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Quality | Theme Update

Q2 2026

In a Nutshell

Out with the old, in with the new

Summary

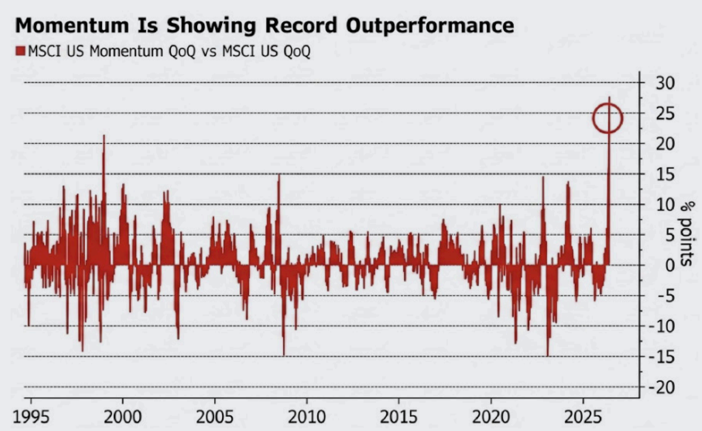
If the first quarter of 2026 went from bad to worse for Fundsmith and many of its quality-investing peers, the second quarter (Q2) inflicted the pain that triggered a classic late-cycle capitulation. Abandoning a signature 'do nothing' mantra, Terry Smith executed a wholesale rotation of over half the portfolio by purging chronic underperformers to chase high-momentum winners.

Only time will tell whether this move is in the best interests of investors. Such profound style drift sadly necessitates that we 'do something' in response. Consequently, we have redeemed our holding in Fundsmith and reallocated the capital to the iShares Edge MSCI World Quality Factor ETF (Quality ETF). This switch preserves our thematic allocation to high-quality compounders while replacing manager risk with a low-turnover, low-cost, and systematic quality-screening process.

Ultimately, the case for holding fast to underperforming quality compounders is illuminated by Terry's own admission of commercial pressure overriding long-term investment philosophy. In capitulating to passive flows, Terry concedes that buying quality now feels like "trying to catch the proverbial falling knife" where "all we are getting is cut fingers". When everyone has given up trying to catch a falling knife, the knife usually stops falling.

Market Developments

Q2 was defined by a violent factor dispersion that pushed global equity market structure to its most extreme state since the dot-com era over 25 years ago. Performance was entirely captured by a parabolic momentum trade, fuelled by Tech and Semiconductor names. Traditional, defensive compounders were left stranded at historically cheap valuations.

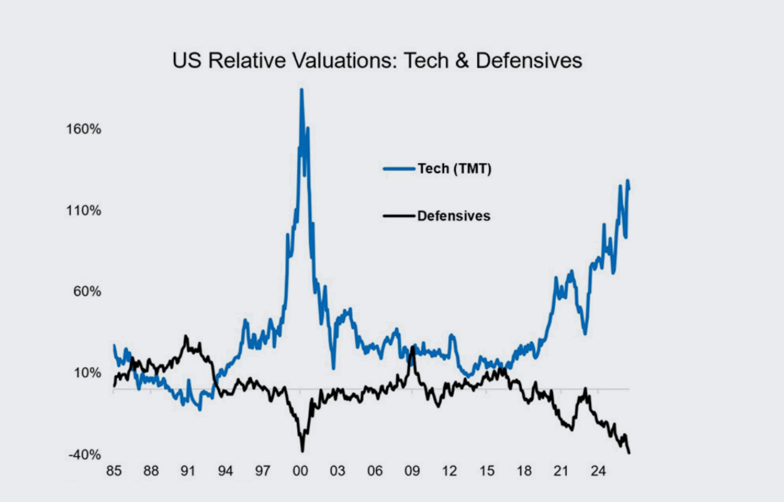


Source: Bloomberg

Momentum stocks have never outperformed like this before. Conversely, defensive quality has rarely performed so poorly

This severe divergence created a brutal backdrop for active managers who anchor their processes in fundamental valuation discipline. The absolute domination of momentum proved an irresistible force for Fundsmith, as it ultimately extracted a style capitulation as the quarter reached its climax.

Fundsmith's rotation from defensives to cyclicals (including Semiconductor behemoth TSMC) comes amidst the record undervaluation of (and index representation of) defensive sectors.



Source: TopDownCharts.com

Fundsmith's rotation from defensives to cyclicals has occurred at an extreme valuation differential in favour of the Healthcare, Staples and Utilities sectors

Memory has been one of the strongest legs of the Semiconductor trade, where Samsung, Micron and Hynix are key players and massive outperformers (to the benefit of index-trackers).

However, it is often said that the 'the cure for high prices is high prices'. Toward the end of Q2, Apple succumbed to enormous memory price inflation by raising prices across its major products.


Apple raises prices of MacBooks, iPads as memory costs skyrocket

By **Stephen Nellis** and **Aditya Soni**

June 25, 2026 1:42 PM GMT+1 · Updated June 26, 2026

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Source: Reuters

Apple's news led to a ferocious rotation that saw Healthcare post a record weekly return into the close of Q2. Signs of momentum's exhaustion have continued in Q3

Portfolio

In Q2 portfolio activity lifted to an unprecedented level, with turnover reaching 51.7%. Eleven new positions were initiated, led by (in terms of position size): TSMC (Semiconductors), Netflix (media content) and Uber (mobility and logistics network).

COMPANY	%	COMPANY	%
MARRIOTT	6.1	TEXAS INSTRUMENTS	3.0
WATERS	5.9	**NETFLIX**	**3.0**
STRYKER	5.7	**UBER**	**2.9**
L'OREAL	5.2	SAGE	2.8
AMADEUS	4.8	**MASTERCARD**	**2.8**
VISA	4.1	**GE VERNOVA**	2.6
PHILIP MORRIS INTERNATIONAL	3.8	**NEXTPOWER**	**1.7**
FORTINET	3.8	ATLAS COPCO	1.7
AUTOMATIC DATA PROCESSING	3.7	**TJX COMPANIES**	**1.5**
CHURCH + DWIGHT	3.7	**APPLOVIN**	**1.5**
ALPHABET	3.7	**VEEVA SYSTEMS**	**0.6**
META	3.6	**LEGRAND**	**0.5**
PROCTER + GAMBLE	3.5	**YUM! BRANDS**	**0.4**
MICROSOFT	3.5	WOLTERS KLUWER	0.3
IDEXX	3.4	COLOPLAST	0.1
TAIWAN SEMICONDUCTOR	**3.1**	CASH	7.0

Source: Fundsmith, 30/06/2026

The Fundsmith portfolio as of 30 June 2026. 11 new holdings added in Q2 are in **bold**

Many long-term holdings whose 'fundamentals had deteriorated alongside their share prices' were sold to make way, including LVMH (luxury), Unilever (staples) and Novo Nordisk (pharma)

This splurge of activity resulted in a meaningful change in the portfolio's regional and sector composition. While cash has temporarily increased (to 7%), we can expect this to be deployed in a manner that maintains this new composition.

Exposure to the US and cyclicals (Tech and Industrials) increases, funded from the UK, Europe and defensives (Healthcare and Staples, which decline to 31.9% from over 50% at the start of 2026).

	31.3.26	30.6.26
USA	69.80	77.50
UK	5.50	2.80
France	11.60	5.70
Sweden	2.50	1.70
Spain	4.50	4.80
Denmark	4.60	0.10
Netherlands	0.70	0.30
Cash	0.70	7.00

Consumer Staples	21.00	16.20
Healthcare	28.40	15.70
Information Technology	11.70	17.70
Consumer Discretionary	15.20	12.80
Industrials	8.90	13.50
Communication Services	8.80	10.20
Cash	0.70	7.00
Financials	5.30	6.80

Source: Fundsmith, 30/06/2026

The Fundsmith regional and sector exposures before and after its Q2 rotation out of European defensives into US cyclical momentum

Performance

Fundsmith rallied +10.8% in Q2 but again trailed the FTSE All World index, which surged +14.5%. This underperformance was a function of poor stock and sector selection.

As an example, an underweight exposure to the Tech sector (which soared by +34%) was exacerbated by the selection of Microsoft, which managed only a +1% gain.

The best performing holdings for Fundsmith in Q2 2026 were Fortinet (cyber security), Texas Instruments (Semiconductors) and Marriott (hotels).

Stock	Q2 Contribution (%)
Fortinet	2.80
Texas Instruments	1.70
Marriott	1.30
Alphabet	1.00
Philip Morris	0.70

Source: Fundsmith

Fortinet (+87% in Q2) was the leading contributor in Q2 as it reported explosive earnings growth from surging demand for its AI-focused security software

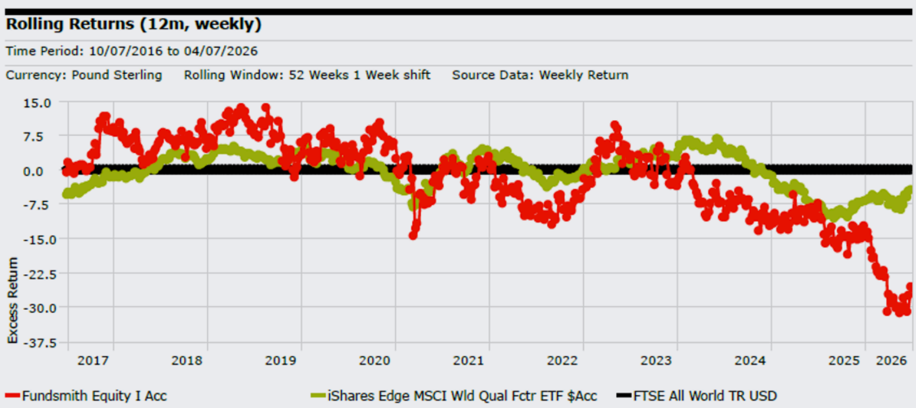
The worst performing holdings were LVMH (luxury), Zoetis (pet health) and IDEXX (pet health).

Stock	Q2 Contribution (%)
LVMH	-1.40
Zoetis	-1.10
IDEXX	-1.10
Microsoft	-1.00
Coloplast	-0.90

Source: Fundsmith

LVMH was the worst contributor in Q2. The company was sold in Q2 as Terry "can't see a recovery until China recovers, for which there's no recovery in sight"

One measure of Quality's attraction is the rolling performance of both Fundsmith and the Quality ETF relative to the All World. While questions remain over the consistency of this signal for Fundsmith (in the wake of their Q2 style shift into momentum), the future for both Quality-focused strategies looks brighter than their very poor recent past.



Source: Morningstar, Bentley Reid

From a contrarian standpoint, the outlook for the Quality ETF versus the All World looks positive

Positioning

Since mid-July, we now access the Quality theme via the iShares Edge MSCI World Quality ETF, the cheapest global Quality ETF (0.25% annual fee). The fund invests in 300 companies in North America, Europe, UK, and Japan. Top holdings include Microsoft, Apple and Nvidia (at 30 June 2026).

The Quality ETF tracks the MSCI World Sector Neutral Quality index, targeting developed-market large- and mid-cap equities that are screened for three fundamental quality metrics: high return on equity (ROE), low leverage, and stable earnings growth.

The Quality ETF portfolio offers superior valuation and quality metrics to those of Fundsmith (according to the latest underlying data via Bloomberg). As examples, the Quality ETF's 6.8x price-to-book ratio is a -20% discount to Fundsmith (8.5x) despite its higher ROE (28.6% vs 28.3%).

To ensure its factor bets are concentrated on Quality, the ETF maintains regional and sector weights that match the MSCI World index (selecting the highest-scoring companies within each area).

We recognise that the Quality ETF carries a larger exposure to the winners driving the momentum factor but concluded a switch was structurally justified. iShares' consistent methodology strips out capitulation risk and maintains a lower allocation to a re-rated US market than Fundsmith's post-rotation weighting of 77.5% (and rising) – all while securing a ~75% fee discount.

Top 10 Holdings

APPLE INC	5.08%
NVIDIA CORP	4.77%
MICROSOFT CORP	4.69%
ASML HOLDING NV	3.54%
VISA INC CLASS A	3.30%
META PLATFORMS INC CLASS A	3.29%
LAM RESEARCH CORP	2.82%
ELI LILLY	2.62%
APPLIED MATERIAL INC	2.39%
TJX INC	2.18%
Total of Portfolio	**34.68%**

Source: iShares

Source: iShares

The Quality ETF's portfolio is significantly higher in quality than the MSCI World index, and its valuation premium well below its 2021 peak

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