The Best High-Quality Stock Funds

These top-rated mutual funds and ETFs favor wide-moat stocks—and are good investments for a recession.

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Many suggest that to tame inflation, the Federal Reserve will need to remain hawkish at the expense of near-term economic activity—and that's fueling talk of a recession. "Our forecasts are consistent with roughly 50% odds of a formal recession being declared between now and the end of 2023," says Morningstar head of U.S. economics Preston Caldwell.

High-quality companies, which are often referred to by Morningstar and others as wide-moat companies, have significant competitive advantages that allow them to withstand economic bumps in the road. Wide-moat companies are financially healthy and highly profitable, two qualities that are prized when recession strikes. Their competitive advantages allow wide-moat companies to maintain reliable cash flows over time, regardless of what's going on in the economy. As a result, wide-moat stocks tend to outperform the broader market during recessions: The Morningstar Wide Moat Index outperformed the Morningstar US Market Index by nearly 9 full percentage points in recessionary 2008.

We publish a quarterly list of undervalued wide-moat stocks, which is fertile hunting ground for investors who want to buy high-quality stocks. But for those investors who'd prefer to invest via a managed product like a mutual fund or an exchange-traded fund, we've compiled a list of top-rated funds that favor high-quality stocks.

The 4 Best High-Quality Stock Funds

These mutual funds and ETFs have at least 60% of their most-recent portfolios in wide-moat stocks and at least one share class that earns a qualitative Morningstar Analyst Rating of Gold.

1) Vanguard Dividend Growth VDIGX
2) Loomis Sayles Growth LGRNX
3) Parnassus Core Equity PRBLX
4) Vanguard Dividend Appreciation ETF VIG

Here's a little bit about each fund's investment process, taken from its latest Morningstar Analyst Report.

Vanguard Dividend Growth

- % of Portfolio in Wide-Moat Stocks: 74
- Morningstar Category: U.S. Large Blend
- Year-to-Date Return % (through 10/21/22): negative 11.78
- Category Rank % (through 10/21/22): 4

"A disciplined, but not rigid, focus on dividend growth earns the fund a High Process rating. Manager Donald Kilbride looks for companies that have proved willing and able to increase their dividends over time but that are trading at reasonable prices. Ideally, he wants firms that can grow their dividends at the rate of inflation plus 3%. Often, he finds companies with five-year dividend-growth rates of at least 10%. The fund's holdings tend to be large blue-chip stocks that have big competitive advantages.

This is not a high-yield fund. Kilbride wants stocks that have the best prospects for steadily increasing their payouts rather than those that offer the highest current yield. Because he likes to buy when dividend-payers are out of favor, many of the fund's holdings may have respectable yields relative to the price at which they were bought, but the portfolio usually will not offer trailing 12-month or projected yields as high as many other equity-income funds.

While Kilbride eliminates stocks that are likely to cut their dividends, he has on occasion added a stock after such a cut. He did that with Pfizer PFE in 2009 and Baxter International BAX in 2018 because he thought both companies would then reignite dividend growth from a low base. He does, however, aim to keep portfolio turnover in check. The fund's 15% turnover in fiscal 2021 was well below most actively managed peers'.

Kilbride builds a compact portfolio of 40-50 stocks, dominated by big companies whose competitive advantages help them maintain and grow their dividends. At year-end 2021, the fund's $171.8 billion average market cap ranked in the large-blend category's top half, while its combined 96.7% stake in firms with a Morningstar Economic Moat

Rating of wide or narrow was one of the category's highest. The fund's sector weightings result from Kilbride's bottom-up focus on sustainable dividend growth. Thus, the fund holds few if any utilities as they tend not to have robust dividend growth. Within tech, he eschews capital-intensive businesses that rely on one or two products with short life cycles and prefers instead mature service- and software-oriented firms such as top-20 holding Microsoft MSFT. Kilbride also likes companies poised to serve the needs of an aging population, which accounts for the fund's hefty healthcare weighting versus the S&P U.S. Dividend Growers Index.

Kilbride is cautious about owning stocks in profit-challenged sectors, like energy. Beginning in early 2016, he reduced his expectations for oil and gas firms' long-term earnings because of the industry's geographical and geological challenges. The fund sold Schlumberger SLB in early 2019 and Exxon Mobil XOM in early 2020, when its dividend was in jeopardy."

Alec Lucas, director

Loomis Sayles Growth

- % of Portfolio in Wide-Moat Stocks: 68
- Morningstar Category: U.S. Large Growth
- Year-to-Date Return % (through 10/21/22): negative 28.31
- Category Rank % (through 10/21/22): 43

"This strategy's rigorous and research-intensive approach earns a High Process rating.

[Manager] Aziz Hamzaogullari looks for best-in-class companies with sustainable competitive advantages that he can hold for the long term. Analysts conduct a rigorous analysis of a company's competitive positioning. They look for business models that are difficult to replicate and management teams that efficiently allocate capital and are financially aligned with shareholders. Analyzing the sustainability and duration of a company's potential growth is a key aspect given the fund's long-term investment horizon. In addition, they conduct in-depth industry analysis to understand its structural features and competitive landscape.

Once a stock has been vetted, Hamzaogullari looks to buy when its valuation is near the team's bear-case estimate. The team maintains a watchlist of 150-200 stocks but needs lower valuations before purchase. Analysts perform an expectation analysis to determine what is embedded in a company's stock price and how the team's thesis differs from the market; they're looking for a disconnect between the fundamentals and embedded expectations. Stocks are sold if they reach the team's intrinsic-value estimate, the team's thesis becomes broken, or the team finds a better opportunity from a risk/reward standpoint.

This is a focused portfolio of 30-40 stocks, which doesn't change much from year to year. Individual stakes can be sizable but are limited to 8% of the portfolio. A long investment horizon is reflected in the fund's low turnover of around 10%. It tends to have a high active share, and sector weightings can deviate significantly from the Russell 1000 Growth Index's.

The focus on quality and growth has been consistent and the strategy's return on equity has been above that of U.S. large-growth peers. The portfolio has also had one of the largest stakes in wide-moat stocks in the Morningstar Category (typically 75%-80% of assets).

Hamzaogullari prioritizes diversification of the portfolio's underlying business drivers. Online advertising, enterprise IT spending, and professional software were among the top drivers as of December 2021. The strategy may invest up to 20% of assets in non-U.S. stocks."

Lena Tsymbaluk, analyst

Parnassus Core Equity

- % of Portfolio in Wide-Moat Stocks: 62
- Morningstar Category: Large Blend
- Year-to-Date Return % (through 10/21/22): negative 23.23
- Category Rank % (through 10/21/22): 85

"This strategy's time-tested and disciplined approach earns a High Process rating.

The managers utilize a proven approach to filter their investment universe. The team excludes companies that derive significant revenue from alcohol, tobacco, weapons, fossil fuels, nuclear power, or gambling and then employs ESG, quality, and valuation screens to filter out about 85% of the universe. From there, the team looks for companies with durable competitive advantages, increasingly relevant products or services, exemplary management, and ethical practices. If a stock meets these criteria, the managers dive into its fundamentals to assess its fair value based on three-year bull-, bear-, and base-case scenarios. They pay close attention to downside risk and prefer stocks that have narrow ranges of potential outcomes. This has led to a portfolio with an asymmetric risk/reward profile. The managers also consider valuations, but some of the portfolio's higher-quality companies command premium multiples. Therefore, at times, the portfolio's price multiples can run higher than the S&P 500's.

This bottom-up approach can lead to sector weightings that at times differ by up to 10 to 15 percentage points from the index. The managers cap individual position sizes at 7% of assets, but most fall below 4%. The portfolio must have 65% of assets in dividend-paying stocks but has no overall yield target.

The managers are high-conviction, patient investors. They hold around 40 stocks and tend to hang on for the long haul. Annual portfolio turnover has averaged 31% during the past five years, in line with the large-blend category median. The strategy has a smaller-cap tilt relative to the S&P 500, though the gap has shrunk recently: Its $161 billion average market cap as of June 2022 was less than the index's $172 billion. Despite this, there is a clear focus on competitive advantages, as nearly all its holdings earned wide or narrow Morningstar Economic Moat Ratings.

Stock-picking drives positioning, but the portfolio has clear preferences. Relative to the index, it is typically overweight materials and industrials, and light on consumer discretionary and energy. The managers accumulated a heavy position in semiconductor firms such as Micron Technology MU and Applied Materials AMAT in 2020 but trimmed the positions in the first half of 2021 and then again in the first half of 2022. The strategy has typically been underweight financials but moved to a slight overweight in the first half of the year, with pickups of insurance broker Marsh & McLennan MMC and financial exchange firm Intercontinental Exchange ICE, which has tangential exposure to energy with significant derivative revenue."

Stephen Welch, analyst

Vanguard Dividend Appreciation ETF

- % of Portfolio in Wide-Moat Stocks: 62
- Morningstar Category: U.S. Large Blend
- Year-to-Date Return % (through 10/21/22): negative 16.39
- Category Rank % (through 10/21/22): 16

"Vanguard Dividend Appreciation's strict criteria produce a high-quality portfolio with a competitive risk/reward profile. However, they also introduce concentration risk and sector bets that may or may not be adequately compensated, warranting a Process rating of Above Average.

The fund tracks the S&P U.S. Dividend Growers Index, which holds stocks with a history of increasing dividends for at least 10 consecutive years. Securities must pass minimum market cap and trading volume requirements to be eligible for inclusion. The index ranks eligible stocks by their indicated annual yield. It then filters out the highest-ranking quartile to avoid riskier bets, but it lowers the threshold for current holdings to the top 15% to limit turnover. Selected stocks are weighted by their float-adjusted market cap, subject to a 4% threshold on individual positions. The index also spreads its reconstitution over a three-day period to mitigate market impact costs.

The index reconstitutes annually and rebalances quarterly. There's also a monthly dividend review to remove any securities no longer meeting its dividend growth requirement.

The strategy's risk profile stands out relative to both the category index and category peers. The combination of the long lookback period and yield screen shifts the focus to profitable companies with established businesses. The stability of its constituents' franchises has insulated the portfolio from volatility throughout most of its existence.

The fund forgoes dividend yield in search of durable dividend growth. As of the end of May 2022, its 12-month yield was only slightly higher than the Russell 1000. This might not meet the needs of all income-oriented investors but will offer a good balance between a steady dividend stream and risk.

Absent from its lineup are many household names that either don't pay dividends or have yet to meet the index's inclusion criteria. Most prominent among those left out is Apple AAPL, whose current stretch of dividend growth dates back to 2012. Besides having no exposure to energy and real estate stocks, the index is also heavily underweight technology names, while loading up on industrials and consumer staples.

The index's discerning selection criteria yields a small lineup. The fund held less than 300 stocks as of April 2022. Market-cap-weighting often concentrates around one third of its asset in its top 10 holdings. Nonetheless, its top holdings are often stable mega-cap firms with entrenched market positions and healthier balance sheets than most.

In addition, the fund's sector composition can look quite different from the category index because of its dividend focus. The index excludes real estate stocks by definition and has historically had very low energy exposure. It also tends to underweight technology and communication-services stocks as they have not been paying dividends for long, or at all. It compensates for this by overweighting in industrials and consumer staples stocks. These sector tilts can lead to distinct performance deviations from the broader market and will not always pay off."

Lan Anh Tran, associate analyst

How to Find High-Quality Stock Funds

Investors who'd like to further research wide-moat stock mutual funds and ETFs can:

- Watch "5 Great Wide-Moat Funds." In this video, Morningstar FundInvestor editor Russ Kinnel talks about a few other highly rated funds focusing on high-quality stocks.
- Read "Wide Moat Funds Play Defense Well," also from FundInvestor's editor, which examines the impact of moats on fund returns.
- Discover how wide-moat-stock-heavy a particular mutual fund or ETF is by clicking on the Portfolio tab on the fund's Morningstar report and scrolling down to the Financial Metrics section.

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Click here for the most recent quarter end fund performance and holdings information:
https://www.loomissayles.com/website/advisor-solutions/Growth-Fund

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Click here to view the fund's current Morningstar Rating.

Overall rating derived from weighted average of the 3-, 5- and 10-year (if applicable) Morningstar Rating metrics; other ratings based on risk-adjusted returns.

For each fund with at least a three-year history, Morningstar calculates a Morningstar Rating™ used to rank the fund against other funds in the same category. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a fund's monthly excess performance, without any adjustments for loads (front-end, deferred, or redemption fees), placing more emphasis on downward variations and rewarding consistent performance. Exchange- traded funds and open-ended mutual funds are considered a single population for comparative purposes. The top 10% of funds in each category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars and the bottom 10% receive 1 star (each share class is counted as a fraction of one fund within this scale and rated separately, which may cause slight variations in the distribution percentages). Past performance is no guarantee of future results.

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