VanEck®

Quality

An all-seasons investment approach

ASX: QUAL — ASX: QHAL — ASX: QSML

QUALITY INVESTING

Competitiveness, efficiency, profit growth, financial and operating leverage, and return-on-equity.

A focus on high 'quality' companies has been the goal of many fundamental investors. While definitions vary, quality is commonly associated with a company's competitiveness, efficiency, profit growth, financial and operating leverage, and return-on-equity (ROE).

Benjamin Graham wrote about it in *The Intelligent Investor* in 1949, where he outlined what has become the basis for, the quality factor. Graham said investors should demand from a company "a sufficiently strong financial position and the potential that its earnings will at least be maintained over the years."

Such companies, he claimed, show resilience by falling less in a downturn and recovering to previous highs quicker than other companies. Analysis shows that while quality does tend to behave defensively in downturns, it also tends to capture a fair share of the upside in bull runs. As a result, we believe quality is the approach for all seasons.

IDENTIFYING QUALITY

Benjamin Graham does not stand alone in his focus identifying quality companies. His protégé Warren Buffett has long focused on companies with demonstrated consistent earning power and businesses earning a good return on equity while employing little or no debt[1]. In academia, Nobel Laureates Eugene Fama and Kenneth French, in their seminal paper titled *A Five-Factor Asset Pricing Model* highlight the "Quality Premium".[2] Economist Robert Novy-Marx is another well-known proponent of quality investing.

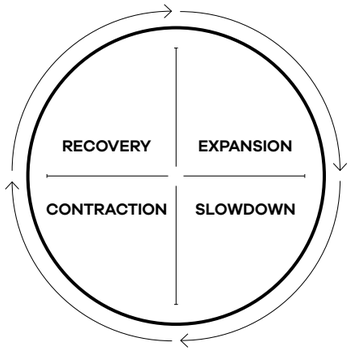
In his paper *Quality Investing*, Robert Novy-Marx set out to identify quality by assessing the best-known quality strategies.[3] MSCI based its Quality Indices, launched in December 2012, on the principles of the best performing quality strategy in his paper.[4]

According to MSCI, its Quality Indices "identify quality growth stocks by calculating a quality score for each security in the eligible equity universe based on three main fundamental variables: high return on equity (ROE), stable year-over-year earnings growth and low financial leverage." This is similar to what Graham said investors should demand from a company in *The Intelligent Investor* and therefore should fall less and recover faster than other companies in a downturn, it is also worthwhile understanding how quality performs in other parts of the economic cycle.

Graham said investors should demand from a company "a sufficiently strong financial position and the potential that its earnings will at least be maintained over the years."

1. Buffett, Warren. (2015) "Berkshire Hathaway Annual Shareholder Letter."
2. Fama, Eugene F. & Kenneth R. French. (2014) "A Five-Factor Asset Pricing Model." SSRN.
3. Novy-Marx, Robert. 2012 (revised 2014). "Quality Investing." Working Paper
4. ibid

THE PERFORMANCE OF QUALITY THROUGH THE CYCLE



Four, identifiable stages make up the economic cycle. These are **expansion, slowdown, contraction and recovery.**

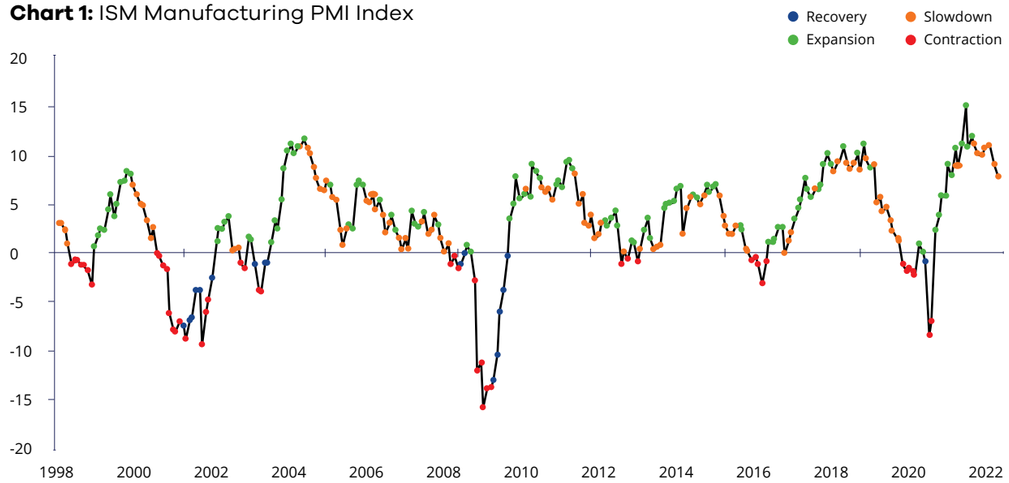
The direction and the pace of economic activity identify these cycles.

- An expansionary environment is when growth is expanding and at a faster rate than usual;
- A slowdown occurs when economic activity is slowing down after an expansion;
- A contraction occurs when economic growth is negative and it is still falling; and
- A recovery is an environment in which the economy, after the trough of a contraction, starts to head toward growth.

The Purchasing Managers' Index (PMI) is an index used to measure the prevailing direction of economic trends in the manufacturing and service sectors. It measures the change in production levels across the economy from month-to-month so is considered a key indicator of the state of the economy. The chart below shows the three-month rolling PMI changes since 1998, highlighting the stage of the economic cycle at that time.

The direction and the pace of economic activity identify these cycles.

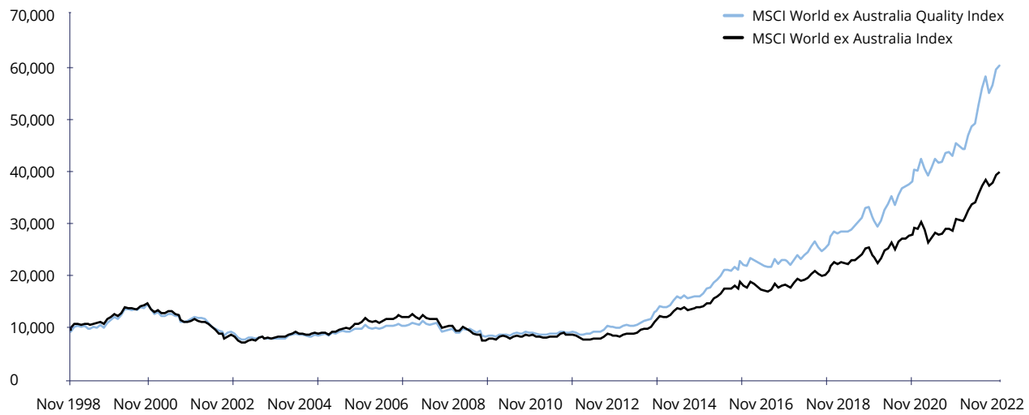
Chart 1: ISM Manufacturing PMI Index



Source: VanEck, Bloomberg. November 1998 to January 2022.

Over that same period (1998 to current) the quality factor, as represented by the MSCI World ex Australia Quality Index has outperformed the MSCI World ex Australia Index.

Chart 2: Growth of 10,000: MSCI World ex Australia Quality Index and MSCI World ex Australia Index



Source: Morningstar Direct, as at 31 January 2022. Past performance is not a reliable indicator of future performance. The above graph is a comparison of performance of MSCI World ex Australia Quality Index (QUAL Index) and the parent index, based to 10,000 from 30 November 1998. Results are calculated to the last business day of the month and assume immediate reinvestment of all dividends and exclude fees and costs associated with investing in VLUE You cannot invest in an index. QUAL's Index base date is calculated at 30 November 1994. QUAL Index performance prior to its launch on 15 October 2014 is simulated.

The MSCI World ex Australia Index ("MSCI World ex Aus") is shown for comparison purposes as it is the widely recognised benchmark used to measure the performance of developed market large- and mid-cap companies, weighted by market capitalisation. QUAL's index measures the performance of 300 companies selected from MSCI World ex Aus based on MSCI quality scores, weighted by market cap x quality score at rebalance. Consequently QUAL's index has fewer companies and different country and industry allocations than MSCI World ex Aus.

Quality outperformed over the long term, but also it is evident that quality had periods of outperformance and underperformance. These tend to correlate to the economic cycle. The table below represents the returns of the quality factor through the cycle compare to other MSCI factors.

Table 1: Total performance (% per annum) during different economic regimes

Period	Quality	Momentum	Growth	Enhanced Value	Benchmark
Recovery	9.16%	5.07%	4.35%	13.72%	2.89%
Expansion	14.75%	21.21%	17.69%	18.64%	15.84%
Slowdown	5.25%	6.39%	2.10%	2.24%	2.02%
Contraction	5.07%	-7.30%	-2.80%	-3.15%	-2.36%
Since Inception	9.40%	9.91%	7.75%	8.66%	6.99%

Source: VanEck, Bloomberg. November 1998 to January 2022. Past performance is not a reliable indicator of future performance.

You can see from the above that quality was among the top two returning factors in three out of the four economic regimes and second overall. Another way to look at this is performance relative to the index as shown in the chart below. You can see that quality's relative underperformance during expansion was dwarfed by its strong relative performance during recoveries and a contractions.

Table 2: Performance differential (% per annum) compared to MSCI World ex Australia benchmark during different economic regimes

Period	Quality	Momentum	Growth	Enhanced Value
Recovery	6.26%	2.17%	1.46%	10.82%
Expansion	-1.10%	5.37%	1.85%	2.80%
Slowdown	3.23%	4.37%	0.08%	0.22%
Contraction	7.43%	-4.94%	-0.44%	-0.79%
Total	2.41%	2.92%	0.76%	1.67%

Source: VanEck, Bloomberg. November 1998 to January 2022. Past performance is not a reliable indicator of future performance. Performance differential is calculated by subtracting the total return from the return of the benchmark.

The quality factor's performance during these periods, typified by lower growth exhibited the performance Graham predicted in The Intelligent Investor. As a result of these performance characteristics, the quality factor has earned the reputation as being a 'defensive factor'. Quality companies have dependable earnings and are lowly leveraged, so they are able to better withstand the extremes of the economic cycle. This is reflected in the quality factor's volatility.

One way that investors measure volatility is the standard deviation of returns, see Table 3. As you would expect the quality factor has lower volatility compared to the market benchmark over the four economic regimes and has the lowest volatility compared to other factors during slowdowns and contractions during the period analysed.

QUALITY: AN ALL-SEASONS INVESTMENT APPROACH

Table 3: Volatility during different economic regimes

Period	Quality	Momentum	Growth	Enhanced Value	Benchmark
Recovery	18.30%	16.36%	21.09%	28.96%	23.60%
Expansion	11.31%	13.22%	12.57%	14.50%	12.05%
Slowdown	13.00%	14.86%	14.33%	15.68%	13.57%
Contraction	19.87%	21.45%	23.13%	23.67%	21.46%

Source: VanEck, Bloomberg. November 1998 to January 2022. Past performance is not a reliable indicator of future performance.

The information ratio combines the return differential with the volatility of those returns. Traditionally it has been used by investors is to evaluate the skill of a portfolio manager at generating returns in excess of the benchmark. The higher the information ratio, the better.

Table 4: Information ratio during different economic regimes

Period	Quality	Momentum	Growth	Enhanced Value
Recovery	0.20	0.02	0.05	0.41
Expansion	-0.08	0.20	0.13	0.13
Slowdown	0.24	0.18	0.02	0.03
Contraction	0.39	-0.15	0.00	-0.01
Over analysed time period	0.14	0.10	0.06	0.08

Source: VanEck, Bloomberg. November 1998 to January 2022. Past performance is not a reliable indicator of future performance.

You can see from the above that quality is among the top two returning factors in three out of the four economic regimes and highest overall. Quality comes to the fore in a contraction, being the only factor that has a positive information ratio during that economic regime.

As a result of these performance characteristics, the Quality Factor has earned the reputation as being a 'defensive factor'.

USING QUALITY IN A PORTFOLIO

Demonstrated long-term outperformance relative to the global benchmark.

The quality factor, as represented by the MSCI World ex Australia Quality Index, has demonstrated long-term outperformance relative to the global benchmark, MSCI World ex Australia Index. We think it can be used throughout the business cycle. While the quality factor will have periods of underperformance, because of its defensive characteristics, quality companies have been shown to be resilient in the past by falling less in a downturn and recovering to previous highs quicker than other regimes.

During expansions, when the quality factor performs relatively weaker compared to other factors, investors may want to consider blending quality with an enhanced value approach, which tends to do well during recoveries and expansions. For more information on MSCI's value approach, see our booklet *Value: A timeless approach*.

VanEck has the following funds available that track MSCI Factor Indices

- VanEck MSCI International Quality ETF (QUAL)
- VanEck MSCI International Quality (Hedged) ETF (QHAL)
- VanEck MSCI International Small Companies Quality ETF (QSML)
- VanEck MSCI International Value ETF (VLUE).

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