JENSEN INVESTMENT MANAGEMENT

Reflationary Headwinds to Quality Investing

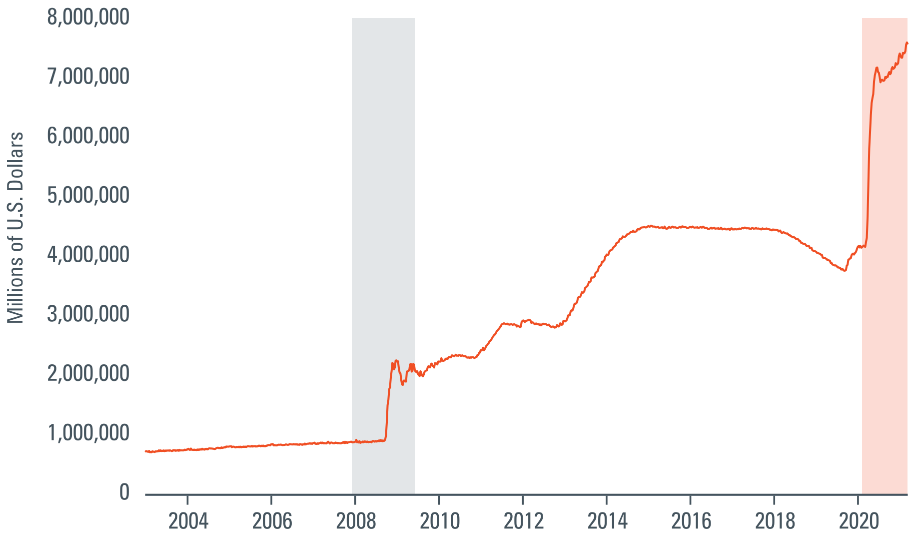
Short-term, benchmark-relative investment performance has been challenged across all three Jensen Quality strategies. Attribution analysis for the Jensen Quality Growth Strategy indicates dual culprits: security selection and an overweight to high-quality stocks. However, while there are a few share price hiccups across the portfolio, it is difficult to find a clear 'smoking gun' among individual holdings that solely explains near-term, index-lagging performance.

As long-term investors, we recognize that investment styles go in and out of favor, which is a function of unpredictable investor sentiment and changes in the macroeconomic landscape. At present, we believe this cycle is negatively impacting quality investment strategies. Our analysis suggests that high-quality stocks are caught between momentum growth sentiment on one side and a wave of government stimulus benefiting low-quality businesses on the other.

We know of the outsized gains from the largest growth stocks in 2020. The top five largest stocks in U.S. equity markets (AAPL, MSFT, AMZN, GOOGL, and FB) produced an average total return of +53.01%, besting the returns of both the S&P 500 Index (+18.40%) and the Russell 1000 Growth Index (+38.49%). Stock price strength from this

Exhibit 1 **U.S. Federal Reserve Total Assets**[1]

U.S. recessions are shaded; the most recent end date is undecided.



[1] Board of Governors of the Federal Reserve System (US), Assets: Total Assets: Total Assets (Less Eliminations from Consolidation): Wednesday Level [WALCL], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/WALCL, February 22, 2021.

Table 1 Quality Bucket Returns[2]

Group/Index	Annualized Total Returns: QE Returns 11/25/08 – 10/29/14	Annualized Total Returns: QE Returns 03/15/20 – 02/28/21	Annualized Total Returns: No QE 10/30/14 – 03/14/20
High-Quality Stocks (A- and above)	14.58%	35.66%	9.48%
Low-Quality Stocks (B+ and below)	19.81%	47.90%	7.34%
S&P 500 Index	17.30%	42.91%	8.09%
Russell 1000 Growth Index	19.36%	54.35%	11.95%

group is attributable to an earnings growth surge in 2020, as these businesses all benefited from the stay-at-home ramifications of the coronavirus pandemic.

Likewise, fiscal intervention injected $2.7 trillion into the U.S. economy in 2020, with another $1.9 trillion expected in 2021. Together, these programs represent approximately 22% of 2020 U.S. gross domestic product. Concurrently, the U.S. Federal Reserve ("Fed") slashed the Fed Funds Rate to near 0% and reinstituted aggressive quantitative easing. This led to a sharp increase in the Fed's balance sheet, dwarfing the increase a decade ago.

Much as a rising tide lifts even the leakiest of boats, government aid disproportionately buoyed low-quality stocks, as shares of those businesses are especially sensitive to external support. As shown in Table 1, the strength of low-quality stocks in the period from March 15, 2020, through February 28, 2021, is reminiscent of the pattern that emerged following the aggressive monetary policy response to the 2008-2009 financial crisis.

The first quantitative easing program launched on November 25, 2008, and continued until October 29, 2014. After an approximately five-year period of neutral to restrictive policy changes, the Fed restarted quantitative easing on March 15, 2020, in an effort to offset economic weakness associated with the COVID-19 outbreak. In both periods of aggressive accommodation, low-quality stocks dramatically outperformed high-quality stocks.

When and how will this impasse end?

We already see signs of change on the horizon, particularly for the investment returns from the top five largest stocks in U.S. equity markets. Share price gains for these companies in 2021 have been mixed, averaging below that of the overall market. Perhaps investors are grappling with the prospect of difficult year-over-year comparisons to strong earnings advances in 2020, particularly for Amazon and Facebook.

On the other hand, we have yet to see an indication of relative weakness from low-quality stocks. In the year-to-date period ending February 28, 2021, low-quality stocks (those rated B+ and below) advanced 2.11%, approximately 100 basis points more than the group of high-quality stocks (those rated A- and above). However, investors may be overlooking the implications of a sharp increase in inflation expectations.

Table 2 Top Five Index Stock Historical and Expected Earnings Per Share Growth[3]

Issuer	Stock Total Return FY 2020	Stock Total Return YTD 2021	Y/Y PF Earnings – Actual FY 2019	Y/Y PF Earnings – Actual FY 2020	Y/Y PF Earnings – Projected FY 2021E	Y/Y PF Earnings – Projected FY 2022E
Apple (AAPL)	82.31%	-8.48%	-0.29%	10.23%	36.17%	5.16%
Microsoft (MSFT)	42.53%	4.72%	22.42%	21.26%	29.17%	9.81%
Amazon (AMZN)	76.26%	-5.04%	14.25%	81.79%	14.97%	40.96%
Alphabet (GOOGL)	30.94%	15.82%	12.49%	19.22%	19.06%	16.32%
Facebook (FB)	33.09%	-5.69%	-15.06%	56.92%	13.78%	18.38%
Average	53.03%	0.27%	6.76%	37.88%	22.63%	18.13%
Median	42.53%	-5.04%	12.49%	21.26%	19.06%	16.32%

[2] Quality buckets are based on S&P Quality Rankings.
[3] Source: Refinitiv Eikon

Exhibit 2

10-Year Breakeven Inflation Rate[4]

U.S. recessions are shaded; the most recent end date is undecided.

As shown in Exhibit 2, the outlook for U.S. inflation has skyrocketed over the past twelve months.

As we saw happen in 2013, investor sentiment may be negatively impacted if resurgent inflation forces the Fed to prematurely end accommodation measures. For now, Fed officials are steadfast in their willingness to let the economy 'run hot' due to confidence that any inflation uptick is merely transitory. However, how long can this patience persist before inflation concerns dictate a more hawkish policy?

Quality investing is out of favor at present. Unfortunately, this is to be expected at some point in any market cycle. In these periods, adherence to process and philosophical discipline is critical. Focus on the long-term, know what you own, strive for an appropriate margin of safety, and keep a steady hand on the wheel.

*The **S&P 500 Index** is a market value weighted index consisting of 500 stocks chosen for market size, liquidity and industry group representation.*

*The **Russell 1000 Growth Index** measures the performance of those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values. These indexes are unmanaged, and you cannot invest directly in an index.*

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JENSEN™ INVESTMENT MANAGEMENT

5500 Meadows Road, Suite 200
Lake Oswego, OR 97035
800.221.4384

jenseninvestment.com

[4] Federal Reserve Bank of St. Louis, 10-Year Breakeven Inflation Rate [T10YIE], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/T10YIE, February 28, 2021.
The breakeven inflation rate represents a measure of expected inflation derived from 10-Year Treasury Constant Maturity Securities (BC_10YEAR) and 10-Year Treasury Inflation-Indexed Constant Maturity Securities (TC_10YEAR).
The latest value implies what market participants expect inflation to be in the next 10 years, on average.