July 20, 2021

There was little difference from Q1 to Q2 in the market forces affecting the positions of The Jensen Opportunity Fund. As you may recall, the movement in the price of our stock positions throughout Q1 was influenced heavily by the view on inflation (inflation and interest rates will be used interchangeably for simplicity) and that was true of Q2 too.

Interest rates are important to the performance of high growth stock prices because of "discounted cash flows" modeling. Market participants use the model on company's earnings and the outcomes vary significantly from a low-rate to a high-rate environment.

A company's so called "multiple" also factors into how rates affect stock prices. The multiple refers to the ratio of the company's stock price to its earnings, also more simply known as the P/E ratio. To consider how the ratio works, think about fixing a company's stock price (the "P"). As the company's earnings (the "E") rise, the ratio is smaller. The market views a company with a lower P/E as being more value oriented. As the company's earnings fall, the ratio is bigger. A higher P/E typically means less value in the company's stock. It makes sense that if a hypothetical stock price remained fixed, the market would be more willing to buy the stock with more earnings than less earnings.

In a low-rate environment, the market is more willing to pay up for high growth stocks. In other words, they allow for higher P/E's. When rates are low, the output of a company's discounted cash flows model on its earnings is worth more, and the market is willing to pay for that in terms of a higher stock price. Companies tend to have higher P/E's when rates are low. The P/E's tend to compress when rates rise or when the market anticipates rising rates.

Let's look at an example:

Effects of 3% vs. 0.5% inflation over a decade on $10 in earnings

	Year	1	2	3	…	10
Inflation rate	0.5%	$ 9.95	$ 9.90	$ 9.85	…	$ 9.51
	3.0%	$ 9.70	$ 9.41	$ 9.13	…	$ 7.37

After 10 years of 3.0% inflation, today's $10 of earnings is worth $2.14 less than what it would be worth with inflation at 0.5% ($9.51 vs. $7.37). Today's ten dollars will be worth a lot more in

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a lower inflation world after a decade. Indeed, the discounted cash flows model will value the hypothetical company's stock with the $10 of today's earnings a lot more when rates are lower.

Also consider:

Difference in $7.37 and $9.51 of earnings on theoretical stock price and P/E scenarios

Earnings	Theoretical stock price	CorrespondingP/E	Theoretical P/E ratio	Corresponding Stock price
$ 7.37	$ 200.00	27.1	21.0	$ 154.86
$ 9.51	$ 200.00	21.0	21.0	$ 200.00

Imagine a company that has a stock price of $200. The company would have a P/E ratio of 21.0 with $9.51 of earnings. With $7.37 of earnings that same company's P/E ratio shoots all the way to 27.1. If the market is predicting a higher rate environment, like the scenario of 3.0% inflation over a decade, the stock price would have to come all the way down to $154.86 to have the same multiple.

To sum it up, the high growth companies that The Jensen Opportunity Fund holds stock positions in tend to have higher P/E's than the general market. As rates rise, or there is anticipation that the rates will rise, the market pays less for earnings. As the market pays less for earnings, it is the high growth and higher P/E company's stocks that get hit the hardest. Once rates stabilize, the stock prices and P/E ratios tend to elevate back to their normal levels. Depending on the trajectory of the rate curve, high growth stocks move accordingly. The stock positions in The Jensen Opportunity Fund fluctuated throughout the quarter depending on the rate view.

The Jensen Opportunity Fund squeaked out an outperformance of the S&P 500 index with the fund up 8.49% and the index up 8.17% at the end of Q2.

Until next time,

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