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Why We Believe Quality Is a Good Guide for Value Investing

Value investing involves picking stocks that are trading at attractive prices as determined by metrics such as price book and price earnings. Clients sometimes ask us why Breton Hill takes a quality approach to value investing when so many of our peers are focused on distressed value. In this note we review the history of applying quality to value investing in an effort to improve outcomes. We then conduct an out-of-sample analysis to assess whether this effect still holds in the more recent decade subsequent to the publication of well-known quality papers.

History of Applying Quality to Value Investing

Quality plays an important role in the history of successful value investing. Benjamin Graham, often referred to as the father of value investing, specified criteria to assess the value and quality of an investment. He advocated for value investments that exhibited quality characteristics such as adequate size, strong financial condition, record of paying dividends and consistent earnings growth.[1] These principles have stood the test of time and have been the cornerstone of value investing.

Warren Buffett and Charlie Munger applied these principles to build Berkshire Hathaway into an $800 billion juggernaut. In his 2015 shareholder letter,[2] Warren Buffet reflected on the wisdom imparted by Munger: "Forget what you know about buying fair businesses at wonderful prices; instead, buy wonderful businesses at fair prices." This shift in perspective from merely focusing on the cheapest assets to prioritizing the inherent quality of the business together with valuation has become a hallmark of contemporary value investing.

In 2000, Piotroski introduced a method to screen for quality stocks within a pool of value stocks (those with low price-to-book ratios) using the F-score, which consists of nine binary tests to evaluate a company's financial strength and profitability. Piotroski's research demonstrated that using this score could significantly increase returns. Between 1976 and 1996, value firms with high F-scores showed a markedly higher average return compared to those with low scores (average 1-year return of 34.1% for high score names vs 7.8% for low score),[3] proving that quality could indeed act as an effective guide in value investing.

Novy-Marx's 2012 paper, "The Quality Dimension of Value Investing," further explored the intersection of quality and value with a focus on profit margin as a quality metric. Novy-Marx showed that not only is purchasing high-quality assets at reasonable prices a form of value investing, but that doing so can yield higher average returns and lower risk. Novy-Marx's study, which spanned from 1963 to 2011, showed that a combined quality and value strategy outperformed strategies that focused solely on either quality or value. This dual approach resulted in an average monthly excess return that was significantly higher than strategies emphasizing just one of these factors. Novy-Marx found that average monthly excess return for High – Low Quality and Value strategy is 0.61%, compared to High – Low Quality: 0.28%, and High – Low Value: 0.31%.[4]

Experience and academic research therefore suggest that value strategies can be improved by incorporating quality metrics into the stock selection process. Focusing solely on price may lead investors to buy "value traps", which are stocks that are cheap for a reason. By considering both price and quality, investors can potentially achieve higher returns with lower risk.

Recent Experience

We assess whether the current market environment still rewards a high quality approach to value investing. This analysis is "out-of-sample" in the sense that we use data from January 2013, which is after the publication of the papers referenced above.

First, we partitioned the MSCI USA Value index into a high-quality and a low-quality segment, each of which comprise 50% of the market cap of the index. Our quality score was constructed as an equally weighted average of the percentiles for the following representative quality metrics:[5]

- (Total Revenue – Cost of Goods Sold) / Total Assets
- External Financing / Total Assets
- Sum of: binary earnings yield, binary cash flow yield, percentile of cash flow yield – earn yield
- Shares outstanding today / shares outstanding last year

MSCI USA VALUE INDEX; HIGH AND LOW-QUALITY SEGMENTS ANNUALIZED PERFORMANCE DEC 12 – DEC 23

Source: Neuberger Berman.

MSCI USA VALUE INDEX (SPLIT INTO HIGH-QUALITY AND LOW-QUALITY SEGMENTS) RETURNS (DEC 2012 – DEC 2023).

	High Quality	Low Quality	MSCI USA Value
2023	9.29%	8.94%	9.24%
2022	-3.63%	-7.87%	-6.24%
2021	27.60%	26.29%	27.17%
2020	3.10%	-1.68%	0.95%
2019	21.15%	30.36%	25.73%

Source: Bloomberg, Neuberger Berman.

The high-quality partition outperformed the low-quality partition by 1.57% annualized over the period December 31, 2012 to December 31, 2023.

Conclusion

In conclusion, historical evidence suggests that quality remains a vital component of successful value investing. By adhering to Graham's time-tested criteria and incorporating modern research that emphasizes the importance of financial strength and profitability, investors can make more informed decisions that potentially lead to better performance and reduced risk. The synergy of quality and value thus continues to be a powerful guide in the quest to identify the right investments.

[1] Graham, Benjamin. *The Intelligent Investor.* HarperBusiness. 2003.
[2] Buffet, Warren. Berkshire Hathaway: 2014 Shareholder Letter. 2015, p 26.
[3] Piotroski, Joseph. Value Investing: "The Use of Historical Financial statement Information to Separate Winners from Losers". *Journal of Accounting Research*, vol. 38, 2000, p 1–41.
[4] Novy-Marx, Robert. "The Other Side of Value: Good Growth and the Gross Profitability Premium". *Journal of Financial Economics*, Volume 108, Issue 1, 2013, p1-28.
[5] Total Revenues and Cost of Goods Sold are measured over the last 12 months. External Financing includes: Issuances net of repurchases of common, preferred stocks and debt, less dividends paid. Binary earnings yield is 1 if earnings >0, otherwise binary earnings yield is 0, Binary cashflow yield is 1 if cashflow >0, otherwise binary cashflow yield is 0.

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