DEFINED CONTRIBUTION (DC): Security Quality Matters When Selecting Equity Managers

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INTRODUCTION

Downside performance protection, higher long-term return, lower long-term risk – achieving these goals (relative to an appropriate benchmark) offers many defined contribution (DC) benefits including:

- larger participant account balances
- reduced participant account impairment risk (the practice of selling low / buying high)
- mitigation of sponsor fiduciary liability exposure

Selecting equity managers capable of meeting these goals can be a difficult task. Historical returns, however, imply that a focus on portfolio security quality may improve your odds[1].

WHAT IS SECURITY QUALITY?

The definition of security quality can vary. Gosselin Consulting Group defines quality as the financial strength of a portfolio's underlying holdings. A strategy that consistently exhibits stronger-than-market (relative to an appropriate benchmark) profit margins, earnings growth, and cash-flow growth with lower-than-market leverage is defined as higher quality. A strategy with the opposite characteristics (weaker margins, earnings growth, cash-flow growth; higher leverage) is defined as lower quality.

MEASURING PERFORMANCE BY QUALITY

FTSE Russell introduced its Stability (defensive/dynamic) Index® Series in 2010 to complement its Size (large-small) and Valuation (value/growth) Series. The Stability Indexes® are constructed using a mix of Quality and Volatility characteristics, with more stable companies (higher return on assets; lower earnings variability, debt/equity, and total return volatility) classified as Defensive and less stable companies (opposing characteristics) as Dynamic. Please see Russell Stability Index® Series v2.2 at www.ftserussell.com for additional information.

The indexes provide a fair measure of performance by security quality type as:

- three of the four variables (ROA, earnings variability, and debt / equity) are accounting-based indicators of quality
- the fourth variable (total stock return variability) may indicate stability of company fundamentals

The US-based defensive / dynamic indexes will represent our higher / lower quality return streams, respectively, for this paper.

GOAL 1: DOWNSIDE PERFORMANCE PROTECTION

A manager who out-performs its benchmark during a period of market stress (negative environment) provides downside performance protection.

Since the backdated inception of Russell's Stability Indexes® (7/1/1996), US large-, mid-, and small-cap stocks lost ground in six, seven, and eight calendar year periods, respectively. The dark blue bars in Exhibits 1.0 - 1.2 illustrate this performance. In all 21 periods, higher quality stocks **(Defensive Index®)** out-performed lower quality stocks **(Dynamic Index®)**, along with the **Base Index**.

This implies that an active manager may improve their odds of out-performing their benchmark in times of market stress by focusing on higher quality securities.

PERFORMANCE (%): NEGATIVE CALENDAR YEAR PERIODS SINCE 1997

EXHIBIT 1.0: US Large-cap Equities

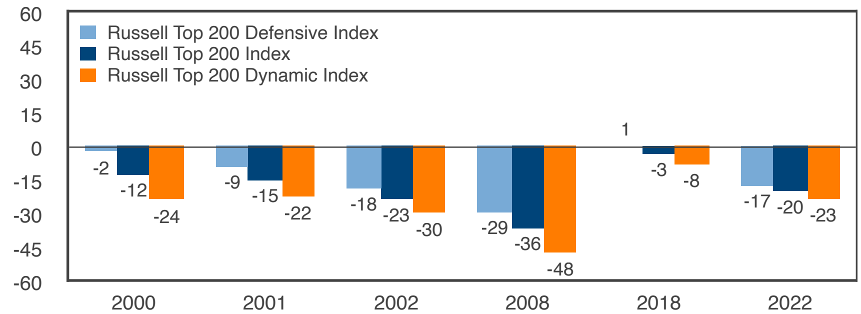


EXHIBIT 1.1: US Mid-cap Equities

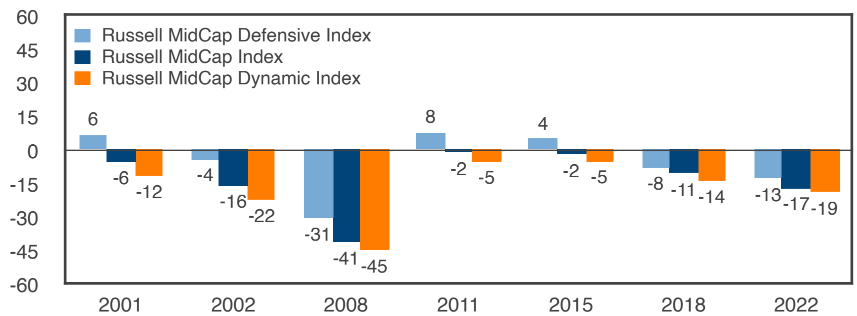
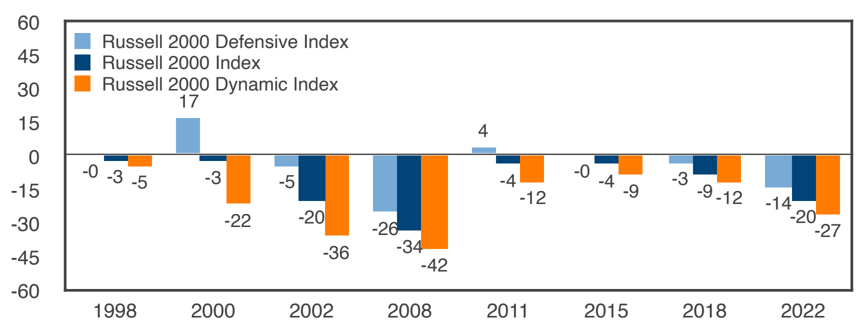


EXHIBIT 1.2: US Small-cap Equities



[1] Past performance is not indicative of future results. Data Source: Morningstar Direct

Why is Downside Performance Protection Important?

For Participants: A significant "absolute" loss in a time of market stress can notably impair a participant's account balance, in some cases on a permanent basis. Participants may choose to (1) stop contributing, thus sacrificing the advantage of dollar-cost averaging or (2) re-allocate their assets out of equities (to cash or fixed income), thus negating any potential recovery. The frequency of these actions likely increase as absolute losses grow larger. To avoid this phenomenon, it makes sense to offer higher quality holdings-biased investment managers (vs. market-like or lower quality) as their historical losses are smaller.

For Plan Sponsors: A significant "relative (vs. benchmark)" loss in a time of market stress can notably increase a sponsor's fiduciary liability exposure. We believe sponsors face greater fiduciary risk when an investment under-performs its benchmark in a period of market stress vs. a period of market exuberance. As an example, most participants would be satisfied with a 25% gain even if the fund's benchmark rose 35% in the same period. Most participants, however, would be dissatisfied with a loss of 35% in a period when the benchmark fell 25%. Not only are participants more apt to take notice of relative returns, but one may question the suitability of the option for a DC plan – thus increasing sponsor fiduciary liability exposure.

GOALS 2 & 3: HIGHER LONG-TERM RETURN; LOWER LONG-TERM RISK

We acknowledge that higher quality portfolios tend to lag their benchmarks in times of market exuberance. That, however, does not detract from the long-term benefit of owning these strategies.

Exhibits 2.0 and 2.1 illustrate long-term risk-return metrics for Russell's Stability Indexes®. The sets of connected circles illustrate performance for US **large-**, **mid-**, and **small-**cap indexes, along with their respective higher quality (defensive) and lower quality (dynamic) indexes, over the past 27+ years.

In all three capitalization ranges, higher quality stocks out-performed lower quality stocks and matched or out-performed their base stock indexes, all at reduced risk levels. Higher quality stocks plotted in the desirable north (more return) and west (less risk) position on a relative basis.

The most dramatic benefit existed within US **small-cap** where:

- higher quality stocks (+10.0%) nearly doubled the return of lower quality stocks (+5.5%) at a 36% risk reduction
- higher quality stocks (+10.0%) out-performed the base index (+8.1%) by 23% at a 19% risk reduction

Achieving these numbers is all the more noteworthy considering the historically low interest rate environment for most of the past 15 years, a period when higher leveraged (lower quality) firms benefitted from cheap financing.

Overall and in contrast to popular belief, we believe that conventional wisdom – the greater one's risk, the greater one's potential for return – does not hold true when it comes to company quality.

EXHIBIT 2.0: Risk / Return Chart
7/1/1996 - 12/31/2023

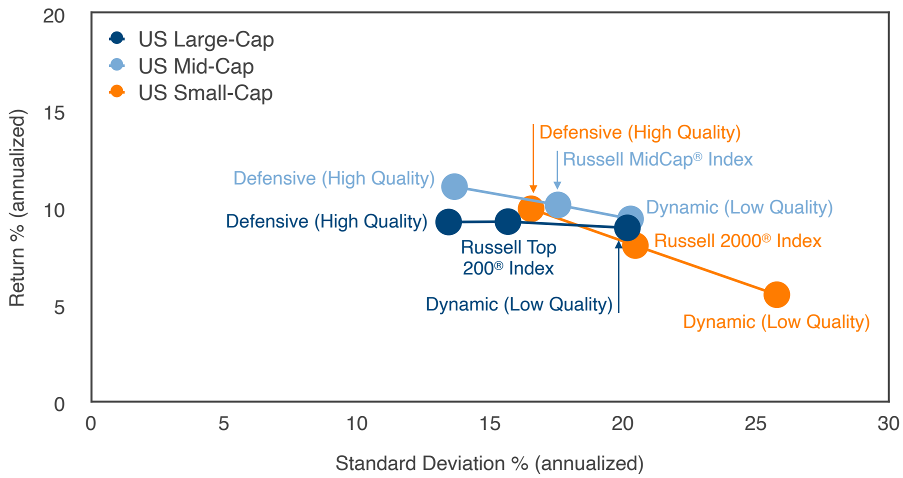


EXHIBIT 2.1: Risk / Return Data
7/1/1996 - 12/31/2023

Capitalization	Index Name	Annlzd Return (%)	Annlzd Std Deviation (%)	High Quality Return Benefit (%)	High Quality Risk Benefit (%)
US Large-cap	Russell Defensive (High)	9.3	13.5		
	Russell Top 200® Index	9.3	15.7	0%	-14%
	Russell Dynamic (Low)	9.0	20.2	3%	-33%
US Mid-cap	Russell Defensive (High)	11.1	13.7		
	Russell MidCap® Index	10.2	17.6	9%	-22%
	Russell Dynamic (Low)	9.4	20.3	18%	-33%
US Small-cap	Russell Defensive (High)	10.0	16.6		
	Russell 2000® Index	8.1	20.5	23%	-19%
	Russell Dynamic (Low)	5.5	25.8	80%	-36%

Russell Core and Stability Indexes® Data Source: Morningstar Direct

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SUMMARY

DC participants and plan sponsors face unique risks when it comes to performance, especially in times of market stress; Participants face the threat of not achieving their financial retirement goals; Plan sponsors face the threat of increased fiduciary liability exposure.

In summary, this study illustrates how investing in higher quality equity managers can not only mitigate downside performance risk (vs. benchmark) in times of market stress but can also deliver higher returns at reduced risk levels over the long-term.

At Gosselin Consulting Group, we are strong proponents of using high-quality holdings-biased equity managers who consistently exhibit at-market or greater-than-market financial strength. As an acknowledged fiduciary to our clients, it serves to better our collective fiduciary position and, most importantly, can improve outcomes for participants.

If you have questions or would like to learn more about how we select and monitor high quality fixed income and equity investment managers, please contact Peter Gosselin at:

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We would be happy to hear from you and provide additional information.

IMPORTANT DISCLOSURE

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