Jensen's Nifty Fifty

Bob Millen's team believes there are 50 stocks in the world that are worth buying at any point in time and selects the best 25 out of those. The purpose is to find the most consistent earners of the decade and thus try to guarantee solid returns over the long haul without volatile roller coaster rides. Bob told Ticker how this conservative strategy has helped the fund stay in the top quintile in the multi-cap core category.

Q: What actually led to The Jensen Portfolio and its unique approach?

A: Jensen Investment Management was founded in 1988 and we introduced The Jensen Portfolio in 1992. I should say that for the first 8 or 9 years of the existence of the mutual fund, it was made available primarily to our high net worth clients. Then, beginning a couple of years ago, we decided to make the fund available in all the 50 states and to allow it to be marketed on the major mutual fund supermarket platforms. As a result of that we have seen nice growth over the past couple of years to the point now where the advisory firm manages $2 billion in assets of which $1.7 billion is in the Jensen Portfolio mutual fund.

Of the $1.7 billion, there is about $400 million that are in 401(k) plans and the balance is made up of either direct retail investors or investors who are being advised by a fee-based advisor.

Q: How did you come up with such a portfolio - concentrated in terms of number of stocks, and yet diversified across capitalizations and industries?

A: I have to get to the team here. We have always managed the portfolio on a team basis, currently five of us are members of the investment team and also owners of the company. Our background is really experience in business, not so much in the investment or brokerage. All of us have run businesses in our lives and we know the value of free cash flow, and we know what makes a business valuable over the long term, and so when we started this firm and decided to crystallize our investment philosophy we wanted to think about investing as if we were buying the entire business as opposed to simply buying the stock. When you do that, given our strict criteria, you don't need 100 companies to create a portfolio that is well diversified, growing, and yet minimizes risk. We believe that it only takes about 25.

The thing we are looking for is companies that have achieved a consistent long-term record of strong business performance. Typically, they maintain strong debt-to-capital ratings, and they possess sustainable competitive advantages over their competitors. To determine our qualifying universe, we start with the idea that any company that is publicly traded in America is a candidate, and they are over 10,000 that are actively traded, as you probably know. But the first test we use, the first big screen is that we will only consider companies that have produced a return on equity of at least 15% every year for ten years in a row. So that takes that whole universe of 10,000 down to 110. So, our qualifying universe is 110 and we have worked that list of 110 ultimately down to about 25 that will be in the Jensen Portfolio, and the way we do that is we are looking for companies that have the best barriers to entry, or to put it another way, the most sustainable competitive advantages. We are looking for companies that generally have less debt or very strong balance sheets. We want companies that have exhibited a history of growing their

Jensen Portfolio

Fund Facts		
Symbol	JENSX	
Website	www.jenseninvestment.com	
Address	Jensen Investment Management, 430 Pioneer Tower, 888 SW Fifth Ave., Portland, OR 97204-2018	
Tel. No.	800-992-4144	
Inception	08/03/92	
Portfolio		
Total Net Assets *		$1,700
Avg Mkt Cap ($ Weighted) *		68,600
Average Price/Earnings Ratio		22.01
Average Price/Book Ratio		7.09
Turnover Ratio		1%
Investment Information		
New Investment		Open
Min Initial Investment		$2,500
Min Subsequent Investment		$100
Min Initial IRA Investment		$1,000
Risk (Against S&P 500 - 3 Years)		
Alpha		0.3458
Beta		0.6524
R-Squared		0.7117
Returns vs. Lipper Multi-Cap Core Index		
	JENSX	Index
1 Year (Cum.)	8.51%	24.33%
3 Year (Ann.)	-1.53%	-6.71%
5 Year (Ann.)	8.02%	2.66%
Returns vs. S&P 500		
	JENSX	Index
1 Year (Cum.)	8.51%	20.80%
3 Year (Ann.)	-1.53%	-8.34%
5 Year (Ann.)	8.02%	0.53%
Fees and Expenses		
Max Sales Charge - Front		0.00%
Max Sales Charge - Deferred		0.00%
Max Redemption Fee		0.00%
Total Expense Ratio		0.90%
Portfolio Manager		
Management Team		---

** millions* *Data through: 10/31/03*

Source: Company Documents; Lipper

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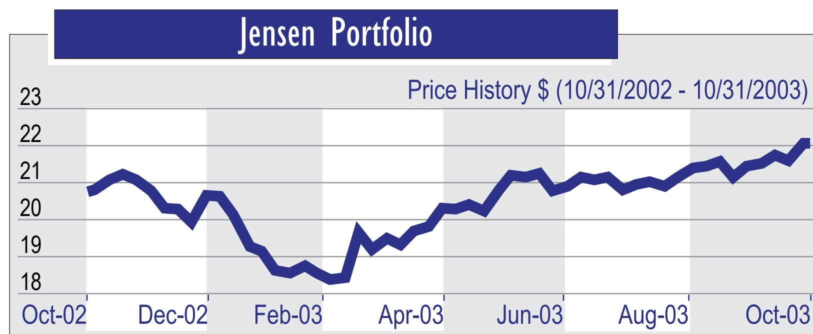

free cash flow. And we are looking for companies that have managements with a record of compensating the shareholder. So, once we find this list of 50 or so of the 110, of which we ultimately choose 25, the buy side of our strategy is that we will buy only if we can buy at a discount of at least 40% to intrinsic value. And we calculate intrinsic value of all of our companies, which is in the classic definition of discounted cash flow model the present value of all of the future free cash flows of the company. We do a 10-year forward forecast and then we determine the terminal value and then we discount it to the present, so that we get a reference point, which we believe to be a true value of the company if it were a private business.

And then, we let the market be our friend, and those times when we can buy at a 40% or higher discount is when we buy, and when we sell, it means that the market price of the company exceeds intrinsic value or the other main reason we will sell is if the company fails to make our 15% return on equity in any one year.

Q: Just one miss, and you sell? One strike and they are out?

A: Yes, and they are out for ten years, by definition, because they have broken that ten-year string.

Q: And you actually managed to find 25 companies that do not violate these stringent criteria?

A: Actually, we found 110. And that list of 110, interestingly, does not change much every year. We only see two or three coming on it, and two or three falling off.

Q: I meant of the 110, those 25 that really sell below 40% of intrinsic value?

A: Yes. Of course, it is kind of an unusual time in the market with interest rates so low, so we can easily buy all 25 in our portfolio, and there is another 25 or more out there that we can buy as well, because they are selling at a 40% discount. The worst time we had in finding a place to put new cash was in 1999.

Q: Why? Looking at your holdings and weightings, I can see financials and things that were pretty undervalued in 1999?

A: We could buy some of our companies back then, but what I was trying to say was that just there weren't so many good deals at that time. And that was primarily, as you remember, because the market was being driven by momentum, a lot of emotion, and a high degree of optimism. And whenever that happens, market prices tend to get ahead of values. And when that happened, we actually sold five of our companies, because their prices went too high.

Q: Well, this year we had quite a run. And looking at mutual fund performers, the Internet is back.

A: No question about it, and what has happened this year is I can name five or so sectors that have been leaders of our market this year and they include Internet retail, Internet software, semiconductors and equipment, wireless telecommunications, and then the utilities have had a run here and there. But those are companies that we typically don't invest in, because they don't have these long-term records of high earnings. And so, the market is up 18% or so this year, as measured by the S&P as of yesterday, we're only up a little over 8% or 9%. So, we are not participating this year as much in the market growth as we might in another year, but that doesn't bother us, because we know that our companies over the longer term are going to generate an increase in their earnings that generally averages in the low double-digit range, somewhere in the 11% to 12% annual increase in earnings. And we know that over time for good companies like that the market will actually reflect a similar growth. So, we are not uncomfortable lagging the market this year, because, frankly, we think that the market has gotten ahead of itself in those sectors that are driving the market.

I would much rather own a stock that just consistently earns year after year after year, than one that has to grow at 25% or 30% a year just to justify its market price. Those kinds of companies aren't going to grow like that forever and they are going to be very volatile, and that is what we are seeing this year.

Q: And how does that affect your turnover?

A: To be honest, our goal, when we put a company in the portfolio is to hold it forever. We would prefer never to sell the company. And when you see somebody with 100% turnover, it means they are just churning the portfolio, trying to find the next big deal.

Q: And when you stick with your fifty picks, it is much lower?

A: Yes, the turnover in that kind of philosophy is quite low. Since the inception of our fund it has averaged about 14% a year.

Q: What names have you added over the past year? They should be just a handful at such a low turnover and such a concentrated portfolio.

A: Sure. The most recent name that we added was McGraw-Hill. And we put that in within the last three months. It actually replaced a company that we sold - Jones Apparel. McGraw-Hill is a great example of a company that meets many, if not all, of our strict criteria. So, that is one that we added. The one that we added prior to that was Colgate. Their competitive advantages are the big brands they built over a long period of time, their dominant market share in some of their brands like toothpaste. They have a broad and strong distribution, and also a wide geographic diversity. Reuben Mark has been CEO for 17 years and he has done a masterful job of leading the compa-

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ny. They have been able to grow not only their top line, but continue to grow their bottom line in the low double digit-levels.

Q: True, but what was your buy signal?

A: Our buy signal was that Colgate is usually a company that is too expensive for us to buy and with the interest rates being low last year and the market price of Colgate coming down, we could finally buy it at a 40% discount.

McGraw-Hill was a name that has qualified both for business reasons and for price reasons for some time, but we just needed a reason to add a company and that came about when we sold Jones Apparel. McGraw-Hill, as you know, is the leader in educational publishing, they also have couple of very strong brands in Business Week and Aviation Week. And then, S&P is also a very strong brand. A company that has grown its free cash flow, I believe, between 15% and 16% a year over the past ten years.

Q: What are the names that you held longest?

A: Abbott Laboratories is one of the holdings from the beginning of the fund. And Equifax is another one we held since the beginning of the fund. They are the leader in credit reporting for consumer, and also one of those experienced, well run companies. They know how to manage the bottom line and they have a great brand, and a great market edge. They are a little bit affected by the economy, and this last year their stock has been down and their earnings haven't been quite as robust, but with the economy improving and if you think about them long-term, they are going to do just fine.

Q: Do you rebalance somehow between sectors or individual stocks?

A: No, we don't manage sectors. What we really do is to try and look at companies and what the opportunities are to invest in what we think has the greatest long-term growth potential and right now we think frankly healthcare is probably as undervalued as any sector in America. We added to healthcare, because it is so cheap right now. But we never had to sell and buy to rebalance. We had such strong cash flow coming into the fund. Like this year we started with $1 billion in the fund and now we are at $1.7 billion. So, we had a 70% growth in the fund just this year.

Q: And you just add with the new inflows? You seldom reduce positions?

A: Very rarely. The only rule we have is that a company goes to 7.5% of the total portfolio weight, then we will consider trimming back, or if we are still having good cash flow, we just won't invest in that company.

Q: What would you tell an investor, who is considering putting some money in your fund? What would they get out of it?

A: What we believe in and what we aim for is we aim to provide investors with good solid returns over the long term that are reflective of growth companies, but are also reflective of more consistent growth companies. Not the ones like in the Internet sector, which tend to be quite volatile. You get consistent growth returns with less risk than the overall market. That is what we strive to achieve, and that is what most people, when they look at our risk-adjusted performance, will see we have achieved.

Q: And what can go wrong with such a portfolio construction? What can hurt you?

A: In the long term, we don't think there is anything, because we believe our companies have delivered their business performance which will ultimately result in stock market performance. In the short term what can go wrong is we can lag the market like we are this year. If somebody wants to be very close to achieving market returns every quarter of every year, they shouldn't invest in our fund. Because when the market is flying high with momentum and emotion, we are going to lag a little. When the market is more fundamental or when it gets depressed as it inevitably does from time to time, we exceed the market quite handsomely.

Alexander Vantchev

> *"I would much **rather own a stock that just consistently earns** year after year after year, **than one that has to grow at 25% or 30% a year** just to justify its market price."*

Robert Millen

Robert G. Millen graduated from the University of Iowa and the Stonier Graduate School of Banking at Rutgers. He has over 30 years of experience in banking, investment management and financial services. His experience includes senior executive positions with Principal Financial Group and Wellmark, Inc., as well as serving as president of First Interstate Bank in Des Moines, Iowa.

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