Fundsmith

Fundsmith's Approach to Responsible Investment

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Buy good companies
Don't overpay
Do nothing

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Fund managers have always had a fiduciary duty to be responsible investors.

In recent years, initiatives such as the United Nations Principles for Responsible Investment (UN PRI) have sought to give added meaning to the word 'responsible,' particularly in respect of how fund managers integrate ESG (environmental, social and governance) considerations into their investment process and how they behave as owners. The UN PRI actually has an initiative entitled, "The Fiduciary Duty in the 21st Century" programme which "finds that investors' duties require them to embed ESG factors in investment processes." Since we believe that all relevant information should be taken into account when making investment decisions and since it is self-evident that ESG factors are highly relevant, we are happy to confirm our support for the UN's Principles of Responsible Investment.

This document sets out what we mean by responsible investment – including ways in which we think our approach is, if not unique, unusual – how we integrate these ESG factors into our investment process and how Fundsmith engages with companies we own on your behalf across all the funds we manage.

The UN PRI defines responsible investment as "an approach to managing assets that sees investors include environmental, social and governance factors in: their decisions about what to invest in; the role they play as owners and creditors." Listed under the headline of "misconceptions" the PRI also provide a long list of what responsible investment is NOT. These misconceptions include; "responsible investment does not necessarily require investing in a specific strategy or product... exactly how an investor practices responsible investment varies widely;" "responsible investment does not require sacrificing returns;" the misconception that responsible investment "is the same as sustainable, ethical, socially responsible and impact investing" and finally, that as opposed to an approach which makes “moral or ethical goals a primary purpose, responsible investment can and should also be pursued by the investor whose sole focus is financial performance.” In short, as the UN PRI explicitly says, “there are many ways to invest responsibly.”

That said, despite these ‘many ways,’ the UN says that responsible investment approaches typically combine ‘two overarching areas.’ The first of these it summarises as “considering ESG issues when building a portfolio.” It divides this into 3 sub-areas – integration, screening and thematic – then goes on to say that “investors select between, or combine, based on their desired outcomes.” The second overarching area concerns “improving investees ESG performance” and it divides this into 2 sub-areas, namely engagement and proxy voting. We will use these two areas as a framework to describe our approach.

Integration

The UN PRI defines 'integration' as "explicitly and systematically including (i.e. integrating) ESG issues in investment analysis and decisions, to better manage risks and improve returns."

When we started Fundsmith in 2010, we published what we called an 'Owner's Manual' which set out our approach to investing. We did this principally because we thought that our investors would have a better experience with us if they understood what we were trying to achieve and equally importantly, what we were not. This document remains, in its 10th year, essentially unchanged from when it was first published and we believe that not only does it already explain much of our approach to responsible investing but also that its very existence is a hallmark of being responsible investors.

The most important aspect of our investment approach can be summed up in the line from the 'Owner's Manual', "we aim to invest in high quality businesses." We also often say that our ideal holding period for a stock is 'forever' and we have proven to be as good as our word here with extraordinarily low portfolio turnover, with 10 of the current 28 holdings in our original fund in the fund since its inception (as at 31/12/19). If you accept that we aim to own high quality businesses forever – as opposed to engaging in short term trading in shares of any quality that we hope will go up, and then selling them – the question isn't, "why should you include ESG considerations into your research process?" The question rather becomes, "how could you not?"

Within our various portfolios, which in total own shares in approximately 100 companies, environmental and social considerations span a spectrum of risk which goes from minor or incidental, through costly and significant and on to existential. Pretty much every company today talks about the need to tackle and prepare for climate change, the need to have a more 'sustainable' business and the general desire to be a better environmental and corporate citizen. We might begin by noting that since we do not and will not invest in auto, energy, utility, banking or mining companies – the rationale for which we go into later – we are not intentionally flying into the path of the storm.

The main environmental and social issues that we have to integrate into our investment process are:

- A company's supply chain presents both environmental and social risks, the former more operational, the latter more reputational. When it comes to the supply of raw materials, our companies are not hypothesising about future events but dealing with the reality of climate, geopolitical and supply-and-demand issues on a daily basis.
- Our companies are all attempting to reduce their environmental footprint. We have assembled an ever-growing database of statistics that somewhat track their progress in pursuit of this because they in turn produce an ever-increasing amount of data on emissions, energy consumption, sustainable sourcing, recycling, waste, water use and so on. We say 'somewhat,' because there is no such thing as a standardised methodology here and thus it's hard enough to get an accurate measure of CO2 emissions, let alone an accurate percentage of recycled packaging. With the information we do have, we like to measure the impact per millions of free cash flow generated. We do this analysis because we want the companies we invest in to grow and compound in value, which is likely to increase their negative environmental impacts, as they are now bigger. So rather than penalising a company for growing, we try to look at how efficiently they are able to produce free cash flow. However, we believe that assigning debt-like environmental ratings for companies who can barely monitor their own supply chains is premature and likely to imply a spurious level of accuracy and analysis. We would again thus regard such a move as the opposite of 'responsible.'
- Our companies are trying to make products or provide services which are better for the planet – elevators are 90% more energy efficient today than they were as recently as the 1990's, beverage bottles in clear plastic make them easier to recycle, hotels are doing away with single-serve plastic shampoo bottles. There are benefits but also costs to all this. There are also unintended consequences. The craze for almond milk has significantly exacerbated the decline in the bee population. Biodegradable plastics degrade into microscopic plastic pieces that get even deeper into the food chain. The desire to replace our dependence on palm oil may well be pushing us towards a reliance on crops that cause even more rainforest destruction.
- Our companies are trying to make products, which are better for us and for society as a whole. Food and beverage companies are trying to remove salt, sugar and fat from their products, social media companies are spending billions trying to remove harmful content from their platforms and tobacco companies are attempting to transition their businesses to so-called 'Reduced Risk Products.' In some cases, companies are undertaking what is probably the biggest change to their business model in a hundred years, with obvious risks.
- Our health care companies are under pressure from all sides to, simply put, reduce prices and improve outcomes.

- Some of our companies are direct beneficiaries of these trends in that they supply the technical expertise to advise on these changes, the equipment that monitors the results or the testing services which certify them.
- Historic hot-button issues such as animal testing have not gone away and have been joined by a whole raft of new ones such as ‘flygskam’ (flight shaming). The tendency of real or perceived social pressures to affect company managements, particularly in terms of M&A activity or the allocation of management resources, is a challenge from an analytical and investment perspective.
- The generally negative light in which ‘big business’ is perceived has exacerbated product liability issues and costs, which in any event have been exacerbated by the tendency on the part of companies to cut down on oversight roles, which are perceived as non-revenue producing.

The exact way we integrate factors such as these into our investment process varies. In some cases, our models reflect these issues to the nearest millions of dollars. In other cases, it’s impossible to say whether an issue will have any impact at all. The fact is however that most of these issues are not new and our companies have been dealing with them for decades, if not centuries. Much commentary today suggests that we have never lived through such a period of disruption. Try telling that to Brown-Forman, a company whose product was declared illegal 100 years ago by an amendment to the Constitution of the United States and yet one that survives and prospers to this day.

Screening

The UN PRI defines 'screening' as using a set of filters to determine which companies are eligible or ineligible for investment "based on an investor's preferences, values and ethics." Looked at through the prism of ESG, the UN divides screening into 3: negative screening, such that one might, for example, exclude the highest carbon emitters from a portfolio; "norms-based screening," which looks at how investments stack up from the perspective of 'international norms' such as the UN Social Compact, Sustainable Development Goals, the Universal Declaration of Human Rights and so forth; and positive screening, e.g. investing in companies based on their "positive ESG performance relative to industry peers."

At Fundsmith however, we believe that the most important step in any screening process should be the screen that answers the question, 'is this a good business?' Put another way, we believe that investing in poor businesses is extremely irresponsible investing, regardless of any ESG credentials. In order to filter out the 'good' businesses from the poor ones, we use a series of financial screens combined with what might loosely be described as mental models. We are strong supporters of the notion that, 'if it's a good business, we'll see it in the numbers'. Good businesses make and sustain high returns on the capital that their investors and lenders have provided them. Good businesses generally exhibit the quality of a significant moat through high gross margins. Good businesses are able to take some of their high returns and reinvest these returns back into the business at similarly attractive returns. Good businesses make their profits in cash.

On top of these financial screens, we layer a series of investment principles taken from, not to over-complicate things, decades and decades of investment experience. A good business does not require leverage to make these high returns. A good business has advantages, which for some reason are self-evidently hard to replicate. A good business is resilient to change but also believes that the best response to disruption is to disrupt itself. Good businesses as we define them tend to make their money from a very large number of small, predictable transactions as opposed to a small number of large ones. Good businesses have obvious and readily understandable paths to growth. Favourable secular trends don't of themselves make for a good business but they certainly help. Unfavourable secular trends can offer opportunities sometimes on valuation grounds, but this is an investment approach we leave to others.

This initial screening means that before we have used any ESG overlay, we have screened out huge swathes and whole sectors of the market. Airlines perennially make returns on capital below their cost of capital. Banks require leverage to make anywhere near an adequate rate of return. Oil is a commodity. The reason that we 'negatively screen out' these sectors is not because of their emissions, their anti-social business practices or their huge secular headwinds. The reason we don't invest in them is rather that we think companies within these sectors are simply poor businesses. In addition to banks, energy companies and airlines, we have a whole slew of additional sectors that we would never invest in including biotech, autos, real estate, and insurance.

When we have finished performing these screens, we end up with what we call our 'investable universe.' Each fund has its own investable universe but the companies in each universe share the same high quality traits and because these traits are relatively rare, our investable universe for each strategy is very small, under 100 stocks in each. For our Fundsmith Sustainable Equity Fund investors, in addition to what might be called our 'quality screen,' we have added an extra screen that takes out stocks that might be considered objectionable. We have hard sector exclusions in the prospectus on alcohol, tobacco, aerospace and defence, metals and mining, oil, gas and consumable fuels, casinos and gaming, gas and electric utilities and pornography. We overlay this with a qualitative screen for where a company is having an excessive net negative impact, isn't aware of their impact and/or isn't doing enough to actively mitigate it. We try to consider a company's impacts in the widest possible sense taking into account all the negative (and positive) impacts a company has on the environment, society or minority shareholders such as ourselves. To make this assessment we use factors such as reputational risk, basic information on how much CO2, waste, water a company uses and everything we have collected on what a company tells us they do categorised under ~75 different topic tags (e.g. waste management, fair labelling and marketing, data privacy etc.).

We do not take – nor do we like – the relative approach, this being the one that allows a sustainable portfolio to own an oil company because it is relatively less harmful than another oil company is. We do however believe that over time, some businesses that have traditionally been eschewed by responsible or sustainable strategies might become suitable for them and we are keeping an open mind as we track developments at these companies.

Thematic

The UN PRI describes the ‘thematic’ approach as “seeking to combine attractive risk-return profiles with an intention to contribute to a specific environmental or social outcome” and would thus include impact investing. Although we do not consider ourselves ‘impact investors,’ we believe that by allocating capital to businesses and managers who behave responsibly and sustainably, we are encouraging companies that have a positive impact and discouraging those that do not.

Engagement and Proxy Voting

The UN PRI tells us that “investors can encourage the companies they are already invested in to improve their ESG risk management or develop more sustainable business practices.” It goes on to say that these investors can do this both by ‘engagement’ - “discussing ESG issues with companies to improve their handling, including disclosure, of such issues” – and by ‘proxy voting’ – “formally expressing approval or disapproval through voting on resolutions and proposing shareholder resolution on specific ESG issues.”

In order to describe how we engage with our companies, it is important to reiterate that our ideal holding period for a stock we own is forever. If you accept this, then how we engage with our companies is a natural outcome of this and drives a highly responsible approach to our engagement. We typically engage with companies across executive management, the chairperson of the board of directors, investor relations or various board committees either in person, electronically or by traditional mail.

Traditional ‘engagement’ with companies has largely taken two forms. Most engagement involves an investor or a group of investors trying to persuade a company to ‘do’ something that will result in, simply put, a short-term boost to the performance of the company and the share price. This can take the form of a major ‘strategic’ move in the form of a break-up or a deal, major financial initiatives involving share buybacks or new and ambitious profit or profitability public targets. Other engagement has been by way of attempting to get companies to end what are seen as abuses against humans, animals, the environment and so forth. However, very little of this traditional engagement has seen much or any link between the two, to the extent that more often than not, making money and being a good corporate citizen are regarded as being diametrically opposed to one another.

When you actually want to own a business for a very long time however, the type of engagement you have by necessity changes. Most obviously, you want your company to do things that make it 'sustainable' in the literal sense of the word and we have a track record of engaging with our companies on this basis which dates right back to our inception. We believe that we have made our biggest contribution to responsible investment by making it crystal clear to our investee companies – in all of whom we are a significant shareholder – that we will support actions that promote the long term health of their business and oppose all actions that borrow from future profits to fund current ones, even if these former decisions might have a short-term negative impact on profits and/or the share price.

From a practical standpoint, this means that we encourage our companies to maintain or increase their levels of research & development and brand marketing spend and discourage them from setting hard or unrealistic margin targets. We believe that the most sustainable companies regard margin as what you have left after you have spent the necessary amount on items that will sustain the long-term health of your business. We also discourage companies from obsessing about those financial metrics that are easy to manipulate in the short term – particularly EPS (Earnings Per Share) – or taking on excessive leverage, which might threaten the sustainability of the business when times are tough. We also discourage our companies from adopting what is regrettably the default behaviour of many, namely completely ignoring or taking their true long-term shareholders for granted while pandering to the demands of those who shout the loudest. We think responsible governance involves siding with those who want to remain shareholders, not with those looking for a quick buck and the exit door. Ultimately, we believe the best defence that companies have against irresponsible predatory investors is responsible shareholders like us.

Warren Buffett famously tells people that they should stick within their circle of competence when it comes to investing and he would probably say the same of engaging. We believe that our long-term approach enables our companies to act responsibly but in the end, we cannot run our companies for them. Put another way, we can encourage 'best practice,' even if best practice might be expensive or disruptive, but it is highly unlikely that we will be the source of what 'best practice' is when it comes to plastic recycling, palm oil usage or alternative energy. We therefore prioritise engagements by where we think we can add the most value for our customers. When we engage, we consider, amongst other factors, whether the negative ESG impact is particularly egregious, the company has a large weighting in the portfolio, or the issue is a recurrence of a previous issue.

That said, there are many areas where we have distinct views on the way things should be done.

First, we encourage our companies in their reporting to see financial and ESG factors as fundamentally linked, not separate. Almost all human and thus corporate activity leaves some kind of footprint. The question is, how much of a footprint relative to what is produced in return, so for example while we would like to see that a company's level of CO_2 emissions has reduced, we encourage CO_2 emissions to be reported in terms of the volume or weight of goods produced.

Second, the popularity of ESG funds has spawned a rash of companies offering ESG ratings. Given our research team's experience over many decades of apparently simple financial metrics being easily distorted or manipulated, we are very suspicious of the quality of many 'ESG scores.' We do however use outside service providers such as RepRisk which scans 80,000 public news sources around the world in 19 languages as a way of ensuring we capture all negative news on a company.

Third, we are highly active proxy and shareholder meeting voters, active not just in the sense that we vote on every item ourselves but also because we unusually do all the research on every item ourselves on a case by case basis. We also do not give permission to our custodians, who hold the shares we have bought on your behalf, to lend out any of these shares as otherwise we wouldn't be able to exercise these votes when appropriate.

We have a particular view on executive remuneration, which can be summed up in the sentence - we care how someone is paid, not how much. Providing an executive remuneration scheme is truly aligned with the interests of shareholders, we see no reason not to applaud high pay. The problem however is that most schemes are not truly aligned but rather tend to foster everything from poor capital allocation decisions to heavy use of 'adjusted' numbers. The crucial missing ingredient in the vast majority of executive remuneration schemes is some measure of return on invested capital. We believe that just as our own investors are laser focused on how much of their capital we can deploy at what returns, so should the companies that we invest in. We are also gathering increasing evidence that companies that adopt this approach tend to outperform. We very deliberately do not outsource any of this work. We also conduct numerous conversations and meetings on this and other proxy items with our companies. We tend to do so in private and we tell our companies that we understand that they have many constituencies with often opposing views to satisfy. However, we stress that in the long run, we think our way is the right way, and that they have to make a choice.

In some instances, this engagement leads to change. Often it doesn't. When it doesn't, our main response by way of an escalation strategy is to vote against an item or multiple items. We do this often, most commonly because of the aforementioned tendency of companies to omit any reference to returns in their remuneration schemes. In the past, we have 'escalated' our engagement by talking with other shareholders although in the most notable instance, this was by way of persuading a proxy service that the 'responsible' way to vote was in favour of existing management and against an activist. Last, we have disposed of several shareholdings because we believed management was behaving 'irresponsibly.' Most frequently, this irresponsibility has taken the form of poor capital allocation or put more simply, a large and in our view foolish acquisition.

To summarise, we would end by stressing that because the central plank of our investment approach is to buy 'good companies,' we do not make investments with the intention of trying to turn a poor, irresponsible business into a good, responsible one. Our goal is to buy good businesses in the first place, and then provide, along with other like-minded shareholders, what might be termed the 'umbrella' under which these companies can do the right thing.

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