"Show me the incentives, and I will show you the outcome." - Charlie Munger

When initially buying a stock, investors typically have cheerful expectations. They examine the merits of the business, and assume management will play their role according to the textbook rules of governance. Investors don't expect management to stack the board with cronies, chase empire-building acquisitions, or pad their compensation with perks. But the investor's optimistic vision may remain unfulfilled. Public-company management provides many tempting opportunities for self-enrichment.

Managers are people—neither saints who will selflessly serve the shareholders, nor villains solely chasing personal gain. Where they fall on the governance spectrum will depend largely on the structure of their incentives.

In our view, the incentive that best aligns management and shareholder interests is stock ownership. If the CEO owns a sizeable portion of the same class of stock as shareholders, he or she has a healthy motivation to maximize the value of that stake. We prefer management teams build their stake as founders, or by writing a cheque to buy shares just as minority shareholders must do. Unfortunately, the more typical situation is that C-level managers become shareholders via option grants. This does provide some alignment, though imperfectly so due to the asymmetry—option holders realize the upside, but not all the downside. So being granted options doesn't have the same mind-focusing effect as putting up cold, hard cash.

Among stocks owned in Laurus portfolios, Steve Sadler of Enghouse is a CEO whose business has benefitted from management interests being well-aligned with those of shareholders. Sadler founded the company and continues to be a significant shareholder. Enghouse generates cash which piles up on its balance sheet and is deployed in acquisitions from time to time; Sadler has every incentive to hold off on acquisitions if favourable terms and prices aren't available, then act quickly when the time is right. This opportunistic attitude has benefitted shareholders in long-term share price outperformance.

Another example of a Laurus-owned stock where insider ownership is material is Winmark, an operator of franchised retail. When we spoke with Brett Heffes, the CEO of Winmark, a few months ago for an update call, Mr. Heffes was at pains to emphasize the "skin in the game" represented by his ownership of $10 million worth of stock—of course, we were well aware of his shareholdings. With the bulk of his net worth tied up in the firm, he may not be diversified, but he certainly is motivated. By iterating the strategy that has worked for the company over the years, he can continue to build his own wealth—and that of shareholders.

Not every stock held in Laurus portfolios has C-level managers who own substantial amounts of stock. When new executives are hired to run longstanding companies, their starting stakes may be modest. We like to see companies establish guidelines on how much stock the executive team members and board members are expected to own. This demonstrates that they too understand the awesome power of incentives. If shareholders are willing to risk capital to invest in a business, it's not an unreasonable expectation that the managers paying themselves from the activities of that business do the same.

- Linda Lebrun