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**FLIGHT TO QUALITY**

# Agenda

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1. Quant Recap
2. MSCI Quality
3. Nucleus Quality
4. Where Quality works / doesn't work

Tim Fuller  
Damien Klassen



# In The News:

## Introduction

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Home > Investment

INVESTMENT

# J.P. Morgan shifts 'quality focus' to US large caps



Tahn Sharpe July 9, 2019

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Tim Fuller  
Damien Klassen



# Quant Recap:

## Introduction

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- Mathematical models to help generate performance
- They don't always work, but they usually do
- This is an implicit assumption about non-reversion

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Damien Klassen



# Quant Recap

Number 1 question

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Are you selling insurance to the  
rest of the market?

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Damien Klassen





# Quant Recap:

## Implicit Assumption

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- **Momentum:** no mean reversion
- **Low Vol:** no mean reversion
- **Growth:** no mean reversion
- **Value:** mean reversion
- **Quality:** no mean reversion

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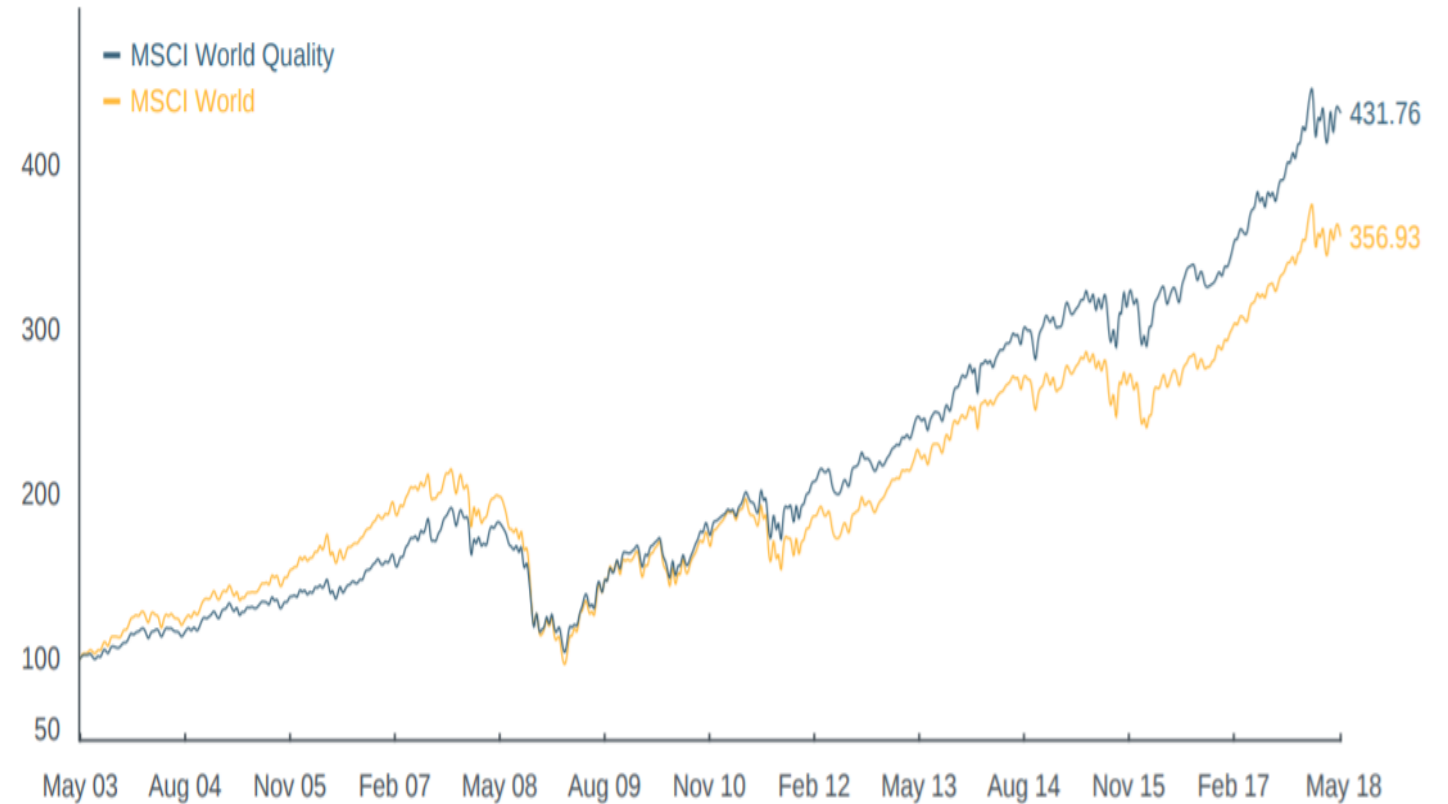


# MSCI Quality:

## MSCI Quality Index

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### CUMULATIVE INDEX PERFORMANCE - GROSS RETURNS (USD) (MAY 2003 – MAY 2018)



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Damien Klassen





# MSCI Quality:

## MSCI Definition

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- Companies that tend to have high ROE, stable earnings that are uncorrelated with the broad business cycle, and strong balance sheets with low financial leverage are targeted for quality growth
- The Quality score for each security is calculated by combining Z-Scores of three winsorized fundamental variables, namely Return on Equity, Debt to Equity and Earnings Variability.

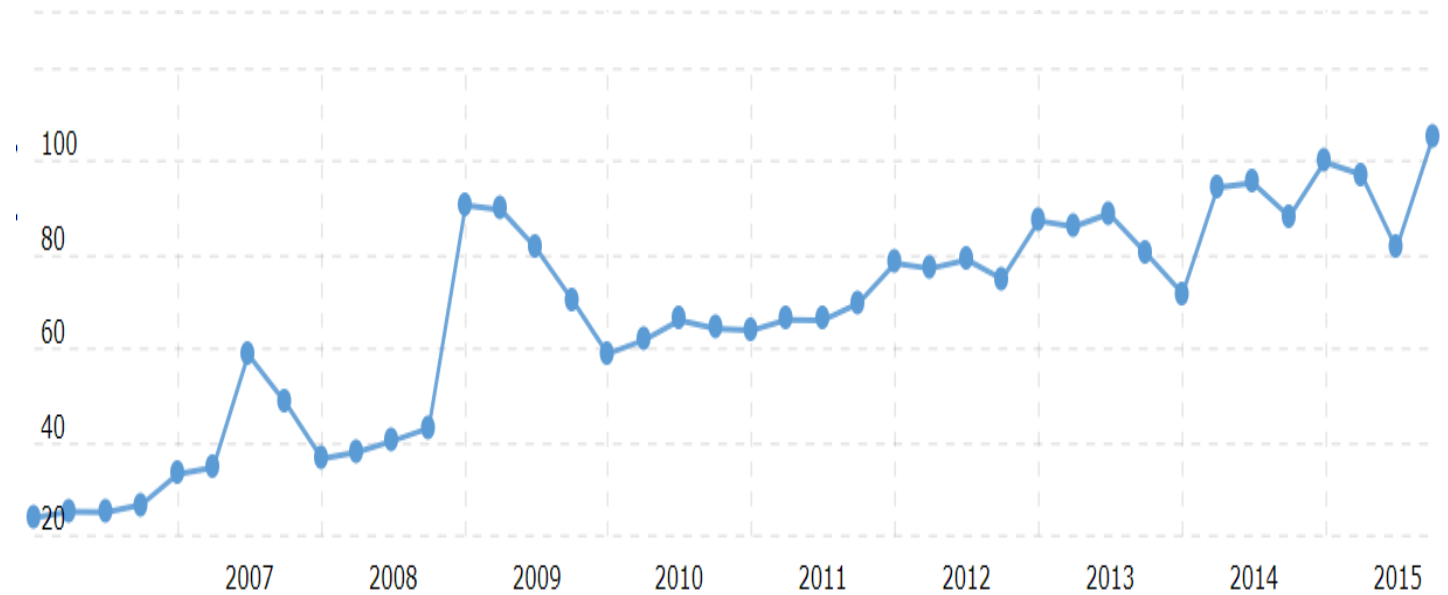
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# MSCI Quality:

## Return on Equity

IBM ROE 2006 - 2016



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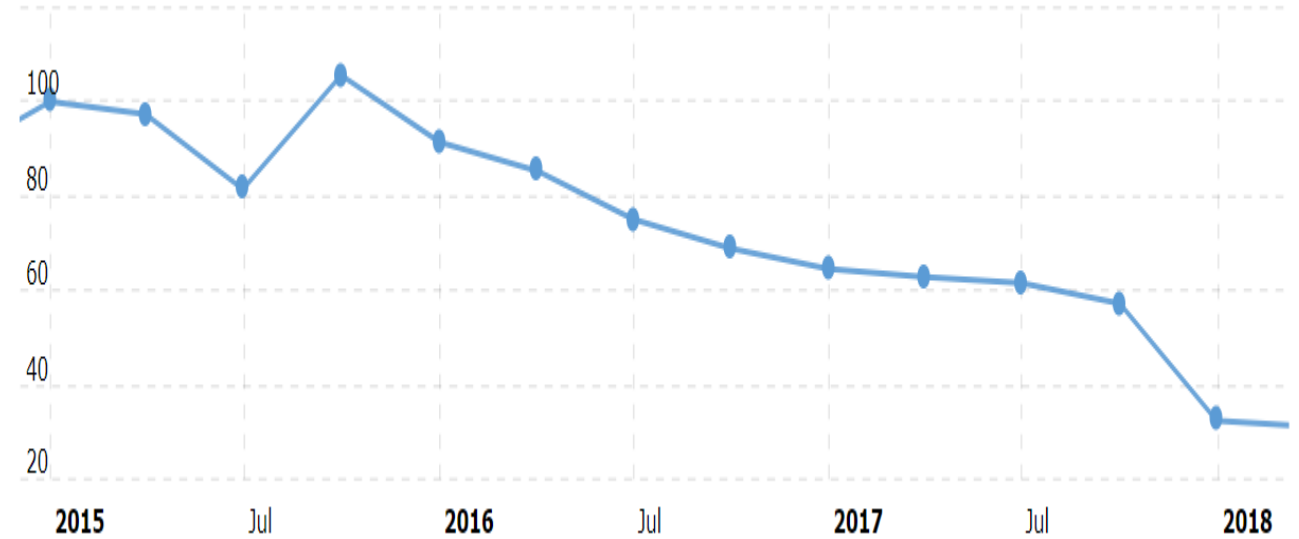


# MSCI Quality:

## Return on Equity

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IBM ROE 2016 - 2018



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# MSCI Quality:

Debt

- Uses Debt/Equity
- Same problems using book equity
- Uses Total Debt

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# MSCI Quality:

## Earnings Variability

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- Standard deviation of earnings growth
- Uses 4 data points (i.e. not enough data points to give much confidence)
- Positive surprises just as damaging as negative surprises

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Damien Klassen



# MSCI Quality:

## Winsorising

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- An excellent way to ignore erroneous data

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# Nucleus Quality:

## Definition

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- Economic Moat
- Economic Trajectory
- Stability
- Gearing
- Corporate Governance

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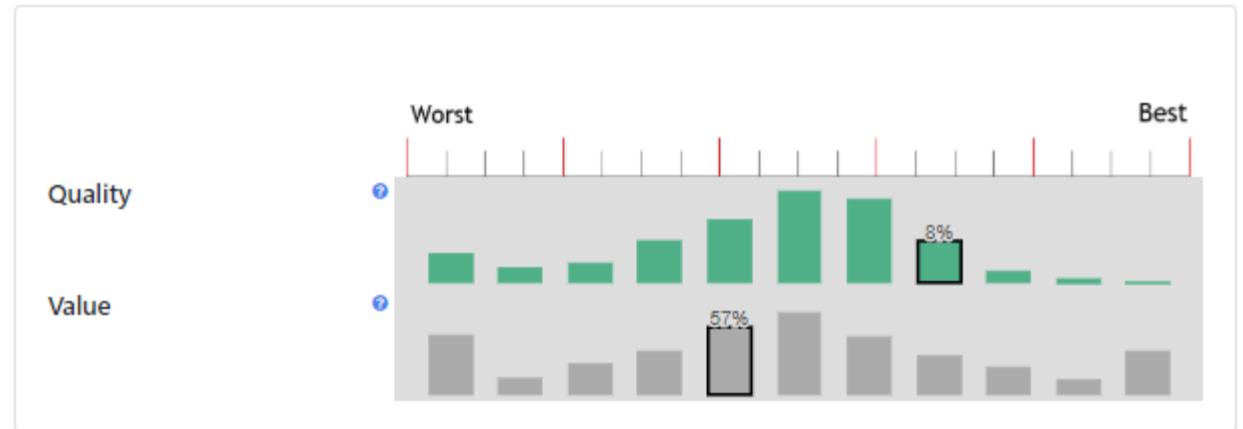




# Nucleus Quality:

## Portal View

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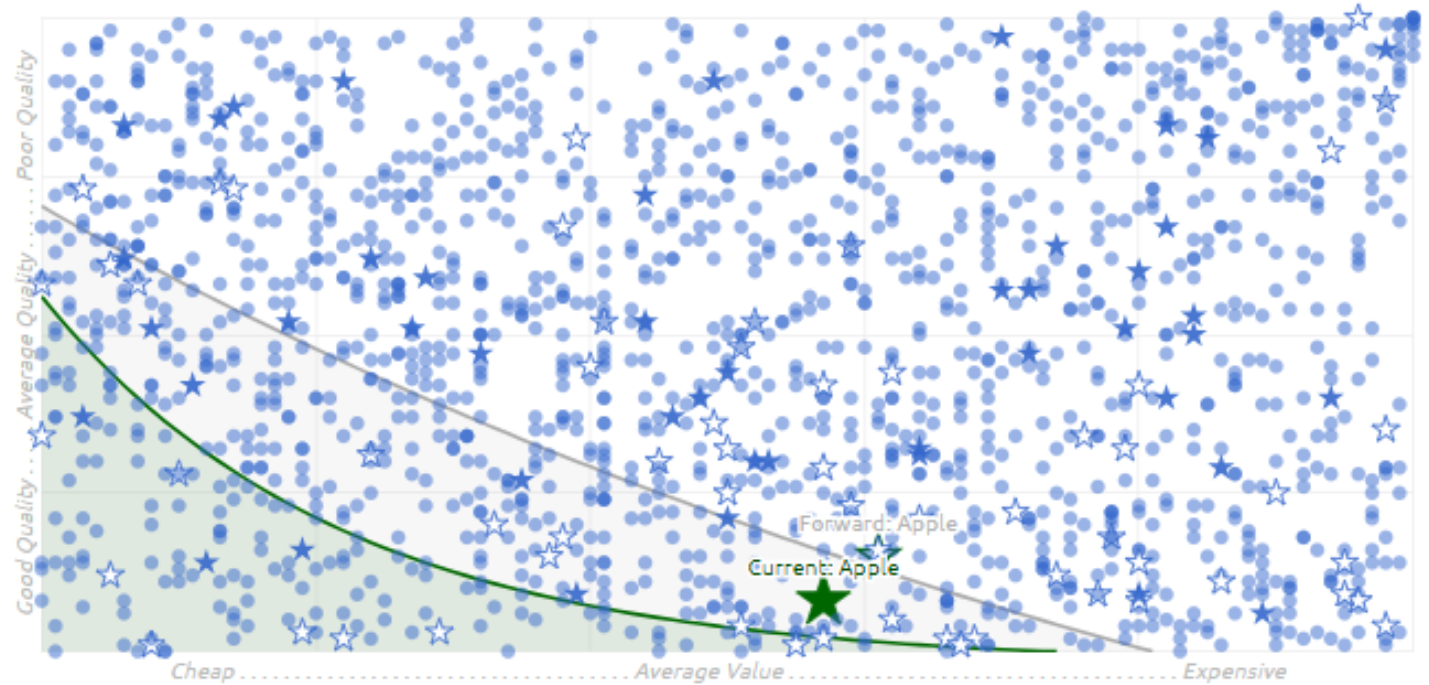


# Nucleus Quality:

## Portal View

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Quality/Value Scattergram [e](#)



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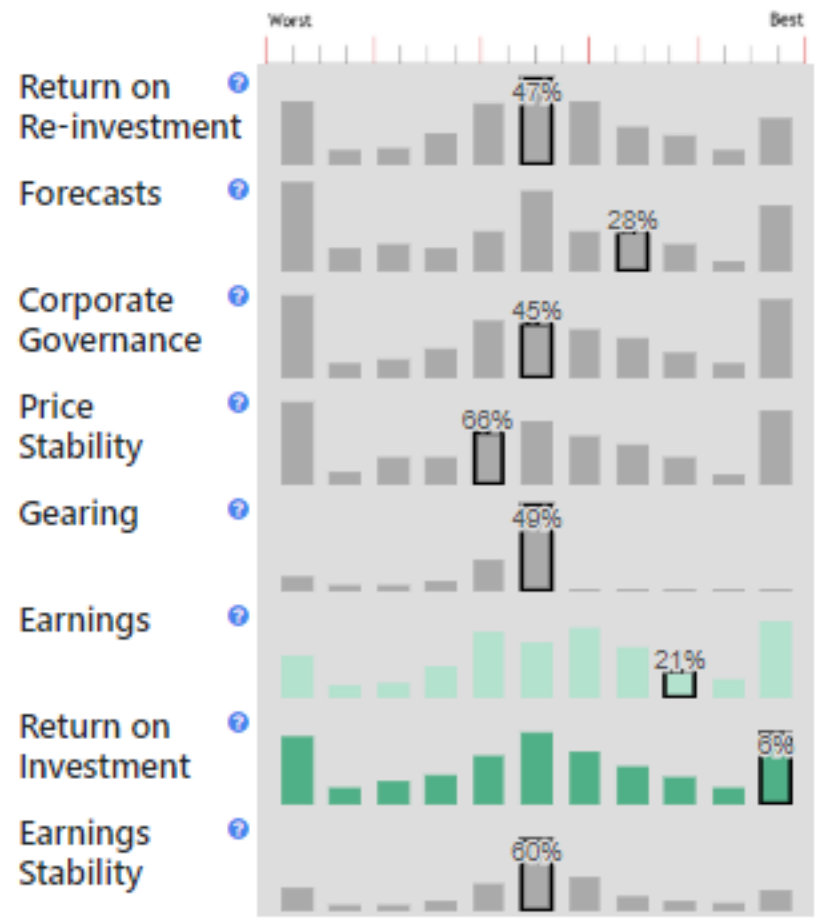


# Nucleus Quality:

## Portal View

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### Quality ?

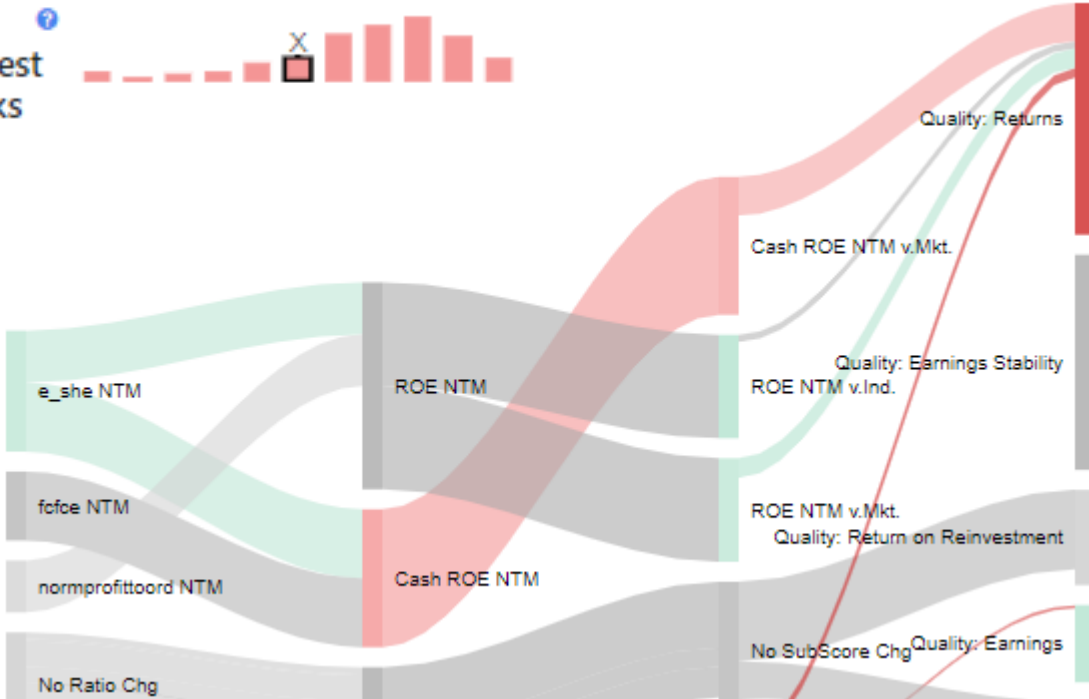


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# Nucleus Quality:

My View



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# Nucleus Quality:

Economic Moat

- High margins
- High returns
- High proportion of earnings converted to cashflow

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Damien Klassen



# Nucleus Quality:

## Economic Trajectory

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- High marginal returns
- Above average EPS growth
- Sustainability of economic moat

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# Nucleus Quality:

Stability

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- Earnings
- Cashflow
- Dividends
- Share price

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# Nucleus Quality:

Financial

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- Appropriate gearing
- Interest cover
- CDS Spreads

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# Where Quant works / doesn't:

Pitfalls

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- Return disaggregation
- Overfitting
- Self serving bias
- Beware reversals

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# Where Quant works / doesn't:

Sectors

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- Resources
- Utilities
- Financials
- Manufacturing vs Services

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## Wrap Up:

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- It is a tool – not a religion
- Needs to change with accounting standards
- Don't lose sight of what you are trying to do

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Damien Klassen



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