

the Jensen Investment Brief

"Enduring wealth comes from owning great companies for a long time."

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Amphenol: Connecting with Investors

As regular readers of the Jensen Investment Brief are aware, the investment team believes that the long-term returns generated by the stock and dividends of a quality business reflect its long-term growth in earnings and free cash flow. In other words, there is a strong connection between business value and stock value over the long-term.

Recently we invested in Amphenol Corporation with world headquarters in Wallingford, CT., a company that demonstrates such a connection, both literally and figuratively speaking.

Amphenol designs, manufactures and markets electrical, electronic and fiber optic connectors and coaxial cables. A connector is a component used to connect two devices, wires or cables. Connectors range from simple cellular phone rechargers to the complex devices used in military aircraft communication systems. Coaxial cable is copper cable used by cable TV companies and phone companies to connect to customer homes and businesses.

Amphenol was founded by Arthur Schmitt in 1932 as a producer of sockets for radio tubes and expanded during WWII into manufacturing for military applications. Amphenol grew through a series of mergers and acquisitions until 1987 when it was spun-off by then-parent company Allied Signal. An initial public offering took place in 1991. Amphenol was majority-acquired by private equity firm Kohlberg Kravis Roberts & Company (KKR) in a 1997 leveraged buyout, but KKR exited its position in 2004 via a secondary offering.

Since that time, Amphenol has used its free cash flow to pay down debt and make selective acquisitions to build out its business. At the end of 2008 Amphenol executed a well-choreographed management transition with Chief Executive Officer Martin Loeffler stepping up to the newly created position of executive chairman while then-COO Adam Norwitt became CEO.

Index of Articles

Amphenol: Connecting with Investors	1
<i>by Eric Schoenstein, Director of Business Analysis and Allen Bond, CFA, Business Analyst of Jensen Investment Management</i>	
Is it Time to Invest?	2
<i>By Robert Millen, Chairman of Jensen Investment Management</i>	

The Markets for Connectors and Cables

Amphenol produces over 100,000 distinct products and serves over 10,000 customers across a broad range of end markets: communications and information processing markets, such as cable television, cellular telephone and data communication and information processing systems; aerospace and military electronics; and automotive, rail and other transportation and industrial sectors.

The worldwide connector industry, which has historically grown at about 8% per year, totals more than \$44 billion and is actually quite substantial. This above-average growth has largely been driven by the broad-based proliferation of electronic devices across industries including advances in automotive safety systems, cellular phone technology and alternative energy products. Amphenol commands about 8% of the overall market which is highly fragmented beyond a few larger competitors.

Competitive Advantages

Amphenol's key competitive advantage is technological innovation. Connectors are highly engineered products that often become a bottleneck in new product development for their customers. These attributes make Amphenol a key partner with their customers and allows them to differentiate based on innovation and responsiveness. Amphenol's reputation for innovation leadership and their longstanding customer relationships makes these advantages sustainable.

In addition, Amphenol is one of a handful of global competitors in the connector industry. This positioning leads to several advantages. First, much of the growth is coming from new infrastructure development in emerging markets. Amphenol's global footprint gives it a strong foundation to take advantage of this growth. In addition, Amphenol manufactures about 70% of its products in low cost geographies which boosts margins and is important because the connector industry is cost-competitive.

Moreover, Amphenol has an edge with its global supply chain which is a barrier to entry for its would-be competitors in servicing large, global customers.

Amphenol has about 60 individual operating units that operate with a decentralized management structure. This allows the company to be nimble. Last year, for example, Amphenol quickly right-sized its workforce when the firm experienced a sharp decrease in demand due to the global recession. Specifically,

- Continued from page 1

Amphenol reduced headcount by 17% in the final quarter of 2008.

Finally, the decentralized structure is well-aligned with its “bolt-on” acquisition strategy which allows Amphenol to bolt-on an acquired firm as a new, quasi-independent operating company and retain existing management. This strategy facilitates maintaining that entrepreneurial culture and strong innovation cycle of the smaller companies.

Many Happy Returns

Amphenol’s return on invested capital has averaged over 20% for the past 10 years. For Amphenol, this has resulted in strong free cash flow generation and a balance sheet that exhibits strength. Amphenol has used its financial flexibility as part of an offensive strategy during this period by making selective acquisitions.

These attributes have proven to be a significant advantage. Amphenol has been able to grab market share as customers have embarked on a “flight to quality” when selecting connector suppliers.

With a solid balance sheet, strong competitive advantages and a capable management team, we believe that Amphenol is well-positioned for long-term, sustainable growth. The recovery in the economy that we’re confident will eventually occur will allow Amphenol’s customers to develop new products that will benefit from the innovations in connectors that the company has long been lauded for. That should allow the company to deliver strong business performance ultimately connecting (pun intended) to solid stock returns for its shareholders.

Is it Time to Invest?

(What follows is a condensed, updated version of a white paper Jensen Investment Management published in early June 2009.)

Many investors are faced again with the age-old question: Is it time to invest? The answer to that question usually lies with an investor’s personal outlook, risk tolerance and time horizon.

But a related question might be: Are we in the beginning of a new bull market or a bear market rally?

Since the S&P 500’s peak of 1,565 on October 9, 2007, we have witnessed a near collapse of the global banking system and a major recession that has been deeper and longer than any since the Great Depression. The U.S. unemployment rate exceeds 9%. The housing market remains sluggish. Business activity has slowed and consumers are more cautious about spending. The fiscal and monetary response, including government ownership of several large institutions, has been enormous and is unparalleled in our country’s history.

So, what lies ahead?

The New Normal, New Market Leadership?

While the current recession may be near or at its end, a growing consensus among economists and market strategists centers around the prospect of the U.S. economy entering into a “new normal” period.

Many economists anticipate that for the next two to five years the U.S. economy will experience below average growth in GDP (Gross Domestic Product), deleveraged business and consumer financial statements, rising inflation and interest rates, and more government regulation. Market strategists opine that, given this economic and regulatory scenario, stock investors will likely receive below average returns over the next several years.

During the stock market’s rally since March 9, 2009, returns from lower quality companies have significantly outperformed those from higher quality companies, according to Standard and Poor’s¹. Experience suggests that it is somewhat common for the more speculative, lower quality stocks to outperform during a significant market rally.

During the recovery period following the last recession, which began in late 2002 and lasted through late 2007, the returns from lower quality stocks significantly outperformed those from higher quality stocks. This outperformance, however, occurred during a period of above average economic growth fueled by excessive risk taking and extensive use of leverage by both businesses and consumers.

A fundamental question is whether these past return patterns will repeat in the next recovery or whether the “new normal” will produce different leadership among stocks.

“...it is our belief that quality growth companies will stand out and outperform other companies.”

In an environment characterized by a slow growing economy, reduced leverage, more government oversight and, eventually, higher inflation and interest rates, it is our belief that quality growth companies will stand out and outperform other companies.

Businesses with sustainable, competitive advantages that provide pricing power should be better able to generate attractive margins in the face of commodity and wage inflation. Quality companies can generate attractive returns on investment without excessive leverage. Companies with strong balance sheets and superior cash flow generation should be able to absorb

¹S&P analyzes about 4,000 stocks traded on the NYSE, AMEX and Nasdaq exchange based upon each firm’s per-share earnings and dividend records, then recalculates “core earnings” by backing out certain items (extraordinary items, discontinued operations, impairment charges, etc.) Figures are also adjusted for changes in rates of earnings/dividend growth, stability over a long-term trend and cyclicality. S&P then divides stocks into a quality category matrix, rating each stock from A+ to D, basing ratings upon each individual company’s growth and stability of earnings and dividends.

Past performance does not guarantee future results.

- Continued from page 3

the rising cost of debt and take advantage of better returns on their surplus cash. Global franchises would be suited to pursue greater growth opportunities outside of the U. S. in economies such as China, India, South America and Eastern Europe.

Furthermore, companies with rich cash positions may be able to capitalize on competitors' weaknesses by gaining market share and making acquisitions to bolster future growth. Additionally, their ability to continue to pay dividends and buy back company shares represents added strengths. Lastly, well-run businesses with shareholder-friendly managers are unlikely to be as affected by new government regulations aimed at reducing risk as managers whose competence was overstated by the short-term benefits of excessive leverage. (For additional information on this subject, please review our white paper, "[*The Power of Fundamentals*](#)" which may be found at www.jenseninvestment.com.)

Trading at a Premium

Businesses possessing high quality characteristics often sell at a P/E premium to the overall market². And why shouldn't they? Investors are often willing to pay a premium for superior and consistent growth and the "all-weather" characteristics that protect the downside.

From October 1999 through September 2009, The Jensen Portfolio (assuming we had owned the current portfolio companies over this entire period) nearly always traded at a premium to the S&P 500 Index (as measured by the weighted average of the leading one-year P/E ratios of the companies held by the Fund at each measurement period) and this premium averaged 25% over this 10-year period. As of September 30, 2009, however, The Jensen Portfolio was selling at a 4.5% discount to the S&P 500 Index as measured by the leading 1 yr P/E ratio.

What does it mean for our portfolio's P/E to be lower than the S&P 500 Index's P/E? Does the market believe our companies no longer possess the high quality characteristics they have demonstrated in the past? Could the market be overvalued? Are the current earnings projections for the market too robust? Will future earnings of companies in the market grow faster than their stock prices, thereby driving down their P/E ratios? Is our portfolio undervalued?

Our experience and valuation models suggest that The Jensen Portfolio is currently undervalued when compared to the overall market.

Bull Market or Bear Rally?

The stock market will likely experience volatility until clarity is achieved in the strength of our banking system, the direction of the economy and the roadmap for the government's plan to ease deficits and reduce private sector involvement. However, it's useful to examine the characteristics of previous recessions and recoveries, as well as the associated bear and bull markets. During the previous eight recessions (from 1953 to 2001), the

average time for the S&P 500 Index to recover from its low point to its previous high was 1.9 years. This recovery time ranged from as little as 83 days to nearly six years.

If it takes five years from the date of the recent market bottom (March 9, 2009) for the market to regain its previous top (which, we remind you, was the S&P 500 at 1,565 on October 9, 2007), the annualized return would be 18.26%. Over a 10-year recovery period, the return would be 8.75%.

Further, even after a 56% increase from the bottom as of September 30, 2009, the annualized return would be 8.17% if it takes five years to regain the top and 4.00% if it takes 10 years.

We're not suggesting that any of these scenarios will happen. Rather, we want to provide some perspective on the possibilities and opine that over time the market will likely recover, providing a reasonable return from the bottom. Moreover, even the lowest return previously quoted here, if achieved, will likely exceed those of Treasury bonds.

Weighing the Real Value

Benjamin Graham, the father of value investing, was quoted as saying that in the short run the market is like a voting machine -- tallying up which firms are popular and which are unpopular. However, he added, that over the long run the market is like a weighing machine -- assessing the true substance of a company.

We like the substance of quality growth companies and believe that this segment of the market will outperform the overall market over the next several years.

Based on this review and our extensive proprietary valuation models used since 1995, we believe it's a very good time for the long-term investor who desires an allocation to equities, to be investing in quality growth companies.

"The business performance of our portfolio companies throughout past recessions has demonstrated their resilience."

The business performance of our portfolio companies throughout past recessions has demonstrated their resilience. We believe the strength of their franchises and balance sheets, as well as their superior cash flow generation, will allow a return to double-digit growth. This should validate their consistent long-term value creation.

Given the prospect of an emerging "new normal" economic environment, it is unlikely that the earnings from lower quality companies will quickly return to their previous highs. Over the long term, we believe earnings growth and dividends will drive the price of a company's stock.

² The leading (forward) one-year P/E of a company is a ratio calculated by dividing the current price of the stock by the company's predicted future year earnings per share, as determined by market consensus.

Morningstar Weighs In: Higher Quality vs. Lower Quality

It seems that Morningstar agrees that opportunities abound at the higher quality end of the investment spectrum.

In a Morningstar.com column from August 21, 2009^[3], Markets Editor Jeremy Glaser notes that while as a group lower quality companies have risen 26.1% between the S&P 500's bottom in March and the end of July 2009, higher quality companies have seen a total return of 4.81% over the same period. (Morningstar dubs low quality companies as "no-moat companies" because of fewer competitive advantages and a reduced ability to fend off the competition over the long run, while terming high quality companies "wide-moat companies" because of their ability to fend off competitors.) Over this same period, mid-spectrum, narrow-moat companies returned 16.6%.

Was that outperformance by lower quality no-moat companies justified? "We think not," Glaser noted. "Given the no-moats' relative outperformance since the bottom, it isn't surprising that our analysts now think that, as a whole, no-moat firms are about 15% overvalued. Wide moats, in aggregate, look much more attractively priced – about 15% undervalued," he added.

[3] "High Quality Firms Getting Left in the Dust: Buying opportunities abound among high-quality, wide-moat businesses."

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.

As of June 30, 2010, the Fund held the following positions (as a percentage of net assets) in the companies mentioned in these articles: Amphenol - 2.48%. Fund holdings are subject to change and are not recommendations to buy or sell any security.

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.

Price/Earnings Ratio: The weighted average of the price/earnings ratios of the equity securities referenced. The trailing P/E ratio is calculated by dividing current price of the stock by the company's past year earnings per share. The leading (forward) P/E ratio is calculated by dividing current price of the stock by the company's predicted future year earnings per share, as determined by market consensus.

Return on Equity: (ROE) is a financial ratio. ROE is obtained by dividing company's fiscal year's after tax income, after preferred stock dividends (but not common stock dividends), by its book value.

Earnings Per Share: The net income of a company divided by the total number of shares it has outstanding.

Free Cash Flow: Measures the cash generating capability of a company by adding non-cash charges (e.g. depreciation) to after tax income and subtracting capital expenditures.

Gross Domestic Product (GDP): The total market value of all final goods and services produced in a country in a given year, equal to total consumer, investment and government spending, plus the value of exports, minus the value of imports.

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



A brand new jenseninvestment.com website is coming soon!

Jensen Investment Management is putting the finishing touches on a new and improved website that will debut next month. It will feature a fresh new layout, better navigation and more tools to help you find and share information.