

A note on quality.

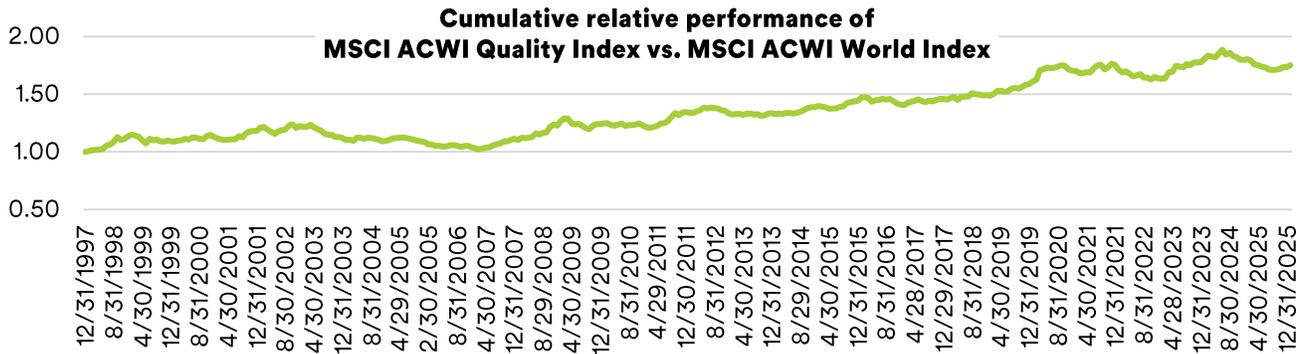


Jason Collins, Global Head of Sub-Advised Equity.



After over a decade of outperformance, quality-oriented investment approaches—which favor profitable companies with sustainable competitive advantages and robust balance sheets—have notably underperformed over the last three years. By some gauges, 2025 was quality’s worst year for relative performance in more than a quarter-century. Investors should keep in mind that most quality strategies have still delivered positive absolute returns.

Exhibit 1: Quality remained positive despite unusually dismal relative returns.



Source: MSCI, FactSet. Returns quoted in USD. Index performance returns do not reflect any transaction costs, management fees or expenses. MSCI Quality Indexes are factor indexes designed to represent the performance of companies with durable business models and sustainable competitive advantages. Indexes are unmanaged and one cannot invest directly in an index.

In the active-management universe, quality managers typically follow a traditional, fundamental approach to stock selection. This enables them to potentially generate additional returns by uncovering more distinctive insights and opportunities. However, severe style headwinds over the past year have made for an extremely challenging period for quality managers—especially within international (ex-U.S.) stock markets and U.S. small companies.

What’s behind the quality lag?

There have been several factors driving the recent underperformance of quality-oriented investors.

Shifting sentiment

Recent years have seen a “perfect storm” for quality investing. An evolving narrative has presented a significant shift in sentiment toward other parts of the market, and a subsequent derating of quality stocks relative to the broader market. There have been several forces behind this change:

Higher inflation and interest rates

As the world reopened following COVID-19 lockdowns, surging inflation and sharp interest-rate hikes created strong headwinds to quality stocks. Why? Higher rates tend to squeeze equity valuations by raising the discount rate on future earnings. Quality stocks are often disproportionately impacted by this due to the very source of their appeal—their tendency to generate solid-but-steady longer-term earnings growth. The rise in rates amplified the discount applied on longer-duration cash flows (which quality stocks traditionally offer), causing more significant derating and share-price falls. The markets have since adjusted to the rate-hiking cycle of 2022-2023, but other headwinds have subsequently hindered returns.

Cyclical value rally

Some of the more traditional cyclical value sectors have outperformed due to a combination of improved sentiment and a cyclical recovery in earnings. This has been particularly the case outside of the U.S., where certain outperforming sectors are more heavily represented in benchmark indexes. Banks have outperformed markedly since early 2023 due to a steepening yield curve and improving profitability, while mining companies have outperformed in recent months on the back of soaring metals prices.

Quality investors typically underweight these areas (or shun them altogether), and we would not want our quality managers to compromise their selection criteria for short-term reasons or panicked “performance chasing.” While quality managers do seek to diversify holdings across sectors, they are more likely to invest in businesses that have sustainable competitive advantages in certain industries such as consumer franchises, healthcare, or technology. Except for technology, these sector preferences have largely worked against quality managers during the latest cyclical value rally.

Defensive laggards

At the same time, more defensive high-quality stocks in sectors such as consumer staples and healthcare have lagged in the “risk-on” environment (where investors favor higher-risk assets that can offer potentially higher returns). With greater economic certainty, the need for safety has dissipated, and markets have rotated into riskier, higher-growth opportunities.

To some extent, this has simply been a function of where we are in the cycle; quality should get its turn in time. However, the following elements have come into play that present short-term challenges to both the sentiment and earnings of more defensive quality stocks:

Post-COVID-19 disruption: Supply-chain disruption and soaring costs of raw materials have eroded profit margins of companies unable to pass on higher prices and maintain sales volumes. Significant price increases have driven consumers to better-value brands, even in luxury segments.

Shifting consumer preferences and demand: Consumer behavior has largely normalized since the pandemic, but investors are increasingly anxious about apparent structural shifts and potential headwinds (decreased alcohol consumption, reduced demand for snacks and sugary drinks due to weight-loss drugs, increased spending on experiences rather than physical goods).

Stock specifics: Managers have been forced to reassess certain companies that are widely held in global and international quality portfolios. For example, weight-loss drug maker Novo Nordisk initially exhibited characteristics of a quality stock but has seen stalling growth and tumbling share prices given competition from rival drug makers.

AI winners

AI euphoria was a major theme of 2025, driving strong outperformance for megacap technology names and other related stocks. These winners include undoubtedly high-quality businesses that quality managers feature in their portfolios. However, in some cases, full valuations have limited, or even deterred, allocations.

Technology hardware manufacturers and chip makers have been key beneficiaries of a surge in AI-related capital expenditure. While some of these businesses have subsequently enjoyed strong profits, many quality managers are discouraged by what is an inherently cyclical industry, prone to periods of overcapacity that damages margins. Quality managers typically take the view that “over-earning” businesses currently in a boom will eventually turn to bust.

Lower-quality, more speculative (even-loss making) AI-related stocks have been carried along by positive momentum but don't make the grade from a quality perspective. Therefore, many quality strategies have been underweight so-called AI winners, which has recently challenged relative returns.

AI losers

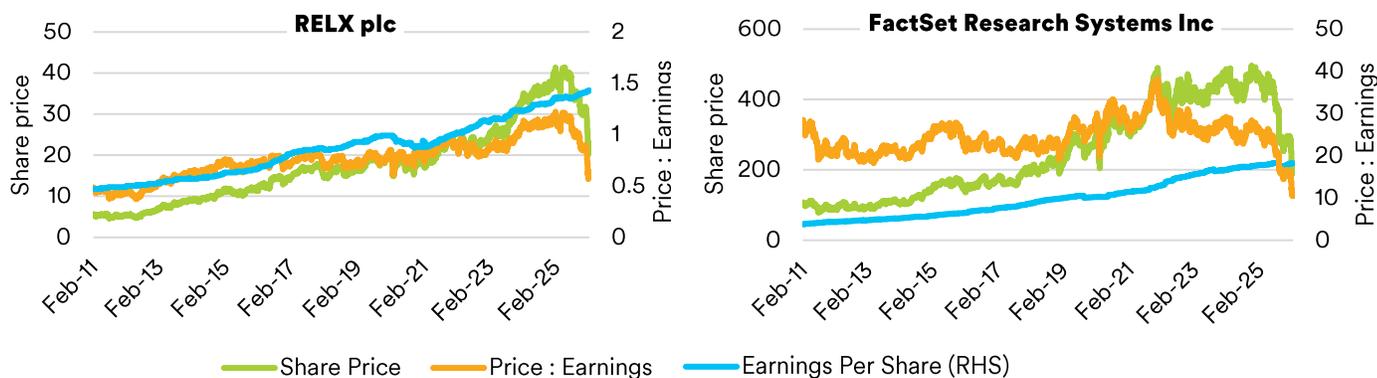
Quality managers seek companies with sustainable sources of competitive advantage. This includes businesses owning proprietary data or intellectual property that becomes embedded in their customers' workflows and can lead to powerful network effects as usage becomes widespread. Examples include software platforms, firms providing financial data and analytics, or professional services in areas such as legal, regulatory compliance, or risk. Many such companies have built highly profitable businesses that are a key part of quality managers' portfolios.

However, with the advent of AI, market participants have become increasingly concerned that AI agents such as Anthropic's Claude Cowork will not only replace these highly profitable workflows but do so more quickly than previously thought possible. While there has yet to be any real impact on the companies' earnings, share prices of perceived "AI losers" have tumbled in recent weeks and months.

It will take time for the true impact of AI to be felt and for the real winners and losers to emerge. Quality managers argue that the fears are overdone, that some of the companies dismissed as "losers" will be best positioned to use AI tools, improve their service offerings, and reinforce their competitive advantages that stem from owning mission-critical data sets not available elsewhere. For many so-called losers, this has already proven to be the case.

AI disruption risk has arguably been more than reflected in the valuations of these stocks, many of which now trade at the lowest multiples in over a decade. This can be seen in the two charts below, which plot the respective share price against profits (earnings per share) and valuation multiple (price-to-earnings ratio) for U.K. information and analytics firm RELX and U.S. financial data/software provider FactSet (both common holdings in quality portfolios).

Exhibit 2: Valuations reflect AI-disruption risk



Source: FactSet. P/E and EPS calculated using next 12-month consensus estimates. Charts shown in local currency. Past performance is no guarantee of future results. No mention of particular securities should be construed as a recommendation or considered an offer to sell or a solicitation to buy any securities.

Still, we don't expect managers to be complacent. In cases where stocks fell sharply or fundamentally disappointed—whether a beverage company, drugmaker, or software company—we are confident that our managers are actively reviewing those positions. We would expect them to sell stocks that have an uncertain or broken long-term investment case, and to hold stocks in which they have conviction that the market overreacted in the short term.

Why stick with quality during periods of underperformance?

The recent underperformance of quality-oriented strategies is an understandable source of worry. During such periods, it can be useful to remember the long-term strategic reasons for investing in the first place.

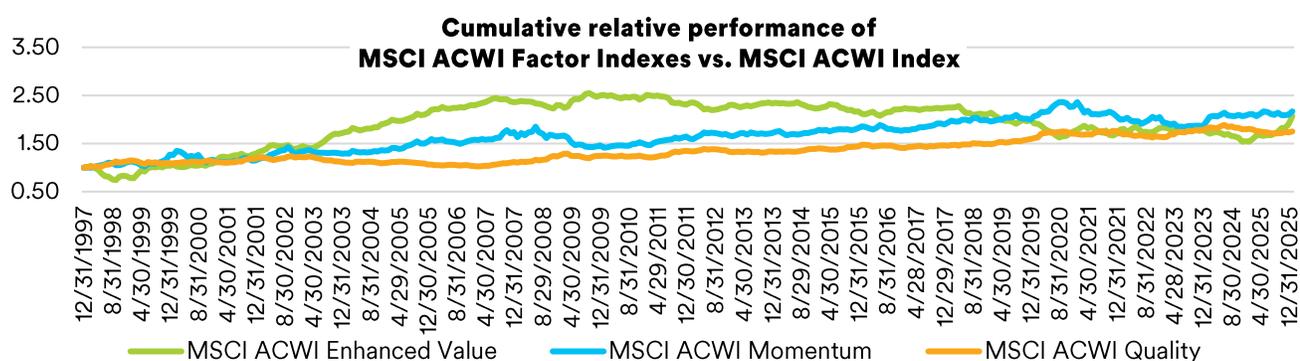
Quality is a proven alpha source.

Quality investing works because the market fails to properly value the relatively few companies that deliver superior levels of profitability consistently over the long term. By “beating the fade” (that is, sustaining high profits for considerably longer than analysts project), these companies can potentially exceed market expectations and deliver powerful compounded returns over the long term for the patient investor.

No approach can consistently outperform in all market environments. When it comes to quality investing, it’s largely a case of “steady wins the race”—even during “risk-on mode,” when market participants happen to be focused on the shorter-term hunt for higher growth opportunities that offer potentially more immediate, higher returns. Quality approaches are likely to lag in more speculative risk-seeking market environments, but such periods are rarely sustainable.

Relative to other approaches, quality investing is more likely to come to the fore in periods of stress and heightened uncertainty. In this respect, quality strategies play a useful role—diversifying riskier approaches such as value, momentum, or growth without compromising expected long-term returns.

Exhibit 3: Slow and steady wins the alpha source race



Source: MSCI, FactSet. Returns quoted in USD. Index performance returns do not reflect any transaction costs, management fees or expenses. MSCI Factor Indexes are designed to help investors seeking to build resilient portfolios and capture opportunities. The indexes aim to explain the drivers behind investment outcomes in a scalable, transparent and cost-effective manner. Indexes are unmanaged and one cannot invest directly in an index.

A time to buy?

Quality-oriented investment strategies merit a strategic allocation in a diversified portfolio alongside other proven approaches such as value or momentum.

Tactically, despite the recent challenges, investors can take some comfort in the fact that much of the recent underperformance has resulted from a shift in sentiment and relative derating of quality stocks—and not from a deterioration in the company fundamentals. Earnings largely remain robust: We estimate that the earnings-per-share growth for quality stocks over the three years ending 2025 averages 24% per annum versus 21% for the broader market (as measured by the weighted average of the MSCI World Quality Index vs. MSCI World Index).

With relative valuations looking more attractive and headwinds of inflation and rate hikes largely behind us, this could prove to be an attractive opportunity to add to quality strategies for those portfolios that are currently underweight the factor. Indeed, if economic growth were to decelerate, quality strategies would be expected to bring added resilience to portfolios as investors seek the relative safety of companies with a proven record of delivering stable earnings growth and profitability.

For financial terms and index definitions, please see:

<https://www.seic.com/ent/imu-communications-financial-glossary>

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