Evaluating Quality Using a Hands-on Approach

Drew Harbeck,
Relationship Management

Throughout 2021, we have experienced stock market leadership by many different types of companies. Day-to-day, news headlines have determined which style of investing is in favor over the short term. However, over the long term, we believe that high quality companies make the most compelling investments. Quality is often defined in terms of quantitative characteristics which include high Returns on Equity (ROE), low levels of debt, and stable earnings. While we agree that these can indicate quality, they are backward-looking metrics and can be subject to change for any company at any time. For long-term investors, the key is assessing whether these factors will be true in the future, as opposed to observing that they were true in the past or are true today.

Finding enduringly high-quality companies takes a disciplined approach, a defined set of criteria, and a thorough appraisal of a company's leadership, customer relationships, and market position. When evaluating a business for quality that lasts, investors should place an emphasis on assessing the caliber of management and the strategic market position of the target company. This qualitative assessment can help determine the quantitative factors that are likely to follow.

> Finding enduringly high-quality companies takes a disciplined approach, a defined set of criteria, and a thorough appraisal of a company's leadership, customer relationships, and market position.

Company management is responsible for capital allocation and leverage decisions. Investors who seek high quality companies look for management teams that are incented to allocate capital for long-term growth–those with a vision for the company that is focused on the next decade, not simply the next quarter. Understanding a management team's approach to taking on debt or issuing equity is also critical to assess the flexibility of their balance sheet.

Additionally, high quality companies often provide a mission critical good or service to their customers. For example, they may help their customers become more efficient, reduce costs, make better decisions, or design and build better products. These types of companies are a strategic partner to their customers, have a strong moat, and are not easily displaced or discarded due to competitive pricing or a change in the economic environment. Their value proposition is compelling in both good times and in challenging times.

In our view, assessing these qualities cannot be done by simply reading financial statements or listening to quarterly investor calls. It takes a hands-on due diligence process to understand the management team's vision for the company and to assess the nature of customer relationships. At Riverbridge, meetings with company management and others throughout their ecosystem (customers, competitors, other employees) positions us to understand and assess the qualitative factors that will lead to quantitative indicators of high quality. A strategic market position helps lead to unit growth and pricing power in all types of economic environments, which ultimately leads to more consistent earnings over the long term. Management teams that allocate capital for long-term growth tend to have strong balance sheets as well. When a company possesses all these characteristics, it is enduring, sustainable, and resilient.

As changes in market leadership cause short-term traders to shift their focus, "high quality" may garner less interest. However, we believe over the long term, investing in high quality companies–those with strong management teams, flexible balance sheets, and customers who depend on the good or service that they provide will produce strong results.