Fidelity European Trust

Not persuaded by great (rotation) expectations

Investment trusts
European equities

Fidelity European Trust (FEV, formerly Fidelity European Values) aims to achieve long-term growth in both capital and income from a portfolio of European stocks. FEV is managed by Sam Morse and Marcel Stötzel and has an established track record of attractive returns and outperformance – it has made an average annual return of 11.3% in share price terms and 10.1% on an NAV basis over the past 10 years and outperformed the index over three, five and 10 years. The trust also did relatively well over most of 2020 and was substantially ahead of the benchmark for the nine months to end September 2020, but the performance, while still positive, lagged the benchmark in Q420 and Q121 as value stocks and cyclicals outperformed growth strategies. However, the trust's managers are sceptical of the case for a full-blown rotation into value and they are not tempted to chase the market and adjust the portfolio in anticipation of a sustained value rally. Instead, they intend to maintain their current, more balanced, course, seeking out quality companies with strong balance sheets and positive dividend growth prospects at attractive valuations. They believe this approach has served FEV's shareholders well and they expect it to continue to do so in the future, when markets are once again guided by fundamentals, rather than expectations of economic developments that are, in their view, far from assured.

Long-term NAV outperformance versus benchmark

Source: Refinitiv

The analyst's view

- FEV aims to capture the diversity of the European market by investing across a range of countries and sectors. The trust may therefore appeal to investors seeking broad European exposure across market cycles.
- Experienced investment management team which has delivered long-term outperformance, supported by Fidelity's extensive research capability.
- A fee reduction that took effect from 1 April 2021 will make the trust's fee structure even more competitive relative to its peers. The tiered rate of 0.85% up to £400m remains unchanged but the 0.75% of net assets in excess of £400m will decline to 0.65%, achieving what the board calls 'useful savings on overall percentage costs for shareholders'.
- A recent widening in the discount provides new investors with the opportunity to invest at a relatively attractive level.

NOT INTENDED FOR PERSONS IN THE EEA

26 April 2021

Price	**296.5p**
Market cap	**£1220m**
AUM	**£1422m**

NAV*	319.0p
Discount to NAV	7.0%

*Including income. At 22 April 2021.

Yield	2.2%
Shares in issue	411.5m
Code	FEV
Primary exchange	LSE
AIC sector	Europe

52-week high/low*	296.5p	224.0p
NAV** high/low	319.0p	243.5p

*Including income.

Gearing

Gross market gearing*	13.8%
Net market gearing	12.8%

*As at 31 March 2021

Fund objective

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

Bull points

- European-wide exposure and diversification away from the UK market.
- Board commitment to maintaining the trend of annual dividend increases established in FY10.
- Recent fee reduction.

Bear points

- Near-term relative performance is vulnerable if the rotation into value continues or if inflation pressures begin to build.
- Longer-term outperformance is only in line with the average of the AIC sector.
- Relatively high gearing compared to peers magnifies the portfolio's exposure to a sharp market correction.

Analysts

Joanne Collins	+44 (0)20 3077 5700
Mel Jenner	+44 (0)20 3077 5720

investmenttrusts@edisongroup.com

Edison profile page

Fidelity European Trust is a research client of Edison Investment Research Limited

The manager's view and positioning

The arrival of several viable vaccines in November 2020 heralded the potential for an improvement in the global economic outlook, as vaccination programmes are rolled out and potentially enabling life to gradually return to some semblance of normality. Equity markets around the world responded positively to the news and have since made significant gains – the 20% rise in the MSCI Europe ex-UK Index in the five months between end October 2020 and end March 2021 mirrored gains in other major markets. Economically sensitive stocks and sectors have outperformed as investors anticipate a surge in demand for eating out, entertainment and travel and there is much speculation that this is just the beginning of a longer-term rotation into value and cyclical stocks, which have underperformed growth and momentum stocks for several years – and dramatically since the onset of the pandemic.

However, FEV's managers Sam Morse and Marcel Stötzel are sceptical. They do not believe the conditions are in place to drive a sustained rotation into economically sensitive parts of the market. In their view, the recovery will be 'a stop/start affair for some time', mirrored by associated market fluctuations. While they acknowledge the possibility that inflation will tick-up in the short term, due to pent-up demand and rising commodity prices, they believe strong disinflationary forces remain, particularly in Continental Europe. They expect globalisation, technological disruption, an aging population, and the eventual need to reduce extraordinary levels of government borrowing, to conspire to keep inflation low.

While they will 'keep scanning the horizon' for evidence of a sustainable economic rebound, accompanied by inflationary pressures and higher interest rates, until it emerges, they intend to maintain their current, more balanced, course, rather than adopting was they see as the riskier course of 'chasing the market and positioning for a sustained value rally that relies on macro conditions that are very difficult to predict'. They intend to continue their search for quality companies with strong balance sheets, whose prospects for delivering sustainable dividend growth are not yet fully discounted in the share price. In their view, this approach, which combines a focus on quality and growth, at attractive valuations, has served their portfolio well and they expect it to continue to do so in the future, when markets are once again 'driven by fundamentals rather than sentiment and unsubstantiated expectations'. Meanwhile, the managers believe that for stock-pickers like themselves, the opportunity set within European equities remains compelling and the ongoing market fluctuations they foresee will continue to provide opportunities to acquire or add to holdings which meet their longstanding investment criteria.

Acquisitions in recent months include a new position in Prosus, a Dutch holding company majority-owned by Naspers, the South African media conglomerate. Prosus has major investments in some of the world's leading on-line consumer franchises such as Tencent and Delivery Hero. The managers believe that the pandemic has accelerated a change in consumer habits such that strong on-line businesses like these will continue to grow faster than anticipated, even when lockdowns end. Worries about regulation and government interference provided the managers with an attractive entry point, as the stock was trading at a significant c 35% discount to its sum-of-the-parts valuation. The managers have also added to existing positions in industrial companies Legrand, a French electrical devices manufacturer; Schindler, a Swiss machinery maker; and DKSH Holding, a Swiss consulting company. They also increased their exposure to Deutsche Borse, the German financial services company.

Strong share price performances have prompted profit-taking on several stocks in recent months, including the outright sale of Andritz, the Austrian industrial distribution company. The managers also trimmed profitable positions in 3i Group, the UK private equity and infrastructure company, Intesa Sanpaolo, an Italian bank, and German luxury fashion house, LVMH, while poor performance led the managers to reduce exposure to the German chemical company Symrise. This company's underperformance in the nascent value rotation of late 2020 was exacerbated by a significant cyberattack, which hit sales and adversely affected performance targets.

However, overall portfolio turnover remained relatively low at an annualised rate of around 25%, due to the trust's long-term horizon and its aim to minimise transaction costs. This is evidenced by the relative stability of the trust's top 10 holdings (Exhibit 1). As at end March 2021, eight of the top 10 holdings were unchanged compared to the previous year, and around 70% of the portfolio's holdings remain unchanged over the past five years. Long-standing holdings include Swiss food producer Nestlé and pharmaceutical company Roche. As at end March 2021, the trust's most significant sectoral overweight positions were in technology and financials, while its heaviest underweights were in industrials and real estate. On a market cap basis, its most notable positions were a 11% overweight to mega-cap companies (valued above €100bn) and an equivalent underweight of companies valued between €20–50bn.

Net gearing rose to almost 13% during late 2020 and Q121, with the 5–15% guideline range recently agreed with the board (up from a maximum of 10% net gearing previously). Gearing is achieved using long contracts for difference (CFD) and Stoxx50 index futures. The recent increase in gearing was motivated by the managers' assessment that some of the main market risks have dissipated – the US election delivered a clear outcome, the first vaccines proved to be more effective than anticipated and a Brexit deal was eventually concluded. However, the managers stress that they have kept gearing below its maximum permitted level due to their concern that market sentiment has become too positive, with IPOs oversubscribed, retail investment surging and riskier assets such as Bitcoin hitting all-time highs. The portfolio currently holds two short positions in single stocks, again implemented via CFDs.

Exhibit 1: Top 10 holdings (as at 31 March 2021)

Company	Country	Sector	Portfolio weight %		Benchmark weight (%)	Active weight (%)
			31 Mar 2021	31 Mar 2020**	31 Mar 2021	31 Mar 2020
Nestlé	Switzerland	Consumer goods	6.3	8.0	3.8	2.5
ASML Holding	Netherlands	Technology	5.4	3.5	3.0	2.4
LVMH	France	Consumer goods	4.6	4.0	2.0	2.6
Roche Holding	Switzerland	Healthcare	4.4	6.5	2.9	1.5
L'Oréal	France	Consumer goods	3.7	3.5	1.1	2.6
Enel	Italy	Utilities	3.4	N/A	1.0	2.4
Sanofi	France	Healthcare	3.1	4.0	1.3	1.8
Total	France	Oil & Gas	3.1	3.4	1.4	1.7
SAP	Germany	Technology	3.1	4.2	1.7	1.4
EssilorLuxottica	France	Healthcare	3.0	N/A	0.6	2.4
Top 10			**40.4**	**43.7**		

Source: FEV, Edison Investment Research, Bloomberg, Morningstar. Note: *Gearing net of short positions. **N/A where not in end-March 2020 top 10.

Exhibit 2: Portfolio breakdown by sector

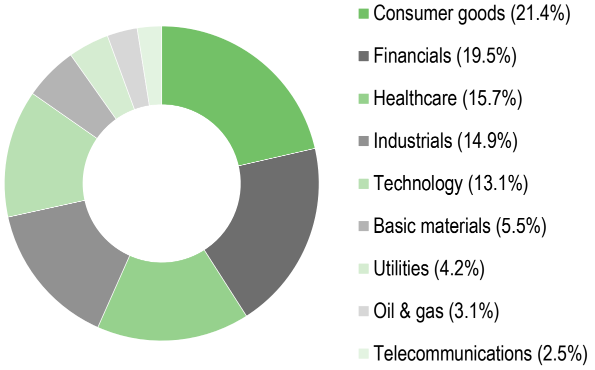
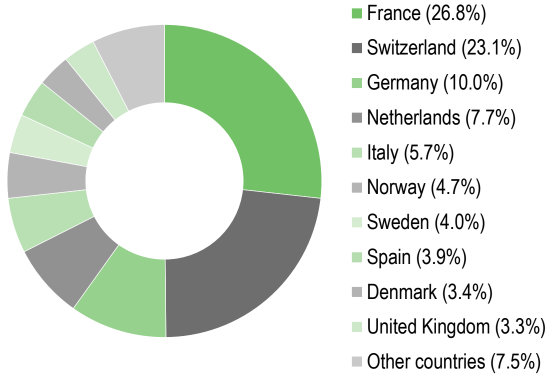


Exhibit 3: Portfolio breakdown by geography



Source: FEV, Edison Investment Research. Note: Data at 31 March 2021.

Performance

Exhibit 4: Five-year discrete performance data

12 months ending	Share price (%)	NAV (%)	MSCI Europe ex-UK (%)	MSCI World (%)	CBOE UK All Cos (%)
31/03/17	19.3	23.2	28.4	32.7	22.6
31/03/18	11.8	7.8	3.7	1.8	1.2
31/03/19	9.0	9.7	3.1	12.6	6.2
31/03/20	0.3	(2.5)	(7.5)	(5.3)	(19.1)
31/03/21	32.5	30.2	34.4	39.1	26.6

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

FEV did relatively well over most of 2020 and was substantially ahead of the benchmark for the nine months to end September 2020, but the performance, while still positive, lagged the benchmark in Q420 and Q121. Thus, in the six months to end March 2021, the trust returned 8.8% on a share price basis and 7.4% on an NAV basis, underperforming the MSCI Europe, ex-UK Index, which returned 12.0%. It also underperformed the index on a one-year basis, returning 32.5% on a share price basis and 30.2% in NAV terms compared to a benchmark return of 34.4% in the year to end-March 2021. Over the longer term, the trust's performance has been good in absolute and relative terms – it has made an average annual return of 11.3% in share price terms and 10.1% on an NAV basis over the past 10 years and outperformed the benchmark over three, five and 10 years (Exhibit 5). FEV has outperformed the UK market more decisively over one, three, five and 10 years.

The managers ascribe the trust's near-term underperformance to a 'perfect storm of negative factors', coupled with disappointing stock selection. The trust's focus on growth has been a drag on relative returns as the improving economic outlook has seen value and cyclical stocks outperform growth strategies in recent months. FEV's significant overweight to mega-cap stocks has also detracted from relative returns as small cap stocks have outperformed larger companies over this period.

On a stock basis, the largest detractor from relative performance over the six months to end February was the portfolio's overweight to the German technology company SAP. The company issued a profit warning due to the disappointing performance of some of its cloud businesses, including Concur, the on-line travel expense management company. SAP also revised down its medium-term guidance as it steps up its shift away from 'on-premise' sales, towards a more 'cloud-based' business model. Despite these setbacks, SAP remains one of FEV's top 10 holdings as the managers believe that SAP's management is doing the right thing for the longer-term growth and sustainability of the business, even though it comes at a cost to medium-term profitability, as up-front licence fees, coupled with maintenance contracts, are gradually replaced by annual subscription fees. This confidence in SAP's outlook may be starting to pay off. The release of very positive preliminary first quarter results in mid-April 2021 saw SAP's share price reach a six-month high.

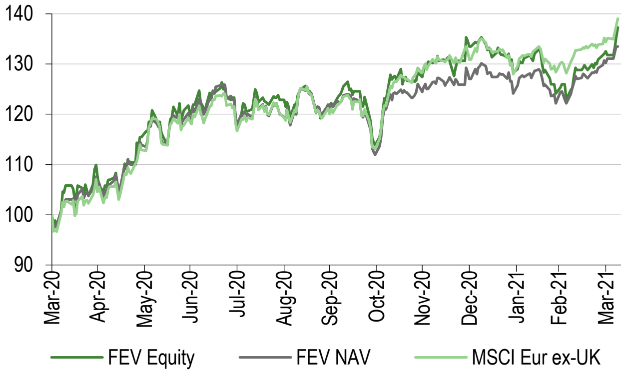
While 're-opening plays' in economically sensitive stocks recovered strongly during November and December 2020 and early 2021, many of the trust's winners during the first nine months of 2020 lagged badly. These included its overweight positions in Symrise (since trimmed, as discussed above), Nestlé and Swedish Match, a tobacco company. The portfolio's short position in the hotel company Accor also detracted from performance, as this stock rebounded strongly on the positive vaccine news.

These adverse influences on relative performance over the six months to February 2021 were in part offset by the positive impact of several overweight positions, including in the Dutch semiconductor producer ASML, which benefited from the surge in demand for semiconductors and the general buoyance of technology companies, as the digitalisation trend accelerates. Overweight positions in LVMH and its French competitor Hermes, and in 3i, also boosted relative returns, as did an underweight to Novartis, the Swiss healthcare stock.

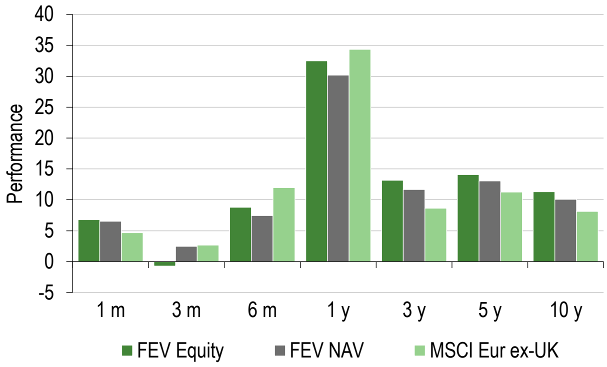
The trust's strong performance in the first three quarters of 2020 saw its share price discount to cum-income NAV narrow from around 9% in H120, to less than 4% at end 2020, its narrowest in five years. The recent underperformance has seen the discount re-widen to 7% as at 22 April 2021.

Exhibit 5: Investment trust performance to 31 March 2021

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.

Peer group comparison

Exhibit 6: AIC Europe sector peer group as at 23 April 2021*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Discount (cum-fair)	Ongoing charge	Perf. fee	Net gearing	Dividend yield
Fidelity European Trust	1,220.0	33.4	43.4	94.0	171.0	(7.0)	0.9	No	113	2.2
Baillie Gifford European Growth	554.2	70.5	55.6	114.0	162.7	1.6	0.4	No	107	2.3
BlackRock Greater Europe	511.6	59.7	77.3	144.1	230.0	0.7	1.0	No	106	1.0
European Opportunities	796.7	8.6	17.8	61.1	196.6	(13.0)	1.0	No	105	0.5
Henderson European Focus	332.5	42.4	38.9	82.9	202.2	(8.3)	0.8	No	100	2.0
Henderson Euro	312.5	41.5	48.4	104.0	220.0	(10.9)	0.8	No	101	1.7
JPMorgan European Growth Pool	245.8	40.1	21.1	68.0	125.3	(12.1)	1.0	No	104	1.3
JPMorgan European Income Pool	129.9	42.4	7.8	53.0	131.4	(8.6)	1.0	No	108	4.4
Average (8 funds)	**512.9**	**42.3**	**38.8**	**90.1**	**179.9**	**(7.2)**	**0.9**		**105**	**1.9**
Trust rank in sector	**1**	**7**	**4**	**4**	**5**	**3**	**5**		**1**	**3**

Source: Morningstar, Edison Investment Research. Note: *Performance to 22 April 2021 based on ex-par NAV. TR=total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

FEV is the largest of eight funds in the AIC Europe sector (Exhibit 6). While its recent disappointing performance means that the trust's NAV returns have lagged the average return among its peers over one year, it has exceeded the average return over three and five years and almost matched the average return over 10 years. Its discount is narrower than the average and its ongoing charge is in line with the average of its peers. Like all the other funds in the sector, FEV does not charge a performance fee. Its gearing is the highest in the sector, while its yield is above average.

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
1185 Avenue of the Americas
3rd Floor, New York, NY 10036
United States of America

Sydney +61 (0)2 8249 8342
Level 4, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia