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# Jensen Summit Series

## Portfolio Managers Allen Bond and Tyra Pratt and Analyst Jannis Fingberg discuss interest rates, consumer spending and AI developments

**ALLEN BOND:** Hi everyone, welcome to another recording of the Jensen Summit series. We're going to talk about investment themes and how they impact the businesses and the stocks within our portfolios. My name is Allen Bond, I'm a portfolio manager on our Quality Growth and Global Quality Growth strategies. I am joined today by Tyra Pratt, who is a portfolio manager on our Quality Mid Cap Strategy, and Jannis Fingberg, an analyst on Quality Growth and Global Quality Growth.

We're going to start today with some personal introductions just so everyone knows who is talking to them. I'll start and then I will pass the proverbial microphone around the room. My name is Allen Bond, as I mentioned. I started at Jensen in 2007 as an analyst to support our Quality Growth Strategy and 17 1/2 or so years later I'm still an analyst that supports Quality Growth but now also covers companies across all three of our strategies as an analyst.

Additionally, as I mentioned, I'm a portfolio manager on Quality Growth and Global Quality Growth, and also head of research across all the investment strategies here at Jensen. Prior to joining Jensen, I was mostly on the fixed income side of the business as a high-yield bond and corporate bond analyst. With that, I'll turn it over to Tyra to talk about her background.

**TYRA PRATT:** Hi, I'm Tyra Pratt. Like Allen said, I am a portfolio manager on our Quality Mid Cap Strategy. I have been at Jensen for about seven years and my whole time here have supported the Mid Cap Strategy. Prior to Jensen, I worked in alternative investments as well as consulting firms.

**JANNIS FINGBERG:** My name is Jannis Fingberg. I have been an investor for around 15 years now, previously working for firms in London, Bermuda and Hong Kong. I have been at Jensen for about two years now, supporting the Quality Growth and Global Quality Growth strategies.

**ALLEN:** Thanks. Well, with that, we will turn it over here to talk about some different topics that we see impacting various companies across the portfolio. And the first topic we want to talk about is interest rates, and in particular the expectation that interest rates, or at least the Fed funds rate, is likely to be cut here. Interest rates have


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been high, they've been high for quite some time and that's had an impact on the economy.

One of the most impacted sectors of the economy is the housing market, and we do have three stocks in the Quality Growth portfolio that are exposed to housing market activity. Those are **Equifax (EFX)**, **Home Depot (HD)** and **Sherwin-Williams (SHW)**. Housing activity has been relatively muted here the past year or so. And in fact, if you look at mortgage application activity as a proxy for housing market activity, that would imply that activity is near a 30-year low. You have to go back to sometime in the 1990s to find mortgage activity as low as it is today. And that's had an impact on those businesses.

Equifax has a massive amount of data that is used to make consumer lending decisions. Home Depot sells supplies for homes, which we need all the time, but if there's more housing activity, there's more demand for those products. And Sherwin-Williams sells paint, and in particular sells paint to professional painters and professional contractors. Those projects can be ongoing, but typically will be higher if there's more housing turnover. So all three of these businesses are impacted by interest rates and by trends in the housing sector. They've actually all held up relatively well, but we do think that if rates decline and the housing market picks back up, these businesses could be poised to benefit from those trends, given the strength of their market positions and the demand for those products if housing market activity ticks higher.

With that, I wanted to turn it over to Tyra. I know she's got some thoughts and examples of quality mid-cap companies that also have exposure to changes in interest rates.

**TYRA:** Thanks, Allen. Another area I think is interesting to think about that's sensitive to interest rate cuts is biotech funding. If you go back to 2021 in that COVID boom and innovation focused on vaccines and antivirals, interest rates are at all-time lows. Biotech funding peaked, the highest it's ever been. Going into 2022 and 2023, obviously interest rates are higher, combating high inflation. There's some macroeconomic concerns. It did a complete 180 and now it's, you know, some of the lowest it's ever been. I think it's back to 2015 or 2016 levels, so we really have lost almost eight years of funding innovation. This has significantly impacted companies that are in the early stage cycle of research.

We think about how this impacts the lower funding and higher cost of debt, how it impacts the biotech company. So there's going to be an increased cost of debt. There's going to be lower VC or private equity funding, just given the outside risk of some of these smaller biotech companies that are now levered up. And there's also going to be a significant impact to the probability of biotech companies leading to financial strain, lower R&D activity and higher bankruptcy rates. Some of the companies that we hold in the Mid Cap Strategy, these biotech firms are the clients of these companies.

One example I can walk you through is **Charles River Laboratories (CRL)**. Charles River is a non-clinical contract research organization that provides essential products and services to both pharmaceutical and biotech companies. They primarily play in drug discovery and safety assessment and they also provide research models for experiments and they have a small manufacturing business. About a quarter of Charles River's revenues is directly tied to what they classify as pre-commercial biotech, which is just a startup biotech firm that typically has less than two years of cash on hand. And as these clients are either going through bankruptcies or just don't have the funds to support the drug discovery process to have as much going on, Charles River has taken a pretty significant hit on the top line. I think the thing that's important to remember, as this funding isn't going away — it's just in a lull right now — it's going to come back. If you think about the biotech industry, it's crucial for advancing health care and improving human lives. So it's playing a critical role in discovering and developing new drugs.

**ALLEN:** OK, thanks, Tyra.

I think with that, let's move on to our next topic. And it's a bit related or maybe a lot related to the first topic, which is about the consumer and consumer spending and the health of consumer spending. We've seen some increasing sluggishness in consumer spending across many of the companies that we follow, and that is logical in the sense that if interest rates are higher, that means debt coverage and debt financing costs are higher and those higher debt financing costs tends to crowd out other forms of spending.

And so we've seen some weakness in consumer spending across portfolio companies. We've seen that in some of the really high-profile companies that we own. **Starbucks (SBUX)**, **Nike (NKE)**, we own those in both Quality Growth and Global Quality Growth. **Diageo (DGE)** we own in Global Quality Growth. These are all leading global consumer-facing companies that have called out consumer weakness for weaker than expected top-line results for those companies. But we have seen some pockets where certain companies and certain brands have been resilient and the slowdown in consumer spending really has not impacted the business all that much.

And with that as a backdrop, we thought it would be interesting to talk about one of our Quality Global companies, which is **Hermès (HRMS.PA)**, versus some of those other consumer products companies that I mentioned. Another one that we follow on our bench that's a particularly interesting comparator to Hermès is **Estée Lauder (EL)**, in the sense that they're both luxury goods, global luxury consumer goods manufacturers. In theory, they should have a lot in common, but their fates financially and business-wise have been very divergent here in the past year or so.

And I thought we could turn the call over to Jannis to talk about those companies.

**JANNIS:** Sure, thank you, Allen. Let me start by sort of adding a point on the interest rate discussion, if I may, in the sense that like Tyra and Allen have said, they do impact the interest rates whether high or low, it does impact many of our portfolio companies to a degree. But the flip side is also that in terms of our investment process, we focus on the long term, the competitive advantages, the management teams, the mode the companies have, etc. So while it may impact the shorter-term performance, both positively and negatively, the interest rate, I don't recall that many discussions here, like in our investment team, where we exclusively, so to speak, focus on the interest rate.

And it's just because our investment style is really bottom-up, and so we are not the experts in predicting on a macro level where interest rates will go. At the same time, we still live in the real world and have to take into account, like my predecessor said, that the interest rate does impact, at least in the short term and sometimes longer, how some of these companies perform, although it's usually not the reason why we would invest in a company. So while Sherwin-Williams, as an example, may benefit from lower rates, we have invested in the company because of its management team, its historical track record, its competitive advantages. And I think that's relevant.

I point this out because when we look at Hermès as a company, as a French luxury goods company that produces really high-end luxury goods, like leather bags, famous leather bags that might sell for thousands, and in some cases, tens of thousands of dollars. Many of you will know Hermès, maybe from airport stores where you can buy their ties, as an example, as a sort of entry-level item from them. What we have seen with Hermès is because the price point for many of their products is so high, and also because of the company's strategy, their sales have been very resilient. So if you look at the second quarter results, for example, sales were up 13%, that is a really different performance than, let's say, Estée Lauder that Allen mentioned that has been very a challenged business on many fronts.

In some ways, you can say, "OK great that we own Hermès and great that Hermès has not been so impacted or not impacted at all arguably by a challenged consumer." And there are various reasons for it. It has to do with the high price point of the product, the consumers they have, they're not necessarily impacted by economic forces on a day-to-day basis. It has to do with a model where they have essentially a waiting list to buy some of their most coveted products. In times of weaker demand, the company essentially calls up its loyal clients and says, "Hey, now you can buy this bag that you always wanted." Therefore, they basically have this tool of managing supply and demand in a more sustainable way.

There are other reasons. The company is really long-term focused, and this brings me back to my point, how we really focus on the business fundamentals. Hermès, the big difference to other companies in the sector, also a difference to Estée Lauder, but even arguably other luxury goods companies, they really build a long-term relationship with their customers. For example, somewhat counterintuitively, they did not increase prices as much as they could. A lot of other luxury groups have increased the prices a lot. Hermès did not do that. And that's because they don't want to annoy their loyal customer base too much, and they charge a little bit more each year, but not too much. And that speaks to the long-term approach and long-term management strategy that this company has employed for decades.

Now, a quick point again on the interest rate discussion. On the other hand, you know, you look at Estée Lauder, more entry-level, aspirational product. I mean, $60 for lipstick might seem outrageous, but the absolute price point is still relatively low, so it's a much more affordable product range or aspirational one. And that one has been absolutely impacted by some of the forces that Allen mentioned in terms of higher interest rates, weakened consumers — especially in China for Estée Lauder — but similar dynamic. But the reason I keep coming back to this interest rate point is that, in some ways, if interest rates decline, you could almost expect Estée Lauder to bounce back quicker or may potentially even outperform Hermès, even though fundamentally in the long term, in our opinion, it's a much weaker business. And that's because Hermès has held up very well and will not necessarily get this extra boost from a few additional consumers that now feel like they can spend money again. Whereas Estée Lauder has been very weak. Now, interest rates go down, maybe the consumer is less challenged as a result. The delta is bigger for Estée Lauder, the incremental buyer might grow faster at Estée Lauder and in the short term it might well be that Estée Lauder actually outperforms. But for our strategy, you know, we think about holding companies and owning them for many years into the future. So that's what I meant, why we take into account what happens to interest rates. It's not the basis of how we invest.

**ALLEN:** A couple of thoughts, I guess. I think the conversation about Hermès is interesting.

You always think about elastic versus inelastic goods from an economic sense. And typically, the way I've always thought about that concept is that inelastic goods are goods that you need, goods that you cannot live without. So they tend to be things like health care or maybe some consumer staples type products. I think what we're seeing here, what you're talking about is that there's actually, if you go to the very, very high end of the curve, you become inelastic again, but for different reasons, right? Like I don't think everyone necessarily needs the most expensive handbag in the world, but there's a subset — and a pretty small subset of the world, but a meaningful one — where that demand essentially is inelastic because they can afford to do that, it doesn't really matter what's going on in the economy. And I think that's, to me, the interesting thing you talked about — the difference between Estée Lauder and Hermès is that Hermès is true and absolute high-end luxury, but Estée Lauder is a little bit more aspirational. I think that's, to me, the interesting takeaway there as you were talking through those two.

The other thing I wanted to circle back on really quick because I think you did a good job of talking about the fact that, yeah, we can make a short-term macro call on companies that have exposure to interest rates in the housing market, but reality is the long-term investment thesis, the reason we own Equifax or Home Depot or Sherwin-Williams is not because of a short-term call on interest rates or the housing markets, it's really about the competitive advantages for those businesses.

I mentioned those businesses have held up relatively well despite a muted housing market. And if you think about what they've been doing and what has caused that, Home Depot's top line's been weak. It's been down a little bit, but not down a lot, not down nearly as much as housing market activity has been down. And the reason for that is that because even in periods when people aren't moving and housing turnover is low, you still need supplies for your home. And Home Depot is extremely well positioned in terms of their assortment, in terms of their real estate, in terms of their brand and recognition in the marketplace that there's resilience there and they've held up relatively well.

Sherwin-Williams has actually grown and they've grown at the expense of their competitors, they've taken share. Some of their competitors have had to retrench in certain markets. And as competitors have retrenched, Sherwin-Williams has used their financial strength, their competitive strength, to actually play offense in certain of those markets. So they're kind of investing countercyclically, which we think positions them very well when the market does turn around.

Same thing with Equifax, they do sell a lot of their data to lenders that make many decisions about home purchases. But it's not just that, they have a very diverse group of customers in terms of the type of lenders they serve, and that's allowed them again to outgrow their end market. So two out of these three have actually grown here despite, you could argue, a pretty weak backdrop for them and I think speaks to the power of competitive advantages there. So I thought that was an interesting point to circle back to.

Last topic I wanted to talk about here was AI and the quote unquote AI trade.

What we thought would be interesting to talk about is sort of how we're seeing what we're hearing from the companies that we follow and how we're seeing AI being implemented across businesses. The reason it's an interesting topic is that right now or so far the AI trade or AI investment has really been focused on the building and the training of the AI models or the large language models.

Really simplistically, the training of these models requires an immense amount of computing power and an immense amount of computing capacity. So that's really fueled when you think about **Nvidia (NVDA)**.

Nvidia has really been the epicenter of the gold rush here with AI. And it's because they design the computer chips that are used to power the training of these models. And they dominate that space, and this has become a massive source of demand for them. So as the models are being trained, there's a lot of demand for their chips. Similarly, if you look at some of the semiconductor equipment companies that are involved in actually producing the computer chips, as the demand for computer chips has gone up because of the training of these models, the prospects for those businesses have gotten a lot higher. So it's been really more about chip manufacturing and semiconductor hardware, right? And we have a little bit of exposure to that in our portfolios, but most of what we've owned in tech is more focused on what we would consider stable and consistent and very well positioned software businesses. We've seen some benefit from the AI trade, but maybe not as much as others because of our focus on the software businesses.

This brings us to the next conversation. Some places there's a lot of investment being made in AI and sometime we would expect to see uses, and this is where we think the software companies may benefit, but there's been skepticism. We've seen increasing skepticism. This is, "Oh, the return on investment, there's not been a lot of use cases for this. We're spending all this money building the models, but we haven't seen the use cases yet." And so we were kind of thinking, what use cases are we seeing and where do we see the roadmap, if you will, of how these large software companies that we own and how they might benefit from that trend as we move forward down the development curve here with AI? I had a couple of thoughts here to start and then I'll swing around the table for Tyra and Jannis to add thoughts because I know they have some as well on this topic.

The best use case that I've seen across companies in our portfolio, or the most common one, is very data-intensive businesses. And these are businesses where there's an immense amount of data, there's multiple data sets, and AI can play a big role in integrating those data sets and making the use of those data sets more efficient and more accurate. A really good example of this is with pharmaceutical companies. The big part of pharmaceutical companies is early stage drug research, which Tyra talked a little bit about with Charles Rivers a moment ago. But in this stage, drug companies are sifting through a multitude of different drug targets and different proteins and protein combinations they may want to target and then how is the best way to target that drug, and the amount of data that's involved in that is immense.

These companies are able to use AI tools to do that process and make it much more efficient, make it much more accurate and improve the likelihood that some of these early exchange drug efforts will result in actual drugs that are approved and are used and generate revenue in the future. So this is one area where we've seen a lot of promise with AI applications and seeing companies increasingly talk about it.

The other is really data intensive businesses. And I mentioned Equifax a couple times earlier. Equifax is a really good example of this. Equifax has proprietary data, and it's proprietary data that is going to help determine whether or not people are likely to be able to pay off loans if they're loaned money. They have payment data on things like credit cards, they have income data, they have employment data, they have wealth data. These things are all critical to making that determination of whether this person is creditworthy, right? Whether you should, whether someone should loan the money, but these are disparate sources. Equifax owns this data, it's proprietary, it's unique, it's very highly valued, but they can use AI and AI tools to help integrate that data and to help make faster and more effective, more inclusive, more holistic decisions about lending. And that's an area where they started talking more and more about that. So we are seeing use cases. It's kind of slow, but it's starting, and we think that that might be an interesting next leg of the conversation here.

Tyra, I know there's some companies you've talked about that do this as well.

**TYRA:** Yeah, I'm going to stick on the kind of more data-intensive businesses using AI, and so I'm going to talk about **Automatic Data Processing (ADP)**.

ADP, just for quick background, is one of the largest providers of human capital management software and solutions. They're dealing with a lot of data, a lot of employee data. They've talked about using AI in two primary ways.

One, they're embedding it into their products. An example of that would be that they are using GenAI to combine extensive data sets with GenAI and then automating routine tasks, providing insights, and then aiding decision-making. so that is helping make the products run smoother and helping clients gain insights from that. They're also using it for internal operations, so similar to what they're embedding in their products for clients, they're again automating and streamlining their tasks. One example they gave would just be digitally onboarding new clients. They're taking in the unstructured employee data and then they're reducing manual data entry and then minimizing risks of implementation errors.

This all really I view as a low hanging fruit of where AI can be applied immediately and have significant impact. For ADP, it's less about them monetizing AI right now, but more about using it to improve their client experience. And for a company that relies on high client retention rates and client satisfaction, this has been a really important part of their business and they've seen a significant impact just on client happiness.

**ALLEN:** Thanks, Tyra. Jannis, you're covering several of the companies that I talked about earlier with the outset of this conversation that are semiconductor equipment companies, a couple of which we own, **KLA Corporation (KLAC)**, we own **ASML (ASML)** in the Global strategy that you've done work on. And I know you and I have had a lot of conversations about what does the future of AI look like and who are likely to be the winners. So maybe you can just expand on some thoughts in that regard from your view?

**JANNIS:** Well, it's difficult. It's such a complex and broad topic and a lot of moving parts. I think you can certainly start to see, increasingly, cases of where AI is basically being used or becoming a requirement. One example would be software engineering. I spent a long time in Silicon Valley, you can see increasing job postings for software engineers for coding and will specifically say unless there is experience with using AI coding assistance then you should essentially not apply if you don't have that experience. So there's certainly increasingly cases where in a very tangible way AI is making an impact in very specific areas. But at the same time, and we have all seen use cases already of like, auto suggest in email, or we have seen now the ability of, depending on which programs you use, summarizing text and so on. But my bigger point is that in some ways, you put this against the massive investments that go into the sector. And of course, it's very easy then to conclude, well, somehow, there seems to be a disconnect. I mean, essentially, it's almost like the stock market has concluded that there's an infinite or at least a very, very large return on AI or knowledge, and in reality the actual ways to make money from it right now are way more limited, even if we can all look at our companies and pick up an example here or there.

Now, that probably does not mean that, therefore, AI is not here to stay. I mean, I believe very much that it's here to stay. The other day I was at a talk where essentially the speaker was comparing it to electricity. So basically it has a more foundational technology that then will enable the creation of many other sort of follow-on innovations that come from that, which I thought was an interesting way of thinking about it. But at the same time, if you look back at the invention of electricity and when it finally became available on a broad scale, it still actually took a long time to truly lead to different work processes, to different products, to different ways of, let's say, transportation and so on. It took a long time even for such a technology that we take for granted today.

Compared to that, actually, you could argue that a ChatGPT only took a couple of months to make an impact. Overall, it's a very dynamic field. Clearly, the key decision makers in Silicon Valley, by and large, have all decided that artificial intelligence is one of the, if not the most central technology over the next decade. That's why so much investment flows into it.

And to Allen's point in the beginning, I mean, I would say that actually in some ways, that fits a Jensen strategy reasonably well in the sense, yes, okay, we could not own Nvidia because it did not have ROE over 15 % for a long time until the beginning of this year, so it did not qualify for the universe of companies that we look at. That's just a matter of fact. And in this case, maybe it was a disadvantage, but there are many other cases where Jensen can point to where this rule of having this universe worked in the long-term favor of the clients.

So I wouldn't be sort of too harsh on that in some ways. And then in other ways, if you look at, Allen mentioned the massive amount of money that goes into investing into building these models.

It's actually only, by and large, only the largest companies can afford those sums. And of course, Quality Growth is a very concentrated, large-cap strategy that does own several of those companies that are more likely than others to eventually be the beneficiaries of that investment.

I mean, **Microsoft (MSFT)** is an interesting case here, for example. If you look at the last results, the share price was relatively weak and one of the key reasons is that the street did not like that Microsoft essentially said we're going to invest a lot more in chips. And in some ways that's a very short -term reason. Maybe that doesn't lead to a return next quarter or the quarter after that or maybe not even in a year. But what does that do in the long term for Microsoft? It will most likely continue to build its mode even further versus other companies that do not have the resources to invest in these technologies.

So in that sense, again, for Jensen's longer-term approach, sometimes looking through those periods of where the market punishes the company because it seemingly invests too much in the short term can, in the long term in our experience, be beneficial.

**ALLEN:** Yeah, I think the skepticism, if you will, that we've been reading about is more about near-term ROI. And I think what you're talking about is that the ROI might need to be measured over years and maybe even decades, not over days and months and so forth.

**JANNIS:** Absolutely, unless you're really one of the most direct beneficiaries that immediately benefit because somebody buys your chip or your chip-making equipment, but I guess on the application side, it might just take a longer period of time until those gains materialize. But that doesn't necessarily mean that they're less powerful or that they are poor. The technology as such is just a short-term phenomenon.

**ALLEN:** And I think it's an interesting point you make about high-quality businesses and financially strong businesses that have the ability to make long-term investments, and they don't have to think about an immediate return on something, but if something is promising for the long term, they have the balance sheet strength and the financial strength to make these investments. I think that's an interesting lens to look through.

That ends our discussion here today in terms of topics.

We talked about interest rates, we talked about consumer spending and then we talked about sort of where we see AI happening today and maybe a roadmap, a little bit of a roadmap for the future. I want to thank my colleagues Tyra Pratt and Jannis Fingberg for joining us here on the Summit Series. And with that, I would like to thank all the listeners and we will be back here sometime soon with the next recording. Thank you very much.

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