Crest Quality Strategy
Conceptual Framework

Executive Summary

- In equity investing "quality" is a subjective and therefore elusive concept. For example, some investors may deem high-quality a company with high growth rates; while some other investors may identify quality with pricing power, predictable revenue and increasing profit margins.

- We believe that the definition of quality must meet two requirements: first, it has to be strictly related to shareholder value creation; second, its adoption in investing should result in superior portfolio performance. We find that the Return on Invested Capital (ROIC) framework meets both requirements.

- A company's ROIC is the most effective way to measure value creation. ROIC measures the efficiency with which capital is employed and highlights a business's ability to create value from operations.

- ROIC is superior to more commonly used return metrics like return on assets (ROA), and return on equity (ROE). These return metrics are distorted by items and financing decisions that do not influence true operating performance.

- We believe that companies that earn high returns on their invested capital usually possess a competitive advantage which allows them to stay ahead of competition.

- Despite premium valuation multiples, high quality stocks outperform. This may seem puzzling but we believe this outperformance of high quality stocks may be the result of investors underestimating these companies' earnings persistence and core operating profitability and a misplaced focus on short-term market and corporate events.

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What is Quality Investing?

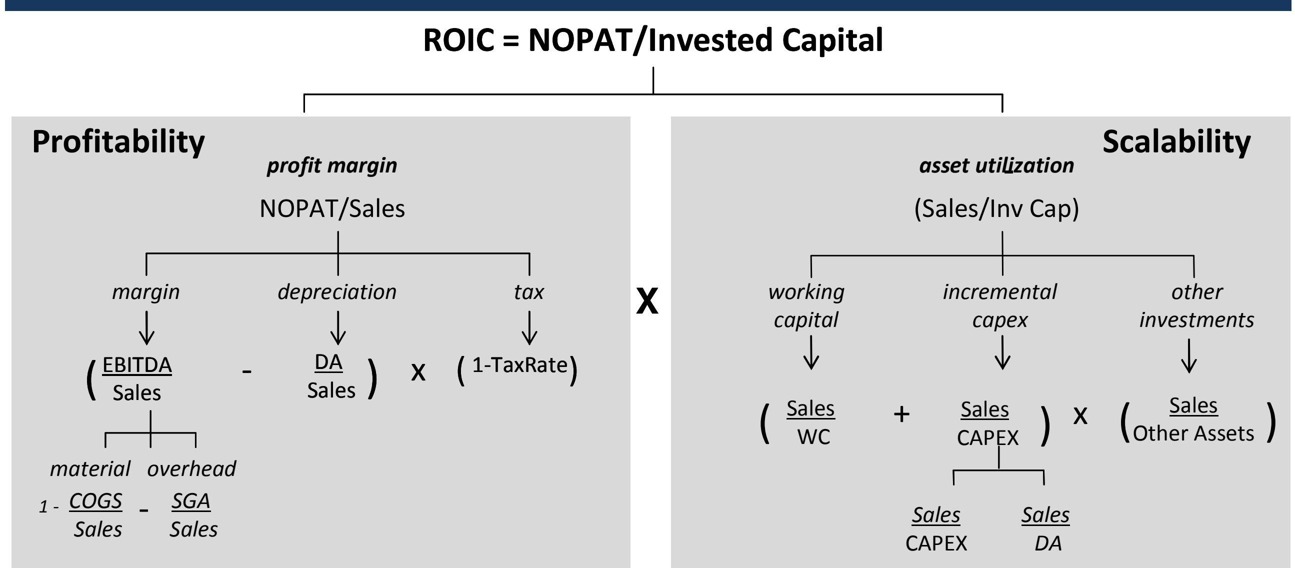
In the corporate credit markets the concept of quality is clearly defined by a company's credit rating which quantifies its capacity to meet financial obligations. In equity investing "quality" is a more subjective and therefore elusive concept. For example, some investors may deem high-quality a company with high growth rates; while some other investors may identify quality with pricing power, predictable revenue and earnings growth and stable or increasing profit margins.

We believe that the definition of quality must meet two requirements: first, it has to be strictly related to shareholder value creation; second, its adoption in investing should result in superior portfolio performance. From a corporate standpoint, the ultimate goal of a firm is to create shareholder value. But how do we measure shareholder value creation?

We believe that a company's return on invested capital (ROIC) is the most effective way to measure value creation. ROIC is defined as the ratio between net operating profit after taxes (NOPAT) and invested capital. Simply speaking, ROIC is a measure of how much cash a company gets back for each dollar it invests in its business.

ROIC measures the efficiency with which capital is employed and highlights a business's ability to create value from operations. For evaluating operating performance, ROIC is superior to more commonly used return metrics like return on assets (ROA), and return on equity (ROE). These return metrics are distorted by items and financing decisions that do not influence true operating performance. For example ROA includes the income from, and capital invested in, items unrelated to core business activities. ROE is influenced by the company's capital structure as it can be artificially enhanced with the use of debt. Chart 1 breaks-down ROIC in its main drivers: profitability and scalability. Wide profit margins are often the result of pricing power and industry dominance achieved through strong brand recognition or unique technology or business model. Companies with highly scalable business models have low fixed assets and are prime candidates for business expansion.

Chart 1. The Drivers of Return on Invested Capital



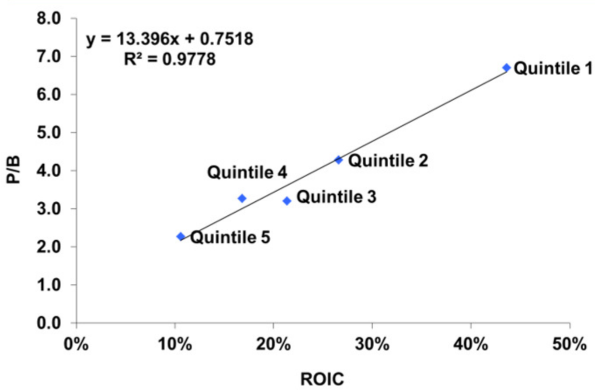
Source: Adapted from: Quantitative Equity Portfolio Management: Modern Techniques and Applications, Chapman & Hall

Thus a high ROIC could be driven by either wide profit margins or high asset utilization or a favorable combination of the two. In either case, companies that earn high returns on their invested capital usually possess a competitive advantage which allows them to stay ahead of competition. Factors determining the sustainability of the competitive advantage are the firm's own competencies and the degree of industry stability and predictability.

Designing a Quality Strategy

Quality investing is in many respects at the opposite spectrum of value investing. Value stocks often display negative business trends, low growth rates and deterioration of profitability.[1] High quality companies, on the contrary, display strong profitability and growth rates and tend to trade at high market multiples. Chart 2 shows a clear positive relationship between ROIC and price-to-book ratio for stocks grouped by ROIC: greater profitability is reflected in higher market multiples.

Chart 2. The Relationship Between ROIC and P/B



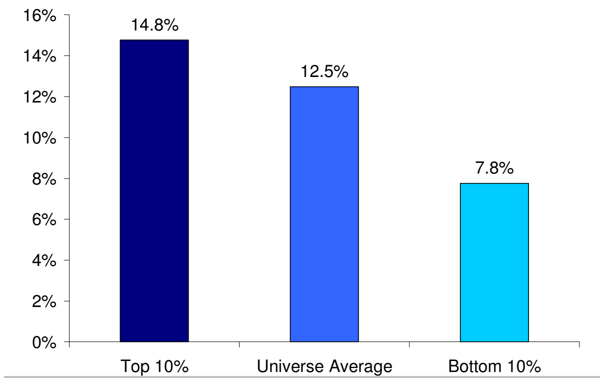
Source: Factset, Crest Investment Partners

Chart 2 begs the legitimate question: why should we invest in high quality companies if their superior quality is already priced in the market? After all, despite the soundness of the ROIC framework, as we stated before, an investment strategy's ultimate goal is to generate superior performance. To answer this question we recur to empirical analysis. Chart 3 reports the results from a backtest conducted over the last two decades. Portfolios are formed based on ranking stocks on their ROIC. The Top (Bottom) 10% is made of the companies falling in the top (bottom) 10% by ROIC. Portfolios are equal-weighted and rebalanced on a quarterly frequency. Results do not include impact of transaction costs or fees. Compounded average total returns are reported.

The analysis shows that high quality stocks (Top 10%) earned an excess return of 2.3% per annum over the market average. Conversely, low quality stocks (Bottom 10%) underperformed the market average by 4.7% per annum over the same period.

[1] See our paper: Value Investing, Conceptual Framework, May 2013

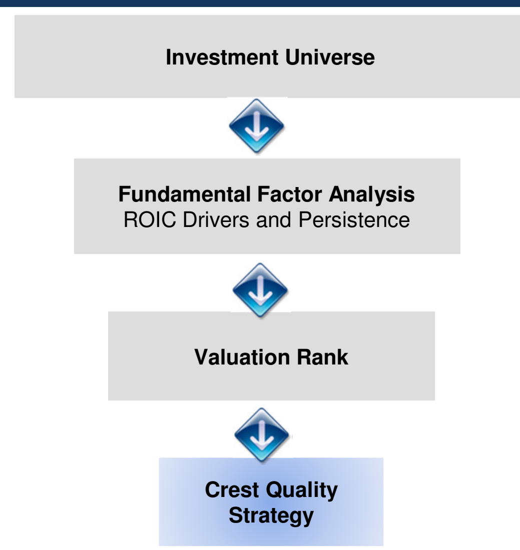
Chart 3. Backtest of ROIC Factor



Source: Factset, Crest Investment Partners

Despite premium valuation multiples, high quality stocks outperform. This may seem puzzling but we believe this outperformance of high quality stocks may be the result of investors underestimating these companies' earnings persistence and core operating profitability. Perhaps a misplaced short-term focus makes investors shift their attention towards short-lived corporate and market events and away from the fundamental drivers of long-term value creation.

Chart 4. Investment Process Flow



Source: Crest Investment Partners

Our process to select high quality stocks is straightforward: after identifying stocks with high and persistent ROIC we then select a sub-set with attractive relative valuation. This process results in portfolios with significantly higher than average ROIC, lower than average debt leverage, and reasonable valuations.

Portfolio Management Massimo Santicchia is a Co-Founder and Chief Investment Officer of Crest Investment Partners. He directs all aspects of the investment strategy as well as develops and manages quantitative equity portfolios. Santicchia has 16 years of investment experience including: S&P Investment Advisory Services LLC, as creator and portfolio manager of the JNL/S&P 4 funds and co-manager of the JNL/S&P Managed and Disciplined funds.