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OPINION

What I have learnt at Fundsmith in the past five years

COMMENT

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Fundsmith, my fund management business, celebrated its fifth anniversary in the past month. What have I learnt over the past five years of running the fund?

One thing I have observed is the obsession of market commentators, investors and advisers with macroeconomics, interest rates, quantitative easing, asset allocation, regional geographic allocation, currencies, developed markets versus emerging markets — whereas they almost never talk about investing in good companies.

It seems to me that most of these subjects pose questions to which no one can reliably forecast the answers, and even if you could the connection to asset prices is tenuous at best. Take GDP growth — few things seem to obsess commentators more, yet no one has ever managed to demonstrate a positive correlation between GDP growth and stock market performance.

Invest in something good

What has continued to amaze me throughout the past five years is not just this largely pointless obsession with factors which are unknowable, largely irrelevant, or both, but how infrequently I hear fund managers or investors talk about investing in something which is good. Like a good company with good products or services, strong market share, good profitability, cash flow and product development.

I suppose I had assumed that the credit crisis might have taught them that you will struggle to make a good return from poor-quality assets. No amount of CLOs, CDOs and the other alphabet soup of structured finance managed to turn subprime loans into a good investment. When the credit cycle turned down, even the triple-A rated tranches of these instruments turned out to be triple-Z. There's a saying involving silk purses and a sow's ears which encapsulates the problem.

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I am not suggesting that there is no other way of making money other than to invest in good companies, but investing in poor or even average companies presents problems. One is that over time they tend to destroy rather than create value for shareholders, so a long-term buy and hold strategy is not going to work for them.

A more active trading strategy also has its drawbacks. Apart from the drag on performance from trading costs, it is evident from the performance of most funds that very few active managers are sufficiently skilled to buy shares in poor companies when their performance and share prices are depressed, and then sell them close to their cyclical peak.

Another obsession I have been surprised about is that with "cheap" shares. I have been asked whether a share is cheap many more times than I have been asked whether the company is a good business.

This obsession often manifests itself in the critique of our strategy which goes something like, "These companies may be high-quality, but the shares are too expensively rated." This is almost certain to be true, as from time to time the share prices are sure to decline, but it misses the point. If you are a long-term investor, owning shares in a good company is a much larger determinant of your investment performance than whether the shares were cheap when you bought them.

Ignore the siren song

A fairly obvious lesson, but one I have re-learnt, is to stick to your guns and ignore popular opinion. I lost count of the number of times I was asked why we didn't own Tesco shares, or was told that I had to own Tesco shares when our analysis showed quite clearly that its earnings-per-share growth had been achieved at the expense of returns on capital. In fact, its return on capital had deteriorated in a manner which pointed to serious problems in Tesco's new investment in areas such as China and California.

Similarly, it is important to ignore the siren song of those who have views on stocks which you hold, particularly if they are based on prejudices about their products. I also lost count of the number of comments I read about how Microsoft was finished as it "wasn't Apple". This included one investor who rang us to ask if we had seen the quarterly numbers from Microsoft which were not good. (It was tempting to respond saying No, of course we had not seen the quarterly results for one of our largest holdings and thank him for pointing this revelation out to us.)

He said we would face questions at our AGM if we still held the stock then. It was of course just one quarter and the stock more or less doubled in price after that. Sadly no question was raised at the AGM.

Stick to the facts

Another of my observations is that impressions about stocks are often formed erroneously because people do not check the simplest facts. Sometimes they simply relate to the wrong company.

We topped up our stake in Del Monte, a processed food and pet food business, on some share price weakness which resulted when a news service carried an article that dock workers in Galveston had gone on strike and so had stopped Del Monte's ships being unloaded. The company it was actually referring to was Del Monte Fresh Foods, which imports tropical fruits like bananas and pineapples, not the one we were invested in. Or the client who contacted us to say how concerned he was about our large holding in

Domino's Pizza since the chief executive and chief financial officer had left. They had left the UK company, but we owned the US master franchiser.

I would be hard pressed to name the least well-understood subject in investment given the wide choice available, but I suspect that currencies is among the leaders. Over the past five years I have heard lots of people talk or ask about the impact of currencies in a manner which betrays a complete lack of understanding of the subject. The commonest question or assumption about our fund is the impact of the US dollar, since the majority of the companies we have owned since inception are headquartered and listed in the US.

This makes little or no sense. A company's currency exposure is not determined by where it is headquartered, listed or which currency it denominates its accounts in. Yet this does not seem to stop people assuming that it does and making statements about the exposure of our fund to the US dollar, based on where the companies are listed.

We own one company which is headquartered and listed in the US, but which has no revenues there at all. Clearly this assumption would not work very well for that company, any more than it would work for the UK listed company we own which has the US as its biggest market and which, perhaps unsurprisingly, reports its accounts in US dollars.

> Hardly anyone reads company accounts any more. Instead they rely upon management presentations of figures

Nor could we understand the reasoning of the commentators who wrote that our holding in Nestlé had benefited from the rise in the Swiss franc. How? Ninety-eight per cent of Nestlé's revenues are outside Switzerland. It may be headquartered and listed in Switzerland and report in Swiss francs, but the fact is that a company's currency exposure is mainly determined by where it does business. In Nestlé's case the Indian rupee is a bigger exposure than the Swiss franc.

Does anyone read accounts?

I have also discovered that hardly anyone reads company accounts any more. Instead they rely upon management presentations of figures which often present "underlying", "core" or "adjusted" numbers. Not coincidentally, the adjustments to get to the core or underlying numbers almost always seem to remove negative items. Reading the actual accounts bypasses this accounting legerdemain.

We have also discovered mistakes in accounts which no one else seems to have noticed. Like the $1.8bn mistake in the IBM cash flow. This alone did not prevent us investing in IBM, but it helped to support our conclusion that hardly anyone reads its accounts thoroughly.

Don't sell good companies

I have also learnt that selling a stake in a good company is almost always a mistake. Take Sigma-Aldrich, a US chemical company based in St Louis. It supplies pots of chemicals to scientists around the world who use them in tests and experiments. Its financial performance fitted our criteria, as did its operational characteristics — supplying 170,000 products to more than a million customers at an average price of $400 per product. It fitted our mantra of making its money from a large number of everyday repeat transactions, as well as having a base of loyal scientists who relied on its service.

It was a predictable company of exactly the type we seek. That was until it was revealed that it was trying to acquire Life Technologies, a much larger company which supplies lab equipment. Given the execution risk involved, we sold our stake. As it happens, Sigma-Aldrich did not acquire Life Technologies as it was outbid. But having gone public on its willingness to combine with another business, it was in no position to defend its independence and succumbed to a bid itself from Merck at a price about 40 per cent above the price we has sold at.

Selling good companies is rarely a good move. The good news is that we don't do it very often.

Terry Smith is chief executive of Fundsmith LLP

Domino's

Our best share

The best performing share contributing to Fundsmith's performance over the past five years was Domino's Pizza Inc, with a return of over 600 per cent from the initial stake purchased on the day the fund opened. What might we learn from this?

- People often assume that for an investment to make a high return it must be esoteric, obscure, difficult to understand and undiscovered by other investors. On the contrary — the best investments are often the most obvious.
- Run your winners. Too often investors talk about "taking a profit". If you have a profit on an investment it might be an indication that you own a share in a business which is worth holding on to. Conversely, we are all prone to run our losers, hoping they will get back to what we paid for them. Gardeners nurture flowers and pull up weeds, not the other way around.
- Domino's is a franchiser. If you regard a high return on capital as the most important sign of a good business, few are better than businesses which operate through franchises, as most of the capital is supplied by them. The franchiser get a royalty from revenues generated by other people's capital.
- Domino's has focused on the most important item for success in its sector - the

food. This is in sharp contrast to other fast food providers like McDonald's which are struggling.
- Domino's is mostly a delivery business. This means that it can operate from cheaper premises in secondary locations, and so cut the capital required to operate compared with fast food operators who need high street restaurant premises.
- Domino's was owned by Bain Capital. Like a lot of private equity firms, Bain leveraged up the business by taking on debt to pay themselves a dividend before IPO, so it started life as a public company with high leverage. This can enhance equity returns. In a business which can service the debt there is a transfer of value to the equity holders as the debt is paid down and the equity is de-risked. Please note — this does NOT indicate that leverage always enhances returns.