Money Life with Chuck Jaffe

Quality Investing for the Long Term

Featuring Kevin Walkush, Jensen Portfolio Manager

CHUCK JAFFE: *Welcome to the Market Call, the part of the show where we talk with experienced money managers about how they do their job, what they look for that determines their buys and sells, what they see happening broadly on the market, and how they put it all together.*

JAFFE: Joining me today for the first time, Kevin Walkush. He's a portfolio manager at Jensen Investment Management. Now, he's new to the Market Call, but Jensen is not. We've had his colleagues Allen Bond and Eric Schoenstein on the show before. But if you want to learn more about Jensen Investment and about the Jensen Quality Growth Fund, and the Jensen Global Quality Growth Fund, which Kevin works on, go to jenseninvestment.com. Jensen, J-E-N-S-E-N, jenseninvestment.com.

Kevin Walkush, thanks so much for joining me on Money Life.

KEVIN WALKUSH: Thanks for having me.

JAFFE: We always start with methodology. At Jensen, well you guys follow a methodology that works for you. Explain how it works to us?

WALKUSH: Sure. First and foremost, we call ourselves a quality manager. Really, what does that mean? Because everyone has their own definition of quality within the market. From our perspective, quality or quality businesses are those that have sustainable high returns on capital, such that market participants can realize that value over the long term. We are focused on investing in these businesses over the long term.

In terms of quality, what drives these high returns on capital? Really it's underpinned first and foremost by companies that have strong and durable competitive advantages, coupled with really strong and compelling and diverse growth drivers, which create a stable top line growth, with improving profitability,

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www.jenseninvestment.com/insights/may-2024-money-life-quality-investing higher earnings growth, strong stewards of capital, strong management teams and really good board structures. The ultimate goal for a quality business in our mind, as a long-term investor, is to find these durable businesses that can perform in all markets and be very durable over the long term.

JAFFE: I need to ask, because we hear quality come up more and more, you guys very pointedly use quality with growth and with value. There are times when I'll hear somebody say they're quality and I'm looking at their methodology going, "Okay, well, quality is another way of saying 'blend' because it's a way that you get to hold your growth or you get to hold your value as one morphs into the other."

For you guys, and I recognize you have the Quality Growth Fund and the Quality Value Fund, is quality enough of a factor that you could just have a quality fund, separate from growth and value, that wouldn't be a drastically different fund? Is it not quality if it doesn't have the additional growth or value label to you?

WALKUSH: Very much so. I think you highlighted the key anchor point of blend. Think of a blend or core within the market, you benchmark it against broad markets — for large cap, typically the S&P 500. When we think of quality, it's really an enhancement. In this regard, on the growth side, we think that growth and that value creation over time drives market outperformance over a full market cycle. The quality aspect is to deliver lower volatility over a full market cycle.

JAFFE: Yeah, I like the enhancement as opposed to, "Here's that strategy." That's the side that I was driving at, given this market, where growth has been somewhat muted, and oh, by the way, although the story's been changing of late, it's been dominated by a small number of stocks. What has that done in terms of making it easy or hard for you to find stuff for the portfolio?

WALKUSH: I think for the portfolio in general, if I take a step back, how we think about the market and how we function within it, we're long-term investors. We're looking for those names that can really deliver over full market cycles. Our average holding period is seven to eight years. We'd like to go longer if we can find a business that can continue to create value.

In that regard, in our mind, the market can often give us great opportunities that may really overplay a risk perspective in the short term. Whereas we look at it through a long-term lens, and maybe see that opportunity through a different opportunity set, so to speak. In that regard, we think the market's always given us opportunities to high grade our portfolio for long-term returns.

Right now, I would say it's definitely been a challenging market just because of the high concentration of these large tech momentum names occupying the top of the benchmark. You really haven't seen that broad recognition of value creation across the market. Our sense would be is that sustainable in the long run? Probably not. We think we're well positioned as the market starts moving away from just a pure focus on AI and looking at broader value creation. We think our quality names and our strategies can really leverage that change of perspective.

JAFFE: Well, let's talk about a name or two. What's a poster child for the methodology? The kind of thing that really spins your fan.

WALKUSH: We think we're well positioned for AI. We can certainly dive into that. But, as I mentioned, we want to be focused on a broader play of opportunity sets beyond just AI.

Stryker, an orthopedic company, is a market leader in knee and hip replacement. They basically perfected a robotic surgery technique that really has garnered them tons of market share. When we think about an aging population, we've seen strong growth recently just because of deferment through COVID of hip and knee replacement. Then, pickleball is a nice near-term catalyst in terms of driving the demand, the incremental demand, for hips and knees right now.

JAFFE: I'm waiting for the first pickleball ETF. But then, when I see it and it has Stryker in it, that'll be even better for me.

WALKUSH: We think that would be positioned highly in that kind of portfolio.

JAFFE: I want to go back because you mentioned AI.

WALKUSH: Sure.

JAFFE: AI is both an opportunity set and a minefield. There's so much going on. Here, you are looking for quality on top of growth, and AI has lots of growth but there's a lot of people who are questioning who's got the real growth here. How are you sorting through AI?

WALKUSH: First, we don't have Nvidia. I think we're probably one of the few maybe strong growth players right now or growth players that probably don't. The reason is, first and foremost, we're looking for companies that have developed a strong track record of high returns on equity. In this case, while we think Nvidia's a great company, it just hasn't passed our quality screen. With that, it's in the benchmark, it's certainly run and has relatively worked against our strategy I think in the near term.

That being said, we think we're really well positioned on the software side and the platform side. What I mean by that, that would be a Microsoft, it would be Alphabet. What we've found over time is those types of companies are really good at monetizing shifts in technology over long periods of time. As they build up their platforms, which enables market share and drives economies of scale, it also drives economies of scope — two key competitive advantages that can drive that ultimate pricing power for these businesses.

If you think about right now, the focus is on chips and computers. Incredibly important. It's very much the near-term constraint. In our mind, semiconductor long term has had a strong history of cyclicality, boom and bust. In that regard, our expectation is that, at some point, there will be a little bit of a turnover or maybe a pullback on the semiconductor demand. But then you'll see that long-term sustainable consumption of these AI services through market leadership from Microsoft and Alphabet. In our mind, there's that positioning.

We think we're also positioned well with the secondaries. We have names like Intuit, which has developed their own generative AI. In that case, they're applying it towards their own product lines, which would include QuickBooks and TurboTax, so we see a lot of opportunity for them. Then long term, we look at our portfolio. I've already mentioned Stryker, but we think all of our companies will benefit from a long-term profitability uplift through improved productivity through AI.

We think we're well positioned now, we think we're well positioned in the near term, then also long term as well.

JAFFE: Now, I have to go back to Nvidia for a second because you don't own it. But did you ever?

WALKUSH: We haven't. For us, for a company, through our lens, to be a quality business, it has to return an excess of 15% return on equity for 10 years minimum. It's not an average. Every year has to hit. What we've seen is that historically with the cyclicality from semiconductors and semiconductor equipment, we haven't really seen that track record. That being said, we've actually seen these companies actually really create more sustainable track records. We see them coming down the pike, so to speak, in terms of opportunity.

We also do have equipment makers that are creating opportunities for us. One play that we have in the strategy that we really like is KLA Corporation. KLA, semiconductor equipment manufacturer, has key positioning in quality. Their technology, first and foremost, helps identify errors in wafers. Any errors kills the yields within wafers and kills the profitability. In essence, you really can't make profitable chips without their technology. They basically are, by far, the market leader within that space.

What we are able to do then is play AI on the chip side, in our mind, not directly through Nvidia, but through components that we think are important in the value chain not only near term, but sustainably long term.

JAFFE: You're looking for long term. What's the sell discipline? What is going to make you give up on any of these companies that you've seen? You've said you're looking for 10 years and you don't want to be selling, and your turnover on your funds historically has been very low. But what is it that ultimately makes you say, "Yeah, even after eight years," or whatever it is, "I can't hang on anymore?"

WALKUSH: We really think of three things that drive our sell discipline. I already mentioned our screen for identifying quality businesses that have to return excess of 15% return in equity for 10 years. We've had companies that violate that through just degradation of competitive advantages or changes within the business, or in the capital structure through acquisition. We'll see them fall out. That's an automatic sale. We'll start dollar cost averaging those out of the strategy, but with an eventual drive towards an eventual exit.

Valuation is incredibly important. We really focus on understanding what the value is of our businesses. We focus on discounted cash flow analysis to determine what we think a business is worth. By applying that, twofold, that helps us on the buy side when we want to look for good margins of safety, good discounts for opportunity. But on the sell side, we don't want to own a name that's overvalued. It goes back to an earlier question about we have opportunities that always high grade the portfolio. We don't want to own names that are beyond what we think they're worth, because it also elicits a risk to the portfolio in terms of our long-term performance.

Then third would be degradation of fundamentals, where the competitive advantages maybe are weaker that we feel like if the business is just not working like it used to and we have opportunities to high grade the portfolio by maybe taking it out and selling it, and adding a name that we think would be better, that's certainly another sell opportunity for us.

JAFFE: Well, now we're going to get your quick and dirty take on some stocks my audience is particularly interested in.

Well, you might want to at least get some of your money and put it to work in the market. We are looking at Quick and Dirty, our lightning round, with Kevin Walkush, portfolio manager at Jensen Investment Management, where he works on their Quality Growth strategies. Jenseninvestment.com, the website.

You know how Quick and Dirty works. Send us tickers if you want to participate yourself and hopefully they'll get it into an interview soon. We start today with a request from Ray in Buena Vista, Florida. He wants to know about Accenture. That's ticker ACN.

WALKUSH: Yeah. To us, Accenture is a sleeper AI company. We think they're incredibly well positioned to really monetize AI long term. Strong investment, in terms of their AI capability. Then right now, a little bit of softness, so we think good price entry point due to end market softness. We like it.

JAFFE: What in the business makes them sleeper AI? Because I don't think people think of Accenture as an AI business.

WALKUSH: Sure. They are a leading IT services company, from a consultancy standpoint. They're the implementer of technology for major corporations. In this case, AI to us is the next wave. They're a market leader, with a stellar reputation in their ability to execute on that front. In that regard, we feel like they don't have to be beholden to the winners or losers of AI, they just have to implement it on the part of their clients. It creates a safe way, in our mind, or a safer way to play AI in a direct way through a great company such as Accenture.

Then the last thing would be, because they're best-in-class in terms of business execution, they can apply those same principles on their own business. They have a massive global delivery network of programmers that they can basically optimize by implementing AI, and really leverage that improvement in productivity and drive efficiency within their own business in the near term and long term.

JAFFE: That's a buy on ACN, Accenture.

Yeah, you're getting on board AI through the sleeper AI play.

Tony in Henderson, Nevada wants to know about Marriott International, MAR.

WALKUSH: We like Marriott. Great franchise model. We think of Marriott as owning a lot of hotels. They typically don't own very many of them. With a franchise model, they don't have that direct exposure to the volatility of the hotel industry. They have a great suite of brands that go well beyond just Marriott, including Ritz, J.W. Marriott to mention a few. Really like the business fundamentally.

Right now, to us, a couple things. Uncertainty around where travel's going to be and hotel demand, so a little bit of near-term uncertainty. They look rich to us right now. We think of it as more of a hold.

JAFFE: Hold it if you've got it, but you're not buying more right now on Marriott International, MAR.

Gil in Buffalo wants to know about United Parcel Service, that's UPS.

WALKUSH: Yeah. For UPS, for us, that's a sell. Former long-term holding, really liked the business historically. Dominated their space, in terms of package delivery globally. But we've really seen competitors rise up and we've really seen their competitive advantages get competed away, so to speak. We don't see the strength in the business that we used to, therefore, we consider it a sell.

JAFFE: That's why UPS, United Parcel Service, was a sell.

Greg in Short Hills, New Jersey wants to know about Eli Lilly and Company, that's ticker LLY.

WALKUSH: Yeah. Eli Lilly is the poster child for the GLP-1 trade right now. They've been doing incredibly well with their drug franchises on that front. The only challenge beyond the fundamentals of the business, which we really like, is just the valuation. The market, in our mind, has gotten really ahead of it. In that regard, we would probably wait for a better price point to enter that position.

JAFFE: Good company, not yet good stock. That's a hold on LLY, Eli Lilly and Company.

Last, for Tom in Smithfield, Kentucky, it's Nestlé, ticker NSRGY.

WALKUSH: We like Nestlé. We like their suite of product lines, in terms of exposure to consumers on the staple side. They have a strong exposure on the pet side, which is a very strong growth driver in our mind. Right now, we think the name is sold off in a relative fashion. It's basically caught a downdraft with companies that have potential exposure to GLP-1. Right now, we like the business, we like the fundamentals from a long-term perspective, and the valuation looks really compelling for a buy.

JAFFE: We finish on a high note. That was a buy on Nestlé, NSRGY.

Well, the whole time we've been talking, we've had high notes. Kevin, this has been great. Thanks so much for joining me on the show. Let's do this again down the line.

WALKUSH: Great. I'm looking forward to it.

JAFFE: That's Kevin Walkush. He's portfolio manager at Jensen Investment Management. The Jensen Quality Growth Fund and the Global [Quality] Growth Fund, learn more about them at jenseninvestment.com. We'll be back. We'll let you know where Kevin agreed or disagreed with some recent guests. We'll tell you what's coming tomorrow and more, as we cross the finish line and wrap up this edition of Money Life.

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