Mitch on the Markets

When a Bull Market Ages, Focus on Quality

By Mitch Zacks
Portfolio Manager

Let's face it – this bull market is old. Very old. And forgive me for being harsh, but it also might die soon. While I don't believe bull markets die of old age, I do think that the longer an economic and market growth cycle runs, the more vulnerable it becomes to fundamental breakdowns – tightening credit conditions, massive waves of debt defaults, inflation pressures, geopolitical conflicts, just to name a few.

I'm not saying it's time to go defensive. But I do think it could make good sense for investors to begin considering how to posture portfolios for a late cycle, mature bull market. In my opinion, that means shifting your portfolio management mindset to focus on quality.

Why Quality, and What Does that Mean?

Perhaps the best way to grasp the 'quality' concept is to think in high-level terms about how different types of stocks perform at different times in a market cycle.

Generally speaking – and based on my own experience – I've have found that small-cap stocks tend to outperform early in an economic cycle. In my view, this happens as capital and liquidity return to the marketplace, and as 'animal spirits' drive fresh investment, spending, and risk taking. I think domestic, small-cap stocks tend to benefit the most in this environment, and from the strong spurts of growth that tend to occur right after a recession ends.

As an economic expansion hits stride and eventually matures, we often find that credit starts to tighten, margins start to fall as costs rise, and consumers start to spend less – all factors that hurt small-caps, in my view. When the economy starts to see those types of changes – which I would argue is taking place today – it makes companies with stable earnings, healthy cash flows, and strong balance sheets look attractive by comparison. And that's what I mean by 'quality.'

For investors, looking for quality stocks means analyzing companies for three features, in my view:

- Stable year-over-year earnings growth
- Low levels of leverage (debt to asset ratios)
- Deep product/service pipelines and strong management

Many long-term dividend paying stocks tend to fall in these categories, and often times it means buying 'boring' stocks that may not offer the most attractive risk-adjusted returns. At the end of the day, however, boring doesn't matter if the company is positioned to succeed over the long-haul. Having strength in all three categories above means a company can survive – and even potentially do well – in adverse macroeconomic conditions, in my view.

An at-a-glance look at this bull market bears out this small-cap versus quality argument. In the first full year of this bull market, 2010, small-cap[1] was among the best performing categories of stocks, delivering a return of +26.9%. 'Quality' stocks, as defined by MSCI,[2] also did well (+12.6%) but not nearly as good as small-caps.[3]

Fast forward to 2017, which again I would argue brings us to the final innings of this bull market, and we see a near-symmetrical reversal of leadership. Last year, quality stocks returned +26% while small-caps were up +14.6%. In my view, this shift in leadership happened as investors have shifted on the risk spectrum to favor more earnings-reliable, larger-cap corporations. A trend I think could continue in 2018.

Bottom Line for Investors

This shift to focus more on quality may not involve the need for wholesale changes to a portfolio strategy – a well-diversified portfolio should probably already have several quality names in it. But, it could warrant a fresh review of their portfolio holdings, to see if the companies you own are positioned to do well in more difficult macroeconomic conditions. Sometimes the best offense is a good defense.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Small cap stocks are represented by the Russell 2000 Index, which is a small-cap stock market index of the bottom 2,000 stocks in the Russell 3000 Index.
[2] Constituents of the MSCI Quality Index are selected based on three main variables: high return on equity, stable year-over-year earnings growth, and low financial leverage.
[3] J.P. Morgan https://am.jpmorgan.com/us/en/asset-management/gim/adv/insights/guide-to-the-markets/viewer

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