Fundsmith Equity Fund

Owner's Manual

Fundsmith
Buy good companies
Don't overpay
Do nothing

Contents

Introduction 1

Why is an Owner's Manual necessary?

Section 1 3

The investment management industry

Section 2 6

How we invest at Fundsmith

We aim to buy and hold

We aim to invest in high quality businesses

We seek to invest in businesses whose assets are intangible and difficult to replicate

We never engage in "Greater Fool Theory"

We avoid companies that need leverage

The businesses we seek must have growth potential

We seek to invest in resilient businesses

We only invest when we believe the valuation is attractive

We do not attempt market timing

We're not fixated on benchmarks – other than long-term

We're global investors

We don't over diversify

Currency hedging, or the lack of it

Management versus numbers

Our investments are liquid and the Fundsmith Equity Fund is open-ended

Section 3 13

The fund manager

Section 4 15

What do we charge you?

Disclaimer: 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 Conduct Authority.

We aim to run the best fund ever. By best fund, we mean the one with the highest return over the long term, adjusted for risk.

Why is an Owner's Manual necessary?

Most fund managers will send you a glossy brochure. At Fundsmith we want you to have an Owner's Manual. Why? Because your understanding of what we are trying to achieve and how we will approach it is a critical element in enabling us to attain our goal.

What is our goal?

Captain Cook, the navigator and explorer who discovered Australia, once said that he didn't want to go further than any man had gone before: he wanted to go as far as a man could go. Such ambition led him to discover a new continent. We aim to run the best fund there has ever been, and certainly aim to provide the best fund you have ever owned.

This is an ambitious goal and we need to clarify what we mean by best and where you come in. By best fund, we mean the one with the highest return over a long period of time, adjusted for risk.

You may think it's odd that by best we don't necessarily mean the fund with the highest return, certainly not over any short period of time or irrespective of how the returns are achieved. Investment is subject to a lot of fads and cycles. A good example was the Dotcom mania when Technology, Media and Telecommunications stocks rose to valuations which could not be supported by any rational analysis. If you weren't invested in technology stocks in that period (and we wouldn't have been) then you would have underperformed the market. We would be happy to have done so, as we would never own a share in a company which we did not think was both good and at worst fairly valued. We would not own something because it is fashionable and might go up. Because eventually it goes down. Usually by a lot.

There are also funds which deliver high returns but which are running what we would regard as unacceptable risks. They may be following fads, like the Dotcoms, and hoping to sell out and realise the gains before the bubble bursts; or using leverage or borrowed money to enhance returns, which is OK until things go wrong and the leverage magnifies the losses, or worse.

Your understanding is important because whilst you own the Fundsmith Equity Fund there may be investment fads which other fund managers are following but we won't. We need you to understand this, since we wish to concentrate all our efforts on making the fund work for you, and don't want to deal with endless queries about why we are not following a particular investment fad. Just as vitally, we don't want you to withdraw your money from our fund in order to follow the investment fad of the moment. Leaving aside the obvious facts that we earn fees on your funds and that in and outflows can be disruptive to our investment strategy, there is also the fact that not being invested continuously for the long haul is likely to significantly reduce your returns.

Michael Johnson once said that he was such a good sprinter that the only person who could defeat him was himself; i.e. that he could only be beaten by his own temperament. The greatest threat you face to your investment performance is from you.

Most investors make some classic mistakes which prevent them from capturing the best investment performance they could obtain. They buy at the top and sell at the bottom of markets or share price cycles, motivated by greed and fear. It takes considerable emotional discipline to buy when others are fearful and sell when others are greedy. Not that we intend to indulge in market timing, but just doing nothing takes iron discipline when faced with the fears and temptations of the markets.

The greatest threat you face to your investment performance is from you.

In general, investors are also too active or they buy funds run by managers who are too active. Active is one of those bits of investment jargon which has more than one meaning and is often misunderstood as a result. Fundsmith does not intend to run a passive or index fund, far from it. But investment activity in the form of buying and selling shares has a frictional cost in terms of the commissions and the difference between the bid-offer spread which dealers charge. The more we can minimise these costs, the better.

As Warren Buffett, probably the greatest contemporary investor once said: "Long ago, Sir Isaac Newton gave us three laws of motion, which were the work of genius. But Sir Isaac's talents didn't extend to investing: he lost a bundle in the South Sea Bubble, explaining later, 'I can calculate the movement of the stars, but not the madness of men.' If he had not been traumatized by this loss, Sir Isaac might well have gone on to discover the Fourth Law of Motion: For investors as a whole, returns decrease as motion increases."

This low level of activity requires the deceptively simple task of buying the right shares in the first place and holding onto them for a long time, both of which are easier said than done.

Investors also buy the wrong type of funds. Perhaps the best way to illustrate this is to tell you how we will run the Fundsmith Equity Fund and how this contrasts with the way most of the fund management industry operates.

The investment management industry

The Fundsmith Equity Fund is an FCA authorised fund which brings to retail investors a method of investment which they have not been able to access before.

91% of Global Equity Funds available for sale in the UK have either underperformed their benchmark or have failed to survive over the 15 years to 31.12.12*. This is hardly surprising as the average equity fund manager owns far too many stocks and in effect tracks the index. So the result you are getting is in fact an index fund less the manager's fees and costs of dealing, which are also expensive. This structure makes underperformance against the index inevitable. Why do fund managers do this? Because for them the greatest risk is not underperforming the index with your money. It is stepping out of line with their peers. Especially if they fail. Warren Buffett also said, 'Failing conventionally is the route to go; as a group lemmings may have a rotten image, but no individual lemming has ever received bad press.' But it is not clear that doing something different to the crowd is career enhancing even if you are right. The gatekeepers of the investment world – the consultants who advise institutional investors and the advisers who advise many private investors – are not generally supporters of divergent thinking or action. This is ironic, because the only way to succeed in investment is to break out from the crowd.

** Vanguard, Morningstar*

The greatest risk to most fund managers' careers is not losing money for you or underperforming the index. It is in doing something different to their peers.

Nor is this problem limited to the UK. A recent study by academics at Yale School of Management, using the Active Share methodology, showed that 'active' mutual funds in the US with a low Active Share ("index huggers" or "closet indexers") had about 30% of all assets in 2003, compared to almost zero in the 1980s, and that low Active Share funds have poor benchmark adjusted returns and do even worse after expenses.

At Fundsmith we are never going to discuss tracking error. Tracking error is the measure of how closely a portfolio tracks the index against which it is benchmarked. In fact, we embrace tracking error. We want to diverge from the benchmarks. In a positive way, of course. So we don't want our owners to be confused into believing that tracking error is a problem or even a legitimate subject for thought or discussion or to waste any time on it.

Most fund managers own too many stocks. Apart from making their performance track the indices, which you can achieve much more cheaply with an index fund, this also makes it difficult for them to invest in the companies they own with conviction. How much can you know about the 80th company in your portfolio?

Most fund management groups also manage a proliferation of funds. There are over 2,400 UK domiciled mutual funds which can invest in UK companies and only some 2,700 companies listed on the London Stock Exchange. This presents a fairly obvious problem. Most fund management groups have a myriad of funds covering growth and income, large companies and small companies, international and domestic equities, emerging markets funds, long only funds and long/short funds, funds covering particular sectors, and that's just in equities.

We want to diverge from the benchmarks. Positively, of course. We don't believe in tracking error. In fact, we regard it as a waste of time.

We could be forgiven for thinking that the strategy of many fund management groups is to raise a new fund for every possible investment technique and for every new fad and to hope that at least some of them succeed in a random process and that you don't notice the ones which don't.

You may notice that our fund's name is simple: the Fundsmith Equity Fund. It doesn't say it's a Growth Fund or an Income Fund. Our marketing advisers were very keen for us to get the word Income or Dividend into the title because apparently income funds outsell growth funds. We haven't followed that advice because we regard the distinction between income and growth as artificial. Good businesses of the sort we seek to invest in produce cash flow returns on their capital invested which are better than the average, and they can sustain those returns, and even replicate them on newly invested capital. When they find opportunities to invest at these superior rates of return we want them to do so rather than pay a dividend. However, most of the companies of the sort we seek will pay a dividend as they generate cash flows which compare favourably with their profits, and opportunities to invest at superior returns are limited even for good companies. Whether you choose to receive that income or seek to compound it is simply a matter of which share class you choose on the fund application form. The idea that there is one set of investible companies which are "growth" companies and which do not pay dividends and a different set that pay most of their earnings out and so are "income" stocks is simply a marketing man's invention, not an investment reality.

Anyway, enough of what's wrong with the fund management industry. How do we run the Fundsmith Equity Fund?

The name is simple: the Fundsmith Equity Fund. It doesn't say it's a Growth or an Income Fund. We regard this distinction as artificial.

How we invest at Fundsmith

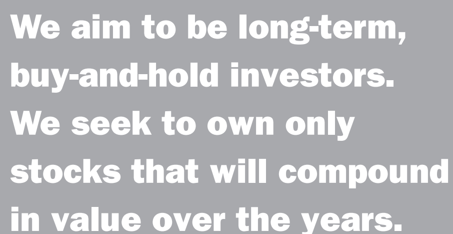
We aim to buy and hold

We aim to be long-term, buy-and-hold investors. We seek to own only stocks that will compound in value over the years. Accordingly, we have to be very careful about the stocks we pick. We believe, as does Warren Buffett, that we do not have a good investment idea every day, or indeed, not even every year. Consequently, we should treat our investment career like one of those tickets you get for a tram which is spent once it's been punched 20 times, as that's the number of great investment ideas we're likely to be able to find at a price we can justify investing in them. This also minimises the frictional cost of trading.

We aim to invest in high quality businesses

This may sound blindingly obvious, but you might be surprised how many investors either don't do this or do not have a good definition of a high quality business.

In our view, a high quality business is one which can sustain a high return on operating capital employed. In cash. It's funny how investors who are not at all confused about this concept when they are seeking the bank deposit with the highest rate of interest (necessarily balanced by risk, as depositors in Icelandic banks discovered) or even the return on a fund such as ours, lose their marbles when it comes to evaluating companies. They start talking about growth in earnings per share and other gibberish. Earnings per share is not the same as cash, but more importantly it takes no account of the capital employed to generate those earnings or the return which is earned on it. If all you want from your investments is earnings per share growth, we can provide as much as you need providing you supply us with unlimited capital and turn a blind eye to the returns we are able to generate. Frankly we wouldn't recommend it as a way of investing, although that's precisely the way many investors do invest, especially in acquisitive companies.



Note that we are not just looking for a high rate of return. We are seeking a sustainably high rate of return. An important contributor to this is repeat business, usually from consumers. A company that sells many small items each day is better able to earn more consistent returns over the years than a company whose business is cyclical, like a steel manufacturer, or "lumpy", like a property developer.

This approach rules out most businesses that do not sell direct to consumers or which make goods which are not consumed at short and regular intervals. Capital goods companies sell to businesses; business buyers are able to defer purchases of such products when the business cycle turns down. Moreover, business buyers employ staff whose sole raison d'être is to drive down the cost of purchase and lengthen their payment terms. Even when a company sells to consumers, it is unlikely to fit our criteria if its products have a life which can be extended. When consumers hit hard times, they can defer replacing their cars, houses and appliances, but not food and toiletries. However, not all companies which sell capital goods or which sell to businesses are outside our investible universe. A business service company may have a source of consistent repeat business, and some capital goods companies earn much of their revenue, and sometimes more than all their profits, from the provision of servicing and spare parts to their installed base of equipment. These can satisfy our criteria.

We seek to invest in businesses whose assets are intangible and difficult to replicate

It may seem counter-intuitive to seek businesses which do not rely upon tangible assets, but bear with us. The businesses we seek to invest in do something very unusual: they break the rule of mean reversion that states returns must revert to the average as new capital is attracted to business activities earning super-normal returns.

They can do this because their most important assets are not physical assets, which can be replicated by anyone with access to capital, but intangible assets, which can be very difficult to replicate, no matter how much capital a competitor is willing to spend. Moreover, it's hard for companies to replicate these intangible assets using borrowed funds, as banks tend to favour the (often illusory) comfort of tangible collateral. This means that the business does not suffer from economically irrational (or at least innumerate) competitors when credit is freely available.

To be fair, during equity market "bubbles", some competition can be funded by equity which seems to require no foreseeable return, but Dotcom style phenomena are mercifully rare, and like every cloud they have a silver lining: the Dotcom boom led to depressed valuations for the "old economy" stocks of precisely the sort we seek.

The kinds of intangible assets we seek are brand names, dominant market share, patents, distribution networks, installed bases and client relationships. Some combination of such intangibles defines a company's franchise.

Since stock markets typically value companies on the not unreasonable assumption that their returns will regress to the mean, businesses whose returns do not do this can become undervalued. Therein lies our opportunity as investors.

We never engage in "Greater Fool Theory"

We really want to own all of the companies in the Fundsmith Equity Fund. We do not own them knowing that they are not good businesses or are over-valued in the hope that someone more gullible will come along and pay an even higher price for them. We wisely assume that there is no greater fool than us.

We avoid companies that need leverage

We only invest in companies that earn a high return on their capital on an unleveraged basis. The companies may well have leverage, but they don't require borrowed money to function. For example, financial companies (such as banks, investment banks, credit card lenders, or leasing companies) typically earn a low unleveraged return on their capital. They then have to lever up that capital several times over with money from lenders and depositors in order to earn what they deem to be an acceptable return on their shareholders' equity. Even worse, some sectors, such as real estate, can only earn an adequate return on equity by employing leverage. This means that not only are their unlevered equity returns inadequate, but periodically the supply of credit is withdrawn, often with disastrous consequences given the illiquidity of their asset base. In assessing leverage, we include off-balance sheet finance in the form of operating leases, which are common in some sectors such as retailing.

We are more interested in companies which have physical growth in the merchandise or service sold than simple pricing power, although that's nice too.

The businesses we seek must have growth potential

It is not enough for companies to earn a high unlevered rate of return. Our definition of growth is that they must also be able to reinvest at least a portion of their excess cash flow back into the business to grow while generating a high return on the cash thus reinvested. Over time, this should compound shareholders' wealth by generating more than a pound of stock market value for each pound reinvested.

In our view, growth cannot be thought about sensibly in isolation from returns. Rapid growth may be good news or it may be bad news. It depends on how much capital you have to invest to generate that growth. The "earnings" of a bank savings account will grow faster, the more money you deposit into the account. But it is unlikely to be a good investment strategy to put most of your assets into such an account, and you certainly shouldn't rejoice at the fact that if you double your capital invested you will get twice as much interest. That is not growth. The source of growth is also a factor to consider. Growth in profits from increasing prices can simply build an umbrella beneath which competitors can flourish. We are more interested in companies which have physical growth in the merchandise or service sold than simple pricing power, although that's nice too.

We seek to invest in resilient businesses

An important contributor to resilience is a resistance to product obsolescence. This means that we do not invest in industries which are subject to rapid technological innovation. Innovation is often sought by investors but does not always produce lasting value for them. Developments such as canals, railroads, aviation, microchips and the internet have transformed industries and people's lives. They have created value for some investors, but a lot of capital gets destroyed for others, just as the internet has destroyed the value of many traditional media industries.

We are at one with Warren Buffett who suggested that the most sensible course of action for an investor who witnessed the Wright brothers' inaugural controlled powered flight at Kitty Hawk in 1903 would have been to shoot them down. Anyone who doubts the wisdom of this should take a look at the financial performance of airlines over time.

Big, exciting new developments, even those that change the world, are not necessarily good long-term investments. We do not have the skills or the appetite to spot a new innovation and ride the wave of initial enthusiasm for the short term with the (often unspoken) aim of selling out before the truth about its potential to destroy value is apparent. As investors, we only seek to benefit from product development in long established products and industries.

We only invest when we believe the valuation is attractive

Again this one may seem obvious but we have seen many investors who invest in quality companies, yet still underperform because they consistently overpay for those investments. We estimate the free cash flow of every company after tax and interest, but before dividends and other distributions, and after adding back any discretionary capital expenditure which is not needed to maintain the business. Otherwise we would penalise companies which invest in order to grow.

Bonds do not grow or compound in value. Our goal is to buy securities that can do both, and provide yields that are similar or better than bonds, at a cheaper price.

Big, exciting new developments, even those that change the world, are not necessarily good long-term investments.

Our aim is to invest only when free cash flow per share as a percentage of a company's share price (the free cash flow yield) is high relative to long-term interest rates and when compared with the free cash flow yields of other investment candidates both within and outside our portfolio.

Our goal is to buy securities that we believe will grow and compound in value, which bonds cannot, at yields that are similar to or better than what we would pay for a bond.

We do not attempt market timing

We do not attempt to manage the percentage invested in equities in our portfolio to reflect any view of market levels, timing or developments. Getting market timing right is a skill we do not claim to possess. Looking at their results, neither do many other fund managers, but that does not seem to stop them trying. Studies clearly show that most successful fund managers avoid market timing decisions. Apart from an inability to do it well are the potential consequences of even trying it. This is illustrated by the fact that if, for example, you had invested in a UK index fund from 1980-2009 you should have achieved a return of some 700% on your investment. However, if you missed the best 20 days of stock market performance during that period, that return would have been reduced to just 240%. We do not claim to be able to time buy and sell decisions so as to capture 20 days out of some 7,000 working days. In addition, the Fundsmith Equity Fund is not meant to provide an asset allocation tool. We assume that if you own the Fundsmith Equity Fund you have already taken the decision to invest that part of your portfolio in equities, managed in the manner we describe.

A subset of our inability and unwillingness to try to make market timing calls is that we will not invest in sectors which are highly cyclical. It is possible to deliver performance from such investments, but it requires a good sense of timing for the economic cycle and how the market cycle relates to it. It also requires strong nerves, because such investments are often counter-intuitive, as exemplified in the investment adage "Only buy cyclicals when they look expensive". This is because when they have little or no earnings, they are at or close to the bottom of the cycle. The converse applies; to sell them when they look cheap, as they are then at peak earnings.

We are not sure we have either the skill set or the constitution for such investing. In any event, investing in cyclical businesses has one big disadvantage even if you get this worrisome timing process roughly right; they are mostly poor quality businesses which struggle to make adequate returns on their capital. There are few barriers to entry into their business sectors. If you want to become a major airline investor, I am sure you will be welcomed with open arms. But whilst you wait to see whether you have got your timing right, the underlying value of your investment is more likely to erode than compound, and of course occasionally airlines do not survive a cycle at all.

We're not fixated on benchmarks

Over a sufficient period of time, you will no doubt want to assess our performance against a range of benchmarks – the performance of cash, bonds, equities and other funds, and we will assist you in that process by providing comparisons.

However, we do not think it is helpful to make comparisons with movements in other asset prices or indices over the short term, as we are not trying to provide short term performance. Be warned: in our view, even a year is a short period to measure things by. Moreover, a year does not have its foundations in the business or investment cycle. It is, in fact, the time it takes the earth to go around the sun and is therefore of more use in studying astronomy than investment.

For this reason, you should only invest in the Fundsmith Equity Fund if it is with money that you will not need for a long period of time, and you are capable of remaining relatively sanguine about mark-to-market adjustments. Falls in market prices may make the market value of our portfolio go down, but we will only be concerned if we believe that the intrinsic value of our portfolio of companies has declined, and we will tell you so.

A year is the time it takes for the earth to revolve around the sun. It has no foundation in the investment cycle.

Conversely, we will not be rejoicing if or when we get a short term performance boost from a takeover. The problem is that we will need to find a replacement investment which can deliver high and sustainable returns on capital in cash and grow its business to deploy at least some of the cash that it generates at those sorts of returns. As you may gather, such investments are few and far between.

We're global investors

We are a bit suspicious of the term "Global". When someone presents a card which states that they are the "Head of Global Sales", it is tempting to ask them how many globes they have sold. It usually just means Head of Sales, but some organisations proliferate Heads and Managing Directors quicker than rabbits breed, so it's probably just a grandiose way of attempting to make a distinction.

Notwithstanding the hyperbole with which the term is often used, the Fundsmith Equity Fund seeks to be a global investor. Fund management groups have tended to proliferate national or regional investment funds that are an anachronism. Investors based in developed economies, such as the UK, who are overweight in their local market as a consequence of buying these funds may find themselves underweight in companies with high growth prospects more typically found in developing markets, and may exclude from their portfolios suitable investments listed outside the UK.

The idea of having an investment fund restricted to UK equities strikes us as bizarre. Why should the best growth companies in the world be listed in a stock market based in a country which only ranks fifth in the world by size of its economy and is located on a smallish island off the coast of Europe? Another advantage of investing with a global perspective is the ability to contrast and compare growth rates and valuations of companies from all geographies.

Some of the companies we seek to invest in derive a significant portion of their revenues from developing markets. This can enable us to obtain some of the benefits of developing markets' exposure (mostly growth), whilst benefiting from the governance structure of a large, international company, typically but not always, listed on one of the world's major stock markets.

We don't over diversify

We do seek portfolio diversification, but the strictness of our investment criteria will inevitably leave us with a concentrated portfolio of 20 – 30 companies. We do not fear the concentration risk which this brings for two reasons. One is that research has shown that you can achieve close to optimal diversity with 20 stocks. But this may not be true in our case, as our investment criteria typically lead to a concentration in certain sectors. We then fall back on our other reason for not fearing concentration risk. As Mr Buffett said 'Wide diversification is only required when investors do not understand what they are doing.'

As a result, we take no notice of sector, industry or country weightings. In any event, the location of a company's headquarters or stock market listing is a very imperfect guide to where a company derives its revenues, profits and cash flows, which is what really interests us.

Our policy is not to hedge our currency exposure. We do not pretend to be any good at it.

We take no notice of sector, industry or country weightings. The country or domicile of a company is a very imperfect guide to where it derives its revenues, and profits.

Currency hedging, or the lack of it

Our policy is not to hedge our currency exposure. There are several reasons for this. One is that we do not purport to be any good at currency trading. It has a cost which is often rather more than it appears when you are being sold the hedge. In addition, you cannot know what any individual company's currency exposure is without knowing what hedging, if any, it has conducted in its own treasury operations. Experience would suggest that not even the treasurer is sure of that on occasions. In any event, you cannot permanently hedge a portfolio or a company against movements in any commodity with a price which fluctuates. Many of the companies we invest in generate revenues in the same currencies as they incur most of their costs. Therefore, their exposure to currency fluctuations is largely a matter of translation of their profits.

It is also a fact that if a fund is denominated in a soft currency, its performance will look better than it will if it is in a hard currency. Again, we don't intend to do anything to mask or alter that by hedging, as we don't think it has any bearing on the real performance the fund delivers and we don't know which currencies will depreciate and which will appreciate. However, if you think you do, you can always hedge your position.

Many companies can be excluded from consideration simply from a description of what they do or the sector they occupy, and the most impressive management team in the world will not induce us to invest in them.

Management versus numbers

We are rather more comfortable analysing numbers than we are trying to gain insights into companies by meeting the management. We intend to find companies which are potential investments by a screening process of their financial results to identify high return, cash generative, consistently performing businesses. In fact, most companies can be excluded from consideration simply from a description of what they do or the sector they occupy, as most are cyclical, require leverage to get adequate returns, sell to other businesses, make capital goods or durable items, or some combination of these factors.

That is not to say that we don't meet management. It is important to assess whether management provides honest stewardship, acting in the interests of the owners and telling it how it is rather than PR spin to try to enhance investors' perceptions. This does not mean we seek management with a narrow focus on what has become labelled "shareholder value". Too often a reliance upon the simplistic targets required by shareholder activists, such as growth in earnings per share and returning capital to make the balance sheet "efficient", (sometimes so efficient that it busts the company) has been to the long term detriment of shareholders. We would prefer management to invest adequately to maintain a company's brands and franchise value and grow it, albeit with good returns, and be honest about the impact of this on earnings and capital requirements. Companies which under-invest in their franchise in order to meet short term targets are not good candidates for compounding wealth.

However, we are aware of the limitations of our insights into human nature and we therefore expect management words to be borne out by figures in the report and accounts.

We are also believers in the adage that you should only buy shares in businesses which could be run by an idiot because sooner or later, they all are.

It's important to remember we are a minority investor in large quoted companies rather than a private equity investor with a controlling stake in a company who can control management. We do engage with management in an effort to ensure that their decisions are in the long term interests of the company and in particular in relation to capital allocation and management remuneration which we regard as vital. But ultimately, our main sanction in the event that management is behaving badly or illogically is to not own the shares.

Our investments are liquid and the Fundsmith Equity Fund is open-ended

The companies we invest in have large market capitalisations without major blocks being held by controlling shareholders. Therefore their shares are easily tradeable. In addition, the Fundsmith Equity Fund is an OEIC, i.e. an open-ended fund. Other fund managers may tend to have lock-up periods during which you have to give notice and wait to redeem your investment. Closed-ended funds mean the performance of your investment is dependent upon the relationship between the share price of the fund and the underlying net asset value of the investments. The liquidity in the shares of the fund itself, or the lack of it, can become an issue for investors seeking to redeem their investment. Investors suffer no such handicap with the Fundsmith Equity Fund.

Fundsmith will always be Terry Smith's main vehicle for his own investments.

The fund manager

The fund will be managed by Terry Smith, based in London, assisted by Julian Robins, as Head of Research, based in the USA, and Daniel Washburn, based in London

Fundsmith is focused on delivering superior investment performance at a reasonable cost. It was established to be different from its peers so as to achieve a different result in line with Sir John Templeton's axiom that "If you want to have a better performance than the crowd, you must do things differently from the crowd." The rigorous research process of Fundsmith is central to what we do. We apply exacting standards to potential investments to produce a portfolio of resilient businesses with excellent performance. Minimising the costs we incur on behalf of our customers in implementing our strategy also sits at the heart of our philosophy.

Fundsmith was established in 2010 by Terry Smith. The business is owned and controlled by its partners, who have worked closely together over many years, and is headquartered in London with an office in Connecticut, USA. It is structured to survive Terry Smith's demise and continue with the same investment philosophy. All partners of the firm have a significant co-investment in our Funds delivering a clear alignment of interest. Ancillary activities are outsourced to some of the world's leading providers in order to deliver high-quality operations whilst allowing the Fundsmith team to focus on investment analysis, portfolio management and customer care. As at 29th December 2017 we managed £14.4bn on behalf of some of the world's largest and most sophisticated wealth managers and private banks as well as for prominent families, charities, endowments and individuals invested in our fund range; Fundsmith Equity Fund (UK OEIC), Fundsmith Equity Fund Feeder (Luxembourg SICAV), Fundsmith Equity Fund L.P. (Delaware L.P.), Fundsmith Emerging Equities Trust plc (London Stock Exchange Listed Investment Trust) and the Smithson Investment Trust (London Stock Exchange Listed Investment Trust).

Terry Smith

Terry Smith graduated in History from University College Cardiff in 1974. He worked for Barclays Bank from 1974-83 and became an Associate of the Chartered Institute of Bankers in 1976. He obtained an MBA at The Management College, Henley in 1979. He became a stockbroker with W Greenwell & Co in 1984 and was the top-rated bank analyst in London from 1984-89. In 1990 he became head of UK Company Research at UBS Phillips & Drew, a position from which he was dismissed in 1992 following the publication of his best selling book Accounting for Growth. He joined Collins Stewart shortly after, and became a director in 1996. In 2000 he became Chief Executive and led the management buy-out of Collins Stewart, which was floated on the London Stock Exchange five months later. In 2003 Collins Stewart acquired Tullett Liberty and followed this in 2004 with the acquisition of Prebon Group, creating the world's second largest inter-dealer broker. Collins Stewart and Tullett Prebon were demerged in 2006 with Terry remaining CEO of Tullett Prebon until September 2014. In 2010 he founded Fundsmith where he is CEO and CIO. In 2012 he was appointed a Member of the New Zealand Order of Merit for services to New Zealand-UK relations following the success of his campaign to commemorate the New Zealander, Air Marshal Sir Keith Park.

Julian Robins

Julian Robins started his career with the stockbroking firm EB Savory Milln in 1984. From 1987 until 1999, he worked for BZW and after their takeover of BZW's equity business in 1998, CSFB. Between 1988 and 1993 he was BZW's senior bank analyst in London, from 1993 until 1999, he worked as an institutional salesman in New York. In 1999 he was one of the founders of Collins Stewart's New York office. He has first class degree in Modern History from Christ Church, Oxford and is qualified as a Series 7 Registered Representative and Series 24 General Securities Principal with FINRA.

Daniel Washburn

Daniel Washburn completed a PhD in Social Anthropology at the London School of Economics in 2010 having undertaken specialist courses in qualitative and quantitative research methods. Whilst a doctoral student, Daniel set up an employment agency to provide English teachers to China. Between 2006 and 2007 he served for 18 months as the King George VI Fellow at Cumberland Lodge, an educational charity. Daniel also has an MSc (Social Anthropology) from the LSE and a BA (Anthropology, Hons) from the University of California, Davis.

What do we charge you?

To begin with we do not charge a 5% initial fee as many UK mutual fund providers do. We welcome direct investors with whom we can have a direct dialogue and in our view, only having 95p in every £1 you invest at work in the fund is an unreasonable handicap to your investment performance, especially once it is allied with the usual problems of the fund manager incurring costs through over trading. You can imagine what it does to your returns when the 5% upfront fee and the costs of over-active dealing are applied to the sort of closet index fund which most managers offer.

You will note that we have not set Fundsmith up as a hedge fund charging the traditional "two and twenty" i.e. 2% of funds under management plus 20% of gains. Why? We have no desire to run a hedge fund in the true meaning of the term; we have no desire to short stocks as a hedge since we regard this as superfluous in respect of the long-term performance we aim to deliver. In addition, we regard it as a positively dangerous distraction from our main task of finding and holding shares in exceptional companies. Moreover, it adds leverage to the fund which we avoid, in the same way we avoid investment in companies which require leverage to deliver adequate returns. Shorting also substantially increases activity in a fund, the cost of which is detrimental to performance. Investors often fail to realise that the more successful a short position is, the quicker it declines as a portion of the portfolio and needs to be replaced by a new short position. That is the reverse of a good long idea. You can run good long ideas forever, and we intend to try.

However, in recent years the term "hedge fund" has come to represent just a charging structure, as hedge funds have developed in every asset class, including equities, bonds, currencies, commodities, derivatives and even collectibles such as art and fine wine. It is not always possible to short some of these assets, and even when it is possible, it is clear from the results of many hedge funds during the credit crunch that they either weren't hedging or weren't doing so effectively. This leaves hedge funds defined by the two and twenty charging structure alone.

1% p.a. for direct investors
No performance fees
No initial fees
No redemption fees
No overtrading

There are two problems with that structure. Firstly, human nature being what it is, it provides temptation for the hedge fund manager to make an extreme and often highly leveraged bet with the fund. If it comes off, he or she walks away with 20% of the gains. If not, it's not their money which is lost. Using this methodology, many hedge fund managers have been able to retire after a short period of good performance. Even if it does not fail and lose the investors' money, this "strategy" does not lead to long-term compounding of returns, because, by definition, the fund manager takes to the hills (or his yacht) after a short period of spectacular performance.

The second issue is more pernicious; the two and twenty charging structure cannot work for investors even if the hedge fund manager is capable of generating superior returns indefinitely. This was illustrated in a study of Warren Buffett's performance. By 2008, Buffett's Berkshire Hathaway had created net worth of some $62bn. But if, instead of Buffett controlling a company in which he was a co-investor with other shareholders and from which he takes no fees, he had invested the money with an outside hedge fund manager who delivered exactly the same performance from the same investments, 90% of the value created would have accrued to the hedge fund manager.

We place a great deal of emphasis on minimising the total cost of investment in our fund as this is a vital contribution to achieving a satisfactory outcome as an investor. Minimising portfolio turnover is key to fulfilling this objective. 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 2017 for the T Class 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 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.

We find that investors are often confused by this and 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 2017 this amounted to a TCI of 1.09%, 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 we are 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, we fully expect that the Fundsmith Equity Fund will compare favourably.

And finally...
what about tax?

We don't guarantee to make you happy to pay tax, only to try to ensure that the amount you are paying it on is as large as possible.

Frequent activity is an investor's worst enemy. It also deprives investors of an unusual advantage; an interest free loan from the government. In the UK, gains which are realised within a mutual fund such as the Fundsmith Equity Fund are not taxable. However, disposals of holdings by investors in mutual funds are chargeable to Capital Gains Tax (CGT). An investor who keeps realising holdings will therefore pay CGT. Once this has been subtracted, the amount which can be reinvested is significantly reduced. Over time this will have a serious effect on the amount an investor can obtain by compounding his or her investment.

Now you might say that an investor can escape this handicap by adopting the same long-term, buy-and-hold strategy that Fundsmith pursues. However, it is hard to pursue perfectly with individual shareholdings. Sometimes it is necessary to buy and sell shares to reflect changes in relative valuations. We are constantly evaluating our investments against each other and other shares in our investible universe for this reason, and from time to time there is involuntary turnover caused by takeovers. In fact, this can happen frequently when you own shares in good businesses. For the investor who owns individual shares, this creates taxable events, whereas it does not create a taxable event in a mutual fund like the Fundsmith Equity Fund. Therefore, by holding such a fund, an investor's gains are compounded on what is in effect an interest free loan from the government, i.e. gains realised within the fund are not taxed and we can earn returns on the tax which would have been paid until such time as the investor withdraws from the fund. This produces the ironic result that an investor who pursues this approach will generate a greater absolute amount of money and of course will owe more tax, but the net amount retained will still be greater than if tax had been paid on gains along the way. Therefore the investor should be happy. Please note we said "should be". We don't guarantee to make you happy to pay tax, only to try to ensure that the amount you are paying it on is as large as possible.

Disclaimer: 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 Conduct Authority.

Fundsmith

33 Cavendish Square
London
W1G 0PW
UK

46 Southfield Avenue, Suite 205
Stamford
CT 06902
USA

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

©2018 Fundsmith LLP. All rights reserved. This financial promotion is communicated by Fundsmith LLP.Fundsmith LLP is authorised and regulated by the Financial Conduct Authority. It is entered on the Financial Services Register under registered number 523102. Fundsmith LLP is a limited liability partnership registered in England and Wales with number OC354233. Its registered office address is 33 Cavendish Square, London, W1G 0PW.