

FINDING
STRENGTH
AND QUALITY
IN THE
STOCK MARKET

STOXX Pulse interviewed Joerg de Vries-Hippen, CIO-European at Allianz Global Investors, to ask him a few questions about the concept of strong quality. De Vries-Hippen manages assets worth 1 billion euros of assets at Allianz Global Investors and oversees about 21 billion euros in assets. He is also involved in selecting strong quality/value stocks for Allianz Global Investors.

OBTAINING EXPOSURE TO STRONG QUALITY STOCKS THROUGH AN INDEX

IN YOUR VIEW, WHAT IS A STRONG QUALITY STOCK AND WHAT FUNDAMENTAL FEATURES DOES IT NEED TO HAVE?

Well, you cannot point to a stock and say it is a strong quality stock simply because the balance sheet is okay. For it to be a quality stock, you have to look at the growth prospects of the company. You need sustainable growth for sustainable cash flows, because in the end, the company underlying a quality stock has to earn money, and it earns money with products or services that satisfy customers. Quality is what is behind growth, yet what is said to be strong quality is not only made up of what can easily be quantified.

A quality stock needs growing cash flows, but you also have to know why the cash flow is growing. For one, you need a product or a service that keeps customers coming back for more and brings in new customers. And that means that an emotional element to the products or services has been established. There must also be a flourishing market for the offered products or services and competition within the market should not be too big. These are all fundamental features of quality stocks. Also, quality management is an absolute necessity.

Let me be clear, though, there is a difference between a quality product and a quality stock. For example, German healthcare is a quality product but it is not necessarily a sector where you will find many quality stocks. It lacks the hallmarks of some of the fundamental

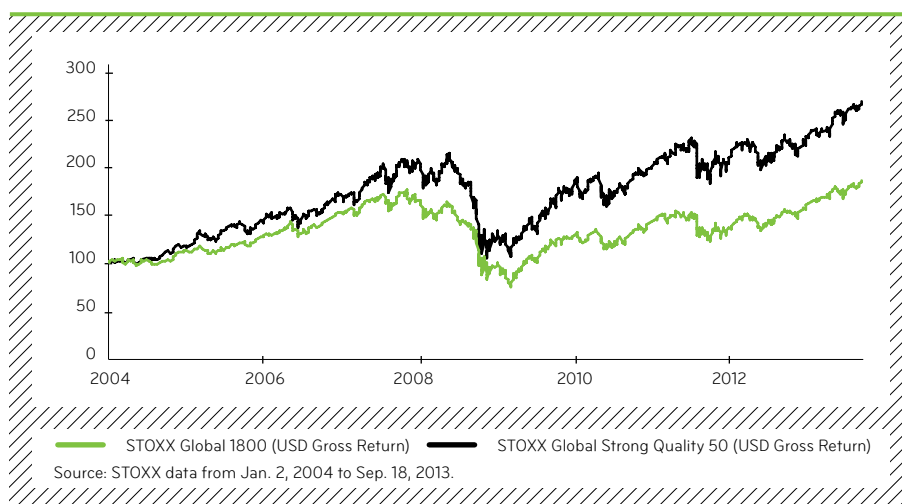


JOERG DE VRIES-HIPPEN
Allianz Global Investors

"Whether we are talking about socks or stocks, I like buying quality merchandise when it is marked down," Warren Buffett, chairman and CEO of Berkshire Hathaway Inc., told shareholders in a letter in 2008. The legendary investor is known globally for his classic value investing style, whose primary tenet is focusing on the value of a company and its market price.

The STOXX Strong Quality index family, released this month, brings together companies that have been historically profitable, enjoy strong working capital positions, lower (relative to the wider market) financial leverage levels and compelling valuations.

PERFORMANCE





WHETHER WE ARE TALKING ABOUT SOCKS OR STOCKS, I LIKE BUYING QUALITY MERCHANDISE WHEN IT IS MARKED DOWN

WARREN BUFFETT,
Chairman and CEO of
Berkshire Hathaway Inc.

features where you would expect to find quality stocks: competition is fierce, the market is not robust and where is the emotional attachment to the products?

Then again, quality is heavily dependent on what an investor is looking for, such as growth, value or dividend. That also plays a role in quantifying why a certain stock is a strong quality stock. Part of the definition of a quality stock depends on the reason you are buying it.

WHAT IS THE DIFFERENCE BETWEEN A BLUE-CHIP STOCK AND STRONG QUALITY STOCK, AND ARE THERE ANY SIMILARITIES BETWEEN THE TWO?

Blue-chip stocks are normally the biggest, best known and good fundamental quality companies in the market. But big does not necessarily equate to beautiful. Usually, blue chips are not the most sought after stocks. The most wanted stocks, the most expensive stocks, the ones seeing the most growth in cash flows and where emotion is attached to the products, these are most often strong quality stocks. Sometimes quality companies and blue-chip companies overlap, but this is usually only when a high quality company grows and grows until it reaches the market cap of a blue chip.

Blue chips are good companies but it does not necessarily follow that they have the highest quality status. With high market capitalization, blue chips normally carry the most weight in benchmarks. But investors need stocks with different perspectives to outperform the market. An investment in high quality stocks opens up the opportunity to perform better than your competitors.

There is no general definition and much disagreement about what makes a quality stock. For me, it is about how good your product is and great management with the ability to manage the lifecycle.

DO YOU THINK THE SEVERAL INDICES THAT INDEX PROVIDERS OFFER IN THE MARKET TO GAUGE STRONG QUALITY OR VALUE STOCKS TAKE INTO CONSIDERATION 'STRONG' AND 'VALUABLE' CRITERIA? OR, DO YOU THINK THEY LACK CERTAIN IMPORTANT ELEMENTS?

There is a clearer view of what value is. There is more consensus about value because a number of people have amassed great fortunes by value investing, such as the Oracle of Omaha. To make the really big money in value you have to be a risk taker. That means you are often looking for what the market believes is a broken business model and then you have to have a clear idea of how to repair it or maybe, know why the market is wrong.

Even so, when we look at the quantitative part of value stocks, it is not easy, but it is doable, according to the criteria. But how do you go about rating management and ascribing values to how the product is different? To use just numbers is not possible. The larger the qualitative part of the input, the more opinion is being brought into why it is a value stock.

There is a reason why the company is so cheap. If it is cheap because the market is truly broken, obsolete or closed, then even the best management team will not be able to turn the company around. Value simply means that the company is cheap. So you could tell me that it is a value stock measured only by numbers, but that does not mean I have to buy it. It has the value that it has for a reason.

Also, we must not forget that even strong quality stocks can change overnight by an event, such as the failure of a drug in a clinical trial or an oil spill. These might be extreme examples, but investors need to realize that while the mathematical, quantitative part of assessing quality and value is difficult but doable, it is the qualitative part that is not doable.

IS THERE A MOVE BACK TO QUALITY STOCKS SINCE THE FINANCIAL CRISIS STRUCK IN 2008 AND WHAT OTHER FACTORS ARE PROMPTING THIS MOVE BACK TO QUALITY STOCKS?

A quality stock is a quality stock no matter what time period we are talking about. It is a quality stock because its business model lets it perform better than other companies during a crisis. If your products and services are better than your competitors, then after a crisis you will be even stronger.

Good, high-quality companies will be stronger after a crisis. Weaker companies will be weaker. Quality companies are those with healthy balance sheets, clear product ideas and good management along with very good lifecycle management of their products.◀

