Factor/Style Investing

Quality Minus Junk

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Quality stocks — those of companies that are profitable, growing and well managed — command higher prices on average than those of unprofitable, stagnant or poorly managed companies, which we refer to as "junk."

While that is to be expected, the "quality margin" is puzzlingly modest, although high-quality stocks have consistently delivered high risk-adjusted returns. Indeed, a quality-minus-junk (QMJ) strategy, in which an investor goes long high-quality stocks and shorts low-quality stocks, has earned significant historical risk-adjusted returns in the U.S. and 24 other countries.

The price of quality — that is, how much more investors will pay for higher quality stocks — varies over time, reaching a low during the internet bubble. However, low prices for quality stocks tend to predict high future returns of QMJ.

We document strong and consistent abnormal returns to quality, and do so in a far more inclusive and complete setting than prior papers using all four components implied by the Gordon Growth Model simultaneously. We also tie these results to the cross-section and time-series of the pricing of quality in novel ways.

Our results present an important puzzle for asset pricing: We cannot tie the returns of quality to risk, or, in a highly related finding, demonstrate that prices cross-sectionally vary "enough" with quality measures. At this point the returns to quality must be either an anomaly, data mining (albeit incredibly robust data mining — across countries, size and time period, and encompassing the strong consistent U.S. and global correlations of quality to size), or a still-to-be-identified risk factor not from the four-factor model.

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