

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 COMMENT

THE APPEAL OF QUALITY

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Eric Winig
Alice Lin

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The Appeal of Quality

As we survey the investment landscape, the theme of quality continues to draw our attention. We are increasingly convinced that systemic risk is rising, as is usually the case when a Fed tightening regime is in its later stages, and consequently portfolios with significant leverage and/or exposure to low-quality assets are particularly vulnerable to any unpleasant surprises. In U.S. equities, for example, we have rarely seen such valuation disparity between high- and low-quality issues.¹

While we regard high-quality stocks as relatively attractive, the outperformance of low-quality equities has been pervasive this year, and has intensified in recent months. In the third quarter, for example, low quality (defined as stocks rated B or lower by S&P) outperformed high quality (B+ or higher) by 432 basis points (bps), continuing a year-long trend (Table B). Further, low quality has outperformed in seven of ten industry groups year-to-date, with the only exceptions being industrials, materials, and utilities (Table C). Indeed, four industry groups show a gap of more than 500 bps. Energy stocks, of course, have been a significant driver of overall equity returns in 2005, but the performance of high- and low-quality energy stocks was comparable.

The outperformance by low-quality stocks has also driven valuations to extreme levels, at least on a relative basis. GMO, for example, says high quality is now cheaper, relative to low quality, than it has been for 95% of the time since 1965.² Prior periods of undervaluation have been followed by high-quality outperformance (relative to the S&P 500) of 19% over the following two years (Table D).

Merrill Lynch, meanwhile, which has tracked relative earnings since 1986, says the ratio of one-year forward price-earnings for low-quality stocks (defined as B-) relative to high quality (A+) is now more than one standard deviation above its long-term mean. In the past, such situations have led to high-quality outperformance over the following year roughly three-quarters of the time.

The valuation gap is also pervasive, with low-quality more expensive than high-quality in nine of ten economic sectors for both 2005 and 2006; materials (2005) and utilities (2006) are the only exceptions. Merrill also notes that analysts are unusually optimistic for this point in the profits cycle, which could lead to substantial downward revisions to estimates over the next six months or so—a likely boon (at least on a relative basis) to high-quality shares. Indeed, profit growth is clearly decelerating,³ which should *at some point* cause investors to seek out more stable investment prospects.

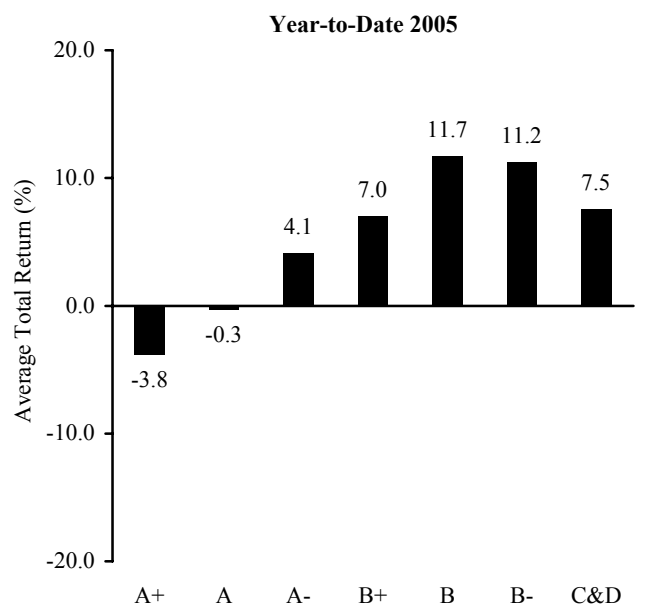
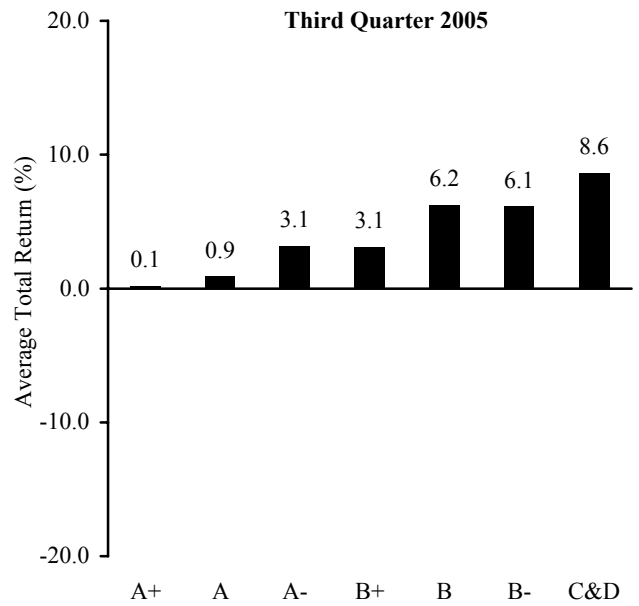
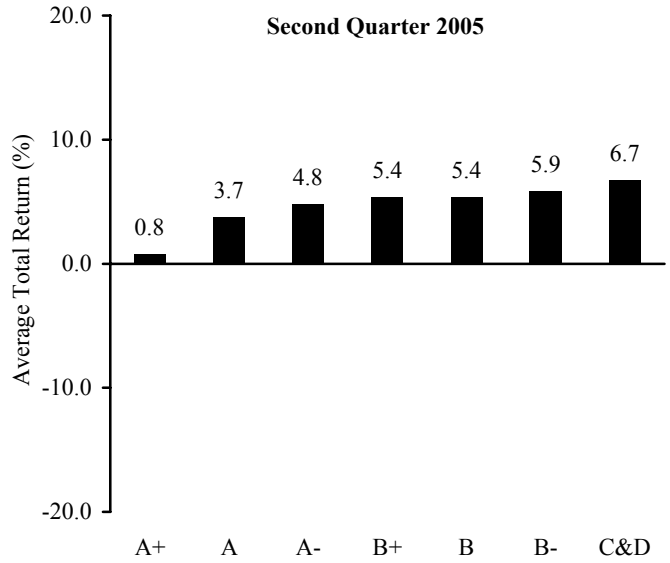
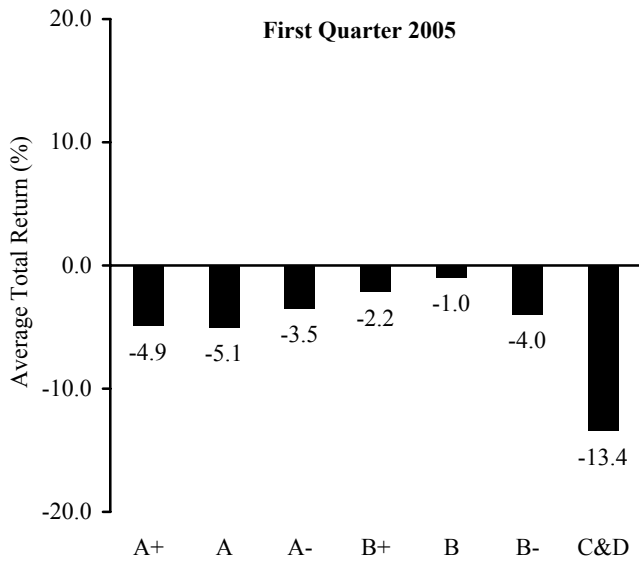
While low-quality stocks have continued to outperform high-quality issues in 2005, we maintain our view that the risks of owning low-quality assets are high. In fact, risks have risen, as valuations of low-quality equities have moved well ahead of those of high-quality stocks. Investors would be well served to tilt their portfolios toward high-quality assets. Those who believe they are well diversified because they own corporate bonds, emerging markets equities, and small-cap value should also realize that despite significant differences among these asset classes, they do have a common denominator of relatively low quality, and therefore relatively high vulnerability to any financial crisis or economic slowdown.

¹ We previously discussed this theme in our June 2004 U.S. Market Comment: *Underweight Small Caps? Not So Fast*, and our August 2004 U.S. Market Comment: *Looking for Themes in a Range-Bound Market*.

² GMO has a proprietary model for assessing quality, but relies on similar metrics to those used by S&P. Specifically, GMO looks for companies with strong and stable earnings, and low leverage.

³ For more details, please see our September 2005 U.S. Market Comment: *Are Earnings Running Out of Gas?*

Table A
PERFORMANCE BY QUALITY:
RUSSELL 3000® INDEX RETURNS
January 1, 2005 - September 30, 2005

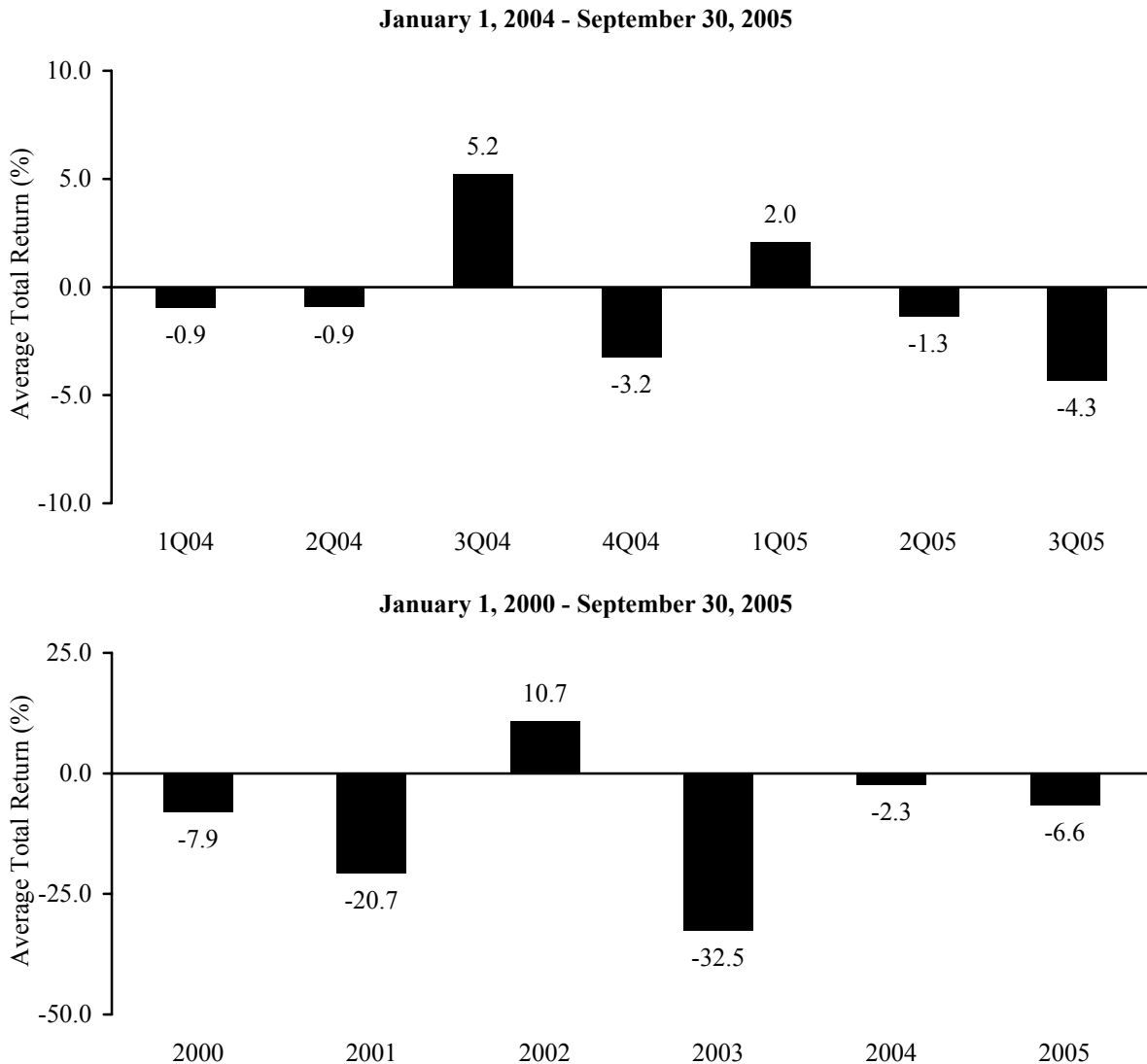


Sources: FactSet and Frank Russell Company.

Notes: Data for 2005 are through September 30. 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 OF HIGH-QUALITY LESS LOW-QUALITY STOCKS**



Sources: FactSet and Frank Russell Company.

Notes: "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 1,933 companies in 2005. 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**SECTOR PERFORMANCE OF MERRILL LYNCH QUANTITATIVE
STRATEGY QUALITY INDICES****January 1, 2005 - September 30, 2005**

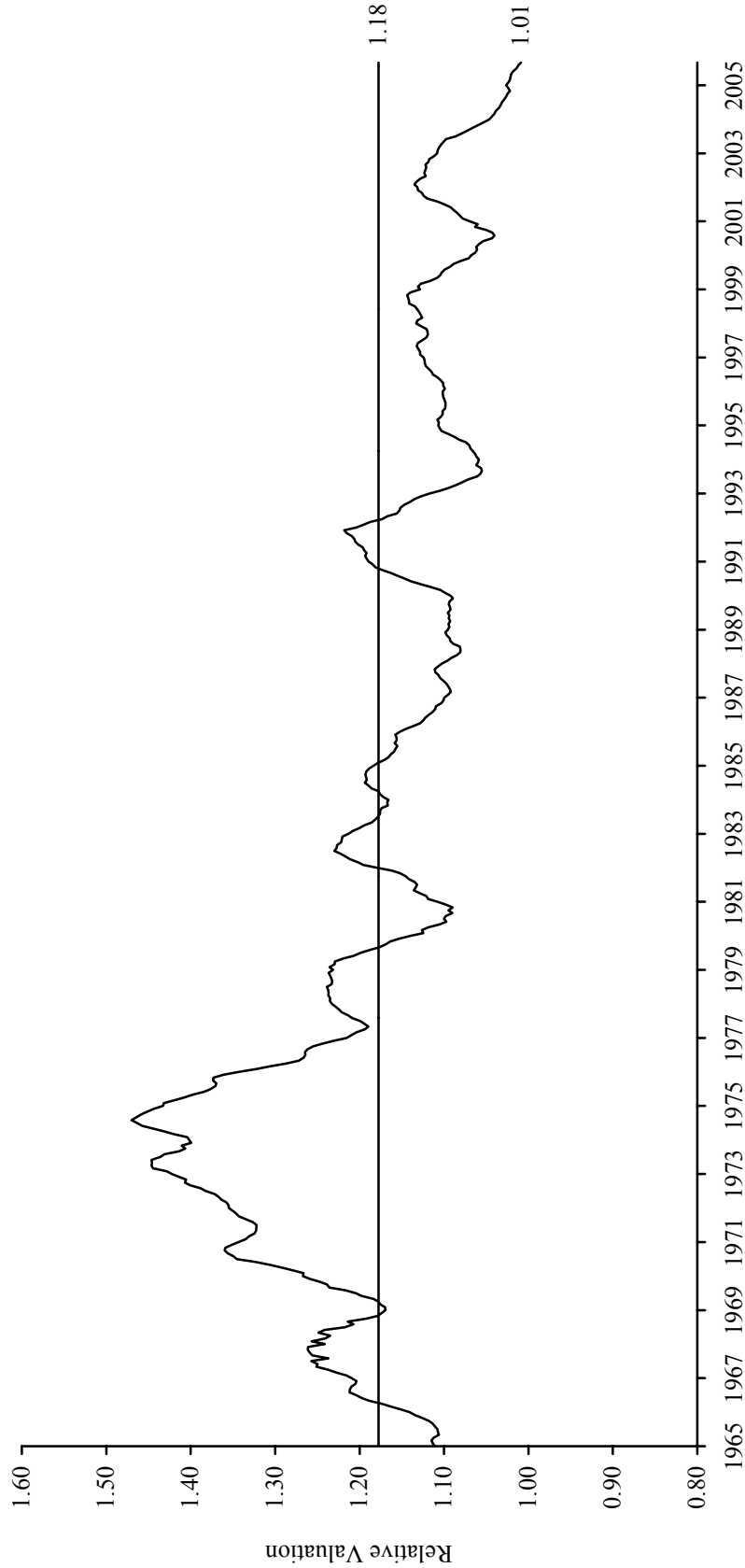
<u>Economic Sector</u>	<u>Total Return (%)</u>		
	<u>A+ through B+</u>	<u>B through C&D</u>	<u>Difference (%)</u>
Consumer Discretionary	-2.4	-1.2	-1.2
Consumer Staples	2.5	16.8	-14.3
Energy	58.0	58.6	-0.6
Financials	1.1	6.9	-5.8
Health Care	8.2	13.5	-5.3
Industrials	5.4	2.2	3.2
Information Technology	-2.2	0.4	-2.6
Materials	4.7	-2.5	7.2
Telecommunication Services	-0.4	8.6	-9.0
Utilities	16.7	15.6	1.1

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

Table D

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

January 31, 1965 - September 30, 2005



Source: GMO.