

Fidelity European Values

Outperforming in an uncertain market

Fidelity European Values (FEV) is a relatively defensively positioned trust investing primarily in continental European equities. Recent performance has been strong relative to its FTSE World Europe ex-UK index benchmark and peers, helped by its exposure to defensive technology stocks, less interest rate-sensitive banks, and energy stocks, as well as holding no automotive stocks. The portfolio remains well-balanced, but is now more concentrated in a smaller number of stocks (currently 47), as the manager has taken profits where prospects for sustained dividend growth have weakened, and few new ideas have met his investment criteria. FEV's consistent longer-term track record and tendency to outperform in periods of market weakness may find appeal in an uncertain market environment.

12 months ending	Share price (%)	NAV (%)	FTSE World Europe ex-UK (%)	MSCI Europe (%)	MSCI World (%)	FTSE All-Share (%)
30/09/14	3.4	5.5	6.2	6.2	12.7	6.1
30/09/15	9.8	3.4	(1.2)	(2.4)	2.1	(2.3)
30/09/16	12.0	21.9	21.1	20.3	30.6	16.8
30/09/17	26.4	19.7	22.7	19.1	15.0	11.9
30/09/18	8.1	9.8	2.0	3.2	15.1	5.9

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

Investment strategy: Selecting for dividend growth

To achieve FEV's capital and income growth objective, the manager seeks to invest in companies with sustainable dividend growth prospects on a three- to five-year view. Stocks are selected on a bottom-up basis, focusing on cash flow generation and dividend growth potential, with strong attention to downside risk as well as upside potential. FEV maintains a balanced portfolio, typically containing 40-60 holdings and up to 10 short positions, via single-stock contracts for difference (CFDs). Gearing is permitted up to 30% of net assets, and is achieved using CFDs and index futures, which are also used to hedge the overall short exposure.

Market outlook: Clouded by uncertainties

Following the recent stock market sell-off, European equities appear attractive on valuation grounds, compared with history and relative to US equities. However, earnings growth prospects are clouded by data suggesting a weakening economic backdrop, and geopolitical uncertainties such as the US-China trade dispute, the UK's Brexit negotiations, Italy's budget plan and the pace of monetary tightening by central banks. Given this mixed picture, investors may be attracted by a relatively defensively positioned fund with a consistent long-term performance track record.

Valuation: Narrowed discount; dividend upside

FEV's share price discount to NAV (including income) has recently narrowed and the current 10.1% discount compares to its 9.7%, 9.9% and 9.2% averages over one, three and five years, respectively. FEV's yield is below the sector average, but a reallocation of fees and expenses from revenue to capital will raise the proportion of distributable income from FY18, supporting dividend growth prospects.

Investment trusts

26 October 2018

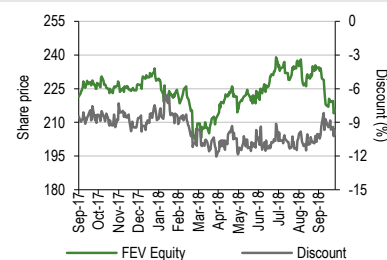
Price 215.5p
Market cap £888m
AUM £1,149m

NAV* 239.7p
Discount to NAV 10.1%

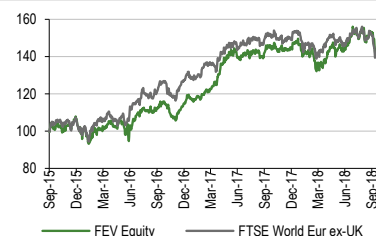
*Including income. As at 25 October 2018.

Yield 2.0%
Ordinary shares in issue 412.2m
Code FEV
Primary exchange LSE
AIC sector Europe
Benchmark FTSE World Europe ex-UK

Share price/discount performance



Three-year performance vs index



52-week high/low 239.0p 202.5p
NAV* high/low 267.7p 227.1p

*Including income.

Gearing

Gross market gearing* 11.0%
Net market gearing* 5.0%

*As at 30 September 2018.

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Exhibit 1: Trust at a glance

Investment objective and fund background

Fidelity European Values' investment objective is to achieve long-term growth in both capital and income from a portfolio predominantly comprising continental European securities. Up to 20% exposure to stocks listed outside continental Europe is permitted, to give the manager investment flexibility. FEV's performance benchmark is the FTSE World Europe ex-UK index.

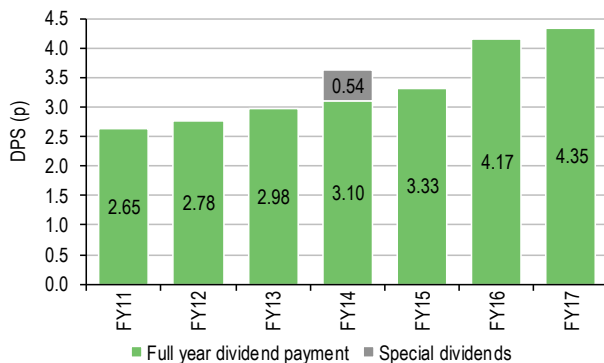
Recent developments

- 1 August 2018: Interim results to 30 June 2018 – NAV TR +2.3% versus benchmark TR -1.4%; share price TR +0.7%.
- 14 May 2018: James Robinson stepped down from the board.
- 14 May 2018: Investment objective and investment policy change approved by shareholders at AGM, and adopted with immediate effect.
- 1 April 2018: New lower, tiered management fee took effect.
- 15 March 2018: Allocation of fees and expenses between capital and revenue accounts revised from 0:100 to 75:25, effective from FY18.

Forthcoming		Capital structure		Fund details	
AGM	May 2019	Ongoing charges	0.93% (FY17)	Group	FIL Investments International
Final results	March 2019	Net market gearing*	5.0%	Manager	Sam Morse
Year end	31 December	Annual mgmt fee	Tiered: 0.85% up to £400m net assets, then 0.75%.	Address	Beech Gate, Millfield Lane, Lower Kingswood, Tadworth, Surrey KT20 6RP
Dividend paid	May	Performance fee	None	Phone	+44 (0)800 414110
Launch date	November 1991	Trust life	Indefinite (subject to vote)	Website	www.fidelity.co.uk/europeanvalues
Continuation vote	Two-yearly (next 2019)	Loan facilities	None – CFDs used		

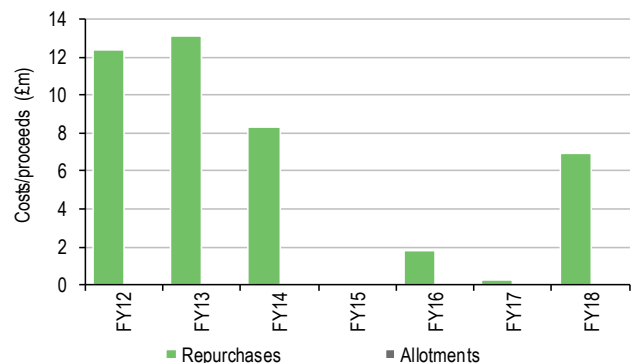
Dividend policy and history (financial years)

FEV pays a single annual dividend in May each year in respect of the previous financial year. Revenue earnings are largely distributed in full.

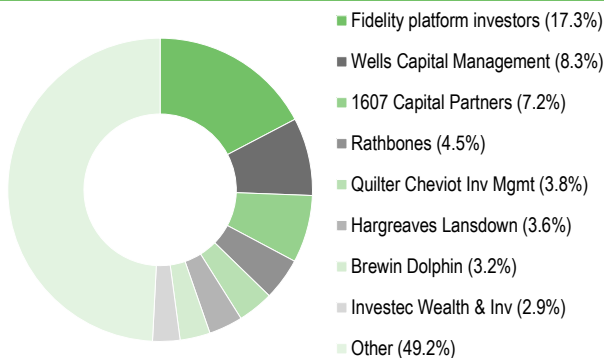


Share buyback policy and history (financial years)

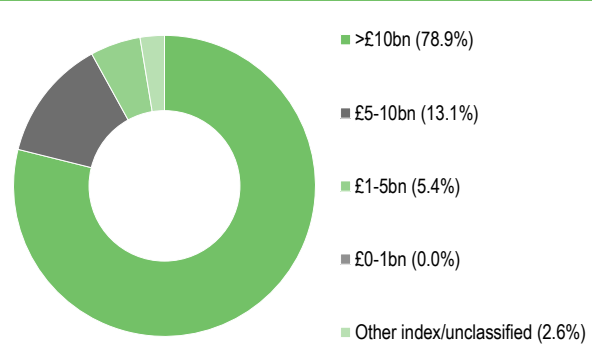
FEV has annually renewed authority to purchase up to 14.99% and allot up to 5% of its issued share capital.



Shareholder base (as at 30 September 2018)



Portfolio exposure by market cap (as at 30 September 2018)



Top 10 holdings (as at 30 September 2018)

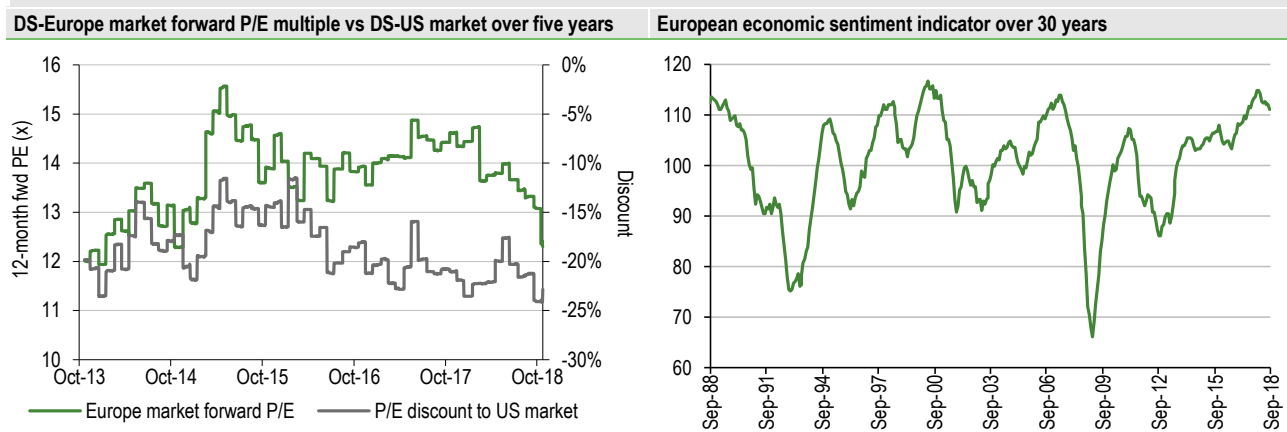
Company	Country of listing	Sector	Portfolio weight (%)		Benchmark weight (%)	Active weight (pp)
			30 Sept 2018	30 Sept 2017**	30 Sept 2018	30 Sept 2018
Nestlé	Switzerland	Consumer goods	6.5	6.3	3.7	2.8
Roche Holding	Switzerland	Healthcare	4.6	5.0	2.6	2.0
Total	France	Oil & gas	4.4	3.7	2.4	2.0
SAP	Germany	Technology	3.9	3.4	1.8	2.1
Sanofi	France	Healthcare	3.8	4.1	1.4	2.4
Sampo	Finland	Financials	3.2	3.1	0.4	2.8
LVMH Moët Hennessy	France	Consumer goods	3.2	N/A	1.3	1.9
DNB	Norway	Financials	3.1	N/A	0.3	2.8
L'Oréal	France	Consumer goods	3.1	3.2	0.9	2.2
ASML Holding	Netherlands	Technology	3.0	3.1	1.1	1.9
Top 10 (% of holdings)			38.8	39.1		

Source: Fidelity European Values, Edison Investment Research, Bloomberg, Morningstar. Note: *Gearing net of short positions. **N/A where not in end-September 2017 top 10.

Market outlook: Mixed picture, clouded by uncertainty

European equity markets rose fairly steadily in 2017 but have been volatile in 2018, with October seeing the FTSE World Europe ex-UK index fall 7.8% in sterling terms over six trading days. This decline has taken the Datastream Europe market forward P/E multiple to 12.3x – its lowest level since November 2014 and c 10% below its five-year average. While the US market has also weakened, the forward P/E multiple for European equities has moved to a c 23% discount to US equities, close to its five-year widest level (see Exhibit 2 left-hand chart). Given the International Monetary Fund’s October 2018 0.2pp downgrade of Euro Area GDP growth to 2.0% in 2018, followed by an unchanged 1.9% in 2019, the outlook for European corporate earnings growth appears to be weakening. This view is supported by the steady decline in the European economic sentiment indicator since December 2017, although it remains at a historically high level, as illustrated in Exhibit 2 (right-hand chart).

Exhibit 2: European market valuation and economic sentiment



Source: Thomson Datastream, Edison Investment Research. Note: Valuation data to 25 October 2018.

While European equities appear relatively attractive on valuation grounds, compared with history and relative to US equities, the outlook for European corporate earnings growth is unclear, given the apparent weakening of the economic backdrop. The outlook is further clouded by geopolitical uncertainties surrounding the US-China trade dispute, the UK’s Brexit negotiations, Italy’s budget plan and the pace of monetary tightening by central banks. In this environment, investors may find appeal in a relatively defensively positioned fund with a strong performance track record.

Fund profile: Continental Europe-focused portfolio

FEV is one of the larger LSE-listed investment trusts focused on continental European equities and has an established track record of more than 25 years. The manager invests in companies with sustainable medium-term dividend growth prospects to achieve capital and income growth, aiming to outperform the benchmark FTSE World Europe ex-UK index by 1-2pp per annum over the longer term. No top-down sector or geographic allocations are imposed, but the manager aims to maintain a balanced portfolio in terms of sector, market cap and underlying geographic exposures, to ensure that stock selection is the primary performance driver. Single-stock CFDs are used to add gearing and to take short positions, while index futures are also used to add gearing, as well as to hedge market risk. Sam Morse has been FEV’s portfolio manager since January 2011. He has more than 26 years’ investment experience and also manages the open-ended Fidelity European Fund.

At the May 2018 AGM, shareholders approved a change in FEV’s investment objective to achieving long-term growth in income as well as capital. This revision was made to reflect the manager’s attention to dividend income, rather than signalling any change in investment approach.

The fund manager: Sam Morse

Manager's view: Consistent approach giving consistent results

Morse emphasises the empirical evidence supporting his investment approach, which focuses on dividend growth. He cites the median cumulative returns of dividend growers versus dividend cutters/holders within the STOXX Europe 600 ex-UK index. Fidelity's analysis shows that dividend growers tend to outperform modestly over one year, and more significantly over three and five years. While observing that this analysis has shown a consistent picture historically, suggesting that achieving outperformance using this approach may be relatively straightforward, Morse notes that the skill lies in selecting future dividend growers on a medium-term view, as the number of stocks in this category dwindles over time (typical ratios of dividend growers to holders/cutters within the STOXX Europe 600 ex-UK index: 2:1 over one year, 4:5 over three years and 2:5 over five years).

Morse points to FEV's relatively consistent outperformance of the benchmark over his tenure, with a NAV total return of 11.2% pa from 1 January 2011 to 31 August 2018, compared with the benchmark return of 8.8% pa. He notes that this is slightly ahead of the investment objective to outperform the index by 1-2pp each year, helped by the recent strong performance and the trust's use of gearing. Morse comments that, while the portfolio has remained fully invested, his naturally cautious outlook led to a conservative c 5.5% average level of gearing being applied over the last cycle, and he currently views c 10% gearing as a more appropriate level. However, he does not believe that it is currently the right time to increase gearing.

Another key feature of the investment approach that Morse highlights is maintaining a balanced portfolio to mitigate top-down factors and make stock selection the most important contributor to performance. Along with keeping sector allocations within 5pp of benchmark weightings, Morse pays close attention to the portfolio's relative positioning in terms of defensive versus cyclical exposure, market cap breakdown and country exposure.

FEV's portfolio turnover is typically between 20% and 30% per annum, reflecting the long-term investment approach, and Morse points out that average turnover has declined to c 15% pa in 2018, due to few new holdings being added, while he continues to run winners. On this topic, he notes that c 60% of the stocks in the portfolio were held five years ago, including largest holding Nestlé, which has been a portfolio constituent since FEV's inception more than 25 years ago.

Asset allocation

Investment process: Dividend-focused, bottom-up selection

Unbiased by sector or company size criteria, Morse seeks to invest in companies with sustainable medium-term dividend growth prospects. Three core principles define his investment approach:

- **Bottom-up stock selection** – focusing on cash flow generation and dividend growth potential.
- **Long-term view** – believed to result in better investment performance and lower costs.
- **Cautious approach** – striking a balance between expected upside and potential downside risk.

In seeking new opportunities, the manager reviews the regular flow of investment ideas generated by Fidelity's well-resourced team of 40 pan-European analysts. Any stocks that meet Morse's initial screening criteria undergo a more detailed evaluation, including at least one meeting with the company. Prior to stocks being considered for inclusion in the portfolio, three specific reasons to invest need to be defined – two relating to fundamentals and one to valuation. Sought-after fundamental characteristics include structural growth prospects, disciplined capital allocation and a proven business model. Strong cash flow generation is viewed as a positive indicator of dividend growth prospects, and a robust balance sheet gives confidence in a company's ability to sustain

dividend payments while also investing for growth. Valuation is the final factor, with investments only made when companies are trading at a discount to their assessed intrinsic valuation. The resulting portfolio is relatively concentrated, typically comprising 40-60 holdings.

A prospective total shareholder return (TSR) analysis is also performed to rank stocks, with the best prospects allocated a higher weighting in the portfolio. The TSR analysis incorporates expected medium-term earnings growth, dividend yield and potential for re-rating/de-rating, as well as liquidity, volatility, downside risk and the Fidelity analyst's rating.

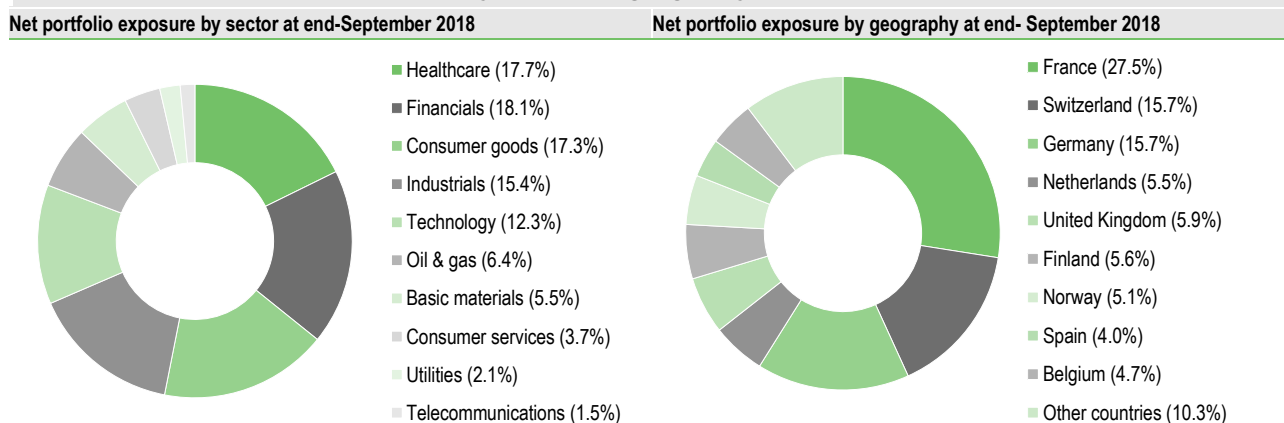
Single company exposure is limited to 10% of gross assets, while companies outside the benchmark (including UK-listed companies) may represent up to 20% of the portfolio, and up to 10% may be invested in unlisted securities. Gearing is permitted up to 30% of net assets (although held below 15% since 2011), while there is a 10% restriction on gross short exposure.

Current portfolio positioning

During 2017, FEV's portfolio holdings reduced from 57 to 49 (eight short positions also initiated), with sales proceeds mainly recycled into existing holdings. In 2018, FEV has sold Elior, Aena and Bic, while adding Atlantia, taking the number of holdings to 47 at end-September 2018. The three holdings were sold due to deteriorating fundamentals, and the manager sees greater likelihood of the portfolio concentrating further if the economic outlook weakens, while noting that a deeper market sell-off could generate buying opportunities. One of the short positions in an automotive stock was closed after performing well, with a new short position initiated in the telecoms sector.

While the overall portfolio has become more concentrated, exposure is still evenly spread, with the top 10 holdings representing 38.8% of the portfolio at end-September 2018, similar to 39.1% a year earlier. Exposure has become more tilted to large-caps over the last year; stocks below £10bn market cap fell from c 24% to c 19% of the portfolio (see Exhibit 1). At end-September 2018, single-stock short positions equated to c 3.0% of net assets (hedged by Euro Stoxx 50 index futures).

Exhibit 3: FEV's net portfolio exposure by sector and geography at end-September 2018



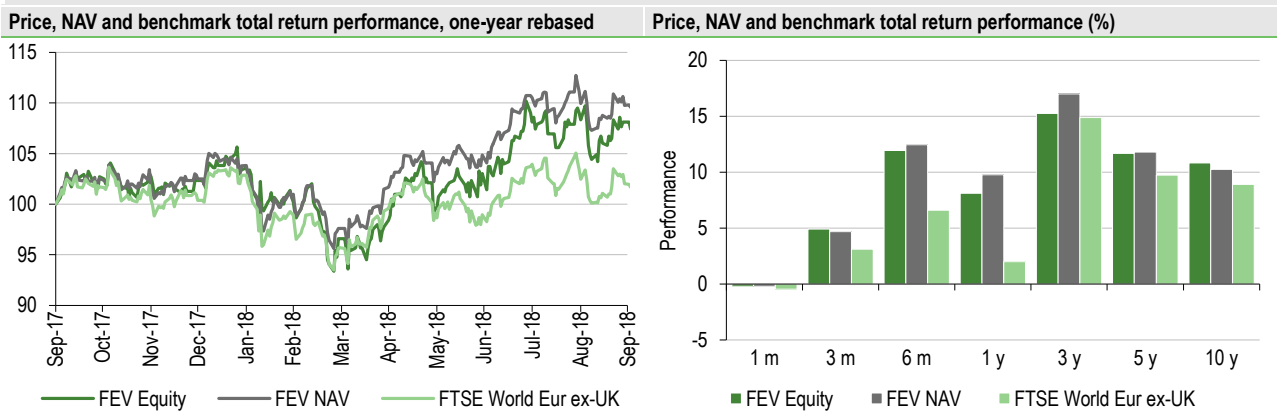
Source: FEV, Edison Investment Research. Note: Exposures are net of short positions, adjusted for gearing and index futures.

FEV's portfolio is well diversified by sector and geography, with the balance of exposures at end-September 2018 (see Exhibit 3) broadly similar to a year earlier. The largest sector changes are a 1.6pp decrease in financials and a 1.5pp increase in consumer goods. Technology (+5.9pp) is FEV's largest overweight, but the manager notes that all four portfolio holdings Dassault Systemes, ASML, Amadeus IT Group and SAP are well-established dividend payers, which are very different in nature from the US technology stocks that have sold off heavily in recent weeks. Healthcare (+3.5pp) is FEV's other major sector overweight, while the greatest underweights are financials (-3.6pp) and utilities (-1.8pp). The greatest shifts in geographical exposure over the year are a 2.2pp increase in Germany and a 1.4pp decrease in France, with the UK (+5.9pp) and France (+4.0pp) remaining the greatest overweights, and Germany (-4.7pp) the largest underweight.

Performance: Particularly strong over one year

As shown in Exhibit 4, FEV's share price and NAV total returns were both appreciably ahead of its benchmark FTSE World Europe ex-UK index over one year to end-September 2018, with the majority of the outperformance in the last six months of the period. Recent performance was strong in both absolute and relative terms, and could be considered slightly out of character in view of FEV's tendency to outperform during periods of market weakness, due to its relatively defensive positioning. As noted earlier, manager Sam Morse attributes the recent relative strength to a number of factors, in particular stock selection in the financials sector and FEV's overweight in technology and underweight in automotive stocks. As shown in Exhibit 5, FEV's NAV total return is ahead of the benchmark over one, three, five and 10 years, and has also outperformed the MSCI Europe and FTSE All-Share indices over these periods. As illustrated in Exhibit 6, FEV has seen two periods of extended outperformance (May 2014 to July 2016; and March 2017 to October 2018) over the last five years, with two lesser periods of underperformance.

Exhibit 4: Investment trust performance to 30 September 2018



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

Exhibit 5: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to FTSE World Eur ex-UK	0.2	1.8	5.0	6.0	1.0	9.3	19.0
NAV relative to FTSE World Eur ex-UK	0.3	1.5	5.5	7.6	5.6	9.9	13.0
Price relative to MSCI Europe	(0.3)	2.8	4.1	4.7	3.6	13.4	19.8
NAV relative to MSCI Europe	(0.2)	2.5	4.6	6.3	8.4	14.1	13.8
Price relative to MSCI World	(0.5)	(1.4)	(2.9)	(6.0)	(11.4)	(12.7)	(15.0)
NAV relative to MSCI World	(0.5)	(1.6)	(2.4)	(4.6)	(7.4)	(12.2)	(19.3)
Price relative to FTSE All-Share	(0.9)	5.8	3.3	2.1	10.6	21.1	17.3
NAV relative to FTSE All-Share	(0.9)	5.5	3.8	3.7	15.7	21.8	11.3

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-September 2018. Geometric calculation.

Exhibit 6: NAV total return performance relative to benchmark over five years

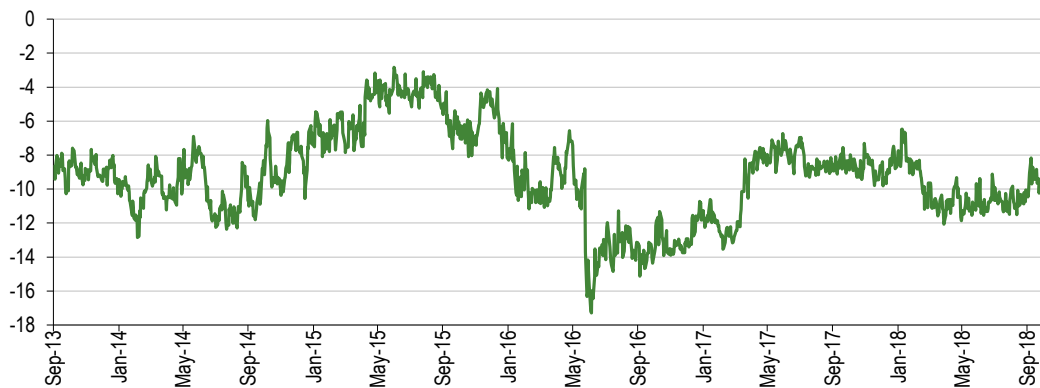


Source: Thomson Datastream, Edison Investment Research

Discount: Close to five-year average level

As illustrated in Exhibit 7, FEV's share price discount to NAV (including income) has ranged between 2.8% and 17.3% over the last five years. From its wide point in early July 2016, shortly after the UK's vote to exit the EU, the discount has narrowed to 10.1%, which compares to its 9.7%, 9.9% and 9.2% averages over one, three and five years, respectively.

Exhibit 7: Share price discount to NAV (including income) over five years (%)



Source: Thomson Datastream, Edison Investment Research

Capital structure and fees

FEV has 412.2m ordinary shares in issue, having bought back 3.0m shares (0.7% of issued capital) since June 2018, when repurchases were restarted after a pause of more than one year. Authority is held to repurchase up to 14.99% and allot up to 5% of FEV's outstanding shares, but buybacks have been modest since a 10-for-1 share division was effected in mid-2014 (see Exhibit 1). FEV's policy has been to employ a low level of gearing via CFDs to enhance investment returns, while index futures have been used to hedge short positions. More recently, index futures have also been used to add gearing, which acts to broaden FEV's market exposure, partly offsetting the increase in portfolio concentration arising from the number of holdings declining over the last 12 months. At end-September 2018, gross market gearing was 11.0%, including c 3.0% in individual stock short positions and c 8.0% in Euro Stoxx 50 index futures, while net gearing was 5.0%.

FEV introduced a tiered management fee structure on 1 April 2018, with an unchanged 0.85% per annum payable on net assets up to £400m, and a reduced 0.75% per annum payable thereafter. No performance fee has been payable since 2014. The ongoing charge declined from 0.99% in FY16 to 0.93% in FY17, helped by share plan expenses no longer being incurred, lower legal and professional fees, and an 18% rise in net assets. The new fee structure should see the ongoing charge decline to c 0.88% in FY19, when the fee reduction has a full-year effect.

From FY18, management fees and finance costs are being allocated 75:25 between capital and revenue accounts respectively, broadly reflecting the balance of longer-term historical contributions to total return. Previously, these costs were charged entirely to revenue. Total returns are not affected by the change in allocation, but the proportion of revenue returns will be higher in the current and future years, supporting dividend growth prospects.

FEV is subject to a two-yearly continuation vote, with the next vote due at the 2019 AGM.

Dividend policy and record

At the May 2018 AGM, shareholders approved a change in FEV's stated investment objective, which is now to achieve long-term growth in both capital and income. Previously, there was no explicit income objective, and the change was made to reflect the manager's investment focus on companies capable of growing their dividend, which has seen FEV's dividend payments rise steadily over time (see Exhibit 1). Revenue earnings are largely distributed in full and significant reserves are not held to smooth dividend payments, but FEV has increased its ordinary dividend in each of the last seven financial years; and currently yields 2.0%, only modestly lower than the sector average (see Exhibit 8). The FY17 dividend was increased by 4.3% to 4.35p per share, after a substantial 25.2% rise in the prior year, with compound growth of 9.4% pa over five years. The move to a 75:25 allocation of fees and expenses between capital and revenue accounts – noted above – will increase the proportion of distributable income from FY18.

Peer group comparison

Exhibit 8 shows a comparison of all eight trusts in the AIC Europe sector, of which FEV is one of the largest. Its NAV total return is ahead of the sector average over one, three and five years. While it is lower than the sector average over 10 years, we note that FEV's NAV total return has comfortably outperformed its benchmark over the 10 years to end-September 2018 (see Exhibit 5). FEV's 0.93% ongoing charge for FY17 is close to the sector average, and the lower management fee from 1 April 2018 should see its ongoing charge decline to c 0.88% in FY19, when the reduction has a full-year effect. Similar to the majority of its peers, FEV does not charge a performance fee. FEV's discount is wider than average, while its net gearing is in line with the sector average and its dividend yield is lower than average.

Exhibit 8: AIC Europe sector peer group as at 25 October 2018*										
% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Discount (cum-fair)	Ongoing charge	Perf. fee	Net gearing	Dividend yield
Fidelity European Values	888.2	(1.8)	40.3	53.7	199.7	(10.4)	0.93	No	105	2.0
BlackRock Greater Europe	277.5	(2.8)	39.6	49.5	239.8	(5.5)	1.09	No	100	1.8
European Investment	334.0	(13.0)	24.2	21.9	149.7	(12.3)	0.59	No	100	2.8
Henderson European Focus Trust	244.0	(11.0)	27.9	52.0	246.5	(7.9)	0.87	Yes	106	2.6
Henderson EuroTrust	220.9	(6.4)	36.4	54.3	243.1	(7.7)	0.84	Yes	100	2.9
JPMorgan European Growth	195.5	(11.9)	27.8	40.5	211.1	(12.8)	0.98	No	115	2.5
JPMorgan European Income	146.4	(8.0)	36.3	51.7	274.8	(12.9)	1.01	No	115	4.3
Jupiter European Opportunities	861.4	5.3	40.7	82.9	596.5	(0.5)	0.90	Yes	100	0.9
Average	396.0	(6.2)	34.1	50.8	270.1	(8.8)	0.90		105	2.5
Rank in peer group	1	2	2	3	7	5	4		4	6

Source: Morningstar, Edison Investment Research. Note: *Performance to 24 October 2018. TR = total return. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

The board

FEV has five independent non-executive directors, following James Robinson stepping down from the board at the May 2018 AGM, after close to 11 years' service. He was succeeded as senior independent director by Marion Sears (appointed January 2013), who is also a director of Aberdeen New Dawn Investment Trust. Chairman Vivian Bazalgette (appointed director December 2015, chairman May 2016) is also a director of Brunner Investment Trust and Perpetual Income and Growth Investment Trust. The other directors are Robin Niblett (appointed January 2010), Paul Yates (appointed March 2017) – also a director of Aberdeen Diversified Income and Growth Trust, The Merchants Trust and Witan Investment Trust – and Fleur Meijs (appointed September 2017) – also a director of Invesco Asia Trust and investment manager Ruffer.

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