

## 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 in their factsheet: "No performance fees, no nonsense, no shorting, no market timing, no index hugging, no hedging" and so on. 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 accessible using 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"*<sup>1</sup>.

Following the lows of the Global Financial Crisis, it's been a great time to be a Momentum investor. Indeed, it has been the best performing style factor, much to the chagrin of [many "purist" factor-based investors](#) who focus only on the original Fama-French framework of Size and Value factors.

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<sup>1</sup> <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") which tracks the MSCI World Momentum Factor index (the "Momentum Index").

*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 the Momentum ETF's return of +132.77% and +90.23% for iShares MSCI World Equity ETF ("World Equity"). In annualised returns this translates to +18.85%, +18.39% and +13.71% respectively<sup>2</sup>.

To be clear, Fundsmith Equity is not managing the fund to this benchmark, so could argue it's not an appropriate comparison, and technically, that's right. But we thought nonetheless a comparative analysis would be informative, not least to show that Fundsmith-like returns were achievable with a Momentum-style investment approach.

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

### How about 2020 performance?

In 2020, Momentum ETF returned +24.85% in GBP terms, compared to Fundsmith Equity's +18.23% and the World Equity ETF +11.81%, possibly helped by its rebalancing in what very much a year of two halves..

<sup>2</sup> As at 31<sup>st</sup> December 2020



Fig.2. Fundsmith vs Momentum in 2020



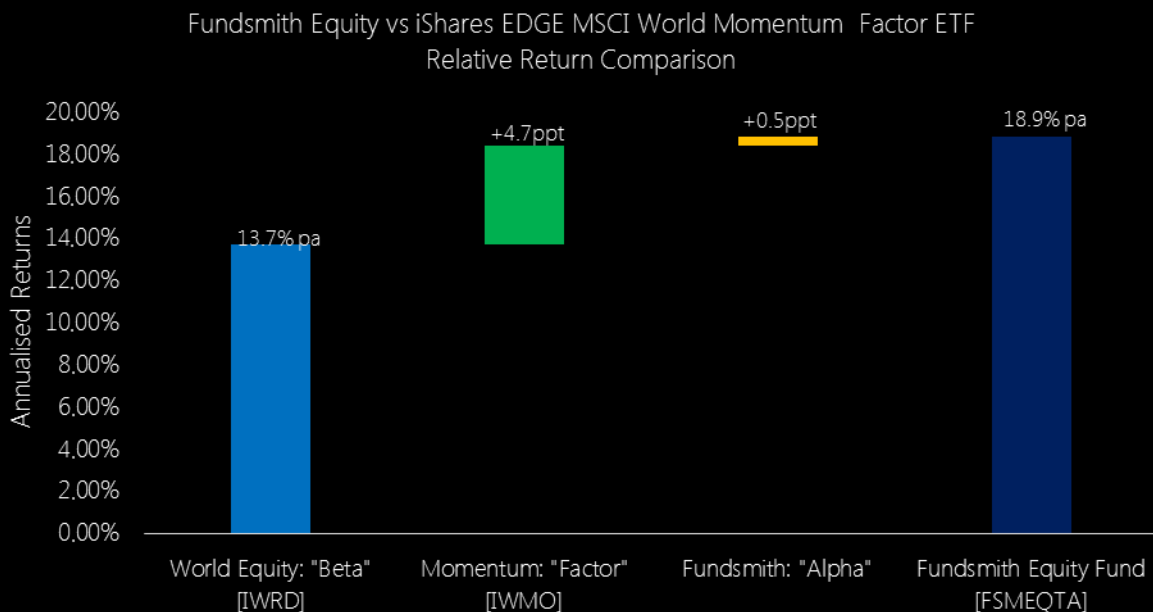
Source: Bloomberg as at 31-Dec-20

### Factor investing: between active and passive?

Factor-based index investing has sometimes been described as being somewhere between passive (cap-weighted index beta) investing and active (non-index) investing. Indeed factor-based investing became mainstream when Ang, Goetzmann and Schaefer (2009) conclude that the bulk of the apparent manager alpha within the Norwegian Sovereign Wealth Fund was explained by macro factors and style factors. Factors therefore explain a large part 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 over 5 years of the world equity ETF (beta), the Momentum ETF (style factor) and the residual difference (Alpha) between Momentum and Fundsmith. Effectively we are using the Momentum ETF as a benchmark for Fundsmith's style.

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?

### Applying a factor perspective to active managers

What we like about the Fundsmith Equity fund is that it is a “true active” fund using high conviction, and high concentration, and see it as a powerful addition to portfolios.

Fundsmith describes his process as “Quality focused” and yet performance is very different to a Quality factor and almost identical to a Momentum factor. We are not saying that Fundsmith is not properly describing their investment process. We are just noting the outcome of its results and similarity to the Momentum factor.

By applying this factor perspective 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.

Both Fundsmith and Momentum Index have had a high concentration to Information Technology, Health Care and Consumer Staples. Fundsmith’s fund is not constrained and his more concentrated approach means that this sector concentration is even more extreme than the Momentum index.

Naturally there is significant overlap in the underlying stock within both Fundsmith and the Momentum ETF, but with Fundsmith able to take larger security weights than a rules-based index.

### 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.

For this period, Fundsmith returned +75.76% outperforming the Momentum ETF which returned +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.

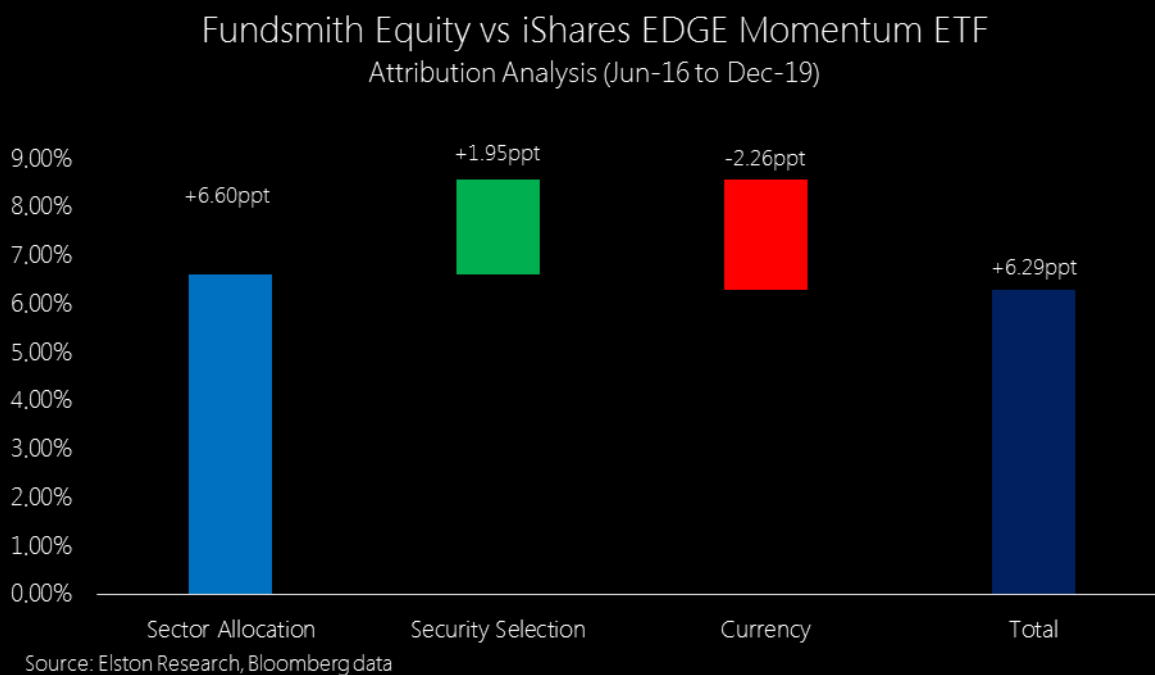
*Fig.4. Sector-level Contributions To Return*

|                        | 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%      |               |               |              |                        |               |              |
| <b>Total</b>           | <b>100.00%</b>  | <b>100.00%</b> | <b>0.00%</b> | <b>75.76%</b> | <b>69.48%</b> | <b>6.29%</b> | <b>75.76%</b>          | <b>69.48%</b> | <b>6.29%</b> |

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

Taking this further into an attribution analysis, 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 detraction from currency effect.

*Fig.5. Attribution analysis*



## Holdings analysis

We also looked at the average largest relative overweights for the Fundsmith Equity fund relative to the Momentum ETF, to look at security-level Contribution to Total Return. During the period under review, Paypal, Idexx and Amadeus were the largest contributors to returns.

*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%    |
| Idexx     | 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 which is his benchmark, or in the Momentum factor-weighted index. which is not.

## 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    |
| <b>Total</b> |           |          |

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.

The correlation between the strategies from December 2015 to December 2020 is high at 84.3%, but not too high

*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 this: usually when comparing actively managed funds, you can often find two strategies that take a similar approach, but have led to very different outcomes. In this case, comparing an actively managed fund with a Momentum index fund, we have two strategies that take a different approach, but reach a very 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 (cap-weighted) beta. As such, we expect advisers to continue to want to include Fundsmith as a core holding within their equity allocation. But we would note decomposing returns to what is attributable to Factors provides additional insight.

However, if the question is are those type of returns accessible using index funds, the answer is emphatically yes.

An equal weight allocation across Consumer Staples, Health Care and Information Technology ETFs, or a single allocation to a Momentum ETF would have delivered similar returns to Fundsmith, but with TERs of 0.30% or so, instead of 0.95%.

So if you are looking for growth, being fully allocated to equities, and backing "winning" business: then you can implement that approach with active funds like Fundsmith, or index exposures like Momentum.

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



## Similarities and Differences

So, apart from the obvious, 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; the Momentum Index reflects 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 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%<sup>3</sup>. 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 Momentum ETF delivered similar performance at a cost of 0.30%

See box for additional information.

### Summary

Fundsmith’s performance is undeniably excellent. We would note that is consistent with that of a Momentum-style investment strategy.

Fundsmith’s “Alpha” can be measured not just against MSCI World, but against the MSCI World 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.

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<sup>3</sup> MSCI factsheet as at December 2020 for last 12 months

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 investor<sup>4</sup>. And yet the performance of the fund is highly correlated and indeed similar to a Momentum-based approach.

#### 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.<sup>5</sup>*

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



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

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

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