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The limits of quality in Australia

Why the quality factor on its own struggles in a narrow, cyclical market

April 2026

Executive summary

The quality factor is a defensive strategy designed to outperform during periods of heightened market volatility, lower inflation and lower growth regimes. The approach is reinforced by academic research and empirical findings.

When applied in international equity markets, quality strategies have delivered the characteristics intended: lower beta, shallower drawdowns, outperformance during market stress and defensive sector exposures. In this paper, we explore whether the quality factor can be replicated effectively in the Australian equity market.

The Australian equities market is one of the most concentrated by stock and sector. The universe is also small relative to global markets. This paper shows that these nuances present challenges when assessing factor strategy efficacy.

Defining quality

The quality factor has deep academic roots. Benjamin Graham wrote in *The Intelligent Investor* in 1949 that 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]

Subsequent research has built on this foundation. Research by Asness, Frazzini and Pedersen (2013) in "Quality minus Junk" found that quality, characterised as profitable and well managed companies, delivered higher risk-adjusted returns[2]. Novy-Marx (2013) in "the Other Side of Value: The Gross Profitability Premium" showed that a combination of profitable and value companies improved performance[3].

In 2015, profitability, a proxy for quality, was added as a fifth driver of portfolio returns in the Fama–French Five-Factor Model, alongside market beta, size, value (high minus low), and investment (conservative minus aggressive)[4].

Research in identifying systematic drivers of investment returns contributed to the emergence of factor indices, which track the performance of a set of companies with similar fundamentals, price behaviour, or a combination of both. This has led to the rise of factor-based ETFs which track these indices, while retaining transparency, liquidity and ease of trading for investors. VanEck Australia is a leader in designing and offering factor-based ETFs for more than 10 years including the quality factor.

MSCI is a global leader in constructing factor index strategies. Through their research, they found companies with three fundamentals: high return on equity, stable year-on-year earnings growth and low financial leverage, exhibited quality 'defensive' characteristics[5].

This means typically falling less in a downturn and recovering to previous highs more quickly than the broader market. When implemented correctly, a quality strategy should exhibit:

- Long term risk-adjusted outperformance (positive information ratio)
- Beta at or below 1.0 relative to the benchmark (lower systematic risk)
- Outperformance during periods of market stress (the "flight to quality" effect)
- Low exposure to cyclical sectors.

1. Graham, B. (1949), The Intelligent Investor: The Definitive Book on Value Investing.
2. Asness, C., Frazzini, A. and Pedersen, L. (2013), Quality Minus Junk.
3. Novy-Marx, R. (2013), The Other Side of Value: The Gross Profitability Premium.
4. Fama, E. and French, K. (2015), A Five-Factor Asset Pricing Model, Journal of Financial Economics.
5. Eugene L. Hung, R., et al (2015) Flight to Quality, Understanding Factor Investing.

Qualifying the efficacy of quality internationally

Before assessing quality in Australia, it is important to confirm that the quality factor works as intended in international markets. To test the efficacy, MSCI World ex Australia Quality Index is used as the reference for quality performance, and it selects the 300 highest scoring companies based on MSCI defined quality fundamentals. This is the reference index for VanEck MSCI International Quality ETF (ASX Ticker: QUAL) which launched on 29 October 2014, and has grown to be the largest smart beta ETF on the Australian Stock Exchange (ASX) at $7.7 billion as at 31 March 2026.

Long term outperformance: From December 1994 to March 2026, the Quality index outperformed its parent benchmark, the MSCI World ex Australia Index, by 3.12% p.a., and delivered consistent risk-adjusted outperformance represented by a positive information ratio on a 36-month rolling basis (see Appendix Exhibits 1 and 2). Noting that past performance is not indicative of future performance.

Drawdown protection: This outperformance has not come at the expense of higher risk. During the GFC and COVID-19 market drawdowns, the Quality Index fell less than the parent benchmark, and returned to previous highs 27 months and 4 months faster, respectively (see Appendix Exhibit 3).

Flight to quality during stress events: When lower economic growth concerns affect global markets and volatility increases, you typically see a flight to quality, where the factor outperforms, as observed during the dot com bubble, GFC, Eurozone Crisis, 2018 US-China Trade War, COVID-19, and last year's US liberation day (see Appendix Exhibit 4).

Lower beta: The rolling three-year beta has remained at or below 1.0 for most of its history, consistent with the defensive nature of a quality strategy (see Appendix Exhibit 5).

Low exposure to cyclical sectors: The strategy has maintained a persistent overweight to defensive sectors such as health care and consumer staples, and underweight exposure to cyclicals including financials, consumer discretionary and energy (see Appendix Exhibit 6).

Low growth, large cap and negative momentum tilt: Multi-linear regression analysis confirms international quality has a large cap, growth and negative momentum tilt, with large cap and growth statistically significant at a p-value below 5% (see Appendix Exhibits 7 and 8). This aligns with expected quality behaviour: large caps are sought in market stress; the growth tilt reflects outperformance in lower growth environments with falling long dated government bond yields; and negative momentum is associated with lower market beta.

Outperformance during lower inflation and growth environments: Analysis of historical performance confirms that international quality factor produced the highest excess returns during lower inflation and growth environments. Additionally, that international quality factor outperformed when the US economic cycle with changes in manufacturing activity as a proxy were in a slowdown, contraction and recovery phases (see Appendix Exhibits 9 to 11).

These examples and metrics confirm that quality, as a single factor strategy, performed as intended in international equity markets.

Testing the efficacy of the quality factor in Australia

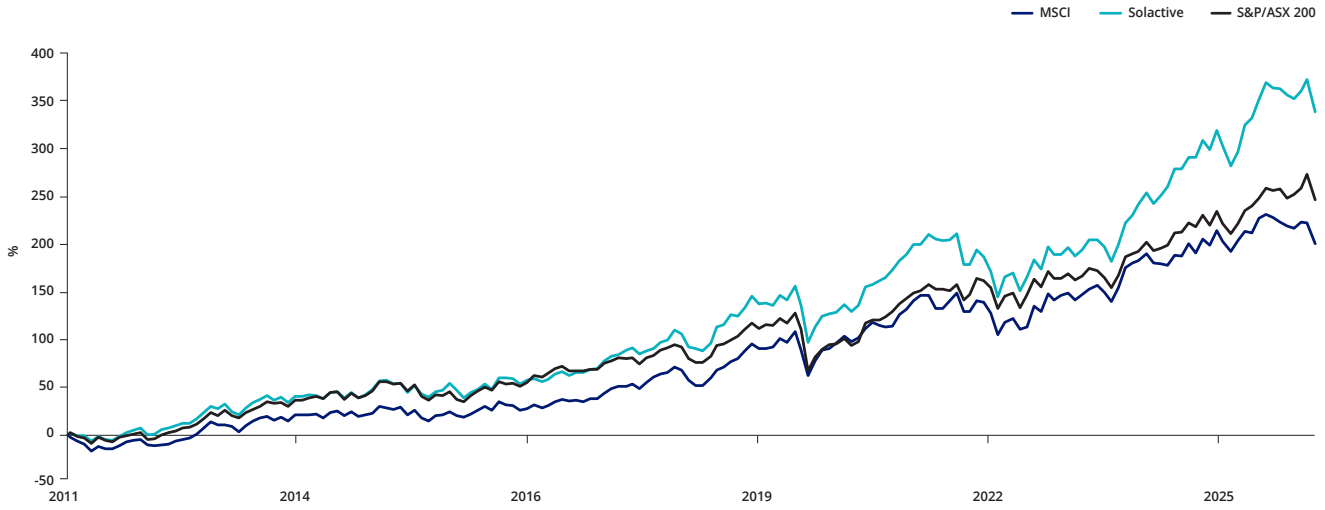
There are two indices that attempt to capture the quality factor in the Australian market; Solactive Australia Quality Select index and MSCI Australia IMI Quality. These both select companies using MSCI defined quality fundamentals.

To test their efficacy, we apply the same tests used to qualify the international quality factor to assess whether these indices deliver the characteristics investors should expect in the Australian share market.

Mixed performance

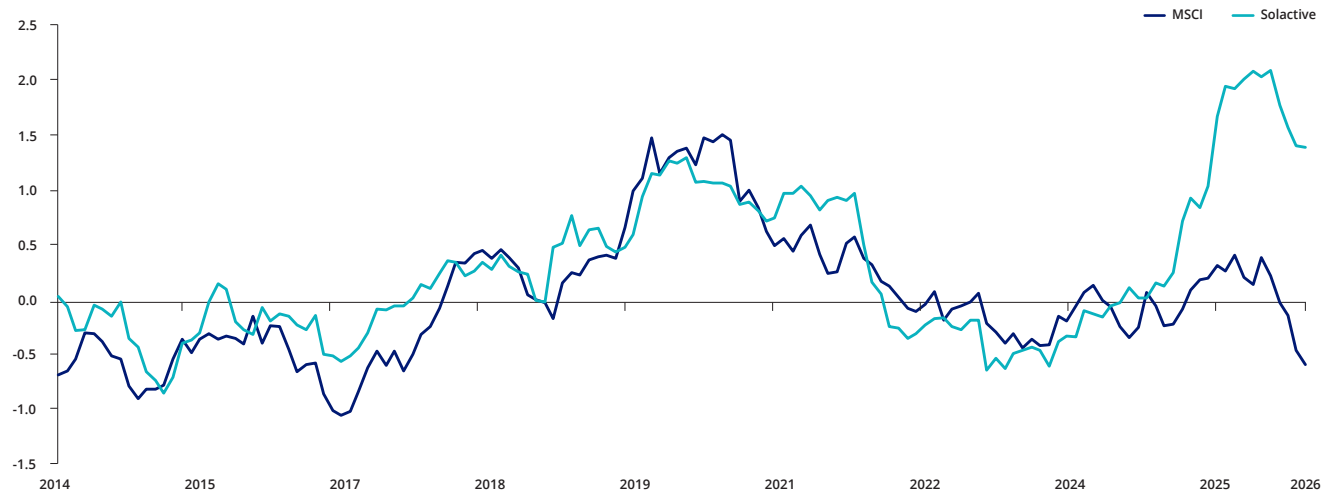
Despite targeting the same quality fundamentals, the performance results are materially different. The Solactive strategy has outperformed but has not been consistent on a risk-adjusted basis. The rolling three-year information ratio has oscillated between positive and negative territory and has had prolonged periods below zero. The MSCI strategy has underperformed. The inconsistency suggests that any outperformance is episodic rather than structural.

Exhibit 1: Cumulative performance



Source: Morningstar, 31 Dec 2010 to 31 Mar 2026. MSCI as MSCI Australia IMI Quality Index, Solactive as Solactive Australia Quality Select index. You cannot invest in an index. Past performance is not indicative of future performance.

Exhibit 2: 36 month rolling information ratio

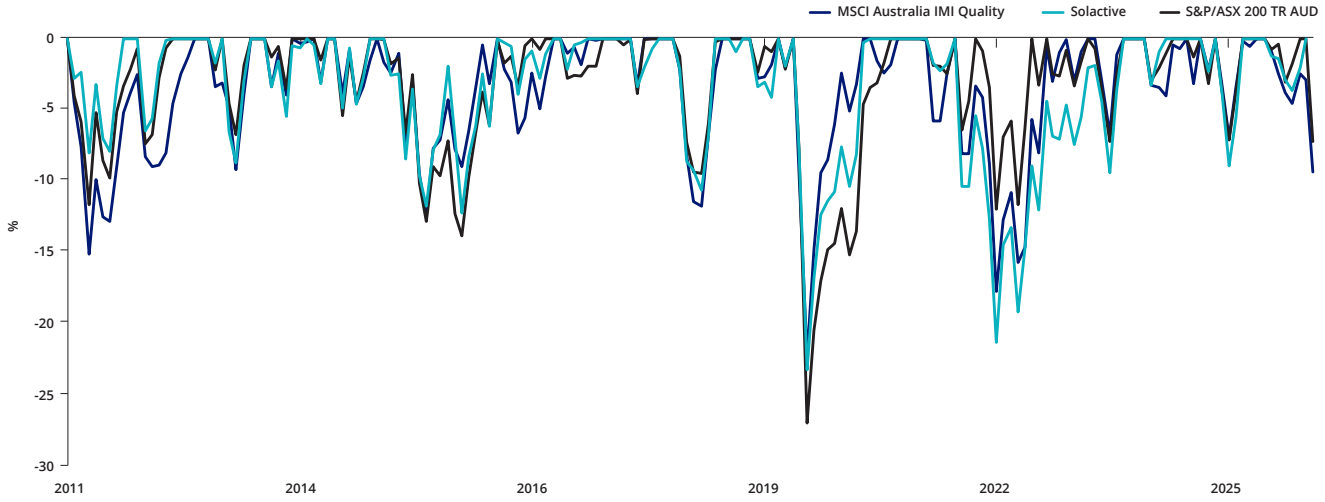


Source: Morningstar, 31 Dec 2010 to 31 Mar 2026. MSCI as MSCI Australia IMI Quality Index, Solactive as Solactive Australia Quality Select index.

No drawdown protection

A quality strategy should typically provide downside protection during market stress. But neither strategy has. During several stress event periods including the 2018 US/China trade war, 2024 yen carry trade and 2025 US liberation day events, the drawdown for both strategies was larger than the S&P/ASX 200.

Exhibit 3: Drawdown

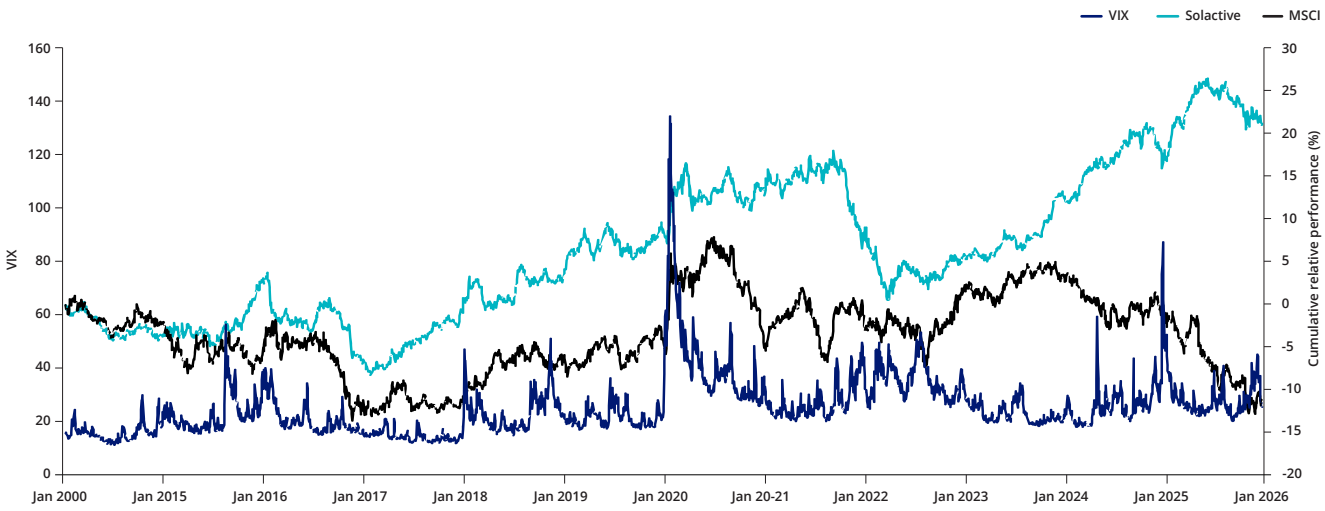


Source: Morningstar, 31 Dec 2010 to 31 Mar 2026. MSCI as MSCI Australia IMI Quality Index, Solactive as Solactive Australia Quality Select index.

No flight to quality during stress events

Neither strategy shows a definitive positive correlation between VIX spikes and the index's relative performance versus the S&P/ASX 200.

Exhibit 4: Cumulative relative performance versus VIX index

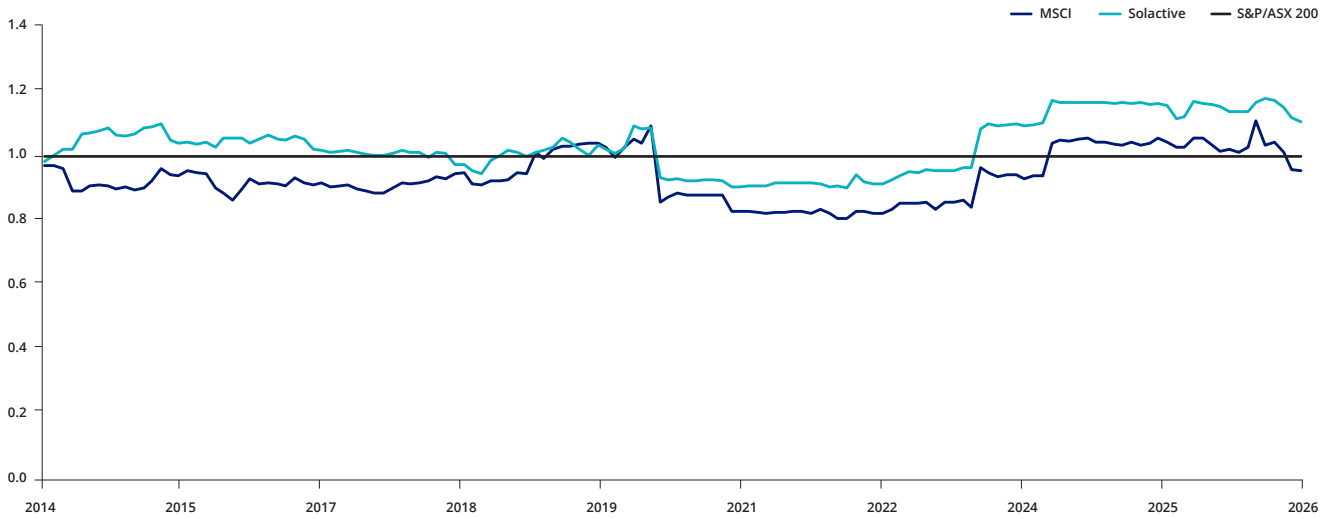


Source: Morningstar, 31 Dec 2010 to 31 Mar 2026. MSCI as MSCI Australia IMI Quality Index, Solactive as Solactive Australia Quality Select index. You cannot invest in an index. Past performance is not indicative of future performance.

Higher beta

The MSCI strategy has demonstrated a lower beta. However, the Solactive strategy's higher drawdowns and upside capture ratio has culminated in a rolling three-year beta persistently above 1.0 relative to the S&P/ASX 200, reaching levels above 1.15 in recent periods. This characteristic is more akin to the growth factor rather than quality.

Exhibit 5: 36 month rolling beta

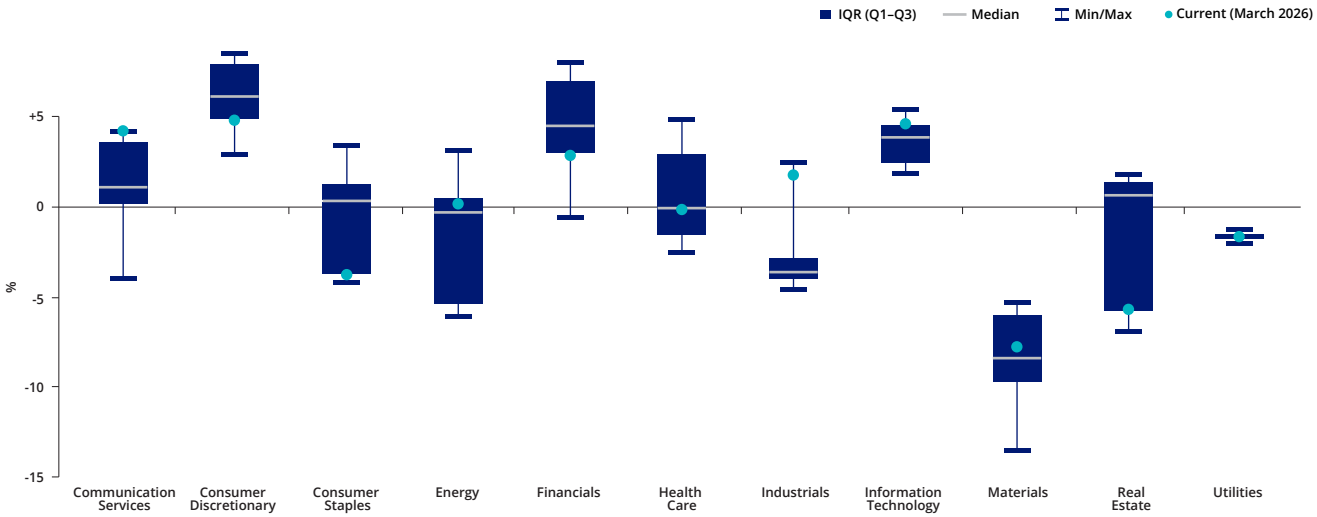


Source: Morningstar, 31 Dec 2010 to 31 Mar 2026. MSCI as MSCI Australia IMI Quality Index, Solactive as Solactive Australia Quality Select index.

High exposure to cyclical sectors

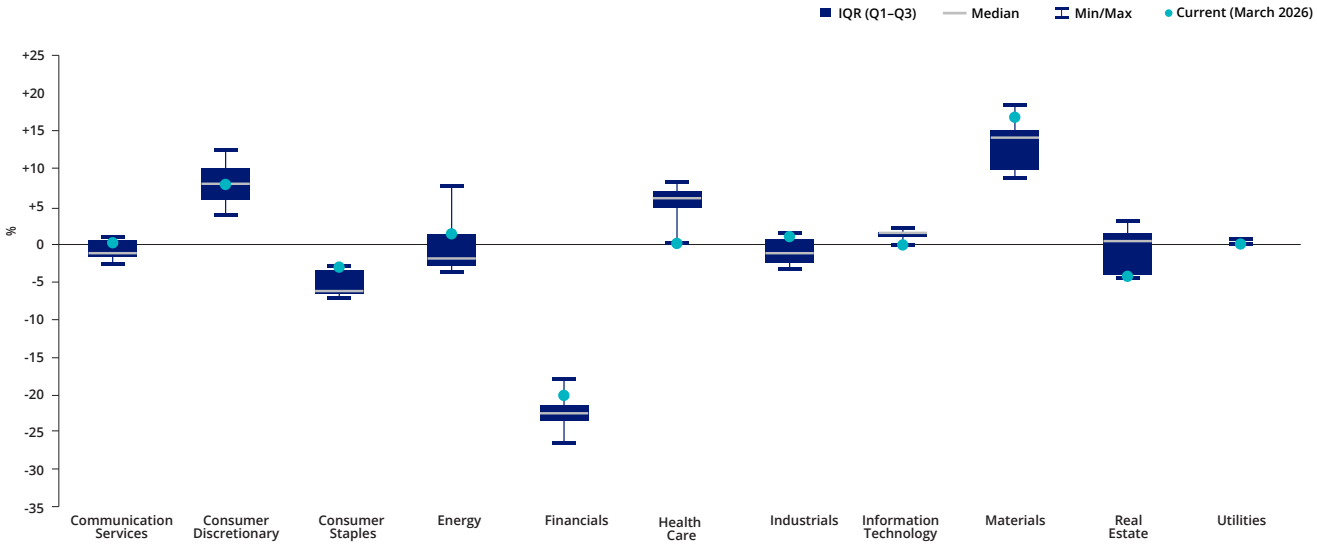
The sector composition tells a different story to what the international quality strategy delivered. MSCI and Solactive Australian quality strategies maintain a persistent overweight to financials and materials respectively and to consumer discretionary, which is cyclical. Both strategies have been underweight the defensive sector, consumer staples.

Exhibit 6: Solactive Sector Active Weight Distribution



Source: Morningstar, 30 Apr 2022 to 31 Mar 2026.

Exhibit 7: MSCI Sector Active Weight Distribution



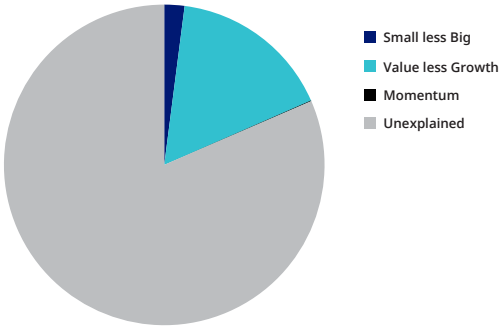
Source: Morningstar, 30 Apr 2022 to 31 Mar 2026.

Inconsistent factor exposure

We applied the same multi-linear regression analysis against market beta, size, growth, value and momentum. Regression analysis is a statistical method used to explain why something happened in relation to something else.

The results showed that both strategies had a higher proportion of performance unexplained by factors. The Solactive strategy had a higher correlation to growth but, uncharacteristically, also a high correlation to smaller companies.

Exhibit 8: Solactive Performance contribution beyond market beta (R2)



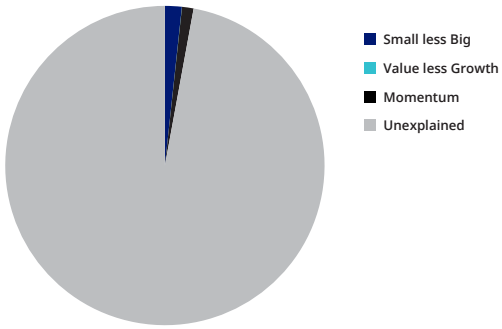
Source: Morningstar, VanEck, MSCI. 30 Apr 2022 to 31 Mar 2026.

Exhibit 9: Solactive Factor coefficient

Factor	Coefficient	P-Value
Market	1.14	0.0%
Small less Big	0.11	15.5%
Value less Growth	-0.15	2.7%
Momentum	0.02	87.7%

Source: Morningstar, VanEck, MSCI. 30 Apr 2022 to 31 Mar 2026.

Exhibit 10: MSCI Performance contribution beyond market beta (R2)



Source: Morningstar, VanEck, MSCI, 30 Apr 2022 to 31 Mar 2026.

Exhibit 11: MSCI Factor coefficient

Factor	Coefficient	P-Value
Market	0.96	0.0%
Small less Big	-0.09	43.7%
Value less Growth	-0.02	84.1%
Momentum	-0.09	55.1%

Source: Morningstar, VanEck, MSCI. 30 Apr 2022 to 31 Mar 2026.

These examples and metrics confirm, in our view, that a single quality factor approach in Australia does not behave as investors would expect.

Why can't the characteristics of international single factor strategies be replicated in Australian equities? It is worth, then, to consider the characteristics of the Australian equities market and the companies included.

The Australian Concentration Conundrum

The Australian indices' failure to deliver genuine quality characteristics is not unique. It is a structural problem inherent to the Australian equity market. In our research paper *The Australian Concentration Conundrum*, we showed that single factor strategies applied in Australian equities fail to achieve factor efficacy for three distinct reasons: high stock and sector concentration, and smaller starting universe.

The annual rebalance of the Solactive index also poses a challenge.

Stock concentration

The S&P/ASX 200 is one of the most concentrated equity markets in the developed world. The top 10 stocks account for almost 50% of total exposure. This concentration limits the ability to construct a meaningfully differentiated factor portfolio.

Sector concentration

Financials and materials account for more than 50% of the S&P/ASX 200. These sectors behave differently to other sectors. Banks are highly leveraged and miners have volatile earnings, lacking quality characteristics. This means constructing a benchmark aware strategy dilutes exposure to the quality factor.

Small starting universe

With only 200 stocks in the S&P/ASX 200, constructing a portfolio subset based on factor scores increases idiosyncratic stock exposure, limiting systematic factor exposure.

The annual rebalance amplifies the challenge

The Solactive strategy rebalances annually. An annual rebalance means the portfolio is therefore slow to respond to deteriorating factor signals. This is more prevalent given the more cyclical nature of the Australian equities market.

Conclusion

The quality factor in international equity markets has been an effective defensive strategy over the long term, delivering risk-adjusted outperformance, lower beta, shallower drawdowns and outperformance during periods of market stress, and lower inflation and growth regimes. However, when a single factor quality strategy is applied in Australian equities it fails to achieve factor efficacy for three reasons: stock concentration, sector concentration and a small starting universe.

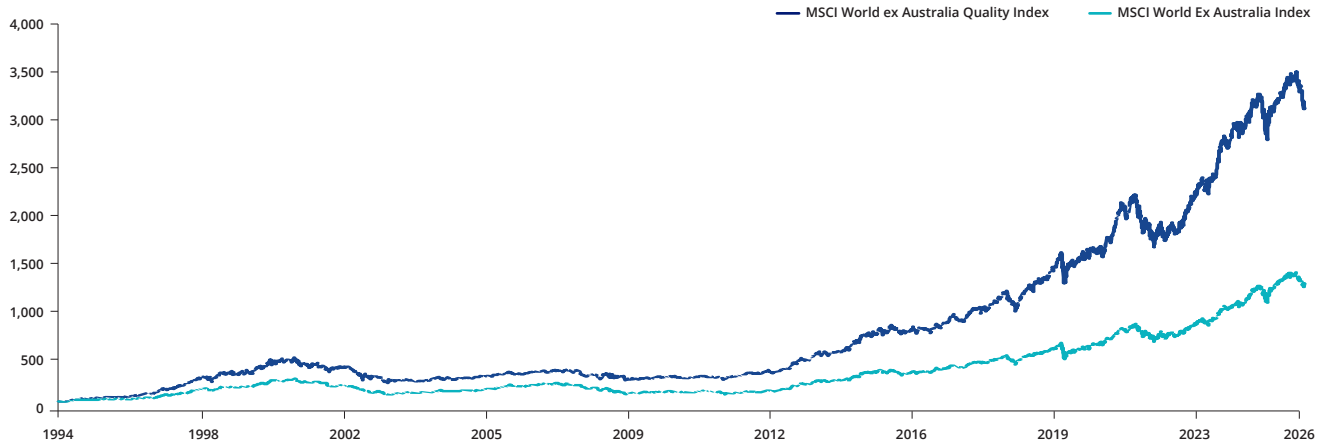
This does not mean quality cannot be achieved in Australian equities, but rather that a pure single-factor quality approach is unlikely to be the most effective implementation in a concentrated, cyclical market such as Australia. The more effective path is an index that places quality characteristics at the centre of construction and uses complementary characteristics to manage the sector and concentration risks that undermine single-factor approaches in this market. Identifying the most effective implementation approach is a priority within our ongoing research.

Investors seeking true quality equity exposure should look beyond the Australian market to international strategies where the universe offers the breadth and depth of companies to perform as intended.

For those seeking diversified exposure to Australian equities, alternative approaches such as equal weighting are worth considering, which have performed as intended. For further details see VanEck's paper *Why Equal Weighting Outperforms: The Mathematical Explanation*.

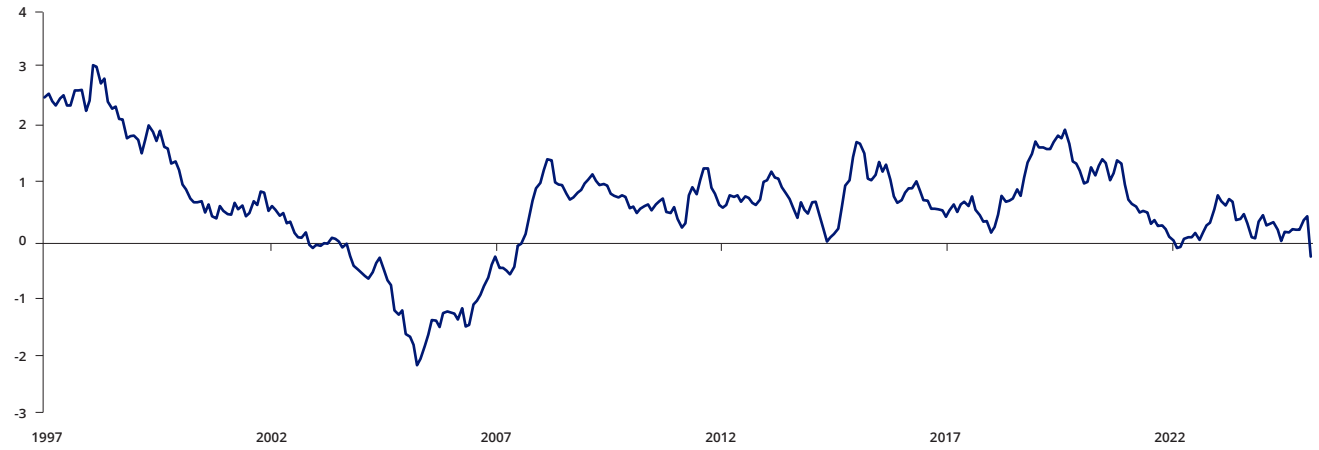
Appendix: International quality exhibits

Appendix Exhibit 1: Cumulative performance



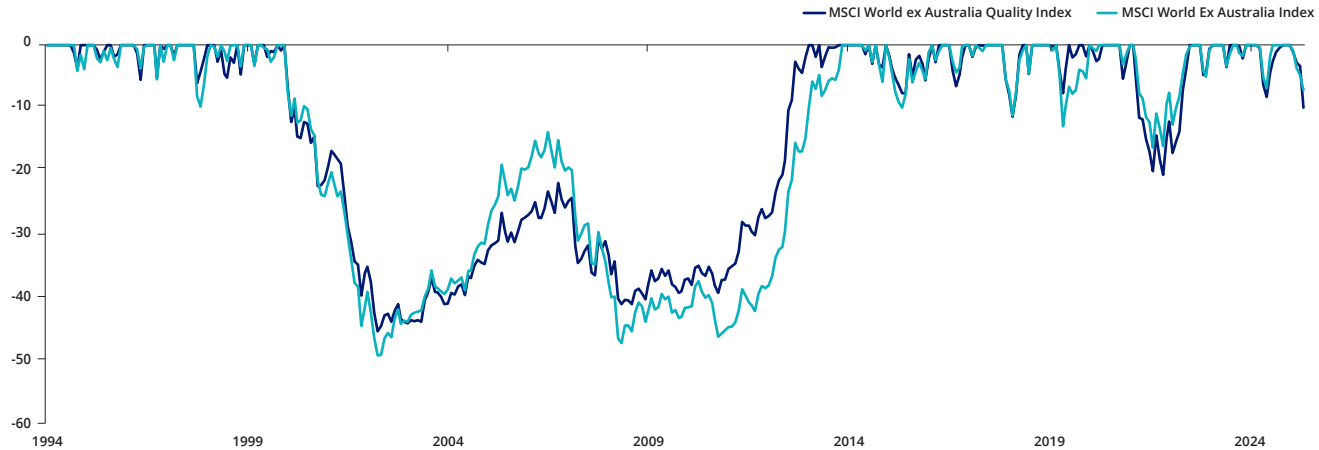
Source: Morningstar, 31 Dec 1994 to 31 Mar 2026. You cannot invest in an index. Past performance is not indicative of future performance.

Appendix Exhibit 2: 36 month rolling information ratio



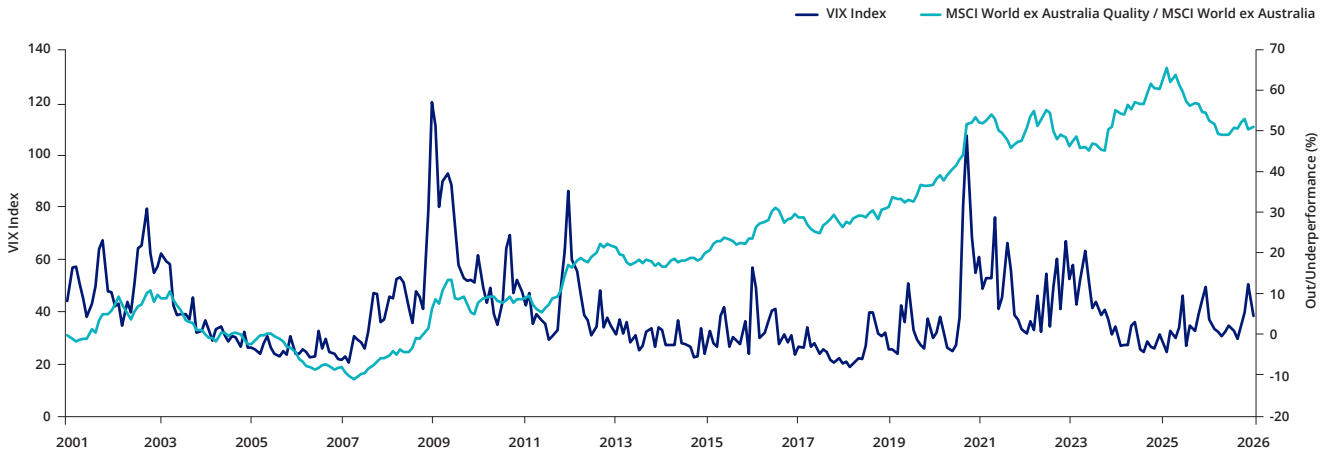
Source: Morningstar, 31 Dec 1994 to 31 Mar 2026.

Appendix Exhibit 3: Drawdown



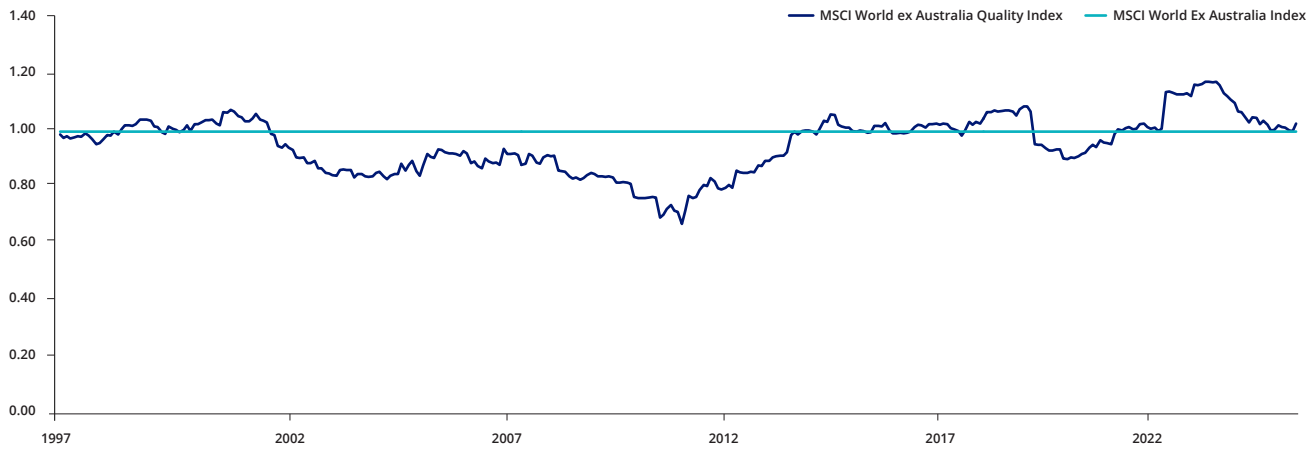
Source: Morningstar, 31 Dec 1994 to 31 Mar 2026.

Appendix Exhibit 4: Cumulative relative performance versus VIX index



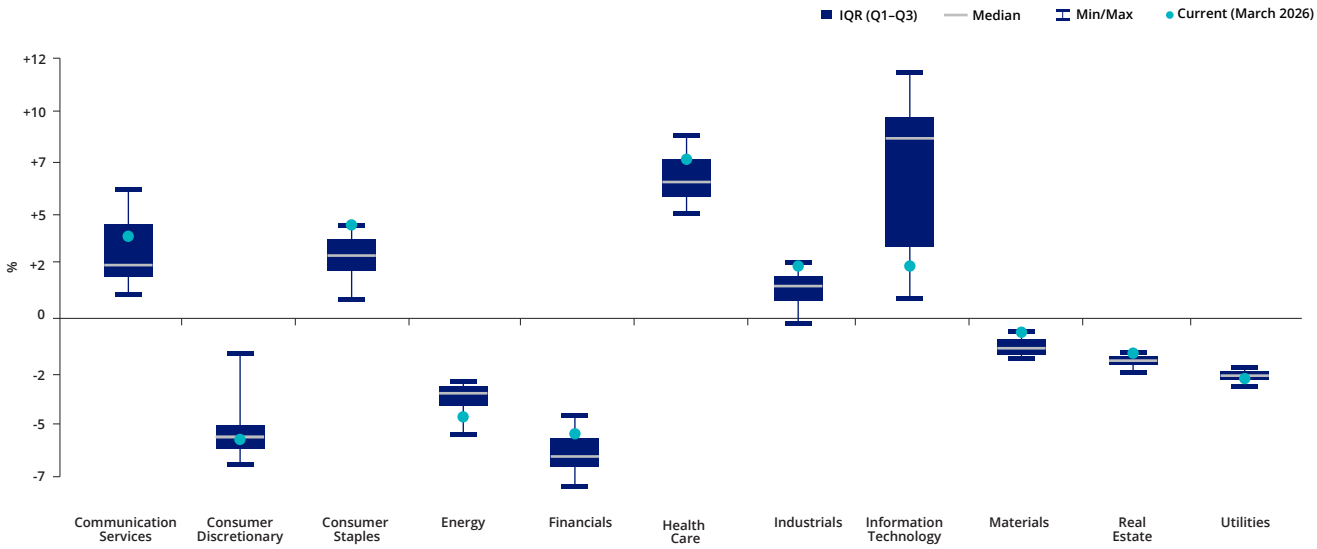
Source: Morningstar, 31 Dec 1994 to 31 Mar 2026.

Appendix Exhibit 5: 36 month rolling beta



Source: Morningstar, 31 Dec 1994 to 31 Mar 2026.

Appendix Exhibit 6: Sector active weight distribution



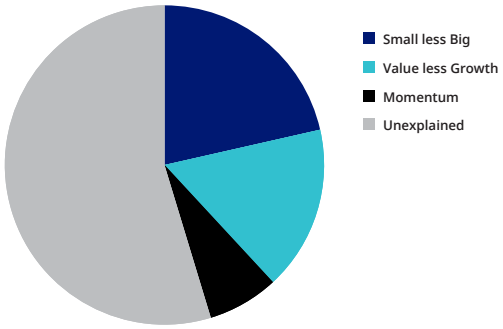
Source: Morningstar, 31 Dec 1994 to 31 Mar 2026.

Multi-linear regression methodology

To assess the behaviour of the quality factor we analysed the performance attribution using multi-linear regression analysis against market beta, size, growth, value and momentum. Regression analysis is a statistical method used to explain why something happened in relation to something else. The results, based on the coefficients which specifies the direction of attribution and the R squared contribution, show that international quality has a large cap, growth and negative momentum tilt. Additionally, that attribution to large cap and growth was statistically significant with a p-value below 5%.

This finding aligns with the behaviour expected from the quality factor for several reasons. First, in times of market stress we see a flight to quality, which typically favours large caps as they are more liquid mature businesses generally offering lower financial leverage and stable earnings growth throughout the economic cycle. Second, the growth tilt is explained by the fact that quality typically outperforms in lower growth and inflation environments which often corresponds with falling long dated yields. Provided that low growth is a 'soft landing' this dynamic is also positive for growth stocks due to their longer duration profile, as it increases the present value of future earnings and supports the key fundamentals targeted. Third, the negative momentum tilt is associated with quality offering a lower market beta.

Appendix Exhibit 7: Performance contribution beyond market beta (R^2)



Source: Morningstar, 31 Mar 1994 to 31 Mar 2026.

Appendix Exhibit 8: Factor coefficient

Factor	Coefficient	P-Value
Market	0.98	0.0%
Small less Big	-0.32	0.8%
Value less Growth	-0.35	4.3%
Momentum	-0.14	9.1%

Source: Morningstar, VanEck, MSCI. 31 Mar 2016 to 31 Mar 2026.

Quality during various economic regimes

To assess the behaviour of the quality factor during various regimes, we calculated the annualised performance and compared it against US inflation and real GDP growth on a year-on-year basis. The analysis shows that the quality factor has produced the highest excess returns during lower inflation and economic growth environments.

Appendix Exhibit 9: Excess return by inflation and GDP regimes

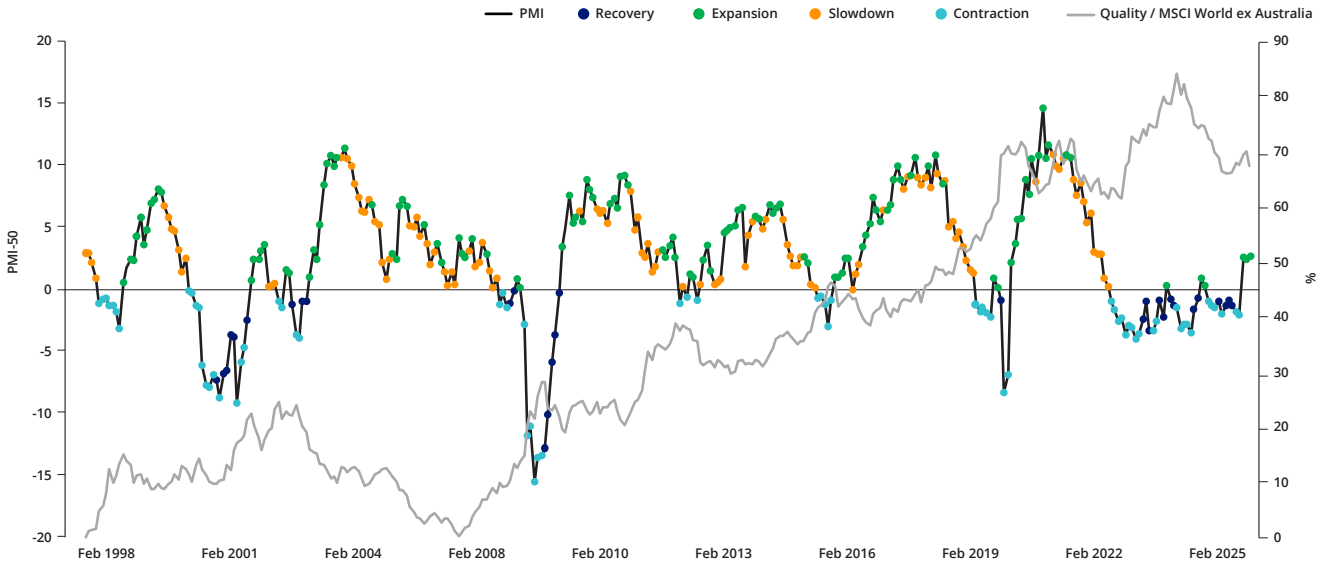
Quality factor excess returns

Ann. excess		US CPI ≤ 2.5%	US CPI > 2.5%
	US GDP ≤ 2.5%	+3.4%	+1.6%
	US GDP > 2.5%	-0.1%	+1.2%
# Calendar year observations	GDP ≤ 2.5%	9	5
	GDP > 2.5%	6	6

Source: Morningstar, VanEck, MSCI. 31 December 1999 to 31 December 2025.

To illustrate how the quality factor performs during various phases of the economic cycle, we overlay the ISM manufacturing activity (a proxy for economic activity) with the relative performance of quality against the parent benchmark as represented by the black line. When the black line is rising, quality is outperforming. In the chart below each economic cycle 'regime' is represented by a colour: recovery (blue), expansion (green), slowdown (orange) and contraction (purple).

Appendix Exhibit 10: Quality relative performance versus ISM manufacturing activity



Source: ISM, VanEck, MSCI. 28 February 1998 to 31 March 2026.

The grey line illustrates that quality has outperformed over the long term, but it is also evident that quality had periods of outperformance and underperformance and that these tend to correlate to the economic cycle. The table below represents the excess returns of the quality factor through the cycle.

You can see that quality historically outperformed during a slowdown, contraction and subsequent recovery, reinforcing its defensive characteristics.

Appendix Exhibit 11: Quality excess return by manufacturing activity regimes

Period	**Recovery**	**Expansion**	**Slowdown**	**Contraction**	**Total**
Quality	5.19%	-1.10%	2.20%	5.56%	1.95%

Source: ISM, VanEck, MSCI. 28 February 1998 to 31 March 2026. You cannot invest in an index. Past performance is not indicative of future performance.

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