

April 21, 2014

## QUALITY AND STABILITY

### *When The Seas Get Rough, Sailors Prefer a Steadier Boat*

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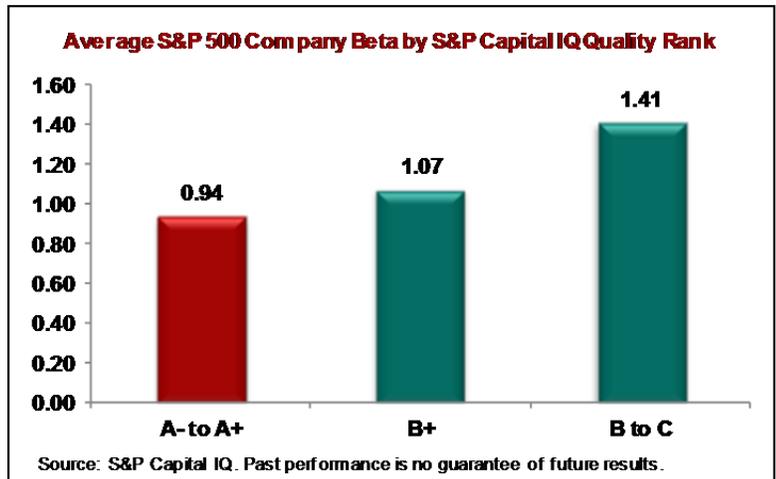
For much of this bull market, total returns have been driven by the low quality companies. During bear markets, those companies priced to go out of business but did not usually offer the greatest upside potential, and typically outperform during the early years of new bull markets. This time around, possibly the artificially low level of interest rates maintained the enthusiasm for these issues. But when the seas start to get rough, investors will likely prefer those companies that offer a higher quality of earnings and greater stability of price returns.

At S&P Capital IQ, one measure of quality is based on consistency. An S&P “Earnings and Dividend Quality Rank” is a letter grade assigned to companies based on a variety of factors, chief among them is the consistency of earnings and dividend growth during the prior 10 years.

As of April 17, there were 443 companies the S&P 500 that had an S&P Quality Rank, with 128 (29%) having ranks of A-, A or A+, otherwise known as “above average.” Also, there were 169 companies ranked B, B- or C, or “Below Average.” Finally, 146 were ranked B+ or “Average.”

It should come as no surprise that those companies with a higher consistency of increasing earnings and dividends tend to experience lower price volatility relative to the broader market. Indeed, those stocks in the S&P 500 with Above Average rankings currently have an average beta of 0.94, compared with the average beta of 1.41 for those ranked Below Average and 1.07 for those ranked Average.

In the past 13 weeks and year, however, investors haven’t worried too much about volatility or the quality of earnings. Indeed, during these two timeframes, there has



**Average S&P 500 Return/Valuation Metrics by Quality Ranking**

Quality Rank	Count	Total Return %		Beta	Dividend Yield %	P/E Ratio 2014E EPS
		13 Wks.	12 Mos.			
A- to A+	128	7.9	16.9	0.94	2.14	16.9
B+	146	11.4	19.5	1.07	2.13	17.5
B to C	169	12.5	21.7	1.41	2.20	26.6
<b>All</b>	<b>443</b>	<b>10.8</b>	<b>19.6</b>	<b>1.16</b>	<b>2.16</b>	<b>20.8</b>

Source: S&P Capital IQ’s MarketScope Advisor.

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been an inverse correlation between ranking and return. Companies with Above Average quality rankings saw an average 13-week total return of 7.9%, compared with a 12.5% average return for those ranked Below Average, and 10.8% for all 443 companies in the S&P 500 quality rank universe. What's more, Above Average companies recorded an average 12-month total return of 16.9% versus an average 21.7% return for those ranked Below Average, and 19.6% for all companies.

However, these outsized returns for lower quality companies have also inflated their valuations. Indeed the average P/E ratio on 2014 estimated operating earnings per share now stands at 26.6X for those ranked Below Average versus a multiple of 16.9X for those ranked Above Average and 20.8X for all companies.

Should there be a rotation back toward those companies with higher quality rankings, which companies do S&P Capital IQ equity analysts believe are best positioned? Using our MarketScope Advisor platform, I screened on four criteria. First, I limited the universe to S&P 500 companies. Next, I selected only those with Above Average Quality Rankings (A-, A or A+). Finally, I chose only those with S&P Capital IQ STARS and Fair Value rankings of 4 (Buy) or 5 (Strong Buy). This screen netted 20 stocks in six sectors, with the greatest number (seven each) coming from the Consumer Discretionary and Health Care sectors.

So there you have it. With the S&P 500 now in the early stages of its seasonally vulnerable period, investors will likely start thinking more about stability of price and quality of earnings. And of course, they don't want to over-pay for any investment they consider making. As a result, it would appear natural to us that investors now begin re-emphasizing large-cap stocks over the more volatile and expensive small-cap issues. In addition, they will likely gravitate to those companies with higher S&P Capital IQ Quality Rankings, as companies with these rankings sport betas that are substantially below those of lower quality companies. Finally, with the average 2014E multiple of high quality companies trading at a 36% discount to the average multiple of low quality companies, investors will likely be attracted to these bargain beta issues.

<b>S&amp;P 500 Companies with Quality Rankings of A- or Higher, and STARS and Fair Value Rankings of "Buy" or "Strong Buy"</b>						
<b>Sector</b>	<b>Company</b>	<b>Ticker</b>	<b>Price</b>	<b>STARS</b>	<b>Fair Value</b>	<b>Quality Rank</b>
<b>Consumer Discretionary</b>						
	COMCAST CORP.	CMCSA	49.1	4	5	A-
	DISNEY (WALT) CO. (THE)	DIS	79.99	4	4	A+
	GAP, INC. (THE)	GPS	38.58	5	4	A
	MATTEL, INC.	MAT	37.47	4	4	A
	ROSS STORES, INC.	ROST	68.99	4	4	A+
	TARGET CORP.	TGT	60	4	4	A
	VF CORP.	VFC	59.85	4	4	A
<b>Energy</b>						
	CHEVRON CORP.	CVX	123.68	4	4	A
<b>Financials</b>						
	T. ROWE PRICE GROUP, INC.	TROW	80.63	5	4	A-
	TRAVELERS COMPANIES, INC.	TRV	86.68	4	5	A-
<b>Health Care</b>						
	AMERISOURCEBERGEN CORP.	ABC	64.68	5	4	A
	BARD (C.R.), INC.	BCR	139.49	4	5	A
	BAXTER INTERNATIONAL INC.	BAX	72.81	4	4	A
	MCKESSON CORP.	MCK	170.98	4	4	A-
	MYLAN INC.	MYL	46.92	4	5	A-
	QUEST DIAGNOSTICS INC.	DGX	59.48	4	4	A-
	STRYKER CORP.	SYK	78.78	4	4	A
<b>Industrials</b>						
	NORFOLK SOUTHERN CORP.	NSC	96.27	4	5	A
	UNITED TECHNOLOGIES CORP.	UTX	118.57	4	4	A+
<b>Information Technology</b>						
	QUALCOMM INC.	QCOM	81.32	5	4	A-

Source: S&P Capital IQ's Market Scope Advisor

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### ★★★★★ 5-STARs (Strong Buy):

Total return is expected to outperform the total return of a relevant benchmark, by a wide margin over the coming 12 months, with shares rising in price on an absolute basis.

### ★★★★ 4-STARs (Buy):

Total return is expected to outperform the total return of a relevant benchmark over the coming 12 months, with shares rising in price on an absolute basis.

### ★★★ 3-STARs (Hold):

Total return is expected to closely approximate the total return of a relevant benchmark over the coming 12 months, with shares generally rising in price on an absolute basis.

### ★★★ 2-STARs (Sell):

Total return is expected to underperform the total return of a relevant benchmark over the coming 12 months, and the share price not anticipated to show a gain.

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Total return is expected to underperform the total return of a relevant benchmark by a wide margin over the coming 12 months, with shares falling in price on an absolute basis.

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**Overweight** rankings are assigned to approximately the top quartile of the asset class.

**Marketweight** rankings are assigned to approximately the second and third quartiles of the asset class.

**Underweight** rankings are assigned to approximately the bottom quartile of the asset class.

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