As we noted in the first paper in this series[1], the mere fact that something is expensive does not make it high quality. In the stock market, like in any market, pricing bubbles can occur which make otherwise normal stocks much higher priced, due to perceived future growth opportunities which do not occur. Think of the tech wreck of the early 2000s, the GFC housing bubble in the US – the list is endless. Even moderate levels of overpricing can occur as investors extrapolate future growth or quality which does not materialise.

The simple expedient of being expensive means that it necessarily reflects actual or future growth in earnings or some other factor, like better quality. This simple fact is often lost in arguments between growth and value styles, in the same way that value stocks do not mean a lack of growth or quality (the subject of our last paper).

So what can we say about expensive stocks in terms of growth and quality? Our results below suggest the following:

- Expensive does not necessarily mean high growth – many stocks trade at high price multiples but have no historical or forecast growth.

- More importantly for us, expensive does not necessarily mean high quality – many low quality stocks can be expensive.

- However, high quality usually means higher growth – few stocks are high quality but have low growth.

- Expensive low quality stocks have greater risk, lower growth and lower sentiment than higher quality expensive stocks.

We have already seen (in the first paper in this series) that there are many stocks in each of the four quadrants of Value (as EY_NTM) and Quality (ROE_NTM) [2]. See Chart 1[3]

Chart 1: Proportion of stocks in Value-Quality quadrants over time, Jan 2000 to Sept 2022.
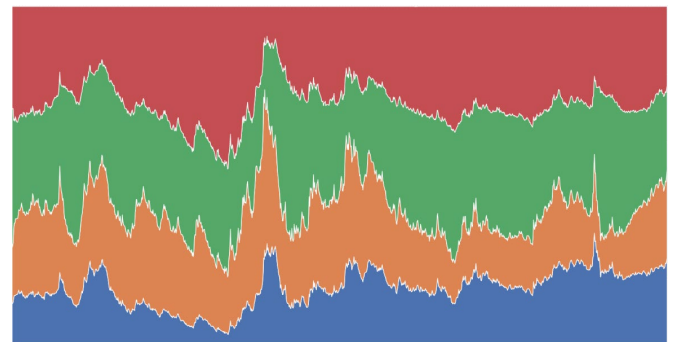
Blue – poor value, low quality; Orange –poor value, good quality,

Green –good value, low quality, Red –good value, good quality.

Source: RQI Investors (formerly known as Realindex), Factset . Past performance is not indicative of future performance.

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[1] Growth, Value Quality and Junk – Part 1: The quality of value is not strained by David Walsh.

[2] Date references have been dropped on the X axis of the charts below to remove clutter from the images. Dates run from Jan 2000 to Sept 2022
[3] The cut offs are: expensive (EY_NTM < 7.5%), cheap (EY_NTM > 7.5%), high quality (ROE_NTM > 12.5%), low quality (ROE_NTM < 12.5%). The quadrants are not of equal size by number of stocks or their weight in the index.

Repeating this for Growth against Quality, we see the following:

Chart 2: Scatterplot of Growth (last five years' average earnings growth: EG5Y) against Quality (next 12 months expected return on equity: ROE_NTM) for MSCI ACWI ex Au at Sept 2022.
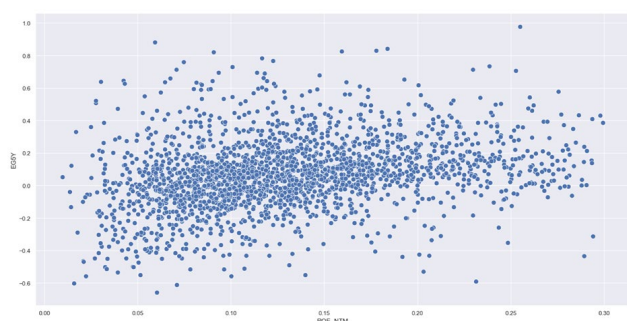
Source: RQI Investors (formerly known as Realindex), Factset . Past performance is not indicative of future performance.

We next look at this spread over time, by dividing the universe at each point in time into four quadrants[4]: good growth and low quality (SW quadrant, blue), good growth and good quality (SE quadrant, orange), poor growth but and low quality (NW quadrant, green) and poor growth and good quality (NE quadrant, red). Percentages of each are shown in Chart 3.

Chart 3: Proportion of stocks in Growth-Quality quadrants over time, Jan 2000 to Sept 2022.
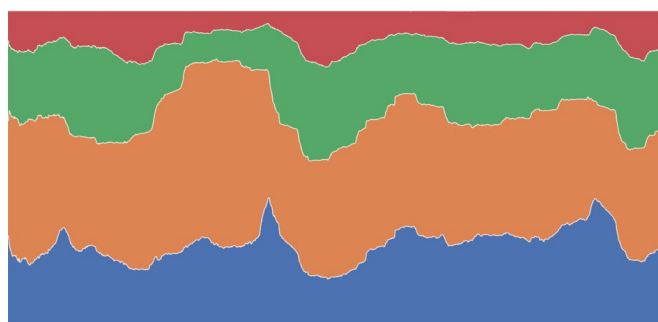
Blue – good growth, low quality; Orange –good growth, good quality,

Green –poor growth, low quality, Red –poor growth, good quality.

Source: RQI Investors (formerly known as Realindex), Factset . Past performance is not indicative of future performance.

The proportions in each quadrant are:

	Chart 1 (that is, at Sept 2022)	Average (whole sample)
Low quality good growth (NW, blue)	28.1%	26.1%
High quality good growth (NE, orange)	37.5%	41.1%
Low quality poor growth (SW, green)	23.1%	22.5%
High quality poor growth (SE, red)	10.4%	10.2%

As we observed above, the small number of stocks in the low growth/good quality quadrant is small, while there are many stocks in the other three quadrants.

Distribution of expensive stocks across quality, growth and value quintiles[5]

Of more interest is how quality and growth are distributed for expensive stocks. We contend that being expensive can also mean low growth and/or low quality ("junk"). There is no guarantee that simply being expensive means that a stock is of high quality or good growth, as we will see. To do this, we now restrict ourselves solely to expensive stocks (EY_NTM < 7.5%).

Chart 4 below shows the proportions of stocks in different quality quintiles for expensive stocks only over time. A large proportion of expensive stocks actually have very low quality, with ROE_NTM below 8%. As we would hope, there is also a large proportion of stocks with good quality. On average, 32% of stocks have an ROE_NTM below 8% and 51% of stocks have an ROE_NTM above 18%.

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[4] The cut offs are: poor growth (EG5Y < 0%), good growth (EG5Y > 0%), high quality (ROE_NTM > 12.5%), low quality (ROE_NTM < 12.5%). These are somewhat arbitrary but the results are not especially sensitive to their selection.

[5] NB: Throughout this paper, we have used the term "quintile" to mean one of five divisions of the data. The "quintiles" here are not chosen be exactly 20% of the sample, instead the aim is to choose consistent and recognisable breakpoints.

Chart 4: Proportion of stocks in Growth-Quality quadrants over time, Jan 2000 to Sept 2022.
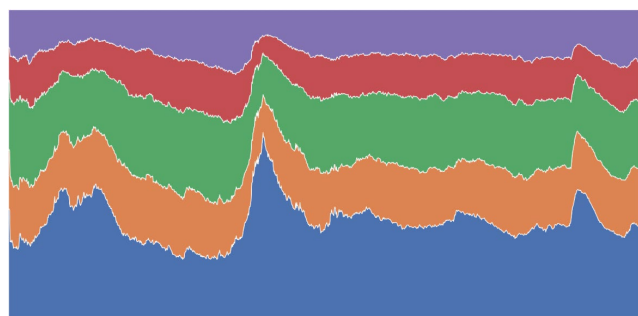

Worst quality quintile is blue (ROE_NTM between 0 and 8%). Next is orange (ROE_NTM between 8 and 12%).

Then green (12 to 18%), red (18 to 24%) and finally purple, highest quality (ROE_NTM between 24 and 30%)

Source: RQI Investors (formerly known as Realindex), Factset . Past performance is not indicative of future performance.

Chart 5 does the same comparison for expensive stocks (EY_NTM < 7.5%) for growth quintiles. There is a lower (but non zero) proportion of stocks that have very low growth but are still expensive, but most expensive stocks have moderate or good growth. . On average, only 13% of expensive stocks (that is, about 1 stock in every 7) have an EG5Y below -30% but 46% of expensive stocks have an EG5Y above +10%. Moderate growth stocks (between -10% and +10%) average about 29% of the sample.

Chart 5: Proportion of stocks of different growth quintiles among expensive stocks only, Jan 2000 to Sept 2022.
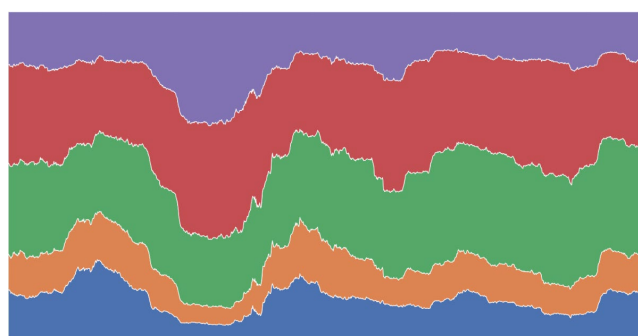
Worst growth quintile is blue (EG5Y less than -30%). Next is orange (EG5Y between -30% and -10%).

Then green (-10% to +10%), red (10% to +30%) and finally purple, highest growth (EG5Y greater than +30%)

Source: RQI Investors (formerly known as Realindex), Factset . Past performance is not indicative of future performance.

Some characteristics of expensive stocks.

As in our first paper, we are interested in the characteristics of expensive stocks as quality changes, to see what might be driving the difference between low and high quality expensive stocks. We look at:

- Growth, measured by EG5Y (see Chart 6)

- Risk, measured by VOL (Chart 7) and BETA (Chart 8)

- Sentiment, measured by MOM (Chart 9)

Table 1 below shows the averages of these. Low quality expensive stocks are characterised by low growth, higher risk and lower sentiment than better quality stocks. Interestingly, these lower quality names are also on average much more expensive (have a lower EY_NTM).

As quality improves, expensive stocks show better sentiment and growth and risk is lower.

*Table 1: Average metrics **for expensive stocks only**, across quintiles of ROE_NTM, Jan 2000 to Sept 2022.*

Quality quintile	Average trailing earnings growth	Average volatility	Average beta	Average price momentum	Average EY_NTM
Lowest (Q1)	-6.83%	40.55%	1.029	0.051	3.48%
Q2	6.49%	34.50%	0.876	0.177	5.17%
Q3	12.21%	34.27%	0.869	0.247	5.01%
Q4	16.58%	34.83%	0.861	0.313	5.07%
Highest (Q5)	17.04%	33.70%	0.868	0.349	4.96%

Source: RQI Investors (formerly known as Realindex), Factset . Past performance is not indicative of future performance.

Growth

Chart 6 shows the average EG5Y in ROE_NTM quintiles for expensive stocks. Low quality expensive stocks have consistently low growth throughout our sample. As quality increases, growth also improves – for the top two quintiles of quality the average growth is very similar.

Chart 6: Average growth (as EG5Y) for expensive stocks (EY_NTM < 7.5%) across ROE_NTM quintiles, Jan 2000 to Sept 2022.

Worst quality quintile is blue (ROE_NTM between 0 and 8%). Next is orange (ROE_NTM between 8 and 12%).

Then Green (12-18%), Red (18 to 24%) and Purple, highest quality (ROE_NTM between 24 and 30%)

Source: RQI Investors (formerly known as Realindex), Factset . Past performance is not indicative of future performance.

Risk

Charts 7 and 8 show average VOL and BETA in ROE_NTM quintiles for expensive stocks. Volatility and beta are both higher for the lowest quality expensive stocks, but apart from those, there is a little to distinguish between the risks of expensive stocks as quality changes.

Chart 7: Average volatility (as 52 week volatility) for expensive stocks (EY_NTM < 7.5%) across ROE_NTM quintiles, Jan 2000 to Sept 2022.
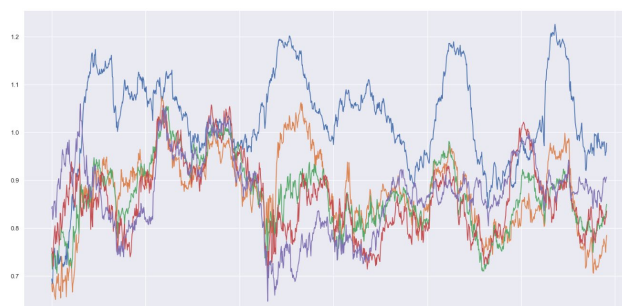

Worst quality quintile is blue (ROE_NTM between 0 and 8%). Next is orange (ROE_NTM between 8 and 12%).

Then Green (12-18%), Red (18 to 24%) and Purple, highest quality (ROE_NTM between 24 and 30%)

Source: RQI Investors (formerly known as Realindex), Factset . Past performance is not indicative of future performance.

Chart 8: Average beta for expensive stocks (EY_NTM < 7.5%) across ROE_NTM quintiles, Jan 2000 to Sept 2022.

Worst quality quintile is blue (ROE_NTM between 0 and 8%). Next is orange (ROE_NTM between 8 and 12%).

Then Green (12-18%), Red (18 to 24%) and Purple, highest quality (ROE_NTM between 24 and 30%)

Source: RQI Investors (formerly known as Realindex), Factset . Past performance is not indicative of future performance.

Finally, sentiment

Chart 9 shows average sentiment (12 month momentum) in ROE_NTM quintiles for expensive stocks. Sentiment improves steadily from low to high quality, with the lowest quintile having the worst sentiment throughout the sample.

Chart 9: Average 12 month price momentum for expensive stocks (EY_NTM < 7.5%) across ROE_NTM quintiles, Jan 2000 to Sept 2022.

Worst quality quintile is blue (ROE_NTM between 0 and 8%). Next is orange (ROE_NTM between 8 and 12%).

Then Green (12-18%), Red (18 to 24%) and Purple, highest quality (ROE_NTM between 24 and 30%) / Source: RQI Investors (formerly known as Realindex), Factset . Past performance is not indicative of future performance.

Conclusion

The aim of this second study was to complete the research around the quality of good value and expensive stocks. We have already seen that stocks which are of higher quality also have, on average, higher growth and can be more expensive. However, lower quality or growth stocks (or both) can also be expensive. A sizeable proportion of expensive names are low quality, have very low growth and sentiment, and show higher risk.

The RQI Investors investment process centres on finding good value stocks which are also good quality, so only a few of the stocks in the universe we have examined in this second paper will form part of our investment thesis. This does not mean that we can ignore them – in fact, we need to study both sides of the story carefully to clarify the picture as best we can regarding quality, value, growth and junk.

This will not be the last word on this topic from us by any means, but next we turn our attention to more pressing issues regarding (a) how the value style might behave in economic turning points (heading into and out of recession) and (b) how the predictability of growth might help us better understand the value premium.

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