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The quality puzzle

Why do markets reward investors for holding stocks that usually provide excess returns over low-quality ones?

Michael Nairne, Focus on Products

Of all the factors associated with long-term outperformance by equities, quality is the most puzzling. Because investors demand a return premium for incurring risk, it is easy to understand why small company stocks have outperformed over long time frames: they are more volatile and less liquid than large-capitalization stocks.

Value stocks – which tend to have more debt, slower growth rates and higher costs of capital than growth stocks do – also have earned a value premium over the long run. But why should markets reward holders of quality stocks with excess returns over those holding low-quality stocks? It is counterintuitive.

There are, however, risk-based reasons why investors might demand a premium for quality stocks. The metrics most associated with identifying quality stocks relate to profitability. The stocks of companies with higher gross profits relative to assets, or higher returns on equity, have, on average, outperformed over the long run. Since profitable firms tend to be growth companies, more of their future cash flow is in more distant time periods. In addition, higher returns on capital may attract more competition, thus eroding future cash flows. Both characteristics add uncertainty, for which investors may demand a risk premium.

Behavioural biases offer an alternative, possibly more compelling explanation. Several studies in recent years have posited that persistent cognitive errors lead to the mispricing of quality stocks. One study found that analysts are, in general, too optimistic in their forecasts for all stocks, but relatively less optimistic about the future returns of high-quality firms compared with those of low-quality companies. Analysts appear to underweight the importance of quality metrics such as cash flow in their estimates of future performance.

Another study found a similar pattern for earnings forecasts. Analysts consistently overestimate the future earning of unprofitable firms relative to profitable firms. Furthermore, investors appear to expect faster reversion to the mean in future earnings than usually occurs.

Another study found that stocks with the "stickiest" forecasts of future earnings have higher returns related to profitability metrics. This is consistent with a cognitive error: investors are slow to incorporate relevant profitability information into their expectations for future performance.

The reward for investing in quality stocks has been considerable. For the 20-year period ended April 30, 2019, global quality stocks – as measured by the MSCI world quality index – earned a 6.6% return (in Canadian dollars), a 1.7% premium over the 4.9% return of the overall global market.

However, quality stocks have had lengthy periods of underperformance. From 1981 to 1988, global quality stocks returned, on average, 6.1% a year less than the overall market. By the end of 1991, this underperformance had been erased and quality stocks were again in the lead, but this decade demonstrates that extreme patience can be needed to earn the quality premium.

Vancouver-based Dimensional Fund Advisors Canada ULC has incorporated the profitability premium in its quantitative weighting of stocks in its equity funds. Toronto-based BMO Asset Management Inc. offers several ETFs focused on quality stocks from different regions. In the U.S., New York-based BlackRock Investments LLC offers two quality-focused ETFs.

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The firm, its principals, employees and clients may own securities mentioned in this article.

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