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Defining Quality and Its Benefits for SMID Cap Stocks

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Introduction

Many investment managers use "quality" to describe their investment philosophy and approach to building portfolios. However, this term necessarily means different things to different investors. For the conservative equity investor, quality may mean financial strength and earnings consistency that provide downside protection in recessionary environments. For the long-term growth investor, it may mean high returns on capital and durable competitive advantages to compound growth over multiple business cycles. No matter the style or investment approach, a quality-focused investment manager must clearly define and communicate what quality means to them.

At the same time, applying an overly narrow definition of quality, such as a letter grade assigned by a rating agency, can be limiting and even misleading. This approach can point you toward expensive defensive stocks that are no longer growing or to highly profitable "winners" that are now overvalued and have a competitive target on their backs. An effective definition of quality guides the portfolio management process, leading to actionable ideas.

By applying a comprehensive quality framework, the Johnson Asset Management SMID Cap Core equity team can better identify companies and build portfolios that will reduce volatility in turbulent markets while delivering superior long-term returns across market cycles to compound capital over time.

How Do We Define Quality?

A quality company wins in the long run by wisely allocating capital, building a solid and durable competitive position, and maintaining robust financial strength through business cycles. While a useful definition to communicate a philosophy of quality, is that enough to be put into practice? We would argue no: A comprehensive approach to quality requires a nuanced and relative perspective across many company characteristics, such as sector, industry, and size.

For example, a regional bank investor might prioritize interest rate sensitivity, reserve adequacy, and credit risk, while a software investor may focus on high recurring revenue and defendable competitive positions. At the same time, over 75% of large cap companies have investment grade credit ratings, while almost 40% of small cap companies have negative net income. These differences illustrate the need for a disciplined framework that applies and evaluates quality appropriately across all types of companies.

Our process of determining quality includes quantitative and qualitative elements evaluated at each step of the research process. Our analysts will explore each facet of quality in a manner specific to the company and industry, focusing on four main elements:

- management team
- competitive position
- balance sheet
- quality of earnings

While not every company needs to be superior in each category to be considered high-quality, when viewed in aggregate, we find that solid marks in these crucial elements indicate companies with higher potential for long-term outperformance. With that in mind, we will dig deeper into these critical components of quality, while considering what each means specifically within the SMID cap space.

Strong Management Team

We look to invest in companies with seasoned management teams with demonstrated vision, prudent capital allocation, and a focus on long-term profitability over short-term growth. These traits often coincide with companies with a proven track record of building shareholder wealth.

Quality companies play both offense and defense; they are dynamic and avoid complacency. Strong returns on capital will reflect successful value-added capital allocation decisions made by management, such as internal investment, merger and acquisition activity, dividend distribution, share repurchases, and debt reduction. Consistent and reliable execution of a well-defined strategy indicates management strength and provides confidence in the durability of a company's quality characteristics.

The process for assessing SMID cap management teams looks similar to that of their larger peers. Strong SMID cap management teams may have company founders with deep knowledge of the business, or skilled leaders with training and experience with larger quality companies. Because SMID cap stocks receive less coverage from Wall Street analysts and the media, there are more opportunities to discover lesser-known business leaders who possess both strong vision and the ability to execute sound strategy with proper shareholder alignment.

Strong Competitive Position

Competition continually threatens any company, especially those operating in high-return or high-growth businesses. Quality companies have successfully carved out a leadership position or proprietary niche in their markets, ultimately leading to stable or improving market share over time. They have a competitive advantage extended over multiple cycles, with cash flow returns routinely above the cost of capital.

Quality SMID cap companies may include market share leaders consolidating a fragmented industry and emerging companies delivering better products or services than large cap incumbents.

Strong Balance Sheet

A company's resilience in challenging economic or capital market conditions plays a crucial role in our quality evaluation. Financial markets tend to punish companies with the weakest balance sheets during periods of turbulence. On the contrary, companies that prudently build rock-solid balance sheets tend to provide downside protection during these difficult periods. Assessing balance sheet health requires credit analysis that looks at financial leverage ratios and interest coverage, in addition to monitoring market signals such as credit spreads and rating changes.

Within the SMID cap universe, many companies are in an earlier growth stage than their large cap counterparts. A quality SMID Cap company uses effective balance sheet management to invest in growth via capital spending or acquisitions. A prudent amount of leverage can be an effective strategy for a quality SMID Cap company. Our approach to quality identifies companies that effectively manage the balance between growth and financial robustness.

High Quality of Earnings

Quality companies enjoy stable earnings and businesses less sensitive to the overall business cycle than their lower-quality counterparts. This lower degree of earnings volatility typically reflects relative price stability over time. Lower-quality stocks may experience periods of higher growth, particularly around cyclical expansions; these periods often revert at cycle peaks and ultimately result in a lower average over time than their high-quality peers.

We look at accounting quality to identify relatively "clean" earnings – not distorted by revenue recognition problems, bloated inventory, or excessive write-offs. Ultimately, we are most interested in the cash produced by these clean, stable earnings. High-quality companies will be free cash flow positive in most years, demonstrating an ability to balance investment in the business with free cash flow generation for the benefit of shareholders.

With more than one-third of the SMID Cap universe producing negative net income results, simply focusing on companies that even have profits can start to narrow the field. While growth opportunities naturally exist for smaller companies that are less mature, we do not invest in companies that aggressively spend to fund their future growth at all expenses.

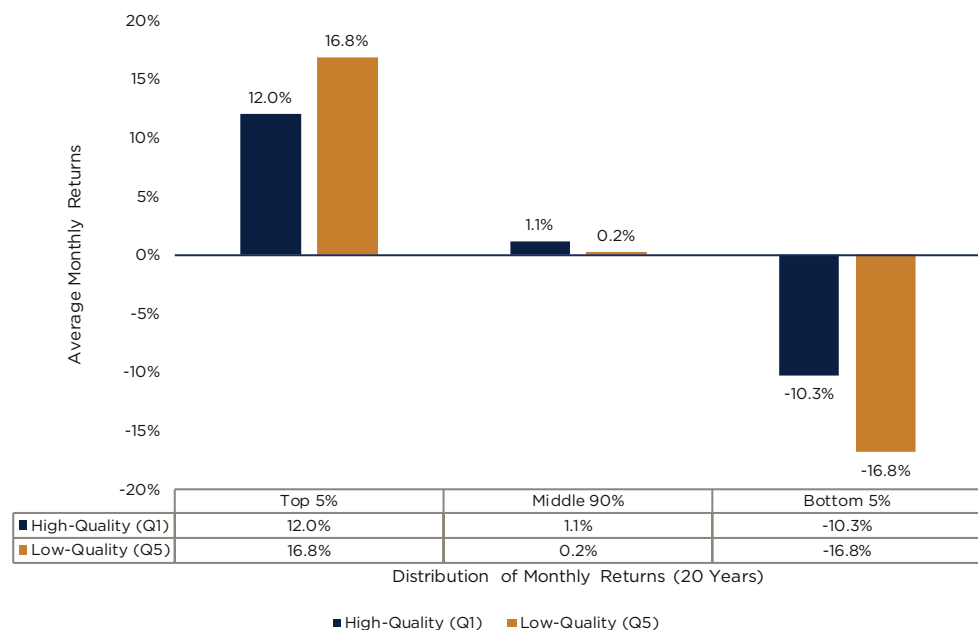
Quality Investing Sounds Good...But Does It Work?

History teaches us to expect two things from the market over time: compounding wealth creation and unpredictable disruptions. Fortunately, our research and experience demonstrate that focusing on high-quality securities can protect a portfolio from the inherent unpredictability of markets through downside protection while also providing superior returns over full market cycles.

In dissecting the performance of high-quality vs. low-quality stocks, we first acknowledge that relative performance will vary depending on market conditions and business cycle dynamics. While rational investors expect most environments to reward the fundamental profitability advantage of quality stocks, both fear and greed play a role in how markets behave, leading to the inherent unpredictability that investors frequently experience. Fortunately, as we break down stock market returns into a normal distribution and examine the results of high-quality vs. low-quality stocks, we see why quality stocks outperform over full market cycles.

The chart below illustrates the average monthly return of high-quality and low-quality stocks segmented by the top 5% and bottom 5% return months over the last twenty years and the remaining 90% of observations. It demonstrates the difference in relative performance, particularly in the tails of the distribution.

HIGH-QUALITY WORKS IN NORMAL & DISTRESSED MARKETS

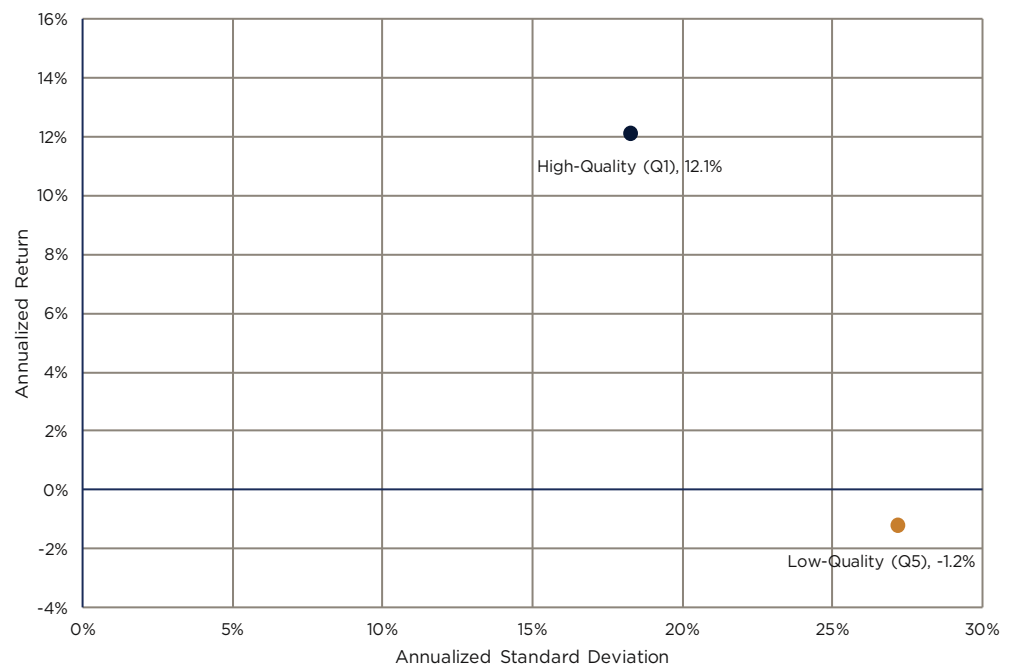


SOURCE: FACTSET, JOHNSON ASSET MANAGEMENT, RETURN DATA FROM 1/1/2004 - 12/31/2023; RUSSELL 2500 STOCKS SORTED INTO QUINTILES BY QUALITY USING A PROPRIETARY MULTI-FACTOR MODEL; "HIGH QUALITY" DEFINED AS TOP QUINTILE (Q1), "LOW QUALITY" DEFINED AS BOTTOM QUINTILE (Q5).

High-quality stocks outperformed significantly in the worst 5% of monthly returns, protecting a portfolio in unpredictable periods of severe market stress. Meanwhile, despite failing to keep pace with low-quality in the top 5% of monthly returns, high-quality stocks provided strong absolute returns in these periods. However, in the majority of monthly returns, the remaining 90% of occurrences, high-quality stocks provided meaningful outperformance over low-quality peers. This return profile, downside protection in the most challenging markets, lagging behind low-quality in the most exuberant and speculative markets, with reliable outperformance in the remaining majority of periods, adds up to consistent outperformance for high-quality stocks over full market cycles.

Ultimately, we observe this dynamic of full market cycle outperformance in the superior risk-adjusted returns of high-quality stocks compared to stocks with the lowest quality characteristics. To demonstrate, we constructed a multifactor model to represent a broad quality characteristic, using key fundamental factors measuring profitability, consistency, and leverage. The chart below shows that over the last 20 years, the top quintile of SMID cap stocks has significantly outperformed the bottom quintile, with a far lower standard deviation. ¹ The highest quality quintile had an annualized return of 12.1%, while annualized returns for the lowest quality quintile were negative.

HIGH-QUALITY VS. LOW-QUALITY STOCKS: 20 YEARS



SOURCE: FACTSET, JOHNSON ASSET MANAGEMENT, RETURN DATA FROM 1/1/2004 - 12/31/2023; RUSSELL 2500 STOCKS SORTED INTO QUINTILES BY QUALITY USING A PROPRIETARY MULTI-FACTOR MODEL; "HIGH QUALITY" DEFINED AS TOP QUINTILE (Q1), "LOW QUALITY" DEFINED AS BOTTOM QUINTILE (Q5).

¹ Using the Russell 2500 Index to represent SMID cap stocks.

Such a large gap suggests that successfully building a high-quality portfolio involves identifying high-quality stocks and avoiding the lowest-quality stocks, often companies with tempting hyper-growth projections or a turnaround story coming off a string of poor results. Focusing on high-quality companies helps investors avoid these temptations and follow a more predictable path to superior long-term results.

Our research strongly suggests the answer to "Does quality investing work?" is "Yes." Focusing on quality within a portfolio will reward the long-term investor focused on compounding wealth over time through full market cycles.

Summary

- Johnson Asset Management defines “quality” as a company that wins in the long run by wisely allocating capital, building a solid and durable competitive position, and maintaining robust financial strength through business cycles.
- Our process for evaluating quality in the SMID cap space requires a comprehensive approach, using quantitative and qualitative research tailored uniquely to companies by sector, industry, and size.
- We focus on four main elements to evaluate quality: management team, competitive position, balance sheet, and quality of earnings.
- High-quality stocks provide downside protection in bear markets and strong relative performance in "normal" market environments while lagging behind low-quality peers in aggressive growth markets.
- This performance profile adds up to outperformance over full market cycles with reduced levels of volatility, leading to superior risk-adjusted returns for high-quality stocks. 🌀



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