Modeling Quality: Focus on Sustainable Value Creation

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Traditional quality metrics, such as earnings quality and financial strength, are not the key drivers of our investment philosophy. We differentiate ourselves by placing more emphasis on what we call sustainable value creation.

Beyond Traditional Quality Metrics

Traditional quality metrics such as earnings quality and financial strength are reflected in a strong balance sheet, and a strong balance sheet is important because it allows a company to invest at a lower cost of capital, survive adverse market conditions, and position itself to make acquisitions at opportune times.

But we place more emphasis on sustainable value creation than we do on traditional quality metrics—and by sustainable value creation I mean strong corporate performance.

In a nutshell, we look for companies that can generate cash flows, then reinvest those cash flows at a rate that is greater than the cost of capital over time.

In addition to cash flow return on invested capital, we focus on productivity and profitability metrics such as short- and long-term return on equity and reinvestment rate. We believe these are all drivers of corporate performance.

Sustainable value creation is offensive rather than defensive. Traditional quality metrics are defensive; they tend to perform best in down markets. The idea is that when other stocks are falling, your stock is falling less.

We want participation through cycles—in up markets as well as down markets. That's what offensive quality can provide, and it aligns with our commitment to our clients to provide long-term investment returns.

Quantifying Quality

To quantify quality, we use a model that we believe captures all of the quality components of a company. Within this model, there are three pillars or subcomponents: sustainable value creation, earnings quality, and financial strength.

Sustainable value creation considers things like cash flow return on invested capital, productivity, and profitability metrics such as return on assets, return on equity, and free cash flow margin. Earnings quality and financial strength include more traditional metrics.

We combine the factors in a way that places emphasis on sustainable value creation while not ignoring the traditional quality metrics represented in earnings quality and financial strength.

Each stock is scored based on those factors, and one overall score that represents the quality of each company we follow is generated. This score allows us to assess a company and stock's potential to participate in up markets and down markets.

In other words, because we measure quality with systematic inputs, we can see how each company scores on both the offensive components of quality and the defensive components.

Of course, this is only the quantitative side of our process. We're active, bottom-up stock-pickers, and qualitative aspects are important to our process as well. Our fundamental analysts simply use our quality model as one of many inputs.

A Reflection of Our Fundamental Philosophy

This model is a reflection of our core investment philosophy.

Because our focus for our clients is on long-term investment returns, the durability of a business franchise and its returns and growth are important to us. And we believe corporate performance is the key driver to a company's long-term returns through market cycles.

That's why we've created a model that is designed to capture quality by combining the sustainable value creation score of a stock with its more traditional earnings quality and financial strength scores. We want to make sure our focus is long-term and not myopic.

We believe the sustainable value creation component is underappreciated by the market, differentiating our approach and helping us in our commitment to delivering long-term investment returns for our clients.

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