



Investment Brief



Examining Financial Market Underpinnings: The Efficient Market Hypothesis, Behavioral Finance, and High ROE Businesses

THE EFFICIENT MARKET HYPOTHESIS (EMH) has been one of the pillars of modern financial theory since its development in the 1960s. Simply put, EMH states that the price of a security reflects all available information about that security.

So, does EMH imply that the market is always right? If so, how can we justify events such as the rapid creation and then deflation of the late 1990's/early 2000's technology bubble? How can we explain the record-setting market high in October 2007 just months before we entered into an historic economic downturn and severe bear market?

The answers to these questions lie in a deeper understanding of EMH – what it implies, what it does not imply, and what it misses.

Efficient Market Hypothesis

EMH was first expressed by French mathematician Louis Bachelier in the early 1900s. It emerged as a prominent theory in the 1960s when Bachelier's work began to circulate among contemporary academics. Famed economist and author Eugene Fama is generally given credit as the father of modern EMH. His work provided evidence for the hypothesis, while he extended and refined the theory. He classified EMH into three forms of efficiency: weak, strong and semi-strong.

Weak-form EMH assumes that current security prices reflect all market technical information such as historical prices, rates of return, trading volume data, etc. Essentially, it implies that historical rates of return are completely independent from future rates of return. Weak-form EMH is hard to dispute. If it did not exist, investors would be able to consistently earn superior returns by simply studying historical price charts and trading data.

At the other end of the spectrum, strong-form EMH states that a security price reflects all information about that security – both public and private. It implies that no investor should be able to consistently earn superior returns. Strong-form EMH does not hold up very well against some very simple tests, the most obvious of which is insider trading. In strong-form EMH, insider trading would not exist because there would be no insiders. Unfortunately, we have seen too many examples of investors profiting from and being prosecuted for insider trading.

Semi-strong EMH lies in the middle of weak-form and strong-form EMH. It states that all publicly available information is reflected in security prices. Semi-strong EMH encompasses weak-form EMH and, consequently, it includes historical technical information in addition to publicly available fundamental information such as earnings, cash flow and valuation. It implies that security prices react quickly and accurately to new public information. While not perfect, semi-strong EMH makes intuitive sense and has held up relatively well to criticism. Semi-strong EMH is the most commonly cited form of EMH by its proponents.

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So, within the framework of EMH (from here on, assume that EMH means semi-strong EMH), we will rephrase our original question: If security prices reflect all publicly available information, does that mean the market is always right? For illustrative purposes, we will consider this question in the context of a couple periods of extraordinary market volatility.

Proving/Disproving EMH

From March 31, 2000 to September 30, 2002, the S&P 500 Index declined 44%. A similar example was the nearly 53% decline in the S&P 500 Index from October 31, 2007 to February 28, 2009 and the subsequent 44% rebound through September 30, 2009. According to EMH, the prices of these indices should have accurately reflected the knowledge and expectations of all investors on each day during these periods. However, given the dramatic short-term volatility during these periods, it is difficult to believe that EMH held true and that the market was “right” on every day.

So, let us move on to what is perhaps a more interesting question: Do these periods of extraordinary market volatility disprove EMH?

To answer this question, we need to reconsider the meaning of EMH. EMH states that security prices reflect all publicly available information. It does not state, however, that this information must be correct. In fact, because security prices are based in large part on unknown and often volatile future information (expectations), EMH is probably more consistent with the statement that the market is always wrong! Future reality is likely to always deviate from expectations to some degree.

This caveat is probably the best way to explain periods of heightened market volatility without violating the framework of EMH. It could be argued that in those periods the market was efficiently pricing in future expectations. It just turns out that those expectations were proven spectacularly wrong.

Unfortunately for EMH, that defense can only go so far. EMH relies on rational investors. More specifically, it needs marginal investors (those that are driving price movements) to objectively and accurately react to new information. Perhaps the market is unbiased and rational on most days but it is not difficult to find some notable exceptions such as the two time periods we have cited here.

So what causes investors and markets to be irrational? This question is best answered by a financial discipline known as a behavioral finance.

Behavioral Finance

Behavioral finance attempts to create a link between investor psychology and economics in order to explain market inefficiencies. Proponents of behavioral finance contend that markets are not always efficient

because markets are driven by human decisions and that humans are notoriously bad decision makers if left to their own devices. These proponents cite a range of cognitive biases such as loss aversion and focus on the short-term as reasons for consistently sub-optimal decisions.

The modern study of Behavioral Finance got its start in the late 1970s based on the academic work of Amos Tversky and Daniel Kahneman. Their work focused on loss aversion – or what they called prospect theory. They found that individuals experience a greater amount of negative emotion associated with prospective losses than they do positive emotion associated with prospective gains. In other words, losses caused more emotional pain than gains caused positive feelings.

Another bias associated with loss aversion is called the disposition effect, which describes the tendency among investors to hang on to losing securities for too long for fear of realizing a loss, while selling winners far too soon due to an eagerness to realize gains.

Another tenet of behavioral finance is recency bias. Recency bias explains the tendency among investors to overweight recent experiences and extrapolate recent trends when making investment decisions. An example of such recency bias is a 1997 study by Yale professor Robert Shiller. He found that at the peak of the Japanese stock market, 14% of Japanese investors expected a market crash, but that after the crash, 32% of these investors subsequently expected a crash.

High ROE Businesses

Now that we have discussed EMH and some of the implications of behavioral finance, let us conclude for now that EMH is a powerful model in explaining market behavior, but not one that is without flaws.

Within the context of EMH and behavioral finance, we will try to answer one final question: How can active investors attempt to identify market inefficiencies and take advantage of them?

At Jensen Investment Management, we have answered this question by focusing our investments within a unique part of the market. We will only invest in companies that have generated a Return on Equity (ROE) of at least 15% for 10 consecutive years. This is a very selective screen. We apply this screen to approximately 5,000 companies each year and are left with an investable universe that is consistently fewer than 200 companies.

So why do we believe that the ROE screen allows us to mitigate some of the pitfalls associated with irrational markets?

The data used to calculate ROE is publicly available and therefore should be accurately reflected in the security prices, according to EMH. Does the market systemically undervalue high-quality companies? Perhaps the ROE

universe exploits some of the holes in EMH that are described by behavioral finance.

We will begin our analysis with a quick summary of ROE and the implications for the companies in the high ROE universe.

While not perfect, ROE is a powerful tool for analyzing a company. It measures three separate components of a business: profitability, efficiency and leverage. Our requirement for 10 consecutive years of strong performance results in a universe of companies with staying power.

Over the past 10 years, on average only 13% of companies have exited the universe each year and a meaningful number of those exits have come from investor-friendly events such as takeovers. The companies within this high ROE universe generally share common characteristics such as strong competitive advantages, redundant cash flow generation, returns above their capital costs and relatively stable business performance.

To summarize, the ROE screen results in an investable universe of extremely high-quality companies.

With that backdrop, let us shift our focus back to behavioral finance. We will begin with loss aversion – the tendency investors have to hang on to losers for too long due to the fear of realizing a loss. We believe the ROE universe minimizes this bias due to its strict inclusion/exclusion rule. For example, a company is

automatically excluded from this universe if it violates the 15% ROE hurdle, whether or not it has generated a loss. While the 15% hurdle may seem arbitrary, we have seen evidence that such a violation may signal a loss of competitive advantage or a major change to the business.

Now onto recency bias – short-term expectations versus long-term focus. The universe of high ROE companies greatly reduces the effect of short-term bias due to its requirement of 10 years of sustained high performance. We believe this is the universe's most powerful attribute. It has served it well during significant market downturns following periods in which the market appeared to have been swayed more by short-term euphoria than by long-term fundamentals.

Conclusion

We believe that EMH is a strong model and worth considering when evaluating market behavior. However, it is not bulletproof. We do not believe that it accurately explains market behavior in all instances. The concepts within behavioral finance shed some light on the human biases that may explain the breakdowns in EMH. We believe these inefficiencies can be exploited by long-term investing in high quality, sustainable businesses.

Inside Jensen

We want to advise you of a future management transition at Jensen Investment Management.

Robert (Bob) Millen, Chairman of Jensen Investment Management and a member of the Investment Committee for the firm as well as The Jensen Portfolio, will retire during the first quarter of next year – 2011 — at age 64. The transition of Bob's responsibilities has been well planned and will take place gradually over the coming months.

As with previous retirements of Jensen Investment Team members, both former and current executives have spent considerable time and effort to assure the long-term sustainability of the firm and continued adherence to Jensen's hallmark investment philosophy and methodology. This transition will not change our quality investment management discipline or the investment advice we provide.

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THE JENSEN INVESTMENT BRIEF

Bob's leadership responsibilities will be divided among senior team members and Jensen will continue to be led by a senior management board working closely to set the firm's strategy.

Many of Bob's client relationships will be transitioned to existing Jensen Portfolio Managers Rob McIver and Robert Zagunis.

Rob McIver has 23 years experience in the management and operations of an investment advisory business and is a member of the Investment Committee for the firm, as well as The Jensen Portfolio, where he serves as the mutual fund's President.

Robert Zagunis, current Chairman of the Investment Committee, has been a member of the Investment Committee for the firm and The Jensen Portfolio since 1993. He has over 33 years of experience in finance and investment management.

In addition, Eric Schoenstein, Principal and Director of Business Analysis, will assume a number of Bob's client relationships as he transitions to a Portfolio Manager role while retaining significant research responsibilities. Eric has served on the Investment Committee for seven years and has 22 years expertise in finance, accounting and investments.

As for the rest of Jensen's senior executives, Kurt Havnaer, a Jensen analyst who has served on the Investment Committee for two years and has 22 years of investment experience, will continue in his present role at Jensen. Allen Bond and Kevin Walkush will continue to serve on the Investment Team as analysts.

Adam Calamar has been promoted to analyst on the Jensen Investment Team.

Brian Ferrie, Principal, CFO and Chief Compliance Officer for Jensen for the past six years, with 23 years of industry experience, will continue to oversee the financial health and regulatory aspects of the firm.

Dave Mertens, having seven years with Jensen as Principal, Sales & Marketing, and 27 years of expertise within the industry, will continue to manage the delivery of services to clients, including shareholders of The Jensen Portfolio.

Jensen has carefully and deftly built a team of professionals with considerable depth and a singular focus on investing in high ROE businesses. We look forward to serving your current and future investment needs as professionally as we have served you in the past.

As of June 30, 2010, the Average Annual Total Returns for The Jensen Portfolio - J Shares were 14.87%, -4.14%, 1.15% and 1.52% for the 1-, 3-, 5-, 10-year periods, respectively. As of June 30, 2010 the S&P 500 Index's Average Annual Total Returns were 14.43%, -9.81%, -0.79%, and -1.59% for the 1-, 3-, 5-, and 10-year periods, respectively. The J Shares annual operating expense ratio is 0.96%. **Performance data quoted represents past performance; past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the Fund may be lower or higher than the performance quoted. To obtain updated performance information that is current as of the most recent month end, please call 1-800-992-4144 or visit www.jenseninvestment.com. All returns include the reinvestment of dividends and capital gains. Performance shown is for the Class J Shares; performance for other Fund shares classes will differ.**

The Fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The prospectus contains this and other important information about the investment company, and it may be obtained by calling 1.800.992.4144, or by visiting www.jenseninvestment.com. Read it carefully before investing.

The Fund is non-diversified, meaning that it may concentrate its assets in fewer individual holdings than a diversified fund, and is therefore more exposed to individual stock volatility than a diversified fund. Mutual fund investing involves risk. Principal loss is possible.

The information provided herein represents the opinions of Jensen Investment Management, and is not intended to be a forecast of future events, a guarantee of future results, nor investment advice. Fund holdings and sector weightings are subject to change and should not be considered recommendations to buy or sell any security.

S&P 500 Index: The S&P 500 Index is a market value weighted index consisting of 500 stocks chosen for market size, liquidity and industry group representation. This index is unmanaged and you cannot invest directly in an index.

Return On Equity: (ROE) Is equal to a company's after-tax earnings (excluding non-recurring items) divided by its average stockholder equity for the year.

Free Cash Flow: (FCF) Is equal to the after-tax net income of a company plus depreciation and amortization less capital expenditures.

The Jensen Portfolio, which is advised by Jensen Investment Management, Inc., is distributed by Quasar Distributors, LLC.