Investing in Quality Companies

FAYEZ
SAROFIM
& CO.

EXECUTIVE SUMMARY

Investing in quality companies is rooted in thorough fundamental analysis to assess a company's financial strength, growth prospects, profit and income generation and overall stability. While various definitions of "quality" abound, most companies considered high quality possess similar attributes in terms of offering consistent profit and income generation, reduced volatility, downside protection in bear markets, and superior risk-adjusted returns as compared to a market index. In addition, Fayez Sarofim & Co. believes additional layers of assessment are appropriate and utilizes its fundamental research capabilities to rate important qualitative factors such as management quality and shareholder orientation, company business models and strategy, and ESG factors to enhance its evaluation process of quality companies. We believe an actively managed strategy provides an aspect of risk management and timeliness not available in passive strategies.

Due to these unique characteristics, quality companies have historically demonstrated predictable periods of outperformance within a market cycle as well as above-average returns with lower risk, as measured by the S&P 500 Quality Index, over longer time periods, which is illustrated later on in Chart 11. Investing in quality companies offers a source of diversification beyond traditional style boxes and should be considered as part of an investor's overall asset allocation decision.

Furthermore, Fayez Sarofim & Co. believes these high quality companies are especially attractive in the current market environment given the unknown stresses placed on the global economy, US financial system and corporate earnings as a result of the Coronavirus pandemic. Historical price performance indicates that high quality stocks typically outperform in volatile markets (hence the term, "flight to quality") and decelerating earnings growth environments, both of which are likely to persist for some time. While the timing and pace of a global economic recovery are unpredictable, quality companies possess attributes such as high profit margins, high return on equity (ROE),[1] low leverage, and free cash flow to weather the current dislocations in economic growth and emerge well-positioned to fully participate in a recovery.

DEFINING QUALITY

While there is not one commonly accepted definition of quality when it pertains to equity investing, definitions can encompass characteristics including, but not limited to, leverage, return on equity, profit margin, history of profit and income growth, liquidity and beta.[2] Typically, high quality companies possess a history of stable earnings and dividend growth, high returns on equity, generous profit margins and cash flow, and low debt levels. Conversely, low quality companies have an inconsistent record of profit growth, low or no dividends, high leverage, low returns on equity and generally more volatility. According to 2012 research from Standard & Poor's, historical price performance indicates that high quality stocks typically outperform in volatile markets (hence the term, "flight to quality"), decelerating earnings growth environments and periods of fiscal and monetary tightening.[3] Lower quality stocks tend to outperform in robust market rallies when risk appetite is high, periods of speculation or in the initial stages of an economic recovery.

One commonly used and accepted metric for assessing a company's quality is the S&P Global Market Intelligence's Quality Rankings which have been compiled since 1956 and rank common stocks based on the long-term growth and stability of a company's earnings and dividends. Furthermore, S&P Dow Jones Indices maintains the S&P 500 Quality Index and the S&P 500 Quality – Lowest Quintile Index[4] which offer a straightforward method for analyzing past performance of these different types of companies.

In addition to these quantitative statistics, other aspects of defining quality may include an assessment of a company's competitive position as well as management's expertise and shareholder orientation. An evaluation of corporate culture and reputation may also add value to this determination.

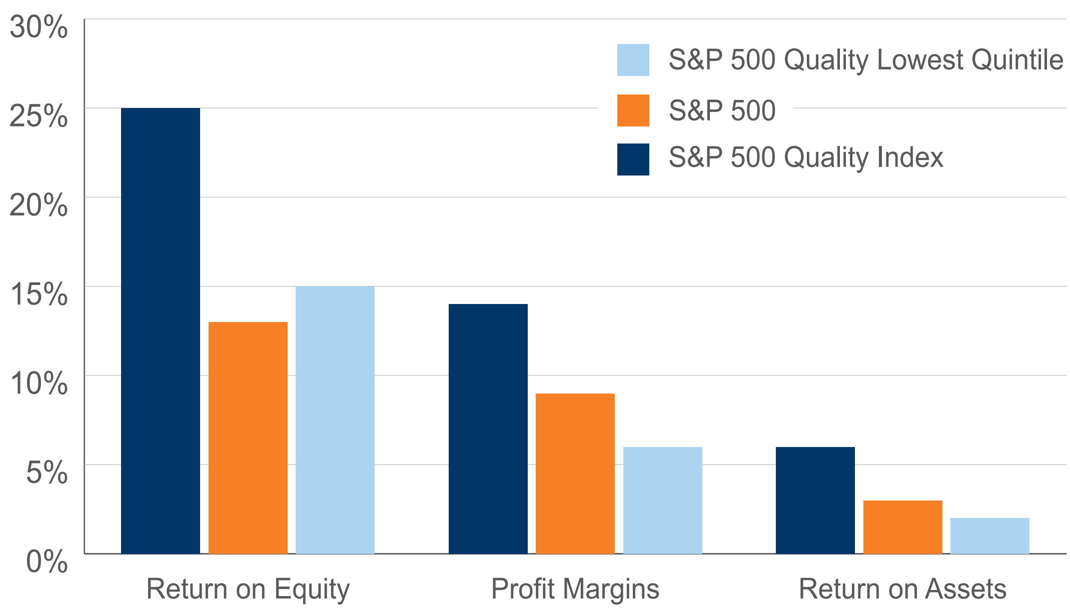
Another measure that cannot be captured in the S&P Rankings is a company's "quality of earnings" – a term meant to reflect how accurately a company's reported earnings reflect the economic reality of its profitability. Accounting choices can provide management with opportunities to distort this connection while staying within the bounds of Generally Accepted Accounting Principles (GAAP).[5] A study conducted by S&P Capital IQ showed that companies ranked highly by the Quality Rankings System "appear less likely to engage in accounting manipulations and reported significantly lower non-recurring items."[6] In addition, "lower dispersion in analyst estimates also indicates higher quality and more predictable earnings for high quality companies."[7]

ATTRIBUTES OF INVESTING IN QUALITY COMPANIES

Attributes of investing in quality companies, as compared to a market index or low quality stocks, include superior profitability and leverage characteristics, cash flow and dividend growth, lower volatility, downside protection, and a history of outperforming in volatile markets.

1. Superior Profitability and Leverage Characteristics

Chart 1: Profitability Ratios



Source: Bloomberg. Data as of March 31, 2020

Leverage Ratios	Total Debt/ Total Equity	Total Debt/ Total Assets
S&P 500 Quality	75%	18%
S&P 500 Lowest Quintile	273%	35%

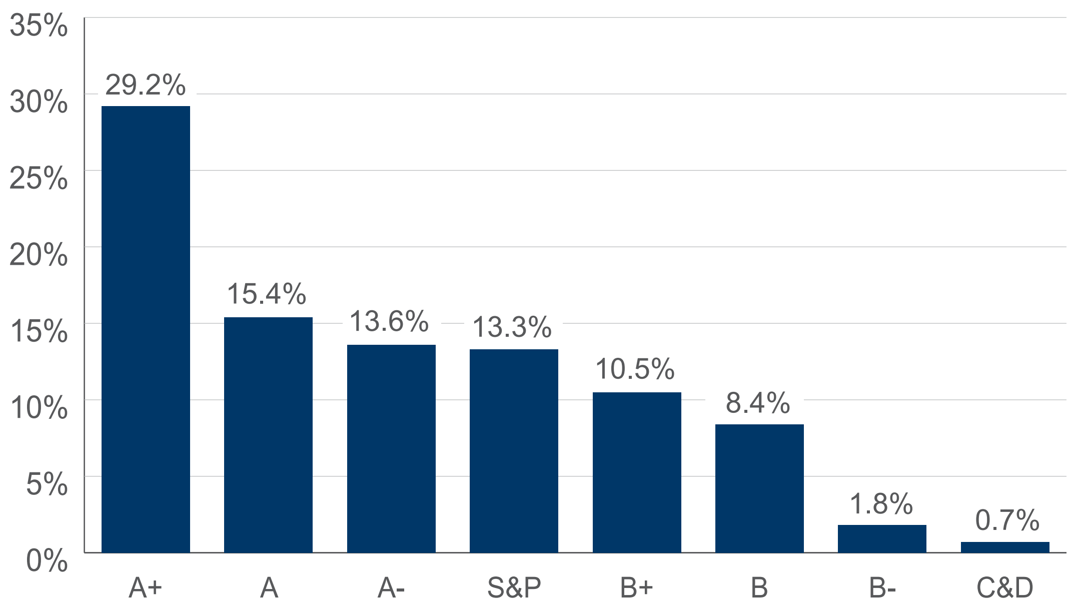
Source: Bloomberg. Data as of March 31, 2020

2. Cash Flow and Dividend Growth

S&P defines high quality companies based on the growth and stability of earnings and dividends over 10 years. High quality companies possess the consistent earnings and cash flow generation necessary to pay, maintain and raise dividends.

Strong cash flows allow these companies to grow their dividends consistently over time. Chart 3 below illustrates that high quality stocks have offered higher dividend growth rates than the low quality stocks as well as the S&P 500 over the past 10 years. This growing stream of income, if maintained, can also benefit investors by serving as a natural inflation hedge.

Chart 3: Quality Rankings 10 Year Historical Dividend Growth '09-'19 (CAGR)



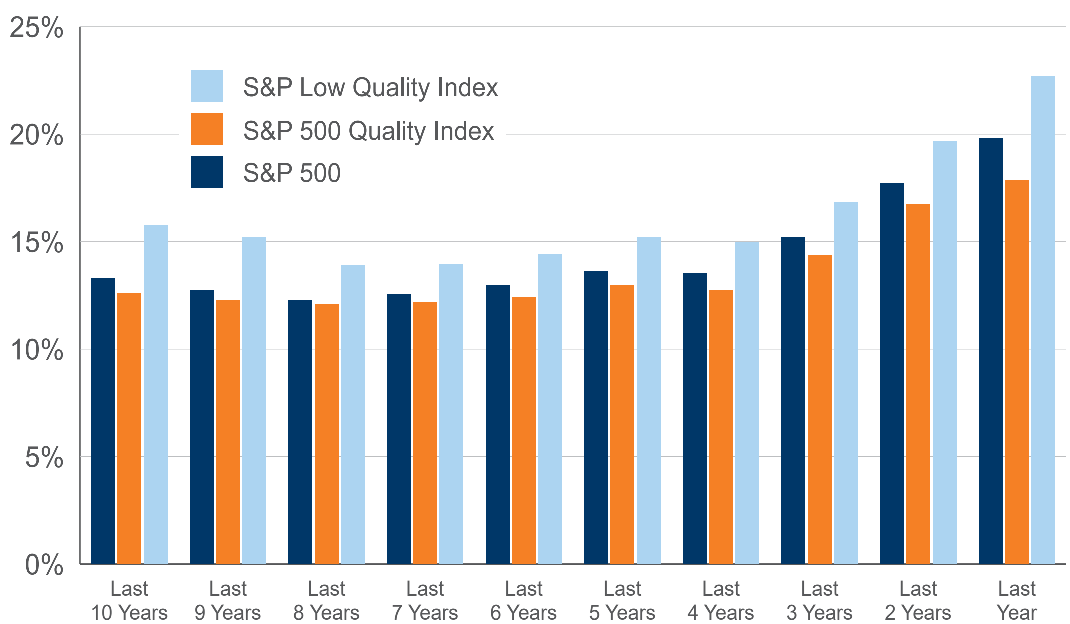
Source: Factset. Data as of March 31, 2020. CAGR stands for Compound Annual Growth Rate.

3. Lower Volatility

High quality companies offer lower volatility given their superior fundamentals such as higher, more stable earnings, higher returns on equity and lower leverage. Low volatility is important to investors because it works to preserve capital in a down market thereby providing a larger foundation for any subsequent market appreciation, typically resulting in higher end values than a higher volatility approach.

Chart 4 below shows a time series measuring the standard deviation[8] of high quality, low quality and S&P 500 stocks over both long and short-term time periods. As you can see, on any time period, high quality stocks offer less volatility than both the low quality or market index.

Chart 4: Standard Deviation

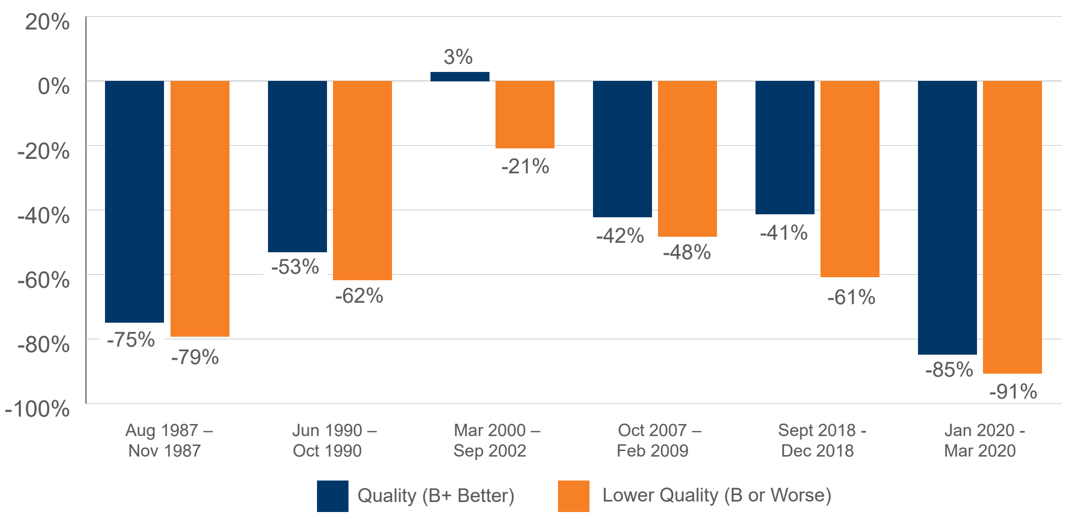


Source: S&P Dow Jones Indices LLC. Data as of March 31, 2020

4. Downside Protection

Higher quality stocks particularly have been shown to shine in bear markets. Chart 5 below shows that over the past six bear markets, high quality stocks have outperformed low quality stocks by an average of 11.3% annualized.

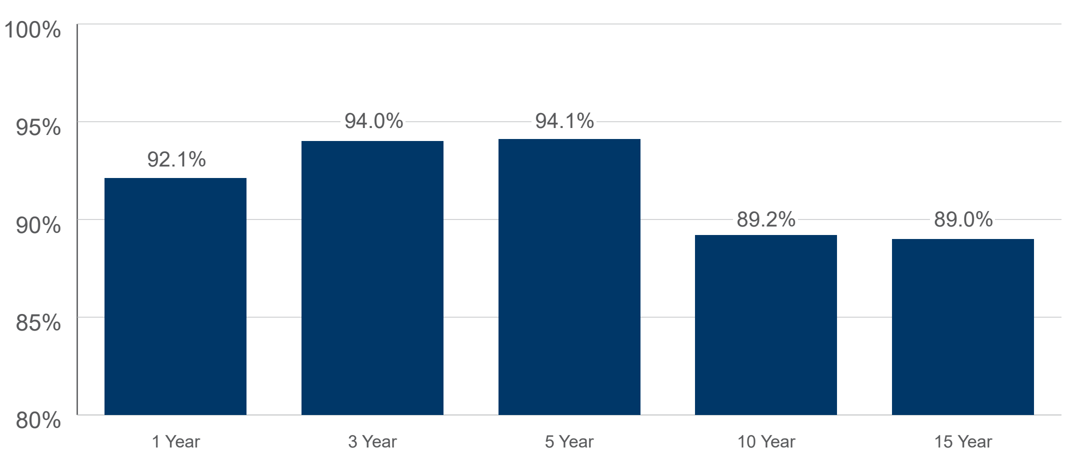
Chart 5: Performance in Various Bear Markets (Annualized)



Source: BofA Merrill Lynch US Quantitate Strategy, Standard & Poor's as B+ or better quality rank, Low Quality defined as B or worse quality rank.

Another way to show downside protection is through the Downside Capture Ratio (Chart 6).[9] While the 3 and 5 year Capture ratios are somewhat elevated due a difficult period for Quality stocks, longer-term periods show the resilience of Quality Stocks with downside capture ratios below 90%.

Chart 6: S&P Quality Index Downside Capture Ratio Relative to S&P 500 Index

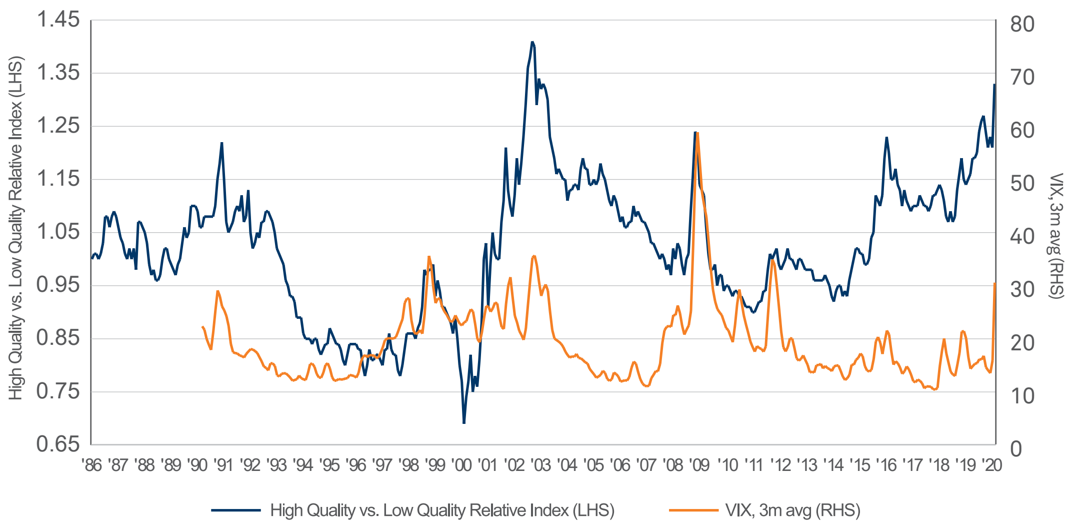


Source: S&P 500 Quality Index. Data as of March 31, 2020.

5. Outperform when Volatility Rises

Chart 7 below shows that most spikes in volatility since 1986 have coincided with the outperformance of higher quality stocks. More recently, as volatility has escalated over the past year, high quality stocks have outperformed low quality stocks.

Chart 7: B+ or Higher vs. B or Lower and 3M Average VIX



Source: BofA US Equity & Quant Strategy, S&P, FactSet, CBOE.

As of 3/31/20. The Chicago Board Options Exchange (CBOE) Volatility Index (VIX) is a real-time market index that represents the market's expectation of 30-day forward-looking volatility.

Another way to look at how quality stocks perform in volatile markets is to analyze an investment's Sortino Ratio. Because the Sortino ratio focuses only on the negative deviation of a portfolio's returns from the mean, it is thought to give a better view of a portfolio's risk-adjusted performance since positive volatility is a benefit. When looking at two similar investments, a higher Sortino ratio is preferred because it means that the investment is earning more return per unit of the bad risk that it takes on. Table 1 below shows the S&P Quality Index has generally offered a superior Sortino Ratio versus the Low Quality Index as well as the S&P 500.

Table 1

Sortino Ratios	3 Years	5 Years	10 Years	15 Years
S&P 500 Quality	.31	.50	1.28	.82
S&P 500 Lowest Quintile	.10	.33	.77	.31
S&P 500 Index	.27	.55	1.12	.60

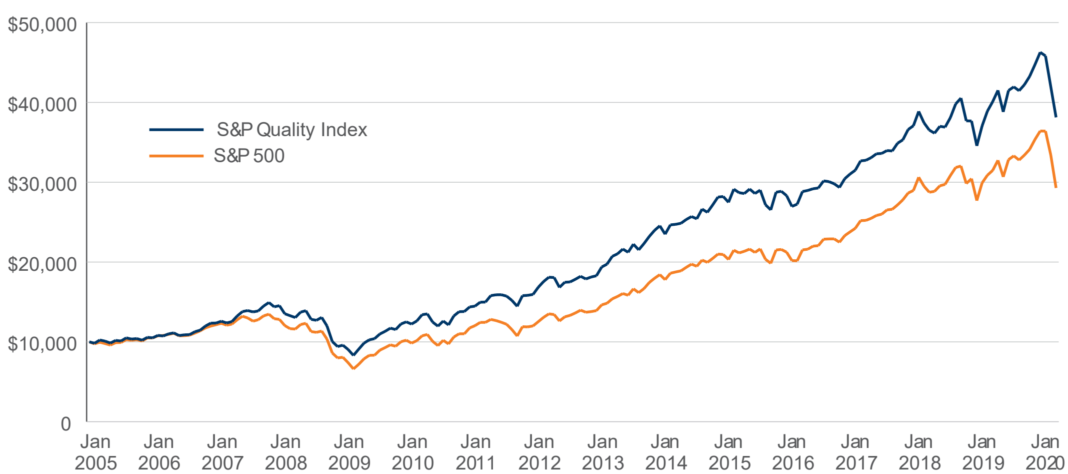
Source: Callan Associates Inc. Data as of March 31, 2020

RECORD OF CONSISTENCY

Besides the attractive income and risk-reward characteristics mentioned above, other notable attributes of high quality companies include greater liquidity, higher average prices per share, market size and stability of quality rankings over time.[10] The stability of quality rankings over time indicates that once a company is rated as high quality, it will tend to keep that rating in the year ahead. Therefore, these stocks appear well-suited for an investor with a buy-and-hold approach, who is not inclined to chase short-term earnings trends or play market cycles. High quality companies tend to retain their quality status from year to year, and so are able to benefit from the advantages of longer holding periods such as potentially lower realized capital gains taxes and transaction costs typically associated with a higher turnover approach.

While the performance of quality stocks can and does go through shorter term cycles, Chart 8 below illustrates that committing to a Quality strategy has resulted in superior capital appreciation over the last 15 years versus the S&P 500.

Chart 8: Growth of $10,000: S&P 500 Quality Index vs. S&P 500 Index



Source: Bloomberg. Data as of 3/31/20.

As of 3/31/20, the ending value for the S&P Quality Index was $38,125 and the ending value for the S&P 500 Index was $29,280.

ESG AND QUALITY INVESTING ARE NOT THE SAME

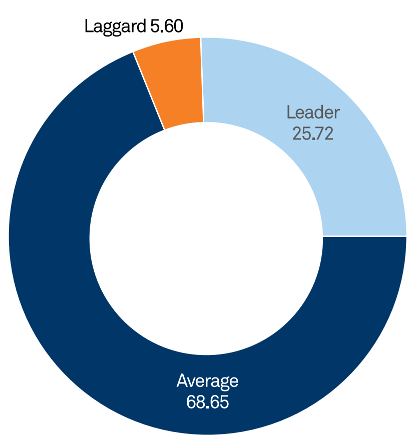
Environmental, Social and Governance (ESG) investing refers to these three factors, which measure the sustainability and societal impact of an investment. ESG has attracted a lot of interest from investors recently and could be easily confused with Quality investing. While these criteria may help to determine a company's future financial performance due to their environmental or labor practices, highly ranked ESG companies have generally low or negative correlations with the Quality factor (Chart 9). Adding Quality to an asset allocation is not redundant with an ESG mandate. Chart 10 on the next page shows poor ESG ranks signaled high risk in earnings per share (EPS)[11] volatility over the ensuing three years. In fact, a portfolio exhibiting both Quality and ESG factors may represent a powerful combination of companies with historical records of superior earnings and dividend growth as well as those with the ability to minimize future earnings risk as a result of implementing good ESG practices.

How MSCI ESG Ratings Work

MSCI ESG Ratings[12] use a rules-based methodology to identify industry leaders and laggards. MSCI ESG rates companies on a 'AAA to CCC' scale according to their exposure to ESG risks and how well they manage those risks relative to their peers. MSCI also rates countries, mutual funds and ETFs.

MSCI ESG Ratings provide insights into potentially significant ESG Risks so you can make better investment decisions.

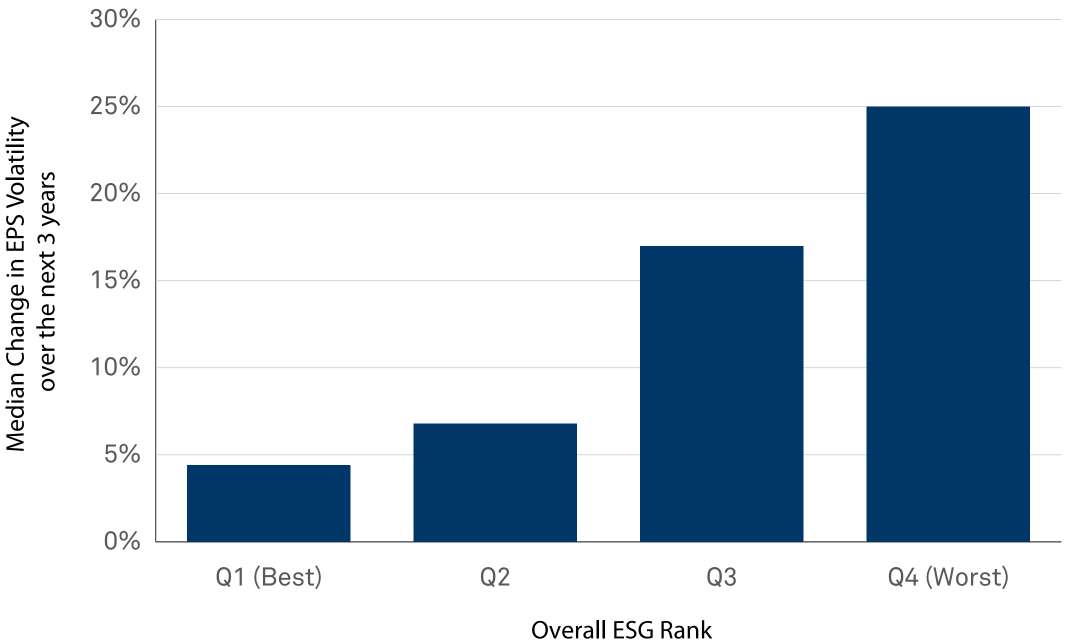
Chart 9: S&P 500 Quality Index MSCI ESG Ratings



Source: Bloomberg, MSCI. Data as of 3/31/20.

Chart 10: Best signal of future earnings risk: worse ESG ranks signaled more earnings deterioration

Median change in 3-year EPS volatility over subsequent five years based on Thomson Reuters Overall ESG score from 12/2005 - 12/2015 (with volatility through 12/2018)



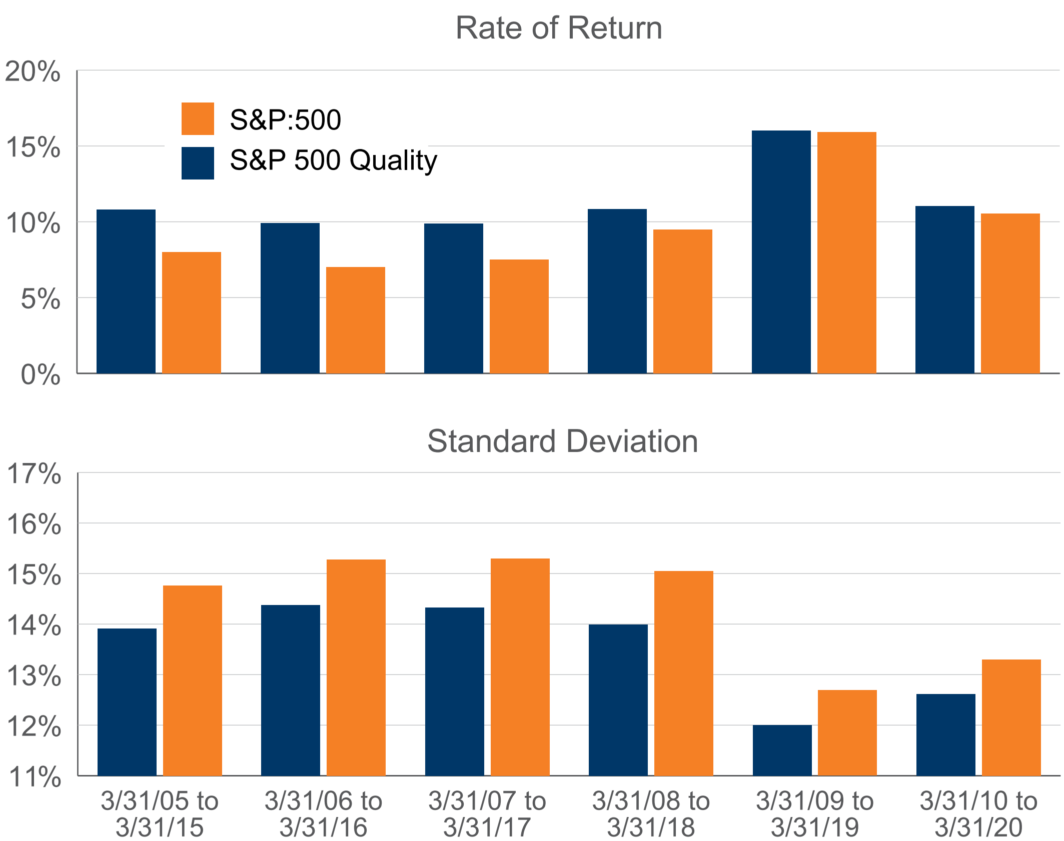
Source: BofA US Equity and Quant Strategy, Thomson Reuters

Thomson Reuters' ESG dataset is broken into Environmental, Social and Governance pillars, in addition to the controversy score, which captures media materials that report on scandals that a company is involved in. To calculate the overall scores, we equal weight Environmental, Social, Governance and controversy scores. These analyses compare stocks ranked within the top quartile/quintile vs. bottom quartile/quintile based on ESG scores from some of the vendors including Refinitiv and Sustainalytics.

QUALITY STOCKS OFFER UNIQUE COMBINATION OF OFFENSE AND DEFENSE

Historically, quality stocks have offered a unique combination of above-average performance with lower risk, as measured by standard deviation. Chart 11 below illustrates the returns of the S&P 500 Quality Index over six rolling ten-year periods from 2005 – 2020 have produced an average excess return of 1.6% over the S&P 500. In addition, this superior performance was achieved with an average 6% lower standard deviation, indicating less risk was employed to achieve these results.

Chart 11: Rolling Ten Year Risk vs. Return Annualized

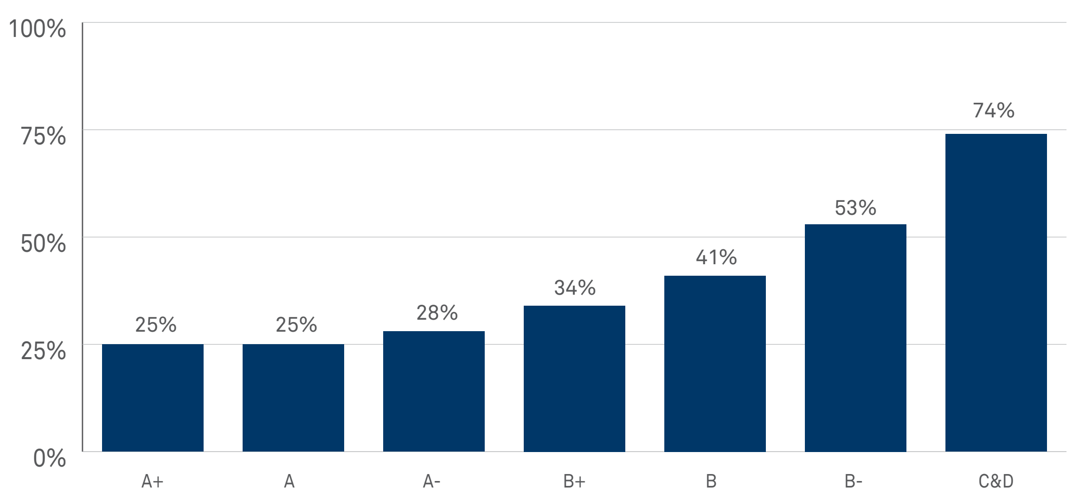


Source: S&P Dow Jones Indices. Data as of March 31, 2020.

While the Quality Index did outperform the S&P 500 over all these time periods, it is worth examining the 3/31/09-3/31/19 period, where high quality outperformance was not as significant due to several factors. First, the starting year of 2009 represented the nadir of the S&P 500 profit cycle after the financial crisis. For most of the ensuing ten year period, profits were accelerating off a very depressed base, and quantitative easing and monetary stimulus were driving a speculative and "risk on" market – known environments where high quality has historically struggled. Chart 12 below illustrates Quality performance lags in accelerating profit environments. Furthermore, December of 2015 through September of 2018 represented a sustained period of accelerating earnings growth driven by the end of an industrials/manufacturing recession, optimism surrounding the election of Donald Trump, and the subsequent implementation of tax reform. Within that period, profits growth inflected higher and hit some of the strongest growth rates on record from 2017 to 2018. Nonetheless, despite a difficult backdrop for quality performance in many of these years, the Quality Index still managed to outperform the index over the ten year period.

Chart 12: ... and have underperformed when the profits cycle accelerates

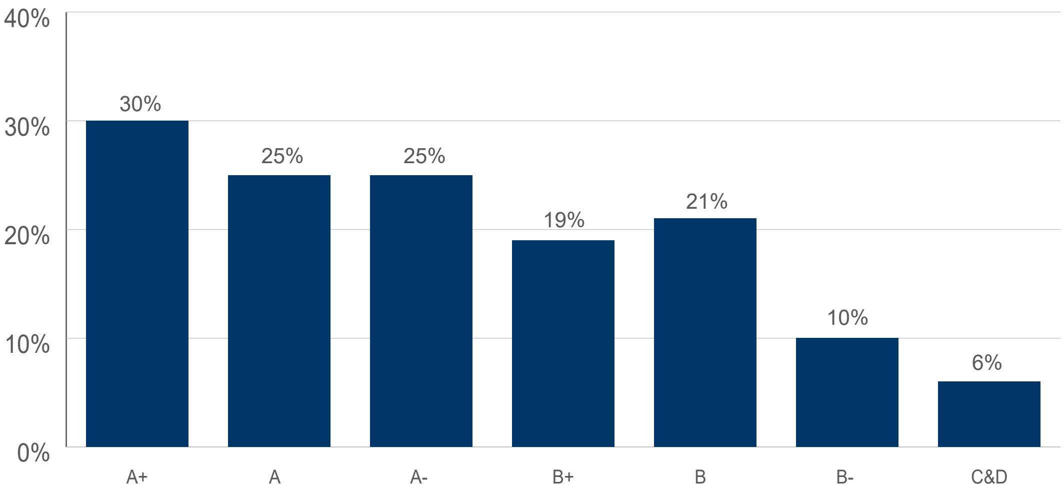
Average performance by S&P Quality Ranks when the profit cycle accelerated (last seven cycles, 1988 - May 2020)



Source: BofA US Equity and Quant Strategy, Standard & Poor's.

Conversely, High quality stocks have historically outperformed when profit cycles decelerate.

Chart 13: Average Performance by S&P Quality Rank When Profit Cycles Decelerate

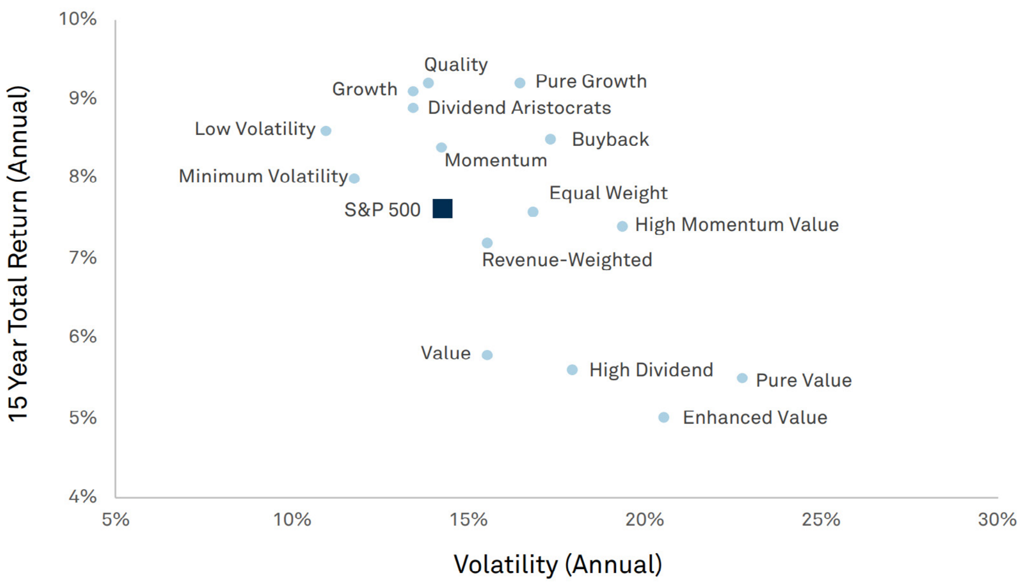


Source: BofA US Equity & Quant Strategy, S&P. Last seven cycles 1988 - May 2019

The following time periods represent Periods of Profits Deceleration: Jun 1988 - Dec 1991; Mar 1995 - Sep 1998; Mar 2000 - Dec 2001; Dec 2003 - Jun 2005; Mar 2006 - Mar 2009; Jun 2010 - Sep 2012; Dec 2013 - Dec 2015; Sep 2018 - May 2019

It is also notable in Chart 14 that, over the past 15 years, Quality has outperformed other style factors including Pure Growth, Momentum and Pure Value, as well as the S&P 500, with a lower volatility profile.

Chart 14: 15 Year Risk Return



Source: S&P Dow Jones Indices LLC and/or its affiliates. Data as of March 31, 2020.

WHY FAYEZ SAROFIM & CO.?

While there are many ways to access aspects of quality investing, Fayez Sarofim & Co. offers a multi-faceted, active approach to creating a quality portfolio. As mentioned above, many definitions of quality abound, yet rely on only a small handful of quantifiable statistics. For example, the S&P quality ranking system is based solely on the long-term growth and stability of a company's earnings and dividends; no other factors are taken into consideration. Fayez Sarofim & Co. has always employed a fundamental, research-based process to drive its stock selection and portfolio construction process relying on numerous inputs.

The integration of portfolio management with internally generated fundamental research sets Fayez Sarofim & Co.'s investment approach apart from that of many other firms. Our extensive, internal research function is crucial to our investment process. We estimate that approximately 80 per cent of our fundamental research is generated internally. Our research analysts are assigned specific industries to monitor, which they follow on a global basis. Furthermore, analysts participate in one or more sector groups, led by a more senior investment professional, that serve as forums for updating industry scenarios and discussing industry-specific competitive and valuation issues.

Approximately one-third of the in-house research effort is devoted to outside visits and direct contact with companies held in the portfolio or under review. Our analysts visit with over 150 companies each year, meeting with both executive and divisional management. Investment professionals also attend industry conferences, trade shows, Congressional hearings, and other forums that can be expected to provide useful information. They regularly review a wide range of business publications, consultant reports, and sell-side research as well as company-issued documents such as 10-Ks, 10-Qs, 8-Ks, and news releases. Analysts also use numerous on-line databases and software products to assist with their research such as FactSet Data Systems, Bloomberg Financial Markets, Eikon, and the S&P CapIQ platform.

The benefits of Fayez Sarofim & Co.'s active and in-depth research and portfolio management process allow for the ability to incorporate a variety of factors, including valuation analysis, management and accounting evaluation, assessment of corporate strategy and ESG factors, in addition to traditional quantitative statistics. Furthermore, timing of purchases and sales can be made in an opportunistic fashion as opposed to mechanistic rebalancing. This approach allows for the avoidance (or emphasis) of certain companies or sectors that may meet limited quantitative requirements of an index but lack long-term growth opportunities.

SUMMARY

A portfolio fortified by quality companies can be a valuable addition to an investor's asset allocation based on their attributes of superior profitability and leverage characteristics, low volatility, downside protection and a record of superior risk-adjusted returns versus both the S&P 500 and lower quality stocks. These companies are especially appropriate for the investor with a longer-term investment horizon due to their ability to preserve capital and outperform a market index over longer time periods. Furthermore, we believe an actively managed portfolio of quality stocks offers advantages over a passive strategy including the ability to ensure sector diversification and avoid over-concentration. In addition, an actively managed portfolio allows for the implementation of portfolio changes in a timely fashion to adjust to market and valuation movements as opposed to infrequent and mechanical rebalancing of an index.

Fayez Sarofim & Co. has a 60+ year history of investing in companies with strong fundamentals, including consistent earnings and dividend growth, lower leverage and higher returns on equity than the market index. In addition, FS&Co. analysis adds an assessment of company management, ESG ranking, culture and reputation to develop a more robust and informed opinion of any one company that goes beyond quantitative statistics. We believe high quality companies are most appropriate for ownership over a longer-term time horizon to allow the benefits of a stable and growing earnings and dividend stream to unfold and compound over a full market cycle. Our investment philosophy's emphasis on industry leaders, financial strength and a long-term time horizon naturally include the ownership of quality companies.

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[1]Return on equity is the adjusted profit of a company divided by its equity.

[2]Beta is a measure of a security’s or portfolio’s volatility, or systematic risk.

[3]S&P Capital IQ, “Earnings & Dividend Ranking System,” January 2012.

[4]S&P 500 Quality Index (ticker: SPXQUT) is designed to track high quality stocks in the S&P 500 by quality score, which is calculated based on return on equity, accruals ratio and financial leverage ratio. The S&P 500 Quality – Lowest Quintile Index (ticker: SPQLUT) is designed to measure the performance of the lowest 100-ranked stocks in the S&P 500 based on the same quality score as SPXQUT.

[5]Generally Accepted Accounting Principles (GAAP) is a combination of authoritative standards (set by policy boards) and the commonly accepted ways of recording and reporting accounting information. GAAP aims to improve the clarity, consistency, and comparability of the communication of financial information.

[6]S&P Capital IQ, “Earnings & Dividend Ranking System,” January 2012, pg. 3.

[7]Ibid. pg. 18.

[8]Standard deviation is a statistical measure of the degree to which an individual portfolio return tends to vary from the mean, based on the entire population. The greater the degree of dispersion, the greater the degree of risk. In mutual funds, the standard deviation tells us how much the return on the fund is deviating from the expected normal returns.

[9]Capture Ratios are calculated by taking the portfolio’s monthly return during the periods of negative or positive benchmark (S&P 500 Index) performance and dividing it by the benchmark return. A downside capture ratio of less than 100 indicates that a fund lost less or outperformed its benchmark in up or down markets.

[10]S&P Capital IQ, “Earnings & Dividend Ranking System,” January 2012.

[11]Earnings per share (EPS) is a company’s net profit divided by the number of common shares it has outstanding. EPS indicates how much money a company makes for each share of its stock and is a widely used metric for corporate profits.

[12]MSCI ESG Ratings aim to measure a company’s resilience to long-term, financially relevant ESG risks.