Quality Value Fund Quarterly Update: 2Q 2024

Hosted by Kurt Havnaer, CFA, Portfolio Manager

KURT HAVNAER: Hello, my name's Kurt Havnaer. I'm one of the portfolio managers on the Jensen Quality Value Fund. I'd like to welcome you to our webinar for the second quarter of 2024.

Here's our agenda for today's webinar. We will begin by reviewing the fund's performance and some of the changes made to the portfolio during the quarter. We will then discuss our outlook for the remainder of 2024 and then open the webinar up for Q&A. Before jumping into performance, we'd like to provide a brief overview of Jensen and our philosophy for the Quality Value Strategy. Jensen was founded in 1988. The firm is owned by approximately half of our current employees. We manage $12.4 billion in assets and three primary investment strategies: Jensen Quality Growth, Jensen Quality Value and Jensen Global Quality Growth.

In terms of our philosophy for the Quality Value Strategy, we believe undervalued stocks of high-quality companies represent attractive investment opportunities. We define a high-quality company as one with strong competitive advantages. If a company has strong competitive advantages, that should enable it to generate high returns on capital. And if those returns on capital exceed the company's cost of capital, that's what drives the value of the business higher in the future. Our goal with the Quality Value Strategy is to outperform the market when it is down and to capture a decent portion of the market's upside when it increases.

Moving on to performance, slide 5 shows the fund's net returns over various time periods through June 30, 2024. As you can see, the fund underperformed its primary benchmark, the Russell Midcap Index, during the second quarter and over the last 12 months, but outperformed over the past three- and five-year periods. The next slide compares the fund's second quarter gross returns to the Russell Midcap Index with a gross return of negative 4.27% shown in the last row of the table on the left. The fund underperformed the Midcap Index, which was down 3.35%. From a sector standpoint, the fund's underweight in Materials was the largest sector contributor to relative performance. Our overweight in Consumer Staples and underweights in Utilities and Real Estate were the largest sector detractors from relative performance. On the right-hand

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side of the slide, you can see the top five individual stock contributors to and detractors from relative performance. We can discuss any of these 10 names during the Q&A, but we would like to provide some color on Amphenol and ULTA on the next two slides.

As indicated on the previous slide, Amphenol was the largest individual stock contributor to relative performance during the quarter. Amphenol is one of the world's largest manufacturers of electronic connectors and sensors. We believe the stock outperformed due to continued improvement in the company's organic sales growth with particular strength in the military, aerospace, automotive, and IT datacom and markets. Long term, we like Amphenol's solid market position, diversified customer base, low-cost manufacturing operations and its focus on higher-margin non-commoditized niches of the connector industry. Despite these fundamental strengths and as part of our disciplined sell process, we reduced our weighting in Amphenol during the quarter by approximately 125 basis points due to the stock's strong outperformance.

ULTA was the fund's largest individual stock detractor from performance during the quarter. ULTA is an omnichannel specialty retailer of skincare products, fragrances, cosmetics and haircare products. The company offers a broad assortment of products across various price points. We believe the stock underperformed during the quarter due to slowing consumer spending, a reduction in guidance for 2024 and market share pressure. To combat this market share pressure, the company is adding new brands to its product offerings and improving the digital experience for its customers. Longer term, we like ULTA's well-known brand name, strong market position, strategically located store footprints and economies of scale versus smaller competitors. We also believe the company stock is attractively priced.

During the quarter, we added three new names to the portfolio: Air Products and Chemicals, IDEXX Labs and Veeva Systems. We also liquidated our position in CBRE, the real estate services company.

Veeva provides software to life sciences companies, primarily biopharma businesses. The company's software helps customers market products more effectively, maintain compliance with government regulations and bring products to market faster. We like Veeva due to the company's diversified customer base, strong recurring revenue streams, and high customer switching costs and renewal rates. We also believe the company's stock is attractively priced.

IDEXX manufactures and sells instruments and equipment used by veterinarians to test for various diseases. These instruments include blood and urine analyzers and diagnostic imaging systems. IDEXX's business is characterized by strong recurring revenue streams, high customer switching costs and high customer retention rates. The company also has a very strong innovation track record and a solid market position, and we believe the company should benefit over time from increasing pet ownership rates. We also believe IDEXX's stock is attractively priced.

Air Products produces industrial gases such as oxygen, nitrogen, helium and hydrogen. The company is the largest producer of hydrogen in the world. Its business is characterized by long-term customer contracts, some of which include take-or-pay provisions, as well as high customer switching costs and high contract renewal rates. Over time, we expect the company to benefit from the production of more environmentally friendly hydrogen as the world gradually reduces its consumption of fossil fuels. Like Veeva and IDEXX, we will believe Air Products' stock is attractively priced. CBRE was sold during the quarter as the company's return on equity fell below our mandatory minimum requirement of 15%. In terms of key adds and trims, as previously mentioned we lowered our weighting in Amphenol for valuation reasons. We also reduced our weighting in Charles River to lower our exposure to the life sciences industry.

Moving on to our outlook for the economy and equity markets for the remainder of 2024. As is usually the case, there are a number of tailwinds that support that outlook. There are also a number of headwinds that could pressure economic growth and market performance going forward. In terms of tailwinds, the next two slides indicate that the U.S. labor market remains strong. This strength could lead to solid consumer spending, which, as a reminder, accounts for approximately two-thirds of GDP in the U.S. This graph shows the year-over-year change and monthly average hourly earnings going back to 2007. While hourly earnings growth declined recently, it remains above the historical average of 3.1%.

The graph on slide 12 shows the U.S. unemployment rate going back to the late 1940s. At 4%, the current unemployment rate remains well below the long-term historical average of 5.7%. The continued decline in inflation is arguably another tailwind for the economy and markets. This graph shows the year-over-year change in monthly core personal consumption expenditures, which is the Fed's preferred measure of inflation, and this data goes back to 2003. While still above the long-term historical average of 2.1%, inflation declined significantly from its recent peak and appears to be approaching the Fed's stated target of 2%.

Another tailwind is the expected improvement in corporate earnings. Slide 14 shows that earnings growth for companies in the S&P 500 is expected to pick up in 2024 and 2025 following weakness in 2022 and 2023. Equity prices could respond favorably if these expectations are realized. The next slide shows the historical delinquency rate on bank loans made to businesses. As you can see, the delinquency rate has remained below the historical average for a number of years. This suggests that U.S. businesses are in solid financial condition. In terms of tailwinds, the strong market rally that started in the fourth quarter of last year appears to have pushed equity valuations to relatively expensive levels. This graph shows the monthly forward P/E on the S&P 500 going back to 1997. At the end of the second quarter of 2024, the forward P/E of 22.8 on the S&P 500 exceeded the historical average of 18.1 and was more than one standard deviation above that historical average.

The graph on slide 17 shows the growth in inflation-adjusted or real disposable personal income on a quarterly basis going back to the 1960s. This graph shows that disposable personal income growth slowed over the past few quarters. To the extent that this trend continues, consumer spending could be negatively impacted. The next slide shows the year-over-year change in household debt on a quarterly basis going back to 2004. The most recent change of 3.8% is below the historical average of 4.3%. It's also below the most recent peak of 8%-plus back in 2022. This graph suggests that consumers could be approaching the point where they are increasingly unwilling to fund expenditures with additional borrowings.

Another potential headwind is a significant decline in the personal savings rate to 3.9%, which is significantly below the historical average of 8.5%. This suggests that consumers may not have much left in the tank to keep driving spending higher going forward. The next slide indicates that the delinquency rate on credit cards and consumer loans, while relatively low on a historical basis, increased since bottoming in 2021. This suggests that financial distress among consumers is headed in the wrong direction. The next slide shows the year-over-year change in quarterly industrial production going back to 1974. The graph indicates that industrial production growth slowed meaningfully over the past several quarters and is now below the historical average. This suggests that the industrial portion of the economy is weakening.

Finally, the next slide shows GDP growth over the past five years. It also shows GDP forecasts from various economists from 2024 to 2027. As you can see, GDP growth is expected to decline in 2024 and to remain below the 50-year average of 2.7% in each of the next four years.

To conclude, as we've mentioned in previous webinars, we believe it is very difficult to predict the short-term direction of the economy and equity markets. Having said this, we believe caution is warranted as we look out over the next several quarters, given what appears to be a weakening consumer financial profile, a potential slowdown in the industrial complex, a sluggish GDP outlook and an equity market that is arguably stretched from a valuation perspective. Regardless of these concerns, we will continue our strategy of investing for the long term and purchasing undervalued stocks of high quality companies with strong competitive advantages and high returns on capital. We believe this strategy should result in attractive risk-adjusted returns throughout various economic and market cycles.

And with that, we can open up the webinar for Q&A.

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