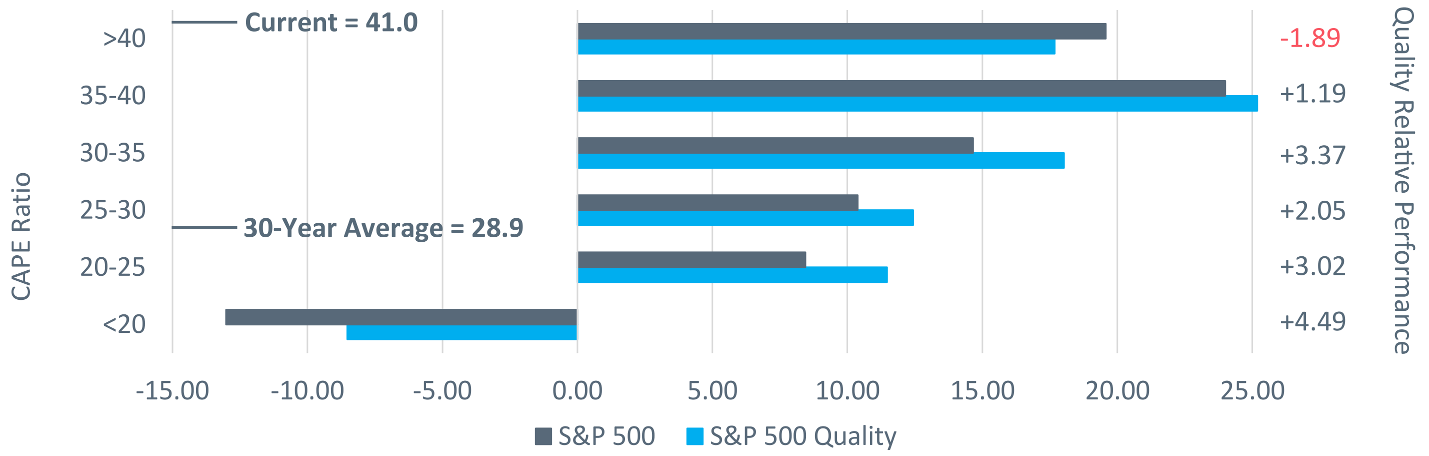
Perspective on Quality's Recent Headwinds

Recent performance dispersion within public equities has created a challenging backdrop for many active managers, particularly those with a meaningful emphasis on quality-oriented companies. Although the data in this piece focuses on US large-cap equities, similar trends have been observed recently across US small-cap and non-US equity markets. This piece examines the challenges facing quality-oriented stocks in the current market environment, how that dynamic may contribute to significant active manager underperformance, and why a disciplined evaluation of manager results remains important before drawing conclusions about long-term viability.

"Quality" refers to a cohort of stocks with higher scores across three metrics: Return on Equity, Accruals Ratio, and Financial Leverage. The investment thesis is that companies rated high across these metrics are likely to demonstrate resilient earnings growth across market environments. However, it is important to note that this thesis can break down during periods of exuberance and elevated evaluations.

Historically, quality stocks have tended to outperform the broader market, except during periods of the most stretched or elevated valuations. Current market valuations, as measured by the CAPE ratio, are among the highest observed historically. This has created a headwind for many active managers that emphasize quality as part of their process.

Figure 1: Average 12-Month Returns by Ending CAPE Ratio

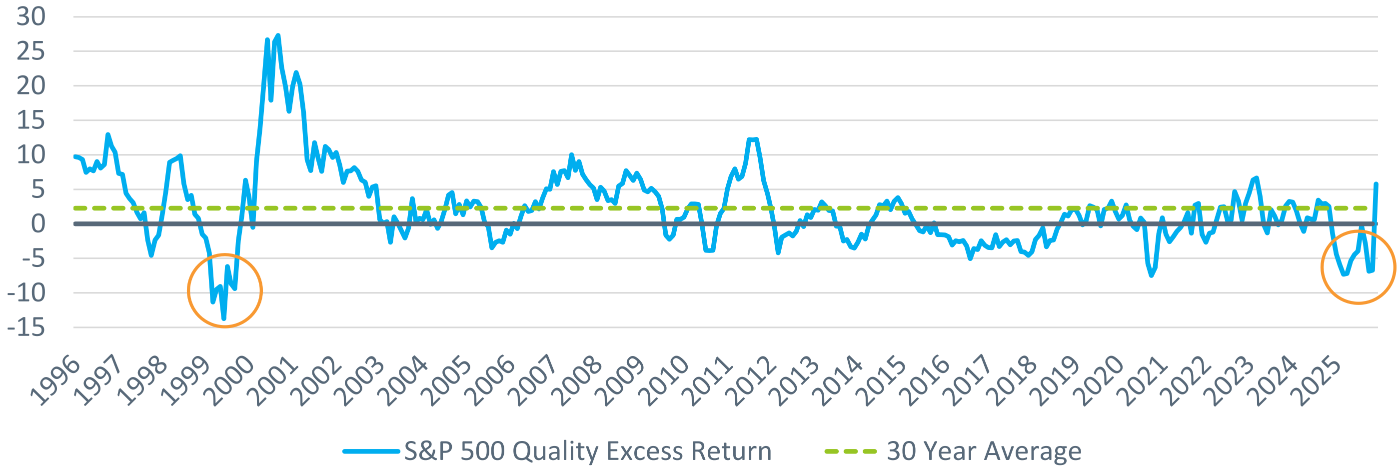


Source: FactSet

Although quality has historically outperformed the S&P 500 Index over longer periods, the pattern has been highly cyclical over shorter horizons. Intermittent periods of underperformance include the years leading up to the Tech Bubble Crash and the re-opening trade experienced during the Covid-19 Pandemic.

More recently, the strong performance of AI-related stocks and more cyclical industries has presented another challenging period for quality-oriented strategies. However, June saw a sharp reversal, with quality outperforming by 6%, resulting in a spike in the 12-month trailing excess return.

Figure 2: S&P 500 Quality Rolling 12-Month Excess Returns vs. S&P 500



Source: FactSet

While recent market conditions help explain a portion of the performance differential, factor exposure alone does not account for every instance of manager underperformance. Managers with similar quality characteristics may experience materially different outcomes, underscoring the importance of evaluating security selection, portfolio construction, and implementation decisions in addition to factor exposures.

Beyond individual managers, periods of pronounced underperformance at the equity composite level may also reveal a concentration in a particular factor, highlighting the importance of maintaining diversified sources of return. Equity portfolios should ideally be diversified by multiple factor exposures, of which quality is only one.

Understanding the role of factor exposures can help provide important context when evaluating manager results. We strive to neither overreact nor underreact to manager underperformance when it occurs. If a manager continues to adhere to the same philosophy and process that has driven long-term success, periods of factor-related underperformance may not, on their own, justify termination. At the same time, it remains important to evaluate whether factor exposure is the primary driver of results or whether other issues may be contributing to underperformance. In periods of extreme underperformance, it becomes especially important to evaluate factors such as organizational stability, asset flows, personnel changes, and the continued integrity of the investment process.

Disclaimer of Warranties and Limitation of Liability

This document was prepared by RVK, Inc. (RVK) and may include information and data from some or all of the following sources: client staff; custodian banks; investment managers; specialty investment consultants; actuaries; plan administrators/record-keepers; index providers; as well as other third-party sources as directed by the client or as we believe necessary or appropriate. In the preparation of this document, the author(s) may have used Microsoft CoPilot to conduct any of the following: proofreading and editing, visual layout and design, assistance with data organization, support with modeling, coding and programming, drafting content with appropriate human oversight, and initial review and summarization of drafted materials. RVK has taken reasonable care to ensure the accuracy of the information or data, but makes no warranties and disclaims responsibility for the accuracy or completeness of information or data provided or methodologies employed by any external source. This document is provided for the client's internal use only. It should not be construed as legal or tax advice. It does not constitute a recommendation by RVK or an offer of, or a solicitation for, any particular security and it is not intended to convey any guarantees as to the future performance of the investment products, asset classes, or capital markets. This document should not be construed as investment advice: it does not reflect all potential risks with regard to the client's investments and should not be used to make investment decisions without additional considerations or discussions about the risks and limitations involved. Any decision, investment or otherwise, made on the basis of this document is the sole responsibility of the client or intended recipient.

About RVK

RVK was founded in 1985 to focus exclusively on investment consulting and today employs over 100 professionals. The firm is headquartered in Portland, Oregon, with regional offices in Boise, Chicago, and New York City. RVK is one of the five largest consulting firms in the world, as reported by *Pensions & Investments' 2025 Special Report–Consultants*. RVK's diversified client base spans over 30 states, and covers endowments, foundations, corporate and public defined benefit and contribution plans, Taft-Hartley plans, and high-net-worth individuals and families. The firm is independent, employee-owned, and derives 100% of its revenue from clients for investment consulting services.