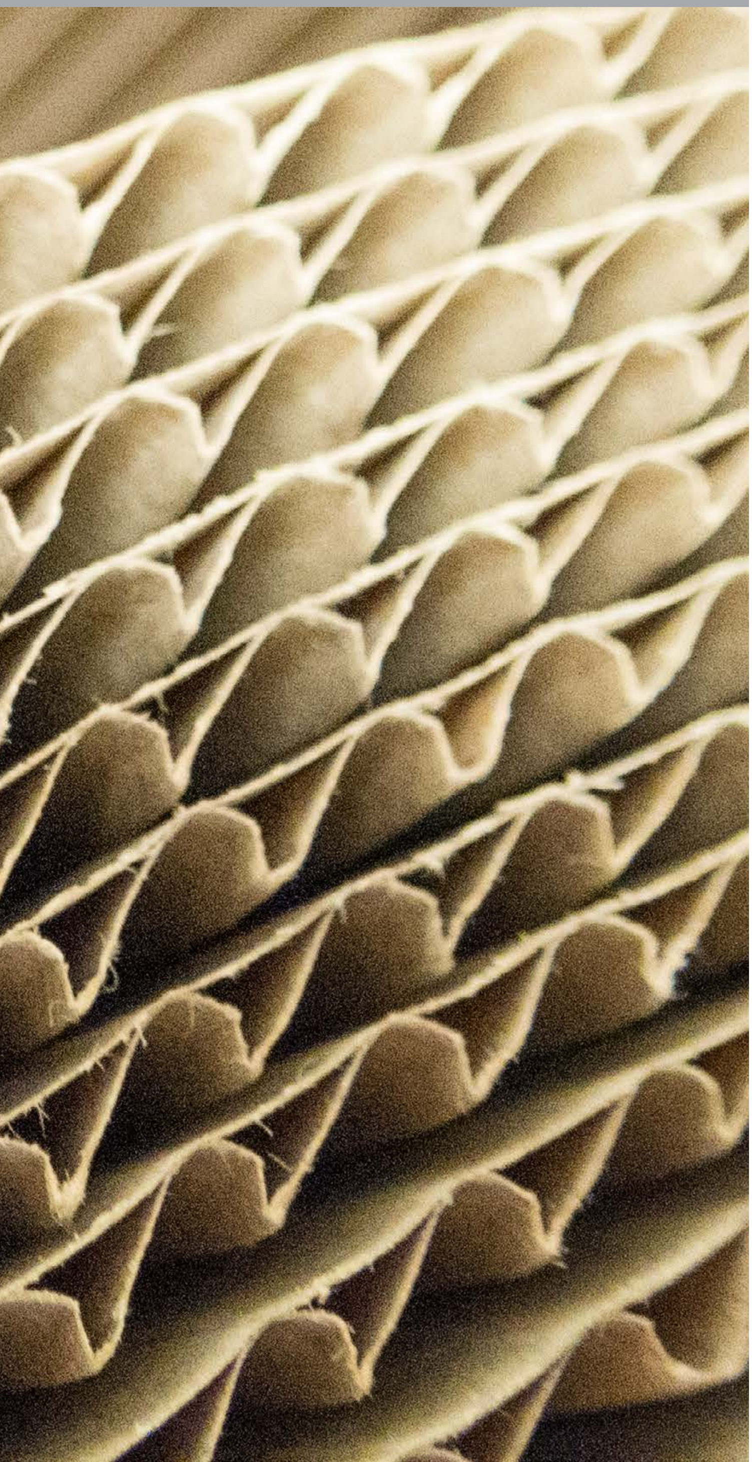
Fundsmith Stewardship Fund

Owner's Manual

Fundsmith
Buy good companies
Don't overpay
Do nothing

Contents

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.



Introduction

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 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 established our first fund, the Fundsmith Equity Fund, with the ambitious aim of running the best fund there has ever been, and certainly the best fund its investors have ever owned. This ambition is the same across the three strategies we run.

It is of course important to clarify what we mean by best and what your role is, as the investor. 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 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 during that period (and we wouldn't have been) you would have underperformed the market. We would be happy to have done so, as we would never own a share in a company that we did not think was both good and, at a minimum, 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 that deliver high returns but run with what we would regard as unacceptable risks. They may be following fads, like the Dotcoms, with the hope of selling out and realising the gains before the bubble bursts or using leverage or borrowed money to enhance returns. This is OK until things go wrong, and the leverage magnifies losses. Or worse.

Your understanding is important. During the period you own our products there may be investment fads that other fund managers are following, we won't. We need you to understand this as 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 aren't following a particular investment fad. Just as vitally, we don't want you to withdraw your money 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 term 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. he could only be beaten by his own temperament. The analogy is directly applicable here; the greatest threat you face to your investment performance is from you.

Most investors make some classic mistakes that 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.

In general, investors are too active or they buy funds run by managers who are too active. 'Active' is one of those bits of investment jargon that 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. 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 that 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. Doing nothing takes iron discipline in the face of the fears and temptations of the markets.

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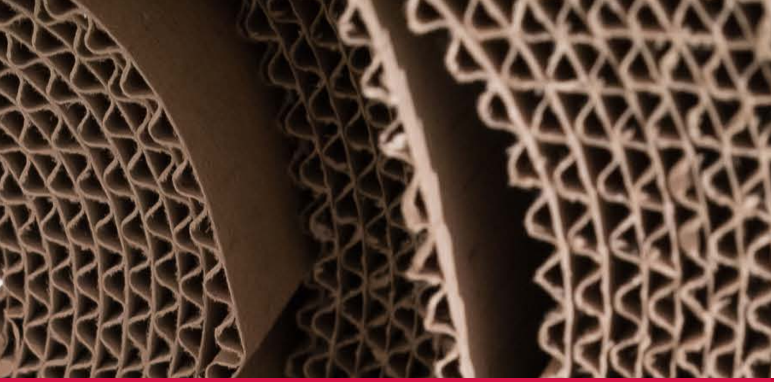
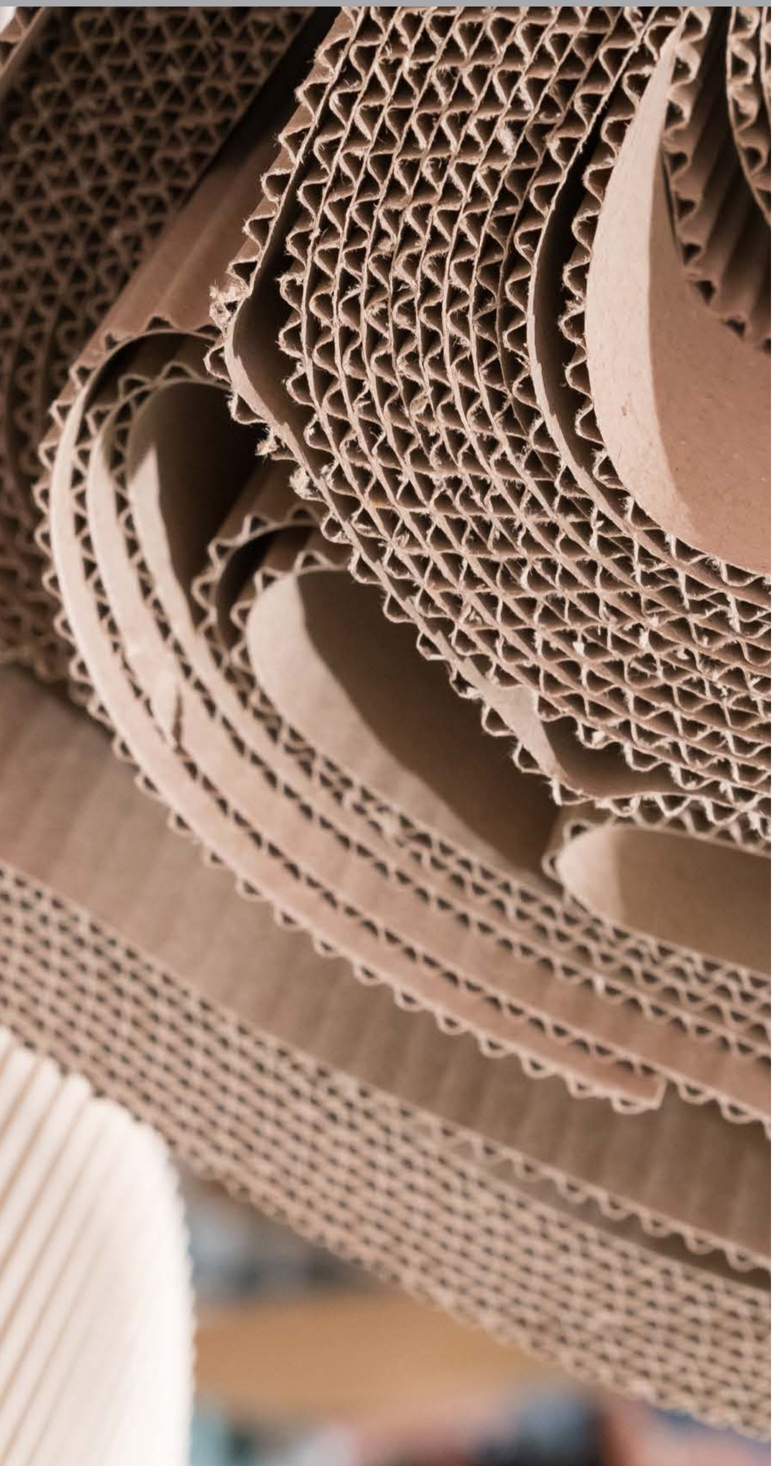
Warren Buffett



We exclude any company that we find to have an excessive net negative impact on the environment or society and are failing to reduce this impact.



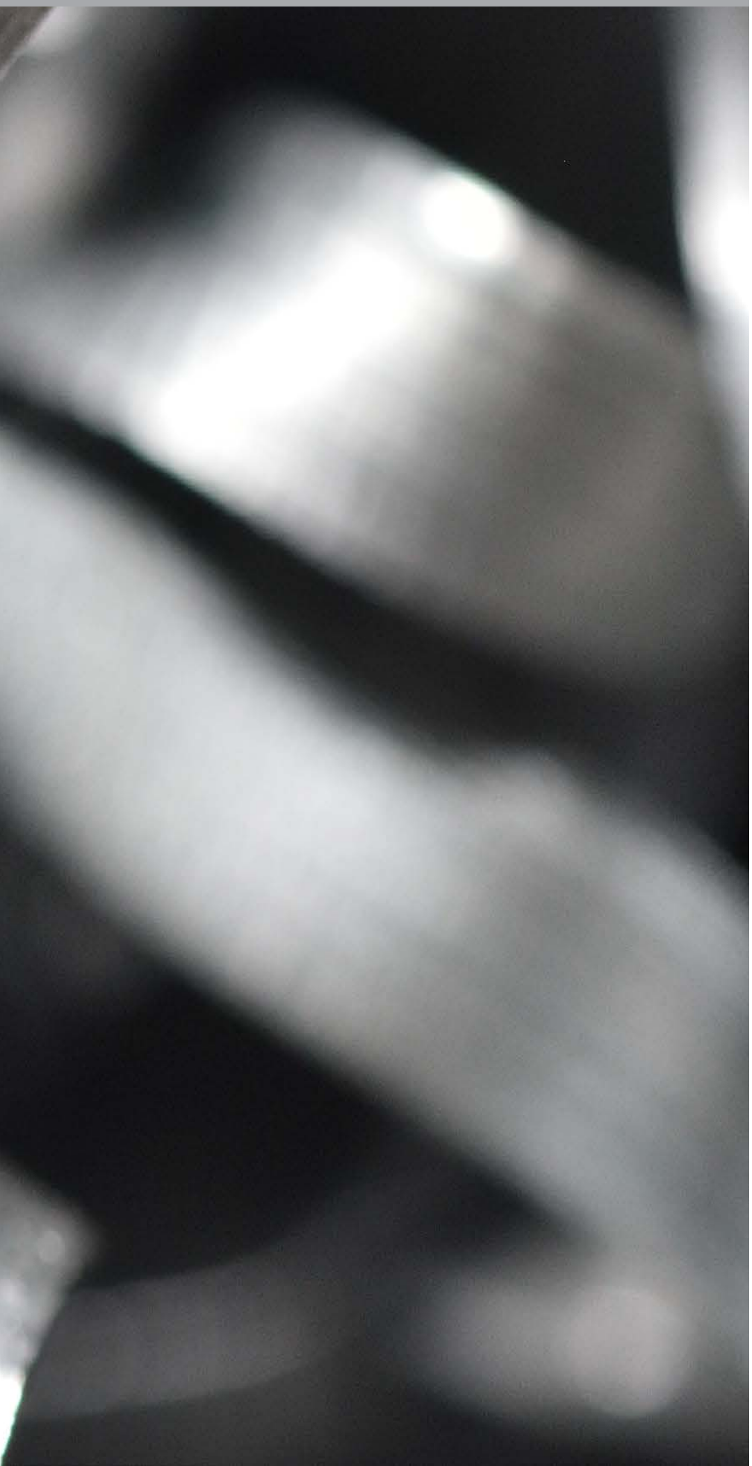
Fundsmith Stewardship Fund

Fundsmith Stewardship Fund was launched in 2017 and follows our firmwide investment philosophy: buy good companies, don't overpay, do nothing. The difference lies in the two additional screens we used during the construction of the Fund's investible universe (IU). After we identify the universe of good companies, we first screen out any that operate in what we deem to be unsustainable industries and sub-industries. Second, we exclude any company that we find to have an excessive net negative impact on the environment or society and are failing to reduce this impact.

Since the launch of the Fundsmith Stewardship Fund, the sustainable investment industry has experienced inexorable growth. The rapid rise of this industry has been accompanied with various bits of new jargon, in particular the inevitable three letter acronyms (TLAs), which the financial services industry enjoys using such as 'ESG' (environmental, social, and governance), 'SRI' (socially responsible investing), and 'PRI' (Principle of Responsible Investment). Alongside the jargon, we find there is significant confusion as to what sustainable investing actually is, and what it is trying to achieve. This Owner's Manual is designed to give you an insight into how we run the Fundsmith Stewardship Fund, how we go about assessing sustainability, and what we are aiming for.

The Fund does not have a UK sustainable investment label as it does not have a sustainability goal. Sustainable investment labels help investors find products that have a specific sustainability goal.

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



The sustainable investment industry

Most sustainable investments take no account of real sustainability.

The vast majority of sustainability assessments rest entirely on the environmental, social, and governance (so-called "ESG") performance of the company in question. Investors measure sustainability through indicators such as a company's environmental policy, human rights record, employee diversity, and board independence. These are all laudable and no doubt important qualities that investors would wish to see considered in their sustainable portfolios, but they are only part of what makes a real sustainable investment.

This confusion is one of the most significant issues with sustainable investing as it is. A company may have excellent ESG performance, but unless they are making the necessary commercial and financial decisions to stay in business, sooner or later there will be no company. That benefits no one. More often than not, investors discussing sustainability fail to include this in their assessments. We think it is difficult to justify the sustainability of an investment without assessing the company's actual sustainability, and investors following this method to identify "sustainable" investments are performing as sensibly as a pilot checking just one of the engines on his twin-engine aircraft before take-off. Likewise, only considering the commercial performance of a business can generate equally disastrous results.

At Fundsmith, we have always concentrated on finding companies that are making the decisions necessary to sustain their performance and generate long-term profitable growth. Sustainability, as far as we're concerned, is the ability to maintain a given level of performance over the long term. This sustainability results from more than simply avoiding the risks resulting from poor ESG performance. Companies' levels of relative capital expenditure (capex), investment in advertising and marketing, and effective innovation in the products and services they offer are all important measures of their ability to sustain their operations. One of the traits we seek is obliquity: we want to invest in businesses that produce great financial returns not because they focus solely on these returns, but because of their intense focus on providing better products and services to their customers than the competition.

Hence, in the Fundsmith Stewardship Fund we first look for high-quality businesses, as we do with the Fundsmith Equity Fund, before excluding those that we assess to have an excessive net negative impact on the environment and/or society.

The second problem is the use of third-party ratings to create "sustainable" portfolios.

The use of these ratings in the sustainable investment industry has spread as investors outsource the contentious and difficult judgements on sustainability to third parties. Our issue with these ratings is less with the scores themselves, and more with the assumptions made by investors and the decisions that follow.

The majority of these ratings use a methodology that ranks companies on an intra-sector basis. Ratings are calculated by scoring a business's performance against ESG factors that the data provider has deemed material to a company's industry and ranking the result against industry peers. This approach is taken as individual sectors face a specific set of challenges; for example, there are factors that clearly apply to an oil and gas or mining company that are hardly relevant to a healthcare business. This is a fair approach and reflects reality. However, too often investors use these ratings as if they were objective and absolute, providing a way to compare the 'sustainability' of a range of businesses. On this basis, investors offer "sustainable" or "ESG" funds which promise to invest in companies that meet a certain standard of sustainability, without acknowledging each industry is held to an entirely different standard. We do not think this is an appropriate way to operate a fund investing in sustainable assets. We have similar distain for "best-in-class" sustainable investment strategies. Just because an oil and gas company has attained a 'triple A' rating does not make it a sustainable investment.

We prefer to assess whether a company has an excessive net negative impact and whether it is failing to reduce it based on what it actually does, how it has responded previously, and whether it has credible incentives to avoid it in the future. We think we are better placed to make this judgement given our focus on long term performance, our ideal holding period of forever and our intimate knowledge of the companies in our investible universe.

Anyway, how do we avoid these challenges and invest the Fundsmith Stewardship Fund?

Investors only considering ESG factors to identify sustainable investments are performing as sensibly as a pilot checking just one of the engines on his twin-engine aircraft before take-off.

[1] MSCI – Morgan Stanley Capital International.

[2] GICS – Global Industry Classification Standard.

We aim to be long-term, buy-and-hold investors. We seek to own only stocks that will compound in value over the years.

Fundsmith Stewardship Fund investment process

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 must 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, every year. Consequently, we should treat our investment career like a ticket for a tram that is spent once it's been punched 20 times. We believe that's roughly the number of great investment ideas we're likely to find at a price we can justify an investment. 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 that sell capital goods or 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. The rule states returns must revert to the average as new capital is attracted to business activities earning super-normal returns.

They are able to do this as their most important assets are not physical assets, which can be replicated by anyone with access to capital, but intangible assets that 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. For example, the Dotcom boom led to depressed valuations of "old economy" stocks, 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 Stewardship 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.

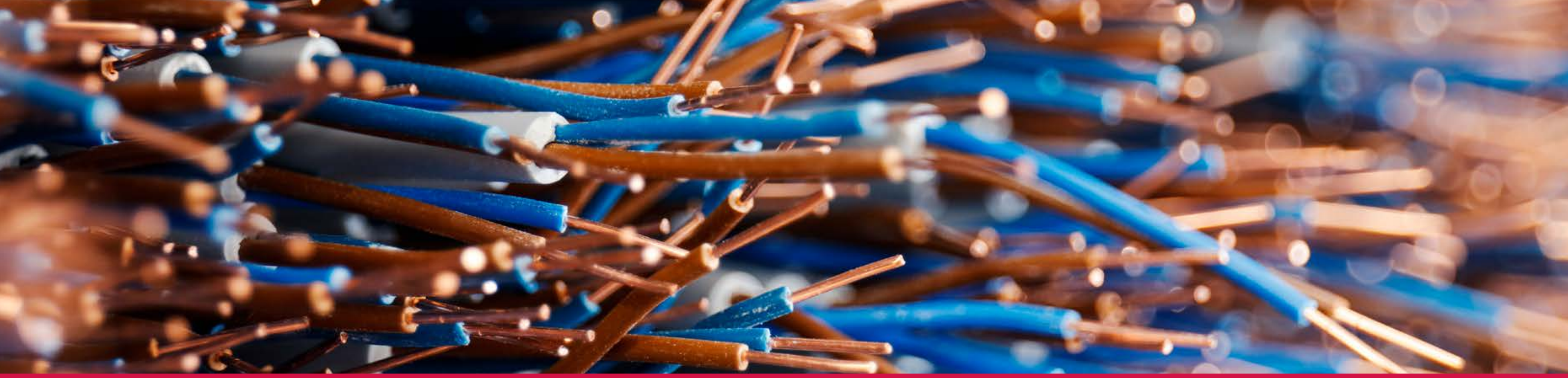
We avoid companies that need leverage

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.

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 the ability to reinvest at least a portion of their excess cash flow back into the business 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



We often find industry classifications to be a poor indicator of a company's actual business activities, as the descriptions over-simplify and group together diverse business models.

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 that 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 society. They have created value for some investors and destroyed capital for others, just as the internet has destroyed the value of many traditional media industries.

We are at one with Warren Buffett and his suggestion 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 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 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 exclude any company operating in industries that sustainable investors wouldn't want to own

We exclude companies classified as operating within, or who generate a substantial[1] proportion of revenues from, the Global Industrial Classification Standard (GICS) industries listed below as these industries generally have a significant, negative impact on the environment and/or society.

We often find industry classifications to be a poor indicator of a company's actual business activities, as the descriptions over-simplify and group together diverse business models. To combat this, this screen not only excludes any company within, but also those generating a significant proportion of profits directly from, the industries and sub-industries listed below. For example, Louis Vuitton Moet Hennessy (LVMH) is classified as a company within the Textiles, Apparel & Luxury Goods industry but generates almost 10% of its revenues from wines and spirits. As such, it is excluded from the investible universe.

These exclusions are listed in the Fund's prospectus meaning we are legally bound to them, unlike other some other funds that simply state they will "avoid" investment in certain industries.

The GICS industries excluded from Fundsmith Stewardship Fund are:

- Aerospace and Defence
- Metals and Mining
- Oil, Gas, & Consumable Fuels
- Tobacco
- Gas Utilities
- Electric Utilities

As well as the following GICS sub-industries:

- Brewers
- Distillers & Vintners
- Casinos and Gaming

The Fund also excludes any company that makes a significant proportion of its cash flow or has a substantial interest in pornography.

[1]Greater than 5% of revenue

We exclude businesses that have an excessive net negative impact and aren't doing enough to reduce it

We screen companies to assess their net impact on the environment and society, identifying and excluding companies that have a net negative impact on the world, be that society or the environment. Essentially, we are looking to exclude companies that an investor in a sustainability fund wouldn't want to allocate their capital to.

We analyse as many of the company's impacts as we can, accounting for both the positive and negative effects the company may have resulting from their operations, innovation and philanthropy/ charity projects.

This is ultimately a subjective assessment, but one we make as objectively as possible using three different sources of information to assess the net impact companies have:

1. We capture what the companies tell us in their annual reports, sustainability reports, earnings calls, result releases, or in our meetings with them, in a database where we tag each piece of information with a selection of our over 100 individual topic tags. This allows us to sort and process the large amount of qualitative information companies produce and means we can sort through the entire portfolio by individual topic tags – e.g. palm oil or employee diversity

2. We take the numbers that companies report (e.g. greenhouse gas emissions, employee diversity) and track these over time, both as an absolute number and also per £m of free cash flow. Across all companies, we track the emissions of waste, hazardous waste, and greenhouse gas emissions as well as usage of water and energy. We estimate the emission numbers for companies that don't report based upon industry averages scaled for the company's assets.

3. Finally, we use an independent assessment of reputation risk from environmental, social, and governance issues provided by RepRisk. It scans 150,000 news sources in 23 languages and using a combination of humans and machines assess how many people the negative impact affects, how reliable the source is and whether it is a repeat story. Using this creates a score that we think is a good proxy for absolute negative impact. As the score isn't industry dependent, it allows us to absolutely rank the companies within the investible universe and compare them inter industry, unlike the intra industry rankings from other ESG ratings providers, which we highlighted earlier.

> **We screen companies to assess their net impact on the environment and society, identifying and excluding companies that have a net negative impact on the world.**

We only invest when we believe the valuation is attractive

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

Our aim is to invest 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 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 Stewardship

Fund is not meant to provide an asset allocation tool. We assume that if you own the Fundsmith Stewardship 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 do not invest in highly cyclical sectors. 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 as such investments are often counter-intuitive, 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 that 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. We 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 Stewardship 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. 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 stating 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 Stewardship 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 the 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 the 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.

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.

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 that this brings for two reasons. The first is that research has shown you can achieve close to optimal diversity with 20 stocks. This may not be true in our case, as our investment criteria typically leads to concentration in certain sectors. We then fall back on our second 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 are what really interests us.

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 that 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 would using 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.

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 that are potential investments by a screening process of their financial results, identifying 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, acts in the interests of the owners, and tells it how it is rather than using PR spin to try to enhance investors' perceptions. This does not mean we seek management with a narrow focus on what has become labelled as "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 and grow a company's brands and franchise value (albeit with good returns) and to be honest about the impact of this on earnings and capital requirements. Companies that under-invest in their franchise in order to meet short term targets are not good candidates for compounding wealth. 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 that 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. We engage with management in an effort to ensure that their decisions are in the long-term interests of the company, particularly regarding capital allocation and management remuneration, which we regard as vital. 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 Stewardship 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 Stewardship Fund is an open-ended fund. Other fund managers may can also 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 Stewardship Fund.

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

The fund manager

The fund is managed by Terry Smith, Fundsmith CEO & CIO, assisted by Julian Robins, Head of Research, Tom Boles, Head of Sustainability, and a team of analysts.

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 offices in Connecticut, USA and Mauritius. 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. We manage funds 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 Stewardship Fund (UK OEIC), Fundsmith Equity Fund SICAV (Luxembourg SICAV), Fundsmith Sustainable Equity Fund SICAV (Luxembourg SICAV), Fundsmith Equity Fund L.P. (Delaware L.P.), Fundsmith Sustainable Equity Fund L.P. (Delaware L.P.), and 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.

Tom Boles

Tom joined Fundsmith in 2013 having completed an MSc in Economics and Finance at the University of Bristol with Distinction in 2012. He wrote his dissertation on the Persistence of Performance in the Mutual Fund Management Industry. He completed a BSc in Economics in 2011, also at Bristol University. Tom is a CFA® charter holder.

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.

What do we charge you?

To begin with we do not charge initial fees. We welcome direct investors with whom we can have a direct dialogue and in our view initial fees are 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 an upfront fee and the costs of over-active dealing are applied to the sort of closet index fund which some managers offer.

You will note that we did not set Fundsmith Stewardship Fund up as a hedge fund charging the traditional “two and twenty” i.e. 2% of funds under management plus 20% of gains. Why? Fundsmith Stewardship Fund will not short stocks, as a hedge fund does, 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.

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

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. 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 2020 for the T Class Shares was 1.07%. 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 2020 this amounted to a TCI of 1.11%, including all costs of dealing for flows into and out of the Fund, not just our voluntary dealing. This compares favourably with other global equity funds in the UK.

We are looking to invest in companies that aren't compromising future profits by inflating their current ones.

And finally... what about tax?

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 Stewardship 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 Stewardship 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.

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