

INVESTMENT STRATEGY COMMENTARY

2009 EQUITY MARKET TRENDS: A LOOK AT "QUALITY"

January 2010

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Much has been said and written about investors' return to risk assets last year, including specific commentary on the surprisingly good performance of investment strategies focused on low-quality or distressed securities. This trend is widely evident in the robust returns realized last year in the high-yield or speculative-grade bond market. However, an equally pronounced example can be found in the public equity markets, where stocks of "low-quality" companies significantly outperformed their "high-quality" peers.

For purposes of this discussion, low-quality companies generally fit the following profile: 1) earnings highly sensitive to economic growth; 2) balance sheet leverage (i.e., debt) high relative to the overall market; and 3) operating profitability lower than the overall market. In 2009, these low-quality stocks rallied sharply both in absolute terms and relative to the higher-quality segments of the public equity universe.

To better quantify this quality effect, we constructed a basket of the low-quality stocks going back several decades and tracked its performance over subsequent time periods through December 2009. As the graph below shows, this lower-quality stock index usually trades at a significant discount to the overall equity market. In fact, earlier in 2009, and as a direct consequence of the severe global economic recession, low-quality stock prices fell to relative valuation levels not seen since the 1970s.

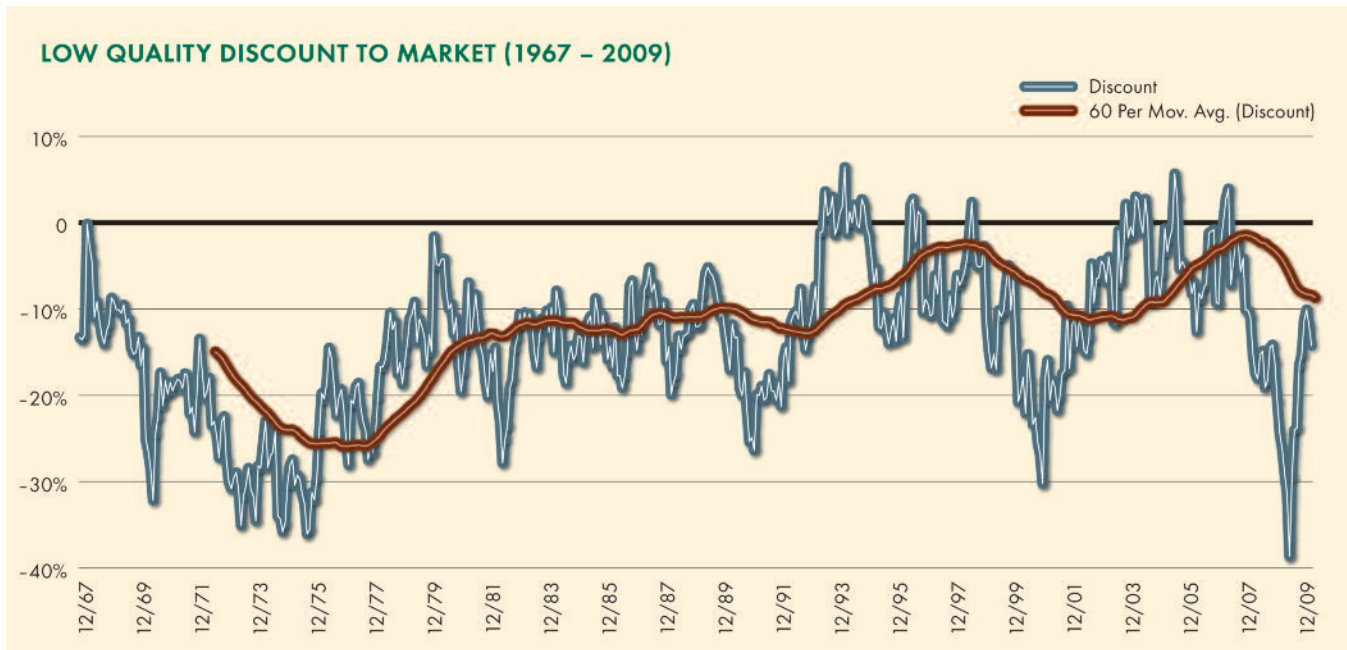


Figure 1: Historical discount to market for low-quality stocks. Source: Northern Trust Global Investments.

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Bottom-quintile ROE companies have enjoyed year-to-date stock price appreciation nearly double that of top-quintile ROE companies.

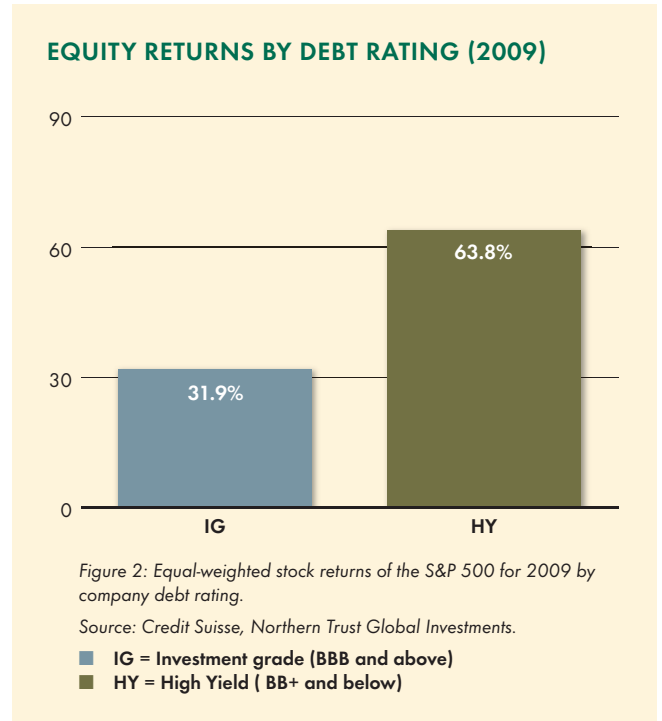
Since March 9, 2009, however, low-quality stock prices have surged, and in many cases have rebounded all the way back to “normalized” discount levels. In other words, the rally in low-quality stocks has been strong enough to recoup most or all of the bear market losses these stocks suffered relative to their high-quality peers in 2008 and early 2009.

Figure 2 provides a closer look at the Standard & Poor’s (S&P) 500 and illustrates that stocks of companies with speculative or “below investment grade” debt ratings have appreciated twice as much as stocks of companies with higher, “investment grade” debt ratings.

Another way to better understand stock price performance last year is to assess individual

companies with respect to return on equity (ROE). ROE is defined as net income divided by shareholders’ equity, a common measure of company profitability. Coming into 2009, and sorting the S&P 500 by ROE, bottom-quintile companies reported a negative ROE, i.e., they had negative profits, while all other companies reported a positive ROE. Yet, as shown in Figure 3, bottom-quintile ROE companies enjoyed stock price appreciation nearly 25% higher than that of top-quintile ROE companies!

Note that the relative outperformance of low-quality stocks is concentrated in the lowest or worst ROE quintile, while all the other ROE quintiles delivered “average” returns.



EQUITY RETURNS BY ROE QUINTILE (2009)

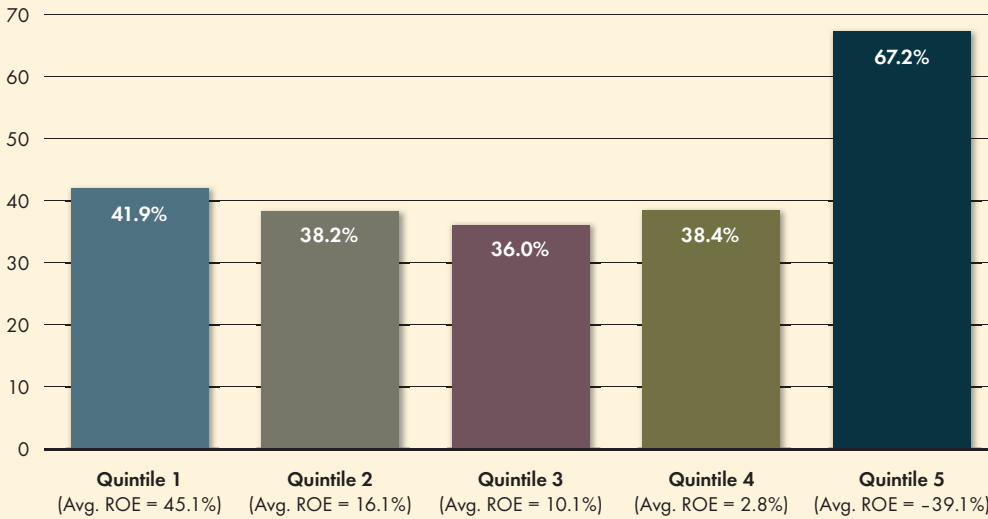


Figure 3: Equal-weighted returns by ROE quintile. Source: Northern Trust Global Investments, Factset.

For managers pursuing investment strategies focused on high-quality equity securities, 2009 was a tough year.

CONCLUSION

Last year was a tough year for managers pursuing investment strategies focused on high-quality equity securities. Specifically, most of the relative outperformance high-quality stocks earned during the 2008/09 bear market was erased by the dramatic recovery of low-quality stocks following the market lows in early March 2009. Valuation levels between high- and low-quality stocks have normalized so that the current low-quality discount is no longer extreme but rather at or near historic averages. While this adjustment does not offer a reliable forecast of future price moves between equity quality tiers, it does help explain investors' recent risk positioning and provides important insight into equity markets' performance dynamics.

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