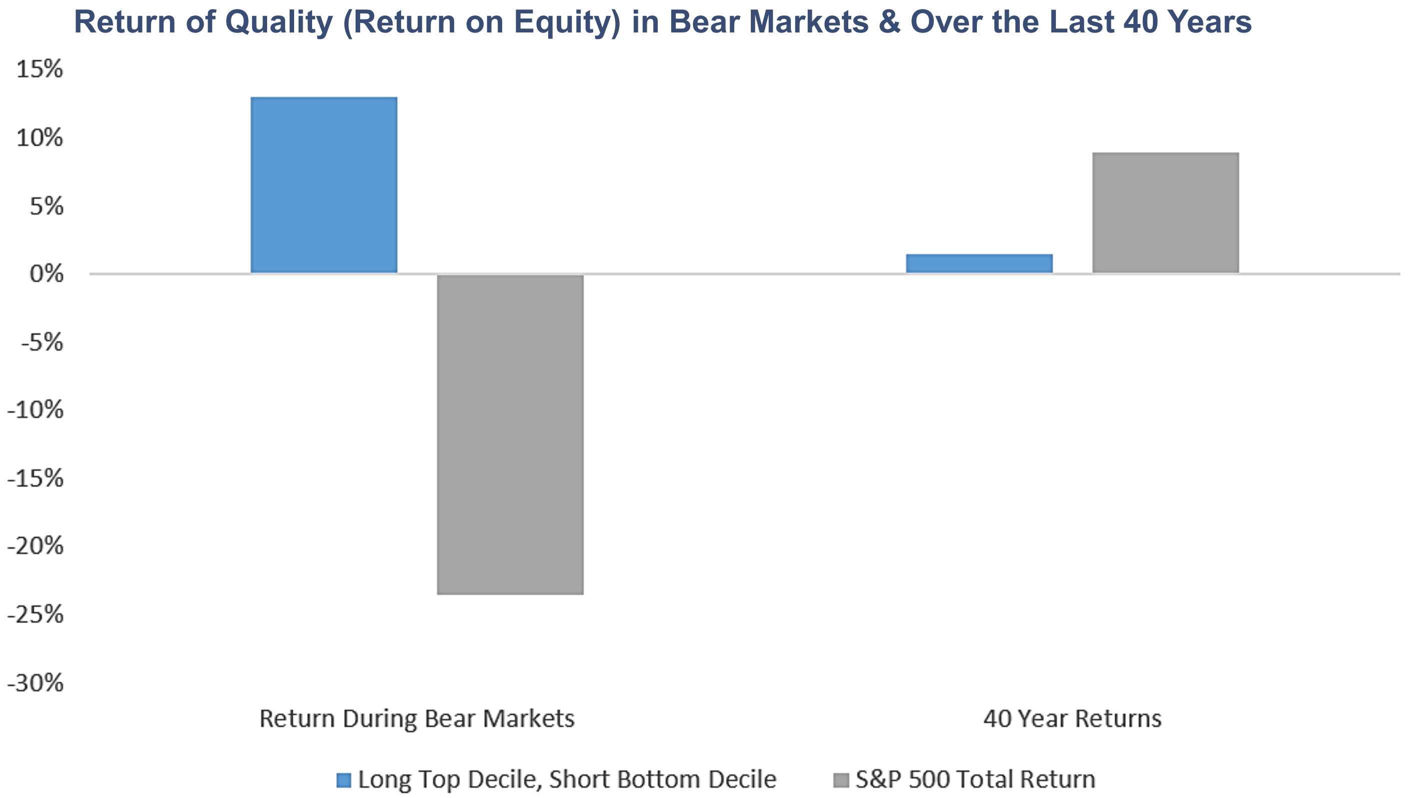
Quality on Sale

The Lead | June 2025



High-quality stocks are defined as ROE using Ned Davis Research's methodology of the difference between long top decile and short bottom decile.
Source: Ned Davis Research.

As active managers who dedicate our time to assessing the markets and opportunities, we are on the hunt for temporary anomalies that enable us to deliver results. Our investment philosophy focuses on quality. Why quality? Qualitatively these are advantaged business models that generate higher profit margins, are more capital efficient, and tend to have lower debt leverage than their competitors. Quantitatively, this can be captured in the return on equity (ROE) calculation. These characteristics tend to shine during periods of higher uncertainty and stock market downturns where there is a "flight to quality." We show in the left portion of the chart above how higher-quality stocks using ROE as a measure have performed well by protecting capital in bear markets over time. What makes quality stocks more interesting to us is how they have tended to outperform the market over the past 40 years.

Ned Davis Research makes this assessment by taking the difference in performance between the top 10% of high return on capital companies and bottom 10% during these time periods. We provide greater detail below. By creating quality-oriented portfolios, we believe we have the opportunity to benefit over time and in negative market environments.

ROE Characteristic - Last 40 Years Statistics

	Annualized Return	Bear Market Returns
Top Decile	12.0%	-17.6%
Bottom Decile	7.4%	-33.2%

Source: Ned Davis Research.

The challenge, in our view, is that high-quality companies are seldom inexpensive. Their track records of delivering returns on capital higher than their peers are recognized by investors, which may lead to valuations that tend to award them a premium in the market.

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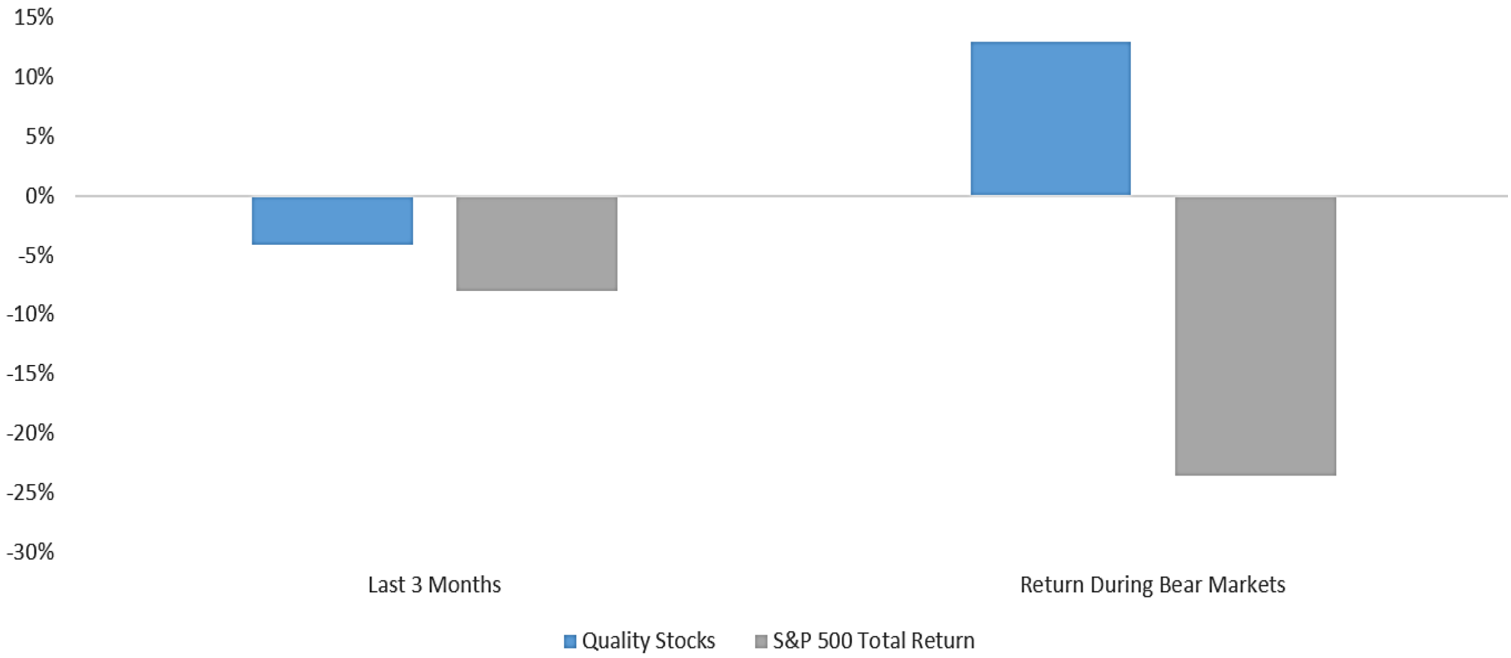
Return of Quality (Return on Equity) in Recent Markets and Bear Markets Over the Last 40 Years



Source: Ned Davis Research.

What has made the last three months unusual is the underperformance of quality stocks in the market downturn this spring. These are the types of anomalies we seek. We compare the performance of high-quality stocks in the most recent market decline (on the left-hand side in the chart above) and how they have historically performed.

We used the same methodology as the chart on the first page by defining quality stocks as high ROE stocks in blue. For active investors with a quality orientation, we believe the latest market sell off represented "quality on sale."

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

Charles J. Wittmann, CFA®, Executive Director, joined Sterling Capital Management in 2014 and has investment experience since 1995. Chip is Co-Portfolio Manager of the Equity Income strategy. 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 and served as President of CFA Society Virginia from 2012-2013.

Important Information

Disclosures

Past performance is not indicative of future results. Any type of investing involves risk and there are no guarantees that these methods will be successful. Economic charts are provided for illustrative purposes only. The information provided herein is subject to market conditions and is therefore expected to fluctuate.

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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.

Dividend-focused strategies may underperform strategies that do not limit their investment to dividend-paying stocks. Stocks held strategy may reduce or stop paying dividends, affecting the strategy's ability to generate income.

Dividend Growing, No-Change-in-Dividend, and Dividend Cutting: Each dividend-paying stock is further classified into one of the three categories based on changes to their dividend policy over the previous 12 months. Dividend Growers and Initiators include stocks that increased their dividend anytime in the last 12 months. Once an increase occurs, it remains classified as a grower for 12 months or until another change in dividend policy. No-Change stocks are those that maintained their existing indicated annual dividend for the last 12 months (i.e., companies that have a static, non-zero dividend). Dividend Cutters and Eliminators are companies that have lowered or eliminated their dividend anytime in the last 12 months. Once a decrease occurs, it remains classified as a cutter for 12 months or until another change in dividend policy. (Source: Ned Davis Research).

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Since we began publishing The Lead in 2015, our primary purpose has been to communicate our investment philosophy and process as an investment advisor in the context of changing markets. In creating portfolios that differ from our benchmarks by focusing on characteristics that have a long term history of attractive relative returns according to Ned Davis Research, the portfolios are different from the benchmarks and as a result there can be periods where results differ including below benchmark performance. Since strategies are oriented toward the long term characteristics, if those characteristics are out of favor over a period of time, the given strategy's performance could be challenged in terms of relative performance. While Sterling believes active professional investment management that employs a consistent process with a long term orientation and aligned with client interests offers benefits, management fees to support the active approach can be higher than certain alternatives. When hiring an investment manager we believe it is important to monitor the investment risks taken including sector concentrations, portfolio turnover, and the impacts of dividend policy changes.

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