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Value Investing: Quality Matters

While investors have focused on the "Magnificent Seven" stocks for several years now, leading to concentration in several well-known indices, deeper analysis shows that other influences have also driven market returns. In particular, quality has been a powerful and consistent source of equity outperformance over the last decade or more. Below, we look at a definition of quality and how various quality factors have accounted for returns.

Quality companies typically have solid profitability, stable and growing earnings that create high free cash flow, and strong balance sheets. Companies with these attributes have weathered economic turbulence and strongly outperformed broader equity benchmarks. Our analysis shows that quality stocks have been clear differentiators, with the higher deciles significantly outperforming the lower deciles. Consequently, given our belief that quality will continue to be rewarded, we believe investors should consider quality when constructing long-term portfolios.

For our analysis, we reviewed four characteristics that typically show quality:

- **High Return on Invested Capital (ROIC)**, which is evidence of efficient and valuable capital allocation;
- **High Free Cash Flow to Enterprise Value (FCF to EV)**, pointing towards strong cash generation with potential undervaluation;
- **Consistent earnings surprise**s, suggesting potential under-appreciation for a company's earnings results; and
- **Momentum**, pointing towards stocks that have performed well and may continue to do so, potentially reducing the risk of a value trap.

A company exhibiting these qualities, we conclude, is likely to have durable business models generating consistent financial performance.[1]

Business Quality and Intrinsic Value

Companies that have historically delivered consistently high ROIC often have a differentiated competitive position. Assessing whether that differentiated competitive position is durable is one of the key determinants of a company's terminal value, and whether it is a reliable source of enduring intrinsic value. Further, it is one of the factors (along with an assessment of a firm's Total Addressable Market, or TAM) that determines whether a company can grow its FCF over time. Hence, our analysis shows a high correlation between business quality and intrinsic value: the former measured using current and historic metrics, the latter (largely) measured via a forecast of the company's future prospects.

Business Quality Data and Investment Returns

In Exhibit 1, we show the performance of companies in the Russell 1000 Index grouped into deciles according to their exposure to the four factors discussed above (ROIC; FCF to EV; consistent earnings surprises; and momentum). The companies with the highest exposure to the four factors are in the top decile, while the companies with the lowest exposure are in the bottom decile. We then calculated the performance of each decile, which are annualized over the past 15 years, through June 30, 2025. Returns are color coded for each decile (green for best; red for worst—with shades of gradation in between). The returns for each factor are shown as well as the aggregate returns for all factors combined. In addition, the exhibit includes standard deviation (a measure of risk) and the Sharpe ratio (risk-adjusted return) for each decile and the returns for the Russell 1000 Value and the Russell 1000 Growth indices.

Exhibit 1: Large Cap US Companies with Quality Characteristics Have Outperformed over the Past 15 Years

Outperforms Underperforms

Annualized Return

	Top Decile	Decile 2	Decile 3	Decile 4	Decile 5	Decile 6	Decile 7	Decile 8	Decile 9	Bottom Decile	R1000 Growth	R1000 Value
US	17.0%	15.4%	14.6%	14.7%	12.9%	14.5%	13.2%	11.0%	8.4%	8.2%	16.3%	10.8%
US ex EPS SUR	15.7%	15.1%	16.8%	13.7%	13.9%	13.4%	11.7%	12.1%	8.5%	8.7%	16.3%	10.8%
US ROIC	16.1%	14.9%	14.0%	13.1%	13.0%	13.5%	12.1%	10.5%	11.2%	10.1%	16.3%	10.8%
US FCF_EV	15.1%	13.2%	13.8%	13.5%	14.6%	14.7%	12.8%	11.2%	10.7%	9.2%	16.3%	10.8%
US MM	14.6%	13.4%	15.2%	14.5%	13.7%	14.0%	13.7%	13.8%	10.5%	6.5%	16.3%	10.8%
US EPS_SUR	15.5%	14.5%	14.4%	14.1%	12.3%	13.7%	12.2%	12.2%	12.3%	8.4%	16.3%	10.8%

Annualized Standard Deviation

	Top Decile	Decile 2	Decile 3	Decile 4	Decile 5	Decile 6	Decile 7	Decile 8	Decile 9	Bottom Decile	R1000 Growth	R1000 Value
US	16.4%	16.0%	16.4%	16.4%	16.7%	17.0%	18.0%	17.8%	18.0%	22.0%	16.2%	14.9%
US ex EPS SUR	16.3%	16.3%	15.9%	16.4%	16.7%	17.4%	17.4%	18.0%	17.9%	23.1%	16.2%	14.9%
US ROIC	17.0%	15.9%	16.5%	17.3%	16.5%	17.1%	18.0%	16.4%	18.1%	23.5%	16.2%	14.9%
US FCF_EV	18.7%	18.1%	17.3%	16.6%	15.9%	15.9%	16.9%	17.2%	18.7%	21.1%	16.2%	14.9%
US MM	16.8%	15.5%	16.1%	16.7%	16.9%	17.2%	18.1%	18.7%	19.6%	20.8%	16.2%	14.9%
US EPS_SUR	18.6%	16.7%	17.0%	17.1%	17.1%	17.1%	16.8%	17.1%	17.1%	20.0%	16.2%	14.9%

Annualized Sharpe

	Top Decile	Decile 2	Decile 3	Decile 4	Decile 5	Decile 6	Decile 7	Decile 8	Decile 9	Bottom Decile	R1000 Growth	R1000 Value
US	1.03	0.97	0.89	0.9	0.77	0.85	0.74	0.62	0.46	0.37	1.01	0.73
US ex EPS SUR	0.96	0.93	1.06	0.83	0.84	0.77	0.67	0.67	0.47	0.38	1.01	0.73
US ROIC	0.95	0.94	0.85	0.76	0.79	0.79	0.67	0.64	0.62	0.43	1.01	0.73
US FCF_EV	0.81	0.73	0.8	0.81	0.92	0.92	0.76	0.65	0.57	0.44	1.01	0.73
US MM	0.87	0.86	0.94	0.87	0.81	0.81	0.76	0.74	0.54	0.31	1.01	0.73
US EPS_SUR	0.84	0.87	0.85	0.82	0.72	0.8	0.73	0.72	0.72	0.42	1.01	0.73

Data from January 2010 through June 2025. Deciles are based on returns (top=highest; bottom=lowest). Deciles are equal-weighted and rebalanced monthly.

Past performance does not guarantee future returns. See disclosures for term definitions.

Sources: Capital IQ, Compustat, Jennison Equity Quantitative Research, MSCI, Russell

The data shows, first, that the top decile of quality factors provides better returns than the bottom decile. In fact, superior returns are observable in the top three deciles versus the bottom three deciles (Exhibit 2). Second, when looking at the Sharpe Ratio, given the higher returns, the top three deciles also provide superior risk adjusted returns than the bottom three deciles (Exhibit 3).

Exhibit 2: The Top Three Deciles Outperform the Bottom Three Deciles

Russell 1000 Ranked in Deciles According to Exposure to Quality Factors

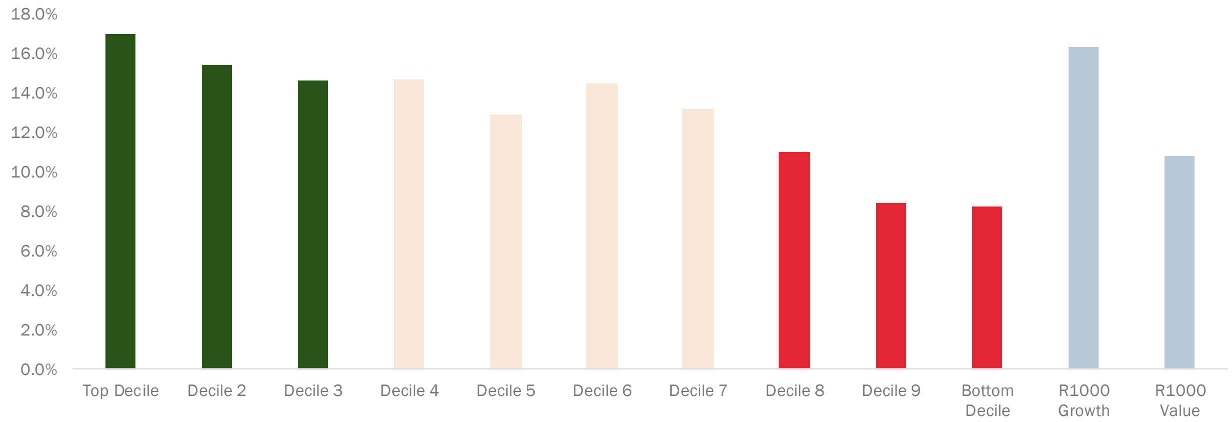

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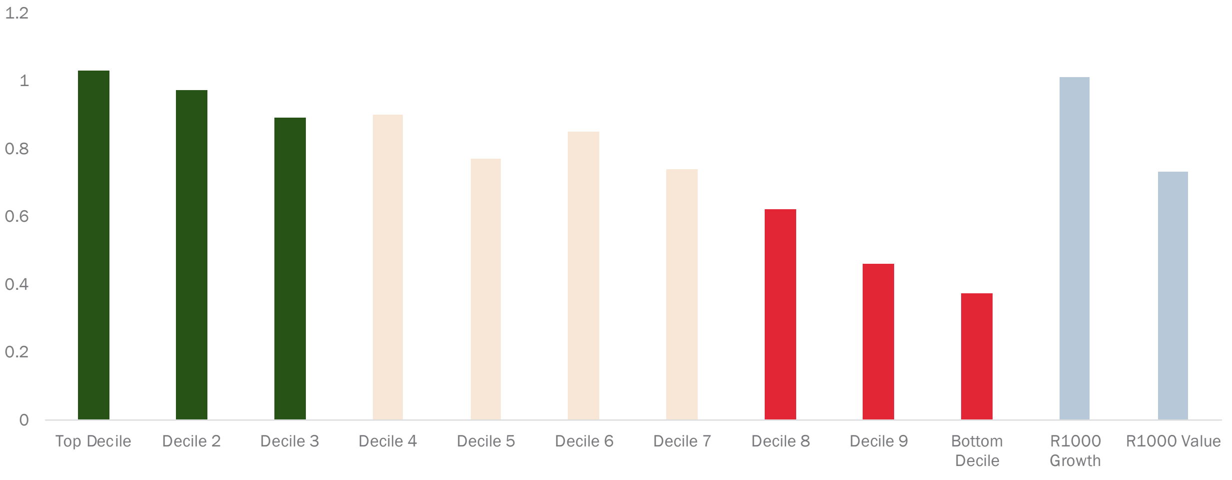
Exhibit 3: The Top Deciles Provide Better Risk-Adjusted Performance

Russell 1000 Index Decile Sharpe Ratios



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A value manager whose portfolio consisted of quality holdings (like the factors used here) could have enhanced their returns meaningfully above the Russell 1000 Value Index, closing the gaps between growth and value returns. Of course, this could also be accomplished by investing in the higher deciles and avoiding the lower deciles.

Is Quality a Durable Trend?

So, will quality continue to provide meaningful excess returns?

One way to answer this question is to look at why quality has done well over the last 15 years. There are several reasons. First, political and economic uncertainty has been high because of rising polarization, the Covid pandemic, disruptive trade policy, and higher inflation and interest rates. This uncertainty has led investors to favor quality stocks, which have stronger resilience during periods of higher uncertainty. Second, the technology sector—led by Magnificent Seven and AI-exposed firms—have many quality companies due to their high margins and solid cash flow. They have been consistent contributors to equity market performance. Third, quality companies have superior financial fundamentals, which over most scenarios have been favored by investors.

Given that these influences are still prevalent today, we believe companies with quality attributes will continue to be rewarded.

Endnotes

[1] We have analyzed these four characteristics over various periods, though for the purpose of this paper we are focusing on the last 15 years. However, we note that all the time periods we examined showed similar results..

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