

Beyond the Barbell: Why Quality Stocks Enhance Your Portfolio

The typical “barbell” strategy of a blended allocation to growth and value strategies can effectively decrease portfolio volatility and improve performance through a market cycle when solely compared to growth- or value-oriented portfolios. It often overlooks the significance of integrating the “quality” factor. We advocate for including a third factor into this blended allocation, adding quality as a factor allocation. Adding quality along with “value” and “growth” styles can cultivate greater downside protection and a less volatile portfolio while still offering growth potential for long-term investors.

What are quality companies, and why do they matter?

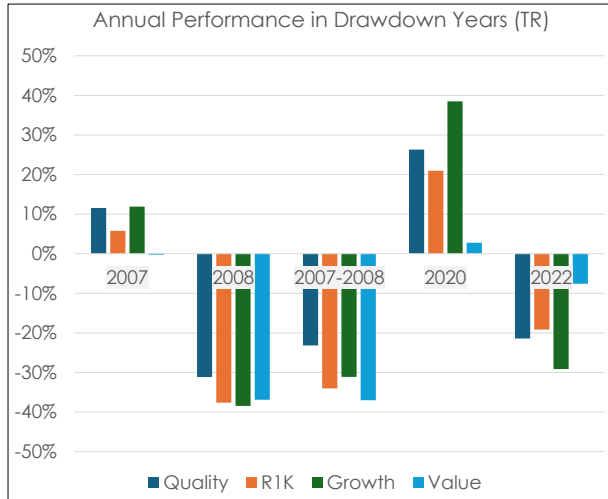
Quality companies tend to have low leverage and strong cash flows, making them less vulnerable to elevated interest rate environments. Additionally, they often possess pricing power, enabling them to pass increased costs onto customers, thereby shielding margins during periods of high inflation. These companies prioritize not only revenue growth but also profitability and efficient use of capital, making them more resilient during economic stress. Other characteristics include sustainable dividends, decreased earnings variability, and robust competitive advantages.

These characteristics mitigate the risk of falling into a value trap by identifying undervalued companies with sound fundamentals rather than merely focusing on those that appear inexpensive. Moreover, they also offer a smoother, more consistent growth trajectory, as high-growth stocks can often be highly volatile in adverse market conditions, especially when they trade at inflated valuations. Therefore, integrating value, growth, and quality elements within a portfolio enhances its resilience across various market conditions, bolstering stability throughout economic cycles.

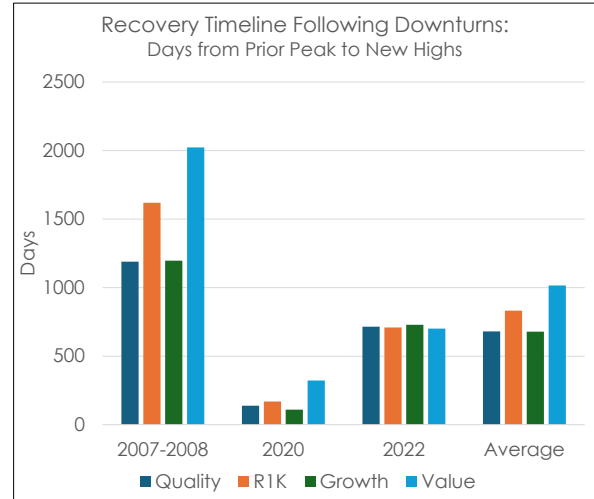
Characteristics	Growth	Value	Quality
Focus	Companies with high earnings growth potential	Undervalued stocks trading below intrinsic value; Emphasis on finding overlooked companies.	Companies with robust fundamentals, competitive advantages, and consistent profitability
Advantages	Potential for rapid price appreciation during bull markets	May offer dividend income and relative safety in down markets; significant gains if undervaluation is corrected.	Lower volatility and downside risk compared to growth stocks. Well-suited for long-term investors focused on wealth preservation.
Valuation	High	Low	Moderate
Volatility	High	Low	Low
Dividends	Low or none	High	Generally average, safer, and growing dividends
Potential Risks	Can become disconnected from fundamentals; Prone to sharp corrections when sentiment shifts; Innovation risk: may fail to live up to the hype.	May underperform in bull market; Value Traps that may stay undervalued	Less potential for dramatic short-term gains; may lag behind and appear less exciting vs. growth stocks in bull market
Rationale	Future earnings will justify a higher current price	Market will eventually recognize undervaluation, leading to price appreciation	Sustainable business models will lead to long-term outperformance

Performance in Turbulent Times: Quality Stands Out

Historical data confirms that quality stocks, defined as companies with robust fundamentals and proven track records, showcase resilience during market volatility. They are less likely to experience sharp declines during downturns and tend to recover faster from troughs. Therefore, quality factors can have a tangible impact on portfolio performance, especially when it matters the most.



Source: Bloomberg



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Why consider Brookmont for your quality style exposure in high-interest-rate environments?

With a macro backdrop that includes higher for longer rates caused by improving but persistent inflation and strong employment, combined with slowing consumer spending and increased geopolitical tension, the team at Brookmont believes that focusing on companies with solid balance sheets and durable business models is the best way to minimize risk. Brookmont's rigorous evaluation process includes analyzing companies' cash flows from operations while considering investing and financing cash flows to gauge their ability to meet capital allocation needs. We do not believe that any of our holdings are short-term investments. We continuously evaluate them to ensure that their fundamentals align with our prioritization of long-term growth and stability of free cash flows and dividends. This highlights the importance of Brookmont's process and its success in capitalizing on the market upside, boasting an upside capture ratio of 95% while maintaining a relatively low downside capture of 66% since its inception.

Brookmont focuses on near-term cash flows within our 3–5-year investment horizon, so our investments typically have a shorter "equity duration" compared to much of the market. This shorter "equity duration" among the companies in our strategies translates to less volatility and reduced sensitivity to changes in interest rates. Consequently, this positioning sets us up favorably to outperform the market, even in the event of further rate increases.

	DGS	Russell 1000 Value
Net Leverage	1.73	1.74
Interest Coverage	39.7	19.07
ROE	25.84%	17.28%
ROA	9.01%	5.98%
Total Debt/Capital	48.91	48.16
Profit Margin	18.80%	13.42%
ROC	15.55%	12.51%

The Brookmont Dividend Growth Strategy has a weighted average net leverage ratio ((Gross Debt – Cash & Cash Equivalents) / TTM Adjusted EBITDA) of 1.35x, which is 0.18x lower than the Russell 1000 Value, indicating a lower level of debt. The strategy also has an interest coverage ratio (TTM Adjusted EBIT / Interest Expense) of 30.30x, which is 5.31x higher than the Russell 1000 Value; this demonstrates that, on average, the companies in the Brookmont Dividend Growth Strategy are more able to pay their interest and comfortably sustain their current leverage levels.

Disclosures

This letter may contain "forward-looking statements" which are based on Brookmont's beliefs, as well as on a number of assumptions concerning future events, based on information currently available to Brookmont. Current and prospective clients are cautioned not to put undue reliance on such forward-looking statements, which are not a guarantee of future performance, and are subject to a number of uncertainties and other factors, many of which are outside Brookmont's control, and which could cause actual results to differ materially from such statements. All expressions of opinions are subject to change without notice.

Brookmont Capital Management is a registered investment advisor that invests in domestic and global securities.

Brookmont Capital is defined as an independent investment management firm that is not affiliated with any parent organizations.

A complete description of Brookmont's performance calculation methodology, including a complete list of each security that contributed to the performance of this Brookmont portfolio is available upon request.

Certain economic and market information contained herein has been obtained from published sources prepared by other parties, which in certain cases has not been updated through the date of the distribution of this letter. While such sources are believed to be reliable for the purposes used herein, Brookmont does not assume any responsibility for the accuracy or completeness of such information.

These individual securities do not represent all of the securities purchased, sold, or recommended for this Brookmont portfolio and the reader should not assume that investments in the securities identified and discussed were or will be profitable.

The Brookmont Dividend Growth Strategy returns are based on an asset-weighted composite of discretionary accounts that include 100% of the recommended holdings. Individual accounts will have varying returns, including those invested in the Strategy. The reasons for this include 1) the period of time in which the accounts are active, 2) the timing of contributions and withdrawals, 3) the account size, and 4) holding other securities that are not included in the Strategy. Dividends and capital gains are not reinvested. The Strategy does not utilize leverage or derivatives. Returns are based on U.S. dollars. The inception of the Strategy is January 1, 2008.

The Brookmont Dividend Growth Strategy Composite contains fully discretionary accounts with similar value equity investment strategies and objectives. For comparison purposes, the Dividend Growth Strategy Composite is measured against the Russell 1000 Value Index. The Russell 1000 Value Index measures the performance of the large-cap segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values. The Russell 1000 Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. There is no representation that this index is an appropriate benchmark for such a comparison. You cannot invest directly in an index, which also does not take into account trading commissions and costs. The volatility of this index may be materially different from the performance of the strategy.

The Brookmont Core Dividend Strategy returns are based on an asset-weighted composite of discretionary accounts that include 100% of the recommended holdings. Individual accounts will have varying returns, including those invested in the Strategy. The reasons for this include, 1) the period of time in which the accounts are active, 2) the timing of contributions and withdrawals, 3) the account size, and 4) holding other securities that are not included in the Strategy. Dividends and capital gains are not reinvested. The Strategy does not utilize leverage or derivatives. Returns are based on U.S. dollars. The inception of the Strategy is January 1, 2015.

The Brookmont Core Dividend Strategy Composite contains fully discretionary accounts with similar value equity investment strategies and objectives. For comparison purposes, the Core Dividend Strategy Composite is measured against the Russell 1000 Value Index. The Russell 1000 Value Index measures the performance of the large-cap segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower than expected growth values. The Russell 1000 Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. There is no representation that this index is an appropriate benchmark for such a comparison. You cannot invest directly in an index, which also does not take into account trading commissions and costs. The Volatility of this index may be materially different from the performance of the strategy.

The Brookmont Quality Growth Strategy returns are based on an asset-weighted composite of discretionary accounts that include 100% of the recommended holdings. Individual accounts will have varying returns, including those invested in the Strategy. The reasons for this include, 1) the period of time in which the accounts are active, 2) the timing of contributions and withdrawals, 3) the account size, and 4) holding other securities that are not included in the Strategy. Dividends and capital gains are not reinvested. The Strategy does not utilize leverage or derivatives. Returns are based on U.S. dollars. The inception of the Strategy is January 1, 2015.

The Brookmont Quality Growth Strategy Composite contains fully discretionary accounts with similar value equity investment strategies and objectives. For comparison purposes, the Dividend Growth Strategy Composite is measured against the Russell 1000 Index. The Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower than expected growth values. The Russell 1000 Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment.

Brookmont's returns do include reinvestment of dividends and are shown gross-of-fees. All transaction costs are included. The Russell 1000 Value cumulative return includes reinvestment of dividends and capital gains. During a rising market, not reinvesting dividends could have a negative effect on cumulative returns.

Gross returns will be reduced by investment advisory fees and other expenses that may be incurred in the management of the account. Net-of-fees performance was calculated using actual management fees. Additional information regarding the policies for calculating and reporting returns is available upon request.

Your account returns might vary from the composites returns if you own securities that are not included in the Strategy or if your portfolio dollar-cost averaged into the Strategy during the reporting period.

The firm maintains a complete list and description of composites, which is available upon request. Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. The composite policy requires the temporary removal of any portfolio incurring a client-initiated significant cash inflow or outflow of at least 15% of portfolio assets. The temporary removal of such an account occurs at the beginning of the month in which the significant cash flow occurs and the account re-enters the composite at the beginning of the month which follows the cash flow by at least 30 days. Additional information regarding the treatment of significant cash flows is available upon request.

Brookmont Capital Management claims compliance with the Global Investment Performance Standards (GIPS®). To receive a complete list and description of Brookmont's composites and a presentation that adheres to GIPS standards, please contact Suzie Begando at 214-953-0190 or write Brookmont Capital Management, 5950 Berkshire Lane, Suite 1420, Dallas, TX 75225.

The Brookmont Dividend Growth Strategy is available through several institutional platforms and registered investment advisors that are not affiliated with Brookmont Capital Management. Required minimum investments and advisory fees differ from one firm to another.

Brookmont Capital does not provide comprehensive portfolio management services for investors who have not signed an Investment Management Agreement with our firm.

Past performance is not indicative of future results.