

Time for A Walk up Quality Street?



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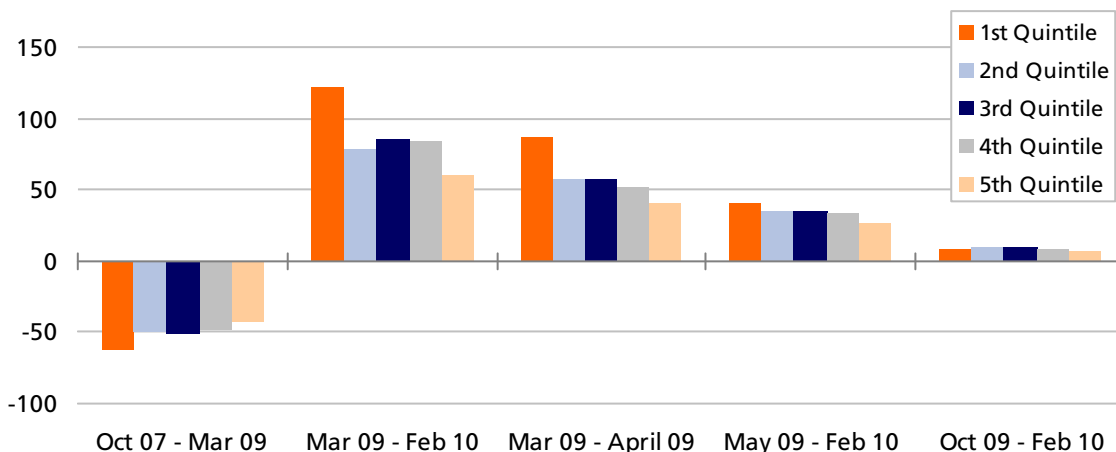
Managing an equity portfolio in tandem with the investment and profit cycles — which have historically averaged around five to six years in duration from trough to trough — necessitates an evolving shift in emphasis between cyclical and non-cyclical stocks, as well as between well- and less-well-capitalized holdings. As a rule of thumb, the cyclical recovery and benign phases of the business cycle typically account for around 80% of the total. After the first, frequently explosive upside moves off a cycle low, a protracted period of outperformance by cyclical and lower-quality stocks has been the norm. Is the current cycle likely to be a replay of this historical pattern, or is it different this time?

A useful proxy to measure quality effects is to create buckets of securities based on their long-term debt-to-capital ratios. We have conducted an analysis of the Russell 1000 (for the U.S. perspective) and MSCI EAFE (for developed international markets) index

constituents in which we measured the equal-weighted returns for both across various market backdrops since October 2007. In the accompanying charts, the first quintiles represent the equal-weighted returns for companies with the highest long-term debt-to-capital ratios (i.e., the weakest balance sheets), while the fifth quintiles represent the stocks with the lowest long-term debt-to-capital ratios (i.e., the strongest balance sheets).

For the Russell 1000, the highest-quality group was considerably more defensive between October 2007 and March 2009 but has lagged better-capitalized peers significantly since then. The bulk of the excess outperformance was achieved in the first weeks following the market low; since October 2009, in a consolidating market, more highly leveraged companies have eked out only a marginally better return than the those companies with the lowest leverage. The low-quality/high-leverage

Russell 1000: Capitalization Effects in the U.S.



Source: FactSet, Frank Russell Company

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phenomenon essentially had a duration of about seven months in the United States.

A similar conclusion is evident in international developed markets, though there are some remarkable differences between the U.S. experience and the international one. In the bear market, the dispersion between the highest- and lowest-leveraged companies in the EAFE universe was considerably higher than that of the U.S. In the recovery phase since March, the lowest-grade U.S. stocks outperformed the other four quintiles significantly; internationally, only the highest-quality quintile was a laggard, with stocks in the other four groupings performing roughly in line with one another. In the market consolidation phase since October, the highest-leveraged quintile actually underperformed all others and posted a negative return — the only global sleeve to suffer a contraction since the rally began in March. Thus, the international low-quality effect appears to have run its course by May 2009, for a duration of around three months.

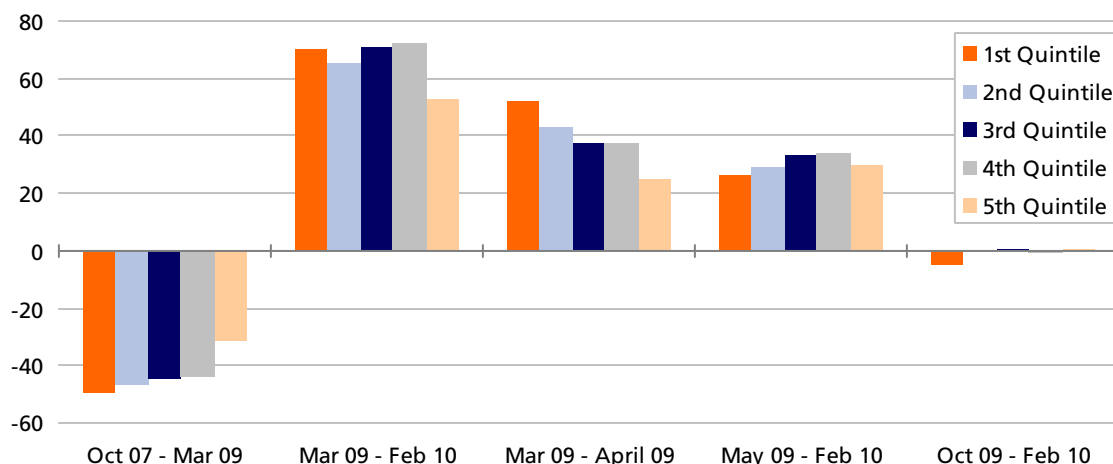
So in sum, the strongest-capitalized companies have seen a headwind abate in recent months, while the change internationally has been much more pronounced, with capital-constrained companies generating sub-par returns for more than nine months. Does this mean that the current recovery/growth phase of the business/investment cycle is truncated and that a renewed period of economic weakness is imminent? Or does this suggest that the historical pattern does not apply here, and that while markets may rise, dynamics are shifting and will increasingly reward the strongly capitalized? It also calls into question the veracity of

a deeply held belief (at least until the recent bear market) that underleveraged companies are sub-optimally managed from a financial engineering perspective and, therefore, destroy shareholder value.

The answers arguably are to be found in a dramatically changed economic and financial environment. While the global banking system was rescued from the brink of disaster, it remains fundamentally undercapitalized and, as such, is likely to be under persistent pressure to shorten balance sheets for the foreseeable future. For developed market consumers, lower housing prices and high debt levels imply that mortgage debt in the aggregate has to be reduced to improve the relationship between the value of the collateral and the level of debt. Consumption growth could be capped for this and many other reasons, not the least of which is the lasting impact of structurally high unemployment rates. The typical strongly rising tide that lifted all boats in prior cycles appears to be absent for a large number of companies.

In this scenario, low debt levels may turn out to be a strategic advantage. Companies in this category are not as dependent on the vagaries of the banking industry and as a group are in a better position to defend and invest in their franchises. There will be companies with stretched balance sheets that can generate growth, but the combination of strength and differentially higher growth could prove relevant for portfolio positioning for a considerable time period. While shorter counter-trends may prevail sporadically, a long walk up "Quality Street" may prove to be more durably rewarding. ■

MSCI EAFE: Capitalization effects for international developed economies.



Source: FactSet, MSCI BARRA