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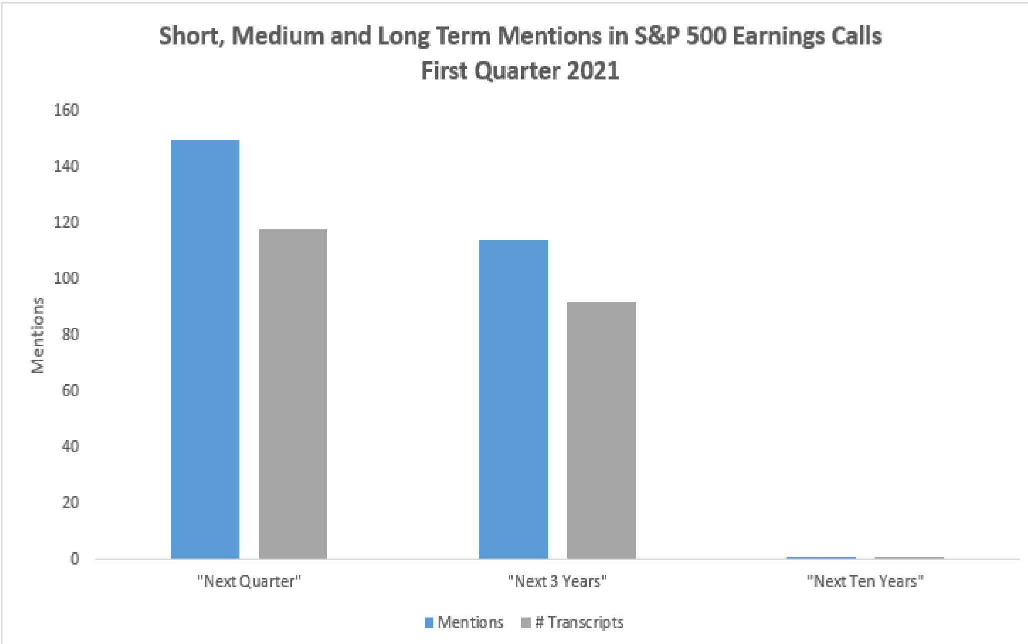
Time for Quality to Shine?



Source: Bloomberg

In a recent client meeting, the Sterling Capital Equity Opportunities Group was asked to describe our investment process. These discussions tend to begin with our four investment pillars, which seek to create portfolios with attractive returns on capital, strong balance sheets, better-than-average earnings growth and below-average valuations. Our investment process is rooted in these pillars and demonstrates the ability to generate outperformance over the long run, according to Ned Davis Research.

This past month, Bank of America's U.S. Equity and Quant Strategy team reconfirmed not only the long-term benefit of owning quality stocks, but also the potential for near-term opportunity. BofA highlights the long-term consistence of quality stocks and shows, in the chart at right, that rolling ten-year returns for high-quality stocks are consistently above zero for all periods since 1986, even excluding dividends.

According to their research, quality investing works best when the stock market focuses on fundamentals, such as earnings growth, earnings estimate revisions, and valuation. In their view, "long term alpha opportunity has increased to multi-decade highs" for this discipline, as stock market participants increasingly focus on the short term. We provide an example of the stock market's focus on near-term results in the chart above. Using Bloomberg, we ran a search on references to short-term information versus long-term information across all S&P 500® Index company earnings calls this past quarter. As the chart illustrates, investor interest decreases as the timeline increases.

Source: BofA Global Research, BofA U.S. Equity & Quant Strategy, S&P

Exhibit 17: Low Quality is crowded, High Quality is neglected
Relative active fund positioning of stocks ranked B+ or better (High Quality) vs. B or Worse (Low Quality), 2008-2/28/21

Low Quality positioning is off the record peak but still crowded

Positioning by long-only funds in Low Quality stock is off the peak but still crowded and elevated vs history.

Positioning in High Quality has picked up but still at secularly low levels.

Source: BofA Global Research, BofA U.S. Equity & Quant Strategy, Lionshares, Standard & Poor's

We believe that taking advantage of this apparent discord between investor interest and the strengths of fundamental investing in quality stocks may offer an advantage as we seek to add value for clients. An assessment of the (typically modest) share turnover ratio of our strategies reveals our focus on aligning our work with our longer-term focus.

With many investors still crowded into low-quality stocks, as shown above, BofA suggests "quality may be one of the better investment strategies for the next month, year and decade." The correlation between longer-term focus, fundamental analysis, and client success is echoed by notable investors over time. A favorite example comes from former Fidelity Magellan manager Peter Lynch who stated, "often, there is no correlation between the success of a company's operations and the success of its stock over a few months or even a few years. In the long run, there is a 100 percent correlation between the success of the company and the success of its stock. This disparity is the key to making money; it pays to be patient, and to own successful companies."

As always, thank you for your interest and trust in managing your investments.

Charles J. Wittmann, CFA®, Executive Director, joined Sterling Capital Management in 2014 and has investment experience since 1995. Chip is an equity portfolio manager. Prior to joining Sterling, he worked for Thompson Siegel & Walmsley as a portfolio manager and (generalist) analyst. Prior to TS&W, he was a founding portfolio manager and analyst with Shockoe Capital, an equity long/short hedge fund. Chip received his B.A. in Economics from Davidson College and his M.B.A. from Duke University's Fuqua School of Business. He holds the Chartered Financial Analyst® designation.

The volatility of an index varies greatly. All indices are unmanaged and investments cannot be made directly in an index.

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