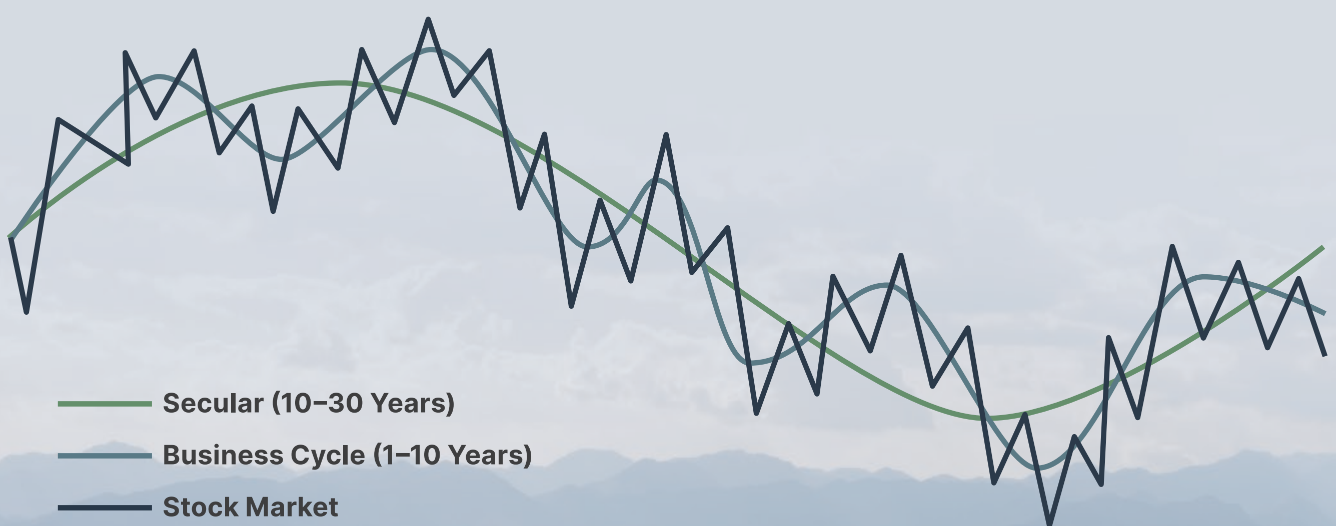
Quality as a Core

Investing in the market can sometimes feel like riding a roller coaster: sudden peaks and drops in a volatile environment may inspire excitement — and fear — for roller coaster passengers and investors. Unlike roller coasters, which have wooden supports that create a fixed path regardless of the feelings of passengers, economic and business cycles can shift unexpectedly, catching investors by surprise, and those "surprises" can cause a wild swing of asset prices in the market.

To understand how investor sentiment affects asset prices, we first need to understand the way the economic and business cycles shape the markets. On the highest level, the economic cycle and macro environments can influence monetary policies, which directly impact credit conditions that alternate between irrationally generous and unfairly restrictive. These economic and credit conditions lead to a business cycle marked by rising and falling sales and profits. In turn, the intrinsic value of the financial assets associated with sales and profits rises and falls. In Figure 1, you can see this concept illustrated visually. The green line represents secular cycles, which last for 10-30 years. Within that cycle, many business cycles, represented by the blue line, occur. These can last from 1-10 years each, evident here by the peaks and troughs. Additionally, the stock market, represented by the black line, fluctuates up and down within the context of the secular and business cycles.

Figure 1: Investment performance is driven by economic, business, and investor behaviors

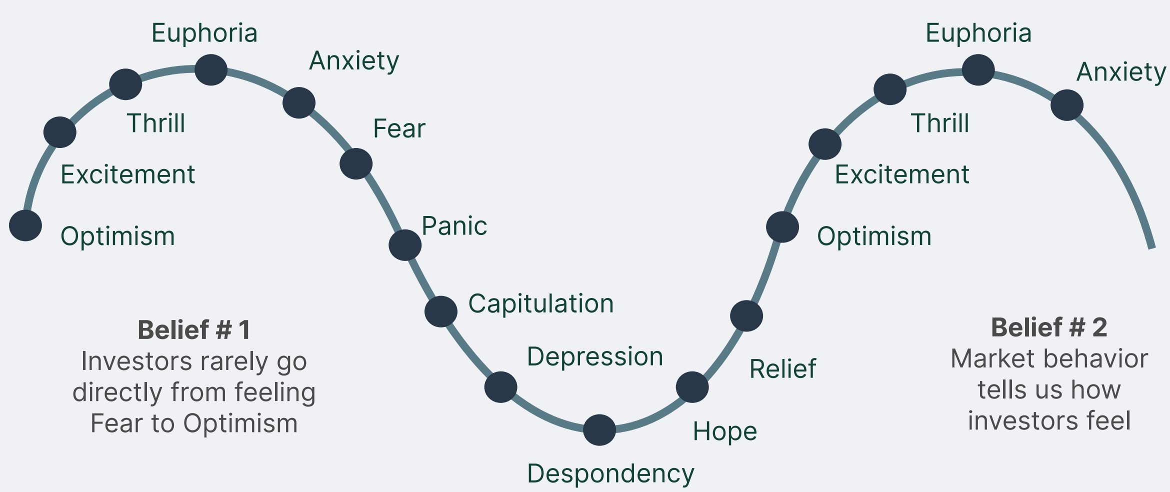


Source: Fidelity Investments, Balentine
For illustrative purposes only

Investor psychology also comes into play at the financial market level. During enriched investment cycles with ample low-cost capital, investors are more likely to take outsized risks and tolerate hefty valuations just to gain the "last mile" of return. Since the economy and, in aggregate, businesses, can be cyclical and the market tends to revert to the mean over time, when business and investment environments come down from their high points, they expose poor investments that cause outsized losses. Investor greed turns to fear as they sell the perceived risky assets to embrace safety, which causes valuations for financial assets to drop below their intrinsic value — imagine individual slats of the roller coaster track collapsing.

These swings between greed and fear create a more volatile market cycle that fluctuates greater than "fundamental" economic and business cycles, causing asset market value disconnected from fair value, thus creating investment opportunities.

Figure 2: Investor emotions through the market cycle



Source: Balentine

At Balentine, our data-driven investment process analyzes these cycles and looks for patterns to maximize the possibility of clients achieving long-term investment goals. As we look ahead and anticipate the conditions of the capital market over the next five to seven years, we see changes on the horizon: higher market volatility and limited valuation expansion due to high inflationary pressure, higher interest rates, uneven global economic recovery, and geopolitical unrest. These conditions signal to us that investors should focus on optimizing portfolio construction and asset selection to weather these tough times — and for strategies that allocate a passive beta-like core, we believe **implementing quality as a core will enable the strategy to capture the potential alpha in the new paradigm more effectively.**

A Regime Shift Signals a Strategic Shift

For the past decade, a low-rate environment drove down return on investment at the safe end of the risk curve and provided the fuel for investors to take outsize risk. Financial innovations have often taken place when people with abundant cheap capital chase the desire to get rich quickly; bearing higher risk generally produces higher returns. Unfortunately, this risk means that the promises that entice investors to commit don't always come to fruition. In fact, there are ample examples throughout financial history:

1960s–early 1970s: With "Nifty Fifty Investing," demand for growth and popular stocks was high, pushing the valuation to an unreasonable level in the early 1970s and precipitating the subsequent market crash.

1980s: Financial innovations like portfolio insurance led investors to believe they could enjoy the appreciation potential that comes with large commitments to equities with less risk. It took the stock market crash to expose the true nature of such innovation.

1990s: High-flying dot-com, e-retailer, and media aggregation stocks brewed the so-called tech bubble. Between March 2000 and October 2002, the NASDAQ fell from 5,048 to 1,139, erasing nearly all its gains during the dot-com bubble. By the end of 2001, most publicly traded dot-com companies had failed.

2000s: Subprime mortgages were granted without background checks, packaged in structured products so complex no one understood who assumed the risks, creating The Financial Crisis concurrent with a 50 percent peak-to-trough drop in stock prices between October 2007 to March 2009.

Similarly, in the past few years, investors believed digital tokens and pandemic stocks would be successful forever and invested heavily. As the Fed shifts monetary policy from accommodative to restrictive, capital markets shift from an environment of low inflation, low rates, and elevated valuations to an environment of higher trend inflation, higher rates, and modest valuation. In turn, many poor investments have crashed and started to file for bankruptcy. This new regime calls for a strategic shift in portfolio positioning.

Figure 3: Regime characteristics

	Where We've Been	Where We're Going
Cost of Capital	Low	Higher
Economic Growth	Moderate	Lower
Fiscal Spending	Abundant	Limited
Inflation	Low	Higher and Stickier
Interest Rates	Low	Higher
Monetary Policy	Accommodative	More Restrictive

Source: Balentine

We believe introducing quality-based investments as the core of one's investment strategy will expand the ability to capture tactical opportunities within this new market environment.

Quality-based investment strategies aim to capture the excess return of high-quality stocks over low-quality stocks. They focus on quality factors, strong business fundamentals typically associated with profitable companies with low leverage and stable earnings. We believe there are three key benefits for quality-based investment strategies:

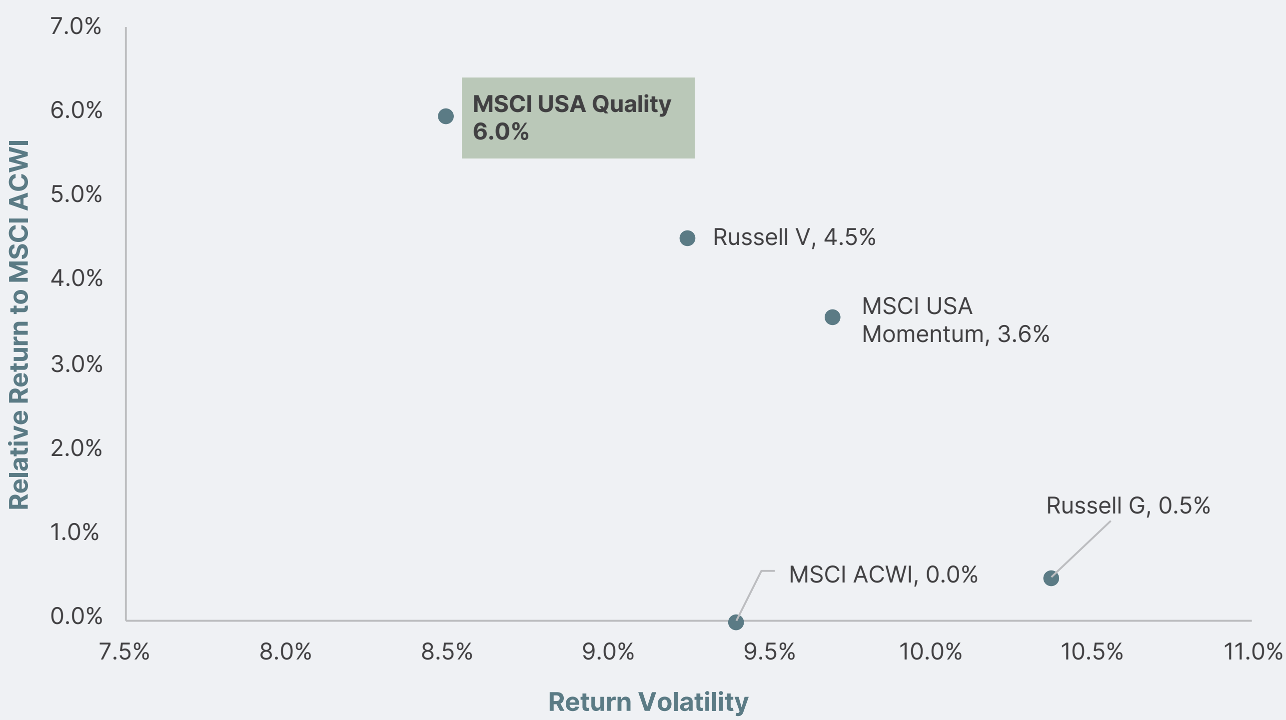
1. Generating crisis alpha with relative downside protection
2. Providing diversification with a low or negative tilt toward value
3. Producing long-term superior risk-adjusted return despite geographic location

As the capital market transitions to a new regime with the greater unknown, asset durability will be tested. A quality-focused core may allow investors to be more tactical with other risky assets, thus generating a different kind of alpha than previous decades.

Crisis Alpha = Survive to Thrive

Standard factors such as Growth, Value, Momentum, and Size; as well as some strategies, such as those with leverage, were able to produce strong returns by taking extra risks when the market was in a favorable condition. Still, taking on extra risk can be a double-edged sword and accelerate loss during a restrictive and stressed market environment where investors seek stability the most. One of the key benefits of quality-focused investments is downside protection. Historical data shows quality factors' ability to produce excess return beyond systematic risk during severe economic and market downturns — a characteristic vital to survival. Consider Figure 4: We aggregated all the relative return and performance volatility data for various factors between 1994 to 2022 when the equity benchmark MSCI ACWI Index had a negative monthly return. Within that period, the quality factor, represented by MSCI USA Quality, had the best relative return against MSCI ACWI Index with the lowest return volatility among other common factors such as value, growth, and momentum. An investor who had systematically overweighted the basket of quality-focused investments over this period would have earned a substantial premium. Please note: the characteristics measured below are only present in months where our benchmark, MSCI ACWI Index, had negative returns.

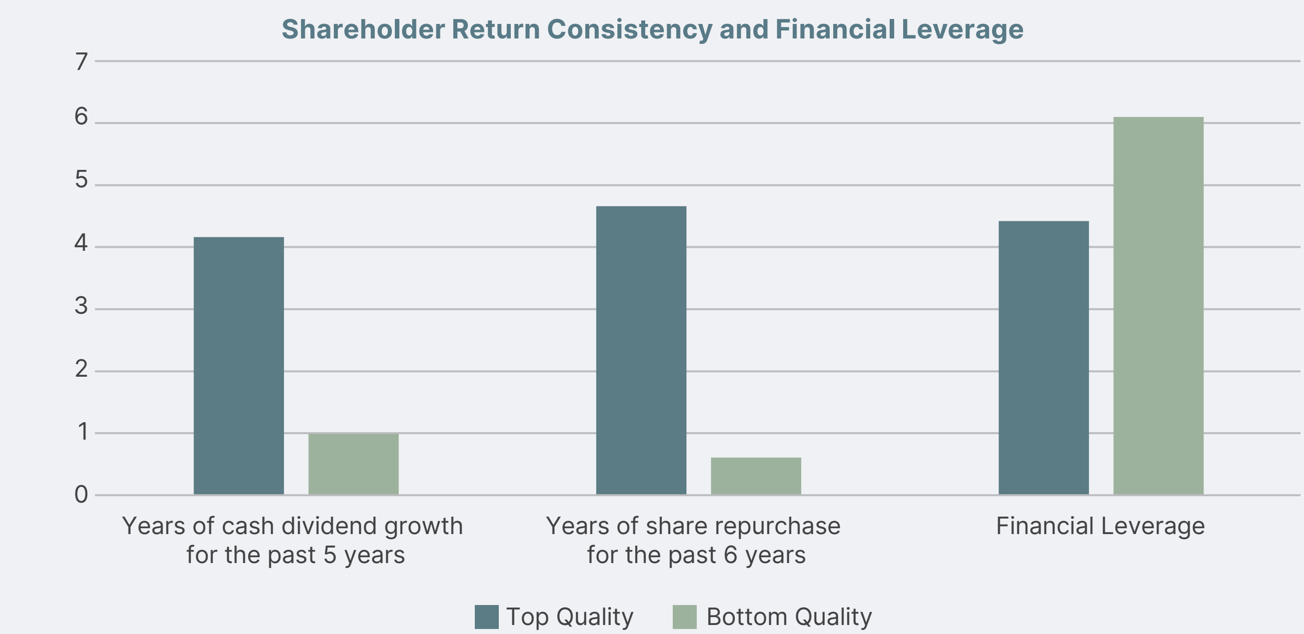
Figure 4: Relative return and volatility during negative market return environment (1994–2022)



Source: Bloomberg, Balentine

How are these quality-focused investments selected? In essence, companies with high profitability, lower financial leverage, and consistent earnings power are likely to withstand adverse economic and business conditions better than the broader equity market. Figure 5 illustrates the key business metrics between the top 20% of companies with high quality score vs. the bottom 20%. Strong business foundations also lead to tangible shareholder returns enhanced by dividends and dividend growth.

Figure 5: Characteristics of the top 20% of quality companies vs. the bottom 20% of quality companies worldwide as of 10/31/22



Source: Bloomberg, Balentine

In addition, high-quality companies also tend to deliver strong shareholder returns in terms of dividends and dividend growth. Based on assessment of available historical and consensus estimated dividend data from Bloomberg, the U.S. Quality Factor Index has a projected average dividend growth rate of 10.4% a year, higher than both U.S. large cap (S&P 500 Index) and Global large and mid-cap (MSCI ACWI Index), which had 7.4% and 4.6% respectively (see Figure 6). Despite a tough economic and financial market in 2022, the consensus still estimates a 22.3% dividend growth for the U.S. Quality Factor Index for the current year. Higher dividend growth rate above expected inflation can serve as an ideal inflation hedge for dividend income.

Figure 6: The quality Factor will likely grow dividends well above inflation expectations and serve as an ideal inflation hedge for dividend income

	U.S. Quality Factor	S&P 500	MSCI ACWI
(2013–2023) 10Yr Average Dividend Growth Rate	10.4%	7.4%	4.6%
Current Year Projected Dividend Growth Rate	22.3%	9.2%	9.1%
1Yr Inflation Expectation		5.9%	

Source: Bloomberg, Balentine

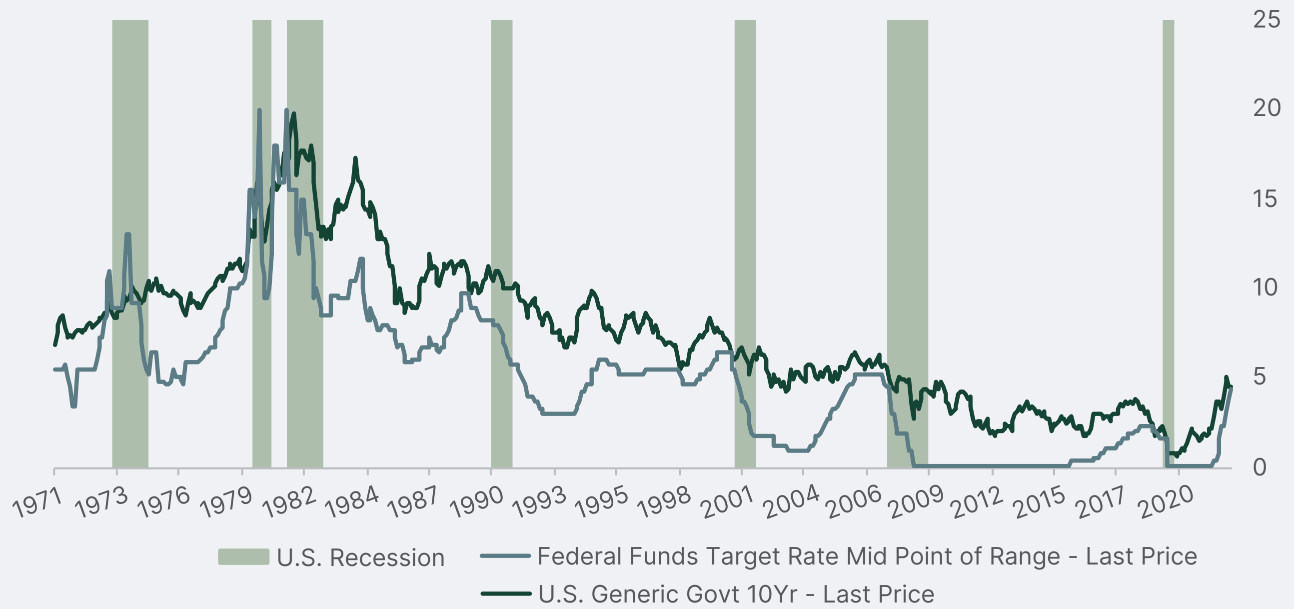
Though quality is present in every asset, quality investments in fixed income means treasuries and investment-grade bonds.

Investment-grade and high-yield credit markets are on pace for their worst year on record as 2022 was defined by a surprisingly hawkish monetary policy and sticky inflation with resilient growth. However, the treasury market could react differently when a true economic crisis presents itself – proving itself as an effective hedge against credit risk.

Treasuries are a reliable “flight to quality” asset — as the debt obligations are issued by the Government and secured by the full faith and credit of the country, they have essentially no credit risk. The longer-dated treasuries might be sensitive to interest rate risk, but their long duration effectively reduces re-investment risks when the near-term capital market condition is highly volatile. In addition, central banks are more likely to provide accommodative monetary policy by cutting interest rates to stabilize and stimulate the economy to provide a tailwind for the assets.

Consider the past 35 years, the 10-year treasury began recessions about 1% above the trend from 1986, rallying eventually to 1% below the trend, usually reaching a trough after each slump. Although the multi-decade downtrend has broken, a 2% drop in 10-year yields is still a likely path over the course of the next cycle. Investors will likely stay invested in long-dated treasuries as a hedge against recession risk and for a potential tailwind for price appreciation, as they are likely seeking some safety amidst economic challenges and await the full effect of the most intense Fed monetary rate hike in recent history. Figure 7 demonstrates the long-held Treasury yield path during true economic stress. Here, you can see recessions shaded in light green.

Figure 7: Interest rates tend to fall during economic recessions, a tailwind for treasuries and investment-grade bonds



Source: Bloomberg, Balentine

Superior Risk-Adjusted Return

If you look outside of the recession and severe market correction periods to consider long-term benefits of the Quality factor, you will notice its superior risk-adjusted return that can be implemented on a standalone basis and serves as a diversifier.

The quality factor produces one of the highest average returns for the past 15 years (2007–2021) with one of the lowest return variations or volatility when compared to other identified factors. Figure 8 illustrates this point by showing different factors in a calendar year for the past 10 years with a 15-year average return ranked from the highest to the lowest. It also ranks the performance volatility from the lowest to highest as preferred side by side to see the most desirable outcome — superior risk-adjusted return.

Figure 8: The quality factor produces one of the highest average returns for the past 15 years with one of the lowest return variations or volatility when compared to other identified factors

12/31/10	12/31/11	12/31/12	12/31/13	12/31/14	12/31/15	12/31/16	12/31/17	12/31/18	12/31/19	12/31/20	12/31/21	15Yr	Volatility Low
Small Cap 26.81%	Low Vol 2.69%	ACWI Market Cap 16.82%	Small Cap 38.82%	Low Vol 11.55%	Low Vol 3.35%	Small Cap 21.28%	Momentum 34.05%	Low Vol -0.98%	Quality 35.69%	Growth 33.60%	Quality 22.50%	Quality 13.13%	Low Vol 11.29%
ACWI Equal weight 17.06%	Quality 2.10%	Growth 16.69%	Momentum 26.81%	Quality 8.77%	Momentum 2.40%	High Div. 11.00%	Growth 30.00%	Momentum -4.57%	Growth 32.72%	Momentum 32.26%	ACWI Market Cap 19.05%	Growth 12.01%	High Div. 17.16%
Growth 15.12%	Momentum 0.28%	Small Cap 16.39%	Value 24.37%	Momentum 6.38%	Quality 1.98%	Value 9.90%	Quality 29.02%	High Div. -6.25%	Momentum 28.07%	Quality 25.38%	Growth 17.10%	Momentum 10.80%	Quality 17.99%
Momentum 14.27%	Small Cap -4.18%	Value 15.89%	Quality 23.88%	Growth 5.43%	Growth 1.55%	ACWI Equal weight 9.24%	ACWI Equal weight 26.47%	Quality -6.95%	ACWI Market Cap 27.32%	Small Cap 19.93%	Value 15.18%	Small Cap 10.34%	Small Cap 18.05%
ACWI Market Cap 13.29%	High Div. -4.37%	ACWI Equal weight 15.71%	ACWI Market Cap 23.49%	Small Cap 4.90%	ACWI Market Cap -1.80%	ACWI Market Cap 8.53%	Value 25.69%	Growth -8.13%	Small Cap 25.49%	ACWI Market Cap 16.87%	High Div. 15.18%	ACWI Market Cap 9.54%	ACWI Market Cap 18.31%
Quality 12.07%	ACWI Market Cap -6.84%	Quality 15.54%	Growth 23.18%	ACWI Market Cap 4.75%	Small Cap -4.41%	Low Vol 8.11%	ACWI Market Cap 24.65%	ACWI Market Cap -8.92%	High Div. 25.12%	ACWI Equal weight 13.18%	Small Cap 14.78%	ACWI Equal weight 7.73%	Momentum 19.12%
Low Vol 11.55%	Growth -7.38%	Momentum 15.53%	High Div. 19.08%	ACWI Equal weight 2.33%	High Div. -4.59%	Quality 6.08%	High Div. 19.87%	Small Cap -11.03%	Low Vol 21.79%	Low Vol 3.40%	Low Vol 14.49%	Low Vol 7.47%	Growth 20.23%
Value 10.62%	Value -12.83%	High Div. 11.86%	Low Vol 17.58%	High Div. 2.01%	Value -5.00%	Momentum 4.69%	Low Vol 18.63%	ACWI Equal weight -13.54%	ACWI Equal weight 21.15%	High Div. 2.81%	ACWI Equal weight 10.16%	Value 7.15%	Value 20.32%
High Div. 4.00%	ACWI Equal weight -15.86%	Low Vol 8.70%	ACWI Equal weight 16.03%	Value -0.40%	ACWI Equal weight -6.08%	Growth 3.27%	Small Cap 14.63%	Value -14.77%	Value 19.22%	Value 2.38%	Momentum 8.32%	High Div. 5.94%	ACWI Equal weight 21.72%

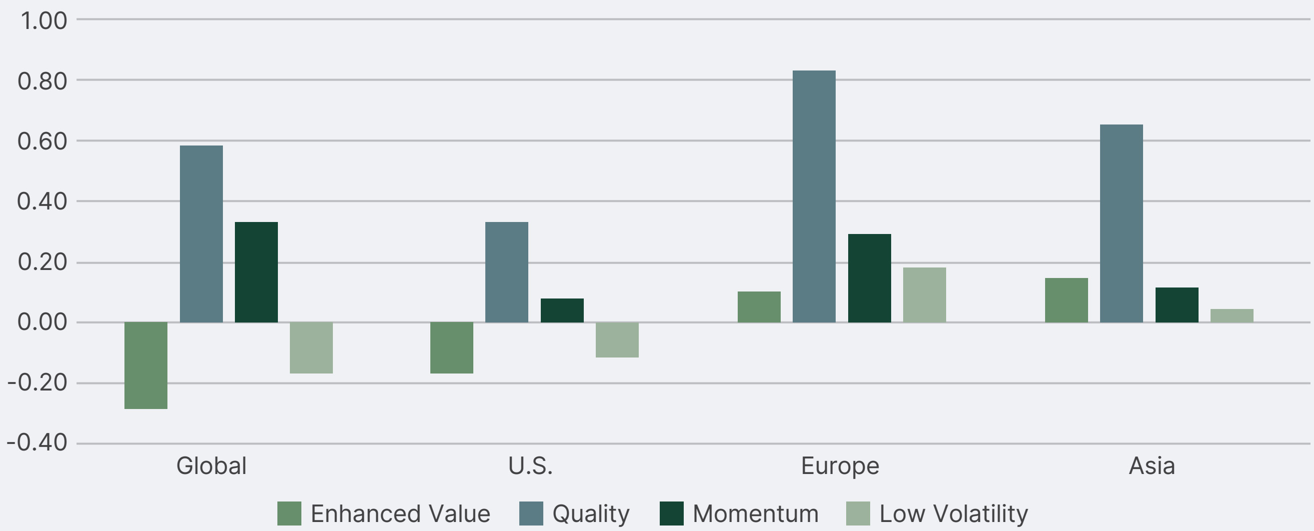
Source: Bloomberg, Balentine

Since there is no single identifiable metric that can consistently explain quality's unique return superiority, there is no consistent definition for it. The most common metrics used to measure quality are profitability, earnings stability, capital structure, and return on investments. Through research findings, the correlations of returns among those individual metrics reveal a lack of similarity, indicating they are not proxies for a common factor, but rather a collection of heterogeneous attributes linked by the theme of financial and return quality. Therefore, quality is more appropriately interpreted as multi-factor portfolios which can invest on a standalone basis or implemented as a diversifier with other factors.

Superiority Across Geographic Locations Through Long Cycles

The other key test for quality as a core is its pervasiveness — its time and geography. Quality investment is hardly a regional phenomenon. When measured by a 15-year information ratio, which measures risk-adjusted returns above the returns of a benchmark to the volatility of those returns, quality leads each region compared to enhanced value, momentum, and low volatility factors (Figure 9).

Figure 9: When measured by 15Yr information ratio, quality leads each region compared to enhanced value, momentum, and low volatility factors



Source: S&P Global

Conclusion

After 10-plus years of easy money, loose credit policy and consistent economic growth, macro conditions have started to quickly deteriorate in the U.S. and globally. As we look ahead and anticipate slowing economic growth, a sharp increase in short-term interest rates, and tightening credit and liquidity conditions, the path to normalization will be highly dependent on how long it takes for inflation to get back to normal. This could take a while, for reasons we mention in the first article.

In these uncertain times, before the next secular trend emerges, there is potential for alpha. In loose monetary policy times, capital is devoted to innovative investments, many of which fail the test of time. In times of crisis, finding alpha is vital to survival so that investors may achieve financial goals over the long run. We believe investors should practice discipline and focus on the durability of investment assets when the capital market environment calls for extra caution, and we believe emphasizing quality as a core can be a strategy to satisfy this need. Incorporating the stable and durable core expands the strategy's ability to capture tactical investment opportunities, which may lead to a more predictable and repeatable investment experience.

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