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Quality is possibly the most subjective factor you will come across and one that is likely to differ depending on who you ask

Enduring Quality

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There are many ways investors try outperforming the market. Tilting the portfolio regionally, moving up and down the market capitalisation spectrum or exposing their portfolio to different investment factors (risk premia). Some factors are well known and easily defined whilst others are less so. In recent times, much has been discussed about the "great rotation" from growth to value. Growth and value companies are widely understood, however there is another factor, namely quality, that has been on the sidelines recently and is less clearly defined. With fears of a correction or pullback rising after such a strong rally in equities – is it time investors start to pay more attention to this cohort of companies which often exhibit lower volatility, and provide more defensive characteristics whilst being capable of delivering a steadier growth path?

Quality is possibly the most subjective factor you will come across and one that is likely to differ depending on who you ask. Unsurprisingly, most investors would claim that they are investing in quality businesses, yet the results can vary wildly across these strategies – so what is quality and how do we define it?

At Momentum we define quality businesses as those that have demonstrated a high and stable level of profitability over the long term. These businesses typically benefit from strong economic 'moats' (defendable competitive advantages) which enable them to sustain above average returns over longer periods. The businesses that fit these criteria generally have low capital intensity (with low reinvestment requirements), low leverage, strong cash flow generation and strong intellectual property such as brands.

The focus on stability typically excludes companies in highly cyclical industries and leads you to more resilient businesses which often have low sensitivity to the economic cycles. These businesses are known as great compounders which can generate returns persistently across different economic environments. They are not fully immune from market swings but nevertheless one can expect a quality firm to be well placed to weather periods of uncertainty.

Unsurprisingly, we have observed that portfolios of genuinely high quality businesses have generated strong excess returns over the long term. The outperformance tends to be more pronounced during periods of heightened risk aversion, but the quality factor has proven it can keep up with the market or even outperform in rising equity markets too. Interestingly, the excess returns over the long run have not been associated with an increase in risk (as measured by volatility). This excess risk "premium" over the market is not widely understood.

So why are these stocks able to generate excess returns over the long term with less risk? This seems counterintuitive and a contradiction to the Capital Asset Pricing Model (CAPM) where extra returns should be accompanied by a *higher* level of risk. There are many possible explanations, of which the majority are behavioural. Firstly, overconfidence bias is one issue. Humans are generally overconfident in their ability to forecast the future, and quality (low volatility) stocks usually have more predictable cashflows which can negate this issue, leaving less scope for forecasting errors. The 'lottery effect' is another reason, as higher volatility stocks are often associated with lottery tickets (potential for a large pay-off but the probability is low) and investors are willing to overpay for this optionality. Quality businesses also tend to be less 'glamorous' and lower octane, which typically leads to lower incidence of unfavourable events compared to their counterparts (high volatility stocks). As a result, they don't tend to fall as much in market downturns relative to other companies and can compound returns at a greater rate over the course of multiple economic cycles. These possible explanations all point towards one thing: quality characteristics have been systematically undervalued by investors over time, relative to lower quality businesses, which has enabled them to outperform broad indices over the long run.

At Momentum, we have invested in quality strategies for many years and believe it plays a key role in all our portfolios, particularly as a diversifier to other style factors within the equity allocation. Quality stocks are a valuable tool for our outcome-based investing approach as their stable return profile and defensive qualities help to deliver a smoother journey for our clients.

Market Focus

- **Global equities rallied +0.2% last week**
- **Crypto-related stocks fell as the People's Bank of China issued a newly restrictive ban on transactions and mining with several other state agencies**
- **Brent crude gained +3.7% last week to $78.1 a barrel, with weekly inventories -3.5m vs. estimate of -2.4m**
- **Gold fell -0.2% to $1750.4 per ounce**

US

- US equities gained +0.5% last week, with the energy and banking sectors outperforming construction and utilities
- August Existing home sales of 5.88m came in lighter than the 5.89m expected and the previous 6m
- Weekly initial jobless claims for the week ending the 18th September rose to 351k from 335k the prior week. The market estimate was for 320k
- The Fed signalled it would probably begin cutting bond purchases in November, and the dot plot revealed the FOMC is now evenly split on whether to start tightening in 2022. Jerome Powell said ending the stimulus program by the middle of next year is "likely to be appropriate," while adding that doesn't mean rate increases would follow immediately
- The Fed raised its 2022 inflation outlook to 2.2% from 2.1%, holding the 2023 forecast at 2.2%
- The U.S. is considering invoking a Cold War-era national security law to force companies in the semiconductor supply chain to provide information on inventory and sales of chips.

UK

- UK equities gained 1.3% last week
- The government took emergency measures over the weekend to ease acute fuel shortages across the country after days of panic buying
- Gas prices continue to rise, and further providers have had to close; the market expects the same to happen this week
- The Bank of England interest rate decision was maintained at 0.10%, in line with market expectations, although two policymakers voted for an early end to the quantitative easing program. The BOE now believes "inflation could remain above 4% into the second quarter of 2022"
- U.K Manufacturing PMI fell to 56.3 from a 59 estimate, previously 60.3.

Europe

- Continental European equities gained +0.3% last week, with travel, leisure, oil and gas outperforming retail and financial services
- In Germany, Olaf Scholz's Social Democrats narrowly won the most votes in Germany's election over the weekend, taking 25.7% versus 24.1% for Armin Laschet's Christian Democrats in a provisional tally. He'll now likely face months of negotiations as he works to secure a ruling coalition
- German September manufacturing PMI decreased to 58.5 from 62.6, and estimates were at 61.5
- Norway is the first G10 country to tighten monetary policy, raising its key short-term lending rate by 0.25%.

Rest of the World/Asia

- The benchmark Global Emerging Markets index fell -0.8% last week
- Chinese equities fell by -2.8% last week, after a four-day weekend. The PBoC flooded the financial system with the largest net injection of short-term liquidity in eight months on Thursday, seen as a signal of support for the market. With Evergrande, risk continues to overhang the market as the dollar bond interest of $83.5M was not paid, adding to default concerns, but the company has a 30day grace period before the bonds default
- Japan's consumer prices stopped falling for the first time in 13 months, ending the longest deflationary stretch since 2011
- Thailand is considering postponing the planned reopening of Bangkok due to increased Covid cases, and South Korea cases are also increasing.

Past performance is not indicative of future returns. Source: Bloomberg Finance L.P., returns in local currency unless otherwise stated.

Market Summary

Asset Class / Region	Currency	Cumulative returns Week ending 24 September	Month to date	YTD 2021	12 months
Developed Markets Equities					
United States	USD	0.5%	-1.4%	19.5%	38.7%
United Kingdom	GBP	1.3%	-0.8%	12.8%	25.5%
Continental Europe	EUR	0.3%	-1.7%	18.1%	32.2%
Japan	JPY	-0.4%	6.6%	17.2%	31.3%
Asia Pacific (ex Japan)	USD	-1.3%	-3.2%	-1.3%	20.3%
Australia	AUD	-0.8%	-1.7%	15.0%	29.4%
Global	USD	0.2%	-1.1%	16.6%	36.9%
Emerging Markets Equities					
Emerging Europe	USD	-0.8%	1.0%	21.3%	49.1%
Emerging Asia	USD	-1.2%	-3.1%	-3.1%	18.5%
Emerging Latin America	USD	0.0%	-7.7%	-2.7%	30.1%
BRICs	USD	-1.5%	-3.5%	-6.3%	10.4%
China	USD	-2.8%	-5.6%	-17.2%	-5.4%
MENA countries	USD	-1.0%	0.1%	26.1%	34.3%
South Africa	USD	1.1%	-5.6%	3.3%	29.5%
India	USD	1.3%	3.1%	27.6%	67.0%
Global emerging markets	USD	-1.0%	-3.1%	-0.3%	22.1%
Bonds					
US Treasuries	USD	-0.5%	-0.7%	-2.3%	-3.4%
US Treasuries (inflation protected)	USD	-0.4%	-0.4%	3.8%	5.8%
US Corporate (investment grade)	USD	-0.4%	-0.3%	-0.5%	2.3%
US High Yield	USD	-0.1%	0.3%	4.9%	12.3%
UK Gilts	GBP	-1.0%	-2.2%	-6.0%	-5.6%
UK Corporate (investment grade)	GBP	-0.7%	-1.3%	-2.8%	1.1%
Euro Government Bonds	EUR	-0.4%	-0.9%	-2.7%	-1.4%
Euro Corporate (investment grade)	EUR	-0.2%	-0.5%	-0.2%	1.8%
Euro High Yield	EUR	-0.2%	0.2%	4.0%	9.4%
Japanese Government	JPY	-0.1%	-0.3%	0.0%	-0.1%
Australian Government	AUD	-0.6%	-1.4%	-1.4%	-1.9%
Global Government Bonds	USD	-0.7%	-1.2%	-4.8%	-2.3%
Global Bonds	USD	-0.1%	-0.6%	-3.3%	-0.2%
Global Convertible Bonds	USD	-0.1%	-0.6%	0.2%	13.9%
Emerging Market Bonds	USD	-1.7%	-2.1%	-3.2%	3.2%

Source: Bloomberg Finance L.P. Past performance is not indicative of future returns.

Market Summary

Asset Class / Region	Currency	Cumulative returns: Week ending 24 September	Month to date	YTD 2021	12 months
Property					
US Property Securities	USD	-0.7%	-3.2%	25.3%	44.2%
Australian Property Securities	AUD	-1.7%	-0.7%	13.4%	26.7%
Asia Property Securities	USD	-1.0%	-2.2%	0.4%	8.5%
Global Property Securities	USD	-0.7%	-3.1%	15.1%	32.6%
Currencies					
Euro	USD	-0.1%	-0.8%	-4.2%	0.5%
UK Pound Sterling	USD	-0.5%	-0.5%	0.2%	7.3%
Japanese Yen	USD	-0.7%	-0.7%	-6.7%	-4.8%
Australian Dollar	USD	-0.2%	-0.7%	-5.7%	2.9%
South African Rand	USD	-1.2%	-2.9%	-1.8%	13.5%
Swiss Franc	USD	0.8%	-1.0%	-4.3%	0.1%
Chinese Yuan	USD	0.0%	-0.1%	0.9%	5.6%
Commodities & Alternatives					
Commodities	USD	1.8%	3.9%	34.4%	54.3%
Agricultural Commodities	USD	1.2%	1.2%	22.3%	46.0%
Oil	USD	3.7%	7.0%	50.8%	86.2%
Gold	USD	-0.2%	-3.5%	-7.6%	-6.4%
Hedge funds	USD	0.0%	0.1%	4.3%	10.0%

Source: Bloomberg Finance L.P. Past performance is not indicative of future returns.

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