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# The Quality Factor

### *What is Quality?*

The quality factor is premised on the work that shows high quality companies have outperformed low quality companies over time. There are numerous academics who have done work on Quality, including Benjamin Graham, Richard Sloan, and Robert Novy-Marx.

### *How is it captured?*

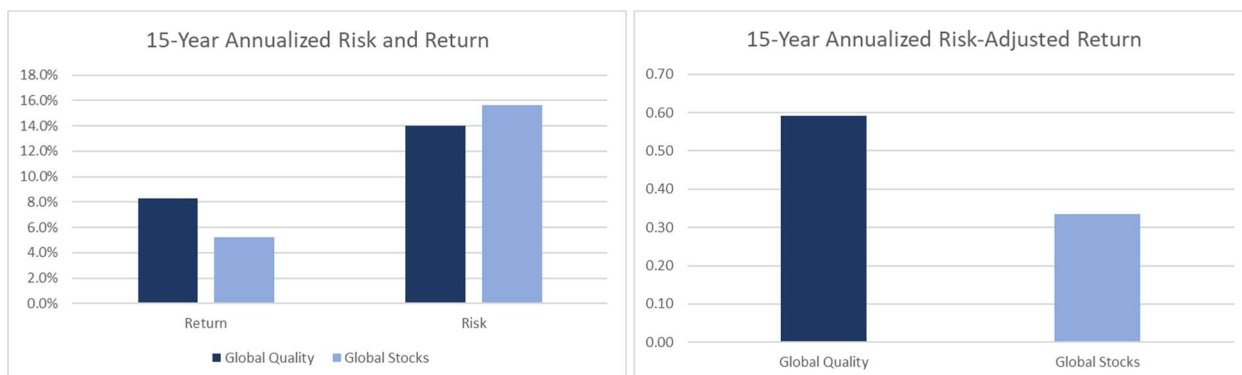
Like other factors, there are many metrics that can be used to target the Quality factor. Some focus on the quality of a company's asset base, while others look at earnings. One popular way to capture the factor is simply by looking at a company's gross profitability.

### *Why does it work?*

The most common explanation for the efficacy of the Quality factor (why it generates an excess return) is that investors over-pay for "lottery tickets". That is, they race to own low quality companies on the promise of higher growth. In cases where that growth isn't delivered, investments may crash.

### *How has it worked?*

Over a 15-year period, Quality (as measured by the MSCI ACWI Quality Index) has outperformed the market (as measured by the MSCI All Country World Index) on both an absolute and risk-adjusted basis.




Source: Morningstar; As of March 31, 2020

### *How do we use it in a portfolio?*

Metric portfolios currently gain exposure to the Quality factor in equities by investing in ETFs that track the MSCI USA and World Ex USA Sector Neutral Quality indexes. Both indexes are constructed based on 3 metrics: return-on-equity, low leverage, and earnings stability. A key benefit of including Quality in a portfolio, aside from its potential for excess return, is the potential for risk mitigation. As can be seen above, Quality demonstrates less risk than the market (unlike Value and Momentum). Quality also has diversifying effects when used with the other factors in the portfolio.

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