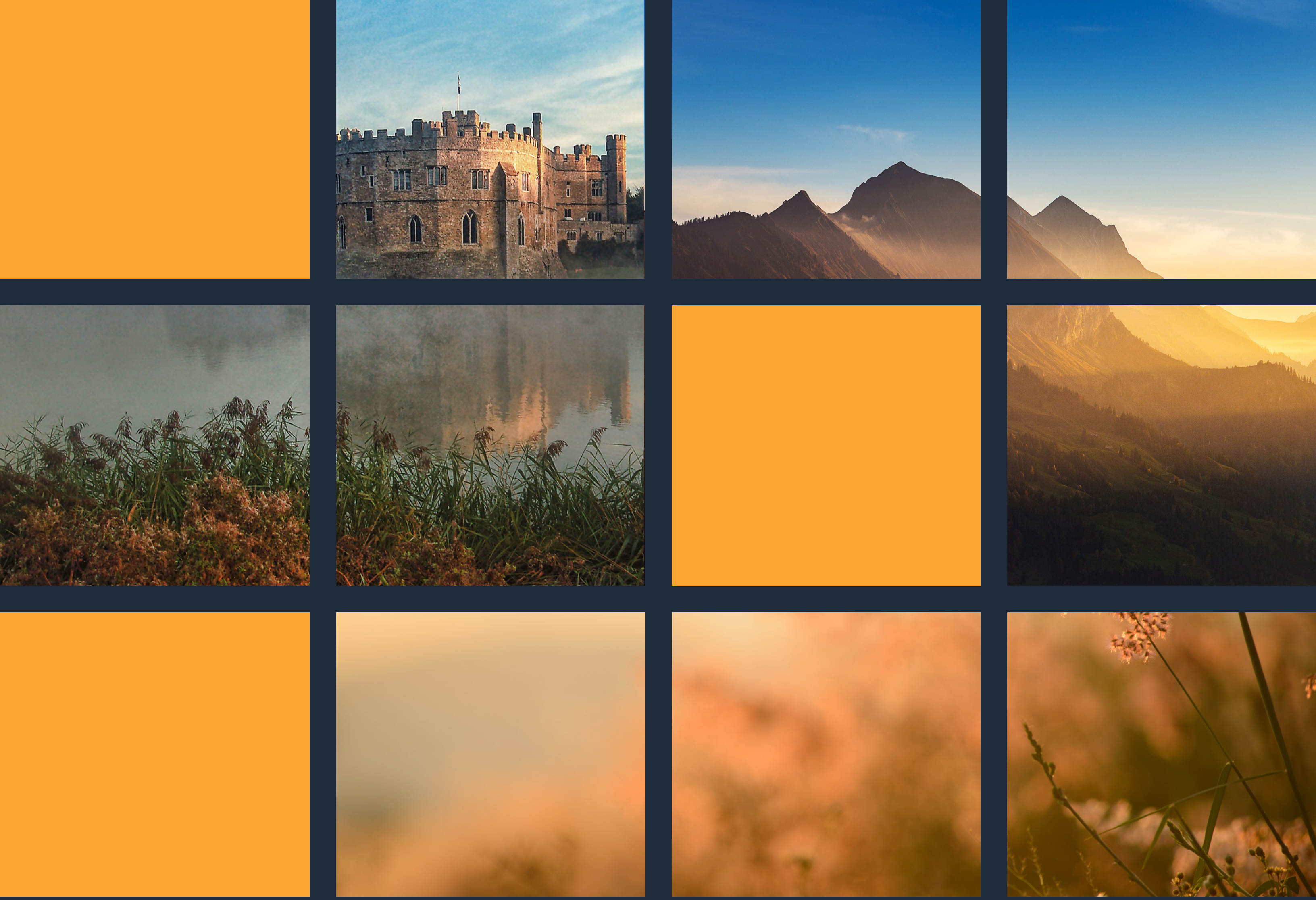


International Quality Growth

The Power of Quality Investing

LAZARD
ASSET MANAGEMENT

International Quality Growth

The Power of Quality Investing

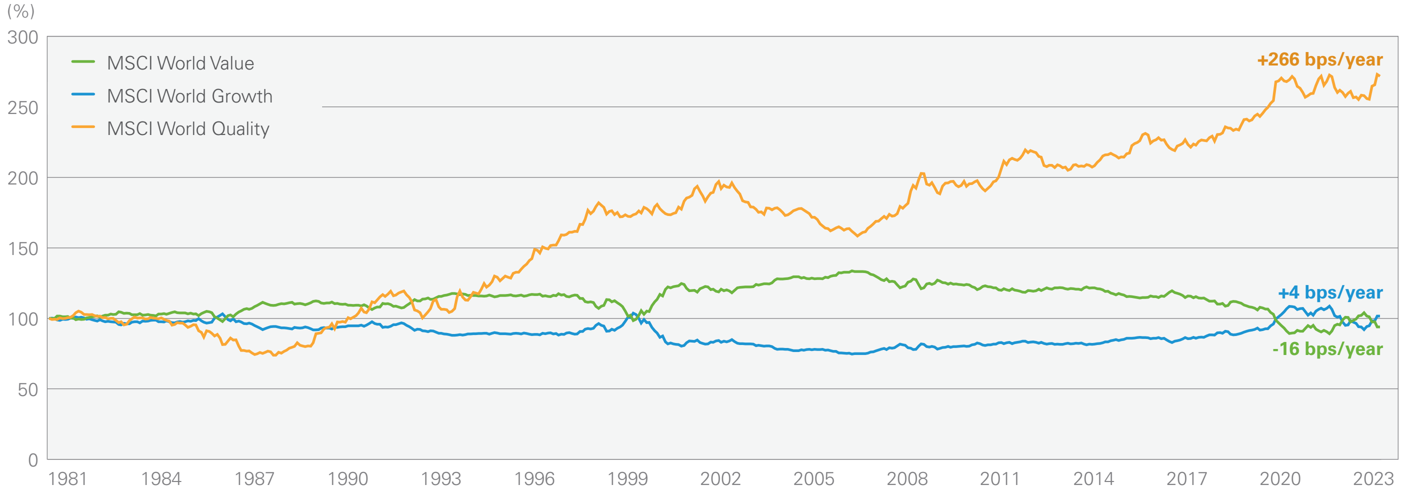
Buy quality companies. It seems intuitively like a straightforward path to investment success, and history supports the argument. As an investment style, however, quality does not get nearly the attention of value (buying cheap companies) or growth (buying fast-growing companies). Yet, quality has outperformed both value and growth in global markets for decades (Exhibit 1).

Even more curious than the fact that such a successful strategy is often sidelined in investment debates is that the definition of "quality" is often, at least in our view, profoundly misunderstood. MSCI defines quality as a combination of financial productivity, low leverage, and stability. We do not believe these factors are created equal, however. Financial productivity—as measured by cash flow return on investment, and return on equity—is the most important metric, in our view, and the driver of the other two components used by MSCI. Importantly, companies with high financial productivity have also consistently outperformed other companies since the early 1990s, based on our analysis.

The market often undervalues financially productive businesses because it assumes, based on economic theory, that competitors will slowly (or not so slowly) nibble away a company's edge, and therefore, its outsized profitability. In our view, however, certain companies have such strong barriers to competition that they can maintain high financial productivity for longer than the market expects. The length of time a company can maintain its competitive advantage, and therefore its extraordinary financial productivity, is the critical element of the International Quality Growth investment philosophy.

Financially productive businesses generate a lot of cash, and we care a great deal about what management does with that cash. We want to buy companies that not only generate high levels of financial productivity, but that also reinvest that

Exhibit 1
Relative Performance versus MSCI World Index



Data is from 30 November 1981 to 30 June 2023.
All data in USD. Indices are Net Total Return.
Source: Lazard, FactSet, MSCI

cash back into the business without eroding the high rates of return that attracted us there in the first place. Done properly, this can help solidify the firm's competitive advantage and set it up for participation in a virtuous circle, which we call the Compounding Cycle (Exhibit 2). The more cash the business generates, the more the company can reinvest in itself. If its investments are the right ones, they will help the business generate more cash to reinvest, and so on. A manufacturing company can invest in automation and optimization that makes it more efficient and lowers costs beyond what competitors can match. A technology company can invest in improving its product to make sure it stays cutting-edge. Healthcare companies can invest in the basic research that keeps their pipelines flowing. Each investment that stands to increase the future rate of return on each dollar of cash flow or that keeps competitors at bay a little longer stacks on top of the one before, with the potential to compound cash flow.

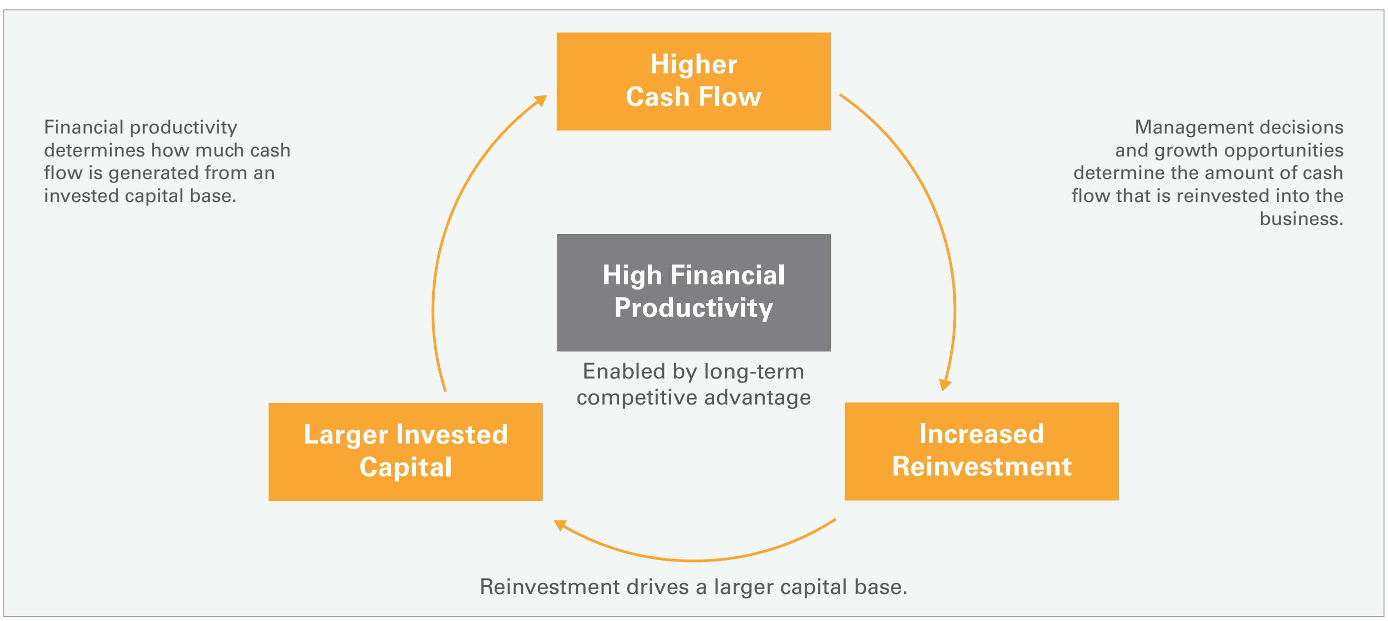
In selecting companies for our International Quality Growth strategy, we require that every company has:

- a **highly profitable business model** now, as opposed to plans to grow into one later
- the ability to **grow its cash flow** over time by reinvesting back in its business while sustaining a high rate of return
- barriers to competition that we believe will allow it to maintain high financial productivity longer than the market expects, which in turn makes it **undervalued**.

In the end, we believe a quality company is one that generates a lot of cash and reinvests it wisely so that it can defend and grow its competitive advantage. It's as simple and as complicated as that. Investing according to this definition has allowed our strategy to perform consistently in a wide range of market environments.

So, as investment managers try to engage you in the debate over value versus growth, we suggest considering the style that has historically beat them both: quality.

Exhibit 2
Sustained Financial Productivity Is the Heart of the Compounding Cycle



This information is for illustrative purposes only.
Source: Lazard

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The MSCI World Growth Index captures large and mid-cap securities exhibiting overall growth style characteristics across 23 Developed Markets (DM) countries. The growth investment style characteristics for index construction are defined using five variables: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate, long-term historical EPS growth trend, and long-term historical sales per share growth trend.

The MSCI World Value Index captures large and mid-cap securities exhibiting overall value style characteristics across 23 Developed Markets (DM) countries. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price, and dividend yield.

The MSCI World Quality Index is based on MSCI World, its parent index, which includes large and mid-cap stocks across 23 Developed Market (DM) countries. The index aims to capture the performance of quality growth stocks by identifying stocks with high quality scores based on three main fundamental variables: high return on equity (ROE), stable year-over-year earnings growth, and low financial leverage. The MSCI Quality Indexes complement existing MSCI Factor Indexes and can provide an effective diversification role in a portfolio of factor strategies.

The indices are unmanaged and have no fees. One cannot invest directly in an index.

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