

Is Fundsmith a Momentum investor?

- Fundsmith's performance vs MSCI World is stellar
- But performance vs MSCI World Momentum Factor is marginal
- Is Fundsmith knowingly or unknowingly a Momentum investor?

Stellar performance

If there's one word to describe the performance of Terry Fundsmith's **Fundsmith Equity Fund**, it would be "stellar".

Beloved by retail investors and advisers alike, it's a key holding in many of the portfolio we see that are run by financial advisers.

The firm's values are clearly set out "No performance fees, no nonsense, no shorting, no market timing, no index hugging, no hedging etc". All this combined with great results, and it's a compelling proposition.

But in this article, we set out to answer four questions:

1. Is Fundsmith a Momentum investor?
2. Where and how has Fundsmith added value?
3. Is Fundsmith fund "hugging" a Momentum index?
4. Are Fundsmith-like returns replicable by lower cost index strategies?

In summary the answers are, respectively: Possibly, Sector Allocation, Definitely Not, and Yes.

What is Momentum investing?

MSCI defines momentum factor as referring to *"the tendency of winning stocks to continue performing well in the near term. Momentum is categorized as a "persistence" factor i.e., it tends to benefit from continued trends in markets"*¹.

Following the lows of the Global Financial Crisis, it's been a great time to be a Momentum investor.

¹ <https://www.msci.com/documents/1296102/1339060/Factor+Factsheets+Momentum.pdf/a766ef6b-cd24-4460-8163-900323fc2957>

Question 1: Is Fundsmith a Momentum investor?

What's the right comparator?

The Fundsmith Equity fund quite rightly uses **MSCI World Index** as a performance comparison on its factsheet. Comparisons against UK equity funds or indices would not be appropriate. In our research around factor-based investing, we thought it would be interesting to plot how the performance of a popular global equity fund like Fundsmith Equity fared against the various factor-based world equity indices.

We were astonished to see that the performance was almost identical to the iShares EDGE MSCI World Momentum Factor UCITS ETF (the "Momentum ETF").

Fig.1. Close call between Fundsmith & Momentum factor for trouncing MSCI World



Source: Elston research, Bloomberg data. Total Return in GBP terms as at 31-Dec-20

Indeed, over the last 5 years from Dec-15 to Dec-20, Fundsmith has delivered a cumulative total return of +137.39%, compared to iShares Edge MSCI World Momentum Factor ETF's return of +132.77% and +90.23% for iShares MSCI World Equity ETF. In annualised returns this translates to +18.85%, +18.39% and +13.71% respectively².

The correlation between the strategies from December 2015 to December 2020 is 84.3%.

How about 2020 performance?

In 2020, the semi-annual rebalancing of the Momentum index potentially worked in its favour as it is not wedded to favourite positions: it simply looks at Momentum scores. In 2020, iShares EDGE MSCI World Momentum ETF returned +24.85% in GBP terms, compared to Fundsmith Equity's +18.23% and iShares MSCI World +11.81%.

² As at 31st December 2020

Fig.2. Fundsmith vs Momentum in 2020



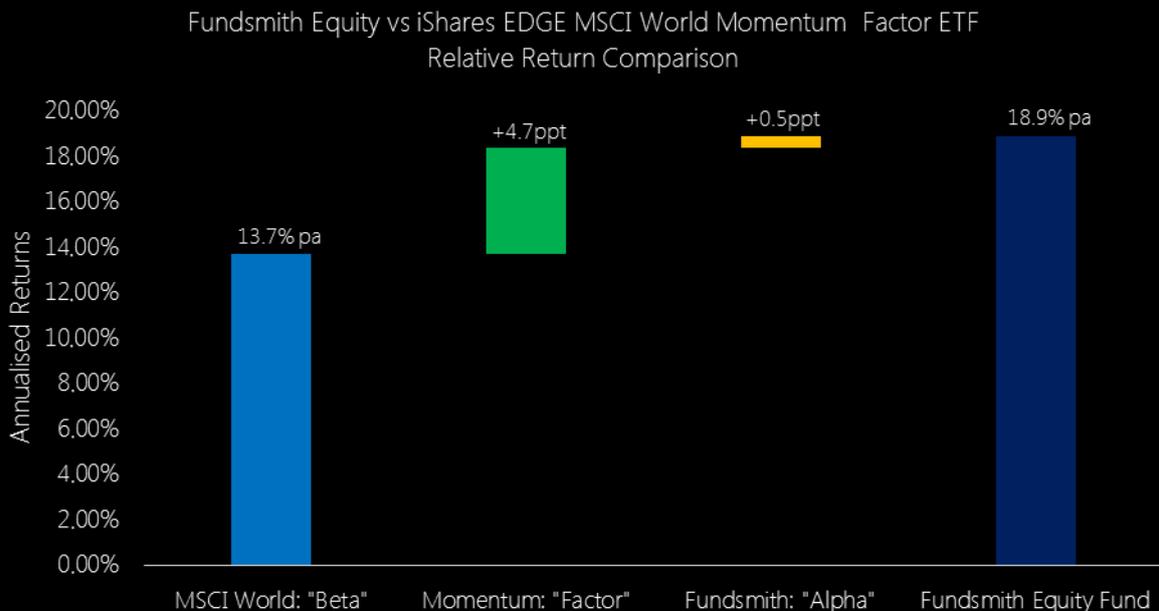
Source: Bloomberg as at 31-Dec-20

Factor investing: between active and passive?

Factor-based index investing has sometimes been described as being somewhere between passive investing (cap-weighted beta) and active investing (non-index). Macro factors and style factors explain some of the difference between market beta and active returns, that were previously attributed to manager alpha.

In the chart below, we compare the annualised performance of the world equity ETF (beta), the Momentum ETF (style factor) and the additional Alpha of Fundsmith relative to that Momentum ETF, effectively using the Momentum ETF as another benchmark.

Fig.3. Relative Return Comparison: Fundsmith Equity vs iShares EDGE MSCI World Momentum Factor ETF



Source: Elston Research, Bloomberg data, Dec-15 to Dec-20

So for evaluating manager skill, which is the right benchmark: World Equities against which both Fundsmith Equity and a low cost Momentum tracker look great, or – if Fundsmith is indeed a Momentum-style investor – a Momentum benchmark, against which Fundsmith has still outperformed – but only marginally?

Fundsmith describes his process as “Quality focused” and yet performance is very different to a Quality factor. Does this mean that Fundsmith is – knowingly or unknowingly – a closet “Momentum” investor?

Applying a factor lens to active managers

By applying a factor lens to traditional active managers we can see what factors those managers are knowingly or unknowingly allocating to, and hence to what extent their performance relates to a particular style factor.

The Fundsmith Equity fund is a “true active” fund using high conviction, and high concentration. The manager’s stated philosophy selects companies based on their quality.

We can see that Fundsmith and MSCI World Momentum Factor index both have in common a high concentration to Information Technology, Health Care and Consumer Staples. Fundsmith’s less constrained and more concentrated approach means that this sector concentration is even more extreme as he zero weights most other sectors, which the Momentum index cannot do.

Naturally there is significant overlap in the underlying stock within both Fundsmith and the Momentum ETF, but with Fundsmith able to take larger active weights.

Given Fundsmith’s focus – whether by accident or design – on companies with persistent share price momentum, a momentum index could be a more relevant comparator than a traditional cap-weighted world equity index for the Fundsmith Equity fund.

Question 2. Where and how has Fundsmith added value?

Performance Attribution

We ran an attribution analysis comparing the Fundsmith Equity fund to the Momentum ETF for the period from June 2016 to December 2019, a period where all look-through data is available.

In aggregate Fundsmith returned +75.76% outperforming Momentum ETF which return +69.48%.

In terms of Total Returns, Fundsmith’s picks in the Information Technology sector delivered +145.22%, compared to Momentum ETF’s +156.32%, an underperformance of -11.1%. This was offset by Fundsmith’s picks in the Health Care sector which returned +77.66%, compared to +67.58% for the Momentum ETF. An outperformance of +10.08%. Fundsmith’s picks in the Consumer Staples sector generated +35.62%, compared to +35.12% for the Momentum ETF.

After adjusting each sector for average weights, the large relative overweight in Information Technology – an advantage of a more concentrated approach – meant that technology was the largest relative contributor to overall return deliver 35.82ppt of the +75.76% return. Similarly, for Momentum, information technology delivered 26.5ppt of the +69.48% return.

In summary for the time period under review Fundsmith has been excellent at sector selection. Good in stock selection within the Health Care sector was offset by poor stock selection in the Information Technology sector. Stock selection in the Consumer Staples sector added almost no value.

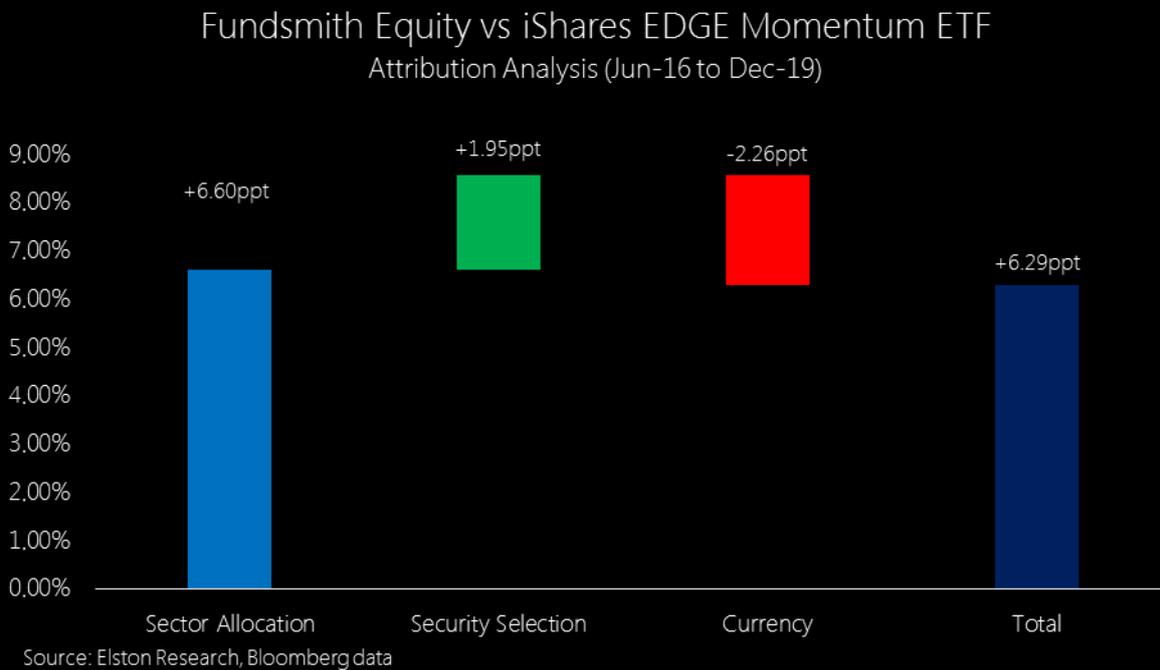
Fig.4. Sector-level Contributions To Return

	Average Weights			Total Return			Contribution To Return		
	Fundsmith	Momentum	Relative	Fundsmith	Momentum	Relative	Fundsmith	Momentum	Relative
Consumer Staples	31.36%	9.14%	22.22%	35.62%	35.12%	0.50%	12.30%	3.31%	8.99%
Health Care	23.96%	12.59%	11.37%	77.66%	67.58%	10.08%	18.97%	6.36%	12.61%
Information Technology	30.98%	24.12%	6.86%	145.22%	156.32%	-11.10%	35.82%	26.50%	9.32%
Other	13.70%	54.15%	-40.45%						
Total	100.00%	100.00%	0.00%	75.76%	69.48%	6.29%	75.76%	69.48%	6.29%

Source: Elston research, Bloomberg data, 30/6/16-31/12/19

The conclusion is that Fundsmith added greatest value by selecting the best performing sectors, where share price momentum was greatest. There was moderate additional value from fund selection, and some deduction from currency effect.

Fig.5. Attribution analysis



Holdings analysis

We looked at the average largest relative overweights for the Fundsmith Equity fund relative to the Momentum ETF.

Fig.6. Security-level Contribution To Return

	Average Weight		CTR		
	Fund	Momentum	Fund	Momentum	Relative
Paypal	5.59%	0.50%	7.67%	0.33%	7.35%
Icxx	3.97%	0.10%	5.36%	0.14%	5.23%
Amadeus	5.19%	0.11%	4.82%	0.06%	4.76%
Visa	4.62%	1.47%	5.83%	1.83%	4.00%
IHG	3.65%	0.03%	3.90%	0.05%	3.84%
Automatic	4.10%	0.50%	3.95%	0.16%	3.79%

Source: Elston research, Bloomberg data, 30/6/16-31/12/19

Fundsmith is “true active” because he is taking large absolute and relative bets relative to securities’ index weights be that in a traditional cap-weighted index or in the Momentum factor-weighted index. During the period under review, Paypal, Icxx and Amadeus were the largest contributors to returns.

Fundamentals

Interestingly, looking at aggregate valuations, the overall Price Earnings Ratio (PER) for Fundsmith and for Momentum is not dissimilar, whilst Price Book Value (PBV) ratios – a traditional value metric – and debt levels were far higher for Fundsmith than Momentum.

Fig.7. Valuation Comparison

	Fundsmith	Momentum
PER	27.58	28.25
PCF	21.26	17.08
PBV	9.91	4.05
Debt/Equity	112.53	96.22
Total		

Source: Elston research, Bloomberg data, 31/12/19

Question 3: Is Fundsmith Equity hugging the Momentum index?

No. Not at all. As a far more concentrated portfolio there are high levels of active weights relative to the much more diverse MSCI World Momentum Index.

Fig.8. Top 5 relative weights

	Average Weight		
	Fund	Momentum	
Paypal	5.59%	0.50%	5.09%
Idexx	3.97%	0.10%	3.87%
Amadeus	5.19%	0.11%	5.08%
Visa	4.62%	1.47%	3.15%
IHG	3.65%	0.03%	3.62%
Automatic	4.10%	0.50%	3.60%

Source: Elston research, Bloomberg data, 30/6/16-31/12/19

Question 4: Are Fundsmith-like returns replicable by lower cost index strategies?

The most interesting element of our analysis is not finding two strategies that take a similar approach to different outcomes, but two strategies that take a different approach to a similar outcome. This is consistent with the concept of factors being the underlying drivers of returns.

Fundsmith is and remains a vindication of the potential value add of active management, and the ability to deliver returns well in excess of the market beta.

However, if we start looking at the “market” not just from the context of traditional capitalisation weightings, but using a more granular factor-based approach, we can get more insight as regards value add.

Furthermore, we can see that that level and style of stellar returns are available to index investors too, in upward trending markets but at a cost of 0.30%, instead of 0.95%.

The holdings or “ingredients” might be different, but the factors or “nutrients” might be the similar.

Similarities and Differences

So what are the similarities and differences between methodologies?

Similarities

- **High concentration:** (at present) of sector exposures in Consumer Staples, Health Care & Information Technology.
- **Max position sizes:** Max positions of 5% in the Momentum Index - much higher than the traditional MSCI World Index, but not dissimilar to the larger position sizes within Fundsmith Equity
- **Outcome:** Both strategies – via very different methodologies – end up with a similar overall “momentum” philosophy, namely “backing winners”.

Differences

- **Investment approach:** stating the obvious, Fundsmith's Equity Fund is a subjective manager-based approach; Momentum factor ETFs reflect a systematic rules-based approach
- **Number Holdings:** Fundsmith's Equity fund is concentrated in 30 holdings. The Momentum factor ETF has 350 or so holdings. The Momentum factor ETF is therefore carries less idiosyncratic risk.
- **Turnover:** But given the dynamic nature of these trends, and semi-annual rebalancing, the Momentum index turnover is high at 149.48%³. Fundsmith's turnover, by contrast is much much lower by design.
- **Cost:** the Fundsmith fund delivered performance at a cost of 0.95% OCF, the iShares Edge World Momentum Factor UCITS ETF delivered similar performance at a cost of 0.30%

See box for additional information.

Summary

Fundsmith's performance is undeniably excellent, but is consistent with that of a Momentum-style investment strategy.

Fundsmith's "Alpha" can be measured not just against MSCI World, but against this Momentum Index. Using the standard MSCI World as a comparator implies Fundsmith's Alpha is a phenomenal 5.14ppt pa over the last 5 years. Using the MSCI World as a comparator implies Fundsmith's Alpha is just 0.46ppt pa.

Incorporating factor-based exposures as a hybrid on the spectrum between traditional cap-weighted passive, and true active, creates more options for portfolio managers looking to isolate and capture specific styles and exposures without having to materially increase either the risk budget or the fee budget.

Fig.9. Investment Approaches Compared

Fundsmith Equity: Investment approach

The investment approach for Fundsmith is clearly articulated and stated in the objectives:

"These criteria aim to ensure that the Company invests in: high quality businesses that can sustain a high return on operating capital employed; businesses whose advantages are difficult to replicate; businesses which do not require significant leverage to generate returns; businesses with a high degree of certainty of growth from reinvestment of their cash flows at high rates of return; businesses that are resilient to change, particularly technological innovation; businesses whose valuation is considered by the Company to be attractive."

The description sounds like the description of investing in quality, and indeed according to media, Terry Fundsmith describes himself as a quality investor⁴. And yet the performance of the fund is highly correlated and indeed similar to a Momentum-based approach.

³ MSCI factsheet as at December 2020 for last 12 months

⁴ <https://masterinvestor.co.uk/funds-and-investment-trusts/what-is-quality-investing-and-why-does-it-work/>

MSCI World Momentum Index: Investment approach

The MSCI World Momentum Index is constructed using the following methodology:

A momentum value is determined for each stock in the MSCI parent index by combining the stock's recent 12-month and 6-month local price performance. This momentum value is then risk-adjusted to determine the stock's momentum score. A fixed number of securities with the highest momentum scores are included in each MSCI Momentum Index, generally covering about 30% of the parent index market cap. Constituents are weighted by the product of their momentum score and their market cap. Constituent weights for broad MSCI Momentum Indexes are capped at 5%. The indexes are rebalanced semiannually; in addition, ad hoc rebalancing may occur, triggered by spikes in market volatility.⁵

This creates a systematic, rules-based approach for including stocks with highest momentum characteristics, subject to a max 5% position size.



Find out more

For more insights and information on research, portfolios and indices, visit:

www.elstonsolutions.co.uk or NH ETF<Go>

www.elstonsolutions.co.uk

⁵ <https://www.msci.com/documents/10199/904e031c-94e4-4dbc-a314-7c373446dffa>

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