How Polen Growth Fund Consistently Beats the Market

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Asset management company Polen Capital's investing template has proven the test of time: Since inception in January 1989 through the end of the first quarter of 2016, the Polen Focus Growth strategy has generated gross annualized returns of 14.5% and net (after-fees) annualized returns of 13.4%, compared with 9.8% for the Russell 1000 Growth Index and 10% for the S&P 500.

Part of the firm's success over these 27 years has come from protecting the downside. According to Morningstar, the strategy lost "considerably less" than the Russell 1000 during the dot-com bust and the 2008 global financial crisis.

Although the firm's separately managed accounts have been around since 1989, it launched the Polen Growth mutual fund (POLIX) in 2010. The fund follows the exact same strategy as the accounts, and the fund has been awarded five stars by Morningstar, which notes that the fund has outperformed 93% of its peers in the past five years.

The firm has more than $9 billion in assets under management and is located in Boca Raton, Fla., far away from the short-term pressures of Wall Street.

Fool analyst John Rotonti recently interviewed portfolio co-managers Damon Ficklin and Dan Davidowitz. Davidowitz also serves as the chief investment officer of the firm.

How do you define a high-quality business?

We have five criteria, which we call guardrails, that each of our investments must meet.

- The company must have a balance sheet with very little debt, and preferably a net cash position. For those companies with debt, we are looking for a net debt to free cash flow ratio of less than two times.
- It must generate tons of free cash flow that it can either reinvest at high rates of return or return to shareholders through dividends and/or intelligent share repurchases.
- It must generate a 20% return on equity and we must believe that the future returns on equity will remain above 20%. This is an indicator of a real, sustainable competitive advantage.
- It must have stable, or preferably increasing profit margins.
- It must have real, organic revenue growth.

How do you define a high-quality management team?

Some key characteristics that we look for when evaluating management teams are significant stock ownership, and whether the management team has a clear strategic direction and is allocating capital in a way that will drive long-term value creation. We look at what management has done versus what they have said.

How do you define a "growth" company?

We invest across a spectrum of growth. So we invest in some safety growth companies like **Nestle** (NASDAQOTH: NSRGY) or **Automatic Data Processing** (NASDAQ: ADP) and some faster growing companies like **Facebook** (NASDAQ: FB). We are looking for organic revenue growth and we typically will not invest if earnings per share are expected to grow at less than a 10% annual rate over the long term. Also, free cash flow should be growing at least in line with earnings. But we are not just looking at the rate of growth, but also the consistency, predictability, and durability of the growth. By investing across the growth spectrum we have been able to protect capital in down markets and compound returns at well above-market rates over time, all with lower volatility than the market and most of our peers.

Is there one source of competitive advantage that is stronger and more enduring than others?

There are many sources of competitive advantage that we find favorable, but the advantage must be real and we must think that it is sustainable over time. We invest in companies that are protected by brands, network effects, patents and scale. Scale is interesting because it can manifest in different ways such as a cost advantage, a distribution advantage, or the ability to spread selling and marketing spend to protect a brand over a larger number of customers. Brands, network effects, patents or scale all ultimately protect the company through high barriers to entry and high switching costs. The switching costs can be financial, operational or psychological, and that customer captivity is ultimately what we are after.

Please explain how you narrow down your investable universe and how large that universe is?

We start by screening roughly 1,000 companies with market capitalizations above $4 billion based in the United States for the five criteria we mentioned at the top. This provides a list of only about 200 companies. We then perform a shallow-dive on those 200 companies. We typically spend a few weeks performing a shallow-dive on each company testing for the permanence of the company's competitive advantage and sustainability of its growth and profitability. This exercise cuts the list down to about 100-125. Finally, we perform deep dives to get down to a twenty stock portfolio. We typically spend months if not years researching individual companies.

Are there any industries you tend to prefer? Or avoid?

Many of the companies that meet our five criteria are in technology, healthcare, or consumer-facing industries. We have never owned energy, telecom, utility, or basic material stocks. We have invested in a small number of financial services companies, but not in the big banks or insurance companies that have lots of leverage and low returns.

How do you think about valuation?

We don't use discounted cash flow models because they are susceptible to behavioral biases, inaccurate assumptions, and false precision. Ultimately we subscribe to Warren Buffett's advice that "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price." All of the businesses we invest in have tremendous competitive advantages that give them the ability to grow their intrinsic values over time, so we are willing to pay a fair price. We typically look at price-to-earnings and price-to-free cash flow ratios because over time we think that if we pay a fair price the company's investment return will roughly track its growth in earnings and free cash flows. We estimate earnings and free cash flows five years out and put what we think is an appropriate multiple five years out to come up with an estimate of value. We compare a company's expected annualized returns to all of the other opportunities available to us in the market. We typically will not invest in a business unless we expect double-digit annualized returns over the next five years.

In a recent interview with Barron's you said "Our approach is not to buy low and

sell high." I know you touched on this in the previous question, but I find this statement so profound so I'm wondering if you can elaborate more?

There is a common investing framework that is to buy something that seems undervalued and sell it once it approaches fair value. This framework assumes that the portfolio manager is generating returns through his or her buying and selling activity. We think that superior returns can be achieved by investing in exceptional businesses that can compound their growth over long periods of time. In this case, the companies are doing the hard work of generating returns while we patiently hold them. Of course, we would prefer to buy these companies at a discount. But we are trying to invest in businesses of such high quality that they rarely traded at a big discount. So, we are perfectly happy paying a fair price and letting the business compound over time. If we can pay a fair price for a business that can compound earnings per share and free cash flow per share at 15% for five to ten years, we'll be very happy with those returns. The proof point here is that over nearly 28 years, our portfolio has only owned 106 companies in total including the 20 we own today.

Do you prefer to invest in a company that is reinvesting 100% of earnings into growth (or nearly all of its earnings at least) or one that can both grow and return cash to shareholders through dividends and smart buybacks?

We only invest in companies with sustainable competitive advantages and permanence. More often than not, by the time a company gets to that point it is generating so much cash flow that it can't reinvest it all internally at high rates of return. Of course, we prefer that a company can invest 100% of its cash flow at high returns, but that is just often not the case with large established companies with durable competitive differentiation. So we often end up investing in companies that reinvest as much of their cash flows as they can at high returns and then returns the rest in the form of dividends or share repurchase. We are skeptical of acquisitions, but for those companies pursuing growth through acquisitions we must see sound business logic and high returns on capital.

What common characteristics or patterns do you recognize in some of your biggest winners?

All of our biggest winners had huge, decades-long market opportunities ahead of them so we were able to generate strong outperformance regardless of when we got on the train or what else was going on in the market. We don't make bets that if X happens, then the investment will be a big winner. We invest when the secular tailwind is already happening, and we are simply analyzing the longevity of the market opportunity and competitive advantage.

What lessons did you learn or patterns did you recognize from some of your losers?

We haven't had many losers over the years because we only invest in competitively advantaged and financially superior businesses. These types of companies typically grow through all sorts of economic environments and as a result, even if the growth is less than we expected, they are more likely an opportunity cost to us rather than a losing investment. We have sometimes gotten in a situation when a legislative or regulatory issue popped up that caught us off guard or a company started to allocate capital in questionable ways. Because we manage a concentrated portfolio, when something pops up like this that we can't quantify or makes us question our thesis, we quickly sell and move to the sidelines. And if it turns out that we overreacted by selling too soon we may return again. Some of our biggest errors though, have been errors of omission. We are very risk averse which means we do sometimes miss out on some big winners if they do not meet our strict investment criteria.

What step(s) should investors take to try avoid "value traps?"

We try to avoid value traps by not making valuation the first, second, or third thing we look at. We never base our thesis on valuation alone. For us it's about the size and durability of the moat, opportunities to reinvest in growth, cash flows and balance sheet, and management's execution and capital allocation. If a business isn't executing well or is making questionable allocation decisions, it is time to sell. We try not to say, "but it's cheap." When you are analyzing your portfolio and opportunity costs, if the only thing your thesis rests on is "it's cheap," then it is time to move on. You don't have to make money back the same way you lost it.

When do you sell?

The most common reason we sell is when we find a better investment idea. We typically invest in 20 companies and we are usually fully invested so we sell most frequently to raise capital to invest in a company that is better than our twentieth best holding. A more important, but less common, reason we sell is when we become concerned that a company's competitive advantage is deteriorating or when management misallocates capital. We are quick to sell when this happens because we don't want anything to get in the way of the compounded earnings growth of the portfolio. And finally, we sometimes sell for valuation reasons. If the price is so expensive that the rate of earnings growth will not be able to overcome the valuation and provide double-digit annualized returns, then we sell.

How do you think about portfolio diversification?

We believe you can get more than adequate diversification from 15 or more stocks. The quality and sustainability of the businesses is far more important for risk management than how many you own. In fact, we believe that after a certain point, owning more companies increases your risk because you have a greater chance of owning an inferior business. That is why the hurdles we set for inclusion in our portfolio are so high. The most important factor in long-term wealth creation is not losing money and continuously compounding.

Can you discuss the research process on the Polen Growth Team?

We have a seven-member investment team and we consider ourselves "business analysts." All of our analysts are generalists and search globally for the highest-quality growth companies. Each analyst covers about 20-30 businesses. We don't work in silos. Our analysts often research companies together or research competing companies and share industry insights. The investment team meets informally daily because we sit close together and are constantly discussing the businesses we own or are interested in. We have formal meetings much less frequently, perhaps once or twice per month, because the hurdle for a new position to make it into the portfolio is so high. Each of our analysts understands that we won't venture outside of our box – those five guardrails – but they are free to pursue any company they want within that box. At a formal investment-idea meeting the analyst can provide any type of deliverable they want. We ask that they provide as much or as little as is needed to get at the truth of the company. Often the deliverable will take the form of a slide deck and a one-pager. Also, the vast majority of our meetings are spent discussing the business as opposed to the stock. Valuation, trading issues or portfolio construction are not relevant unless the business is one we would truly want to own. We think and act as if we were going to buy the entire business and hold it for many years. We believe this is a very different mindset than most others use.

What qualities does a great analyst have and what qualities/skill sets does a great portfolio manager have? How are the two different?

An analyst must have a true passion for investing, a genuine curiosity about businesses, and the ability to get the details right while still seeing the big picture. In short, our analysts balance passion, curiosity, and intellect, and are able to operate within our strict framework. Portfolio managers must look at things through a different lens. We look all the way through to the end client first. Before we make a buy or sell decision we think about our clients' retirement money and why it was given to us to manage in the first place. When we think about our clients first, it makes it very easy to stay within our guardrails rather than being tempted to venture out. Our template has proven that it can provide safety and growth, that it can protect the downside and compound to the upside over time. Portfolio managers need perspective, discipline and patience. Of course all Polen Capital employees need to have the highest integrity and a client-first focus.

What role does the director of research play at Polen?

This is a fairly new position for us. We currently have seven members on the investment team but we are bringing on two more. As our team grows and we continue to look at companies on a global basis, we felt we needed a dedicated person to make sure the right things are being prioritized and well resourced, that coverage is fairly and evenly distributed, and that each analyst's ideas are getting the attention they deserve. We also wanted to ensure that the communication between analysts and portfolio managers is open and fluid at all times. This was also a nice career progression for Todd Morris, who is an exceptional researcher and a great mentor to our newer teammates.

Do you meet with management of the companies you are invested in?

We don't have a hard and fast rule saying that we must meet with each and every management team, but we probably do meet with most management teams in our portfolio about once per year. Our meetings with management are not the meat and potatoes of our research process. They are more of the gravy. By the time we meet with management we have done extensive research on the companies and most of our questions have been answered. So we are rarely surprised after speaking with management. When we meet with them we focus on the company's culture and how it has evolved or taken shape over time and their long-term view of the business. We want to make sure that the CEO and his or her team are putting the long-term health of the business ahead of short-term results. It is a red flag for us if we ask a long-term question and get a short-term answer.

Do you have any performance metrics that you prefer management compensation be based on?

It often depends on the business and where it is in its growth cycle. But we tend to like metrics to be long-term focused and have a return component such as return on equity or return on invested capital. Sometimes growth and market share are more relevant for a company with a wide-open opportunity. For more mature businesses, sometime margins and returns are more appropriate. We also really like to see a total shareholder return metric as well.

David Gardner owns shares of Facebook. Joe Magyer owns shares of Automatic Data Processing. John Rotonti owns shares of Facebook. Tom Gardner owns shares of Facebook. The Motley Fool owns shares of Facebook.