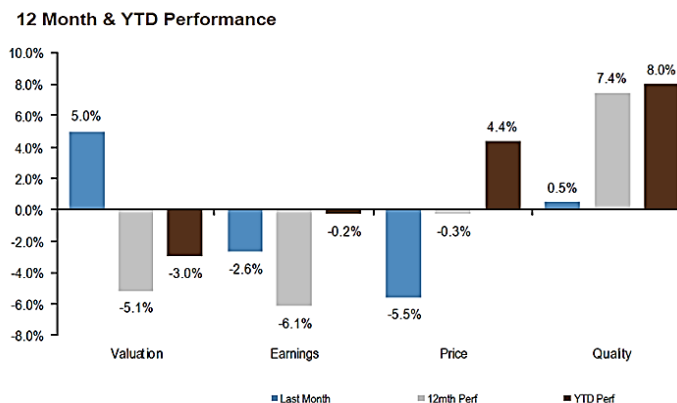




“A stock is not just a ticker symbol or an electronic blip; it is an ownership interest in an actual business, with an underlying value that does not depend on its share price.”

- Benjamin Graham, *The Intelligent Investor*

Performance Difference Between Top and Bottom 10% of MSCI All World Index by Characteristic



Source: MSCI, FactSet, Reuters, J.P. Morgan Macro QDS

In recent client meetings, two common topic discussions have centered around the questions, “what’s worked?” and “what’s your outlook?” In terms of performance in 2019, quality is one theme that has worked. Whether one looks at global equity markets (above) or domestic markets (second page), stocks with higher quality ratings have performed well.

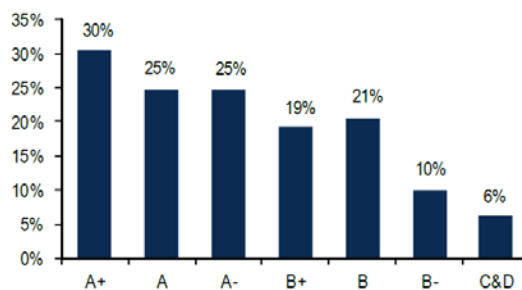
Typically in these discussions, it is a fair question to ask how we define an attractive business. The businesses we want to invest in have six essential elements:

- Industry Leadership
- Niche Domination
- Mission Critical
- Quality Compounder
- Misunderstood
- Disrupter

Market strategists have been searching for reasons for quality’s outperformance through the first nine months of 2019. Merrill Lynch ascribes it to elevated uncertainty in the markets, but many fear gauges, such as the VIX, have remained low and credit spreads tight. Strategas research posits that the flight to quality may be related to a flight to safety with global bond yields hitting historic lows and the potential implications from negative interest rates.

We stay away from predicting the future, but would note Merrill’s observation that high quality stocks tend to outperform in the later stages of the business cycle. Ten years into the economic expansion and with global measures of manufacturing contracting in 2019, a case can be made that investors may have an increasing preference for quality. This month, for example, Ned Davis Research increased their allocation to high quality domestic stocks.

Average performance by S&P 500 Quality Ranks when the profits cycle decelerated (last seven cycles, 1988-present)



Source: BofA Merrill Lynch US Equity and Quant Strategy, S&P

We’d note that the performance of quality has not been consistent in 2019. As seen in the chart at the top of page two, low quality stocks had a brief sprint in outperformance during September.



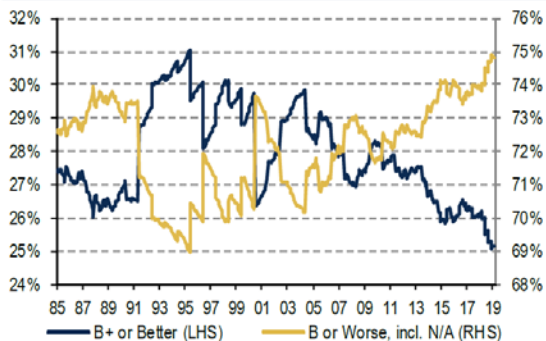
Merrill Lynch Investment Strategy Selected Proprietary Indices (Price Performance as of September 2019)

Quality Indices (1)	1 M	3 M	6 M	12 M	YTD
A+	1.33%	3.57%	6.41%	5.00%	17.00%
A	2.32%	3.62%	8.99%	11.47%	24.17%
A-	3.72%	2.75%	6.86%	7.71%	20.38%
B+	4.47%	1.67%	5.36%	2.98%	19.98%
B	4.57%	-0.01%	2.40%	-2.75%	17.25%
B-	3.89%	-2.12%	-4.56%	-12.44%	11.03%
C&D	0.05%	-10.53%	-11.46%	-23.43%	6.48%

Source: Merrill Lynch

We'd like to note that many of our Sterling Capital strategies possess attractive quality measures based on returns on capital, profit margins, and strength of balance sheets. If these qualities are attractive to clients, we'd note that our actively managed strategies hold stocks that are increasingly in short supply. Investors in a domestic market proxy such as a Russell 3000 ETF are increasingly holding fewer quality holdings (blue line, left axis) and more lower quality stocks as measured by Merrill.

Chart 26: Russell 3000: % of high quality (B or better) vs. low quality (B or worse, including N/A) stocks, 1986-present



Source: FactSet, BofA Merrill Lynch US Equity & US Quant Strategy

As one of the most successful equity investors of all time Peter Lynch said, "Know what you own and why you own it." Quality stocks have worked in 2019 and owning quality into 2020 with an active manager focused on sourcing quality where "the proportion of high quality stocks within the Russell 3000 is at an all-time low, but low quality is at a record high" (Merrill Lynch, "Equity Strategy Focus Point," May 2019) may prove beneficial to returns. If scarcity drives value, quality may prove even more valuable into the New Year.

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

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