The Art of Quality Investing: Balancing Discipline and Opportunity

Stu Morrow | Investment Counsellor

Quality investing focuses on identifying and investing in companies with strong, enduring fundamentals, at the right price. These companies typically possess competitive advantages, maintain dominant market positions, exhibit comfortable financial leverage, generate sustainable free cash flow, and are led by management teams with a history of deploying capital effectively. This article will delve into the characteristics of quality companies, the metrics used to quantify quality, and the durability of quality through market cycles.

Defining Quality Characteristics

At Mawer, our quality approach may contrast with value investing, which focuses solely on undervalued stocks, and growth investing, which solely seeks high earnings potential. Instead, we seek wealth-creating companies that earn returns on capital exceeding their cost of capital over time, thanks to sustainable competitive advantages. These companies are led by excellent management teams that effectively allocate capital and consistently deliver on their promises. Our approach emphasizes a bottom-up investment process rooted in fundamental analysis, eschewing market fads and speculative ventures, that are ultimately purchased at the right price.

Quality companies typically exhibit several key attributes:

- **Competitive Advantages:** These companies possess unique economic moats that protect their market positions and enable sustained profitability. These moats often stem from economies of scale, strong brand recognition, technological superiority, privileged access to resources, network effects, high switching costs, and intellectual property**. Dominant Market Share**: A strong market presence allows these companies to maintain pricing power and stability.

- **Comfortable Financial Leverage:** Quality companies manage debt effectively, ensuring financial flexibility and resilience.

- **Sustainable Free Cash Flow Generation:** Consistent cash flow supports long-term growth and stability.

- **Effective Management:** Management teams with a proven track record of deploying capital into high-return businesses are vital for sustaining competitive advantages.

There is no standard definition for quality companies. However, popular quantitative metrics include:

Return on Invested Capital (ROIC), **Return on Equity (ROE)**, **and Return on Assets (ROA):** These metrics are crucial indicators of a company's financial health and operational efficiency. High values in these metrics suggest efficient capital allocation, strong profitability, and effective utilization of resources.

ROIC measures how effectively a company uses its capital—both debt and equity—to generate profits, and is particularly important when compared to the company’s Weighted Average Cost of Capital (WACC). A company creates economic value only when its ROIC exceeds its WACC, as this indicates that the firm is generating returns higher than the cost of financing its operations, signaling efficient capital allocation and value creation for stakeholders.

ROE focuses on returns generated from shareholders' equity, while **ROA** evaluates profitability relative to total assets. Together, these metrics provide a holistic view of a company's ability to allocate resources effectively, generate sustainable profits, and maintain a competitive edge in the market.

Other valuable quantitative metrics include:

- **Free Cash Flow Margin (FCF%):** Consistent cash flow generation supports long-term sustainability.
- **Gross Margin:** Gross margin measures the percentage of revenue a company retains after subtracting the direct costs of producing goods or services. High gross margins may indicate efficient operations and are a popular metric for defining quality companies as they reflect the company's ability to generate profit and reinvest in growth compared to industry peers.
- **Leverage:** Comfortable debt levels relative to peers enhance financial stability.
- **Dividend Yield:** Regular dividend payments can indicate stable cash flows and investor confidence.

Moving Beyond the Numbers: A Comprehensive Qualitative Assessment

In addition to the quantitative side, it will come as no surprise that *qualitative* considerations are key to a quality investment analysis. This is designed to assess the sustainability of a company's competitive advantages and provide a more forward-looking perspective on its potential for long-term success. These include management effectiveness, corporate governance, and strategic decision-making.

Our process involves conducting our own interviews with management, collecting scuttlebutt from independent information sources, and performing a forensic accounting risk screening of a company's intangible assets and operational capabilities. We examine factors such as brand strength, customer loyalty, intellectual property, and organizational culture—elements that often form the foundation of a company's economic moat, protecting it from competitive pressures and enabling sustained profitability.

Furthermore, we evaluate a company's strategic positioning within its industry, including how well it differentiates itself from competitors via cost leadership, product differentiation/innovation, or niche market focus. This involves understanding the company's value proposition, its target market, and how effectively it delivers on its promises to customers.

By thoroughly examining these qualitative factors, we aim to identify companies with robust, sustainable competitive advantages that are well-positioned to outperform in the long run, even in the face of evolving market dynamics and competitive pressures.

The Spectrum of Quality

Quality is not a binary attribute but rather a continuum, with companies exhibiting varying degrees of distinction based on their financial health, competitive advantages, and management effectiveness. An active and nuanced approach to quality investing is crucial, as it allows for a comprehensive understanding of a company's characteristics and ongoing monitoring of developments that could alter its quality and valuation over time. This dynamic perspective ensures that portfolios can adapt to changing conditions.

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SPOTLIGHT

Amphenol Corporation – A Quality Company Example

Amphenol Corporation is a leading global producer of precision sensors, antennas, and connectors. Their specialized components are integral to various end-market applications, from defense and commercial aerospace to mobile devices. While often invisible to consumers, Amphenol's products are crucial in many everyday systems and products, including hospital HVAC systems, aircraft, and automobiles.

Quality Merits of Amphenol:

- **Critical Components**: Amphenol's parts typically represent only 1-2% of end-product costs but are mission-critical for performance and reliability. This discourages customers from switching suppliers due to the high risk and minimal potential savings.

- **Technological Expertise**: Many products are custom designed for specific applications, positioning Amphenol as a valuable design partner to its customers.

- **Strong Customer Relationships**: The combination of critical components and design partnerships results in high client retention and "sticky" customer relationships.

- **Diversification:** Amphenol serves a wide variety of industries and markets worldwide, reducing vulnerability to fluctuations in specific sectors.

- **Global Presence:** The company conducts business in nearly 79 countries, providing geographic diversification

Durability of Quality Through the Cycle

Quality investing is particularly beneficial over the long term due to its ability to withstand market volatility. High quality companies tend to exhibit lower volatility and more consistent returns across market cycles. This resilience is attributed to their strong financial foundations and competitive advantages, which help them weather economic downturns more effectively than lower quality peers.

Research by Hsu, Kalesnik, and Kose (What is Quality?) highlights that profitability, accounting quality, payout/dilution, and investment are robust quality metrics associated with superior returns. Profitability, in particular, has been extensively studied and is linked to higher investment returns due to its ability to capture a company's financial health and efficiency. Accounting quality and dividend payout/dilution also show strong evidence of contributing to long-term performance by reflecting transparent financial reporting and effective capital allocation.

Performance Expectations: Quality-Focused Portfolios Tend to Perform Well Over Time... But Not All the Time

Quality-focused portfolios generally perform well across economic cycles, but they do not consistently outperform. This is because high quality stocks often underperform during strong bull markets when speculative and growth-oriented stocks dominate. Conversely, in moderate bull markets or bear markets, quality stocks typically demonstrate resilience due to their financial stability and lower volatility.

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Chart 1 illustrates the calendar-year price performance from 1993 through December 2024 of the broader market proxied by the MSCI All Country World Index (MSCI ACWI), a “generalist” index that captures the entire market, and the MSCI ACWI Quality Index, a “specialist” index targeting financially sound companies with sustainable profitability and resilience. Shaded green areas highlight years where either index achieved higher relative returns.

Chart 1. Calendar year price returns, in US Dollars (1993-2024), MSCI All Country World Index versus MSCI All Country World Index (Quality)

Year	MSCI ACWI	MSCI ACWI Quality
1993	-1.6%	**-0.8%**
1994	**2.9%**	-1.0%
1995	16.9%	**26.7%**
1996	10.9%	**23.8%**
1997	12.9%	**24.3%**
1998	19.9%	**36.1%**
1999	**25.0%**	20.8%
2000	-15.1%	**-11.9%**
2001	-17.3%	**-13.3%**
2002	-20.5%	**-17.7%**
2003	**31.6%**	20.5%
2004	**13.3%**	11.0%
2005	**11.3%**	7.5%
2006	18.8%	16.0%
2007	9.6%	**17.3%**
2008	-43.5%	**-37.7%**
2009	31.5%	**32.5%**
2010	**10.4%**	9.2%
2011	-9.4%	**-0.6%**
2012	**13.4%**	12.4%
2013	20.3%	**20.9%**
2014	2.1%	**6.3%**
2015	-4.3%	**-0.2%**
2016	**5.6%**	3.7%
2017	21.6%	**26.2%**
2018	-11.2%	**-8.8%**
2019	24.0%	**33.0%**
2020	14.3%	**23.3%**
2021	16.8%	**20.7%**
2022	**-19.8%**	-24.8%
2023	20.1%	**30.6%**
2024	15.7%	**17.8%**

Sources and notes. Data sourced from Bloomberg LP. Annual returns calculated from daily data, in US dollars, before fees, commissions and taxes. You cannot invest directly in an index and past performance is no guarantee of future performance. The MSCI ACWI Index represents a broad global equity benchmark, covering large- and mid-cap stocks across 23 developed and 27 emerging markets. It aims to provide comprehensive exposure to global equity markets. The MSCI ACWI Quality Index, on the other hand, is a factor-based index that selects stocks from the MSCI ACWI universe based on specific quality metrics such as high return on equity (ROE), stable earnings growth, and low financial leverage. This results in a more concentrated portfolio focused on companies with robust fundamentals.

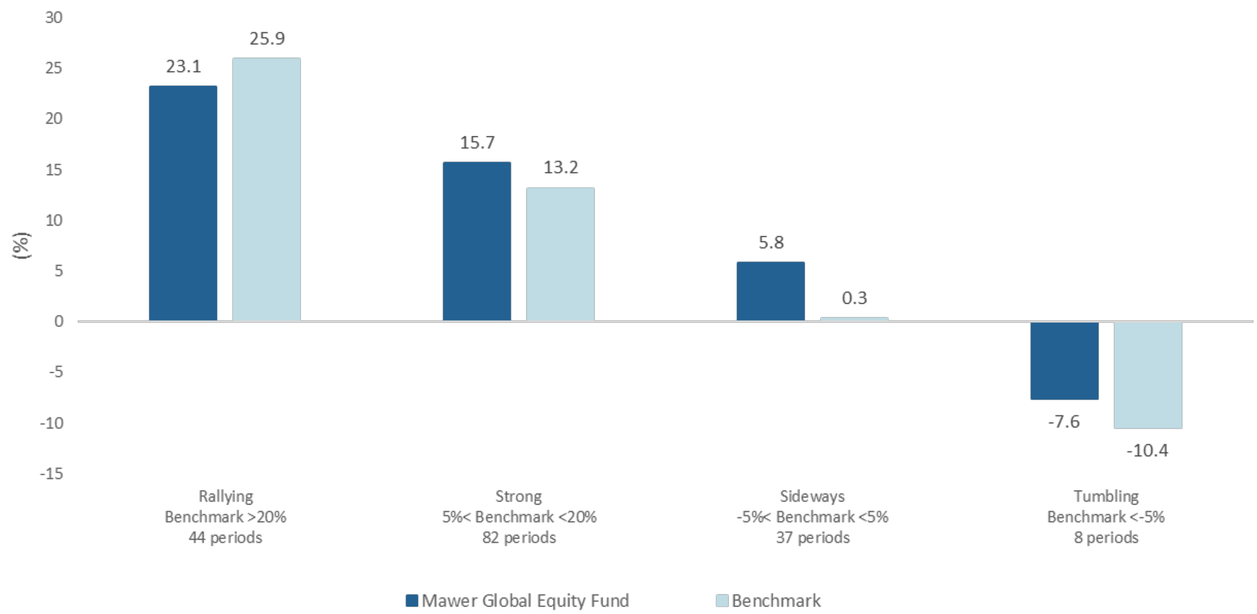
Over this period:

- Quality-focused stocks outperformed the broad market two-thirds of the time, with an average excess return of 6.1%.
- Underperformance occurred one-third of the time, with an average lag of -3.7%.

This demonstrates that while quality stocks offer resilience and sustainable growth, they are not immune to periods of underperformance relative to broader indices.

The consistency of our quality at the right price approach is demonstrated in Chart 2 which shows the average 1-year return for the Mawer Global Equity Fund as of December 30, 2024 during various market periods since 2009.

Chart 2. Consistency in returns across the cycle – Average rolling 1-year returns since inception*
(As at December 30, 2024)



Source: Mawer Investment Management Ltd.

Notes: *Inception date: October 22, 2009. Benchmark: MSCI ACWI (net); prior to October 2016, MSCI World (net). The figures shown are the average of the monthly 1-year rolling returns for the fund and the Benchmark for the specified Benchmark return environments. Periods presented is for the number of 1-year rolling returns in each Benchmark return environment. Past performance does not guarantee or indicate future results. Performance has been presented for the O-series mutual funds and has been calculated gross of management fees and net of operating expenses. Performance has been expressed in Canadian dollars. For more information on the mawer mutual funds, please refer to www.mawer.com/funds/. See full disclaimers at the end of the document.

This example illustrates historical outperformance versus the benchmark across different market periods, with one exception: during extremely bullish markets (20%+ annual returns), where momentum-based strategies may lead. As evident from Chart 2, our historical performance demonstrates capital protection compared to the benchmark during market downturns, largely due to our emphasis on quality. This is consistent with the general behavior of quality stocks, which typically exhibit lower volatility and reduced maximum drawdowns compared to the broader market. This resilience is particularly advantageous for investors seeking stable returns across various market cycles.

The Conundrum: Price vs. Quality

As consumers, we often face the tradeoff between price and quality. Imagine buying a car: you can choose a reliable Toyota for $50,000, which may last longer with fewer repairs, or a cheaper model from a lesser-known brand for $35,000, which might require more maintenance over time.

Investors also face a dilemma between paying for quality and seeking bargains. While pure value investors prioritize undervalued stocks and pure growth investors chase high earnings potential, our approach to quality focuses on searching for companies whose intrinsic excellence justifies their valuation. In other words, we are not merely looking for the best price or the highest growth rate; we are seeking companies where the inherent strength of the business—its financial health, management quality, and competitive advantages—substantially supports its valuation, making it a worthwhile investment over the long term.

At Mawer, we seek quality companies trading at discounts to their intrinsic value, thereby transforming great businesses into great investments. Our approach to estimating intrinsic value recognizes the inherent imprecision in forecasting. In doing so, our discounted cash flow models (DCF) utilize stochastic methods, leveraging Monte Carlo simulations to conduct sensitivity analyses. This approach is particularly valuable when it comes to protecting capital since it gives us a degree of understanding of the likely downside risks for a potential investment.

This approach helps to provide for a margin of safety, offering room to absorb errors in judgment or unexpected market shifts. By maintaining this margin, we reduce the likelihood of overpaying for quality while recognizing that the sheer strength of a high-quality business model inherently provides a margin of safety.

Conclusion

Quality investing offers a disciplined and strategic approach to identifying and investing in companies with strong, enduring fundamentals, at the right price. By focusing on competitive advantages, financial stability, and effective management, quality investors can navigate market volatility more effectively. While quality investing at the right price may not always outperform in the short term, particularly in strong bull markets where speculative stocks may dominate, its benefits become more pronounced over longer investment horizons. This approach can result in relatively stable, risk-adjusted returns and better capital protection during economic downturns. Ultimately, quality investing is about recognizing the intrinsic value of robust business models, which can transform great companies into great investments by balancing discipline with opportunity.

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