TR European Growth Trust

Diversified approach to small-cap Europe

Investment trusts

TR European Growth Trust (TRG) is an established investment trust investing in small and mid-sized continental European companies. Managed by Ollie Beckett at Henderson Global Investors since July 2011 (assisted by Rory Stokes from 2013), its principal aim is to achieve capital growth, although it also has a long record of year-on-year dividend growth. TRG has a longer stock list than its peers, driven by its focus on companies further down the market capitalisation spectrum, where greater diversification may be advised. This focus on the smaller end of the market (as well as a small exposure to unquoted companies) means performance may diverge from that of the benchmark; the trust has outperformed the Euromoney Smaller Europe ex-UK index in four of the last five 12-month periods to 30 September in both NAV and share price total return terms.

12 months ending	Share price (%)	NAV (%)	Euromoney Smaller Europe ex-UK (%)	FTSE World Europe ex-UK (%)	FTSE All-Share (%)
30/09/11	(16.7)	(19.1)	(13.9)	(13.6)	(4.4)
30/09/12	7.7	9.1	5.8	12.6	17.2
30/09/13	52.2	41.7	37.4	28.3	18.9
30/09/14	11.3	9.4	6.7	6.2	6.1
30/09/15	9.9	10.4	5.8	(1.2)	(2.3)

Source: Thomson Datastream. Note: Total return basis.

Investment strategy: Focus on value and growth

TRG's managers, Ollie Beckett and Rory Stokes, seek to build a diversified portfolio of European small and mid-cap companies where growth or recovery potential is not currently reflected in valuations. The universe is large and the managers make use of quantitative screens as well as c 600 manager meetings and calls per year in order to identify compelling investment ideas. The portfolio is a mix of structural growth companies that can perform throughout an economic cycle, and shorter-term, more opportunistic holdings, although turnover is moderate at c 40% a year. There is a focus on mature Western European markets.

Market outlook: Sentiment in the balance

Fear currently outweighs greed in most markets, with investors still focused on downside risks following the China-led sell-off in late summer and continued declines in commodity-related sectors. However, many countries in Europe are seeing ongoing economic improvements, and the more domestically focused small-cap sector has held up better than European large-caps year-to-date.

Valuation: Discount within medium-term range

At 27 October, TRG's shares were trading at an 11.3% discount to cum-income net asset value. While significantly wider than the 12-month low of 6.4% seen in mid-August, this was still within medium-term ranges, and compares with average levels of 10.9%, 13.0% and 15.3% over one, three and five years respectively. The manager points out that appetite for European smaller company investment is highly dependent on the economic outlook, suggesting potential for the current discount to narrow again if worries about the global economy recede.

29 October 2015

Price	**586.0p**
Market cap	**£292.9m**
AUM	**£373.8m**

NAV*	660.4p
Discount to NAV	11.3%
NAV**	660.8p
Discount to NAV	11.3%

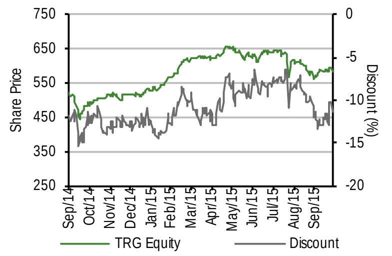
*Excl income. **Incl income. Data at 27 October 2015.

Yield*	1.6%

*Includes special dividend

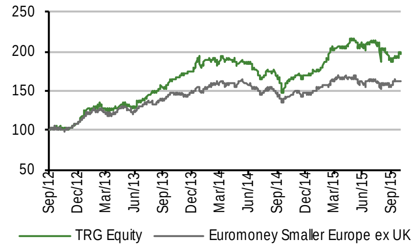
Ordinary shares in issue	49.98m
Code	TRG
Primary exchange	LSE
AIC sector	European Smaller Cos

Share price/discount performance*



*Including income. Negative values indicate a discount; positive values indicate a premium.

Three-year cumulative perf. graph



52-week high/low	658.0p	482.0p
NAV* high/low	729.1p	553.8p

*Including income.

Gearing

Gross	15.0%
Net	15.0%

Analysts

Sarah Godfrey +44 (0)20 3681 2519
Andrew Mitchell +44 (0)20 3681 2500
investmenttrusts@edisongroup.com

Edison profile page

TR European Growth Trust is a research client of Edison Investment Research Limited

Exhibit 1: TR European Growth Trust at a glance

Investment objective and trust background

TR European Growth Trust's objective is to achieve capital growth by investing in smaller and medium-sized companies in Europe (ex-UK). It aims to achieve a net asset value total return in excess of the benchmark Euromoney Smaller Europe ex-UK index (in sterling terms).

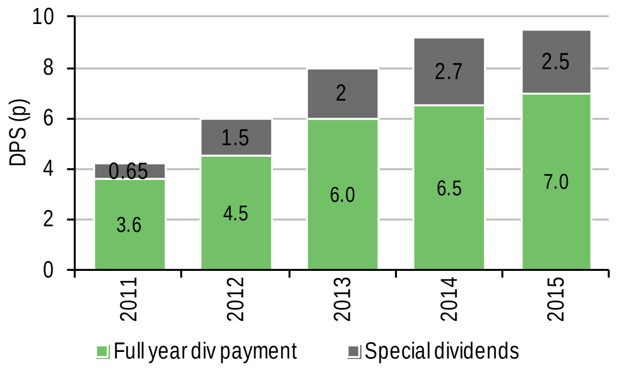
Recent developments

- 29 September 2015: final results for the year ended 30 June. NAV TR +5.3%, versus -0.4% for benchmark. Share price TR +10.8%.
- 23 February 2015: half-year results for the six months ended 31 December. NAV TR -8.4% versus -8.0% for the benchmark.

Forthcoming		Capital structure		Fund details	
AGM	November 2015	Ongoing charges	0.78%	Group	Henderson Global Investors
Half-year results	February 2016	Net gearing	15.0%	Manager	Ollie Beckett, Rory Stokes
Year end	30 June	Annual mgmt fee	0.6% (see p10)	Address	201 Bishopsgate, London, EC2M 3AE
Dividend paid	November	Performance fee	Yes (see p10/11)		
Launch date	1990	Trust life	Indefinite	Phone	020 7818 6825
Continuation vote	Three-yearly, next 2016	Loan facilities	£50m overdraft (see p10)	Website	www.treuropeangrowth.com

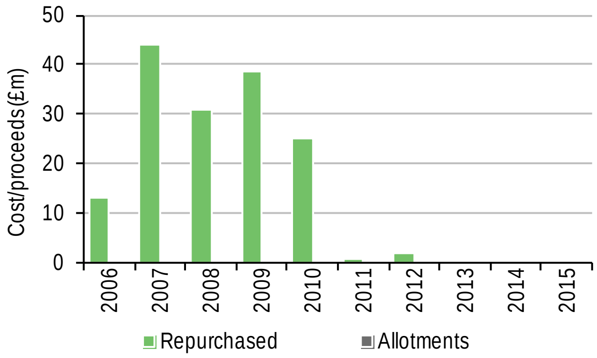
Dividend payments

Dividends paid annually in November. While TRG's primary objective is to achieve capital growth, the board also hopes to maintain and grow the ordinary dividend. Note: 2015 dividend pending shareholder approval at AGM.

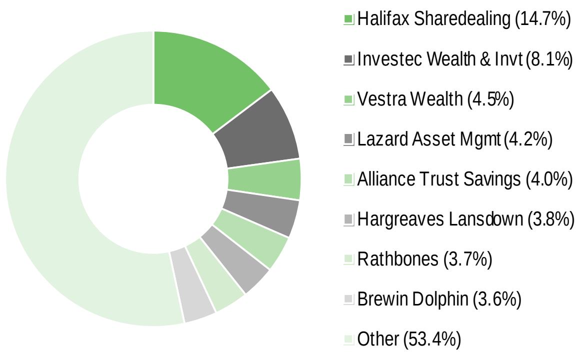


Share buyback policy and history

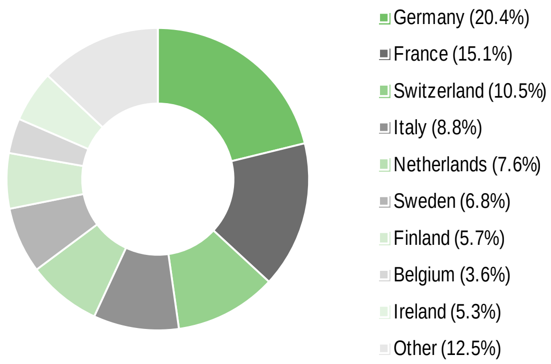
TRG has the authority, renewed annually, to buy back up to 14.99% of shares. At the 2010 AGM a requirement to buy back shares if the discount breached 10% was removed, and all buybacks are now at the board's discretion.



Shareholder base (as at 1 July 2015)



Geographical breakdown of portfolio (as at 30 September 2015)



Top 10 holdings as at end September

			Portfolio weight %	
Company	Country	Sector	30 September 2015	31 March 2015*
Brainlab**	Germany	Medical technology	2.7	2.4
OC Oerlikon	Switzerland	Industrial technology	1.8	1.9
Cie d'Entreprises CFE	Belgium	Diversified industrials	1.7	1.5
Verkkokauppa.com	Finland	Online retailer	1.6	1.4
Nobia	Sweden	Kitchens	1.5	N/A
Faiveley Transport	France	Railway equipment	1.5	N/A
Van Lanschot	Netherlands	Private bank	1.4	N/A
Europcar Groupe	France	Vehicle hire	1.4	N/A
Origin Enterprises	Ireland	Agricultural services	1.3	N/A
Aareal Bank	Germany	Bank	1.3	N/A
Top 10 (% of portfolio)			16.2	16.2

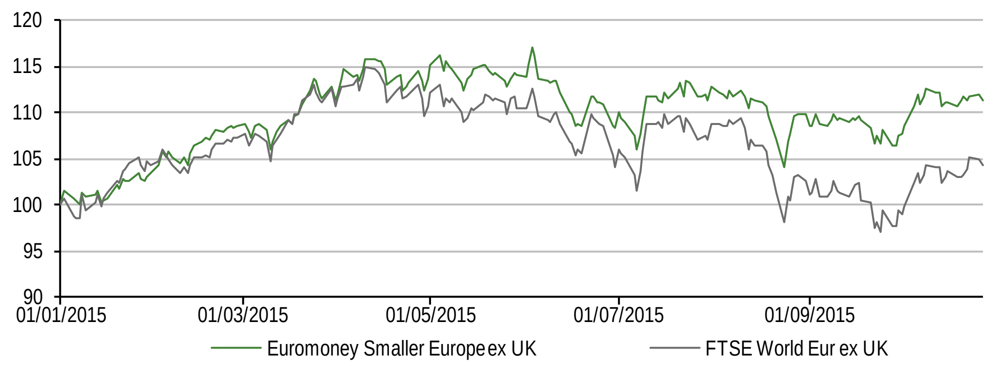
Source: TR European Growth Trust, Edison Investment Research, Morningstar, Bloomberg. Note: *Top 10 – N/A where not in top 10 at end March 2015. **Unquoted investment.

European equity outlook

Having started the year brightly following the introduction of quantitative easing in the Eurozone by the European Central Bank, European markets wobbled in early summer as the Greek debt crisis threatened to derail the common currency area, and sold off again in late summer as fears over China's future growth path spilled over into global markets.

Interestingly for an area of the market that is seen as more vulnerable to changes in investor sentiment, European smaller companies – which had performed largely in line with large-caps until April – have held up better during the recent volatility, with total returns still positive year-to-date (to 27 October) for the Euromoney Smaller Europe ex-UK index, while the broader FTSE World Europe ex-UK index is marginally underwater over the same period (Exhibit 2).

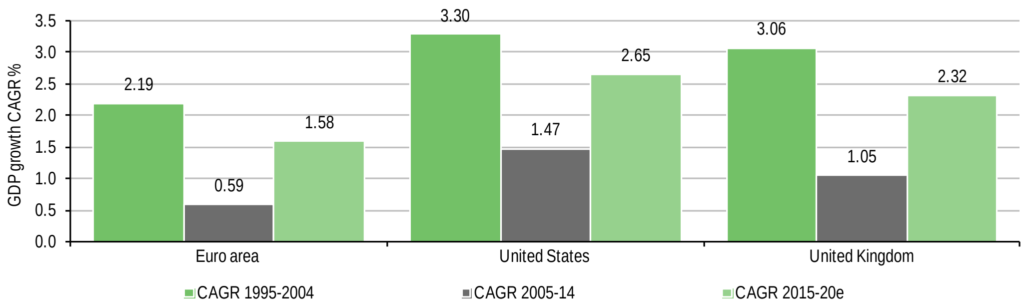
Exhibit 2: European small-cap vs large-cap performance, 2015 to 27 October



Source: Thomson Datastream. Note: Sterling-adjusted, total return indices, rebased to 100.

Underlying the recovery in European markets is an expected improvement in economic growth (Exhibit 3); Europe was hit harder than the US or UK by the recessionary impact of the global financial crisis, but austerity programmes in peripheral nations such as Ireland, Italy and Spain – while undoubtedly painful for the local population – have proved economically beneficial and these economies are recovering well. Domestic economic improvements tend to feed into positive performance for smaller companies, which are often less exposed to global factors than their larger brethren.

Exhibit 3: GDP growth by market/region, 1995-2020



Source: International Monetary Fund, World Economic Outlook April 2015

Although liquidity from quantitative easing programmes in the US, UK, Europe and Japan has almost certainly found its way into equity markets, pushing some indices to new long-term highs earlier in the year, forward P/E valuations in most cases (with the exception of the UK) are slightly below long-term averages (Exhibit 4), and range from 35% to 50% short of 20-year peak levels, with Europe ex-UK being furthest from peak valuations. While any mood of optimism regarding valuations should be measured against the ongoing presence of destabilising factors (uncertainty over the pace, timing and wider effects of US and UK interest rate rises, the slowdown in China, and geopolitical concerns such as how Europe will absorb the large numbers of refugees and migrants arriving from Syria, the Middle East and Africa), dividend yields of 2.2-3.6% provide a degree of compensation when interest rates in Western economies are still close to the zero bound.

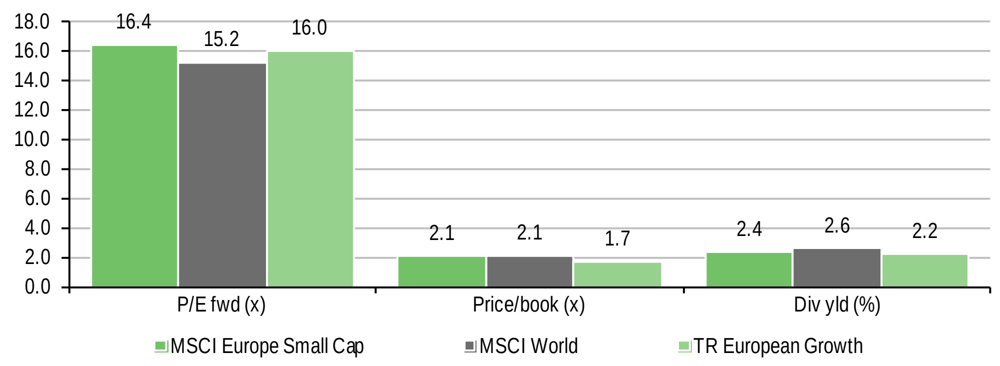
Exhibit 4: Global market valuations (12-month forward P/E) and dividend yields

Index	12m fwd P/E	20y high	20y low	20y ave	Last as % of ave	Dividend yld %
Europe ex-UK	12.8	24.8	7.7	13.9	92%	3.2
EU	13.8	24.0	7.6	14.1	98%	3.2
UK	14.3	21.9	7.5	13.8	103%	3.6
US	15.5	26.0	9.3	16.7	93%	2.2
World	13.7	24.9	8.8	15.5	89%	2.7

Source: Thomson Datastream, Edison Investment Research. Note: Data to 30 September 2015, uses Datastream indices.

Looking at European small-caps in a global context (Exhibit 5, using a different set of indices from the large-cap measures in Exhibit 4), it is clear that forward P/E valuations are some way above the world average – arguably in recognition of the greater growth potential of smaller companies – although other valuation measures are broadly in line.

Exhibit 5: Valuation metrics for European small-caps versus the world



Source: MSCI, TR European Growth Trust, Edison Investment Research. Note: Figures at 31 August.

In the very short term, further market volatility is to be expected. It may take some time to gain a fuller understanding of the scale of any threat to the global economy from a slowing China and normalising interest rates in the West. If the threats prove to be less severe than implied by the current climate of fearfulness however, smaller companies in areas of economic improvement could rally. Given the level of uncertainty, a diversified and valuation-focused investment approach could provide a measure of downside protection, although investors should bear in mind the risks should the bears be proved correct in the longer term.

Fund profile: Established European small-cap specialist

TR European Growth Trust (TRG) was launched in September 1990, originally under the management of Touche Remnant (TR). In 1992 TR was acquired by Henderson Global Investors, and since then the board has continued to subcontract the management to Henderson. From 1 July 2011 the portfolio has been managed by Ollie Beckett, assisted by Rory Stokes as deputy manager since 2013. Beckett (again with Stokes) is also manager of the €540m Henderson Horizon Pan European Smaller Companies SICAV, which he has run since 2005. TRG pursues long-term capital growth by investing in a diversified portfolio of small and mid-sized companies in Europe (excluding the UK). Income is a secondary consideration, although the board aims to achieve year-on-year growth in dividends. The trust is benchmarked against the Euromoney Smaller Europe ex-UK index, but is biased towards the smaller end of the market, with 89.5% of the portfolio (at the 30 June 2015 year end) held in companies with market capitalisations of £2bn or less.

The fund managers: Ollie Beckett and Rory Stokes

The managers' view: Balancing value and momentum

The managers appreciate the economic sensitivity of smaller companies, and focus the portfolio differently according to their reading of the economic cycle. Describing the cycle as a four-stage process of expansion, slowdown, recession and recovery, Beckett argues that Europe is currently in the recovery phase, at which stage he favours the smaller end of the size spectrum, a tilt to value rather than growth, and less of an emphasis on quality than would be necessary in a recessionary phase.

The stimulative effects of Eurozone quantitative easing may be pushing the cycle ahead into the expansionary phase, as suggested by the momentum style of investing having dominated returns so far in 2015. With the market having been driven by earnings upgrades and multiple expansion, Beckett and Stokes have reservations over the level of some P/E multiples, and are adding to companies where they believe valuations have become too cheap. They note that if the slowdown in China is less bad than the consensus fear, or if there is a recovery in commodity prices, those investors who have gone all-out for momentum will find themselves in the wrong place.

The portfolio does have exposure to growth situations, such as recent IPOs from Europcar and OVS, but also out-of-favour, undervalued stocks such as Irish agricultural services company Origin and Swiss travel services specialist Kuoni. The managers' focus on value is vindicated by examples such as Danish ferry operator DFDS and German advertising company Ströer Out of Home Media, which were bought when they were "hated by everyone" but now have significant momentum, with share prices up 132% and 193% respectively in local currency terms over 12 months to 1 October.

In spite of these significant successes and concerns over aggregate valuation levels, the managers still see better performance potential from Europe versus other markets (they point to earnings growth since 2007 of 90% in the US and 75% in the UK, but only 8% in Europe), and within that, expect more upside from smaller than larger companies.

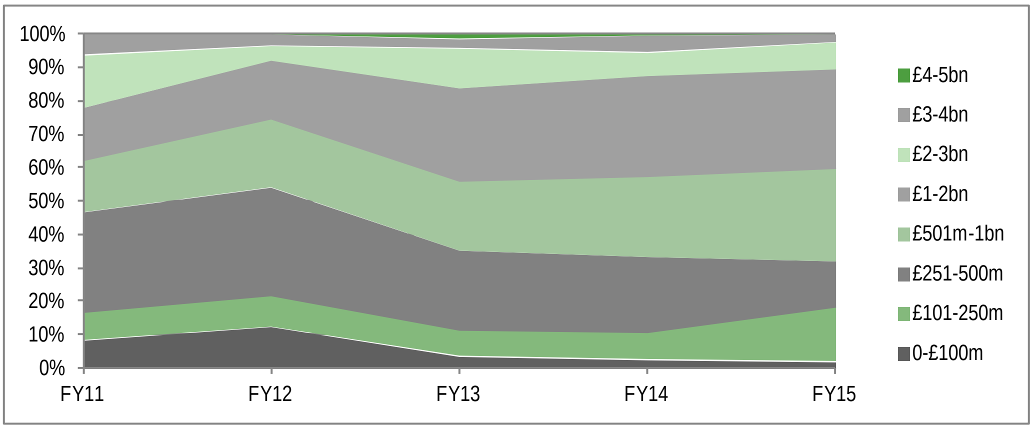
The recent global market turmoil has seen investors' attention more focused on risks than rewards, but Beckett and Stokes remain optimistic about the economic outlook, arguing that fears over a Chinese slowdown may be founded in the past rather than the future, with some measures of consumption such as car sales (particularly of Chinese-made cars) providing encouraging data. For this reason gearing on the portfolio is being maintained at c 10-15%, with the managers saying they would only be completely ungeared in a clear economic downturn.

Maintaining a true small-cap focus

Lead manager Beckett took over the TRG portfolio in July 2011 from Stephen Peak. While Beckett is a small and mid-cap specialist, Peak had a more general focus, and TRG's portfolio was more multi-cap as a result, including large stocks such as Volkswagen and Fresenius Medical Care that are no longer held. Beckett began rebalancing the portfolio towards the smaller end of the market (Exhibit 6 tracks the positioning of the portfolio from to 30 June 2011 year-end to the 30 June 2015 year-end), and TRG is now 89.5% invested in sub-£2bn companies, compared with 77.9% at FY11.

The managers say the 'sweet spot' in terms of company size at present is the c £800m range. At the larger end of the small to mid-cap market, valuations have become stretched due to large-cap fund managers venturing down the size scale in search of greater growth potential, while in micro-caps (where TRG has significant exposure) the managers see value relative to cash and bonds, but say the key to realising this value is for the wider market to have greater faith in European economic recovery than is currently in evidence. "Our view is that Europe is still getting better, although not in a hurry," says Beckett.

Exhibit 6: Portfolio breakdown by market capitalisation, 2011-2015



Source: TR European Growth Trust, Edison Investment Research

Asset allocation

Investment process: Value-driven, contrarian approach

Ollie Beckett and assistant manager Rory Stokes are part of the well-resourced European equities team at Henderson Global Investors, which manages assets of £8-9bn and covers the spectrum of European companies, from micro to mega-cap. Henderson has grown through acquisition over the past decade and the team includes former Gartmore and New Star managers, ensuring a range of investment styles, including strategies based on quantitative analysis, as well as those that use more fundamental, bottom-up methods of stock selection.

Beckett and Stokes's ultimate aim is to create a portfolio of stocks where misperceptions have led to undervaluation. In order to narrow down the universe of more than 1,000 small and mid-cap European companies, they use the screening techniques employed by the quant team as well as the Holt analysis tool to generate ideas and as a valuation 'sense check'. The managers make only limited use of sell-side research, preferring to generate their own ideas and building simplified valuation models to understand the factors driving a company's performance. No one valuation measure can provide all the answers, the managers say, so they take into account a range of metrics such as price/earnings ratios, EV/EBITDA, free cash flow and dividend yield. Meetings with management are fundamental to the process, with more than 600 face-to-face or telephone interactions taking place each year. These meetings help the managers to understand each business, looking at the quality of the management, the robustness of the business model and how well it can defend itself against threats, such as a change in the competitive landscape, customer behaviour or the supply chain. Having identified undervalued companies, one of the principal benefits of interacting directly with the management is the ability to gain an understanding of what might change, in order to drive a rerating for the stock.

Positions are sized according to conviction, and TRG's stock list is longer than those of its peers (c 150 stocks versus 45-65 for the other three funds in the peer group) because of its greater focus on the smaller, less liquid end of the market and the resultant need to ensure diversification. The managers also take account of top-down factors such as the oil price and currency exchange rates (the trust does not use currency hedging at present), and work with Henderson's risk team to ensure there are no unintended biases in the portfolio.

The managers describe the investment style as bottom-up driven, with a value/contrarian slant and a current tilt towards companies exposed to domestic markets, rather than the more uncertain emerging economies. However, they point to the need to anticipate change, which may lead them to take early positions in out-of-favour areas: with liquidity more of a challenge in smaller companies, investors who wait for evidence of a turning point may find themselves unable to build a meaningful position at an acceptable valuation. Turnover is moderate at c 40% a year, implying a holding period of two-and-a-half years. Within this however, there will be core, long-term holdings and those that are more overtly cyclical.

While the focus is on the smaller end of the market, where companies may be less well known, TRG's portfolio is not geographically esoteric, preferring to focus on mature Western European markets. Geography is defined by a company's domicile rather than the location of its listing (for instance, the portfolio contains a couple of European companies quoted on the NASDAQ exchange).

Stocks may be sold if they reach valuation targets, if better opportunities arise elsewhere, or if deteriorating fundamentals call the original investment thesis into question. The managers point out that one bad quarter is rare, and that it can be better to exit a poorly performing stock early rather than holding on for an upturn and incurring further losses. While TRG would not take a new position in a stock with a market capitalisation above £5bn, it does not have to sell existing holdings when they reach a certain size.

Unquoted investments

TRG has three positions in unquoted investments, all of which are legacy positions from before the current managers' tenure. The largest holding, Brainlab, is a management-controlled German company focused on surgical and therapeutic technologies principally for brain tumours. There are also smaller positions in two private equity funds – 21 Centrale Partners (0.9% of portfolio at FY15), which is in the process of realisation, and Doughty Hansen & Co Fund III (0.1% of portfolio at FY15), which holds one asset involved in outsourcing for wind turbine manufacture. All of these holdings are currently valued at below their acquisition cost, although as the valuations are subject to an illiquidity discount, this should not be taken as evidence of poor performance. TRG's managers are looking to maximise shareholder value from Brainlab if a buyer can be found, and say they do not intend to make any further investments in unquoted companies.

Current portfolio positioning

At 30 September 2015 TRG had 148 holdings. This is a substantially longer stock list than any of its peers, which all own between 45 and 65 companies. Because of its broadly diversified portfolio, TRG's individual position sizes also tend to be smaller than those of its peer group (the largest quoted holding, OC Oerlikon, is 1.8% of the portfolio) and its top 10 stocks make up only 16.2% of the total, compared with an average of 28.7% for the three peers.

Prior to Beckett's tenure as manager, TRG had quite a broad interpretation of 'Europe', straying into markets that might be more generally thought of as Middle Eastern or Central Asian. Now the focus is firmly on mature Western European markets (Exhibit 7), with the largest exposures to Germany, France and Switzerland (all overweight versus the Euromoney Smaller Europe ex-UK benchmark). The managers see somewhat divergent economic outlooks across Europe, with Ireland, Spain and Italy growing following a period of austerity, the Netherlands improving, Germany stagnating and France quietly defying persistently negative perceptions. Beckett says that while the decline in GDP growth in Germany is mildly disappointing, the trust remains structurally overweight Germany and Switzerland. There is a small exposure to Greece through Aegean Airlines and industrial conglomerate Mytilineos. The high weighting to France – including mass-market housebuilder Nexity and broadcaster TF1 – partly reflects the managers' contrarian positive view of the French economy.

In sector terms there is a large weighting to industrials and also an overweight to technology (Exhibit 8). The managers note that the industrials sector is heterogeneous, with companies operating in many different areas and a significant overlap with technology. With European small-caps tending to do best in periods of economic recovery (see the managers' view section), the portfolio has a pro-cyclical bias. There is currently an underweight to healthcare (a sector not separately identified in the Euromoney indices), following the sale of life science tools company Stratec and the takeover of asthma specialist Aerocrine by an American company.

Exhibit 7: Exposure by country (% unless stated)

	Portfolio end Sept 2015	Portfolio end Mar 2015	Change from Mar (% pts)	Benchmark weight*	Active weight vs index (% pts)	Trust weight/ index weight (x)
Germany	20.4	20.1	0.3	14.4	6.0	1.4
France	15.1	13.5	1.6	13.1	2.0	1.2
Switzerland	10.5	12.3	-1.8	10.1	0.4	1.0
Italy	8.8	12.5	-3.7	12.8	-4.0	0.7
Netherlands	7.6	7.1	0.5	N/S	N/A	N/A
Sweden	6.8	3.9	2.9	12.1	-5.3	0.6
Finland	5.7	5.2	0.5	4.7	1.0	1.2
Ireland	5.3	N/S	N/A	N/S	N/A	N/A
Denmark	3.7	N/S	N/A	N/S	N/A	N/A
Belgium	3.6	3.6	0.0	4.5	-0.9	0.8
Other	12.5	21.8	-9.3	28.3	-15.8	0.4
	100.0	100.0	0.0	100.0	0.0	

Source: TR European Growth Trust, Edison Investment Research. Note: *Benchmark is Euromoney Smaller Europe ex-UK index. N/S: not separately stated; included in 'other'.

The managers point to Swiss industrial stock OC Oerlikon as a good example of how they run the trust, seeking to exploit market misperceptions. The company makes equipment for the textiles industry and for the coating of metal components for car manufacture and other applications. It has been out of favour for several reasons: the main markets for its textiles equipment are India and China, where concerns over economic growth have affected sentiment; it has a large Russian shareholder which the market has speculated may wish to raise money; and when Beckett first bought the holding in 2011, it had a solar energy business, which was a very unpopular sector at the time. But having divested the solar business as well as the lower-return natural fibres machinery business, Oerlikon has focused on higher-growth synthetic fibres and metal coatings, and the managers say that at some point they expect the market to begin to appreciate that "there are two world-class businesses underneath the messy Swiss conglomerate with a Russian shareholder". The shares sold off heavily in August and are down 18.8% over two months to 5 October.

Exhibit 8: Sector allocations (% unless stated)

	Portfolio end Sept 2015	Portfolio end Mar 2015	Change from Mar (% pts)	Benchmark* weight	Active weight vs index (% pts)	Trust weight/ index weight (x)
Industrial goods	27.2	26.5	0.7	14.7	12.5	1.9
Technology	12.7	15.0	-2.3	7.6	5.1	1.7
Basic materials	12.5	12.5	0.0	9.8	2.7	1.3
Retail providers	7.3	6.5	0.8	7.9	-0.6	0.9
Natural resources	1.2	1.5	-0.3	1.9	-0.7	0.6
Consumer goods	13.0	10.0	3.0	17.0	-4.0	0.8
Business providers	11.5	13.5	-2.0	18.4	-6.9	0.6
Financials	14.6	14.5	0.1	22.7	-8.1	0.6
	100.0	100.0	0.0	100.0	0.0	

Source: TR European Growth Trust, Edison Investment Research. Note: *Benchmark is Euromoney Smaller Europe ex-UK index. Ranked by active weight. End-March weightings are approximate.

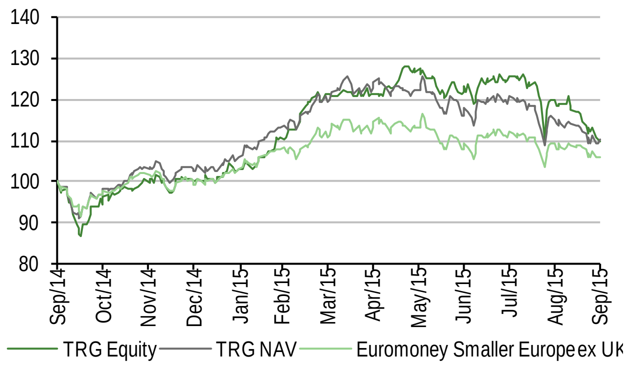
The managers are active in the IPO market and in the past year have bought into car hire firm Europcar and Italian clothing retailer OVS among others. With smaller companies there is always a risk of failure, particularly in the early stages; a holding in Danish marine fuel stock OW Bunker was bought at IPO but sold following a profit warning. TRG's managers reached the view that the company management had misrepresented it at IPO, and while a loss was incurred on the sale, the company subsequently declared bankruptcy, meaning further losses were avoided by the early exit.

TRG does not hedge its euro exposure but has made use of Swiss franc hedges in the past when overweights to Switzerland have been significant (currently the weighting is largely in line with the index). At present the portfolio is unhedged.

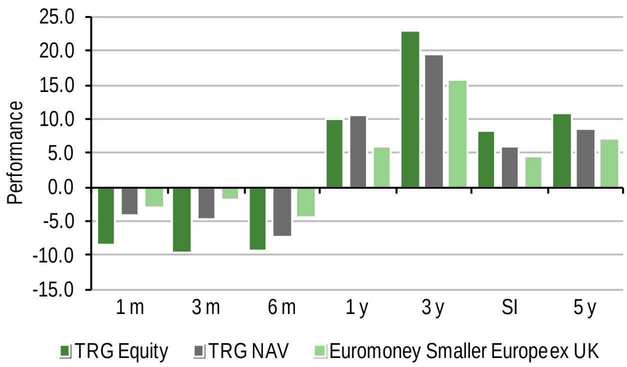
Performance: Long-term record intact despite sell-off

Exhibit 9: Investment trust performance to 30 September 2015

Price, NAV and benchmark one-year total return performance



Price, NAV and benchmark total returns (%)*



Source: Thomson Datastream, Edison Investment Research. Note: *Three years, five years and since managed by current fund manager (SI) figures annualised. Ollie Beckett appointed 1 July 2011.

Exhibit 10: Share price and NAV total return performance relative to benchmarks (%) to 30 September 2015

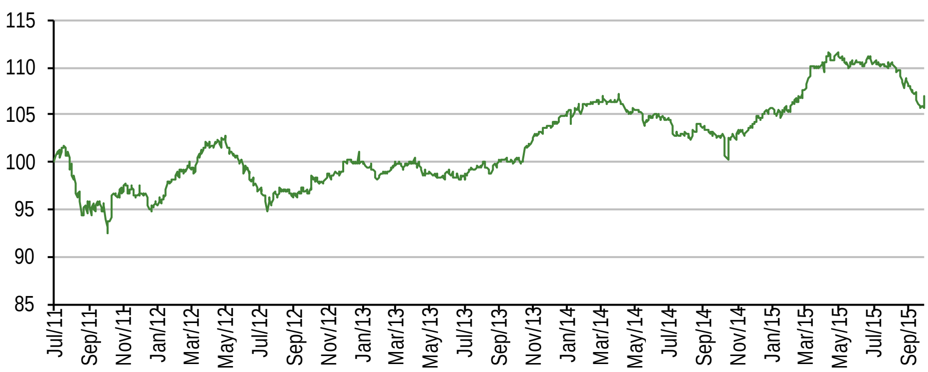
	One month	Three months	Six months	One year	Three years	SI*	5 years
Price relative to Euromoney Smlr Eur ex-UK	(5.6)	(8.0)	(5.0)	3.8	20.0	16.4	18.1
NAV relative to Euromoney Smlr Eur ex-UK	(1.2)	(3.1)	(3.0)	4.4	10.3	6.3	6.9
Price relative to FTSE World Eur ex-UK	(5.4)	(5.3)	1.0	11.2	38.3	23.1	27.5
NAV relative to FTSE World Eur ex-UK	(1.0)	(0.2)	3.1	11.8	27.1	12.4	15.4
Price relative to FTSE All-Share	(5.9)	(4.1)	(2.2)	12.4	51.0	13.1	20.7
NAV relative to FTSE All-Share	(1.5)	1.0	(0.2)	13.0	38.9	3.3	9.3

Source: Thomson Datastream, Edison Investment Research. Note: Geometric calculation. * SI = manager start date, 1 July 2011.

TRG has performed strongly versus its benchmark over the medium to longer term, but has suffered in both absolute and relative terms during the recent sell-off (Exhibit 9). Small-caps are more vulnerable to negative sentiment than larger stocks, and the trust's focus on the smaller end of the market will have contributed to the poorer recent performance. In addition, TRG was geared towards the higher end of its range during the summer, magnifying losses. While the manager concedes this has been an unfortunate effect, gearing is being maintained (albeit at a slightly lower level) in order to avoid compounding underperformance by missing out on any upturn.

Over shorter periods the trust has also underperformed the FTSE World Europe ex-UK and FTSE All-Share indices in both NAV and share price total return terms (Exhibit 10), although it has outperformed, in some cases significantly, over longer periods. As Exhibit 11 shows, manager Ollie Beckett has beaten the index in aggregate since taking on the trust, although there have been periods of better and worse relative performance owing to the trust's differentiation from the index.

Exhibit 11: NAV performance relative to benchmark under Ollie Beckett



Source: Thomson Datastream, Edison Investment Research. Note: Data from 1 July 2011 to 30 Sept 2015.

Discount: Narrower following removal of rigid policy

At 27 October, TRG's shares stood at an 11.3% discount to cum-income net asset value. This is a little wider than the c 5-10% discount range in which the shares have traded over the summer, but remains within the 5-15% range established over the past two years following a rerating from the 15-25% level. This narrowing over time has been achieved in spite of the removal (at the 2010 AGM) of a hard discount control mechanism, whereby shares were bought back if the discount exceeded 10%; this rigid policy saw 46% of the shares bought back in the five years to 30 June 2011, and was arguably inappropriate for a trust investing in an economically sensitive and sentiment-driven sector such as European smaller companies. Over one, three and five years TRG's discount to NAV has averaged 10.9%, 13.1% and 15.3% respectively, although a 12-month narrowest point of 6.4% was reached in mid-August. While the trust retains the ability to buy back shares to manage a discount, only 1.4m shares (less than 3% of the total) have been repurchased in the past five years, with no buybacks at all since June 2012.

Exhibit 12: Discount/premium over three years (to cum-income NAV with debt at fair value)

Source: Thomson Datastream, Edison Investment Research.

Capital structure and fees

TRG is a conventional investment trust with one class of share. At 27 October, there were 49.98m shares in issue. The trust has a subsidiary called TREG Finance which is a legacy investment dealing company; this is consolidated on the balance sheet but has little impact (under £1m). A hard discount control mechanism, whereby the trust bought back shares if the discount to NAV exceeded 10% was removed in 2010, but TRG retains the ability to buy back up to 14.99% of shares annually. There is a three-yearly continuation vote, the next of which will occur at the November 2016 AGM.

The trust may use gearing via a multicurrency overdraft facility with HSBC, equivalent to £50m or 25% of assets held in custody with the bank, whichever is lower. Based on 27 October net assets, use of the whole £50m facility would equate to 15.1% gearing. The board has set an informal maximum working level of gearing of 15% of net assets, although TRG's articles permit borrowing of up to 30%. During the 12 months to 30 September 2015, month-end net gearing ranged from 6% (April 2015) to 16% (October 2014), averaging 11.8% and standing at 15% at the end of the period.

Under the Alternative Investment Fund Managers Directive (AIFMD), Henderson Investment Funds acts as the AIFM and subcontracts investment management to Henderson Global Investors. TRG pays Henderson an annual management fee of 0.6% of net assets (as of the 2014/15 financial year; prior to 1 July 2014 the fee was 0.5% of net assets). A performance fee may be paid based on NAV total return performance over three years: subject to a 1% hurdle, the performance fee is 15% of the outperformance of the average annual NAV total return of the trust over the average annual total return of the Euromoney Smaller Europe ex-UK benchmark. The NAV total return does not have to be positive in absolute terms for the performance fee to be paid. There is a cap on the total fees payable of 2% (reduced from 2.4% from 1 July 2014). For FY15, a performance fee of £1,759,000 was paid, an increase of 55.7% on the previous year's performance fee. Ongoing charges (calculated excluding the performance fee) were 0.78% at FY15, which compares favourably with the 1.72% ongoing charges figure for the equivalent Henderson European Smaller Companies OEIC. Including the performance fee this rises to 1.34%. Fees are charged 20% to income and 80% to capital.

Dividend policy and record

While TRG's objective is to achieve capital growth, the board also aims to make steadily increasing annual dividend payments, and has grown or maintained the dividend each year since 1999. As an investment trust, TRG is required to pay out at least 85% of its net income; for FY15 the revenue return per share was 11.3p. As smaller companies can be a volatile asset class, the board of TRG is mindful of the possibility that revenue returns in future years may be lower. For this reason, a special dividend has been declared in 10 of the past 12 years in order to bring the total dividend to c 85% while protecting the year-on-year ordinary dividend growth record. Dividends are paid annually in November; the FY15 total dividend of 9.5p (3.3% up on the FY14 total dividend) is made up of an ordinary dividend of 7.0p (an increase of 7.7% on FY14) and a special dividend of 2.5p (down 7.4% on the FY14 special). Based on the FY15 dividend and the 27 October share price of 586p, TRG currently has a yield of 1.6% including the special dividend or 1.2% based on the ordinary dividend alone. The trust has a large revenue reserve, amounting to 43.9p per share at FY15 (before payment of the 2015 dividend). Deducting the 9.5p per share dividend gives a reserve of 34.4p per share, sufficient to fund the dividend at the FY15 level for two-and-a-half years.

Peer group comparison

Exhibit 13: European Smaller Companies peer group

% 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
TR European Growth	292.9	21.4	74.0	50.3	0.7	Yes	-11.1	115.0	1.6	0.7	1.2
European Assets Trust	324.5	24.3	77.0	109.2	1.3	No	1.2	99.0	5.3	1.2	1.5
JPMorgan European Smaller Cos	411.2	30.6	77.2	55.8	1.3	No	-8.6	100.0	1.3	1.7	1.2
Montanaro European Smaller Cos	90.0	18.2	30.6	29.7	1.5	No	-6.1	106.0	1.5	0.7	0.7
Sector weighted average		25.4	72.5	67.7	1.2		-6.2	104.1	2.5	1.2	1.3
TRG rank in sector	3	3	3	3	4		4	1	2	3	2
OEIC sector average	420.7	21.6	50.5	69.7	1.6				0.3		

Source: Morningstar, 27 October 2015, Trustnet, Edison Investment Research. Open-ended peer group data sourced from Trustnet at 21 October; shows weighted averages for funds with a track record of more than one year. Notes: TR = NAV 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. 100 = ungeared.

The Association of Investment Companies' European Smaller Companies sector is a small peer group containing just four funds, three of which are quite large (£250m and above) and long established (one in 1972 and two in 1990). Of these, three large funds of long standing, TRG is the smallest and the youngest, although in each case by only a narrow margin. In terms of NAV total return performance, TRG ranks third over one, three and five years, with returns broadly in line with the weighted average over one and three years. Risk-adjusted performance as measured by the Sharpe ratio is average over three years but below average over one year. The manager says TRG has more of a focus on the smaller end of the market than its two large peers, which will lead differentiated performance. TRG has the highest level of gearing in the sector, standing at 15% versus its average of 11.8% over the past 12 months. Gearing was increased during the summer months, which may have had a detrimental effect on short-term performance owing to the global market correction from late August. The trust has the second-highest yield in the peer group (we have included the special dividend in this calculation, as historically a 'special' has been paid far more often than not), although the sector weighted average yield of 2.5% is inflated by the high distribution policy of European Assets Trust (EAT), and the other three trusts all have below-average yields as a result. EAT's high yield has also seen it trade on a much smaller discount than its peers, again influencing the average figure. TRG stood at the widest discount in the sector at 27 October. TRG has the lowest ongoing charges in the sector; however, it is also the only trust to levy a performance fee.

The board

There are five directors on TRG's board, all non-executive and independent of the manager. Audley Twiston-Davies joined the board in January 2000 and has been chairman since May 2002. Andrew Martin Smith was appointed in 2008, followed by Christopher Casey in 2010 and Alexander Mettenheimer (resident in Germany) in 2011. The newest director, Simona Heidempergher (resident in Italy and working in Belgium), was appointed in September 2014 following the retirement of Robert Jeens; Jane Tufnell also stepped down from the board at the November 2014 AGM. All the directors have financial backgrounds, with areas of expertise ranging from banking and accountancy to fund management and private equity.

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
245 Park Avenue, 39th Floor
10167, New York
US

Sydney +61 (0)2 9258 1161
Level 25, Aurora Place,
88 Phillip Street, Sydney
NSW 2000, Australia

Wellington +64 (0)4 8948 555
Level 15, 171 Featherston St
Wellington 6011
New Zealand