Money Life Podcast: Quality Investing

Featuring Jensen's Eric Schoenstein

CHUCK JAFFE: *Welcome to the Market Call, the part of the show where we talk with experienced money managers about how they do their job, what they look for that determines their buys and sells, what they see happening on the market, [and] how they put it all together.*

JAFFE: [T]oday we're joined again by Eric Schoenstein, he is portfolio manager and chief investment officer at Jensen Investment Management. He manages the Jensen Quality Growth Fund, that's J-E-N-S-X, and he's on the team for Jensen Quality Value, that's J-N-V-S-X. If you want to learn more, [visit] Jensen, jenseninvestment.com.

Eric Schoenstein, it's great to have you back on Money Life.

ERIC SCHOENSTEIN: Thank you, Chuck, it's great to be back with you as well.

JAFFE: Now, we always start with methodology. And, of course, you guys have "quality" in the name of the funds. But it's more than just in the name of the funds, it's in what you do. So explain what it is that you look for in terms of quality, but then what you're looking for in terms of other qualities that make a company stand out as a buy, or makes it stand out as something you'd rather not buy.

SCHOENSTEIN: It might sound simple in the name itself, but I think the way you can really sum it up is that we seek to invest for the long term in businesses that grow and create value. Now, what we focus on, and some of the factors we look at, are the factors that are linked with this concept of sustainable business value creation. And I think that word "sustainable" is an important element there. So you're talking about things like competitive advantages, free cash flow, a consistency to the business model and, importantly, the execution of that business model from a long-term perspective.

What makes a quality company stand out?

"[Jensen seeks] to invest for the long term in businesses that grow and create value. [We focus on] factors that are linked with this concept of sustainable business value creation. And I think that word 'sustainable' is an important element there.

So, you're talking about things like competitive advantages, free cash flow, a consistency to the business model and, importantly, the execution of that business model from a long-term perspective."

We really want to look at identifying what we think are consistent growth drivers. It doesn't necessarily mean explosive growth, but steady, predictable growth. And then you have to match that up with good attention to detail or focus on valuation, because you want to make sure that you're not overpaying for that quality element. Quality is something we all seek and we know quality can basically price at a premium. From a stock perspective, we don't want to be paying premium prices and we want to make sure we've got room to have it actually be a long-term holding for us.

JAFFE: You guys have low turnover, particularly on the Jensen Growth Fund, so what's that longer purview? I mean, how long is your lens when you're buying something? Because right now there's a lot of stuff that kind of looks mushy. You can make a good longer-term case, but you can't be saying, oh, I love what this stock's going to do for me in the next six months or a year.

SCHOENSTEIN: That's actually been one of probably the biggest changes that I've seen over my 20-plus year career in this business. We've all seen it. Holding periods for stocks — public equities — have come down. It's become something where generally investors feel that they can be more tactical. And when we talk about long-term for us, the turnover of our strategy is such that the average holding period for a stock in our fund is seven to eight years, probably.

We only own 25 to 30 businesses, and the foundation they all need to have is that they have to generate high returns on capital, which we sort of measure by saying we want companies to have a 15% return on equity each and every year for 10 consecutive years. But if you were to try to take that lens and that prism and think about it as a forward-looking opportunity and then only invest in those companies for a year or two, you'd probably miss the opportunity within the full cycle.

And that's where this idea of really truly owning the business, knowing it and owning it through a full economic cycle, we believe makes a difference in more resilience to the way the model will work, and more resilience to the way the fund will perform. It's not going to be lights out, but it's not going to be really, really challenging when the lights are off either. It's going to be something steady and comfortable for investors to experience as the investment objective.

JAFFE: In this market where we've seen a lot of froth, we've seen very narrow leadership, how much do you have to look at those leaders to participate? How much are you willing to say, I'll be on the outs?

SCHOENSTEIN: Well, I think you nailed it as far as what's happened. The first seven months of this year in 2023 have been all about, I guess the most common term is, "the magnificent seven." A lot of momentum, a lot of top line growth, a lot of future expectations for growth.

To be honest, we own three of them. We own Microsoft, we own Apple, we own Alphabet. And we don't own the other four: Tesla, Amazon, Meta and Nvidia. Not necessarily because we've made a determination that they don't work for us. It's actually that they don't qualify for our discipline yet. In other words, they haven't generated that 10-year standard of excellence that we like to start with as a foundation.

That doesn't mean they're bad companies, it just means until they get to that level of excellence, they're not yet qualified for us. And our universe that we look at is about 320 names, so it's robust enough to give us the opportunity to get down to 25 to 30. If and when any of those businesses qualify for our discipline, we'll be happy to take a look at them and feel like they're much more viable opportunities.

But I think actually this year, because of how concentrated everything has been, certainly, it's left a lot of businesses on the sidelines that frankly aren't, we think, well positioned. And as things are slowing or feeling like they're slowing right now, this might be the time to start thinking a bit more about those businesses that are not part of the magnificent seven.

JAFFE: Let's get a "for instance." You mentioned owning three of the magnificent seven. What's something outside of the magnificent seven that's that kind of business, that opportunity that's just waiting for its time?

SCHOENSTEIN: Well, I'll give you an example of one. The most recent purchase, the most recent add we made to the portfolio. You sort of hear a lot about AI and what's happening with semiconductors and the momentum in that space. The most recent company we just added was KLA Corporation, KLAC is the ticker. Their world is about building particularly important processing equipment, special testing equipment, that is essential to the semiconductor industry for ensuring the accuracy of the chips that are manufactured. And they've got a really strong servicing model. They have dominance in the tools that they produce where they may have anywhere from say 50 to 90% market share, which is massive dominance.

And 20 to 25% of that business is actually coming from services, meaning that they have to constantly make sure that they've got all their research and development up to the standards that they need. They're doing a lot of that servicing on an ongoing basis, which dampens the cyclicality you typically see in the semiconductor space.

So they have a runway we think is very attractive, and probably a bit steadier than some of the more cyclical components that are the capital intensive semiconductor manufacturing. And we know that the semiconductor business is obviously going to be a big part of that world of AI going forward. Here's a way where we can tap into AI and future generations of chip manufacturing without having to worry too much, or as much, about the momentum or the cyclicality that's likely to come within those industries.

JAFFE: You talked about how your average holding period is long. What does it take to get you to sell and how much of it, if any of it is ever the conditions of the market, or the industry, rather than the conditions of the company?

SCHOENSTEIN: It's probably more going to be about the conditions of the company, although that's not to say that the industry can't influence that. A great company in a declining industry, that could be a challenge. Those kinds of situations have proven to be challenges for us in the past. Market conditions, certainly from a pricing perspective, when these things get too expensive and sort of run ahead of expectations, we start trimming. And if it runs aggressively ahead of expectations, we're going to trim aggressively, and maybe even sell.

We'll certainly think about getting rid of a company or exiting a position if the fundamentals have deteriorated. These are long-term successful business models, and any kind of contraction in the competitive advantage is certainly a red flag for us that we're going to take a hard look at.

Honestly, the biggest reason we sell businesses is because we've got a robust bench. While we own 25 to 30, we've got another 20-25 sitting there waiting to hopefully get into the portfolio. It's a competitive process, and if there are better ideas that we can upgrade our portfolio either from a fundamental perspective or a valuation opportunity perspective, that's going to drive a lot of the changes that we make. And the team of us, the six of us that run the strategy, along with three other analysts that contribute, it's a daily process, a daily debate, and a daily opportunity to think about those upgrades, although we do want to maintain that long-term lens for stability and resilience.

"[T]he biggest reason we sell businesses is because we've got a robust bench. While we own 25 to 30, we've got another 20-25 sitting there waiting to hopefully get into the portfolio. It's a competitive process, and if there are better ideas that we can upgrade our portfolio either from a fundamental perspective or a valuation opportunity perspective, that's going to drive a lot of the changes that we make."

JAFFE: I was going to say that's got to feel like a real victory when somebody gets to talk the team into, hey, we should make this change given how infrequently you actually are making changes.

SCHOENSTEIN: Yeah, I suppose it probably can. I mean, those certainly are probably some of the most robust dialogues we have is when someone, and it's not the person that covers a business for us, we do all that research ourselves. The person that covers it, though, isn't necessarily the one that's tasked with recommending that we buy it or we sell it, it's anybody on the team. So you do see sort of a rise in the engagement, if you will, not that we aren't engaged all the time. But when it's about to be one of these debates about a company it definitely gets the juices going and everybody gets a little more excited about the conversation because they're interesting dialogues. They may not be interesting to everybody else, but they're interesting to us.

JAFFE: Well, now we're going to get your quick and dirty take on some stocks my audience is particularly interested in.

We are talking businesses and specifically quality businesses with Eric Schoenstein. He is portfolio manager, chief investment officer at Jensen Investment Management. We are talking about the Jensen Quality Growth Fund, J-E-N-S-X, to learn more about it and the firm, jenseninvestment.com.

Quick and Dirty, of course, is our lightning round. If you want to jump in, we need your name, your hometown, and the ticker symbols you're interested in to chuck@moneylifeshow.com. We start today with two requests from Sam in Water Fleet, New York. The first is for Johnson and Johnson, J&J, and I have to point out, it's in my portfolio.

SCHOENSTEIN: Strong healthcare business. I think healthcare has probably been underappreciated over the course of this year. And it's pharmaceuticals, it's medical devices, and diagnostics. It's the things that are necessary across the spectrum. And the recent growth's been pretty solid, frankly. I mean, the last print they just had was 5% organic revenue growth, pretty strong EPS growth, a lot of free cash flow that's being driven through the business. And, importantly, I think they've made good investments in new drugs that will be part of the pipeline going forward. And all of that will help to offset some of the issues they're still facing in terms of litigation. And we think it's one that might require a little patience, but it certainly is a good solid performer for a portfolio.

JAFFE: That's a buy on J&J, Johnson and Johnson.

Sam's other request, Proctor and Gamble, PG, another stock in my portfolio.

SCHOENSTEIN: Classic consumer staple business. And I think as we move into sort of an environment where interest rates are going to stay higher for longer than people think we might need, tipping a little bit more towards a defensive component. The thing I like about Proctor and Gamble, they do have some higher-end products in terms of price points and consumer spending seems to stay relatively robust.

Importantly, they've got pricing power, and that's a really essential element here. They've been averaging sort of mid-to-high single digit pricing and not seeing any kind of degradation on the volume side. So, for us, it's one of our favorite consumer staple holdings, and we think it's in solid shape given everything that's changing out there.

JAFFE: It either gets on board or it gets left behind. That's a buy on PG, Proctor and Gamble. We'll stay with consumer-oriented companies. Ryan in Anchorage, Alaska, wants to know about LVMH, Moet, Hennessy, Louis Vuitton, that trades under LVMUY.

SCHOENSTEIN: Interesting business from the standpoint that now you're talking about the luxury side of things. And I'd say there's a bit, maybe a little bit more caution here from the standpoint that there's a lot of international in their business. China's probably struggling more than I think people expected coming out of zero-COVID lockdown, it just hasn't quite recovered as much as everybody thought it would. And the business has definitely seen sort of, I guess I'd call it a little bit more choppy performance.

I think the way to think about that is maybe a bit more of, I don't know, I guess a hold if you will. It's not something that we're enthusiastically doing anything with right now. I think the longer term LVMH people, there are companies like that, like Hermes, like others in that space, they're all going to do, I think, actually really well. And the brand distribution within LVMH should hold them up in the long run.

JAFFE: I'd put that in the cautious category. It's a good company, not necessarily a great stock right now.

Richard in Chula Vista, California, wants to know about Accenture, ACN.

SCHOENSTEIN: Consulting business, one of our longer-term holdings in the space. And I think they constantly are a business that looks to capitalize on new trends, whether it's digitization or, in this case now, maybe thinking more about artificial intelligence and the consulting that can go around that.

They've got a lot of runway in front of them. They think about 40% of their workloads are cloud-based right now. They're certainly looking at modernizing enterprise resource planning, ERP systems. But they're also looking at AI. They're committing billions of dollars to new projects in the AI space. And the combination of AI and cloud should give the company pretty good runway ahead. We have to be a little sensitive to price sometimes on Accenture because it tends to run a little bit. Other than that, though, I think it's been a very solid company for us over time.

JAFFE: That's a buy on Accenture, ACN.

And last for Dave in Jacksonville, Florida, it's CDNS, that's Cadence Design Systems.

SCHOENSTEIN: Cadence, good business. It's actually, again in the semiconductor space, this is one we hold in the value strategy, the mid-cap value strategy. Really solid addressable market they've got. The addressable market's growing, you've got 5G, you've got hyperscale, Internet of Things, AI cloud, which we've mentioned. All these things are benefiting Cadence and their semiconductor design complexes. And then they're really solidly positioned, 85 to 90% of the company's revenue is recurring in the form of software and IP licenses and maintenance contracts, and almost 99% customer retention in some of their key areas. So solid business and one that we're enthusiastic about within the mid-cap value space.

JAFFE: We finish on a high note, that's a buy on Cadence, Design Systems, CDNS.

Well, in fact, yeah, we had high notes throughout if you're looking for things to buy. Because while there was that softness there on LVMUY, everything else was in the buy territory. And we got one more goodbye to talk about, it's our goodbye to Eric Schoenstein. But Eric, great as always, thanks so much for joining me. We'll talk to you again down the line.

SCHOENSTEIN: Thanks, Chuck, and happy holidays to everybody.

JAFFE: Eric Schoenstein is a portfolio manager and chief investment officer at Jensen Investment Management, jenseninvestment.com for more information.

We'll be back to tell you where you agreed or disagreed with some very recent guests and then we'll cross the finish line together, right after this message.

JENSEN™ INVESTMENT MANAGEMENT

5500 Meadows Road, Suite 200
Lake Oswego, OR 97035
800.221.4384

jenseninvestment.com