TAKE 5 VIEWS

Quality matters

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During this current period of turbulence in the markets, professional investors may attempt to mitigate some of the market volatility by seeking out high-quality companies. This edition looks at what defines these stocks, and why their stodgy characteristics may be attractive in a volatile environment. Our first contributor J.P. Morgan believes they should exhibit strong profitability, financial solvency and accounting consistency. Invesco believes that in an environment of high uncertainty and low returns, investors may place increased emphasis on companies with stable dividends. American Century suggests that over time high-quality stocks have outperformed with less risk. Franklin Templeton has seen very strong dividend trends over the past year and good opportunities across sectors. Capital Group sums it up succinctly "When market volatility is rising, boring is beautiful."

1 Quality over quantity: High quality equity portfolios

J.P.Morgan ASSET MANAGEMENT

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One of the most successful investors of all time, Warren Buffet, once said, "it's far better to buy a wonderful company at a fair price than a fair company at a wonderful price". Despite the recent rise in interest associated with "quality" investing, the premise of owning consistent, profitable companies is not a new phenomenon.

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In this issue

In the shadows of the COVID-19 pandemic, and with more potential stressors to come, we have observed more and more investors taking advantage of the opportunity to reassess the fundamental quality of the companies within their portfolios. With revenues and profits across industries potentially at risk, those companies with strong, consistent balance sheets offer a very attractive value proposition to investors looking to weather any storm that may be ahead. This shift across the global economy has led many investors to take a deeper look at the landscape of "quality"-oriented investments. Yet for investors familiar with this space, and for those just considering it, two main questions arise in the evaluation of a quality stock allocation to their portfolios:

1. What does the research show in terms of quality companies being sound, long-term investments?
2. What are the various ways to define a quality company, and are there differences between these definitions?

A brief review of "quality" factor research

Let's start by quickly reviewing some of the research on "quality" as a company attribute, and how that translates into long-term performance expectations. Quality companies can be defined in many ways, but broadly speaking, we believe that a quality company is one that has strong profitability, manageable debt loads, and consistent earnings and accounting practices, especially relative to industry peers. And, while it may seem as though most of the research related to these types of companies has been published in the last 10 years, the first references to the power of investing in higher-quality companies actually dates back almost a century. While Benjamin Graham and David Dodd's seminal book "Security Analysis" is widely regarded as the foundation for value investing, the authors actually suggested much more just than buying inexpensive stocks. The book also laid out the fundamental importance of profitability and consistency of earnings when determining the fair value of a company. So, despite the terminology of "quality" investing being new to some, we would actually contend that it is actually one of the oldest investing styles in existence.

That said, with more and more fundamental data at all investor's fingertips, there has definitely been a corresponding increase in the amount of research published on the topic of high-quality stocks. Despite an abundance of data showing consistent outperformance of high-quality stocks relative to their lower-quality peers, the question of intuition remains. One would believe that investing in high-quality companies would be accompanied by less risk than lower-quality peers, so why would investors be compensated to take on less risk? While there is no one correct answer to this question, we believe that both behavioral and structural rationale help to explain why this performance gap persists. From a behavioral standpoint, outperformance may occur because of the so-called "glamour stock" effect—whereby investors overestimate and overpay for risky, low-quality stocks that may be perceived as disruptive. In a typical scenario, investors would tend to overvalue these "glamour stocks" that have greater price uncertainty because they see greater potential for outsized gains. At the same time, consistent, high-quality stocks become relatively undervalued, thus positioned to offer increased return potential over the long term. Another potential explanation would be structural in nature. In this scenario, the lower volatility typically associated with quality stocks could reduce demand from investors that have limited, if any, ability to take on leverage. This shifts investor's preferences to securities with higher risk/reward prospects in order to gain potential outperformance relative to their market benchmark. Again, this leaves higher-quality stocks underpriced, increasing their return potential.

Notwithstanding an absolute explanation for quality stock outperformance, we do tend to see this outperformance of high-quality stocks does persist across both time periods and geographic regions. To illustrate this, the chart below shows the annualized performance of our quality factor (which we describe in more detail below) across various regions, spanning a time frame from late 1994 to late 2020. As you can see, no matter which market you evaluate, high-quality stocks have provided strong excess returns relative to their lower-quality peers.

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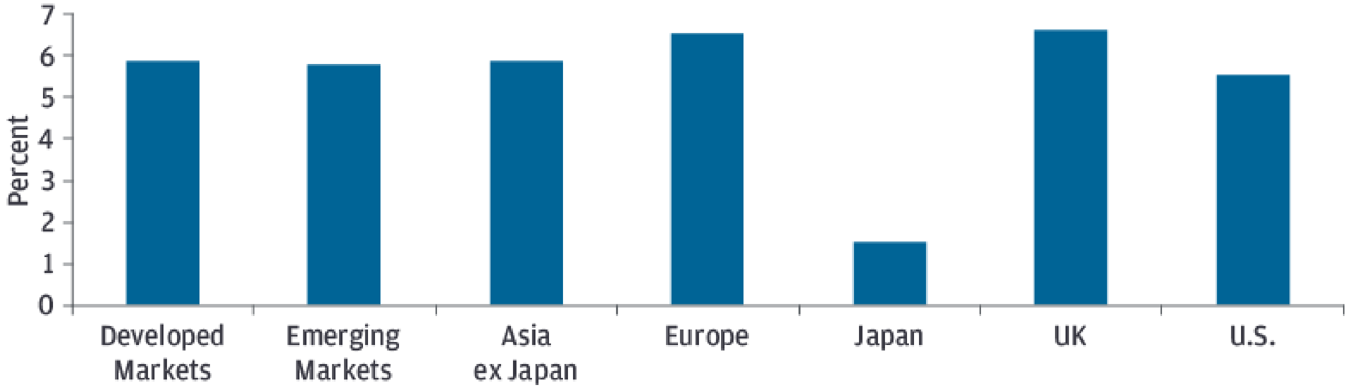
Quality stocks provide attractive returns

Exhibit 1: Excess annualized return of quality factor across all regions



Source: J.P. Morgan Asset Management, Factset. Return data annualized from 12/31/1994 to 9/30/2020. Factors presented are long-short in nature and represented as 100% long notional exposure.

How to define "quality" in factor investing

While all of that research is helpful, most investors raise the question of the ambiguity of the term "quality": How does one truly define quality, and do the various ways to define this characteristic really make much of a difference? The short answer is absolutely! Based on years of research and implementation of factor portfolios, we believe that the most complete picture of a company's fundamental quality should be based on three main pillars: profitability, financial solvency and accounting consistency. There is strong intuition and academic research behind each of these pillars, which we believe is an extremely important foundation for our research. But when it comes to actual implementation, we believe it is just as important to consider how each component interacts with the others. Specifically, do they help us gain a clearer picture of the company's overall quality, or do they just duplicate the same signal, thereby making multiple metrics unnecessary? Looking at our data spanning 30 years (from 1990 to 2020), we see an average pairwise correlation between these three pillars of quality of just 0.34. This is a clear sign to us that each of these pillars gives us a unique picture of company quality, and are therefore diversifying to each other. Not only are they diversifying, but all of the pillars have also exhibited excess performance on a global basis over these 30 years. This means that, as the old saying goes, the whole is greater than the sum of its parts. Finding companies that have strong profitability, low leverage, and reliable accounting practices provides us a more complete and consistent picture of quality than any one of these signals individually.

2 Dividend-paying stocks for uncertain markets

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Invesco

Investors are rediscovering the potential benefits of dividend-paying stocks in a volatile market that's favored stability and income over riskier growth companies.

In fact, we believe we are entering a period when dividends may play a key role in portfolios. In an environment characterized by high uncertainty and the possibility of more muted or even negative returns, we believe investors will place increased emphasis on companies with stable dividends. Generational tailwinds also support the case for the rising importance of dividend-paying stocks as baby boomers age and increasingly seek sources of income. Dividend-paying stocks are viewed as less risky than high-growth stocks, but can still help deliver long-term capital appreciation, which is important to protect purchasing power in a backdrop of rising inflation.

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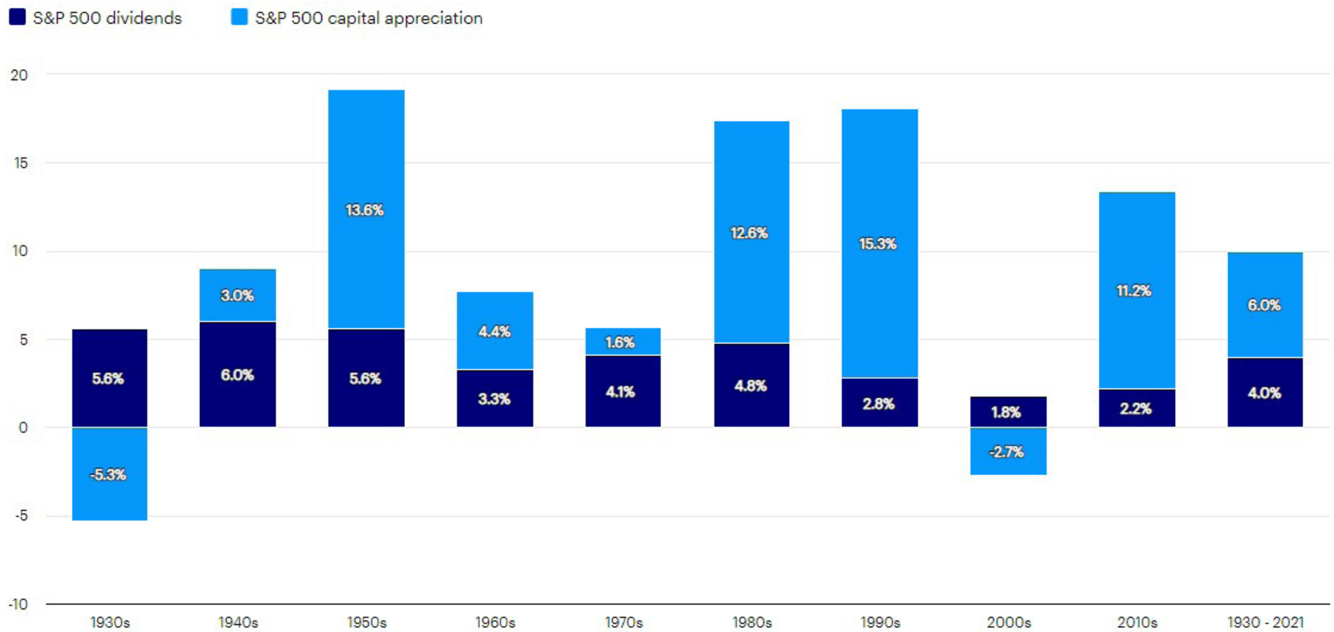
We'll examine three reasons why dividend-paying stocks may be a foundation for investor portfolios, and why active management is valuable when choosing a dividend investing strategy.

1. Dividends have been a meaningful source of the market's overall return

Dividend-paying stocks are an important component of total investment returns over long time periods and across varying market environments. From 1930 through 2021, compounded dividends accounted for about 40% of the S&P 500 Index's total return. Dividend income can help investors during rocky markets since dividends have historically added to returns even during periods in which S&P 500 Index returns were negative when only factoring in capital appreciation, as they were during the 1930s and 2000s.

Dividends have been an important component of S&P 500 Index returns
S&P 500 Index returns by dividend and capital appreciation



Source: Ned Davis Research as of 12/31/21. Data is updated annually.

2. Dividend-paying stocks have outpaced non-payers

Dividend-paying stocks have significantly outperformed non-payers over the long term. For example, dividend payers delivered a 13.16% average annual return while non-payers saw a return of 12.34% from 1973 to 2021. A difference of less than one percentage point might not seem like much of a difference until you compare the results over time with the power of compounding. A $100 investment in non-dividend paying stocks in 1973 would have yielded $34,161 by 2021 compared with $50,025 if one had invested in dividend-paying stocks.[1] That's a difference of more than 40% in final value!

1 The performance results shown are hypothetical. Past performance is not a guarantee of future results.

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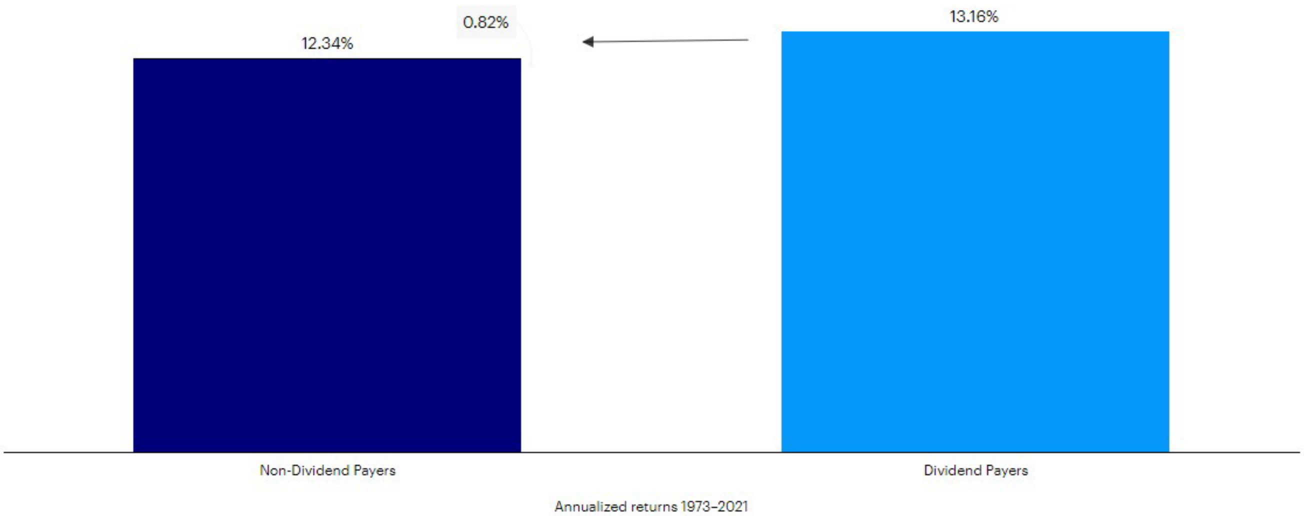
Dividend-paying stocks have outperformed non-payers over time



Source: Ned Davis Research, S&P Capital IQ, Compustat.

3. Dividend-paying stocks are a potential alternative to cash and fixed income

Market volatility and risk aversion can force some investors to throw in the towel on equities and seek the safety of cash, and it may be tough for them to return to stocks. However, investors in money market funds and certificates of deposit haven't generated much income because interest rates have been so low. Now, rising inflation means real returns for many cash-like investments are trending into significantly negative territory.

Some investors moved into longer maturity government bonds and bond funds in search of higher yield for their cash. However, with additional interest rate hikes in 2022 and 2023 looking more likely, bond prices have generally fallen. As a result, investors who fled equities for the safety of fixed income with longer durations also may need to re-evaluate their portfolios.

With inflation rising and unlikely to cool anytime soon, some investors will need to consider increasing their risk appetites and returning to equities to get back on track with their long-term financial goals. We believe dividend-paying stocks are a prudent option with lower volatility and more downside protection potential due to the income generation than riskier equity investments that rely solely on capital appreciation.

The case for active management in dividend value investing

Diversified dividend value investing is a comprehensive strategy, not a single investment factor or narrow style box. Simply screening for the highest-yielding stocks in the market can be a risky approach because those companies may not be able to sustain the dividends or may even be distressed. Instead, we believe actively focusing on companies with growing free cash flow and strong balance sheets is a better way to gauge and value a company's ability to pay and grow dividends, which may be an essential part of a total return strategy.

When done the right way, dividend value investing also requires an eye on overall portfolio construction. Aside from potentially increasing risk, chasing stocks with the highest dividend yields can also lead to inadvertent sector concentrations. This in turn can result in unintended portfolio volatility, extreme factor bets, and elevated correlations among individual stocks in a portfolio, which hurts diversification. Diversified dividend value investing, on the other hand, may result in better risk-adjusted returns potential and limit volatility during turbulent markets.

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Conclusion: dividends may deserve a place in your portfolio

Dividends have been and should continue to represent a vital part of the equity market's total return. And as investors navigate the increasingly complex market dynamics of geopolitical tensions and inflation, we believe they would be well served to reconsider the importance of dividend income. Consistent dividend payouts can also indicate financial strength, strong corporate governance, and a company's commitment to shareholder value.

Rather than looking for the highest dividend yields, we believe investors should focus on quality companies with growing free cash flow, strong balance sheets, and capital discipline. Dividends should also be viewed within the context of total return and risk, including potential capital appreciation with lower potential volatility. We believe active managers are best equipped to assess the total-return potential of investing in dividend-paying stocks throughout a full market cycle.

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3 The Enduring Case for Investing in Quality Companies

Peter Hardy, CFA, Sr. Client Portfolio Manager
American Century Investments

American Century Investments®

Key Takeaways

- The potential for rising inflation and market volatility are top of mind for many investors.
- We think investment strategies that incorporate high-quality companies may be appropriate for those seeking to manage long-term risk.
- Over time high-quality stocks have outperformed with less risk.

What Is a Quality Stock?

While there's no universally accepted definition of quality, we consider various characteristics when evaluating the quality of companies, including:

- Strong management teams
- Leading market positions and strong brands
- Business models that provide steady streams of income
- High standards for environmental, social and corporate governance issues
- Low levels of debt that could help weather market downturns or acquire other businesses

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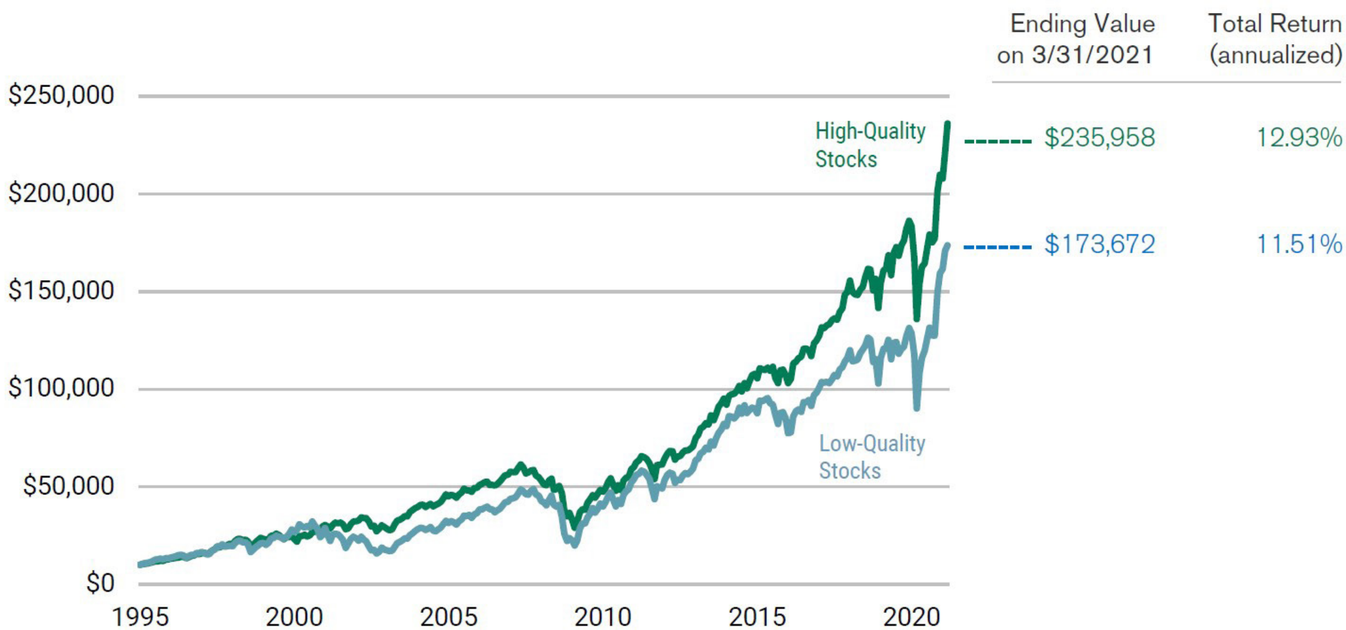
High-Quality Stocks Have Performed Well Over the Long Haul

As shown in figure 1, high-quality stocks (rated B+ or better by S&P Quality Rankings) have outperformed low-quality stocks (rated B or worse) over the last 25 years. The ratings are based on past performance of a stock's earnings and dividends over the most recent 10 years. A $10,000 investment in high-quality stocks in 1995 would have grown to $235,958 by March 31, 2021, compared to an ending balance of $173,672 for low-quality stocks. This equates to an average annual total return of 12.93% versus 11.51%.

We believe higher-quality companies are better equipped to grow when the economy is strong and withstand downturns when the economy weakens. We look for businesses whose assets achieve high, sustainable returns on capital and generate attractive free cash flow. Low levels of debt and leading market positions also are key characteristics.

Figure 1
Growth of $10,000 Invested in High-Quality and Low-Quality Stocks



Data from 12/31/1994 – 3/31/2021. Performance in USD. Quality is based on S&P Quality Rankings using equal-weighted returns of the Russell 1000 Index. High-quality and low-quality stocks are defined as those rated B+ or better and B or worse, respectively. Source: FactSet, Merrill Lynch.

High-Quality Stocks Have Historically Outperformed with Less Risk

Investment returns are helpful for evaluating performance of a given investment, but they don't account for the risks involved. One way to assess risk is by measuring the variability of investment returns. Investments whose returns are relatively steady are considered less risky than those whose returns vary widely over time.

Figure 2 plots the returns of high- and low-quality stocks versus their levels of risk, or variability, since 1995. High-quality stocks have not only outperformed low-quality stocks and the broad market over time, but they've also done so with less risk. We believe their performance profile may appeal to conservative equity investors.

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FIGURE 2
Return vs. Risk of High-and Low-Quality Stocks Compared to the S&P 500 Index
12/31/1994 –3/31/2021

Data from 12/31/1994 –3/31/2021. Performance in USD. Quality is based on S&P Quality Rankings using equal-weighted returns of stocks in the Russell 1000 Index. Broad stock market is represented by the equal-weighted returns of all stocks in the S&P 500 Index. Risk is represented by annualized standard deviation, a measure of the variability of returns around the average. Source: FactSet, Merrill Lynch.

High-Quality Companies May Offer Good Options for Conservative Investors

Concerns about inflation and potentially higher interest rates continue. Many observers believe improving economic growth, rising commodity prices, soaring federal debt and onshoring trends among U.S. businesses eventually will drive inflation higher. Besides inflation, many investors have concerns about market volatility, international tensions, extended stock valuations and the global response to COVID-19 and its variants.

Understandably, some investors have also agonized over investments intended to fund college educations, retirement and more. While it's impossible to predict how the downturn will play out, we believe the stocks of high-quality companies have the potential to enhance portfolio resilience and performance throughout the market's ups and downs.

4 The dividend trend may be your friend

Matt Quinlan, Portfolio Manager
Franklin Equity Group

We have seen very strong dividend trends over the past 12 months and good opportunities across sectors, and the outlook remains positive. Many companies that cut dividends during the pandemic have reinstated them, and in some instances, at higher levels than before the recovery. Consider the energy sector as an example. During the early months of COVID-19, many energy companies were cutting dividends.

This trend has reversed over recent quarters, and for many companies their dividend growth has been high. In some cases, special dividends have been distributed because cash flows have been so strong. The banking sector is another area where the pandemic initially hampered dividend growth, but we have seen solid expansion since last summer. We have a positive dividend outlook in the health care sector, an industry that has more predictable demand and good pricing innovation. Finally, we still see opportunities in the technology sector as well.

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An income focus helps mitigate volatility

In our view, an effectively optimized income strategy generates income through attractive dividend-paying companies, equity-linked notes and convertibles, while also offering the potential for market gains. Focusing on income leads to companies with attractive cashflow profiles. In some ways, managing to income is part of managing volatility. Companies that have more predictable cash flows and more resilient dividends are likely to be less volatile.

In our view, the key is to invest in high-quality, blue-chip companies, which allow for better dividend growth and stronger dividend resilience during difficult times. We look to identify market-leading businesses that have proven track records, attractive free cash flow profiles, investment-grade balance sheets, improving cash-flow trends, large addressable markets, and are gaining market share. These companies likely offer strong dividend resilience during tougher times.

As global economies slow, we anticipate smaller dividend increases going forward, and we expect cuts from struggling companies. These scenarios sharpen our focus on companies with stronger moats that may be more resilient during recessionary periods.

For example, companies with pricing power benefit during inflationary periods. Low-cost producers, such as semiconductor manufacturers, are important suppliers to their end markets, whether it be industrial or auto. All industries see pressure when growth stalls, but some are better insulated to withstand headwinds. Companies with good brand equity are valued partners to their customer base and tend to perform better.

5 Rising dividends can counter inflation

from Capital Group mid-year outlook

CAPITAL GROUP®

When market volatility is rising, boring is beautiful. That's why many dividend paying stocks today are compelling, if dull and dependable, investment opportunities.

Global companies paid out a remarkable $1.9 trillion for the 12 months ended May 31, 2022, as measured by the MSCI ACWI (All Country World Index). That represents a 20% jump from the prior 12 months.

"In this low-growth, inflationary environment, I am focusing on companies with manageable debt and sustainable dividends," says Caroline Randall, an equity portfolio manager. "We are finding many across a range of sectors that are increasing dividends 10% a year."

Proven dividend growers can help bolster investment returns when inflation is rising. "I look closely at what companies actually do with their dividend, rather than just what they say they will do," says Randall. "Dividend growth commitments are a critical signal by management about their confidence in the future earnings growth potential of their company."

Companies paying growing dividends can be found across the financials, energy, materials and health care sectors, among others. Examples include U.S. oil giant Chevron, which recently increased its dividend for a 35th year, exploration and production company EOG Resources, Brazilian mining company Vale, defense contractor Raytheon Technologies and British American Tobacco.

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