

Looking out at what markets are signaling

Is Quality Broken?

AI-driven disruption is testing standard definitions of profitability

Key Takeaways

- **AI-driven disruption is testing standard definitions of quality.** In transformative innovation cycles, markets historically reward anticipated earnings acceleration over established operating strength.
- **Factor cycles tied to technological change can be prolonged.** Past episodes - most notably in the 1990s - demonstrate that these rotations can persist longer than expected.
- **Diversification across complementary factors is critical.** Blending quality with value and momentum may provide greater resilience than reliance on any single style.

Is quality broken? This has been a recurring question in our recent conversations with investors as quality has meaningfully underperformed over the past several quarters.

We don't believe so. Our research suggests that quality - defined by companies with high operating profitability - has generated excess returns across most market portfolios over the long term. That said, like every factor, it is cyclical and influenced by prevailing market dynamics. Periods of underperformance are not necessarily evidence of structural failure (though implementation matters); they often reflect shifting leadership and evolving economic regimes.

Today's debate is unfolding against the backdrop of broad AI-driven disruption, which may prove to be one of the most meaningful technological shifts in decades. Historically, innovation of this scale has rewarded inflections in profitability rather than established profitability. As new technologies reshape cost structures, competitive advantages, and growth expectations, markets tend to reward anticipated earnings acceleration over demonstrated historical returns. In these environments, backward-looking measures of quality can lag as investors pay for perceived future dominance and rotate away from businesses viewed as more exposed to disruption - software arguably being central to this shift today. This dynamic highlights two vulnerabilities for quality: valuation risk - what investors are willing to pay for dependable compounding - and sensitivity to regime change - when innovation reshapes both market preferences and future fundamentals.

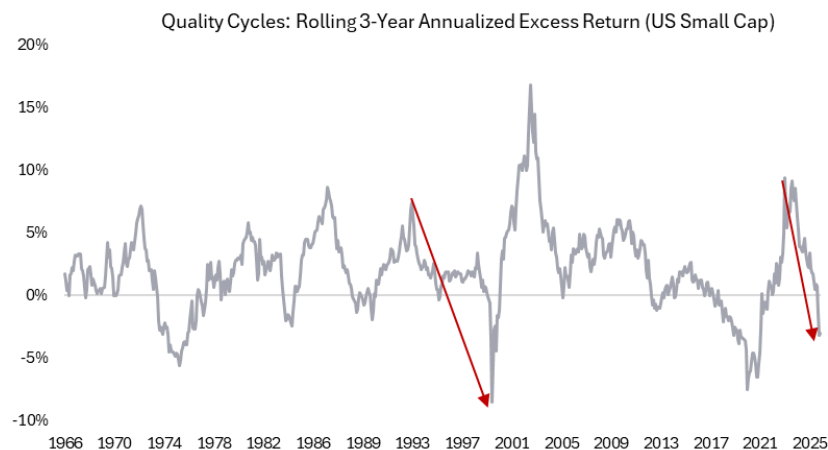
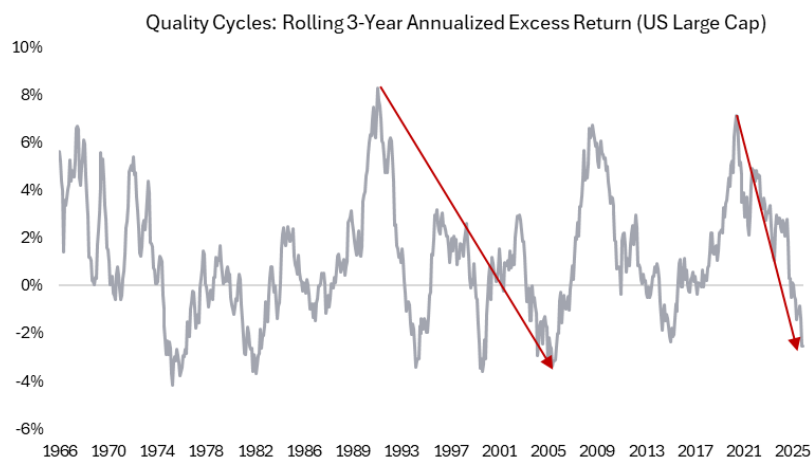
Importantly, this is not unprecedented. During the mid-to-late 1990s, amid the rise of the internet, quality experienced a prolonged stretch of relative underperformance (see nearby charts). It was not a brief anomaly, but a sustained cycle driven by enthusiasm for transformative growth and the repricing of future opportunity. While the cycle eventually turned, the adjustment was neither quick nor predictable. If history offers any guidance, factor cycles tied to major technological shifts can persist longer than many expect.

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None of this necessarily implies that quality is broken. It may simply be behaving in line with past cycles. In our view, the appropriate response is balance, not abandonment. We believe a portfolio that blends quality with value and momentum - factors that tend to lead at different points in the cycle and have shown an ability to generate excess returns over the long term - may offer greater resilience. However, many investors appear to carry a quality and value bias while remaining underexposed to momentum. In periods of rapid disruption and shifting leadership, momentum may help diversify risk and cushion extended quality underperformance. Over time, combining complementary factors - not relying on a single style—is what we believe supports more durable outcomes.



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