The European Investment Trust

Improving performance under new lead manager

Investment trusts

The European Investment Trust (EUT) aims to generate long-term capital growth from a diversified portfolio of European equities. Since August 2016, EUT has been managed by Craig Armour, who follows the disciplined Edinburgh Partners valuation-driven investment process, aiming to buy stocks that are trading on a five-year P/E multiple (Y5 P/E) of less than 11x. The manager is currently more cautious on the outlook for continental European equities as EUT's portfolio Y5 P/E is towards the high end of its 7x to 11x long-term historical range. As a result, EUT is currently ungeared and Armour is not planning to increase cyclical exposure in the near term. Near-term investment performance has improved versus the peer group and the benchmark, and EUT has increased or maintained its ordinary annual dividends since 2009.

12 months ending	Share price (%)	NAV (%)	Benchmark (%)	FTSE All-Share (%)	MSCI World (%)
31/05/13	37.5	37.0	42.0	30.1	30.5
31/05/14	32.1	20.6	12.5	8.9	8.0
31/05/15	9.4	3.7	4.1	7.5	16.8
31/05/16	(19.1)	(11.7)	(3.6)	(6.3)	1.3
31/05/17	41.8	39.9	35.8	24.5	32.0

Source: Thomson Datastream. Note: All % on a total return basis in pounds sterling.

Investment strategy: Focus on valuation

EUT is managed following Edinburgh Partners' disciplined fundamental, bottom-up investment process. This is based on in-house analysis showing that stock prices are correlated with inflation-adjusted five-year earnings performance, but stock price moves are more random over shorter time periods. Armour and his team determine five-year earnings estimates, seeking companies that are trading on a Y5 P/E of less than 11x. EUT is a concentrated portfolio of 35-45 stocks diversified by sector and geography, selected without reference to the benchmark FTSE All-World Europe ex-UK Index. Gearing of up to 20% of net assets is permitted; however, at end-April 2017, EUT had a net cash position of 1.3%.

Market outlook: European equities relatively cheaper

Over the last year, equity markets have rallied and total returns to UK-based investors have been enhanced by the weakness of sterling. Although indices across the globe are trading at a forward P/E premium to their 10-year averages, European equities are more attractively valued on an absolute basis than US and global equities. For investors wishing to have exposure to the region, a fund with a disciplined and clear investment approach may be of some interest.

Valuation: Narrower over the nearer term

EUT's current 11.8% share price discount to cum-income NAV is more towards the lower end of the last 12-month range of 8.9% to 18.1%. It compares to the averages of the last one, three and five years of 14.1%, 9.8% and 11.2%, respectively. There has been a noticeable narrowing of the discount since December 2016 and there is potential for it to narrow further if investment performance continues to improve or there is higher demand for European equities.

6 June 2017

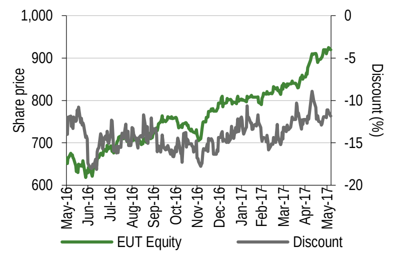
Price	**920.0p**
Market cap	**£387m**
AUM	**£425m**

NAV*	1,021.1p
Discount to NAV	9.9%
NAV**	1,043.5p
Discount to NAV	11.8%

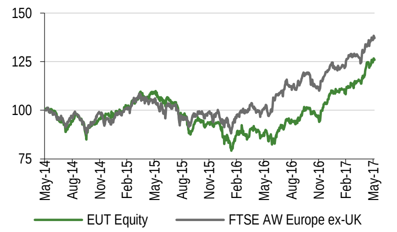
*Excluding income. **Including income. As at 2 June 2017.

Yield (including special dividend)	2.4%
Ordinary shares in issue	42.0m
Code	EUT
Primary exchange	LSE
AIC sector	Europe
Benchmark	FTSE AW Europe ex-UK

Share price/discount performance



Three-year performance graph



52-week high/low	925.0p	618.5p
NAV* high/low	1,044.4p	713.7p

*Including income.

Gearing

Gross*	0.0%
Net cash*	1.3%

*As at 30 April 2017.

Analysts

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

Exhibit 1: Trust at a glance

Investment objective and fund background

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 investment approach. The trust has an indefinite life and is not subject to a periodic continuation vote.

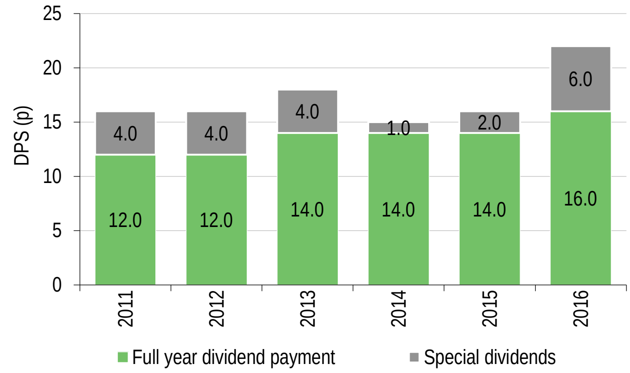
Recent developments

- 24 May 2017: Half-year report to 31 March 2017. NAV TR +18.8% versus benchmark TR +12.8%. Share price TR +19.5%. Announcement of 9.5p interim dividend.
- 24 January 2017: Retirement of chairman Douglas McDougall at AGM; he is succeeded by Michael MacPhee.
- 30 November 2016: Annual report to 30 September 2016. NAV TR +14.9% versus benchmark TR +21.8%. Share price TR +9.8%.

Forthcoming		Capital structure		Fund details	
AGM	January 2018	Ongoing charges	0.62%	Group	Edinburgh Partners
Annual results	November 2017	Net cash	1.3%	Manager	Craig Armour
Year end	30 September	Annual mgmt fee	0.55% of market cap	Address	27-31 Melville Street, Edinburgh EH3 7JF
Dividend paid	July, January	Performance fee	None		
Launch date	1972	Trust life	Indefinite	Phone	+44 (0) 131 270 3800
Continuation vote	None	Loan facilities	€30m	Website	www.edinburghpartners.com

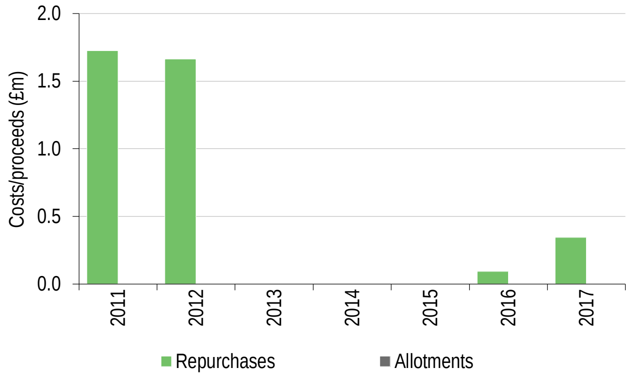
Dividend policy and history (financial years)

The investment objective is to seek long-term capital growth so dividend yield is not the primary aim. Historically, annual dividends were paid in January, but starting in July 2017 an interim dividend will also be paid.

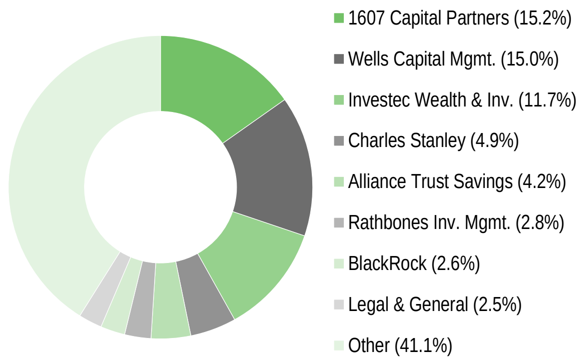


Share buyback policy and history (financial years)

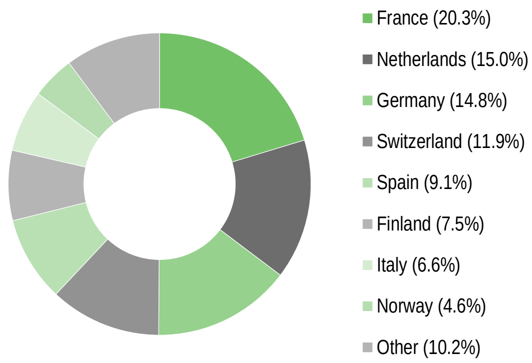
EUT is authorised both to repurchase up to 14.99% of its ordinary shares and to allot shares up to 5% of the issued share capital.



Shareholder base (as at 31 March 2017)



Portfolio exposure by geography (as at 30 April 2017)



Top 10 holdings (as at 30 April 2017)

			Portfolio weight %	
Company	Country	Sector	30 April 2017	30 April 2016*
PostNL	Netherlands	Industrials goods & services	4.8	4.8
BNP Paribas	France	Banks	3.6	3.6
Sanofi	France	Healthcare	3.5	3.0**
Bayer	Germany	Chemicals	3.5	3.2
Novartis 'R'	Switzerland	Healthcare	3.4	3.1**
Roche	Switzerland	Healthcare	3.3	3.6
BBVA	Spain	Banks	3.2	3.0**
Telefonica	Spain	Telecoms	3.2	N/A
Total	France	Oil & gas	3.0	3.8
Royal Dutch Shell 'A'	Netherlands	Oil & gas	3.0	4.0
Top 10			34.5	36.6

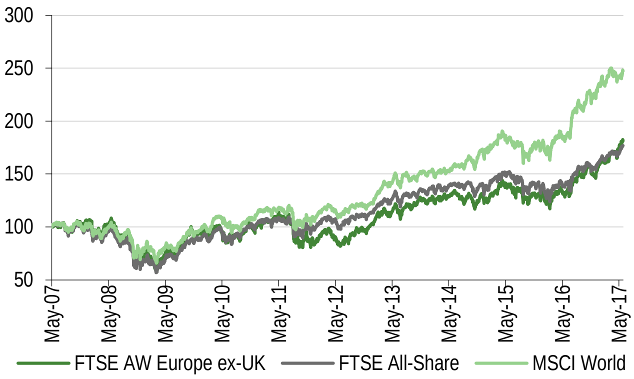
Source: The European Investment Trust, Edison Investment Research, Bloomberg, Morningstar. Note: *N/A where not in the portfolio as at April 2016. **Not in April 2016 top 10.

Market outlook: European equities relatively attractive

Exhibit 2 (left-hand side) shows the performance of European, UK and global equities over the last five years. The FTSE AW Europe ex-UK and FTSE All-Share indices have failed to keep pace with the MSCI World Index, as US equities have been relatively strong over the period; the US now represents c 60% of the index. Over the last year, global equities have rallied strongly, with the weakness in sterling boosting returns for UK-based investors in overseas equities and UK equities with overseas earnings. As a result, global equities are trading above their average forward P/E valuations of the last 10 years in a range of 120% to 126% (Exhibit 2, right-hand side). However, on an absolute basis, European equities are looking more attractively valued than US and world equities. In this environment, investors may wish to consider a fund with a disciplined valuation approach, which also has an improving performance record.

Exhibit 2: Market performance and valuation

Performance of indices, last 10 years (in £ terms)



Forward P/E multiples of Datastream indices

	Last (x)	High (x)	Low (x)	10-year avg (x)	Last as % of 10-year avg
Europe ex-UK	14.7	15.5	7.8	11.6	126
UK	14.7	15.6	7.4	12.0	123
US	18.1	18.3	9.4	14.5	125
World	15.7	16.0	8.8	13.1	120

Source: Thomson Datastream, Edison Investment Research. Note: Data to 29 May 2017.

Fund profile: Edinburgh Partners' value approach

EUT was launched in 1972 as Foreign & Colonial Eurotrust and since February 2010 has been managed by Edinburgh Partners (EP). EP was launched in 2003 and currently has c £7bn of assets under management, of which c £1.5bn are in European mandates. Its founder Sandy Nairn previously worked with John Templeton and developed EP's value-driven process on the understanding that stock markets are efficient over the longer term, but behave in a more random manner over shorter periods. EP's investment process is bottom-up, seeking undervalued stocks based on five-year earnings forecasts. Since August 2016, EUT has been managed by Craig Armour, who joined EP in 2009. He aims to generate long-term capital growth from a relatively concentrated portfolio of 35-45 continental European stocks, benchmarked against the FTSE All-World Europe ex-UK Index. Up to 10% of the portfolio may be held in countries that are not included in the benchmark, while any investment in unquoted companies requires prior board approval. EUT has the ability to hedge against currency movements, although does not do so in practice. Gearing of up to 20% of net assets is permitted.

The fund manager: Craig Armour

The manager's view: More caution given equity valuations

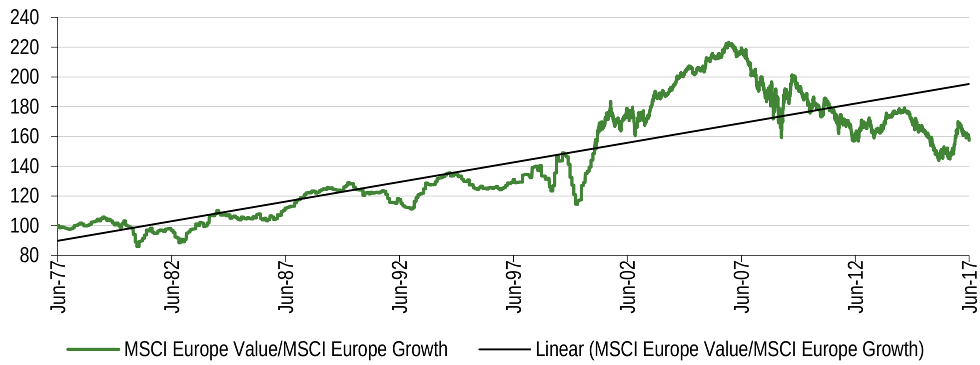
Manager Armour comments that there has been a widespread economic recovery across the globe and that following particularly strong performance from US equities, valuations in other stock markets are looking relatively attractive. He says that this includes Europe and as a result the region is experiencing positive fund flows. Regarding the political environment, the manager says that the outcomes of the UK's European referendum and the US presidential election were populist shifts. However, this has not been mirrored in recent European elections, which has reduced the level of risk for investors. The manager is finding the strength of the cyclical rally challenging; he comments that some of the more economically sensitive sectors in the stock market have experienced dramatic upward price moves since mid-2016 and he questions whether the economic improvement is already priced into cyclical stock prices. Armour notes that the average Y5 P/E on EUT's portfolio is now c 10.5x, which is close to the historical high of 11.0x, and that the European stock market has already risen by c 10% in the first four months of 2017, which is the equivalent of a decent annual return for investors in just one-third of a year.

Asset allocation

Investment process: Bottom-up, valuation focused

EUT employs EP's valuation-based bottom-up investment process, which assumes that future earnings growth is the best predictor of share price returns. EP deems the stock market to be rational over the long term, but believes that investor short-termism leads to less rational stock price moves over shorter time periods (ie random correlations between earnings growth and stock price moves). Manager Armour works in a team of 12 analysts/portfolio managers and three applied research specialists. Each member of the team is responsible for in-depth research on 30-50 stocks to derive five-year inflation-adjusted earnings forecasts, which results in a Y5 P/E multiple. The team uses a standard research template, which along with a five-year profit forecast, includes valuation metrics and an ESG (environmental social and governance) rating; companies under coverage are reviewed at least semi-annually. EP's analysis has shown that above-average real returns can be delivered when companies are purchased at a Y5 P/E below 11x. Historically, the average Y5 P/E of EUT's portfolio has ranged between 7x and 11x; it is currently close to the high end of the range. EUT is a relatively concentrated portfolio of 35-45 holdings; the manager explains that when equity valuations are lower there tends to be a higher number of holdings, as there are more investment opportunities available. When valuations are high, he finds it easier to sell positions rather than buy, so portfolio concentration tends to rise. Given EUT's disciplined valuation-driven process, there may be periods when the trust lags the performance of the benchmark; as a result, investors should be prepared to have a long-term investment horizon.

Exhibit 3: Value has outperformed in the long term, but underperformed in recent years



Source: Thomson Datastream, Edison Research. Note: 5 June 1977 to 5 June 2017.

Exhibit 3 shows that value stocks have outperformed over the longer term but in recent years have lagged the performance of growth stocks. The manager notes that style shifts do not last forever and in H216, there was a definite shift as cyclical and value stocks outperformed growth stocks in an environment of rising bond yields. This shift has contributed towards EUT's improved near-term investment performance.

Current portfolio positioning

At end-April 2017, EUT's top 10 positions comprised 34.5% of the portfolio, which was a modest decrease in concentration versus 36.6% at end-April 2016. As shown in Exhibit 4, given EUT's bottom-up valuation approach, its sector exposures differ markedly from the benchmark.

Exhibit 4: Portfolio sector exposure vs benchmark (% unless stated)

	Portfolio end-April 2017	Portfolio end-April 2016	Change (pp)	Index weight	Active weight vs index (pp)	Trust weight/ index weight (x)
Industrial goods & services	19.6	14.6	5.0	11.9	7.7	1.6
Banks	17.0	15.0	2.0	13.7	3.3	1.2
Healthcare	12.9	9.7	3.2	13.1	(0.2)	1.0
Oil & gas	11.1	13.8	(2.7)	4.4	6.8	2.6
Telecoms	7.1	4.6	2.5	3.7	3.4	1.9
Retail	5.0	3.3	1.7	2.8	2.2	1.8
Technology	4.9	8.9	(4.0)	4.7	0.3	1.1
Automobiles & parts	3.9	3.2	0.7	4.4	(0.5)	0.9
Chemicals	3.5	3.2	0.3	7.2	(3.7)	0.5
Personal & household goods	3.0	3.0	0.0	7.1	(4.1)	0.4
Travel & leisure	2.9	2.9	0.0	0.5	2.4	6.3
Utilities	2.3	3.4	(1.1)	3.5	(1.2)	0.6
Basic resources	1.9	3.3	(1.4)	1.2	0.7	1.6
Financial services	1.9	5.8	(3.9)	1.6	0.3	1.2
Media	1.7	2.9	(1.2)	1.8	(0.1)	1.0
Construction & materials	0.0	0.0	0.0	3.4	(3.4)	0.0
Food & beverage	0.0	0.0	0.0	7.7	(7.7)	0.0
Insurance	0.0	4.9	(4.9)	5.8	(5.8)	0.0
Real estate	0.0	0.0	0.0	1.5	(1.5)	0.0
Cash & others	1.3	(2.5)	3.8	0.0	1.3	N/A
	100.0	100.0		100.0		

Source: The European Investment Trust, Edison Investment Research

The manager has a positive outlook for the banking sector; he suggests that banks are in a 'positive direction of travel' having rebuilt their balance sheets, and offer attractive dividend yields. He argues that the degree of digital penetration versus bricks and mortar exposure is key. EUT has a bias to those banks that have advanced digital development, such as BBVA, ING and the Nordic banks, which had their crises in the 1990s and, the manager comments, are always at the forefront of development.

Armour is also confident in the outlook for the healthcare sector; EUT has holdings in BB Biotech, Novartis, Sanofi, and Roche. He comments that the sector was affected by pricing concerns ahead of the US election and that healthcare companies need to be innovative or address unmet medical needs. However, he says that research and development productivity has increased and in recent years the drug companies have negotiated a patent cliff and have worked to rebuild their product pipelines. He believes that there is the potential for a sharp uptick in the sector's earnings.

Two relatively new positions in EUT's portfolio are Airbus and Gemalto. For Airbus, the manager felt that investors were fixated with short-term issues including losses on its A350 and A400 programmes, near-term book-to-bill ratios and problems with Pratt & Whitney's geared turbofan on its key A320 programme. He says that newer programmes were absorbing cash but the A350 is now in production, as is the A320 Neo, which, along with stemming losses from older programmes are positive for Airbus's cash flow generation. Armour says that the company's order books stretch for the next seven to eight years, helped by high demand from Asia where intra-Asian air traffic is growing rapidly, partly due to the growing middle class. The manager says that he is not concerned if Airbus's short-term book-to-bill ratio is less than 1x, given the strong long-term order book.

Gemalto is a Dutch technology company focusing on digital security. Products include smart cards and tokens, and Gemalto is the world's largest manufacturer of SIM cards. The company has a mixture of structurally growing and more mature businesses, which means that order flow can be lumpy. This results in short-term share price volatility; however, the manager says that Gemalto is a world leader and is well positioned over the long term. The company has indicated that Q217 was a trough and it expects revenue to improve in H217. Its recent acquisition of 3M's identity management business for $850m, which includes a full spectrum of biometric solutions, is expected to be accretive to earnings in the first year following acquisition.

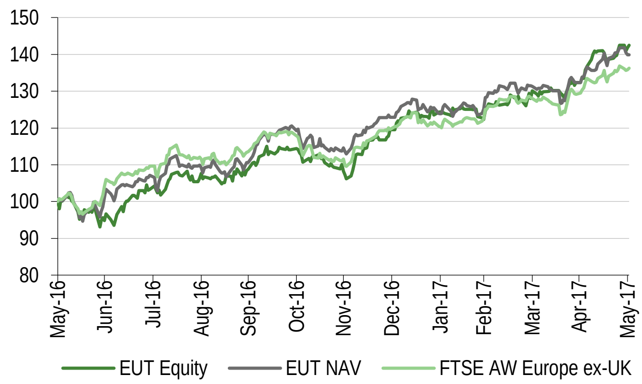
Recent disposals in the portfolio have mainly been due to extended valuations, such as SAP (a German software and service provider that was trading on a Y5 P/E of 13.8x) and Hexagon (a Swedish technology company that was trading on a Y5 P/E of 13.2x). Other disposals include Italian financial company Unipol Gruppo Finanziario, which was trading of a Y5 P/E of 11.5x; the manager suggests that although its insurance business is satisfactory, its banking subsidiary is likely to require a rights issue, which offers investors an unfavourable risk/reward outlook.

Performance: Improving over the near term

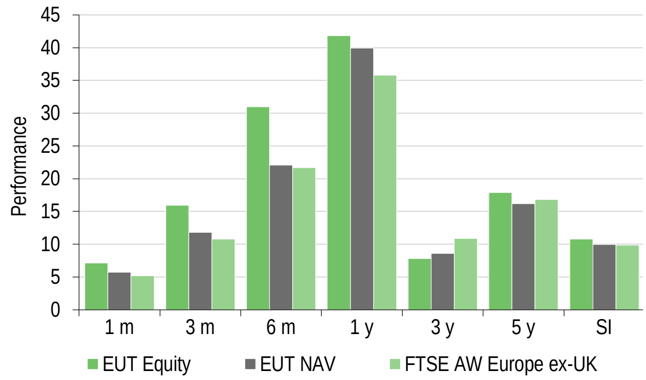
Exhibit 5 (right-hand side) shows absolute returns; the one year numbers have been boosted significantly by the weakness of sterling (over the last 12 months the euro has strengthened by more than 10% versus the pound). Over the last year, EUT's share price and NAV total returns of 41.8% and 39.9%, respectively, are ahead of the benchmark's 35.8% total return. In recent months, positive contributors to performance include Leoni (a German industrial company), Telefonica (a Spanish telecom company) and Ubisoft Entertainment (a French video game developer).

Exhibit 5: Investment trust performance to 30 April 2017

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



Price, NAV and benchmark total return performance (%)



Source: Thomson Datastream, Edison Investment Research. Note: SI is since inception (1 February 2010). Three, five and SI performance figures annualised.

EUT's relative returns are shown in Exhibit 6. Its NAV total return is ahead of the benchmark over one year and marginally so since EP took over management of the trust in February 2010. Of interest to UK-based shareholders, EUT's total return is meaningfully ahead of the FTSE All-Share Index total return over one and five years, while more modestly ahead over three years.

Exhibit 6: Share price and NAV total return performance, relative to indices (%)

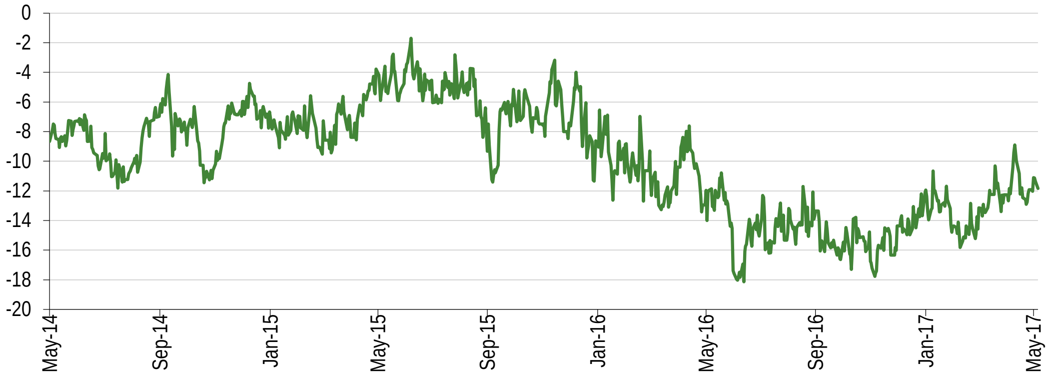
	One month	Three months	Six months	One year	Three years	Five years	SI
Price relative to FTSE AW Europe ex-UK	1.9	4.6	7.6	4.4	(8.0)	4.7	6.3
NAV relative to FTSE AW Europe ex-UK	0.5	0.9	0.3	3.0	(6.0)	(2.7)	0.8
Price relative to FTSE All-Share	2.7	10.2	15.3	13.9	0.1	28.3	5.5
NAV relative to FTSE All-Share	1.3	6.2	7.5	12.4	2.2	19.2	0.1
Price relative to MSCI World	4.6	14.6	19.5	7.4	(19.7)	3.5	(17.8)
NAV relative to MSCI World	3.2	10.5	11.4	6.0	(18.0)	(3.8)	(22.1)

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-April 2017. Geometric calculation.

Discount: Recent narrowing trend

EUT's current 11.8% share price discount to cum-income NAV is narrower than the 14.1% average discount of the last 12 months (range of 8.9% to 18.1%). It compares to the averages of the last three, five and 10 years (range of 9.8% to 12.9%). Since December 2016, there has been a noticeable narrowing of the discount from c 18% to the current c 12% level.

Exhibit 7: Share price premium/discount to NAV (including income) over three years (%)



Source: Thomson Datastream, Edison Investment Research

Capital structure and fees

EUT is a conventional investment trust with one class of share; there are currently 42.0m ordinary shares outstanding. The trust has authority to buy back up to 14.99% or allot up to 5% of shares to manage a discount or premium. As shown in Exhibit 1, in recent years, share repurchases have been very modest. A new €30m overdraft facility with Northern Trust was announced in February 2016, available until further notice. At end H117 (March 2017), €12.5m had been drawn down, which represented gross gearing of 2.6% of net assets. However, by end-April 2017, EUT had moved into a net cash position of 1.3%.

EP receives an annual management fee of 0.55% of EUT's market cap; no performance fee is payable. Ongoing charges in FY16 were 0.62%, which was a 1bp reduction versus the prior financial year. EUT's ongoing charge is the lowest of all of its peers in the AIC Europe sector (see Exhibit 8), c 30bp lower than the sector weighted average.

Dividend policy and record

EUT's primary focus is capital growth rather than income, but ordinary annual dividends have grown or been maintained since 2009, with a compound annual growth rate of 6.64%. Dependent on the level of income, EUT also regularly pays out special dividends (see Exhibit 1).

The 16p ordinary annual dividend paid in FY16 was a 14.3% increase versus the prior financial year and was c 1.2x covered by income. If special dividends are also taken into account, the FY16 total dividend of 22p was a 27.5% increase on the 16p total dividend paid in FY15 (3p of the FY16 dividend was from a French withholding tax reclaim). At the last financial year end, EUT had revenue reserves of £12.3m, which is equivalent to 29p per share.

Historically, EUT paid dividends once a year in January. However, following a review by the board, an interim dividend will also be paid in July (the first payment will be made in July 2017). The interim dividend will be 9.5p – a regular dividend of 8.0p plus a special dividend of 1.5p as a result of a further French withholding tax reclaim. EUT's current dividend yield (including special dividends) is 2.4%.

Peer group comparison

Exhibit 8 shows the members of the AIC Europe sector. EUT's performance over one year is significantly improved since our last note published in October 2016. Its NAV total return now ranks first, rather than last within the peer group, 5.1pp ahead of the weighted average and 2.2pp ahead of the second-ranked trust. However, EUT's NAV total performance still lags the peers over three and five years by some margin. The trust trades at one of the widest discounts in the group, but has the most competitive ongoing charge, by a meaningful c 30bp, and no performance fee is payable. Although EUT has a focus on capital growth rather than income, its dividend yield is the second highest in the peer group.

Exhibit 8: AIC Europe peer group as at 5 June 2017*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	Discount (ex-par)	Ongoing charge	Perform. fee	Net gearing	Dividend yield (%)
The European Investment Trust	386.5	40.6	28.9	117.7	(9.9)	0.6	No	99	2.4
BlackRock Greater Europe	303.8	29.8	40.1	129.1	(3.3)	1.1	No	100	1.7
Fidelity European Values	917.6	35.7	47.9	129.9	(6.8)	1.0	No	103	1.9
Henderson European Focus Trust	288.9	37.7	50.1	171.3	3.2	0.9	Yes	108	1.9
Henderson EuroTrust	240.5	36.1	49.9	155.9	(4.3)	0.9	Yes	106	1.9
JPMorgan European Growth Pool	232.0	35.5	44.6	150.2	(11.7)	1.1	No	108	2.3
JPMorgan European Income Pool	153.3	38.4	47.3	159.6	(6.8)	1.1	No	109	3.1
Jupiter European Opportunities	779.9	33.3	63.3	163.4	(2.1)	1.0	Yes	113	0.8
Weighted average		35.5	48.7	144.6	(5.0)	0.9		106	1.8
EUT rank in sector	3	1	8	8	8	8		8	2

Source: Morningstar, Edison Investment Research. Note: *Performance data to 2 June 2017. TR=total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

The board

Following the retirement of chairman Douglas McDougall at the January 2017 AGM, there are currently four directors on the board of EUT; all are non-executive and independent of the manager. Chairman Michael MacPhee was appointed in January 2016. The other three board members and their year of appointment are: Senior Independent Director Michael Moule (2004), William Eason (2007) and Dr Michael Woodward (2013). All directors have backgrounds in investment management and investment trusts.

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