Smart Money Circle Show Podcast

Hosted by Adam Sarhan and Featuring Jensen's Allen T. Bond, CFA®

ADAM SARHAN: [W]elcome everybody to another Smart Money Circle Update. I'm Adam Sarhan. With me today is Allen T. Bond, who's a CFA. He's managing director, head of research and a portfolio manager at Jensen Investment Management, which has a combined AUM of just about $13 billion. Allen, thank you so much for taking the time to speak with me today.

ALLEN T. BOND: Thanks for having me on the show.

SARHAN: So Allen, I know you have three public funds that Jensen manages. One is the Quality Growth, which is J-E-N-I-X. Then you've got Value, which is J-N-V-I-X, and then you have Global, which is J-G-Q-I-X. Is that correct?

BOND: Yep, that's right.

SARHAN: Beautiful. So before we dive into those, I always like to ask, can you tell us a little about your story and how you got to where you are today, please?

BOND: Sure. Well, thanks again for having me on the podcast here. So, I started personally in the investment business in 1998, which was kind of an interesting time to start in the sense that it was the buildup to the tech bubble, not quite at the height of it, but definitely in the buildup to it. And the weird thing about that just at a personal level was that I was kind of aware of it at the time, but given that it was my first job out of college, it didn't really sink in how significant it was. But I remember talking a lot about it and hearing a lot about it and learning about it. And then obviously very quickly thereafter, experiencing the other side of the tech bubble when it burst. I started out on the fixed income side of the business as a fixed income trader on the buy side.

I had two roles there. One doing investment grade bonds. The next role was high-yield bonds, and then eventually I became a high-yield bond analyst, which really was kind of where I learned a lot about business analysis, which is what I still do today at Jensen. I think as a high-yield investor, it's really critical to understand the business and understand you are really trying to answer two questions. The

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first question is: Can this company pay its interest on time? And the second question is: Can they pay us back when the loan is due? And to try to answer those questions, it requires a lot of work and a lot of diligence, and frankly, in that market, a lot of cynicism because there's a lot of issuers that come into that market that probably can't answer those questions affirmatively.

So I spent a few years doing that. And then my current role at Jensen, I started in 2007 as an equity analyst here at Jensen, and that's kind of just grown as Jensen's grown. When I started, we had two or three billion under management, I can't remember, like we talked about earlier. We're about 13 billion today. So the firm has had a lot of success and a lot of growth and my career has grown. I started as an analyst, became a portfolio manager, and then more recently head of research across all three of our strategies here.

SARHAN: I love it. Well, next question for you. Can you tell us a little about your investment strategy?

BOND: Sure. So I'll talk about Jensen a little bit at a high level and I can kind of talk about all three strategies because they're all very similar. So Jensen, we're based just outside of Portland, Oregon. It's a boutique firm. We have 41 employees, 20 of us are employee-owners, and that's a neat part of the Jensen story. It's 100% owned by current employees. And at this point we're all second and third and fourth generation owners. The first generation of Jensen is retired and hopefully enjoying their retirement at this point. But we've been able to transition ownership, and do so internally, and that's something we're very proud of here at Jensen. And we think it's a really critical part of the culture and part of our investment success because we believe if we're invested in our firm and invested in the long-term success of our firm, it can help us better align with our clients, which are focused on long-term investment outcomes.

So, we feel like that alignment is really critical and it's something we talk a lot about with clients and think it really resonates. We manage about 13 billion in assets. Most of the assets, the lion's share of those assets are in the Jensen Quality Growth strategy. And that's the firm's flagship strategy launched essentially when the firm was opened in 1988. And the mutual fund for that strategy has been available since 1992. So we're a boutique firm, but like to believe we're an established firm at this point as well with more than 30 years in business.

From an investment strategy or investment philosophy standpoint, this is going to be true across all three strategies. The difference is just asset class. We are looking to invest for the long term in businesses that we think will grow and create business value. We obviously are stock investors, but we think over the long term, if a business grows and creates value, we experience that as shareholders.

And on average we hold stock seven to eight years. We've held some for as long as 20. So it's a very long-term mindset. And really our research and our investment process is focused on identifying business factors that we think are linked with sustainable business value creation. So what's really critical for us are competitive advantages and the sustainability of competitive advantages, growth prospects, the attractiveness of growth prospects. We're not always looking for explosive growth. A normal company for us has maybe got mid-to-high single digit revenue growth and low double digit earnings growth. That's kind of a pretty typical Jensen company, have some that are higher than that, some that are lower, but that's kind of typically what we're looking for.

But for us, it's more about studying predictable growth as opposed to explosive, maybe unpredictable growth. And then the third factor is just financial strength, free cash flow generation, balance sheet strength and so forth. And we think this combination is really critical to that value creation because competitive advantages allow businesses to generate business returns above capital costs and do so sustainably. Attractive growth prospects allow those businesses to invest in these high return projects and grow. And then if you have a strong balance sheet and strong free cash flow, you have the resources to make these investments. So we think this is a really critical combination of factors that allow for business value creation over time.

And we spend most of our time on the business. That's critical for us. And I think the other thing to talk about is that we're really focused on businesses that have generated high-end consistent returns on equity over time. And the takeaway there is that we want to invest and focus our efforts on businesses that have proven that they can be good businesses, not ones that we think are good businesses today, and hope they'll be good businesses in the future. These are ones that have proven in the past, we still think they're good businesses today and are confident in the future. So that's really the other critical factor to it.

Most of our time is on that. Now, at the end of the day, we do own the shares in the businesses, and so we have to make sure we pay a fair price. So we do a lot of valuation work to arrive at an estimate of full value and only own stocks at a discount to that estimate of full value. And then the other thing we'll look at is stock volatility, beta, and upside and downside capture, and so forth. And the goal there is we can measure that

historically and we can use that to help us determine sizing positions within the portfolio and kind of hopefully smooth out any unwanted volatility at the portfolio level. And then that's true across all three strategies. Jensen Quality Growth is domestic large-cap. Jensen Quality Value is domestic mid-cap. And Jensen Quality Global is global large-cap. And basically it's almost a facsimile of the Quality Growth Strategy, but about 45% or so of the portfolio was held in stocks that are domiciled outside the U.S. So that's the investment philosophy in a nutshell across all three of the products.

SARHAN: That sounds great. So as far as portfolio management, you like to look for, if I understand that correctly, but the Quality Growth, you're looking to own something for seven or eight years on average, could be longer as high as twenty. And if something isn't working, how do you know when to exit and or when your thesis is just wrong? So it starts going straight down, but the earnings and revenue are up. How do you square for X or solve for X on that one?

BOND: Yeah, and that's a good question. So we have a three-pronged sell discipline. The first two are pretty straightforward, and the third one's a bit more subjective. I'll start with the two easy ones. So I mentioned we're going to focus on businesses with high and consistent return on equity. And so we require before we will look at a business that they've generated at least 15% return on equity for at least 10 years in a row. So that's our quality screen. It's a bright line, it's been part of the process really since day one with the firm. And we've learned over time really, it points us in this high-quality direction of the kind of businesses we're going to look at. So that creates our investible universe and if a business's ROE declines below 15%, it'll fall out of that universe and we would sell it from the portfolio.

Now the reality is that doesn't happen often. Most of the businesses that have generated that track record, there's something unique about the business, usually it's some form of a competitive advantage that allows them to do that and do so consistently. So that universe is relatively stable, but it does happen from time to time. We had one recently where a company just made a capital allocation decision to issue equity and didn't get the returns on that equity that we were looking for, ROE fell below 15% we got out of the stock. So that's really one, and that's really just a check on business returns and that focus on value creation. The second is valuation. So if we have a stock that I mentioned, we'll only own a stock at a discount to our estimate of full value. If a stock price exceeds that estimate, we will get out of the stock, usually kind of dollar cost out over time.

So that's another instance in which we get out of a stock and it's a bit more of a bright line as well. Full value is full value and that's something we can measure over time. And then the third is a bit more subjective and that's just a better idea. And that might be more applicable to the question you asked about what's going on. If there's a disconnect between a business that we think is doing fine, but it's not reflected in the stock price. At that point, it's on us to roll up our sleeves and make sure we understand why, and at least try to understand the answer to that question. And if we determine that there is something that has gone wrong in the investment thesis or has changed and there's better opportunities either within the portfolio or on our bench of portfolio ideas, we would sell a stock and reinvest those proceeds at that point.

SARHAN: I love that. Thank you for that explanation. So as far as the valuation or determining the fair value or your estimated value, can you speak about that and educate the audience a little bit? How you go about determining whether a company's at your estimated value or not? Is it a PE, is it a multiple? Is it a combination thereof? Is it ROE or what exactly do you do?

BOND: Primarily it's discounted cash flow analysis. And so we make an estimate of free cash flow that will be available to equity shareholders like ourselves and discount that based on a discount rate that incorporates both the risk-free rate we get in the Treasury market plus a company-specific risk premium that's based on business attributes. And this is actually something that we think we've improved over time is often times you'll hear a discount rate that's basically the market risk-free rate plus some sort of a risk premium based on the beta of the stock. And it's a fine framework, but the reality is it's not usually statistically significant. What we've done is we say, okay, we're going to start with the market risk-free rate, but we can estimate risk premiums based on business factors. And they're factors that we would look at as analysts anyway. This would be the magnitude and consistency of profit margins and ROE, these would be things like the size of the business.

Larger businesses tend to have lower risk premiums than smaller businesses and so on and so forth. We think this is a good framework that helps us identify company specific discount rates that we use to discount these cash flows. It is a very long-term cash flow model investors, and we want to think about valuing the stock for the long term. So it's a 10-year discreet build with a drawdown phase after that, and then the terminal phase.

And the reason we like that framework is it allows us to, most of the value that we're assuming in our models, we're actually

calculating ourselves. It's not like we're going out three years and then having a terminal value that's worth 80% of the value, and we're not even really doing any work on that. So we like that framework. And then what we do is we have a range of full value estimates based on the tightness of the fit with that discount rate, if you will. And basically for full value, we're going to assume that we're going to be generous on the discount rate. The reason for that is we want to let winners run. So we want to have, okay, what's the fair value and what's a full value? And fair value, okay, we'll pay attention. But if it's at full value, then that's usually when the decision's made to get out and hopefully we've allowed that winner to run at that point.

SARHAN: Gotcha. No, that was my next question. How do you know that you don't prematurely sell it? Okay, beautiful. How do you handle risk and what are some mistakes you see with respect to risk management that people make?

BOND: Yeah, I think it is something that we've thought about a lot. I will give you a couple of frameworks. The way we look at it as long-term investors is that there's three risks that we face primarily. The first is business risk. And I think that the interesting thing about that question to us is that we generally think about equity investing in terms of risk. You won't hear us talking a lot about, oh, we're going to buy this stock at 50 because we think it's worth 100 and we're going to sell when we get 100. I mean obviously that's all implicit, but it's not something that really drives our decision making. We're really trying to manage risk. And so business risk, well, we can mitigate that by owning high-quality businesses that have sustainable competitive advantages, that have financial strength, that have a strong track record of execution.

And that's really a critical thing is, again, we're going to focus on proven businesses, not hopeful businesses, if you will. So we think we can manage business risk in that regard. And then knowing our businesses really well. Second risk is pricing risk, and that's what we just talked about with valuation. That's the risk that you pay too much for a stock. And so maybe the business has got a really bright future, but you paid for the next 50 years of income and really you should only be paying for the next 10. So that's the risk. And that could be one of those situations like you talked about earlier, where the business is doing well, but the stock's not doing much. So we mitigate that risk by making sure we have a long-term full value target, and we will make sure we pay a discount. So we think about that in terms of that classic margin of safety, but also trying to make sure that we're buying the shares at a price where we think there will be good traction over time between the share price and the business value that's being created.

Third risk factor is just security specific volatility. And this is not something, we do think about it, and it does help us make sizing decisions, but what I guess I'm getting at is that you can have two very high-quality businesses, but one stock may be a relatively low-risk stock and the other one may be relatively high-risk. And so the way we look at it is if we've got a higher-risk stock, but we really like the business, well, we don't have to take as big a weighting in that stock in order to still get the benefits because the stock should be more sensitive to positive news, negative news on the other side and vice versa. So that helps us manage that risk at the portfolio level and hopefully reduce unwanted volatility. So that's our risk framework. From a portfolio level, we are a high-conviction strategy.

Right now we own 26 stocks in Quality Growth. On average, we'll hold 25 to 30. So it's a high-conviction, high-active share. And so risk management from that standpoint, we want to be high-active or high-conviction. We want to take meaningful bets versus an index if we really believe in a company and in stock, but we want to be prudent about that. We have maximum position size of 7.5%. Sector it's kind of the industry guideline of about 30%. We want to have high-conviction bets, but we don't want to bet it all on one or two stocks. We want to still have diversification at the portfolio level. So it's really trying to manage the risk to long-term investment at the company level and the stock level, and then manage portfolio risk at the portfolio level.

SARHAN: No, that's fantastic. I love the fact that you lead with risk management even though the people don't "talk about it," but it's the most important thing. And I've noticed now a thread among very successful managers like yourself and business, you have continuity. You've been around for decades. It's not by accident, so you don't get a six-pack by accident. So managing risk is one of those things where if you do that and you focus like a hawk on that, you're way ahead of the game and you increase the odds of success just dramatically. Okay. Next question for you, Allen, what are some timeless lessons you've learned along the way that you'd like to share with the audience, please?

BOND: Yeah, I guess a couple of thoughts along those lines. The first is just simply know what you own. That's something that we talk about a lot. And the reason that's important is that a lot of times the market can become complacent or investors can be complacent. We had this slide, a presentation I did a couple weeks ago, a slide with the three little piggies and the big bad wolf. And the first slide is about how everyone's all happy and it doesn't matter how your house is built, but then the next slide is, well, now the wolf is angry and the only house

left is the brick house. And that's kind of the point of know what you own, is that in times of strong and positive markets, maybe it doesn't really matter. No one seems to pay attention to the difference between company A and company B, as long as they're in the same industry and they're supposed to have these same factors over time.

It's like the market kind of treats them the same, but at the business level, there can be really large differences. And knowing what you own, making sure you understand that at a deep and nuanced level and how different changes to the business and macro environment can impact those factors. That is really critical when things go south, because when we get into a risk-off market, it happens often suddenly. It can be violent and it can be very unsettling if you have a portfolio of stocks that you are not really confident in what they do and the staying power that they should have during these periods of uncertainty and volatility. And again, and the thing of it is there's two components to long-term returns in the stock or in the market, which is how well does that stock hold up when things are rocky and how well does that stock or that portfolio capture the upside as the market appreciates?

But the reality is being able to limit that risk on the way down mathematically is very important to long-term returns. And so by understanding that and being confident, it allows an investor to stay invested even if things are shaky and stay in the market, stay invested so that they're there and they're ready when the market does return. So it's kind of know what you own within that long-term mindset. I think that's one really critical lesson. The other I think is just the importance or the difference between business returns and earnings per share or net income growth. And so what do we mean by that? Well, there's a lot of focus on earnings per share. And if you listen to an earnings call or any kind of focus around quarterly earnings, there's a lot of focus on, oh, did the company beat or did they miss?

And did they raise guidance? And this is often very short term, and that gets the lion share of the attention, and that's fine. And we obviously pay attention to that too. I think in order to understand the long term, you have to understand the short term first, right? So that's fine. But over the long term, when you zoom out, much more important than that is what are the business returns? And we talked about return on equity. That's one factor that we've focused on. The other is return on invested capital.

So these are the ways we can measure the business returns that a company is generating as they hopefully grow. And as long as those business returns are above their capital costs, there's value being created. And again, this goes back to that short-term versus long-term mindset. So in the short term, whether or not they beat earnings by a penny or two probably doesn't matter. And even if it was a big beat, it may not matter. In the long term it is, are they able to invest their free cash flow and their proceeds into projects that are going to generate business returns above capital costs, and do so consistently. And then we kind of get that compounding effect where one good investment leads to another, leads to another, and those are the long-term stories that we want to be involved in. So it's really kind of that short term versus long term and pay attention to business returns versus earnings per share.

SARHAN: I love that. And now let's talk about timeless mistakes, please, that you've made or you've seen other people make, and how do you avoid them?

BOND: Yeah, so that's a good question. And I think as an investor, if you've been around a long time, there's always going to be mistakes. And I think that—

SARHAN: That's good.

BOND: Yeah, right. And we can all kind of talk about our list of ones that we've been involved in. I think the lesson there is to accept it, right? At the end of the day, we have to make decisions, and that means that hopefully you make mostly good decisions, but there's probably going to be some ones that you regret as well. That's okay. Don't let that prevent you from making the next decision. Have a short memory in that regard.

From that angle, have a long memory in the sense of learn from your mistakes. One of the things is that the market's always changing and always evolving, but there are patterns. And if we can start to recognize those patterns and understand what happened and why, and have kind of a diary of those mistakes, if you will, that could help us make better decisions in the future. And for us at the firm level, one of the things that we have really used that to improve on is that risk management piece about two businesses could be equally great businesses from the standpoint of competitive advantages and value creation. They can be equally cheap stocks, but at the end of the day, if one stock is much more volatile and much more sensitive to market moves than the other, well, we can manage that, we can measure that, and we can use that at the portfolio level to help us optimize that risk return on the portfolio side. And I think that's something that we've really grown and improved on in terms of analyzing previous performance and saying, okay, how could we do this better? And I think that's one of them. But I think the biggest lesson is just be willing to accept

the mistakes are part of our business, but don't be shy about learning from them and kind of owning up to them.

SARHAN: No, I love that. So I'm taking notes as you're speaking here, Allen, I really like what you're saying. There's a lot of really good lessons here. Let's talk about some advice. What's the best piece of advice you'd like to give the audience or give your 30-year-old self?

BOND: Yeah, so I mean, one of the most timeless pieces of advice is invest early and invest often. And I think the reason for that is that we know that first of all, over the long term, the stock market has just marched higher. There's been periods where it's been kind of flattish, but at the end of the day, the best time to invest was yesterday. Next best time is today. So that's it. The other piece of advice is it's really hard to time those market cycles from where we sit today. So if we invest early, but we more importantly invest often, do so consistently, you can dollar cost in and get exposure to the market and do so in a way that maybe isn't as scary. You're not trying to time things, you're just, Hey, look, I'm going to look at this with a long-term mindset.

And over time, I know the market's appreciated about 10% a year or total returns have been about 10% a year. Well, may not be next year, may not be the year after, but over time I've got a long-term time horizon, that can be it. So I think that's the biggest long-term piece is invest early and invest often, and from the other standpoint is just focus those on high quality investments. And I think if you're looking for investment strategies like our own is we believe in quality investing for the long term. We think our strategies can be a really critical and important part of a lot of different portfolios, but there's other successful strategies out there. And what I would encourage folks to do is to identify best-in-class across different types of approaches with a long-term focus, with a long-term track record and be patient with those investments. We think that's kind of a good key to long-term success.

SARHAN: Love that. And then we spoke about Growth and Global is going to be growth overseas. What about Value. Can you speak about that strategy a little bit and educate the audience on how you value a stock?

BOND: Yeah, so it's kind of funny. So Value, there's a reason we call it the Value Strategy, and I can talk about that a little bit. The reality is right now it's more of a mid-cap core strategy, and I think that's likely to be the case for a while. So what is that strategy? Well, we started the strategy technically in 2008 and launched a mutual fund in 2010. That strategy came out of some back-testing work that we were doing to help us make better decisions in the Quality Growth Strategy. And the back-testing looked at the entire investible universe. So that's the universe of stocks that has generated return on equity of at least 15% for at least 10 years in a row, and then looked at other factors and said, are there any factors that we can look at that are going to drive future performance kind of in a back-test?

SARHAN: Wait, sorry, you said return of equity of 10% or 15%?

BOND: 15% for 10 years in a row.

SARHAN: 15% for 10 years. Okay, got it.

BOND: Yeah, thank you. And so we ran this back-test, and the reality is the factors it identified were more value-based factors, and they said, "Okay, if you can buy the cheap stocks within this universe over time, those stocks will do well." And we said, "Okay, well that's great." And so we used that. I think that was one of the initial focuses. And this work was done when I started at Jensen, but one of the initial focuses that helped us get more, maybe just put a little bit more work into our valuation models, but the reality is the stocks the back-test had come up with were not the kind of stocks that we went on. They're smaller stocks, tend to be more volatile, and again, we want to talk about high-quality, consistent proven businesses. And the ones that back-test focused on were like, well, yeah, they're proven, but there's maybe some questions.

That's why the stocks are cheap, right? So we said, okay, well there's an opportunity here. We can create a new product. And so we did that. And so the product was based on those factors. So it was really kind of a factor-driven product. And we did that for almost 10 years. That product had some very good years, but also some years that were a little head-scratching in terms of investment performance. And the reality is, we're a long-only, conservatively focused manager, and that's what most of our clients know us for and want. And then it was like, okay, how can we with a straight face going and try to talk to them about this Value Strategy that is less, we just don't feel good about? So what we did, we basically rebooted it in 2017. We hired analysts to support it, and we made it very much like Quality Growth in terms of the investment process.

And so it's very much a fundamental bottom-up strategy right now. There's subtle differences, and the subtle difference is this, the turnover there is still a bit more focused on stock price valuation in that strategy. And the turnover is a little higher now. The turnover, like I said, seven-to-eight year holding period for Quality Growth, maybe it's about half that for Quality Value. The reason is that we think valuation is more

important in that space. Mid-cap stocks can be more volatile, and we think we can do a good job of managing that volatility with a bit more tight focus on valuation. So our valuation selling in that strategy is a bit more formulaic, but it's still very much with a long-term mindset of high-quality businesses. And then the reality is, I will just say since we've started that process in 2017, relative to the category, our investment performance has been phenomenal. So we've been really happy with that decision to essentially stick with the strategy, but make it better. And it's paying dividends today.

SARHAN: I love that. So one more question on value we can wrap up is, I know value's very subjective. It's like beauty in the eye of the beholder. How do you determine if a stock is overvalued, undervalued? I know value is a big part of what you're doing both in Growth and in Value, because you have fair value and full value, you have ways of quantifying it. Can you educate the audience a little bit or help us give some color to that a little bit, please?

BOND: I think the best way to answer that question is relative value versus absolute value. So when you're talking about things like PE ratios or enterprise value EBITDA, these are relative value ratios. You're going to come up with a ratio of price earnings, you're going to compare it to other companies or other stocks on a relative basis. And so we look at those things. We have a big dashboard that we look at on a weekly basis, and that stuff's all on there, but our focus is on absolute value. And the difference is that is we're going to come up with what we think of businesses worth based on its cash flows, based on the discount rate, and we're going to come up with an absolute value of the stock. And the reality is that you could have a stock that we think is attractively priced or fairly priced trading at 40 times earnings, and we have a handful of those in Quality Growth.

You could also come up with a stock that's trading at 10 times earnings, and we might think it's expensive because again, those earnings multiples are relative. And to us, it's more important to put an absolute value on the business and make sure we're paying a discount to that absolute value. We pay attention to the multiples. But for us, a fairly valued stock has less to do with multiple and more to do with the earnings power, the cash flow power and the growth of those cash flows over time for the company. So it's very much a company-specific valuation and very much an absolute value mindset.

SARHAN: Got it. Well, thank you so much for coming on the show. Your website is jenseninvestment.com, is that correct?

BOND: Yes.

SARHAN: And folks can go there to learn more about everything you offer and get in touch.

BOND: That's great. Thank you so much for having me on.

SARHAN: Beautiful. I'll speak to you again soon.

Beta: A measure of the volatility of the fund's total returns relative to the general market as represented by a corresponding benchmark index of the fund. A beta of more than 1.00 indicates volatility greater than the market, and a beta of less than 1.00 indicates volatility less than the market.

Active Share: A measure of the differentiation of the holdings of a portfolio from the holdings of its appropriate passive benchmark index.

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