

January 2019

Dear Fellow Investor,

The table below shows performance figures for the last calendar year and the cumulative and annualised performance for the main share classes of the Fundsmith Equity Fund Feeder (“the Fund/Feeder”) compared with various benchmarks.

| % Total Return I Class Accumulation Shares | 2018 | Since Inception to 31 December 2018 | Annualised since inception |
|---|-------------|--|---|
| Fundsmith Equity Fund Feeder EUR ¹ | 0.9 | 218.6 | 17.6 |
| MSCI World Index EUR ² | -4.1 | 122.6 | 11.8 |
| Fundsmith Equity Fund Feeder CHF ¹ | -2.7 | 156.9 | 15.0 |
| MSCI World Index CHF ² | -7.3 | 86.3 | 9.7 |
| Fundsmith Equity Fund Feeder USD ¹ | -3.5 | 104.9 | 13.1 |
| MSCI World Index USD ² | -8.7 | 47.3 | 6.9 |
| Fundsmith Equity Fund Feeder GBP ¹ | 2.1 | 126.0 | 18.9 |
| MSCI World Index GBP ² | -3.0 | 64.9 | 11.2 |
| European Bonds ³ | 2.4 | 76.2 | 8.2 |
| Cash ⁴ | -0.4 | 0.1 | 0.0 |

1 I Class Accumulation Shares, net of fees, priced at noon CET (source: Bloomberg)
 2 MSCI World Index priced at close of business US time (source: www.msci.com)
 3 Bloomberg/EFFAS Bond Indices Euro Government 10 years (source: Bloomberg)
 4 3 Month EUR LIBOR Interest Rate (source: Bloomberg)

Launch dates:
 • EUR: February 2, 2011
 • CHF: April 5, 2012
 • USD: March 13, 2013
 • GBP: April 15, 2014

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 and the relative performance compared to the

MSCI World Index is therefore similar and shows the Fund significantly outperformed the MSCI World Index in 2018. All of the classes have also significantly outperformed since their dates of inception. 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.

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:

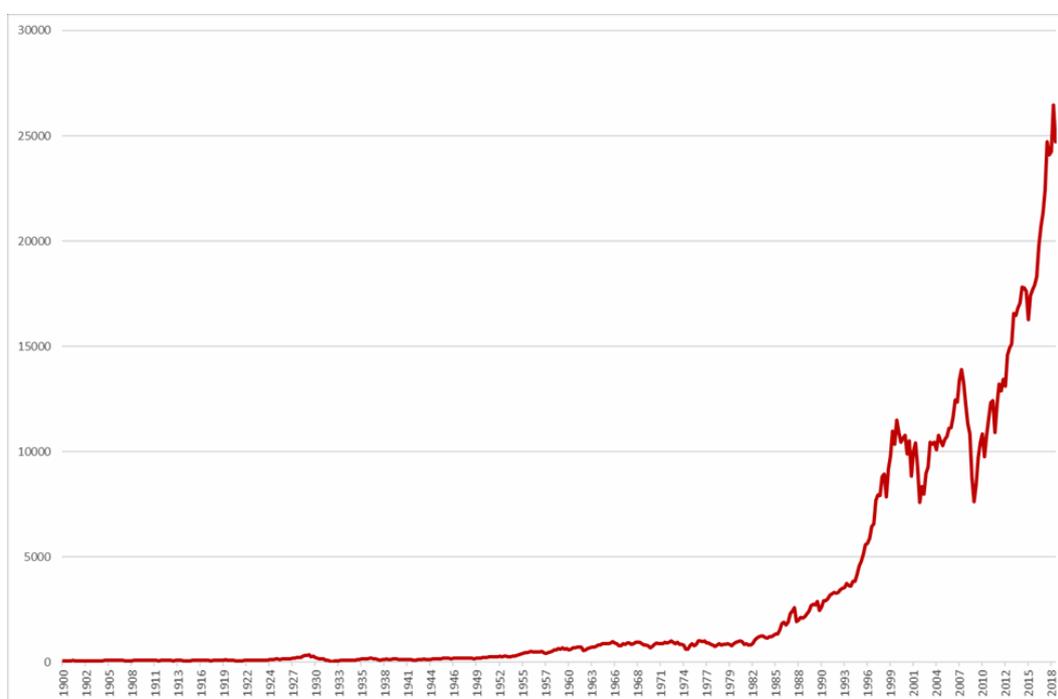
- The threat of a trade war between the USA and China
- Brexit
- The rise in US interest rates
- The US mid-term elections
- The Italian budget squabble (Italy is the third largest government bond market in the world)
- The US government shutdown

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.

| Year ended | Fundsmith Equity Fund Portfolio | | | | | | | | S&P 500 | FTSE 100 |
|------------------|---------------------------------|------|------|------|------|------|------|------|---------|----------|
| | 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 | <u>3yr</u> | <u>5yr</u> |
|--|-------------------|-------------------|
| 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.

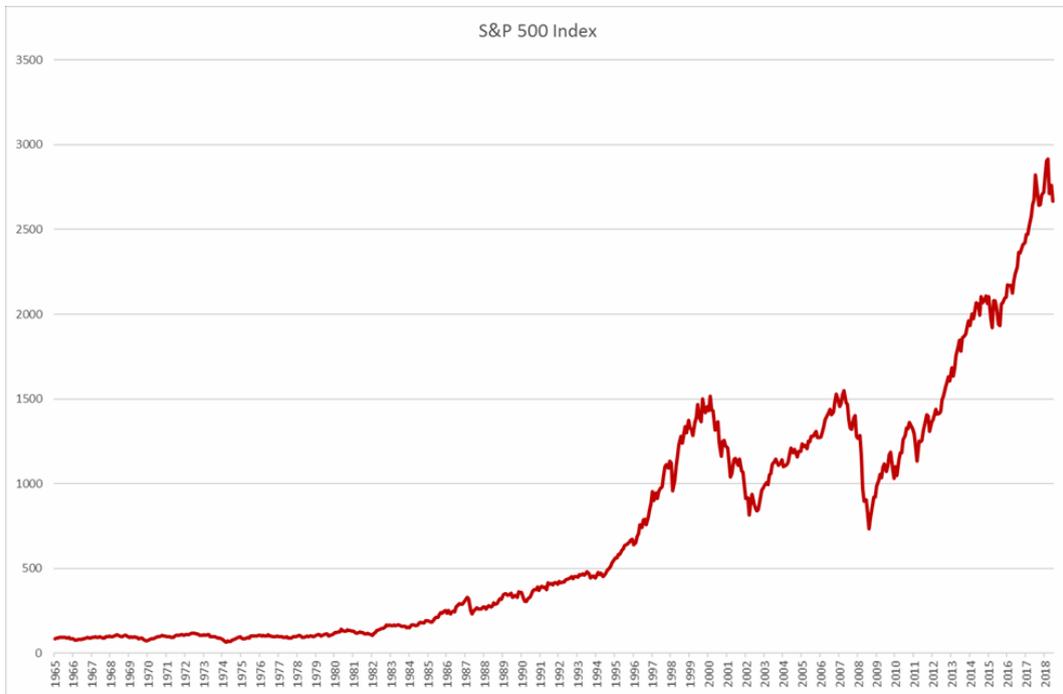
There are several problems with this though. Berkshire Hathaway is not the S&P 500. Its shares rose 49.5% in 1965 and only fell by 3.4% in 1966. So, your hesitancy would not have paid off. Moreover, by 1967 the market had recovered to a new peak.

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.

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.