

JPMorgan European Smaller Cos

Ready for the next 25 years

JPMorgan European Smaller Companies Trust (JESC) has a 25-year track record of seeking capital appreciation by investing in smaller Continental European companies. The managers note that the sector competes for investor attention against other high-growth areas such as emerging markets, and the recent sell-off in Asia could underpin investor demand, a trend suggested by the historically low level of discount. Performance has been strong versus the benchmark over both short and longer periods, with a 20-year NAV total return of 1,173% – all of which has been achieved under the long-serving current managers – beating the nearest peer by more than 60%. The managers favour cyclical stocks in the expectation of further economic recovery in Europe, driven by domestic demand.

12 months ending	Share price (%)	NAV (%)	Euromoney Smr Eur Cos ex-UK (%)	FTSE World Europe ex-UK (%)	FTSE All-Share (%)
31/08/12	(17.2)	(13.5)	(9.6)	1.4	10.2
31/08/13	58.6	42.9	37.2	26.3	18.9
31/08/14	4.1	7.9	14.6	10.4	10.3
31/08/15	23.5	17.6	5.3	1.3	(2.3)

Source: Thomson Datastream. Note: Total return basis.

Investment strategy: In search of quality growth

JESC's managers, Jim Campbell and Francesco Conte, use their own long experience and the wider resources of J.P. Morgan Asset Management's European equity team to select companies with a blend of positive momentum, attractive valuations and indicators of quality, such as credible management, healthy balance sheets and a strong competitive position. The portfolio of 60-80 stocks is built from the bottom up, with sector and country diversification ensured by the wide opportunity set, rather than by top-down constraints. The managers regularly travel throughout Europe and meet frequently with current and potential holdings. The portfolio is actively managed with a relatively high level of turnover.

Market outlook: Domestic bliss or world of worry?

A sharp sell-off in world markets, sparked by worries about China's economy, has been felt less keenly in the European small-cap sector, which has outperformed the UK and world markets over one, three and six months and one, three and five years to the end of August. Tailwinds from a recovering economy, domestic demand and valuations that do not look stretched versus the rest of the world should be assessed in the context of continued global volatility and worries about rate rises.

Valuation: Discount narrower despite global sell-off

JESC's discount to NAV has narrowed since the first quarter of 2015 and at 9 September the shares stood at a cum-income discount of 8.3%, compared with average figures of 11.7%, 12.8% and 14.0% over one, three and five years. The global market volatility seen from late August does not seem to have had any adverse impact on the trust's discount, suggesting that demand for the growth potential of smaller European companies is holding up, as investors distance themselves from Asian and emerging markets.

Investment trusts

10 September 2015

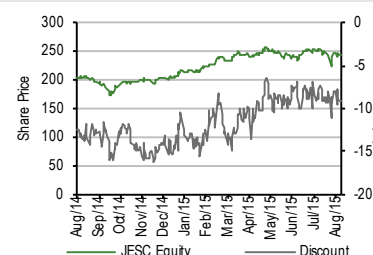
Price 248.3p
Market cap* £397.6m
AUM £494.8m

NAV* 267.0p
Discount to NAV 7.0%
NAV** 270.8p
Discount to NAV 8.3%
Yield 1.3%

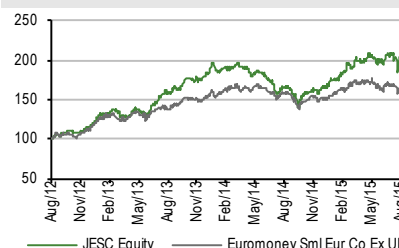
*Excluding income. **Including income.
Data at 9 September 2015.

Ordinary shares in issue 160.15m
Code JESC
Primary exchange LSE
AIC sector European Smaller Companies

Share price/discount performance*



Three-year cumulative perf. graph



52-week high/low* 256.0p 173.0p
NAV (cum-inc) high/low* 281.5p 204.7p

*Adjusted for five-for-one stock split on 23 July 2014.

Gearing

Gross 3.0%
Net 3.0%

Analysts

Sarah Godfrey +44 (0)20 3681 2519
Andrew Mitchell +44 (0)20 3681 2500

investmenttrusts@edisongroup.com

[Edison profile page](#)

Exhibit 1: Trust at a glance
Investment objective and fund background

JPMorgan European Smaller Companies Trust (JESC) aims to achieve capital growth from a diversified portfolio of shares in smaller European companies (excluding UK). Liquidity and borrowings are actively managed (investments 80-120% of net assets) with a view to enhancing returns to shareholders. As JESC's investment policy emphasises capital growth, rather than income, the dividend is expected to vary from year to year. JESC is benchmarked against the Euromoney (formerly HSBC) Smaller European Companies (ex-UK) total return index in sterling terms.

Recent developments

- 26 May 2015: final dividend of 2.0p declared for the year ended 31 March, payable on 15 July.
- 26 May 2015: annual results for the year ended 31 March 2015. NAV total return of +0.3% compared with +0.1% for the benchmark Euromoney Smaller Europe ex UK index. Share price TR -1.4%.
- 1 May 2015: Nicholas Smith appointed to the board with immediate effect.

Forthcoming

AGM	July 2016
Annual results	May 2016
Year end	31 March
Dividend paid	January, July
Launch date	April 1990
Continuation vote	N/A

Capital structure

Ongoing charges	1.31%
Net gearing	3.0%
Annual mgmt fee	1% of net assets (see p7)
Performance fee	None
Trust life	Indefinite
Loan facilities	€100m

Fund details

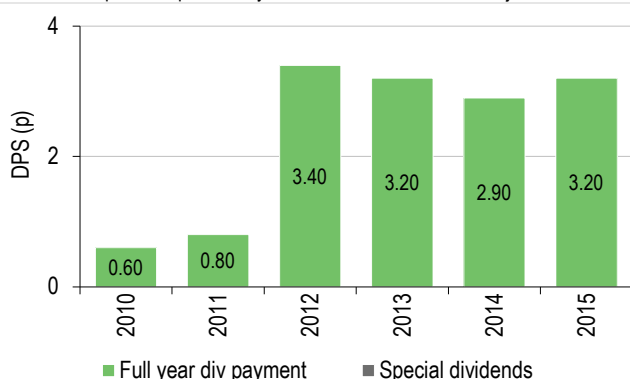
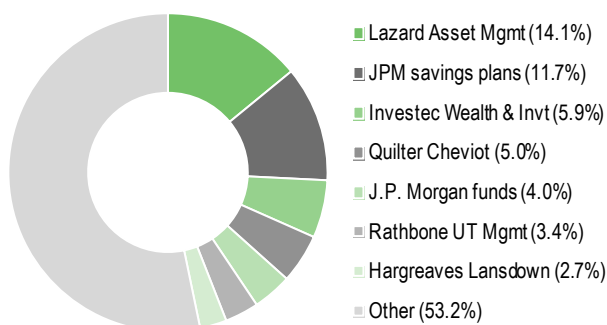
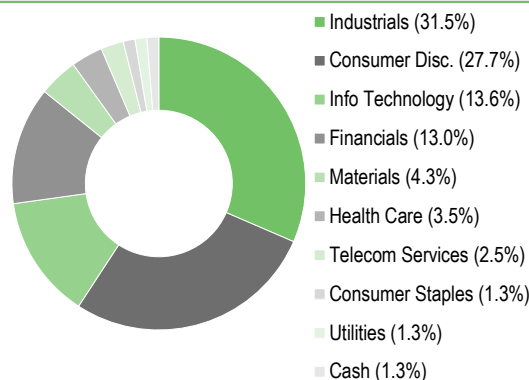
Group	JPMorgan Asset Mgmt (UK) Ltd
Manager	Jim Campbell, Francesco Conte
Address	60 Victoria Embankment, London EC4Y 0JP
Phone	+44 (0)800 731 1111
Website	www.jpmeuropeansmallercompanies.co.uk

Dividend policy and history

Between zero and two dividends annually. Interims, when paid, are paid in January. Finals, when paid, are paid in July. Numbers below have been adjusted for stock split.

Share buyback policy and history

Renewed annually, the trust has authority to purchase up to 14.99% and allot up to 5% of issued share capital.


Shareholder base (as at 1 September 2015)

Distribution of portfolio (as at 31 July 2015)

Top 10 holdings (as at 31 July 2015)

Company	Country	Industry	Business area	Portfolio weight %
Faiveley Transport	France	Industrials	Railway equipment	2.8
Kingspan	Ireland	Industrials	Building materials	2.4
Moncler	Italy	Consumer discretionary	Luxury apparel	2.3
Trigano	France	Consumer discretionary	Camper vans	2.2
Alten	France	Information technology	Technology consulting	2.2
SEB	France	Consumer discretionary	Household appliances	2.2
Temenos	Switzerland	Information technology	Banking software	2.2
Ackermans & van Haaren	Belgium	Financials	Holding & investment company	2.2
Ubisoft Entertainment	France	Information technology	Video games	2.1
OVS	Italy	Consumer discretionary	Fashion retailer	2.1
Top 10 (% of investments)				22.7

Source: JPMorgan European Smaller Companies Trust, Edison Investment Research

Small-cap outlook: Outperforming in global uncertainty

European smaller companies (as measured by the Euromoney Smaller Europe ex UK index) were hit less badly in the August sell-off than many other markets (down 2.66% on a total return basis). This is likely to be a result of a combination of the improving economic backdrop (Exhibit 2), the more domestic focus of many small caps – protecting them to an extent from the shocks emanating from China – and the boost to European stock markets from ECB QE since the start of 2015.

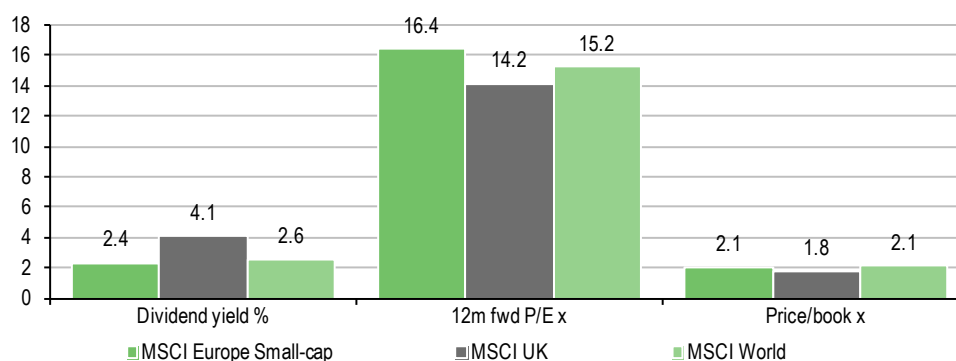
Exhibit 2: European Union economic sentiment indicator since inception



Source: European Commission. Note: Data to end-August 2015.

Looking ahead, valuations (Exhibit 3, using MSCI indices) are largely in line with the world index, which given the generally greater growth potential of smaller companies, could point to opportunity in the sector. However, with markets still jittery as participants return from the summer break, a focus on quality stocks at attractive valuations could provide a measure of insulation from further wobbles.

Exhibit 3: Key valuation metrics for European small caps versus other indices



Source: MSCI, Edison Investment Research. Data at 31 August 2015.

Fund profile: Long-established small-cap expert

JPMorgan European Smaller Companies Trust (JESC), launched in 1990, has been managed since 1995 by Jim Campbell and Francesco Conte at J.P. Morgan Asset Management (JPMAM). The managers aim to achieve capital growth by investing in the under-researched area of continental European smaller companies. They are supported by the wider resources of JPMAM's European equities team, and use an investment approach based on the team's behavioural finance-based process, seeking to blend positive momentum, value and quality. Dividends are a secondary consideration and broadly reflect portfolio income after certain costs. Long-term performance has been strong, with the trust producing an NAV total return of 1,173% over 20 years, a 63% outperformance versus its closest rival.

The fund managers: Jim Campbell & Francesco Conte

The managers' view: Reasons to be cheerful

JESC's managers remain optimistic on the outlook for the European small-cap sector, in spite of the world market tremors seen in late summer. Francesco Conte points to favourable economic signals such as strong PMI readings (particularly for domestic demand) and support from ongoing QE, with an increase in the money supply tending to translate into positive market performance six months down the line. Low oil prices have provided a boost to consumption as well as cutting input costs for many companies, and the managers say this could have the effect of doubling eurozone GDP growth compared with forecasts at the start of the year. This should feed through into company earnings, which could be further boosted by the weak euro. The fact that European banks led the pack in terms of beating earnings expectations in the second quarter is a further positive: Conte says that proof of 'healing' in the banking sector is needed "for the wider economy really to get going". At present, the managers argue, earnings expectations for European companies do not fully account for these positive signals, meaning that P/E valuations are less extended than they may appear, because the denominator (the 'E' of P/E) is lower than it should be.

From a macro perspective the managers see limited political risk in peripheral Europe, arguing the recent Greek bailout crisis – leading to lengthy bank and stock market closures, a split in the Syriza government and the calling of emergency elections – points to the unpalatable consequences of electing anti-austerity governments. In Italy, prime minister Matteo Renzi is making good progress on reforms, while electoral support for Podemos in Spain may recede following the Greek experience.

Asset allocation

Investment process: Blending quality, value and momentum

The universe of small caps in Europe is large, with c 1,000 companies across 15 countries making up the benchmark Euromoney Smaller Europe ex UK index. From this universe JESC's managers aim to construct a diversified portfolio of c 60-80 stocks with good capital growth potential. The trust uses an approach based on J.P Morgan Asset Management's multi-factor, behavioural finance-based investment process, which is mainly bottom-up and incorporates fundamental analysis and frequent company meetings. Analysis of macro factors and leading indicators is incorporated as a guide to the likely direction of markets. Candidate stocks should exhibit improving underlying business fundamentals leading to strong operational momentum, a valuation that is reasonable compared with peers and a company's own history, and a high level of quality, assessed on such factors as strength of management team, sustainability of earnings and balance sheet discipline.

The majority of stocks make up between 1% and 2% of the portfolio, and frequent change in the top 10 names is less a result of portfolio turnover than the effect of relatively small moves on holdings that are broadly similar in size. That said, the portfolio is actively managed, and the managers tend to take profits in any stock that reaches 3%. Turnover is in the range of 200-400% a year, and was at the lower end of this range at 215% for FY15. Gearing is actively managed between 20% net cash and 20% geared, and the level of gearing is disclosed daily to the London Stock Exchange.

Current portfolio positioning

At 31 July 2015, JESC had 74 holdings, somewhat more than the 68 stocks held at the 31 March year end. Its top 10 holdings made up 22.7% of the total, a level of concentration broadly in line with the average for its peer group. Geographically, the trust has a large overweight to France (Exhibit 4), where holdings include a mix of industrial and service companies. Italy is also overweight, although exposure is now tilted to consumer stocks (Moncler, OVS and footwear maker Geox), as the managers felt the exporters they formerly held had become too expensive. Sweden is

now a somewhat underweight position versus the benchmark, in contrast with its overweight position at the trust's year end; earlier in the year the Swedish krona was weak versus the euro, but a reversal of this tailwind caused the managers to reduce exposure. Exposure to peripheral European countries is low (with the exception of Italy); Spain is the largest underweight versus the index, while there is no exposure to Greece (formerly 4-5% of the portfolio but sold in advance of the election of the Syriza government) or to Portugal.

From a sector perspective, the major overweights are consumer discretionary (including the three Italian clothing/footwear stocks mentioned above), industrials (including Irish building materials stock Kingspan and French train engineer Faiveley) and IT (including French consulting firm Alten and video game producer Ubisoft). These three sectors exemplify the managers' preference for cyclical stocks over defensives; consumer staples and healthcare, which fall into the defensive category, are two of the biggest underweights. Financials are the largest underweight but exposure to the sector has risen by more than 50% over the year to 31 July.

Exhibit 4: Geographical breakdown, as at 31 July 2015

	Trust weight %	Benchmark weight %	Active weight (% pts)	Trust weight/benchmark weight
France	28.4	14.0	14.4	2.0
Netherlands	7.9	4.3	3.6	1.8
Ireland	4.5	1.6	2.9	2.8
Italy	14.7	12.7	2.0	1.2
Belgium	3.6	4.4	-0.8	0.8
Denmark	2.5	3.5	-1.0	0.7
Finland	3.8	5.0	-1.2	0.8
Portugal	0.2	1.5	-1.3	0.1
Switzerland	9.1	10.7	-1.6	0.9
Sweden	9.5	11.3	-1.8	0.8
Greece	0.0	1.9	-1.9	0.0
Germany	11.7	13.6	-1.9	0.9
Norway	0.8	4.4	-3.6	0.2
Austria	0.0	3.7	-3.7	0.0
Spain	2.0	7.4	-5.4	0.3
Cash	1.3	0.0	1.3	N/A
Total	100.0	100.0	0.0	

Source: JPMorgan European Smaller Companies Trust, Edison Investment Research. Note: Ranked by active weight, excluding cash.

The managers are sanguine about the portfolio's exposure to a hard landing in China: for instance, automobile parts maker Plastic Omnium sold off heavily in late August but has a far lower exposure to China (c 8% of sales) than many of its peers, while luxury sportswear brand Moncler, whose down-filled jackets retail for as much as £1,500, is seeing good growth in Europe and the US to offset any slowing in Asia.

JESC has participated in several recent IPOs, including Belgian personal care firm Ontex (sold after its valuation became stretched), OVS, Flow Traders (an ETF market maker) and chemical company IMCD. Europcar was bought after the IPO following a meeting with management.

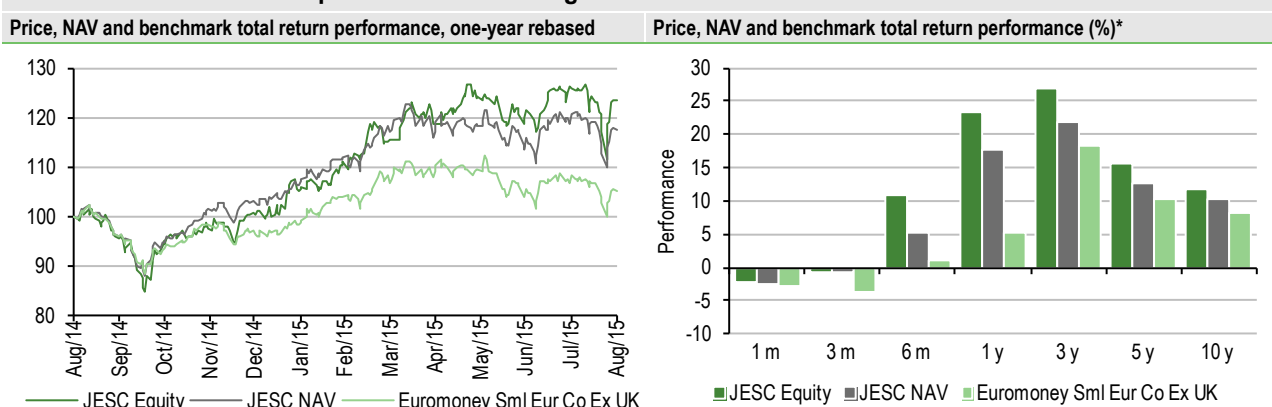
Exhibit 5: Sector breakdown (all data are for 31 July 2015 except where shown)

	Trust weight %	Trust weight % 31 July 2014	Benchmark weight %	Trust active weight (% pts)	Trust weight/benchmark weight
Consumer discretionary	27.7	21.6	14.9	12.8	1.9
Industrials	31.5	31.0	24.6	6.9	1.3
Info technology	13.6	13.9	7.5	6.1	1.8
Telecom services	2.5	4.0	2.1	0.4	1.2
Utilities	1.3	0.0	3.1	-1.8	0.4
Materials	4.3	11.4	7.0	-2.7	0.6
Energy	0.0	2.9	3.2	-3.2	0.0
Consumer staples	1.3	1.1	6.0	-4.7	0.2
Healthcare	3.5	3.1	10.9	-7.4	0.3
Financials	13.0	8.5	20.7	-7.7	0.6
Cash	1.3	2.5	0.0	1.3	N/A
Total	100	100	100	0.0	

Source: JPMorgan European Smaller Companies Trust, Edison Investment Research. Note: Ranked by active weight, excluding cash. Benchmark is Euromoney Smaller European Companies Index.

Performance: Strong record versus benchmark

Exhibit 6: Investment trust performance to 31 August 2015



Source: Morningstar, Thomson Datastream, Edison Investment Research. Note: *Three, five and 10 years annualised.

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

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to Euromoney Sml Eur Co ex UK	0.6	3.2	9.8	17.2	23.1	27.9	35.8
NAV relative to Euromoney Sml Eur Co ex UK	0.0	3.2	4.0	11.7	9.5	11.4	20.9
Price relative to FTSE World Europe ex UK	3.7	6.8	16.1	21.9	44.3	39.9	56.4
NAV relative to FTSE World Europe ex UK	3.2	6.8	10.0	16.1	28.3	21.9	39.2
Price relative to FTSE All Share	3.4	8.7	18.3	26.4	59.2	37.0	64.2
NAV relative to FTSE All Share	2.8	8.7	12.1	20.4	41.6	19.3	46.2

Source: Morningstar, Thomson Datastream, Edison Investment Research. Note: Geometric calculation.

JESC has outperformed its benchmark, the Euromoney Smaller Europe ex UK index, in both share price and NAV terms over all the periods shown in Exhibit 6, from one month to 10 years. Having performed poorly in absolute and relative terms over the first half of 2014, it recovered strongly in the second half of the year. As shown in Exhibit 7, relative performance is also positive over all periods versus the large-cap FTSE World Europe ex UK index, and the FTSE All-Share index, included as a comparator because of its relevance to UK-based investors.

The managers note that outperformance has been driven by holdings in cyclical stocks in sectors such as consumer discretionary, (which includes makers of cars and car parts). They see broad support for this area given that service PMIs (a measure of business confidence) remain strong, even as manufacturing PMIs are weakening. The managers point out that the late August sell-off was notable in that defensive stocks broadly fell by more than cyclical stocks, which runs somewhat counter to the idea of 'cyclical' and 'defensive'.

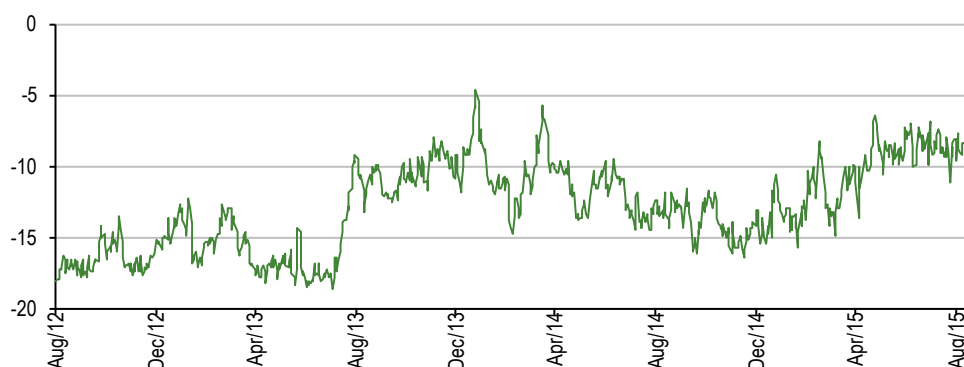
Recent performance has been boosted by a \$1.8bn takeover bid for top holding Faiveley Transport, whose shares rose 37.8% on news of the prospective deal in late July and remain some 35% above the pre-bid share price. Other strong performers include French campervan specialist Trigano, up 45.6% over the six months to 31 August on the back of strong trading performance, and Italian clothing retailer OVS, bought at IPO in early March and up 44.3% from flotation to 31 August.

Discount: On a narrowing trend

JESC's discount to cum-income net asset value has been in a broadly narrowing trend over the past year and stood at 8.3% at 9 September, compared with an average of 11.7%, 12.8% and 14.0% over one, three and five years respectively.

The trust has the authority to repurchase up to 14.99% and allot up to 5% of shares annually in order to manage a discount or a premium. It may also conduct periodic tender offers allowing shareholders to sell back some of their holding at an agreed discount. No buybacks have been made since December 2013 and the last tender offer was in July 2013. The board continues to monitor the discount and may use its buyback powers to minimise short-term discount volatility.

Exhibit 8: Discount to NAV (debt at fair value, including income) – past three years



Source: Thomson Datastream. Note: Positive values indicate a discount.

Capital structure and fees

JESC is a conventional investment trust with one class of share. Following a five-for-one share split in July 2014 intended to improve liquidity and facilitate regular savings and dividend reinvestment, there are 160.15m ordinary shares in issue. The trust has access to a €100m multicurrency loan facility with Scotiabank, of which half is on a fixed and half a floating rate of interest. JESC's managers actively manage the level of gearing, which stood at 10.6% at FY15 and 4.4% at 7 September. The permitted gearing range is between 20% geared and 20% net cash, although the maximum achievable gearing if the whole €100m were drawn (based on 4 September exchange rates) is currently 17.0%.

Following a reduction in the management fee with effect from 1 April 2015, J.P. Morgan Funds Ltd (JESC's alternative investment fund manager [AIFM] under the AIFM Directive) is paid a fee of 1.0% of net assets (previously 1.3% of market capitalisation). There is no performance fee and ongoing charges for FY15 (based on the previous fee arrangements) were 1.31%.

Dividend policy and record

JESC's objective is to achieve capital growth, although it has a policy of paying out the majority of its net revenue in the form of an interim (paid January) and/or final (July) dividend. Management fees and finance costs are charged 30% to income and 70% to capital, and the net revenue return per share for the year ended 31 March 2015 was 3.45p, of which 3.2p was paid in dividends, representing a yield of 1.3% based on the 9 September share price of 248.3p. The revenue reserve at FY15 was 3.9p per share. The total dividend for FY15 was 10% higher than for the previous year, after adjusting for a stock split in July 2014, although as the level of dividend is dependent on the level of income received, there is no guarantee of a year-on-year rise in the payout.

Peer group comparison

The AIC's European Smaller Companies peer group is a small sector containing just four trusts, three of which have market capitalisations above £300m. JESC's NAV total return performance is above the weighted average over one and three years and ranks second over five years. Risk-adjusted performance as measured by the Sharpe ratio is broadly average over both one and three years. The yield of 1.3% is the second-lowest in the group, although the average is skewed by the high distribution policy of European Assets Trust (EAT), which yields 5.3%. Because of its high yield, EAT has tended to trade at a premium, which also distorts the discount for the sector, where JESC ranks third. JESC's gearing is currently the second-lowest in the sector, although the level of gearing is actively managed and tends to fluctuate significantly over even quite short periods. Ongoing charges are broadly average.

Exhibit 9: European Smaller Companies investment trusts

% unless stated	Market cap £m	TR one year	TR three years	TR five years	Ongoing charge	Perf. fee	Discount (-) /premium	Net gearing	Yield	Sharpe NAV 1 year	Sharpe NAV 3 years
JPMorgan European Smaller Cos	390.8	15.0	75.2	74.8	1.3	No	-10.0	104.4	1.3	1.3	1.3
European Assets Trust	306.3	15.7	80.0	131.5	1.3	No	1.7	101.0	5.3	1.5	1.7
Montanaro European Smaller Cos	84.8	3.2	28.1	39.4	1.5	No	-10.6	110.0	1.6	0.5	0.8
TR European Growth	304.9	6.2	76.4	68.8	0.7	Yes	-8.5	114.0	1.1	0.7	1.5
Sector weighted average		11.8	73.2	86.4	1.2		-6.3	106.6	2.4	1.1	1.4
JESC rank in sector	1	2	3	2	3		3	3	3	2	3

Source: Morningstar, 7 September 2015, Edison Investment Research. 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.

The board

JESC has five non-executive directors. Carolan Dobson has been on the board since 2010 and was appointed chairman in 2013. Federico Marescotti has been a director since 2005, while Stephen White and Ashok Gupta were appointed in 2012 and 2013 respectively. The newest director, Nicholas Smith, joined the board in May 2015 and replaces Anthony Davidson, who stood down with effect from the AGM in July. The directors have backgrounds in business and investment management.

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