Insight
Fundamental Growth & Core Equity

June 2022

The CQ Framework for Assessing Company Quality

The Confidence Quotient is a measure of company quality, a measure of our conviction in a sustainable growth estimate, a language for use in debate and discussion with portfolio managers, and a driver of discipline and rigor in our investment process.

> “When I sit down with an analyst to talk about a new idea, the discussion is invariably about much more qualitative aspects. How's the management team? Is the business model durable? What's their competitive advantage? Before we had CQ, each analyst had a different approach. We needed more rigor around our discussions, and CQ solved that. It created a common language and a disciplined process.”
>
> — Mike Solecki (CIO, Fundamental Growth & Core Equity)

The Fundamental Growth & Core Equity (FGC) team at State Street Global Advisors takes an active, concentrated, high-conviction approach to equity investing. Investing like owners, not like traders, we seek to hold our companies for the long term. This approach demands that we get to know our portfolio companies well through deep due diligence and ongoing engagement. Our investment philosophy is based on the premise that identifying **Quality** companies with **Sustainable Growth** at **Reasonable Valuations** can drive above-average, long-term investment returns.

A critical element of our proprietary investment process is our **Confidence Quotient (CQ)** framework for assessing company Quality. We believe company Quality cannot easily be measured through backward-looking quantitative analysis, and in this respect our approach differs from those used by smart-beta/index providers. CQ focuses on five key qualitative attributes of a company that are likely to contribute to sustainable growth:

- Management team
- Market position
- Fundamental momentum
- Transparency
- Financial condition

A company's CQ score is an average of numeric scores (between 1 and 10) by an FGC analyst for each of the five key attributes. Underlying the scoring is a rubric of considerations that help to guide the analyst in making their assessments. A detailed CQ summary worksheet for a portfolio company, created by the analyst, also includes qualitative comments explaining the rationale for the scoring of each subsection within the five areas. (See Figure 1.)

Figure 1
Sample CQ Summary Scoresheet/Comments
Illustrative

Management Team — Conviction in leadership Has positioned firm to benefit from secular growth trends Record of under-promising/over-delivering Highly complementary skill sets in C-suite	8.0
Market Position — Sustainable competitive advantage Scale enables control of input costs Pricing power is gradually increasing Substantial barriers to competitor market entry	8.5
Fundamental Momentum — Whether business is trending positively Strongly positive revenue and earnings revisions Experiencing secular (non-cyclical) growth Demand forecast improving	9.0
Financial Condition — Strength of the financial model Strong balance sheet Steadily improving EBIT margins Strong cash flow generation	8.0
Transparency — Visibility of business/financial model High-quality financial disclosure Advantageous tax rate driven by foreign earnings Business diversification starting to reduce cyclicality	7.5
Composite CQ Score	**8.2**

Source: State Street Global Advisors.

Our analysts "own" the CQ assessments for their companies and update them whenever, in their judgment, a change is warranted. Changes in CQ signal to portfolio managers (PMs) that the analyst's views are changing; tracking the movement in a company's CQ can be more useful to a PM than any single CQ snapshot. CQ changes are recorded and displayed in the FGC team's dashboards, which are updated daily. These changes quite often lead to portfolio adjustments by the PM.

> "While the absolute level of the CQ score or its' components is informative — I get significant insight from the changes analysts make. This makes the CQ process more dynamic — it signals real change and it enhances the dialogue the process is designed to promote."
>
> — Laura Ostrander (Emerging Markets Equity Portfolio Manager and Macro Strategist)

In a larger sense, a company's CQ represents: a measure of company quality; a measure of conviction in our sustainable growth estimate; a language for discussions with PMs; and a driver of discipline and rigor in the overall FGC investment process. Unlike quantitative metrics, our analyst's qualitative judgments are not easily replicated, as they are supported and informed by the judgment and culture of our entire team. CQ creates rigor, repeatability, and measurability around qualitative analysis. Combining CQ with valuation allows us to compare any two stocks in any industry globally, and this is what we are continually doing — ultimately to find the best combination of quality and valuation.

The Origin of CQ

> “A consultant once asked me how I knew that I owned high-quality companies with great management teams and great financial characteristics, and I realized then what a subjective question that really was.”
>
> — Paul Nestro, CFA, Director of Research

The FGC team formalized the CQ framework in 2002 as a way of evaluating company quality to support the team's assessment of long-term sustainable growth potential. The idea for the CQ framework grew out of many investment discussions in which our analysts were asked by PMs to look beyond the quantitative analysis they had prepared and instead provide an assessment that included qualitative/subjective factors, e.g., integrating assessments of company management or market position.

Acknowledging the importance of essential qualitative attributes in stock evaluations, the FGC team codified the five key qualitative attributes of a company that are likely to lead to sustainable growth and then set up a rigorous process for measuring them. Rigor comes from several sources, and it is an iterative process. We rely on analyst judgment and sector expertise in addition to various data inputs where applicable. An initial CQ assessment is presented to PMs leading to debate and discussion from a broader perspective. Analysts “fine-tune” their CQ score with this additional input and then modify scores based on evidence and developments over time.

The CQ framework has been continually refined since its inception. One example of this evolution is that we incorporate ESG considerations into all quality assessments, based on our belief that companies that are strong in ESG are more likely to deliver the sustainable growth we seek. ESG considerations are therefore integral to our alpha thesis and are not merely an overlay in the process.

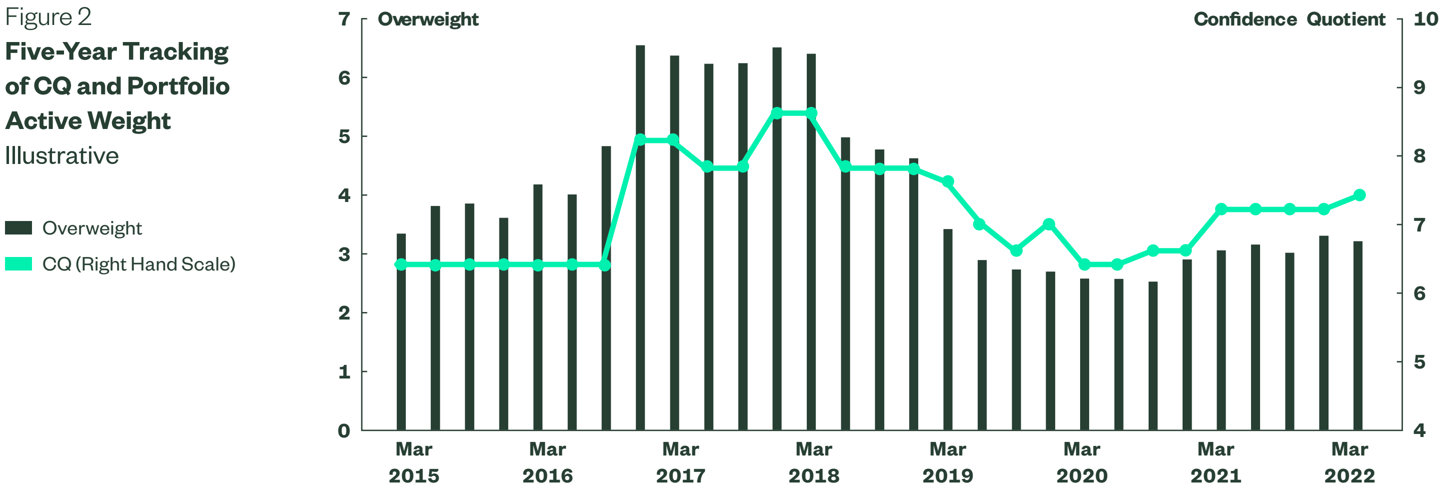
CQ in Practice

> “While we weight all five components of CQ equally, we spend a lot of time on Market Position and Management in particular. Both are more subjective and hence open for debate, but when you get them right you can really get sustained, long-term growth.
>
> — John Flynn (Portfolio Manager)

Perhaps the best way to understand how we use the CQ in practice is through an example. A full-service wealth management provider is a long-time holding in our strategies, but its active weight has varied over time, driven by our views primarily around its Market Position and Fundamental Momentum CQs. Five years ago, our conviction in the firm's competitive positioning and the strength of its business model in a secularly growing industry drove the overall CQ higher particularly with respect to Market Position and Fundamental Momentum, but also with respect to Transparency, as visibility into its future earnings trajectory improved. At this time, we took large active weights in the company in our portfolios.

Over time, however, competition intensified and the Market Position CQ deteriorated; also, the interest rate environment became a headwind that lowered the Fundamental Momentum CQ. The PM team discussed these issues with the analyst and reduced portfolio positions significantly over a two-year period. But we continued to hold the firm based on the belief that the competitive environment, while difficult in the near term, had the potential to improve as the number of players reduced and the levers on pricing were pulled. (See Figure 2.)

Figure 2
Five-Year Tracking of CQ and Portfolio Active Weight
Illustrative



Source: State Street Global Advisors.

We also felt that the macro headwinds, while unpredictable, would abate at some point, and this firm offered a higher-quality way to position the portfolio for that eventuality versus other financial firms (including banks and insurers). In the meantime, we had a strong franchise with secular growth and a very reasonable valuation.

This turned out to be prescient because the economic recovery that followed was a strong tailwind for the firm's business. While competitive pressures remain, keeping the Market Position at a lower level, the analyst raised the Fundamental Momentum CQ throughout 2020, correctly anticipating the improving macro conditions.

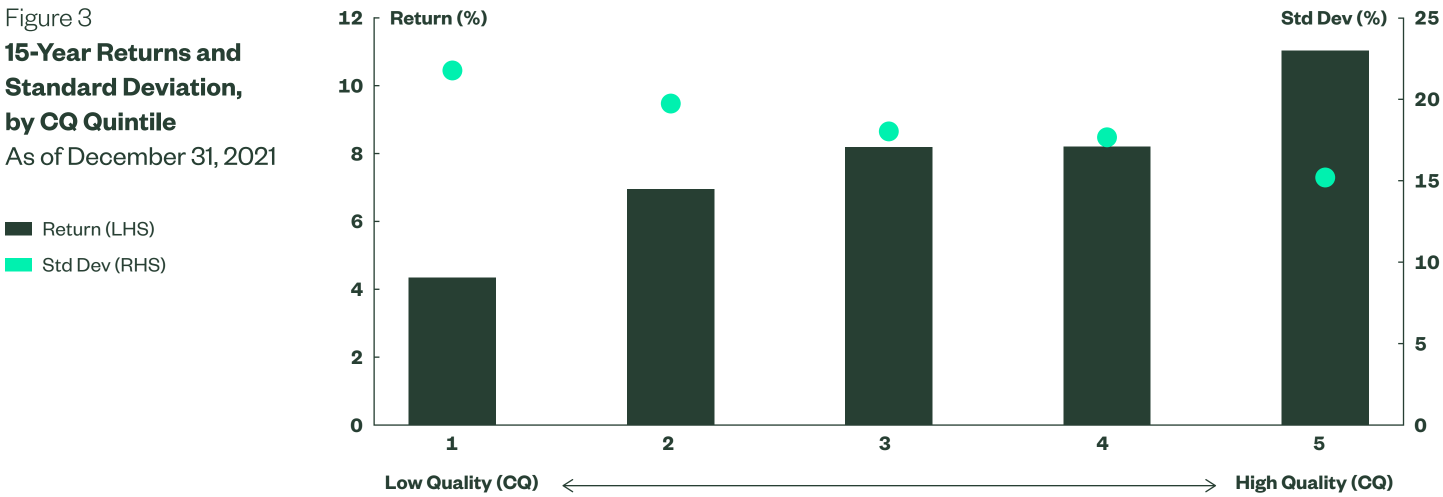
CQ and Performance

The FGC team believes that quality leads to sustainable growth. If two companies with similar business models are being considered by a PM, we believe that the company with a higher CQ has a higher probability of sustaining its growth rate, based on traits such as better management, stronger market position, more positive ESG traits, and less financial risk. Conversely, we think that the company with a lower CQ may evidence less pricing power, more vulnerability to competition, or management that mis-allocates capital, which would lower the probability of sustaining its growth rate. CQs help us differentiate growth rates according to their sustainability. It measures how much confidence we have in that sustainability.

> With concentrated portfolios, we are very focused on managing our idiosyncratic risk. The CQ framework not only defines Quality for our team but creates a forward-looking risk-management tool with which to assess these qualitative factors on a security-level basis. We have a detailed scorecard of questions behind the CQ process — to facilitate a holistic conversation with our analyst team, to inform a debate on the critical assumptions behind our investment thesis, and to highlight company-specific risks that may not be apparent in the financial metrics.
>
> — Chris Sierakowski (Head of North America Portfolio Management)

Because CQ doesn't incorporate our analysts' projection of Growth and Valuation (the other core components of our investment approach), in isolation we wouldn't necessarily expect CQ to correlate with returns. Nevertheless, over the last fifteen years, high-CQ companies have provided better adjusted returns than low-CQ companies, as well as lower volatility. (See Figure 3.)

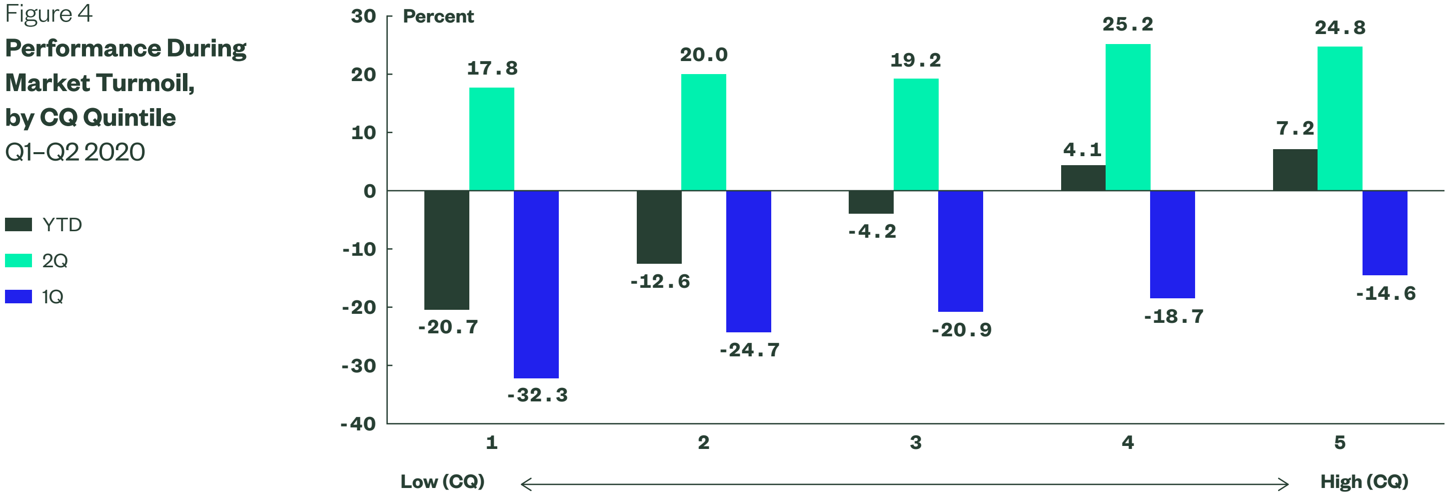
Figure 3
15-Year Returns and Standard Deviation, by CQ Quintile
As of December 31, 2021



Source: State Street Global Advisors. CQ data from FGC global research portfolios representing 332 companies.
Past performance is not a guarantee of future results.

In addition, high-CQ companies have also done well in times of market turmoil. This was the case in the first half of 2020. Figure 4 shows that high-CQ companies across the FGC team's coverage substantially outperformed low-CQ companies during this market drop and recovery.

Figure 4
Performance During Market Turmoil, by CQ Quintile
Q1–Q2 2020



Source: State Street Global Advisors. CQ data from FGC global research portfolios representing 332 companies. YTD is as of June 30, 2020.

Closing Thoughts

For the FGC investment process, alpha is an output. The inputs are a differentiated and disciplined process (including CQ), a strong team and culture, a long-term investment horizon, a fiduciary mindset with strong risk management, and a high-conviction approach. The CQ framework is a critical component of this process, and for nearly two decades it has been used to help gauge the quality of portfolio companies. We believe that the application of analytical rigor to assess key qualitative attributes is one of the main reasons why FGC has outperformed in this space.[1] And, in service of our investors, we expect to continue to innovate and outperform in the years to come.[2]

Endnotes

1 For more performance information, contact your State Street representative.

2 Past performance is not a guarantee of future results.

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Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals we live our guiding principles each and every day:

- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 30 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's fourth-largest asset manager* with US $4.02 trillion† under our care.

* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of March 31, 2022 and includes approximately $73.35 billion USD of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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