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Resources Management Corp

MARKET COMMENTARY

THE ROLE OF QUALITY IN INVESTING

The concept of “quality” is one that, as a society, we have a strong general understanding of, but have a difficult time capturing the full essence of in a single explanation. Merriam-Webster defines quality as the “degree of excellence” of something. This is certainly accurate on the surface, but it lacks the subtlety that an application of actually evaluating degrees of excellence would require. As investors, we are constantly judging the quality of a variety of assets and investment opportunities to identify the most appropriate places to allocate capital. This process, however, is not a rigid one, and the measures vary depending on whether business or investment quality is being assessed.

Given that our investment strategy is focused on identifying long term holdings, the quality of a security’s underlying business is a core requisite for addition to a portfolio. Similarly, it is the fundamentals of the business that drive our continuous consideration of current holdings and whether they still meet our standards. While there is no “one size fits all” checklist of characteristics that make a business wonderful, there are several traits that tend to typify the types of businesses we look for. First, we prefer companies that have demonstrated a consistent ability to generate returns on the capital employed in the businesses that are above average (both on an absolute basis and relative to their peer group). There are many companies that have been able to generate strong returns in the short term, but competition quickly reduces these returns to more average levels if the business model is not protectable.

High quality businesses, however, are able to sustain high returns on capital as a result of what is functionally an “economic moat.” This “moat” is a competitive advantage that allows the company to continuously perform at a high level for extended periods of time. A low-cost strategy would be an example of a moat that could allow a business to compete more effectively than its peers. In this scenario, either scale or proprietary processes (which can simply be just an extremely lean organization) allow the company to charge lower prices than its competitors, who are unable to replicate this cost structure. Lower prices for comparable products, naturally, give the company a competitive advantage that allows for exceptional financial performance. Dynamics such as these can be critical to ensuring that the business model is sustainable, making the company an appropriate holding for the long term. In addition to the aforementioned criteria, a highly competent management team and a well-capitalized balance sheet are critical to the long-term success of a business.

Despite these and other factors being suggestive of the quality of a business, they are not always indicative of a logical investment opportunity. Identifying a great business is an important starting point, but investment results are often driven by purchasing interests in companies at prices that are appropriate given the cash flow that will be produced in the future. Valuation frequently has the largest impact of any single variable on the outcome of an investment in that overpaying for an asset increases the odds of a poor outcome, while purchasing an undervalued asset makes a positive result more likely. History suggests that acquiring excellent companies at fair (or wonderful) prices provides strong risk adjusted returns over the long term. Our intention is to identify these opportunities and hold them for extended periods of time.

Building a high-quality portfolio requires a multi-layered evaluation of, first, the underlying business in question, followed by the valuation at which it can be acquired. Great businesses can be poor investments if purchased at the wrong price (just as average businesses can be excellent investments if purchased at a favorable price), so we focus on acquiring outstanding businesses at appropriate prices with the expectation that we will be holding it for the long term. Warren Buffett once pointed out that "time is the friend of the wonderful company, the enemy of the mediocre." We aim to keep this in mind as we deploy capital in the market.

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