
(Shutterstock)

What are quality stocks?

15 August 2024, 2:02 pm CEST, written by UBS Editorial Team

Discover more about quality stocks, how CIO finds them, and how they can help navigate choppy markets.

Times of market turbulence can test even the most seasoned stock investor. Those who have never invested in equities before may feel even less convinced about the long-term investment case for shares having seen the market gyrations of early August, where Japan's Nikkei 225 suffered its second worst one-day loss ever, followed by its third-best daily rally of all time.

By the end of the week, though, shares had recovered, as yen carry trades unwound, more reassuring US economic data assuaged fears of a recession, and second quarter US earnings suggested corporate America was still in fine health.

What if investors could find companies whose performance was less subject to swings in the economic, political, and geopolitical news flow over the longer term? We believe such stocks exist and make sense in the current environment. We describe them as "quality stocks."

What are quality stocks?

While there is no universal definition, we consider quality stocks shares of companies that exhibit strong fundamentals in terms of profitability and pricing power, relative safety, and earnings quality.
These companies often have a track record of consistent earnings growth, robust free cash flow generation, and strong balance sheets. They are typically leaders in their industries, with established brand names and a history of delivering superior returns on invested capital.

To identify quality stocks, investors can look for the following five characteristics:

1. **Competitive advantage**: Companies with a sustainable competitive edge often dominate their markets and have strong pricing power. This can be due to unique products, strong brand loyalty, or technological superiority.

2. **Consistent earnings growth**: Quality stocks tend to show consistent earnings growth or stability. This can be seen in companies like the leading members of the MSCI Asia ex-Japan index we call the Asian titans, which have grown their earnings at an annual rate of 9.4% from 2019 to 2022.
3. **Strong free cash flow**: Companies that generate strong free cash flow are better positioned to reinvest in their businesses, pay dividends, and weather economic downturns.
4. **High return on invested capital (ROIC)**: A high and sustainable ROIC indicates optimal capital allocation and efficient use of financial capital to generate profits.
5. **Fair valuations**: While quality stocks are seldom underpriced, valuations can come to within fair valuation ranges relative to their long-term growth prospects in a market correction.

By focusing on these attributes, investors can identify quality stocks that can potentially provide stable returns and withstand market turbulence and geopolitical uncertainties.

For more see **Market scenarios from here**, published 6 August 2024