Fundsmith

33 Cavendish Square
London
W1G 0PW

T +44 (0)20 3551 6337
E enquiries@fundsmith.co.uk
W www.fundsmith.co.uk

January 2019

Dear Fellow Investor,

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

The table below shows performance figures for the last calendar year and the cumulative and annualised performance since inception on 1st November 2017 compared with various benchmarks.

% Total Return	1st Jan to 31st Dec 2018	Inception to 31st Dec 2018 Cumulative	Inception to 31st Dec 2018 Annualised
Fundsmith Sustainable Equity Fund[1]	+4.5	+5.3	+4.5
Equities[2]	-3.0	-1.4	-1.2
UK Bonds[3]	+1.2	+2.2	+1.9
Cash[4]	+0.7	+0.8	+0.7

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

The table shows the performance of the I Class Accumulation shares, the most commonly held Class, which rose by +4.5% in 2018 and compares with a fall of -3.0% for the MSCI World Index in sterling with dividends reinvested. The Fund therefore beat this benchmark in 2018, and our Fund is the third best performer since its inception out of 133 onshore and offshore ethical funds available in the UK listed in the Ethical Sector by Financial Express Analytics.

However, I realise that many or indeed most of our investors do not use the MSCI World Index as the natural benchmark for their investments. Those of you who are based in the UK may look to the FTSE 100 Index ('FTSE' or 'FTSE 100') as the yardstick for measuring your investments and may hold funds which are benchmarked to this index and often hug it. The FTSE delivered a total return of -8.7% in 2018 so our Fund outperformed this by a margin of 13.2 percentage points.

It would not be surprising if some of you are worried about the returns in 2018, 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 2nd percentile — only 1% of funds performed better.

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

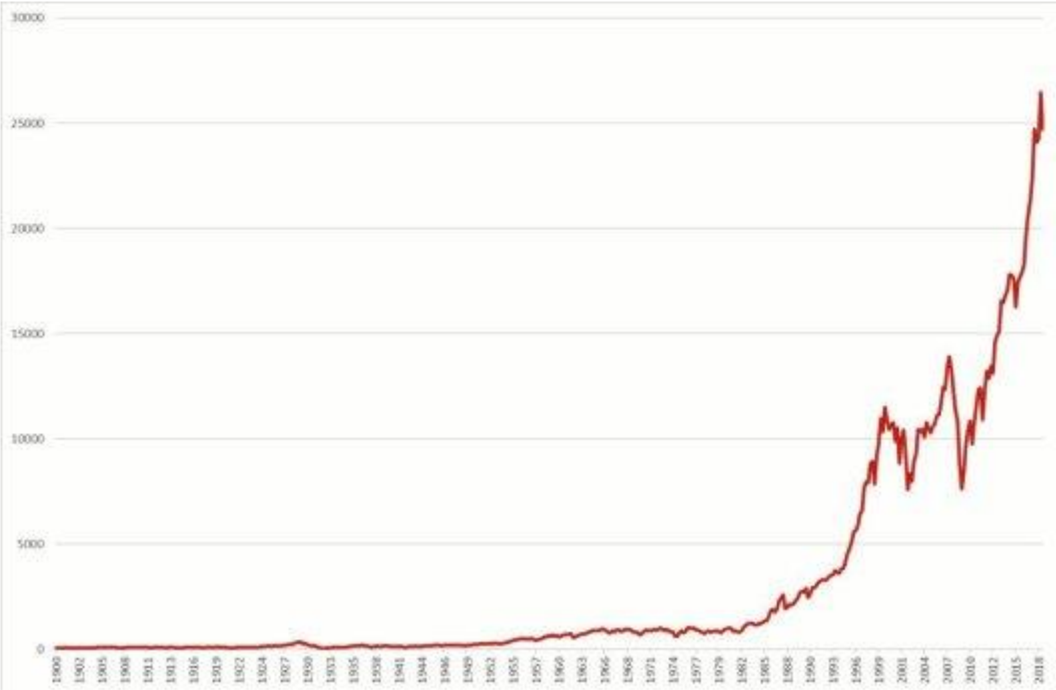
- The threat of a trade war between the USA and China
- Brexit
- The rise in US interest rates
- The US mid-term elections
- The Italian budget squabble (Italy is the third largest government bond market in the world)
- The US government shutdown

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 and our strategy would underperform. During that time the Fundsmith Equity 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 four step investment strategy:

- Buy good companies
- ESG screen
- 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 End	FSEF		S&P 500	FTSE 100
	2017	**2018**	**2018**	**2018**
ROCE	28%	30%	16%	17%
Gross margin	66%	64%	45%	39%
Operating margin	26%	26%	15%	16%
Cash conversion	104%	97%	84%	96%
Leverage	29%	44%	46%	39%
Interest cover	19x	18x	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 eight of our stocks which have net cash and two 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 13th stock in order of leverage but those either side have leverage of 27% and 49% 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 18x 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 1928.

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 10% 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 15%, so the starting base for comparison in 2018 was a tough one.

The second leg of our strategy is to employ both negative Environmental Social and Governance ('ESG') screening (not investing in high ESG risk sectors such as aerospace and defence, brewers, distillers and vintners, casinos and gaming, gas and electric utilities, metals and mining, oil, gas and consumable fuels, pornography and tobacco) and screening for sustainability in the widest sense, taking account not only the companies handling of ESG policies and practices but also their policies and practices on research and development, new product innovation, dividend payments and the adequacy of capital investment. Both these types of screening benefitted the fund in 2018.

Whilst we have never identified an investable company in the majority of the excluded sectors there may be relatively good companies to be found in the brewers, distillers and vintners and tobacco sectors. However the Fund benefitted from not holding any of these companies in 2018 as they underperformed the MSCI World Index (£ net) by 11% in aggregate.

Facebook, which also meets our criteria for a good company from a financial standpoint was excluded from the outset because our proxy for negative impact — the RepRisk indicator — was significantly higher than other companies (63 vs. portfolio average 20). Facebook had also done very little to reduce its negative impact score. Hardly that surprising for a company whose motto until 2014 was 'Move Fast and Break Things'.

The decision to exclude Facebook was made before the Cambridge Analytica scandal broke in March, where Facebook was accused of allowing external firms to harvest personal data from users through its site. This was done using an app called "This is Your Digital Life", which not only collected data of the person who agreed to take the survey, but also the personal information of all the people in those users' Facebook social network. Since the scandal broke, Facebook has had to reassure users how it uses and profits off their personal data, while also increasing its transparency and the range of tools it offers to control the use of your data.

Facebook still has more to do to meet our sustainability criteria.

During 2018, the weighted average RepRisk indicator for the portfolio fell from 23.7 to 20.1, which means that the portfolio now has less reputational risk from ESG factors than it started the year with. At the end of 2018 the four companies with the highest RepRisk Indicator scores were:

Johnson & Johnson	65
Marriott International	56
Unilever	48
PepsiCo	44

The list looks very similar to that of 2017 with the highest scorer from last year, Nestlé, being replaced this year in the list by Marriott. Nestlé was sold from the FSEF portfolio during 2018, while Marriott's RepRisk indicator increased by 28 in December after the data leak from its Starwood brand. Johnson & Johnson's RepRisk indicator has increased from 53 to 65 as its medical subsidiary, Ethicon, has been widely criticised for the risks involved in transvaginal mesh implants, which caused chronic and excruciating pain for thousands of woman and has also been subject to extensive litigation and punitive damages awarded to patients who developed mesothelioma, a deadly form of cancer caused by exposure to asbestos-contaminated talcum powder between 1972 and 2003.

At the end of 2018 the four companies with the lowest RepRisk scores were:

IDEXX	0
Intertek	0
Sage	0
Waters	0

This list also looks very similar to end 2017, with the only change being CR Bard, which was taken over by Becton Dickinson, being replaced by Sage.

A noticeable trend over 2018 has been the increasing number of companies commenting on their efforts to improve the recyclability of packaging and in particular plastics — especially since Sir David Attenborough highlighted the impact plastic waste can have on the oceans at the end of the television series Blue Planet II.

Out of the food and personal care companies owned in the Fundsmith Sustainable Equity Fund in 2018, PepsiCo, Nestlé, Colgate and Unilever have committed to 100% of their packaging being some combination of recyclable, compostable, biodegradable or reusable by 2025. This commitment could have a large impact on plastic waste as for example, only 25% of Colgate and Unilever's plastic packaging is currently recyclable, while Unilever alone produces the equivalent weight of the entire global population in plastic. PepsiCo committed to 50% of the plastic it uses coming from recycled plastic (vs. 13% currently), while Colgate wants to use 25%.

However, in order to reduce the amount of waste in the environment, there needs to be an increase in recycling capabilities around the world, as just because packaging can be recycled, doesn't mean it necessarily is. Around 85% of Nestlé's current packaging is technically recyclable but practically the number is far lower because different countries have significantly different recycling infrastructures and capabilities. Unilever recently collected 450 tonnes of single-use plastic sachets in Indonesia, which would have otherwise ended up in the ocean. The sachets will be re-used in other Unilever products.

To avoid the dependency on the need for better recycling infrastructure, Unilever announced that they signed an agreement with Bio-On, an Italian biodegradable plastic specialist, to develop new packaging.

A further concern for the FMCG companies in the portfolio is how they source palm oil, which was brought to national attention in Iceland's (the supermarket not the country) recently "banned" viral Christmas advert that highlighted the environmental impact of the palm oil industry. The advert was used as part of a campaign highlighting how it has removed palm oil from all of its private label products.

For a bit of context, palm oil is the most widely used vegetable oil in the world because it's one of the few fats that is semi solid at room temperature, has excellent cooking properties (smooth and creamy texture, lack of scent, natural preservative properties) and can be grown very efficiently, which means it can be produced cheaply. The average western consumer eats almost 2kg of palm oil a year and it is used in everything from personal products and cosmetics to pastries and baked goods.

Currently 85% of palm oil production is in Malaysia and Indonesia where the industry employs 4.5m people and for many is their only way out of poverty. However, the industry often results in what was once virgin rainforest being converted into biologically uniform palm oil plantations. The complexity of the issues surrounding the industry was shown when 2,000 palm oil plantation workers gathered in Malaysia's capital, Kuala Lumpur, to protest against the EU's plan to remove palm oil from its list of designated renewable fuels because of the impact it has on deforestation and the draining of wetlands. The farmers in Malaysia argued this wasn't the case and that the only motive was to put Malaysian small holders back into poverty.

The problem for FMCG companies is that substituting palm oil in their products will have a larger negative impact on the environment than continuing to use it. This is because palm oil yields around 5 tonnes of oil per hectare per year, which is almost 5x as much as rapeseed oil, the next best alternative with similar characteristics. Palm oil production also requires less fertilizer and fewer pesticides.
Should a company decide to replace palm oil in its products with rapeseed oil or any other alternative, it would not only require at

least 5x more land — therefore contributing to more deforestation — but also, those products would need to be reformulated, which could have a major impact on sales and profits. Therefore, in the Fundsmith Sustainable Equity Fund we look for companies that are aware of the negative impacts of using palm oil and are looking to source more of it in sustainable ways.

In 2018, Nestlé and Unilever were the most vocal about their efforts to improve the sustainability of their palm oil supply chains. Nestlé was reinstated by the Roundtable on Sustainable Palm Oil after it submitted a plan to only use sustainable palm oil by 2023. While Unilever also committed to using 100% sustainable palm oil, compared to 50% in 2017, but will do so by the end of 2019.

We continue to monitor as many statistics as the portfolio companies produce in a consistent way to assess the overall sustainability of the portfolio, which are shown in the tables below and report every month in our sustainability factsheet. The sustainability of the companies in the FSEF portfolio on these measures continues to be markedly better than the main index for which we can get comparable data — the S&P 500 Index — on every count with the sole exception of the percentage of independent directors, which was 82% versus 89% for the Index largely because some of the investee companies have board members representing controlling founder family shareholders.

The third step in our strategy is to not overpay. 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 3.8% and ended it at 3.9%, 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 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:

IDEXX	+1.4%
Intuit	+1.3%
Microsoft	+1.2%
Visa	+1.0%
Coloplast	+0.9%

The bottom five were:

Sage	-1.0%
Marriott	-0.8%
Colgate Palmolive	-0.7%
Reckitt Benckiser	-0.7%
Nestlé	-0.5%

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

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 -12.2% during the period. Negative turnover occurs because the method of calculating turnover excludes flows into or out of the Fund, otherwise a newly established fund would automatically have 100% or more turnover. However, it is not very helpful in judging our activities.

It is perhaps more helpful to know that we spent a total of just 0.031% (3.1 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).

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 I 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 1.16%, including all costs of dealing for flows into and out of the Fund, not just our voluntary dealing.

We did undertake some activity in 2018. In particular we sold our holdings in Dr Pepper Snapple, InterContinental Hotels and Nestlé during the year. We purchased holdings in Estée Lauder, the US based cosmetics business and Coloplast, the Danish medical devices company which specialises in the production of catheters, wound and skin care and a new position in a consumer staples business whose name will be revealed when we have accumulated our desired weighting across funds.

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 in the Fundsmith Equity Fund Annual Letter 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.

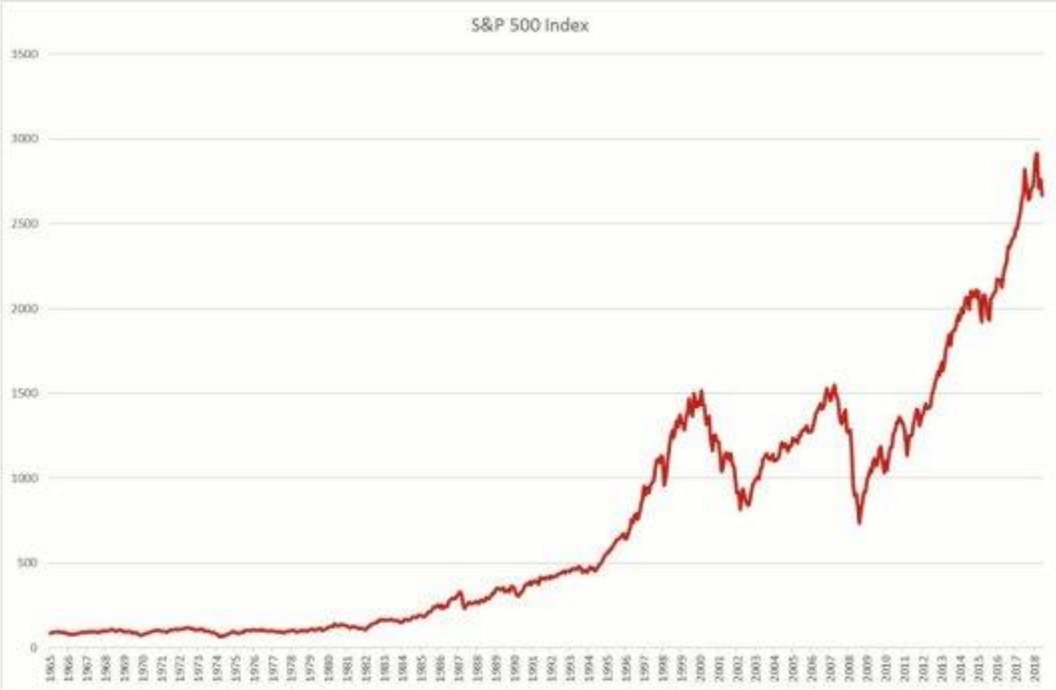
There are several problems with this though. Berkshire Hathaway is not the S&P 500. Its shares rose 49.5% in 1965 and only fell by 3.4% in 1966. So, your hesitancy would not have paid off. Moreover, by 1967 the market had recovered to a new peak.

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? Below is 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 Sustainable Equity Fund are available via the Fundsmith Sustainable Equity Fund 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.