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Quality Growth Fund Quarterly Update: 4Q 2023

Hosted by Allen T. Bond, CFA, Managing Director, Head of Research & Portfolio Manager; and Kevin Walkush, Portfolio Manager & Head of ESG

KEVIN WALKUSH: Thank you for joining us for today's call. I'm Kevin Walkush and I'm joined by my long-term colleague, Allen Bond. We have been with Jensen Investment Management for over 16 years and proudly serve as co-portfolio managers and analysts on this strategy as well as on our Global Quality Growth strategy, which hit its three-year mark this past year. It's our pleasure to review Quality Growth fourth quarter performance, attribution, and portfolio changes, reflect on 2023, and review an update to our near-term outlook. We'll not cover full year performance and attribution since these webinars typically focus on quarterly performance. At the end of the prepared marks, we are happy to take your questions. If your question is not answered today, please feel free to reach out to our sales and client service team. Their contact information is at the end of this presentation.

Before we get started, I would like to provide a brief overview of our firm and philosophy. Founded in 1988, Jensen Investment Management is an independent employee-owned investment management company focused solely on quality investing strategies. 21 of our 41 employees are shareholders. As of December 31st, 2023, we managed over 13 billion in assets across three strategies. The Jensen Quality Growth Fund, which is our flagship large cap equity strategy, focused on the long-term ownership of high quality value creating U.S. businesses. The strategy was launched with the founding of our firm in 1988 and has been available in mutual fund form since 1992. As I stated, this webinar will focus on the quarterly results of this strategy.

The other two strategies include the Jensen Quality Value Fund, which is a relative value mid-cap strategy. The composite was launched in 2008. The strategy was launched in 2010 and following a very good performance, the Value strategy is seeing strong interest in the marketplace.

And the third strategy is the Jensen Quality Global Growth Fund. Our third product that we launched in April of 2020 and represents an extension of the U.S.-based Quality Growth strategy with an expanded investable universe that includes overseas companies. In the short time since launch, performance has been

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encouraging, having recently earned five Morningstar stars and assets have been growing.

To briefly touch on our philosophy, for those who may not be aware, we believe that the stocks of quality businesses with durable competitive advantages that generate consistent value creation are favorably recognized by equity markets over the long term. We believe the best way to achieve this is by building a concentrated high conviction portfolio of quality businesses that we know very well. To us quality businesses or those that have a foundation of stable and ideally growing competitive advantages which create a price or cost advantage. Coupled with sustainable diverse growth drivers, these companies typically realize consistent and strong financials via top line, profitability, and cash flow generation.

These businesses are also stewarded by well-governed and effective management teams that optimize capital allocation for all stakeholders with a bias towards ensuring the durability of a company's competitive advantages followed by returning excess cash to shareholders via share buybacks and dividends. While over the long term, we believe our portfolio's business attributes have been reflected in our market performance of lower volatility with downside protection and equity-like returns in up markets. There are periods where market conditions work against the strategy in the short term, as we believe is the case in this quarter. With that, I will now hand it over to Allen to review fund performance and portfolio changes.

ALLEN BOND: Well, thanks Kevin, and good morning to everyone on the call from me or good afternoon, wherever you are. On this next slide, we have a review of historical performance for the Quality Growth Fund, and as you can see, the fund has outperformed the S&P 500 index over the past 10 year period. However, shorter and intermediate term performance has lagged the benchmark. During the fourth quarter of 2023 in particular the fund's I-shares generated a total return of 9.68%, and while we are pleased with the fund's return on an absolute basis, it did underperform the S&P 500 index.

At a high level, we think, or we believe the fund's underperformance in this period is explained by two primary factors. The first is security selection within the health care sector, and the second is security selection within the financials sector.

Based on our analysis of the S&P quality rankings, we do not believe the fund's overweight to high quality stocks had a material impact on relative investment performance during the quarter. However, other quality factor analysis does indicate that high quality stocks were out of favor during the quarter, and here on the next slide, we show style factor attribution for the fourth quarter for companies in the MSCI US, an investable market index, and like I mentioned, in contrast to the S&P quality rankings, this analysis does show that high quality stocks were out of favor during the quarter. Factors that were in favor were volatility and growth, and volatility is certainly a factor that we are underexposed to in the quality growth strategy, so we look at this as somewhat of a headwind.

Moving on to the next slide with sector attribution. In the financials sector, relative performance for the fund was held back by its lack of exposure to traditional money center banks such as Bank of America, JP Morgan Chase, and Wells Fargo. None of these stocks qualify for our investable universe. We generally find that banks, between their sensitivity to unpredictable interest rates and regulatory constraints, don't qualify for our investable universe, but the fourth quarter, we do attribute their strength to increased expectations for reductions in the Fed funds rate and therefore a more normalized treasury yield curve, which we think would be favorable to banks in the short term.

Portfolio holdings Marsh McLennan and Mastercard also detracted from relative performance in the sector to a lesser degree. Within healthcare, portfolio holding Pfizer was the largest performance detractor. We will discuss Pfizer in detail here in a few moments.

On the positive side, at the sector level, the portfolio's lack of exposure to energy sector stocks boosted relative performance. There are no companies in the sector that qualify for the Jensen investable universe due to inconsistent earnings and cash flow that stemmed from their exposure to volatile commodity prices.

Moving on to individual contributors and detractors. The top individual performance contributor in the quarter was Microsoft. Microsoft is an enterprise cloud and consumer software company. During the quarter, the company reported positive earnings that were driven by strong financial results across its businesses. Investors, in our view, reacted favorably to this report and also to progress with Microsoft's leadership position in artificial intelligence via its integration of ChatGPT and other AI models into its products and services.

On the other side, the leading individual detractor to portfolio performance during the quarter was Pfizer. Pfizer is a multinational biotechnology company, and during the quarter, Pfizer shares were pressured due to poor clinical results from a once promising drug pipeline target and from the issuance of 2024 financial guidance that fell short of investor expectations. We continue to believe in Pfizer's long-term competitive advantages, including their strength in terms of global scale with clinical research with marketing and distribution and with regulatory relationships.

We believe that core competitive advantage remains intact. We also are favorable on their recent strategic objective of utilizing near-term cash flow to bolster their drug pipeline, and we view the recent acquisition of CGEN, which is a leader in antibody drug conjugate cancer treatments as a positive step toward this strategic goal. However, in light of this recent acquisition and its recently issued 2024 Outlook, we are scrutinizing longer term implications in our financial model with Pfizer.

Next slide, we'll talk about some portfolio changes. During the quarter, the quality growth team liquidated the position in TJX companies and the most significant reduction was the position in Moody's during the quarter. So starting with TJX, it was first added to the portfolio in 2012. The company is a global off-price retailer with store concepts including TJ Maxx, Marshall's, and HomeGoods. We exited the TJX position in keeping with our valuation discipline as the company's share price exceeded our estimate of full value throughout most of 2023. We do retain a positive view on the business due to the company's unique position as the world's largest off-price retailer and its favorable spot within the global retail and apparel supply chain, which allows it to manage its inventory in a unique way that allows it to acquire products at a discount and sell them at a discount and turn their inventory rapidly. This is a concept that we still see evidence that's resonating with consumers even in the brick and mortar space that TJX occupies.

So as a result, we intend to closely monitor TJX and may consider reestablishing a position in the future if there's improvement in the combination of the company's valuation fundamentals and or risk characteristics. Moving on to Moody's. 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 global dominance in credit ratings, its high customer retention rates, high degree of recurring revenue, and its demonstrated pricing power. During the quarter, we trimmed the Moody's position as the company shares traded higher than our estimate of full value. We suspect the difference is that short-term investors may be bidding up Moody's share price in anticipation of a sharp rebound in bond issuance in 2024 due to the expectation of lower interest rates.

We have this assumption in our model as well, but perhaps shorter term investors are more focused on this than we are as long-term investors. In any case, our long-term investment thesis we think is intact and we believe Moody's is high quality business.

So the next slide, I'm going to go back to longer term investment performance, and before I turn the call back over to Kevin for thoughts on our outlook, I would like to add a few high level comments relative to full year 2023 investment performance. And to start with, similar to the fourth quarter, we were happy to deliver absolute investment performance in the high teens for the year. However, we do recognize the underperformance of the fund relative to the benchmark. When we think about that, in our view, the strong equity market returns in 2023 really defied a somewhat meager backdrop of traditional metrics that we would look at.

Earnings growth for the broader market was somewhat lackluster in the mid to high single digits. Interest rates remained high and the U.S. Federal Reserve remained hawkish with monetary policy in terms of raising rates and continuing to shrink their balance sheet. So in our view, market participants focused instead on positive surprises and on future expected benefits. This included better than expected U.S. economic growth and economic growth that coincided with lowering inflation, and this led investors to anticipate rate cuts in 2024 and arguably maybe even aggressive rate cuts in 2024 from the Fed. The other big factor we saw during the year that drove returns was the future financial benefits that are associated with the development of artificial intelligence models and then the associated information technology infrastructure buildout. We believe that Nvidia, when they reported earnings early in mid 2023, created the proof of concept that artificial intelligence not only was real, but it's a real growth driver from a financial standpoint, and that really drove the markets through the second half of the year in our view.

So when we think about that in terms of our own performance, we look at the funds relative underperformance in 2023 as more of a function of what the fund did not own rather than what was actually held in the fund, and in particular, four stocks that are not held in the fund, including Nvidia, Meta, Tesla, and Amazon represented the four largest individual detractors from relative performance. And of those four companies, only Meta qualifies for our investible universe based on its ROE track record. The other three companies have yet to demonstrate a sufficient historical track record as a business in order to qualify.

The fifth-largest individual detractor was Pfizer, which is owned in the strategy and we previously discussed. So despite investment performance that was below the benchmark in 2023, we really believe that many of the portfolio companies are well positioned to benefit from expected growth in some of these secular growth drivers like AI development and technology infrastructure buildout. In fact, if you look at the fund's top three holdings, which are Microsoft, Alphabet and Accenture, we believe all these companies stand to benefit from these trends in the near term and in the future and even into the distant future. And importantly, we think AI related investments can help companies throughout the portfolio make their businesses more efficient and do so from a position of strength in terms of strong and existing business models, strong free cash flow, and strong financial returns.

So with that, I'd like to hand the call back over to Kevin to discuss our outlook.

WALKUSH: Great. Thank you, Allen. Now switching to our outlook as Allen mentioned. We just recently posted our quarterly commentary, which included our updated views on our outlook. In summary, despite robust market returns in the year and fourth quarter of 2023, we maintain a neutral stance on results for 2024. While global economic challenges persist, we find encouraging trends in familiar near-term economic and market drivers, including inflation, interest rates, a potential soft economic landing, positive earnings and margin expectations, tempered by the impact of U.S. elections and ongoing global conflicts. To unpack a few of these, I would like to start with inflation since to us, it is one of the main drivers of interest rates at this time. The most recent inflation price was 3.35% compared with 3.14% the previous month and versus the long-term average of 3.28%. Overall inflation was mostly driven by services inflation, which is most heavily influenced by wage inflation followed by food.

We perceive a tension between street expectations and the Fed with regard to interest rates to combat inflation. The Fed continues to guide towards a 2% inflation goal, which is admirable, but we view difficult to achieve, especially if it comes at the expense of overly restrictive monetary policy for too long, such that it cools the economy too much and forces it into a recession. So far, that has not happened. The Fed has messaged that it would like to keep rates higher for longer and that interest rate mitigation would begin later in the year and in fewer tranches, specifically 325 basis point cuts.

Despite this guidance, the street continues to be more optimistic. Even after Tuesday's reaction to a Federal Reserve governor reinforcing hawkish comments, forward rates on overnight indexed swaps, derivatives that act as a gauge of where investors expect interest rates to be, still point to between six and seven 25 basis point cuts from the Fed this year. Even though there is a slight reversal of rates on Tuesday, it looks like the street is still not sobering to the fact that the Fed's modest approach is the more likely case due to the persistence and stickiness of inflation, particularly around labor markets and the level of employment which remains high.

We believe given time, the street will run out of time to justify its case, and will more closely align with the Fed's modest interest rate cut viewpoint, which to us could likely tamp economic growth and mute stock returns this year. Long-term, we struggle to see the Fed able to drive inflation to 2% and worry that it may mute economic performance as a result. We believe de-globalization will make it more difficult to keep the inflation rate low, considering that we believe China acted as the manufacturer of the world and was able to absorb significant global inflation through its massive economies of scale and cheap labor. Such persistently low goods inflation, coupled with a balanced domestic labor supply, enabled central banks to keep interest rates low, thus fueling economic growth. We believe those conditions have reversed course and would not be surprised to see long-term inflation settle closer to 3%, a more normalized long-term level.

Another interesting trend that has played out over the past periods of high inflation has been two peaks. The U.S. experienced three periods of high inflation in the 20th century starting in 1910, 1939, and 1972. Each of those high inflation periods experienced two peaks of high inflation. Relative to trend, we're currently in a troughing period between peaks, and in our mind the Fed is walking a tightrope to avoid the historical stop and go periods of monetary policy that drove the second waves by keeping rates higher for longer and more steady.

The challenge we see is it takes roughly 12 months for an interest rate change to have a widespread impact on the economy. Therefore, we won't see the evidence for some time. We believe our quality portfolio can benefit from either scenario of a successful Fed mitigating a second inflation peak or not. In the case of higher interest rates for longer, but no second peak, we believe that would tap the brakes on economic growth, but we believe quality businesses have held up well in these periods.

Likewise, if another period of high inflation takes place, we believe the strong pricing power of our companies, reflective of their competitive advantages may enable them to perform better than those of companies that do not exhibit as such strong pricing power. Turning back to the current environment, in our opinion, capital markets continue to send mixed signals. Equity market indicators would suggest that would be economic challenges stemming from restrictive monetary policy are behind us. Earnings estimates indicate a continuation of steady growth, predicting high single digit and low double-digit gains for S&P 500 index companies in 2023 and 2024, respectively. S&P 500 index companies margin estimates are also indicating improvement from 2023 to 2024. On the other hand, the fixed income market continues to indicate a pending economic slowdown. In particular, the treasury yield curve. The difference between long-term and short-term treasury yields has been inverted for the past 18 months.

Such inversions, when short-term rates are greater than long-term rates are rare, but have accurately predicted all 10 recessions since 1955, typically with a lag of 12 to 24 months. This combination of narrow stock market leadership and cautionary signals from the treasury market suggest that equity investors are engaging in the dangerous exercise of fighting the Fed.

However, we acknowledge the uniqueness of the current economic environment. Idiosyncratic factors include secular growth prospects from increased technology investments, unique pandemic driven economic fluctuations, and associated policy responses. And that 2024 is a presidential election year in which administrations are highly incentivized to bolster economic growth.

Therefore, we believe these factors may allow the economy to achieve a soft landing. Given this backdrop, we're encouraged by the opportunity provided for higher quality, more resilient businesses to garner favor from investors looking for lower volatility in the face of the issues discussed here, be they transient or more systemic.

We remain confident in the diverse high quality businesses owned in the fund because our research that favors companies we believe have strong and robust business models, durable competitive advantages, pricing power, resilient operating margins, and strong free cash-flow generation that has been consistently reinvested into future growth opportunities and rewarding shareholders in the shorter term via growing dividends and stock buybacks.

While economic uncertainty going forward often requires more fortitude when making investment choices, the Jensen Investment Team remains confident that the strategy and process guiding our management of the fund is sound. It remains our goal to be the owner of a diverse portfolio of quality companies positioned to grow and accrue business value. We seek to participate in this value creation via the long-term ownership of what we believe are fairly priced high quality stocks. We believe these attributes enable such globally dominant companies to generate business returns consistently above their cost of capital, ultimately resulting in shareholder value creation.

Finally, we remain steadfast in our belief that paying attention to company fundamentals can help investors manage risk. This should offer a measure of capital protection in more volatile or generally lower market return environments and provide the opportunity for long-term capital appreciation.

Thank you for your time today and your attention. We're tremendously grateful for the ongoing support of our firm and investment strategies from our partners and fellow shareholders. This concludes our prepared remarks.

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