

Investing in Quality

UBS Quantitative Conference 2014

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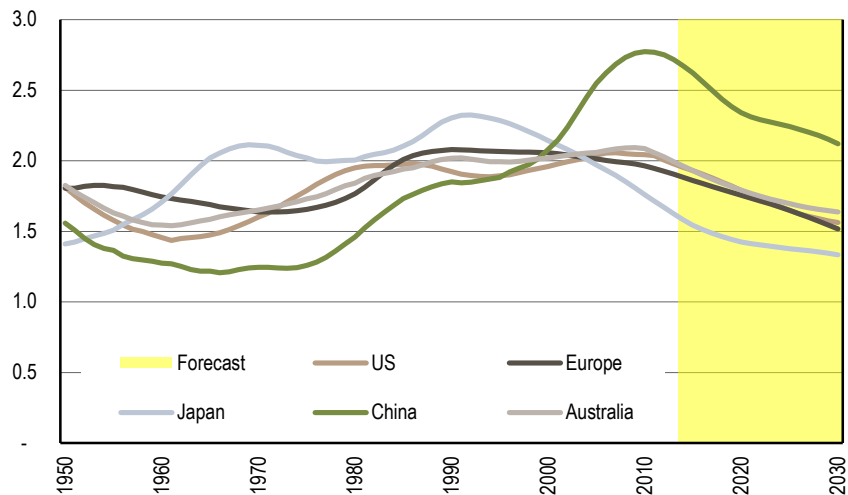
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SECTION 1

Why does Quality matter right now?

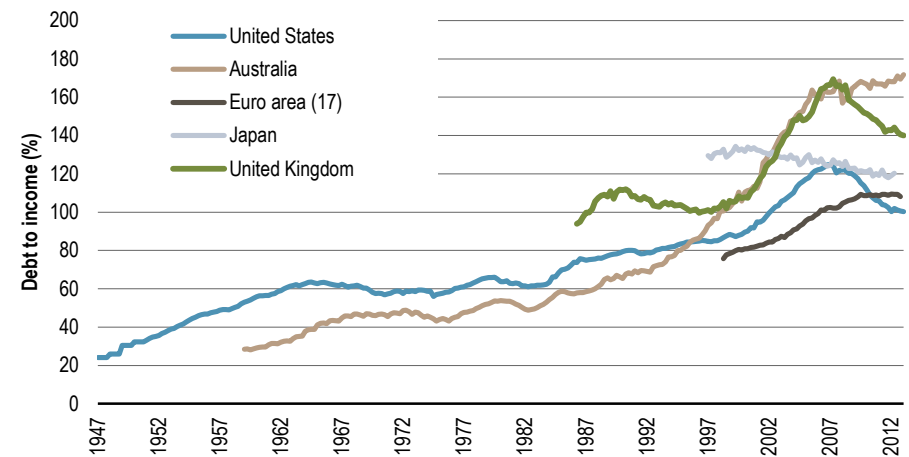
Economic growth is likely to be sub-par for a long time

Inverse dependency ratios across major economies



Source: UBS

Household & NPISHS debt to disposable income %

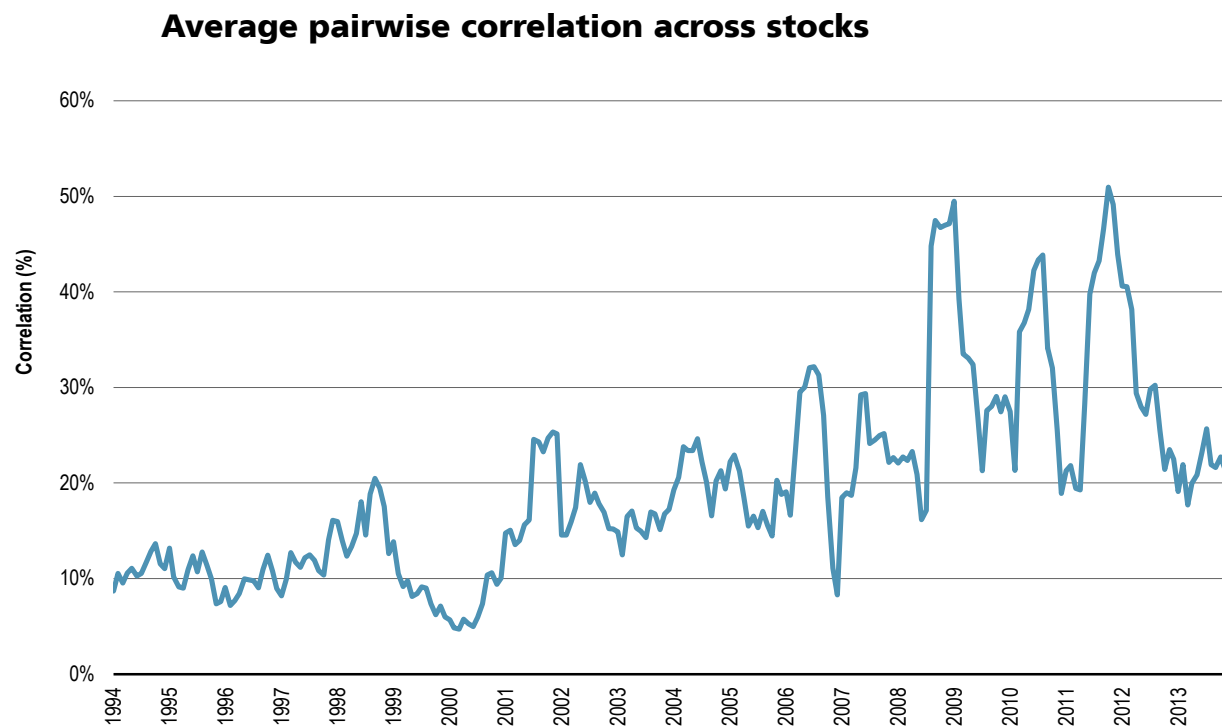


Source: UBS

As the working age population declines relative to the number of dependants (the Dependency Ratio), economic growth is likely to slow.

Debt levels around the developed world have increased dramatically.

Macro risk



Source: UBS

As a consequence of lower growth and higher levels of gearing, stocks are now demonstrating increased sensitivity to macro factors along with higher levels of correlation.

In a highly leveraged world of sub-par growth and elevated macro risk, we believe that defensive styles such as Quality are likely to outperform.

SECTION 2

What is Quality

Defining Quality

- Investors tend to think about Quality as either investing in high quality stocks, avoiding risky stocks or picking up on companies with improving quality.
- Linear vs. Binary
- We model factors based on their ability to predict
 - Excess returns,
 - Future earnings growth rates, and
 - Volatility.
- Tested across different economic regimes: US, Europe, Japan, Asia, and of course Australia
- In both up and down markets
- Excluding Financials
- Investigating twenty financial statement items across:
 - Profitability
 - Financial health
 - Efficiency
 - Management signalling
 - Risk

Note: for a list of factors tested, please see the report "Investing in Quality" Winter et al, 17 April 2014

Testing Quality

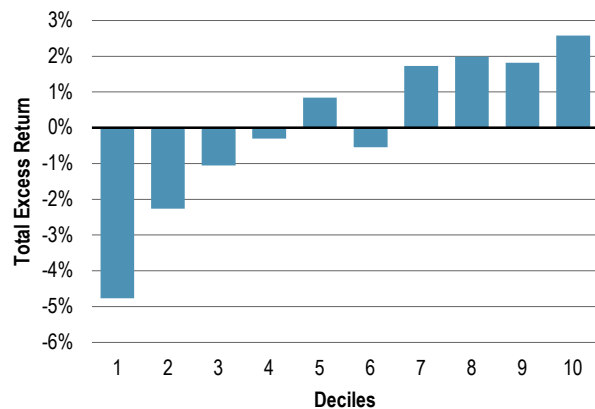
- Universe: MSCI World
- 1997 to 2014
- Tested in US\$
- Equal weighted returns against an equal weighted benchmark
- Monthly rebalancing
- Tested both globally and regionally, unconstrained and sector neutral.
- Note: in all decile ranks, decile 10 is regarded as desirable, and decile 1 as undesirable.

SECTION 3

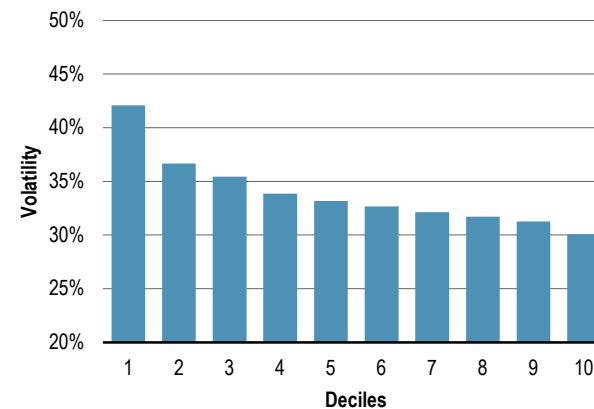
How does Quality perform?

High Quality

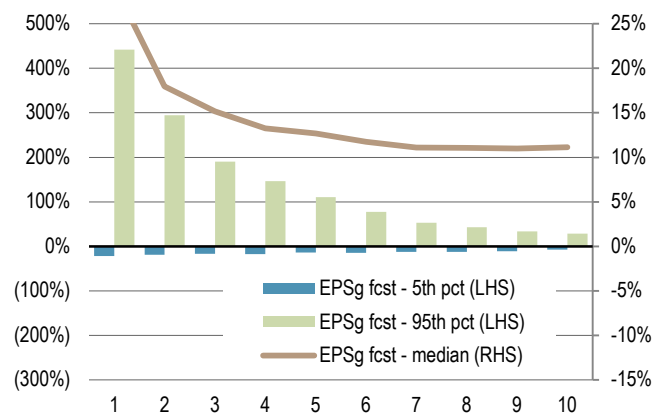
Total excess returns (12m, monthly)



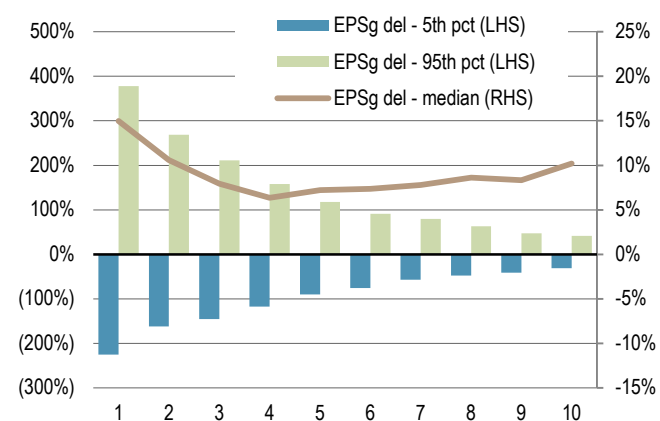
Subsequent volatility (12m, monthly)



Forecast earnings growth

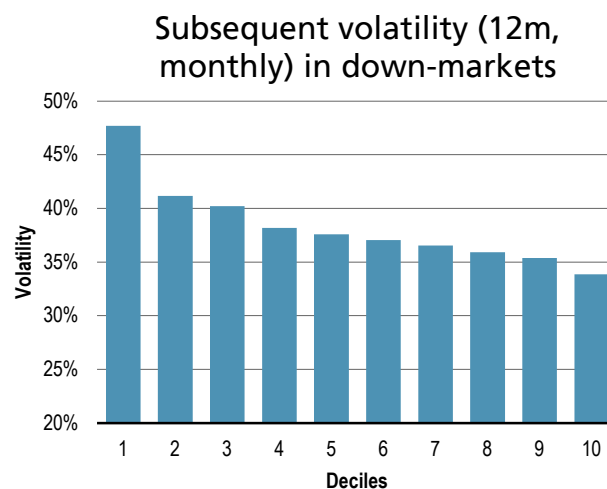
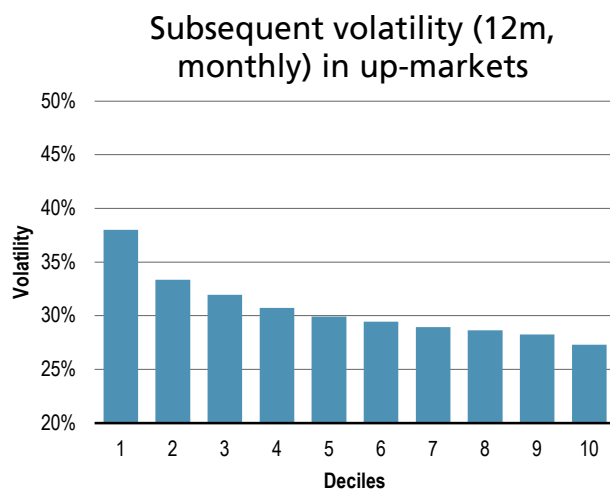
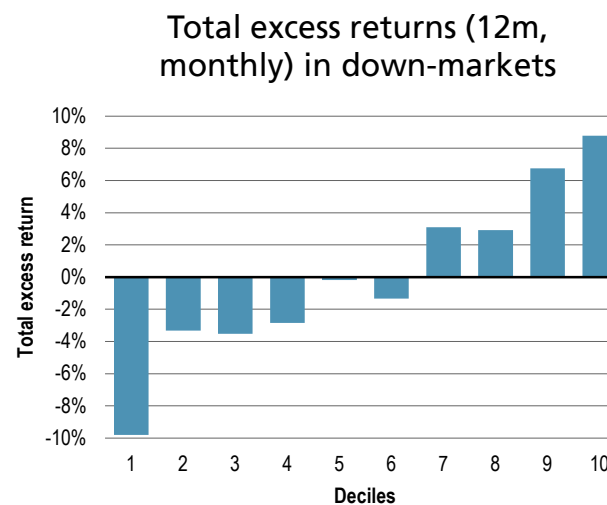
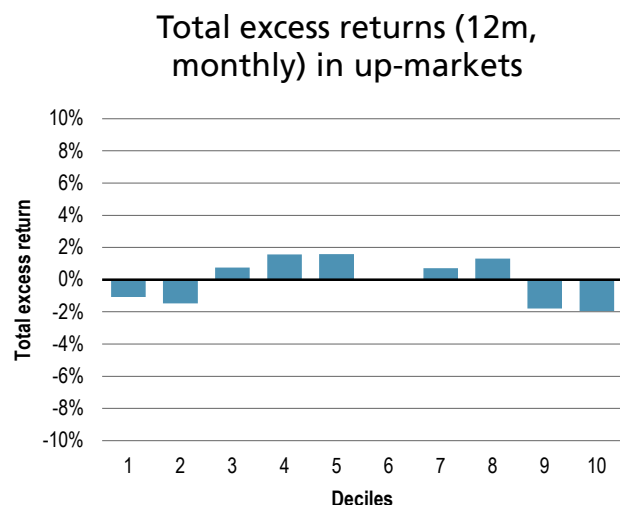


Delivered earnings growth rate



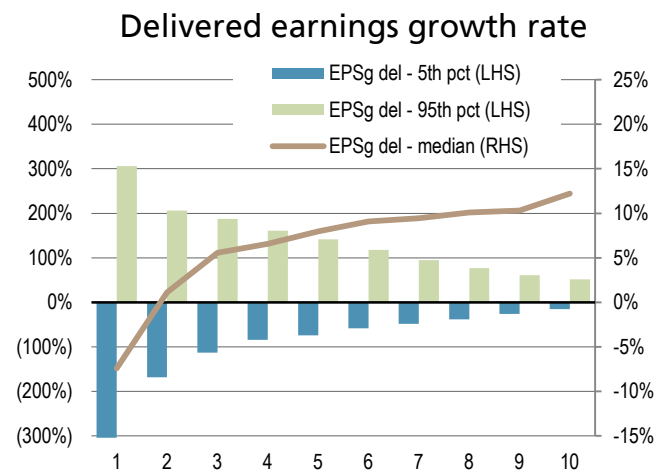
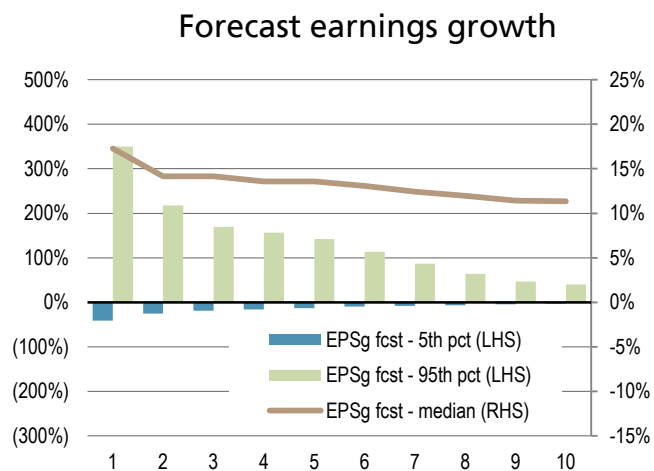
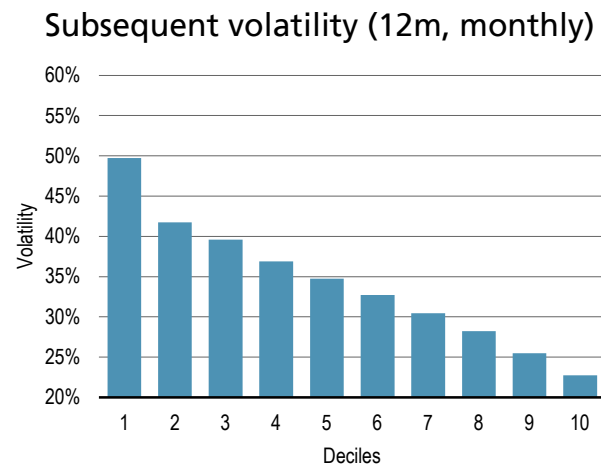
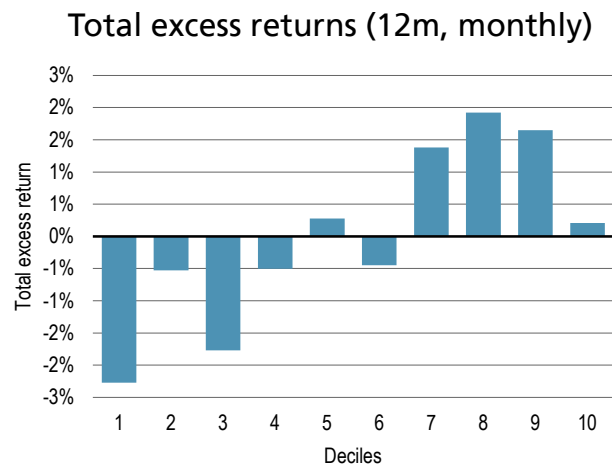
Source: UBS

High Quality – performance in up and down markets



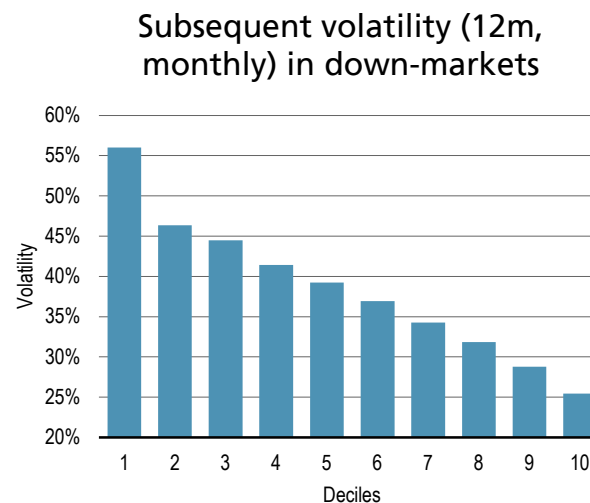
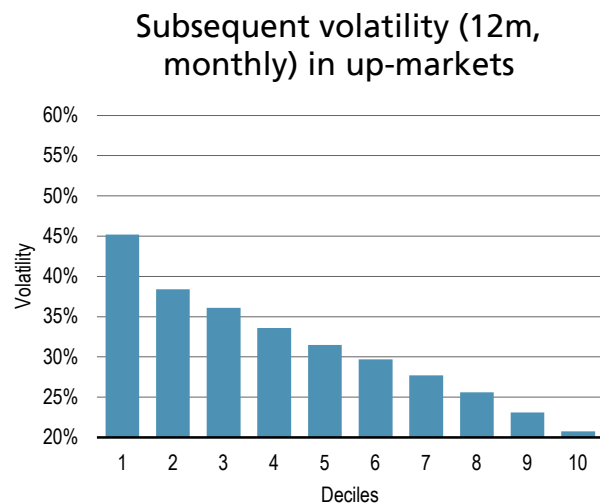
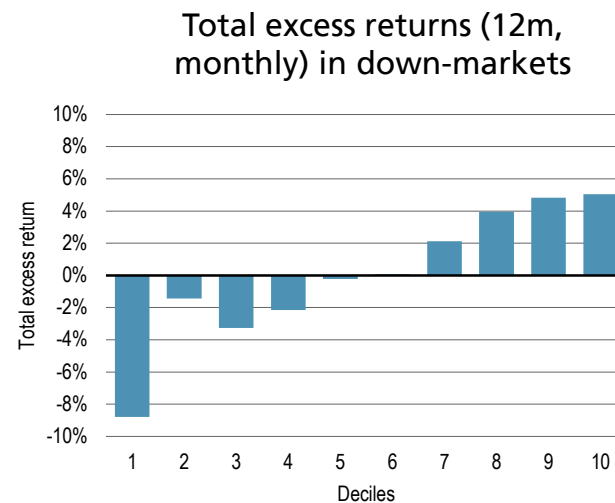
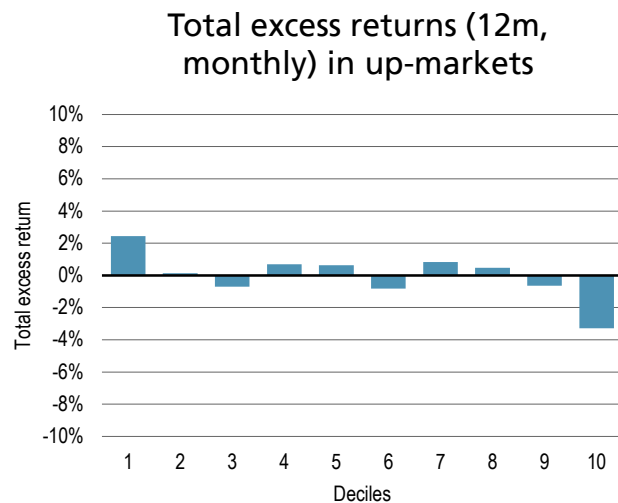
Source: UBS

Risk Alert



Source: UBS

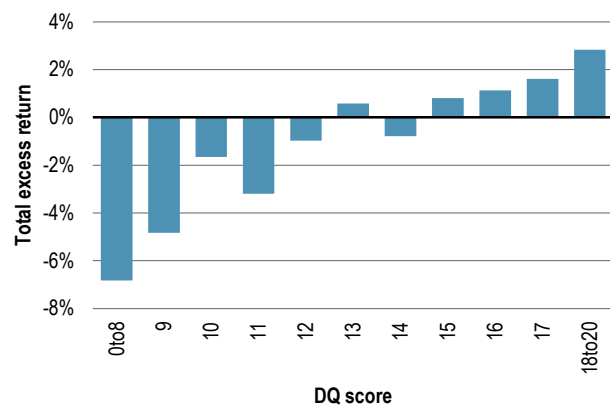
Risk Alert – performance in up and down markets



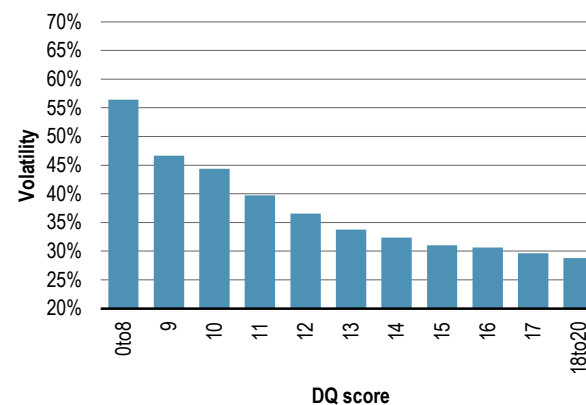
Source: UBS

Delta Quality

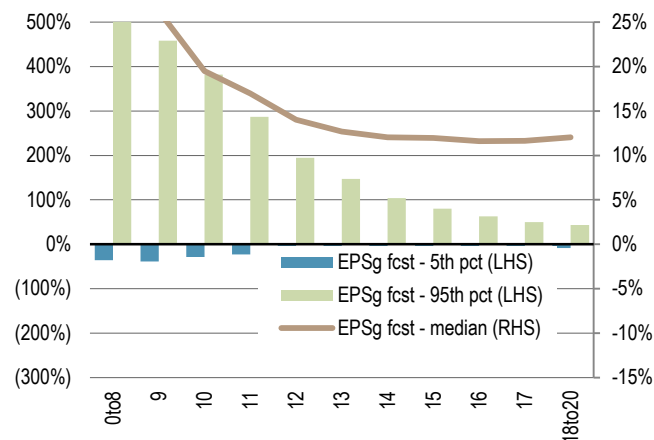
Total excess returns (12m, monthly)



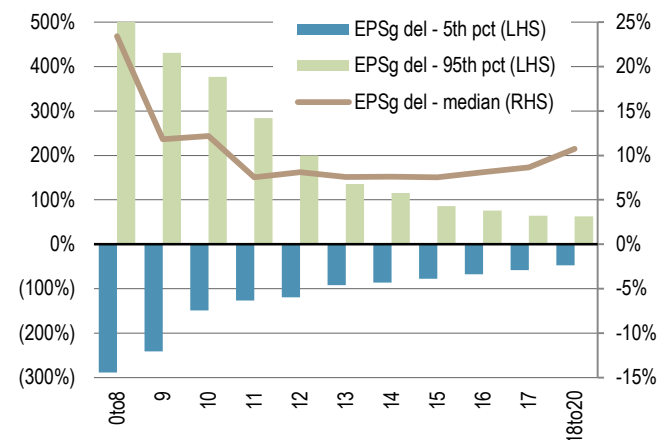
Subsequent volatility (12m, monthly)



Forecast earnings growth

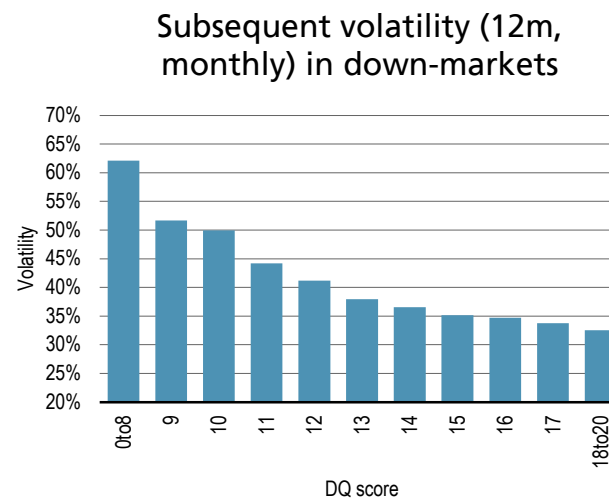
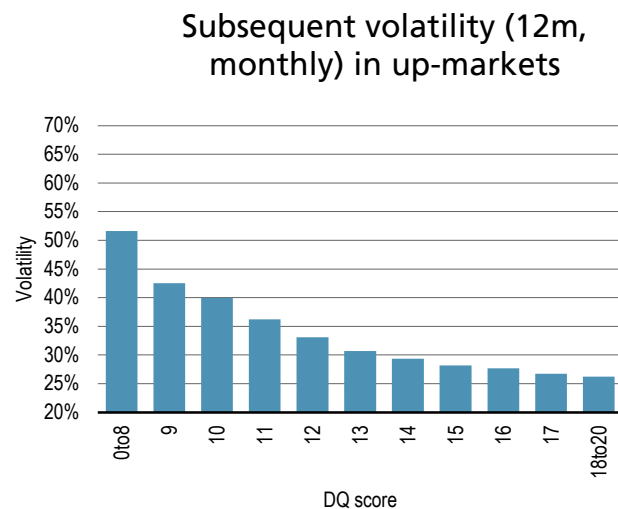
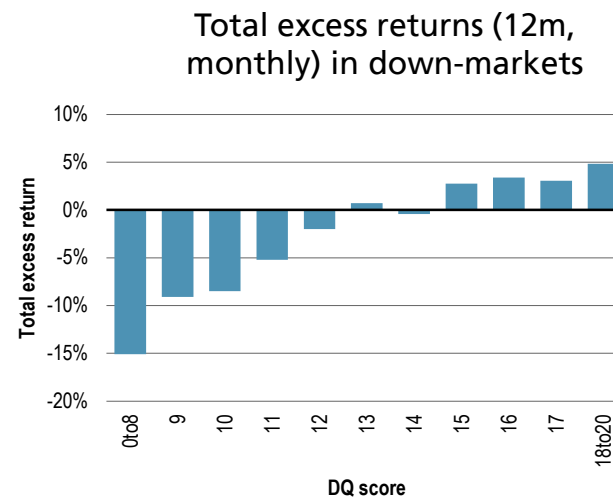
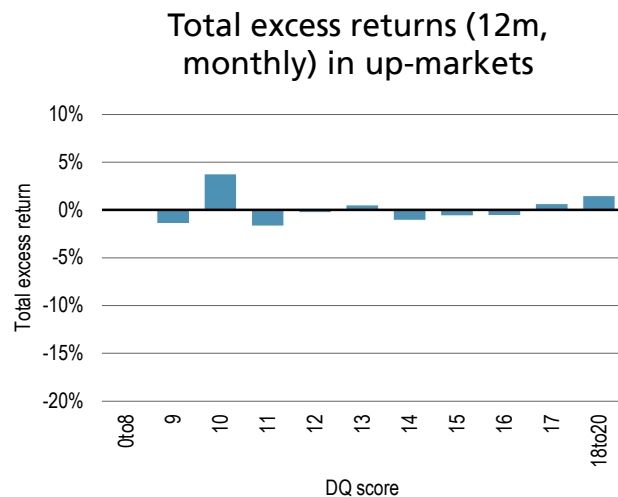


Delivered earnings growth rate



Source: UBS

Delta Quality – performance in up and down markets



Source: UBS

SECTION 4

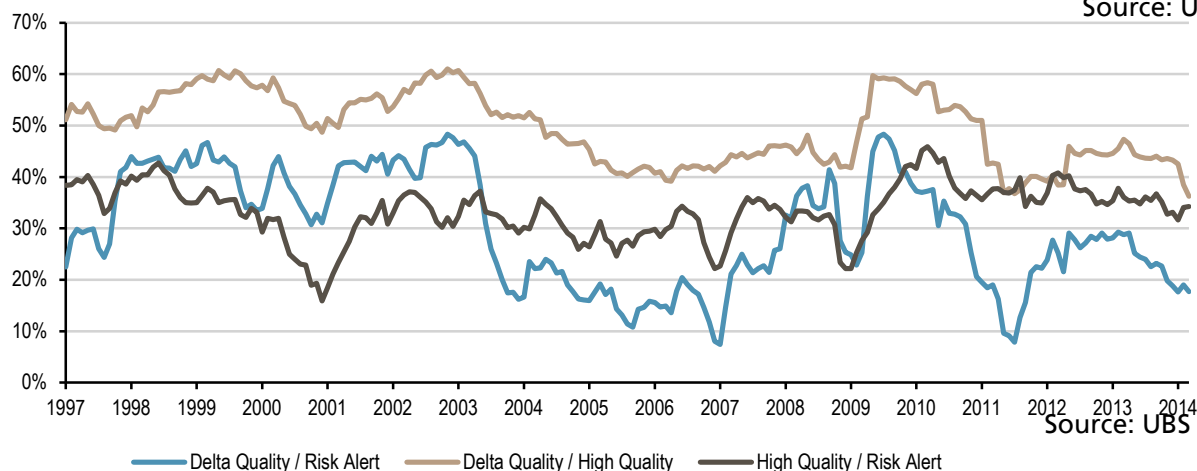
Digging into the detail

Performance metrics & rank correlations

Model	Intersection	Total Excess Return	Volatility	Sharpe	T-stat
High Quality	High Quality	2.4%	4%	0.55	2.30
High Quality	Neutral Quality	0.4%	2%	0.19	0.79
High Quality	Low Quality	-3.0%	5%	-0.65	-2.72
Risk Alert	Safe	1.4%	7%	0.19	0.80
Risk Alert	Neutral	-0.7%	2%	-0.30	-1.24
Risk Alert	Risky	-1.3%	13%	-0.10	-0.44
Delta Quality	Improving	1.9%	5%	0.41	1.71
Delta Quality	Stable	-0.5%	2%	-0.32	-1.35
Delta Quality	Deteriorating	-9.0%	14%	-0.64	-2.66

Rank correlations of the Quality models

Source: UBS For illustrative purposes only



Show me it's not just volatility

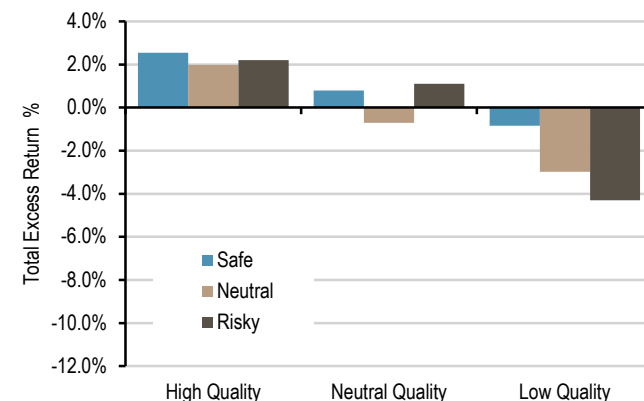
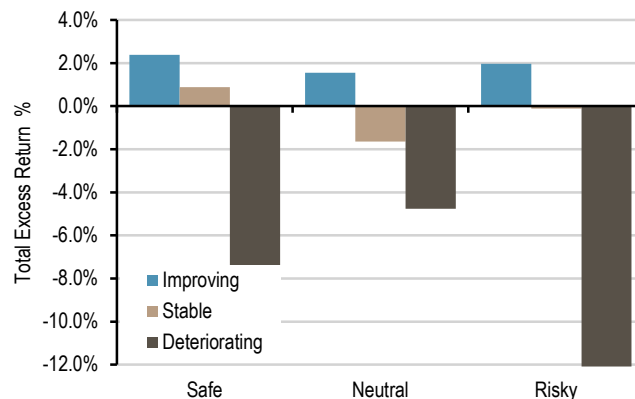
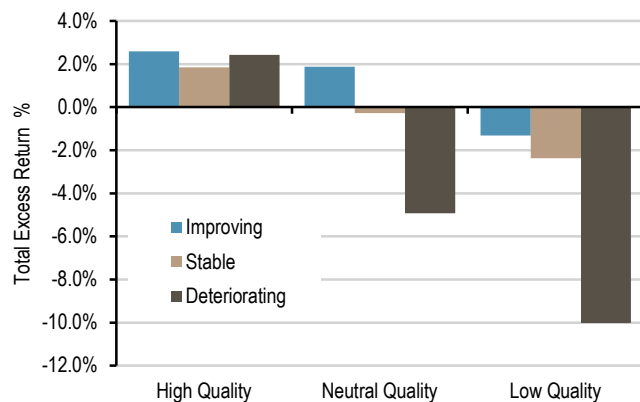
High Quality and Risk Alert models excess returns adjusted for volatility

	<< Highest Volatility			Deciles of Volatility					Lowest Volatility >>	
	1	2	3	4	5	6	7	8	9	10
High Quality Model	-3.5%	-2.7%	-1.4%	-0.3%	-0.2%	1.6%	1.0%	1.8%	2.2%	2.3%
Risk Alert Model	-1.0%	-1.2%	-0.3%	-0.6%	-1.1%	-0.2%	1.1%	-0.1%	1.8%	1.6%

Delta Quality model excess returns adjusted for volatility

	<< Highest Volatility			Deciles of Volatility					Lowest Volatility >>	
	1	2	3	4	5	6	7	8	9	10
Delta Quality Model										
Declining Quality	-18.9%	-16.8%	-9.7%	-6.4%	-9.0%	-10.3%	-6.1%	-15.9%	0.9%	-1.5%
Stable Quality	-9.0%	-4.7%	-3.0%	-5.9%	-2.6%	-1.8%	-1.5%	-0.9%	-0.9%	-1.3%
Improving Quality	-3.5%	-5.3%	-4.8%	-0.6%	-0.9%	2.0%	0.3%	1.0%	1.0%	-0.9%

Quality model intersections



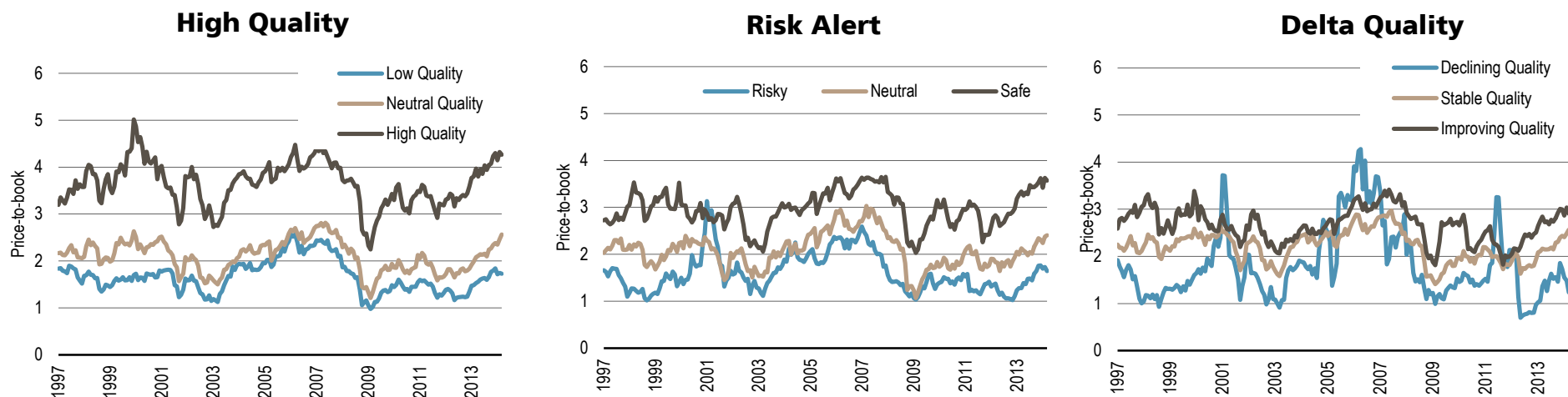
Performance of Quality model intersections

Model 1	Intersection	Model 2	Intersection	Total excess return	Volatility	Sharpe	T-stat
High Quality	High	Delta Quality	Improving	2.6%	6%	0.44	1.82
High Quality	Low	Delta Quality	Deteriorating	-10.0%	15%	-0.68	-2.83
Risk Alert	Safe	Delta Quality	Improving	2.4%	8%	0.30	1.26
Risk Alert	Risky	Delta Quality	Deteriorating	-12.1%	23%	-0.54	-2.22
Delta Quality	High	Risk Alert	Safe	2.5%	8%	0.33	1.37
Delta Quality	Low	Risk Alert	Risky	-4.3%	16%	-0.27	-1.12

SECTION 5

Surely it's priced?

Price to Book of each Quality model

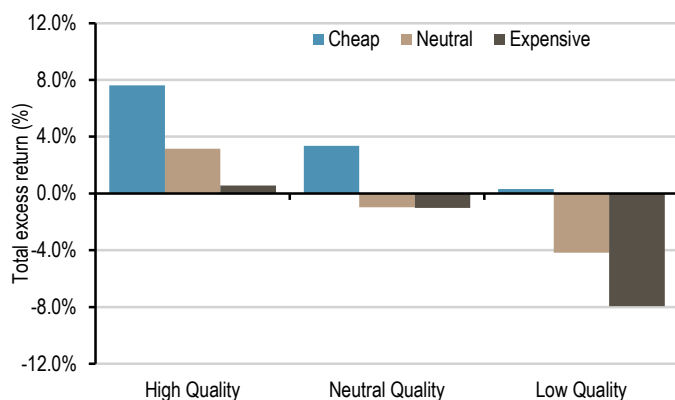


Source: UBS For illustrative purposes only

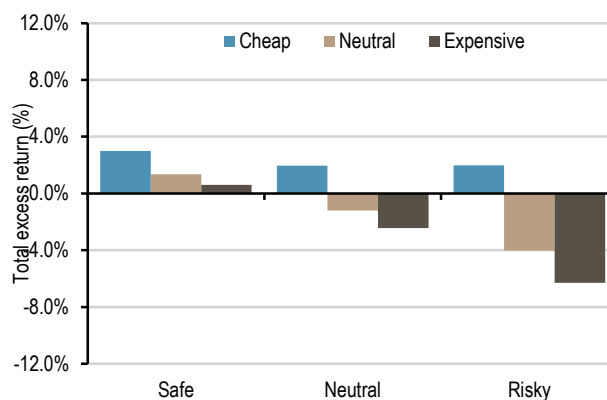
- Absolute levels of Quality (our High Quality and Risk Alert models) are reasonably efficiently priced, whilst the Delta Quality model is less so.
- These mispricing effects line up with periods of 'irrational exuberance' such as the Tech Bubble, the Resource Bubble and the post GFC recovery.

So where is the opportunity?

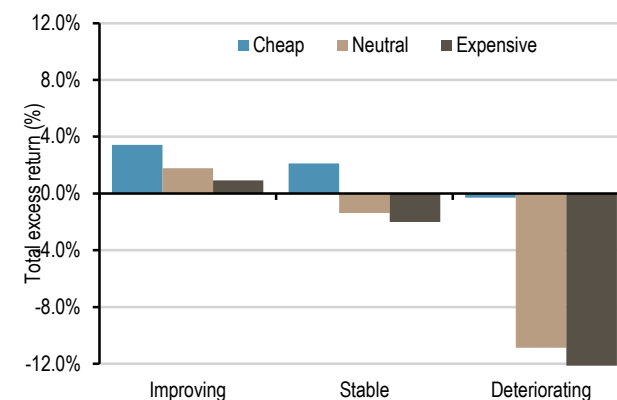
**High Quality Value Premium:
total excess returns**



**Risk Alert Value Premium:
total excess returns**



**Delta Quality Value Premium:
total excess returns**



Source: UBS For illustrative purposes only

Performance of Quality model intersections with Value (Price-to-Book)

Quality model	Description	Valuation	Total excess return	Volatility	Sharpe	T-stat
High Quality	High	Cheap	7.6%	31%	0.24	5.64
High Quality	Low	Expensive	-7.9%	39%	-0.21	-6.25
Risk Alert	Safe	Cheap	3.0%	25%	0.12	4.34
Risk Alert	Risky	Expensive	-6.3%	47%	-0.13	-3.35
Delta Quality	Improving	Cheap	3.4%	27%	0.13	5.05
Delta Quality	Deteriorating	Expensive	-12.5%	51%	-0.24	-3.81

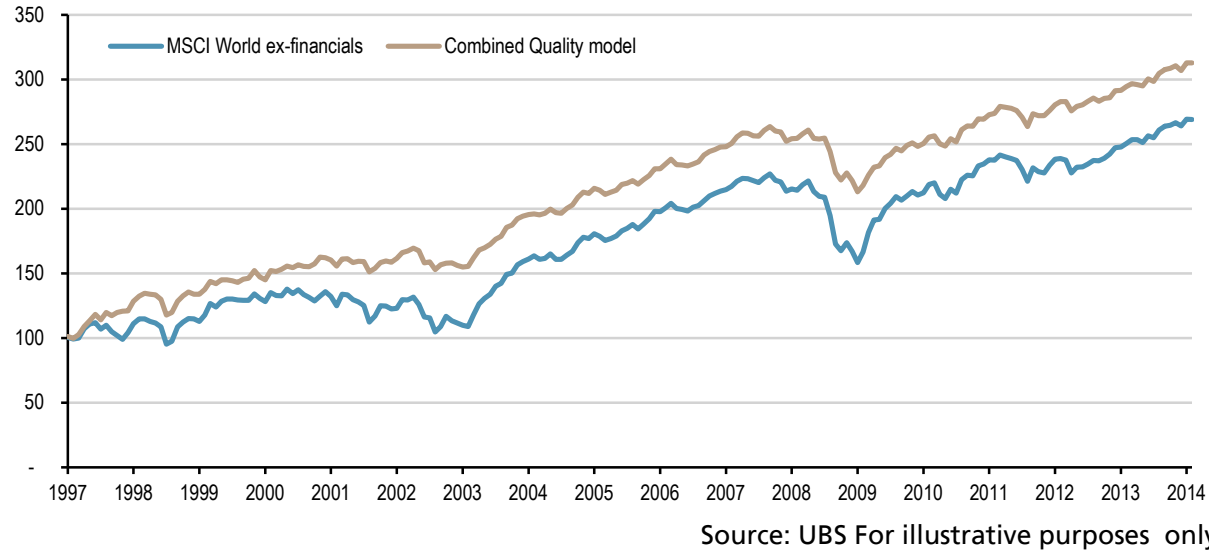
Source: UBS For illustrative purposes only

SECTION 6

Building a Quality model

A simple intersection approach

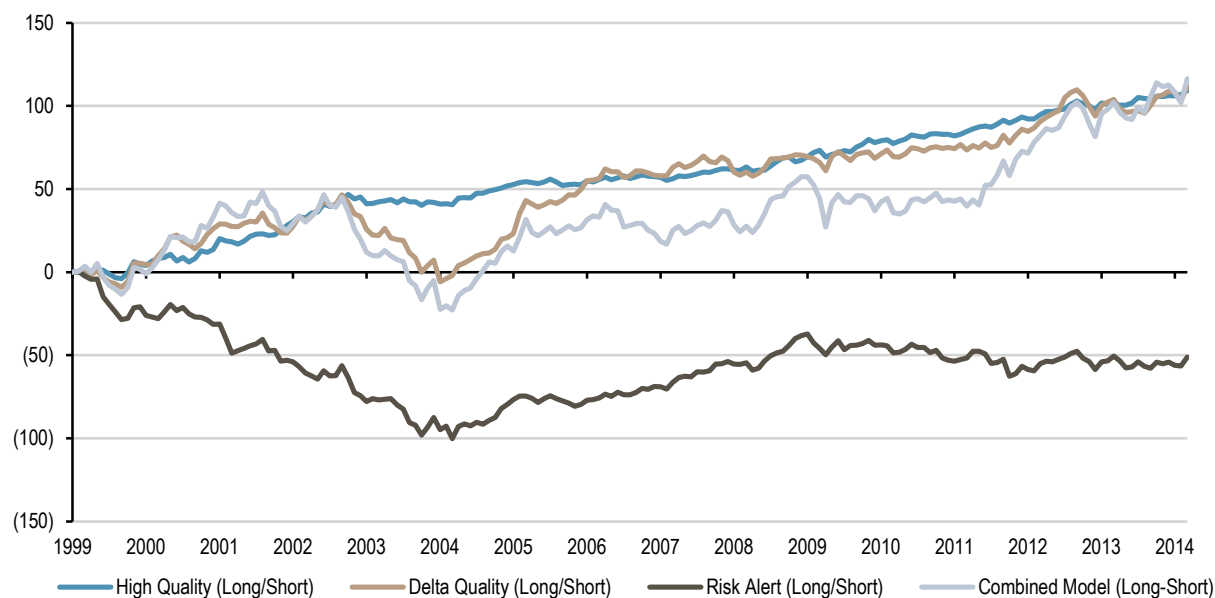
Combined Quality Model vs MSCI World ex-financials equal weighted



- We take the intersection of High Quality stocks with Improving Quality, and eliminate any stocks that fall into the Risky category of the Risk Alert model. The intersection has an average of 171 stocks in it at any point in time.
- Overall, the model outperforms the benchmark by 2.6% per annum, with 6.4% volatility, a Sharpe ratio of 0.40 and a t-stat of 1.65

Four factor alphas

High Quality model (Long Short) four factor alpha



	Ann Ret	Vol	Sharpe / IR	Tstat
High Quality (High-Low)	7.2%	6%	1.16	4.50
Risk Alert (Safe-Torpedo)	-3.4%	12%	-0.29	-1.12
Delta Quality (Improving-Declining)	7.4%	13%	0.57	2.22
Combined Model (Long Only)	2.1%	4%	0.49	1.89
Combined Model (Short Only)	-5.6%	18%	-0.32	-1.23
Combined Model (Long-Short)	7.7%	20%	0.39	1.52

Source: UBS For illustrative purposes only

SECTION 7

Conclusion

Quality matters

- Quality matters right now for two reasons:
 - we have entered into a world of structurally lower growth defined by ageing populations and rising dependency ratios.
 - secondly, as a result of the demographic dividend and consummate credit bubble we now find ourselves in a highly leveraged world with lower growth rates.

As a consequence, we face heightened macro-economic risk which is likely to result in higher levels of volatility and correlation in the future. In this environment, good quality companies are likely to outperform.
- We find that Quality can be defined as: High Quality, Risky or Change in Quality
- Quality models can be used in two ways:
 - Firstly to deliver a low risk equity risk premium,
 - and secondly to enhance the Value Premium.

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Buy	FSR is > 6% above the MRA.	47 %	33 %
Neutral	FSR is between -6% and 6% of the MRA.	42 %	34 %
Sell	FSR is > 6% below the MRA.	11 %	23 %
UBS Short-Term Rating	Definition	Coverage ³	IB Services ⁴
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1 %	less than 1 %
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1 %	less than 1 %

Source: UBS. Rating allocations are as of 31 March 2014.

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