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# TERRY SMITH

Foreword by  
**LIONEL  
BARBER**

Founder, CEO and CIO of **Fundsmith**

## INVESTING *for*

# GROWTH

How to **make money** by only buying the

**BEST COMPANIES**

in the world

"Britain's  
most popular  
stockpicker"  
– *Financial  
Times*

"Buffett  
2.0"  
– *Investors  
Chronicle*



"Impressive  
returns"  
– *Money  
Week*

"a  
rare grasp  
of common  
sense"  
– Jeff  
Randall

*Fundsmith Equity T Acc,  
Nov 2010–Sept 2020*

An **ANTHOLOGY** of  
*investment writing,*  
**2010–20**

# Investing *for* Growth

How to make money by only buying the best  
companies in the world

*An anthology of investment writing, 2010–20*

**TERRY SMITH**

*Foreword by* **LIONEL BARBER**



Harriman  
House

*For Hendrix and Felix*

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## *Foreword by Lionel Barber*

**I**N November 2011, one year after launching Fundsmith, Terry Smith asked me whether the *Financial Times* would consider publishing his obituary-commentary on the death of Smokin' Joe Frazier, the former heavyweight boxing champion with the murderous left hook.

This was an unusual request, but all good newspaper editors know that readers enjoy an element of surprise. Besides, I knew that Terry was passionate and, more importantly, knowledgeable about boxing. (He once tried to entice me into the ring to raise money for charity, an offer wisely declined on my part.)

The ensuing tribute in the *FT* captured one of life's essential truths. What made Frazier so great, Terry wrote, was his link to the men he fought – George Foreman and Muhammad Ali – and the significance the bouts had. 'We would all do well to remember that we are defined by those with whom we compete – be they boxer, banker or politician.'

Those who have come to appreciate Terry Smith, as I have over the past 15 years, know that he is a man who is fiercely competitive, whether cycling uphill in the French Alps, kickboxing on a beach patio, or squaring up against rival brokers and fund managers. He too has been defined by his opponents, the great, the good and the not so good. But what sets him apart is not just his formidable winning streak, but the principles on which he has chosen to take a stand.

During a career in financial services stretching more than four decades, Terry has been as lethal as "Smokin' Joe" in cornering competitors. He has reserved a special place for those who, in his eyes, are guilty of incompetence, obfuscation or misleading investors via sophisticated marketing or creative accounting. He is the unabashed champion of "quality" which, he argues, is synonymous with true value.

Terry has always put his money where his (considerable) mouth is. He single-handedly organised the campaign to build a London memorial to Sir

Keith Park, the Kiwi flying ace and unsung hero of the Battle of Britain. He built up Tullett Prebon as a pre-eminent inter-dealer broker and then walked away to launch Fundsmith, where his commitment to invest in sound businesses has proved a winning, if still somewhat unfashionable, formula. Or as he puts it, succinctly:

‘...a good company with good products or services, strong market share, good profitability, cash flow and product development.’

Fundsmith was launched a decade ago in less-than-propitious circumstances. True, the 2007–09 global financial crisis had abated, thanks to unprecedented intervention by central banks. But the economic recovery was far from secure, and Europe was in the middle of a full-blown sovereign debt crisis. In the following years, Fundsmith would come to thrive and challenge many of the (lazy) assumptions about the fund management industry.

***Myth number one:*** algorithms have taken over the world and there is no serious alternative to passive investing, exemplified by the rise of exchange-traded funds (ETFs). These funds have indeed grown exponentially, ostensibly offering far more reliable returns compared to so-called “active” investing. But Fundsmith has demonstrated that there is a profitable niche in the market alongside the titans of BlackRock, Fidelity and Vanguard.

***Myth number two:*** so-called value investing has run its course. Chief witness for the prosecution is Neil Woodford, long hailed as Britain’s Golden Boy. Woodford certainly had his moments at Invesco; but after striking out on his own in 2014, his record looks more similar to that of another golden boy: Billy Walker, the British heavyweight from Stepney, known as “the Blond Bomber” who eventually gave up his gloves for a brief career in movies. In fact, Woodford’s demise owes more to hubris and an unhealthy reliance on illiquid stocks. It does not spell the end of the savvy stock picker.

***Myth number three:*** asset allocation trumps all considerations and, almost by implication, the addition of a small/mid-cap element to a portfolio constitutes an unacceptable level of risk. In fact, as Terry argued in a myth-busting *FT* column in August 2018, ‘there is no doubt that adding a small/mid-cap element to a portfolio can achieve the seemingly impossible

feat of generating additional return while reducing risk.’ No doubt Terry had half an eye on the launch of Smithson, his small-to-mid-cap fund; but once again the subsequent performance of the fund speaks for itself.

***Myth number four:*** blue-chip companies deserve a measure of respect which makes them impregnable or untouchable. Terry has shown time and again a willingness to challenge conventional wisdom. He has taken on national champions such as IBM in the US and Tesco in the UK, relentlessly probing their underlying performance and profitability. In retrospect, his critical analysis has proven remarkably prescient.

There is, I believe, a certain correlation between Terry’s “without fear and without favour” approach to stock-picking and my own approach to journalism. We are both students of history as well as practitioners of direct verbal communication and unfussy written prose. My early editorship was indeed partly defined by my first encounters with Terry in late 2005 when we settled a messy legal dispute which I inherited from my predecessor.

What Terry has taught me, and I suspect many others, is that there is little to be gained from venturing into the speculation business. Many things are inherently unknowable. This, of course, does not prevent many people, especially journalists, from becoming armchair forecasters. In the age of social media, where news and views are spread at scale in real time, too many are tempted to opine about the future, not simply to anticipate but also to attempt to influence events. This is not an argument against free speech, more a health warning about vacuous pronouncements and the (relative) value of talking heads.

This offers me a perfect excuse for not commenting on what may lie in store for Fundsmith over the next decade. As a Big Picture person, who worries about the state of liberal democracy, I must remain silent for now. Nor do I have much wisdom to offer about Brexit and what it means for the UK. Finally, as an amateur economist, I have little to contribute to the debate about the return of inflation. I would merely add that, in the spirit of Sir Isaac Newton’s third law of physics, at some point the extraordinary actions of the central banks must produce an opposite (if not necessarily equal) reaction.

In the meantime, only three words matter for investors and admirers alike.

Happy Birthday, Fundsmith.

LIONEL BARBER  
Editor, *Financial Times* 2005–2020

# *The lessons of the first ten years*

INTRODUCTION BY TERRY SMITH

**I** DECIDED to publish this book to mark the tenth anniversary of Fundsmith's foundation. It comprises articles that I have published over that period together with my annual letters to investors in the Fundsmith Equity Fund.

At the outset Fundsmith believed that direct communication with our investors was important because it gave us the best chance of explaining our investment strategy, how we were performing and what we are doing, without the intervention of intermediaries. This is particularly important when things don't go well, which is inevitable from time to time, as it might prevent our investors taking actions which are injurious to themselves and our fund. To this end we not only publish an annual letter to investors, we also hold an annual meeting at which investors can pose questions and see us answer them live and in public. This is not mandatory and we are the only mutual fund in the UK which does it. It has become the best attended annual general meeting in the UK. This book is intended to contribute to that tradition of direct communication.

I thought I would use this introduction to spell out some of the lessons we have learnt over the past ten years.

One is that Fundsmith's investment strategy works. Over the past ten years to the end of August 2020, our T-class accumulation units – which is our most popular class with direct investors and one in which I am invested – have increased in value by 425% or 18.4% p.a. compared with a return of 193.5% or 11.6% p.a. for the benchmark MSCI World Index. And 54% for the FTSE 100 Index.

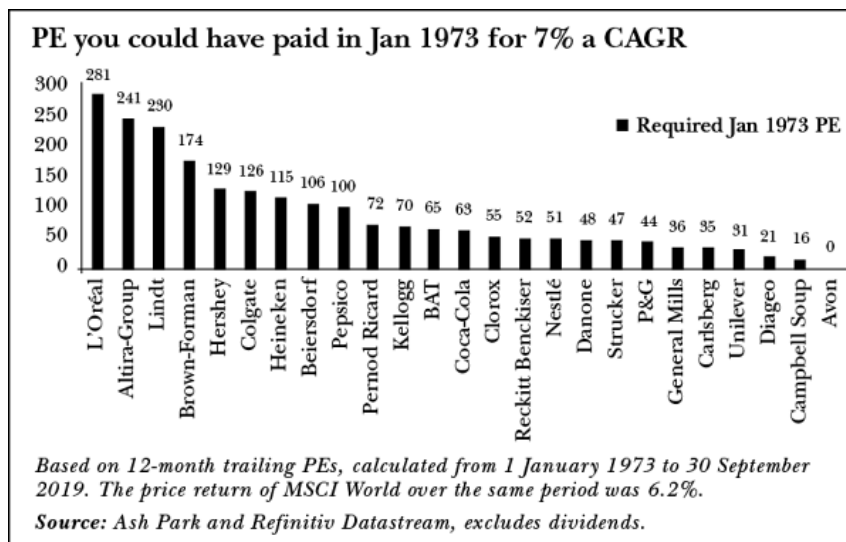
If you have read the financial press and commentary from various investment advisers you might be confused about why it has worked. You may have seen references to the period of low interest rates since the financial crisis of 2008–09 and the impact of quantitative easing (QE) in which central banks and governments bought large quantities of financial assets which they say has benefitted the performance of stocks of the sort



we invest in (and other stocks, I might observe). You may encounter certain buzzwords like “bond proxies” – the stocks we invest in reliably produced profits and cash flows like bonds. Bonds did very well over this period, and so stocks of the sort we like were turned to as an alternative by investors when bond yields approached or went below zero. There was much talk in the early years of Fundsmith’s existence about our strategy being all about consumer staples even though these stocks were never much more than half the portfolio at their peak. Latterly it is said to be all about tech stocks that are slated as a bubble about to burst even though such stocks have never been close to half our portfolio. I have been told by people that Fundsmith’s performance owes a great deal to fortunate timing in terms of when it was started, often by the same people who told me at the outset that it was a bad time to start a fund. The only explanation I haven’t heard very often is the correct one so I thought I would take this opportunity to try to set the record straight.

Some of these naysayers are protagonists in the ongoing debate about so-called value investing, which they contrast with growth or quality investing. Value investing can be traced back at least to Ben Graham, the author of *The Intelligent Investor* and *Security Analysis*, who was Warren Buffett’s mentor. For Ben Graham, and Buffett in his early years, value investing meant buying a stock below its intrinsic value as the most important investment consideration, and then waiting for the two to converge – hopefully by means of the share price rising rather than the intrinsic value declining. Latterly, in the hands of other practitioners, it has morphed into a simplistic approach of investing in stocks with low valuations, which is not the same thing – hence my use of the term “so-called”. A stock may have a low valuation but an even lower intrinsic value. Buying such a stock is not a recipe for investment success. Nor is growth or quality investing (I believe the latter is a more accurate descriptor for Fundsmith’s approach) best done irrespective of valuation. However, the level of valuation which may represent good value at which to buy shares in a high-quality company may surprise you. The following chart shows the “justified” PEs (price-to-earnings ratios) of a group of stocks of the sort we invest in. What does that mean? It looks at the period 1973 to 2019 when the MSCI World Index produced an annual return of 6.2% and works out what PE an investor

could have paid at the outset for those stocks and still returned 7% p.a. over the period, so beating the index.



You could have paid 281 times earnings for L'Oréal in 1973 and beaten the index return. Or a PE of 126 for Colgate. A PE of 63 for Coca-Cola. Clearly this approach would not fit the mutation of value investing in which the rating must simply be low. Yet it is hard to argue with the fact that these stocks would have been good value even on some eye-watering valuation metrics.

The fact, as Warren Buffett has acknowledged, is that growth is a component of valuation. Growth can enhance or diminish the value of a company – growing a business with inadequate returns is simply sending good money after bad. But when a company has superior returns on capital employed, and a source of growth which enables it to reinvest a substantial portion of those returns, the result is compound growth in its value and share price over time. It is important to realise that this is over the long term. In any given period, stocks of the sort which Fundsmith invests in may underperform those lowly rated stocks which we shun, which are in heavily cyclical sectors, are highly leveraged, have flawed or outdated business models and/or which consequently have poor profitability, returns and cash generation. As the sayings go, every dog has its day, and a rising tide floats all ships. In a strong bull market, especially in a recovery from an economic downturn, companies of this sort are apt to outperform the shares of the high-quality businesses we own. After all, the high-quality

companies have nothing to recover from. If this worries you then Fundsmith's approach is not for you.

No doubt when this occurs we will hear much crowing from so-called value investors and commentators who will of course forget to mention that if you had followed their advice and switched out of quality stocks of the sort we own at almost any time over the past decade it would have been to your detriment. I can trace the first mention of this to a publication called *Investment Adviser* on 12 August 2012: 'Looking at PE ratios there is evidence in abundance that shows that from a relative perspective quality stocks may today be considered expensive.' Since that date the Fundsmith Equity Fund T-class accumulation units have risen by 306% and outperformed the benchmark MSCI World Index by 131%. If you follow their advice when lowly rated, poor-quality businesses have their day, or year, in the sun you may gain some short-term additional performance but you will need good timing, nerves of steel and a willingness to revert back to investing in high-quality businesses if you wish to prosper for the much longer periods of time when they outperform once again.

The relative success of quality investing over value investing cannot be solely or mainly attributed to the factors which I listed earlier – low interest rates, QE, bond proxies, consumer or tech stocks. The fact is that the poor fundamental performance of many value stocks has correctly produced a poor stock market performance relative to quality stocks.

The following table compares the performance of a group of “value” stocks, defined simply (as it too often is) from their low PEs in 2015 with a group of highly rated growth stocks (the stocks and dates have not been chosen to suit my argument):

*How growth became value but value didn't*

|       | <b>LTM<br/>EPS<br/>Jan<br/>2015</b> | <b>LTM<br/>EPS<br/>August<br/>2020</b> | <b>%<br/>change</b> | <b>Trailing<br/>PE 2<br/>Jan<br/>2015</b> | <b>Trailing PE 2 Jan<br/>2015 PRICE / Aug<br/>2020 LTM EPS</b> | <b>Share price<br/>performance from<br/>1/1/15 to 31/8/2020</b> |
|-------|-------------------------------------|--|---------------------|---|--|---|
| Exxon | \$7.60                              | \$1.68                                 | -78%                | 12  | 55   | -36%  |
| GE    | \$1.50                              | -58¢                                   | -139%               | 16  | -42  | -65%  |

HSBC

|                 |        |         |         |       |      |       |
|-----------------|--------|---------|---------|-------|------|-------|
|                 | 42p    | -1.6p   | -104%   | 15    | -385 | -26%  |
| Marks & Spencer | 31p    | 1.2p    | -96%    | 15    | 380  | -68%  |
| Vodafone        | 42p    | -2.7p   | -106%   | 5     | -81  | -31%  |
| Adobe           | 53¢    | \$7.58  | +1,330% | 136   | 10   | 723%  |
| Amazon          | -52¢   | \$26.01 | n/a     | (593) | 12   | 1195% |
| Facebook        | \$1.10 | \$8.19  | +645%   | 71    | 10   | 337%  |
| Netflix         | 9¢     | \$5.93  | +6,489% | 554   | 8    | 1164% |
| PayPal          | 46¢    | \$2.18  | +374%   | 88    | 19   | 581%  |

Looking back from 2020, it is now apparent that the earnings of the “value” stocks would be so poor that their PEs looking forward five years were far from low – in fact, in most cases, there is now no E(arnings). In contrast, the rather expensive looking growth stocks have had much better earnings performance and have, at least to date, justified their seemingly expensive starting valuations. If you had chosen the “value” stocks you would have experienced the double whammy of the earnings falling even faster than the share price, thereby leaving you with stocks which now look expensive. Ah, but I can hear the siren sounds of pundits now saying that’s because they are now recovery stocks... None of that owes anything to low interest rates, QE, or bond proxies.

To repeat:

- lowly rated does not equal good value
- highly rated doesn’t not equal expensive.

One thing which we have not become any more confident about over the past decade is the value of forecasts. We continue to marvel at people who make predictions. Most recently, I have heard people vigorously debate whether the recovery from the Covid-19 pandemic will be shaped like a V, a U, a W (with a recovery followed by a second wave of infection and economic lockdown), a bathtub or the Nike swoosh (I am not making this

up). I like the observations of the economist J. K. Galbraith on this subject: ‘The only function of economic forecasting is to make astrology look respectable.’ This applies not only to economic forecasts. Over the past decade we have seen forecasters tell us amongst other things that:

- Brexit would not happen
- Narendra Modi would not become Prime Minister of India (twice)
- Donald Trump would not become President of the United States
- gold would be replaced by cryptocurrencies
- it was different this time and airline stocks would become good investments.

In some cases it seems that the inability of forecasters to achieve any accuracy is caused by a degree of role confusion. It seems some pollsters, commentators and forecasters have decided that their job is not to predict or report on events but to influence them. It seems not to have occurred to them that having set out their stance that a vote for Brexit/Trump/Modi is a sign of nationalism, bigotry and/or a lack of education, respondents polled by them might be reluctant to tell them their true stance. Their trumpeting that their chosen candidate or policy would win might have the same effect as the sundry celebrities and politicians ranging from Eddie Izzard to Barack Obama seem to have had when hectoring people about how they should vote on Brexit. Their approach is in my view encapsulated by the lyrics of the Simon & Garfunkel song “The Boxer”: ‘a man hears what he wants to hear and disregards the rest.’ It’s not an approach likely to produce an accurate forecast.

Even if they were not handicapped by blinkers in predicting the outcome of events, those who wish to rely upon forecasts would still labour under the problem that markets are second-order systems. In order for a forecast to be useful it not only has to be accurate (and that includes the timing) but you also need to know what the market expects in order to have a chance to predict how it will react to events and benefit from it. But where was the recession which we were told would follow a vote for Brexit, or the market crash which would follow a Trump victory?

To return to J. K. Galbraith: ‘We have two classes of forecasters. Those who don’t know – and those who don’t know they don’t know.’ We are in the former camp, and so long as many other investors rely upon people in the latter camp this gives us an advantage.

The irony of this is that as Ian E. Wilson, the former chairman of General Electric, said, ‘No amount of sophistication is going to allay the fact that all your knowledge is about the past and all your decisions are about the future.’ Given that we acknowledge that the future is unknowable – we regard the phrase “foreseeable future” as an oxymoron – how do we manage to select companies to invest in which will perform well in future and better than our benchmarks?

The short answer is carefully. Very few companies make it through our filtering system as potential investments and even fewer make it into our portfolio.

The longer answer is that, whilst we seek companies which have superior financial performance, that should be an outcome of their operations – not their primary objective. We are seeking companies that offer a superior product and/or service to customers which enables them to generate these impressive financial returns and prevent competition from eroding them. I can’t think of a company which was mainly focused on driving financial results, and especially those that have obsessed about quarterly earnings in comparison with “the Street’s” expectations, which has blossomed into a great company and investment. It is ironic to quote a former chairman of GE, given the fate of General Electric after the Jack Welch era of suspiciously consistent quarterly earnings “beats” is itself a moral tale about this.

We try not to let share prices inform us about businesses but rather do this the other way around. If you look back to the “How growth became value but value didn’t” table earlier it suggests that the reason why “value” investors fell into the trap of owning some of those stocks is because they felt that the low valuation and share price was the most important piece of information. It is not. The fundamental performance of the business is.

When Fundsmith bought its stake in Microsoft it was greeted with a cacophony of comments – many from our investors – and demands that we



sell it, most of which prematurely sounded the Last Rites for Microsoft. One leading financial newspaper analytical column, written I believe by its technology analyst, said that no one should own Microsoft stock at this price when we were buying our stake at about \$25 a share. They were right, albeit not in the way they intended given that we have made nearly ten times our money on our first purchases of Microsoft. The moral here, I suspect, is not just that you need to ignore the noise and look at the facts but that some people are actually a useful negative indicator. When Eddie Izzard comes out in public support of a political campaign it is more telling than any poll. By the way, I have nothing against Mr Izzard and think his Death Star Canteen sketch is hilarious. I just think he is a lot better at comedy than he is at political campaigning. However, given his predictive abilities I don't want him to stop.

One of the lessons this illustrates is that you may only get to invest in really good businesses at a cheap rating when they have a problem. Our Microsoft investment coincided with the troubled period under its previous CEO when it managed to come third in a two-horse race in mobile devices and second in a one-horse race in online search. Our job is to determine whether such problems are a temporary glitch that presents an opportunity for us as investors or an existential threat.

This is quite close to another lesson we have learned, namely that every company has a problem. For example:

- Drug companies – patent expiries and government pricing controls.
- Fast food – fat taxes.
- Food and beverages – fat taxes.
- Infant formula – falling birth rates.
- Medical equipment and devices – litigation risk.
- Payments companies – projects like the EU's Payment Services Directive which aims to set up a payments network which is cheaper and more secure than existing payments systems (I wonder if those are conflicting objectives).
- Social media – control and use of client data, political campaigns and the question of free speech versus no-platforming.

- Tech companies – start-ups which are funded with capital which does not appear to require any return other than an eventual sale or IPO so they can ignore profitability.
- Tobacco companies – where do we even start?

Whilst we do not belittle any of these issues on the whole, we take the view that if you can find a company which does not face any competitive, regulatory or other threat please let us know as we have yet to find one. Spotting the problems isn't difficult. An assessment of the company's products, services, management, competitive positioning and prospects should lead you to determine what share price you might be willing to pay for it, not the other way around. The following chart illustrates how this strategy has worked over time:



It compares the MSCI World Quality Index of companies of the sort that we seek to own with the main MSCI World Index for a 34-year period. Over this period there has never been a rolling period of 120 months when World Quality has not outperformed the World Index. Bear in mind that quality is handicapped in this comparison insofar as the quality stocks are still included in the World Index so this does not fully illustrate the performance advantage of owning quality stocks versus the remainder. I know ten years (120 months) would be a long time to wait for this, but if your time horizon is shorter than this I would suggest you shouldn't be invested in the equity market. You certainly shouldn't be invested with Fundsmith.

When I am driving I sometimes see an ice-cream van which has emblazoned across the back the advertising slogan 'IT'S QUALITY THAT COUNTS'. The ice-cream vendor seems to have figured out one of the great

axioms of equity investment. He also does a decent 99 so he has two advantages over most pundits.

We spent some of the past ten years marvelling at the rise in the importance of “guidance” in which companies provide analysts with a guess of the outlook for their revenues and profits. This has become an opiate for the analytical community who seem unable to function without it. We prefer the refreshing candour of the CEO of Stryker, the medical equipment and devices company in which we have been invested since the inception of Fundsmith, who remarked during the Covid lockdown ‘the reason we’re not giving guidance, right, is because we just don’t know what’s going to happen in the future’. One analyst who wasn’t satisfied that Nestlé had still given guidance of 2–3% revenue growth for the year, described it as ‘quite a wide range’. Call us old fashioned but we thought it was the role of the analysts to provide “guidance”.

We have learnt to be wary of companies that make lots of adjustments when reporting their figures. Mondelez once produced 27 GAAP (Generally Accepted Accounting Principles) to Non-GAAP ‘schedules’ and eight pages of accompanying text, largely designed to persuade us that an actual 42% decline in pre-tax profits should be seen in terms of an 18% increase in ‘adjusted constant currency EPS’. I doubt it is coincidental that the things which are omitted as a result of the adjustments are invariably the costs and debits. Some companies seem to view *Accounting for Growth*, which I wrote 28 years ago, as an instruction manual.

Finally, I am often asked about the future of Fundsmith and me. I am acutely aware that what makes God laugh is people making plans. However, if the fates allow, I intend to continue running Fundsmith for many years to come. I have no desire to cease doing so. Nonetheless I hope and expect that the succession arrangements we have put in place will enable Fundsmith to continue to provide superior returns for investors long after I am gone. When asked how long the firm can endure I am fond of quoting Buzz Lightyear from *Toy Story*: ‘To infinity and beyond’.

TERRY SMITH  
September 2020

# *Fund management fees*

STRAIGHT TALKING, 28 SEPTEMBER 2010

**T**HERE has been some recent press about the launch of Fundsmith, my new fund management venture.

Since the press was generated by a leak, there has been much speculation about what features Fundsmith will offer investors. One area of focus of this has been on fees.

Without confirming or denying that fees will be a main area of focus for Fundsmith (we'd like to keep at least some secrets back for the launch), I thought it might provide a flavour of things to come if I comment on some problems with the structure of fees (and costs) which investors in funds currently experience.

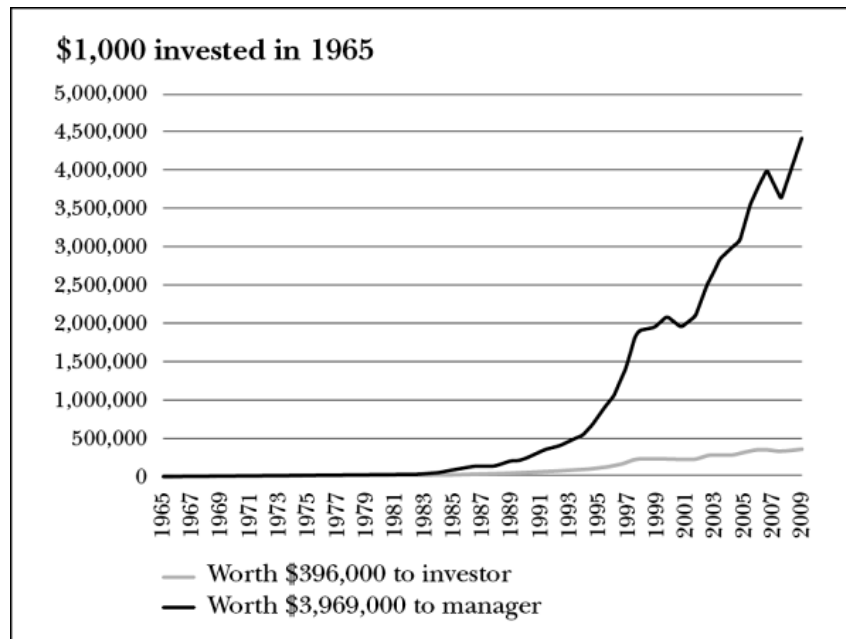
## **RDR**

A lot has been written about fund management fees recently, particularly with regard to the impact of the Retail Distribution Review (RDR). This comes into effect at the end of 2012 and will thereafter prevent advisers (IFAs, wealth managers and private client stockbrokers) from obtaining payment of part of the egregious upfront fees of up to 5% of the sum invested charged by many fund managers and/or "trail" commission paid from the annual charges levied by managers.

From 2012, advisers will need to obtain payment via advisory fees charged direct to the clients, which may prove somewhat harder to justify when they are explicitly charged to the client rather than paid by the fund manager after he/she has extracted them from the client's investment.

What few people seem to realise is that trail commissions will still be paid to advisers on investments in funds made by clients in 2012 and earlier. This presents an obvious problem. We are told ("Serious Money: Take my (free) advice and avoid a haymaking IFA", by Alice Ross, *Financial Times*, 27 August 2010) that the FSA is monitoring turnover in fund holdings to try to spot any "churning" which may be caused prior to the end of 2012 by

advisers getting their clients to invest in funds which will still pay a trail thereafter.



This leaves a rather more pernicious danger which needs to be watched for: the absence of turnover in those funds after 2012. Whilst activity is something which is correctly seen as the enemy of a good investment performance, it would be unsurprising if, having got their clients into trail-paying funds prior to 2013, a lot of advisers weren't suddenly seized by inactivity. This needs to be guarded against as much as churning.

## Two and twenty

Two and twenty is the standard fee formula for the hedge fund industry.

It is unsupportable.

I am not so much shocked as flabbergasted by the number of people who do not realise the impact of these performance-fee structures. I am not talking here about the fact that such a performance-fee structure clearly led many fund managers to gear up their funds as much as the credit bubble allowed and place bets which many attendees at Las Vegas would regard as outrageous, knowing that they had little or no downside and 20%+ of the upside.

I have had discussions with numerous professionals in sophisticated jobs in

the investment industry who are either unaware of or disbelieve the mathematics of what I am about to demonstrate.

As you are aware, Warren Buffett has produced a stellar investment performance over the past 45 years, compounding returns at 20.46% p.a. If you had invested \$1,000 in the shares of Berkshire Hathaway when Buffett began running it in 1965, by the end of 2009 your investment would have been worth \$4.3 million.

However, if instead of running Berkshire Hathaway as a company in which he co-invests with you, Buffett had set it up as a hedge fund and charged 2% of the value of the funds as an annual fee plus 20% of any gains, of that \$4.3m, \$4.0m would belong to him as manager and only \$300,000 would belong to you, the investor. And this is the result you would get if your hedge fund manager had equalled Warren Buffett's performance. Believe me, he or she won't.

Two and twenty does not work. That does not mean that 1.5% and 15% is OK, or even 1% and 10%. Performance fees do not work. They extract too much of the return and encourage risky behaviour. The only way to focus your fund manager on performance without gifting him or her most of your returns is to ensure he or she invests a major portion of their net worth alongside you in the fund and on exactly the same terms.

### **TERs and costs**

There is a justified focus on the total expense ratio (TER) of funds which include those expenses which the manager charges to the fund rather than simply on the fund management fee. However, there is one major cost that is not charged to the funds: the cost of dealing in the underlying investments.

This is not insignificant given that, according to FSA research, the average fund manager in the UK turns over their fund 80% per annum. This adds three layers of additional costs: 1. The commissions charged by brokers and investment banks for dealing; 2. The difference between the bid-offer spread for securities sold and bought; and 3. The fact that no fund manager has sufficient good investment ideas to warrant buying and selling 80% of your investment portfolio per annum.



Soon we shall see what Fundsmith can do about all this...

# *Annual letter to shareholders 2010*

FUNDSMITH, JANUARY 2011

**T**HIS is the first annual letter to owners of the Fundsmith Equity Fund. Fundsmith opened for business on 1 November 2010, and we are critical of attempts to measure investment performance over short periods of time. Two months is not a short period, it is a ludicrously short period to do so. However, I thought that this letter is a good opportunity to give you a flavour of the reporting which is likely to occur in years to come.

From 1 November to 31 December 2010, the Fundsmith Equity Fund rose by 6.14% net of fees. This compares with some common benchmarks as follows:

|  |        |
|--|--------|
| <b>Fundsmith Equity Fund</b>           | 6.14%  |
| <b>MSCI</b>                            | 7.99%  |
| <b>MSCI EAFE</b>                       | 5.76%  |
| <b>FTSE 100</b>                        | 4.40%  |
| <b>Long bond (10-year UK Treasury)</b> | -2.57% |

Benchmarks are useful for measuring performance, provided a long enough timescale is used. Problems arise when fund managers start to use them for portfolio construction. At Fundsmith we do not endeavour to track any index or to minimise our “tracking error” versus any index (even the use of the expression tracking “error” tells you that an active fund manager has the wrong mindset).

The fund underperformed the MSCI and outperformed the MSCI EAFE – the difference being in the performance of US stocks which are included in the former but not the latter. It outperformed the FTSE 100 and long bonds.

The main positive contributors to that performance were:

1. Del Monte Foods
2. Becton Dickinson

3. Domino's Pizza Inc

4. Nestlé

5. Stryker Corp

The main contributor was Del Monte Foods. Del Monte could almost be a case study in how investment opportunities arise. We were attracted to Del Monte by its main product: pet food.

Pet food is typical of the sort of product we seek to invest in. It is a small-ticket consumer non-durable. As a small-ticket purchase, no credit is required to buy it. The consumer has no opportunity to bargain on price – the price the supermarket or pet store displays is the price you pay. Consumers are typically brand loyal, and once it has been consumed there must be a replenishment purchase – there is no opportunity to defer this by prolonging the life or ownership of the product as there is with a consumer durable, like a car. Moreover, research clearly shows that if times are hard, consumers will reduce their spending on food for themselves or their children rather than cut back on their pets' food.

However, the fact that pet food is Del Monte's main product line seemed to be lost on most investors, many of whom were assessing it on the basis of their folk memory of its main historic product range in canned fruit and veg. This is what produced the opportunity to buy Del Monte stock on a free cash flow yield which was generous for its likely financial performance. On one occasion this misunderstanding was compounded when Bloomberg managed to publish an article from the *Galveston County Daily News* about a strike at Fresh Del Monte Produce Inc – an entirely different company which sells fresh produce – against Del Monte Foods. Such events can create opportunities to buy great companies at good prices.

Eighteen days after the fund opened and we purchased our initial holding in Del Monte it was bid for by private equity firm KKR at a significant premium to the price we had paid.

Whilst it would be churlish to suggest that we do not like receiving a premium for our investments in cash, such events are not without their downside as we have to find an equivalent investment for our cash. The fact is we really want to own our stakes in the companies in our portfolio and

benefit from the good cash returns on capital which they generate. We are not simply hoping to on-sell the investment at a higher price. This changes perspectives on events such as takeovers.

Just as we counsel you not to become overly enthusiastic about share price rises, even those which relate to cash bids for our holdings at a premium which represents a good return on our investment, we hope that you will understand when we are explaining that price falls within the portfolio will often represent an opportunity for investment on even more rewarding ratings rather than an opportunity for soul searching and recriminations. Often but not always.

The detractors from the fund's performance were:

1. Serco Group
2. Imperial Tobacco
3. Dr Pepper Snapple
4. Reckitt Benckiser

In no case do we believe that the fall in the price alters our view of the investment (other than the obvious point that we wish we had made it at the lower price) nor do we believe it reflects an adverse change in the intrinsic worth of the business.

The historic dividend yield on the fund at year end was 2.47%. This dividend was covered over 2.5 times by earnings. Only one stock in the fund does not currently pay a dividend. This is significant: dividends have historically provided a significant portion of the total return on equities. The current yield on the fund may not fully reflect its dividend-paying capabilities as some of the companies also utilise share buybacks. These can contribute to shareholder value creation when they are used correctly (to purchase shares which are undervalued when no better investment opportunity presents itself).

At the end of 2010 we held a portfolio of 22 stocks, including Del Monte.

The average company in our portfolio was founded in 1883. We are investing in businesses which have shown great resilience over a long

period of time – in most cases surviving two world wars and the Great Depression.

The trailing free cash flow (FCF) yield was about 7%. This free cash flow was either distributed as dividends, used for share buybacks, or invested by the companies in order to generate further returns. As our portfolio had an average return on operating assets of 50% this reinvestment of cash flows should produce compounding of value for us as shareholders.

This FCF yield compares with a FCF yield on the S&P 500 of a bit less than 7%. The median (250th ranked) FCF yield in the S&P is 6.6%.

What we can say with a high degree of certainty is that our portfolio has a FCF yield higher than the average for the market. Yet it is inconceivable in our view that it is not of higher than average quality in terms of longevity, resilience, predictability, profit margins, return on operating capital and the conversion of profits into cash. Put simply this means that we own shares in businesses which are higher quality than the market on a valuation lower than the average for the market. Whilst that is not a total solution to successful investing, it strikes us as at least a good start.

We regard an equity holding as a claim on a share of the cash flow produced by a business. In the fund we seek to own companies which produce high cash returns on capital and distribute part of those returns as dividends and re-invest the remainder at similar rates of return. And we want to own those companies' shares at prices which at best undervalue their returns and at worst value them fairly.

We do not regard equity investment as a sophisticated game of pass the parcel in which we buy shares in companies that we don't understand, which may be poorly performing businesses and/or which are overvalued, hoping to sell them to a greater fool when they have become even more expensive as a result of some fad or share price ramp. Such games are best left to video consoles unless your hobby is losing money whilst investing, which I rather suspect it is for some people.

I aim to restrict myself to one rant per letter about a subject relevant to investment. Frankly, given the behaviour of much of the wealth/asset management industry, I regard this as a model of self-restraint in a target-rich environment.

This year's rant is a warning about the misunderstanding and misuse of exchange-traded funds (ETFs). I think this is relevant as the Fundsmith Equity Fund launch was somewhat against the tide of events. We launched an active equity fund at the end of a decade in which a) equities have performed badly; and b) the average active fund manager has again underperformed the index and so made a bad performance by the asset class worse.

Faced with this failure of active management, it is hardly surprising that investors have turned their backs on active management and headed for lower-cost, passive alternatives. As a result, the rise of ETFs has been a major feature of the investment landscape in recent years. By the third quarter of 2010, there were 2,379 ETFs with 5,204 listings on 45 exchanges managing \$1,181.3 billion of assets.

So what's the problem? I suspect that the average investor regards all ETFs as just another form of index fund, and indeed many of them are. But many aren't and therein lies the potential for misunderstanding. Or worse.

Some ETFs do indeed replicate the performance of an index by purchasing a weighted package of all or most of its constituent securities. But many so-called synthetic ETFs do not do so and instead use so-called swap agreements with counterparties who agree to provide a monetary return which matches the underlying asset class or the index the ETF is seeking to track.

Anyone who has studied the events of the Credit Crisis should be able to spot a potential problem here: what if the counterparty supplying the swaps defaults? This risk may once have been considered theoretical, but after the collapse of Lehman and the need to rescue AIG in order to prevent the contagion from a default, it surely no longer is. True, the ETF should be holding collateral against such a failure, but collateral is an imperfect science even where it is held – which is not in all cases.

Moreover, synthetic ETFs are often used to access markets which are not directly accessible to retail investors (such as the Chinese A-share market) or where liquidity in the underlying investments is poor (such as equities in some emerging markets). The opportunity for the performance of the ETF to diverge from the performance of the underlying assets and therefore from



investors' expectations in these cases seems obvious. The idea that a counterparty will provide you with a contract which matches the returns from underlying illiquid assets which you cannot directly own should give pause for thought – not least about how the counterparty will fulfil those obligations, for example in the case of extreme market movement and a liquidity crisis (a not unlikely combination).

Of course, not all ETFs are used to simply match the performance of an index. There are leveraged ETFs which multiply index performance, inverse ETFs which replicate a short position in an index and, naturally, leveraged inverse ETFs. The issue with these ETFs is that their returns are compounded daily. These problems may be best illustrated by a couple of tables:

|                            | <b>Day 1</b> | <b>Day 2</b> | <b>Day 3</b> | <b>Day 4</b> |
|----------------------------|--------------|--------------|--------------|--------------|
| <b>Index</b>               | 100          | 125          | 90           | 103          |
| <b>Daily change</b>        |              | 25%          | -28%         | 14%          |
| <b>Cumulative change</b>   |              | 25%          | -10%         | 3%           |
| <hr/>                      |              |              |              |              |
| <b>Leveraged ETF (+2×)</b> | 100          | 150          | 66           | 85           |
| <b>Daily change</b>        |              | 50%          | -56%         | 29%          |
| <b>Cumulative change</b>   |              | 50%          | -34%         | -15%         |

The first table shows the movement in an index in a highly volatile period in which it rises sharply then falls to finish just 3% up over the period. The second table shows the performance of a 2× leveraged ETF over the same period. With daily compounding, the leveraged ETF produces a cumulative loss of 15% of value over the period versus a 3% rise in the index.

How about an inverse ETF?

|              | <b>Index</b> | <b>% Movement</b> | <b>Short position</b> | <b>ETF (short)</b> |
|--------------|--------------|-------------------|-----------------------|--------------------|
| <b>Day 1</b> | 100          |                   | 100                   | 100                |
| <b>Day 2</b> | 80           | -20.0%            | 120                   | 120                |
| <b>Day 3</b> | 60           | -25.0%            | 140                   | 150                |

|              |     |       |     |       |
|--------------|-----|-------|-----|-------|
| <b>Day 4</b> | 55  | -8.3% | 145 | 162.5 |
| <b>Day 5</b> | 100 | 81.8% | 100 | 29.5  |

In a week where the index was volatile on the downside but got back to par by the end of the week, an inverse ETF with daily compounding would turn in a 70.5% loss. You can imagine what a leveraged inverse ETF would do!

I would bet that a large proportion of ETF investors do not realise that leveraged and inverse ETFs can produce these apparently perverse results. The moral of this is that these sorts of ETFs are really day-trading tools. If they are held for more than one day, they will begin to diverge from the performance of the underlying index or asset class. However, it would not be surprising if in many cases they were being used inappropriately – as if they are index funds.

Investors in ETFs may be quite logical in avoiding most active management, but many of their ETFs are not as inactive as they think.

Finally, returning to our own active fund, we look forward to the year ahead. This is not because we have any faith in a sustained recovery in major economies and/or that we regard equities in general as cheap or equity markets as a whole as good value or well placed to track improvements in corporate profitability (which in any event may not be forthcoming).

It is firstly because we believe our fund contains a portfolio of shareholdings in great businesses which we have purchased at reasonable prices or better, and which we intend to hold on to in order for them to deliver the benefits of such investments.

Secondly, it is because we enjoy running the Fundsmith Equity Fund. Robson Walton, the chairman of Walmart and son of its founder Sam Walton said, ‘My dad did not set out to make Walmart the world’s largest retailer. His goal was simply to make Walmart better every day, and he thought constantly about how to do just that.’

Please be assured we are doing the same with Fundsmith.

# *Share buybacks – friend or foe?*

INVESTMENT WEEK, 11 APRIL 2011

**A**LMOST 20 years on from publishing my book, *Accounting for Growth*, I am exposing another loophole in the accountancy rules which is allowing companies to appear to have created value when they have not.

Today I am publishing a paper ([tinyurl.com/y8d9l7bm](http://tinyurl.com/y8d9l7bm)) scrutinising the invogue use of share buybacks – are they a friend or foe to shareholders? Do they create or destroy value?

You might think the answer is obvious, but think again. The problem is when a company repurchases shares they disappear from the balance sheet and this can be used to distort measures of company performance.

Simply by executing a share buyback rather than paying out dividends, companies can inflate their earnings per share (EPS) and are almost universally seen to have created value for shareholders when mostly they clearly have not.

Capital allocation decisions are amongst the most important decisions which management of companies make on behalf of shareholders. Yet share buybacks are not sufficiently understood by company investors and commentators, and maybe even by company management.

One of the most important facts that is continually overlooked is share buybacks only create value if the shares repurchased are trading below intrinsic value and there is no better use for the cash which would generate a higher return.

Most share buybacks destroy value for remaining shareholders, and management is able to get away with this as the current accounting for share buybacks conceals their true effect. So what needs to change?

1. Management should be required to justify share buybacks by reference to the price paid and the implied return and compare this with alternative uses for the cash.
2. Investors and commentators should analyse share buybacks on

exactly the same basis as they would if the company bought shares in another company.

3. Investors and commentators should use return on equity to analyse the effect of share buybacks rather than movements in earnings per share.
4. Share buybacks need to be viewed with more than average scepticism when done by companies whose management are incentivised by growth in EPS.
5. Accounting for share buybacks should be changed so that the shares remain as part of shareholders' funds and as an equity accounted asset on the balance sheet in calculating returns.

# *Exchange-traded funds are worse than I thought*

THE TELEGRAPH, 24 MAY 2011

**O**N 11 January I published my first annual letter to the holders of the Fundsmith Equity Fund. In it, I levelled some criticisms at the investment fad for exchange-traded funds (ETFs).

One of my basic concerns was that I thought there was a danger of ETFs being mis-sold.

I suspect a lot of retail investors think that ETFs are the same as index funds. Some of them are, but many aren't. In particular, the performance of short ETFs and leveraged ETFs may diverge markedly from what an investor who believes they are simply index funds would expect.

It isn't hard to give examples in which investors would lose money on a leveraged long ETF if the market went up over a period of significant volatility, or in which they lost money owning a short ETF and the market went down over a period in which there were some sharp rallies.

The problem is with the daily compounding of ETFs.

Plus, many ETFs do not contain a basket of the underlying securities or assets which they are attempting to track. Instead, they hold asset swap agreements with a counterparty (often the bank which is the ETF sponsor) which aim to replicate the performance of the index or asset concerned.

There are obvious dangers in such an arrangement in the areas of counterparty risk and collateralisation of the sort which caused so many problems during the Credit Crisis.

A good example of the potential risks here is given by PEK, the NYSE-listed Market Vectors China A Shares ETF. It is illegal for foreign investors other than licensed institutions to buy A Shares listed in Shanghai or Shenzhen. So the ETF owns swaps with brokers who are licensed to hold the underlying shares. If PEK owned a significant portion of the float in A Shares and its holders tried to liquidate at speed, it might be interesting.

Some commentators claim we need not worry much about retail investors misunderstanding ETFs as in Europe, at least, they are mainly utilised by institutional investors.

This of course misses a couple of vital points. One is that the underlying clients for many of those “institutions” are individual investors – do they really understand the risks their private wealth manager is running with ETFs?

Also, the *Financial Times* FTfm supplement carried an article on 9 May pointing out this lack of direct retail involvement in ETFs in Europe on the same day as the wrap-around advert for its supplement was supplied by Amundi ETF. On that day, commuters coming into London were being given handouts of glossy brochures on Amundi ETFs plus a natty plastic credit card/season ticket wallet emblazoned with the slogan:

*‘Amundi ETF: More than just another tracker.’*

Quite so.

At this rate, we may soon have to worry about direct retail involvement in ETFs.

However, there is another and perhaps more pernicious danger with ETFs than misunderstanding or mis-selling.

An ETF is in effect a hybrid vehicle which combines features of an open-ended or mutual fund with those of a closed-end fund. They are like open-ended funds insofar as a purchaser buys or redeems so-called creation units. But they are also tradable in the secondary market, so ostensibly providing real-time liquidity.

Secondary trading activity brings with it the possibility that market participants will short the ETFs themselves. And there is no limit to the short selling, which is impossible in an ETF in the same way that there is in an equity.

In an ordinary equity, the short selling is limited by the ability of the short sellers to borrow the stock so that they can deliver it to complete their sell bargains. In an ETF, a short seller can always rely on the process of creating shares in the ETF to ensure he can deliver. This leads to the possibility that

a buyer of an ETF share is buying from a short seller and that no new share has yet been created.

The investors who buy from the short sellers don't own a claim on the underlying basket of securities or swap in the ETF; they own a promise to deliver the ETF share given by the short seller.

The problem this causes is that, as no new shares are created in the ETF by this process, the assets of the ETF may become significantly less than the outstanding cumulative buy orders would suggest. This is a significant problem given reports that there has been short selling up to levels of 1,000% short in some ETFs.

You might think that one way to overcome the risks involved in this at a stroke is for the ETF sponsor to create the shares represented by the cumulative buying interest, but this may be easier said than done.

Take an ETF like IWM in which the short interest recently exceeded 100% or \$15bn (£9.3bn). IWM invests in the Russell 2000 US small-cap index. To invest \$15bn in the basket of stocks involved would require about a week's trading – and that is if the ETF creation was the sole trading in those stocks. The scope for a short squeeze is tremendous.

The net result is that across the entire ETF asset class a portion of the funds which ETF purchasers think has been invested in ETFs, via the creation of new shares, has in effect been lent to hedge funds. The ETF holdings are not all backed by assets of the sort investors expect, even if they understand what the ETF is meant to do.

Perhaps these little understood structural issues explain why 70% of the cancelled trades in last May's Flash Crash were in ETFs when ETFs represent only 11% of the securities in issue in the US.

Moreover, in the case of some ETFs such as PEK, it is difficult to fathom what the short interest in PEK really represents as it is illegal to short China A shares.

Another example of the issues in this sector which recently crossed my desk was a fundraising proposition for a business which undertakes trading in ETFs. It shall of course remain nameless, but it trades, arbitrages and makes prices in ETFs with a particular focus on the less-traded ETFs. This

company describes itself as a 'fairly thinly capitalised entity'. There are echoes of the parallel banking system in the Credit Crisis here.

It also describes the pace of development in the ETF area as 'breakneck'. I just wonder whose neck will eventually get broken.



# *Accelerated stock repurchases*

STRAIGHT TALKING, 4 JULY 2011

**T**HIS week there was a new development in the share-buyback mass-shareholder-value-destruction exercise which has gripped American companies and has some following in the UK.

To date this year Citigroup reckons that in the US market there have been 26 accelerated share repurchases (ASRs) totalling \$8.5bn.

What happens in an ASR is that the company does the whole or a significant proportion of a share buyback programme in a single transaction with an investment bank or a small group of banks, rather than executing the programme over an extended period in line with volumes traded in the market. The investment bank(s) makes a short sale to the company and borrows the stock it delivers to the company.

Of course, at some point the investment bank will need to purchase stock to cover its short position and enable it to return the borrowed stock to the stock lender(s). Investment banks are not noted for doing something for nothing and certainly not taking on short positions just to assist companies. After all, share buybacks can generate share price rises at least in the short term and indeed part of the *raison d'être* for ASRs is to trigger a bigger short-term boost to share prices. No sane organisation would go short of shares faced with that likelihood. So the company is required to give the investment bank an agreement to cover any losses it incurs in purchasing the shares to cover the short.

In an 118.8m share ASR which IBM did in May 2007, it paid an initial price of \$105.18 per share for the shares purchased from the investment bank's short sales totalling \$12.5bn, and then another \$2.95 per share or a total of \$351m to cover the higher price of \$108.13 at which the banks eventually closed their shorts.

One of the rules that I have found in business life is that when management is doing something they really don't want examined they use polite euphemisms to camouflage the reality of the situation. Thus, the payments

by IBM to the banks are termed ‘adjustments’ in its accounts not “extra costs” or even “losses”.

This is a truly amazing thing for a company to do. I have previously contended (“Share buybacks – friend or foe?”, [page 20](#)) that many companies seem to pay little or no apparent heed to the implied returns from share repurchases or even the price at which they buy back shares. With an ASR they literally have no idea at what price they are repurchasing them. They have in effect agreed to write a blank cheque to the investment bank to cover the cost of eventually purchasing the shares. How can this be acceptable? Surely all but the most stupid management must accept the contention that the price at which shares are repurchased has some bearing on whether the repurchase creates or destroys value for remaining shareholders. What this implies about managements’ lack of understanding and/or care about shareholder value seems to me to amount to malfeasance.

Add to that the fact an ASR gives investment banks even more ways to take money from the unfortunate shareholders of these companies. No doubt there is commission and a bid–offer spread on the short sale, then interest on the stock borrow and prime brokerage fees for arranging it, then further commission and bid–offer spreads on the ultimate purchases. Who knows, maybe some of these companies are actually daft enough to pay an advisory fee for the investment banks’ advice on ASRs. It’s a field day for the investment bankers who, let’s remind ourselves, are engaging in a risk-free trade. Let’s also not forget that they earn precisely zero from that other totally acceptable means of distributing cash: dividends.

# *Murdoch should give up control of News Corp*

*INVESTMENT WEEK, 13 JULY 2011*

**T**HE announcement of an increased share buyback at News Corporation is clearly meant as a sop to shareholders who might justifiably be querying whether Murdoch family control is really in their best interests.

The main criteria which determine whether a share buyback creates value for remaining shareholders are a) the shares should be trading below intrinsic value; and b) there should be no better alternative use for the cash that would deliver superior returns than the buyback.

Given the outcome of News Corp's acquisitive activity in recent years, there seems little doubt a buyback would deliver better value than, for example, the acquisition of MySpace, for which News Corp paid \$580m and then sold it for \$35m, or the acquisition of Dow Jones for \$5.7bn which has so far produced a \$2.8bn write-down.

Whether or not News Corp's shares are cheap is more difficult to determine. They are certainly low-rated relative to peers such as Disney, Time Warner or Viacom, but the fundamental prospects must be more than usually difficult to determine in the light of the phone-hacking scandal and the uncertainty this has caused over the future of Sky.

More generally, looking at the performance of News Corp, an investor should surely query why Rupert Murdoch believes the best person to control News Corp must be someone named Murdoch.

So far his clan's control has produced a mediocre 10% return on capital employed over the past five years, and a share price which has underperformed the S&P 500 Index for the past 15 years.

It is almost certain that what would create far more value than a buyback would be for News Corp to enfranchise the class-A non-voting shares which the Murdoch family does not own.

# *News Corp: a family business*

*THE GUARDIAN*, 18 JULY 2011

**L**AST week, while I was in New York, I had the unusual experience of being interviewed about the implications of the phone-hacking scandal in the newsroom of Fox News for Sky TV. So I was being interviewed in the epicentre of Rupert Murdoch's news empire in America for the satellite TV channel where his son James is chairman and in which, at least until last week, his News Corp master vehicle was trying to buy out the outside shareholders. What happened in the interview was revealing about some aspects of this scandal which have yet to come into full focus.

In my view, the Sky News interviewer, Anna Jones, demonstrated a pro-Murdoch bias. I suggested to her that, as the CEO of a public company, I think the shareholders would have had me fired if I had indulged in the following:

1. paid \$580m (£360m) for MySpace and then sold it for \$35m (£22m)
2. paid \$5.7bn (£3.5bn) for Dow Jones and written off \$2.8bn (£1.7bn)
3. paid \$615m (£382m) for my daughter's business in an example of what has been described as 'blatant nepotism'
4. seen my company's shares underperform the S&P 500 Index for 15 years; and
5. been in charge when several of my staff had engaged in criminal phone-hacking and bribing police officers, activities which had been covered up by my management.

So, I asked, why hasn't Murdoch been fired? The answer, of course, is that nobody can fire Rupert Murdoch because the Murdochs control News Corp through differential voting rights.

News Corp has two classes of share capital: A shares which carry no votes, and B shares which have all the votes. The Murdochs own 40% of the B voting shares. The much more numerous A shares have no votes, so the

Murdochs are able to control a company in which they own only 13% of the total issued share capital (being the total of the A and B shares).

So when News Corp paid \$615m for Elisabeth Murdoch's business, Shine, her father was literally buying it mainly with other people's money – which as we all know is much easier to spend than your own. Similarly, the impact in terms of lost value of the other disasters which I mentioned has mainly fallen on those long-suffering but non-voting A shareholders in News Corp because they are putting up most of the money.

My responses about the Murdoch situation were clearly not what the Sky interviewer was expecting, or wanted to hear. She mounted a defence of Rupert Murdoch's achievements in building a 'big empire'. I reminded her that to qualify as a business empire, News Corp would need to generate, for example, a decent return on capital – something which it has failed to do.

Return on capital employed is one of the most important measures of corporate performance – it is the profit return which the management earns on the capital shareholders provide. News Corp has managed a decidedly poor return on capital employed of just 10% a year in the past five years. Comparable companies have done much better: the US media company Viacom managed a return of 20% a year and Daily Mail and General Trust 30% a year.

The interviewer ended by cutting me off after she said she would like to take me through the achievements of James Murdoch and Elisabeth Murdoch. I would welcome that debate on live TV. Of course, the clip of the interview on the Sky website omits the interviewer's questions and comments.

If this is the standard of editorial independence and integrity at Sky before the Murdochs owned the company outright, one can only cringe at the thought of what would have followed if they gained outright ownership.

The whole litany of phone-hacking, police bribery, and cosiness with politicians of both major parties who competed to see who could engage in the greatest pandering to the Murdoch acolytes is, in general terms, an example of an abuse of power. So is the shareholder voting structure at News Corp.

News International published an apology in the newspapers for the phone-

hacking scandal. Rupert Murdoch should apologise in person to his shareholders for the damage he has wrought and, since actions speak louder than words, he should enfranchise the class-A non-voting shares which the Murdoch family does not own. Then the owners of News Corp can pass judgement upon his actions.

# *UBS debacle highlights dangers of ETFs*

INVESTMENT WEEK, 16 SEPTEMBER 2011

**T**HE losses of \$2bn incurred by an allegedly rogue trader on the Delta One desk at UBS have again raised the subject of the (lack of) risk controls by banks dealing in opaque instruments, the need to separate investment and retail banking and the risks inherent in ETFs.

I have written over the past year about the unappreciated risks in ETFs and it is probably time to bring these thoughts up to date. ETFs are regarded by many investors as the same as index funds.

They clearly are not:

1. Some ETFs do not hold physical assets of the sort they seek to track. They are “synthetic” and hold derivatives. This gives rise to a counterparty risk, and as we saw with the UBS incident, some interesting risks within the counterparties supplying the basket of derivatives.  
What if (when?) such ETF trades cause such a mammoth loss in a counterparty which does not have sufficient capital to bear the loss and pay out under the derivative contract? Answer: the ETF will fail.
2. ETFs do *not* always match the underlying in the way people expect. Because of daily rebalancing and compounding, you can own a leveraged long ETF and lose money over a period when the market goes up but during which there are some sharp falls.  
Equally, you can own an inverse ETF (which provides a short exposure) during a period when the market goes down but there are some sharp rallies and lose money. This actually occurred with some inverse ETFs in 2008. I would strongly suggest that people would not expect to be leveraged long and lose money if the market goes up or short and lose it when it goes down.
3. Because you can exchange trade these funds, they are used by hedge

funds and banks to take positions and they can short them. Because they can apparently rely upon creating the units to deliver on their short, there are examples of short interest in ETFs being up to 1,000% short, i.e. some market participants are short ten times the amount of the ETF.

If the ETF is in an illiquid sector, can you really rely upon creating the units as you may not be able to buy (or sell) the underlying assets in a sector with limited liquidity?

In the past week, I am told there have been examples of the cost of borrowing (the cost of borrowing stock to deliver on a short sale until such time as you close the short by buying back) up to 14% p.a. on the IWM ETF (the iShares Russell 2000 Index ETF). Now why would someone pay 14% p.a. to borrow something in what is more or less a zero-interest rate environment and when you should be able to deliver the underlying securities to create unlimited units in the ETF?

The answer, I suspect, is that the short sellers cannot create the units because the ETF operates in an area with limited liquidity (the Russell 2000 is the US small-cap stock index).

The dangers of allowing short sales which are a multiple of the value of a fund in an area where it may not be possible to close the trades by buying back the stocks are clear – but, amazingly, during the debate in which I have been engaged by various cheerleaders for ETFs, they have claimed there is no such risk in shorting ETFs. They clearly do not understand the product they are peddling, and if they can't, what chance has the retail investor got?

4. Although ETFs are billed as low cost, they are also the most profitable asset management product for a number of providers. How can this apparent contradiction be so? The answer is that the charge for managing the ETF is only one part of the cost.

There are also the hidden costs in the synthetic and derivative trades which the provider undertakes for the ETF. As a result of all this, I have long thought and written that there is a certainty that ETFs are being mis-sold to the retail market and that the risks that are being incurred in running, constructing, trading and holding them are not



sufficiently understood. After the UBS incident, I think this should be regarded as indisputable.

# *The great contender – how Smokin’ Joe Frazier defined an era*

FINANCIAL TIMES, 12 NOVEMBER 2011

*‘I shall not look upon his like again’*

*– Hamlet, Act 1, Scene 2*

A quote from Shakespeare may seem an odd way to summarise the career of Smokin’ Joe Frazier, the former heavyweight champion boxer who died this week aged 67 from liver cancer.

What made Joe Frazier so great was his link to the men he fought – George Foreman and Muhammad Ali – and the significance their bouts had. We would all do well to remember that we are defined by those with whom we compete – be they boxer, banker or politician.

For an era in boxing to produce greatness it requires at least three contenders who are willing to fight each other. Why not just two? A beats B. B beats C. So when A fights C, surely it is a foregone conclusion? C may have lost to B, but may still have the means of defeating A in an upset that shocks the world.

So it was with Frazier, Foreman and Ali. Frazier won his title after Ali was stripped of it for refusing to be drafted during the Vietnam War. But he beat Ali on his comeback in 1971. It was Ali’s first defeat, floored in the 15th round by Frazier’s speciality – a left hook. Frazier went on to lose to Foreman in 1973. Foreman then fought Ali in the Rumble in the Jungle in Zaire in 1974, where Ali caused a great upset with his “rope-a-dope” tactics and reclaimed the crown.

Other boxers have since managed to engineer this dramatic tension in which several contenders fought an epic series of fights, most notably between middleweights Sugar Ray Leonard, Tommy “The Hitman” Hearns, Roberto Durán and “Marvellous” Marvin Hagler in the 1980s. But such encounters

between the best boxers are now a rarity. Television coverage of sporting events, and the associated money it brings with it, is the cause. If a channel advances tens of millions to a boxer for a series of fights, it is not going to risk its investment by putting him in against the best contender. So we are still awaiting the much-heralded encounter between Floyd Mayweather Jr and Manny Pacquiao, the two best welterweights in the world. This is one of the reasons for the proliferation of sanctioning bodies, each handing out their own version of titles. If the best boxers in the world are not going to fight for the world title, maybe they can all get a version of the title. When Frazier fought Ali and Foreman, there was only one world champ.

Many of the sportsmen who now have agents chiselling out money from television networks and sponsors will find out, as Frazier did, that making money is not the hard bit – holding on to it is. Like so many boxers before him, Frazier died penniless, living above a boxing gym in the Philadelphia ghetto. How many former star bankers, traders and hedge fund managers will prosper or suffer at the hands of nature's redistribution mechanism?

Even though there have been other periods when a group of three or so world-class contenders fought for the title, the clashes between Ali, Frazier and Foreman transcended their sport. They occurred against the backdrop of the upheaval over segregation in the US and unrest about the Vietnam War. This gave a meaning to Ali's fights beyond boxing. The two issues came together in Ali's explanation for why he had refused drafting: 'I ain't got no quarrel with them Viet Cong. They never called me nigger.'

The combination of these factors meant that their fights were more significant than any before or since. They had names: The Fight of the Century (Frazier v Ali, 1971), The Rumble in the Jungle (Foreman v Ali, 1974), The Thrilla in Manila (Ali v Frazier, 1975). Ali was the most recognised person on the planet. In an age before cable and satellite, if you wanted to watch the fight you either went to it or to a cinema to watch it on closed-circuit TV. It is hard to see boxing ever having such popular appeal again, and even harder to see athletes now having such stature that they transcend their sport.

Frazier was a man who, when asked by his cornerman Eddie Futch during the Thrilla in Manila whether he could still see Ali (he was partly blind in one eye and the other eye had been closed by Ali's punches), said: 'No, but

I can still feel him.’ This exemplified Frazier’s style: always going forward and close enough to feel his opponent. Boxers did not have to seek out Frazier in the ring. He was a true champion, who would never have failed to rise from his stool to fight one more round. But as a boxing saying goes: “You need brave fighters, not brave cornermen.” A cornerman’s duty is to take care of his fighter and Futch did so, at the price of Frazier never forgiving him for stopping the fight.

It is, perhaps, fitting to leave the last word on Frazier to a man who fought him, Foreman: ‘I wanted to be champ of the world but I kept hoping something would happen to Frazier. I didn’t want to fight him. The bell rung and he threw that left hook that barely missed me. It sounded like a bullet and I got nervous. I knocked him down and I said, he’s gonna kill me now. I knocked him down again and said, oh, he’s mad now. I knocked him down again. I kept knocking him down and he kept getting up. After six times I was awarded the championship of the world. He was still trying to get me when they stopped the fight.’

We may never see his like again, and the world is poorer for it.

# *Annual letter to shareholders 2011*

FUNDSMITH, JANUARY 2012

**T**HIS is the second annual letter to owners of the Fundsmith Equity Fund. Fundsmith opened for business on 1 November 2010, and so completed its first year on 31 October 2011. We have presented two sets of performance figures this year – the performance since inception and the last calendar year.

We remain critical of attempts to measure investment performance over short periods of time. Even a calendar year is too short for this purpose – it is the time it takes the earth to go around the sun and has no natural link to the investment or business cycle.

However, this proviso notwithstanding, the Fundsmith Equity Fund rose by 8.4% net of fees for the year. This compares with some relevant benchmarks as follows:

|                                      | Since inception | 2011   |
|--------------------------------------|-----------------|--------|
| <b>Fundsmith Equity Fund</b>         | 15.0%           | 8.4%   |
| <b>MSCI World £</b>                  | 3.2%            | -4.5%  |
| <b>MSCI EAFE £</b>                   | -6.1%           | -11.2% |
| <b>FTSE 100</b>                      | 2.8%            | -1.5%  |
| <b>FTSE Actuaries UK Gilts Index</b> | 14.7%           | 15.6%  |

The fund outperformed the MSCI World Index, which we regard as the most relevant comparator, by 12.9% for the year.

This strikes us as a good performance. It was achieved against the background of a year in which it gradually dawned on many people that the financial crisis of 2008–09 had not been solved but had rather been transformed into a sovereign debt crisis: if 2008 was the year in which governments saved banks, 2011 was the year in which the main question which emerged was who would save the governments. Against this

backdrop it is hardly surprising that equity markets performed poorly and so has the average fund.

Only six other funds in the IMA Global Growth sector (into which the fund is classified) achieved a positive return in 2011. This performance for the year took the fund to third place in the Morningstar performance rankings for global equity funds.

The main positive contributors to that performance were: Domino's Pizza, Philip Morris, Imperial Tobacco, Colgate-Palmolive and Unilever.

The main detractors from the fund's performance were: Serco, Stryker, Kone, Becton Dickinson and InterContinental Hotels.

Turnover in the fund in 2011 was 15%. This was higher than we would ideally like, although still significantly lower than most funds.

Part of this turnover was really involuntary. We sold Del Monte Foods prior to the closing of the cash bid from KKR, and sold our holding in Clorox after a bid approach from Carl Icahn which we correctly judged would not result in an actual takeover but which drove the share price to a valuation which we regarded as offering poor value.

Excluding dealing in Del Monte and Clorox, the turnover was 4% which is much closer to the level we seek (zero ideally).

The only voluntary turnover during the year were sales of our holdings in Kimberly-Clark Corporation and Domino's Pizza, Inc. Kimberly-Clark began to show adverse results from our regular calculation of the incremental return on capital. We sold the shares at a small profit. They have subsequently performed poorly in terms of fundamental performance although the share price has ironically been quite firm. We prefer to judge our investments by what is happening in their financial statements than by the share price. Domino's shares rose in price by 113% during the year and had reached a point at which they no longer represented good value. Domino's also has a re-financing of debt due by 2014. There is nothing in the performance of Domino's which causes us the slightest concern about this but there is plenty wrong with the banking system which will be required to provide the refinancing. As a result we hope to have the opportunity to become investors in Domino's again.

The net result of this was that the total expense ratio of the fund was 1.2%.

We hope to reduce that in future.

The historic dividend yield on the fund at year end was 2.4%. This dividend was covered 2.6 times by earnings. There is only one stock in the fund that does not currently pay a dividend. This is significant: it is becoming clear that dividends are likely to provide a more significant portion of the total return on equities in the future than they did in the equity bull markets of 1982–2000 and 2003–07.

The current yield on the fund may not fully reflect its dividend-paying capabilities as some of the companies also utilise share buybacks. During the course of the year we published some research on share buybacks ([tinyurl.com/y8d9l7bm](http://tinyurl.com/y8d9l7bm)) in which we concluded that buybacks were rarely accompanied by any reasoned justification; that they had become almost universally regarded as a good thing and contributing to shareholder value irrespective of the price paid or the valuation implied, which simply cannot be true; and in many cases their timing was poor.

During the year we wrote to the management of those companies within our portfolio which have engaged in share buybacks to ask for some insight into their rationale. The responses ranged from prompt, personalised (by the CEO) and well reasoned to being completely ignored. We regard the greatest risk for our investors – after the obvious potential for us to buy the wrong shares or pay too much for shares in the right companies – as being reinvestment risk: we seek to buy companies which deliver high returns on capital in cash. What the management then does with these cash returns is one of the major factors affecting future returns on the portfolio.

Management faces three main options for deploying these cash returns: return cash to shareholders, invest to grow the business organically or make acquisitions. The criteria they use for choosing between these options are important. So are the ways in which they operate each option.

So, for example, having determined to return a portion of earnings to shareholders, how does a management decide between a dividend and a buyback? In many cases we do not know as the management does not give any detailed rationale and we suspect that the answer is with the “benefit” of advice from their investment bankers who get fees, commissions, bid–offer spreads and maybe proprietary trading profits for advising companies

to pursue buybacks but get nothing when a dividend is used. No prizes for guessing which way the advice is slanted.

At the end of 2011 we held a portfolio of 24 stocks.

On average, companies in our portfolio were founded in 1894. We continue to invest in businesses which have shown great resilience over a long period of time.

The trailing free cash flow (FCF) yield at the start of the year was about 7% and about 5.8% at the end. The fall in the FCF yield was caused by a combination of the rise of share prices in the portfolio, changes in the portfolio and higher capital expenditure and working capital invested by the portfolio companies. This FCF yield compares with a median FCF yield on the S&P 500 of 6.1%. We have used the median, by the way, as the average is distorted by inclusion, for example, of a free cash flow yield of 76% on shares in Bank of America (BoFA). Before you rush to buy BoFA shares, however, you might like to know that cash flows at banks are not the same as they are at non-banking businesses. So, for example, in the calculation of BoFA's cash flow the computation adds back the provisions for bad debts and impaired assets which is a deduction from profits. This is strictly true – a provision is a non-cash item – but it means that comparisons of banks with other companies' cash flow in this manner is truly a case of comparing apples and ugly fruit (I chose a fruit which was more alphabetically remote from “A for apples” than the commonly used “P for pears” and which exemplifies our view of banks).

Our portfolio has a FCF yield about the same as the average for the market. Yet it is inconceivable in our view that it is not of higher than average quality in terms of longevity, resilience, predictability, gross margins, operating margins, return on operating capital and the conversion of profits into cash. Put simply, this means that we own shares in businesses which are higher quality than the market on a valuation about the same as the average for the market.

Last year I started a policy of allowing myself one rant per letter about a subject relevant to investment. I thought I would provide an update on how that went. Last year I sounded a warning about the perils of exchange-traded funds (ETFs). What happened next surprised even me (and I thought



I had lost the capacity for such an emotion in the face of the shenanigans of the financial services industry).

Practitioners within the ETF sector reacted with a fury which can only be generated by two factors: 1. the criticism was accurate and/or hit a nerve; and 2. it was in danger of derailing a large gravy train.

Some ETF practitioners suggested that I was criticising ETFs because of concerns about the impact the growth of ETFs would have on the active fund management sector in general and Fundsmith in particular. This response is not just wrong it is preposterous for two reasons:

1. Fundsmith's market share of the active fund management sector is so small that I do not possess a calculator capable of getting enough zeroes to the right of the decimal point to calculate it. As a result, ETFs could continue growing to the point where they had replaced most active funds and still leave Fundsmith with an insignificant share of the remaining sector, so they are unlikely to affect us.
2. I have long and publicly maintained that the best equity investment for most investors most of the time is an index fund because of its low cost and outperformance of most active fund managers.

In an effort to be clear, my criticisms of ETFs are:

1. ETFs are almost certainly being mis-sold. My straw poll of investment professionals suggests that many investors think that ETFs are simply index funds. Many are not. Synthetic ETFs do not hold underlying securities of the sector or market they are supposed to replicate. Inverse ETFs can lose money even when the market sector they track has gone down, and leveraged long ETFs can lose money when their market or sector has gone up. None of these is consistent with the performance of a simple index fund.
2. Synthetic ETFs are of particular concern. If a fund which is described by the words "synthetic", "derivative", "swap" and "counterparty" does not cause you obvious concerns, I suggest you may need to study the events of the Credit Crisis of the past four years more carefully.

3. Because ETFs are tradable on markets (unlike mutual funds) traders can sell them short. Relying upon the assumed ability to create more shares in the ETF in order to close these short sales, it is not unknown for the short interest in certain ETFs to reach ten times the size of the underlying ETF's assets. In these circumstances, the average ETF holder may be unaware that only some 10% of their holding in the ETF is represented by assets of the type they expect – the other 90% is a promise to deliver units from the short sellers. All will be well unless the short sellers find it difficult or impossible to buy enough of the underlying securities to deliver the required ETF shares, which in some illiquid index or sector ETFs is entirely possible.

My own warnings on ETFs were followed by warnings from, amongst others, the Bank of England, the Financial Services Authority, the International Monetary Fund and the U.S. Securities and Exchange Commission – in a rare example of closing the door on a stable which may still contain a horse. Since regulators have come in for so much criticism of their loose handling of the financial sector prior to the Credit Crisis, it would be churlish to criticise them for these warnings, and foolish to ignore them.

One more problem with ETFs became apparent to me in the course of this debate. ETFs are represented as low-cost investments. Yet research published during the year demonstrated that ETFs were amongst the largest profit generators for some banks. This seems counterintuitive: how does a low-cost product become a major profit contributor? The answer, of course, is that synthetic ETFs in particular provide banks with innumerable ways to “clip the ticket” of the ETF. The fees paid by the ETF investor are a very small portion of the total revenues which operating the ETF provides. They also deal for the ETF, provide the swap agreements by which it holds its synthetic positions (I wonder who works out whether the bank is providing them a fair price?), and maybe earn leverage, prime brokerage, custodian and registrar fees. The banks also deal for the hedge funds and traders who want to trade the ETF. At about this point, I began to realise why my critique of ETFs had caused so much fury.

My advice on this matter is simple. A broadly-based index fund is often the best investment you can make in the equity markets. But if you decide this is correct, buy precisely that, an index fund, not an ETF. The only difference between a physical ETF (which frankly is the only sort you should contemplate unless you like the risk of synthetic derivative swaps with counterparty risk) and an index fund is that the ETF is traded on the market as the term “exchange-traded” implies. Every piece of research I have encountered, and all my experience, shows that frequent dealing is the enemy of a good investment performance. So why buy an ETF rather than an index fund? You can deal daily in most index funds. The only people who want to deal more frequently than daily are hedge funds, high-frequency traders, algorithmic traders and idiots (these terms are not mutually exclusive). Why join them? If you don’t want active management, and mostly you shouldn’t, buy an index fund.

During 2010 Fundsmith also launched a SICAV and a US LLP. Neither of these affects your investment in the Fundsmith Equity Fund but I feel that you should be informed about this and it affords me an opportunity to raise another subject – currencies.

The SICAV is denominated in euros and based in Luxembourg. It is a so-called “feeder” fund – the only assets it holds are units in the Fundsmith Equity Fund. The US LLP is a Delaware partnership denominated in US dollars which is invested with exactly the same strategy as the Fundsmith Equity Fund but it cannot be run as a feeder fund.

We launched these two funds in response to investor demand. US-based investors face a massive tax disadvantage in investing in a UK fund as it cannot issue a Form K1 for IRS reporting, and offshore investors wanted a non-UK vehicle for investment. But in neither case does the denomination of the fund in a currency other than sterling affect the investments’ currency exposure.

We are often asked by investors whether we hedge currencies. The answer is a firm “No”. How would we do so? Should we base it on the currency of the country in which the companies are listed? This obviously would not work. There may be no connection between the country in which a company is listed and its area of operations. The same is true of its country of incorporation or headquarters. Nestlé is an example we often cite in this

respect. Although it is headquartered in Switzerland, has its main listing there and reports in Swiss francs, it has only about 2% of its revenues in Switzerland, so hedging our holding by selling Swiss francs forward against sterling would surely not be a hedge at all. It is also far from unknown for companies to report in a different currency to that of the country in which they are headquartered or listed.

Perhaps we should hedge currencies based upon the country in which each of our investee companies has its revenues? The problem with this approach is twofold. Firstly, most of the companies supply low-value items and so manufacture and sell locally or at least regionally. No one exports significant amounts of bulky low-value items such as detergent. So the exposure, if there is any, relates only to the profit margin. Secondly, the corporate treasurer may already have taken out a currency hedge for the translation and/or transmission of those profits so that any currency hedge by us would in fact be creating an exposure.

A lot of nonsense is talked about currency exposure and hedging. Our new funds denominated in euros and US dollars do not change the currency risks of those funds, which are driven by the underlying investments. For those who don't believe this, we are prepared to launch a new class of our fund which will change its currency denomination each year to the worst-performing currency. In 2011 it would have been denominated in Turkish lira – and would have risen by 32%. However, since you would receive this depreciated currency when you sell the fund units, you won't be any wealthier as a result. If you think you would be, let us know and we will set up the Money Illusion class of the fund.

We view the year ahead with some trepidation. It seems that it has yet to dawn on many of the key participants in the financial crisis that you cannot borrow and spend your way out of a crisis caused by overleverage, and that there is no higher authority than the governments (whose credit is now in doubt) which can extend further funds to provide a painless “solution” or maybe even a temporary respite. The dawning of this reality is sure to have some very painful consequences.

However, in contrast, the credit default swaps of Nestlé have been less expensive than the cost of insuring against default on the debt of European governments and the US Treasury for some time. We are far from believers

that the market is always right, but this does suggest that holding shares in major, conservatively financed companies which make their profits from a large number of small, everyday, predictable events is a relatively safe place to be if you have the patience, fortitude and liquidity to ride out the share price volatility which is likely to occur in such circumstances. And that's exactly where and how our fund is invested.

# *Traders are the ruin of retail banking*

THE GUARDIAN, 1 JULY 2012

**T**HE reaction of the British Bankers' Association to the revelation that Barclays traders had been manipulating the Libor interest rates – they say they were 'shocked' – is reminiscent of the scene in the movie *Casablanca* in which the gendarme Captain Renault closes down Rick's gambling joint and says 'I'm shocked, shocked to find that gambling is going on in here!' while simultaneously pocketing his winnings.

If the BBA was genuinely unaware that manipulation of Libor was going on, then its officers need to get out more. Its assertion looks doubly ridiculous given that it shares a chairman with Barclays, and will look increasingly unbelievable if, as seems likely, more banks are found to have engaged in this practice and other benchmark rates are found to have been rigged.

A great banker, the late Sir Brian Pitman, once said that most banks serve their employees well, but few serve their customers or shareholders. There was never any doubt that he was right about this, as he was about most things. But what conclusions should we draw from this latest example?

First, the arguments against separating retail and investment banks were always thin. Now they are surely unanswerable. It is quite clear that, whenever we allow investment bank traders to operate alongside retail bank operations (which are central to the economy's essential functions of credit creation and payment systems), the traders will overwhelm the retail bankers and the results will be damaging to the vital retail banking operations. We saw this in the causes of the credit crunch, when the investment bankers devised an alphabet soup of toxic products – CDOs, CLOs, CDOs-squared – and sold them to customers of the banks. We have seen it again with the staff taking part in the Libor setting suborned by their traders.

What needs to happen? The UK and the US must enact a Glass-Steagall Act

(the 1933 banking act passed in the wake of the Great Crash, which separated commercial and investment banking) and separate retail and investment banks. Ringfencing, as proposed by the Vickers Commission, will not work. As this Libor scandal illustrates, ways will be found to climb over, burrow under and go round the ringfence. The only people who seem to have lobbied against such separation are bankers. Why are we listening to them? Here the government has failed – its natural affinity to business has allowed it to be persuaded by the special pleading of the investment bankers who are now running many of our banks.

Second, we need to repeal those aspects of Big Bang which allowed banks, investment banks and brokerage firms to combine operations in which they traded for their own account and also acted as an agent for clients. In such organisations, the client always loses.

In addition, we need to learn an important lesson about who should be allowed to run banks. Traders should never be allowed to run banks. Traders are all about the short term and their myopia leads them to do things for short-term profit which risk ruination in the longer term. In my view, every bank that puts a trader in charge risks ruin. Take a look at the examples of Salomon Brothers, Bear Stearns and Lehman.

Look back to an era before British banks got into the problems which have followed their adventures in investment banking: their leaders were from a retail banking background – men like Bruce Pattullo and Peter Burt at Bank of Scotland, Willie Purves at HSBC, Malcolm Williamson at Standard Chartered and of course Brian Pitman at Lloyds. Knights of the realm to a man, and there's never been any question of a need to strip them of their honours. They were real bankers, and that's a compliment.

# *Lessons of the great Wall Street Crash*

THE INDEPENDENT, 24 OCTOBER 2012

**T**HE philosopher George Santayana said, ‘Those who cannot remember the past are condemned to repeat it.’ We are in the sixth year of the financial crisis which started in 2007 and experiencing problems which are reminiscent of the Great Depression, with faltering economic growth, high unemployment, deflation, and a badly damaged and still shaky banking system.

It’s therefore unsurprising that commentators and policy makers would look to that period for lessons on what to do and what to avoid.

However, what we need in order to learn from the Great Depression is a firm grasp of what happened then. Most commentary I hear or read is along the lines of: “The Great Depression was triggered by the Wall Street Crash, itself the result of laissez-faire capitalism. The Depression was deepened as a result of the failure of governments to adopt what would come to be called Keynesian techniques to stimulate demand and by adherence to the gold standard. It was only when Franklin D. Roosevelt took office and implemented the New Deal that America began to recover from the Depression as these Keynesian methods stimulated demand.”

Sadly, this version of events owes more to myth than reality. Firstly, the idea that laissez-faire free market policies were the root cause of the Crash and subsequent Depression is far removed from reality. In fact, Herbert Hoover, who preceded Roosevelt as president until 1932, was criticised by FDR for ‘reckless and extravagant spending’ and ‘thinking we ought to control everything in Washington’, and he introduced the Smoot-Hawley Tariff in 1930 which stopped many imports. The dramatic contraction of the money supply by the Fed, which began in 1929, and the rise in interest rates from 1928 helped to cause and then exacerbate the impact of the Crash. This was not simply a failure of capitalism or free markets. It had a lot of help from the government. The Hoover administration was interventionist,



not laissez-faire, and its interventions caused problems and made matters worse.

But surely all this changed after FDR said, ‘We have nothing to fear but fear itself’ (which was not original – it was a phrase borrowed from 19th-century writer Henry Thoreau)? Roosevelt announced spending of \$10bn when government revenues were \$3bn a year, and government spending rose by 83% between 1933 and 1936 while federal debt rose by 73%.

Simultaneously, many measures were implemented which were a drag on economic activity. The Social Security Act, which introduced a minimum wage, kept many unskilled workers out of the labour market. The Agricultural Adjustment Act produced the destruction of crops and cattle. The National Recovery Administration or NRA created a massive bureaucracy which increased the cost of doing business significantly: shortening hours and raising wages. Night work was banned. Five hundred NRA codes were introduced, governing production of articles ranging from lingerie to lightning rods. So-called “cutthroat” pricing was banned – a tailor was sent to jail for pressing a suit for 35 cents instead of the NRA-mandated 40 cents. How these anti-competitive and bureaucratic measures were supposed to promote activity is a mystery. The net result was industrial production dropped 25% in the six months after the NRA came into effect.

Simultaneously, Roosevelt’s Civil Works Administration (CWA) engaged in employment of masses in some perfectly pointless activities such as researching the history of the safety pin and using balloons to frighten birds away from public buildings. When the CWA became the Works Progress Administration (WPA), similar nonsense continued, such as cataloguing ways of cooking spinach. In a foretaste of our times, WPA workers were also used to collect Democratic Party campaign contributions. So was born the idea of a “client” class dependent on the state who would automatically vote for the party giving the handouts. The parallel with today’s loyal Labour following in the public sector in the north of England, Scotland and Wales is obvious.

Far from ending the Great Depression, such measures served to prolong it – preventing the workforce from seeking real jobs and diverting resources to politically motivated projects.

They were accompanied by a series of anti-business and “soak the rich” tax provisions. The top marginal rate of income tax was raised first to 79% then to 90%, personal tax exemption was lowered to just \$600 a year, estate tax went up to 70% and gift tax to 52.5%. Corporate taxes were also raised, with surtaxes for undistributed profits.

Unsurprisingly, the economy slumped back into depression in 1938 and the stock market halved again from 1937 to 1938, which can hardly have been the result of laissez-faire capitalism. FDR acolytes claim this was due to the Supreme Court outlawing the NRA and premature attempts to cut spending and balance the budget. But it is estimated that the reduction which resulted from this was only about 1% of GDP, which was far too small to cause the problem – just as austerity cannot now be the cause of the UK’s problems because there hasn’t been any yet. Government spending has continued to rise inexorably since the Coalition took office.

By the time war broke out in 1941, unemployment was still 17%. Hardly a triumph for two presidential terms of Keynesian policies.

So what did pull America out of the Depression? The Second World War? America’s involvement in the war was unique. It did not join the war until two years after it started, allowing America to benefit from the rearmament of the Allies as the ‘arsenal of democracy’, to quote FDR. Even when it entered the war, it suffered none of the destruction of assets and infrastructure which the other Allies did, other than the attack on Pearl Harbour, and so had all the benefits in terms of demand from rearmament and none of the disruption suffered by other combatants.

The war was then followed by the Truman administration, which was far less anti-business than FDR’s had been. This combination of factors was the cause of recovery.

We have to learn from history if we are not to repeat its mistakes, but we will learn nothing if the experiences of history are heavily edited to suit political agendas and prejudices. We need to be told the truth.

# *Lessons from the Tour de France*

*FINANCIAL TIMES*, 23 NOVEMBER 2012

**T**HE Tour de France has been in the news a lot this year, with a Brit winning it for the first time and Lance Armstrong being stripped of his titles for alleged doping.

You might ask what this has to do with investment. There's at least one vital lesson for successful investment from the Tour. It will be run for the 100th time next year, yet has never been won by a rider who won every stage, and it never will.

That's because cyclists, like investment products, are built for different ends. Imagine the peloton is like the mass of index-hugging funds. In each stage (quarter or year) it produces a winner, but the leadership continually changes. In the mountain stages, the climbers are those defensive funds that outperform in adverse market conditions, but don't do so well in rampant bull markets. The sprinters are the high-frequency traders built for speed. Gearing and derivatives are the investment equivalent of EPO and steroids – they can boost performance but at a cost, and added risk.

The Tour has three distinct stages. In the flat stages, the riders group together in the peloton, gaining advantage by slipstreaming those around them to save the effort of riding alone.

In the time-trial stages, the riders are on bikes with tri-bars on which they place their arms so that their posture is more aerodynamic. They wear skinsuits because they cannot “slipstream” as in the peloton. They set off individually, so the result is a pure test of riding ability.

Then there are the lung-busting mountain stages in which the rider must ride up alpine passes and roads. Here, it's about endurance.

There is no one rider with the physique to win all three types of stage. The way to win is to be excellent at one discipline, not bad at others, and to work with your team.

Searching for an investment strategy or fund manager who can outperform the market in all reporting periods and varying market conditions is as

pointless as trying to find a rider who can win every stage of the Tour. But this is precisely what many investors do. We persist in examining our funds' performance in every reporting period, as often as every quarter, and sometimes exiting when a manager underperforms.

An element of this is sensible – investment performance has to be measured over some time period, and some funds are persistent “dogs” in almost all market conditions.

But a quarter is too short a period to judge performance reasonably, and even a year is just the time it takes the earth to go round the sun. It is not a natural time period over which to measure the performance of any business or investment unless it is linked to the earth's orbit. To assess an investment strategy or a fund, you need to see its results across a full economic cycle with both bull and bear markets.

There is a lot of evidence to suggest that where investors are switching between funds and changing investment strategies, their timing is almost invariably wrong. Professional investors, in the form of trustees of endowments and pension funds, are just as guilty of this as retail investors. They often ditch managers after a poor streak only to find those managers recover their touch, while those they have adopted start to underperform. That would be like Team Sky parting with a cyclist who failed to win a mountain stage, only to see him triumph in a time trial.

Even worse are any strategies which rely upon an element of market timing. As the old saying goes, there are only two types of investor: those who can't time the markets, and those who don't know they can't time the markets. Like the Tour, investment is a test of endurance, and the winner will be the investor who finds a good strategy or fund and sticks with it.

# *Annual letter to shareholders 2012*

FUNDSMITH, JANUARY 2013

**T**HIS is the third annual letter to owners of the Fundsmith Equity Fund. We have presented three periods of performance figures this year – the performance since inception, the annualised returns and the last calendar year.

| T accumulation shares, total return | 2012 | Since inception to 31.12.12 | Annualised |
|-------------------------------------|------|-----------------------------|------------|
|                                     | %    | %                           | %          |
| Fundsmith Equity Fund £             | 12.5 | 29.4                        | 12.6       |
| MSCI World Index £                  | 11.4 | 14.8                        | 6.6        |

We remain critical of attempts to measure investment performance over short periods of time. Even a calendar year is too short for this purpose. It is the time it takes the earth to go around the sun and has no natural link to the investment or business cycle other than for agricultural businesses.

However, this proviso notwithstanding, how did we do in 2012?

The fund rose by 12.5% in 2012 and modestly outperformed the market (which we take as the Morgan Stanley Capital International World Index – or MSCI World – in sterling with dividends reinvested) by 1.1%.

I'm rather surprised that we managed to outperform the market at all in this reporting period. 2012 was a year in which so-called risk assets performed well. This is unsurprising in a year in which the major central banks in the developed world supplied increasing amounts of liquidity through their quantitative easing programmes in increasingly desperate attempts to keep some modest amount of economic growth. All that liquidity has to go somewhere and indeed the supply of liquidity by central banks' purchases of bonds helps to push investors towards the purchase of riskier assets, as does the regime of record low interest rates, of which more anon.

This is not an environment in which I would expect our fund to perform well relative to the market as the rising tide of liquidity floats all ships, many of which we would not consider owning.

Moreover, the year was characterised by what is in my opinion a naïve view: that the words spoken or (more rarely) actions taken have somehow helped to resolve the financial crisis we have been living with since 2007. I cannot see how the supply of liquidity can solve a crisis caused by overleverage and insolvency. These events were exemplified for me when the *Financial Times* declared Mario Draghi, the President of the European Central Bank, as its Man of the Year. This was based upon the fact that in July Mr Draghi pledged to do ‘whatever it takes’ to save the euro, which was followed by him doing precisely nothing – and yet the borrowing costs of the major European problem countries, most notably Spain, dropped and the eurozone crisis went into remission.

Depending upon your point of view, this is either an example of the perfect act of a central banker – the mere threat of action producing the desired result – or another episode in kicking for touch without any attempt to solve the underlying problems. No prizes for guessing which camp I am in, but in any event positive reactions to such events are far more likely to buoy the share prices of financial stocks, cyclical companies, those who might otherwise be bust or at least in difficulty and indeed a whole series of assets which we will never own in our fund. For example, the MSCI World Banks Index in sterling with dividends reinvested was up 22.3% in 2012. We do not own any bank stocks and will never do so. The *Financial Times* also reported that a number of hedge funds doubled their money by investing in Greek bonds in 2012. Clearly such a double or quits trade is not ever going to attract us, and it is hard to see how a fund manager can hope to repeat such trades consistently enough to warrant the risk, which is presumably one of the reasons why HSBC reported that 88% of hedge funds underperformed their relevant benchmarks in 2012. With assets such as this performing well I hope you can see why I am surprised that our fund outperformed the market.

It is also worth bearing in mind that we do not seek to outperform in every reporting period or in all market conditions. Rather, we seek to outperform the market and other funds over longer periods of time.

The analogy I use for this is the Tour de France, which topically was won by a British rider – the now “Sir” Bradley Wiggins – for the first time in 2012. The Tour is the greatest of cycling Grand Tours, with 21 stages run

over 23 days. In the 100 years since the Tour was first run, no rider has ever succeeded in winning every stage of a Tour. Nor in my view will anyone ever achieve this. This is because the Tour encompasses three distinct types of stage:

1. The stages in which the riders form a peloton and riders can gain vital aerodynamic assistance by slipstreaming (or getting “a wheel”) from the rider(s) in front of them. A team can carry a sprinter (like Mark Cavendish) in the peloton and release him close to the line for the final sprint in an effort to win the stage.
2. Time trials in which the riders are released individually and so cannot gain any assistance from each other. In order to maximise their own aerodynamic efficiency, the riders use tri handlebars, wear skin suits and aerodynamic helmets and often have solid rear wheels and wide rims on the front wheel. This is a test of individual riding ability over the whole stage.
3. Mountain stages which are run as a team but involve significant climbs, unlike the main peloton stages which are much flatter.

A rider needs a very different physique to win as a sprinter to a time trialist or a mountain climber – compare Bradley Wiggins with Mark Cavendish – which is why no one can win all stages. The rider who wins the Tour is likely to be one who excels at one discipline – Wiggins is a time trialist, the discipline in which he also won a gold medal at the 2012 Olympics – and is not too bad at, and obtains help from his team with, the other stages. Indeed, on two occasions, the Tour has been won by riders who did not win a single stage.

In my view there is a moral here for investors. What we are trying to achieve with Fundsmith is to win the investment equivalent of the Tour de France for you – to outperform over a long period of time. However, we do not expect to outperform all the time or in all market conditions. Rather our expectation is that we will perform relatively well in bear market conditions, and may struggle to keep pace in more bullish conditions, which is why I am surprised that we outperformed the market albeit modestly in 2012.

It is important that our investors recognise that this is what we are aiming for. Too often investors seek to find fund managers who can outperform all the time and in all market conditions. The trouble is that no such person exists. But the attempt to find this mythical creature leads to some investors moving their assets between managers, incurring costs and most frequently ditching a manager whose investment style is out of step with the current market in favour of one with recent good performance just as they are about to switch positions.

Having said all that, how are we doing at winning the Tour? Since inception our fund has managed an annualised return in sterling of 12.6% p.a. versus a return of 6.6% p.a. for the MSCI. This seems like a satisfactory start on our investment Tour campaign.

Our fund remains the best performing fund in the IMA Global sector since inception to the end of December 2012.

The main positive contributors to that performance in 2012 were: InterContinental Hotels, L'Oréal, Reckitt Benckiser, Kone and Diageo.

The main detractors from the fund's performance were: Procter & Gamble, McDonald's, Imperial Tobacco, Becton Dickinson, and a consumer company which we are in the course of buying a position in and so would prefer not to name at this point. McDonald's is a small position as it has only recently come within valuation range for us after reporting a number of periods with poor sales performance. We believe it is a business of the quality which we seek and therefore are willing to use this as an opportunity to buy stock. It might be worth thinking about the implications when a business which sells some meals for one dollar is struggling to grow sales. Clearly this is not because consumers are feeling flush and trading up.

Portfolio turnover in the fund in 2012 was 0.48%. This figure is flattered by the inflow of funds over the period, which is not included in the calculation (otherwise a new fund would have 100% turnover from investing cash inflows), but even so it is exceptionally low.

Our only outright sale during the year was of SGS, the Swiss testing company. We remain convinced that it and the sector are good-quality businesses, but the shares had reached the point at which they were one of



the most highly rated within our investable universe and so we thought that there was better value to be found elsewhere.

We finished the year with 28 holdings, up from 24 holdings at the end of 2011, which is towards the top end of our range but we are in the course of selling a holding which will reduce this number.

Our outright purchases for the year were Choice Hotels, Domino's Pizza, McDonald's, Visa and the aforementioned consumer company. Our purchase of Domino's is perhaps the one which requires most explanation since we sold it the year before. The sale was partly based upon apprehension about Domino's debt refinancing which had been postponed. We took this as a bad sign in a banking market which is exemplified by a cartoon which shows a man sitting in front of a bank manager (you can tell this because there's a sign on the desk saying "Bank Manager") who says 'I'd like to borrow some money' to which the bank manager replies, 'What a coincidence, so would we.' There is clearly nothing wrong with Domino's but plenty wrong with the banking industry on which it was reliant for its refinancing.

In the event, Domino's proved us comprehensively wrong. Not only did it manage to refinance but it did so on terms which enabled it to pay a \$3 per share special dividend. So I did what you should always do when you get it wrong (but which all of us rarely manage to):

a) admit this (most importantly to yourself)

b) reverse the decision.

So Domino's was repurchased.

Fortunately there was a period of share price weakness after the refinancing which enabled us to do this on reasonable terms, but frankly that does not matter as much as whether the shares were still good value when we repurchased them, which we believe they were. It is always a mistaken strategy to wait for the shares to get below the point at which you sold them before repurchasing, or the even more common trait of waiting for a loss-making share purchase to get back to break-even before selling. As I am fond of saying, the shares are unlikely to follow this desired pattern since they do not know whether you own them or not or at what price you bought or sold.

There are several morals to the Domino's trades but the main one is that almost every time we sell a position in a quality company we get to regret it in terms of subsequent share price performance. The good news is that we don't do it very often.

This brings me onto the wider subject of the expenses borne by the fund. The ongoing charges figure (OCF) for the year is likely to be 16bps or 0.16% in addition to the annual management charge. This is a 4bp reduction compared to the 2011 figure. These expenses are often ignored both by investors and other fund managers. But, like all charges, they detract from the performance of the fund, deserve proper attention and should be minimised. The fund can only perform as well as the performance of the shares it owns – and, to the extent that performance is absorbed by expenses, the returns for investors will suffer.

The majority of the costs borne by the fund are those of running and maintaining the share register. These costs are driven by numbers of shareholders and transactions. We continue to focus on reducing these charges, ensuring the fund benefits from economies of scale as it grows and does not overpay for services simply because of the increase in its size. If the fund remains at its current size, we would expect the OCF to fall by another 3bps in 2013.

Perhaps surprisingly, the OCF does not include all charges the fund has paid in the year. The commission paid on share purchases and sales are not included and neither is stamp duty or the bid-offer spread incurred in dealing. During the year, the fund paid £231,000 in commission – less than 4bp on the value of the total trades. The vast majority of those trades were due to inflows into the fund. Stripping out the commission on trades caused by the inflow, the amount of commission paid on trades executed voluntarily was under 1bp of the average funds under management. This compares with estimated charges incurred by the average UK mutual fund manager of about 1% p.a. excluding stamp duty.

Turning to the characteristics of our portfolio, probably the question I am asked most frequently is whether the strong performance of most shares in the fund to date means that they are now overvalued.

The weighted average free cash flow (FCF) yield – our primary valuation

yardstick – of the companies in the portfolio started the year at about 5.8% and finished at about 5.7%.

This 5.7% FCF yield compares with a median yield on the non-financial stocks in the S&P 500 of about 6.1% and an average of 5.4%; or a median for the non-financial stocks in the FTSE 100 of 4.6% and an average of 4.9%. The valuation of our stocks on this basis therefore looks about the same or a bit better (cheaper) than the average.

The yield is also significantly higher than the yield on government bonds, which was previously known as the risk-free rate (before investors started to relearn that governments default). This is significant. The coupon on those bonds cannot grow over time, whereas the free cash flow from our companies can. So if we can buy them with a higher FCF yield than the bond yield, then we have probably created value.

We should perhaps compare the FCF yield of the portfolio not with the yield on major government bonds but what we think that bond yield should be, since government bond yields across the developed world are distorted by quantitative easing (in which the central banks, controlled by the government, are the main or even the sole buyer of bonds). We work on the assumption that government bonds would need to yield at least 1% over the expected rate of inflation to attract rational investors, and so we seek to invest in companies only when their FCF yield is the same as or more than that required bond yield.

The return on capital of the companies in our portfolio averaged about 32% p.a. This compares to an average of about 20% p.a. for the non-financial stocks in both the S&P 500 and the FTSE 100. Bearing in mind the longevity and resilience of our portfolio companies, I think we can remain confident that we own stocks with a superior fundamental performance to the average which is not fully reflected in their valuation relative to bonds or other equities.

It may seem surprising that we can buy shares in quality companies at reasonable or even cheap valuations and thereby expect to generate superior investment performance. I have written a short research note in an effort to explain this entitled “Return Free Risk” which can be downloaded from our website at [tinyurl.com/y2hro8py](http://tinyurl.com/y2hro8py). The title is not a mistype, rather it’s a pun.

As investors we are taught that to obtain higher returns you must assume higher risk, but much of the evidence contradicts this assumption. The fact is that for much of the time you get better returns from investing in predictable high-quality companies than in smaller, riskier, more obscure company shares. But there appears to be a human desire to indulge in excitement and back the 100–1 shot rather than the favourite, and to engage in complicated bets such as the Yankee (defined as ‘four selections and consisting of 11 separate bets: 6 doubles, 4 trebles and a fourfold accumulator’). Can you accurately calculate whether the odds on such a bet are fair, in your favour or the bookmaker’s favour? If you can’t, then the bookmaker has the advantage. For bookmaker, read “market”. The principle is the same.

At Fundsmith we obtain excitement not from the delusion that we have discovered an investment that no other investors have found or from a long shot winning, but from delivering predictable, superior investment returns.

The marginal fall in free cash flow yield of our portfolio is a result of the rise in the share prices of the companies in the portfolio nearly offset by a 9.6% increase in the free cash flows per share produced by our companies.

On the whole, we would prefer that the share price performance of our stocks tracked the underlying free cash flow performance of the companies, since performance from increasing valuations is a finite game which also tends to even out over long periods of time, and we intend to run this portfolio for a long period of time.

Similarly, we would prefer that the increase in free cash flow from our portfolio companies was derived from top-line volume growth, albeit from companies which are able to maintain good prices and high margins on their sales. However, in the low-growth environment which we occupy, free cash flow growth is increasingly a result of cost-cutting and/or share buybacks. These are also finite sources of growth even when share buybacks are executed in a way which creates value for remaining shareholders, which is not always the case. But it is better to be invested in companies which can maintain growth in free cash flow per share by these means in these circumstances than in companies which can’t.

The historical dividend yield of the portfolio is 2.3% and we forecast the

prospective yield is 2.5%. Dividend cover remains 2.6 times. Yield is an important element of investment return. Over the long run, it has contributed a higher percentage of equity performance than share price appreciation. But I would caution against a blind search for higher yields.

The current record low interest rates and bond yields have produced a desperate search by investors for yield. The investment industry stands ready to supply products to satisfy any craving by investors, not always to their advantage. Investment flows have started to gravitate to higher-risk bonds such as junk bonds and emerging market debt as government bond yields in the supposed safe haven countries have shrunk towards zero. The yield on US high yield or junk bonds sank to 6% at the beginning of 2013, the lowest ever recorded. New issuance has boomed in high-yielding real-estate investment trusts, and so-called master limited partnerships in energy stocks and pipeline companies (I wonder how many investors can explain how they work). Even collateralised loan obligations (CLOs), part of the toxic alphabet soup of instruments which helped start the Credit Crisis, have been making a comeback, with issuance trebling in 2012. How soon we forget.

Equity investors are far from immune from this trend. For many investors the search for yield is satisfied by investing in an income fund which invests in high-yielding equities. This can be a mistake. At certain levels of yield, all that is happening is that the investor is being paid back some of the capital value of his or her investment as income, and taxed upon it. All but one of the income funds in the IMA Global Equity Income sector apply their charges not to income but to capital in order to maximise their stated yield. This has some obvious disadvantages, not the least of which is that it maximises the investor's tax bill as income tax is higher than capital gains tax and much more difficult to avoid or defer. It also exaggerates the true yield, which has obvious marketing advantages for the funds.

We think that investors should not focus solely upon yield but rather on the total return they derive from a share or a portfolio, and should not take the dividend yield as an exact indicator of what they can afford to remove from the fund periodically and spend. To this end we have recently launched a regular withdrawal facility for Fundsmith investors, which enables you to draw down whatever figure you want in a regular income from your

investment in the fund without reference to the dividend yield. I am convinced that this, rather than buying high-yielding shares which may have poor overall returns and managing them in a fund which overstates the yield by applying charges to capital, is the right way to address this need. It seems like an odd innovation for a fund manager to devise a way to make it easier for investors to withdraw money, so I doubt this will catch on with other managers.

The average company in the portfolio was founded in 1902 – this time last year it was 1894. Clearly some of our purchases have shortened the average age of our companies, which has produced a worrying leap on average into the 20th century.

Looking forward to 2013, one reasonably likely outcome is that we might experience “Groundhog Year” in which there are more EU summits, further commitments to do ‘whatever it takes’ whilst actually doing nothing, another “rescue” deal for Greece, wrangling over the US debt ceiling to follow the Fiscal Cliff, and more QE to keep an otherwise stagnant economy across the developed world alive on life support.

However, it seems likely that one thing is changing: the mandate of central banks in the developed world. The Fed recently doubled its monthly QE programme to \$85bn and said it would maintain this programme *at least* (emphasis added) until unemployment falls below 6.5%. Shinzo Abe became prime minister of Japan for the second time with the stated intention of making the Bank of Japan target an increase in inflation. Mark Carney, the much-heralded new governor of the Bank of England, got off to an unusual start by announcing seven months before he starts work that he thinks there should be a debate about whether central bankers should currently be targeting nominal GDP growth, i.e. ignoring inflation.

Now, depending upon your point of view, this is either good news because it means yet more stimulus will be applied – or bad news, because you do not think that the additional stimulus will do much to achieve economic growth or increased employment but it will risk side effects which can be as bad or worse than the ailment they are seeking to treat.

I am in the latter camp. I think that central bankers should be independent of government and should be concerned with the soundness of the currency,

and if they have the regulatory authority, the soundness of the banking system. Allowing them to stray outside that is dangerous as it will lead to confusion of fiscal and monetary policy, or in plain English, governments will be able to fund their profligate spending programmes by getting the central bankers to print more money and buy their bonds until the employment or nominal growth targets are achieved, or even beyond (note the term ‘at least’ used by the Fed).

At some point, the inevitable consequence of this is inflation and currency depreciation. The newer generation of central bankers such as Mr Carney have yet to experience that. When they do, they may discover that when inflation takes hold it does not conveniently stop at some predetermined target rate. They may also find that the only device they have to control inflation is the blunt instrument of interest rates, and a significant rise in rates would have some interesting effects on the affordability of government debt, private debt and the economy in its current condition.

You might legitimately point out that depreciation of the major currencies is a bit tricky as they are all trying to depreciate against each other in order to achieve some competitive advantage. But maybe they will all depreciate against hard assets, or to put it more simply – inflation.

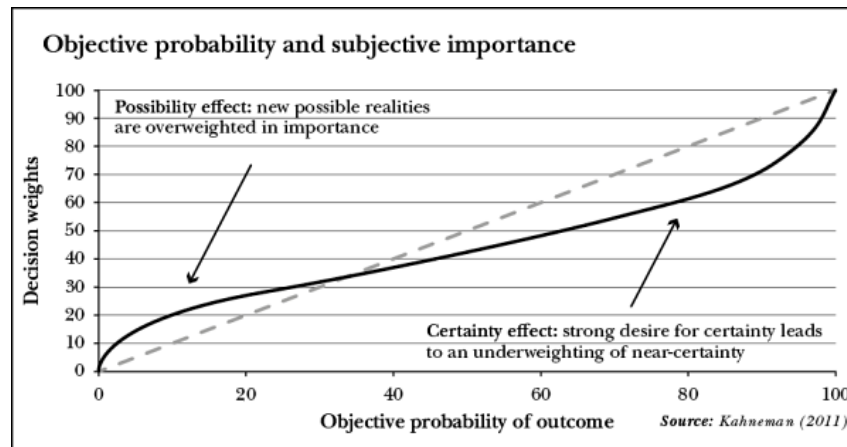
Still, whilst we wait to see if or when this scenario comes to pass, the good news is that macro views and developments have no bearing on our strategy; increasingly desperate attempts to stimulate the economy are far more likely to stimulate the valuation of our portfolio (not that we like to make money that way); and our stocks are likely to be a relatively good hedge against a resurrection of inflation.

# *Return-free risk – why boring is best*

*FINANCIAL TIMES*, 18 JANUARY 2013

**T**HE title of this piece is a play on the expression “risk-free return” used to describe the return on investment which can be obtained without incurring any risk to the capital sum invested. Prior to the current financial crisis, this characteristic was generally assumed to apply to sovereign debt in the developed world.

The efficient-market hypothesis (EMH) asserts that financial markets are “efficient” in that the only way an investor can achieve higher returns is to take on more risk. But this is not necessarily true in practice. Research by Robert Haugen of Haugen Financial Systems and Nardin Baker of Guggenheim Partners shows that the least volatile decile of stocks generated annualised total returns of 8.7%, while the most volatile decile lost 8.8% a year. These results seem flatly to contradict the risk/return bit of the EMH.



Another study by Goldman Sachs brings in fundamental quality – defined as cash return on cash invested, or CROCI. It created portfolios based upon CROCI performance and found that market returns increase with relative CROCI. Better companies made better investments.

But why can “quality” shares outperform like this when EMH postulates



that only more risk can drive superior returns? Part of the answer lies in investor psychology.

Imagine you have a gravely ill loved one, but you can purchase treatment that would enhance their chances of survival by 10%. What would you pay for it?

Research suggests that this depends upon their starting chances of survival without the treatment. If their chances were 50/50, then a 10% improvement would certainly be valuable.

But if their chances were zero, I'd suggest most people would pay more to improve that to 10%.

Similarly, most people would surely pay more highly for certainty – if the relative had a 90% chance of survival, but by paying you could take this to 100%.

This goes some way towards explaining why investors will buy a bond which yields less than an equity in the same company. They desire certainty of outcome: the bond will pay a certain coupon and be redeemed for a certain value at a certain time. By contrast, dividends from the equity may vary or even disappear and the price of the shares is unpredictable. Daniel Kahneman, the psychologist and behavioural economist, illustrates this point in his book *Thinking, Fast and Slow* using the chart on page 53.

The solid line is the “decision weight” – the psychological importance attached to each level of probability, derived from laboratory experiments. You can see that from about zero to 30% probability of survival, the relative will pay more for a given level of probability. From about 30% to close to 100% they will underpay, but there is a sharp increase in the relative amount they will pay from about 90% probability to certainty.

In investing, the near-certain bit just before 90% is the world of low beta/high-quality stocks. They have bond-like returns and low share-price volatility, but they are still stocks with uncertainty about share price and dividend payments.

This helps to explain why “boring” quality stocks tend to be consistently undervalued, and that undervaluation is what helps to produce superior performance.

The upshot of all this is relatively simple, but nonetheless startling. Rather than seeking superior portfolio performance by chasing high-risk stocks (“return-free risk”), investors should seek out “boring” quality companies which have predictable returns and superior fundamental financial performance, and take advantage of their persistent undervaluation relative to those returns to buy and hold them.

# *Ten golden rules of investment*

*FINANCIAL TIMES*, 15 FEBRUARY 2013

**I**N theory, individual private investors have plenty of advantages compared to managers of big retail and pension funds. They don't have to write quarterly reports to investors justifying their fees. They don't have to worry about beating benchmarks all the time. And they're not constrained by rules about liquidity or limits on portfolio constituents.

But many investors fail to capitalise fully on these advantages because they make basic mistakes, such as buying the wrong companies, trading too often and paying charges that are too high. My rules are designed to help investors avoid such pitfalls – I'll be expanding on some of them in future columns.

## **1. If you don't fully understand it, don't invest**

Reginald Mitchell, the designer of the iconic Spitfire fighter plane, once said: 'If anybody ever tells you anything about an aeroplane which is so bloody complicated you can't understand it, take it from me: it's all balls.'

The same is true in investment. How many investors have bought, or rather been sold, "structured products" without truly understanding the risks involved? My personal favourite to illustrate this point is a fund launched in 2011 by Parkstone Asset Management called The Tracker UK Managed Alpha Fund. This described itself as a 'securitised derivative, low-cost, actively managed, multi-asset, structured investment'. I wonder what it does.

I always think that if you can't understand what an investment does, it is because you are not meant to understand. So don't invest in it.

## **2. Don't try to time the market**

"Market timing" is investing somewhere near the bottom in market cycles and getting out somewhere near the top. It sounds obvious and simple, but in practice it works in reverse: money flows into funds and markets when they have gone up and comes out when they have gone down.

Stocks are a “Giffen good” for most investors – demand paradoxically rises as their price increases. Investors feel comforted by the presence of others investing or dis-investing alongside them, rather like lemmings heading towards a cliff edge together. We don’t enjoy the lonely feeling of the contrarian who invests when everyone else is selling and sells when everyone else is bullish.

Humans are hard-wired to be bad at market timing, so don’t try to do it.

### **3. Minimise fees**

Fees paid to fund managers and advisers are a drag on investment performance. The average UK investor who invests via an adviser, uses a platform and then invests in mutual funds incurs total charges of about 3% each year. This is higher than the yield on equities and most government bonds. So all and more of the income from his or her investments is being consumed by fees.

### **4. Deal as infrequently as possible**

Since we’re so bad at market timing, and fees eat into our returns, it logically follows that investors should deal as infrequently as possible. The same applies to fund managers. But the Financial Services Authority estimated that the average UK mutual fund manager turns over 80% of his or her portfolio each year, and in so doing incurs an additional cost of about 1.0–1.4% in commissions, bid–offer spreads and stamp duty. This lot is added to annual management fees and is yet another drag on your investment performance.

### **5. Don’t over-diversify**

While portfolio diversification can improve your investment performance, it does have limits and is not without drawbacks. Research suggests that 90% of diversification benefits can be obtained in most markets with a portfolio of just over 20 stocks. The more you diversify beyond that, the less you know about each investment.

### **6. Never invest just to avoid tax**

Instruments like venture capital trusts, enterprise investment schemes and

film finance projects are primarily vehicles to enable you to avoid or defer tax. Many investors who put money into them have no burning desire to invest in movies or solar panels. They are so blinded by the tax advantages that they tend to overlook the mammoth fees and the poor performance of the underlying investments. It's often cheaper just to pay the tax.

## **7. Never invest in poor-quality companies**

A good company is one that regularly makes a high return in cash terms on capital employed, and can reinvest at least part of that cash flow in order to grow its business and compound the value of your investment. Bad companies do not do this. They make inadequate returns on the capital they employ. You may think you should invest in these poor companies as they are going to improve because the management will change, or they will be taken over, or their results will pick up with the economic or business cycle. But each day you wait for such events, these companies destroy a little bit more value. Good companies do the opposite. With a good company, time is on your side.

## **8. Buy shares in a business which can be run by an idiot**

Never buy shares in companies which require a genius or charismatic chief executive to make them work. Sooner or later that individual will no longer be there, and what then?

## **9. Don't engage in "greater fool theory"**

Only buy investments that you really want to own and at a price at which you are happy to own them. If you buy shares – or any other investment – with the sole intention of on-selling them, or if you overpay even for good companies, you are engaging in "greater fool theory". The success of that strategy depends upon someone else being willing to play the same game.

## **10. If you don't like what's happening to your shares, switch off the screen**

The price of the shares you buy may vary for reasons which have nothing to do with the fundamentals of the business. So movements in share prices are not necessarily a guide to whether your investment is good or bad. If you

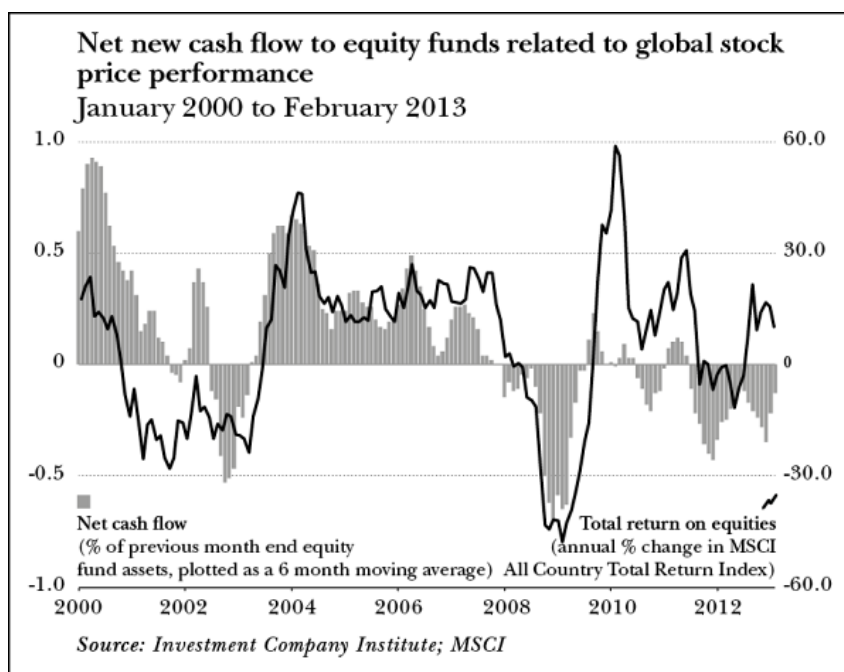
have chosen shares in good companies or a fund at reasonable prices, and you find gyrations in their prices unsettling, then simply stop looking at the share prices.

# *Market timing: don't try this at home*

## The fundamentals of investment, part 1 of 5

*FINANCIAL TIMES*, 1 MARCH 2013

**W**HAT is meant by market timing? It's the classic investor aim: to buy low and sell high. This can be applied to individual stocks or funds, trying to buy them at the bottom of a business or market cycle and sell close to the top, or to the timing of committing your funds to the market as a whole – waiting for a market bottom before coming out of cash and taking the plunge, and cashing out when the market is at a top.



Nothing wrong with that, you might think. Surely it enhances your return to miss the fall in markets from a peak and get back in for the recovery from its lows? It does indeed. The trouble is that very few, if any of us, are any good at it.

There is quite a lot of data available about investors' behaviour and as the chart shows, investors' flows into and out of funds mainly achieve the

opposite of what is desired. Money flows into markets and funds when they have risen and flows out when they have fallen – precisely the opposite of what effective market timing would require.

Professional investors, such as fund managers and trustees of pension funds and endowments, may scoff at this as the typical herd instinct of retail investors. But the available evidence suggests that they are no better. The average active fund manager underperforms the market and Cambridge Associates' data clearly shows that the average pension fund or endowment decision to hire or fire a fund manager is just as mistimed.

It is not hard to see why we are almost all bad at market timing. It is hard enough to have the strength of conviction to convince yourself that markets are too high and sell when the background is looking rosy and everyone else is bullish. But it requires an extraordinarily flexible psyche to be able to complete the required volte-face at the bottom and buy the stock, market or fund after your predictions have come true, its prospects look bleak and the price has fallen.

Another way of looking at this problem is to examine how few days you need to miss being in the market to seriously damage your investment returns. If you take the decade from 31 December 1994 to 2004, the S&P 500 Index produced a compound total return of 12.07% each year. That's what you would have got – before costs – if you were fully invested in the index. Put another way, \$10,000 invested at the outset of the ten-year period would have become \$31,260 by 2004.

But what if you have tried some market-timing moves and as a result missed a few days in the market, which happened to be some of its best days in that decade? What if you missed just the best ten days? That's not much, is it – one day per year on average. Maybe, but your return would be cut to 6.89% a year and you would be left with \$19,476. If you missed the best 30 days, your returns would be negative.

You may argue that you might also have missed some of the worst days, but all the evidence is that there are more good days than bad days. Do you really think you are good enough to spot those days and make sure you are fully invested and ready for them? I know I'm not.

Which brings me to my punchline: there are only two types of investors –



those who know they can't make money from market timing, and those who don't know they can't. This is why I seek to follow the advice from a great investor, which is that you should buy low and sell high, but if you are buying stocks in high-quality companies, it doesn't matter if you forget the second bit. But that's an article for another day.

# *Sorting the wheat from the chaff*

## **The fundamentals of investment, part 2 of 5**

*FINANCIAL TIMES*, 15 MARCH 2013

**I** ENDED my last article about market timing, which can be encapsulated by the mantra “buy low, sell high”, by saying that if you buy shares in good companies at reasonable prices, you’ll still make money even if you forget the “sell high” bit.

But what do I mean by “good companies”? If you read investment research, you will see a great deal about earnings growth, growth in earnings per share or valuations based on earnings per share. You will rarely read much about a company’s return on capital employed (ROCE).

That’s a shame, because ROCE is important. If you invest your capital in a fund, a bond or a bank account, you will be very interested in the expected rate of return you will get. If you buy a share in a company, you are in effect purchasing your share of its capital. Why aren’t you interested in the return it will earn on it? After all, you own part of it. Return on capital employed is usually calculated as cash operating profit divided by the sum of shareholders’ equity and long-term liabilities – all numbers that can be found in a normal set of company accounts.

If, as individuals, we borrow money at a rate of say 5% each year and we invest it at a return of 10% a year, we will become richer. But if we earn a return of 2.5% we would become poorer. The same is true of companies. Those that make a return above their cost of capital create value for their shareholders, while those that make a return below their cost of capital destroy value.

But assessing companies on this basis is less easy than just looking at earnings because of the cost of capital concept. We can easily assess the cost of a company’s debt – a description of the debt profile and interest costs is usually included in the notes to a company’s annual accounts – but what is the cost of its equity capital? This is the subject of much research and in reality it can only ever be an estimate. But don’t let that put you off,

because as an investor you should only be truly interested in companies whose returns are so high that they exceed any feasible cost of capital.

There's no need to accept my word for this. In his 1979 annual letter to Berkshire Hathaway shareholders, Warren Buffett described return on capital as the primary test of performance in managing a company. It has often puzzled me why such a clear statement from such a successful investor is so widely ignored.

You may think that your fund manager is busy using metrics such as ROCE to dig out great investments. Not in my experience. Managers will often invest in companies in industries with endemically poor returns. Why? Because they think that they can pick a point to buy the shares at which the performance of the company will improve. Maybe they expect the business cycle to pick up, or a new management team will take over, or the company itself will be taken over.

A good example of this is the airline industry, where consolidation has long been a great white hope. The International Air Transport Association (IATA) and the consultancy McKinsey published a report in 2011 called *Vision 2050*. It showed that there was \$500bn of capital invested in the airline industry in 2010. IATA/McKinsey reckoned the industry had an overall cost of capital of 7–8% a year. Comparing the returns generated with this cost of capital over the previous decade, they found that the airline industry destroyed value at the rate of about \$20bn a year. During the 2002–09 business cycle, airlines' return on invested capital averaged just 2.8% a year. Even in 2007 – the best year for the industry during that decade – the industry still destroyed more than \$9bn of investor value on this basis. And airlines are far from alone.

The problem is that while fund managers who buy these low-return companies wait for the events which they think will change the situation, the companies destroy value. But the reverse is true when you own shares in a company that generates returns well above its cost of capital. You don't need to hold out for a takeover, a boardroom coup or a change in the business cycle, because you can be assured that its intrinsic value is growing practically every day. Time is on your side.

# *Never invest just to avoid tax*

## **The fundamentals of investment, part 3 of 5**

*FINANCIAL TIMES*, 28 MARCH 2013

**T**HE tax year ends this coming week and if your mail is anything like mine, you are being inundated with offers of investments which qualify for tax relief provided you invest on or before April 5.

Some of these offers make sense. They are the ones in which tax relief is available for investment through a so-called “wrapper” such as an individual savings account (ISA) or a self-invested personal pension (SIPP). You don’t pay any tax on capital gains realised or dividends received in your ISA, or on any funds withdrawn from it, and you can also get tax relief on contributions into SIPP. You can put sensible investments into ISAs (stocks, cash, mutual funds) and an even wider range of assets in SIPPs, including commercial property.

The problem comes when you invest mainly to obtain the tax relief, rather than because of a genuine desire to invest in the underlying assets. With enterprise investment schemes (EISs), film finance schemes and venture capital trusts (VCTs), I suspect that the main object of most investors is to avoid or defer tax rather than to access the highly restricted and specialised investments which these schemes involve.

Do you really want to invest in unquoted companies with less than £15m of gross assets, which is what is required to qualify for an EIS or a VCT? And should anyone invest in movies? Last year, Disney, which is not exactly inexperienced in the movie business, lost more than \$200m on the movie *John Carter*.

We are often blinded by the ability to avoid tax. Not only does this lead us to invest in assets which we would not normally consider, but it means we tend not to look as closely at the fees which are charged. From a selection of EISs and VCTs, I found initial fees which ranged from 2% to 7.5% of the amount invested, charges of 2 to 3% each year and performance fees, typically at 20% on any gains, albeit over a hurdle rate. A product with such

a rich fee structure generates a lot of sales effort, as you may also have spotted from your mailbox.

This combination of tiny, illiquid companies and high fees produces an inevitable result. Out of 131 VCTs, only 17 have a net asset value higher than the subscription price. Worse than that, the only way you can realise your investment in a VCT is to sell the shares. That is usually done not at net asset value (NAV) but at the share price, which typically trails the NAV by some margin. Only five of the 131 had a share price above their issue price, partly because purchases in the secondary market don't attract tax relief.

To be fair, a lot of VCTs distribute dividends, as they are also exempt from tax, but if I look at the only VCT which I have ever invested in, the cumulative total of dividends plus NAV barely gets me back above the price at which I subscribed for the shares seven years ago. A prospectus inviting new subscriptions this tax season shows the total return since subscription excluding subscription costs as 8%. That's not 8% per year; it's 8% in total.

You might object that I was unlucky or chose badly. But the VCT in question features in the middle of the 131 VCTs in NAV terms, and scored 86 out of a possible 100 in "Tax Efficient Review" in February.

Managers of tax-based investments seem to want investors to focus on returns after tax relief. So if you got 30% income tax relief on your VCT subscription, they will try to get you to focus on the return from the 70p each £1 invested cost you after tax relief (even though the tax relief is actually applied to your tax code through self-assessment, not added to your investment as basic-rate pension tax relief is).

The flaw in this argument is that the 30p was supplied by the taxman, not by the manager, who had 100p to invest, before the not-inconsiderable fees, of course.

Rather than investing in assets you would not normally want to own through these complex, illiquid and expensive vehicles, purely to avoid tax, it is usually better to invest in things you really want to own and pay the tax due on any profits you make.

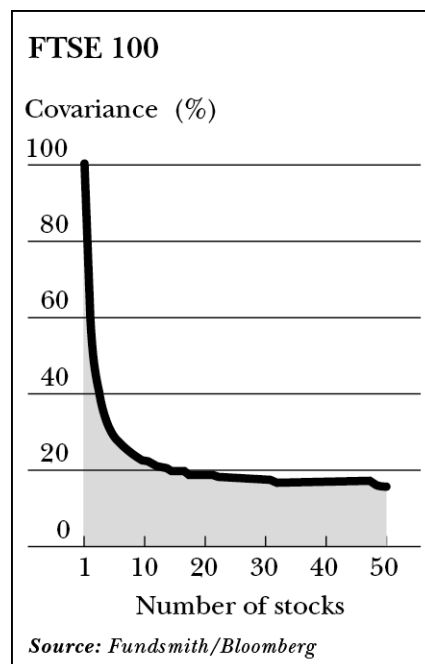
# *Too many stocks spoil the portfolio*

## The fundamentals of investment, part 4 of 5

*FINANCIAL TIMES*, 12 APRIL 2013

**P**ORTFOLIO diversification is a good thing. Right? Whether you reach that conclusion intuitively from the simple adage “don’t put all your eggs in one basket” or have heard of modern portfolio theory, you know it makes sense.

The concept of modern portfolio theory is that a collection of investment assets has lower risk than any individual asset. This is possible because different types of assets often change in value in opposite or different ways.



But like many concepts in finance, portfolio diversification requires more than superficial examination if you are not going to get some unintended or downright poor results from applying it.

Covariance is a measure of the degree to which returns on assets move in tandem. A positive covariance means that returns move together. A negative covariance means returns move inversely. The lower the covariance number, the less risk.

Unsurprisingly, the covariance of a portfolio of FTSE 100 stocks falls as the number of stocks in the portfolio increases, but the covariance – or risk – does not fall in a straight line. The risk falls sharply as the portfolio increases in number from just one stock, but by the time it has reached about 20 to 30 stocks most of the reduction in risk that can be attained has already been achieved.

The problem is that increasing the number of stocks beyond this not only fails to achieve any significant further risk reduction, but it also leads to other problems. In “Sorting the wheat from the chaff” ([page 49](#)), I wrote about why it is important to invest in good companies. But there is a severe limit to the number of good companies available – and the more stocks you own, the more you are likely to have to compromise on quality.

It is also a fact that the more stocks you own, the less you know about each of them and I have never found a theory of investment that suggests that the less you know about something, the more likely you are to generate superior returns.

There is even a term for this: “diworsification”, which was coined by the legendary fund manager Peter Lynch in his book *One Up On Wall Street*. He suggested that a business that diversifies too widely risks destroying itself, because management time, energy and resources are diverted from the original investment. Similarly, adding more investments to a portfolio can lead to diworsification.

Ultimately, if you own too many stocks, your performance will match that of the benchmark or index which is composed of those stocks. There is no point in managing a portfolio or paying a fund manager to do so if you are going to do this. It is cheaper to simply buy an index fund.

Given this limitation to the benefits of diversification, why do so many fund managers own far more stocks than are necessary to obtain optimal diversification? A study from the US in 2008 (*Security Concentration and Active Fund Management: Do Focused Funds Offer Superior Performance?* by Travis Sapp and Xuemin Yan) showed that the average mutual fund manager owned a portfolio of 90 stocks, and the 20% of fund managers with the most diversified portfolios owned an average of 228 stocks.

The answer is that most fund managers perceive the biggest threat to their job is not whether they lose investors' money but whether they differ from their peers. If they own so many stocks that they hug the index, they feel that they cannot be criticised.

The problem is that this behaviour, when combined with high fees for so-called active management plus overtrading, leads to an inevitable outcome: the fund underperforms the index. But this is the subject for another article.



# ***Keep a lid on costs to protect your investment***

## **The fundamentals of investment, part 5 of 5**

*FINANCIAL TIMES*, 29 APRIL 2013

**T**HIS is the final part of my series on the fundamentals of investment. So far, I have looked at why most or all of us should not try so-called market timing, and should instead focus on buying shares in good companies and holding them. I've suggested that you should never invest primarily to avoid tax, and that over-diversification in a portfolio is not only pointless but injurious to your investment performance. My last piece of advice concerns investment costs.

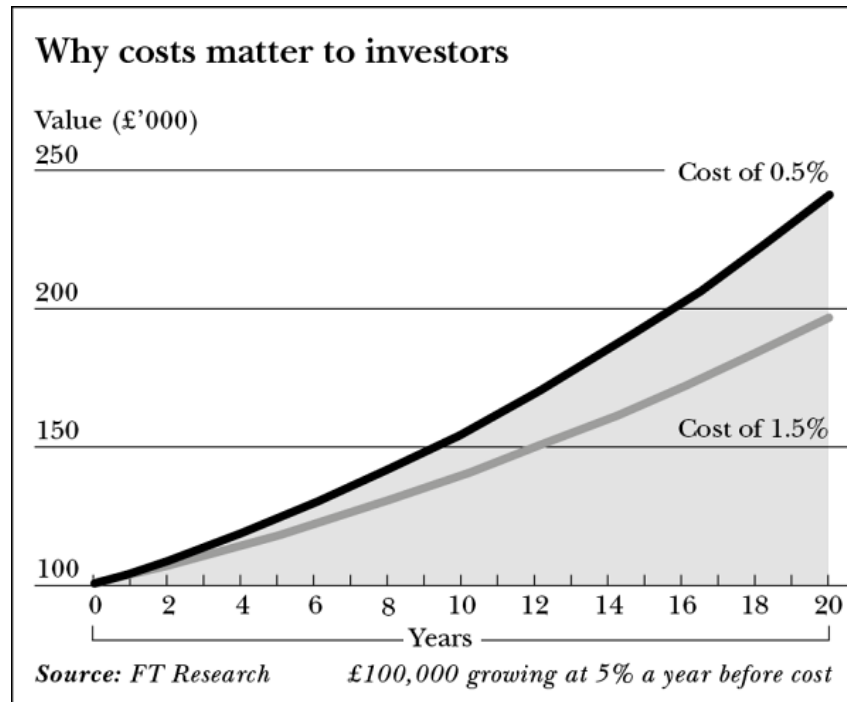
Even if you run a concentrated portfolio of quality shares, your returns will be constrained if you fail to control costs. Many investors are unaware of precisely how much they are being charged for their investment activity, so let's have a look at the costs the average investor might incur.

Financial advisers and wealth managers typically charge fees of 0.5–1.0% on the value of the portfolio, and will often use an investment platform to hold the individual funds or shares. That might cost another 0.25% a year, usually collected as “trail commission” from the underlying fund managers. The investor may also use the platform direct.

If the investments are held in mutual funds, there will be an annual management charge (AMC) of 0.75–1.5%. In addition, the funds charge certain expenses to the fund: typically things such as custody, administration and legal expenses, but they have been known to charge marketing expenses too. Add that lot up and you get to what used to be called the total expense ratio and is now known as the ongoing charges figure. That's typically 1.0–1.75%; add in platform and advice costs and the running total is generally between 1.75% and 3%.

Even that isn't it. There is also a hidden cost which is not disclosed in any of these figures: the cost of dealing within the fund. When a fund manager

or an investor deals in stocks, he or she pays commissions, stamp duty at 0.5%, the levy that funds the Takeover Panel and the difference between the broker's bid and offer prices (the spread). A big order in a low-liquidity share might force the price up quite a lot.



Data published in a Financial Services Authority study (“The Price of Retail Investing in the UK”, by Kevin James, available at [tinyurl.com/y2xuy8gf](http://tinyurl.com/y2xuy8gf)) suggested that the average UK fund manager turned over about four-fifths of the portfolio each year. Apart from the questions this raises about the lack of conviction and hyperactivity, it would suggest that additional undisclosed costs of up to 1.4% are being incurred each year on top of the “total” expense ratio.

All that would be bad enough, but these costs are in stark contrast to the income available from bonds and equities. The yield on the FTSE 100 is 3.8%, on the S&P 500 it is 2.1% and 10-year government bonds in countries such as the UK and the US yield significantly under 2%. In other words, more than 100% of the expected income on portfolios is being absorbed by charges.

Given this myriad of charges, you might ask how the funds are able to pay dividends. The problem is not immediately apparent, because many funds,

and almost all income funds in particular, apply these charges to the capital value of the fund and not as a deduction from income. But this does not alter the fact.

John Bogle, the legendary US investor and founder of Vanguard, calculated that during the 81 years to 2007, reinvested dividend income accounted for approximately 95% of the compound long-term return earned by the companies in the S&P 500. The bull markets of 1981–2000 and 2003–07 may have misled investors into thinking that equity investment is mainly about share price appreciation. But history suggests otherwise. No one can afford to throw away all or more than all of the income from their portfolio on charges. If you do, the inevitable result is that you will experience poor performance net of these fees.

So how do you avoid or reduce charges? The obvious routes are to cut out as many of the layers of intermediation as you can between you and the actual stocks which you own. It is those layers which add to the costs. Where you can, invest direct. The other method – though it might seem odd for an active manager to advocate this – is to buy an index fund, which just tracks an index. You should be able to buy an index fund for all-in charges of 0.25% a year or less.

Given that the average active fund manager underperforms the benchmark index anyway, why would you pay more?

# *If they use these words, don't buy their shares*

THE TELEGRAPH, 18 OCTOBER 2013

**H**AVING been involved in financial analysis for nearly four decades, I have increasingly formed the view that there are some words and phrases used by company managements, analysts and commentators which investors should be wary of. Apart from being an abuse of the English language, they represent a combination of woolly thinking and a desire to disguise or divert attention from a problem.

Take Walmart, the US-based retailer. In a recent results presentation, the management used the term “leverage” no fewer than 80 times. Leverage has a legitimate meaning. It can mean to use a rigid bar to move an object. It can also mean the use of borrowing for finance which magnifies or “leverages” the operating results of a business.

It should not be used, as Walmart did, to say, ‘Asda is a leader in online grocery delivery, and we’ve leveraged that experience in the US.’ Copied, benefitted or learnt from, but not leveraged.

It is probably no coincidence that this mass outbreak of Banned Word Syndrome (or BWS, as you must have a three-letter acronym) accompanied a set of results in which Walmart revealed falling sales.

So this first category of words which shouldn’t be used, and which should raise your suspicions when they are, is words which are used for a meaning beyond their original purpose. Other examples include “runway” used to describe the scope for development of a product or service as in “there’s plenty of runway to develop sales for this product”. A runway is a strip on which an aircraft lands or takes off. You should only describe something as “key” if it relates to a lock, so no “key objectives”. “Footprint” should only be used in relation to feet or footwear, not the area of operations of a business.

Another category is words which are used in an effort to sound profound, when a much simpler word exists. You will often hear management and

investment analysts talking about granular data or granularity. Detail is a perfectly good word.

Sometimes the word used is not intended to convey an impression of profundity but has a pejorative or critical tone. I have lost count of the number of failed bankers and CEOs whose pension “pot” has been the subject of critical reporting and subsequent rage. I wonder if they would have suffered the same fate if it was correctly described as a pension fund. A pot is a type of container.

There are also some expressions that you should be wary of. If someone tells you they are “reaching out” to you, you might ask how this is different to or better than contacting you. And, of course, be wary of anyone who begins a statement with “to be honest”, as it begs the question of whether they are normally dishonest. Always be wary of any organisation which is run by a “steering committee”. Would you ever steer a boat or a car by committee, and what do you think the outcome would be if you did? Organisations run by steering committees are unlikely to achieve any good results in my view.

Which brings me on to a type of expression for which I am laying claim to a new law – Smith’s Law: you should never use an expression if its opposite is so nonsensical that you would never say it. I have seen innumerable companies say they have a strategy of “select acquisitions”. Would anyone ever admit to a policy of indiscriminate acquisitions (although it seems that’s what many of them actually do)? The new governor of the Bank of England, Mark Carney, has been struggling to get the markets to accept his “forward guidance” on interest rates. He might like to pause to think whether he would ever use backward guidance. If so, perhaps he would also be happy to “group together” (can you group apart?) and do some “forward planning” (what other sort is there?). Perhaps he would have more success if he just called it a prediction.

Be wary of management or commentators who engage in hyperbole. “Global” is a common example of hyperbole. Very few businesses are truly global. They may be international, but that is not the same. And when “global” is used in job titles, it is almost always an example of status inflation. Whenever I am given the business card of a head of global sales, I am tempted to ask how many globes he or she has sold. A newspaper this

year ran a cycling event which it described in its advertising as “iconic”. The Tour de France is iconic, but a ride around the Surrey Hills isn’t.

At Fundsmith we keep a banned word count for the companies we analyse because we think they provide an insight into their management. Our investment approach is about investing in good companies. They are best spotted by their good results – we do not need managements to tell us how good they are – but when we do listen to management, the straight talkers get our vote and our money.

A classic example is Domino’s Pizza, which began a turnaround in 2009 by publishing harsh criticism from its customers such as ‘Pizza was cardboard’. You only do that if you intend to change. Since then, shares have risen from \$8.50 to \$68. It has been one of our largest holdings since the inception of the fund.

# *Why it is safe to pay up for quality*

THE TELEGRAPH, 22 NOVEMBER 2013

**W**ARREN BUFFETT, the legendary investor, has described compound interest as the eighth wonder of the world. Understanding its effects is essential to success in investment. Yet it remains a mystery for many people.

The simplest illustration of this is to ask how long it takes to double your capital at 10% a year compound return.

The whole point is that we are talking about compound returns in which the gains are added to the capital sum to which each successive period's rate of return is applied. Consequently, the answer is seven years. It only takes a compound return of 7% per annum to double your money in ten years.

How about this example: starting with £1,000, what is the difference in final capital from 30 years of investment at 10% a year compound versus 30 years at 12.5% a year? I ask this because it may represent a reasonable range of outcomes from an investment lifetime in which a person saves for 30 years before retiring then trying to live on the income from investments. The answer, rather surprisingly, is that the extra 2.5% of compound return would double the final sum – so £1,000 invested would become £34,243 at 12.5% as opposed to £17,449 at 10%.

At Fundsmith, we only invest in companies which make high returns on capital employed; convert most or all of their profits into cash; have high profit margins; and which have proved resilient to economic cycles over many decades.

But the valuation of such companies has become a subject of concern to investors. Their valuations have risen through the financial crisis and the Great Recession which has followed. This is because they produce consistent performance from the provision of our everyday necessities and luxuries, and have an ability to grow in a world in which there has been little or no economic growth in contrast to most other sectors of the market.

Since the rise in their share prices has outpaced the rise in the companies'

profits or cash flows in recent years, they are certainly more highly rated than they were, but that is not the same as being overvalued. While I accept that they are not as attractively valued as they were before this recent rise, I would suggest a study of compounding should perhaps give reason to pause before moving swiftly on to the presumption that as a result they should be sold or even avoided.

We don't often look at price-to-earnings (PE) ratios, the traditional measure of value, at Fundsmith as we prefer to look at cash flows, but since almost everybody else uses them, it is the simplest way of expressing the relative valuation of our portfolio, which currently has a PE about two points higher than the market – the Fundsmith stocks are on about 21 times forecast earnings and the MSCI World Index is on about 19 times.

In judging what this implies, there are a number of things which you should also be aware of, namely that not all earnings (the “E” in that ratio) are of equal value. The shares in the Fundsmith portfolio produce their earnings with significantly less capital intensity (hence their higher return on capital) than the market in general, and they deliver more of their earnings in cash, which is more valuable. Their earnings are also more predictable, which brings me back to compounding.

I have taken a look at how much you could have paid for some of these companies over the 30-year period between 1979 and 2009. In particular, I looked at Coca-Cola and Colgate-Palmolive. In 1979 they had about the same rating as the market – ten times earnings. But what could you have paid for them at that time in terms of PE and still equalled the performance of the market over the next 30 years? The answer rather surprisingly is about 40 times earnings. Why? Because these companies' total returns grew at about 5% a year faster than the market over this period, and rather like the earlier illustration of a 2.5% differential in compound growth, this 5% differential multiplied the final capital sum represented by their share prices four times faster than the market rose.

Of course, the next 30 years may be different. However, if I had to guess how it would affect this calculation, it would be that companies like Coke and Colgate will fare even better in terms of growth given that cyclical stocks are unlikely to get a repetition of the growth that was stimulated by the credit bubble. It is also fair to point out that quality stocks may indeed



not be expensive relative to the rest of the market but that both will prove to be expensive, particularly when interest rates rise. But even so, I suggest you consider how you might have reacted if someone had suggested you invest in Coca-Cola or Colgate at, say, twice the market PE in 1979. In rejecting that idea, you would have missed the chance to make twice as much money as an investment in the market indices over that period.

# *It's déjà vu all over again*

*FINANCIAL TIMES*, 6 DECEMBER 2013

**P**ETER “YOGI” BERRA was a baseball player for the New York Yankees, and managed both the Yankees and their New York rivals, the Mets. He’s also famous for a series of deceptively simple witticisms known as Yogi-isms which are often contradictory – as in “Nobody goes there any more. It’s too crowded.” One of my favourites – “It’s déjà vu all over again” – might have been invented for the investment industry.

Time and again we are told that someone has devised a new technique of investing, or a new investment product. The truth is that in this area of human endeavour there are few, if any, new products or methods. By and large, we have seen it all before.

For example, we mostly think that pensions are a 20th-century phenomenon. The first state pension was implemented in the UK in 1909, and occupational pension schemes providing benefits for company employees had their heyday after the Second World War.

Once you reach retirement, you are generally required to use your pension fund to purchase an annuity from an insurer which provides the pension income. Or at least, that’s the theory. Latterly, one of the problems encountered by pension funds has been the general improvement in longevity. Pensioners are living longer, which has increased the liabilities of pension funds and so strained their funding.

Our 17th-century forebears would have known all about that. They encountered these same problems over 300 years ago and developed products called “tontines” to deal with them. A tontine is an investment plan named after a banker, Lorenzo de Tonti, who is credited with inventing it in France in 1653. Each subscriber paid a sum into the tontine, and thereafter received an annuity. Sound familiar? As members died, their shares transferred to the other participants, and so the value of each remaining annuity increased. On the death of the last member, the scheme was wound up.

Tontines were relatively widespread in the 18th and 19th centuries. France

established a state tontine in 1689. The English government organised one in 1693. But tontines soon caused problems. Their structure created an obvious incentive for members to kill each other, one reason why they are often used as a plot device in murder mysteries. And just as they have today, governments running tontines tended to underestimate the longevity of the population.

What's the purpose of this history lesson? It is that you might be well advised to check the history of any investment product you are offered to see how it has fared in the past, even if it was called something else at the time.

Take so-called "precipice bonds". Typically, this is an investment product offering an eye-catchingly high yield – 10% is not that unusual. Of course, it's easy to sell investors something they are desperate for – such as high yield in a low-yield environment – and salesmen use this craving to encourage investors to overlook the pitfalls. The catch with a precipice bond is that the investor may not get all of his or her capital back. The yield is typically supplied by collecting premiums for writing put options (which oblige the option writer to buy at a fixed price) based on a given scenario, such as a fall in the stock market over the period of the bond.

Why the term "precipice"? High option premiums can be obtained for writing put options on something very volatile which is trading at a record high. Precipice bonds first came to my attention in 1999 at the peak of the dotcom boom, when several such bonds were floated with high yields obtained by writing put options on tech stocks, which were then at record highs.

Investors subsequently lost much of their capital when the options were exercised. The option writers – their bond funds – were obliged to buy the tech stocks at the peak prices at which the options had been struck, even though market prices were by now well below those levels. The investors were metaphorically looking over the edge of a precipice in financial terms at the moment they accepted the risk that tech stocks might fall.

Needless to say, "precipice bonds" is a colloquial term. They were marketed with much more mundane names, such as stock market income bonds, so as not to scare investors or give too many clues to their true risks.

But surely people have learnt that lesson? I'm not sure they have. In January, Goldman Sachs sold "Autocallable Contingent Coupon Buffered Equity-Linked Medium-Term Notes" (here's a clue: what does it do? If you don't understand it, don't invest) yielding 10% plus some upside tied to the performance of Apple's common stock. But if Apple shares dropped, the notes would decline at the same rate. Apple shares were over \$500 at the time the instrument was created. They have been below \$400 this year. The notes were sold the day before the company announced a set of earnings that sent its share price down 12%. Investors bought a total of \$1.75bn of structured notes linked to Apple in 2012.

As the old adage goes: "There are no new jokes, only some people who haven't heard them before."

# *Annual letter to shareholders 2013*

FUNDSMITH, JANUARY 2014

**T**HIS is the fourth annual letter to owners of the Fundsmith Equity Fund. The table shows performance figures for the last calendar year and the cumulative and annualised performance since inception on 1 November 2010.

| % Total return                     | 1 Jan to 31 Dec 2013 | Inception to 31 Dec 2013 |                   |
|------------------------------------|----------------------|--------------------------|-------------------|
|                                    |                      | <i>Cumulative</i>        | <i>Annualised</i> |
| Fundsmith Equity Fund <sup>1</sup> | +25.3                | +62.2                    | +16.5             |
| Equities <sup>2</sup>              | +24.3                | +40.5                    | +11.3             |
| UK bonds <sup>3</sup>              | -4.3                 | +11.9                    | +3.6              |
| Cash <sup>4</sup>                  | +0.5                 | +2.3                     | +0.7              |

<sup>1</sup> T-class acc Shares, net of fees, priced at noon UK time. <sup>2</sup> MSCI World Index, £ net, priced at close of business US time. <sup>3</sup> Bloomberg/EFFAS Bond Indices UK Govt 5–10 yr. <sup>4</sup> 3-month Libor interest rate. <sup>1,3,4</sup> Source: Bloomberg. <sup>2</sup> Source: [www.msci.com](http://www.msci.com)

We remain critical of attempts to measure investment performance over short periods of time. However, this proviso notwithstanding, the table shows the performance of the T-class accumulation shares which rose by 25.3% in 2013 and compares that with 24.3% for the MSCI World Index in sterling with dividends reinvested. The fund therefore outperformed the market in 2013 by 1%.

You (and we) may find this surprising, given that 2013 was a bullish period for equity markets and our portfolio could reasonably be categorised as “defensive”. The market, as measured by the MSCI World Index,<sup>2</sup> rose by 19.1% from 1 January to 22 May, where it hit a temporary peak from which it fell by 9.4% after Ben Bernanke spoke on 22 May and indicated that the Federal Reserve Bank was considering so-called “tapering” of its quantitative easing (QE) programme of purchasing bonds, then running at no less than \$85bn per month.

It began to recover from July as it became evident that even the suggestion of tapering would have adverse consequences, not least for emerging

markets (which have been the recipients of an estimated \$4 trillion dollars in capital since QE began after the financial crisis of 2007–08). A much smaller tapering than originally anticipated started in December, and has been accompanied by soothing statements about the long-term continuance of that other policy measure – a zero interest rate policy (ZIRP).

It is clear that the authorities took fright at the impact of their plans to moderate the stimulus and backed down, leaving the markets to resume their bullish mood.

The market dip which began in May also coincided with the market sensing economic recovery in the GDP numbers (for the US and the UK at least), so that in the second and third quarters the sectors which performed well were all those which you would expect to do well in such conditions – Consumer Discretionary, Industrials, Finance, Information Technology and Energy – most of which we will never own. Consumer staples, which are the bedrock of our strategy and portfolio, were one of the worst-performing sectors in this period.

Now this might strike you as odd, that a sell-off in the market coincided with increasing evidence of economic recovery, but apart from the fact that no one has ever established a correlation between GDP growth and the performance of stock markets, one of the more apparently perverse aspects of markets has been the growing view that “good news is bad news”. It all comes down to QE – the markets were more concerned that economic recovery would lead to the withdrawal of this stimulus than they were bullish about the recovery itself.

Although we have an interest in this subject, these market shenanigans have no bearing on the manner in which our portfolio is invested. People often ask us what we think the outlook is for the economy and/or the market. Apart from prefacing any response with the phrase, “we don’t know”, we usually point out that whatever the outlook it will not alter our methodology of investment. We mention this because we sometimes feel that the questioner supposes that if we too scent economic recovery we might switch the portfolio into cyclicals, financials and highly leveraged companies which might benefit from a recovery most (but which might otherwise go bust). Whatever our view on the economy, the Fundsmith Equity Fund will always be fully invested in high-quality companies which

satisfy our exacting criteria on financial performance and have done so for many decades.

However, at least one aspect of the debate about economic recovery and so-called tapering of QE puzzles us. If we are in an economic recovery, why is the growth rate of our investee companies slowing? We both understand and accept that in an economic recovery, companies in areas of discretionary spending and big-ticket durable items such as cars and houses will fare better than the companies in our portfolio, as will companies in the cyclical industries which supply them. But we keep track of the “underlying” (excluding acquisitions, currency effects and exceptional items) revenue growth rate at all the companies in our investable universe (currently 64 stocks) and there is no doubt that it has slowed by a couple of percentage points over the past year. Remarks from several of their CEOs make it clear that consumer markets are not becoming significantly better. We can see why they would lag cyclical stocks in an upturn but not why their performance would start to deteriorate. This leaves us feeling sceptical about the nature and strength of the recovery.

For the year, the top five contributors to the fund’s performance were:

|                         |        |
|-------------------------|--------|
| <b>Domino’s Pizza</b>   | +3.02% |
| <b>Microsoft</b>        | +2.05% |
| <b>Stryker</b>          | +1.98% |
| <b>Becton Dickinson</b> | +1.96% |
| <b>3M</b>               | +1.93% |

The bottom five were:

|                           |        |
|---------------------------|--------|
| <b>Swedish Match</b>      | -0.06% |
| <b>Serco</b>              | +0.03% |
| <b>Imperial Tobacco</b>   | +0.14% |
| <b>Schindler</b>          | +0.14% |
| <b>Philip Morris Intl</b> | +0.21% |

It is worth noting the following about the bottom five contributors: only one

actually had a negative performance, Swedish Match, which we began buying during the year in response to share price weakness and a resulting more attractive valuation. Three of the five are tobacco companies which suffered from concerns about plain packaging and e-cigarettes. We suspect that these concerns are overdone but nonetheless have a self-imposed limit on our exposure to the sector, as we do to most sectors, in order to ensure that the effects are limited if we are wrong. Schindler and Serco, two of the other bottom five performers, were sold during the year.

Minimising portfolio turnover is one of our objectives and this was again achieved with a negative turnover of -17.6% during the period. Negative turnover occurs because the method of calculating turnover excludes flows into or out of the fund, otherwise a newly established fund would automatically have 100% or more turnover. However, it is not very helpful in judging our activities. It is perhaps therefore more helpful to know that we spent a total of £351,227 or just 0.025% (2.5bps) of the fund on dealing other than that associated with flows into the fund which was involuntary.

Why is this important? It helps to minimise costs, and minimising the costs of investment is a vital contribution to achieving a satisfactory outcome as an investor. Too often investors, commentators and advisers focus on the annual management charge (AMC) or the ongoing charges figure (OCF), which includes some costs over and above the AMC, which are charged to the fund. The OCF for 2013 for the T-class shares was 1.11%. The trouble is that the OCF does not include an important element of costs – the costs of dealing. When a fund manager deals by buying or selling investments for a fund, the fund typically incurs commission paid to a broker, the bid–offer spread on the stocks dealt in and, in some cases, stamp duty. This can add significantly to the costs of a fund yet it is not included in the OCF.

I find that investors are often confused by this and in my view do not pay enough attention to it. The fact is that as an investor you can only benefit from the price appreciation of shares in your fund and dividends paid. Costs of dealing detract from those returns and therefore need to be taken into account when you are comparing funds.

We have published our own version of this total cost including dealing costs, which we have termed the “total cost of investment”, or TCI. For the T-class shares in 2013 this amounted to a TCI of 1.2%, including all costs



of dealing for flows into and out of the fund, not just our voluntary dealing. As a result of the Investment Management Association's campaign for fuller disclosure I am hopeful that we will eventually get such disclosure from many more funds so that investors can make a well-informed comparison between funds. When they are able to do so, I fully expect that the Fundsmith Equity Fund will compare favourably.

Although our turnover was once again very low in 2013, we sold five holdings: McDonald's, Schindler, Serco, Sigma-Aldrich and Waters Corporation. There may seem to be an inherent contradiction between the fact that we sold five holdings yet our turnover was low. Part of the explanation is that some of these holdings had already become an insignificant proportion of our portfolio because we had been struggling to add to them as their valuations had become too high to represent good value in our view. Once this point is reached it begs the obvious question of whether we should in fact sell our holding to make way for an investment which offers better value, either within our existing portfolio stocks or from within our wider investable universe of stocks on which we maintain research.

There were also individual reasons for sale in each case:

- McDonald's valuation had held up despite a run of poor sales figures, which made it hard to add to our holding. The poor sales also arose despite McDonald's offering meal options for as little as \$1. This began to convince us that McDonald's had started to become a business which was selling solely on price, which we seek to avoid, and it seems that its Dollar Menu has perhaps unsurprisingly handicapped its attempts to sell premium items. Its performance was in sharp contrast to Domino's Pizza, which has had no trouble growing sales with price points close to \$6 for a pizza, and we took comfort in the fact that we retained our Domino's holding and with it a continued exposure to the franchised fast-food business which we like.
- Schindler had simply become too expensive for us to add to our holding and we were able to retain an exposure to the attractive elevator and escalator sector via Kone.

- Serco seemed to fit the profile of businesses we seek to invest in as it depends on a large number of everyday repeat transactions: if you ride a Boris bike, take the Docklands Light Railway, see a traffic light being repaired in London, get a parking ticket in San Francisco, have the misfortune to be incarcerated in certain UK prisons or transported to court in a prison van, pass through airspace governed by US air traffic control or encounter the Australian immigration authorities, you are dealing with Serco. But we had always been troubled by the fact that these transactions emanated from much larger contracts, typically with governments, which gave rise to the risk that large contracts could be lost and in so doing could adversely affect Serco's relationship with its government customers. Then early in 2013 it became apparent that a significant acquisition of an Indian-based business-process outsourcing business, which Serco had undertaken, had changed its cash flow generation and capital intensity in a way which was adverse and we sold our holding in February. Serco's problems with electronic tagging of offenders followed some months later and confirmed our concerns.
- Sigma-Aldrich is a company based in the US Midwest which supplies chemicals and equipment to researchers and manufacturers in the life sciences, high-tech industries and R&D. It supplies a large number of items in small ticket sizes to a large number of purchasers, and so fitted our investment profile, not least because it also has an excellent record in terms of return on capital and cash conversion (turning profits into cash, in plain English). However, Sigma-Aldrich attempted to acquire Life Technologies, a company which is much larger in every sense – revenues and market valuation. This worried us a lot. With our low portfolio turnover we are in effect leaving the allocation of capital generated by the wonderful returns earned by our portfolio companies to the management of those companies. When one of them looks likely to take a business with good, predictable returns and do something large, exciting and risky, we have a strong impulse to run away.
- Waters Corporation makes and services liquid chromatography, mass spectrometry and thermal analysis equipment. The company's main

customers are in the pharmaceutical and biotechnology industries but it also supplies industrial, food and environmental customers. Its revenues are partly a play on the growth in the requirement for testing in these areas. Although its equipment represents large ticket capital items, it makes nearly half its revenues from consumables, service and spares, so satisfying our criteria on repeat purchases. But it has significant sales to Asia including the Indian generic pharmaceutical industry and we were fearful that the slowdown in emerging markets would adversely impact the equipment sales which underpin its revenue model. Waters was also the only non-dividend-paying stock which we held. Whilst we are prepared to hold such stocks, we need to be convinced that their reinvestment opportunities warrant the absence of a dividend and we were increasingly wary of this with Waters.

So much for the sales.

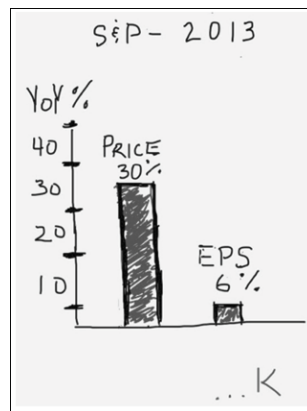
The fund purchased a holding in C. R. Bard, which makes medical devices – particularly catheters for use in oncology, urology and vascular conditions. It is to some extent a play on the medical needs of an ageing population. Its business is centred on the developed world at present and we believe it may have a significant opportunity to grow in emerging markets. Unlike Waters, Bard's opportunities in emerging markets are not linked to the capital expenditure cycle of its customers, which is by definition lumpy and cyclical, as it does not sell high-value equipment but mainly consumables.

We also began to acquire a holding in a transaction services company but this has not yet reached a size where we feel that our buying is complete and so we do not wish to disclose the name at present.

Perhaps the question we faced most frequently from investors or prospective investors over the year was whether companies of the sort we invest in have become too expensive.

There has certainly been a growing fashion for investing in the type of large, well-established companies whose business consists of selling or supplying goods and services which are characterised by the small ticket, repeat, relatively predictable everyday events which we seek. Whilst this

may seem like a welcome development insofar as it means that the fund's shares have risen in value faster than the market, it also means that an increasing proportion of the fund's performance has been delivered by rising valuations of those stocks rather than growth in their revenues, profits and cash flows. As we cautioned in this letter last year, 'increasingly desperate attempts to stimulate the economy are far more likely to stimulate the valuation of our portfolio'. That this happened in 2013 – not just for our portfolio, but for the whole market – is demonstrated by this chart which looks as though it was drawn by and/or for a child.



Whilst such increases in valuation may seem like cause for celebration, it is not always so as we intend to be long-term or even indefinite investors and such valuation changes are certainly finite and maybe even temporary. They are the result of the massive injection of liquidity from QE and a sustained period of zero interest rates. Apart from the fact that we intend to be long-term investors, even if we were trying to guess the timing of the withdrawal of these factors in order to exit from markets, we would point out that there is no certainty that such increases in valuations may not be sustained or even go further as QE continues. The so-called taper is a token – US QE continues at \$75bn per month, \$900bn p.a. – and it seems that most major central banks are targeting a further sustained period of ZIRP. At the moment stories of QE's demise are at least exaggerated. Fortunately, seeking to profit from short-term valuation anomalies or changes is not part of our strategy but, given the upside which has been generated from these policies, I have little doubt that we will have to live through some character-testing times when they are withdrawn.

There are many ways of looking at valuation, but here are a few thoughts:

1. We seek to buy our portfolio companies when their free cash flow (FCF) yield (the free cash flow they generate divided by their market value) is at or above the yield we would expect to get on long-term government bonds in the same currency. Please note: not the current yield on bonds, which in most cases has been depressed by governments buying their own bonds, but the yield we think might apply if this were to stop and all bonds had to be sold to third-party investors. Our starting guess for the yield that might then be required is 1% over the expected rate of inflation. If we can buy shares with FCF yields higher than that and which will grow, unlike the coupon on the bonds, we should have captured some value. There are still shares within our portfolio which look good value on this basis, albeit not as many or as cheap as they were a year or two ago.
2. The weighted average FCF yield of the portfolio started the year at 5.7% and ended it at 5.1% – still above the level we would find acceptable on the basis of the comparison with expected bond yields. Our companies on average grew their free cash flow per share by 6.6% during the year. They actually grew their operating cash flow by 8.1% but also spent 21% more on capital expenditure (capex). We find the fact that they have significantly increased their capex to be encouraging as we have yet to find an industry which can grow without committing additional capital in order to do so.
3. This 5.1% FCF yield compares with a median FCF yield for the non-financial stocks in the S&P 500 of 4.6% and a mean of 4.1%, or a median for the non-financial stocks in the FTSE 100 of 4.0% and a mean of 3.7%. Our stocks do not look bad value in comparison to the market. Of course, both may be expensive – and both may continue to be so or become more expensive.
4. Consumer staples, in particular, have been more highly rated in the past than they are now. We mention this because we frequently read or are told that they are more expensive than ever. This is simply not so – they were more highly rated in the 1990s, for example. Moreover, whilst commentators seem to focus on consumer staples stocks, these are less than half of our portfolio, and some of our

medical equipment stocks are much closer to the low end of their historic valuation range.

5. We examined the relative performance of Colgate-Palmolive and Coca-Cola over a 30-year time period from 1979–2009. Why 30 years? Because we thought it was long enough to simulate an investment lifetime in which individuals save for their retirement after which they seek to live on the income from their investment. Why 1979–2009? We wanted a recent period and in 1979 it so happens that Coca-Cola was on exactly the same price-to-earnings ratio (PE) as the market ( $10\times$ ) and Colgate was a little cheaper ( $7\times$ ). The question we posed is what PE could you have paid for those shares in 1979 and still performed in line with the market, which we took as the S&P 500 Index, over the next 30 years? We found the answer rather surprising – it was  $36\times$  in the case of Coke and  $34\times$  in the case of Colgate, when the market was on  $10\times$ . Another way of looking at it is that you could therefore have paid a PE of  $3.6\times$  the market PE for Coke and  $4.9\times$  the market PE for Colgate in 1979 and still matched the market performance over the next 30 years. The reason is the differential rate of compound growth in the share prices (to a large extent driven by growth in the earnings) of those companies over the 30 years. They compounded at about 5% p.a. faster than the market. You may be surprised that this differential can have such a profound effect upon the outcome. It's the magic of compounding.
6. Albert Einstein said that he thought compound interest was the eighth wonder of the world. It is certainly one of the concepts least understood by investors. The simplest illustration of this is to ask how long it takes to double your capital at 10% p.a. compound return. The whole point is that we are talking about compound returns in which the gains are added to the capital sum to which each successive period's rate of return is applied. Consequently, the answer is a counterintuitive seven years. It only takes a compound return of 7% p.a. to double your money in ten years.
7. That is a simple enough example, but how about this one: starting with the same initial sum, what is the difference in final capital from

30 years of investment at 10% p.a. compounded versus 30 years at 12.5% p.a.? I ask this because it may represent a reasonable range of outcomes from an investment lifetime. The answer, rather surprisingly, is that the extra 2.5% of compound return would double the final sum.

8. As discussed earlier, Coke and Colgate's total returns grew at about 5% p.a. faster than the market over the period 1979–2009. This 5% differential multiplied their share prices four times more than the market over that period. Of course, the next 30 years may be different to the 1979–2009 period. However, if I had to guess how it would affect this calculation it would be that companies like Coke and Colgate will fare even better versus the rest of the market in terms of growth, given that the cyclical stocks are unlikely to benefit from a repetition of the growth stimulated by the credit bubble. But what do I know?
9. It is also fair to point out that quality stocks may indeed not be too expensive relative to the rest of the market but that *both* will prove to be expensive, particularly when interest rates rise. But even so, I suggest you consider how you might have reacted if someone had suggested that you invest in Coke or Colgate at, say, twice the market PE in 1979. In rejecting that idea you would have missed the chance to make nearly twice as much money as an investment in the market indices over that period, which included some periods of very high interest rates. Of course, capturing this opportunity would have required you to have the fortitude to sit on your hands during those periods of high interest rates and poor performance (hint: we will be reminding you about this when interest rates rise). As at 31 December 2013 they were trading at PEs slightly above the market – our portfolio was on a PE of 20.6× versus 17.4× for the S&P 500, which doesn't sound quite so expensive when you look at their historical performance and quality.
10. In fact, we rarely look at PEs, usually only doing so to make such comparisons as other market commentators use them. We prefer instead to rely upon free cash flow yields when evaluating our investments, as not all Es – or Earnings – are created equal. Our

portfolio companies' businesses are less capital intensive than the market as whole. As their earnings are generated with less capital, their return on capital employed is much higher than the average, which we regard as the primary test of their performance. The return on capital of the companies in our portfolio averages 34%. This compares with an average of about 19% for the non-financial stocks in both the S&P 500 and the FTSE 100. They also deliver more of their earnings in cash than the market as a whole, typically 90–100%. And we like cash – it is the main way of paying bills, and earnings delivered in cash are of higher quality than those which aren't.

11. We remain confident that we own stocks with a superior fundamental performance to the average, which is not fully reflected in their valuation relative to bonds or other equities.
12. A striking and direct comparison is between the dividend yield on some of our stocks and the redemption yield on their bonds. Take Nestlé, for example. At the end of December 2013 its 2018 bonds had a redemption yield of 0.21%, whilst its ordinary shares yielded 3.1%. Leaving aside fund managers who are limited to investing in bonds by their mandate, why would anybody in their right mind own the bonds rather than the shares? The answer is that some investors are willing to overpay for the apparent certainty which the bonds bring. They have a fixed coupon, a redemption date and a par value which will be repaid to the holder on redemption. The shares have none of those things. (Although it has to be said that the dividend is pretty safe given that Nestlé has only reported one loss in 146 years, but it is still not a fixed charge, as the interest coupon is.) And you cannot rely on the shares being a particular price if you need to dispose of them. But this does seem to suggest that the shares are at least good value relative to the bonds. While that does not mean that either of them is cheap, it does raise the question of where you would invest the money as an alternative to the shares with a better risk/reward relationship in the current environment.
13. As at 31 December 2013 the weighted historic dividend yield of the



fund was 2.3%, the weighted prospective yield was 2.5% and the prospective dividend cover was 2.4×

Although all of our portfolio companies are headquartered and listed in Europe and North America, some 32% of their underlying revenues are from emerging markets. This is generally considered a positive attribute as emerging markets have generally outperformed developed markets in terms of economic growth in recent years.

We are often asked why we do not invest directly in emerging markets if we like exposure to their superior growth. The reasons are complex but one of the main ones is liquidity. The Fundsmith Equity Fund is an open-ended fund with daily liquidity. We hope that if you invest with us you will be a long-term investor because we believe that this delivers the best results, but you can redeem your investment on any business day. This would be incompatible with direct investment in the companies of the sort we seek but which are headquartered and listed in emerging markets. Although some of these companies are not small, there is not enough liquidity in their shares in local markets to hold them responsibly through an open-ended fund. Especially one with daily dealing.

In order to overcome this problem, we have decided to launch a new fund, the Fundsmith Emerging Equities Trust (FEET), in 2014. This will be an investment trust investing in the same strategy as our existing fund but mostly in companies which are listed in emerging markets. Its focus will be on consumer stocks since a) this is the largest area of focus of our strategy, and b) there is an established trend for the emergence of consumer classes in emerging markets which looks likely to last several decades and which should provide a tailwind for its performance.

We have identified an investable universe of over 150 companies for FEET, many are already known to us as they are quoted subsidiaries, associates or franchisees of companies which we already research for the Fundsmith Equity Fund. This also helps with the corporate governance issues which can plague emerging markets.

For reasons which we will detail in the soon-to-be-published *FEET Owners' Manual* we believe that this approach should produce better results for investors compared to many of the other investment products and

approaches which have sought to capitalise on the growth in emerging markets.

As an investment trust, FEET will overcome the issue of combining an open-ended fund with stocks which have limited liquidity in the underlying investments since it will raise an initial fixed amount of capital, to which I will subscribe. Thereafter investor liquidity will be provided by trading in the trust's shares, thus removing the costly need to liquidate or add to the portfolio on investor demand.

You can expect to hear more from us about the opportunity which we feel FEET provides later in the year.

# *Just the facts when weighing investments*

*FINANCIAL TIMES*, 24 JANUARY 2014

**I**N the 1950s, an early detective series on TV was *Dragnet*, starring the fictional Joe Friday. In the opening sequence to every show he would say: ‘My name is Friday. I’m a cop.’ His other famous one-liner, usually delivered while trying to extract evidence from a hapless babbling witness, was: ‘Just the facts.’

We would all do well to remember Joe’s witness interview technique when it comes to investing. So let’s start with a few facts – those shown in the table below. Would you want to own a company which had delivered those results?

| Year | Revenue | Operating cash flow |
|------|---------|---------------------|
| 2006 | 44.3    | 14.4                |
| 2007 | 51.1    | 17.8                |
| 2008 | 60.4    | 21.6                |
| 2009 | 58.5    | 19.0                |
| 2010 | 62.5    | 21.1                |
| 2011 | 70.0    | 27.0                |
| 2012 | 73.7    | 31.6                |

It has seen revenues rise by 66% over the past six years, a compound growth rate of 8.8% – no mean feat for a period which spanned the financial crisis and a deep recession. The company experienced a downturn in 2009, but revenues only fell by 3%, so it is barely cyclical.

Its cash flow performance has been even better. Operating cash flows grew by 119% over the same period – a compound annual growth rate of 14% – and its operating cash flows are 43% of its revenues, so its margins are exceptionally good.

All in all, it's an impressive operating performance. Of course, you can't make an investment decision on the basis of that alone. You'd need some data on valuation – and you could be forgiven for thinking that, given its recent record, its shares must be so highly valued as to be uninvestable.

What if I told you that you could currently buy this company on a free cash flow yield (the free cash flow it generates, divided by its market value) of over 8%? That it is on a prospective price/earnings ratio of 12? It pays dividends too – giving a 3.2% yield covered 2.4 times. To cap it all, it has cash on its balance sheet equivalent to about a quarter of its market value.

“How do I buy the shares?” might well be your response. It was certainly mine. If you put a dollar sign at the beginning of those figures and “billions” after them, the company I have described is Microsoft.

At this point, I would guess that investors who might have been salivating at the prospect of this investment opportunity will be surprised. Surely Microsoft is a loser in the tech wars? I have lost count of the number of articles I have read in computer publications, business magazines, newspapers, analysts' reports and blogs questioning whether Microsoft can “save itself”.

Save itself from what? Bears argue that Microsoft has lost out to Apple in mobile devices and Google in online search and mobile operating systems. It is also inextricably linked to the declining PC replacement cycle as that uses its Windows operating system, which is the Microsoft product most of us know.

That is certainly the view you will get if you read most commentary on Microsoft. However, back to those pesky facts. Microsoft's largest division by both revenues and profits is its servers and tools division, which develops and markets software for servers and software developer tools. Its customers are IT professionals and software developers. How much do you know about that?

If you use Microsoft software for work, and the vast majority of us do, then I would guess that you have gone through, or are about to go through, an upgrade from Windows XP to Windows 7 as Microsoft is halting support for the older product. Windows XP runs 95% of the world's cash machines. This is an example of a gift which keeps on giving – an annuity income for

Microsoft which results from us all having to update to more recent versions of its operating system.

I do not profess to know anything about technology investment (although at least with this awareness of my limitations, I suspect I am one step ahead of most of those who think they do). Nor do I have any insight into who will take over from Steve Ballmer as chief executive. But I do know something about financial analysis, which often seems to be ignored, as it has been by many commentators on Microsoft.

Worse, much of the “research” and commentary about Microsoft is not about whether it is doing well or badly. It’s more about the biases of the commentators, who often seem to feel that because Microsoft is not hip or fashionable, and doesn’t have the design sense of Apple, it doesn’t deserve to succeed.

The facts suggest otherwise. Just stick to the facts.

# *Shale: miracle, revolution or bandwagon?*

*FINANCIAL TIMES*, 7 FEBRUARY 2014

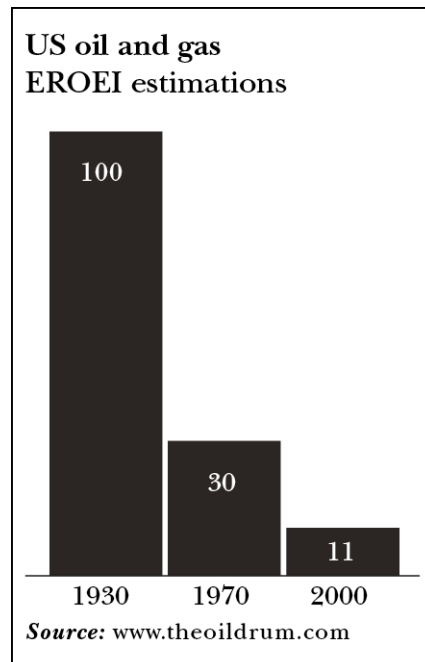
**U**NLESS you have been in hibernation for the past few years, you will have heard that there is a shale hydrocarbon “revolution” or “miracle” under way. Barack Obama, the US president, pledged support for shale gas development in his 2012 State of the Union speech. David Cameron has urged opponents of fracking to ‘get on board’.

“Fracking” has passed into the vernacular. The term was added to the *Oxford English Dictionary* last June. It involves releasing a high-pressure mix of water, sand and chemicals to crack rocks and release oil and gas from shale. Environmentalists have all sorts of objections to this practice. And there are other problems with the concept of shale as a saviour – either in terms of cheap energy or as an investment.

The first is the concept of “energy return on energy investment” or EROEI. This is the ratio of the amount of energy generated from an energy source to the amount of energy expended to obtain that energy. It is an important and mostly ignored ratio which determines both the efficiency of our economies – how much of our resources have to be expended into getting our energy – and the economics of energy exploration and generation.

The oil discoveries which took place a century or more ago were mostly in onshore locations, often in politically stable countries and close to key consumer markets.

However, there is a natural tendency to pick the low-hanging fruit first, and over time, oil and gas exploration and production has, out of necessity, moved to less hospitable and remote locations, which place logistical barriers between oil and gas and the markets.



Shale gas/oil and fracking are just an extension of this trend. US oil production had an EROEI of 100:1 in the 1930s – every hundred units produced required one unit to be expended. By 2000, despite huge technological advances, that had dropped to 11:1. The ratio for shale oil is about 5:1. This is a critical difference.

There is also the issue of depletion. An old trick in investment analysis is to ask whether an annual return of £20 for an investment of £100 is good or bad. Most people will say it is a good return. But you lack other vital information necessary to assess the investment: the asset life and maturity value. If the asset only lasts for three years and is then worthless, it is a bad investment, as you will only recoup £60 in total from £100 invested. If it lasts for 20 years, it's a good investment, as you will recoup £400.

Asset life is critical to assess all investments. In the case of oil and gas exploration and production, it is the period until the well or field is no longer economically viable and has to be abandoned.

The steepness of decline in production rates for shale oil wells has been a surprise. A typical well in the Bakken Formation, North Dakota, drilled in 2012 is likely to be producing at less than 30% of its initial production rate today. Recent disappointing performance relative to expectations at the newer Utica Shale play in the northeast US and Canada mirrors this.

Investor returns on shale gas investments have broadly come in two main periods. From the discovery of most shale gas in 2002 until 2007, share prices of shale companies rose rapidly. Once the newly discovered gas came on stream, natural gas prices fell – and so did returns and share prices. The largest shale player in the UK is Cuadrilla Resources, which was founded in 2007 and is owned by AJ Lucas, Riverstone Holdings and Carlyle and is exploring for shale gas deposits in Lancashire. AJ Lucas, a quoted Australian company, owns 42% of Cuadrilla. Its own shares are just a quarter of what they were worth in 2009.

Nor is this disappointing performance limited to small companies. BP wrote off \$1bn on shale in July 2012 whilst the Canadian company Encana said it lost almost \$2bn on its shale gas assets in recent years. Shell is selling its stake in the Eagle Ford shale reserve in Texas, having written off more than \$2bn on its assets there. It claims more than 200 wells are incapable of reaching their production target. Peter Voser, the former Shell chief executive, has said the rhetoric about the US shale revolution being exported to other countries was ‘hyped’, and that the rest of the world was in an early ‘exploration phase’ which could yield ‘negative surprises’.

As the late Jimmy Goldsmith was fond of saying: ‘If you see a bandwagon, it’s too late.’ The shale bandwagon may already have passed.



# *Investors are their own worst enemies*

*THE TELEGRAPH*, 14 FEBRUARY 2014

**M**ICHAEL JOHNSON, the former American sprinter, once said: ‘The only one who can beat me is me.’ I suspect that this statement simply demonstrates a lack of modesty, but it can have another, subtler meaning: that even if we are good at what we do, we are capable of producing a bad result because we allow our own emotions to defeat us. So often we are defeated not by our competition or the difficulty of the task but by our own psyche.

In investment it is easy, and indeed accurate, to criticise the poor service which much of the fund management industry provides to investors and to identify this as a major reason why investors get such poor returns.

Most managers do not regard the biggest threat to their career as losing investors’ money or performing badly. They regard the biggest threat as differing from their peers. The only thing that they regard as worse than failing is standing out from the crowd.

Never mind that they and their fellow fund managers produce dire results for investors: if they all perform roughly the same, they are unlikely to see mass withdrawals by savers or get fired from their jobs. This leads the majority of “long-only” fund managers (those who do not use the sophisticated techniques of “short selling”) to buy so many shares that they more or less replicate the performance of whatever index is their performance benchmark. I say ‘more or less’ but the reality is that they mostly produce less.

If a fund manager owns enough shares to roughly track an index – and you don’t need more than about 25 randomly chosen shares to do so in most markets – their fund will underperform the index once it has suffered from the fund manager’s fees and the cost of his or her dealing activity. This outcome is as inevitable as it is poor.

I have lost count of the number of investors who have told me that they

have withdrawn their savings from a long-term savings plan or personal pension only to discover that the amount realised is approximately the same as the amount subscribed over many years or decades, any gains that were realised having been swallowed by fees. One investor I know claims to have gained more from compensation from mis-selling than from the investment returns on her savings.

The situation doesn't appear to be any better with hedge funds. *The HSBC Investment Funds Performance Review* shows that on average hedge funds have underperformed the market for five years in a row. One of my colleagues who recently applied to withdraw his investment from such a hedge fund was asked why.

He said it was due to the poor performance, to which the fund manager responded that almost all hedge funds had underperformed in recent years. Perhaps unsurprisingly, this did not provide much comfort. It's that herd instinct again. The fund managers feel that they can justify their position if they all fail together.

Collectively, fund managers ignore Sir John Templeton's axiom that 'If you do what everyone else does, you will get what everyone else gets.'

As a result of all this groupthink, the average US fund investor over the past 20 years has earned a return of 7% a year below the market (Dalbar Statistics) because of poor performance of the fund, fees and their own poor timing.

There is not much point in trying to negotiate your way around the poor performance of the fund management industry if you are going to make matters worse by your own actions. And we are certainly capable of doing that even when the fund manager does well.

Between 2000 and 2010, the best-performing US fund was the CGM Focus Fund, which delivered annualised returns of 18% a year. Mightily impressive. Over the same period, the average investor in the fund lost 11% a year. Investors showed an unerring ability to buy into the fund at its peak in valuation and sell out at its troughs.

The vast majority of us are terrible at so-called "market timing", in which investors try to sell at or close to market peaks and buy at market lows. All the statistics about investor flows show that believing you can accomplish

this feat is the triumph of hope over experience. The wisest investors who are most likely to get the best performance are those who have at least realised that they can't do this successfully and so don't try.

The other major fault that most investors have, whether private investors or professional fund managers, is that they are too active – they deal too much.

Leaving aside the fact that if our timing decisions are almost all bad we would be better off making as few as possible, all dealing activity has a cost, much of which is hidden. We are taught that, to be successful investors, we need up-to-the-minute information and the ability to deal instantaneously. In fact, nothing could be further from the truth.

We should instead emulate the favourite client of fund manager Jonathan Ruffer, who said that 'he would be monitoring performance on a quarterly basis, and if, after the first 25 years...'

It is a sobering thought: the fund management industry may serve us badly as investors, but there is one thing more detrimental to our wealth than that – us.

# ***Big Blue investors may not have a winning hand***

*FINANCIAL TIMES*, 24 FEBRUARY 2014

**I**N 2011, the legendary investor Warren Buffett caused a stir by announcing Berkshire Hathaway's first major investment in a technology company, an area of the market he had always avoided, claiming that he didn't understand it.

This approach accorded well with his advice that investors should always stick to investing within their so-called "circle of competence". Most sensible investors would agree with this idea; after all, who would embrace a strategy of investing in companies or assets they don't understand? In my experience, however, many investors still fail to realise how narrow their circle of competence is.

Buffett's purchase was over \$10bn of stock in technology company IBM, making it Berkshire's second-largest portfolio investment after Coca-Cola and turning Berkshire into IBM's largest shareholder.

Since his purchase, IBM has reported falling revenues. The fourth quarter of 2013 was the seventh in a row in which revenues were lower than they had been in the equivalent quarter the year before. The chief executive and other senior executives have volunteered to forego their bonuses for 2013 as a result of this poor performance. As the Lex column of the *FT* said recently, 'IBM quarterly results practically write themselves now: dreadful revenue growth accompanied by cost controls, share buybacks and dividends that combine to make the technology legend look somewhat less bad than the top line would suggest.'

It so happens that I was looking at IBM at about the same time as Warren Buffett was accumulating his stake, but I decided to avoid it. Why?

A couple of features about IBM unsettled me. One was that they had announced a 'roadmap' to generate growth in earnings per share (EPS) to \$20 by 2015, up from \$11.50 in 2010. I do not like management that uses

terms such as “roadmap” unless they are discussing driving cars. “Plan” is a perfectly good word.

I also dislike the focus on EPS. Not all earnings are created equal. Some require greater or lesser amounts of capital to generate them and not all are delivered in cash. This should come as no surprise to Mr Buffett, who identified return on capital as the primary test of company performance in his 1979 annual chairman’s letter. Much EPS growth is generated at the expense of return on capital and so destroys value.

But if the focus on EPS growth was worrying, the planned means of achieving this identified in the ‘roadmap’ was even more troubling: roughly 40% revenue growth, including acquisitions, 30% operating leverage and 30% share buybacks.

Revenue growth is a higher-quality source of value creation than share buybacks or cost control (which is what I take it IBM means by ‘operating leverage’), provided it is not achieved at the expense of returns. I am wary of revenue growth achieved through acquisitions, the majority of which do not create value. However, there is at least no limit to revenue growth, while cost-cutting and buybacks are both finite.

Moreover, although some buybacks create value for shareholders, many do not and are executed seemingly irrespective of the valuation of the shares. A company cannot create value for remaining shareholders if it pays more for the shares it buys than their intrinsic value, but many companies (and investors) are fooled by the familiar boast that buybacks are accretive to EPS. In an age where the alternative use of cash often generates little income because interest rates are close to zero, almost any alternative is accretive to EPS, but it does not necessarily create value.

I found a five-year plan for significant share buybacks particularly disturbing. How can the management possibly know whether the shares will trade sufficiently below intrinsic value to create value-enhancing buyback opportunities on such a scale and so far ahead?

One other feature of IBM struck me in 2010, when my Fundsmith colleagues and I were reading the company’s 2009 annual report. We noticed that it had a \$1.9bn error in its cash flow statement. We rang IBM to

check that we were not misinterpreting it, and they confirmed we were correct and that we were the only people who had asked about it.

Maybe others had discovered it and didn't bother to call, but I suspect the reality is that very few investors or analysts read annual reports and 10-K filings any more. The error was corrected in the 2010 annual report and did not materially affect my view of IBM, but it certainly affected my view of those who were analysing it.

# *What did you invest in before the war, great-grandpa?*

*FINANCIAL TIMES*, 8 MARCH 2014

**I**N this centenary year of what contemporaries called the Great War and we now call the First World War – because it became necessary to number them – what can we learn from the changes in the constituents of the stock market over the intervening century?

The problem in attempting to answer this question is that most of the major stock market indices on which we now rely were devised long after 1914.

Looking at the world's two most significant equity markets, London and New York, Standard & Poor's first introduced what is now the S&P 500 Index in 1923, and it has only existed in its current form since 1957. The FTSE 100 is of even more recent vintage having only come into existence in 1984. Even the much less representative FT 30 share index was devised in 1935.

The only index from either side of the Atlantic that existed when Gavrilo Princip's fateful shot echoed around the world, and which still exists today, is the Dow Jones Industrial Average, established by Charles Dow in 1884. By 1914 the Dow consisted of ten companies. Today it contains 30.

The constituents in 1914 show that the commanding heights of the US economy were occupied by heavy industrial companies. They were manufacturers, mostly of basic materials consumed by other manufacturers.

Only one company made it into both lists: General Electric. Even so, its business has changed radically over the century. Nearly half of its revenues now come from aero engines and financial services – two businesses that did not exist in 1914, since Wilbur and Orville Wright had only taken to the skies just over a decade earlier.

Just two of the 1914 companies, Amalgamated Copper and Central Leather, have actually ceased to exist. The remainder have disappeared from

prominence and no longer form part of any index, apart from US Steel, which has not made a profit since 2008.

Today's index is dominated by companies of a very different ilk.

Five are involved in financial services, if you include Visa, which is a payment processor. Four are involved in computer hardware, software or services; four are in the drug or healthcare sector; and four are in consumer goods or fast food. Two are oil companies, two are in retailing and two are telecoms companies. The aerospace industry has Boeing, but is also represented within GE and United Technologies, which makes Sikorsky helicopters and Pratt & Whitney engines. There is one entertainment company (Walt Disney). The only companies which look anything like the 1914 vintage are 3M and chemicals group Du Pont.

What should we conclude from this?

The idea of investing with a century as a time horizon is clearly unrealistic. Not much lasts forever in the world of equity investment. If you had invested a trust in the Dow constituents for the benefit of your descendants before you marched off to the Western Front in 1914, and locked it away for the next century, your great-grandchildren would now be mightily bemused by its contents.

If instead you had invested in the companies which rose to the top of the Dow, in terms of market capitalisation, you would certainly have done better (even though these companies may have become large partly by issuing large amounts of equity on which they have made inadequate returns).

But the position of these companies offers some clue to what is regarded as representative of the dominant sectors of the economy now and then.

In so doing it serves to remind us that the US economy, somewhat like the UK economy, is increasingly post-industrial with a growing reliance on financial services, consumers and healthcare.

Finally, the evolution of the Dow shows it is better to invest in companies that make aeroplanes (and their engines) than those that fly them – there isn't a single airline in the Dow.



# *Why buy Brics when you can have Mugs?*

*FINANCIAL TIMES*, 11 APRIL 2014

**P**ERHAPS the most dangerous investment concept is the “no brainer”. Take emerging markets equities as an example. They should surely have much better returns than those in developed economies, as they mostly have better demographics with young, fast-growing populations; higher GDP growth; and they didn’t suffer the meltdown from the collapse of their banking systems that plagued the US and Europe.

How to play this theme? Most would buy an actively managed emerging markets equity fund. If you did so in the past few years, you have almost certainly suffered disappointment.

Over the past five years, the average return for the funds in the Investment Management Association’s Global Emerging Markets sector was 65.7%. They underperformed the MSCI Emerging Markets Index, which rose by 69% over the same period.

Nothing new here, you might well think – the average active manager underperforms the benchmark, often owning so many shares that the fund becomes a “closet index tracker”, replicating the performance of the index but with the added drag of fees and dealing costs. Far from being a surprise, underperformance is a near-certainty.

You could avoid it by investing in an index fund instead. Had you bought a fund that tracked the MSCI EM index you would indeed have fared better over the past few years.

But you would still have done significantly worse than if you had bought a fund that tracks a developed-world benchmark; the FTSE 100 is up by 102% and the S&P 500 by 124% over the same period. Faced with this experience, it must be tempting for investors to conclude that the assumption of superior returns from emerging markets is just plain wrong.

But the peak of disappointment would be if you had bought into one of the

most popular themes of emerging market investing over the past decade and put money into a Bric fund. The acronym Bric was coined by Jim O'Neill, then an economist at Goldman Sachs, in 2001 and stands for Brazil, Russia, India and China. It was supposed to identify the four economic powerhouses of the future, and plenty of passive and active products have been constructed and promoted around it.

Surely few EM investments can have performed better than a Bric fund? Wrong again. Over the past five years, the MSCI Bric Index is up just 44%, underperforming both emerging markets generally and developed markets such as the US and UK. Needless to say, the average Bric active fund has also underperformed the Bric index too.

A big reason for this disappointment lies in what makes up these indices. The largest companies, which dominate the EM index, are Asian consumer electronics companies, Chinese banks and internet companies, phone companies and Russian energy companies. I would regard all of these companies as uninvestable. In the case of the banks in particular, their risk exposure is opaque. I wouldn't invest in a bank in the UK, so what would possess anyone to trust the accounts of a Chinese bank? Yet the largest sector by far in the EM index, representing over a quarter of it, is financials.

The companies that I would regard as most investable are consumer staples. These represent just 8% of the EM index. So it is no surprise to me that the EM index, its tracker funds and the closet trackers among the active funds who secretly track it too have performed badly.

Investing in an index of the Brics is a leap of faith for another reason. The Heritage Foundation, a US think tank, publishes an annual report using a factor model, which attempts to rank countries in an index of economic freedom.

The index assesses how attractive they are for business and investment based on data on a series of factors including property rights, corruption, size of government, regulation, flexibility of labour and liberality of markets.

Places such as Singapore, Switzerland and Hong Kong rank near the top. The highest-ranked Bric is Brazil at number 114 (out of 186), followed by India at 120, China at 137 and Russia down in 140th position.

If you were willing to invest on the basis of a snappy acronym with no regard for the economic and political characteristics of the countries, perhaps you should have subscribed to a fund investing in a group of countries which each rank a little ahead of the Brics in terms of economic freedom. Forget the Mints or the Civets – how about Moldova (110), Uganda (91), Greece (119) and Suriname (130)? These I have christened the Mugs, a pretty good description of anyone who would invest on this basis.

# *A hitchhiker's guide to emerging markets*

*FINANCIAL TIMES*, 1 AUGUST 2014

**I**N my last column for *FT Money* I tried to get to the bottom of why so many investors have had such a bad experience pursuing the superior economic growth in emerging markets. This begs a further question: is there a better way to invest in the developing world?

Growth is often achieved only at the expense of returns on capital and so does not create any value for shareholders. This problem is sometimes ignored by investors hungry for growth, particularly so in emerging markets where superior growth rates are such a significant part of the rationale for investment.

When a company makes an inadequate return on capital – which I will define as one below its cost of capital – it destroys value. Far from growing and employing more of their capital, shareholders should want such a business to shrink its operations and return any cash liberated as a result.

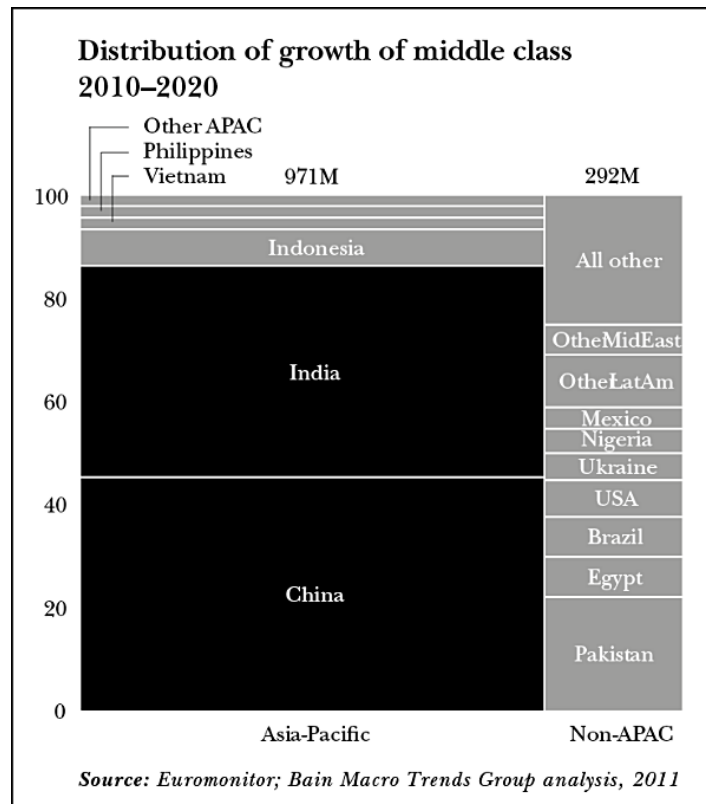
So where can you find companies with consistently high returns on capital and which are capable of profitable growth?

One of the clearest trends after the Second World War has been the rise of the middle class or consumers. In emerging markets there are various definitions of what constitutes this class, but one of the commonly accepted cut-off points is around \$10 per day in disposable income. Below this level, individuals cannot afford to be consumers. Their life is one of subsistence.

Out of a world population of 2.5bn in 1950, probably only some 300m were consumers by this definition. By 2010 this had become 2.4bn out of a total population of 6.8bn. Extrapolation is a dangerous forecasting technique but by 2025 it is estimated (by Groningen University, the Brookings Institute and McKinsey) that out of an estimated world population of 7.9bn, 4.2bn will be consumers.

More importantly, it is expected that the growth rate in consumption in

emerging markets will be more than three times that in the developed world.



The ranks of the middle-class consumer are expected to be swelled by >1bn between 2010 and 2020. On the chart shown, it is sobering to note that the UK, and indeed the whole of Europe, is included in the small box in the top right-hand corner labelled ‘All other’.

*The Hitchhiker’s Guide to the Galaxy* discovers that the entry for earth in the guide consists in its entirety of the word ‘harmless’. His friend Ford Prefect, a contributor to the guide, tells him that the next edition will contain an updated entry on earth that Ford has been researching. It will read: ‘Mostly harmless’.

What Arthur Dent is forced to come to terms with is that his home planet is not particularly significant in cosmic terms. Similarly, as investors, we would do well to realise that our home market, the one with which we are most familiar, is not that important.

This is certainly so in terms of growth in consumer spending. A strategy that relied solely on such growth in the developed world would at best be

forgoing better opportunities elsewhere – which is exactly why so many multinationals in consumer sectors are focused on growing their business in emerging markets.

Ally this to the consistent high returns on capital that many consumer companies are able to sustain and you have an investment strategy with the potential for superior returns. Consumer staples companies generate those returns as their combination of brands, pricing power, distribution and control of their supply chain helps fend off competition.

A strategy of investing in consumer staples companies with the bulk of their operations in developing markets has substantially outperformed the other emerging markets investment strategies that I reviewed in my previous article, over the past five to ten years. Of course, the past is an imperfect guide to the future but it would be unwise to ignore the rapid and predictable growth in consumption of everyday necessities and luxuries when considering investment in emerging markets.

# *How investors ignored the warning signs at Tesco*

*FINANCIAL TIMES*, 6 SEPTEMBER 2014

**S**INCE starting Fundsmith, the stock which I have most frequently been asked about, and implored to buy, is Tesco. Yes, the same Tesco which has just issued two profit warnings within six weeks, which has cut its interim dividend by 75% and has a share price which has fallen to its 2003 level.

I was even asked about it at one of the fund's annual meetings, and a member of the audience tweeted afterwards of his incredulity that I had not been pressed further on the subject.

Superficially it's easy to see why. We are talking not just about the UK's most powerful retailer which has underperformed the market for several years, thereby attracting investors who rely on the theory that what goes down must come up (ignoring the fact that Sir Isaac Newton popularised a theory which proclaims the opposite) and so might present a buying opportunity.

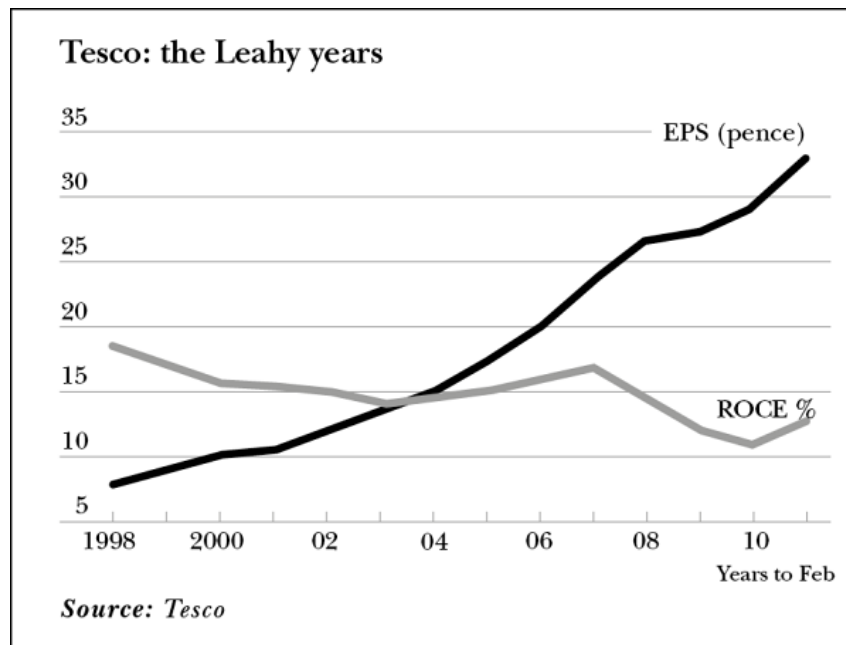
Furthermore, this is a UK stock owned by Warren Buffett, the "Sage of Omaha". In the face of such endorsement, how could I resist owning this gem?

There are many reasons why I am unlikely ever to own a retailer in the Fundsmith Equity Fund, but when it comes to Tesco, a single lesson from the Sage himself was enough to put me off.

In his 1979 letter to shareholders, Mr Buffett stated: 'The primary test of managerial economic performance is the achievement of a high earnings rate on equity capital employed (without undue leverage, accounting gimmickry, etc.) and not the achievement of consistent gains in earnings per share.'

This makes it all the more surprising to me that both Mr Buffett and the

many acolytes who have seemingly followed him to the gates of hell in Tesco, ignored this chart.



This is not the first such chart that I have come across in which a company reports steadily rising earnings per share (EPS), on which most analysts and “investors” focus.

For them, the rise in EPS seems to have a mesmeric effect like Kaa, the snake in *The Jungle Book*. But they ignore the point that more capital is being employed to generate those earnings at ever lower returns. Add in the fact that Tesco has changed its definition of return on capital employed (ROCE) eight times during those years, and there’s more than enough material to send investors running for cover – even those who have less aversion than I do to retailers.

Yet much of the commentary about what has gone wrong at Tesco focuses on Philip Clarke, who took over as chief executive from Sir Terry Leahy in 2011, as if everything was going swimmingly until then. Looking at the ROCE line in the chart, it is clear that this was not the case.

Moreover, one thing to bear in mind is that if Tesco’s ROCE during the Leahy years fell from a very good 19% to a less than adequate 10%, this is an average of returns on capital employed, which includes both capital invested years ago and more recent commitments.



To drag the average ROCE down so dramatically, it is likely that returns on new investments in those years were not just inadequate, but in some cases negative – as the ill-starred US expansion proved to be.

Even if return on capital employed does not have the same importance for you as it does for me, or the Sage (at least in 1979), consider this: in 14 of the past 18 years (taking us back to 1997 when Sir Terry became chief executive), Tesco's free cash flow less its dividend (with free cash defined as operating cash flow less gross capital expenditure) was a negative number.

In plain English, Tesco was not generating enough cash both to invest and to pay its dividend. In half of those 14 years, the proceeds of fixed asset disposals took the numbers back into the black, but that is not exactly a sustainable source of financing.

So guess what they did instead? Yes, they borrowed it. Tesco's gross debt, which was £894m when Sir Terry took over, peaked at nearly £15.9bn in 2009. The company spent much of its free cash on fixed asset investment and raised debt to help pay the dividend. This is neither healthy nor sustainable, as investors in Tesco have now come to realise.

The concept that this might not be sustainable hardly requires much thought. Neither does charting the ROCE versus the growth in EPS. Yet it is evident that many investors, including it seems the Sage of Omaha (who has been trimming his Tesco stake in recent years) either didn't do this or ignored the results if they did. It makes me wonder what else they are ignoring.

# *Eureka! I discovered how funds are named*

*FINANCIAL TIMES*, 3 OCTOBER 2014

**L**AST month Calpers, the California Public Employees' Retirement Scheme, one of the world's largest pension funds, announced it was withdrawing its \$4bn investment in hedge funds. This raises some serious issues, not the least of which is why it invested in hedge funds in the first place.

In its fiscal year ended 30 June 2014, Calpers earned just 7.1% on its hedge fund portfolio compared with 18.4% on its fund overall. But 2013–14 was not a uniquely bad year for hedge funds and neither was Calpers' poor experience unusual. The average hedge fund returned an average of 7.4% in 2013, underperforming the S&P 500 Index by 23% and underperforming the market for the fifth straight year.

In a sense, the underperformance of hedge funds against a benchmark is not the main problem for a fund such as Calpers which should probably ignore index benchmarks anyway, but the underperformance of hedge funds compared to what Calpers can and has achieved in other investments is more problematic – as is the fact that it paid \$135m in fees in 2013–14 to those hedge funds.

In his 2012 book *The Hedge Fund Mirage*, Simon Lack presented evidence that over the period 1998–2010, hedge fund managers' fees accounted for between 86% and 98% of total returns earned. The term “hedge fund” has become a means of describing a fee structure which benefits the fund managers rather than a description of any particular methodology of investment.

The defence which is sometimes raised for hedge funds is that this underperformance is not a good reason to abandon them, as their strategies are uncorrelated to the general trend in markets and that will prove worthwhile when markets go into reverse. This would be more credible if it weren't for their lamentable performance during the financial crisis of

2008–09, when so many of them proved to be leveraged long-only funds rather than hedged in any way which would justify the name.

However, there may have been another way of spotting the incipient problem in Calpers' hedge fund portfolio. Of the 24 hedge funds involved, no fewer than 11 had the word “Eureka” in their title. “Eureka!” is the transliteration of an ancient Greek word meaning “I have found it!” which Archimedes is alleged to have exclaimed upon discovering the way to measure the volume of an irregular object by measuring its displacement of water. More recently, it became a term associated with the discovery of gold, especially in the California gold rush of the 1840s–1850s.

Naming your fund after such a well-known scientific discovery or finding riches was setting yourself up for a fall, or your investors for disappointment, but it was clearly of great benefit if you were trying to market your fund to Calpers.

This brings me to the subject of fund names. You may be familiar with the concept of the circle of competence, often quoted by the great investor Warren Buffett and his partner Charlie Munger. The idea is that you are only likely to succeed in investing if you stick to investing in things which you understand, which seems intuitively obvious but is often disregarded by many investors.

Names of funds are often a clue to the fact that you may not understand what they do (or perhaps aren't meant to). I am spoilt for choice with regard to examples, but I wonder what investors in the “SocGen UK Step Down Defensive Kick-out Plan” think they own, for example.

Many fund names also send warning signals by breaching Smith's Law, which states that you should never use a phrase if its opposite is so illogical that you would never say it. For example, you may find individuals who refer to “forward planning”. Has anyone ever done any backward planning? At best, forward planning is tautology. How many companies say they will grow by means of “selective acquisitions”? Of course, none would say they have a policy of indiscriminate acquisitions (even though that is surely the reality in some cases).

What are we to make of the Sanlam Global Best Ideas Fund? Would anyone ever market a Worst Ideas Fund? If I were an investor with the group I

might be concerned about what I was getting in any of their other funds. How about Pimco's Fundamental Advantage Fund? Would the fees perhaps be lower to attract investors into a Fundamental Disadvantage Fund?

# *Why I don't own bank shares*

*FINANCIAL TIMES*, 1 NOVEMBER 2014

**T**HIS seems like a good week to explain why I don't own bank shares. Although it is seven years since the onset of the financial crisis, around 24–25 banks in Europe still have insufficient capital, according to the latest European Central Bank “stress tests”.

I've often been asked why I won't invest in bank shares given that I was once the top-rated banking analyst in the City. The answer is that having an understanding of banks would make anyone more wary of investing in them.

One of my basic tenets is never to invest in a business which requires leverage or borrowing to make an adequate return on equity.

Most of the companies that we invest in at Fundsmith have some borrowing. But they do not require it in order to survive, and they make decent returns before the use of debt, rather than making small returns on their assets and then financing most of those assets with debt.

Banks rely on leverage to a greater extent than any other business. A 5% equity to assets ratio for a bank is leverage of 19 in debt to 1 of equity.

The good news about such high leverage is that when something goes wrong, at least you go bust quickly.

Have a look below at this very simplified bank balance sheet for Lloyds Banking Group at the end of 2013:

|                                       | Liabilities<br>(£bn) | Liabilities<br>(%) |                               | Assets<br>(£bn) | Assets<br>(%) |
|---------------------------------------|----------------------|--------------------|-------------------------------|-----------------|---------------|
| <b>Equity capital</b>                 | 40                   | 5                  | <b>Cash</b>                   | 50              | 6             |
| <b>Deposits and other liabilities</b> | 807                  | 95                 | <b>Loans and other assets</b> | 797             | 94            |
| <b>Total</b>                          | <b>847</b>           | <b>100</b>         | <b>Total</b>                  | <b>847</b>      | <b>100</b>    |

This is not unusual. It is the normal banking model. A bank makes a small return, typically 1–2%, on its total assets, but as 95% of the assets are funded by depositors and bondholders, the return on equity is much higher. A return of £1 on £100 of assets is a return of 20% on the £5 of equity capital.

Which is all fine – until something goes wrong. Then a loss of just 5% of the value of the assets means the shareholders’ equity is wiped out.

A more pernicious threat is a run on the bank. Investors had forgotten about the credit cycle until 2007, and when credit is withdrawn sometimes it is withdrawn from banks as well as their customers.

When I was analysing banks in the 1980s, it was possible – by studying the bank’s accounts and regulatory returns – to gauge a bank’s exposure to bad debts or credit risk, interest rates and currencies. With the advent of over-the-counter derivatives in these products, which began with interest rate swaps in the 1980s, this is no longer possible.

Someone working in the bank’s treasury department may have altered all those exposures with a phone call or the click of a mouse and there is no way for investors to know. Judging by the events of the financial crisis, it is clear that a fair few bank managements were in the dark too.

All of which leads me to suggest that if you are going to own any bank shares, they should be in retail banks which simply take deposits, lend money to their own customers and make payments for them.

Such banks do exist and if I had to invest in a bank, that would be where I would look. But even those institutions are not immune to the threat which can arise from so-called systemic risk. They can be brought down by a run caused not by their own misjudgements, but by those of other banks in the system.

The fragility of banks is illustrated by a story from the 1980s, when there was a wave of nervousness in Hong Kong following the signing of the joint declaration regarding the colony's handover to China. Property prices began to collapse and banks ran up bad debts as a result.

During this febrile period, a queue of people waited for a bus. It started to rain, and the queue moved across the pavement to shelter under the cover of a canopy on a building, which happened to house a branch of a local family-controlled bank. Passers-by, seeing the queue, concluded that there was a problem with the bank. Rumours of a run spread rapidly and by the following day, the bank was besieged by depositors demanding to withdraw their savings.

# *Is this the next Tesco?*

THE TELEGRAPH, 29 NOVEMBER 2014

I HAVE been reading Warren Buffett's annual chairman's letter to the shareholders of Berkshire Hathaway for more than 30 years. But he's been having a bumpy ride lately.

Probably most conspicuous was his admission of a 'huge mistake' in buying shares in Tesco. He sold part of his stake in Berkshire's only significant investment in a British company at a loss after Tesco's string of disasters.

But it is another stake purchased by Mr Buffett that is also going badly which interests me currently. In 2011 Berkshire bought a large number of shares in IBM and is now the largest shareholder, owning 7% of the company.

IBM recently abandoned its 2015 profit target of \$20 per share, having made only \$10.76 in the first three quarters of this year. Its share price fell as a result to a current \$162, against a high for the year of nearly \$200 and an average price for Berkshire's holding of \$170 per share.

By coincidence, when Mr Buffett was buying Berkshire's stake in IBM, we were looking at it for the Fundsmith Equity Fund and rejected it. Why?

The computer services giant had just delivered its "IBM 2015 Roadmap" in May 2010 via a PowerPoint presentation. My defensive instincts are immediately aroused when someone uses the term "roadmap" unless they are in a motor vehicle. "Plan" is a perfectly good and much less pretentious term.

This 'roadmap' was intended to show how IBM would grow its 2010 profits of \$11.52 per share to \$20 by 2015.

Quite why any other investor should be impressed with this goal, even if IBM could achieve it, is beyond me.

But it is particularly curious that Mr Buffett might have been impressed given that he wrote in his 1979 chairman's letter: 'The primary test of managerial economic performance is the achievement of a high earnings



rate on equity capital employed (without undue leverage, accounting gimmickry, etc.) and *not the achievement of consistent gains in earnings per share.*' (Emphasis added.)

He seems to have overlooked his own advice in this case, as well as with Tesco.

Just to add to our sense of unease, the IBM 'roadmap' described a number of 'bridges' to growth in earnings per share. There was me thinking that a bridge was a structure that crosses a physical obstacle.

The 'bridges' ("source" is a good word unless you are a civil engineer) for this 'roadmapped' growth were roughly 40% revenue growth, although this included acquisitions; 30% 'operating leverage' (cost-cutting or productivity gains in English); and 30% share 'buybacks', where a company uses its cash to buy its own shares, reducing the number in issue.

Acquisitions, cost-cutting and share buybacks are not a particularly high-quality source of growth. The cost-cutting and share buybacks are certainly finite – you can't cut costs and shrink your business to growth, other than growth in earnings per share, which Mr Buffett had already correctly rejected as a useful measure of value creation or performance.

And how can you know you will make acquisitions, and doesn't price come into it?

The share buyback 'bridge' was particularly worrying. The slides show it as \$50bn of planned share repurchases. How could anyone be sure that they will repurchase shares over the coming years, let alone such a vast quantity? After all, what will the share price be? If the shares are trading above their intrinsic value, a share repurchase will destroy value, other than for those shareholders who exit by taking the opportunity to sell.

Yet when he disclosed Berkshire's stake in IBM, Mr Buffett said: 'I don't know of any large company that really has been as specific on what they intend to do and how they intend to do it as IBM.' So he was clearly impressed by the 'roadmap'.

Since IBM's abandonment of its 'roadmap' target for earnings per share, much has been made in articles and blogs of Mr Buffett's sanguine view of IBM's share price performance over the years of this proposed buyback programme.

In his 2011 chairman's letter he wrote: 'We should wish for IBM's stock price to languish throughout the five years [of the proposed buyback programme]. The logic is simple: if you are going to be a net buyer of stocks in the future, either directly with your own money or indirectly (through your ownership of a company that is repurchasing shares), you are hurt when stocks rise. You benefit when stocks swoon.'

This has led commentators to suggest that Mr Buffett must be cheering the drop in the IBM share price. However, there are probably a few useful words of qualification that he should have added to his views on IBM's share price and stock buybacks. They are: "But of course it depends on the reason why the share price falls."

If the shares fall because the company's prospects have deteriorated and so has their intrinsic worth, pressing on with share buybacks may just be a waste of money – money that belongs to Berkshire and other remaining shareholders.

Given that this is exactly what appears to have happened, I suspect that the sound which can be heard from Omaha is not the cheering that some commentators have suggested but something reminiscent of an Edvard Munch painting.

# *Let's all do the corporate hokey-cokey*

*FINANCIAL TIMES*, 5 DECEMBER 2014

**T**HERE seems to have been an outbreak of the hokey-cokey participation dance song among companies lately. You know, the one where you put your right hand in, take your right hand out, shake it all about and so on.

The most prominent tendency of late seems to be to split companies into smaller enterprises, predominantly in the US but also closer to home. Even in the limited number of sectors and companies in which Fundsmith seeks to invest, there has been a rush to demerge. Just this week, Unilever announced the spin-off of its spreads business, but we have also seen:

- ADP, the payroll company, spin off its car dealership software business CDK
- eBay's announcement that it will separate its Marketplaces and PayPal businesses
- Kimberly-Clark, the tissue and nappy manufacturer, planning to spin off its healthcare business
- Procter & Gamble announcing its intention to spin off its Duracell battery business and then selling it to Warren Buffett's Berkshire Hathaway
- Reckitt Benckiser's decision to float its pharmaceutical business, to be called Indivior.

And just to maintain the symmetry of the song, Coca-Cola is going through one of its periodic volte-faces on whether it is good or bad for it to own its bottlers by buying back stakes in them, many of which it had previously sold. It seems that sometimes not owning bottlers is good because it is a capital-intensive, low-return business. At other times, it is essential to own them in order to control distribution. Coke is so bipolar on this issue that it could perform the corporate M&A hokey-cokey all on its own.

In some cases, the urge to demerge seems to result from the conclusion that the company had two or more completely different businesses which did not produce any synergies and might have better futures and/or higher valuations apart from each other. One might wonder why this thought did not occur to anyone when the businesses were being acquired. Part of the answer lies in so-called shareholder activism.

Activism can take many forms and mean different things but often it involves a shareholder buying a stake in a company and then agitating for change, either via the media or through corporate governance channels.

Sometimes that change does not involve separating a company into smaller component businesses, but rather it aims to get the company to put itself up for sale. We saw this in 2011 when veteran US activist Carl Icahn made a bid for Clorox, the US household cleaning products company, in an effort to get them to sell themselves. More recently we have seen an activist make a public appeal to the board of InterContinental Hotels to put the company up for sale.

Activism definitely has a role in promoting shareholders' interests but too often it involves an attempt by the activist to get the company to do a deal which will generate some attention among the analytical community and so enable the activist to sell its stake at a profit. All very exciting, but not of much use to long-term shareholders like us who are left with holdings in fragmented businesses, often with new management teams and strained balance sheets. Then there are the huge frictional costs of separation fees to investment bankers, lawyers, accountants and others – followed by financial statements that contain so many adjustments that they border on the incomprehensible.

But sometimes seemingly frenetic merger and demerger activity is dreamt up by the management of the company all by itself. A classic case is Mondelez. It is the product of Kraft's controversial takeover of Cadbury in 2010, which was followed just two years later by the demerger of Kraft and Mondelez (which consisted of Cadbury plus Kraft's snack businesses). Hardly any analysts queried why it was a good idea to demerge two businesses which it had only combined two years previously, and if you can follow the logic in all of this you are ahead of me.

The result of Kraft's hyperactivity was that the 2013 results for Mondelez – the first post-demerger – contained 19 schedules of adjustments and reconciliations to its reported numbers. This legerdemain had not ceased by the first quarter of 2014, when it gave 11 adjustments, magically turning reported growth of operating profits from 1.1% to 15.8%. And for my next trick...

There have of course been the usual restructuring programmes and integration programmes, and the hokey-cokey activity has not slackened with the announcement this year that Mondelez is now spinning out its coffee business into a joint venture with D.E. Master Blenders called Jacobs Douwe Egberts.

At least all this is bullish for investment bankers' bonuses.

# *Annual letter to shareholders 2014*

FUNDSMITH, JANUARY 2015

**T**HIS is the fifth annual letter to owners of the Fundsmith Equity Fund. The table shows performance figures for the last calendar year and the cumulative and annualised performance since inception on 1 November 2010 compared with various benchmarks.

| % Total return                     | 1 Jan to 31 Dec 2014 | Inception to 31 Dec 2014 |                   |
|------------------------------------|----------------------|--------------------------|-------------------|
|                                    |                      | <i>Cumulative</i>        | <i>Annualised</i> |
| Fundsmith Equity Fund <sup>1</sup> | +23.3                | +100.0                   | +18.1             |
| Equities <sup>2</sup>              | +11.5                | +56.6                    | +11.4             |
| UK bonds <sup>3</sup>              | +10.0                | +23.1                    | +5.1              |
| Cash <sup>4</sup>                  | +0.5                 | +2.9                     | +0.7              |

<sup>1</sup> T-class acc Shares, net of fees, priced at noon UK time. <sup>2</sup> MSCI World Index, £ net, priced at close of business US time. <sup>3</sup> Bloomberg/EFFAS Bond Indices UK Govt 5–10 yr. <sup>4</sup> 3-month Libor interest rate. <sup>1,3,4</sup> Source: Bloomberg. <sup>2</sup> Source: [www.msci.com](http://www.msci.com)

We never tire of reminding people that we remain critical of attempts to measure investment performance over short periods of time, such as a year. However, this proviso notwithstanding, the table shows the performance of the T-class accumulation shares which rose by 23.3% in 2014 and compares that with 11.5% for the MSCI World Index in sterling with dividends reinvested. The fund therefore outperformed the market in 2014 by 11.8%. However, we are assisted in forming a longer-term perspective on the fund's performance by the fact that it finished 2014 with the improbably precise outcome of having doubled investors' capital since inception.

2014 was another bullish period for equity markets. In this letter last year we wrote about the so-called “taper tantrum” in which markets fell in May 2013 when the Federal Reserve Bank first mooted that it was planning to begin reducing its programme of quantitative easing (QE) – “printing” money (or at least clicking a mouse to create it) with which to buy bonds. Although US QE has now ended, equity markets had a somewhat bullish year (at least in sterling and in the US – the FTSE 100 and emerging

markets fared badly) and the US and UK economies are growing, it is tempting to conclude that the market wobble of May 2013 was just an example of the so-called “wall of worry” which a bull market is said to climb.

This may be so, but this economic recovery is neither uniform nor unaided. The core countries of the eurozone – Italy, France and even Germany – are now struggling, as is a large part of the developing world (much of which is still driven by commodity exports), at a time when China’s seemingly insatiable demand for commodities to fuel its industrialisation has slackened markedly. Nor is such anaemic growth being achieved without considerable stimulus. Japan is engaged in a QE experiment of epic proportions as it tries to stimulate its way out of a slump which innumerate commentators have described as a “lost decade” with no economic growth. It has in fact gone on for the better part of two decades. Even the growth in the US and the UK is being achieved against a backdrop of record low interest rates and continuing government deficit spending, the necessity for which is unusual and worrying this far into a recovery.

I do not think it would add much for me to weigh in on the debate about the reasoning behind QE, its effectiveness and possible consequences, except to observe that many of its proponents seem to assume that inflating asset values will lead to prosperity. I suspect this is the reverse of what should occur which may not bode well.

We are often asked what our view is of the economic outlook for the world and how our fund is positioned to take advantage of, or cope with, those conditions. Our investment approach is thankfully not based upon our view of the global economic outlook. I say thankfully because we do not profess any great expertise in this area, and we are not particularly optimistic. This is in contrast to many others in the industry who certainly profess to such expertise, often it seems without any obvious justification. We are at least one step ahead of most of them in recognising that we do not know what will happen.

The desire of people to rely on forecasting despite its obvious drawbacks is illustrated by an anecdote from the Nobel laureate and retired Stanford University economist Kenneth Arrow. Arrow did a tour of duty as a weather forecaster for the US Army Air Forces during the Second World War.

Ordered to evaluate mathematical models for predicting the weather one month ahead, he found that they were worthless. Informed of this, his superiors sent back another order: 'The Commanding General is well aware that the forecasts are no good. However, he needs them for planning purposes.'

Our investment strategy is based first and foremost on buying shares in good companies. We cannot promise you much about our fund. But one thing we are clear about is that we seek to own shares in good companies and at least most of the time we succeed in that objective.

You may think that this part of our strategy is so obvious that it must surely be the case that all fund managers seek to invest in good companies. However, this is certainly not the case. Fund managers will buy shares in bad companies – by which I mean companies which do not consistently create value for their shareholders or, even worse, which destroy value some or even all of the time. If they have a reason for doing this it usually boils down to some expectation that the performance of the companies will improve, at least temporarily, because they think that the economic or business cycle will improve and those companies will start to make adequate returns, or there will be a change of management which will improve their performance, or a takeover bid, all of which may benefit the share price. Or they may just think that the shares are cheap.

One problem with this approach to investing is that companies rarely go through a transformational improvement (a phrase involving leopards and spots springs to mind) and these events are also difficult to predict. But in our view the main problem with this investment strategy, other than the fact that we have no expectation that we could make it work, is that whilst fund managers await the kiss that will turn their corporate frogs into princes, they steadily erode value. The companies in our portfolio are certainly not immune to periodic downturns in business and/or management errors, and their share prices are subject to the usual factors which affect the stock market, but we can at least be reasonably sure that they are adding to their intrinsic value over time.

To demonstrate this we thought of a new way to inform you about the portfolio of companies which we own. The table below shows what the Fundsmith Equity Fund would be like if instead of being a mutual fund it



was a company and accounted for the stakes which it owns in the portfolio, and compares this with the market (in this case the FTSE 100 and the S&P 500):

|                                   | Fundsmith Equity Fund <sup>1</sup> | FTSE 100 Index <sup>2</sup> | S&P 500 Index <sup>2</sup> |
|-----------------------------------|------------------------------------|-----------------------------|----------------------------|
| Return on capital employed (ROCE) | 29%                                | 18%                         | 18%                        |
| Gross margin                      | 60%                                | 39%                         | 44%                        |
| Operating profit margin           | 25%                                | 16%                         | 16%                        |
| Cash conversion                   | 102%                               | 79%                         | 81%                        |
| Leverage                          | 28%                                | 40%                         | 38%                        |
| Interest cover                    | 15×                                | 9×                          | 9×                         |

<sup>1</sup> Source: Fundsmith Research. <sup>2</sup> Source: Bloomberg. ROCE, gross margin, operating profit margin and cash conversion are the weighted mean of the underlying companies invested in by the Fundsmith Equity Fund and mean for the FTSE 100 and S&P 500 indices. The FTSE 100 and S&P 500 numbers exclude financial stocks. The leverage and interest cover numbers are both median. All ratios are based on last reported fiscal year accounts and as defined by Bloomberg. Cash conversion compares free cash flow per share with net income per share.

What does this table demonstrate? Taking each of the measures in turn:

**Return on capital employed:** The legendary investor Warren Buffett in his 1979 annual letter as chairman of Berkshire Hathaway described ROCE as ‘The primary test of managerial economic performance’. In our “company” it was 29% versus an average of 18% for the market. For every pound of capital which we own, our companies produce 29p of profits versus 18p for the market.

**Gross margin:** The difference between sales revenue and cost of goods sold for our company was 60% versus about 40% for the market. Our company makes things for £4 and sells them for £10. The market makes things which cost £6 and sells them for £10.

**Operating profit margin:** Our company’s operating profit margin is 25% versus an average of 16% for the market.

**Cash conversion:** Our company converts just over 100p out of every £1 of profit into cash, whereas the market manages about 80p as its businesses require more capital expenditure and working capital to function.

**Leverage:** Our company has net debt (net of cash) of about a quarter of shareholders' funds whereas the market has around 40%.

**Interest cover:** Our company's profits are 15 times its interest charge, which means there is little doubt that it can service its debt even in a dramatic downturn. The market looks quite safe, too, but its interest cover is below ten times.

In short, our "company" has much better financial performance than the market as a whole and is more conservatively funded.

So when it comes to quality we are confident that we have selected good companies, but one of the questions which most frequently arises when we are talking to investors is that of valuation. The companies we invest in may be high-quality businesses, but perhaps their shares have become too expensive. There is no doubt that the shares in our portfolio have become more highly rated over the past four years. It is also true that this is not the way we would prefer the performance of the portfolio to be delivered, as increases in the multiples which company shares trade on are finite and reversible.

But there is no certainty that such improvements in valuation will reverse any time soon or indeed that they won't continue. We remain unimpressed by those who tell us about their concerns about valuation and who have been doing so for several years. No doubt they may prove to be right at some point but following their advice would have been very expensive in the interim. We do not attempt to make any so-called "market timing" judgements. We aim to have our fund fully invested in companies of the sort we like, thereby acknowledging that we do not possess any expertise in guessing the right moment or even the right year in which to invest or to sell. In this we seem to have an advantage over those investors who think they can accomplish this, exemplified in my mind by at least one investor who refused to invest with us at the launch of our fund because he thought our timing was not propitious and who now ascribes our performance to our good timing. I have news for him: we took no account of such timing when we launched and neither do we now.

Having said all of that, where are we on valuation? The weighted average free cash flow (FCF) yield of the portfolio (the free cash flow generated by

the companies divided by their market value) started the year at 5.1% and ended it at 4.5% so we had a tailwind from increased valuations again, but the yield is still above the level that we would find acceptable on the basis of the comparison with expected bond yields. Our companies on average grew their free cash flow per share by 7.0% during the year but also spent 7.8% more on capital expenditure (capex). We find the fact that they continue to increase their capex to be encouraging, as we have yet to find an industry which can grow without committing additional capital in order to do so.

This 4.5% FCF yield compares with a median FCF yield for the non-financial stocks in the S&P 500 of 4.2% and a mean of 3.4% or a median for the non-financial stocks in the FTSE 100 of 4.4% and a mean of 3.8%. Our stocks do not look bad value in comparison to the market, especially when their relatively high quality is taken into account. Although, of course, both may be expensive, but then both may continue to be so or even become more expensive.

For 2014 the top five contributors\* to the fund's performance were:

|                          |       |
|--------------------------|-------|
| <b>Dr Pepper Snapple</b> | +3.3% |
| <b>Microsoft</b>         | +2.3% |
| <b>Domino's Pizza</b>    | +2.0% |
| <b>Stryker</b>           | +2.0% |
| <b>Becton Dickinson</b>  | +1.7% |

Of the top five contributors it is perhaps worth noting that no fewer than four – Becton Dickinson, Domino's Pizza, Microsoft and Stryker – were in this position last year as well. So much for the theory that no one ever did badly by taking a profit.

The bottom five were:

|                      |        |
|----------------------|--------|
| <b>Diageo</b>        | -0.08% |
| <b>Swedish Match</b> | -0.05% |
| <b>L'Oréal</b>       | +0.01% |
| <b>Amadeus</b>       | +0.22% |

**Colgate-Palmolive** +0.24%

*\* Contribution shows the gross contribution to the fund's return by stock as calculated by State Street Investment Analytics. The list excludes stocks held for less than one month so as to be more meaningful.*

Only two of the bottom five produced negative contributions, Diageo and Swedish Match. We sold the latter, which had also been our worst contributor in 2013, during 2014. We took the view that the e-cigarette development, whilst not necessarily harmful to the cigarette companies, was a potentially disruptive change which could adversely impact its Snus smokeless product. We are sensitive to the possibility of permanent loss of value which disruptive change can cause and on the whole we seek to avoid investing in companies which could be affected by it. We also feared another disruptive change which could affect Swedish Match – a thawing of relations between the US and Cuba, as Swedish Match distributes non-Havana cigars in America. We did not think that its business would fare well in the event that the US embargo on trade with Cuba was lifted, which we thought was likely. It appeared to us that most people would struggle to explain the rationale for this Cold War measure, whose lack of coherence has been lampooned by the saying we are fond of: that it is the first attempt in history to bring about regime change by smoking inferior cigars. Since we sold our holding in Swedish Match, the events we foresaw have indeed begun to unfold. Our only other disposals during 2014 were our holdings in CDK, a supplier of software to motor dealers, which was spun out of ADP during the year, and a small holding in Indivior, the pharmaceutical company, which we received when it was demerged by Reckitt Benckiser.

We started three new holdings during the year, two of which are within the technology sector. You may think this fits awkwardly with our professed desire to avoid businesses which might be subject to disruptive change (for which the technology sector is renowned). However, in neither case are our new investee companies operating in areas at the leading edge of technology.

eBay is probably well known to you through one or both of its two major businesses – the Marketplaces business, through which you can buy and sell new or second-hand items, and PayPal, the leader in online payments. Whilst so-called activist investing has its place in ensuring that company managements pay due attention to shareholders' interests, we are not fans

of the commonest form of this activity, the modus operandi of which could be described as:

- Activist acquires stake in company.
- Activist campaigns noisily and publicly for change, which can consist of the company trying to sell itself to an acquirer, splitting the company into a number of listed entities for each of its activities, taking on more debt, share buybacks, or some combination of these.
- Shares go up as a result of excitement amongst the “analytical” community about this activity.
- Activist sells stake at a profit.
- Long-term shareholders are left trying to make sense of fragmented businesses, new management teams, higher leverage, costs of separation or integration and financial statements which are rendered incomprehensible by many adjustments.

However, in the case of eBay an activist acquired a stake and pushed the company to agree to separate its Marketplaces and PayPal businesses and we tend to agree that they may be better separated so that PayPal can develop its payment service with other online businesses. I should add that we started buying our stake before this was announced and it was not part of the rationale for our investment.

In the case of Sage, we started buying a stake in the UK’s largest software business. Sage has an installed base of software used by millions of small and medium-sized businesses which makes it the dominant supplier of accounting software outside America. Like many software businesses it is transitioning from selling software in the form of a disc in a box, which is paid for upfront, to an online subscription model which we think will ultimately make it an even better business.

Close to the end of the year we also began acquiring a stake in an international testing and inspection company, the name of which we are yet to reveal as we are in the process of buying our position.

That is the sum total of our outright sales and purchases for 2014, at least part of which was involuntary in that we received the CDK holding as a

result of our stake in ADP and the Indivior holding from Reckitt Benckiser. Which is just as well, since minimising portfolio turnover remains one of our objectives and this was again achieved with a negative turnover of -8.4% during the period. Negative turnover occurs because the method of calculating turnover excludes flows into or out of the fund, otherwise a newly established fund would automatically have 100% or more turnover. However, it is not very helpful in judging our activities. It is perhaps therefore more helpful to know that we spent a total of £98,081 or just 0.005% (0.5bp) of the fund on voluntary dealing.

Why is this important? It helps to minimise costs, and minimising the costs of investment is a vital contribution to achieving a satisfactory outcome as an investor. Too often investors, commentators and advisers focus on the annual management charge (AMC) or the ongoing charges figure (OCF), which includes some costs over and above the AMC, which are charged to the fund. The OCF for 2014 for the T-class shares was 1.09%. The trouble is that the OCF does not include an important element of costs – the costs of dealing. When a fund manager deals by buying or selling investments for a fund, the fund typically incurs commission paid to a broker, the bid–offer spread on the stocks dealt in and, in some cases, stamp duty. This can add significantly to the costs of a fund yet it is not included in the OCF.

I find that investors remain confused by this no matter how many times I attempt to explain it, or maybe because of my attempts to explain it. The fact is that as an investor you can only benefit from the price appreciation of shares in your fund and dividends paid. Costs of dealing detract from those returns and therefore need to be taken into account when you are comparing funds.

We have published our own version of this total cost including dealing costs, which we have termed the total cost of investment, or TCI. For the T-class shares in 2014 this amounted to a TCI of 1.18%, including all costs of dealing for fund inflows and outflows, not just our voluntary dealing.

In order to minimise the cost of dealing and avoid the mistakes which seem to result when we sell stakes in good businesses our mantra is: “Don’t just do something, sit there.”

# *What exactly do we mean by “shareholder value”?*

*FINANCIAL TIMES, 9 JANUARY 2015*

**A**s an investor you will probably have encountered two terms which have the word “shareholder” in common: shareholder value and activist shareholder.

Just before the end of last year we were contacted by an activist investor who has a stake in one of our portfolio companies to discuss a set of proposals. They basically amounted to a demand that the company should seek to sell itself to one of its competitors to ‘create additional shareholder value’.

This set me thinking again about the nature of shareholder value, and indeed activism. In this and a subsequent article, I’ll attempt to explain what I think these terms really mean and how they fit into the world of investment.

Company managers, fund managers and activist investors often say they are committed to generating or releasing shareholder value without ever spelling out precisely what that means. For me, it is simply determining whether or not a company is creating additional wealth for its ultimate owners, and whether its managers are acting appropriately to achieve this. I’m not sure this is everyone’s definition, though. Latterly, I have come to wonder whether this concept has come to be misused, like so many others in finance.

Put simply, my definition of value creation is when a company delivers returns that are above the cost of the capital used to generate them. Companies are in essence just like us. If you borrow money at a cost of 10% a year and invest it at a return of 5% a year, you will become poorer. If you invest it at a return of 20% a year, you will become richer.

Similarly, companies which consistently make returns above their cost of capital become more valuable and vice versa. A company that can sustain a return on capital above its cost of capital creates value for its shareholders,

who should want it to retain at least part of its profits to reinvest at these attractive rates of return rather than handing them all over as dividends or using them to buy back shares.

I define returns as the “return on capital employed” or ROCE. That is fairly easily determined from company accounts; it’s basically operating cash flow divided by the sum of shareholders’ equity and net debt.

Determining what the cost of capital is for a company is rather more difficult. If you borrow money at a cost of 10% in order to invest, then your cost of capital is fairly clear. A company’s cost of debt capital is equally clear and can often be found in, or calculated from, the notes to its accounts. But what about the cost of its equity?

The commonest way of estimating this uses the so-called capital asset pricing model, often snappily known as “Cap-M” after its acronym. This defines the cost of equity capital as a risk-free rate, usually taken as the yield on government bonds in the same currency as the company, plus a risk premium. This premium is observed over time from the actual return that equities deliver relative to the bonds that form the risk-free rate.

If I haven’t lost your attention with that last paragraph, I’d be amazed. And therein lies one of the problems: a company’s cost of capital is not easy to define and can only ever be an estimate. These problems have been compounded more recently because of the financial crisis. This has led some investors to query whether government bonds are truly risk-free, while ultra-low official interest rates, quantitative easing and a lack of inflation have sent bond yields down to record lows and even into negative territory.

Perhaps because cost of capital is not straightforward to define or compute, the most commonly accepted means of measuring value creation is growth in earnings per share (EPS), which is just the profits net of tax divided by the number of shares in issue. What could be simpler to calculate? Not much – which is probably why so much importance is attached to this simplistic measure of performance and its related valuation metric, the price/earnings ratio. Look through any analyst’s research and you’ll find dozens of references to them, often on the front page.

Simple they may be, but EPS and PE ratios suffer from some serious flaws.



The most important is that they take no account of the capital employed or the returns made on it. As the Tesco example shows, it is perfectly possible for a company to generate rising EPS at the same time as it is employing increasing amounts of capital at falling and inadequate rates of return. In other words, a company can be busy destroying shareholder value even as it increases its earnings.

So I'm sticking with ROCE as my preferred measure of value creation. But of course neither ROCE nor EPS is the same as making the share price go up. This, I suspect, is an even more common definition of shareholder value creation, especially among activist investors, of which more in the next column.

# *Shareholder value is an outcome, not an objective*

*FINANCIAL TIMES*, 6 FEBRUARY 2015

**I**N the first article of this two-part series I explained how I define the term shareholder value: whether or not a company is able to generate a sustained return on capital employed (ROCE) above its cost of capital. This time I want to link that definition with shareholder activism.

When an activist shareholder becomes involved in a company, the *modus operandi* is often something like this:

1. Acquire a stake in the company, usually via on-market purchases.
2. Campaign noisily for change, which can entail the company trying to sell itself to an acquirer, splitting itself into a number of listed entities for each of its activities, taking on more debt, buying back its own shares, or some combination of these.
3. The share price rises as a result of excitement about this activity, which it is claimed will “create shareholder value” and benefit all investors.
4. Sell the shares at a profit.

Nothing wrong with that, you might think, and certainly not from the point of view of the activist. But there is plenty wrong for those of us who are long-term investors and actually want to own the shares to gain from their ability to compound in value over time. We are often left trying to make sense of fragmented businesses, new management teams, higher leverage, the costs of separation or integration and financial statements which are rendered incomprehensible by many adjustments.

This particular problem of activism comes from confusing creating shareholder value with making the share price go up. One should lead to the other, but when short-term share price movements become the main

objective, as they clearly are with many activists, the inevitable by-product is future problems for the business and its long-term shareholders.

You might conclude from this that the main target of my criticism is activists who pursue corporate action to promote short-term share price gains. But there are plenty of pitfalls for exponents of shareholder value, including those who embrace my own view on how to measure its creation.

Too often, the measures of shareholder value creation become the objectives of management. ROCE is after all only a financial ratio. In order to improve it, executives focus on getting the numerator to rise or reducing the denominator, or both.

The numerator is usually taken as operating profit, which may be increased by raising prices (which may lose market share and build a platform for competitors), cutting costs (which is not a likely source of growth), and cutting research, product development and marketing spend (to the long-term detriment of the company).

When it comes to the denominator, managers usually look to reduce the capital employed by “de-equitising” the business, using debt to buy back shares.

But if the pursuit of improving shareholder value in the form of high ROCE can lead to problems, they are nothing compared to those which can arise when growth in earnings per share is the target. A fixation on earnings per share (EPS) is one factor behind the mania which has developed for share buybacks. In an era of zero interest rates, every buyback which reduces cash or increases debt can be claimed to be “accretive to EPS”. Sadly, it doesn’t actually make the shrunken share base any more valuable.

When it comes to misconceived actions which aim to boost shareholder value metrics, Stanley Druckenmiller, the legendary hedge fund manager, has described IBM as a ‘poster child’.

Last year, IBM abandoned its 2015 EPS target of \$20 per share, having made only \$10.76 in the first three quarters of 2014. The computer services business had delivered its “IBM 2015 Roadmap” in May 2010, purporting to show how IBM would increase its 2010 EPS of \$11.52 per share to \$20 by 2015.

Quite why any other investor should be impressed with this goal, even if

IBM could achieve it, is beyond me. As I never tire of reminding people, EPS takes no account of the capital required to generate it, or the return on that capital.

The IBM 'roadmap' described a number of 'bridges' to growth in EPS. Roughly 40% was to come from revenue growth, although this included acquisitions; 30% 'operating leverage' (cost-cutting, in English); and 30% from share 'buybacks'.

Acquisitions, cost-cutting and share buybacks are not a particularly high-quality source of growth. The cost-cutting and share buybacks are certainly finite – you can't shrink your business to growth.

The outcome for IBM has been inevitable, and not good. Investors and executives need to realise that the creation of shareholder value is an outcome – not an objective.

# *Three steps to heaven*

FIDELITY, 27 FEBRUARY 2015

“**T**HREE Steps to Heaven” was a posthumous number-one hit by Eddie Cochran for which Showaddywaddy did a cover version. At Fundsmith it’s the foundation of our investment process for the Fundsmith Equity Fund:

1. invest in good companies
2. don’t overpay
3. do nothing.

## **1. Invest in good companies**

A good company is one which creates value for its shareholders by making a high return on capital – significantly above its cost of capital – across the business and economic cycle.

What is return on capital? It is usually measured by the operating profit of the business, divided by the capital employed, expressed as a percentage.

What is the cost of capital? The cost of debt is relatively easy – you can find a reference to the cost of bonds in the accounts and if there is bank debt you can just use the interest charge divided by the average of opening and closing debt as the percentage cost. Cost of equity is trickier to ascertain and is usually taken as a so-called risk-free rate, such as the yield on government bonds in the same currency that the company operates in, plus a risk premium to compensate for the additional risks inherent in equity investment. This slightly complex formula probably explains at least in part why so few investors seem to try to work this out.

Why is this important? Companies are just like us in some respects. If you borrowed money at 10% per annum and invested it at a 20% per annum return, you would become richer. But if you invested at 5% per annum, you would become poorer. Similarly, a company which makes a return above its

cost of capital becomes more valuable – it creates value for its shareholders – and vice versa.

But don't all companies create value for their shareholders? Sadly not. There are some industries which are prone to make returns below their cost of capital much or all of the time, such as the airline industry which has probably not created value for shareholders throughout most of its existence.

But surely if a whole industry just keeps destroying value, why would anyone invest in it? Fund managers invest in companies which do not make adequate returns and so destroy value because they hope they will change – that a change of management, an upturn in the business cycle, a takeover or industry consolidation will alter this fundamentally poor characteristic. Whilst fund managers wait for their investments in bad companies to come good, they steadily erode value by the equivalent of borrowing money from you the shareholder and investing it at an inadequate rate of return.

When you own shares in a good company, you can be sure that its value will rise over time.

## **2. Don't overpay**

The secret of investment may be to buy low and sell high, but if you are buying shares in good companies, it doesn't matter if you forget the second bit. If you are going to own a portfolio of good companies with high returns which compound in value over time, you can't play "greater fool theory" in which you knowingly overpay for the shares hoping that a greater fool will buy them off you at an even more egregious valuation, as you intend to hold on to them. Which leads to:

## **3. Do nothing**

In many ways the most difficult part of the strategy. Fund managers often seem to act as though they are paid by investors for activity when in fact they are paid for their results. And those results are generally enhanced by masterly inactivity as dealing activity costs money in terms of commissions, bid-offer spreads, and stamp duty on UK shares.

# *Where's the beef? McDonald's uncertain recovery*

*FINANCIAL TIMES, 22 MAY 2015*

“**W**HERE’S the beef?” is a catchphrase in the US. It originated as an advertising slogan for the fast-food chain Wendy’s in a TV commercial in 1984. Since then it has become an all-purpose phrase questioning the substance of an idea, event or product. It strikes me as relevant to the current predicament of McDonald’s.

McDonald’s, the world’s largest fast-food operator, is experiencing serious problems. Global same-store sales have now been down for four consecutive quarters and six of the past nine quarters.

US same-store sales have now been down for six consecutive quarters. European same-store sales have been down for four consecutive quarters and for seven out of the past ten quarters, and you shouldn’t ask about what is happening to McDonald’s Japanese sales if you are squeamish.

Perhaps even worse is the fact that the number of customers visiting McDonald’s in the US fell 1.6% in 2013 and then 4.1% in 2014. The European guest count fell 1.5% in 2013 and then 2.2% in 2014.

Nor are things any better in the developing world. Same-store sales in Asia-Pacific, the Middle East and Africa have been down for eight of the last ten quarters and the guest count fell 3.8% in 2013 and 4.7% in 2014.

In other words, fewer people are going to McDonald’s and the rate of decline is accelerating.

Some commentators would have you believe that the problem rests with the entire sector, for which they use the pejorative term “junk food”. Yet Domino’s Pizza reported results for its first quarter ended March 2015 with US same-store sales up by 14.5%, and this is not an isolated example.

Nor can McDonald’s blame the economy: the company managed 3.8% same-store growth in 2009 and 6.9% in 2008. Comparable global sales grew in every month in 2008 and 2009.

The fact is, there is something fundamentally wrong with McDonald's rather than the whole fast-food sector. It affects all regions of its operation and it is getting worse.

At least McDonald's has figured out that it has a problem. The result is a new chief executive, Steve Easterbrook, who ran the relatively successful UK operations, and the obligatory "turnround plan" launched at an investor conference.

My misgivings about this plan began with the news release which preceded the conference. It said the new chief executive identified the company's priorities as threefold: 'driving operational growth, returning excitement to our brand and unlocking financial value'. It continued, 'the first critical step of our operational growth-led plan is to strengthen our effectiveness and efficiency and drive faster and more customer-led decisions'. I'm not sure I know what this means, but what will he do to achieve it?

Restructure the business, of course, into four new segments. As well as the US, the business will have three other segments – 'international lead markets', 'high growth markets' and 'foundational markets'. How rearranging the reporting segmentation will help is beyond me – a phrase about the rearrangement of the deckchairs on the *Titanic* springs to mind.

Note that the word "food" was entirely absent from the release and the word "burger" was only mentioned once, as in 'burger company'.

Language which felt like it had been lifted from a management consultancy lexicon continued in the chief executive's presentation: 'As we turn around our critical markets, we will create strategies which leverage our scale and competing power, bring disruptions to life and sharp brands on the move. We will also seek to be more progressive around our social purpose in order to deepen our relationships with communities on the issues that matter to them.' Note, still no mention of the food.

I think that the first thing McDonald's needs to address is whether its target customers like the food it sells, and if not, figure out why this is and what it can do about it. Domino's Pizza did this in 2009 when it made a very public mea culpa about the quality of its pizzas, publishing some damning findings from a customer survey along the lines of "the cardboard box tastes better



than the pizzas”. This is the sort of action you only take if you intend to change and Domino’s has been reaping the benefits since.

But I don’t think we should solely blame McDonald’s management for this lack of focus on the one thing that matters more than any other – the food. The analytical and investment community must share the blame. To illustrate why, here are the first three questions from analysts in the Q&A session following the chief executive’s presentation:

1. The first questioner asked whether the increase in the percentage of franchised restaurants, which McDonald’s is planning, would be dilutive or accretive to earnings per share.
2. The second questioner suggested that the higher franchised percentage should enable the company to support a higher level of debt.
3. The third question was on whether the company had considered an OpCo-PropCo structure in which a company’s properties are held in a “PropCo” and leased to the operating company or “OpCo” with the PropCo then usually sold to “unlock the value” in the company’s real estate.

In other words, all these analysts seemed to be interested in was financial engineering. They do not seem to realise that without a business selling something which customers want, no amount of financial wizardry will create lasting value. But faced with this obsession with financial legerdemain among the analysts, you can hardly blame the management for sharing some of the same focus.

If you are thinking of investing in McDonald’s or any other potential “turnround” situation, I suggest you hold back until you encounter a CEO who talks about the need to improve the company’s product or service in a basic manner. Someone who can answer the question, “Where’s the beef?”

# *What investors can learn from Alex Bird's 500 winning bets at the races*

THE TELEGRAPH, 12 JUNE 2015

‘**T**HEY think it’s all over...’ Commentator Kenneth Wolstenholme’s remark at the end of the 1966 World Cup final has passed into popular culture as a widely used expression. But I am amazed how little investors learn from the world of sport, which has a lot to teach us.

In managing the Fundsmith Equity Fund, we seek to invest in companies that have a long history of success in a few sectors such as consumer staples, medical equipment and franchising.

People often say to us: “Oh, you try to pick winners.” The reality is that we don’t seek to predict who will win, but rather to bet on a company that has already won.

To explain what we seek to do, I would turn to the world of horse racing. As a professional gambler, Alex Bird made a fortune betting on photo finishes. You can read about it in his autobiography, *Alex Bird: The Life and Secrets of a Professional Punter*.

In Bird’s day, photo finishes were not digital and it took several minutes to develop the film and view the outcome, during which time bookmakers continued laying odds on the outcome.

Bird realised that they were breaking one of the fundamental rules of bookmaking – never make odds on an event that has already occurred, as someone who knows the outcome can take you to the cleaners.

Allegedly, bookmakers in the vicinity of St James’s Palace learnt this the hard way when they laid odds on the name of royal babies while the Queen Mother, who liked a bet, was still alive.

Bird noticed that when horses crossed the line together, the horse on the far side often appeared to have won. What he had figured out was “parallax”:

the difference in the apparent position of an object viewed along two different lines of sight.

He discovered a simple technique to exploit this. By standing as near to the winning post as possible, closing one eye and creating an imaginary line across the track at the finishing line, he could tell which horse had actually won. Using this simple system for the next 20 years he made himself a fortune, with a reported 500 consecutive successful bets.

This can happen in the financial world. When Warren Buffett announced that after a career investing only in the US he had bought a British share for the first time, the bookmakers made odds on which share it was. This was dangerous given that a number of intermediaries, such as Berkshire Hathaway's brokers, already knew.

What has all this got to do with investment? At Fundsmith we do not seek to pick winners in the sense that most punters do, which is studying form, viewing the horses in the ring and then betting.

We seek to emulate Alex Bird – we wait until we know who has won and then wait for the bookmakers to offer us odds against them winning. In our case, these are not bookmakers in the sense of a racecourse; we are talking about the market mispricing shares.

There are some companies where we do not need to speculate on whether they have won in the sense of being successful and dominating certain product categories. Nestlé is the world's largest food and beverage company and has been in business for 148 years with only one loss. Colgate-Palmolive has 45% of the world market for toothpaste and 35% for toothbrushes. It is also the leader in liquid soap and third in pet food. We simply need to wait until the market misprices these shares in order to get our chance to bet on a certain winner.

This can happen for many reasons, for example when a panic occurs such as the whole market experienced in 2008–09. Or it can come about because investors sensing recovery dump known winners and turn to the shares that rise most in such circumstances, such as cyclicals, financials, recovery stocks and highly indebted companies.

It may entail particular concerns about the product, such as cola drinks or microbeads in toothpaste, or a milk powder safety scare. Or currency moves

such as the recent rise in the Swiss franc, which sent Nestlé's shares down by more than 10% even though 98% of its business is outside Switzerland.

Situations such as these can all provide chances to invest by betting on a certain winner if they drive the valuation to a level which does not reflect these companies' sustainable returns.

# *What investors can learn from Sir Alex Ferguson's success*

*THE TELEGRAPH*, 19 JUNE 2015

**I**NVESTORS can learn a lot from the world of sport. Last week I looked at how the professional punter Alex Bird made a fortune betting on horse races after the race was over.

The moral of his story: don't try to predict which horse will win, but find a way to bet on the horse that has already won. An important element of success in sports, and in investment, is narrowing the chance of success.

Another good example comes from football. Research by the United States Sports Academy found that more than 90% of goals in the matches studied were scored from inside the penalty area. Faced with these statistics, any sensible player would stop shooting from outside the area.

How does this apply to the world of investment? Many investors spend their time trying to predict the next big winner in a sector, particularly in technology, despite the difficulty of forecasting developments in this area.

The following table shows the top ten software companies from just over 30 years ago. All but one have more or less ceased to exist. Clearly trying to predict a long-term winner in the software sector is extremely difficult, even if you start with those that are already leading. What must the odds be like if you are backing start-ups and early-stage investments?

*Top 10 software companies in 1984*

- 1 Microsoft
- 2 VisiCorp
- 3 DRI
- 4 Micropro
- 5 Lotus
- 6 Ashton-Tate
- 7 Peachtree
- 8 SPC
- 9 CAR/Sorcim
- 10 Perfect

This question is answered in part if you look at the results of clinical trials in the biotechnology and pharmaceutical sector.

Clinical trials involving new drugs are commonly classified into four phases: zero, one, two and three. Only if a drug passes all four phases will it usually be approved by the national regulatory authority for use in the general population.

A study by KMR Group published in 2012 used data on drug successes and failures between 2007 and 2011 submitted by 13 of the world's largest pharmaceutical firms. It found that 97% of drugs in preclinical tests never made it, and neither did 95% of the molecules in phase-one clinical trials or 88% of molecules in phase two. Not until phase three did prospects get much better – of the ones that made it that far, 54% were approved.

The odds of a drug at the preclinical stage making it all the way are one in 10,000 (if you are interested in the maths, the calculation is  $(1 - 0.97) \times (1 - 0.95) \times (1 - 0.88) \times (10.46) = 0.0001$ ). Trying to pick winners in the early stages of drug trials by investing in biotech companies is clearly a full-contact sport.

You can also learn something about companies' prospects from changes of

manager, just as you can with sports teams.

What did you expect the outcome to be when Sir Alex Ferguson retired as manager of Manchester United after 27 years, a time in which the club won 13 Premier League titles, five FA Cups, four League Cups, ten Community Shields, two UEFA Champions Leagues, the UEFA Super Cup, the Intercontinental Cup, and the FIFA Club World Cup?

It is hard not to see his short-lived successor, David Moyes, as the recipient of a so-called “hospital pass”. In his brief reign of less than a year, Manchester United won only the Community Shield.

There are parallels in the retirement of Sir Terry Leahy as chief executive of Tesco. When Sir Terry stepped down, laden with accolades, after 14 years, he was replaced by Philip Clarke, who lasted just three years – a period strewn with profit warnings, food contamination scares and an accounting scandal.

I am not suggesting that any of this was Mr Clarke’s fault. In my view, the root of the problem lay in the Leahy years, but came to light only after the charismatic leader had left.

Similarly, it wasn’t all that hard to predict the outcome when Jim Skinner, the chief executive who was credited with turning McDonald’s fortunes around, left in 2012 after eight years at the helm during which he was named as “chief executive of the year”. His successor, Don Thompson, lasted the obligatory three years before admitting defeat.

The point of this is not who is to blame for the slide in the fortunes of McDonald’s, Manchester United or Tesco, but that investors should be wary when a long-standing and highly successful chief executive leaves a business, just as football fans are.

As an old saying goes: acorns do not flourish under mighty oaks.

# ***Bond proxies: can you afford not to own them?***

*FINANCIAL TIMES*, 26 JUNE 2015

**I**T'S far better to buy a wonderful company at a fair price than a fair company at a wonderful price,' Warren Buffett once said. I agree with Mr Buffett's description of a good company. To quote from his 1979 annual chairman's letter: 'The primary test of managerial economic performance is the achievement of a high earnings rate on equity capital employed (without undue leverage, accounting gimmickry, etc.) and not the achievement of consistent gains in earnings per share.'

What Mr Buffett is describing is return on equity capital and despite this guidance more than 35 years ago from one of the world's most successful investors, his advice continues to be ignored by most. One of the objections levelled at investors who attempt to invest along the lines which Mr Buffett suggested – and I would count myself as one of them – is that the sort of companies with these characteristics may be too expensive. This concern has reached fever pitch recently, with myriad warnings about what will happen to so-called “bond proxies” when US interest rates rise. A “bond proxy” is shorthand to describe equities such as consumer staples and utilities with safe, predictable returns, but have higher yields than much of the bond market (and, crucially, yields which can grow over time).

Bond markets have experienced a bull run since the financial crisis and the onset of quantitative easing, which has seen central banks pump billions into buying their own governments' bonds, and a disinflationary environment which has led to the sister policy of zero interest rates. Faced with seemingly ever-lower yields, investors have crowded into equities in general and especially those which are considered “bond proxies”. The obvious problem is what happens if – or when – interest rates rise. Bond yields then rise and those equities which have been used as bond proxies will surely fare badly. I would suggest a slightly less simplistic approach.

Let's start with the assumption that interest rates will rise. Eventually that



must be true, but when and by how much is less easy to predict. The “when” has some bearing on the matter. There are a number of fine fund managers who have had their performance shredded by attempting to time this and other events. The “how much” also matters. In my view, we remain in a disinflationary environment with a mostly weak economic recovery, so the rise when it comes may not be anything like the gradient which we have come to expect from previous recoveries. Short-term interest rates may be at or close to zero and may rise, but they are of less significance in valuing bonds and equities than long-term rates, and US 30-year Treasuries already yield over 3%. This yield may not budge much.

If you are worrying about bond proxy equities in this scenario, you might also like to ask yourself where you will put the money that you realise from selling them. Into cash? Good luck with your timing. Into bonds? I think not. Into other equities? Maybe, but the S&P 500 Index’s price/earnings ratio is 19×, so it’s not that they are obviously cheap, and most of the index is much more heavily cyclical than the bond proxies, making it an interesting choice if you are seeking safety in a rising rate environment. One thing we can be sure of is that the stocks in the index are not of the same quality as the so-called bond proxies.

There is another quote from Mr Buffett’s business partner, Charlie Munger, on this subject: ‘Over the long term, it’s hard for a stock to earn a much better return than the business which underlies it earns. If the business earns 6% on capital over 40 years and you hold it for that 40 years, you’re not going to make much different than a 6% return – even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive-looking price, you’ll end up with one hell of a result.’

I agree with them both about this. Let’s take two examples of potential investments which you can make and hold for 40 years – from when you start work in your 20s until you retire. Company A (the bond proxy) generates a return on capital employed (ROCE) of 20% per annum throughout this period. It has ample opportunities to grow and can reinvest all of its earnings each year at the same rate of return. That’s the good news. The bad news is that its shares are not cheap and to buy them you have to pay four times book value. That’s not all – when you come to sell them in

40 years' time, the rating has halved and you can only sell them for two times book value.

Company B (the market) earns a 10% ROCE over this period and reinvests all its earnings at that rate of return. Moreover, the investors who take this option have better luck in terms of timing, as they can buy B's shares at two times book value and when they come to sell them in 40 years, they can sell them for four times book value – their rating has doubled.

So if these were the alternatives on offer for your investment career, which would you take?

Company A would produce compound returns of 18% per annum and Company B 12% per annum. If you plan to hold a share for the long term, the rate of return on capital it generates and can reinvest at is far more important than the rating you buy or sell at.

That's why if you are a long-term investor, you should own the high-quality bond proxies and close your ears to the siren song of those who say a rate rise will cause you problems. If you are not a long-term investor, I wonder what you are doing in the stock market at all and so will you one day.

# *Income is not what it used to be*

## **Investing for income, part 1 of 2**

*FINANCIAL TIMES*, 17 JULY 2015

**A**N old joke goes: nostalgia is not what it used to be. Neither, it seems, is investing in equities for income.

If you consult anyone in fund marketing about the name of a fund they will tell you to put “income” in the name.

Investors are desperate for income, with zero interest rates in most of the developed world setting a clear barrier to finding high yields. In a world in which Italian 10-year government bond yields went below 1.5% per annum, you know that the search for yield has become extreme.

Yet increasing numbers of so-called “income” funds are dropping out of the Investment Association’s UK Income sector classification because they can’t make the three-year 110% of All-Share yield benchmark. Both the Invesco Perpetual High Income and Invesco Perpetual Income funds have been moved to the UK All Companies sector, as has St James’s Place UK High Income and most recently the Schroders Income Fund.

It remains to be seen whether they retain “income” in their name even though they no longer qualify for the sector. If you thought they couldn’t do that, you were wrong.

Even more surprising is the fact that you can launch a fund with “income” in the name and have three years in the sector to gather assets before having to prove that the fund can achieve the yield benchmark or leave the sector, at which point you can still call it an income fund. Surely this is questionable, given the label seems able to mesmerise investors.

I would in any case question the whole importance attached to yield. Several factors seem to have led to some confusion among investors, who can perhaps be excused when faced with funds with “income” in their name that are not in the sector.

Investors have learnt that dividends are an important contributor to equity

performance over the long term. But as with many concepts in finance, it is necessary to understand the concept fully and I doubt that many do.

Investors often quote evidence such as that from Jack Bogle, the father of index funds and one of my investment heroes, about the importance of dividends.

He said:

‘An investment of \$10,000 in the S&P 500 Index at its 1926 inception with all dividends reinvested would by the end of September 2007 have grown to approximately \$33.1m (10.4% compounded). If dividends had not been reinvested, the value of that investment would have been just over \$1.2m (6.1% compounded) – an amazing gap of \$32m.

‘Over the past 81 years, then, reinvested dividend income accounted for approximately 95% of the compound long-term return earned by the companies in the S&P 500.’

There you have it – dividends are more important than share price appreciation. Right? Sadly, it’s not as simple as that. Note that Mr Bogle uses the word “reinvestment” no fewer than three times. It is this reinvestment and the return on it that accounted for almost all of stocks’ long-term total return.

You do not achieve this result if you invest in equities and take the dividend and spend it. The critical feature that Mr Bogle alighted upon is the benefit from reinvesting the dividends in equities. While this does make a dramatic difference to the outcome, it does not prove that income funds or high-yielding equities are likely to deliver a superior return.

You would have had a better result than in Mr Bogle’s example if you had invested dividends not in the whole index, but in companies that delivered a return superior to the index; and/or if instead of paying a dividend the companies had simply retained all the earnings and reinvested them, assuming they could deploy the additional cash at an adequate rate of return.

This is illustrated by the performance of Warren Buffett’s Berkshire Hathaway, which has never paid a dividend during the 50 years he has run it. Mr Buffett correctly concluded that if the rate of return he could obtain by reinvesting funds at Berkshire was higher than the rate of return on the S&P 500 Index, it would produce a better performance for investors if he retained all the earnings and reinvested them.

You might think you could get the same result if Berkshire paid a dividend and you reinvested it. Not if you pay income tax on your investment income, as you would only have the amount of the dividend net of tax to reinvest.

So it is not the dividend that is important, or even just the reinvestment of the dividend, but rather it is the rate of return on reinvestment of the dividend that drives the return.

# ***Keep your eyes on the prize: total return is what matters***

## **Investing for income, part 2 of 2**

*FINANCIAL TIMES*, 24 JULY 2015

**U**NDERSTANDING of this subject might not be assisted by the plethora of research available online that basically asserts “dividend-paying stocks outperform non-dividend payers”. Just try typing those words into a search engine and see how many links you get.

This statement is a classic example of statistical analysis that finds a correlation without proving cause and effect.

I am told you can find a correlation between the sightings of storks and the number of births, but it does not mean one leads to the other. Similarly, the observation that dividend payers tend to outperform non-dividend-paying equities does not explain the factors which cause this. Understanding those factors is vital to avoid fundamental errors.

There are two types of company into which non-dividend payers might be divided:

1. those that cannot pay a dividend as they do not have the profits and/or cash flows from which to do so – these are start-ups and companies in some distress; and
2. companies that have the capability to pay a dividend, but choose not to and reinvest the whole of their earnings and cash flow to expand the business.

There is clearly a massive gulf in quality between these two groups, yet research often simply lumps them both together as “non-dividend payers”. They include companies such as Warren Buffett’s Berkshire Hathaway.

I wonder what the result would be if you compared the performance of

dividend payers with those non-dividend payers that are capable of paying a dividend, but choose not to?

After all, where management is behaving in a logical manner and retaining all the earnings because they are capable of earning a superior investment return, like Mr Buffett did, they will outperform a company in the same situation that pays a dividend. Nor is Berkshire an isolated example.

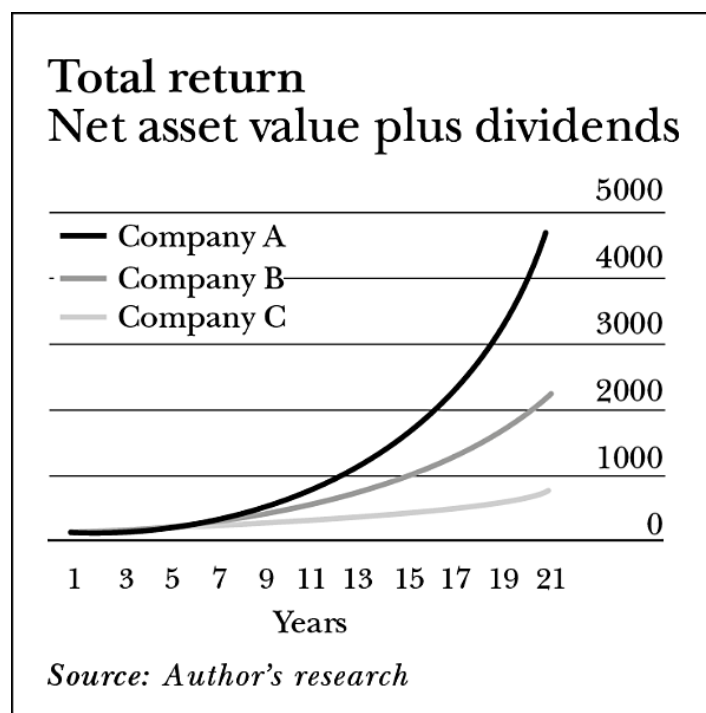
There is also an intermediate class of companies that pay a dividend, but retain most of their earnings for reinvestment. In most cases this means they are unlikely to qualify as high yielders and find their way into income funds.

But if this distribution policy is driven by reinvestment opportunities to earn high returns within their business, they are likely to be good performers as investments.

The chart here illustrates this. It shows the return to investors from investment in three companies based on the following:

- Company A makes a 20% return on capital. It pays no dividend and reinvests 100% of its profits.
- Company B also makes a 20% return on capital. It reinvests 70% of its profits – the other 30% is distributed as a dividend to investors who spend it, or at least do not reinvest it.
- Company C reinvests 100% of its profits, but makes only a 10% return on capital.

The vertical axis shows the resulting net asset value (NAV) of the companies plus the amount of the dividends, if any, received by the investors.



The chart illustrates the point that it is the rate of return you make on the reinvested earnings or dividend that makes the most difference, as A and B outperform C. It also makes the case that you do not perform as well if you either spend the dividend or do not reinvest it.

You might argue that NAV is not the best indicator of the performance for investors – what about the share price? I agree, but I would suggest that A and B will obtain a higher “share price to NAV” ratio than C, as the market will value their higher returns, and that A would be more highly rated than B because it invested more of its earnings at the high rate of return.

So £1 reinvested by A or B is likely to be far more valuable in stock market terms than £1 reinvested by C.

You might also argue that the relative valuation at which you – or your fund manager – could buy each of these shares would affect the outcome. This is true, but if you are a long-term investor it has less of an effect than the rate of return the companies can generate. This was covered in a previous column, “Bond proxies: can you afford not to own them?” on [page 108](#).

Turning to individual investors’ behaviour, it seems the desperate search for yield and the popularity of income funds is in part driven by a view, which many investors seem to hold, that they can only safely spend the income



from their portfolio. This view seems particularly prevalent among retirees, for whom this is the sole source of income.

This thinking is what attracts investors to income funds and high-yield equities. While it might seem commendably prudent, it is erroneous and can lead to the assumption of risks associated with high-yield investment.

What investors should be doing is seeking to maximise their total return. Maximising total return over the long term relies upon investing in companies that can generate a high return on capital and retain some or all of their earnings to reinvest at that high rate of return. Such companies are unlikely to feature heavily in true income funds. If the resulting yield is too low to fund investors' spending requirements, the solution is simply to redeem some of the capital sum.

I realise that what I have just said may sound like sacrilege to many investors. But what they fail to realise is that providing you leave at least enough of your gains invested to allow capital to keep pace with inflation, you are not behaving imprudently, assuming savings were adequate to begin with.

The suggestion also has the merit of tax efficiency. It is hard to avoid income tax outside an ISA or SIPP and few people regularly exceed the capital gains tax threshold, which is any event charged at a significantly lower rate than top-rate income tax.

# *Why bother cooking the books if no one reads them?*

*FINANCIAL TIMES*, 24 SEPTEMBER 2015

**I**N August 1992, my book *Accounting for Growth* was published. It exposed how companies used accounting trickery to flatter their reported performance. Nowadays, there are brokers such as Muddy Waters and Iceberg who specialise in revealing these practices, but in 1992 such research was most unusual so it caused quite a stir.

My then-employer tried to stop its publication, which of course only made people want to read it, sending it to the top of the nonfiction charts. I was fired, which sent my career off in a more entrepreneurial direction, and several of the companies named in the book got into serious difficulty or simply went bust.

A second edition was published in 1996 and I've often been asked to reprise the subject with another book.

One of the reasons I haven't is that publication of the book roughly coincided with the start of a successful campaign by the Accounting Standards Board, led by Sir David Tweedie, to stamp out many of the abuses in company accounting.

Another is that I am not sure many investors or analysts study company accounts any longer. Instead, they seem to rely upon management presentations using "adjusted", "core" or "underlying" earnings or profits.

One sector in which my Fundsmith Equity Fund does not own any stocks is pharmaceuticals. This seems to surprise some commentators, who think that drug companies would represent exactly the sort of dependable returns we seek. After all, such stocks benefit from seemingly inexorable growth in demand for healthcare, especially among the ageing populations of the developed world, and margins that are shielded from competition by patents.

One reason we don't own them is that the sector has become rated on the

basis of “underlying” earnings. Beginning in about 2010, many major pharmaceutical companies started a switch to reporting what they term “core” earnings. This switch was allegedly to smooth out exceptional items from reported earnings and make trends more recognisable.

So what is excluded from earnings based on generally accepted accounting principles (GAAP) to get to “core” earnings?

1. Restructuring costs, although they seem to be a recurring item in the accounts of a number of companies. GlaxoSmithKline, for example, has not had a quarter without any since 2008.
2. “Exceptional” legal charges. Once again, given the nature of the industry involving patents, patent disputes, regulation and product liability, it seems inevitable that significant legal expenses will be a more or less constant feature of a pharmaceutical company’s profit & loss (P&L) account. So it is hard to see how they are by nature exceptional.
3. Intangible asset amortisation and impairment. When pharmaceutical companies buy a drug from another company or buy another drug company – and they have been doing a lot of that – they create intangible assets that represent the amount they paid over and above the tangible or hard assets acquired. This is usually the vast majority, if not all, of the cost and GAAP requires it to be both amortised by a charge to the profit and loss account, usually over the life of the drug patents, and written off in the event that a drug fails its trials – a not infrequent event.

Some will argue that it is acceptable to exclude these intangible charges as they are “non-cash”, but doing so turns the P&L account into a hybrid of accrual accounting and cash flows. If you are interested in a company’s cash flow, and you should be, the place to gauge that is in the cash flow statement, not a doctored P&L account which excludes some non-cash items. AstraZeneca, for example, has over £16bn of these intangibles on its balance sheet which would cause an annual charge of some £1.6bn, but this is not reflected in its “core” earnings.

Moreover, excluding these intangible items means that the cost of acquiring

new drugs and biotech companies does not appear anywhere in these “core” earnings. In light of this, is it any surprise that the pharmaceutical sector has been on a binge of buying biotech companies, spending \$80bn in 2014 alone?

All of the adjustments have one thing in common – they make the reported “core” earnings higher.

Faced with this opportunity to flatter the earnings, it is also no wonder that management incentives have been remodelled to take advantage, with some or all of management remuneration in the sector based on “core” earnings.

Unsurprisingly, since 2010 the GAAP earnings per share (EPS) in the sector have decreased significantly as a percentage of “core” EPS – in the case of AstraZeneca from 84% to just 23% by 2014. In other words, as their pay has come to depend upon “core” earnings, more and more bad stuff has been excluded from the calculation.

For example, AstraZeneca reported GAAP EPS of \$5.60 in 2010 but courtesy of “core” earnings this became EPS of \$6.17. By 2014 the GAAP EPS of just \$0.98 had become “core” EPS of \$4.28.

The net result of all this is that the ratings which many pharmaceutical stocks appear to trade on bear little resemblance to reality based on their GAAP earnings:

|                             | GAAP PE | Core PE |
|-----------------------------|---------|---------|
| <b>AstraZeneca</b>          | 69.5    | 15.9    |
| <b>GlaxoSmithKline</b>      | 22.5    | 13.5    |
| <b>Novartis</b>             | 22.9    | 18.6    |
| <b>Sanofi</b>               | 26.8    | 17.2    |
| <b>Bristol Myers Squibb</b> | 52.6    | 34.2    |
| <b>Eli Lilly</b>            | 39.6    | 31.7    |
| <b>Pfizer</b>               | 24.6    | 15.5    |

In my view, if you are an investor in pharmaceutical stocks, this should worry you a lot. If you want to know more, broker Badon Hill recently published a critical – and in my view good – research report on “Big

Pharma". The irony is that in order to discover what is really going on, you do not need to be a sophisticated financial analyst. All you need to do is get the GAAP EPS number from the accounts.

Hence my view that there is no point in companies engaging in any form of accounting chicanery, when their ledgerdomain seems to have the entire market looking somewhere other than the accounts.

# *Firms which provide good products or services are key to investing*

DAILY MAIL, 9 NOVEMBER 2015

**W**HEN it comes to generating good returns, the most important thing is quality.

The Fundsmith Equity Fund celebrated its fifth anniversary this week. When we started, it was with the aim of providing the best fund you could invest in with the highest return adjusted for risk.

To attain this we needed to invest only in good companies.

By this I meant businesses that have a long track record of high profitability derived from providing good products or services and strong market positions.

It may sound blindingly obvious to say you only want to own things that are high quality, but in the investment industry it is not, and as the famous investor Sir John Templeton said: 'If you want to have a better performance than the crowd, you must do things differently from the crowd.'

I remain amazed at the number of people who talk about investment and spend most or all of their time talking about asset allocation, regional allocation, sector weightings, economic forecasts, bonds vs equities, interest rates, currencies, risk controls... but never mention the need to invest in something good.

I naively supposed that the experience of the financial crisis might have taught investors a lesson about the inability to generate good returns from bad assets.

No amount of structuring using CDOs, CLOs and all the other alphabet soup of structured finance could turn subprime loans into investable assets.

When things went wrong, even the triple-A tranches of those subprime loan structures turned out to be triple-Z. There's an old saying about silk purses and sow's ears which encapsulates this.

Similarly, it is hard to make a good return over the long term by investing in

poor-quality or even average businesses.

I am not suggesting that investing in high-quality companies is the only way to make money. However, investing in poor-quality companies has a couple of disadvantages.

One is that you are continually faced with the problems of timing and the headwind of their value destruction.

If investors have any coherent reason for such investments, they usually are diversification and/or the belief they can buy them when their fortunes and share prices are depressed and about to improve, and sell them close to or preferably just before they turn down.

Taking the diversification point first, I am also surprised how many investors assume that it is better to be diversified across low-quality investments than to be concentrated in high-quality ones.

With regard to timing, the sale and purchase of shares in poor-quality companies, leaving aside the drag on performance from the dealing costs involved, the performance record of the vast majority of active managers would suggest that there are far more who think they can play the investment and business/economic cycle successfully, and outperform, than can actually do so.

I am fond of saying that when it comes to so-called market timing there are two types of people: those who can't do it and those who don't know they can't do it.

How have we fared? The Investment Association's Global sector comprises 270 funds, and my fund is the third best performing over the five-year period, returning 17.2% per annum compound return compared with 9.9% per annum for the MSCI World Index.

I would just point out that the two funds which rank ahead of us are specialist healthcare funds. They have performed well in a period which has seen a boom in M&A activity in biotech companies in particular. But their concentration on a single sector is a risk we would not be willing to take.

We still have the same strategy that we launched with five years ago. We only buy shares in good companies, try not to overpay and then do nothing.

We have made a good start – however, our investment time horizon is

indefinite.

We will not waver from this no-nonsense approach, and strive to deliver long-term outperformance.



# *What I have learnt at Fundsmith in the past five years*

*FINANCIAL TIMES*, 21 NOVEMBER 2015

**F**UNDSMITH, my fund management business, celebrated its fifth anniversary in the past month. What have I learnt over the past five years of running the fund?

One thing I have observed is the obsession of market commentators, investors and advisers with macroeconomics, interest rates, quantitative easing, asset allocation, regional geographic allocation, currencies, developed markets versus emerging markets – whereas they almost never talk about investing in good companies.

It seems to me that most of these subjects pose questions to which no one can reliably forecast the answers, and even if you could the connection to asset prices is tenuous at best. Take GDP growth – few things seem to obsess commentators more, yet no one has ever managed to demonstrate a positive correlation between GDP growth and stock market performance.

## **Invest in something good**

What has continued to amaze me throughout the past five years is not just this largely pointless obsession with factors which are unknowable, largely irrelevant, or both, but how infrequently I hear fund managers or investors talk about investing in something which is good. Like a good company with good products or services, strong market share, good profitability, cash flow and product development.

I suppose I had assumed that the Credit Crisis might have taught them that you will struggle to make a good return from poor-quality assets. I am not suggesting that there is no other way of making money other than to invest in good companies, but investing in poor or even average companies presents problems. One is that over time they tend to destroy rather than create value for shareholders, so a long-term buy-and-hold strategy is not going to work for them.

A more active trading strategy also has its drawbacks. Apart from the drag on performance from trading costs, it is evident from the performance of most funds that very few active managers are sufficiently skilled to buy shares in poor companies when their performance and share prices are depressed, and then sell them close to their cyclical peak.

Another obsession I have been surprised about is that with “cheap” shares. I have been asked whether a share is cheap many more times than I have been asked whether the company is a good business.

This obsession often manifests itself in the critique of our strategy which goes something like, “These companies may be high quality, but the shares are too expensively rated.” This is almost certain to be true, as from time to time the share prices are sure to decline, but it misses the point. If you are a long-term investor, owning shares in a good company is a much larger determinant of your investment performance than whether the shares were cheap when you bought them.

### **Ignore the siren song**

A fairly obvious lesson, but one I have re-learned, is to stick to your guns and ignore popular opinion. I lost count of the number of times I was asked why we didn’t own Tesco shares, or was told that I had to own Tesco shares when our analysis showed quite clearly that its earnings-per-share growth had been achieved at the expense of returns on capital. In fact, its return on capital had deteriorated in a manner which pointed to serious problems in Tesco’s new investment in areas such as China and California.

Similarly, it is important to ignore the siren song of those who have views on stocks which you hold, particularly if they are based on prejudices about their products. I also lost count of the number of comments I read about how Microsoft was finished as it “wasn’t Apple”. This included one investor who rang us to ask if we had seen the quarterly numbers from Microsoft which were not good. (It was tempting to respond saying “No, of course we had not seen the quarterly results for one of our largest holdings” and thank him for pointing this revelation out to us.)

He said we would face questions at our AGM if we still held the stock then.

It was of course just one quarter and the stock more or less doubled in price after that. Sadly no question was raised at the AGM.

### **Stick to the facts**

Another of my observations is that impressions about stocks are often formed erroneously because people do not check the simplest facts. Sometimes they simply relate to the wrong company.

We topped up our stake in Del Monte, a processed food and pet food business, on some share price weakness which resulted when a news service carried an article that dock workers in Galveston had gone on strike and so had stopped Del Monte's ships being unloaded. The company it was actually referring to was Del Monte Fresh Foods, which imports tropical fruits like bananas and pineapples, not the one we were invested in. Or the client who contacted us to say how concerned he was about our large holding in Domino's Pizza since the chief executive and chief financial officer had left. They had left the UK company, but we owned the US master franchiser.

I would be hard pressed to name the least well understood subject in investment given the wide choice available, but I suspect that currencies is among the leaders. Over the past five years I have heard lots of people talk or ask about the impact of currencies in a manner which betrays a complete lack of understanding of the subject. The commonest question or assumption about our fund is the impact of the US dollar, since the majority of the companies we have owned since inception are headquartered and listed in the US.

This makes little or no sense. A company's currency exposure is not determined by where it is headquartered, listed or which currency it denominates its accounts in. Yet this does not seem to stop people assuming that it does and making statements about the exposure of our fund to the US dollar, based on where the companies are listed.

We own one company which is headquartered and listed in the US, but which has no revenues there at all. Clearly this assumption would not work very well for that company, any more than it would work for the UK-listed

company we own which has the US as its biggest market and which, perhaps unsurprisingly, reports its accounts in US dollars.

Nor could we understand the reasoning of the commentators who wrote that our holding in Nestlé had benefitted from the rise in the Swiss franc. How? Ninety-eight per cent of Nestlé's revenues are outside Switzerland. It may be headquartered and listed in Switzerland and report in Swiss francs, but the fact is that a company's currency exposure is mainly determined by where it does business. In Nestlé's case the Indian rupee is a bigger exposure than the Swiss franc.

### **Does anyone read accounts?**

I have also discovered that hardly anyone reads company accounts any more. Instead they rely upon management presentations of figures which often present "underlying", "core" or "adjusted" numbers. Not coincidentally, the adjustments to get to the core or underlying numbers almost always seem to remove negative items. Reading the actual accounts bypasses this accounting legerdemain.

We have also discovered mistakes in accounts which no one else seems to have noticed. Like the \$1.9bn earlier mistake in the IBM cash flow. This alone did not prevent us investing in IBM, but it helped to support our conclusion that hardly anyone reads its accounts thoroughly.

### **Don't sell good companies**

I have also learnt that selling a stake in a good company is almost always a mistake. Take Sigma-Aldrich, a US chemical company based in St Louis. It supplies pots of chemicals to scientists around the world who use them in tests and experiments. Its financial performance fitted our criteria, as did its operational characteristics – supplying 170,000 products to more than a million customers at an average price of \$400 per product. It fitted our mantra of making its money from a large number of everyday repeat transactions, as well as having a base of loyal scientists who relied on its service.

It was a predictable company of exactly the type we seek. That was until it was revealed that it was trying to acquire Life Technologies, a much larger company which supplies lab equipment. Given the execution risk involved,

we sold our stake. As it happens, Sigma-Aldrich did not acquire Life Technologies as it was outbid. But having gone public on its willingness to combine with another business, it was in no position to defend its independence and succumbed to a bid itself from Merck at a price about 40% above the price we had sold at.

Selling good companies is rarely a good move. The good news is that we don't do it very often.

### **Our best share**

Our best share was Domino's Pizza Inc, with a return of over 600% from the initial stake purchased on the day the fund opened. What might we learn from this?

- People often assume that for an investment to make a high return it must be esoteric, obscure, difficult to understand and undiscovered by other investors. On the contrary – the best investments are often the most obvious.
- Run your winners. Too often investors talk about “taking a profit”. If you have a profit on an investment it might be an indication that you own a share in a business which is worth holding on to. Conversely, we are all prone to run our losers, hoping they will get back to what we paid for them. Gardeners nurture flowers and pull up weeds, not the other way around.
- Domino's is a franchiser. If you regard a high return on capital as the most important sign of a good business, few are better than businesses which operate through franchises, as most of the capital is supplied by them. The franchiser gets a royalty from revenues generated by other people's capital.
- Domino's has focused on the most important item for success in its sector – the food. This is in sharp contrast to other fast-food providers like McDonald's which are struggling.
- Domino's is mostly a delivery business. This means that it can operate from cheaper premises in secondary locations, and so cut the capital required to operate compared with fast-food operators who

need high street restaurant premises.

- Domino's was owned by Bain Capital. Like a lot of private equity firms, Bain leveraged up the business by taking on debt to pay themselves a dividend before IPO, so it started life as a public company with high leverage. This can enhance equity returns. In a business which can service the debt there is a transfer of value to the equity holders as the debt is paid down and the equity is de-risked. Please note – this does *not* indicate that leverage always enhances returns.

# *Annual letter to shareholders 2015*

FUNDSMITH, JANUARY 2016

**T**HIS is the sixth annual letter to owners of the Fundsmith Equity Fund. The table below shows performance figures for the last calendar year and the cumulative and annualised performance since inception on 1 November 2010 compared with various benchmarks.

| % Total return                     | 1 Jan to 31 Dec 2015 | Inception to 31 Dec 2015 |                   |
|------------------------------------|----------------------|--------------------------|-------------------|
|                                    |                      | <i>Cumulative</i>        | <i>Annualised</i> |
| Fundsmith Equity Fund <sup>1</sup> | +15.7                | +131.4                   | +17.6             |
| Equities <sup>2</sup>              | +4.9                 | +64.3                    | +10.1             |
| UK bonds <sup>3</sup>              | +1.0                 | +24.3                    | +4.3              |
| Cash <sup>4</sup>                  | +0.0                 | +3.5                     | +0.7              |

<sup>1</sup> T-class acc shares, net of fees, priced at noon UK time. <sup>2</sup> MSCI World Index, £ net, priced at close of business US time. <sup>3</sup> Bloomberg/EFFAS Bond Indices UK Govt 5–10 yr. <sup>4</sup> 3-month Libor interest rate. <sup>1,3,4</sup> Source: Bloomberg. <sup>2</sup> Source: [www.msci.com](http://www.msci.com)

The table shows the performance of the T-class accumulation shares which rose by 15.7% in 2015 and compares that with 4.9% for the MSCI World Index in sterling with dividends reinvested. The fund therefore outperformed the market in 2015 by 10.8%, its fifth consecutive year of outperformance, which is ironic given that outperforming the market in any given reporting period is not what we are seeking to achieve.

However, we realise that many or indeed most of our investors do not use the MSCI World Index as the natural benchmark for their investments.

Those of you who are based in the UK and look to the FTSE 100 Index as the natural yardstick for measuring your investments, and/or who hold funds which are benchmarked to the FTSE 100 Index and often hug it, will have had a much worse experience than the performance of the MSCI World Index. The FTSE 100 Index was down -4.9% in 2015 and the total return including dividends reinvested was still negative at -1.0%.

Similarly, for US dollar investors, the S&P 500 finished the year down -0.7% and only delivered a return of +1.4% with dividends reinvested.

2015 was also the fifth anniversary for our fund and so maybe a good moment to pause and reflect on the longer-term performance. As well as outperforming the market with a compound return of +17.6% against +10.1% for the MSCI World Index, our fund was the third best performing fund out of 203 in the Investment Association's Global sector. Why only third, you might ask? The two funds which performed better than ours are specialist healthcare funds which have benefitted from the extraordinary boom in takeovers within the biotech sector in recent years. That won't last indefinitely, at which point anyone who has benefitted from investment in those companies and funds needs to find the next hot sector if that is their investment strategy. This is a game we profess no skill at and therefore will not be playing. This skill also seems to elude most other investors but that does not seem to stop them trying.

2015 was not a particularly bullish year for equity markets which were held back by the slowdown in China, setbacks in other emerging markets and the move on from the end of quantitative easing in America to the first rise in interest rates by the Federal Reserve in nearly ten years. After all that the S&P 500 Index was down by -0.7% for the year.

Trillions of pixels have been expended on the likely impact of this increase in interest rates and I do not intend to add much, if anything, to the debate. However, one aspect may be worth commenting upon. For at least the past three years we have been reading comments which suggested that investors in our fund faced at least one problem: the shares we own are highly rated and have become more highly rated in recent years. This has often been linked with the observation that these stocks are "bond proxies" – that the relative certainty of their returns and dividends compared with most equities makes them a substitute for bonds, which many investors now seek to avoid, and so they may fare badly along with bonds as and when interest rates rise.

There are several points to consider in response to this.

One is that during the period that these commentators have been sounding this warning, these stocks and our fund have continued to outperform the market significantly. So if, like the proverbial stopped clock which is right twice a day, the scenario which they paint eventually comes to pass, it will be worth remembering what you would have missed out on if you had



followed their advice when they gave it. They will certainly forget to mention it when they proclaim the brilliance of their foresight and the accuracy of their predictions.

There are also reasons to doubt both their predictions and the efficacy of their proposed solutions.

Firstly, the assumption that all US interest rates are set by the Federal Reserve is too simplistic. The target federal funds rate is a short-term rate and was increased from 0–0.25% to 0.25–0.50% on 17 December 2015. Longer-term rates are set by the US Treasury bond market and the swap market in which banks, companies, people with mortgages and investors can switch between fixed and floating interest rates. The current 30-year US Treasury bond has a yield just under 3% which does not look quite so low.

It is possible that the main surprise with the Fed's rate rise (I refuse to use the popular term "hike" as "to hike an object" is described in the dictionary as a sharp or unexpected increase – a description which clearly does not apply to the Fed's decision) is the limited scope for subsequent increases and the lack of effect on long-term rates. In which case worries about the effect on so-called bond proxies may prove to be overdone.

Secondly, what would these commentators have you do about this possible adverse impact on so-called bond proxies? Presumably they recommend selling them in view of this predicted disaster and investing your money elsewhere. Leaving aside the commentator who suggested that the answer was to invest in a fund which is 'more immune to future market performance' (seems like an overly modest target – why not just find one that only ever goes up?), the most common suggestion, it seems, is that you should consider switching into more cyclical stocks because they are more lowly rated and their returns are too volatile to be considered as bond proxies. Switching into cyclical stocks in anticipation of a rise in interest rates, what could possibly go wrong?

As ever, spotting potential problems with our or any other investment strategy is not that difficult. In all my years in business I have never found that identifying a problem is quite as difficult as solving it. Likewise, suggesting what it is you should switch into that is immune from problems which may result from an interest rate rise is a bit more difficult.

However, it seems likely that sooner or later the “stopped clock” commentators will prove to be right and our fund will experience a period of underperformance. What to do about that? You could try some market timing and redeem your shares in the fund in advance of this event and maybe re-invest later when you think the time is right for it to begin outperforming again. If you do so I hope you have better luck and/or skill than I have because I know that I can’t accomplish that successfully.

If you intend to remain invested in the fund, as I do, including through any periods of underperformance, you might also, like me, take comfort in the fact that our investment strategy is based first and foremost on buying shares in good companies. We cannot promise you much about our fund. But one thing we are clear about is that we seek to own shares in good companies and at least most of the time we succeed in that objective.

Repeating an approach we took last year to demonstrate this, the table below shows what Fundsmith would be like if instead of being a mutual fund it was a company and accounted for the stakes which it owns in the portfolio on a “look through” basis and compares this with the market (in this case the FTSE 100 Index and the S&P 500 Index).

|                         | <b>Fundsmith Equity Fund*</b> | <b>FTSE 100 Index<sup>+</sup></b> | <b>S&amp;P 500 Index<sup>+</sup></b> |
|-------------------------|-------------------------------|-----------------------------------|--------------------------------------|
| ROCE                    | 26.0%                         | 14.8%                             | 17.5%                                |
| Gross margin            | 61.1%                         | 40.2%                             | 43.7%                                |
| Operating profit margin | 25.0%                         | 14.3%                             | 15.3%                                |
| Cash conversion         | 98.4%                         | 69.8%                             | 70.9%                                |
| Leverage                | 29.3%                         | 38.5%                             | 52.5%                                |
| Interest cover          | 16.1×                         | 8.2×                              | 8.7×                                 |

*Note: ROCE, gross margin, operating margin and cash conversion are the weighted average for the Fundsmith Equity Fund and averages for the FTSE 100 Index and S&P 500 Index. The FTSE 100 and S&P 500 numbers exclude financial stocks. The leverage and interest cover numbers are medians. \*Source: Fundsmith LLP <sup>+</sup>Source: Bloomberg*

What does this table demonstrate? In short, that our companies have much better financial performance than the market as a whole and are more conservatively funded.

The companies in our portfolio are certainly not immune to periodic

downturns in business and/or management errors, and their share prices are subject to the usual factors which affect the stock market, but we can at least be reasonably sure that they are adding to their intrinsic value over time by continuing to invest at wonderful rates of return.

If I gave you an exhaustive list of all the subjects in investment – and the ways in which investors and commentators behave – that perplex me, this annual letter would be considerably longer. However, one of these subjects is the obsession with share prices. Ultimately, of course, a focus on share price movements must be correct. It is no use owning shares in good companies if the strength of their business is never reflected in the share price, but a continuous focus on share price movements to the exclusion of the underlying fundamental economics of the companies is neither healthy nor useful. In the long term one will follow the other, and it is not the fundamentals which will follow the share price.

Returning to the subject of valuation, what are the facts as opposed to commentators' views? The weighted average free cash flow (FCF) yield of the portfolio (the free cash flow generated by the companies divided by their market value) started the year at 4.5%\* and ended it at 4.3%\* so the overall portfolio saw little increase in valuation in 2015. Our companies on average grew their free cash flow per share by 9.7%\* during the year, which was a much more significant contribution to performance.

This 4.3% FCF yield compares with a median FCF yield for the non-financial stocks in the S&P 500 Index of 4.4%+ and a mean of 2.7%+ or a median for the non-financial stocks in the FTSE 100 Index of 3.8%+ and a mean of 3.9%+. Our stocks do not look bad value in comparison to the market, especially when their relatively high quality is taken into account. Although, of course, both may be expensive – but then both may continue to be so or even become more expensive.

For the year, the top five contributors to the fund's performance were:

|                          |        |
|--------------------------|--------|
| <b>Dr Pepper Snapple</b> | +1.94% |
| <b>Imperial Tobacco</b>  | +1.79% |
| <b>Microsoft</b>         | +1.69% |
| <b>Sage</b>              | +1.36% |

**Reckitt Benckiser** +1.05%

The bottom five were:

**Procter & Gamble** -0.22%

**PayPal** -0.15%

**3M** -0.02%

**Kone** +0.02%

**Colgate-Palmolive** +0.05%

Of the bottom five performers, the only one which gives us significant cause for concern is Procter & Gamble which is on its third internally sourced CEO in as many years.

We sold our holding in Domino's Pizza during the year since it had reached a valuation which we felt was only justifiable if the current rapid rate of growth was sustainable (which we doubted). However, we sold it with some regret and trepidation. Regret since it is undoubtedly a fine business and had been our best-performing share since the inception of our fund. Trepidation since selling shares in good companies is something we are justifiably reluctant to do. Still, we believe that you "make money with old friends" – which is to say that we would be keen to own Domino's again if the opportunity arises at a valuation which we regard as at least reasonable.

We also sold our holding in Choice Hotels in 2015 as we did not like the risk/reward potential from the company's investment in developing a third-party reservations system called SkyTouch. As we do not do much trading to reallocate the fund's capital between our holdings we are reliant on the management of our investee companies to make decisions to reinvest part of their companies' cash flows for us. When they do things which are different, exciting and outside their core area of competence we become worried. Hence our sale of Choice Hotels.

We also sold the holding in eBay which we obtained when eBay split the eponymous online Marketplaces business and PayPal, the online payments processor (which we have retained).

During the year we built a holding in Waters Corporation, a US-based

manufacturer of mass spectrometry, liquid chromatography and thermal imaging equipment, which makes much of its returns from the sales of consumables, service, spares and software to the operators who have installed its equipment. It should have a clear source of growth from the seemingly inexorable trend for more testing and certification of products.

We also began building a stake in another testing company with a similar source of growth, and a new consumer staples company, both of which will be revealed in due course.

Minimising portfolio turnover remains one of our objectives and this was again achieved with a portfolio turnover of 2%\* during the period. It is perhaps more helpful to know that we spent a total of £496,507 or just 0.014% (1.4 basis points) of the fund on voluntary dealing which excludes dealing costs associated with fund subscriptions and redemptions as these are involuntary.

Why is this important? It helps to minimise costs, and minimising the costs of investment is a vital contribution to achieving a satisfactory outcome as an investor. Too often investors, commentators and advisers focus on the annual management charge (AMC) or the ongoing charges figure (OCF), which includes some costs over and above the AMC, which are charged to the fund. The OCF for 2015 for the T-class accumulation shares was 1.07%.\* The trouble is that the OCF does not include an important element of costs – the costs of dealing. When a fund manager deals by buying or selling investments for a fund, the fund typically incurs the cost of commission paid to a broker, the bid–offer spread on the stocks dealt in and, in some cases, stamp duty. This can add significantly to the costs of a fund yet it is not included in the OCF.

We have published our own version of this total cost including dealing costs, which we have termed the total cost of investment (TCI). For the T-class accumulation shares in 2015 this amounted to a TCI of 1.13%\*, including all costs of dealing for flows into and out of the fund, not just our voluntary dealing. We think that figure will prove to be low if or when other funds produce comparable numbers, although we are not holding our breath whilst we await this. However, just as we think an obsession with share prices to the exclusion of companies' fundamental performance is unhealthy, we would caution against becoming obsessed with charges to

such an extent that you lose focus on the performance of a fund. It is worth pointing out that the performance of the fund at the beginning of this letter is after charging all fees, or as someone expressed it more elegantly “You get what you pay for”, or at least you should aim to.

\*Source: Fundsmith LLP †Source: Bloomberg

# *If you do one thing with your money in 2016*

*FINANCIAL TIMES*, 15 JANUARY 2016

**I**F you do one thing with your money in 2016 it should be this: buy an investment you can forget about.

The saying “cobblers’ children have no shoes” exemplifies the tendency for professionals to concentrate on their work and neglect their own needs – even in their own area of speciality. Investment professionals are not exempt from this tendency. But if you don’t have the time or inclination to manage your investments every day or even every week or month, then surely the best option is to adopt an investment strategy which can prosper as a result of this apparent neglect.

I say apparent neglect because, combined with the right investment strategy, such inactivity is a virtue as it cuts dealing costs, a significant drag on investment performance.

In my view there are two obvious routes to achieve superior investment performance without the need for constant vigilance or activity.

One is to buy an index fund. Given that the average active manager underperforms the relevant index benchmark, charges more than an index fund and deals more, this outcome is inevitable. I mean an index fund, not an exchange-traded fund (ETF). Given that the rationale for this strategy is your lack of attention, why would you want a fund which allows intraday dealing, which is what the “exchange-traded” part of ETF is telling you it provides?

The other route is to invest in a portfolio of equities in good companies which can be relied upon to compound in value over time. Such companies have been around for decades or longer, have good financial results (high returns on capital, high margins, good cash conversion of profits and moderate debt levels) even at the bottom of the economic cycle.

They also have identifiable competitive advantages which should enable

those returns to persist despite their obvious attraction to competitors.

Whichever of these routes you choose, buy them, forget them and enjoy the results.



# *Investors should not write off bond proxies*

*FINANCIAL TIMES*, 8 SEPTEMBER 2016

**T**HE Fundsmith Equity Fund which I run seeks to generate superior returns for investors with a simple three-step strategy:

1. buy shares in good companies
2. don't overpay
3. do nothing.

The three steps are not placed in that order accidentally. The strategy begins with the decision about whether or not the shares are in a company of sufficient quality for us to want to own it. In our view, that is more important than the valuation.

But don't take my word for it. Here's what Charlie Munger, vice chairman of Berkshire Hathaway and Warren Buffett's business partner, said on the subject in a speech entitled "A Lesson on Elementary, Worldly Wisdom as it Relates to Investment Management and Business":

'Over the long term, it's hard for a stock to earn a much better return than the business which underlies it earns. If the business earns 6% on capital over 40 years and you hold it for that 40 years, you're not going to make much different than a 6% return – even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you'll end up with a fine result.'

Mr Munger was not guessing or putting forward a theory. He was stating a fact. If you are a long-term investor, the return on capital which a company can generate, and its ability to reinvest at a superior rate of return, is more likely to determine how well its shares do – and not the valuation at which you buy or sell it. Or as his partner Warren Buffett once said more pithily, 'It's better to buy a great company at a fair price than a fair company at a great price.'

However, most people are incapable of behaving as long-term investors

either for behavioural reasons and/or because they have the “benefit” of advisers who see their *raison d’être* and fees as driven by activity.

The arithmetic is inexorable – high rates of return on capital can compensate for seemingly high valuations, whereas low-return companies are not worthwhile for the long-term investor almost irrespective of how lowly the shares are rated. The strategy of most investors who choose to invest in persistently low-return companies is usually some combination of buying them ahead of a perceived cyclical upturn in results or events, and/or waiting for the valuation and therefore the share price to improve.

The problem – other than the fact that very few investors seem able to perform this successfully – is that even if you get it right, you then have to sell the shares and find a new investment that fits these criteria. Such shares should never be allowed to become long-term holds otherwise the share price returns will start to gravitate to the low return on capital the underlying business produces.

In a corporate version of the axiom “You are what you eat”, a number of acquisitive conglomerates have managed to demonstrate the drawbacks of an approach based primarily on valuation rather than quality by acquiring businesses in basic foodstuffs, building products and engineering. They managed to produce short-term gains by improving their profitability, albeit some of this was a manifestation of the magic of acquisition accounting rather than anything more fundamental. But thereafter, the acquired businesses started to produce returns and growth rates which began to drag the acquirers’ performance down to their level.

Hence the demise of BTR, Hanson and Tomkins. Just about the only UK-based serial acquirer which has managed to buck the trend is Melrose, which makes a point of selling businesses once the short-term gains have been realised, much in the same way a portfolio manager would have to.

But notwithstanding the sound advice from two demonstrably great investors, I have much more frequently been asked whether a share is cheap or expensive rather than whether a company is good enough to want to own it. This has reached a crescendo in recent times with the strong investment performance of so-called bond proxies: shares in companies which have such reliable returns that investors have allegedly flocked to invest in them.

The suggestion is that whilst these bond proxies have performed well as investors have desperately reached for yield in an era of low, zero or even negative interest rates, their valuations have now become too extreme to make the strategy viable.

Needless to say, this suggestion usually seems to emanate from investors who have completely missed out on the performance of these shares and who have been singing this siren song for a considerable time.

Following their advice to date would have been disastrous. I can trace back warnings about the perceived over valuation of so-called bond proxies for over three years, a period of time over which the total return on this strategy has approximated 100%. However, just because a theory has been consistently wrong for some time does not mean that it might not ultimately be proved correct – like the proverbial stopped clock which is right twice a day.

So I have decided to explore this subject a bit further. In my next column, to be published next week, I will turn to the Nifty Fifty, the 50 NYSE-listed companies that were viewed in the 1960s and 1970s as solid buy-and-hold growth stocks.

The rise of the so-called bond proxies is often compared to the era of the Nifty Fifty, so it might be wise to look back at those events and see what we can learn from them.

# *What the Nifty Fifty can tell us about bond proxies*

*FINANCIAL TIMES*, 14 SEPTEMBER 2016

**L**AST week, I suggested that we might learn something about the outlook for so-called bond proxy stocks by studying the events of the Nifty Fifty era and its aftermath in the US.

So what happened? The term refers to a period in the 1960s and 70s when 50 large-cap stocks on the New York Stock Exchange that were widely regarded as solid buy-and-hold growth stocks reached towering valuations. The stocks were often described as “one-decision”. They were viewed as extremely stable, even over long periods of time, so that only a decision to buy them was required as they never needed to be sold.

Their most common characteristic was solid earnings growth, for which these stocks were assigned extraordinarily high price/earnings ratios (PE). Critics of the quality investment strategy cite the Nifty Fifty as evidence of the bad things that can happen to investors who ignore valuation. Drawing comparisons with bond proxy stocks today, they point to the subsequent underperformance of most of the Nifty Fifty list as a warning today’s investors should heed. Yet like many other stock market events, I find that they more frequently rely upon urban myth rather than analysis.

So let us examine the data. The first problem? There was never an official Nifty Fifty. Various lists of stocks published by Morgan Guaranty and Kidder Peabody have been taken as a proxy. The Morgan Guaranty List was cited by Malcolm Forbes Jr in a *Forbes* Magazine article in 1977 entitled “When Wall Street Becomes Enamored”. The Kidder Peabody list is actually from a monthly list published by Kidder of the stocks traded on the NYSE which had the highest PE ratios. A research paper then christened the 24 stocks which were found on both lists as the ‘Terrific 24’.

However, whichever list you want to take, the average PE was somewhere between double and treble than that of the wider market:

**PE ratios, end of 1972**

| <i>Stocks</i>               | <i>Average multiple</i> |
|-----------------------------|-------------------------|
| Morgan Guaranty Nifty Fifty | 45.2                    |
| Kidder Peabody Nifty Fifty  | 57.9                    |
| ‘Terrific 24’               | 59.8                    |
| S&P 500                     | 19.2                    |

*Source:* Fundsmith research

How this group of stocks came to be so highly valued is not clear. It wasn’t a typical market mania such as the 1920s excitement over mass production, or the dotcom era’s blind zeal over the promise of technology – though the Nifty Fifty lists were sprinkled with new technology stocks which have since proven to be costly disasters. (Eastman Kodak, Polaroid and Xerox are the most obvious examples.)

What seems to have happened is that investor behaviour somewhat mirrored that of society as a whole. There was a kind of “Woodstock moment” as investors decided to throw away their old conservative dividend-paying stocks and move into so-called growth companies. This became self-fulfilling as an investment strategy whilst the performance lasted. One commentator concluded that it was a ‘change in the Zeitgeist of Wall Street’.

The bursting of the bubble is rather simpler to explain. The S&P peaked on 5 January 1973 and then fell 48% over the next 22 months as inflation rose from 3.2% in 1972 to 11.8% by the beginning of 1975. Oil prices almost quadrupled after the Yom Kippur War, the 1973–75 recession began and the US became gripped by Watergate.

Data are difficult to come by but the Nifty Fifty stocks held up somewhat longer than the market – although they eventually succumbed to the inevitable. That said, Coca-Cola’s share price peaked in January 1973 at the same time as the market peak and then fell 66% over the next 22 months. Johnson & Johnson stock also peaked in January 1973 but held its decline to 42% between then and October 1974. Of the highest-rated names, Disney also peaked in January 1973 and then fell 82% by October 1974. The long bear market of the 1970s that lasted until 1982 caused valuations of the

Nifty Fifty to fall to low levels along with the rest of the market, with most of these stocks underperforming the broader market averages. This might seem to confirm the doom-laden forecast for bond proxies.

If a Nifty Fifty exists today, which stocks would it contain? Taking the same methodology as that used for the original Nifty Fifty, the 50th highest-rated stock in the S&P 500 today is Welltower, the healthcare property provider, with a PE of 40.7×. This valuation is very similar to the 50th stock on the Kidder 1972 list – Clorox, the consumer goods company, with a PE of 41.4×.

Furthermore, the overall PE of the S&P 500 Index today, at 20.5×, is similar to its PE back in 1972. In contrast, the current PE of the S&P 500 consumer staples sector – which is the largest constituent of the so-called bond proxy stocks – is only 22.8×. The parallels with 1972 look rather clear, but the read across to bond proxies does not.

In fact, the only consumer staples stock in my updated version of the Nifty Fifty is Monster Beverage, the energy drink company. What type of stocks make up the remainder? Well, here is a selection which may help explain: Activision, Adobe, Amazon, Broadcom, Digital Reality, Expedia, Facebook, Illumina, Micron, Netflix, ProLogis, Red Hat, Tripadvisor, Yahoo, and Alexion Pharma, Allergan, and Regeneron. Of the current Nifty Fifty, only 29 pay a dividend – which is not often a good sign and not an accusation you could level against the bond proxies. None of the current constituents of the Nifty Fifty are in the portfolio of the fund I run, the Fundsmith Equity Fund, or our investable universe of stocks we would be prepared to own.

If you are looking for something to worry about in terms of valuation and the possible loss of value caused by a rise in interest rates, I think there are far more extreme valuations to worry about than the so-called bond proxies.

# *Stay focused on the ‘known knowns’*

THE TELEGRAPH, 29 OCTOBER 2016

**D**ONALD RUMSFELD, the former US defence secretary, once said: ‘There are known knowns. These are things that we know. There are known unknowns. That is to say, there are things that we know we don’t know. But there are also unknown unknowns. There are things we don’t know we don’t know.’

I am amazed by how much time and effort people waste trying to guess what will happen in known unknowns. Brexit, China, commodities, interest rates, the oil price, quantitative easing and the US presidential election are all known unknowns.

Take Brexit: who would feel confident in taking an investment stance based on the outcome of an event that every pollster got wrong? Evidently some fund managers did: ‘Brexit changes everything’ exclaimed one absolute return (what an inappropriate title that is) fund manager who was down by more than 20% over the year to date.

On the contrary, so far I think it has changed very little. After all, it hasn’t happened yet.

I have just as little sympathy with the few fund managers who were praised for being up by 20% immediately after the referendum. They were willing to bet their investors’ money on a coin toss, it seems.

The problem isn’t just that these events are difficult or even impossible to predict. Markets are what are known as “second order” systems: to invest successfully on this basis you would not only have to predict the outcome of the events but would also have to know what the market was expecting and how it would react. Good luck with that.

Then there is the problem of the unknown unknowns. The event that may cause a major move in the market may be one that no one has even spotted. It’s hard to predict the outcome of something you don’t even know exists.

One proposed investment solution to this uncertainty are the so-called absolute return funds, which have attracted huge amounts of money in recent years, rising from a total of £2bn of assets in June 2008 to £63bn by June 2016. How have they fared?

The average absolute return fund is up by 0.7% in the past year and had gains of 2.9% in 2015 and 4.3% in 2014. By contrast, Fundsmith Equity is up by 42% in the past year, 15.2% in 2015 and 15.3% in 2014. Absolute return funds have also underperformed the MSCI World Index in four of the past five years.

| % Total return                     | 2016  | 2015 | 2014  | 2013  | 2012  |
|------------------------------------|-------|------|-------|-------|-------|
| <i>Year to 30 September</i>        |       |      |       |       |       |
| IA Targeted Absolute Return sector | +0.7  | +2.9 | +4.3  | +4.9  | +2.5  |
| MSCI World Index                   | +29.9 | +1.6 | +12.1 | +19.9 | +17.3 |

Leaving aside the fact that absolute return funds use complex hedging strategies that neither you nor I understand, their hedging has pretty much ensured that while their investors have not lost money, they do not make any either, to the point that the word “return” in their title looks inappropriate.

So what should you focus on? I would suggest just three things.

First and foremost, invest in the shares of good businesses. They are not that difficult to identify, having typically been around for ages and produced good financial results by providing products and services that customers want.

The average company in the portfolio of the Fundsmith Equity fund, which I run, was founded in 1912. Having survived two world wars, the Great Depression and the financial crisis, they will probably survive whatever known or unknown unknowns lie ahead.

Second, stick to investing in things you understand. I have never found anyone who disagrees that this is an essential ingredient for success. But investors are terrible at defining what it is they understand narrowly enough. Do you really understand banking nowadays? If not, why do you own bank shares? How does an absolute return fund use derivatives? No



idea? Then why do you own it? How does an exchange-traded fund work? Don't know? Then buy an index tracker fund (and if you think ETF and index tracker funds are the same, you definitely do not understand the subject).

Third, don't worry too much about valuations. You will find pundits and commentators who will tell you that good companies' shares are too highly valued. Sooner or later they are bound to be right, albeit temporarily, but what gains will you forgo while you wait for that to occur? If you are a long-term investor, buying shares in a good business is more important than valuation. If you are not a long-term investor, what are you doing investing in the stock market?

# *Annual letter to shareholders 2016*

FUNDSMITH, JANUARY 2017

**T**HIS is the seventh annual letter to owners of the Fundsmith Equity Fund. The table below shows performance figures for the last calendar year and the cumulative and annualised performance since inception on 1 November 2010 compared with various benchmarks.

| % Total return                     | 1 Jan to 31 Dec 2016 | Inception to 31 Dec 2016 |                   |
|------------------------------------|----------------------|--------------------------|-------------------|
|                                    |                      | <i>Cumulative</i>        | <i>Annualised</i> |
| Fundsmith Equity Fund <sup>1</sup> | +28.2                | +196.6                   | +19.3             |
| Equities <sup>2</sup>              | +28.2                | +110.6                   | +12.8             |
| UK bonds <sup>3</sup>              | +6.5                 | +32.4                    | +4.7              |
| Cash <sup>4</sup>                  | +0.6                 | +4.0                     | +0.6              |

<sup>1</sup> T-class acc shares, net of fees, priced at noon UK time. <sup>2</sup> MSCI World Index, £ net, priced at close of business US time. <sup>3</sup> Bloomberg/EFFAS Bond Indices UK Govt 5–10 yr. <sup>4</sup> 3-month Libor interest rate. <sup>1,3,4</sup> Source: Bloomberg. <sup>2</sup> Source: [www.msci.com](http://www.msci.com)

The table shows the performance of the T-class accumulation shares, the most commonly held class and one in which I am invested, which rose by +28.2% in 2016 and compares with +28.2% for the MSCI World Index in sterling with dividends reinvested. The fund therefore equalled the performance of this benchmark in 2016, and our fund is still currently the number-one performer since its inception in the Investment Association Global sector by a cumulative margin of 15% over the second-best fund and 127% above the average.

However, we realise that many or indeed most of our investors do not use the MSCI World Index as the natural benchmark for their investments.

Those of you who are based in the UK and look to the FTSE 100 Index as the natural yardstick for measuring your investments and/or who hold funds which are benchmarked to the FTSE 100 Index and often hug it will have had a much worse experience than the performance of the MSCI World Index. The FTSE 100 Index was up +14.4% in 2016 and the total return including dividends reinvested was +19.2%. The fund outperformed this by +9%.

It is a commentator's cliché that football is a game of two halves, and that was certainly true of our relative performance in 2016. At half time on 30 June our fund (T-class accumulation shares) was up +16.4% versus +11.0% for the MSCI World Index, aided by the sharp fall in the pound after the Brexit result in the referendum of 23 June as the majority of the shares in our portfolio are listed in the United States. Even though this is not an accurate reflection of the fund's currency exposure, which really depends upon where the companies generate their revenues and profits, the fact is that the US dollar is still the largest currency exposure we have.

So what happened in the second half of the year? We experienced what stock market commentators often describe as a sector "rotation", in which the sectors in which we are invested mostly fell out of favour and share prices of those companies underperformed, whilst other sectors which we do not own performed well, and in particular the bank sector.

This "rotation" seems to have occurred as a result of expectations about a pick-up in economic growth which focused attention on a potential recovery in the performance of cyclical stocks. This became more intense after the election (it is common to qualify this with the word "surprise" – "surprising to some" might be a better descriptor as indeed it might for Brexit) of Donald Trump as US president in early November as a result of predictions that his economic policies would stimulate more rapid growth in the US economy.

I have no way of knowing whether this "rotation" will continue, but then again neither do any of the analysts or commentators who are involved in opining on the matter.

When judging this situation I think it is worth bearing in mind a number of points.

I can trace back four years of market commentary which warned that shares of the sort we invest in, our strategy and our fund would underperform. During that time the fund has risen in value by about 100%. The fact that you would have foregone this gain if you had followed their advice will of course be forgotten by them at the very least.

Much of the commentary is simplistic – for example, concentrating on the consumer staples sector as an easily identifiable set of stocks of the sort we

invest in, as in a recent note by Deutsche Bank which said ‘the party’s over’ in consumer staples. Even if this is true, these represent only about a third of our portfolio.

The predictions of underperformance also focus on so-called “bond proxies” – stocks of companies with relatively predictable returns – which investors have supposedly turned to as a substitute for bonds as bond yields have declined to (and even fallen below) zero. We are told that these bond proxies will do badly when rates rise and that they are starting to do so. As I write, the US Federal Reserve has raised the Fed Funds rate by a total of 0.5% from its record low in a whole year (the first 0.25% rise was on 17 December 2015 – how time flies!). As I pointed out last year, this glacial rate of increase does not seem to justify the popular term “hike”, defined in the dictionary as a sharp or unexpected increase – a description which clearly does not apply to the Fed’s decision. Of course, I have no idea when or by how much the Fed or any other central bank will subsequently increase interest rates. Neither, I suspect, do any of the commentators or analysts, judging by their track record thus far – but that will not stop them making predictions and suggesting that you should make investment decisions based upon them.

There is also the question of what we might invest in as an alternative if we chose to sell the fund’s holdings in defensive so-called bond proxy stocks or if you chose to redeem your shares in our fund. The obvious suggestion, and it is one which would have worked well in the second half of 2016, is that you should switch into cyclical stocks such as banks. Buying cyclical stocks in anticipation of a rise in interest rates does pose a fairly obvious problem – won’t they perform worse than defensive stocks if the rise in rates causes an economic slowdown? There is also the fact that these stocks are in companies which over time do not create shareholder value by generating returns on capital above their cost of capital and growing by deploying more capital at such favourable returns, which is what the companies we seek to invest in accomplish. If you choose to invest in such companies then I would suggest it is not because you want to hold their shares indefinitely and allow them to compound in value but because you think you perceive an opportunity for a trade in which you buy them and then sell them for a higher price. If so I hope you have better luck with your

timing in this game of “greater fool theory” (in which you hope to buy from a seller who is less competent than you at spotting this opportunity and when the time comes you need to sell to a buyer who is similarly ill-informed) than most people seem to have. As we do not profess to possess this skill, our fund will not be attempting it.

I remain amazed (I could stop this sentence there) by the number of commentators, analysts, fund managers and investors who seem to be obsessed with trying to predict macro events on which to base their investment decisions. The fact that they are seemingly unable to predict events does not seem to stop them trying. During 2016 we had the spectacle of all the major polling organisations and the mainstream media failing to predict the outcome of the EU referendum in the UK or the US presidential election. Yet many of the same people are now busy telling us what the effect of Mr Trump’s economic policies will be and how they will affect our investments.

I spend little time worrying about the macro trends and even less time trying to apply predictions about them in order to manage our portfolios. Here’s a short list of possible macro factors which may affect companies and markets in the near future:

- Brexit
- China
- “demonetisation” in India
- French presidential elections
- German elections
- interest rates
- Korea
- President Trump
- quantitative easing by the European Central Bank
- Syria
- the oil price.

Even if you could correctly predict how these matters would develop, and

the timing of that, this would not enable you to use this as a basis of investment decisions. Markets are a so-called second-order system – to usefully employ your predictions you would not only have to make mostly correct predictions but you would also need to gauge what the markets expected to occur in order to predict how they would react. Good luck with that.

Rather like the management of some of the companies we most admire, I waste little or no time trying to guess what will happen to factors I cannot control or predict and deploy most of my time and effort on things I can control. Two of those are whether we own good companies and what valuation we pay to own their shares.

As usual, we seek to give some insight into the first of those – whether we own good companies – by giving you the following table which shows what Fundsmith would be like if instead of being a fund it was a company and accounted for the stakes which it owns in the portfolio on a “look through” basis, and compares this with the market (in this case the FTSE 100 Index and the S&P 500 Index).

| <i>As at 31.12.16</i>   | <b>Fundsmith Equity Fund*</b> | <b>FTSE 100 Index<sup>+</sup></b> | <b>S&amp;P 500 Index<sup>+</sup></b> |
|-------------------------|-------------------------------|-----------------------------------|--------------------------------------|
| ROCE                    | 26.7%                         | 13.5%                             | 14.7%                                |
| Gross margin            | 61.9%                         | 40.0%                             | 43.2%                                |
| Operating profit margin | 25.5%                         | 12.9%                             | 13.9%                                |
| Cash conversion         | 99.4%                         | 81.4%                             | 83.6%                                |
| Leverage                | 37.7%                         | 48.9%                             | 52.1%                                |
| Interest cover          | 17.0×                         | 7.9×                              | 7.9×                                 |

*Note: ROCE, gross margin, operating margin and cash conversion are the weighted average for the Fundsmith Equity Fund and averages for the FTSE 100 Index and S&P 500 Index. The FTSE 100 and S&P 500 numbers exclude financial stocks. The leverage and interest cover numbers are medians. All data as last reported. \*Source: Fundsmith LLP <sup>+</sup>Source: Bloomberg*

The companies in our portfolio have significantly higher returns on capital and better profit margins than the average for the indices. They convert more of their profits into cash and achieve this with a much lower level of borrowing than the average company. Nor is this a one-off – they have been achieving these superior results for many years. The average year of foundation of our portfolio companies at the year end was 1912.

Consistently high returns on capital are one sign we look for when seeking companies to invest in. Another is a source of growth – high returns are not much use if the business is not able to grow and deploy more capital at these high rates. So how did our companies fare in that respect in 2016? The weighted average free cash flow (the cash the companies generate after paying for everything except the dividend, and our preferred measure) grew by just over 11%\* in 2016. We regard this as a rather good result given the generally lacklustre growth which the world is experiencing and which led to earnings falling on the FTSE 100 and S&P 500 companies in the past year.

This leads onto the question of valuation. The free cash flow (FCF) yield (the free cash flow generated by the companies divided by their market value) on the portfolio at the outset of the year was 4.3%\* and ended it at 4.4%\* so they did not become any more highly rated. The mean FCF yield on the FTSE 100 is 4.7%+ and the median is 4.6%+. The mean FCF yield on the S&P 500 is 4.3%+ and the median 4.8%+. To try to cut through all these means and medians, our portfolio consists of companies which are fundamentally a lot better than those in the index and are valued a little more highly than the average FTSE 100 company and about the same as the average S&P 500 company, and they grew more rapidly in the past year. I would suggest that is not a bad situation for our portfolio to be in.

For the year, the top five contributors to the fund's performance were:

|                                |        |
|--------------------------------|--------|
| <b>IDEXX Laboratories</b>      | +3.10% |
| <b>Stryker</b>                 | +2.54% |
| <b>C. R. Bard</b>              | +2.06% |
| <b>InterContinental Hotels</b> | +1.71% |
| <b>Johnson &amp; Johnson</b>   | +1.68% |

The bottom five were:

|                             |        |
|-----------------------------|--------|
| <b>Estée Lauder</b>         | -0.06% |
| <b>Procter &amp; Gamble</b> | -0.02% |
| <b>Novo Nordisk</b>         | +0.07% |

**Colgate-Palmolive** +0.23%

**Imperial Brands** +0.37%

The largest contributor, IDEXX, is a company which we began buying in 2015. It is the world's largest maker of veterinary testing equipment. In contrast, we have held stakes in Stryker, InterContinental Hotels and Johnson & Johnson since inception.

Of the bottom five performers, we sold our stake in Procter & Gamble in January 2016. You may note that out of the five worst contributors to our performance last year, four were consumer stocks and at least three are regularly cited as “bond proxies”. It seems strange to be accused of having benefitted from the popularity of these stocks when in fact they have underperformed.

We only recently began buying stakes in Estée Lauder, the US cosmetics business, and even more recently in Novo Nordisk, a Danish company, which is the world's leading supplier of insulins.

Turning to the third leg of our strategy which we succinctly describe as ‘do nothing’, minimising portfolio turnover remains one of our objectives and this was again achieved with a portfolio turnover of -15.6%\* during the period. It is perhaps more helpful to know that we have held 14 of our portfolio companies since inception and we spent a total of £181,025 or just 0.003% (0.3 of a single basis point) of the fund on voluntary dealing, which excludes dealing costs associated with fund subscriptions and redemptions as these are involuntary.

Why is this important? It helps to minimise costs, and minimising the costs of investment is a vital contribution to achieving a satisfactory outcome as an investor. Too often investors, commentators and advisers focus on the annual management charge (AMC) or the ongoing charges figure (OCF), which includes some costs over and above the AMC, which are charged to the fund. The OCF for 2016 for the T-class accumulation shares was 1.06%.\* The trouble is that the OCF does not include an important element of costs – the costs of dealing. When a fund manager deals by buying or selling investments for a fund, the fund typically incurs the cost of commission paid to a broker, the bid–offer spread on the stocks dealt in and,



in some cases, stamp duty. This can add significantly to the costs of a fund yet it is not included in the OCF.

We provide our own version of this total cost including dealing costs, which we have termed the total cost of investment (TCI). For the T-class accumulation shares in 2016 this amounted to a TCI of 1.11%,\* including all costs of dealing for flows into and out of the fund, not just our voluntary dealing. We think that figure will prove to be low if or when other funds produce comparable numbers. However, we would caution against becoming obsessed with charges to such an extent that you lose focus on the performance of a fund. It is worth pointing out that the performance of the fund at the beginning of this letter is after charging all fees.

As a cautionary tale about the merits of doing nothing, you may recall that in 2015 we sold our holding in Domino's Pizza since it had reached a valuation which we felt was only justifiable if its rapid rate of growth was sustainable, which we doubted was likely. In my annual letter last year I said that I 'sold it with some regret and trepidation. Regret since it is undoubtedly a fine business and had been our best-performing share since the inception of our fund. Trepidation since selling shares in good companies is something we are justifiably reluctant to do.' Domino's managed to prove these fears right in the most painful way, as the share price rose by +45%+ in 2016. Apart from demonstrating that I am... could we agree on "fallible" as a descriptor? ... I hope this illustrates why I am reluctant to agree with the commentators who suggest that you or I should sell our portfolio of great companies and invest in a portfolio of assorted junk in the hope that it will go up, the great companies' share prices will go down and we can then profitably reverse the trade.

\*Source: Fundsmith LLP +Source: Bloomberg

# *Emerging markets ETFs and the Jaws of Death*

*FINANCIAL TIMES*, 17 FEBRUARY 2017

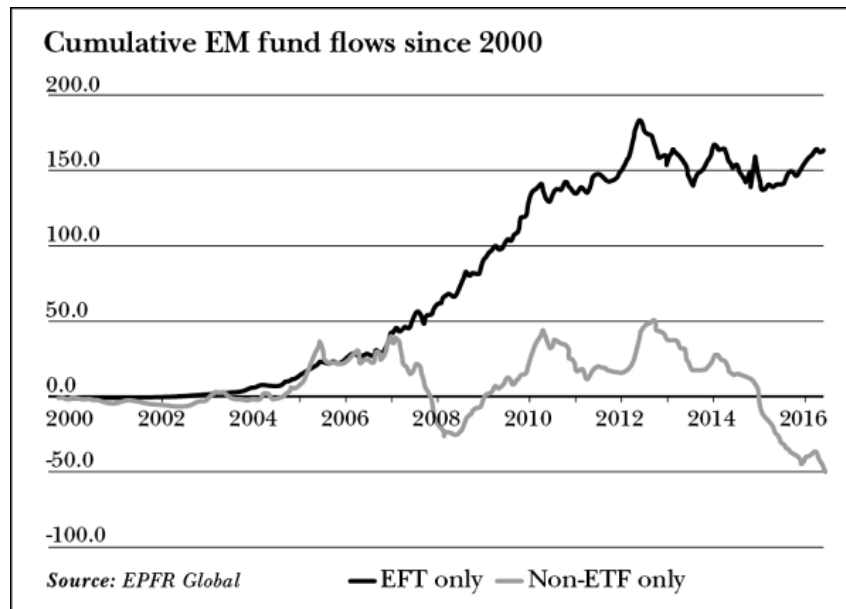
**I**T may seem a strange position for an active fund manager to adopt but I am in favour of passive or index investment.

The advantages of index investing are clear. Investors can invest in a widely diversified portfolio at minimal cost as management charges are low, as are costs of dealing.

The obvious drawback to index funds and exchange-traded funds (ETFs) is that they deprive investors of the opportunity to focus their investment only in good companies and/or shares which offer reasonable value or better. However, it seems that most active fund managers do not even attempt to invest only in good companies, or if they do they are not very good at identifying them. They seem to have similar problems in determining what is reasonable value. Many hold so many shares in their portfolio that it is bound to track the index. When combined with active management fees and dealing costs this means that they are certain to underperform the index. Hence my view that most investors would be better served by an index fund.

But the growth in index funds and ETFs has significant side effects. In an index fund or ETF, the weighting of stocks is based upon whatever criterion is used to compile the index, typically the market capitalisation of the companies. This means that as more money is invested via index funds or ETFs it is automatically routed via the fund into the companies in the relevant index based solely upon their market value.

This can cause some major distortions, one of which we are almost certainly seeing recently in emerging markets. Funds flow into emerging markets has increased significantly in the past couple of years as investors have sought to capitalise on a recovery. However, all of this inflow and more has gone into emerging markets ETFs whilst money has actually been withdrawn from emerging market active funds as this chart shows:



It looks rather like the Jaws of Death, a term taken from shark-attack movies and military encounters such as the Charge of the Light Brigade.

Increasing amounts of money are being allocated via this inflow into the largest companies in the emerging markets index, and they are not good companies. Last year the return on capital employed (ROCE) of the top ten constituent stocks of the MSCI Emerging Markets Index averaged just 12%.

Of course, this is a single year and you might wonder whether it is representative. Looking back at the returns of the largest companies in the index for the past ten years or so shows a more or less continuous decline, particularly amongst the Chinese companies which seem to be investing on the basis that debt capital in particular for them is close to free. This is always a dangerous assumption, as the dotcom era and Japan in the late 1980s illustrated.

Or maybe the shares which dominate the index are lowly rated, which more than compensates for their low returns? This does not seem to be the case, given the current price/earnings ratio of 28 times for the top ten largest constituents, versus 23 times for the MSCI index, unless their earnings are about to undergo a sharp recovery. However, this seems unlikely for a mixture of internet and e-commerce stocks, electronics manufacturers, Chinese banks and mobile telecoms companies.

Many active managers bemoan the rise of index funds and ETFs as they say

it makes their job more difficult. In the short term this is undoubtedly true. If money pours into markets via ETFs it will cause the shares of the largest companies in the index to perform well irrespective of their quality or value, or lack of it, even though active managers seeking quality and/or value will not want to own them. The weight of money flows will make it a self-fulfilling prophesy that the index will outperform the active managers who behave in this rational manner.

This can be very frustrating but an active fund manager should regard this as an opportunity to own more of the shares which are better than the index average and will eventually produce superior returns if the manager and the investors have the patience necessary to wait for this to occur. The irony is that active management has value for investors as a means of exploiting market inefficiencies such as those caused by the rise of ETFs in emerging markets, but those events make it harder for managers and investors to follow the active path.

# *The unique advantage of equity investment*

*FINANCIAL TIMES, 20 APRIL 2017*

**I**NVESTMENT in stocks and shares – equities – has a unique advantage over other asset classes which in my experience is rarely understood and almost never discussed.

Equities can compound in value in a way that investments in other asset classes, such as bonds and real estate, cannot. The reason for this is quite simple: companies retain a portion of the profits they generate to reinvest in the business.

If you look at companies in the major indices, such as the S&P 500 or the FTSE 100, you will find that on average companies pay out about half of their earnings in dividends. The earnings that are not paid out are invested in the business.

No other asset class provides this. If you own bonds, you receive an interest payment but it is not automatically reinvested in the bonds. The only exception to this is so-called “payment in kind” bonds issued by highly leveraged companies, which provide the option for them to issue more bonds if they are unable to pay the cash coupon. So you get more bonds but only at a moment when the last thing you want is for your interest payment to be invested in more of this junk.

Similarly, if you own real estate, you will receive rental income but none of it will be reinvested in property for you.

As well as being a unique feature of equity investment, this can also be a valuable source of compounding in the value of your investments. For example, if you owned the average company in the S&P 500 it earned a return on equity capital employed of 13% last year. If it can retain half the earnings which are attributable to you as an investor, and it can continue to invest at its current rate of return as its business grows, that half should also earn 13%. What makes it even more attractive is that on average the companies in the S&P 500 trade on three times book value, so for every

dollar of earnings they retain, they currently create \$3 of market value (although of course this – the valuation – can change).

This is not the same as the frequently uttered mantra that the majority of the return on equities comes from reinvestment of the dividends paid. Dividends which are reinvested have to be used to purchase shares at market value – at three times book value currently in the S&P – whereas each \$1 of retained earnings gets reinvested at book value. It is the reinvestment of retained earnings, not dividends, which provide the majority of the growth in the value of equities.

Of course, what is even more attractive is if instead of simply owning the index and seeing the companies reinvest your retained earnings at an average rate of return, you own only companies which can achieve a high return on capital and which can as a result manage to translate each \$1 of retained earnings into a market value which is a much higher multiple of book value.

If you follow this reasoning you would conclude that if a company is able to invest retained earnings at a high rate of return then the last thing you would want it to do is pay you a dividend. This is perhaps best illustrated by Warren Buffett's Berkshire Hathaway, which has not paid a dividend in over half a century.

Of course, this needs to be pursued with care. There is a reasonably sound piece of economic theory called “mean reversion” which suggests that companies which generate high returns should attract competition which will eventually reduce their returns to the average, or worse. The very small group of companies that manage to avoid this economic law of gravity have some kind of defence which enables them to fend off the competition. This is the oft-quoted concept of the “moat” popularised by Mr Buffett.

In this article, I have described the benefit of equity investment purely in financial terms, but the company has to have a source of growth to enable it to reinvest retained earnings – and furthermore the growth has to provide an opportunity for it to reinvest at a good rate. There are plenty of examples of companies which start with good rates of return but then invest retained earnings at much lower rates and destroy value for shareholders. For an

illustration of this, read my article on what went wrong at Tesco (“How investors ignored the warning signs at Tesco”, on [page 82](#)).

# *AstraZeneca is beginning to look like Tesco*

FINANCIAL TIMES, 4 AUGUST 2017

**I**T might be tempting to view last week's fall in the AstraZeneca share price in isolation, related to the results of the "Mystic" lung cancer drug trial. However, I suspect that AstraZeneca's problems go much deeper than a setback for a single drug.

To paraphrase the title of a Christmas song which was a hit for Perry Como in 1951, AstraZeneca is beginning to look a lot like Tesco.

In *FT Money* nearly two years ago I wrote a column about AstraZeneca's accounting ("Why bother cooking the books if no one reads them?", on [page 114](#)) in which I highlighted that AstraZeneca's move to "core" earnings in 2007 had allowed its reported results and most of the investment community to exclude three major costs from its reported profits, namely:

- restructuring charges
- "exceptional" legal costs
- intangible asset amortisation.

In other words, major costs were being ignored in the calculation of profits. It is this approach to accounting which is beginning to remind me of Tesco.

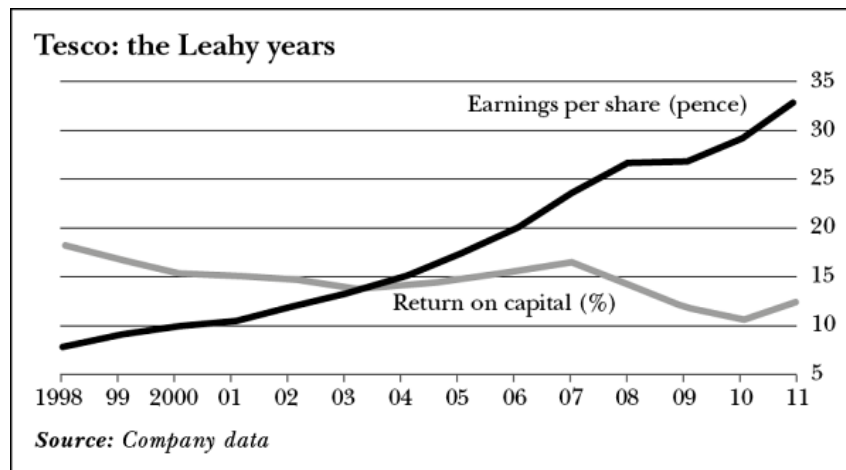
Historically, Tesco also managed eight changes in the definition of return on capital employed over the period 1998–2011, years when Terry Leahy was the chief executive (I examined these in an *FT Money* column in September 2014, "How investors ignored the warning signs at Tesco" – see [page 82](#)).

AstraZeneca moved to reporting "core" earnings in 2007. In 2012 it moved to excluding all intangible asset amortisation and impairment charges as opposed to only certain amortisation charges. In a pharmaceutical company, almost all the assets are intangible – namely the drug patents. This change led to reported "core" earnings in 2012 going up. *Quelle surprise*. While this accounting treatment would not fool a decent analyst, who in any event



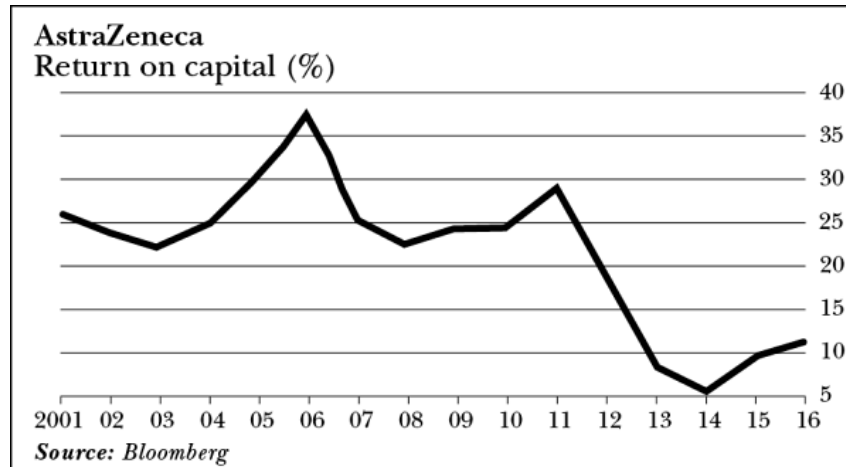
would be looking at cash flows rather than earnings, it certainly seems to have fooled some people.

The other way in which AstraZeneca is beginning to resemble Tesco is its vast increase in invested capital at the expense of returns. As you may know, I regard return on capital as the single best measure of financial success for a business (as does Warren Buffett for what it's worth).



In my September 2014 article, one of the planks in the argument that Tesco was headed for a fall was a chart – reproduced here – which contrasted the steady upward march of Tesco's earnings per share (EPS), which seemed to have mesmerised investors, with the more or less continuous fall in its return on capital employed (ROCE).

Alongside the Tesco chart is one showing AstraZeneca's ROCE for the period 2001–16. You will see that the returns fall from a superior 28.4% in 2001 and a wonderful 40.9% in 2006 to a barely acceptable 11.9% over the period (and have been as low as 5.1% recently).



This is hardly surprising given that invested capital, the denominator in this calculation, has risen 114% since returns peaked in 2006. Even “core” EPS has risen by just 10% in total over the same period, and that’s with the benefit of all those “core” adjustments.

It looks as though all that additional capital has not been very well invested. An example may be the 2007 acquisition of US biotechnology business MedImmune for \$15.6bn.

MedImmune had revenues of just \$1.3bn and its main product at that time – a nasal flu spray called FluMist – had failed to live up to expectations. Yet AstraZeneca paid a premium of 53% to MedImmune’s share price before the company put itself up for sale – a price that one analyst (Brian Lian at CIBC World Markets) described as ‘extraordinary’ and ‘difficult to rationalise’.

I guess it’s not that difficult to rationalise if you exclude any resulting restructuring costs and write-down of the intangible assets acquired from the calculation of earnings. It is no coincidence that AstraZeneca’s ROCE peaked the year before this acquisition and that it moved to reporting “core” earnings that year.

Leaving aside AstraZeneca’s exploits in acquisitions and accounting, last week’s Mystic drug trial problem was hardly their debut. In the past, clinical trials have also failed for drugs billed as potential blockbusters to treat heart disease, strokes, lung cancer, diabetes and blood clots.

This is hardly surprising given that the odds of any one compound making

it through all the stages of clinical trials and to market are about one in 10,000. Moreover, even when a drug is successful, patents have a limited life and the drug companies are running on a treadmill which requires more and bigger discoveries and product development to drive growth.

It makes me wonder what investors find so attractive about them. You might say the dividend yield – with AstraZeneca's shares now yielding nearly 5% – but with the dividend cover at  $1.1\times$  there must be a reasonable chance that the fate of the dividend may also soon remind me of Tesco.

I would guess that by now AstraZeneca shareholders are rueing the support they gave to reject the Pfizer bid at £55 a share three years ago.

Many investors' approach to these companies, with their accounting issues, remind me of the chorus of another song – “Where Have All the Flowers Gone?” performed by Peter, Paul and Mary in 1962.

# *Annual letter to shareholders 2017*

FUNDSMITH, JANUARY 2018

**T**HIS is the eighth annual letter to owners of the Fundsmith Equity Fund. The table below shows performance figures for the last calendar year and the cumulative and annualised performance since inception on 1 November 2010 compared with various benchmarks.

| % Total return                     | 1 Jan to 31 Dec 2017 | Inception to 31 Dec 2017 |                   |
|------------------------------------|----------------------|--------------------------|-------------------|
|                                    |                      | <i>Cumulative</i>        | <i>Annualised</i> |
| Fundsmith Equity Fund <sup>1</sup> | +22.0                | +261.7                   | +19.7             |
| Equities <sup>2</sup>              | +11.8                | +135.5                   | +12.7             |
| UK bonds <sup>3</sup>              | +1.4                 | +34.2                    | +4.2              |
| Cash <sup>4</sup>                  | +0.4                 | +4.4                     | +0.6              |

<sup>1</sup> T-class acc shares, net of fees, priced at noon UK time. <sup>2</sup> MSCI World Index, £ net, priced at close of business US time. <sup>3</sup> Bloomberg/Barclays Bond Indices UK Gov. 5–10 yr. <sup>4</sup> 3-month Libor interest rate. <sup>1,3,4</sup> Source: Bloomberg. <sup>2</sup> Source: [www.msci.com](http://www.msci.com).

The table shows the performance of the T-class accumulation shares, the most commonly held class and one in which I am invested, which rose by +22.0% in 2017 and compares with +11.8% for the MSCI World Index in sterling with dividends reinvested. The fund therefore beat this benchmark in 2017, and our fund remains the number-one performer since its inception in the Investment Association Global sector by a cumulative margin of 40 percentage points over the second-best fund and 160 percentage points above the average for the sector which delivered +101.2%.

However, I realise that many or indeed most of our investors do not use the MSCI World Index as the natural benchmark for their investments. Those of you who are based in the UK may look to the FTSE 100 Index as the yardstick for measuring your investments and may hold funds which are benchmarked to this index and often hug it. The FTSE delivered a total return of +12.0% in 2017 so our fund outperformed this by a margin of 10.0%. I will come back to the subject of the FTSE 100 Index later.

Last year, in order to describe our fund's performance for the year, I quoted the commentator's cliché that football is a game of two halves, because in 2016 a strong first-half performance by our fund contrasted with a weaker second half of the year. In 2017 we experienced what stock market commentators often describe as a sector "rotation", in which the sectors in which we are invested mostly fell out of favour and share prices of those companies underperformed, whilst other sectors which we do not own performed well – in particular the bank sector.

This rotation seems to have occurred as a result of expectations about a pick-up in economic growth leading to a potential recovery in the performance of cyclical stocks, especially after the election of Donald Trump as US president in early November with predictions that his economic policies would stimulate more rapid growth in the US economy.

The commentator's quote I wish to use to describe this year's performance is from Yogi Berra, the American baseball player, manager and coach, who had some deceptively simplistic or seemingly illogical aphorisms. One of my favourites is 'You can observe a lot by watching', which I think some people would do well to consider. However, the one which I think expresses the performance of the fund and market in 2017 is 'It's déjà vu all over again'. What have we experienced in December? A fall in technology sector shares and a rise in bank shares in anticipation of the next rise in interest rates by the Federal Reserve Bank (being a stickler for at least attempting to use language correctly, I refuse to use the popular term "hike" to describe the Fed's actions as the dictionary definition of this in context is a sharp increase. I am fairly confident that is not what we are getting. My concern about correct usage may not be to everybody's liking but in my view we should use language more carefully than many modern commentators do, as it is after all our main means of communication).

When judging these events, the fact that we seem to have seen this movie before might lead us to conclude that we know how it will end.

I can now trace back five years of market commentary that has warned that shares of the sort we invest in, our strategy and our fund would underperform. During that time the fund has risen in value by over 175%. The fact that you would have foregone this gain if you had followed their advice will of course be forgotten by them if or when their predictions that

our strategy will underperform the “value” strategy of buying cyclicals, financials and assorted junk pays off for a period.

You or they might well counter by saying that this past outperformance is all very well but it does not help you in making a decision on whether to own our fund from today, which must surely be determined by its future performance – or, as the legalese goes, ‘Past performance is not necessarily a guide to future performance’. I think the key word in that sentence is ‘necessarily’.

Let me offer a couple of thoughts on that.

The first problem is of course that the commentators upon whom you might rely may simply be wrong. I have lost track of the number of analysts, commentators and pundits who predicted that:

- the UK would vote for “Remain” in the Brexit referendum
- the UK would enter a recession immediately if it voted to “Leave” the EU
- Donald Trump would not become president
- Narendra Modi would not become prime minister of India
- Narendra Modi’s economic reforms would fail
- Theresa May would have such a resounding victory in the 2017 election that Labour would disintegrate
- Angela Merkel would sweep to victory in the German elections
- President Trump’s tax reform bill would not be passed by the US legislature.

In some cases, they have a “full house”, having made all these predictions. The fact that they have been shown to be comprehensively wrong does not seem to stop them from giving us the dubious benefit of further predictions. In this regard they remind me of the broker who was always wrong and who is mentioned in the book *Hedgehogging* by Barton Biggs, the strategist and hedge fund manager. Biggs found him useful to talk to because once the broker had given his views on what would happen or what to do, Biggs knew that the opposite was bound to be correct. For what it’s worth, my

diagnosis of the problem for these commentators who seem to emulate this broker is that they are experiencing role confusion. They seem to have forgotten that their role is to report events accurately and have decided that instead they need to influence the outcome to one they desire. They also seem to have missed the point that voicing your views in an echo chamber is not likely to lead to a challenging debate in which to test your opinions.

Thankfully, I spend little or no time trying to apply predictions about macro events in order to manage our portfolio. However, that does not mean that I do not think about them. As I have maintained for most of the decade since the financial crisis, looking back to the Great Depression for an analogy that would enable us to understand these events and form a view of how they may unfold is probably a mistake.

A better analogy may be the Long Depression of 1873–96 when a new industrial power came on stream and caused a wave of deflation as it could manufacture goods cheaper than in the Old World. That industrial power was America after the Civil War. The Long Depression was also preceded by a collapse of part of the banking system. Sound familiar?

The wave of deflation we have been experiencing has been caused by a number of factors. These include the rise of China as the world's greatest industrial power, other cheap manufacturers (South Korea, Thailand, Vietnam, India and Malaysia for example) and the offshoring of manufacturing to cheap manufacturers under free trade agreements, such as Mexico under NAFTA, which so exorcises President Trump. The situation now is probably worse than it was during the Long Depression insofar as then there was virtually no international competition in services, whereas now in our connected world there is in software (India) and call centres (the Philippines), for example. Plus there is the rise of the so-called gig economy in which the internet, casual employment and the sharing of assets have made price comparisons easier, and have driven down prices and returns in retail (Amazon), transport (Uber) and lodging (Airbnb), for example.

If the closest analogy for the events which we have experienced since the financial crisis is the Long Depression, we may be barely halfway through it simply on the basis of elapsed time. In which case, the period of sluggish economic growth and low interest rates which we have experienced over

the past decade may persist for some considerable time. I think this is likely for the simplest of reasons: little or nothing has been done to correct the problems which led to the financial crisis. The unsupportable expansion of credit that sparked the crisis has not been resolved. There is in fact more debt in existence now than there was in 2007. Admittedly, some of it is in different hands – China has more debt now and much of the debt in the developed world has been “socialised” and assumed by governments. However, governments are just us collectively, contrary to the fevered imaginings of the “magic money tree” devotees. What seems to have happened over the past decade is a prolonged experiment in borrowing your way out of a debt problem. Maybe it will work, although I am amongst those who would bet against it, but it certainly is not the sort of circumstance which would suggest that a “normal” economic recovery or a rapid rise or “hike” in interest rates is likely.

As an aside, I would suggest that the headlong expansion of credit in much of the Western world which preceded the financial crisis was an attempt to compensate for the effects of deflation. Instead of accepting that the loss of manufacturing and service jobs to the developing world meant we had to accept lower pay and lower standards of living to compete, we opted for an expansion of the state, the mushrooming of non-productive jobs and borrowing to maintain our spending patterns.

Secondly, if you nonetheless take the view that our fund’s strategy has indeed delivered a good performance but that valuations (which I will come to later) for stocks of the sort it owns are high and that this will limit their share price performance at least in the near term, the obvious problem this poses is what you or we might invest in as an alternative.

This presents several problems. One is that the valuation of the fund’s stocks are not all that much higher than the market, especially when their relative quality is taken into account. Of course, all this may prove is that everything is expensive or at least highly rated, and there are plenty of pundits and fund managers who have indeed suggested that we are in a bubble which will end badly with everything falling a long way. So far, they have only managed to demonstrate the difficulty in making predictions and implementing actions based upon them. Even if they are eventually proven right, why will a basket of cyclical stocks and financials prove to perform



better in these circumstances than a group of companies which are high quality and defensive in terms of supplying everyday consumables and necessities? The events of 2007–09 suggest that the opposite is true.

There is also the fact that the alternative of investing in cyclicals, financials and so-called “value” stocks involves investing in companies, which over time do not create shareholder value by generating returns on capital above their cost of capital and growing by deploying more capital at such favourable returns. We seek to invest in companies which accomplish this.

Quoting Warren Buffett, the “Sage of Omaha” and arguably the best investor over the past 50 or so years, has in my view become somewhat passé. It is frequently done by acolytes or imitators, many of whom seem to have done only the most cursory study of what he actually does, if anything at all. So instead I am going to quote his business partner and Berkshire Hathaway’s vice chairman, Charlie Munger:

‘Over the long term, it’s hard for a stock to earn a much better return than the business which underlies it earns. If the business earns 6% on capital over 40 years and you hold it for that 40 years, you’re not going to make much different than a 6% return – *even if you originally buy it at a huge discount*. Conversely, if a business earns 18% on capital over 20 or 30 years, *even if you pay an expensive looking price, you’ll end up with a fine result.*’ (Emphasis added.)

I have no idea why Mr Munger chose those particular rates of return but what I do know is that he is not voicing an opinion. What he is describing is a mathematical certainty. If you invest for the long term in companies which can deliver high returns on capital, and which invest at least a significant portion of the cash flows they generate to earn similarly high returns, over time that has far more impact on the performance of the shares than the price you pay for them. Yet I have been asked far more frequently whether a share, a strategy or a fund is cheap or expensive than I am asked about what returns the companies involved deliver and whether they are good companies which create value or not.

Even though Mr Munger is right, it requires a long-term investment perspective to capture that compounding by high-return companies, and finding those companies is not easy especially as you need to assess their ability to grow and ward off competition. But the most difficult part of applying the investment strategy suggested by Mr Munger’s quote, and which we seek to apply, is us. Our inability to take a really long-term view,

particularly through the periods when our chosen strategy and companies are not performing as well as less good companies, which are enjoying their period in the sun, is our greatest enemy.

I will leave this subject with a sporting analogy. We are often told that life is a marathon not a sprint. So is investing. Most of us will be investors for the majority of our lives. If we start investing in our 30s, with current average life expectancy most of us will be investing for over half a century. It makes Mr Munger's 40-year example seem a bit short. So why we should think about what happens over shorter time periods, like quarters or even years, is a bit of a puzzle.

However, some people behave as though the best way to win this marathon is to engage the services of one hundred and five 400-metre runners (26 miles 385 yards or 42.195 kilometres divided by 0.4 = 105.5), who could surely run the distance faster than a single marathon runner. The analogy in investment is a strategy in which every so often you change the fund manager or stocks in your portfolio to suit whatever change you expect in market conditions. The problem is this: if you choose the one hundred and five 400-metre runner route I presume that to make the contest against the marathon runner realistic you have to carry a baton that you hand over to the next runner. This is the equivalent of you making the decision to sell all your high-quality stocks and switch into somewhat cheaper (although maybe not cheap) cyclicals and value stocks. However, I seem to recall that very often that baton gets dropped, or the changeover is not made within the allowed zone and the team is disqualified. I suppose the investment version of this is that you get the timing of your switch wrong or you sell one strategy but remain in cash.

The problem in trying to apply this sprint strategy in the real world of investment is even worse. In a relay race the runners for each stage are selected in advance. Whereas in an attempt to apply this technique in investment you would need to select whom you wish to receive the baton as you enter the changeover area each time. After all, do you know in advance whether you want to go from high-quality consumer staples to financials, commodity stocks or industrials, emerging markets, bonds or some combination of these? The scope for fumbled handovers is endless. And you have to do it many times to succeed with this approach.

Moving on to review the outcome for 2017 in terms of our fund's strategy. As you hopefully know by now, we have a simple three step investment strategy:

1. buy good companies
2. don't overpay
3. do nothing.

I intend to review how we are doing against each of these in turn.

As usual, we seek to give some insight into the first of those – whether we own good companies – by giving you the following table which shows what Fundsmith would be like if instead of being a fund it was a company and accounted for the stakes which it owns in the portfolio on a “look through” basis, and compares this with the market, in this case the FTSE 100 Index and the S&P 500 Index.

This year we not only show you how the portfolio compares with the major indices but also how it has evolved over time.

| Year ended       | Fundsmith Equity Fund portfolio |      |      |      |      |      |      |      |  | S&P 500 | FTSE 100 |
|------------------|---------------------------------|------|------|------|------|------|------|------|--|---------|----------|
|                  | 2010                            | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 |  | 2017    | 2017     |
| ROCE             | 29%                             | 28%  | 29%  | 31%  | 29%  | 26%  | 27%  | 28%  |  | 15%     | 14%      |
| Gross margin     | 54%                             | 58%  | 58%  | 63%  | 60%  | 61%  | 62%  | 63%  |  | 44%     | 41%      |
| Operating margin | 20%                             | 22%  | 23%  | 24%  | 25%  | 25%  | 26%  | 26%  |  | 13%     | 13%      |
| Cash conversion  | 117%                            | 103% | 101% | 108% | 102% | 98%  | 99%  | 102% |  | 97%     | 96%      |
| Leverage         | 63%                             | 15%  | 44%  | 40%  | 28%  | 29%  | 38%  | 37%  |  | 52%     | 46%      |
| Interest cover   | 15×                             | 27×  | 18×  | 16×  | 15×  | 16×  | 17×  | 17×  |  | 7×      | 8×       |

**Source:** Fundsmith LLP/Bloomberg. ROCE, gross margin, operating profit margin and cash conversion are the weighted mean of the underlying companies invested in by the Fundsmith Equity Fund and the mean for the FTSE 100 and S&P 500 indices. The FTSE 100 and S&P 500 numbers exclude financial stocks. The leverage and interest cover numbers are both median. All ratios are based on last reported fiscal year accounts as at 31 December and as defined by Bloomberg. Cash conversion compares free cash flow per share with net income per share.

The companies in our portfolio have consistently had significantly higher returns on capital and better profit margins than the average for the indices.

They convert more of their profits into cash and achieve this with a much lower level of borrowing than the average company. Moreover, their average level of borrowing is significantly lower than it was when we started the fund. The world at large may not have de-gearred much but the companies in our portfolio have. Nor is this a one-off – they have been achieving these superior results for many years. The average year of foundation of our portfolio companies at the year end was 1916.

Consistently high returns on capital are one sign we look for when seeking companies to invest in. Another is a source of growth – high returns are not much use if the business is not able to grow and deploy more capital at these high rates. So how did our companies fare in that respect in 2017? The weighted average free cash flow (the cash the companies generate after paying for everything except the dividend, and our preferred measure) grew by 13% in 2017. We regard this as a very good result given the generally lacklustre growth which the world continues to experience.

This leads onto the question of valuation. The weighted average free cash flow (FCF) yield (the free cash flow generated by the companies divided by their market value) on the portfolio at the outset of the year was 4.4% and ended it at 3.7% so they did become more highly rated. However, it is important to bear in mind that this is not a like-for-like comparison as our portfolio did not remain static over the year. In fact, the two shares we sold – Imperial Brands and J. M. Smucker – had by far the highest FCF yields in the portfolio and much higher than the FCF yields of the one we purchased – Intuit. If we had not made these changes the portfolio FCF yield would have remained at 4.0% (although it is worth noting that the growth rate would have been significantly lower – the FCF of both companies fell in 2017) so some of the fall in yield was a result of our action rather than any rise in market valuations.

The year-end mean FCF yield on the S&P 500 was 3.9% and the median 4.1%. The year-end mean FCF yield on the FTSE 100 was 5.6% and the median 4.9%. More of our stocks are in the former index than the latter. To try to cut through all these means and medians, our portfolio consists of companies that are fundamentally a lot better than those in the index and are valued more highly than the average FTSE 100 company and slightly higher than the average S&P 500 company.

In the case of the FTSE 100 Index this is because the valuation of the index is dominated by what I would regard as uninvestable companies like Anglo American and Centrica, which traded on FCF yields of around 15% as at 31 December 2017. They may be lowly rated but that does not mean that they are necessarily cheap given their poor quality. The past may not be a perfect guide but their return on capital has averaged 3% and 6% respectively since 2011 and they have achieved a total shareholder return of -35.3% and -40.7% respectively from 1 November 2010 to 31 December 2017, when our fund (T-class accumulation shares) has returned 261.7%. Maybe all this is about to change. It had better if you are thinking of owning them or the FTSE 100 Index.

The characteristics of the FTSE 100 Index make me marvel (as is often the case, I could stop the sentence there) at people who use the index as a product or guide to enable them to “invest in the UK”. Firstly, I have to question why you would want to restrict your investments to the UK. You may live in the UK, as most of our investors do, but to quote Arthur Daley: ‘The world’s your lobster’. You can invest outside it and it is unlikely that all or even many of the good companies in the world that you might benefit by investing in are headquartered or listed in a country which constitutes about 3% of world GDP.

There is also the question of how representative the FTSE 100 Index is of the UK economy. As at 31 December 2017, of the ten largest market cap (non-financial) companies in the FTSE 100, only three report in sterling. Only numbers 6, 8, 9 and 10 gave any UK numbers in their last reported accounts:

- For no. 6, Rio Tinto, the UK is 1% of sales. Australia is bigger.
- For no. 8, GSK, the UK is 3.8% of sales. The US is bigger.
- For no. 9, AstraZeneca, the UK is 8% of sales. Japan is bigger.
- For no. 10, Vodafone, the UK is 14.5% of sales. Germany is bigger.

Which is all a clue that investing in the FTSE 100 Index is not investing in the UK. So if you are doing so you have already, perhaps inadvertently,

made the decision to invest internationally. If so, you may as well do it properly and look at companies listed abroad.

Finally, what sort of companies are in the FTSE 100? An insight into this is provided by the fact that as at 31 December 2017 just 1.8% of the FTSE is in information technology. This compares with 23.9% in the S&P 500 Index, not the technology-centric Nasdaq Composite Index. I am not suggesting that information technology is the only sector to invest in to capture future growth, nor is it immune from becoming overvalued and delivering poor returns to investors from time to time. But if you were to ask which two sets of stocks were more likely to capture the benefit of future growth, one with 1.8% in information technology or one with 23.9%, I think the answer would be pretty obvious.

So for all those reasons I do not really regard the FTSE 100 as a genuine benchmark for our fund and neither am I at all concerned about the fund's valuation relative to it.

However, that should not be taken to mean that we are entirely comfortable with the seemingly ever higher rating which the shares in our portfolio are achieving. It is clearly a finite and reversible source of performance. However, the growth in the free cash flows of the portfolio are providing a greater portion of the performance which is how we would prefer it and what Mr Munger might have predicted.

One aspect of our performance which we have often been asked about in the past is the degree to which it has benefitted from the strength of the US dollar as the majority of the stocks we own are listed in the United States. This is a complex subject as currency exposure is driven by where a company derives its revenues rather than where it is headquartered or listed. However, this year there has been a noticeable absence of such questions. Could this perhaps be because in 2017 the best estimate we have is that the weakness of the US dollar cost our fund some -5.9%. The performance in 2017 was attained despite this headwind.

For the year the top five contributors to the fund's performance were:

|                |       |
|----------------|-------|
| <b>Paypal</b>  | +2.9% |
| <b>Amadeus</b> | +2.3% |

**C. R. Bard** +1.8%

**Novo Nordisk** +1.5%

**Waters Corp** +1.4%

C. R. Bard is making an appearance for the second year running, at least partly because it was bid for by Becton Dickinson, another of our portfolio companies.

The bottom five were:

**J. M. Smucker** -0.3%

**Imperial Brands** -0.2%

**Dr Pepper Snapple** 0.0%

**Colgate-Palmolive** +0.1%

**Reckitt Benckiser** +0.1%

We sold our holdings in J. M. Smucker and Imperial Brands during the year.

J. M. Smucker was a disappointment. One half of the business is in ambient packaged food in which it is a struggle to generate growth – Folgers coffee, Jif peanut butter and Smucker’s jams (jellies if you are American). However, what attracted our interest was when J. M. Smucker acquired the Big Heart Pet Brands pet food business from private equity. We are keen on businesses which sell to pet owners, such as IDEXX, albeit indirectly, and we had made a very good return on the Big Heart business when it was owned by Del Monte before it was acquired by private equity. However, the outcome in terms of the margins and returns achieved on the business by J. M. Smucker proved to be disappointing and we were concerned by the management’s reaction to this, especially as J. M. Smucker is a family-controlled company.

Imperial Brands is the former Imperial Tobacco that we had held since the inception of the fund. We had become increasingly concerned about the company’s positioning in terms of its lack of exposure to the developing world and to next generation reduced-risk products such as heat-not-burn devices, all of which has led to volumes falling at a rate that it is difficult to

cope with. We were even more concerned by the management reaction, which we literally could not understand.

Colgate makes the table of our five worst performers for the second year running, even though it is our smallest position. It has been facing a tough time with its largest market being Brazil.

Turning to the third leg of our strategy which we succinctly describe as ‘do nothing’, minimising portfolio turnover remains one of our objectives and this was again achieved with a portfolio turnover of 5.4%^ during the period. It is perhaps more helpful to know that we have held 13 of our portfolio companies since inception and we spent a total of £1.3m or just 0.011% (1.1 basis points) of the fund’s average value over the year on voluntary dealing (which excludes dealing costs associated with fund subscriptions and redemptions as these are involuntary).

Why is this important? It helps to minimise costs, and minimising the costs of investment is a vital contribution to achieving a satisfactory outcome as an investor. Too often investors, commentators and advisers focus on or in some cases obsess about the annual management charge (AMC) or the ongoing charges figure (OCF), which includes some costs over and above the AMC, which are charged to the fund. The OCF for 2017 for the T-class accumulation shares was 1.05%. The trouble is that the OCF does not include an important element of costs – the costs of dealing. When a fund manager deals by buying or selling investments for a fund, the fund typically incurs the cost of commission paid to a broker, the bid–offer spread on the stocks dealt in and, in some cases, transaction taxes such as stamp duty in the UK. This can add significantly to the costs of a fund yet it is not included in the OCF.

We provide our own version of this total cost including dealing costs, which we have termed the total cost of investment (TCI). For the T-class accumulation shares in 2017 this amounted to a TCI of 1.08%, including all costs of dealing for flows into and out of the fund, not just our voluntary dealing. We think that figure will prove to be low if or when other funds produce comparable numbers. However, we would caution against becoming obsessed with charges to such an extent that you lose focus on the performance of a fund. It is worth pointing out that the performance of



the fund tabled at the beginning of this letter is after charging all fees which should surely be the main focus.

This year I thought I would use the opportunity afforded by this letter to talk about so-called activism and takeovers since we have seen a lot of events in these areas in the past year which have affected the companies we own and follow.

Investment is a world in which words get used in confusing ways. Take the words active and activism. Active investors are the opposite of passive investors who simply seek to replicate the performance of an index. At Fundsmith we are active investors – our fund will only own a maximum of 30 shares (it owned 27 as at 31 December 2017) and we limit it to a few sectors which have the characteristics we seek: consumer staples, some consumer discretionary products, healthcare and technology being the main sectors. So we are far removed from a passive investor. However, we change our portfolio positions very infrequently, which I suppose makes us an inactive active investor. You can see why people are often confused.

Activists are a different animal. They seek to benefit by causing change in corporations they invest in. Activists are usually active managers but some of them are passive (I'm not making this up) as they seek to improve the returns on their index fund by agitating for change where they feel it is necessary. So I suppose they could be described as passive activists. Still with me?

On the whole we are not fans of activism. Too often it seems to follow a playbook that has the following steps:

1. The activist “buys” a stake in a company. I have put “buys” in inverted commas because often much or all of the stake is held through derivative products which means that the activist can announce a seemingly large position in the company's stock whilst risking and committing relatively little actual cash. This methodology also gives some clue as to the activist's time horizon which may not coincide with ours, as derivatives have an expiry date whereas stocks don't.
2. Engage in a public row with the target company and seek board

representation, a spin-off of part of the business, a merger with or sale to a competitor, raise debt to execute a share buyback (the activist can helpfully tender stock to assist with this), etc.

3. If the company responds by following the activist's demands, they then sell their stake.
4. We and other long-term shareholders are left with a company that has incurred fees and diverted time from running the business to respond to the activist and execute the changes, which is now potentially more fragmented, more highly leveraged and has had to install new management.
5. Rinse and repeat with another victim investment.

We have many possible objections to this process. In our experience a dialogue in which you seek to change someone's behaviour is best at least started in private. Seeking a public spat at the outset seems to us to be more closely aligned with a desire to seek a certain public profile rather than to effect corporate change. Often the proposals hinge on a misconception or two. We have often been told that if a company has two divisions and one is in a slow-growing segment and one is faster growing (like PepsiCo with soft drinks and snacks) then if the two are separated (as Nelson Peltz suggested to PepsiCo) the faster-growing one will attain a higher stock market rating once on its own. This is probably true, but won't that be compensated by a lower rating on the slower growth division? Of course not for the activist who intends to sell out as soon as possible. Thankfully, in our view, on this occasion Mr Peltz was unsuccessful and PepsiCo remains a drinks and snack business – which is not to say that we think everything is fine with PepsiCo's management or that Mr Peltz is always wrong, of which more later.

Leveraging up the balance sheet to buy back stock is a frequent demand of activists and is invariably described as “returning cash to shareholders” and not only when it is suggested by activists. The correct description for this action should be “returning cash to exiting shareholders” as we remaining shareholders don't receive any of it and this perhaps best encapsulates the problem we identify with this practice. Those of us who actually seek to own the company and remain shareholders see debt raised to take out

shareholders who wish to exit. It is beyond us why we would want that to happen unless the shares purchased are demonstrably cheap.

However, whilst we question the motivation and methods of activists, and how companies respond to them, we do not always disagree with them. For example, we agreed with Carl Icahn's view that separation of the two businesses which were part of eBay (the eBay Marketplaces business and PayPal the payment service provider) would set PayPal free to grow more rapidly, and as you can see PayPal is the largest contributor to our fund's performance over the past year.

Quite a lot happened to affect our portfolio companies and we have seen some takeover activity in the past year. In addition to the bid for C. R. Bard and the bid approach from Kraft Heinz for Unilever, activists became involved in ADP and Nestlé, which we own, and P&G, which we had already sold, but which remains in our investable universe of stocks we would own given certain conditions. I thought it might therefore be helpful to investors if I described our reaction to each of these in turn, since we may not be very active in the sense of changing portfolio positions but we are often engaged in thinking about situations such as these.

### **Automatic Data Processing (ADP) / Pershing Square**

Payroll and HR services company ADP was approached by activist fund Pershing Square, led by Bill Ackman, who had "bought" an 8.3% stake. The inverted commas are because this stake involved 36.8m shares, 28.0m of which were in fact call options and not actual shares. This did not amount to true ownership in our view since Pershing Square had no right to vote the shares covered by those call options and neither had they expended the cash to purchase the shares.

Pershing Square's approach to ADP became a public row and proxy contest, with Pershing Square delivering a 168-page presentation, several letters suggesting ways to improve operating efficiency (which might be summarised as "cut costs quickly"), and demanding three board seats.

The reaction of the ADP management was interesting. They did not do what so many managements do when faced with an activist by issuing new guidance showing an increase in forecast profits or margins, increasing the dividend and/or share buybacks. Instead they challenged the analysis and

assumptions underlying the Pershing Square proposals. We found this direct and refreshingly honest.

The stock had significantly outperformed the S&P 500 Index over the past five years even before Pershing Square became involved. Maybe it could have done even better if Mr Ackman is right, but during this period the management has also had to oversee a transition of the business from one which was mainly paper based to one where its products are delivered by a variety of electronic means, and it is not as though Pershing Square's suggestions were without risk. We therefore decided to give the ADP management something rather old-fashioned, called the benefit of the doubt, and so voted with them and against Pershing Square's proposals. We suspect there are far worthier targets for Mr Ackman to attack even within our portfolio.

### **Nestlé / Third Point**

Hedge fund Third Point, run by Dan Loeb, purchased a \$3.5bn stake in Nestlé and in his June letter to investors Mr Loeb talked of Nestlé's 'unrealized potential for margin improvement and innovation in its core businesses, an un-optimized balance sheet, a number of non-core assets'.

Third Point's approach to Nestlé strikes us as close to the activist playbook which I described earlier in that it calls for 'improving productivity'; 'returning capital to shareholders'; 're-shaping the portfolio'; and 'monetizing its L'Oréal stake'.

In respect of productivity, Mr Loeb said Nestlé should 'adopt a formal margin target'. He went on to specify the margin level he believes Nestlé should formally target as '18–20%' by 2020. There is more to attaining an improvement in profitability than committing to a target. The approach reminds me of the G20 meeting in 2014, at which the countries committed to attaining GDP growth of more than 2%. If it's that simple, why not commit 3% or even 4%? Some people seem to believe that GDP growth or profit margins can be conjured up by a commitment. Sadly it may take rather more than that.

In respect of returning capital, Mr Loeb says that 'capital return in conjunction with a formal leverage target makes sense as well'. He goes on to say that raised leverage would provide share buyback capacity, which

would probably be a better use of cash than acquisitions given high valuations (remember that bit please).

Mr Loeb mentions ‘re-shaping the portfolio’ and invokes the fact that the company has over 2,000 brands, some of which he believes could fetch ‘above-market multiples’ given ‘large synergies to potential acquirers’. He also thinks Nestlé should consider ‘accretive, bolt-on acquisitions in high growth and advantaged categories’ (presumably despite the ‘high multiples in Nestlé’s sector’ he already mentioned).

His proposal for ‘monetizing the L’Oréal stake’ is based on his belief that the stake is ‘not strategic and shareholders should be free to choose whether they want to invest in Nestlé or some combination of Nestlé and L’Oréal’. He ended by saying that divestiture ‘via an exchange offer for Nestlé shares ... would accelerate efforts to optimize its capital return policies, immediately enhance the company’s return on equity (ROE) and meaningfully increase its share value in the long run as earnings improve over a reduced share count’. Fairly obviously, the enhancement of ROE from disposal of a stake which is equity accounted is purely cosmetic – but then again some people are impressed by cosmetic changes. We are not amongst them and if I had managed to acquire a 23% stake in the world’s leading cosmetic company, as Nestlé has, I would need some more compelling arguments to persuade me to dispose of it.

Nestlé’s first response to Third Point came only two days after Mr Loeb’s letter. This talked about ‘value creation’. However, it did include one specific, namely the announcement of a CHF 20bn share buyback programme.

A more detailed response came when Nestlé CEO Mark Schneider and other executives presented at the Nestlé investor day on 26 September. The company set a new formal margin target – up 150–250bps from the underlying 16% in 2016 to 17.5–18.5% by 2020; and said that it would accelerate share buyback activity. It also said that as well as the already announced decision to ‘explore strategic options’ for the US confectionery business, it was ‘actively adjusting its product portfolio ... as shown by the recent investments in Blue Bottle Coffee, Sweet Earth and Freshly’. However the company defended the L’Oréal stake.

On the whole we are not impressed when a company announces new margin targets, share buybacks and acquisitions and/or disposals in response to activists or takeover approaches. The question which always springs to our mind is ‘If these things are possible and desirable, why weren’t you already doing them?’ In the case of Nestlé, however, the CEO Mark Schneider should probably not be criticised for this as he is new in the role so he can’t be blamed for any past dilatoriness.

To date Third Point’s approach to Nestlé has not led to anything we are required to vote on which may be just as well.

### **Procter & Gamble (P&G) / Trian**

Trian is a fund run by Nelson Peltz, whom I have already mentioned in the context of PepsiCo. Although we don’t directly have a dog in this particular fight, as we do not have any P&G in our portfolio, it still resides in our investable universe and so an investment is still regularly considered by us, and as we sold our stake because of concerns about P&G’s strategy we were interested in what Mr Peltz had to say.

Trian’s plan for P&G was detailed on 6 September. It called for ‘organizing P&G in a way that promotes accountability, faster decisions and responsiveness to local preferences’; ‘ensuring management’s \$12–13bn productivity plan actually delivers’; ‘fixing the innovation machine’; ‘improving development of small, mid-size and local brands, both organically and through M&A’; ‘winning in digital’; ‘addressing P&G’s insular culture’; ‘improving corporate governance, including aligning management compensation with market share gains’.

The page after these proposals – i.e. very much to the fore of the piece – detailed what Trian is ‘NOT’ (they wrote the word in capital letters) recommending. Among the things which they are not recommending – a break-up of the company, a new CEO, replacement of any directors, taking on excessive leverage, pension benefits cuts, slashing of R&D, marketing or capital expenditure budgets, cost-cuts which might impact product quality, moving out of Cincinnati. We like this approach. The next page reminded us that all Trian was seeking was that ‘Nelson become 1 of 11 (or 12)’ directors of P&G and that it is ridiculous to suggest that as one person out of 11 or 12, he would ‘derail’ P&G.

The Triun presentation is 93 pages long and is all centred around P&G having a poor organisational structure – ‘suffocating bureaucracy and complexity’ – which means that no one is accountable, decisions take forever and so forth. When we sold our P&G stake the fact that the company is the overwhelming market leader with Gillette but was ranked number 50 in online shave clubs struck us as illustrating the sort of point Mr Peltz was making.

David Taylor, P&G CEO, went on Jim Cramer’s CNBC programme, at one point calling some of Peltz’s proposals ‘very dangerous’. They strike me as more dangerous to Mr Taylor than to P&G’s shareholders.

Mr Peltz succeeded in his bid to win a board seat, even though P&G is said to have spent more than \$100m of shareholders’ money to prevent it. We wish him well with his endeavours. His presence makes P&G more interesting to us.

### **Unilever / Kraft Heinz**

On 17 February, the story broke that Unilever had received a bid approach from Kraft Heinz, the listed food products company controlled by 3G, the Brazilian entrepreneurs who also control AB InBev, the world’s largest brewer, and Burger King, together with Warren Buffett’s Berkshire Hathaway.

On 22 February, Unilever put out two releases by way of immediate response. The first was entitled, ‘Unilever guidance update’, which said that Unilever ‘now expects core operating margin improvement for 2017 to be at the upper end of its 40–80bps guidance’. The second release said, ‘Unilever is conducting a comprehensive review of options available to accelerate delivery of value for the benefit of our shareholders. The events of the last week have highlighted the need to capture more quickly the value we see in Unilever. We expect the review to be completed by early April, after which we will communicate further.’

On 6 April, Unilever announced the results of this review. The company said it was:

- accelerating its ‘Connected 4 Growth’ programme and ‘targeting a 20% underlying operating margin, before restructuring, by 2020’

- combining its foods and refreshment units into one unit, ‘unlocking future growth and faster margin progression’
- establishing a net debt/EBITDA target of 2×
- launching a €5bn share buyback programme
- raising the dividend by 12% – about double the recent rate of increase.

This approach clearly falls foul of our scepticism of management producing rabbits from a hat when an activist or takeover comes into view. We think we should already have seen the rabbits or at least been told about their existence.

To (hopefully) be clear, we are not fans of Kraft Heinz. We have never owned any shares in Kraft Heinz or its constituent parts. Although 3G has managed to operate the business with efficiency (as they have AB InBev), producing great cost savings which led to operating profit margins of 23% in 2016 and strong gains for owners (well, certainly for 3G and Berkshire Hathaway), we have never found a business which can cut its way to growth. Although the Kraft Heinz management are certainly handicapped in this regard by the nature of the company’s brands, which are mostly not in growing areas of the market, the sort of people and approaches you need to grow businesses tend not to flourish in cultures in which the emphasis is on cost-cutting.

However, the contrast between their approach and that of Unilever does raise some questions for Unilever’s management which remain unanswered. To give you a simple illustration of this, in 2016 Unilever had €52.7bn of revenues and an average of 169,000 employees, thus revenue per employee of about €312,000. Kraft Heinz had €23.8bn of sales and an average of 41,500 employees, and so revenue per employee of about €574,000. Kraft Heinz has slightly less than half the sales of Unilever but manages to achieve this with less than a quarter of the number of the employees. You don’t have to be a fan of brutal cost-cutting to see that Unilever has a case to answer here.

Unfortunately we never got to hear Unilever justify its rather interesting sales/employee ratios because Kraft Heinz withdrew as soon as it became



evident that Unilever was hostile to the approach. Warren Buffett is notoriously opposed to hostile takeovers.

I hope that has given you all some insight into how we think about and interact with the companies in our portfolio and those we are interested in, and other shareholders, activists and bidders.

# ***ESG? SRI? Is your green portfolio really green?***

*FINANCIAL TIMES*, 18 JANUARY 2018

**Y**OU decide to buy a car. You tell the dealer you want to be environmentally responsible and trust him to supply something appropriate. You had an electric car in mind but he supplies a hybrid. Not too bad, but when it arrives you find that the internal-combustion part of the powertrain is a diesel supplied by a German maker caught lying about emissions.

Things get worse. A couple of years on, the car is rusting and you discover there is no corrosion protection. Soon your car is heading for the scrapheap. Not very sustainable, eh?

This experience should be familiar to most investors in so-called sustainable funds. Whichever term you use to describe them – green, sustainable, socially responsible investment (SRI) or environmental, social and governance (ESG) – the assets that investors entrusted to these strategies totalled more than \$12trn for ESG funds in Europe last year. Sustainable investing sells, so it is hardly surprising. But what are investors getting?

You might assume that your sustainable fund would exclude sectors such as fossil fuels and “sin” stocks – arms, drinks and tobacco. It may come as a surprise that almost all sustainable funds do not have any hard sector exclusions.

If they combine this with a peculiar application of sustainability analytics, which typically ranks companies within sectors, you get unexpected results. That’s because the funds using this approach can and do invest in many obviously questionable sectors, albeit they invest in the “best of a bad bunch”.

For example, the S&P Dow Jones Sustainability indices are considered by many to be the best benchmark for ESG investing – but British American Tobacco is in the index. The same is true for funds. The Vanguard SRI

European Stock Fund at the end of November had 6% in oil and gas production. Is this what you expect from ESG/SRI investments?

If you think of yourself as a responsible investor, such breaches are shocking. You will need to ask if your ESG/SRI fund or index owns any drinks, gaming, tobacco, oil, gas, mining, fossil-fuel burning utilities, or arms companies.

There is a deeper problem. Your ESG/SRI fund manager may monitor your investments for the commonly collected statistics such as CO2 emissions, hazardous waste production, and the age and benefits of the labour force, but how many monitor fundamental business sustainability? Or how much a company spends on research & development? Or its capital expenditure? We have rarely found businesses that can prosper without renewing and expanding physical facilities. What return does a company get on its capital expenditure? If it is inadequate it will fail.

There are virtually no examples of sustainable funds monitoring these real-world sustainability measures. Without them your sustainable investment will simply fail no matter how low its CO2 emissions. It is the investing equivalent of the hybrid car that rusts away.

The results of this for investors are clear and not in a good way.

The average five-year annualised return for ethical and sustainable equity funds in the Investment Association universe is 11.9%. The equivalent for the MSCI World Index is 15.5%. I would guess some investors may be willing to forgo performance in return for ensuring that their principles are adhered to. Given the lack of hard sector exclusions, though, they get the worst of both worlds – poor performance and a breach of their principles.

# *Adding small-caps to a global equity portfolio adds value without heightening the risk*

**Busting the myths of investment, part 1 of 3**

*FINANCIAL TIMES*, 31 AUGUST 2018

**I**F you are an investor you may have encountered these two adages. First, that in order to earn a higher return you must take greater risk. Second, that asset allocation is the most important contributor to performance.

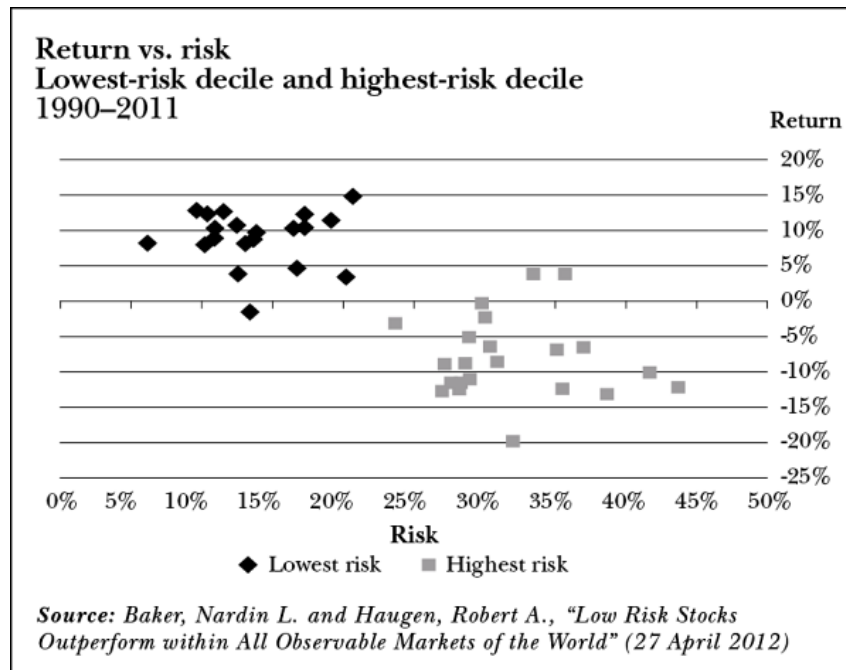
The first proposition at least sounds like it's common sense. More formally it is known as the capital asset pricing model or CAPM for short. The only problem is that it doesn't seem to work.

In 2012, Robert Haugen and Nardin Baker published research entitled "Low Risk Stocks Outperform within All Observable Markets of the World" ([tinyurl.com/y4nh5s8j](http://tinyurl.com/y4nh5s8j)). If you have not read it, maybe it's because the title is not exactly the sort to catch your eye at the airport bookstand. That is a pity because its conclusions were startling.

To quote Haugen and Baker:

'The fact that low-risk stocks have higher expected returns is a remarkable anomaly in the field of finance. It is remarkable because it is persistent – existing now and as far back in time as we can see. It extends to all equity markets in the world. And finally, it is remarkable because it contradicts the very core of finance: that risk bearing can be expected to produce a reward.'

Their findings can be illustrated by this chart of a subset of their data which covers 21 developed markets for 1990–2011 – in other words, a long period for much of the world's equity markets.



Risk is defined as the volatility of the share prices.

For CAPM, or the old adage about risk and return to be correct, this chart would have to have the pattern of dots running up to the right, not down. The high-risk stocks have lower returns than the low-risk stocks. Something's not right in the world of investment theory, it seems.

We have all been told that in order to make high returns we need to find stocks which are complex, difficult to understand, poorly researched, highly leveraged and risky. There is only one problem with this. As Richard Feynman, winner of the Nobel Prize for physics, said: 'It doesn't matter how beautiful your theory is, it doesn't matter how smart you are. If it doesn't agree with experiment, it's wrong.'

What about asset allocation? The seminal research on this was published in 1986 by Brinson, Hood and Beebower (or "BHB" as they are known in the industry). Their study of large pension plans, entitled "Determinants of Portfolio Performance", is often incorrectly cited as concluding that asset allocation was responsible for 91.5% of the portfolios' returns.

Unfortunately, that's not what BHB's paper said. What it concluded was that asset allocation was responsible for 91.5% of the variability in returns – not the returns themselves.

However, this mistaken conclusion has led a large portion of the investment

industry to focus almost exclusively on asset allocation. If you attend enough meetings with investment advisers you will surely hear that asset allocation is more important than choice of individual assets, such as which stocks to own in an equity portfolio.

Another manifestation of this obsession with asset allocation is that many advisers focus on regional allocation of assets within equity portfolios and eschew investment in global funds. However, a research paper “The ‘New Classic’ Equity Allocation?” published in October 2010 by MSCI, the compilers of the Morgan Stanley Capital International World Index, looked at asset allocation within equity portfolios and found some glaring problems in this approach.

Among the most obvious is that many elements of business are now conducted globally rather than regionally or nationally, which makes regional asset allocation ineffective. In many cases, the country in which a company is incorporated, has its headquarters or listing has little or nothing to do with its real exposure to geographic business and risk factors. The conclusion was that developed markets equities should be managed using global investment mandates, not regional ones.

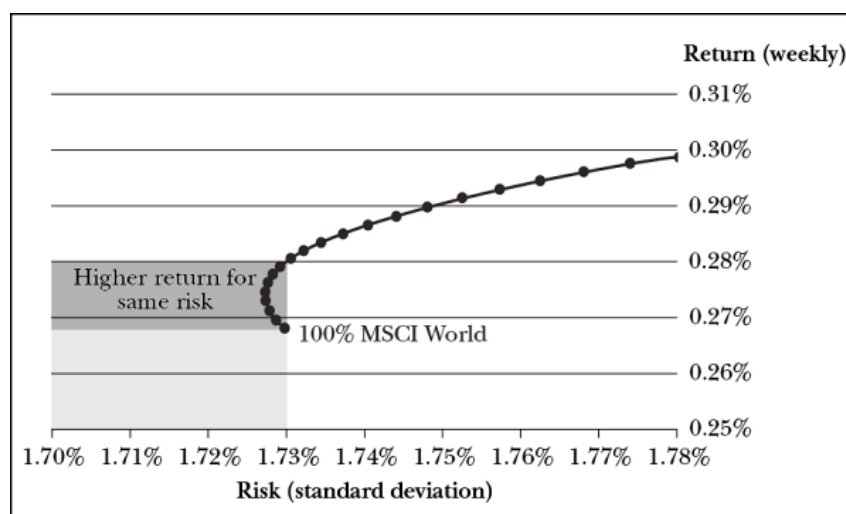
Another issue identified by the MSCI study is “home bias” – the tendency of investors or advisers to overweight equity allocations to the market in which they are domiciled. In the UK, this leads funds not only to benchmark themselves against the FTSE 100 but to use it as a guide to portfolio construction given their desire to hug the index.

Why anyone would want to limit their investment choices to the UK economy is beyond my comprehension, even if they are UK domiciled. Moreover, the FTSE 100 is not even representative of the UK economy, with more than three-quarters of its constituents’ revenues coming from outside the UK.

The MSCI study put forward the case for global equity allocation structured around three separate segments: developed world large/mid-cap stocks, developed world small-cap stocks and emerging markets.

It did so separately, since the small and emerging market segments have different liquidity constraints to global large-cap stocks and are influenced by particular macro factors and individual stock risk to a greater degree.

However, there is no doubt that adding a small/mid-cap element to a portfolio can achieve the seemingly impossible feat of generating additional return whilst reducing risk, as this chart shows:



This chart is an “efficient frontier” to use the jargon of the investment business. It takes the data for the past five years and shows the weekly return which you could have achieved with 100% of your portfolio invested in the MSCI World Index and the risk of variation in returns you would have assumed in doing so.

It changes, with each blob indicating a 5% shift in your portfolio from the MSCI World to the MSCI World Small Cap Index. What it shows is that if you changed 35% (seven blobs) of your portfolio to MSCI World Small Cap you would get a higher return for the same risk. For any lower percentage, the higher return would be accompanied by lower risk.

I think Mr Feynman might conclude that we should all be managing our equity portfolios on a global basis and adding an element of small-cap exposure.

# *Who needs income?*

## *Tax and a higher market price mean reinvested dividends are no bargain*

**Busting the myths of investment, part 2 of 3**

*FINANCIAL TIMES*, 3 OCTOBER 2018

**T**HERE appears to be something so alluring about dividend income that it often seems to lead investors to abandon common sense or be encouraged to do so by the investment industry.

For example, how many times have you heard it said that the majority of returns from investment in equities comes from reinvestment of the dividends? This assertion is usually accompanied by charts which show the difference in returns from an index with the dividends paid out versus one where the dividends are reinvested. Unsurprisingly, the latter has a significantly higher return. But this is not the same as demonstrating that the majority of returns come from reinvested dividends. In fact, they come from retained profits.

Take the example of an average S&P 500 company. Currently it has a payout ratio of 52% – in other words, half its profits are distributed as dividends – a return on equity net of tax of 15% and its shares trade on a price to book (market value divided by book value) of 3.5×

So, which generates more value for shareholders – reinvestment of the dividend paid out, or the reinvestment of profits by the company?

The first handicap of reinvested dividends is that dividends are taxable in the hands of most shareholders. The exact amount of tax payable will depend upon where the shareholder is resident and which tax band they are in. If you are in the UK and a higher-rate taxpayer, dividend income will be taxed at 32.5%, so you will only be left with 67.5 cents out of every dollar of dividend to reinvest. (I am using US dollars as I chose the S&P index for the example, but the principles are the same for the FTSE 100 and sterling.)

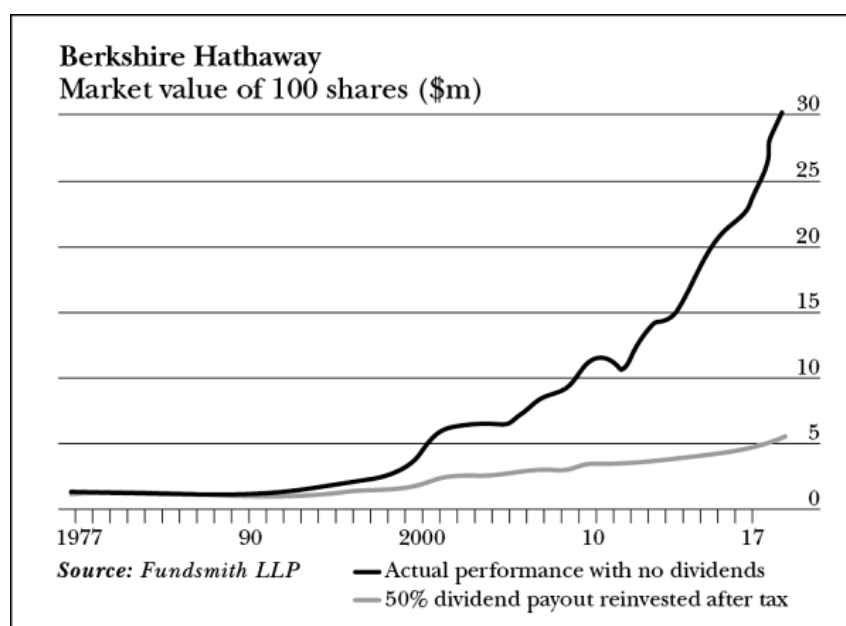


Handicap number two is that you reinvest at the market price for the shares which, given the price to book is  $3.5\times$ , means that you will get to own just 28.5 cents ( $100 \div 3.5$ ) of the company's capital for every \$1 you reinvest. For every \$1 of dividend paid out you get 67.5 cents after tax, which buys you just 19 cents of the company's capital ( $67.5 \div 3.5$ ).

That doesn't sound like much of a bargain. In contrast, every \$1 of retained income which also belongs to you as a shareholder suffers no additional tax and is reinvested in the company's capital at book value, so you get 100 cents of capital for every \$1 retained.

As if that is not enough of a reason to prefer retained earnings to dividends, each \$1 which is retained on your behalf is turned into \$3.50 of market value because the company's shares trade on  $3.5\times$  book.

This is the arithmetic of compounding and it is what equity investors should seek to capture, as those in Warren Buffett's Berkshire Hathaway have done since it has not paid a dividend since Mr Buffett took control in 1965.



The chart illustrates this. It shows the performance of 100 Berkshire Hathaway shares since 1977 as it actually occurred (the earliest date for which data are available for this analysis) – with all the earnings reinvested. Against this we have compared what would have happened if instead half the earnings were paid out and then reinvested after tax (estimated at 30%) at market price.

The effect on investors' returns is startling, as the table shows.

**Annual compound return on Berkshire Hathaway sales**

***Berkshire reinvests all net income    Berkshire pays 50% of net income as dividend***

19.0%

14.0%

*Source: Fundsmith LLP*

This is a feature of equities which no other asset class possesses. A portion of the returns that companies generate are retained and automatically reinvested on your behalf. This creates more value than you can ever capture by reinvesting dividends – except, of course, when the reinvestment is done badly, with management investing when returns are inadequate.

It is not a feature of bonds or property assets. Investors receive interest or rent from these investments, but they are not reinvested for you. This advantage of equities is magnified if instead of investing in an average company you invest in a company with a higher than average rate of return on capital.

Given this, it seems remarkable that income funds outsell all other types of funds by some margin. Because of this marketing phenomenon, funds use income in their name and seek to qualify for the Investment Association's Equity Income sector.

Amazingly, they can claim membership if they have a yield which exceeds the yield on the FTSE All-Share Index by any amount, no matter how small, over a three-year rolling period, which is a rather low bar. In the event that a fund fails this test and is excluded from the sector, it is not required to remove the term "income" from its name. And the investment industry wonders why it gets a bad name.

But why do people want income from equities in the first place? The need to get spending money from your investments once you're retired is obvious. But why does it have to come from dividends? Surely the right approach is to invest for the maximum total return you can achieve and then redeem whatever units you have to provide for your spending needs.

The benefit of this alternative approach is evident if you compare the

performance of the MSCI World Index with the High Dividend Yield (HDY) subset of the same index (see below).

| <b>Index performance (%)</b> |                              |                          |
|------------------------------|------------------------------|--------------------------|
| <b><i>Term</i></b>           | <b><i>MSCI World HDY</i></b> | <b><i>MSCI World</i></b> |
| 1 year                       | 7.40                         | 13.71                    |
| 3 year                       | 10.67                        | 12.56                    |
| 5 year                       | 8.35                         | 10.84                    |
| 10 year                      | 7.02                         | 7.74                     |

*Source:* Fundsmith LLP; MSCI

The index outperformed the high-yield stocks, and this comparison understates the performance advantage of avoiding the high-yield stocks since they are still included in the MSCI World Index. Investors could invest in an index tracker, sell enough units to match the HDY yield and be left with more capital than they would have if they had bought the high-yield index. Yet most investors seem to regard this idea of redeeming part of the capital sum to provide income as the road to perdition.

# ***Do equities outperform bonds?***

***Most stocks are doomed to disappoint –  
you need to find the few that don't***

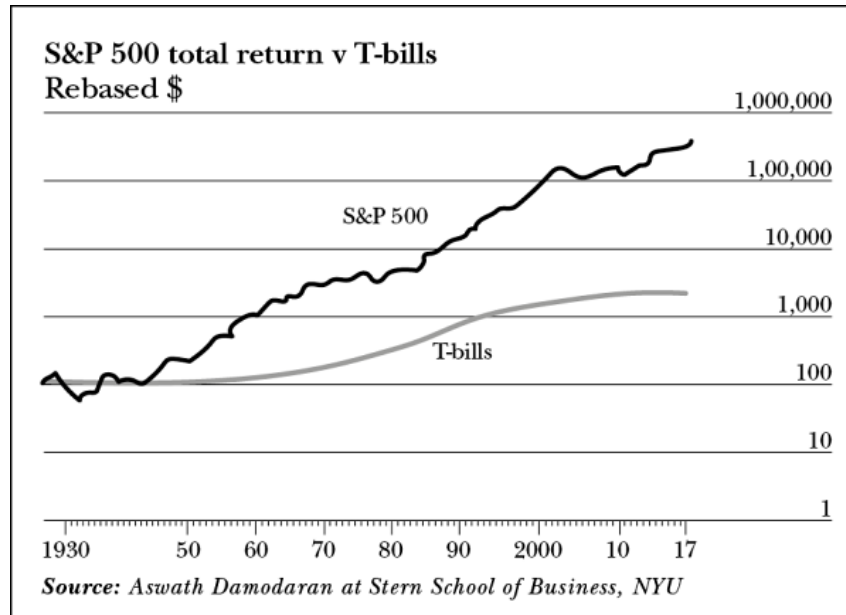
**Busting the myths of investment, part 3 of 3**

*FINANCIAL TIMES*, 7 NOVEMBER 2018

**A**s an equity fund manager, questioning the investment myth that equities outperform bonds is the equivalent of coprolalia, an occasional characteristic of Tourette's syndrome in which the sufferer involuntarily utters socially inappropriate remarks.

We all know that stocks outperform bonds over the long term, don't we? It is an integral part of the capital asset pricing model – or CAPM – in which rational investors demand an equity risk premium, and therefore return, for assuming the risk of investing in equities rather than bonds.

It has been popularised in works such as Jeremy Siegel's 1994 book *Stocks for the Long Run*. The main equity indices clearly outperform bonds:



However, a research paper by Hendrik Bessembinder published in the September edition of the *Journal of Financial Economics* posed the question “Do Stocks Outperform Treasury Bills?” with some rather worrying conclusions for most equity investors.

Prof Bessembinder examined the performance of all the common stocks listed on the NYSE, Amex and Nasdaq exchanges from 1926 to 2016 and found that only 47.8% of the monthly returns from these stocks were greater than for one-month US Treasury bills in the same month.

When focusing on the stocks’ return over their full lifetime as quoted entities, up until the end of the period or delisting – essentially a buy-and-hold strategy for all stocks – he found that only 42.6% of stocks exceeded the return on one-month Treasury bills, even with dividends reinvested.

The reason that equity index returns beat US Treasuries while most of the stocks in them do not is really quite simple. Large positive returns from a few stocks offset the modest or negative returns from the vast majority of stocks.

In one sense this is not surprising. The study covers a 90-year period, but very few companies have long lives as quoted entities. In fact, during the period covered by the study, the median life was just 7.5 years. The rarer stocks which have been listed for longer have more time to compound in value and if they have been in existence as quoted companies for multiple

decades the chances are it is because they are relatively successful businesses.

Nonetheless, the degree of concentration of returns is still startling. Just five companies out of the universe of 25,967 in the study account for 10% of the total wealth creation over the 90 years, and just over 4% of the companies account for all of the wealth created.

But does a 90-year study have much relevance to your actual investment experience? It is, after all, longer than the average life expectancy, let alone the average investing lifespan and covers a period which most investors probably regard as prehistoric. However, it would probably be wrong to dismiss the implications of the study for these reasons.

The study also looks at returns decade by decade and reaches more or less the same conclusion: that the decade returns for most equities are lower than those earned by investment in Treasury bills. Moreover, the results have been getting worse for equity investors more recently. Of the stocks floated between 1947 and 1956, 87% had higher returns than US Treasuries. This fell to 61.5% for those entering from 1957 to 1966 and just 31.7% of those floated from 1977 to 1986.

Most alarmingly, the median stock entering the market since 1977 did not just underperform Treasuries but had a negative return. This may be attributable to the type of companies which floated in recent decades, which many have characterised as showing revenue growth, but very poor earnings.

What conclusions to draw from all this? Stocks in aggregate outperform bonds, but most stocks do not and positive returns are concentrated in very few stocks. Most active investors are doomed to underperform not only the equity indices but also bonds.

This outcome has largely been attributed to the impact of fees, other costs, lack of skill and institutional biases producing closet indexation. But it may also be because their portfolios are more concentrated than the index but not in the few stocks which can produce outperformance.

Last and by no means least, of course, it shows that the returns from active stock selection can be large if the investor selects a concentrated portfolio of the few stocks which offer positive returns. But if you are not confident

you can identify the few stocks which outperform not just the indices but also bonds, then just buy the index.

# *Annual letter to shareholders 2018*

FUNDSMITH, JANUARY 2019

**T**HIS is the ninth annual letter to owners of the Fundsmith Equity Fund. The table below shows performance figures for the last calendar year and the cumulative and annualised performance since inception on 1 November 2010 compared with various benchmarks.

| % Total return                     | 1 Jan to 31 Dec 2018 | Inception to 31 Dec 2018 |                   |
|------------------------------------|----------------------|--------------------------|-------------------|
|                                    |                      | <i>Cumulative</i>        | <i>Annualised</i> |
| Fundsmith Equity Fund <sup>1</sup> | +2.2                 | +269.6                   | +17.4             |
| Equities <sup>2</sup>              | -3.0                 | +128.4                   | +10.6             |
| UK bonds <sup>3</sup>              | +1.2                 | +35.7                    | +3.8              |
| Cash <sup>4</sup>                  | +0.7                 | +5.1                     | +0.6              |

<sup>1</sup> T-class acc shares, net of fees, priced at noon UK time. <sup>3</sup> Bloomberg/Barclays Bond Indices UK Gov. 5–10 yr. <sup>2</sup> MSCI World Index, £ net, priced at US market close. <sup>4</sup> 3-month Libor interest rate. Source: Bloomberg.

The table shows the performance of the T-class accumulation shares, the most commonly held class and one in which I am invested, which rose by +2.2% in 2018 and compares with a fall of -3.0% for the MSCI World Index in sterling with dividends reinvested. The fund therefore beat this benchmark in 2018, and our fund remains the number-one performer since its inception in the Investment Association Global sector by a cumulative margin of 13 percentage points over the second-best fund and 188 percentage points above the average for the sector which has delivered +81.9% over the same time frame.

However, I realise that many or indeed most of our investors do not use the MSCI World Index as the natural benchmark for their investments. Those of you who are based in the UK may look to the FTSE 100 Index as the yardstick for measuring your investments and may hold funds which are benchmarked to this index and often hug it. The FTSE delivered a total return of -8.7% in 2018 so our fund outperformed this by a margin of 10.9 percentage points.



It would not be surprising if some of you are worried about the returns in 2018, which were our weakest in absolute terms since inception. However, I would suggest that the background needs to be taken into account and not just how the market indices performed but also other active funds.

There are 2,592 mutual funds in the Investment Association universe in the UK. In 2018, 2,377 or 92% of these produced a negative return. Thirteen posted a return of exactly 0%. Just 202 had a positive return. Our fund was in the fourth percentile – only 3% of funds performed better. Ironically, 2018 was not a great year for our absolute returns but it was actually our second-best year relative to all IA mutual funds. 2011, when the market also fell, was our best – probably not coincidentally.

2018 was a year in which we saw considerable anxiety from some market participants due to:

- the threat of a trade war between the USA and China
- Brexit
- the rise in US interest rates
- the US mid-term elections
- the Italian budget squabble (Italy is the third largest government bond market in the world)
- the US government shutdown.

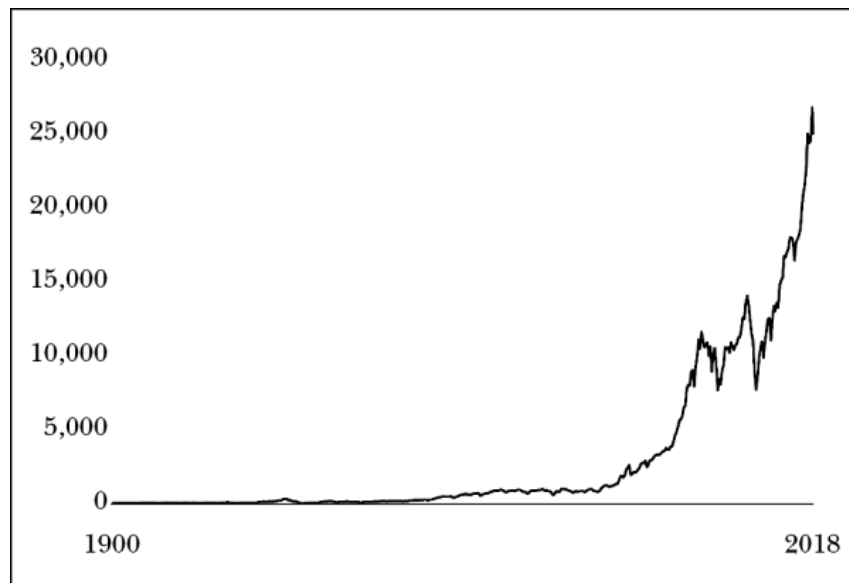
The response to this was a series of market jitters. The MSCI World Index (£ net) fell by 5.4% in October and after a rally this was followed by a fall of 7.4% in December. Despite the hysterical headlines this, in my opinion, falls well short of turmoil – a word frequently used to describe these events.

October has been a notoriously bad month for stock markets in recent decades. An example of what might reasonably be described as market turmoil was so-called Black Monday, 19 October 1987, when the Dow Jones Industrial Average index fell 22.6% in a single day. That felt dramatic. I should know, as I was in work that day on the trading floor of the investment bank BZW and when I went home I received a slew of sell orders from a large US client who rang me. I had to be careful writing them down as I only had candlelight since the power still had not been restored

from the hurricane which struck on the previous Friday, adding to the dramatic effect.

I can only imagine with some amusement how some of the commentators, “investors” and market participants who are reeling from the events of this October and December would have performed in October 1987. A December 2018 *Financial Times* headline referred to ‘Wild market swings’ and whilst the author might like to blame the headline writers for hyperbole – they are trying to sell papers/pixels after all – the article described a recent one-day fall in the Dow of 3.1% as ‘eye-popping’. The fall of seven times that scale in 1987 would surely have led them to exhaust the lexicon of hyperbole. Who knows what might have popped then?

Tumultuous, turmoiled or turbulent Black Monday may have been, but did it really matter? Take a look at the chart below of the Dow Jones and see if you can spot Black Monday. You will need good eyesight or reading glasses to do so.



In the long term, it did not matter.

However, this does not stop advisers and commentators predicting crashes and bear markets and suggesting you take preventative action – which ranges from reducing your equity holdings, buying or “rotating” into lowly rated so-called “value” stocks, through to selling everything and holding cash to safeguard the value of your assets or buying Bitcoin (down 80% in 2018).

My guiding principles for dealing with such events and predictions are as follows:

1. No one can predict market downturns with any useful level of reliability. Forecasts of what may happen in the market are about as reliable as Michael Fish's infamous denial that there would be a hurricane in the BBC weather forecast on 15 October 1987.
2. However, when one of the repeated warnings proves to be accurate the forecasters will ignore the fact that if you had followed their advice you would have forgone gains which far outweigh your losses in the downturn. I can now trace back six years of market commentary that has warned that shares of the sort we invest in, our strategy and our fund would underperform. During that time the fund has risen in value by over 185%. The fact that you would have forgone this gain if you had followed their advice will, of course, be forgotten by them if, or when, their predictions pay off for a period. I suggest you don't forget it.
3. Bull markets do not die of old age so ignore warnings which are based on a phrase such as "This bull market has gone on for a long time." They usually die from some event, often but not always rising interest rates.
4. Bull markets climb a wall of worry. The troubling events you can readily see unfolding are rarely the cause of a bear market. Alan Greenspan had already described the market as irrationally exuberant in 1996, so we were in a worryingly well-developed bull market. This was followed by the Asian crisis of 1997, Russian default and Long-Term Capital Management collapse in 1998 which all looked scary, but ironically they made the Federal Reserve hesitate to raise rates which gave the bull market a new leg which lasted until 2000. Maybe the possible trade war with China and market jitters will have a similar effect.
5. Bull markets do not broaden as they age – they narrow. The current bull market started in 2009 when shares rose indiscriminately. Then amongst developed markets, the US took the lead. Then the technology sector in the US. Then just the "FAANGs" (Facebook,

Amazon, Apple, Netflix and Google). The idea that in the late stages of a bull market investors can make gains by switching into the stocks which have lagged the market flies in the face of experience.

6. As for buying so-called value stocks, if you wish to pursue this strategy it is best done after the bear market has struck, not before. If you approached any of the famous value investors and suggested they buy some of the assorted value stocks in the FTSE 100 Index as a value play, I think they would just laugh at you. A “value” stock like Imperial Brands (formerly Imperial Tobacco) was on an historic PE of 8.1× at the end of 2000 in a bear market. It is now on an historic PE of 16.5×. An aim for a value investor might be to buy “value” stocks in a downturn when their yield is higher than the PE.
7. A bear market will occur at some point. We may indeed already be in one. The best stance is to ignore it since you can’t predict it or position yourself effectively to avoid it without impoverishing yourself by forgoing gains. But you have to possess the emotional and financial stability to stick to this stance when it strikes.

Returning to the events of 2018, the MSCI World Index (£ net) fell by -3.0%. So it was a poor performance but it still seems well short of justifying hysteria or a wholesale change of investment strategy. I say this notwithstanding the fact that on the bad days in the stock market there were clear signs of the sort of “rotation” into “value” stocks, which I touch upon in point 6 above.

I often use the term “value” in inverted commas for a number of reasons:

- What some people mean by value is *lowly rated*. A stock may be lowly rated but not good value if the (lack of) quality of its business and/or its prospects mean that its intrinsic or fundamental value is still below its lowly valuation.
- The distinction which many commentators make between growth or quality investing and value investing is in my view a somewhat superficial one. To quote Warren Buffett:

‘Most analysts feel they must choose between two approaches customarily thought to be

in opposition: “value” and “growth”. Indeed, many investment professionals see any mixing of the two terms as a form of intellectual cross-dressing.

‘We view that as fuzzy thinking (in which, it must be confessed, I myself engaged some years ago). In our opinion, the two approaches are joined at the hip: Growth is always a component in the calculation of value, constituting a variable whose importance can range from negligible to enormous and whose impact can be negative as well as positive.’

Most investment strategies require some regard for the valuation of the stocks purchased or held – even strategies like ours which focus on high-quality companies. The rate of growth of a company is a critical component of its valuation.

- As pointed out in point six above, most stocks are not currently at valuations which would attract classic value investors.

True value investing involves buying stocks when they are trading significantly below your estimate of their intrinsic or fundamental value and then waiting for some event(s) to lift the share price up to or above the intrinsic value – usually a management change, takeover, demerger, a change in the economic or market cycle, or simply when they come back into fashion amongst investors. When this occurs, the value investor seeks to realise his or her gains and move on to find another value stock on which to repeat this performance.

Value investing has been out of fashion in recent years as persistently low interest rates have driven the value of almost all stocks beyond the reach of true value investors. Nonetheless, value investing has its merits and will surely have its day when stocks of the sort which attract value investors perform well.

However, it is not a strategy which we will be pursuing even if we could foresee it coming back into fashion, which it will at some point. The sort of stocks which trade on low enough valuations to attract value investors are unlikely to be those which we seek – businesses which can somewhat predictably produce a high return on capital employed, in cash, and can invest at least part of that cash back into the business to fund their growth and so compound in value.

Unlike our strategy – which is to seek such stocks and hold on to them,

letting the returns which the company generates from this reinvestment produce good share price performance – value investing suffers from two handicaps. One is that whilst the value investor waits for the event(s) which will crystallise a rise in the share price to the intrinsic value that has been identified, the company is unlikely to be compounding in value in the same way as the stocks we seek. In fact, it is quite likely to be destroying value. Moreover, it is a much more active strategy. Even when the value investor succeeds in reaping gains from a rise in the share price to reflect the intrinsic value he identified, he or she needs to find a replacement value stock, and as events of the past few years have demonstrated, this is far from easy. Moreover, this activity has a transaction cost. Our strategy has the merit that inactivity is a benefit. If we have correctly identified the good companies whose stock can compound in value, we can hope to hold them indefinitely and still derive good investment performance from them with lower transaction costs.

There are a couple of indices which tell you how value stocks perform. One is the MSCI Europe Value Index (£ net). In the 2007–09 financial crisis its maximum fall was 52%, which is 16 percentage points worse than the performance of the MSCI World Index (£ net) over that period. So much for the theory that value stocks protect you in a downturn.

As you hopefully know by now, we have a simple three-step investment strategy:

1. buy good companies
2. don't overpay
3. do nothing.

I will review how we are doing against each of these in turn.

As usual we seek to give some insight into the first of those – whether we own good companies – by giving you the following table, which shows what Fundsmith would be like if instead of being a fund it was a company and accounted for the stakes which it owns in the portfolio on a “look through” basis, and compares this with the market, in this case the FTSE 100 Index and the S&P 500 Index.

We not only show you how the portfolio compares with the major indices but also how it has evolved over time.

|                  | Fundsmith Equity Fund portfolio |      |      |      |      |      |      |      | S&P 500 | FTSE 100 |
|------------------|---------------------------------|------|------|------|------|------|------|------|---------|----------|
| Year ended       | 2011                            | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2018    | 2018     |
| ROCE             | 28%                             | 29%  | 31%  | 29%  | 26%  | 27%  | 28%  | 29%  | 16%     | 17%      |
| Gross margin     | 58%                             | 58%  | 63%  | 60%  | 61%  | 62%  | 63%  | 65%  | 45%     | 39%      |
| Operating margin | 22%                             | 23%  | 24%  | 25%  | 25%  | 26%  | 26%  | 28%  | 15%     | 16%      |
| Cash conversion  | 103%                            | 101% | 108% | 102% | 98%  | 99%  | 102% | 95%  | 84%     | 96%      |
| Leverage         | 15%                             | 44%  | 40%  | 28%  | 29%  | 38%  | 37%  | 47%  | 46%     | 39%      |
| Interest cover   | 27×                             | 18×  | 16×  | 15×  | 16×  | 17×  | 17×  | 17×  | 7×      | 9×       |

*Source: Fundsmith LLP/Bloomberg. ROCE, gross margin, operating profit margin and cash conversion are the weighted mean of the underlying companies invested in by the Fundsmith Equity Fund and mean for the FTSE 100 and S&P 500 indices. The FTSE 100 and S&P 500 numbers exclude financial stocks. The leverage and interest cover numbers are both median. All ratios are based on last reported fiscal year accounts as at 31 December and as defined by Bloomberg. Cash conversion compares free cash flow per share with net income per share.*

As you can see, not much has changed. I would suggest ignoring the increase in leverage – the amount of debt the portfolio companies have as a proportion of their capital. The arithmetic average of our portfolio companies would not be very meaningful as it would average a wide range between nine of our stocks which have net cash and three which have leverage of over 1,000% (as they have reduced their capital through share buybacks). Even the median which we use is not much better – the median is the average between the 14th and 15th stocks in order of leverage but those either side have widely differing leverage of 27% and 73% respectively. For those of you who glaze over at statistical explanations – the figure tells you virtually nothing about the actual financial characteristics of the businesses. You might therefore wonder why we include it, and latterly so do I, but I don't like taking figures out of tables we have provided in the past as it can cause suspicion about the reasons why (figures are rarely omitted when everything appears to be going well).

The interest cover – which remains stable at about 17× and twice the level of the index companies – is a much better guide to the financial stability of our portfolio companies.

What is more interesting is that the companies in our portfolio continue to have significantly higher returns on capital and better profit margins than the average for the indices. They convert more of their profits into cash and achieve this with at least no more leverage than the average company.

The average year of foundation of our portfolio companies at the year end was 1922.

Consistently high returns on capital are one sign we look for when seeking companies to invest in. Another is a source of growth – high returns are not much use if the business is not able to grow and deploy more capital at these high rates. So how did our companies fare in that respect in 2018? The weighted average free cash flow (the cash the companies generate after paying for everything except the dividend, and our preferred measure) grew by 8% in 2018. We regard this as a very good result given the generally subdued and patchy growth which the world continues to experience – and the fact that the previous year the portfolio companies achieved growth of a remarkable 13%, so the starting base for comparison in 2018 was a tough one.

This leads onto the question of valuation. The weighted average free cash flow (FCF) yield (the free cash flow generated by the companies divided by their market value) of the portfolio at the outset of the year was 3.7% and ended it at 4.0%, so they became cheaper or more lowly rated. Whilst this is not a good thing from the viewpoint of the performance of their shares or the fund, it is inevitable that sooner or later the cash flows generated by our companies will grow faster than their share prices, rather than vice versa. This is far from an unhealthy development, especially if we are investing more in the fund, as most of us are, through the accumulation shares.

The year-end median FCF yield on the S&P 500 was 4.7%. The year-end median FCF yield on the FTSE 100 was 5.2%. More of our stocks are in the former index than the latter and I will not repeat the explanation which I gave last year on why I think the FTSE 100 is not an appropriate benchmark or investment proxy for investors to use. Our portfolio consists of companies that are fundamentally a lot better than those in either index and are valued more highly than the average FTSE 100 company and a bit higher than the average S&P 500 company but with a significantly higher quality.



For the year the top five contributors to the fund's performance were:

|                          |       |
|--------------------------|-------|
| <b>Microsoft</b>         | +1.3% |
| <b>IDEXX</b>             | +1.0% |
| <b>Intuit</b>            | +1.0% |
| <b>PayPal</b>            | +1.0% |
| <b>Dr Pepper Snapple</b> | +0.9% |

Intuit, the US leader in accounting and tax software, was a relatively new holding having been purchased in 2017. PayPal is putting in an appearance for the second year running and IDEXX is returning to this list after being in our top five contributors in 2016. Microsoft makes its fourth appearance after 2015, 2014 and 2013. So much for taking profits as a strategy. Dr Pepper Snapple was the recipient of a bid from Keurig Green Mountain.

The bottom five were:

|                           |       |
|---------------------------|-------|
| <b>Philip Morris Intl</b> | -1.5% |
| <b>Sage</b>               | -0.8% |
| <b>Facebook</b>           | -0.7% |
| <b>3M</b>                 | -0.5% |
| <b>Novo Nordisk</b>       | -0.4% |

Philip Morris was caught up in the noise and uncertainty which surrounds the new reduced-risk products – vaping and heat-not-burn technology – where Philip Morris has a market-leading product in iQOS. I suspect we can tell that the company is on the right track, not just in terms of introducing products which wean smokers off cigarettes and so make their consumption safer and give a new leg to its business, but also by the number of regulators and commentators who oppose them.

Sage, the accounting software provider, was the subject of an unplanned change of CEO during the year, of which more later.

Our purchase of a holding in Facebook is certainly one of our more controversial decisions in the light of the furore over its use of personal data and what role some Facebook users may have made of this in elections.

As pointed out earlier and on many other occasions, we tend to look for suitable investments from the numbers that they report. Facebook's historic numbers are certainly impressive. It has some 1.5bn daily active users (DAU) and some 2.3bn monthly active users (MAU). Bearing in mind that Facebook has no presence in China, these numbers suggest ubiquity.

In 2017 Facebook had a return on capital of 30%, gross margins of 87% and operating profit margins of 50%. Its revenue growth rate has averaged 49% p.a. for the past five years and over the same period operating profits have grown by 106% p.a.

Of course, all that is in the past and the future for Facebook is likely to be different. When we started buying its shares we estimated that its revenue growth rate would halve to about 20% p.a. In the third quarter of 2018 they grew at 34% p.a., but the company has indicated that the growth rate would slow further to perhaps the mid 20% range in the fourth quarter, and the operating margin was down to a still impressive 42%. Against the background of the media furore over the use of personal data, this has been enough for some commentators on Facebook to experience very public attacks of the vapours.

But bear in mind the following:

The 42% operating margin in the third quarter which gave 13% profit growth was after a 53% increase in costs. You could look at this as a glass half full or empty, but in its third quarter Facebook increased R&D costs by 29%, marketing and sales costs by 65% and general and administrative costs by 76%. You might see such a rise in costs as problematic, but I suspect that faced with a furore Facebook's management has decided to very publicly spend a lot of money on data security and content control and to improve users' experience. In doing so it has, a) depressed Facebook's results, albeit to a still very acceptable level – showing great results whilst under such scrutiny might be a red rag to a bull, and b) built an even bigger barrier to entry for competitors. Ironically the response to the furore may just have cemented Facebook's competitive position. I also note that at the time of writing, Facebook's new political advertising transparency tools show that the UK government spent £96,684 on Facebook ads promoting Prime Minister May's Brexit deal. Political attacks on Facebook have the look of a circular firing squad.

Similarly, Facebook's capital expenditure doubled in the first nine months of 2018 to \$9.6bn, yet free cash flow in the third quarter was still 16% higher than it was a year ago.

Yet Facebook is on an historic PE of 19.7× – about the same as the S&P 500. Unless there is going to be a much more severe deterioration in Facebook's operational performance than we have seen to date or reasonably expect, this looks cheap to us.

Also consider the following:

Facebook makes no money from its social network users. It makes most of its revenue from online advertising, a business in which it has a virtual duopoly with Google.

I strongly suspect that most people's judgement of Facebook is based upon their personal experience and prejudices. But 69% of Facebook's DAU and 73% of its MAU are outside the United States and Europe. How much do you think they care about allegations of misuse of data in a US election? Not much, I would suggest, which seems to be borne out by the fact that in the third quarter the number of DAU grew by 9% and MAU by 10%.

Facebook has yet to "monetise" WhatsApp. I found it particularly amusing that one person queried our holding in Facebook using a message sent on WhatsApp. Who said the age of irony is dead?

Our Facebook holding has cost us some performance to date, and no doubt it will continue to be a difficult stock to hold in terms of media attention, but we have often found that the only time you can hope to buy stock in great businesses at a cheap valuation is when they have a glitch.

Turning to the third leg of our strategy, which we succinctly describe as 'do nothing', minimising portfolio turnover remains one of our objectives and this was again achieved with a portfolio turnover of 13.4% during the period. This is the highest level of annual turnover which we have undertaken to date, but it is still tiny in comparison with most funds. Moreover, it is somewhat exaggerated by the fact that we ran down the net cash as the market experienced some weakness later in the year. If this element of turnover was excluded, the number would be about 11%. It is perhaps more helpful to know that we spent a total of just 0.018% (1.8 basis points or hundredths of a per cent) of the fund's average value over the year

on voluntary dealing (which excludes dealing costs associated with fund subscriptions and redemptions as these are involuntary). We have held 11 of our portfolio companies since inception in 2010.

Why is this important? It helps to minimise costs and minimising the costs of investment is a vital contribution to achieving a satisfactory outcome as an investor. Too often investors, commentators and advisers focus on or in some cases obsess about the annual management charge (AMC) or the ongoing charges figure (OCF), which includes some costs over and above the AMC, which are charged to the fund. The OCF for 2018 for the T-class accumulation shares was 1.05%. The trouble is that the OCF does not include an important element of costs – the costs of dealing. When a fund manager deals by buying or selling, the fund typically incurs the cost of commission paid to a broker, the bid–offer spread on the stocks dealt in and, in some cases, transaction taxes such as stamp duty in the UK. This can add significantly to the costs of a fund, yet it is not included in the OCF.

We provide our own version of this total cost including dealing costs, which we have termed the total cost of investment (TCI). For the T-class accumulation shares in 2018 this amounted to a TCI of 1.09%, including all costs of dealing for flows into and out of the fund, not just our voluntary dealing.

We have long said that we look forward to the day when we can compare our TCI with other funds and that day has arrived. The table below shows the TCI of the 15 largest equity and total return funds in the UK and how their TCI differs from their OCF:

**15 largest active equity and total return funds in the UK**

|  | <i><b>OCF</b></i><br><i><b>(%)</b></i> | <i><b>Transaction costs</b></i><br><i><b>(%)</b></i> | <i><b>TCI</b></i><br><i><b>(%)</b></i> | <i><b>Additional costs</b></i><br><i><b>(%)</b></i> |
|--|--|--|--|---|
| Fundsmith Equity Fund                  | 1.05                                   | 0.04   | 1.09                                   | 4%  |
| Standard Life Investments GARS         | 0.89                                   | 0.25   | 1.14                                   | 28%   |
| Invesco Global Total Return            | 0.87                                   | 0.40   | 1.27                                   | 46%   |
| Invesco High Income                    | 0.92                                   | 0.10   | 1.02                                   | 11%   |
| Stewart Investors Asia Pacific Leaders | 0.89                                   | 0.13   | 1.02                                   | 15%   |

|                                    |             |             |             |            |
|------------------------------------|-------------|-------------|-------------|------------|
| Newton Real Return                 | 0.80        | 0.15        | 0.95        | 19%        |
| Baillie Gifford Diversified Growth | 0.82        | 0.63        | 1.45        | 77%        |
| M&G Global Dividend                | 0.91        | 0.09        | 1.00        | 10%        |
| Lindsell Train UK Equity           | 0.70        | 0.13        | 0.83        | 19%        |
| Artemis Income                     | 0.79        | 0.13        | 0.92        | 16%        |
| Jupiter European                   | 1.03        | 0.09        | 1.12        | 9%         |
| Newton Global Income               | 0.79        | 0.10        | 0.89        | 13%        |
| Ruffer Absolute Return             | 1.15        | 0.20        | 1.35        | 17%        |
| Woodford Equity Income             | 0.75        | 0.27        | 1.02        | 36%        |
| Aviva Multi Strategy Target Return | 0.85        | 0.23        | 1.08        | 27%        |
| <b>Average</b>                     | <b>0.88</b> | <b>0.20</b> | <b>1.08</b> | <b>23%</b> |

*Source: Financial Express Analytics/Fundsmith as at 7.1.19, in descending order of size.*

We are pleased that our TCI is not only just 4% above our OCF when transaction costs are taken into account, but that this is the lowest increase in the group. However, we would caution against becoming obsessed with charges to such an extent that you lose focus on the performance of funds. It is worth pointing out that the performance of our fund tabled at the beginning of this letter is after charging all fees, which should surely be the main focus. This point is rammed home when the same 15 largest active equity and total return funds in the UK are ranked by their three-year performance (the picture does not change much if we rank them on their five-year performance but two were launched too recently to have five-year track records):

| <b>Annualised performance</b>          | <b>3-yr</b> | <b>5-yr</b> |
|--|-------------|-------------|
|  | <b>%</b>    | <b>%</b>    |
| Fundsmith Equity                       | 16.9        | 17.9        |
| M&G Global Dividend                    | 14.0        | 7.3         |
| Stewart Investors Asia Pacific Leaders | 12.7        | 11.8        |
| Newton Global Income                   | 11.5        | 10.7        |

|                                    |      |      |
|------------------------------------|------|------|
| Jupiter European                   | 10.2 | 11.8 |
| Lindsell Train UK Equity           | 9.9  | 9.7  |
| Artemis Income                     | 3.9  | 4.3  |
| Baillie Gifford Diversified Growth | 2.6  | 2.9  |
| Ruffer Absolute Return             | 2.2  | 2.5  |
| Newton Real Return                 | 2.0  | 2.1  |
| Invesco Global Targeted Returns    | 0.3  | 2.1  |
| Invesco High Income                | -0.9 | 3.4  |
| Standard Life Investments GARS     | -2.2 | 0.3  |
| Aviva Multi Strategy Target Return | -2.5 | n/a  |
| Woodford Equity Income             | -4.6 | n/a  |

*Source: Financial Express Analytics as at 31.12.18.*

I think the above table speaks for itself.

We did undertake some activity in 2018. In particular we sold our holdings in Dr Pepper Snapple and Nestlé during the year.

Dr Pepper Snapple was a stock we have held since inception. We found the strategic rationale for the acquisition by Keurig Green Mountain difficult to comprehend and so took our leave of the situation. Commentators seem to forget that a similar combination was tried between Coca-Cola and Keurig which was unsuccessful and quietly abandoned.

Last year we wrote about the attention which Nestlé, amongst other portfolio companies, had attracted from activist investors. In Nestlé's case this was followed by the announcement of new margin and share buyback targets and then a deal to purchase Starbucks supermarket coffee products, excluding the "Ready to Drink" ones, for \$7.15bn. In other words, bags of coffee. Presumably we can also look forward to being able to purchase Starbucks Nespresso pods. Virtually no mention was made of the royalty which Nestlé will continue to pay to Starbucks on sales of these products. We rely on the management of our companies to allocate capital in ways which create value for us as investors, and this deal did not seem to meet

those criteria, although it certainly seemed to fit the activist imperative to do something and looked like a good deal for Starbucks.

This year I thought I would use the opportunity afforded by this letter to talk about our engagement with companies. We are often asked by investors whether we meet company management and how we engage with them.

The answer is that we meet them a lot. We visit companies we wish to research and meet them physically or virtually at results meetings and industry conferences. We are often engaged by members of the board remuneration committee and we review and vote on all resolutions and proxy statements at general meetings. We do not employ any outside agency for this.

However, meeting management is not our primary test of whether a business is of sufficient quality for us to invest. We think good businesses are identifiable from the numbers they produce. Nor do we meet management to give them our views on how to run the business. If they don't know how to do so we are in serious trouble.

There were two examples in 2018 of the closer engagement which we undertake when necessary.

One was with Sage, the accounting software company and the UK's largest quoted IT company. Sage, like many software providers, is in the midst of a switch from provision of perpetual software licences for its products – historically in the form of a disc – to the provision of software as a service (or “SaaS” as it is known in the jargon) in which the product is provided online as a subscription service. This has many advantages – knowing who the customer is, the ability to provide upgrades and sell adjacent products (like payroll and HR services) and repeat revenues. But it is not an automatic win – legacy customers can be reluctant to switch and the move to SaaS can provide an opportunity for disruptive competitors. Sage has had a couple of disappointing quarters of results in 2018 when the revenue growth, which was expected to be 8% p.a., looked like it might come in closer to 6% p.a. Whilst this was not ideal it was not as worrying as the possibility that the product development might not be fit for purpose and/or that in trying to reach for short-term targets essential product development might be neglected.

We therefore engaged with the chairman to ensure that our concerns were understood. In this respect we felt we could draw upon our experience as shareholders in Intuit, which competes with Sage and has made a so far successful transition to becoming a SaaS company. We did not, however, call for any change in management. The board nonetheless subsequently took the decision to part company with the CEO.

We engaged with the chairman to try to ensure that a suitable choice was made, drawing on our experience as a shareholder in Microsoft during the transition from Steve Ballmer as CEO to Satya Nadella, which has gone very well, and finally we met with the new CEO when he was appointed permanently to discuss the way forward for the business. We were at pains to stress that we are not interested in short-term fixes at the expense of long-term success, something which he seems to agree with since he has announced £60m of additional expenditure, two thirds of which is on product development.

The other main corporate engagement outside the run-of-the-mill AGM proxies and remuneration consultations in 2018 concerned Unilever, which announced a plan to unify its Anglo Dutch dual share structure and centre the headquarters and listing in the Netherlands. This was to be subject to a shareholder vote in the UK PLC which never occurred, presumably because the board could see it was about to be defeated.

Unlike some investors, the switch of listing would not have affected our ability to continue as shareholders. Our engagement with the chairman centred around the motivation for the move, which was portrayed as a desirable simplification that would make it easier for Unilever to engage in acquisitions involving share issues, particularly in the United States.

We were rather sceptical about the stated reasons for the change. The previous year Unilever had a near-death experience with a takeover approach from Kraft Heinz. Add to this the episode in which the US chemical company PPG Industries had bid for the Dutch paint maker Akzo Nobel, and a subsequent freedom of information request had revealed collusive activity between Akzo Nobel's management and Dutch politicians to thwart the bid, and you did not need to be the fictional Dutch detective Van der Valk to figure out that there might be some other motivations for the proposed move.



As you will be able to tell if you read our annual letter last year, we are far from enthusiastic about most shareholder activism nor are we shareholders in or fans of the Kraft Heinz business model. But we thought that Unilever's management had a case to answer and we think that the ability to mount a hostile takeover is an important discipline in ensuring that our assets are properly managed. When the chairman told us that he was never in favour of such actions, though he concurred that some companies were poorly managed, we were at best a bit confused about what mechanism he thought might be applied if such a change became necessary. Harsh language maybe?

We did not take part in any public commentary about our voting intentions in the event that the Unilever changes came to a vote. And, please note, that we have not revealed them here – we have merely commented on the process. In our view, achieving good stewardship of a business is not always a process best conducted through the media.

I would like to end by addressing the question of what will happen next in equity markets, which may surprise you given that I always respond to questions about this by saying I haven't got a clue, and neither has anyone else.

Imagine a fund manager approached you with an offer for you to invest in a portfolio of high-quality companies. You may quite like the strategy but you are worried about whether or not this is a good time to invest in the stock market. Take a look at the chart below, which shows the world's largest index by market capitalisation, the S&P 500, and which includes more quality companies than any other index.



The chart looks like a roller coaster that has just passed the peak of the ride. Surely you would be stupid if you invested now, no matter how good the strategy is. Better to wait until the market has had a proper fall.

You may notice that there are no dates on this chart of the S&P 500. That's because I wanted you to assume I was referring to the current market and our own fund, Fundsmith. In fact, the chart above shows the 37 years up to 1965 – the year in which Warren Buffett took control of Berkshire Hathaway. If you had made the decision to time the market and hold back from investing then, you would probably have missed out on the 20.9% compound growth in the market value per share of Berkshire since 1965 as a result.

“Ah, but that's not how market timing works”, I can foresee someone saying. “Just because I didn't buy into it in June 1965 doesn't mean that I wouldn't have bought into Berkshire later after the market had fallen.” Seems fair, except that the market didn't fall in the remainder of 1965. In fact, the S&P 500 went up by a further 13% in the second half of 1965. What would you have done then? Panicked and bought Berkshire or held off? If you had the nerve to do the latter, you might have felt vindicated in 1966 when the S&P 500 fell by 22% at one point.

There are several problems with this, though. Berkshire Hathaway is not the S&P 500. Its shares rose 49.5% in 1965 and only fell by 3.4% in 1966. So,

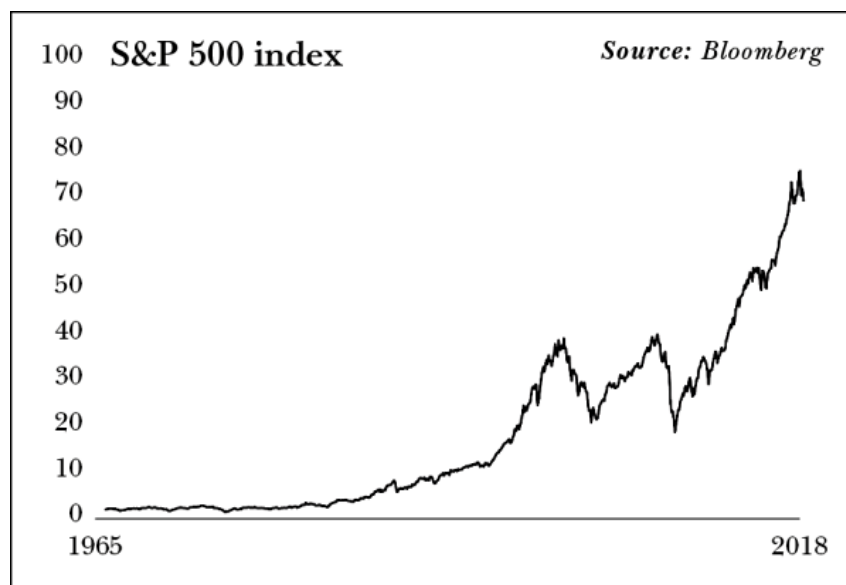
your hesitancy would not have paid off. Moreover, by 1967 the market had recovered to a new peak.

Are you really smart enough to not only a) predict a market fall but also; b) figure out how this translates into individual stock movements; c) get your timing sufficiently correct that you do not either forgo gains which far outweigh any losses you protect against or suffer some of the downturn; d) have sufficient mental agility and nerve to start buying when your prediction of a market fall has become reality; and e) get the timing roughly right on that side of the trade so that you don't end up catching the proverbial falling knife or missing some or all of the recovery? If so, I doubt you will be reading this letter on your private island. But above all, I doubt you exist.

To be fair, there have been plenty of big falls in both the market and Berkshire Hathaway's stock in the intervening 50 odd years since 1965. Berkshire's shares fell by over 50% in 1973–75 and 2008–09, and by nearly 50% in 1998–2000, plus a mere 37% in 1987.

The point about this is not simply that getting the timing of markets right is impossible, it is also that in even attempting to do so you might have missed out on investing in Warren Buffett's Berkshire Hathaway, the results of which far outweigh any market timing gains.

So where are we now? Here's the S&P 500 Index from the end of the previous chart in 1965 over the 53 years to date:



Looks familiar doesn't it? And it makes people reluctant to invest.

“Ah”, but I can hear someone say, “things are different – the valuation was much lower in 1965 than it is now.” In mid-1965 the S&P 500 was on a PE of 18.6×. Now it is on a 2019 forecast PE of 17.1×. There is no significant difference, although it is actually more lowly rated now.

But surely only an idiot would invest in a portfolio of high-quality company stocks when the market chart looks like that...

As Mark Twain said, ‘History doesn't repeat itself, but it often rhymes.’

# *The myths of fund management*

GLOBAL FINANCE MAURITIUS, NOVEMBER 2019

**T**HERE are a lot of myths which surround fund management and in my view it's wise to question them rather than blindly accepting them if you want to understand the industry.

One of them is that fund managers need to be located close to major financial markets – in London and New York, for example. To some extent this myth was already exposed long ago by the development of powerful enclaves of successful fund managers outside these main financial centres – like in Edinburgh in the UK and Boston in the United States.

Some of the most successful fund managers have gone further and shown that not only could you operate outside the major financial centres but that it was best to be remote from the centres of trading in the City of London and Wall Street so as to avoid the “noise” of daily events and trading. Most famously this has been demonstrated by Warren Buffett – the so-called “Sage of Omaha” and the most successful investor over the past half century – who has made a virtue of operating from Omaha, Nebraska.

Another famous and successful investor who also demonstrated this was Sir John Templeton, who operated from Nassau in the Bahamas. Templeton was a client of the broking firm I used to run and on one occasion told us that one advantage of managing money from the Bahamas was that the newspapers arrived a day late (this was in the pre-internet age), so that when he read some shocking news headline it was already too late to panic as the markets had already reacted, thereby exposing another myth of fund management – that success is about activity or quick reactions.

In the digital age a fund manager can now manage money from anywhere that broadband works. With the development of the cloud you can even move from one location to another as you work –seamlessly opening your computer online with a Bloomberg feed and carrying on.

If that's so, why do so many fund managers still congregate in cities like London and New York? If you ask them, they often say it's because they like to be close to the companies they invest in. This of course is nonsense –

they invest in companies which are mainly located far away in California, middle America, Europe or Asia. The reality is that they like to be near the investment banks who service them and near each other. This of course leads to group think and breaks one of Sir John Templeton's rules: 'If you want to have a better performance than the crowd, you must do things differently from the crowd.' This partly explains why most of their performance has been so poor. In some cases, the desire of these birds of a feather to flock together is so extreme that I wonder if some hedge funds and private equity funds could leave Mayfair and St James in London W1 and SW1 without using GPS.

But then most fund managers are not trying to do anything different: 'Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally,' said John Maynard Keynes, the famous economist who was also a successful fund manager. The majority of fund managers do not see the biggest threat to their career as underperforming their benchmark but in differing from that benchmark and their peers. As a result, they become "index huggers" who own enough shares in whatever market index is used for their performance benchmark to make sure their performance more or less matches it. But that of course is before fees and other costs such as dealing. The inevitable result is that the majority of active fund managers underperform the index.

I agree with Warren Buffett and John Bogle (the founder of Vanguard, one of the world's largest index fund providers) that most investors would be better served investing in a low-cost tracker fund which charges a lot less than the "active" managers who are simply index hugging.

One of the problems for outsiders trying to understand fund management is that words are often used in ways that differ from their common meaning. Take the word "active". It doesn't denote that the manager of an active fund engages in a lot of dealing activity – rather, it is meant to distinguish those managers who manage funds which are not strictly index trackers.

Some of the finest fund managers such as Warren Buffett eschew index-hugging and so run active funds – but also avoid dealing activity as much as possible, as dealing adds to the costs of managing money and so detracts from funds' performance. As Buffett says, 'The stock market is designed to transfer money from the active to the patient.' This also confuses people

who ask, “If the fund manager doesn’t deal much what am I paying fees for?” The answer is that the fees are payment for the outcome, the performance. Look at it this way: would you be happy paying fees to a manager who dealt a lot but delivered poor performance – or, as it is known, “busy fool syndrome?” I doubt it.

# *Annual letter to shareholders 2019*

FUNDSMITH, JANUARY 2020

**T**HIS is the tenth annual letter to owners of the Fundsmith Equity Fund. The table below shows performance figures for the last calendar year and the cumulative and annualised performance since inception on 1 November 2010 and various comparators.

| % Total return                        | 1 Jan to 31 Dec<br>2019 | Inception to 31 Dec<br>2019 |                   | Sharpe<br>ratio <sup>5</sup> | Sortino<br>ratio <sup>5</sup> |
|---------------------------------------|-------------------------|-----------------------------|-------------------|------------------------------|-------------------------------|
|                                       |                         | <i>Cumulative</i>           | <i>Annualised</i> |                              |                               |
| Fundsmith Equity<br>Fund <sup>1</sup> | +25.6                   | +364.4                      | +18.2             | 1.22                         | 1.22                          |
| Equities <sup>2</sup>                 | +22.7                   | +180.3                      | +11.9             | 0.63                         | 0.59                          |
| UK bonds <sup>3</sup>                 | +3.8                    | +40.9                       | +3.8              | n/a                          | n/a                           |
| Cash <sup>4</sup>                     | +0.8                    | +6.0                        | +0.6              | n/a                          | n/a                           |

<sup>1</sup> T-class acc shares, net of fees, priced at noon UK time, source: Fundsmith LLP. <sup>2</sup> MSCI World Index, £ net, priced at US market close, source: Bloomberg. <sup>3</sup> Bloomberg/Barclays Bond Indices UK Gov. 5–10 yr., source: Bloomberg. <sup>4</sup> 3-month Libor interest rate, source: Bloomberg. <sup>5</sup> Sharpe & Sortino ratios are since inception on 1.11.10 to 31.12.19, source: Financial Express Analytics.

The table shows the performance of the T-class accumulation shares, the most commonly held class and one in which I am invested, which rose by +25.6% in 2019 and compares with a rise of +22.7% for the MSCI World Index in sterling with dividends reinvested. The fund therefore beat this comparator in 2019, and our fund remains the number-one performer since its inception in the Investment Association Global sector by a cumulative margin of 233 percentage points above the average for the sector which has delivered +131.8% over the same time frame.

However, I realise that many or indeed most of our investors do not use these as the natural comparator for their investments. Those of you who are based in the UK may look to the FTSE 100 Index as the yardstick for measuring your investments and may hold funds which are benchmarked to this index and often hug it. The FTSE 100 delivered a total return of



+17.3% in 2019 so our fund outperformed this by a margin of 8.3 percentage points.

For the year the top five contributors to the fund's performance were:

|                           |       |
|---------------------------|-------|
| <b>Microsoft</b>          | +2.7% |
| <b>Estée Lauder</b>       | +2.1% |
| <b>Facebook</b>           | +2.0% |
| <b>PayPal</b>             | +1.8% |
| <b>Philip Morris Intl</b> | +1.4% |

Microsoft makes its fifth appearance whilst PayPal is putting in an appearance for the third year running. Someone once said that no one ever got poor by taking profits. This may be true, but I doubt they got very rich by this approach either. We are not the sort of people who ever declare victory – we invest with a strong sense of paranoia – but it is nonetheless pleasing to note the contribution of Facebook, which was certainly our most controversial stock purchase and led to more questions (and demands for its sale) from some of our investors than any other company. We had similar views expressed to us when we purchased Microsoft.

The bottom five were:

|                          |       |
|--------------------------|-------|
| <b>3M</b>                | -0.2% |
| <b>Colgate-Palmolive</b> | 0.0%  |
| <b>Clorox</b>            | 0.0%  |
| <b>Brown-Forman</b>      | 0.0%  |
| <b>Reckitt Benckiser</b> | +0.2% |

We sold our stakes in 3M and Colgate-Palmolive during the year and began buying Brown-Forman, the distiller of Jack Daniel's Tennessee Whiskey, and Clorox, the US household products and personal care products company. With 3M we were acting on growing doubts about the current management's capital allocation decisions, and in the case of Colgate-Palmolive we grew tired of waiting for an effective growth strategy to emerge. As is often the case, our buying of Brown-Forman has coincided

with a period of share price weakness – caused in this case mainly by the impact of EU tariffs on American spirits.

This year we have included the Sharpe and Sortino ratios for our fund and the index in the performance table. I realise that for those of you who are not investment professionals what I say next may well seem to be gobbledegook. However, whilst the returns which our fund provides are very important so is the amount of risk assumed in producing those returns. These ratios attempt to measure that.

The Sharpe ratio takes the return on the fund, subtracts a so-called risk-free return (basically the return on government bonds) to get the excess return over the risk-free rate, and divides the resulting number by the variation in that excess return (measured by its standard deviation – I warned you it was gobbledegook). The result tells you what unit of return you get for a unit of risk and our fund has a Sharpe ratio of 1.22 since inception against 0.63 for the MSCI World Index – it is producing about twice the amount of return that the index produces for each unit of risk.

The Sortino ratio is an adaption of the Sharpe ratio, and in my view an improvement. Whereas the Sharpe ratio estimates risk by the variability of returns, the Sortino ratio takes into account only downside variability as it is not clear why we should be concerned about upside volatility (i.e. when our fund goes up a lot) which mostly seems to be a cause for celebration. The result for our fund since inception is a Sortino ratio of 1.22 but the MSCI World Index Sortino ratio is lower than its Sharpe ratio at 0.59.

As you hopefully know by now, we have a simple three step investment strategy:

1. buy good companies
2. don't overpay
3. do nothing.

I will review how we are doing against each of those in turn.

As usual we seek to give some insight into the first of those – whether we own good companies – by giving you the following table, which shows what Fundsmith would be like if instead of being a fund it was a company

and accounted for the stakes which it owns in the portfolio on a “look through” basis, and compares this with the market, in this case the FTSE 100 Index and the S&P 500 Index. We not only show you how the portfolio compares with the major indices but also how it has evolved over time.

|                  | Fundsmith Equity Fund portfolio |      |      |      |      |      |      |      | S&P 500 | FTSE 100 |
|------------------|---------------------------------|------|------|------|------|------|------|------|---------|----------|
| Year ended       | 2012                            | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2019    | 2019     |
| ROCE             | 29%                             | 31%  | 29%  | 26%  | 27%  | 28%  | 29%  | 29%  | 17%     | 17%      |
| Gross margin     | 58%                             | 63%  | 60%  | 61%  | 62%  | 63%  | 65%  | 66%  | 45%     | 39%      |
| Operating margin | 23%                             | 24%  | 25%  | 25%  | 26%  | 26%  | 28%  | 27%  | 15%     | 17%      |
| Cash conversion  | 101%                            | 108% | 102% | 98%  | 99%  | 102% | 95%  | 97%  | 84%     | 86%      |
| Leverage         | 44%                             | 40%  | 28%  | 29%  | 38%  | 37%  | 47%  | 39%  | 53%     | 41%      |
| Interest cover   | 18×                             | 16×  | 15×  | 16×  | 17×  | 17×  | 17×  | 16×  | 7×      | 10×      |

*Source: Fundsmith LLP/Bloomberg. ROCE, gross margin, operating profit margin and cash conversion are the weighted mean of the underlying companies invested in by the Fundsmith Equity Fund and mean for the FTSE 100 and S&P 500 indices. The FTSE 100 and S&P 500 numbers exclude financial stocks. The leverage and interest cover numbers are both median. All ratios are based on last reported fiscal year accounts as at 31 December and as defined by Bloomberg. Cash conversion compares free cash flow per share with net income per share.*

As you can see, not much has changed, which is how we like it. Our portfolio companies remain superior to those in the main indices on any of the financial measures of returns, profitability, cash flow, or balance sheet strength.

As we indicated last year, we are going to remove the leverage calculation from the table in future as it can be close to meaningless. As you can see, we are not planning to remove it just because it looks bad. On the contrary, this year it is at 39% for our fund’s portfolio versus 53% for the S&P 500 and 41% for the FTSE 100. But it gives a sense of how little meaning it has that the values for the companies that comprise the median number are 26% and 53%. Nor is a mean (average) number much better, as eight stocks in the portfolio have net cash on their balance sheets.

The average year of foundation of our portfolio companies at the year end was 1925.

Consistently high returns on capital are one sign we look for when seeking

companies to invest in. Another is a source of growth – high returns are not much use if the business is not able to grow and deploy more capital at these high rates. So how did our companies fare in that respect in 2019? The weighted average free cash flow (the cash the companies generate after paying for everything except the dividend, and our preferred measure) grew by 9% in 2019.

This leads onto the question of valuation. The weighted average free cash flow (FCF) yield (the free cash flow generated by the companies divided by their market value) of the portfolio at the outset of the year was 4.0% and ended it at 3.4%, so they became more highly rated. Whilst this is a good thing from the viewpoint of the performance of their shares and the fund, it makes us nervous as changes in valuation are finite and reversible, although it is hard to see the most likely source of such a reversal – a rise in interest rates – in the near future.

The year-end median FCF yield on the S&P 500 was 4.2%. The year-end median FCF yield on the FTSE 100 was 5.5%. More of our stocks are in the former index than the latter and I will not repeat the explanation which I gave in my 2017 annual letter on why I think the FTSE 100 is not an appropriate benchmark or investment proxy for our investors to use. Our portfolio consists of companies that are fundamentally a lot better than the average of those in either index and are valued more highly than the average FTSE 100 company and a bit higher than the average S&P 500 company but with significantly higher quality. It is wise to bear in mind that, despite the rather sloppy shorthand used by many commentators, highly rated does not equate to expensive any more than lowly rated equates to cheap.

Turning to the third leg of our strategy, which we succinctly describe as ‘do nothing’, minimising portfolio turnover remains one of our objectives and this was again achieved with a negative portfolio turnover during the period. It is perhaps more helpful to know that we spent a total of just 0.005% (half a basis point or one two hundredth of one per cent) of the fund’s average value over the year on voluntary dealing (which excludes dealing costs associated with fund subscriptions and redemptions as these are involuntary). We have held ten of our portfolio companies since inception in 2010.

Why is this important? It helps to minimise costs and minimising the costs of investment is a vital contribution to achieving a satisfactory outcome as an investor. Too often investors, commentators and advisers focus on, or in some cases obsess about, the annual management charge (AMC) or the ongoing charges figure (OCF), which includes some costs over and above the AMC, which are charged to the fund. The OCF for 2019 for the T-class accumulation shares was 1.05%. The trouble is that the OCF does not include an important element of costs – the costs of dealing. When a fund manager deals by buying or selling, the fund typically incurs the cost of commission paid to a broker, the bid–offer spread on the stocks dealt in and, in some cases, transaction taxes such as stamp duty in the UK. This can add significantly to the costs of a fund, yet it is not included in the OCF.

We provide our own version of this total cost including dealing costs, which we have termed the total cost of investment (TCI). For the T-class accumulation shares in 2019 this amounted to a TCI of 1.06%, including all costs of dealing for flows into and out of the fund, not just our voluntary dealing. The table below shows the TCI of the 15 largest equity and total return funds in the UK and how their TCI differs from their OCF:

|  | <b>OCF<br/>(%)</b> | <b>Transaction costs<br/>(%)</b> | <b>TCI<br/>(%)</b> | <b>Additional costs<br/>(%)</b> |
|--|--------------------|----------------------------------|--------------------|---------------------------------|
| Fundsmith Equity Fund                  | 1.05               | 0.01                             | 1.06               | 1                               |
| Invesco Global Targeted Returns        | 0.87               | 0.43                             | 1.30               | 49                              |
| Baillie Gifford Diversified Growth     | 0.77               | 0.50                             | 1.27               | 65                              |
| Lindsell Train UK Equity               | 0.65               | 0.09                             | 0.74               | 14                              |
| Stewart Investors Asia Pacific Leaders | 0.88               | 0.16                             | 1.04               | 18                              |
| BNY Mellon Real Return                 | 0.80               | 0.20                             | 1.00               | 25                              |
| Invesco High Income                    | 0.92               | 0.15                             | 1.07               | 16                              |
| BNY Mellon Global Income               | 0.80               | 0.07                             | 0.87               | 9                               |
| Liontrust Special Situations           | 0.89               | 0.18                             | 1.07               | 20                              |
| Artemis Income                         | 0.80               | 0.12                             | 0.92               | 15                              |

|                                       |             |             |             |           |
|---------------------------------------|-------------|-------------|-------------|-----------|
| ASI Global Absolute Return Strategies | 0.90        | 0.15        | 1.05        | 17        |
| Jupiter European                      | 1.02        | 0.06        | 1.08        | 6         |
| LF Ruffer Absolute Return             | 1.22        | 0.35        | 1.57        | 29        |
| Baillie Gifford Managed               | 0.42        | 0.05        | 0.47        | 12        |
| Threadneedle UK Equity Income         | 0.82        | 0.05        | 0.87        | 6         |
| <b>Average</b>                        | <b>0.85</b> | <b>0.17</b> | <b>1.03</b> | <b>20</b> |

*Source: Financial Express Analytics/Fundsmith as at 6.1.20, funds in descending order of size.*

We are pleased that our TCI is not only just 1% above our OCF when transaction costs are taken into account, but that this is the lowest increase in the group. However, we would again caution against becoming obsessed with charges to such an extent that you lose focus on the performance of funds. It is worth pointing out that the performance of our fund tabled at the beginning of this letter is after charging all fees, which should surely be the main focus. This point is rammed home when the same 15 largest active equity and total return funds in the UK are ranked by their three-year performance (the picture does not change much if we rank them on their five-year performance).

|                              | <b>3-year cumulative performance to last year end overall %</b> | <b>5-year cumulative performance to last year end overall %</b> |
|------------------------------|---|---|
| Fundsmith Equity Fund        | 56.6  | 132.2   |
| Jupiter European             | 53.5  | 98.4  |
| Lindsell Train UK Equity     | 46.6  | 81.9  |
| Liontrust Special Situations | 39.0  | 83.3  |
| Baillie Gifford Managed      | 35.8  | 70.3  |
| BNY Mellon Global Income     | 30.5  | 85.9  |
| Artemis Income               | 25.0  | 45.3  |

|  |      |      |
|--|------|------|
| Stewart Investors Asia Pacific Leaders | 24.1 | 51.3 |
| Threadneedle UK Equity Income          | 21.0 | 43.8 |
| BNY Mellon Real Return                 | 14.8 | 20.8 |
| Baillie Gifford Diversified Growth     | 13.9 | 23.4 |
| ASI Global Absolute Return Strategies  | 2.8  | 2.9  |
| LF Ruffer Absolute Return              | 2.5  | 16.0 |
| Invesco Global Targeted Returns        | 0.6  | 5.7  |
| Invesco High Income                    | -0.5 | 13.7 |

*Source: Financial Express Analytics/Fundsmith as at 6.1.20*

I think the above table speaks for itself in terms of the relative performance of our fund, so that you can look not just at the fees and costs but what you get in return – performance.

The fund’s performance for the year was adversely affected by a couple of poor months in September and October which cost the fund about 6%. This was caused by two factors: 1) a rally in the sterling exchange rate from the recent lows which it had plumbed after the Brexit referendum result in 2016 and on subsequent hard Brexit fears; and 2) a “rotation” from the high quality and relatively highly rated stocks of the sort which our fund owns into lower quality and more lowly rated “value” stocks.

If you read the breathless commentary on this in much of the press without knowing the actual performance of our fund you might be surprised to find that, notwithstanding these events, it ended the year up by 25.6%, which was our second-best year since inception, and outperformed the MSCI World Index by 2.9%.

Taking each of these factors in turn, currency movements clearly have some effect on our portfolio. Over 60% of our portfolio is invested in companies

listed in the United States. The actual exposure to the US dollar and therefore the pound/dollar exchange rate is better gauged by the c.40% of our portfolio companies' revenues which are in the USA. However, currency movements are not something we believe we can predict – they seem to have about the same predictability as a game of Snakes and Ladders – or hedge.

I would suggest looking at the matter this way: imagine we were in a discussion with some of the companies which have produced great returns for us over the last nine years, or which might do so over the next nine, and we asked them to name the top three factors in their success. What do you think the chances are that they would say “currency exposure and exchange rates”? I would suggest they might name product innovation and R&D, strong brands, control of distribution, market share, customer relationships, installed bases of equipment or software, management, successful capital expenditure and acquisitions as far more important. So, we think it's best to ignore the Snakes and Ladders of currency movements.

Turning to the second point – the so-called rotation into value stocks – I am not much of a gardener but I believe this is becoming what gardeners term a “hardy perennial”, as it crops up every year. To quote from *Investment Adviser*, ‘Looking at PE ratios there is evidence in abundance that shows that from a relative perspective quality stocks may today be considered expensive.’ The interesting point about that assertion is that it was published on 13 August 2012. A lot of superior returns have been had from those allegedly expensive stocks in the subsequent seven years.

The argument might be encapsulated thus: stocks of the sort which our fund owns have had a good run of outperformance as has the fund but this is all about to end, or even has already ended, and so-called “value investing” – buying stocks mainly based upon their supposed undervaluation by the market – is making a comeback and funds which pursue that strategy are about to outperform us.

Value investing has its flaws as a strategy. Markets are not perfect but they are not totally inefficient either, and most of the stocks which have valuations which attract value investors have them for good reason – they are not good businesses. This means that the value investor who buys one of these companies (which are indeed lowly rated but which rarely or never



make an adequate return on capital) is facing a headwind. The intrinsic value of the company does not grow (except for any new capital that its hapless investors allow it to retain or subscribe for in some form of share issue), or even erodes over time, whilst the value investor is waiting for the lowly valuation to be recognised and the share price to rise to reflect this.

Moreover, even when the value investor gets it right and this happens, they then need to sell the stock which has achieved this and find another undervalued stock and start again. This activity obviously incurs dealing costs. Value investing is not something which can be pursued with a buy-and-hold strategy. In investment you “become what you eat” insofar as over the long term the returns on any portfolio which has such an approach will tend to gravitate to the returns generated by the companies themselves, which are low for most value stocks. As Charlie Munger, Warren Buffett’s business partner, said:

‘Over the long term, it’s hard for a stock to earn a much better return than the business which underlies it earns. If the business earns 6% on capital over 40 years and you hold it for that 40 years, you’re not going to make much different than a 6% return – *even if you originally buy it at a huge discount*. Conversely, if a business earns 18% on capital over 20 or 30 years, *even if you pay an expensive looking price, you’ll end up with a fine result.*’ (Emphasis added.)

Mr Munger is not offering a theory or an opinion – what he is saying is a mathematical certainty. The only uncertainty concerns our ability to forecast returns far ahead, which is why we prefer to invest in relatively predictable businesses.

The biggest flaw in value investing is that it does not seek to take advantage of a unique characteristic of equities. Equities are the only asset in which a portion of your return is automatically reinvested for you. The retained earnings (or free cash flow if you prefer that measure, as we do) after payment of the dividend are reinvested in the business. This does not happen with real estate – you receive rent not a further investment in buildings, or with bonds – you get paid interest but no more bonds.

This retention of earnings which are reinvested in the business can be a powerful mechanism for compounding gains. Some 80% of the gains in the S&P 500 over the 20th century came not from changes in valuation but from the companies’ earnings and reinvestment of retained capital. If you were a great (and long-lived) value investor who bought the S&P 500 at its

low in valuation terms, which was in 1917 when America entered the First World War and it was on a PE of 5.3×, and sold it at its high in valuation terms in 1999 when it was on a PE of 34×, your annual return during that period would have been 11.6% with dividends reinvested, but only 2.3% p.a. came from the massive increase in PE and 9.3% (80% of 11.6%) came from the companies' earnings and reinvesting their retained earnings.

The S&P example is for 500 average large companies. This proportion of your return from the companies' reinvestment activities is even more extreme when you invest in a good company with a high return on retained capital than in an average company.

All of this was much more succinctly encapsulated by Warren Buffett when he said: 'It's far better to buy a wonderful company at a fair price, than a fair company at a wonderful price.'

He made the transition from being a traditional value investor based upon studying under Benjamin Graham (author of *The Intelligent Investor* and *Security Analysis*) into a quality investor looking for companies which could compound in value based upon the teachings of Philip Fisher (author of *Common Stocks and Uncommon Profits*) and the influence of Charlie Munger.

Here's how Buffett explained this change in his 1989 letter to Berkshire Hathaway shareholders:

'[t]he original "bargain" price probably will not turn out to be such a steal after all. In a difficult business, no sooner is one problem solved than another surfaces – never is there just one cockroach in the kitchen. [Plus], any initial advantage you secure will be quickly eroded by the low return that the business earns. For example, if you buy a business for \$8 million that can be sold or liquidated for \$10 million and promptly take either course, you can realize a high return. But the investment will disappoint if the business is sold for \$10 million in ten years and in the interim has annually earned and distributed only a few per cent on cost. Time is the friend of the wonderful business, the enemy of the mediocre.'

The problems of waiting for value investment to pay off can be seen in the performance of the MSCI World Value Index (USD) which hit 6570 at the end of October 2007 and was lower than this at the end of February 2016. At 31 December 2019 it stood at 9812, just 49% higher than its 2007 peak value.

Compare and contrast the S&P 500 (USD) which peaked on 9 October

2007 but had regained its 2007 high by 2013 and at 31 December 2019 stood 189% higher.

Ah, but I can hear the siren song of the value investors who will take this data as confirmation that the resurgence of value investment which they have long predicted is about to commence. As an old saying goes, “To a man with a hammer, everything looks like a nail”.

The longer the strategy underperforms the market, and the more money it costs investors, the louder the siren song becomes. And sooner or later they will be right. But a) they have no idea when that will be (note the reference above to *Investment Adviser*’s comment in 2012); b) if you had followed their advice to date it would require a gargantuan reversal of performance to make up the gains forgone; and c) that may continue to be the case for some time to come.

Lastly, there are some commentators who say that one way to address this is to have a portion of your portfolio invested in both strategies – some in quality growth and some in value. I think the assertion that there is no harm in this diversification approach has been disproved rather comprehensively by Warren Buffett, but what does he know? Perhaps we should look at the value investment versus quality and growth strategy debate this way: would you rather side with a) a large section of the UK financial press and rent-a-quote investment advisers; or b) Warren Buffett, Charlie Munger (Berkshire Hathaway), Bill Gates (Microsoft), the Bettencourt family (L’Oréal), the Brown family (Brown-Forman), the Walton family (Walmart) and Bernard Arnault (LVMH)? The latter all seem to have become extraordinarily rich by concentrating their investment in a single high-quality business and not trading regardless of valuation. So much for it not doing any harm to diversify across strategies.

It seems impossible to comment upon developments in equity investing in the UK in 2019 without mentioning the word Woodford. The demise of Woodford Investment Management following the “gating” of its main LF Woodford Equity Income Fund was undoubtedly the main news in the industry last year.

We have no desire to engage in a general commentary on this matter or to engage in an unseemly exercise in schadenfreude. We had long identified

the problems which were brewing at Woodford but we kept our own counsel on the matter. The only comments you will find from us mentioning Woodford were in answer to direct questions concerning Woodford from our investors at our annual meeting. We regard it as a lack of professional courtesy to comment upon our competitors except when we are asked to do so by our investors. We only wish others in the industry would maintain the same stance.

However, we now feel freer to comment on Woodford since it is hard to see how it can now exacerbate the situation, and I feel that we need to as the Woodford debacle has raised important questions about the industry, some of which have been directed at us and I feel that our investors should know our response.

The most obvious problem at Woodford was the lethal combination of a daily-dealing open-ended fund with significant holdings in unquoted companies and large percentage stakes in small quoted companies which had very limited liquidity. Whilst this was clearly a very bad idea, Woodford is not the only fund to have encountered this problem. A large swathe of UK property funds was gated after the Brexit referendum for the same reason, and more recently so was the M&G Property Portfolio. An open-ended daily-dealing fund is clearly not an appropriate vehicle through which to hold such assets. The daily dealing and open-ended structure give investors the illusion of liquidity but when a large number of them try to exercise it at once the effect is similar to shouting “Fire!” in a crowded theatre.

Amongst the causes which commentators seem to have failed to realise is the effect which the rise of investment platforms has had on this and other areas of the fund management industry. It is now the case that no one can expect to effectively market an open-ended fund on any of the major investment platforms which retail investors and wealth managers use to manage their investments unless it is a daily-dealing fund. As none of these platforms will admit an open-ended fund, unless it allows daily dealing, that is what fund managers will use even for strategies for which this structure is wholly inappropriate.

Where does the Fundsmith Equity Fund stand on this? We have always regarded liquidity as an important issue. As evidence of this, we have

published a liquidity measure on our fund factsheet since 2012. Equally, we only invest in large companies. At 31 December 2019 the average market capitalisation of the companies in our fund was £114bn and we estimate we could liquidate 57% of the fund in seven days.

The reality is that the only type of fund which can guarantee 100% liquidity on demand is a cash fund, and I presume that is not what you wish us to invest in. But I suspect you will find it hard to find more liquid equity funds than ours. It tells you much about its liquidity that some of the least liquid stocks we hold are the FTSE 100 companies, InterContinental Hotels, Intertek and Sage.

Another question which arises from the Woodford incident is the question mark over so-called “star” fund managers, a label the press seems obsessed by. I can’t say I like the term; it strikes me as equally inappropriate as the term “beauty parade”, which is used when selecting professional advisers, many of whom do not seem to me to have obvious photogenic qualities.

I think this concern is focused on the wrong issue. I think it makes no more sense to avoid funds run by “star” fund managers than it does to avoid supporting sporting teams because they have star players. The trouble arises not because teams have star players but if the star tries to play a different game to the one which delivered their stellar performance. Would Juventus do as well if Cristiano Ronaldo played as goalkeeper? How is Usain Bolt’s second career as a soccer player going?

Neil Woodford made his name as a fund manager at Invesco Perpetual with his successful Income Fund. In the course of this he took two high-profile negative positions on sectors. In the run up to the dotcom bust in 2000 he seems to have seen what was coming and avoided investments in technology, media and telecommunications stocks which was a major success. He also paired this with taking positions in some of the old economy neglected stocks which had become de-rated during the dotcom mania. Similarly, in the run up to the Credit Crisis he decided not to hold bank stocks.

However, when he opened his own fund management business he took positions in a wide range of companies – AA, AstraZeneca, Capita, Imperial Brands, Provident Financial and Stobart are some examples. There

is no common theme that I can detect to those companies, other than the fact that they all subsequently fared badly. This was supplemented by a raft of unquoted investments in start-ups and biotech. My suggestion is that what went wrong is that Neil Woodford changed his investment strategy. In the technical jargon of the industry, he engaged in “style drift”. The problem wasn’t that he was regarded as a star but that he changed his game. This style drift actually started when he was still at Invesco Perpetual in that his Income Fund began to accumulate large stakes in small illiquid companies and unquoted, but this was taken further once he had his own firm.

Is there any chance of style drift or a similar change of strategy at Fundsmith? I think not. We published an *Owner’s Manual* at the outset which describes our investment strategy, write to you in these annual letters analysing how we are faring in implementing our strategy and are the only mutual fund in the UK which holds an annual meeting at which our investors can question us and see their questions answered publicly. So, it would be extraordinary if we were able to effect a change in our investment strategy without you noticing.

Moreover, we have no desire to change our strategy. We are convinced that it can deliver superior returns over the long term. I would pose a different question which links the discussion of the Woodford affair with the earlier discussion of the “rotation” from quality stocks into value stocks. If you expect such a “rotation” to occur at some point, and for value stocks to enjoy a period in the sun, would you rather we tried to anticipate that and switched into a value investment approach of buying stocks based mainly or solely on the basis of their valuation, or would you rather we stuck to our existing approach of buying and holding high-quality businesses? I would suggest the latter approach might be better, and it is what we are doing. There will be no style drift at Fundsmith.

# *A pandemic letter to shareholders*

FUNDSMITH, 31 MARCH 2020

**I**T would be an understatement to say it has been an eventful start to the year so I thought I should take this opportunity to update you on how we are faring in the coronavirus Covid-19 pandemic environment.

First and foremost, the Fundsmith Equity Fund continues to operate. We can price it, people can deal in it and we have been able to provide liquidity where required.

I know that you normally just look at the price and do not worry about such matters, but we need you to know that you can contact us, that any information you need will be provided, and that any dealing instructions you give us will be executed. This is important. If we fail on one or more of those aspects we need not worry about what comes next. As Rick Mears, one of only three drivers to win the Indianapolis 500 Race four times, said: ‘In order to finish first you must first finish.’

Secondly, our fund’s performance has been as we would have expected, hoped and predicted. I would even say it is satisfactory if you accept that some fall in valuation is inevitable in a bear market.

| <b>% Change</b>                    | <b>2020 YTD</b> |
|------------------------------------|-----------------|
| Fundsmith Equity Fund <sup>1</sup> | -7.9            |
| MSCI World <sup>2</sup>            | -15.7           |
| MSCI World Value <sup>2</sup>      | -22.0           |
| FTSE 100 <sup>3</sup>              | -23.8           |

<sup>1</sup> T-class acc shares, net of fees, priced at noon UK time, source: Fundsmith LLP. <sup>2</sup> MSCI indices, £ net, priced at US market close, source: Bloomberg. <sup>3</sup> FTSE 100, £, total return, priced at UK market close, source: Bloomberg.

The Fundsmith Equity Fund<sup>1</sup> is down 7.9% for the year to date, having outperformed the comparator MSCI World Index<sup>2</sup> by nearly 8%. It outperformed the FTSE 100<sup>3</sup> by nearly 16% and the MSCI World Value Index<sup>2</sup> by over 14%.

It also outperformed all these indices significantly in the fall from the peak

of the market to its trough before the recent rally. Bear in mind the MSCI World and FTSE 100 indices benefit from the inclusion of our companies. The companies we do not own are collectively performing worse than the index numbers.

As you know, I was immensely sceptical of the view that so-called value stocks could protect you in a downturn. I have never been a believer in the philosophy that “value” investments would perform well or protect your investment in an economic and market downturn. Shares in companies that are lowly rated are so mostly for good reasons – because their businesses are heavily cyclical, highly leveraged, they have poor returns on capital and/or they face other structural or management issues. It doesn’t sound like a combination likely to protect the business and your investment in difficult times, and so it has proven thus far.

Our companies which are most in the firing line – Amadeus and InterContinental Hotels in airline reservations and hotels – are sensibly putting in place cost-cutting and cash-conservation measures and securing liquidity to enable them to hold their breath for 18 months or so with no revenues. This in our view is far more useful than speculation about what their sector will look like afterwards. They have to survive to find out (reference Mr Mears’ thoughts earlier). If our equity in both is vapourised we will lose about 5% of our current portfolio. Whilst I would not be pleased with that, if that’s the worst thing that happens I would suggest we can live with it. Whilst we have various stocks exposed to knock-on effects in travel retail – for example, in cosmetics and drinks – and supply-chain issues in other portfolio companies, if we were forced to guess we think about a third of the portfolio will endure this year with increased revenues: Microsoft, the payment processors, Clorox, and Reckitt Benckiser, for example.

It is said that every cloud has a silver lining and we are seeing opportunities. We have bought two new holdings which we have been following for some while and which have been hard hit in this market because of China exposure and a classic “glitch”.

I suspect the current market reaction to the pandemic is explained by a simple analogy which relates to the virus itself. The Covid-19 virus is not fatal for the vast majority of the population. However, where it seems to be



lethal is when it encounters someone with an immune system already weakened by age and/or pre-existing ailments.

Similarly, what has increased the impact of the virus, or rather measures taken to counter it, on the economy and markets is that in this area it has encountered structures with weakened immune systems too. The fact that most of the emergency measures taken in 2008–09 – deficit spending, low or zero interest rates and QE – were still in place ten years after the crisis demonstrated that the patient (in this case the global economy) was not back in rude health when the virus struck. Cue a market panic.

What will emerge from the current apocalyptic state? How many of us will become sick or worse? When will we be allowed out again? Will we travel as much as we have in the past? Will the extreme measures taken by governments to maintain the economy lead to inflation? I haven't a clue. Rather like some of the companies we most admire, I try to spend very little time considering matters which I can neither predict nor control and focus instead on those which I can affect. So at Fundsmith our focus will be on keeping our service to investors fully functioning, and then seeking to grasp any new investment opportunities which are unearthed by the turmoil – whilst ensuring that our colleagues, families, friends, and anyone else we can reach receives any help they need and that we can provide.

I hope and expect that our strategy of only investing in good businesses will continue to see our fund through these trying times intact and continuing to prosper.

# *Never let a crisis go to waste*

*FINANCIAL TIMES*, 30 APRIL 2020

**W**E now have a fully-fledged economic crisis caused by the reaction to the Covid-19 pandemic. What should you do about it in terms of investment?

I would strongly advise avoiding the approach of many investment advisers or analysts. They spend their time speculating about what will happen. When will the lockdowns end? What will happen in the travel and hospitality industry? When will there be a vaccine (I suspect that question should be “Will there ever be an effective vaccine?”)? Who will be the winners – makers of disinfectant and masks? Drug companies? E-commerce plays? Home food delivery?

In my view, all of this speculation is useless. No one knows. It is about as useful as all those “risk registers” which companies are required to produce, demonstrating that they have assessed the main risks to their business. How many of them do you suppose had “pandemic” listed prior to these events? Equally, how many will omit it in future? It is not only generals who are prone to fighting the last war.

My award for the silliest question asked by an analyst so far goes to the questioner who asked a US company presenting its quarterly results: ‘What would cause your device sales to be down in the second quarter?’ (I’m not making this up.)

But as an old saying goes, “Never let a crisis go to waste.” You should always think about a crisis as an opportunity. This was expressed in the notorious remarks of a spin doctor working for Stephen Byers, the former UK transport secretary, who wrote of 9/11, ‘It’s now a very good day to get out anything we want to bury.’

We can already see this advice being followed. The Investment Association has suspended its Equity Income requirements for 12 months. This is bad news for equity income investors. It’s not as if these requirements were exactly stringent to begin with.

To qualify for inclusion in the IA UK Equity Income sector, all a fund had to do was exceed 90% of the yield on the FTSE All-Share Index each year (not a mistype – yes, a fund yielding nearly 10% less than the index qualified as an income fund) and exceed the index yield on a three-year rolling basis.

In a ridiculous piece of deception, which I suspect would not be permitted in any other product, a fund can lose its Investment Association status and still carry the word “income” in its title. To paraphrase a common saying, “It doesn’t do what it says on the tin.”

To some extent the Investment Association is just acknowledging reality. By mid-April a quarter of the stocks in the Stoxx Europe 600 Index had suspended their dividends.

However, I suspect that the really bad news for equity income investors is yet to surface. As at mid-April, the dividend cover on the top 20 highest dividend yield stocks in the FTSE 100 was just 1.3 times. For the top 20 largest absolute dividend-paying stocks in the UK it was 1.1 times – net profits are just 10% more than the dividend.

One of the more ridiculous questions which investors and others have been asking in this crisis is, “When do you think things will get back to normal?” This ignores the fact that what came before the crisis may not have been normal. Over time, dividend cover for most businesses cannot be sustained at 1.1–1.3 times, as most of them need retained earnings in order to grow. An average cover of two times is more normal. I would suspect that the boards of companies which have passed the dividend will indeed not be allowing a good crisis to go to waste and will return with a much smaller and more sustainable dividend which will mean much lower yields for equity income investors.

I have long said that no one should invest in equities for income. If you had invested in the IA UK Equity Income sector over the past five years, you would on average have lost nearly 1.3% a year. The best way to approach this is to invest for the highest total return you can achieve and sell whatever shares or units you need to provide cash. However, I realise that for many investors, the idea of realising part of their capital to provide income is anathema. So what to do?

If you insist on investing for dividend income, consider investing alongside a family which founded and has control of a public company. Out of the 47 stocks in the Stoxx Europe 600 that are “family influenced”, only three have cancelled or postponed dividends. Very often these extended families, descended from the business founder, rely on the dividend income from the family business.

The chief executive of one of the family-controlled companies we invest in at Fundsmith says his first piece of advice from the patriarch of the family was to never cut the dividend. Investing alongside them can help to preserve your income too, and in this market environment you may get some attractive opportunities to do so.

# *There are only two types of investors*

*FINANCIAL TIMES*, 2 JULY 2020

I LAST wrote about the problems of so-called market timing in 2013 (“Market timing: don’t try this at home”, [page 47](#)).

With the Covid-19 pandemic dominating the news, and recent volatility on world stock markets, you may have heard a lot about market timing again.

Advisers and financial commentators will probably not use that actual term. What they will talk about is whether you should sell some or all of your equity investments because of the economic effects of the coronavirus and the subsequent effect on the markets.

All of this is what is termed “market timing” in the jargon of the investment trade – holding back investment or taking some or all of your money out of the market when you anticipate a fall.

The word “anticipate” indicates the first problem with this approach. Most people whom I encounter take their money out during or after a fall – as they did in March. They are doing the equivalent of driving whilst looking in the rearview mirror (or at best, out of the side window of the car). You need to look out of the windscreen in order to have the best chance of driving safely. The trouble with doing that in terms of the stock market is that the visibility is often so poor it feels like driving in fog.

Such approaches to investment are almost all futile. Markets are second-order systems. What this means is that in order to successfully implement such market-timing strategies you not only have to be able to predict events – interest-rate rises, wars, oil-price shocks, the impact of the coronavirus, the outcome of elections and referendums – you also need to know what the market was expecting and how it will react, and get your timing right. Tricky.

However, there are quite long periods when the market falls and takes a

long time to regain previous highs. How shall we judge whether you should try to take advantage of this?

Take the market (in this case the Dow Jones Industrial Average – the Dow – which I will use because there is data on this strategy courtesy of YCharts) from 1970–2020. This is a period of 50 years which spans inflationary and deflationary cycles and which has seen several crises and crashes as well as bull markets. It seems like a long and fair sample period.

Imagine that over this 50-year period there were two competing investment strategies. One is to invest an equal amount every trading day throughout the period irrespective of market conditions – so-called pound (or dollar) cost averaging which many investors actually apply by making regular contributions into a pension, ISA or regular savings plan.

The other strategy requires enough foresight for the investor to invest the same amount daily, but to stop investing when the market turns down and save the cash. This money is only invested when the Dow makes a new bottom, hitting its low point in any period of decline (hence why it's known as an “absolute-bottom-buying strategy”).

In my view, this is a somewhat more realistic example of how you might apply foresight, rather than measuring what would happen if you had such certainty about the future you were able to sell everything just before the market turned down and then buy it back at the bottom.

Over the 50-year period, the second strategy would have produced returns 22% higher than the first. It sounds impressive – perhaps a little less so when you break it down to an 0.4% outperformance per year. But think of the time and effort you would have to spend monitoring markets to get those calls just right.

Compare and contrast this with the rise in the market since I last wrote about this subject in March 2013. The Dow is up just over 150% in total, averaging 13.3% per annum. Imagine if you had acted on market fears and taken your money out of equities or stopped investing ahead of that performance. Should you risk foregoing any significant portion of that gain for a maximum upside of 0.4% per year?

In reality, attempts to implement the second strategy will almost certainly cause harm to your net worth as nobody has perfect foresight. In your desire

to time the markets, you will stop investing, or worse, sell and take money out when you expect the market to go down, and instead it goes up.

Think back to Brexit and Trump's election. We were told by most commentators that they would not happen, but if they did, the markets would plunge. Not only were they wrong about the events but they were also wrong about the market's reaction to events. The markets soared.

When it comes to so-called market timing there are only two sorts of people: those who can't do it, and those who know they can't do it. It's safer and more profitable to be in the latter camp.

# *In order to finish first*

GLOBAL FINANCE MAURITIUS, AUGUST 2020

**T**HE economist J. K. Galbraith once said, ‘The only function of economic forecasting is to make astrology look respectable.’ His views are clearly not shared by or even familiar to the people whom I have encountered opining about whether the recovery from the Covid-19 pandemic and the associated economic shutdown will be a recovery which is shaped like a V, a U, a W, a bathtub or the Nike swoosh.

The pandemic has also led to people voicing a number of assumptions, many of them erroneous or at least questionable:

1. The statement “When there is a vaccine” should perhaps be “If there is ever a vaccine”. After all, there isn’t a vaccine for other viral infections such as the common cold and HIV.
2. The question “When do you think things will get back to normal?” What makes the questioners think that the state of affairs which existed before the pandemic was normal? Maybe long-distance tourism and commuting to work weren’t normal.
3. “This is an unprecedented situation”. Most people by now have heard of the Spanish Flu of 1918–19 (which originated in Kansas by the way), but here is a list of pandemics from the past 130 years:

| Recent pandemics | Date      | Estimated death toll |
|------------------|-----------|----------------------|
| Russian Flu      | 1889–90   | 1m                   |
| Third Plague     | 1894–1922 | 12m                  |
| Spanish Flu      | 1918–19   | 50m                  |
| Asian Flu        | 1957–58   | 2–5m                 |
| Hong Kong Flu    | 1968–69   | 1–4m                 |
| Swine Flu        | 2009–10   | 0.5m                 |

The Covid-19 pandemic is far from unprecedented.



4. Many of the people who have now heard of the Spanish Flu regard this as the greatest pandemic of all time. How about the Plague of Justinian (a Byzantine Emperor) which started in 541AD or the Black Death which started in 1331AD (and which coincidentally originated in China)? Both killed an estimated 40% of the affected population.
5. Will there be a second wave as there was with the Spanish Flu? We do not know if Covid-19 is seasonal and less contagious in warm weather and will reassert itself when the northern winter returns. The rally in the MSCI World Index from its low in March may prove to be premature, particularly if there is a second wave and lockdown.

### **What we can safely say about Covid-19**

This market reaction probably indicates two things. One is the sheer size of the fiscal and monetary stimulus from government spending on “furloughing” and healthcare, and quantitative easing – “printing” (electronically, of course) money to buy assets. It’s easier to stimulate asset prices than it is to stimulate an economy.

The other is that the lockdown is a supply-side shock. The fall in economic activity has been caused not by a fall in demand but because governments shut down economic activity which was deemed non-essential. Because the physical assets are still there, it may be tempting to assume that these businesses can just reopen when allowed and there will be a sharp recovery as demand is unaffected. But for many of them the lockdown may have exposed their fragility, leading to a wave of bankruptcies and a fall in demand as furloughs morph into longer-term unemployment. But even if this is true it may not help in predicting a market retrenchment. The only type of market which ends in a recession is a bear market – markets are forward-looking discounting mechanisms.

But with all these examples of pandemics in the recent and distant past, surely we should be able to draw some conclusions about some likely outcomes of Covid-19? Looking back, it seems that crises, including pandemics, accelerate some existing economic trends. One example is the assembly line for mass production. It existed before the Spanish Flu – the

Ford Model T was placed on an assembly line in 1913 – but the reduction in the workforce caused by the death rate in the pandemic may have accelerated its adoption.

What trends in society are likely to be accelerated by the reaction to Covid-19? Here are some:

- working from home (WFH) and remote working
- e-commerce
- digital payments
- food delivery
- home cooking
- social media
- tele medicine
- online schooling
- pets
- automation.

### **The perils of greater “efficiency”**

Of course, it's not all good news. Some previous trends will be slowed or derailed by the Covid-19 pandemic. Air travel is an obvious victim and discount air travel especially so. The hospitality industry will struggle. Most restaurants were barely viable before social distancing cut their number of covers. The real estate business providing offices or shopping malls is obviously challenged. Businesses which have become more “efficient” may now need to retrench. Manufacturers in sectors ranging from fast fashion to the motor industry who have relied upon global supply chains for “just in time” supply of goods and components may now need to shorten those supply lines and hold stock “just in case”. The result may well be higher stocks and costs, and lower returns. Those who became financially more efficient may also suffer. The five largest US airlines are surely regretting buying back \$47bn of their shares over the past decade given estimates that maybe not coincidentally they need \$50bn to survive.

As Rick Mears, the driver who has won the Indianapolis 500 race four times, said: 'In order to finish first you must first finish.' There is no point in driving so fast that you crash, as those companies who listened to the siren song of the investment bankers and geared up to buy back stock and become "efficient" may discover.

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 **Harriman  
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Hh

# TERRY SMITH

Foreword by  
LIONEL  
BARBER

Founder, CEO and CIO of **Fundsmith**

## INVESTING *for* GROWTH

How to **make money** by only buying the

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An **ANTHOLOGY** of  
investment writing

