

Theme: Quality

JANUARY 2025

Overview

The concept of investing in Quality is a simple one: buy good quality companies that earn high margins, have sensible balance sheets and let the returns from the underlying businesses compound over time.

Of course, each investor's definition of 'quality' can be slightly different. One investor we have followed since launch in 2010 is Terry Smith, who manages the Fundsmith Equity Fund.

"In the long run, it is the quality of the business that you invest in which determines your returns. Our strategy is not about trying to time the market; it's about time in the market with quality companies", Terry Smith

We previously enjoyed strong returns from Fundsmith's portfolio of high-quality, global companies. We sold our holding in 2022 after a period of strong returns. Since then, Quality as a style has underperformed the broader market in the face of the strong growth but higher risk AI euphoria. This presented us a wonderful opportunity to buy back into the fund in November 2024.

Another part of the reason for Quality lagging the broader market has been the inexorable rise of passive investing. Broadly speaking, actively managed funds have underperformed cheap market-weighted ETFs, net of fees. As a result, investors have shifted their capital to passive funds at an accelerating rate. Bentley Reid has been part of this shift. Today, we invest the majority of your capital in low cost vehicles replicating indices, sectors and themes we deem attractive.

However, the stampede into passive investing also throws up opportunities to invest with top-notch active managers when their style is out of favour. Active managers can outperform following periods of intense criticism and, ironically, when investors have given up. Similarly, the 'quality' style of investing can once again prove its value after an unusually prolonged period of underperformance.

The theme can be summarised as follows:

What?

Quality global equities

Why?

The quality of a business you invest in determines your returns over the long run. In the short run, the market has offered a compelling entry point

How?

Fundsmith Global Equity fund, a portfolio of 20-30 quality companies managed by Terry Smith and Julian Robins

Holding Period?

3yrs+

A more detailed explanation of why investing in Quality equities (which we refer to simply as 'Quality' below) offers a compelling investment opportunity now follows:

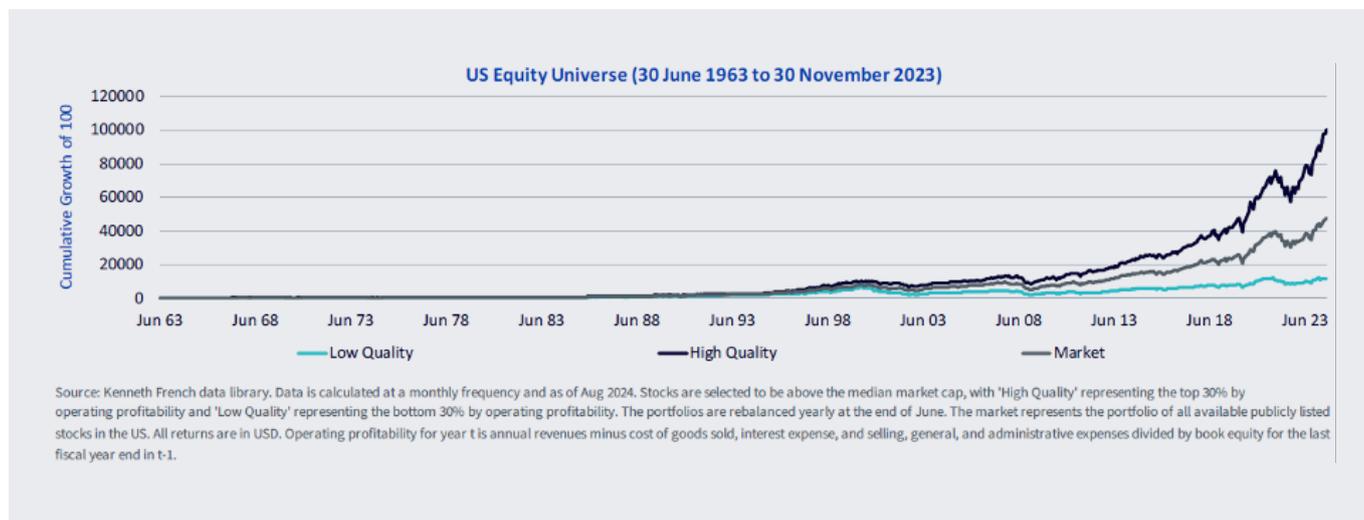
What is Quality investing?

"It's far better to buy wonderful companies at a fair price than fair companies at a wonderful price", Warren Buffett

Quality investing is:

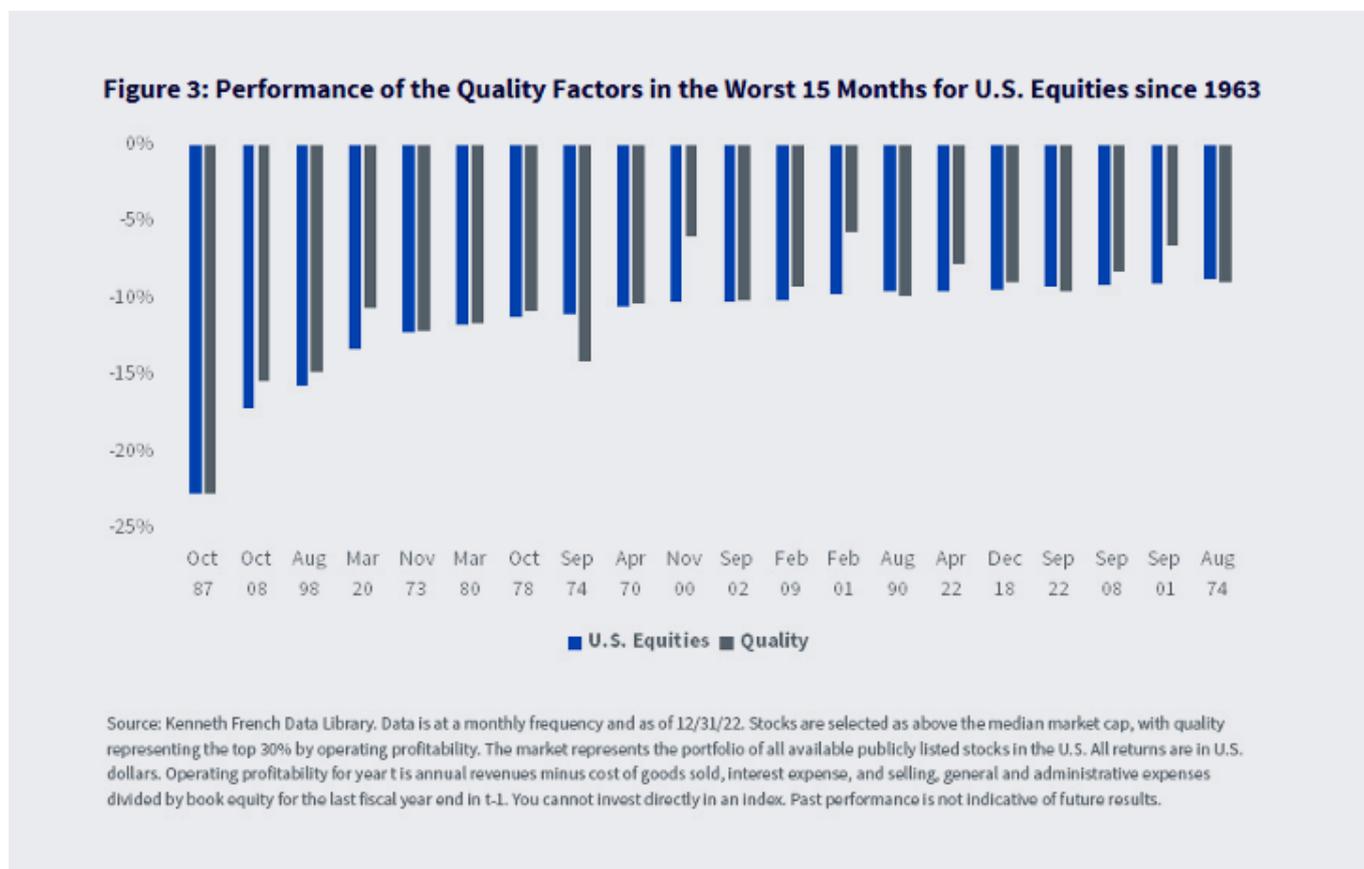
- **Focused on Sustainable Competitive Advantages:** Quality investing prioritises companies with unique strengths that protect them from competition, such as strong brands, valuable patents or low-cost production. This is often referred to as their "competitive moat".
- **Emphasises Long-Term Growth:** This approach focuses on companies with consistent earnings growth, strong cash flow generation and the potential for long-term value creation.
- **Patient and Disciplined Approach:** Quality investors are patient and avoid short-term market fluctuations. The focus is on building a portfolio of high-quality companies, and holding them for the long term

Over the long term, the key to a successful investment is to capture more upside than downside. High quality stocks have historically outperformed the market and exhibited lower volatility:



The Kenneth French library disaggregates the returns of high and low quality businesses using an operating profit filter. 'High quality' stocks are represented by the top 30% of companies by operating profitability, 'Low quality' by the bottom 30%. High quality has outperformed low quality, as measured by returns and volatility, especially during the worst periods for equities:

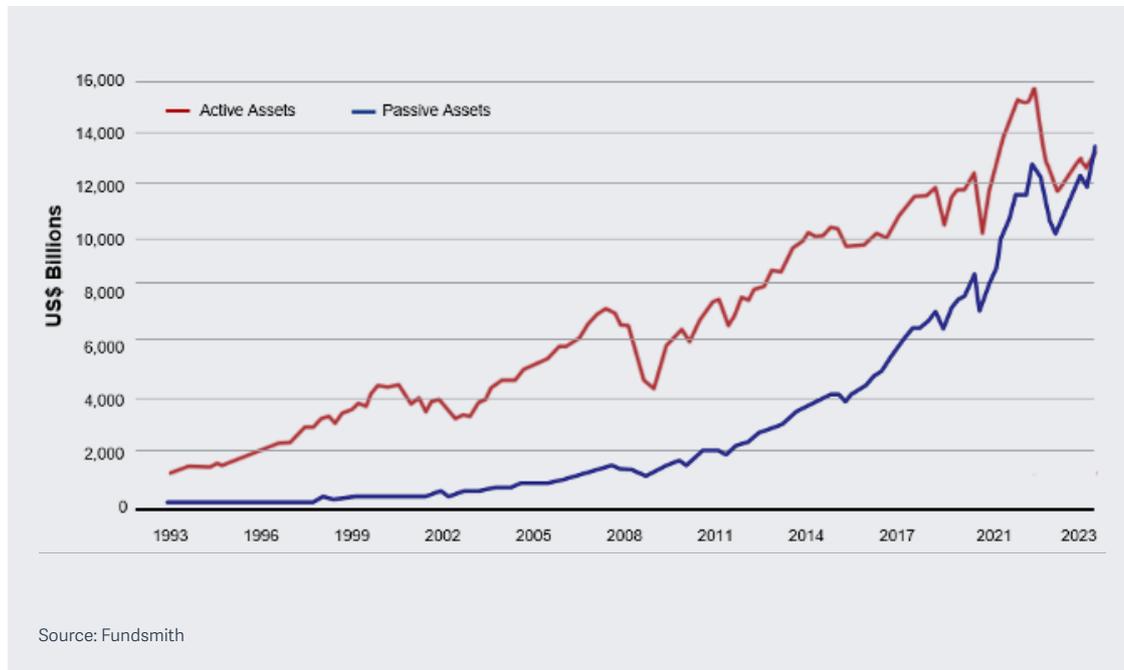
	Low Quality	High Quality	Market
Annualised Return	8.1%	12.0%	10.6%
Volatility	17.8%	15.2%	15.5%



Rise of Passive, Demise of Active

“Active management is a zero-sum game before cost, and the winners have to win at the expense of the losers”, David Fama

In 2022, the Financial Times reported that passive fund ownership of US stocks overtook active for the first time. By late 2023, the amount of capital invested passively exceeded that held in active funds for the first time:



Passive investments follow a simple, singular rule. Equity-tracking funds allocate capital according to the market capitalisation of the index constituents. The bigger the company (e.g. Apple), the greater the size in the fund. For bond-tracking funds (to simplify), the hungrier the borrower, the greater the lend (size within the index).

Active management employs many objective and subjective ‘rules’ to build and maintain portfolios. ‘Doing nothing’ is difficult for those paid to ‘do something’. Management fees and dealing costs all pose a headwind to returns net of fees. Passive funds are more often than not cheaper.

The recent outperformance of a small number of large US Tech companies (known as the ‘Magnificent 7’: Apple, Nvidia, Microsoft, Tesla, Alphabet, Amazon and Meta), is intrinsically linked to the growing popularity of passive funds. For active strategies, this dynamic has led to a vicious cycle; underperformance has led to outflows and a forced selling of smaller cap holdings:

Stockpicking funds suffer record \$450bn of outflows

Shift into passive strategies and ETFs has accelerated as performance of pricier mutual funds lags behind benchmarks

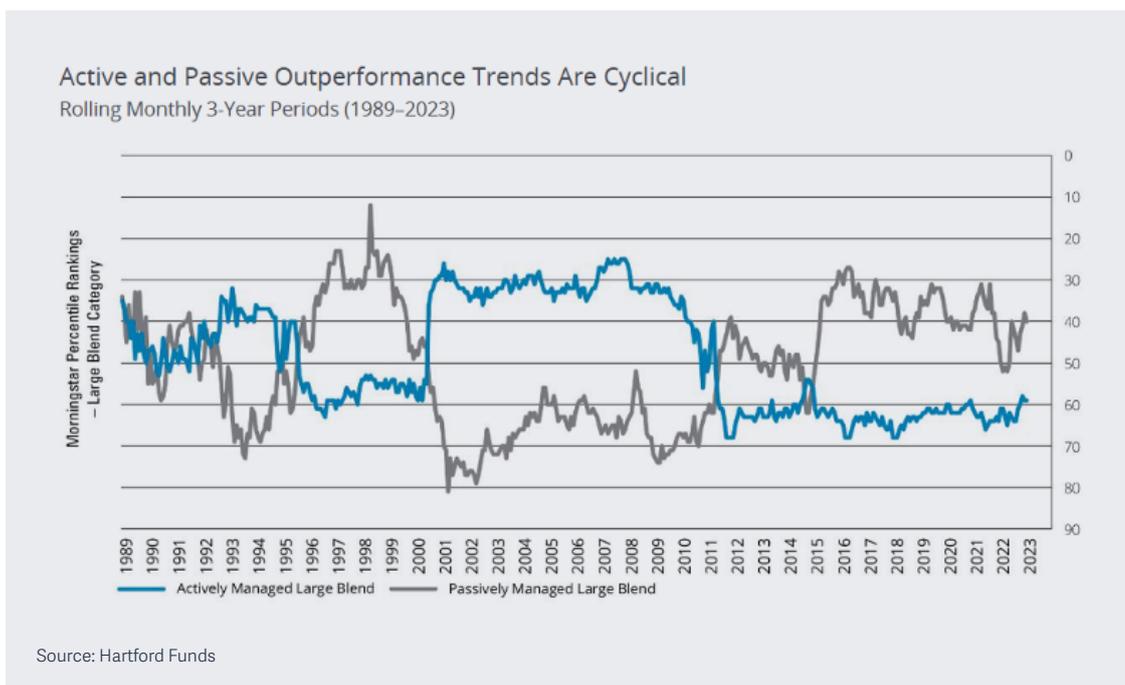
Source: FT.com

Passive investors now face a concentration conundrum: markets are now heavily skewed towards a small handful of stocks. Any plateauing in this trend will ease the headwind faced by active managers. Any reversal in this trend would radically lower the bar to outperform:



Though recent years have been poor for active managers, their underperformance is not outside a historically observed range. The leadership of passives versus actives is cyclical.

The rolling 3-year return of active vs passive funds showed a similar degree of underperformance in the 1990s, culminating in the 'Dot Com' passive bubble in 1998/1999. A decade of outperformance by active funds followed:



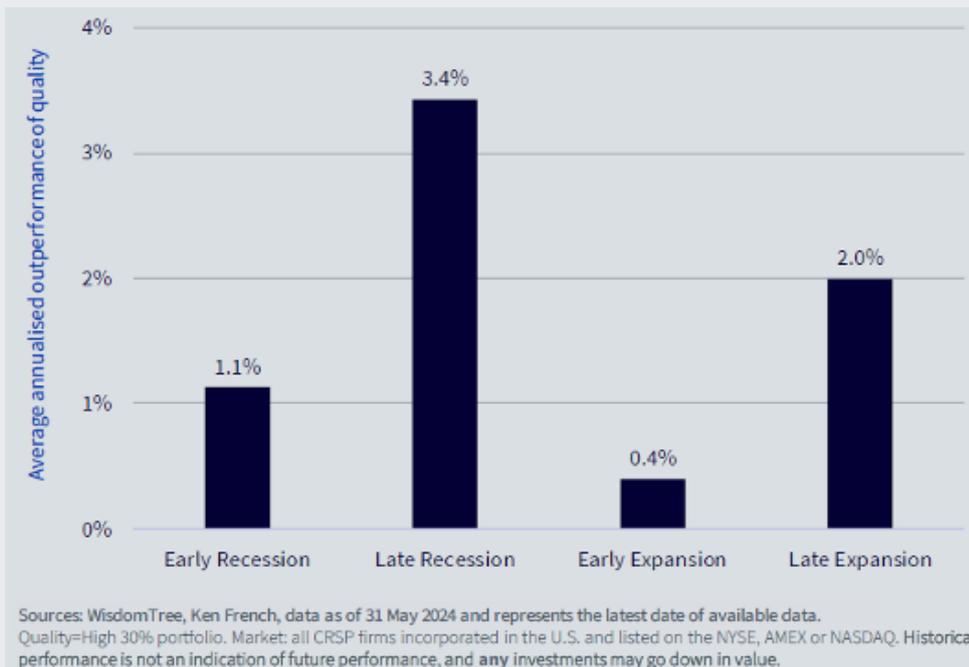
Just when it seems that active or passive has permanently pulled ahead, markets change, performance trends reverse and the futility in declaring a “winner” in the active vs passive debate is revealed anew:

Active fund managers face extinction as investors turn more passive

A record \$450 billion was pulled out of active funds last year as investors balked at their steep charges

Source: The Times

Quality companies perform well across the business cycle, but most strongly during the latter stages of a recession. US economic data from the National Bureau of Economic Research since 1964 highlights this defensive characteristic:



Source: Wisdomtree

Fundsmith Equity Fund

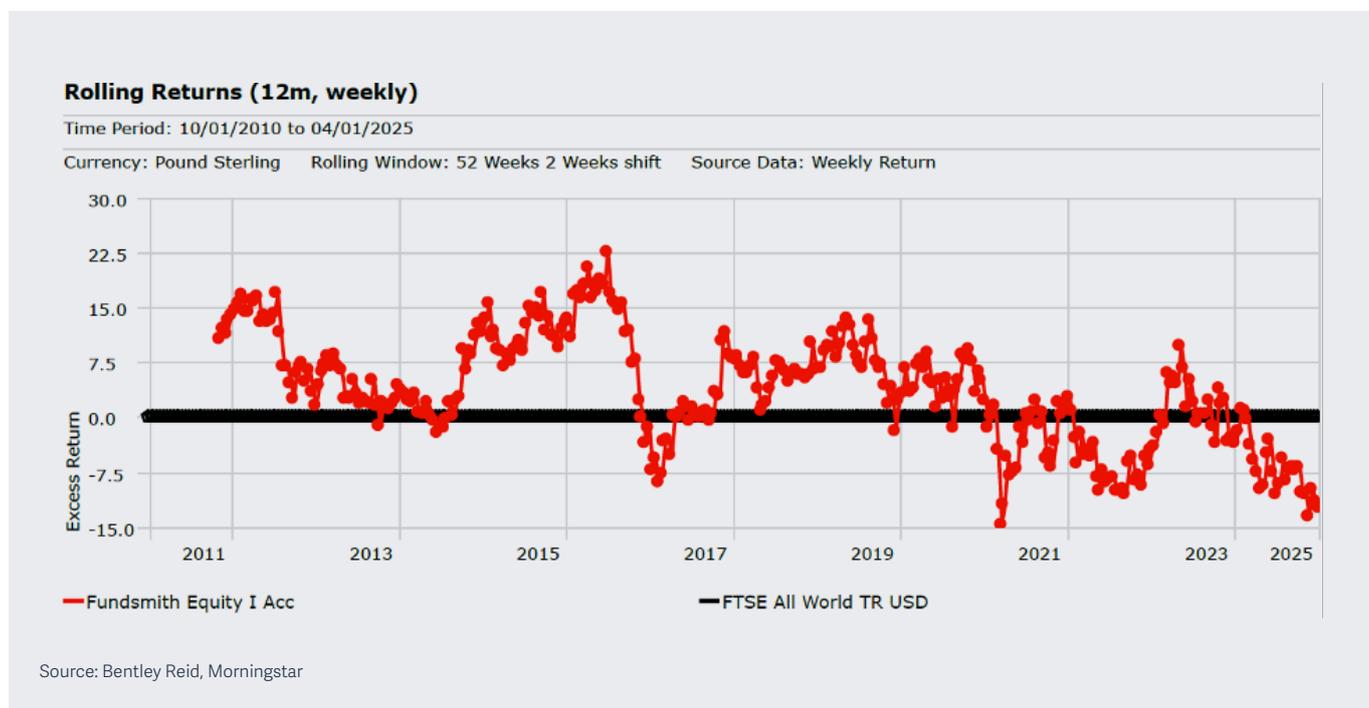
Fundsmith applies a three-step investment strategy:

“Buy good companies, Don't overpay, Do nothing”, Terry Smith

It is rare to find a fund manager who is willing and able to ‘do nothing’. Terry Smith is abnormally devoted to the ‘do nothing’ mantra. As the former CEO of Tullett Prebon, the world’s second largest inter-dealer broker, he understands the spoils from trading accrue to intermediaries (not the investor). Fundsmith has demonstrated a consistent record of low portfolio turnover and costs: just 3.2% in 2024.

However, ‘doing nothing’ leaves a strategy vulnerable to the myopic whims of the market and short-termism. The valuation of the portfolio ebbs and flows with sentiment. This offers investors attractive entry and exits points.

We measure the relative attraction (or lack thereof) of Fundsmith, and Quality investing, via a ‘rolling alpha’ analysis of Fundsmith’s performance relative to the FTSE All World. The chart below illustrates the rolling 12-month performance of Fundsmith (red line) versus the All World index:



At the time of our investment in November 2024, Fundsmith had lagged the All World by 12% over the prior 12-months, leaving Fundsmith at a low since inception versus its benchmark. We deemed this an attractive entry point, with an above average chance of outperformance from such depressed levels. Fundsmith has proven itself a good active manager over a long time-frame. Since inception, it leads the All World index by 3.15% per annum net of fees:



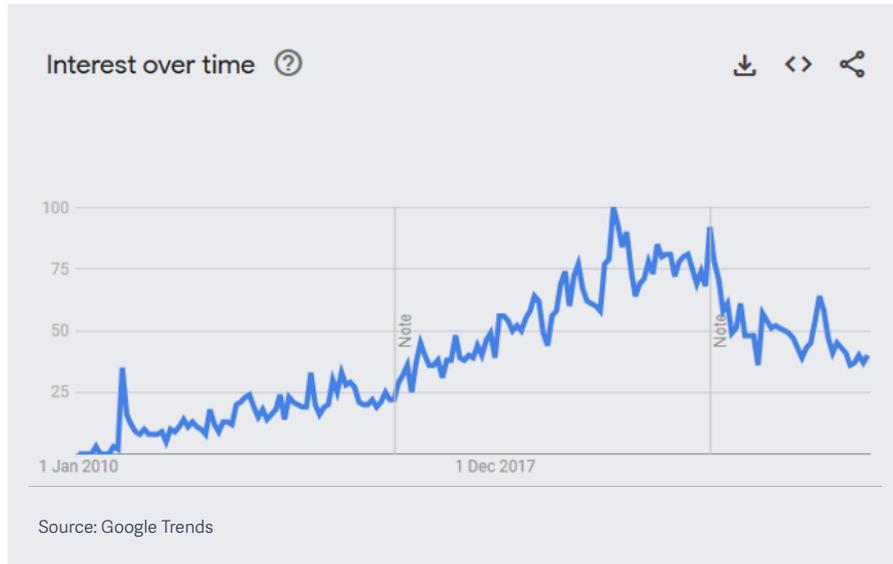
Source: Bloomberg

Fundsmith also leads the Global Equity peer group by an enormous margin since inception (to end December 2024): 607% vs 253%. However, short-term performance has lagged peers for all periods less than 3 years:

Key	Instrument	YTD	1M	3M	6M	1Y	3Y	5Y	10Y	From inception
A	Fundsmith Equity Fund T Acc ⁵	8.9	-1.6	1.6	-0.4	8.9	5.5	52.3	253.7	607.3
B	Sector: IA Global (GBP) ⁶	12.9	-1.8	3.6	3.8	12.9	12.8	52.2	154.0	252.9

Source: Fundsmith

Most investors choose to invest in funds when the going is good, attracted by strong returns and the positive coverage it brings. In 2020/21, investors were Googling for (then investing in) Fundsmith like never before (or since):



When we were sellers of Fundsmith in 2022, the Financial Times was asking:



The answer unequivocally arrived soon after. The success of Fundsmith attracted the attention of the regulator (stung into action by the Woodford debacle). Terry also endured a public divorce and fund performance waned, leading to investors redeeming despite excellent long-term results:

Terry Smith's fund business asked by Financial Conduct Authority to undertake review of its operations

Terry Smith to close emerging markets investment trust
One of UK's best-known fund managers says performance 'fallen below our expectations'

Robin Powell: Why 'star' stock-picker Terry Smith is losing to the index

Terry Smith's flagship fund on track to end 2024 with second-worst year for outflows
Investors have pulled £1.8bn from the Fundsmith Equity fund this year, already surpassing outflows achieved for the whole of 2023

Fundsmith Equity plummets down most bought list as passives dominate

Terry Smith's Breakup Fuels Spat Over \$1 Million in Mauritius
The fund manager, popular with retail investors, is in a long-running dispute with his former partner

Fund manager Terry Smith blames central banks for poor performance
One of the UK's best known stockpickers says end of 'easy money' hurt flagship fund

Source: Reuters, FT, Telegraph, Daily Mail, The Times

The Fundsmith Portfolio

“The best protection against inflation is not gold or commodities, but companies with pricing power and the ability to pass on cost increases”, Terry Smith

Bentley Reid has excellent access to Terry Smith and Julian Robins, courtesy of our long relationship. We receive timely portfolio data. Major holdings include Mag 7 cohorts Microsoft, Meta & Alphabet (Tesla, Nvidia, Apple and Amazon are not held) and out-of-favour defensive Consumer Brands, such as L’Oreal, Philip Morris and Unilever.

Fundsmith Equity Portfolio	%	30-Sep-24	%
MICROSOFT	8.92	PEPSICO	3.08
META PLATFORMS	8.52	AMADEUS	3.03
NOVO NORDISK	7.93	METTLER TOLEDO	2.52
L'OREAL	6.12	COLOPLAST	2.45
STRYKER	5.70	PROCTER & GAMBLE	2.27
VISA	4.54	CHURCH + DWIGHT	2.01
AUTOMATIC DATA PROCESSING	4.47	OTIS	1.92
PHILIP MORRIS INTERNATIONAL	4.46	FORTINET	1.91
IDEXX	4.07	NIKE	1.74
LVMH	3.92	BROWN FORMAN	1.58
WATERS	3.80	APPLE	1.09
UNILEVER	3.42	TEXAS INSTRUMENTS	1.01
ALPHABET	3.34	ATLAS COPCO	0.77
MARRIOTT	3.17	MCCORMICK	0.51
CASH	1.76	TOTAL	100%

Source: Fundsmith

The portfolio has a long-held bias to the US, avoids Emerging Markets entirely and rarely invests in the UK or Japan. It avoids low quality cyclical industries, such as Resources and Banks. Healthcare and Consumer Staples (e.g. toothpaste, soap, nappies, etc.) account for half the portfolio, providing defensive ballast when times are tough.

Geographic Split

As at 31 Dec 2024, by Country of Listing	%
US	74.2
France	8.9
Denmark	8.8
UK	3.4
Spain	3.3
Sweden	0.8
Cash	0.7

Source: Fundsmith

Sector Split

As at 31 Dec 2024, GICS® Categories	%
Health Care	25.7
Consumer Staples	22.2
Communication Services	13.8
Information Technology	12.6
Consumer Discretionary	12.6
Industrials	7.5
Financials	4.8
Cash	0.7

Fundsmith describe quality through four metrics: return on capital employed (ROCE), profit margins, cash conversion and (debt) interest coverage. All are superior to the US and UK market (two right hand columns). Hence, the portfolio often trades at a premium.

Year ended	Fundsmith Equity Fund Portfolio								S&P 500	FTSE 100
	2017	2018	2019	2020	2021	2022	2023	2024	2024	2024
ROCE	28%	29%	29%	25%	28%	32%	32%	32%	16%	17%
Gross Margin	63%	65%	66%	65%	64%	64%	63%	64%	45%	42%
Operating Margin	26%	28%	27%	23%	26%	28%	29%	30%	16%	15%
Cash Conversion	102%	95%	97%	101%	95%	88%	91%	85%	85%	90%
Interest Cover	17x	17x	16x	16x	23x	20x	20x	27x	9x	9x

Source: Fundsmith LLP/Bloomberg.

ROCE (Return on Capital Employed), Gross Margin, Operating 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. Interest Cover is median.

2017–2019 ratios are based on last reported fiscal year accounts as of 31st December and for 2020–24 are Trailing Twelve Months and as defined by Bloomberg.

Cash Conversion compares Free Cash Flow per Share with Net Income per Share.

Source: Fundsmith

Despite taking over the moniker as ‘largest equity fund in the UK’ from Neil Woodford, Terry Smith does not have the same liquidity concerns that brought about Woodford’s collapse. His portfolio holds some of the largest and most traded liquid companies on the planet e.g. Microsoft, Visa, Novo Nordisk, etc.

DISCLAIMER

Published and distributed by **Bentley Reid & Co (UK) Limited**

29 Queen Anne's Gate, London SW1H 9BU, England
Tel +44 (0) 20 7222 8081, Fax +44 (0) 20 7227 8440, Email info@bentleyreid.com

Authorized and regulated by the Financial Conduct Authority (FRN 572096), registered office 29 Queen Anne's Gate, London SW1H 9BU. Registered Number 07602886

The content of this document is for information purposes only. The authors believe that, at the time of publication (December 2024), the views expressed and opinions given are correct but cannot guarantee this and readers intending to take action based upon the content of this document should first consult with the professional who advises them on their financial affairs. Any companies cited in this report are used to support the view of the authors, and should not be construed as recommendations to purchase or sell the underlying securities. Neither the publisher nor any of its subsidiaries or connected parties accepts responsibility of any direct or indirect or consequential loss suffered by a reader or any related person as a result of any action taken, or not taken in reliance upon the content of this document. The past is not necessarily a guide to future performance. The value of investments can go down as well as up and your capital is at risk.