JENSEN® INVESTMENT MANAGEMENT

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Quality Growth Fund Quarterly Update: 4Q 2024

Hosted by Allen Bond, CFA, Managing Director, Head of Research & Portfolio Manager; and Jeff Wilson, CFA, Business Analyst

ALLEN BOND: My name is Allen Bond. I am one of the portfolio managers on the Jensen Quality Growth Fund. Today I'm joined on the webinar by my colleague, Jeff Wilson. In terms of an agenda for the call, I will begin with a brief overview of our firm and investment philosophy. Jeff will cover quarterly performance trends and portfolio changes, and I will then conclude our prepared remarks with some comments on market trends and our outlook. We will then conduct a Q&A session at the end of the call, so please submit questions at any time into the webinar portal.

On this first slide is a brief description of Jensen. Jensen is an employee-owned investment management company, solely focused on quality investing strategies. The company was founded in 1988 by Val Jensen. It's currently owned by 23 employees out of 40 total employees. Jensen manages approximately $11 billion in assets across its three quality strategies. The first is Jensen Quality Growth. This is a large-cap equity strategy focused on the long-term ownership of high-quality, value-creating businesses.

The strategy was launched with the founding of our firm in 1988, and has been available in mutual fund form since 1992. It is our flagship strategy. It is the focus of this call, and it accounts for the vast majority of the firm's assets.

Our second strategy is Jensen Quality Mid Cap. This is a mid-cap strategy focused on investing in mid-sized, high-quality businesses with a bit more focus on stock price valuation. The composite for the strategy was launched in 2008. The mutual fund for the strategy was launched in 2010. And the strategy was essentially rebooted in 2017, by adding more focus on the fundamental research that is similar to what we use in Quality Growth.

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Today the strategy is very similar to Quality Growth, but with a focus on mid-sized businesses.

Jensen Quality Global is the final strategy and our newest product. It's very much an extension of the domestic Quality Growth Strategy, but with an expanded investable universe that includes companies that are domiciled overseas. The fund was launched in April 2020, and we will very soon be achieving a five-year investment performance track record for that product.

On the next slide, we discuss some of our investment philosophy, and there's obviously a lot here on the slide. I think the simple way to sum it up is that we seek to invest for the long term in businesses that we believe will grow and create business value. As a result, we focus our research on factors that are linked with sustainable business value creation. These factors include competitive advantages, free cash flow generation and business model consistency. We also identify growth drivers, not always explosive growth, but more of a focus on steady and predictable growth. We pay attention to stock price valuation, and as a result we maintain discounted cash flow models on all the stocks held in the portfolio and only invest when shares trade below our estimate of intrinsic value.

The importance of valuation for us is twofold. The first is to provide a margin of safety that can help manage against the long-term pricing risk. And the second is we want to maximize the chance of traction between the value that's created by the business, and how that's reflected in the share price over the long term.

The result, in our view, is a portfolio of high-quality and fairly valued stocks. I will now turn the call over to Jeff, who will discuss quarterly investment performance and portfolio changes.

JEFF WILSON: Thanks, Allen. Here we have a review of the investment performance for the Jensen Quality Growth Fund. As you can see, the fund underperformed the S&P 500 Index by 473 basis points in the fourth quarter, with I Shares down 2.32% versus a 2.41% return for the S&P 500 benchmark. At a high level, the fund's underperformance during this period can be explained by two main dynamics.

First, several high-quality factors being out of favor during the period acting as a notable headwind for our investment discipline, with Q4 returns primarily driven by lower-quality factors, such as high volatility and momentum-based growth. And secondly, a continued narrow market leadership with just four stocks accounting for over 100% of Q4 S&P 500 Index returns: Tesla, Nvidia, Amazon and Broadcom.

Apple was the fifth-largest contributor, in which Jensen has an overweight position. As Allen will expand on later, there are several market dynamics we're paying close attention to as we're entering 2025, including bond market activity, interest rates and inflation expectations. Notably, fiscal and geopolitical uncertainty remains elevated, driving discount rates and term premium higher.

In times like these, we believe it remains important for investors to remain disciplined, have a keen eye toward risk management and know what you own, thereby avoiding the urge to chase what's in favor.

This slide shows style factor attribution in the fourth quarter for companies in the MSCI USA Investable Market Index. This analysis indicates several high-quality factors were out of favor during the fourth quarter, including earnings growth stability and profit margin. The factors most in favor were volatility and momentum-based growth, while valuation and yield factors were broadly out of favor during the period.

Additionally, based on our analysis of the S&P Quality Rankings data, the fund's overweight to high-quality stocks did have a material impact on its relative investment performance. Higher-quality stocks as measured by the S&P materially trailed those of lower-quality stocks, which contributed to the fund's underperformance during the period.

Moving on to sector analysis, the Information Technology sector was the largest detractor from relative performance, detracting 197 basis points. Two stocks not owned in the fund accounted for roughly two-thirds of this, namely Nvidia and Broadcom, while the fund's ownership of KLA accounted for the balance of IT sector relative performance.

The Consumer Discretionary sector also weighed on relative performance, detracting 187 basis points. Two

stocks not owned in the fund accounted for the bulk of this, with neither Amazon nor Tesla qualifying for the Jensen investable universe due to historically inconsistent ROE track records.

The remaining detraction was mostly attributable to the fund's position in Nike, which underperformed during the period as new leadership embarks on a strategic pivot. On the positive side, stock selection within the Industrials sector was the largest contributor to relative investment performance, adding 54 basis points, driven by the fund's positions in Automatic Data Processing, Broadridge Financial Services and Copart.

The fund's lack of exposure to stocks in the Real Estate, Energy and Utilities sectors also boosted relative performance. There are very few companies in these three sectors that qualify for the Jensen investable universe due to insufficient and often volatile ROE histories.

The fund's top individual contributor to performance in the fourth quarter was Alphabet Inc.

Alphabet is a leading communications, services and technology company known for its dominant position in online search via its Google search engine and YouTube, it's juggernaut online video business, among other businesses. The company's shares rose during the quarter, driven by a strong earnings report and demonstrated progress in its integration of artificial intelligence or AI into its products and services.

Amid this strong performance, Alphabet was also our largest trim during the period, taking the opportunity to capture some profits and right-size the fund's position to manage risk as the company navigates elevated regulatory pressure and emerging AI-driven competition in its core search business. Alphabet remains a top-10 position in the fund and a relative overweight.

The leading individual detractor to fund performance during the quarter was the aforementioned KLA. KLA is a semiconductor production equipment company that makes highly specialized machines used in the manufacturing process of semiconductors. The company's shares declined in the quarter, reflecting investor concerns about potential U.S. export restrictions to China, weakness in some customers' end markets and company-specific challenges for certain other customers. We remain confident in the long-term investment thesis for KLA, including the mission-critical nature of its process control tools, its countercyclical services business and the secular drivers behind the growth of its customers' markets. It remains a core holding in the fund.

In fact, year-to-date KLA has been one of the fund's better-performing stocks, rebounding after its weak Q4 performance attributable in our view to solid capex announcements by hyperscalers like Microsoft. And importantly, KLA management offers transparent, quantitative guidance relating to the impact from China export controls on its business, which differentiates it from its peers.

Next, we will offer some perspective on portfolio changes. During the quarter, the Quality Growth investment team added one new position in Cadence Design Systems, and sold two full positions in Starbucks and Ball Corporation. The team also trimmed several positions, including Alphabet, Apple, Microsoft and Stryker.

The newest addition to the portfolio is Cadence Design Systems, which provides software, hardware, services and licensed IP to semiconductor companies that design semiconductors, circuit boards and computer systems. Cadence holds a leading market position in a duopolistic market and enjoys strong competitive advantages, including high customer switching costs, high barriers to entry and a large intellectual property portfolio.

Additionally, the company benefits from a high proportion of recurring revenue, solid long-term growth drivers, and an excellent balance sheet and high profitability. While the semiconductor industry is cyclical, Cadence's cash flows tend to be much more stable due to the subscription nature and mission-critical status of its products. The combination of strong business fundamentals and attractive valuation drove the team's decision to add Cadence to the fund.

Now, on to the sales. Starbucks is a global restaurant company and roaster, marketer and retailer of specialty coffee. The company has benefited from competitive advantages, such as global brand recognition and strong customer loyalty.

However, recent financial performance has suffered from increased competition in its China operations, as well as negative consumer sentiment due in part to a series of

price increases and inflation that has outpaced average wage growth over the last several years. The company's stock price moved sharply higher in conjunction with a recent leadership transition announcement in which the embattled, former CEO was replaced with a highly-respected outsider. We are hopeful that this change will, in fact, improve the company's business performance in the long run. However, we took advantage of the share price rebound, and used it as an opportunity to exit the position in favor of more attractive fund opportunities. We will closely monitor Starbucks' evolution and business performance, and may consider reestablishing a position based on improvement in the company's valuation, fundamentals and/or risk characteristics.

Ball Corporation is the world's largest aluminum beverage can manufacturer. When we originally purchased Ball in 2022, our investment case was centered on the company's strong market position, contracted revenue streams, high-customer renewal rates, scale-derived cost advantages versus its competitors, and a secular shift from plastic and glass to aluminum cans. However, the volatility of the company's sales exceeded our expectations and growth appears to have become increasingly reliant on customer promotions to drive volumes, thereby reducing our confidence in the long-term stability of the business prospects. As such, the investment team decided to liquidate the position in favor of superior risk-adjusted return opportunities available for the fund.

In terms of trims, in addition to the Alphabet trim profiled earlier, the investment team executed small trims in Apple and Microsoft to maintain position sizes in accordance with our risk management guidelines, while the Stryker position was trimmed in accordance with our valuation discipline. With that, I'll turn the call back to Allen to discuss our outlook.

BOND: Thanks, Jeff. So on our outlook slide, we're detailing a number of what we see as potentially offsetting positive and negative market forces, and therefore we maintain a neutral outlook for market returns.

Starting with potential tailwinds, as you can see here, S&P earnings are forecast to increase in both 2024 and 2025. This follows an advance in 2023, and we generally view this as supportive of further stock price increases.

Second, there is the potential for favorable U.S. policy changes as a result of a change in political leadership. The stock market also tends to fare well in the first year of new presidencies, and we will talk more in detail about that here in a moment.

Finally, the U.S. economy continues to be resilient. This comes despite a Fed rate hiking cycle and widespread predictions of recession as recently as two years ago. On the more negative side of things, the S&P 500 Index remains historically concentrated and these large index weights have been outsized contributors to recent market gains.

This concentration raises the risk of lower future market returns should the momentum wane in the top index holdings. Secondly, stock prices have increased at a much faster rate than earnings for the S&P 500 Index companies, resulting in elevated valuation multiples. And lastly, inflation has come down but has remained higher than previous trends, and historical precedent indicates that another bout of heightened inflationary pressure may arise in the future.

On this next slide, we simply show changes in the S&P 500 Index over the past four quarters, and as you can see, the index is significantly higher over this period. There was a brief period of higher volatility in the third quarter.

But generally speaking, what we show here has largely been consistent with a risk-on environment. We did see a subtle shift towards a bit more risk aversion near the end of the fourth quarter, and that has continued here into the early days of the new year. That coincides with higher-than-expected inflation and stronger-than-expected employment data, which has perhaps dampened investor hopes of aggressive cuts to the Feds funds rate.

The next slide here shows earnings growth for S&P 500 Index companies. And as you can see, earnings increased in 2023 and are forecast to do the same in 2024 and '25. And as I stated previously, we view this positive outlook as a supportive backdrop for further market advances.

The next slide shows annual domestic real GDP growth over the past 10 years. As you can see on the chart, real GDP expanded in 2022 and 2023, and is expected to advance in 2024. As I mentioned, this increase stands in sharp contrast to widespread expectations of an economic

contraction in response to the sharp increase in the Feds funds rate in 2022. And the resilience in the economy makes it now appear that we may see our first economic soft landing in nearly 30 years.

In any case, we believe better-than-expected economic growth has been a key contributor to the stock market appreciation we've experienced over the past two-plus years. This next chart shows U.S. stock market performance in each year of a new presidency. And on the chart, investment performance is broken down into three different time periods. In each time period shown, stocks were higher on average in the first year of a new presidency.

That trend was even stronger over the past 20 years. Now, we are not in a position to make specific policy predictions and we don't make portfolio changes based on policy expectations. But it does stand to reason that new presidents are motivated to enact policy changes and have the political capital to do so in the early stages of their presidency. In the next slide, we'll turn our attention towards potential market headwinds.

On this slide, we show the top 10 stocks as a percentage of the S&P 500 Index. And as you can see, the index still remains historically concentrated at the top, and has become even more so over the past two years. This trend is obviously not new and is supported by growth and business strength amongst those large index weightings. However, historical precedence would suggest that this dramatic upward trend is unlikely to be sustainable. And therefore, there is a risk to future stock market returns if this pattern stalls and/or reverses.

In the next slide, we show the impact of the Magnificent Seven stocks to overall index earnings. As you can see here, these stocks have had an outsized positive impact on index earnings since the beginning of 2023. In fact, index earnings would have declined in two of the periods shown here if not for the contribution of those seven stocks. This same pattern holds for the 2025 forecast, in that the expected acceleration in index earnings growth is heavily dependent on a continued outsized contribution from the Magnificent Seven stocks.

Now, as we stated previously, earnings growth for these stocks is supported by business strength and secular growth opportunities. However, we would note that the index's reliance on a select handful of stocks raises the risk of unforeseen business headwinds impacting the earnings growth for these stocks and, therefore, for the overall market.

The next slide shows the price-to-earnings multiple for the S&P 500 Index. And except for arguably a pandemic-related distortion in 2020, the index multiple is currently at a 16-year peak. This is largely because index returns have come in well ahead of earnings growth over the past five years. And in fact, since 2019, the index has produced an annualized investment return of 17.2%.

Meanwhile, earnings in the same period advanced at a much slower annualized rate of 7.4%. Multiple expansion has happened simultaneously to a nearly 200 basis point increase in the 10-year Treasury yield, which would normally be a headwind to multiple expansion. We attribute this trend to investors focusing on the long-term financial benefits from artificial intelligence, and the related technology investment and buildup.

Now, stepping back, as we know, market participants continually discount future expectations when making buy-sell decisions in the market. However, in this case, it would appear investors are trying to discount expectations more into the distant future. In any case, the index earning multiple could remain elevated in the short term. But high earnings multiples are typically bearish for longer-term return expectations.

On the next slide, we show the valuation of the Russell 3000 Value Index versus Russell 3000 Growth stocks. As you can see, the increase in earnings multiples shown on the previous slide was driven by strength in growth stocks.

On the next slide, we show the trend in core inflation over the past 10 years. And as you can see here, and as we referenced, inflation spiked in 2022 before declining in 2023 and '24.

However, as we mentioned, the rate of inflation does not return to its pre-pandemic trend. Current core inflation is running close to 3%, compared to the 1% to 2% range prior to 2020. In the next slide, we show inflation trends after previous periods of sharp inflation increases. As you can see on the slide, there is a clear historical trend of a resurgence in inflation in the years following the first wave of inflation.

And we're showing data here for the U.S. over the past 100 years or so, but this trend is also notable in other economies around the world, and no doubt FOMC members are aware of this tendency. And that, coupled with some of the stubborn inflation readings we've been seeing, could create hesitancy to pursue aggressive monetary easing as we work through the year.

And on the next slide, we show historical changes to the Feds funds rate alongside expectations for the future rate path. Now, both the FOMC and market participants expect further reduction to the Fed fund rate. However, these hopes of incrementally dovish policy changes may not come true if inflationary pressures remain resurgent. In our view, this concern could explain the risk-off pattern we have observed here during the first two weeks in January.

Wrapping up, in any case, regardless of changes in market sentiment, we remain confident in our strategy of building the Quality Growth portfolio one stock at a time. We encourage everyone here to read our recently published year-end commentary, in which we discuss portfolio positioning in more detail.

Our goal is to own businesses that we believe are uniquely well positioned to grow and create business value. And we believe it's important that as long-term investors, we own these businesses at reasonable prices. In contrast, we are not trying to make short-term predictions or time changes in the market environment. This approach has served us well in the past. We are confident it will continue to do so again in the future.

In closing, we would like to thank you and your clients for your business and your confidence in the Quality Growth Strategy. We certainly do not take that for granted.

The Jensen Quality Growth Fund's investment objective, risks, charges and expenses must be considered carefully before investing. The statutory and summary prospectus for each fund contain this and other important information about the investment company, and they may be obtained by visiting www.jenseninvestment.com or by calling 800.992.4144. Read it carefully before investing.

The Fund is non-diversified, meaning it may concentrate its assets in fewer individual holdings than a diversified fund. Therefore, the Fund is more exposed to individual stock volatility than a diversified fund.

Mutual fund investing involves risk. Principal loss is possible. The prices of growth stocks may be sensitive to changes in current or expected earnings, may experience larger price swings and may be out of favor with investors at different periods of time.

Visit www.jenseninvestment.com to view the Jensen Quality Growth Fund's current performance, including the 5-year upside/downside capture. 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. All returns include the reinvestment of dividends and capital gains.

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