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"In money management what sells is the illusion of certainty." **... John Hempton**

There has been a great deal of chatter recently on whether an investment process focused on acquiring "quality companies" (high future returns on capital through sustainable competitive advantage) is more marketing spin than reality. Much has been discussed about the sustainability of high returns on capital, the "inevitable" reversion to mean as competitive forces slow growth, and, not surprisingly in a short-term biased market, whether investors can withstand the long term investment horizon given normal market gyrations.

We would admit that investing in quality companies is not an easy strategy to undertake. First, identifying a business with sustainable profit growth requires significant fundamental research and due diligence. Next, one must establish a reasonable valuation on the business, as the market will likely misprice the future value of the profit growth. And finally, one must be willing to avoid "temptation" – the emotional pull of owning stocks like the rest of the herd.

Determining "quality" is not a science, it's an art. If it was the former, then any investor buying companies with high return on capital would, ipso facto, own a high quality portfolio. In fact, quality is comprised of a number of exogenous factors to pure "ratio-driven" analysis. Companies with a proven sustainable competitive advantage are under appreciated – it's much easier to evaluate companies using valuation multiples and consensus thinking. However, true investing is counterintuitive: what's clear to the broad consensus of investors is almost always wrong.

Howard Marks discusses the concept of consensus in his comments around second-level thinking. A first-level thinker looks for the highest quality company, the best product, the fastest earnings growth, the lowest price/earnings ratio. Second-level thinking approaches a potential investment quite differently: businesses with the most obvious merit become the ones everyone likes, are the most hotly pursued, the most highly priced, and therefore the least promising and most treacherous.

Investing in quality businesses has its roots in "low risk" investing – simply stated, protecting the underlying value of a portfolio during periods when markets are dislocated. James Montier and Chuck Joyce of GMO contend that "a portfolio constructed of companies with high and stable profits, ...should, by controlling "real risk", result in low and stable "price risk". They refer to superior branding, franchise value, and intellectual capital as the corporate moats that protect profitability from competitive pressures. Further, Montier and Joyce provide statistical evidence there is a strong correlation between profitability and leverage – companies with lower leverage have averaged a 5% higher profit margin than companies with high leverage.

The entire principle behind mean reversion – highly profitable companies attract capital while capital leaves those with low profits – is not particularly relevant when measuring a high quality company. These are businesses that persistently earn high returns and use those returns in the form of dividends, stock buybacks, and accretive growth. Persistently high economic returns are one of the better predictors of a company's future stock price performance. Better said, companies that generate exceptional future profitability generate exceptional future returns.

Certain investment managers purporting to own high quality companies may actually own companies whose recent results are driven by cyclicality or consensus thinking in the short term. Simply understanding how a company maintains a defendable market position, the strengths of a proven management team, and the financial wherewithal to preserve their competitive position takes considerable time and effort which, in an era where the investment community looks at two quarterly periods as a long-term horizon, takes too much time and effort for most professionals.

Being an investor in quality businesses is certainly a road less travelled. It's not easy. Of course, to quote Charlie Munger, "It's not supposed to be easy. Anyone who finds it easy is stupid."

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