Fundsmith
Sustainable Equity Fund

Annual Sustainability Summary - 2021

Fundsmith
Buy good companies
Don't overpay
Do nothing

Fundsmith Sustainable Equity Fund Annual Sustainability Summary

The intention of this Sustainability Summary is to act as a supplement to our Responsible Investment Policy and annual Stewardship Report, providing our investors an insight into the positive and negative impacts of our companies on the environment and society, and comparing this to the impact of the average company in MSCI World and S&P 500 indexes.

We operate concentrated portfolios of "good companies", with an ideal holding period of forever. Given the length of our investment horizon, we expect our companies to avoid inflating current profits at the expense of the environment or society as this can damage future returns.

We will continue to add data to this factsheet as the collection and reporting methods become more standardised and we feel it provides a more meaningful and insightful assessment of our portfolio companies' impacts.

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Environmental

The quality of environmental reporting has increased significantly in recent years. Companies have been under increasing pressure to quantify their environmental impact and, consequently, the infrastructure/systems needed to collect and report this data has improved rapidly. Despite this, not all companies report environmental data and fewer still report using the same collection, processing, and reporting methodologies. The lack of standardisation both within and between industries, as well as the lag in reporting (typically 2 years) often renders comparing companies' environmental performance as both unreliable and inaccurate. Additionally, it means environmental data is retrospective and doesn't necessarily have any bearing on how the company will behave in the future.

We estimate the numbers for those companies that do not report data by taking the average of the metric in question and balancing it per £m of assets for their respective subsector. We then scale this to the assets of the company we are trying to estimate.

To produce statistics that are meaningful to investors and that are relevant to all the companies we invest in, we have chosen to track five metrics that are most commonly reported and related to globally pertinent issues. The issues are climate change (greenhouse gas emissions and energy use), resource scarcity (water and energy use) and pollution (non-hazardous and hazardous waste).

As the table below shows, just over 75% of our companies report these simple environmental numbers, significantly better than the MSCI World or S&P 500 where only around 50% of companies report metrics.

Fund (31/12/21)	Weighted average absolute emissions					per £m of FCF				
	Total waste	Hazard waste	Water use	Energy use	GHG emiss	Total waste	Hazard waste	Water use	Energy use	GHG emiss
	k metric tonnes	k metric tonnes	m m^3	k of MWh	k metric tonnes	metric tonnes	metric tonnes	m^3	MWh	metric tonnes
FSEF OEIC	264	5.0	18	3,633	1,184	24	0.4	1,574	324	106
S&P 500	6,687	11.2	477	17,546	5,495	590	1.0	42,106	1,547	485
MSCI World Index	11,595	220	394	15,527	4,644	1,268	24	43,063	1,698	508
FSEF port % reported	76%	44%	76%	92%	100%	76%	44%	76%	92%	100%
S&P 500 % reported	50%	35%	58%	77%	85%	50%	35%	58%	77%	85%
MSCI World % reported	56%	34%	58%	74%	82%	56%	34%	58%	74%	82%

Table 1: Environmental look through table showing the weighted average emissions of the different FSEF fund vehicles both on an absolute basis and by our measure of intensity (per £m of free cash flow) relative to both the MSCI World and S&P 500. Source – Latest company reported numbers with numbers for those not reporting estimated.

Climate change

Climate change has the potential to be one of the most significant risks to our portfolio companies given the potential consequences of failing to mitigate the drivers behind it and/or adapt to the consequences of it. An essential part of managing this risk is reducing global greenhouse gas emissions. The 2015 Paris Agreement set a target of keeping warming below 2°C and, if possible, below 1.5°C by the year 2100 to avoid the worst predicted impacts of climate change.

The Science Based Targets initiative (SBTi) was established to provide corporations with a platform to develop and assure emission reduction targets in support of the 2°C target and the more ambitious 'Business Ambition for 1.5°C' framework. The table below shows the percentage of the portfolio that has committed to the SBTi as well as those that have already aligned to either a 2°C or 1.5°C reduction target.

% of Portfolio	FSEF OEIC
SBTi Commitment	68%
Paris Agreement Aligned (max 2°C)	63%
Business Ambition for 1.5°C	59%
Net Zero Commitment	74%

Table 2: Percentage of portfolio with different emissions reduction commitments. Source – SBTi & company reports.

For comparison, 19% of listed companies in the G7 indices have climate targets aligned with the Paris Agreement[1].

[1] https://sciencebasedtargets.org/news/g7-stock-indexes-science-based-targets.

Social/Society

Social data is far more challenging to collect and report compared to environmental data. This is largely due to environmental data being significantly easier to quantify (e.g. CO_2 emissions) and, if the methods used are the same, compare between companies. The impacts a company has on society are more nuanced and, as such, difficult to compare with other businesses. For example, how can one accurately measure the positive social impact of diabetes medication? How would one then net that with the negative impacts that inevitably come with the supply chain that creates them? To accurately reflect the positive and negative impacts a company has, one needs to look beyond the numbers they report and make an objective assessment of what the company does and the resultant effects on society.

To demonstrate the paucity of social and governance data, Bloomberg, who collect data from a variety of third parties such as CDP, Sustainalytics, and MSCI, as well as any data companies report themselves, show that the average environmental stat is reported by 20% of our investable universe, compared to just 8% for social metrics. What's more troubling is that for all the businesses in our investable universe, which as our previous environmental stats show are better than most at reporting, the most widely reported social metric is only reported by 28% of companies.

The difficultly in quantifying an impact that fundamentally cannot be quantified results in most investors and companies reporting diversity statistics when looking at the 'S' in ESG. At Fundsmith, we think this data is important as, for a business to adapt and successfully sell their products their employees should be representative of their customer base. Further, it is important to create an inclusive and supportive working environment as, not only is it the right thing to do, it typically results in lower employee turnover and helps a company attract the best talent to support its long-term success.

However, while we think it is important to report what we can, we don't think that these limited numbers reflect the social impact our companies actually have. These impacts can't be quantified, making contrasting the various positive and negative impacts a company may have to reach an overall conclusion very difficult. For example, all companies will know the percentage of their board or upper management who are women and will be quick to report it. Nevertheless, obtaining a number that accurately reflects how happy employees are working for the company is far more challenging.

The table below is what we can report for our portfolio and comparable indices. We will continue to add to the statistics below when we have enough companies reporting informative metrics in a comparable way.

Social	FSEF OEIC	MSCI World
% of employees who are women	62%	39%
% of management who are women	30%	29%
% of executives who are women	26%	17%
% of the board who are women	35%	29%

Table 3: Averages with no estimates. Source – company reports.

Governance

Governance refers to the processes and systems a company has in place to protect the interests of minority shareholders, such as ourselves. This can be in the form of independent checks and balances on management's actions by the board of directors, but also anything that influences the decision-making and incentive structure within an organisation. This can be a company's policy toward forced labour, which is somewhat easy to measure, or a company's culture and whether that incentivises employees to do the right thing, which is much harder to assess.

Knowing whether a company has a policy toward something is all well and good, but it doesn't tell us much about how the company actually behaves in the real world nor how it responds when it becomes aware of negative impacts it may be having. Policies provide an expectation of how a company would like to behave but is not necessarily a reflection of its actual actions. Further, while one can measure the percentage of independent directors on a board, which is reported by most companies, it is much harder to know whether they are truly independent. There is also a question over whether someone who is paid more than $100k a year for four meetings can ever really be independent.

Much like the challenges with social data, meaningful data on governance can also be hard to find; what comparable metric is going to reflect a company's culture? Even when one can find it, the numbers can still be manipulated by a company to be misleading should they wish.

That being said, there are some limited numbers we can report but we don't find these to be an effective proxy for the quality of governance in our portfolio. As mentioned above, just because a company has more independent non-executive directors on its board or on various committees, this doesn't say a huge amount about the quality of its corporate governance. It also says nothing about how the company's incentive structure is designed to promote sustainable growth, nor whether the company's culture attracts employees who want to promote the company's purpose.

Like social impacts, a lot of the quality of a company's corporate governance can only be measured qualitatively, making it impossible to aggregate across a portfolio. We would like to report more data but not enough companies produce meaningful and comparable statistics on anything other than the make-up of their boards.

Governance	FSEF OEIC	MSCI World
% non-executive directors on board	85%	80%
% non-executive directors on nomination committee	98%	95%
% of board independent	80%	70%
% of executives holding shares in the company	67%	50%

Table 4: Averages with no estimates. Source – company reports.

Until the companies we invest in produce better data on their impacts on society and the quality of their governance structure, we will continue to use data from RepRisk as proxy. The reasoning for this is explained in the RepRisk section of this document.

Remuneration

One of the areas of governance that we have a particularly strong view on is the remuneration of our companies' executive management teams. We don't care how much a management team is paid, but we do care how it is calculated.

Usually, executive management have three components to their compensation: 1) a fixed base salary, 2) a short-term bonus (STI), and 3) a pay out from a long-term incentive plan (LTIP). The LTIP is typically paid out in shares or options with the amount that is paid based on the company achieving a set of targets based on a selection of performance-related metrics.

We have come across many different types of metrics in company's LTIPs, with the worse versions including metrics that management have no control over (e.g. total shareholder return) or those that they have too much control over (e.g. adjusted EPS growth).

We will typically vote against remuneration policies without measures of both growth and returns, as we believe these are the most effective way of incentivising profitable growth. It is not very difficult to grow revenues if one is willing to make a loss. We also frequently engage with management teams and remuneration committees, putting forward our arguments to better align management's incentives with those of long term shareholders, where necessary.

In 2021, across both FEF and FSEF, of the 30 companies whose shares we owned at their AGM and were given the opportunity to vote on their executive compensation plan, we voted against 19 as we failed to see how it benefitted long term performance.

Year	No. of compensation votes	Voted against	No. of votes changed after engagement
2019	26	16	3
2020	26	16	4
2021	30	19	3

Table 5: Source – Fundsmith.

RepRisk

Due to the challenges in reporting effective and meaningful social and governance data, we use a proxy derived from data provided by RepRisk alongside our own qualitative research on the company. RepRisk provides their 'RepRisk Index' (RRI), which is a measure of the reputational risk resulting from their environmental, social, and governance performance. It measures this by scanning over 100,000 news sources in 23 languages on a daily basis. They then use a combination of machine automation and human analysis to assess the scale of the negative impact, the reliability of the source, and whether it is a repeated story to create the RRI; a higher score indicates greater reputational risk. Whilst we are concerned about the reputational risks our businesses face, we mainly use the indicator as we think it acts as a strong proxy for the underlying impact companies have.

The RepRisk Indicator gives us an independent assessment which, when combined with what we know about the companies and the other information they give us, means we have what we think is an objective framework to assess our companies' impact on the world.

It is by no means a perfect proxy as it only looks at negative impacts. The majority of companies we invest in are consumer facing and these businesses typically have higher scores due to the public nature of their operations. However, it remains the best proxy we have found for these hard-to-measure impacts and risks.

Below is a table showing the weighted average RRI for the portfolio broken down by environmental, social and governance risk components. It also shows how the RRI has changed over the past year, and what the weighted average of the peak RRI for each of our companies is. We also give tables showing the highest and lowest RRI companies in the portfolio, which we think is a relatively good proxy for the ranking of negative impacts. We discuss the contributors to the changes in RRI over the year in more detail in the FSEF annual letter.

	FSEF OEIC	MSCI World
Environmental	4.1	5.1
Social	12.2	12.5
Governance	14.4	11.6
TOTAL	**30.7**	**29.2**
Peak RRI	40	41

Table 6: Total RepRisk Indicator (RRI) for different fund vehicles split by proportion of score from Environmental, Social and Governance factors. Peak RRI is highest RRI in the last 2 years. Source – RepRisk/Fundsmith.

As at the end of last year the companies with highest/lowest RRI in the portfolio:

Highest ranked portfolio firms
1. Johnson & Johnson (67)
2. Alphabet (58)
3. P&G (57)
4. Starbucks (54)
Lowest ranked portfolio firms
1. IDEXX (0)
2. Waters (0)
3. ADP (15)
4. Church & Dwight (15)

Table 7: Source RepRisk.

Innovation

As well as assessing a company's negative impacts on the environment and/or society, we also look at the positive impacts they have through innovation. Improving existing products and innovating to create alternatives is an important aspect of many of our companies' business models. Innovation allows businesses to maintain or gain an advantage over the competition and to meet unexplored or emerging areas of demand, generating growth.

Product innovation is also the area where the most tangible examples of a company's adaptation to minimise their impacts are present. For many of our companies, reducing the impact of their products' lifecycles is not just beneficial to sales, but also their sustainability targets. Reducing the energy and raw materials required to make a product, using sustainable alternatives, and increasing the efficiency of the production chain can all result in significant reductions to the business's environmental and social impact. As well as minimising impact, innovation also allows our companies to create a positive impact, for example through creating new products that are beneficial to the environment and/or society by giving a solution to some unsolved problem, or by simply giving consumers a wider range of choice.

Accounting for the advances made through innovation is vital, as increasing sustainability and generating positive impacts directly influences the long-term sustainable outperformance of a company. Moreover, identifying companies failing to reduce negative impacts is an important aspect of our risk analysis. This final section gives some brief examples of some of our companies' innovations over the past 12 months to give you an idea of what the companies in the portfolio have been working on.

Johnson & Johnson

Figure 1: Johnson & Johnson's COVID-19 vaccine[2].

One of the most notable innovations from our companies over the last year was Johnson and Johnson's development of a COVID-19 vaccine. Johnson and Johnson's pharmaceutical arm, Janssen, used their vaccine technology platform 'AdVac' to develop a single shot vaccine. The vaccine recorded 66.3% efficacy in preventing instances of mild to moderate cases and 76.7% efficacy against severe to critical cases after 14 days. The big advantage of the Janssen vaccine over others, other than it only needs a single injection, is that it can be stored and transported using existing cold-chain distribution infrastructure. This is because it only needs to be stored at fridge temperatures unlike some of the alternatives, which require storage at -70 degrees. This was particularly important for vaccination programs in emerging markets.

[2] https://www.jnj.com/latest-news/latest-facts-news-about-johnson-johnson-covid-19-vaccine-candidate.

Novo Nordisk

Semaglutide, which Novo Nordisk developed in 2012 as a longer-acting treatment for type 2 diabetics to manage glucose levels, saw continued innovation over the last year. Semaglutide works by mimicking a hormone called glucagon-like peptide-1 (GLP-1) targeting the areas of the brain that regulate appetite and food intake, resulting in reduced hunger and increased feeling of fullness. The US Food and Drug Administration (FDA) first approved the drug in 2017 as a treatment for diabetes under the brands Ozempic (injection) and Rybelsus (pill), but it has been found to have other uses outside this, especially as a treatment for obesity.

In June 2021, the FDA approved semaglutide, under the brand name 'Wegovy' for chronic weight management in adults with obesity or who are overweight with at least one weight related condition. In trials of non-diabetic patients, Wegovy saw an average weight loss in all participants of 12.4% compared to the placebo group and an average weight loss of 17-18% among obese patients. Novo is currently running trials to see if larger doses of semaglutide result in larger weight loss and whether it could be delivered as a pill rather than injection. Combating obesity would have a significant impact on public health and health budgets. Approximately 70% of American adults are overweight, which is associated with the increased risk of serious health issues such as heart disease, stroke, diabetes, and certain types of cancer.

It is also thought, although research is still in its early stages, that semaglutide could be used as a treatment for fatty liver disease (NASH) and Alzheimer's.

Unilever

Figure 2: Unilever's paper-based detergent bottle[3].

Unilever set a variety of commitments this year as part of their ambition to be a global leader in sustainable business. One of the targets they announced was a 50% reduction in their use of virgin plastic by 2025. This year, as part of the company's progress towards this goal, Unilever, in partnership with the Pulpex consortium, revealed the first ever paper-based laundry detergent bottle[4]. The Pulpex consortium was set up last year by Unilever, PepsiCo and Diageo to produce plastic-free, single-mould bottles that can be produced in large volumes, which makes them viable for large FMCG companies.

The bottle is made from sustainably sourced paper pulp and is coated inside with a proprietary water-repellent spray, ensuring it can hold liquids and is not damaged by the active ingredients in detergent. All of this has been achieved without using any plastic, meaning the bottle can be recycled in the normal paper waste stream. Its carbon footprint is also 90% lower than glass bottles and 30% lower than a PET alternative. The bottle will be launched for OMO (Persil in the UK) in Brazil in 2022, and worldwide shortly after. Unilever are also testing the bottles for use in their hair care brands, which if successful, would further reduce their use of virgin plastics and increase the amount of Unilever packaging that can be recycled. The Pulpex consortium plans to eventually share the technology with other FMCG companies.

[3] https://www.unilever.com/news/press-releases/2021/unilever-reveals-world-first-paper-based-laundry-detergent-bottle.html.
[4] https://packagingeurope.com/unilever-reveals-world%E2%80%99s-first-paper-based-laundry-detergent-bottle/.

By 2030, Unilever is also aiming to replace all the fossil-fuel derived ingredients with renewable or recycled versions for all cleaning and laundry formulas. Working with carbon recycling company LanzaTech and chemical company India Glycols over the last few years, Unilever has produced a surfactant (the ingredient for creating foam and cleaning action in many household cleaning and laundry products) with carbon captured from industrial emissions[5]. Surfactants are usually derived from fossil fuels, but Unilever uses captured gases, turning them firstly into ethanol and then ethylene oxide, which is used to make the surfactant. The process emits 82% less greenhouse gases compared to the traditional fossil fuel-based method. A detergent made this way is already on sale in China and Unilever are planning to expand the use of the technology to other brands, helping them move away from fossil fuels over the next few years.

Microsoft

Figure 3: Microsoft's underwater datacentre[6].

During 2020, Microsoft completed Phase 2 of 'Project Natick', which is investigating the potential benefits of using undersea datacentres. They deployed their submarine datacentre off the coast of Orkney in June 2018, retrieving it two years later. The project ties into Microsoft's ongoing research to develop datacentre solutions that require fewer resources and lower costs. Data centres typically use a lot of energy to cool their servers. One of the advantages a company with Microsoft's scale has is that it can use this scale to attempt "moonshot" innovations that potentially benefit humanity.

The Natick datacentre ran on the Orkney Isle's renewable energy for the entire period and reported a component failure rate 1/8th of that seen in the land-based control group. Microsoft believes that these datacentres, coupled with offshore renewable energy creation, offers a highly sustainable and almost zero-waste alternative to the traditional land-based approach. As well as this, given that about 50% of the global population live within 200km of the coast, consumers could benefit from significantly lower latency in their internet connection.

[5] https://www.unilever.com/news/news-and-features/Feature-article/2021/the-worlds-first-laundry-capsule-made-using-recycled-carbon-emissions.html.
[6] https://news.microsoft.com/innovation-stories/project-natick-underwater-datacenter/.

Fundsmith

Fundsmith LLP
33 Cavendish Square
London
W1G 0PW
UK
T +44 20 3551 6337

Fundsmith Partners U.S. LLC
46 Southfield Avenue
Suite 205
Stamford
CT 06902
USA
T +1 203 594 1863

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