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"Hidden Quality" in International Equity Markets

Over the past few years, markets have favored a quality approach in non-U.S. developed markets. We believe that the indicators of quality that investors have sought out have been too narrowly focused on identifying companies that have a combination of high operating margins/returns, low debt and earnings "visibility," resulting in a concentration in the Consumer Staples and Health Care sectors and valuation risk for many companies with these characteristics.

While maintaining the importance of bottom-up research into individual companies' fundamentals, we recognize the attractiveness of quality, particularly in the current uncertain times. To identify quality companies, however, we suggest going beyond a simple focus on high margins/returns, low debt and earnings stability, to look at the efficiency with which capital and leverage are deployed and the complex interplay of these factors. We believe this can help build quality portfolios with less valuation and concentration risk.

Executive Summary

- Quality is generally (and understandably) associated with the combination of high operating margins/returns, low debt and stable earnings.
- When a portfolio or equity index is oriented in favor of those characteristics, it tends to become concentrated in Consumer Staples and Health Care stocks.
- In addition to that concentration risk, during periods when investors seek out quality, those sectors can become expensive and subject to greater valuation risk.
- To avoid these risks, it would be useful to identify a richer indicator of quality that meaningfully broadens the list of eligible companies outside of these two sectors.
- We argue that understanding the interplay of margins, efficiency and leverage that underpins return on equity (RoE) can serve that purpose: this deeper analysis of RoE urges us to focus not solely on high margins, stable earnings and low debt, but on the efficiency with which capital and leverage are deployed and the complex interplay of these factors—acknowledging that some high-margin businesses are not run very efficiently.
- When we segment the MSCI EAFE Index by ranking companies by their RoE and their operating margins and stripping out those sectors where these metrics can be misleading, we find that 113 stocks, or 13% of the index, exhibit relatively high RoE despite generating relatively low margins.
- Moreover, we find that a high proportion of these "Hidden Quality" companies are not in either the Consumer Staples or the Health Care sectors, but the Industrials and Consumer Discretionary sectors; and that by virtue of being "hidden," they currently trade at lower valuations, on average, than the traditional quality-oriented index.

Many investors associate "quality" businesses with high operating margins/returns, low debt and stable earnings. If we treat a company's sales, operational efficiency and capital structure as constants and margins as the one variable, higher margins do indeed enable companies to generate a higher return on capital. High operating margins may also imply lower levels of fixed operating costs, and lower fixed costs tend to make a business less cyclical, which can translate into superior earnings stability and less need to utilize the balance sheet to generate financial returns above the cost of capital.

For these reasons, quality-oriented equity indices tend to concentrate holdings in companies that exhibit high operating margins/returns, low debt and earnings stability. As a result, they tend to be overweight companies in the Consumer Staples and Health Care sectors, where customers tend to stay loyal to trusted brands. Figure 1 shows that these two sectors, which constitute only 22% of the MSCI EAFE Index, represent 39% of the MSCI EAFE Quality index.

FIGURE 1. QUALITY-ORIENTED INDICES SIGNIFICANTLY OVERWEIGHT HEALTH CARE AND CONSUMER STAPLES

Sector weights by market capitalization

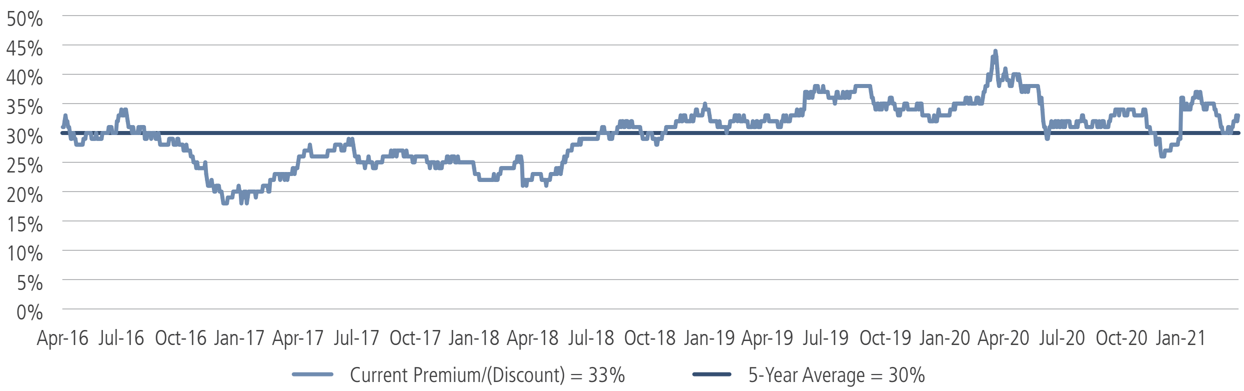
	MSCI EAFE	MSCI EAFE Quality
Communication Services	5%	3%
Consumer Discretionary	13%	11%
Consumer Staples	10%	17%
Energy	3%	0%
Financials	17%	7%
Health Care	12%	22%
Industrials	15%	16%
Information Technology	9%	16%
Materials	8%	7%
Real Estate	3%	0%
Utilities	4%	0%
	100%	**100%**

Source: MSCI, Bloomberg. Data as of March 31, 2021. For illustrative purposes only.

This highlights the concentration risk associated with an over-simplified view of these traditional markers of quality. That is now paired with valuation risk after investors have migrated toward stocks with these characteristics in search of resilience during the COVID-19 crisis and the end of an exceptionally long business cycle. By the end of March 2021, the MSCI EAFE Quality Index was trading at a 33% premium relative to the EAFE index (figure 2), which may leave the stocks vulnerable to a change in investor sentiment.

FIGURE 2. TRADITIONAL "QUALITY" TRADES AT A 33% PREMIUM

Premium/Discount of MSCI EAFE Quality Index relative to the MSCI EAFE Index, based on the two-year forward P/E ratio



Source: MSCI, Bloomberg. Data as of March 31, 2021. For illustrative purposes only.

Does the Combination of Stable, High Margins and Low Debt Really Define a "Quality" Business?

Faced with this combination of concentration and valuation risk, we think it makes sense to ask whether a deeper analysis of "quality" can expand the opportunity set. We believe that it can, and would suggest looking not solely at the traditional markers of high margins, "visible" earnings and low debt, but at the efficiency with which capital and leverage are deployed and the interplay between these factors—acknowledging that some high-margin and low-debt businesses are not run very efficiently.

Back in the 1920s, the DuPont Corporation began to assess its own efficiency using a formula that disaggregated return on equity (RoE) into its main constituents. According to the now widely used "DuPont formula":

$$\begin{aligned}\text{Return on Equity} &= \text{profit margin x asset utilization x leverage}\\ &= \text{(operating profit/sales) x (sales/average total assets) x}\\ &\quad \text{(average total assets/average shareholder equity)}\\ \pi / E &= (\pi / S) \times (S / A) \times (A / E)\end{aligned}$$

Expressed this way, we see that RoE can be boosted not only by higher profit margin, but also by how efficiently companies use their assets and leverage their balance sheets. That is important because we often find that high-margin companies generating strong income statement profitability are not focused on operating their assets as intensely, or optimizing their balance sheets and capital structure as efficiently, as some lower-margin companies. It's also important to note that the three components interact dynamically in the DuPont formula—they are all variables, not constants. Recall that, at the start of this paper, we wrote that higher margins always result in a higher RoE as long as sales, efficiency and capital structure are kept constant. When companies operate less efficiently, however, perhaps by not working either their assets or their balance sheet as hard as they could, high-margin companies can potentially generate a lower RoE.

We are not arguing that higher margins are never an important marker of quality. It's true that lower-margin companies have above-average costs compared to higher margin companies, by definition. More important than the magnitude of costs, however, is the type: if costs are overwhelmingly variable (moving up and down in line with revenue), then profits can be stable even for a low-margin business. Similarly, if the vast majority of costs are fixed (and insensitive to revenue), then even high-margin companies won't have high earnings stability or visibility—particularly if their revenues are economically sensitive.

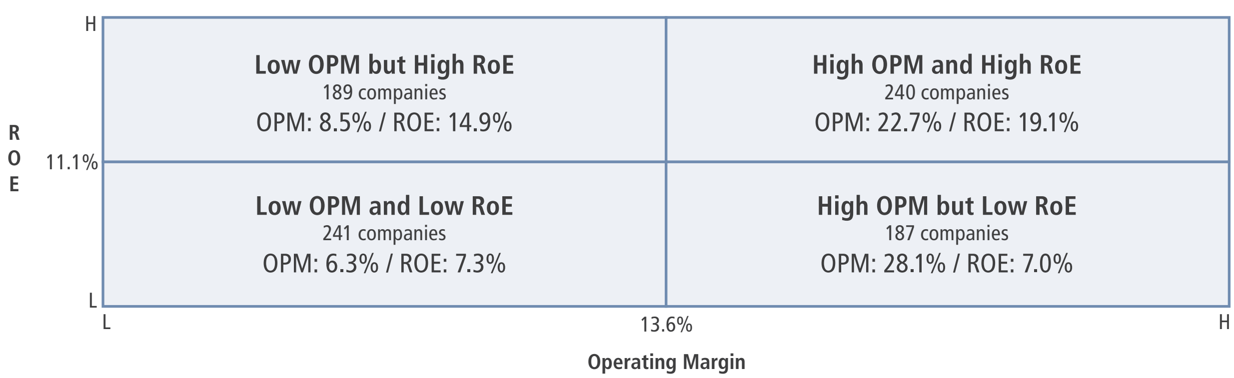
We would also acknowledge that, while excessive financial leverage can be an issue, debt need not be completely minimized—companies should seek a level that's appropriate for their business model, not a level that is overly cautious. Separately, asset utilization, though often neglected in traditional assessments of quality, is also important to understand for each business model.

Identifying Quality

For simplicity, we analyzed a broad international equity universe (MSCI EAFE Index, which has over 850 companies), and separated them into groups based on operating profit margin and RoE—specifically, whether each company exhibited below- or above-average profitability on each metric. The results are shown in figure 3.

FIGURE 3. HIGH OPERATING MARGIN DOES NOT NECESSARILY MEAN HIGH RETURN ON EQUITY

MSCI EAFE Index segmented into four groups, showing median operating profit margin and median RoE in each group, and for the total universe



Source: MSCI, Bloomberg. Data as of March 31, 2021. For illustrative purposes only.

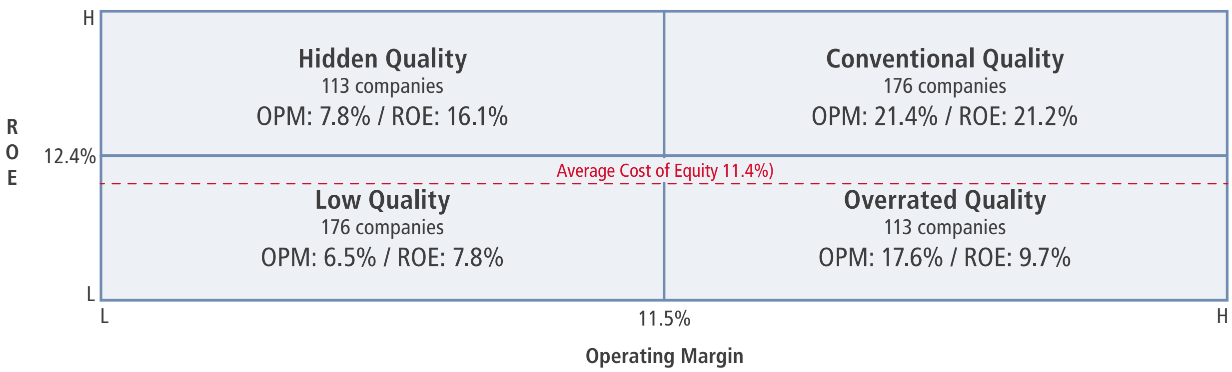
Profit margins and RoE are correlated for more than half of the companies in the index. But what is more notable is that there are almost 380 companies where they are not correlated.

We took the analysis further. For manufacturing and many service businesses, RoE and operating margin are intuitive metrics. For Financials, Energy and Mining companies, however, operating margin and RoE are generally very cyclical, reflecting the credit and commodity cycles, respectively, rather than operating efficiency. For Real Estate, Telecoms (within Communication Services) and Utilities, RoEs are boosted by financial leverage, such that interest rates are a major influence on profitability. We therefore culled the universe by excluding these sectors. The remaining sectors are those where quality businesses tend to be concentrated: Consumer Staples, Consumer Discretionary, Health Care, Industrials and IT, as well as Media/Internet (within Communication Services) and Materials (excluding Mining).

We gave each group a name, and show the new segmentation in figure 4.

FIGURE 4. THERE IS A LOT OF "HIDDEN QUALITY" IN THE INDEX

A subset of the MSCI EAFE Index segmented into four groups, showing median operating profit margin and median RoE in each group, and for the total universe



Source: MSCI, Bloomberg. Data as of March 31, 2021. The companies in the universe are those in the MSCI EAFE Index minus Financials, Energy, Mining, Real Estate, Telecoms and Utilities. For illustrative purposes only.

The data indicate that many companies in the traditional quality sectors barely meet their cost of equity despite relatively high operating margins. We classify these as "Overrated Quality." We classify as "Conventional Quality" those companies that offer high margins and high returns, while "Low Quality" companies offer neither.

Most important, however, is the sizable subset of "Hidden Quality" companies that are able to generate returns on equity well above their cost of equity (for which an 11.4% hurdle is a reasonable proxy)—despite lower-than-average margins.

What type of businesses exhibit Hidden Quality characteristics? As figure 5 shows, whereas Conventional Quality is disproportionately represented by Health Care and Consumer Staples firms (they constitute 35% of this group), many Hidden Quality companies are categorized as Industrials (42%) and Consumer Discretionary (24%).

FIGURE 5. "HIDDEN QUALITY" IN INDUSTRIALS AND CONSUMER DISCRETIONARY

A subset of the MSCI EAFE Index segmented into four groups, showing sector representation in each group

	Hidden Quality	Conventional Quality	Overrated Quality	Low Quality
% of Companies in Consumer Staples & Health Care Only	19%	35%	25%	19%
% of Companies in Quality Sectors				
Communication Services	0%	4%	9%	3%
Consumer Discretionary	24%	11%	6%	20%
Consumer Staples	16%	11%	10%	13%
Financials	2%	7%	4%	0%
Health Care	3%	24%	15%	6%
Industrials	42%	19%	21%	34%
Information Technology	8%	15%	7%	13%
Materials	3%	8%	7%	10%
Real Estate	2%	1%	21%	2%
	100%	**100%**	**100%**	**100%**

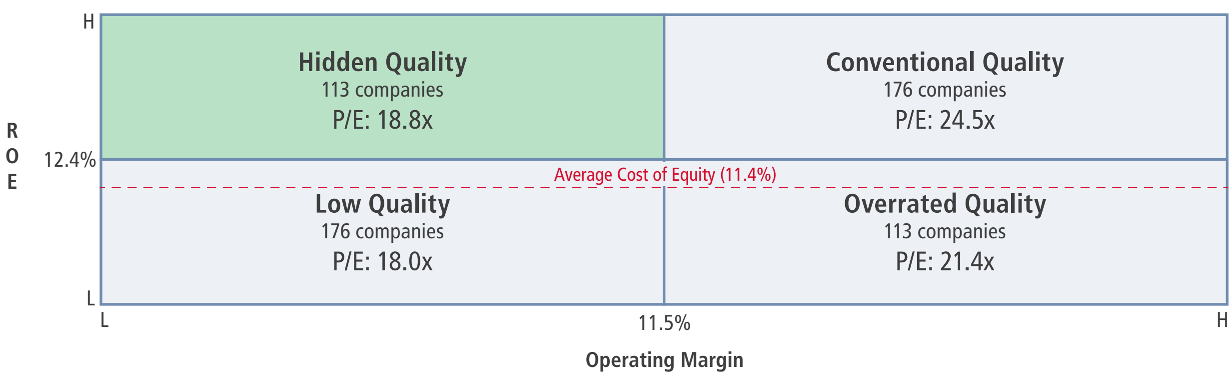
Source: MSCI, Bloomberg. Data as of March 31, 2021. The companies in the universe are those in the MSCI EAFE Index minus Financials, Energy, Mining, Real Estate, Telecoms and Utilities. For group definitions see figure 4. For illustrative purposes only.

Temporary staffing within the Industrial sector is a prime example. These businesses' largest component of costs is that of the workers dispatched. They operate like exchanges, matching supply and demand for labor with few operating costs other than a strong IT system. An example is Europe's largest staffing company, Adecco, which has generated a double-digit RoE despite just 4% operating margins.

Hidden Quality can also be found in Consumer Discretionary. By charging high prices and therefore high margins, a high-end apparel company like Moncler utilizes its 30% operating margin to generate 20% returns, turning its assets over by 0.5x per year. Adidas, on the other hand, a company that serves a broader audience in the apparel industry but has strong brand equity, attains the same level of returns despite lower operating margins of 10% by turning its inventory over twice as quickly.

Aside from diversifying the concentration risk, investing in Hidden Quality comes with a valuation opportunity. As you can see in figure 6, Hidden Quality companies trade at a 23% discount to their Conventional Quality counterparts. Hidden Quality also currently trades over 13% less expensive than Overrated Quality companies. This discount could help minimize the valuation risk that is likely embedded in those two other groups, leaving those names vulnerable to changes in investor sentiment.

FIGURE 6. QUALITY SECTORS IN A SUBSET OF MSCI EAFE: VALUATION METRICS



Source: Bloomberg, MSCI. Data as of March 31, 2021. Metrics are median of each group. The companies in the universe are those in the MSCI EAFE Index minus Financials, Energy, Mining, Real Estate, Telecoms and Utilities. For group definitions see figure 4. For illustrative purposes only.

As always, we would end by restating the case for thorough fundamental analysis that goes beyond the systematic identification of favorable ratios, simply because these ratios not only fall short in explaining a company holistically, but do so in a backward-looking fashion. For example, our "Hidden Quality" group includes a number of automotive suppliers, where accounting rules have allowed firms to write down their equity and thereby report relatively high RoEs despite low margins. The challenging current outlook for many of these firms is a good reminder to consider the details and make forward-looking assessments. Nonetheless, as a first step toward identifying a broader range of quality companies, it makes sense to go beyond simple operating margin to consider all three components of RoE.

Conclusion

Our analysis supports the idea that Hidden Quality companies, which generate high RoEs via operating efficiency, may offer an attractive expanded opportunity set relative to their Conventional Quality peers, where RoEs are boosted simply by higher operating margins.

Hidden Quality companies can have higher levels of bottom-line profitability and tend to be more intensively managed to achieve higher operating efficiencies. These low-margin but high-RoE companies operate in different sectors to Conventional Quality firms, which can enable investors to build more diversified quality portfolios.

Moreover, operating in less well-known sectors means that Hidden Quality firms tend to attract less investor attention, which can result in discounted valuations relative to their higher-margin peers, potentially offering investors less valuation risk and the possibility of multiple expansion once the underlying quality aspects are recognized by the market.

INDEX DEFINITIONS

The **MSCI EAFE Index** aims to capture the performance of large and mid cap quality growth stocks across 21 developed market countries excluding the U.S. and Canada.

The **MSCI EAFE Quality Index** aims to capture the performance of large and mid cap quality growth stocks across 21 developed market countries excluding the U.S. and Canada 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.

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