Fundsmith
Sustainable Equity Fund | SICAV

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Dear Fellow Investor,

The table below shows performance figures for the last calendar year and the cumulative and annualised performance of the Fundsmith Sustainable Equity Fund – a sub fund of the Fundsmith SICAV ('Fund' or 'SICAV') since inception on 1st March 2021 and various comparators.

% Total Return	1st Jan to 31st Dec 2023	Inception to 31st Dec 2023		Sortino Ratio[5]
		Cumulative	Annualised	
Fundsmith Sustainable Equity Fund EUR T Class[1]	+8.7	+16.8	+5.7	0.20
MSCI World Index EUR[2]	+19.6	+33.6	+10.8	0.50
European Bonds[3]	+10.5	-26.6	-10.4	
Cash[4]	+3.2	+2.7	+0.9	
Fundsmith Sustainable Equity Fund CHF I Class[1]	+2.4	-1.1	-0.4	
MSCI World Index CHF[2]	+13.3	+13.8	+4.7	
Fundsmith Sustainable Equity Fund USD I Class[1]	+13.0	+7.9	+2.7	
MSCI World Index USD[2]	+23.8	+21.6	+7.1	
Fundsmith Sustainable Equity Fund GBP I Class[1]	+6.7	+18.0	+6.0	
MSCI World Index GBP[2]	+16.8	+33.3	+10.7	

[1] Accumulation Shares, net of fees, priced at 13:00 CET, source: Bloomberg
[2] MSCI World Index priced at close of business US time, source: Bloomberg
[3] Bloomberg/EFFAS Bond Indices Euro Govt 10 yr., source: Bloomberg
[4] € Interest Rate, source: Bloomberg
[5] Sortino ratio is since inception to 31.12.23, 3.5% risk free rate, source: Financial Express Analytics
The Fund is not managed with reference to any benchmark, the above comparators are provided for information purposes only.

Given we do not hedge currency exposure, the main difference in performance between the currency share classes is the relative currency movements in the year. The relative performance compared to the MSCI World Index is therefore similar for each share class and shows the Fund underperformed in 2023.

Outperforming the market or even making a positive return is not something you should expect from our Fund in every year or reporting period, and outperforming the market was more than usually challenging in 2023. The performance of the Nasdaq Composite Index, which was up 43% in USD in 2023, was dominated by a few companies, the so-called Magnificent Seven — Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla — which accounted for 68% of that Index's gains. Nvidia, the designer of chips for use in AI applications, alone accounted for 11% of the 43% gain. We do not own all the Magnificent Seven and would probably not be willing to take the risk of doing so, even if all of them fitted our investment criteria.

In looking at individual stock contribution to performance I prefer to start with the problems. The bottom five detractors from the Fund's performance in 2023 were:

Stock	Attribution
Estée Lauder	-1.6%
McCormick	-0.9%
Mettler-Toledo	-0.9%
Johnson & Johnson	-0.7%
PepsiCo	-0.4%

Source: Northern Trust

We sold our stake in Estée Lauder whose mishandling of the demand/supply situation in China following reopening post Covid and in the travel retail market revealed serious inadequacies in its supply chain.

McCormick has yet to return the profit margins in its food service business to the level they were before the pandemic.

Mettler-Toledo suffered from a downturn in demand for laboratory equipment post the pandemic, demand falling in China and a tighter funding market for biotech companies. However, we have no concerns about their longer-term prospects and our holding in Mettler-Toledo, in particular, is small and we may be able to use share price weakness to acquire more.

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Johnson & Johnson completed the spin-out of the Kenvue OTC medicine and personal care business but continues to be overhung by the end of the Covid vaccine boost.

PepsiCo had a lacklustre year in share price terms as did most of the FMCG sector perhaps aided by some early and probably premature worries about the possible effect of the GLP-1 weight loss drugs.

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

Stock	Attribution
Novo Nordisk	+3.0%
Microsoft	+2.2%
L'Oréal	+1.8%
Alphabet	+1.4%
IDEXX Laboratories	+1.1%

Source: Northern Trust

Novo Nordisk rose to prominence this year as a result of the wild success of its weight loss drug Wegovy (also known as Ozempic when sold for treating diabetes). However, the Fund has owned the stock since inception in 2021 — attracted by its seemingly unusual approach to drug discovery and its ownership structure. We are not aware of another drug company whose stated aim is the eradication of the ailment from which it derives most of its revenues. The controlling stake held by the Novo Nordisk Foundation seems to guarantee a genuine long-term approach to the business.

Microsoft appears in this list of contributors for the first time but has been a perennial contributor to our older funds since we originally bought it at about $25 a share in 2011, a decision which subsequently attracted strident criticism (2023 year end price $376).

L'Oréal is a long-term favourite whose handling of the China market contrasts sharply with that of Estée Lauder.

Perhaps the most surprising to the five contributors was Alphabet (formerly Google) as it faced a number of headwinds, not least from competition authorities with the EU fining it €2.6bn and the Department of Justice bringing a case to stop Google paying to be the favoured search engine on Apple devices. Notwithstanding this the shares rose by 58% over the year.

IDEXX, the supplier of veterinary diagnostic equipment, was a top contributor despite concerns about a hangover following the upsurge in pet ownership during Covid.

We continue to apply a simple four step investment strategy:

- Buy good companies
- ESG screen
- 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 the Fund 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 also shows you how the portfolio has evolved over time.

	Fundsmith Sustainable Equity Fund SICAV Portfolio			S&P 500	FTSE 100
Year ended	2021	2022	2023	2023	2023
ROCE	28%	31%	34%	18%	17%
Gross Margin	61%	61%	60%	45%	41%
Operating Margin	25%	26%	29%	16%	15%
Cash Conversion	97%	88%	93%	76%	85%
Interest Cover	20x	19x	20x	11x	10x

Source: Fundsmith LLP/Bloomberg.
ROCE, Gross Margin, Operating Margin and Cash Conversion are the weighted mean of the underlying companies invested in by the Fundsmith Sustainable 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.
Ratios are Trailing Twelve Months and as defined by Bloomberg.
Cash Conversion compares Free Cash Flow per Share with Net Income per Share.

In 2023 returns on capital and operating profit margins were higher in the portfolio companies than in the past. Gross margins were steady. Importantly all of these metrics remain significantly better than the companies in the main indices (which include our companies). Moreover, if you own shares in companies during a period of inflation it is better to own those with high returns and gross margins.

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 2023? The weighted average free cash flow (the cash the companies generate after paying for everything except the dividend, and our preferred measure) grew by 18% in 2023.

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The only metric which continues to lag its historical performance is cash conversion — the degree to which profits are delivered in cash. Although this recovered slightly to 93% in 2023, this is still below its historical level of around 100% as a result of unusual events affecting a handful of our companies which we expect to largely unwind to their benefit in 2024.

The average year of foundation of our portfolio companies at the year-end was 1932. Collectively they are a little under a century old.

The second leg of our strategy is to employ a negative sector-based sustainability screen, excluding companies operating in sectors with excessive sustainability-related risk (aerospace and defence, brewers, distillers and vintners, casinos and gaming, gas and electric utilities, metals and mining, oil, gas and consumable fuels, pornography and tobacco). We then assess company sustainability in the widest sense, evaluating a business's handling of risks and opportunities and their policies and practices covering research and development, new product innovation, dividend payments and the adequacy and productivity of capital investment.

One of the key metrics we use to assess sustainability risks is their RepRisk Index (RRI)*, which measures a company's current reputational risk exposure based on recent controversies. At the end of December 2023, the weighted average RepRisk Index for our portfolio was 26.8, lower than the 27.4 it was at the start of the year and lower than the MSCI World's weighted average of 29.9, which implies our portfolio has lower exposure to reputational risks related to sustainability factors than the MSCI World.

At the end of 2023, the four companies with the highest RepRisk Index scores were:

Stock	RepRisk
Alphabet	65
Johnson & Johnson	56
McDonald's	53
Unilever	52

Source: RepRisk

Alphabet has retained its position as the company with the highest RepRisk Index score in the portfolio. Two new entries to the top four are McDonald's and Unilever, replacing Microsoft and Procter & Gamble, respectively. Alphabet's RRI is high not due to real and significant negative impacts but because of a large amount of press coverage resulting from their size and the fact that their products are used by millions daily. This continued to be the case in 2023.

Additionally, US and European competition authorities tried to find evidence of market abuse or noncompliance with various updates to consumer privacy rules during the year. We expect the companies in which we invest to manage this regulatory risk effectively and do not currently think that Alphabet is excessively abusing its market position. One of the reasons that Alphabet is such an attractive company to invest in is its dominant position in the markets within it operates.

McDonald's RepRisk is higher than the portfolio average due to accusations of sexual harassment at some franchisee-owned stores in the US and the treatment of migrant workers in Saudi Arabia. We have assessed it as not having a significant net negative impact because of its ongoing and significant progress towards making its food healthier and improving animal welfare in its supply chain. Its restaurants also provide a cheap source of calories and protein to many underprivileged communities while providing thousands of young people their first employment experience.

Unilever and Johnson & Johnson's RRI tends to be among the highest in the portfolio due to the environmental impact of its large, complex supply chain and various historic legal cases against the company, respectively.

At the end of 2023, the four companies with the lowest RepRisk Index scores were:

Stock	RepRisk
Waters Corp	0
ADP	0
Fortinet	0
Mettler-Toledo	0

Source: RepRisk

Waters and ADP remain on the list from 2022 and are joined this year by measurement specialist Mettler-Toledo and Fortinet. Fortinet is another new holding for the portfolio this year and specialises in cybersecurity solutions.

We use the RepRisk Index scores in two ways: first, to capture any coverage relating to the companies in the Fund's investable universe we may have missed in our routine research, and second, as a proxy for the absolute negative impacts a company has, particularly on society. While environmental impacts are relatively easy to measure (e.g. greenhouse gas emissions) and therefore assess both absolutely and relatively between companies, impacts on society are often qualitative and much more challenging to assess. Hence, we use the RRI as a proxy for evaluating these negative impacts.

Although it isn't perfect, it gives us a framework to assess and compare non-quantitative impacts between the companies in our investable universe.

The portfolio companies continue to show their commitment to reducing their contribution to climate change. By the end of 2023, 90% of the Fund's emissions were covered by a commitment to set Science Based Targets initiative (SBTi) emission reduction targets. Further, 59% of the companies in the portfolio had SBTi-approved targets, all aligned with the more ambitious goal of keeping global warming within 1.5°C of pre-industrial levels. This compares to 22% of the MSCI All Country World Index.

While it is important to ensure our companies are making the commitments necessary to avoid the worst impacts of climate change, it is more important to ensure that they act upon these commitments. Companies failing to act risk facing accusations of greenwashing and corporate complacency which can be damaging.

Between 2018 and 2022, the portfolio companies have collectively reduced their carbon emissions (Scope 1 and 2) by over four million tonnes and have averaged a 23% emission reduction per company. Some have made more progress than others, however. Three consumer staples stocks in the portfolio account for over 3.8 million tonnes of the total emissions reduction: Procter & Gamble, Unilever, and PepsiCo. Other companies have also made similarly impressive reductions, though not in the same absolute terms. Our payment companies, Visa and Mastercard, achieved 90% and 87% emissions reductions, respectively. Both can now claim to have carbon-neutral operations.

The carbon emission reductions made by these five companies all have one thing in common: they were made by using more renewable energy. Visa and Mastercard sourced 100% of their energy from renewable sources by the end of the period, while P&G, PepsiCo and Unilever were able to scale up their renewable energy usage significantly, reaching totals of 99%, 65% and 86%, respectively.

The impact of increasing renewable energy usage on a company's emissions can be seen in their reported Scope 2 emissions. Scope 2 represents the emissions generated by a company's electricity purchases and can be reported using two different methodologies. The first is a location-based methodology, which accounts for the energy mix of the local electricity grid. The second is the market-based method. This approach considers any Power Purchase Agreements or energy attribute certificates the company has chosen to acquire to increase the share of renewable energy it uses.

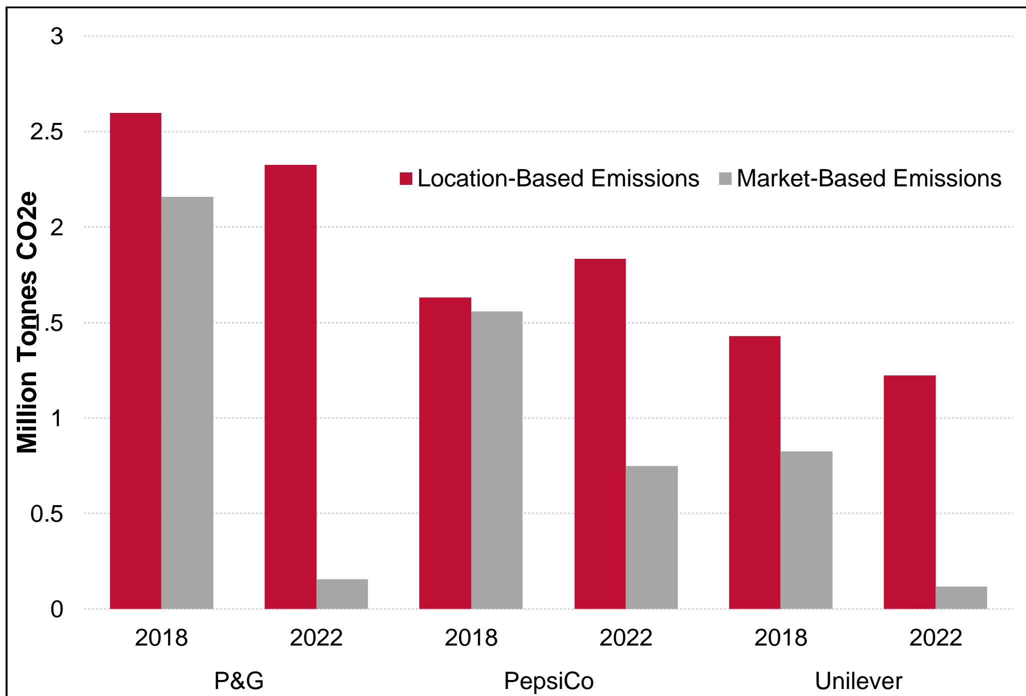
The market-based methodology has come under some criticism, mainly because the approach does not represent the energy consumed by companies as it comes off the local grid. We do not believe companies should be penalised for the energy mix of the country where their operations occur; even nations with mature renewable energy industries still use high percentages of fossil fuels to generate electricity. For example, the UK is one of the world's leading producers of renewable energy but still relied on fossil fuels to generate 44% of the total electricity it generated in 2022. The market-based method allows companies to increase their use of renewable energy and incentivises investment in renewable energy.

In our view, the market-based approach is a better representation of a company's decisions and efforts to reduce its emissions. In contrast, the location-based approach represents the energy mix of where their operations are located, which is not necessarily a company's choice.

As mentioned, companies can purchase renewable energy in two ways. Power Purchase Agreements (PPAs) are a long-term agreement between a consumer, typically a company that consumes large amounts of energy, and a renewable energy developer. The company agrees to buy either all or a pre-determined proportion of the renewable energy generated by the project. These agreements incentivise the developer to pursue renewable energy projects as they can ensure their profitability and they can also provide funding for the project. We prefer to see our companies following this route as it adds an additional renewable energy generation to the grid compared to the alternative option, Energy Attribution Certificates (EACs). EACs are instruments designed to track the origin of renewable energy, giving the purchaser insight into where the energy was produced, which technology was used to produce it and the age of the machine generating it. Companies can purchase these certificates (which each represent one MWh hour of renewable energy) and use them to offset non-renewable energy they use.

P&G, PepsiCo and Unilever have used a combination of these methods, for example PepsiCo's renewable project with Iberdrola and P&G's with EDPR, to significantly increase the amount of renewable energy they use over the past 5 years. This in turn has allowed them to reduce the amounts of greenhouse gasses they are responsible for and therefore reduce their contribution to climate change. The impact these power purchasing projects and EACs have had on the emissions of the companies can be seen by comparing the location and market-based emissions reported in 2018 and 2022, as we have illustrated in the chart below.

P&G, PepsiCo & Unilever Reported Emissions 2018-2022



Taking P&G as an example, its location-based emissions have fallen from 2.6m tonnes in 2018 to 2.3m tonnes in 2022, a 12% reduction in its absolute emissions despite its revenues and operating profit growing by 20% and 33%, respectively. However, as the market-based emissions show, the reduction in net contribution to climate change has been even more significant due to the various renewable energy deals the company has signed. P&G's market-based emissions have fallen from 2.2m tonnes in 2018 to 0.2m tonnes in 2022, an impressive 93% reduction.

The third leg of our strategy is about 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 3.1% and ended it at 3.2%. The year-end median FCF yield on the S&P 500 was 3.7%.

Our portfolio consists of companies that are fundamentally a lot better than the average of those in the S&P 500 so it is no surprise that they are valued more highly than the average S&P 500 company. In itself this does not necessarily make the stocks expensive, any more than a lowly rating makes a stock cheap. However, we expect some of this disparity in valuation to be eradicated in 2024 if, as we expect, the cash conversion of our portfolio companies improves.

Turning to the fourth 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 15.4% during the period. It is perhaps more helpful to know that we

spent a total of just 0.01% (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 sold our stakes in Adobe and Estée Lauder and purchased stakes in Marriott, Mastercard, McDonald's and Fortinet. As last year this may seem a lot of names for what is not a lot of turnover as in some cases the size of the holding sold or bought was small. We have held 17 of our companies since inception in 2021.

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 2023 for the T Class Accumulation shares was 1.11% (I Class shares 0.97%). 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 2023 the TCI was 1.13% (I Class Shares 0.99%), 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 0.02% (2 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. 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.

Last year I spent quite a lot of this letter trying to explain the background to the period of low interest rates and Quantitative Easing and how the resurgence of inflation and interest rate rises had affected company valuations, and especially those which had above average valuations.

As an illustration of this effect, consider the following. If you had invested $100 in the Vanguard Long US Government Bond Index Fund (Ticker: VBLAX, 'Bond Fund') in June 2020, at the trough in yields on US Treasury bonds, your total income over the next 10 years would be a mere $7 i.e. you would receive 70 cents per annum in income. You would have had to invest a lot of dollars to get an

income you could live on. Had you invested in October 2023, which may represent the high point in this economic cycle for bond yields, your total income over the life of the investment will be $47.50. Quite a change.

This illustrates two points.

One is that you would have lost a lot of money had you bought the Bond Fund in 2020 and had still been holding it in October 2023. The Bond Fund's net asset value, at which it trades, declined from a peak of $17.71 in June 2020 to a low of $9.19 in October 2023, a fall of 48%. This puts the losses from investing in high quality equities over this period into perspective. Better to be in equities than long bonds when interest rates rise sharply.

The other point it illustrates is that bonds have been offering an alluring alternative to equities for many investors. If Uncle Sam is willing to pay a risk-free income (and short dated bonds are as close to risk free as you can get) of close to 5%, why take the risk of investing in equities? The short answer is because equities provide a better return. For the period 1928–2023 (the earliest for which I can get reliable data), the annualised return on 10 Year US Treasury Bonds was 4.6% whereas the S&P 500 compounded at 9.8% with dividends reinvested[#]. This of course includes the Great Depression and World War Two as well as other more recent and lesser incidents like the 1987 Crash, the Dotcom meltdown, the Great Financial Crisis of 2008–09 and the Covid pandemic.

This is unsurprising. Equities benefit from a feature which no other asset class, including bonds, can provide: a portion of the profit or cash flow which belongs to the shareholders is reinvested each year by the company. This is the retained profit which is not paid out as dividends, and its investment is the source of compounding which underpins the returns of long-term investment. In my view this is the least discussed and appreciated aspect of equity investment versus all other asset classes.

So, if equities outperform bonds why are investors so keen to hold bonds at the moment? The answer of course is that whilst equities may outperform bonds over long periods of time, there is no guarantee that equities will provide this superior return in any given period, and in fact they may lose value for periods of time, as they did in 2022. Many investors do not have the appetite to invest in an asset whose price is set daily by a process which was illustrated by this wonderful cartoon:

It requires not only a grasp of investment analysis but also an iron constitution to ignore the periodic shenanigans of the stock market and reap the rewards of long-term equity investment.

I thought it would be amiss not to mention two events which marked 2023.

The first event is the rise of Artificial Intelligence, or AI, as one of the driving forces behind the rise of most of the Magnificent Seven and especially Nvidia. What to make of it? I would offer a few observations.

Firstly, AI is not quite as new as the rise in interest in AI in the stock market this year, driven by Microsoft's investment in OpenAI and the adoption of its ChatGPT large language model (actually launched in November 2022). IBM launched an AI model called Watson which beat two human champions in the US quiz show Jeopardy! in 2011. Google (now Alphabet) acquired the AI developer DeepMind in 2014.

Secondly, the stock market, in a fashion exemplified by the earlier cartoon, has decided at the outset that it can identify winners in AI in the form of Nvidia designing the chips on which the generative AI models will run and Microsoft as a provider of an AI model. If it can do so at this stage it would seem to me to be a break with tradition. Think back to some of the major technology developments of the past half century or so and the early leaders:

- Microchips: Intel
- Internet Service Providers: AOL

- Mobile Phones: Nokia
- Search Engines: Yahoo
- Smartphones: Research In Motion (Blackberry)
- Social Media: Myspace

Where are they now? Does this experience suggest that we can predict a winner in the area of AI at the outset?

Moreover, maybe there won't be a winner, either in the provision of large language models or their use. There are numerous large language models in development and deployment by the major tech companies: such as Alphabet's Gemini, Meta's Llama 2 (stands for Large Language Model) and Microsoft's ChatGPT, as well as stock market excitement about the deployment of such models by Adobe, Intuit and Fortinet amongst just the companies that we follow. There is no shortage of contenders.

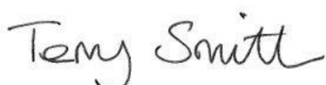
The adoption of AI may lead to a situation where everyone has it, so no one has any advantage. The analogy I would offer (with acknowledgement to Warren Buffett) is a football stadium. As the game becomes exciting and the striker runs into the penalty area with the ball, the second row of spectators stands up to get a better view. This blocks the view of those in the third row who follow suit. Pretty soon all the spectators are standing but no one has a better view than before, but they are all less comfortable.

So, I think we will suspend judgement of who, if anyone, will emerge as a winner in AI.

The second event worthy of mention is the passing of Charlie Munger, Warren Buffett's long time business partner, who passed away in November at the age of 99. Apart from offering a perspective on the perennial question about my retirement, Mr Munger's demise has led to the inevitable repetition of quotations from him by commentators. However, none of the commentators has alighted upon the Charlie Munger quote which in my view encapsulates the current state of world affairs: "If you're not a little confused about what's going on, you don't understand it."

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

Yours sincerely,



Terry Smith
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Sources: Fundsmith LLP & Bloomberg and #NYU Stern School of Business, unless otherwise stated.

Data is as at 31st December 2023 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.

P/E ratios and Free Cash Flow Yields are based on trailing twelve month data and as at 31st December 2023 unless otherwise stated. Percentage change is not calculated if the TTM period contains a net loss.

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