Alley Company Commentary
Quality: In the Eye of the Beholder

Who doesn't prefer 'quality' over junk? Whether it be with the craftsmanship of a product or the service received by a customer, quality is universally associated with excellence and consistently meeting or exceeding expectations. Think Steve Jobs and his obsession with best-in-class product development; or The Ritz-Carlton and its legendary culture of top-notch customer service. Time and again, the decision to choose quality has delighted consumers and proven worth the price by delivering lasting value.

When it comes to investing, the link between quality and long-term value holds true. This is because companies that have the ability to produce sustainably strong financial performance over time will ultimately screen favorably in traditional valuation models. Below, for example, is the formula for the discounted cash flow (DCF) model, which emphasizes how **stronger expected long-term performance equates to higher present value**. (The dividend discount model, which analyzes dividends in the place of cash flows, would produce a similar conclusion.)

Basic DCF model:

$$DCF = \frac{CF_1}{(1+r)^1} + \frac{CF_2}{(1+r)^2} + \ldots + \frac{CF_n}{(1+r)^n}$$

Where,

- **DCF** = Present value of future discounted cash flows that a business is expected to produce
- **CF** = Cash flow for a given year
- **r** = Discount rate

While the intrinsic value of quality is made clear by securities analysis, the *definition* of what exactly constitutes a quality company or a quality-oriented investment philosophy is more elusive. In fact, if you were to ask ten investment practitioners and ten professors of finance to define quality, you might get twenty different answers. Quality, like beauty, is ***in the eye of the beholder***.

In this Commentary, we will outline our view of the characteristics that define a quality company. We will go on to discuss some of the attendant benefits that accrue to investors that focus on such companies

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and conclude by relating quality to the gold standard in investing, which is the achievement of attractive *risk-adjusted* investment returns.

Investment Philosophy

First and foremost, one of the most critical elements of investing is the existence of a set of beliefs and principles that guide the decision-making process. At Alley Company, our investment philosophy in the equity markets is to take a long-term approach with the objective of reaching investment goals and outpacing the deleterious effects of inflation. In the portfolio, we strive to accomplish this through **the ownership of a diversified group of quality companies with proven track records of success and, based on our fundamental research, favorable future business prospects**. This investment philosophy has been in place at our firm since it was founded in 1998.

Quality Dampens Volatility

Periods of economic contraction and/or financial market stress are both inevitable and unpredictable. Adding insult to injury, these periods are typically accompanied by excess volatility in the stock market which can shine a light on the pitfalls of owning companies that don't meet quality standards. When the breeze is at everyone's back, lower quality companies can perform as well or even better than stable companies for a period of time. But when the wind starts to swirl and storms hit, market cycles can turn quickly and companies with challenged long-term business prospects or overly leveraged balance sheets typically become exposed for their shortcomings and their share prices can suffer harsh fates. Since the timing and duration of these rocky periods are indeed unpredictable, investors that have been willing to own lower quality companies can get caught in the storm of volatility. Couple this with the emotional decision making that routinely takes place during these times and the consequences for long-term investment performance can be damaging.

The table below depicts the simple but cruel mathematics of the trek back to breakeven for a stock that has suffered a significant market drawdown. Net, volatility and low quality can be a dangerous mix, especially if fundamentals become so impaired that permanent losses develop. Quality companies, on the other hand, can exhibit less volatility as investors see the ability to expand market share and the wherewithal to make important investments in future growth during these periods.

The Cruel Math of Returning to Breakeven

Loss Incurred	Gain Required to Break Even
-20%	25%
-30%	43%
-40%	67%
-50%	100%
-60%	150%
-70%	233%

What IS and What is NOT Quality?

Despite the subjective nature of quality, investors should still be leery of investment managers that too loosely or inconsistently define it. The attributes of a quality company should be ascertained by **rigorous bottom-up fundamental research** and not by lax definitions or quantitative measurements of shortsighted valuation metrics that are based on this year or next. For example, simply because a company has a low current price-to-book value multiple or a high current dividend yield, doesn't make it quality. In fact, inexpensively valued companies often trade at such levels for good reasons and sometimes it can mean there are daunting fundamental challenges for the company.

The table below provides a framework for our definition of quality. We segment the discussion into four (4) categories and outline what constitutes quality and what does not in each. An investment philosophy that claims to focus on quality companies should have as clear of a definition as possible and, perhaps most importantly, the discipline to consistently implement the process.

Defining Quality

	What IS Quality?	What is NOT Quality?
Track Record	• Demonstrated history of favorable financial results • Positive long-term trendline in per-share earnings and cash flow • Strong profitability and return on invested capital metrics	• Historical inconsistency of financial results • Highly cyclical per-share earnings and cash flow • Periods of low return metrics or lack of profitability
Market Power	• Leadership positions within markets served • Strong market shares and durable competitive advantages • "Price makers," not "price takers"	• Tertiary share in markets served • Needing to compete on price • Lacking leadership positions
Balance Sheet	• Limited use of financial leverage • Cash flow strength to support debt payments • Ability to access capital markets through cycles	• Extensive use of debt to finance the business • Growth in debt faster than growth in cash flow • Subject to downgrades from credit rating agencies
Management Team	• Demonstrated history of sound management • Exemplary capital allocation decisions • Promote productive culture and groom future leaders	• Poor track record of capital allocation • Value-destroying acquisitions • Lack of productive culture and limited management depth

A Quality Approach

The benefits of an investment philosophy that focuses on the ownership of quality companies are several fold. The following sections discuss some of these long-term benefits for investors.

LOW TURNOVER and TAX EFFICIENCY

The fundamental attributes of quality companies help them to stand the test of time for investors. As a result, trading in and out of these companies with frequency is less needed than with low-quality companies that might have more suspect long-term fundamentals. Higher levels of trading typically means higher portfolio turnover, which in turn can mean higher capital gains taxes for the investor. Especially for taxable accounts, the portfolio turnover ratio is an important metric to evaluate in order to judge the tax efficiency of an investment manager. As the saying goes, “it’s not what you make, it’s what you keep,” and lower portfolio turnover can lead to better after-tax investment performance.

FOCUS

Quality companies can allow an investment manager to concentrate the portfolio into fewer holdings, making each more meaningful to overall results. A larger number of holdings will eventually stray from quality and begin to look more and more like an index fund. Our investment process limits portfolio holdings to the 25-40 range, preserving the ability to focus on the highest-conviction companies.

DIVIDENDS

Many quality companies pay attractive and growing dividends to their shareholders. If dividends are sustainable into the future, they can offer long-term investors tremendous value by tapping into the power of compounding – i.e., reinvested dividends can earn future returns on past returns. Additionally, quality companies that have sustainable dividends can offer volatility-dampening “yield support” in the portfolio. Sustainable dividends come from businesses that have strong recurring revenues, stable cash flows, conservative balance sheets, and moderate payout ratios. Businesses that are highly cyclical or have too much debt, conversely, are inherently lower quality in nature and their dividends can be a value illusion. Investment managers that “reach for yield” in these lower quality companies may be disappointed by the lack of future dividend growth potential or possibly outright cuts to the dividend.

CAPTURE RATIO ANALYSIS

Upside- and Downside-Capture Ratio analysis measures how a portfolio performs during up- and down-market environments. A capture ratio of 100%, for example, would mimic the market performance while a ratio of 50% would “capture” exactly half of the benchmark performance. Quality companies have the ability to produce a Downside-Capture Ratio of less than 100% while still doing well in up markets. A market downturn is the true test of an investment philosophy and downside risk protection can lead to more favorable long-term results. For example, a portfolio that combines a Downside-Capture Ratio of 70% with an Upside-Capture Ratio of 90% would produce results above the benchmark with less risk (e.g., lower volatility or standard deviation) over time.

Conclusion

Our perspective is that 'quality' is defined by companies with demonstrated track records of success, leadership positions with strong market power, dependable balance sheets, and astute management teams. An investment philosophy that focuses on the ownership of quality companies and remains disciplined in implementing the investment process can give an investor the confidence and peace of mind to focus on an appropriately long-term time horizon in achieving their financial goals. Through attractive dividends and the ability to reinvest excess cash flow into productive operational assets, investors can tap into the power of compounding with quality companies. Finally, the gold standard in investing is the achievement of superior *risk-adjusted* returns – that is, an attractive return relative to the level of risk being taken – and our view is that quality companies can help investors achieve this objective.

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Alley Company, LLC is a private money management firm based in Lake Forest, Illinois. The firm was founded in 1998 by Steven J. Alley to operate a disciplined investment philosophy in a separate account format.

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