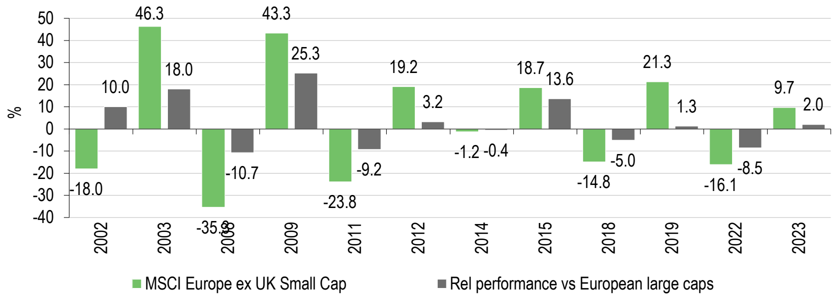
European Assets Trust

Tentative signs of recovery in Europe

Investment trusts
European smaller companies

In times of economic stress or extreme investor risk aversion, small-cap stocks are frequently indiscriminately sold down by investors, which has created significant headwinds for European Assets Trust (EAT) over the past 12 months. Factors like stock market volatility created by the war in Ukraine and associated secondary effects such as supply chain disruption, lower economic growth, higher inflation and more hawkish central bank activity have contributed to weak investor sentiment towards European small-cap stocks. Also, the rotation away from long-duration growth assets has presented seismic challenges for managers regardless of asset class, but especially for European smaller companies. In our November 2022 update on EAT, we made the case for backing the experienced management duo, and continue to believe that once markets focus on the fundamentals of the innovation, growth and cheapness in the market, EAT and European smaller companies are well placed to outperform again.

European small caps have rebounded strongly historically



Source: Morningstar. Note: Total returns in sterling. 2023 data to 28 February.

Why consider EAT?

The managers believe that the best time to buy European small-cap stocks is after they have performed poorly. This makes sense (and arguably for almost all asset classes) but was especially the case, as illustrated above, in 2003, 2009, 2012, 2015 and 2019. 2022 was another weak year for the asset class, and although there have been some better returns in 2023 to date, they are modest compared with previous recoveries. Given the volatility of the asset class, economic theory suggests that investors should be compensated for this, as has been the case with higher risk-adjusted returns (Sharpe ratios) for European small caps versus large caps over 10, 15 and 20 years. Timing in investment is everything, and for those with a diversified portfolio, a long-term investment horizon and an appropriate attitude to risk, it may be time to consider European smaller companies and EAT within that opportunity set.

CTI/BMO integration bearing fruit

It is heartening to see the tangible results of the investment team integration between BMO Financial Group and Columbia Threadneedle Investments (CTI) on the portfolio, with several new holdings initiated as a result of the greater investment resource available to fund managers Sam Cosh and Lucy Morris and the collaboration between the teams.

NOT INTENDED FOR PERSONS IN THE EEA

9 March 2023

Price	**95.6p**
Market cap	**£344.2m**
Total assets	**£380.8m**
NAV*	103.3p
Share discount to NAV	7.5%

*Including income. At 7 March 2023.

Yield	6.1%
Shares in issue	360.1m
Code Ord/ISIN	EAT/GB00BHJVQ590
Primary exchange	LSE
AIC sector	European Smaller Companies
Financial year	31 December

52-week high/low*	116.8p	77.2p
NAV* high/low	122.7p	84.1p

*Including income.

Gearing

Net gearing at 7 March 2023	1.4%

Fund objective

European Assets Trust was launched as a Dutch company in 1972 and was previously dual listed on the LSE and Euronext Amsterdam exchanges. The trust formally migrated from the Netherlands to the UK on 16 March 2019. It targets capital growth through investment in quoted small and medium-sized companies in Europe (ex-UK), using the EMIX Smaller Europe ex-UK Index as a benchmark.

Bull points

- Scope for strong share price rebounds.
- Valuation support for European small caps.
- Tangible benefits from CTI acquisition appearing.

Bear points

- Potential for further market volatility.
- Timing for potential re-rating is uncertain.
- Fund NAV lagging on growth derating.

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Edison profile page

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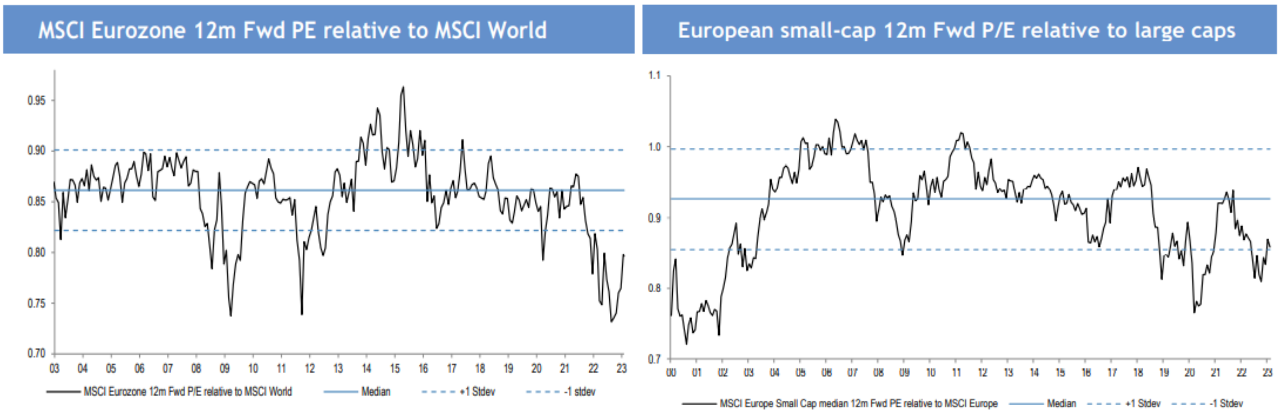
Green shoots emerging?

Europe, despite its proximity to the war in Ukraine, has looser monetary policy and better labour market conditions compared with some other economic regions and as supply bottlenecks and energy prices have eased, inflation has begun to roll over. These are tailwinds for Europe, especially versus the United States, and stock market returns are reflecting these factors. In the last three months, the differential between the outperformance of the European market over the US market was a significant 15.3% compared with the 10-year previous return differential of an annualised 4.6% in favour of the United States (source: Morningstar, in pounds sterling terms, data to the end of January 2023). It may be early days, but there is momentum appearing behind European stocks that has been absent for some time.

Aside from more favourable domestic macroeconomic conditions, European stocks can also be considered a good way to play global growth. Morningstar calculates that the MSCI Europe ex UK Index has less than a third of its revenues derived from the eurozone, although this is a little higher for small caps, at around 40%. In addition, both the European large- and small-cap indices have 10-year betas of 1.2 compared with the MSCI All Countries World Index, indicating more sensitivity in aggregate to market movements (either up or down). Overall, there are more cyclical and less defensive sectors within Europe and within European small caps especially when compared with the global equity index. The post-COVID-19 re-opening of China was a catalyst for European markets to outperform global indices given the factors described above, and as the pace and effects of re-opening continue this is likely to be supportive of global growth and potentially European domiciled companies' earnings and share prices.

Exhibit 1: European (and small-cap) valuation anomalies versus global equity markets



Source: EAT investor presentation

As seen in Exhibit 1 (left-hand side), European equities are trading at a significant discount (12-month forward price to consensus earnings numbers) versus global equities. In addition, European small caps are standing at a significant discount to European larger companies (right-hand side). The asset class has significant valuation support.

Country and sector changes over the past year

Geographic and sector weightings are predominantly a factor of stock-specific merits, with the overweight Swedish position a result of established fund holdings in Karnov Group and Coor Service Management. Exposure to Irish-listed companies has increased from a year ago, to 7.7%, (January 2023) via initiations in 2022 to Bank of Ireland Group, Dalata Hotel Group and Glanbia.

Conversely, the fund's weighting to Germany has reduced by 11pp with sales of CANCOM, Norma Group, Scout24, Patrizia and Global Fashion Group.

Exhibit 2: Country weightings

Country	January 2023 (%)	January 2022 (%)	Change (pp)	Benchmark (%)	Active weight vs benchmark (pp)
Sweden	14.9	15.0	(0.1)	13.5	1.4
Switzerland	12.3	10.6	1.7	10.6	1.7
Norway	11.7	13.3	(1.6)	6.5	5.2
Germany	11.1	22.1	(11.0)	14.5	(3.4)
Netherlands	9.5	6.7	2.8	4.9	4.6
France	8.2	7.6	0.6	13.3	(5.1)
Ireland	7.7	1.8	5.9	1.2	6.5
Italy	7.4	7.5	(0.1)	10.8	(3.4)
Spain	6.9	2.7	4.2	5.5	1.4
Denmark	5.7	7.1	(1.4)	4.8	0.9
Belgium/Luxembourg	2.5	2.0	0.5	5.4	(2.9)
Austria	2.1	0.0	2.1	3.9	(1.8)
Portugal	0.0	1.7	(1.7)	1.1	(1.1)
Iceland	0.0	1.9	(1.9)	0.0	0.0

Source: CTI. Note: Benchmark = EMIX Smaller European Companies (ex UK).

The broad industrials sector remains a prominent sector within the portfolio, albeit with a myriad of end-market uses, from Interpump and its high-pressure water pumps used in construction, drilling and agriculture, to Rational, a manufacturer of kitchen equipment. Financials also remains a key sector, with long-established positions in Ringkjoebing Landbobank, Storebrand and SpareBank augmented by newer additions such as Bank of Ireland Group. The consumer sector is an area that has been under pressure, and there have been sales of Dometic Group, Marr and Mister Spex in this sector over the past year.

Exhibit 3: Sector weightings

Sector	January 2023 (%)	January 2022 (%)	Change (pp)	Benchmark (%)	Active weight vs benchmark (pp)
Industrials	22.5	21.8	0.7	25.5	(3.0)
Financials	14.9	16.6	(1.7)	13.2	1.7
Technology	14.0	17.5	(3.5)	10.3	3.7
Consumer disc	13.9	19.5	(5.6)	13.8	0.1
Consumer staples	13.0	10.2	2.8	5.7	7.3
Healthcare	10.4	9.7	0.7	7.8	2.6
Basic materials	6.8	3.7	3.1	5.7	1.1
Energy	3.3	0.0	3.3	4.5	(1.2)
Real estate	1.2	1.0	0.2	7.9	(6.7)

Source: CTI. Note: Benchmark = EMIX Smaller European Companies (ex UK).

Broadening the portfolio at the margin

At the end of January 2023 the portfolio had 52 holdings, which is an increase from 48 in Q422 as the managers are focused on broadening the exposure within sectors and industries. In the current economic environment, the managers are looking for high-quality companies that may have been sold down indiscriminately, and there are two examples of this within the consumer space detailed below. Fundamentally, those companies that have an element of pricing power and that are able to pass through cost price inflation are in a strong position. More structurally the team is looking for capex beneficiaries (Kardex), as supply lines are brought closer to domestic markets to counter potential future disruption in this area, and companies that are able to help alleviate productivity declines or labour market shortages via automation (engcon). Likewise, companies that benefit from energy security (Schoeller-Bleckmann), efficiency and defence spending are currently in a sweet spot. However, the managers are mindful that conventional fossil fuel energy production is in long-term structural decline. Finally, the team is looking for companies that are able to positively harness the shift to higher interest rates within their operations or business model, such as Bank of Ireland Group.

Exhibit 4: Top 10 holdings

Company	Sector	January 2023 (%)	January 2022 (%)	Benchmark weight (%)	Change (pp)	Active weight vs benchmark (pp)
Ringkjoebing Landbobank	Financials	3.7	3.8	0.3	(0.1)	3.4
Interpump	Industrials	3.7	N/A	0.4	N/A	3.3
Tecan	Health care	3.6	N/A	0.3	N/A	3.3
SIG Group	Industrials	3.6	N/A	0.0	N/A	3.6
Storebrand	Financials	3.1	3.5	0.3	(0.4)	2.8
Karnov	Industrials	2.9	N/A	0.0	N/A	2.9
Sligo Food Group	Consumer staples	2.9	N/A	0.1	N/A	2.8
IMCD	Basic materials	2.9	N/A	0.0	N/A	2.9
Atea	Industrials	2.7	N/A	0.1	N/A	2.6
Bank of Ireland Group	Financials	2.6	N/A	0.0	N/A	2.6
Total		31.7	7.3			

Source: CTI. Note: N/A denotes not in the top 10 at January 2022.

New positions added to the portfolio since our last note in November 2022 include Vidrala, which is the premium glass-bottle packaging operator in Spain and a stock that the fund managers have previously owned in EAT. They sold the position in early 2022 as the company had not hedged its energy costs, which is a significant and increasing element of input costs for the business. However, this has become less relevant as wholesale energy prices have reduced and a position was reintroduced in December 2022 via a reduction in the fund's holding in Virallia. Virallia, which has been held since June 2021, is a similar French business that had hedged its energy prices previously. Virallia and Vidrala (among others) can be considered to largely operate as regional oligopolies, which provides for an element of pricing power and is a reason why the managers favour these two positions.

A new position in Rémy Cointreau, which had previously been held by the managers, was initiated when it de-rated to a more attractive valuation and re-entered EAT's investment universe. Similarly, a new position was initiated in Davide Campari-Milano, which the fund managers held many years ago. Like Rémy Cointreau, it is a high-quality consumer defensive brand that had fallen out of favour with investors. In this example, Cosh and Morris were able to draw on the CTI analytical pool to gain sufficient conviction in order to add a position to the portfolio. This is not an isolated example and it is pleasing to see the tangible benefits of the greater resource available since the acquisition of BMO by CTI. These additions help increase and diversify the consumer staples element within the fund and augment the existing holding in Royal Unibrew, which has operations across Europe and brews and markets Heineken in Denmark. Although, with market caps of c €8.5bn and €10.9bn, Rémy Cointreau and Davide Campari-Milano respectively are towards the upper end of the market-cap spectrum within the portfolio (weighted average currently €2.6bn).

Within technology, the managers have reduced holdings in both Nordic Semiconductor and ASM International. The end-market consumer has been weak and as TSMC is capacity constrained it can negatively affect Nordic Semiconductor in the event it reaches capacity. As with the consumer names above, the rebalancing within the technology sector is part of the more general theme of broadening the diversification within the portfolio, and the fund managers have also recently initiated positions in Dutch BE Semiconductor Industries and Italian Technoprobe. Both of these holdings are held across other CTI European small-cap portfolios, and the CTI analyst pool was again instrumental in articulating the buy case and assisting in the technical nuances of the story. These two new positions are in addition to Alten, ASM, Atea, Lectra and Nordic Semiconductor. Since mid-2020, the fund's weighting to technology has reduced, partly as a result of market movements and stock transactions. With the addition of these two positions the weighting has increased to 14%, which compares to the index weight of 10.3%. Technological innovation is one of the four areas of preference for the fund managers, the others being health & wellbeing, emerging growth and sustainability, so it is an area that may continue to be added to at the margin, although of course technological innovation can be found in other sectors apart from purely technology.

Aside from the new positions mentioned above, there have been some recently added to holdings such as Merlin REIT, which reduced leverage and sold off assets before interest rates began rising, and has low void rates across its portfolio with most of the rents linked to inflation. Engcon has a dominant market share in tiltrolators, which enhance excavator efficiency and reduce energy use. Viscofan produces synthetic sausage casings, which are more efficient to use and have become more popular since COVID-19. We discussed the two other recent additions of Schoeller-Bleckmann and Kardex in our November EAT update, Keeping the faith in a volatile world.

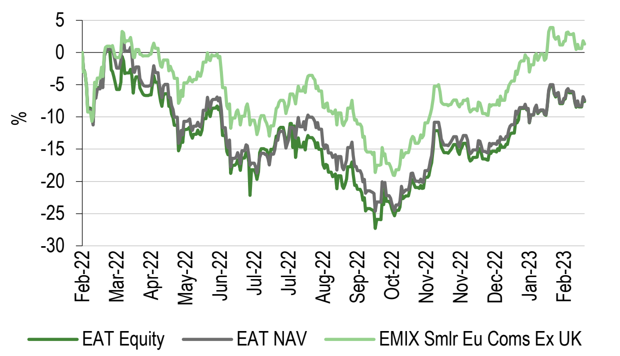
In terms of reductions, in addition to Virallia, there has been some trimming to the position sizes within financials, with SpareBank, Bank of Ireland Group and Ringkjoebing Landbobank, the last two both having performed very strongly in the last year, trimmed with a view to again broadening out the exposure to financials. Also within the financials sector, trading platform flatexDEGIRO, which was a COVID-19 ‘winner’, was sold even though it is still taking market share from brokers, as the management’s poor communication around the German regulator (BaFin) investigation diminished the team’s conviction. In healthcare, the very longstanding position in Gerresheimer was substantially reduced after its capital markets day in November, where the management guided to more growth but only with additional investment.

Challenging times for EAT

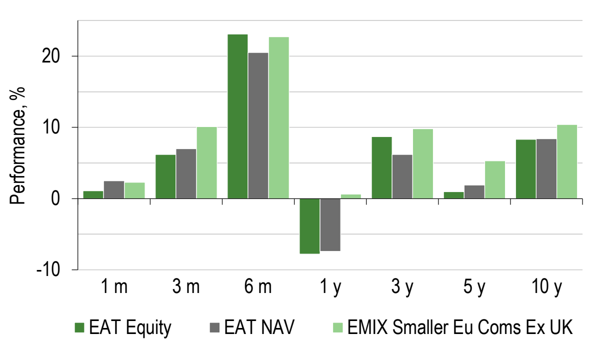
It has been a difficult period for EAT over the last 12 months. The NAV (source: Morningstar, cum fair including income, in pounds sterling) return to the end of February 2023 was -7.4% versus the EMIX Smaller European Companies (ex UK) Index return of 0.6% and the Morningstar Europe ex UK Small/Mid Cap category (this includes both open and closed-ended funds) return of 1%. The simple average of the AIC peer group over that period was -0.6%.

Exhibit 5: Investment company performance to 28 February 2023

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



Price, NAV and index total return performance (%)



Source: Refinitiv, Morningstar, Edison Investment Research. Note: Three-, five- and 10-year performance figures annualised. In pounds sterling.

Over the last 12 months, sector positioning has proven to be broadly neutral from a performance perspective, with the significant underweight to the poorly performing real estate sector a positive contributor to relative performance. This was largely offset by the portfolio’s underweight position in the strong returning energy sector and overweight positioning in the weaker technology sector. Overall, stock selection was the primary detractor to performance, with a positive contribution from stocks such as Tecan Group in healthcare and Schoeller-Bleckmann in energy. These were offset by weaker stock selection in industrials via Fluidra, consumer via names such as MIPS and HelloFresh, and within financials via flatexDEGIRO. Given the high level of active share within the portfolio of 96% (this measures commonality with another data set, with 0% indicating identical and

100% completely different), it is always likely that stock selection will be the key driver of long- term returns for EAT, and this has been the case historically.

Another way to contextualise EAT's performance is to consider the stylistic characteristics of the fund. With 45% of the portfolio categorised as growth stocks (source: Morningstar, January 2023) and only 10% in value stocks, the portfolio has faced headwinds to performance as, over the 12 months to the end of February 2023, the MSCI Europe ex UK Small Cap Growth Index has returned -2.3%, while the value part of the small-cap index returned 7.9%.

Since China began re-opening and investor sentiment has improved, the fund has had a better time, returning 7.5% over the past three months (to the end of February 2023) versus the Morningstar peer group returning 12.6% and the EMIX Smaller European Companies (ex UK) Index returning 10%. Over this short time period, stock selection has again been the primary driver of the relative underperformance.

Exhibit 6: Five-year discrete performance data

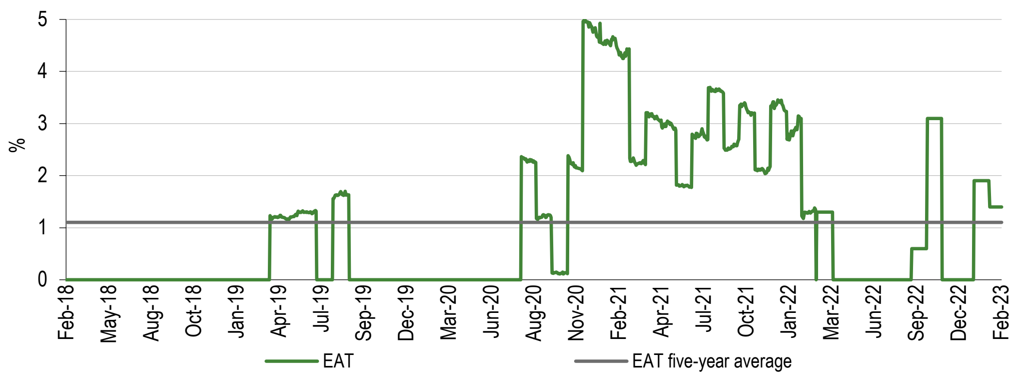
12 months ending	EAT total share price return (%)	EAT total NAV return (%)	EMIX Smaller European Companies Ex UK (%)	MSCI Europe Ex-UK (%)	Broad UK Equities(%)	MSCI All Country World (%)
28/02/19	(17.4)	(6.3)	(7.9)	(3.6)	1.7	2.7
29/02/20	(1.1)	0.7	6.2	6.1	(1.4)	8.2
28/02/21	35.7	33.6	28.9	13.2	3.5	19.0
28/02/22	2.6	(3.9)	2.1	8.4	16.0	12.3
28/02/23	(7.8)	(7.4)	0.6	9.3	7.3	1.7

Source: CTI, Refinitiv, Morningstar. Note: All % on a total return basis in pounds sterling.

Gearing: Less a feature of EAT

EAT can borrow up to 20% of NAV via a €45m multi-currency revolving loan facility, although it has been used sparingly over recent years (Exhibit 7). The war in Ukraine was a cue to reduce gearing, but given the marginally improving sentiment towards Europe, very recently gearing has been increased to 1.4% and the manager is looking to selectively increase market exposure at these levels.

Exhibit 7: EAT has been modestly geared historically



Source: CTI/Morningstar. Note: Gearing figure.

ESG: A key feature of the investment process

We previously discussed EAT's investment process and the integration of ESG considerations within this in our March 2022 update. According to analysis carried out by Sustainalytics, EAT's portfolio in aggregate is better than average in terms of addressing ESG issues within a broad category of peers. In addition, it has been awarded a low carbon designation from Morningstar based on its lower carbon risk and fossil fuel involvement than peers. The world of ESG data analysis is developing and while there will be methodology differences between one rating and another, it is heartening to see that the team's rigorous focus on these factors is reflected in the above-average ESG scores. Engagement with company management is a core part of the fund managers' efforts to optimise investee company practices and to maximise the potential for long-term shareholder returns. Recent examples include the managers' engagement with the board of Coor Service Management to advise on the executive management's long-term incentive plans and with ASM International to discuss employee engagement. Cosh and Morris also discussed the monitoring of tier 3 suppliers and managing the supply chain with ASM International.

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