



Governance Factors in the Jensen Quality Growth Strategy

Introduction

Jensen Investment Management has a long history of analyzing governance as an important element in our assessment of a company's fundamentals. As part of our in-depth research, we examine the integrity of management teams, board structures, incentive compensation, and stakeholder treatment, all within the context of intending to be a long-term shareholder in quality growth businesses.

Below are some notable examples where specific governance factors influences our investment decisions. In some cases, the Quality Growth Investment Committee declined to invest in companies as a result of an inappropriate board structure, a lack of management credibility, or an insider-type of behavior involving related party transactions. In other cases, we owned a company for a period of time but decided to sell once deteriorating governance became apparent. Lastly, current portfolio names, such as Alphabet and Nike, illustrate how a company's improvement in corporate governance helped us to commit to an investment once our questions were satisfactorily answered.

Estée Lauder

Estée Lauder (EL) held promise as a candidate for the Quality Growth Strategy in the early part of the last decade given its strong brand portfolio, global diversification, runway for growth in emerging markets, and strong profit margins. However, the Investment Committee believed that concentrated ownership by the Lauder family—40% of the outstanding common stock and 87% of the voting power at the time—would increase the chances of managerial infighting, distraction, and favoritism, some of which the company had already experienced.

Estée Lauder has a dual class share structure. Members of the Lauder family own Class B shares, which afford ten votes per share, whereas the Class A shares carry one vote per share. Class B shares automatically convert to Class A shares if transferred to an investor outside of the Lauder family or a family-controlled entity. Effectively, this dual class share structure gives the Lauder family the ability to control all matters requiring a stockholder vote—including the election of board members, amendments to the articles of incorporation, and decide significant corporate transactions.



After performing our fundamental analysis on the company, we decided against initiating a position in Estée Lauder. We concluded that the risks associated with its governance structure, together with the cyclical nature of the cosmetics industry, to be inappropriate for the Jensen Quality Growth Strategy. We also noted other ESG-related risks associated with Estée Lauder, such as concerns about testing on animals and the industry's treatment and portrayal of women. While Estée Lauder stock outperformed the broader market since our decision in May of 2013, generating a +18.04% annualized return versus +13.00% for the S&P 500 Index, it did so with considerably higher volatility, likely driven by the high risk in the underlying business. Consequently, the stock's risk-adjusted returns over the period were well below that of the broader market, 0.99 annualized Sharpe ratio for Estée Lauder shares versus 1.17 for the S&P 500 Index as of January 31, 2020.

Bed Bath & Beyond

Bed Bath & Beyond (BBBY) was held in the Quality Growth Strategy from July 2006 through October 2008. During that time, the company began to display business performance that not only reflected some deterioration in fundamentals but, more importantly, highlighted to us the founders' mentality of running a privately-held business while expecting the benefits of being a publicly-listed company. During this period, new store growth became challenged due to market saturation and department stores began offering more home furnishings. Other home furnishing competitors, such as Linens 'n Things, filed for Chapter 11 bankruptcy. At the same time, the company was reluctant to provide investors with critical market share data as the global financial crisis unfolded.

Subsequent to exiting our position in 2008, the founders and other insiders meaningfully reduced their personal stakes, which had been acquired through the granting of stock options and / or restricted shares. Adding to our concerns, related party transactions were discovered and unwound, one of the independent directors retired from the board, and another decided not to seek re-election. Our fundamental analysis revealed an unsustainable pricing strategy that appeared uncompetitive given the rise of online shopping alternatives, outdated store design, and a reluctance to meaningfully expand the company's online presence. The subsequent share price performance was unimpressive as the company failed to implement substantive changes to its business model necessary to protect its market position. We considered these problems to be symptomatic of significant corporate governance issues, and we sold our position in Bed Bath & Beyond. Since we exited our position in 2008, the company generated a negative annualized return of -3.48% while the broad market index, as measured by the S&P 500, produced a positive annualized return of +14.28% as of January 31, 2020.

Nike

Nike (NKE) has been a Jensen Quality Growth holding since 2011. We believe that Nike demonstrates the key characteristics of a quality growth company: strong competitive advantages, robust financials, and a proven strategy that leverages its economies of scale, globally recognized brand names, and powerful marketing strength to sell its products across the world through wholesale and retail channels.

However, cofounder and former CEO Phil Knight's significant involvement at the board level and outsized voting power were issues that the Investment Committee paid special attention to in our investment decision-making process. Succession planning is an important consideration in assessing the long-term prospects of quality growth companies. Knight, now 81, has gradually stepped back from day-to-day operations and transferred his Class A shares to a trust as part of a longer-term transition plan.

While the Knight family still controls the trust (and can elect ten of the fourteen board members), the board has become increasingly diversified in experience and background over the years and it has been active in holding management accountable as a responsible steward of shareholder capital. Unlike the case of Estee Lauder, we believed Nike's positive attributes were strong enough to overcome our initial governance concerns and we chose to make the investment. Since our initial purchase in April 2011, Nike shares have posted an annualized return of +21.34%, compared to +13.07% for the S&P 500 Index as of January 31, 2020.

Alphabet

The Jensen Investment Committee added **Alphabet (GOOGL)** to the Jensen Quality Growth portfolio in 2016. Fundamentally, we believe the company's competitive advantages—such as its iconic brands, innovation, and economies of scale—represent wide and sustainable economic moats. Alphabet was a portfolio candidate for several years before the Investment Committee decided to invest. Our hesitancy was, in large part, due to equity and voting power concentrated between Alphabet's three company leaders, Larry Page (CEO), Sergey Brin (Chairman), and Eric Schmidt (Founder). During our initial analysis of the business, we concluded that shareholders were insufficiently represented and had little ability to influence Alphabet's leadership and corporate direction. Over time, senior management's share concentration diminished, and we became more comfortable with the company's ownership structure.

Another positive change was that Alphabet's management team structure matured into what we consider to be a quality management team. Alphabet hired Ruth Porat as CFO in the spring of 2015, and she was instrumental in restructuring



Google into the Alphabet holding company which separated the “Other Bets” segment. “Other Bets” are considered long term, exploratory investments that have very little chance of immediate profitability, such as self-driving cars and Google Fiber. However, by breaking out these ventures, investors had better visibility into how much these projects cost and what impact they had on the overall business. We expect continued improvement in the level of detail in Alphabet’s financial statements and investor relations in the future. Since our initial purchase in September 2016, Google shares posted an annualized return of +19.04% versus 14.54% for the S&P 500 Index as of January 31, 2020.

Governance has always been a key Jensen consideration

The objective of our fundamental research is to identify what we consider to be Jensen Quality Growth companies: those with sustainably high returns on capital, underpinned by formidable competitive advantages that enable companies to generate more than enough cash to productively fund their needs and return the excess to shareholders. We place significant value on companies’ management teams that embrace a long-term perspective and are thoughtful stewards of financial and non-financial resources. We have always believed that effective governance and responsible corporate strategy represent critical components to the longevity of a business model. Examples of how governance factored into our investment decision could be applied to any one of the companies in which we invest. However, the company examples discussed here — Estée Lauder, Bed Bath & Beyond, Nike, and Alphabet—each illustrate some of the explicit and more nuanced governance matters considered by the Investment Committee and which comprises a critical element of Jensen’s fundamental research process.

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Unless otherwise noted in this paper, all information is current as of February 2020 and is subject to change at any time, based on market and other conditions. All returns data is as-of January 31, 2020.

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