

Sustaining 15% Return on Equity for 10 Years in a Row: How Jensen Investment Management Defines Quality

A U.S. equity market that keeps testing conviction

Quality means different things to different investors. Some approaches evaluate a collection of present-day financial characteristics, such as balance sheet strength, margin levels, and earnings stability. Others emphasize price momentum or analyst sentiment, an approach that has been rewarded during the momentum-driven market that has persisted for much of the past three years. That variability raises a basic question for allocators evaluating quality strategies. What should a company actually have to demonstrate to be considered a “quality” company?

At Jensen Investment Management, our answer to this question has been the same for more than 30 years, regardless of market cycle. A company must produce a minimum 15% return on equity (ROE) for 10 consecutive years. Companies that pass that test tend to look different from the market’s most exciting stories. They also tend to hold up when the excitement fades.

That consistency has held through recessions, rate shocks, bubbles, and corrections alike. We believe it remains just as relevant today as it has been throughout.

What high return on equity reveals

There are many ways to evaluate a business. Revenue indicates how much a company sells. Margin indicates how much of each sales dollar it keeps. Earnings indicate the resulting dollar profit.

Return on equity measures profitability relative to shareholders’ equity. A company earning \$15 for every \$100 of shareholder equity produces a 15% ROE. This metric demonstrates how effectively a company is using the capital shareholders have put at risk, which matters because that capital is finite. A company that generates a high ROE can fund its own growth from the profits it already produces, rather than relying on

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new debt or new share issuance to expand. ROE, in other words, speaks directly to the quality of a company's capital allocation, not just how much profit it produces, but how well it puts that profit to work.

Measuring a decade of performance

The 10-year window reflects Jensen's own assessment of what constitutes a full market cycle, long enough to capture a full cycle of growth and contraction. For large cap companies, in particular, this is the kind of range needed to test whether a company's profitability holds up across different conditions, not just favorable ones.

A shorter window, for example, may return a slightly different set of businesses depending on when those years happen to fall, for instance, during an economic expansion versus a downturn.

A longer window is unnecessary and introduces its own problems. Data reliability declines the further back a screen reaches and newer public companies are unfairly excluded before they have a long enough track record. An excessively long period also risks spanning a structural shift, in accounting standards or the broader economy, that makes the early and late years of the period difficult to compare on equal terms.

The importance of consistency

Consecutiveness matters because it demands consistency and removes companies whose ROE is cyclical or the product of a single good year. A single strong year of ROE can be produced by heavy debt or aggressive buybacks rather than durable profitability, which is why one good year, or even several non-consecutive good years, isn't sufficient evidence of quality.

When the requirement is loosened, for example to a non-consecutive basis, the universe changes in a specific and measurable way. Lower credit and earnings quality ratings become more common, betas rise, and the resulting group of companies looks meaningfully less durable.

A bar set above what shareholders require

Most companies' cost of equity, the return shareholders require for the risk they take on, falls below 15% per year. Research using the Fama-French three-factor model estimates that only around 11% of companies have a cost of equity at or above that

level.¹ Therefore, a company that clears a 15% ROE bar for ten straight years isn't just profitable; it is very likely generating returns above what its own shareholders require, year after year, which is a meaningfully higher bar than simply being profitable.

In 1979, Harvard Business School professor William Fruhan published research identifying exactly this kind of screen, companies with a high, sustained ROE over roughly a decade, as providing clear evidence of a firm creating lasting shareholder value.² This combination of length, consistency, and threshold isn't new. Jensen's founder built this discipline on that same insight in the late 1980s, and the rule has not changed since.

What a quality discipline demonstrates over time

Three additional ideas underpin our conviction, and each one feels particularly relevant in the current environment.

- > **Consistency compounds.** A company that earns a high return on equity year after year is not just profitable, it is reinvesting that profitability into its own growth. Over time, that compounding advantage can separate durable businesses from businesses whose profitability is more of a passing phase. In a market where narratives can shift quickly, we would rather own the durable growth than the hype.
- > **High ROE tends to persist.** Our long-running research into this discipline suggests that companies capable of sustaining a high ROE for many years are likely to keep doing so. We believe this is because these businesses tend to have real economic moats, competitive advantages that are difficult for competitors to erode. Strong brands, scale efficiencies, switching costs and intellectual property all show up disproportionately in this universe. Moats do not disappear when markets become volatile. If anything, they matter more when conditions get harder.
- > **Quality has historically meant lower volatility.** Companies that meet our 10-year, 15% ROE requirement tend to exhibit lower beta relative to the broader market. That does not mean these stocks never decline. It means the businesses underneath them have historically been less dependent on any single economic condition to perform. In a market defined by uncertainty about rates, growth and geopolitics, we think that kind of ballast matters.

¹ Cost of Equity is calculated using the Fama-French Three-Factor Model, an asset-pricing model developed by Eugene Fama and Kenneth French that explains stock returns based on three factors: market risk, company size, and value, as measured by book-to-market equity. For details, please see Eugene F. Fama and Kenneth R. French (1992), The Cross-Section of Expected Stock Returns. The Journal of Finance, 47: 427-465.

² William E. Fruhan Jr., Financial Strategy: Studies in the Creation, Transfer, and Destruction of Shareholder Value (Homewood, IL: Richard D. Irwin, 1979).



From screen to benchmark

The 10-year, 15% return on equity standard now exists as a rules-based benchmark. The **Jensen U.S. Quality Index** (ticker: JQUI), administered by VettaFi, applies this discipline systematically across the market, then selects the 100 largest qualifying companies by free-float market capitalization. The result is a benchmark built entirely around a long-term definition of business quality, reconstituted twice a year to keep pace with which companies continue to meet the standard. It reflects our long-standing view that quality is something a company has to demonstrate over time, not something it can show in a single year.

Looking ahead

Markets will keep offering new stories, new themes and new reasons to abandon a strict standard for something that looks easier or faster. We have heard those arguments before, across multiple cycles, and our answer has not changed. We would rather own businesses that have proven, over a decade or more, that they can generate real profitability above their cost of capital, and then do the work to understand why.

It is not a prediction about where markets go next, but a continued commitment to a discipline that has guided our process from the beginning and that we believe remains just as sound today.

Definitions

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.

Cost of Equity: The rate of return that equity investors require to compensate them for the risk of investing in a company. It is also referred to as the required rate of return on equity.

Free-Float Market Capitalization: The market value of a company based only on shares considered freely available for public purchase, rather than all shares outstanding.

Market Cycle: A period over which a securities market moves through rising and falling phases, from one market peak to another or from one trough to another.

Return on Equity: Is equal to a company's after-tax earnings (excluding non-recurring items) divided by its average stockholder equity for the year.

To view a list of the Jensen Quality Growth Strategy's current holdings, visit www.jenseninvestment.com/growth-composite-holdings.

Strategy holdings are subject to change.

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Jensen U.S. Quality Index ("Index"), owned and administered by VettaFi, applies a nondiscretionary, rules-based methodology to the VettaFi US Equity 3000 Index, selecting the 100 largest qualifying companies and weighting then using a modified market capitalization approach designed to reduce concentration. The Index is reconstituted and rebalanced semiannually.

VettaFi US Equity 3000 Index is a broad U.S. equity benchmark representing the 3,000 largest publicly listed U.S. stocks. It is part of the VettaFi US Benchmark Index family, which collectively covers more than 98% of the U.S. market's capitalization.

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