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Investment Perspectives

Equities: Exploring Quality Metrics in Value Stocks

Portfolio Manager, John Hardy, explains what represents quality in value investing today.

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KEY TAKEAWAYS

- Higher interest rates have re-anchored markets around fundamentals, making quality and cash flow matter again.
- Modern value investing looks beyond traditional metrics, focusing on free cash flow and capital discipline in a higher cost of capital world.
- Market volatility and artificial intelligence (AI)-driven disruption could create opportunities where consensus expectations may be wrong.

With interest rates closer to historical norms and capital once again carrying a real price, the current environment has restored differentiation between companies with durable cash flows and those dependent on easy financial conditions. Here, we explore the importance of quality equities and the metrics active managers use to help identify opportunities in the space.

Why has quality become so important for value stocks in a higher-rate world?

When rates were near zero, the penalty for poor capital allocation decisions was much lower, and the performance gap between companies that made money and those that didn't narrowed as valuations expanded across the market.

With interest rates at today's levels, companies must earn well above their cost of capital to create a cushion that allows them to reinvest in their businesses or return capital to shareholders through buybacks. When rates were near zero, the distinction between companies that made money or not had much less impact on stock performance. Since rates began rising in 2021, however, the performance gap between profitable and unprofitable companies has widened significantly, creating potential opportunities for active investors to distinguish between the two with a focus on quality and discipline.

How does the growth of AI fit into a value investing framework?

Investor concerns around AI have increasingly focused on which industries and sectors could be disrupted by its adoption. The bigger source of confusion, however, is identifying who ultimately benefits. The value team views it through the same top-down framework applied to other structural shifts across industries, whether they unfold at a micro or macro level. Within that framework, companies can be categorized into four groups:

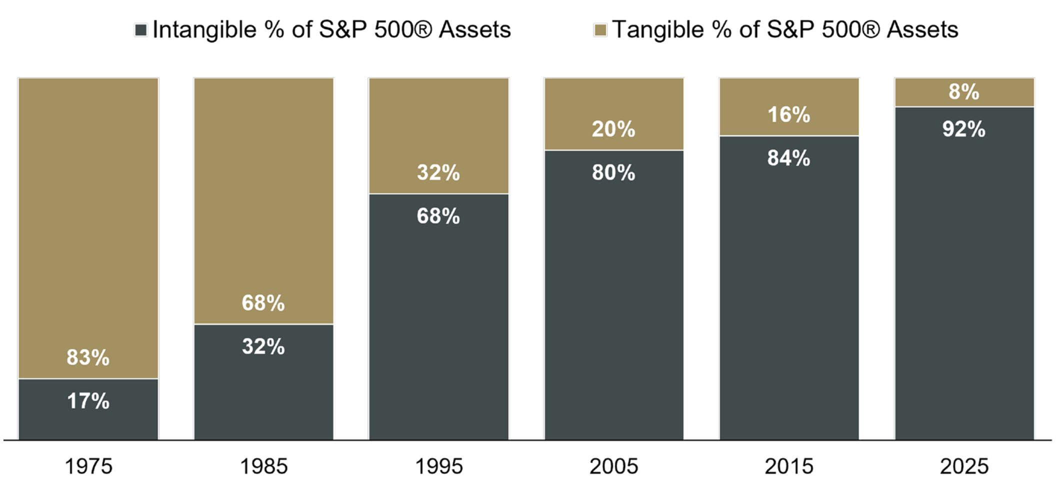
1) Companies that both we and the market believe will benefit from AI. These businesses are typically fairly valued or even expensive, reflecting broad consensus around their upside.
2) Companies the market expects to benefit from AI, but where we disagree. These are companies we avoid, as we do not see the anticipated gains materializing.
3) Companies that both we and the market believe will be negatively impacted by AI. These are generally uninteresting from an investment standpoint.
4) Companies the market believes will be harmed by AI, but we see opportunity. This is where we are spending the most time today, as misperceptions around AI's impact may be creating attractive entry points.

This final group, where market expectations appear misaligned with fundamentals, is where we believe active investors have the greatest opportunity to add value.

What is a modern value equity view of valuation and risk management?

Traditional measures like price to book once defined value, but as intangible assets have become a larger driver of returns, those metrics have lost relevance (see Figure 1).

Figure 1. Company Balance Sheets Have Changed with the Technology Boom



Municipal Bonds

Senior Unsecured Corporates

Source: Kenneth French data library at Dartmouth as of 2/28/2026. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. **Past performance is not a reliable indicator or guarantee of future results.**

Today, valuation looks beyond surface-level "cheapness" to fundamentals such as:

- **Free cash flow**—the capital a company can reinvest or return to shareholders
- **Capital requirements**—the amount of capital required to generate earnings
- **Earnings durability**—the durability of returns across economic cycles

A stock may appear inexpensive, but without strong cash generation and reasonable capital intensity, it may offer little true value. Risk management is embedded directly into the selection process, rather than reacting after purchase. It emphasizes systematic assessments of quality, fundamental stability to avoid value traps—a stock that looks cheap based on traditional valuation metrics but stays cheap, or gets cheaper, because the underlying business is deteriorating—and portfolios driven by stock-specific insights rather than macro bets.

Looking Ahead

Large parts of the economy have experienced only modest growth since the COVID-19 pandemic. Manufacturing activity, housing, and select cyclicals remain subdued, suggesting the next phase may not begin from a place of excess. In that backdrop, maintaining a quality bias toward leverage and cash flow remains critical. For disciplined value investors, the current mix of normalized rates, uneven growth, and innovation-driven disruption may offer a more balanced opportunity set where active investors can thrive.

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Glossary & Index Definitions

Cost of capital is the minimum rate of return a company must earn on its investments to satisfy its providers of capital (both debt and equity investors).

Fama-French: In 1992, Eugene Fama and Kenneth French released their influential research on how to define value companies, growth companies, and the high-minus-low (HML) factor, which showed, historically, how value companies had outperformed growth companies, i.e., the value premium. Value companies were defined as companies with lower price-to-book values (P/B), while growth companies had higher P/B ratios.

Free cash flow (FCF) represents the amount of cash generated by a business, after accounting for reinvestment in non-current capital assets by the company. **Normalized free cash flow** attempts to smooth out a company's FCF by excluding non-core operations and one-time items.

Growth/Value Investing: Growth stocks may be characterized as equities of companies that have demonstrated better-than-average gains in earnings in recent years and that are expected to continue delivering high levels of profit growth. Growth equities typically carry higher price-to-earnings multiples than the broader market, high earnings growth records, and greater volatility than the broader market. **Secular growth stocks** are stocks of companies whose economic performance is relatively immune to economic cycles. **Value stocks** may be characterized as equities of companies that have fallen out of favor with investors but still have good fundamentals, or new companies that have yet to be recognized by investors. Value stocks typically feature lower price-to-earnings multiples than the broader market, and often industry peers, and somewhat lower volatility than the overall equity market.

Market capitalization: The U.S. Financial Industry Regulatory Authority, or FINRA, defines the following categories of stocks based on their market value: mega cap stocks, $200 billion or more; large cap stocks, between $10 billion and $200 billion; mid cap stocks, between $2 billion and $10 billion; small cap stocks, between $250 million and $2 billion; and micro cap stocks, less than $250 million.

The **price-to-book ratio** compares a company's market value to its book value. The market value of a company is its share price multiplied by the number of outstanding shares. The book value is the net assets of a company.

Price-to-earnings ratio: Stock analysts calculate a price-to-earnings ratio by dividing a stock's current price by its earnings per share on a trailing 12-month basis. A forward price-to-earnings ratio is calculated by dividing a stock's current price by estimated future earnings per share.

Tangible assets are assets with a physical form and that hold value. Examples include property, plant, and equipment. **Intangible assets** lack physical substance and include are patents, copyright, franchises, goodwill, trademarks, and trade names.

A **top-down** investment process generally places more emphasis on macroeconomic forecasts than on individual stock picking. A bottom-up approach typically relies on selecting individual securities as the primary driver of investment returns.

Value trap refers to a stock that appears to be attractively priced based on company fundamentals and the stock's market price but ultimately provides either a negative or subpar return.

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