Fundsmith
Sustainable Equity Fund

Summary

Fundsmith Sustainable Equity Fund

Fundsmith
Buy good companies
Don't overpay
Do nothing

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Growth in “sustainable” investing

In recent times there seems to have been a seemingly inexorable growth in interest in investing on a "sustainable" or "ethical" basis. This takes many forms and certainly has many labels some of which are the inevitable three letter acronyms ("TLAs") used to describe the activity – ESG (Environmental, Social and Governance) or CSR (Corporate Social Responsibility) based investing.

The Assets Under Management ("AUM") of asset managers who are signatories of the UN Principles of Responsible Investment ("PRI" – yes another TLA and probably the loosest definition of an ESG fund) has increased from $6.5 trillion (100 signatories) in 2006 to $62 trillion (1,500 signatories) in 2016, which is growth of 850%. A signatory of the UNPRI volunteers to incorporate its six principles related to ESG factors into its investment process.

In the US, according to the US Forum for Sustainable and Responsible Investment, the AUM of ESG strategies (incorporating some ESG analysis into the investment process) had increased to $8.72 trillion (22% of total AUM of $40 trillion) in 2016 compared to just $0.7 trillion in 1995.

In Europe total AUM investing by ESG criteria grew in 2016 to $12.04 trillion (53% of total) with exclusionary screens still the dominant method ($11.06 trillion), which has grown by 48% since 2014.

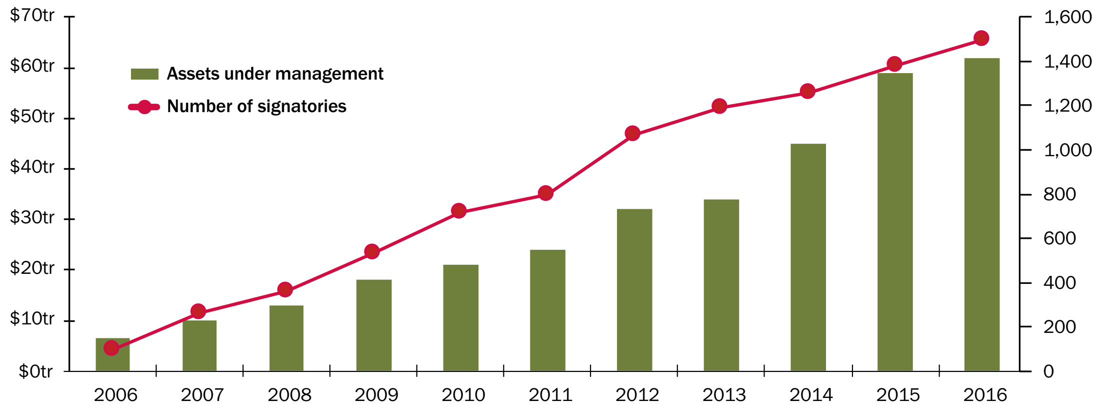
But what does it mean?

The actual approach adopted by funds which lay some claim to invest sustainably covers a wide range.

On the one hand there are those which merely claim to incorporate the UNPRI's six principles as part of their investment process.

Other funds seek to exclude investment in certain sectors which are regarded as uninvestable from an ethical or sustainability standpoint, or both: alcohol, tobacco, arms, coal, oil & gas. Some use factor based models such as those provided by Sustainalytics to rank companies on a range of factors in an effort to assess how sustainable a company's operations are and incorporate this into their investment process. Others take a more positive stance and seek to invest in companies which they believe will benefit from trends towards sustainable activity: electric cars, alternative energy sources such as biomass, solar power, wind power and forestry.

UN Principles of Responsible Investment



What are the problems with the current approaches to sustainable investment?

First and foremost, it mostly takes no account of real sustainability.

If you examine the factors which are most commonly used to measure sustainability you will find plenty of measures of environmental policy, social welfare, fair trade, and human rights. All laudable and no doubt high on the list of behaviour which investors might reasonably wish to see considered in their sustainable and ethical investments. However, there is no mention of items which may not fall into the ESG forms but which are equally vital to real sustainability. Items like the level of capital expenditure ("capex") relative to a company's own operations and its competitors. Spending on advertising, marketing and promotion of products. The amount of product innovation and the proportion of revenues derived from new and improved products and research & development spending.

This presents a big problem for existing ESG assessments. No matter how compliant a company may be with desired policies on the environment, human rights and corporate governance, if it is not taking the commercial actions necessary to sustain its business sooner or later there may be no business no matter how ethically it behaves.

At Fundsmith we have always been concerned with finding companies to invest in which take and implement the commercial decisions necessary to sustain and grow their business and have always measured items like capex, marketing and product innovation. One of the traits we seek is obliquity: we want to invest in businesses which produce great financial returns not because they focus solely on those returns but because of their intense focus on providing better products and services to their customers than the competition.

Without any measurement of these commercial actions needed to sustain the business, existing ESG/SRI monitoring systems are performing as sensibly as a pilot who only checks the status of one engine on his twin engine aircraft before take-off.

Secondly there are in our view some fatal flaws in the way that existing ESG monitoring is applied (please note the word "applied" – if we are criticising anything here it is the way the data is utilised, not the data itself). Take the data from Sustainalytics (www.sustainalytics.com) who are the leader in providing ESG ratings on companies.

Sustainalytics use a framework of measuring Environmental, Social and Governance factors that ranks the companies intra sector. So Repsol is the best oil and gas company on this methodology and gets an overall rating of 88/100 whereas Novo Nordisk the world's leading manufacturer of insulin which treats the world's largest and most rapidly growing medical condition is the best pharmaceutical company and gets an overall rating of 85/100. Thus implying that Repsol is a more sustainable business than Novo. Really?

Anglo American has a score of 76/100 whereas Becton Dickinson the medical technology company which manufactures syringes, diagnostic systems and safety devices has a score of 65/100. Are these scores really a fair reflection of the relative sustainability of their businesses?

It is easy to see why Sustainalytics makes the comparisons intra sector. There are factors which might apply to oil & gas and mining companies which are hardly likely to apply to medical equipment and pharmaceutical companies. Whilst these scores may accurately reflect ESG performance relative to their sectors, the idea that medical equipment companies can have worse ESG scores than oil & gas and mining companies simply flies in the face of common sense. It certainly makes a nonsense of those who seek to take the approach of comparing these scores across sectors when constructing or measuring a portfolio's sustainability.

Thus the Vanguard SRI European Stock Fund (as at 31/08/17) with 6% in oil and gas production gets a higher sustainability score from Morningstar at 55/100 than Fundsmith Equity Fund's score of 50/100 which has never owned an oil and gas company. Clearly an investor making a decision on where to invest based upon these sustainability rankings might have a nasty shock when they discover what the fund actually invests in, let alone when they look at the performance.

Fundsmith
Sustainable Equity Fund

At Fundsmith we have always been concerned with finding companies to invest in which take and implement the commercial decisions necessary to sustain and grow their business and have always measured items like capex, marketing and product innovation.

There is nothing in these approaches to enable a comparison between companies operating in different sectors or to reflect the companies' sustainability from R&D, product innovation and capex. The results, as you will see are inevitable and not good.

Then of course there are the funds which move on from measuring the sustainability of businesses and seek to invest in new alternatives to the sort of businesses which score badly on sustainability measures. The problem here is that this search for alternatives often leads investors to suspend their normal critical faculties.

Moreover, just as it is a law of physics that nature abhors a vacuum and natural forces will attempt to breach the seals which protect a vacuum, so the investment banking industry is adept at spotting trends in investor demand and finding new companies to issue stock which can satisfy that demand, often of dubious quality. The area of sustainable investing has been prone to this phenomenon.

A few examples (all data as at May 2017):

Power Generation

Drax (coal fired power station that could co-fire biomass and petcoke) – Drax before it **IPO**'d in 2006 announced it was sponsoring studies into carbon capture and storage (CCS) but noted that it was not commercially viable. Government funding for biomass conversion followed in 2012, which was later withdrawn in 2015 and the company announced it wouldn't be investing anymore into CCS and may not be able to convert all its capacity to biomass. Share price is -43.3% since its **IPO** in 2006, -68.8% since its peak on 14/08/2006.

Solar Power

- PV Crystalox Solar (produces a component for solar power cells) – Shares lost 95.2% of their value since **IPO** in 2007.
- Jetion (developed, produced and marketed solar cells and modules) – Shares lost 53.9% of their value since **IPO** in 2007 until it delisted in 2011.
- Hanergy Thin Film (mass production of thin film silicon solar modules) – Share price increased by 3,513% from 2008 to its peak in April 2015, after which its shares fell by 47%, before trading in Hong Kong was suspended on 20/05/2017 after an insider trading scandal and has remained so ever since.

Wave Power

- Ocean Power Technologies (makes equipment to produce electricity from ocean waves) – Shares are down 99% since its **IPO** in 2007. Iberdrola failed to buy its wave power system after extensive trials.

Clean Water

- Halosource (develops technology to purify drinking water) – Shares are down 99.3% since its **IPO** in 2010.

Wind Power

- Inox wind (Indian company that makes wind turbine components) – **IPO**'d in 2015. Shares are currently 46.8% lower than its **IPO** price.
- Clipper Windpower (UK company that designs and makes wind turbines) – Share price fell by 92.9% since its peak in May 2007, until it was bought by Platinum Equity, a private equity firm, towards the end of 2010.

Fundsmith
Sustainable Equity Fund

No matter how compliant a company may be with desired policies on the environment, human rights and corporate governance, if it is not taking the commercial actions necessary to sustain its business sooner or later there may be no business no matter how ethically it behaves.

The investment banking industry is adept at spotting trends in investor demand and finding new companies to issue stock which can satisfy that demand, often of dubious quality.

Cleantech

- Intelligent Energy (UK company that develops new power systems using proprietary fuel cell tech) – Shares are down 97.9% since its **IPO** in 2014, having fallen 39% within two weeks of its **IPO**.

- ITM Power (develops materials and tech to reduce the cost of Hydrogen production and develop hydrogen fuel cell tech) – Share price is down 93.1% since its peak in 2006.

- Proton Power (Produces clean fuel cell systems for industrial applications) – Shares down 96.9% since its **IPO** in 2006.

- Ceres Power Holdings (Develops fuel cells for the global distributed power generation market) – Shares down 96.5% since its peak in 2007.

- AFC Energy (Makes alkaline-based fuel cells) – Shares down 82.5% since its peak in 2010.

Alternative Fuels

- Velocys (develops tech that makes synthetic oil from waste gas that would otherwise be flared and other waste products) – Share price is down 79.7% since its listing in 2006. Although it did almost go above its **IPO** price in 2014, it has fallen 79.6% since then.

- Flowgroup (develops alternative energy products) – Shares are down 96.5% since its **IPO** in 2006 and down 98.8% from its peak in 2007.

Agriculture/resources

- SinoForest (operated forestry plantations) – Shares fell by 89.7% in June 2011 after Muddy Waters released research showing that it was inflating its revenues through a complex relationship with its Chinese holding company.

- Accsys Technologies (wood technology company) – The company tried to give the properties of hard wood to soft wood. Share price fallen by 93.7% since its peak in 2007.

- Felda Global Ventures (Malaysian government backed company producing palm oil from small scale plantations, so greener) – Share price rose by 20.9% after its **IPO** in 2012. Since then, its share price has fallen by 64.4%.

- Zincox (turns zinc waste powder into refined zinc in Korea) – Shares have fallen 99.9% since its peak in late 2007 till it was delisted in 2016.

We have highlighted the letters **IPO** in these examples – Initial Public Offering. The promoters of many of these sort of stocks and the “entrepreneurs” behind them had obviously figured out that their credentials as “ethical”, “green” and “sustainable” would be enough to get the shares sold to gullible investors.

The results of these confused approaches to sustainable investing are inevitable and mostly not good.

The following table shows the performance of the Fundsmith Equity Fund since inception and compares it with the FTSE Environmental Technology 100 Index which comprises the 100 largest pure play environmental technology companies globally, by full market capitalisation. The Index is designed to measure the performance of companies that have a core business in the development and operation of environmental technologies.

	Annualised return 1/11/10 – 30/09/17
Fundsmith Equity Fund T Class Acc	19.2%
FTSE Environmental Technology 100 Index	8.8%

Past performance is not a reliable indicator of future performance. The value of investment and the income from them can fall as well as rise.
You may not get back the amount originally invested.

What is clear is that investors are paying a heavy price in performance terms for embracing environmental technologies.

Now you might say this is a price worth paying for ethical and sustainable investments. But is it a price which has to be paid in order to adopt these sustainable credentials?

Since 2014 Fundsmith has been running a segregated mandate for one of the UK's leading charities – Comic Relief – which as well as relying upon our usual focus of investing in really sustainable businesses also operates the follow sectoral exclusions:

- Aerospace & Defence
- Brewers, Distillers & Vinters
- Casinos & Gaming
- Gas & Electric Utilities
- Metals & Mining
- Oil, Gas and Consumable Fuels
- Pornography
- Tobacco

In addition Fundsmith provides ESG reporting. The table opposite shows how the Comic Relief portfolio has fared relative to other equity funds in the IMA Global Sector with ethical and sustainable mandates as defined by Financial Express.

The moral of this would seem to be clear. There is merit in investing in sustainable businesses but investors will pay a penalty in terms of performance for doing so if it is not approached in a holistic manner. The investment process needs to pay as much attention to the economic sustainability of the business as it does to commonly reported ESG factors and the Fundsmith Sustainable Equity Fund, utilising the same strategy, sectoral exclusions and ESG reporting which it has for Comic Relief, provides it.

IA Global Funds with Ethical & Sustainable Mandates defined by Financial Express	Hard Sector Exclusions	Annualised return % 06/10/14 – 29/09/17
Fundsmith Comic Relief Segregated Mandate[1]	YES	23.9
Pictet Global Environmental Opportunities	NO	18.0
Stewart Investors Worldwide Sustainability	NO	17.1
F&C Responsible Global Equity	NO	16.8
Pictet Water	NO	16.0
Hermes Global Equity ESG	NO	15.6
Henderson Global Care Growth	NO	15.2
FP WHEB Sustainability	NO	14.8
Old Mutual Ethical	NO	14.7
Liontrust Sustainable Future Global Growth	NO	14.6
Vanguard SRI Global Stock	NO	14.2
Jupiter Ecology	NO	14.0
Jupiter Global Ecology Growth	NO	13.5
Sarasin Responsible Global Equity	NO	12.9
Candriam SRI Equity World	NO	11.1
GS Global Equity Partners ESG Portfolio	NO	10.9
Halifax Ethical	NO	10.7
Pictet Clean Energy	NO	9.6
EdenTree Amity International*	NO	9.5

Source: Financial Express. Analytics, Main Units. Total Return in Sterling. *Only Income shares available
[1] Simulated return: Total return ex cash, dividends reinvested pari passu, net of fees

Hard Sector Exclusions: Fundsmith research has found that few ESG funds stipulate hard sector exclusions in their prospectuses but at best merely state that they seek to avoid investment in certain types of companies. This can mean that investors in some of these so – called ESG funds find themselves invested in sectors with poor ESG factors. For instance Aberdeen Ethical World Equity's 6th largest holding as at 31/8/17 was EOG Resources, an oil and gas company, which has in the past made headlines for illegally burying waste and for human rights violations.

Past performance for Fundsmith Comic Relief Segregated Mandate is based on simulated returns of a segregated account run for a single client adjusted to show total return, ex cash with dividends reinvested pari passu. Simulated past performance is not a reliable indicator of future performance, in particular the Comic Relief portfolio was more concentrated than will be permissible for the Fundsmith Sustainable Equity Fund. Comic Relief has not independently verified the financial performance data stated. The value of investment and the income from them can fall as well as rise. You may not get back the amount originally invested.

The Assets Under Management ("AUM") of asset managers who are signatories of the UN Principles of Responsible Investment … has increased from $6.5 trillion (100 signatories) in 2006 to $62 trillion (1,500 signatories) in 2016.…

About Fundsmith

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 the investment analysis and portfolio management and customer care. As at 31st December 2016 we managed £10bn 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.) and the Fundsmith Emerging Equities Trust plc (London Stock Exchange Listed Investment Trust).

The Team

The portfolio manager of the Fund is Terry Smith, assisted by Julian Robins as Head of Research.

Terry Smith graduated in History from University College Cardiff in 1974. He worked for Barclays Bank from 1974 to 1983 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 to 1989. 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 bestselling 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 interdealer 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 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 a 1st class degree in Modern History from Christ Church, Oxford.

Tom Boles – Head of Sustainability.

Tom joined Fundsmith having completed an MSc in Economics and Finance from the University of Bristol with distinction in 2012, where his dissertation was on Persistence of Performance in the Mutual Fund Management Industry. He completed a BSc in Economics in 2011, also at Bristol University, having conducted work experience at Odey Asset Management and Neptune Investment Management. Tom is a CFA® charter holder.

The S&P Dow Jones Sustainability Indices (DJSI) are considered the gold standard for corporative environmental, social and governance (ESG). Notable additions to this year's rankings include British American Tobacco (BAT). Some ESG investors might be surprised to find BAT in their portfolio tracking a sustainability Index.

Fundsmith Sustainable Equity Fund Investment Process

The Fundsmith Sustainable Equity Fund will follow the same strategy as the highly successful Fundsmith Equity Fund but with an important difference, namely the following sectoral exclusions that are stipulated in the fund prospectus;

- No Aerospace and Defence
- No Brewers, Distillers and Vintners
- No Casinos and Gaming
- No Gas and Electric Utilities
- No Metals and Mining
- No Oil, Gas and Consumable Fuels
- No Pornography
- No Tobacco

In addition, Fundsmith screens investments for sustainability in the widest sense, taking account of a company's handling of environmental, social and governance policies and practices.

To this end we monitor our companies on a daily basis under our main sustainability categories of environmental, social, governance and innovation. We also expect the companies we invest in to have well-managed policies for ethical working practices and a sustainable relationship with the environment and their stakeholders. Fundsmith analysts integrate these expectations of a company's environmental, social, governance and innovation impacts on the world into our model forecasts.

For example, Pepsico's 2025 Sustainability Agenda targets/ forecasts are incorporated into analysts' models.

We also monitor innovation, as companies in the sectors we frequently invest in have a positive impact. They achieve this through improving their products efficacy, inventing new solutions to problems or by reducing the negative impact of their products. Our daily monitoring, which has both quantitative and qualitative elements, consists of:

- Firstly, we maintain a dynamic database of all the qualitative information a company has provided on its own sustainability efforts from their sustainability report, annual reports and/ or their website. These pieces of information are tagged and categorised under approximately 60 different topic 'tags' (see below), under the main headings of environmental, social, governance and innovation. These are updated periodically to reflect current perceptions of what is considered unsustainable. This allows us to look across the entire portfolio or investible universe to see the company's response or policy towards specific topics. This database also includes any comments from Fundsmith analysts on a company's performance at mitigating its negative impacts.

- An independent assessment of negative reputational risk from environmental, social and governance issues provided by RepRisk. We use this as a proxy for overall sustainability as it provides us with a way to absolutely rank companies within our investable universe, rather than relying on other ESG data providers, which would only allow us to rank companies intra industry.

- Data on environmental emissions, diversity, corporate governance and innovation provided by Bloomberg, which we use to provide a look-through of the portfolio compared to the S&P 500 Index. We expect our portfolio to demonstrate superior metrics to the S&P 500.

Fundsmith sustainability database categories:

Environmental	Social	Governance	Innovation
Air Pollution	Animal Testing	Code of Conduct	Product Innovation
Carbon Dioxide	Brand Specific	Corporate Governance	R&D
Climate Change	Charitable Giving	Corporate Responsibility	
Cocoa	Child Labour	Data Protection	
Ecosystem	Customer Relations	Ethics	
Energy	Community	Illicit Trade	
Environmental Reporting	Corruption	Remuneration	
External Recognition	Disaster Relief	Standards	
Greenhouse Gases	Employee Benefits	Transparency	
Packaging	Employee Diversity		
Palm Oil	Employee Health		
Raw Materials	Employee Safety		
Recycling	Employee Training		
Renewable Energy	Farmer Livelihoods		
Renewable Materials	HIV/AIDS		
Safe Drinking Water	Human Rights		
Soy	Product Marketing		
Sustainable Forestry	Product Standards		
Tallow	Stakeholder Relations		
Transport	Supplier Relations		
Waste Management	Supporting Charities		
Water Management	Supporting Entrepreneurs		
	Supporting Start-ups		
	Supporting Young People		

Thereafter we employ the same 3 step investment process of the highly successful Fundsmith Equity Fund, namely;

1. Buy Good Companies

High returns on operating capital employed: In cash. 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.

Businesses whose advantages are difficult to replicate: We seek companies with brand names, high market shares, patents, licenses, distribution networks, installed bases and client relationships. Together these define a company's franchise and its ability to outperform competitors.

No significant leverage required to generate returns: We only invest in companies that earn a high return on their capital on an unleveraged basis in recognition that sometimes credit is withdrawn.

Growth driven from reinvestment of their cash flows at high rates of return: We like to find businesses with a high degree of certainty of growth from reinvestment of their cash flows at high rates of return.

Resilience to change, particularly to technological innovation: We will not invest in industries which are exposed to rapid technological innovation and therefore obsolescence. This approach renders many sectors uninvestible. For example, we would never own a pharmaceutical development company.

2. Don't overpay

We are not buying shares in the hope that they will rise and we will then be able to on-sell them to someone else at a higher price, we aim to hold them indefinitely. To value the company we estimate the free cash flow 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. When a good company is cheap enough for us to buy we will build a stake which we aim to own indefinitely and collect the dividends paid out and pass those on to our investors. In contrast many fund managers will overpay for shares simply because they expect them to continue rising so that someone else will pay even more for them. This is sometimes appropriately called the Greater Fool Theory of Investment.

3. Do nothing

No market timing: If investors had missed the 20 best days between 1980 and 2009, an index fund would have risen by 240% instead of 700%. Therefore we won't risk playing "hokey cokey" with your investment and will maintain a full exposure.

Emotional discipline: Investors are their own worst enemy. Research from Dalbar Inc. in the US shows that the average equity fund investor significantly underperforms the average equity fund due to their propensity to buy funds at the top and sell at the bottom of market cycles. This is a core reason for writing our Owner's Manual, the aim of which is to help our investors understand the importance of rational and emotionally disciplined investing. Often the best course of action is to do nothing.

Investors should also be aware that the application of these investment criteria significantly limits the number of potential investments for the Fund's portfolio, giving us an investible universe of around 60 stocks. It is envisaged that the investment portfolio of the Fund will be concentrated, generally comprising between 20 and 30 stocks.

Fund Facts	
Fund Type:	UK OEIC
Launch Date:	November 2017
Units:	Income & Accumulation
Min. Lump Sum:	£5,000,000
Initial Charge:	None
AMC (I Class):	0.9%
Registrar:	DST
Depositary:	State Street Trustees Ltd.
Auditor:	Deloitte LLP
Dealing:	Daily at noon
IMA Sector:	Global Growth
Dividend Dates:	On or about 28/02 & 31/08

We are committed to the following

No Fees for Performance

No Up Front Fees

No Nonsense

No Debt or Derivatives

No Shorting

No Market Timing

No Index Hugging

No Trading

No Hedging

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