

# Quality Under Pressure: Cyclical Headwind Or Structural Shift?

By Paul Ehrlichman



**FLEXTION** It's about *time*.

Quality investing has always promised something simple: own the strongest businesses and let time do the work. High returns on equity. Durable margins. Consistent cash flow. Prudent balance sheets. In theory, it's the safest corner of the equity market.

Yet over the past three to five years, quality strategies have steadily lagged the broader U.S. market. The question investors must now confront is whether this is just another rotation — or a deeper reset in what "quality" really means.



Part of the underperformance is cyclical. Capital has gravitated toward economically sensitive sectors — energy, industrials, materials — that benefit most from fiscal stimulus and reflation. In periods when growth expectations accelerate, markets reward operating leverage over stability. Steady compounders look uninspiring next to cyclical torque.

### **But rotation alone doesn't explain the pressure.**

Secular forces are quietly reshaping many businesses once considered textbook examples of quality. Artificial intelligence is challenging established software franchises. Consumer behavior is shifting away from legacy food and beverage brands. Healthcare companies face regulatory scrutiny and pricing constraints. Businesses that once generated predictable, high-margin growth now confront slower expansion, rising capital intensity, and greater earnings volatility.

Value investors know the fear of the "value trap" — a stock that looks cheap but keeps falling as the business deteriorates. Printed media. Brick-and-mortar retail. Traditional advertising agencies. Legacy automakers. Low multiples did not save them.

Quality investors face a different but equally dangerous risk:

### **THE "QUALITY TRAP."**

A company may look pristine based on historical metrics, yet its economics may already be eroding beneath the surface. Growth slows. Cash flow becomes less reliable. Capital requirements rise. Meanwhile, the stock remains expensive because investors are still paying for yesterday's stability.

History offers a reminder. In the mid-1990s, Coca-Cola traded at more than 40 times earnings — a premium so high that even solid execution couldn't justify it for years. Today, Walmart and Costco sit at record valuations and dominate many quality portfolios. At the same time, quality strategies remain heavily tilted toward technology and largely absent from materials and energy — precisely the sectors that have benefited most from reflation and global liquidity shifts.

**This concentration risk increases the odds of missing the next phase of leadership.**

The solution may not be abandoning quality — but refining it. Research by Professor Joseph Piotroski found that combining strong quality metrics with attractive valuations produced annualized outperformance of roughly 7%, particularly among smaller-cap companies. Blending quality with value discipline — and expanding exposure to small-cap and international markets — may help investors avoid overpaying for perceived safety while positioning for structural change.

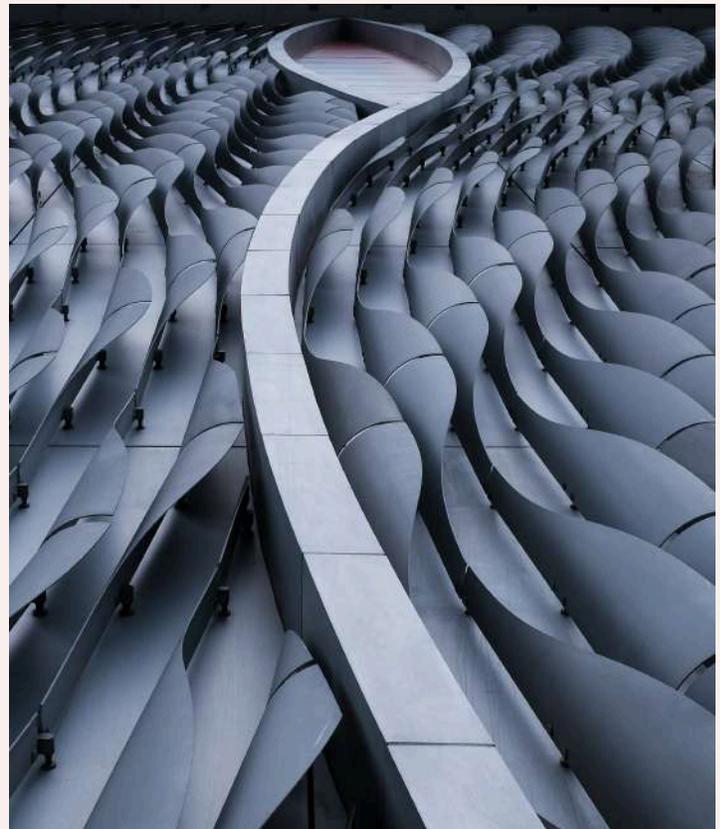
Quality investing is not broken. But it is being repriced. The market is no longer rewarding quality simply because it once worked. It is demanding adaptability, durability, and valuation discipline.

## The critical distinction now is this: Are you buying quality - or paying too much for comfort?

That line may define the next cycle of returns.

Below are some funds, ETFs and SMA's that we find interesting.

- ▶ Vontobel Quality Growth Emerging Markets Equity SMA
- ▶ GMO Quality Strategy SMA
- ▶ Saratogo RIM Large Cap Quality SMA
- ▶ Port Street Quality Growth Fund
- ▶ Westwood Quality Small Cap
- ▶ Haverford Quality Equity SMA
- ▶ Wisdomtree International Quality Dividend Growth ETF
- ▶ Fidelity Quality Factor ETF
- ▶ Invesco S&P 500 Quality ETF
- ▶ Victoryshares Free Cash Flow ETF



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### About the Author

Paul Ehrlichman, Flextion's CEO and CIO, has over four decades of experience in portfolio management, leveraging fundamental and quantitative research to develop investment processes and strategies that enhance client returns and manage risks in volatile markets. He has led equity teams focused on global and international value strategies, serving a diverse client base that includes individuals, pension funds, and endowments at several leading global asset managers.

**Flextion** is a breakthrough platform for evaluating fund strategy returns, helping investors identify managers at a pivotal turning point—those poised to outperform after a period of underperformance. Designed by seasoned portfolio managers, Flextion bridges the gap between "clock time" and "market time," empowering investors to unlock long-term value and uncover hidden performance potential.

### For more information contact:

Paul Ehrlichman, CEO and CIO ▶ [paul@flextion.ai](mailto:paul@flextion.ai)  

Bevin Crodian, President and COO ▶ [bevin@flextion.ai](mailto:bevin@flextion.ai) 