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Quality Growth Fund Quarterly Update: 1Q 2024

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

ALLEN BOND: My name is Allen Bond. I am one of the portfolio managers on the Quality Growth Strategy. I'm joined today on the webinar by my colleague Jeff Wilson. For the call, I will begin with a brief overview of our firm and investment philosophy. Jeff will then cover quarterly performance trends and portfolio changes. I will then conclude our prepared remarks with some comments on market trends and our outlook, and we will conduct a Q&A session at the end of the call. So please submit questions at any time into the webinar portal. So this slide contains a brief overview of Jensen Investment Management. Jensen is an employee-owned investment management company focused on quality investing strategies. The company was founded in 1988 by Val Jensen. It is currently owned by 23 active employee owners out of a total of 38 total employees. We currently manage about $13 billion in assets across three strategies.

First is Jensen Quality Growth. It is a large-cap equity strategy focused on the long-term ownership of high-quality value-creating businesses. It 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 and accounts for the vast majority of our assets under management. Second strategy is Jensen Quality Mid-Cap. It is a mid-cap strategy focused on investing in mid-sized high-quality businesses with a bit more focus on stock price valuation. We launched the composite for the strategy back in 2008. We launched it in fund form in 2010, and the strategy was essentially rebooted in 2017 where we focused more on fundamental business research similar to that of the Quality Growth strategy. Today the strategy is very similar to Quality Growth, but with a focus on mid-sized businesses. And then finally, Jensen Quality Global is very much an extension of the domestic Quality Growth strategy, but with an expanded investable universe that includes companies located overseas. The strategy was launched in April of 2020 and

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clientservices@jenseninvestment.com
800.221.4384

recently achieved its four-year investment performance track record during this month.

So moving on to our investment philosophy and objectives. There's quite a bit here on this slide, but 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 we think are linked with sustainable business value creation. These include competitive advantages, free cash flow and business model consistency. We also want to identify growth drivers. Not always explosive growth drivers, but steady, consistent, predictable growth. We also pay attention to stock price valuation, which we think at times can differentiate us from other versions of quality strategies. From an evaluation perspective, 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.

To us, the importance of valuation is twofold. First, by investing at a discount to intrinsic value, we believe we get a margin of safety, which helps manage against long-term pricing risk. And secondly, if we buy stocks at the right price, we maximize the chances that there will be traction between the business results and share price appreciation over the long term. The result in our view is a portfolio of high-quality, fairly valued stocks. Now, before I turn the call over to Jeff to discuss quarterly performance trends and portfolio changes, I would like to make a few comments about longer-term performance trends.

And it's really no surprise to say that the Quality Growth Fund has underperformed the benchmark index by a wide degree over the past 15 months. These periods are frustrating, but such periods of relative performance gaps are not entirely unprecedented in recent history. In fact, we witnessed similar relative performance shortfalls during instances of market concentration in the late-1990s and in the mid-2000s. Following both these periods, bear markets quickly ensued and the Jensen Quality Growth Strategy substantially outperformed the benchmark during these bear market periods. For more information, we recently published a paper that analyzes this relationship and its impact on long-term investment performance that is available on our website. I'll now turn the call over to Jeff to 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 626 basis points in the first quarter. At a high level, the fund's under performance in this period is explained by high-quality factors being out of favor during the period, acting as a material headwind for our investment discipline, and an increasingly narrow market leadership profile with nearly half of this period's returns attributable to just four stocks, including nearly a quarter driven by a single stock, NVIDIA.

In times like these, we believe it is important for investors to know what you own and have a keen eye toward risk management in the face of this narrow market leadership, avoiding the urge to chase what's in favor. Turning to style performance, this slide shows style factor attribution in the first quarter for companies in the MSCI US Investable Market Index. This analysis shows that high-quality stocks were out of favor during the quarter. The factors that were in favor were momentum, volatility and growth. Additionally, based on our analysis of the S&P Quality Rankings, the funds overweight to high-quality stocks did have a material impact on relative investment performance as higher-quality stocks as measured by S&P trailed that of lower quality stocks, which contributed to the underperformance.

Turning to sector analysis, the Information Technology sector was the largest detractor from relative performance, detracting 281 basis points. However, nearly all of this was attributable to one stock, NVIDIA, which contributed 254 basis points to the index's return for the first quarter, as NVIDIA shares returned over 82% during the first quarter. The Communication sector also detracted from relative performance by 53 basis points, due primarily to the fund's overweight position in Alphabet, which underperformed relative to other companies in the sector, most notably Meta, which the fund does not own. Stock selection within the Consumer Discretionary sector detracted 96 basis points from relative performance.

Three portfolio companies, Nike, Starbucks and McDonald's detracted, while ownership of Home Depot and the fund's lack of exposure to Tesla, which happened to be down almost 30% during the period, contributed positively. The fund's lack of exposure to Amazon, which does not qualify for the Jensen investable universe due to historically inconsistent ROE, accounted for nearly half of relative sector performance during the period. Health Care stock selection also detracted from relative performance, despite Stryker being the fund's top individual contributor to performance, which we will provide further detail. Relative performance was driven primarily by weakness in UnitedHealth shares, along with a lack of exposure to Eli Lilly shares, which does qualify for our investable universe but remains expensive based on our determination of fair value due in part to optimism surrounding GLP-1 drug prospects. On the positive side, the portfolio's lack of exposure to stocks in the Real Estate and Utilities sectors boosted relative performance. There are very few companies in either of these sectors that qualify for the Jensen investable universe due to insufficient ROE histories.

As mentioned, the fund's top individual performance contributor in the first quarter was Stryker. Stryker is a healthcare devices and equipment company focused on orthopedic implants and medical surgical equipment. Stryker shares appreciated during the quarter in conjunction with strong financial results tied to a series of new product launches, and increasing orthopedic procedure volume due to pent-up demand stemming from the COVID-19 pandemic. Stryker remains a top portfolio holding, reflecting its strong market positions and technology leadership in orthopedic implants, hospital equipment and surgical tools, along with favorable long-term growth prospects.

Leading individual detractor to fund performance during the quarter was Apple. Apple is a leading global consumer electronics and services company. The company's shares declined in response to sluggish sales and earnings growth during the company's first quarter fiscal. In our view, Apple's near-term performance has been constrained by a lull in the product cycle. Despite this slowdown in product revenue, we were encouraged by the sales growth in the company's higher-margin services segment.

Apple remains a core portfolio holding due to the strength of its brand and its product and services ecosystem. Next, I'll offer some perspective on portfolio changes during the quarter. During the quarter, the Quality Growth investment team added new positions in Zoetis and McDonald's and liquidated its position in Pfizer. The team also added to its position in Marsh McLennan and trimmed Moody's. Zoetis develops, manufactures and markets animal health medicines, vaccines, diagnostic products, genetic tests and bio devices, and is diversified across approximately 300 product lines supporting eight core species. Roughly two-thirds of its revenue is derived from products for cats, dogs and horses, while a little over one-third is from products for livestock. We believe that Zoetis possesses strong competitive advantages including intellectual property, economies of scale, an efficient R&D organization and a well-respected brand. The animal health industry has high barriers to entry and solid long-term growth drivers, including an increasing focus on treating pet diseases, a growing pet population, and significant unmet needs in both pets and livestock.

McDonald's, founded in 1940, operates over 40,000 quick service restaurants in over 100 countries with 95% franchised and 5% company-operated. This capital-light franchise-centric business model means the company generates revenues primarily from royalty payments tied to franchisee sales, producing a high-margin, low-volatility stream of cash flows for the McDonald's parent company. We believe McDonald's also benefits from its real estate portfolio, well-known brand, leading market position and strong diversification across customers, suppliers and geographies. While our expectations for revenue growth are tempered by the company's size and industry, we believe that McDonald's can continue to grow its store footprint in the low single digits while steadily increasing pricing and consumer traffic, leading to a steady earnings growth and cash flow growth over time and acting as ballast for the fund. Most recently purchased in 2018, Pfizer is a biopharmaceutical company. Our sale of Pfizer was a decision driven by weaker-than-expected financial results, largely due to a sharp decline in COVID-19 treatment sales and the company's $43 billion acquisition of Seagen in 2023. The combination of these two factors has resulted in a stretched balance sheet and constrained free cash flow generation profile.

Strategically, we had been supportive of Pfizer's use of excess free cash flow to bolster future growth prospects via tuck-in acquisitions of drug pipeline candidates. However, in our view, the Seagen acquisition was more transformational in nature and has reduced Pfizer's financial flexibility in the event of further negative surprises. Marsh McLennan, which we added to in the quarter, is a leading professional services firm, offering its clients advice and solutions in areas of risk, strategy and people. We took advantage of recent share price weakness to add to the position as investors focus on short-term interest rate fluctuations and the potential impact on the interest that Marsh earns on funds held for clients created a favorable long-term buying opportunity in our view.

Lastly, in terms of portfolio changes, Moody's is a global risk assessment firm and provider of credit ratings, private company information and commercial real estate data. Our investment case for Moody's is based on its dominance and credit ratings, high customer retention rates, and a high degree of recurring revenue. While we remain favorable on the long-term business prospects for Moody's, we trim the position primarily due to valuation. With that, I'll turn the call back to Allen to discuss our outlook.

BOND: Thanks, Jeff. So moving on to our outlook and some thoughts on market trends. As you can see on the slide, if you just count them up, the number of headwinds that we've identified do outnumber the tailwinds, but that does not necessarily imply that we expect an imminent market decline. So for that reason, we do retain a neutral stock market outlook for the remainder of 2024. We'll start with some of the headwinds, and we've got some slides here to back up these thoughts for both the headwinds and the tailwinds that follow here. Stock prices have advanced at a faster rate than earnings, and this has resulted in an uptick in valuation multiples. Additionally, stock market leadership continues to be very narrow. The Magnificent Seven, which led the rally in 2023 has become closer to something like the "Fabulous Four" in the first quarter, which indicates the market leadership has become even more narrow. And earnings multiples for the largest index weightings have become detached from the overall market, and that's not something we've seen for 20-plus years.

If we flip over and look at the fixed income market, the Treasury market is still signaling a near-term economic slowdown. And inflation, while it's declined from its peak, remains stubbornly higher than pre-pandemic levels, and we think this reduces the likelihood of aggressive dovish monetary policy actions. However, on the positive side, earnings growth remains positive and is forecast to remain positive for this year and for next year, and is supported by election year incentives that we'll talk about here in a few moments. And then the final thing is that we do see structural economic growth from the development of artificial intelligence models and associated investments. This was a key theme during first quarter earnings reports. Mention of AI was sprinkled all through these reports. This certainly validates that companies expect this to be long-term growth opportunity and they're taking steps to try to benefit from that. And we think this all is another trend that does support further market advances.

Starting here with the first slide, we show the increase in the index price versus the increase in earnings growth for the S&P 500 Index. And as you can see on the slide, the index price has increased at a faster rate than index earnings. And in fact, in the period shown above, which is about 10 years, the index price increased at an annualized rate of nearly 10% while earnings grew at only a bit more than 7%. Now, in the short term, this disconnect is probably not terribly meaningful. Earnings in price are not always correlated exactly during the short term, but over the longer term, earnings growth and price growth tend to be highly correlated, which suggests this trend is unlikely to persist indefinitely.

The result of this trend is an increase in valuation multiples across different measures. As you can see in this slide, multiples have crept higher than pre-pandemic levels, pulled higher by the multiple expansion that we've seen among the Magnificent Seven stocks. And also we note this slide, the index multiple has drifted higher than that of the median stock multiple. This is another sign of market concentration and the impact and influence of the large weightings in the index. This slide illustrates heightened stock market valuation across a variety of different metrics and corroborates what we saw in the previous earnings multiple charts. These factors shown in this slide have been measured over many years. And all but one are signaling and confirming that the market is overvalued at the present.

So this slide is a recap of 2023 investment performance trends. In fact, I think we used this slide during the last webinar, and 2023 was very much about the Magnificent Seven. And as you can see in this table, those seven stocks comprised about 26% of the index during 2023 and accounted for 60% of its total return. So this is not new news, this is a recap of what happened last year. Moving on to the first quarter, index performance became even more concentrated, and the Magnificent Seven shrunk down to the "Fabulous Four." These stocks were NVIDIA, Microsoft, Meta and Amazon. This group of four stocks comprised a bit more than 17% of the index in the quarter and accounted for nearly half of its total return, as Jeff mentioned. This trend indicates that stock market leadership has become even more narrow as the rally has progressed. Of note, these four stocks, only Microsoft is held in the Quality Growth Strategy.

So this slide shows valuation multiples over a longer time period. It goes back nearly 30 years. And what's notable in this chart is that earnings multiples for the top five index stocks are separating from the overall market. The last time we observed a similar trend was in the build up to the dot-com bubble in the late 1990s. And while we're not calling for a repeat of that period, we do think this is a trend that we should monitor and we will continue to keep our eye on. This slide shows yearly performance contribution from the top 10 index stocks in positive return years over the past 30 years. As you can see, performance contribution from top the 10 stocks in 2023 was the second highest in the period shown in this illustration. Previous instances of concentrated performance contribution occurred in 2007, 2020, 2021, 1998 and 1999.

So this slide here shows performance trends directly subsequent to those periods of concentrated performance contribution. And as you can see, all three periods were followed by meaningful drawdowns in the S&P 500 Index. Also of note, during the drawdown periods the Jensen Quality Growth Strategy outperformed the index. So this slide we've used before, this is a measure of the Treasury yield curve. It shows the difference between the yield on the 10-year Treasury note and the three-month Treasury bill. Normally, the yield on longer-dated notes is greater than that on shorter-dated notes, but as is the case presently when the yield on shorter-term insurance is higher, the curve is said to be inverted.

Yield curve inversions are relatively rare, but when they do occur, they've been excellent recession predictors, accurately predicting all 10 recessions since 1955. So this is a signal that we've talked about a lot over the past year and a half. It's something we're still monitoring. However, we do acknowledge the unique economic circumstances that may allow the economy to avert a recession this time and perhaps achieve a soft landing. That said, inflation has remained stubbornly high. As you can see in this chart, which shows the annualized change in the core CPI index, which strips out volatile components such as food and energy in an attempt to measure "sticky inflation." Inflation peaked here in early 2023 and has steadily declined since. But the current run rate of about 4% inflation remains above the Federal Open Market Committee target and may preclude aggressive cuts to the Fed funds rate that would run counter to investor expectations at the outset of this year.

Okay, so on the positive side of the ledger, earnings growth has been supportive of market advances and continues to be supportive of market advances. As you can see, earnings are expected to grow in the low double digits in both 2024 and in 2025. And in the short term, these earnings advances are supported by the trends we've talked about in terms of artificial intelligence and overall economic growth. There's also short-term benefit from actions from the U.S. Treasury Department, which have more than offset the money supply reductions from the shrinking of the Fed balance sheet as you can see on this slide. These actions support earnings growth and economic growth most likely for the rest of the year.

And this type activity is consistent with a pattern that we've seen in which stocks in presidential reelection years outperform stocks in open presidential election years and speaks to the incentives that incumbent administrations have to stimulate the economy in the stock market prior to the election. So we talked a lot about artificial intelligence, and it certainly dominated earnings calls during the first quarter. In total, we counted about 300 mentions of the term "AI" in the earnings calls among those top index contributors: NVIDIA, Microsoft, Meta and Amazon. We've got a few examples here on this slide, but suffice to say this is a trend that has captured corporate America and we think is going to be a theme and a secular growth theme for some time to come.

So in summary, absolute returns in the first quarter in 2024 were solid and were supportive of long-term investment objectives. However, relative investment performance in these periods was frustrating and has been restrained by quality trends and a lack of exposure to some of the top momentum stocks at the top of the index. We cannot predict when these trends will end: concentration, low-quality stocks, momentum. But historical precedent would suggest that investors should be prepared for a drawdown once the current euphoria period fades away. For 2024, we maintain a neutral outlook due to offsetting factors that we've previously discussed. Taking a step back, momentum-driven top-heavy markets, great opportunities for patient investors, focused on high-quality stocks. These high-quality businesses benefit from durable competitive advantages, steady free cash flow generation and attractive long-term growth opportunities. In an environment characterized by stubborn inflation, high interest rates and elevated stock price valuations, we believe these high-quality attributes can provide resiliency via pricing power and financial flexibility.

The Jensen investment team remains confident in the strategy and our process guiding our management of the portfolio. Our goal remains the ownership of a portfolio of companies positioned to grow and accrue business value. We seek to participate in this value creation as investors via the long-term ownership of what we believe are fairly priced high-quality stocks. We believe these attributes noted above enable quality companies to generate business returns consistently above their cost of capital, ultimately resulting in shareholder value creation. So 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. I will now turn the call back to Gabby to facilitate questions and answers.

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

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