EDISON

The European Investment Trust

Looking through the short-term noise

Investment trusts

The European Investment Trust (EUT) aims to achieve long-term capital growth from a portfolio of continental European companies chosen for their potential to outperform over a five-year time horizon. Medium-term outperformance points to some success in achieving this objective. Over the past six to nine months there has been a major rotation in the portfolio, with the manager taking profits from cyclical stocks bought when they were out of favour, and tilting the portfolio towards healthcare, where improved pipelines may translate into superior long-term performance. A recent correction in European stocks has seen the discount drift out a little wider (EUT's share price hit a 52-week low on 15 October), after reaching a five-year low point in early October.

12 months ending	Share price (%)	NAV (%)	FTSE Europe ex UK (%)	FTSE All Share (%)	MSCI World (%)
30/09/11	(12.9)	(12.8)	(13.6)	(4.4)	(2.7)
30/09/12	13.6	12.3	12.5	17.2	18.0
30/09/13	38.6	29.3	27.1	18.9	20.6
30/09/14	12.1	7.0	5.3	6.1	12.7

Source: Thomson Datastream. Note: Total return figures.

Investment strategy: Buy low, sell high

EUT is a focused portfolio of 35-50 stocks (currently 40), chosen on a bottom-up, valuation-driven basis by manager Dale Robertson of Edinburgh Partners (EP). EP's investment process hinges on rigorous financial analysis, constructing a five-year inflation-adjusted earnings growth outlook and a year five P/E ratio for all prospective holdings. EP's view is that future earnings, not past performance, are the best predictor of share price total returns, and its analysis suggests a clear relationship between price total return and earnings growth on a five-year view. As such, all stocks are bought on the basis of their five-year outlook, aiming to profit from the short-termism of most market participants.

Market outlook: Europe not out of the woods yet

After performing strongly in the 18 months from summer 2012, European equity markets have pared back gains recently as risk-aversion rises and investors focus on the possibility of deflation and a triple-dip recession, combined with geopolitical tension and the withdrawal of QE liquidity support in the US. Valuations on a forward P/E basis are less stretched relative to history than six months ago, and remain below forward P/Es for the UK, US and world markets, but near-term volatility is to be expected, although EUT's manager notes that this may represent a more favourable entry point for long-term investors.

Valuation: Market wobble causes discount to widen

EUT's discount to cum-income NAV of 7.6% on 20 October was narrower than the average discount over one, three and five years, but wider than the five-year low of 4.2% reached earlier in the month. Having tended to trade at a wider discount than its peers in the AIC's Europe sector, there have been signs that this gap is closing, although volatility in European markets may mean EUT's discount, and those of its peers, could drift out in the short term as investors favour other markets.

21 October 2014

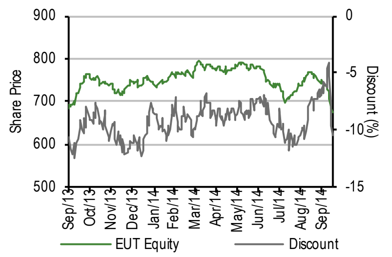
Price	**693p**
Market cap	**£291.5m**
AUM	**£310.3m**

NAV*	734.8p
Discount to NAV	5.7%
NAV**	749.8p
Discount to NAV	7.6%
Yield (incl. special dividend)	2.6%

*Excluding income. **Including income. Data to 20 October 2014.

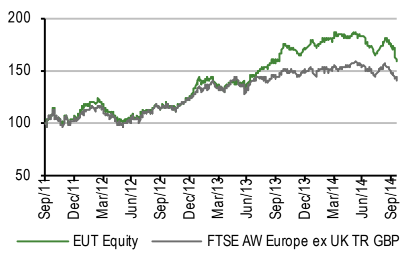
Ordinary shares in issue	42.1m
Code	EUT
Primary exchange	LSE
AIC sector	Europe

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	794.5p	665.0p
NAV* high/low	866.7p	717.4p

*Excluding income.

Gearing

Gross	0.0%
Net	-0.9%

Analysts

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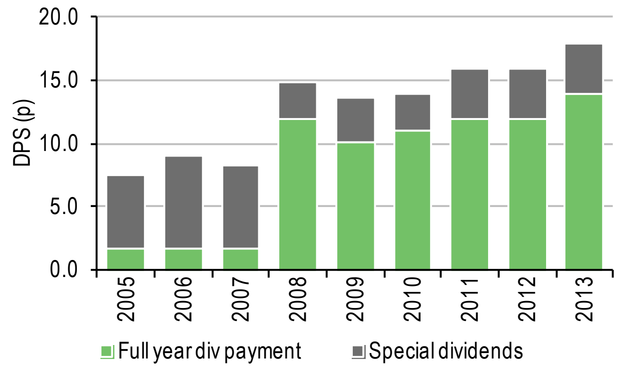
The European Investment Trust is a research client of Edison Investment Research Ltd

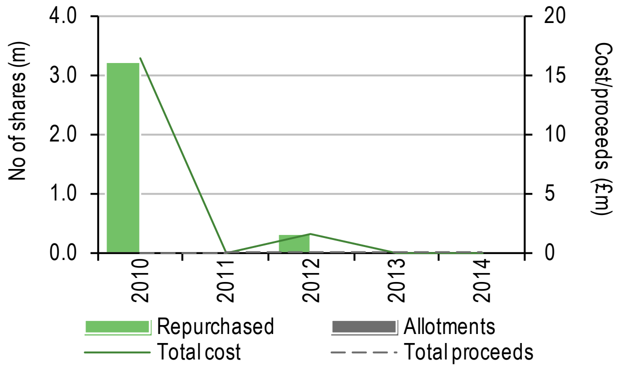
Exhibit 1: Trust at a glance

Investment objective and fund background	Recent developments
The European Investment Trust (EUT) seeks long-term capital growth through investment in a diversified portfolio of continental European securities. The trust was launched in 1972 and management was transferred to Edinburgh Partners on 1 February 2010 following a tender process. The manager follows a disciplined, long-term value management approach. The trust has an indefinite life and is not subject to a periodic continuation vote.	13 August 2014: Interim management statement for the three months to June. NAV total return -1.7% compared with +0.3% for FTSE Europe ex UK index. 1 July 2014: EUT cancels its €30m multicurrency borrowing facility with Scotiabank.

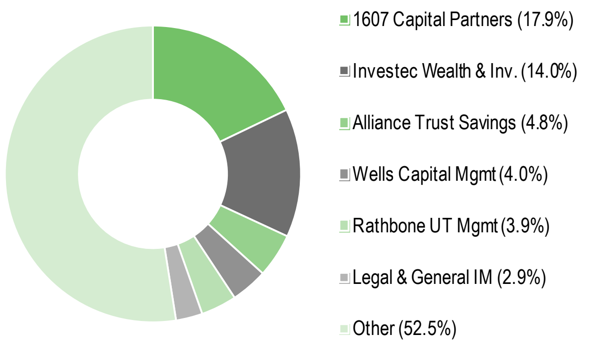
Forthcoming		Capital structure and fees		Fund details	
AGM	January 2015	Ongoing charges	0.59%	Group	Edinburgh Partners
Annual results	November 2014	Net gearing	-0.9%	Manager	Dale Robertson
Year end	30 September	Annual mgmt fee	0.55% of market cap	Address	27-31 Melville Street, Edinburgh EH3 7JF
Dividend paid	January	Performance fee	None		
Launch date	1972	Trust life	Indefinite	Phone	+44 (0) 131 270 3800
Continuation vote	None	Loan facilities	None	Website	www.edinburghpartners.com

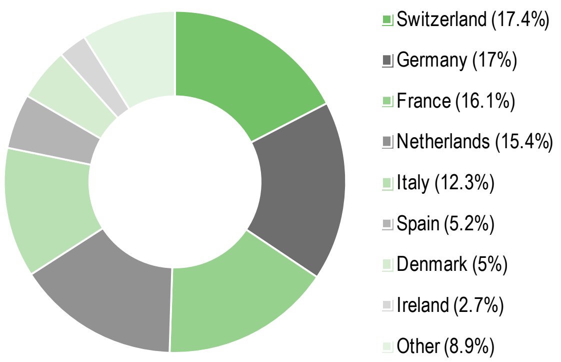
Dividend policy and history	Share buyback policy and history
The company objective is to seek long-term capital growth so dividend yield is not the primary aim. Dividends are paid annually in January.	EUT is authorised both to repurchase up to 14.99% of its ordinary shares and to allot shares up to approximately 5% of the issued share capital.





Shareholder base (as at 13 October 2014)	Geographical exposures of portfolio (as at 30 September 2014)





Top 10 holdings as at end September

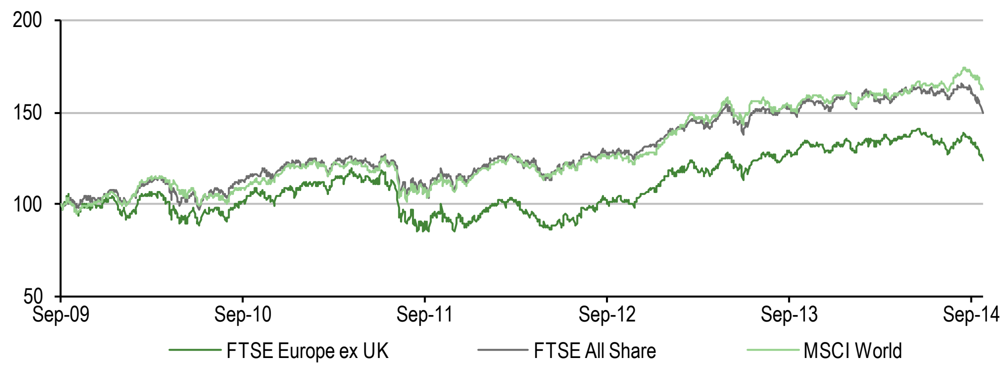
			Portfolio weight %	
Company	**Country**	**Sector**	**30 September 2014**	**31 March 2014***
Gerresheimer	Germany	Health care	3.2	2.9
Danske Bank	Denmark	Banks	3.2	3.0
Roche Holdings	Switzerland	Health care	3.2	N/A
BNP Paribas	France	Banks	3.2	N/A
PostNL	Netherlands	Industrial goods & services	3.1	3.0
Novartis 'R'	Switzerland	Health care	3.1	N/A
BB Biotech	Switzerland	Health care	3.0	N/A
ENI	Italy	Oil & gas	2.9	2.8
Sanofi	France	Health care	2.9	N/A
Delta Lloyd	Netherlands	Insurance	2.9	N/A
Top 10 (% of portfolio)			**30.7**	**30.3**

Source: European Investment Trust, Edison Investment Research, Morningstar, Bloomberg. Note: *Top 10 – N/A where not in top 10 at end March 2014.

Market outlook: Europe still not out of trouble

Having performed strongly in the 18 months following ECB president Mario Draghi's vow to do "whatever it takes" to safeguard the single currency, European markets have stuttered recently. While the IMF in its latest World Economic Outlook (October 2014) says it believes "euro area fundamentals are slowly improving", it has downgraded its euro area GDP growth forecasts to 0.8% in 2014 and 1.3% in 2015, compared with 1.1% and 1.5% in July. As the US prepares to end its QE programme, profit-taking has caused a dip in European equities (Exhibit 2), which may take time to reverse as investors begin to shun equities even in markets with a better macroeconomic outlook.

Exhibit 2: FTSE Europe ex UK, FTSE All Share and MSCI World indices compared



Source: Thomson Datastream. Note: FTSE Europe ex-UK is trust benchmark. 30 Sept 2009 to 15 Oct 2014.

Valuations look less stretched relative to history than six months ago (12-month forward P/E ratio at 109% of the three-year average versus 123% in April), but the same is true of all the markets shown in Exhibit 3, and the differential between Europe and the US and world has remained largely unchanged (although Europe's P/E is the lowest). While the near-term picture remains uncertain, the current correction may point to a better entry point for regular investors with a longer view.

Exhibit 3: Valuation comparison

12-month forward P/E ratio	Last (x)	High (x)	Low (x)	Three-year average (x)	Last % of three-year average
Europe	12.3	13.6	8.3	11.3	109%
EU	13.1	14.5	8.5	11.9	110%
UK	12.9	14.2	8.8	11.8	109%
US	15.1	16.3	11.4	14.1	106%
World	13.4	14.4	10.1	12.6	106%

Source: Thomson Datastream. Note: As at 15 October 2014. Uses Datastream indices.

Fund profile: Long-term, value-driven Europe specialist

The European Investment Trust (EUT) was formerly known as Foreign & Colonial Eurotrust, but changed its name and investment approach when the mandate was awarded to Edinburgh Partners (EP) in February 2010. The trust is listed on the London Stock Exchange with a secondary listing in New Zealand. Managed since the move to EP by Dale Robertson (who joined the firm in 2003 and is one of nine investment partners), it takes a long-term, value-driven approach to investing in continental Europe, with a focused portfolio of 35-50 holdings. Its benchmark is the FTSE Europe ex UK index, although given its bottom-up style and concentrated stock list, its portfolio and performance are likely to differ quite markedly from the index. The trust is permitted to use gearing of up to 20% and may hedge its currency exposure, although in practice it has tended to do neither. Currency exposures at 30 September 2014 (based on country of listing) were 72.5% euro, 17.4% Swiss franc and 9.2% Nordic currencies. Broad risk controls ensure diversification by country and sector, and no more than 10% of the portfolio (30 September: 0%) can be held in countries outside the benchmark index.

The fund manager: Dale Robertson

The manager's view: An attractive long-term entry point?

The confidence with which investors in Europe entered 2014 has been dented in recent months, initially over Ukraine, and more recently on signs of a triple-dip recession. "Europe is still in a recovery phase from a global financial crisis and we are faced with a continued period of sub-trend growth, so any external shocks can quickly knock confidence" says Robertson. However, the recent sell-off has produced more attractive valuations, with the aggregate year five P/E (see Investment process, below) of the portfolio falling from 10x (the top of a 7-10x range over five years) to just under 9x. Robertson says this may represent an attractive entry point for investors considering revisiting Europe, although he cautions that with global financial markets still largely driven by monetary stimulus or its withdrawal, and with earnings recovery yet to materialise, near-term volatility is likely.

Asset allocation

Investment process: Taking a five-year view of earnings

Edinburgh Partners' investment philosophy is based on its co-founder Sandy Nairn's interpretation of Sir John Templeton's hypothesis that a five-year horizon is the most appropriate timeframe over which to evaluate a share. Nairn, previously at Scottish Widows Investment Partnership and Templeton before setting up EP in 2003, observed a clear relationship between earnings growth and share price total returns over a five-year period, with no such correlation evident over shorter timescales. Working from the starting point that the best determinant of future share price appreciation is future earnings growth, EP's investment team undertake rigorous analysis of potential investments, building a five-year earnings forecast and calculating a year five price/earnings ratio (Y5 P/E) for each stock. Theory and practice have shown that a Y5 P/E of 11x or less at investment is optimum for achieving long-term returns in excess of the market.

EP's 14-strong investment team feeds in ideas to EUT manager Dale Robertson, for debate at regular meetings. The risk/reward potential of all new ideas is compared with that of companies already in the portfolio. Robertson has a strong sell discipline and will sell holdings when they reach their valuation target – which in practice has tended to be sooner than five years, although all stocks are included on a five-year view – or if the investment case (following reassessment by a different analyst than the one who initially presented the idea) is proved not to be working.

Current portfolio positioning

EUT held 40 stocks at 30 September, towards the lower end of its 35-50 stock range. The trust aims for a broadly equal weighting in all its holdings, and the 30.7% representation of the top 10 stocks bears this out. While the portfolio is not built on thematic lines, Robertson assigns the stocks he holds to one of five broad themes (three 'growth' and two 'value'). At 30 September 2014 the largest theme was value – defensive at 32.6% of the portfolio (16.1% at 30 September 2013). Next was value – higher risk/reward at 27.9% (down from 37.8%), then visible or structural growth at 20.0% (20.5%), with emerging market-related growth at 12.8% (16.4%) and sector leaders at 5.8% (9.0%).

Having held a bias to cyclical stocks (broadly, the 'value – higher risk/reward' group) – particularly telecoms, automotive stocks and peripheral European financials – for most of the past 18 months, Robertson has recently rotated into more defensive areas, specifically healthcare. Bought as a contrarian bet, strong relative performance from the cyclical stocks in 2013 meant the valuation gap versus other areas had closed, leading to a risk/reward imbalance compared with more defensive stocks. The market's re-rating of cyclical names led to strong performance for many of Robertson's choices, with the top five contributors to returns in the 12 months to 30 September made up of a

Portuguese bank (Banco Espirito Santo), an Italian asset manager (Azimut), Belgian and French telcos (Belgacom and Orange) and an auto parts maker (Valeo). These five stocks (the first three no longer held) contributed 4.6 percentage points of EUT's 6.4% NAV total return over the period.

Exhibit 4: Sector breakdown at 30 September (% unless stated)

Sector	Trust weight 30 September 2014	Trust weight 31 March 2014	Change from March (% pts)	FTSE Europe ex UK weight 30 Sept	Active weight vs index (% pts)	Trust weight/ index weight
Industrial goods & services	17.0	16.6	0.4	10.8	6.2	1.6
Automobiles & parts	9.8	10.7	-0.9	3.9	5.9	2.5
Healthcare	18.0	7.9	10.1	13.1	4.9	1.4
Telecoms	8.5	12.4	-3.9	4.2	4.3	2.0
Technology	7.2	4.9	2.3	3.8	3.4	1.9
Travel & leisure	2.7	2.7	0.0	0.6	2.1	4.5
Financial services	2.6	2.5	0.1	1.2	1.4	2.1
Oil & gas	8.0	9.6	-1.6	6.9	1.1	1.2
Media	2.7	4.8	-2.1	2.1	0.7	1.3
Insurance	5.3	2.4	2.9	5.6	-0.3	0.9
Food & beverage	6.2	7.0	-0.8	7.6	-1.4	0.8
Banks	11.2	9.9	1.3	15.8	-4.6	0.7
Other*	0.0	6.5	-6.5	24.5	-24.5	n/a
Cash	0.9	2.2	-1.3	0.0	0.9	n/a
	100	**100**		**100**	**0.0**	

Source: The European Investment Trust, Edison Investment Research, FTSE. Note: Ranked by active weight (excluding cash). *Includes chemicals, basic resources, construction & materials, personal & household goods, retail, utilities and real estate.

The most significant change in weighting has been the rotation into healthcare stocks (evident in the sector breakdown in Exhibit 4 and also the sub-themes in Exhibit 5). Four names (Roche, Novartis, Sanofi and BB Biotech) have been added here in the past nine months. Robertson says that after a difficult decade, characterised by patent expiries and lack of new products, the fundamentals now look better for the sector. Scientific progress and a more accommodative regulatory stance, particularly regarding rare conditions, point to advances in R&D productivity and an acceleration of sales growth over the next five to 10 years. With most global healthcare and particularly biotech stocks based in the US, choices can be limited for a European fund manager. Roche, Novartis and Sanofi are among the leading healthcare companies in Europe, while BB Biotech – a Switzerland-listed closed-ended fund – offers diversified exposure to the growth potential of US biotech at a c 20% discount to NAV.

While the move into healthcare constitutes a major change in the portfolio's balance of cyclical and defensive stocks, Robertson continues to avoid the 'expensive defensive' areas, typically consumer staples such as food and beverages and consumer discretionary areas like luxury goods, which the manager feels enjoy unjustly high ratings because of their exposure to emerging markets, in spite of having largely underperformed and disappointed in earnings terms.

The significant rotation in the portfolio has caused turnover to tick up a little on a six-month view to around 40%, but on a 12-month basis it is in line with long-term averages at c 34-35%, indicative of a three-year holding period.

Exhibit 5: Portfolio sub-themes with average year five P/E ratios

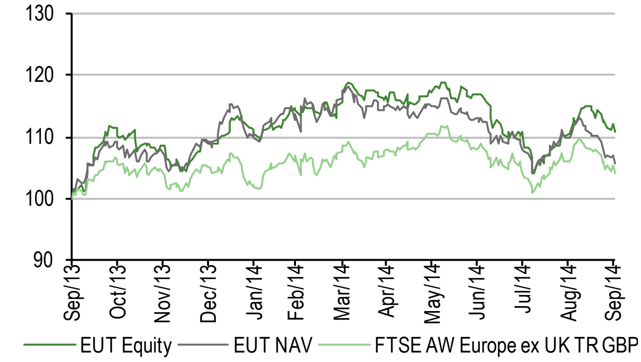
Sub-theme or 'cluster'	Portfolio weight at 30 Sept (%)	Average year five P/E at 30 Sept (x)
Biotech/pharma pipelines	16.0	10.8
Regulated market repair	12.0	8.5
Secular trend, various	12.0	10.2
European auto cycle	9.0	7.6
Emerging markets	8.0	9.6
Technology trend	8.0	8.7
Utility banking	8.0	9.5
Oil/gas price	8.0	9.7
Peripheral economies	7.0	8.6
Capex pick-up	6.0	7.8
Bond-like equity	6.0	7.8
Weighted average year five P/E		**9.2**

Source: The European Investment Trust

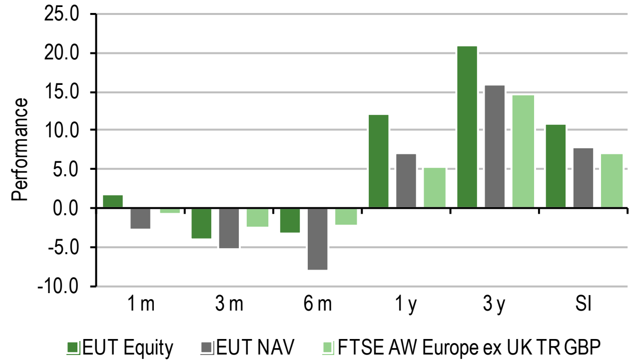
Performance: Short-term wobble in improving trend

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: Inception 1 February 2010. Three-year and since inception (SI) figures are annualised. All data to 30 September 2014.

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

	One month	Three months	Six months	One year	Three years	Since inception
Price relative to FTSE Europe ex UK	2.5	(1.6)	(0.9)	6.5	17.2	17.2
NAV relative to FTSE Europe ex UK	(2.0)	(2.7)	(5.8)	1.6	3.3	3.3
Price relative to FTSE All Share	4.6	(3.2)	(4.3)	5.6	19.2	4.0
NAV relative to FTSE All Share	0.0	(4.3)	(9.1)	0.8	5.0	(8.3)
Price relative to MSCI World	2.0	(7.2)	(8.5)	(0.5)	10.0	(4.0)
NAV relative to MSCI World	(2.4)	(8.3)	(13.0)	(5.1)	(3.1)	(15.3)

Source: Thomson Datastream, Edison Investment Research. Note: Data to 30 September 2014 and indices £ adjusted. Geometric calculation. Inception 1 February 2010.

Edinburgh Partners has now managed EUT for almost five years, and over periods of one year and longer (to 30 September) it has beaten the total return on the benchmark FTSE Europe ex UK index in both share price and net asset value terms (Exhibit 6). Share price total returns have been notably better as a result of a narrowing in the discount, particularly in the more recent period. EP takes a five-year view of all its investments and focusing on short-term performance is of limited value, as contrarian bets may take some time to come good. However, one stock-specific factor behind underperformance in 2014 has been the impact on Portugal Telecom of its holding in the commercial paper of the struggling Portuguese financial group Espirito Santo. (EUT also held Banco Espirito Santo, but sold it earlier in the year before the problems at its parent emerged; in fact it was the biggest positive stock contributor to performance in the 12 months to 30 September.) The (albeit reduced) bias to cyclical stocks has also been a negative factor in recent months.

Negative relative performance versus the FTSE All Share and MSCI World indices over most periods (Exhibit 7) reflects the better returns that have generally been achieved in recent years by investors outside continental Europe.

Discount: Wider again after reaching five-year low

European equities have been unloved for much of the past three years and EUT's discount chart (Exhibit 8) reflects both the periods out of favour and the brief spells of more positive sentiment, although as a trust with a historically wider discount than many of its peers, the chart also illustrates a gradual re-rating. A five-year low for the discount to cum-income net asset value (4.2%) was reached in early October, although at the time of writing the discount had widened again to 7.6% (20 October). This is, however, lower than the averages over one, three and five years (9.2%, 13.2% and 14.0% respectively). The lack of a formal discount control policy may contribute to discount volatility, though some may feel a hard target tends to 'bake in' a certain level of discount. In the past six months, discount-focused investor 1607 Capital Partners has reduced its stake in EUT from 21.3% to 17.9%, perhaps capitalising on the narrowing seen since the turn of the year.

Exhibit 8: Discount over three years (including income)

Source: Thomson Datastream, Edison Investment Research. Note: Data to 12 October 2014.

Capital structure and fees

EUT has 42.1m ordinary shares in issue, its only class of share. The trust is conventionally structured with an indefinite life and no requirement for a continuation vote. It may buy back up to 14.99% and allot up to 5% of its shares annually, but in practice there has been no issuance and no buybacks since 2012.

Edinburgh Partners receives a management fee of 0.55% of EUT's market capitalisation (because the fee is based on market cap rather than net assets, it will rise if the discount narrows). Fees are charged to revenue, and there is no performance fee. Ongoing charges of 0.59% are the lowest in the AIC Europe sector by some 30 basis points.

The trust is currently ungeared, and cancelled its €30m borrowing facility with Scotiabank in July. While the manager says he has no immediate plans to introduce gearing and would never gear by more than 10%, EUT is currently looking at a number of short- and longer-term borrowing options to provide the flexibility to gear if needed.

Dividend policy and record

Dividends are paid annually in January, although EUT's principal objective is to achieve capital growth. The dividend in respect of FY14 will be announced with the annual results to 30 September. For FY13 a total dividend of 18p was paid, which included a 4p special dividend, fully covered by income. Special dividends have been paid every year since 2001 as a means of distributing extra income while achieving a less volatile rise in the underlying dividend. The net revenue return for the half year ended 31 March 2014 was 3.23p per share, a fall of c 5% on the same period a year earlier (net revenue per share: 3.39p), although it should be noted that H113 revenue included a large special dividend from Ryanair. If the revenue received in the second half of the 2014 financial year bears a similar relation to the previous year, it is reasonable to expect the dividend to be at least maintained, particularly in the light of EUT's fairly substantial revenue reserve (equivalent to 75% of last year's total dividend). However, with most European companies paying their dividends in the second half of EUT's financial year, there is scope for some variability in the outcome. Based on the FY13 dividend and the 20 October share price of 693p, EUT's yield is 2.0% (2.6% including the special dividend).

Peer group comparison

There are eight investment trusts in the Association of Investment Companies' Europe sector with a track record of at least one year (the Sanditon IT was launched in June). Following a sell-off in many global markets at the beginning of October, three-quarters of the peer group (Exhibit 9) now has flat or negative one-year NAV total returns, with EUT ranking eighth over this period, as well as over three and five years. However, risk-adjusted performance as measured by the Sharpe ratio has been close to or above the peer group weighted average over both one and three years. EUT's yield is in line with the average, while its gearing is below average. EUT has the lowest ongoing charges in the peer group and is the only trust in the sector not to charge a performance fee. Its discount to NAV at 14 October was one of the widest in the group, after widening by more than five percentage points since the early part of the month.

Exhibit 9: European 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 Investment Trust	**282.7**	**(5.8)**	**36.2**	**28.5**	**0.6**	**No**	**(9.3)**	**99.0**	**2.0**	**1.1**	**0.9**
BlackRock Greater Europe	236.2	(5.1)	41.7	35.6	1.0	Yes	(4.8)	100.0	2.0	0.5	0.7
Fidelity European Values	593.4	(1.4)	44.9	34.2	0.9	Yes	(11.0)	105.0	2.1	0.7	0.9
Henderson European Focus Trust	155.6	6.5	62.1	52.9	1.0	Yes	(3.2)	108.0	2.4	1.5	1.2
Henderson EuroTrust	149.9	(2.1)	44.3	48.0	1.0	Yes	(2.1)	103.0	2.4	0.9	1.0
JPMorgan European Growth	178.3	(2.9)	42.3	28.7	0.9	Yes	(7.3)	115.0	3.2	0.9	0.8
JPMorgan European Income	80.9	1.3	47.8	44.9	1.1	Yes	(9.6)	109.0	4.3	1.4	1.1
Jupiter European Opportunities	360.7	0.1	63.7	101.2	1.1	Yes	(1.4)	113.0	0.9	0.8	1.2
Sanditon Investment Trust	53.6					Yes	5.4	0.0	0.0		
Sector weighted average		**(1.6)**	**47.8**	**47.8**	**0.9**		**(6.4)**	**106.1**	**2.1**	**0.9**	**1.0**
EUT rank in sector	**3**	**8**	**8**	**8**	**8**		**7**	**8**	**7**	**3**	**5**

Source: Morningstar, 14 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

EUT has four non-executive directors. Chairman Douglas McDougall was appointed to the board in 1999 and became chairman the same year. Michael Moule, the senior independent director, joined the board in 2004. William Eason became a director in 2007 and Dr Michael Woodward was appointed in 2013. All the directors have backgrounds in investment management.

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