MONTHLY COMMENTARY | May 2021

"Quality is never an accident; it is always the result of intelligent effort" – *John Ruskin*

Last month we briefly discussed our concept of "quality investments": well-managed businesses with reasonable growth outlooks, and the financial strength to be investible for over the intermediate or long term. While not an earthshaking concept, we were surprised by the considerable response asking about alignment with various other styles – growth, value, deep value, momentum, etc.

In fact, quality investing is not really new, just not widely-used (though many tout the attributes). Likely the best-known quality firm globally would be AKO Capital in London, England – their 2015 book "Quality Investing" (written by Lawrence Cunningham) is an excellent read. Quality as a style established its firmest foothold in the aftermath of the dotcom bubble of 2001 when investors were licking the wounds inflicted by a number of high-profile corporate implosions, most notably Enron and WorldCom.

While true that combining a quality portfolio with high-beta growth, momentum, or value portfolios makes sense, we leave that to the professionals responsible for asset allocation. But we wish to re-emphasize the two main points of our last commentary; 1) quality investment portfolios perform especially well during economic downturns or periods of risk aversion, and, 2) quality companies have the cash-generative power to make themselves top-notch competitors in their respective industries.

Finding quality companies for small cap portfolios enhances the long-term return impact. One of our partners coined the phrase "emerging blue-chip companies" which is quite apt, given these businesses tend to disrupt the status quo in their respective industries and potentially take over market leadership. By aggressively deploying their considerable cash generation, a quality small cap company can exploit competitor and industry weaknesses to their advantage, resulting in strong top-line growth and additional margin expansion. Yet, there are cyclical periods when quality companies are disenfranchised by the whims of Mr. Market.

The past year has seen a mighty rebound in stock prices as we began a new market cycle. For example, the S&P500 price collapsed 1000 points in the month ending March 23, 2020 only to rise almost 2000 points in the subsequent year. Of course, with vaccines being rolled out more steadily and the expectation of increasing economic growth, combined with 10-year yields doubling in the past year, traditional value stocks in the cyclical and financial categories have come into vogue.

Warren Buffett was once quoted as saying "the stock market is designed to transfer money from the active to the patient". While the traditional value investments are now trending, it is neither possible to catch the turn in the market (about early November alongside the US Presidential regime change) nor recognize when it comes to an end. Similarly, prior to the 2020 collapse, small cap investments were largely underperforming their large cap peers – leading to few expecting the explosion of small cap performance coming out of the March 2020 bottom.

As markets are discounting mechanisms, their pricing depends on what's happening next, not on what's happening now. Many refer to the potential market headwinds caused by valuation, based on the notion that, since low interest rates have supported higher valuations then, obviously, higher interest rates should lead to lower market values.

So how, one might ask, do all these factors affect a quality company. In truth, they don't.

First, the balance sheet of a quality company is strong. They are able to invest their profits in growing their businesses, while still maintaining limited debt – so rising interest rates are not a factor. Also, most have solid pricing power and, therefore, high margins. Combining these features with strong customer loyalty creates predictable cash flow, allowing a quality company to transcend weakness in the economic cycle. And finally, valuation is less sensitive for high-quality companies since their outlook and investor expectations are of a long-term nature, not based on short term fluctuations.

We are fond of saying that long-term performance is created in weak markets not bull markets. Our preference for investing in, and remaining invested in, quality continues unabated.