

Quality: A guide for stock pickers

In theory, quality investing makes a lot of sense in an uncertain world. In practice, it takes a great deal of skill and effort.

"I have the simplest tastes," Oscar Wilde declared. "I am always satisfied with the best."¹ Many successful investors, such as the legendary Philip Fisher, tend to take a similar approach to picking quality stocks. At a time of geopolitical, economic and technological uncertainties, the idea of compounding return by investing into a proven winner is appealing.²

Of course, that leaves the problem of how to recognize "the best." In identifying high-quality stocks, the traditional distinction has been in terms of metrics encompassing offensive and defensive characteristics. Offensive traits include durable growth, innovation leadership and management quality. Defensive strengths relate to a solid balance-sheet, financial flexibility and shareholder-oriented capital allocation. Especially over the last 30 years, new techniques have emerged to refine traditional measures of quality and value creation more precisely. These are constantly refined further, as our understanding of equities is still in the making.³

Partly, that is because causality, when it comes to returns, can be quite tricky. A strong stock-market performance can be self-reinforcing by helping attract high-quality staff, leading to a "flywheel" of driving more innovation and better execution, thus generating stronger financial results and driving the share price higher. When buying a leading technology company in the late 1990s, it might already have seemed smart to look for a would-be Internet leader skillful at adopting the tools of technology and being capital lite. Extra points might have been awarded for sticky customer relationships, recurring revenues, high predictability in cash flows and the ability for self-funding. Still, an investor might well have endured periods of significant stock-price volatility with the leading e-commerce platform – and be in for many years of lean returns.

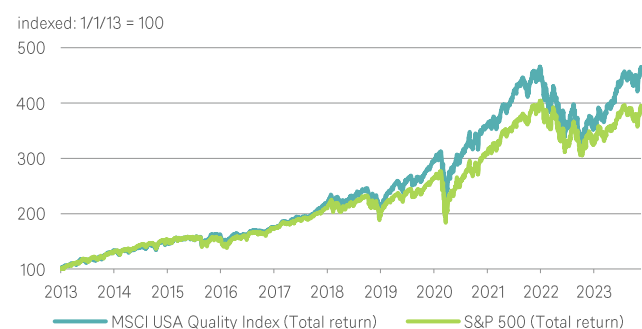
On the other hand, a company which delivered great returns for ages may all of the sudden struggle. "Nothing fails like success," as the business scholar Richard Pascale has argued.⁴ Even the best-managed companies with a stellar

track record, can become subject to what Clayton Christensen famously called "The Innovator's Dilemma."⁵ "In an age of disruption and fast-paced structural change, resiliency and adaptability are key quality criteria aside from hard financial metrics," argues Sebastian Werner, Head of Growth Equities, Americas at DWS.

Adaptability includes undertaking investments even in uncertain times. Having the support of long-term-thinking and patient investors who understand the need to prepare for the next wave and see the potential of new opportunities early on helps. Resilience means risk-preparedness, operationally and financially as well as via diversification. Just as a good defense enables a good and effective offense, resilience is a precondition for adaptability, as it creates financial flexibility. In combination with continuous improvement, this can create a virtuous cycle, enabling market leaders to profitably grow further, independent of the macroeconomic circumstances.

Identifying such potential long-term value creators involves qualitative assessments of management, organizational flexibility and effective corporate culture. This takes a great deal of skill and effort. Conversely, the potential rewards from correctly identifying long-term winners have rarely seemed larger with so many unknowns lying ahead.

Over the last ten years, quality has outperformed the broader market



Source: Bloomberg Finance L.P., DWS Investment GmbH as of 11/21/23

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Footnotes

¹ Day, B. (2000) "Oscar Wilde: A Life in Quotes Hardcover", p. 88

² Fisher, P. (2003 ed.) "Common Stocks and Uncommon Profits and Other Writings", John Wiley & Sons, p. 113

³ Notably, this can be done by adjusting reported accounting figures in various ways to get clearer measures of capital invested and returns generated. See Curto, F. (2020), Valuing and Investing in Equities: CROCI: Cash Return on Capital Investment, Academic Press, esp. p. 21 and p. 183

⁴ Pascale, R. T. (199), "Managing On the Edge: How Successful Companies Use Conflict to Stay Ahead", Penguin, p. 11

⁵ Clayton, M. Christensen (2011), "The Innovator's Dilemma: The Revolutionary Book That Will Change the Way You Do Business", esp. part 1.

Glossary

The [MSCI USA Quality Index](#) aims to capture the performance of quality growth stocks by identifying stocks with high quality scores based on three main fundamental variables: high return on equity (ROE), stable year-over-year earnings growth and low financial leverage.

The [S&P 500](#) is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

The [total return](#) is a performance measure of an investment. It measures the earned income of an investment over a specific time period.

[Volatility](#) is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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