INVESTING IN QUALITY COMPANIES

Executive Summary
Investing in quality companies is rooted in a thorough fundamental analysis of all aspects of a company's financial strength, growth prospects, profit and income generation and overall stability. While various definitions of "quality" abound, we believe that most companies considered to be in this category possess similar attributes: consistent profit and income generation, reduced volatility, downside protection in bear markets, and superior risk-adjusted returns as compared to a market index. Quality companies have historically demonstrated predictable periods of outperformance within a market cycle as well as above-average returns versus the S&P 500 over longer time periods. Investing in such companies offers a source of diversification beyond traditional style boxes and should be considered as part of an investor's overall asset allocation decision.

Fayez Sarofim & Co. believes these high quality companies are especially attractive in the current market given our multi-year forecast of continued low global growth combined with increasingly restrictive monetary and fiscal policy. Historically, this type of economic and market backdrop has favored the ownership of quality stocks. Furthermore, we believe that the current valuation discount of high quality stocks to low quality stocks presents an attractive entry point.

Defining Quality
While there is not one commonly accepted definition of quality when it pertains to equity investing, definitions often center around leverage, return-on-equity, profit margin, history of profit and income growth, liquidity and beta. Typically, high quality companies possess a history of stable earnings and dividend growth, high returns-on-equity, generous profit margins and low debt levels. Conversely, their counterparts tend to have an inconsistent record of profit growth, low or no dividends, high leverage, low returns-on-equity and generally more volatility. 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. 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 Standard & Poor'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, Standard & Poor's maintains S&P 500 High Quality and Low Quality Rankings
Indices\textsuperscript{1} 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 is not 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 GAAP. 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.”\textsuperscript{2} In addition, “lower dispersion in analyst estimates also indicates higher quality and more predictable earnings for high quality companies.”\textsuperscript{3}

**Benefits of Investing in Quality Companies**

Benefits of investing in quality companies, as compared to a market index or low quality stocks, include higher income generation and growth, lower volatility and downside protection, and superior risk-adjusted returns.

1. **Yield and Income 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 generation necessary to pay, maintain and raise dividends. The chart below illustrates the higher yields consistently offered by high quality stocks (those rated A- or above) since 2000.

**Exhibit A – Quality Ranking – Dividend Yield**

\footnotesize{\textsuperscript{1} S&P 500 High Quality Rankings Index (ticker: SPXQRUP) includes companies with a Quality Ranking of A and above. The S&P 500 Low Quality Rankings Index (ticker: SPXQRLUP) includes companies with Quality Rankings of B and below.}

\footnotesize{\textsuperscript{2} S&P Capital IQ, “Earnings and Dividend Ranking System,” January 2012, p. 3.}

\footnotesize{\textsuperscript{3} Ibid. page 18.}
Past performance is no guarantee of future results. This chart is for illustrative purposes only. Other time periods may have produced different results. Standard & Poor’s quantitative evaluations are based on models that incorporate historical numbers and forward-looking growth projections. Earnings/Dividend (Quality) Rank reflects Standard & Poor’s appraisals of growth and stability of earnings and dividends over the past 10 years for individual companies. Please see chart below for a full rankings description. An investor cannot invest directly in any index. There is no guarantee that dividend-paying companies will continue to pay, or increase, their dividend.

Perhaps more important than the above-average yield of the high quality stocks is the ability of these companies to grow their dividends consistently over time. The chart below illustrates that high quality stocks have offered higher dividend growth rates than both low quality stocks and 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.

**Exhibit B – Quality Ranking – Dividend Growth**

10 Year Historical Dividend Growth (2003 – 2013)

<table>
<thead>
<tr>
<th></th>
<th>A+</th>
<th>A-</th>
<th>B+</th>
<th>S&amp;P 500</th>
<th>B</th>
<th>B-</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>10 Year Historical Dividend Growth (2003 – 2013)</td>
<td>16.24%</td>
<td>14.69%</td>
<td>13.30%</td>
<td>10.34%</td>
<td>7.25%</td>
<td>6.63%</td>
<td>0.46%</td>
</tr>
</tbody>
</table>

Source: FactSet Inc. Data as of 12/31/13. Past performance is no guarantee of future results. (A+ = Highest, A = High, A− = Above Average, B+ = Average, B = Below Average, B− = Lower, C = Lowest, D = Reorganization). Quality rankings reflect the long-term growth and stability of a company’s earnings and dividends. The index is weighted by quality rankings. The rankings are generated by a computerized system and are based on per-share earnings and dividends records of the most recent 10 years.

Basic scores are computed for earnings and dividends and, then, adjusted by a set of predetermined modifiers for changes in the rate of growth, stability within long-term trends and cyclical. Adjusted scores for earnings and dividends are then combined to yield a final ranking.
**Lower Volatility and Downside Protection** - High quality companies offer lower volatility and downside protection 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. The chart below shows a time series measuring the standard deviation of high quality, low quality and S&P 500 stocks over both long and short-term time periods. As you can see, over any time period, high quality stocks offer less volatility than both low quality stocks and market indices.

**Exhibit C - Standard Deviation**

- **Source:** FactSet Inc. Data as of 12/31/2013 based on deviation of daily returns. **Standard deviation** is the statistical measure of the degree to which an individual value in a probability distribution tends to vary from the mean of the distribution. The S&P 500 High Quality Index represents all stocks in the S&P 500 with a quality score of A+, A, or A- (on a scale of A+–C). The S&P 500 Low Quality Index represents all stocks in the S&P 500 with a quality score of B, B-, C and D (on a scale from A+ to D).

Specifically, in bear or down markets, high quality stocks fall less that the market index or the low quality stocks.
2. **Superior risk-adjusted returns** – Due to the lower volatility characteristics of high quality stocks discussed above, they have historically offered better risk adjusted returns than a market index or low quality stocks. The chart below shows a time series of risk adjusted returns for the S&P 500, high quality stocks and low quality stocks which illustrates the outperformance of high quality stocks over longer time periods more representative of a full market cycle.
Furthermore, the S&P 500 High Quality Index has historically outperformed the S&P 500 index on an absolute basis over these longer time periods. History indicates that over longer holding periods, high quality stocks are able to outperform a market index.

**Exhibit F – Growth of $10,000, 2000 – 2013**

![Growth of $10,000, 2000 – 2013](image)

*Source: Standard & Poor's. This example assumes a $10,000 investment on 1/1/00 and is for illustrative purposes only. Other time periods may have produced different results. The S&P 500 Index is a widely accepted, unmanaged index of overall stock market performance. The S&P 500 High Quality Index represents all stocks in the S&P 500 with a quality score of A+, A, or A– (on a scale from A+ to C). Quality rankings reflect the long-term growth and stability of a company's earnings and dividends. The index is weighted by quality rankings. The rankings are generated by a computerized system and are based on per-share earnings and dividends records of the most recent 10 years. Basic scores are computed for earnings and dividends and, then, adjusted by a set of predetermined modifiers for changes in the rate of growth, stability within long-term trends and cyclical. Adjusted scores for earnings and dividends are then combined to yield a final ranking. An investor cannot invest directly in any index. Past performance is no guarantee of future results.*

**Other Notable Attributes**

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. 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 are able to benefit from the advantages of longer holding periods such as potentially lower realized capital gains taxes and commission charges typically associated with a higher turnover approach.
**Current Valuation Offers Opportunity**

Historical valuation analyses illustrate that over longer time periods high quality stocks have traded at a premium to low quality stocks, presumably based on their strong fundamentals. The chart below shows that for most of the past 10 years, high quality stocks have traded at such a premium.

However, over shorter time periods, deviations from this relationship can and do occur, providing opportunities for the alert investor. For example, this chart includes the 2009 time period when the market was emerging from the 2008 financial crisis, and low quality stocks were sought for their leverage to an improving economy. This outperformance combined with depressed earnings coming out of the crisis combined to inflate low quality companies’ P/E’s in this time frame. More recently, the chart below shows that in late 2012 low quality stocks began trading at a premium to high quality stocks and that relationship has persisted throughout 2013. The backdrop of an improving US economy combined with substantial quantitative easing by the Federal Reserve has favored the riskier segments of the stock market that benefit the most from this increased liquidity. However, as the Fed has begun to taper its asset purchases, we expect investors’ focus to return to fundamentals, ultimately benefiting the high quality segment of the market.

**Exhibit G – Historical Valuation of High and Low Quality Stocks**

Source: FactSet Inc. Data as of 12/31/2013. Past performance is no guarantee of future results. Price-to-earnings is the ration of the market price of the firm’s common stock to its current (or predicted) earnings per share. These charts are for illustrative purposes only. Other time periods may have produced different results.

In our opinion, the current market environment, offers a rare opportunity in the market cycle to purchase high quality stocks at a discount to low quality stocks.
**Summary**

Quality stocks can be a valuable addition to an investor's asset allocation based on their attributes of above-average income generation, low volatility, downside protection and a record of superior risk-adjusted returns versus both the S&P 500 and low quality stocks. These companies are especially appropriate for the conservative investor with a longer-term investment horizon due to their ability to preserve capital and outperform a market index over longer time periods.

Fayez Sarofim & Co. believes these high quality companies are especially attractive in the current market given our outlook over the next few years for continued low global growth and a decelerating profit growth environment combined with increasingly restrictive monetary and fiscal policy. Historically, this type of economic and market backdrop has favored the ownership of quality stocks. Furthermore, the current valuation discount to low quality stocks presents an attractive entry point, in our opinion.

Fayez Sarofim & Co. has a 50+ 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, 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 includes the ownership of quality companies.
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