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What are quality stocks – and where to find them?

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Discover more about quality stocks, how CIO finds them, and how they can help navigate choppy markets.

Times of market turbulence can test even the most seasoned stock investor. Those that have never invested in equities before may feel even less convinced about the long-term investment case for shares having seen the market gyrations of early August, where Japan's Nikkei 225 suffered its second worst-one day loss ever, followed by its third-best daily rally of all time.

By the end of the week, though, shares had recovered as yen carry trades unwound, more reassuring US economic data assuaged fears of a recession, and second-quarter US earnings suggested corporate America was still in fine health.

What if investors could find companies whose performance was less subject to swings in the economic, political, and geopolitical newsflow over the longer term? We believe such stocks exist and make sense in the current environment. We describe them as "quality stocks."

What are quality stocks?

While there is no universal definition, we think quality stocks are shares of companies that exhibit strong fundamentals in terms of profitability and pricing power, relative safety, and earnings quality.

These companies often have a track record of consistent earnings growth, robust free cash flow generation, and strong balance sheets. They are typically leaders in their industries, with established brand names and a history of delivering superior returns on invested capital.

To identify quality stocks, investors can look for the following five characteristics:

1. **Competitive advantage:** Companies with a sustainable competitive edge often dominate their markets and have strong pricing power. This can be due to unique products, strong brand loyalty, or technological superiority.
2. **Consistent earnings growth:** Quality stocks tend to show consistent earnings growth or stability over time. This can be seen in companies like the leading members of the MSCI Asia ex-Japan index we call the Asian titans, which have grown their earnings at an annual rate of 9.4% from 2019 to 2022.
3. **Strong free cash flow:** Companies that generate strong free cash flow are better positioned to reinvest in their businesses, pay dividends, and weather economic downturns.
4. **High return on invested capital (ROIC):** A high and sustainable ROIC indicates optimal capital allocation and efficient use of financial capital to generate profits.
5. **Fair valuations:** While quality stocks are seldom underpriced, valuations can come to within fair valuation ranges relative to their long-term growth prospects in a market correction.

By focusing on these attributes, investors can identify quality stocks that can potentially provide stable returns and withstand market turbulence and geopolitical uncertainties.

Where can I find these stocks?

Here are three examples of quality stocks for investors to consider as additions or complements for their portfolios:

Quality in Asia. We like 10 of the benchmark heavyweights across the MSCI Asia ex-Japan index's 10 markets—the so-called Asian titans—given our view that they offer some of the highest-quality opportunities in volatile markets. We expect these stocks to continue to outperform the broader index over the next three to five years thanks to favorable fundamentals. For instance, we expect the Asian titans to deliver free cash flow margins of around 6.8% in 2024, compared to 5.3% for the broader Asia ex-Japan equities index. We also expect these companies to deliver a median return on equity of 15.8%, significantly higher than the regional average of 11.2%. And valuations look reasonable too: despite trading at a premium, the Asian titans are valued below their 10-year average P/B multiple, suggesting potential for further appreciation.

Within China, select state-owned enterprises with large domestic markets and a firm commitment to dividend payments may present opportunities. Additionally, we think select Japanese stocks, such as large-cap banks, high dividend yield stocks, and tech companies, offer quality and strong fundamentals.

Global quality wealth compounders. These are stocks of companies that can reinvest their earnings at returns consistently above their cost of capital, generate strong free cash flows, and have generally boosted their company value year after year. Many such firms have invested significantly in building either competitive advantages or brand loyalty. In the event of a more hostile global trade environment, consumers and business customers may be less willing or able to substitute away from these global quality wealth compounders, potentially supporting their investors' risk-adjusted returns.

Europe's "Magnificent 7." While the original US megacap tech companies under this moniker have come under pressure recently from mixed second quarter earnings and a sector rotation, Europe has its own group of seven highly profitable and innovative companies that are global leaders in their respective industries. Consensus (FactSet) expects these companies to deliver average sales growth of 9%, 13%, and 9% for 2024, 2025, and 2026, respectively. We believe these stocks can deliver high and durable earnings growth, strong free cash flow generation, and lower volatility than the broader market.

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