What is Quality and Why it Matters

What Is Quality?
Quality companies can be viewed as those with a consistent ability to generate strong cash flows while remaining relatively resilient during periods of economic hardship. Quality is assessed from several perspectives: profitability, efficiency, cash earnings and leverage.

Profitability
Profitability is measured with Return on Assets (ROA), defined as net income divided by assets. Assets include productive things like buildings and machinery. ROA measures how much profit a company makes with its assets. If two companies have identical factories as their only assets, the company generating more profits with its factory will have a higher ROA, all else equal.

Efficiency
Efficiency reflects improvement in profitability. Improvement is represented by Change in Asset Turnover, which measures changes in revenue generated by a company's assets. In short, efficiency measures how much better a company gets at generating revenue with its assets. If a company with a factory as its only asset generates more sales with its factory in year 2 versus year 1, the company has improved its asset turnover, all else equal.

Cash earnings
Earnings can be grouped into those based on cash and those driven by accruals, which include non-cash items like receivables and depreciation. The more earnings are driven by cash, the higher the earnings quality, all else equal. Consider a company that sells a product and receives a full cash payment versus another company that sells the same product but receives a promise to pay later. Because the first company receives cash, the earnings would be considered higher quality.

Why Quality Matters?
Investing in quality companies means avoiding low quality ones. While quality companies typically have strong profitability and leverage metrics, low quality companies can have risks associated with earnings and debt, resulting in more sensitivity to the economy and market volatility. By investing in quality companies, investors can take advantage of growth and the benefits of equities, while reducing risk.

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**Why?**
Wealth management needs of a multi-generational family trust

**What’s the Focus?**
Less Risk, more Income than “traditional” benchmarks

**Index Criteria?**
Rules for Quality Balance Sheets, Profitability, Low Volatility

**Index Partner?**
Index developed by FTSE Russell for O'Shares

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