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CAMBRIDGE ASSOCIATES LLC

GLOBAL MARKET COMMENTARY

IN SEARCH OF GLOBAL QUALITY

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In Search of Global Quality

We have been arguing for some time that investors should overweight "quality" in their U.S. equity portfolios, both on a valuation and tactical basis,[1] as high-quality stocks are fairly valued in absolute terms and "cheap" relative to low-quality stocks, and have historically outperformed when the earnings and credit cycles have taken a turn for the worst. Yet can the same case be made for quality outside the United States? Namely, are companies with solid profitability and dependable earnings growth attractively priced in non-U.S. markets, and where does one find quality, both from a country and sector perspective?

Data Dilemma

Any discussion of quality requires a brief clarification of terms. By "high quality" we are referring to companies that have shown an ability to consistently grow earnings, pay dividends, and retain a high level of profitability (return on equity) even in the face of cyclical downturns. Other characteristics of quality include strong balance sheets, a high caliber of management, clear competitive advantages, well-defined brands, and strong market penetration. "Low quality," however, is not meant to be a pejorative term, but instead refers to firms whose profitability is more tied to the economic and credit cycle, and therefore whose earnings are more volatile, although may offer higher growth potential.

While most investors and money managers agree on the basic traits of high- and low-quality companies, opinions widely diverge as how to systematically define quality, given the mixture of quantitative and qualitative factors involved. From the U.S. perspective, although investment processes vary and different factors are stressed, most money managers agree that Standard & Poor's (S&P) Quality Rankings are a *reasonable*, albeit imperfect, approximation of quality. While the S&P methodology looks only at the stability of earnings and dividends, and does "not profess to reflect all of the factors, tangible or intangible, that bear on stock quality," companies rated highly by S&P have over time displayed the characteristics and performance that one would expect from high-quality stocks.[2]

While S&P has been assigning quality ratings on U.S. stocks since 1956 and has developed and tracked a comprehensive data set since 1986, S&P's global quality coverage is less robust. Quality rankings for non-U.S. companies begin in 1998 and follow a slightly different methodology (notably using seven years of earnings and dividend data, instead of ten years). Furthermore, differences in accounting rules complicate cross-country comparisons. S&P is aware of these shortcomings and is currently in the process of revamping its coverage and reconstructing an extended history of global quality rankings.

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[1] Please see our June and August 2006 U.S. Market Commentaries *Still Pounding the Table on Quality* and *The Unloved Mega-Caps*, and this month's special Global Market Commentary: *It's Getting Late—Risks are Rising.*

[2] "Standard & Poor's Quality Rankings: Portfolio Performance, Risk, and Fundamental Analysis," Massimo Santicchia and Philip Murphy, Standard & Poor's, October 2005.

A Rough Guide

With that said, Merrill Lynch's Quantitative Strategy group (MLQS) has done solid work in tracking global quality based upon the S&P Global Quality Rankings. Based upon their work, we can draw some broad conclusions regarding global quality.[3]

(1) Quality has underperformed low quality over the past 12 months (Table A).
(2) Quality is cheap relative to low quality on a global basis (Table B).
(3) Quality is concentrated among mega- and large-cap companies (Table C).
(4) Quality is "low beta" (Table D).
(5) Quality is skewed toward the United States. (Table E).

From a global perspective, quality seems to be consistent with what we have observed in the United States, namely that the strong run-up in low-quality cyclical stocks have left large-cap, high-quality names trading at attractive relative valuations, precisely at a time when their defensive properties are most desirable, given the stretched nature of the global earnings cycle (indeed analysts are already ratcheting down their typically over-optimistic earnings expectations). In other words, should earnings growth slow sharply and credit conditions tighten (or heaven forbid even contract), high-quality stocks should begin to outperform as the markets begin to "pay-up" for companies that can generate earnings growth and pay dividends.

Countries and Sectors

Overall, the MLQS data indicate that approximately only 25% of stocks covered globally by S&P fall into the high-quality category. The United States by far has the highest concentration, with quality accounting for roughly 45% of U.S.-ranked stocks, while Japan follows at roughly 30%, Europe at 25%, Emerging Markets at 20%, and Asia Pacific ex Japan at slightly less than 20%. While the concentration of quality in the United States may well reflect biases in the S&P data (broader coverage of U.S. stocks), the tilt toward lower-quality/higher cyclicality of earnings outside the United States conceptually holds water, given the reliance on export-driven growth in Asia and the developing world (and to some extent Japan and Europe), while disappointing domestic growth in Europe and Japan (up until recently) coupled with a prolonged period of corporate restructuring in these economies would also weigh on the "quality" of earnings over the past few years.[4]

Looking at the sector breakdown, while consumer staples and utilities are among the highest-quality sectors, we find that S&P-defined quality has its largest concentration among financials, especially in the

[3] MLQS defines high quality as those stocks ranked B+ and above, while low quality those ranked B or worse. S&P Quality Rankings include A+ (the most stable companies), A, A-, B+, B, C (least stable earnings), and D (companies in reorganization).
[4] While restructuring may have weighed on profitability and earnings in the past, it can be argued that European and Japanese companies have completed the bulk of the necessary adjustments (via increased outsourcing, information technology investment, and cost-cutting) and are now experiencing a structural shift in profitability, part of which we have already witnessed in the high level of return on equity and earnings growth over the past four years.

United States, which is some what counterintuitive, as the financial sector tends to be geared toward the economic and credit cycles, and should exhibit lower-quality earnings. Yet over the past decade financials have been growing as a share of high-quality stocks; based on MLQS analysis of S&P data, over 90% of the covered stocks in the U.S. bank sector are considered high quality, while over 60% of U.S. diversified financials are deemed the same. This compares to less than 60% for banks on a global level and roughly 30% for diversified financials. According to S&P "the performance of this sector has been driven by on-going consolidation, technology-driven efficiency improvements, diversification into new business lines, better duration-matching of assets and liabilities, and a favorable interest rate environment (versus the 1970s and 1980s)…the financial sector achieved more stable margins and earnings growth as fee-based revenues increasingly represent a higher percentage of total revenues, and as they reduced their dependence on interest based income."

While we would not deny that the performance of the financial sector worldwide has been remarkable (with record profit announcements becoming common place in the sector), we strongly hesitate to view U.S. (and to some extent European) financials as a defensive quality play, especially given that any serious downturn in the U.S. and global economy would likely be tied to some sort of financial fall-out linked to the end of the credit boom in the United States and elsewhere, upon which most of the prosperity of the past few years has been built. Said differently, financials may be less cyclical than in the past, but we do not necessarily view them as quality given their high levels of leverage (nor do some money managers with a "quality" tilt), as we have yet to go through a serious turn in a credit cycle in which banks have been especially active. We are somewhat less concerned about Asian financials (especially Japanese) as these economies remain relatively unleveraged (a legacy of the painful aftermath of credit excesses in Asia's not too distant past) and whose banks have not fully participated in a lending and securitization boom akin to that seen in the United States[5] and to some extent in Europe (Australian banks, however are a notable exception, as are Chinese banks, which have been financing a frothy real estate and investment boom). With that said, risks still remain, and Asian financials may not display the defensive characteristics of quality stocks should global liquidity conditions turn.

What Does this Mean for Asset Allocation?

We continue to advise overweighting quality throughout investment portfolios. From a global equity portfolio standpoint, this implies reducing low-quality, high-beta exposure, namely by cutting investments with dedicated small- and mid-cap managers, and investing the proceeds in high-quality stocks either through an active or passive "mega cap" investment (as these stocks have a high degree of overlap with high-quality stocks), or increasing allocations to managers that focus on high-quality equities. However, given that definitions of quality can vary significantly across managers, it is important to evaluate the degree to which a manager's investment program remains defensive. With regard to emerging markets, given their slight valuation edge relative to developed markets and their attractive long-term prospects, we regard this as one

[5] However, Asian banks (and other institutions) have been avid buyers of U.S. mortgage-backed debt in the global hunt for yield, and therefore are still somewhat exposed, albeit at a much smaller scale.

of the best places to take risk today, but caution that emerging markets will surely suffer should the economic and credit cycle turn.

While we continue to recommend investors underweight U.S. equity allocations relative to a neutral weight of roughly 50% implied by the United States' share of global equity market capitalization, we recognize that this long-term strategic view may result in *increased* exposure to high-beta, lower-quality assets.[6] Indeed, if taken at face value, the MLQS S&P Global Quality Rankings data would imply that overweighting the United States relative to global markets would increase the level of quality in global equity portfolios. However, we would caution that investors take care not to implement an overweight to quality by ramping up broad U.S. equity allocations given that U.S. equities are expensive relative to most other developed markets and emerging markets on the whole, and more importantly, that there remain significant secular headwinds facing U.S. assets relative to non-U.S. assets that are not fully priced into capital markets.[7]

Over time, as economic restructuring completes in Europe and Japan, and global growth shifts from an export-driven/U.S.-demand model toward a more balanced global economy supported by domestic consumption in Europe, Asia, and emerging markets, we expect the nature of global quality to shift and become more dispersed across global equity markets. Indeed, as S&P has remarked, "the key point is that quality is not static but fluctuates across sectors and industries according to numerous business environmental factors. Thus we should not assume that today's high quality sectors, industries, and companies will be tomorrow's."

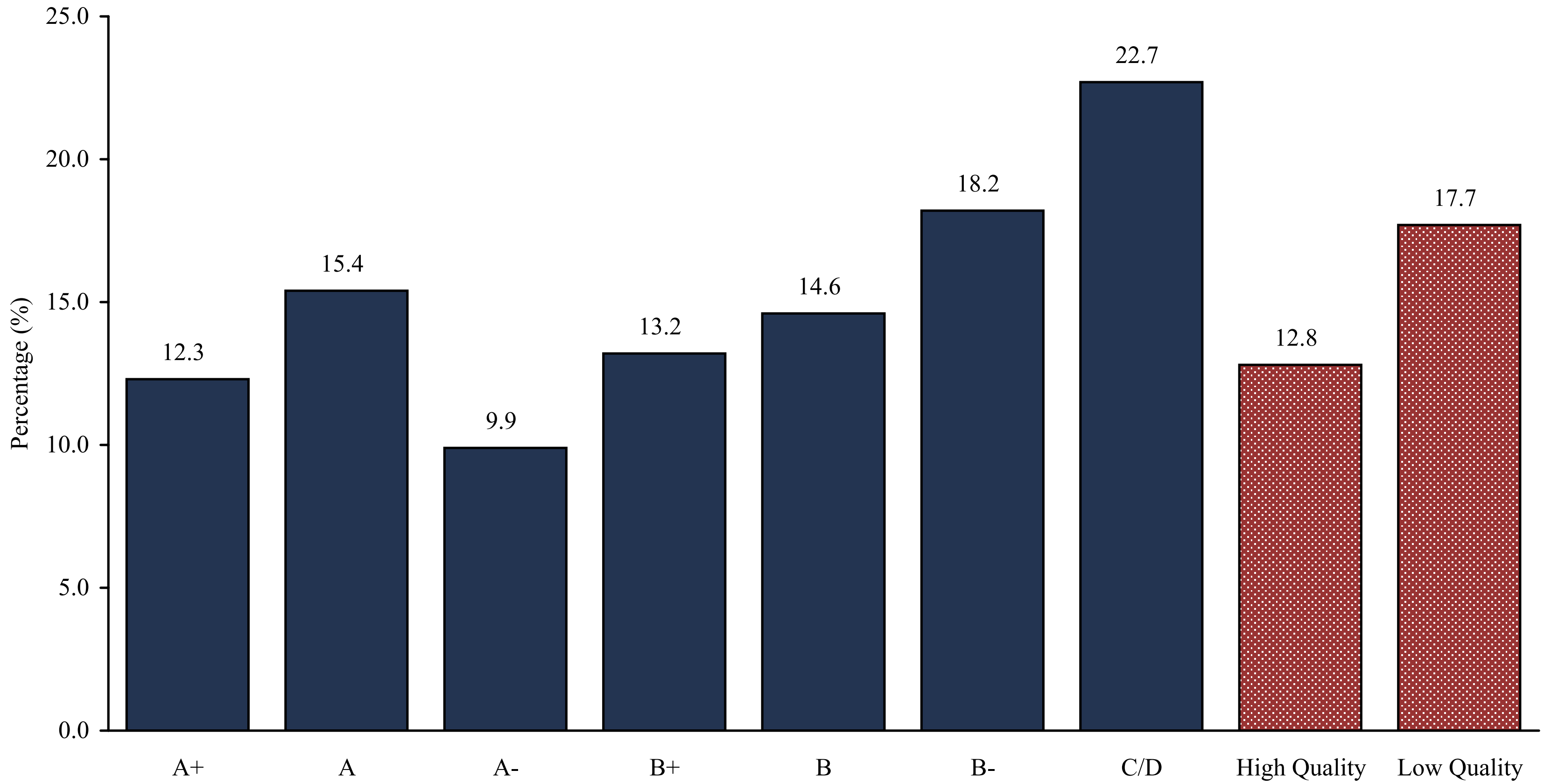
We would agree. Meanwhile, more work is needed to gain a better perspective on global quality, as the current S&P rankings may distort the picture and not capture adequately those companies that we would deem as high quality. Over the coming months we will continue to explore alternative methods in identifying quality in global equity markets.

[6] Although Japan, the cornerstone of any Asia strategy, is relatively low beta, and of higher quality compared to most global markets.
[7] Please see our reports, *Cutting Strategic Allocations to U.S. Equity* (2006) and *Increasing Strategic Equity Allocations to Asia* (2005).

Table A

TWELVE-MONTH PERFORMANCE FOR GLOBAL QUALITY INDICES

Period Ending February 28, 2007



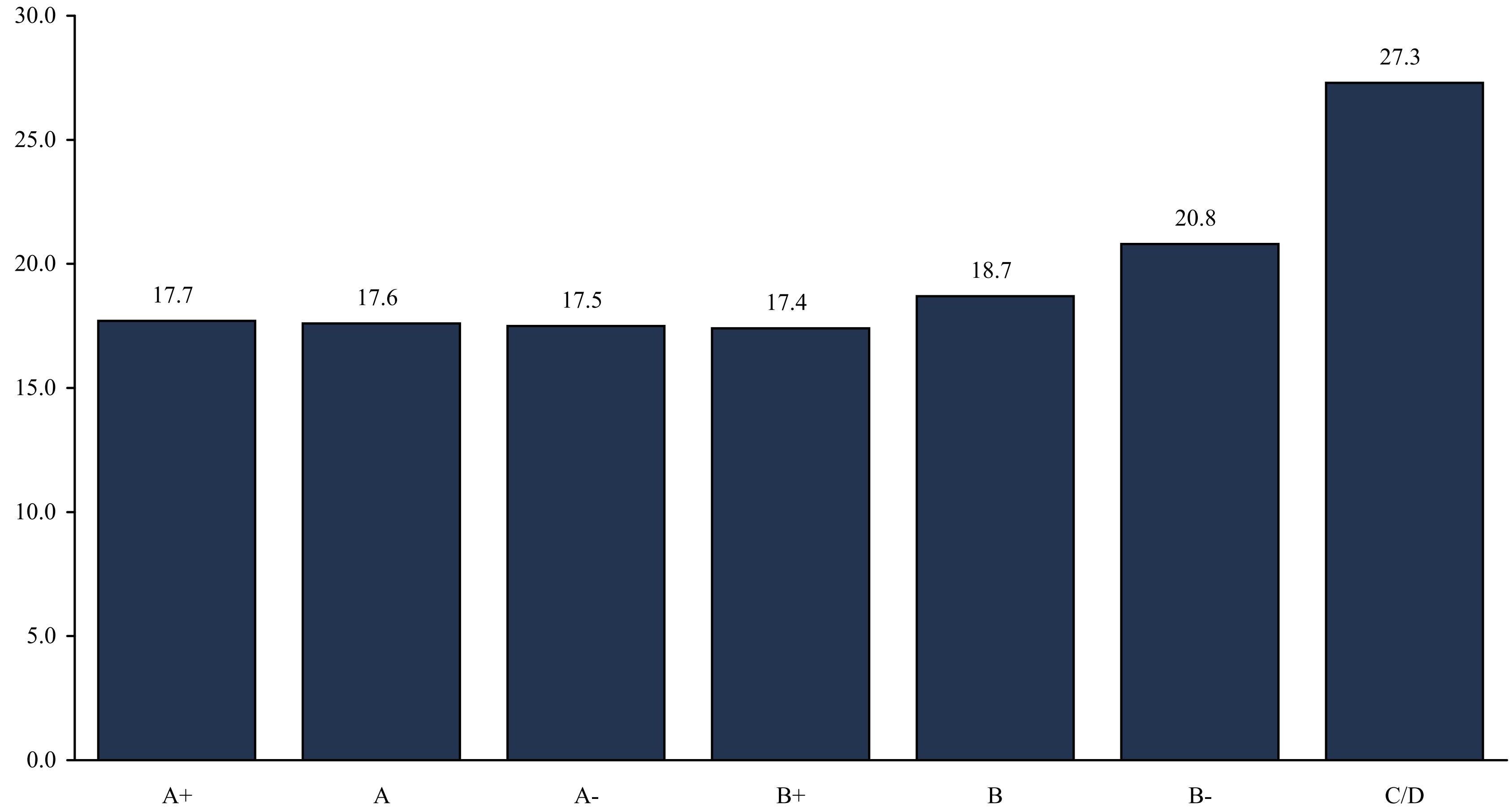
Sources: Merrill Lynch Global Quantitative Strategy and Standard and Poor's.

Note: High quality represents B+ or better and low quality represents B or worse.

Table B

PROSPECTIVE PRICE-EARNINGS OF GLOBAL STOCKS BY QUALITY RANKING

As of February 28, 2007

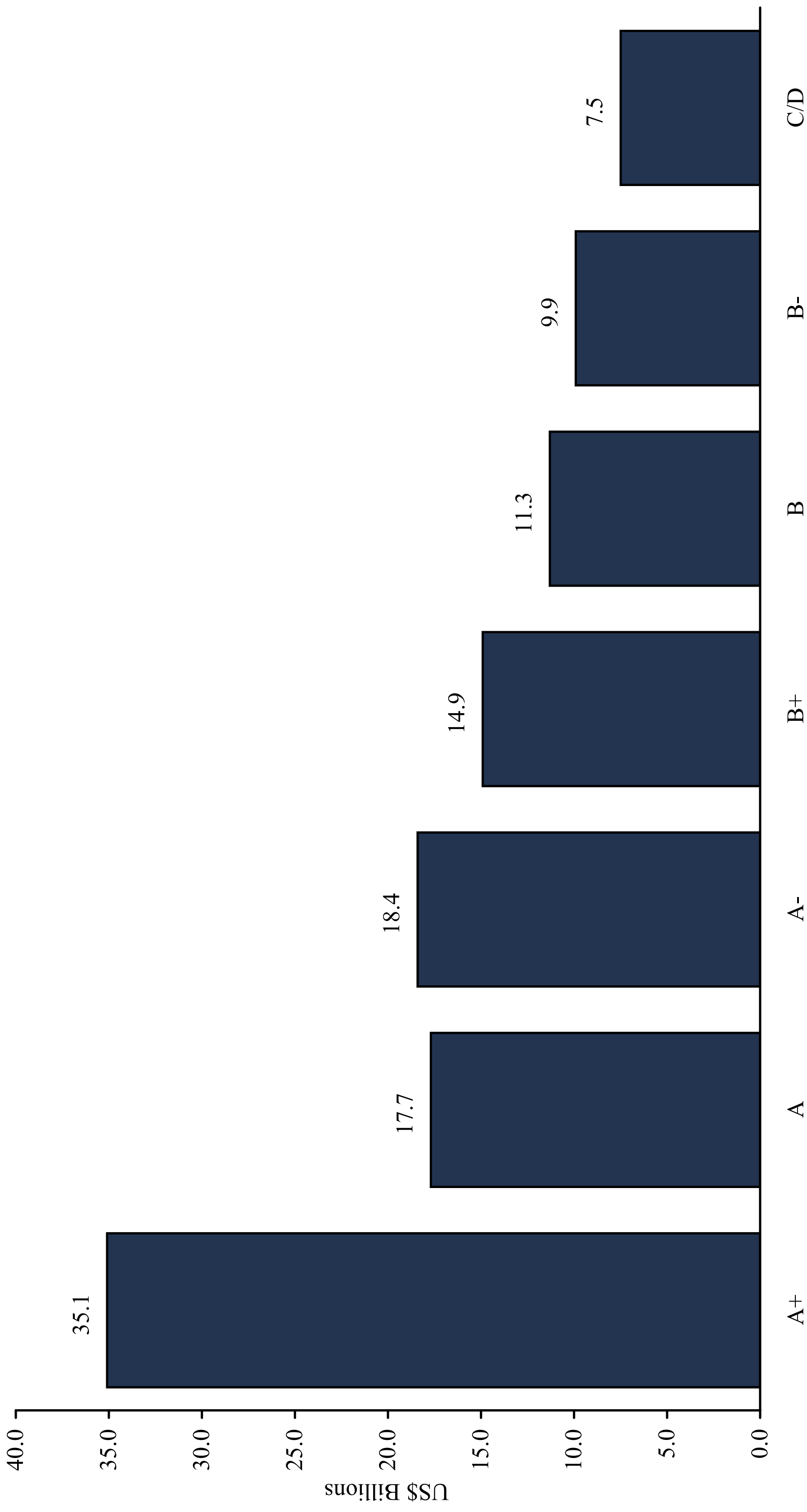


Sources: Merrill Lynch Global Quantitative Strategy and Standard and Poor's.

Table C

AVERAGE MARKET CAP BY QUALITY RANKING

As of February 28, 2007

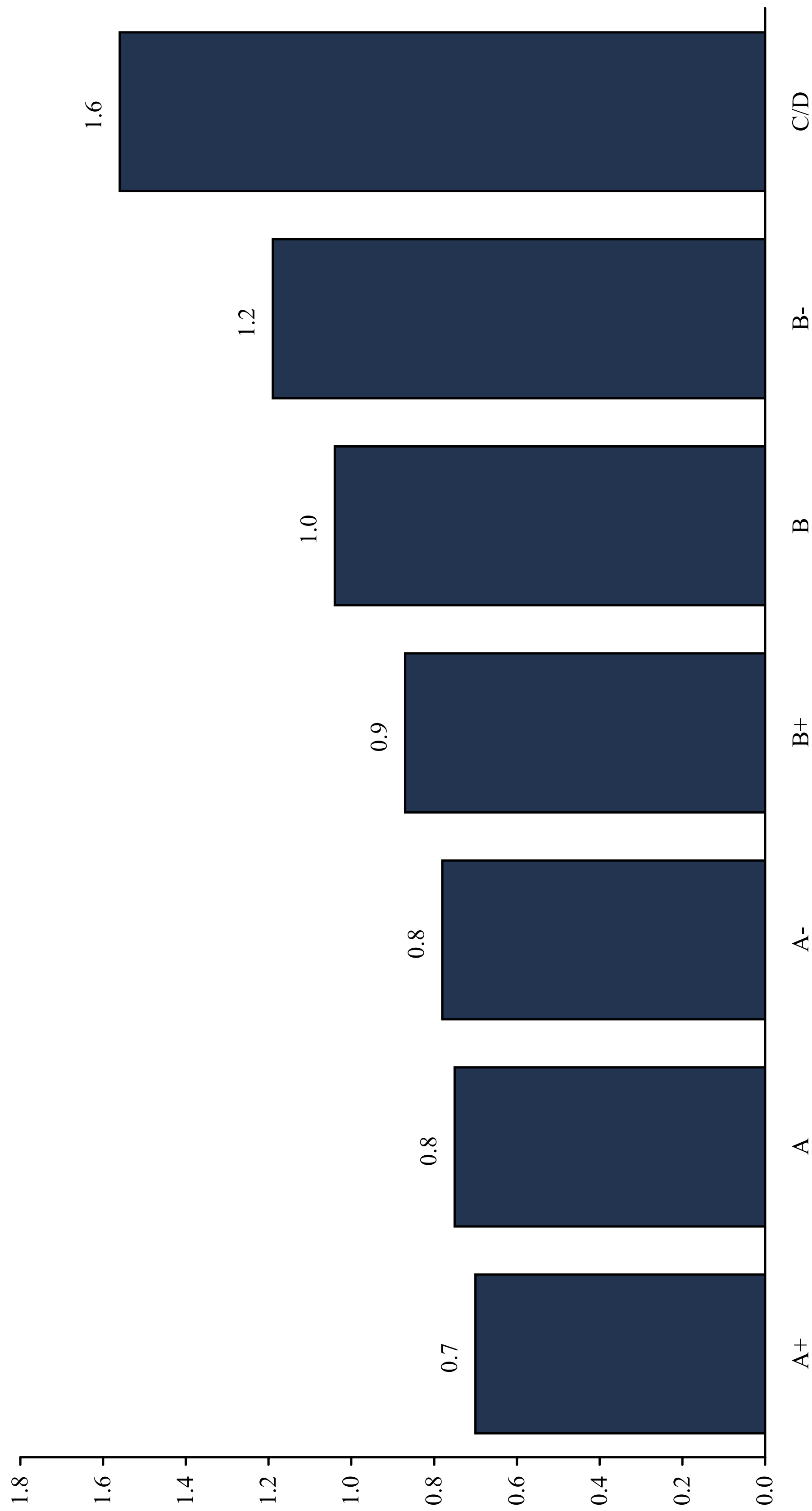


Sources: Merrill Lynch Global Quantitative Strategy and Standard and Poor's.

Table D

MEDIAN BETA BY QUALITY RANKING

As of February 28, 2007

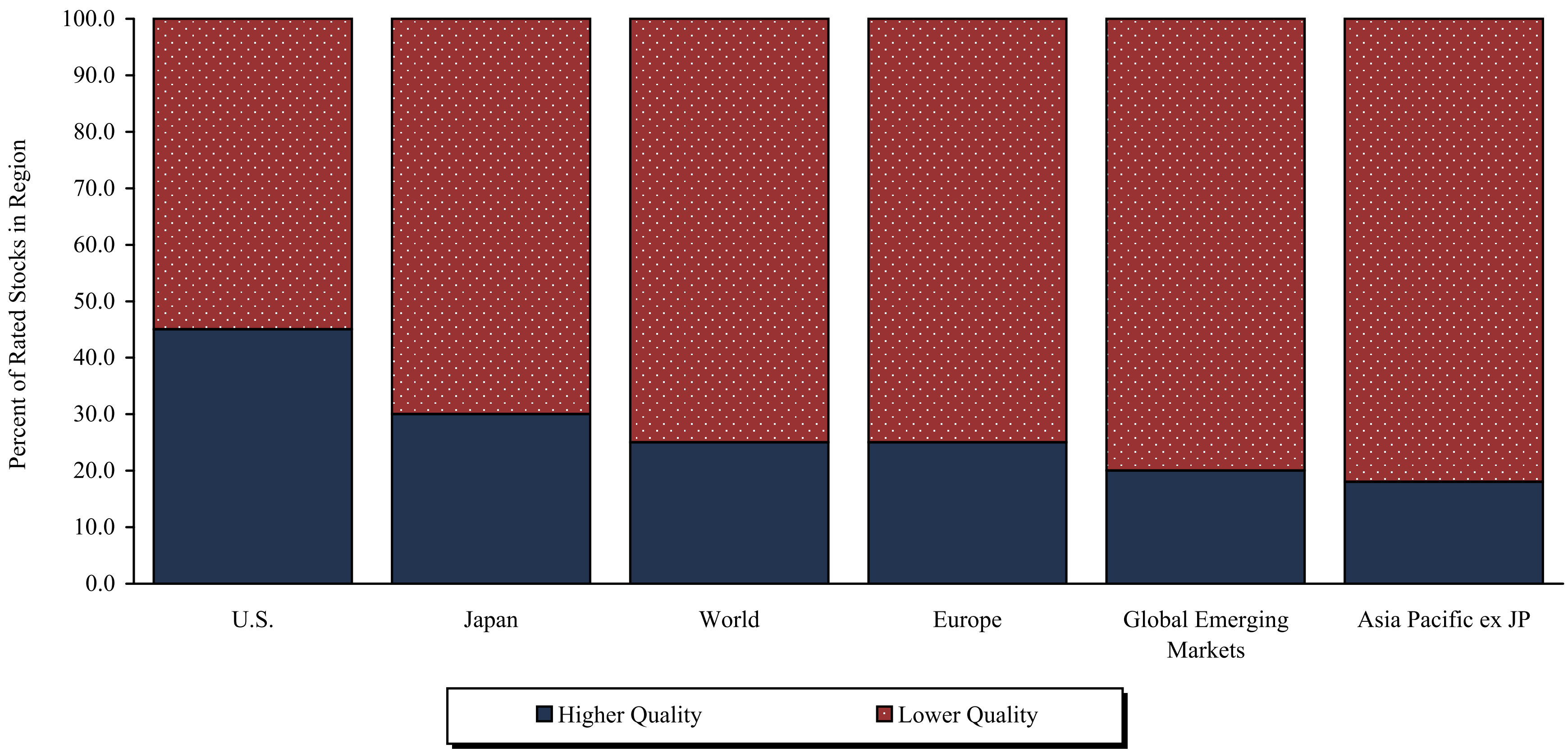


Sources: Merrill Lynch Global Quantitative Strategy and Standard and Poor's.

Table E

REGIONS BY PERCENT OF HIGHER-/LOWER-QUALITY STOCKS

As of February 28, 2007



Sources: Merrill Lynch Global Quantitative Strategy and Standard and Poor's.

Note: High quality represents B+ or better and low quality represents B or worse.