

## High Quality Stocks vs. Low Quality Stocks

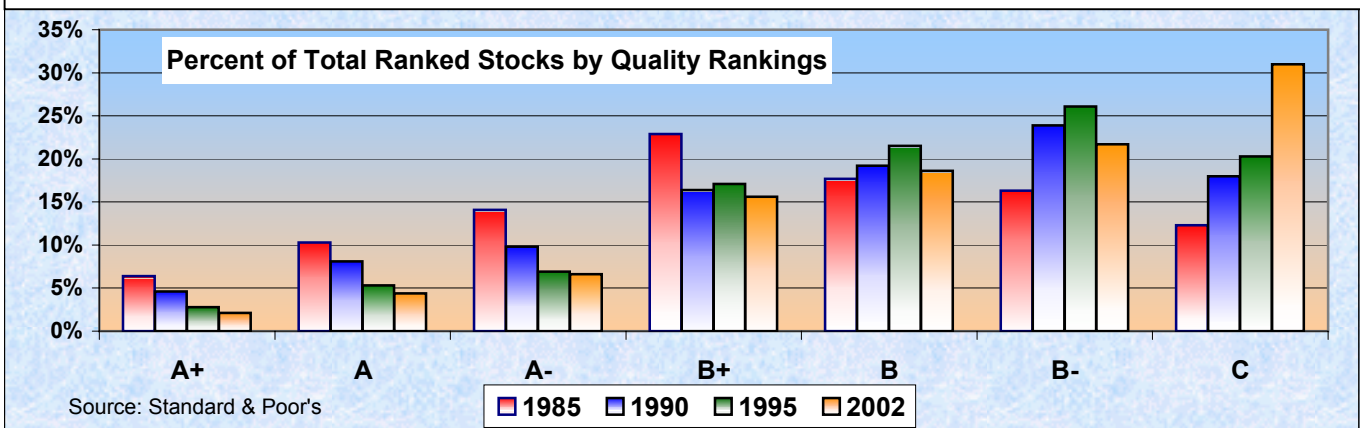
"Quality is never an accident; it is always the result of intelligent effort." John Ruskin, 1819-1900, writer

What is a high quality stock? What makes a low quality stock? Typically, these sorts of investment distinctions are very subjective. However, Standard & Poor's, widely known for its debt rating services, has helped to level the debate by providing objective Earnings and Dividend Rankings on common stocks since 1956. These rankings (commonly referred to as Quality Rankings), are generated by a computerized system and based upon per-share earnings and dividend records of the most recent 10 years - a period sufficient to cover the full peak-to-peak of a business cycle, and to include bull and bear markets.

The basic scores calculated are adjusted in a predetermined way for stability within a long-term trend and for cyclicalty. The result is a single symbol that represents a stock's Quality Rank. The S&P quality rankings classification is as follows: A+ Highest, A High, A- Above Average, B+ Average, B Below Average, B- Lower, C Lowest, D In Reorganization, LIQ In Liquidation. The ranking system favors companies that pay dividends, as those that do not are unlikely to rank higher than A-. Further, if a company pays a dividend, it is highly unlikely that it will rank below B- even if it has incurred losses. Currently, S&P quality ranks over 3,400 U.S. companies.

The chart above shows the earnings and dividend growth rates from 1985 through 2001 for stocks within the various quality ranks. The rates of growth were highest for the highest quality stocks and declined with the quality level. Stocks in the lowest categories produced no earnings growth and saw their dividend payments decline.

There is not a uniform number of high quality vs. low quality stocks, as no adjustment is made to fit a certain percentage into each quality bracket. For example, only 2.1% are ranked A+, whereas 31% of the companies are ranked C. The chart below shows an historical analysis of the Quality Rankings over the last 17 years. It's clear that the proportion of high quality stocks has been decreasing, perhaps signs of very competitive business conditions and, until recently, less emphasis by corporations on growing their dividends. As a consequence, companies able to achieve long-term stable earnings and dividend growth are becoming increasingly scarce.



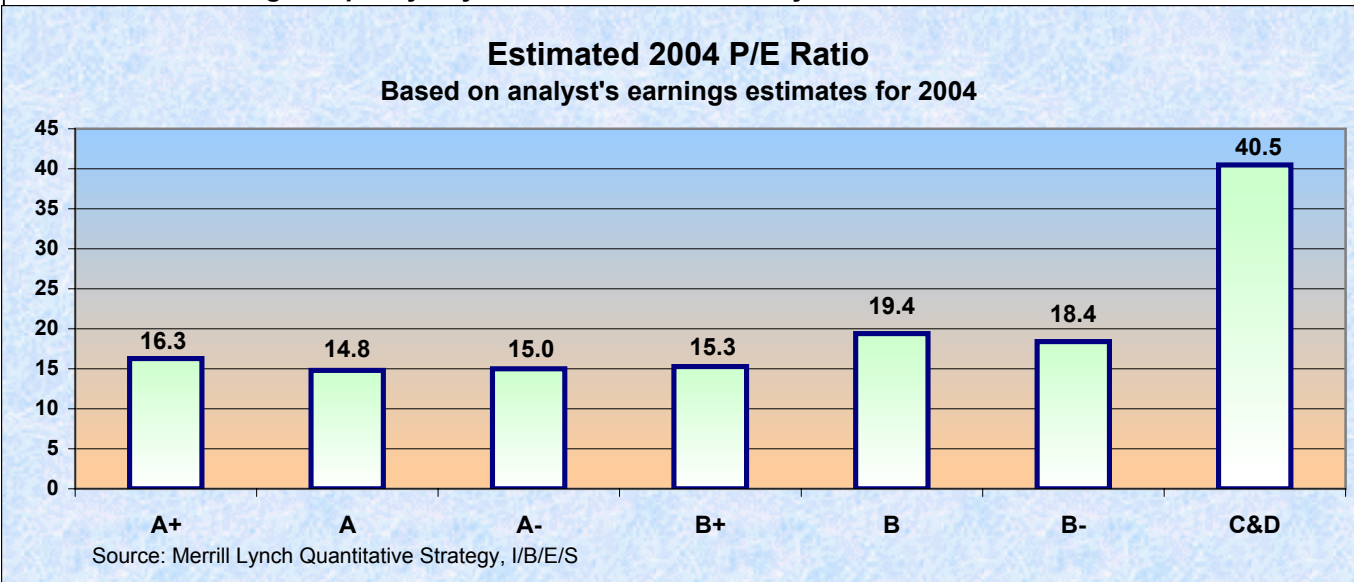
"To know that we know what we know, and that we do not know what we do not know, that is true knowledge."  
Confucius, 551-479 B.C., Chinese philosopher

While the distinction between high and low quality might be interesting, the question is: Is the distinction between high and low quality useful for investors? A study by Standard & Poor's (dated February 2003) appears to answer that question with a resounding "yes". The study contained the following among its conclusions:

- 1) Portfolios of stocks with high quality rankings outperformed the S&P 500 Index and substantially outperformed portfolios of stocks with low quality rankings over the 1986 to 2002 period. A portfolio consisting of stocks from the highest quality rank (A+) produced compounded annual returns of 12.3% versus 10.8% for the S&P 500 Index and 7.1% for the portfolio consisting of stocks from the C & below categories.
- 2) Portfolio risk is lower for companies with higher quality rankings, meaning that these portfolios produced higher risk adjusted returns. The volatility of a portfolio containing stocks from the three highest quality rankings was 10% less than the S&P 500 Index, while the volatility of a portfolio containing stocks from the three lowest quality rankings was 12% higher.
- 3) Fundamental risk is lower in portfolios of stocks with high quality rankings. The portfolios exhibit stable and persistent earnings, high returns on equity, stable and wide profit margins, and low debt levels. The higher and more stable levels of profitability bring about greater and more consistent earnings and dividend growth for the higher-quality companies.
- 4) Companies with high quality rankings appear less likely to engage in accounting manipulations as they reported significantly lower non-recurring items. Since the quality rankings reflect earnings and dividend growth over a long time period it is difficult to sustain accounting manipulation.
- 5) Earnings growth for companies with high quality rankings are not correlated with overall corporate earnings and credit cycles, whereas earnings growth for companies with low quality rankings is highly dependent on earnings and credit cycles.
- 6) High-quality stocks are ideally employed in portfolio strategies trying to maintain low portfolio turnover as the high-quality companies rankings are quite stable over time. Based on past data, the probability that a company ranked A+ in the current year will maintain the same rank in the next year is 84%, making the current ranking a significant predictor of future rank.

In addition to the findings listed above it appears that the valuation of high quality stocks are attractive. According to Merrill Lynch's Quantitative Group, investors appear to be paying a high price for low quality stocks and higher quality stocks appear to be more attractively valued. (see chart below).

**Interested in knowing the quality of your stocks? Call us today to find out!**



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