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QUALITY VS. JUNK: WHY QUALITY IS SO COMPELLING

Eagle's Todd McCallister offers his perspectives on quality stocks vs. junk stocks.

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After a significant rally among high-beta, lower quality stocks, the question remains: Can quality names do well in an up market?

Eagle portfolio managers, including Portfolio Manager Todd McCallister, PhD, CFA — who has been named on Barron's Top 100 Managers list in 2008, 2007, 2006, 2005, 2004, 2003 and 2002* — believe that a focus on fundamentals and a consistent approach to stock-picking should prevail as the market eschews lower-quality companies in favor of a long-term preference for stable companies that offer greater potential opportunities over time.

The small- and mid-cap stocks that did the best in 2009 were, in a word, junk. Those that likely will do the best in 2010 are those on the other end of the quality spectrum. That's according to Todd McCallister, PhD, CFA, who has helmed Eagle's small- and mid-cap core investing programs since 1997 and has more than 22 years of investment experience.

McCallister's counterparts at subsidiary Eagle Boston Investment Management also have seen this cycle before in their 19 years of investment experience. Dave Adams, CFA, and Jack McPherson, CFA, agree that it's easier for lagging (low-quality) companies to do well in the euphoria of a post-downswing environment but have seen that it doesn't take long for investors to begin to question those companies' fundamentals.

One measure of "quality" is earnings. Companies that have produced earnings have outperformed those that didn't by more than 300 percent since 1991. Non-earning companies have outperformed those with earnings in the past but, with the exception of the 1999-2000 technology bubble and 2003, that outperformance typically fades after four or five months, according to Bank of America-Merrill Lynch research.

Companies in the Russell 2500 Index that don't pay a dividend yield were up nearly 40 percent through September vs. less than a 17 percent gain for dividend-paying companies, according to the same report.

Another measure of "quality" is a company's debt

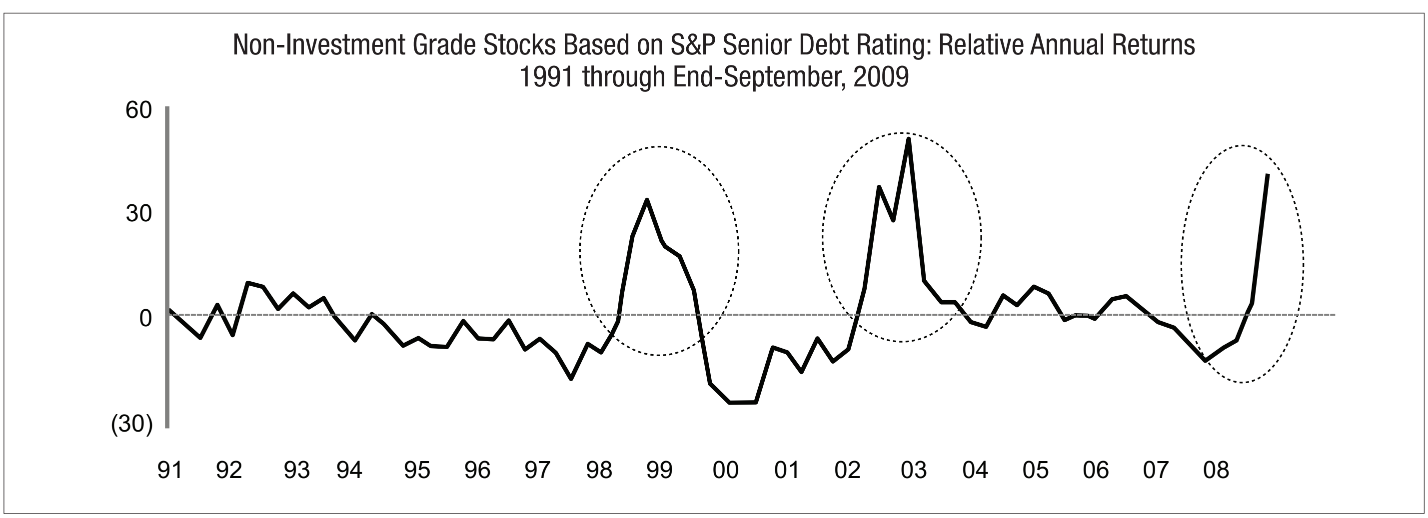

Chart 1 - Source: Bernstein analysis

rating. The outperformance of those companies considered to have non-investment-grade bonds very much mimics the performance of non-earnings companies (see Chart 1).

The run off the March 2009 bottom has been an unusual time, said McCallister. If one were to split stocks into five groups — quintiles — according to their quality, the WORST group has had the BEST PERFORMANCE (see Table 1).

Average Annualized Relative Returns by Quality Quintiles
March-September 2009

	Relative Return	Standard Deviation	Information Ratio
Q1	(23.1%)	7.6%	(3.02)
Q2	(20.0%)	5.1%	(3.95)
Q3	(10.5%)	4.5%	(2.35)
Q4	(2.5%)	1.5%	(1.65)
Q5	56.2%	15.1%	3.73

Table 1 - Source: Bernstein analysis

The stock market, over time, has shown a preference for stability, for companies that do what they say they are going to do. Quality stocks generally trade at a 10 percent premium above the market but currently are trading at 95 percent of the market average, according to Bernstein Research.

Earnings-growth expectations for junk stocks are estimated at nearly 48 percent, according to Bernstein Research, with a projected growth in sales of 6 percent. Meanwhile, quality stocks are projected to grow earnings by nearly 11 percent on a 6.7 percent increase in sales.

Paying attention to the fundamentals — at the company level, not a macroeconomic level — are key for portfolio managers to be successful in times such as these, said McPherson, portfolio co-manager of the Eagle Boston Small Cap Core Value program.

That's because the broad economic downturn of the last couple of years undoubtedly has taken its toll on the lower-quality companies themselves beyond their stock prices.

"Those companies that have survived this likely will be stronger because some of their competitors will have gone out of business," said McPherson. "It is our job to figure out for individual companies the kind of recovery being reflected in its stock price and what we should pay for its potential growth opportunity."

An adherence to a discipline that seeks out long-term quality companies is key, said Adams, who is McPherson's investing partner.

"Our challenge is separating the here-and-now from potential opportunities in two years," he said. "We try to know our companies well enough that it's not a question of whether they'll go out of business but, rather, when things will come around."

This past year has brought with it a sense of déjà vu for McCallister, who — in addition to being a long-term portfolio manager who has been named on Barron's Top 100 Managers list each year from 2002-2008* (an accomplishment shared by only seven other portfolio managers) — is a former economics professor.

Eagle Small/Mid Cap Core portfolios underperformed the Russell 2500 Index from a market bottom on March 12, 2003, through the end of that year. Advisors and clients wanted to know why McCallister and co-manager Stacey Serafini Thomas hadn't bought all the "winners."

McCallister and Thomas explained their thorough, bottom-up stock-selection process to identify growing small companies that are reasonably priced, how they look beyond price-to-earnings multiples and stated growth rates to buy companies that the managers believe have sustainable advantages that will allow them to outperform over the long term.

How what they look for, ultimately, to buy for the portfolio is quality.

It's likely those clients and advisors are happy McCallister and Thomas ignored the calls to buy junk. Chart 1 shows just how quickly the "junk rally" fizzled out in previous cycles.

Meanwhile, the Eagle Small/Mid Cap Core portfolio cumulatively outperformed (on a net basis) the benchmark Russell 2500 Index by more than 10 percentage points (5.34 percent vs. -4.80 percent) from Jan. 1, 2003, through Dec. 31, 2008.

It is clear to our portfolio managers that a focus on quality now is key for long-term investors.

"It's clichéd but true: We believe it's going to be a stock-picker's market," said McPherson. "Our adding value is going to come down to picking good individual stocks. And we believe that, with all the names we have to choose from in the small-cap universe, we will be able to find companies that outperform even in underperforming sectors."

McCallister and Thomas are going to continue their long-term philosophy of buying businesses, not numbers.

"Junk had a nice run off the March lows," he said. "I believe the market will turn its attention increasingly to quality. Earnings are probably going to be scarce while the economy recovers so it makes sense to buy stable companies.

"I believe we may start to see some mergers-and-acquisitions activity and some high-quality companies might get taken over."

* To determine the 2008 Barron's/Value Line annual rankings, Value Line screened 1,008 equity funds, first eliminating funds with more than two lead managers and managers with less than three years' tenure, and those with less than $200 million in assets. The survey was then organized by nine investment objectives. The remaining 564 managers were then scored based on how much risk-adjusted value he or she added relative to other managers in the same Value Line investment objective. "They're the Tops," appeared in the Aug. 11, 2008 edition of Barron's.

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