

JPMorgan European Smaller Cos

Strong continuity of management

JPMorgan European Smaller Companies Trust (JESC) is managed by a dedicated, highly experienced, three-man team. The 'best ideas' portfolio, which generally comprises 60-80 holdings, currently numbers 63. Stocks are selected on a bottom-up basis from a universe of c 1,000 companies, which constitute the Euromoney Smaller Companies ex-UK index, the trust's benchmark. Long-term performance has been strong, as evidenced by its 10- and 20-year NAV and share price returns, which comfortably outstrip the benchmark and the MSCI Europe ex-UK index.

12 months ending	Share price (%)	NAV (%)	Euromoney Smaller Eur Cos ex-UK (%)	FTSE World Europe ex-UK (%)	FTSE All-Share (%)
31/12/12	14.9	10.2	16.9	17.8	12.3
31/12/13	59.6	49.0	37.5	25.2	20.8
31/12/14	(9.4)	(5.6)	(1.9)	0.2	1.2
31/12/15	44.1	32.4	17.2	5.3	1.0
31/12/16	1.9	13.9	23.3	19.7	16.8

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

Investment strategy: Bottom-up with thematic overlay

In the current environment, JESC seeks to invest in companies that can flourish, however tough macroeconomic conditions might become. JESC's managers seek to own stocks 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 bottom-up stock-picking strategy is allied to a thematic overlay, with sector and country diversification ensured by the wide opportunity set, rather than by top-down constraints.

Market outlook: Upbeat, but ready for surprises

Recent European business confidence data has come in ahead of expectations, but economic uncertainty and political risk remain high, with 2017 heralding a number of elections in Europe, the arrival of a new president in the White House and a reduction in the scale of quantitative easing in Europe. At the same time, the lingering global debt burden continues to dampen economic growth prospects, arguably most negative for mega-cap companies operating in mature markets and least negative for smaller innovative companies able to build market share, tap new markets or disrupt an existing market. Confident that it can navigate a harsher environment and currently fully invested in equities, JESC last month utilised its leverage facility and is now modestly geared.

Valuation: Share price lagging NAV growth

During 2016, JESC's share price lagged its strong absolute NAV performance, resulting in a widening of the discount to 16.8%, close to its widest in several years. The discounts of JESC's close peers stand at similar levels, suggesting a lack of investor appetite for smaller company funds, although perversely, in terms of P/E multiples, European small-caps currently trade at a premium to their historic averages and to large-caps, arguably reflecting the superior earnings growth potential of smaller companies in a low-growth, increasingly competitive world.

Investment trusts

9 January 2017

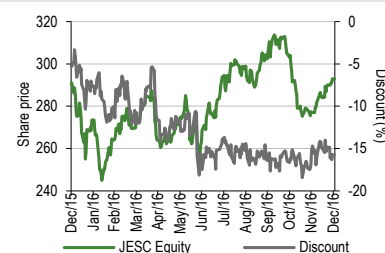
Price 293.0p
Market cap £468.8m
AUM £598.1m

NAV* 344.7p
Discount to NAV 15.0%
NAV** 347.7p
Discount to NAV 15.7%

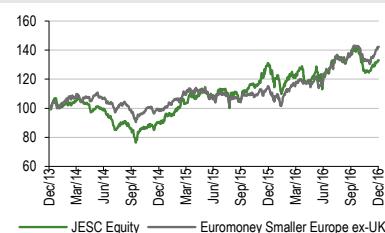
*Excluding income. **Including income. As at 30 December 2016.

Yield 1.1%
Ordinary shares in issue 160.0m
Code JESC
Primary exchange LSE
AIC sector European Smaller Companies
Benchmark Euromoney Smaller Eur Cos ex-UK

Share price/discount performance



Three-year performance vs index



52-week high/low 313.8p 245.0p
NAV** high/low 375.1p 269.2p

**Including income.

Gearing

Net gearing* 2.9%

*As at 30 December 2016.

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JPMorgan European Smaller Companies Trust is a research client of Edison Investment Research Limited

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 the 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

- 24 November 2016: Interim dividend of 1.2p declared for the six months ended 30 September, payable on 4 January 2017.
- 24 November 2016: Six-month results ended 30 September. NAV total return of +17.7% compared with +16.1% for the benchmark Euromoney Smaller Companies ex-UK index. Share price TR +10.3%.
- 23 November 2016: The company purchased 60,000 shares for cancellation at 278.5p a share.

Forthcoming

AGM	July 2017
Final results	May 2017

Capital structure

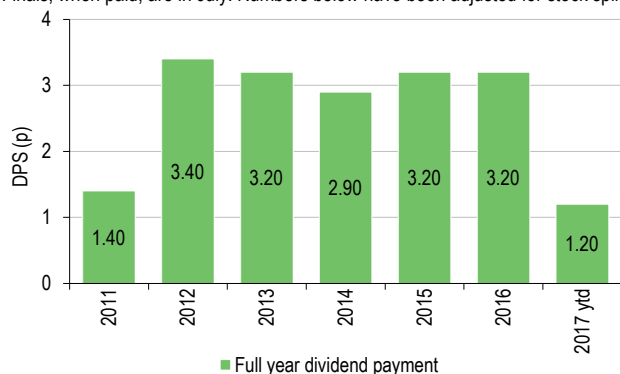
Ongoing charges	1.18%
Effective gearing	2.9% (30/12/16)
Annual mgmt fee	1.0% of net assets
Performance fee	None
Trust life	Indefinite
Loan facilities	€100m

Fund details

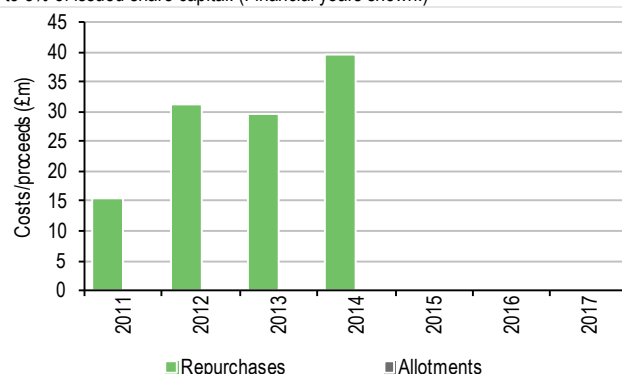
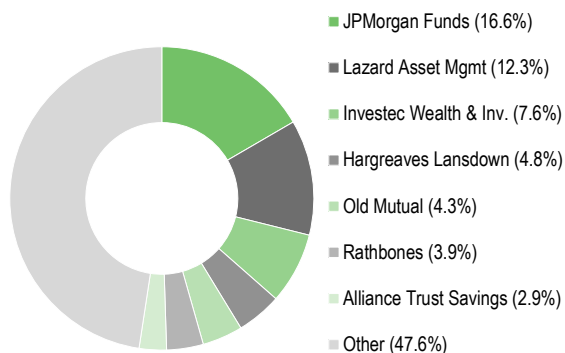
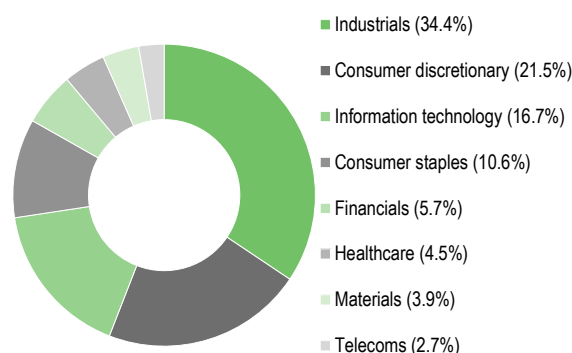
Group	JPMorgan Asset Management (UK) Ltd
Manager	Jim Campbell, Francesco Conte, Edward Greaves
Address	60 Victoria Embankment, London EC4Y 0JP
Phone	+44 (0)800 731 1111
Website	www.jpmeuropeansmallercompanies.co.uk

Dividend policy and history

Between zero and two dividends annually. Interims, when paid, are in January. Finals, when paid, are 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. (Financial years shown.)


Shareholder base (as at 31 October 2016)

Sector breakdown of portfolio (as at 30 November 2016)

Top 10 holdings (as at 30 November 2016)

Company	Country	Sector	Portfolio weight %	
			30 November 2016	31 May 2016*
Trigano	France	Campervan producer	2.2	N/A
Datalogic	Italy	Barcode readers	2.2	N/A
Alten	France	Research & Development consultancy	2.1	2.0
Ipsen	France	Pharmaceutical product manufacturer	2.1	N/A
Tarkett	France	Flooring products	2.0	N/A
dorma+kaba	Switzerland	Security and building access	2.0	N/A
Amplifon	Italy	Hearing aid retailer	2.0	N/A
Ubisoft Entertainment	France	Multinational video game publisher	2.0	N/A
IMA	Italy	Pharmaceutical and food packaging	2.0	N/A
Interpump Group	Italy	High pressure pumps	2.0	N/A
Top 10 (% of holdings)			20.6	23.4

Source: JPMorgan European Smaller Companies Trust, Edison Investment Research, Morningstar, Thomson Reuters. Note: *N/A where not in May 2016 top 10.

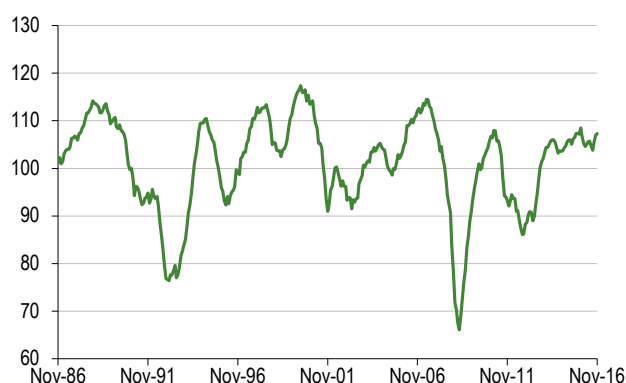
Market outlook: Small-caps – greater agility, same reach

The rapid growth seen in e-commerce in the last two decades, both business-to-business and business-to-consumer, and the significant progress made in digital technology more generally, have enabled smaller companies to compete more effectively in the global market. As a result of new low-cost technology, today's small companies have the opportunity to increase their potential global reach, enabling them to scale their business model, often sell directly to the customer rather than through an intermediary (disintermediation), and geographically diversify their earnings (thereby reducing risk), at a much earlier stage in their development and at a lower cost than had hitherto been the case. Moreover, technological advances and the creation of the 'cloud' have enabled smaller companies to reduce capital expenditure as well as variable costs by renting labour-saving 'software-as-a-service' and reducing headcount, increasing competitiveness and productivity.

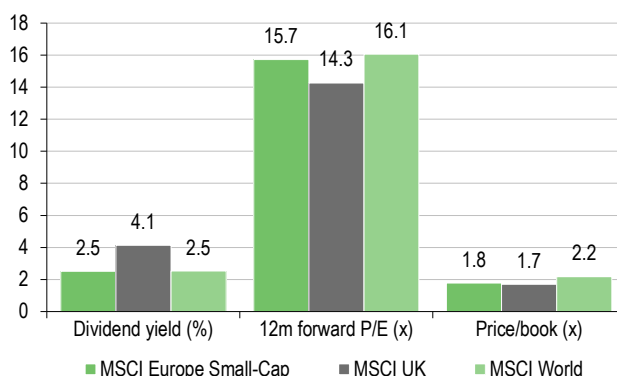
This change in competitive position might be viewed as one reason to take a closer look at a well-managed European small cap fund, especially one trading on a wider than average discount with a solid long-term performance record. However, it should be borne in mind that earlier-stage companies may carry a greater risk of failure than their more established counterparts. It is a global phenomenon that smaller company valuations no longer necessarily trade at a discount to those of large-caps, as had historically been the case. This is arguably the result of the technological changes referred to above that have levelled the competitive landscape. That said, not all small-caps aim to become large-caps, since certain smaller companies have small niche markets that are themselves not destined to grow. JESC's managers report that the companies in which they invest continue to enjoy reasonable trading conditions and benefit from their own self-help measures. The managers remain optimistic for the prospects of the companies in which they invest.

Exhibit 2: Market performance and valuation

European Union economic indicator for the last 10 years



Key valuation metrics for European small caps versus other indices



Source: Edison Investment Research, MSCI, European Commission. Note: Valuation data as at 30 November 2016.

Fund profile: Best ideas from across 14 countries

JPMorgan European Smaller Companies Trust (JESC) was launched in 1990. In 1995 Jim Campbell became the named manager of the fund and three years later, management resource and experience was broadened with the appointment of Francesco Conte as co-manager. Each manager takes responsibility for specific regions. Conte covers Benelux, France, Switzerland and Italy, while Campbell covers Austria, Germany, Ireland, the Nordics and Iberia. The named management team for the trust has recently been expanded to include Edward Greaves, who has been part of the team working on JESC for the last five years. He works across the geographic spectrum alongside the two others. All three are part of, and receive analytical research input from, J.P. Morgan Asset Management's sizeable European equities division.

The fund managers: Campbell, Conte and Greaves

The managers' view: "It's all about finding the right stocks"

"It's difficult to be pessimistic and it's difficult to be excited. We're marginally positive. If we can find the right stocks we'll do well for our investors." Francesco Conte (November 2016).

While wary of the extreme levels of political and economic uncertainty in the second half of 2016, Conte reports that the managers took advantage of market weakness to add to high-quality companies that are not dependent on the economic cycle. The team acknowledges that the era of loose monetary policy may be gradually coming to an end in Europe, but the managers remain positive about the long-term prospects for the portfolio.

The managers are confident that long-term, European small-caps will perform well, but they expect to exploit setbacks and sector anomalies along the way. Their aim is to navigate current heightened levels of uncertainty by owning companies with reliable and sustainable earnings growth. Given macro headwinds across many sectors, there is currently a bias towards digitally focused companies with scalable business models that have scope to generate international earnings. Two decades ago the expectation would have been that the vast majority of smaller companies would be largely dependent on their domestic customer base. This is no longer the case, since many of today's European smaller companies derive their earnings, not just in the eurozone but internationally. Such companies are not dependent on the success of one single economy or indeed of the European economy. Also, because many of Europe's successful smaller companies are knowledge-based with few fixed assets, they are easily transferable to other jurisdictions, should the regulatory burden of their domestic market become too onerous.

European equity research produced by the sell side has been in decline for some years now, with Conte reporting that analyst output was down by 30% in 2016 alone. This plays into the hands of asset managers with in-house research expertise like J. P. Morgan Asset Management. In addition, because, arguably, the market today is under-researched, there are potentially more anomalies for proactive managers to identify and exploit.

Asset allocation

Investment process: A mix of art and science

The benchmark Euromoney Smaller European Companies ex-UK index comprises c 1,000 stocks across 14 countries. From this universe, JESC's managers select a portfolio of 60-80 stocks. The focus is on investing in high-quality companies that offer attractive value and good momentum in terms of earnings growth and share price. Quality is defined as having sustainable earnings growth and disciplined capital management. Such companies are often what the managers view as market-leading growth companies offering a catalyst for outperformance. Stock position sizing is determined by investment conviction and trading liquidity. The significant collective experience of the management team means that its knowledge of listed stocks often dates back to when the companies were private or when they were initially floated on the stock market. Portfolio construction is unconstrained with regard to how much stocks and countries can differ from the benchmark, but there is a limit of 35% exposure to any one sector. The portfolio essentially comprises the managers' best ideas. Winning positions are allowed to run but are regularly 'top-sliced' to prevent them from becoming too large a part of the portfolio. Positions are sold outright when there is a change in business outlook, the share price momentum has broken down, cash is required to fund a better idea or they have simply become too large to justify being in a smaller companies portfolio. Portfolio turnover is reasonably high – reflecting the aforementioned reasons,

as well as takeover activity. At any given time, each of the portfolio holdings needs to justify its place in the portfolio and each is regularly reappraised.

Current portfolio positioning: Secular growth themes

While the investment process is broadly bottom-up, the team marries this approach with myriad other inputs to generate the best new investment ideas. This strategy can in turn lead to a number of investments that relate to the same theme. For example, the team views the widespread adoption of the electric car in place of the combustion engine as an irreversible trend, and this theme has influenced stock selection in the auto parts sector – companies that rely on sales of the combustion engine are avoided, while the opposite applies to companies where this secular growth trend is a tailwind. An example of this is Freni Brembo, the Italian maker of lightweight, high-performance braking systems, which is able to service both the growing electric car and declining petrol car markets. The team also favours companies which either have, or offer the potential to have, an internationally diversified customer base by which to leverage growth and spread risk – an example of this is the Swiss banking software company Temenos, which has disrupted traditional accounting services through digital technology. Another high-conviction theme is the ageing population and the growing market of wealthy retired people (soon to be yet further boosted by the post-war baby boomers) who wish to remain active. Exposure to this segment is gained through Italian hearing aid company Amplifon and French camper van manufacturer Trigano, among others. Other current investment themes include the 'challenger banks' with their technology and zero-legacy advantages, and salmon farms – due to the increasing demand for perceived healthy living.

Exhibit 3: Portfolio geographic exposure vs benchmark (% unless stated)

	Portfolio end-Nov 2016	Index weight	Active weight vs index (pp)	Trust weight/ index weight (x)
France	23.1	12.0	11.1	1.9
Sweden	14.0	14.1	-0.1	1.0
Italy	14.2	10.5	3.7	1.4
Finland	10.5	5.4	5.1	1.9
Netherlands	8.0	4.3	3.7	1.9
Switzerland	8.5	11.2	-2.7	0.8
Germany	5.3	14.2	-8.9	0.4
Denmark	5.8	4.1	1.7	1.4
Norway	6.9	5.8	1.1	1.2
Spain	2.8	7.7	-4.9	0.4
Belgium	1.0	4.3	-3.3	0.2
Other	0.0	6.4	-6.4	0.0
	100.0	100.0		

Source: JPMorgan European Smaller Companies Trust, Edison Investment Research. Note: Excludes cash.

At end-November 2016, the top 10 holdings accounted for 21% of the portfolio. This was a lower level of concentration versus the end of May 2016, when the top 10 accounted for 23.4%. Versus the benchmark, the largest overweight exposure is to France, while the largest underweight is Germany. Although exposure to France had been reduced following the sale of Ubisoft and the takeover of Faiveley, the manager continues to find new opportunities there. While French employment law reduces flexibility on labour, Conte argues that counterintuitively, as a result of inflexible labour laws, France's entrepreneurs are inclined to make better decisions as to who they hire, and how many they hire, automating where possible. This, argues Conte, results in superior productivity and long-term profitability. A recent example is the holding in Maisons du Monde, a French furniture retailer floated in May 2016, which Conte describes as a Habitat for the digital age. It marries a well-designed physical store presence with a complementary online offering.

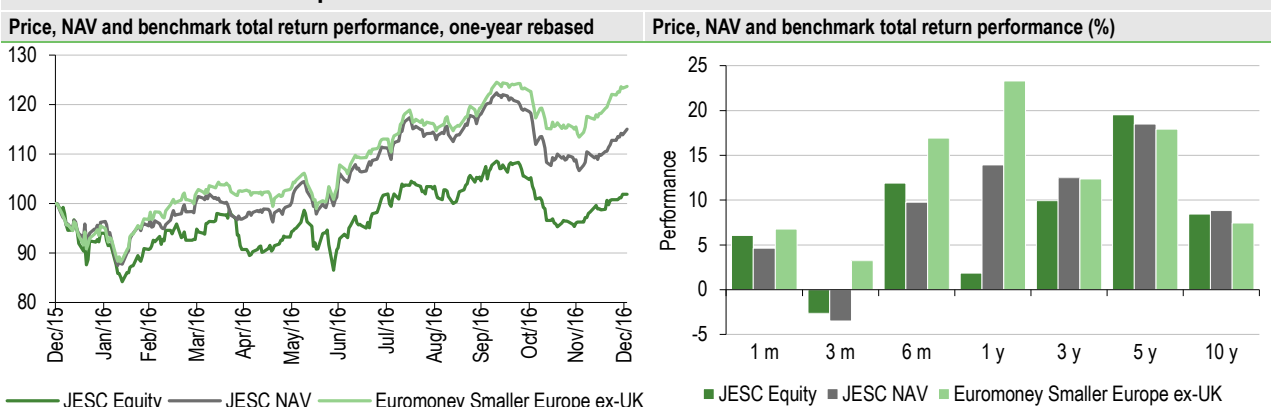
Exhibit 4: Portfolio sector exposure vs benchmark (% unless stated)

	Portfolio end-November 2016	Portfolio end-May 2016	Change (pp)	Index weight	Active weight vs index (pp)	Trust weight/index weight (x)
Industrials	34.4	32.1	2.3	22.9	11.5	1.5
Consumer discretionary	21.5	26.0	-4.5	14.7	6.8	1.5
Information technology	16.7	20.2	-3.5	9.0	7.7	1.9
Consumer staples	10.6	6.3	4.3	7.3	3.3	1.4
Financials	5.7	6.0	-0.3	7.6	-1.9	0.7
Healthcare	4.5	5.1	-0.7	7.0	-2.5	0.6
Materials	3.9	3.6	0.3	13.4	-9.5	0.3
Telecoms	2.7	0.0	2.7	3.1	-0.4	0.9
Real estate	0.0	N/A	N/A	8.1	-8.1	0.0
Energy	0.0	0.0	0.0	3.7	-3.7	0.0
Utilities	0.0	0.7	-0.7	3.2	-3.2	0.0
	100.0	100.0		100.0		

Source: JPMorgan European Smaller Companies Trust, Edison Investment Research. Note: Excludes cash.

Performance: Short-term setback, long-term strength

Over the long term JESC's total return performance has been strong: over 10 and 20 years to 31 December 2016, NAV annualised total returns are 8.8% and 13.9% respectively, comfortably ahead of both the benchmark Euromoney Smaller European Companies (ex-UK) index, up 7.4% and 10.7%, and the MSCI (Europe) ex-UK index, up 6.4% and 8.1% respectively (all in GBP). However, during these periods of long-term outperformance, JESC, like all actively managed funds, has witnessed occasional periods of underperformance, reflecting the fact that stock markets do not move in straight lines and that the portfolio is actively managed and therefore its NAV performance is unlikely to correlate closely with the benchmark at all times. Over the last three months to the end of December, the trust has underperformed its benchmark as the share prices of certain portfolio holdings have suffered stock-specific setbacks. Recent detractors from performance have included Swedish window producer Inwido, Dutch bedroom furnishings retailer Beter Bed, and French flooring company Tarkett. Against this, contributors to performance have included Italian hearing aid retailer Amplifon, Finnish construction company YIT and Swedish bus operator Nobina.

Exhibit 5: Investment trust performance to 31 December 2016


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

Exhibit 6: 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 Euromoney Smaller Europe ex-UK	(0.7)	(5.7)	(4.3)	(17.4)	(6.3)	7.0	9.8
NAV relative to Euromoney Smaller Europe ex-UK	(2.0)	(6.5)	(6.1)	(7.6)	0.4	2.5	13.7
Price relative to FTSE World Eur ex-UK	(0.9)	(7.1)	(2.0)	(14.9)	5.3	30.9	26.7
NAV relative to FTSE World Eur ex-UK	(2.2)	(7.9)	(3.9)	(4.8)	12.7	25.5	31.2
Price relative to FTSE All-Share	1.0	(6.3)	(0.1)	(12.8)	11.4	50.7	30.9
NAV relative to FTSE All-Share	(0.4)	(7.1)	(2.0)	(2.4)	19.3	44.4	35.5

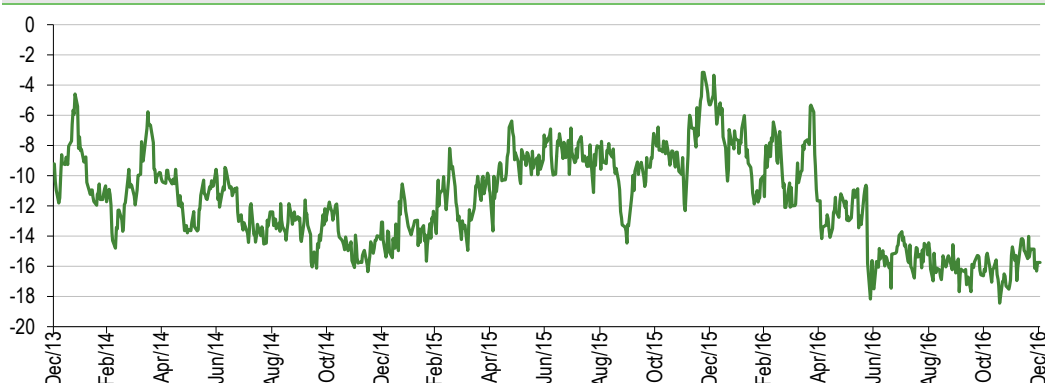
Source: Thomson Datastream, Edison Investment Research. Note: Data to end-December 2016. Geometric calculation.

Exhibit 7: NAV total return performance relative to benchmark over three years


Source: Thomson Datastream, Edison Investment Research

Discount: Currently wider than historic average

Exhibit 8 shows how JESC's discount has remained wide since the Brexit vote, when sterling's fall gave an immediate uplift to the NAV. European small-cap peers also de-rated following the Brexit vote. It seems possible that once sterling's new level versus the euro is perceived to have stabilised, the discount could narrow as investors seek to exploit the anomaly. JESC may repurchase up to 14.99% on an annual basis to help manage the discount. Since December 2013 there have been two minor share repurchases, both in November 2016.

Exhibit 8: Share price premium/discount to NAV (including income) over three years (%)


Source: Thomson Datastream, Edison Investment Research

Capital structure and fees

JESC is a conventional investment trust with one class of share. There are currently 160m shares in issue. The trust has a €100m lending facility in place with Scotiabank split 50:50 fixed and floating rate. The permitted gearing range is set by the board and the current range is between 20% gearing and 20% net cash. Within that range the managers have discretion on deployment of gearing. At end-November 2016, JESC had net cash of 1.9%. The management fee is 1.0% of market cap. For FY16 it was 30% paid out of revenue and 70% out of capital. There is no performance fee. The ongoing charge was 1.18% for FY16 versus 1.32% in the previous year.

Dividend policy and record

JESC has an investment objective of capital growth and therefore its investment selection is not constrained by yield requirements. As a result, the fund's dividend income is likely to fluctuate from

year to year. The board's dividend policy is therefore to pay out the majority of income generated each year, but with no guarantee or stated objective of an increase in the year-on-year payout. Dividends are paid in the form of an interim, paid in January and/or a final dividend paid in July. In FY16, an interim dividend of 1.2p was followed by a final dividend of 2.0p; the total 3.2p matches the payout of the previous year. Based on the current share price, the dividend yield is 1.1%.

Peer group comparison

With a market cap of over £400m, JESC is the largest investment trust in the four-strong peer group. It is the best performer in terms of NAV total return over 10 years and is broadly in line with the average over shorter time horizons. The peer group average discount is skewed by European Assets Trust, which in recent times has tended to trade on a higher rating due to its high dividend payout objective. Nonetheless, the whole of the peer group saw a widening of discounts in 2016, arguably reflecting a belief that markets had moved too far too quickly.

Exhibit 9: AIC European Smaller Companies peer group as at 2 January 2017

% unless stated	Market cap £m	NAV TR 1 Year	NAV TR 3 Year	NAV TR 5 Year	NAV TR 10 Year	Sharpe 1y (NAV)	Sharpe 3y (NAV)	Discount (ex-par)	Ongoing charge	Perf. fee	Net gearing	Dividend yield (%)
JPMorgan European Smaller Cos	468.8	15.8	44.1	137.6	134.9	(0.3)	0.2	(16.1)	1.2	No	100	1.1
European Assets Trust	339.4	8.3	40.5	146.2	111.6	(0.6)	0.1	(9.5)	1.1	No	100	0.3
Montanaro European Smaller	102.4	19.7	37.5	99.2	113.1	(0.1)	0.1	(18.6)	1.4	No	111	1.2
TR European Growth	385.0	30.3	58.9	180.2	120.2	0.4	0.4	(15.6)	0.8	Yes	113	1.2
Simple average	323.9	18.5	45.2	140.8	119.9	(0.1)	0.2	(15.0)	1.1		106	0.9
JESC rank in sector	1	3	2	3	1	3	2	3	2		3	3

Source: Morningstar, Edison Investment Research. Note: TR=total return. Sharpe ratio is a measure of risk-adjusted return. The ratios shown 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 total assets less cash and equivalents as a percentage of net assets.

The board

There are five non-executive directors on the board of JESC. Chairman Carolan Dobson was appointed in September 2010 and has been chairman since 2013. Federico Marescotti resigned from the board following recommended practice after 10 years of service and was replaced by Marc van Gelder in August 2016; Stephen White was appointed in April 2012, Ashok Gupta in January 2013 and Nicholas Smith was appointed in May 2015.

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