



## Focus: Quality



VALUE



SIZE



MOMENTUM



QUALITY



YIELD



VOLATILITY



GROWTH



LIQUIDITY

# Factor focus: Quality

In the realm of investing, a factor is any characteristic that helps explain the long-term risk and return performance of an asset. MSCI Factor Indexes are designed to capture the return of factors which have historically demonstrated excess market returns over the long run.

MSCI Factor Indexes are rules-based, transparent indexes targeting stocks with favorable factor characteristics – as backed by robust academic findings and empirical results – and are designed for simple implementation, replicability, and use for both traditional indexed and active mandates.

## Defining Quality

The Quality factor is described in academic literature as capturing companies with durable business models and sustainable competitive advantages. Quality is categorized as a “defensive” factor, meaning it has tended to benefit during periods of economic contraction (see “Performance and Implementation”).

The quality factor has helped explain the movement of stocks that have low leverage, stable earnings and high profitability.

The MSCI Quality Index employs three fundamental variables to capture the quality factor:

- **Return on equity** – which shows how effectively a company uses investments to generate earnings growth;
- **Debt to equity** – a measure of company leverage; and
- **Earnings variability** – how smooth earnings growth has been

## Why investors have used quality strategies

The long-term outperformance of the quality factor against the market is well documented in financial literature. Nobel

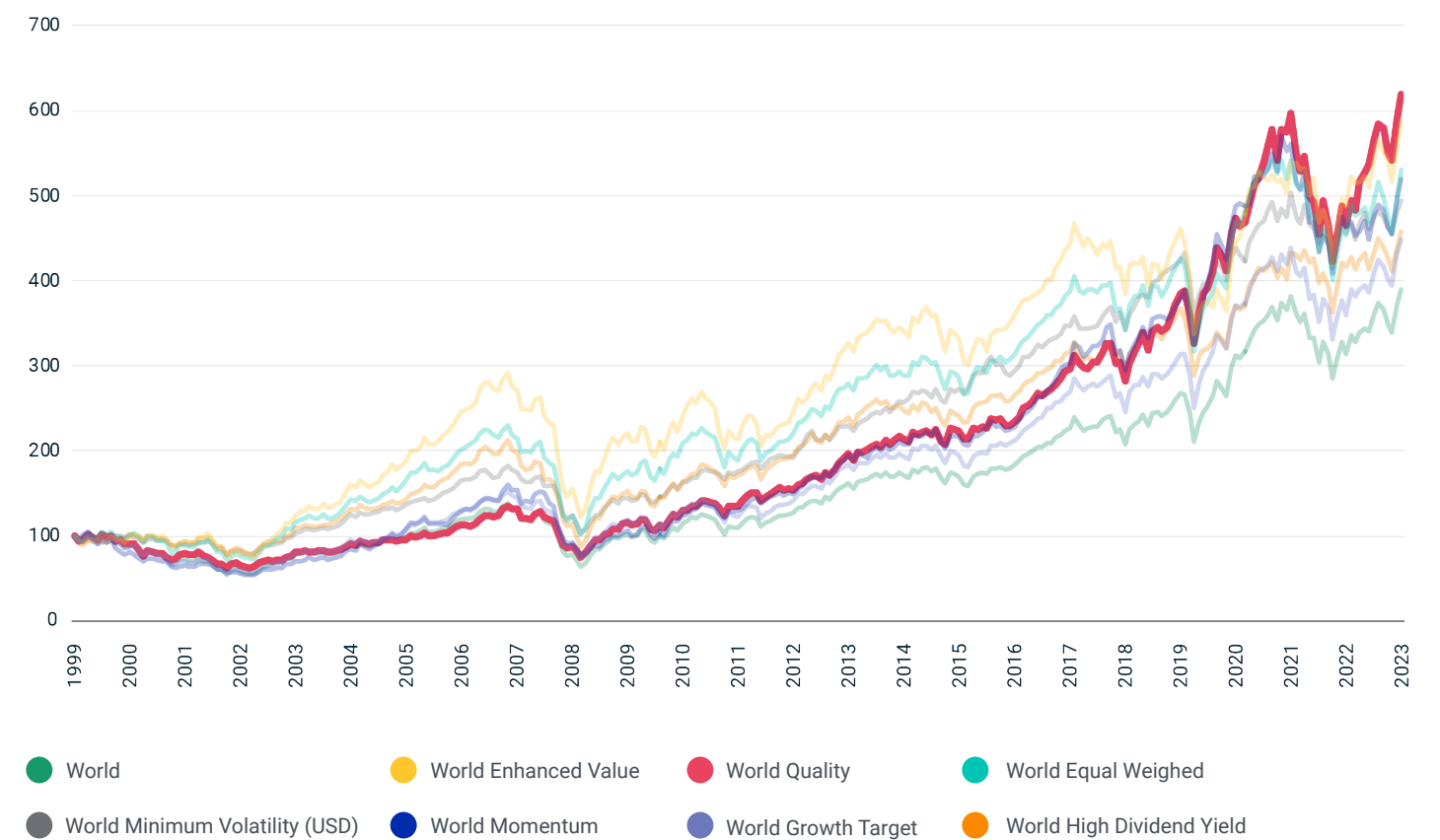
laureates Eugene Fama and Kenneth French, economists known for their groundbreaking work in explaining stock returns, recently revised their signature three-factor model (company size, company value and market risk) to add two quality-related factors (profitability and asset growth).

Many active strategies have emphasized quality growth as an important factor in their security selection and portfolio construction.<sup>1</sup> In 2012, Robert Novy-Marx published a pioneering paper that found profitability and stability were just as useful for explaining returns as traditional value measures.<sup>2</sup>

# Performance & implementation

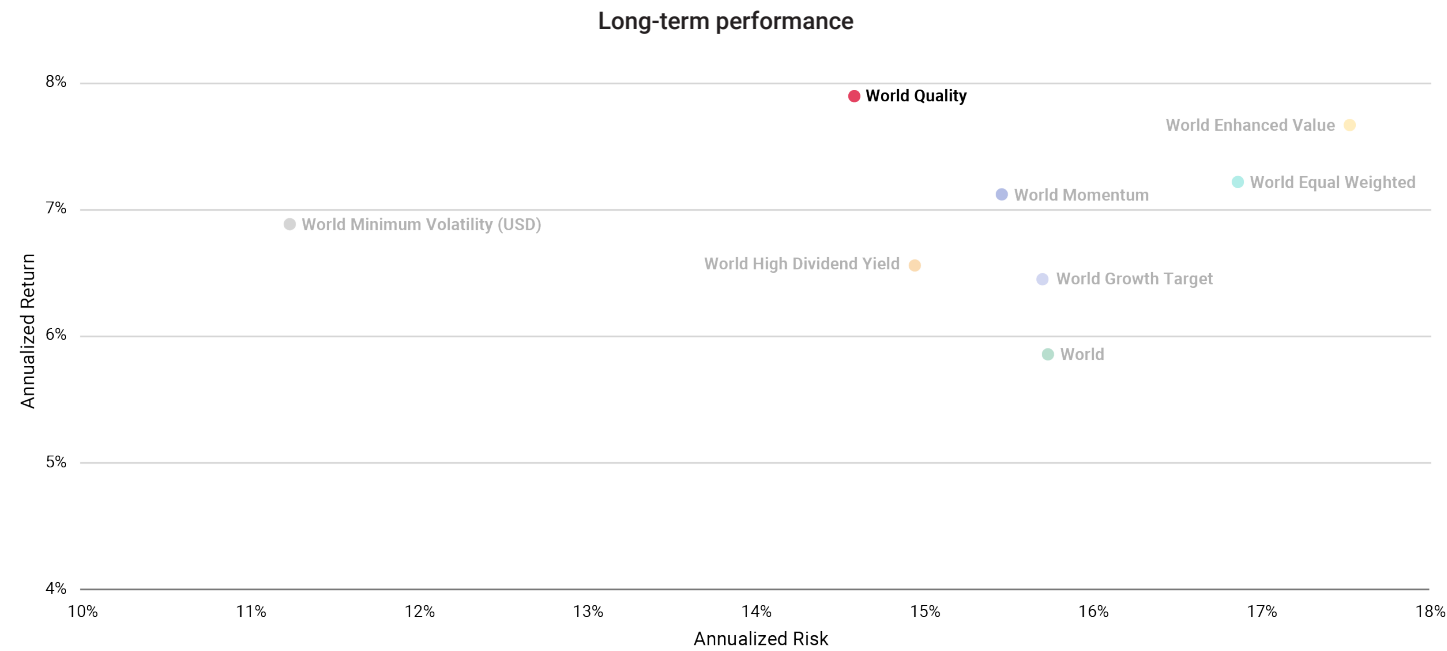
## MSCI World Factor Indexes

Over time, individual factors have delivered outperformance relative to the market.



The MSCI World Quality Index has historically generated excess returns over the long run with a 2.1% annual return over the MSCI World Index since 1999 as represented above.

## Long-term performance: December 1999 - December 2023



Although factor strategies have exhibited long-term outperformance, in the short-term, factor performance has been cyclical and has generated periods of underperformance.

Many active strategies have emphasized quality growth as an important factor in their security selection and portfolio construction.

How factors have performed relative to each other:

# Quality

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
World Quality	1.5%	-4.5%	-9.6%	56.7%	28.6%	28.4%	31.0%	19.9%	-29.2%	42.0%	18.2%	8.0%	16.7%	32.7%	12.1%	5.8%	10.3%	32.6%	-1.4%	36.7%	28.7%	26.1%	-3.9%	33.0%
World Enhanced Value	1.2%	-8.0%	-9.8%	50.4%	24.1%	17.2%	28.9%	16.8%	-33.5%	41.9%	16.5%	-4.8%	16.5%	30.7%	9.0%	4.5%	9.4%	26.6%	-2.4%	28.4%	22.7%	22.3%	-9.2%	24.4%
World Momentum	0.3%	10.0%	13.6%	40.1%	21.3%	15.2%	22.1%	11.4%	-37.8%	33.8%	12.8%	4.8%	15.0%	30.3%	7.0%	4.2%	8.9%	26.6%	-5.1%	28.3%	18.1%	20.8%	9.3%	24.4%
World Growth Target	-2.1%	-11.5%	-14.4%	33.8%	20.8%	12.5%	21.8%	10.3%	-39.9%	33.5%	12.3%	4.4%	14.8%	27.7%	5.5%	1.2%	8.9%	23.9%	-6.7%	27.4%	16.5%	18.2%	-16.4%	20.3%
World High Dividend Yield	-10.2%	-12.1%	-15.1%	30.5%	20.0%	10.0%	21.2%	9.6%	-40.3%	31.9%	11.4%	-5.0%	14.7%	27.4%	4.6%	-0.3%	8.2%	23.1%	-8.2%	24.5%	10.1%	16.8%	-17.3%	17.3%
World Equal Weighted	12.5%	16.5%	-16.5%	26.0%	19.3%	8.5%	20.7%	7.3%	-41.9%	30.8%	9.3%	-5.4%	13.7%	26.5%	4.6%	1.0%	8.2%	22.9%	8.5%	24.3%	9.3%	15.4%	-17.7%	12.2%
World Minimum Volatility (USD)	-12.9%	-19.4%	-19.4%	25.9%	15.2%	8.3%	19.1%	6.4%	-42.4%	17.2%	9.1%	-9.3%	13.3%	22.9%	3.4%	-2.4%	5.1%	19.2%	-11.8%	24.0%	1.0%	15.0%	-17.8%	10.1%
World	-18.9%	-20.5%	-19.5%	22.0%	12.7%	6.0%	16.8%	6.1%	-42.6%	14.8%	7.2%	-11.0%	8.9%	19.4%	3.3%	-2.7%	4.7%	18.0%	-13.4%	19.8%	-3.3%	14.8%	-21.9%	8.1%

- World
- World Enhanced Value
- World Quality
- World Equal Weighted
- World Minimum Volatility (USD)
- World Momentum
- World Growth Target
- World High Dividend Yield

The analysis and observations in this report are limited solely to the period of the relevant historical data, backtest or simulation. Past performance – whether actual, back tested or simulated – is no indication or guarantee of future performance. None of the information or analysis herein is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision or asset allocation and should not be relied on as such. The time periods covered in the charts in this paper were dictated by the data available when we conducted the simulations which produced them. There are frequently material differences between backtested or simulated performance results and actual results subsequently achieved by any investment strategy.

# Conclusion

The quality factor aims to reflect the performance of companies with durable business models and sustainable competitive advantages. This is achieved by targeting companies that tend to have high ROE, stable earnings, and strong balance sheets with low financial leverage. Institutional investors consider quality for additional sources of return and/or for diversification purposes. Quality has also traditionally served as a defensive factor when a flight to quality occurs.

# Footnotes

- 1 Asness, C. S., A. Frazzini and L.H. Pederson, L. H. (2013). "Quality Minus Junk," s.l.: Working Paper, AQR Capital Management.
- 2 Novy-Marx, R. (2012). "The Other Side of Value: The Gross Profitability Premium." Journal of Financial Economics, Volume 108, pp. 1-28.

Learn more about Factor Investing at  
[www.msci.com/factor-investing](http://www.msci.com/factor-investing)

## About MSCI Inc.

MSCI is a leading provider of critical decision support tools and services for the global investment community. With over 50 years of expertise in research, data and technology, we power better investment decisions by enabling clients to understand and analyze key drivers of risk and return and confidently build more effective portfolios. We create industry-leading research-enhanced solutions that clients use to gain insight into and improve transparency across the investment process.

To learn more, please visit [www.msci.com](http://www.msci.com).

The information contained herein (the "Information") may not be reproduced or disseminated in whole or in part without prior written permission from MSCI ESG Research. The Information may not be used to verify or correct other data, to create any derivative works, to create indexes, risk models, or analytics, or in connection with issuing, offering, sponsoring, managing or marketing any securities, portfolios, financial products or other investment vehicles. Historical data and analysis should not be taken as an indication or guarantee of any future performance, analysis, forecast or prediction. MSCI ESG Research is provided by MSCI Inc.'s subsidiary, MSCI ESG Research LLC, a Registered Investment Adviser under the Investment Advisers Act of 1940. MSCI ESG Research materials, including materials utilized in any MSCI ESG Indexes or other products, have not been submitted to, nor received approval from, the United States Securities and Exchange Commission or any other regulatory body. None of the Information or MSCI index or other product or service constitutes an offer to buy or sell, or a promotion or recommendation of, any security, financial instrument or product or trading strategy. Further, none of the Information is intended to constitute a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. MSCI ESG and climate ratings, research and data are produced by MSCI ESG Research LLC, a subsidiary of MSCI Inc. MSCI ESG Indexes, Analytics and Real Estate are products of MSCI Inc. that utilize information from MSCI ESG Research LLC. MSCI Indexes are administered by MSCI Limited (UK) and MSCI Deutschland GmbH. The Information is provided "as is" and the user of the Information assumes the entire risk of any use it may make or permit to be made of the Information. NONE OF MSCI INC. OR ANY OF ITS SUBSIDIARIES OR ITS OR THEIR DIRECT OR INDIRECT SUPPLIERS OR ANY THIRD PARTY INVOLVED IN THE MAKING OR COMPILING OF THE INFORMATION (EACH, AN "INFORMATION PROVIDER") MAKES ANY WARRANTIES OR REPRESENTATIONS AND, TO THE MAXIMUM EXTENT PERMITTED BY LAW, EACH INFORMATION PROVIDER HEREBY EXPRESSLY DISCLAIMS ALL IMPLIED WARRANTIES, INCLUDING WARRANTIES OF MERCHANTABILITY AND FITNESS FOR A PARTICULAR PURPOSE. WITHOUT LIMITING ANY OF THE FOREGOING AND TO THE MAXIMUM EXTENT PERMITTED BY LAW, IN NO EVENT SHALL ANY OF THE INFORMATION PROVIDERS HAVE ANY LIABILITY REGARDING ANY OF THE INFORMATION FOR ANY DIRECT, INDIRECT, SPECIAL, PUNITIVE, CONSEQUENTIAL (INCLUDING LOST PROFITS) OR ANY OTHER DAMAGES EVEN IF NOTIFIED OF THE POSSIBILITY OF SUCH DAMAGES. The foregoing shall not exclude or limit any liability that may not be applicable law be excluded or limited. Privacy notice: For information about how MSCI collects and uses personal data, please refer to our Privacy Notice at <https://www.msci.com/privacy-pledge>.