Twitter Thread by Thomas Chua

Thomas Chua
@SteadyCompound

Terry Smith is often referred to as "the English Warren Buffett".

He runs Fundsmith which has a fund size of £27.9bn.

Despite the size, Fundsmith did a CAGR of 18.4%.

In his book Investing for Growth, he explains his investing philosophy.

Here's a breakdown:

1. Fundsmith's winning formula

Find companies that focus on delivering value.

Not those who are looking to pacify Wall Street with short-term results.

The short answer is carefully. Very few companies make it through our filtering system as potential investments and even fewer make it into our portfolio.

The longer answer is that, whilst we seek companies which have superior financial performance, that should be an outcome of their operations – not their primary objective. We are seeking companies that offer a superior product and/or service to customers which enables them to generate these impressive financial returns and prevent competition from eroding them. I can't think of a company which was mainly focused on driving financial results, and especially those that have obsessed about quarterly earnings in comparison with "the Street's" expectations, which has blossomed into a great company and investment. It is

2. Avoiding "cheap" companies?

Low multiples are not a reason to buy a company.

A ship will continue to sink if it has a hole in it.

"A stock may have a low valuation but an even lower intrinsic value. Buying such a stock is not a recipe for investment success."

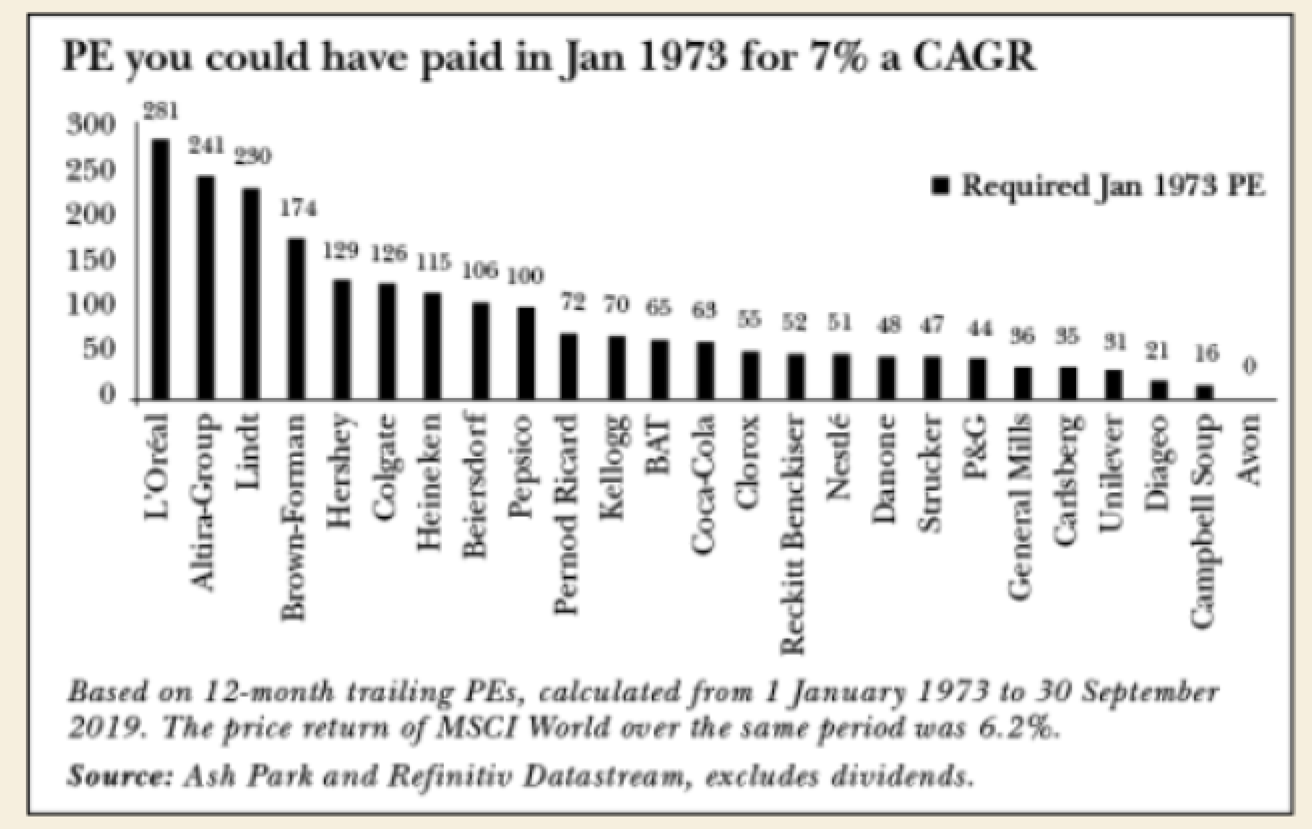
How growth became value but value didn't

	LTM EPS Jan 2015	LTM EPS August 2020	% change	Trailing PE 2 Jan 2015	Trailing PE 2 Jan 2015 PRICE / Aug 2020 LTM EPS	Share price performance from 1/1/15 to 31/8/2020
Exxon	$7.60	$1.68	-78%	12	55	-36%
GE	$1.50	-58¢	-139%	16	-42	-65%
HSBC	42p	-1.6p	-104%	15	-385	-26%
Marks & Spencer	31p	1.2p	-96%	15	380	-68%
Vodafone	42p	-2.7p	-106%	5	-81	-31%

3. Getting quality right

For long-term investors, getting the quality of the business is more important than the valuation.

"An investor could have paid 281 times earnings for L'Oréal, 156 times for Colgate, and 147 times for Brown-Forman and still beat the market."



Based on 12-month trailing PEs, calculated from 1 January 1973 to 30 September 2019. The price return of MSCI World over the same period was 6.2%.

***Source:** Ash Park and Refinitiv Datastream, excludes dividends.*

4. "Unprofitable" companies could be good investments

Many of the best companies don't show earnings today.

But that's because they're heavily reinvesting for the future.

It's just that the earnings hasn't show up.

Adobe	53¢	$7.58	+1,330%	136	10	723%
Amazon	-52¢	$26.01	n/a	(593)	12	1195%
Facebook	$1.10	$8.19	+645%	71	10	337%
Netflix	9¢	$5.93	+6,489%	554	8	1164%
PayPal	46¢	$2.18	+374%	88	19	581%

5. Not all growth are good

Growth is good only when the return on invested capital (ROIC) exceeds the cost of capital (COC).

If COC > ROIC, the company destroys value as it grows.

valuation. Growth can enhance or diminish the value of a company – growing a business with inadequate returns is simply sending good money after bad. But when a company has superior returns on capital employed, and a source of growth which enables it to reinvest a substantial portion of those returns, the result is compound growth in its value and share price over time. It is impor-

6. On share buybacks

A repurchase only creates value if the shares are trading below intrinsic value and there is no better use for the cash.

1. Management should be required to justify share buybacks by reference to the price paid and the implied return and compare this with alternative uses for the cash.
2. Investors and commentators should analyse share buybacks on exactly the same basis as they would if the company bought shares in another company.
3. Investors and commentators should use return on equity to analyse the effect of share buybacks rather than movements in earnings per share.
4. Share buybacks need to be viewed with more than average scepticism when done by companies whose management are incentivised by growth in EPS.
5. Accounting for share buybacks should be changed so that the shares remain as part of shareholders' funds and as an equity accounted asset on the balance sheet in calculating returns.

7. On price anchoring

Often times investors hold back from buying because they "missed the boat".

Or they're waiting for it to "retrace back".

If it's a good company and within your buy range, just buy it.

Fortunately there was a period of share price weakness after the refinancing which enabled us to do this on reasonable terms, but frankly that does not matter as much as whether the shares were still good value when we repurchased them, which we believe they were. It is always a mistaken strategy to wait for the shares to get below the point at which you sold them before repurchasing, or the even more common trait of waiting for a loss-making share purchase to get back to break-even before selling. As I am fond of saying, the shares are unlikely to follow this desired pattern since they do not know whether you own them or not or at what price you bought or sold.

8. 10 advice for retail investors

-If you don't fully understand it, don't invest
-Don't try to time the market
-Minimize fees
-Deal as infrequently as possible
-Don't over-diversify

-Never invest just to avoid tax
-Never invest in poor-quality companies
-Buy shares in a business which can be run by an idiot
-Don't engage in "greater fool theory"
-If you don't like what's happening to your shares, switch off the screen

If you like this, follow me here @steadycompound

I write about investment concepts, business breakdowns and growth philosophies.

If you have enjoyed this thread, you're gonna love my newsletter where I curate 3 ideas on investing and growth philosophies.

Every week.

https://t.co/96pjE7aGBm