The Enduring Case for Investing in Quality Companies

May 2021

Notes from the Global Value Equity Desk

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"We believe the stocks of high-quality companies have the potential to enhance portfolio resilience and performance throughout the market's ups and downs."

Key Takeaways

- The potential for rising inflation and market volatility are top of mind for many investors.
- We think investment strategies that incorporate high-quality companies may be appropriate for those seeking to manage long-term risk.
- Over time high-quality stocks have outperformed with less risk.

What Is a Quality Stock?

While there's no universally accepted definition of quality, we consider various characteristics when evaluating the quality of companies, including:

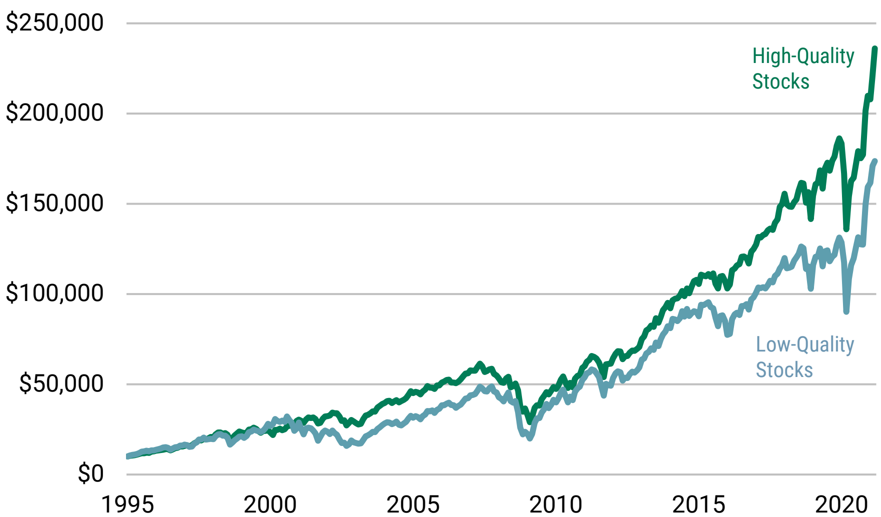
- Strong management teams
- Leading market positions and strong brands
- Business models that provide steady streams of income
- High standards for environmental, social and corporate governance issues
- Low levels of debt that could help weather market downturns or acquire other businesses

High-Quality Stocks Have Performed Well Over the Long Haul

As shown in Figure 1, high-quality stocks (rated B+ or better by S&P Quality Rankings) have outperformed low-quality stocks (rated B or worse) over the last 25 years. The ratings are based on past performance of a stock's earnings and dividends over the most recent 10 years. A $10,000 investment in high-quality stocks in1995 would have grown to $235,958 by March 31, 2021, compared to an ending balance of $173,672 for low-quality stocks. This equates to an average annual total return of 12.93% versus 11.51%.

We believe higher-quality companies are better equipped to grow when the economy is strong and withstand downturns when the economy weakens. We look for businesses whose assets achieve high, sustainable returns on capital and generate attractive free cash flow. Low levels of debt and leading market positions also are key characteristics.

FIGURE 1
Growth of $10,000 Invested in High-Quality and Low-Quality Stocks



	Ending Value on 3/31/2021	Total Return (annualized)
High-Quality Stocks	$235,958	12.93%
Low-Quality Stocks	$173,672	11.51%

Data from 12/31/1994 – 3/31/2021. Performance in USD. Quality is based on S&P Quality Rankings using equal-weighted returns of the Russell 1000 Index. High-quality and low-quality stocks are defined as those rated B+ or better and B or worse, respectively. Source: FactSet, Merrill Lynch.

High-Quality Stocks Have Historically Outperformed with Less Risk

Investment returns are helpful for evaluating performance of a given investment, but they don't account for the risks involved. One way to assess risk is by measuring the variability of investment returns. Investments whose returns are relatively steady are considered less risky than those whose returns vary widely over time.

Figure 2 plots the returns of high- and low-quality stocks versus their levels of risk, or variability, since 1995. High-quality stocks have not only outperformed low-quality stocks and the broad market over time, but they've also done so with less risk. We believe their performance profile may appeal to conservative equity investors.

FIGURE 2
Return vs. Risk of High-and Low-Quality Stocks Compared to the S&P 500 Index
12/31/1994 – 3/31/2021

Data from 12/31/1994 – 3/31/2021. Performance in USD. Quality is based on S&P Quality Rankings using equal-weighted returns of stocks in the Russell 1000 Index. Broad stock market is represented by the equal-weighted returns of all stocks in the S&P 500 Index. Risk is represented by annualized standard deviation, a measure of the variability of returns around the average. Source: FactSet, Merrill Lynch.

High-Quality Companies May Offer Good Options for Conservative Investors

Concerns about inflation and potentially higher interest rates continue. Many observers believe improving economic growth, rising commodity prices, soaring federal debt and onshoring trends among U.S. businesses eventually will drive inflation higher. Besides inflation, many investors have concerns about market volatility, international tensions, extended stock valuations and the global response to COVID-19 and its variants.

Understandably, some investors have also agonized over investments intended to fund college educations, retirement and more. While it's impossible to predict how the downturn will play out, we believe the stocks of high-quality companies have the potential to enhance portfolio resilience and performance throughout the market's ups and downs.

Glossary

Environmental, Social, Governance (ESG) Criteria. The risk and/or opportunity to a company's market valuation resulting from ESG factors. Depending on the sector, environmental and social factors include, but are not limited to, 1) climate change, 2) water stress, 3) product safety and quality (supply chain and manufacturing), 4) cybersecurity and data privacy, and 5) human capital management. Regardless of the sector, governance factors include: 1) business (mis)conduct, 2) board composition, independence and entrenchment, 3) accounting practices, 4) ownership structure, and 5) executive pay-for-sustainability performance alignment.

Russell 1000® Index. A large-cap stock index created by the Frank Russell Co. to measure the performance of the 1,000 largest publicly traded U.S. companies, based on total market capitalization.

S&P 500® Index. This index is composed of 500 selected common stocks most of which are listed on the New York Stock Exchange. It is not an investment product available for purchase.

S&P Quality Rankings System. Managed by S&P Global Market Intelligence, the rankings attempt to capture the long-term growth and stability of a company's earnings and dividends. The rankings are generated by a computerized system and based on per-share earnings and dividend records of the most recent 10 years—a period long enough to measure significant secular (long-term) growth, capture indications of changes in trends as they develop, encompass the full peak-to-peak range of the business cycle, and include a bull and a bear market. Basic scores are computed for earnings and dividends and then adjusted and combined to yield a final ranking. Quality rankings are based on the following scale:

Quality Ranking	Description
A+	Highest
A	High
A-	Above average
B+	Average
B	Below average
B-	Low
C	Lowest
D	In reorganization
LIQ	Liquidation

Standard deviation. A statistical measurement of variations from the average, it's often used to measure risk when risk is measured or defined in terms of volatility. In general, more risk means more volatility, and more volatility means a higher standard deviation—there's more variation from the average of the data being measured. In this context, reducing risk means seeking lower standard deviation.

Investment return and principal value of security investments will fluctuate. The value at the time of redemption may be more or less than the original cost. Past performance is no guarantee of future results.

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