

THE QUALITY PULSE

ONE INSIGHT. ONE PERSPECTIVE. EVERY WEEK.

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6 MIN READ



The price of Quality

When does a great company become a bad investment?

There are two questions in investing that are easy to confuse: is this a great company? And: is this a great investment at today's price?

Quality investors place particular weight on the first question. We look for durable competitive advantages, high returns on capital, strong balance sheets, recurring cash flows and the ability to reinvest at attractive rates. These qualities help us judge what a business may be worth over time. The second question determines whether today's price offers an attractive return for owning it.

That price already reflects assumptions about future growth, margins, reinvestment opportunities and, perhaps most importantly, how long exceptional economics can persist. A company can therefore continue to perform well while its shareholders experience disappointing returns. The business does not have to fail. Sometimes it merely has to perform less exceptionally than the price assumed.

QUALITY DESERVES A PREMIUM – BUT NOT AN UNLIMITED PREMIUM.

THE BUSINESS GREW. THE INVESTMENT SHRANK.

Adobe provides a striking recent example. In fiscal 2021 it looked close to the textbook definition of a Quality company: category leadership in creative software, a predominantly subscription-based model, recurring revenues, extraordinary margins and low capital intensity.

Revenue reached \$15.8b, gross margin was approximately 88%, and GAAP EPS was \$10.10. At the end of 2021, Adobe traded at roughly 57 times fiscal-year GAAP earnings. Investors were not simply paying for the excellent business that already existed. They were paying for the future.



INVESTMENT TAKEAWAY

A price is not a label but a set of expectations. It defines how much a business must deliver for today's buyer to earn an acceptable return.

Adobe did not collapse. Under the fiscal-2026 targets raised in September 2026, the company expects revenue of \$26.58–26.63b and GAAP earnings per share of \$18.12–18.17. If achieved, revenue will have risen by roughly 68% since fiscal 2021 and earnings per share by roughly 81%. Yet the share price on 21 September 2026 was \$249.52 – about 56% below its 2021 year-end close.

+68%

Revenue, fiscal 2021 to 2026:
\$15.8b → \$26.58–26.63b

SOURCE: ADOBE [1], [2]

+81%

GAAP earnings per share:
\$10.10 → \$18.12–18.17

SOURCE: ADOBE [1], [2]

–56%

Share price 31 Dec 2021 → 21 Sep 2026:
\$567.06 → \$249.52

SOURCE: MARKET DATA [3]

56.6x

Valuation at end-2021 on
fiscal-2021 GAAP earnings

SOURCE: HQAM [6]

The company delivered. The investment disappointed.

PRICE IS A SET OF EXPECTATIONS

The conventional debate about whether 20x, 30x or 40x earnings is “expensive” is less useful than it appears. A multiple is not a valuation thesis. It is the consequence of one.

In the previous edition of The Quality Pulse, we argued that growth creates value only when the returns it generates justify the investment required. One variable was still missing: for how long can the company keep doing it?

A capital-light company with durable demand, strong cash generation and room to grow may rationally command a higher multiple than a capital-intensive business with limited opportunities. The better question is: What must this business deliver for an investor buying at today’s price to earn an acceptable return?

The answer depends on the scale of the opportunity, the economics of future growth and its duration. Mauboussin and Callahan call that last element the Competitive Advantage Period: the time over which a company can sustain returns above its cost of capital. Two companies may look equally attractive today, yet have radically different values if one can sustain its advantage for three years and the other for twenty.



WHAT DID ADOBE'S PRICE REQUIRE?

Instead of pretending to know a precise fair value, reverse the question. An investor buys Adobe at roughly 56.6 times fiscal-2021 GAAP earnings and requires a 10% annual return. How fast would earnings per share have needed to grow if the valuation eventually normalised?

REQUIRED ANNUAL EPS GROWTH	EXIT AT 20x	EXIT AT 25x	EXIT AT 30x
5 years	35.4%	29.5%	24.9%
10 years	22.1%	19.4%	17.2%
15 years	17.9%	16.2%	14.8%

Illustrative calculation: purchase at 56.6 times fiscal-2021 GAAP earnings, 10% required annual return, exit multiple as per column. Not a claim about actual 2021 market expectations.

SOURCE: HQAM / THE QUALITY PULSE, OWN CALCULATION [6]

AT SUFFICIENTLY HIGH VALUATIONS, DURATION BECOMES PART OF THE BET.

ADOBE DID NOT NEED TO FAIL

Three things changed. Growth normalised from the exceptional pace of 2021. Generative AI increased uncertainty around the future structure of creative workflows and therefore the duration of Adobe's competitive advantage. And the required return on long-duration assets rose as interest rates moved higher. None of these developments required Adobe to become a bad company. A moat does not have to disappear for its valuation to fall; its expected duration merely has to shorten.

QUALITY AT THE RIGHT PRICE

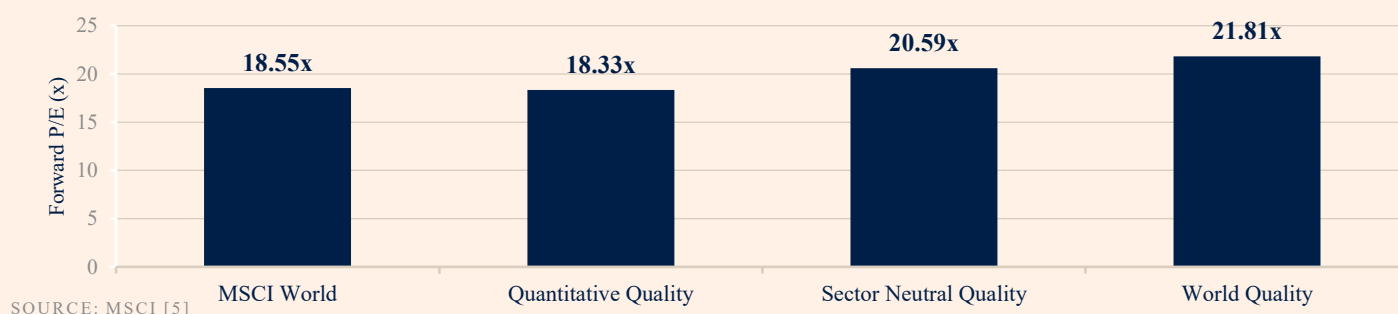
THE OTHER SIDE OF THE VALUATION STORY

Adobe shows why valuation discipline matters when the market attaches a very high price to an exceptional business. But discipline must work in both directions. If superior businesses deserve a premium because they generate higher returns on capital, carry stronger balance sheets and can reinvest for longer, the relevant question is: how large is that premium – and what expectations does it embed?

HOW LARGE IS THE QUALITY PREMIUM TODAY?

There is no single 'Quality multiple'. As at 31 August 2026, MSCI World traded at 18.55 times forward earnings. Depending on the Quality methodology, the premium ranged from virtually zero to around 18%: MSCI World Quantitative Quality traded at 18.33x, slightly below the market; Sector Neutral Quality at 20.59x, an 11% premium; and the standard MSCI World Quality Index at 21.81x, an 18% premium.

Forward price/earnings, index fundamentals as at 31 August 2026.



The dispersion matters. Portfolio construction, sector exposures and the exact definition of Quality change the valuation conclusion. The robust message is not that 'Quality is cheap'. It is that the premium is not uniformly extreme.

WHEN IS A PREMIUM ATTRACTIVE?

A premium is not automatically a valuation problem. If a company earns structurally higher returns on capital, has lower financial risk and can reinvest at attractive rates for longer, paying the same multiple as the average company would itself be unusual. The relevant comparison is therefore not premium versus no premium, but premium versus economic advantage. A 10–15% valuation premium can be entirely rational if superior earnings and free-cash-flow compounding persist. Even a modest premium can be too high if the moat is eroding or incremental returns are falling.

WHAT SHOULD A QUALITY INVESTOR LOOK FOR TODAY?

The most interesting setup is not simply 'Quality + low P/E'. It is a company where ROIC remains structurally above the cost of capital, attractive reinvestment opportunities remain, the balance sheet is robust and the competitive advantage is durable – while the current price does not require a near-perfect outcome.

In that situation, the business can do most of the work. The investor does not need heroic multiple expansion: earnings growth, cash generation and reinvestment can drive the return.

That is the mirror image of Adobe in 2021. Then, a very high starting multiple required exceptional economics to persist for a long time. Today, parts of the Quality universe offer a more balanced equation: superior economics without an obviously extreme price for them.

THE PULSE



Quality deserves a premium. The question is how much. Adobe demonstrates the danger of paying a price that requires exceptional performance for too long. Today's Quality market is more nuanced: depending on index construction, the forward earnings premium ranges from almost zero to around 18%.

That does not make Quality automatically cheap. But valuation discipline should work in both directions: protect against excessive expectations when the premium is large – and recognise opportunity when superior economics are available at a reasonable price.

Quality determines how much value a company can create. Duration determines how long it can create it. Price determines how much of that value is left for the investor.

SOURCES

1. Adobe Inc. (2021), FY2021 Form 10-K – revenue \$15.8b, GAAP EPS \$10.10
2. Adobe Inc. (2026), Q3 FY2026 results and FY2026 targets – revenue \$26.5–26.6b, GAAP EPS \$17.90–18.00
3. Price data: 31 December 2021 \$567.06, 21 September 2026 \$249.52 – S&P Global Market Intelligence via StockAnalysis
4. Mauboussin, M. & Callahan, D. (2026), 'Competitive Advantage Period: The Neglected Value Driver', Morgan Stanley Investment Management, 14 April 2026
5. MSCI (2026), index fundamentals for MSCI World, Quantitative Quality, Sector Neutral Quality and Quality – as at 31 August 2026; methodologies differ
6. HQAM / The Quality Pulse (2026), reverse-valuation calculation and indexation – own calculations, illustrative



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