

January 2014

Dear Fellow Investor,

This is the fourth annual letter to owners of The Fundsmith Equity Fund (“the Fund”).

The table shows performance figures for the last calendar year and the cumulative and annualised performance since inception on 1<sup>st</sup> November 2010.

| % Total Return                     | 1 <sup>st</sup> Jan to 31 <sup>st</sup> Dec 2013 | Inception to 31 <sup>st</sup> Dec 2013 |            |
|------------------------------------|--|--|------------|
|                                    |  | Cumulative                             | Annualised |
| Fundsmith Equity Fund <sup>1</sup> | +25.3  | +62.2                                  | +16.5      |
| Equities <sup>2</sup>              | +24.3  | +40.5                                  | +11.3      |
| UK Bonds <sup>3</sup>              | -4.3   | +11.9                                  | +3.6       |
| Cash <sup>4</sup>                  | +0.5   | +2.3                                   | +0.7       |

<sup>1</sup>T Class Acc Shares, net of fees, priced at noon UK time.

<sup>3</sup>Bloomberg/EFFAS Bond Indices UK Govt 5-10 yr.

<sup>1,3,4</sup>Source: Bloomberg,

<sup>2</sup>MSCI World Index, £ net, priced at close of business US time.

<sup>4</sup>3 Month £ LIBOR Interest Rate.

<sup>2</sup>Source:www.msci.com

We remain critical of attempts to measure investment performance over short periods of time. However this proviso notwithstanding, the table shows the performance of the T Class Accumulation shares which rose by 25.3% in 2013 and compares that with 24.3% for the MSCI World Index in Sterling with dividends reinvested. The Fund therefore outperformed the market in 2013 by 1%.

You (and we) may find this surprising given that 2013 was a bullish period for equity markets and our portfolio could reasonably be categorised as “defensive”. The year in stock market terms was, to use the football cliché, “a game of (roughly) two halves”. The market, as measured by the MSCI World Index<sup>2</sup>, rose by 19.1% from 1<sup>st</sup> January to 22<sup>nd</sup> May, where it hit a temporary peak from which it fell by 9.4% after Ben Bernanke spoke on 22<sup>nd</sup> May and indicated that the Federal Reserve Bank was considering so-called “tapering” of its Quantitative Easing (“QE”) programme of purchasing bonds, then running at no less than \$85bn per month. It began to recover from July as it became evident that even the suggestion of tapering would have adverse consequences, not least for Emerging Markets which have been the recipients of an estimated \$4 trillion dollars in capital since QE began after the financial crisis of 2007-08. A much smaller tapering than originally anticipated started in December, and has been accompanied by soothing

statements about the long term continuance of that other policy measure - a Zero Interest Rate Policy (or "ZIRP"). It is clear that the authorities took fright at the impact of their plans to moderate the stimulus and backed down, leaving the markets to resume their bullish mood.

The market dip which began in May also coincided with the market sensing economic recovery in the GDP numbers for the US and the UK at least, so that in the second and third quarters the sectors which performed well were all those which you would expect to do well in such conditions - Consumer Discretionary, Industrials, Finance, Information Technology and Energy - most of which we will never own. Consumer Staples, which are the bedrock of our strategy and portfolio, were one of the worst performing sectors in this period.

Now this might strike you as odd, that a sell-off in the market coincided with increasing evidence of economic recovery, but apart from the fact that no one has ever established a correlation between GDP growth and the performance of stock markets, one of the more apparently perverse aspects of markets has been the growing view that "good news is bad news". It all comes down to QE - the markets were more concerned that economic recovery would lead to the withdrawal of this stimulus than they were bullish about the recovery itself.

Although we have an interest in this subject, these market shenanigans have no bearing on the manner in which our portfolio is invested. People often ask us what we think the outlook is for the economy and/or the market. Apart from prefacing any response with the phrase, "we don't know", we usually point out that whatever the outlook it will not alter our methodology of investment. We mention this because we sometimes feel that the questioner supposes that if we too scent economic recovery we might switch the portfolio into cyclicals, financials and highly leveraged companies which might benefit from a recovery most (but which might otherwise go bust). Whatever our view on the economy, The Fundsmith Equity Fund will always be fully invested in high quality companies which satisfy our exacting criteria on financial performance and have done so for many decades.

However, at least one aspect of the debate about economic recovery and so-called tapering of QE puzzles us. If we are in an economic recovery, why is the growth rate of our investee companies slowing? We both understand and accept that in an economic recovery, companies in areas of discretionary spending and big ticket durable items such as cars and houses will fare better than the companies in our portfolio, as will companies in the cyclical industries which supply them. But we keep track of the "underlying" (excluding acquisitions, currency effects and exceptional items) revenue growth rate at all the companies in our Investable Universe (currently 64 stocks) and there is no doubt that it has slowed by a couple of percentage points over the past year. Remarks from several of their CEOs make it clear that consumer markets are not becoming significantly better. We can see why they would lag cyclical stocks in an upturn but not why their performance would start to deteriorate. This leaves us feeling sceptical about the nature and strength of the recovery.

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

|                  |        |
|------------------|--------|
| Domino's Pizza   | +3.02% |
| Microsoft        | +2.05% |
| Stryker          | +1.98% |
| Becton Dickinson | +1.96% |
| 3M               | +1.93% |

The bottom five were:

|                     |        |
|---------------------|--------|
| Swedish Match       | -0.06% |
| Serco               | +0.03% |
| Imperial Tobacco    | +0.14% |
| Schindler           | +0.14% |
| Philip Morris Intl. | +0.21% |

It is worth noting the following about the bottom five contributors: only one actually had a negative performance, Swedish Match, which we began buying during the year in response to share price weakness and a resulting more attractive valuation. Three of the five are tobacco companies which suffered from concerns about plain packaging and e-cigarettes. We suspect that these concerns are overdone but nonetheless have a self-imposed limit on our exposure to the sector, as we do to most sectors, in order to ensure that the effects are limited if we are wrong. Schindler and Serco, two of the other bottom five performers, were sold during the year.

Minimising portfolio turnover is one of our objectives and this was again achieved with a negative turnover of -17.6% 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 therefore more helpful to know that we spent a total of £351,227 or just 0.025% (2.5bps) of the Fund on dealing other than that associated with flows into the Fund which was 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 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 2013 for the T Class Shares was 1.11%. The trouble is that the OCF does not include an important element of costs - the costs of dealing. When a fund manager deals by buying or selling investments for a fund, the fund typically incurs commission paid to a broker, the bid-offer spread on the stocks dealt in and, in some cases, Stamp Duty. This can add significantly to the costs of a fund yet it is not included in the OCF.

I find that investors are often confused by this and in my view do not pay enough attention to it. The fact is that as an investor you can only benefit from the price appreciation of shares in your fund and dividends paid. Costs of dealing detract from those returns and therefore need to be taken into account when you are comparing funds.

We have published our own version of this total cost including dealing costs, which we have termed the Total Cost of Investment, or TCI. For the T Class Shares in 2013 this amounted to a TCI of 1.2%, including all costs of dealing for flows into and out of the Fund, not just our voluntary dealing. As a result of the Investment Management Association's campaign for fuller disclosure I am hopeful that we will eventually get such disclosure from many more funds so that investors can make a well informed comparison between funds. When they are able to do so, I fully expect that the Fundsmith Equity Fund will compare favourably.

Although our turnover was once again very low in 2013, we sold five holdings: McDonald's, Schindler, Serco, Sigma-Aldrich and Waters Corporation. There may seem to be an inherent contradiction between the fact that we sold five holdings yet our turnover was low. Part of the explanation is that some of these holdings had already become an insignificant proportion of our portfolio because we had been struggling to add to them as their valuations had become too high to represent good value in our view. Once this point is reached it begs the obvious question of whether we should in fact sell our holding to make way for an investment which offers better value, either within our existing portfolio stocks or from within our wider Investable Universe of stocks on which we maintain research.

There were also individual reasons for sale in each case:

McDonald's valuation had held up despite a run of poor sales figures which made it hard to add to our holding. The poor sales also arose despite McDonald's offering meal options for as little as \$1. This began to convince us that McDonald's had started to become a business which was selling solely on price, which we seek to avoid, and it seems that its Dollar Menu has perhaps unsurprisingly handicapped its attempts to sell premium items. Its performance was in sharp contrast to Domino's Pizza which has had no trouble

growing sales with price points close to \$6 for a pizza, and we took comfort in the fact that we retained our Domino's holding and with it a continued exposure to the franchised fast food business which we like.

Schindler had simply become too expensive for us to add to our holding and we were able to retain an exposure to the attractive elevator and escalator sector via Kone.

Serco seemed to fit the profile of businesses we seek to invest in as it depends on a large number of everyday repeat transactions: if you ride a Boris bike, take the Docklands Light Railway, see a traffic light being repaired in London, get a parking ticket in San Francisco, have the misfortune to be incarcerated in certain UK prisons or transported to court in a prison van, pass through airspace governed by US air traffic control or encounter the Australian immigration authorities, you are dealing with Serco. But we had always been troubled by the fact that these transactions emanated from much larger contracts, typically with governments, which gave rise to the risk that large contracts could be lost and in so doing could adversely affect Serco's relationship with its government customers. Then early in 2013 it became apparent that a significant acquisition of an Indian-based business process outsourcing business, which Serco had undertaken, had changed its cash flow generation and capital intensity in a way which was adverse and we sold our holding in February. Serco's problems with electronic tagging of offenders followed some months later and confirmed our concerns.

Sigma-Aldrich is a company based in the US Midwest which supplies chemicals and equipment to researchers and manufacturers in the life sciences, high tech industries and R&D. It supplies a large number of items in small ticket sizes to a large number of purchasers, and so fitted our investment profile, not least because it also has an excellent record in terms of return on capital and cash conversion (turning profits into cash, in plain English). However, Sigma-Aldrich attempted to acquire Life Technologies, a company which is much larger in every sense - revenues and market valuation. This worried us a lot. With our low portfolio turnover we are in effect leaving the allocation of capital generated by the wonderful returns earned by our portfolio companies to the management of those companies. When one of them looks likely to take a business with good, predictable returns and do something large, exciting and risky, we have a strong impulse to run away.

Waters Corporation makes and services liquid chromatography, mass spectrometry and thermal analysis equipment. The company's main customers are in the pharmaceutical and biotechnology industries but it also supplies industrial, food and environmental customers. Its revenues are partly a play on the growth in the requirement for testing in these areas. Although its equipment represents large ticket capital items, it makes nearly half its revenues from consumables, service and spares, so satisfying our criteria on repeat purchases. But it has significant sales to Asia including the Indian generic pharmaceutical industry and we were fearful that the slowdown in Emerging Markets would adversely impact the equipment sales which underpin its revenue model. Waters was also the only non-dividend paying stock which we held. Whilst we are prepared to hold such stocks, we need to be convinced that their reinvestment opportunities warrant the absence of a dividend and we were increasingly wary of this with Waters.

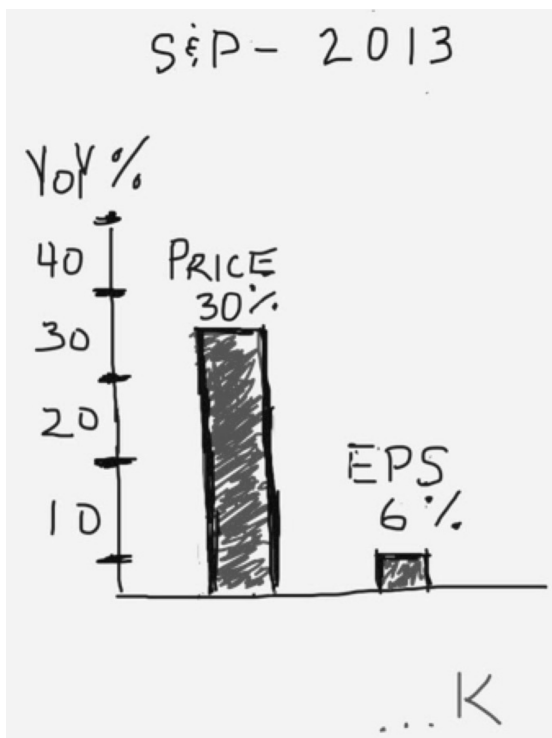
So much for the sales.

The Fund purchased a holding in C.R. Bard which makes medical devices, particularly catheters for use in oncology, urology and vascular conditions. It is to some extent a play on the medical needs of an aging population. Its business is centred on the developed world at present and we believe it may have a significant opportunity to grow in Emerging Markets. Unlike Waters, Bard's opportunities in Emerging Markets are not linked to the capital expenditure cycle of its customers which is by definition lumpy and cyclical as it does not sell high value equipment but mainly consumables.

We also began to acquire a holding in a transaction services company but this has not yet reached a size where we feel that our buying is complete and so do not wish to disclose the name at present.

Perhaps the question we faced most frequently from investors or prospective investors over the year was whether companies of the sort we invest in have become too expensive.

There has certainly been a growing fashion for investing in the type of large, well established companies whose business consists of selling or supplying goods and services which are characterised by the small ticket, repeat, relatively predictable everyday events which we seek. Whilst this may seem like a welcome development insofar as it means that the Fund's shares have risen in value faster than the market, it also means that an increasing proportion of the Fund's performance has been delivered by rising valuations of those stocks rather than growth in their revenues, profits and cash flows. As we cautioned in this letter last year, 'increasingly desperate attempts to stimulate the economy are far more likely to stimulate the valuation of our portfolio'. That this happened in 2013 - not just for our portfolio, but for the whole market - is demonstrated by this chart which looks as though it was drawn by and/or for a child:



Whilst such increases in valuation may seem like cause for celebration it is not always so as we intend to be long term or even indefinite investors and such valuation changes are certainly finite and maybe even temporary. They are the result of the massive injection of liquidity from QE and a sustained period of zero interest rates. Apart from the fact that we intend to be long term investors, even if we were trying to guess the timing of the withdrawal of these factors in order to exit from markets, we would point out that there is no certainty that such increases in valuations may not be sustained or even go further as QE continues. The so-called taper is a token - US QE continues at \$75bn per month, \$900bn p.a. - and it seems that most major central banks are targeting a further sustained period of ZIRP. At the moment stories of QE's demise are at least exaggerated. Fortunately seeking to profit from short term valuation anomalies or changes is not part of our strategy but given the upside which has been generated from these policies, I have little doubt that we will have to live through some character testing times when they are withdrawn.

There are many ways of looking at valuation, but here are a few thoughts:

1. We seek to buy our portfolio companies when their free cash flow ("FCF") yield (the free cash flow they generate divided by their market value) is at or above the yield we would expect to get on long term government bonds in the same currency. Please note; not the current yield on bonds, which in most cases has been depressed by governments buying their own bonds, but the yield we think might apply if this were to stop and all bonds had to be sold to third party investors. Our

starting guess for the yield that might then be required is one percent over the expected rate of inflation. If we can buy shares with FCF yields higher than that and which will grow, unlike the coupon on the bonds, we should have captured some value. There are still shares within our portfolio which look good value on this basis, albeit not as many or as cheap as they were a year or two ago.

The weighted average FCF yield of the portfolio started the year at 5.7% and ended it at 5.1% - still above the level we would find acceptable on the basis of the comparison with expected bond yields. Our companies on average grew their free cash flow per share by 6.6% during the year. They actually grew their operating cash flow by 8.1% but also spent 21% more on capital expenditure ("capex"). We find the fact that they have significantly increased their capex as encouraging as we have yet to find an industry which can grow without committing additional capital in order to do so.

This 5.1% FCF yield compares with a median FCF yield for the non-financial stocks in the S&P 500 of 4.6% and a mean of 4.1% or a median for the non-financial stocks in the FTSE 100 of 4.0% and a mean of 3.7%. Our stocks do not look bad value in comparison to the market. Although of course, both may be expensive, but both may continue to be so or become more expensive.

2. Consumer Staples, in particular, have been more highly rated in the past than they are now. We mention this because we frequently read or are told that they are more expensive than ever. This is simply not so - they were more highly rated in the 1990s, for example. Moreover, whilst commentators seem to focus on Consumer Staples stocks, these are less than half of our portfolio, and some of our medical equipment stocks are much closer to the low end of their historic valuation range.
3. We examined the relative performance of Colgate-Palmolive and Coca-Cola over a 30 year time period from 1979-2009. Why 30 years? Because we thought it was long enough to simulate an investment lifetime in which individuals save for their retirement after which they seek to live on the income from their investment. Why 1979-2009? We wanted a recent period and in 1979 it so happens that Coca-Cola was on exactly the same Price Earnings Ratio ("PE") as the market - 10 and Colgate was a little cheaper on 7x. The question we posed is what PE could you have paid for those shares in 1979 and still performed in line with the market, which we took as the S&P 500 Index, over the next 30 years? We found the answer rather surprising - it was 36x in the case of Coke and 34x in the case of Colgate when the market was on 10x. Another way of looking at it is that you could therefore have paid a PE of 3.6x the market PE for Coke and 4.9x the market PE for Colgate in 1979 and still matched the market performance over the next 30 years. The reason is the differential rate of compound growth in the share prices (to a large extent driven by growth in the earnings) of those companies over the 30 years. They compounded at about 5% p.a. faster than the market. You may be surprised that this differential can have such a profound effect upon the outcome. It's the magic of compounding.

Albert Einstein said that he thought compound interest was the eighth wonder of the world. It is certainly one of the concepts least understood by investors. The simplest illustration of this is to ask how long it takes to double your capital at 10% p.a. compound return. The whole point is that we are talking about compound returns in which the gains are added to the capital sum to which each successive period's rate of return is applied. Consequently, the answer is a counterintuitive seven years. It only takes a compound return of 7% p.a. to double your money in ten years.

That is a simple enough example, but how about this one: starting with the same initial sum, what is the difference in final capital from 30 years of investment at 10% p.a. compound versus 30 years at 12.5% p.a.? I ask this because it may represent a reasonable range of outcomes from an investment lifetime. The answer, rather surprisingly, is that the extra 2.5% of compound return would double the final sum.



As discussed earlier Coke & Colgate's total returns grew at about 5% p.a. faster than the market over the period 1979-2009, this 5% differential multiplied their share prices four times more than the market over that period. Of course, the next 30 years may be different to the 1979-2009 period. However, if I had to guess how it would affect this calculation it would be that companies like Coke and Colgate will fare even better versus the rest of the market in terms of growth given that the cyclical stocks are unlikely to benefit from a repetition of the growth which was stimulated by the credit bubble. But what do I know?

It is also fair to point out that quality stocks may indeed not be too expensive relative to the rest of the market but that both will prove to be expensive, particularly when interest rates rise. But even so, I suggest you consider how you might have reacted if someone had suggested that you invest in Coke or Colgate at say twice the market PE in 1979. In rejecting that idea you would have missed the chance to make nearly twice as much money as an investment in the market indices over that period which included some periods of very high interest rates. Of course, capturing this opportunity would have required you to have the fortitude to sit on your hands during those periods of high interest rates and poor performance (hint: we will be reminding you about this when interest rates rise). As at 31<sup>st</sup> December 2013 they were trading at PE's slightly above the market – our portfolio was on a PE of 20.6x versus 17.4x for the S&P 500, which doesn't sound quite so expensive when you look at their historical performance and quality.

4. In fact, we rarely look at PE's, usually only doing so to make such comparisons as other market commentators use them. We prefer instead to rely upon free cash flow yields when evaluating our investments as not all E's, or Earnings, are created equal. Our portfolio companies' businesses are less capital intensive than the market as whole. As their earnings are generated with less capital, their Return on Capital Employed is much higher than the average, which we regard as the primary test of their performance. The return on capital of the companies in our portfolio averages 34%. This compares with an average of about 19% for the non-financial stocks in both the S&P 500 and the FTSE 100. They also deliver more of their earnings in cash than the market as a whole, typically 90-100%. And we like cash - it is the main way of paying bills and earnings delivered in cash are of higher quality than those which aren't.

We remain confident that we own stocks with a superior fundamental performance to the average which is not fully reflected in their valuation relative to bonds or other equities.

5. A striking and direct comparison is between the dividend yield on some of our stocks and the redemption yield on their bonds. Take Nestle for example, at the end of December 2013 its 2018 bonds had a redemption yield of 0.21% whilst its ordinary shares yielded 3.1%. Leaving aside fund managers who are limited to investing in bonds by their mandate, why would anybody in their right mind own the bonds rather than the shares? The answer is that some investors are willing to overpay for the apparent certainty which the bonds bring. They have a fixed coupon, a redemption date and a par value which will be repaid to the holder on redemption. The shares have none of those things. Although it has to be said that the dividend is pretty safe given that Nestle has only reported one loss in 146 years, but it is still not a fixed charge, as the interest coupon is. And you cannot rely on the shares being a particular price if you need to dispose of them. But this does seem to suggest that the shares are at least good value relative to the bonds. Although that does not mean that either of them is cheap, it does raise the question of where you would invest the money as an alternative to the shares with a better risk/reward relationship in the current environment.
6. As at 31<sup>st</sup> December 2013 the weighted historic dividend yield of the Fund was 2.3% and the weighted prospective yield was 2.5% and the prospective dividend cover was 2.4x.

Although all of our portfolio companies are headquartered and listed in Europe and North America, some 32% of their underlying revenues are from Emerging Markets. This is generally considered a positive attribute as Emerging Markets have generally outperformed developed markets in terms of economic growth in recent years.

We are often asked why we do not invest directly in Emerging Markets if we like exposure to their superior growth. The reasons are complex but one of the main ones is liquidity. The Fundsmith Equity Fund is an open ended fund with daily liquidity. We hope that if you invest with us you will be a long term investor because we believe that this delivers the best results, but you can redeem your investment on any business day. This would be incompatible with direct investment in the companies of the sort we seek but which are headquartered and listed in Emerging Markets. Although some of these companies are not small, there is not enough liquidity in their shares in local markets to hold them responsibly through an open ended fund. Especially one with daily dealing.

In order to overcome this problem we have decided to launch a new fund, the Fundsmith Emerging Equities Trust ("FEET"), in 2014. This will be an investment trust investing in the same strategy as our existing Fund but mostly in companies which are listed in Emerging Markets. Its focus will be on consumer stocks since a) this is the largest area of focus of our strategy, and b) there is an established trend for the emergence of consumer classes in Emerging Markets which looks likely to last several decades and which should provide a tailwind for its performance.

We have identified an Investable Universe of over 150 companies for FEET, many are already known to us as they are quoted subsidiaries, associates or franchisees of companies which we already research for the Fundsmith Equity Fund. This also helps with the corporate governance issues which can plague Emerging Markets.

For reasons which we will detail in the soon to be published FEET Owners' Manual we believe that this approach should produce better results for investors compared to many of the other investment products and approaches which have sought to capitalise on the growth in Emerging Markets.

As an investment trust, FEET will overcome the issue of combining an open ended fund with stocks which have limited liquidity in the underlying investments since it will raise an initial fixed amount of capital, to which I will subscribe. Thereafter investor liquidity will be provided by trading in the trust's shares thus removing the costly need to liquidate or add to the portfolio on investor demand.

You can expect to hear more from us about the opportunity which we feel FEET provides later in the year. But in the interim, I wish you a Happy New Year and thank you for your continued support for our Fund.

Yours sincerely,



Terry Smith  
CEO  
Fundsmith LLP

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