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THE CASE FOR QUALITY

BY ANDREW B. WETZEL, CFA

An unusual aspect of the current bull market in U.S. stocks is that we have not had a “correction” in almost 3½ years. Historically, a correction – defined as a 10% drop in stock prices from a peak level – has occurred about every eight months. In addition, while stock values currently are not at extreme levels, the S&P 500 Index has a forward price / earnings ratio (a measure of valuation) of 17.5x, well above its 20-year average of 15.7x. With the U.S. stock market now entering year seven of a bull market, an underappreciated aspect of F.L.Putnam’s investment philosophy – a focus on quality – seems worth discussing. Please note that we are not predicting a major decline in the stock market – no one is that prescient. However, we believe that an increased focus on quality has become more important at this point in the cycle.

At F.L.Putnam, we are GARP (growth at a reasonable price) equity investors. As the moniker suggests, we look for companies that are growing faster than the market or their peers but whose stocks trade at attractive valuation levels. However, the term “GARP” does not fully capture quality – a part of our process equally as important as growth and value. While the concepts of growth and value are straightforward, definitions of quality vary widely.

We believe an understanding of quality extends beyond seemingly “safe” stocks with lower price volatility. To us, quality includes a number of quantifiable fundamental factors in addition to a qualitative understanding of company strategy, industry position and management effectiveness. We consider earnings predictability, return on capital, profit margins and financial leverage among our fundamental factors. This combined quantitative and qualitative analysis provides us with a level of comfort that the growth we are investing in is not ephemeral and the stock that appears to be cheap is not a value trap. Combining growth, value *and* quality has proven to be a durable strategy over the long-term.

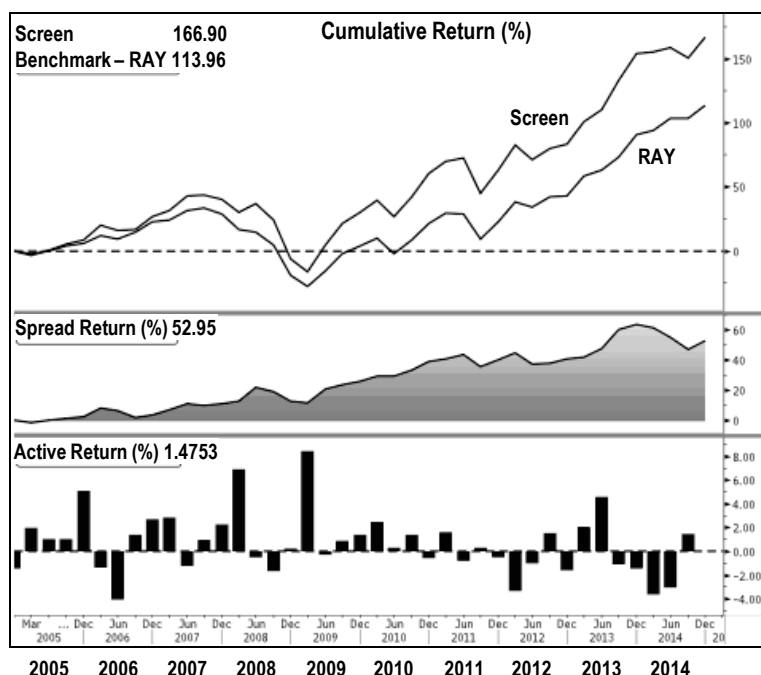
Quality characteristics tend to persist. Companies with consistently superior returns on invested capital and profit margins, that are achieved with lower than average amounts of leverage, tend to be industry leaders. They also tend to have some competitive advantage, such as a respected brand or patent-protected products. Part of our research process involves rigorously analyzing these underlying building blocks of quality. Companies exhibiting these characteristics typically maintain leadership positions as long as company management is effective and far-sighted. As a result, owning higher quality companies tends to benefit investors over the long term.

While an emphasis on quality is an important part of our investment process, it does not add value in all market environments – something that is true of all investment styles. Recent research from Clifford S. Asness et al.¹ shows that quality (based on a set of quantifiable fundamental factors) tends to be undervalued in periods leading to major market tops, while in weaker markets a “flight to quality” instinct typically results in quality stocks becoming more expensive.

MARKET INSIGHT

This insight is important and makes sense given our knowledge of investor psychology. Investors (both professionals and do-it-yourselfers) have a natural tendency to get excited in bull markets and stretch for “story” stocks or cyclical stocks that leave them exposed to an increase in market volatility or to a significant downturn (something that Wall Street strategists predict exactly 0% of the time). Put simply, quality is just too boring for many investors in a hot market.

The research by Asness et al.¹ also indicates that high-quality stocks tend to produce higher than average risk-adjusted returns relative to low-quality stocks because investors systematically underprice high-quality characteristics. Backtesting a strategy that buys stocks with better than average quality is a simple way to illustrate both the underpricing and performance variability of such stocks.



Source: Bloomberg Capital Markets and F.L.Putnam

The chart at the left displays the cumulative return of a high-quality strategy backtested against the broad market (as represented by the Russell 3000 index – RAY) over ten years. There are two important takeaways: First, owning higher quality stocks led to better-than-market performance over the period, as illustrated by the spread return in the middle panel. Second, looking at the bottom panel that displays quarterly relative returns, high-quality outperformed the most during the 2008-09 downturn, while recently the performance spread narrowed because investors became more comfortable with a positive market outlook.

As mentioned at the outset, we do not anticipate a major market decline. Above-average valuation in isolation is not a sell signal and bull markets can last much longer than seven years. That said, volatility should increase if the Federal Reserve begins to raise interest rates this year as expected. More importantly, the market seems overdue for a correction and we would not be shocked to see one.

At F.L.Putnam, we are not market timers but we do shift portfolio positioning as the environment changes. We currently believe that an increasing emphasis on quality will serve clients well at this point in the market cycle.

¹ Quality Minus Junk, Social Science Research Network; Posted 8/19/13, Last Revised 8/03/14

2015 MARKET DIARY		
	3/31/15	YTD Change*
Dow Jones Industrials	17,776.12	0.33 %
NASDAQ	4,900.89	3.86 %
S&P 500	2,067.89	0.95 %
Russell 2000	1,252.77	4.32 %
10-Year Treasury Bond Yield	1.92 %	-25 b.p.

Source: Bloomberg Capital Markets

* Includes dividends for equity indices