sh, 2025

Ticker	Company	Sector	Market Cap. (US $Bn.)
SO	The Southern Company	Utilities	97.07
AMP	Ameriprise Financial, Inc.	Financials	46.50
DHI	D.R. Horton, Inc.	Consumer Discretionary	43.46
ODFL	Old Dominion Freight Line, Inc.	Industrials	36.38
CINF	Cincinnati Financial Corporation	Financials	24.65
AOS	A. O. Smith Corporation	Industrials	9.89
DBX	Dropbox, Inc.	Information Technology	6.88
YELP	Yelp Inc.	Communication Services	1.74

Source: Trivariate Research

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