"Achieving Successful Outcomes"

Compound Interest

CRAWFORD INVESTMENT COUNSEL Est. 1980

Article #3 ATLANTA, GA USA March 2024

QUALITY: THE DIFFERENTIATED INVESTMENT FACTOR

We believe that quality is a very important factor in portfolio management, but we note that it is fundamentally different from other investment criteria because it impacts not just return but risk as well. In the lexicon of finance, quality means something quite different than in everyday usage. In finance, a firm is considered to be high quality in nature if its earnings and dividends exhibit an unusual level of consistency and growth through time.

We do not need to delve into financial theory to see why quality, as it is defined here, carries such significance for money managers. When you buy a stock, you are purchasing the right to a share of the stream of earnings and dividends that company generates. It is our belief that the more predictable future earnings are, the more accurately one can forecast the returns that accrue to shareholders. A consistent and growing dividend over time is a demonstration of a company's ability to generate an earnings stream and is the key indicator of quality, in our opinion. Companies that pay dividends, and especially those that can increase dividends consistently over time, generally have businesses that are less cyclical, more predictable, and tend to be financially sound. At Crawford, we believe that dividend history and quality are inexorably linked.

Our equity investment team performs fundamental, bottom-up research on all of the stocks considered for purchase. This includes digging into businesses' financial statements, performing industry and competitive evaluations, assessing the business model, and talking to management teams. Our analysts start with a universe made up of dividend-payers and take a look under the hood for quality attributes like earnings stability, high margins and returns on capital, balance sheet strength, strong free cash flow generation, and management team effectiveness.

Many investment managers' goal is to provide better-than-market returns. While high-quality companies have attractive investment attributes, providing above-market results is not the key value proposition associated with these stocks. Rather, the primary advantages of high-quality stocks are the combination of return and risk reduction they bring to the portfolio. Investing in high-quality stocks enables investors to benefit from the fundamental progress and strength of the underlying businesses (return). These are companies with sustainable business models that are better able to weather periods of economic weakness, so market declines are dampened and the pattern of returns is typically much smoother (risk reduction). Because of our focus on dividend-paying companies, investors also receive the added benefit of income, which is a component of return that is always positive and can help investors meet spending needs.

For these reasons, when the return history of individual high-quality companies is considered, we know that they have done well over time. We also know there can be periods of relative underperformance over the short-to-intermediate term, or even for a number of years. We encourage our investors to think about high-quality investments in a longer-term context and relative to the level of risk assumed. Our preference is to invest where there is the greatest degree of visibility into the future and the highest assurance that positive returns will be produced. Therefore, we focus on investments in companies where there is little doubt regarding their long-term viability. This can mean being willing to earn a less-than-market return over some period of time, especially when risk-takers are being rewarded by the market. We do this knowing that when more difficult economic or financial times arrive, high-quality stocks will protect capital and outperform by a strong margin. This is aligned with our belief that returns must be evaluated over a full market cycle. It is in times of market distress when the merits of quality are most fully realized, and we like to say our strategies earn alpha when you need it most.

While our primary focus is on quality, we are also value-sensitive when making investment decisions. We believe the best conditions for purchasing high-quality stocks are when short-term interruptions in the long-term growth trajectory drive prices down to a point where these stocks can be purchased at a discount, which corresponds to elevated dividend yield. Legendary value investor Benjamin Graham said that “in the short term, markets behave like a voting machine, but that in the long term, they behave like a weighing machine.” A long and consistent dividend history provides confidence that we have an accurate “weighing machine” to identify opportunities in the short-term ups and downs of market sentiment.

In conclusion, we believe quality is a differentiated investment factor with various benefits including attractive long-term returns, protection in market declines, smoother patterns of return, and income production. All of these factors reduce volatility (and emotional responses to it) and influence an investor’s ability to stay invested and compound returns over time. Investing in quality also enables our clients to own more of the higher-returning asset class (stocks) without taking on substantial risk. These benefits are best achieved over full market cycles via long-term stock ownership. We believe our unwavering focus on investing in quality has been the primary contributor to our clients’ successful outcomes over our 40+ years in business.