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Dear Fellow Investor,

The table below shows performance figures for the last calendar year and the cumulative and annualised performance for the I class shares of the Fundsmith Equity Fund Feeder ("the Feeder") compared with various benchmarks. Please note the differing start dates for the various share classes, noted below the table.

% Total Return	**1st Jan to 31st Dec 17**	**Inception to 31st Dec 2017 Cumulative**	**Annualised**
Fundsmith Equity Fund Feeder €[1]	+17.7	+215.7	+20.5
MSCI World Index €[2]	+7.5	+132.2	+14.6
Fundsmith Equity Fund Feeder CHF[1]	+28.2	+163.9	+18.4
MSCI World Index SFR[2]	+17.8	+101.0	+12.9
Fundsmith Equity Fund Feeder USD[1]	+33.9	+112.3	+17.0
MSCI World Index USD[2]	+22.4	+61.4	+10.5
Fundsmith Equity Fund Feeder GBP[1]	+21.8	+121.2	+23.9
MSCI World Index GBP[2]	+11.8	+70.1	+15.4
European Bonds[3]	-0.3	+72.1	+9.2
Cash[4]	-0.4	+0.4	+0.1

[1] I Class Accumulation Shares, net of fees, priced at noon CET
[3] Bloomberg/EFFAS Bond Indices Euro Govt 10 yr
[1,3,4] Source: Bloomberg
Launch Dates, Euro: 2.11.11 CHF: 5.4.12

[2] MSCI World Index priced at close of business US time
[4] 3 Month € LIBOR Interest Rate
[2] Source: www.msci.com
Launch Dates, USD: 13.3.13 GBP: 15.4.14

Given we do not hedge currency exposure the main difference in performance between the differing currency share classes is as a result of movements in exchange rates in the year. For instance the US dollar, in which over 60% of the underlying portfolio is denominated, weakened by 13% vs the euro in 2017. The 2017 relative performance vs MSCI World Index (also unhedged) is therefore similar across the currency share classes and shows the Feeder healthily outperformed in 2017. According to Financial Express, as at 31st December 2017, the Feeder is the best performing fund since inception out of over 507 funds in their Offshore International Funds sector (€ shares). As the fund is a feeder and therefore only holds the Fundsmith Equity Fund (the "Fund") and a very small amount of cash the comments that follow refer to the Fundsmith Equity Fund and its performance in sterling, other than where stated to the contrary.

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 € I 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, 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 € I Class Accumulation shares in 2017 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 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.

Yours sincerely,

Terry Smith

Terry Smith
CEO
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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.