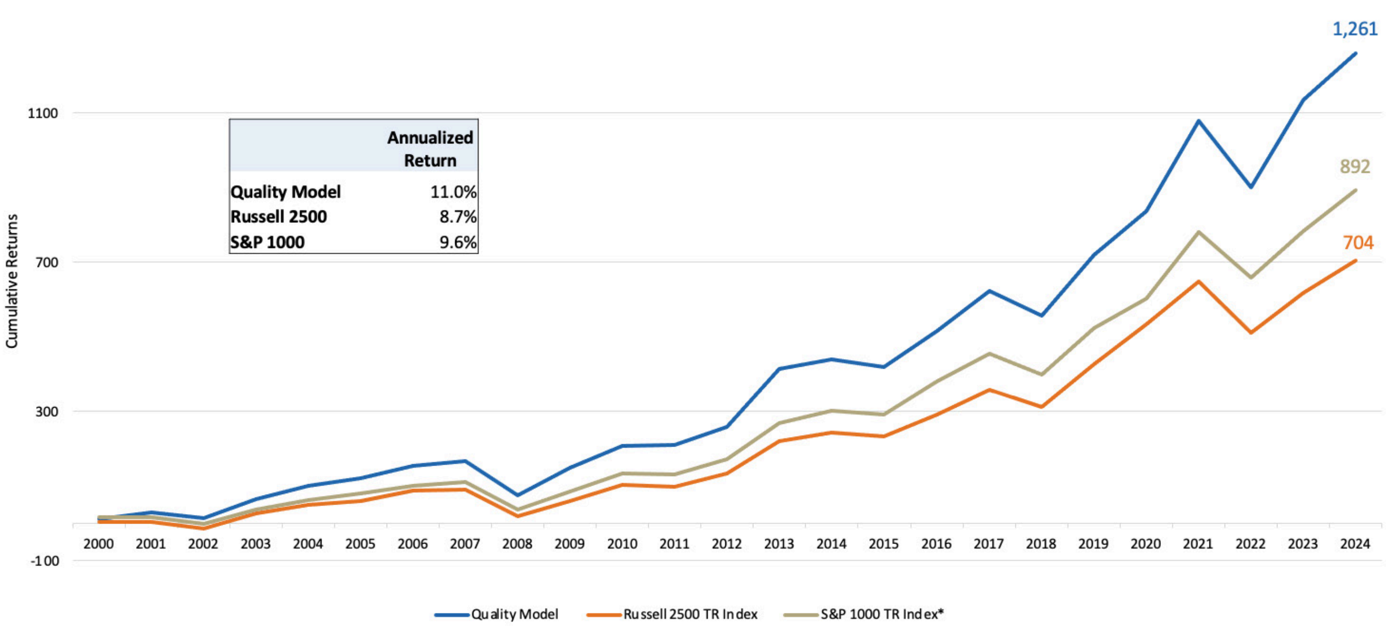
Authors: Crit Thomas, CFA, CAIA / Erik M. Aarts, CIMA / Brian Cheyne, CFA, CIMA

March 25, 2025

Where Quality Helps the Most

- We created a quantitative quality model to test whether focusing on quality metrics can improve performance in the small and mid-cap space. We backtested the model using Bloomberg's equity screening tool.
- Our universe was the Russell 2500 Index, which includes small and mid-cap stocks. We screened for stocks with the following characteristics:
  - Positive earnings over the past 12 months
  - Net debt-to-EBITDA ratio below 4x
  - Return on equity (ROE) above 10%
- Our chart shows performance from a backtest that equal-weighted the stocks passing our screen, an approach we think better reflects how an active manager might allocate across a small or mid cap portfolio. However, we note that the results were similar to a market cap-weighted version: the market-weighted version returned 10.9% annualized.
- We also included results for the S&P 1000 Index, another small and mid-cap benchmark that already excludes companies with negative earnings. This let us isolate the added value of our other two quality metrics: balance sheet strength and profitability.
- For simplicity and to reduce turnover, we rebalanced annually, which is also how Bloomberg reports returns. This limits our ability to analyze volatility using higher-frequency data, but the results still support the idea that quality can provide downside protection.
- Over the last 25 years, the Russell 2500 Index had 6 down years. The model outperformed in five of them, with the only exception being slight underperformance in 2015. Of the 19 up years, the model outperformed in 11, and even when isolating only the up years, the model outperformed the indexes.
- We ran the model in the large cap space and found it to be less impactful. Having a quality bias clearly helped in down years, but the model underperformed in up markets. We also found that the weighting methodology in large caps mattered: in the first half of our 25-year test period, through the Great Financial Crisis, an equal-weighted approach added value. Since then, market weighting had been more effective.

The Importance of Quality in Mid and Small-Caps



	Annualized Return
Quality Model	11.0%
Russell 2500	8.7%
S&P 1000	9.6%

Source: Bloomberg. 25 years of annual total returns through 2024. Past performance is no guarantee of future results.

**Combines the S&P 600 and 400 small and mid-cap indexes. S&P indexes exclude non-earners.*

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