The Tortoise and the hare

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The Quality Premium
An exciting new opportunity?

Author:
Helge Kostka
Chief Investment Officer

I am currently in the process of buying a new bicycle for my daily commute. Given I have not purchased a bike in over a decade, I am hopelessly out of touch in terms of the different levels of quality I can buy and it took me a lot of research to feel somehow comfortable about what I want and what is considered a great price.

Among the many factor premia that are recently hotly discussed is also the so-called quality premium. What on earth is that? It is an investment strategy that aims to outperform the market by buying “high-quality” companies and avoiding “low-quality” companies. This gives reason to pause and think hard about a good rationale, why an investor would be rewarded to prefer high quality over low quality. One school of thought looks at investor behavior and proponents argue that market participants underappreciate the true quality of companies, so the respective security prices don’t reflect it. The other school of thought searches for an explanation from a risk angle. When one makes the argument for avoiding companies with high leverage and preferring the ones with low leverage, it seems quite plausible. But preferring companies with high profitability surely does not sound like a risk taking activity I should be systematically rewarded for.

So how does one define quality? Coming back to my bicycle purchase, the answers differ. For some people it is all about the material of the frame, others focus on the technology of the gears whilst others focus on the comfort such as the saddle and the seating position Some judge quality simply by the design. All I believe is that the bicycle is one of many items in our lives, where quality cannot be defined by a single measure, and even if multiple angles are taken, the combination is often highly subjective.

Judging the quality of a company is not much different. There is a host of numbers on a balance sheet and a Profit & Loss statement. Should I choose to look at return on equity (ROE) or return on assets (ROA), gross-profits-to-assets ratio or instead operating profit? If I pick one, do I look at current figures or changes over 1 year, 3 years or a different time period? Here an ex-ante rationale for a preference is mission critical. Otherwise there is a huge risk to be miss-led by data mining, where someone compares all options and simply picks to show the one with the best back tested, hypothetical performance.

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If the quality premium is a truly robust phenomenon, then we should find (statistically) positive performance for the majority of tests undertaken with slight variations in the definition of the quality factor and this is where I still need to be convinced. Hidden in the appendix of the paper I recently co-authored, we did exactly that. As can be seen by the bold number in the columns labelled "t-stat", only 1 factor variation (3%) produces a statistically significant, positive return in a US large cap universe. Results are similar for international stocks. In a small cap universe results look more promising but fail to climb above 50%, in other words there are still more failures to test than there are successes.

Quality Group	Definition	Large					Small					Combined				
		Quality		Junk		t-Stat of	Quality		Junk		t-Stat of	Quality		Junk		t-Stat of
		Return	Volatility	Return	Volatility	Long/Short	Return	Volatility	Return	Volatility	Long/Short	Return	Volatility	Return	Volatility	Long/Short
Accounting Quality	Accruals	10.7%	15.7%	10.0%	17.0%	0.37	14.3%	21.8%	12.9%	20.4%	1.70	12.7%	17.9%	11.6%	17.9%	1.18
	Net Operating Assets	11.3%	16.3%	9.2%	15.7%	**2.15**	15.1%	20.7%	10.7%	21.1%	**3.91**	13.4%	17.6%	10.1%	17.7%	**3.87**
	Accruals (Sloan 1996)	10.7%	16.6%	8.7%	17.3%	1.43	13.3%	22.9%	9.7%	23.3%	**3.98**	12.2%	18.9%	9.4%	19.5%	**3.09**
	Accruals Decline/Growth	11.0%	15.7%	9.8%	16.4%	1.12	14.7%	22.0%	12.3%	22.6%	**3.34**	13.1%	18.1%	11.3%	18.6%	**2.57**
	Earnings Smoothness	11.0%	15.3%	11.3%	15.5%	-0.33	13.3%	20.2%	14.7%	20.3%	-1.66	12.3%	16.9%	13.2%	17.0%	-1.07
Growth in Margins	L.T. Change in Margin	10.4%	15.9%	11.2%	16.0%	-0.74	14.1%	21.0%	13.6%	20.4%	0.70	12.4%	17.6%	12.5%	17.5%	-0.10
	S.T. Change in Asset Turnover	11.8%	15.7%	10.0%	17.0%	1.53	15.1%	22.3%	11.6%	22.3%	**4.68**	13.7%	18.2%	11.0%	18.9%	**3.62**
	S.T. Change in Margin	9.8%	16.3%	10.4%	16.0%	-0.51	13.6%	21.3%	12.8%	21.4%	1.02	11.9%	18.1%	11.8%	17.9%	0.22
Growth in Profitability	L.T. Change in ROA	10.5%	15.9%	10.3%	16.6%	0.05	13.9%	20.7%	13.5%	23.5%	-0.37	12.3%	17.5%	12.1%	19.1%	-0.18
	L.T. Change in ROE	10.5%	15.9%	10.4%	16.7%	-0.05	14.3%	20.9%	13.4%	23.4%	0.36	12.6%	17.6%	12.1%	19.2%	0.16
	L.T. Change in Cash Flow Profitability	11.5%	15.6%	9.6%	16.7%	1.48	14.5%	20.8%	12.5%	22.6%	1.71	13.2%	17.4%	11.3%	18.8%	1.89
	L.T. Change in Gross Profitability	11.8%	15.3%	9.8%	16.6%	1.66	15.3%	21.1%	12.8%	22.3%	**2.75**	13.7%	17.4%	11.5%	18.6%	**2.59**
Margins	ROR	10.2%	14.9%	11.0%	17.6%	-0.98	13.2%	19.5%	11.1%	24.9%	0.41	11.9%	16.3%	11.3%	20.6%	-0.24
	Margins	10.2%	15.5%	10.6%	16.2%	-0.42	13.2%	20.5%	13.7%	21.6%	-0.88	11.9%	17.2%	12.3%	18.1%	-0.76
	Operating Margins	9.9%	14.7%	10.8%	17.6%	-1.05	13.5%	18.6%	11.4%	24.6%	0.35	11.9%	15.8%	11.3%	20.4%	-0.31
Financial Constraints / Distress	Kaplan Zingales Index	9.8%	15.9%	9.9%	16.0%	-0.09	13.0%	21.7%	12.5%	23.7%	-0.06	11.6%	17.8%	11.4%	19.1%	-0.09
	Debt Coverage Ratio	10.5%	16.2%	9.9%	16.9%	0.33	13.9%	20.5%	11.2%	22.2%	**2.07**	12.4%	17.6%	10.8%	18.7%	1.45
	S.T. Change in Asset Liquidity	9.6%	16.2%	11.1%	16.5%	-1.78	12.3%	21.7%	12.9%	22.7%	-1.34	11.1%	18.2%	12.2%	18.9%	-2.04
	Net Cash Outflow	10.2%	17.0%	9.9%	16.4%	0.28	13.2%	21.4%	9.4%	24.8%	**2.24**	11.9%	18.4%	9.9%	19.9%	1.47
	Interest Coverage Ratio	10.4%	15.4%	9.5%	17.2%	0.45	13.6%	20.7%	10.1%	25.4%	1.63	12.2%	17.3%	10.1%	20.5%	1.29
Capital Structure	Change in L.T. Leverage	10.6%	16.3%	10.5%	15.6%	0.32	13.7%	21.0%	12.2%	21.5%	**2.31**	12.3%	17.9%	11.5%	17.8%	1.51
	Market Leverage	9.4%	16.4%	10.7%	17.2%	-0.82	11.1%	22.7%	15.9%	19.3%	-2.10	10.5%	18.7%	13.4%	17.6%	-1.62
	Book Leverage	10.6%	16.7%	9.9%	16.2%	0.67	13.3%	20.3%	13.5%	21.3%	-0.43	12.1%	17.8%	11.8%	18.0%	0.24
Growth Activities	R&D Expense	10.5%	17.8%	11.5%	14.9%	-0.25	12.2%	27.6%	11.5%	22.4%	0.87	11.7%	21.6%	11.9%	17.2%	0.42
	Capital Expense	9.8%	15.3%	10.3%	17.5%	-0.74	12.3%	22.2%	11.7%	22.0%	0.66	11.3%	18.0%	11.2%	19.0%	-0.18
	Advertising Expense	11.8%	15.7%	11.5%	19.1%	-0.13	12.8%	23.6%	14.7%	22.8%	-0.78	12.8%	17.9%	13.4%	19.7%	-0.62
Earnings Stability	S.T. Change in Inventory	11.5%	15.7%	9.4%	17.3%	1.60	14.4%	21.0%	11.6%	21.8%	**3.00**	13.2%	17.5%	10.7%	18.8%	**2.61**
	Stability of Gross Profitability	10.0%	15.3%	10.3%	17.2%	-0.42	15.4%	16.8%	12.7%	23.5%	0.57	12.8%	15.3%	11.8%	19.5%	0.13
	Stability of Cash Flow Profitability	10.0%	15.1%	10.4%	17.4%	-0.49	15.9%	16.9%	12.2%	24.0%	1.02	13.0%	15.2%	11.5%	19.9%	0.36
	Stability of Margins	10.5%	15.0%	10.1%	17.2%	-0.04	15.4%	19.0%	13.1%	21.8%	1.21	13.1%	16.1%	11.8%	18.7%	0.73
Profitablity	Gross Profitability	11.1%	16.1%	9.6%	16.5%	0.89	14.5%	22.1%	12.5%	19.2%	**2.01**	13.0%	18.2%	11.2%	17.0%	1.62
	ROA	10.3%	15.7%	9.6%	17.8%	0.17	13.6%	20.7%	11.5%	23.6%	1.04	12.1%	17.4%	10.8%	19.8%	0.72
	ROE	10.5%	15.6%	10.4%	16.9%	-0.07	13.8%	20.6%	11.1%	24.9%	1.08	12.3%	17.3%	11.0%	20.1%	0.65
	Net ROE	10.5%	15.8%	9.9%	17.4%	0.26	13.3%	21.6%	10.8%	24.2%	1.33	12.1%	17.9%	10.5%	20.1%	0.94
	Cash Flow Profitability	10.9%	15.3%	9.2%	17.7%	0.87	14.2%	20.7%	11.4%	21.9%	**1.98**	12.8%	17.2%	10.5%	18.9%	1.75
Average Result		10.6%	15.8%	10.2%	16.8%	0.19	13.8%	21.1%	12.3%	22.5%	1.15	12.4%	17.6%	11.4%	18.8%	0.80
Result of Average Portfolio		10.7%	15.3%	10.3%	16.1%	0.40	13.9%	20.7%	12.4%	22.1%	**2.66**	12.5%	17.3%	11.5%	18.4%	1.73
Number of Significant Results						1					11					6
Percentage of Results Significant						3%					31%					17%

Note: L.T. is long term; S.T. is short term; ROA is return on assets; ROE is return on equity; ROR is return on revenue. Source: Beck, Hsu, Kalesnik, Kostka, FAJ, 2016, Will Your Factor Deliver? An Examination of Factor Robustness and Implementation Costs

In summary:

» The rationale for the existence of a quality premium is not as strong as for other premia.

» It is also difficult to argue to define "quality" for companies by choosing just a single measure.

» Tests varying the measure show that the existence of a quality premium is highly dependent on the measure chosen. On average evidence is not supportive.

Risk Warnings

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