EP.125 – Is Active Management Worth Paying For? With Terry Smith (Founder, CEO & CIO of Fundsmith)

Terry Smith – Intro Highlight
I think the most under-appreciated and under-discussed aspect of equities is that they have a unique quality that no other asset that you can invest in has. They can compound in value.

Simon Brewer – Show Introduction
Welcome to the Money Maze Podcast. I'm Simon Brewer, and Will Campion and I have created this show to explore and unravel some of the mysteries surrounding the investment business. You can keep up to date by visiting money maze podcast.com, and please sign up to our newsletter to ensure you won't miss a release. If you enjoy this show, please subscribe and we'd love you to tell a friend or colleague about it. Thank you for listening.

Simon Brewer – Episode Introduction
Our guest today has been referred to as the English Warren Buffett. He might even prefer to be known as the English Charlie Munger for his style and success in investing. His book, published in 1992, 'Accounting for Growth' and its ensuing controversy helped propel it to the top of the best-sellers chart, displacing Stephen Hawking's 'A Brief History of Time' from the number one spot. And I did ask myself, has any book with accounting in the title ever been a best seller before or after? He's been head of research, CEO of a public company, a former top banks analyst who won't own a bank in his fund, and a highly respected and extremely successful founder and CIO of the global equity fund manager Fundsmith. So Terry Smith, welcome today to the Money Maze Podcast.

Terry Smith
Simon, thank you.

Simon Brewer
Looking back, Terry, you graduated in history from University College Cardiff in 1974 and finance in the '70s was a different, duller beast, some might say the better for it. What was the attraction?

Terry Smith
I got a first in history in fact, and my professor, Stanley Chrimes, SB Chrimes, had me in one of those classic meetings that took place in those days in his study with a glass of sherry one afternoon and said to me that he thought I was going to do very well in my finals. I said, ‘Well, you should know, Prof. You're marking them after all.’ It was lots of [inaudible] for a job. He said, I think you're going to be- because he was about to retire actually. He said, I think you're going to be my last first, which was a nice thing. And he said, I'd like to offer you a role basically, go and do a PhD, take up a research fellowship or whatever it was in college, and I think you could have a career in teaching history, researching, teaching, writing history. I said, ‘Very flattering. Can I ask how much it pays?’ And he said, ‘I'm sorry?’ How much do you get paid? He said, ‘I really don't know. I have to find out. Why?’ I said, ‘Because I haven't actually got any money.’ He said, ‘Oh.’ But I eventually did find out how much it paid and decided that I was going into banking, which is what I did instead. He said and he meant it in a very light-hearted but deterministic manner that I've turned down my career in history for quote 'vulgar commercial considerations' unquote.

Simon Brewer
You can't beat academia. I want to advance a few years because it didn't take long for you to be the top-rated banks analyst in London. I wondered what it was that you were doing at that time that propelled you to the top spot.

Terry Smith
I think at the time, I was literally the only banks analyst who'd ever worked in a bank. All the other banks analysts were people who got into stock broking and had done various things in stock broking firms in terms of sales or whatever and had been selected out of the pool of people to analyse and they might have become a mining analyst, they might become a stores analyst or banks analyst. I was the first of actually a generation of, I can think of a good handful that followed me after that who dropped out from banking and became banks analysts. I was the very first one. When, for example, we had what was then called the less developed country crisis, the LDC crisis of the 1980s, where we had the big problems of basically default in South America from developing countries not being able to pay their obligations, and the banks were very abided by this. And if you look at the numbers in Taleb's 'The Black Swan', he reckons that the banking sector wiped out all of the profits that it made in history to date at that point from its losses. So it was pretty severe stuff and it affected the banks a lot. They had to have a massive rights issue to recapitalise with it. I was able to do things to say- because there wasn't a disclosure then. It was nowhere like what it is now in terms of accounting. I was able to find ways to enable us as brokers and our clients, investors to get very good estimates of what the bank's exposures were, things like I knew that we'd done a filing for a bond issue in the United States of America and that we'd have to comply with the SEC requirements on disclosure, and they were a lot more onerous that the UK PLC regime I think, and all the limited companies. And therefore, you could go and have a look at the bond filings and you could look at what the concentration of risk was. So it was things like that that I was able to do because I worked in a bank. I worked in a bank's finance department for about half the time. So I had a reasonable idea how it all worked.

Simon Brewer
Got it. So by 1990, you become Head of UK Company Research at Phillips & Drew. Now, I was a client of Phillips & Drew in the late '80s, and that followed in ‘92 your book I referred to. I want to pause on this because of course the book led to a disagreement and to you and UBS parting company, one would say acrimoniously. I know it was a private settlement. But what is important about that is two things, is the issue you're addressing, and I know the accounting for growth was a pun, was about what you started to observe. And I'm going to quote you because you say, 'Whatever rules you put in place, smart people will find a way to express and distort it or flattering picture of their performance.' And I guess we would only say that trend has got worse. But how was it that you became fixed on this?

Terry Smith
Yeah, it was a sort of confluence of factors really. I'd gone to UBS in 1990 to do research because they were in difficulty. And the difficulty was, they’d taken place in a deal for a company called Blue Arrow run by a man called Tony Berry, I think it controlled Tottenham Hotspur for a while, to buy a temporary employment agency called Manpower in America. They'd done a big convertible issue along with NatWest as co-runner to finance that. And I think back to the fact that we're in 1990 or 1989 when this occurred, it was a £750 million issue. That's quite big nowadays, but it was colossal then and it was a complete flop because it was a shell company buying it. It completely flopped. But of course, instead of admitting it was a complete flop and they were stuck with most of the issue, they basically hid it all on their market makers book was exempt from disclosure, in fact, took out four-page adverts in newspapers saying how successful it was. And of course, when it came to light that they were lying about this, frankly, a number of things happened. One was four senior management, including the head of research, were under arrest. And the other thing was that the institutions who were righteously

annoyed by this action went on strike, stopped dealing with them. So I got a phone call from a headhunter. You have to not laugh at this point, please, because [inaudible]. He said, UBS want to hire you as head of research. And I said, good because I wanted to move on and do other things in my career, not always be a banker. And he said, 'They want you to reclaim the moral high ground from them. They think you've got a reputation for integrity with institutions and you will come and help them do that.' And as I always say to people to explain the accounting for growth incident and the fallout new best, I think I can reclaim the moral high ground just a notch or two higher than they wanted. That was the background to me arriving. And then when I arrived, it was a recession. We obviously had just had the invasion of Kuwait by Iraq, the oil price had gone up very significantly. And as a result, we had a recession on our hands. So we had a war in the Middle East, and the big rise in oil prices and a recession. And a couple of companies, big companies that were in the FTSE or just been the FTSE went bust and they went bust just after reporting record profits, which is interesting in one case. Polly Peck being one, British and Commonwealth being another. And I was really struck by my late father-in-law who was a headmaster and an intelligent man definitely, but not a man who had anything to do with finance. And I remember him talking to me about this because he was generally interested and he knew what I did for a living so he talked to me about these things. And he said, 'Surely that's not possible. How can you go bust after reporting record profits?' And I said, 'You only go bust because you haven't got enough cash.' 'Aren't profits and cash the same thing?' And I said, 'No, they're not.' And I gradually gained the impression that first of all, there was a kind of an educational job, if you like, to do. And secondly, that there was clearly an awful lot of fast and loose being played by companies with capital. Basically, the losses went in the balance sheet, and all of the income went into the P&L account, and the two diverged like that in terms of what they were telling you. So I sat down and wrote this book, and I thought it would be useful to do this reclaiming the moral high ground that UBS said they wanted. So I said I think I may have slightly overestimated their desire for that.

Simon Brewer
What's the expression? Maybe virtuous, but maybe it's tomorrow. I guess that in this incident, the seeds for your subsequent investment philosophy were being planted.

Terry Smith
Yes, they were. I was probably by nature anyway in terms of what I had one as a bank analyst, but as you say also during this episode more particularly, and again, a bit later on when I got to Collins Stewart, I began to feel that the numbers were pretty much the most important thing you got out of companies, and that an awful lot of people focused on the spiel, a story, what they're telling us, how they present. So I said, well, shouldn't we look at the numbers? Why? Because isn't that why we have accounts? Sure, I read that stuff but that's why we have accounts. I began to focus on that as something which should be, not always is, but should be your primary source of information out there.

Simon Brewer
So that's interesting because of course there's a small shift in your skill set. You go to Collins Stewart as a management buy-out, you end up as CEO of a public company. And I wonder what different skills you had to acquire being CEO.

Terry Smith
Being an analyst and being a CEO are quite different things actually. Clearly, with an analyst, it's about being able to work out what's going on in terms of companies creating or destroying value, and attempting to value their equity, and then being able to communicate that effectively to investors. That's basically what you're doing. Once you get to companies, you've got to deal with other things like people, which is interesting. You really do. You've got somewhere between hundreds and thousands, depending upon which business it is I run, of people and it becomes a bit like boxing but with 20-foot poles on your arms because you basically inevitably have to

delegate and accept that there are other people who are doing things. And you have to learn to let them do it to some degree as well, providing they're operating within a framework that you want. I don't think an awful lot of people have ever made that transition, and it's because it's not an obvious one or an easy one. To give you a small story if you can stand it for a minute, there used to be a client that I dealt with in the Bahamas who was the head of research for Templeton, a man called Mark Holowesko. And I used to go fly into Lyford Cay and present my analysis and so on. I always found him okay but a bit of a grumpy guy to deal with somewhat. And then he dropped out from Templeton and set up his own firm called Holowesko. They sponsored a cycle team, maybe still do for all I know. And then next time I went to see him as Holowesko, everything went wrong. We were in the Bahamas and the power went out. He said, 'Don't worry about it, come home, fix your computer up there. My son will show you how to get connected.' It was very nice. I had a cup of coffee. And I said to him, 'Don't mind me saying this, you seem an awful lot more relaxed.' And he said, 'Yeah, when I was at Templeton, what I really wanted to do was analyse things and make investment decisions, but I ended up having to deal with blocked toilets.' He said, 'I don't want to do that.' And the reality of being a CEO or managing personalities is you're going to end up dealing with blocked toilets.

Simon Brewer
I never got that high to have that opportunity.

Terry Smith
I'm not making it up by the way. I actually literally have had to deal with problems involving the toilet. [inaudible]

Simon Brewer
When I was taking that research at Collins Stewart, this CFROI, this cash flow return on investment became a very central plank of what you were doing. That leads us to Fundsmith which we're going to talk about. But brief history, launched in 2010, you've annualised somewhere around 16% per annum which are very impressive numbers. You manage, correct me if I'm wrong, circa $40 billion on behalf of families and endowments and banks. Just fill in the gaps for me. Number of people, number of offices.

Terry Smith
Fifty-nine people, three offices. One in London, one in Connecticut, one in Mauritius. We keep the numbers low deliberately. I might touch upon military history I think as you mentioned. I always remember the adage of Colonel David Stirling about small groups of like-minded individuals. So we do that. And also because we think there are very few things that we might have an edge at. We believe and hope we've got an edge at managing the money, and we believe we might have a bit of an edge over other people in terms of the way that we communicate and deal with clients. But that's about it. Once you get to the call centre, I don't think we've got any edge in running a call centre. Once it gets outside those core competencies as it were, we're really keen to try and find other people to do that if we can.

Simon Brewer
Got it. So let's start with what was your goal when you began Fundsmith, and has it been modified?

Terry Smith
The goal was to run the best fund there was. You might say that's a bit of an immodest statement, and it is. But I'm a great believer in if you don't set down a high objective for yourself, if you don't shoot for the moon, I don't see how you're going to hit the top of the house basically. That's really what we were setting out to do. We felt that needed to be done in a way which was different to the vast majority of the industry. Because when we looked at the vast majority of the industry, we were trying to use, going back to Templeton, an adage of the late

Sir John Templeton, which is if you want a different result, you have to do something different. You can't get a better result by copying what other people do. There's a Henry Ford quote where he goes, success doesn't come through imitation, and I think that's true. So we decided we wanted to do things differently than the way the rest of the industry did. We wanted to do things in terms of how we invested, the concentration of our investments, the way that we communicated directly and clearly with clients. We wanted to do that all very differently, and as a result, produce the best fund. Define best fund. The one with the best long-term risk-adjusted return, not the best return. It may or may not be the best return, but the fact of the matter is, somebody might produce a better return but you have a look at the risk they're taking and thinking, wow, that's interesting. So best long-term risk adjusted return is what we were aiming to do.

Simon Brewer
And you've been very clear, the only way to succeed in investment is to break out from the crowd. Now, for those who don't know Fundsmith, if you go onto your website, which I have done, and looked at, read your reports, listened to your commentaries, I have to say it's absolutely clear and approachable. You have something called the Owner's Manual, which is very helpful. As I needed to fix one of my tires the other day, I was in the garage and I looked at the owner's manual. It was a German made car, could not have been more difficult to find where the right tire pressures were, which are actually on the doorpost on the inside of the driver's seat. Your owner's manual is excellent. And you start talking about the things that we want to get into right now, which is A, high-quality businesses, one which can sustain a high return of capital employed. Lots of people talk about we buy great businesses, it's such an easy slogan. Let's narrow through your lens what defines a good company.

Terry Smith
Okay. What defines a good company? It's a company which has three or four things, a high return on capital employed, often overlooked. Buffett, in his 1979 annual letter said it was the most important measure of performance by a company, but almost ignored since. Go and have a look at any research you get on companies and see how many of them cite the return on capital at all, let alone whether any of them put it down as the primary measure. Why? Because it is in everything else we look at. If you invest in my fund, you're interested in the return, aren't you? You just mentioned the returns just now. If you invest in your bank account, you're interested in the rate of interest, which is the return. Buy some bonds, you want to know what the yield is, the return. Why ignore it when you get to companies? Because after all we're doing when we invest is we're purchasing a portion of their capital. We want to know what the return is. And if the return is too low, then it won't create any value for us over time whatever the cost of capital is. And I was well taught as a broker, if you don't know the answer to a question, it's 10%. Let's assume it's 10%, which by the way, it probably is quite close to 10% and I'll tell you why I think it's quite close to 10%. So if a company can't make 10%, it's taking capital at a cost of 10% and not making anything. Whereas if it can make 30%, which is what the average is of the companies in our portfolio roughly speaking over time, it's clearly borrowing money from the market at 10% and making 30. It's creating a great deal of value. So that's point one. It must make a high return. Point two, it must have a source of growth. It's no good having a great return if you've nothing to invest in. I think the most under-appreciated and under-discussed aspect of equities is that they have a unique quality that no other asset that you can invest in has. They can compound in value. How? If your company has a return on capital of 30%, or even 20% for that matter, and retains about half of that capital, which on average companies do, they pay a dividend that's two times covered on average, and it can invest the half that it retains of the profits each year at 20 or 30% again, it will compound in value far more effectively than you could do it by any other method. Whereas if you own the building that you're in today or I own this building, we'll get rent from renting it, but the rent is not reinvested in buildings, is it? You might say, well, I could go and do that and still could, but there are quite high frictional costs of doing that and you won't get necessarily the same yield as your initial investment. If you add bonds, if you're currently invested in some US Treasuries, you'll get a 4 or 5% return, but they'll just send you a check putting in more bonds. But if rates fall, that's quite a big problem for you. Because to get his

money out, you've got reinvestment risk. So they must have a source of growth into which they can invest some of those fantastic returns. And it's usually a combination of consumerisation of the developing world, people consuming more as they become more affluent, premiumisation of the developed world, us drinking no more but drinking higher-quality spirits or whatever it is, secular trends like ageing and healthcare, and so on and so forth. So they must have a source of growth. And then they must have a means of fending off the competition, what Buffett calls the moat, the protection around your castle, basically. I don't particularly like the term but I haven't thought of a better one, so we'll stick with this term. If a company has got 30% returns on capital and it's capable of growing at 8% per annum, so take a company like Coloplast or something like that where your investment has got that, capitalism should mean that other people want to take that from you. Other people should look at that and go, I want to do that. So you should find that there are new entrants to your industry or that your competitors invest more capital to try and take your market share, or that private equity becomes involved to try and finance things like this, etc. So there must be a means of you protecting those returns. And that usually comes down to brands, strong brands, control of distribution, an installed base of equipment or software that gives you a captive market, patents sometimes in patented developments like medicines and so on. So those are the sort of things that we look for in terms of companies. As much as I'm a man who says the numbers are a primary focus, it's no good just finding someone with high returns and growth, you need to be able to pose and at least think you could answer this question. Why is this business so good? Given the nature of capitalism, we would expect people to go from high returns to average returns over time. So why is it that Coca-Cola can stick around for over 100 years and still have high returns? What gives them the ability to do that? You need to be able to answer that question, not just does it have good numbers, but why does it have good numbers and why have they been able to persist.

Simon Brewer
Now, one of the things that's changed over our careers has been the growth of intangibles as businesses have become more asset-light. I'd just like to understand how you've had to tack your thinking as the old price to book value maybe is a less relevant measure in today's world.

Terry Smith
Yeah. You do need to adapt to that because one of the things that begins to register is that the most valuable assets are intangible assets, and that things which are difficult to replicate are things like brands, distribution, network effects, patents, and so on. Whereas physical assets, things like factories and offices and ships and vehicles and equipment, providing you've got enough money, you can go and replicate most of those things. And frankly, it's a bit easier than that, because usually, these people called banks will lend you the money if you've got physical assets because probably rather stupidly in my view, they think it's safer. They lend to you against, oh, yeah, I've got this asset. So the thing about intangibles is they are more difficult to create because you can't borrow money very easily. If you go to the bank and say, I want to buy this building and the rent still exists and you can't put up that amount of equity, you'll get a deal done eventually on some numbers. If you go along and say, I've got this idea, I'm going to create this brand, they'll go, let us know when you've done that. So you need real equity to do that. That's one of the things that makes intangibles very valuable is they're difficult to replicate with borrowed money and they're very difficult to get around as well. Being tangible, that means that we're more likely to drink Coke or Pepsi as a medical practitioner are more likely to use Becton Dickinson sharps. They are unlikely to use the Stryker Mako surgical robot for a paediatric procedure. These are very difficult things to replicate.

Simon Brewer
A number of these are companies that you own in your fund, but one of the dilemmas we've all had as investors is that a great company doesn't always equate with a great investment. So can we talk a little bit about how you try to solve the equation?

Terry Smith
The obvious point is that a good company may not become a good investment for a couple of reasons. The most obvious one is price. Oh my god, it's way overpriced. That is by and large a matter of time and patience. There's a great Charlie Munger quote where he says, over the long term, the return you get on shares will equate to the return the company gets on its capital. And he's got a great punch line, no matter what you pay in price. A company that has got very low returns will be a bad investment over the long term no matter how cheap you buy it. People often get confused about this. They think highly valued equals expensive and lowly valued equals cheap. Not necessarily. The funny thing is, if you go and buy a car, they charge you more for a Ferrari than a Ford. It's just a fact. And the same goes with this. You get some shocking results in history if you go and look back at what you could have paid for very high-quality companies and still made a superior return. We got a piece of data back to about 1973 and looked at a whole swathe of companies in terms of what PE you could have paid and still beaten the index by about 1%, which most people don't do of course. And the answer was something like you could pay 278 times earnings for L'Oreal, 100 times for Pepsi. We're very bad human beings at working out what is the premium we could pay for things. Now, the problem with paying 278 times, probably that it’s very scary, is there will probably be a period in that 50-year span where you lose money because of that. We've just been through one pretty much in the last 18 months when interest rates go up and those within suffer. And really, the problem in terms of translating a high-quality business to an investment and turning not a blind eye to valuation but certainly not letting it dominate your thinking because you shouldn't, a rather Charlie Munger thing, the problem is the emotional stress that you can get with it. The great enemy in investment performance is us. We're our own worst enemies with regard to it. Because the other reason why sometimes a great company doesn't become a great investment is the management screw up. The reality of investment is that if you invest with us at Fundsmith, you have subcontracted to us a portion of your wealth, your capital for us to make. Thank you. We are then subcontracting it to the management of the companies when we purchase the shares and we are hoping that every year, this company with its great returns will take a portion of those great returns, probably about half in most houses, and reinvest them to make great returns on that extra portion, on that incremental piece of capital that we think if it's [inaudible] company, it would it be great if they got somewhere around that on their incremental investments, which could be in growing the business, acquiring businesses, developing new products, all those things that they can invest in. And of course, from time to time, you get management who managed to do the opposite of that and destroy value by doing it, and that's one of the reasons why a great company sometimes doesn't become a great investment because you're judging a great company driving, looking in the rearview mirror. What you have to do is look out the windscreen to drive properly. The problem with looking out the windscreen is sometimes, it's a little bit obscure out there, cloudy, foggy, the windscreen wipers and the lights don't work as well as they should, all that kind of stuff, whatever amount you want. That's what you've got to do. It's not just a great company looking that way, but you’ve got to have reason to believe correctly that it's a good company looking that way, that the manager you're talking to who's doing the job is going to do sensible things. And that's not always the case.

Simon Brewer
And have you got better at assessing whether management is providing good stewardship?

Terry Smith
I think we have. An awful lot of it, to keep coming back to my theme, is in the numbers. If the numbers are doing that, then we don't need to discuss it all that much, do we? Telling us funny stories about how good they are won't change that. But yeah, we have. And there are some very simple things that give you indications apart from the numbers of how people are doing. Often the way that they present and talk about things will tell you quite a lot about it. I can give you two examples in recent times of people who completely missed what was going on to the detriment of the business. And you could tell it from the way they presented it. When PayPal

was getting into difficulty, and I can describe that difficulty as during the pandemic, they obviously had a good time with online payments, and they named a target of going from 450 million users to 750 and they abandoned that target within one year. Their engagement with the 450 million users they had was not going up. So they weren't getting any new users, or not as fast as they thought. They weren't selling any more to the users they had, they weren't clicking on PayPal anymore. The expenses were going up a lot faster than revenues, and as a result, the performance was poor And the share price went down by, I can't remember exactly, by 60%, 70%. And the then CEO Dan Schulman got up at the results meeting and said he was dismayed. He was dismayed about events in the Ukraine. I thought there was quite a lot to be dismayed about in the performance of PayPal. And I'm not quite sure why we wanted his views on Ukraine. He's entitled to his views on the Ukraine of course, everybody is, but what's it got to do and PayPal? And we had another one recently, exactly the same, Estee Lauder, a company which has performed quite badly in recent times. They had three profit warnings, a 500 million euro stock right off for getting the Chinese reopening travel channel wrong. The CEO at the results presentation said that he was very dismayed as well about events in the Middle East. When I was running businesses or when I run businesses, I always say to people, I found it quite tough sometimes even when I was focused on the right things. It's not like if you flick a green switch and all those important things you should focus on come right. However, if you're not even focused on the right things, how does this work? And literally, we find if people still come out with gobbledygook, if they utter whole sentences, that we can't understand what it means. It's not a great sign. They're really able to tell you about what's going on. There are lots of things along those lines. The most obvious one is if they invest outside their core competency. Most of us are not polymaths. Not many of us are going to be like Leonardo da Vinci. We might be good at one thing or two things and companies are the same. They might be good at snacks and drinks, but are they really going to be good at also doing oats? PepsiCo, for example. The answer is no, by the way. No, they're not. They aren’t going to be very good at that. They might be very good at doing- in the case of if you take Google or Alphabet, clearly, they've had a runaway success with online search and advertising. Why do we think they're going to be good at autonomous cars? Why will their investment there pay off? Because after all, Ford and Volkswagen have run away from that as a project. Once they start getting outside their core strength, you can usually feel that you've got a problem on your hands.

Simon Brewer
So as I was thinking about our conversation today, I went over some of your older work, and one of the ones that was very perspicacious and not without controversy at the time was Tesco. And of course, under Terry Leahy, you write, the ROC, the return on capital employed fell from 19 to 10. And you say the market was ignoring the point that more capital is being employed to generate those earnings. Now, I think they were putting on a lot of debt. Just give us a couple of minutes on why the warning signals were flashing around Tesco when quite frankly the market was deeply in love with it.

Terry Smith
If you go back to that 1979 quote from Buffett in his annual letter which I've referenced earlier, he says the primary test of management performance is return on capital and not growth in earnings per share. And the market gets mesmerised by earnings per share. It comes back to something you mentioned right at the beginning of this interview, which is whatever you set down as a means of looking at things, people will find ways to try and circumvent it. So once you get management who realise that the only thing that people are looking at is the growth in earnings per share, guess what they're going to deliver. They deliver growth to the detriment of capital. People often get confused. How can that be? Think of it this way. You've got 100 in your bank account and you get 5 in interest on it. Okay. And then you put another 100 in your bank account and you get 10 in interest. Is that great? It doesn't sound particularly good to me. But even worse, this is closer to the Tesco example, you have 100 in your bank account and you get 5, then you put another 100 in and you get a total of 7.5. That sounds quite bad to me. It means that the other hand was getting 2.5. And that was what

Tesco was. The core UK powerful franchise that have been producing 18 or 19% was still there. But the other investments, things like Fresh & Easy in California and Thailand were producing negative returns actually. But of course, the earnings per share were doing that, people were mesmerised. Oh yes, the earnings per share are wonderful, and then of course, suddenly it's not. The whole thing has collapsed and has never really come back from it basically.

Simon Brewer
I have to ask you, having been successful with banks, it's something you don't invest in. One could make an argument that there's a concentration of power. I know UBS, they've acquired CS at an extremely cheap rate, etc. Is that a red line? Will you not own a bank?

Terry Smith
I wouldn't say never. Never is a very long time, and so one's got to be a bit careful. There are lots of good reasons not to own banks, including I might say UBS notwithstanding the very cheap CS steal, and nothing to do with my history with them, by the way. That's long, ancient history and I don't think anyone involved in it, and I was in touch with people who were involved in it, including people on the other side of that dispute in recent years, bore any great grudges. The reality is it set me free because I had to become an entrepreneur after that. I didn't bear any great ill will. I did none of that. Even the buying of CS is, are you sure that's really a good thing for UBS? Because the whole point about CS is it was trouble. And unless they're really going to dismantle the bit that was trouble, I don't see it. Are they going to get out of investment banking? Which doesn't work. And so there is a lot of reasons to not own banks. They need leverage to deliver an adequate return, which is always a red flag dangerous. They are subject to regulation which weighs heavily upon their ability to deliver returns. The regulator's attitude to every crisis in banking is more regulation, more capital, which handicaps them in that regard. They're subject to systemic risk. You might be running a bank, you might be running your bank perfectly well, but what somebody else does in a bank down the road can cause a run, and as a result, boom! The Silicon Valley Bank thing has clearly led to knock-on effects into other US regional banks who may or may not have done anything particularly bad in their business. But the degree of disappointment caused by the run on Silicon Valley Bank, it's not impossible they'll ever be a bank. I wouldn't go that far.

Simon Brewer
Some would argue we've gone back to the past that we knew with a higher cost of capital and more realistic monetary policy, but there are consequences as we see companies reacting to these higher rates. A question that struck me, and I was talking to Chris Dale who runs Kintbury Capital, which is a European long-short, I'm an investor in it, and we were talking about the decline of research standards. We're in an era where technology has never been more ubiquitous at our fingertips and yet, it seems when I was listening to him, there is an irony here that nobody wants to trawl through the footnotes of accounts.

Terry Smith
If you go back to 'Accounting for Growth', part of the aftermath of accounting for growth, I'm not pitting too much on 'Accounting for Growth', but I knew David Tweedie quite well and it was the Accounting Standards Board on improving things. The standard of accounting undoubtedly improved in the years after 'Accounting for Growth' not because of me, but because it needed to. And other people like Sir David Tweedie did quite good work to improve it. The problem became that nobody was reading the accounts after that. As you say, people weren't going through. We went through the accounts of IBM when we were opening Fundsmith in 2010, and we never invested in it fortunately, I've got to say. We found a $1.8 billion error in the cash book. And so we rang up IBM's IR and said, 'Hello, you don't know us but we're a bunch of fund managers who have just started and we're looking at your company and we're on page whatever it was of your accounts, and we've got this issue. We can't make the cash flow work.' And they said, 'Oh, usual, we'll come back to you.' And they rang us

back and said, ‘You're actually right. It's incorrect.’ We said, ‘Oh, that's rather interesting. Did anybody else notice that?’ And they said, ‘Not worth that. They certainly haven't rung us up and asked.’ And it was one of those things which was such a large error that you thought, ‘I might be going mad, I better ring the company on this.’ I could cite you as many examples as you could record and listen to of where it's obvious that other people are not reading because what they're reading now is the management presentation, those nice slideshows that they put out, which funnily enough, I run a couple of public companies, I can tell you a couple of things, secrets, tricks of the trade. You always put your best foot forward, weirdly. When you look those numbers that are out there which says EBITDA did this, it usually has an asterisk you'll find by them which says at the bottom ‘adjusted’. And weirdly, the things that are adjusted for are all the bad things, things like litigation and restructuring costs and acquisition costs and acquisition write-offs. Oh, okay. So if we take that out, it all looks a lot better. People are not actually doing the work to read the accounts, which probably now are pretty good. Again, you asked me earlier about what to look for and red flags in companies and that sort of thing. When you get publications of results by companies, not the report, [inaudible] the actual slide deck and so on, if the pages referring to the adjustments are bigger than the main accounts, you've clearly got a problem on your hands. And you end up with a point where it's a strange thing, people start to believe their own stories. Management starts to make decisions on the basis of the adjusted numbers. They convinced everybody in the end, they convinced themselves that this is the right thing to do. So there are things going on out there which I think are quite injurious. The other thing that I would cite on our analytical community is guidance. When I was an analyst, there was no such thing as guidance. It was my job to try and forecast what was going to happen. I had to say what would happen to bulk rates and profits and returns and everything else. Now they get guidance from companies, and they believe it. And of course, in many cases, they're actually right to believe it. But the companies sometimes don't have a particular crystal ball. So a company that we follow called Adyen, a Dutch-listed payment processing company, if you don't know has had quite a bad time this year, share prices halved, because it basically missed its goals, I don’t know, 30%, and it like I said ran into an actual disaster. But it's gone from 30% growth to 20% growth or something like that. And the problem with the share price has been of course it got rated by the analytical community on the basis of the EBITDA. And now it just rallied a third the other day. Literally, on Monday, it went up by a third because they’d given guidance for next year which was raised. And I thought, haven’t we been here before?

Simon Brewer
Now, would it be fair to say that you have all the skills needed to be a pretty good short seller, but you just use your skills to avoid the blow-ups for your long book? But in this higher rate environment, do you find yourself thinking, oh?

Terry Smith
Obviously, not in our main fund because it is a long-only fund, but it's tempting. Yeah. Well, I've worked with some of the best and most famous short sellers in the world that you've heard of in the time when I was an analyst. And it's a skill that I much admire, but it is quite a different methodology of investment. The risk-reward ratio is completely different for one thing. It's the diametric opposite of what we do as I'm sure you're aware. There is limited downside, can't be more than 100%, unlimited downside. Share prices can go up infinitely. It's also very active. If I short something today and it went to zero tomorrow, I need a new short, don’t I? Even if it doesn't go to zero, if it just works significantly, it becomes the more successful it is, the less significant it becomes to my portfolio. It's very active, but you also have to be active in risk management terms. I remember having a client when I was still a broker who I'd given a short idea to in the online directory business. Was it called LuLu?

Simon Brewer
Yellow Pages, Yell.

Terry Smith
And she was short of it for about £9 to 90p and lost money. She said what kept happening was they kept having takeovers, this funny old thing. And I kept being rang up my broker who said, as a collateral call, you've either got to cover this or send me more money. So I cover it, then the shares will collapse again. It's not as easy as it looks.

Simon Brewer
Absolutely. I've tried a bit of it in my career, and I would testify to that. The other thing that you don't do I think assiduously but I just want to understand if it ever filters into your investment process, and that's thinking about the macro.

Terry Smith
We think about the macro, but it doesn't really have a great deal or any effect on the investment process. In the end, we're investing in companies. I always cite when people talk about macro a saying from when I was a broker at Mercury Asset Management, which became Merrill Lynch and so on. It had this triumvirate that ran it, Stephen Zimmerman, Carol Galley, and Leonard Licht. They had a sort of dealing room set up and I'm told that in those days, the trade figures were a big thing. The whole of the market would stop on whatever, the third Thursday of the month or whatever to get the last month's trade, or second Tuesday. The market at about 11:30 would come to a standstill until we got the trade figures and then people would- maybe they still should, I don't know. People tell me it doesn't matter anymore. I'm not convinced. But anyway, that's what it used to do. And the young man who just started working was told to always be on the ball with things. And this was in the days when everybody didn't have a Bloomberg or a Reuters or anything. He saw these things flush up somewhere and immediately stood up by his desk and shouted out, 'Bad trade figures!' And apparently, Leonard Licht shouted back, 'Sell mine for me!' Great son, but what do I do with it? We invest in companies in the end. We do think about macro. We absorb an awful lot of stuff from companies over time and that does inform us. When we're talking about inflation, for example, which obviously is the subject du jour, as it were, we often say- or recession, which of course might be the subject of tomorrow, I suspect, because it could be coming. We always say it's interesting how people look at statistics like the CPI and they look at the GDP and so on. How about looking at some of the company's statistics? One of the things that can tell you quite a lot about an economy is the payment processes. Where are Visa or MasterCard? What do they tell you is going on? Are the payment processes going up and down? How much are they going up? Are people using debit? Are they using credit? Because it quite often tells you, it informs you. I remember when one of the many controversies about the size of immigration in the UK was going on in the last few years, not whether it should be allowed or what to do about it, but just how much was it. If you might recall the government was saying tens of thousands. It turned out to be hundreds of thousands. Somebody did a good piece of research which looked at the data you could get on footfall through retail grocery outlets, so Tesco, Sainsbury's, Asda, Lidl, Aldi, Morrison's, etc. So what was the footfall across them and what was the number of operating mobile phone SIM cards out there? And they looked at it and went, no, the population is going up by half a million a year. And it was. There's an awful lot of good data that companies get out there that can inform you about macro that we think quite often gets ignored, and we're interested in it basically. But it doesn't really drive the investment decision. I don't sit there and think I know what's going to happen in macro, and as a result, I'm going to do this or that. First of all, I don't know what's going to happen in macro, and secondly, that's not why I invested.

Simon Brewer
Tell me about Fundsmith. Where would you like to see this business in five years' time?

Terry Smith

Probably doing exactly the same as it's doing now, not doing anything different, hopefully delivering a good risk-adjusted performance for our investors. I don't mind whether it's got bigger or it hasn't got bigger or it's got a bit smaller. There's no particular I'd like it to be this amount of money or that amount of money. It's absolutely okay as it is. Increasingly, as time goes by, and I've got to be careful with this, is 'Oh, you're about to retire.' I have no desire to retire, no intention of doing anything, but it is to continue with something which we've started, which is to bring on people within the business and the ownership of business so that it can have a long-term future. So when I'm no longer around or capable, or whatever it is, that there are other people who will be sitting there doing the job after me and taking it on. I think that's the sort of thing. I'd like to see it progress along that, basically. That's all. We haven't got any idea particularly at the moment for a new fund. If we do think we've got an idea for a new fund, we'll probably give it a try with our own money first before we trouble anybody else, and so on. But we haven't got one and we may never have one. I don't know. It doesn't matter. We're okay as we are.

Simon Brewer
Now, you've been as we said earlier one of a very unusual cohort to outperform world indices. I think the data is circa 90% of active global equity firms, certainly in the US have underperformed their benchmarks.

Terry Smith
98% of global equity funds have underperformed the index since we opened over the last decade.

Simon Brewer
Let's pause on that. Because we all know what has happened with passive and that extrapolation may be lazy. What do you think we might see in a higher rate environment where the Magnificent Seven have maybe some characteristics of the NIFTY 50?

Terry Smith
The way I think about it is, first of all, passive is a really good choice for most people. Given that 98% or 90% or somewhere underperform, it's obviously a very good choice for most people, because outperforming over the long term is not easy, finding something to outperform is not easy. So it's a very good choice for people. But I think that if we have rates that remain where they are, or somewhere around where they are for periods of time, I don't fear for the methodology of investment that we've got. It clearly suffers during periods of rising rates because markets are not perfect. I can cite as much of that [inaudible]. Not totally imperfect either. They're somewhere in between and they vary a bit from time to time. But it does mean that if we do own high-quality companies, and that's the one thing that I would stake my reputation on is that we've got high-quality companies, on average, they're going to be a bit more highly valued, on average. Not always, not all the time. I hope to find a Microsoft or Novo Nordisk or a Domino's Pizza from time to time where the market missed it. But I'm not going to find one every day or even every year actually. On average, it'll be a bit more highly valued, which means when rates go up, they're going to perform a bit worse than lowly rated shares. So value will have its day in the sun. It must. If there was never a day in the sun for alternative strategies, everyone would do the strategies and it would be all over. So there's bound to be that. But if rates are not rising, I don't think it damages what we do as an active investor. And if it remains roughly where it is, if inflation remains roughly where it is and rates remain roughly up, I think we're quite good. Because if inflation is 5% or 6%, it's better to have a company that's earning 30% on capital than one that's earning 10%, clearly. The other thing that doesn't worry me unduly as much as it will be unpleasant when it happens, and you can ring me up and say Terry how are you feeling now, is a recession. I've seen plenty of these. I started work during one in the 1970s. I saw one in '79, '81, I saw another one in 1992. I saw one in 2000 to 2001. It takes a lot to impress me, frankly. And I think things of the sort that we own as an active manager will fare relatively well during that. So there's none of those things that you describe that are around a continued high-rate environment that bothers me. The only thing I

think it will do, which we're seeing already and I think we'll continue to see, let's assume rates stay right where they are, is Uncle Sam. The US government will give you 5%. That's quite tempting to a lot of people. So I don't think we'll see great flows into the equity sector. I think we'll actually see flows out of the equity sector continue if that happens because people will think I can get 5% with no risk. So they're going to take that. They're probably wrong to do that. Over very long periods of time, you get about 9% in equities overtime as a passive investor. Over very long periods of time, you measure that and it's pretty consistent. But of course, you can't guarantee you'll get it this year. And so a lot of people go, I'd rather have the 5%, and I'll wait until I'm sure. When they wait until they're sure, they've missed it.. The fact of the matter is if rates remain where they are, first of all, passive is for most people better than active to summarise. Secondly, if rates remain where they are, it doesn't bother me in terms of us as an active manager with the sort of companies we own. The recession doesn't bother me in terms of the sort of companies that we own. But the competition from bonds for most investors will remain stiff in those circumstances because most people are more concerned about not losing money than they are about making it. Terry, you're absolutely right. You've got all these statistics that seem to demonstrate that passive equity investment will make me 9% over time, but I'd rather have 5% because it might lose me 9%. Can you guarantee it won't lose me 9% this year? No, I can't. I can't.

Simon Brewer
That's great. That's a great place for us to wind up. I've got a few general questions. We started this by talking about your passion for military history, which I happen to share. As I said, I'm going to hold it up. We have being released tomorrow General Petraeus and Andrew Roberts's terrific book on conflict.

Terry Smith
Currently reading the second volume which is a biography of Nelson which I'm reading. It's the second one, 'The Sword of Albion.'

Simon Brewer
How interesting. Now, I read that you did some important work to have a New Zealand gentleman by the name of Keith Park, then Sir Keith Park, recognised for his work during the Battle of Britain. Just tell us why you did that.

Terry Smith
Why did I do that? It was a confluence of things really. My father had been in the RAF, so I guess I had a slight emotional attachment in that way. I was a keen pilot myself. I flew gliders, then fixed wing, then helicopters, so I was interested in it. As you rightly point out, I've got a great interest in military history. And then I was reading the book by Stephen Bungay, who's written some very good military history. And he's a very unusual military historian. As far as he's not a historian by training, he actually ran Ashridge Management Centre. I think he was involved in the insurance industry at a high executive level at one point. But he's write, in my view, extremely well, and I though his book 'The Most Dangerous Enemy' was the definitive history about the Battle of Britain. When I was reading it, he basically points out that Park was the one man that Dowding trusted to execute his strategy. He was the one man who could have lost the entire battle in a day, and yet he showed great judgment and character to implement that strategy, notwithstanding all the temptations to do other things. And that they had gamed his decisions, people have war-gamed his decisions over time, and it's pretty much impossible. Nobody really managed to materially improve upon his actual deployment decisions. And then finally, he said two things which really got me. He said, he was like a magician in an Arthurian tale. He literally travelled halfway around the world, because he was in New Zealand, to defend a country which was not his own, and then having finished doing that, he just disappeared. A very understated character. And he's ended that by saying there's no memorial to him anywhere in the world other than a close of houses in Biggin Hill near the old fighter base in Kent called [inaudible]. There's no monument anywhere in the world. Anway, when I finally managed to get the

memorial to him put up in Auckland [inaudible], I had Bungay attend the dinner because he was very supportive of the campaign and I thought to some level inspired me to finally take it on. I said to him, I want to correction printing.

Simon Brewer
I'm told by friends who are still in the military that this new film being released next year 'Masters of the Air' which is about US Bomber Command over the Second World War is going to be absolutely terrific. Two final questions we ask of our guests after the book, if you could tell us just one thing. And as a piece of advice to listeners, what would it be?

Terry Smith
Don't keep looking at things. Think carefully about what it is you want to do. And having done it, go do something else for a while. I always say to investors, because they'll ring me up and say, what about this, what about that. I say, you should only look at the fund once a year, just one day a year when you look at it. Because in between times, all of the noise that happens in terms of quarterly reportings, share price movements. Quite often in our daily notes, we write to each other within the firm. We'll point out that after all the hullabaloo for the year, the index is the same as it was six months ago. So ignore the noise. Try and ignore the noise. Very important, I think.

Simon Brewer
We have a good cohort of young people at universities. We sponsor eight now at the Money Maze Podcast, their finance and business societies. Young people thinking about finance and the investment business, any advice?

Terry Smith
Get some training. Lucy Kellaway who wrote for the FT on work wrote a very good column some considerable time ago when she was still working there. And she said, the internet age has done a disservice to a lot of people because they come along and think I want to start a business, and they've got none of the skills to do that. So even if they could eventually be successful, they write themselves off. What they should do is go and take a job and get training, which is what I did in banking. I went into banking after turning down history for vulgar commercial considerations. And every time somebody appeared and said, would you like to take a course on law, yes, accounting, yes. Absorb stuff. And once you're doing all that, try and do one other thing. Try and find a mentor. Try and find a mentor, somebody who knows how it works and is prepared to take the time and effort share that with you. Usually, and this happened to me in my career, by an exchange, and the exchange usually is you end up doing their job for them and they take all the credit, which is fine. It's what people would have called an apprenticeship.

Simon Brewer
Who was your mentor?

Terry Smith
A man called John Spencer, who was the head of group finance at Barclays when I started there and who had a great love of sailing and eventually would go off sailing for six weeks in the summer and leave me to run the group finance department. I always tell the story that in those days, as I said, I was an angry young man. Now I'm an angry old man. I would always have a view about every other day on something we were doing wrong. A bond issue in America, we're doing it wrong. We shouldn't be doing it that way, we should do it this way. Always a liability mismatching. I would always charge into his office and berate him about something we were doing wrong. And he had this methodology which you could work in those days. He'd say, come back at five o'clock at the close of business and we'll talk about it. And he had a drinks cabinet. So he'd get a bottle of

something out of the drinks cabinet and ply me with drinks. And when I woke up the next morning, I had a hangover and I couldn't remember what I was annoyed about. It worked like a dream until one day, I don't know, I had some built-up immunity to drinking. I eventually turned up the next day and I launched into the same subject and he sat there and he said, ‘Terry, you seem to be confused.’ And I said, 'What am I confused about?’ He said, ‘You work for me, not the other way around.’ We're still in touch and we work together to this day, and that was 1979.

Simon Brewer
I needed one shout-out to a mutual friend of ours, Tyrrell Young who was at Morgan Stanley with me. He really wanted to make sure that we had this interview. So thank you, Tyrrell. Three conclusions. Number one, when you're looking at companies, do not forget return on capital employed is absolutely at the top of the list. Number two, ask yourself a question as an investor, why is this business so good? And number three, that the intangibles are actually much more difficult to create than we may think, and therefore, their scarcity and their appeal and the valuation you apply to them makes them different and more valuable than perhaps previous investing generations would have thought.

Terry Smith
Correct. Yeah. That's a good summary.

Simon Brewer
Terry, it's been a great pleasure to meet you after all these years of reading and hearing about you, and so thank you very much.

Terry Smith
Regards the other way to [inaudible] and Tyrrell, please.

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