

Quality Equity Theme Update

Q4 2025

In a Nutshell

The year the market turned upside down; the lower the quality, the higher the returns

Summary

The patience of ‘Quality’ investors was severely tested in 2025, a year where the lowest quality companies enjoyed the highest returns. This bifurcation was exacerbated by a mass exodus from active funds, with record outflows of \$680bn driving a vicious cycle of forced selling that paid no heed to underlying quality or price.

Despite its poor performance, the underlying engine of Fundsmith’s portfolio remains robust. The portfolio’s free cash flow (FCF) grew +16% in 2025, and return on capital remains far higher than the market. Valuations have become highly attractive: the portfolio’s weighted-average FCF yield ended the year at 3.7%, a +32% premium to the S&P 500’s (2.8%).

Fundsmith has leaned further into this disconnect. The allocation to defensive sectors has increased to 50.7%, targeting companies trading at historic discounts. While the “gravity” of earnings growth has yet to reassert itself on share prices, history suggests such extreme deviations are temporary. The portfolio is of higher quality and on a lower valuation than the market, awaiting the inevitable reversion.

Market Developments

Quality stocks were left behind like never before in 2025. The weaker the quality, the higher the returns while those companies with the strongest fundamentals (such as those with high recurring revenues and return on equity) posted the worst returns.

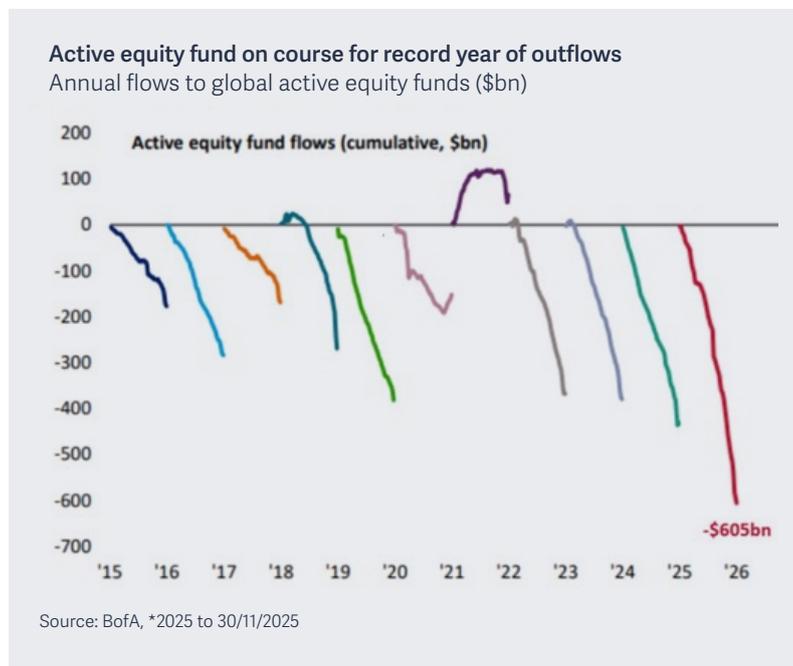


In the long run equity returns are closely correlated to earnings per share growth. In the short run, this relationship can break down, offering good entry points to high-quality companies

Given this backdrop, it is little surprise that 2025 proved a tough year for Fundsmith, where a +0.9% return lagged its MSCI World benchmark by -12.3%. Fundsmith was far from the only one; Morgan Stanley Global Brands, a popular franchise with assets in excess of \$20bn, fell -7.6% during the year.

2025 saw the stampede out of active equity funds (into index-tracking ETFs) step-up a gear, with outflows hitting \$680bn. Active strategies are in the midst of a vicious cycle of underperformance, causing outflows and the forced selling of out-of-favour holdings (irrespective of quality or price).

While Fundsmith has suffered, the strategy’s bias toward liquid, large cap companies is reassuring and serves to reduce fund and firm risk relative to less liquid, smaller rivals. When the returns from quality businesses and active strategies turns brighter, we expect Fundsmith to have survived these dark times better than most and to prosper.



Investors withdraw \$680 billion from global active equity funds in 2025, surpassing the previous record set in 2024. It also marks the 10th annual outflow in the past 11 years

Valuation

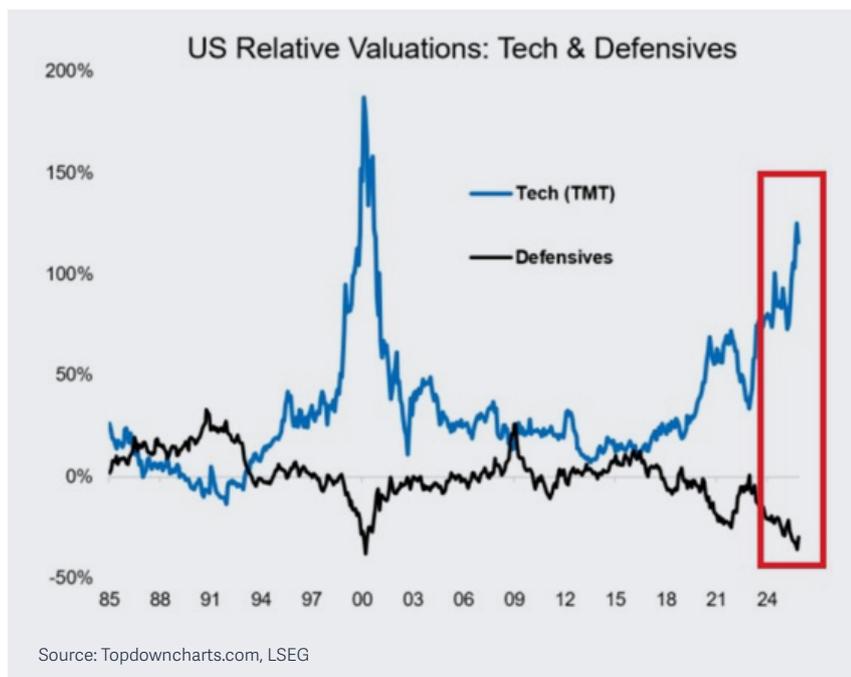
Within the Fundsmith portfolio, return on capital, gross margins and operating profit margins remained high and steady in 2025. The portfolio remains of far higher quality than the market. Terry Smith’s favoured valuation metric improved significantly through 2025. The portfolio’s weighted average FCF yield (FCFY) ended 2025 at 3.7%, up from 3.1% 12 months earlier. It is now superior to both the MSCI World (3.1%) and S&P 500 (2.8%).

Year ended	Fundsmith Equity Fund Portfolio								S&P 500	FTSE 100
	2018	2019	2020	2021	2022	2023	2024	2025	2025	2025
ROCE	29%	29%	25%	28%	32%	32%	32%	31%	17%	17%
Gross Margin	65%	66%	65%	64%	64%	63%	64%	62%	45%	43%
Operating Margin	28%	27%	23%	26%	28%	29%	30%	28%	18%	17%
Cash Conversion	95%	97%	101%	95%	88%	91%	85%	94%	89%	99%
Interest Cover	17x	16x	16x	23x	20x	20x	27x	29x	9x	8x

The quality of Fundsmith’s portfolio is higher than ever and free cash flow is growing at a faster pace than the portfolio’s historic average

Source: Fundsmith

Fundsmith’s allocation to defensives (Healthcare and Consumer Staples) increased again in Q4 (to 50.7%). Defensives’ consistent earnings coupled with their declining share of equity indices, leaves them trading at their widest discount to the market in history.



Defensive sectors trade at a record discount to a World market re-rated via the outperformance of cyclicals (led by Tech and Financials)

In Q4, new holdings were initiated in Wolters Kluwer (software for professional services) and Magnum Ice Cream (received after its spin out from existing holding, Unilever).

COMPANY	%	COMPANY	%
WATERS	5.9	PROCTER & GAMBLE	2.6
STRYKER	5.7	CHURCH + DWIGHT	2.4
IDEXX	5.6	COLOPLAST	2.3
VISA	5.4	FORTINET	2.2
MARRIOTT	5.4	ZOETIS	2.1
L'OREAL	5.4	ATLAS COPCO	2.1
LVMH	5.0	TEXAS INSTRUMENTS	2.0
UNILEVER	4.8	INTUIT	1.8
ALPHABET	4.7	NIKE	1.6
AUTOMATIC DATA PROCESSING	4.7	ESSILORLUXOTTICA	1.5
PHILIP MORRIS INTERNATIONAL	4.4	OTIS	1.3
AMADEUS	4.4	MAGNUM ICE CREAM COMPANY	0.3
MICROSOFT	4.4	WOLTERS KLUWER	0.1
NOVO NORDISK	4.1	CASH	0.0
META PLATFORMS	4.0	TOTAL	100.0
METTLER TOLEDO	3.5		

Source: Fundsmith

The Fundsmith portfolio as at 31 December 2025 (defensive holdings in Healthcare & Staples are highlighted)

Performance

The fourth quarter proved the best of a bad bunch in 2025 as Fundsmith once again trailed the FTSE All World index but did so by only -0.3%. This rounds off a poor year for the strategy, as its +0.9% return lagged its MSCI World benchmark by -12.3% and most major asset classes, including cash.

Novo Nordisk proved the most damaging holding over the past 12 months as the formerly largest company in Europe suffered a -44% share price collapse. Other 2025 losers included Automatic Data Processing (payroll software) and Church & Dwight (Consumer Staples). In his 2025 annual letter, Terry Smith shared his unvarnished views on Novo:

“One of our mantras has been that we should always invest in businesses which could be run by an idiot so that performance is not heavily reliant upon management.

We have been made painfully aware that the range of businesses which can be run by an idiot is much more limited than we thought and hereafter we will aim to be more aware of the impact that poor management can have. Our experience suggests that when we encounter poor management, engagement to change it is less effective than selling the shares”.

Stock	Attribution
Novo Nordisk	-3.0
Automatic Data Processing	-0.9
Church & Dwight	-0.7
Coloplast	-0.7
Fortinet	-0.7

Source: Fundsmith

Novo Nordisk was Fundsmith’s worst performing holding in 2025, contributing -3.0% to performance

The best performing holdings for Fundsmith in 2025 were Alphabet (Google), IDEXX (veterinary products) and Philip Morris (tobacco).

Stock	Attribution
Alphabet	+2.6
IDEXX	+2.3
Philip Morris	+1.5
Meta Platforms	+1.1
Microsoft	+1.0

Source: Fundsmith

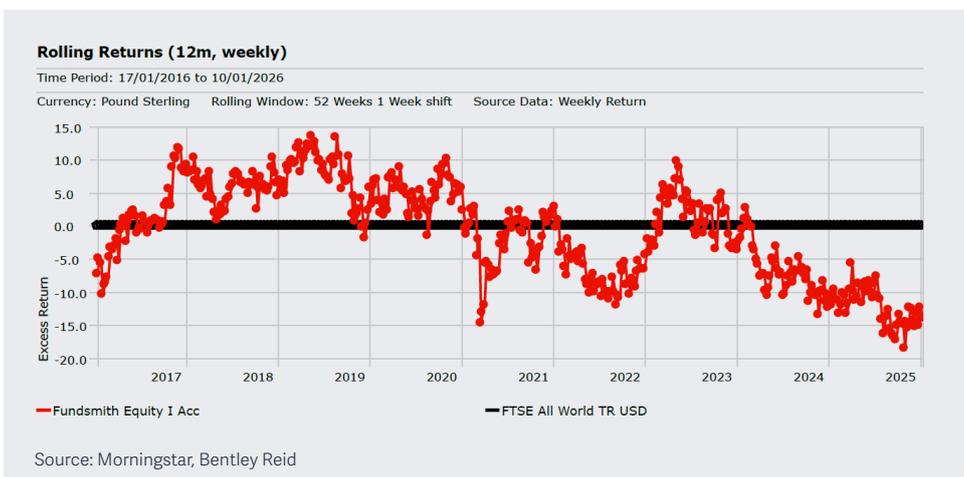
The contributors to 2025 performance were led by Alphabet, driven by enthusiasm for its AI and semiconductor advances

Positioning

We access the Quality theme via the Fundsmith Equity fund managed by Terry Smith. The fund invests in 29 companies in North America, Europe and the UK. Top holdings include Waters, Stryker and IDEXX (as at 31st December 2025).

The fund’s long term track record is excellent. Since launch in November 2010, its 613% return leads the MSCI World by 145.3%. Recent performance has been poor, prompting outflows in favour of index-tracking funds. Since we reinvested with Fundsmith in November 2024, its +0.3% (£) return (to end 2025) has been disappointing, lagging the FTSE All World by -14.5%.

One measure of Fundsmith’s attraction is its rolling performance relative to its benchmark. Fundsmith’s future looks brighter than a poor recent past.



From a contrarian standpoint, the outlook for Fundsmith versus the FTSE All World looks very positive

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