European Assets Trust

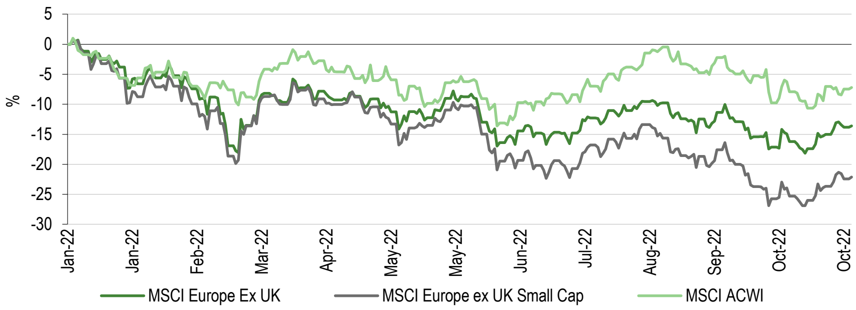
Keeping the faith in a volatile world

Investment trusts
European smaller companies

4 November 2022

European smaller companies' funds focused on growth investing have had a torrid 2022 as soaring inflation, rising interest rates, cost of living pressures and slowing economic growth have prompted increasing investor risk aversion, resulting in a dramatic sell-off for long-duration growth assets. EAT has not been immune to such pressures despite its focus on growing, high-quality, well-capitalised and modestly indebted companies. In our last update, Well placed to deliver further capital growth, we made the case for the EAT's place in this niche area of investment. Performance of the asset class has since deteriorated further, with the possible headwinds for European smaller companies strengthening. However, investors can take comfort in the investment process established by experienced fund managers Sam Cosh and Lucy Morris, which they have used here since 2011 to good effect.

European smaller companies have been out of favour in 2022



Source: Morningstar, Edison Investment Research. Note: Total returns in sterling.

Why consider EAT now?

Arguably, 2022 has not provided the most supportive environment for equities and for European smaller companies in particular. However, it is always darkest before dawn and the current de-rating in the asset class may well present a contrarian opportunity for the long-term investor. EAT has been investing in a portfolio of high-quality, dynamic growth businesses for more than 50 years, through a variety of economic conditions. The focus on good-quality companies, which should be relatively well-placed to pass on increased costs, counter margin pressures and take advantage of opportunities in the market, looks to be valid. The key to successful growth investing is not to overpay for growth and the managers have built a portfolio of high-quality, fast-growing, less indebted companies for only a modest valuation premium over the market; valuation discipline is an important factor in the process. For investors who are comfortable with high levels of volatility and a sufficiently long investment time horizon, EAT provides a solid option in this specialist area of investment.

Price	**86.80p**
Market cap	**£312.5m**
Total assets	**£337.9m**
NAV*	89.07p
Discount to NAV	2.6%

*Including income. at 3 November 2022.

Yield	10.1%
Shares in issue	360.1m
Code/ISIN	EAT/BD0BSY3
Primary exchange	LSE
AIC sector	European Smaller Companies
Financial year end	December

52-week high/low	146.0p	77.2p
NAV* high/low	153.8p	84.1p

*Including income.

Gearing

Net gearing at 3 Nov 2022	0.0%

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

- Experienced managers and collegiate team.
- In aggregate, European smaller companies are trading on attractive valuations versus large-cap peers and international equities.
- High dividend yield.

Bear points

- EAT's dividend is likely to be lower in 2023.
- Widespread profit warnings could lead to additional market weakness.
- The volatility is unlikely to abate while macro concerns prevail.

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NOT INTENDED FOR PERSONS IN THE EEA

There is always something for markets to worry about

EAT's managers, Sam Cosh and Lucy Morris, note that economic recovery from COVID in 2022 has been completely overridden by macroeconomic and geopolitical events. Rising inflation that was 'transient' in Q421 became entrenched and at 40-year highs in Q222. Central banks which, arguably, had previously been behind the curve, were left scrambling to raise rates to curb soaring inflation. The subsequent 'risk-off' environment saw global equity market weakness. Small-caps and long-duration growth assets whose prices are especially sensitive to rising interest rates were particularly hard, hit while rising input prices challenged global economic growth. The secondary effect of rising prices is impacting on corporate earnings, with potential downgrades a possible catalyst for further market correction.

Europe is facing the most significant negative impact from the war in Ukraine, with consumers facing a cut to their disposable income through rising food and energy prices. Potential gas shortages would be another hammer blow to industrial production, while the Eurozone Manufacturing Purchasing Managers Index is at multi-year lows.

While there is a long list of concerns, in some ways it is business as usual in that over the past 15 years there has been a constant stream of adverse economic events such as the European sovereign debt crisis, numerous bank bailouts, taper tantrums, Brexit, trade wars, COVID and now the Ukraine war. The latest events may well be the most serious from an economic and geopolitical perspective, but markets look through near-term events so it is promising to see energy prices, freight rates and some raw material prices rolling over. This may provide a welcome inflection point for inflation. Likewise, supply chain disruption is reducing, but wage growth remains high and provides an embedded structural support for process.

Europe has made good progress in reducing liquid natural gas (LNG) consumption and stocking up on LNG for the winter ahead, while banks are well capitalised going into this downturn. Other supportive measures for Europe include the potential for the European Central Bank to be less aggressive in raising rates than the Federal Reserve and some governments are also likely to be more generous, where able, in their fiscal response. Lastly, European companies trade on attractive valuations relative to their own history, but especially compared with the US market. In the European market, smaller companies are one standard deviation cheaper than large caps (source: CTI, 5 September 2022) over the past 22 years.

Fund profile: Above-average income

EAT is managed by Columbia Threadneedle Investments (CTI) and targets capital growth through investment in quoted small and medium-sized European companies. Its benchmark is the EMIX European Smaller Companies ex-UK Index. The fund is managed by Sam Cosh (lead manager) and Lucy Morris, who have been working together on this fund since 2011.

Cosh joined BMO in 2010 (which was acquired by CTI in 2022) from BNP Investment Partners, having been involved in analysing and investing in European smaller companies since 2000. Morris joined BMO in 2007 and worked in the performance analytics team before moving to the European smaller companies desk in 2011. Cosh and Morris are part of the broader global small-cap team and, while most team members have sectoral analytical responsibilities, Cosh and Morris, as dedicated European small-cap investors, have a free hand to search for opportunities in their sphere of specialisation, regardless of the country or sector.

Investment process: Quality growth at the right price

There are approximately 2,000 quoted European small- and mid-cap companies, a large and diversified universe where companies are not always well-researched by sell-side broker coverage, which can result in investor misunderstanding. This leads to market inefficiencies, which Cosh and Morris seek to exploit to deliver superior long-term investment performance via a portfolio of typically 40–50 holdings.

More specifically, they seek high-quality smaller companies, which they define as having the following characteristics:

- proven business models that are defended by scale, intellectual property, brand or market positions;
- management teams that have the right balance of entrepreneurial flair and rational capital allocation and where team members are incentivised appropriately;
- higher growth rates, margins and returns on capital than the market;
- superior cash flow generation and strong balance sheets that provide stability and opportunity for value-added deployment; and
- investments fit for the future, with attractive environmental, social and governance (ESG) credentials.

An assessment of the strength of a company's competitive advantages or 'moats' is also essential to the team's selection process, as these are what will allow a business to defend or improve its market position and deliver growing profits to its shareholders.

The managers adopt a well-established, bottom-up, fundamental analysis approach and are supported by CTI's well-resourced small-cap and global equities teams. They meet with around 250 companies a year and produce detailed analysis of each potential investment, including valuation targets and sell triggers. Cosh and Morris monitor all positions continuously. Their approach is benchmark-agnostic and they are happy to adopt a contrarian stance when a business satisfies their investment criteria.

The managers' focus is on quality, and they believe the evolution of a company's profits and cash generation will be the principal determinant of shareholder returns. However, they view valuation as another important driver of long-term performance, and they are disciplined about adopting or adding to positions only at the right price. They look for companies that trade at a substantial discount to their intrinsic value. Companies that meet EAT's investment criteria but are not trading at acceptable valuations are placed on a watch list of stocks, awaiting a better price entry point. This allows the team to execute quickly when opportunities present themselves.

Positioning: Focus on strong business models

The investment process is essentially looking for good-quality growing companies at the right price. These companies may be disruptors to incumbents within structurally growing end-markets, companies with barriers to entry via intellectual property or those with enduring and strong brands able to scale up their activities in growing markets. However, specifically in the current investment and economic environment, the managers' focus is on finding companies exposed to structural growth that have pricing power, with high margins, which can absorb rising costs and deliver growth irrespective of economic activity. There are some emerging themes such as energy security and defence spending but these have ESG challenges. There is also a focus on capex beneficiaries as companies look to source energy, raw materials and components locally to reduce supply chains as globalisation brings increasing challenges. Another theme is identifying companies that can enhance productivity and automation plays to mitigate rising input costs. Lastly, the managers are especially selective with regard to consumer discretionary exposure due to potential pressure on disposable income in 2022 and beyond. The managers were largely adding to existing positions in the early part of the sell-off in Q122 and rotated their focus on initiating a handful of new positions in the second half of the year, as follows:

Bank of Ireland: unlike some other quality-focused investors, the managers believe that well-positioned banks can have strong franchises and create a lot of value for shareholders, for example Ringkjoebing Landbobank has been one of EAT's best long-term performers. Bank of Ireland is operating in an attractive market, where the economy is fundamentally stronger than most of its European peers and the market structure is advantageous in that it is a tight oligopoly. Rising interest rates are also very supportive for operations. The shares were trading below book value, which prompted the purchase, but the managers believe that prospective returns should significantly exceed the cost of equity and that the shares are materially mispriced.

Kardex Group: the company's share price has been very weak this year, which has provided the managers with an opportunity to add a position. Kardex is a Swiss industrial with a market-leading position in intralogistics solutions, focusing on automated storage and material handling systems. These systems materially improve the productivity and efficiency of warehouses or logistics centres, which is particularly important in a tight labour market where wages are increasing and staff churn is an additional risk. While the managers acknowledge that there may be some cyclical risk with this stock, they believe it is a rare opportunity to invest in a company that should grow structurally through the next cycle.

Schoeller-Bleckmann: the company has been well known to the managers over many years. It is a well-positioned business with a market-leading position in manufacturing non-magnetic drill bits for oil wells. The shares had performed poorly until this year when the prospects for the company changed dramatically. The Ukrainian war has highlighted the need for energy security and has prompted renewed activity in the exploration and production of traditional energy. This has driven the start of a new capital cycle for the industry, of which Schoeller-Bleckmann is likely to be a key beneficiary.

Enhanced dividend policy: The mechanics

EAT's board is committed to an enhanced dividend distribution policy, paying an annual dividend of 6% of NAV as at the end of the preceding financial year (31 December) with the annual total dividend declared in January each year and paid quarterly in January, April, July and October. EAT's dividend can be funded from a variety of sources, which gives the managers a degree of flexibility founded upon many years of managing this mandate. Historically revenue from dividends has accounted for around a third of the annual requirement. This is augmented by the selective use of a combination of income and distributable reserves, gearing or portfolio rebalancing.

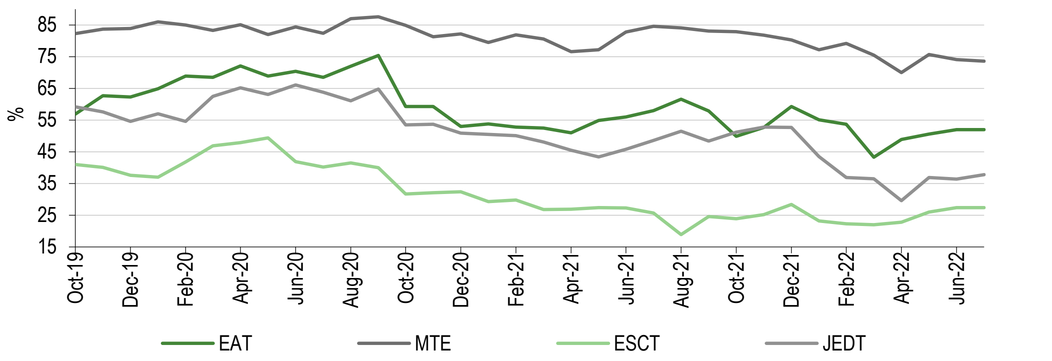
The dividend environment for European smaller companies was volatile through the worst of the COVID-19 pandemic, but there has been a recovery from the March 2020 lows. While the portfolio tends to yield in line with the index, the level of absolute or relative dividends is less important for this strategy given the sources of capital available to pay the dividend to investors with EAT's distributable reserve standing at £322.7m at the financial year end (2020: £346.0m) sufficient to cover more 11 years of total annual dividend payments at the current rate. EAT allows investors to receive a high regular income from what is fundamentally a quality growth portfolio investing in smaller companies. Cosh and Morris would prefer that their portfolio companies reinvest cash flows into higher returning projects in order to grow and make the most of their competitive advantage rather than returning cash to investors as a matter of course.

Over the last two decades there have been four calendar years that have seen a material drawdown in EAT's NAV (2002: -22.5%, 2008: -42.6%, 2011: -9.8% and 2018: -16.3%). As described above, EAT's distribution policy is fairly mechanical, with dividends paid in the years following a fall in the NAV decreasing (2003, 2009, 2012 and 2019). Investors should thus be prepared for a significant fall in their income from EAT in FY23. On the basis of an 8.8p distribution per share in 2022, EAT currently yields 10.1%. Should the fund's NAV make no material recovery before the end of the financial year on 31 December 2022, then based on the current NAV of 89.29p the distribution for FY23 would be in the region of 5.4p, which would be a fall of c 38% in absolute terms from the level shareholders received for FY22. The last time the fund paid a similarly sized dividend was in 2015 (5.55p).

Positioning: A growth strategy

Country and sector positioning is a result of stock selection. However, sector positioning is influenced through the investment process, which looks for faster-growing sales, revenues and cash flows and results in a growth investment style (Exhibit 1).

Exhibit 1: EAT has a growth bias compared with AIC peers



Source: Morningstar. Note: MTE = Montanaro European Smaller Companies Trust, ESCT = European Smaller Companies Trust, JEDT = JPMorgan European Discovery Trust.

As shown in Exhibit 2, the fund is overweight relative to its benchmark index in what may be considered growth sectors such as technology, consumer discretionary and healthcare but also financials and consumer staples.

Exhibit 2: Portfolio sector exposure vs benchmark (% unless stated)

	Portfolio end-September 2022	Portfolio end-September 2021	Change (pp)	Index weight	Active weight versus index (pp)
Industrials	22.0	23.3	(1.3)	25.3	(3.3)
Financials	16.0	14.4	1.6	12.5	3.5
Consumer Discretionary	15.0	17.3	(2.3)	9.2	5.8
Health Care	12.2	10.1	2.1	9.7	2.5
Technology	12.1	19.3	(7.2)	9.5	2.6
Consumer Staples	11.4	10.6	0.8	5.2	6.2
Basic Materials	7.7	3.7	4.0	7.7	0.0
Energy	2.5	0.0	2.5	4.2	(1.7)
Real Estate	1.1	0.0	1.1	7.9	(6.8)
Communication services	0.0	0.0	0.0	4.7	(4.7)
Utilities	0.0	1.3	(1.3)	4.1	(4.1)
	100.0	**100.0**			

Source: Columbia Threadneedle Investments, Edison Investment Research

Key positions here include Swiss healthcare company Tecan Group, Danish retail bank Ringkjoebing Landbobank, Nordic IT infrastructure provider Atea, British insulation specialist SIG Group and Belgian biscuit manufacturer Lotus Bakeries. The portfolio is structurally underweight in real estate, communication services and utilities, where arguably the scope for higher than trend growth is limited.

Exhibit 3: Top 10 holdings at the end of September 2022

Company	Sector	End-September 2022 (%)	End-September 2021 (%)	Change (pp)	Benchmark weight (%)	Active weight vs benchmark (%)
Tecan	Healthcare	4.1	N/A	N/A	0.4	3.7
Ringkjoebing Landbobank	Financials	4.1	3.4	0.7	0.3	3.8
SIG Group	Industrials	3.9	N/A	N/A	0.0	3.9
Interpump	Industrials	3.3	N/A	N/A	0.3	3.0
Storebrand	Financials	3.1	2.7	0.4	0.3	2.8
Karnov	Consumer discretionary	3.0	N/A	N/A	0.0	3.0
IMCD	Basic materials	2.9	N/A	N/A	0.0	2.9
Gerresheimer	Healthcare	2.8	2.5	0.3	0.1	2.7
Coor	Industrials	2.8	N/A	N/A	0.1	2.7
Atea	Technology	2.8	N/A	N/A	0.1	2.7

Source: Columbia Threadneedle Investments Note: N/A where stock not held in the portfolio in September 2021.

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

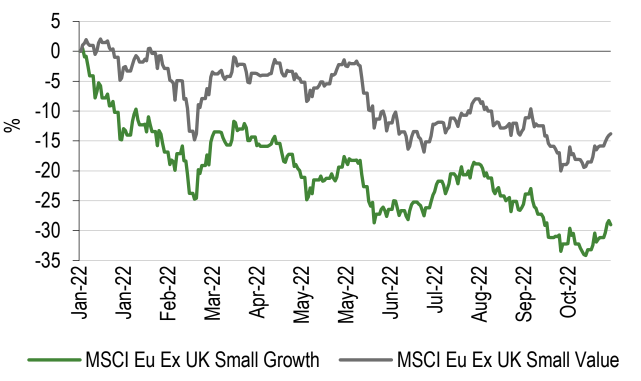
	Portfolio end-September 2022 (%)	Portfolio end-September 2021 (%)	Change (%)	Index weight (%)	Active weight vs index (%)
Sweden	15.8	15.4	0.4	14.9	0.9
Switzerland	13.8	9.6	4.2	11.7	2.1
Germany	13.5	24.1	(10.6)	13.2	0.3
Norway	13.0	11.7	1.3	6.3	6.7
Netherlands	7.8	6.7	1.1	4.8	3.0
France	7.3	7.2	0.1	12.6	(5.3)
Ireland	6.9	1.4	5.5	1.3	5.6
Denmark	6.2	6.6	(0.4)	4.8	1.4
Spain	4.9	4.7	0.2	5.9	(1.0)
Italy	4.8	7.5	(2.7)	9.7	(4.9)
Belgium	2.8	1.7	1.1	5.8	(3.0)
Portugal	1.9	1.7	0.2	1.1	0.8
Austria	1.3	0.0	1.3	3.8	(2.5)
Other	0.0	1.7			
	100.0	**100.0**			

Source: Columbia Threadneedle Investments, Edison Investment Research

Challenges to performance through 2022

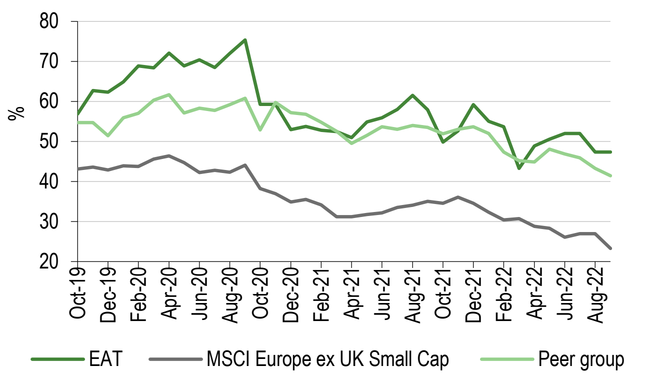
In common with other European small-cap funds, EAT has struggled through 2022 and over the past 12 months. The fund's NAV returned -35.3% versus the EMIX European Smaller Companies ex UK Index's return of -24.4% and the Morningstar Europe ex UK Small/Mid-Cap Equity peer group's -25.1% (source: Morningstar, GBP, 12 months to end-September 2022.). Growth as an investment style significantly underperformed value over this period, which contributed to the fund's underperformance compared with peers and the MSCI Index (see Exhibits 5 and 6).

Exhibit 5: Performance of growth vs value in 2022 ytd



Source: Morningstar

Exhibit 6: EAT's historical exposure to growth factors



Source: Morningstar. Note: The peer group is the Morningstar universe of European ex-UK small- and mid-caps.

Of the fund's near 11% underperformance of the index over the period, sector positioning accounted for around a quarter, with stock selection driving the majority. As a growth strategy, it is perhaps not a surprise to find that the fund's overweight to technology versus the index was the largest sector contributing to underperformance, while the virtual absence of energy stocks was also a significant contributor. On the other side, the slight overweight to financials was a positive. From a stock selection perspective, consumer discretionary was the single largest detractor, with industrials also a detractor. Although the overweight technology position was a drag on performance, stock selection within the sector was positive relative to the index.

The managers acknowledge that there was too much cyclicality in the portfolio via an overweight consumer discretionary position going into the current economic slowdown. They have used life assurance and banks to balance the portfolio, but have not had sufficient allocation there to compensate for the weakness in other parts of the portfolio. In addition, some of the companies with nascent business models that prospered during the COVID crisis such as Global Fashion Group had arguably not been tested previously in a tougher economic environment. In some cases, the managers did not take sufficient profits in some areas of the portfolio that had performed well before the downturn.

Given the fund's performance over the past year, it is easy to be pessimistic about the prospects for the portfolio, however many portfolio companies are trading well despite the economic headwinds. Operational highlights in the portfolio include **Verallia**, which is Europe's leading glass bottle manufacture supplying to the food and beverage industries. It delivered excellent Q3 results (Q3 sales up 28% on the same period last year) due to its pricing power and operational efficiencies raised full year EBITDA guidance by 6%. **Rational** is a global market leader in the production of combi-steamer ovens and increased its guidance following strong Q3 results, which showed both an acceleration in sales growth and expanding margins. While it sells to the catering market which is under pressure, Rational's products are productivity tools and help its customers significantly reduce their operating costs and reduce energy consumption. In a challenging environment, Rational again proved its operational strength. **Symrise** is a Germany-listed leader in flavours, fragrances and personal care ingredients. It increased guidance following much higher than expected organic growth, driven by stellar growth in pet food. **Gerresheimer** is a pharmaceutical packaging provider and released Q3 results demonstrating accelerated growth in sales and EBITDA, both ahead of market expectations. Sales were up 24%, which was a mixture of both volume and price. EBITDA grew by 21% despite a scheduled furnace repair in the quarter and the company has reiterated its FY22 guidance. **Hexpol** is a world-leading polymer compounder with Q3 sales 7% ahead of consensus, delivering organic growth of 21% versus Q3 last year. EBIT was 4% ahead of consensus (up 24% y-o-y) and the company is confident on the outlook for sales as the Americas pick up despite softness in Europe. Lastly, **Lectra** is a hardware and software technology provider to the automobile, fashion and furniture industries. Its recent Q322 results showed strong development, which is impressive given the weakness in end-markets. Sales were up 22% versus last year, EBITDA was up 49% and margin increased by 3.8% to 21%.

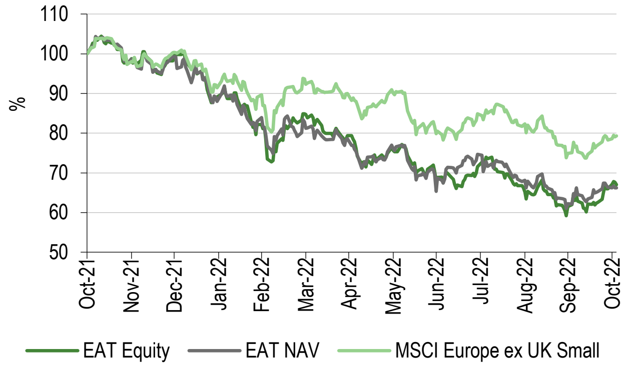
Exhibit 7: Five-year discrete performance data

12 months ending	Total share price return (%)	Total NAV return (%)	MSCI Europe ex UK Small (%)	MSCI Europe Ex-UK (%)	CBOE UK All Companies (%)	MSCI World (%)
31/10/18	(14.7)	(7.1)	(5.4)	(5.4)	(1.6)	5.7
31/10/19	4.3	5.5	5.6	11.9	6.9	11.9
31/10/20	5.3	7.7	3.7	(4.2)	(20.2)	5.0
31/10/21	49.1	41.5	42.0	33.2	36.0	33.0
31/10/22	(32.9)	(33.7)	(21.4)	(11.0)	(1.6)	(2.5)

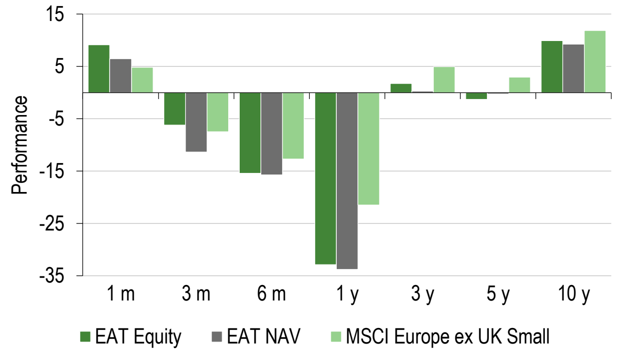
Source: Refinitiv. Note: All % on a total return basis in pounds sterling.

Exhibit 8: Investment company performance to 30 October 2022

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



Price, NAV and index total return performance (%)



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

EAT in the context of its AIC peer group

EAT is unique in its AIC European Smaller Companies peer group in that at the end of each financial year (31 December), the board commits to pay out 6% of this year-end NAV by way of a quarterly dividend over the subsequent year. This results in a relatively high-yielding fund compared with peers and the index.

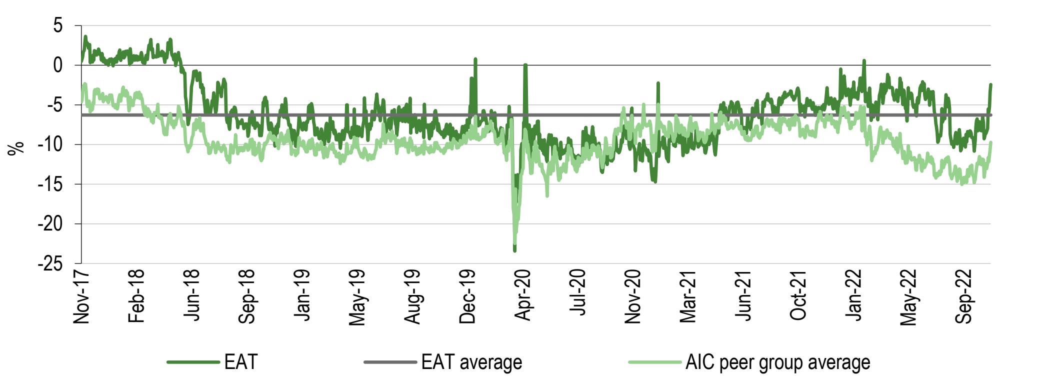
Exhibit 9: AIC peer group at 30 October 2022*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Ongoing charge (ex PF)	Perf. fee	Discount (cum-fair)	Net gearing	Dividend yield
European Assets	310	(34.0)	1.8	(1.4)	143.5	0.89	**No**	(3.4)	99	10.2
JPMorgan European Discovery	608	(30.1)	8.1	3.0	203.0	0.93	No	(11.8)	98	1.7
Montanaro European Smaller	222	(36.4)	27.3	51.4	222.8	1.09	No	(13.4)	105	0.8
The European Smaller Companies	527	(22.1)	31.8	15.6	275.9	0.65	Yes	(15.9)	110	3.3
Simple average of 4 funds	417	(27.5)	15.2	14.2	195.4	0.89	**N/A**	(11.1)	103	4.0
EAT rank in sector	**3**	**3**	**4**	**4**	**4**	**2**	**N/A**	**1**	**3**	**1**

Source: Morningstar, Edison Investment Research. Note: *Performance to 30 October 2022 based on ex-par NAV. TR = total return. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

Despite challenges to performance versus peers, EAT trades on a substantially tighter discount (Exhibit 10) to NAV compared with peers, which indicates the attractiveness of the investment proposition.

Exhibit 10: EAT has historically traded on a narrower discount compared with AIC peers



Source: Morningstar

EAT’s approach to ESG

EAT’s managers believe that solid ESG credentials are essential if a business is to succeed over the long term. They do not apply an ESG screen to potential holdings – instead, they give consideration to the sustainability of a company’s production process, its carbon footprint and the treatment of its suppliers, employees and customers is thus integral to EAT’s investment process. The trust’s managers are supported in this regard by input from CTI’s Responsible Investment (RI) team, which is one of the industry’s longest established and largest ESG teams. This team uses a scoring system that is developed using input from several external sources, such as MSCI and the Institutional Shareholder Services Group (ISS) but adapted by the RI team to take account of the most relevant factors. The RI team makes continuous efforts to improve the depth of its ESG research. Recent refinements include the introduction of measures to identify ‘greenwashing’ – a practice whereby companies make false or exaggerated claims intended to mislead consumers and investors about the environmental merits of their products.

Where necessary, CTI’s RI team engages actively with the management of investee companies, to encourage them to adopt the highest standards of ESG practice. It may join with other major investors to strengthen their efforts to drive change. CTI is also a signatory of the United Nations Principles for Responsible Investment (UNPRI), under which signatories contribute to the development of a more sustainable global financial system.

All ESG considerations are important, but EAT’s managers have particular focus on climate change factors in investee companies given the potential this has to impact on all other areas of society. As active custodians of client capital, company engagement can bring about positive change can be an effective way to influence corporate behaviour for the benefit of all. EAT has a four (out of five) global rating from Sustainalytics, meaning that the portfolio has better than average ESG characteristics than a wide range of global mid- and small-cap investment funds average on ESG considerations.

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