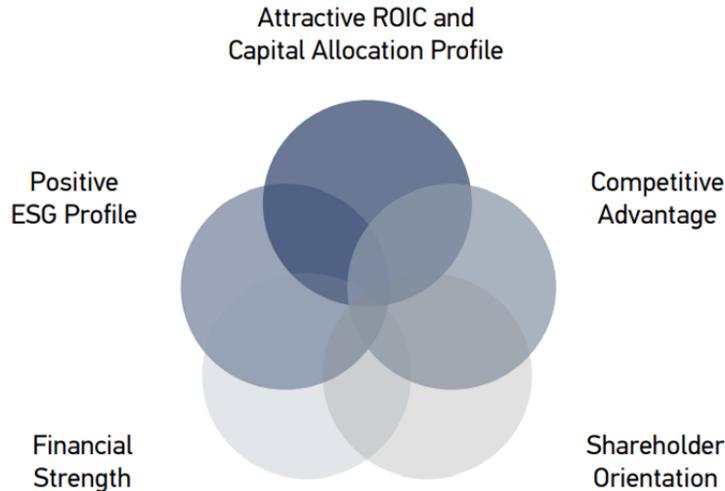




## Quality on the Move

### What is High Quality?



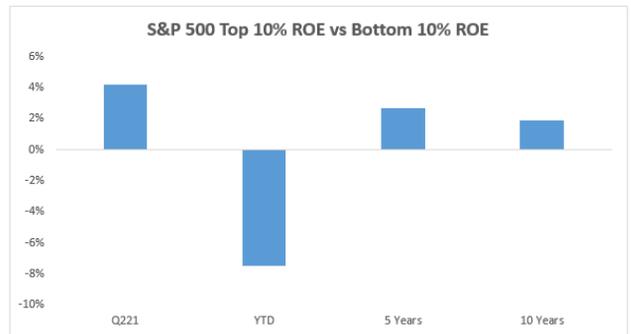
Source: Sterling Capital

In March of this year, we noted that several of our strategies started taking advantage of opportunities to add quality stocks to their portfolios. These moves commenced as our four investment pillars seek out companies with not only high returns on capital but also stocks that appear attractive through the lens of a second investment pillar: valuation.

As the second quarter comes to a close, we have witnessed a gradual improvement in the relative performance of quality stocks. Yes, low-quality stocks made a mark on their respective indices year-to-date. Look no further than the Russell 2000® Index, where “meme stocks” AMC Entertainment and GameStop impacted performance by over 100 basis points (bps). In the larger-cap S&P 500® Index, the top-performing stock, Marathon Oil, was awarded a “C” quality rating by Bank of America’s Quant Strategy group. Regardless, the Ned Davis chart to the right demonstrates that quality made an impressive comeback halfway through the year, in keeping with its long-term track record of outperforming.

So, what is quality? Quality can mean different things for equity investors. Metrics such as return on equity, dispersion of earnings estimates, size, and beta were employed with varied effectiveness over time, per

BofA. According to their quantitative work, earnings stability was especially effective when measured over their data set from 1989 to April 2021.



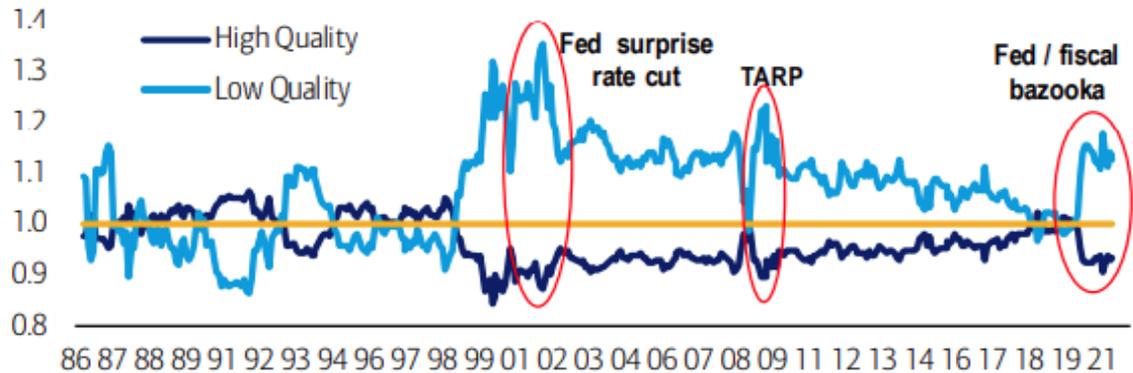
Source: Ned Davis Research

In an age when algorithms can be employed to extract known anomalies such as quality, we seek to define quality through a quantitative lens, but also by employing our assessment of fundamental characteristics of quality, as seen in the chart above. We would note that a positive Environmental, Social, and Governance (ESG) profile is in-line with BofA’s work, where ESG is a strong signal for future earnings and bankruptcy risk, even better than leverage characteristics.



### Exhibit 1: Re-rating has begun, but more to go especially when tapering nears

Relative fwd P/E of High Quality (B+ or better) vs. Low Quality (B- or worse) stocks (1986-5/21)

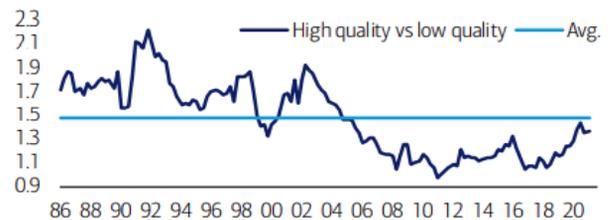


Source: FactSet, BofA US Equity & Quant Strategy, BofA Global Research

The chart above is updated from our March 2021 version of “The Lead,” and as noted, it appears a re-rating of quality stocks, and as noted, it appears a re-rating of quality stocks has begun, but how much further could it go? To the right, we provide one last chart showing that quality remains inexpensive on a price-to-sales basis. With BofA stating this month that quality stocks represent the “best entry point in over a decade,” fundamental investing in quality equities appears timely.

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

Relative Price/Sales of High (B+ or Better) vs Low Quality (B or Worse), 1986-1Q21



Source: FactSet, BofA US Equity & Quant Strategy, BofA Global Research

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**The S&P 500® Index** is a readily available, carefully constructed, market-value-weighted benchmark of common stock performance. Currently, the S&P 500 Composite includes 500 of the largest stocks (in terms of stock market value) in the United States and covers approximately 80% of available market capitalization.

**The Russell 2000® Index** measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000® Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000® is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set.

Technical Terms: **Return on Equity (ROE)**: the measure of a company's annual return (net income) divided by the value of its total shareholders' equity, expressed as a percentage. **Price-to-Sales**: a formula used to measure the total value that investors place on the company in comparison to the total revenue generated by the business. It is calculated by dividing the share price by the sales per share. **Return on Invested Capital (ROIC)**: a profitability or performance ratio that aims to measure the percentage return that a company earns on invested capital. The ratio shows how efficiently a company is using the investors' funds to generate income. **ESG**: ESG is the acronym for Environmental, Social, and (Corporate) Governance, the three broad categories, or areas, of interest for what is termed "socially responsible investors." They are investors who consider it important to incorporate their values and concerns (such as environmental concerns) into their selection of investments – as opposed to simply considering the potential profitability and/or risk presented by an investment opportunity. (Technical definitions are sourced from Corporate Finance Institute.)

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