THE OWNER-OPERATOR ADVANTAGE

By Aligned Investors, an investment group within Principal Global Investors

Principal® Global Investors

OUR CONVICTION IN THE POWER OF ALIGNED INCENTIVES IS SO STRONG THAT WE NAMED OUR FIRM AFTER IT

– ALIGNED INVESTORS

IT WAS A TYPICAL MONDAY MORNING FOR JEFFREY LORBERBAUM.

He went to the office, ready to start the week, but by the time he got to his desk he noticed something was different. Nobody else was there. Confused, he called his wife. Smiling to herself, she politely informed her husband that it was a holiday, Memorial Day, and most people wouldn't be working.

Most bosses of Fortune 500 companies aren't working on Memorial Day either. In fact, it wouldn't surprise us to find many of them in a location far from the office that weekend. And, of course, that's perfectly fine. Mr. Lorberbaum has nothing against Memorial Day – we're sure he supports the honoring of our veterans. It was a mere oversight, and in our view a telling one. He wasn't on a yacht, drink in hand. He was, as usual, in his office, thinking about carpet.

Jeffrey Lorberbaum is the Chairman & CEO of Mohawk Industries. As the son of immigrants who started a successful carpet manufacturer, Aladdin Mills, his mind has been on carpet pretty much from the beginning. He was running the family business when it merged with Mohawk Industries in 1994, and has led the flooring manufacturer ever since. Today, he owns more than 13% of Mohawk[2], which makes up the vast majority of his net worth. He has some very good reasons to be thinking about carpet.

We like Jeffrey Lorberbaum. His story is unique, but it's also familiar. Similar anecdotes could be shared about more than a few CEOs in our portfolios. That's not an accident – it's by design. We believe incentives matter, so when it comes to choosing a manager, we'd prefer another owner – someone with capital at stake, someone with incentives that are aligned with ours. We call them Owner-Operators.

Owner-Operators are different than the average CEO in corporate America. They have different motivations, feel different pressures. This affects their behavior and decision-making in positive, value-adding ways. Even better, the data suggest this value creation is rarely reflected fully in prices – creating an opportunity for consistent excess returns over time. This paper will describe our observations from more than 15 years of managing a strategy that prefers Owner-Operators. We'll supplement these observations with quotes from Owner-Operators in our portfolios, as well as findings from an academic study by Ulf von Lilienfeld-Toal and Stefan Ruenzi on high ownership CEOs published in the *Journal of Finance*.

"The company was the family, and the family was the company. Every cent went back into the company to make it bigger, better, faster."

— Jeffrey Lorberbaum[1]
Chairman & CEO,
Mohawk Industries

PASSIONATE LEADERSHIP: MORE THAN A JOB

> The man who does not work for the love of work, but only for money, is likely to neither make money nor find much fun in life.
>
> **— Charles Schwab[3]**
> **Chairman,**
> **Charles Schwab Corporation**

The first thing you notice about Owner-Operators, whether it's a local restaurant owner or the head of a large corporation, is the passion they have for their business. It's not an occupation, it's a lifestyle. The emotional connection they have is hard to comprehend, until you remember that they've known the business from its humble origins. They've seen it at its most vulnerable. They understand that success was never – and never will be – inevitable. They've celebrated each passing triumph, no matter how small. And now that the business is established, it represents more than a means of making money. It's the culmination of work, creativity, and sacrifice over many years, sometimes the better part of a lifetime. Everything about the business reflects on them personally. Sometimes it even bears their name.

That passion is admirable and, more importantly for shareholders, generates real results. While their enthusiasm affects everything Owner-Operators do, there are a couple key areas where this passion impacts the business directly.

First, few care for the long-term health of a business like the people present at the beginning. The experience and industry network they've gained provide Owner-Operators with an information advantage, and this intimate knowledge makes them natural innovators always looking to improve their product or service. Owner-Operators don't need to be taught to think about their business like a castle with a moat around it, as widening that moat long ago became basic instinct. It's common for management teams of companies in our portfolios to share stories about the CEO calling at odd hours to discuss their latest idea. That obsession with remaining a step ahead – quite different than hiring a consultant to catch up with "best practices" – is something that can't be taught, and it's valuable.

Second, the enthusiasm doesn't stop at the top. It's contagious and permeates entire organizations, instilling a culture meant to outlast the founder. The emotional connection Owner-Operators have with their business resonates at a deep level. Owner-Operators understand that no matter how brilliant they may be, one person cannot do everything, and they have a responsibility to inspire their workforce. Creating a culture that attracts and inspires talented employees is crucial for operating a business, and passionate Owner-Operators have key advantages in this respect.

Owner-Operators believe in motivating talented employees. However, as we'll see in the next section, they are not willing to employ more people than necessary or spend large sums on unnecessary perks that benefit headquarters at the expense of shareholders.

EXPENSES COME FROM THE WALLET

The agency problem is as old as the corporate legal form. There simply is nothing easier to spend than other people's money. Jokingly referred to as "OPM" around our office, phonetically similar to opium, the corporate expense account seems to produce its own form of addiction. The shinier office building always seems necessary. The corporate jet can always be justified.

Business expenses are different to Owner-Operators. When the business was in its early stages, its expenses quite literally came from the founder's wallet. This careful approach to expenses rarely falls away as the business grows and attracts capital from others. Having experienced a time when each dollar needed to be stretched, Owner-Operators are far less susceptible to acquiring a taste for waste. Furthermore, given Owner-Operators still own a material share of the company, a real portion of the expenses still comes from their wallet.

One outcome from this situation is that Owner-Operators often take relatively small salaries for their role as manager. Most of their compensation will come from the performance of their ownership stake, so their salary is relatively insignificant. This sends an important message – to employees and shareholders alike. If Owner-Operators aren't willing to spend excessively on their own pay, they likely aren't willing to spend lavishly in other parts of the business. And with their firsthand knowledge of the company, they know the difference between smart investments and simple excess. Warren Buffett is one of the more famous examples. He takes a salary of only US $100,000 per year even though he's been the long-time CEO of one of the world's most successful companies (Berkshire Hathaway).

"...our results show a strong and highly significant negative impact of high ownership on the log of total compensation. For example, **firms with CEO ownership of above 10% pay on average a 39.6% lower total compensation to their CEO** as compared to low ownership firms."

– von Lilienfeld-Toal and Ruenzi [4]

There is something you don't hear often from Owner-Operators, but is routine at many other companies: the announcement of the latest cost-cutting initiative. The idea that a special exercise is needed to remove excess costs doesn't make sense to consistently thrifty enterprises. Cost control is either a priority or it

"Whenever I read about some company undertaking a cost-cutting program, I know it's not a company that really knows what costs are all about. Spurts don't work in this area. The really good manager does not wake up in the morning and say, "This is the day I'm going to cut costs," any more than he wakes up and decides to practice breathing."

**– Warren Buffett[5]
Chairman & CEO,
Berkshire Hathaway**

isn't. According to Fastenal co-founder Bob Kierlin (see portfolio example), "being careful about your expenditures, whether large or small, requires a total commitment. Either you do a good job of cost control in all aspects of your business, or you start losing it."[5] By our observation, other Owner-Operators would agree.

> "We find that labor productivity in high managerial ownership firms is significantly higher than in low ownership firms... **firms with high managerial ownership are also more cost efficient."** – *von Lilienfeld-Toal and Ruenzi* [6]

PORTFOLIO EXAMPLE:

Bob Kierlin • Co-Founder, Fastenal Company
Will Oberton • Chairman & CEO, Fastenal Company

Bob Kierlin co-founded Fastenal, a wholesale distributor of industrial and construction supplies, and went on to lead the company for more than 30 years. His frugal ways once led to him being profiled in Inc. Magazine as "the cheapest CEO in America."[7] He routinely took a lower salary than the board authorized, didn't have a personal secretary, and bought used furniture for his office. We once met Fastenal's current CEO, Will Oberton, at a conference in Chicago. He and the other Fastenal executives had driven themselves over five hours and stayed in a hotel far from the city center to save costs. In fact, they even shared rooms. Kierlin's example had influenced Oberton, who joined Fastenal in 1980 when the company only had 35 employees and $2 million in sales. He wanted to continue sending the message that cost control is important to everyone in the organization. Even though Kierlin no longer runs Fastenal, the company has held on to its frugal culture, and the results have been impressive. Bloomberg Businessweek ran an article in 2012 that highlighted Fastenal as the best performing stock over the previous 25 years, with a return exceeding 38,000%.[8]

CAPITAL ALLOCATION: WHAT TO DO WITH THE PROFITS?

Intimate knowledge, passionate leadership, and constant focus on expenses make Owner-Operators terrific managers, and there's no doubt this significantly benefits the companies they run. Even more important, though, is the perspective they bring to capital allocation. All CEOs have two primary jobs: manage the day-to-day operations of the business, and make decisions about how to allocate the firm's capital. Capital allocation – the decisions that a CEO makes about what to do with the profits of the business – is often the key determinant of long-term shareholder returns.

We'll spend the next few pages describing how Owner-Operators bring a much different perspective to these decisions than most corporate executives. Their established position at the helm insulates them from many of the pressures felt by the average CEO, and since the lion's share of their potential income comes from their ownership stake – rather than their paycheck – their incentives are aligned better with outside shareholders.

THERE ARE FIVE BASIC OPTIONS FOR DECIDING WHAT TO DO WITH PROFITS:


Re-invest in the business

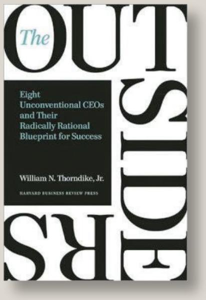

Acquire another company


Pay down debt


Pay out a dividend


Buy back your own stock

> "We run a very decentralized operation. We believe very strongly that if you incentivize people as owners, and treat them like owners, they'll act like owners."
>
> **– Nicholas Howley CEO, Transdigm[9]**

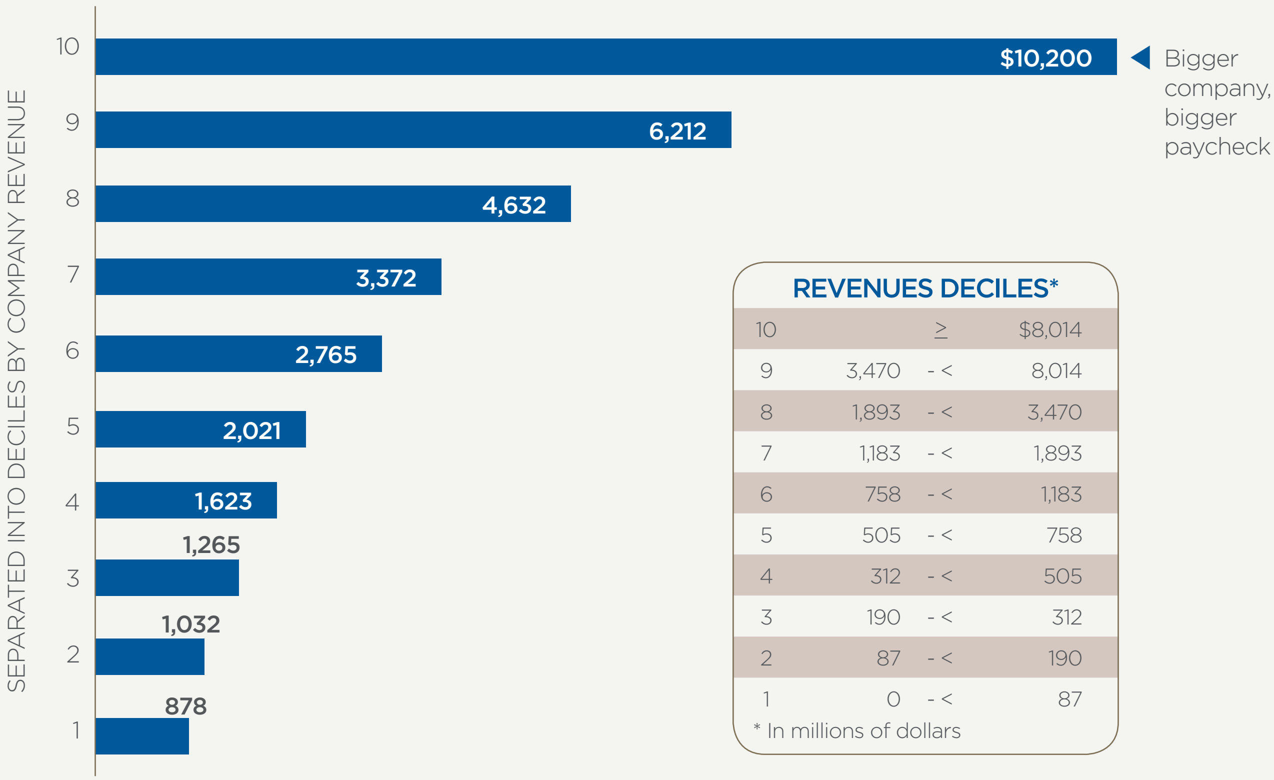


TransDigm received a mention in William Thorndike's outstanding book, The Outsiders, which profiles eight CEOs that created a tremendous amount of value through decentralization and effective capital allocation. The book's message fits hand-in-glove with our investment philosophy. In fact, some of the people and companies mentioned in the book are familiar. We've invested alongside John Malone for many years, and the investment philosophy of Warren Buffett has heavily influenced our own. It's natural that Thorndike would highlight TransDigm. In our view, TransDigm's CEO Nicholas Howley is a great example of a current "outsider" CEO.

Depending on the situation, each has their place as the optimal choice. However, executives often have their own motivations. For example, most CEOs have an incentive to choose options that make their company bigger: in addition to inflating their ego, growing the "empire" helps make the case for a larger paycheck (see graph below).

CEO – TOTAL COMPENSATION BY REVENUE

Total compensation rises with revenue.



REVENUES DECILES*

10		≥	$8,014
9	3,470	- <	8,014
8	1,893	- <	3,470
7	1,183	- <	1,893
6	758	- <	1,183
5	505	- <	758
4	312	- <	505
3	190	- <	312
2	87	- <	190
1	0	- <	87

* In millions of dollars

Source: *The Conference Board's* 2010 U.S. Top Executive Compensation Report[10]

"The acquisition activity of firms with high ownership is significantly lower than that of low ownership firms... Overall, these findings suggest that **high ownership firms engage less in empire building."** – *von Lilienfeld-Toal and Ruenzi*[11]

ACQUISITIONS: FOR CREATING VALUE, NOT BUILDING EMPIRES

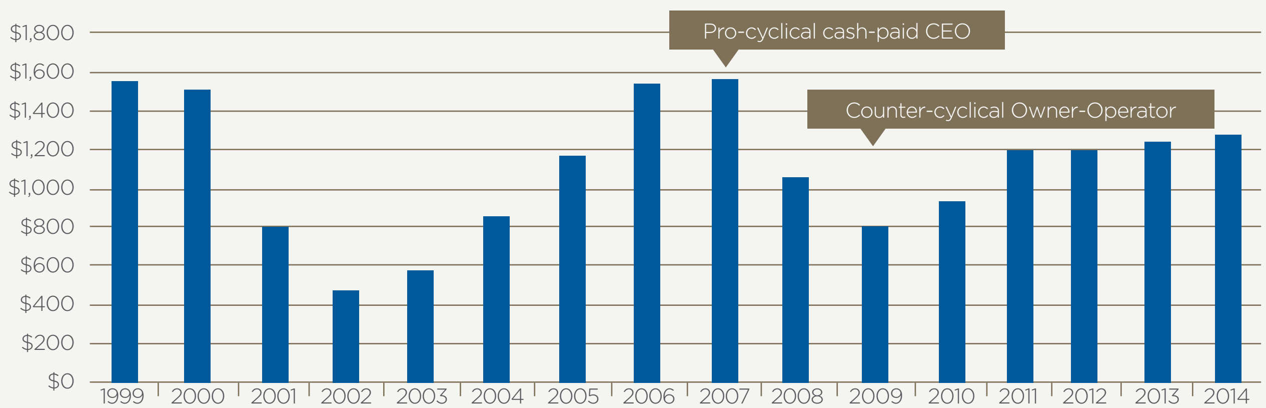
Acquisitions can be done for the wrong reasons (bigger company, bigger paycheck), but they are not *always* wrong. In the same manner, actions that shrink the business, such as share repurchases, are not necessarily right. In both cases, managers may have ulterior motives. The important determinants for value creation are *when* and *how* these decisions are made. As the graph below shows, most CEOs are pro-cyclical. In other words, rather than buy low and sell high, they do the opposite.

The average CEO enters a pressure-cooker on Day 1. They've been hired by the board of directors and know their window of opportunity is short. They feel the need to produce visible results, and soon. Investment bankers are knocking on their door every day, dreaming up the latest strategy to double the company's value. When times are good, nothing sounds better than the long-sought "catalyst" for further share price improvement. And, frankly, acquisitions are more exciting than the day-to-day minutiae of improving operating results. With profits strong and confidence high, most CEOs have what they need to pull the trigger. So, they enter the competition for a desired target, and lever up to complete their big deal. Unfortunately for shareholders, this is frequently done at the wrong time. Had they waited for a different part of the cycle, they might have had the flexibility to make a better deal with very little competition (and a lower valuation). But then again, with prospects bleak, that would seem quite rash. What sensible person would take on risk at such a time?

In our experience, that person is more often than not an Owner-Operator. They've been through business cycles before. They know that good times don't last forever and the deals to be had are when nobody else is interested. They have an established reputation and track record, so they're less anxious to show signs of immediate activity. The trust they've built with the firm's stakeholders enables patient, farsighted decision making. As for the investment bankers, they may as well not bother. Owner-Operators are not likely to be sweet-talked into a deal by someone with a fraction of their industry knowledge.

Owner-Operators have a good reason to be focused on a longer time horizon: they're in the job longer. Two Harvard Law School professors, John Coates and Reiner Kraakman, studied the tenure of CEOs in the S&P 500 from 1992 to 2004. They found that those who held more than 1% of the stock were at the helm for an average of **13.9 years**, compared with **5.7 years** for other companies.[12]

U.S. M&A ACTIVITY • $US BILLIONS Source: Bank of America Merrill Lynch



The examples shown are hypothetical, are for illustrative purposes only, and do not represent the activities of any specific companies.

PORTFOLIO EXAMPLE:

This long-term, counter-cyclical approach to acquisitions is critically important to shareholders. The fastest way to destroy capital is through a poor – or even just poorly timed – acquisition. In contrast, as the two portfolio examples below show, being aggressive during uncertain times can produce impressive results.

Brookfield Asset Management has long had a reputation as a contrarian investor, but in the mid-2000s the company was being criticized for its aversion to commercial real estate. As real estate values continued to rise, competitor firms were (seemingly) getting rich. Looking back, Brookfield was smart to avoid getting caught in the frenzied boom, but that outcome was far from inevitable at the time.

Even more controversial was Brookfield's next move. The company had financial flexibility, but few firms were willing to make significant investments in the aftermath of the financial crisis. Vacancies were going up, rents were going down, and the conventional wisdom was to stay away from property investments. One of the companies that had taken on too much leverage during the good times was General Growth Properties (GGP). A mall operator with several attractive properties, GGP was a good business with a bad balance sheet. Its share price fell 97% during 2008 and the company declared bankruptcy in April 2009.

This is when Brookfield saw its opportunity. With few investors looking to take on risk, Brookfield stepped in to provide the necessary capital. Its injection of a little more than $2.6 billion enabled GGP to eventually depart bankruptcy and offer new shares to the public. Brookfield's investment was worth more than $8 billion as of September 30, 2015.

While this investment turned out especially well, the discipline that led to it is typical of CEO Bruce Flatt. Together with current and former senior executives, they own approximately 20% of the firm.[13] They are willing to endure short-term criticism for long-term gain. Their counter-cyclical owner's perspective rewards outside shareholders that have a similar mindset.

O'Reilly Automotive was founded in Springfield, Missouri in 1957. Today its more than 4,000 stores cover most of the United States, but the O'Reilly family is still very much involved. David O'Reilly, son of the co-founder, has been with the company since 1972 and remains in his post as Chairman of the Board.

Few industries received as much negative press during the financial crisis as the auto industry. While seemingly every other company was hunkering down to survive the coming downturn, O'Reilly decided to move forward with a different idea: completing the biggest acquisition in its history. CSK Auto had over 1,000 stores, primarily concentrated in western states, which enabled O'Reilly to complement its existing footprint. Better yet, the CSK stores were under-earning their potential. The deal made a lot of strategic sense, and completing it during a low in the cycle enabled an attractive price. O'Reilly wasn't going to walk away due to short-term concerns. The company knew it had the wherewithal to make it through even a severe and prolonged crisis.

Although the deal would make sense in hindsight, most were unimpressed at the time. The move seemed like an unnecessary risk. From the time it was announced in early 2008 until the time it was completed in July of that year, O'Reilly's share price declined from about $30 to the low $20s.

Secure in their position and focused on the long-term, O'Reilly management didn't waver. And what a good thing that has been for long-term shareholders. O'Reilly closed at $250 — more than 10x its July 2008 low — on September 30, 2015.

SHARE REPURCHASES: ABOUT MORE THAN QUARTERLY EPS

Acquisitions aren't the only area where Wall Street pressures and poor incentives lead to cyclical behavior. In the case of share repurchases, pressure mounts from sell-side analysts. Hitting aggressive earnings-per-share targets is difficult to do each quarter, and sometimes reducing the denominator (share count) is easier than increasing the numerator (earnings), especially near the peaks of cycles.

"If managers are paid on the basis of EPS targets—as up to half of American bosses are—they have a temptation to go buy-back bananas."

– *The Economist* (September 2014)[14]

This is a case of something good – management attuned to shareholders – being taken too far. Many market participants have short-term, quarter-by-quarter mindsets. In their attempt to please the market each quarter, weak management teams can inflict damage on their firm's long-term prospects.

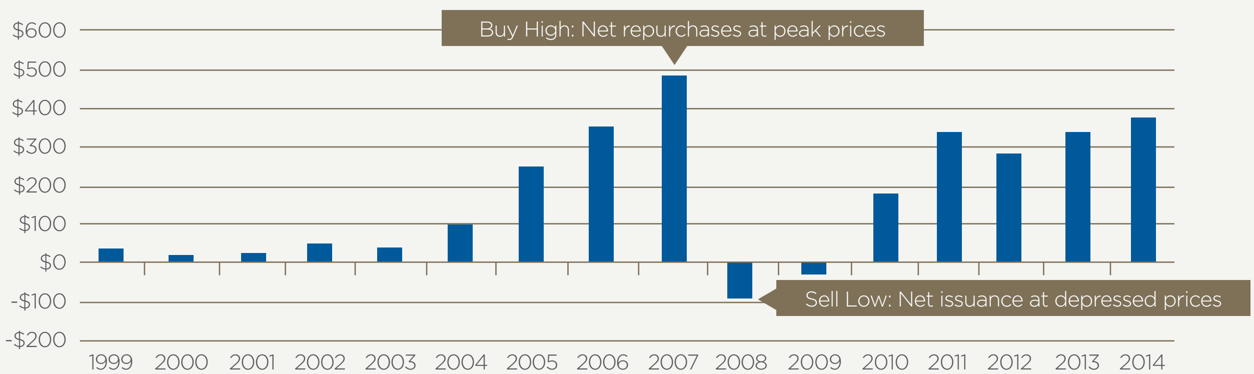
The decision to buy back shares should be based, like any other investment decision, on the investment merits. If the company's shares are trading at a genuine discount, which typically happens at the low point of business cycles, then management teams are right to buy them. However, as the graph below illustrates, this is not when most shares are repurchased. In fact, the opposite has occurred with most management teams buying high and selling low.

Owner-Operators, on the other hand, are far less inclined to sacrifice long-term value for the temporary affection of Wall Street. They see share count decisions for what they are. They have no interest in cashing out other investors at a premium, nor are they willing to dilute their own ownership stake by issuing shares at a discount.

"We like making money for continuing shareholders, and there's no surer way to do that than by buying an asset — our own stock. The angel says, 'Explain the Loews story to everyone; tell them about the discount. Then the devil is whispering, 'Don't do anything. Just file the 10-Ks, and the stock will remain cheap for you to buy back.'"

— James Tisch[15]
CEO, Loews Corporation

NET STOCK REPURCHASES – COMPANIES IN RUSSELL 3000 • $US BILLIONS



Source: Bank of America Merrill Lynch

THE OWNER-OPERATOR IMPACT ON RETURNS

Throughout this paper, we have attempted to illustrate some of the most compelling advantages that Owner-Operators provide. They have deep knowledge of their industry, run their businesses efficiently, and are insulated from many of the pressures and perverse incentives that lead to so many poor capital allocation decisions.

But, as an investor, that still leaves perhaps the most important question: do Owner-Operators produce especially good stock returns over time? Believers in the efficient market hypothesis would make the argument that since their ownership stake is public knowledge, the benefit they provide is already priced into the stock. Our experience tells us otherwise.

> "But, as an investor, that still leaves perhaps the most important question: do Owner-Operators produce especially good stock returns over time?"

The *Journal of Finance* published a paper in May 2014 in which the authors set out to isolate the effect of CEO stock ownership on long-term stock returns. They wanted to know if high ownership leads to better company management, and, if so, how the market responds to that information. Meeting the high standards expected of publication in a prestigious academic journal, they controlled for other factors known to influence returns (such as size, sector, momentum, index membership, and book-to-market valuation) and conducted a "battery of stability tests"[16] to ensure the results were robust.

Throughout this paper, we've quoted some of their findings: high ownership firms are operationally more efficient and less likely to build empires, which leads to better returns on assets. No surprise there. What is more interesting, at least to the study's authors, is that the benefits of having an owner running the business are not fully appreciated by the market. In their analysis, they used ownership information that had been publicly disclosed for at least two months, thereby removing any announcement effects. Their portfolio of high-ownership firms still dramatically outperformed low-ownership firms. Their core finding was stated as such: "We examine the relationship between CEO ownership and stock market performance. A strategy based on public information about managerial ownership delivers annual abnormal returns of 4 to 10%."[17]

If markets are perfectly efficient, then any material information should be incorporated into the stock price when it becomes available. All the gain from that information should be captured in the post-announcement price movement and should not affect returns from that point forward. Yet in this case, the information about CEO ownership clearly does.

The authors spend the latter part of the paper investigating possible reasons for this disconnect, honing in on two reasons in particular. The first is that "ownership can act as an incentive mechanism and is thus a corporate governance device."[18] This explanation argues that "positive incentive effects arising from managerial ownership are also not fully priced, but lead to the positive abnormal returns we find because **the market is not fully efficient in understanding incentive effects."**[19]

The second reason relies on a game theory model whereby market participants understand incentive effects, but don't want to reward high-ownership CEOs up front. Creating value is hard work, and if CEOs could profit immediately by selling shares post-announcement (of their significant ownership stake) then they would do that rather than "carry out the value-increasing effort and bearing the associated personal costs."[20]

The authors concede it is not obvious to them which situation is more likely, and that "ultimately, the interpretation of our results to a large degree depends on our view of investor rationality and market efficiency."[21] In other words, if you believe investors are inherently rational and the market is efficient, you'll give more weight to the game theory argument. If you believe markets are in some ways inefficient, then, like us, you'll find it more likely that the incentive mechanism is underappreciated.

The positive returns are created in either case, and investors can benefit from that knowledge.

> "I've been in the top 5% of my age cohort all my life in understanding the power of incentives, and all my life I've underestimated it."
>
> **— Charlie Munger[22]**
> **Vice Chairman,**
> **Berkshire Hathaway**

ABOUT THE PAPER

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This paper is noteworthy to us because it is based on completely independent, academic research. It was not commissioned by anyone with commercial interests. Our belief in the power of incentives applies to more than our investment philosophy. Being researchers ourselves, we know that it's all too possible to find what you set out looking for — especially if there are material reasons to do so — so the independence of this research is important to us.

Titled "CEO Ownership, Stock Market Performance, and Managerial Discretion", the paper was published in the June 2014 issue of *The Journal of Finance.* The authors are Ulf Von Lilienfeld-Toal and Stefan Ruenzi. Dr. Von Lilienfeld-Toal is an associate professor at the Université du Luxembourg. He focuses on the interaction of incentives and markets. Dr. Ruenzi is a professor of finance at the University of Mannheim. His primary interests are liquidity, empirical asset pricing, and behavioral finance, with particular emphasis on the mutual fund and asset management industries.

OUR APPROACH

Although beneficial to have a rigorous academic study provide more evidence in support of our Owner-Operator focus, it is important to note that our portfolio management approach is quite different from that laid out by the study's authors. We don't blindly select companies based purely on CEO ownership levels. Our review of Owner-Operators is more nuanced, and the Owner-Operator focus is just one, albeit very important, aspect of our investment philosophy. In addition to the Owner-Operator focus, we believe in holding great companies with identifiable competitive advantages and buying them at a discount to intrinsic value.

In terms of our approach to Owner-Operators, we separate companies into three buckets:

Founder, second generation family member, meaningful stake.

BUCKET 1: True Owner-Operators are run by someone who owns a material stake of the company. These companies are often still managed by the founder or a second generation family member. Many of the companies and CEOs referenced in this paper are in Bucket 1, including: Mohawk, Berkshire Hathaway, Charles Schwab, Transdigm, O'Reilly, Loews, Brookfield Asset Management, and Liberty Media. Bucket 1 companies represent the largest share of our portfolios, typically around 40% of the weight.

Management team with an Owner-Operator culture. Think and act like an owner.

BUCKET 2: Companies we've identified as having a "culture of such". These companies have often transitioned from Bucket 1, with the original Owner-Operator's strong leadership having instilled a culture and approach to management that remains firmly in place today. As we look at these companies' track records – how they operate, how they invest – over a long time period, we gain a comfort level that they've retained an owner's mindset. TJX Companies and Fastenal are examples referenced in this paper. Other examples from our portfolios include EOG Resources, Martin Marietta Materials, and Fidelity National Information Services. Bucket 2 companies typically make up about 35% of our portfolios.

Cash-paid CEO

BUCKET 3: The majority of companies in corporate America. While the smallest bucket – about 25% of our portfolios – we don't completely rule them out. We still look closely at who is running the business and make sure they are not a capital destroying management team. Some companies have such strong franchises that a management team would have to be quite poor to mess them up. In these cases, our portfolios can still benefit significantly, and we don't want our clients to miss those opportunities. Examples from our portfolios include Moody's and MasterCard.

> "Basically, for my whole life all my assets have been tied up in the companies I've started and run."
>
> **— John Malone[23]**
> **Chairman, Liberty Media**

> "I believe that one reason we hold on to our best people is TJX's culture."
>
> **— Carol Meyrowitz[24]**
> **CEO, TJX Companies**

About Aligned Investors

Aligned Investors is an investment boutique within Principal Global Investors* that utilizes a completely fundamental, bottom-up approach. The name Aligned Investors highlights the group's conviction in the power of aligned incentives. This is emphasized in the investment process through a distinctive preference for Owner-Operators. Led by Bill Nolin since 1999, Aligned Investors manages more than $15.1 billion as of September 30, 2015 in MidCap and Blue Chip strategies.

Bill Nolin, CFA
CIO & Portfolio Manager

MBA, Yale School of Management
22 Years Industry Exp.

Tom Rozycki, CFA
Head of Research & Portfolio Manager

BA, Drake University
14 Years Industry Exp.

*Principal Global Investors is the asset management arm of the Principal Financial Group®. The multi-boutique firm managed more than $341 billion as of September 30, 2015.

OUR FOCUS

Questions about management are often given little attention, and for most market participants that makes sense. Many are traders mainly interested in how a stock will perform over the next week or month or quarter – and given that time horizon, the quality of management doesn't matter as much. Those trades will be impacted more by the outcome of a single earnings report or the vacillations of any number of macroeconomic variables.

We are investors, not traders. We don't think of our job in terms of buying and selling stocks. We invest in companies we believe can use capital effectively. Our time horizon is long – a full business cycle, usually more. Historically the turnover in our portfolios has been around 20%, implying an average holding period of five years. As demonstrated in the portfolio examples, we're comfortable investing in companies for much longer.

As long-term investors, management matters a great deal. Over a full market cycle their decisions will affect the outcome of our investment more than anything else. Especially for firms with high returns on equity, reinvested profits quickly make up the majority of capital at work in a company – meaning the decisions on how to reinvest those profits are the most important drivers of shareholder returns. The economy will go up and down, as will the stock market. Interest rates, commodity prices, currency values – they'll all fluctuate and grab headlines. Given our outlook, we're much more concerned about the moves our companies are making to entrench their competitive advantage, as well as the investments they're making with their capital.

When choosing a manager to make these decisions, we strongly prefer another owner. Their total compensation is largely determined by the performance of their own equity stake, which aligns their interests with ours. This leads to important outcomes: knowledgeable and engaged leadership, lower expenses, counter-cyclical capital allocation, all done with a long-term perspective.

This focus on Owner-Operators has worked well for clients in our MidCap strategy for over 15 years. The same approach has been applied to our Blue Chip strategy since its 2012 inception, and we're confident the Owner-Operators in these larger companies will create value for our clients in the same way. Over the long-term, proper alignment of incentives matters much more than the market appreciates. We hope you agree that Owner-Operators provide important advantages and will consider investing with us, Aligned Investors, over the next 15 years.

SOURCES

[1] Jennings, Jason. 2009. *Hit the Ground Running: A Manual for New Leaders.* New York, New York: Portfolio. Print.

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