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Monday 10th January 2011

Dear Fellow Investor,

This is the first annual letter to owners of The Fundsmith Equity Fund.

Fundsmith opened for business on 1st November 2010, and we are critical of attempts to measure investment performance over short periods of time. Two months is not a short period, it is a ludicrously short period to do so. However, I thought that this letter is a good opportunity to give you a flavour of the reporting which is likely to occur in years to come.

From 1st November to 31st December 2010, The Fundsmith Equity Fund rose by 6.14% net of fees. This compares with some common benchmarks as follows:

Fundsmith Equity Fund	**6.14%**
MSCI	**7.99%**
MSCI EAFE	**5.76%**
FTSE100	**4.40%**
Long Bond (10 year UK Treasury)	**-2.57%**

Benchmarks are useful for measuring performance, provided a long enough time scale is used. Problems arise when fund managers start to use them for portfolio construction. At Fundsmith we do not endeavour to track any index or to minimise our "tracking error" versus any index (even the use of the expression tracking "error" tells you that an active fund manager has the wrong mindset).

The Fund underperformed the MSCI and outperformed the MSCI EAFE-the difference being in the performance of US stocks which are included in the former but not the latter. It outperformed the FTSE100 and long bonds.

The main positive contributors to that performance were:

1. Del Monte Foods
2. Becton Dickinson
3. Domino's Pizza Inc
4. Nestle
5. Stryker Corp

The main contributor was Del Monte Foods. Del Monte could almost be a case study in how investment opportunities arise. We were attracted to Del Monte by its main product-pet food.

Pet food is typical of the sort of product we seek to invest in. It is a small ticket, consumer, non-durable. As a small ticket purchase, no credit is required to buy it. The consumer has no opportunity to bargain on price - the price the supermarket or pet store displays is the price you pay. Consumers are typically brand loyal, and once it has been consumed there must be a replenishment purchase-there is no opportunity to defer this by prolonging the life or ownership of the product as there is with a consumer durable, like a car. Moreover, research clearly shows that if times are hard, consumers will reduce their spending on food for themselves or their children rather than cut back on their pets' food.

However, the fact that pet food is Del Monte's main product line seemed to be lost on most investors, many of whom were assessing it on the basis of their folk memory of its main historic product range in canned fruit and veg. This is what produced the opportunity to buy Del Monte stock on a free cash flow yield which was generous for its likely financial performance. On one occasion this misunderstanding was compounded when Bloomberg managed to publish an article from the Galveston County Daily News about a strike at Fresh Del Monte Produce Inc - an entirely different company which sells fresh produce - against Del Monte Foods. Such events can create opportunities to buy great companies at good prices.

Eighteen days after the Fund opened and we purchased our initial holding in Del Monte it was bid for by private equity firm KKR at a significant premium to the price we had paid.

Whilst it would be churlish to suggest that we do not like receiving a premium for our investments in cash, such events are not without their downside as we have to find an equivalent investment for our cash. The fact is we really want to own our stakes in the companies in our portfolio and benefit from the good cash returns on capital which they generate. We are not simply hoping to on-sell the investment at a higher price. This changes perspectives on events such as takeovers.

Just as we counsel you not to become overly enthusiastic about share price rises, even those which relate to cash bids for our holdings at a premium which represents a good return on our investment, we hope that you will understand when we are explaining that price falls within the portfolio will often represent an opportunity for investment on even more rewarding ratings rather than an opportunity for soul searching and recriminations. Often but not always.

The detractors from the Fund's performance were:

1. Serco Group
2. Imperial Tobacco
3. Dr Pepper Snapple
4. Reckitt Benckiser

In no case do we believe that the fall in the price alters our view of the investment (other than the obvious point that we wish we had made it at the lower price) nor do we believe it reflects an adverse change in the intrinsic worth of the business.

The historic dividend yield on the Fund at year end was 2.47%. This dividend was covered over 2.5 times by earnings. Only one stock in the fund does not currently pay a dividend. This is significant: dividends have historically provided a significant portion of the total return on equities. The current yield on the Fund may not fully reflect its dividend paying capabilities as some of the companies also utilise share buybacks. These can contribute to shareholder value creation when they are used correctly (to purchase shares which are under-valued when no better investment opportunity presents itself).

At the end of 2010 we held a portfolio of 22 stocks including Del Monte.

The average company in our portfolio was founded in 1883. We are investing in businesses which have shown great resilience over a long period of time-in most cases surviving two world wars and the Great Depression.

The trailing free cash flow ("FCF") yield was about 7%. This free cash flow was either distributed as dividends, used for share buybacks, or invested by the companies in order to generate further returns. As our portfolio had an average return on operating assets of 50% this reinvestment of cash flows should produce compounding of value for us as shareholders.

This FCF yield compares with a FCF yield on the S&P 500 of a bit less than 7%. The median (250^{th}ranked) FCF yield in the S&P is 6.6%.

What we can say with a high degree of certainty is that our portfolio has a FCF yield higher than the average for the market. Yet it is inconceivable in our view that it is not of higher than average quality in terms of longevity, resilience, predictability, profit margins, return on operating capital and the conversion of profits into cash. Put simply this means that we own shares in businesses which are higher quality than the market on a valuation lower than the average for the market. Whilst that is not a total solution to successful investing, it strikes us as at least a good start.

We regard an equity holding as a claim on a share of the cash flow produced by a business. In the Fund we seek to own companies which produce high cash returns on capital and distribute part of those returns as dividends and re-invest the remainder at similar rates of return. And we want to own those companies shares at prices which at best under-value their returns and at worst value them fairly.

We do not regard equity investment as a sophisticated game of pass the parcel in which we buy shares in companies that we don't understand, which may be poorly performing businesses and/or which are over-valued, hoping to sell them to a greater fool when they have become even more expensive as a result of some fad or share price ramp. Such games are best left to video consoles unless your hobby is losing money whilst investing, which I rather suspect it is for some people.

I aim to restrict myself to one rant per letter about a subject relevant to investment. Frankly given the behaviour of much of the wealth/asset management industry, I regard this as a model of self restraint given the target rich environment.

This year's rant is a warning about the misunderstanding and misuse of Exchange Traded Funds ("ETFs"). I think this is relevant as The Fundsmith Equity Fund launch was somewhat against the tide of events as we launched an active equity fund at the end of a decade in which a) equities have performed badly; and b) the average active fund manager has again underperformed the index and so made a bad performance by the asset class worse.

Faced with this failure of active management, it is hardly surprising that investors have turned their backs on active management and headed for lower cost, passive alternatives. As a result, the rise of ETFs has been a major feature of the investment landscape in recent years. By the third quarter of 2010, there were 2,379 ETFs with 5,204 listings on 45 exchanges managing $1,181.3bn of assets.

So what's the problem? I suspect that the average investor regards all ETFs as just another form of index fund, and indeed many of them are. But many aren't and therein lies the potential for misunderstanding. Or worse.

Some ETFs do indeed replicate the performance of an index by purchasing a weighted package of all or most of its constituent securities. But many so-called synthetic ETFs do not do so and instead use so-called swap agreements with counterparties who agree to provide a monetary return which matches the underlying asset class or the index the ETF is seeking to track.

Anyone who has studied the events of the Credit Crisis should be able to spot a potential problem here: what if the counterparty supplying the swaps defaults? This risk may once have been considered theoretical, but after the collapse of Lehman and the need to rescue AIG in order to prevent the contagion from a default it surely no longer is. True the ETF should be holding collateral against such a failure, but collateral is an imperfect science even where it is held which is not in all cases. Moreover, in some cases the sole counterparty

Moreover, synthetic ETFs are often used at access markets which are not directly accessible to retail investors such as the Chinese A-share market or where liquidity in the underlying investments is poor such as equities in some emerging markets. The opportunity for the performance of the ETF to diverge from the performance of the underlying assets and therefore from the investors' expectations in these cases seems obvious. The idea that a counterparty will provide you with a contract which matches the returns from underlying illiquid assets which you cannot directly own should give pause for thought-not least about how the counterparty will fulfil those obligations, for example in the case of extreme market movement and a liquidity crisis-a not unlikely combination.

Of course not all ETFs are used to simply match the performance of an index. There are leveraged ETFs which multiply index performance, inverse ETFs which replicate a short position in an index and of course, leveraged inverse ETFs. The issue with these ETFs is that their returns are compounded daily. These problems maybe best illustrated by a couple of tables;

	Day 1	Day 2	Day 3	Day 4
Index	100	125	90	103
Daily Change		25%	-28%	14%
Cumulative Change		25%	-10%	3%

Leveraged ETF (+2X)	100	150	66	85
Daily Change		50%	-56%	29%
Cumulative Change		50%	-34%	-15%

The first table shows the movement in an index in a highly volatile period in which it rises sharply then falls to finish just 3% up over the period. The second table shows the performance of a 2x leveraged ETF over the same period. With daily compounding the leveraged ETF produces a cumulative loss of 15% of value over the period versus a 3% rise in the index.

How about an inverse ETF?

	Index	% Movement	Short Position	ETF (Short)
Day 1	100		100	100
Day 2	80	-20.0%	120	120
Day 3	60	-25.0%	140	150
Day 4	55	-8.3%	145	162.5
Day 5	100	81.8%	100	29.5

In a week where the index was volatile on the downside but got back to par by the end of the week an inverse ETF with daily compounding would turn in a 70.5% loss. You can imagine what a leveraged inverse ETF would do!

I would bet that a large proportion of ETF investors do not realise that leveraged and inverse ETFs can produce these apparently perverse results. The moral of this is that these sort of ETFs are really day trading tools. If they are held for more than one day, they will begin to diverge from the performance of the underlying index or asset class. However, it would not be surprising if in many cases they were being used inappropriately as if they are index funds.

Investors in ETFs may be quite logical in avoiding most active management, but many of their ETFs are not as inactive as they think.

Finally, returning to our own active fund, we look forward to the year ahead. This is not because we have any faith in a sustained recovery in major economies and/or that we regard equities in general as cheap or equity markets as a whole as good value or well placed to track improvements in corporate profitability which in any event may not be forthcoming.

It is firstly because we believe our Fund contains a portfolio of shareholdings in great businesses which we have purchased at reasonable prices or better and which we intend to hold onto in order for them to deliver the benefits of such investments.

Secondly, it is because we enjoy running The Fundsmith Equity Fund. Robson Walton, the Chairman of Wal-Mart and son of its founder Sam Walton said, "My dad did not set out to make Walmart the world's largest retailer. His goal was simply to make Walmart better every day, and he thought constantly about how to do just that."

Please be assured we are doing the same with Fundsmith.

Yours sincerely,

Terry Smith
CEO
Fundsmith LLP

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Should you feel you need advice please contact a financial adviser. Past performance is not necessarily a guide to future performance.
The value of investments and the income from them may fall as well as rise and be affected by changes in exchange rates, and you may not get back the amount of your original investment.

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Wednesday 11th January 2012

Dear Fellow Investor,

This is the second annual letter to owners of The Fundsmith Equity Fund.

Fundsmith opened for business on 1st November 2010, and so completed its first year on 31st October 2011. We have presented two sets of performance figures this year- the performance since inception and the last calendar year.

We remain critical of attempts to measure investment performance over short periods of time. Even a calendar year is too short for this purpose-it is the time it takes the Earth to go around the Sun and has no natural link to the investment or business cycle.

However this proviso notwithstanding, The Fundsmith Equity Fund rose by 8.4% net of fees for the year. This compares with some relevant benchmarks as follows:

	Since Inception	2011
Fundsmith Equity Fund	15.0%	8.4%
MSCI World £	3.2%	-4.5%
MSCI EAFE £	-6.1%	-11.2%
FTSE 100	2.8%	-1.5%
FTSE Actuarial Gilt Index	14.7%	15.6%

The Fund outperformed the MSCI World Index, which we regard as the most relevant comparator, by 12.9% for the year.

This strikes us as a good performance. It was achieved against the background of a year in which it gradually dawned on many people that the financial crisis of 2008-09 had not been solved but had rather been transformed into a sovereign debt crisis: if 2008 was the year in which governments saved banks, 2011 was the year in which the main question which emerged was who would save the governments. Against this backdrop it is hardly surprising that equity markets performed poorly and so has the average fund.

Only six other funds in the IMA Global Growth sector (into which the Fund is classified) achieved a positive return in 2011. This performance for the year took the Fund to third place in the Morningstar performance rankings for global equity funds.

The main positive contributors to that performance were: Domino's Pizza, Philip Morris, Imperial Tobacco, Colgate Palmolive and Unilever.

The main detractors from the Fund's performance were: Serco, Stryker, Kone, Becton Dickinson and Intercontinental Hotels.

Turnover in the Fund in 2011 was 15%. This was higher than we would ideally like although still significantly lower than most funds.

Part of this turnover was really involuntary. We sold Del Monte Foods prior to the closing of the cash bid from KKR, and sold our holding in Clorox after a bid approach from Carl Icahn which we correctly judged would not result in an actual takeover but which drove the share price to a valuation which we regarded as offering poor value.

Excluding dealing in Del Monte and Clorox, the turnover was 4% which is much closer to the level we seek (zero ideally).

The only voluntary turnover during the year were sales of our holdings in Kimberly-Clark Corporation and Domino's Pizza, Inc. Kimberly-Clark began to show adverse results from our regular calculation of the incremental return on capital. We sold the shares at a small profit. They have subsequently performed poorly in terms of fundamental performance although the share price has ironically been quite firm. We prefer to judge our investments by what is happening in their financial statements than by the share price. Domino's shares rose in price by 113% during the year and had reached a point at which they no longer represented good value. Domino's also has a re-financing of debt due by 2014. There is nothing in the performance of Domino's which causes us the slightest concern about this but there is plenty wrong with the banking system which will be required to provide the refinancing. As a result we hope to have the opportunity to become investors in Domino's again.

The net result this was that the Total Expense Ratio of the Fund was 1.2%. We hope to reduce that in future.

The historic dividend yield on the Fund at year end was 2.4%. This dividend was covered 2.6 times by earnings. There is only one stock in the Fund that does not currently pay a dividend. This is significant: it is becoming clear that dividends are likely to provide a more significant portion of the total return on equities in the future than they did in the equity bull markets of 1982-2000 and 2003-07.

The current yield on the Fund may not fully reflect its dividend paying capabilities as some of the companies also utilise share buybacks. During the course of the year we published some research on share buybacks ("Share Buybacks-Friend or Foe?" April 2011-available on the Fundsmith website) in which we concluded that buybacks were rarely accompanied by any reasoned justification; that they had become almost universally regarded as a good thing and contributing to shareholder value irrespective of the price paid or the valuation implied, which simply cannot be true; and in many cases their timing was poor.

During the year we wrote to the management of those companies within our portfolio which have engaged in share buybacks to ask for some insight into their rationale. The responses ranged from prompt, personalized (by the CEO) and well reasoned to being completely ignored. We regard the greatest risk for our investors after the obvious potential for us to buy the wrong shares or pay too much for shares in the right companies, as being reinvestment risk: we seek to buy companies which deliver high returns on capital in cash. What the management then does with these cash returns is one of the major factors affecting future returns on the portfolio. Management faces three main options for deploying these cash returns: return cash to shareholders, invest to grow the business organically or make acquisitions. The criteria they use for choosing between these options are important. So are the ways in which they operate each option. So, for example, having determined to return a portion of earnings to shareholders, how does a management decide between a dividend and a buyback? In many cases we do not know as the management does not give any detailed rationale and we suspect that the answer is with the "benefit" of advice from their investment bankers who get fees, commissions, bid-offer spreads and maybe proprietary trading profits for advising companies to pursue buybacks but get nothing when a dividend is used. No prizes for guessing which way the advice is slanted.

At the end of 2011 we held a portfolio of 24 stocks.

On average companies in our portfolio were founded in 1894. We continue to invest in businesses which have shown great resilience over a long period of time-in most cases surviving two world wars and the Great Depression.

The trailing free cash flow ("FCF") yield at the start of the year was about 7% and about 5.8% at the end. The fall in the FCF yield was caused by a combination of the rise of share prices in the portfolio, changes in the portfolio and higher capital expenditure and working capital invested by the portfolio companies. This FCF yield compares with a median FCF yield on the S&P 500 of 6.1%. We have used the median by the way as the average is distorted by inclusion, for example, of a free cash flow yield of 76% on shares in Bank of America ("B of A"). Before you rush to buy B of A shares however you might like to know that cash flows at banks are not the same as they are at non banking businesses. So, for example, in the calculation of B of A's cash flow the computation adds back the provisions for bad debts and impaired assets which is a deduction from profits. This is strictly true-a provision is a non cash item-but it means that comparisons of banks with other company's cash flow in this manner is truly a case of comparing apples and ugli fruit (I chose a fruit which was more alphabetically remote from A for Apples than the commonly used P for Pears and which exemplifies our view of banks).

Our portfolio has a FCF yield about the same as the average for the market. Yet it is inconceivable in our view that it is not of higher than average quality in terms of longevity, resilience, predictability, gross margins, operating margins, return on operating capital and the conversion of profits into cash. Put simply this means that we own shares in businesses which are higher quality than the market on a valuation about the same as the average for the market.

Last year I started a policy of allowing myself one rant per letter about a subject relevant to investment. I thought I would provide an update on how that went. Last year I sounded a warning about the perils of Exchange Traded Funds ("ETFs"). What happened next even surprised me and I thought I had lost the capacity for such an emotion in the face of the shenanigans of the financial services industry.

Practitioners within the ETF sector reacted with a fury which can only be generated by two factors: 1) the criticism was accurate and/or hit a nerve; and 2) it was in danger of derailing a large gravy train.

Some ETF practitioners suggested that I was criticizing ETFs because of concerns about the impact the growth of ETFs would have on the active fund management sector in general and Fundsmith in particular. This response is not just wrong it is preposterous for two reasons: 1) Fundsmith's market share of the active fund management sector is so small that I do not possess a calculator capable of getting enough zeroes to the right of the decimal point to calculate it. As a result, ETFs could continue growing to the point where they had replaced most active funds and still leave Fundsmith with an insignificant share of the remaining sector, so they are unlikely to affect us; and 2) I have long and publically maintained that the best equity investment for most investors most of the time is an index fund because of its low cost and outperformance of most active fund managers.

In an effort to be clear, my criticisms of ETFs are:

1. ETFs are almost certainly being mis-sold. My straw poll of investment professionals suggests that many investors think that ETFs are simply index funds. Many are not. Synthetic ETFs do not hold underlying securities of the sector or market they are supposed to replicate. Inverse ETFs can lose money even when the market sector they track has gone down, and leveraged long ETFs can lose money when their market or sector has gone up. None of these is consistent with the performance of a simple index fund.

2. Synthetic ETFs are of particular concern. If a fund which is described by the words synthetic, derivative, swap and counterparty does not cause you obvious concerns, I suggest you may need to study the events of the credit crisis of the past four years more carefully.

3. Because ETFs are tradable on markets unlike mutual funds, traders can sell them short. Relying upon the assumed ability to create more shares in the ETF in order to close these short sales, it is not unknown for the short interest in certain ETFs to reach ten times the size of the underlying ETF's assets. In these circumstances, the average ETF holder may be unaware that only some 10% of their holding in the ETF is represented by assets of the type they expect-the other 90% is a promise to deliver units from the short sellers. All will be well unless the short sellers find it difficult or impossible to buy enough of the underlying securities to deliver the required ETF shares which in some illiquid index or sector ETFs is entirely possible.

My own warnings on ETFs were followed by warnings from amongst others, the Bank of England, the Financial Services Authority, the International Monetary Fund and the U.S. Securities and Exchange Commission in a rare example of closing the door on a stable which may still contain a horse. Since regulators have come in for so much criticism of their loose handling of the financial sector prior to the credit crisis it would be churlish to criticize them for these warnings, and foolish to ignore them.

One more problem with ETFs became apparent to me in the course of this debate. ETFs are represented as low cost investments. Yet research published during the year demonstrated that ETFs were amongst the largest profit generators for some banks. This seems counter intuitive: how does a low cost product become a major profit contributor? The answer of course is that synthetic ETFs in particular provide banks with innumerable ways to "clip the ticket" of the ETF. The fees paid by the ETF investor are a very small portion of the total revenues which operating the ETF provides. They also deal for the ETF, provide the swap agreements by which it holds its synthetic positions (I wonder who works out whether the bank is providing them a fair price?), and maybe earn leverage, prime brokerage, custodian and registrar fees. The banks also deal for the hedge funds and traders who want to trade the ETF. At about this point, I began to realise why my critique of ETFs had caused so much fury.

My advice on this matter is simple. A broadly-based index fund is often the best investment you can make in the equity markets. But if you decide this is correct, buy precisely that, an index fund, not an ETF. The only difference between a physical ETF (which frankly is the only sort you should contemplate unless you like the risk of synthetic derivative swaps with counterparty risk) and an index fund is that the ETF is traded on the market as the term “Exchange Traded” implies. Every piece of research I have encountered and all my experience shows that frequent dealing is the enemy of a good investment performance. So why buy an ETF rather than an index fund? You can deal daily in most index funds. The only people who want to deal more frequently than daily are hedge funds, high frequency traders, algorithmic traders and idiots (these terms are not mutually exclusive). Why join them? If you don’t want active management, and mostly you shouldn’t, buy an index fund.

During 2010 Fundsmith also launched a SICAV and a US LLP. Neither of these affects your investment in The Fundsmith Equity Fund but I feel that you should be informed about this and it affords me an opportunity to raise another subject-currencies.

The SICAV is denominated in Euros and based in Luxembourg. It is a so-called “feeder” fund-the only assets it holds are units in The Fundsmith Equity Fund. The US LLP is a Delaware partnership denominated in US dollars which is invested with exactly the same strategy as The Fundsmith Equity Fund but it cannot be run as a feeder fund.

We launched these two funds in response to investor demand. US based investors face a massive tax disadvantage in investing in a UK fund as it cannot issue a Form K1 for IRS reporting, and offshore investors wanted a non UK vehicle for investment. But in neither case does the denomination of the fund in a currency other than sterling affect the investments currency exposure.

We are often asked by investors whether we hedge currencies. The answer is a firm ‘No’. How would we do so? Should we base it on the currency of the country in which the companies are listed? This obviously would not work. There may be no connection between the country in which a company is listed and its area of operations. The same is true of its country of incorporation or headquarters. Nestle is an example we often cite in this respect. Although it is headquartered in Switzerland, has its main listing there and reports in Swiss francs, it has only about 2% of its revenues in Switzerland, so hedging our holding by selling Swiss francs forward against sterling would surely not be a hedge at all. It is also far from unknown for companies to report in a different currency to that of the country in which they are headquartered or listed.

Perhaps we should hedge currencies based upon the country in which each of our investee companies has its revenues? The problem with this approach is twofold. Firstly, most of the companies supply low value items and so manufacture and sell locally or at least regionally. No one exports significant amounts of bulky low value items such as detergent. So the exposure, if there is any, relates only to the profit margin. Secondly, the corporate treasurer may already have taken out a currency hedge for the translation and/or transmission of those profits so that any currency hedge by us would in fact be creating an exposure.

A lot of nonsense is talked about currency exposure and hedging. Our new funds denominated in Euros and US Dollars do not change the currency risks of those funds which are driven by the underlying investments. For those who don’t believe this, we are prepared to launch a new class of our Fund which will change its currency denomination each year to the worst performing currency. In 2011 it would have even denominated in Turkish Lira and would have risen by 32%. However, since you would receive this depreciated currency when you sell the Fund units, you won’t be any wealthier as a result. If you think you would be, let us know and we will set up the Money Illusion class of the Fund.

We view the year ahead with some trepidation. It seems that it has yet to dawn on many of the key participants in the financial crisis that you cannot borrow and spend your way out of a crisis caused by over leverage, and that there is no higher authority than the governments who's credit is now in doubt which can extend further funds to provide a painless "solution" or maybe even a temporary respite. The dawning of this reality is sure to have some very painful consequences.

However, in contrast the Credit Default Swaps of Nestle have been less expensive than the cost of insuring against default on the debt of European governments and the US Treasury for some time. We are far from believers that the market is always right, but this does suggest that holding shares in major, conservatively financed companies which make their profits from a large number of small, everyday, predictable events is a relatively safe place to be if you have the patience, fortitude and liquidity to ride out the share price volatility which is likely to occur in such circumstances. And that's exactly where and how our Fund is invested.

Yours sincerely,

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January 2013

Dear Fellow Investor,

This is the third annual letter to owners of The Fundsmith Equity Fund.

We have presented three periods of performance figures this year - the performance since inception, the annualised returns and the last calendar year.

T Accumulation Shares, Total Return	**2012** %	**Since Inception to 31.12.12 %**	**Annualised** %
Fundsmith Equity Fund £	12.5	29.4	12.6
MSCI World Index £	11.4	14.8	6.6

We remain critical of attempts to measure investment performance over short periods of time. Even a calendar year is too short for this purpose. It is the time it takes the Earth to go around the Sun and has no natural link to the investment or business cycle other than for agricultural businesses.

However this proviso notwithstanding, how did we do in 2012?

The Fund rose by 12.5% in 2012 and modestly outperformed the market (which we take as the Morgan Stanley Capital International World Index - or MSCI World - in sterling with dividends reinvested) by 1.1%.

I'm rather surprised that we managed to outperform the market at all in this reporting period. 2012 was a year in which so-called risk assets performed well. This is unsurprising in a year in which the major central banks in the developed world supplied increasing amounts of liquidity through their Quantitative Easing programmes in increasingly desperate attempts to keep some modest amount of economic growth. All that liquidity has to go somewhere and indeed the supply of liquidity by central banks' purchases of bonds helps to push investors towards the purchase of riskier assets, as does the regime of record low interest rates, of which more anon.

This is not an environment in which I would expect our Fund to perform well relative to the market as the rising tide of liquidity floats all ships, many of which we would not consider owning.

Moreover, the year was characterised by what is in my opinion is a naïve view that the words spoken or (more rarely) actions taken have somehow helped to resolve the financial crisis which we have been living with since 2007. I cannot see how the supply of liquidity can solve a crisis caused by over leverage and insolvency. These events were exemplified for me when the Financial Times declared Mario Draghi, the President of the European Central Bank as its Man of the Year. This was based upon the fact that in July Mr Draghi pledged to do 'whatever it takes' to save the Euro, which was followed by him doing precisely nothing and yet the borrowing costs of the major European problem countries, and most notably Spain, dropped and the Eurozone crisis went into remission.

Depending upon your point of view, this is either an example of the perfect action by a central banker - the mere threat of action producing the desired result; or another episode in kicking for touch without any attempt to solve the underlying problems. No prizes for guessing which camp I am in, but in any event positive reactions to such events are far more likely to buoy the share prices of financial stocks, cyclical companies, those who might otherwise be bust or at least in difficulty and indeed a whole series of assets which we will never own in our Fund. For example, the MSCI World Bank Index in sterling with dividends reinvested was up 22.3% in 2012. We do not own any banks stocks and will never do so. The Financial Times also reported that a number of hedge funds doubled their money by investing in Greek bonds in 2012. Clearly such a double or quits trade is not ever going to attract us, and it is hard to see how a fund manager can hope to repeat such trades consistently enough to warrant the risk, which is presumably one of the reasons why HSBC reported that 88% of hedge funds underperformed their relevant benchmarks in 2012. With assets such as this performing well I hope you can see why I am surprised that our Fund outperformed the market.

It is also worth bearing in mind that we do not seek to outperform in every reporting period or in all market conditions, rather we seek to outperform the market and other funds over longer periods of time.

The analogy I use for this is the Tour de France, which topically was won by a British rider - the now 'Sir' Bradley Wiggins - for the first time in 2012. The Tour is the greatest of cycling Grand Tours, with 21 stages run over 23 days. In the 100 years since the Tour was first run, no rider has ever succeeded in winning every stage of a Tour. Nor in my view will anyone ever achieve this. This is because the Tour encompasses three distinct types of stage:

- the stages in which the riders form a peloton and riders can gain vital aerodynamic assistance by slipstreaming (or getting "a wheel") from the rider(s) in front of them. A team can carry a sprinter (like Mark Cavendish) in the peloton and release him close to the line for the final sprint in an effort to win the stage;

- time trials in which the riders are released individually and so cannot gain any assistance from each other. In order to maximise their own aerodynamic efficiency, the riders use tri handlebars, wear skin suits and aerodynamic helmets and often have solid rear wheels and wide rims on the front wheel. This is a test of individual riding ability over the whole stage; and

- mountain stages which are run as a team but involve significant climbs unlike the main peloton stages which are much flatter.

A rider needs a very different physique to win as a sprinter to a time trialist or a mountain climber - compare Bradley Wiggins with Mark Cavendish - which is why no one can win all stages. The rider who wins the Tour is likely to be one who excels at one discipline - Wiggins is a time trialist, the discipline in which he also won a Gold medal at the 2012 Olympics - and is not too bad at, and obtains help from his team with, the other stages. Indeed on two occasions, the Tour has been won by riders who did not win a single stage.

In my view there is a moral here for investors. What we are trying to achieve with Fundsmith is to win the investment equivalent of the Tour de France for you-to outperform over a long period of time. However, we do not expect to outperform all the time or in all markets conditions. Rather our expectation is that we will perform relatively well in bear market conditions, and may struggle to keep pace in more bullish conditions, which is why I am surprised that we outperformed the market albeit modestly in 2012.

It is important that our investors recognise that this is what we are aiming for. Too often investors seek to find fund managers who can outperform all the time and in all market conditions. The trouble is that no such person exists. But the attempt to find this mythical creature leads to some investors moving their assets between managers, incurring costs and most frequently ditching a manager who's investment style is out of step with the current market in favour of one with recent good performance just as they are about to switch positions.

Having said all that, how are we doing at winning the Tour? Since inception our Fund has managed an annualised return in Sterling of 12.6% p.a. versus a return of 6.6% p.a. for the MSCI. This seems like a satisfactory start on our investment Tour campaign.

Our Fund remains the best performing fund in the IMA Global Sector since inception to the end of December 2012.

The main positive contributors to that performance in 2012 were: Intercontinental Hotels, L'Oreal, Reckitt Benckiser, Kone and Diageo.

The main detractors from the Fund's performance were: Procter & Gamble, McDonald's, Imperial Tobacco, Becton Dickinson, and a Consumer Company which we are in the course of buying a position in and so would prefer not to name at this point. McDonald's is a small position as it has only recently come within valuation range for us after reporting a number of periods with poor sales performance. We believe it is a business of the quality which we seek and therefore are willing to use this as an opportunity to buy stock. It might be worth thinking about the implications when a business which sells some meals for one dollar is struggling to grow sales. Clearly this is not because consumers are feeling flush and trading up.

Portfolio turnover in the Fund in 2012 was 0.48%. This figure is flattered by the inflow of funds over the period which is not included in the calculation otherwise a new fund would have 100% turnover from investing cash inflows, but even so it is exceptionally low.

Our only outright sale during the year was of SGS, the Swiss testing company. We remain convinced that it and the sector are good quality businesses, but the shares had reached the point at which they were one of the most highly rated within our Investable Universe and so we thought that there was better value to be found elsewhere.

We finished the year with 28 holdings up from 24 holdings at the end of 2011, which is towards the top end of our range but we are in the course of selling a holding which will reduce this number.

Our outright purchases for the year were Choice Hotels, Domino's Pizza, McDonald's, Visa and the aforementioned Consumer Company. Our purchase of Domino's is perhaps the one which requires most explanation since we sold it the year before. The sale was partly based upon apprehension about Domino's debt refinancing which had been postponed. We took this as a bad sign in a banking market which is exemplified by a cartoon which shows a man sitting in front of a bank manager (you can tell this because there's a sign on the desk saying "Bank Manager") who says "I'd like to borrow some money" to which the Bank Manager replies "What a coincidence, so would we." There is clearly nothing wrong with Domino's but plenty wrong with the banking industry on which it was reliant for its refinancing.

In the event, Domino's proved us comprehensively wrong. Not only did it manage to refinance but they did so on terms which enabled it to pay a $3 per share special dividend. So I did what you should always do, but we so rarely manage to do, when we get it wrong a) admit this - most importantly to yourself; and b) reverse the decision. So Domino's was repurchased

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.

There are several morals to the Domino's trades but the main one is that almost every time we sell a position in a quality company we get to regret it in terms of subsequent share price performance. The good news is that we don't do it very often.

This brings me onto the wider subject of the expenses borne by the Fund. The Ongoing Charges Figure (or "OCF" as it is now called) for the year is likely to be 16bps or 0.16% in addition to the Annual Management Charge. This is a 4bp reduction compared to 2011 figure. These expenses are often ignored both by investors and other fund managers. But, like all charges, they detract from the performance of the Fund, deserve proper attention and should be minimised. The Fund can only perform as well as the performance of the shares it owns and to the extent that performance is absorbed by expenses, the returns for investors will suffer.

The majority of the costs borne by the Fund are the costs of running and maintaining the share register. These costs are driven by numbers of shareholders and transactions. We continue to focus on reducing these charges, ensuring the Fund benefits from economies of scale as it grows and does not overpay for services simply because of the increase in its size. If the Fund remains at its current size, we would expect the Ongoing Charges Figure to fall by another 3bps in 2013.

Perhaps surprisingly, the Ongoing Charges Figure does not include all charges the Fund has paid in the year. The commission paid on share purchases and sales are not included and neither is Stamp Duty or the bid/offer spread which is incurred in dealing. During the year, the Fund paid £231,000 in commission-less than 4bp on the value of the total trades. The vast majority of those trades were due to inflows into the Fund. Stripping out the commission on trades caused by the inflow, the amount of commission paid on trades executed voluntarily was under 1bp of the average funds under management. This compares with estimated charges incurred by the average UK mutual fund manager of about 1% pa excluding Stamp Duty.

Turning to the characteristics of our portfolio, probably the question I am asked most frequently is whether the strong performance of most shares in the Fund to date means that they are now over-valued.

The weighted average free cash flow (“FCF”) yield, which is our primary valuation yardstick, of the companies in the portfolio started the year at about 5.8% and finished it at about 5.7%.

This 5.7% FCF yield compares with a median yield on the non-financial stocks in the S&P 500 of about 6.1% and an average of 5.4%; or a median for the non-financial stocks in the FTSE 100 of 4.6% and an average of 4.9%. The valuation of our stocks on this basis therefore looks about the same or a bit better (cheaper) than the average.

The yield is also significantly higher than the yield on government bonds which was previously known as the risk free rate before investors started to relearn that governments default. This is significant. The coupon on those bonds cannot grow over time whereas the free cash flow from our companies can. So if we can buy them with a higher FCF yield than the bond yield then we have probably created value.

We should perhaps compare the FCF yield of the portfolio not with the yield on major government bonds but what we think that bond yield should be since government bond yields across the developed world are distorted by Quantitative Easing in which the central banks, controlled by the government, are the main or even the sole buyer of bonds. We work on the assumption that government bonds would need to yield at least 1% over the expected rate of inflation to attract rational investors, and so we seek to invest in companies only when their FCF yield is the same as or more than that required bond yield.

The return on capital of the companies in our portfolio averaged about 32% p.a. This compares to an average of about 20% p.a. for the non-financial stocks in both the S&P 500 and the FTSE 100. Bearing in mind the longevity and resilience of our portfolio companies I think we can remain confident that we own stocks with a superior fundamental performance to the average which is not fully reflected in their valuation relative to bonds or other equities.

It may seem surprising that we can buy shares in quality companies at reasonable or even cheap valuations and thereby expect to generate superior investment performance. I have written a short research note in an effort to explain this entitled “Return Free Risk” which can be downloaded from our website at www.fundsmith.co.uk/research. The title is not a mis-type, rather it’s a pun. As investors we are taught that to obtain higher returns you must assume higher risk, but much of the evidence contradicts this assumption. The fact is that for much of the time you get better returns from investing in predictable high quality companies than in smaller, riskier, more obscure company shares. But there appears to be a human desire to indulge in excitement and back the 100-1 shot rather than the favourite, and to engage in complicated bets such as the Yankee defined as “four selections and consisting of 11 separate bets: 6 doubles, 4 trebles and a fourfold accumulator”. Can you accurately calculate whether the odds on such a bet are fair, in your favour or the bookmakers favour? If you can’t, then the bookmaker has the advantage. For bookmaker, read “market”. The principle is the same.

At Fundsmith we obtain excitement not from the delusion that we have discovered an investment that no other investors have found or from a long shot winning, but from delivering predictable, superior investment returns.

The marginal fall in free cash flow yield of our portfolio is a result of the rise in the share prices of the companies in the portfolio nearly offset by a 9.6% increase in the free cash flows per share produced by our companies.

On the whole, we would prefer that the share price performance of our stocks tracked the underlying free cash flow performance of the companies since performance from increasing valuations is a finite game which also tends to even out over long periods of time, and we intend to run this portfolio for a long period of time.

Similarly, we would prefer that the increase in free cash flow from our portfolio companies was derived from top line volume growth, albeit from companies which are able to maintain good prices and high margins on their sales. However, in the low growth environment which we occupy, free cash flow growth is increasingly a result of cost cutting and/or share buybacks. These are also finite sources of growth even when share buybacks are executed in a way which creates value for remaining shareholders, which is not always the case. But it is better to be invested in companies which can maintain growth in free cash flow per share by these means in these circumstances than in companies which can't.

The historical dividend yield of the portfolio is 2.3% and we forecast the prospective yield is 2.5%. Dividend cover remains 2.6 times. Yield is an important element of investment return. Over the long run, it has contributed a higher percentage of equity performance than share price appreciation. But I would caution against a blind search for higher yields.

The current record low interest rates and bond yields have produced a desperate search by investors for yield. The investment industry stands ready to supply products to satisfy any craving by investors, not always to their advantage. Investment flows have started to gravitate to higher risk bonds such as junk bonds and emerging market debt as government bond yields in the supposed safe haven countries have shrunk towards zero. The yield on US high yield or junk bonds sank to 6% at the beginning of 2013, the lowest ever recorded. New issuance has boomed in high yielding real estate investment trusts, and so-called master limited partnerships in energy stocks and pipeline companies (I wonder how many investors can explain how they work). Even Collateralised Loan Obligations ("CLO"s), part of the toxic alphabet soup of instruments which helped start the Credit Crisis have been making a comeback with issuance trebling in 2012. How soon we forget.

Equity investors are far from immune from this trend. For many investors the search for yield is satisfied by investing in an income fund which invests in high yielding equities. This can be a mistake. At certain levels of yield all that is happening is that the investor is being paid back some of the capital value of his or her investment as income, and taxed upon it. All bar one of the income funds in the IMA Global Equity Income sector apply their charges not to income but to capital in order to maximise their stated yield. This has some obvious disadvantages, not the least of which is that it maximizes the investor's tax bill as Income Tax is higher than Capital Gains Tax and much more difficult to avoid or defer. It also exaggerates the true yield, which has obvious marketing advantages for the funds.

We think that investors should not focus solely upon yield but rather on the total return they derive from a share or a portfolio, and should not take the dividend yield as an exact indicator of what they can afford to remove from the fund periodically and spend. To this end we have recently launched a Regular Withdrawal Facility for Fundsmith investors which enables you to draw down whatever figure you want in a regular income from your investment in the Fund without reference to the dividend yield. I am convinced that this, rather than buying high yielding shares which may have poor overall returns and managing them in a fund which overstates the yield by applying charges to capital, is the right way to address this need. It seems like an odd innovation for a fund manager to devise a way to make it easier for investors to withdraw money, so I doubt this will catch on with other managers.

The average company in the portfolio was founded in 1902 – this time last year it was 1894. Clearly some of our purchases have shortened the average age of our companies which has produced a worrying leap on average into the twentieth century.

Looking forward to 2013, one reasonably likely outcome is that we might experience "Groundhog Year" in which there are more EU summits, further commitments to do "whatever it takes" whilst actually doing nothing, another "rescue" deal for Greece, wrangling over the US debt ceiling to follow the Fiscal Cliff, and more QE to keep an otherwise stagnant economy across the developed world alive on life support.

However, it seems likely that one thing is changing: the mandate of central banks in the developed world. The Fed recently doubled its monthly QE programme to $85bn and said it would maintain this programme **at least** (emphasis added) until unemployment falls below 6.5%. Shinzo Abe became Prime Minister of Japan for the second time with the stated intention of making the Bank of Japan target an increase in inflation. Mark Carney, the much heralded new Governor of the Bank of England, got off to an unusual start by announcing seven months before he starts work that he thinks there should be a debate about whether central bankers should currently be targeting nominal GDP growth i.e. ignoring inflation.

Now depending upon your point of view this is either good news because it means yet more stimulus will be applied or bad news because you do not think that the additional stimulus will do much to achieve economic growth or increased employment but it will risk side effects which can be as bad or worse than the ailment they are seeking to treat.

I am in the latter camp. I think that central bankers should be independent of government and should be concerned with the soundness of the currency, and if they have the regulatory authority, the soundness of the banking system. Allowing them to stray outside that is dangerous as it will lead to confusion of fiscal and monetary policy, or in plain English, governments will be able to fund their profligate spending programmes by getting the central bankers to print more money and buy their bonds until the employment or nominal growth targets are achieved, or even beyond (note the term 'at least' used by the Fed).

At some point, the inevitable consequence of this is inflation and currency depreciation. The newer generation of central bankers such as Mr Carney have yet to experience that. When they do, they may discover that when inflation takes hold it does not conveniently stop at some predetermined target rate. They may also find that the only device they have to control inflation is the blunt instrument of interest rates, and a significant rise in rates would have some interesting effects on the affordability of government debt, private debt and the economy in its current condition.

You might legitimately point out that depreciation of the major currencies is a bit tricky as they are all trying to depreciate against each other in order to achieve some competitive advantage. But maybe they will all depreciate against hard assets, or to put it more simply-inflation.

Still whilst we wait to see if or when this scenario comes to pass, the good news is that macro views and developments have no bearing on our strategy; increasingly desperate attempts to stimulate the economy are far more likely to stimulate the valuation of our portfolio (not that we like to make money that way); and our stocks are likely to be a relatively good hedge against a resurrection of inflation.

Happy New Year.

Yours sincerely,

Terry Smith
CEO
Fundsmith LLP

Important information:
An English language prospectus for the Fundsmith Equity Fund is available on request and via the Fundsmith website and investors should consult this document before purchasing shares in the fund. Past performance is not necessarily a guide to future performance. The value of investments and the income from them may fall as well as rise and be affected by changes in exchange rates, and you may not get back the amount of your original investment. Fundsmith LLP does not offer investment advice or make any recommendations regarding the suitability of its product. This financial promotion is intended for UK residents only and is communicated by Fundsmith LLP which is authorised and regulated by the Financial Services Authority.

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January 2014

Dear Fellow Investor,

This is the fourth annual letter to owners of The Fundsmith Equity Fund ("the Fund").

The table shows performance figures for the last calendar year and the cumulative and annualised performance since inception on 1st November 2010.

% Total Return	1st Jan to 31st Dec 2013	Inception to 31st Dec 2013	
		Cumulative	Annualised
Fundsmith Equity Fund[1]	+25.3	+62.2	+16.5
Equities[2]	+24.3	+40.5	+11.3
UK Bonds[3]	-4.3	+11.9	+3.6
Cash[4]	+0.5	+2.3	+0.7

[1]T Class Acc Shares, net of fees, priced at noon UK time.
[3]Bloomberg/EFFAS Bond Indices UK Govt 5-10 yr.
[1,3,4]Source: Bloomberg,
[2]MSCI World Index, £ net, priced at close of business US time.
[4]3 Month £ LIBOR Interest Rate.
[2]Source:www.msci.com

We remain critical of attempts to measure investment performance over short periods of time. However this proviso notwithstanding, the table shows the performance of the T Class Accumulation shares which rose by 25.3% in 2013 and compares that with 24.3% for the MSCI World Index in Sterling with dividends reinvested. The Fund therefore outperformed the market in 2013 by 1%.

You (and we) may find this surprising given that 2013 was a bullish period for equity markets and our portfolio could reasonably be categorised as "defensive". The year in stock market terms was, to use the football cliché, "a game of (roughly) two halves". The market, as measured by the MSCI World Index[2], rose by 19.1% from 1st January to 22nd May, where it hit a temporary peak from which it fell by 9.4% after Ben Bernanke spoke on 22nd May and indicated that the Federal Reserve Bank was considering so-called "tapering" of its Quantitative Easing ("QE") programme of purchasing bonds, then running at no less than $85bn per month. It began to recover from July as it became evident that even the suggestion of tapering would have adverse consequences, not least for Emerging Markets which have been the recipients of an estimated $4 trillion dollars in capital since QE began after the financial crisis of 2007-08. A much smaller tapering than originally anticipated started in December, and has been accompanied by soothing statements about the long term continuance of that other policy measure - a Zero Interest Rate Policy (or "ZIRP"). It is clear that the authorities took fright at the impact of their plans to moderate the stimulus and backed down, leaving the markets to resume their bullish mood.

The market dip which began in May also coincided with the market sensing economic recovery in the GDP numbers for the US and the UK at least, so that in the second and third quarters the sectors which performed well were all those which you would expect to do well in such conditions - Consumer Discretionary, Industrials, Finance, Information Technology and Energy - most of which we will never own. Consumer Staples, which are the bedrock of our strategy and portfolio, were one of the worst performing sectors in this period.

Now this might strike you as odd, that a sell-off in the market coincided with increasing evidence of economic recovery, but apart from the fact that no one has ever established a correlation between GDP growth and the performance of stock markets, one of the more apparently perverse aspects of markets has been the growing view that "good news is bad news". It all comes down to QE - the markets were more concerned that economic recovery would lead to the withdrawal of this stimulus than they were bullish about the recovery itself.

Although we have an interest in this subject, these market shenanigans have no bearing on the manner in which our portfolio is invested. People often ask us what we think the outlook is for the economy and/or the market. Apart from prefacing any response with the phrase, "we don't know", we usually point out that whatever the outlook it will not alter our methodology of investment. We mention this because we sometimes feel that the questioner supposes that if we too scent economic recovery we might switch the portfolio into cyclicals, financials and highly leveraged companies which might benefit from a recovery most (but which might otherwise go bust). Whatever our view on the economy, The Fundsmith Equity Fund will always be fully invested in high quality companies which satisfy our exacting criteria on financial performance and have done so for many decades.

However, at least one aspect of the debate about economic recovery and so-called tapering of QE puzzles us. If we are in an economic recovery, why is the growth rate of our investee companies slowing? We both understand and accept that in an economic recovery, companies in areas of discretionary spending and big ticket durable items such as cars and houses will fare better than the companies in our portfolio, as will companies in the cyclical industries which supply them. But we keep track of the "underlying" (excluding acquisitions, currency effects and exceptional items) revenue growth rate at all the companies in our Investable Universe (currently 64 stocks) and there is no doubt that it has slowed by a couple of percentage points over the past year. Remarks from several of their CEOs make it clear that consumer markets are not becoming significantly better. We can see why they would lag cyclical stocks in an upturn but not why their performance would start to deteriorate. This leaves us feeling sceptical about the nature and strength of the recovery.

For the year, the top five contributors to the Fund's performance were:

Domino's Pizza	+3.02%
Microsoft	+2.05%
Stryker	+1.98%
Becton Dickinson	+1.96%
3M	+1.93%

The bottom five were:

Swedish Match	-0.06%
Serco	+0.03%
Imperial Tobacco	+0.14%
Schindler	+0.14%
Philip Morris Intl.	+0.21%

It is worth noting the following about the bottom five contributors: only one actually had a negative performance, Swedish Match, which we began buying during the year in response to share price weakness and a resulting more attractive valuation. Three of the five are tobacco companies which suffered from concerns about plain packaging and e-cigarettes. We suspect that these concerns are overdone but nonetheless have a self-imposed limit on our exposure to the sector, as we do to most sectors, in order to ensure that the effects are limited if we are wrong. Schindler and Serco, two of the other bottom five performers, were sold during the year.

Minimising portfolio turnover is one of our objectives and this was again achieved with a negative turnover of -17.6% during the period. Negative turnover occurs because the method of calculating turnover excludes flows into or out of the fund, otherwise a newly established fund would automatically have 100% or more turnover. However, it is not very helpful in judging our activities. It is perhaps therefore more helpful to know that we spent a total of £351,227 or just 0.025% (2.5bps) of the Fund on dealing other than that associated with flows into the Fund which was involuntary.

Why is this important? It helps to minimise costs, and minimising the costs of investment is a vital contribution to achieving a satisfactory outcome as an investor. Too often investors, commentators and advisers focus on the Annual Management Charge (“AMC”) or the Ongoing Charges Figure (“OCF”), which includes some costs over and above the AMC, which are charged to the fund. The OCF for 2013 for the T Class Shares was 1.11%. The trouble is that the OCF does not include an important element of costs - the costs of dealing. When a fund manager deals by buying or selling investments for a fund, the fund typically incurs commission paid to a broker, the bid-offer spread on the stocks dealt in and, in some cases, Stamp Duty. This can add significantly to the costs of a fund yet it is not included in the OCF.

I find that investors are often confused by this and in my view do not pay enough attention to it. The fact is that as an investor you can only benefit from the price appreciation of shares in your fund and dividends paid. Costs of dealing detract from those returns and therefore need to be taken into account when you are comparing funds.

We have published our own version of this total cost including dealing costs, which we have termed the Total Cost of Investment, or TCI. For the T Class Shares in 2013 this amounted to a TCI of 1.2%, including all costs of dealing for flows into and out of the Fund, not just our voluntary dealing. As a result of the Investment Management Association’s campaign for fuller disclosure I am hopeful that we will eventually get such disclosure from many more funds so that investors can make a well informed comparison between funds. When they are able to do so, I fully expect that the Fundsmith Equity Fund will compare favourably.

Although our turnover was once again very low in 2013, we sold five holdings: McDonald’s, Schindler, Serco, Sigma-Aldrich and Waters Corporation. There may seem to be an inherent contradiction between the fact that we sold five holdings yet our turnover was low. Part of the explanation is that some of these holdings had already become an insignificant proportion of our portfolio because we had been struggling to add to them as their valuations had become too high to represent good value in our view. Once this point is reached it begs the obvious question of whether we should in fact sell our holding to make way for an investment which offers better value, either within our existing portfolio stocks or from within our wider Investable Universe of stocks on which we maintain research.

There were also individual reasons for sale in each case:

McDonald’s valuation had held up despite a run of poor sales figures which made it hard to add to our holding. The poor sales also arose despite McDonald’s offering meal options for as little as $1. This began to convince us that McDonald’s had started to become a business which was selling solely on price, which we seek to avoid, and it seems that its Dollar Menu has perhaps unsurprisingly handicapped its attempts to sell premium items. Its performance was in sharp contrast to Domino’s Pizza which has had no trouble growing sales with price points close to $6 for a pizza, and we took comfort in the fact that we retained our Domino's holding and with it a continued exposure to the franchised fast food business which we like.

Schindler had simply become too expensive for us to add to our holding and we were able to retain an exposure to the attractive elevator and escalator sector via Kone.

Serco seemed to fit the profile of businesses we seek to invest in as it depends on a large number of everyday repeat transactions: if you ride a Boris bike, take the Docklands Light Railway, see a traffic light being repaired in London, get a parking ticket in San Francisco, have the misfortune to be incarcerated in certain UK prisons or transported to court in a prison van, pass through airspace governed by US air traffic control or encounter the Australian immigration authorities, you are dealing with Serco. But we had always been troubled by the fact that these transactions emanated from much larger contracts, typically with governments, which gave rise to the risk that large contracts could be lost and in so doing could adversely affect Serco's relationship with its government customers. Then early in 2013 it became apparent that a significant acquisition of an Indian-based business process outsourcing business, which Serco had undertaken, had changed its cash flow generation and capital intensity in a way which was adverse and we sold our holding in February. Serco's problems with electronic tagging of offenders followed some months later and confirmed our concerns.

Sigma-Aldrich is a company based in the US Midwest which supplies chemicals and equipment to researchers and manufacturers in the life sciences, high tech industries and R&D. It supplies a large number of items in small ticket sizes to a large number of purchasers, and so fitted our investment profile, not least because it also has an excellent record in terms of return on capital and cash conversion (turning profits into cash, in plain English). However, Sigma-Aldrich attempted to acquire Life Technologies, a company which is much larger in every sense - revenues and market valuation. This worried us a lot. With our low portfolio turnover we are in effect leaving the allocation of capital generated by the wonderful returns earned by our portfolio companies to the management of those companies. When one of them looks likely to take a business with good, predictable returns and do something large, exciting and risky, we have a strong impulse to run away.

Waters Corporation makes and services liquid chromatography, mass spectrometry and thermal analysis equipment. The company's main customers are in the pharmaceutical and biotechnology industries but it also supplies industrial, food and environmental customers. Its revenues are partly a play on the growth in the requirement for testing in these areas. Although its equipment represents large ticket capital items, it makes nearly half its revenues from consumables, service and spares, so satisfying our criteria on repeat purchases. But it has significant sales to Asia including the Indian generic pharmaceutical industry and we were fearful that the slowdown in Emerging Markets would adversely impact the equipment sales which underpin its revenue model**.** Waters was also the only non-dividend paying stock which we held. Whilst we are prepared to hold such stocks, we need to be convinced that their reinvestment opportunities warrant the absence of a dividend and we were increasingly wary of this with Waters.

So much for the sales.

The Fund purchased a holding in C.R. Bard which makes medical devices, particularly catheters for use in oncology, urology and vascular conditions. It is to some extent a play on the medical needs of an aging population. Its business is centred on the developed world at present and we believe it may have a significant opportunity to grow in Emerging Markets. Unlike Waters, Bard's opportunities in Emerging Markets are not linked to the capital expenditure cycle of its customers which is by definition lumpy and cyclical as it does not sell high value equipment but mainly consumables.

We also began to acquire a holding in a transaction services company but this has not yet reached a size where we feel that our buying is complete and so do not wish to disclose the name at present.

Perhaps the question we faced most frequently from investors or prospective investors over the year was whether companies of the sort we invest in have become too expensive.

There has certainly been a growing fashion for investing in the type of large, well established companies whose business consists of selling or supplying goods and services which are characterised by the small ticket, repeat, relatively predictable everyday events which we seek. Whilst this may seem like a welcome development insofar as it means that the Fund's shares have risen in value faster than the market, it also means that an increasing proportion of the Fund's performance has been delivered by rising valuations of those stocks rather than growth in their revenues, profits and cash flows. As we cautioned in this letter last year, 'increasingly desperate attempts to stimulate the economy are far more likely to stimulate the valuation of our portfolio'. That this happened in 2013 - not just for our portfolio, but for the whole market - is demonstrated by this chart which looks as though it was drawn by and/or for a child:

Whilst such increases in valuation may seem like cause for celebration it is not always so as we intend to be long term or even indefinite investors and such valuation changes are certainly finite and maybe even temporary. They are the result of the massive injection of liquidity from QE and a sustained period of zero interest rates. Apart from the fact that we intend to be long term investors, even if we were trying to guess the timing of the withdrawal of these factors in order to exit from markets, we would point out that there is no certainty that such increases in valuations may not be sustained or even go further as QE continues. The so-called taper is a token - US QE continues at $75bn per month, $900bn p.a. - and it seems that most major central banks are targeting a further sustained period of ZIRP. At the moment stories of QE's demise are at least exaggerated. Fortunately seeking to profit from short term valuation anomalies or changes is not part of our strategy but given the upside which has been generated from these policies, I have little doubt that we will have to live through some character testing times when they are withdrawn.

There are many ways of looking at valuation, but here are a few thoughts:

1. We seek to buy our portfolio companies when their free cash flow ("FCF") yield (the free cash flow they generate divided by their market value) is at or above the yield we would expect to get on long term government bonds in the same currency. Please note; not the current yield on bonds, which in most cases has been depressed by governments buying their own bonds, but the yield we think might apply if this were to stop and all bonds had to be sold to third party investors. Our

starting guess for the yield that might then be required is one percent over the expected rate of inflation. If we can buy shares with FCF yields higher than that and which will grow, unlike the coupon on the bonds, we should have captured some value. There are still shares within our portfolio which look good value on this basis, albeit not as many or as cheap as they were a year or two ago.

The weighted average FCF yield of the portfolio started the year at 5.7% and ended it at 5.1% - still above the level we would find acceptable on the basis of the comparison with expected bond yields. Our companies on average grew their free cash flow per share by 6.6% during the year. They actually grew their operating cash flow by 8.1% but also spent 21% more on capital expenditure ("capex"). We find the fact that they have significantly increased their capex as encouraging as we have yet to find an industry which can grow without committing additional capital in order to do so.

This 5.1% FCF yield compares with a median FCF yield for the non-financial stocks in the S&P 500 of 4.6% and a mean of 4.1% or a median for the non-financial stocks in the FTSE 100 of 4.0% and a mean of 3.7%. Our stocks do not look bad value in comparison to the market. Although of course, both may be expensive, but both may continue to be so or become more expensive.

2. Consumer Staples, in particular, have been more highly rated in the past than they are now. We mention this because we frequently read or are told that they are more expensive than ever. This is simply not so - they were more highly rated in the 1990s, for example. Moreover, whilst commentators seem to focus on Consumer Staples stocks, these are less than half of our portfolio, and some of our medical equipment stocks are much closer to the low end of their historic valuation range.

3. We examined the relative performance of Colgate-Palmolive and Coca-Cola over a 30 year time period from 1979-2009. Why 30 years? Because we thought it was long enough to simulate an investment lifetime in which individuals save for their retirement after which they seek to live on the income from their investment. Why 1979-2009? We wanted a recent period and in 1979 it so happens that Coca-Cola was on exactly the same Price Earnings Ratio ("PE") as the market – 10 and Colgate was a little cheaper on 7x. The question we posed is what PE could you have paid for those shares in 1979 and still performed in line with the market, which we took as the S&P 500 Index, over the next 30 years? We found the answer rather surprising - it was 36x in the case of Coke and 34x in the case of Colgate when the market was on 10x. Another way of looking at it is that you could therefore have paid a PE of 3.6x the market PE for Coke and 4.9x the market PE for Colgate in 1979 and still matched the market performance over the next 30 years. The reason is the differential rate of compound growth in the share prices (to a large extent driven by growth in the earnings) of those companies over the 30 years. They compounded at about 5% p.a. faster than the market. You may be surprised that this differential can have such a profound effect upon the outcome. It's the magic of compounding.

   Albert Einstein said that he thought compound interest was the eighth wonder of the world. It is certainly one of the concepts least understood by investors. The simplest illustration of this is to ask how long it takes to double your capital at 10% p.a. compound return. The whole point is that we are talking about compound returns in which the gains are added to the capital sum to which each successive period's rate of return is applied. Consequently, the answer is a counterintuitive seven years. It only takes a compound return of 7% p.a. to double your money in ten years.

   That is a simple enough example, but how about this one: starting with the same initial sum, what is the difference in final capital from 30 years of investment at 10% p.a. compound versus 30 years at 12.5% p.a.? I ask this because it may represent a reasonable range of outcomes from an investment lifetime. The answer, rather surprisingly, is that the extra 2.5% of compound return would double the final sum.

As discussed earlier Coke & Colgate's total returns grew at about 5% p.a. faster than the market over the period 1979-2009, this 5% differential multiplied their share prices four times more than the market over that period. Of course, the next 30 years may be different to the 1979-2009 period. However, if I had to guess how it would affect this calculation it would be that companies like Coke and Colgate will fare even better versus the rest of the market in terms of growth given that the cyclical stocks are unlikely to benefit from a repetition of the growth which was stimulated by the credit bubble. But what do I know?

It is also fair to point out that quality stocks may indeed not be too expensive relative to the rest of the market but that both will prove to be expensive, particularly when interest rates rise. But even so, I suggest you consider how you might have reacted if someone had suggested that you invest in Coke or Colgate at say twice the market PE in 1979. In rejecting that idea you would have missed the chance to make nearly twice as much money as an investment in the market indices over that period which included some periods of very high interest rates. Of course, capturing this opportunity would have required you to have the fortitude to sit on your hands during those periods of high interest rates and poor performance (hint: we will be reminding you about this when interest rates rise). As at 31st December 2013 they were trading at PE's slightly above the market – our portfolio was on a PE of 20.6x versus 17.4x for the S&P 500, which doesn't sound quite so expensive when you look at their historical performance and quality.

4. In fact, we rarely look at PE's, usually only doing so to make such comparisons as other market commentators use them. We prefer instead to rely upon free cash flow yields when evaluating our investments as not all E's, or Earnings, are created equal. Our portfolio companies' businesses are less capital intensive than the market as whole. As their earnings are generated with less capital, their Return on Capital Employed is much higher than the average, which we regard as the primary test of their performance. The return on capital of the companies in our portfolio averages 34%. This compares with an average of about 19% for the non-financial stocks in both the S&P 500 and the FTSE 100. They also deliver more of their earnings in cash than the market as a whole, typically 90-100%. And we like cash - it is the main way of paying bills and earnings delivered in cash are of higher quality than those which aren't.

   We remain confident that we own stocks with a superior fundamental performance to the average which is not fully reflected in their valuation relative to bonds or other equities.

5. A striking and direct comparison is between the dividend yield on some of our stocks and the redemption yield on their bonds. Take Nestle for example, at the end of December 2013 its 2018 bonds had a redemption yield of 0.21% whilst its ordinary shares yielded 3.1%. Leaving aside fund managers who are limited to investing in bonds by their mandate, why would anybody in their right mind own the bonds rather than the shares? The answer is that some investors are willing to overpay for the apparent certainty which the bonds bring. They have a fixed coupon, a redemption date and a par value which will be repaid to the holder on redemption. The shares have none of those things. Although it has to be said that the dividend is pretty safe given that Nestle has only reported one loss in 146 years, but it is still not a fixed charge, as the interest coupon is. And you cannot rely on the shares being a particular price if you need to dispose of them. But this does seem to suggest that the shares are at least good value relative to the bonds. Although that does not mean that either of them is cheap, it does raise the question of where you would invest the money as an alternative to the shares with a better risk/reward relationship in the current environment.

6. As at 31st December 2013 the weighted historic dividend yield of the Fund was 2.3% and the weighted prospective yield was 2.5% and the prospective dividend cover was 2.4x**.**

Although all of our portfolio companies are headquartered and listed in Europe and North America, some 32% of their underlying revenues are from Emerging Markets. This is generally considered a positive attribute as Emerging Markets have generally outperformed developed markets in terms of economic growth in recent years.

We are often asked why we do not invest directly in Emerging Markets if we like exposure to their superior growth. The reasons are complex but one of the main ones is liquidity. The Fundsmith Equity Fund is an open ended fund with daily liquidity. We hope that if you invest with us you will be a long term investor because we believe that this delivers the best results, but you can redeem your investment on any business day. This would be incompatible with direct investment in the companies of the sort we seek but which are headquartered and listed in Emerging Markets. Although some of these companies are not small, there is not enough liquidity in their shares in local markets to hold them responsibly through an open ended fund. Especially one with daily dealing.

In order to overcome this problem we have decided to launch a new fund, the Fundsmith Emerging Equities Trust ("FEET"), in 2014. This will be an investment trust investing in the same strategy as our existing Fund but mostly in companies which are listed in Emerging Markets. Its focus will be on consumer stocks since a) this is the largest area of focus of our strategy, and b) there is an established trend for the emergence of consumer classes in Emerging Markets which looks likely to last several decades and which should provide a tailwind for its performance.

We have identified an Investable Universe of over 150 companies for FEET, many are already known to us as they are quoted subsidiaries, associates or franchisees of companies which we already research for the Fundsmith Equity Fund. This also helps with the corporate governance issues which can plague Emerging Markets.

For reasons which we will detail in the soon to be published FEET Owners' Manual we believe that this approach should produce better results for investors compared to many of the other investment products and approaches which have sought to capitalise on the growth in Emerging Markets.

As an investment trust, FEET will overcome the issue of combining an open ended fund with stocks which have limited liquidity in the underlying investments since it will raise an initial fixed amount of capital, to which I will subscribe. Thereafter investor liquidity will be provided by trading in the trust's shares thus removing the costly need to liquidate or add to the portfolio on investor demand.

You can expect to hear more from us about the opportunity which we feel FEET provides later in the year. But in the interim, I wish you a Happy New Year and thank you for your continued support for our Fund.

Yours sincerely,

Terry Smith

Terry Smith
CEO
Fundsmith LLP

An English language prospectus for the Fundsmith Equity Fund is available on request and via the Fundsmith website and investors should consult this document before purchasing units in the fund. Past performance is not necessarily a guide to future performance. The value of investments and the income from them may fall as well as rise and be affected by changes in exchange rates, and you may not get back the amount of your original investment. Fundsmith LLP does not offer investment advice or make any recommendations regarding the suitability of its product. This financial promotion is intended for UK residents only and is communicated by Fundsmith LLP which is authorised and regulated by the Financial Conduct Authority. Data sources: Bloomberg & Fundsmith research.

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January 2015

Dear Fellow Investor,

This is the fifth annual letter to owners of the Fundsmith Equity Fund ('Fund').

The table shows performance figures for the last calendar year and the cumulative and annualised performance since inception on 1st November 2010 compared with various benchmarks.

% Total Return	**1st Jan to 31st Dec 2014**	**Inception to 31st Dec 2014**	
		Cumulative	**Annualised**
Fundsmith Equity Fund[1]	+23.3	+100.0	+18.1
Equities[2]	+11.5	+56.6	+11.4
UK Bonds[3]	+10.0	+23.1	+5.1
Cash[4]	+0.5	+2.9	+0.7

[1]T Class Acc Shares, net of fees, priced at noon UK time.
[3]Bloomberg/EFFAS Bond Indices UK Govt 5-10 yr.
[3,4]Source: Bloomberg
[2]MSCI World Index, £ net, priced at close of business US time.
[4]3 Month £ LIBOR Interest Rate.
[2]Source: www.msci.com

We never tire of reminding people that we remain critical of attempts to measure investment performance over short periods of time, such as a year. However, this proviso notwithstanding, the table shows the performance of the T Class Accumulation shares which rose by 23.3% in 2014 and compares that with 11.5% for the MSCI World Index in sterling with dividends reinvested. The Fund therefore outperformed the market in 2014 by 11.8%. However, we are assisted in forming a longer term perspective on the Fund's performance by the fact that it finished 2014 with the improbably precise outcome of having doubled investors' capital since inception.

2014 was another bullish period for equity markets. In this letter last year we wrote about the so-called 'taper tantrum' in which markets fell in May 2013 when the Federal Reserve Bank first mooted that it was planning to begin reducing its programme of Quantitative Easing ('QE') - 'printing' money (or at least clicking a mouse to create it) with which to buy bonds. Although US QE has now ended, equity markets had a somewhat bullish year (at least in sterling and in the US - the FTSE 100 and Emerging Markets fared badly) and the US and UK economies are growing, it is tempting to conclude that the market wobble of May 2013 was just an example of the so-called 'wall of worry' which a bull market is said to climb.

This may be so, but this economic recovery is neither uniform nor unaided. The core countries of the Eurozone - Italy, France and even Germany - are now struggling, as is a large part of the developing world, much of which is still driven by commodity exports, at a time when China's seemingly insatiable demand for commodities to fuel its industrialisation has slackened markedly. Nor is such anaemic growth being achieved without considerable stimulus. Japan is engaged in a QE experiment of epic proportions as it tries to stimulate its way out of a slump which innumerate commentators have described as a 'lost decade' with no economic growth. It has in fact gone on for the better part of two decades. Even the growth in the US and the UK is being achieved against a backdrop of record low interest rates and continuing government deficit spending, the necessity for which is unusual and worrying this far into a recovery.

I do not think it would add much for me to weigh in on the debate about the reasoning behind QE, its effectiveness and possible consequences except to observe that many of its proponents seem to assume that inflating asset values will lead to prosperity. I suspect this is the reverse of what should occur which may not bode well.

We are often asked what our view is of the economic outlook for the world and how our Fund is positioned to take advantage of, or cope with, those conditions. Our investment approach is thankfully not based upon our view of the global economic outlook. I say thankfully because we do not profess any great expertise in this area, and we are not particularly optimistic. This is in contrast to many others in the industry who certainly profess to such expertise, often it seems without any obvious justification. We are at least one step ahead of most of them in recognising that we do not know what will happen.

The desire of people to rely on forecasting despite its obvious drawbacks is illustrated by an anecdote from the Nobel laureate and retired Stanford University economist Kenneth Arrow. Arrow did a tour of duty as a weather forecaster for the US Air Force during World War Two. Ordered to evaluate mathematical models for predicting the weather one month ahead, he found that they were worthless. Informed of that, his superiors sent back another order: 'The Commanding General is well aware that the forecasts are no good. However, he needs them for planning purposes.'

Our investment strategy is based first and foremost on buying shares in good companies. We cannot promise you much about our Fund. But one thing we are clear about is that we seek to own shares in good companies and at least most of the time we succeed in that objective.

You may think that this part of our strategy is so obvious that it must surely be the case that all fund managers seek to invest in good companies. However, this is certainly not the case. Fund managers will buy shares in bad companies, by which I mean companies which do not consistently create value for their shareholders or even worse which destroy value some or even all of the time. If they have a reason for doing this it usually boils down to some expectation that the performance of the companies will improve at least temporarily because they think that the economic or business cycle will improve and those companies will start to make adequate returns, or there will be a change of management which will improve their performance or a takeover bid, all of which may benefit the share price. Or they may just think that the shares are cheap.

One problem with this approach to investing is that companies rarely go through a transformational improvement (a phrase involving leopards and spots springs to mind) and these events are also difficult to predict. But in our view the main problem with this investment strategy, other than the fact that we have no expectation that we could make it work, is that whilst fund managers await the kiss that will turn their corporate frogs into princes, they steadily erode value. The companies in our portfolio are certainly not immune to periodic downturns in business and/or management errors, and their share prices are subject to the usual factors which affect the stock market, but we can at least be reasonably sure that they are adding to their intrinsic value over time.

To demonstrate this we thought of a new way to inform you about the portfolio of companies which we own. The table below shows what the Fundsmith Equity Fund would be like if instead of being a mutual fund it was a company ('Company') and accounted for the stakes which it owns in the portfolio and compares this with the market (in this case the FTSE 100 and the S&P 500):

	Fundsmith Equity Fund [1]	**FTSE 100 Index** [2]	**S&P 500 Index** [2]
Return on Capital Employed ('ROCE')	29%	18%	18%
Gross Margin	60%	39%	44%
Operating Profit Margin	25%	16%	16%
Cash Conversion	102%	79%	81%
Leverage	28%	40%	38%
Interest Cover	15x	9x	9x

[1] Source: Fundsmith Research. [2] Source: Bloomberg.
ROCE, Gross Margin, Operating Profit Margin and Cash Conversion are the weighted mean of the underling companies invested in by the Fundsmith Equity Fund and mean for the FTSE 100 and S&P 500 Indices. The FTSE 100 and S&P 500 numbers exclude financial stocks. The Leverage and Interest Cover numbers are both median. All ratios are based on last reported fiscal year accounts and as defined by Bloomberg. Cash Conversion compares Free Cashflow per Share with Net Income per Share.

What does this table demonstrate? Taking each of the measures in turn:

Return on Capital Employed: The legendary investor Warren Buffett in his 1979 annual letter as Chairman of Berkshire Hathaway described ROCE as 'The primary test of managerial economic performance'. In our Company it was 29% versus an average of 18% for the market. For every pound of capital which we own our companies produce 29p of profits versus 18p for the market.

Gross Margin: The difference between sales revenue and cost of goods sold for our Company was 60% versus about 40% for the market. Our Company makes things for £4 and sells them for £10. The market makes things which cost £6 and sells them for £10.

Operating Profit Margin: Our Company's operating profit margin is 25% versus an average of 16% for the market.

Cash Conversion: Our Company converts just over 100p out of every £1 of profit into cash whereas the market manages about 80p as its businesses require more capital expenditure and working capital to function.

Leverage: Our Company has net debt (net of cash) of about a quarter of shareholders' funds whereas the market has around 40%.

Interest Cover: Our Company's profits are 15 times its interest charge which means there is little doubt that it can service its debt even in a dramatic downturn. The market looks quite safe too but its interest cover is below 10 times.

In short, our Company has much better financial performance than the market as a whole and is more conservatively funded.

So when it comes to quality we are confident that we have selected good companies, but one of the questions which most frequently arises when we are talking to investors is that of valuation. The companies we invest in may be high quality businesses, but perhaps their shares have become too expensive. There is no doubt that the shares in our portfolio have become more highly rated over the past four years. It is also true that this is not the way we would prefer the performance of the portfolio to be delivered as increases in the multiples which company shares trade on are finite and reversible.

But there is no certainty that such improvements in valuation will reverse any time soon or indeed that they won't continue. We remain unimpressed by those who tell us about their concerns about valuation and who have been doing so for several years. No doubt they may prove to be right at some point but following their advice would have been very expensive in the interim. We do not attempt to make any so-called 'market timing' judgments. We aim to have our Fund fully invested in companies of the sort we like, thereby acknowledging that we do not possess any expertise in guessing the right moment or even the right year in which to invest or to sell. In this we seem to have an advantage over those investors who think they can accomplish this, exemplified in my mind by at least one investor who refused to invest with us at the launch of our Fund because he thought our timing was not propitious and who now ascribes our performance to our good timing. I have news for him: we took no account of such timing when we launched and neither do we now.

Having said all of that, where are we on valuation? The weighted average Free Cash Flow ('FCF') yield of the portfolio (the free cash flow generated by the companies divided by their market value) started the year at 5.1% and ended it at 4.5% so we had a tailwind from increased valuations again, but the yield is still above the level that we would find acceptable on the basis of the comparison with expected bond yields. Our companies on average grew their free cash flow per share by 7.0% during the year but also spent 7.8% more on capital expenditure ('capex'). We find the fact that they continue to increase their capex as encouraging as we have yet to find an industry which can grow without committing additional capital in order to do so.

This 4.5% FCF yield compares with a median FCF yield for the non-financial stocks in the S&P 500 of 4.2% and a mean of 3.4% or a median for the non-financial stocks in the FTSE 100 of 4.4% and a mean of 3.8%. Our stocks do not look bad value in comparison to the market especially when their relatively high quality is taken into account. Although of course, both may be expensive, but then both may continue to be so or even become more expensive.

For 2014 the top five contributors* to the Fund's performance were:

Dr Pepper Snapple	+3.3%
Microsoft	+2.3%
Domino's Pizza	+2.0%
Stryker	+2.0%
Becton Dickinson	+1.7%

Of the top five contributors it is perhaps worth noting that no less than four - Becton Dickinson, Domino's Pizza, Microsoft and Stryker - were in this position last year as well. So much for the theory that no-one ever did badly by taking a profit.

The bottom five were:

Diageo	-0.08%
Swedish Match	-0.05%
L'Oreal	+0.01%
Amadeus	+0.22%
Colgate Palmolive	+0.24%

* Contribution shows the gross contribution to the Fund's return by stock as calculated by State Street Investment Analytics. The list excludes stocks held for less than one month so as to be more meaningful.

Only two of the bottom five produced negative contributions, Diageo and Swedish Match. We sold the latter, which had also been our worst contributor in 2013, during 2014. We took the view that the e-cigarette development, whilst not necessarily harmful to the cigarette companies, was a potentially disruptive change which could adversely impact its Snus smokeless product. We are sensitive to the possibility of permanent loss of value which disruptive change can cause and on the whole we seek to avoid investing in companies which could be affected by it. We also feared another disruptive change which could affect Swedish Match - a thawing of relations between the US and Cuba as Swedish Match distributes non Havana cigars in America. We did not think that its business would fare well in the event that the US embargo on trade with Cuba was lifted which we thought was likely. It appeared to us that most people would struggle to explain the rationale for this Cold War measure whose lack of coherence has been lampooned and its relevance to Swedish Match was encapsulated in the saying we are fond of: that it is the first attempt in history to bring about regime change by smoking inferior cigars. Since we sold our holding in Swedish Match the events we foresaw have indeed begun to unfold. Our only other disposals during 2014 were our holdings in CDK, a supplier of software to motor dealers, which was spun out of ADP during the year and a small holding in Indivior, the pharmaceutical company, which we received when it was demerged by Reckitt Benckiser.

We started three new holdings during the year, two of which are within the technology sector. You may think this fits awkwardly with our professed desire to avoid businesses which might be subject to disruptive change for which the technology sector is renowned. However, in neither case are our new investee companies operating in areas at the leading edge of technology.

eBay is probably well known to you through one or both of its two major businesses - the Marketplaces business through which you can buy and sell new or second hand articles, and PayPal the leader in online payments. Whilst so-called activist investing has its place in ensuring that company managements pay due attention to shareholders' interests, we are not fans of the commonest form of this activity, the modus operandi of which could be described as:

- Activist acquires stake in company.
- Activist campaigns noisily and publicly for change, which can consist of the company trying to sell itself to an acquirer, splitting the company into a number of listed entities for each of its activities, taking on more debt, share buybacks, or some combination of these.
- Shares go up as a result of excitement amongst the 'analytical' community about this activity.
- Activist sells stake at a profit.
- Long term shareholders are left trying to make sense of fragmented businesses, new management teams, higher leverage, costs of separation or integration and financial statements which are rendered incomprehensible by many adjustments.

However, in the case of eBay an activist acquired a stake and pushed the company to agree to separate its Marketplaces and PayPal business and we tend to agree that they may be better separated so that PayPal can develop its payment service with other online businesses. I should add that we started buying our stake before this was announced and it was not part of the rationale for our investment.

In the case of Sage we started buying a stake in the UK's largest software business. Sage has an installed base of software used by millions of small and medium sized businesses which makes it the dominant supplier of accounting software outside America. Like many software businesses it is transitioning from selling software in the form of a disc in a box, which is paid for upfront, to an online subscription model which we think will ultimately make it an even better business.

Close to the end of the year we also began acquiring a stake in an international testing and inspection company the name of which we are yet to reveal as we are in the process of buying our position.

That is the sum total of our outright sales and purchases for 2014, at least part of which was involuntary in that we received the CDK holding as a result of our stake in ADP and the Indivior holding from Reckitt Benckiser. Which is just as well since minimising portfolio turnover remains one of our objectives and this was again achieved with a negative turnover of -8.4% during the period. Negative turnover occurs because the method of calculating turnover excludes flows into or out of the Fund, otherwise a newly established fund would automatically have 100% or more turnover. However, it is not very helpful in judging our activities. It is perhaps therefore more helpful to know that we spent a total of £98,081 or just 0.005% (0.5bp) of the Fund on voluntary dealing.

Why is this important? It helps to minimise costs, and minimising the costs of investment is a vital contribution to achieving a satisfactory outcome as an investor. Too often investors, commentators and advisers focus on the Annual Management Charge ('AMC') or the Ongoing Charges Figure ('OCF'), which includes some costs over and above the AMC, which are charged to the Fund. The OCF for 2014 for the T Class Shares was 1.09%. The trouble is that the OCF does not include an important element of costs - the costs of dealing. When a fund manager deals by buying or selling investments for a fund, the fund typically incurs commission paid to a broker, the bid-offer spread on the stocks dealt in and, in some cases, Stamp Duty. This can add significantly to the costs of a fund yet it is not included in the OCF.

I find that investors remain confused by this no matter how many times I attempt to explain it, or maybe because of my attempts to explain it. The fact is that as an investor you can only benefit from the price appreciation of shares in your fund and dividends paid. Costs of dealing detract from those returns and therefore need to be taken into account when you are comparing funds.

We have published our own version of this total cost including dealing costs, which we have termed the Total Cost of Investment, or TCI. For the T Class Shares in 2014 this amounted to a TCI of 1.18%, including all costs of dealing for Fund inflows and outflows, not just our voluntary dealing.

In order to minimise the cost of dealing and avoid the mistakes which seem to result when we sell stakes in good businesses our mantra is: 'Don't just do something, sit there.'

As I foreshadowed in this letter last year we launched the Fundsmith Emerging Equities Trust (or 'FEET' which is its stock market ticker symbol) in June 2014. This is an investment trust investing in the same strategy as our existing Fund but investing in companies which have the majority of their revenues from the developing world and which are mostly listed in Emerging Markets. They do not have enough liquidity in their shares in local markets for us to consider holding them through an open ended fund with daily dealing like the Fundsmith Equity Fund. For those of you who are invested in FEET there will be a separate update on its progress with its annual results in March.

Finally, I wish you a Happy New Year and thank you for your continued support for our Fund.

Yours sincerely,

Terry Smith

Terry Smith
CEO
Fundsmith LLP

An English language prospectus for the Fundsmith Equity Fund is available on request and via the Fundsmith website and investors should consult this document before purchasing units in the fund. Past performance is not necessarily a guide to future performance. The value of investments and the income from them may fall as well as rise and be affected by changes in exchange rates, and you may not get back the amount of your original investment. Fundsmith LLP does not offer investment advice or make any recommendations regarding the suitability of its product. This financial promotion is intended for UK residents only and is communicated by Fundsmith LLP which is authorised and regulated by the Financial Conduct Authority.

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January 2016

Dear Fellow Investor,

This is the sixth annual letter to owners of the Fundsmith Equity Fund ('Fund').

The table below shows performance figures for the last calendar year and the cumulative and annualised performance since inception on 1st November 2010 compared with various benchmarks.

% Total Return	1st Jan to 31st Dec 2015	Inception to 31st Dec 2015 Cumulative	Inception to 31st Dec 2015 Annualised
Fundsmith Equity Fund[1]	+15.7	+131.4	+17.6
Equities[2]	+4.9	+64.3	+10.1
UK Bonds[3]	+1.0	+24.3	+4.3
Cash[4]	+0.0	+3.5	+0.7

[1] T Class Acc shares, net of fees, priced at noon UK time.
[3] Bloomberg/EFFAS Bond Indices UK Govt 5-10 yr.
[1,3,4] Source: Bloomberg
[2] MSCI World Index, £ net, priced at close of business US time.
[4] 3 Month £ LIBOR Interest Rate.
[2] Source: www.msci.com

The table shows the performance of the T Class Accumulation shares which rose by 15.7% in 2015 and compares that with 4.9% for the MSCI World Index in Sterling with dividends reinvested. The Fund therefore outperformed the market in 2015 by 10.8%, its fifth consecutive year of outperformance, which is ironic given that outperforming the market in any given reporting period is not what we are seeking to achieve.

However, we realise that many or indeed most of our investors do not use the MSCI World Index as the natural benchmark for their investments.

Those of you who are based in the UK and look to the FTSE 100 Index as the natural yardstick for measuring your investments and/or who hold funds which are benchmarked to the FTSE 100 Index and often hug it will have had a much worse experience than the performance of the MSCI World Index. The FTSE 100 Index was down -4.9% in 2015 and the total return including dividends reinvested was still negative at -1.0%.

Similarly, for US dollar investors, the S&P 500 finished the year down -0.7% and only delivered a return of +1.4% with dividends reinvested.

2015 was also the fifth anniversary for our Fund and so maybe a good moment to pause and reflect on the longer term performance. As well as outperforming the market with a compound return of +17.6% against +10.1% for the MSCI World Index, our Fund was the third best performing fund out of 203 in the Investment Association's Global Sector. Why only third, you might ask? The two funds which performed better than ours are specialist healthcare funds which have benefited from the extraordinary boom in takeovers within the biotech sector in recent years. That won't last indefinitely, at which point anyone who has benefited from investment in those companies and funds needs to find the next hot sector if that is their investment strategy. This is a game we profess no skill at and therefore will not be playing. This skill also seems to elude most other investors but that does not seem to stop them trying.

2015 was not a particularly bullish year for equity markets which were held back by the slowdown in China, setbacks in other Emerging Markets and the move on from the end of quantitative easing in America to the first rise in interest rates by the Federal Reserve ('the Fed') in nearly ten years. After all that the S&P 500 Index was down by -0.7% for the year.

Trillions of pixels have been expended on the likely impact of this increase in interest rates and I do not intend to add much, if anything, to the debate. However, one aspect may be worth commenting upon. For at least the past three years we have been reading comments which suggested that investors in our Fund faced at least one problem: the shares we own are highly rated and have become more highly rated in recent years. This has often been linked with the observation that these stocks are 'bond proxies' - that the relative certainty of their returns and dividends compared with most equities makes them a substitute for bonds, which many investors now seek to avoid, and so they may fare badly along with bonds as and when interest rates rise.

There are several points to consider in response to this.

One is that during the period that these commentators have been sounding this warning, these stocks and our Fund have continued to outperform the market significantly. So if, like the proverbial stopped clock which is right twice a day, the scenario which they paint eventually comes to pass, it will be worth remembering what you would have missed out on if you had followed their advice when they gave it. They will certainly forget to mention it when they proclaim the brilliance of their foresight and the accuracy of their predictions.

There are also reasons to doubt both their predictions and the efficacy of their proposed solutions.

Firstly, the assumption that all US interest rates are set by the Federal Reserve ('Fed') is too simplistic. The target federal funds rate is a short term rate and was increased from 0-0.25% to 0.25-0.50% on 17th December 2015. Longer term rates are set by the US Treasury bond market and the swap market in which banks, companies, people with mortgages and investors can switch between fixed and floating interest rates. The current 30 year US Treasury bond has a yield just under 3% which does not look quite so low.

It is possible that the main surprise with the Fed's rate rise (I refuse to use the popular term 'hike' as 'to hike an object' is described in the dictionary as a sharp or unexpected increase - a description which clearly does not apply to the Fed's decision) is the limited scope for subsequent increases and the lack of effect on long term rates. In which case worries about the effect on so-called bond proxies may prove to be overdone.

Secondly, what would these commentators have you do about this possible adverse impact on so-called ‘bond proxies’? Presumably they recommend selling them in view of this predicted disaster and investing your money elsewhere. Leaving aside the commentator who suggested that the answer was to invest in a fund which is ‘more immune to future market performance’ (seems like an overly modest target - why not just find one that only ever goes up?), the most common suggestion, it seems, is that you should consider switching into more cyclical stocks because they are more lowly rated and their returns are too volatile to be considered as bond proxies. Switching into cyclical stocks in anticipation of a rise in interest rates, what could possibly go wrong?

As ever, spotting potential problems with our or any other investment strategy is not that difficult. In all my years in business I have never found that identifying a problem is quite as difficult as solving it. Likewise, suggesting what it is you should switch into that is immune from problems which may result from an interest rate rise is a bit more difficult.

However, it seems likely that sooner or later the ‘stopped clock’ commentators will prove to be right and our Fund will experience a period of underperformance. What to do about that? You could try some so-called market timing and redeem your shares in the Fund in advance of this event and maybe re-invest later when you think the time is right for it to begin outperforming again. If you do so I hope you have better luck and/or skill than I have because I know that I can’t accomplish that successfully.

If you intend to remain invested in the Fund, as I do, including through any periods of underperformance, you might also, like me, take comfort in the fact that our investment strategy is based first and foremost on buying shares in good companies. We cannot promise you much about our Fund. But one thing we are clear about is that we seek to own shares in good companies and at least most of the time we succeed in that objective.

Repeating an approach we took last year to demonstrate this, the table below shows what Fundsmith would be like if instead of being a mutual fund it was a company and accounted for the stakes which it owns in the portfolio on a ‘look through’ basis and compares this with the market (in this case the FTSE 100 Index and the S&P 500 Index).

	Fundsmith Equity Fund*	**FTSE 100 Index+**	**S&P 500 Index+**
ROCE	26.0%	14.8%	17.5%
Gross Margin	61.1%	40.2%	43.7%
Operating Profit Margin	25.0%	14.3%	15.3%
Cash Conversion	98.4%	69.8%	70.9%
Leverage	29.3%	38.5%	52.5%
Interest Cover	16.1x	8.2x	8.7x

Note: ROCE, Gross Margin, Operating Margin and Cash Conversion are the weighted average for the Fundsmith Equity Fund and averages for the FTSE 100 Index and S&P 500 Index. The FTSE 100 and S&P 500 numbers exclude financial stocks. The Leverage and Interest Cover numbers are medians.

*Source: Fundsmith LLP +Source: Bloomberg

What does this table demonstrate? In short, that our companies have much better financial performance than the market as a whole and are more conservatively funded.

The companies in our portfolio are certainly not immune to periodic downturns in business and/or management errors, and their share prices are subject to the usual factors which affect the stock market, but we can at least be reasonably sure that they are adding to their intrinsic value over time by continuing to invest at wonderful rates of return.

If I gave you an exhaustive list of all the subjects in investment and the ways in which investors and commentators behave that perplex me then this annual letter would be considerably longer. However, one of these subjects is the obsession with share prices. Ultimately, of course, a focus on share price movements must be correct. It is no use owning shares in good companies if the strength of their business is never reflected in the share price, but a continuous focus on share price movements to the exclusion of the underlying fundamental economics of the companies is neither healthy nor useful. In the long term one will follow the other, and it is not the fundamentals which will follow the share price.

Returning to the subject of valuation, what are the facts as opposed to commentators' views? The weighted average Free Cash Flow ('FCF') yield of the portfolio (the free cash flow generated by the companies divided by their market value) started the year at 4.5%[*] and ended it at 4.3%[*] so the overall portfolio saw little increase in valuation in 2015. Our companies on average grew their free cash flow per share by 9.7%[*] during the year which was a much more significant contribution to performance.

This 4.3% FCF yield compares with a median FCF yield for the non-financial stocks in the S&P 500 Index of 4.4%[+] and a mean of 2.7%[+] or a median for the non-financial stocks in the FTSE 100 Index of 3.8%[+] and a mean of 3.9%[+]. Our stocks do not look bad value in comparison to the market especially when their relatively high quality is taken into account. Although of course, both may be expensive, but then both may continue to be so or even become more expensive.

For the year, the top five contributors to the Fund's performance were:

Dr Pepper Snapple	+1.94%
Imperial Tobacco	+1.79%
Microsoft	+1.69%
Sage	+1.36%
Reckitt Benckiser	+1.05%

The bottom five were:

Procter & Gamble	- 0.22%
PayPal	- 0.15%
3M	- 0.02%
Kone	+0.02%
Colgate Palmolive	+0.05%

Of the bottom five performers, the only one which gives us significant cause for concern is Procter & Gamble which is on its third internally sourced CEO in as many years.

We sold our holding in Domino's Pizza during the year since it had reached a valuation which we felt was only justifiable if the current rapid rate of growth is sustainable, which we would doubt. However, we sold it with some regret and trepidation. Regret since it is undoubtedly a fine business and had been our best performing share since the inception of our Fund. Trepidation since selling shares in good companies is something we are justifiably reluctant to do. Still we believe that you 'make money with old friends' which is to say that we would be keen to own Domino's again if the opportunity arises at a valuation which we regard as at least reasonable.

We also sold our holding in Choice Hotels in 2015 as we did not like the risk/reward potential from the company's investment in developing a third party reservations system called SkyTouch. As we do not do much trading to reallocate the Fund's capital between our holdings we are reliant on the management of our investee companies to make decisions to reinvest part of their companies' cash flows for us. When they do things which are different, exciting and outside their core area of competence we become worried. Hence our sale of Choice Hotels.

We also sold the holding in eBay which we obtained when eBay split the eponymous online marketplace business and PayPal, the online payments processor, which we have retained.

During the year we built a holding in Waters Corporation, a US based manufacturer of mass spectrometry, liquid chromatography and thermal imaging equipment, which makes much of its returns from the sales of consumables, service, spares and software to the operators who have installed its equipment. It should have a clear source of growth from the seemingly inexorable trend for more testing and certification of products.

We also began building a stake in another testing company with a similar source of growth and a new consumer staples company, both of which will be revealed in due course.

Minimising portfolio turnover remains one of our objectives and this was again achieved with a portfolio turnover of 2%* during the period. It is perhaps more helpful to know that we spent a total of £496,507 or just 0.014% (1.4 basis points) of the Fund on voluntary dealing which excludes dealing costs associated with fund subscriptions and redemptions as these are involuntary.

Why is this important? It helps to minimise costs, and minimising the costs of investment is a vital contribution to achieving a satisfactory outcome as an investor. Too often investors, commentators and advisers focus on the Annual Management Charge ('AMC') or the Ongoing Charges Figure ('OCF'), which includes some costs over and above the AMC, which are charged to the Fund. The OCF for 2015 for the T Class Accumulation shares was 1.07%*. The trouble is that the OCF does not include an important element of costs - the costs of dealing. When a fund manager deals by buying or selling investments for a fund, the fund typically incurs the cost of commission paid to a broker, the bid-offer spread on the stocks dealt in and, in some cases, Stamp Duty. This can add significantly to the costs of a fund yet it is not included in the OCF.

We have published our own version of this total cost including dealing costs, which we have termed the Total Cost of Investment ('TCI'). For the T Class Accumulation shares in 2015 this amounted to a TCI of 1.13%*, including all costs of dealing for flows into and out of the Fund, not just our voluntary dealing. We think that figure will prove to be low if or when other funds produce comparable numbers, although we are not holding our breath whilst we await this. However, just as we think an obsession with share prices to the exclusion of companies' fundamental performance is unhealthy, we would caution against becoming obsessed with charges to such an extent that you lose focus on the performance of a fund. It is worth pointing out that the performance of the Fund at the beginning of this letter is after charging all fees, or as someone expressed it more elegantly “You get what you pay for”, or at least you should aim to.

Finally, I wish you a Happy New Year and thank you for your continued support for our Fund. I and my colleagues look forward to seeing many of you at our Annual Shareholders’ Meeting on 1st March and to trying to answer your questions.

Yours sincerely,

Terry Smith

Terry Smith
CEO
Fundsmith LLP

An English language prospectus for the Fundsmith Equity Fund is available on request and via the Fundsmith website and investors should consult this document before purchasing shares in the Fund. Past performance is not necessarily a guide to future performance. The value of investments and the income from them may fall as well as rise and be affected by changes in exchange rates, and you may not get back the amount of your original investment. Fundsmith LLP does not offer investment advice or make any recommendations regarding the suitability of its product. This letter is intended for owners of the Fundsmith Equity Fund only and is communicated by Fundsmith LLP which is authorised and regulated by the Financial Conduct Authority.

[*]Source: Fundsmith LLP [+]Source: Bloomberg

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January 2017

Dear Fellow Investor,

This is the seventh annual letter to owners of the Fundsmith Equity Fund ("Fund").

The table below shows performance figures for the last calendar year and the cumulative and annualised performance since inception on 1st November 2010 compared with various benchmarks.

% Total Return	1st Jan to 31st Dec 2016	Inception to 31st Dec 2016 Cumulative	Annualised
Fundsmith Equity Fund[1]	+28.2	+196.6	+19.3
Equities[2]	+28.2	+110.6	+12.8
UK Bonds[3]	+6.5	+32.4	+4.7
Cash[4]	+0.6	+4.0	+0.6

[1] T Class Acc shares, net of fees, priced at noon UK time.
[2] MSCI World Index, £ net, priced at close of business US time.
[3] Bloomberg/EFFAS Bond Indices UK Govt 5-10 yr.
[4] 3 Month £ LIBOR Interest Rate.
[1,3,4] Source: Bloomberg
[2] Source: www.msci.com

The table shows the performance of the T Class Accumulation shares, the most commonly held Class and one in which I am invested, which rose by +28.2% in 2016 and compares with +28.2% for the MSCI World Index in Sterling with dividends reinvested. The Fund therefore equaled the performance of this benchmark in 2016, and our Fund is still currently the No.1 performer since its inception in the Investment Association Global sector by a cumulative margin of 15% over the second best fund and 127% above the average.

However, we realise that many or indeed most of our investors do not use the MSCI World Index as the natural benchmark for their investments.

Those of you who are based in the UK and look to the FTSE 100 Index as the natural yardstick for measuring your investments and/or who hold funds which are benchmarked to the FTSE 100 Index and often hug it will have had a much worse experience than the performance of the MSCI World Index. The FTSE 100 Index was up +14.4% in 2016 and the total return including dividends reinvested was +19.2%. The Fund outperformed this by +9%.

It is a commentator's cliché that football is a game of two halves, and that was certainly true of our relative performance in 2016. At half time on 30th June our Fund (T Class Accumulation shares) was up +16.4% versus +11.0% for the MSCI World Index, aided by the sharp fall in the Pound after the Brexit result in the referendum of 23rd June as the majority of the shares in our portfolio are listed in the United States. Even though this is not an accurate reflection of the Fund's currency exposure, which really depends upon where the companies generate their revenues and profits, the fact is that the US Dollar is still the largest currency exposure we have.

So what happened in the second half of the year? We experienced what stock market commentators often describe as a sector "rotation" in which the sectors in which we are invested mostly fell out of favour and share prices of those companies underperformed, whilst other sectors which we do not own performed well, and in particular the bank sector.

This "rotation" seems to have occurred as a result of expectations about a pick-up in economic growth which focused attention on a potential recovery in the performance of cyclical stocks. This became more intense after the election (it is common to qualify this with the word "surprise" - "surprising to some" might be a better descriptor as indeed it might for Brexit) of Donald Trump as US President in early November as a result of predictions that his economic policies would stimulate more rapid growth in the US economy.

I have no way of knowing whether this "rotation" will continue but then again neither do any of the analysts or commentators who are involved in opining on the matter.

When judging this situation I think it is worth bearing in mind a number of points:

I can trace back four years of market commentary which warned that shares of the sort we invest in, our strategy and our Fund would underperform. During that time the Fund has risen in value by about 100%. The fact that you would have foregone this gain if you had followed their advice will of course be forgotten by them at the very least.

Much of the commentary is simplistic, for example, concentrating on the Consumer Staples sector as an easily identifiable set of stocks of the sort we invest in, as in a recent note by Deutsche Bank which said "the party's over" in Consumer Staples. Even if this is true, these represent only about a third of our portfolio.

The predictions of underperformance also focus on so-called "bond proxies" - stocks of companies with relatively predictable returns - which investors have supposedly turned to as a substitute for bonds as bond yields have declined to and even below zero. We are told that these bond proxies will do badly when rates rise and that they are starting to do so. As I write the US Federal Reserve has raised the Fed Funds rate by a total of 0.5% from its record low in a whole year (the first 0.25% rise was on 17th December 2015 - how time flies!). As I pointed out last year, this glacial rate of increase does not seem to justify the popular term 'hike' described in the dictionary as a sharp or unexpected increase - a description which clearly does not apply to the Fed's decision. Of course I have no idea when or by how much the Fed or any other central bank will subsequently increase interest rates. Neither I suspect do any of the commentators or analysts judging by their track record thus far, but that will not stop them making predictions and suggesting that you should make investment decisions based upon them.

There is also the question of what we might invest in as an alternative if we chose to sell the Fund's holdings in defensive so-called bond proxy stocks or if you chose to redeem your shares in our Fund. The obvious suggestion, and it is one which would have worked well in the second half of 2016, is that you should switch into cyclical stocks such as banks. Buying cyclical stocks in anticipation of a rise in interest rates does pose a fairly obvious problem - won't they perform worse than defensive stocks if the rise in rates causes an economic slowdown? There is also the fact that these stocks are in companies which over time do not create shareholder value by generating returns on capital above their cost of capital and growing by deploying more capital at such favorable returns, which is what the companies we seek to invest in accomplish. If you choose to invest in such companies then I would suggest it is not because you want to hold their shares indefinitely and allow them to compound in value but because you think you perceive an opportunity for a trade in which you buy them and then sell them for a higher price. If so I hope you have better luck with your timing in this game of Greater Fool Theory (in which you hope to buy from a seller who is less competent than you at spotting this opportunity and when the time comes you need to sell to a buyer who is similarly ill informed) than most people seem to have. As we do not profess to possess this skill, our Fund will not be attempting it.

I remain amazed (I could stop this sentence there) by the number of commentators, analysts, fund managers and investors who seem to be obsessed with trying to predict macro events on which to base their investment decisions. The fact that they are seemingly unable to predict events does not seem to stop them trying. During 2016 we had the spectacle of all the major polling organisations and the mainstream media failing to predict the outcome of the EU referendum in the UK or the US presidential election. Yet many of the same people are now busy telling us what the effect of Mr Trump's economic policies will be and how they will affect our investments.

I spend little time worrying about the macro trends and even less time trying to apply predictions about them in order to manage our portfolios. Here's a short list of possible macro factors which may affect companies and markets in the near future:

- Brexit
- China
- "Demonetisation" in India
- French presidential elections
- German elections
- Interest rates
- Korea
- President Trump
- Quantitative Easing by the European Central Bank
- Syria
- The oil price

Even if you could correctly predict how these matters would develop, and the timing of that, this would not enable you to use this as a basis of investment decisions. Markets are a so-called second-order system - to usefully employ your predictions you would not only have to make mostly correct predictions but you would also need to gauge what the markets expected to occur in order to predict how they would react. Good luck with that.

Rather like the management of some of the companies we most admire, I waste little or no time trying to guess what will happen to factors I cannot control or predict and deploy most of my time and effort on things I can control. Two of those are whether we own good companies and what valuation we pay to own their shares.

As usual, we seek to give some insight into the first of those - whether we own good companies - by giving you the following table which shows what Fundsmith would be like if instead of being a fund it was a company and accounted for the stakes which it owns in the portfolio on a 'look through' basis, and compares this with the market (in this case the FTSE 100 Index and the S&P 500 Index).

As at 31.12.16	Fundsmith Equity Fund*	FTSE 100 Index+	S&P 500 Index+
ROCE	26.7%	13.5%	14.7%
Gross Margin	61.9%	40.0%	43.2%
Operating Profit Margin	25.5%	12.9%	13.9%
Cash Conversion	99.4%	81.4%	83.6%
Leverage	37.7%	48.9%	52.1%
Interest Cover	17.0x	7.9x	7.9x

Note: ROCE, Gross Margin, Operating Margin and Cash Conversion are the weighted average for the Fundsmith Equity Fund and averages for the FTSE 100 Index and S&P 500 Index. The FTSE 100 and S&P 500 numbers exclude financial stocks. The Leverage and Interest Cover numbers are medians. All data as last reported.

*Source: Fundsmith LLP +Source: Bloomberg

The companies in our portfolio have significantly higher returns on capital and better profit margins than the average for the indices. They convert more of their profits into cash and achieve this with a much lower level of borrowing than the average company. Nor is this a one off - they have been achieving these superior results for many years. The average year of foundation of our portfolio companies at the year end was 1912.

Consistently high returns on capital are one sign we look for when seeking companies to invest in. Another is a source of growth - high returns are not much use if the business is not able to grow and deploy more capital at these high rates. So how did our companies fare in that respect in 2016? The weighted average free cash flow (the cash the companies generate after paying for everything except the dividend, and our preferred measure) grew by just over 11%* in 2016. We regard this as a rather good result given the generally lackluster growth which the world is experiencing and which led to earnings falling on the FTSE 100 and S&P 500 companies in the past year.

This leads onto the question of valuation. The Free Cash Flow ("FCF") yield (the free cash flow generated by the companies divided by their market value) on the portfolio at the outset of the year was 4.3%* and ended it at 4.4%* so they did not become any more highly rated. The mean FCF yield on the FTSE 100 is 4.7%+ and the median is 4.6%+. The mean FCF yield on the S&P 500 is 4.3%+ and the median 4.8%+. To try to cut through all these means and medians, our portfolio consists of companies which are fundamentally a lot better than those in the index and are valued a little more highly than the average FTSE 100 company and about the same as the average S&P 500 company, and they grew more rapidly in the past year. I would suggest that is not a bad situation for our portfolio to be in.

For the year, the top five contributors to the Fund's performance were:

IDEXX Laboratories	+3.10%
Stryker	+2.54%
CR Bard	+2.06%
InterContinental Hotels	+1.71%
Johnson & Johnson	+1.68%

The bottom five were:

Estée Lauder	- 0.06%
Procter & Gamble	- 0.02%
Novo Nordisk	+0.07%
Colgate Palmolive	+0.23%
Imperial Brands	+0.37%

The largest contributor, IDEXX, is a company which we began buying in 2015. It is the world's largest maker of veterinary testing equipment. In contrast, we have held stakes in Stryker, InterContinental Hotels and Johnson & Johnson since inception.

Of the bottom five performers we sold our stake in Procter & Gamble in January 2016. You may note that out of the five worst contributors to our performance last year, four were consumer stocks and at least three are regularly cited as "bond proxies". It seems strange to be accused of having benefitted from the popularity of these stocks when in fact they have underperformed.

We only recently began buying stakes in Estée Lauder, the US cosmetics business and even more recently in Novo Nordisk, a Danish company, which is the world's leading supplier of insulins.

Turning to the third leg of our strategy which we succinctly describe as "do nothing", minimising portfolio turnover remains one of our objectives and this was again achieved with a portfolio turnover of -15.6%* during the period. It is perhaps more helpful to know that we have held 14 of our portfolio companies since inception and we spent a total of £181,025 or just 0.003% (0.3 of a single basis point) of the Fund on voluntary dealing which excludes dealing costs associated with fund subscriptions and redemptions as these are involuntary.

Why is this important? It helps to minimise costs, and minimising the costs of investment is a vital contribution to achieving a satisfactory outcome as an investor. Too often investors, commentators and advisers focus on the Annual Management Charge ("AMC") or the Ongoing Charges Figure ("OCF"), which includes some costs over and above the AMC, which are charged to the Fund. The OCF for 2016 for the T Class Accumulation shares was 1.06%*. The trouble is that the OCF does not include an important element of costs - the costs of dealing. When a fund manager deals by buying or selling investments for a fund, the fund typically incurs the cost of commission paid to a broker, the bid-offer spread on the stocks dealt in and, in some cases, Stamp Duty. This can add significantly to the costs of a fund yet it is not included in the OCF.

We provide our own version of this total cost including dealing costs, which we have termed the Total Cost of Investment ("TCI"). For the T Class Accumulation shares in 2016 this amounted to a TCI of 1.11%*, including all costs of dealing for flows into and out of the Fund, not just our voluntary dealing. We think that figure will prove to be low if or when other funds produce comparable numbers. However, we would caution against becoming obsessed with charges to such an extent that you lose focus on the performance of a fund. It is worth pointing out that the performance of the Fund at the beginning of this letter is after charging all fees.

As a cautionary tale about the merits of doing nothing, you may recall that in 2015 we sold our holding in Domino’s Pizza since it had reached a valuation which we felt was only justifiable if its rapid rate of growth was sustainable, which we doubted was likely. In my annual letter last year I said that I “sold it with some regret and trepidation. Regret since it is undoubtedly a fine business and had been our best performing share since the inception of our Fund. Trepidation since selling shares in good companies is something we are justifiably reluctant to do.” Domino’s managed to prove these fears right in the most painful way as the share price rose by +45%[+] in 2016. Apart from demonstrating that I am, could we agree on “fallible” as a descriptor, I hope this illustrates why I am reluctant to agree with the commentators who suggest that you or I should sell our portfolio of great companies and invest in a portfolio of assorted junk in the hope that it will go up, the great companies share prices will go down and we can then profitably reverse the trade.

Finally, I wish you a Happy New Year and thank you for your continued support for our Fund. My colleagues and I look forward to seeing many of you at our Annual Shareholders’ Meeting on 20th March and to trying to answer your questions.

Yours sincerely,

Terry Smith
CEO
Fundsmith LLP

P.S. As part of the Financial Conduct Authority’s (FCA) review of investor communications (Policy Statement 16/23 - Smarter Consumer Communications: Removing ineffective disclosure requirements in our Handbook) they have consulted and concluded that the half-yearly Short Form Report that we send you in March and September, for the periods ending 31st December and 30th June respectively, does not fulfill its purpose. I agree in that the format and complexity of this document was difficult to understand and I welcome the FCA’s decision that we are no longer required to send you one. Not only will this save the fund the costs of physically producing and sending it to you but it will also reduce the already excess amount of paperwork that you are required to receive and that I know many of you find frustrating. For those of you that remain interested in the detail, we will continue to produce the report and post it on our website. I believe that our annual letter to shareholders, our Annual Shareholders’ Meeting, the monthly factsheets on our website and the semi-annual Investment Statements, that coincide with the tax year end, are all more effective in evaluating how your investment has performed and we continually seek to improve the levels of these communications.

Disclaimer: An English language prospectus for the Fundsmith Equity Fund is available on request and via the Fundsmith website and investors should consult this document before purchasing shares in the Fund. Past performance is not necessarily a guide to future performance. The value of investments and the income from them may fall as well as rise and be affected by changes in exchange rates, and you may not get back the amount of your original investment. Fundsmith LLP does not offer investment advice or make any recommendations regarding the suitability of its product. This financial promotion is intended for UK residents only and is communicated by Fundsmith LLP which is authorised and regulated by the Financial Conduct Authority.

*Source: Fundsmith LLP   +Source: Bloomberg

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January 2018

Dear Fellow Investor,

This is the eighth annual letter to owners of the Fundsmith Equity Fund ('Fund').

The table below shows performance figures for the last calendar year and the cumulative and annualised performance since inception on 1st November 2010 compared with various benchmarks.

% Total Return	**1st Jan to 31st Dec 2017**	**Inception to 31st Dec 2017 Cumulative**	**Annualised**
Fundsmith Equity Fund[1]	+22.0	+261.7	+19.7
Equities[2]	+11.8	+135.5	+12.7
UK Bonds[3]	+1.4	+34.2	+4.2
Cash[4]	+0.4	+4.4	+0.6

[1]T Class Acc shares, net of fees, priced at noon UK time.
[3]Bloomberg/Barclays Bond Indices UK Gov. 5–10 yr.
[1,3,4]Source: Bloomberg.
[2]MSCI World Index, £ net, priced at close of business US time.
[4]3 Month £ LIBOR Interest Rate.
[2]Source: www.msci.com.

The table shows the performance of the T Class Accumulation shares, the most commonly held class and one in which I am invested, which rose by +22.0% in 2017 and compares with +11.8% for the MSCI World Index in sterling with dividends reinvested. The Fund therefore beat this benchmark in 2017, and our Fund remains the No.1 performer since its inception in the Investment Association Global sector by a cumulative margin of 40 percentage points over the second best fund and 160 percentage points above the average for the sector which delivered +101.2%.

However, I realise that many or indeed most of our investors do not use the MSCI World Index as the natural benchmark for their investments. Those of you who are based in the UK may look to the FTSE 100 Index ('FTSE' or 'FTSE 100') as the yardstick for measuring your investments and may hold funds which are benchmarked to this index and often hug it. The FTSE delivered a total return of +12.0% in 2017 so our Fund outperformed this by a margin of 10.0%. I will come back to the subject of the FTSE 100 Index later.

Last year in order to describe our Fund's performance for the year I quoted the commentator's cliché that football is a game of two halves, because in 2016 a strong first half performance by our Fund contrasted with a weaker second half of the year. In 2017 we experienced what stock market commentators often describe as a sector 'rotation' in which the sectors in which we are invested mostly fell out of favour and share prices of those companies underperformed, whilst other sectors which we do not own performed well—in particular the bank sector.

This 'rotation' seems to have occurred as a result of expectations about a pick-up in economic growth leading to a potential recovery in the performance of cyclical stocks, especially after the election of Donald Trump as US President in early November with predictions that his economic policies would stimulate more rapid growth in the US economy.

The commentator's quote I wish to use to describe this year's performance is from Yogi Berra, the American baseball player, manager and coach, who had some deceptively simplistic or seemingly illogical aphorisms. One of my favourites is 'You can observe a lot by watching' which I think some people would do well to consider. However, the one which I think expresses the performance of the Fund and market in 2017 is 'It's déjà vu all over again'. What have we experienced in December? A fall in technology sector shares and a rise in bank shares in anticipation of the next rise in interest rates by the Federal Reserve Bank (being a stickler for at least attempting to use language correctly, I refuse to use the popular term 'hike' to describe the Fed's actions as the dictionary definition of this in context is a sharp increase. I am fairly confident that is not what we are getting. My concern about correct usage may not be to everybody's liking but in my view we should use language more carefully than many modern commentators do as it is after all our main means of communication).

When judging these events, the fact that we seem to have seen this movie before might lead us to conclude that we know how it will end.

I can now trace back five years of market commentary that has warned that shares of the sort we invest in, our strategy and our Fund would underperform. During that time the Fund has risen in value by over 175%. The fact that you would have foregone this gain if you had followed their advice will of course be forgotten by them if or when their predictions that our strategy will underperform the 'value' strategy of buying cyclicals, financials and assorted junk pays off for a period.

You or they might well counter by saying that this past outperformance is all very well but it does not help you in making a decision on whether to own our Fund from today, which must surely be determined by its future performance or as the legalese goes 'Past performance is not necessarily a guide to future performance'. I think the key word in that sentence is 'necessarily'.

Let me offer a couple of thoughts on that.

The first problem is of course that the commentators upon whom you might rely may simply be wrong. I have lost track of the number of analysts, commentators and pundits who predicted that:

- The UK would vote for ‘Remain’ in the Brexit referendum

- The UK would enter a recession immediately if it voted to ‘Leave’ the EU

- Donald Trump would not become President

- Narendra Modi would not become Prime Minister of India

- Narendra Modi’s economic reforms would fail

- Theresa May would have such a resounding victory in the 2017 election that Labour would disintegrate

- Angela Merkel would sweep to victory in the German elections

- President Trump’s tax reform bill would not be passed by the US legislature

In some cases, they have a ‘Full House’ having made all these predictions. The fact that they have been shown to be comprehensively wrong does not seem to stop them from giving us the dubious benefit of further predictions. In this regard they remind me of the broker who was always wrong and who is mentioned in the book ‘Hedgehogging’ by Barton Biggs, the strategist and hedge fund manager. Biggs found him useful to talk to because once the broker had given his views on what would happen or what to do, Biggs knew that the opposite was bound to be correct. For what it’s worth, my diagnosis of the problem for these commentators who seem to emulate this broker is that they are experiencing role confusion. They seem to have forgotten that their role is to report events accurately and have decided that instead they need to influence the outcome to one they desire. They also seem to have missed the point that voicing your views in an echo chamber is not likely to lead to a challenging debate in which to test your opinions.

Thankfully, I spend little or no time trying to apply predictions about macro events in order to manage our portfolio. However, that does not mean that I do not think about them. As I have maintained for most of the decade since the Financial Crisis, looking back to the Great Depression for an analogy that would enable us to understand these events and form a view of how they may unfold is probably a mistake.

A better analogy may be the Long Depression of 1873–96 when a new industrial power came on stream and caused a wave of deflation as it could manufacture goods cheaper than in the Old World. That industrial power was America after the Civil War. The Long Depression was also preceded by a collapse of part of the banking system. Sound familiar?

The wave of deflation we have been experiencing has been caused by a number of factors. These include the rise of China as the world’s greatest industrial power, other cheap manufacturers (South Korea, Thailand, Vietnam, India and Malaysia for example) and the offshoring of manufacturing to cheap manufacturers under free trade agreements, such as Mexico under NAFTA, which so exorcises President Trump. The situation now is probably worse than it was during the Long Depression insofar as then there was virtually no international competition in services whereas now in our connected world there is in software (India) and call centres (the Philippines), for example. Plus there is the rise of the so-called gig economy in which the internet, casual employment and the sharing of assets have made price comparisons easier, and have driven down prices and returns in retail (Amazon), transport (Uber) and lodging (Airbnb), for example.

If the closest analogy for the events which we have experienced since the Financial Crisis is the Long Depression, we may be barely half way through it simply on the basis of elapsed time. In which case, the period of sluggish economic growth and low interest rates which we have experienced over the past decade may persist for some considerable time. I think this is likely for the simplest of reasons: little or nothing has been done to correct the problems which led to the Financial Crisis. The unsupportable expansion of credit that sparked the crisis has not been resolved. There is in fact more debt in existence now than there was in 2007. Admittedly, some of it is in different hands—China has more debt now and much of the debt in the developed world has been 'socialised' and assumed by governments. However, governments are just us collectively, contrary to the fevered imaginings of the 'magic money tree' devotees. What seems to have happened over the past decade is a prolonged experiment in borrowing your way out of a debt problem. Maybe it will work, although I am amongst those who would bet against it, but it certainly is not the sort of circumstance which would suggest that a 'normal' economic recovery or a rapid rise or 'hike' in interest rates is likely.

As an aside, I would suggest that the headlong expansion of credit in much of the western world which preceded the Financial Crisis was an attempt to compensate for the effects of deflation. Instead of accepting that the loss of manufacturing and service jobs to the developing world meant we had to accept lower pay and lower standards of living to compete we opted for an expansion of the state, the mushrooming of non-productive jobs and borrowing to maintain our spending patterns.

Secondly, if you nonetheless take the view that our Fund's strategy has indeed delivered a good performance but that valuations (which I will come to later) for stocks of the sort it owns are high and that this will limit their share price performance at least in the near term, the obvious problem this poses is what you or we might invest in as an alternative.

This presents several problems. One is that the valuation of the Fund's stocks are not all that much higher than the market, especially when their relative quality is taken into account. Of course, all this may prove is that everything is expensive or at least highly rated, and there are plenty of pundits and fund managers who have indeed suggested that we are in a so-called 'bubble' which will end badly with everything falling a long way. So far, they have only managed to demonstrate the difficulty in making predictions and implementing actions based upon them. Even if they are eventually proven right, why will a basket of cyclical stocks and financials prove to perform better in these circumstances than a group of companies which are high quality and defensive in terms of supplying everyday consumables and necessities? The events of 2007–09 suggest that the opposite is true.

There is also the fact that the alternative of investing in cyclicals, financials and so-called 'value' stocks involves investing in companies, which over time do not create shareholder value by generating returns on capital above their cost of capital and growing by deploying more capital at such favourable returns. We seek to invest in companies which accomplish this.

Quoting Warren Buffett, the 'Sage of Omaha' and arguably the best investor over the past fifty or so years has in my view become somewhat passé. It is frequently done by acolytes or imitators many of whom seem to have done only the most cursory study of what he actually does, if anything at all. So instead I am going to quote his business partner and Berkshire Hathaway's Vice Chairman, Charlie Munger:

'Over the long term, it's hard for a stock to earn a much better return than the business which underlies it earns. If the business earns 6% on capital over 40 years and you hold it for that 40 years, you're not going to make much different than a 6% return—*even if you originally buy it at a huge discount.* Conversely, if a business earns 18% on capital over 20 or 30 years, *even if you pay an expensive looking price, you'll end up with a fine result'* (emphasis added).

I have no idea why Mr. Munger chose those particular rates of return but what I do know is that he is not voicing an opinion. What he is describing is a mathematical certainty. If you invest for the long term in companies which can deliver high returns on capital, and which invest at least a significant portion of the cash flows they generate to earn similarly high returns, over time that has far more impact on the performance of the shares than the price you pay for them. Yet I have been asked far more frequently whether a share, a strategy or a fund is cheap or expensive than I am asked about what returns the companies involved deliver and whether they are good companies which create value or not.

Even though Mr. Munger is right it requires a long-term investment perspective to capture that compounding by high return companies, and finding those companies is not easy especially as you need to assess their ability to grow and ward off competition. But the most difficult part of applying the investment strategy suggested by Mr. Munger's quote, and which we seek to apply, is us. Our inability to take a really long-term view, particularly through the periods when our chosen strategy and companies are not performing as well as less good companies, which are enjoying their period in the sun, is our greatest enemy.

I will leave this subject with a sporting analogy. We are often told that life is a marathon not a sprint. So is investing. Most of us will be investors for the majority of our lives. If we start investing in our 30's with current average life expectancy most of us will be investing for over half a century. It makes Mr. Munger's 40 year example seem a bit short. So why we should think about what happens over shorter time periods, like quarters or even years is a bit of a puzzle.

However, some people behave as though the best way to win this marathon is to engage the services of one hundred and five 400-metre runners (26 miles 385 yards or 42.195 kilometres divided by 0.4=105.5) who could surely run the distance faster than a single marathon runner. The analogy in investment is a strategy in which every so often you change the fund manager or stocks in your portfolio to suit whatever change you expect in market conditions. The problem is this; if you choose the one hundred and five 400-metre runner route I presume that to make the contest against the marathon runner realistic you have to carry a baton that you hand over to the next runner. This is the equivalent of you making the decision to sell all your high quality stocks and switch into somewhat cheaper (although maybe not cheap) cyclicals and value stocks. However, I seem to recall that very often that baton gets dropped, or the changeover is not made within the allowed zone and the team is disqualified. I suppose the investment version of this is that you get the timing of your switch wrong or you sell one strategy but remain in cash.

The problem in trying to apply this sprint strategy in the real world of investment is even worse. In a relay race the runners for each stage are selected in advance. Whereas in an attempt to apply this technique in investment you would need to select whom you wish to receive the baton as you enter the changeover area each time. After all do you know in advance whether you want to go from high quality consumer staples to financials, commodity stocks or industrials, emerging markets, bonds or some combination of these? The scope for fumbled handovers is endless. And you have to do it many times to succeed with this approach.

Moving on to review the outcome for 2017 in terms of our Fund's strategy. As you hopefully know by now, we have a simple three step investment strategy:

- Buy good companies
- Don't overpay
- Do nothing

I intend to review how we are doing against each of these in turn.

As usual, we seek to give some insight into the first of those—whether we own good companies—by giving you the following table which shows what Fundsmith would be like if instead of being a fund it was a company and accounted for the stakes which it owns in the portfolio on a 'look through' basis, and compares this with the market, in this case the FTSE 100 Index and the S&P 500 Index ('S&P 500').

This year we not only show you how the portfolio compares with the major indices but also how it has evolved over time.

	Fundsmith Equity Fund Portfolio								**S&P 500**	**FTSE 100**
Year ended	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2017**	**2017**
ROCE	29%	28%	29%	31%	29%	26%	27%	28%	15%	14%
Gross margin	54%	58%	58%	63%	60%	61%	62%	63%	44%	41%
Operating margin	20%	22%	23%	24%	25%	25%	26%	26%	13%	13%
Cash conversion	117%	103%	101%	108%	102%	98%	99%	102%	97%	96%
Leverage	63%	15%	44%	40%	28%	29%	38%	37%	52%	46%
Interest cover	15x	27x	18x	16x	15x	16x	17x	17x	7x	8x

Source: Fundsmith LLP/Bloomberg.
ROCE, Gross Margin, Operating Profit Margin and Cash Conversion are the weighted mean of the underlying companies invested in by the Fundsmith Equity Fund and the mean for the FTSE 100 and S&P 500 Indices. The FTSE 100 and S&P 500 numbers exclude financial stocks. The Leverage and Interest Cover numbers are both median. All ratios are based on last reported fiscal year accounts as at 31st December and as defined by Bloomberg. Cash Conversion compares Free Cash Flow per Share with Net Income per Share.

The companies in our portfolio have consistently had significantly higher returns on capital and better profit margins than the average for the indices. They convert more of their profits into cash and achieve this with a much lower level of borrowing than the average company. Moreover, their average level of borrowing is significantly lower than it was when we started the Fund. The world at large may not have de-geared much but the companies in our portfolio have. Nor is this a one off—they have been achieving these superior results for many years. The average year of foundation of our portfolio companies at the year end was 1916.

Consistently high returns on capital are one sign we look for when seeking companies to invest in. Another is a source of growth—high returns are not much use if the business is not able to grow and deploy more capital at these high rates. So how did our companies fare in that respect in 2017? The weighted average free cash flow (the cash the companies generate after paying for everything except the dividend, and our preferred measure) grew by 13% in 2017. We regard this as a very good result given the generally lackluster growth which the world continues to experience.

This leads onto the question of valuation. The weighted average free cash flow ('FCF') yield (the free cash flow generated by the companies divided by their market value) on the portfolio at the outset of the year was 4.4% and ended it at 3.7% so they did become more highly rated. However, it is important to bear in mind that this is not a like-for-like comparison as our portfolio did not remain static over the year. In fact the two shares we sold—Imperial Brands and J M Smucker—had by far the highest FCF yields in the portfolio and much higher than the FCF yields of the one we purchased—Intuit. If we had not made these changes the portfolio FCF yield would have remained at 4.0% (although it is worth noting that the growth rate would have been significantly lower—the FCF of both companies fell in 2017) so some of the fall in yield was a result of our action rather than any rise in market valuations.

The year end mean FCF yield on the S&P 500 was 3.9% and the median 4.1%. The year end mean FCF yield on the FTSE 100 was 5.6% and the median 4.9%. More of our stocks are in the former index than the latter. To try to cut through all these means and medians, our portfolio consists of companies that are fundamentally a lot better than those in the index and are valued more highly than the average FTSE 100 company and slightly higher than the average S&P 500 company.

In the case of the FTSE 100 Index this is because the valuation of the index is dominated by what I would regard as uninvestable companies like Anglo American and Centrica which traded on FCF yields of around 15% as at 31st December 2017. They may be lowly rated but that does not mean that they are necessarily cheap given their poor quality. The past may not be a perfect guide but their return on capital has averaged 3% and 6% respectively since 2011 and they have achieved a total shareholder return of -35.3% and -40.7% respectively from 1st November 2010 to 31st December 2017, when our Fund (T Class Accumulation shares) has returned 261.7%. Maybe all this is about to change. It had better if you are thinking of owning them or the FTSE 100 Index.

The characteristics of the FTSE 100 Index make me marvel (as is often the case, I could stop the sentence there) at people who use the index as a product or guide to enable them to ‘invest in the UK’. Firstly, I have to question why you would want to restrict your investments to the UK. You may live in the UK as most of our investors do, but to quote Arthur Daley ‘The world’s your lobster’. You can invest outside it and it is unlikely that all or even many of the good companies in the world that you might benefit by investing in are headquartered or listed in a country which constitutes about 3% of world GDP.

There is also the question of how representative the FTSE 100 Index is of the UK economy. As at 31st December 2017, of the 10 largest market cap (non-financial) companies in the FTSE 100, only three report in sterling. Only numbers 6, 8, 9 and 10 gave any UK numbers in their last reported accounts:

- For No. 6, Rio Tinto, the UK is 1% of sales. Australia is bigger.
- For No. 8, GSK, the UK is 3.8% of sales. The US is bigger.
- For No. 9, AstraZeneca, the UK is 8% of sales. Japan is bigger.
- For No. 10, Vodafone, the UK is 14.5% of sales. Germany is bigger.

Which is all a clue that investing in the FTSE 100 Index is not investing in the UK. So if you are doing so you have already, perhaps inadvertently, made the decision to invest internationally. If so, you may as well do it properly and look at companies listed abroad.

Finally, what sort of companies are in the FTSE 100? An insight into this is provided by the fact that as at 31st December 2017 just 1.8% of the FTSE is in Information Technology. This compares with 23.9% in the S&P 500 Index, not the technology centric Nasdaq Composite Index. I am not suggesting that Information Technology is the only sector to invest in to capture future growth nor is it immune from becoming over-valued and delivering poor returns to investors from time to time. But if you were to ask which two sets of stocks were more likely to capture the benefit of future growth, one with 1.8% in Information Technology or one with 23.9%, I think the answer would be pretty obvious.

So for all those reasons I do not really regard the FTSE 100 as a genuine benchmark for our Fund and neither am I at all concerned about the Fund’s valuation relative to it.

However, that should not be taken to mean that we are entirely comfortable with the seemingly ever higher rating which the shares in our portfolio are achieving. It is clearly a finite and reversible source of performance. However, the growth in the free cash flows of the portfolio are providing a greater portion of the performance which is how we would prefer it and what Mr. Munger might have predicted.

One aspect of our performance which we have often been asked about in the past is the degree to which it has benefited from the strength of the US dollar as the majority of the stocks we own are listed in the United States. This is a complex subject as currency exposure is driven by where a company derives its revenues rather than where it is headquartered or listed. However, this year there has been a noticeable absence of such questions. Could this perhaps be because in 2017 the best estimate we have is that the weakness of the US dollar cost our Fund some -5.9%. The performance in 2017 was attained despite this headwind.

For the year the top five contributors to the Fund's performance were:

Paypal	+2.9%
Amadeus	+2.3%
CR Bard	+1.8%
Novo Nordisk	+1.5%
Waters Corp	+1.4%

CR Bard is making an appearance for the second year running, at least partly because it was bid for by Becton Dickinson, another of our portfolio companies.

The bottom five were:

JM Smucker	- 0.3%
Imperial Brands	- 0.2%
Dr Pepper Snapple	0.0%
Colgate Palmolive	+0.1%
Reckitt Benckiser	+0.1%

We sold our holdings in JM Smucker and Imperial Brands during the year.

JM Smucker was a disappointment. One half of the business is in ambient packaged food in which it is a struggle to generate growth—Folgers coffee, Jif peanut butter and Smucker's jams (jellies if you are American). However, what attracted our interest was when JM Smucker acquired the Big Heart Pet Brands pet food business from private equity. We are keen on businesses which sell to pet owners, such as IDEXX, albeit indirectly, and we had made a very good return on the Big Heart business when it was owned by Del Monte before it was acquired by private equity. However, the outcome in terms of the margins and returns achieved on the business by JM Smucker proved to be disappointing and we were concerned by the management's reaction to this especially as JM Smucker is a family controlled company.

Imperial Brands is the former Imperial Tobacco that we had held since the inception of the Fund. We had become increasingly concerned about the company's positioning in terms of its lack of exposure to the developing world and to the next generation reduced risk products such as heat not burn devices, all of which has led to volumes falling at a rate that it is difficult to cope with. We were even more concerned by the management reaction which we literally could not understand.

Colgate makes the table of our five worst performers for the second year running even though it is our smallest position. It has been facing a tough time with its largest market being Brazil.

Turning to the third leg of our strategy which we succinctly describe as 'do nothing', minimising portfolio turnover remains one of our objectives and this was again achieved with a portfolio turnover of 5.4%^ during the period. It is perhaps more helpful to know that we have held 13 of our portfolio companies since inception and we spent a total of £1.3m or just 0.011% (1.1 basis points) of the Fund's average value over the year on voluntary dealing (which excludes dealing costs associated with fund subscriptions and redemptions as these are involuntary).

Why is this important? It helps to minimise costs, and minimising the costs of investment is a vital contribution to achieving a satisfactory outcome as an investor. Too often investors, commentators and advisers focus on or in some cases obsess about the Annual Management Charge ('AMC') or the Ongoing Charges Figure ('OCF'), which includes some costs over and above the AMC, which are charged to the Fund. The OCF for 2017 for the T Class Accumulation shares was 1.05%. The trouble is that the OCF does not include an important element of costs—the costs of dealing. When a fund manager deals by buying or selling investments for a fund, the fund typically incurs the cost of commission paid to a broker, the bid-offer spread on the stocks dealt in and, in some cases, transaction taxes such as stamp duty in the UK. This can add significantly to the costs of a fund yet it is not included in the OCF.

We provide our own version of this total cost including dealing costs, which we have termed the Total Cost of Investment ('TCI'). For the T Class Accumulation shares in 2017 this amounted to a TCI of 1.08%, including all costs of dealing for flows into and out of the Fund, not just our voluntary dealing. We think that figure will prove to be low if or when other funds produce comparable numbers. However, we would caution against becoming obsessed with charges to such an extent that you lose focus on the performance of a fund. It is worth pointing out that the performance of the Fund tabled at the beginning of this letter is after charging all fees which should surely be the main focus.

This year I thought I would use the opportunity afforded by this letter to talk about so-called activism and takeovers since we have seen a lot of events in these areas in the past year which have affected the companies we own and follow.

Investment is a world in which words get used in confusing ways. Take the words active and activism. Active investors are the opposite of passive investors who simply seek to replicate the performance of an index. At Fundsmith we are active investors—our Fund will only own a maximum of 30 shares (it owned 27 as at 31st December 2017) and we limit it to a few sectors which have the characteristics we seek: consumer staples, some consumer discretionary products, healthcare and technology being the main sectors. So we are far removed from a passive investor. However, we change our portfolio positions very infrequently which I suppose makes us an inactive active investor. You can see why people are often confused.

Activists are a different animal. They seek to benefit by causing change in corporations they invest in. Activists are usually active managers but some of them are passive (I'm not making this up) as they seek to improve the returns on their index fund by agitating for change where they feel it is necessary. So I suppose they could be described as passive activists. Still with me?

On the whole we are not fans of activism. Too often it seems to follow a playbook that has the following steps:

1. The activist 'buys' a stake in a company. I have put 'buys' in inverted commas because often much or all of the stake is held through derivative products which means that the activist can announce a seemingly large position in the company's stock whilst risking and committing relatively little actual cash. This

methodology also gives some clue as to the activist's time horizon which may not coincide with ours, as derivatives have an expiry date whereas stocks don't.

2. Engage in a public row with the target company and seek board representation, a spin-off of part of the business, a merger with or sale to a competitor, raise debt to execute a share buyback (the activist can helpfully tender stock to assist with this) etc.

3. If the company responds by following the activist's demands they then sell their stake.

4. We and other long term shareholders are left with a company that has incurred fees and diverted time from running the business to respond to the activist and execute the changes, which is now potentially more fragmented, more highly leveraged and has had to install new management.

5. Rinse and repeat with another ~~victim~~ investment.

We have many possible objections to this process. In our experience a dialogue in which you seek to change someone's behavior is best at least started in private. Seeking a public spat at the outset seems to us to be more closely aligned with a desire to seek a certain public profile rather than to effect corporate change. Often the proposals hinge on a misconception or two. We have often been told that if a company has two divisions and one is in a slow growing segment and one is faster growing (like PepsiCo with soft drinks and snacks) then if the two are separated (as Nelson Peltz suggested to PepsiCo) the faster growing one will attain a higher stock market rating once on its own. This is probably true, but won't that be compensated by a lower rating on the slower growth division? Of course not for the activist who intends to sell out as soon as possible. Thankfully in our view, on this occasion Mr. Peltz was unsuccessful and PepsiCo remains a drinks and snack business, which is not to say that we think everything is fine with PepsiCo's management or that Mr. Peltz is always wrong, of which more later.

Leveraging up the balance sheet to buy back stock is a frequent demand of activists and is invariably described as 'returning cash to shareholders' and not only when it is suggested by activists. The correct description for this action should be 'returning cash to exiting shareholders' as we remaining shareholders don't receive any of it and this perhaps best encapsulates the problem we identify with this practice. Those of us who actually seek to own the company and remain shareholders see debt raised to take out shareholders who wish to exit. It is beyond us why we would want that to happen unless the shares purchased are demonstrably cheap.

However, whilst we question the motivation and methods of activists, and how companies respond to them, we do not always disagree with them. For example, we agreed with Carl Icahn's view that separation of the two businesses which were part of eBay (the eBay marketplaces business and PayPal the payment service provider) would set PayPal free to grow more rapidly, and as you can see PayPal is the largest contributor to our Fund's performance over the past year.

Quite a lot happened to affect our portfolio companies and we have seen some takeover activity in the past year. In addition to the bid for CR Bard and the bid approach from Kraft Heinz for Unilever, activists became involved in ADP and Nestlé, which we own, and P&G, which we had already sold, but which remains in our Investable Universe of stocks we would own given certain conditions. I thought it might therefore be helpful to investors if I described our reaction to each of these in turn, since we may not be very active in the sense of changing portfolio positions but we are often engaged in thinking about situations such as these.

Automatic Data Processing (‘ADP’) / Pershing Square

Payroll and HR services company ADP was approached by activist fund Pershing Square, led by Bill Ackman, who had ‘bought’ an 8.3% stake. The inverted commas are because this stake involved 36.8m shares, 28.0m of which were in fact call options and not actual shares. This did not amount to true ownership in our view since Pershing Square had no right to vote the shares covered by those call options and neither had they expended the cash to purchase the shares.

Pershing Square’s approach to ADP became a public row and proxy contest with Pershing Square delivering a 168 page presentation, several letters suggesting ways to improve operating efficiency, which might be summarized as ‘cut costs quickly’, and demanding three board seats.

The reaction of the ADP management was interesting. They did not do what so many managements do when faced with an activist by issuing new guidance showing an increase in forecast profits or margins, increasing the dividend and/or share buybacks. Instead they challenged the analysis and assumptions underlying the Pershing Square proposals. We found this direct and refreshingly honest.

The stock had significantly outperformed the S&P 500 Index over the past five years even before Pershing Square became involved. Maybe it could have done even better if Mr. Ackman is right, but during this period the management has also had to oversee a transition of the business from one which was mainly paper based to one where its products are delivered by a variety of electronic means, and it is not as though Pershing Square’s suggestions were without risk. We therefore decided to give the ADP management something rather old-fashioned, called the benefit of the doubt, and so voted with them and against Pershing Square’s proposals. We suspect there are far worthier targets for Mr. Ackman to attack even within our portfolio.

Nestlé / Third Point

Hedge fund Third Point, run by Dan Loeb, purchased a $3.5bn stake in Nestlé and in his June letter to investors Mr. Loeb talked of Nestlé’s ‘unrealized potential for margin improvement and innovation in its core businesses, an un-optimized balance sheet, a number of non-core assets’.

Third Point’s approach to Nestlé strikes us as close to the activist playbook which I described earlier in that it calls for ‘improving productivity’; ‘returning capital to shareholders’; ‘re-shaping the portfolio’; and ‘monetizing its L’Oréal stake’.

In respect of productivity, Mr. Loeb said Nestlé should 'adopt a formal margin target'. He went on to specify the margin level he believes Nestlé should formally target as '18–20%' by 2020. There is more to attaining an improvement in profitability than committing to a target. The approach reminds me of the G20 meeting in 2014 at which the countries committed to attaining GDP growth of more than 2%. If it's that simple, why not commit 3% or even 4%? Some people seem to believe that GDP growth or profit margins can be conjured up by a commitment. Sadly it may take rather more than that.

In respect of returning capital, Mr. Loeb says that 'capital return in conjunction with a formal leverage target makes sense as well'. He goes on to say that raised leverage would provide share buyback capacity, which would probably be a better use of cash than acquisitions given high valuations (remember that bit please).

Mr. Loeb mentions 'Re-shaping the portfolio' and invokes the fact that the company has over 2,000 brands, some of which he believes could fetch 'above-market multiples' given 'large synergies to potential acquirers'. He also thinks Nestlé should consider 'accretive, bolt-on acquisitions in high growth and advantaged categories' (presumably despite the 'high multiples in Nestlé's sector' he already mentioned).

His proposal for 'Monetizing the L'Oréal stake' is based on his belief that the stake is 'not strategic and shareholders should be free to choose whether they want to invest in Nestlé or some combination of Nestlé and L'Oréal'. He ended by saying that divestiture 'via an exchange offer for Nestlé shares…would accelerate efforts to optimize its capital return policies, immediately enhance the company's return on equity ('ROE') and meaningfully increase its share value in the long run as earnings improve over a reduced share count'. Fairly obviously the enhancement of ROE from disposal of a stake which is equity accounted is purely cosmetic but then again some people are impressed by cosmetic changes. We are not amongst them and if I had managed to acquire a 23% stake in the world's leading cosmetic company, as Nestlé has, I would need some more compelling arguments to persuade me to dispose of it.

Nestlé's first response to Third Point came only two days after Mr. Loeb's letter. This talked about 'value creation'. However it did include one specific, namely the announcement of a CHF 20bn share buyback program.

A more detailed response came when Nestlé CEO Mark Schneider and other executives presented at the Nestlé investor day on 26th September. The company set a new formal margin target—up 150–250bps from the underlying 16% in 2016 to 17.5–18.5% by 2020; and said that it would accelerate share buyback activity. It also said that as well as the already announced decision to 'explore strategic options' for the US confectionery business, it was 'actively adjusting its product portfolio...as shown by the recent investments in Blue Bottle Coffee, Sweet Earth and Freshly'. However the company defended the L'Oréal stake.

On the whole we are not impressed when a company announces new margin targets, share buybacks and acquisitions and/or disposals in response to activists or takeover approaches. The question which always springs to our mind is 'If these things are possible and desirable, why weren't you already doing them?' In the case of Nestlé, however, the CEO Mark Schneider should probably not be criticised for this as he is new in the role so he can't be blamed for any past dilatoriness.

To date Third Point's approach to Nestlé has not lead to anything we are required to vote on which may be just as well.

Procter & Gamble ('P&G') / Trian

Trian is a fund run by Nelson Peltz whom I have already mentioned in the context of PepsiCo. Although we don't directly have a dog in this particular fight, as we do not have any P&G in our portfolio, it still resides in our Investable Universe and so an investment is still regularly considered by us, and as we sold our stake because of concerns about P&G's strategy we are interested in what Mr. Peltz had to say.

Trian's plan for P&G was detailed on 6th September. It called for 'organizing P&G in a way that promotes accountability, faster decisions and responsiveness to local preferences'; 'ensuring management's $12–13bn productivity plan actually delivers'; 'fixing the innovation machine'; 'improving development of small, mid-size and local brands, both organically and through M&A'; 'winning in digital'; 'addressing P&G's insular culture'; 'improving corporate governance, including aligning management compensation with market share gains'.

The page after these proposals—i.e. very much to the fore of the piece—details what Trian is 'NOT' (they wrote the word in capital letters) recommending. Among the things which they are not recommending—a break-up of the company, a new CEO, replacement of any directors, taking on excessive leverage, pension benefits cuts, slashing of R&D, marketing or capital expenditure budgets, cost cuts which might impact product quality, moving out of Cincinnati. We like this approach. The next page reminded us that all Trian was seeking was that 'Nelson become 1 of 11 (or 12)' directors of P&G and that it is ridiculous to suggest that as one person out of 11 or 12, he would 'derail' P&G.

The Trian presentation is 93 pages long and is all centred around P&G having a poor organizational structure—'suffocating bureaucracy and complexity'—which means that no one is accountable, decisions take forever and so forth. When we sold our P&G stake the fact that the company is the overwhelming market leader with Gillette but was ranked no. 50 in online shave clubs struck as illustrating the sort of point Mr. Peltz was making.

David Taylor, P&G CEO, went on Jim Cramer's CNBC programme at one point calling some of Peltz's proposals 'very dangerous'. They strike me as more dangerous to Mr. Taylor than to P&G's shareholders.

Mr. Peltz succeeded in his bid to win a board seat even though P&G is said to have spent more than $100m of shareholders' money to prevent it. We wish him well with his endeavours. His presence makes P&G more interesting to us.

Unilever / Kraft Heinz

On 17th February, the story broke that Unilever had received a bid approach from Kraft Heinz, the listed food products company controlled by 3G, the Brazilian entrepreneurs who also control AB InBev, the world's largest brewer, and Burger King, together with Warren Buffett's Berkshire Hathaway.

On 22nd February, Unilever put out two releases by way of immediate response. The first was entitled, 'Unilever guidance update' which said that Unilever 'now expects core operating margin improvement for 2017 to be at the upper end of its 40–80bps guidance'. The second release said, 'Unilever is conducting a comprehensive review of options available to accelerate delivery of value for the benefit of our shareholders. The events of the last week have highlighted the need to capture more quickly the value we see in Unilever. We expect the review to be completed by early April, after which we will communicate further.'

On 6th April, Unilever announced the results of this review. The company said it was:

- 'Accelerating its 'Connected 4 Growth' programme and targeting a 20% underlying operating margin, before restructuring, by 2020'
- Combining the foods and refreshment units into one unit, 'unlocking future growth and faster margin progression'
- Establishing a net debt/EBITDA target of 2x
- Launching a €5bn share buyback program
- Raising the dividend by 12%—about double the recent rate of increase

This approach clearly falls foul of our scepticism when management produces rabbits from a hat when an activist or takeover comes into view. We think we should already have seen the rabbits or at least been told about their existence.

To hopefully be clear, we are not fans of Kraft Heinz. We have never owned any shares in Kraft Heinz or its constituent parts. Although 3G has managed to operate the business with efficiency as they have AB InBev, to produce great cost savings leading to operating profit margins of 23% in 2016 and strong gains for owners, well certainly for 3G and Berkshire Hathaway, we have never found a business which can cut its way to growth. Although the Kraft Heinz management are certainly handicapped in this regard by the nature of the company's brands, which are mostly not in growing areas of the market, the sort of people and approaches you need to grow businesses tend not to flourish in cultures in which the emphasis is on cost cutting.

However, the contrast between their approach and that of Unilever does raise some questions for Unilever's management which remain unanswered. To give you a simple illustration of this, in 2016 Unilever had €52.7bn of revenues and an average of 169,000 employees, thus revenue per employee of about €312,000. Kraft Heinz had €23.8bn of sales and an average of 41,500 employees, and so revenue per employee of about €574,000. Kraft Heinz has slightly less than half the sales of Unilever but manages to achieve this with less than a quarter of the number of the employees. You don't have to be a fan of brutal cost cutting to see that Unilever has a case to answer here.

Unfortunately we never got to hear Unilever justify its rather interesting sales/employee ratios because Kraft Heinz withdrew as soon as it became evident that Unilever was hostile to the approach. Warren Buffett is notoriously opposed to hostile takeovers.

I hope that has given you all some insight into how we think about and interact with the companies in our portfolio and those we are interested in, and other shareholders, activists and bidders.

Finally, I wish you a happy New Year and thank you for your continued support for our Fund. My colleagues and I look forward to seeing many of you at our Annual Shareholders' Meeting on 27th February 2018 and to trying to answer any questions you may have. Please see the enclosed invitation for details.

Yours sincerely,

Terry Smith

Terry Smith
CEO
Fundsmith LLP

Disclaimer: An English language prospectus for the Fundsmith Equity Fund is available on request and via the Fundsmith website and investors should consult this document before purchasing shares in the Fund. Past performance is not necessarily a guide to future performance. The value of investments and the income from them may fall as well as rise and be affected by changes in exchange rates, and you may not get back the amount of your original investment. Fundsmith LLP does not offer investment advice or make any recommendations regarding the suitability of its product. This financial promotion is intended for UK residents only and is communicated by Fundsmith LLP which is authorised and regulated by the Financial Conduct Authority.

Sources: All data sourced from Fundsmith research and where appropriate using Bloomberg.

^The PTR (Portfolio Turnover Ratio) has been calculated in accordance with the methodology laid down by the FCA. This compares the total share purchases and sales less total creations and liquidations with the average net asset value of the fund.

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January 2019

Dear Fellow Investor,

This is the ninth annual letter to owners of the Fundsmith Equity Fund ('Fund').

The table below shows performance figures for the last calendar year and the cumulative and annualised performance since inception on 1st November 2010 compared with various benchmarks.

% Total Return	1st Jan to 31st Dec 2018	Inception to 31st Dec 2018 Cumulative	Inception to 31st Dec 2018 Annualised
Fundsmith Equity Fund[1]	+2.2	+269.6	+17.4
Equities[2]	-3.0	+128.4	+10.6
UK Bonds[3]	+1.2	+35.7	+3.8
Cash[4]	+0.7	+5.1	+0.6

[1] T Class Acc shares, net of fees, priced at noon UK time.
[2] MSCI World Index, £ net, priced at US market close.
[3] Bloomberg/Barclays Bond Indices UK Gov. 5–10 yr.
[4] 3 Month £ LIBOR Interest Rate.
Source: Bloomberg.

The table shows the performance of the T Class Accumulation shares, the most commonly held Class and one in which I am invested, which rose by +2.2% in 2018 and compares with a fall of -3.0% for the MSCI World Index in sterling with dividends reinvested. The Fund therefore beat this benchmark in 2018, and our Fund remains the No.1 performer since its inception in the Investment Association Global sector by a cumulative margin of 13 percentage points over the second best fund and 188 percentage points above the average for the sector which has delivered +81.9% over the same timeframe.

However, I realise that many or indeed most of our investors do not use the MSCI World Index as the natural benchmark for their investments. Those of you who are based in the UK may look to the FTSE 100 Index ('FTSE' or 'FTSE 100') as the yardstick for measuring your investments and may hold funds which are benchmarked to this index and often hug it. The FTSE delivered a total return of -8.7% in 2018 so our Fund outperformed this by a margin of 10.9 percentage points.

It would not be surprising if some of you are worried about the returns in 2018 which were our weakest in absolute terms since inception. However, I would suggest that the background needs to be taken into account and not just how the market indices performed but also other active funds.

There are 2,592 mutual funds in the Investment Association ('IA') universe in the UK. In 2018, 2,377 or 92% of these produced a negative return. 13 posted a return of exactly 0%. Just 202 had a positive return. Our Fund was in the 4th percentile — only 3% of funds performed better. Ironically, 2018 was not a great year for our absolute returns but it was actually our second best year relative to all IA mutual funds. 2011 when the market also fell was our best, probably not coincidentally.

2018 was a year in which we saw considerable anxiety from some market participants due to:

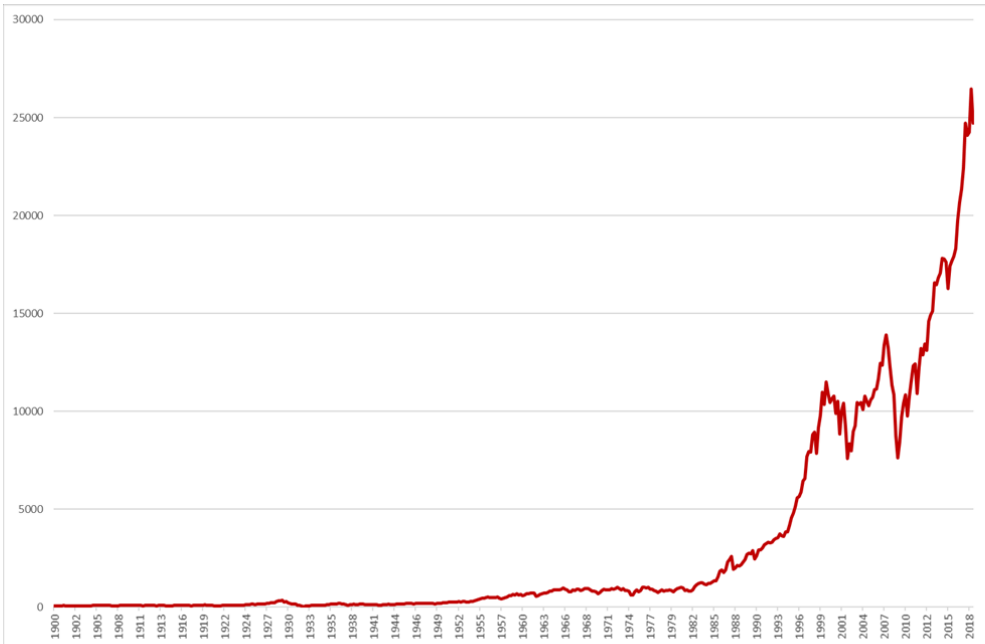
- The threat of a trade war between the USA and China
- Brexit
- The rise in US interest rates
- The US mid-term elections
- The Italian budget squabble (Italy is the third largest government bond market in the world)
- The US government shutdown

The response to this was a series of market jitters. The MSCI World Index (£ net) fell by 5.4% in October and after a rally this was followed by a fall of 7.4% in December. Despite the hysterical headlines this, in my opinion, falls well short of turmoil — a word frequently used to describe these events.

October has been a notoriously bad month for stock markets in recent decades and an example of what might reasonably be described as market turmoil was so-called Black Monday 19th October 1987 when the Dow Jones Industrial Average Index ('Dow Jones' or 'Dow') fell 22.6% in a single day. That felt dramatic. I should know as I was in work that day on the trading floor of the investment bank BZW and when I went home I received a slew of sell orders from a large US client who rang me. I had to be careful writing them down as I only had candlelight since the power still had not been restored from the hurricane, which struck on the previous Friday, adding to the dramatic effect.

I can only imagine with some amusement how some of the commentators, 'investors' and market participants who are reeling from the events of this October and December would have performed in October 1987. A December 2018 Financial Times headline referred to 'Wild market swings' and whilst the author might like to blame the headline writers for hyperbole — they are trying to sell papers/pixels after all — the article described a recent one day fall in the Dow of 3.1% as 'eye-popping'. The fall of seven times that scale in 1987 would surely have led to them to exhaust the lexicon of hyperbole. Who knows what might have popped then?

Tumultuous, turmoiled or turbulent Black Monday may have been, but did it really matter? Take a look at the chart below of the Dow Jones and see if you can spot Black Monday. You will need good eyesight or reading glasses to do so.



In the long term, it did not matter.

However, this does not stop advisers and commentators predicting crashes and bear markets and suggesting you take preventative action which ranges from reducing your equity holdings, buying or 'rotating' into lowly rated so-called 'value' stocks, through to selling everything and holding cash to safeguard the value of your assets or buying Bitcoin (down 80% in 2018).

My guiding principles for dealing with such events and predictions are as follows:

1. No one can predict market downturns with any useful level of reliability. Forecasts of what may happen in the market are about as reliable as Michael Fish's infamous denial that there would be a hurricane in the BBC weather forecast on 15th October 1987.

2. However, when one of the repeated warnings proves to be accurate the forecasters will ignore the fact that if you had followed their advice you would have forgone gains which far outweigh your losses in the downturn. I can now trace back six years of market commentary that has warned that shares of the sort we invest in, our strategy and our Fund would underperform. During that time the Fund has risen in value by over 185%. The fact that you would have forgone this gain if you had followed their advice will, of course, be forgotten by them if, or when, their predictions pay off for a period. I suggest you don't forget it.

3. Bull markets do not die of old age so ignore warnings which are based on a phrase such as 'This bull market has gone on for a long time.' They usually die from some event, often but not always rising interest rates.

4. Bull markets climb a wall of worry. The troubling events you can readily see unfolding are rarely the cause of a bear market. Alan Greenspan had already described the market as irrationally exuberant in 1996, so we were in a worryingly well-developed bull market. This was followed by the Asian crisis of 1997, Russian default and Long Term Capital Management collapse in 1998 which all looked scary, but ironically they made the Federal Reserve hesitate to raise rates which gave the bull market a new leg which lasted until 2000. Maybe the possible trade war with China and market jitters will have a similar effect.

5. Bull markets do not broaden as they age — they narrow. The current bull market started in 2009 when shares rose indiscriminately. Then amongst developed markets, the US took the lead. Then the technology sector in the US. Then just the 'FAANGs' (Facebook, Amazon, Apple, Netflix and Google). The idea that in the late stages of a bull market investors can make gains by switching into the stocks which have lagged the market flies in the face of experience.

6. As for buying so-called value stocks, if you wish to pursue this strategy it is best done after the bear market has struck, not before. If you approached any of the famous value investors

and suggested they buy some of the assorted value stocks in the FTSE 100 Index as a value play, I think they would just laugh at you. A 'value' stock like Imperial Brands (formerly Imperial Tobacco) was on an historic P/E of 8.1x at the end of 2000 in a bear market. It is now on an historic P/E of 16.5x. An aim for a value investor might be to buy 'value' stocks in a downturn when their yield is higher than the P/E.

7. A bear market will occur at some point. We may indeed already be in one. The best stance is to ignore it since you can't predict it or position yourself effectively to avoid it without impoverishing yourself by forgoing gains. But you have to possess the emotional and financial stability to stick to this stance when it strikes.

Returning to the events of 2018, the MSCI World Index (£ net) fell by -3.0%. So it was a poor performance but it still seems well short of justifying hysteria or a wholesale change of investment strategy. I say this notwithstanding the fact that on the bad days in the stock market there were clear signs of the sort of 'rotation' into 'value' stocks, which I touch upon in point 6 above.

I often use the term 'value' in inverted commas for a number of reasons:

- What some people mean by value is lowly rated. A stock may be lowly rated but not good value if the (lack of) quality of its business and/or its prospects mean that its intrinsic or fundamental value is still below its lowly valuation.

- The distinction which many commentators make between growth or quality investing and value investing is in my view a somewhat superficial one. To quote Warren Buffett:

  'Most analysts feel they must choose between two approaches customarily thought to be in opposition: "value" and "growth". Indeed, many investment professionals see any mixing of the two terms as a form of intellectual cross-dressing.

  We view that as fuzzy thinking (in which, it must be confessed, I myself engaged some years ago). In our opinion, the two approaches are joined at the hip: Growth is always a component in the calculation of value, constituting a variable whose importance can range from negligible to enormous and whose impact can be negative as well as positive.'

  Most investment strategies require some regard for the valuation of the stocks purchased or held — even strategies like ours which focus on high quality companies. The rate of growth of a company is a critical component of its valuation.

- As pointed out in point 6 above, most stocks are not currently at valuations which would attract classic value investors.

True value investing involves buying stocks when they are trading significantly below your estimate of their intrinsic or fundamental value and then waiting for some event(s) to lift the share price up to or above the intrinsic value — usually a management change, takeover, demerger, a change in the economic or market cycle, or simply when they come back into fashion amongst investors. When this occurs the value investor seeks to realise his or her gains and move on to find another value stock on which to repeat this performance.

Value investing has been out of fashion in recent years as persistently low interest rates have driven the value of almost all stocks beyond the reach of true value investors. Nonetheless value investing has its merits and will surely have its day when stocks of the sort which attract value investors perform well.

However, it is not a strategy which we will be pursuing even if we could foresee it coming back into fashion, which it will at some point. The sort of stocks which trade on low enough valuations to attract value investors are unlikely to be those which we seek – businesses which can somewhat predictably produce a high return on capital employed, in cash, and can invest at least part of that cash back into the business to fund their growth and so compound in value.

Unlike our strategy which is to seek such stocks and hold onto them, letting the returns which the company generates from this reinvestment produce good share price performance, value investing suffers from two handicaps. One is that whilst the value investor waits for the event(s) which will crystallise a rise in the share price to the intrinsic value that has been identified, the company is unlikely to be compounding in value in the same way as the stocks we seek. In fact, it is quite likely to be destroying value. Moreover, it is a much more active strategy. Even when the value investor succeeds in reaping gains from a rise in the share price to reflect the intrinsic value he identified, he or she needs to find a replacement value stock, and as events of the past few years have demonstrated, this is far from easy. Moreover, this activity has a transaction cost. Our strategy has the merit that inactivity is a benefit. If we have correctly identified the good companies whose stock can compound in value, we can hope to hold them indefinitely and still derive good investment performance from them with lower transaction costs.

There are a couple of indices which tell you how value stocks perform. One is the MSCI Europe Value Index (GBP Net). In the 2007-09 financial crisis its maximum fall was 52%, which is 16 percentage points worse than the performance of the MSCI World Index (GBP Net) over that period. So much for the theory that value stocks protect you in a downturn.

As you hopefully know by now, we have a simple three step investment strategy:

- Buy good companies
- Don't overpay
- Do nothing

I will review how we are doing against each of these in turn.

As usual we seek to give some insight into the first of those — whether we own good companies — by giving you the following table which shows what Fundsmith would be like if instead of being a fund it was a company and accounted for the stakes which it owns in the portfolio on a 'look through' basis, and compares this with the market, in this case the FTSE 100 Index and the S&P 500 Index ('S&P 500').

We not only show you how the portfolio compares with the major indices but also how it has evolved over time.

	Fundsmith Equity Fund Portfolio								**S&P 500**	**FTSE 100**
Year ended	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2018**	**2018**
ROCE	28%	29%	31%	29%	26%	27%	28%	29%	16%	17%
Gross margin	58%	58%	63%	60%	61%	62%	63%	65%	45%	39%
Operating margin	22%	23%	24%	25%	25%	26%	26%	28%	15%	16%
Cash conversion	103%	101%	108%	102%	98%	99%	102%	95%	84%	96%
Leverage	15%	44%	40%	28%	29%	38%	37%	47%	46%	39%
Interest cover	27x	18x	16x	15x	16x	17x	17x	17x	7x	9x

Source: Fundsmith LLP/Bloomberg. ROCE, Gross Margin, Operating Profit Margin and Cash Conversion are the weighted mean of the underlying companies invested in by the Fundsmith Equity Fund and mean for the FTSE 100 and S&P 500 Indices. The FTSE 100 and S&P 500 numbers exclude financial stocks. The Leverage and Interest Cover numbers are both median. All ratios are based on last reported fiscal year accounts as at 31st December and as defined by Bloomberg. Cash Conversion compares Free Cash Flow per Share with Net Income per Share.

As you can see, not much has changed. I would suggest ignoring the increase in Leverage — the amount of debt the portfolio companies have as a proportion of their capital. The arithmetic average of our portfolio companies would not be very meaningful as it would average a wide range between nine of our stocks which have net cash and three which have leverage of over 1,000% (as they have reduced their capital through share buybacks). Even the median which we use is not much better — the median is the average between the 14th and 15th stocks in order of leverage but those either side have widely differing leverage of 27% and 73% respectively. For those of you who glaze over at statistical explanations — the figure tells you virtually nothing about the actual financial characteristics of the businesses. You might therefore wonder why we include it, and latterly so do I, but I don't like taking figures out of tables we have provided in the past as it can cause suspicion about the reasons why (figures are rarely omitted when everything appears to be going well).

The interest cover — which remains stable at about 17x and twice the level of the index companies — is a much better guide to the financial stability of our portfolio companies.

What is more interesting is that the companies in our portfolio continue to have significantly higher returns on capital and better profit margins than the average for the indices. They convert more of their profits into cash and achieve this with at least no more leverage than the average company.

The average year of foundation of our portfolio companies at the year end was 1922.

Consistently high returns on capital are one sign we look for when seeking companies to invest in. Another is a source of growth — high returns are not much use if the business is not able to grow and deploy more capital at these high rates. So how did our companies fare in that respect in 2018? The weighted average free cash flow (the cash the companies generate after paying for everything except the dividend, and our preferred measure) grew by 8% in 2018. We regard this as a very good result given the generally subdued and patchy growth which the world continues to experience and the fact that the previous year the portfolio companies achieved growth of a remarkable 13%, so the starting base for comparison in 2018 was a tough one.

This leads onto the question of valuation. The weighted average free cash flow ('FCF') yield (the free cash flow generated by the companies divided by their market value) of the portfolio at the outset of the year was 3.7% and ended it at 4.0%, so they became cheaper or more lowly rated. Whilst this is not a good thing from the viewpoint of the performance of their shares or the Fund, it is inevitable that sooner or later the cash flows generated by our companies will grow faster than their share prices, rather than vice versa. This is far from an unhealthy development especially if we are investing more in the Fund, as most of us are, through the Accumulation shares.

The year-end median FCF yield on the S&P 500 was 4.7%. The year-end median FCF yield on the FTSE 100 was 5.2%. More of our stocks are in the former index than the latter and I will not repeat the explanation which I gave last year on why I think the FTSE 100 is not an appropriate benchmark or investment proxy for investors to use. Our portfolio consists of companies that are fundamentally a lot better than those in either index and are valued more highly than the average FTSE 100 company and a bit higher than the average S&P 500 company but with a significantly higher quality.

For the year the top five contributors to the Fund's performance were:

Microsoft	+1.3%
IDEXX	+1.0%
Intuit	+1.0%
PayPal	+1.0%
Dr Pepper Snapple	+0.9%

Intuit, the US leader in accounting and tax software, was a relatively new holding having been purchased in 2017. PayPal is putting in an appearance for the second year running and IDEXX is returning to this list after being in our top five contributors in 2016. Microsoft makes its fourth appearance after 2015, 2014 and 2013. So much for taking profits as a strategy. Dr Pepper Snapple was the recipient of a bid from Keurig Green Mountain.

The bottom five were:

Philip Morris Intl.	-1.5%
Sage	-0.8%
Facebook	-0.7%
3M	-0.5%
Novo Nordisk	-0.4%

Philip Morris was caught up in the noise and uncertainty which surrounds the new reduced-risk products — vaping and heat-not-burn technology — where Philip Morris has a market leading product in iQOS. I suspect we can tell that the company is on the right track not just in terms of introducing products which wean smokers off cigarettes and so make their consumption safer and give a new leg to its business but also by the number of regulators and commentators who oppose them.

Sage, the accounting software provider, was the subject of an unplanned change of CEO during the year, of which more later.

Our purchase of a holding in Facebook is certainly one of our more controversial decisions in the light of the furore over its use of personal data and what role some Facebook users may have made of this in elections.

As pointed out earlier and on many other occasions, we tend to look for suitable investments from the numbers that they report. Facebook's historic numbers are certainly impressive. It has some 1.5 billion Daily Active Users ('DAU') and some 2.3 billion Monthly Active Users ('MAU'). Bearing in mind that Facebook has no presence in China these numbers suggest ubiquity.

In 2017 Facebook had a return on capital of 30%, gross margins of 87% and operating profit margins of 50%. Its revenue growth rate has averaged 49% p.a. for the past five years and over the same period operating profits have grown by 106% p.a. (one hundred and six percent per annum).

Of course, all that is in the past and the future for Facebook is likely to be different. When we started buying its shares we estimated that its revenue growth rate would halve to about 20% p.a. In the third quarter of 2018 they grew at 34% p.a., but the company has indicated that the growth rate would slow further to perhaps the mid 20% range in the fourth quarter, and the operating margin was down to a still impressive 42%. Against the background of the media furore over the use of personal data, this has been enough for some commentators on Facebook to experience very public attacks of the vapours.

But bear in mind the following:

The 42% operating margin in the third quarter which gave 13% profit growth was after a 53% increase in costs. You could look at this as a glass half full or empty, but in its third quarter Facebook increased R&D costs by 29%, marketing and sales costs by 65% and general and administrative costs by 76%. You might see such a rise in costs as problematic, but I suspect that faced with a furore Facebook's management has decided to very publicly spend a lot of money on data security and content control and to improve users' experience. In doing so it has, a) depressed Facebook's results, albeit to a still very acceptable level — showing great results whilst under such scrutiny might be a red rag to a bull, and b) built an even bigger barrier to entry for competitors. Ironically the response to the furore may just have cemented Facebook's competitive position. I also note that at the time of writing, Facebook's new political advertising transparency tools show that the UK government spent £96,684 on Facebook ads promoting Prime Minister May's Brexit deal. Political attacks on Facebook have the look of a circular firing squad.

Similarly, Facebook's capital expenditure doubled in the first nine months of 2018 to $9.6 billion, yet free cash flow in the third quarter was still 16% higher than it was a year ago.

Yet Facebook is on an historic P/E of 19.7x — about the same as the S&P 500. Unless there is going to be a much more severe deterioration in Facebook's operational performance than we have seen to date or reasonably expect, this looks cheap to us.

Also consider the following:

Facebook makes no money from its social network users. It makes most of its revenue from online advertising, a business in which it has a virtual duopoly with Google.

I strongly suspect that most people's judgement of Facebook is based upon their personal experience and prejudices. But 69% of Facebook's DAU and 73% of its MAU are outside the United States and Europe. How much do you think they care about allegations of misuse of data in a US election? Not much I would suggest which seems to be borne out by the fact that in the third quarter the number of DAU grew by 9% and MAU by 10%.

Facebook has yet to 'monetise' WhatsApp. I found it particularly amusing that one person queried our holding in Facebook using a message sent on WhatsApp. Who said the age of irony is dead?

Our Facebook holding has cost us some performance to date and no doubt it will continue to be a difficult stock to hold in terms of media attention, but we have often found that the only time you can hope to buy stock in great businesses at a cheap valuation is when they have a glitch.

Turning to the third leg of our strategy, which we succinctly describe as 'Do nothing', minimising portfolio turnover remains one of our objectives and this was again achieved with a portfolio turnover of 13.4% during the period. This is the highest level of annual turnover which we have undertaken to date, but it is still tiny in comparison with most funds. Moreover, it is somewhat exaggerated by the fact that we ran down the net cash as the market experienced some weakness later in the year. If this element of turnover was excluded the number would be about 11%. It is perhaps more helpful to know that we spent a total of just 0.018% (1.8 basis points or hundredths of a percent) of the Fund's average value over the year on voluntary dealing (which excludes dealing costs associated with fund subscriptions and redemptions as these are involuntary). We have held 11 of our portfolio companies since inception in 2010.

Why is this important? It helps to minimise costs and minimising the costs of investment is a vital contribution to achieving a satisfactory outcome as an investor. Too often investors, commentators and advisers focus on or in some cases obsess about the Annual Management Charge ('AMC') or the Ongoing Charges Figure ('OCF'), which includes some costs over and above the AMC, which are charged to the Fund. The OCF for 2018 for the T Class Accumulation shares was 1.05%. The trouble is that the OCF does not include an important element of costs — the costs of dealing. When a fund manager deals by buying or selling, the fund typically incurs the cost of commission paid to a broker, the bid-offer spread on the stocks dealt in and, in some cases, transaction taxes such as stamp duty in the UK. This can add significantly to the costs of a fund, yet it is not included in the OCF.

We provide our own version of this total cost including dealing costs, which we have termed the Total Cost of Investment ('TCI'). For the T Class Accumulation shares in 2018 this amounted to a TCI of 1.09%, including all costs of dealing for flows into and out of the Fund, not just our voluntary dealing.

We have long said that we look forward to the day when we can compare our TCI with other funds and that day has arrived. The table below shows the TCI of the 15 largest equity and total return funds in the UK and how their TCI differs from their OCF:

15 Largest Active Equity & Total Return Funds in the UK

	OCF %	**Transaction Costs %**	**TCI %**	**% Additional Costs**
Fundsmith Equity Fund	1.05	0.04	1.09	4%
Standard Life Investments GARS	0.89	0.25	1.14	28%
Invesco Global Total Return	0.87	0.40	1.27	46%
Invesco High Income	0.92	0.10	1.02	11%
Stewart Investors Asia Pacific Leaders	0.89	0.13	1.02	15%
Newton Real Return	0.80	0.15	0.95	19%
Baillie Gifford Diversified Growth	0.82	0.63	1.45	77%
M&G Global Dividend	0.91	0.09	1.00	10%
Lindsell Train UK Equity	0.70	0.13	0.83	19%
Artemis Income	0.79	0.13	0.92	16%
Jupiter European	1.03	0.09	1.12	9%
Newton Global Income	0.79	0.10	0.89	13%
Ruffer Absolute Return	1.15	0.20	1.35	17%
Woodford Equity Income	0.75	0.27	1.02	36%
Aviva Multi Strategy Target Return	0.85	0.23	1.08	27%
Average	**0.88**	**0.20**	**1.08**	**23%**

Source: Financial Express Analytics/Fundsmith as at 7.1.19, in descending order of size.

We are pleased that our TCI is not only just 4% above our OCF when transaction costs are taken into account, but that this is the lowest increase in the group. However, we would caution against becoming obsessed with charges to such an extent that you lose focus on the performance of funds. It is worth pointing out that the performance of our Fund tabled at the beginning of this letter is after charging all fees which should surely be the main focus. This point is rammed home when the same 15 largest active equity and total return funds in the UK are ranked by their three year performance (the picture does not change much if we rank them on their five year performance but two were launched too recently to have five year track records):

% Annualised Performance	**3yr**	**5yr**
Fundsmith Equity	16.9	17.9
M&G Global Dividend	14.0	7.3
Stewart Investors Asia Pacific Leaders	12.7	11.8
Newton Global Income	11.5	10.7
Jupiter European	10.2	11.8
Lindsell Train UK Equity	9.9	9.7
Artemis Income	3.9	4.3
Baillie Gifford Diversified Growth	2.6	2.9
Ruffer Absolute Return	2.2	2.5
Newton Real Return	2.0	2.1
Invesco Global Targeted Returns	0.3	2.1
Invesco High Income	-0.9	3.4
Standard Life Investments GARS	-2.2	0.3
Aviva Multi Strategy Target Return	-2.5	n/a
Woodford Equity Income	-4.6	n/a

Source: Financial Express Analytics as at 31.12.18.

I think the above table speaks for itself.

We did undertake some activity in 2018. In particular we sold our holdings in Dr Pepper Snapple and Nestlé during the year.

Dr Pepper Snapple was a stock we have held since inception. We found the strategic rationale for the acquisition by Keurig Green Mountain difficult to comprehend and so took our leave of the situation. Commentators seem to forget that a similar combination was tried between Coca-Cola and Keurig which was unsuccessful and quietly abandoned.

Last year we wrote about the attention which Nestlé, amongst other portfolio companies, had attracted from activist investors. In Nestlé's case this was followed by the announcement of new margin and share buyback targets and then a deal to purchase Starbucks supermarket coffee products, excluding the 'Ready to Drink' ones, for $7.15bn. In other words, bags of coffee. Presumably we can also look forward to being able to purchase Starbucks Nespresso pods. Virtually no mention was made of the royalty which Nestlé will continue to pay to Starbucks on sales of these products. We rely on the management of our companies to allocate capital in ways which create value for us as investors, and this deal did not seem to meet those criteria, although it certainly seemed to fit the activist imperative to do something and looked like a good deal for Starbucks.

This year I thought I would use the opportunity afforded by this letter to talk about our engagement with companies. We are often asked by investors whether we meet company management and how we engage with them.

The answer is that we meet them a lot. We visit companies we wish to research and meet them physically or virtually at results meetings and industry conferences. We are often engaged by members of the board remuneration committee and we review and vote on all resolutions and proxy statements at general meetings. We do not employ any outside agency for this.

However, meeting management is not our primary test of whether a business is of sufficient quality for us to invest. We think good businesses are identifiable from the numbers they produce. Nor do we meet management to give them our views on how to run the business. If they don't know how to do so we are in serious trouble.

There were two examples in 2018 of the closer engagement which we undertake when necessary.

One was with Sage, the accounting software company and the UK's largest quoted IT company. Sage like many software providers is in the midst of a switch from provision of perpetual software licenses for its products — historically in the form of a disc — to the provision of Software as a Service (or 'SaaS' as it is known in the jargon) in which the product is provided online as a subscription service. This has many advantages — knowing who the customer is, the ability to provide upgrades and sell adjacent products (like payroll and HR services) and repeat revenues. But it is not an automatic win — legacy customers can be reluctant to switch and the move to SaaS can provide an opportunity for disruptive competitors. Sage has had a couple of disappointing quarters of results in 2018 when the revenue growth which was expected to be 8% p.a. looked like it might come in closer to 6% p.a. Whilst this was not ideal it was not as worrying as the possibility that the product development might not be fit for purpose and/or that in trying to reach for short term targets essential product development might be neglected.

We therefore engaged with the Chairman to ensure that our concerns were understood. In this respect we felt we could draw upon our experience as shareholders in Intuit which competes with Sage and has made a so far successful transition to becoming a SaaS company. We did not however call for any change in management. The board nonetheless subsequently took the decision to part company with the CEO.

We engaged with the Chairman to try to ensure that a suitable choice was made, drawing on our experience as a shareholder in Microsoft during the transition from Steve Ballmer as CEO to Satya Nadella, which has gone very well, and finally we met with the new CEO when he was appointed permanently to discuss the way forward for the business. We were at pains to stress that we are not interested in short term fixes at the expense of long-term success something which he seems to agree with since he has announced £60m of additional expenditure, two thirds of which is on product development.

The other main corporate engagement outside the run of the mill AGM proxies and remuneration consultations in 2018 concerned Unilever, which announced a plan to unify its Anglo Dutch dual share structure and centre the headquarters and listing in the Netherlands. This was to be subject to a shareholder vote in the UK PLC which never occurred, presumably because the board could see it was about to be defeated.

Unlike some investors, the switch of listing would not have affected our ability to continue as shareholders. Our engagement with the Chairman centred around the motivation for the move which was portrayed as a desirable simplification that would make it easier for Unilever to engage in acquisitions involving share issues, particularly in the United States.

We were rather sceptical about the stated reasons for the change. The previous year Unilever had a near death experience with a takeover approach from Kraft Heinz. Add to this the episode in which the US chemical company PPG Industries had bid for the Dutch paint maker Akzo Nobel and a subsequent freedom of information request had revealed collusive activity between Akzo Nobel's management and Dutch politicians to thwart the bid and you did not need to be the fictional Dutch detective Van der Valk to figure out that there might be some other motivations for the proposed move.

As you will be able to tell if you read our annual letter last year, we are far from enthusiastic about most shareholder activism nor are we shareholders in or fans of the Kraft Heinz business model. But we thought that Unilever's management had a case to answer and we think that the ability to mount a hostile takeover is an important discipline in ensuring that our assets are properly managed. When the Chairman told us that he was never in favour of such actions, though he concurred that some companies were poorly managed, we were at best a bit confused about what mechanism he thought might be applied if such a change became necessary. Harsh language maybe?

We did not take part in any public commentary about our voting intentions had the Unilever changes come to a vote and please note that we have not revealed that here, we have merely commented on the process. In our view achieving good stewardship of a business is not always a process best conducted through the media.

I would like to end by addressing the question of what will happen next in equity markets, which may surprise you given that I always respond to questions about this by saying I haven't got a clue, and neither has anyone else.

Imagine a fund manager approached you with an offer for you to invest in a portfolio of high quality companies. You may quite like the strategy but you are worried about whether or not this is a good time to invest in the stock market. Take a look at the chart below which shows the world's largest index by market capitalisation, the S&P 500, and which includes more quality companies than any other index.

Source: Bloomberg

The chart looks like a roller coaster that has just passed the peak of the ride. Surely you would be stupid if you invested now no matter how good the strategy is. Better to wait until the market has had a proper fall.

You may notice that there are no dates on this chart of the S&P 500. That's because I wanted you to assume I was referring to the current market and our own fund, Fundsmith. In fact, the chart above shows the 37 years up to 1965 — the year in which Warren Buffett took control of Berkshire Hathaway. If you had made the decision to time the market and hold back from investing then you would probably have missed out on the 20.9% compound growth in the market value per share of Berkshire since 1965 as a result.

'Ah but that's not how market timing works', I can foresee someone saying. 'Just because I didn't buy into it in June 1965 doesn't mean that I wouldn't have bought into Berkshire later after the market had fallen.' Seems fair except that the market didn't fall in the remainder of 1965. In fact, the S&P 500 went up by a further 13% in the second half of 1965. What would you have done then? Panicked and bought Berkshire or held off? If you had the nerve to do the latter, you might have felt vindicated in 1966 when the S&P 500 fell by 22% at one point.

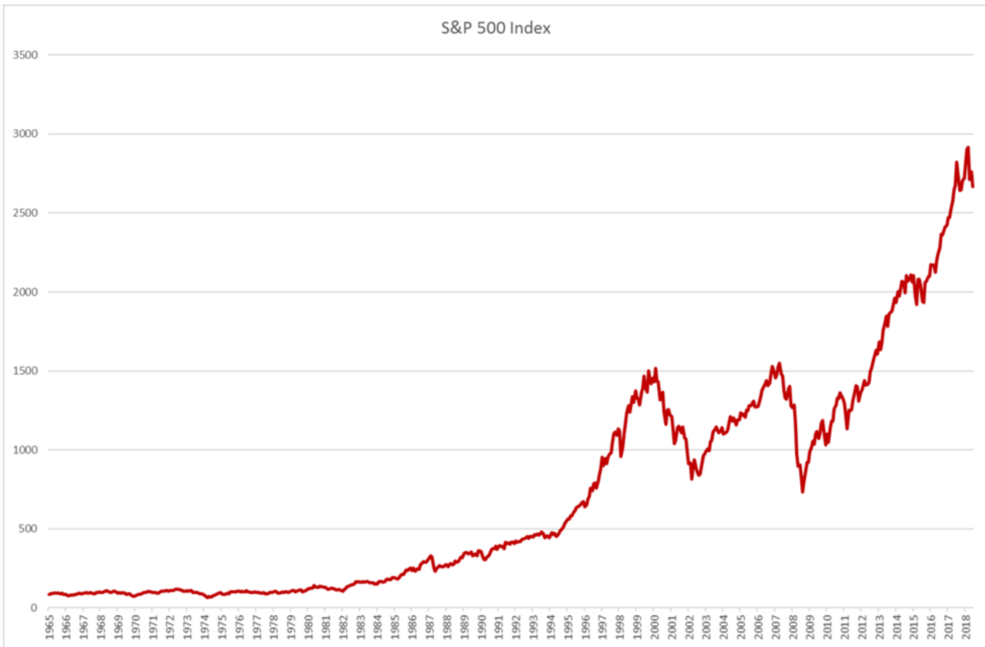
There are several problems with this though. Berkshire Hathaway is not the S&P 500. Its shares rose 49.5% in 1965 and only fell by 3.4% in 1966. So, your hesitancy would not have paid off. Moreover, by 1967 the market had recovered to a new peak.

Are you really smart enough to not only a) predict a market fall but also; b) figure out how this translates into individual stock movements; c) get your timing sufficiently correct that you do not either forgo gains which far outweigh any losses you protect against or suffer some of the downturn; d) have sufficient mental agility and nerve to start buying when your prediction of a market fall has become reality; and e) get the timing roughly right on that side of the trade so that you don't end up catching the proverbial falling knife or missing some or all of the recovery? If so, I doubt you will be reading this letter on your private island. But above all, I doubt you exist.

To be fair, there have been plenty of big falls in both the market and Berkshire Hathaway's stock in the intervening 50 odd years since 1965. Berkshire's shares fell by over 50% in 1973–75 and 2008–09, and by nearly 50% in 1998–2000, plus a mere 37% in 1987.

The point about this is not simply that getting the timing of markets right is impossible it is also that in even attempting to do so you might have missed out on investing in Warren Buffett's Berkshire Hathaway, the results of which far outweigh any market timing gains.

So where are we now? Here's the S&P 500 Index from the end of the previous chart in 1965 over the 53 years to date:



Source: Bloomberg

Looks familiar doesn't it? And it makes people reluctant to invest.

'Ah' but I can hear someone say, 'Things are different — the valuation was much lower in 1965 than it is now.' In mid-1965 the S&P 500 was on a P/E of 18.6x. Now it is on a 2019 forecast P/E of 17.1x. There is no significant difference, although it is actually more lowly rated now.

But surely only an idiot would invest in a portfolio of high quality company stocks when the market chart looks like that...

As Mark Twain said, 'History doesn't repeat itself, but it often rhymes.'

Finally, I wish you a happy New Year and thank you for your continued support for our Fund. My colleagues and I look forward to seeing many of you at our Annual Shareholders' Meeting on 26th February 2019 and to trying to answer any questions you may have. Please see the enclosed invitation for details.

Yours sincerely,

Terry Smith
CEO
Fundsmith LLP

Disclaimer: A Key Investor Information Document and an English language prospectus for the Fundsmith Equity Fund are available via the Fundsmith website or on request and investors should consult these documents before purchasing shares in the fund. Past performance is not necessarily a guide to future performance. The value of investments and the income from them may fall as well as rise and be affected by changes in exchange rates, and you may not get back the amount of your original investment. Fundsmith LLP does not offer investment advice or make any recommendations regarding the suitability of its product. This document is communicated by Fundsmith LLP which is authorised and regulated by the Financial Conduct Authority.

Sources: Fundsmith LLP & Bloomberg unless otherwise stated.

Portfolio turnover has been calculated in accordance with the methodology laid down by the FCA. This compares the total share purchases and sales less total creations and liquidations with the average net asset value of the fund.

P/E ratios and Free Cash Flow Yields are based on trailing twelve month data and as at 31st December 2018 unless otherwise stated.

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January 2020

Dear Fellow Investor,

This is the tenth annual letter to owners of the Fundsmith Equity Fund ('Fund').

The table below shows performance figures for the last calendar year and the cumulative and annualised performance since inception on 1st November 2010 and various comparators.

% Total Return	**1st Jan to 31st Dec 2019**	**Inception to 31st Dec 2019 Cumulative**	**Annualised**	**Sharpe ratio[5]**	**Sortino ratio[5]**
Fundsmith Equity Fund[1]	+25.6	+364.4	+18.2	1.22	1.22
Equities[2]	+22.7	+180.3	+11.9	0.63	0.59
UK Bonds[3]	+3.8	+40.9	+3.8	n/a	n/a
Cash[4]	+0.8	+6.0	+0.6	n/a	n/a

[1] T Class Acc shares, net of fees, priced at noon UK time, source: Fundsmith LLP
[2] MSCI World Index, £ net, priced at US market close, source: Bloomberg
[3] Bloomberg/Barclays Bond Indices UK Gov. 5–10 yr., source: Bloomberg
[4] 3 Month £ LIBOR Interest Rate, source: Bloomberg
[5] Sharpe & Sortino ratios are since inception on 1.11.10 to 31.12.19, source: Financial Express Analytics

The table shows the performance of the T Class Accumulation shares, the most commonly held Class and one in which I am invested, which rose by +25.6% in 2019 and compares with a rise of +22.7% for the MSCI World Index in sterling with dividends reinvested. The Fund therefore beat this comparator in 2019, and our Fund remains the No.1 performer since its inception in the Investment Association Global sector by a cumulative margin of 233 percentage points above the average for the sector which has delivered +131.8% over the same timeframe.

However, I realise that many or indeed most of our investors do not use these as the natural comparator for their investments. Those of you who are based in the UK may look to the FTSE 100 Index ('FTSE 100') as the yardstick for measuring your investments and may hold funds which are benchmarked to this index and often hug it. The FTSE 100 delivered a total return of +17.3% in 2019 so our Fund outperformed this by a margin of 8.3 percentage points.

For the year the top five contributors to the Fund's performance were:

Microsoft	+2.7%
Estée Lauder	+2.1%
Facebook	+2.0%
PayPal	+1.8%
Philip Morris Intl.	+1.4%

Microsoft makes its fifth appearance whilst PayPal is putting in an appearance for the third year running. Someone once said that no one ever got poor by taking profits. This may be true but I doubt they got very rich by this approach either. We are not the sort of people who ever declare victory — we invest with a strong sense of paranoia — but it is nonetheless pleasing to note the contribution of Facebook which was certainly our most controversial stock purchase and led to more questions (and demands for its sale) from some of our investors than any other company. We had similar views expressed to us when we purchased Microsoft.

The bottom five were:

3M	-0.2%
Colgate Palmolive	0.0%
Clorox	0.0%
Brown-Forman	0.0%
Reckitt Benckiser	+0.2%

We sold our stakes in 3M and Colgate Palmolive during the year and began buying Brown-Forman, the distiller of Jack Daniel's Tennessee Whiskey, and Clorox, the US household products and personal care products company. With 3M we were acting on growing doubts about the current management's capital allocation decisions, and in the case of Colgate Palmolive we grew tired of waiting for an effective growth strategy to emerge. As is often the case, our buying of Brown-Forman has coincided with a period of share price weakness caused in this case mainly by the impact of EU tariffs on American spirits.

This year we have included the Sharpe and Sortino ratios for our Fund and the Index in the performance table on p.1. I realise that for those of you who are not investment professionals what I say next may well seem to be gobbledegook. However, whilst the returns which our Fund provides are very important so is the amount of risk assumed in producing those returns. These ratios attempt to measure that.

The Sharpe ratio takes the return on the Fund, subtracts a so-called risk-free return (basically the return on government bonds) to get the excess return over the risk-free rate, and divides the resulting number by the variation in that excess return (measured by its standard deviation — I warned you it was gobbledegook). The result tells you what unit of return you get for a unit of risk and our Fund has a Sharpe ratio of 1.22 since inception against 0.63 for the MSCI World Index — it is producing about twice the amount of return that the Index produces for each unit of risk.

The Sortino ratio is an adaption of the Sharpe ratio, and in my view an improvement. Whereas the Sharpe ratio estimates risk by the variability of returns, the Sortino ratio takes into account only downside variability as it is not clear why we should be concerned about upside volatility (i.e. when our Fund goes up a lot) which mostly seems to be a cause for celebration. The result for our Fund since inception is a Sortino ratio of 1.22 but the MSCI World Index Sortino ratio is lower than its Sharpe ratio at 0.59.

As you hopefully know by now, we have a simple three step investment strategy:

- Buy good companies
- Don't overpay
- Do nothing

I will review how we are doing against each of those in turn.

As usual we seek to give some insight into the first of those — whether we own good companies — by giving you the following table which shows what Fundsmith would be like if instead of being a fund it was a company and accounted for the stakes which it owns in the portfolio on a 'look through' basis, and compares this with the market, in this case the FTSE 100 Index and the S&P 500 Index ('S&P 500'). We not only show you how the portfolio compares with the major indices but also how it has evolved over time.

	Fundsmith Equity Fund Portfolio								**S&P 500**	**FTSE 100**
Year ended	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2019**	**2019**
ROCE	29%	31%	29%	26%	27%	28%	29%	29%	17%	17%
Gross margin	58%	63%	60%	61%	62%	63%	65%	66%	45%	39%
Operating margin	23%	24%	25%	25%	26%	26%	28%	27%	15%	17%
Cash conversion	101%	108%	102%	98%	99%	102%	95%	97%	84%	86%
Leverage	44%	40%	28%	29%	38%	37%	47%	39%	53%	41%
Interest cover	18x	16x	15x	16x	17x	17x	17x	16x	7x	10x

Source: Fundsmith LLP/Bloomberg. ROCE, Gross Margin, Operating Profit Margin and Cash Conversion are the weighted mean of the underlying companies invested in by the Fundsmith Equity Fund and mean for the FTSE 100 and S&P 500 Indices. The FTSE 100 and S&P 500 numbers exclude financial stocks. The Leverage and Interest Cover numbers are both median. All ratios are based on last reported fiscal year accounts as at 31st December and as defined by Bloomberg. Cash Conversion compares Free Cash Flow per Share with Net Income per Share.

As you can see, not much has changed, which is how we like it. Our portfolio companies remain superior to those in the main indices on any of the financial measures of returns, profitability, cash flow, or balance sheet strength.

As we indicated last year, we are going to remove the leverage calculation from the table in future as it can be close to meaningless. As you can see, we are not planning to remove it just because it looks bad. On the contrary, this year it is at 39% for our Fund's portfolio versus 53% for the S&P 500 and 41% for the FTSE 100. But it gives a sense of how little meaning it has that the values for the companies that comprise the median number are 26% and 53%. Nor is a mean (average) number much better as eight stocks in the portfolio have net cash on their balance sheets.

The average year of foundation of our portfolio companies at the year end was 1925.

Consistently high returns on capital are one sign we look for when seeking companies to invest in. Another is a source of growth — high returns are not much use if the business is not able to grow and deploy more capital at these high rates. So how did our companies fare in that respect in 2019? The weighted average free cash flow (the cash the companies generate after paying for everything except the dividend, and our preferred measure) grew by 9% in 2019.

This leads onto the question of valuation. The weighted average free cash flow ('FCF') yield (the free cash flow generated by the companies divided by their market value) of the portfolio at the outset of the year was 4.0% and ended it at 3.4%, so they became more highly rated. Whilst this is a good thing from the viewpoint of the performance of their shares and the Fund, it makes us nervous as changes in valuation are finite and reversible, although it is hard to see the most likely source of such a reversal — a rise in interest rates — in the near future.

The year-end median FCF yield on the S&P 500 was 4.2%. The year-end median FCF yield on the FTSE 100 was 5.5%. More of our stocks are in the former index than the latter and I will not repeat the explanation which I gave in my 2017 annual letter on why I think the FTSE 100 is not an appropriate benchmark or investment proxy for our investors to use. Our portfolio consists of companies that are fundamentally a lot better than the average of those in either index and are valued more highly than the average FTSE 100 company and a bit higher than the average S&P 500 company but with significantly higher quality. It is wise to bear in mind that despite the rather sloppy shorthand used by many commentators, highly rated does not equate to expensive any more than lowly rated equates to cheap.

Turning to the third leg of our strategy, which we succinctly describe as 'Do nothing', minimising portfolio turnover remains one of our objectives and this was again achieved with a negative portfolio turnover during the period. It is perhaps more helpful to know that we spent a total of just 0.005% (half a basis point or one two hundredth of one percent) of the Fund's average value over the year on voluntary dealing (which excludes dealing costs associated with fund subscriptions and redemptions as these are involuntary). We have held ten of our portfolio companies since inception in 2010.

Why is this important? It helps to minimise costs and minimising the costs of investment is a vital contribution to achieving a satisfactory outcome as an investor. Too often investors, commentators and advisers focus on, or in some cases obsess about, the Annual Management Charge ('AMC') or the Ongoing Charges Figure ('OCF'), which includes some costs over and above the AMC, which are charged to the Fund. The OCF for 2019 for the T Class Accumulation shares was 1.05%. The trouble is that the OCF does not include an important element of costs — the costs of dealing. When a fund manager deals by buying or selling, the fund typically incurs the cost of commission paid to a broker, the bid-offer spread on the stocks dealt in and, in some cases, transaction taxes such as stamp duty in the UK. This can add significantly to the costs of a fund, yet it is not included in the OCF.

We provide our own version of this total cost including dealing costs, which we have termed the Total Cost of Investment ('TCI'). For the T Class Accumulation shares in 2019 this amounted to a TCI of 1.06%, including all costs of dealing for flows into and out of the Fund, not just our voluntary dealing. The table below shows the TCI of the 15 largest equity and total return funds in the UK and how their TCI differs from their OCF:

	OCF %	**Transaction Costs %**	**TCI %**	**% Additional Costs**
Fundsmith Equity Fund	1.05	0.01	1.06	1
Invesco Global Targeted Returns	0.87	0.43	1.30	49
Baillie Gifford Diversified Growth	0.77	0.50	1.27	65
Lindsell Train UK Equity	0.65	0.09	0.74	14
Stewart Investors Asia Pacific Leaders	0.88	0.16	1.04	18
BNY Mellon Real Return	0.80	0.20	1.00	25
Invesco High Income	0.92	0.15	1.07	16
BNY Mellon Global Income	0.80	0.07	0.87	9
Liontrust Special Situations	0.89	0.18	1.07	20
Artemis Income	0.80	0.12	0.92	15
ASI Global Absolute Return Strategies	0.90	0.15	1.05	17
Jupiter European	1.02	0.06	1.08	6
LF Ruffer Absolute Return	1.22	0.35	1.57	29
Baillie Gifford Managed	0.42	0.05	0.47	12
Threadneedle UK Equity Income	0.82	0.05	0.87	6
Average	**0.85**	**0.17**	**1.03**	**20**

Source: Financial Express Analytics/Fundsmith as at 6.1.20, funds in descending order of size.

We are pleased that our TCI is not only just 1% above our OCF when transaction costs are taken into account, but that this is the lowest increase in the group. However, we would again caution against becoming obsessed with charges to such an extent that you lose focus on the performance of funds. It is worth pointing out that the performance of our Fund tabled at the beginning of this letter is after charging all fees which should surely be the main focus. This point is rammed home when the same 15 largest active equity and total return funds in the UK are ranked by their three year performance (the picture does not change much if we rank them on their five year performance).

	3 year Cumulative Performance to Last Year End Overall %	**5 year Cumulative Performance to Last Year End Overall %**
Fundsmith Equity Fund	56.6	132.2
Jupiter European	53.5	98.4
Lindsell Train UK Equity	46.6	81.9
Liontrust Special Situations	39.0	83.3
Baillie Gifford Managed	35.8	70.3
BNY Mellon Global Income	30.5	85.9
Artemis Income	25.0	45.3
Stewart Investors Asia Pacific Leaders	24.1	51.3
Threadneedle UK Equity Income	21.0	43.8
BNY Mellon Real Return	14.8	20.8
Baillie Gifford Diversified Growth	13.9	23.4
ASI Global Absolute Return Strategies	2.8	2.9
LF Ruffer Absolute Return	2.5	16.0
Invesco Global Targeted Returns	0.6	5.7
Invesco High Income	-0.5	13.7

Source: Financial Express Analytics/Fundsmith as at 6.1.20

I think the above table speaks for itself in terms of the relative performance of our Fund so that you can look not just at the fees and costs but what you get in return — performance.

The Fund’s performance for the year was adversely affected by a couple of poor months in September and October which cost the Fund about 6%. This was caused by two factors: 1) a rally in the sterling exchange rate from the recent lows which it had plumbed after the Brexit referendum result in 2016 and on subsequent hard Brexit fears; and 2) a ‘rotation’ from the high quality and relatively highly rated stocks of the sort which our Fund owns into lower quality and more lowly rated ‘value’ stocks.

If you read the breathless commentary on this in much of the press without knowing the actual performance of our Fund you might be surprised to find that, notwithstanding these events, it ended the year up by 25.6% which was our second best year since inception and outperformed the MSCI World Index by 2.9%.

Taking each of these factors in turn, currency movements clearly have some effect on our portfolio. Over 60% of our portfolio is invested in companies listed in the United States. The actual exposure to the US dollar and therefore the pound/dollar exchange rate is better gauged by the c.40% of our portfolio companies' revenues which are in the USA. However, currency movements are not something we believe we can predict — they seem to have about the same predictability as a game of Snakes & Ladders — or hedge.

I would suggest looking at the matter this way: imagine we were in a discussion with some of the companies which have produced great returns for us over the last nine years, or which might do so over the next nine, and we asked them to name the top three factors in their success. What do you think the chances are that they would say 'currency exposure and exchange rates'? I would suggest they might name product innovation and R&D, strong brands, control of distribution, market share, customer relationships, installed bases of equipment or software, management, successful capital expenditure and acquisitions as far more important. So, we think it's best to ignore the Snakes & Ladders of currency movements.

Turning to the second point — the so-called rotation into value stocks, I am not much of a gardener but I believe this is becoming what gardeners term a hardy perennial as it crops up every year. To quote from Investment Adviser *'Looking at PE ratios there is evidence in abundance that shows that from a relative perspective quality stocks may today be considered expensive.'* The interesting point about that assertion is that it was published on 13th August 2012. A lot of superior returns have been had from those allegedly expensive stocks in the subsequent seven years.

The argument might be encapsulated thus: stocks of the sort which our Fund owns have had a good run of outperformance as has the Fund but this is all about to end, or even has already ended, and so-called 'value investing' — buying stocks mainly based upon their supposed under valuation by the market — is making a comeback and funds which pursue that strategy are about to outperform us.

Value investing has its flaws as a strategy. Markets are not perfect but they are not totally inefficient either and most of the stocks which have valuations which attract value investors have them for good reason — they are not good businesses. This means that the value investor who buys one of these companies which are indeed lowly rated but which rarely or never make an adequate return on capital is facing a headwind. The intrinsic value of the company does not grow (except for any new capital that its hapless investors allow it to retain or subscribe for in some form of share issue), or even erodes over time, whilst the value investor is waiting for the lowly valuation to be recognised and the share price to rise to reflect this.

Moreover, even when the value investor gets it right and this happens, they then need to sell the stock which has achieved this and find another undervalued stock and start again. This activity obviously incurs dealing costs but value investing is not something which can be pursued with a 'buy and hold' strategy. In investment you 'become what you eat' insofar as over the long term the returns on any portfolio which has such an approach will tend to gravitate to the returns generated by the companies themselves, which are low for most value stocks. As Charlie Munger, Warren Buffett's business partner, said:
'Over the long term, it's hard for a stock to earn a much better return than the business which underlies it earns. If the business earns six percent on capital over forty years and you hold it for that forty years, you're not going to make much different than a six percent return — <u>even if you originally buy it at a huge discount</u>. Conversely, if a business earns eighteen percent on capital over twenty or thirty years, <u>even if you pay an expensive looking price</u>, you'll end up with one hell of a result.' Our emphasis added.

Mr Munger is not offering a theory or an opinion — what he is saying is a mathematical certainty. The only uncertainty concerns our ability to forecast returns far ahead, which is why we prefer to invest in relatively predictable businesses.

The biggest flaw in value investing is that is does not seek to take advantage of a unique characteristic of equities. Equities are the only asset in which a portion of your return is automatically reinvested for you. The retained earnings (or free cash flow if you prefer that measure, as we do) after payment of the dividend are reinvested in the business. This does not happen with real estate — you receive rent not a further investment in buildings, or with bonds — you get paid interest but no more bonds.

This retention of earnings which are reinvested in the business can be a powerful mechanism for compounding gains. Some 80% of the gains in the S&P 500 over the 20th century came not from changes in valuation but from the companies' earnings and reinvestment of retained capital. If you were a great (and long-lived) value investor who bought the S&P 500 at its low in valuation terms, which was in 1917 when America entered world war one and it was on a P/E of 5.3x, and sold it at its high in valuation terms in 1999 when it was on a P/E of 34x, your annual return during that period would have been 11.6% with dividends reinvested, but only 2.3% p.a. came from the massive increase in P/E and 9.3% (80% of 11.6%) came from the companies' earnings and reinvesting their retained earnings.

The S&P example is for 500 average large companies. This proportion of your return from the companies' reinvestment activities is even more extreme when you invest in a good company with a high return on retained capital than in an average company.

All of this was much more succinctly encapsulated by Warren Buffett when he said:
'*It's far better to buy a wonderful company at a fair price, than a fair company at a wonderful price*.'

He made the transition from being a traditional value investor based upon studying under Benjamin Graham (author of "The Intelligent Investor" and "Security Analysis") into a quality investor looking for companies which could compound in value based upon the teachings of Philip Fisher (author of *Common Stocks and Uncommon Profits*) and the influence of Charlie Munger.

Here's how Buffett explained this change in his 1989 letter to Berkshire Hathaway shareholders:
'The original 'bargain' price probably will not turn out to be such a steal after all. In a difficult business, no sooner is one problem solved than another surfaces — never is there just one cockroach in the kitchen. [Plus], any initial advantage you secure will be quickly eroded by the low return that the business earns. For example, if you buy a business for $8 million that can be sold or liquidated for $10 million and promptly take either course, you can realize a high return. But the investment will disappoint if the business is sold for $10 million in ten years and in the interim has annually earned and distributed only a few percent on cost. Time is the friend of the wonderful business, the enemy of the mediocre.'

The problems of waiting for value investment to pay off can be seen in the performance of the MSCI World Value Index (USD) which hit 6570 at the end of October 2007 and was lower than this at the end of February 2016. At 31st December 2019 it stood at 9812, just 49% higher than its 2007 peak value.

Compare and contrast the S&P 500 (USD) which peaked on 9th October 2007 but had regained its 2007 high by 2013 and at 31st December 2019 stood 189% higher.

Ah, but I can hear the siren song of the value investors who will take this data as confirmation that the resurgence of value investment which they have long predicted is about to commence. As an old saying goes 'To a man with a hammer, everything looks like a nail'.

The longer the strategy underperforms the market and the more money it costs investors the louder the siren song becomes. And sooner or later they will be right. But a) they have no idea when that will be (note the reference above to Investment Adviser's comment in 2012); b) if you had followed their advice to date it would require a gargantuan reversal of performance to make up the gains forgone; and c) that may continue to be the case for some time to come.

Lastly, there are some commentators who say that one way to address this is to have a portion of your portfolio invested in both strategies — some in quality growth and some in value. I think the assertion that there is no harm in this diversification approach has been disproved rather comprehensively by Warren Buffett, but what does he know? Perhaps we should look at the value investment versus quality and growth strategy debate this way: would you rather side with a) a large section of the UK financial press and rent-a-quote investment advisers; or b) Warren Buffett, Charlie Munger (Berkshire Hathaway), Bill Gates (Microsoft), the Bettencourt family (L'Oréal), the Brown family (Brown-Forman), the Walton family (Walmart) and Bernard Arnault (LVMH)? The latter all seem to have become extraordinarily rich by concentrating their investment in a single high quality business and not trading regardless of valuation. So much for it not doing any harm to diversify across strategies.

It seems impossible to comment upon developments in equity investing in the UK in 2019 without mentioning the word Woodford. The demise of Woodford Investment Management following the 'gating' of its main LF Woodford Equity Income Fund was undoubtedly the main news in the industry last year.

We have no desire to engage in a general commentary on this matter or to engage in an unseemly exercise in schadenfreude. We had long identified the problems which were brewing at Woodford but we kept our own counsel on the matter. The only comments you will find from us mentioning Woodford were in answer to direct questions concerning Woodford from our investors at our Annual Meeting. We regard it as a lack of professional courtesy to comment upon our competitors except when we are asked to do so by our investors. We only wish others in the industry would maintain the same stance.

However, we now feel freer to comment on Woodford since it is hard to see how it can now exacerbate the situation, and I feel that we need to as the Woodford debacle has raised important questions about the industry, some of which have been directed at us and I feel that our investors should know our response.

The most obvious problem at Woodford was the lethal combination of a daily-dealing open-ended fund with significant holdings in unquoted companies and large percentage stakes in small quoted companies which had very limited liquidity. Whilst this was clearly a very bad idea, Woodford is not the only fund to have encountered this problem. A large swathe of UK property funds was gated after the Brexit Referendum for the same reason, and more recently so was the M&G Property Fund. An open-ended daily-dealing fund is clearly not an appropriate vehicle through which to hold such assets. The daily-dealing and open-ended structure give investors the illusion of liquidity but when a large number of them try to exercise it at once the effect is similar to shouting 'Fire!' in a crowded theatre.

Amongst the causes which commentators seem to have failed to realise is the effect which the rise of investment platforms has had on this, and indeed other areas of the fund management industry. It is now the case that no one can expect to effectively market an open-ended fund on any of the major investment platforms which retail investors and wealth managers use to manage their investments unless it is a daily-dealing fund. As none of these platforms will admit an open-ended fund, unless it allows daily-dealing, that is what fund managers will use even for strategies for which this structure is wholly inappropriate.

Where does the Fundsmith Equity Fund stand on this? We have always regarded liquidity as an important issue. As evidence of this, we have published a liquidity measure on our Fund factsheet since 2012. Equally we only invest in large companies. At 31st December 2019 the average market capitalisation of the companies in our Fund was £114bn and we estimate we could liquidate 57% of the Fund in seven days.

The reality is that the only type of fund which can guarantee 100% liquidity on demand is a cash fund, and I presume that is not what you wish us to invest in. But I suspect you will find it hard to find more liquid equity funds than ours. It tells you much about its liquidity that some of the least liquid stocks we hold are the FTSE 100 companies, InterContinental Hotels, Intertek and Sage.

Another question which arises from the Woodford incident is the question mark over so-called 'star' fund managers, a label the press seems obsessed by. I can't say I like the term, it strikes me as equally inappropriate as the term 'beauty parade' which is used when selecting professional advisers, many of whom do not seem to me to have obvious photogenic qualities.

I think this concern is focused on the wrong issue. I think it makes no more sense to avoid funds run by 'star' fund managers any more than it does to avoid supporting sporting teams because they have star players. The trouble arises not because teams have star players but if the star tries to play a different game to the one which delivered their stellar performance. Would Juventus do as well if Cristiano Ronaldo played as goalkeeper? How is Usain Bolt's second career as a soccer player going?

Neil Woodford made his name as a fund manager at Invesco Perpetual with his successful Income Fund. In the course of this he took two high profile negative positions on sectors. In the run up to the dotcom bust in 2000 he seems to have seen what was coming and avoided investments in technology, media and telecommunications stocks which was a major success. He also paired this with taking positions in some of the old economy neglected stocks which had become de-rated during the dotcom mania. Similarly, in the run up to the Credit Crisis he decided not to hold bank stocks.

However, when he opened his own fund management business he took positions in a wide range of companies — AA, AstraZeneca, Capita, Imperial Brands, Provident Financial and Stobart are some examples. There is no common theme that I can detect to those companies, other than the fact that they all subsequently fared badly. This was supplemented by a raft of unquoted investments in start-ups and biotech. My suggestion is that what went wrong is that Neil Woodford changed his investment strategy. In the technical jargon of the industry, he engaged in 'style drift'. The problem wasn't that he was regarded as a star but that he changed his game. This style drift actually started when he was still at Invesco Perpetual in that his Income Fund began to accumulate large stakes in small illiquid companies and unquoteds, but this was taken further once he had his own firm.

Is there any chance of style drift or a similar change of strategy at Fundsmith? I think not. We published an Owner's Manual at the outset which describes our investment strategy, write to you in these annual letters analysing how we are faring in implementing our strategy and are the only mutual fund in the UK which holds an annual meeting at which our investors can question us and see their questions answered publicly. So, it would be extraordinary if we were able to effect a change in our investment strategy without you noticing.

Moreover, we have no desire to change our strategy. We are convinced that it can deliver superior returns over the long term. I would pose a different question which links the discussion of the Woodford affair with the earlier discussion of the 'rotation' from quality stocks into value stocks. If you expect such a 'rotation' to occur at some point and for value stocks to enjoy a period in the sun would you rather we tried to anticipate that and switched into a value investment approach of buying stocks based mainly or solely on the basis of their valuation or would you rather we stuck to our existing approach of buying and holding high quality businesses? I would suggest the latter approach might be better, and it is what we are doing. There will be no style drift at Fundsmith.

Finally, I wish you a happy New Year and thank you for your continued support for our Fund. My colleagues and I look forward to seeing many of you at our Annual Shareholders' Meeting on 25th February 2020 and to trying to answer any questions you may have. Please see the enclosed invitation for details.

Yours sincerely,

Terry Smith

Terry Smith
CEO
Fundsmith LLP

Disclaimer: A Key Investor Information Document and an English language prospectus for the Fundsmith Equity Fund are available via the Fundsmith website or on request and investors should consult these documents before purchasing shares in the fund. Past performance is not necessarily a guide to future performance. The value of investments and the income from them may fall as well as rise and be affected by changes in exchange rates, and you may not get back the amount of your original investment. Fundsmith LLP does not offer investment advice or make any recommendations regarding the suitability of its product. This document is communicated by Fundsmith LLP which is authorised and regulated by the Financial Conduct Authority.

Sources: Fundsmith LLP & Bloomberg unless otherwise stated.

Portfolio turnover has been calculated in accordance with the methodology laid down by the FCA. This compares the total share purchases and sales less total creations and liquidations with the average net asset value of the fund.

P/E ratios and Free Cash Flow Yields are based on trailing twelve month data and as at 31st December 2019 unless otherwise stated.

Fund liquidity is based on 30% of average trailing 20 day volume.

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31st March 2020

Dear Fellow Investor,

It would be an understatement to say it has been an eventful start to the year so I thought I should take this opportunity to update you on how we are faring in the coronavirus Covid-19 pandemic environment.

First and foremost, the Fundsmith Equity Fund ('Fund') continues to operate. We can price it, people can deal in it and we have been able to provide liquidity where required.

I know that you normally just look at the price and do not worry about such matters, but we need you to know that you can contact us, that any information you need will be provided, and that any dealing instructions you give us will be executed. This is important. If we fail on one or more of those aspects we need not worry about what comes next. As Rick Mears, one of only three drivers to win the Indianapolis 500 Race four times, said 'In order to finish first. You must first finish.'

Secondly, our Fund's performance has been as we would have expected, hoped and predicted. I would even say it is satisfactory if you accept that some fall in valuation is inevitable in a bear market.

% Change	**2020 YTD**
Fundsmith Equity Fund[1]	-7.9
MSCI World[2]	-15.7
MSCI World Value[2]	-22.0
FTSE 100[3]	-23.8

[1] T Class Acc shares, net of fees, priced at noon UK time, source: Fundsmith LLP
[2] MSCI Indices, £ net, priced at US market close, source: Bloomberg
[3] FTSE 100, £, total return, priced at UK market close, source: Bloomberg

The Fundsmith Equity Fund[1] is down 7.9% for the Year to date having outperformed the comparator MSCI World Index[2] by nearly 8%. It outperformed the FTSE 100[3] by nearly 16% and the MSCI World Value Index[2] by over 14%.

It also outperformed all these indices significantly in the fall from the peak of the market to its trough before the recent rally. Bear in mind the MSCI World and FTSE 100 indices benefit from the inclusion of our companies. The companies we do not own are collectively performing worse than the index numbers.

As you know, I was immensely sceptical of the view that so-called value stocks could protect you in a downturn. I have never been a believer in the philosophy that so-called “value” investments would perform well or protect your investment in an economic and market downturn. Shares in companies that are lowly rated are so mostly for good reasons. Because their businesses are heavily cyclical, highly leveraged, they have poor returns on capital and/or they face other structural or management issues. It doesn’t sound like a combination likely to protect the business and your investment in difficult times, and so it has proven thus far.

Our companies which are most in the firing line – Amadeus and InterContinental Hotels in airline reservations and hotels – are sensibly putting in place cost cutting and cash conservation measures and securing liquidity to enable them to hold their breath for 18 months or so with no revenues. This in our view is far more useful than speculation about what their sector will look like afterwards. They have to survive to find out (reference Mr. Mears thoughts earlier). If our equity in both is vaporised we will lose about 5% of our current portfolio. Whilst I would not be pleased with that, if that’s the worst thing that happens I would suggest we can live with it. Whilst we have various stocks exposed to knock-on effects in travel retail for example in cosmetics and drinks, and supply chain issues in other portfolio companies, if we were forced to guess we think about a third of the portfolio will endure this year with increased revenues – Microsoft, the payment processors, Clorox, and Reckitt Benckiser, for example.

It is said that every cloud has a silver lining and we are seeing opportunities and have bought two new holdings which we have been following for some while and which have been hard hit in this market because of China exposure and a classic “glitch”.

I suspect the current market reaction to the pandemic is explained by a simple analogy which relates to the virus itself. The COVID-19 virus is not fatal for the vast majority of the population. However, where it seems to be lethal is when it encounters someone with an immune system already weakened by age and/or pre-existing ailments.

Similarly, what has increased the impact of the virus, or rather measures taken to counter it, on the economy and markets is that in this area it has encountered structures with weakened immune systems too. The fact that most of the emergency measures taken in 2008—09 – deficit spending, low or zero interest rates and Quantitative Easing – were still in place 10 years after the crisis demonstrated that the patient – in this case the global economy – was not back in rude health when the virus struck. Cue a market panic.

What will emerge from the current apocalyptic state? How many of us will become sick or worse? When will we be allowed out again? Will we travel as much as we have in the past? Will the extreme measures taken by governments to maintain the economy lead to inflation? I haven’t a clue. Rather like some of the companies we most admire, I try to spend very little time considering matters which I can neither predict nor control and focus instead on those which I can affect. So at Fundsmith our focus will be on keeping our service to investors fully functioning, and then seeking to grasp any new investment opportunities which are unearthed by the turmoil whilst ensuring that our colleagues, families, friends, and anyone else we can reach receives any help they need and that we can provide.

I hope and expect that our strategy of only investing in good businesses will continue to see our Fund through these trying times intact and continuing to prosper.

Yours as ever,

Terry Smith

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January 2021

Dear Fellow Investor,

This is the eleventh annual letter to owners of the Fundsmith Equity Fund ('Fund').

The table below shows performance figures for the last calendar year and the cumulative and annualised performance since inception on 1st November 2010 and various comparators.

% Total Return	1st Jan to 31st Dec 2020	Inception to 31st Dec 2020 Cumulative	Inception to 31st Dec 2020 Annualised	Sharpe ratio[5]	Sortino ratio[5]
Fundsmith Equity Fund[1]	+18.3	+449.3	+18.2	1.11	1.06
Equities[2]	+12.3	+214.8	+11.9	0.56	0.52
UK Bonds[3]	+4.6	+47.5	+3.9	n/a	n/a
Cash[4]	+0.3	+6.3	+0.6	n/a	n/a

[1] T Class Acc shares, net of fees, priced at noon UK time, source: Fundsmith LLP
[2] MSCI World Index, £ net, priced at US market close, source: Bloomberg
[3] Bloomberg/Barclays Bond Indices UK Gov. 5–10 yr., source: Bloomberg
[4] 3 Month £ LIBOR Interest Rate, source: Bloomberg
[5] Sharpe & Sortino ratios are since inception on 1.11.10 to 31.12.20, source: Financial Express Analytics

The table shows the performance of the T Class Accumulation shares, the most commonly held share class and one in which I am invested, which rose by +18.3% in 2020 and compares with a rise of +12.3% for the MSCI World Index in sterling with dividends reinvested. The Fund therefore beat this comparator in 2020, and our Fund is the second best performer since its inception in the Investment Association Global sector with a return 283 percentage points above the sector average which has delivered just +166.6% over the same timeframe. The annual return of 18.3% is almost exactly in line with our ten year average.

However, I realise that many or indeed most of our investors do not use these as the natural comparator for their investments. Those of you who are based in the UK may look to the FTSE 100 Index ('FTSE 100') as the yardstick for measuring your investments and may hold funds which are benchmarked to this index and often hug it. The FTSE 100 delivered a total return of -11.5% in 2020 so our Fund outperformed this by a margin of 29.8 percentage points.

For the year the top five contributors to the Fund's performance were:

PayPal	+5.1%
IDEXX	+3.1%
Microsoft	+2.8%
Intuit	+1.5%
Facebook	+1.4%

Microsoft makes its sixth appearance whilst PayPal is putting in an appearance for the fourth year running. IDEXX is making its third appearance. Someone once said that no one ever got poor by taking profits. This may be true but I doubt they got very rich by this approach either. We are not the sort of people who ever declare victory — we invest with a strong sense of paranoia — but it continues to be pleasing to note the contribution of Facebook which was certainly our most controversial stock purchase and led to more questions (and demands for its sale) from some of our investors than any other company. We had similar views expressed to us when we purchased Microsoft. You rarely get to purchase high quality businesses at cheap prices unless there is a 'glitch' which provides an opportunity to do so.

The bottom five were:

Amadeus	-1.1%
Sage	-0.6%
InterContinental Hotels	-0.6%
Becton Dickinson	-0.4%
Philip Morris	-0.2%

We hardly need to discuss the reasons for the poor performance of Amadeus and InterContinental Hotels. Airline and travel reservations and hotel management have not been happy places to be in the past year, although it is worth noting nowhere near as bad as investing in actual airlines or hotels. Amadeus's share price fall of -13.5% in 2020 compares with a drop of -27.9% for the Bloomberg World Airlines Index. InterContinental's share price fall of -9.9% compares with a drop of -35.1% for the Dow Jones US Hotel and Lodging REIT Index. This illustrates the virtues of Amadeus's and InterContinental's business models in contrast to the industries they serve.

However, in both cases whilst they face a difficult situation, we are pleased that management has spent its time and effort managing liquidity and costs in an effort to ensure that they survive these events rather than pointlessly speculating about the likely timescale and course of recovery. In both cases we believe that they should not only survive but also strengthen their competitive position.

Sage's share price remains in the doldrums as we wait to see whether the new management team can make the product fit for purpose in the age of the cloud and subscription software and compete effectively with those who can.

We are impressed with Philip Morris's development of Reduced Risk Products or RRPs, most notably its heat not burn system iQOS. It seems we are not the only ones to view it this way as it was recently included in the Dow Jones Sustainability North America Index for the first time. For the moment the shares are weighed down by COVID related disruption to some of its markets and simple prejudice which seems to prevent some commentators from weighing the benefits the RRPs bring against the obvious fact that it is a tobacco company.

We sold our stakes in Clorox and Reckitt Benckiser and purchased stakes in Nike and Starbucks during the year. Clorox and Reckitt Benckiser traded strongly due to the rush to purchase increased quantities of household cleaning products, personal cleaning products and OTC medicines. We felt that in both cases the ratings achieved did not reflect the pedestrian nature of these businesses in more normal circumstances or the issues they face which may come back into focus if or when the COVID related boost fades. Moreover, at the same time as these two stocks were enjoying an unusually good performance, two other companies which we admire saw share price falls of over 40% at the height of the panic over COVID — Nike and Starbucks. They are probably familiar to you as the world's leading sneaker and sporting apparel supplier and the leading coffee shop brand. Both are companies with high returns on capital and good growth rates — two characteristics which we seek.

In the case of Nike we felt that few companies were as well adapted to digital distribution of its products which has become de rigeur as a result of the COVID induced restrictions.

Whilst it is easy to see the challenge to the lockdowns for Starbucks's urban outlets which partly rely on seating and coffee collected on the way to the office, this is far from their only format. The sometimes spectacular queues and resulting traffic jams at Starbucks drive-through outlets both illustrate another format and testify to the continued loyalty to the brand as does the rise in loyalty club members in 2020. During this period Starbucks's main competitor in its second largest market — Luckin Coffee in China — was exposed as a fraud in yet another illustration of the rule that it is only when the tide goes out that you find out who has been swimming naked.

After the COVID lockdowns we also purchased a stake in LVMH — the world's leading designer and luxury goods business. Although we had some exposure to luxury goods through our cosmetics and drinks companies, we had no exposure to designer apparel and jewellery which LVMH brings.

We continue to apply a simple three step investment strategy:

- Buy good companies
- Don't overpay
- Do nothing

I will review how we are doing against each of those in turn.

As usual we seek to give some insight into the first and most important of these — whether we own good companies — by giving you the following table which shows what Fundsmith would be like if instead of being a fund it was a company and accounted for the stakes which it owns in the portfolio on a 'look through' basis, and compares this with the market, in this case the FTSE 100 and the S&P 500 Index ('S&P 500'). This shows you how the portfolio compares with the major indices and how it has evolved over time.

	Fundsmith Equity Fund Portfolio								**S&P 500**	**FTSE 100**
Year ended	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2020**	**2020**
ROCE	31%	29%	26%	27%	28%	29%	29%	25%	11%	10%
Gross margin	63%	60%	61%	62%	63%	65%	66%	65%	44%	39%
Operating margin	24%	25%	25%	26%	26%	28%	27%	23%	12%	9%
Cash conversion	108%	102%	98%	99%	102%	95%	97%	101%	94%	95%
Interest cover	16x	15x	16x	17x	17x	17x	16x	16x	6x	6x

Source: Fundsmith LLP/Bloomberg. ROCE, Gross Margin, Operating Profit Margin and Cash Conversion are the weighted mean of the underlying companies invested in by the Fundsmith Equity Fund and mean for the FTSE 100 and S&P 500 Indices. The FTSE 100 and S&P 500 numbers exclude financial stocks. Interest Cover is median. 2013-2019 ratios are based on last reported fiscal year accounts as at 31st December and for 2020 are Trailing Twelve Months and as defined by Bloomberg. Cash Conversion compares Free Cash Flow per Share with Net Income per Share. Percentage change is not calculated if the TTM period contains a net loss

Returns on capital and profit margins were lower in the portfolio companies in 2020. This is hardly surprising in light of events in the economy, but the scale of the falls were hardly disastrous. When people have said to us, 'You invest in non-cyclical businesses' I always reply that I have never found one. It is the degree of cyclicality in our portfolio which we seek to control through our stock selection. As a group our stocks still have excellent returns, profit margins and cash generation even in poor economic conditions. As you can see the same cannot be said for the major indices even though they have the benefit of including our good companies.

The average year of foundation of our portfolio companies at the year-end was 1922. They are just under a century old collectively.

Consistently high returns on capital are one sign we look for when seeking companies to invest in. Another is a source of growth — high returns are not much use if the business is not able to grow and deploy more capital at these high rates. So how did our companies fare in that respect in 2020? The weighted average free cash flow (the cash the companies generate after paying for everything except the dividend, and our preferred measure) grew by 8% in 2020.

This leads onto the question of valuation. The weighted average free cash flow (‘FCF’) yield (the free cash flow generated by the companies divided by their market value) of the portfolio at the outset of the year was 3.4% and ended it at 2.8%, so they became more highly rated as growth in the share prices has significantly outperformed growth of the free cash flows. Whilst this is a good thing from the viewpoint of the performance of their shares and the Fund, it makes us nervous as changes in valuation are finite and reversible, although it is hard to see the most likely source of such a reversal — a rise in interest rates — in the near future.

The year-end median FCF yield on the S&P 500 was 3.7%. The year-end median FCF yield on the FTSE 100 was 4.2%. More of our stocks are in the former index than the latter and I will not repeat the explanation which I gave in my 2017 annual letter on why I think the FTSE 100 is not an appropriate benchmark or investment proxy for our investors to use. Moreover, the valuation disparity with the FTSE 100 has been widened by the portfolio’s 30% outperformance of the FTSE 100 during the year. It’s hard to outperform by such a wide margin without becoming relatively more highly valued unless the portfolio’s cash flows have grown at a similar differential rate. What the market seems to be rewarding is consistency of performance which has been emphasised by economic conditions in 2020.

Our portfolio consists of companies that are fundamentally a lot better than the average of those in either index and are valued much more highly than the average FTSE 100 company and higher than the average S&P 500 company. It is wise to bear in mind that despite the rather sloppy shorthand used by many commentators, highly rated does not equate to expensive any more than lowly rated equates to cheap.

Turning to the third leg of our strategy, which we succinctly describe as ‘Do nothing’, minimising portfolio turnover remains one of our objectives and this was again achieved with a portfolio turnover of 4.1% during the period. It is perhaps more helpful to know that we spent a total of just 0.03% (3 basis points) of the Fund’s average value over the year on voluntary dealing (which excludes dealing costs associated with fund subscriptions and redemptions as these are involuntary). We have held nine of our portfolio companies since inception in 2010.

Why is this important? It helps to minimise costs and minimising the costs of investment is a vital contribution to achieving a satisfactory outcome as an investor. Too often investors, commentators and advisers focus on, or in some cases obsess about, the Annual Management Charge ('AMC') or the Ongoing Charges Figure ('OCF'), which includes some costs over and above the AMC, which are charged to the Fund. The OCF for 2020 for the T Class Accumulation shares was 1.06%. The trouble is that the OCF does not include an important element of costs — the costs of dealing. When a fund manager deals by buying or selling, the fund typically incurs the cost of commission paid to a broker, the bid-offer spread on the stocks dealt in and, in some cases, transaction taxes such as stamp duty in the UK. This can add significantly to the costs of a fund, yet it is not included in the OCF.

We provide our own version of this total cost including dealing costs, which we have termed the Total Cost of Investment ('TCI'). For the T Class Accumulation shares in 2020 this amounted to a TCI of 1.09%, including all costs of dealing for flows into and out of the Fund, not just our voluntary dealing. We are pleased that our TCI is just 0.03% (3 basis points) above our OCF when transaction costs are taken into account. However, we would again caution against becoming obsessed with charges to such an extent that you lose focus on the performance of funds. It is worth pointing out that the performance of our Fund tabled at the beginning of this letter is after charging all fees which should surely be the main focus.

Some commentators have attributed our recent outperformance to the performance of technology stocks accompanied by warnings that a 'bubble' is building in technology stocks rather like the Dotcom Bubble and that it may burst with similar ill effects. The technology heavy NASDAQ Index has provided a total return of +40.9% in 2020 and the MSCI World Information Technology Index delivered +40.2% so maybe they have a point.

I suspect that some of these commentators are the same ones who told you some years ago that our investment strategy was too heavily dependent on consumer staples stocks which they also viewed as over-rated. However, it's always good to start with the facts. Our Fund's sectoral exposure was as follows at the year-end:

Sector	**%**
Technology	28.9
Consumer Staples	27.0
Healthcare	22.6
Consumer Discretionary	10.1
Communication Services	4.5
Industrials	3.4
Cash	3.5

Technology is certainly the largest sectoral exposure but it is closely followed by Consumer Staples and in fact if you take all our consumer stocks — discretionary and staples — together, they far outweigh our technology exposure.

Moreover, I am not sure that these sector labels are all that helpful in determining what we are really exposed to. For example, our Communication Services holding is in fact Facebook. Isn't that a technology company?

What do the following companies have in common? Amadeus, Automatic Data Processing, Facebook, Intuit, Microsoft, PayPal, Sage and Visa? They are all owned by our Fund and they are all labelled as technology companies. Yet they span airline reservation systems; payroll processing; social media, digital advertising and communications; accounting and tax software; operating systems, distributed computing (the 'cloud'), software development tools, business applications and video gaming; and payment processing. I would suggest that the secular drivers of these businesses have some distinct differences and that their prospects are not governed by a single factor — technology. This one size fits all label does not help much in evaluating them.

There are also issues with the relative valuation of some technology businesses which — like a number of businesses of the sort we seek to invest in — rely on intangibles.

The main assets of the companies we seek to invest in are often intangible. Some examples of intangible assets are brands, copyrights, patents, know-how, installed bases of equipment which require servicing and maintenance and so produce customers who are locked-in to the supplier, software systems which are critical to a business or person and so-called network effects. They are distinct from tangible assets such as real estate, machinery and equipment, and vehicles.

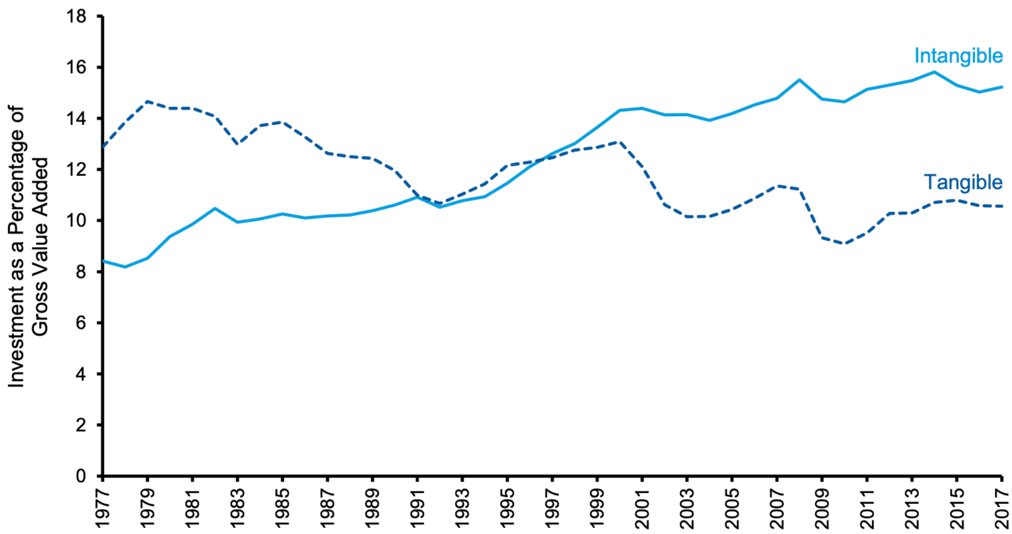
The return on intangible assets is higher as they mostly need to be funded with equity not debt and attract an appropriate return. Lenders seem to crave the often false security of lending against tangible collateral. Intangible assets can also last indefinitely if they are well maintained by advertising, marketing, innovation and product development and the duration of an asset is an important factor in figuring out its real returns.

However, there are obvious problems in comparing businesses which rely on tangible assets with those that rely mostly on intangibles. Tangible assets appear on a company's balance sheet. Cash is expended to purchase them or liabilities are assumed (debt or leases) and the assets are placed on the balance sheet. Only the depreciation charge, if any, enters the profit and loss account and there may be no impact on cash flow after the purchase. In contrast, intangible assets are mostly built through spending which goes through the profit and loss account and cash flow. Although some software development is capitalised, most is not and neither is brand development nor most research & development. Of course acquisitions skew this picture.

The net result is that for any given level of investment in assets, the profitability of a company building an intangible asset is likely to be depressed versus a company building or buying a tangible asset. This makes a mockery of the comparison of their valuations which are done by some commentators and investors who simply compare their price-to-earnings ratios (‘PE’).

In addition, the degree to which this needs to be taken into account in making such comparisons has been rising. The chart below shows the rise of intangible investments by US corporations:

The Rise of Intangible Investments in the US, 1977-2017

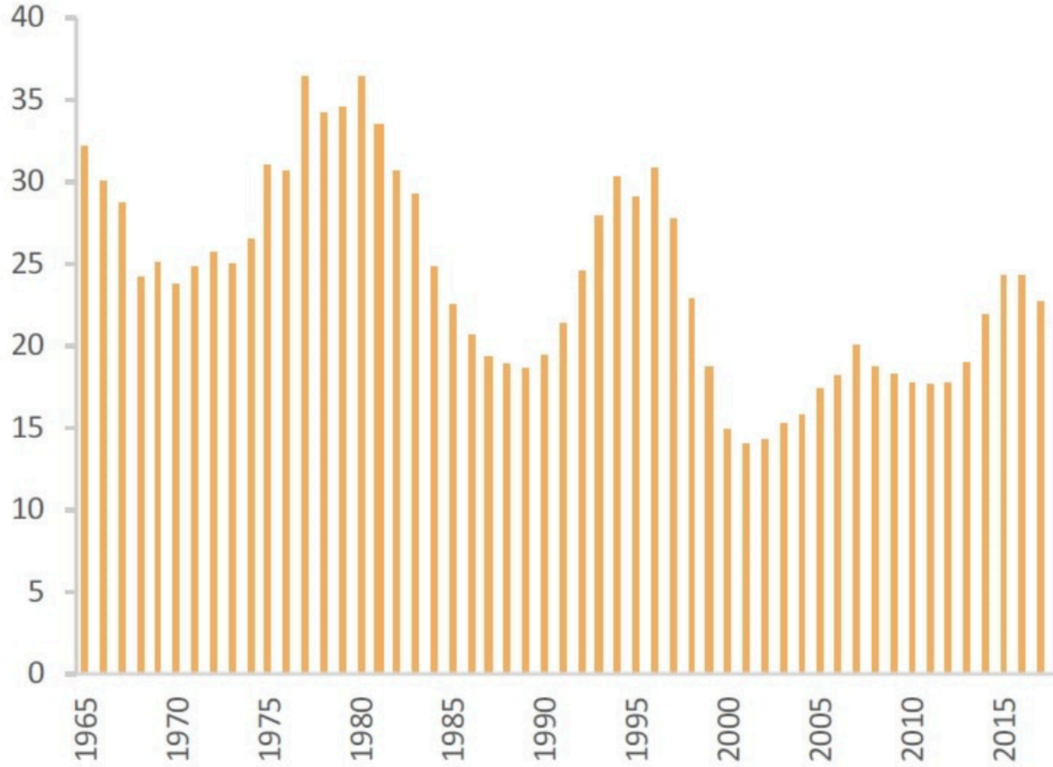


Source: Morgan Stanley (2020), Corrado and Hulten (2010)

As you can see intangible investments have been rising inexorably since the mid-1970s and overtook the proportion of investment in tangible assets in the 1990s — not coincidentally as the internet age hit full pace.

This not only makes comparisons between different types of company difficult, it also makes assertions about market valuations over time — such as the Cyclically Adjusted PE (or CAPE) difficult. A simple illustration of this is that in 1964 the average (median) tenure of a company that was in the S&P 500 was 33 years. By 2016 this had fallen to 24 years:

Average Company Lifespan in S&P 500 Index



Source: Innosight analysis based on public S&P 500 data sources. www.innosight.com. Years, rolling 7 year average

They are not the same companies and at least in part not even the same sort of companies.

I lived through the rise and fall of the Japanese equity market. When it reached its peak in 1989 with a PE of over 60 we were told that this was because Japanese company accounting was much more conservative than western companies. In fact, their shares were just expensive. So I am wary of explanations for why we should accept high valuations, especially if they are based upon theories about accounting. But whilst Sir John Templeton did say that the four most dangerous words in investment are ‘This time it’s different’ (which is actually five words before anyone points this out) sometimes it really is different and if you miss such inflection points it is to the detriment of your net worth.

It is impossible for me to report on 2020 without mentioning COVID. I hope you agree that our portfolio performed well, both in terms of the share price performance and the fundamental performance of the companies, which is just as important.

It is also important to note that our operations were not impaired by the lockdowns and travel restrictions. Whilst the performance of the fund is important, it is also important that if you wish to contact us you can and are dealt with promptly and efficiently. You should be able to get any information you reasonably require which should be accurate and up to date. Perhaps most importantly, if you wish to deal — including redeeming your investment — we can execute for you. All of these vital functions continued seamlessly throughout the depths of the lockdowns. We have long been managing the dealing, operations, portfolio management and research across a number of widespread geographies, much to the amazement of some people who felt this could only be accomplished in a few London postcodes. So the need to Work From Home and an inability to travel were not major obstacles for us.

Sadly, one thing which won't be business as usual is our Annual Meeting. Given the ongoing restrictions on public gatherings we have taken the decision that we will not be able to host an in-person meeting this year. However, we are delighted that Ian King from Sky News will chair a recorded question and answer session that we will post on our website on Tuesday 2nd March. Please send your questions to ASM@fundsmith.co.uk and Ian will select the most topical which Julian and I will endeavour to answer.

One of the mantras which has been regularly trotted out by commentators is that the events of 2020 are unprecedented. Whilst that is literally true, as Mark Twain observed, history doesn't repeat itself but it often rhymes. It is certainly true that most of us have never experienced anything like it, yet it may not be strictly true that the events of 2020 are without precedent.

There have been six identifiable pandemics over the past 130 years:

Recent Pandemics	**Estimated Deaths**
Russian Flu (1889–90)	1m
Third Plague (1894–1922)	12m
Spanish Flu (1918–19)	50m
Asian Flu (1957–58)	2–5m
Hong Kong Flu (1968–69)	1–4m
Swine Flu (2009–10)	0.5m

We might be able to draw some parallels from these past pandemics as a guide for what may happen as a result of COVID.

One of the conclusions that you might draw from the economic effects of pandemics is that they do not so much cause new trends but rather they accelerate some existing trends.

The most obvious comparator — and one which people have most frequently alighted upon — is the Spanish Flu pandemic of 1918–19. The death toll of at least 50 million people caused a reduction in the workforce which may have been a factor in the subsequent widespread adoption of assembly line techniques for mass production. The assembly line was not invented as a result of the

Spanish Flu pandemic — the Model T Ford was put on an assembly line in 1913 — but it accelerated its adoption.

The increase in productivity this delivered helped to fuel an economic boom as the cost of production of items such as cars and household electrical appliances were reduced as the volume of production rose so that they became affordable by the middle classes for the first time. This helped to fuel the economic and stock market boom of the Roaring Twenties.

Might something similar happen as a result of COVID? Obviously, I do not know, and fortunately my predictive capability is not the basis of our investment strategy. However, there are some clear signs that existing trends have been accelerated by COVID. For example:

- E-commerce
- Online working from remote locations using the cloud or distributed computing
- Home cooking and food delivery
- Online schooling and medicine
- Social media and communications
- Pets — which have become more important in isolation and when their owners are at home more
- Automation and AI

The result is that many people have become more productive. Salespeople can visit many more clients if video conferencing is acceptable and at virtually no incremental cost. We receive reports of factories which we are told are operating with 50% staffing due to social distancing rules but which have more or less maintained production. I wonder what conclusion that leads to.

Of course not all businesses benefit from these developments. The airline industry, hospitality, bricks & mortar retailing and office property may all have some very difficult problems to face, just as you wouldn't have wanted to have been a saddler when Henry Ford and his competitors hit their stride.

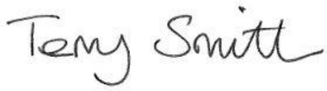
I became increasingly bemused listening to or reading various commentators predict that the economic recovery from the COVID lockdowns would be V shaped, or shaped like a U, an L, a W, a bathtub or like the Nike swoosh (I'm not making this up). But just when I was bored of this entire meaningless alphabet soup of predictions, I came across one that I thought might be correct and help to explain what may happen. It was that the recovery may be shaped like a K. A K shaped recovery occurs when different sectors of the economy emerge from a downturn with sharply differing trajectories — like the arms of the Roman letter K.

Imagine if you had been told this time last year that there would be a pandemic and that the measures taken to contain it would so affect the world economy that US GDP would fall by 9% in the second quarter of the year and the hospitality and travel sectors would be devastated by the measures as would large segments of traditional retail activity. Considering this would you have predicted that the MSCI World Index would deliver a return of 12.3%, slightly above its ten year average? Hopefully this illustrates the dangers of forecasting and market timing even when you know what major events will occur.

I will leave you with this thought: What are the similarities between a forecaster and a one-eyed javelin thrower? Answer: Neither is likely to be very accurate but they are typically good at keeping the attention of the audience.

Finally, may I wish you a happy New Year, a COVID free 2021 and thank you for your continued support for our Fund.

Yours sincerely,



Terry Smith
CEO
Fundsmith LLP

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PE ratios and Free Cash Flow Yields are based on trailing twelve month data and as at 31st December 2020 unless otherwise stated.

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August 2021

Dear Fellow Investor,

The table below shows the performance of the Fundsmith Equity Fund ('Fund') during the first half of 2021 and since inception and other comparators:

% Total Return	**1st Jan to 30th June 2021**	**Inception to 30th June 2021 Cumulative**	**Inception to 30th June 2021 Annualised**
Fundsmith Equity Fund[1]	+13.1	+521.2	+18.7
Equities[2]	+11.9	+252.2	+12.5
UK Bonds[3]	-3.2	+42.7	+3.4
Cash[4]	+0.0	+6.3	+0.6

The Fund is not managed with reference to any benchmark. Above are a number of comparisons of performance.
[1]T class accumulation shares, net of fees priced at midday UK time, source: Bloomberg.
[2]MSCI World Index (£ Net) priced at close of business US time, source: www.msci.com.
[3]Bloomberg/Barclays Bond Indices UK Govt 5-10 yr., source: Bloomberg.
[4] £ Interest Rate, source: Bloomberg.

Our Fund outperformed what is perhaps the most obvious comparator – the MSCI World Index – by a bit over 1% during the first half of 2021. It outperformed the FTSE100 Index which is relevant to many of our UK investors by over 2%.

If you have been reading what investment commentators have been saying during this period you might be rather surprised that our Fund has fared so well. You might even be surprised that we are still here. Since markets started to sense an end to the economic disruption caused by the lockdowns in the final quarter of 2020 there has been a so-called 'rotation' from quality stocks, of the sort we own, into so-called value stocks and those expected to recover as the lockdowns end. In such a situation our Fund is always likely to underperform for a period, after all the companies we invest in mostly have little or nothing to recover from.

However, this inevitable blip was accompanied by lurid headlines and articles which seemed to suggest that we were in imminent danger of extinction:

'Fundsmith Equity sees run of outflows as growth stocks slide'
Citywire 19th May 2021

Followed a week later by:

'Investors 'begin to drop' star stock picker Terry Smith as £360m flows out of UK's largest fund'
City A.M. 26th May 2021

I realise that some commentators do not want the facts to get in the way of a good story but our performance versus the 'value' stocks and Covid recovery plays tells its own story.

	Covid Drawdown[1]	**Covid Recovery[2]**	**Pre-Covid High to 30th June 2021**
Fundsmith Equity Fund	-21%	59%	25%
S&P 500 Value Index	-37%	79%	12%
FTSE 100 index	-35%	41%	-8%
American Airlines	-70%	135%	-30%
BP	-62%	63%	-38%
Carnival Cruises	-84%	175%	-55%
Exxon	-56%	101%	-11%
JP Morgan	-44%	97%	10%
Lloyds Bank	-62%	95%	-27%
Ryanair	-49%	95%	-1%

Note:
[1] Fall from 2020 high to Covid low.
[2] Increase from Covid low until 30th June 2021.
Source: Bloomberg.

You could have made some good gains by buying the value or recovery stocks at or close to the bottom, although of course this depends on getting your timing right, but if you ran the value/recovery stocks across the period of the downturn and recovery, they would still have significantly underperformed our portfolio.

There are several lessons to be learnt from this, not the least of which is that no amount of recovery or low valuation will turn a poor business into a good one and quality is the main determinant of long term performance.

Moreover, neither have we seen the kind of outflows which the headlines might lead you to imagine. Net outflows of £130m for the half year were somewhat dwarfed by the £3 billion rise in the value of the Fund.

However, I am not expecting these facts to produce a change of heart amongst some commentators. As I believe former German Chancellor Helmut Kohl said, ‘Nothing so disappoints deserting rats as a ship which refuses to sink’.

Returning to the more important subject of our performance, the main contributors in the first half of 2021 were:

PayPal	+1.8%
Microsoft	+1.5%
IDEXX	+1.4%
Facebook	+1.2%
Intuit	+1.2%

All of these have featured in our previous tables of Top Five contributors. So much for the idea of taking profits. I suppose a theme which connects at least four of these companies is the growth of everything digital.

The bottom five detractors from our Fund’s performance during the period were:

McCormick	-0.4%
Amadeus	-0.2%
Brown Forman	-0.1%
Unilever	-0.1%
Pepsico	0.0%

There isn’t much of a theme connecting the detractors. Amadeus continues to suffer unsurprisingly as an airline reservation company and Brown Forman has been affected by the loss of travel retail and on-premise drinking. The comedown from ‘pantry loading’ in 2020 may also explain the performance of the consumer staples.

Our portfolio turnover was -2.69%. Voluntary dealing (dealing not caused by redemptions or subscriptions) cost £1,267,018 during the half year (0.005% or 0.5bps). The Ongoing Charges Figure was 1.05% and with the cost of dealing added, the Total Cost of Investment was 1.06%.

This time last year I wrote this:

We face an uncertain outlook given recent events, but ‘twas ever thus. We have no crystal ball unlike the commentators who tell us that the recovery from the pandemic and resulting closure of economic *activities deemed non-essential will be shaped like a V, a U, a W, a bathtub or the Nike swoosh (I'm not making this up). No one knows- as the economist J K Galbraith said, 'The only function of economic forecasting is to make astrology look respectable'. However, what we know is that we have assembled a portfolio of high quality companies which have to date proven to be resilient. If you are a long term investor that is the most certain determinant of your future returns.*

I am not sure I have anything to add.

Yours sincerely,

Terry Smith
CEO
Fundsmith LLP

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The MSCI World Index is a generic portfolio of global equities across all sectors and, as such, is a fair comparison given the Fund is also global and sector agnostic.

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January 2022

Dear Fellow Investor,

This is the twelfth annual letter to owners of the Fundsmith Equity Fund ('Fund').

The table below shows performance figures for the last calendar year and the cumulative and annualised performance since inception on 1st November 2010 and various comparators.

% Total Return	1st Jan to 31st Dec 2021	Inception to 31st Dec 2021 Cumulative	Inception to 31st Dec 2021 Annualised	Sharpe ratio[5]	Sortino ratio[5]
Fundsmith Equity Fund[1]	+22.1	+570.7	+18.6	1.31	1.25
Equities[2]	+22.9	+287.1	+12.9	0.78	0.74
UK Bonds[3]	-4.5	+40.9	+3.1	n/a	n/a
Cash[4]	+0.1	+6.4	+0.6	n/a	n/a

The Fund is not managed with reference to any benchmark, the above comparators are provided for information purposes only.
[1] T Class Accumulation shares, net of fees, priced at noon UK time, source: Bloomberg
[2] MSCI World Index, £ net, priced at US market close, source: Bloomberg
[3] Bloomberg/Barclays Bond Indices UK Gov. 5–10 year, source: Bloomberg
[4] £ Interest Rate, source: Bloomberg
[5] Sharpe & Sortino ratios are since inception to 31.12.21, 1.5% risk free rate, source: Financial Express Analytics

The table shows the performance of the T Class Accumulation shares, the most commonly held share class and one in which I am invested, which rose by +22.1% in 2021 and compares with a rise of +22.9% for the MSCI World Index in sterling with dividends reinvested. The Fund therefore marginally underperformed this comparator in 2021 but is still the best performer since its inception in November 2010 in the Investment Association Global sector with a return 357 percentage points above the sector average which has delivered just +213.9% over the same timeframe.

However, I realise that many or indeed most of our investors do not use these as natural comparators for their investments. Those of you who are based in the UK may look to the FTSE 100 Index ('FTSE 100') as the yardstick for measuring your investments and may hold funds which are benchmarked to this index and often hug it. The FTSE 100 delivered a total return of +18.4% in 2021 so our Fund outperformed this by a margin of 3.7 percentage points.

Whilst a period of underperformance against the MSCI World Index is never welcome it is nonetheless inevitable. No investment strategy will outperform in every reporting period and every type of market condition. So, as much as we may not like it, we can expect some periods of underperformance.

This is particularly so when we have a period like 2020–21 which was obviously heavily influenced by the pandemic. Our Fund outperformed the market by 6% in 2020 when the economic effects of the pandemic were at their height and most of the businesses we are invested in proved to be highly resilient. However, last year was more of a year of recovery and our companies had relatively little to recover from.

We find it difficult to outperform in particularly bullish periods where the market has a strong rise — 22.9% in 2021 — as a rising tide floats all ships, including some which might otherwise have remained stranded and that we would not wish to own.

In investment, as in life, you cannot have your cake and eat it, so it is difficult if not impossible to find companies which are resilient in a downturn but which also benefit fully from the subsequent recovery. Of course, you could try to trade out of the former and into the latter at an appropriate time but it is not what we seek to do as the vast majority of the returns which our Fund generates come from the ability of the companies we own to invest their retained earnings at a high rate of return because they own businesses with good returns and growth opportunities. In our view it would be a mistake to sell some of these good businesses in order to invest temporarily in companies which are much worse but which have greater recovery potential.

For the year the top five contributors to the Fund's performance were:

Microsoft	+3.9%
Intuit	+3.1%
Novo Nordisk	+2.3%
Estée Lauder	+2.0%
IDEXX	+1.9%

Microsoft makes its seventh appearance on this list, IDEXX its fourth, Intuit its third, Novo Nordisk and Estée Lauder their second. Someone once said that no one ever got poor by taking profits. This may be true but I doubt they got very rich by this approach either, as I've observed before. We continue to pursue a policy of trying to run our winners.

The bottom five were:

PayPal	-0.7%
Amadeus	-0.2%
Kone	-0.2%
Unilever	-0.2%
Brown-Forman	-0.1%

PayPal's performance last year was a clear exception to the benefits of running winners. The shares performed poorly amid concerns that its ambitions to construct a 'super app' to drive users to its payment systems might involve some value destruction, brought home by its apparent interest in acquiring social media operator Pinterest. We may be wrong but we would prefer if PayPal stuck to its knitting.

Amadeus is clearly still suffering from the effects of the pandemic on travel which is hardly surprising given that airline reservations are its largest business segment. However, we remain convinced that Amadeus will both survive this downturn and emerge in a stronger market position.

Kone was affected by the travails of the Chinese construction sector which represents its largest market.

Unilever seems to be labouring under the weight of a management which is obsessed with publicly displaying sustainability credentials at the expense of focusing on the fundamentals of the business. The most obvious manifestation of this is the public spat it has become embroiled in over the refusal to supply Ben & Jerry's ice cream in the West Bank. However, we think there are far more ludicrous examples which illustrate the problem. A company which feels it has to define the purpose of Hellmann's mayonnaise has in our view clearly lost the plot. The Hellmann's brand has existed since 1913 so we would guess that by now consumers have figured out its purpose (spoiler alert — salads and sandwiches). Although Unilever had by far the worst performance of our consumer staples stocks during the pandemic we continue to hold the shares because we think that its strong brands and distribution will triumph in the end.

Brown-Forman struggled under the twin impacts of the on trade shutdowns caused by the pandemic and EU tariffs on American sprits which gave us the opportunity to increase our stake. We expect both these headwinds to dissipate.

We sold our stakes in Intertek, Sage, Becton Dickinson, InterContinental Hotels and purchased a stake in Amazon and an as yet undisclosed position during the year.

As three of our sales were companies which are listed in the UK I am sure some will see this as some clue that we are selling out of the UK, or that we have some view on the prospects for the FTSE 100 versus the S&P 500 Index (S&P 500) or some other market or macro view. This is not the case. We invest in companies not indices or countries and in our view the country where a company is listed is largely irrelevant, if of course it has a well regulated stock market, and certainly does not provide a good guide to where the company generates its revenues. For example, InterContinental Hotels is listed in the UK but its largest market is the United States, hence why it reports in US dollars.

I don't intend to go into the reasoning on every sale and purchase transaction but the purchase of Amazon has attracted a lot of attention as we had previously declined to purchase its shares. Rather than give a lengthy rationale I would rather summarise it with a quote from the economist (and successful fund manager) John Maynard Keynes who said, 'When the facts change, I change my mind.' Although it could be explained by the simpler aphorism 'Better late than never' or at least it will be if our purchase delivers the performance we expect.

We continue to apply a simple three step investment strategy:

- Buy good companies
- Don't overpay
- Do nothing

I will review how we are doing against each of those in turn.

As usual we seek to give some insight into the first and most important of these — whether we own good companies — by giving you the following table which shows what Fundsmith would be like if instead of being a fund it was a company and accounted for the stakes which it owns in the portfolio on a 'look-through' basis, and compares this with the market, in this case the FTSE 100 and the S&P 500. This shows you how the portfolio compares with the major indices and how it has evolved over time.

Year ended	Fundsmith Equity Fund Portfolio								S&P 500	FTSE 100
	2014	2015	2016	2017	2018	2019	2020	2021	2021	2021
ROCE	29%	26%	27%	28%	29%	29%	25%	28%	16%	14%
Gross margin	60%	61%	62%	63%	65%	66%	65%	64%	45%	45%
Operating margin	25%	25%	26%	26%	28%	27%	23%	26%	17%	15%
Cash conversion	102%	98%	99%	102%	95%	97%	101%	95%	106%	124%
Interest cover	15x	16x	17x	17x	17x	16x	16x	23x	9x	8x

Source: Fundsmith LLP/Bloomberg. ROCE, Gross Margin, Operating Profit Margin and Cash Conversion are the weighted mean of the underlying companies invested in by the Fundsmith Equity Fund and mean for the FTSE 100 and S&P 500 Indices. The FTSE 100 and S&P 500 numbers exclude financial stocks. Interest Cover is median. 2013-2019 ratios are based on last reported fiscal year accounts as at 31st December and for 2020-21 are Trailing Twelve Months and as defined by Bloomberg. Cash Conversion compares Free Cash Flow per Share with Net Income per Share. Percentage change is not calculated if the TTM period contains a net loss.

Returns on capital and profit margins were higher in the portfolio companies in 2021 recovering from the downturn in 2020.

As a group our stocks still have excellent returns, profit margins and cash generation even in poor economic conditions. As you can see the same cannot be said for the major indices — with the exception of their current cash conversion which I suspect is a temporary phenomenon — if you can't get the stock you need because of supply chain problems, cash tied up in working capital is likely to be low. It's also worth remembering that the index numbers have the benefit of including our good companies.

The average year of foundation of our portfolio companies at the year-end was 1926. They are just under a century old collectively.

Consistently high returns on capital are one sign we look for when seeking companies to invest in. Another is a source of growth — high returns are not much use if the business is not able to grow and deploy more capital at these high rates. So how did our companies fare in that respect in 2021? The weighted average free cash flow (the cash the companies generate after paying for everything except the dividend, and our preferred measure) grew by 20% in 2021.

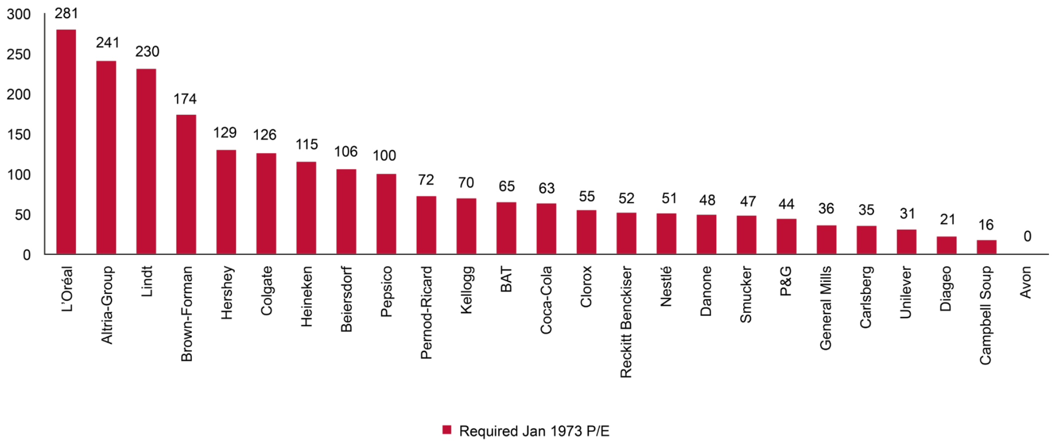
This leads onto the question of valuation. The weighted average free cash flow ('FCF') yield (the free cash flow generated as a percentage of the market value) of the portfolio at the outset of the year was 2.8% and ended it at 2.7%.

The year-end median FCF yield on the S&P 500 was 3.6%. The year-end median FCF yield on the FTSE 100 was 5.4%.

Our portfolio consists of companies that are fundamentally a lot better than the average of those in either index and are valued higher than the average S&P 500 company and much higher than the average FTSE 100 company. However, it is wise to bear in mind that despite the rather sloppy shorthand used by many commentators, highly rated does not equate to expensive any more than lowly rated equates to cheap.

The bar chart below may help to illustrate this point. It shows the 'Justified P/Es' of a number of stocks of the kind we invest in. What it shows is the Price/Earnings ratio (P/E) you could have paid for these stocks in 1973 and achieved a 7% compound annual growth rate (CAGR) over the next 46 years (to 2019), versus the 6.2% CAGR the MSCI World Index (USD) returned over the same period. In other words, you could have paid these prices for the stocks and beaten the index — something the perfect markets theorists would maintain you can't do.

Justified P/E's



Source: Ash Park Capital and Refinitiv Datastream, excludes dividends, in USD.

You could have paid a P/E of 281x for L'Oréal, 174x for Brown-Forman, 100x for PepsiCo, 44x for Procter & Gamble and a mere 31x for Unilever.

I am not suggesting we will pay those multiples but it puts the sloppy shorthand of high P/Es equating to expensive stocks into perspective.

Turning to the third leg of our strategy, which we succinctly describe as 'Do nothing', minimising portfolio turnover remains one of our objectives and this was again achieved with a portfolio turnover of 5.6% during the period. It is perhaps more helpful to know that we spent a total of just 0.009% (just under one basis point) of the Fund's average value over the year on voluntary dealing (which excludes dealing costs associated with subscriptions and redemptions as these are involuntary). We have held seven of our portfolio companies since inception in 2010.

Why is this important? It helps to minimise costs and minimising the costs of investment is a vital contribution to achieving a satisfactory outcome as an investor. Too often investors, commentators and advisers focus on, or in some cases obsess about, the Annual Management Charge ('AMC') or the Ongoing Charges Figure ('OCF'), which includes some costs over and above the AMC, which are charged to the Fund. The OCF for 2021 for the T Class Accumulation shares was 1.04%. The trouble is that the OCF does not include an important element of costs — the costs of dealing. When a fund manager deals by buying or selling, the fund typically incurs the cost of commission paid to a broker, the bid-offer spread on the stocks dealt in and, in some cases, transaction taxes such as stamp duty in the UK. This can add significantly to the costs of a fund, yet it is not included in the OCF.

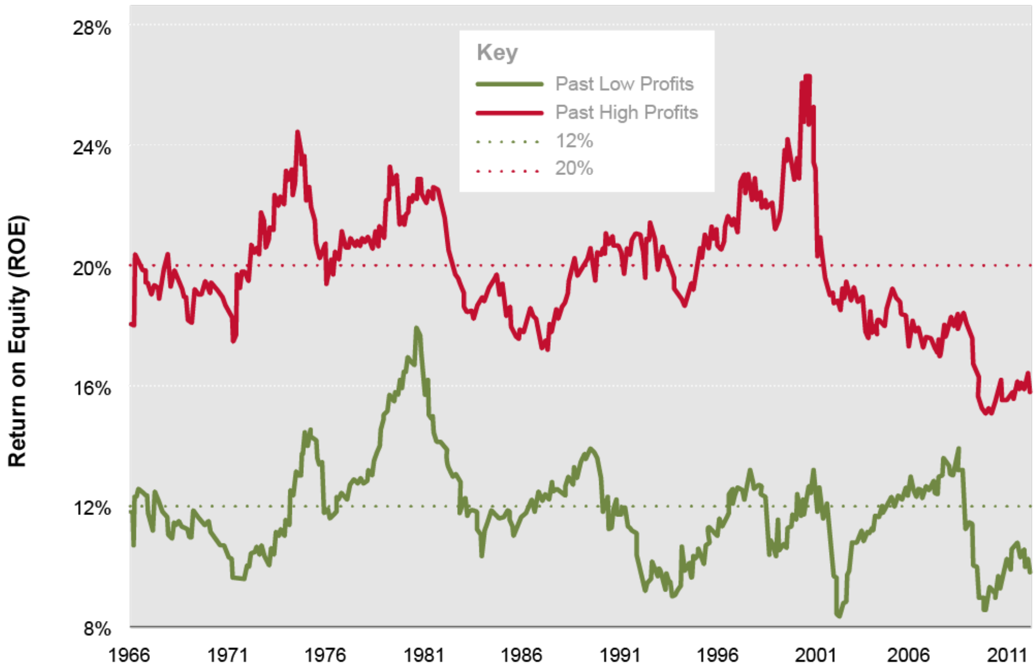
We provide our own version of this total cost including dealing costs, which we have termed the Total Cost of Investment ('TCI'). For the T Class Accumulation shares in 2021 this amounted to a TCI of 1.05%, including all costs of dealing for flows into and out of the Fund, not just our voluntary dealing. We are pleased that our TCI is just 0.01% (1 basis point) above our OCF when transaction costs are taken into account. However, we would again caution against becoming obsessed with charges to such an extent that you lose focus on the performance of funds. Some commentators state that an investor's primary focus should be on fees. To quote Charlie Munger (albeit in another context) this is 'Twaddle'. It is worth pointing out that the performance of our Fund tabled at the beginning of this letter is after charging all fees which should surely be the main focus.

Turning to the themes which dominated 2021, you may have heard a lot talked about the so-called 'rotation' from quality stocks of the sort we seek to own to so-called value stocks, which in many cases is simply taken as equating to lowly rated companies. Somewhat related to this there was periodic excitement over so-called reopening stocks which could be expected to benefit as and when we emerge from the pandemic — airlines and the hospitality industry, for example.

There are multiple problems with an approach which involves pursuing an investment in these stocks. Timing is obviously an issue. Another is that their share prices may already over anticipate the benefits of the so-called reopening. As Jim Chanos, the renowned short seller, observed 'The worst thing that can happen to reopening stocks is that we reopen.' It is often better to travel hopefully than to arrive.

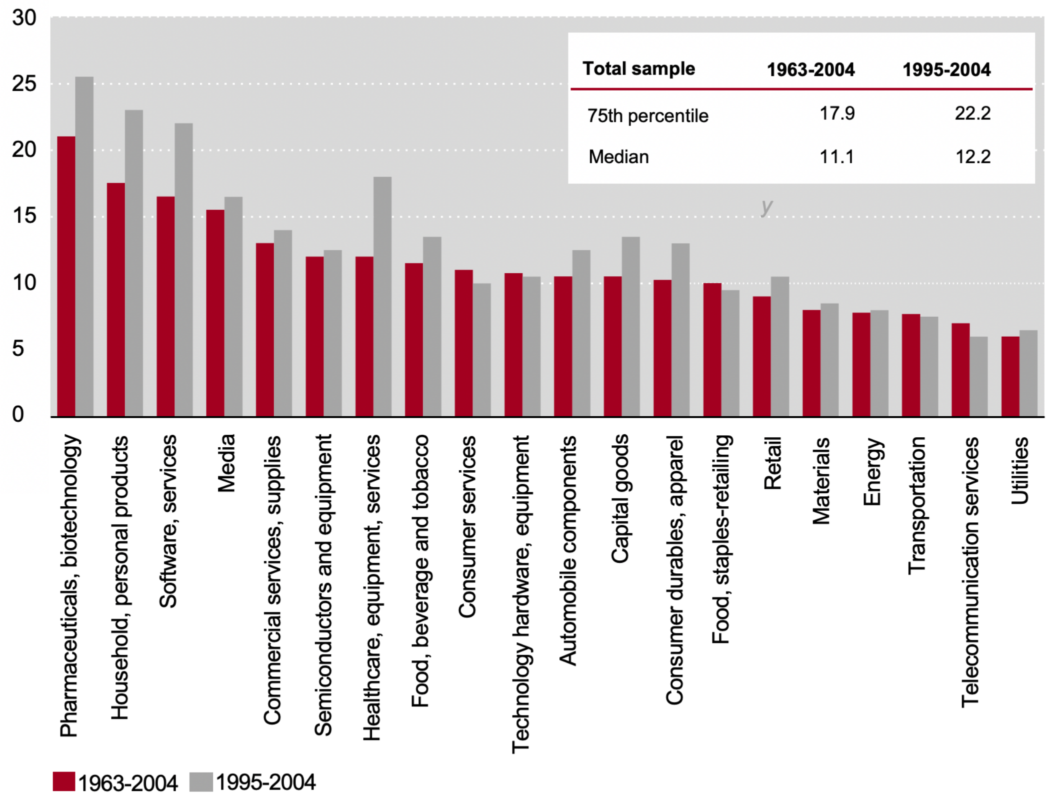
In our view, the biggest problem with any investment in low quality businesses is that on the whole the return characteristics of businesses persist. Good sectors and businesses remain good and poor return businesses also have persistently poor returns as the charts below show:

Persistence in Profitability



Source: GMO. The 1000 largest companies in the U.S. were sorted for each point in the graph into quartiles based on return on equity (ROE). Past Low Profits consists of those companies in the quartile with the lowest ROE. Past High Profits consists of those companies in the quartile with the greatest ROE.

Median and annual ROIC, excluding goodwill %



Source: McKinsey

These return characteristics persist because good businesses find ways to fend off the competition — what Warren Buffett calls 'The Moat' — strong brands; control of distribution; high spend on product development, innovation, marketing and promotion; patents and installed bases of equipment and/or software which are troublesome to change for example.

Poor returns also persist because companies which have many competitors, no control over pricing and/or input costs, and an ability for consumers to prolong the life of the product in a downturn (like cars) cannot suddenly throw off these poor characteristics just because they are lowly rated and/or benefit from an economic recovery.

Contrary to the mantra that every fund has to recite, past returns of companies are a good guide to future returns.

Even if you manage to identify a truly cheap value or reopening stock and time the rotation into that stock correctly so as to make a profit, this will not transform it into a good long term investment. You need to sell it at a good moment — presumably when some of your fellow ~~punters~~ investors will also be doing so because its cheapness will not transform it into a good business and in the long run it is the quality of the business that you invest in which determines your returns.

The chart below shows the excess returns — the amount by which it beats the index — of the MSCI World Quality Index (which I am taking as a surrogate for our strategy). Over the last 25 years there has never been a rolling 120 month (ten year) period when quality has not performed as well as or better than the MSCI World Index.

Source: MSCI

I know 10 years is a long time and well beyond the time horizon of most investors, but we are long term investors and aim to capture this inevitable outperformance by good companies. If this investment time horizon is too long for you then you may be invested in the wrong fund. Moreover, if anything this chart flatters the outcome of investing in low quality, cyclical, value or recovery stocks as the index with which the quality stocks are being compared includes those quality stocks. If they were taken out of the index, the relative outperformance would be even more pronounced.

You may have heard a lot about inflation over the past year and I suspect you will continue to hear more about it in 2022.

In some respects, we needn't discuss whether or not we have inflation — German wholesale prices were up 16.6% year on year in November but were easily trumped by Spain whose producer price index (PPI) rose 33.1% in the same period. However, that eye-catching statistic is far from the whole story.

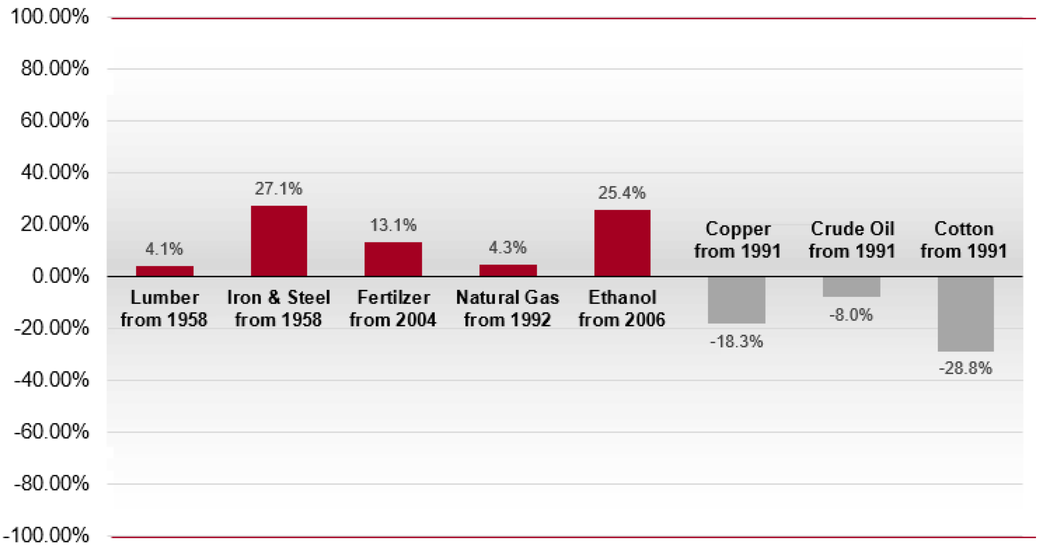
It is not difficult to see potential causes of inflation. The expansion of central bank balance sheets with Quantitative Easing after the Credit Crisis has been followed by huge monetary and fiscal stimuli put in place to counter the economic effects of the pandemic. One might reason that given the growth in the money supply has vastly outstripped the increases in production of goods and services the price of those goods and services was sure to be bid up and ipso facto inflation must follow.

However, this omits another important element of the equation — the velocity of circulation of money. Are people more inclined to save the additional money or to spend it? The savings ratio leapt after the Credit Crisis and again during the pandemic partly no doubt due to caution but also because there were fewer opportunities to spend, for example on travel and vacations. However, it is now on its way back to pre-crisis levels so maybe we have all the ingredients for inflation to take hold.

You might well be confused at this point (I know I am) particularly considering that the 'authorities' spent most of the decade post the Credit Crisis trying to generate inflation in order to negate the deflationary effects of the Credit Crisis and its causes. The trouble is that with inflation, as with so much else, you need to be careful what you wish for. It is a bit like trying to light a bonfire or a traditional BBQ on a damp day. If you put an accelerant like gasoline on it you can go from no fire to a loud 'Whoosh!' and find that you have also set fire to the garden fence. When inflation takes hold, it too may exceed your expectations.

In terms of how to react, if at all, there are also other factors to consider. Inflation in the cost of commodities does not necessarily equate to retail price inflation or asset inflation. The chart below attempts to correlate the price increases or decreases in a number of commodities with the Consumer Price Index over time.

Correlation of Long Term Commodity Prices With Inflation



Source: Federal Reserve Economic Research. 100% = perfect positive correlation, 0% = no correlation, -100% = perfect negative correlation.

As you can see, there is no correlation. One of the reasons for this is that consumers do not buy commodities. They are bought by companies which make them into the goods which consumers buy. Interestingly, the eye-popping Spanish PPI rise of 33.1% in the year to November included an 88% increase in energy prices, 48% for basic metals and 16% for paper products but only 8.3% for food. Consumers don't buy basic metals.

So the initial impact of input cost inflation is not on consumer prices but on company profits. All companies are not equal in this regard. The higher a company's gross margin — the difference between its sales revenues and cost of goods sold — the better its profitability is protected from inflation.

The table below shows the impact of input cost inflation on two companies in the consumer sector — L'Oréal which we own and Campbell's Soup, which we do not own. L'Oréal has gross margins of 73% and Campbell's has 35%. A 5% rise in input cost inflation would cut L'Oréal's profits by 7% if it took no other action, whereas Campbell's profits would fall by 22%.

Impact of 5% Inflation

L'Oreal	Before	After
% of revenues		
Revenue	100%	100%
COGs	27%	28%
Gross profit	73%	72%
SG&A	55%	55%
Operating profit	18%	17%
Decline in profit		**-7%**

Campbell's	Before	After
% of revenues		
Revenue	100%	100%
COGs	65%	68%
Gross profit	35%	32%
SG&A	20%	20%
Operating profit	15%	12%
Decline in profit		**-22%**

Source: Fundsmith Research

You will recall from the look-through table earlier that our portfolio companies have gross margins of over 60%, versus about 40% for the average company in the index. So, from a fundamental respect our companies are likely to be better able to weather inflation.

However, inflation also affects valuations. Rises in inflation and interest rates also do not affect the valuation of all companies equally. In the bond market, the longer the maturity of a bond, the more sensitive its valuation is to rate changes. A short-dated bond soon matures and the proceeds can be reinvested at whatever the new rate is. The same is not true of a 10 or 30 year bond.

The equivalent to the duration of a bond in terms of equities is the valuation multiple whether it is expressed in terms of earnings or, as we would prefer, cash flows. The higher rated a company's shares are, the more it will be affected by changes in inflation or interest rates. This is one reason why the shares of the new wave of unprofitable tech companies have performed so poorly latterly. As they are loss-making more than 100% of their expected value is in the future (there are probably other reasons like the growing realisation that you are often being invited to invest in a business plan rather than a business).

So in brief, if inflation is seen to have taken hold rather more than some people, including the Federal Reserve Bank expects, then we are probably in for an uncomfortably bumpy ride in terms of valuations but we can be relatively sanguine in terms of the effect on the fundamental performance of our portfolio businesses which is our primary focus.

The good news is that we do not invest on the basis of our ability to forecast inflation or any other macroeconomic factor. We invest in companies not countries, indices or macroeconomic forecasts.

I would like to leave you with this thought: our Fund has prospered during the pandemic. The companies it invests in have endured much more — the Great Depression, World War II, the Great Inflation of 1965–82, the Dotcom meltdown and the Credit Crisis. They will probably survive whatever comes next and so will we if we stick to our principles and we have every intention of doing so.

Finally, may I wish you a happy New Year and thank you for your continued support for our Fund.

Yours sincerely,

Terry Smith
CEO
Fundsmith LLP

Disclaimer: A Key Investor Information Document and an English language prospectus for the Fundsmith Equity Fund are available via the Fundsmith website or on request and investors should consult these documents before purchasing shares in the fund. Past performance is not necessarily a guide to future performance. The value of investments and the income from them may fall as well as rise and be affected by changes in exchange rates, and you may not get back the amount of your original investment. Fundsmith LLP does not offer investment advice or make any recommendations regarding the suitability of its product. This document is communicated by Fundsmith LLP which is authorised and regulated by the Financial Conduct Authority.

Sources: Fundsmith LLP & Bloomberg unless otherwise stated.

Portfolio turnover has been calculated in accordance with the methodology laid down by the FCA. This compares the total share purchases and sales less total creations and liquidations with the average net asset value of the Fund.

PE ratios and Free Cash Flow Yields are based on trailing twelve month data and as at 31st December 2021 unless otherwise stated.

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July 2022

Dear Fellow Investor,

The table below shows the performance of the Fundsmith Equity Fund ('Fund') and other comparators during the first half of 2022 and since inception.

% Total Return	**1st Jan to 30th June 2022**	**Inception to 30th June 2022 Cumulative**	**Annualised**
Fundsmith Equity Fund[1]	-17.8	+451.5	+15.8
Equities[2]	-11.3	+243.2	+11.2
UK Bonds[3]	-7.1	+30.9	+2.3
Cash[4]	+0.3	+6.7	+0.6

The Fund is not managed with reference to any benchmark, the above comparators are provided for information purposes only.
[1] T class Accumulation shares, net of fees priced at midday UK time, source: Bloomberg.
[2] MSCI World Index, £ Net, priced at close of business US time, source: www.msci.com.
[3] Bloomberg/Barclays Bond Indices UK Govt 5-10 year, source: Bloomberg.
[4] £ Interest Rate, source: Bloomberg.

Our Fund underperformed what is perhaps the most obvious comparator — the MSCI World Index (£ net), which itself fell by 11.3% — by 6.5 percentage points during the first half of 2022.

The cause of the downturn in global equity markets is obvious — the upsurge in inflation and the consequent need to raise interest rates and risk a recession. A combination of surging inflation and looming recession reminds me of the quote from soccer manager Tommy Docherty, 'When one door closes, another slams in your face.'

If a recession ensues but inflation persists we will not have seen conditions of this sort since the 1970s when the term 'stagflation' was coined. My first full year in work was 1974 when inflation in the UK, as measured by the CPI, was 24.24%. In an example of history not repeating itself but rhyming, as Mark Twain observed, the 1970s inflation was boosted by the Arab oil embargo which followed the Yom

Kippur War. On this occasion we have a similar effect from the Russian invasion of Ukraine.

I have no insight into how severe or persistent the rise in interest rates will need to be to quell inflation, but I am not optimistic. Interest rates as a tool to combat inflation are a blunt instrument at the best of times and I suspect more so in this instance where the inflation has not been caused by demand exceeding supply during an economic boom.

In a recent interview former Bank of England Governor Lord King of Lothbury observed that today's inflation was sparked by a misdiagnosis of the problem at the height of the Covid pandemic back in March 2020. Attempts were made to stimulate demand by further Quantitative Easing when the issue was not weak demand but the lack of supply, with disruption in supply of energy and its derivative products like fertilizers and plastics, metals, glass, agricultural commodities like palm oil and essential components like microchips, and even the supply of labour with the Great Resignation and an inability for migrant labour to travel.

Raising interest rates is now a necessity. This will eventually quell demand. It may take a while to become effective because consumers were quite liquid given the lack of certain types of spending opportunities during the pandemic. However, higher interest rates will do nothing to correct the continuing supply problems in commodities, semiconductors and just about everything else so it may also take some time and high interest rates for demand to become depressed enough for the supply to exceed it and so start to moderate price inflation.

Fortunately, we do not invest on the basis of our prognostications about macroeconomics but it is not a matter of speculation that we now have inflation. Inflation, rising interest rates and an increasingly likely recession have two obvious effects on equity investments; fundamental effects and valuation effects. I will try to address each of these in turn as I review the performance of some of our holdings.

Inflation causes an increase in the cost of the ingredients, components and other inputs which constitute companies' Cost of Goods Sold ('COGS'). The best defence against this inflation is a high gross margin — the difference between sales revenues and COGS. On average last year the companies in our portfolio had a gross margin of 60% compared with about 40% for the average large, listed company. Our companies make things for £4 and sell them for £10 whereas the average company makes things for £6 and sells them for £10. A 10% rise in the COGS clearly has much less effect on the profitability of the companies in our portfolio than the average. Moreover, if they want to compensate for say a 10% rise in COGS, our portfolio companies can achieve this with a much smaller price rise than the average company. The effect on COGS is not the only effect of inflation but it is clear that the high and sustainable gross profit margins of our companies provide a robust first line of defence.

An illustration of the problems of low gross margins was recently supplied by the US retailer Target — a stock we would never own — in its first quarter results. Gross margin contracted from 30.0% in the same quarter last year to 25.7% — a fall of 4.3 percentage points — driven largely by inventory impairments, lower than expected sales in discretionary categories as well as higher costs related to freight, supply chain disruptions and increased compensation and headcount in distribution centres. The operating margin fell from 9.8% in the prior year quarter to 5.3% — so by a similar 4.5 percentage points. Operating profit declined 43%. The combination of low gross margins and high fixed costs is dangerous and we seek to avoid it.

It may seem little source of comfort at the moment but our companies continued to deliver decent underlying business performance in the first half of 2022. Last reported portfolio weighted average free cash flow per share ended June 2022 4% higher than in December 2021, equivalent to annualised growth of about 8%. Long-term readers of these letters will recognise this as not far off the historic average.

Revenue growth was strong, bordering on very strong at some of our companies. Results reported in the first half of 2022 showed two-year top line growth — which we look at in attempt to avoid confusion caused by the gyrations during the pandemic — of 48% at Adobe, 66% at Alphabet, 51% at Brown-Forman, 79% at Intuit, 40% at Microsoft, 39% at PayPal and 47% at Waters.

If these were our privately owned family businesses we would still for the most part be applauding the growth they had delivered in much the same way as we were six months ago, albeit we might well be concerned about their ability to replicate this performance over the next couple of years.

It is too early in the development of this inflationary economic cycle to be sanguine about this and the next few quarterly earnings seasons are unlikely to be overly exciting. Nonetheless, the structure of our companies' profitability gives us considerable comfort. Nor do we feel that they are likely to be in the forefront of collapsing top line revenue growth in a recession given that we primarily invest in three sectors: consumer staples, albeit with some consumer discretionary, healthcare and technology. It seems likely that they will fare better in a recession than other sectors for which demand is more cyclical, fixed assets and costs are higher and profitability and cash generation are lower.

From a fundamental perspective, which is what we seek to focus on, we are therefore confident that our portfolio companies will perform relatively well over an inflationary and recessionary cycle. But sadly our investments are not our privately owned family businesses where we can focus on the fundamental performance and not worry about the stock market.

It is axiomatic that in a period of rising interest rates, long dated assets will fare worse than short-dated ones. This applies not only to bonds but also to equities. The share prices of more highly rated equities which are in effect discounting profits or cash flows further into the future by being rated on higher PEs tend to be more affected by rising interest rates than lowly rated so-called value stocks.

Our portfolio is not exempt from this effect. Broadly speaking, the stocks that have suffered most from rising interest rates so far were those that started the year the most highly rated and were thus most impacted by the rising discount rate.

The five biggest detractors from our Fund's performance during the period were:

PayPal	-3.0%
Meta Platforms	-2.3%
IDEXX	-2.3%
Intuit	-1.5%
Microsoft	-1.2%

Of these, PayPal and maybe Intuit, exacerbated their situation with self-inflicted wounds that negatively impacted their underlying performance. IDEXX and Microsoft really didn't see any slowdown at all.

Did we miss out by not owning more lowly-rated 'value' stocks during this period? Not much. The much talked about 'rotation' from 'growth' to 'value' stocks during the first half of 2022 was rather underwhelming from the perspective of the latter. In the US, the S&P Value Index did indeed significantly outperform its S&P Growth counterpart and the NASDAQ but this outperformance took the form of a 12% fall for the S&P Value Index versus a 28% decline for the S&P Growth Index and a 30% decline in the NASDAQ. Falling less than others when times are tough has obvious merit but still isn't a sufficient payback for the long preceding wait during which value stocks underperformed massively.

For the most part, not owning the sectors we have frequently said we will never own didn't do us any harm during the first half of 2022. In the US the S&P Banks Index for example was down 25% during the six-month period and the S&P Airlines Index was down 22% notwithstanding the sharp pick-up in travel demand. Even the S&P Metals & Mining Index fell in absolute terms, albeit by much less than the market. The one sector in the 'we'll never own' category that did cost us by our absence was energy. In the US, the S&P Energy Index increased 29% in the first half while in the UK, BP shares rose 17% and Shell 34%. For those regretting the absence of energy stocks from our portfolio, these increases have only taken the S&P Energy Index back to a level it first reached in 2008 or the two UK stocks reached in the 1990s.

To try to get some objectivity into where we are now on valuation, the free cash flow ('FCF') yield on the portfolio, which had ended 2021 at 2.7%, increased to 3.6% at the end of June 2022. This means that in the space of six months, the valuation of the portfolio has declined all the way back to where it was at the end of 2017. We have cautioned in the past that a rising fund price caused in part by rising valuations is nice but also worrying because it is finite and reversible, but that again is not much of a source of comfort when this is shown to be the case.

Moreover, the rotation from 'growth' to 'value' has also led to a situation where the narrative of the 'highly-rated tech sector' has been turned on its head. The median FCF yield on the 78 technology stocks in the S&P 500 Index is 4.6% and the mean is actually 5.2%. Conversely the equivalent numbers for the 36 stocks in the consumer staples sector are 3.8% and 4.6%. The technology stocks in the S&P 500 are actually now more lowly-rated than consumer staples.

The reason why the aforementioned 'narrative' exists is because of the large number of tech stocks which had or still have two or more of the following characteristics — giant market values, little or no revenue or profits, well publicised 2020 or 2021 IPOs, and charismatic CEOs. Probably the best-known investor for these types of stock has been ARK Investment Management, notably in the form of the ARK Innovation ETF. Bloomberg suggests that the forward price-to-earnings ratios for this ETF's top 10 holdings are in seven cases 'N/A', i.e., there are no earnings, and in the other three cases average 53x.

Conversely the price-to-earnings ratio on most of the stocks in our portfolio that could loosely be described as 'tech' — Microsoft, Adobe, Alphabet, Visa, ADP, Intuit, PayPal and Meta — averages 24x, Amazon is the only outlier. It is worth bearing these contrasting valuations in mind when people lump the whole technology sector together.

What did well for us in the first six months of 2022? It is tempting to observe 'not a lot' but here are the five biggest positive contributors to performance:

Philip Morris	+0.8%
Novo Nordisk	+0.4%
Brown-Forman	+0.3%
PepsiCo	+0.3%
Waters	+0.1%

Novo Nordisk discovered that a drug it had developed for diabetics was also the world's first really effective weight loss drug. The potential market for this product, branded Wegovy, is vast. Philip Morris International meanwhile benefited from its low rating, the perceived defensive nature of tobacco and latterly an attractive-looking agreement to purchase Swedish Match to create the undoubted leader in smokeless tobacco products and nicotine pouches. Despite this outperformance, Philip Morris International still ended the quarter as our second most lowly-rated stock. The title for the lowest-rated belongs to Meta Platforms. Meta's stock now trades on a FCF yield of 8.7%. At this level it is either cheap or a so-called value trap. We will let you know which when we find out, but we are inclined to believe it is the former.

Our portfolio turnover in the first half was 3.2%. Voluntary dealing (dealing not caused by redemptions or subscriptions) cost £392,705 during the half year (0.002% or a fifth of a basis point). The Ongoing Charges Figure for the T Class Accumulation shares was 1.04% and with the cost of all dealing added, the Total Cost of Investment was 1.05%.

The first half of 2022 marked the end, for the time being, of a long period during which the shares in our companies benefited not only from their underlying business performance but also from falling interest rates and thus rising valuations. Not only did this tailwind disappear but a significant headwind materialised in short order in the form of rising interest rates combined with fears about the impact of inflation and a possible recession.

We claim no insight into how far the headwind to valuations caused by rising interest rates will go, but we are confident that the companies in our portfolio will survive and prosper relatively well in such an environment. This has been and will continue to be our primary focus. If we get that right then our Fund will emerge with the intrinsic value of its investments maintained or enhanced. Sooner or later share prices reflect fundamentals, not the other way around.

In inflationary periods, an acronym which is sometimes used to describe the investment options is TINA — There Is No Alternative. It refers to the concept that equities will be the least poorly performing sector in such conditions because of the ability of at least some companies to continue to grow revenues in real terms and generate real returns on capital above the rate of inflation.

Bonds with fixed interest coupons are certainly not the place to be in these conditions. Real estate may provide some safety but it is a notoriously local market with poor liquidity and high frictional trading costs. Commodities have had a day in the sun at the start of this inflationary cycle and this may continue, or not. But there is no inherent return on commodities — no interest coupon, dividends or profits reinvested. Investing in them is pure Greater Fool Theory — you can only make money by selling them to someone willing to pay more than you did. I have no confidence in my ability to accomplish that. All of which may point to the fact that There Is No Alternative to equities even though they have performed poorly so far this year.

However, even if you accept that, it may be tempting to sell equities and go into cash as this may enable you to avoid further falls in the equity market. Timing is of the essence in doing this and if you haven't done it already I think we can safely say you missed the top. Getting the other side of the trade roughly right will almost certainly mean buying back into equities when economic conditions are at their most bleak. This is a skill which few, if any, possess. Meanwhile, time spent in cash whilst waiting is hardly a good bolt hole from inflation.

Finally, even if you accept the logic of the TINA mantra, maybe equities of the sort in our portfolio are still not the best place to be for a while. This is really a subset of the market timing approach: Sell quality equities, buy lowly-rated 'value' stocks and then reverse this when the time is right. I wish you luck if you intend to pursue this approach not least because I am fairly sure how lowly-rated stocks, most of which are heavily cyclical, have low profit margins and returns on capital, will fare in a recession.

We meanwhile will continue to do what we set out to do. Which is to assemble a portfolio of high-quality companies and hold onto them so that their inherent ability to compound in value will determine how we perform over the long term, not the vagaries of the market. I hope to see you on the other side.

Yours sincerely,

Terry Smith

Terry Smith

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Sources: Fundsmith LLP & Bloomberg unless otherwise stated.

Portfolio turnover compares the total share purchases and sales less total creations and liquidations with the average net asset value of the fund.

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