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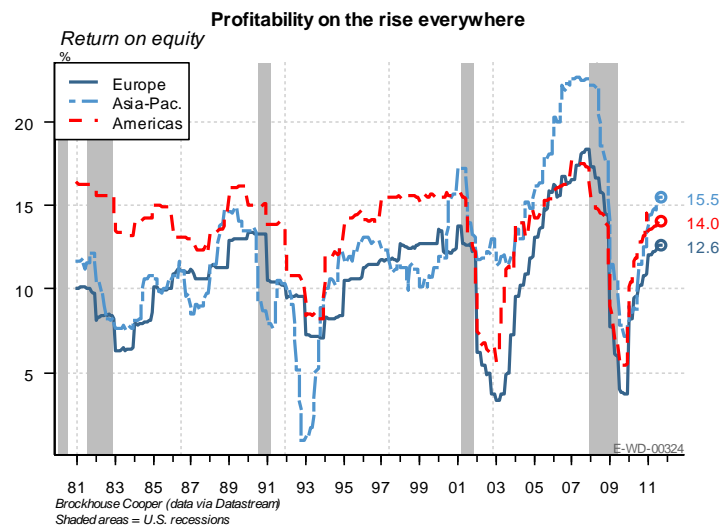
Equities: Is quality expensive? To gauge quality, we like to look at three factors: 1) high return on equity; 2) stable profitability through time; and 3) low leverage. Looking at these three factors individually for the broad market, we note that two out of three currently point towards higher quality markets. Globally, equities present high ROEs and low leverage compared to the past decades. Valuation for these two factors is also very appealing considering the indicated quality level. Going forward, we believe that investors will continue to pay a premium for higher quality stocks, especially the ones with low profit volatility.

Are quality stocks expensive?

Earlier this week, we wrote about defensive versus cyclical stocks. Our conclusion was that defensive stocks cannot be considered cheap anymore. But defensive stocks are not a synonym for quality stocks. Defensive companies usually present a lower beta to the market. Quality companies are defined as highly profitable companies with low debt.

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Firstly, ROE is now back near the top of the range of the past three decades in all regions. The Asia-Pacific region remains the most profitable while Europe lags other regions.



Are markets expensive for this level of profitability? The following chart shows that the MSCI is trading at very low trailing P/Es. The current level of profitability is usually consistent with higher P/E multiples.

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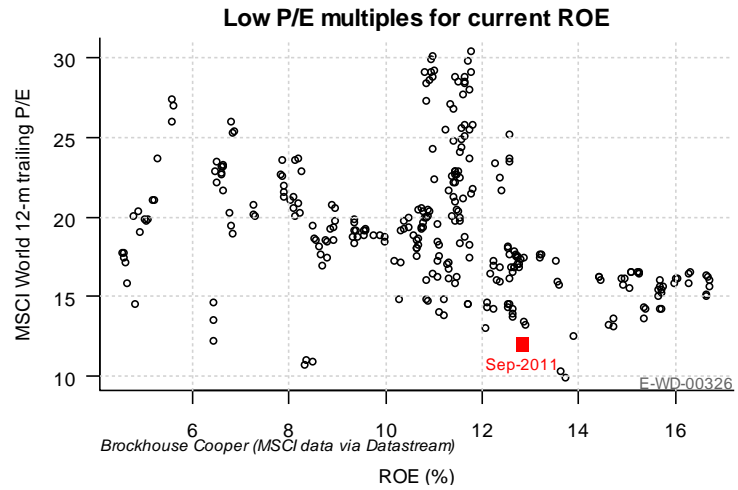
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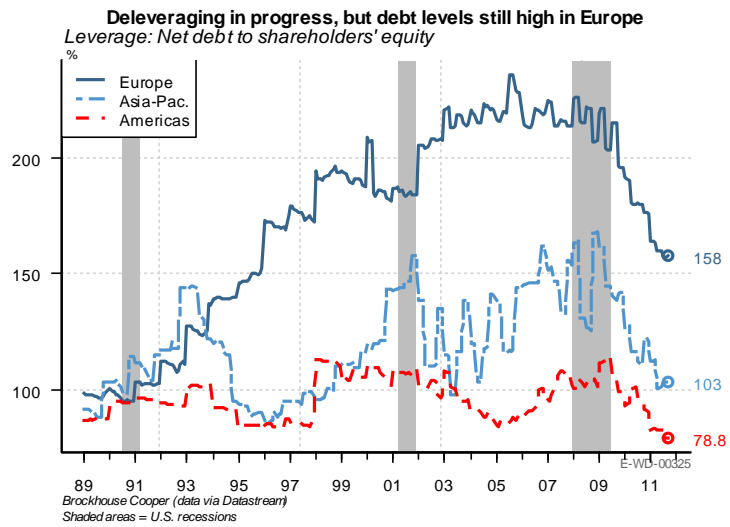
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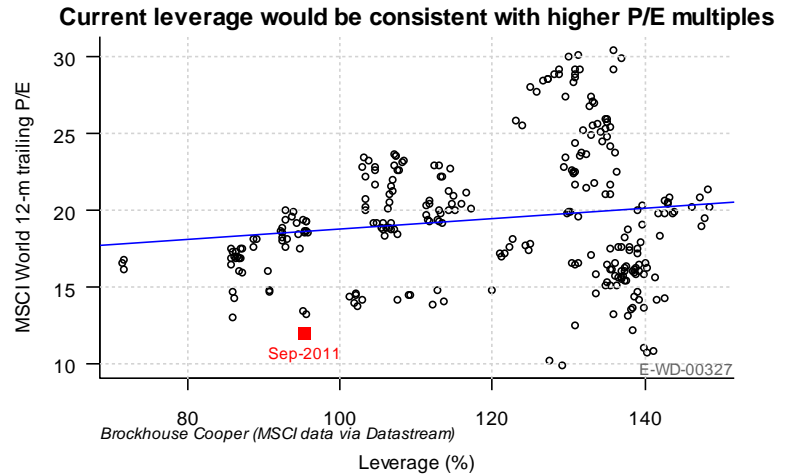
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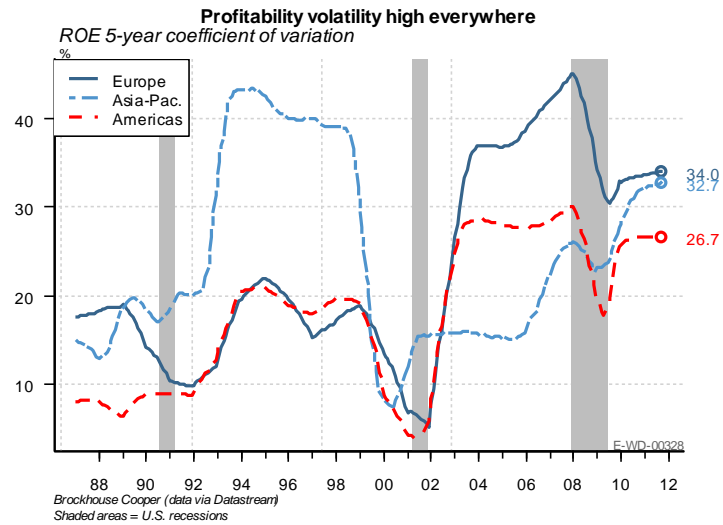
Secondly, with regard to leverage, we note that equities have significantly reduced their debt levels over the past few years. A non-trivial portion of this improvement comes from bank recapitalizations.



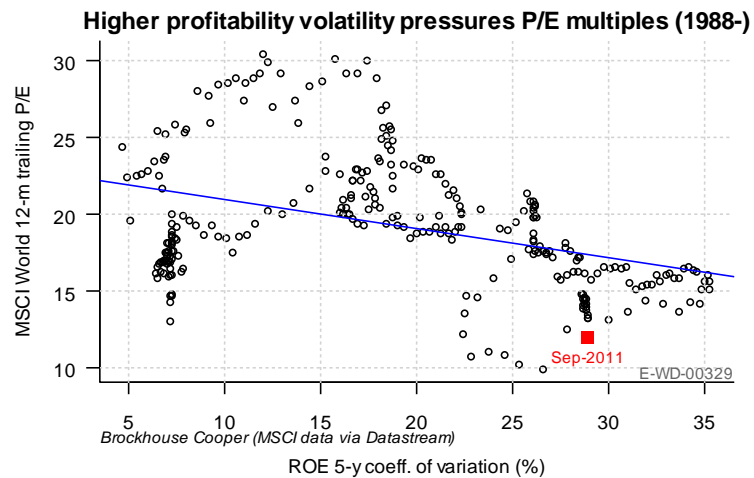
Still, we note that lower debt levels are not convincing investors that the quality of stocks has improved. Investors still apply very low multiples to leveraged stocks.



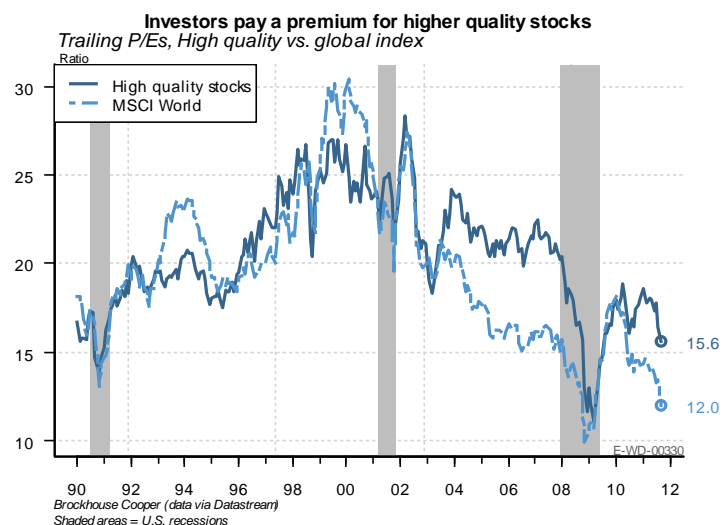
The third quality factor – profit volatility – is not good enough to convince investors that stocks are cheap. Over the past five years, the ROE coefficient of variation has remained near the top of its historical range in all regions.



And the following chart shows that investors dislike profit volatility. Since 1988, as ROEs grew more volatile, price-earnings ratios declined.



How do high quality stocks compare to lower quality ones? We have screened for S&P Global 1200 companies with high ROEs (>15%), low profit volatility (6-y ROE coefficient of variation < 25%) and low leverage (debt to common equity < 80%). We obtained a subsample of 137 companies, roughly the top 10% of the index in terms of quality. What we found is that prior to 2000, there was little difference between high and low quality stock valuations. But the tech bubble led investors to prefer higher quality stocks. With the exception of the 2007-09 bear market, quality stocks have consistently traded at higher valuations than lower quality ones. However, we would not conclude that quality stocks are expensive. In our opinion, because investors have been burned twice in the past decade, a premium for quality is the new reality.



Bottom-line: According to two quality factors (ROE and leverage), global equities present very appealing valuations considering the indicated quality. However, the third factor, profitability volatility, is a major concern for investors. As long as the latest recession will remain fresh in investors' minds, concerns over profit volatility will keep pressure on valuations. Going forward, we believe that investors will continue to pay a premium for higher quality stocks, especially the ones with low

profit volatility. Here are the top companies in our screen of global high quality stocks, ordered by ROE volatility.

S&P Global 1200 high quality stocks						
Company	Ticker	Country	Sector	ROE	Debt/Common Equity	ROE 6-y Coeff. Variation
AIR LIQUIDE SA	AI FP	France	Materials	17.0	74.2	4.4
SIGMA-ALDRICH	SIAL UW	United States	Materials	21.1	22.7	4.5
METRO INC -A	MRU/A CT	Canada	Cons. Staples	15.9	39.9	4.9
TESCO PLC	TSCO LN	Britain	Cons. Staples	17.1	67.0	5.4
RALPH LAUREN CORP	RL UN	United States	Cons. Discr.	20.5	9.5	5.6
C.H. ROBINSON WORLDWIDE INC	CHRW UW	United States	Industrials	34.6	0.0	5.7
MCCORMICK & CO-NON VTG SHRS	MKC UN	United States	Cons. Staples	26.5	60.6	5.8
HORMEL FOODS CORP	HRL UN	United States	Cons. Staples	19.2	9.4	5.9
HENNES & MAURITZ AB-B SHS	HMB SS	Sweden	Cons. Discr.	47.4	0.0	6.3
GENERAL DYNAMICS CORP	GD UN	United States	Industrials	19.8	22.8	6.4
ROCKWELL COLLINS INC	COL UN	United States	Industrials	37.5	35.0	6.5
BECTON DICKINSON AND CO	BDX UN	United States	Health Care	26.2	51.4	6.7
GENUINE PARTS CO	GPC UN	United States	Cons. Discr.	18.9	17.1	6.8
STRYKER CORP	SYK UN	United States	Health Care	17.2	13.1	6.9
SYSCO CORP	SYU UN	United States	Cons. Staples	27.0	56.7	7.2
WALMART DE MEXICO-SER V	WALMEXV M	Mexico	Cons. Staples	17.1	12.9	7.4
JOHNSON & JOHNSON	JNJ UN	United States	Health Care	20.2	30.1	7.4
KUEHNE & NAGEL INTL AG-REG	KNIN VX	Switzerland	Industrials	29.9	4.9	7.4
HERMES INTERNATIONAL	RMS FP	France	Cons. Discr.	21.4	2.0	7.5
WOOLWORTHS LTD	WOW AT	Australia	Cons. Staples	28.0	63.8	7.8
INDITEX	ITX SQ	Spain	Cons. Discr.	30.6	0.1	8.0
COLRUYT SA	COLR BB	Belgium	Cons. Staples	24.8	1.6	8.0
INTUIT INC	INTU UW	United States	IT	23.3	38.2	8.1
ESSILOR INTERNATIONAL	EI FP	France	Health Care	16.2	22.9	8.1
ASTRAZENECA PLC	AZN LN	Britain	Health Care	35.8	40.6	8.1
VARIAN MEDICAL SYSTEMS INC	VAR UN	United States	Health Care	28.4	1.2	8.2
COGNIZANT TECH SOLUTIONS-A	CTSH UW	United States	IT	23.6	0.0	8.3
RECKITT BENCKISER GROUP PLC	RB/ LN	Britain	Cons. Staples	32.2	52.5	8.5
UNITED TECHNOLOGIES CORP	UTX UN	United States	Industrials	22.2	50.2	8.5
REYNOLDS AMERICAN INC	RAI UN	United States	Cons. Staples	20.6	55.4	8.7

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