

# Introducing the Quality Adjusted Valuation Ratio (QVR): A New Approach to Stock Valuation and a Quality Active Alternative to Passive Investing

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## ABSTRACT

Traditional valuation metrics, such as the Price-to-Earnings (P/E) ratio, have long been used to assess the attractiveness of stocks. However, these metrics often fail to account for two critical factors: consistency of earnings growth and profitability. This paper introduces the Quality Adjusted Valuation Ratio (QVR), a unique valuation framework that adjusts the traditional earnings multiple for consistency of growth and return on invested capital (ROIC). The Quality Adjusted Valuation Ratio (QVR) is calculated as the Price/Earnings-to-Growth Linearity (PEGLI) divided by ROIC, offering a more comprehensive and nuanced approach to stock valuation.

The components of this ratio: valuation, profitability, and consistency of earnings growth, are some of the key pillars of our alpha thesis and our approach to valuations and security selection. Long term studies demonstrate that these factors outperform over a market cycle. This analysis led us to start looking at valuations from a three-dimensional perspective, adjusting the P/E multiple for consistency of earnings growth and profitability.

## THE SHORTCOMING OF TRADITIONAL VALUATION MEASURES

The earnings multiple is a widely used ratio when it comes to stock valuations, but it has limitations. It does not consider a company's growth prospects or its efficiency in generating returns on invested capital. For example, a high-growth company with a high P/E ratio might appear overvalued, while a low-growth company with a low P/E ratio might seem undervalued. The PEG ratio, which divides the P/E ratio by earnings growth, partially addresses this issue by incorporating the growth component. However, it still ignores profitability and capital efficiency, which are critical to understanding a company's true value-generation potential. For example, a highly acquisitive company growing inorganically just to gain market share could reduce the capital efficiency if the deals turn out to be not accretive and fail to earn the cost of capital.

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## INTRODUCING THE QUALITY-ADJUSTED VALUATION RATIO

The Quality Adjusted Valuation Ratio (QVR) addresses these shortcomings by combining growth and profitability into a single metric. The formula is as follows:

$$\text{Quality Adjusted Valuation Ratio (QVR)} = (\text{PEGLI Ratio}) / \text{ROIC}$$

Where:

- $\text{PEGLI Ratio} = (\text{P/E Ratio}) / (\text{Free Cash Flow Per Share Growth Rate} \times \text{Linearity of FCF/PS})$ 
  - Where: Linearity = R-Squared of historical annual Free Cash Per Share
- $\text{ROIC} = \text{Return on Invested Capital (Cash Flow Based)}$

### Example Calculation

Consider two companies:

- Company A: P/E = 30, Free Cash Flow Per Share Growth = 10%, Linearity (FCF/PS) = 0.80 ROIC = 15%
  - $\text{PEGLI} = 30 / (10 \times 0.80) = 3.75$
  - $\text{Quality Adjusted Valuation Ratio (QVR)} = 3.75 / 15 = 0.25$
- Company B: P/E = 10, Free Cash Flow Per Share Growth = 5%, Linearity (FCF/PS) = 0.20 ROIC = 5%
  - $\text{PEGLI} = 10 / (5 \times 0.20) = 10$
  - $\text{Quality Adjusted Valuation Ratio (QVR)} = 10 / 5 = 2.0$

Despite Company A having a significantly higher P/E ratio, its Quality Adjusted Valuation Ratio (QVR) is significantly better than Company B's, reflecting Company A's superior growth consistency and higher profitability.

The Quality Adjusted Valuation Ratio (QVR) provides a more holistic view of a stock's valuation by:

1. **Adjusting for Consistency of Earnings Growth:** The PEGLI ratio ensures that faster and consistent growth companies are not unfairly penalized for having higher P/E ratios. It also penalizes companies with unstable and volatile growth and high cyclicalities by incorporating the linearity of free cash flow measure.
2. **Incorporating Profitability:** ROIC measures how efficiently a company generates returns from its total invested capital, ensuring that high-quality growth is rewarded.
3. **Focusing on Free Cash Flow Per Share –** We believe this is the best approach of measuring shareholder value creation, adjusting for non-cash charges, required capex, and capital allocation policy with share buybacks and accretive M&A.

A lower and positive Quality Adjusted Valuation Ratio (QVR) indicates a more attractive valuation, as it suggests the stock is priced reasonably relative to its growth and profitability. Conversely, a higher Quality Adjusted Valuation Ratio (QVR) may signal overvaluation.

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## CONFIRMATION OF THE QUALITY ADJUSTED VALUATION RATIO (QVR)

Components of the Quality Adjusted Valuation Ratio (QVR) are some of the key parts of the alpha pillars of our security selection process: Valuation, Consistency of Earnings Growth, and Profitability.

### CONFIRMATION – VALUATION

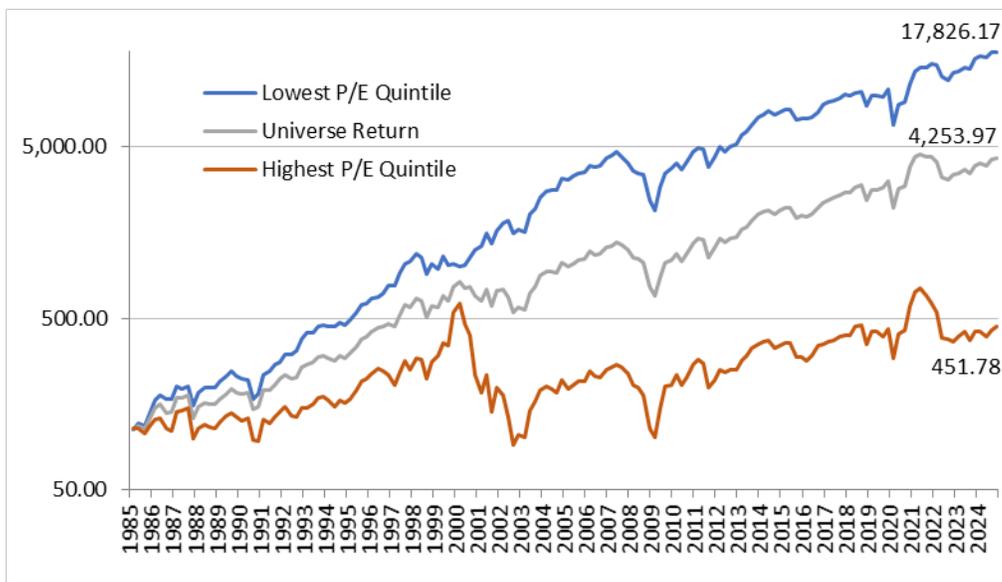
“In the short run, the market is a voting machine, but in the long run, it is a weighing machine.”

- Benjamin Graham

This famous quote highlights how market sentiment can drive prices in the short term, but intrinsic value prevails over time. In fact, the longer-term studies demonstrate the cheapest stocks have outperformed the markets on average while the richest/highly valued stocks have underperformed. Richly valued stocks can provide spectacular performance in a short period and attract the crowd chasing the momentum, but in most cases, valuations tend to reach unrealistic growth assumptions, and that adjustment and stock price correction to reality can be severe. That’s why the valuation factor outperforms in the long run because of the embedded margin of error and the naturally lower expectation feature of the cheaply valued stocks by market participants.

The following chart (Figure 1) demonstrates how valuation has performed over a 30+ year period. Our study shows low P/E has outperformed.

**Figure 1**



\*Source: FactSet, Axioma, Universe Screen Based on 3000 Largest Stocks, 3 Month Rebalance, Linked Returns.

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In the last decade, we witnessed an extraordinary run for U.S. large growth stocks, an incredible rise coinciding with the rise of passive investing, which further contributed to the momentum. This has been the lost decade of value and a challenging period for active management as professional money managers tend to focus more on fundamentals. We are confident that this is an anomaly. As the chart shows, markets ultimately mean revert in the long run and the valuation factor outperforms.

## CONFIRMATION - CONSISTENCY OF EARNINGS GROWTH

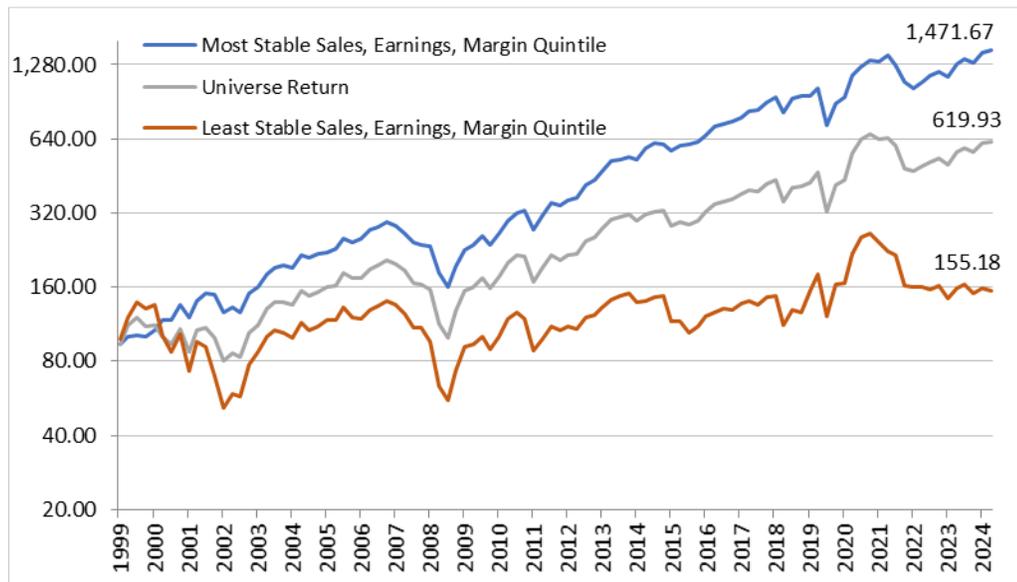
“Look for companies with strong moats.”

- Warren Buffet

This famous quote highlights the importance of a company’s sustainable competitive advantage that protects it from competitors, a key element that enables high returns on capital. The best way to quantify the moat and the quality of the business is to look at a company’s growth and, more importantly, the consistency of growth. A company with a wide moat, high margins and a high-quality business has strong pricing power and the ability to protect the gross margins. This enables the company to generate and sustain consistent growth for a long period of time. These quality companies are the hidden monopolies.

The following chart (Figure 2) demonstrates how consistency of growth has performed over a 25-year period. Our study shows that stocks with consistent growth have outperformed their less consistent peers.

Figure 2



\*Source: FactSet, Axioma, Universe Screen Based on 3000 Largest Stocks, 3 Month Rebalance, Linked Returns.

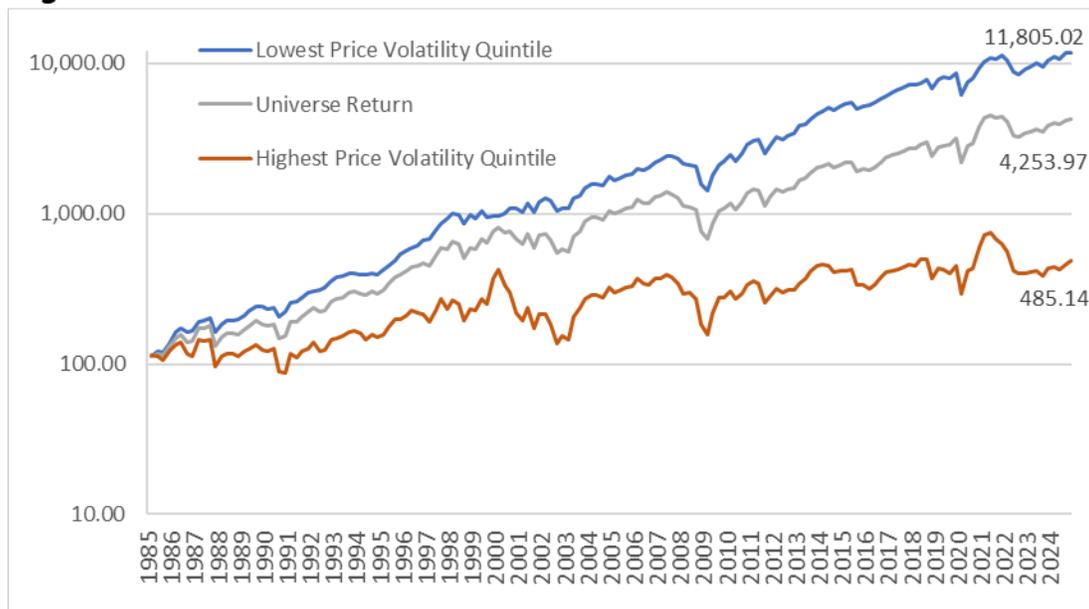
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Companies with strong pricing power and consistent growth tend to exhibit significantly lower price volatility than the market. In fact, our study shows that lower price volatility has outperformed over a longer time period.

The following chart (*Figure 3*) demonstrates how price volatility has performed over a 30+ year period.

**Figure 3**



\*Source: FactSet, Axioma, Universe Screen Based on 3000 Largest Stocks, 3 Month Rebalance, Linked Returns.

It is another illustration that quality businesses with strong pricing power exhibiting the consistency of earnings growth outperform the market over a full market cycle.

## CONFIRMATION - PROFITABILITY

“If a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you’ll end up with a fine result.”

- Charlie Munger

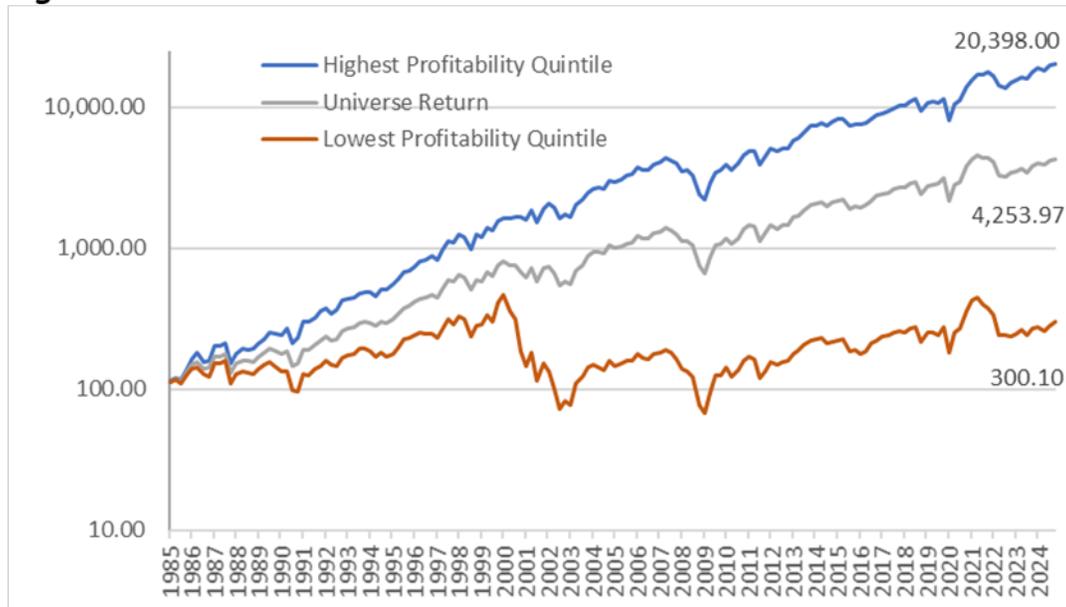
This famous quote emphasizes the importance of the quality of the business to achieve sustainable returns on capital. The best way to quantify the profitability of a company is to look at key ratios such as return on invested capital. A Company with high profitability provides an indication of strong financial health, competitive advantage, and shareholder value creation.

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The following chart (Figure 4) demonstrates how profitability has performed over a 30+ year period. Our study shows profitability has outperformed.

**Figure 4**



\*Source: FactSet, Axioma, Universe Screen Based on 3000 Largest Stocks, 3 Month Rebalance, Linked Returns.

Profitable companies reinvest the earnings into further expansion, which drives future growth and enables sustainable growth and long-term compounding for shareholders. The chart above illustrates the clear benefit of investing in highly profitable companies and the effect of long-term compounding at an above market Compound Annual Growth Rate (CAGR).

## APPLICATIONS OF THE QUALITY ADJUSTED VALUATION RATIO (QVR)

- 1. Comparative Analysis:** Investors can use the Quality Adjusted Valuation Ratio (QVR) to compare companies within the same industry or across sectors, identifying those with the best combination of growth, profitability, and valuation.
- 2. Portfolio Construction:** The Quality Adjusted Valuation Ratio (QVR) can serve as a screening tool for building a portfolio of high-quality, reasonably priced stocks. Sawgrass uses the Quality Adjusted Valuation Ratio (QVR) in our security selection process.
- 3. Risk Management:** By emphasizing profitability (ROIC), the Quality Adjusted Valuation Ratio (QVR) helps investors avoid companies that grow recklessly without generating adequate returns.

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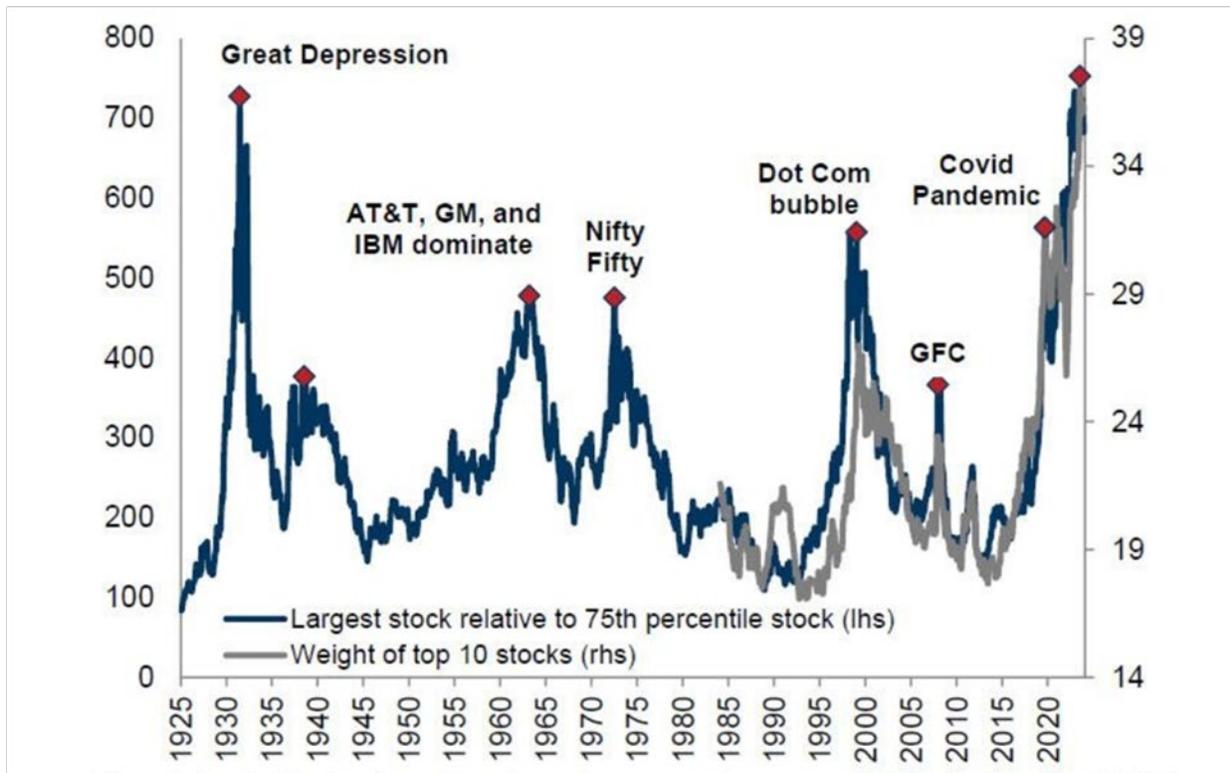
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## QUALITY ADJUSTED VALUATION RATIO (QVR) APPROACH: QUALITY ACTIVE ALTERNATIVE TO PASSIVE INVESTING

Investors can consider an active quality strategy that incorporates the Quality Adjusted Valuation Ratio (QVR) principles, which is based on a quality-adjusted valuation framework. The evidence of the long-term studies shows that formula components/factors outperform in a full market cycle. This approach could mitigate the current risks of a passive strategy, which are extreme concentration and elevated valuations.

The following chart (Figure 5) demonstrates the extreme concentration in a few Mega-Cap stocks. The Top 10 stocks account for nearly 40% of the S&P 500's market capitalization. This level of concentration is historically unprecedented.

Figure 5



\*Source: Goldman Sachs GIR, Keneth R. French, as of 12/31/2024

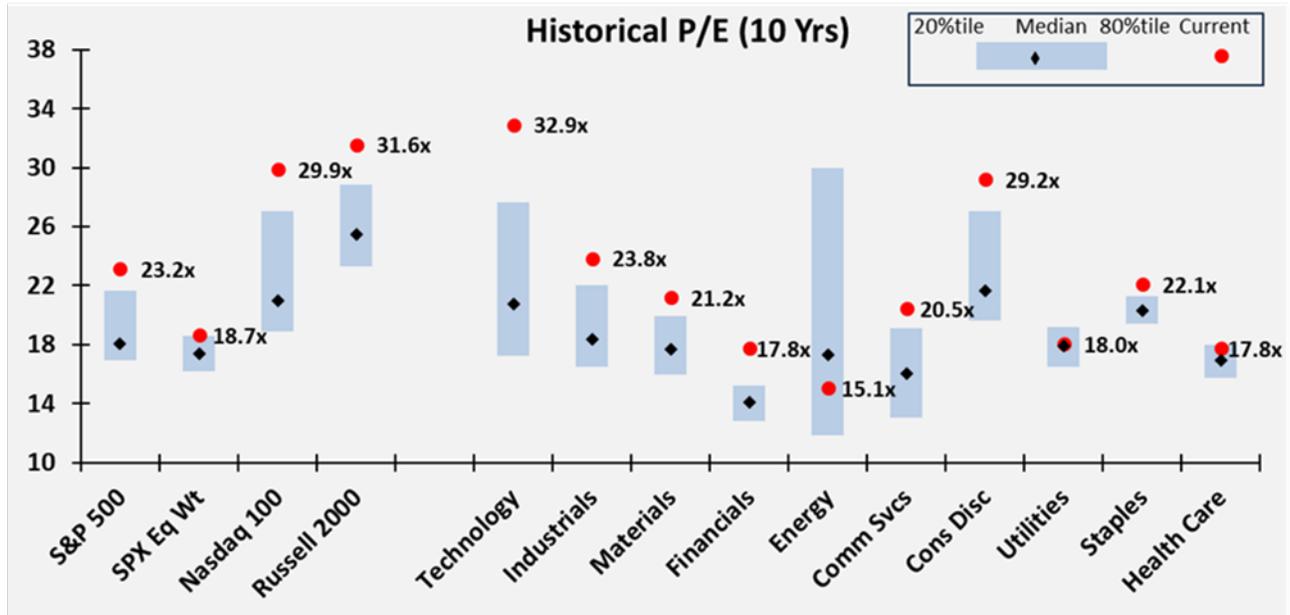
Also, the US equity market is currently trading at historically very rich valuations, raising concerns about the outlook of future expected returns of this asset class. Looking from the perspective of a blend of various valuation multiples (Price to Earnings, Price to Book, Price to Sales, Cyclically Adjusted P/E CAPE), we observe that the U.S. stock market valuations are very elevated relative to historical levels. The extreme valuation is more concentrated in the Mega-Cap stocks; the top ten largest companies trade at a significant premium relative to the rest of the market.

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The following chart (Figure 6) demonstrates that U.S. Equities absolute valuations look stretched.

**Figure 6**



\*Source: UBS Global Research, Bloomberg, as of 12/31/2024

Passive investing has become increasingly popular over the past decade. However, there are hidden risks to this strategy. We identify several disadvantages of passive investing that are relevant especially in the current market environment: extreme concentration, elevated valuation multiples, and rich cross-asset equity valuations with equity risk premium levels near zero (ERP is the most mean-reverting variable in the financial markets). This implies that investors are not getting compensated to take on equity risk at the index level.

While index investing has been a winning strategy for the past decade, the current environment poses significant risks. Investors who are passively exposed to overvalued mega-cap stocks through index funds could face severe underperformance if the market corrects. In such an environment, we believe a quality-focused active strategy applying the principles of the Quality Adjusted Valuation Ratio (QVR) could mitigate risks and improve the risk-adjusted return profile.

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## CONCLUSION

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We believe the Quality Adjusted Valuation Ratio (QVR) represents a novel approach to stock valuation methodology. By integrating valuations, consistency of earnings growth and profitability into a single metric, it provides investors with a more comprehensive tool for assessing stock attractiveness. Also, it offers a forward-looking approach to valuation that aligns with the principles of shareholder value creation.

## AUTHOR

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Co-CIO, Portfolio Manager

20 Years of Investment Experience

17 Years with Sawgrass

Mr. Gila is Co-CIO, Portfolio Manager at Sawgrass. He is a Co-Manager of various Equity and Fixed Income strategies. He is responsible for portfolio construction and fundamental research of the entire capital structure. He serves on several of the firm's committees, including Executive and strategic planning, equity research, and fixed income. Prior to Sawgrass, he worked with Fidelity National Financial as a fixed-income analyst, helping manage fixed-income investments of over \$3 billion. His educational accomplishments include an M.B.A. and B.A. in Finance from the University of North Florida and earning a Chartered Financial Analyst (CFA) designation from The CFA Institute (formerly AIMR), of which he is a member. He is also a member of the Jacksonville Financial Analysts Society.

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