

Is Quality a Surrogate for Market Cap?

Alleron assesses every top-100 stock and selected ex-100 stocks on a bottom-up qualitative basis. As part of our evaluation process, 10 distinct aspects of quality are rated and particular attention is given to how these factors change through time. As examples, quality factors include measures of management track record, growth in competitive advantage, financial health and barriers to entry. Each factor is given a score from 1 to 5 and combined into an overall Quality Score, with values typically ranging between 25 and 43. Stocks with Quality Scores below 30 are considered uninvestable on the long side, but may be candidates for the short portfolio.

As larger companies often have strong financial health, competitive advantages, barriers to entry in their industry and so forth, the question naturally arises:

Is quality simply a surrogate for market capitalisation?



Figure 1: Market Capitalisation by Alleron Quality Score



Figure 1 collates the Alleron-assigned Quality Score for all research papers produced in the period 7 Feb 2005 to 31 Dec 2015 (2,794 in total). The Quality Score values range from 23 to 43. For each Quality Score a marker is placed at its (approximate) ASX 200 capitalisation weight at the time the paper was produced. Both the capitalisation level and Quality Score for an individual stock vary through time so many stocks will be represented by twenty or more points.

For Quality Scores ranging from sub-30 through to 37 there is in fact a correlation to market capitalisation. For example, not one single stock scored 32 or lower achieved a market cap of 2% or more. Between 32 and 37 however there is an upward progression and many stocks with much higher cap. For Quality Scores of 38+ however there is a change in this pattern. Although some large stocks are still present, many of the highest quality stocks have been uncovered in the ex-20 space. This is because the Alleron Quality Score highlights those factors of the information set that align best with our investment philosophy. Alleron actively searches for stocks with sound growth characteristics, transformative properties and a margin of safety and our Quality Score measure is tailored for this process.

One consequence of the distribution in Figure 1 is that the long-side of the Alleron long-short fund tends to be overweight in the ex-20 space (high-quality lower-cap stocks on the right) and short stocks tend to be drawn from lower cap bands as well (low-quality, lower-cap stocks on the left).



Disclaimer

While the information contained herein has been prepared in good faith, neither Alleron Investment Management Limited ("the Company") nor any of its shareholders, directors, officers, agents, employees or advisers give, have given or have authority to give, any representations or warranties (express or implied) as to, or in relation to, the accuracy, reliability or completeness of the information in this document, or any revision thereof, or of any other written or oral information made or to be made available to any interested party or its advisers (all such information being referred to as "Information") and liability therefore is expressly disclaimed. Accordingly, neither the Company nor any of its shareholders, directors, officers, agents, employees or advisers take any responsibility for, or will accept any liability whether direct or indirect, express or implied, contractual, tortious, statutory or otherwise, in respect of, the accuracy or completeness of the Information or for any of the opinions contained herein or for any errors, omissions or misstatements or for any loss, howsoever arising, from the use of this document.

Information in this presentation should not be considered as a recommendation in relation to holding, purchasing or selling shares, securities or other instruments.