

YOUR MONEY

Stay focused on the 'known knowns'



Terry Smith

Donald 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 20pc 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 20pc 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 0.7pc in the past year and had gains of 2.9pc

in 2015 and 4.3pc in 2014. By contrast, Fundsmith Equity is up by 42pc in the past year, 15.2pc in 2015 and 15.3pc in 2014. Absolute return funds have also underperformed the MSCI World index in four of the past five years.

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?

Terry Smith is the chief executive of Fundsmith, the asset manager



—EJW/PA/PHOTO

David Cameron resigns after the Brexit vote

How 'absolute return' funds have performed

Total Return Year to 30th Sept	2016	2015	2014	2013	2012
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%

Source: Fundsmith