



QUARTERLY THINKING

TRUSTING IN THE
COSTCO WAY

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For more than two centuries, the elected board of directors has been the bedrock of corporate management. In 1811, the New York state legislature passed the first general incorporation act, decreeing that a company’s “stock, property and concerns...shall be managed and conducted by trustees, who, except those for the first year, shall be elected”.

Today, the importance of the board of directors to long-term corporate success and the protection of shareholder interests is beyond dispute. Regrettably, it is also abundantly clear that the board can play a central role in corporate

collapse, whether through wilful malfeasance, negligence or plain old incompetence. From Enron and WorldCom to Parmalat and Wirecard, recent history is littered with tawdry tales of boardrooms failing in their duties.



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Given this importance, it's little wonder that a great deal of ink has been spilled over the years defining what a good board looks like. In truth, there is no fixed formula; some of the aforementioned corporate catastrophes happened on the watch of seemingly fit and proper boards. That's not to say, however, that investors shouldn't seek to establish what they believe constitutes best practice. Nor that they shouldn't engage with those companies where they believe board composition is sub-optimal and where changes would be in the best interests of shareholders.

“From Enron and WorldCom to Parmalat and Wirecard, recent history is littered with tawdry tales of boardroom dysfunction”

In that vein, we recently initiated several engagements with companies on the issue of board independence. Good governance demands that boards are composed of individuals with the necessary skills and external experience to bring support, and robust challenge to the boardroom. In our view, this requires strong independent representation. The objectivity and outsider perspective that suitably qualified, high-quality independent directors can bring are assets that can help to minimise the risk of mismanagement and its potential financial implications. Where we believe it to be in the best interests of shareholders, we will not hesitate to actively encourage companies to strike a better balance regarding independent representation.

Typically, we expect a minimum of 50% of directors on the board of non-controlled companies to be independent (we generally presume directors are not independent if they

have served on the board for ten or more years). Furthermore, we generally prefer to see an independent chair and/or an independent lead director. Note, however, the presence of the words “typically” and “generally”. As with many other ESG-related issues, we would rather avoid a cookie-cutter approach to board composition. Context is everything and, in some circumstances, levels of board independence may not align optically with acknowledged best practice for very good reasons.

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A case in point is Costco, the leader in North American warehouse retailing. On first inspection, the Costco board falls short of our stated preferences on independence. We have, however, taken the decision not to engage with Costco on this issue, given we believe the composition of the board is an important ingredient in Costco's secret sauce and that change would not be in the best interests of shareholders. We could, of course, be proven wrong and there is no question that the stakes do feel higher when you step away from the standard view, but we put value in our judgement and our knowledge of the companies in which we invest.

At the time we took the decision not to engage with Costco, seven of its twelve board members were ‘non-independent’ by our definition, short of our preferred 50% threshold. That split has since changed to six out of eleven following the death of legendary investor and long-term Costco director Charlie Munger. A self-confessed Costco “addict” Mr. Munger served as a director of the firm for more than 25 years,

bringing not only seven-decades’ worth of investment experience but also a deep understanding of business models and, importantly, Costco’s culture.

Of the six remaining non-independent directors, three are executives and three are non-executives with tenures in excess of ten years. In our view, these non-executive directors not only boast invaluable experience and expertise but, due to their long tenure, they are steeped in Costco’s culture and fully understand the benefits of doing business in the unique Costco way. It’s also worth noting that the independence ratio of the board will improve when former CEO Craig Jelinek, one of the three executives on the board, steps down in April.

The Costco approach to business is built around the concept of delayed gratification – resisting the temptation of immediate rewards in anticipation of greater rewards later. This is a very rare trait in business. In practice, it means paying employees more than you need to, so they stay and perform better over the long term; treating your suppliers well and offering better payment terms than necessary, in order to build and maintain long-term business relationships; and sharing growing economies of scale with your customers, so as to offer better value for money and increase loyalty.

“The Costco approach to business is built around the concept of delayed gratification”

Costco’s ways have not always been well understood or appreciated. In the early 2000s, the company was out of favour on Wall Street for ‘disregarding shareholder interests’. For analysts, Costco’s tortoise was no match for Walmart’s hare with its ruthless approach to costs,

employees and suppliers. Not for the first time, however, the tortoise has outperformed. Today, Costco is one of the most admired brands in the world and its stock has comfortably outpaced Walmart's.* On top of this, employee retention is amongst the highest in retail and the company ranks as one of the most efficient large retailers (including from a carbon perspective). In other words, the Costco way of doing business has benefited shareholders, the company *and* the wider community. It is Costco's people – from board members to in-store employees – who are tasked with preserving this rare but successful culture.

Jeff Raikes, for example, has been a board member since 2008. A well-known philanthropist, Mr. Raikes co-founded the Raikes Foundation and was previously CEO of the Bill & Melinda Gates Foundation. Attuned to Costco's community values, his experience makes him an ideal fit for the role of chair of Costco's nominations committee.

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Similarly, Sue Decker, a board member since 2004, brings invaluable insights in technology and internet business models at a time when Costco is in the early stages of developing its own e-commerce platform and team. CEO and founder of digital media platform Raft, Ms. Decker is also a long-standing member of the Berkshire Hathaway board, a company with similar long-term values to Costco.

The final non-executive director is Hamilton James, a board member since 1988 and chairman since 2017. Highly experienced across many global industries and a former president and COO of Blackstone, Mr. James' “non-independence” provides better challenge than the combined chair and CEO role that is typical of non-independence in the US.

Judged solely on the experience they bring to the board, it would be very difficult to advocate for the removal of any of the aforementioned directors. But add in their deep knowledge and understanding of Costco's unique approach to doing business and we think that to do so would be counter-productive for the company and shareholders.

Any of Costco's principles could be sacrificed in the hope of delivering a sugar rush for profits or the share price. To do so would be to prioritise short-lived gains over long-term success and it is vital to have people in place who understand this. Costco is a case study in business success and the current board plays an integral role in preserving the culture that makes it a special business. Best to leave the cookie cutter in the kitchen drawer.

*Factset, Costco +2050.4% vs Walmart 245.1% (total return from 31 December 1999 to 19 December 2023 in USD)

IMPORTANT INFORMATION

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