GLOBAL FINANCIAL
Private Capital
COMPREHENSIVE WEALTH MANAGEMENT

Thought for the Week: Monday, February 28th, 2011

What is Investment Quality?

Quality is one of the most frequently used words in modern marketing materials. Prefixing a word with "quality-" immediately creates credibility; adding "high-quality" turns the original word into a superlative. However, this phrase rarely comes with the definition of "Quality", unless it's J. D. Power.

So what do I mean if I suggest that we try to construct the "high-quality portfolios" on the street?

This question is timely as **current opinion suggests we are entering a phase of the recovery where "high-quality", less volatile, stocks should outperform** lower quality ones.

At the start of a recovery, smaller, lower quality stocks tend to lead the way, partly because they normally got hit hardest in the downturn. This is why they tend to be more volatile. **When a recovery matures, larger higher- quality stocks tend to assume the lead**.

Investment Quality

In our opinion, **quality is primarily related to the following** features of a business or issuer of debt:

1. Financial Strength

A quality company will have a strong balance sheet, be it a company quoted on a stock exchange or a company issuing debt through the bond market. Detailed balance sheet analysis is the first step in identifying a 'quality' company. We are primarily looking for a **high ratio of liquid assets**; we are also checking there are **no surprising liabilities/debts** on this important financial statement.

We do not look as deeply into the Profit & Loss statement. Profits can always be 'pumped up', especially by incurring debt. Profits show on the P&L but the debt will only appear on the balance Sheet.

There are additional financial strength factors we analyze, one of which is the **Altman Z-Score**. This is a simple number which gives **the probability of a company falling into bankruptcy** within the next two years. Unfortunately, it doesn't work for financial companies as their financial statements tend to involve 'off-balance-sheet' and other financial engineering items.

2. Free Cash Flow

It's pretty obvious that quality is synonymous with the generation of profits; however, **cash from profits only impresses us if it's available for distribution**. If the company needs the cash, maybe to service debt, we are less impressed - the cash isn't free to be distributed.

We use Free Cash Flow and not net income as a measure of quality because it is a clearer indication of the actual cash available for distribution. Who said: *"**No one is rich whose expenditures exceed his means, and no one is poor whose incomings exceed his outgoings**."*

**Past performance is not indicative of future results. This commentary is not intended as investment advice or an investment recommendation it is solely the opinion of our investment managers at the time of writing.
Nothing in this commentary should be construed as a solicitation to buy or sell securities.**

3. Consistent & Rising Dividends and Dividend Coverage

Over the years, we have realized there's a **correlation between successful, stable companies with longevity and companies who pay consistent, and in many cases rising, dividends**.

We are one of the leaders in the exploitation of dividends and the companies that pay them.

Companies that pay dividends to investors have been frowned upon by some commentators who feel they should be investing all their free cash flow back into chasing growth. Furthermore, the same market observers feel companies should actually be aggressively borrowing, over and above their cash flow, to fund expansion.

We respectfully disagree. While this is a valid form of investing, it's not what we call quality.

As previously stated, **we like companies that are self-financing; they don't need to borrow**. Although most companies do borrow, often through advantageous bond offerings, we try and find those that don't rely on other people's money.

4. Sustainable Business Models

This measure of quality is qualitative (meaning it's not something we put into numbers), it's something we research and use our experience and instinct. **Warren Buffet calls this a "Franchise Business".**

We look at an industry and compare the leaders. We look **for the best of breed; the nicest house on the street**. In every sector, in every industry there's normally one company that generally wins. This, in our view, is quality. As they say in sports, "**form is temporary; quality is permanent"**.

For a number of years, **companies that generate a substantial percentage of their revenues from emerging markets** have ranked higher on our quality lists. We feel these are more sustainable revenue models than those companies who hung around and whined about the U.S. recession.

5. Lack of Negative Surprises

Every quarter, the companies we invest in publicly report their recent performance and provide guidance on the future. Our research systems have access to all this data, including black marks when they miss guidance. **A quality company does not surprise! As soon as they do, we take it personal and stop considering them for investment**.

6. Is Size Important?

Many asset managers will imply that size equals quality, after all a company must be really good to get so big. Although many of the companies we consider quality are larger capitalization companies, **smaller organizations can also provide our portfolios with quality**.

Ratings Agencies, such a Moody's and Standard & Poor's, weight their A's and B's towards larger companies. They assume a larger company has less chance of failure. We disagree and cite **2008 and the "too big to fail" fiasco** as evidence. When we analyze the credit risk of a bond issue, **we do our own research to determine quality**, based on the factors above. If the rating agency thinks the same bond is a lower credit risk, it might represent good value.

Past performance is not indicative of future results. This commentary is not intended as investment advice or an investment recommendation it is solely the opinion of our investment managers at the time of writing.
Nothing in this commentary should be construed as a solicitation to buy or sell securities.