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The long term case for Quality

April 2020

Introduction

The portfolio benefits of including international equities have been well documented. International equities provide:

1. Better geographic diversification - the Australian stock market represents around 3% of global stock markets;
2. Better sector diversification - Australia is dominated by resources and financials with limited opportunities in technology and health care; and
3. Exposure to different economic cycles.

Despite these diversification benefits, Australian investors are underweight international equities. According to Towers Watson, after the US, Australian pension funds have the largest home bias in domestic equities. The bias to domestic equities is understandable as local stocks are more easily understood and recognised by investors and they are easier to trade. As a result, most Australian investors are missing opportunities that are only available offshore.

The economic cycles this century highlight the importance that investors have a diversified portfolio including international shares to maximise returns and minimise risk.

As an example, in the bull market prior to the GFC (Global Financial Crisis), the investment case for international equities for an Australian investor, was not so compelling. Just prior to the GFC impacting markets, as at June 2007, a review of the performance of international equities as measured by the MSCI World ex Australia Index over five and ten years, the long term trailing periods that investors consider, showed returns of 4.7% p.a. and 5.5% p.a. respectively. Over the same periods the S&P/ASX All Ordinaries Index ("All Ords") returned 19.5% p.a. and 13.1% p.a. respectively.

The result for Australian investors overexposed to domestic equities was positive pre-GFC.

By failing to include international equities in their holdings prior to the GFC however, most Australian investors missed the stellar returns experienced by international equities in the post-GFC recovery. If we fast forward to the time of writing, to 31 March 2020, a review of the respective index performance tells a very different story. Driven by sustained low interest rates and the longest US bull market in history, over five years the MSCI World ex Australia Index had returned 8.1% p.a. while the All Ords had returned 1.5% p.a. Over 10 years to 31 March 2020, the MSCI World ex Australia Index had returned 11.2% p.a. outpacing the All Ords return of 4.8% p.a. over the same period.

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A diversified portfolio that includes both domestic and international equities would have resulted in less volatile returns over these different cycles. Over the 20+ years of analysis outlined above (1 July 1997 to 31 March 2020) a 50% blend of each index would have only experienced volatility, as measured by standard deviation of returns, of 11.0%. This compares favourably to the standard deviations of the MSCI World ex Australia Index (11.9%) and the All Ords (13.5%) over that same timeframe.

Naturally, investors need to be cautious about what shares to buy and when to buy them. Investing in international equities is for the long term and the principles for investing are the same as investing locally.

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Selecting Quality international equity stocks

Over the long term, the equity investment strategies that have done well have focused as much on capital preservation as achieving growth. Benjamin Graham, author of *The Intelligent Investor*, highlights the importance of capital preservation, "Once you lose 95% of your money, you have to gain 1,900% just to get back to where you started."

"Graham will always be remembered as the father of Value investing" (Novy Marx, 2013) and is perhaps the second most famous investor in the world, surpassed only by his pupil, Warren Buffett. Buffet and Graham have demonstrated long term outperformance using similar investment methods.

Graham is perhaps best known for his 'margin of safety' and buying stocks on the basis of valuation metrics, but according to Novy Marx, "Graham never advocated just buying cheap stocks." Novy Marx said, "Graham was just as concerned with the quality of a firm's assets as he was with the price that one had to pay to purchase them." In *The Intelligent Investor* (1973), the tome Buffett calls "the best book about investing ever written" 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." Five quality criteria that Graham insists a company should meet for inclusion in an investor's portfolio are:

1. "Adequate" enterprise size, as insulation against the "vicissitudes" of the economy;
2. Strong financial condition, measured by current ratios that exceed two and net current assets that exceed long term debt;
3. Earnings stability, measured by 10 consecutive years of positive earnings;
4. A dividend record of uninterrupted payments for at least 20 years; and
5. Earnings-per-share growth of at least one-third over the last ten years.

Academics identify these demands as 'Quality' characteristics. Quality "has no universally accepted definition" (Novy Marx, 2012) but an analysis of well-known characteristics identified in academic research demonstrates Quality companies are commonly characterised by low debt, stable earnings growth and other metrics such as strength of balance sheet, accounting policies, accruals, and cash flows (Bender et al, 2013).

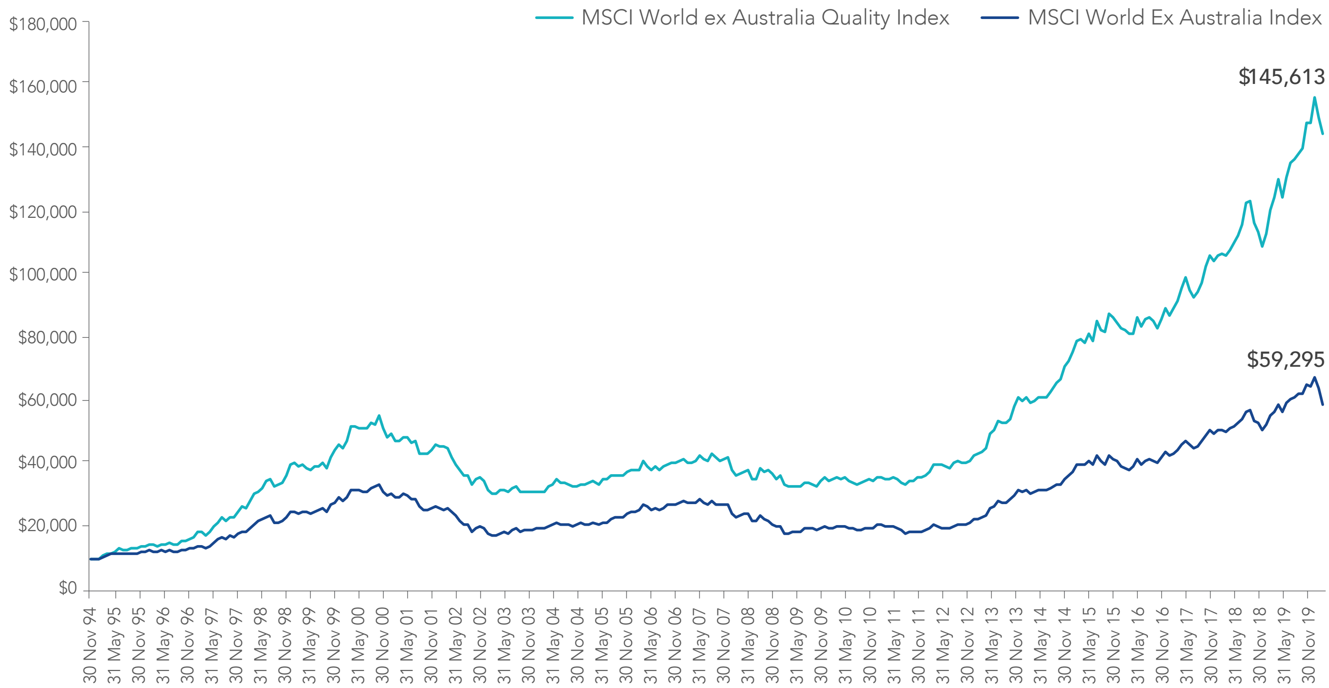
MSCI, the world's largest index provider and the creator of the first international index states, "Quality growth companies tend to have high return of equity (ROE), stable earnings that are uncorrelated with the broad business cycle and strong balance sheets with low financial leverage. Many active strategies emphasise Quality growth as an important factor in their security selection and portfolio construction." Based on this, MSCI Quality scores are based on three fundamental characteristics:

1. High return on equity;
2. Stable earnings growth; and
3. Low debt-to-equity ratio.

There is a parallel between MSCI's Quality characteristics and those Graham insisted investors should demand from companies. Graham defined a strong financial position as one where long-term debt does not exceed current net assets and there is a high ROE. Graham argued that the best way to determine whether earnings will be maintained is to examine the earnings of the company over its past ten years. This is almost exactly what MSCI seeks to do with its Quality factor.

MSCI analyses these three financial characteristics for its Quality Indices, which includes the MSCI World ex Australia Quality Index. The MSCI World ex Australia Quality Index demonstrates outperformance against the Australian investor's standard international equities benchmark, the MSCI World ex Australia Index over the long term.

Chart 1: Hypothetical growth of $10,000 – 30 November 1994 to 31 March 2020



Source: Morningstar Direct, as at 31 March 2020. QUAL Index base date is 30 November 1994

The above graph is a hypothetical comparison of performance of a $10,000 investment in the MSCI World ex Australia Quality Index and the MSCI World ex Australia Quality Index. The calculations for the above include the reinvestment of all dividends but do not include fees and other costs of an investment in the fund. You cannot invest directly in the Index. The above performance information is not a reliable indicator of current or future performance of the indices, QUAL or QHAL, which may be lower or higher.

Quality for the long term

MSCI notes that its factor indices "are highly cyclical" (Gupta et al, 2014). So while the MSCI World ex Australia Quality Index is able to illustrate outperformance over the long term, there will be economic periods in which the Quality factor underperforms.

In 2014 Gupta and his MSCI colleagues, as part of research analysing the performance of indices in different economic conditions, over a period of almost 40 years, conducted a bivariate analysis of the performance of the MSCI World Quality Index, the MSCI World Index and MSCI's World Sector Indices. The analysis classified four different economic conditions identified by rising and falling OECD growth and inflation and analysed the performance of these indices during multiple cycles. The results demonstrate that Quality consistently outperforms in all but one of four economic conditions, namely during periods of rising growth and falling inflation. A summary of the analysis is below.

Table 1: Summary of bivariate analysis of MSCI Quality and sector indices in different economic cycles

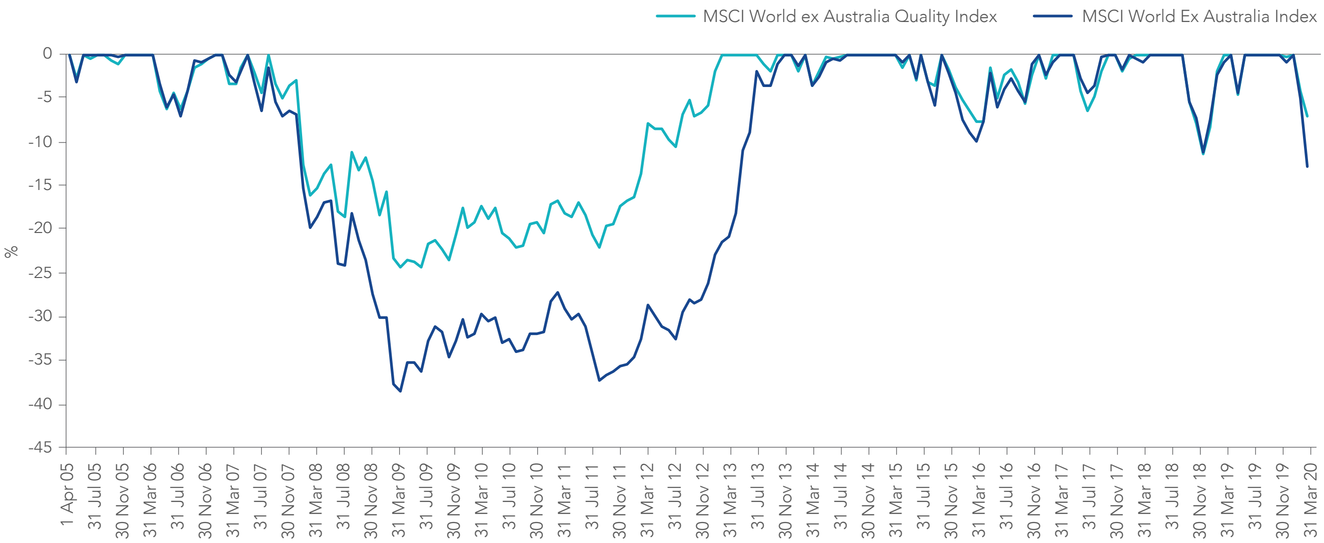
Economic conditions	Quality factor performance	Sector comments
Rising inflation/rising growth	Moderate outperformance	IT sector outperforming; financials and telecommunications underperforming
Falling inflation/rising growth	Moderate underperformance	Energy and materials outperforming; health care and consumer sectors underperforming
Falling inflation/slowing growth	Strong outperformance	Health care and consumer staples outperforming; materials, energy and industrials underperforming
Rising inflation/slowing growth	Strong outperformance	Health care, energy and consumer staples outperforming; consumer discretionary and materials underperforming

Source: VanEck, Gupta et al, 2014, Period of analysis, December 1975 to December 2013.

MSCI World Quality Index traditionally has its strongest relative performance during economic downturns. Recall the importance of capital preservation Graham discussed. A measure called 'drawdown' demonstrates both the depth of a fall from an historical peak and the pace of the recovery to a new peak. The chart below shows the drawdown of the MSCI World ex Australia Quality Index versus the broader MSCI World ex Australia Index for the past 15 years, capturing the GFC. In summary:

- The maximum drawdown of the Quality Index was 24.28% versus the benchmark's much bigger fall of 38.41%.
- The pace of recovery of the Quality Index was eight months faster.

Chart 2: Drawdown – 1 April 2005 to 31 March 2020



Source: Morningstar Direct. The calculations for the above include the reinvestment of all dividends but do not include fees and other costs with an investment in the fund. You cannot invest in an index. Past performance is not a reliable indicator of future performance of the indices, QUAL or QHAL.

The Quality factor tends to be more defensive, generating its most sustained relative outperformance in weaker macroeconomic environments. Table 2 below highlights market crises and Quality's lower drawdowns and quicker recoveries.

Table 2: Periods of Quality outperformance

Financial crisis	Quality Index (Maximum Drawdown)	Benchmark (Maximum Drawdown)	Relative recovery rate of Quality Index
March 2000 – Dot-com bubble	-45.02%	-48.74%	10 months faster
October 2007 – Stock market sell off	-21.95%	-34.93%	9 months faster
August 2008 – Lehman Brothers file for bankruptcy	-14.76%	-24.73%	16 months faster
April 2010 – European sovereign debt crisis	-6.48%	-13.83%	11 months faster
February 2020 – COVID-19*	-19.61%	-23.71%	?

*Drawdown to 31 March 2020.

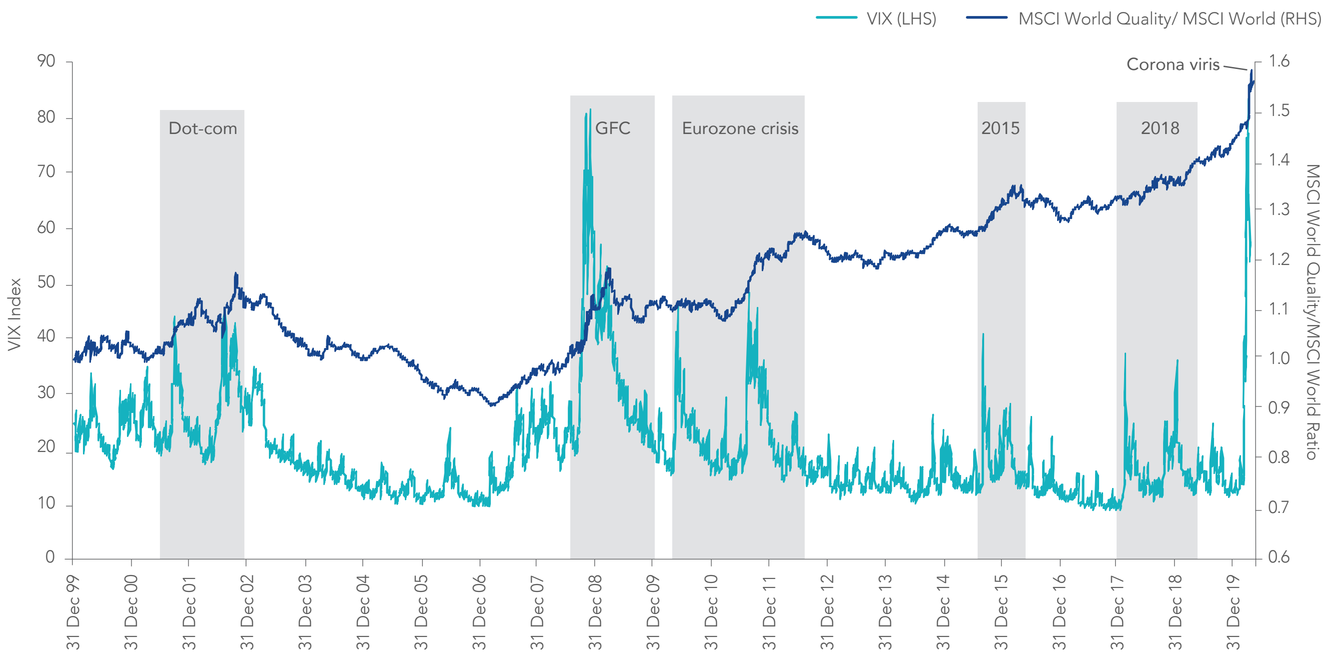
Source: MSCI, VanEck, Morningstar Direct. Comparison of drawdown between the MSCI World ex Australia Quality Index ('Quality Index') versus the MSCI World ex Australia Index ('Benchmark'). Maximum drawdown is the peak to trough decline from the start of the month specified to the recovery date, expressed as a percentage. The rate of recovery is the number of periods taken to recover from the trough to peak incline. The calculations for the above include the reinvestment of all dividends but do not include fees and other costs associated with an investment in the Fund. You cannot invest in an index. Past performance is not a reliable indicator of future performance of the indices, QUAL or QHAL.

While Quality will be impacted by these types of market events, in the past the level of retracement has typically been less severe than the broader market.

This has led to outperformance

History has persistently shown that in times of volatility, Quality companies have outperformed. In the chart below, the blue line is VIX, a real time volatility index, it is also known as the 'fear index' and is a useful gauge of investor sentiment and expected market volatility. Below we plot the VIX Index against a ratio of MSCI's Quality Index and its World Index. When the dark blue line is rising in the chart, Quality is outperforming. In the most recent periods of extreme volatility – 2001's dot-com bust, 2007/08, the Euro debt crises, 2015 and 2018 – Quality has outperformed the market benchmark. You can also see it has outperformed sharply during the start of COVID-19 impacting markets.

Chart 3: Relative performance of Quality vs VIX



Source: MSCI Data/Calculations, Bloomberg, CBRE, December 1999 to 31 March 2020. The chart shows performance of MSCI World Quality relative to MSCI World compared to VIX Index. Results include the reinvestment of all dividends, but exclude fees and other costs associated with an investment in the Fund. You cannot invest in an index. Past performance is not a reliable indicator of future performance of the indices, QUAL or QHAL.

This resilience is one of the reasons Quality companies have outperformed over the long term.

Investing in Quality companies makes sense. Companies that exhibit MSCI's Quality characteristics outperform over the long term. It would be virtually impossible for an Australian investor to know all the companies in the developed world, to analyse their performance to determine the highest quality ones and to execute the trades.

MSCI analyses the 1,500+ companies in the MSCI World ex Australia Index and selects only the top 300 with the best combined results demonstrating high ROE, stable earnings growth and low financial leverage for inclusion in its Quality Index.

You can now make the 300 Quality companies identified by MSCI in its MSCI World ex Australia Quality Index a part of your portfolio via a single trade on ASX. The Quality Index is tracked by an Exchange Traded Fund (ETF) called the VanEck Vectors MSCI World ex Australia Quality ETF with ASX trading code "QUAL".

Since its inception on ASX, QUAL has outperformed all trailing time periods.

Table 4: QUAL performance to 31 March 2020

	1 Year (%)	3 Years (% p.a.)	5 Years (% p.a.)	Since QUAL Inception* (% p.a.)
QUAL	15.63	16.20	12.41	15.60
MSCI World Ex Australia Index	4.44	9.94	8.09	11.38
Difference	+11.19	+6.26	+4.32	+4.22

*Inception date is 29 October 2014

Source: Morningstar Direct, VanEck. Results are calculated to the last business day of the month and assume immediate reinvestment of distributions. QUAL results are net of management fees and other costs incurred in the fund, but before brokerage fees and bid/ask spreads incurred when investors buy/sell on the ASX. Returns for periods longer than one year are annualised. Past performance is not a reliable indicator of future performance.

QUAL is unhedged to foreign currency exposure. For investors wishing to hedge their currency exposure the VanEck Vectors MSCI World ex Australia Quality (Hedged) ETF trades on the ASX under the code "QHAL".

In summary

Investing internationally can provide Australian investors with important diversification benefits. Investing directly can be costly, as can actively managed funds. Up until now the choice on ASX has been limited to market capitalisation based index trackers, which include the good stocks with the bad. QUAL and QHAL address this by only including the top 300 highest Quality companies based on MSCI's Quality characteristics. In summary:

1. QHAL and QUAL are ASX-traded ETFs that provide investors with an international equity portfolio of 300 companies with fundamentals that satisfy key principles of Quality investing advocated by investment greats Benjamin Graham and Warren Buffett, namely:
   i. High ROE;
   ii. Stable year-on-year earnings growth; and
   iii. Low financial leverage.
2. Quality companies have demonstrated outperformance during periods of economic slowdown and over the long term.
3. QHAL and QUAL provide access to 20 developed countries and are overweight sectors such as health care and information technology which are underrepresented in Australia.
4. QHAL is an Australian dollar hedged version of QUAL so you can now also achieve your desired currency exposure.

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