Fundsmith

33 Cavendish Square
London
W1G 0PW

T +44 (0)330 123 1815
E enquiries@fundsmith.co.uk
W www.fundsmith.co.uk

Mr Forename Surname
Company Name
Address line one
Address line two
Address line three
Address line four

Monday 10th January 2011

Dear Fellow Investor,

This is the first annual letter to owners of The Fundsmith Equity Fund.

Fundsmith opened for business on 1st November 2010, and we are critical of attempts to measure investment performance over short periods of time. Two months is not a short period, it is a ludicrously short period to do so. However, I thought that this letter is a good opportunity to give you a flavour of the reporting which is likely to occur in years to come.

From 1st November to 31st December 2010, The Fundsmith Equity Fund rose by 6.14% net of fees. This compares with some common benchmarks as follows:

Fundsmith Equity Fund	**6.14%**
MSCI	**7.99%**
MSCI EAFE	**5.76%**
FTSE100	**4.40%**
Long Bond (10 year UK Treasury)	**-2.57%**

Benchmarks are useful for measuring performance, provided a long enough time scale is used. Problems arise when fund managers start to use them for portfolio construction. At Fundsmith we do not endeavour to track any index or to minimise our “tracking error” versus any index (even the use of the expression tracking “error” tells you that an active fund manager has the wrong mindset).

The Fund underperformed the MSCI and outperformed the MSCI EAFE-the difference being in the performance of US stocks which are included in the former but not the latter. It outperformed the FTSE100 and long bonds.

The main positive contributors to that performance were:

1. Del Monte Foods
2. Becton Dickinson
3. Domino's Pizza Inc
4. Nestle
5. Stryker Corp

The main contributor was Del Monte Foods. Del Monte could almost be a case study in how investment opportunities arise. We were attracted to Del Monte by its main product-pet food.

Pet food is typical of the sort of product we seek to invest in. It is a small ticket, consumer, non-durable. As a small ticket purchase, no credit is required to buy it. The consumer has no opportunity to bargain on price - the price the supermarket or pet store displays is the price you pay. Consumers are typically brand loyal, and once it has been consumed there must be a replenishment purchase-there is no opportunity to defer this by prolonging the life or ownership of the product as there is with a consumer durable, like a car. Moreover, research clearly shows that if times are hard, consumers will reduce their spending on food for themselves or their children rather than cut back on their pets' food.

However, the fact that pet food is Del Monte's main product line seemed to be lost on most investors, many of whom were assessing it on the basis of their folk memory of its main historic product range in canned fruit and veg. This is what produced the opportunity to buy Del Monte stock on a free cash flow yield which was generous for its likely financial performance. On one occasion this misunderstanding was compounded when Bloomberg managed to publish an article from the Galveston County Daily News about a strike at Fresh Del Monte Produce Inc - an entirely different company which sells fresh produce - against Del Monte Foods. Such events can create opportunities to buy great companies at good prices.

Eighteen days after the Fund opened and we purchased our initial holding in Del Monte it was bid for by private equity firm KKR at a significant premium to the price we had paid.

Whilst it would be churlish to suggest that we do not like receiving a premium for our investments in cash, such events are not without their downside as we have to find an equivalent investment for our cash. The fact is we really want to own our stakes in the companies in our portfolio and benefit from the good cash returns on capital which they generate. We are not simply hoping to on-sell the investment at a higher price. This changes perspectives on events such as takeovers.

Just as we counsel you not to become overly enthusiastic about share price rises, even those which relate to cash bids for our holdings at a premium which represents a good return on our investment, we hope that you will understand when we are explaining that price falls within the portfolio will often represent an opportunity for investment on even more rewarding ratings rather than an opportunity for soul searching and recriminations. Often but not always.

The detractors from the Fund's performance were:

1. Serco Group
2. Imperial Tobacco
3. Dr Pepper Snapple
4. Reckitt Benckiser

In no case do we believe that the fall in the price alters our view of the investment (other than the obvious point that we wish we had made it at the lower price) nor do we believe it reflects an adverse change in the intrinsic worth of the business.

The historic dividend yield on the Fund at year end was 2.47%. This dividend was covered over 2.5 times by earnings. Only one stock in the fund does not currently pay a dividend. This is significant: dividends have historically provided a significant portion of the total return on equities. The current yield on the Fund may not fully reflect its dividend paying capabilities as some of the companies also utilise share buybacks. These can contribute to shareholder value creation when they are used correctly (to purchase shares which are under-valued when no better investment opportunity presents itself).

At the end of 2010 we held a portfolio of 22 stocks including Del Monte.

The average company in our portfolio was founded in 1883. We are investing in businesses which have shown great resilience over a long period of time-in most cases surviving two world wars and the Great Depression.

The trailing free cash flow ("FCF") yield was about 7%. This free cash flow was either distributed as dividends, used for share buybacks, or invested by the companies in order to generate further returns. As our portfolio had an average return on operating assets of 50% this reinvestment of cash flows should produce compounding of value for us as shareholders.

This FCF yield compares with a FCF yield on the S&P 500 of a bit less than 7%. The median (250^{th}ranked) FCF yield in the S&P is 6.6%.

What we can say with a high degree of certainty is that our portfolio has a FCF yield higher than the average for the market. Yet it is inconceivable in our view that it is not of higher than average quality in terms of longevity, resilience, predictability, profit margins, return on operating capital and the conversion of profits into cash. Put simply this means that we own shares in businesses which are higher quality than the market on a valuation lower than the average for the market. Whilst that is not a total solution to successful investing, it strikes us as at least a good start.

We regard an equity holding as a claim on a share of the cash flow produced by a business. In the Fund we seek to own companies which produce high cash returns on capital and distribute part of those returns as dividends and re-invest the remainder at similar rates of return. And we want to own those companies shares at prices which at best under-value their returns and at worst value them fairly.

We do not regard equity investment as a sophisticated game of pass the parcel in which we buy shares in companies that we don't understand, which may be poorly performing businesses and/or which are over-valued, hoping to sell them to a greater fool when they have become even more expensive as a result of some fad or share price ramp. Such games are best left to video consoles unless your hobby is losing money whilst investing, which I rather suspect it is for some people.

I aim to restrict myself to one rant per letter about a subject relevant to investment. Frankly given the behaviour of much of the wealth/asset management industry, I regard this as a model of self restraint given the target rich environment.

This year's rant is a warning about the misunderstanding and misuse of Exchange Traded Funds ("ETFs"). I think this is relevant as The Fundsmith Equity Fund launch was somewhat against the tide of events as we launched an active equity fund at the end of a decade in which a) equities have performed badly; and b) the average active fund manager has again underperformed the index and so made a bad performance by the asset class worse.

Faced with this failure of active management, it is hardly surprising that investors have turned their backs on active management and headed for lower cost, passive alternatives. As a result, the rise of ETFs has been a major feature of the investment landscape in recent years. By the third quarter of 2010, there were 2,379 ETFs with 5,204 listings on 45 exchanges managing $1,181.3bn of assets.

So what's the problem? I suspect that the average investor regards all ETFs as just another form of index fund, and indeed many of them are. But many aren't and therein lies the potential for misunderstanding. Or worse.

Some ETFs do indeed replicate the performance of an index by purchasing a weighted package of all or most of its constituent securities. But many so-called synthetic ETFs do not do so and instead use so-called swap agreements with counterparties who agree to provide a monetary return which matches the underlying asset class or the index the ETF is seeking to track.

Anyone who has studied the events of the Credit Crisis should be able to spot a potential problem here: what if the counterparty supplying the swaps defaults? This risk may once have been considered theoretical, but after the collapse of Lehman and the need to rescue AIG in order to prevent the contagion from a default it surely no longer is. True the ETF should be holding collateral against such a failure, but collateral is an imperfect science even where it is held which is not in all cases. Moreover, in some cases the sole counterparty

Moreover, synthetic ETFs are often used at access markets which are not directly accessible to retail investors such as the Chinese A-share market or where liquidity in the underlying investments is poor such as equities in some emerging markets. The opportunity for the performance of the ETF to diverge from the performance of the underlying assets and therefore from the investors' expectations in these cases seems obvious. The idea that a counterparty will provide you with a contract which matches the returns from underlying illiquid assets which you cannot directly own should give pause for thought-not least about how the counterparty will fulfil those obligations, for example in the case of extreme market movement and a liquidity crisis-a not unlikely combination.

Of course not all ETFs are used to simply match the performance of an index. There are leveraged ETFs which multiply index performance, inverse ETFs which replicate a short position in an index and of course, leveraged inverse ETFs. The issue with these ETFs is that their returns are compounded daily. These problems maybe best illustrated by a couple of tables;

	Day 1	Day 2	Day 3	Day 4
Index	100	125	90	103
Daily Change		25%	-28%	14%
Cumulative Change		25%	-10%	3%

Leveraged ETF (+2X)	100	150	66	85
Daily Change		50%	-56%	29%
Cumulative Change		50%	-34%	-15%

The first table shows the movement in an index in a highly volatile period in which it rises sharply then falls to finish just 3% up over the period. The second table shows the performance of a 2x leveraged ETF over the same period. With daily compounding the leveraged ETF produces a cumulative loss of 15% of value over the period versus a 3% rise in the index.

How about an inverse ETF?

	Index	% Movement	Short Position	ETF (Short)
Day 1	100		100	100
Day 2	80	-20.0%	120	120
Day 3	60	-25.0%	140	150
Day 4	55	-8.3%	145	162.5
Day 5	100	81.8%	100	29.5

In a week where the index was volatile on the downside but got back to par by the end of the week an inverse ETF with daily compounding would turn in a 70.5% loss. You can imagine what a leveraged inverse ETF would do!

I would bet that a large proportion of ETF investors do not realise that leveraged and inverse ETFs can produce these apparently perverse results. The moral of this is that these sort of ETFs are really day trading tools. If they are held for more than one day, they will begin to diverge from the performance of the underlying index or asset class. However, it would not be surprising if in many cases they were being used inappropriately as if they are index funds.

Investors in ETFs may be quite logical in avoiding most active management, but many of their ETFs are not as inactive as they think.

Finally, returning to our own active fund, we look forward to the year ahead. This is not because we have any faith in a sustained recovery in major economies and/or that we regard equities in general as cheap or equity markets as a whole as good value or well placed to track improvements in corporate profitability which in any event may not be forthcoming.

It is firstly because we believe our Fund contains a portfolio of shareholdings in great businesses which we have purchased at reasonable prices or better and which we intend to hold onto in order for them to deliver the benefits of such investments.

Secondly, it is because we enjoy running The Fundsmith Equity Fund. Robson Walton, the Chairman of Wal-Mart and son of its founder Sam Walton said, “My dad did not set out to make Walmart the world’s largest retailer. His goal was simply to make Walmart better every day, and he thought constantly about how to do just that.”

Please be assured we are doing the same with Fundsmith.

Yours sincerely,

Terry Smith
CEO
Fundsmith LLP

Disclaimer: Fundsmith does not offer investment advice or make any recommendations regarding the suitability of its product and no information contained within this document should be construed as advice.
Should you feel you need advice please contact a financial adviser. 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.