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Dear Fellow Investor,

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

We have presented three periods of performance figures this year - the performance since inception, the annualised returns and the last calendar year.

T Accumulation Shares, Total Return	**2012** %	**Since Inception to 31.12.12 %**	**Annualised** %
Fundsmith Equity Fund £	12.5	29.4	12.6
MSCI World Index £	11.4	14.8	6.6

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 other than for agricultural businesses.

However this proviso notwithstanding, how did we do in 2012?

The Fund rose by 12.5% in 2012 and modestly outperformed the market (which we take as the Morgan Stanley Capital International World Index - or MSCI World - in sterling with dividends reinvested) by 1.1%.

I'm rather surprised that we managed to outperform the market at all in this reporting period. 2012 was a year in which so-called risk assets performed well. This is unsurprising in a year in which the major central banks in the developed world supplied increasing amounts of liquidity through their Quantitative Easing programmes in increasingly desperate attempts to keep some modest amount of economic growth. All that liquidity has to go somewhere and indeed the supply of liquidity by central banks' purchases of bonds helps to push investors towards the purchase of riskier assets, as does the regime of record low interest rates, of which more anon.

This is not an environment in which I would expect our Fund to perform well relative to the market as the rising tide of liquidity floats all ships, many of which we would not consider owning.

Moreover, the year was characterised by what is in my opinion is a naïve view that the words spoken or (more rarely) actions taken have somehow helped to resolve the financial crisis which we have been living with since 2007. I cannot see how the supply of liquidity can solve a crisis caused by over leverage and insolvency. These events were exemplified for me when the Financial Times declared Mario Draghi, the President of the European Central Bank as its Man of the Year. This was based upon

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the fact that in July Mr Draghi pledged to do 'whatever it takes' to save the Euro, which was followed by him doing precisely nothing and yet the borrowing costs of the major European problem countries, and most notably Spain, dropped and the Eurozone crisis went into remission.

Depending upon your point of view, this is either an example of the perfect action by a central banker - the mere threat of action producing the desired result; or another episode in kicking for touch without any attempt to solve the underlying problems. No prizes for guessing which camp I am in, but in any event positive reactions to such events are far more likely to buoy the share prices of financial stocks, cyclical companies, those who might otherwise be bust or at least in difficulty and indeed a whole series of assets which we will never own in our Fund. For example, the MSCI World Bank Index in sterling with dividends reinvested was up 22.3% in 2012. We do not own any banks stocks and will never do so. The Financial Times also reported that a number of hedge funds doubled their money by investing in Greek bonds in 2012. Clearly such a double or quits trade is not ever going to attract us, and it is hard to see how a fund manager can hope to repeat such trades consistently enough to warrant the risk, which is presumably one of the reasons why HSBC reported that 88% of hedge funds underperformed their relevant benchmarks in 2012. With assets such as this performing well I hope you can see why I am surprised that our Fund outperformed the market.

It is also worth bearing in mind that we do not seek to outperform in every reporting period or in all market conditions, rather we seek to outperform the market and other funds over longer periods of time.

The analogy I use for this is the Tour de France, which topically was won by a British rider - the now 'Sir' Bradley Wiggins - for the first time in 2012. The Tour is the greatest of cycling Grand Tours, with 21 stages run over 23 days. In the 100 years since the Tour was first run, no rider has ever succeeded in winning every stage of a Tour. Nor in my view will anyone ever achieve this. This is because the Tour encompasses three distinct types of stage:

- the stages in which the riders form a peloton and riders can gain vital aerodynamic assistance by slipstreaming (or getting "a wheel") from the rider(s) in front of them. A team can carry a sprinter (like Mark Cavendish) in the peloton and release him close to the line for the final sprint in an effort to win the stage;

- time trials in which the riders are released individually and so cannot gain any assistance from each other. In order to maximise their own aerodynamic efficiency, the riders use tri handlebars, wear skin suits and aerodynamic helmets and often have solid rear wheels and wide rims on the front wheel. This is a test of individual riding ability over the whole stage; and

- mountain stages which are run as a team but involve significant climbs unlike the main peloton stages which are much flatter.

A rider needs a very different physique to win as a sprinter to a time trialist or a mountain climber - compare Bradley Wiggins with Mark Cavendish - which is why no one can win all stages. The rider who wins the Tour is likely to be one who excels at one discipline - Wiggins is a time trialist, the discipline in which he also won a Gold medal at the 2012 Olympics - and is not too bad at, and obtains help from his team with, the other stages. Indeed on two occasions, the Tour has been won by riders who did not win a single stage.

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In my view there is a moral here for investors. What we are trying to achieve with Fundsmith is to win the investment equivalent of the Tour de France for you-to outperform over a long period of time. However, we do not expect to outperform all the time or in all markets conditions. Rather our expectation is that we will perform relatively well in bear market conditions, and may struggle to keep pace in more bullish conditions, which is why I am surprised that we outperformed the market albeit modestly in 2012.

It is important that our investors recognise that this is what we are aiming for. Too often investors seek to find fund managers who can outperform all the time and in all market conditions. The trouble is that no such person exists. But the attempt to find this mythical creature leads to some investors moving their assets between managers, incurring costs and most frequently ditching a manager who's investment style is out of step with the current market in favour of one with recent good performance just as they are about to switch positions.

Having said all that, how are we doing at winning the Tour? Since inception our Fund has managed an annualised return in Sterling of 12.6% p.a. versus a return of 6.6% p.a. for the MSCI. This seems like a satisfactory start on our investment Tour campaign.

Our Fund remains the best performing fund in the IMA Global Sector since inception to the end of December 2012.

The main positive contributors to that performance in 2012 were: Intercontinental Hotels, L'Oreal, Reckitt Benckiser, Kone and Diageo.

The main detractors from the Fund's performance were: Procter & Gamble, McDonald's, Imperial Tobacco, Becton Dickinson, and a Consumer Company which we are in the course of buying a position in and so would prefer not to name at this point. McDonald's is a small position as it has only recently come within valuation range for us after reporting a number of periods with poor sales performance. We believe it is a business of the quality which we seek and therefore are willing to use this as an opportunity to buy stock. It might be worth thinking about the implications when a business which sells some meals for one dollar is struggling to grow sales. Clearly this is not because consumers are feeling flush and trading up.

Portfolio turnover in the Fund in 2012 was 0.48%. This figure is flattered by the inflow of funds over the period which is not included in the calculation otherwise a new fund would have 100% turnover from investing cash inflows, but even so it is exceptionally low.

Our only outright sale during the year was of SGS, the Swiss testing company. We remain convinced that it and the sector are good quality businesses, but the shares had reached the point at which they were one of the most highly rated within our Investable Universe and so we thought that there was better value to be found elsewhere.

We finished the year with 28 holdings up from 24 holdings at the end of 2011, which is towards the top end of our range but we are in the course of selling a holding which will reduce this number.

Our outright purchases for the year were Choice Hotels, Domino's Pizza, McDonald's, Visa and the aforementioned Consumer Company. Our purchase of Domino's is perhaps the one which requires most explanation since we sold it the year before. The sale was partly based upon apprehension about Domino's debt refinancing which had

been postponed. We took this as a bad sign in a banking market which is exemplified by a cartoon which shows a man sitting in front of a bank manager (you can tell this because there's a sign on the desk saying "Bank Manager") who says "I'd like to borrow some money" to which the Bank Manager replies "What a coincidence, so would we." There is clearly nothing wrong with Domino's but plenty wrong with the banking industry on which it was reliant for its refinancing.

In the event, Domino's proved us comprehensively wrong. Not only did it manage to refinance but they did so on terms which enabled it to pay a $3 per share special dividend. So I did what you should always do, but we so rarely manage to do, when we get it wrong a) admit this - most importantly to yourself; and b) reverse the decision. So Domino's was repurchased

Fortunately there was a period of share price weakness after the refinancing which enabled us to do this on reasonable terms but frankly that does not matter as much as whether the shares were still good value when we repurchased them, which we believe they were. It is always a mistaken strategy to wait for the shares to get below the point at which you sold them before repurchasing, or the even more common trait of waiting for a loss-making share purchase to get back to break even before selling. As I am fond of saying, the shares are unlikely to follow this desired pattern since they do not know whether you own them or not or at what price you bought or sold.

There are several morals to the Domino's trades but the main one is that almost every time we sell a position in a quality company we get to regret it in terms of subsequent share price performance. The good news is that we don't do it very often.

This brings me onto the wider subject of the expenses borne by the Fund. The Ongoing Charges Figure (or "OCF" as it is now called) for the year is likely to be 16bps or 0.16% in addition to the Annual Management Charge. This is a 4bp reduction compared to 2011 figure. These expenses are often ignored both by investors and other fund managers. But, like all charges, they detract from the performance of the Fund, deserve proper attention and should be minimised. The Fund can only perform as well as the performance of the shares it owns and to the extent that performance is absorbed by expenses, the returns for investors will suffer.

The majority of the costs borne by the Fund are the costs of running and maintaining the share register. These costs are driven by numbers of shareholders and transactions. We continue to focus on reducing these charges, ensuring the Fund benefits from economies of scale as it grows and does not overpay for services simply because of the increase in its size. If the Fund remains at its current size, we would expect the Ongoing Charges Figure to fall by another 3bps in 2013.

Perhaps surprisingly, the Ongoing Charges Figure does not include all charges the Fund has paid in the year. The commission paid on share purchases and sales are not included and neither is Stamp Duty or the bid/offer spread which is incurred in dealing. During the year, the Fund paid £231,000 in commission-less than 4bp on the value of the total trades. The vast majority of those trades were due to inflows into the Fund. Stripping out the commission on trades caused by the inflow, the amount of commission paid on trades executed voluntarily was under 1bp of the average funds under management. This compares with estimated charges incurred by the average UK mutual fund manager of about 1% pa excluding Stamp Duty.

Turning to the characteristics of our portfolio, probably the question I am asked most frequently is whether the strong performance of most shares in the Fund to date means that they are now over-valued.

The weighted average free cash flow ("FCF") yield, which is our primary valuation yardstick, of the companies in the portfolio started the year at about 5.8% and finished it at about 5.7%.

This 5.7% FCF yield compares with a median yield on the non-financial stocks in the S&P 500 of about 6.1% and an average of 5.4%; or a median for the non-financial stocks in the FTSE 100 of 4.6% and an average of 4.9%. The valuation of our stocks on this basis therefore looks about the same or a bit better (cheaper) than the average.

The yield is also significantly higher than the yield on government bonds which was previously known as the risk free rate before investors started to relearn that governments default. This is significant. The coupon on those bonds cannot grow over time whereas the free cash flow from our companies can. So if we can buy them with a higher FCF yield than the bond yield then we have probably created value.

We should perhaps compare the FCF yield of the portfolio not with the yield on major government bonds but what we think that bond yield should be since government bond yields across the developed world are distorted by Quantitative Easing in which the central banks, controlled by the government, are the main or even the sole buyer of bonds. We work on the assumption that government bonds would need to yield at least 1% over the expected rate of inflation to attract rational investors, and so we seek to invest in companies only when their FCF yield is the same as or more than that required bond yield.

The return on capital of the companies in our portfolio averaged about 32% p.a. This compares to an average of about 20% p.a. for the non-financial stocks in both the S&P 500 and the FTSE 100. Bearing in mind the longevity and resilience of our portfolio companies I think we can 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.

It may seem surprising that we can buy shares in quality companies at reasonable or even cheap valuations and thereby expect to generate superior investment performance. I have written a short research note in an effort to explain this entitled "Return Free Risk" which can be downloaded from our website at www.fundsmith.co.uk/research. The title is not a mis-type, rather it's a pun. As investors we are taught that to obtain higher returns you must assume higher risk, but much of the evidence contradicts this assumption. The fact is that for much of the time you get better returns from investing in predictable high quality companies than in smaller, riskier, more obscure company shares. But there appears to be a human desire to indulge in excitement and back the 100-1 shot rather than the favourite, and to engage in complicated bets such as the Yankee defined as "four selections and consisting of 11 separate bets: 6 doubles, 4 trebles and a fourfold accumulator". Can you accurately calculate whether the odds on such a bet are fair, in your favour or the bookmakers favour? If you can't, then the bookmaker has the advantage. For bookmaker, read "market". The principle is the same.

At Fundsmith we obtain excitement not from the delusion that we have discovered an investment that no other investors have found or from a long shot winning, but from delivering predictable, superior investment returns.

The marginal fall in free cash flow yield of our portfolio is a result of the rise in the share prices of the companies in the portfolio nearly offset by a 9.6% increase in the free cash flows per share produced by our companies.

On the whole, we would prefer that the share price performance of our stocks tracked the underlying free cash flow performance of the companies since performance from increasing valuations is a finite game which also tends to even out over long periods of time, and we intend to run this portfolio for a long period of time.

Similarly, we would prefer that the increase in free cash flow from our portfolio companies was derived from top line volume growth, albeit from companies which are able to maintain good prices and high margins on their sales. However, in the low growth environment which we occupy, free cash flow growth is increasingly a result of cost cutting and/or share buybacks. These are also finite sources of growth even when share buybacks are executed in a way which creates value for remaining shareholders, which is not always the case. But it is better to be invested in companies which can maintain growth in free cash flow per share by these means in these circumstances than in companies which can't.

The historical dividend yield of the portfolio is 2.3% and we forecast the prospective yield is 2.5%. Dividend cover remains 2.6 times. Yield is an important element of investment return. Over the long run, it has contributed a higher percentage of equity performance than share price appreciation. But I would caution against a blind search for higher yields.

The current record low interest rates and bond yields have produced a desperate search by investors for yield. The investment industry stands ready to supply products to satisfy any craving by investors, not always to their advantage. Investment flows have started to gravitate to higher risk bonds such as junk bonds and emerging market debt as government bond yields in the supposed safe haven countries have shrunk towards zero. The yield on US high yield or junk bonds sank to 6% at the beginning of 2013, the lowest ever recorded. New issuance has boomed in high yielding real estate investment trusts, and so-called master limited partnerships in energy stocks and pipeline companies (I wonder how many investors can explain how they work). Even Collateralised Loan Obligations ("CLO"s), part of the toxic alphabet soup of instruments which helped start the Credit Crisis have been making a comeback with issuance trebling in 2012. How soon we forget.

Equity investors are far from immune from this trend. For many investors the search for yield is satisfied by investing in an income fund which invests in high yielding equities. This can be a mistake. At certain levels of yield all that is happening is that the investor is being paid back some of the capital value of his or her investment as income, and taxed upon it. All bar one of the income funds in the IMA Global Equity Income sector apply their charges not to income but to capital in order to maximise their stated yield. This has some obvious disadvantages, not the least of which is that it maximizes the investor's tax bill as Income Tax is higher than Capital Gains Tax and much more difficult to avoid or defer. It also exaggerates the true yield, which has obvious marketing advantages for the funds.

We think that investors should not focus solely upon yield but rather on the total return they derive from a share or a portfolio, and should not take the dividend yield as an exact indicator of what they can afford to remove from the fund periodically and spend. To this end we have recently launched a Regular Withdrawal Facility for Fundsmith investors which enables you to draw down whatever figure you want in a regular

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income from your investment in the Fund without reference to the dividend yield. I am convinced that this, rather than buying high yielding shares which may have poor overall returns and managing them in a fund which overstates the yield by applying charges to capital, is the right way to address this need. It seems like an odd innovation for a fund manager to devise a way to make it easier for investors to withdraw money, so I doubt this will catch on with other managers.

The average company in the portfolio was founded in 1902 – this time last year it was 1894. Clearly some of our purchases have shortened the average age of our companies which has produced a worrying leap on average into the twentieth century.

Looking forward to 2013, one reasonably likely outcome is that we might experience "Groundhog Year" in which there are more EU summits, further commitments to do "whatever it takes" whilst actually doing nothing, another "rescue" deal for Greece, wrangling over the US debt ceiling to follow the Fiscal Cliff, and more QE to keep an otherwise stagnant economy across the developed world alive on life support.

However, it seems likely that one thing is changing: the mandate of central banks in the developed world. The Fed recently doubled its monthly QE programme to $85bn and said it would maintain this programme **at least** (emphasis added) until unemployment falls below 6.5%. Shinzo Abe became Prime Minister of Japan for the second time with the stated intention of making the Bank of Japan target an increase in inflation. Mark Carney, the much heralded new Governor of the Bank of England, got off to an unusual start by announcing seven months before he starts work that he thinks there should be a debate about whether central bankers should currently be targeting nominal GDP growth i.e. ignoring inflation.

Now depending upon your point of view this is either good news because it means yet more stimulus will be applied or bad news because you do not think that the additional stimulus will do much to achieve economic growth or increased employment but it will risk side effects which can be as bad or worse than the ailment they are seeking to treat.

I am in the latter camp. I think that central bankers should be independent of government and should be concerned with the soundness of the currency, and if they have the regulatory authority, the soundness of the banking system. Allowing them to stray outside that is dangerous as it will lead to confusion of fiscal and monetary policy, or in plain English, governments will be able to fund their profligate spending programmes by getting the central bankers to print more money and buy their bonds until the employment or nominal growth targets are achieved, or even beyond (note the term 'at least' used by the Fed).

At some point, the inevitable consequence of this is inflation and currency depreciation. The newer generation of central bankers such as Mr Carney have yet to experience that. When they do, they may discover that when inflation takes hold it does not conveniently stop at some predetermined target rate. They may also find that the only device they have to control inflation is the blunt instrument of interest rates, and a significant rise in rates would have some interesting effects on the affordability of government debt, private debt and the economy in its current condition.

You might legitimately point out that depreciation of the major currencies is a bit tricky as they are all trying to depreciate against each other in order to achieve some competitive advantage. But maybe they will all depreciate against hard assets, or to put it more simply-inflation.

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Still whilst we wait to see if or when this scenario comes to pass, the good news is that macro views and developments have no bearing on our strategy; increasingly desperate attempts to stimulate the economy are far more likely to stimulate the valuation of our portfolio (not that we like to make money that way); and our stocks are likely to be a relatively good hedge against a resurrection of inflation.

Happy New Year.

Yours sincerely,

Terry Smith
CEO
Fundsmith LLP

Important information:
An English language prospectus for the Fundsmith Equity Fund is available on request and via the Fundsmith website and investors should consult this document 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 financial promotion is intended for UK residents only and is communicated by Fundsmith LLP which is authorised and regulated by the Financial Services Authority.