

Saturna's Fund Investment Process and Philosophy

Core Principle: Investing in Quality



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Our previous two papers provided insight on Saturna Capital's approach to investing in low-debt companies and holding those positions over an investment horizon stretching well beyond that typically found among actively managed mutual funds. This third discussion covers our belief that sustainable, long-term value creation accrues to high-quality companies.

Quality can mean different things to different people. Historically, the phrase was interchangeable with "blue chip." As the application of statistical processes and quantitative risk control became more sophisticated, quality evolved into a "factor"¹ and came to define a specific set of characteristics including:

1. Transparent accounting in which cash flows and profits generally align
2. Resilient earnings power due to demand, pricing, or diversification attributes
3. An identifiable and sustainable competitive advantage
4. Attractive returns on invested capital (ROIC) that exceed the cost of capital
5. Balance sheet strength (as discussed in our first core principles paper)

Key Takeaways

- 1 Quality companies – those with strong profitability, high returns on capital, resilient earnings, and solid balance sheets – have historically delivered **superior long-term, risk-adjusted returns.**
- 2 Quality characteristics tend to persist over many years, and markets systematically underreact to this information, **allowing patient investors to benefit from a durable "quality premium."**
- 3 Ethical business practices as well as strong governance and stewardship reinforce financial quality, so investing in high-quality, ethical companies can enhance returns **while reducing risk rather than sacrificing performance.**

While not a function of the financial metric, we believe quality also accrues to companies displaying sustainability characteristics and that manage their businesses ethically. Our expectation that such companies generate superior risk-adjusted returns is not merely aspirational, it represents a carefully reasoned investment philosophy that builds on our low-debt, long-term approach and is supported by rigorous academic research, empirical evidence, and decades of practical experience.

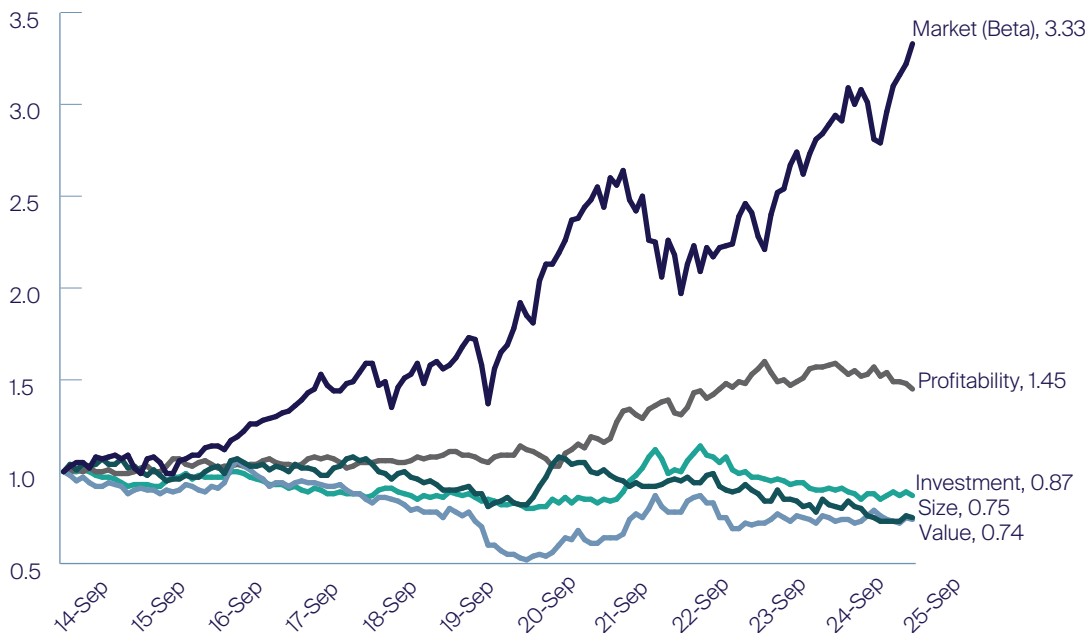
The Quality Premium: Academic Foundations and Empirical Evidence

Whereas our approach to debt may contradict the Modigliani-Miller Theorem, the “quality premium” has been documented extensively in financial literature. The case for quality investing rests on a fundamental insight: companies with strong operational characteristics (i.e., attractive returns on capital, robust profitability, and sound governance outperform their lower-quality counterparts). Despite evidence of a

quality premium, the notion contradicts the efficient market hypothesis and its associated capital asset pricing model (CAPM) that suggests returns are simply compensation for bearing risk.

In 2014, Fama and French published their now eminent five-factor model. In the research published along with this model, they found profitability, a proxy for quality, helps explain stock outperformance.² Since that time, the factor has been the best performer of all the additional explanatory factors suggested in their model (size, value, profitability, and investment). Note that in Exhibit 1, “Market (Beta)” refers to the overall market return. This model, which builds on the CAPM seems to suggest that higher profitability is associated with riskier firms, a notion we consider far-fetched. Further, with more than a decade in circulation and thousands of citations, surely there’s been enough time and attention for an efficient market to arbitrage away any non-risk-related excess returns – yet profitability continues to outperform.

Exhibit 1: Normalized Performance of Fama-French Five-Factors Since Initial Publication



Source: Saturna Capital, Dartmouth

In addition to profitability, our approach to quality emphasizes a company's ROIC. When a company's ROIC, the profit generated per dollar of investment, exceeds its weighted average cost of capital (WACC) its value tends to compound. Like a snowball rolling down the hill, companies where ROIC consistently exceed WACC create a positive feedback loop, taking today's earnings and reinvesting them to generate tomorrow's returns.

As with profitability, the association of strong returns on capital with attractive stock appreciation is far from a novel observation. Legendary founder of Berkshire Hathaway, Warren Buffett, cemented his position as the world's greatest investor by investing in companies with attractive returns on capital,³ while myriad researchers have explored the subject. Saturna's analysis supports the idea.

In Exhibit 2, we illustrate that companies that both started and ended in the best quintile for return on investment (ROI), provided a 13.5% median annual return from 2015–2024, while the median return for all companies that finished in the top quintile, regardless of where they started, ranged from an attractive 13.5% to 16.1%. Meanwhile, companies that finished in the worst quintile, again regardless of where they started, saw median returns of a paltry 2.7% to 6.8%. Over the same period, the global market returned 8.7%. Close readers will observe that the median returns form companies that started in lower quintiles but finished at the top, enjoyed even better returns than those companies that maintained their top quintile positions. That's entirely logical as companies that move up the ROI ladder will certainly be rewarded by investors for doing so.

Unfortunately, turning to Exhibit 3, very few companies move from worst to best and even fewer from second worst to best. Of 178 companies that began the decade-long period in the bottom quintile, only nine migrated to the top, while only six of the companies in the second worst quintile transitioned to the top cohort. The odds start to improve when moving higher and we devote a significant portion of our research to discovering those companies with the opportunity and skill to improve their returns.

Just as companies with poor returns tend to remain at the bottom, companies featuring the best returns tend to stay at the top. In our survey covering 831 global stocks, of the 169 in the top quintile of returns at the beginning of the period, 10 years later 51% remained in the top quintile, while 27% finished in the second quartile and a mere 6% fell to the bottom quartile. The persistence of top-notch returns improves the investor's opportunity to achieve the same.

Exhibit 2: Median Annual Return for Global Stocks by Starting and Ending ROI Quintile 2015–2024

Starting Quintile	Ending Quintile		
	Global	(Best) 5	(Worst) 1
(Best) 5		13.5%	3.5%
4		14.1%	3.1%
3		16.1%	2.7%
2		13.6%	4.3%
(Worst) 1		15.1%	6.8%

Exhibit 3: Count of Global Stocks by Starting and Ending Quintile 2015–2024

Starting Quintile	Ending Quintile		
	Global	(Best) 5	(Worst) 1
(Best) 5		86	10
4		50	18
3		24	30
2		6	40
(Worst) 1		9	80

Source: Saturna Capital

Quality Breeds Persistence and Persistence Breeds Success

Several ingredients underpin the superior returns quality companies generate. First, quality firms exhibit more stable and predictable cashflows, reducing fundamental business risk. Second, quality companies demonstrate operational resilience during economic downturns. Finally, quality firms invest systematically in research and development, maintain leaner operations, cultivate loyal customer and supplier relationships, and implement robust governance structures that mitigate tail risks. Each of these factors contributes incrementally to long-term value creation.

A critical feature of quality investing is that, as demonstrated above, these characteristics persist over time. Companies that demonstrate high profitability, strong balance sheets, and prudent growth today tend to maintain these attributes for years into the future. Indeed, analysts have documented that quality scores forecast future quality characteristics five to ten years ahead. Profitable, growing, and safe stocks continue to display these characteristics at statistically significant levels throughout extended periods. Key to the persistence of quality company outperformance, the market appears to underreact to quality information.⁴

To us, for a company to be high quality, it must also be ethical. While this definition may seem a stretch to some, here too, there's empirical evidence of a positive correlation. Research by Ang et. al. found companies with strong ethical profiles demonstrate higher earnings quality, better credit profiles, and higher profitability.⁵

A Price for Virtue?

At Saturna Capital, our investment philosophy rests on the conviction that quality and ethics are complementary rather than competing considerations. As part of this, we prioritize companies demonstrating strong governance, environmental stewardship, and positive social impact. A natural concern for investors implementing ethical screens is whether excluding certain industries or companies based on non-pecuniary factors compromises financial returns.

Economic theory suggests that when investors exclude stocks for non-financial reasons, the reduced



demand should lower current prices and raise future expected returns for excluded companies. If a substantial portion of investors refuse to hold tobacco or weapons manufacturers, remaining investors must be compensated with higher returns. This theoretical “sin premium” would represent a transfer of wealth from socially conscious investors to those willing to hold excluded stocks. However, three factors determine whether this premium materializes in practice: the scale of exclusions, the availability of substitutes, and the correlation between exclusions and other risk factors.

Empirical research is mixed on whether exclusions create a “sin premium.” We hold that if such a premium exists, it can be substantially mitigated through careful portfolio construction, including replacing excluded stocks with high-quality alternatives that offer similar or better factor characteristics. In practice, this means replacing a profitable tobacco company not with an unprofitable clean energy firm, but with a profitable healthcare or consumer staples company with similar fundamental characteristics.

Beyond exclusions, evidence suggests that companies with superior environmental stewardship, social responsibility, and governance quality exhibit lower risk. Specifically, companies in the worst ethical quintile were found to have total volatility that is 15% higher than companies in the best quintile. What's more, ethical profiles provided insight on future risk increases not captured by current statistical risk models.⁶

The Convergence of Quality, Ethics, and Performance

Empirical literature and practical experience converge on a compelling conclusion: investing in high-quality ethical companies can offer superior risk-adjusted returns over the long term. This outperformance reflects multiple reinforcing factors such as:

- Quality firms generate stable, profitable growth.
- Ethical firms avoid costly scandals and regulatory sanctions.
- The combination of quality and ethics produces operational resilience during economic disruptions.

At Saturna Capital, our approach integrates these insights into a coherent investment philosophy. We screen for companies meeting ethical standards while emphasizing quality characteristics: attractive returns on capital, strong balance sheets, good governance, environmental stewardship, and positive social impact. We conduct deep fundamental research to identify best-in-class companies within permitted sectors, integrate ethical analysis throughout our investment process, and maintain a long-term orientation that allows quality and ethical characteristics to compound over time. Saturna's track record demonstrates that this approach generates competitive returns while maintaining strong an ethical compass.

¹ A factor is any measurable characteristic of a group of securities that helps explain their common patterns of risk and return. In other words, factors are systematic drivers – such as value, size, momentum, quality, or macro variables like interest rates and inflation – that portfolio and risk models use to decompose and attribute performance and volatility.

² Fama, Eugene F. and French, Kenneth R. A Five-Factor Asset Pricing Model. Fama-Miller Working Paper. September 23, 2014. <https://ssrn.com/abstract=2287202>

³ Berkshire Hathaway Inc. 2007 Annual Report. 2008. www.berkshirehathaway.com/2007ar/2007ar.pdf

⁴ Asness, Clifford et al. Quality Minus Junk. 2019. *Review of Accounting Studies*, 24, 34-112.

⁵ Ang, Andrew. et al. A Systematic Approach to Sustainable and ESG Investing. 2024. *Financial Analysts Journal*. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=5124671

⁶ Dunn, Jeff, et al. Assessing Risk through Environmental, Social and Governance Exposures. *Journal of Investment Management*. <https://joim.com/wp-content/uploads/remember/downloads/p0566.pdf>.

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