

January 2015

Dear Fellow Investor,

This is the fifth annual letter to owners of the Fundsmith Equity Fund ('Fund').

The table shows performance figures for the last calendar year and the cumulative and annualised performance since inception on 1st November 2010 compared with various benchmarks.

% Total Return	1 st Jan to 31 st Dec 2014	Inception to 31 st Dec 2014	
		Cumulative	Annualised
Fundsmith Equity Fund ¹	+23.3	+100.0	+18.1
Equities ²	+11.5	+56.6	+11.4
UK Bonds ³	+10.0	+23.1	+5.1
Cash ⁴	+0.5	+2.9	+0.7

¹T Class Acc Shares, net of fees, priced at noon UK time.

³Bloomberg/EFAS Bond Indices UK Govt 5-10 yr.

^{3,4}Source: Bloomberg

²MSCI World Index, £ net, priced at close of business US time.

⁴3 Month £ LIBOR Interest Rate.

²Source: www.msci.com

We never tire of reminding people that we remain critical of attempts to measure investment performance over short periods of time, such as a year. However, this proviso notwithstanding, the table shows the performance of the T Class Accumulation shares which rose by 23.3% in 2014 and compares that with 11.5% for the MSCI World Index in sterling with dividends reinvested. The Fund therefore outperformed the market in 2014 by 11.8%. However, we are assisted in forming a longer term perspective on the Fund's performance by the fact that it finished 2014 with the improbably precise outcome of having doubled investors' capital since inception.

2014 was another bullish period for equity markets. In this letter last year we wrote about the so-called 'taper tantrum' in which markets fell in May 2013 when the Federal Reserve Bank first mooted that it was planning to begin reducing its programme of Quantitative Easing ('QE') - 'printing' money (or at least clicking a mouse to create it) with which to buy bonds. Although US QE has now ended, equity markets had a somewhat bullish year (at least in sterling and in the US - the FTSE 100 and Emerging Markets fared badly) and the US and UK economies are growing, it is tempting to conclude that the market wobble of May 2013 was just an example of the so-called 'wall of worry' which a bull market is said to climb.

This may be so, but this economic recovery is neither uniform nor unaided. The core countries of the Eurozone - Italy, France and even Germany - are now struggling, as is a large part of the developing world, much of which is still driven by commodity exports, at a time when China's seemingly insatiable demand for commodities to fuel its industrialisation has slackened markedly. Nor is such anaemic growth being achieved without considerable stimulus. Japan is engaged in a QE experiment of epic proportions as it tries to stimulate its way out of a slump which innumerate commentators have described as a 'lost decade' with no economic growth. It has in fact gone on for the better part of two decades. Even the growth in the US and the UK is being achieved against a backdrop of record low interest rates and continuing government deficit spending, the necessity for which is unusual and worrying this far into a recovery.

I do not think it would add much for me to weigh in on the debate about the reasoning behind QE, its effectiveness and possible consequences except to observe that many of its proponents seem to assume that inflating asset values will lead to prosperity. I suspect this is the reverse of what should occur which may not bode well.

We are often asked what our view is of the economic outlook for the world and how our Fund is positioned to take advantage of, or cope with, those conditions. Our investment approach is thankfully not based upon our view of the global economic outlook. I say thankfully because we do not profess any great expertise in this area, and we are not particularly optimistic. This is in contrast to many others in the industry who certainly profess to such expertise, often it seems without any obvious justification. We are at least one step ahead of most of them in recognising that we do not know what will happen.

The desire of people to rely on forecasting despite its obvious drawbacks is illustrated by an anecdote from the Nobel laureate and retired Stanford University economist Kenneth Arrow. Arrow did a tour of duty as a weather forecaster for the US Air Force during World War Two. Ordered to evaluate mathematical models for predicting the weather one month ahead, he found that they were worthless. Informed of that, his superiors sent back another order: 'The Commanding General is well aware that the forecasts are no good. However, he needs them for planning purposes.'

Our investment strategy is based first and foremost on buying shares in good companies. We cannot promise you much about our Fund. But one thing we are clear about is that we seek to own shares in good companies and at least most of the time we succeed in that objective.

You may think that this part of our strategy is so obvious that it must surely be the case that all fund managers seek to invest in good companies. However, this is certainly not the case. Fund managers will buy shares in bad companies, by which I mean companies which do not consistently create value for their shareholders or even worse which destroy value some or even all of the time. If they have a reason for doing this it usually boils down to some expectation that the performance of the companies will improve at least temporarily because they think that the economic or business cycle will improve and those companies will start to make adequate returns, or there will be a change of management which will improve their performance or a takeover bid, all of which may benefit the share price. Or they may just think that the shares are cheap.

One problem with this approach to investing is that companies rarely go through a transformational improvement (a phrase involving leopards and spots springs to mind) and these events are also difficult to predict. But in our view the main problem with this investment strategy, other than the fact that we have no expectation that we could make it work, is that whilst fund managers await the kiss that will turn their corporate frogs into princes, they steadily erode value. The companies in our portfolio are certainly not immune to periodic downturns in business and/or management errors, and their share prices are subject to the usual factors which affect the stock market, but we can at least be reasonably sure that they are adding to their intrinsic value over time.

To demonstrate this we thought of a new way to inform you about the portfolio of companies which we own. The table below shows what the Fundsmith Equity Fund would be like if instead of being a mutual fund it was a company ('Company') and accounted for the stakes which it owns in the portfolio and compares this with the market (in this case the FTSE 100 and the S&P 500):

	Fundsmith Equity Fund ¹	FTSE 100 Index ²	S&P 500 Index ²
Return on Capital Employed ('ROCE')	29%	18%	18%
Gross Margin	60%	39%	44%
Operating Profit Margin	25%	16%	16%
Cash Conversion	102%	79%	81%
Leverage	28%	40%	38%
Interest Cover	15x	9x	9x

¹ Source: Fundsmith Research. ² Source: Bloomberg.

ROCE, Gross Margin, Operating Profit Margin and Cash Conversion are the weighted mean of the underlying companies invested in by the Fundsmith Equity Fund and mean for the FTSE 100 and S&P 500 Indices. The FTSE 100 and S&P 500 numbers exclude financial stocks. The Leverage and Interest Cover numbers are both median. All ratios are based on last reported fiscal year accounts and as defined by Bloomberg. Cash Conversion compares Free Cashflow per Share with Net Income per Share.

What does this table demonstrate? Taking each of the measures in turn:

Return on Capital Employed: The legendary investor Warren Buffett in his 1979 annual letter as Chairman of Berkshire Hathaway described ROCE as 'The primary test of managerial economic performance'. In our Company it was 29% versus an average of 18% for the market. For every pound of capital which we own our companies produce 29p of profits versus 18p for the market.

Gross Margin: The difference between sales revenue and cost of goods sold for our Company was 60% versus about 40% for the market. Our Company makes things for £4 and sells them for £10. The market makes things which cost £6 and sells them for £10.

Operating Profit Margin: Our Company's operating profit margin is 25% versus an average of 16% for the market.

Cash Conversion: Our Company converts just over 100p out of every £1 of profit into cash whereas the market manages about 80p as its businesses require more capital expenditure and working capital to function.

Leverage: Our Company has net debt (net of cash) of about a quarter of shareholders' funds whereas the market has around 40%.

Interest Cover: Our Company's profits are 15 times its interest charge which means there is little doubt that it can service its debt even in a dramatic downturn. The market looks quite safe too but its interest cover is below 10 times.

In short, our Company has much better financial performance than the market as a whole and is more conservatively funded.

So when it comes to quality we are confident that we have selected good companies, but one of the questions which most frequently arises when we are talking to investors is that of valuation. The companies we invest in may be high quality businesses, but perhaps their shares have become too expensive. There is no doubt that the shares in our portfolio have become more highly rated over the past four years. It is also true that this is not the way we would prefer the performance of the portfolio to be delivered as increases in the multiples which company shares trade on are finite and reversible.

But there is no certainty that such improvements in valuation will reverse any time soon or indeed that they won't continue. We remain unimpressed by those who tell us about their concerns about valuation and who have been doing so for several years. No doubt they may prove to be right at some point but following their advice would have been very expensive in the interim. We do not attempt to make any so-called 'market timing' judgments. We aim to have our Fund fully invested in companies of the sort we like, thereby acknowledging that we do not possess any expertise in guessing the right moment or even the right year in which to invest or to sell. In this we seem to have an advantage over those investors who think they can accomplish this, exemplified in my mind by at least one investor who refused to invest with us at the launch of our Fund because he thought our timing was not propitious and who now ascribes our performance to our good timing. I have news for him: we took no account of such timing when we launched and neither do we now.

Having said all of that, where are we on valuation? The weighted average Free Cash Flow ('FCF') yield of the portfolio (the free cash flow generated by the companies divided by their market value) started the year at 5.1% and ended it at 4.5% so we had a tailwind from increased valuations again, but the yield is still above the level that we would find acceptable on the basis of the comparison with expected bond yields. Our companies on average grew their free cash flow per share by 7.0% during the year but also spent 7.8% more on capital expenditure ('capex'). We find the fact that they continue to increase their capex as encouraging as we have yet to find an industry which can grow without committing additional capital in order to do so.

This 4.5% FCF yield compares with a median FCF yield for the non-financial stocks in the S&P 500 of 4.2% and a mean of 3.4% or a median for the non-financial stocks in the FTSE 100 of 4.4% and a mean of 3.8%. Our stocks do not look bad value in comparison to the market especially when their relatively high quality is taken into account. Although of course, both may be expensive, but then both may continue to be so or even become more expensive.

For 2014 the top five contributors* to the Fund's performance were:

Dr Pepper Snapple	+3.3%
Microsoft	+2.3%
Domino's Pizza	+2.0%
Stryker	+2.0%
Becton Dickinson	+1.7%

Of the top five contributors it is perhaps worth noting that no less than four - Becton Dickinson, Domino's Pizza, Microsoft and Stryker - were in this position last year as well. So much for the theory that no-one ever did badly by taking a profit.

The bottom five were:

Diageo	-0.08%
Swedish Match	-0.05%
L'Oreal	+0.01%
Amadeus	+0.22%
Colgate Palmolive	+0.24%

* Contribution shows the gross contribution to the Fund's return by stock as calculated by State Street Investment Analytics. The list excludes stocks held for less than one month so as to be more meaningful.

Only two of the bottom five produced negative contributions, Diageo and Swedish Match. We sold the latter, which had also been our worst contributor in 2013, during 2014. We took the view that the e-cigarette development, whilst not necessarily harmful to the cigarette companies, was a potentially disruptive change which could adversely impact its Snus smokeless product. We are sensitive to the possibility of permanent loss of value which disruptive change can cause and on the whole we seek to avoid

investing in companies which could be affected by it. We also feared another disruptive change which could affect Swedish Match - a thawing of relations between the US and Cuba as Swedish Match distributes non Havana cigars in America. We did not think that its business would fare well in the event that the US embargo on trade with Cuba was lifted which we thought was likely. It appeared to us that most people would struggle to explain the rationale for this Cold War measure whose lack of coherence has been lampooned and its relevance to Swedish Match was encapsulated in the saying we are fond of: that it is the first attempt in history to bring about regime change by smoking inferior cigars. Since we sold our holding in Swedish Match the events we foresaw have indeed begun to unfold. Our only other disposals during 2014 were our holdings in CDK, a supplier of software to motor dealers, which was spun out of ADP during the year and a small holding in Indivior, the pharmaceutical company, which we received when it was demerged by Reckitt Benckiser.

We started three new holdings during the year, two of which are within the technology sector. You may think this fits awkwardly with our professed desire to avoid businesses which might be subject to disruptive change for which the technology sector is renowned. However, in neither case are our new investee companies operating in areas at the leading edge of technology.

eBay is probably well known to you through one or both of its two major businesses - the Marketplaces business through which you can buy and sell new or second hand articles, and PayPal the leader in online payments. Whilst so-called activist investing has its place in ensuring that company managements pay due attention to shareholders' interests, we are not fans of the commonest form of this activity, the modus operandi of which could be described as:

- Activist acquires stake in company.
- Activist campaigns noisily and publicly for change, which can consist of the company trying to sell itself to an acquirer, splitting the company into a number of listed entities for each of its activities, taking on more debt, share buybacks, or some combination of these.
- Shares go up as a result of excitement amongst the 'analytical' community about this activity.
- Activist sells stake at a profit.
- Long term shareholders are left trying to make sense of fragmented businesses, new management teams, higher leverage, costs of separation or integration and financial statements which are rendered incomprehensible by many adjustments.

However, in the case of eBay an activist acquired a stake and pushed the company to agree to separate its Marketplaces and PayPal business and we tend to agree that they may be better separated so that PayPal can develop its payment service with other online businesses. I should add that we started buying our stake before this was announced and it was not part of the rationale for our investment.

In the case of Sage we started buying a stake in the UK's largest software business. Sage has an installed base of software used by millions of small and medium sized businesses which makes it the dominant supplier of accounting software outside America. Like many software businesses it is transitioning from selling software in the form of a disc in a box, which is paid for upfront, to an online subscription model which we think will ultimately make it an even better business.

Close to the end of the year we also began acquiring a stake in an international testing and inspection company the name of which we are yet to reveal as we are in the process of buying our position.

That is the sum total of our outright sales and purchases for 2014, at least part of which was involuntary in that we received the CDK holding as a result of our stake in ADP and the Indivior holding from Reckitt Benckiser. Which is just as well since minimising portfolio turnover remains one of our objectives and this was again achieved with a negative turnover of -8.4% during the period. Negative turnover occurs because the method of calculating turnover excludes flows into or out of the Fund, otherwise a newly established fund would automatically have 100% or more turnover. However, it is not very helpful in judging our

activities. It is perhaps therefore more helpful to know that we spent a total of £98,081 or just 0.005% (0.5bp) of the Fund on voluntary dealing.

Why is this important? It helps to minimise costs, and minimising the costs of investment is a vital contribution to achieving a satisfactory outcome as an investor. 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 2014 for the T Class Shares was 1.09%. 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.

I find that investors remain confused by this no matter how many times I attempt to explain it, or maybe because of my attempts to explain 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 2014 this amounted to a TCI of 1.18%, including all costs of dealing for Fund inflows and outflows, not just our voluntary dealing.

In order to minimise the cost of dealing and avoid the mistakes which seem to result when we sell stakes in good businesses our mantra is: 'Don't just do something, sit there.'

As I foreshadowed in this letter last year we launched the Fundsmith Emerging Equities Trust (or 'FEET' which is its stock market ticker symbol) in June 2014. This is an investment trust investing in the same strategy as our existing Fund but investing in companies which have the majority of their revenues from the developing world and which are mostly listed in Emerging Markets. They do not have enough liquidity in their shares in local markets for us to consider holding them through an open ended fund with daily dealing like the Fundsmith Equity Fund. For those of you who are invested in FEET there will be a separate update on its progress with its annual results in March.

Finally, I wish you a Happy New Year and thank you for your continued support for our Fund.

Yours sincerely,



Terry Smith
CEO
Fundsmith LLP

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 units 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.