<u>Fundsmith Prep Notes</u>

<u>Questions</u>

Enjoying your holiday? And have you met Terry yet?

When did you first buy Fundsmith? Story with Schroders etc?

Performance of investment?

Position size in portfolio?

Why did you buy? (Communication/strategy: 1) Best companies: 2) Try not to overpay: 3) Do nothing:)

Any particular companies in the fund that stand out for you? (Top 10 holdings: **Microsoft** | **Novo Nordisk** | **Philip Morris** | **L'Oreal** | **IDEXX** | **Automatic Data Processing** | **Stryker** | **Estee Lauder** | **LVMH** | **McCormick)**

Thoughts on performance of fund -- 16% CAGR etc?
(Maynard on FCF/share growth and re-rating/currency tailwinds)

My sums show 'underlying' FCF/share growth of c8%/yr. Would you be happy with 8% growth pa from here?

How comfortable are you with Fundsmith buying/holding 'expensive' companies?
(Maynard on change of valuation approach -- now relative to S&P)
(Maynard on Justified P/Es)

Thoughts on the lack of trading within the fund? Always states low transaction costs!
(Maynard on Do nothing)

How has Fundsmith compared to your own stock-picking?

Why bother with stock-picking? Could/should you/me go 'all in' with Fundsmith?

Attended 4 annual meetings -- your verdict?

- Your questions at the meeting? Satisfactorily answered?
- Standard of questions generally?
  - Economy, inflation, Brexit etc => seem irrelevant to me. Best Qs concern stock picks!

(Maynard) Questions on Facebook, Amazon recently?
(Maynard on Facebook)

How concerned are you about 'style drift' from toothpaste to tech?

(Maynard on Amazon, Apple and Terry changing his mind)

How concerned are you about greater number of non-dividend payers? 1 non-payer in 2013, 9 non-payers in 2022. Dividend dropped significantly in recent years.

How do you monitor a fund? Do you double-check the holdings, or just trust the manager? (Woodford/Bolton disappointing? Nick Train seemingly losing his touch (FGT stagnant over 3 years). Risk of complacency among fund holders?

Fundsmith versus FTSE 100 (an index that Terry has derided!)? Now lagging significantly over 2 years? Cause for concern? How do you benchmark Fundsmith?

Have you ever sold any Fundsmith and when would you sell?

Charges 1% -- thoughts on paying 1% when fund loses value (perhaps for several years?)

Life-changing investments -- skill or luck? (My LSE investment from 20 years ago: my performance since suggests more luck than skill!)

General wrap-up -- buy, hold, sell? Persuaded by my 'bear case'? :-)

Strategy: Try not to overpay ?

From absolute valuation to relative valuation:

Initially compares company valuations with bonds and inflation:

2013: "*We seek to buy our portfolio companies when their free cash flow ("FCF") yield is at or above the yield we would expect to get on long-term government bonds in the same currency. Please note; not the current yield on bonds, which in most cases has been depressed by governments buying their own bonds, but the yield we think might apply if this were to stop and all bonds had to be sold to third party investors. Our starting guess for the yield that might then be required is one percent over the expected rate of inflation. If we can buy shares with FCF yields higher than that and which will grow, unlike the coupon on the bonds, we should have captured some value.*"

2014 and 2015: Then starts comparisons with S&P 500/FTSE 100. Fund's FCF yield = 4.5% vs 4.2%=4.4% for S&P and FTSE 100 'not bad in comparison' and 2015

End of 2017: Now relying on better quality companies. FCF yield less than available on indices, so mentions "*but with significantly higher quality*" than S&P 500 and FTSE 100
Fundsmith 3.7% FCF versus 3.9% S&P and 5.6% FTSE 100.

2017 "*However, that should not be taken to mean that we are entirely comfortable with the seemingly ever higher rating which the shares in our portfolio are achieving.* ***It is clearly a finite and reversible source of performance***."

End of 2019: FCF: *"The weighted average free cash flow ('FCF') yield of the portfolio at the outset of the year was 4.0% and ended it at* ***3.4%****, so they became more highly rated. Whilst this is a good thing from the viewpoint of the performance of their shares and the Fund,* ***it makes us nervous as changes in valuation are finite and reversible****,* ***although it is hard to see the most likely source of such a reversal*** *— a rise in interest rates — in the near future.*

March 2019 ASM: Q: Biggest threat 2019? A: Rising interest rates, and not seen inflation for a decade, tightening cycle etc.

End of 2021: Portfolio FCF 2.7% versus S&P 3.6% and FTSE 100 at 5.4% -- twice as expensive as FTSE 100.

"*Our portfolio consists of companies* ***that are fundamentally a lot better than the average*** *of those in either index and are valued higher than the average S&P 500 company and much higher than the average FTSE 100 company. However, it is wise to bear in mind that despite the rather sloppy shorthand used by many commentators,* ***highly rated does not equate to expensive any more than lowly rated equates to cheap****.*"

2022 YTD performance: Fundsmith -13%, FTSE 100 +6%:
2-year performance: Fundsmith +8%, FTSE 100 +24%

So valuation finally catching up!

2021 report: Justified P/Es chart

Annoys me! Data mining to prove a pre-conceived point ('pay up for quality'), rather than assessing all data to determine what actually works!

Buy L'Oreal at 281x earnings in 1973... and still beat the market.

But what about hindsight bias? Or survivorship bias? Was L'Oreal a quality company back in 1973? What about all the companies that looked like quality in 1973 but then failed? Where are Tesco or Glaxo on that bar chart?

ASM 2021 -- "*Time bails you out*" with a good business => trick is to ensure you are in a good business!

But 2021 ASM recalled buying: IDEXX Labs (2015) at 36x now 10x, Visa (2012) at 23x now 6x,
Intuit (2017) at 37x, now 18x

Other hindsight: buying when shares prices fall. 2021 ASM: Netflix in 2011/12 down 80%, then went on to 6000% gain. Is Terry averaging down with Facebook now? Never easy when companies have problems.

Do nothing ?
Typically <5 sales/trims a year out of 25+ shares => so yes, not doing a lot with portfolio membership.

Reveals useful 'reasons to sell:
1) Questionable management strategy

(2019) *With **3M** we were acting on growing doubts about the current management's capital allocation decisions, and in the case of **Colgate Palmolive** we grew tired of waiting for an effective growth strategy to emerge*

(2018) **Nestle:** *We rely on the management of our companies to allocate capital in ways which create value for us as investors, and this deal [with Starbucks] did not seem to meet those criteria, although it certainly seemed to fit the activist imperative to do something and looked like a good deal for Starbucks.*

(2017) **Imperial Brands:** *We had become increasingly concerned about the company's positioning in terms of its lack of exposure to the developing world and to the next generation products, all of which has led to volumes falling at a rate that is difficult to cope with. We were even more concerned by the management reaction which we literally could not understand.*

2) Small position size
2013 -- Sold McDonald's and Schindler due in part to small position size
"Some of these holdings had already become an insignificant proportion of our portfolio because we had been struggling to add to them as their valuations had become too high to represent good value in our view." Once this point is reached it begs the obvious question of whether we should in fact sell our holding to make way for an investment which offers better value, either within our existing portfolio stocks or from within our wider Investable Universe of stocks on which we maintain research.

3) Valuation

(2020) *We sold our stakes in **Clorox** and **Reckitt Benckiser** and purchased stakes in Nike and Starbucks during the year. **Clorox** and **Reckitt Benckiser** traded strongly due to the rush to purchase increased quantities of household cleaning products, personal cleaning products and OTC medicines. **We felt that in both cases the ratings achieved did not reflect the pedestrian nature of these businesses in more normal circumstances** or the issues they face which may come back into focus if or when the COVID related boost fades "*

But some trading!
E.g. Waters -- laboratory instruments (chromatography, spectrometry)

2013: Sold **Waters**, but re-bought in 2015 and 2016, selling some in 2018 and 2020

JM Smucker -- biggest purchase in 2016, sold completely 2017
Ebay -- bought 2014, sold 2015
Swedish Match: bought 2013, sold, 2014
Reckitt Benckiser -- bought and sold 2017

Dividends --> no longer important -> chart

2011: "*it is becoming clear that dividends are likely to provide a more significant portion of the total return on equities in the future than they did in the equity bull markets of 1982-2000 and 2003-07.* *The historical dividend yield on the Fund at year end was 2.4%. This dividend was covered 2.6 times by earnings.*

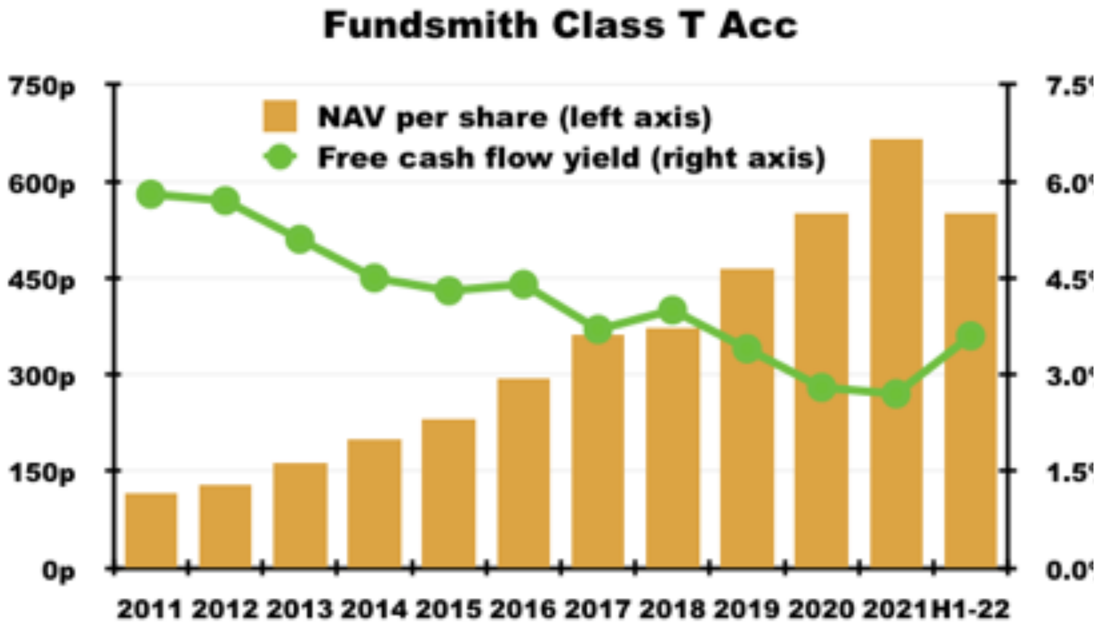
2012: "*The historical dividend yield of the portfolio is 2.3% and we forecast the prospective yield is 2.5%. Dividend cover remains 2.6 times.* ***Yield is an important element of investment return. Over the long run, it has contributed a higher percentage of equity performance than share price appreciation***

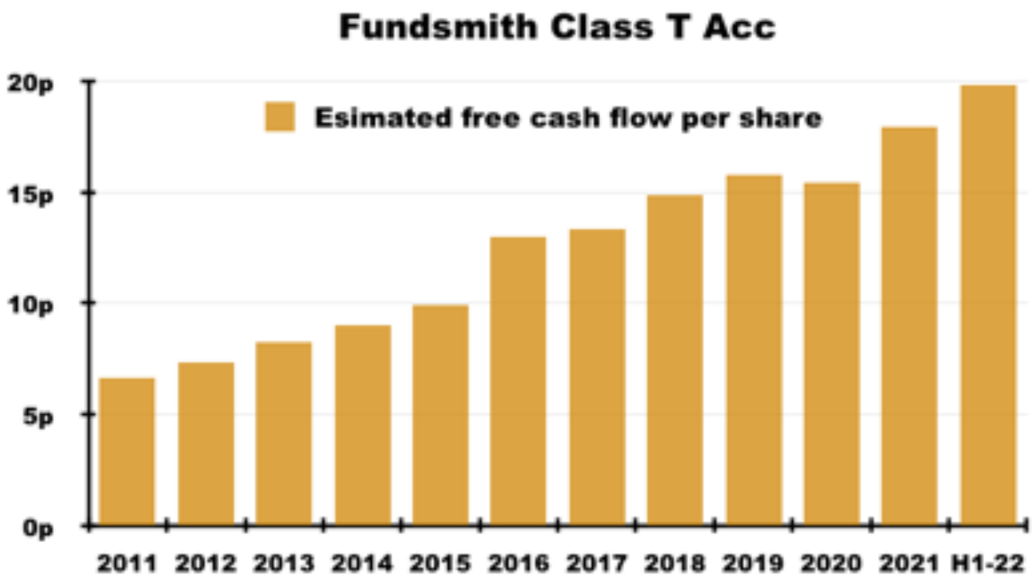
2013: "*Waters was also the only non-dividend paying stock which we held. Whilst we are prepared to hold such stocks, we need to be convinced that their reinvestment opportunities warrant the absence of a dividend and we were increasingly wary of this with Waters* *." As at 31st December 2013 the weighted historic dividend yield of the Fund was 2.3% and the weighted prospective yield was 2.5% and the prospective dividend cover was 2.4x.*

2014 (dividend not mentioned) at all since

9/28 Non-payers now: IDEXX | Adobe | Meta | Amazon | Paypal | Waters | Alphabet | Mettler-Toledo | Amadeus

Largest three purchases during H1 2022 non-payers => Adobe, Mettler-Toledo, Alphabet


Fundsmith Class T Acc
750p
600p
450p
300p
150p
0p
NAV per share (left axis)
Free cash flow yield (right axis)
2011 2012 2013 2014 2015 2016 2017 2018 2019 2020 2021 H1-22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20p
15p
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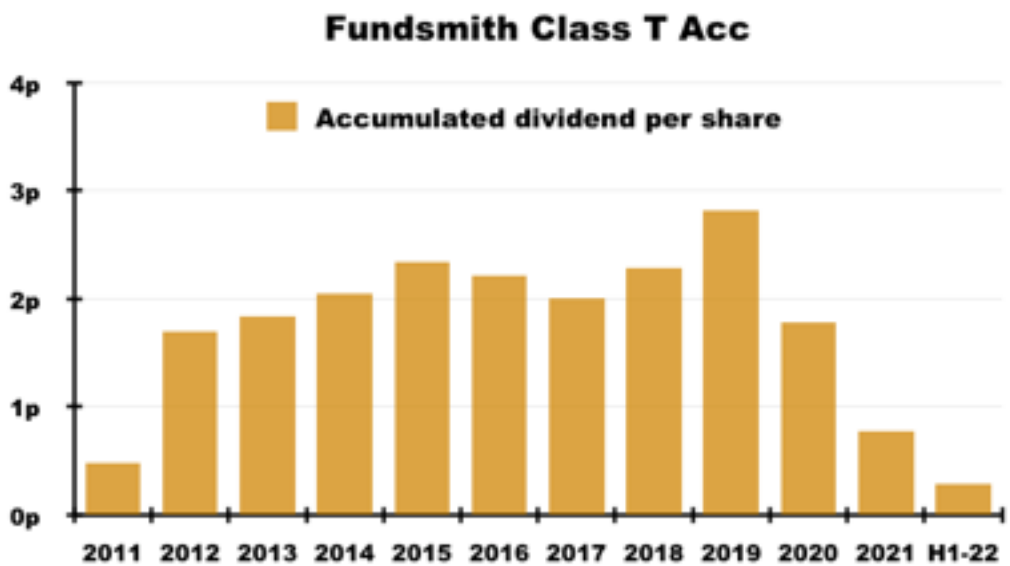
Esimated free cash flow per share
2011 2012 2013 2014 2015 2016 2017 2018 2019 2020 2021 H1-22


Fundsmith Class T Acc
4p
3p
2p
1p
0p
Accumulated dividend per share
2011 2012 2013 2014 2015 2016 2017 2018 2019 2020 2021 H1-22

Currency tailwind

Launch 01-Nov-2010 GBPUSD = 1.6059
Recent c1.21
c32% currency gain GBP versus USD
Underlined by USD institutional fund versus GBP institutional fund (+160% versus 100%) since 2015.

Fund performance

NAV up from 100p at launch to 551p to June 2022. => CAGR 16% over 11.5 years.

Helped by re-rating of investments.

Trailing FCF was 5.8% at 2011 => 3.6% at June 2022.

Can work out FCF per share from year-end NAV and FCF yield information => FCF per share increased from 6.7p/share to 19.9p/share over 10.5 years => 11% CAGR.

So overall CAGR of 16%, but underlying FCF growth = 11%.

Then adjust for currency movement, so less a third of 11% = c8%.

June 2022: annualised FCF growth of 8%, which "*Long-term readers of these letters will recognise this as not far off the historic average.*"

So => Fundsmith has done well to capture stronger USD and re-rating of quality growth shares since 2011.

But favourable USD and re-rating won't extend for ever => best not to extrapolate 16% CAGR

Going forward, perhaps expect NAV to match underlying FCF/share growth at c8%/year.

Buying at 551p => FCF yield of 3.6% -- or 28x FCF -- for 8% FCF growth => not an obvious bargain?

Becoming big on tech
-- owned MSFT for years, but Facebook, Google, Amazon, Apple. Risk of 'style drift' away from toothpaste to tech?

2011: 49% Consumer Staples/ 9% Information Technology
June 2022: 33% Consumer Staples/27% Information Technology

Facebook: 2018 buy ($175) => $100 recent
Amazon: 2021 buy ($175) => $100 recent
Adobe: H1 2022 buy ($475) => $330 recent

Changing his mind
1a) **Amazon:** 52mins ASM 2021: "*If Mr Bezos would float AWS, we would be very interested. We don't particularly like the idea of owning one business cross-subsidising a barely profitable business...I am not aware there's any significant synergy between the two businesses [retail and cloud computing]... it seems a happy coincidence.*"

Er, Amazon retail was built on AWS!!! Terry S not understanding synergy between the two is worrying!
Then buys AMZN within 9 months for Fundsmith!

1b) **Alphabet**: also mentions Alphabet in ASM 2021 and cross-subsidising certain ventures with its Google ads. Then buys later in 2021! Chart => (late stage tech investor?) -- watched it go up 10-fold before buying.

2) **Apple** https://www.trustnet.com/news/13338895/terry-smith-buys-apple-for-fundsmith-equity
Said in 2021:
"*“What scares me with Apple is that I lived through the rise and fall of Nokia, and I heard all the same reasons why we shouldn’t worry about a consumer electronics business reverting to mean returns because it was ‘an ecosystem’, “Maybe it is, and maybe I’m wrong, but it does worry me.”*"

"*It seems Apple is driven at least in part by the need to continue to churn out the next nice flat device with rounded corners that you want to buy, even though it's the same as the last one roughly speaking."*

Has started buying Apple in 2022

Facebook/META

2018: "*Our Facebook holding has cost us some performance to date and no doubt it will continue to be a difficult stock to hold in terms of media attention, but we have often found that the only time you can hope to buy stock in great businesses at a cheap valuation is when they have a glitch."*

2019 ASM: Q: "*Why are we still in Facebook, feels like a business coming under attack from regulators, governments, politicians, and its own customers. Management seems to be making a lot of mistakes. What am I missing? Can we get out please?*"

A: high returns on capital, high growth rate, duopoly with Google for online ads, has only 6 million advertisers => potential for more. Compares with tobacco for regulation = greater regulation => barriers to entry. 30% margins. Who is the competitor that can take away the users? "*I can't think of one*"

2019: "*We are not the sort of people who ever declare victory — we invest with a strong sense of paranoia — but it is* ***nonetheless pleasing to note the contribution of Facebook*** *which was certainly our most controversial stock purchase and led to more questions (and demands for its sale) from some of our investors than any other company.* "

2020: "*We are not the sort of people who ever declare victory – we invest with a strong sense of paranoia – but* ***it continues to be pleasing to note the contribution of Facebook*** *which was certainly our most controversial stock purchase and led to more questions (and demands for its sale) from some of our investors than any other company. We had similar views expressed to us when we purchased Microsoft. You rarely get to purchase high quality businesses at cheap prices unless there is a 'glitch' which provides an opportunity to do so.* "

June 2022: "*The title for the lowest-rated belongs to Meta Platforms. Meta's stock now trades on a FCF yield of 8.7%* ***At this level it is either cheap or a so-called value trap****. We will let you know which when we find out, but we are inclined to believe it is the former. "* *(*Slowing user growth, ad revenue slowing and significant Metaverse losses)

* Price at June 2022 $160 = $425b mkt cap
* FCF = $39b Q1 2022 => c9% FYF yield
* Quarterly FCF c$8-9b then $4.5b for Q2 2022 and then ***<u>collapsed to $173m for Q3 2022</u>***
* Trailing FCF now = $26b, six months ago was $39b
* FCF yield for 2023??? Will Terry mention Meta's FCF again???

Facebook => A mistake to date, but one fundholders expressed some doubt over at the time. *<u>Embarrassing for Terry S to be proven wrong by ordinary investors paying Terry to handle their money!</u>*

Commitment bias?


Share price
Amazon.com Inc (AMZN)
20,000
18,000
16,000
14,000
12,000
10,000
8,000
6,000
4,000
2,000
0
Share price
2006
2008
2010
2012
2014
2016
2018
2020
2022
Year
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Share price
Alphabet Inc (GOOG)
16,000
14,000
12,000
10,000
8,000
6,000
4,000
2,000
0
Share price
2006
2008
2010
2012
2014
2016
2018
2020
2022
Year
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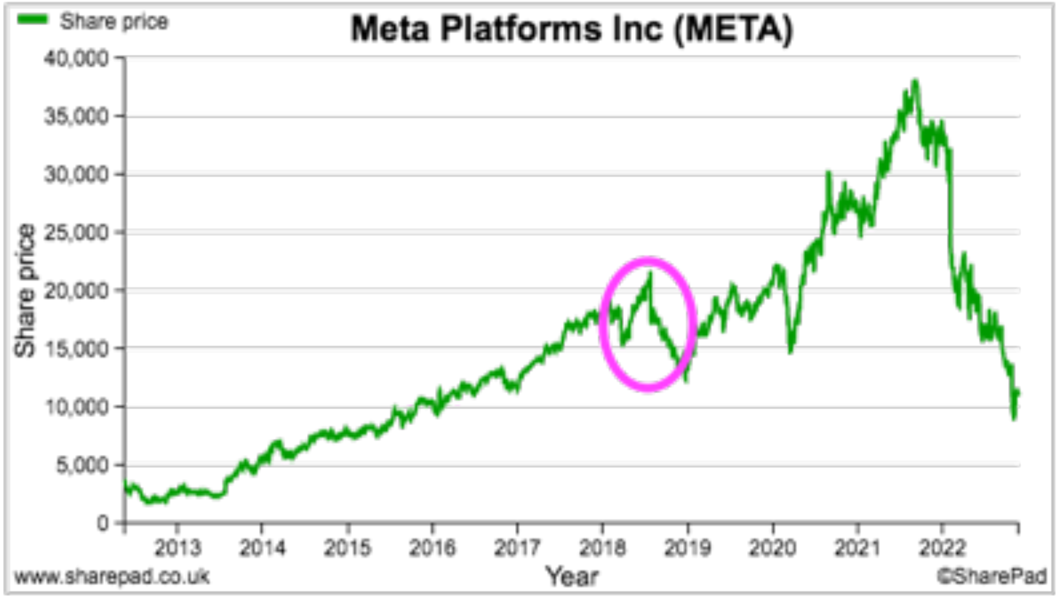
Share price
Meta Platforms Inc (META)
40,000
35,000
30,000
25,000
20,000
15,000
10,000
5,000
0
Share price
2013
2014
2015
2016
2017
2018
2019
2020
2021
2022
Year
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