The advantages of focusing on quality cannot be understated. By investing in quality you significantly reduce the probability of permanent loss of capital.

And since the business is strong, the long term returns are far superior to average quality businesses. Thus investing in quality is the perfect recipe to generate superior risk adjusted returns. But quality has become a generic term today when it comes to investing. No investor would tell you that they don't invest in quality stocks. But the definition of quality is different for everyone and one might even say that quality is often in the eye of the beholder.

Rather than debating on the various definitions of quality we would like to discuss how we look at quality in Multi-Act.

Quantitative Analysis:

There are certain Quantitative and Qualitative attributes that help us identify quality. We certainly use some of the widely used quantitative criteria like High Return on Capital Employed (ROCE) and Return on Equity (RoE) which should over a business cycle be higher than the cost of capital, high Free Cash Flow (FCF) generation, low leverage etc. In addition to that we also look at the market share of the company and how market shares have changed within industry to understand the competitive structure of the industry and the relative positioning of the company.

NSE launched the NSE Quality 30 Index, which is the index of high quality stocks selected by NSE using quantitative criteria like ROE, Leverage etc. (*Click here for methodology*). As you can see from the chart below, since the inception of the index NSE Quality 30, the index has outperformed NIFTY 50 by decent margin. In fact if we compare the CAGR and the worst drawdowns, one can say the returns have been generated with relatively less risk. Thus by using pure quantitative parameters superior risk adjusted returns have been generated by NSE Quality 30 as compared to NIFTY 50.

	NSE Quality 30	NIFTY 50
CAGR (1 Oct 2009 – 30 Apr 2018)	11.9%	9.1%
Worst Drawdown	-17.7%	-28.0%

Qualitative Analysis:

While filtering stocks, using quantitative criteria is an essential first step; identifying the qualitative attributes is equally, if not more, important.

When we filter stocks using quantitative criteria, we have to appreciate the fact that the entire analysis is being done using historical data. Thus the quantitative parameters identifying past quality of a business may not essentially reflect the sustainability of the quality in the future. This is where the qualitative analysis comes into the picture.

Also as quantitative criteria is being applied on company reported data, one needs to be sure that numbers that we are working with are clean i.e. there is no manipulation happening from accounting/reporting perspective. If the numbers that we are working with have quality of earnings issues it could lead to wrongful determination of quality and could have devastating effect.

If a business has shown attributes of quality based on quantitative analysis of past numbers, the sustainability of these numbers in the future depends on whether the business enjoys any competitive advantage. If the business does not have any identifiable competitive advantage, the high profitability numbers would attract competition and the excess returns over cost of capital would be faded away. We at Multi-Act devote our time to identify the competitive advantage once the business has shown evidence based on long term historical numbers.

Going back to our example of NSE Quality 30, if we look through the constituents, only 47% companies have sustainable competitive advantage as per Multi-Act research. Thus almost 53% of the companies in the NSE Quality 30 index may reflect historical attributes of quality, but the sustainability of the same in the future is questionable.

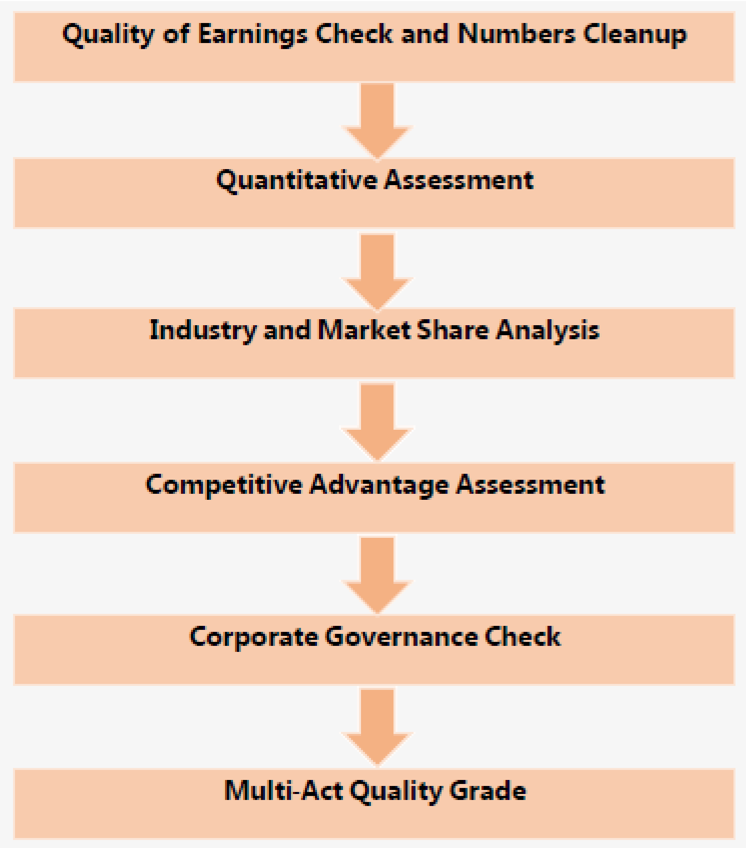
A business might show quality attributes based on historical numbers and we might also be able to identify the competitive advantage that could make these quality attributes sustainable in the future.

But one more important criterion is the prudence of the majority shareholder/management in deploying capital and the willingness of the majority shareholder to share the fruits of such a business with the minority shareholders (i.e. us as investors). Being a minority shareholder in a business, we are essentially partners with the majority shareholder/management without having much say, which makes it extremely crucial to focus on the corporate governance.

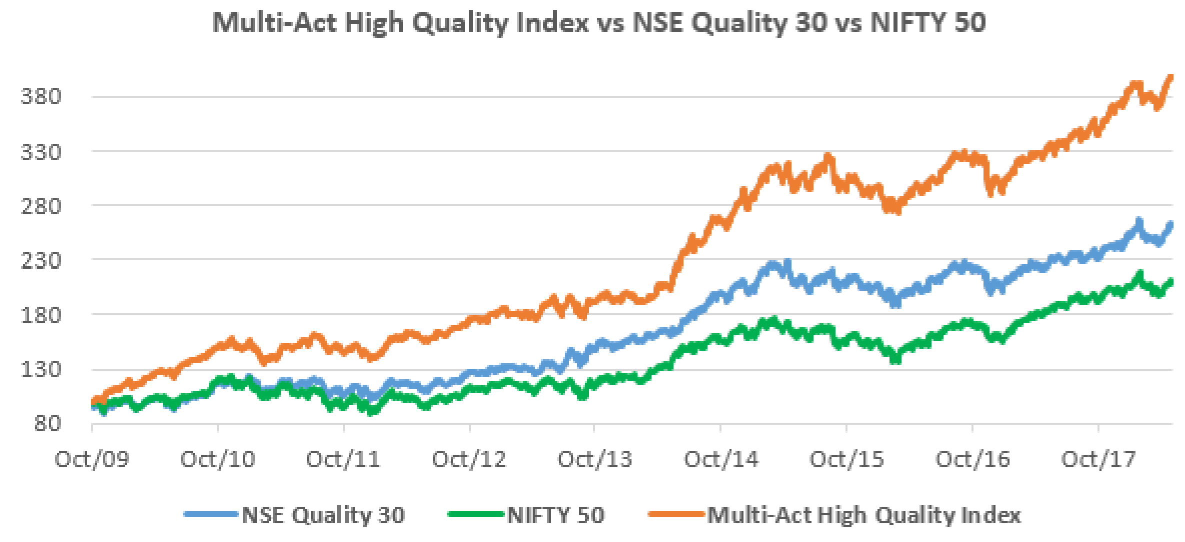
All the positives of the business could be negated by poor corporate governance if the management is not prudent enough in their capital allocation or if the management takes actions which benefit the majority shareholder at expense of minority.

Again if we look at the NSE Quality 30, there is currently a stock which might have cleared the quantitative parameters of quality but would have miserably failed based on qualitative analysis of the business model and significant red flags from a quality of earnings and corporate governance perspective (Refer to our blog on this company). This stock has lost close to 84% of value from its peak in less than 6 months.

We at Multi-Act believe that Quantitative analysis to identify quality stocks is only a starting point and needs to be completed by thorough qualitative analysis.



The result of such an approach can be seen through the Multi-Act High Quality Index, which is a 30 stock equal weighted index of High Quality stocks identified by Multi-Act. This index has beaten both the NIFTY and NSE Quality 30 Index by a wide margin and with lower drawdowns.



	NSE Quality 30	NIFTY 50	Multi-Act High Quality Index
CAGR (1 Oct 2009 – 30 Apr 2018)	11.9%	9.1%	17.5%
Worst Drawdown	-17.7%	-28.0%	-16.7%

Such holistic approach makes sure that you identify companies that have the attributes of quality from historical as well as forward looking perspective (i.e. sustainability of quality) and most importantly helps you to avoid potential landmines which a pure quantitative approach would not be able to identify.