Fundsmith

33 Cavendish Square
London
W1G 0PW

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

Wednesday 11th January 2012

Dear Fellow Investor,

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

Fundsmith opened for business on 1st November 2010, and so completed its first year on 31st October 2011. We have presented two sets of performance figures this year-the performance since inception and the last calendar year.

We remain critical of attempts to measure investment performance over short periods of time. Even a calendar year is too short for this purpose-it is the time it takes the Earth to go around the Sun and has no natural link to the investment or business cycle.

However this proviso notwithstanding, The Fundsmith Equity Fund rose by 8.4% net of fees for the year. This compares with some relevant benchmarks as follows:

	Since Inception	2011
Fundsmith Equity Fund	15.0%	8.4%
MSCI World £	3.2%	-4.5%
MSCI EAFE £	-6.1%	-11.2%
FTSE 100	2.8%	-1.5%
FTSE Actuarial Gilt Index	14.7%	15.6%

The Fund outperformed the MSCI World Index, which we regard as the most relevant comparator, by 12.9% for the year.

This strikes us as a good performance. It was achieved against the background of a year in which it gradually dawned on many people that the financial crisis of 2008-09 had not been solved but had rather been transformed into a sovereign debt crisis: if 2008 was the year in which governments saved banks, 2011 was the year in which the main question which emerged was who would save the governments. Against this backdrop it is hardly surprising that equity markets performed poorly and so has the average fund.

Only six other funds in the IMA Global Growth sector (into which the Fund is classified) achieved a positive return in 2011. This performance for the year took the Fund to third place in the Morningstar performance rankings for global equity funds.

The main positive contributors to that performance were: Domino’s Pizza, Philip Morris, Imperial Tobacco, Colgate Palmolive and Unilever.

The main detractors from the Fund's performance were: Serco, Stryker, Kone, Becton Dickinson and Intercontinental Hotels.

Turnover in the Fund in 2011 was 15%. This was higher than we would ideally like although still significantly lower than most funds.

Part of this turnover was really involuntary. We sold Del Monte Foods prior to the closing of the cash bid from KKR, and sold our holding in Clorox after a bid approach from Carl Icahn which we correctly judged would not result in an actual takeover but which drove the share price to a valuation which we regarded as offering poor value.

Excluding dealing in Del Monte and Clorox, the turnover was 4% which is much closer to the level we seek (zero ideally).

The only voluntary turnover during the year were sales of our holdings in Kimberly-Clark Corporation and Domino's Pizza, Inc. Kimberly-Clark began to show adverse results from our regular calculation of the incremental return on capital. We sold the shares at a small profit. They have subsequently performed poorly in terms of fundamental performance although the share price has ironically been quite firm. We prefer to judge our investments by what is happening in their financial statements than by the share price. Domino's shares rose in price by 113% during the year and had reached a point at which they no longer represented good value. Domino's also has a re-financing of debt due by 2014. There is nothing in the performance of Domino's which causes us the slightest concern about this but there is plenty wrong with the banking system which will be required to provide the refinancing. As a result we hope to have the opportunity to become investors in Domino's again.

The net result this was that the Total Expense Ratio of the Fund was 1.2%. We hope to reduce that in future.

The historic dividend yield on the Fund at year end was 2.4%. This dividend was covered 2.6 times by earnings. There is only one stock in the Fund that does not currently pay a dividend. This is significant: it is becoming clear that dividends are likely to provide a more significant portion of the total return on equities in the future than they did in the equity bull markets of 1982-2000 and 2003-07.

The current yield on the Fund may not fully reflect its dividend paying capabilities as some of the companies also utilise share buybacks. During the course of the year we published some research on share buybacks ("Share Buybacks-Friend or Foe?" April 2011-available on the Fundsmith website) in which we concluded that buybacks were rarely accompanied by any reasoned justification; that they had become almost universally regarded as a good thing and contributing to shareholder value irrespective of the price paid or the valuation implied, which simply cannot be true; and in many cases their timing was poor.

During the year we wrote to the management of those companies within our portfolio which have engaged in share buybacks to ask for some insight into their rationale. The responses ranged from prompt, personalized (by the CEO) and well reasoned to being completely ignored. We regard the greatest risk for our investors after the obvious potential for us to buy the wrong shares or pay too much for shares in the right companies, as being reinvestment risk: we seek to buy companies which deliver high returns on capital in cash. What the management then does with these cash returns is one of the major factors affecting future returns on the portfolio. Management faces three main options for deploying these cash returns: return cash to shareholders, invest to grow the business organically or make acquisitions. The criteria they use for choosing between these options are important. So are the ways in which they operate each option. So, for example, having determined to return a portion of earnings to shareholders, how does a management decide between a dividend and a buyback? In many cases we do not know as the management does not give any detailed rationale and we suspect that the answer is with the "benefit" of advice from their investment bankers who get fees, commissions, bid-offer spreads and maybe proprietary trading profits for advising companies to pursue buybacks but get nothing when a dividend is used. No prizes for guessing which way the advice is slanted.

At the end of 2011 we held a portfolio of 24 stocks.

On average companies in our portfolio were founded in 1894. We continue to invest 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 at the start of the year was about 7% and about 5.8% at the end. The fall in the FCF yield was caused by a combination of the rise of share prices in the portfolio, changes in the portfolio and higher capital expenditure and working capital invested by the portfolio companies. This FCF yield compares with a median FCF yield on the S&P 500 of 6.1%. We have used the median by the way as the average is distorted by inclusion, for example, of a free cash flow yield of 76% on shares in Bank of America ("B of A"). Before you rush to buy B of A shares however you might like to know that cash flows at banks are not the same as they are at non banking businesses. So, for example, in the calculation of B of A's cash flow the computation adds back the provisions for bad debts and impaired assets which is a deduction from profits. This is strictly true-a provision is a non cash item-but it means that comparisons of banks with other company's cash flow in this manner is truly a case of comparing apples and ugli fruit (I chose a fruit which was more alphabetically remote from A for Apples than the commonly used P for Pears and which exemplifies our view of banks).

Our portfolio has a FCF yield about the same as 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, gross margins, operating 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 about the same as the average for the market.

Last year I started a policy of allowing myself one rant per letter about a subject relevant to investment. I thought I would provide an update on how that went. Last year I sounded a warning about the perils of Exchange Traded Funds ("ETFs"). What happened next even surprised me and I thought I had lost the capacity for such an emotion in the face of the shenanigans of the financial services industry.

Practitioners within the ETF sector reacted with a fury which can only be generated by two factors: 1) the criticism was accurate and/or hit a nerve; and 2) it was in danger of derailing a large gravy train.

Some ETF practitioners suggested that I was criticizing ETFs because of concerns about the impact the growth of ETFs would have on the active fund management sector in general and Fundsmith in particular. This response is not just wrong it is preposterous for two reasons: 1) Fundsmith's market share of the active fund management sector is so small that I do not possess a calculator capable of getting enough zeroes to the right of the decimal point to calculate it. As a result, ETFs could continue growing to the point where they had replaced most active funds and still leave Fundsmith with an insignificant share of the remaining sector, so they are unlikely to affect us; and 2) I have long and publically maintained that the best equity investment for most investors most of the time is an index fund because of its low cost and outperformance of most active fund managers.

In an effort to be clear, my criticisms of ETFs are:

1. ETFs are almost certainly being mis-sold. My straw poll of investment professionals suggests that many investors think that ETFs are simply index funds. Many are not. Synthetic ETFs do not hold underlying securities of the sector or market they are supposed to replicate. Inverse ETFs can lose money even when the market sector they track has gone down, and leveraged long ETFs can lose money when their market or sector has gone up. None of these is consistent with the performance of a simple index fund.

2. Synthetic ETFs are of particular concern. If a fund which is described by the words synthetic, derivative, swap and counterparty does not cause you obvious concerns, I suggest you may need to study the events of the credit crisis of the past four years more carefully.

3. Because ETFs are tradable on markets unlike mutual funds, traders can sell them short. Relying upon the assumed ability to create more shares in the ETF in order to close these short sales, it is not unknown for the short interest in certain ETFs to reach ten times the size of the underlying ETF's assets. In these circumstances, the average ETF holder may be unaware that only some 10% of their holding in the ETF is represented by assets of the type they expect-the other 90% is a promise to deliver units from the short sellers. All will be well unless the short sellers find it difficult or impossible to buy enough of the underlying securities to deliver the required ETF shares which in some illiquid index or sector ETFs is entirely possible.

My own warnings on ETFs were followed by warnings from amongst others, the Bank of England, the Financial Services Authority, the International Monetary Fund and the U.S. Securities and Exchange Commission in a rare example of closing the door on a stable which may still contain a horse. Since regulators have come in for so much criticism of their loose handling of the financial sector prior to the credit crisis it would be churlish to criticize them for these warnings, and foolish to ignore them.

One more problem with ETFs became apparent to me in the course of this debate. ETFs are represented as low cost investments. Yet research published during the year demonstrated that ETFs were amongst the largest profit generators for some banks. This seems counter intuitive: how does a low cost product become a major profit contributor? The answer of course is that synthetic ETFs in particular provide banks with innumerable ways to "clip the ticket" of the ETF. The fees paid by the ETF investor are a very small portion of the total revenues which operating the ETF provides. They also deal for the ETF, provide the swap agreements by which it holds its synthetic positions (I wonder who works out whether the bank is providing them a fair price?), and maybe earn leverage, prime brokerage, custodian and registrar fees. The banks also deal for the hedge funds and traders who want to trade the ETF. At about this point, I began to realise why my critique of ETFs had caused so much fury.

My advice on this matter is simple. A broadly-based index fund is often the best investment you can make in the equity markets. But if you decide this is correct, buy precisely that, an index fund, not an ETF. The only difference between a physical ETF (which frankly is the only sort you should contemplate unless you like the risk of synthetic derivative swaps with counterparty risk) and an index fund is that the ETF is traded on the market as the term “Exchange Traded” implies. Every piece of research I have encountered and all my experience shows that frequent dealing is the enemy of a good investment performance. So why buy an ETF rather than an index fund? You can deal daily in most index funds. The only people who want to deal more frequently than daily are hedge funds, high frequency traders, algorithmic traders and idiots (these terms are not mutually exclusive). Why join them? If you don’t want active management, and mostly you shouldn’t, buy an index fund.

During 2010 Fundsmith also launched a SICAV and a US LLP. Neither of these affects your investment in The Fundsmith Equity Fund but I feel that you should be informed about this and it affords me an opportunity to raise another subject-currencies.

The SICAV is denominated in Euros and based in Luxembourg. It is a so-called “feeder” fund-the only assets it holds are units in The Fundsmith Equity Fund. The US LLP is a Delaware partnership denominated in US dollars which is invested with exactly the same strategy as The Fundsmith Equity Fund but it cannot be run as a feeder fund.

We launched these two funds in response to investor demand. US based investors face a massive tax disadvantage in investing in a UK fund as it cannot issue a Form K1 for IRS reporting, and offshore investors wanted a non UK vehicle for investment. But in neither case does the denomination of the fund in a currency other than sterling affect the investments currency exposure.

We are often asked by investors whether we hedge currencies. The answer is a firm ‘No’. How would we do so? Should we base it on the currency of the country in which the companies are listed? This obviously would not work. There may be no connection between the country in which a company is listed and its area of operations. The same is true of its country of incorporation or headquarters. Nestle is an example we often cite in this respect. Although it is headquartered in Switzerland, has its main listing there and reports in Swiss francs, it has only about 2% of its revenues in Switzerland, so hedging our holding by selling Swiss francs forward against sterling would surely not be a hedge at all. It is also far from unknown for companies to report in a different currency to that of the country in which they are headquartered or listed.

Perhaps we should hedge currencies based upon the country in which each of our investee companies has its revenues? The problem with this approach is twofold. Firstly, most of the companies supply low value items and so manufacture and sell locally or at least regionally. No one exports significant amounts of bulky low value items such as detergent. So the exposure, if there is any, relates only to the profit margin. Secondly, the corporate treasurer may already have taken out a currency hedge for the translation and/or transmission of those profits so that any currency hedge by us would in fact be creating an exposure.

A lot of nonsense is talked about currency exposure and hedging. Our new funds denominated in Euros and US Dollars do not change the currency risks of those funds which are driven by the underlying investments. For those who don’t believe this, we are prepared to launch a new class of our Fund which will change its currency denomination each year to the worst performing currency. In 2011 it would have even denominated in Turkish Lira and would have risen by 32%. However, since you would receive this depreciated currency when you sell the Fund units, you won’t be any wealthier as a result. If you think you would be, let us know and we will set up the Money Illusion class of the Fund.

We view the year ahead with some trepidation. It seems that it has yet to dawn on many of the key participants in the financial crisis that you cannot borrow and spend your way out of a crisis caused by over leverage, and that there is no higher authority than the governments who's credit is now in doubt which can extend further funds to provide a painless "solution" or maybe even a temporary respite. The dawning of this reality is sure to have some very painful consequences.

However, in contrast the Credit Default Swaps of Nestle have been less expensive than the cost of insuring against default on the debt of European governments and the US Treasury for some time. We are far from believers that the market is always right, but this does suggest that holding shares in major, conservatively financed companies which make their profits from a large number of small, everyday, predictable events is a relatively safe place to be if you have the patience, fortitude and liquidity to ride out the share price volatility which is likely to occur in such circumstances. And that's exactly where and how our Fund is invested.

Yours sincerely,

Terry Smith
CEO
Fundsmith LLP