European Assets Trust

Small-cap growth potential with high distributions

Investment companies

European Assets Trust (EAT) is a concentrated portfolio of 43 (at 30 September) small- and mid-cap European companies chosen for their growth or re-rating potential. It has a high distribution policy, paying out 6% of its 31 December NAV as a dividend in three instalments. While 2014 has seen lacklustre returns from Europe, EAT has a strong longer-term record of share price and NAV performance versus its benchmark, and its focus on quality has offered a measure of protection in recent market volatility. Having traded at a premium for much of the past year, the recent move to a slight discount may present a near-term buying opportunity.

12 months ending	Total share price return* (%)	Total NAV return* (%)	TR Euromoney Smaller Europe ex-UK* (%)	Total return FTSE World Euro ex-UK* (%)	Total return FTSE All-Share* (%)
30/09/11	7.1	3.0	(13.9)	(13.6)	(4.4)
30/09/12	25.2	15.8	5.8	12.6	17.2
30/09/13	50.6	42.2	37.4	28.3	18.9
30/09/14	6.8	6.8	6.7	6.2	6.1

Source: Thomson Datastream. Note: *Twelve-month rolling discrete performance.

Investment strategy: 'Best ideas' with quality bias

In running EAT, Manager Sam Cosh aims to construct a 'best ideas' portfolio of 40-50 quality European small- and mid-cap companies, drawn from a universe of 2,000. F&C's European analyst team scans the under-researched universe and ideas for research are debated at regular meetings. Fundamental analysis is conducted and companies are ranked and assigned an intrinsic value. Cosh selects those he feels offer high and sustainable returns on capital, a healthy balance sheet and strong cash flows. While there is an overall bias to quality/growth stocks, up to 35% may be invested in value and recovery situations.

Market outlook: Mixed messages

So far 2014 has proved a tricky year for European stocks, with the large-cap FTSE Europe ex-UK index falling 4.3% and the Euromoney Smaller Europe ex-UK index falling 5.4% from 1 January to 24 October. Market sentiment remains fragile even in areas where economic recovery is more evident, although confidence indicators in Europe suggest a degree of optimism among businesses. After a strong run up, valuations across many markets no longer look cheap, though there are pockets of better value, such as in German small-caps. Bond buying from the ECB may provide support, but with so many areas of potential geopolitical and economic worry, investors may prefer to take a measured and selective approach.

Valuation: Discount spikes after market wobble

Probably as a result of its high distribution policy (although medium-term performance has also been strong), EAT has spent much of the past year trading at around par or at a small premium to NAV, which has led to the issuance of 3.7m shares since 25 October 2013. However, a spell of market volatility in mid-October saw the discount spike to a 12-month high of 5.5% on 23 October, before falling back to 3.2% at 29 October. While this is still narrower than the three- and five-year average discounts (5.1% and 7.4%), it could be seen as a short-term buying opportunity.

30 October 2014

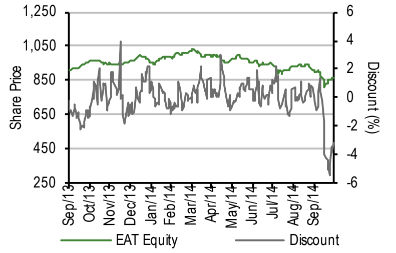
Price	**870.0p**
Market cap	**£183m**
AUM	**£204m**

NAV*	898.9p
Discount to NAV	3.2%
Yield	6.6%

* Including income. Data to 29 October 2014.

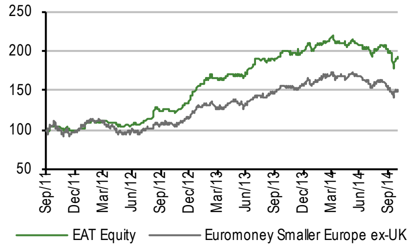
Ordinary shares in issue	21.1m
Code	EAT
Exchanges	LSE and Euronext Amsterdam
AIC sector	European Smaller Companies

Share price/discount performance*



*Including income. Positive values indicate a premium; negative values indicate a discount.

Three-year cumulative perf. graph



52-week high/low	1,037.5p	809.0p
NAV high/low	1,030.8p	842.4p

Gearing

Gross	5.25%
Net	5.25%

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Edison profile page

European Assets Trust is a research client of Edison Investment Research Limited

Exhibit 1: Company at a glance

Investment objective and fund background

European Assets Trust is an investment company incorporated in the Netherlands and listed on the LSE and Euronext. It targets capital growth through investment in quoted small and medium-sized companies in Europe (ex-UK), taking the Euromoney Smaller Europe (ex-UK) Index as benchmark. It has adopted a high distribution policy; dividends have been paid from a combination of income and capital.

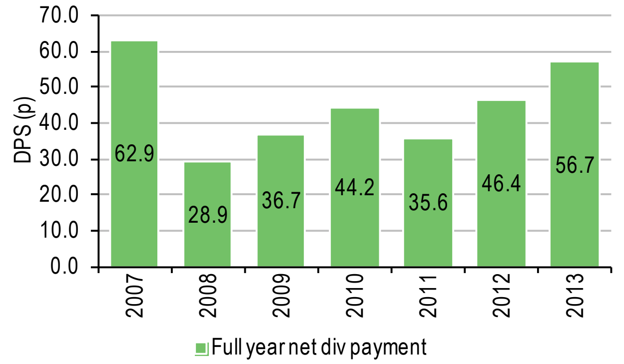
Recent developments

22 October 2014: Interim management statement for the three months ended 30 September. NAV TR (£) of -2.2% for the period, versus -7.5% for the index.
1 August 2014: Half-year results to 30 June. NAV TR (£) of +2.5% versus +6.6% for the index.

Forthcoming		Capital structure		Fund details	
AGM	April 2015	Ongoing charges	1.4%	Group	F&C Management
Half-year results	March 2015	Net gearing	5%	Manager	Sam Cosh
Year end	31 December	Annual mgmt fee	0.8% of gross assets	Address	Exchange House, Primrose Street, London, WC2A 1AL, UK
Dividend paid	January, May, August	Performance fee	None		
Launch date	1972	Trust life	Indefinite	Phone	+44 (0) 800 136420
Continuation vote	None	Loan facilities	€25m with KASBANK	Website	www.europeanassets.eu

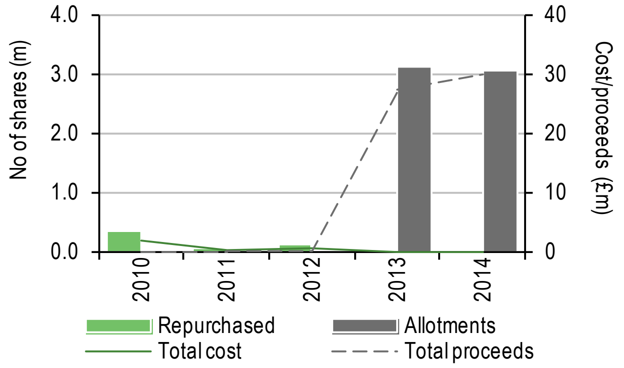
Dividend policy and history

Three dividends are paid annually (January, May and August) totalling 6% of the opening NAV at the start of the financial year.

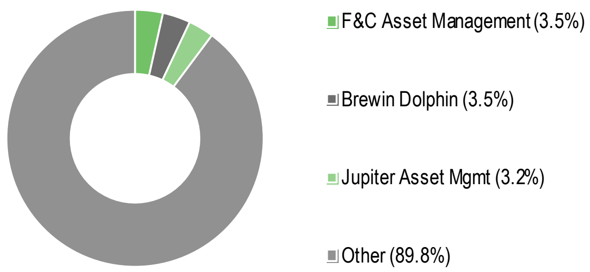


Share buyback policy and history

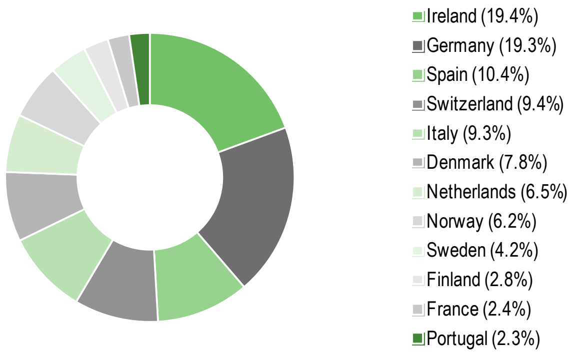
EAT is authorised to both repurchase and allot its ordinary shares. The chart of buybacks and issuance excludes shares issued as scrip dividends.



Shareholder base (Bloomberg, as at 31 July 2014)



Geographical distribution of portfolio (as at 30 September 2014)



Top 10 holdings as at end September

			Portfolio weight %	
Company	**Country**	**Sector**	**30 September 2014**	**31 March 2014***
Glanbia	Ireland	Food producers	3.6	3.3
Azimut Holdings	Italy	Financial services	3.5	4.2
Jazztel	Spain	Telecoms	3.4	2.8
Ringkjoebing Landbobank	Denmark	Banks	3.3	3.2
Origin Enterprises	Ireland	Food producers	3.2	3.1
Forbo	Switzerland	Construction & materials	3.1	2.8
Amer Sports	Finland	Leisure goods	3.0	2.8
Grafton Group	Ireland	Construction & materials	3.0	N/A
Mediaset España Comunicacion	Spain	Media	2.9	N/A
Aareal Bank	Germany	Banks	2.9	N/A
Top 10 (% of portfolio)			**31.9**	

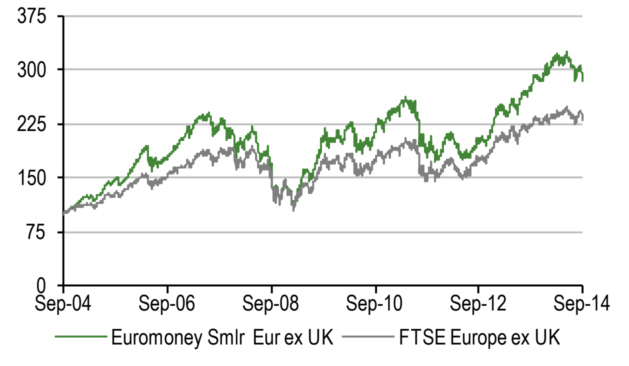
Source: European Assets Trust, Edison Investment Research, Morningstar, Bloomberg. Note: *Top 10 – N/A where not in top 10 at end March 2014. At 31 March the top 10 accounted for 30.3% of the portfolio.

Market outlook: Reasons to be cheerful?

Having outperformed their larger counterparts significantly during 2013 (Exhibit 2), European small-caps have struggled in 2014, particularly since the summer, with the Euromoney Smaller Europe ex-UK Index falling 9.6% from 1 June to 24 October, compared with a decline of 5.6% for the FTSE Europe ex-UK Index. General risk aversion over the withdrawal of US quantitative easing, geopolitical tension in Eastern Europe and the Middle East, and fears about the Ebola virus have caused global markets to wobble in recent weeks, while Europe has also had more specific fears to contend with, centred on the lacklustre economic recovery and the continued threat of deflation.

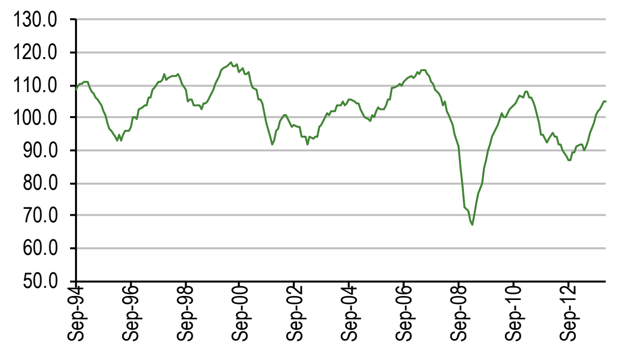
In spite of these reasons to be gloomy, however, sentiment is still broadly positive (Exhibit 3). Valuations for European stocks as a whole are above their 10-year average on a trailing P/E basis, but to a lesser extent than the UK and a similar degree to the US. Meanwhile, particularly in Germany, the largest EU market, smaller company valuations are well below average, although there is less obvious value in Spain (Exhibit 4). The commencement of targeted bond-buying by the European Central Bank may provide a boost to confidence, although with risk and reward factors so finely balanced, a selective and long-term approach to investing in Europe may be advisable.

Exhibit 2: European small-caps relative to large-caps



Source: Thomson Datastream

Exhibit 3: EU economic sentiment indicator



Source: European Commission services

Exhibit 4: Valuation comparison

Price to earnings ratio (x)	Last	High	Low	10-year average	Last % of average
Europe	15.2	16.8	6.9	13.4	114%
Germany small cos	11.6	24.0	7.3	14.5	80%
France small cos	12.1	25.5	7.4	14.8	82%
Spain small cos	22.6	44.9	4.3	19.3	117%
UK	15.0	16.1	6.4	12.8	117%
US	19.5	22.8	9.6	17.3	113%
World	16.4	20.0	8.6	15.4	106%

Source: Thomson Datastream. Note: As at 24 October 2014. Uses Datastream indices.

Fund profile: Established specialist with 6% distribution

EAT was launched in 1972. Incorporated in the Netherlands, it is listed in London and Amsterdam, and reports its financial statements in euros. EAT has been run since launch by F&C Investments and its predecessor firms. F&C is now part of the BMO group, having been bought by the Canadian bank in May 2014. Sam Cosh joined F&C in 2010 and has been lead manager of EAT since October 2011. He has more than 14 years' experience in European small- and mid-caps.

EAT adopted a high distribution policy in 2001, initially in order to distribute its substantial reserves following a change in the rules on Dutch withholding tax. As a Dutch company it was able to pay out capital as 'income' at a time when UK investment trusts could not, although the playing field was levelled in 2012. The annual distribution is currently set at 6% of the 31 December NAV. Partly funding dividends out of capital will cause capital erosion in periods of flat to negative returns, but over longer timescales capital has not been eroded; from 1 January 2001 to 24 October 2014 (the period since the adoption of the high distribution policy, encompassing several prolonged bear market spells), EAT produced a positive net asset value capital return of 41.3% and an NAV total return of 171.5%.

The fund manager: Sam Cosh

The manager's view: Still cautiously optimistic

Having been more heavily invested than usual in value and cyclical areas for the past two to three years (see Investment process section below), manager Sam Cosh says it was clear to him at the start of 2014 that the valuation gap between the cheapest and most expensive stocks had closed substantially. "When that gap narrows, it tells you that people have moved away from quality, and that makes me nervous," says Cosh. EAT has always had a bias to higher-quality rather than 'deep value' stocks, and Cosh slightly repositioned the portfolio in the early part of the year to focus more at the quality end. This meant the portfolio underperformed the benchmark in the first half of 2014, while value stocks continued to rally, but as the market moved to a period of reassessment over the summer, outperformance resumed.

Sentiment towards Europe has cooled as investors focus on lacklustre economic performance and the continued threat of deflation, but Cosh says his outlook for the region is still broadly positive. Targeted ECB support should mean European banks have more money to lend to small businesses, and Cosh believes the appetite is there for companies to borrow. Although much of the recent economic news from Europe has been poor, recent PMI figures – a key measure of business confidence – are still in positive territory, particularly in Germany. Having tilted the portfolio away from the value end, Cosh is happy with the balance for the time being, and says the 'do nothing' option, although psychologically difficult, is often the right path to take in volatile markets.

A recent pick-up in M&A activity (see Current positioning section below) is evidence of the strength of company balance sheets, with extra cash (also deployed in special dividends and share buy-backs) now being used to make takeover bids at attractive valuations. The long-awaited recovery in corporate earnings is still not evident across the market, but Cosh says EAT's quality focus means the portfolio has seen earnings growth coming through. However, his optimism is tempered with caution, and he has reduced gearing to a neutral level (factoring in pending M&A proceeds), though he says he may look to re-gear slightly in some stocks where prices have fallen unjustifiably.

Asset allocation

Investment process: Research-based hunt for quality and value

EAT is a concentrated portfolio of 40-50 stocks, drawn from a small- and mid-cap universe of around 2,000 quoted companies across Europe. The universe is not well covered by sell-side analysts, and F&C's European equities team deploys its considerable in-house resources in identifying promising candidates for EAT and the firm's other European portfolios. Analysts produce a research note on each company, with an intrinsic value, a qualitative score and a ranking. Using these notes as well as meetings with company management, manager Sam Cosh looks to identify quality stocks with high and sustainable returns on capital, strong balance sheets and healthy cash flows.

Stocks selected for the EAT portfolio are assigned to one of four broad categories:

- Durable franchise – typically 40-50% of the portfolio (currently 37.2%) is in companies with robust business models, disciplined management and at least modest growth potential.

- Wide moat growth – 25-30% of the portfolio (currently 28.3%) is in growing companies with traits such as a strong brand, a unique product or a high market share in a competitive industry.
- Transformation/recovery – 15-20% of the portfolio (currently 22.7%) is in stocks that have a catalyst for change, such as a new management team.
- Deep value – 10-15% of the portfolio (currently 11.8%) is invested in companies on depressed valuations, where Cosh feels there is under-appreciated growth or recovery potential. This area has been reduced somewhat in recent months as there are currently fewer opportunities.

Stocks in the portfolio are monitored against their valuation targets, and a review process is triggered when they reach these targets or if they have risen or fallen in value by more than 25%.

Current portfolio positioning

At 30 September 2014 EAT had 43 holdings, with the top 10 stocks (Exhibit 1) accounting for 31.9% of assets. Because of its stock picking approach, geographical and sector weights are incidental, although notable divergences from the benchmark include a very large overweight in Ireland and a significant underweight to France. At a sector level there is a bias to consumer stocks and financials, while materials stocks and 'business providers' (a Euromoney grouping including support services, telecoms, transport, media and utilities) are less favoured.

Exhibit 5: Portfolio sector allocations

Euromoney sector	Portfolio 30 Sept (%)	Benchmark* 30 Sept (%)	Active weight (% pts)	Trust weight/ benchmark weight
Consumer goods	26.2	16.8	9.4	1.6
Financials	29.3	21.3	8.0	1.4
Industrial goods	16.3	13.3	3.1	1.2
Retail providers	6.2	7.0	-0.8	0.9
Natural resources	0.0	2.8	-2.8	0.0
Technology	4.4	7.5	-3.1	0.6
Basic materials	4.9	10.8	-5.9	0.5
Business providers	12.7	20.5	-7.8	0.6
	100.0	**100.0**	**0.0**	

Source: European Assets Trust, Euromoney, Edison Investment Research. Note: EAT holdings have been classified by Euromoney sectors. *Benchmark is Euromoney Smaller Europe (ex-UK). Ranked by active weight.

Recent purchases include Leonteq, a Swiss designer/manufacturer of structured financial products, and CTT – Correios de Portugal, the Portuguese post office. Leonteq is taking market share from investment banks, as its proprietary systems are more able to manage the complexities of structured products, while it is able to pass on risk to the firms to which it licenses the products via 'white label' agreements. CTT has an attractive 8% yield and offers growth potential should online shopping in Portugal take off from its current low base.CTT also has a more effective branch network than many Portuguese banks, which are increasingly using the post office to distribute their own products.

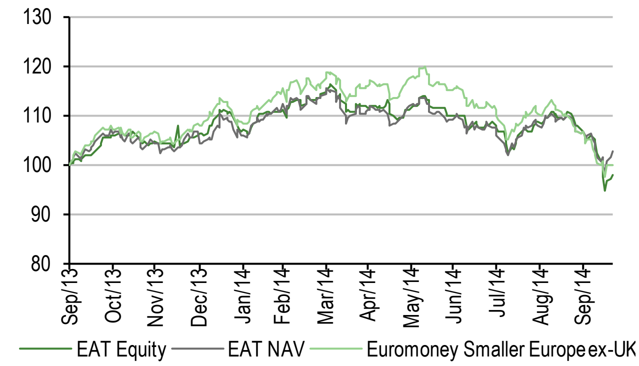
Sales include Kuka, a German robotics firm, and the Swiss chocolatier Lindt & Sprüngli. Cosh says Lindt had become too expensive at 35x earnings, but he still likes the stock and would buy it back at a more sensible valuation. Kuka was bought in 2010, when the balance sheet was stretched and the value of its robotics business was unappreciated. Cosh says the investment case came through as the trend towards factory automation took hold, buoyed by the US repatriating manufacturing from overseas. The stock was reassessed when it hit its valuation target and sold as the team were unconvinced by an acquisition that would divert focus from the more attractive robotics area.

Three stocks are likely to exit the portfolio as the result of takeovers. Jazztel, a Spanish broadband provider, has jumped back into the top 10 after its shares rose on the back of a takeover bid from Orange, which needs to acquire fixed-line capability if it is to continue to challenge in the Spanish market. Dutch accountancy software and cloud computing firm Exact has agreed an approach from private equity investor Apax Partners, while animal nutrition specialist Nutreco has jumped by 40% after a bid from a family-owned Dutch investment vehicle. Cosh says a counter-bid is possible as Nutreco has competitors for which a deal would offer more obvious synergies.

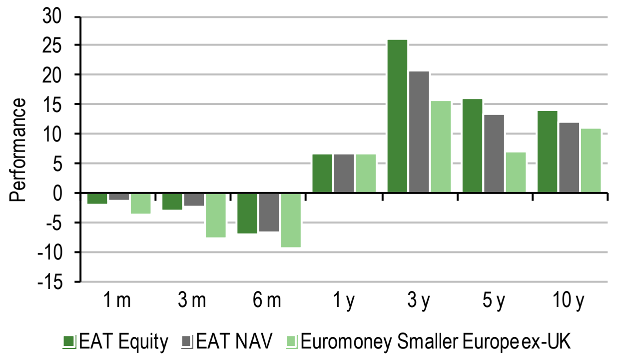
Performance: Longer-term outperformer

Exhibit 6: Investment trust performance

Price, NAV and benchmark total return performance, one year rebased



Price, NAV and benchmark total return performance (%)*



Source: Thomson Datastream, Edison Investment Research. *Note: Three-, five- and 10-year figures are annualised.

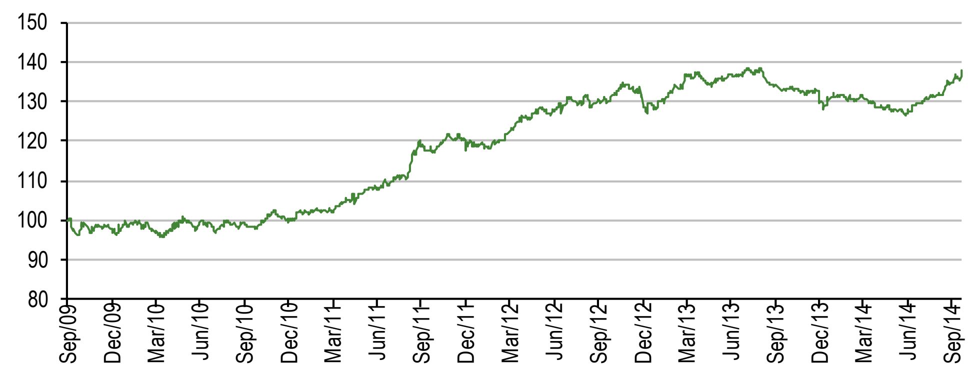
Exhibit 7: Share price and NAV total return performance (sterling adjusted), relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to Euromoney Smlr Europe ex-UK	1.6	5.1	2.4	0.1	29.8	50.3	28.7
NAV relative to Euromoney Smlr Europe ex-UK	2.4	5.8	2.6	0.1	13.4	34.6	8.0
Price relative to FTSE Europe ex-UK	(1.1)	(0.4)	(4.8)	0.6	31.3	56.6	59.3
NAV relative to FTSE Europe ex-UK	(0.4)	0.3	(4.6)	0.6	14.6	40.3	33.7
Price relative to FTSE All Share	0.9	(1.8)	(8.1)	0.7	36.1	32.6	69.5
NAV relative to FTSE All Share	1.7	(1.1)	(7.9)	0.7	18.9	18.7	42.3

Source: Thomson Datastream, Edison Investment Research. Note: As at end September 2014. Geometric calculation.

EAT has performed almost exactly in line with the benchmark Euromoney Smaller Europe ex-UK index over the past 12 months, although as can be seen in the left-hand chart in Exhibit 6, there have been times in the past year where the index has done better and, as shown in the right-hand chart of Exhibit 6 and in Exhibits 7 and 8, EAT's recent performance has been ahead of the index. In the longer term, and particularly over three and five years, NAV and share price performance have been significantly better than the benchmark (share price total returns of c 25% a year over three years), and also well ahead of returns on larger European stocks, and the UK (Exhibit 7).

Exhibit 8: Five-year NAV performance relative to benchmark, rebased to 100



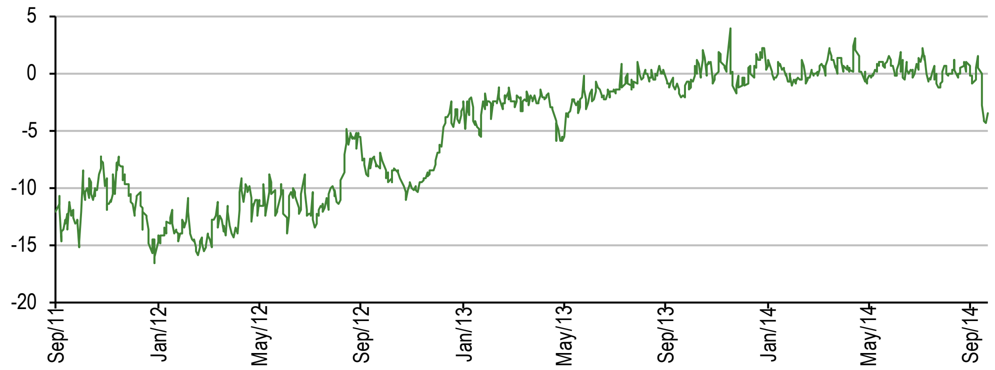
Source: European Assets Trust, Thomson Datastream, Edison Investment Research

Because of its focus on quality stocks, which may be more expensively rated than the market as a whole, EAT has tended to underperform in strongly rising markets. However, relative performance tends to be better in sideways or falling market conditions, as can be observed from Exhibit 8, showing EAT outperforming the index over a difficult summer and early autumn, a period when EAT's portfolio was also boosted by bid approaches for three of its holdings.

Discount: Slight widening in volatile markets

EAT has traded at par on average over the 12 months to 29 October, with an additional 3.7m shares issued during this period. Its shares have seen high demand in part because of the high distributions they offer in an otherwise low-yield environment, and the premium reached a 10-year high of 3.9% in December 2013. However, recent volatility has seen the shares move to a discount, reaching a 12-month high of 5.5% on 23 October before settling back to 3.2% on 29 October. This is still narrower than the average discount over three or five years (5.1% and 7.4% respectively). The board would consider buying back shares to manage the discount, but would only be likely to do so if the shares traded at a material discount for a prolonged period.

Exhibit 9: Discount/premium over three years (including income)



Source: Thomson Datastream, Edison Investment Research. Data to 21 October 2014.

Capital structure and fees

EAT is a conventional investment company with one class of share. At 24 October there were 21.1m shares in issue, an increase of 3.1m since the start of 2014 as the result of share issuance to manage the premium to NAV. The company may gear up to 20% of net assets and at 30 September net gearing stood at 5%, although factoring in the unrealised proceeds of bid activity (three transactions that are yet to complete, making up 7.1% of the portfolio at 30 September) there is effectively a small net cash position.

FCA Management BV (the Dutch management board director) is paid a fixed fee for its services, amounting to €101,428 in FY13, and F&C Investment Business (the investment manager) receives a quarterly fee of 0.2% of net assets. Ongoing charges for FY13 were 1.4%, but at the half-year end on 30 June 2014 the annualised ongoing charges figure (which is subject to change) was 1.27%. Ongoing charges for FY14 are likely to be lower than in 2013 because fixed costs are spread across a larger number of shares. There is no performance fee.

Dividend policy: High yield partly funded from capital

In 2001 EAT adopted a high distribution policy, and now pays a dividend equivalent to 6% of its NAV per share calculated each 1 January. The dividend is paid in three instalments, in January, May and August, and shareholders may elect to receive the dividend as further shares (a ‘scrip’ dividend). As European small- and mid-cap companies are not in aggregate a high-yielding asset class, some of the dividend is usually paid out of capital. Because the dividend is based on a fixed percentage of NAV at 1 January, the actual amount payable will vary from year to year and may fall as well as rise. The 2014 dividend of €0.699 per share is a 27% increase on the €0.5502 dividend paid in 2013, which was itself 24.8% higher than the 2012 dividend of €0.441. All dividends are paid net of Dutch withholding tax where applicable.

Peer group comparison

The AIC's European Smaller Companies sector is a small peer group containing just four funds, of which EAT is the second-smallest. Performance against the peer group has been strong, and EAT is ranked first for NAV total returns over one, three and five years. Five-year returns in particular are more than double those achieved by any of the peers. Risk-adjusted performance as measured by the Sharpe ratio is average over one year and well above average (again ranking first) over three years. EAT's ongoing charges are slightly higher than the weighted average. Its gearing is average, while it has the lowest discount and substantially the highest yield in the sector, both of which (arguably in the case of the discount) are a result of its high distribution policy.

Exhibit 10: European Smaller Companies investment trusts

% unless stated	Market cap £m	TR one year	TR three years	TR five years	Ongoing charge	Perf. fee	(Discount)/ premium	Net gearing	Yield	Sharpe NAV 1 year	Sharpe NAV 3 years
European Assets Trust	**178.1**	**-2.5**	**61.3**	**83.0**	**1.4**	**No**	**-5.8**	**105.0**	**6.9**	**0.8**	**1.3**
JPMorgan European Smaller Cos	295.5	-10.6	29.4	32.1	1.3	No	-13.8	98.0	1.6	0.5	0.6
Montanaro European Smaller Cos	69.4	-12.5	23.0	36.2	1.5	No	-14.3	105.0	1.6	0.0	0.5
TR European Growth	232.9	-3.8	50.3	35.9	0.7	Yes	-13.8	115.0	1.4	1.3	0.8
Sector weighted average		**-6.9**	**42.4**	**45.3**	**1.2**		**-12.0**	**105.3**	**2.7**	**0.8**	**0.8**
EAT rank in sector	**3**	**1**	**1**	**1**	**2**		**1**	**2**	**1**	**2**	**1**

Source: Morningstar, 22 October 2014, Edison Investment Research. Notes: TR = total return. The Sharpe ratio is a measure of risk-adjusted return. The ratios we show are calculated by Morningstar for the past 12- and 36-month periods by dividing a fund's annualised excess returns over the risk-free rate by its annualised standard deviation. Net gearing is shown here as total assets less cash/cash equivalents as a percentage of shareholders' funds.

The board

As a Netherlands-incorporated company, EAT has a two-tier board structure. The management board has a single 'director', FCA Management BV, represented by Wilbert van Twuijver and Tim Koster. The supervisory board is more akin to the board of a UK investment trust. It has seven members: Chairman Sir John Ward, Neville Cook, Professor Robert van der Meer, Laurence Jacquot, Duco Sickinghe, and two new members appointed during FY14, Julia Bond and Jack Perry.

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