

Why it pays to buy quality companies

ASX: QLTY, HQLT

Betashares Global Quality Leaders ETF

Betashares Global Quality Leaders Currency Hedged ETF

High and sustained returns on equity (“ROE”) are the true mark of a quality company.

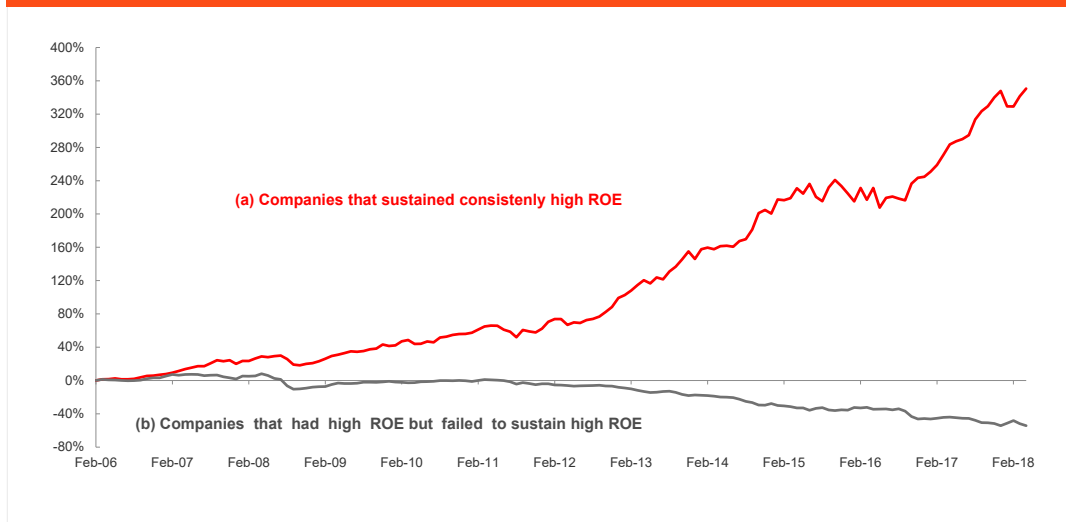
It stands to reason that so-called quality companies, i.e. those with high return on equity (ROE), tend to be able to produce good shareholder returns over time.

After all, if a company can generate high profits relative to its invested equity, it will be well positioned to provide attractive investor returns over time – be it through high dividends and/or in the form of high earnings growth from the reinvestment of profits.

That said, as seen in the chart below, it is not enough simply to identify companies with a high ROE over the past year. What has mattered historically for market-beating share price performance is a company’s ability to sustain a high ROE over time.



Cumulative performance comparison vs MSCI World Index: companies with high, sustained ROE and companies with high, non-sustained ROE - Feb-2006 to Apr-2018 (for coverage up to Apr-2020)



Source: FACTSET, STOXX, MUTB. You cannot invest directly in an index. Past performance is not an indicator of future performance. Companies with "consistently high" ROE are defined as those with an ROE in the top 1/3 of the STOXX Global 1800 Index (being the stock universe of the index which QLTY aims to track) for a given year and remained in the top 1/3 over the next 2 fiscal years. Companies "that failed to sustain high ROE" are those with a ROE in the top 1/3 of the same stock universe in a given year but not in the top 1/3 in either or both of the next two fiscal years.

But how can we judge the likely sustainability of a company's ROE over time? It turns out there are several tell-tale signs.

Firstly, companies with higher than average ROEs at any given time are a natural starting point. Additionally, companies with **low leverage** (i.e. debts relative to equity) are less likely to be affected by changing market conditions and so are more likely to maintain their high ROE over time. The same could be said for companies with high profitability (i.e. strong cash-flow generation ability).

Finally, companies with a **consistent track record of strong earnings** (or low variability in earnings) are likely to sustain consistent growth and achieve higher ROE.

These considerations happen to be in keeping with one of doyen investor Warren Buffett's key strategies in picking stocks, namely, to look for companies able to sustain high and reasonably stable earnings over time without undue reliance on debt.

The Betashares Global Quality Leaders ETF (ASX: QLTY) and The Betashares Global Quality Leaders Currency Hedged ETF (ASX: HQLT)

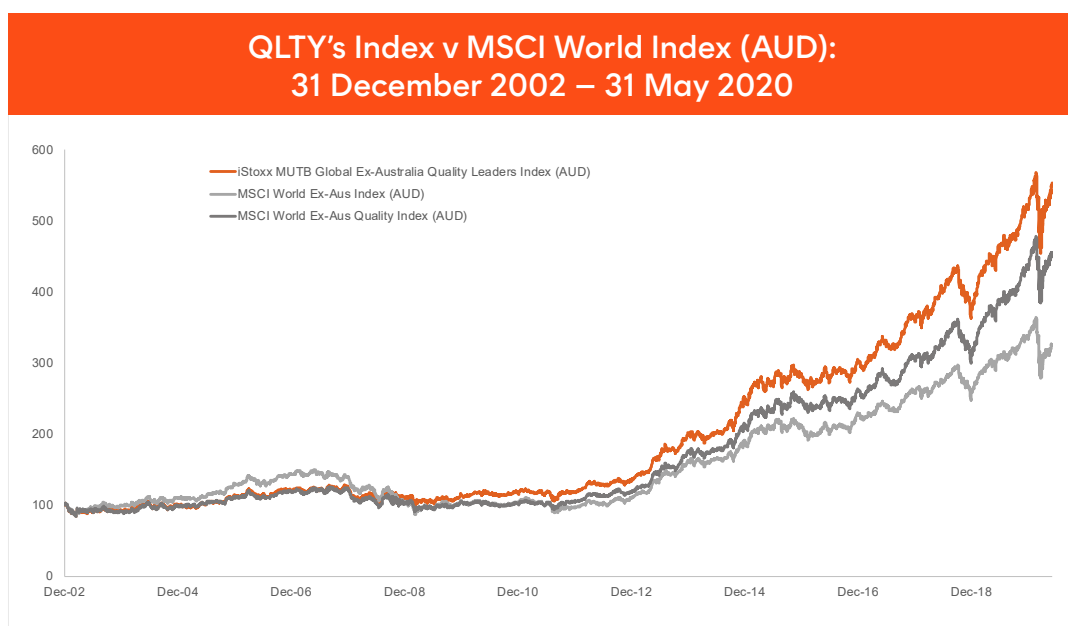
Given the benefits of this investment approach, the **Betashares Global Quality Leaders ETF (ASX: QLTY)** was specifically designed to provide investors exposure to a diversified portfolio of global companies (ex-Australia) that demonstrate quality characteristics with the potential to deliver a relatively high and sustainable ROE over time.

From a universe of 1800 stocks across global markets, the Index which QLTY aims to track identifies the top 150 that each year pass a series of quantitative screens covering return on equity, financial health, profitability and business stability measures¹.

The **Betashares Global Quality Leaders Currency Hedged ETF (ASX: HQLT)** adds currency hedging to the portfolio, aimed at minimising the impact of currency fluctuations on returns. HQLT currently obtains its investment exposure indirectly by investing into QLTY. HQLT aims to track the same index as QLTY, hedged into Australian Dollars.

This approach leads to a portfolio of premium companies, many of whom are household names. For example, as at May 2020, some of the largest index holdings included: Nvidia Corporation, Facebook, Apple, Intel and Nike.

As seen in the chart below, the Index which QLTY aims to track has delivered impressive total return performance over the last 15 years or so. From 2003 to end-May 2020, it's compound annualised return was 10.3% p.a. compared with 6.7% p.a. for the MSCI World Index.



Source: Bloomberg. Graph shows performance of iSTOXX MUTB Global ex-Australia Quality Leaders Index (being QLTY's Index) v MSCI World Index, not ETF performance and does not take into account ETF management costs. You cannot invest directly in an index. Past performance is not an indicator of future performance of Index or ETF.

Over the same interval, QLTY's Index also benefited from significantly lower drawdowns during periods of market falls, with a maximum drawdown approximately half of that experienced by the MSCI World Index.

¹ Specifically, to be eligible for inclusion in the Index each year, companies must be in the top half of global companies based on current ROE, but also not carry too much leverage (financial health), display too much historic earnings volatility (business stability) and exhibit high operating cash flows relative to operating assets (profitability). For more details please see the PDS.



A currency-hedged quality approach

HQLT may suit investors who want to invest in quality companies, and who also want to minimise the currency variable from the investment equation.

Currency fluctuations can have a significant impact on the returns from an unhedged investment. In periods when the Australian Dollar is rising, an unhedged approach will underperform an equivalent currency-hedged approach. Equally, in periods when the Australian Dollar is falling, unhedged exposures will outperform equivalent hedged exposures.

The main aim of currency hedging is not so much to take a position that the Australian Dollar will strengthen (although investors who are of this view can use currency-hedged investments to express that view), but rather to achieve a 'purer' exposure to the performance of the companies in the portfolio, minimising the influence of exchange rate movements, and substantially reducing a source of uncertainty.

Summary

All up, QLTY and HQLT provide an easy, transparent and cost-effective way for Australian investors to gain exposure to a diversified portfolio of quality global companies that have the potential to sustain high returns on equity - and hence potential to outperform benchmark global equities indices over time.

As exchange traded funds (ETFs), moreover, QLTY and HQLT can be easily accessed on the ASX just like shares.

There are risks associated with investment in the Funds, including market risk, index methodology risk, international investment risk and sector concentration risk, as well as currency risk (for QLTY) and currency hedging risk (for HQLT). For more information on risks and other features of each Fund please see the relevant Product Disclosure Statement.

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