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"Quality is never an accident. It is always the result of intelligent effort." - John Ruskin

Think about your last big purchase. Whether a house, or car, or boat, or television – your evaluation a successful purchase was likely based on the highest quality item for the best price you could negotiate. However, turned around, one could actually argue that your first evaluation is likely the quality of the item – without the quality, it likely has no value.

The book Quality Investing written by Lawrence Cunningham alongside Torkell Eide and Patrick Hargreaves (of AKO Capital fame) begins with the contention that, while the concept of quality is quite familiar to people, the definition of quality is challenging. They go on to further refer to a quote from Zen and the Art of Motorcycle Maintenance that "…even though Quality cannot be defined, you know what Quality is!"

Investors understand value investing. Buying something at less than its intrinsic value helps us feel we're in control and getting a bargain, something more for your money. Ask any professional what value investing means and, in all likelihood, there will be a lot of consistency in the answers. Ask those same professionals what quality investing means, and the responses will likely be as diverse as the number of professionals asked.

When we began Laurus almost ten years ago, we chose "quality investing" as our core philosophy around small cap investing. Not growth – which can also be easily defined – or value, but the ineffable traits of fundamental quality that investors have such a difficult time understanding. Which makes growing our assets under management a little more challenging.

So why in the world would we choose this style?

A quality approach to small cap investing seeks to identify companies with outstanding financial and business characteristics, including soft (e.g., competitive advantage or management competence) and hard criteria (e.g., high returns on capital or balance sheet health). Our goal is to create a portfolio of what we believe are the highest-quality businesses by following an in-depth research process.

The hard criteria we speak of – high returns on capital, balance sheet health, strong historical growth – are easy to identify. There are plenty of statistical tools that will screen mountains of data. The more challenging part of analyzing data is understanding the variety, and consistency, of inputs to these financial outputs. Put another way, anyone can use statistical screens to identify certain characteristics – the question is whether these are opportunistic or sustainable.

If sustainable, the question of valuation is less prevalent. Yes, the risk of overpayment does exist but mid to long-term growth will eventually overcome entry level values. Price-earnings multiples on high quality companies may look high relative to their growth rates, but there is a big difference between expected and realized growth. Street analysts are often wrong, and high-quality businesses frequently exceed expectations. Some mispricing has to do with "short-termism" – quality businesses thrive over the longer term, but markets tend to over, or under, price on short term results.

And finally, investing in quality companies is an approach that has enabled investors to earn strong risk-adjusted returns. Over time, high-quality stocks tend to experience lower volatility and greater strength and consistency in returns over a full market cycle, including and perhaps especially, during the downturns.

As we've mentioned in previous commentaries, there are periods when high-quality businesses experience underperformance relative to lower quality companies, especially at the beginning of bull market cycles. Lower-quality companies tend to rebound more sharply from recessions than the high-quality segment. This is largely due to a greater reliance on credit, they gain more from improving economic conditions and, particularly, from an improving credit market. However, they also tend to experience more dramatic declines during the bear market phase, setting up more recovery potential.

Our readers know we believe strongly in the reasoning that small cap investments are a strong foundation for a well-balanced portfolio. To improve risk-adjusted returns in small cap investing, the quality style is an important ballast against volatility due to their financial stability and greater propensity for growth across the full cycle of varying macroeconomic environments.