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Featuring Portfolio Managers Allen Bond, Adam Calamar and Jeff Wilson

ALLEN BOND: All right, guys, well I guess this is our first PM Roundtable here, so this is awesome. I thought maybe we'd just go around the room and introduce ourselves, just professionally in terms of what we do, our roles here are at Jensen and history here at Jensen, and so on and so forth. So I'll start.

ALLEN: I'm Allen Bond. I joined Jensen in 2007 as an analyst supporting the Quality Growth Strategy, and I'm still an analyst supporting the Quality Growth Strategy, but as it happens at firms like this, there's other hats now as well. So now I support all three strategies as an analyst. I cover companies across all three strategies. I am a portfolio manager on Quality Growth and on Quality Global, and the head of research across the organization. And so the way this is going to work today is I'm going to moderate the session. I'll probably chip in with a few thoughts and comments here as well, but that's going to be primarily my role here today. Adam, do you want to go next here in terms of introductions?

ADAM CALAMAR: Sure. My name is Adam Calamar. I've been at Jensen since 2008, about 15 years ago. I'm a portfolio manager on the Quality Growth and Quality Value Strategies. I spend most of my time doing analytical work for the strategies, researching companies, building financial models, that sort of thing. Jeff, go ahead.

JEFF WILSON: Jeff Wilson. Joined Jensen in 2019, so coming up on five years now. And I'm portfolio manager on the Global Strategy and contributing analyst on the Quality Growth Strategy.

ALLEN: That's right. So we have all three strategies covered here today, and hopefully we'll be able to work in conversation about each of the strategies as we kind of work through the topics. First thing I wanted to talk about is quality investing. At Jensen, we define quality investing as ownership of high-quality businesses for the long term. We're looking for businesses that we think will grow and create business value and then we want to participate in that business value creation for shareholders. So we're focused on businesses with competitive advantages, businesses with free cash flow and financial strength, and then businesses that have attractive long-term growth opportunities, and we think if we get that formula right, we can identify value creators and compound that value over time.

I think one of the more pertinent focuses that we have from a process standpoint is we focus on businesses that have proven they can create value over the long term. So for us, high and consistent return on equity is really critical and that defines our investible universe, and I think as we flow through the conversation here, that approach and that discipline around long-term value creation historically, it drives

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a lot of our portfolio construction and research, and I think we can kind of hit on that as we talk about value investing or quality investing. What I'm curious about, and maybe I'll start, Adam, with you, is just from the Quality Value Strategy, what's been working, where have there been headwinds and where do you see opportunities within that strategy?

ADAM: Well, for the last year, a couple of years, obviously tech has done well, so some of our tech holdings have held up really well. We've had a few semiconductor companies, for example, that have added to our performance. Consumer areas have helped out a little bit, some of our healthcare picks.

I would say that as far as where the headwinds are, because of our investment universe, we don't tend to participate in energy and financials. When those tend to rally, we can be left behind a little bit. So those have been areas where we've lagged. Typically, energy and financial companies don't have the consistent track record of return on equity that we require, 10 years of 15% return on equity, so we don't get too many of those in our investible universe.

ALLEN: I would think though, over the longer term, that not owning energy and traditional financial stocks has probably helped on a relative basis.

ADAM: Over the long term, it certainly has. Looking back five, 10, 15 years, a lot of those sectors, they failed to generate economic profits, right? It's just very cyclical, but boom, boom and bust kind of cancel each other out.

ALLEN: So we talk about quality investing, and I think it's most often thought about in large-cap, given the big competitive moats that large-cap companies can create. Can you talk about maybe either an example or just sort of how you think about those quality investing tenets in the mid-cap space?

ADAM: Sure. Mid-cap companies, it can be a little harder to separate some of the wheat from the chaff, right? There can be companies that just seem to hang out in the mid-cap zone forever because they have a market share of an industry that's just not growing and they're not able to really grow their share either. So we try to look for companies that have a growing industry or they're growing share or ideally both. And the best situation for us, of course, would be that you buy a mid-small size kind of company and it grows up through your portfolio becomes one of the largest-cap companies and then it goes out of the portfolio because it's too big for the strategy. That would be ideal. We've had a few of those cases, it's been great. Other times the stock ends up treading water and we sell it, and we upgrade the portfolio and get something else that we think is a better opportunity.

ALLEN: I think one of those ones recently was Cadence Design Systems, correct?

ADAM: Sure.

ALLEN: Can you maybe talk about, just high level, the history with that one and we owned it and ended up selling it because the market cap became too big for the strategy, right?

ADAM: Yes. Cadence Design Systems sells software that is used to design semiconductors and semiconductor systems, so like a printer circuit board, and things like that. Obviously that's been a very hot space for the last few years. Their sales have grown massively from where they were when we originally looked at it, and the market cap has grown along with it. And so we started trimming out of the name once it went above our maximum market cap size. Which we have to do, it's in our prospectus for the strategy. So it's a hard rule that we have to get out of the name as it gets above our maximum market cap, but it certainly is eligible for other strategies as well, which are large-cap focused.

ALLEN: Yeah, that's great. OK, maybe just switching gears here on Global, Jeff, do you want to talk about headwinds, tailwinds and where we see opportunities right now within Global?

JEFF: Sure. So we launched Global, speaking of headwinds, right during COVID, so April 2020. It was an exciting time, we were building a portfolio out, but it was also exciting from the standpoint that we got a larger investible universe. We gained access to international companies that everyone knew from managing our Quality Growth Strategy. There were investible opportunities outside the U.S. that happened to be domiciled overseas, in certain cases have meaningful businesses in the U.S., and there are several cases of that in the portfolio. Looking at attribution and performance over the last three years, there's been good stock selection within the portfolio. Similar to mid-cap and similar to Quality Growth, tech has been the gift that keeps on giving. We have several names in there, companies that we've owned for several years. Taiwan Semiconductor, SAP, but also newer examples of ASML and KLAC that have really benefited from the rise of AI and just value creation in the semiconductor space.

We are finding opportunities. Similar to mid-cap, we don't have a lot of traditional financials in our investible universe, but also in the portfolio. The financials that we do own tend to be capital light, tend to be very capital efficient, free cashflow, generative high-margin businesses, like Aon and like Mastercard, which over a long-term value creation standpoint we think is a great position to be. Looking at where we have lagged in terms of three years, 2022 was a huge year for energy. We missed out on that because there's not a lot of investible opportunities that screen through

our investible universe because of that cyclicality, because that dependency on the underlying commodity for their economic profits tends to be volatile, and we really view investing through a long-term cycle and try to have ownership stakes of businesses that have that consistency, that dependability over the cycle.

ALLEN: Yeah. Great. Maybe I'll offer some thoughts here on the Quality Growth Strategy, and I think it's going to dovetail really well into the next thing we wanted to talk about here. We've had some really good individual company success stories, I think. One of the top holdings in the strategy is Stryker. Stryker is a medical devices and medical equipment company, and they benefited from really three primary factors. No. 1 is there were a lot of procedures that they support that were deferred during the pandemic, and so there's pent-up demand, and that pent-up demand has actually been coming through the system. So there's been an above average use of healthcare volume for orthopedic procedures and other procedures that they support.

The second big trend is that they were the first to market with a surgical robot that supports orthopedic surgeries, that makes them faster, makes them more accurate and reduces the time of recovery after the procedure. So they've been very popular and they had a massive first mover advantage, and so now a lot of surgeons, especially younger ones, have been trained on their platform, and it's allowing them to maintain market share and sell new products, but also to gain competitive accounts in a business where, in orthopedic implants, that share does not change very often. So it's been a real growth driver for them.

And then the last thing is they're really well positioned in ambulatory surgical centers, which is a space where a lot of orthopedic procedures are moving away from the hospital. It's a more efficient and more economic location to do these surgeries. And Stryker's suite of products fits really well as that's being built out. So they've been able to grow on an above-average basis and outgrow their peers, and it's been a real success story for us in Quality Growth.

I think another one that's kind of a neat story is Waste Management. Waste Management is the largest waste collection and disposal company in the U.S., and for us we identified a competitive advantage for them, and they have the largest landfill network in the U.S., and that was very obvious early on. And that is important because it's a scarce asset. Building new landfills is very difficult due to permitting and so forth. So they have this landfill network, and what we saw with them is during this period where we had high inflation a year or so ago, they were able to use that competitive advantage to raise prices and still maintain volumes, and so they did a really good job holding up during that period.

And then what they've been doing on the side is they've been reinvesting to make their collection fleet more efficient, to make their transfer stations more efficient, their recycling centers more efficient, and also more recently have been investing in capturing the methane that comes off their landfills, converting that into natural gas. They can use that to power their fleet and use that to sell back into the natural gas grid, and it's a way to earn excess economics on top of an asset that was already there. So some really good company-specific stories.

The other trend, and we're going to talk about this a little bit more in a minute, is AI. And we have a few companies in Quality Growth that we think are very well positioned. They've already benefited, we think they'll continue to benefit from development of artificial intelligence. Most obvious is probably Microsoft, it's our top holding. We think their early investment in ChatGPT is paying off for them and will continue to pay off.

Another top holding for us is Accenture. Accenture made a big investment last to bolster their capabilities at helping their clients use AI to make businesses more efficient. So we think there'll be a long-term winner as well. We also have a couple other companies that may not be as well-known or thought of, but KLAC or KLA Corporation, Amphenol, we think is the infrastructure that is built up to support AI and support the training of the AI models, these businesses will work well.

The company I didn't mention, which is kind of at the center of the AI gold rush is Nvidia.

Nvidia doesn't qualify for our investible universe, so we kind of talked about this, but the line for us is 15% return on equity for at least 10 years in a row. Nvidia is in about year eight right now, so they're likely to qualify in two years, at which point we'll take a hard look at them and determine whether or not we think they're a fit for our strategy. Our read right now is it looks like a very high-quality business, but it's a changed business. If you go back five years ago, Nvidia was making chips to support gaming devices. That was their primary business, both from a revenue standpoint, both from a profitability standpoint. They would talk about AI, but it wasn't prominent. It was the gaming business that was prominent. And it was actually up until recently, the gaming business was still earning more money for them than the AI business. Now that's changed. Last year the AI business grew dramatically and that looks like the future of Nvidia, and that's something that we will obviously, I think all investors are focused on right now.

What I'm curious about with Adam and Jeff is just your perspectives on how we would view a situation like this as quality investors, and specifically quality investors that want to see

businesses that have proven it. And so Nvidia, they're on the way to proving it, but their business has changed a lot. And maybe, Adam, we'll start with you for your perspective on that and how we might think about that.

ADAM: Yeah, it's tough when you have a business that changes a lot in a short time and suddenly becomes something that looks very attractive, but doesn't meet our criteria for the performance over a long period. We've definitely seen those companies in the past, where they've come into our universe and stayed in there for a long time because something changed about the business and it was a great business. Actually, I think Apple is a great example of that. We've also seen some that almost made it in and then didn't, or they made it in for a year or two and then didn't, because what they actually had was more of a flash in the pan rather than a sustainable competitive advantage.

And Nvidia, it's hard to tell. Right now, it seems like they almost have a monopoly on AI, but at the same time there are also a lot of nascent competitors who have an increasing ability to run AI code on other devices — graphics cards from AMD, just on a CPU, Apple, M1 Silicon is really good at that. And the developer base and the code base is expanding as well. And Intel has partnered with some third-party applications that basically let you translate code design for Nvidia's chips to other hardware. Nvidia recently changed their licensing agreement to stop people from doing that.

So there's a lot of competitive threats out there and I don't think that their monopoly is unassailable. So what we do at Jensen is we look at the long term, and 10 years is our track record, the requirement that we need to see. A couple of years from now we'll evaluate it and see how they're doing, and see if those competitive inroads have started to happen, or maybe they haven't. But for now we still believe we have a lot of other companies that have AI exposure, if you will, like a Microsoft for example, that we don't feel like there's a dearth of opportunities for us.

ALLEN: Okay. And Jeff, maybe your perspective, because I know we've talked about this before, just about how we should get comfortable or we should think about these situations from an investment performance perspective, where we've seen Nvidia, it's been a phenomenal success but we don't own it. How do we think about that? If you think about how you zoom out to the market cycle type of lens in terms of evaluated investment performance.

JEFF: I mean, it's a great example of the exuberance of markets and the despondency of markets at times. That wasn't that long ago. The market has turned on a dime with the AI frenzy and it's really turned into a FOMO, fear of missing out, kind of a dynamic. It's not to say it's a bad company, it's a phenomenal company, and they've clearly shown resiliency through their own cycle. But cycles happen. Behavioral cycles happen in the market, and it's our job as stewards of our investors' capital to ride through those cycles and pick and choose our opportunities.

Oftentimes we use exuberance to trim positions based on our evaluation discipline that are in the portfolio. We use opportunities where the underlying fundamentals don't match what the market may be reflecting, and we'll use opportunities like that to add and trim to our positions. So it's what makes our job exciting. No two days are the same and there's a lot of moving parts and it's our job to keep on top of them. And I assume in two years, when it does qualify, the landscape will look a lot different.

ALLEN: Yeah, I think that's right. I think that the way I think about these situations, and Nvidia is an extreme example of this, is that we approach investing from a risk-first perspective. We want to try to manage business risk by buying the best businesses with competitive advantages and financial strength. We want to manage pricing risk by making sure we pay a discount to what we think a business is worth. We manage security risk by paying attention to volatility measures and so forth. And what that means is that there will be times where, if the market runs like this, we're not really designed to keep up in these environments, but where we have been able to add value in the past is when the market rolls over, and we don't keep up all the way on the way up, but hopefully we don't keep up all the way on the way down.

"We want to try to manage business risk by buying the best businesses with competitive advantages and financial strength. We want to manage pricing risk by making sure we pay a discount to what we think a business is worth."

We've seen this before, Adam mentioned Apple. I think it's a great example of that as well. And that's kind of how we're looking at Nvidia right now. And like we've said, it's one of those ones that we will probably look at, give it a hard look assuming it qualifies ultimately for our strategy.

Next thing I wanted to move on to talk about is China. I think China has implications certainly in our Global Strategy, but given its importance in the world, it has implications across basically every investment strategy. And the calculus on investing in China has really changed. And Jeff mentioned the launch of the Global Strategy about four years ago, and it's changed even since then. At

one point, China was the world's growth driver, and it still kind of is, but maybe not as much.

If you look at China right now, the recovery out of the pandemic lockdown period has been uneven at best. You've still got very high youth unemployment, you've got a property market that appears to probably depressed. And the other thing that is happening in China is the population's actually been shrinking, and this is calling into question that investment theme where, for the longest time if you could get exposure to China, that was good exposure to growth and that was a fairly investible theme, and that isn't really the case right now.

I'm curious, Jeff, in the Global Strategy, we've dealt with this explicitly in terms of the different stocks that we own. We own some with China exposure that we like and we've exited others that had China exposure that we don't like. Maybe can you talk us through a little bit of that and how we've looked at that in the Global Strategy?

JEFF: Yeah. That's a great topic for global investors. China's a phenomenal success story over the last 30-plus years. It's the second-largest economy in the world. There's been a great amount of industrialization and development there.

Fun fact, if you're an investor since 1993 in the Chinese stock market, you actually have a negative return over 30 years on a compounded basis.[1] So there's a clear misalignment here from an investor base and a prioritization of their overall economy. And I think that gets to the heart of where we see, as quality investors, the challenge of finding opportunities that fit our mandate and our strategy and our underlying philosophy, is we want to hold business interest for the long term, right? We are owners and investors in the actual businesses. And we need to have certainty, or at least clarity of rule of law, and governance practices that give us comfort that we're going to participate in that underlying growth and economics in the underlying businesses.

So in China there's clearly been a disconnect there where the state and overall societal priorities siphon off some of the underlying returns where minority shareholders and especially foreign shareholders don't necessarily participate in those gains. So the most recent example, when we launched the Global Strategy, we owned Tencent. And Tencent's a phenomenal business. They have the dominant messaging and payments platform, and gaming franchises in China through WeChat. And where they may have amassed too much power within an authoritarian government, but they also don't align necessarily well with the government's current priorities, developing chips to compete with the U.S. and the world, to pivot from that real estate property market to something more productive and higher up the value chain.

In 2018, we studied a case where there was a crackdown in youth gaming, which is 40% of Tencent's business, and they were able to kind of ride through that relatively unscathed. But starting in 2020, there was a massive tech crackdown where Alibaba, Tencent and JD, etc., really came under scrutiny. And it was clear the pendulum continues to shift more and more toward anti-business or at least less friendly to the business climate, private businesses in China, more toward SOEs and state priorities. There's a lot of state interests in private businesses now, and it's just getting a little bit more muddled for investors like ourselves to parse through all of this and understand where our underlying economic interests are aligned and if companies like Tencent truly control their own destiny to the standpoint that we could gain comfort with that.

So ultimately we sold the company from the portfolio. Another one that kind of fell victim to the China property market downturn was Kone. Kone is an elevator manufacturer and servicer. They were first mover advantage. They participated in a lot of the development, industrialization in China, and really garnered a lot of share on that new equipment side especially. But the market is dynamic and competitors, both local and foreign, have gained market share and presence in that market, and the market has slowed. So those combined factors led us to also exit that position. So structurally we are underweight to China versus our benchmark and many of our peers, but actually that's an area of comfort. At this point, it's something that we're continuing to evaluate.

ALLEN: So to me, Tencent's straightforward because Tencent is domiciled in China, generates the lion's share of the revenue in China and is in large part, not controlled, but heavily influenced by the Chinese government, right? Kone is different because Kone is a Finnish company, doesn't just have business in China, has business all over the world, but Kone was getting an outsized proportion of their growth from development in the Chinese property market. So like Jeff mentioned, we exited that.

However, we do have one company that we still hold in Global, we still think very highly of. Also not a Chinese company, it's a French company that has a big exposure to China at the very, very high end of the luxury space, and that's Hermès. So Jeff, maybe walk us through how we can be, we've kind of soured on certain parts of China, but we're still very confident in Hermès and their ability to grow and add value there.

JEFF: Yeah. The concept of controlling your own destiny is a great juxtaposition because Hermès, globally, is one of the companies we think absolutely controlled their own destiny. They play

[1] MSCI China Compound Annual Growth Rate 1993 - 2023, Strategas Daily Macro Brief 2/8/24

at the very top of the luxury spectrum. Bain put out a study in 2022 that said 2% of luxury consumers account for 40% of overall luxury purchases. So that very affluent, very prestigious category is afforded to Hermès, Louis Vuitton, those premier brands. And Hermès really has an outsized presence in China. And Chinese consumers, especially that top tier, are phenomenal luxury consumers. They really appreciate strong craftsmanship, the heritage that is associated with the brand, and they've seen phenomenal growth and resilience importantly through the cycle, even during China's COVID-zero policy, they still grew through that period, and they were the only luxury brand to do so. So catering to that very affluent sub-segment of the Chinese consumer is an area where we're comfortable playing, and Hermes globally has that catbird seat.

ALLEN: Yeah, makes sense. Adam, do you want to talk, so within Quality Growth and in Global we own Starbucks and Nike, both of those companies have big presences in China and which had an impact on recent financial results. Maybe talk us through the investment thesis for those ones and how China fits into that and how we view those.

ADAM: Sure. First, I will say Starbucks and Nike both don't have a large revenue or profit exposure to China, but they have, over the last 10 years or so, continually stated and restated that China is a big portion of their future growth. So a lot of the concern is not so much that a large portion of their revenues come from that geography, but that large portion of the future growth.

What we've seen with Nike and Starbucks is they've both had some company-specific issues that are related to management turnover and strategy, and they've also had some geographic exposure issues to China, you can't really blame them for like the Chinese consumer pulling back on spending and trading down to cheaper options. For example, Starbucks is a very premium coffee product in China, there are a lot of less-expensive options. If consumers don't feel confident about the future, they're going to go to Luckin Coffee, for example, and get a cup of coffee that costs a third as much as Starbucks. No frills, probably doesn't taste quite as good, not as customizable, but you save a lot of money.

So the same thing appears to be happening in sportswear and apparel, where Nike seems to be maintaining market share, but they're just not growing their share like they used to be. And the same could be said for Starbucks as well.

Overall, long term, our thesis is that these companies are going to continue to grow, they'll continue to create value for shareholders. They probably won't see the outsized growth that maybe they've seen in the past, but say mid-single-digit revenue growth type of businesses with very high returns on capital, good balance sheets, good strategies, defensible competitive advantages. In the consumer discretionary space, I think they're two great names to own, but at the time the stock prices certainly looked depressed and part of that is just a concern over future growth and concern basically over, can these companies manage through this cycle in China with consumers trading down without, say, damaging their brand. We've seen many consumer companies over the years decide to go down-market and then they damage the brand, and then the brand ends up being sold off to a conglomerate, and we all kind of know the cycle there. I don't think that's a risk for either of these companies. So for us it's more just having the long-term vision and managing the position size appropriately relative to the risk.

ALLEN: Yeah, I always like to think about these situations kind of short term/long term, and in the short term right now, I think there's concerns about both companies, and China's part of that short-term concern. Long term, I think we still structurally believe in the long-term tenets of the investment thesis in terms of the strength of the brand as a competitive advantage. Their ability to continue to grow around the world based on the strength of those brands, based on new product introductions, and like you mentioned, the financial strength of both companies. Is that kind how you're viewing that right now as a short term?

ADAM: Yeah, exactly. Yeah, I think there's a short term versus long term issue. One of the things that we try to do when we manage the portfolio is balance companies that are exposed to short-cycle nature things, like consumer spending, versus long-cycle companies that are focused on long-term trends and aren't dependent on the short fluctuations of the economy. Nike and Starbucks are both on the shorter-term nature, right? Yeah. Something to keep in mind.

ALLEN: For sure. Next topic, I wanted to talk about inflation and interest rates. They're not the same, but they're tied at the hip, if you will. We just had the Fed chairman out yesterday talking about that we're likely to see rate cuts this year, but they'd like to see more evidence that inflation's not going to rear back up. So we had a big spike in inflation a couple of years ago, that's come down a lot, and now we're kind of monitoring, OK, are we done? Are we going to get a second wave of inflation? And that seems to be what the Fed has their eyes on.

And that has implications. One of the things we saw with our companies in the phase where we did have a lot of inflation was their ability to raise prices. And one of the things that we think is really critical is, if a business has competitive advantages, that allows them to have pricing power and to be able to raise prices without severely hurting demand or hurting volume. And we saw that, we saw the companies flex those muscles and that

was a good proof statement of our investment thesis in those companies. But we're kind of through that now. The era of big price increases seems to be over for now, and now we're looking for volume gains again. Jeff, this was a theme that was prevalent throughout earnings season, as we just finished up the earnings season for fiscal fourth quarter of last year. Maybe talk about some anecdotes from companies in terms of earnings season and how they're thinking about these issues.

JEFF: Yeah. So it was very prevalent on the consumer product space, pretty much anyone you can think of in that landscape. Nestlé, Procter & Gamble and Colgate all referenced that they're seeing decelerating price increases and increased marketing dollars to try to drive volume. And that's refocusing that energy toward growing that in a more sustainable fashion. There comes a point where the consumer will get price fatigue and you need to be able to grow volumes in a consistent way.

One in the Global portfolio is Compass Group. They were fighting food inflation, so they're the largest food service company in the world, two-thirds of their business is in the U.S. actually, they serve sports stadiums, educational facilities, campuses, corporate campuses, that sort of thing. So food and labor inflation were hitting them. They've seen a pretty sizable drop in food inflation, disinflation, and have caught up on pricing front.

Wage inflation on that side is harder to navigate. But to your point, our companies that are globally dominant that have scale advantages, Compass for example, is really rolling out automation throughout their facilities, licensing the Amazon technology where you can grab something and go, and have it automatically charge your credit card, and require less labor to operate some of these facilities. Smaller competitors, regional competitors don't have the resources to invest in that sort of technology and infrastructure. So we're monitoring how this is playing out, especially for the consumer products companies in the portfolio. But it is clear that price increases can't go on forever, right? You need to see that more sustainable, healthy growth.

ALLEN: The other one I wanted to ask you about, you mentioned Aon earlier as an example. So Aon is a company that has explicit exposure to interest rates because of the fiduciary funds they hold for their clients. They can invest that, and if rates are high, that's good because they get to invest that at higher rates and vice versa. Maybe walk us through Aon. It's a business I suspect a lot of people don't know a lot about, maybe just to get a high level of investment thesis of Aon, and then how interest rates impacts Aon and our thinking on the company.

JEFF: Sure. So Aon is a risk insurance and reinsurance broker, so they help marry risk and capital. There's insurance needs, helps the global economy. There's only really two companies that can service multinationals at scale, that's Marsh McLennan, which we own in Quality Growth, and Aon. So basically both companies have functioned more in terms of rate sensitivity recently because they benefited in a big way from going from zero on federal policy to 5.5%, holding premiums on behalf of their clients that can invest that at the very short end of the curve. And that basically just drops down to the bottom line.

So for Aon, it's roughly 6% of pre-tax profit, and I don't personally expect interest rates to go plummeting down to zero, so they will retain some of that benefit regardless, but their business is very sticky, very recurring-revenue centric, 95% retention rates on their core business.

Really, you could think of them as fiduciaries on behalf of property and casualty insurance policies. So global businesses that have complex needs, complex insurance needs that span the scope of their businesses that Aon and other peers get to know their business pretty intimately. Think about your relationship with the CPA, right? You have intimate knowledge. There's that ingrained nature, that relational benefit, which creates that recurring stickiness.

So you can build off that, bolt on acquisitions and capabilities, geographic capabilities, and really expand that capability set to benefit the whole. But in the short term, there's been some noise around interest rates that have given us an opportunity to increase the position in Global.

ALLEN: Yep. The other implication that we see with interest rates is in our discounted cash flow models. And I think one of the biggest disconnects that we see coming into the year in the market more to macro level is the expectation of investors that the Fed's going to dramatically cut rates versus the Fed who said, "Yeah, we might cut rates, but we're not in a huge hurry." And that's one of the debates we're sort of interested to see play out as we get through the year. But it does have implications for our models because we use discounted cash flow, so we have to have discount rates and the foundation of a discount rate is your risk-free rate, which is based on the Treasury market. And as a result of rates increasing and staying at a high level, our discount rates have gone up a bit in that regard. Adam, maybe talk us through some of the DCF model implications of higher rates from there.

ADAM: Sure. Right. Well, when you discount cash flows back from the future, back to the present to get a value for a company, you have some sort of, what you might call a hurdle rate or a required rate of return that you're looking at, that you want to benchmark those cash flows against and say, "Is it worth making this investment?" The higher that rate is, the less attractive the

investment looks. And so when rates go up, discount rates go up, and that means that equities start to look more expensive. So there's this idea that, "Oh, well, if rates go up, the stock market's going to crash." And obviously that's not always true, right? We've had rates go up and the stock market hasn't really crashed. We had a down year in 2022 and it bounced back.

And if you go back to the 1980s, early '80s when they were raising rates, you didn't see a major stock market crash. There was some volatility, but overall it was pretty good to be a stock market investor in there, even in the early '80s through the later '80s.

So it's hard to say that raising rates directly translates to everything's worse, but it can directly impact your valuation. That's something that we spend a lot of time on at Jensen. We build long-term discounted capital models with all the cash flow projections. We discount them. We spent a lot of time on our discount rate model and our assumptions underlying the discount rate. Overall, we think we're doing about as good a job as we can. I know over the 15 years that I've been here, we've made some pretty great improvements to our process and I think they hold up both empirically and sort of at an academic and intellectual level as well.

JEFF: And it's not all bad, right? Rising interest rates off of zero, now we're getting to a point where you actually have cost capital, you have decisions where you can place your capital, you can earn something in the bank. So in my view, it's a more healthy environment than pinning rates at the floor and potentially having misallocation of capital where you're basically forcing capital in the market that needs to find a return that you can't get in a risk-free way.

ALLEN: Yeah, for sure. Last topic is about the election cycle this year, I think obviously there's a lot of focus on the U.S. election cycle, but I read recently that there's 46 countries around the world that are holding national elections in 2024, and it accounts for almost half of the world's population. So we obviously think the election cycle is a U.S.-centric thing, but it's happening globally.

I think this is probably the way to frame this up. We don't expect that we're not going to make portfolio changes explicitly because of our expectations about any kind of an election cycle. We like to invest in businesses that we think can thrive regardless of the economic environment or the political environment. And so competitive advantages and resiliency, these characteristics are going to allow the companies to adapt and thrive in a variety of scenarios, and they've proven they can do that in the past, that gives us confidence that they can do that in the future because we know there could be a lot of uncertainty about what might happen with the election cycles. But I think there are a couple of trends that we've identified, that we think are interesting and may transcend even the cycle a little bit. I know one of the things we talked about was just this deglobalization trend. That's something that we've seen across different industries here recently. I know, Jeff, I know you've talked about that a little bit, maybe you can expand on the whole deglobalization trend in our thoughts there.

JEFF: Yeah, I mean the U.S. political system can't agree on much across the aisle, but this is one that tends to be pretty bipartisan, is we no longer want to be the world police and patrol the high seas, and make sure that global commerce is happening at scale. This happened before Trump was elected. There were the underpinnings of the sea change of wanting to retrench from the wars we were fighting in the Middle East, what have you, and not wanting to get as involved in other people's business, other countries' business.

That has implications for rates. Broadly, this has been, globalization has been disinflationary. This kept low prices, right? This was great for finding the lowest-cost area to manufacture and then send it safely around the world. The pendulum is continuing to shift toward deglobalization, where not all decisions from an allocation of capital or political choices — there's more nationalism, there's more protectionism, there's more security-based regionalized manufacturing decisions — where the decisions are not just how can we produce this the cheapest and provide that to our consumers, it is we need to ensure supply by either regionalizing, or colocating, or investing in our own capabilities. That's had implications across, especially the semiconductor supply chain. There's no real economic case for all these different countries to invest in duplicative capacities, but they are because they want to ensure supply decades in the future, and they don't trust that the world will remain in a globalized order, so it will become more disorderly. So it does have implications mostly from that..

ALLEN: The two companies I can think of that we hold in our Global Strategy are ASML and KLA, and these are semiconductor equipment manufacturers. I would think both of those companies would stand to benefit from this deglobalization trend that we're talking about, just because there's going to be more semiconductor manufacturing capacity built, and as those manufacturing facilities get built, they need semiconductor equipment.

JEFF: Yup. And to your point, these are risks and situations that we monitor outside of just an election cycle, but there's more uncertainty. There's clearly polarization in the U.S. and in other nations, especially the U.S. though. You could argue that there's three wars going on right now, the Ukraine war, the war

in the Middle East, and the war of the U.S. with itself. Finding alignment and order within the U.S., finding certainty beyond the election will be key.

ALLEN: Yeah, for sure. I think the other topic we've mentioned with a cycle, and this may be a U.S.-specific thing for the most part, is just there's uncertainty, right? And the markets don't like uncertainty. And that could end up having kind of an impact on capital markets activity. If people were waiting for certainty about tax rates or particular policies, we may not see as much capital markets activities. Have you guys seen examples of that or any thoughts around that topic at all?

ADAM: Yeah, definitely. I mean, you can see there's been a huge slowdown in deal-making on the private equity venture capital side. Part of that's capital cost going up, the other part is, well, we need to be kind of cautious on what might happen. Obviously, the 2016 election, there were some pretty disruptive policy changes, some of them good for businesses. Tax change was very good for most U.S.-based businesses because they saw a lower tax rate, that increases earnings, increases the valuation of their stock.

If we somehow went back to the prior tax regime of a higher corporate tax, you can potentially see the stock market suffer for that because everyone has to start paying more taxes and that's less money for investors, right?

I don't see that as very likely, one, because we've had four years where it hasn't changed, and if we go a different direction on the election, then it probably won't change either. We've also seen some concerns about, "Well, let's wait to see how the election shakes out," and because of what you said earlier, policy uncertainty, right? If there's policy uncertainty, that can affect everything from government contractors to healthcare companies, worried about what the next healthcare role or law change is going to be to all the way down the tax line as well.

JEFF: Yeah, I mean you've seen companies explicitly say, "We're not going to pursue this. Let's see what the environment looks like from an antitrust perspective after the election." This is a very high-scrutiny, antitrust kind of regime right now, and large deal-making is pretty much on hold right now.

ALLEN: That's great. I think that wraps up the topics that we wanted to discuss. I think maybe the closing thoughts here, and if you guys have closing thoughts, please feel free to offer them. For me, this is a really unique market environment. I don't know that we've seen a trend like this novel trend in terms of the development of artificial intelligence and all the implications in, I don't know, maybe 20-25 years. And so it's been a really unique market for us.

I think the message that we talk about internally is control what you can control. That continues to be our focus. It just continues to come down to buying the best businesses, making sure we pay fair price and managing risk along the way. Based on all the different topics we talked about, that's what underlies all of that and how these topics relate to our decision-making within the three different strategies.

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