

Quality will out

Frank Gannon, assistant portfolio manager at Royce & Associates, argues that quality stocks will lead the market recovery – whatever their market cap.

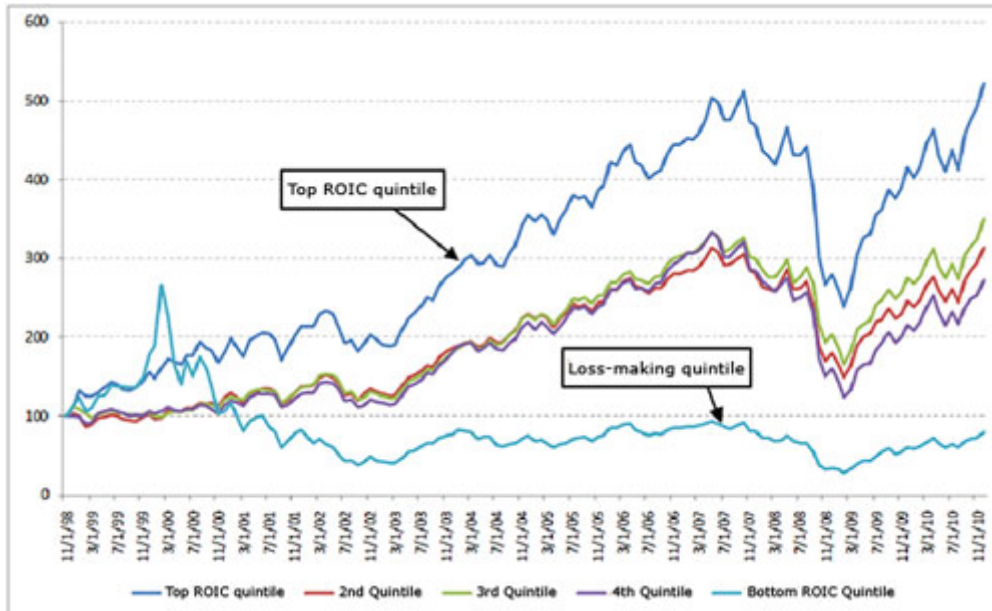
For some time, we have been arguing that higher-quality companies would lead in the market recovery regardless of market capitalisation and especially as the economic recovery matures. Many high-quality stocks still look attractively undervalued, are defensive by nature, and tend to perform better as the economy migrates from recovery to expansion.

We believe a shift in market leadership to high-quality stocks is at hand, especially within small-caps. But what is quality? It may be the most overused word in the investment community today. After all, who thinks that their portfolio isn't high quality?

Still, understanding quality is critical to our efforts. We believe that finding high quality companies is paramount to mitigating risk and achieving above-average, long-term returns. It has always seemed to us that companies with sound fundamentals should deliver superior returns over the long term, particularly when purchased at attractive prices. Our rigorous search for quality includes an examination of a company's historical returns, with a particular focus on return on invested capital (ROIC).

For us, historical returns over full business cycles is one of the first markings of a quality company. Furey Research Partners, an independent small companies research firm, in a recent research report on small-cap highlighted the fact that higher quality companies, as defined by companies with higher return on invested capital, tend to outperform on average over time (see chart below).

Small-caps' "High quality" top ROIC quintile has outperformed over time



Source: Furey Research Partners and FactSet. Small-caps defined as companies possessing market capitalizations between \$200mm and \$3 Bn. Returns presented as cumulative difference between top and bottom quintiles' discrete monthly returns. Data as of 12/31/10.

Another key factor in the process is looking at how a company has achieved its returns. In addition to a strong balance sheet, a record of success as a business and the potential for a profitable future are of prime importance. We engage in a disciplined, bottom-up approach that focuses on identifying companies that are generating strong or improving free cash flow and returns on capital. Our goal is to find quality companies that are trading at a discount to our estimate of their worth as a business. It is a process we repeat everyday.

PLEASE REFER TO THE IMPORTANT INFORMATION ON THE FINAL PAGE.

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While we would agree with those who suggest that now is the time for quality, it has actually been an integral part of our investment criteria for the past several decades. Over the next 10 years, alternating market leadership will likely be the norm. Yet when this decade comes to a close, a focus on quality will still be a cornerstone to achieving our desired results.

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