intellidex
Researching Capital Markets and Financial Services

Prepared for clients of EasyEquities

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Satrix Quality South Africa ETF (JSE:STXQUA)

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Fund suitability

This ETF is suitable for investors who would like to gain exposure to quality listed companies on the JSE using an ETF.

Fees

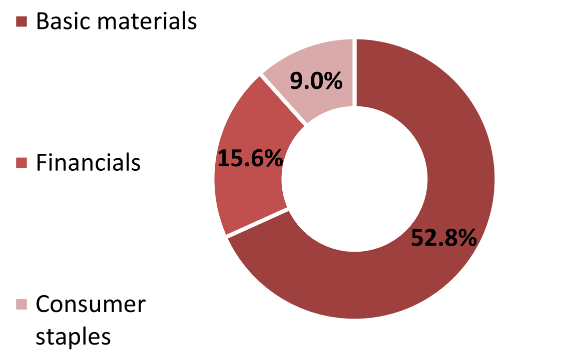
The fund's total investment charge is 0.64%.

Alternative funds

None

"Quality investing favours companies with solid business models, a strong financial history and superior cash generation"

Sector allocation – top 3 (%)



Quality investing is arguably one of the most prominent investment styles within equities. From an asset management perspective, fund managers often refer to these companies as compounders, which implies holding them in equity portfolios for extended periods of time.

Underpinned by fundamental analysis, quality investing favours companies with solid business models, a strong financial history and superior cash generation. Investors may differ slightly in their definitions of quality, however, this reflects the importance of different quality-related factors (e.g. competitive advantage vs capital allocation) as part of investment processes.

Quality investing has an interesting relationship with the value and growth investment styles as being the possible result of combining the two factors. Buying shares in companies with strong competitive advantages, dominant market positions and healthy financials at attractive prices (low price is a key feature of value investing) is the holy grail of equity and all investing.

In addition, quality differs from growth in that the latter investment style is concerned with acquiring shares in early-stage companies that may not be profitable/cash generative but have *business models* likely to succeed in the future – hence these companies' tendencies to reinvest, rather than pay dividends, which combined with capital gains are the two components of total investment return.

Robert Novy-Marx's 2013 study is one of the most popular academic research articles on quality investing and describes the relationship between quality and value as the former style being an alternative implementation of the latter.

It states: "buying high quality assets without paying premium prices is just as much value investing as buying average quality assets at a discount."

Given the importance of business models that are hard to replicate and dominant market positions which are key to being a quality company, it comes as no surprise that Novy-Marx finds that the gross margin has power in predicting the return of share prices.

A high gross margin (gross profit as a percentage of revenue) indicates pricing power due to inelasticity of demand (demand that is not sensitive to price increases) or a product or service that simply appeals strongly to customers. As a result, high gross profitability is definitely a function or sign of a business model that is insulated from competitive forces, which leads to a dominant industry position.

The next questions investors may have are: When does quality perform best? And does it perform well in all the phases of the economic cycle? According to research by global asset manager Schroders, quality shares produce higher average annualised excess returns relative to value shares in all market periods.

In addition, quality shares seem to perform best when market volatility is high, which often occurs during times of market distress or recession.

Given the backdrop above, we move to this week's ETF pick: the Satrix Quality SA ETF that tracks the performance of the S&P Quality South Africa Index. To be included in the index, new constituents must have liquidity of R5m (R4m for existing companies) and must score favourably across three quality ratios calculated by S&P Dow Jones Indices – return on equity, the accruals ratio and the financial leverage ratio.

Return on equity is a profitability measure, while financial leverage has to do with debt, which implies that high-quality companies often have less debt and higher free-cash flow to fund the company's growth or pay dividends. The accruals ratio measures the quality of earnings – in other words, cash flow growth must be higher than net profits, as cash flow is a better indicator of profitability and financial strength than profit.

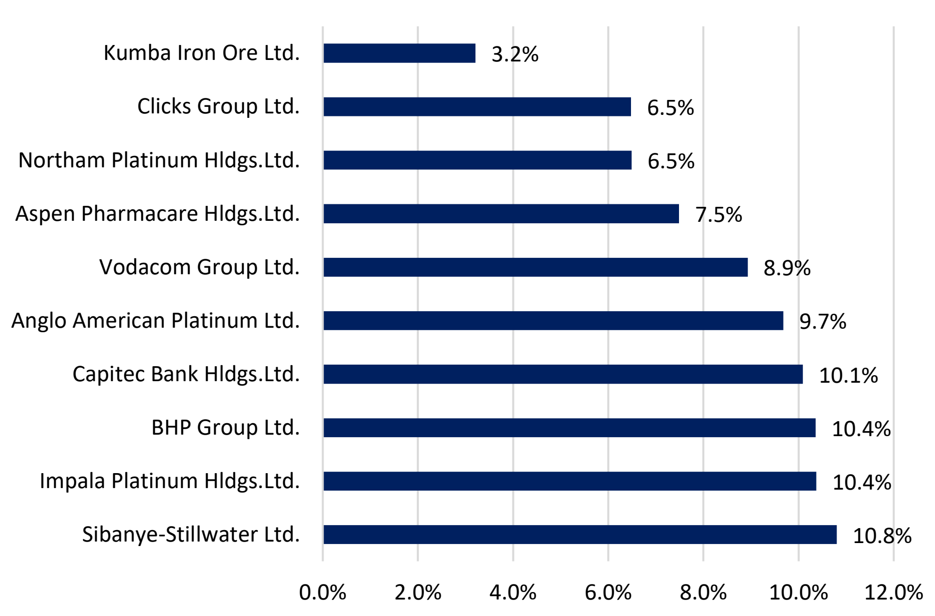
The fund, which has an estimated total investment cost of 0.64%, is slightly expensive. In addition, the limited amount of metrics used to measure quality given SA's smaller equity universe (relative to developed markets) means less firms to choose from.

Interestingly, the fund's underperformance relative to the Satrix Top 40 ETF (8.1% vs 23.2% to end Jan.2021) may be indicative of how quality underperforms during rising markets which was the case throughout 2021. However, given SA's weak economic outlook, in which Intellidex economists forecast real GDP growth of just 2.1% in 2022, we expect SA quality shares to hold their mettle, albeit under increasingly tough conditions.

Investment approach and portfolio composition

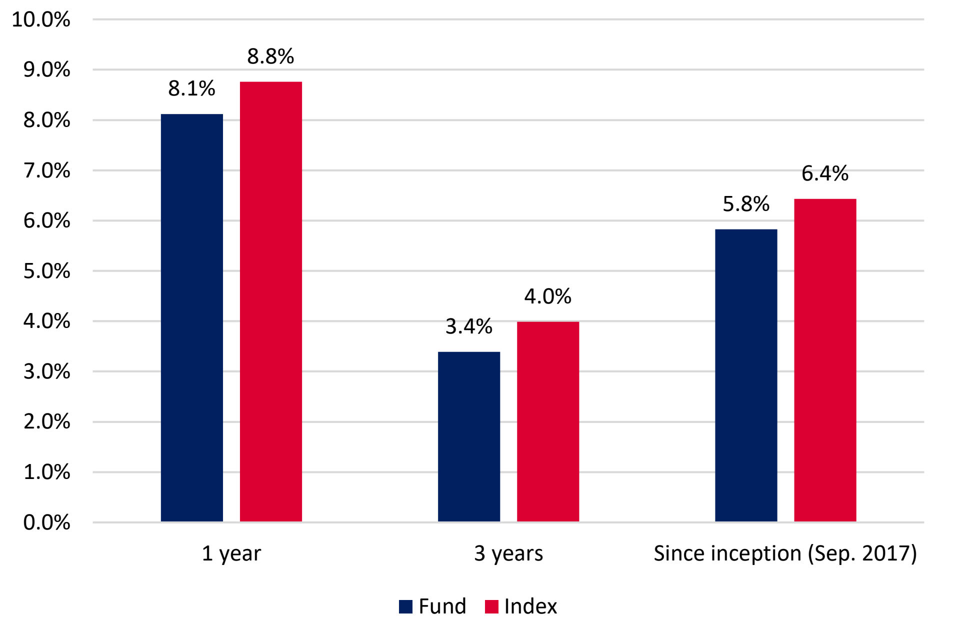
The Satrix Quality South Africa ETF tracks the performance of the S&P Quality South Africa Index before fees and expenses.

Top holdings (%)



Performance

ETF and index performance to end-January 2022 (annualised for periods longer than one year; with dividends reinvested).



Fund information: 31 January 2022

Launched on	26 September 2017
Trading symbol (JSE)	STXQUA
Weighted average market cap.	R68m
Total investment charge	0.64%
Risk rating	High
Benchmark	S&P Quality South Africa Index

Market data: 24 March 2022

Spot price	R9.08
One-year high	R9.66
One-year low	R7.25
Average monthly volume	495,807
Dividend yield (estimated)	5.1%

Source: www.etfsecurities.com.au, yahoo finance