BY Chris Faber
Portfolio Manager

The Case for High Quality

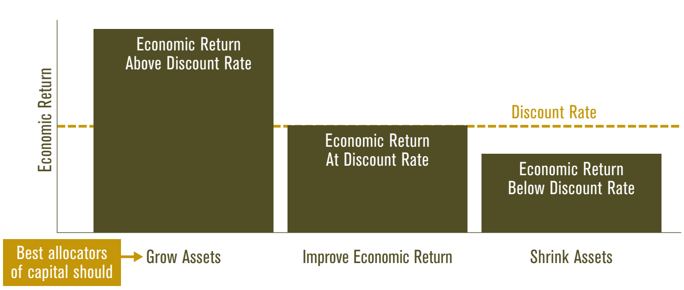
Imagine the year is 2009 and you have a small stockpile of cash to invest. After surveying the marketplace, you decide to put your hard-earned money into high-quality equities. High-quality companies, you are told, generally have stable business models with extremely low credit risk. The decision seems like a no-brainer. But, as the market rockets up over the better part of a decade, you watch your high-quality equity portfolio fall behind. Yes, your returns are positive, but they are regularly outpaced by your benchmark. You begin to wonder if "high quality" might simply be code for "low return." »

No, you have not been bamboozled. And no, we at RMB would assert, you have not made the wrong decision. Focusing on high quality is a core component of our investment philosophy, and it goes hand in hand with another essential element—investing for the long term. This article explains *why* high-quality stocks tend to outperform low-quality stocks over the long term, and, importantly, why high-quality stocks are typically strongest when most needed—during a bear market. This article also forecasts that, while the last handful of years have been a challenging time for high-quality investments, the environment looks poised for a change.

Defining High Quality

What makes an investment "high quality"? We consider a stock to be high quality if we believe the company is well managed. While this may seem subjective, we rely upon data-driven analysis to draw an objective conclusion about a company's stability, profitability, and growth potential. We assess whether the company's management team allocates capital in a way that is consistent with creating value. Well-managed businesses grow assets when their economic return on capital is above the cost of capital, shrink assets when economic return is below the cost of capital, and seek to improve economic return when it is approximately equal to the cost of capital (Exhibit 1). Using our internally developed value creation model and our proprietary corporate performance measure, each variable of quality can be objectively measured.

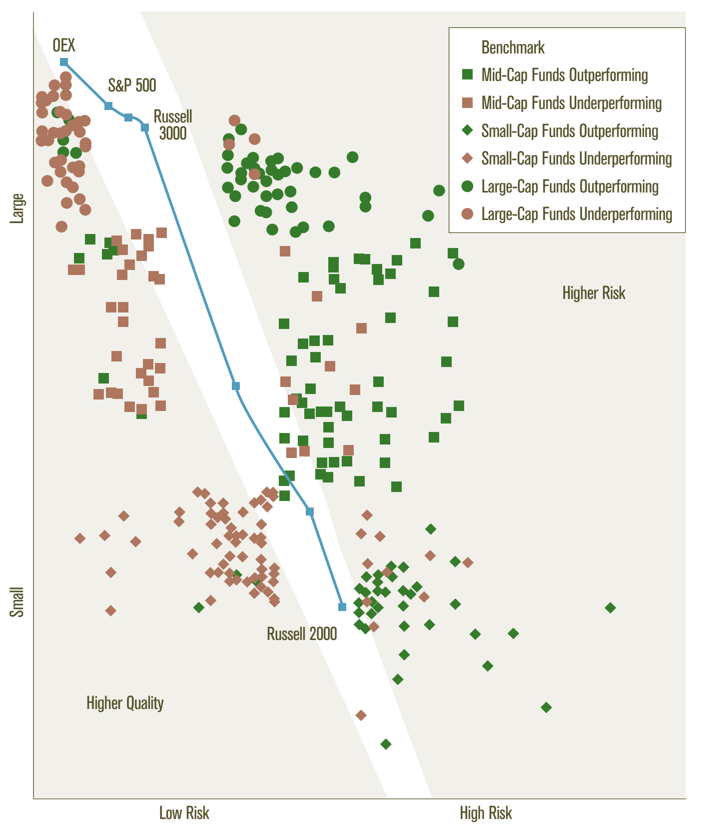
EXHIBIT 1 CAPITAL ALLOCATION



Source: RMB Asset Management.

Because high-quality equity portfolios generally have lower volatility, less credit risk, and less operating leverage, they tend to lag in strong bull markets, particularly in "risk-on" markets—i.e., periods when investors are more likely to invest in higher-risk investments than they would be at other times. A recent example of a risk-on market was the post-2016 U.S. election environment, where lower-quality Russell 2000 Index stocks sprinted 17% higher from November 16 through the end of the year, compared to the 7% increase of the S&P 500. By using our research team's risk model to plot the universe of mutual funds and observe the relative performance results, we can identify a clear pattern. Mutual funds that invest in higher-quality companies underperformed during this period, while mutual funds that invested in the lower-quality companies outperformed (Exhibit 2). »

EXHIBIT 2 MUTUAL FUND RELATIVE PERFORMANCE FOLLOWING THE ELECTION (11/09/16-12/31/16)



Source: Bloomberg, CRSP–The Center for Research in Security Prices, RMB Asset Management. Relative performance was calculated by comparing each fund's total return from 11/09/2016 to 12/31/2016 against the corresponding Russell ETF universe (Small Cap: IWM [Russell 2000 ETFs]; Mid Cap: IWR [Russell Mid Cap ETFs]; Large Cap: IWB [Russell 1000 ETFs]) total return from 11/09/2016 to 12/31/2016. Funds shown are (1) the 20% of the total universe analyzed with significant credit quality bias (high and low) compared to their respective benchmark and (2) the 80% of that subset of funds that out/underperformed their corresponding benchmark by 100 basis points or more. High Risk means the fund has higher risk than its designated benchmark. Low Risk means a risk of loss of all or part of your investment.

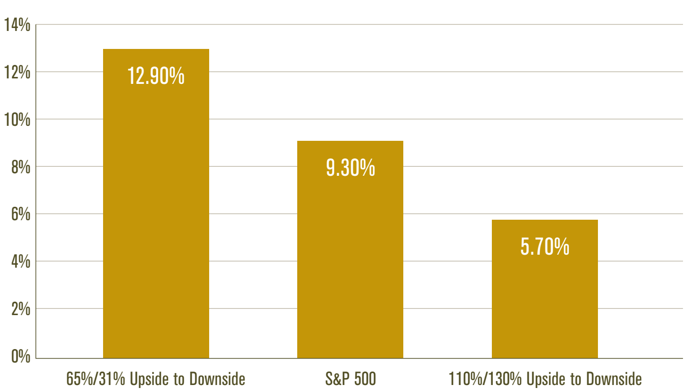
If the performance of high-quality companies is going to drag when the market is charging ahead, why should you consider owning them in your portfolio? Because they provide critical downside protection in risk-off markets, during which they tend to outperform, and protecting capital in down markets is essential for long-term capital growth.

So then, what is more important—gaining more in up markets or losing less in down markets? There is no simple answer. It depends in large part on the length of time over which you're investing and the proportion of down markets during that time.

To illustrate, we'll look at the annualized returns from 1928-2016.[1] As shown in Exhibit 3, a hypothetical equity portfolio that captured 63% of the upside but only 31% of the downside over that period (as, theoretically, a high-quality portfolio would) delivered a 12.9% annualized return compared to only 9.3% for the S&P 500. Comparatively, a portfolio that captured 110% of the upside but 130% of the downside delivered an annualized return of only 5.7% in that time. The lesson is clear. Over this extremely long time horizon, capital preservation is vital to the long-term compounding of wealth. Given that high-quality portfolios historically preserve more capital in down markets, they offer a clear advantage in this scenario.

Most investors, though, don't have the luxury of holding their investments for the better part of a century.

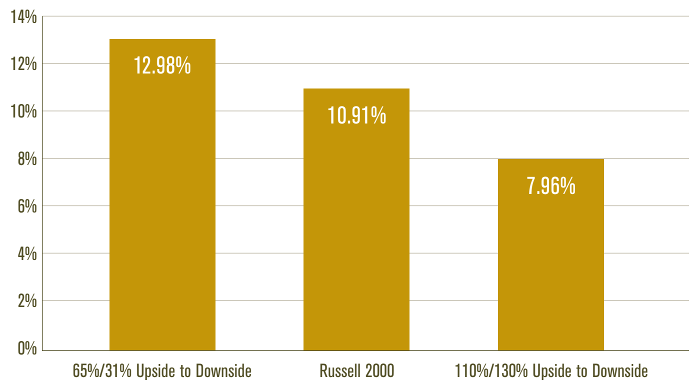
EXHIBIT 3 ANNUALIZED RETURNS 1928-2016



Source: Pension Partners, Charlie Bilello.

How do these percentages compare to a shorter, but still "long-term," investing period? Exhibit 4 shows annualized returns of the Russell 2000 Index from 1980 to Q3 2018 and illustrates similar results. For a portfolio that captured 65% of the upside but only 31% of the downside, annualized returns were 12.98%—beating the Russell 2000 benchmark and the portfolio that captured 110% upside and 130% downside scenario.

EXHIBIT 4 ANNUALIZED RETURNS 1980-Q3 2018

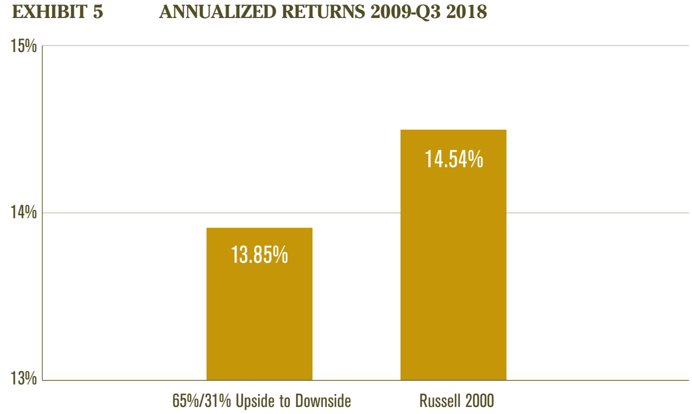


Source: RMB Asset Management.

In contrast, if we return to the scenario hypothesized at the very beginning of this article, where the investment period is 2009 through 2018, the results look substantially different (Exhibit 5).

Why the difference? It's a function of both the frequency and magnitude of down markets since the beginning of central banks' grand experiment, quantitative easing (QE). Starting in 2009, to stanch the losses of the »

EXHIBIT 5 ANNUALIZED RETURNS 2009-Q3 2018



Source: RMB Asset Management.

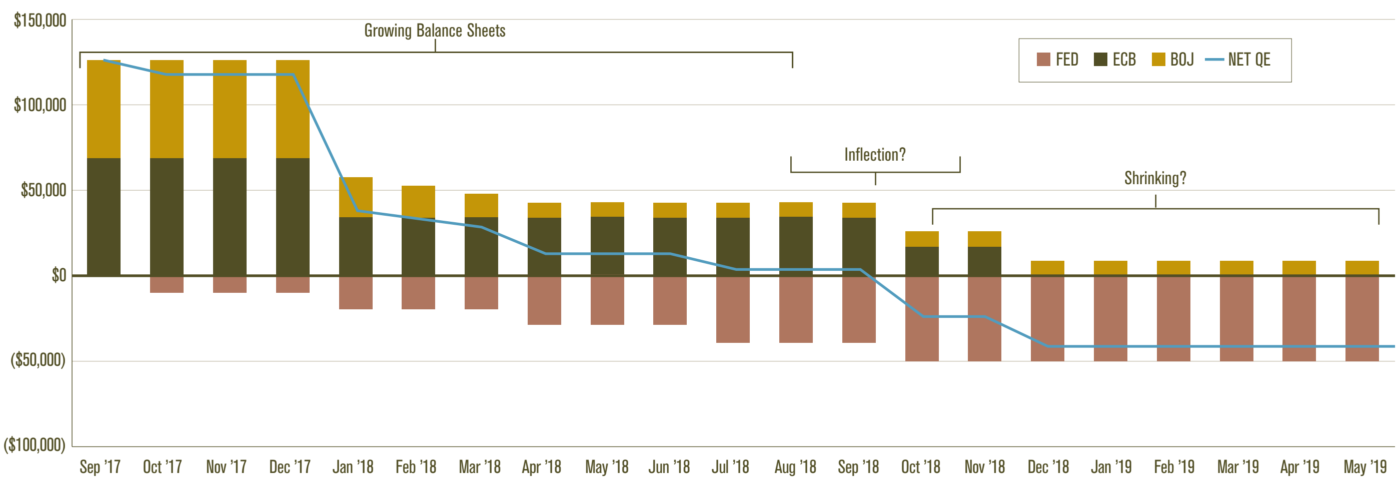
Great Recession, the Fed and other central banks flooded the market with cash, artificially raising prices. Each year since then, or 100% of the time on an annual basis, the S&P 500 has gone up. For comparison, looking at annual results from 1928 through 2017, the S&P 500 went up 73% of the time and down 27% of the time. From a magnitude standpoint, the S&P 500 averaged 19% annual returns from 2009-2017, but only returned 9.4% annually from 1928-2017. If markets only go up, then downside capture—the main benefit of high-quality portfolios—is irrelevant.

Why Now Is a Good Time to Consider High-Quality Portfolios

Back in October 2017, an important milestone occurred related to QE. The Fed started reducing its balance sheet by $10 billion per month, marking the beginning of the end of expanding excess liquidity. In June 2018, the European Central Bank (ECB) announced it would begin winding down its QE program as well, with a goal of wrapping up by the end of 2018. The Bank of Japan (BOJ) is also actively discussing when to end its program. In September 2018, the net QE of the central banks shifted to negative for the first time since the Global Financial Crisis (Exhibit 6).

As QE continues to wind down, markets should begin to normalize (meaning up 73% of the time and down 27% of the time), and the downside-capture benefit of high-quality portfolios should become apparent again. Given the historical inherent long-term advantage of high-quality stocks, we believe now is the perfect time for investors to examine how their portfolios are positioned from a quality perspective. In our view, it is not a question of *if* we will return to a more normalized market environment, but *when.* ■

EXHIBIT 6 MAJOR CENTRAL BANK QUANTITATIVE EASING ESTIMATES (IN MILLIONS)



Source: RMB Asset Management Core Research. Data as of 9/30/18.

1 *This information duplicates a study that was originally conducted by Charlie Bilello, director of research at Pension Partners.*

Index Descriptions

- The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities. There is over USD 7.8 trillion benchmarked to the index, with index assets comprising approximately USD 2.2 trillion of this total. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.
- The OEX is the ticker symbol used to identify index options traded on the S&P 100 Index. The S&P 100 Index (OEX) is a capitalization-weighted index of 100 U.S. stocks from a broad range of industries.
- The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. It includes approximately 2,000 of the smallest U.S. equity securities in the Russell 3000 Index based on a combination of market capitalization and current index membership. The Russell 2000 Index represents approximately 10% of the total market capitalization of the Russell 3000 Index.
- The Russell 3000 Index measures the performance of the largest 3,000 U.S. companies, representing approximately 98% of the investable U.S. equity market. The Russell 3000 Index is constructed to provide a barometer of the broad equity market and is reviewed annually to ensure it includes new and growing equities.