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The Mercy of Quality

Readers of these missives will know some of our fundamental beliefs: human nature determines investment prices, human nature is relatively unchanging, and consequently you *can* learn from history. When people appear to behave differently than they have in the past, therefore, it piques our interest. Despite the jarring meltdowns of the 2007-2009 credit crisis, investors have been shunning high-quality stocks in favor of low-quality stocks recently. We want to understand why.

The typical behavior is a flight to the safety of high-quality stocks after speculative excess leads to a bear market. After the late 1960s technology boom and bust, investors flocked to the so-called "Nifty Fifty," 50 leading blue chip stocks that wound up selling at fantastically high valuations while the average stock languished. The subsequent severe bear market in 1973-74 had a tremendous psychological impact, since the buyers of the Nifty Fifty high-quality companies thought they were being prudent – but they vastly overpaid.

The blue line on the top of the chart on the next page shows the ratio (since 1981) of the performance of high quality stocks relative to low quality stocks, while the red line in the lower half shows the trailing annual difference. The chart illustrates the speculative boom that peaked in 1983 (the low point for the red line on the left), followed by a flight to high quality stocks in 1984-86 (the red line moving to the top of the bottom clip). The technology bubble of the late 1990s leads to another trough (low-quality stock outperformance) in early 2000, followed by another flight to high quality stocks in 2001-02.

So far, so good - the chart shows a "mean-reverting" pattern, with alternating out-performance by high and low quality stocks. In the past decade, though, this pattern has not held. There was an understandable, but *very* brief period of high quality performance in the crisis of 2008, followed by yet another rush to low quality stocks. Have we repealed human nature? Are investors really so much more steely-nerved now that they no longer need the comfort of the likes of Pfizer and Coca-Cola?

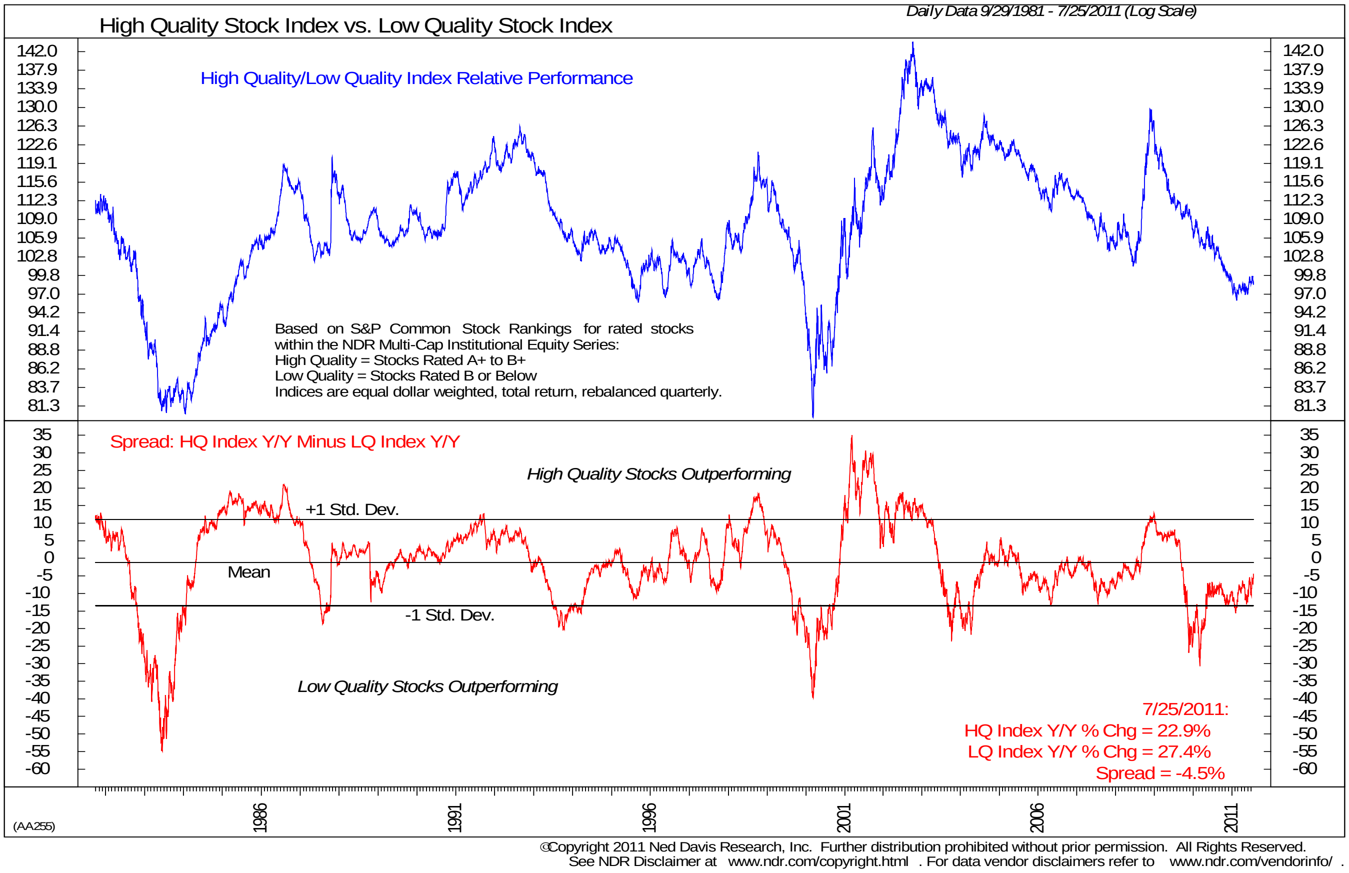

Chart source: Ned Davis Research, Inc.

We have yet to read what we believe is an adequate analysis of this continuing investor preference for low quality stocks. Aside from the historical pattern, it does not make much sense – after all, investors should be willing to pay a premium for a solid balance sheet and consistent earnings growth. So what is going on? We have two theories. First, perhaps from 2004 to 2007 we had a *disguised* replay of the Nifty Fifty market. Rather than a flight to high quality companies generally, investors focused on financials and real estate, stocks that "felt" safe. After all, there had never been a decline in residential real estate prices, and the commercial banks issuing mortgages and the investment banks packaging those mortgages into securities seemed like solid corporate citizens. Second, consider the behavior of hedge funds, the most active buyers and sellers in current markets. Hedge fund managers receive a large share of the profits on the money they manage, which inclines them to buy volatile, low-quality stocks that *might* generate outsized gains (and the resulting outsized compensation). Anyone can buy warhorses like Exxon or IBM – how can anyone justify fees of a quarter of investor gains by buying boring old blue chips?

Not bound by such behavioral quirks, we attempt to buy our clients solid investments for a nice long-run return. Who cares how others are paid? The message of the chart is that market seasons change. Someday those now-cheap high-quality blue chip stocks will once again be in fashion – the world does not feel to us like it is getting safer any time soon. Meanwhile, if the world really falls apart (as we hear it will soon on the news every night), won't you be more comfortable owning the Johnson & Johnsons and Procter & Gambles of the world as opposed to some volatile stock selected solely to gratify the fee-lust of managers without a sense of fiduciary duty?