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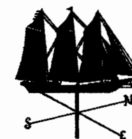
INVESTMENT COUNSEL



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("NOT MANY BUT MUCH")

When attempting to define pornography, Supreme Court Justice Potter Stewart once declared "I know it when I see it." Some investors might say the same about the investment quality of their common stocks.

Assessing quality is a key part of successful investing. However, it can be difficult to define and hard to measure. But ignoring quality is one of the biggest mistakes an investor can make.

Quality is essentially an assessment of the risks of investing in a company's common shares. Some of these risks relate to the company itself, such as its long-term history of growth in earnings and dividends, while others relate to the seasoning, marketability and valuation of the common shares themselves.

Standard & Poor's, which has been ranking stocks since 1956, recently examined common stock quality. Its work has resulted in some interesting findings, including the importance of quality over the long term for achieving superior investment results.

S&P's Quality Ranking System

Standard & Poor's system for assessing common stock quality is based on the growth and stability of a company's earnings and dividends. Over time, a company's track record is the result of several interrelated factors. These include the product lines or services offered, the company's competitive position in its industry, the human, financial, and other resources and how they are put to use, and the management team and its ability to execute its strategic plan.

S&P studied common stock quality for the period 1986 to 2002. Over 3,400 companies were ranked, including companies listed on the New York Stock Exchange, the American Stock Exchange and the NASDAQ. The ranking classifications are shown below:

Rank	Description	Rank	Description
A+	Highest	B-	Lower
A	High	C+	Lowest
A-	Above Average	D	In Reorganization
B+	Average	LIQ	Liquidation
B	Below Average		

It should be noted that in this system, companies not paying dividends are penalized -- that is, all things being equal, it is unlikely they will rank higher than A-. Conversely, companies that do pay dividends are unlikely to receive a score lower than B-, even if a loss has been posted. Finally, companies with higher sales volumes will likely score higher than those with lower sales volumes.

In order to analyze the long-term results of the different quality categories, S&P constructed seven portfolios, consisting of each of the ranks from A+ to C+. In addition, two other portfolios were constructed, one consisting of all-A stocks and one of all-B stocks.

Common Stock Quality

The study included several areas related to common stock quality. The long-term performances of the different quality categories were analyzed as were the differences in the fundamental characteristics of top- and low-quality companies. In addition, S&P also examined how the quality rankings changed over time.

Over the seventeen-year period of 1986-2002, S&P noted the following:

- The portfolios of stocks with high quality rankings *outperformed* the portfolios with low quality rankings.
- The portfolio of A+ stocks *outperformed* the S&P 500 on an annual basis by almost 150 basis points.
- Adjusted for risk, the all-A portfolio *outperformed* the all-B portfolio on an annual basis by 400 basis points.

In its analysis of the fundamental differences between top- and low-quality companies, S&P noted that the better companies tended to have higher and more stable rates of earnings growth over long periods of time.

Specifically, top-quality companies had faster rates of sales growth as well as more stable profit margins. These factors led to higher returns on equity and to better track records for growth in earnings and dividends. S&P noted that top-quality companies achieved these results without the use of financial leverage -- in other words, without the financial risk that frequently accompanies higher levels of debt.

It was also noted that top-quality companies appeared less likely to engage in accounting manipulations. These companies had fewer non-recurring items or expenses (i.e., "write-offs") in their financial statements and thus had better earnings quality.

The study also looked at how the different quality categories fared during the various phases of the business cycle. Because top-quality companies had less debt, they tended to perform better during profit recessions. They were also not as susceptible to economic slowdowns. In contrast, low-quality companies had greater levels of debt and

thus higher levels of interest expense. When earnings growth slowed and funds became tight, these expenses became increasingly burdensome for the low-quality companies.

How the different quality categories reacted to different conditions in the stock market was also examined. In general, the all-A portfolio tended to have better returns in down markets as well as in up markets. The A+ portfolio had higher returns in strong markets and did not decrease as much as other the portfolios in weak markets.

The original study period comprised the years 1986 through 2002 and a follow-up study was completed for the year 2003. In contrast to the previous years, the top-quality stocks under-performed both lower quality stocks and the S&P 500 Index in the year 2003. However, this was not surprising because in an unusual period of accelerating corporate profits *and* declining interest rates, lower quality companies would be expected to perform better as their interest expenses decline. In addition, they are more sensitive to improving economic conditions. However, over the long-term, top-quality stocks still significantly outperformed low-quality stocks.

Quality Over Time

To examine the dynamics of the ranking system, S&P also looked at how the different ranks were distributed over time. As can be seen from the table below, the number of top-quality companies has been steadily decreasing while the number of low-quality companies has been steadily increasing since 1985:

	1985		1990		1995		2002	
Quality Ranking	# of Companies	% of Total	# of Companies	% of Total	# of Companies	% of Total	# of Companies	% of Total
A+	173	6.4 %	115	4.6 %	82	2.8 %	69	2.1 %
A	280	10.3	205	8.1	157	5.3	145	4.4
A-	382	14.1	248	9.8	205	6.9	217	6.6
B+	623	22.9	413	16.4	504	17.1	515	15.6
B	482	17.7	483	19.2	635	21.5	614	18.6
B-	443	16.3	603	23.9	771	26.1	713	21.7
C	334	12.3	455	18.0	597	20.2	1,018	31.0

Source: Standard & Poor's

The number of top-quality companies (the A+, A, and A- companies) had decreased by more than half and constituted less than 14% of the total in 2002. In contrast, top-quality companies in 1985 were over 30% of the total number in the study.

One explanation for this phenomenon is that competition has become tougher over the years as markets have been deregulated and global competition has increased. This would make it increasingly difficult for companies to achieve stable earnings growth over long periods of time and thus harder to qualify for top-quality ranking.

In addition, many high-quality companies have disappeared from the investment landscape over the last two decades due to merger and acquisition activities. This is especially true in the financial industry where many of the top-rated banks have been targets of widespread consolidation. So, in many ways top-quality companies have become increasingly harder to find.

Owning Top Quality Companies

Over the years, we have recommended companies with good track records in earnings and dividend growth, proven management teams as well as the other factors indicative of quality. These include:

- Above-average growth in demand for products or services
- A dominant or leading market position
- A heavy emphasis on research and/or new product development
- A high return on invested capital
- Substantial plowback of earnings to finance future expansion
- Strong financial position with low levels of debt

The universe of companies demonstrating high-quality characteristics is limited. For example, as shown on the previous page, less than 14% of the companies meeting the stringent ranking requirements by S&P are in the top-quality categories. In our work, we focus on top-quality companies attractively valued rather than on the broader range of companies with second-rate pedigrees that are less likely to excel over the long haul.

Below is a list of twenty-five companies we have recently recommended as well as their current S&P ranking:

Company	S&P Rank	Company	S&P Rank	Company	S&P Rank
Abbott Labs	A	Colgate-Palmolive	A+	Microsoft	B+
Alberto-Culver	A+	Dentsply Int'l	A-	Paychex	A+
American Int'l Grp.	A+	First Data Corp.	A-	Pfizer	A
Amgen	B	Home Depot	A+	Starbucks	B+
Anheuser-Busch	A+	Johnson & Johnson	A+	State Street	A
Auto. Data Proc.	A+	Linear Technology	A	Stryker	B+
Cintas	A+	Medtronic	A-	Sysco Corp.	A+
Cisco Systems	B+	Merck	A+	Walgreen	A+
Coca-Cola	B+				

As can be seen, considering the total number of existing companies, there are not many on this list. However, each of the listed companies represents much in terms of quality and, as a group, they are likely to provide superior investment results over long periods of time.