Kepler Trust Intelligence

Fidelity European Trust

Kepler GROWTH RATING

FEV, impressive capital and dividend growth over many years...

Update
03 May 2024

Overview

Fidelity European Trust (FEV) is a £1.5bn FTSE 250 investment trust providing investors with a core European equity strategy. FEV's managers have generated superior performance on a consistent basis over many years, and under Sam Morse's tenure, beginning at the start of 2011, the NAV total return is c. 305 %, compared to the benchmark's c. 164%. This has contributed to FEV winning a Kepler Growth Rating for 2024. As well as generating strong performance, FEV scores well in our analysis of factors such as risk and downside protection, which are shown in the **Performance section**. FEV has a relatively concentrated portfolio of stocks, in the range of 40–50, and the team is primarily concerned with stock picking over making sector bets, with historical analysis showing that the bulk of returns come from individual stocks.

While FEV is not an equity income trust, the team's strategy places value on companies that pay growing and sustainable dividends, which means that FEV does produce a dividend somewhat higher than the average for its peer group and has a current yield of 2.2%. FEV has increased its dividend every year for the last 13 years, which coincides with Sam's tenure as manager.

FEV is geared c. 13%. The team does not try to time markets or dynamically adjust gearing, and the trust will typically be geared in the range of 10–15%. This is based on an analysis of what the best gearing for the strategy would be over the long term.

FEV is currently trading at a discount of c. 4%, narrower than the Morningstar Europe peer group average of c. 9%. Historically, the FEV board has acted when the discount is wider than 10% and utilised its buyback powers, most recently in 2022.

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Analyst's View

As we discuss in the **Discount section** there are a number of factors we see contributing to FEV's relatively narrow discount, but probably the most fundamental of all is the trust's excellent performance record. Add in its size, which puts it on the radar for a broader range of investors, a responsive approach to managing the discount using share buybacks and a good dividend track record and it's not hard to see why the discount has proved quite resilient against a tough backdrop for investment trusts generally. While FEV's capital performance is impressive, the dividend growth achieved under Sam's tenure, over 350% , is a timely reminder that dividend growth can often come from trusts with lower initial starting yields. FEV is not an equity income trust, but the strategy places value on company dividends and this has paid off for FEV's investors over a period where CPI inflation has added up to about 50%.

In the **Performance section** we look at how investors have not yet reversed a trend that began in 2018 of pulling money from European equities, which in our view means that notwithstanding 2023's good performance for the market generally and FEV specifically, there are probably many investors still underweight Europe. A shift in sentiment could see that change, which could be very positive for FEV's performance and its discount. In our view FEV's size, dividend growth, performance track record and core characteristics make for a compelling option for investors seeking to address their underweight position in European equities.

BULL
Strong long- and short-term performance record in capital and income terms
A change in investor sentiment towards European equities could be very constructive
Large, liquid trust makes for an ideal core holding in Europe

BEAR
Income investors should note FEV is not, in spite of strong income growth, specifically an equity income trust
Sentiment to European equities has been weak for several years and could be hard to turn around
Strategic gearing amplifies losses as well as gains

Portfolio

Fidelity European Trust's (FEV)'s portfolio is a relatively concentrated one of 40–50 stocks, with the active focus very much on stock selection. This means from a sector perspective the trust is benchmark aware, typically ranging +/-5% from the index, leaving the bulk of the risk against the benchmark to come from stock selection. Historically, this is justified by the team's attribution analysis, which shows that overall, the majority of excess returns have generally come from stock picking. Even here, there are no particular sectors from which stock-picking alpha has tended to come.

The team take a long-term approach and expect turnover to be less than 20% p.a., meaning stocks are on average held for over five years. The team always approach each investment by asking what could go wrong. In the **Performance section** we look at FEV's incremental outperformance and downside protection, both of which it scores very highly on, and which offers some empirical evidence that this risk-aware approach has worked in the past.

In our recent meeting co-manager Marcel Stötzel shared with us a regular analysis undertaken on the key sensitivities for the FEV portfolio, which over time has shown a consistent pattern of which the most positive and negative factors are, and which together give a very good sense of FEV's long-term characteristics. As at 31/12/2023 positive sensitivities, in order of the greatest magnitude are:

- Growth outperforms value (Europe/World)
- Core outperforms periphery (Europe)
- GBP/EUR strength against USD

Negative factors, again from most to least impactful are:

- UK equity outperforms world equity
- US High yield/ Government ten-year spread widens
- Inflation expectations rise (US two year)

This neatly encapsulates what an investor might expect to get from a core European equity holding, while adding some context of factors beyond Europe that can have an influence on performance, e.g. rising corporate bond risk, or how the UK is performing.

The table below shows some key financial metrics for the portfolio. As we discuss in the **Dividend section**, FEV has a long track record (13 years) of raising its dividend, but it's important to set out that while dividends are a metric that Sam and Marcel use to assess their portfolio companies, they do not target a yield equal to or higher than the index. Nevertheless, underlying dividend growth is likely to be higher than the index. As we discussed in a recent article , lower starting yields combined with higher dividend growth can be a successful strategy for the investor seeking income, with trusts such as FEV potentially working as part of an overall portfolio of income trusts. To emphasise the point, since the start of 2011, when Sam took on the management role, FEV's dividend has grown c. 350% compared to UK CPI's c. 50% growth. We use UK CPI rather than European CPI, as the point here is not to measure FEV's dividend growth in the context of European equities but to show how the dividend has grown compared to inflation in the UK, where FEV's investors are predominantly based. Therefore, FEV has delivered significant real growth in income, even if the headline yield, c. 2.2% is relatively low. The yield is relatively low because, of course, the share price and NAV have also risen significantly during that period.

The table below also highlights that FEV's portfolio is very much biased to quality, with higher return on equity (ROE) and return on invested capital (ROIC) than the index, for which the manager believes in paying a higher price, shown by the price to earnings (P/E) and price to book (P/B) ratios. The data shown is for FEV's stablemate open-ended fund run using the same strategy and so should be seen as representative rather than as a precise representation of FEV's portfolio.

Portfolio Characteristics

	PORTFOLIO	INDEX
Dividend growth (2024e)	6.1%	3.1%
Volatility (ex ante)	13.9	14.1
ROE (2024e)	18.3%	14.7%
ROIC (2024e)	16.2%	12.6%
P/E (2024e)	17.0	14.7
P/B (2024e)	3.0	2.1

Source: Fidelity International, as at 31/01/2024. Index is MSCI Europe ex UK

Marcel notes that one of the linking themes of many of the most successful US stocks in the last decade has been that a great part of their business is business-to-consumer. Naturally, this makes these types of stocks higher profile and better known than some of the European stocks, which tend to be more business-to-business. Thus, while many people reading this will likely have an Nvidia chip in their device, and quite conceivably even an Nvidia sticker on the case, no one buys a device with ASML written on it, but ASML is the global leader in semiconductor production equipment that will likely be part of any chip-manufacturing process. Marcel notes that while reshoring, an oft-discussed part of deglobalisation, is really happening, it is much more active in areas such as semiconductors, where there is political impetus driven by security and intellectual property concerns. It's notable then that in the last few weeks TSMC has announced the construction of a factory in the US, with the decision to do so helped along by some federal funding. It seems very likely that ASML, one of FEV's largest holdings at time of writing a nd one of the largest companies in Europe, will supply manufacturing equipment to this facility. Thus, ASML is able to benefit wherever manufacturing is actually located, and like many other large European companies, has international revenues that mean it isn't really correlated to the European economic outlook, except in so far as this might affect its global sales.

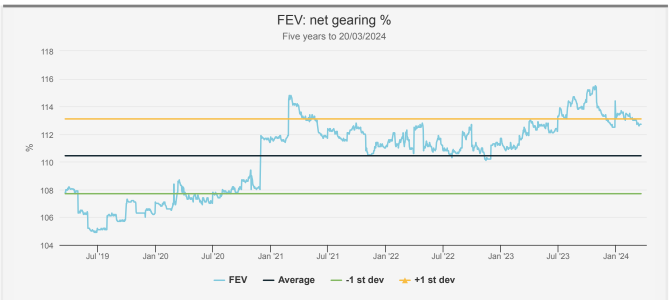
In another example of a business-to-business company that has great growth potential, Marcel points to Epiroc, which was spun out of the Swedish industrial company Atlas Copco in 2018, and which specialises in mining equipment, including deep mine equipment, in which it is a world leader. Spin-offs of existing companies can be an interesting situation for an active fund manager, as unlike an IPO, a spin-off will see the shares go to existing holders of the parent company, who may not wish to own the shares for the long term. Thus Epiroc's share price was somewhat weak in the period after its listing, but has since more than doubled. Again, while the team isn't concerned by sector themes, Epiroc is likely to be a significant beneficiary of the energy transition, as every year the demand for commodities such as copper and lithium grows, and each year it becomes a little bit harder to mine for these near the surface. Epiroc is therefore firmly tied to the energy transition, as it provides mining and safety equipment that allows mines to go deeper more efficiently than they could in the past. Although Epiroc offers a range of specialist drilling equipment, a very simple example of how it can help a mining company go deeper is to supply electric trucks, rather than diesel , to operate in the mine. This removes the need to install complex air filtration kit that would otherwise be required in a very deep mine.

In summary, FEV's concentrated portfolio is focussed on the individual company's prospects, has a bias to growth companies but generally those with real cash flows and dividends, and tends to do well when large-cap is doing well. On the other hand, it may underperform in a value market, or when smaller companies are outperforming, but has shown over many years that the portfolio is also relatively resilient when markets are tougher, which is discussed in more detail in the **Performance section**.

Gearing

FEV's net gearing is currently c. 14%. From 2020 the board's policy has been to maintain a relatively fixed level of gearing, at around the current level, supported by analysis by the manager, which shows that this is the optimal level for FEV's investment strategy, balancing risk and reward. This means that Sam and Marcel are not trying to time markets, and investors should have a general expectation that gearing over the long term will fluctuate in a small range around the current level. That said, gearing is reviewed regularly between the manager and board and there could be circumstances where it is reduced. The chart below shows how gearing rose and stabilised at around the current level once the policy was implemented.

Fig.1: Net Gearing %



Source: Morningstar

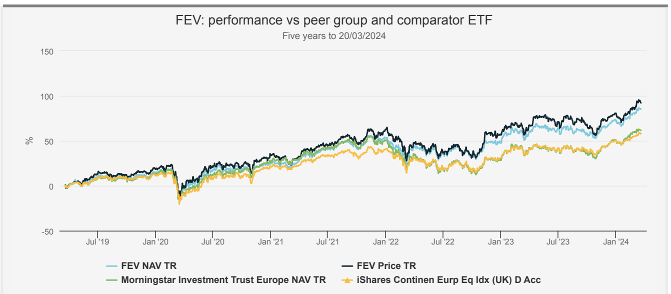
FEV uses contracts for difference (CFDs) to gear the portfolio rather than traditional debt. This is a relatively common tool used by investment trusts, generally by those investing in large-cap equities, where CFDs are low cost and easily tradeable. Fidelity has an in-house team who specialise in using CFDs, and they may offer a cost advantage to debt and potentially greater flexibility.

FEV's formal limit on gearing is 30%, or 130% long exposure. The team may also make limited use of CFDs and other derivative contracts to either short individual stocks or reduce more general market exposure, so for example the team could opt to short a market index rather than individual stocks if they wanted to reduce market exposure. Overall, short exposure is limited to 10% and in practice is likely to be much smaller than this, as at 31/12/2023 the short book stood at -0.8%.

Performance

FEV's net asset value and share price total return over the last five years are c. 82% and 94% respectively, comparing very well to the Morningstar IT Europe peer group's NAV total return of c. 59% and the benchmark's 53%. Since FEV is more than one third of the Morningstar peer group its performance will have a large impact on the weighted average, and so in reality FEV's outperformance of the peer group is larger than the weighted average implies.

Fig.2: Five-Year Performance

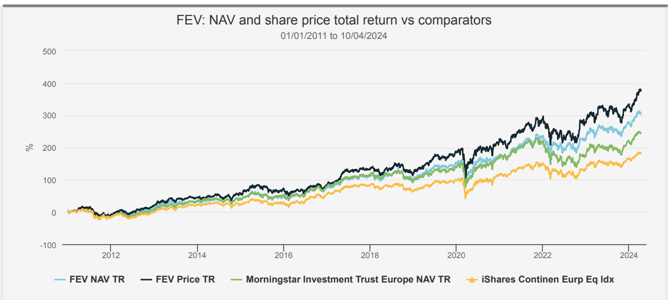


Source: Morningstar

Past performance is not a reliable indicator of future results.

Since Sam took on the management role 13 years ago, the NAV and share price total return is c. 305% and c. 375%, compared to the Morningstar peer group's NAV total return of c. 244% and the benchmark's c. 164%.

Fig.3: Performance Under Sam's Tenure

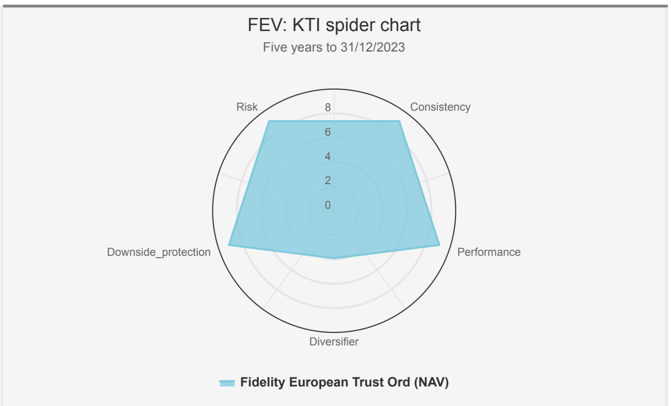


Source: Morningstar
Past performance is not a reliable indicator of future results.

In our proprietary KTI Spider Chart below we show how FEV has performed versus an expanded peer group of all AIC Europe and AIC European Smaller Companies trusts over the past five years, in some key categories. Each category is scored out of ten, based on returns over this period, and scores are normalised to the peer group. As such, this data reflects the performance characteristics investors would have experienced over the last five years.

Given that FEV is a core large-cap mandate with a sector-neutral approach, it's not very surprising that its score as a diversifier is low, but given the consistent and strong performance, it's not very surprising either that it scores well in all the other categories. As a core holding, we suspect that investors aren't in any case prioritising diversification, as the whole point is to get exposure to European equities, so we'd argue the low score is just as desirable as all of the other high scores for a trust filling this role.

Fig.4: KTI Spider Chart

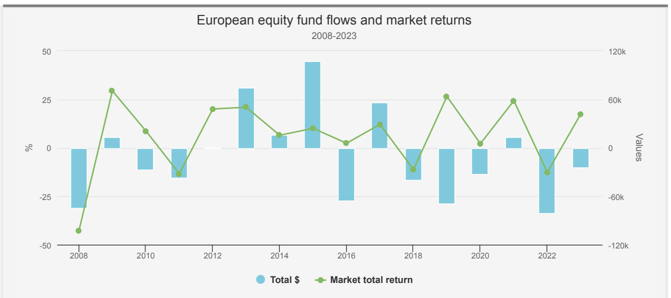


Source: Morningstar, Kepler, as at 31/12/2023
Past performance is not a reliable indicator of future results.

The next chart is our own analysis of fund flows in and out of all European equity funds on the Morningstar database and this analysis provides useful context to the **Discount section** below too.

This is a group of funds with c. £780bn so it's reasonable to see this as a proxy for overall investor sentiment to European equities. The chart shows annual net in- or outflows against the performance of European equity markets. With the caveat that, in the short term, both market direction and fund flows could be either the cause or the effect of each other, over the long term fewer buyers will be a headwind for markets and one could see the chart below as one part of the explanation for why European equities are at a discount to US equities. One needs to go back to 2017 to find a year when investors made a truly positive allocation to European equities. So, in 2023 the market rose in spite of weak investor sentiment to Europe, which in our view means that there is still the potential for a significant shift in sentiment, together with positive fund flows. This could be very constructive for FEV's performance and for its discount, although, as we discuss in the **Discount section**, FEV has a good record of maintaining a narrower-than-average discount.

Fig.5: Fund Flows And Market Returns



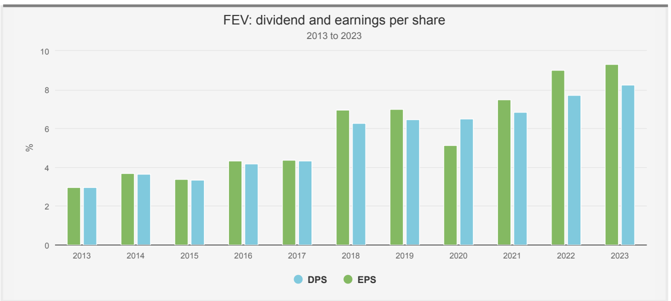
Source: Morningstar
Past performance is not a reliable indicator of future results.

Dividend

FEV currently yields c. 2.1%. The trust pays dividends twice a year, in October and May. FEV has increased its dividend for 13 consecutive years, putting it on the list of AIC's next generation of so-called **dividend heroes**, which is for trusts that have increased their dividend for between ten and 20 years. It's important to note though that while Sam and Marcel do look at company dividends as a core metric, FEV has a total return objective rather than an equity income objective.

The chart below shows both dividend and earnings since 2013, and only once, in 2020, were earnings lower that the dividend, with the board using some of FEV's revenue reserves to top up the dividend.

Fig.6: Dividend And Earnings Per Share



Source: Fidelity

Management

FEV is managed jointly by Sam Morse and Marcel Stötzel. Sam has managed FEV for over 13 years, and started at Fidelity in 2004, initially in the UK equities team before moving to European equities. Sam began his career in 1986, working as an analyst before moving to a fund management role in 1992. He also manages the c. £4.5bn open-ended Fidelity European Fund, using the same investment approach.

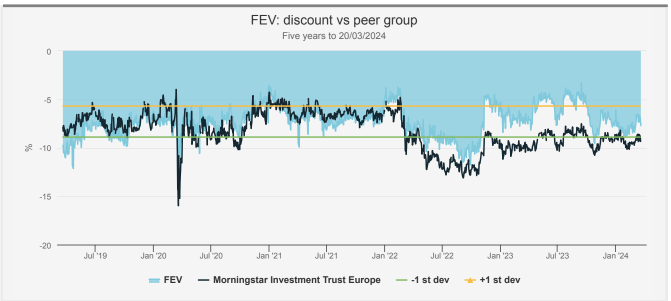
Marcel became co-manager of FEV 2020, having joined Fidelity in 2014 as a pan-European equity analyst and gaining fund management experience in 2018, when he became a sector lead for what is now Fidelity's Sustainable European Equity Fund. Marcel began his career in investment banking in 2011.

Fidelity has a team of 174 equity analysts, covering the US, Europe, pan-Asia and emerging markets, of whom 30 are European specialists. As we discuss in the **Gearing section** the team has limited capability to short stocks and indices using CFDs, and Fidelity has a specialist team in this area of six people. Fidelity also has a dedicated ESG team of 35. In total, Fidelity has 246 professionals working within its global research platform and has long-term incentive plans in place that reward analysts for successful stock picking.

Discount

FEV's current discount is c. 4%, narrower than the peer-group average of just over 9%. As the chart below shows, FEV tends to trade at a narrower discount than average, and there are a few possible reasons for this. First, the trust is a FTSE 250 constituent and the largest trust in its peer group and therefore has a higher profile. Second, FEV has a strong track record, and the combination of higher profile and track record is very likely helpful. Third, while not an equity income trust, FEV has a long track record of increasing its dividend, and while the yield is a little lower than the average equity income trust, it's still high enough at c.2.1% to put it on the radar for income investors looking to broaden their portfolios.

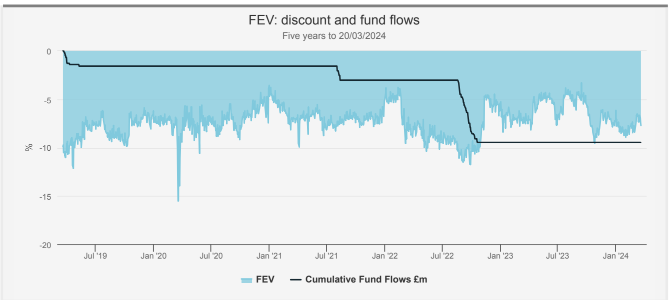
Fig.7: Five-Year Discount



Source: Morningstar

A further explanation for the narrower-than-average discount is that while FEV does not have an explicit target discount, the board has used share buybacks from time to time when the discount has widened, and the chart below shows this alongside the discount. The black line, cumulative fund flows, when sloping down, indicates the trust is buying shares back, and one can see how buyback activity has corresponded with the discount widening, particularly in 2022 when the board spent c. £6m in a short burst in response to a c. 10% discount.

Fig.8: Discount And Flund Flows



Source: Morningstar

Charges

FEV's ongoing charges figure (OCF) is 0.77% (2022: 0.78%), which compares to a simple average of 0.80% for the AIC Europe peer group. FEV's management fee is on a tiered basis of 0.85% on the first £400m of net assets, reducing to 0.65% of net assets over £400m. With net assets of approximately £1.57bn at the time of writing, this would equate to an average management fee of 0.70%.

FEV's reduction in yield (RIY) figure is 0.98%, compared to an average of 1.09% for the same peer group, although there can be some variability in methodologies regarding how RIY figures are calculated by different trusts.

ESG

FEV has an ESG rating of average from Morningstar. European equities conform to higher ESG standards when measured against global indices, and so an average rating for Europe is, in global terms, above average. Fidelity has its own large ESG team and its own proprietary ESG ratings, which show different scores for some companies when compared to the industry ratings from Morningstar and MSCI. On Fidelity's in-house measure the portfolio screens as having a more favourable profile when compared to the market . Fidelity has a team of 34 sustainability specialists integrated into its overall research platform and ESG factors are fully integrated into the team's overall assessment of a company.

As the example of Epiroc in the **Portfolio section** shows, some of FEV's companies are beneficiaries of themes such as energy transition and this more pragmatic approach to ESG that doesn't exclude industries such as mining may appeal to some investors. Further, the team's preference for companies that can grow dividends over time makes sustainability an important factor. Similarly, the team's risk-aware approach means that ESG assessments can help them have a broader understanding of where a company might go wrong. Fidelity's approach to engagement with companies is flexible and may take different forms, depending on the specific circumstances, and may be led by sustainability specialists or the sector analyst. Their proprietary system allows them to track engagement and to track trends in ESG performance by their investee companies.

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