MARKET COMMENTARY

CONSISTENCY AND QUALITY

Consistency is not flashy. Consistency does not take center stage. Consistency does not make headlines. Yet, consistency wins the day when predictability is in short supply, as it is now.

With many observing that the recession risk is high, earnings could be at risk. Sales and profit margins for the S&P 500 companies are rolling over. Forecasted earnings trends are also headed down. Several high-profile companies that boasted stellar growth in 2020-2021 are falling flat. For this reason, we thought we should focus on consistency — one of the three pillars of our definition of "quality."

CONSISTENCY DEFINED

When evaluating consistency, we focus primarily on a company's profitability. Specifically, we want to know if a firm's assets are generating profitable operations year after year. Profitability is essential because survival and growth depend on it. When companies' assets are not profitable, the risk of failure and trouble increases.

To demonstrate the impact of consistent fundamentals, we create two groups of stocks based on consistency or lack thereof. We started with the 1,000 most valuable companies in the United States and ranked them by the consistency of asset profitability. We call the top 20% of the list "most consistent" and the bottom 20% "least consistent." We then measured the performance of the two groups. To demonstrate how important consistency is from a defensive perspective, we looked at the downside stock performance of two groups.

Not surprisingly, the "most consistent" group suffered a much smaller drawdown than the inconsistent group during the worst week at the start of the pandemic in 2020. In that week, the average large company stock was down 13%. That same week, the "least consistent" group was down a far more significant 18%, while the "most consistent" group was down 11%. In other words, the "most consistent" companies based on profitability had a 40% smaller drawdown than the "least consistent" group.

WHEN EVALUATING CONSISTENCY, WE FOCUS PRIMARILY ON A COMPANY'S PROFITABILITY. SPECIFICALLY, WE WANT TO KNOW IF A FIRM'S ASSETS ARE GENERATING PROFITABLE OPERATIONS YEAR AFTER YEAR.

VOLATILITY AND RETURN

Understanding a concept called "volatility drag" is essential to fully appreciate consistency's value. It is a fact of mathematics that your average yearly return differs from your long-run annual return, sometimes significantly. For example, a portfolio that goes down 20% in year one and up 20% in year two does not produce a 0% average return but a -2% annual return. To see how it works, observe that if you start with $100 and lose 20%, you get to $80 after the first year. Then, if you earn 20% on the $80 in the second year, you will only get back to $96. The return was not 0%, but a loss of $4 (about 2% each year).

The loss is even more significant if the volatility increases and the swings are 50% instead of 20%. The starting $100 amount becomes $50 after the first year of loss and rebounds to $75 after the year two gain. Again, going down 50% and then up 50% was not a 0% return. It produced a 25% two-year loss or a 13.4% annual decline.

In each case, the average annual return was 0%. The only difference was the volatility. Volatility can matter greatly over the long run as it directly saps return. Volatility "drag" is real and often overlooked. So, volatility saps return, and returns are linked to fundamentals. Why wouldn't it pay to seek out fundamentally consistent businesses if you want to raise your return over time?

CONCLUSION

I hope you now see how we think about consistency and why it is integral to a quality portfolio. Quality is essential, but the word is often overused and, as such, can lose its meaning. Therefore, we must explain what we mean when discussing quality. Quality should capture traits like durability, flexibility, and predictability, and these traits should be evident in the companies of portfolios that claim to be quality focused. Moreover, quality is also to be consistent.

Most important, we find a significant and measurable link between fundamental profitability and stock performance. Moreover, the performance benefit tends to be seen as a defensive benefit (less drawdown in bad markets) and an offensive advantage over time (less volatility drag on long-run return).

WCA Fundamental Conditions Barometer Description: We regularly assess changes in fundamental conditions to help guide near-term asset allocation decisions. The analysis incorporates approximately 30 forward-looking indicators in categories ranging from Credit and Capital Markets to U.S. Economic Conditions and Foreign Conditions. From each category of data, we create three diffusion-style sub-indices that measure the trends in the underlying data. Sustained improvement that is spread across a wide variety of observations will produce index readings above 50 (potentially favoring stocks), while readings below 50 would indicate potential deterioration (potentially favoring bonds). The WCA Fundamental Conditions Index combines the three underlying categories into a single summary measure. This measure can be thought of as a "barometer" for changes in fundamental conditions.

Index Descriptions: WCA Quality Indices are based on Washington Crossing Advisors' quantitative analysis of firms along three dimensions: asset profitability, consistency, and leverage. Higher quality companies are defined as those which fall in the top quintile of largest-cap U.S. companies and tend to have higher average profitability, greater than normal consistency, and low leverage. Lower quality companies are defined as those which fall in the lowest quintile based on the same criteria. Indices are reconstituted annually, continuously rebalanced, and presented on a total return basis, as calculated by Bloomberg. Indices are unmanaged and do not represent performance of any actual portfolio or portfolio strategy offered by Washington Crossing Advisors, LLC.

Standard & Poor's 500 Index (S&P 500) is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. S&P 500 Growth Index and S&P 500 Value Indices are designed to provide a comprehensive measure of global equity growth and value performance.
S&P High Beta Total Return Index is designed to measure the performance of the constituents of the S&P 500 that are most sensitive to changes in market returns.
S&P Low Beta Total Return Index is designed to measure the performance of the constituents of the S&P 500 that are least sensitive to changes in market returns.

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