March 2024

Kayne Anderson Rudnick
Investment Management

The Case for Quality

EXECUTIVE SUMMARY

We believe investing in high-quality businesses enables investors to increase their chances of capturing what have been historically stronger risk-adjusted returns. In our experience, this is because high-quality companies tend to experience lower volatility and greater strength and consistency in returns over a market cycle, including the most difficult times. The combination of these factors provides a compelling investment story.

Lower-quality companies tend to rebound sharply from recessions while the high-quality segment typically lags. This typically occurs because low-quality companies have the most to gain from improving credit market and economic conditions. Low-quality companies are inherently more reliant on lower-cost capital because they can be more capital intensive and/or less able to finance growth through internal resources. However, a return to a more "normal" monetary environment will benefit those higher-quality businesses that are less leveraged and less dependent on the credit markets, as they will have the financial reserves to continue self-funding their growth opportunities.

This tendency for high-quality and low-quality companies to inversely come in and out of favor in response to the economic and stock market cycle is sometimes referred to as the "quality cycle." Inherent in the word "cycle" is the idea that there may be short-term economic periods when high-quality businesses will experience relative underperformance. However, as long-term investors, we believe high-quality companies outperform over time and provide an important ballast for any investment portfolio given their financial stability across varying macroeconomic environments.

INVESTING IN QUALITY COMPANIES

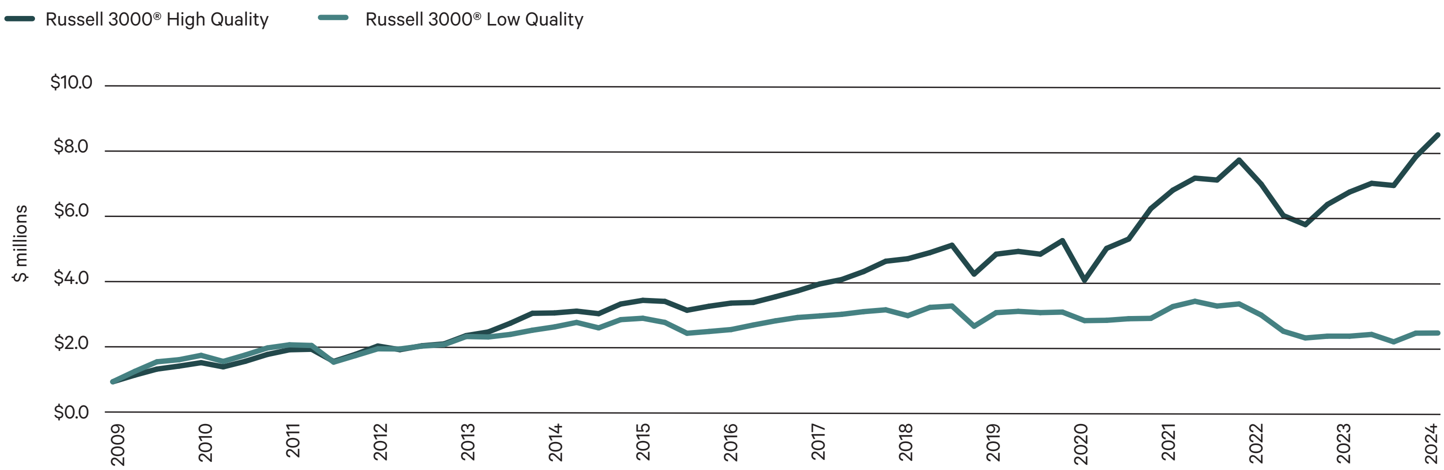
In our view, quality investing looks beyond the traditional style boxes of market capitalization (large, mid and small) and investment style (value, core and growth). We take the view that a high-quality approach seeks to identify companies with outstanding financial and business characteristics, including both soft (e.g., competitive advantage or management competence) and hard criteria (e.g., high returns on capital or balance-sheet health).

While most investment managers exclusively focus on exposure to large or small cap, as well as growth or value stocks, the amount of exposure to high and low-quality stocks can have as meaningful of an impact on a portfolio's long-term return. As we see it, this is mainly due to high-quality companies providing greater financial stability and a greater propensity to grow across varying macroeconomic environments, which leads to more consistent returns over time.

HISTORICAL OUTPERFORMANCE

To illustrate this, consider the growth of $1 million over a 15-year period ending March 31, 2024 (see Figure 1). Over this timeframe, high-quality stocks within the Russell 3000 Index grew to $8.58 million compared to about $2.50 million with the same amount dedicated to lower-quality stocks.

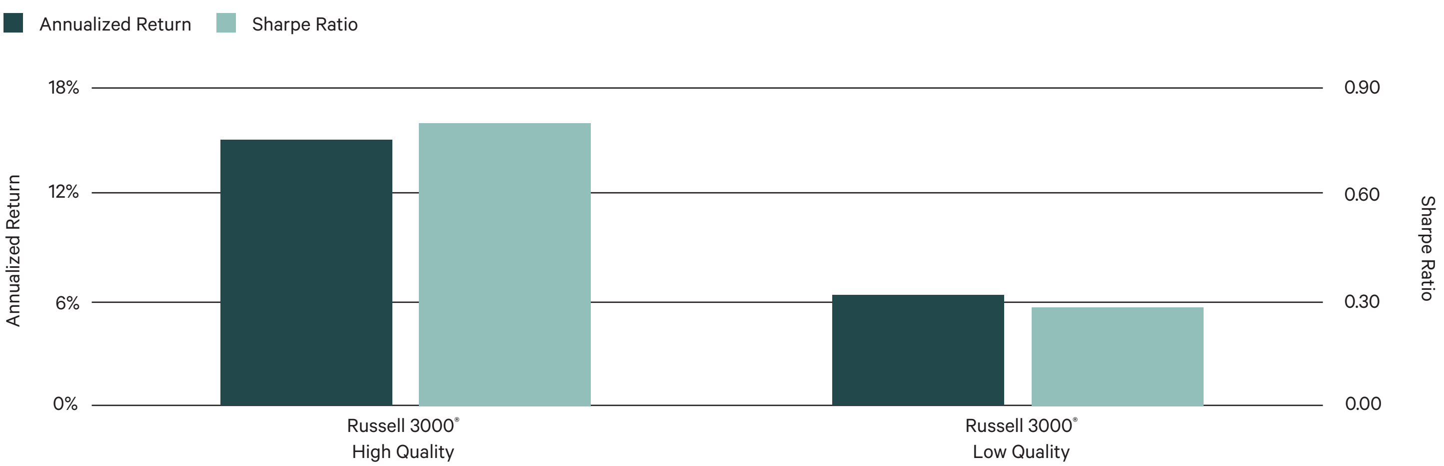
FIGURE 1: OUTPERFORMANCE OF HIGH-QUALITY STOCKS OVER 15-YEAR PERIOD (GROWTH OF $1,000,000)



Data presented is for the period ending March 31, 2024. High Quality and Low Quality are represented by the median of their respective universes. Data is obtained from FactSet Research Systems and is assumed to be reliable. The Russell 3000® is not actively managed and does not reflect the deduction of any investment management or other fees and expenses. Indices are not available for direct investment. ***Past performance is no guarantee of future results.***

During this same timeframe, the annualized return for the median of high-quality stocks was 15.41% versus 6.29% for low-quality stocks. Further, the median of high-quality stocks experienced a higher risk-adjusted return, with a Sharpe ratio of 0.82 versus 0.29 for the low-quality stocks (see Figure 2).

FIGURE 2: STRONGER ANNUALIZED AND RISK-ADJUSTED RETURNS OF HIGH-QUALITY STOCKS OVER 15-YEAR PERIOD



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THE QUALITY CYCLE

The market at times favors low-quality stocks, and this occurs typically in upbeat markets that drive stock rallies. Sometimes referred to as “junk rallies,” these phases usually occur at the beginning and the end of a stock market cycle because low-quality companies have the most to gain from improving credit market and economic conditions. They are often more reliant on the debt markets because they are more capital intensive and less able to finance growth through internal resources.

Rallies, however, always recede. It is our belief that what’s important is the consistency of long-term performance in both good times and bad. In Figure 3, we observe the relative performance of high-quality and low-quality stocks starting with a few years into the economic expansion in the early 2000s.

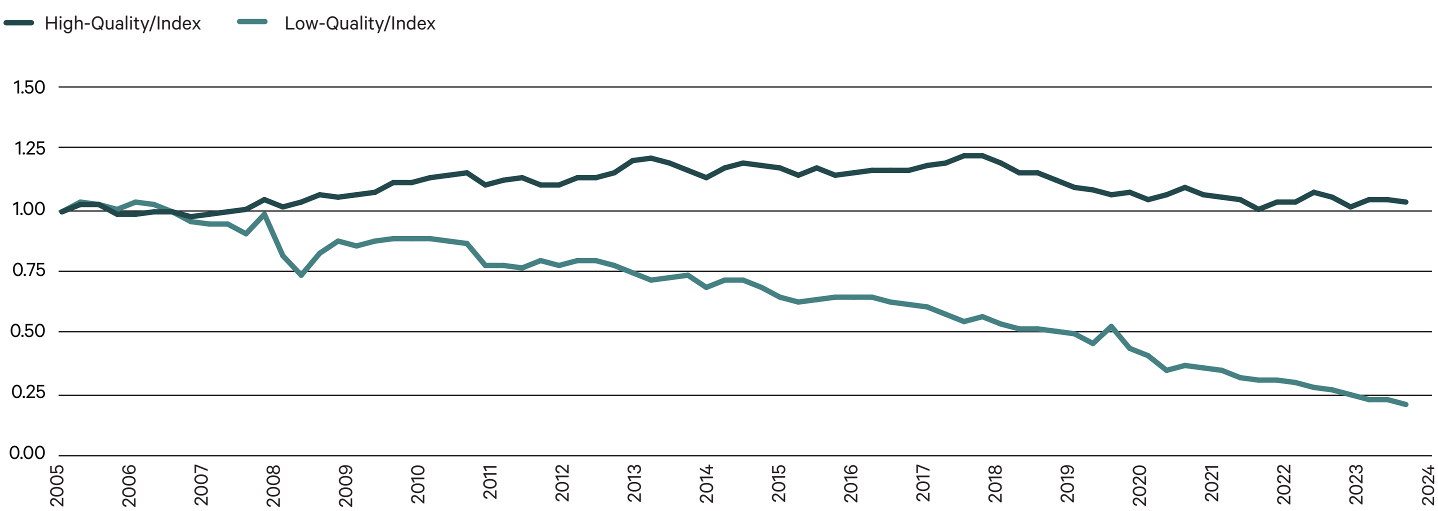
The dark green line charts the cumulative relative performance of high-quality stocks within the Russell 3000 Index versus the index itself. A reading above 1 shows the high-quality segment is outperforming the broad index. During this timeframe, quality has outperformed over time.

The light green line charts the relative performance of low-quality stocks over the Russell 3000 Index. Similarly, a ratio above 1 represents low-quality outperformance. Note that this segment outperforms the index from 2005 through mid 2007; it even does better than the dark green line in some stretches during those years. Moving into 2008, the economic expansion drew to a close, with the stock market falling in the fourth quarter of 2007 and setting off the Great Recession that lasted until June 2009.

It is clear that the low-quality carve-out underperformed the index through and after the financial crisis. In contrast, the high-quality subset continued to outperform the index steadily, rarely dipping below 1. This illustrates that the cumulative performance of high-quality stocks during this timeframe, while similar to that of their low-quality counterparts in certain market cycles, can be much more favorable in other times, including during times of market duress.

We believe that markets are too complex and dynamic for anyone to reliably predict future price movements and thereby time the market as it transitions from a low-quality bias to a high-quality bias, and vice versa.

FIGURE 3: RATIO OF CUMULATIVE PERFORMANCE HIGH-QUALITY STOCKS OVER INDEX VS. LOW-QUALITY STOCKS OVER INDEX



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OUR APPROACH

In our view, there is no shortage of investment managers claiming they invest in quality, but we believe most of them fail to adhere to the same standards of quality that we employ at Kayne Anderson Rudnick. Our goal is to create a portfolio of what we believe are the highest-quality businesses out there. We want companies that have a differentiated and sustainable competitive advantage within their industry, an advantage that we believe creates favorable long-term growth prospects and profitability in both good economic times and bad. Typically, these are companies with strong free cash flow and returns on capital. We also look for management teams that are prudent and effective in allocating this capital. Lastly, our goal is to find these businesses at attractive valuations.

We begin by screening our universe of companies using quantitative metrics to filter out lower-quality companies. With these financial metrics in hand, we then focus on understanding the underlying business that is generating these numbers. We look for companies that have effective competitive barriers, such as an exceptionally strong brand franchise, a unique cost advantage, a network effect or high-customer-switching costs (their product becomes embedded in their customers' business). In our opinion, these companies have the ability to shape and control their own markets, and these unique business models are what drive strong financial results over time. Management sticks to the company's core competencies, cultivates the business' competitive advantage and allocates capital in a shareholder friendly manner, such as dividends and share repurchases.

Once we have tackled the qualitative side of the business, we conduct disciplined quantitative analysis of the company's financial statements. In our view, high-quality companies will demonstrate steady and consistent earnings growth, prudent debt-to-equity ratios and above-average returns on invested capital. Meanwhile, low-quality stocks usually demonstrate erratic earnings, poor returns on capital and substantial debt burdens. We then call management directly with our questions regarding these qualitative and quantitative issues. In this way, we believe our proprietary research process helps produce information to help manage risk in our portfolios.

If we do invest in a company, our plan is to do so for the long-term, knowing there may be short-term economic periods when our types of businesses will be out of favor. In the past, portfolios of high-quality companies such as those we manage at Kayne Anderson Rudnick have experienced short-term periods of relative underperformance. However, as long-term investors, we are resolute in our belief that high quality outperforms over time. We will not change our investment philosophy or approach even as market "fads" go in and out of favor. Rather, we will maintain our commitment to sound investment principles, including our steadfast belief that high-quality companies are an important ballast for any investment portfolio given their financial stability across varying macroeconomic environments.

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