In Search of Quality: More Than a Buzzword

At Aristotle Capital Management (Aristotle), we have three core tenets to our investment process: we seek to invest in **high-quality businesses**, trading at **attractive valuations**, where there are company-specific **catalysts** underway to propel the company forward. While the term "quality" is common in the investment management industry, we would like to explain how we think about quality and why we invest a tremendous amount of effort attempting to assess quality.

> ***qual·i·ty***: *the standard of something as measured against other things of a similar kind; the degree of excellence of something*[1].

We believe identifying quality businesses is a combination of art and science. Quality does not lend itself to a formula. Both quantitative and qualitative "brushes" are required. That is part of the beauty of our process – it is not formulaic, but rather a mosaic.

Many investors seek quality by "screening" for financial figures they believe to be "proof" of a high-quality company. While we, too, scrutinize financial data, we do not utilize screens. We believe quantitative screens to be exclusionary, at best, and think they often funnel investors into the same stocks, leading to herd behavior. Instead, our new ideas are "screened in" based on the knowledge and expertise the team garners by spending the vast majority its time studying our existing holdings and their value chains (e.g., competitors, suppliers, customers and disruptors).

"These instructions are useless. Keep up the good work."

Source: cartoonstock.com

Admittedly, there are financial metrics[2] that may *suggest* a business has a high "degree of excellence." While this information is insightful in helping investors understand *what* has occurred with a business, a stand-alone statistic provides little insight as to *why* a business has performed in a particular manner. Perhaps more important, from an investment perspective, is the quest to understand why a business *will continue* to demonstrate a high "degree of excellence." Our team of analysts endeavors to determine whether a company will remain high quality regardless of the macroeconomic or political environment.

Certain indications of quality do not change quickly. These might include things such as brand, scale advantages, operational efficiencies or market share. Other indications of quality, such as profit margin, debt to equity or return on invested capital, can vary dramatically over short periods of time. For these reasons, we do not have a preferred or required metric(s) when seeking quality. In our opinion, the identification of a high-quality business does not lend itself to a formula or computer screen, but rather to the very human interpretation of information – both quantitative and qualitative.

> *"Not everything that can be counted counts, and not everything that counts can be counted"*
> *~ William Bruce Cameron**

It should also be noted that our assessment of quality does not stop with the analysis of a particular business; it extends to assessing boards of directors, management teams and their track records, employee relations, industry dynamics, competitive positioning, and other forces that may directly impact the long-term worth of a business, such as barriers to entry (implicit and explicit). We also seek out companies that perform well in times of adversity. We want to understand the predictability and stability of a business. Many of these items are what others frequently refer to as "ESG factors." For Aristotle, these matters are inherently part of assessing quality. Ultimately, we seek to identify companies with sustainable competitive advantages.

Of equal importance – and often to the surprise of our prospective investors – is the fact that we do not assess valuation unless and until we have deemed a company to be high quality. While many value investors begin their investment process with valuation and then attempt to determine quality, at Aristotle, we do the opposite. We do this because the pursuit of quality is a risk management and mitigation tool. We focus on a universe of high-quality companies because it can minimize the potential for negative surprises and can offer downside protection in difficult markets.

*Quote is often attributed to Albert Einstein.

So, what makes a company "high quality?" There are several traits we look for in building our mosaic. Among the determinants of quality we seek, in no particular order and far from an exhaustive list, are:

Product or service superiority – The ability of a company's product or service to successfully compete and attract demand due to factors other than price is often a key contributor to its profitability. These businesses often garner higher prices relative to their peers because of attributes such as: technological superiority, better functionality, enhanced features, a premium image or a strong brand name.

An exceptional management team – There are perhaps as many characteristics of a great management team as there are identifying features of a high-quality company. For instance, we look for management teams whose interests are aligned with those of stakeholders, with proven track records and often a history of successful innovation. While we generally avoid highly acquisitive businesses, we may invest in a firm with demonstrated success in integrating its acquisitions and bringing the acquired business to new heights. A company in a great industry with a poor management team may never realize its potential, while a well-managed company may be able to outperform despite difficult economic and/or industry conditions.

Consolidated or consolidating industry – A company operating in an industry with a "moat" around it, with few new entrants, typically enjoys higher profits than businesses in highly competitive industries. High barriers to entry can also help sustain and extend a company's competitive advantage. As long as competitors act rationally, companies operating in oligopolistic industries typically earn outsized profits. Similarly, the market leader in a highly fragmented industry generally earns above-average margins.

In control of its own destiny – We prefer to invest in businesses that are in control of their own destinies. We often avoid pure commodity sellers or companies whose input costs or selling prices are subject to the vagary of factors outside their control. When we do invest in these types of businesses, we seek out those with competitive advantages, such as access to unique materials or a very low (and sustainable) cost structure.

Recurring revenue – Recurring revenue from sources such as subscriptions, royalties, licenses or service demand from an installed base of diversified customers can lead to more stable and predictable cash flows.

High and/or increasing return on capital – We seek companies that are structured to generate a high return on capital. Contributing factors may include: products or services that generate higher margins, efficient cost structures, more productive use of its capital inputs, or low capital intensity. Such companies enjoy greater operational flexibility and sustainability compared to peers that cannot consistently earn their cost of capital.

Prudent use of leverage – We shy away from heavily indebted businesses. Debt tends to amplify one's prospects, both positive and negative. Used judiciously, debt can play an important role in a company's strategy. But taken to extremes, it creates unwarranted risks or underutilized resources. This, in our view, is not an optimal corporate strategy, and it is therefore rare for us to invest in highly indebted enterprises.

Strong FREE cash flow generation – We look for businesses that we believe possess the ability to consistently generate cash in excess of capital and operating requirements. We also favor companies that put FREE cash flow to use in a manner that most benefits shareholders, whether it be in the form of profitable reinvestment in the business, dividends or share repurchases.

These are just a few of the quality characteristics we seek in every investment we make. While each company in client portfolios may exhibit quality in different ways, all investments possess several of these features. It is important to note that some of these traits are quantifiable, while many are not. Therefore, to identify high-quality businesses, we must intensely (and continuously) examine individual companies one by one rather than rely on quantitative screens.

Fortunately, we believe the universe of high-quality companies is narrow (roughly 400-500 globally) and static (it does not change much from year to year), making it possible for our experienced investment team to develop a deep understanding of these businesses over time. Our investment team has spent decades researching companies across the globe to define and create what we consider to be a universe of outstanding businesses. This is an ongoing, dynamic process, as companies evolve and change. *In fact, we seek to identify businesses that are moving into the high-quality universe before the transition is recognized by others*.

At Aristotle, we intentionally begin with an assessment of quality. This research-intensive pursuit of what we believe to be great companies with dependable competitive advantages forms the foundation of our approach. We do not seek to identify the cheapest stocks in the market, nor will we invest in low-priced companies if we do not deem them to be high-quality. Our primary focus is on companies with products or value-added services that typically are sold for reasons other than price alone. We do this because it leads us to sustainable business models, high and/or growing margins and market shares, high returns on invested capital, and the ability to perpetuate a virtuous cycle. We employ fundamental techniques, including the analysis of numbers, with the goal of identifying high-**quality** businesses, trading at discounts to our estimates of their intrinsic **value**, that possess **catalysts** to unlock their potential.

Sources:
[1]Lexico.com; https://www.lexico.com/definition/quality.
[2]These quantitative metrics might include, but are not limited to, market share, profit margin, financial leverage, return on equity, return on invested capital and even dividend consistency.