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## MANAGING OVER THE LONG-HAUL

*In light of current financial conditions and concerns about the economy, we thought this an appropriate time to revisit a topic last discussed nine years ago.*

More than any other factor, the quality of management is crucial to a company's long-term success. Managerial decisions on a wide range of issues, from marketing and manufacturing, to debt levels and managing cash flow, can have far-reaching and long-lasting effects. Understanding management -- its structure, competency and caliber -- is a key part of successful investing.

Over the last several decades, dramatic changes have affected most companies. Global economic growth has presented both opportunities and challenges. Technological innovations have created new markets, products and services, including new financial models and investment vehicles that, unfortunately, may be here to stay.

Today's management teams must be able to do more than just cope with a constantly changing environment -- they must be able to thrive in it. How well management responds, especially in a crisis, has a great deal to do with how well the company will fare in the future.

As long-term investors, we look at the fundamental characteristics of companies in order to gauge their prospects for future growth. Many of the traits we favor, such as an expanding market share, a solid financial condition, and superior growth rates in earnings and dividends per share, are directly attributable to the actions of management over time.

Other factors, such as industry growth rates, have less to do with managerial talent. Sometimes a company is simply in the right place at the right time. But no firm can or should rely on external factors alone -- a rising tide does not necessarily lift all boats; some may have leaky seams, gaping floorboards, or even rotting struts.

In this Letter, we discuss the characteristics that define good management. Unlike the quantitative areas of investment analysis, evaluating a company's management is by nature qualitative. At times, it can be more art than science. Nevertheless, it is an important part of the fundamental analysis of any company considered for long-term ownership.

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First and foremost, good management is a team effort. Many executives rise to the top of their organizations through exceptional talent, personality or leadership qualities. Once there, however, they usually find a myriad of demanding and sometimes conflicting responsibilities, many with impossible time frames. The only way to effectively manage an organization is to delegate among a team of managers.

A well-formed management team typically consists of several members who not only work well together but also have complementary skills and talents. For example, people with strong technical skills may not be as good in other areas such as employee relations. Similarly, a genius at marketing may be a dunce when it comes to finance.

How management organizes itself can indicate how effective it is in fulfilling its responsibilities. For example, a structure in which a few top managers oversee many functional areas may be a sign of over extension. A preferable structure would allow managers to focus on just a few related activities.

Just as fads in fashion come and go, there are fads in business management too. Years ago, the consensus-building approach to problem solving was seen as cutting edge and many companies tried to implement it, with varying degrees of success.

Then the focus turned to the Chief Executive Officer as the sole leader of an organization. From this, the cult of the personality developed and larger-than-life CEOs became media superstars. Tony O'Reilly of Heinz and Dennis Kozlowski of Tyco are just two examples.

For investors, this situation can indicate a weak organization with scattered priorities and may be a prelude to underperformance going forward. If a CEO or other top executive becomes enthralled with the media's attention, the management team as a whole may be unable to be proactive to changing conditions and developments.

A management team should have withstood the test of time. In general, a tenure of more than one business cycle is preferable. A management team experienced in not only the ups and downs of its own industry but also the entire economic cycle is more likely to be prepared for and withstand unforeseen shocks, shifting demand, and new competition.

Perhaps the best way to gauge management's effectiveness is to look at the company's ability to identify, attract and retain high-quality, talented people. A company at which top-notch personnel want to work is in far better shape than a company unable to attract the best candidates, or one experiencing a net outflow of personnel.

One example of a company that seems to have dealt effectively with various management issues is Wm. Wrigley, the family-run gum company founded in 1893. William Wrigley Jr. took over when his father passed away unexpectedly in 1999 and promptly set about expanding the company's product lines. A health-care division was launched to produce gum infused with antacid, a Spanish lollipop company was purchased, and later the candy brands Altoids and Life Savers were acquired.

Through his later hiring of William D. Perez as President and Chief Executive Officer, Bill Wrigley seemed to acknowledge the increasing complexity of the business as well as his limitations in certain executive functions. Bill Perez was, and is, a highly regarded manager with in-depth CEO experience, both at Nike, a shoe company, and S.C. Johnson & Son, a family-run consumer products company. Bill Wrigley became Executive Chairman and Chairman of the Board.

In the company's 2006 Annual Report, both Bills specifically discuss how their skills and abilities complement each other's and how the new management structure will allow each to concentrate his efforts in areas where they are most effective. While the company is still a work in progress, it is commendable that a situation was recognized and acted upon and that perceived weaknesses were strengthened.

A good management team is highly motivated. Motivation is the fuel that keeps the energy flowing, and it comes from a variety of sources. Compensation is an obvious motivator but not necessarily the best. There have been numerous examples of managers driven solely by personal wealth, and this focus has gotten them and their companies into difficulties. Having a mission higher than one's own self-interest is the best motivator of all.

Management's forthrightness with shareholders and the public is important and an indication of quality. One way to judge this is through the annual letter to shareholders, the various regular reports submitted to the government, and the company's press releases. A great deal about a company's management team can be gleaned from how it communicates with shareholders and outsiders.

This is even more important in a crisis situation. How well and how quickly management responds to a crisis and developments as they occur can be an indication of how well the company may perform in the future, once the crisis has passed.

A classic example is Johnson & Johnson's handling of the Tylenol crisis twenty-five years ago in 1982. Several cyanide-related deaths resulted from packages tampered with in stores. Management acted quickly by recalling the product nationwide and stayed in the forefront to update the public on other actions it was taking.

Management also made the decision that the company's reputation was far more important than whatever costs would be associated with remedying the crisis. Tylenol capsules were eventually replaced with more tamper-resistant caplets, and the containers were also changed. Johnson & Johnson's management team during the emergency has since been held as the model for effective crisis management.

In our work, we have noted that if management cannot discuss in clear and understandable terms what is happening within its organization or industry and what it is doing about it, then it is very likely that something somewhere is amiss. Muddled thinking leads to muddled actions -- not characteristics of leading, high-quality growing companies.

A more recent example of a company and its communications with its shareholders is Walgreen, which reported its first earnings shortfall in a decade last October. Historically, the company's progress was fairly predictable, so these results surprised Wall Street, which of course responded in its own "predictable" way.

However, Walgreen's Annual Report was released shortly after the earnings surprise and in its letter to shareholders, management goes into excruciating detail as to what went wrong and what they are doing to fix it. While the company clearly has its work cut out for it, management cannot be accused of glossing over, covering up, or generally ignoring the problem. Based on the company's fundamental characteristics and management's attitude, we think Walgreen will get back on track.

Good management can translate directly into good growth over time. The types of companies we favor typically have growth rates exceeding their industry averages. Above-average rates of growth can be achieved in several ways.

Maintaining high levels of spending on research and development is the lifeblood of many companies. These companies also tend to have a high return on equity. Both are essential for future growth, and cutting corners on R&D or placing investment priorities elsewhere hampers the future development of products, services and the company.

A record of consistently high profit margins can also translate into above-average growth. Superior management teams do this by keeping administrative overhead low, maintaining high levels of inventory turnover, and ensuring that the organization does not become bloated. Having a well-defined, long-range plan that is periodically updated and publicly stated is also important. Many successful management teams place a high priority on a formal planning process.

Most importantly, management sets the tone for the company through the policies, standards and operating norms it defines. Its attitude is also important. A company with above-board practices is undeniably a better investment than a company with overly aggressive procedures and questionable policies. While these issues are more frequently seen in the accounting and financial functions, they apply equally well to other areas.

In the end, management is all about leadership. Companies, such as the ones described above, led by competent, qualified and motivated management teams are likely to deliver superior progress in earnings and dividend growth over long periods of time. They are likely to achieve above-average results no matter the phase of the business cycle, through economic thick and economic thin.

Over time, history has shown that it is this progress, a result of good management, that drives share prices higher. While many Wall Streeters spend their days trying to outsmart each other with complex and tricky trades, good managers spend their days focusing on growing their businesses, increasing their sales, and delivering progress in earnings and dividend growth.