CAMPBELL NEWMAN

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WHAT IS QUALITY AND WHY YOU WANT IT

Campbell Newman (CN) is a boutique investment management firm best known for investing in "quality" companies. Quality is a rather vague term used by many investment managers to characterize their style of investing as safe or conservative. The term is used liberally throughout investment literature. Some investment managers focus on balance sheet metrics while others focus on income statement metrics to define quality. Both have their merits but, does the term have any tangible influence specific to the investment strategy? In the following paragraphs we will define what quality means to Campbell Newman and its Small Cap Growth strategy, along with how it influences the construction and behavior of clients' investment portfolios.

To start it might be helpful to first review the definition of "quality" embedded in the Small Cap Growth strategy as expressed in our investment philosophy. We believe that:

"Profitability is tangible evidence of the validity of a company's business model, increasing the probability of sustainable earnings growth and stock price appreciation."

This philosophy and our bottom-up investment process are differentiated by this strict focus on profitability.

Our process begins with a screen of all Russell 2000 Growth Index constituents to eliminate the companies that are not profitable on a trailing four-quarter basis from our investable universe.

This screen typically eliminated about 30% of the Russell 2000 Growth's ~1,109 companies because they operate at a loss! More recently, nearly 50% of the benchmark's companies have been unprofitable, and thus removed by the screen.

Profitability is a key quality characteristic because:

"The use of traditional research and valuation metrics is more insightful and reliable when applied to profitable companies, compared to the speculation necessary when analyzing unprofitable companies."

Quality implies greater predictability and consistency. Standard analysis metrics like return on equity and price/earnings ratios become non-sensical when calculated with the negative outputs from a money-losing business, thus losing most predictive value. As well, unprofitable companies are by definition unable to self-fund so that an analyst must guess at metrics like the capital burn rate and whether new financing will be available when needed.

Let's now turn our attention to some of the positive portfolio statistics generated due to the imbedded quality bias of the strategy. Small Cap Growth is constructed to participate in up markets and protect during down markets in order to outperform the Russell 2000 Growth benchmark over a market cycle at lower levels of risk.

Since inception, Small Cap Growth's downside capture ratio is 88.10%. In addition to protecting during selloffs, the strategy participates well in rising markets with an upside capture ratio of 99.66%[1] Recall that volatility doesn't cut equally both ways. If a price declines by 50%, it must rise 100% just to get back to even. If it goes down by 25%, it only has to appreciate by 33% to get back to even.

From Small Cap Growth's inception on January 1, 2014, there have been nine quarters when the Russell 2000 Growth Index had negative returns. Tellingly, Small Cap Growth beat the benchmark, net of fees, in seven of the nine down quarters, or 78% of the time. Importantly, in these down quarters for the Index, Small Cap Growth outperformed, by an average of 270 bps on a net of fees basis. Further, the strategy actually had positive returns in two of these quarters.

Another common measure of volatility is Beta, which is frequently paired with Alpha, a measurement of a strategy's excess return. The Campbell Newman Small Cap Growth strategy has produced compelling risk/return statistics by these measures, again pointing toward quality:

SINCE INCEPTION[2]	BETA	ALPHA
Small Cap Growth	0.89%	4.48%

Source: Zephyr

Campbell Newman's bottom-up process of building the portfolio with carefully selected high-quality companies has historically dampened the volatility of returns versus the benchmark.

Why is this important? It is said that emotions are the worst enemy of investors during periods of heightened volatility because they interfere with rational thought. Protecting on the downside provides investors with greater security in the moment of turmoil while also giving them a larger pool of capital to work with when markets improve.

For more information, please visit campbellnewman.com or call John Bonnell at (414) 635-1002.

IMPORTANT DISCLOSURES:

[1]Statistics shown as supplemental information only and compliment the full disclosure presentations, which are available upon request.
[2]Inception date for Large Cap Dividend Growth composite is 7/1/03. Inception date for Small Cap Growth composite is 1/1/14. NOTE: All performance periods are as of 12/31/22 and presented net of fees.

Past performance is not indicative of future results. All investments involve risk, including possible loss of principal. There is no guarantee investment objectives will be met. Gross returns are presented before deducting management fees (and custodian fees) and include the reinvestment of all income. Net returns are presented after deducting management fees (and custodian fees) and include the reinvestment of all income. Performance returns are calculated using a time-weighted formula with appropriate adjustments for cash flows, and include all dividends and interest, accrued income, and realized and unrealized gains or losses. Indexes are unmanaged and do not incur fees or expenses. It is not possible to invest directly in an index.

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