Fundsmith

Fundsmith Stewardship 2020 Report

Fundsmith
Buy good companies
Don't overpay
Do nothing

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Introduction

Welcome to Fundsmith's 2020 Stewardship Report. This document, following the 12 Principles for Asset Owners and Asset Managers outlined in the Financial Reporting Council's (FRC) updated UK Stewardship Code 2020 and having regard to UK rules implementing the requirements of the EU Shareholder Rights Directive 2007/36/EC (as amended), details how we allocate, manage, and oversee capital to generate value for our investors.

The FRC define stewardship for the updated Code as:

> **"The responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society".[1]**

As long-term, buy-and-hold investors in the companies we choose to buy, stewardship is not only part of our fiduciary duty but an essential and implicit component of our investment strategy. Fulfilling our responsibility as stewards is a key contributor to ensuring the success of our investment approach. This report explains how Fundsmith has applied the Code's Principles over the 12-month period beginning 1st January 2020 and, in doing so, gives details on how Fundsmith understands Stewardship, the policies and processes used to encourage and support it, and how we performed as stewards of our investors' capital during 2020.

[1] https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Dec-19-Final-Corrected.pdf

Principle 1

Signatories' purpose, investment beliefs, strategy and culture enable stewardship that creates long-term value for clients and beneficiaries leading to sustainable benefits for the economy, environment and society.

Fundsmith LLP

Fundsmith was founded in 2010 as a fund management business responding to what the founding partners saw as failings in the industry. At the time, many of the equity funds available in the UK were consistently underperforming their benchmark, holding too many companies in their portfolios making them indistinguishable from the market as a whole, and reducing investment returns through expensive overtrading. Put simply, many equity funds were over-priced, under-performing and offered little difference from an index tracker.

Fundsmith is focused on delivering superior investment performance over the long term at a reasonable cost. It was established to be different from its peers so as to achieve a different result in line with Sir John Templeton's axiom that "If you want to have a better performance than the crowd, you must do things differently from the crowd." We apply exacting standards to potential investments to produce a portfolio of resilient businesses with excellent performance across a small number of equity funds. Minimising the costs we incur on behalf of our customers in implementing our strategy also sits at the heart of our philosophy.

Fundsmith is owned and controlled by its partners, who have worked closely together over many years, and is headquartered in London with offices in Mauritius and Connecticut, USA. It is structured to survive Terry Smith's demise and continue with the same investment philosophy. All partners of the firm have a significant co-investment in our Funds delivering a clear alignment of interest.

Our investment beliefs and strategies

When Fundsmith was first established in 2010, we published an 'Owner's Manual' outlining our purpose, approach to investing and strategy. We want those investing with us to understand our investment beliefs and approach so they know exactly what we are and aren't offering. We like to compare investing to competing in the Tour De France; the overall winner of the Tour (the "yellow jersey") never wins every stage. Similarly, we don't expect to outperform every quarter, or even year, but we do expect the companies we invest in to compound in value by more than the average company over the long term. Our Owner's Manual remains essentially the same as it was in 2010 and can be found on our website. We also write an annual letter for our investors, which is published on the respective fund's website. The letter shows the metrics we look for in the companies we have invested in and how (little) they have varied over time. Fundsmith Equity Fund's 2020 letter is available here.

At Fundsmith, we believe that over the long term, we will generate superior risk-adjusted returns compared to our peers. We achieve this by investing in predictable businesses with defensive characteristics who invest their capital at rates of return substantially above their cost of that capital. Our investing strategy is simple and builds from this basic belief: buy 'good companies', don't overpay, do nothing.

We believe that the most important driver of a business' returns is whether it is in fact a good business. Of the 96,000 listed equities in the world, we have identified fewer than 300 across all our fund products that qualify as being 'good', according to our criteria.

In our view, a good business is one that can sustain a high return on operating capital employed, in cash. We are not just looking for a high rate of return, but a sustainably high rate of return, which means we invest in businesses with significant distinct, competitive advantages. An important factor to this is repeat business, usually from consumers. A company that sells many small items every day is better able to earn consistent returns over the years than a company whose business is cyclical, like a steel manufacturer, or lumpy, like a property developer. This approach rules out many businesses that do not sell directly to consumers or make goods that are not consumed at short, regular intervals. We look for businesses that typically have an advantage over the market via some form of intangible asset (brand, distribution network, technology etc.) that helps to sustain a high rate of return on the capital they employ. Further, we like businesses that have the opportunity to reinvest some of those returns at the same high rate. This approach comes from the belief that over the long term a company's share price will compound at about the rate of return that the underlying business invests its capital, even if one buys the company's shares at a large discount.

There are many industries in which we don't believe a good company could ever exist due to specific factors that make it impossible to generate a high return on capital, or through little control of pricing, as with many commodity-based industries. For example, we can confidently say that we will never invest in a mining company, an oil and gas company or a bank. Combined with this, we operate our high-quality business screen, removing some of the most environmentally and/or socially damaging industries such as airlines, energy, automotive and biotechnology. We avoid these, as we believe their business models are unsustainable and they will struggle to generate sufficiently high returns over the long term.

We analyse companies in the widest possible sense, taking into account their net impact on the environment and society as well as any positive contributions they may have through research and development. Environmental, social and governance (ESG)

factors are becoming increasingly important to all companies and can significantly influence their long-term performance. We view damaging activity across any of these factors as taking profits from tomorrow to fund today's, which is unsustainable. Companies with poor performance in these areas may struggle to sustain the high return on capital our good companies must have. As long-term investors, we won't invest in companies that generate returns and profits unsustainably, as we want to own these businesses forever. We believe this approach makes us good stewards of our investors' capital as we expect management of investee companies to act like owners of the company, encouraging capital allocation for the very long term.

We believe that detailed research and developing a deep understanding of the companies before we invest is the best way to build a portfolio that performs over the long term. Our research process is detailed and is the most important part of our investment strategy. We use this research and our in-depth knowledge of the companies in our investable universe to build concentrated portfolios of high quality, resilient global growth companies.

When we identify a good company, we don't want to overpay if we choose to invest in its stock, but we also realise that to buy superior businesses you may need to pay a higher price. Despite this, we will only invest when we believe the valuation is attractive. Our goal is to buy securities that will grow and compound in value over time. These securities must offer free cash flow yields that are high relative to long-term interest rates and relative to the investments already selected within our portfolios or the other investment candidates in our investable universe. The securities should also offer yields that are similar to, or better than, what we would get from a bond. We estimate the free cash flow of every company after tax and interest but before dividends and other distributions and after adding back any discretionary capital expenditure, that is not needed to maintain the business.

This avoids penalising companies for investing capital at high rates of return to grow their business, which is exactly what we want.

Finally, once we have invested in a company, we aim to do nothing. Ironically, this is the part of the process when we are most active. In doing nothing, we try to only buy and sell a company based on its fundamentals, not on whether the share price is going up or down. This discipline means that we avoid the temptation of rebalancing our portfolios and keep trading to a minimum, reducing costs and consequently the charges for our investors.

We constantly monitor our companies after investing and rigorously continue to evaluate whether there are any changes in approach or new factors that might affect the company's long-term performance. If we identify an issue with an investee company, we follow the engagement, escalation and voting practices outlined in our report on Principles 9, 11 and 12 respectively, to promote resolutions that support the long-term performance of the company.

These investment beliefs are followed and complied with across the four investment strategies that we operate: Fundsmith Equity Fund (FEF), Fundsmith Sustainable Equity Fund (FSEF), Smithson Investment Trust (SSON), and Fundsmith Emerging Equities Trust (FEET). The same research process is followed by each strategy, which involves defining an investable universe of "good companies", all of which meet our strict investment criteria. This investable universe forms the basis for the respective fund portfolios.

Enabling Effective Stewardship

We rely on the proper execution of this strategy to achieve what we aimed to at our inception, which is to deliver superior, risk-adjusted returns over the long term. Once we purchase a business, we want to hold it indefinitely; ensuring companies are run on a sustainable basis to enable long-term generation of profits and increase in shareholder value is imperative. Therefore, stewardship is not simply a task that needs to be completed alongside our investment activities; it is an integral part of our investment philosophy and strategy. Our report on Principle 2 discusses how our governance is structured to support stewardship, and our report on Principle 7 goes into more detail about how stewardship is integrated into our investment process itself.

Fundsmith's staff share its investing beliefs and many of the firm's employees have significant amounts invested in the firm's products. We encourage this, as we believe it aligns our incentives with those of our investors. We view this as an important aspect of good stewardship as it means we invest our client's capital as though it were our own, as for many of Fundsmith's employees it is.

How have we done?

Since inception (Nov 2010 – Dec 2020), our main UK Fundsmith Equity Fund, has generated returns of 449% (annualised: 18.2%), compared to 215% (annualised: 11.9%) for the MSCI World. Not only have we outperformed but have done so with less risk. Over the past 5-years, the Fundsmith Equity Fund has a monthly Sharpe ratio of 1.58 compared to the MSCI World's 0.86. The Sharpe ratio is a measure of risk-adjusted returns. Even though our strategy has now been running for over a decade, market cycles can be longer than that and, just because we have performed well so far, there is no guarantee that we will continue to do so. As such, we keep reassessing the defensiveness and the risks of the companies we invest in.

Fundsmith publishes independent value assessments for FEF and FSEF, the 2020 value assessment is available here. Our Value Assessment analyses the performance of the Funds across seven areas; quality of service, performance, costs, economies of scale, comparable market rates, comparable service rates, and share classes. These reports conclude that the Funds provide good value to our investors, and when considered alongside the strong Sharpe ratio, means we are delivering strong risk-adjusted returns at good values, as our investors expect.

We continually look for ways to improve our disclosure on our stewardship activities and will be using this report as an opportunity to explain how we interact with our investee companies to promote sustainable long-term returns.

Principle 2

Signatories' governance, resources, and incentives support stewardship.

An essential part of ensuring we are good stewards is establishing practices within our business that not only support but encourage stewardship. Our report on this principle addresses the way we do this through how our governance provides oversight and accountability for stewardship, how we select and work with our resources to ensure our stewardship activities are fully supported, and how we incentivise the integration of stewardship and investment decision making. The following discusses this and highlights areas we could improve upon.

Governance

Fundsmith LLP continues to be wholly owned by its partners all of whom are actively involved in the business on a day to day basis. As such, Fundsmith's ownership and governance structure is completely aligned with the long-term focus of our funds and the aim to ensure the long-term growth of the business.

The Management Committee determines the firm's strategy and oversees all aspects of the business. Throughout 2020 this Committee comprised the Founding Partners of Fundsmith. It is ultimately responsible for setting the tone for the approach to stewardship throughout the firm and for ensuring that the business adheres to the stewardship principles and policies it has set itself.

Our investment beliefs are the same across the four investment strategies that we operate (Fundsmith Equity Fund, Fundsmith Sustainable Equity Fund, Smithson and Fundsmith Emerging Equities Trust). The same research process is followed by each investment strategy, which involves defining and investable universe of "good companies", which meet our strict investment criteria.

Each strategy that we operate has a respective investable universe (IU) of companies that have met our "good company" criteria within the strategy's respective market cap and geographic region, from which the portfolio is created. For new

companies to be added to the IU, the research team produce a comprehensive report on all aspects of the company, looking at both financial and non-financial factors that might affect its ability to sustain a high return on capital. This is then put to the strategy's portfolio management team, who then decide whether the company is worthy of IU inclusion. All IU inclusions are reviewed and approved by the Management Committee to assure that the "good company" process has been followed. This ensures that we have a consistency of approach and independent review of the process.

For the sustainable version of the Fundsmith Equity Fund, the Fundsmith Sustainable Equity Fund, companies are put forward for entry into the Fundsmith Equity Fund, with further analysis then done to assess if the company meets the additional criteria for the Fundsmith Sustainable Equity Fund. This process is discussed in more detail in Principle 7.

During 2020, as part of our review of our governance procedures, we identified the need for and set up a Stewardship and Sustainability Committee ("Stewardship Committee") to provide oversight and control over our stewardship activities and responsible investment processes. The Committee's purpose is two-fold; firstly, to provide a forum to align, support and review our stewardship activities within the investment process; and, secondly, to monitor any potential entries to any of our Fund's Investable Universes for compliance with the "do no harm" principle and Responsible Investment Policy. Should the Stewardship Committee deem a potential investee company unsuitable, the decision is final and that company will not be admitted to the strategy's investable universe. The Committee is chaired by Julian Robins, Fundsmith's Head of Research, with representatives from each portfolio management team and the Head of Sustainability. The Stewardship Committee meets twice a year and Julian reports the conclusions of its discussions to the Management Committee.

Stewardship also builds from the ongoing oversight and management of our investments. Our approach to this is detailed in Principles 9, 10 and 11, but follows the practices laid out in our Responsible Investment Policy. As part of his role as Head of Research, Julian Robins oversees the monitoring of our existing investments. He decides when, in accordance with our Responsible Investment Policy, we might need to engage, escalate, or consider divesting in a portfolio company. While Julian, as chairman of the Stewardship Committee, is accountable for our stewardship activities and processes, all of our research division support our stewardship activities and work to keep our decision making appropriately informed.

The policies we use to guide our stewardship activities are subject to an annual review by the Stewardship Committee and approved by the Management Committee.

Resources

We rely on our research team to conduct the in-depth research and analysis of companies to identify those that can produce the long-term, sustainable growth our strategy relies on. Our research team consists of ten analysts, including our Head of Research, working across all our Funds. Across the team, there is a total of over 130 years of experience, 5 CFAs, a variety of masters' degrees, a doctor of social anthropology and a chartered accountant. The team also has a diverse range of backgrounds from degrees in history and economics to electronic engineering and computer science. The team has a wealth of experience across the investment industry and is focussed on fulfilling our objectives as long-term investors. Their experience allows us to reliably build the resilient portfolios of high-quality businesses and to analyse any issues that may affect our view of the stewardship of those companies. Stewardship is embedded in our research process and a vital part of our assessment of prospective investee companies.

In addition, in response to increasing reporting expectations, we have recruited a member of the team who is specifically focussed on stewardship and how we as a business assess and react to any stewardship issues that might arise. This extra resource also helps ensure we are correctly documenting, reporting, and communicating our stewardship activities. He has a degree in environmental science and is currently studying for his CFA Certificate in ESG Investing. He has specific responsibility for keeping the research team aware of best practice and any changes in thinking of how to approach our Stewardship activities.

It is also important to integrate and utilise a diverse workforce to support stewardship. In support of this, Fundsmith has committed to being an equal opportunities employer and operates under a full Diversity, Equal Opportunities, and Inclusion Policy. Our recruitment, promotion and all other selection processes are conducted based on merit against an objective set of criteria, avoiding discrimination against all protected characteristics.

We use various resources to support our analysts and their research process. We collect qualitative and quantitative information from a variety of publicly available sources: earnings reports, sustainability reports, press releases, and Bloomberg. Fundsmith Sustainable Equity Fund (FSEF) and the Fundsmith Sustainable Equity Fund SICAV use ESG data from Bloomberg to retrieve and calculate basic stats such as CO2 emissions, water and energy use, as well as the amount of waste emitted. We also use RepRisk's Index and Rating software to assess individual company's risk exposure to ESG issues and to benchmark the Fund against our chosen index. We use RepRisk as it avoids the 'intra-industry' approach that facilitates investment in the 'less damaging' companies operating in highly damaging sectors.

We use these sources in combination to support qualitative decisions on the companies that can be part of FSEF's investment universe, to assess potential investments, and to monitor the companies in which we are currently invested, across all our funds. We do not make investment decisions based on an individual score RepRisk provides but use it to inform our research.

Incentives

Fundsmith is owned, funded and managed by its Partners. The Founding Partners of Fundsmith receive only a fixed percentage of the net income of the firm, so they are incentivised to achieve the long-term growth and success of the business without prioritising short-term profits. The portfolio managers other than Terry Smith (who is a Founding Partner and the majority owner of Fundsmith) have their remuneration structured to ensure they are similarly focussed on the long-term success of their funds. All our funds follow the same long-term, buy-and-hold philosophy and achieve this through purchasing high-quality companies in their individual investment area. We do not set short-term targets and our portfolio managers are not rewarded with respect to the short-term performance of the fund. It is important to note again that our portfolio managers are also invested in the funds they manage. This alignment of interests with our clients is an important incentive in encouraging the sustainable growth of the businesses within each fund, and as such the sustainable growth in value of their own and our client's investment.

Our incentive scheme for the portfolio managers other than Terry Smith depends on the long-term performance of the fund which they manage. As mentioned, active and effective stewardship from our portfolio managers is a key contributor to the fund's performance, and consequently, portfolio managers' remuneration. Short term remuneration is assessed on an annual basis and makes up a large percentage of the manager's total remuneration package. Further details on our portfolio manager's remuneration is available in our annual report and accounts. We consider a range of metrics combined with qualitative judgments to analyse the effectiveness of our portfolio

manager's stewardship activities. However, there are difficulties in identifying and quantifying a single, holistic measure that accurately represents the many facets of our stewardship activities and achievements over the previous 12 months. We continue to work to find better ways to measure the effectiveness of our stewardship activities. Given our investment and business strategy will only succeed if our portfolio managers encourage the long-term performance of their companies through being effective stewards; we feel stewardship is adequately addressed and incentivised.

Our Remuneration Policy is available on our website.

Effectiveness

As discussed in our report on Principle 1, we feel that the long-term sustainable outlook we take when investing is the key driver of stewardship at Fundsmith. Our internal governance, resources and incentives are structured around generating long-term, sustainable growth in the value of the companies in which we invest for our funds. This is the aim of all of our fund products. Since Fundsmith LLP's inception in 2010, we have been successful in creating long term value for our clients and beneficiaries, and we believe that our approach will continue to do so.

Our investable universes (IUs) for each respective strategy are relatively concentrated and static. Since our inception in 2010, in the Fundsmith Equity Fund on average, we have added 3 and removed 2 companies each year. This low turnover allows for robust oversight of the investment process and the respective strategy IUs by the Management and Stewardship committees.

However, we are aware that effective stewardship does not simply result from relying on established processes but reviewing our policies, assessing the effectiveness of our activities and continually improving our approach. Our report on Principle 5 reviews this in more detail and explains how we typically approach the area. Even the process of producing this Stewardship Code Report has presented opportunities to assess our approach and identify areas that we can improve upon.

Principle 3

Signatories manage conflicts of interest to put the best interest of clients & beneficiaries first.

Fundsmith is under a regulatory duty to ensure that any conflicts of interest are managed in such a way so as to put the interests of clients first.

Fundsmith LLP is a small business, employing under 50 people. Fundsmith's investment criteria means our investable universe, across all our funds, totals less than 300 companies, significantly less than many fund managers with comparable assets under management. The result of this is a very low chance of conflicts of interest arising between Fundsmith, its Partners and employees and the companies we invest in. Regardless, we still strive to avoid any conflicts of interest in our investment activities. Should any potential or actual conflicts of interest be identified across our stewardship activities, they will be recorded in our internal Conflicts of Interest Register. Fundsmith follows the procedure detailed in our Conflicts of Interest Policy, which outlines the steps we take to avoid, minimise and manage such conflicts or potential conflicts.

Managing these potential conflicts is important. Failure to do so in the normal course of business could put us in a situation where the interests of clients and the interests of the firm are at odds with one another. Given the range of investors that invest in our products and the accompanying range of approaches to stewardship, we will not change our approach in any way under the pressure of a single investor. However, should a situation arise where the majority of our investors are of a similar mind, we are prepared to adapt our approach. We communicate our investment beliefs and approach to stewardship to potential investors in our Owner's Manual and product prospectuses to ensure all investors understand and are comfortable with our approach before investing, minimising the potential for this kind of conflict occurring. Fundsmith will always act in the best interests of the majority of the respective fund's investor base.

Our Conflicts of Interest Policy follows four steps: identification, prevention, management and disclosure. Conflicts of interest relevant to us may occur between our Partners, employees or any person directly or indirectly linked to Fundsmith by control (relevant persons), and a client of Fundsmith or potentially between different clients. In our policy, we identify five scenarios where there is potential for conflicts of interest in our activities. These arise when the firm, or a relevant person:

- Is likely to make a financial gain, or avoid a financial loss, at the expense of a client or fund.
- has an interest in the outcome of a service provided to the client or fund or of a transaction carried out on behalf of the client or fund, which is distinct from the client's or fund's interest in that outcome.
- has a financial or other incentive to favour the interest of another client or fund over the interests of a client or fund.
- carries on the same business as the client, or carries on the same activities for a UCITS fund and for another client or clients which are not UCITS funds; and
- receives or will receive from a person other than the client an inducement in relation to a service provided to the client or fund, in the form of money, goods or services, that is not the standard commission or fee for that service.

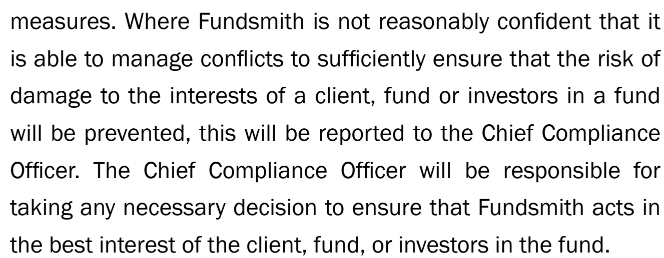
Fundsmith's Partners, with the input and assistance of the Compliance Team, have considered various situations arising from the day-to-day business of the firm in which a conflict of interest may occur, given the services and activities that Fundsmith undertakes. These are documented in the Conflicts of Interest Register that the Partners review and update on an annual basis. The potential for additional conflicts of interest will be considered each time Fundsmith takes on a new client, considers launching a new fund, develops a new investment strategy, or undertakes a new line of business.

The Conflicts of Interest Register also summarises the approach Fundsmith takes to manage and mitigate these conflicts. Where the potential for a conflict of interest has been identified, Fundsmith will seek to organise its business activities in a manner that prevents such a conflict from arising.

Where conflicts are unavoidable, Fundsmith will seek to provide measures for their mitigation and management. These management arrangements are designed to ensure that Fundsmith always acts in the best interests of its clients and puts their interests ahead of Fundsmith's. Where a conflict arises between two clients, Fundsmith will seek to treat both clients fairly.

This year we identified a potential conflict of interests resulting from a personal relationship. The external party has a professional association with an IU company which may influence some of our future stewardship activities, such as proxy voting. This potential conflict has been logged in our Conflicts of Interest Register, and is now being monitored by the compliance department. It is highly unlikely that our voting would be influenced by this, however, as all voting activity is monitored by the compliance team and follows our proxy voting policy. Votes inconsistent with the policy would be quickly identified by our internal processes.

Our Partners have allocated responsibility separately for supervising different areas of the business, such as client relationship management, business development, portfolio management, investment research, risk management, operations, and compliance. Fundsmith ensures that the risk management function does not carry out any portfolio management or investment research tasks and is supervised and remunerated independently from those functions to further minimise any potential conflicts. As part of Fundsmith's risk and compliance framework, the firm has a Compliance Monitoring Plan to ensure the requirements of this, and various other policies, are complied with. The Chief Compliance Officer and the Compliance Team are responsible for ensuring appropriate measures exist to mitigate and manage conflicts. The Partners are responsible for reviewing and approving these management



measures. Where Fundsmith is not reasonably confident that it is able to manage conflicts to sufficiently ensure that the risk of damage to the interests of a client, fund or investors in a fund will be prevented, this will be reported to the Chief Compliance Officer. The Chief Compliance Officer will be responsible for taking any necessary decision to ensure that Fundsmith acts in the best interest of the client, fund, or investors in the fund.

The Partners review and update our Conflicts of Interest Policy on an annual basis, reviewed by our lawyers, Travers Smith LLP. The Conflicts of Interest Register is also reviewed on a regular basis, at a minimum annually, to ensure conflicts have been properly managed throughout the period and to assess if any new conflicts have arisen.

Principle 4

Signatories identify and respond to market-wide & systemic risks to promote a well-functioning financial system.

At Fundsmith, we believe that there are more systemic risks that we cannot identify than those we can. Who at the start of 2020 would have predicted the impact that COVID-19 would have had on the global economy?

As ex-US Secretary of Defence Donald Rumsfeld once said *"there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns—the ones we don't know we don't know. And if one looks throughout the history of our country and other free countries, it is the latter category that tends to be the difficult ones."*

To best minimise the impact of the known and unknown risks, we invest in defensive "good companies" for the long term. In our report on Principle 1, we expand in more detail on our definition of good companies. Picking companies with defensive characteristics helps us build a portfolio that is more resilient to market-wide risks, such as changes in interest, currency rates or other macroeconomic/geopolitical issues. We also engage with our investor base and wider community on the dangers of market timing and the benefits of investing with a long-term investment horizon. Our CEO and CIO regularly contributes to the investment community through various interviews and articles, discussing the misunderstandings and risks that occur within investment and assessing ongoing market events and trends. For example, he has previously discussed the poorly understood risks associated with investing in speculative assets, such as Bitcoin. We hope that by illuminating such issues we can encourage wider discussion around these risks and encourage more sustainable capital allocation and management.

During a falling market, outflows are a key risk for an open-ended investment funds such as ours. Ensuring we have enough liquidity

to be able to return investors' cash when they want it is essential. To do this we typically only invest in large companies and monitor the liquidity of the underlying investments regularly. We believe our long-term investment horizon clearly communicated to our investors stops them panicking or overtrading, which also adds resilience.

Our Owner's Manual clearly outlines our long-term focus which we believe helps promote a more efficient and well-functioning financial system. By way of an example, we've owned 9 of the companies in our 30 stock Fundsmith Equity Fund since the fund was first launched in 2010. By focusing on the long term, we allow and encourage the management teams at companies that we invest in to also think over a similar investment horizon, making them better able to address long-term challenges, such as climate change.

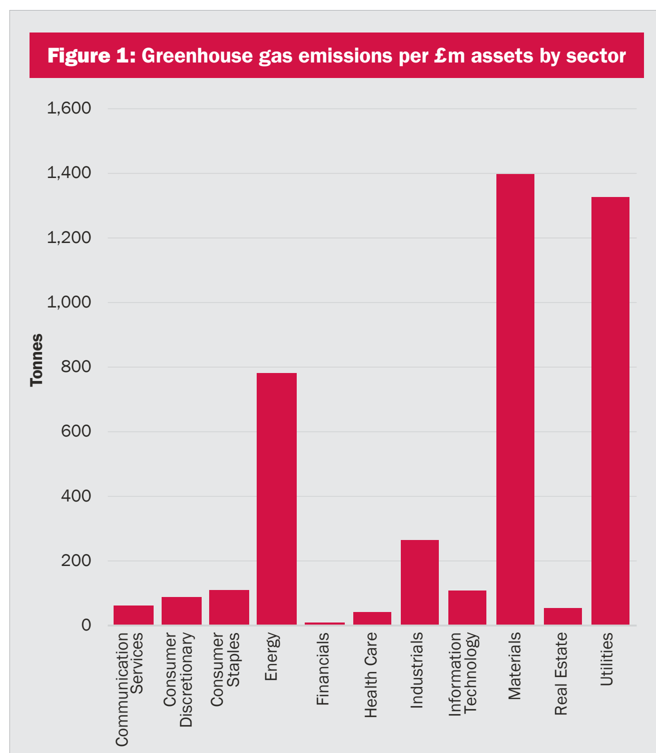
Our approach was tested during 2020 as COVID-19 put strain on both societies' worldwide and financial markets. We believe our strategy has shown itself to be effective in producing and maintaining value for our investors during the difficult circumstances this year has presented. Our funds performed well both in absolute and relative terms.

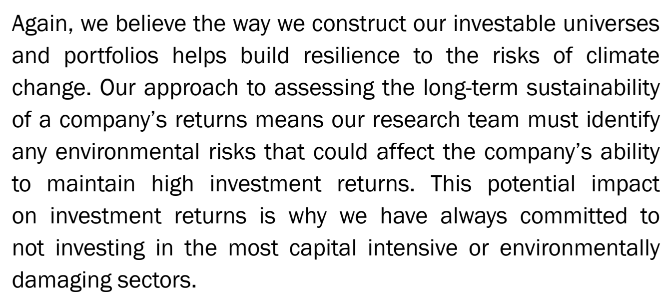
During March 2020, as markets fell with the global spread of coronavirus, our main investment vehicle, the Fundsmith Equity Fund, fell by 3.7% compared to a 10.6% fall for the MSCI World Index. Overall, in 2020 the Fundsmith Equity Fund outperformed the MSCI World by 6%, generating an 18.3% total return between 1st January 2020 and 31st December 2020.

Further, the outflows from the Fund amounted to 3% of our AUM, demonstrating that our long-term approach was heeded by a significant proportion of our investor base. Our operations showed that they were robust during the increase of outflows, with us being able to pay all redemptions in time and having no non-dealing days or significant operational issues.

Climate change and its associated risks also spent a lot of time in the spotlight last year as the pandemic reminded investors of the impact external factors can have on their investments. While we are unlikely to ever invest in, or have exposure to, the industries that contribute most to climate change, such as oil & gas, mining, and utilities, we are still exposed to the challenges and risks it poses. Figure 1 shows the contribution of different industries to greenhouse gas emissions (in tonnes of CO2e) per million GBPs of total assets for different GICS sectors. We typically invest in companies that Global Industry Classification Standard (GICS) would classify as Consumer Staples, Consumer Discretionary, Health Care or Information Technology, which, as Figure 1 shows, emit significantly lower concentrations of greenhouse gases than other industry sectors.

Figure 1: Greenhouse gas emissions per £m assets by sector





Again, we believe the way we construct our investable universes and portfolios helps build resilience to the risks of climate change. Our approach to assessing the long-term sustainability of a company's returns means our research team must identify any environmental risks that could affect the company's ability to maintain high investment returns. This potential impact on investment returns is why we have always committed to not investing in the most capital intensive or environmentally damaging sectors.

We regularly engage with companies to remind them of how little significance we put on short-term guidance or any small changes in it. This, we believe, directly contributes to a more efficient and well-functioning financial system by reminding management that not every shareholder is focused on the short-term.

Fundsmith is also a signatory to the UN Principles for Responsible Investment (UN PRI). This UN-supported network of investors works to promote sustainable investment practices through incorporating environmental, social and governance (ESG) factors into investment process. This initiative encourages investors, and, through investor engagement, companies, to think about the longer-term impacts their capital allocation decisions have, which we believe will lead to more efficient capital markets. We have engaged with the UN PRI over its new reporting tool and how its new assessment system works.

Principle 5

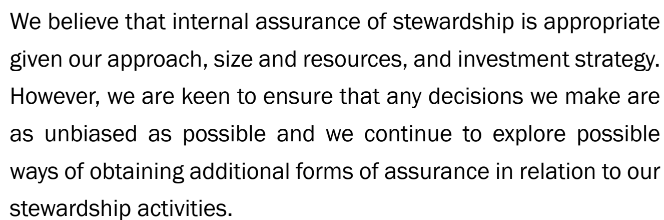
Signatories review their policies, assure their processes and assess the effectiveness of their activities.

The principle policy that relates to our stewardship activities is our Responsible Investment Policy, which details our approach to engagement and proxy voting. We review these policies at least annually to ensure that we are delivering consistency across the business, reflecting new information and continuously improving.

All our policies are internally reviewed, firstly by our Compliance Department followed by Fundsmith's Management Committee. This ensures that the final policy is aligned with the goals it set out to achieve, is consistent with Fundsmith's investment approach and values and complies with any regulatory requirements.

This year we established a Stewardship & Sustainability Committee to centralise discussions regarding stewardship and responsible investment decision making. The Committee is responsible for assessing potential entrants to all our Investment Universes and conducting an annual review of our Responsible Investment Policy, UN Principles for Responsible Investment Report and any other stewardship or sustainability related reporting. The committee is chaired by the Head of Research and comprised of representatives for each of our products and the Head of Sustainability.

We aim to report on all our stewardship activities in a fair, balanced and understandable way, as a core part of our approach. Ensuring investors understand how we behave and act on their behalf promotes good practices and market stability. Our stewardship reporting is done by analysts in the research department who are directly involved in the investment process. Reports are then checked by the compliance department, and our newly established Stewardship and Sustainability Committee is in place to monitor the overall process and method. Finally, report is reviewed and approved (or rejected) by the Management Committee.



We believe that internal assurance of stewardship is appropriate given our approach, size and resources, and investment strategy. However, we are keen to ensure that any decisions we make are as unbiased as possible and we continue to explore possible ways of obtaining additional forms of assurance in relation to our stewardship activities.

The rapid rise of ESG awareness during 2020 highlighted some areas and processes we could improve to assist in the quality and quantity of ESG-related information we report to our investors. One such area was the way we record the details of our engagements with companies. Our investors increasingly want to understand how we engage with companies regarding ESG topics and the outcomes of these engagements. To achieve this, we redesigned our internal company meetings record to allow team members to give greater detail about the topics covered in meetings, the motivation for initiating engagement and the outcomes of these meetings.

Principle 6

Signatories take account of client & beneficiary needs and communicate the activities and outcomes of their stewardship and investment to them.

Fundsmith operates a small number of fund vehicles across four investment strategies, which only invest in listed equities. As of 31 December 2020, Fundsmith's assets under management totalled £33bn. Of this, 91% was invested in large cap developed markets, 7% in small and mid-cap developed markets and 1% in emerging markets. 89% of our AUM are in open-ended collective investment vehicles, 3% in Delaware LPs and the remaining 8% in investment trusts, which are closed-ended investment companies listed on a stock exchange.

Fundsmith has a wide variety of investors in its funds, from individual retail investors to large institutional investors. Across our funds, 24% of our assets under management are from retail investors, investing in our open-ended funds directly through our website or an investment platform. The remaining 76% is from institutional investors, such as charities and pension funds. Within our open-ended funds, UK-based investors account for 75% of the assets under management, the rest of Europe 17%, Asia 4%, Africa 3% and the rest of the world accounting for less than 1%.

Given the number of investors in our funds, rather than adapting our investment approach to particular individual investors, we clearly communicate our investment philosophy, allowing investors to decide whether we fit with their investment and stewardship policies and preferences. We believe this is the appropriate approach to take given the diverse range of our investor base and, in particular, the mix between retail and institutional investors. Adapting our approach based on the preferences of a particular investor, or group of investors, risks disenfranchising our retail or smaller institutional investors and would be contrary to our aim of building a group of likeminded investors. This is why we put so much emphasis on potential investors to read our Owner's Manual and Responsible Investment Policy before investing in our products.

Most importantly, we want those who wish to invest with us to understand that we are long-term investors. We spend a great deal of time identifying and researching companies that we believe will provide the best returns over the long term. It is important to us that investors understand why we think the types of companies we invest in will outperform and compound in value over the long term as this will make them less likely to sell in the inevitable periods where we underperform. Our recommended holding period for investors is at least 5 years.

Unlike many other investment managers, we hold an annual shareholders' meeting (ASM) for the Fundsmith Equity Fund (FEF) to which all our direct investors in the fund are welcome to attend. The ASM has grown each year and now has almost a thousand of our investors in attendance. Investors are encouraged to submit questions in advance of the meeting. The ASM provides an effective format for feedback, allowing us to assess how successfully we are meeting our investors' needs. Outside the ASM, we encourage questions from our clients, and consider any issues brought to our attention in this way. We also have an investor relations team dedicated to answering investor queries.

We periodically publish updates for all our products on their respective websites. These updates ensure that investors are kept informed about a variety of financial and non-financial information regarding the relevant fund. Our monthly Factsheets provide data and a short description of key activity within the fund over the previous month. We also publish annual accounts for all our funds. For the open-ended funds, we publish an annual Shareholder's Letter, updating investors. For institutional investors, there are also regular fund updates from the respective fund manager. This Stewardship Code Report is a further opportunity for us to communicate our stewardship approach and how we allocate the capital invested with us.

Over the past year, the propagation of ESG through the investment industry has generated increased interest in, and expectations for, ESG disclosures from our investor base. As a result, we are looking to expand our reporting across our other funds, where appropriate, in a style similar to the monthly ESG Factsheets we already publish for FESF. We are also in the process of updating our website after investor feedback. We are aiming to increase the accessibility of all the information we report concerning the company and fund performance to current and prospective investors.

Principle 7

Signatories systematically integrate stewardship and investment, including material environmental, social and governance issues to fulfil their responsibilities.

As we outlined in our report on Principle 1, as long-term, buy-and-hold investors, active and effective stewardship is an essential part of our investment approach. In 2020, we published our firm wide Responsible Investment Policy as part of our participation in the UN Principles for Responsible Investment initiative. This Policy outlines, in detail, how we consider and assess ESG issues as part of the investment process for all our products and how this assessment promotes the responsible allocation of capital. It also discusses how we use engagement and proxy voting to manage and oversee the long-term performance and value of investee companies. To see the full policy, follow this link.

The success of our approach relies upon the long-term performance of the companies we invest in. Our priority is to invest in "good companies" and hold the stocks in these companies forever. Ensuring effective stewardship and appropriately considering ESG risks and factors are therefore fundamental components of our investment approach. As all of our investment strategies are global equity based, we adopt the same basic principles in our approach for each fund or client portfolio. Our Owner's Manual and the fund literature is very clear that investors should be prepared to invest for the long term, with a minimum recommended holding period of at least 5 years.

We conduct our own internal research and use all sources of publicly available information to assess the companies we invest in. Furthermore, we regularly engage and interact with the management of those companies to ensure that they are looking to improve their businesses and achieve long-term success. The information we gain from the combination of our research and these interactions is the main way we would assess whether to buy or sell a company, rather than what has necessarily happened to its share price.

We classify a company as good if they can make and sustain a high return on capital employed across the full business cycle. Of the approximately 96,000 listed companies in the world, our good company screen removes 98%. It is also notable that many of the companies that do the most damage to the environment and wider society would not meet this good company definition. We will not invest in auto, energy, utility, banking, or mining companies, as we do not find them to be businesses with sustainable business models that fit our criteria. This good company screen leaves each of our funds with around 100 individual companies in their respective investable universes, any of which we would ideally hold forever, assuming they remain good companies, but may not currently trade at an attractive valuation or form a balanced portfolio when all held at once.

Understanding how ESG risks can affect the ability to sustain a high return on capital invested is essential; unsustainable practices can severely affect a company's return on capital over the long term. We see damaging practices towards the environment or society as potentially resulting in the company's failure to sustain the high, long-term returns we prioritise and damaging their growth potential. Our research team identifies and assesses these issues and risks as an integrated part of our pre-investment research and continual monitoring of IU companies.

The ESG risks we consider are varied and differ depending on the company in question. We aim to understand the risks associated with the company in a holistic sense, that is the risks associated with direct activity, its supply chain, the lifecycle of end products, and in the interaction with end users/customers. We also assess how effectively the company is mitigating these risks, should they be present and material.

Supply chains are exposed to both environmental and social risks that can impact the operation and sustainability of the supply chain, and consequently the performance of the company. To assess supply chain sustainability, we look at various factors, for example, identifying any potential human and/or labour rights abuses, or the extent of the supply chain's exposure to extreme weather events.

We analyse the risks associated with the company's direct activities through various metrics. For example, we use greenhouse gas emissions to judge exposure to the transitional risks associated with the movement to a low-carbon economy. High concentrations of greenhouse gas emissions increases the likelihood a company will be exposed to the fines and regulations implemented to assist in this economic transition. Greenhouse gas emissions also contribute to the wider, systemic risk of climate change and is something that we monitor closely. However, as discussed in Principle 4, our investment approach means our companies are relatively small contributors to this.

The environmental and social risks associated with the distribution, use, and disposal of the company's products is also considered. We assess the product's impact; is it beneficial, neutral, or detrimental to society? Detrimental products are more likely to suffer from negative consumer sentiment and increased regulation over time. It is important to include an assessment of how the company is innovating to improve the impact of their products. For example, introducing "heat-not-burn" tobacco products, or reduced fat/salt/sugar food products and the benefits and costs associated with this innovation.

We consider ESG impacts in the widest possible sense, taking into account both the positive and negative effects that an investee company may have on the environment and/or society. We analyse and evaluate the company's environmental and social impacts, its governance policies and practice, its policies regarding dividends and executive remuneration and its methodology for assessing the adequacy of capital investments. We also look at a company's positive impacts including their research and development and product innovation activities. Many of the companies in the investable universe for Fundsmith's funds are constantly striving to develop their products in ways that improve their sustainability and offer a positive impact. They achieve this through improving product efficacy, inventing new solutions to problems, or reducing the negative environmental or social impacts of their existing products. Sustainability is an area which is developing and evolving, and we expect the companies

in our investable universe to be aware of this and always seeking to improve.

We monitor and assess a company's sustainability risk and establish an objective view of its net negative ESG impacts using three main sources of data and information. The first of these is our ESG and innovation database. We maintain a database of all the qualitative information a company has provided on its own sustainability efforts from their sustainability reports, earnings calls, press releases, annual reports and/or their website. These pieces of information are tagged and categorised within approximately 75 different topic tags, under the main categories of environmental, social, governance and innovation. These tags are updated to reflect current issues of global concern and to incorporate new factors. This allows us to look across the entire investable universe for all funds by these topics and to have a record of what a company has said about a regarding an issue across a number of years. The database currently has over 6,000 pages of information collected over the past 6 years.

Secondly, Fundsmith collates the data on environmental performance, diversity, corporate governance and innovation reported by companies. We use this to provide a look-through of the portfolio compared to the S&P 500 Index, to publish as part of the monthly Sustainability Factsheet. Not all companies report the same numbers and even fewer use the same methodology or have them assured to the same standards, hence we don't overly rely on these numbers. We do, however, think that they still offer some insight into the relative impact of the portfolio compared to the benchmark. The environmental stats are reported per million GBPs of free cash flow. This helps us to address the trade-off between a company's investment proposition and what its net negative impacts are on the world, within our universe of good companies.

Finally, we utilise an independent assessment of negative reputational risk from environmental, social and governance issues provided by RepRisk. RepRisk scans over 100,000 public news sources from around the world in 20 different languages every day, creating a company score based on the severity, reach and novelty of the respective issues a company is deemed to be responsible for. This service is used in two ways by Fundsmith.

Firstly, it serves as a proxy for the overall negative impact a company may have as it provides us with a way to absolutely rank companies within our investable universe. We can then adjust these rankings based on any significant positive impacts, or where we think RepRisk's score may be overstated due to its focus on the negative impacts. Secondly, it acts as a catch- all for any negative news regarding a company that our usual news filtering services may miss.

Additionally, we require the companies we invest in to have well-managed policies for ethical working practices and a sustainable relationship with the environment and their stakeholders. Fundsmith integrates expectations of a company's environmental, social, governance and innovation impacts on the world into our model forecasts.

We are constantly searching for ways to improve how we monitor ESG risks and integrate them into our investment process. As the industry moves towards a more standardised method of measuring these factors, we can start developing more consistent metrics that allow a more accurate assessment of, and comparisons between, the companies within and outside our investable universes.

Fundsmith Sustainable Equity Fund (FSEF)

FSEF follows the same process outlined above but uses additional hard sector exclusions and a "sustainability screen" over the Fundsmith Equity Fund investable universe. This means that the FSEF investable universe will always be a subset of the Fundsmith Equity Fund investable universe.

The hard sector exclusions are as described in the Fund's prospectus and mean that we cannot invest in any companies classified as being in the following GICS industries: Aerospace & Defence, Metals & Mining, Oil, Gas & Consumable Fuels, Tobacco, Gas Utilities and Electric Utilities or the following GICS sub-industries: Brewers, Distillers & Vintners and Casinos & Gaming.

We also exclude any companies that profit from pornography or those, such as Louis Vuitton Moet Hennessy (LVMH), which despite not being classified by MSCI in the above sectors, makes a significant proportion of its profits from alcohol.

We then apply our sustainability screen. This screen uses the information we have collected regarding FEF's companies and their sustainability risks, net environmental and social impact on the world, awareness of these impacts and mitigation measures undertaken to make a qualitative judgement on their overall level of sustainability. This qualitative judgement assesses whether the company's net environmental and social impact on the world is firstly, negative, secondly, excessive, and thirdly, decreasing due to concerted mitigating action by the company. We try to assess environmental and social impact, both positive and negative, in the widest possible sense. The assessment of negative environmental and social impacts has an inherent subjectivity, but we attempt to make our process as objective as possible by leveraging as much information as we can in our decision-making process. We think we are well positioned to make this assessment as our investable universe is small and we know the companies inside the universe intimately. Once we have removed the companies that we find to have an excessive amount of environmental or social harm we are left with the FSEF investable universe.

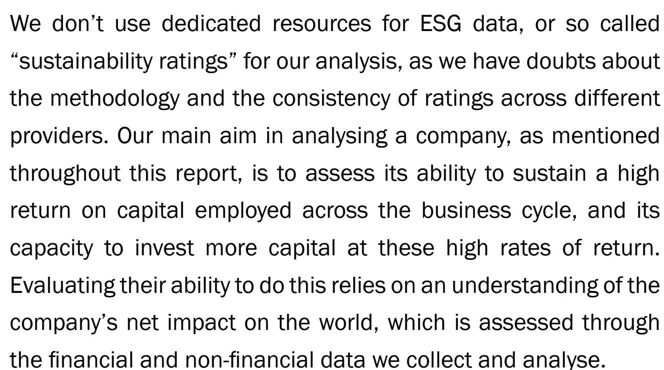
Fundsmith Sustainable Equity Fund's additional ESG criteria means companies such as Facebook and Philip Morris are excluded in its investable universe, both of which are present in the Fundsmith Equity Fund's investable universe. Both pass our good company screen, but Philip Morris is a tobacco company and is removed by our sector screen, while Facebook is excluded because of our qualitative assessment of its excessive net negative impact on society and its current attempts to mitigate these impacts.

Principle 8

Signatories monitor and hold to account managers and/or service providers

We use a variety of quantitative and qualitative data to assess potential investments and monitor existing investments. Our research team does all our analysis in-house, using data collected directly from company websites and publications. Data for prospective investee companies is collected from company websites through their publications of annual reports and other public documentation. We meet management, attend conferences and read industry publications (e.g. Pet Food Digest) to help build the profiles of the companies and industries in all our respective investment universes. We also collate data on environmental emissions, diversity, corporate governance, and innovation from data companies provide themselves. For practical reasons, much of this data is delivered to our Research team through Bloomberg.

We check the quality/accuracy of the data we get this way by cross referencing against other freely available sources. For example, we reconcile company reported greenhouse gas emission against those provided by the CDP, which are calculated and reported separately. Though, as CDP participation grows, more companies are using this data within their own reports. The result is that when companies do this, we are accessing data that has already been audited and approved by a third-party. Across the research department, we also have access to sell-side research from investment banks and other research brokers. Typically, we use our relationship with investment banks for access to company management teams and for information on companies that can sometimes be more difficult to access, particularly in emerging markets. We place little value on any recommendations, opinions or advice that this research provides. Each year, we assess the value offered by different sell-side research providers before deciding to resign the contract.



We don't use dedicated resources for ESG data, or so called "sustainability ratings" for our analysis, as we have doubts about the methodology and the consistency of ratings across different providers. Our main aim in analysing a company, as mentioned throughout this report, is to assess its ability to sustain a high return on capital employed across the business cycle, and its capacity to invest more capital at these high rates of return. Evaluating their ability to do this relies on an understanding of the company's net impact on the world, which is assessed through the financial and non-financial data we collect and analyse.

To help us assess these net impacts independently, we use reputational risk scores from RepRisk. We think this acts as a strong proxy for negative impacts on the world and is superior to the sustainability ratings we looked at. The service analyses over 100,000 news sources in 20 languages a day and acts as a catchall for any negative news on a company that our usual news filtering services may miss.

To check the validity of the information RepRisk provides, we collect and store both positive and negative media coverage of our companies in our internal daily news emails. We can then compare what we've collected to what RepRisk has considered significant. We have regular contact with RepRisk to help improve their system and help our investment process. This contact is typically twice a year. However, if any specific issues emerge between these meetings, we have a designated customer service representative we can engage with to address them.

It's also important to note that we don't rely on any single service provider for any part of our investment process. Data from each provider is used as part of our assessment of a company's investment proposition and is never relied on exclusively. We do not use any proxy service providers, deciding our votes on each proxy independently.

Principle 9

Signatories monitor and hold to account Signatories engage with issuers to maintain or enhance the value of assets

Fundsmith's engagement policy is available as part of our Responsible Investment Policy, which is available here.

Our approach to engaging with the companies in our portfolios comes directly from our desire to be long-term shareholders in those businesses. We engage with companies to encourage sustainable business decisions that will benefit the long-term performance of the company.

Practically, this means we generally support changes and/or investment that promotes long-term growth and oppose the establishment of unrealistic short-term targets and activity that negatively impacts the ability to sustain high returns.

The decision to engage with a company is made on a case-by-case basis and is prompted by various factors, both internal and external. We only engage with companies regarding topics relevant to their operations and when we deem the risk to be material and detrimental to long-term performance. Engaging with a company is an effective way to generate change that reduces risk, but we do not always engage with the goal of changing the company. We use engagement to reassure ourselves, and to better understand the company's perception of the potential risk. Companies are often aware of the risks we identify and either have plans to, or are currently, mitigating it, or have deemed it immaterial. These engagements are equally as successful as those that force change within a company. Of course, if the company is unaware or not doing enough to address the risk, the engagement can then be used to generate the change needed.

One key issue we frequently engage with investee companies regarding is executive remuneration. Generally, we care how executives are paid, not how much. We would like the remuneration policies of the companies we invest in to be aligned with the sustainable, long-term growth of the business. We don't like remuneration polices that are based on the kind of short-term metrics discussed above. We believe an effective remuneration policy includes both a measure of growth and a measure of returns, it is no use having one without the other.

We also want to encourage companies to integrate sustainability into their business model and give due diligence to environmental, social and governance factors. As we have previously discussed, poor ESG performance may generate immediate profits but has the potential to negatively affect future growth. These non-financial, ESG factors are becoming increasingly likely to bring material financial impacts as consumer interest and regulatory pressure continues to grow.

Our engagement differs between our funds slightly given the different size of businesses and geographies they invest in. As at the end of 2020, the companies in FEF and FSEF had an average market capitalisation of £147bn and £140bn respectively, while Smithson has a much smaller average at £10bn and FEET smaller again at £4.7bn.

Engaging with the companies in our emerging market fund is typically more difficult than in our developed market funds as these companies have fewer resources to devote to engaging with investors.

Table 1 below sets out information on our engagements with investee companies for each of our funds during 2019 and 2020.

	Total no. of engagements		% of Portfolio engaged (2020)	Average no. of engagements per portfolio company (2020)
	2020	2019		
FEF	78	53	69%	3
FSEF	61	43	66%	3
SSON	50	81	67%	1
FEET	75	159	55%	1
Total	264	336		

Table 1: Fundsmith 2020 engagements summary

During 2020, Fundsmith, between all our products, recorded 264 engagements with 85 of the 144 companies owned. Many of these engagements were calls with company management teams that largely updated us on their performance, introduced new executives and/or involved a discussion over their long-term strategy. Excluding these, 45% of the engagements we initiated to address specific concerns related to the company's remuneration policy.

The coronavirus pandemic had a large influence over our engagement activities during 2020. The physical meetings some of our companies relied upon became impossible and were replaced by virtual alternatives. These changes resulted in the total number of engagements across all our products falling by over 20% compared to 2019. The negative effects of the pandemic were particularly pronounced in our emerging markets fund, FEET, and small/ mid-cap fund, Smithson, as, in FEET in particular, uptake of virtual alternatives was slow. Comparatively, for our large cap funds, FEF and FSEF, we engaged with companies more often during 2020, up by 47% and 44% respectively.

Engagements via video conferencing saw a large increase during 2020 in the wake of the COVID-19 pandemic, with the large-cap companies we own in FEF and FSEF responding particularly well to this transition to a virtual meeting world. Video conferencing accounted for 8% of our meetings with FEF investee companies during 2019, increasing to just under 45% of all engagements in relation to FEF's portfolio companies in 2020.

Some examples of our engagements with companies are detailed below.

Company	Intertek
Sector	Industrials
Country	United Kingdom
Fund	Fundsmith Equity Fund (FEF), Fundsmith Sustainable Equity Fund (FSEF)
Context	Remuneration policy
Objective	Understand how the existing remuneration policy incentivised long-term sustainable growth.
Activity	Engaged with Human Resources VP & Remuneration Committee Chair in 2019 and met with the CEO several times during 2020.
Outcome	The company introduced a new remuneration policy in 2020 that we were supportive of as it included a returns-based measure in its LTIP. Hence, we voted in favour of the company's remuneration policy at the 2020 AGM, having voted against it at the 2019 AGM.

Company	Intuit
Sector	Information Technology
Country	United States
Fund	FEF, FSEF
Context	Negative media coverage regarding free filing software
Objective	Understand the company's position and the facts behind the media coverage and anything the company thinks they could do better in the future.
Activity	Two meetings with Investor Relations and Corporate Governance teams in late 2020
Outcome	They explained to us that the media coverage was largely a misunderstanding. The company outlined the mistakes it thought it had made, explaining how they have now made their free filing software easier to find and more accessible. This reassured us that there was minimal risk of the issue recurring. We continue to monitor the situation and will engage with them on the topic again after the next tax filing season.

Company	Johnson & Johnson
Sector	Health Care
Country	United States
Fund	FEF, FSEF
Context	Negative media coverage on certain products
Objective	Understand the company's position on the situation and what corporate governance controls they had in place to ensure a sustainable balance between marketing and safety.
Activity	Met with Worldwide VP of Corporate Governance and an ESG representative in late 2020.
Outcome	The company verified our understanding of the facts behind the media coverage and reassured us that it had appropriate corporate governance controls in place. We will continue to monitor the situation and will engage again if we are no longer satisfied.

Company	Integrated Diagnostic Holdings (IDH)
Sector	Industrials
Country	Egypt
Fund	Fundsmith Emerging Equities Trust (FEET)
Context	Stock liquidity
Objective	Discussion on best option to increase stock liquidity
Activity	Met with the company's Investor Relations team and their advisor
Outcome	As long term holders, we made it clear we wanted to keep our shares in the company. We gave our views on the alternative options available and the logic behind our preference of those options. We await the company's final decision.

Principle 10

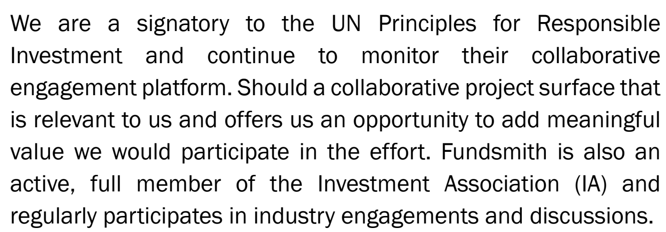
Signatories, where necessary, participate in collaborative engagement to influence issuers

Fundsmith is open to participating in collaborative engagement when we feel an issue is severe enough and it can achieve a result we could not alone. As a long-term investor, we value the relationships we build with the companies in which we invest. Our preference is to deal with companies directly and usually in private. Collaborative engagement is usually only considered when our independent engagement and escalation activities have failed to produce the desired change.

Although we don't regularly participate in collaborative engagements, we have done so. Most recently, we worked alongside a proxy advisor to change its recommendation in response to an activist's proposal on a company. The activist wanted to make significant changes to the company that the proxy advisor had initially supported, but we felt would negatively affect long-term performance. We engaged with the proxy advisor to explain why their support for the changes was wrong, which led them to change their position regarding the activist's proposals. We also used collaborative engagement to encourage an emerging market company to appoint an independent board member. The proposed board member's purpose was to introduce modern commercial systems and promote effective minority shareholder representation into what was an inefficiently run public company. We engaged with local government and other likeminded, significant investors to send a letter to the Public Enterprises Minister, requesting their support for our nominated candidate. The engagement was successful, with the nominated candidate elected to the board and the company. Development has since started, modernising the company's procedures.

We did not, however, participate in a collaborative engagement during the reporting period, as we did not find it necessary.

We also find that with the increased pressure on investment managers to engage collaboratively, more engagements are being undertaken that seem to serve the interests of the investment manager over those of the underlying company. We prefer speaking to management and exchanging opinions and views on different issues directly. This, we believe, is more effective than any number of investors signing a generic letter sent to multiple companies.



We are a signatory to the UN Principles for Responsible Investment and continue to monitor their collaborative engagement platform. Should a collaborative project surface that is relevant to us and offers us an opportunity to add meaningful value we would participate in the effort. Fundsmith is also an active, full member of the Investment Association (IA) and regularly participates in industry engagements and discussions.

Principle 11

Signatories, where necessary, escalate stewardship activities to influence issuers

As discussed in our report on Principle 9, we engage with our companies with the aim of promoting their long-term performance and growth and to discuss to any activities that we believe may limit their ability to sustain growth and returns over the long-term.

However, our engagement does not always produce the results we desire, as some companies fail to act on the issues highlighted, or their response fails to address them effectively. When we find our engagement is failing to bring change we will often escalate to help the company understand our views, or to get a more comprehensive statement from the company about why they cannot/will not make the change we seek. Our decision to escalate our stewardship activities, as with our engagement decision making process, is done on a case-by-case basis. If our engagement fails to generate the changes we want, we will not automatically escalate the engagement. This decision is largely, but not exclusively, based on the scale of the impact the issue may have and the length of time before those impacts are felt, supported by our research team's knowledge of the company in question. If the severity is lower and the time frame long, we are likely to continue our engagements with the company without escalation. Conversely, if the potential impact is high and the time frame short, we will escalate our stewardship activities as necessary.

Generally, we escalate our stewardship activities by taking the issue to the company's board of directors, sending a letter to the CEO, and/or by exercising our right to vote against management's recommendations at its annual general meeting (AGM). We will usually inform management that it is our intention to vote against at the AGM, so that they have an opportunity to engage with us to exchange points of view before the meeting. As discussed in our report on Principle 10, when we feel the issue is particularly significant, we may look to collaborate with other shareholders to support our cause. While we prefer to keep our dealings with companies private, in some instances we may deem it necessary to express our concerns publicly should we feel that it increases the chances of a constructive dialogue.

Our final escalation step, should the previous escalation efforts prove ineffective or the action of the company be particularly egregious, is the sale of our shareholding in the company. We would likely do this because of consistently poor capital allocation by the company's management and no incentive structure present to encourage management to fix it. We may also sell a holding if we believe there is an issue that will seriously impact the company's ability to make and sustain a high return on capital over the long term.

Reaching the point of exiting our investments is rare; most of our escalations are resolved through voting against management, on multiple occasions if necessary, and continuing our engagement with company executives.

Some examples of escalating engagements with companies during the reporting period are given below.

Company	Domino's Pizza
Sector	Consumer Discretionary
Country	United Kingdom
Fund	Smithson (SSON)
Context	Internal issue with franchisees
Objective	Understand how the company intended to respond to internal issues affecting recent performance
Activity	Met with the Head of Operations in early 2019, followed by a call with the company's Chairman. Met with the CEO in March 2019 and again in August 2019. Had a final meeting with the new Chairman and CEO in mid-2020.
Outcome	Our initial engagement with the Head of Operations failed to ease our concerns, so we escalated our engagement to the company's Chairman and CEO. The CEO's response to our concerns was unsatisfactory, which we reported to the Chairman. In early 2020, Domino's replaced the Chairman and CEO. We were satisfied these new executives were suitable replacements and could solve the issues that initiated our engagement. Early signs are positive, and we continue to monitor the company closely and engage with management to ensure they persist. However, it is still too early to tell if this engagement was successful.

Company	Diageo
Sector	Consumer Staples
Country	United Kingdom
Fund	FEF
Context	Remuneration policy
Objective	Understand how the existing remuneration policy incentivised long-term sustainable growth.
Activity	Received offer to discuss the new remuneration policy in February 2020. Met with the Head of the Remuneration Committee in March and June 2020, which we followed with a letter in late-June.
Outcome	Following a consultation on their remuneration policy, we gave our view that the policy would be improved with the addition of a returns-based metric. As we are not Diageo's only shareholders and there are others with different views, the company decided against this. We then engaged with the head of Diageo's Remuneration Committee to understand their reasoning for not including such a measure. The company decided to not include a returns-based measure in their final policy, which we voted against at their 2020 AGM. We will continue to engage with the company regarding our views on remuneration and if necessary, vote against the policy again to encourage the changes that we feel are needed.

Principle 12

Signatories actively exercise their rights and responsibilities.

As long-term shareholders, viewing our funds as part owners, we have always taken our voting rights very seriously. It is key for us to vote whenever we can and in a way that supports the long-term, sustainable growth of our investments. We will exercise voting rights in nearly all circumstances, but in some instances we may abstain from voting where we consider this to be appropriate. These rights are exercised for the exclusive benefit of the relevant fund and its investors. Our full voting records for 2020 are available here.

We assess matters subject to a shareholder vote ourselves on a case-by-case basis and do not use any proxy advisors. As we assess each vote individually, our policy is specific to the company's situation. When we exercise voting rights, we will do so in a manner that is consistent with the best interests of our funds, our investors and our clients, as the case may be. We will always ensure that the exercise of voting rights is consistent with the investment objectives and policies of the relevant fund. We will always aim to support the long-term sustainable performance of the company and create long-term value for our clients and beneficiaries. Individual clients cannot override this approach in either our pooled or segregated accounts. We have never engaged in stock lending.

Our custodians input our holdings into proxy voting software ProxyEdge. This software informs us of when our company's AGMs are occurring, what voting rights we have and the voting deadline for each AGM.

Below we discuss our voting history for 2020, giving examples of some of our most significant votes. Significance is defined is various ways. It may be significant due to the size of our holding in the company, or the weighting of the company in our portfolio. Equally, it may be significant if we feel that the vote can bring about substantial, positive change in the company, or that failing to vote could result in large, negative impacts to ourselves and our clients. A vote can also be significant if it is different from our typical approach to voting on a particular issue, or if it results from previous engagement with the investee company regarding the issue.

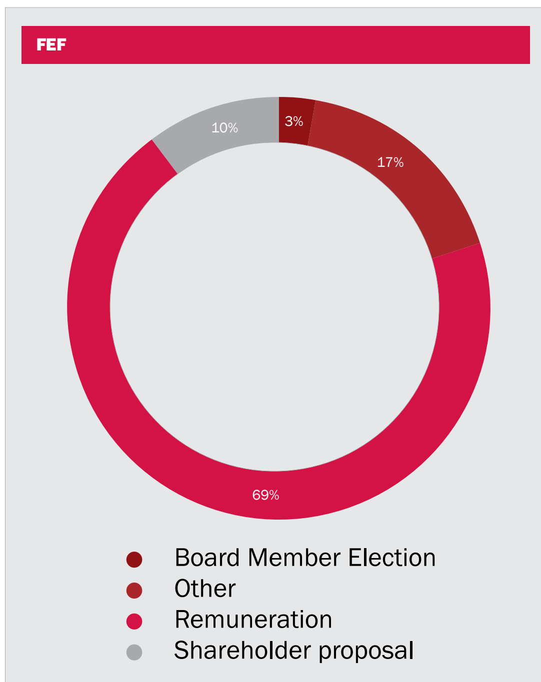
	No. of AGMs	No. of Voteable Proxies	% Voted		Votes Against Management			Votes Against by Category			
			2020	Since inception	2020		Since Inception	Board Member Election	Remuneration	Shareholder Proposal	Other
					No.	%	%				
FEF	30	454	100%	88%	44	10%	7%	0%	40%	16%	3%
FSEF	25	367	100%	100%	30	8%	6%	0%	42%	33%	3%
FEET	48	439	100%	88%	3	1%	2%	2%	0%	N/A	1%
SSON	33	363	100%	99%	11	3%	6%	0%	36%	100%	2%
Total	**248**	**3,206**	**100%**	**92%**	**217**	**7%**	**5%**	**0%**	**36%**	**25%**	**2%**

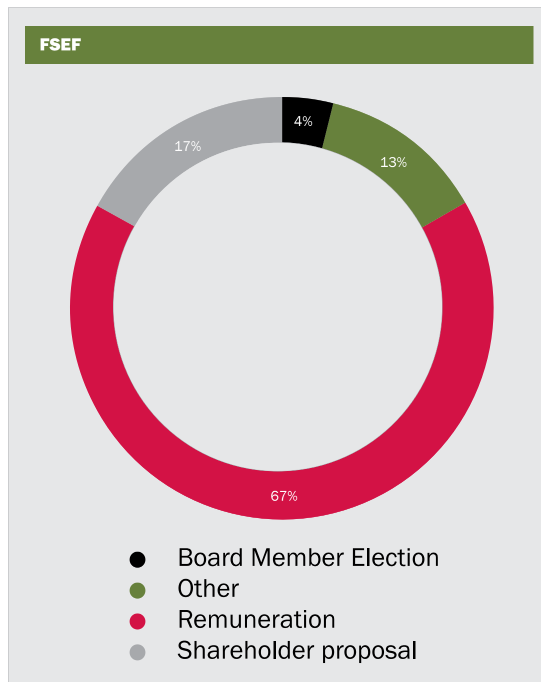
Table 2: 2020 proxy voting summary

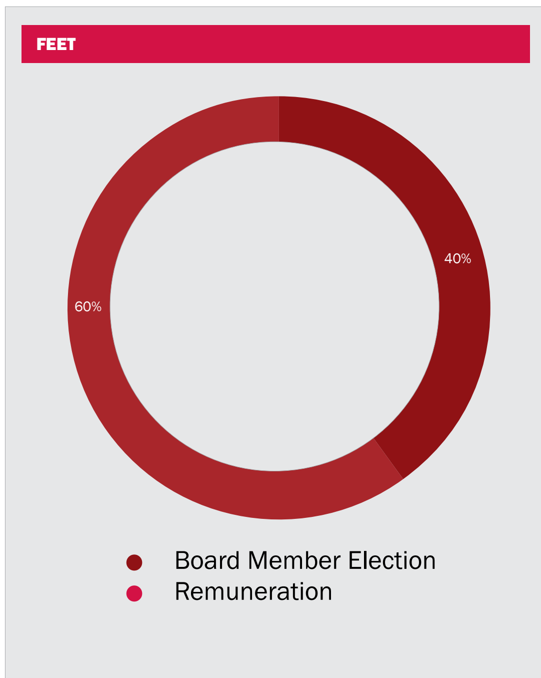
During 2020, all our funds voted on 100% of the 3,206 proxy votes available to them, as we aim to every year. Exercising our right to vote is an important part of us fulfilling our role as effective stewards and satisfying our responsibilities to investors. Of these votes, 217 were against management's recommendations.

The right-hand section of the table highlights the proportion of times we voted against or abstained from voting, on specific topics at company AGMs. We were largely aligned with management regarding board member elections last year, but a significant rejection was seen in FEET. We voted against management to oppose the reappointment of DP Eurasia's Chairman of the board who is also an independent director as we felt he was taking too large a fee for the size of the company and his stake in it. We were unsuccessful, so continue our engagement.

As discussed in principle 9, We voted against a large proportion of the remuneration policy proposals in our developed market funds (FEF, FSEF and Smithson) throughout 2020. FEF voted against 40% of the remuneration proposals it saw, accounting for almost 70% of its total votes against management in 2020. Similarly, FSEF and Smithson voted against 42% and 36% of proposed remuneration policies accounting for 67% and 75% of their total votes against management, respectively.







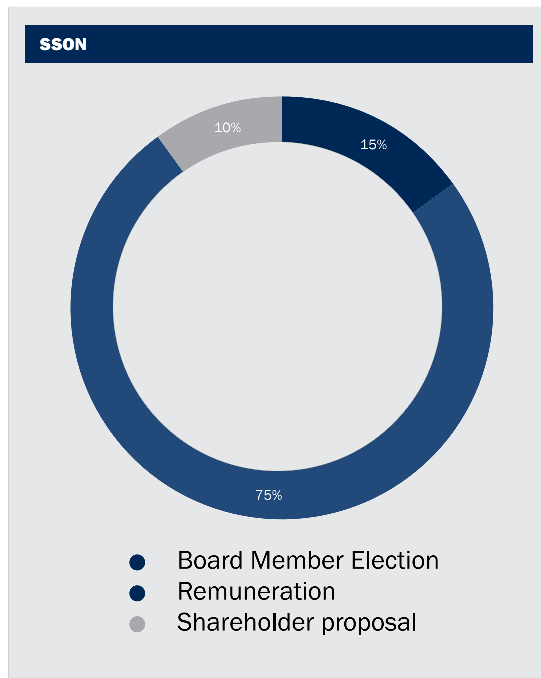


Figure 2: Votes against management: breakdown per fund

Despite the high number of votes against remuneration policies last year, one of our most significant was a vote in favour of a policy. This vote resulted from an engagement we had with Coloplast, a business held in both FEF and FSEF, regarding the lack of a measure of returns and growth in their existing policy. We met with the Chairman of the company's board who took the time to explain why the company didn't include these measures, and why they thought the long-term health of the company was supported by the current policy. This meeting satisfied our concerns and resulted in us voting in favour of the policy, a notable departure from our typical position.

While we would like to be proven wrong in our approach to remuneration, it is rare that a company without a returns-based metric can convince us it benefits their long-term performance. This was the case with Diageo, held in FEF. Following votes against their existing policy at their 2017, 2018 and 2019 AGMs, we opened an engagement with the company's remuneration committee ahead of the start of their next LTIP cycle.

Our engagements continued with the company throughout 2020 as we continued to discuss our thoughts on their proposed remuneration policy. After escalating the engagement and failing in our attempts, we had to vote against the policy at their 2020 AGM. As we still think we can bring change to the company to benefit its long-term health, we are continuing our engagement.

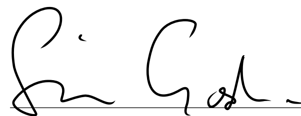
Similarly, following various engagements and escalating the issue with Domino's, a significant holding in Smithson, we voted against their director's remuneration policy last year. We thought the metrics used to calculate director's compensation didn't do enough to promote the long-term growth of the company, and the failure to convince us of the existing scheme's merits forced us to vote against it at their AGM.

Whilst compiling our voting records for this Principle, we identified a minor inconsistency in our voting record. A couple of proxy votes did not match the voting instructions given. Having identified the error, we have made changes to our process to reduce the chances of this happening.

Constructing this Stewardship Code Report has given us the opportunity to assess our policies, activities and processes surrounding stewardship, which allows us to improve our overall performance. Building this report has identified some areas we can start to improve upon, such as identifying an appropriate, stewardship-based metric for our incentive plan, but also some shorter-term adjustments.

This document was discussed and approved at the Fundsmith LLP Partners' meeting on the following date, as evidenced by the minutes of that meeting:

Date of Partners' Meeting: 23 March 2021



Signed, Simon Godwin, CCO & Partner

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