How Kopp Investments Selects Winning Companies:
The Total Quality Management Investment Fund

Does a focus on process and quality techniques give return on the investment of using them? “Sales and Marketing the Six Sigma Way” illustrates process improvement techniques that can transform sales and marketing from voodoo art to understandable, measurable production, with causes and effects understood. Underlying that work is the belief that using these techniques will generate higher revenue and profits, and generate them more predictably.

Since 1999, the Kopp Total Quality Management Fund has used a proprietary quality scoring method that identifies companies that are committed to quality as a way of business. For 22 of the past 26 quarters Kopp Totally Quality Management Fund has out performed the S&P 500 – hard evidence that process and quality improvement techniques do make a difference in the performance of a company. If you are investing for the long run, the difference between a winner and a dog is the ability of a company’s management.

Are quality and process improvement techniques a management system? The answer is yes. Quality and process improvement techniques drive precision in people’s use of language. They ensure that managers deal with facts rather than opinions. They help identify cause and effect, and can separate signals in the data from background noise. Extend this way of thinking beyond the manufacturing floor and you have the makings of a powerful performance management system. Quality and process improvement principles enable a thorough analysis of business problems (as well as technical ones) so better decisions can be made.

Kopp was looking for a way to pick winners – companies that had better management systems than their peers. They figured that companies focused on quality in their management systems would have higher valuation than their peers. To test their theory, Kopp Investments built a scoring system that rewarded equally quality focus and financial measures of performance. Let’s walk through the elements of Kopp’s system so you can understand how you might select your own winning stocks. (Of course, the description below is for your informational purposes only, and is not a recommendation for or against any specific approach to evaluating your investment decisions.)

How Does Kopp Investments Use Quality?

To identify companies with a quality focus (which represents 50% weight in its scoring method), Kopp Investments developed a three-part composite analysis including:

1. How a company stacks up on the Baldridge Criteria for Performance Excellence;
2. An proprietary survey of quality experts that looks at companies in the S&P 500 on a rolling basis; and
3. An assessment of the array of quality awards given each year.

Companies in the S&P 500 are assessed against each of these categories and are given a score. Kopp has a massive spreadsheet that is used to track all the criteria and the scores. Companies that achieve scores in multiple categories are given more weight than those that don’t. Over the past 10 years, Kopp has continually validated each of these three criteria statistically and found that there is tight correlation across the variables. Since these criteria seem to do a good job of identifying quality-focused companies, they are worth understanding better.

The Baldrige Award is given by the President of the United States to outstanding organizations that are judged in seven areas:

1. Leadership
2. Strategic planning
3. Customer and market focus
4. Measurement, analysis, and knowledge management
5. Human resource focus
6. Process management
7. Business results

These seven areas are known as “The Baldrige Criteria for Performance Excellence.” Taken as a whole, they reflect leading-edge management practices that support a systems approach to performance management. Receiving a Baldrige Award requires that a company submit a detailed application, and undergo extensive audits from highly educated Baldrige examiners.

Often, companies prepare for years before they actually go through the process. However, most companies agree that the exercise was well worth the effort, because it enables them to think through their systems and procedures in a way they never had before. The result is their company operates in a more professional and more efficient way.

Simply selecting Baldrige Award winners isn’t good enough. Not every company submits an application for the Baldrige Award and the Baldrige assessments on each of the seven criteria are not publicly available. So, Kopp needed to figure out ways to assess companies on their effectiveness in each of the seven criteria and generate scores for every S&P 500 company. For example, are they ISO9000 certified, have they won an award for being a great place to work, or are they market leaders? Although they may not be able to score every company in all seven criteria, those that score highest should be quality-focused companies. Kopp’s next challenge was to ensure that the assessments they made using the Baldrige criteria were accurate. For balance, Kopp regularly polls quality experts on their opinion on what companies they think are quality in the S&P 500. These experts simply rate companies on a one to five scale where five is outstanding. These scores are then added to the scores from the Baldrige assessment.

Kopp understands that there are organizations that make it their business to understand and assess performance in quality techniques, so why not use their expertise? Kopp assembles all the national, state and international quality awards and gives winning companies extra points. If a company wins a prestigious international quality award, they’ll get more points than another company whose division wins a state quality award. Quality awards along with the other two assessments of quality (the Baldrige criteria proxies and the quality expert opinion poll) enable Kopp to produce a composite score. Through statistical validation over the years, the Kopp’s composite quality score has proven to be thorough and balanced.

One thing to note – none of the assessments Kopp uses is focused on a single style of quality management, such as Six Sigma, Lean or any other method. It is the results that matter more than what a company calls its particular approach.

What Else Besides Quality?

Business results are the other 50% of the Kopp Investments assessment. Having a company in your portfolio that is quality focused doesn't mean much unless they also deliver good financial performance.

To this end, Kopp uses straight forward financial measures that have been refined year after year to support their type of investment portfolio. Measures such as market capitalization, shareholder value, profitability and long term trends are the kind of traditional financial measurements that Kopp considers. By using financial measures to ensure that a company's quality focus actually delivers results, Kopp ensures its picks are well balanced. Kopp balances the Total Quality Management Fund portfolio in other ways as well. They carefully weight all the various criteria (from the specifics of the Baldrige criteria proxies, to the importance of various quality awards, to the measures of financial performance). They continually analyze the results using statistical methods to validate that their techniques hold up against actual market performance over time.

Kopp Investments does one more thing to balance their portfolio. Since you can't reasonably compare Intel to Georgia Pacific, companies are evaluated against their peers within each of the S&P 500 business sectors. When the S&P moves a company from one sector to another, they are reevaluated against their new peers. For example, when Johnson Controls was moved to automotive and was no longer compared to the likes of GE and 3M they were added to the portfolio. Companies that fall out of the S&P 500 entirely are immediately dropped from the Total Quality Management Fund portfolio. In this way Kopp makes sure their portfolio is aligned with the S&P 500 as well as protected against volatility in any given sector.

How Has the Total Quality Management Fund Performed?

Back in 1998 Kopp had a theory that companies with a focus on quality would perform better over the long run than other companies. They built a weighted and statistically validated scoring system that uses three different measures of quality and selected financial measurements. Kopp gave the financial measures equal weight with the combined quality score and balanced the portfolio within and across the categories within the S&P 500. Were they right?

The Total Quality Management Fund has consistently out-performed the S&P 500 in both upside and downside market conditions while at the same time being slightly less volatile (their five year beta score is 0.94). Fund performance against the S&P 500 (Annualized Return) Years Total Quality Management Fund S&P 500 1 ↑ 10.52% ↑ 6.32% 3 ↑ 13.82% ↑ 8.30% 5 ↑ 7.43% ↓ 2.37%

With this performance as a foundation, Kopp continues to improve its methods. For example, early in the fund's history, the financial measures were not as robust as they are today. Along with many other investors, Kopp learned from their experience with Enron that narrow assessments of financial performance are inadequate. Whatever stock picking method you use should balance a careful assessment of financial performance against other assessment techniques.

Conclusion

Kopp's method of picking companies for their portfolio is a winner – a credible method for identifying companies that focus on quality and have strong financial performance. The track record for this approach provides sound evidence that companies that take quality management philosophies seriously make better management decisions, and have the financial performance to prove it.

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