THE "BUFFETT FACTOR" REVISITED

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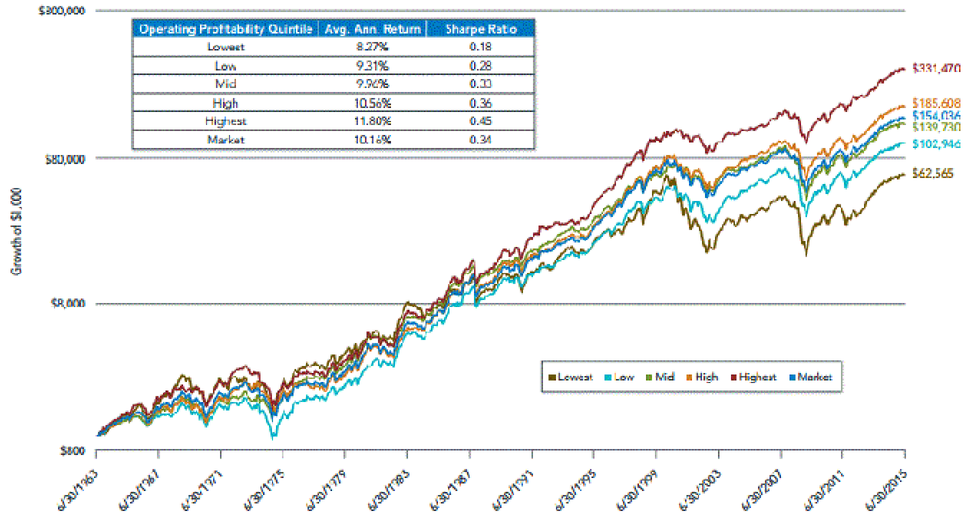
One of our most popular blog posts this year has been the one that connects our [quality dividend](#) growth Index methodology to [the way Warren Buffett looks at potential acquisitions](#), key aspects being: **Berkshire Hathaway Inc. Acquisition Criteria**[1] • Demonstrated consistent earnings power • Businesses earning good [return on equity (ROE)](#) while employing little or no debt   The key phrase is "businesses earning good returns on equity while employing little or no debt." However, the Quality Discussion within equity investing has a long history, and Warren Buffett certainly isn't the only one to mention it.   **Benjamin Graham's Quality Criteria** One of Warren Buffett's teachers, Benjamin Graham, who is known as one of the fathers of [value](#) investing, also had a rigorous focus on quality traits. Many focus on Graham's criteria for finding inexpensive companies, but he was at least equally focused on attributes of quality, if not more so.   **Benjamin Graham's Attributes of Quality**[2] • "Adequate" enterprise size, as insulation against the "vicissitudes" of the economy • Strong financial condition, measured by [current ratios](#) that exceed 2 and [net current assets](#) that exceed [long-term debt](#) • Earnings stability, measured by 10 consecutive years of positive earnings • A dividend record of uninterrupted payments for at least 20 years • [Earnings-per-share](#) growth of at least one-third over the last 10 years   **Fama-French [Operating Profitability](#) Factor** Research done by Kenneth French and Eugene Fama arrives at a similar place. In their draft of "A Five-Factor Asset Pricing Model" from September 2014, they cite operating profitability, defined as annual revenues minus cost of goods sold, interest expense and [selling, general & administrative (SG&A) expenses](#), all divided by [book value of equity](#). Note, this is similar to Buffett's criteria above: a company earning a good return (profits) on its equity (book value)—in other words, a high ROE. Arranging the U.S. market into [quintiles](#) based on operating profitability further emphasizes that high-quality stocks have won over longer holding periods.   **The Spectrum of Operating Profitability Quintiles from June 30, 1963, to June 30,**



Operating Profitability Quintile	Avg. Ann. Return	Sharpe Ratio
Lowest	8.27%	0.18
Low	9.31%	0.28
Mid	9.96%	0.33
High	10.56%	0.36
Highest	11.80%	0.45
Market	10.16%	0.34

Source: Kenneth French Data Library, with data as of 6/30/2015. Period based on availability of operating profitability returns sorted into quintiles, which begins 6/30/1963. Past performance is not indicative of future results. You cannot invest directly in an index.

2015   • **Top Two**

Quintiles Outperformed the Market: We saw the top two quintiles outperform the market on two fronts—average annual returns and Sharpe ratio. In other words, this outperformance was not achieved with a significant increase in risk. **Grantham on Why Quality May Outperform over Long Periods** One of the long-standing investment practitioners of quality investing has been Jeremy Grantham's firm, GMO. In a paper written in 2004,[3] GMO wrote of quality firms:

> … even though many of these corporations tend to generate high profits year after year, they are systematically underpriced because they lack volatility. Instead of overpaying for these companies, as finance theory would suggest—given their low risk profile—shareholders in fact do just the opposite: they underpay. The result is that investors in high-quality companies get to forge ahead with 15+% returns year after year without overpaying. Of course, in any given year, low-quality stocks can and do stage rallies and high-quality stocks can underperform. But the high-quality stocks have always won over longer holding periods. No matter what metric is used to identify quality stocks—leverage, profitability, earnings volatility or beta—high-quality stocks have beaten out low-quality stocks.

In other words, the desire to try to find that "next big thing" tends to exert so much power over the investment psyche that focusing on quality companies has, at least historically, been one avenue through which to achieve outperformance. We will continue exploring some of our other findings from our research into the concept of quality investing. Click here for the full in-depth research piece "The Dividends of a Quality and Growth Factor Approach." [1]Source: Berkshire Hathaway annual letter to shareholders from Warren E. Buffett, 2/28/15. [2]Source: Benjamin Graham, "The Intelligent Investor" (4th revised edition), Harper & Row, 1973. [3]"The Case for Quality—The Danger of Junk," GMO white paper, 3/04.

Important Risks Related to this Article

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DEFINITIONS

Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over tim.

Dividend : A portion of corporate profits paid out to shareholders.

Return on Equity (ROE) : Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Current ratios : The current ratio is a liquidity ratio that measures a company's ability to pay short-term and long-term obligations.

Net Current Assets : Current assets minus current liabilities. This amount indicates how much capital is being generated or used up by day-to-day activities.

Long-term debt : Long-term debt consists of loans and financial obligations lasting over one yea.

Earnings per share : Total earnings divided by the number of shares outstanding. Measured as a percentage change as of the annual Index screening date compared to the prior 12 months. Higher values indicate greater growth orientation.

Selling, general & administrative (SG&A) expenses : It is the sum of all direct and indirect selling expenses and all general and administrative expenses of a company, which is a major non-production cost presented in an income statement.

Book value per share : Total book value divided by the number of shares outstanding. Measured as a percentage change as of the annual Index screening date compared to the prior 12 months. Higher values indicate greater growth orientation.

Quintile : One of the class of values of a variate which divides the members of and batch or sample into equal-sized subgroups of adjacent values or a probability distribution into distributions of equal probability.

Sharpe ratio : Measure of risk-adjusted return. Higher values indicate greater return per unit of risk, specifically standard deviation, which is viewed as being desirable.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Risk : Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.

Leverage : Total assets divided by equity. Higher numbers indicate greater borrowing to finance asset purchases; leverage can tend to make positive performance more positive and negative performance more negative.

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.