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What is Quality Investing?

By Brian J. Sokolowski, CFA, Vice President and Investment Officer, 617-441-1422

A Google search for "quality and investing" yields a staggering 136 million results, which is only slightly less than the 158 million results returned when simply searching "investing." We mention this for two reasons: there are clearly varying definitions of quality investing; and quality investing as a style is not undiscovered, and therefore attractive returns adhering to a quality style will require a more robust process than simply buying "the best companies." As practitioners we hope to consistently apply our definition of quality investing to construct durable equity portfolios which produce favorable returns for our clients.

What is quality?

Quality takes on many forms: Central Park or Nantucket real estate, a new Tesla or vintage Cadillac, fine wine, a John Deere tractor, well-crafted dress shoes, the Godfather movies (Parts 1 and 2, at least), a Monet painting, a great restaurant. Most would agree that these are examples of high quality, even if one does not have a particular affinity for Monet, Marlon Brando, or footwear beyond sneakers or flip flops. These examples share some common characteristics, such as being well-made, durable, and holding their value over time.

Outside of the investing world, quality is a relatively straightforward concept on which reasonable people often agree. In the investing world, quality often means different things to different people. A sampling of some of the more popular definitions is presented below.

One of the most influential advocates of quality investing in recent decades has been Jeremy Grantham. His firm, GMO, defines a quality company as one which has low financial leverage, high profitability, and low earnings volatility[1]. A trio of practitioners and academics from AQR Capital and New York University build on Grantham's definition with their definition of quality as "stocks that are safe, profitable, growing, and well managed."[2] Investor and Colombia Business School Professor Joel Greenblatt popularized return on invested capital (ROIC) as a key metric in determining quality[3]. These concepts, in addition to others, have helped contribute to the proliferation of a number of investment products such as the AQR Defensive Equity Fund, Russell Defensive Equity Fund, Dow Jones' Market Neutral Anti-Beta, and Guggenheim Defensive Equity, to name a few[4]. These funds are based on the theory that defensive, or low-volatility, investing shares some of the attributes of quality investing listed above. Finally, a recent notable definition is from University of Rochester Professor Robert Novy-Marx, who believes that gross profitability scaled by assets is a more accurate quality measure[5]. We would describe this measure as an indicator of "quality growth."

How does Cambridge Trust define quality in equity investing?

Our goal is to build durable equity portfolios for our clients, with the objective of achieving attractive long-term returns, while at the same time minimizing risk. To form the foundation of these portfolios we purchase companies that can sustainably grow cash flow over long periods of time, in various economic environments, while being good stewards of - and earning superior returns on - investor capital, and exhibiting the ability to both create and retain a strong competitive position. This is our definition of quality.

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To transform this definition into a repeatable investment process, we incorporate a number of core financial parameters in our quality assessment. We look for companies with strong returns on equity; stable or increasing profit margins, preferably from an already-high base; stable or increasing balance sheet capacity; and strong free cash flow generation.

From this combination of qualitative and quantitative parameters, we build portfolios which hold securities that appear across a number of different approaches to quality investing, many of which were discussed above. For example, we hold both defensive, noncyclical companies as well as cyclical, high-return companies. We also hold "new economy" growth companies that exhibit strong cash flow characteristics and high gross margins, important signals of strong competitive positioning, and indicators of future growth potential.

Why quality?

The case for buying quality investments is intuitive and has ample historical precedent. For our investment objective – long-term growth and preservation of our clients' capital - building quality portfolios of companies that should survive and thrive over time is the most sensible approach, in our opinion. Quality is enduring, which we believe is a good match for investors with a long time horizon. Our philosophy is that we are buying shares of a business on behalf of our clients, not trading stocks. We aim to reduce portfolio turnover and trading activity in order to minimize capital gains and reduce trading costs. Holding quality businesses for long periods is consistent with our goals.

The historic precedent in practice and theory is sound, dating at least back to Benjamin Graham and David Dodd's work nearly a century ago, and exemplified and popularized by great investors such as Warren Buffett. Many of the various quality measurements presented above can trace their roots to the work of Graham and Dodd. Graham cited adequate company size, strong financial condition, earnings stability, a history of consistent dividend payments, and a track record of earnings growth as the main tenets of quality[6]. Graham's most famous student, Warren Buffett, has become a legend by buying quality assets, and characteristically portraying his view with the colorful line, "it's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."[7]

Is quality enough on its own?

Returning to the list of real world quality examples listed above, while most would agree that these are of high quality, there is sure to be disagreement over whether or not these items are worth their often-high prices. Tesla cars are excellent, but many of us would instead prefer one Ford, one Toyota, and the leftover funds to be put towards several mortgage payments (or a boat, or a year of college tuition, etc.). Here enters the very important concept of value.

While there are studies that show favorable performance of quality styles over time, there are also studies that show that the investment return added by quality alone is actually rather small[8]. But, when quality is combined with value, the returns improve dramatically. A recent study by MFS Investments found that over time, low valuation stocks outperformed high quality by a small margin. However, stocks that fit both factors – quality at a value price – outperformed the market by almost 5% per year over the 38 year study period[9]. Further, the study found that the persistence (i.e. the consistency) of returns was greater in the high quality group of stocks, which makes quality well suited for the long-term, low-turnover strategy we implement on behalf of our clients.

Quality is an indicator, but the future is what matters

So if quality plus value results in such favorable returns, why do not all investment managers just follow this strategy? There are several answers to this question, most of which are based on the observation that there is a positive correlation between quality and valuation – meaning that investors are typically willing to pay more for higher quality companies[10]. So when a quality company has some missteps and the stock price falls, investors are forced to attempt to answer very difficult questions, most of which are centered on whether or not the problems are short term in nature, or if the long-term viability of the business has meaningfully changed. If it is the former – what a great buying opportunity! If it is the latter, the investor is left holding a richly-valued stock with diminished long term prospects, which is not an attractive combination for future returns.

Creative destruction is an immutable law of capitalism, and companies that exhibit financial characteristics consistent with quality investing are not immune to its forces. There is a seemingly endless list of industries that appeared most secure and impenetrable at the moment right before their demise began: horse carriages before the dawn of the automobile,

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mainframe computers before personal computers, copy machines before the internet, and so on.

The New York Times, for example, had many of the hallmarks of a quality investment in 2001: attractive and growing operating margins (19%), excellent returns on capital (20%), cash flow well in excess of reported earnings, a history of earnings growth, and a well-regarded brand and industry leader. Today, we would argue that the New York Times is still a high quality brand, but secular changes in its industry have dramatically altered the company's financial results and its investment merits. Compared to the 2000-2002 timeframe, profit margins have fallen by more than half, revenue per share has declined by 50%, and free cash flow per share is down by 90%. This has resulted in a stock price which now sits 80% below its 2002 peak. With the enormous forces working against the newspaper industry over the past 15 years, one could argue that the company has performed admirably to remain in business and still deliver a good product, but from an investment standpoint the case illustrates that backwards looking quality analysis is not sufficient on its own.

Quality is a dynamic concept

As illustrated in the newspaper example above, sometimes lost in the discussion of quality is what really matters for the performance of any stock is the future – cash flow growth, profitability, and returns, to name a few factors. Indeed, the foundation of equity valuation theory is that the value of a stock is the sum of all future cash flow, discounted at a rate appropriate for the firm's expected risk level. Investors use quality factors as an *indication* of future cash flow and returns, but as discussed above, a quality past by no means guarantees a quality future for a company.

Along with creative destruction come new business and financial models, and different metrics to help investors measure the health and prospects of a company. These evolving factors require that our analysis is adaptable to changing business models, which may not pass quality tests under traditional metrics. For example, twenty years ago almost no one had heard the term "cost-per-click," and just ten years later, when Google first sold shares to the public, it was becoming one of the most closely analyzed metrics in the advertising industry[11].

While cost-per-click is a new business model that had minimal impacts on financial models (advertising dollars still flowed through the financial statement in a similar manner as before), the current move towards the rental of software on a subscription basis rather than through the one-time purchase of a perpetual license has had an enormous impact on financial statements throughout the technology industry. The move towards subscription software (also known as Software as a Service or SaaS) is one component of the trend towards cloud computing. According to Bessemer Venture Partners, spending on cloud computing has increased from $5.6 billion in 2008 to $56.6 billion in 2014, and is forecast to reach $127 billion in 2018[12].

For the software portion of the cloud market, if an investor were to rely on traditional quality metrics such as return on capital, reported earnings, and dividends – one would miss this massive and extremely important trend in technology investing. This is due to the new financial model associated with the adoption of SaaS. In a traditional perpetual software license sale, the bulk of revenue is collected and recognized upfront, resulting in attractive financials the faster a company grows. In a subscription model, revenue is spread equally over the life of a relationship, yet the software company needs to pay its salesperson upfront. While the subscription model is significantly more profitable over time, it actually results in losses in early years as the company pays out commissions which are higher than a single year's worth of revenue from each contract. In this model, cash flow and deferred revenue on the balance sheet are important indicators of quality and growth prospects and need to be prioritized over accounting returns and margins, as the former are leading indicators and the latter are lagging indicators. Having the flexibility to adapt our approach and metrics is critical to success in a dynamic investment world.

A portfolio approach

We have touched on the concept that buying quality companies alone is not sufficient to produce excess equity returns over time. In addition to buying quality companies when short term factors reduce the valuation, while attempting to avoid quality companies which are potential victims of creative destruction, a third tool we utilize is a portfolio approach to degrees of quality. Across most aspects of investing the rate of change of a given factor has the largest impact on returns. Also, as mentioned above, the highest quality companies

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A Quality of Life Plan

By Laura C. McGregor, Vice President and Trust Officer, 617-441-1434

How do life changes affect planning?

There are many changes in life and those we think of most often are the birth of a child or grandchild, retirement, or loss of a spouse. Other changes we do not think of as often are longevity, incapacity of a spouse or partner, unexpected changes in living costs, or shifts in the financial landscape.

Longevity

When we think of longevity, it is often associated with the idea of traveling and enjoying the golden years but not of living long in retirement. Today, more than one in three 65 year olds will live to the age of 90 and more than one in seven will live to the age of 95 (www.socialsecurity.gov). Planning for a long life is critical as we are living much longer. There are the financial aspects of longevity involving retirement benefits such as 401(k) plans, IRAs, and social security; when and how much to contribute and when to withdraw. There are also the nonfinancial considerations of having a life plan for the unexpected and living longer. Even if we do not live longer, we should have a plan in place to maintain or improve our quality of life.

The Unexpected

We think about our own health as we visit doctors, have tests, and monitor our results, but may not often think about serious illness or incapacity of our spouse, partner, or parents. When the unexpected happens, it can be a very difficult time for you, your spouse, family, or close friends regardless of your age. Preparation is critical in handling the unexpected. It is important to know where assets are located, how assets are titled, have your legal documents up to date, and know where those documents are and how they work.

What would you do if a parent has a sudden illness, is hospitalized for weeks, and then passes away leaving a surviving spouse? The deceased spouse paid all the bills and handled the finances and the surviving spouse had no idea where their funds were located, who had access to the funds, and who to contact for assistance. How are the bills going to be paid including the funeral bill? You need a plan.

Have a Life Plan

A life plan is comprised of organizing documents, selecting a team, keeping legal documents up to date, and communicating with key players in your plan.

First: Organize your documents. Gather and organize information about your assets, benefits, insurance (including life, health, long-term care, and homeowners), and your income and expenses, bank, retirement, and investment accounts. In addition you should include the name and contact information of your advisers, your medical history, healthcare wishes, and burial wishes. All of this material should be made accessible to your spouse, partner, attorney-in-fact, health care agent, trustee, or named executor. The location of all legal documents should be made known to the person who will be in charge of your affairs if you are incapacitated. A notebook with electronic back up is a great way to organize your plan. If the notebook is in your home and you are unable to access your home because of a natural disaster, the alternative electronic storage will be helpful and someone you rely on will have all of the important information together in one location.

Second: Select a team. You will need key players to serve as your health care agent under a health care proxy for medical decisions, attorney- in- fact under a durable power of attorney for handling financial matters, guardian for minor children, trustee, and personal representative. These individuals may be family, friends, or trusted advisers such as an accountant, lawyer, or trust officer (not named individually). You will need people whom you trust and find comfortable and easy to communicate. However, they must understand in advance what may be expected of them, be available and able to assist when needed to handle decisions on your behalf, and also know when to seek help.

Third: Make sure you have the appropriate legal documents which name the key players of your team. The basic documents include: health care proxy, durable power of attorney, will, and if appropriate, a revocable trust. Your attorney may suggest additional documents depending upon whether you own a business or investment properties, for example. The legal documents needed depend on each individual's assets.

Fourth: Make sure your assets are titled properly and your beneficiary designation forms are up to date. Only assets titled in your sole name pass under your will. Assets with a beneficiary designation such as IRAs or life insurance pass to the beneficiary named on the form. Assets in the name of the trustee of a revocable trust stay in trust and pass according to the terms of the trust. You want your estate plan to work and you may have a great plan but if the assets are not titled properly or beneficiary designations are not up to date, your plan may not work. Here are two examples of what can go wrong:

Wife has married twice and has children from her first marriage. All of wife's assets are titled in joint names with rights of survivorship with her second husband. She has an estate plan with a will and a revocable trust leaving all of her assets under her will to her trust. The trust provides to take care of husband during his lifetime if he survives her and on his death the assets will pass to her children. Warning! Since all of wife's assets are jointly titled with husband as mentioned above, all of her assets will pass to him if he survives her and nothing will be in her trust and ultimately nothing to her children as she intended. Husband will be able to pass the assets according to his will. Make sure your assets are titled properly.

Individuals with multiple IRAs or 401(k) plans should review the beneficiary designations to make sure the named beneficiaries are accurate. This situation can arise over a long career and a few job changes. Each 401(k) plan, IRA, or other type of retirement account has a beneficiary designation form on file with the trustee or custodian and each account could have a different beneficiary. The balances in each plan may vary widely even if they have started out at the same size. The result could be that some beneficiaries receive substantially more than others. A thorough review of all beneficiary designations should be done and changes made if necessary to carry out the intent of the account owner. For example, if your will or trust treats all beneficiaries equally and your retirement account designations are not up to date, your will does not accomplish this intent unless there is a specific provision in the will to equalize among your beneficiaries. As a reminder, assets with a beneficiary designation pass outside of your will or trust.

Fifth: Keep your legal documents up to date. As your life or your family changes, make sure your will and trust change along with them. For example, if a child develops health issues and your plan has this child's share of assets distributing outright to your child upon your death, you may want to consider a change in the terms of your will and trust. Your concern may now be to ensure that there will be assets for your child's care during lifetime and then go to your grandchildren. You would change your plan accordingly so instead of the assets going outright upon your death, they remain in trust for the benefit of your child during their lifetime and then to grandchildren. As your life changes, and as the tax laws change, these should also prompt a review and update.

Finally: Communication is crucial. It is great to be organized and updated on all aspects of your life plan, but you must communicate the location of your information to your key players. Your attorney must know your wishes to prepare your legal documents, which will give your key players the authority to act on your behalf. Communication is the way to ensure that your wishes are carried out during your lifetime and after your death. Being prepared and the extra effort in communication and planning make a difference.

What is Quality Investing? *(continued from page 3)*

are often afforded the highest valuation multiple on their earnings from investors. Therefore, by utilizing a portfolio approach to quality, we aim to identify and purchase a number of "good" companies which we believe are on their way to becoming "very good"; a number of "very good" companies which are on their way to becoming "great"; and a number of "great" companies which we believe can remain "great" for a long period of time. This approach helps us capture the very powerful valuation increase as a company moves up in quality level, and – equally as important – it reduces risk by ensuring that the portfolio is populated not only by richly valued great companies, which can be susceptible to corrections during periods of market weakness. In the ideal scenario, we identify and purchase these great businesses, such as Starbucks, O'Reilly Automotive, and Google before they become great, which lead to very strong stock returns as earnings grow rapidly and investors place a higher valuation multiple on the shares.

How does Cambridge Trust apply quality across its equity strategies?

At Cambridge Trust, we manage four distinct Equity Strategies for our clients: Total Return Equity (large cap growth); Equity Income (dividend growth); Capital Appreciation (multi-cap growth with a focus on small and mid-cap companies), and Sustainable and Responsible Investing. We utilize the quality approach outlined above for each of these strategies, although it is tailored to meet the needs and goals of each specific strategy. For example, Total Return balances a mix of quality growth companies that may have high gross margins but lower current operating margins as the firms continue to invest for the future, with an exposure to slower growing firms with very high returns and high dividend payouts. For Equity Income, our quality focus is primarily on companies' ability and willingness to consistently return cash to shareholders through meaningful dividend payments, as well as the companies' ability to continue to grow the dividend in the future. For Capital Appreciation, our focus is on small and medium sized quality growth companies with strong competitive positioning in attractive industries, which is often signaled by high gross margins and substantial cash flow. Finally, for Sustainable and Responsible Investing, we focus on quality in terms of a company's commitment to and impact on environmental, social, and governance issues, as well as its traditional financial quality metrics.

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[1] "The Case for Quality – The Danger of Junk"; GMO, March 2004

[2] "Quality Minus Junk"; Clifford Asness, Andrea Frazzini, Lasse Pedersen; October 9, 2013

[3] *The Little Book that Beats the Market*; Joel Greenblatt; Wiley; November 2005

[4] "Quality Investing"; Robert Novy-Marx; May 2014

[5] Ibid.

[6] *The Intelligent Investor*; Benjamin Graham; Harper Brothers; 1949

[7] Berkshire Hathaway Chairman's Letter, 1989.

[8] "Quality Investing"; Robert Novy-Marx; May 2014; Table 2, Page 12

[9] "Quality and Value; The Essence of Long-Term Equity Returns"; MFS Investments; White Paper Series, June 2015.

[10] "High-quality stocks do have higher prices, on average", from "Quality Minus Junk"; Clifford Asness, Andrea Frazzini, Lasse Pedersen; October 9, 2013

[11] Cost-per-click is the amount paid by an advertiser to a website when a user clicks on an advertisement.

[12] "State of the Cloud Report 2015", Bessemer Venture Partners

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