Kenanga Investors

Date: 18 January 2023

Navigating Financial Markets in Transition with the Quality Factor

The Edge CEO Morning Brief (17 January 2023)

Market volatility, global political risks and economic uncertainty continue to shake global markets. As investors in this environment, it's critical we re-evaluate our portfolio positioning to achieve both financial and sustainability objectives.

Kenanga Investors Berhad and **Northern Trust Asset Management** answer some of the key questions facing Asian investors looking to build resilient, alpha-generating and sustainable portfolios.

How is the current economic uncertainty impacting investors?

Over the next five years, we think investors will need to navigate increasingly complex economic, environmental, and political threats and opportunities to achieve their goals.

We have been experiencing a new era of extreme volatility that is leaving investors searching for new ways to achieve the same portfolio objectives. In an environment marked by rapid market swings, investors looking to consistently outperform are reassessing their portfolios' readiness for this new volatility paradigm.

How can investors manage risk in this environment?

With this heightened volatility, we think investors should pay more attention to financial measures that we believe define high-quality companies, such as profitability, cash flow and efficient balance sheet management. We believe these companies are positioned to potentially navigate challenging markets.

More specifically, what do high-quality companies look like?

Northern Trust Asset Management has developed a multi-dimensional view of quality companies, exhibiting characteristics such as:

Profitability
Our research shows that more profitable firms historically have delivered excess returns to shareholders, but no one measure of profitability is best. Examples of profitability include operating margin and return on invested capital.

Strong cash flow
Companies with strong cash flow produce sufficient cash to meet their debt obligations and day-to-day liquidity needs, while sustaining or growing dividends. We prefer companies that self-finance their capital needs, which is especially important when interest rates are high or companies are struggling to obtain loans.

Conservative balance sheets

We seek companies with executive teams that manage capital in a conservative manner. Our research and external studies (Titman, Wei, Xie 2004) show that overly aggressive executive teams can excessively deploy capital that fails to deliver positive return and cash flow to shareholders.

Style factor excess returns across business cycles

	Entire period	Contraction	Recovery	Expansion	Slowdown
Small size	1.01%	-2.02%	12.37%	4.84%	-2.14%
High value	2.94%	5.26%	2.82%	3.95%	1.29%
High momentum	1.88%	-1.38%	-1.57%	2.64%	4.42%
Low volatility	0.98%	8.82%	-4.46%	-6.28%	2.39%
High div. yield	1.29%	5.19%	-1.00%	-0.89%	1.32%
High quality	**2.27%**	**5.81%**	**5.09%**	**1.44%**	**2.68%**
Number of observations	*524*	*94*	*57*	*172*	*201*

Source: For illustrative purposes only. NTAM Quantitative Research, Bloomberg. Entire period = December 31, 1978 - August 31, 2022. Note: Russell 1000 Index data is shown. Factor returns are excess returns of the equal weighted top quintiles of MSCI Barra Factors over the Russell 1000 returns. Geometric averages used for entire period. For regime analysis, annual averages are displayed. Past performance is no guarantee of future results. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

How does the Quality factor perform during the various phases of the economic cycles?

Historically, quality has delivered high excess returns the economic contraction and ensuing recovery phases of the economic cycle while still showing positive excess return during the other two phases of economic expansion and slowdowns in economic growth. For that reason, we think now is an opportune time for investors to lean into quality. Quality is among the six factors that we utilize within our portfolio construction, which also include small size, value, momentum, low volatility and high dividend yield. We selected these factors given their proven historical ability to compensate investors for the risk taken over the long-term.

While investing in quality, can investors also meet their economic, social and governance (ESG) objectives?

Quality may help investors meet their objectives as a single factor or in combination with other characteristics. We have found that strong ESG and financial management go hand-in-hand, as Quality and ESG strategies both seek to provide excess returns by investing in companies with sustainable business models and managed for short- and long-term growth. ESG data can also help identify risks and opportunities not apparent in financial statements.

When combining Quality with ESG, these high-quality companies must also demonstrate effective management of their exposure to ESG risks and management of ESG opportunities.

The added insight of ESG information can often identify risks not apparent in financial statements. When combined with the data from your company financials you can receive a broader coverage of insight into potential risk.

We can combine these in the portfolio construction and management process in a unified approach to compose a portfolio that is designed to invest in issuers that exhibit both robust quality and sustainable investing signals, and to encourage them to continue to do so.

By incorporating this quality factor overlay into an ESG portfolio, investors are able to emphasize the long-run sustainability of ESG practices while increasing the likelihood of performance above the benchmark. In fact, with an effective framework in place, build around quality, we can consider how ESG research can complement or enhance performance.

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