



C A M B R I D G E A S S O C I A T E S L L C

## U.S. MARKET COMMENTARY

# STILL POUNDING THE TABLE ON QUALITY

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## Still Pounding the Table on Quality

*“To be angry at the market because it unexpectedly or even illogically goes against you is like getting mad at your lungs because you have pneumonia.” - Jesse Livermore, *Reminiscences of a Stock Operator**

*“We know that going through life buying Bentleys at Volkswagen prices is probably a pretty good strategy regardless of whether everyone realizes that the Bentley is a Bentley. However, investors in the stock market rarely apply that same rule.” - Richard Bernstein, Merrill Lynch*

Two years ago, we suggested investors “shift from principally investing by capitalization to investing in quality companies across the capitalization spectrum.” Since that time, high-quality stocks have consistently lagged their lower-quality counterparts (Table A); indeed, prior to the current quarter low-quality had outperformed for four quarters in a row, with returns for the first quarter of 2006 showing a particularly large gap (Table B). Nevertheless, we have continued to advocate investors lean toward quality, for two reasons. First, quality valuations remain low (especially relative to the overall market), and second, quality is likely to outperform when the market cycle turns down (as it has over the past two months). Thus, we continue to pound the table on quality. Whether the recent downturn is the resumption of a secular bear or just a correction in an ongoing cyclical uptrend, quality remains cheap, and if history is a guide, investors who buy at current prices are likely to outperform the overall market over the medium to long term.

As can be seen from Table C (courtesy of Boston money manager GMO), quality<sup>1</sup> is now cheaper relative to the overall market than at any time since their data series began in 1965. According to GMO, quality has reached “cheap” levels relative to the overall market five times since 1965; over the following two years, quality has outperformed the S&P 500 by an average of 19%. Further, February marked the first time quality stocks have *ever* had a lower price-earnings (P/E) than the S&P 500, and there is currently an inverse relationship between quality and P/E multiples—i.e., the lower quality the stock the higher the P/E (Table D). On an absolute basis, quality looks fairly valued, with P/E multiples below their historical average on a trailing 12-month basis, and very close to their long-term mean using normalized earnings (Tables E and F).<sup>2</sup> While it could be argued that these means are skewed upward due to the time period (the average P/E for the S&P 500 for this period is 17.7, versus a long-term mean of about 15), adjusting for this does not materially change our view.

Considering the generally overvalued state of global asset markets, high-quality companies look to be one of the last bargains left. Still, they have actually gotten *cheaper* over the past few years, both in absolute terms and relative to the overall market. In other words, while P/E multiples have fallen across all quality buckets, P/Es of high-quality stocks have fallen further than those of low-quality shares. While this is not all that surprising (i.e., investors tend to prefer riskier, higher-beta assets when liquidity is plentiful, as it has been), it *does* suggest quality stocks are poised for a significant period of outperformance when the cycle finally turns. In sum, high-quality shares look cheap relative to the overall market, and fairly valued relative to their own history. Buy quality.

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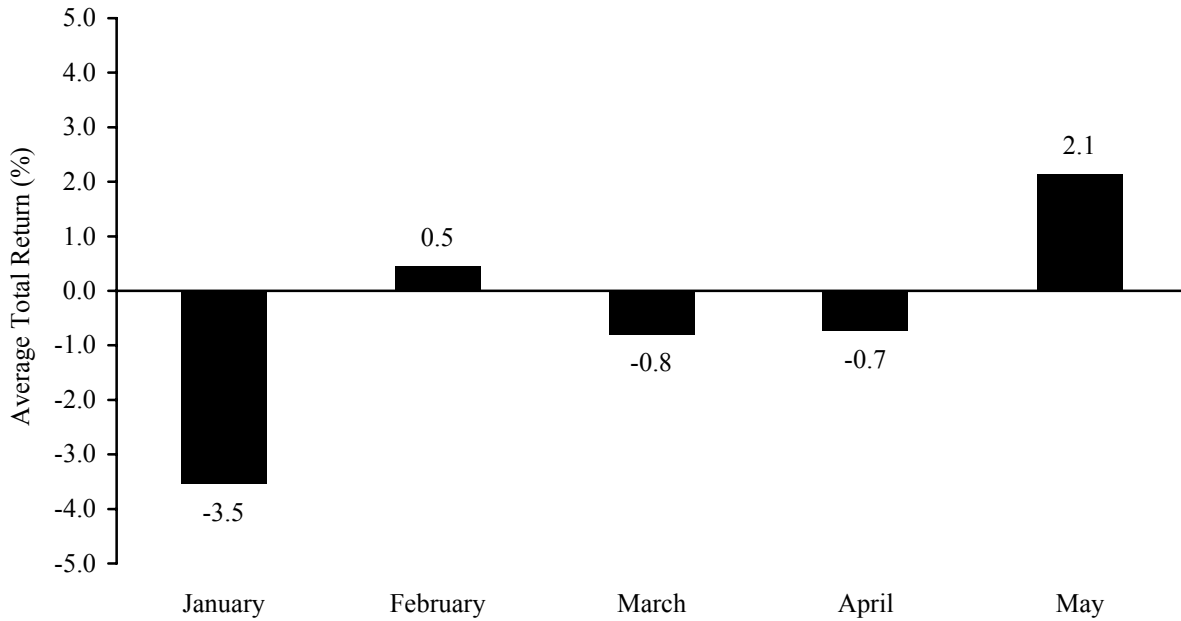
<sup>1</sup> GMO defines quality firms as those with high profitability, low leverage, and low earnings volatility.

<sup>2</sup> It is important to note that these charts use different earnings measures due to a lack of reliable data on quality valuations. The first chart uses trailing 12-month *reported* earnings, while the second uses normalized *operating* earnings. The similarity in the charts, however, gives us comfort in the underlying story (namely, that quality is at roughly fair value relative to its own history).

Table A

**PERFORMANCE BY QUALITY:  
RUSSELL 3000® INDEX RETURNS OF HIGH-QUALITY LESS LOW-QUALITY STOCKS**

January 1, 2006 - May 31, 2006



First Quarter 2004 - Second Quarter 2006

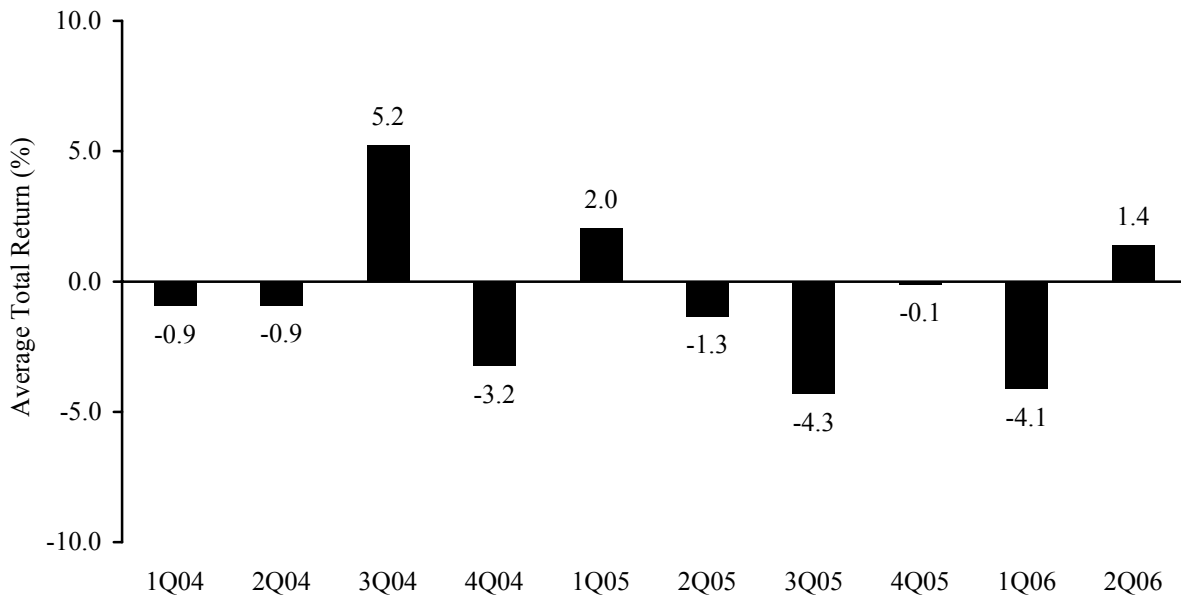
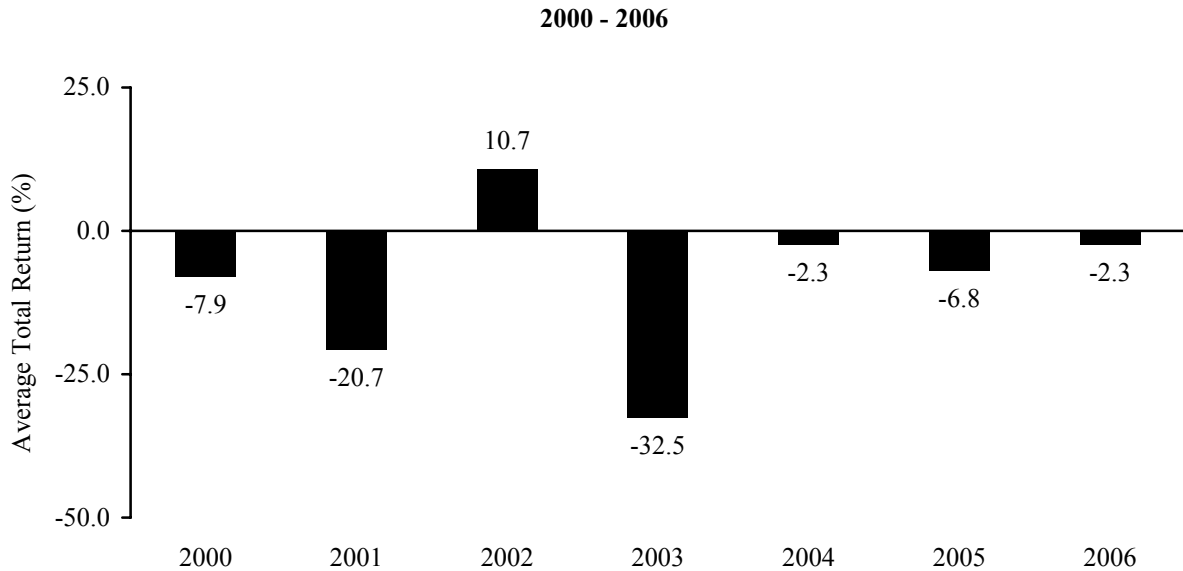


Table A (continued)

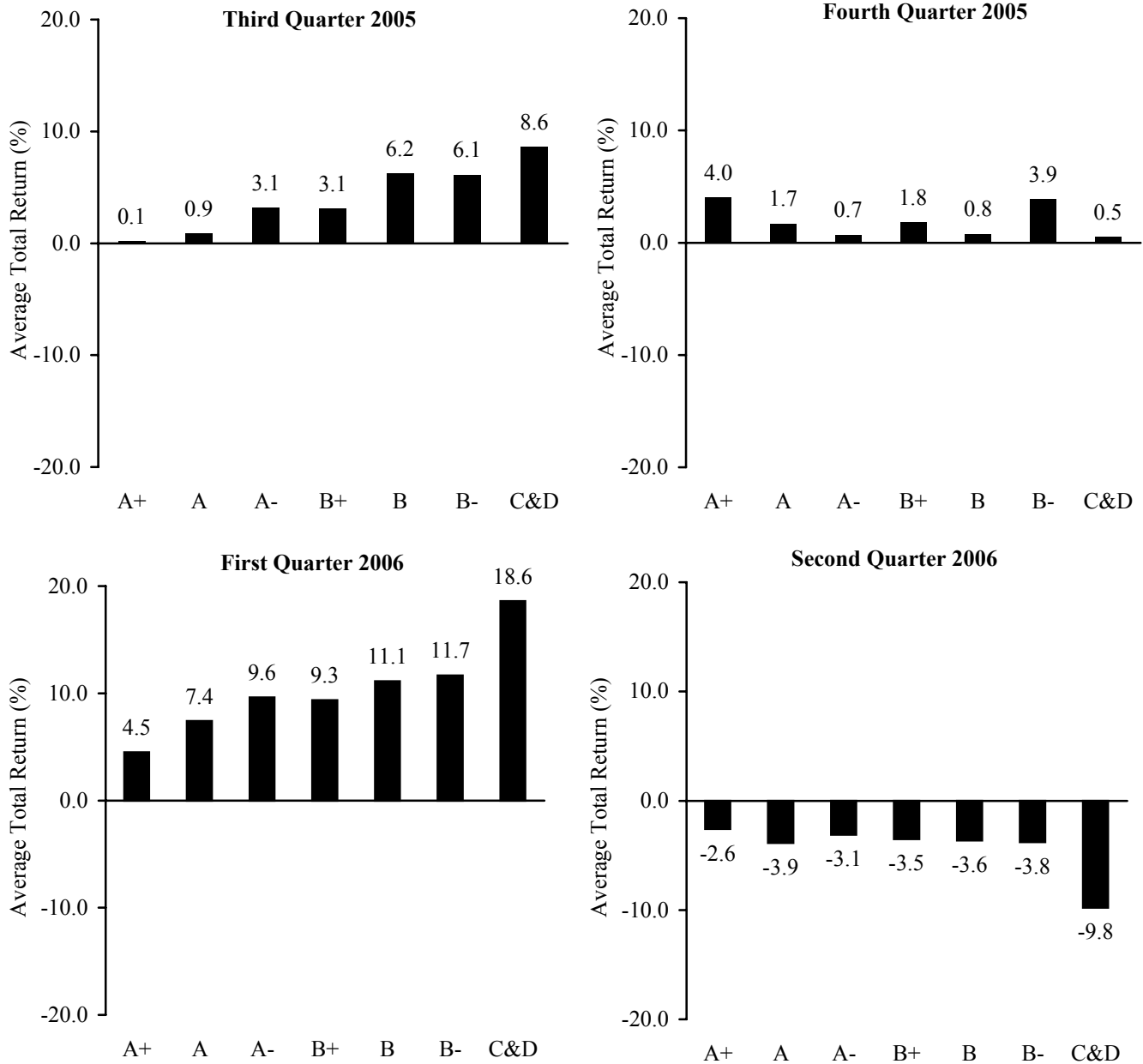
**PERFORMANCE BY QUALITY:  
RUSSELL 3000® INDEX RETURNS OF HIGH-QUALITY LESS LOW-QUALITY STOCKS**



Sources: FactSet and Frank Russell Company.

Notes: Data for 2006 are through May 31. "Quality" is measured by the total return spread between high-quality and low-quality companies, as rated by Standard & Poor's. High-quality companies include those rated A+ through B+, and low-quality companies include those rated B through D. Calculations are based on constituents that were given a rating in that specific time period; constituent numbers range from 1,388 companies in 2000 to 2,027 companies in May 2006. Constituents, quality ratings, and total returns are all period specific. "S&P Common Stock Rankings" are determined by appraising the past performance of a stock's earnings and dividends, as well as its relative standing at the time of the company's current fiscal year-end. Growth and stability of earnings and dividends are key elements in establishing S&P's earnings and dividends rankings.

**Table B**  
**PERFORMANCE BY QUALITY:**  
**RUSSELL 3000® INDEX RETURNS**  
**Third Quarter 2005 - Second Quarter 2006**



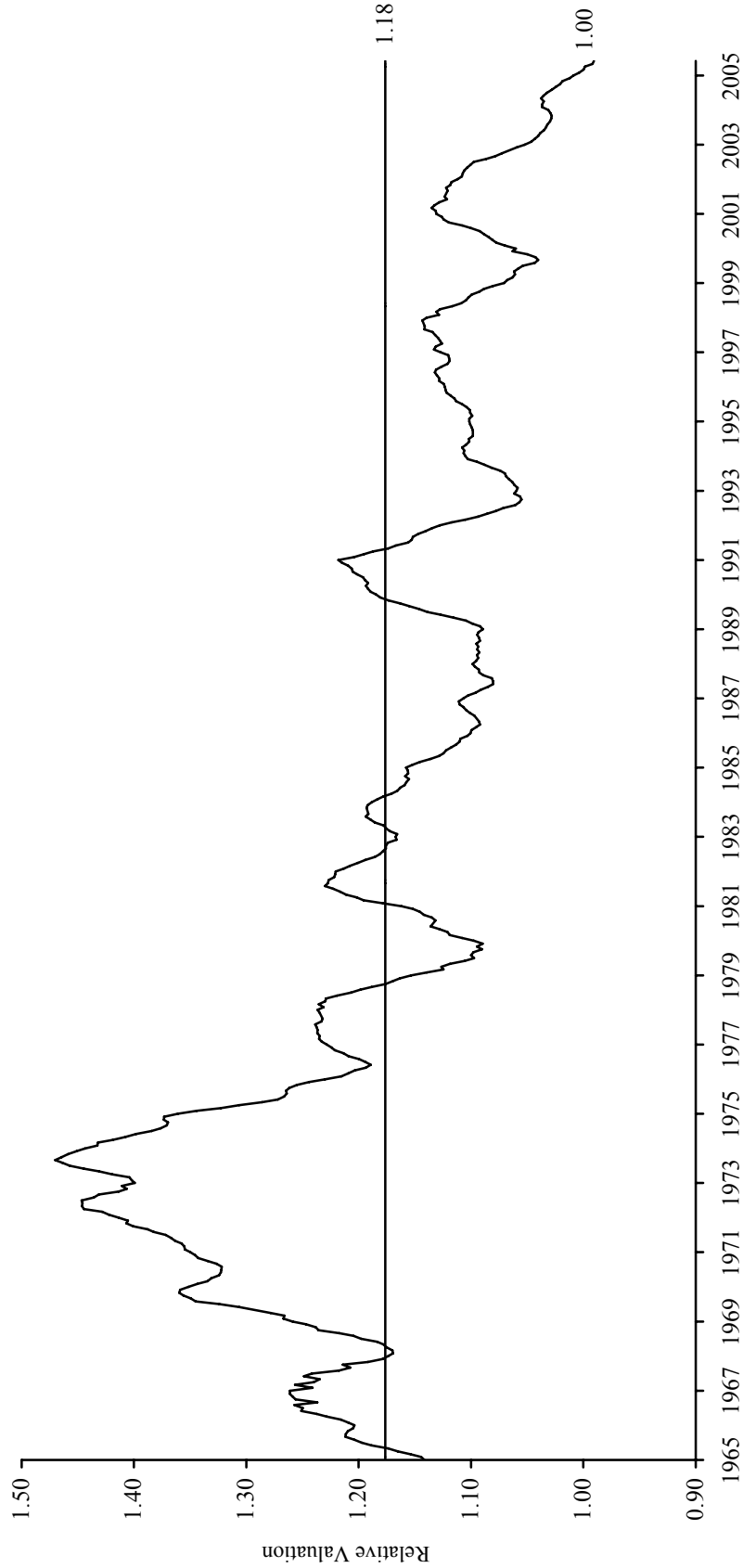
Sources: FactSet and Frank Russell Company.

Notes: Second Quarter 2006 data are through May 31. Constituents, quality ratings, and total returns are all period specific. "S&P Common Stock Rankings" are determined by appraising the past performance of a stock's earnings and dividends, as well as its relative standing at the time of the company's current fiscal year-end. Growth and stability of earnings and dividends are key elements in establishing S&P's earnings and dividends rankings.

Table C

**RELATIVE VALUATION OF QUALITY STOCKS:  
QUALITY EQUITY/S&P 500**

**December 31, 1965 - May 31, 2006**



Source: GMO.

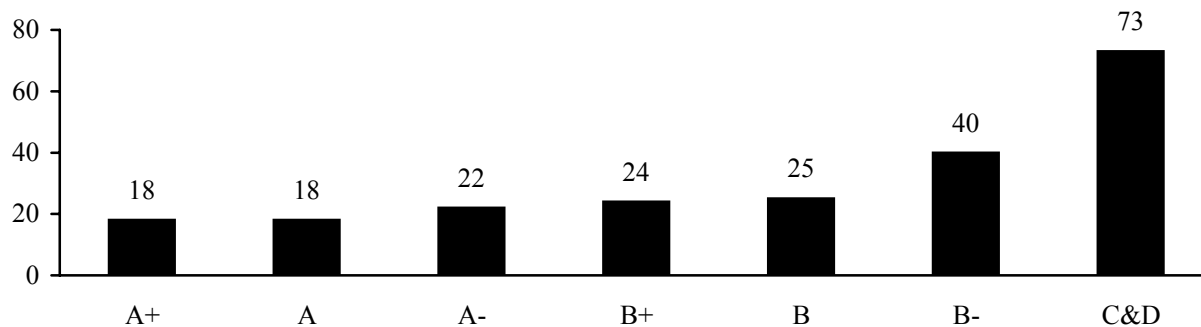
Notes: Based on trailing 12-month reported earnings. GMO defines quality firms as those with high profitability, low leverage, and low earnings volatility.

Table D

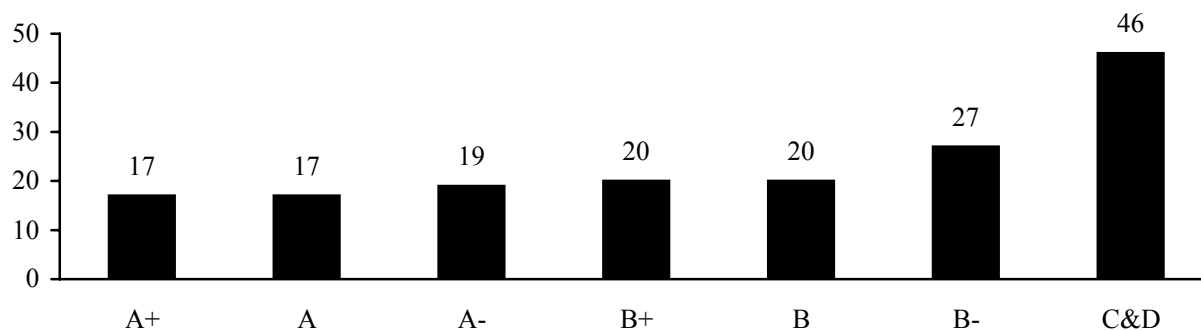
**MERRILL LYNCH QUANTITATIVE STRATEGY QUALITY INDICES:  
PRICE-TO-EARNINGS RATIOS**

**As of May 31, 2006**

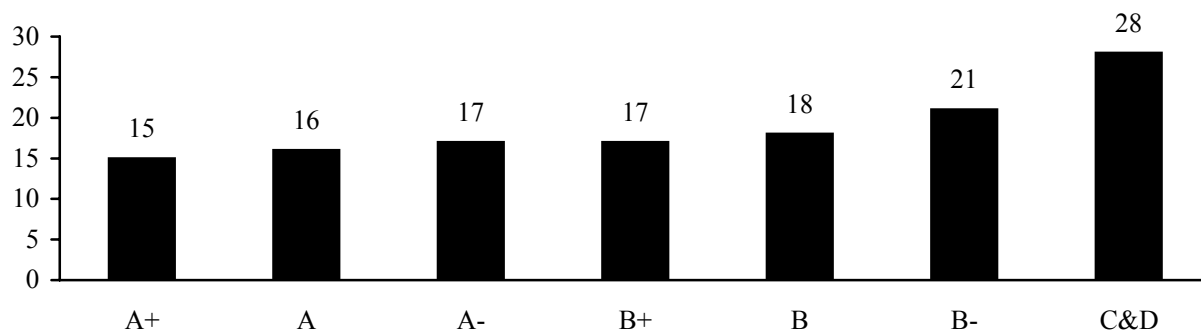
**Based on Trailing 12-month Earnings**



**Based on Consensus 2006 Estimated Earnings**

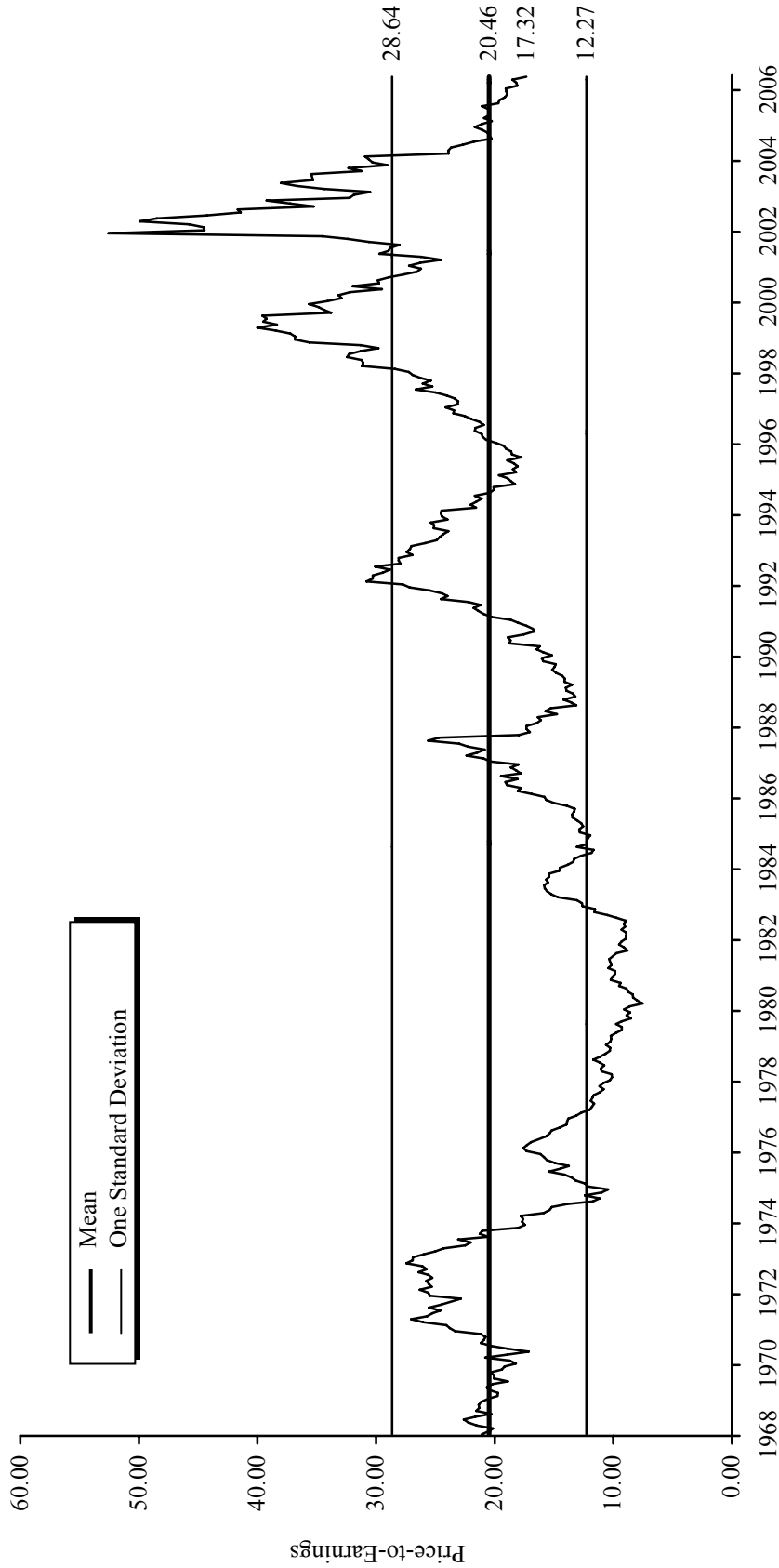


**Based on Consensus 2007 Estimated Earnings**



Sources: Merrill Lynch Quantitative Strategy, Standard & Poor's, and Thomson Financial.

**Table E**  
**PRICE-TO-EARNINGS RATIOS OF HIGH-QUALITY STOCKS**  
**January 31, 1968 - May 31, 2006**

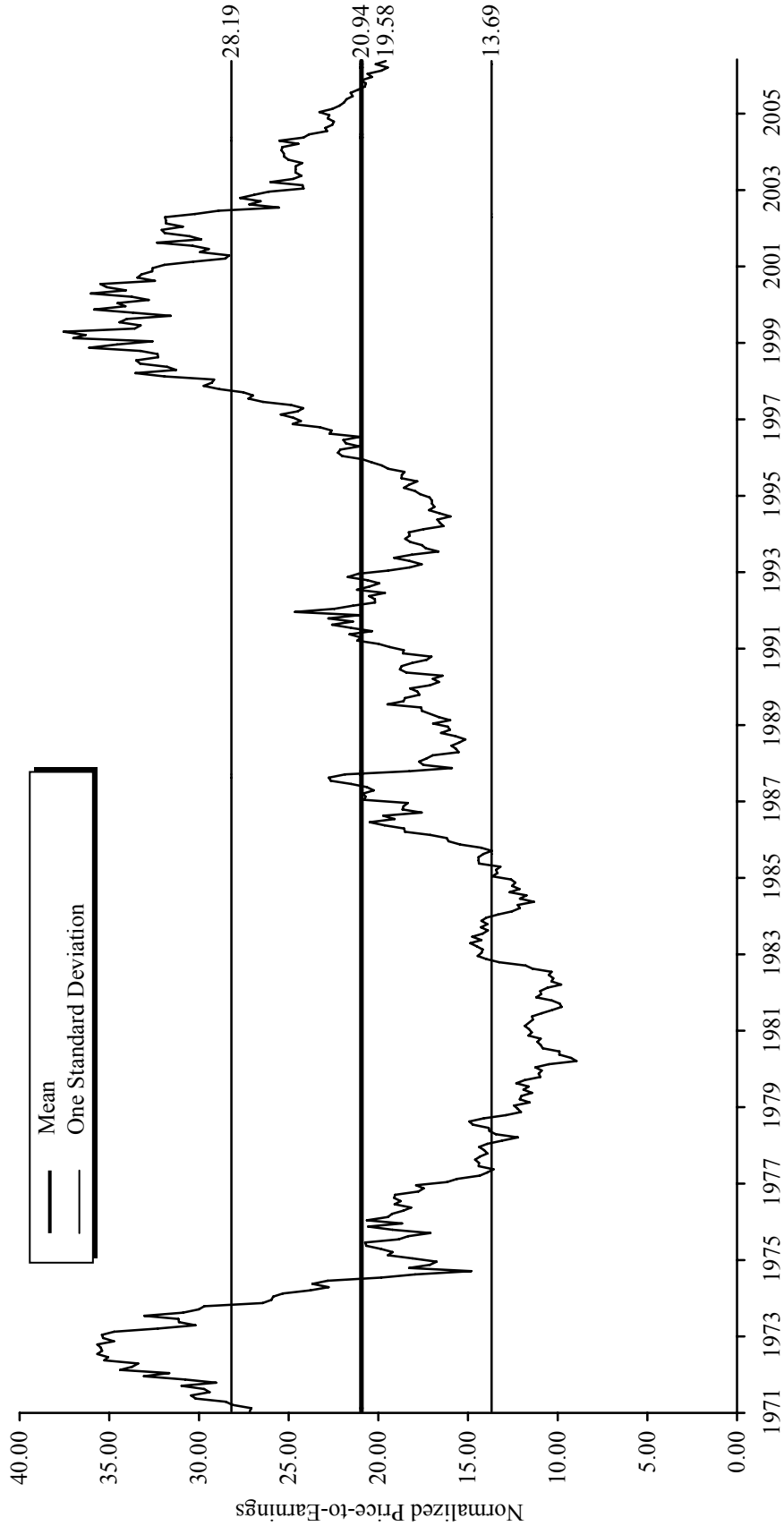


Sources: GMO, Standard & Poor's, and Thomson Datastream.

Notes: Based on trailing 12-month reported earnings. GMO defines quality firms as those with high profitability, low leverage, and low earnings volatility.



**Table F**  
**NORMALIZED PRICE-TO-EARNINGS RATIOS OF HIGH-QUALITY STOCKS**  
**January 31, 1971 - May 31, 2006**



Source: GMO.

Notes: Based on operating earnings. GMO calculates normalized price-to-earnings ratios using seven years of earnings and profitability data.