Focus: Quality
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. 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.
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 1.79% annual return over the MSCI World Index since 1999 as represented above.
Although factor strategies have exhibited long-term outperformance, in the short-term, factor performance has been cyclical and has generated periods of underperformance.

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How factors have performed relative to each other:

### Quality

<table>
<thead>
<tr>
<th>Year</th>
<th>World</th>
<th>World Enhanced Value</th>
<th>World Quality</th>
<th>World Equal Weighted</th>
<th>World Minimum Volatility (USD)</th>
<th>World Momentum</th>
<th>World Growth Target</th>
<th>World High Dividend Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>1.5%</td>
<td>-4.5%</td>
<td>-9.6%</td>
<td>56.7%</td>
<td>28.6%</td>
<td>28.4%</td>
<td>31.0%</td>
<td>19.9%</td>
</tr>
<tr>
<td>2001</td>
<td>1.2%</td>
<td>-8.0%</td>
<td>-9.8%</td>
<td>50.4%</td>
<td>24.1%</td>
<td>17.2%</td>
<td>28.5%</td>
<td>16.8%</td>
</tr>
<tr>
<td>2002</td>
<td>0.3%</td>
<td>-10.0%</td>
<td>49.4%</td>
<td>21.3%</td>
<td>15.2%</td>
<td>22.1%</td>
<td>11.4%</td>
<td>-37.8%</td>
</tr>
<tr>
<td>2003</td>
<td>-2.1%</td>
<td>-13.5%</td>
<td>-14.4%</td>
<td>33.8%</td>
<td>20.8%</td>
<td>12.5%</td>
<td>21.8%</td>
<td>-39.9%</td>
</tr>
<tr>
<td>2004</td>
<td>-10.2%</td>
<td>-12.1%</td>
<td>-15.1%</td>
<td>30.5%</td>
<td>20.0%</td>
<td>10.0%</td>
<td>21.2%</td>
<td>-40.3%</td>
</tr>
<tr>
<td>2005</td>
<td>-12.5%</td>
<td>-16.5%</td>
<td>-16.5%</td>
<td>26.0%</td>
<td>19.3%</td>
<td>8.5%</td>
<td>20.7%</td>
<td>-41.9%</td>
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<tr>
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<td>-19.4%</td>
<td>25.9%</td>
<td>15.2%</td>
<td>8.3%</td>
<td>19.1%</td>
<td>-42.4%</td>
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<tr>
<td>2007</td>
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<td>-19.5%</td>
<td>22.0%</td>
<td>12.7%</td>
<td>6.0%</td>
<td>16.8%</td>
<td>-42.5%</td>
</tr>
</tbody>
</table>

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.
In general, factor performance has been cyclical in nature. Individual factors have been shown to outperform during different macroeconomic environments.
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


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