

# Fidelity European Values

Increasing confidence in the earnings outlook

**Fidelity European Values (FEV) is an actively managed closed-end fund with a focus on continental Europe. The manager aims to achieve long-term growth through investing in a diversified portfolio of companies able to grow dividends consistently over a three- to five-year time horizon. NAV total return performance has been ahead of the FTSE World Europe ex-UK index benchmark over one, three, five and 10 years. With market valuations implying improving earnings growth, the manager highlights increasing confidence in the European corporate earnings outlook, seeing above-average earnings and dividend growth prospects in the near term.**

12 months ending	Total share price return (%)	Total NAV return (%)	FTSE World Eur ex-UK (%)	MSCI Europe (%)	MSCI World (%)
30/04/12	(12.9)	(12.1)	(19.8)	(13.5)	(1.5)
30/04/13	36.4	30.1	28.1	24.0	22.5
30/04/14	6.5	7.4	14.8	13.3	8.1
30/04/15	19.3	14.1	7.0	6.9	18.7

Note: 12-month rolling discrete sterling-adjusted total return performance.

## Investment strategy: Selecting for dividend growth

To achieve long-term capital growth, the manager seeks to invest in companies he considers attractively valued and capable of maintaining consistent dividend growth over a three- to five-year time horizon, focusing on companies with structural growth prospects and strong balance sheets. While bottom-up stock selection drives portfolio construction, the manager aims to maintain a well-diversified portfolio with sector weightings within five percentage points of the benchmark. As well as assessing dividend yield and growth prospects, a total shareholder return (TSR) ranking analysis is used to indicate where rebalancing the portfolio may be appropriate. Recent changes to the investment policy provide the manager with additional flexibility rather than indicating a change in the investment approach.

## Market outlook: Improving earnings growth implied

Although the European market rally over the last seven months has pushed the forward P/E multiple to a 10-year high, the current 15.9x multiple represents only a 2% premium to world markets and stands at a 9% discount to the US market. European earnings growth is expected to outpace the US significantly in 2015 with consensus forecast EPS growth of 34% for the FTSE World Europe ex-UK index compared with 5% for the FTSE USA index. Contributing to this, and potentially offering the hope of positive earnings surprises for the current year and beyond, have been recent currency and oil price weakness. In addition, quantitative easing by the ECB has the potential to support current valuation levels.

## Valuation: Recent narrowing of the discount

FEV's share price discount to NAV (including income) has been following a narrowing trend, moving from a 12-month low of 12.4% in August 2014 to its current level of 3.4%, arguably reflecting an improvement in FEV's relative performance. Despite this, the discount remains wider than the peer group average, suggesting some scope for further narrowing.

## Investment trusts

18 May 2015

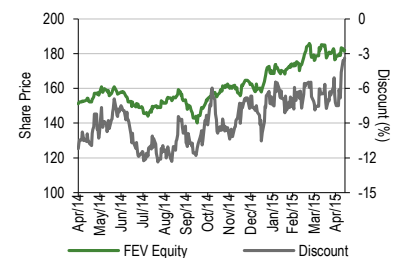
**Price** 182p  
**Market cap** £758m  
**AUM** £833m

NAV\* 185.8p  
Discount to NAV 2.0%  
NAV\*\* 188.4p  
Discount to NAV 3.4%

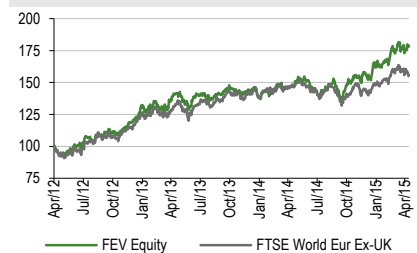
\*Excluding income. \*\*Including income.

Yield 1.7%  
Ordinary shares in issue 416.4m  
Code FEV  
Primary exchange LSE  
AIC sector Europe

## Share price/discount performance



## Three-year cumulative perf. graph



52-week high/low 186.0p 140.0p  
NAV\*\* high/low 198.1p 157.6p

\*\*Including income.

## Gearing (through CFDs)

Gross\* 5.8%  
Net\* 3.8%

\*As at 31 March 2015.

## Analysts

Gavin Wood +44 (0)20 3681 2503  
Andrew Mitchell +44 (0)20 3681 2500

[investmenttrusts@edisongroup.com](mailto:investmenttrusts@edisongroup.com)

[Edison profile page](#)

### Exhibit 1: Trust at a glance

#### Investment objective and fund background

FEV's investment objective is to achieve long-term capital growth from a portfolio of primarily continental European securities. In December 2014, the maximum permitted exposure to stocks listed outside continental Europe was increased from 5% to 20% to give the manager additional investment flexibility. FEV's performance benchmark is the FTSE World Europe ex-UK index.

#### Recent developments

- 16 March 2015: FY14 results – NAV total return +5.1%, benchmark +0.2%.
- 30 January 2015 – performance fee removed, effective 1 January 2015.
- 15 December 2014 – new investment policy approved and adopted with immediate effect.

#### Forthcoming

AGM	May 2016
Interim results	July/August 2015
Year end	31 December
Dividend paid	May
Launch date	November 1991
Continuation vote	Two-yearly (next 2017)

#### Capital structure

Ongoing charges	0.97%
Net gearing	3.8% (through CFDs)
Annual mgmt fee	0.85% of net assets
Performance fee	None
Trust life	Indefinite
Loan facilities	None – CFDs used

#### Fund details

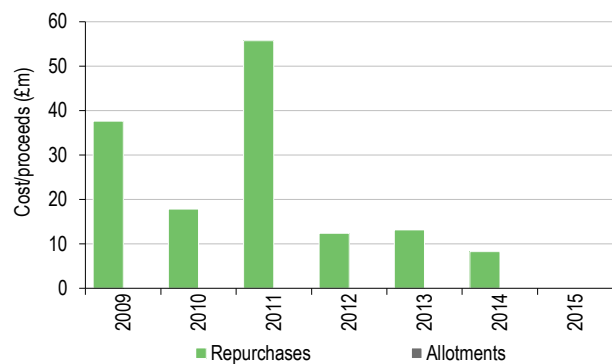
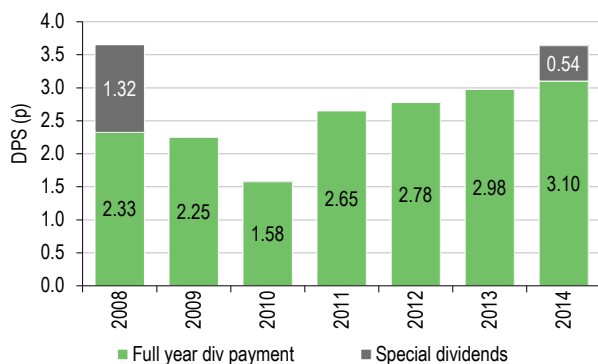
Group	FIL Investments International
Manager	Sam Morse
Address	Beech Gate, Millfield Lane, Lower Kingswood, Tadworth, KT20 6RP
Phone	+44 (0)800 41 41 10
Website	<a href="http://www.fidelity.co.uk/europeanvalues">www.fidelity.co.uk/europeanvalues</a>

#### Dividend policy and history\*

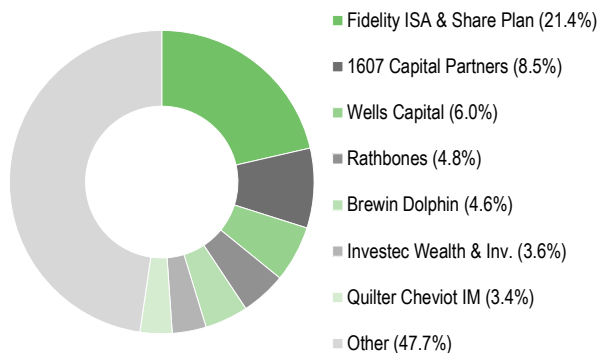
FEV pays an annual dividend in May. Revenue earnings are distributed in full.

#### Share buyback policy and history\*

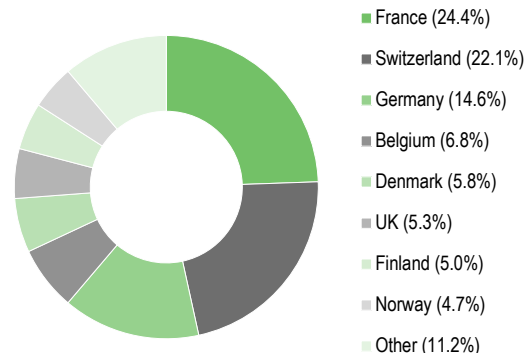
Renewed annually, FEV has authority to purchase up to 14.99% and allot up to 5% of issued share capital.



#### Shareholder base (as at 5 May 2015)



#### Distribution of portfolio (as at 31 March 2015)



#### Top 10 holdings (as at 31 March 2015)

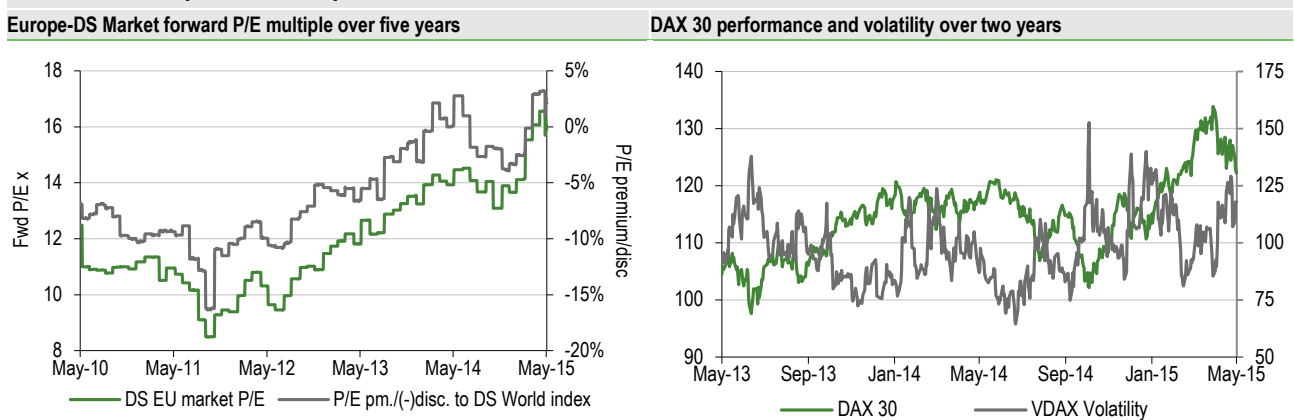
Company	Country	Sector	Portfolio weight %		Benchmark weight %	Active weight %
			31 March 2015	31 March 2014**	31 March 2015	31 March 2015
Nestlé	Switzerland	Consumer Goods	5.7	6.3	4.0	1.7
Roche	Switzerland	Healthcare	5.6	4.1	3.2	2.4
Novo-Nordisk	Denmark	Healthcare	4.1	4.0	1.7	2.4
UBS Group	Switzerland	Financials	3.6	3.7	1.1	2.5
Sanofi	France	Healthcare	3.5	4.3	1.9	1.6
Anheuser Busch Inbev	Belgium	Consumer Goods	3.3	3.2	1.6	1.7
Intesa Sanpaolo	Italy	Financials	3.3	N/A	0.7	2.6
Zurich Insurance	Switzerland	Financials	2.9	N/A	0.8	2.1
Sampo	Finland	Financials	2.7	2.9	0.4	2.3
Christian Dior	France	Consumer Goods	2.7	N/A	0.2	2.5
<b>Top 10</b>			<b>37.4</b>	<b>N/A</b>	<b>15.6</b>	<b>21.8</b>

Source: Fidelity European Values, Edison Investment Research. Note: \*Adjusted for 10-for-1 share split in June 2014; \*\*N/A where not in March 2014 top 10.

## Market outlook: Earnings growth to support valuations

As illustrated in Exhibit 2, the European market rally over the last seven months was not matched by earnings growth, leading to a sharp re-rating and the forward P/E multiple expanding from 13.1x in October 2014 to 15.9x currently. Based on Datastream indices, while close to its 10-year high, the European market forward P/E multiple is at only a 2% premium to the world market and stands at a 9% discount to the US market. European earnings growth is expected to outpace the US by some margin in 2015 with 34% consensus forecast EPS growth for the FTSE World Europe ex-UK index in 2015 considerably higher than the 5% forecast for the FTSE USA index. Contributing to this, and potentially offering the hope of positive earnings surprises for 2015 and future years, have been recent currency and oil price weakness. In addition, quantitative easing by the ECB may support current European valuation levels while rising interest rates could pressure US valuations.

**Exhibit 2: European market performance and valuation metrics**



Source: Thomson Datastream, Edison Investment Research

Concerns were raised in mid-2014 over the historically low level of market volatility, with many investors fearing a return of volatility to more normal levels could be accompanied by a market correction. However, as illustrated in Exhibit 2 (right-hand chart), market volatility has now moved to the higher end of its two-year range and, while events such as developments in Greece could cause near-term market moves, for longer-term investors European exposure through investment in companies capable of delivering sustainable cash flows and dividends still has appeal.

## Fund profile: Focus on continental Europe

Launched in November 1991, FEV is a closed-ended investment trust listed on the LSE. Its investment objective is to achieve long-term capital growth from an actively managed portfolio, consisting primarily of continental European securities. The performance benchmark is the FTSE World Europe (ex-UK) index; however, the portfolio is constructed through bottom-up stock selection and sector and geographic allocations are not set by reference to the benchmark index. The investment approach is to focus on companies able to deliver consistent dividend growth over a three- to five-year time horizon. FEV's investment portfolio is managed by FIL Investments International. Sam Morse has been the portfolio manager since January 2011.

In December 2014, the investment objective was revised to give the manager additional flexibility to invest in UK stocks by increasing the maximum permitted exposure to companies listed outside continental Europe from 5% to 20%. In addition, the investment policy was amended to enable the manager to use a wider range of derivatives, allowing investment returns to be protected or enhanced. In practice, this gives the manager scope to take short positions in stocks through CFDs within strict exposure limits, as well as continuing to use CFDs to provide gearing.

## The fund manager: Sam Morse

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### The manager's view: Increasing confidence in earnings outlook

Sam Morse acknowledges that European market valuations appear high in the context of recent downward revisions to near-term economic growth forecasts, together with macroeconomic uncertainties such as Greece's future eurozone membership, although he notes that equities still appear cheap relative to bonds and financials and energy sector earnings are low relative to history. While he has trimmed FEV's gearing to 4% from 8% in October 2014 to reflect a cautious market view, Morse does not see a specific catalyst for a correction, but envisages a cooling of the rally as a more likely near-term prospect.

Morse points to increasing confidence in the European corporate earnings and dividend growth outlook, highlighting 11% forecast dividend growth for the portfolio in 2015 and c 8% for the benchmark index, compared with four-year averages of 7-8% and 3-4% respectively. While FEV's dividend yield relative to the benchmark index has declined from a peak of 94% in March 2014 to 87% at end-March 2015, it remains towards the higher end of its four-year trading range, which Morse regards as a positive indicator, suggesting scope for FEV to outperform.

The manager attributes the increase in portfolio turnover to 34.7% in 2014 (from 25.1% in 2013) to the addition of Roche and Total as top 10 portfolio holdings, noting that turnover has been running at 15% to 20% pa in 2015. Recent portfolio changes include new investments in Spanish and Swiss airport operators Aena and Flughafen Zürich and an increase in FEV's holding in L'Oréal, prompted by a notable decline in its relative valuation. This stemmed from concerns over L'Oréal losing market share to smaller brands in the US, which the manager considers does not materially affect long-term growth prospects. FEV's holding in Czech tobacco company Philip Morris CR was sold due to the dividend no longer growing, as well as concerns over the competitive environment.

FEV invested in Aena at its IPO in February 2015, when the Spanish government sold a 49% stake, subsequently reducing its holding after a strong share price performance. Aena ranks as one of the world's largest airport groups, operating at major hubs Madrid and Barcelona in Spain as well as Luton airport in the UK, and the manager sees significant growth potential due to major government investment. Operator of Zürich airport, Flughafen Zürich has been conservatively run for the last decade with debt reduction being prioritised. A new CEO and further board changes lead the manager to expect a more shareholder-friendly approach. As well as prospects of dividend growth through a rising payout ratio, potential airline capacity increases could also drive earnings growth.

## Asset allocation

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### Investment process: Bottom-up stock selection

The manager seeks to identify companies that he believes capable of delivering consistent dividend growth over a three- to five-year time horizon and looks for the following main characteristics:

- **positive fundamentals** – proven business models in markets with structural growth prospects;
- **ability to generate cash** – free cash flow forecasts providing scope for dividend growth;
- **strong balance sheet** – funding requirements unlikely to restrict dividend payments; and
- **attractive valuation** – relative to peers and history, taking growth prospects into account.

The manager is able to draw on Fidelity's pan-European analyst team in assessing stocks and a strong emphasis is placed on meeting company management to gain a more qualitative insight.

The portfolio is constructed through bottom-up stock selection to deliver outperformance over a three- to five-year investment horizon. In addition to screening stocks by comparing dividend yield against dividend growth prospects, portfolio holdings are ranked using a more comprehensive total

shareholder return (TSR) analysis. This analysis considers earnings growth, dividend yield, re/de-rating potential, liquidity and volatility, as well as Fidelity's internal analyst rating. Significant differences between TSR rankings and stock weightings indicate where rebalancing the portfolio may be appropriate. Although the TSR analysis may lead to increased portfolio turnover, this should be outweighed by improved execution of the investment process.

Although top-down geographic allocations are not imposed, at least 80% of the portfolio must be invested in countries included in the benchmark index, while up to 20% may be invested in non-European companies with some European exposure. The manager aims to keep portfolio sector weightings within five percentage points of the benchmark. Up to 10% can be invested in any one quoted company at the time of acquisition and aggregate exposure to unquoted securities is limited to 5%. A maximum of 10% may be invested in other investment companies.

## Current portfolio positioning

FEV has a relatively concentrated portfolio, typically holding 55 to 60 investments. At 31 March 2015 the top 10 holdings represented 37.4% of the portfolio (see Exhibit 1), similar to 38.3% a year earlier, which compares with 23.2% for the FTSE World Europe ex-UK benchmark index. As shown in Exhibit 3, at end-March 2015 healthcare represented the largest overweight exposure with basic materials the largest underweight. Other principal overweight positions were in consumer services, consumer goods and technology while telecommunications was the one other notable underweight.

**Exhibit 3: Portfolio sector exposures as at 31 March 2015**

	Portfolio weight 31 March 2015 (%)	Portfolio weight 31 March 2014 (%)	Change (%)	Benchmark weight (%)	Trust active weight (%)	Trust weight/ benchmark weight
Financials	24.1	23.5	0.6	23.4	0.7	1.0
Consumer Goods	19.7	19.4	0.3	18.3	1.5	1.1
Healthcare	16.6	15.5	1.1	13.4	3.2	1.2
Industrials	13.6	13.0	0.6	14.1	(0.5)	1.0
Consumer Services	7.5	8.6	(1.1)	5.7	1.8	1.3
Technology	5.6	6.9	(1.3)	4.1	1.5	1.4
Basic Materials	3.9	4.9	(1.0)	9.0	(5.1)	0.4
Oil & Gas	3.9	3.2	0.7	4.0	(0.1)	1.0
Utilities	3.5	3.4	0.1	3.8	(0.3)	0.9
Telecommunications	1.5	1.7	(0.2)	4.3	(2.8)	0.4
	<b>100.0</b>	<b>100.0</b>		<b>100.0</b>		

Source: Fidelity European Values, Edison Investment Research

The portfolio's geographic exposure is broadly diversified, although individual country weightings can differ appreciably from the benchmark index (Exhibit 4). At 31 March 2015, notable active exposures included overweight positions in the UK, Norway, Belgium and France with underweight positions in Germany, Sweden and Spain. The main changes since March 2014 are increases in Switzerland and the UK, offsetting reductions in Germany, Norway and Belgium. Recently increased investment flexibility has allowed UK exposure to move above the previous 5% limit.

**Exhibit 4: Portfolio geographic exposures as at 31 March 2015**

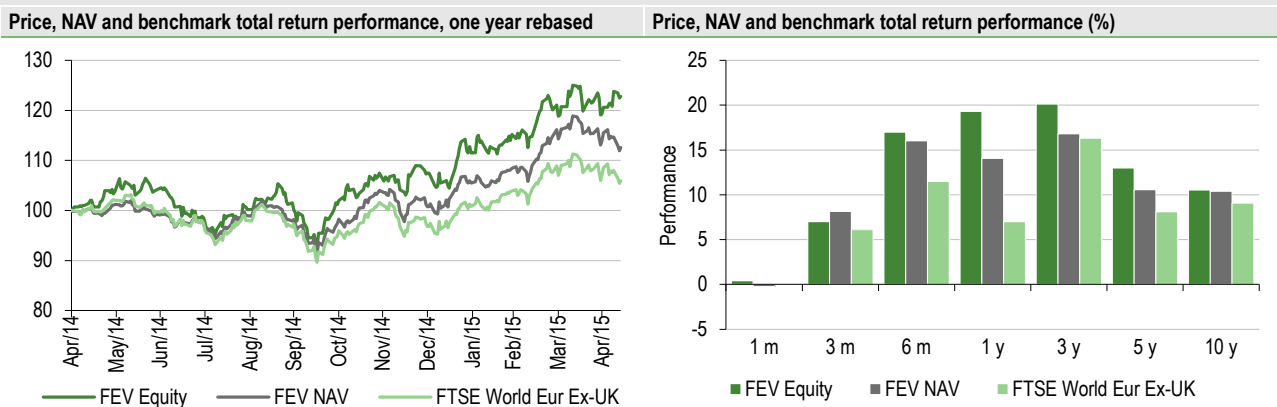
	Portfolio weight 31 March 2015 (%)	Portfolio weight 31 March 2014 (%)	Change (%)	Benchmark weight (%)	Trust active weight (%)	Trust weight/ benchmark weight
France	24.4	23.7	0.7	20.9	3.5	1.2
Switzerland	22.1	19.9	2.2	20.2	1.9	1.1
Germany	14.6	16.3	(1.7)	20.3	(5.7)	0.7
Belgium	6.8	7.9	(1.1)	2.8	4.0	2.4
Denmark	5.8	5.2	0.6	3.7	2.1	1.6
UK	5.3	4.1	1.2	0.2	5.1	26.5
Finland	5.0	5.2	(0.2)	2.0	3.0	2.5
Norway	4.7	6.2	(1.5)	N/A	4.7	N/A
Spain	3.6	3.4	0.2	7.4	(3.8)	0.5
Sweden	2.7	3.0	(0.3)	6.7	(4.0)	0.4
Other*	4.9	5.1	(0.2)	15.8	(10.9)	0.3
	<b>100.0</b>	<b>100.0</b>		<b>100.0</b>		

Source: Fidelity European Values, Edison Investment Research. Note: \*Other countries include Netherlands, Italy, Russia, which together comprise c 14% of the index.

## Performance: Long-term outperformance

As shown in Exhibit 6, FEV's share price and NAV total return has outperformed its FTSE World Europe ex-UK index benchmark over one, three, five and 10 years, with outperformance particularly evident over the last seven months. Relative performance was helped by the trust's financials sector holdings in particular, with strong contributions from GAM Holding, Intesa Sanpaolo and 3i Group outweighing relatively weak performances by BNP Paribas and UBS. The industrials sector also had a beneficial effect, with positive contributions from Aena and Bpost outweighing Intertek and Edenred's underperformance. In the healthcare sector, the lag in performance from not holding Novartis and Bayer more than offset strong contributions from Novo-Nordisk and Sanofi. While Total, Statoil and Royal Dutch Shell individually weighed on the portfolio, energy sector holdings as a whole only detracted marginally from performance. Exhibit 7 illustrates that over the last year, FEV has largely regained earlier outperformance given up over the preceding year. During the last five years, FEV achieved its strongest period of outperformance between October 2011 and April 2012, most notable as the market declined in March and April 2012.

**Exhibit 5: Investment trust performance to 30 April 2015**



Source: Thomson Datastream, Edison Investment Research. Note: Index performance is sterling adjusted. Three-, five- and 10-year performance figures annualised.

**Exhibit 6: Share price and NAV total return performance, versus indices (percentage points)**

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price versus FTSE World Europe ex-UK	0.4	0.8	4.9	11.5	10.1	24.8	14.3
NAV versus FTSE World Europe ex-UK	(0.2)	1.9	4.1	6.6	1.2	12.0	12.8
Price versus MSCI Europe	(0.5)	1.2	5.7	11.6	15.4	22.8	19.7
NAV versus MSCI Europe	(1.1)	2.3	4.8	6.7	6.1	10.2	18.1
Price versus MSCI World	1.5	2.5	6.6	0.5	10.3	9.1	6.7
NAV versus MSCI World	0.9	3.6	5.8	(3.9)	1.4	(2.1)	5.3

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-April 2015. Geometric calculation.

**Exhibit 7: NAV total return performance relative to benchmark over five years**



Source: Fidelity European Values, Thomson Datastream, Edison Investment Research



## Discount: Narrowing trend

The board maintains an active discount management policy with the primary aim of reducing share price volatility relative to NAV, while repurchasing shares at a discount also enhances NAV per share. There have been no share buybacks since July 2014, while the discount has followed a narrowing trend, moving from a 12-month low of 12.4% in August 2014 to its current level of 3.4%, arguably reflecting an improvement in FEV's relative performance.

**Exhibit 8: Share price premium/discount to NAV (including income) over three years (%)**



Source: Thomson Datastream, Edison Investment Research.

## Capital structure and fees

FEV has 416.4m shares in issue, with a 10-for-1 subdivision having been effected in June 2014. While 1.2% of the outstanding shares were bought back during 2014, no share repurchases have been made since July 2014. The board's view is that long-term returns can be enhanced through gearing and FEV's normal policy is to maintain a modest level of gearing. Although borrowing is permitted, FEV uses contracts for difference (CFDs) to achieve an equivalent gearing effect, often at lower financing costs. Restricted to a maximum 30%, the current gearing range set by the board is 0% to 10% and at 31 March 2015, FEV had 5.8% gross and 3.8% net effective gearing.

FEV pays a management fee of 0.85% pa of net assets and, effective from 1 January 2015, no performance fee is payable (previously 15% of benchmark outperformance above 0.5% pa). All management fees and expenses are charged to revenue rather than capital.

FEV is subject to a two-yearly continuation vote, next scheduled at the May 2017 AGM.

## Dividend policy

While FEV's objective is to achieve long-term capital growth, the manager's stock selection process focusing on companies able to grow their dividends has provided a rising income, enabling the dividend to be increased in each of the last four years (see Exhibit 1). The ordinary dividend increased 4.2% to 3.1p for the 12 months to 31 December 2014 and a 0.54p special dividend relating to the recovery of £2.3m of French withholding tax and interest was also declared, bringing the total dividend for the year to 3.64p. While revenue earnings are largely distributed in full and there is no certainty that dividends will continue to increase, the manager sees potential for portfolio companies to deliver double-digit dividend growth in 2015. In addition, revenue reserves equating to 1.7p per share may be used to smooth future dividend payments.

## Peer group comparison

Exhibit 9 shows a comparison of FEV with a peer group comprising the AIC Europe sector excluding funds with less than one year's track record. While Jupiter European Opportunities has over 20% UK exposure, the majority of peers do not hold any UK stocks. Although its investment policy allows up to 20% exposure, FEV currently holds only 5% of its portfolio in UK stocks. FEV's NAV total return performance is lower than the peer group average over three, five and 10 years, but ranks second in the peer group over one year. In terms of risk-adjusted returns, FEV's Sharpe ratio of 1.2 over one and three years compares with the peer group average, which has declined from 1.4 to 1.0. Despite narrowing over the last year, FEV's share price discount to NAV is wider than the peer group average. FEV's ongoing charge is modestly higher than average; however, it is one of only two funds in the peer group that do not charge a performance fee. Excluding income funds, FEV's 1.7% dividend yield is similar to the 1.8% peer group average.

**Exhibit 9: Europe closed-ended sector selected peer group as at 13 May 2015**

% unless stated	Market cap £m	NAV TR 1 Year	NAV TR 3 Year	NAV TR 5 Year	NAV TR 10 Year	Sharpe 1y (NAV)	Sharpe 3y (NAV)	Discount (ex-par)	Ongoing charge	Perf fee	Net gearing	Dividend yield (%)
Fidelity European Values	757.9	12.5	62.7	65.3	158.3	1.2	1.2	(3.4)	0.97	No	106	1.7
BlackRock Greater Europe	267.8	5.6	58.9	59.0	179.0	0.6	1.1	(2.0)	0.95	Yes	100	1.9
European Investment Trust	344.5	4.8	67.3	57.9	98.3	0.5	1.3	(5.9)	0.61	No	96	1.8
Henderson European Focus Trust	204.4	11.3	85.2	92.4	231.6	1.0	1.5	2.8	0.88	Yes	114	2.2
Henderson EuroTrust	186.1	7.6	72.1	77.3	206.8	0.9	1.4	1.2	0.86	Yes	105	2.0
JPMorgan European Growth	208.6	5.9	69.7	57.4	126.4	0.6	1.2	(6.4)	0.86	Yes	108	2.7
JPMorgan European Income	109.4	9.1	77.1	74.5		1.1	1.4	(1.6)	1.06	Yes	105	3.5
Jupiter European Opportunities	552.1	19.8	83.1	135.9	328.9	1.9	1.7	1.5	1.06	Yes	107	0.7
<b>Average</b>	<b>328.8</b>	<b>9.6</b>	<b>72.0</b>	<b>77.5</b>	<b>189.9</b>	<b>1.0</b>	<b>1.4</b>	<b>(1.7)</b>	<b>0.91</b>		<b>105</b>	<b>2.0</b>

Source: Morningstar, Edison Investment Research. Note: TR=total return. Sharpe ratio is a measure of risk-adjusted return. The ratios shown are calculated by Morningstar for the past 12- and 36-month periods by dividing a fund's annualised excess returns over the risk-free rate by its annualised standard deviation. Net gearing is total assets less cash and equivalents as a percentage of net assets.

## The board

The board consists of five non-executive directors, four of whom are considered independent of the investment manager. The independent directors are Humphrey van der Klugt (appointed director June 2007, chairman May 2010), James Robinson (senior independent director, appointed June 2007), Robin Niblett (appointed January 2010) and Marion Sears (appointed January 2013). Simon Fraser (appointed July 2002) spent 27 years at Fidelity, acting as CIO for Fidelity International from 1999 to 2005 before retiring at the end of 2008; he is also a director of Fidelity Japanese Values investment trust, managed by FIL, and is therefore not deemed to be an independent director.

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