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Investment Views

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A Detour Still Leading Home

In business, as in life, you are only ever as good as your next move. Jeff Bezos called this "Day 1" thinking, and warned that Day 2 is stasis, irrelevance, decline, and eventually death. It is not a comfortable way to operate, but it is capitalism in its purest, least forgiving form - the worst system, except for all the others.

Few illustrate this better than the active equity fund manager. Every day, they must justify to clients why it is worth paying anywhere from four to twenty times the cost of a comparable, easily tradable passive index. Then they must explain why clients should also accept firm risk, key-man risk, potentially misaligned incentives, concentration risk, illiquidity risk and style drift, on top of ordinary investment risk. Good answers can satisfy a client. But it is a hurdle the passive alternative simply does not face - and that is before any question of underperformance arises. Clients cannot eat historical returns; they are, rightly, interested only in how a fund has performed since their money was invested.

The task gets harder with time. Information now travels faster, more freely, and more cheaply than ever, making a “variant perception” edge difficult to sustain. Computing power and algorithms have taken an ever-firmer grip on trading. For the active manager, it can feel like playing the same fixture against a stronger opponent, day after day - not the kind of contest that does much for morale.

A recent paper from AJ Bell will not have lifted spirits. Manager versus Machine revisited the data and reached a familiar conclusion: over ten years, only 21% of active managers outperformed the relevant passive fund. Within global active equity funds specifically, the figure was a slim 12%. The report's own verdict was blunt - that the passive industry "will be rubbing its hands with glee."

We raise the global active category because, shortly before the paper's release, we sold our holding in Fundsmith, Terry Smith's global equity fund. Sometimes dubbed the British Warren Buffett, Terry has built an enviable long-term track record on a simple, transparent philosophy: buy good companies, don't overpay, do nothing. For a long time, he was one of the 12%.

Why we bought it

We most recently initiated a position in November 2024 to implement a Quality equity theme - an area where our research suggested a persistent mispricing. As markets gravitated toward high-growth narratives, we were wary of a common trap: extrapolating today's growth rates and margins too far into the future for industries that are, by nature, young, fast-changing, and therefore hard to predict. Behavioural economists call this recency bias. Quality stocks - unglamorous but predictable businesses with strong balance sheets, high returns on capital, durable free cash flow, wide, defensible moats and inflation-protecting pricing power - had, by contrast, been left behind. That is generally how it works: capital flowing toward one area flows away from another.

This is precisely the kind of business that an experienced operator tends to identify well, and there are few managers still active with more market memory than someone who has watched five decades of fads come and go.

The style had been out of favour for some time, and we expected an eventual reversion as quality reasserted itself over hype. We already have broad market exposure within the core of the portfolio, so this was a deliberate tilt toward an area we expected to hold up better should a downturn emerge.

What changed

Performance disappointed after our purchase, largely because the AI-driven rally continued to starve more defensive parts of the market of attention, and the Quality theme kept lagging. That, on its own, is an acceptable cost of the thesis: we will never buy the exact bottom or sell the exact top, and we are willing to top up positions provided nothing but the price has changed.

Some of the shortfall, though, came from more unexpected missteps - holding Novo Nordisk and Nike longer than he should have, for instance. There is a real risk that predictability, brand strength and switching costs no longer persist for as long as they once did, in a global, technology-driven market with aggressive social-media-native competitors.

To his credit, Terry has always been brutally frank about any mistakes. That, too, is part of what we were paying for.

What we did not expect came at the start of July: a marked change in the fund's approach. Turnover jumped to over 50%, against a typical figure of 10% or less. Familiar names left the portfolio; unfamiliar ones arrived. Exposure to defensive sectors dropped considerably compared with the start of the year. This went well beyond a little bit of style drift, and we concluded it was no longer the mandate we had underwritten.

What this tells us

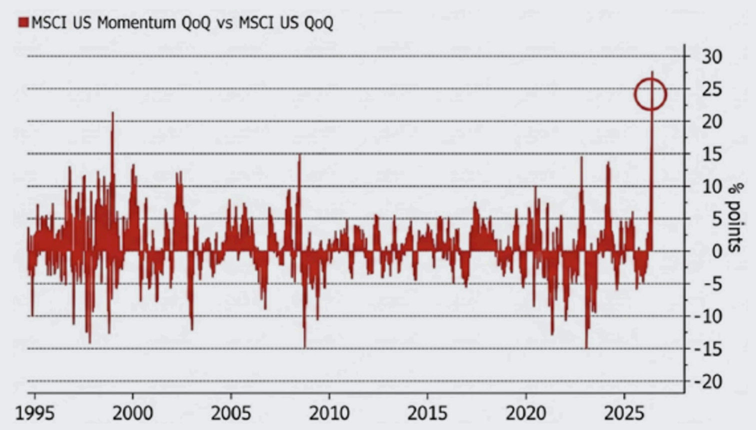
The abruptness of that shift may say as much about the current momentum-driven market as it does about active management itself - echoes of Julian Robertson closing Tiger Management, or Tony Dye leaving Phillips & Drew, both near the peak of the dot-com bubble, just before value reasserted itself. Active managers may yet see their time come again.

More likely, though, it is the Quality theme itself that is closer to its moment. One advantage of thematic investing is that you are not wedded to a star manager. Other active managers run similar strategies and should benefit from the same eventual reversion - though, as the AJ Bell data confirms, few in the global active space are outperforming, and fewer still combine Terry's scale and liquidity. For now, we express the theme through the MSCI Quality ETF: c.300 holdings instead of c.30, at 0.25% rather than 1%. The upside is more modest but still attractive, whereas the potential downside is far more limited.

There is a broader point here about process. Going in, we had done the work. We were never in an active fund that could implode on a single misstep; it could weather any storms. We sized the holding appropriately, never let conviction curdle into attachment, and never changed our target weight simply to defend a thesis (or an ego). We held on while the case remained sound, and when it stopped being sound, we sold - with no gates, no additional redemption terms and our capital back without friction.

Adopting Keynes' advice, when the facts changed, we changed our minds. There are always other ways to express a view we believe in. A detour, yes, but one that will still lead us home.

Momentum Is Showing Record Outperformance



Source: Bloomberg