21 September 2021

# FIDELITY EUROPEAN TRUST PLC

## FEV: follow the money

**Over five years, Fidelity European Trust (FEV) has outperformed UK markets, UK listed competition and European benchmarks. It "follows the money" using detailed research, leveraging Fidelity's global capabilities, to identify mis-priced strong, growing dividends. Over 10 years, Fidelity's stock selection has added ca.2% p.a. to returns. Around two thirds of portfolio company revenue is non-European. FEV invests for the long term and in quality businesses with downside protection, but it can face short-term headwinds and have above-market volatility. FEV's assets are listed and liquid, but its shares trade at a 7% discount to NAV.**

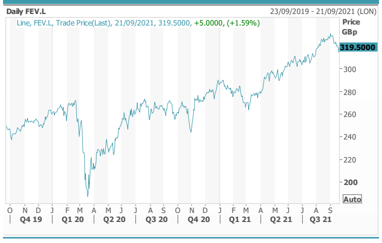
- **Favoured companies:** FEV invests in businesses with strong balances sheets, good franchises, robust dividend growth and above-average profitability. These factors give businesses sustainable and growing dividends, and good resilience to recessions; they have also outperformed their indices over time.
- **Other advantages:** FEV has a long-term focus, and has all the advantages of a closed-ended structure. It enhances returns through modest gearing using derivatives, and has strong ESG credentials. Europe has the advantages of a wealthy population and catch-up from a low start to vaccination.
- **Valuation:** 99.9% of investments are valued using quoted prices in active markets (around five-sixths is realisable in just three days). The NAV is "real" – so any discount is anomalous. The discount of 7% is below low-run averages but above peers, whom FEV has outperformed. FEV pays a modest dividend.
- **Risks:** FEV has seen periods of short-term underperformance, when its investment style has been out of favour – typically when the market's preference has been for lower-quality, more cyclical stocks assets. Usually, recovery has been swift. COVID-19 remains an uncertainty. There are European sentiment issues.
- **Investment summary:** FEV has outperformed its peers, benchmarks and UK indices with a distinctive, research-driven, sustainable and growing dividend investment approach. Its companies show faster-than-average revenue growth (ca.2x European market average) and have higher ROE and ROIC (ca.50% and 20%, respectively). It invests for "Dividend Growth at a Reasonable Price" – so its companies' valuations are also higher. FEV's style will not always be popular, it is likely to see some return volatility, and sentiment to Europe may vary.

### Financial summary and valuation

| Year-end Dec (£000) | 2017 | 2018 | 2019 | 2020 | 2021E | 2022E |
|---|---|---|---|---|---|---|
| Gains & losses on investments | 152,924 | -64,871 | 183,944 | 89,664 | 228,126 | 128,533 |
| Gains & losses on derivatives | 1,211 | -6,143 | 17,516 | 2,768 | 2,770 | 2,770 |
| Income | 29,384 | 33,763 | 34,201 | 25,552 | 39,165 | 46,585 |
| Investment mgt. fees | -8,281 | -8,120 | -8,476 | -8,899 | -8,405 | -9,997 |
| Other expenses | -802 | -846 | -857 | -845 | -854 | -854 |
| Investments | 1,011 | 939 | 1,109 | 1,201 | 1,428 | 1,561 |
| Cash | 4,128 | 4,427 | 9,490 | 7,070 | 7,070 | 7,070 |
| NAV (£m) | 1,030 | 955 | 1,141 | 1,220 | 1,451 | 1,583 |
| NAV per share (p) | 2.48 | 2.32 | 2.77 | 2.97 | 3.53 | 3.85 |
| Discount to NAV* | -8.6% | -10.7% | -6.2% | -3.6% | -9.8% | -17.3% |
| Yield | 1.4% | 2.0% | 2.0% | 2.0% | 2.3% | 2.7% |
| Dividend (p) | 4.35 | 6.28 | 6.47 | 6.50 | 7.31 | 8.74 |

**2017-20 NAV on year-end s/p, 2021-22E NAV on current s/p; Source: Hardman & Co Research*

### Closed End Investments



*Source: Refinitiv*

### Market data

| EPIC/TKR | FEV |
|---|---|
| Price (p) | 318.5 |
| 12m high (p) | 331.5 |
| 12m low (p) | 243.5 |
| Shares (m) | 411 |
| Mkt cap (£m) | 1,309 |
| NAV (17 Sep'21, p) | 341.4 |
| Discount to NAV | 7% |
| Country of listing | UK |
| Market | STMM |

### Description

Fidelity European Trust (FEV) aims to achieve long-term capital growth by investing predominantly in equities and their related securities of European companies.

### Company information

| | |
|---|---|
| Chairman | Vivian Bazalgette |
| NED | Marion Sears (SID), Paul Yates, Fleur Meijs, Sir Ivan Rogers |
| Fund Manager | Sam Morse (lead) Marcel Stotzel (co) |

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### Key shareholders

| | |
|---|---|
| Fidelity Platform/HL/II | 25% |
| Wells Capital Mgt. | 9% |
| Brewin Dolphin | 8% |
| Quilter Cheviot IM | 7% |
| Rathbones | 6% |
| Smith & Williamson WM | 3% |

### Diary

| | |
|---|---|
| Mid-Oct | Sep monthly summary |

### Analyst

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mt@hardmanandco.com

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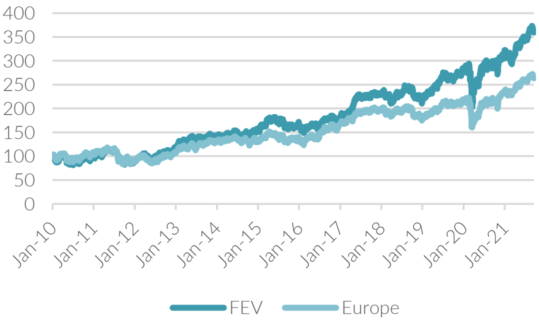
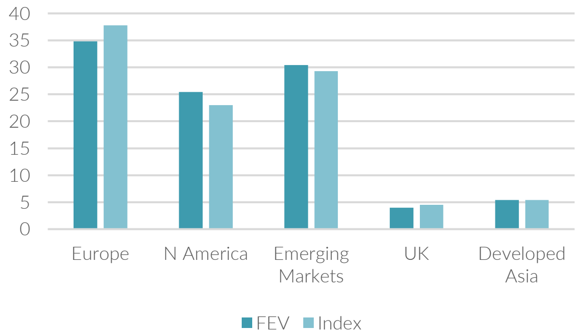
## FEV has outperformed against European markets (indexed to 100, 1 Jan 2010, managers' appointment date)



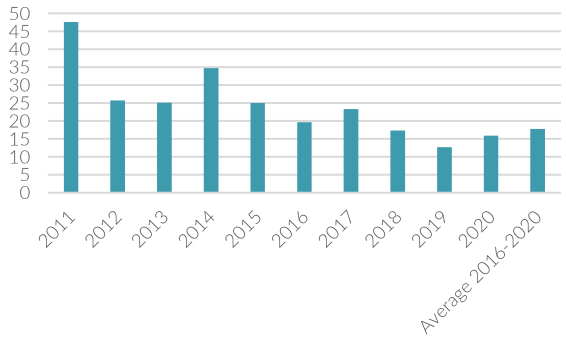

- Over the medium and long term, FEV has materially outperformed against UK indices.
- Over five years, FEV has outperformed the AIC Europe sub-sector listed investment companies by 5%.
- Over five years, FEV has outperformed average peer open-ended funds investing in Europe by 6%.
- Over five years, FEV has materially outperformed against European benchmark indices by 9%.

## 2020 geographical split of investee company revenue (%)



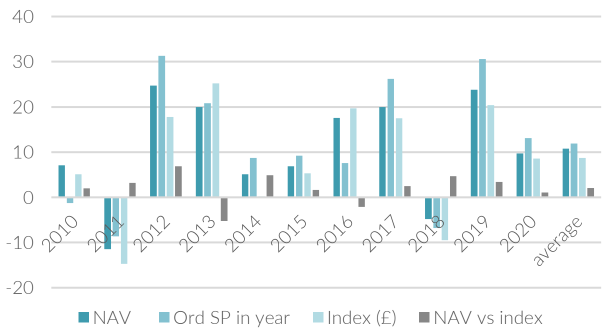

- FEV invests in European-based companies, but they generate their revenue globally. FEV's exposure is to global factors and growth, not just European.
- The portfolio is primarily large-cap (June 2021: 93% >£10bn) names, which are highly liquid.
- Its focus is on strong, well-established, diversified businesses that show above-average growth and profitability, with sustainable and growing dividend potential.
- Growth is at a reasonable price approach – so valuations are also higher than the market.

## Turnover (annual, %)




- FEV has a team of 37 in Europe to identify mis-priced (under-researched) companies and access to global resources.
- FEV invests for the long term. Turnover is low (average 18% 2016-20), reducing trading costs. The investment thesis for each company is reviewed at least quarterly.
- Derivatives are used to manage exposure, and have ranged from -4% to +12% of fair value (FV) of investments over 2011-20.
- Portfolio risk is managed through position size – typically keeping sector exposures within 5% of the benchmark.

## Annual total return for NAV, share price and index, and relative to index (2010-20, %)




- Average 10.8% annual total NAV return 2010 to 2020, against index performance of 8.7%.
- Can be volatile, with a range from -11.5% to +24.7% (index -14.7% to +25.2%).
- Sentiment to Europe can affect the discount, even when (global) fundamentals are unaffected.
- Investor appetite for FEV's investment approach can create headwinds. Normally, FEV has overcome them, but not always in the short term.

*Source: Company data, Hardman & Co Research*

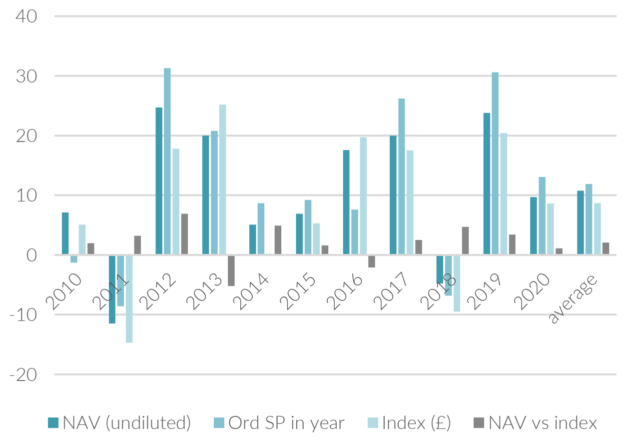
# Summary

## Investment positives

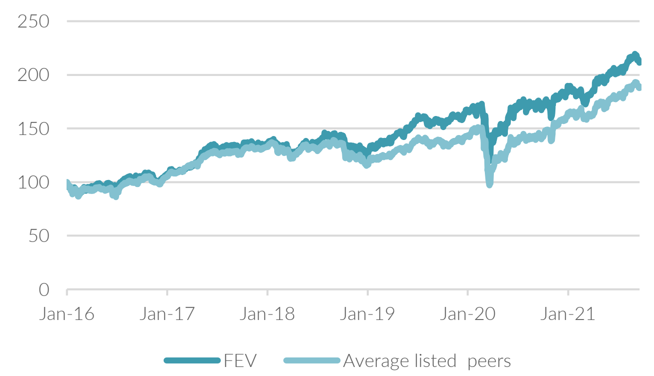
**FEV has outperformed UK markets, UK listed and open-ended peers, and its European benchmark**

FEV has outperformed against UK indices (ca.2.5x total shareholder return since January 2016), and against the listed closed-ended investment companies and open-ended funds in the same space (5% and 6%, respectively). It has also beaten its European benchmark by 9% p.a. over this timescale. This outperformance is due partially to European markets beating the UK market over the long term, but, much more significantly, because of the value added by Fidelity in its investment process. It outperformed when the market fell in spring 2020, with further outperformance through the rest of year, as FEV's 2020 investment income fell by just a fifth on 2019, against European average dividend cuts of a third.

**Standardised performance total return (%)**




**FEV and average of listed peers' total return, indexed to Jan 2016**




*Source: Refinitiv, Hardman & Co Research*

**FEV has delivered this outperformance by investing in businesses with sustainable and growing dividend capacity**

FEV's companies have a proven track record of outperforming markets over the long term – each of FEV's top five holdings have beaten the index over five years. FEV's approach is bottom-up, long-term and cautious, with the focus being on dividend growth at a reasonable price (GARP). Its companies typically are larger, long-established businesses, with proven track records through multiple economic scenarios. FEV is investing primarily in global businesses, with nearly two thirds of portfolio company revenues coming from outside Europe. They have faster-than-average European revenue growth, better-than-average profitability and, to pay for this quality, the P/E and P/B valuation ratings are also above-average. The yield on the portfolio is in line with the market (FEV is focused on dividends but invests in sustainable dividend growers – not the highest-yielding companies, where the dividend may be at risk).

**Other characteristics include i) steady outperformance, not risk-taking, ii) detailed research, iii) long-term holdings generating compounding returns, iv) strong ESG, v) avoiding high-valuation "hot" sectors, and vi) managing portfolio risk via position size**

Other company characteristics include i) FEV aims for steady outperformance, not shooting the lights out one year and risking a major underperformance the next, ii) FEV's approach is underpinned by detailed research conducted by Fidelity's team of 37 in Europe (the origination of new ideas flows from this analytical model/company meetings, the benefits of Fidelity's global research, the managers' and analysts' networks, and external recommendations), iii) the company regularly re-visits each company's investment thesis, but turnover over the past five years has averaged just 17.8%, i.e. an implied hold period of 5.6 years, iv) FEV has strong ESG characteristics, viewing this as both a social responsibility and an opportunity to create value, v) FEV avoids hot sectors where valuations cannot be justified/dividends may not be paid, or they may prove unsustainable, and vi) the portfolio risk is managed through position size, with sector exposures typically kept within 5% of the benchmark.

Flexible mandate using derivatives modestly to increase returns

FEV has a flexible mandate and uses long contracts for difference (CFDs) and futures (non-complex derivatives) to increase stock-specific exposure in an efficient way. Short CFDs are used where the managers feel the investment thesis is the opposite of a buy case, rather than for hedging/valuation-exclusive reasons. Their market value is shown in the balance sheet, but the "real" nominal amount of exposure is shown in the notes to the accounts. Net derivatives ranged from -4% to +12% of investment FV over 2011-20.

Other advantages include i) benefit of closed-ended structure, ii) good liquidity in own shares, and iii) good liquidity in investments

Other company-specific investment advantages include i) closed-ended structures, like FEV, outperform open-ended ones, as they have less cash drag, can invest long term, offer more favourable trading options (e.g. immediate purchase/sale), have a board of directors to supervise risk and performance, and allow gearing (FEV has outperformed comparable open-ended funds over five years), ii) there is good liquidity in FEV shares, and its register has little concentration and has proved very stable (all top six holders, including two retail platforms, had disclosable stakes in 2016), and iii) investing primarily in large-cap, listed names means there is good liquidity in the investments, and investors can take comfort that the NAV is a realistic reflection of the realisable value of the portfolio.

Trends in Europe have modest impact on NAV (noting it is just a third of revenue), but can affect sentiment and so the discount

Trends in Europe may have a direct influence on the NAV (with around a third of portfolio company revenue from the region), but also – through investor appetite for FEV shares – on the discount to NAV. Some of the positives from the region include i) as a major trading partner, Europe is likely to benefit from superior growth in the US and China, and Japanese trade should increase with the effect of the Economic Partnership Agreement (EPA), which the EU estimates could increase exports by 13% (the exposure to global trade wars/tension is complex, but we do not believe it should be a material issue), ii) the region should benefit from the effect of the short-term stimulus from COVID-19 recovery plans – a total of €1.8tr (2018 prices) will be injected to help rebuild a post-COVID-19 Europe (importantly, most of this benefit is still to come, giving the region a positive delta for 2021-22, compared with 2019), and iii) Europe ranks highly for affluent and wealthy populations with high discretionary spending power.

FEV's ESG better than market

In terms of ESG, in our view, Europe has mixed credentials. For Fidelity, ESG is simply good business practice, with both social and investment-return benefits. It uses a proprietary model, dedicated teams and external consultants, and has been a signatory to UNPRI since 2012. Between 80% and 90% of FEV's portfolio is invested in companies rated A or B (well above the index's ca.70%) on Fidelity's internal measures.

## Investment-neutral factors

Investment-neutral factors include discount management, gearing, fees, currency exposure, FEV's own dividend, KID disclosure, rising local tax rates post-Brexit, and European index valuations

Investment-neutral factors include i) the discount to NAV can be helped by buybacks, but this can create share liquidity issues, worsen expense ratios and send mixed messages regarding growth prospects – FEV does them selectively to keep the discount within single digits, and there is a continuation vote every two years, which should also limit extreme discounts, ii) exposures are geared through derivatives, not debt – gearing is capped at 30% of shareholders' funds but, over the past 10 years, it has averaged 6% (this is likely to increase to ca.10% going forward), and we believe this increases long-term returns but introduces greater volatility, and iii) ongoing charges have fallen sequentially every year since 2016 – further reductions may be expected with the 10bp cut in the tiered rate on NAV over £400m, effective from April 2021 (this should save investors ca.£0.8m p.a. on the current portfolio), but FEV is only in line with peers on the AIC ongoing costs basis and 20bps below using the Key Information Document (KID) disclosure – and 15bps of this is due to lower transaction costs, given the low turnover mentioned above. Other neutral factors include i) currency exposure, ii) KID sensitivity in line with peers, iii) a modest but progressive dividend policy, iii) post-Brexit, local tax rates may increase in Italy, Norway and France, and iv) the overall level of the market valuation is a relatively small factor in its performance.

## Investment risks/downsides

Investor appetite can be contrary to FEV's approach when market is buying i) small-cap over large-cap, ii) value over growth, and iii) low-quality businesses, not high-quality. Such conditions most often seen in sharp "trash" rallies.

The market appetite for FEV's investment style (and investments) may vary, and has the potential to create both NAV and discount headwinds.

- FEV is invested primarily in large-cap companies, and so faces an NAV headwind if small-cap names are preferred by the market.
- Dividend GARP faces potential NAV headwinds if the market is buying purer value. Rising inflation expectations can be a driver to this trend, as the present value of future dividends is reduced by higher long-term rates.
- FEV invests in substantial, sustainable businesses, and so faces an NAV headwind if the market favours lower-quality, cyclical opportunities.
- Despite these potential headwinds, FEV's NAV has underperformed its benchmark in only two of the past 10 years. In 2016, it saw just a 2% NAV underperformance (although the share price underperformed by a greater amount, driven by sentiment issues).

It is important to recognise that FEV has generally overcome such headwinds, and periods of NAV and share price underperformance have been short.

FEV may also show volatility

FEV may also show volatility. In FY'10-'20, the NAV average annual return was 10.8%, but it ranged from -11.5% to +24.7% (and the share price averaged 11.9%, with a range of -8.6% to +31.3%). The former range was slightly better than the benchmark, while the latter was slightly worse.

Could be adverse sentiment to Europe, as Europe lurches from crisis to crisis and given relatively slow GDP growth. Given earnings mix of investments, greater impact on discount than performance of investments.

As noted above, European issues may affect the NAV – although, with just a third of revenue earned by portfolio companies in the region, we believe this is likely to have a greater impact on sentiment, rather than the performance of investments. Geo-political risk cannot be ignored, as the EU appears to lurch from one crisis to another, and both France and Germany are facing major elections within the next year. It is unclear how trade nationalism, or the perception of it, may develop. Europe has a poor record of GDP growth, which may not help sentiment, and faces a GDP headwind from an ageing population (19% of Europe's population is over 65, compared with the global average of 9%). Pre-pandemic Southern European central government debt was high and, across the whole region, it has increased materially with pandemic measures. Short term, Europe's generally slow vaccination rates could see incremental pressures from COVID-19, and Europe scores poorly in terms of restrictive labour laws.

FEV stock selection makes it less sensitive to market bubbles

Strong European stock markets may see some concerns about a short-term bubble, but FEV's stock selection gives it a very different profile from European markets as a whole. European companies have below-average cash holdings, but FEV's focus is in companies with strong balance sheets – so the risk is relatively modest.

## Portfolio

Investors buying into process, not specific portfolio

We believe investors should focus on the value-added investment process, rather than the portfolio on any given date. Noting that caveat, the main underweights are currently Germany and Sweden, with overweights being France, Switzerland, Norway and the UK.

## Valuation

Discount closing would be icing on cake, but only small part of expected return from compounding capital gains

FEV's discount to NAV is below its historical levels, but slightly above that of its peers. We believe investors should consider investing for long-term, compounding capital gains, with any one-off discount reduction being an added bonus.

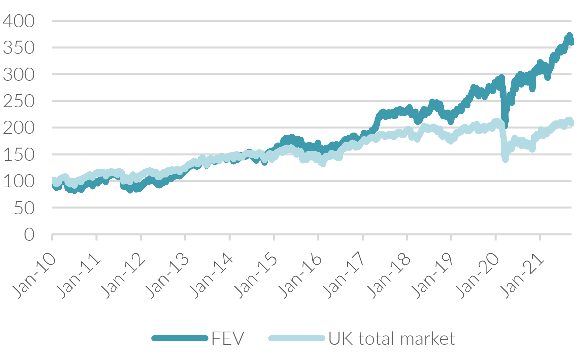
# Investment attractions

## 1) FEV: superior investment performance

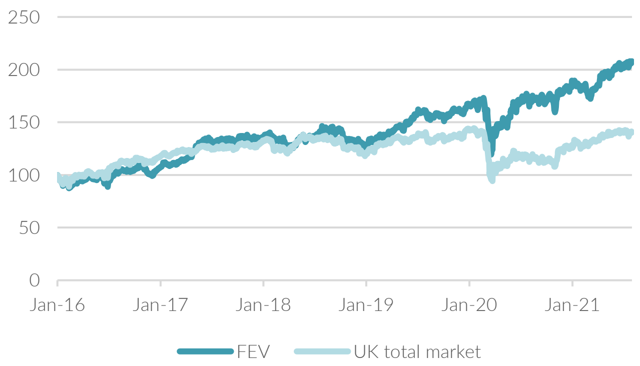
For UK investors, FEV has outperformed over long term against UK indices

As a UK listed vehicle, with a high proportion of UK retail shareholders, we believe many investors will look to FEV because they expect superior returns over their UK alternative investments. This expectation has been delivered. As can be seen in the charts below, FEV has materially beaten all these comparators, with its total return roughly treble the UK large-cap companies since 2016. Since 2010, i.e. since the managers' tenure, the outperformance has been even greater.

**FEV, UK large-cap and overall market total return, indexed to Jan 2010**




**FEV, UK large-cap and overall market total return, indexed to Jan 2016**



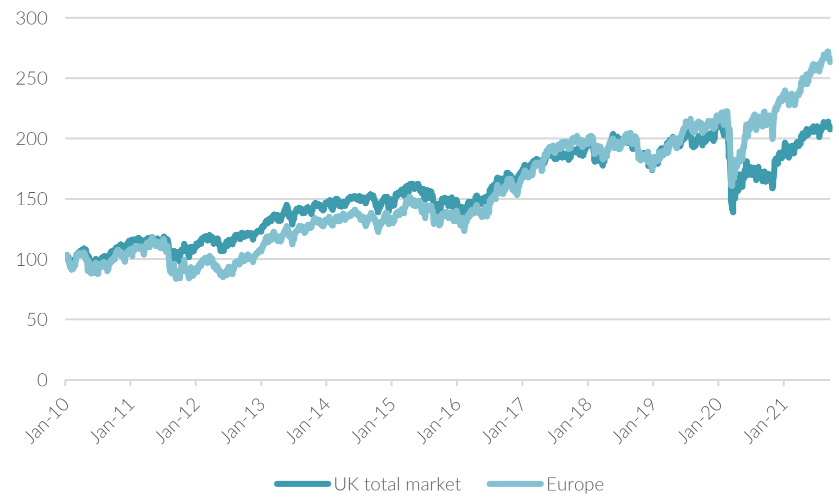

*Source: Refinitiv, Hardman & Co Research*

### European market outperformance against UK

European market beaten UK market over long term…

The chart below shows the total return for the UK market compared with the European market (sterling-hedged). As can be seen, over the long term, Europe has outperformed. As always, there are mix issues, and the European index, like FEV, is weighted to global revenue streams.

**Performance total return for European market (sterling-hedged) and UK market, indexed to 100, Jan 2010**




*Source: Refinitiv, Hardman & Co Research*

**...but, much more significantly, FEV has outperformed local benchmark indices by average of 2.1% p.a. FY'10 to FY'20**

Investors want not only to be in an attractive market, but also want investments that outperform that market. Again, FEV has delivered on this expectation. In seven of the years 2010 to 2020, FEV outperformed its benchmark. Over the whole period, the average annual outperformance was 2.1%.

Investors wanting to compare FEV with its UK listed peers can see their relative performance updated daily on the AIC website. At the time of this report, FEV was ca.5% ahead of the average-performing "Europe" investment company over five years, despite a challenging one-year performance, when its investment style was unusually out of favour and was ca.8% behind peers.

**Outperforming open-ended vehicles in same space**

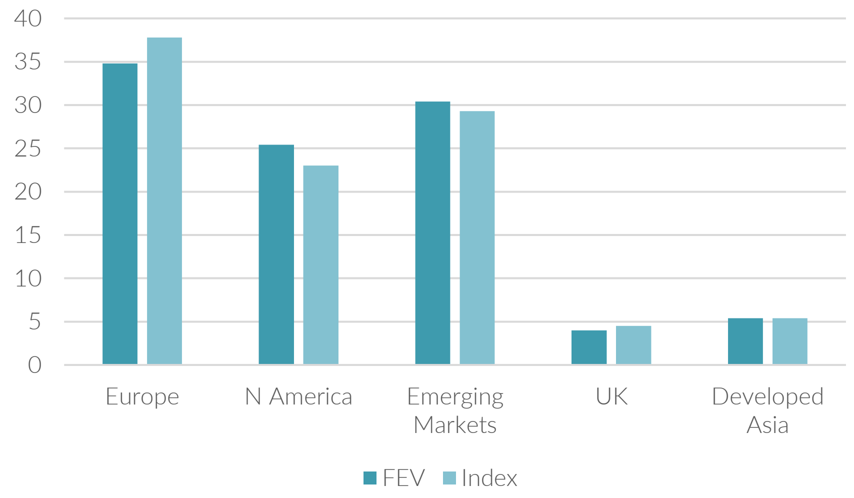
Looking at open-ended funds, Fidelity Funds platform alone lists funds in Europe ex UK (139 funds) and European smaller company sectors (17 funds), of which all but 10 are actively managed. FEV has again outperformed over the medium term.

## 2) FEV: portfolio companies earn two thirds of their revenue outside Europe

**FEV investing in global businesses with nearly two thirds of portfolio company revenue from outside Europe**

Looking at the portfolio companies, European sales account for just over a third of FEV's investee companies' revenues – somewhat less than the index as a whole. FEV is slightly overweight North America (which should bode well for the stimulus-driven growth expected in that market) and emerging markets. The key business message is that FEV's investee companies will benefit from global trends, and the impact of the issues on Europe that we identify below (both positive and negative) will affect only a third of these companies' sales. In terms of investee company earnings, the message is the same.

**Geographical split by sales exposure (%)**




*Source: Fidelity, Hardman & Co Research*

# 3) FEV: investing in dividend-growing companies because they outperform

Businesses with sustainable and growing dividend capacity outperform over long term. Since January 2010, all top five holdings have outperformed European index.

FEV has a very clear strategy of focusing on companies with a sustainable and growing dividend capacity, and uses fundamental research to identify where this has been mis-priced. The conceptual approach is based off empirical evidence that, over the long term, companies with sustained and growing dividends outperform the market. Looking at FEV's top five holdings at end-2020, each of them had outperformed the European market since the start of 2010.

Top holdings outperformed market falls in spring 2020, given their balance sheet strength and global operations. Further outperformance in rest of year.

The top holdings in the portfolio outperformed the index in 2020, as well as over the long term. The reasons for this include i) balance sheet strength at times of uncertainty, ii) global businesses that benefited from the stronger growth seen, *inter alia*, in China/the US, and iii) strong recoveries in equity markets helping luxury brands. Fidelity's analysis indicates that, over one year to June 2020, dividend growers' median-cumulative returns were positive, while they were negative for dividend cutters/holders. Perhaps, more importantly, over five years to that date, dividend growers' median-cumulative returns were ca.1.3x the level of dividend cutters/holders.

FEV's investment income down 8% against European average dividend cuts of a third, as FEV invests in companies with more sustainable dividend prospects

In 2020, FEV's investment income as a percentage of opening investments was 3.39%, down from 4.19% in 2019 and the average of 3.81% over 2015-19. This represents a drop in the yield of a fifth (the actual income fell by just 8%, from £11.5m to £10.6m, as the 2020 opening investments were higher than the 2019 level). This reduction in income is significantly less than reported across Europe as a whole. The Janus Henderson Global Dividend Index showed that the European dividend (ex-UK) fell 29.4% on an underlying basis, with a further drop of 3.1% from the loss of special dividends.

**2020 annual growth rate in dividends (%) – underlying and headline ($ terms)**

| | U/L | Special | Ccy. | Index chgs. | Timing | Headline |
|---|---|---|---|---|---|---|
| Japan | -2.1 | -0.2 | 1.8 | -5.1 | 0 | -5.6 |
| **Europe (ex-UK)** | **-29.4** | **-3.1** | **0.6** | **-0.7** | **0** | **-31.7** |
| North America | 0.1 | 2.4 | -0.1 | 0.2 | 0 | 2.6 |
| Asia Pacific (ex-Europe) | -11.9 | -4.8 | 0.3 | -1.9 | 0 | -18.3 |
| UK | -32.8 | -9.1 | 0.3 | 0.6 | 0.0 | -40.9 |
| **Global** | **-10.5** | **-1.4** | **0** | **-0.3** | **0** | **-12.2** |

*Source: Janus Henderson Global Dividend Index, Hardman & Co Research*

# 4) FEV: investment process summary

FEV's approach is bottom-up, long-term and cautious, with focus on sustainable growth and dividend GARP. It leverages local skills, as well as Fidelity's extensive global analytical resource.

The underlying philosophy is that good dividend growers outperform over time. FEV characterises its approach to exploiting this as:

- Stock selection, with a focus on dividend growth. What this means, in practice, is positive company fundamentals in structural growth markets (such as digitalisation, ecommerce or an ageing population), and businesses with a disciplined use of capital and proven business models. It looks for cash-generative companies, with strong balance sheets, which help ensure the ability to grow, and the dividend is unlikely to be jeopardised by short-term events.

- In Europe, Fidelity has a team of 37 research analysts, and has access to the global resource, including sustainable investing (13), shorting (seven), technical and quant analysts (four), and the global sector research specialists based in India and China (70). Against pure local investors, the global network is a competitive advantage, identifying ideas that may not be visible with a European-only focus.

- Ideas are generated from on-the-ground analyst input, complemented by global and independent research, and joining the dots via multiple information sources. The managers will, for example, often listen to the global sector reviews, giving FEV a competitive advantage over competitors with a solely European focus. Each team member typically follows several companies in detail and, from this pool, the manager then selects a portfolio of 40-50 names. Given the low turnover in the portfolio, the manager is looking for only a handful of new ideas each year, and so can cherry-pick very selectively from the large target pool.

- A long-term view reduces transaction costs, with FEV looking for companies with the ability to grow dividends sustainably over a three- to five-year time horizon. We highlight, in the section on turnover below, that the average hold period is 5.6 years, and the largest position (Nestlé) has had this position for over 10 years.

- A focus on managing downside risk creates a strong foundation for long-term outperformance, and we discussed, in the section above, how FEV's income fell by significantly less than the market dividends through 2020. Fidelity advises that its European OEIC has outperformed in >70% of negative months since the tenure of the current manager in 2011, and that the listed trust's performance is similar to, if not better than, this. The aim is to build a portfolio that is agnostic to Europe's financial fortunes and can perform well in all economic weathers.

- FEV invests for growth at a reasonable price, not growth at any price or in pure value plays. The stated investment objective is to "*outperform the Benchmark Index steadily and consistently over a number of years. We are not trying to shoot the lights out. The Company will have good years and it will have bad years but over longer periods of time steady outperformance of the Benchmark should deliver returns competitive with the peer group average*."

**Other features include i) constantly re-visiting investment thesis, ii) looking for strong ESG characteristics, and iii) avoiding hot sectors**

Other features include:

- FEV advises that it regularly revisits the investment thesis (at least quarterly and *ad hoc* on major developments), reviewing the key screening criteria, the "three reasons to hold" sheet, and the expected total shareholder return table. We understand that the main drivers to selling a position are when the core investment thesis has changed, with a (sustained) change in dividend prospects being a good indicator of this. Valuation is always a consideration, but a period of a short-term high, but not extremely high, valuation would be tolerated where the long-term dividend growth story were strong.

- As noted, FEV has strong relative ESG characteristics, which we explore in more detail in a section below.

- Businesses that FEV avoids include i) where fundamental analysis indicates that the market may be pricing in a greater near-term recovery than Fidelity thinks likely, e.g. business travel and hospitality, and ii) "hot" sectors, where company valuations, again, are not justified by the prospects established after detailed analysis. Short positions, taken via CFDs, are used where the investment case is the opposite of long positions (i.e. weak balance sheets, limited – if any – growth and likely dividend cuts), rather than for hedging or pure valuation reasons.

**FEV companies typically are larger, long-established businesses, with proven track records through multiple economic scenarios, with faster-than-average growth, better-than-average profitability and above-average valuations**

Consequences of FEV's investment style are typically as follows:

- The investee companies have larger market capitalisations – as at June 2021, companies with a market capitalisation in excess of £10bn had an exposure totalling 93% of net assets of the portfolio (index 84%), with a further 7% in market capitalisations of £5bn-£10bn (and 6% sub-£5bn).
- The investee companies are long-established, with a track record of trading through downturns and across different global conditions. By way of example, five top holdings at end-2020 had been established for well over a century: Nestlé (1866), Roche (1896), ASML (1984), LVMH Moët Hennessy (1854 LV, 1593 wine) and L'Oréal (1909).
- The portfolio of stocks is fairly concentrated, at between 40 and 50 diversified stocks, with no bias to a particular sector or company size.
- The investee companies have above-average revenue and dividend growth (January 2021 6.9% vs. index 3.4%, and 7.6% vs. index 5.5%, respectively).
- The investee companies have above-average returns (January 2021 ROE 15% vs. index 11.1%, ROIC 12.5% vs. index 10.5%).
- The investee companies have above-average valuations (spring 2021 ca.3x above index on P/E and ca.1.5x above index on P/BV). One example of a portfolio company on a high rating is Hermes. The manager has highlighted that it has always been highly rated – a valuation supported by a long-term track record of low double-digit annual shareholder returns, a low free float, a strong balance sheet with cash, and the value of being a prize asset, potentially attracting bid speculation. Despite meeting many of FEV's criteria, the size of the position has been limited because of this valuation. As noted above, a period of full valuation will be tolerated if the fundamental investment case remains robust.

**Overall portfolio risk managed through position size**

The overall portfolio construction then reflects i) position size, driven by conviction in growth prospects, liquidity, valuations and upside, and the resulting expected total shareholder returns, ii) stock and portfolio-level risk being continually monitored, with all holdings frequently reassessed, and iii) that consideration is given to benchmark weightings – and it is unusual for FEV to vary by more than 5% from the benchmark. This is not a hard limit requiring positions to be sold, but rather a level where more consideration may be given to a position size. As noted above, FEV is not trying to shoot the lights out by taking excessive risk, and its portfolio management reflects this approach.

# 5) FEV: long-term focus

## Turnover of portfolio

**Turnover over past five years averaged 17.8%, i.e. implied hold period of 5.6 years, limiting transaction costs**

The chart below shows turnover (defined as the average of the total amount of securities purchased and the total amount of the securities sold in the reporting year divided by the average FV of the investment portfolio). For the period 2015-20, the average turnover was 17.8% (i.e. an average implied hold period of 5.6 years). To quote economist Ben Graham, "*As in roulette, the same is true of the stock trader, who will find that the expense of trading weights the dice heavily against him.*"

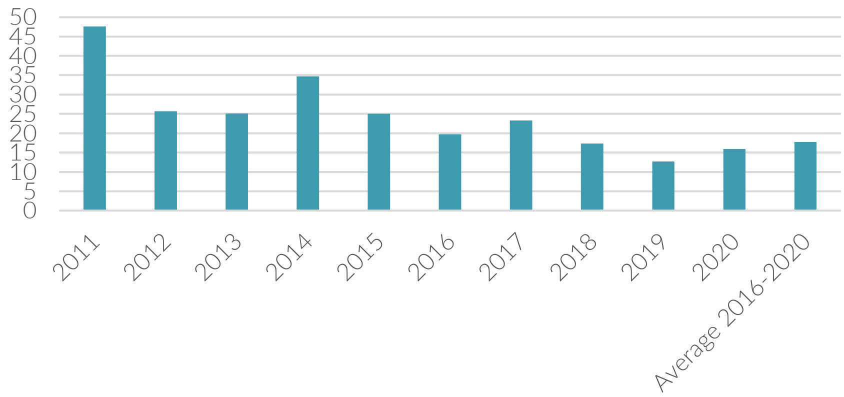
**Largest holdings show remarkable consistency**

The key message is that these key holdings have barely changed over the past five years – indeed, the top two, at end-2016, were still the top two at the end of 2020, with their overall weighting going from 11.6% to 12.2% of the portfolio. Nestlé represented around 7.4% of the total exposure of the investment portfolio in 2011, against 6.1% in June 2021.

**For a reasonable hold period, good, strong-growth companies offer better returns**

FEV sees that there is enough alpha in picking good-quality growth companies at a fair price, rather than churning, lowly-valued bombed-out ones that may or may not see a re-rating. Multi-year conviction holdings generate compounding returns and reduce re-investment risk.

**Turnover of portfolio, 2011-20 (%)**




*Source: FEV Report and Accounts, Hardman & Co Research*

## 6) FEV: active user of derivatives

**FEV uses long contracts for difference and futures (non-complex derivatives) to increase stock-specific exposure in an efficient way**

For several years, the derivatives used by FEV have been contracts for difference (whose values change with the difference between the current market price and the agreed price in the contract) and long futures. They are used to increase stock-specific exposure without incurring the balance sheet gearing necessary to fund such positions. FEV will take short exposures on stocks that the investment manager considers to have the opposite characteristics to ones in the long portfolio. The exposures created by such derivatives are included at their nominal value, and managed in the same way as a share position would be for risk control purposes.

**Derivative assets and liabilities, and total investments in balance sheet, end-Dec 2011-20 (£m)**

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|---|---|---|---|---|
| Long CFDs | 41 | 91 | 73 | 21 | 6 | 0 | 36 | 59 | 73 | 99 |
| Short CFDs | 16 | 10 | 0 | 23 | 29 | 39 | 49 | 19 | 14 | 14 |
| Long futures | 0 | 0 | 0 | 0 | 0 | 0 | 70 | 35 | 26 | 50 |
| **Total gross derivs.** | **58** | **101** | **73** | **45** | **35** | **39** | **155** | **113** | **113** | **164** |
| FV investments | 669 | 669 | 669 | 717 | 747 | 863 | 1,011 | 939 | 1,109 | 1,201 |
| **Gross derivs. as % FV** | **9%** | **15%** | **11%** | **6%** | **5%** | **4%** | **15%** | **12%** | **10%** | **14%** |
| **Net derivs. as % FV** | **4%** | **12%** | **11%** | **0%** | **-3%** | **-4%** | **6%** | **8%** | **8%** | **11%** |

*Source: FEV Report and Accounts, Hardman & Co Research*

Other factors to consider are i) in FEV's case, over the past six years, the cash at settlement houses and brokers has been material only at one year-end, and then it represented only 1% of investments (we do not believe derivatives will present a liquidity challenge), and ii) FEV deals only with global investment banks, thus mitigating counterparty risk.

## 7) FEV: closed-ended structure benefits

Closed-ended structures outperform open-ended ones, as they have less cash drag, can invest long term, offer more favourable trading options, have board of directors to supervise, and allow gearing

There are many open-ended investment vehicles available to those wanting to invest in Europe/European smaller companies. However, we see structural advantages in FEV's closed-ended vehicle structure, including:

- The manager can make long-term decisions, without having to worry about needing to sell assets to meet investor redemptions.
- The shares are listed on a stock exchange – this offers investors the ability to buy and sell shares at any time in normal trading hours, as well as the comfort from the governance associated with a listing.
- Less cash drag, as there is no need to hold liquidity against potential redemptions.
- Boards of directors – the independent directors provide an additional layer of oversight, protecting investors' interests.
- Investment trusts can hold back some of the income they receive in good years, thereby building up revenue reserves, which can then be used to supplement dividends to shareholders at a time when companies in the portfolio may be cutting or cancelling their dividends.
- Gearing – the ability of investment companies to borrow money to invest means that they may perform better over the long term (see section below).

FEV outperformed comparable open-ended funds over five years

The AIC has indicated that, across all closed-ended vehicles, it believes the incremental return is over 1% p.a. better than open-ended comparable vehicles. As noted above, looking at FEV over the past five years, we estimate that it has outperformed open-ended comparable funds available to retail investors on the *Fidelity Funds Platform,* confirming this thesis.

## 8) FEV: good liquidity in investments and own shares

FEV invests predominantly in large-cap names where its holdings are a tiny proportion of the market capitalisation. FEV advises that it believes five sixths of the portfolio could be liquidated within three days, a view supported by the large-cap bias of investee companies. There are no unlisted investments, and we understand that the appetite for such vehicles is limited. The investment process is more weighted to long-established businesses with proven dividend growth characteristics, and it has a relatively low-risk appetite; these are not typical features for many unlisted businesses. FEV's track record would suggest that there are plenty of opportunities in the listed space.

Good liquidity in FEV shares

FEV's share trading has been very liquid, even in challenging market conditions, and liquidity was strong through the early stages of the pandemic. In 2019, the value traded was £314m, rising to £394m in the more active 2020 – broadly speaking, a quarter of the current market capitalisation of £1.3bn.

All top six holders (including two retail platforms) had disclosable stakes in 2016 and, overall, have increased their holdings from 43% to 49%

The table below shows the disclosed major shareholders. 57% of the shares are held in the top eight names (noting that these include the major retail platforms). Of these eight largest shareholders, there has been remarkable stability, with six having significant holdings in 2016.

History of key shareholders (%)

| December | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|
| Fidelity Platform | 18.93 | 17.93 | 17.08 | 16.76 | 16.10 |
| Wells Capital Management | 9.28 | 7.63 | 8.39 | 8.49 | 9.16 |
| Brewin Dolphin | 3.70 | 3.38 | 3.22 | 3.15 | 7.81 |
| Quilter Cheviot | 3.45 | 3.52 | 3.88 | 5.15 | 6.86 |
| Rathbones | 4.55 | 4.37 | 4.50 | 5.53 | 5.51 |
| Hargreaves Lansdown | 3.09 | 3.49 | 3.55 | 4.12 | 4.36 |
| Interactive Investors | n/d | n/d | n/d | 3.41 | 3.82 |
| Smith and Williamson WM | n/d | n/d | n/d | n/d | 3.15 |
| 1607 Capital Partners | 7.03 | 6.34 | 7.89 | 4.56 | n/d |
| Investec | 4.21 | 6.72 | n/d | n/d | n/d |

*Source: FEV Report and Accounts, Hardman & Co Research*

## 9) FEV: strong relative ESG credentials

Europe has mixed ESG credentials

To measure how Europe adheres to ESG principles, we note that the UN reports signatories to its *Principles for Responsible Investment (PRI) by region*. There were over 1,100 net new signatories across Europe in FY'19-'20, although this is only just double the level of UK/Ireland combined.

For Fidelity, ESG simply good business practice

FEV dedicates pages 29-31 of its 2020 Report and Accounts to ESG in the *Investment Process*. Fidelity has been a signatory to the United Nations Principles for Responsible Investment (UNPRI) since 2012, and submits an annual report detailing how it incorporates ESG into its investment analysis. In practice, we understand that Fidelity:

Fidelity uses proprietary model, dedicated teams and external consultants, and has been signatory to UNPRI since 2012

- Employs a proprietary sustainability rating process (established in 2019), leveraging its internal research and interactions with corporates. Analysts assign an overall A to E rating (C being understood as the sector average) for each rated name on a sector-relative basis.
- Has a dedicated "Sustainable Investing Team", with responsibility to ensure engagement with companies, incorporate ESG into the investment analysis, including internal reporting, responding to client and company queries, and providing training to the broader team. The team has 13 research specialists – nearly a tenth of the total 137 global equity-specific analysts.
- Subscribes to an external ESG research provider and rating agency to supplement its organic analysis. Fidelity receives reports that include company-specific and industry-specific research, as well as *ad hoc* thematic research looking at particular topics.
- Receives, from the external research vendor, controversy alerts that include information on companies within its coverage, which have been identified to have been involved in a high-risk controversy that may have a material impact on the company's business or its reputation.

Looking at FEV specifically, over 80% of portfolio invested in companies rated A or B (well above index's ca.70%)

Pages 8-9 of the 2020 Report and Accounts give a more detailed review of ESG in FEV. At the end of 2020, 38 out of 48 companies were rated A or B on the internal system, and they accounted for over 80% of the portfolio, compared with the index, where just over 70% were at this standard.

# 10) Europe: near-term outlook

As a major trading partner, Europe likely to benefit from US stimulus-driven growth

The chart below shows the trade in goods between the US and Europe. It is noticeable that exports fell sharply, with slower US growth in 2019 (down $31bn). Looking forward, as the US economy responds to the latest stimulus package, European exports may be expected to rise to their more recent levels.

China is large trading partner (around half size of US) and, again, Europe should benefit from its above-average growth

Exports of goods to China nearly doubled 2020 on 2010, to €203bn[1], rising even in 2020. Imports were higher – so there is a large goods-trade deficit – but, as China shows superior real GDP growth in 2021 (IMF July World Economic Outlook forecasts 8.1% vs. Euro area 4.6%), further export growth may be expected. Concluding an EU-China bilateral investment treaty would be an important step, but there are two main obstacles on the EU side: i) the necessary reciprocity for EU companies operating in China; and ii) ensuring that Chinese companies operating in the EU comply and do not breach state aid rules (this is especially the case for state-owned enterprises (SOEs), but could also apply to private companies.

Japan trade should increase with the effect of EPA, which EU estimates could increase exports by 13%

The EU's trading of goods with Japan is broadly balanced, with 2020 imports and exports ca.€55bn.[2] The EU-Japan Economic Partnership Agreement (EPA), in force since 1 February 2019, removed tariffs and other trade barriers. The EU estimates that, when the agreement is fully in place, it could increase annual exports of goods and services to Japan by 13.2%, or €13.5bn[3], and these benefits are more likely to flow as global trade returns in time to normal levels, post the pandemic.

Exposure to global trade wars/tension complex, but we do not believe should be a material issue

Europe's exposure to trade wars, between say China and the US, is complex. Issues include i) European multinationals who have manufacturing sites in China, which export to the US, could be affected, ii) with global supply chains, where any of the links are weakened, this can create pressure through the whole manufacturing chain, iii) freight rates could fall if there is less global trade – thus reducing costs of exporting to the US, and iv) this could fuel pressure to diversify supply chains, potentially bringing back some manufacturing into the EU. However, overall, we believe the issue is unlikely to be material.

Total of €1.8tr (2018 prices) will help rebuild post-COVID-19 Europe. Importantly, stimulus still to come, given positive delta of forecasts, compared with immediate past.

The EU will adopt a large stimulus package, consisting of i) the EU's long-term budget for 2021 to 2027 of €1.211tr (€1.074tr in 2018 prices), and ii) topped up by €806.9bn (€750bn in 2018 prices) through NextGenerationEU (NGEU), a temporary instrument to power the recovery. The latter consists of the Recovery and Resilience facility (€338bn in grants, €386bn in loans) and a €83bn contribution to other programmes[4]. The expected timing of the spending of the NGEU is important (2021 €356bn, 2022 €338bn, 2023 €113bn), as it is a stimulus that has yet to be effective, unlike say the US, where the incremental change in stimulus 2021 on 2020 is much less. It also has a relatively long tail – so, in 2021, the EU will not be looking at a materially lower stimulus package for 2022.

[1] https://webgate.ec.europa.eu/isdb_results/factsheets/country/details_china_en.pdf
[2] https://webgate.ec.europa.eu/isdb_results/factsheets/country/details_japan_en.pdf
[3] https://trade.ec.europa.eu/doclib/docs/2017/july/tradoc_155725.pdf
[4] https://op.europa.eu/en/publication-detail/-/publication/d3e77637-a963-11eb-9585-01aa75ed71a1/language-en

ECB support to March 2022 at earliest

In addition, the European Central Bank employed a €1.85tr pandemic emergency purchase programme[5] (PEPP), buying vast amounts of private and public sector securities to funnel money into the economy and ease the burden of the lockdown restrictions. The eligibility of non-financial commercial paper under the corporate sector purchase programme (CSPP) was expanded to include securities with a remaining maturity of at least 28 days. The Governing Council will terminate net asset purchases under the PEPP once it judges that the COVID-19 crisis phase is over but, in any case, not before the end of March 2022.

# 11) Europe: affluent population

Europe ranks highly for affluent and wealthy population, with high discretionary spending power

World Bank data[6] for 2019 indicate that, in the EU area, the average per capita GDP was $34,913, more than three times the world average of $11,433, with a figure for East Asia and Pacific of $11,503, 18x the South Asia average of $1,957. North America is higher ($63,343), but Europe is a rich region with high discretionary spending power. Focus Economics' 2025 forecasts of the wealthiest countries in the world (defined as GDP per capita) have the top five slots all occupied by European countries[7], while the Allianz 2020 Wealth Report estimated that Western European private households held ca.€40tr of assets, second only to the US.[8]

[5] https://www.ecb.europa.eu/mopo/implement/pepp/html/index.en.html
[6] https://data.worldbank.org/indicator/NY.GDP.PCAP.CD?name_desc=false
[7] https://www.focus-economics.com/blog/richest-countries-in-the-world
[8] https://www.allianz.com/en/economic_research/publications/specials_fmo/23092020_AllianzWealthReport2020.html

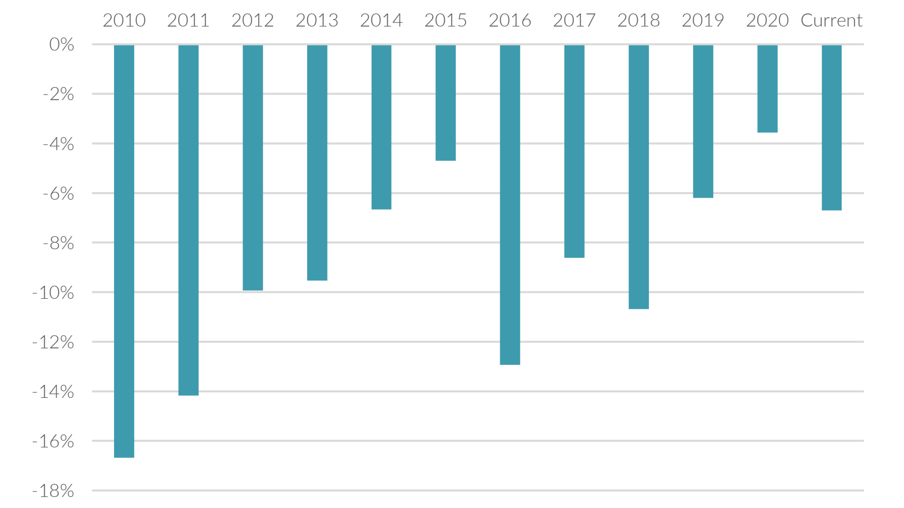
# Investment-neutral issues

## 1) FEV: discount control mechanisms

Discount can be helped by buybacks, but this can create liquidity issues, worsen expense ratios and send mixed messages re growth prospects. FEV does buybacks selectively to keep discount within single digits.

The board's formal discount control policy is that it will seek to maintain the discount in single digits in normal market conditions and, under certain circumstances, will repurchase shares. On average, 2016-20 buybacks have been just £2m p.a., as the discount has been well under the policy level. For a week in early August 2021, FEV started buying back shares again. Should the shares trade at a premium, we expect new shares to be issued, initially from those held in Treasury (5m). The fact that there is a policy in place to limit the discount is likely to be well received by investors, although, in practice, we believe its effects in the near term are unlikely to be material.

Year-end share price discount to NAV (%)




*Source: FEV Report and Accounts, Hardman & Co Research*

Continuation vote every two years

A continuation vote takes place every two years, with the last one passed at the AGM in 2021. We believe there is an element of virtuous circle with this vote. If there is a material discount, which could encourage some shareholders to press for termination, there becomes a natural pull to par. Given the liquidity of the assets, a level close to NAV would be realised even in a termination event. This pull to par then reduces the incentive to vote against termination.

## 2) FEV: gearing

Policy cap 30% NAV but, over past 10 years, has averaged ca.6%

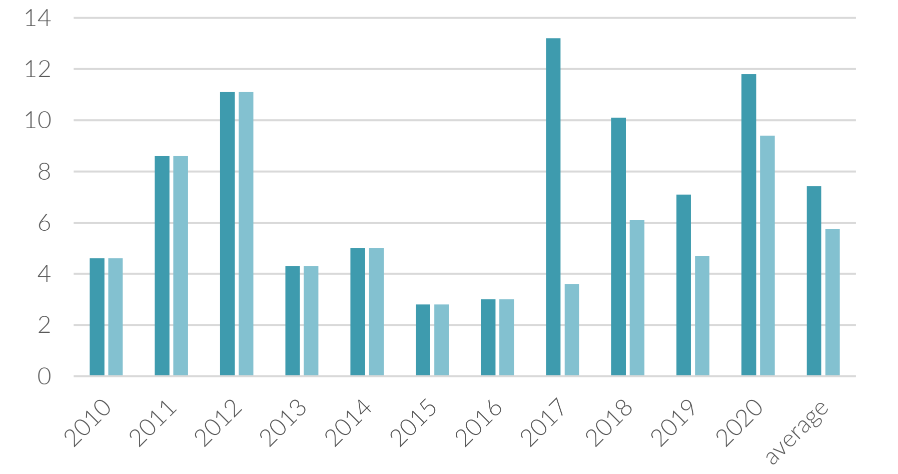
FEV stays fully invested, and then uses modest gearing through derivatives. It has not had debt in the past 10 years. The portfolio manager has the discretion to be up to 30% geared but, as the chart below shows, since 2010, the average has been around a fifth of the cap. There was a low point for gearing in 2015/16, rising to a high in 2020, reflecting market opportunities.

Increases returns but also volatility. Over long term, should help enhance returns.

By introducing gearing, FEV:

- Increases the long-term return. FEV's attribution analysis shows that, from 2010 to 2020, on average, gearing added 0.6% p.a.to the NAV.
- Introduces further volatility – over 2010-20, the impact of gearing on the annual NAV ranged from -1.2% to +2.2%.

Gross and net gearing as percentage of shareholder funds since 2010 (%)




*Source: FEV Report and Accounts, Hardman & Co Research*

Going forward, gearing levels likely to be over 10%, compared with historical averages ca.6%

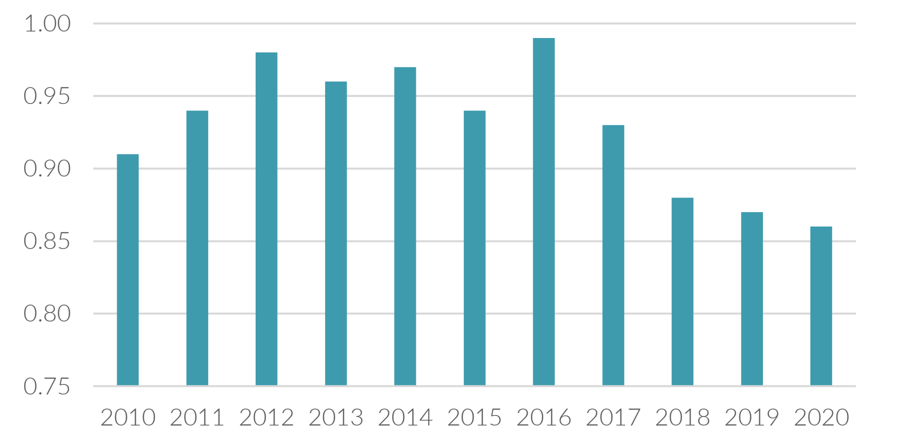
We note the comments in the 2020 report and accounts, "*With the benefit of hindsight, the Company was too timid in this respect in the last decade with gearing averaging around six percent. At the time, it always felt uncomfortable to be more levered, as continental Europe lurched from one crisis to another. It is, of course, often like that so we have decided, in future, to stick to a structurally higher level of gearing, while staying within the parameters set by the Board. We would expect the Company to be around twice as geared, on average, as it has been in the last ten years*". The increase in gearing was also discussed at the 2021 AGM, where the manager emphasised that this was a cautious increase to take market opportunities, rather than a strategic change of direction.

# 3) FEV: fees falling but in line with peers

Ongoing charges fallen sequentially every year since 2016. Further reduction expected, with 10bp cut in tiered rate on NAV over £400m, effective from April 2021 (saves investors ca.£0.8m p.a.).

The overall trend in ongoing charges is shown below, falling sequentially every year since 2016. The largest element is the investment management fee, and we note, from the 2020 report and accounts, that Fidelity was charging investment management fees at an annual rate of 0.85% of net assets up to £400m, and 0.75% of net assets in excess of £400m. The latter was reduced to 0.65% from April 2021, saving investors ca.£0.8m a year. Fees are payable monthly in arrears, and are calculated on a daily basis.

FEV's ongoing charges (%)

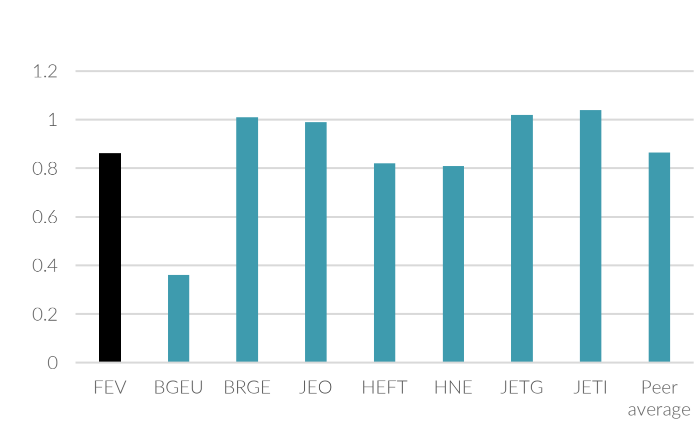



*Source: FEV Report and Accounts, Hardman & Co Research*

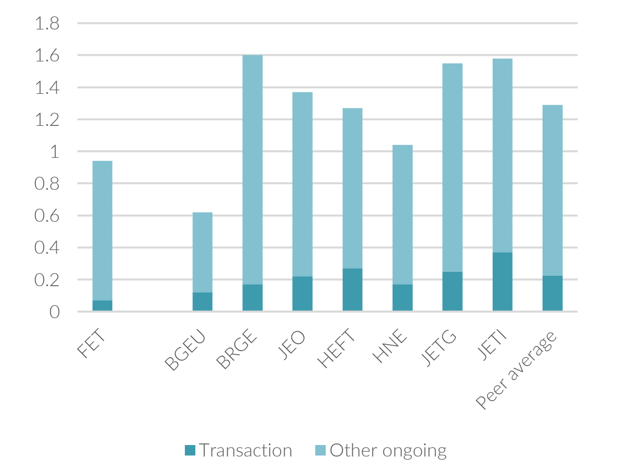
**FEV in line with peer averages on AIC basis, but 20bps below using KID disclosure (o/w 15bps due to lower transaction costs)**

Relative to other companies in the sector, FEV's ongoing charges are in line with the average on the AIC basis and 20bps below-average on the KID basis. Unsurprisingly, given the long-term nature of the portfolio, the KID disclosure shows that transaction costs are one third of the peer average.

**Costs on AIC basis (%)**




**Ongoing costs on KID basis (%)**




*Source: Company websites and KIDS, Hardman & Co Research*

We note that the management fee is split 25% to the revenue account and 75% to the capital, in line with the board's expectations of the returns earned across the business.

# 4) Other investment-neutral issues

**Currency exposure is complex. Can introduce some short-term volatility, as exposure not hedged. Over long term, effects are modest, and hedging incurs real costs.**

The Euro/Sterling exchange rate was quite volatile over 2010 to 2016, but has been much more stable since. FEV's currency exposure is complex, with its investee companies having a range of currency revenue streams, but reporting in Euros, and FEV is a sterling-listed and reporting business. Looking at the profit and loss account, the impact of forex has been small, but this rather misses the point, as most of the effect is taken in the valuation of the assets, and so is not in this line. FEV gives an attribution analysis for the progression of the NAV, from which we note that, in four of the past 10 years, currency movements have driven a +/- move in excess of 5% of NAV. In 2016, post-Brexit, the NAV total return was 17.6%, but there was an exchange rate gain of 16.3%. Over time, the effect has been relatively modest, and we believe investors know they are buying a Euro asset. Accordingly, FEV does not hedge this risk, and thus saves the real costs associated with hedging.

**KIDs need to be treated with caution but, against closest peers, FEV's KID appears very much in line with peers**

We, like many others, have concerns about some of the methodologies in calculating KID information (for example, likely performance under different scenarios is based off share price performance, which makes it very sensitive to the date of the KID). With that large caveat, our May 2019 report, *Understanding the deepest discounts,* did find correlations between extreme discounts and the KID stress scenarios. Against the closest peers, FEV is very much in line with peers.

**FEV: dividend generates modest 2.0% yield, against AIC sector average 1.3%, and with progressive policy**

The dividend policy is "*it seeks to pay a progressive dividend in normal circumstances and to pay dividends twice yearly in order to smooth dividend payments for the reporting year… and also has the authority to pay from capital reserves if required. Accordingly, the Board's intention in the medium term is to pay nominal increases in total annual dividends, utilising reserves if necessary. Once things return to normal, however, should dividend practices be judged to have changed on a permanent rather than temporary basis, then the Board will reconsider its dividend paying policy at that time*". In 2020, the dividend was 6.5p, of which 5.12p was earned in the reporting year and 1.38p was paid from previously accumulated revenue reserves. At the 2021 AGM, FEV expressed confidence that most companies appeared to be back on track in terms of dividend payments and that there could even be some positive surprises. The dividend yield for FEV and peers is updated daily ion the AIC website. At the time of writing, FEV's yield is above the average.

**Local tax rates may increase in Italy, France and Norway, but relative to 2020 fall in dividends received, and with 2021 expected to bounce back, tax implications relatively small (we estimate ca.30bps of performance)**

Brexit has not affected any tax treaties between the UK and EU member states. These treaties remain in force and, where applicable, provide tax benefits to FEV. The company has, however, lost access to tax benefits under two EU member states' domestic laws: i) Italy (6% of gross exposure end-2020), where the tax rate on dividends has moved from 1.2% to 15% – permanently; and ii) France (29% of gross exposure end-2020), where the rate has moved from 0% to 15% – believed to be on a temporary. The situation in France is complex, as it is dependent upon equivalence and court rulings and, at the time of writing, it is not clear if or when FEV may be able to benefit again from a 0% rate. In addition, the company has lost access to tax benefits under Norway's (4.9% of gross exposure end-2020) domestic laws, where the tax rate on dividends has moved from 0% to 15%. Relative to the changes in dividend seen in 2020, and the expected bounceback in 2021, the tax implications are small.

**Mix of European indices major factor in them having lower ratings than US markets. FEV is about stock selection and, while not immune from market trends, overall level of market valuation a relatively small factor in its performance.**

When considering European indices' valuations, it is important to recognise the mix of businesses. Banks are an important component of the European market, and their ratings are relatively low. Technology stocks represent around a quarter of the proportion of the large-cap index of the US, and half that of the UK. As with FEV, there is a significant element of non-European revenue within European-based companies. Comparing individual stocks with US comparators does suggest that, on average, European listed businesses are on lower ratings. However, we emphasise that FEV is about stock selection, and the overall level of the market valuation is a relatively small factor in its performance. At the 2021 AGM, the manager expressed confidence that, while the market dividend yield was at the lower end of historical averages, he expected strong dividend growth and low bond yields to continue to be a market prop for the foreseeable future.

# Investment risks

## 1) FEV: market appetite for FEV's investment style

Short periods of underperformance seen when market appetite been for deep value rally

We identify below the characteristics of the FEV portfolio that may be most at risk of falling out of favour. In the main, the investment process has overcome any such headwinds, with, as noted above, limited periods of short-term underperformance, often followed by a sharp recovery. We believe that the time when FEV would be most exposed to such a risk would be in the event of a sharp rally in depressed cyclical stocks, with deep value being preferred over other investments.

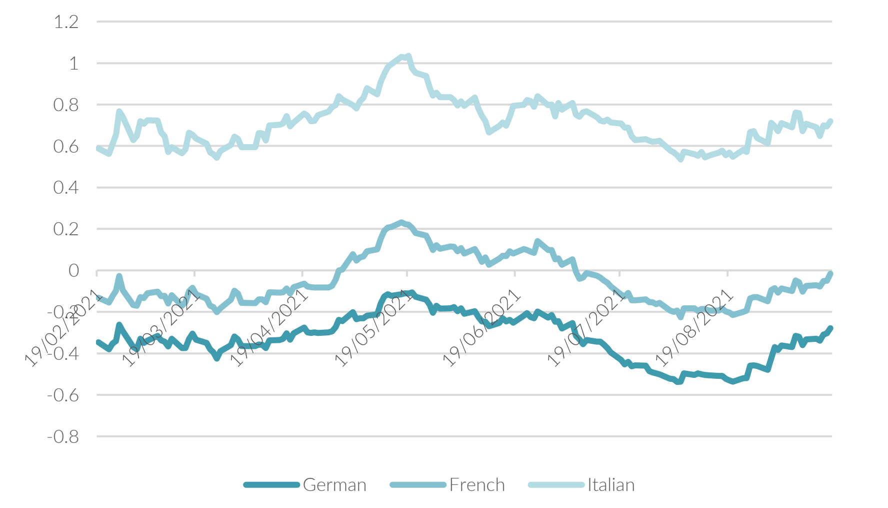
### Growth vs. value/inflation

Dividend GARP faces headwind if market is buying value. Inflation can be driver to this trend, as present value of future dividends reduced by higher long-term interest rates.

FEV is very stock-specific in its investments, but the best description for its style is dividend GARP. While not a growth-at-any-price investor, it is likely to be sensitive to the market appetite for growth overall. When there is a sharp reversal from growth and into value, this is likely to create a headwind for FEV. One factor driving this trend can be inflationary expectations. As we have seen across the world, rising inflationary expectations can see rising long-term interest rates. These, in turn, reduce the present value of the future earnings from growth companies to a much greater extent than is the case for value ones. Consequently, growth stocks can underperform against value ones.

In common with much of the world, the market's sensitivity to stimulus packages is finely balanced, with the most recent bias being to focus on the potential inflationary impacts from them. Accordingly, long-term interest rates have started to rise, with the German, French, and Italian 10-year rates all shown in the chart below.

**German, French and Italian government benchmark 10-year redemption yield (%)**



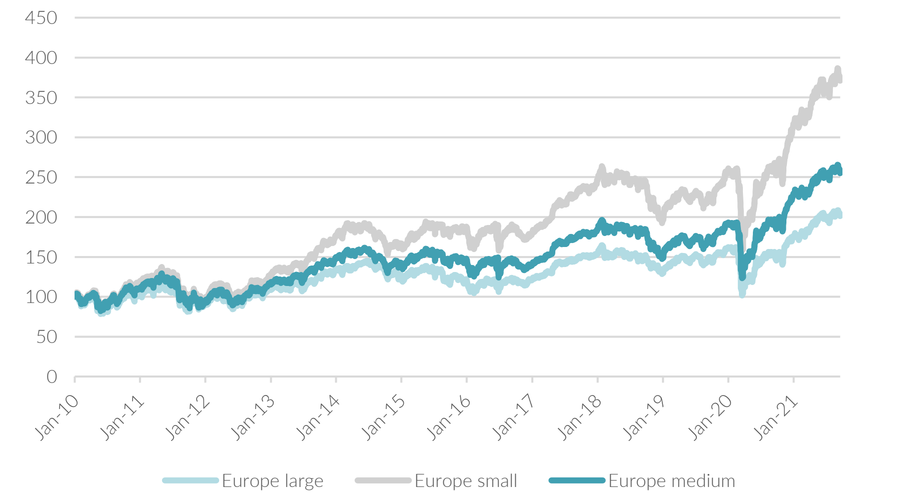

*Source: Refinitiv, Hardman & Co Research*

FEV invested primarily in large-cap companies, so faces headwind if small-cap names preferred by investors

## Large-cap vs. mid-/small-cap

The chart below shows the total return for European large-cap against small- and mid-cap, indexed to January 2010. The experience here is very different from, say, the US, where a small number of tech mega names have dominated market performance (indeed, technology has just a 9% weighting in FEV's benchmark index). By being predominantly in large-cap names, FEV has thus faced a headwind against the European market, which it has consistently beaten through its stock selection. We note that, on the current split, FEV is more significantly underweight mid-caps, rather than small-caps, when compared with the index.

Total return European large-cap vs. mid- and small-cap, indexed to Jan 2010




*Source: Refinitiv, Hardman & Co Research*

FEV invests in companies with sustainable and growing dividends, and these more likely to be defensive

Larger companies are, on average, more established and more diversified (by both product and geography), and may have stronger balance sheets and more established processes to manage downside risk; they are thus more likely to fit FEV's investment thesis. These characteristics mean that they can be more defensive. From end-February 2020 to the lows three weeks later, the European large-cap index fell by 20%, compared with a 26% fall in the small-cap index.

FEV invests in substantial, sustainable businesses, so faces headwind if market favours lower-quality businesses

## Low-quality vs. high-quality assets

We noted above that FEV invests in companies with above-average revenue and dividend growth and higher returns, and that it is willing to pay above market P/E/and P/BV multiples to buy such quality names. This means that, when the market is buying lower-quality assets (typically on an expected turn in the economic cycle or for anticipated M&A), there is a headwind that FEV's stock selection has normally, but not always, overcome. FEV's NAV has modestly underperformed its benchmark in the year to date and underperformed the UK markets by slightly more, as the market has bought into cyclical recovery stocks.

FEV's NAV has underperformed its benchmark in only two of the past 10 years. In 2016, it saw 2% NAV underperformance. Share price underperformed more, driven by sentiment issues.

## 1H'16 as a case study

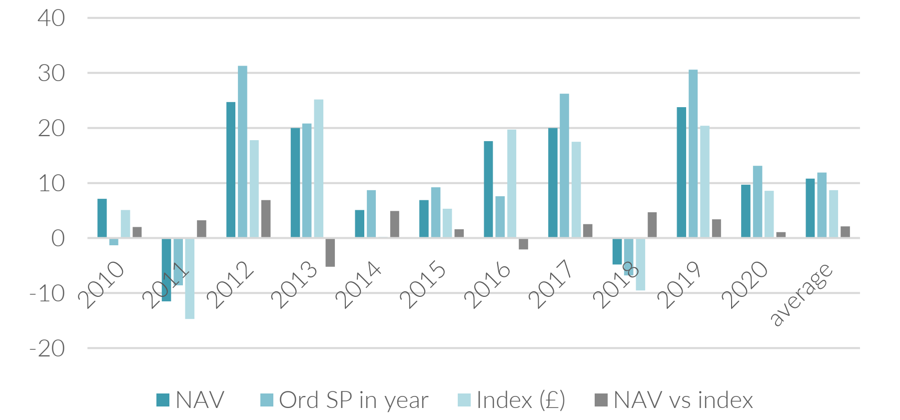
In 2016, FEV's full-year NAV underperformance was just 2%, but the discount widened sharply (from 5% to 13%), as the share price lagged the index. Interestingly, the underperformance was weighted to 1H, when the share price underperformed the index by 9%. The year began in a very negative mood, with industrials, commodity-related sectors, autos and banks all falling heavily on concerns about Chinese, and therefore global, economic growth, while defensive sectors outperformed. This all reversed from mid-February, in a V-shaped fashion, led by the oil price and many sectors (except the banks) that had, hitherto, led down the market, as evidence appeared suggesting that Chinese officials would introduce some modest measures to re-stimulate the economy. The volatility continued into 2Q, especially with the Brexit vote, which sharply impacted the financial holdings in the trust (at end-2015, banks were 11.5% of shareholders' funds, with other financials at 12.4%).

## 2) FEV: volatility of returns

**Over FY'10-FY'20, NAV average annual return was 10.8%, but ranged from -11.5% to +24.7% (and share price averaged 11.9%, with range of -8.6% to +31.3%).**

The chart below shows the volatility of returns in the NAV, share price and index for FY'10-FY'20. While, over this period, the NAV average annual return was 10.8%, it ranged from -11.5% to +24.7% (and the share price averaged 11.9%, with a range of -8.6% to +31.3%). 2016 included a 16.3% uplift from forex effects (the year's performance was 1.3% otherwise), but that year's performance was not one of the outliers. In eight of the past eleven years, FEV has shown more volatility than the benchmark index.

FEV's NAV, share price and benchmark total returns (%)




*Source: FEV Report and Accounts, Hardman & Co Research*

## 3) European sentiment

**Europe lurching from crisis to crisis may create adverse sentiment to European-based stocks – even global ones**

Europe has seemingly lurched from one crisis to another. Some of these crises have been internal (Greece debt, Brexit, arguments over the recovery budget pitting the frugal four against the rest), as well as outside Europe's control (such as the GFC or the pandemic), and some have been a combination of both (e.g. immigration). The consistent theme has been well-publicised division and disharmony. Despite this noise, European markets have outperformed UK markets over the medium term.

**Both France and Germany facing major elections within next year**

Europe faces a continuous cycle of elections in key economies[9]. Of note, in the near future, i) Germany's (11% of NAV) general election is due on 26 September – the CDU/CSU share of the vote is down from 36% at the start of 2021 to 28% now, having briefly fallen below the Greens in May, and the anti-EU AFD has consistently been polling at ca.11%[10], and ii) France's (30% of NAV) presidential elections will be held in 2022 – Marie le Pen is vying for leadership with Macron, each with ca.25% of the vote (Eurosceptics took 28 of the 74 seats in the 2019 European elections).

[9] https://www.coe.int/en/web/electoral-assistance/2021-electoral-calendar - Council of Europe ones
[10] https://www.politico.eu/europe-poll-of-polls/germany/

**Unclear how trade nationalism may develop**

It is unclear to what extent trade nationalism may be aggravated by the pandemic. The suggestion that vaccine export bans should be introduced could be seen as establishing a precedent for supra-national interest over trade, and how the ongoing Brexit-related discussions are perceived remains to be seen.

**Europe's poor record on GDP growth may not help sentiment**

Europe has delivered slower growth than the US or the world over the medium to long term. Stock markets are not always correlated to domestic GDP, even over the long term, but faster growth can create a following wind and slower growth a headwind. As noted, FEV invests in companies that are in Europe, but these companies' operations are global – so its NAV may be less affected by domestic growth but, again, sentiment may see a wider-than-justified discount in the share price.

**19% of Europe's population over 65 years-old, against global average of 9%. Likely to see shrinking total and working age populations, with multiple adverse effects.**

We believe one potential drag on Europe's growth prospects, and so the valuation of European companies, is the ageing population. 19% of Europe's population is over 65, against the global average of 9%. Just 26% of Europe's population is under 25, against the global average of 41%. This is due partially to long life expectancy (78 years against global 72), combined with low fertility rates (around half the global average). This has been only partially offset by net migration (average 1.4m p.a. 2010-20). Overall, the population is expected to fall by 6m 2030 on 2019 (747m) and by a further 31m by 2050.[11] This has multiple effects, including i) a declining population, and so less domestic demand, ii) increased social security, health and care costs, iii) a reduction in the active tax-paying workforce, iv) falling savings rates, as people move to spend their resources, rather than save for the future, and v) increasing inefficiency, as businesses reduce investment to match their falling demand outlook. It is unclear what the political repercussions will be of policies to address the shrinking population, such as increased migration.

**Pre-pandemic, southern European central government debt was high. Across whole region, has materially increased with pandemic measures.**

Going into the crisis, southern Europe, in particular, was carrying high levels of debt. The limited 2020 data show an average 19% increase on 2019, with both higher debt and lower GDP. As we detail in the portfolio section below, Italy and Spain are ca.10% of FEV's NAV, and Greece does not register as a major exposure, while Switzerland (29.7% of NAV) and Germany (17.4%) are relatively lowly geared.

**Europe's slow vaccination rate could see incremental pressures from COVID-19**

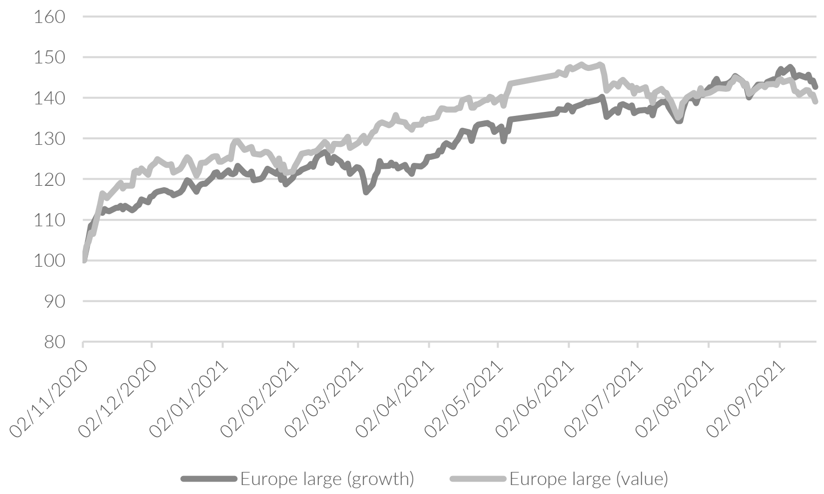
At the time of writing, Europe had vaccinated ca.59% of its population (49% fully vaccinated), well behind the UK's 70% and 57%, respectively[12]. This has led to well-documented political strains, as well as the human and economic costs. While FEV is positioned in global businesses, slower-than-average vaccinations and new variants could have an adverse effect on sentiment to European (and so FEV) shares.

**Strong stock markets may see some concerns about short-term bubble, but FEV's stock selection gives it a very different profile**

Since before the start of November, European markets have shown an exceptionally strong performance, driven, in part, by expectations that the vaccine rollout would gather pace, better visibility on the EU stimulus support packages, lower-than-expected defaults seeing below-forecast bank bad debts, and rising global growth expectations feeding through to international businesses. As can be seen in the chart below, the whole market index is up ca.40%, with large-cap names leading the charge. Since the depths of the pandemic, large-cap names have roughly doubled in market capitalisation. The large-cap growth index is well ahead of pre-pandemic levels, and large-cap value is slightly ahead. There is a risk that some may perceive such a strong short-term performance as a bubble, especially if rising inflation expectations see increases in interest rates, and so a lower value ascribed to future growth. This could see at least a temporary setback. While FEV cannot be totally immune to market movements, its stock selection is about companies delivering sustainable growth in dividends, and its performance may be expected to reflect this.

[11] UN World Population Prospects 2019
[12] https://ig.ft.com/coronavirus-vaccine-tracker/?areas=gbr&areas=isr&areas=usa&areas=eue&cumulative=1&populationAdjusted=1

Total return from European large-cap growth and value indices, indexed to start of Nov 2020




*Source: Refinitiv, Hardman & Co Research*

**European companies have below-average cash holdings, but not the case for FEV's target companies**

European companies have been gearing their balance sheets to a greater extent than the UK, the S&P 500 and Japanese companies (see Coupland Cardiff 25 February 2021 article). While this may be a feature of the market, geared companies are not the type of investments made by FEV. We therefore characterise this risk as one of sentiment to market, rather than having any substantive support.

**Europe scores poorly in terms of restrictive labour laws**

The chart below uses the OECD's Employment Protection Legislation Database[13] to give an indication of how easy it is to dismiss workers. As can be seen, compared with the US/UK, most European countries are much more restrictive in terms of employment law. We characterise the issue as a sentiment one, because FEV's companies have not only global revenue streams, but also global production – so European restrictive labour laws do not impact on the whole labour force.

Procedural requirements for individual dismissals of regular workers (2019)


*Source: OECD, Hardman & Co Research*

[13] https://www.oecd.org/employment/emp/oecdindicatorsofemploymentprotection.htm

# Portfolio

**Historical sectoral split**

The table below shows the evolution of the portfolio by sector over the past five years. There have been relatively few changes (unsurprising, given the long-term focus we noted above), but technology has increased, from 7.7% to 14.1% 2016-1H'21, as has healthcare, from 16.6% to 17.5% (albeit down a little on the end-2020 level of 19.7%), both of which are sectors in which FEV is overweight relative to the index.

**Gross asset exposure as % net assets by sector, 2016-20**

| | 2016 | 2017 | 2018 | 2019 | 2020 | July factsheet | Benchmark |
|---|---|---|---|---|---|---|---|
| Consumer goods | 18.8 | 18.7 | 17.1 | 18.8 | 20.7 | * | * |
| Financial services | 6.5 | 5.6 | 5.3 | 8.9 | 9.9 | ) 20.2 | ) 15.5 |
| Other financials (incl. banks/insurance) | 14.2 | 15.6 | 13.5 | 11.5 | 10.1 | ) combined | ) combined |
| Healthcare | 16.6 | 18.8 | 20.3 | 19.5 | 19.7 | 17.5 | 15.6 |
| Industrials | 15.9 | 19.1 | 19.1 | 15.7 | 17.0 | 16.9 | 17.9 |
| Technology | 7.7 | 11.2 | 10.1 | 11.3 | 14.0 | 14.1 | 9.1 |
| Basic industries | 3.9 | 7.2 | 6.0 | 6.2 | 5.5 | 6,3 | 5.3 |
| Consumer services | 8.1 | 6.6 | 4.8 | 3.5 | 4.6 | * | * |
| Utilities | 3.5 | 2.0 | 2.9 | 1.0 | 4.5 | 3.4 | 4.2 |
| Oil & Gas | 6.6 | 7.0 | 8.0 | 7.0 | 3.2 | n/d | n/d |
| Telecoms | 1.2 | 1.4 | 3.0 | 3.7 | 2.6 | 2.3 | 3.6 |
| **Total** | **103.0** | **113.2** | **110.1** | **107.1** | **111.8** | **111.1** | **100** |

**Factsheet disclosure shows consumer discretionary at 13.9% (index 14.1%) and consumer staples at 9.7% (index 9.2%)*

*Source: FEV Report and Accounts, Hardman & Co Research*

**Historical geographic split**

The table below shows the evolution of the portfolio by country over the past five years. There have been relatively few changes (unsurprising, given the long-term focus we noted above).

**Gross asset exposure as % net assets by country, 2016-20**

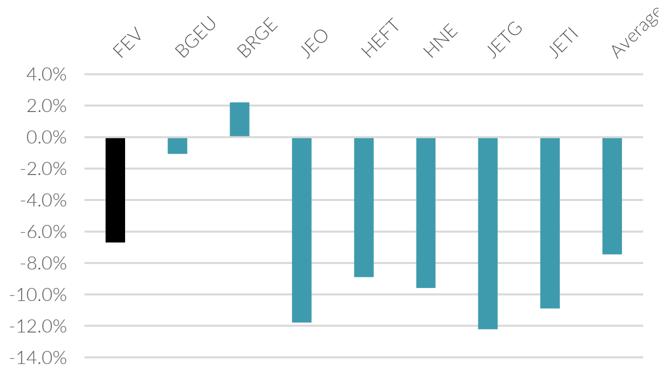
| | 2016 | 2017 | 2018 | 2019 | 2020 | July factsheet | Benchmark |
|---|---|---|---|---|---|---|---|
| France | 29.7 | 31.6 | 30.1 | 29.0 | 29.7 | 29.2 | 21.7 |
| Switzerland | 18.1 | 17.3 | 18.0 | 18.9 | 25.0 | 24.9 | 19.4 |
| Germany | 13.5 | 19.2 | 13.7 | 19.6 | 17.4 | 11.4 | 18.5 |
| Netherlands | 6.4 | 8.8 | 8.6 | 6.1 | 7.6 | 7.9 | 8.9 |
| Italy | 3.7 | 5.1 | 4.9 | 4.7 | 5.9 | 5.5 | 5.0 |
| Norway | 6.1 | 4.3 | 5.2 | 5.4 | 4.9 | 4.1 | 1.4 |
| Sweden | 4.3 | n/d | n/d | 3.7 | 3.9 | 4.4 | 7.7 |
| Denmark | n/d | 4.9 | 4.2 | n/d | 4.2 | 4.3 | 5.1 |
| Spain | 4.4 | 5.5 | 6.5 | 4.8 | 4.2 | 3.4 | 4.8 |
| UK | n/d | n/d | 3.4 | 4.7 | 3.7 | 3.4 | 0 |
| Finland | 5.2 | 5.2 | 5.7 | 3.4 | n/d | n/d | n/d |
| Others / unclassified | 11.6 | 11.3 | 9.8 | 6.8 | 5.3 | 12.5 | 7.7 |
| **Total** | **103.0** | **113.2** | **110.1** | **107.1** | **111.8** | **111.1** | **100** |

*Source: FEV Report and Accounts, Hardman & Co Research*

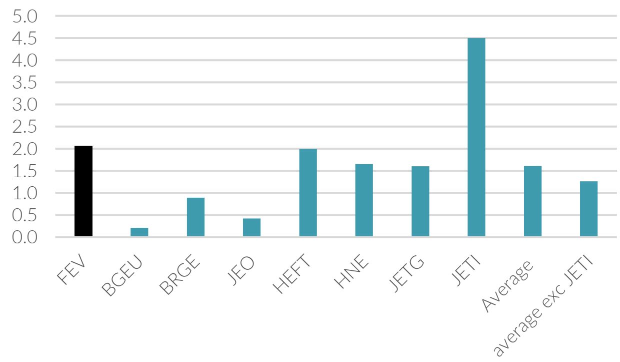
# Valuation

As can be seen in the chart below, FEV's discount to NAV is broadly in line with that of its peers the in AIC Europe sub-sector. Its dividend yield is above-average in the AIC Europe sub-sector (especially excluding the JPMorgan European Income Fund).

FEV and peers' discount to NAV (%)




FEV and peers' dividend yield (%)

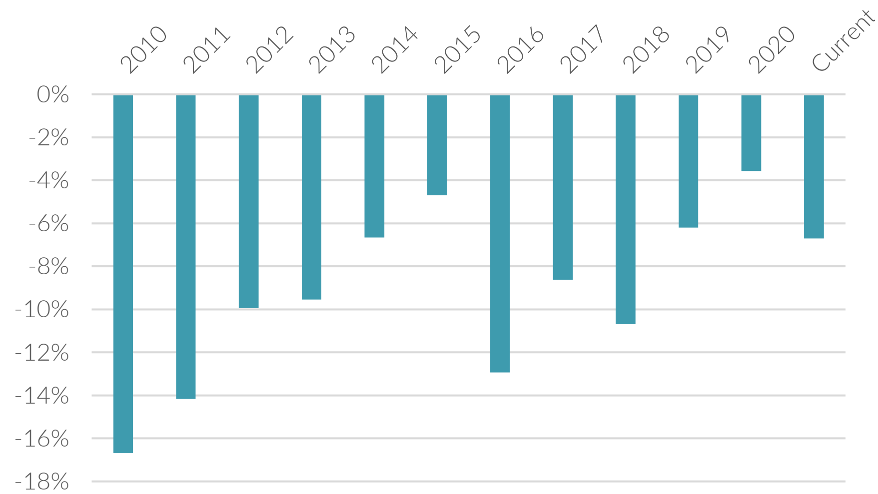



*Source: NAV announcements LSE, dated 20 September 2021, Hardman & Co Research*

**Current discount to NAV narrower than seen in past, reflecting confidence in European outlook**

As can be seen, FEV's discount to NAV has been trending at low- to mid-single-digit levels, and is currently slightly above this level.

FEV's historical discount to NAV (at end-Dec) and latest




*Source: FEV Report and Accounts, NAV announcements LSE, dated 20 September 2021, Hardman & Co Research*

# Financials

| Income statement (£000) | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | 2020 | | | 2021E | | | 2022E | |
| Year-end Dec | Revenue | Capital | Total | Revenue | Capital | Total | Revenue | Capital | Total |
| Gains/losses on derivatives | | 89,664 | 89,664 | | 228,126 | 228,126 | | 128,533 | 128,533 |
| Gains/losses on investments | | 2,768 | 2,768 | | 2,770 | 2,770 | | 2,770 | 2,770 |
| Income | 25,552 | | 25,552 | 39,165 | | 39,165 | 46,585 | | 46,585 |
| Investment management fees | -2,225 | -6,674 | -8,899 | -2,101 | -6,303 | -8,405 | -2,499 | -7,498 | -9,997 |
| Other expenses | -845 | | -845 | -854 | | -854 | -854 | | -854 |
| Foreign exchange gains/losses | | -175 | -175 | | 0 | 0 | | 0 | 0 |
| Profit/(loss) bef. finance costs & taxation | 22,482 | 85,583 | 108,065 | 36,210 | 224,592 | 260,802 | 43,232 | 123,806 | 167,038 |
| Finance costs | -89 | -265 | -354 | -300 | -900 | -1,200 | -300 | -900 | -1,200 |
| **Profit/(loss) bef. taxation** | **22,393** | **85,318** | **107,711** | **35,910** | **223,692** | **259,602** | **42,932** | **122,906** | **165,838** |
| Taxation | -1,325 | | -1,325 | -2,519 | | -2,519 | -3,012 | | -3,012 |
| Profit/(loss) after taxation for the year | 21,068 | 85,318 | 106,386 | 33,391 | 223,692 | 257,083 | 39,920 | 122,906 | 162,826 |
| Earnings/(loss) per ordinary share (p) | 5.12 | 20.74 | 25.86 | 8.12 | 54.42 | 62.55 | 9.71 | 29.90 | 39.62 |

*Source: FEV Report and Accounts, Hardman & Co Research*

| Balance sheet | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| @ 31 Dec (£000) | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021E | 2022E |
| Investments | 746,648 | 862,747 | 1,011,114 | 938,826 | 1,108,702 | 1,200,663 | 1,428,149 | 1,560,924 |
| | | | | | | | | |
| **Current assets** | | | | | | | | |
| Derivative instruments | 61 | 0 | 3,652 | 2,391 | 16,576 | 2,119 | 5,000 | 5,000 |
| Other receivables | 2,670 | 3,557 | 5,929 | 6,405 | 5,134 | 5,814 | 5,814 | 5,814 |
| Amounts held at futures clearing houses and brokers | 3 | 1,382 | 11,127 | 4,279 | 2,029 | 5,977 | 5,977 | 5,977 |
| Fidelity Instit'l. Liquidity Funds | 8,800 | 6,283 | 3,030 | 1,847 | | | | |
| Cash and cash equivalents | 4,080 | 4,003 | 4,128 | 4,427 | 9,490 | 7,070 | 7,070 | 7,070 |
| Total current assets | 15,614 | 15,225 | 27,866 | 19,349 | 33,229 | 20,980 | 23,861 | 23,861 |
| Total assets | 762,262 | 877,972 | 1,038,980 | 958,175 | 1,141,931 | 1,221,643 | 1,452,010 | 1,584,785 |
| | | | | | | | | |
| **Current liabilities** | | | | | | | | |
| Derivative instruments | -83 | -577 | -6,575 | -2,024 | -457 | -403 | -403 | -403 |
| Other payables | -1,875 | -2,044 | -2,357 | -840 | -912 | -955 | -955 | -955 |
| Total current liabilities | -1,958 | -2,621 | -8,932 | -2,864 | -1,369 | -1,358 | -1,358 | -1,358 |
| Net current assets | 760,304 | 875,351 | 1,030,048 | 955,311 | 1,140,562 | 1,220,285 | 1,450,652 | 1,583,427 |
| | | | | | | | | |
| **Net assets** | **760,304** | **875,351** | **1,030,048** | **955,311** | **1,140,562** | **1,220,285** | **1,450,652** | **1,583,427** |
| **NAV per share (£)** | **1.83** | **2.11** | **2.48** | **2.32** | **2.77** | **2.97** | **3.53** | **3.85** |

*Source: FEV Report and Accounts, Hardman & Co Research*

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