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Quality Growth Fund Quarterly Update: 3Q 2024

Hosted by Allen Bond, CFA, Managing Director, Head of Research & Portfolio Manager; and Adam Calamar, CFA, Portfolio Manager

ALLEN BOND: My name is Allen Bond. I am a portfolio manager on the Jensen Quality Growth Strategy and Jensen Quality Growth Fund. I am joined on the webinar today by my colleague, Adam Calamar. For the call, I will begin with a brief overview of our firm and investment philosophy. Adam will cover quarterly performance trends and portfolio changes. I will then conclude our prepared remarks with some comments on market trends and outlook.

So to start, a quick overview of Jensen Investment Management as a company. Jensen is an employee-owned investment management firm focused on quality investing strategies. The company was founded in 1988 by Val Jensen and is currently owned by 23 active employees out of a total of 40 total employees. We manage about $12 billion in assets across three strategies. The first and focus of this call is the Jensen Quality Growth Strategy. 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 the firm's flagship strategy and accounts for the vast majority of firm assets under management. Second strategy is Jensen Quality Mid-Cap. This is a mid-cap strategy focused on investing in mid-sized high-quality businesses, a bit more focused on stock price valuation.

We launched the composite for this strategy in 2008. The mutual fund was launched in 2010 and the strategy was largely rebooted in 2017 to add more of a focus on fundamental business research similar to that of the Quality Growth Strategy. So today the strategy is very similar to Quality Growth, but with a focus on mid-sized businesses. The last strategy is our newest strategy, Jensen Global Quality Growth. It was launched in 2020 and it is very much an extension of the domestic Quality Growth Strategy, but with an expanded investable universe that includes companies that are domiciled overseas.

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So here we have a summary of our investment philosophy and objectives, and there's obviously a lot here on the slide. I think a simple way to sum it up is that philosophically we seek to invest for the long term in businesses that we think will grow and create business value. As a result, we focus our research on factors that are linked with sustainable business value creation. These include competitive advantages, free cash flow generation and financial strength, business model consistency, and attractive growth prospects.

And growth to us is a critical part of our research process, but we don't always require explosive growth. We would actually prefer steady and predictable growth that allows for consistent value creation over time. We also pay close attention to stock price valuation, and in keeping with that, we maintain discounted cash flow models on all the stocks held in the portfolio and only invest when a company's shares trade below our estimate of total value. The result in our view is a portfolio of high-quality businesses that are uniquely well positioned to grow and create value that are fairly valued as stocks. With that, I will turn the call over to Adam to discuss quarterly investment performance and portfolio changes.

ADAM CALAMAR: Thanks, Allen. My name's Adam Calamar. I'm a portfolio manager on the Jensen Quality Growth Fund. For the third quarter of 2024, the S&P 500 Index produced a total return of 5.89%, representing a continuation of the equity market rally that began in October 2022. The Jensen Quality Growth Fund I Shares produced a return of 6.84% in the quarter, outperforming the index.

Here we have a style perspective where it shows the broader market with strength in the value and yield factors. While there was some weakness in the growth and momentum factors, we believe that this type of environment is generally more favorable to our investment style, which seeks to own high-quality companies at reasonable valuations. The portfolio's overweight position in high-quality stocks contributed to its relative outperformance of the benchmark. Investment performance in higher-quality stocks that are ranked A+, A or A- by the Standard and Poor's Earnings and Dividend Quality Rankings exceeded that of the lower-ranked stocks. Relative strength among these high-quality stocks was most apparent during the first two months of the quarter during our risk-off period, but weakened in September when a reduction in the Fed funds rate appeared to rekindle investor interest in lower-quality companies.

At the sector level, Financials stocks were the largest contributors to the market return, led by shares of Berkshire Hathaway and Mastercard, the latter of which is in our portfolio. The third quarter market advance was very broad-based with price appreciation from stocks in 10 out of 11 index sectors. Only Energy stocks declined during the quarter. The portfolio security selection within Consumer Discretionary was the largest contributor to relative investment performance. Within the sector, portfolio holding Starbucks was the strongest contributor, followed by a lack of exposure to Amazon. Relative share price strength in Nike also boosted investment performance. On the negative side, security selection in the Communication Services sector, particularly the portfolio's overweight position in Alphabet, constrained relative investment performance.

The portfolio's top contributor in the quarter was Accenture. Accenture is a leading global information technology consulting and business outsourcing company. During the quarter, Accenture shares performed well due to strong demand for the company's services, especially related to artificial intelligence and the shares also performed we believe well because of evidence that the transient softness in IT services demand was subsiding and businesses were spending again. Looking ahead, we expect demand drivers for Accenture services to intensify and diversify, driven by the heightened interest in adopting and leveraging AI to enhance business productivity, but also the more typical enterprise cloud and security solutions that they offer their clients. In our view, Accenture is well positioned to capitalize on this trend. We maintain conviction in Accenture's long-term prospects as a top portfolio holding.

The bottom contributor to portfolio performance as mentioned above was Alphabet. As I'm sure you know, Alphabet is a prominent communication services and technology company known for its flagship products, Google Search, Android and YouTube. The company's shares declined in the quarter, reflecting investor concerns about an adverse U.S. antitrust ruling and the potential for market share losses arising from new competition from AI-based search platforms. We remain confident in our long-term investment thesis based on the company's dominant position in online advertising and in the ubiquitous nature of Google Search, YouTube and Android. However, we have reduced the portfolio's position in Alphabet in order to manage risk of further share price volatility.

During the quarter, the Quality Growth Investment Team initiated a new position in Copart and meaningfully reduced our position in Starbucks. Copart operates auctions and wrecking yards for salvage title vehicles with services including pickup, delivery, auction and title transfer for those vehicles. The company's primary business is collecting totaled cars from insurance companies and auctioning them off to individuals and small businesses. We believe Copart enjoys several competitive advantages, primarily driven by the company's scale and scope of operations and its real estate footprint. Insurance companies require the best and broadest service, especially during surges and claims that occur during natural disasters, making that scale and scope of operations very valuable. Copart benefits from some very good long-term growth opportunities including market share gains in both salvage title and clean title vehicles; expansion in Europe; acquisition of smaller competitors; further expansion into ancillary markets; and an increasing natural disaster frequency.

Recognizing Copart's strong business fundamentals and attractive share price, we were pleased to have added the company to the portfolio. Starbucks, of course, is a global restaurant company and roaster of coffee. During the quarter, the company's stock price moved sharply higher in conjunction with a leadership transition announcement in which the embattled former CEO was replaced by highly respected outsider. We are hopeful that this change will improve the company's financial performance in the long run, but we took the advantage of the share price rebound as an opportunity to reduce our position and add to some more attractive investments in the portfolio. Next, Allen will discuss our outlook.

BOND: Thank you very much, Adam. Our outlook for near-term market returns is neutral. We see a number of offsetting potential positive and negative market forces. Starting on the positive side of things here, S&P 500 earnings are forecast to increase both in 2024 and 2025, and that follows an increase last year. Secondly, U.S. monetary policy became supportive last month when the U.S. Federal Reserve Open Market Committee announced a 50-basis-point decrease to the Fed funds rate. This pivot and Fed policy is supported by a meaningful decrease in inflation, which we also think is a positive for stock market returns. And then, finally, we continue to see heightened investment in artificial intelligence models, and we believe this investment in the development of these models and the use of these models will be a secular growth driver that we expect to continue for the foreseeable future and is supportive of further stock market gains.

On the negative side or the headwind side, and we've spoken about this a lot in the past, but the S&P 500 Index remains historically concentrated at the top of the index with very large index weights. And these large index weights have been an outsized contributor to recent market gains. This concentration obviously raises the risk of lower future market returns if the momentum in these top index holdings should begin to decrease. Additionally, and relatedly, earnings growth is strong as we mentioned, but it has lagged stock market returns in the last couple of years. It lagged stock market returns in 2023 and is on track to do the same here in 2024. As a result, much of the recent market rally has been driven by multiple expansion that may or may not be sustainable.

This slide just shows an overview of the changes in the S&P 500 Index over the past year. It's broken into quarters. As you can see, the index is significantly higher over this period. However, if you look a bit more closely, there is more market volatility in the past six months and most notably in the past quarter that we just ended and we highlighted a few key events that took place during this period. The first was President Biden's decision to drop out of the 2024 presidential race that happened in mid-July.

The second is the date of Nvidia's second quarter earnings report. And normally we wouldn't highlight one company's earnings report as a significant market event, but in this case, and we all know this, Nvidia shares have disproportionately driven the current bull market. And this report was the first time in quite a while where Nvidia shares actually declined in conjunction with the earnings announcement. The last highlight is the Federal Reserve announcement last month that they will reduce the Fed funds rate by 50 basis points. In our view, and you can see this a little bit on the chart here, this announcement was a catalyst for renewed market momentum and renewed market focus on lower-quality businesses.

This slide shows earnings growth for S&P 500 Index companies, and as you can see, and as we mentioned before, earnings increased last year in 2023 and are forecast to do the same in 2024 in 2025. And to the extent that this forecast is correct, we believe that earnings growth is supportive of further stock market advances because price growth tends to follow earnings growth over time, and this paints a supportive picture for further stock price advances.

This slide shows the Fed funds rate trend over the past 20 years, and as you can see in the slide, the rate peaked in mid-2023 through mid-2024, and as previously discussed, the FOMC lowered the Fed funds rate last month. This chart also shows expectations both from FOMC members and from the futures market. And these expectations are that rates are likely to decline further, and we view this trend towards lower Fed funds rates and ultimately lower interest rates as supportive of further stock market advances.

This chart shows the trend in CPI inflation over the past six years and this is highly linked with the previous slide in the sense that decreases in the rate of inflation have allowed the Fed to reduce the Fed funds rate. As you can see here in the chart, the rate of inflation peaked in 2022 and has steadily dropped since that time. Also important, present price increases are predominantly being driven by increases in the cost for services. So in other words, inflation for food, energy and other goods is currently trending close to 0%.

This is important because all categories were experiencing a high rate of inflation in 2022 when the overall rate of inflation peaked. All in all, we view this trend towards lower inflation as positive for the stock market and also supportive of future monetary policy accommodation. Lower inflation gives the Fed more flexibility to lower rates and supports the outlook shown on the previous slide. Additionally, in this case, the decrease in the rate of inflation has occurred so far without a reduction in employment or a slowdown in the economy. And should these trends continue, the trends being a lower rate of inflation and resilient economy, the Fed may be able to achieve the first economic soft landing in nearly 30 years.

This slide is a little bit of a different way of looking at the AI investment theme, and it shows capital expenditures spending as a percentage of sales by sector, but it breaks out the Magnificent Seven stocks, which are Microsoft, Apple, Nvidia, Meta, Alphabet, Amazon and Tesla into a separate sector. A couple takeaways here. The first is that the Magnificent Seven companies are spending very generously on capital expenditures. And given that these businesses all have exposure to the development and utilization of artificial intelligence models, it stands to reason that a significant portion of this spending is being directed towards AI-related projects. This spending is just one more data point that indicates the impact of the development of artificial intelligence engines, and we view this investment trend as positive for future equity market returns.

Now we turn our attention to potential market headwinds, and in this slide we show the outsize impact of Magnificent Seven stocks in terms of sector weights. The key takeaway from this slide is that the index weight of the Magnificent Seven stocks dwarfs that of any traditional sector. And moreover, these stocks have contributed a disproportionate benefit to year-to-date market returns, accounting for about 45% of the total S&P 500 Index returns in this period. So as we think about these businesses, they're all in some way benefiting from the AI investment that was shown on the previous slide.

And as a result, recent financial results for these businesses do support stock price increases. However, as you can see in the chart, the net income contribution for this group is lower than the sector weight contribution from this group. This implies that multiple expansion has played a key role in the outsized impact of these stocks on the index. So at this point, it's difficult to identify a near term catalyst that would dampen the enthusiasm for these stocks. However, markets are notoriously fickle and this index concentration does raise the risk that the market could suffer if the momentum associated with these stocks begins to fade.

This slide is very similar to the first outlook slide that we showed. This is the annual S&P 500 Index earnings growth, but this time we juxtapose it with S&P 500 Index total returns. And as you can see, index advances were well ahead of earnings growth in 2023 and are on track for the same trend here in 2024. Again, this is another data point that suggests that multiple expansion has been a strong contributor to the bull market that started two years ago. Again, difficult to predict changes in market sentiment, but we believe investors should be cautious when stock prices advance well ahead of earnings.

This slide shows stock valuations by sector, and as you can see here, valuations are elevated for 10 out of the 11 sectors relative to historical norms. And in fact, in some cases, multiples are well ahead of long-term averages. This is another indication of frothiness in certain pockets of the market where stock price valuations have been boosted by multiple expansion, which raises the downside risk should there be a shift in investor sentiment.

Stepping back, regardless of any changes in market sentiment, we remain confident in our strategy of building the Quality Growth Strategy, one business and one stock at a time. Our goal is to own businesses that we believe are uniquely well positioned to grow and create business value. And we believe it's important that, as long-term investors, we purchase and own these businesses at reasonable prices. So in contrast, we are not trying to make short-term market predictions, we're not trying to time changes in the market environment. Our approach is on building the portfolio one business at a time and making changes in the portfolio to optimize future returns and manage risk. This approach has created value in the past, and we remain confident that it is well positioned to do so again in the future. 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.

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