

## The Case for Quality, Stability & Income® (QSI)

WHITEPAPER

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Factor-based investing involves targeting securities based on specific attributes, or “factors.” While factor investing is certainly not a new concept, it is far more widely used today as a means to achieve superior returns and portfolio diversification through specific, identifiable factors.

Most institutional investors have an investment return target that is well above the returns available from the safest investment-grade bonds. As a result, sizable strategic investments in higher-returning equities are necessary to meet investment goals. Based on the research presented below, Meketa Investment Group believes that a US equity portfolio tilted towards three factors – higher quality, higher stability, and higher income stocks – can increase risk-adjusted returns for equity-oriented investors.

In some environments, investors may expect to be extremely well compensated for equity risk. In others, such as the late 1990s and late 2010s, investors may expect to be less well compensated for equity risk based on substantially elevated valuation metrics, such as price-to-earnings (P/E) ratios. Figures 1 and 2 depict two important predictors of long-term equity returns over time: the ten-year normalized P/E ratio<sup>1</sup> and the dividend yield.<sup>2</sup>

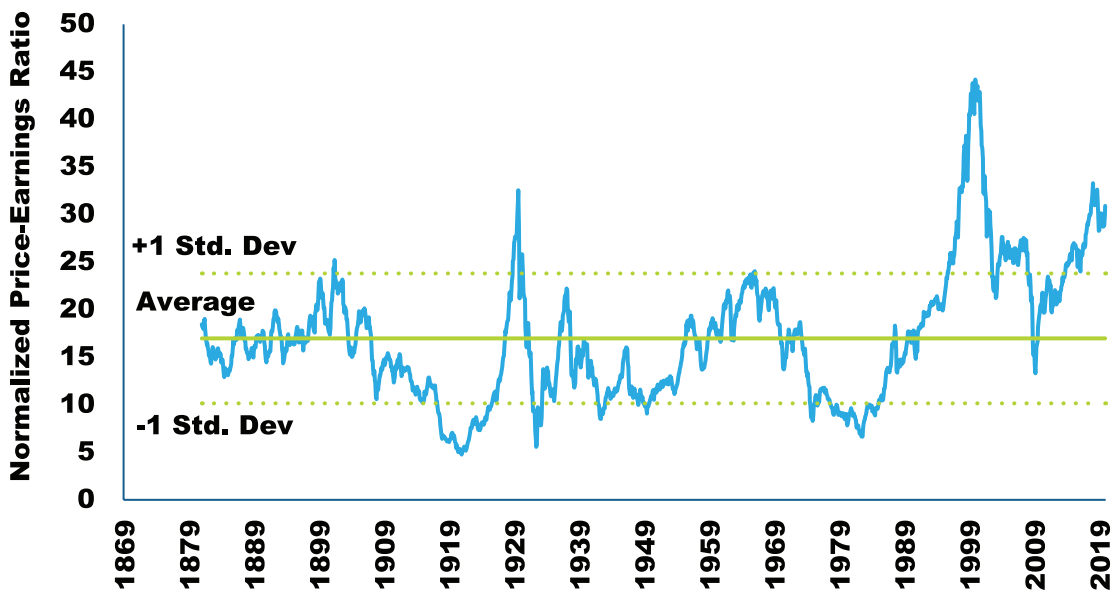
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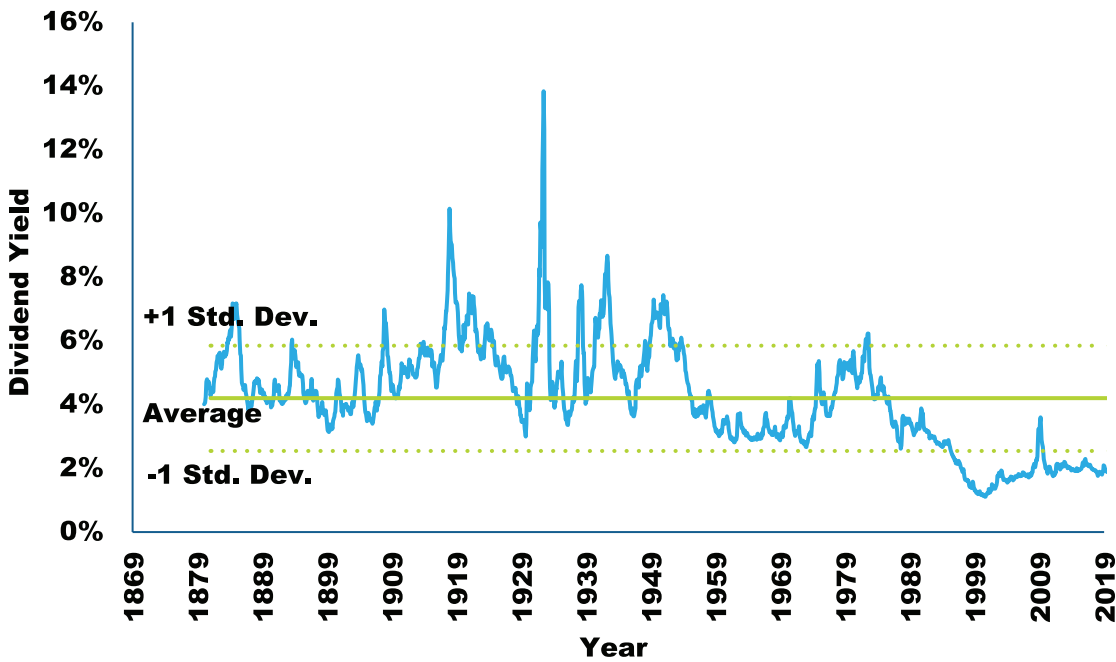


<sup>1</sup> The normalized P/E ratio is the cyclically adjusted price to earnings ratio as reported by Shiller.

<sup>2</sup> Other well-known predictors, such as the Q measure, paint a similar picture of less-than-satisfactory long-term equity returns.

**FIGURE 1**  
Ten-Year Normalized Price Earnings Ratio of S&P 500, 1880-2019

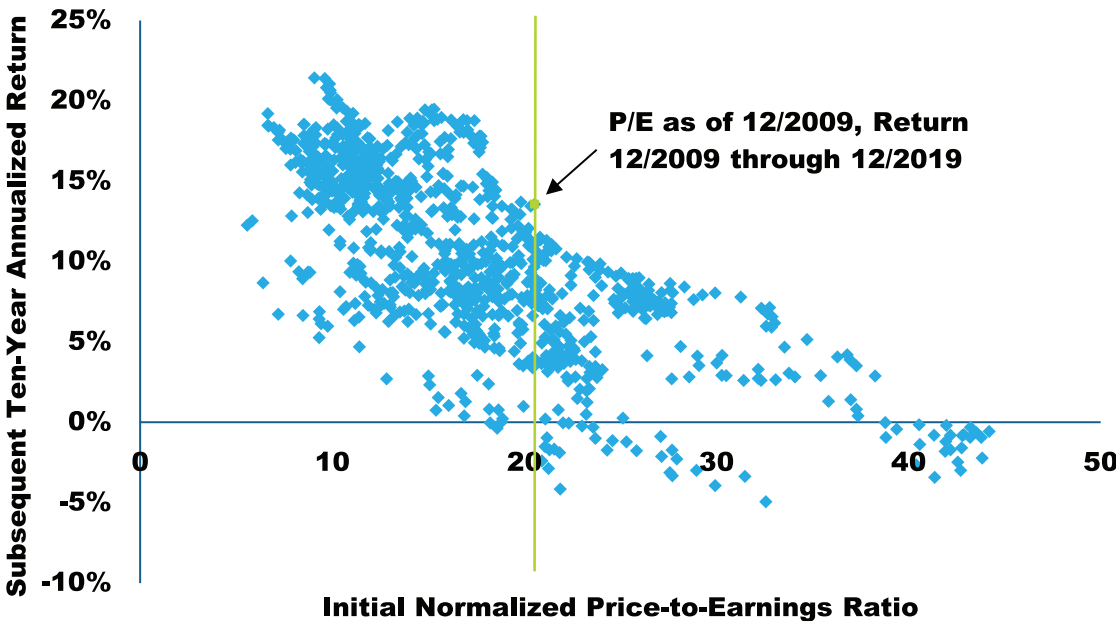
Source: Shiller, Global Financial Data, S&P, Meketa Investment Group.



**FIGURE 2**  
Dividend Yield, 1880-2019

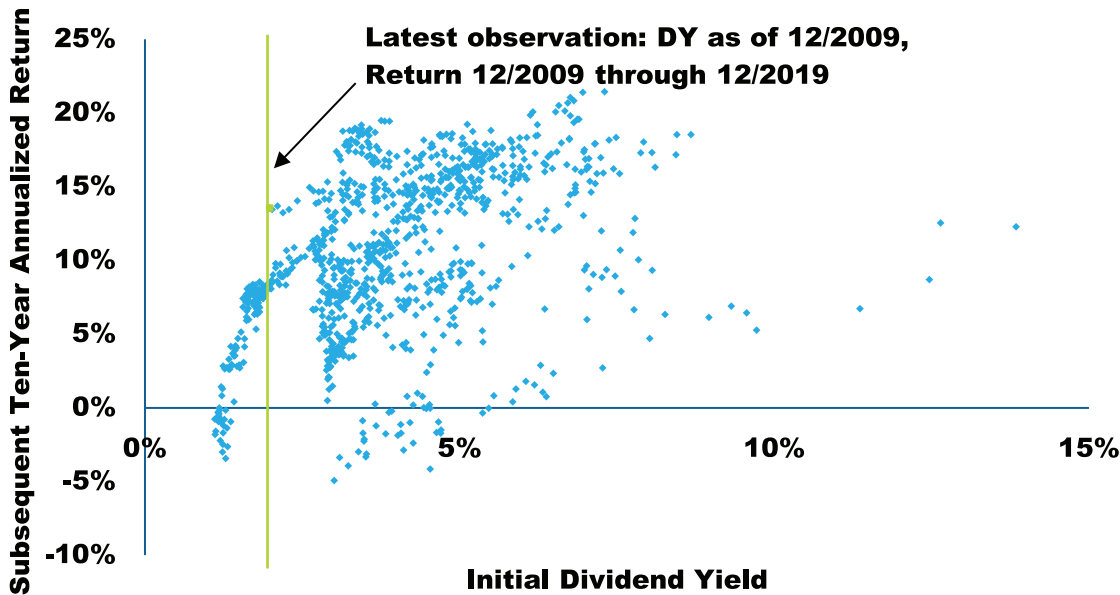
Source: S&P.

When the ten-year normalized P/E ratio is high compared with its historical average, long-term returns to equities tend to be low compared with their historical average (see Figure 3). As shown in Figure 1, the normalized P/E ratio is currently well over one standard deviation above average, implying a sub-standard long-term return is likely. Similarly, when the dividend yield is low, future long-term returns to equities tend to be low (see Figure 4). Figure 2 indicates that the current dividend yield is close to historic lows, again implying expected equity returns that may be significantly below the average historical experience.



**FIGURE 3**  
Initial Normalized Price-to-Earnings Ratio and Subsequent Ten-Year Annualized Return

Source: Shiller, Global Financial Data, S&P, Meketa Investment Group.



**FIGURE 4**  
Initial Dividend Yield and Subsequent Ten-Year Annualized Return

Source: Shiller, Global Financial Data, S&P, Meketa Investment Group.

If equity risk were expected to be low, these currently muted expectations for equity returns might be acceptable for many investors. In such a case, equity investors would expect to be fairly compensated for the risk they have assumed. But it is hard to imagine that equity risk will in fact be consistently low, and institutional investors are rightly concerned that they are not being fairly compensated for equity risk. As a result, institutional investors may wish to mitigate their exposure to downside equity risk.

## A proposed approach

Based on our research, institutional investors should consider an investment in *high quality* stocks with *high dividends* that *perform relatively well in adverse economic environments*. Such an investment should help mitigate downside risk and improve the risk-adjusted return of an equity allocation.

### Quality

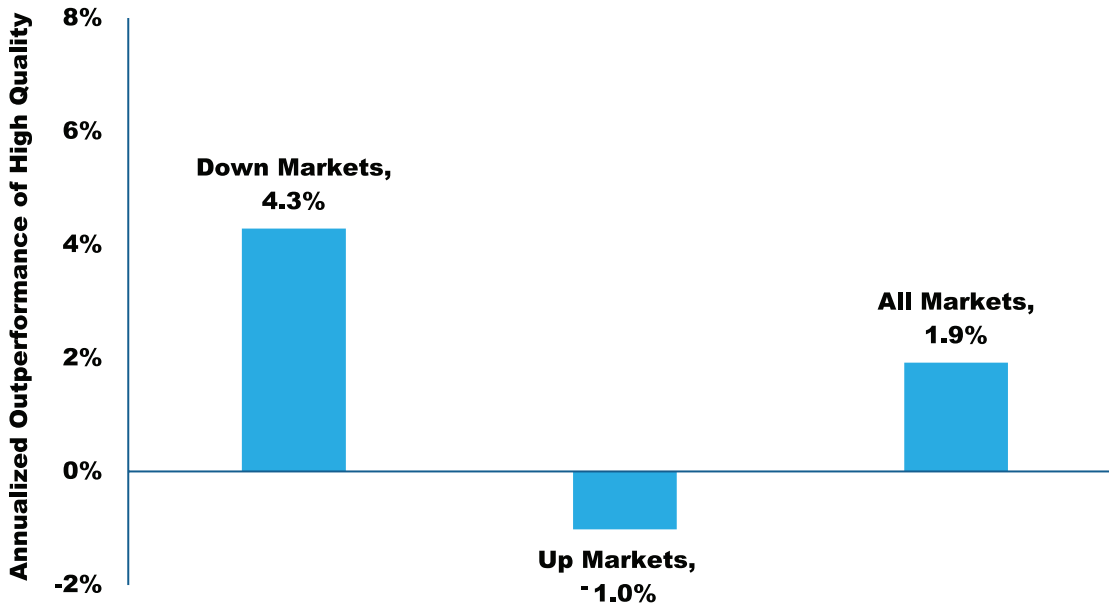
In industry parlance, *high quality* stocks are those issued by companies that display relatively consistent earnings, strong balance sheets, low leverage, and have positive or stable growth outlooks. Quality is often considered a stand-alone factor, akin to style (i.e., value or growth) and capitalization.<sup>3</sup>

<sup>3</sup> See references section for a list of relevant publications.

The following three figures show how high quality stocks have historically provided better shelter during difficult environments. Figure 5 summarizes the performance of high quality stocks<sup>4</sup> relative to the broad equity market from January 1990 through December 2019, as separated into “down” and “up” markets.<sup>5</sup> During down markets, a basket of high quality stocks outperformed the market by 4.3% on an annualized basis. And while they lagged by 1.0% during up markets, high quality stocks outperformed by 1.9% over the entire period.

<sup>4</sup> Throughout this section, the Market is represented by the MSCI USA index and High Quality is represented by the MSCI USA Quality.

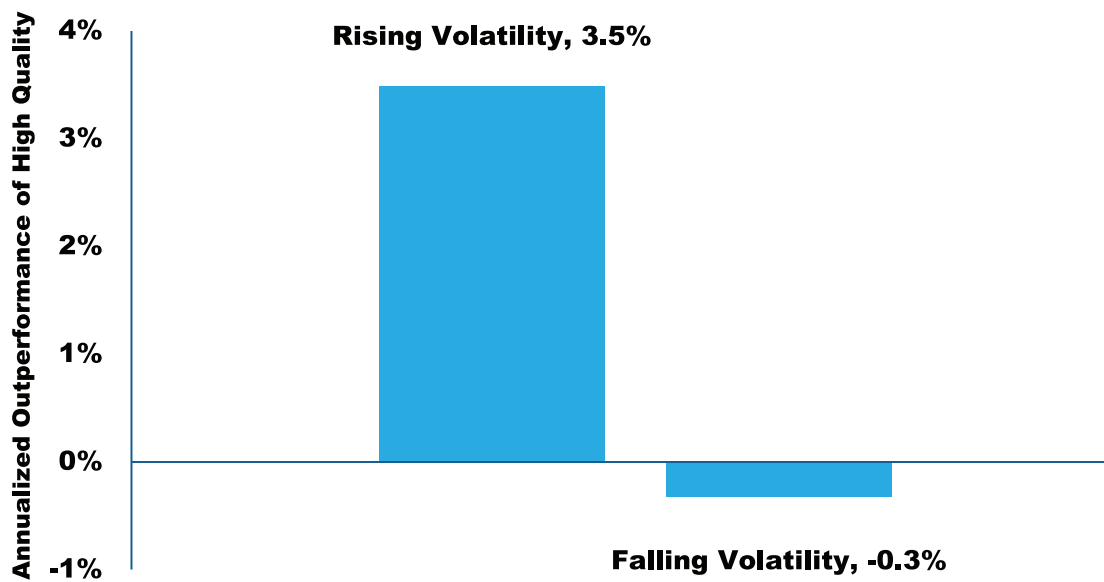
<sup>5</sup> “Down” markets are defined as months in which the broad market lost value (i.e., the MSCI USA index had a negative total return). “Up” markets are defined as months in which the broad market gained value.



**FIGURE 5**  
**High Quality Relative Performance in Down, Up, and All Markets**

Source: Meketa Investment Group.

Figure 6 provides another related view into the benefits of high quality stocks. In this case, performance is divided into rising and falling volatility environments. In rising volatility environments, high quality stocks outperformed low quality stocks by 3.5%—providing better protection in adverse conditions. The cost of this protection is that high quality stocks underperformed by 0.3% during more benign, falling volatility environments.

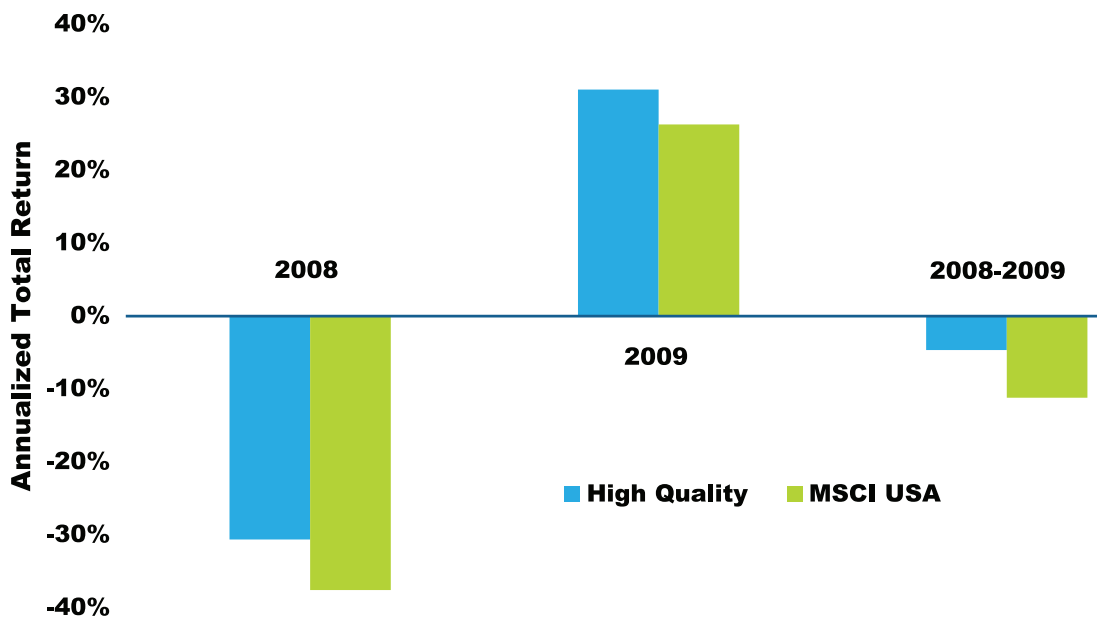


**FIGURE 6**  
**High Quality Relative Performance in Periods of Rising and Falling Volatility**

Source: Meketa Investment Group.

Note: Rising/falling volatility months are those months during which the CBOE VIX increases/decreases from January 1990 to March 2019. High quality is represented by the MSCI USA Quality Index.

A similar pattern emerges when focusing specifically on the most significant market event of this century, the Global Financial Crisis (“GFC”), as depicted in Figure 7. In 2008, high quality stocks provided a safer haven than low quality stocks, but in this case actually outperformed during the rally of 2009 as well. The result was greater annualized returns over the combined period.



**FIGURE 7**  
**High Quality During the GFC (2008-2009)**

Source: Meketa Investment Group.

Note: Market is represented by MSCI USA index, High Quality represented by MSCI USA Quality.

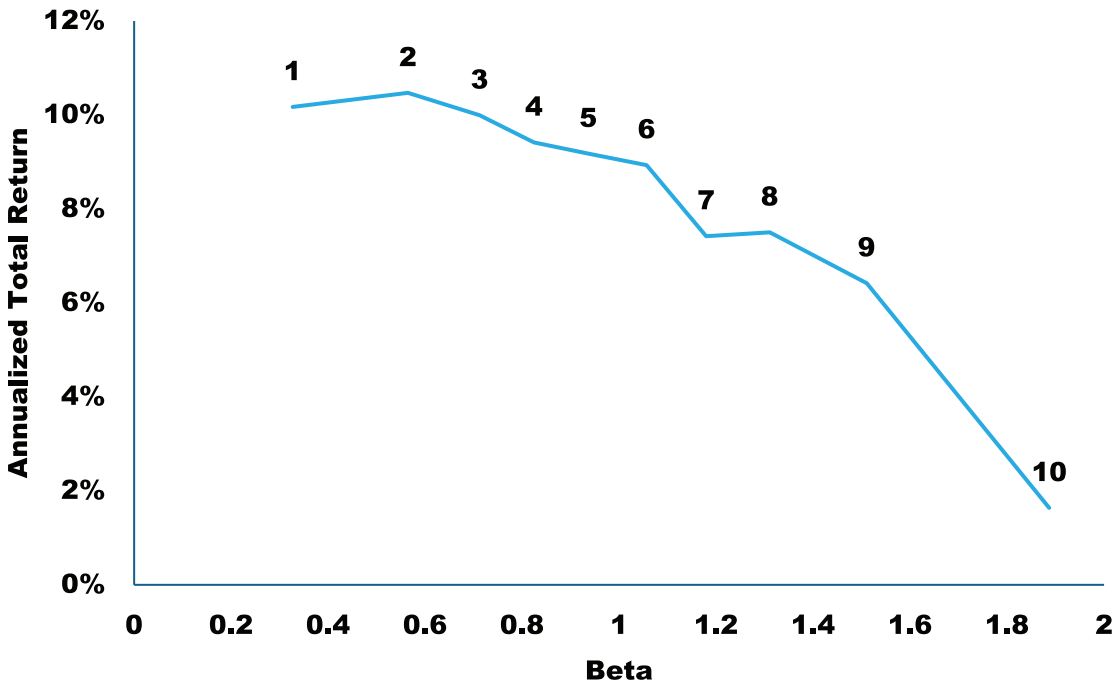
## Stability

Stability refers broadly to stocks that exhibit low price or market volatility. While sharing several characteristics with quality, stability is considered to be distinct enough to deserve a separate line of research.<sup>6</sup> There is fairly widespread recognition that stability, or low volatility, is another important driver (often termed a market “anomaly”) that may contribute to higher risk-adjusted equity returns (Baker et al., 2011; De Silva, 2010; Ang et al., 2008; Blitz and van Vliet, 2007). This is an especially interesting finding, because one of the basic assumptions of conventional financial theory is that stocks with greater price or market risk should give greater return. Many theories have been proposed to explain the anomaly, including behavioral biases that prompt investors to invest in lower-returning, risky stocks (see Kumar, 2009), leverage or benchmarking constraints that make arbitrage difficult (see Baker et al., 2011), or the volatility drag that hampers the returns of a portfolio of highly volatile stocks (see Bouchey, 2013).

<sup>6</sup> See references section for a list of relevant publications.

The following figures summarize some findings on stability as a factor. Figure 8 displays stocks by “beta” decile<sup>7</sup>. Beta measures how much a stock moves relative to the broader equity market and is one common measure of stability. Over the period from 1999 through 2019, those stocks with low betas—which implies high stability—exhibited significantly higher annualized average returns than those with high betas.

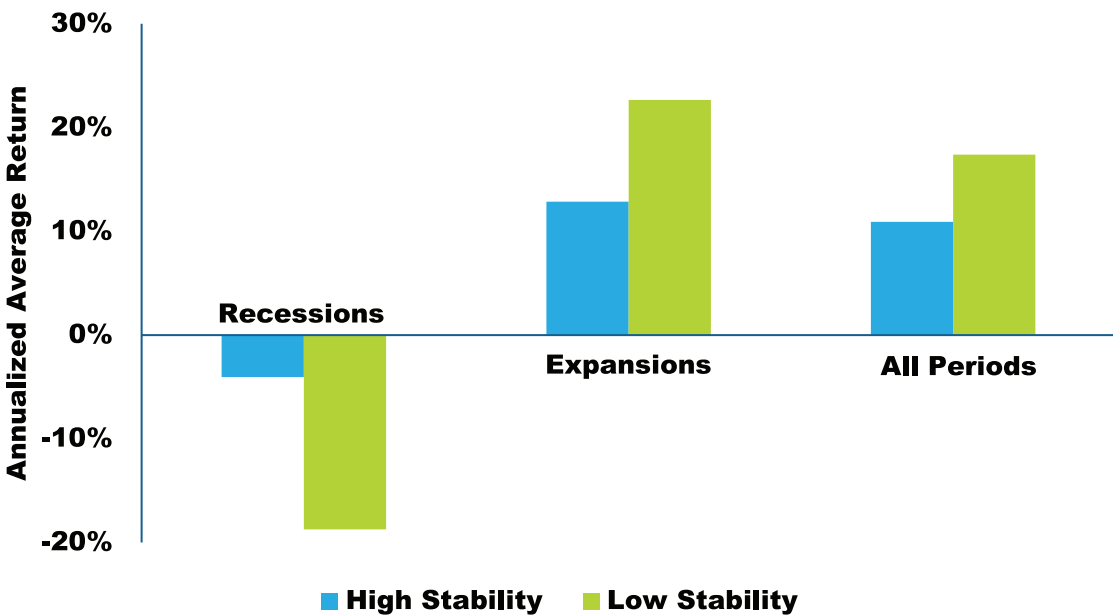
<sup>7</sup> Deciles are composed of equal-weighted Russell 3000 stocks as broken down by beta from December 1998 to March 2019.



**FIGURE 8**  
**Low and High Stability**  
**Performance, by Beta**  
**Decile**

Source: Bloomberg.

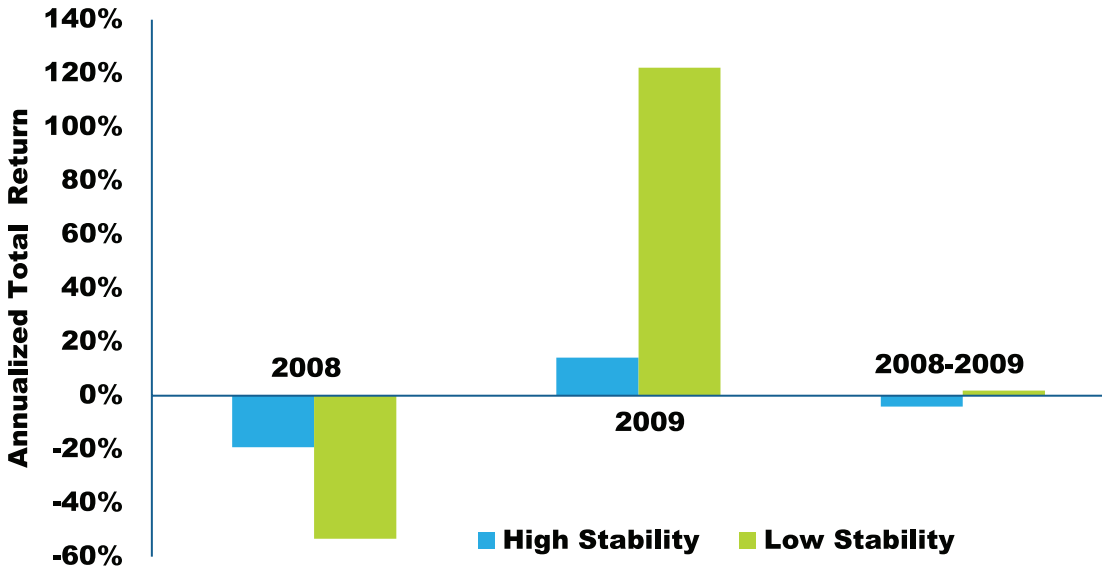
Figure 9 shows how high stability stocks performed relative to low stability stocks during recessions and expansions. From the period 1999 through 2019, high stability stocks generated a -4.1% annualized return during recessions—compared with -18.8% for low stability stocks. High stability stocks performed similarly during the 2008-2009 period, as shown in Figure 10, outperforming during 2008’s crash and subsequently underperforming during 2009’s rally, though unlike high quality, slightly underperforming the lower stability stocks overall.



**FIGURE 9**  
**High and Low Stability**  
**During Recessions and**  
**Expansions, 1999–2019**

Source: Meketa Investment Group.

Note: Annualized average return for the lowest/highest quintile of Beta in Russell 3000 stocks that were constituents for the entire time period.



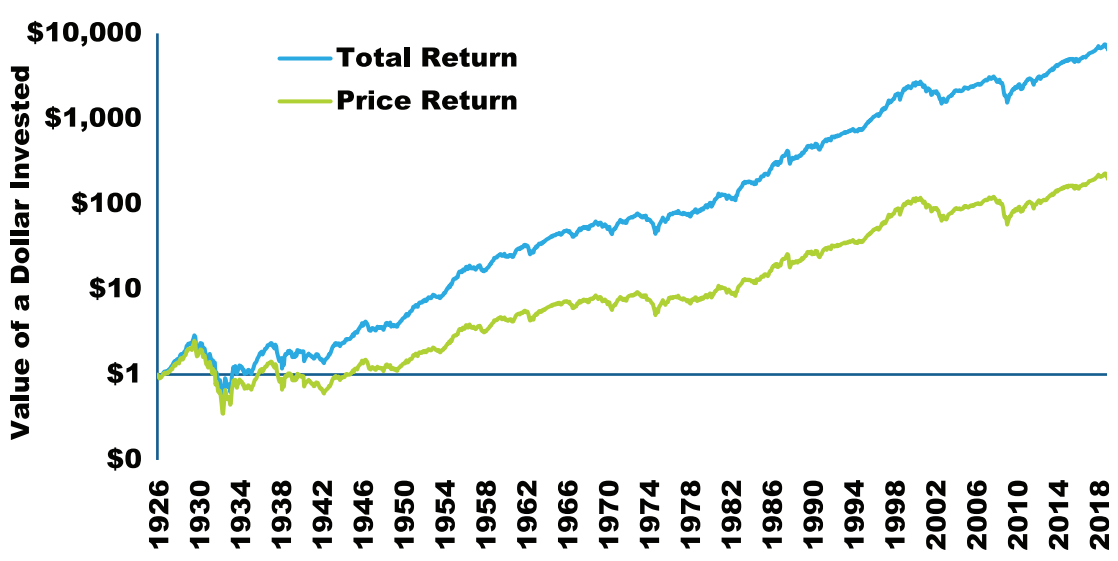
**FIGURE 10**  
**High and Low Stability**  
**during the GFC (2008-**  
**2009)**

Source: Meketa Investment Group.

Note: Annualized average return for the lowest/highest quintile of Beta in Russell 3000 stocks that were constituents for the entire time period.

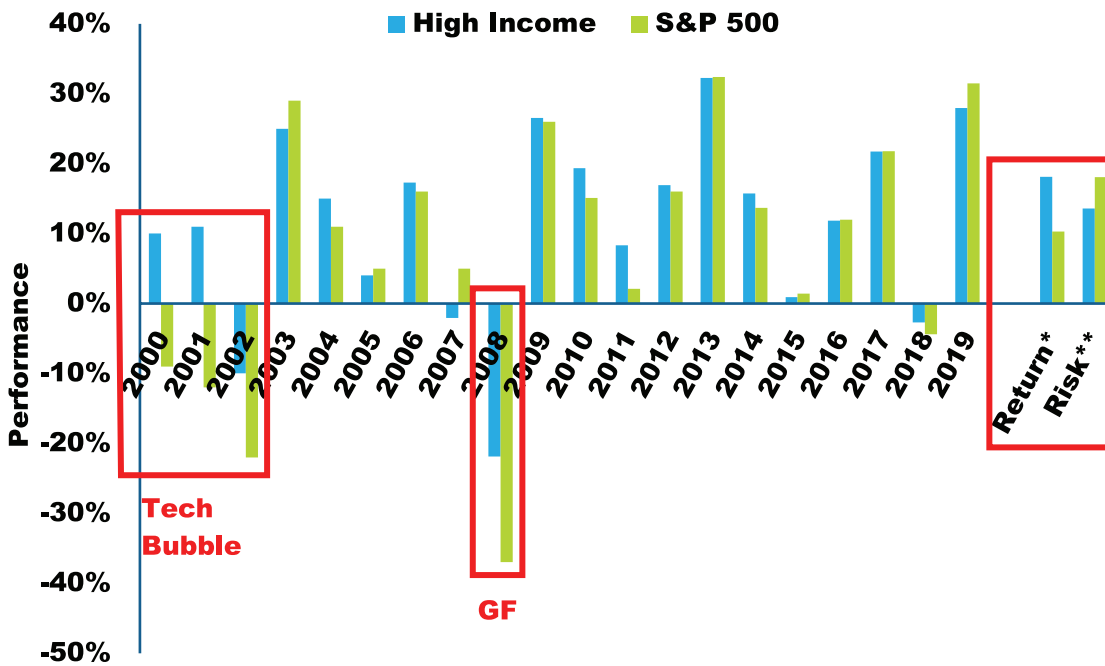
**Income**

As Figure 11 shows, dividends have historically been a major contributor to equity returns. This is because whenever a dividend is paid and reinvested, it contributes to returns first as the dividend but later compounds with both price and future dividend return on that initial dividend. Recently, however, dividends have constituted a smaller percentage of total return. Those companies that still pay high dividends tend to share many characteristics with high quality and high stability companies: consistency of dividends and earnings, stable operating models, and positive outlooks. It is no surprise, therefore, that investments in high income stocks have provided downside protection in tough markets (see Figure 12). Though high income stocks generally lagged the market during up years, both total returns and risk-adjusted returns were higher for high income stocks over the entire period.



**FIGURE 11**  
**Dividends' Contribution to**  
**Total Return**

Source: S&P 500, Global Financial Data.



**FIGURE 12**  
High Income Stocks and the Broad Market, 2000-2019

Source: S&P; S&P 500 Dividend Aristocrats.

\*Return is 20-year annualized return.  
\*\*Risk is 20-year annualized standard deviation.

## The case for Quality, Stability & Income® (QSI)

Our original research into QSI was prompted by our desire to find options to mitigate downside equity risk in the fragile market environment during and after the GFC without giving up a significant portion of the upside potential that equities usually offer. In analyzing domestic stock performance during the GFC, we discovered that three factors, namely quality, stability, and income, had substantial and statistically significant effects on performance during those years. These results prompted a review of outside research, which highlighted the importance of these factors.

We felt that an investment approach that combined these three factors was worth pursuing. Therefore, we developed a cap-neutral and sector-neutral portfolio<sup>8</sup> of stocks that were selected based on several metrics related to QSI. Some characteristics of the QSI portfolio as of September 30, 2019 are presented in Figures 13 and 14.

<sup>8</sup> Relative to the Russell 3000.

Capitalization Structure	QSI Portfolio September 2019	Russell 3000 September 2019
Number of Issues	203	2,988
Weighted Average Market Cap. (US \$bn)	128.4	195.3
Large (% over US \$10bn)	66	70
Medium (% US \$2bn to US \$10bn)	28	24
Small (% under US \$2bn)	6	6

**FIGURE 13**  
QSI Portfolio  
Capitalization Structure

Note: Portfolio is designed to be approximately cap- and sector-neutral at time of semi-annual reconstitution, and will deviate throughout the subsequent year. The reconstitution occurs in February and August.

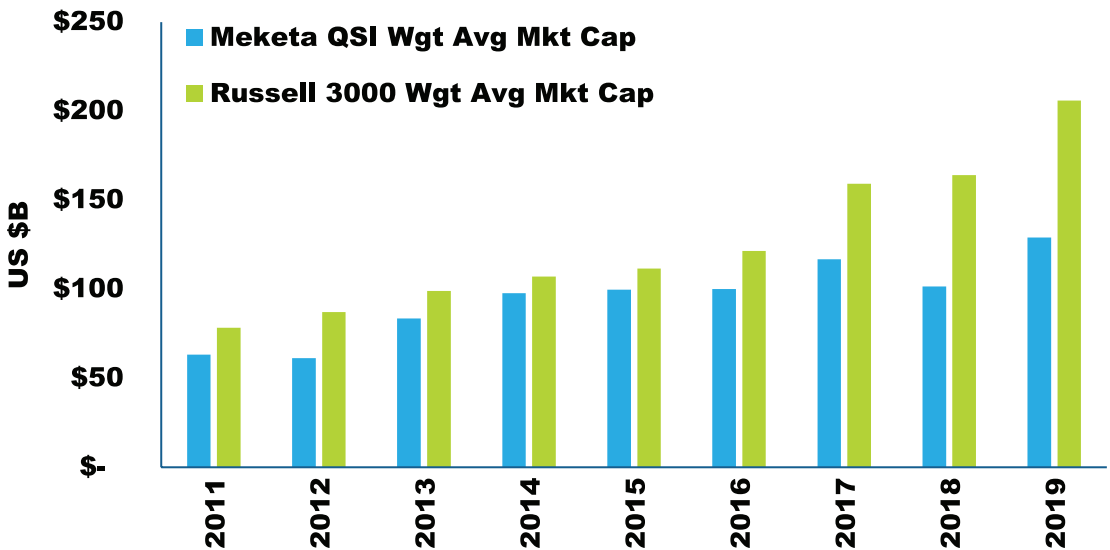


Fundamental Structure	QSI Portfolio September 2019	Russell 3000 September 2019
Average Quality	A-	B
Beta	0.90	1.00
Dividend Yield (%)	2.3	1.9
Price-to-Earnings	20.0	24.0
Price-to-Book	3.5	2.8
Debt-to-Equity (%)	75.4	93.4

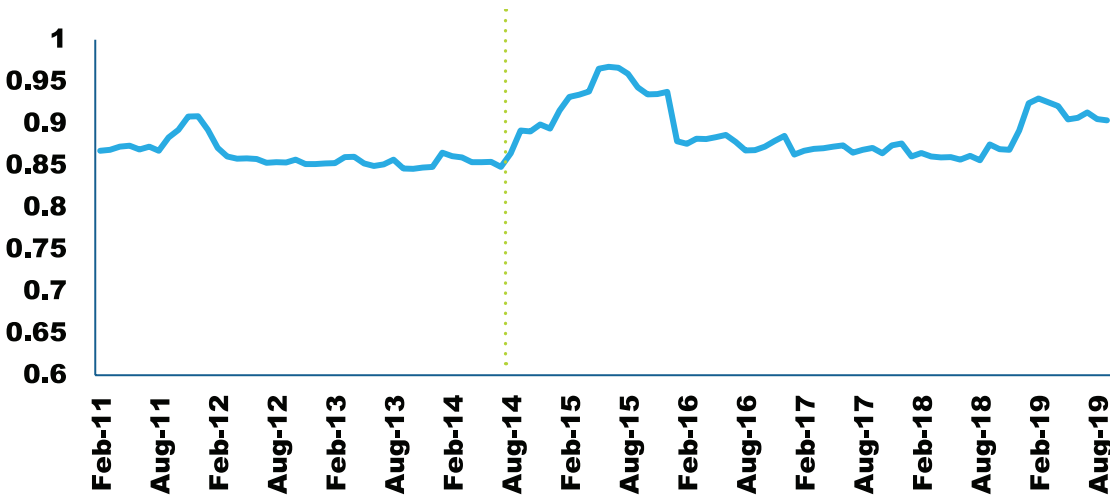
**FIGURE 14**  
**QSI Portfolio Summary**  
**Statistics**

As can be seen from Figure 13, the QSI portfolio of 203<sup>9</sup> stocks is generally cap-neutral, but can be slightly skewed toward smaller issues (i.e., the weighted average market cap is lower than the benchmark). Figure 14 indicates that the QSI portfolio is higher quality, higher stability (i.e., lower beta), and higher income than the Russell 3000 index. The following Figures 15–18 show how several of these metrics have evolved over time.

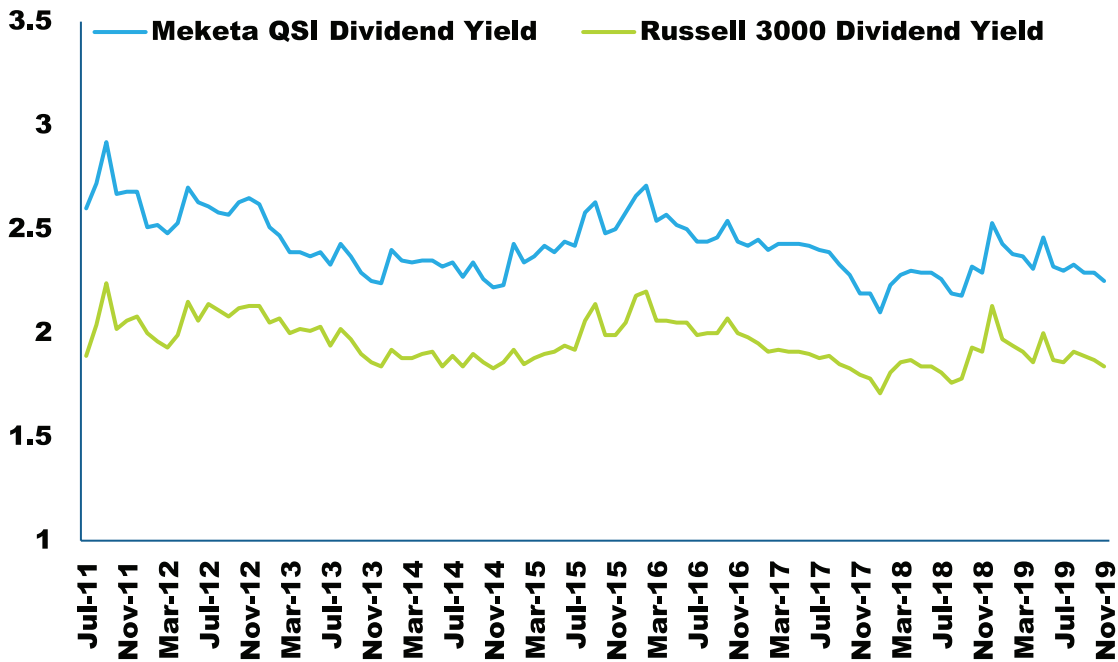
<sup>9</sup> The number of stocks will vary from year to year, but should generally be between 190 and 220.



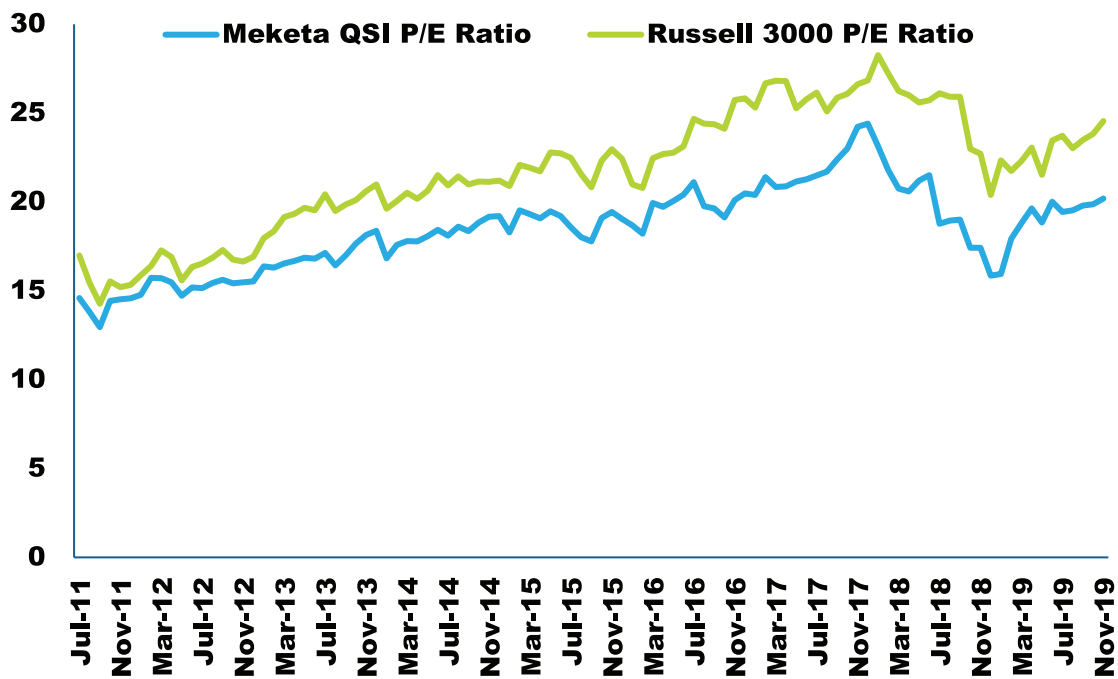
**FIGURE 15**  
**Weighted Average Market**  
**Cap, QSI vs. Russell 3000,**  
**December 2011 through**  
**September 2019**



**FIGURE 16**  
**Rolling 3 Year Beta vs.**  
**Russell 3000, February**  
**2011 through September**  
**2019**



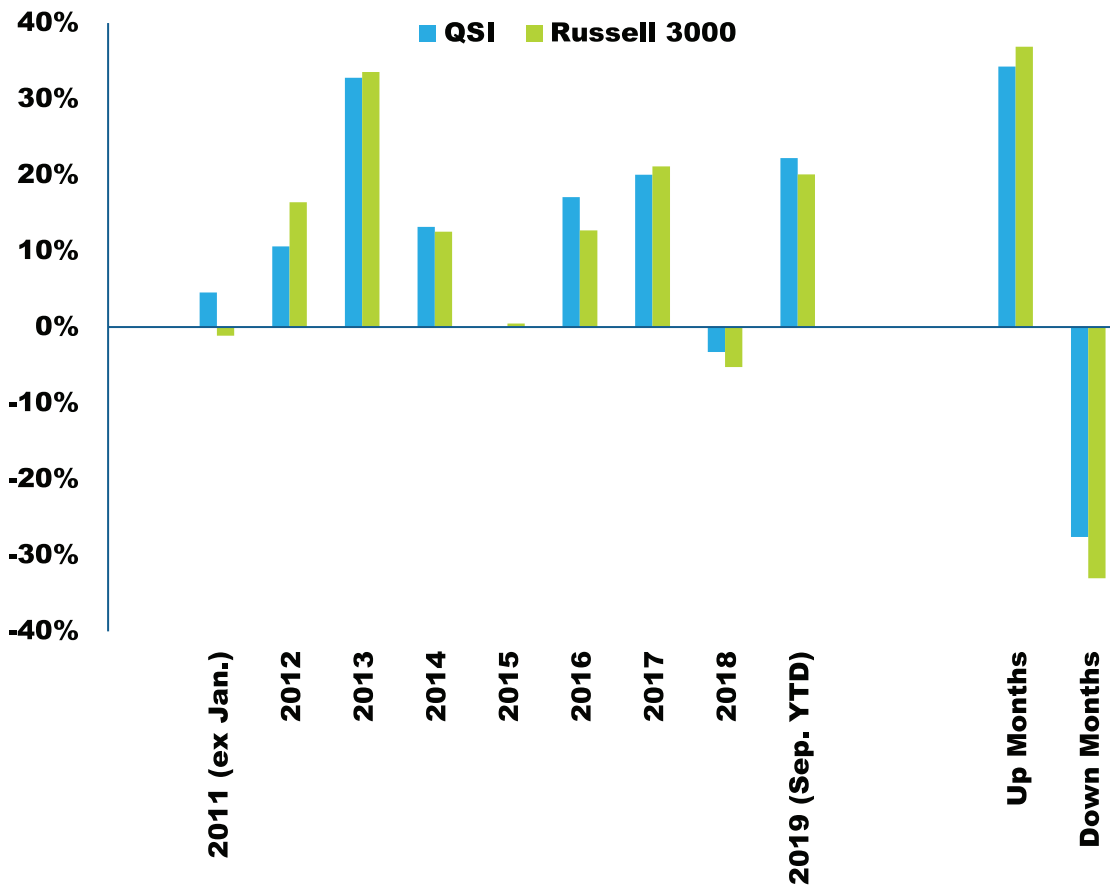
**FIGURE 17**  
Dividend Yield (%), QSI vs. Russell 3000, July 2011 through November 2019



**FIGURE 18**  
P/E Ratio, QSI vs. Russell 3000, July 2011 through November 2019

	Performance and Risk Comparison (February 2011 – September 2019)	
	QSI Index	Russell 3000
Annualized Return	13.0%	12.1%
Annualized Standard Deviation	12.3%	13.6%
Sharpe	1.01	0.85

**FIGURE 19**  
Performance and Risk Comparison of QSI Index Performance vs. Russell 3000

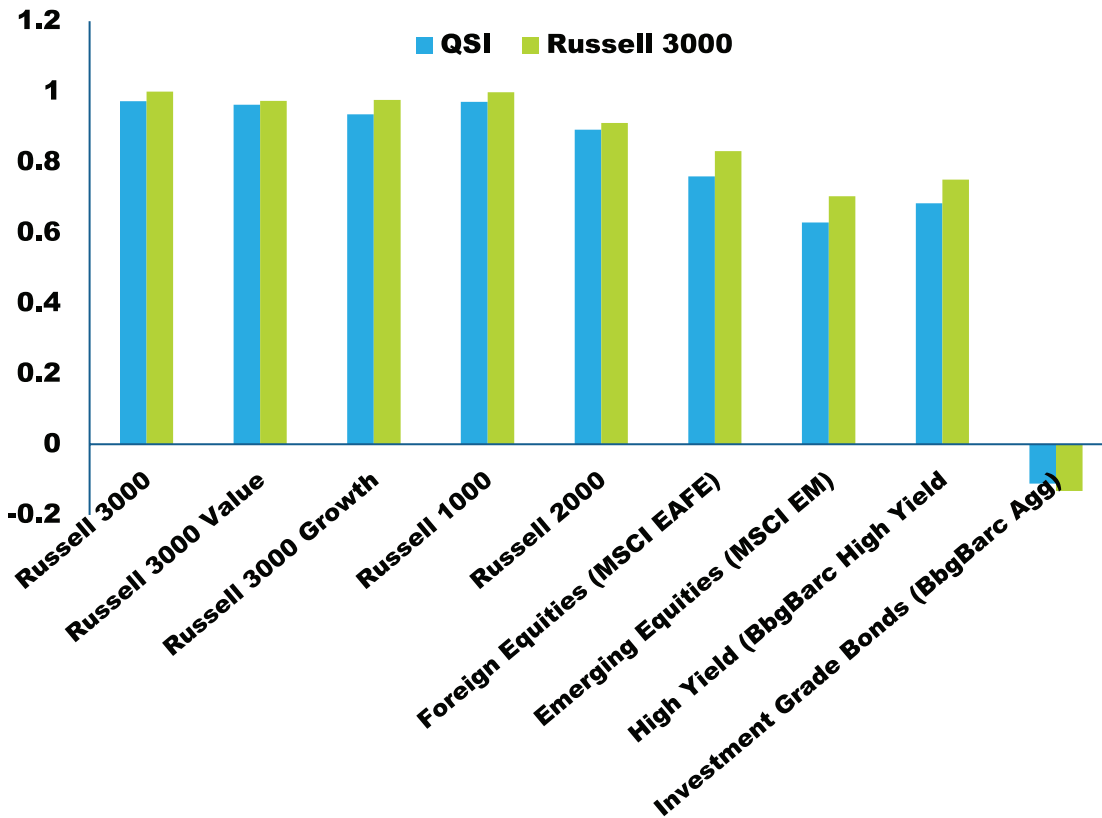


**FIGURE 20**  
**QSI Performance:**  
**February 2011 through**  
**September 2019**

Source: Meketa Investment Group; QSI Index® actual results.

The QSI Index has performed at least as expected and perhaps better than expectations over the past eight years, a period of an extended bull run. QSI has effectively participated in 100% of the market upside while still providing downside protection (81% downside capture). The QSI Index has outperformed the Russell 3000 Index since it went live, by 90 basis points. Importantly, the QSI portfolio has exhibited less risk (standard deviation) than the Russell 3000, 12.3% vs. 13.6%. This is not totally unanticipated given how much less volatile the markets have been since 2011. Note that we do not believe that achieving a higher return should be a necessary expectation for an investor in a QSI portfolio, as they should (theoretically) be willing to accept modestly lower returns for a reduced risk level (as they do with an allocation to bonds).

As an added benefit, correlations with other risky asset classes were slightly lower than for the Russell 3000 (see Figure 21). While the QSI portfolio's correlation with the Russell 3000 Value was higher than with the Russell 3000 Growth (0.98 vs. 0.96), the difference was not significant enough for us to be concerned that we had essentially replicated a value index. Furthermore, what slight value effect is present is arguably not enough to explain the risk adjusted return we witnessed (see Clarke, de Silva, and Thorley, 2006; Thomas and Shapiro, 2009).



**FIGURE 21**  
**QSI Correlations**

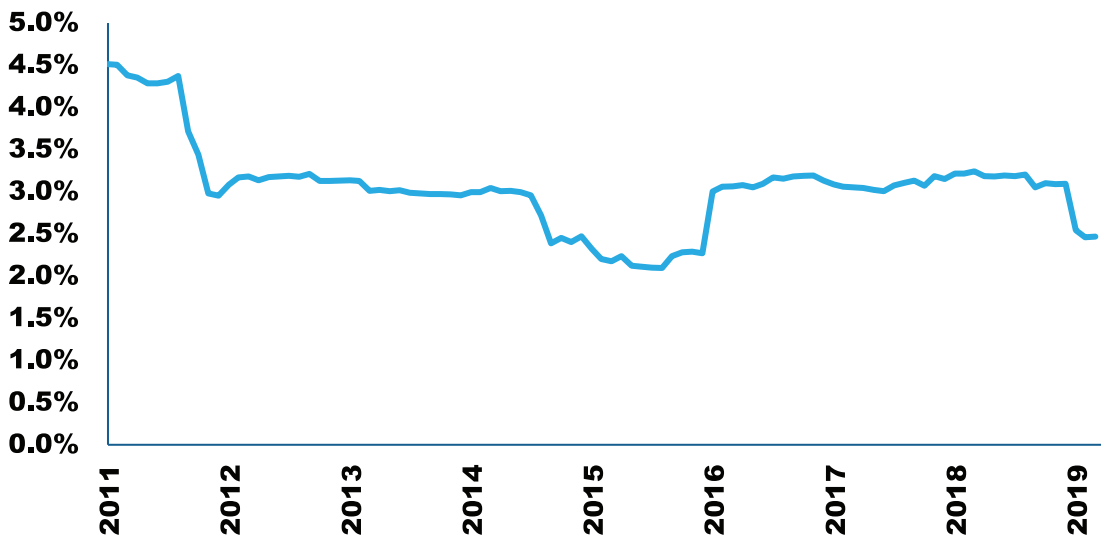
Source: Meketa Investment Group; QSI Index® actual results.

Lower correlations with other risky assets imply that a QSI allocation may increase a portfolio’s risk-adjusted returns not only through the potentially better characteristics of the QSI portfolio, but also through its dampening of portfolio-wide volatility. Alternatively, an investor could redeploy its risk budget to other higher risk/expected returning asset classes to seek a higher returning total portfolio without increasing total portfolio risk.

## Risks

While portfolios that focus on higher quality, stability, and income factors may reduce equity risk, they are *not* riskless. We would also expect the QSI Index to lag during up markets—and likely during major liquidity operations, or “easy money” policies, by the central bank. The rationale is simple: high quality companies do not need “easy money,” but low quality companies do. Therefore, the valuation of the lowest quality companies increases much more than quality companies when the central bank (and risk-taking, generally) drive the market.

This return behavior means that portfolios focused on quality, stability, and income have moderate tracking errors—in the range of 2% to 5%—similar to the tracking error of an actively managed portfolio. Comfort with substantial market deviations should be taken into consideration by any plan sponsor interested in implementing this type of strategy.



**FIGURE 22**  
Rolling 3-Year Tracking Error vs. Russell 3000 from February 1, 2011 to March 31, 2019

## Implementation

Active strategies focused on one or more of these approaches will typically charge an active management fee ranging between 0.5% and 1.0%, as well as any attendant transaction and operational costs.

Rules-based strategies, sometimes called “quasi-passive,” are primarily attractive because they are less expensive than active strategies. Furthermore, these strategies could serve as a benchmark for an active quality, stability, or income strategy. A sample of rules-based strategies, including the QSI Index®, is presented in Figure 23.

	Factors			Details				
	Q	S	I	Number of Stocks	Sector Neutral?	Cap Neutral?	Expense Ratio (%)	Inception
S&P High Quality	X		X	100-200	No	No	0.19 <sup>10</sup>	6/2010
S&P Dividend Aristocrats		X	X	~50	No	No	0.35 <sup>11</sup>	11/2005
MSCI Minimum Volatility		X		Varies	No	No	0.15 <sup>12</sup>	4/2008
MSCI High Dividend Yield			X	Varies	No	No	0.38 <sup>13</sup>	9/2006
Russell Dividend Achievers		X	X	200-250	No	No	0.54 <sup>14</sup>	6/2009
Meketa QSI Index	X	X	X	200-250	Yes	Yes	0.07 <sup>15</sup>	2/2011

**FIGURE 23**  
Rules-Based Options for Quality, Stability & Income

<sup>10</sup> Expense ratio reflects Invesco S&P 500 Quality ETF (SPHQ).  
<sup>11</sup> Expense ratio reflects SPDR S&P Dividend ETF (SDY).  
<sup>12</sup> Expense ratio reflects iShares Edge MSCI Min Vol USA ETF (USMV).  
<sup>13</sup> Expense ratio reflects iShares MSCI MSCI World Quality Dividend UCITS ETF (WQDV).  
<sup>14</sup> Expense ratio reflects Invesco Dividend Achievers ETF (PFM).  
<sup>15</sup> The Meketa QSI Index Fund is offered by Rhumblin Advisors.

The QSI approach is attractive relative to some related rules-based options for several reasons. First, it is the oldest, and thus most tested, approach to combine all three factors. Second, it is broadly diversified, holding approximately 200 to 250 stocks. Finally, because it is both cap and sector neutral, investors can take comfort that performance will not be driven by some other, unintended factor.



## Summary

Investing in high quality stocks that provide high income and perform well in adverse environments may be an attractive option for institutional investors who wish to lessen their overall equity risk without sacrificing equity returns. There is substantial evidence that a focus on quality, stability, and income will decrease the downside risk of an equity allocation. In an environment characterized by relatively low expected returns, investments in these stocks appear especially attractive. Nevertheless, such portfolios will experience a relatively high tracking error and may lag in strong bull markets.

Provided that such an allocation fits within an investor's overall objectives and constraints, Meketa Investment Group recommends a strategic allocation to QSI portfolios.

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