

Episode 10

What Is Quality?

October 10, 2019

Jason Hsu and Vitali Kalesnik discuss which definitions of the quality factor are robust and have been shown to generate a return premium. Their findings suggest a link between the quality factor and ESG investing.

This Conversation is based on

What Is Quality?
(March 2019)

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 **Conversations**

 Joe It's great to have Jason Hsu and Vitali Kalesnik with us today to talk about their paper "What Is Quality?" which has been published in the *Financial Analysts Journal*. I think it's very well needed because there seems to be a lot of confusion, especially amongst investors, about quality investing. What inspired the research? Jason, would you like to answer that?

 Jason *When Vitali and I embark on a new research idea, oftentimes it's not because we're insightful and creative, but because we work with really insightful people. We talk to asset owners. We talk to consultants. About three years ago, they were asking us about quality as a factor. It was difficult to answer that question, however, because we didn't know what people meant by "quality."*

I think some people meant quality of accounting in that "This is a firm whose numbers all add up." Or does quality refer to the management team? Or maybe it's the quality of the business, for example, a business with growing margins. But without really knowing, it was impossible to answer that question. So we decided to do some comprehensive research—the whole kitchen sink—to include any definition of quality that we have read or heard about.

 Vitali *We looked at it from the perspective of factor investing, considering a few problems common in factor investing, such as data mining. Quality, meaning different things to different people, is a big challenge because, by being ill defined, it offers much opportunity to data mine. That focus as well as looking at the robustness of some of the metrics in terms of their ability to generate return are the core contributions of our article.*

 Joe Based on your research, what quality definitions would you say are robust? What generates a premium?

 Vitali *A few quality definitions that we found to be the most robust are related to profitability, investment, conservative accounting, and conservative issuance policies. Actually, these areas have seen quite a bit of academic research, even though quality is not an academic term. There are numerous articles published on profitability, conservative investment, conservative issuance, and conservative accounting practices. So, not surprisingly, these academically inspired or academically studied definitions tend to be the most robust in terms of generating return and thus are more valuable quality definitions.*

 Jason *As you can see, these four quality factors are not the same thing. They all point to some type of quality, but it's hard to say they are a proxy for the same firm attribute. It's helpful to view them as separate effects that work. Take profitability, for example. These companies tend to have a healthy margin, a great economic moat. They're kind of boring. They're still growing, but are probably not in that initial super-explosive phase when they are seen as sexy. They're no longer sexy, they're not that interesting anymore. They're not what you think of as a ten-bagger, which is what investors are looking for when they're buying growth. In some ways these companies are offering growth at a reasonable price. That makes sense as an investment characteristic that could lead to a better return.*

Look at, say, conservative investment. This is really about CEOs who—despite the fact they have cash sitting around—can raise more cash because they've got strong earnings and a quality business. They show a lot of restraint in reinvesting their firm's money. They don't have an empire-building desire or an issue of money

burning a hole in their pocket. They don't waste investor money. Again, that kind of restraint is actually really rare and it signals high-quality management.

So these things do make sense, and they've been well studied in the corporate finance literature. There's a really good understanding of why these attributes lead to outperformance and what the mechanism for outperformance is.

 Joe

So, Vitali, Jason mentioned the high-profitability companies. Could you give a few examples of those?

 Vitali

Companies that are often picked up in the profitability category typically have other metrics of accounting quality, such as conservative investment, and tend to have strong moats, like ExxonMobil, or companies with strong consumer brands, like PepsiCo or Coca-Cola. These companies generally have been around for a very long time and have a steady stream of cash flows because their profit margins are protected. ExxonMobil has a very strong infrastructure that is very hard to replicate. Coca-Cola and PepsiCo both have a collection of brands that are trademarked and that guarantee their profit stream over long periods.

These companies, especially when we look at other elements related to conservative governance, tend to make sure that management doesn't squander, doesn't build pet projects, doesn't buy jets, but instead returns the company's profits to its investors. Thus, conservative investment, for example, tends to be a very good proxy for quality. And so these are the types of company that get picked up by metrics that have been shown to represent quality.

 Joe

Do you find a link between quality investing and ESG or responsible investing?

 Jason

Definitely. Vitali and I found that, despite the fact these are really different attributes—some are related to management, others, perhaps, to dividend policy or issuance policy—there is a link. Instead of calling them quality, we find the better description may be governance, so the G in ESG. It's management restraint in that management, for example, tries to time the market of a new issue so the stock price isn't so expensive that they are taking advantage of new shareholders.

These attributes, I would say, all fall under the governance label. And certainly there's a reason to believe that governance could be beneficial. These factors do particularly well, especially in emerging markets where governance is more of an issue, where regulators, perhaps, aren't as much on the ball as they could be in terms of dealing with these types of issue.

 Vitali

What is the type of company that would be avoided using this type of screen? Well, a company like Tesla. Tesla is not really profitable and it is making large new capital investments. Elon Musk is a fantastic marketer, but many of the things he does are done to bring more attention to the company and sell the great story around it. We haven't seen tunnels under Los Angeles yet—not even drilling—and there's no colony on

Mars yet—or seen a rocket shoot toward Mars, but his goals are really fascinating. When his plans draw attention, they drive up the price of Tesla stock and make it easier for Elon Musk to build an empire. When there is an unchecked CEO whose attention is engaged in empire building, this is not necessarily the best type of governance.

So it's not surprising then to see a few scandals from time to time and governance-related questions around Elon Musk. That's where the ESG dimension of quality—the governance or G—is probably the strongest. The other piece—an important piece—is that ESG is very topical, although there is not much academic research about ESG and investment performance. But, in my opinion at least, for a few of these financial discipline-related metrics we have pretty strong evidence and economic theory as to why they could be associated with better performance. That provides a potential rationale for investors to marry the ESG considerations with the desire to generate better returns.

 Joe

Interesting. So we've talked about the robust quality definitions. Can you talk about the duds, the definitions that aren't robust but that have been used quite a lot in the practitioner community?

 Jason

There are definitely a lot that didn't work. I'll just offer one. Some people call it capital-structure quality. Essentially, some people claim that firms that are very geared, very leveraged, are bad-quality firms. The United States is a very efficient financial market and US banks have been lending to companies for a very, very long time. Debt buyers are very sophisticated, maybe more sophisticated than equity buyers. If they are willing to lend you money that means you've got cash flow, you've got hard assets in place. If they won't lend you money, it's usually because you're not generating cash flow, you have nothing you could pledge as a hard asset, so you can't finance debt.

So in terms of the amount of debt in a company's capital structure, more is not less healthy, more is not low quality. More is, in equilibrium, exactly what the company deserves. We found that the amount of debt in a company's capital structure is not telling—specifically, nothing shows less debt means higher quality. We just don't see that.

 Vitali

Even economic theory argues that more leverage makes a company riskier and it should earn a higher return. So it's not all that surprising that when we test the data, we don't see any pattern in terms of debt level as a proxy for quality and performance.

Other metrics used in popular quality definitions are earnings growth and earnings stability. Growth-related metrics tend to be already priced in by the time the growth in earnings is apparent, because the frequency of information release is actually quite low. By the time an investor can incorporate that information, the earnings surprise is already in the share price, so it's not all that surprising we don't see a relation to performance.

The fact that we see quite a few quality definitions that are not robust is an important piece of information in itself. That makes the point that factor definitions require quite a bit of scrutiny. There are too many incentives for and possibilities of data mining. Specifically, quality has potentially the greatest vulnerability of the more popular factors to data mining and investors should pay attention.

 Joe

On that last point, do you have any parting words of wisdom for investors who are interested in quality investing? What are things they should watch out for?

 Jason

The quality definitions we found to be robust are actually things that are well understood in the academic literature. A long and thriving corporate finance literature explains why variables such as conservative issuance, conservative investment, and profitability all lead to better outcomes. Other, sort of sexier, innovations and interesting concepts don't really pan out as being robust.

It's the quality metrics, which are supported by rigorous research, that tend to be persistent over time in terms of driving returns. A lot of the bells and whistles that appear in product sales tend to be more fluff than of actual use. So my advice to investors is to really pay attention to the robustness of a factor's attributes. If there are five different definitions for a factor, I'd pick the one that had the best-looking back test. What could they be hiding from you? That's really useful to ask, really useful to think about.

 Vitali

The robust quality definitions share an inherent element, especially when they're combined, and that is quality at a reasonable price. Profitability together with conservative governance-related metrics is more likely to identify well-performing companies, which are not in the spotlight. Even with that general tendency, there's no guarantee the category will not get mispriced, because there is no natural price anchor.

If a company has good profitability and is conservatively governed, it's not true that it will generate return at any price. Therefore, building in some element of a price check is very important. Today, for example, profitability-related metrics tend to be expensive relative to their own history. So I would say watch out. Going forward, profitability may disappoint, at least in the short term, but building into the process some value component can significantly mitigate this risk.

 Joe

Thank you both very much for having this conversation with us and for speaking at the Research Affiliates Investment Symposium in London.

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