JPMorgan European Discovery Trust

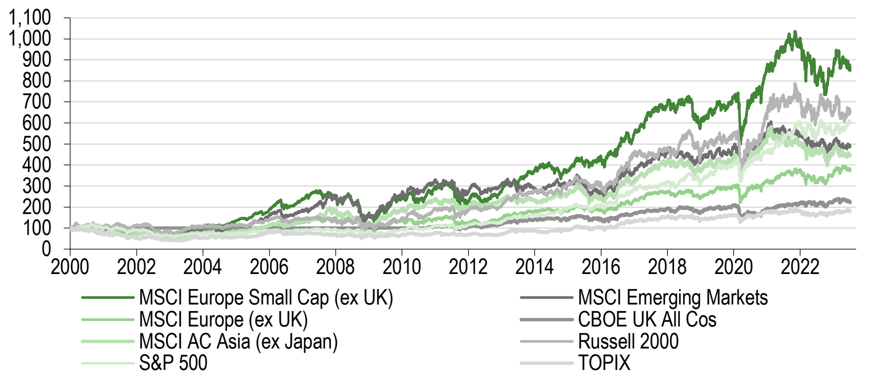
A balanced trust targeting a world-beating market

Investment trusts
European Smaller Companies

12 September 2023

JPMorgan European Discovery Trust (JEDT) invests in European small-cap companies (excluding UK), with the aim of providing shareholders with long term capital growth. The investment case for this sector is clear and simple. European small caps have outperformed most other markets over the long term. JEDT's disappointing performance during H122 prompted its managers to rotate out of high-growth IT software and medtech stocks, in favour of a more balanced approach focused on quality and value names. Many of these acquisitions are now contributing to returns.

European small caps are among the world's best long-term performers



Source: Morningstar, Edison Investment Research.

The analyst's view

- Potential investors may be attracted to the European small-cap sector by its long-term track record of outperformance versus most other major markets.
- JEDT offers investors diversified access to this world-beating market. The trust's long-term performance track record attests to the managers' stock selection skills, and potential investors may like its recent, more balanced investment approach, which offers the potential to deliver steady returns, relatively immune to stylistic turbulence.
- The trust's balanced investment approach distinguishes it from its more growth focused peers, as does its significant overweights to Italy and France.
- JPMorgan Asset Management's very significant fundamental research resources, combined with the use of state-of-the-art, AI-driven quantitative tools, arguably provides JEDT with a competitive edge over its peers.
- Now may be a good time to acquire exposure to JEDT, as the valuations of European small caps ex-UK are low both historically and relative to European large caps (see the following section for details), and JEDT's discount has recently been trading two percentage points or more above its long-term average of c 12% (over the 10 years to end August 2023). However, the discount has scope to narrow as and when performance returns to form, and investor sentiment towards the sector improves.
- The main risk to the investment case for JEDT is an unexpected deterioration in economic activity and a resultant decline in earnings expectations.

Price	**380.5p**
Market cap	**£599.2m**
AUM	**£682.2m**
NAV*	438.7p
Discount to NAV	13.3%

*Including income. As at 7 September 2023.

Yield	2.4%
Shares in issue	157.5m
Code/ISIN	JEDT
Primary exchange	LSE
AIC sector	European Smaller Companies

52-week high/low	448.0p	345.0p
NAV* high/low	521.3p	415.8p

*Including income.

Gearing (net)

Net gearing at 8 Sept 2023	5.5%

Fund objective

JPMorgan European Discovery Trust (JEDT) aims to provide capital growth from a diversified portfolio of smaller European companies (excluding the UK).

Bull points

- The trust's recent, more balanced investment approach offers the possibility of a 'smoother ride' for those seeking consistent returns even in turbulent and uncertain times.
- Valuations of European small caps are low relative to both history and European large caps.
- The trust's managers use innovative proprietary research tools to sift through vast amounts of data in search of research insights.

Bear points

- JEDT tends to underperform when macroeconomic factors, rather than bottom-up fundaments, drive markets, as they did in 2022.
- The trust's rebalancing in favour of quality and value names has not yet resulted in a decisive improvement in performance.
- The trust's emphasis is on capital growth rather than income, so dividends will vary from year to year depending on portfolio income.

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NOT INTENDED FOR PERSONS IN THE EEA

JEDT: Adapting with the times

European smaller caps: Beating the world over the long-term

The investment case for European smaller companies is clear and simple. This sector of the European equity markets has outperformed not only European large-cap stocks, but also emerging and Asian markets, the United Kingdom, Japanese equities and US stocks over the long term (see chart on page 1).

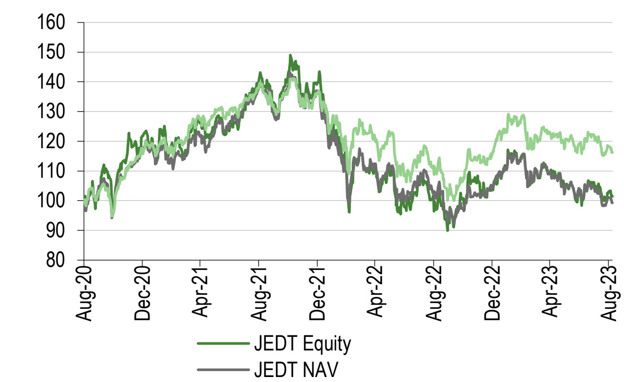
There are many possible reasons for this. Smaller companies tend to have a more nimble, dynamic, entrepreneurial approach, which allows them to adjust quickly to, and profit from, unforeseen events and market developments. Superior earnings growth has followed. The region also boasts global leaders in many fields reliant on state-of-the-art engineering and design skills, and its luxury consumer and high-end fashion brands are world renowned and in perpetual demand.

JEDT: A strong long-term performance

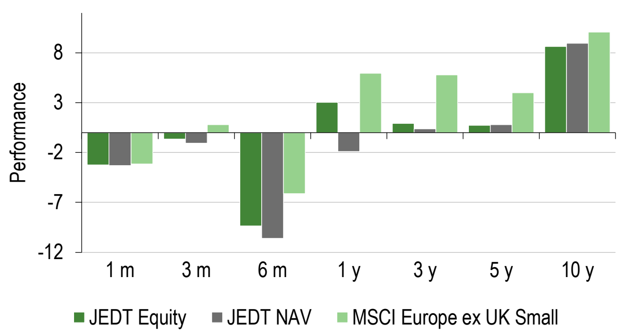
JEDT has a good performance track record in the European smaller cap market over the long term. Over the 10 years ended August 2023, it delivered strong absolute returns relatively close to those of its benchmark, the MSCI Europe ex-UK Small Cap Index. JEDT's average annualised return over this period was 8.9% per annum in net asset value (NAV) terms, and 8.6% on a share price basis, versus the benchmark return of 10.1% (Exhibit 1). The short-term performance has been more challenged, as the trust was overweight higher-growth stocks early last year, and these holdings were adversely affected by the sudden rise in inflation and interest rates following Russia's invasion of Ukraine.

Exhibit 1: Investment company performance to 31 August 2023

Price, NAV and index total return performance, three-years rebased



Price, NAV and index total return performance (%)



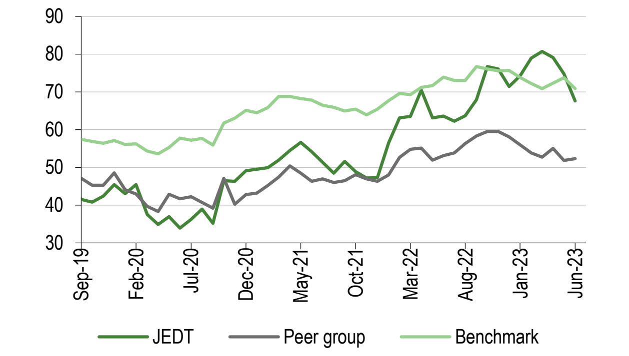
Source: Refinitiv, Edison Investment Research. Note: Three-, five- and 10-year performance figures annualised.

However, by mid-2022, the managers began rotating the portfolio out of many of its high-growth stocks in the IT software and medtech sectors, in favour of quality companies better placed to cope with the new high-inflation, high-rate environment. Specifically, the managers sought out companies with strong competitive positions and associated pricing power, or inflation-linked earnings, and those set to benefit from higher interest rates (see the Current portfolio positioning section for details). They also acquired good companies temporarily undervalued by the market and stocks whose potential earning power is underappreciated. As a result of these changes, the portfolio is now more balanced across high-quality and value names, which should add value steadily, free of the stylistic turbulence it experienced in early 2022. Indeed, there are early signs that these changes are already having a favourable effect on performance (see the Performance section for discussion).

Balanced, potentially less volatile approach distinguishes JEDT from its peers

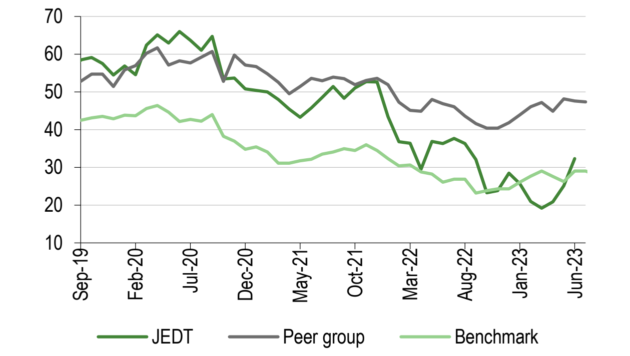
JEDT's shift towards a more balanced investment approach, and the potentially less volatile performance that accompanies it, differentiates it from its peers in the AIC European smaller cap sector, which tend to be more growth focused (Exhibits 2 and 3). (See our July 2022 note for further discussion.) This 'smoother ride' will be welcomed by investors seeking consistent investment returns even in turbulent and uncertain times.

Exhibit 2: Weighting to core and value still increasing



Source: Morningstar. Note: Peer group is Morningstar open and closed ended Europe ex UK small- and mid-cap category. Benchmark is MSCI Europe ex UK Small Cap Index.

Exhibit 3: Weighting to growth still decreasing

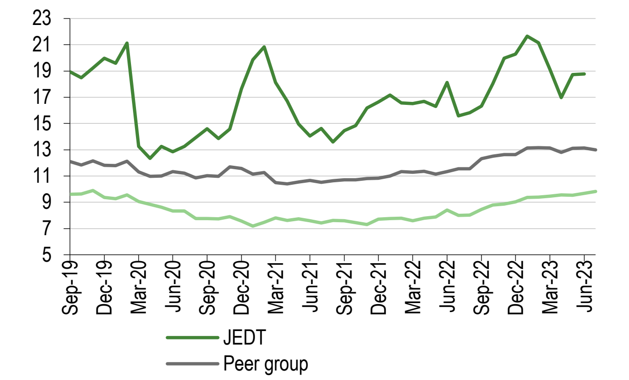


Source: Morningstar. Note: Peer group is Morningstar open and closed ended Europe ex UK small- and mid-cap category. Benchmark is MSCI Europe ex UK Small Cap Index.

Overweights to overlooked, undervalued Italy and France

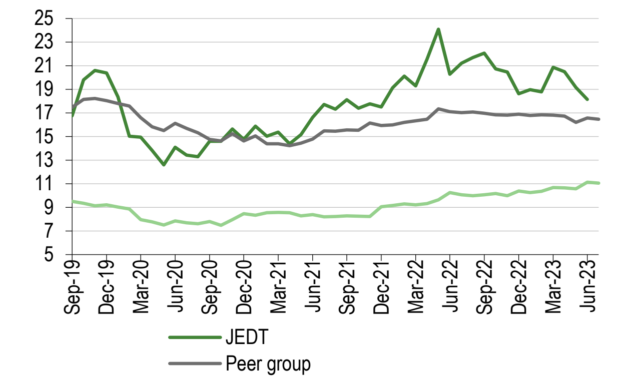
Another factor that distinguishes JEDT from its peers is its notable overweights to Italy and France (Exhibits 4, 5 and 6). These markets tend to be overlooked by many investors, and undervalued accordingly, compared to other countries in the region, because of some unfavourable structural characteristics, including high taxes, labour market issues and burdensome bureaucracies. Others are deterred by their turbulent political environments, but Edward Greaves, one of JEDT's two, longstanding portfolio managers, views domestic politics mainly as 'noise' that does not detract from the fundamental solidity of these countries' institutions, or from the attractiveness of the many reasonably priced investment opportunities they offer. JEDT's exposure to Italy recently increased thanks to the acquisition of Technogym, a manufacturer of high-end gym equipment, and Brembo, which produces premium automotive brake discs and other components.

Exhibit 4: Continued bias to Italian equities (%)



Source: Morningstar. Note: Peer group is Morningstar open and closed ended Europe ex UK small- and mid-cap category.

Exhibit 5: Still overweight France (%)



Source: Morningstar. Note: Peer group is Morningstar open and closed ended Europe ex UK small and mid-cap category.

Exhibit 6: Portfolio geographic exposure (% unless stated)

	Portfolio			Index weight	Active weight vs index (pp)
	End-July 2023	End-July 2022	Change (pp)		
Sweden	17.2	10.8	6.4	15.2	2.0
France	16.5	18.5	(2.0)	11.2	5.3
Germany	15.6	7.1	8.5	14.2	1.4
Italy	14.9	14.2	0.7	10.0	4.9
Switzerland	7.1	11.7	(4.6)	13.0	(5.9)
Netherlands	6.3	9.1	(2.8)	6.5	(0.2)
Belgium	3.9	9.9	(6.0)	3.7	0.2
Denmark	2.6	4.1	(1.5)	6.1	(3.5)
Norway	2.1	0.0	2.1	6.8	(4.7)
Others	4.4	5.8	(1.4)	13.3	(8.9)
Cash	9.4	8.8	0.6	0.0	9.4
	100.0	**100.0**		**100.0**	

Source: JPMorgan European Discovery Trust, Edison Investment Research.

Leveraging AI to glean investment insights

JEDT's managers are supported by JPMorgan Asset Management's (JPMAM's) vast and well-resourced research teams. In addition, the trust is further differentiated from its peers, and indeed most other investment trusts, by its innovative approach to fundamental research, which incorporates proprietary research tools that use AI to sift through vast amounts of data for valuable investment insights. One of these tools uses a natural language processing (NLP) model based on machine learning to read millions of earnings call transcripts, corporate filings and internal research reports, etc, related to all the stocks in the trust's universe. This tool thus gives JEDT's managers access to much more potentially relevant information than could ever be compiled by human analysts, and it has proved effective at predicting changes in earnings expectations.

The team also employ an Equity Failure Model (EFM) that draws on a wide range of information sources, including company financials, analyst estimates and short interest positions, to systematically identify stocks with a higher likelihood of material underperformance. This tool generates a daily report covering 170 key characteristics of all stocks in the universe, and flags potential issues related to rising debt levels, reduced dividend payments and reporting irregularities for the analysts to investigate. This combination of significant fundamental research resources, complemented by the use of state-of-the-art, AI-driven quantitative tools, arguably provides JEDT with a competitive edge over its peers.

Managers positive about the outlook for European small caps

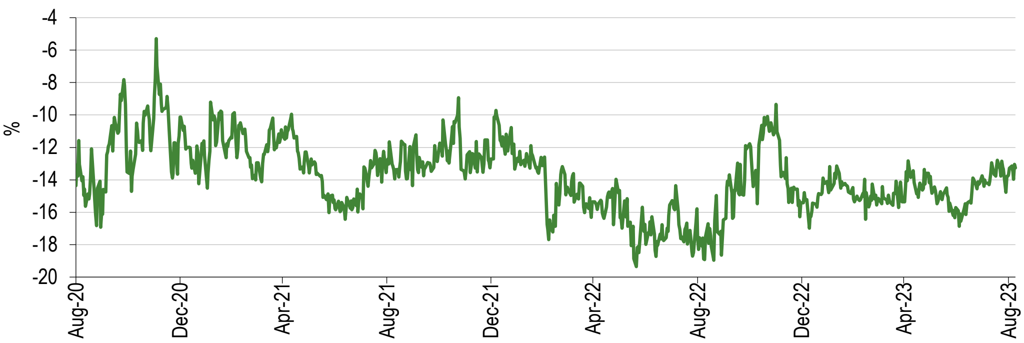
JEDT's managers are positive about the outlook for European smaller caps, and for the trust, for several reasons in addition to their well-established track record of outperformance, illustrated above. Firstly, there are signs of some improvement in the region's macroeconomic background. Inflation pressures are beginning to abate as energy prices decline and supply chain issues ease, helped by China's post-pandemic re-opening, wage inflation is normalising, and consumer confidence is rising off last year's record lows. JEDT is prone to underperformance when macro events dominate markets, as they did during 2022, while it tends to outperform when bottom-up fundamentals are ascendent, so the prospect of a more stable macro environment bodes well for the trust.

So do the fundamentals. European small caps look extremely attractive from a valuation perspective. According to JPMAM, the sector's price-to-book (P/B) ratio was 1.5x in April 2023, compared to its long-term average of 1.6x, and European small caps are also cheap relative to the large-cap ex-UK index. These metrics suggest that investors currently have the chance to access the European small-cap market at attractive levels both in historical terms and relative to European large caps.

JEDT's discount provides market access at an arguably attractive price

For those investors who share the managers' confidence in the outlook for European small-cap companies, now may be a particularly favourable time to initiate or top up a position in JEDT. Its share price discount to NAV has recently been trading two percentage points or more above its long-term average of c 12% (Exhibit 7), and wider than most of its immediate peers (Exhibit 8). This is probably at least in part the result of JEDT's recent underperformance, and possibly also adverse investor sentiment towards European stocks in general, and small caps in particular. However, the discount has scope to narrow as and when performance returns to form, and investor sentiment towards the sector improves.

Exhibit 7: Share price discount to NAV (including income) over three years (%)



Source: Refinitiv, Edison Investment Research

Exhibit 8: AIC European Smaller Companies sector (as at 12 September 2023)

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Ongoing charge	Perf fee	Discount (cum fair)	Net gearing	Dividend yield
JPMorgan European Discovery	600.8	(3.8)	(1.2)	3.0	124.9	0.9	No	(13.3)	106	2.4
European Assets	310.0	9.2	2.9	7.2	98.1	1.0	No	(8.7)	100	6.7
European Smaller Companies	607.3	10.9	28.5	39.3	212.8	0.6	Yes	(13.7)	114	2.9
Montanaro European Smaller	239.4	5.7	5.2	43.2	194.9	1.0	No	(11.4)	102	0.8
Average (six funds)	**439.4**	**5.5**	**8.9**	**23.2**	**157.7**	**0.9**		**(11.8)**	**105**	**3.2**
JEDT rank in sector	**2**	**4**	**4**	**4**	**3**	**3**		**3**	**2**	**3**

Source: Morningstar, Edison Investment Research. Note: Performance to 8 September 2023 based on cum-fair NAV. TR, total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

Performance: Recent acquisitions supporting returns

Exhibit 9: Five-year discrete performance data

12 months ending	Share price (%)	Total NAV (%)	MSCI Europe ex-UK Small Cap (%)	MSCI Europe ex-UK (%)	CBOE UK All Cos (%)
31/08/19	(9.6)	(8.2)	(4.9)	5.2	0.3
31/08/20	11.5	12.0	8.0	0.6	(13.5)
31/08/21	39.8	37.4	37.7	27.0	27.1
31/08/22	(28.6)	(25.0)	(18.8)	(10.9)	1.8
31/08/23	3.0	(1.9)	5.9	15.7	5.5

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

Near-term performance has disappointed

As mentioned above, JEDT's long term performance has been good: over the 10 years ended 31 August 2023, the trust has delivered significant positive returns, close to the benchmark, on an annualised basis. In the nearer-term, absolute and relative performance has been disappointing, due in large part to the unexpected surge in inflation and interest rates following Russia's invasion of

Ukraine, which adversely affected the trust's growth stocks. In the 12 months ended 31 August 2023, the portfolio returned -1.9% in NAV terms and 3.0% on a share price basis, trailing the benchmark by 7.8 percentage points on an NAV basis.

Detractors from performance over this period included VGP, a Belgian developer of warehouses, which has been hit by rising construction and funding costs and seen valuations diminished by higher rates. Kion Group, a German manufacturer of warehouse automation equipment and forklift trucks, also detracted due to the adverse impact of rising input costs, which it has struggled to pass on to customers. These stocks have since been sold. Banco de Sabadell, a Spanish bank, was another poor performer. It was hurt by concerns about banking sector fragility following the collapse of SVB in the US and the takeover of Credit Suisse. However, the managers view this company as an interesting value opportunity that has made great progress in improving performance and earnings, so they retain this position.

Quality and value names have supported recent performance

The good news is that many of the portfolio's high-quality names, some acquired in 2022, have been performing very well. It is early days yet, but this suggests that JEDT's more balanced approach is beginning to yield results. Notable contributors to recent performance include several top 10 holdings including SPIE, a French technical services company that is seeing strong demand for its electrical installations as companies make the transition towards electrification (Exhibit 11). Prysmian, another top 10 holding, is an Italian cable manufacturer benefiting from increased investment in Europe's electricity grid in response to the region's current energy crisis. Elis, also one of the trust's largest positions, is an industrial laundry services company supplying hotels and other commercial premises. Demand for these services rebounded strong after the pandemic and the managers like the company's ESG credentials, as its machines are very efficient in terms of energy and water usage. Melexis, a Belgian designer of automotive semiconductors, is seeing increased demand as the semiconductor content of vehicles continues to escalate, while Italian luxury yacht maker Sanlorenzo is attracting orders from wealthy clients. Ipsos, a French market research company, provides clients with what JEDT's managers believe to be valuable insights and analysis, not just raw data. This company has seen strong demand for market intelligence as companies and governments seek to understand how consumer behaviours have shifted since the pandemic.

Dividends: Modestly contributing to total returns

JEDT's dividend policy aims to pay out the majority of revenue available each year, although the company's objective is to maximise capital growth, so the managers are not constrained to deliver income in any one financial year, and the dividend will vary from year to year, as it is a function of portfolio dividend income.

An interim dividend of 1.2p/share was paid on 3 February 2023 for the financial year ended 31 March 2023. This was the same as last year's interim dividend, and a final dividend of 7.8p/share was paid on 4 August, taking the total dividend for FY23 to 9p/share (FY22: 6.70p/share) (Exhibit 10). This represents a yield of 2.4% based on the current share price, which is much lower than the dividend yield of European Assets Trust, which has an enhanced dividend policy, but higher than Montanaro European Smaller Companies Trust, which is far more growth oriented (Exhibit 8).

Exhibit 10: Dividend history since FY13

Source: JPMorgan, Edison Investment Research

Current portfolio positioning

Balancing the portfolio, focusing on quality…

As mentioned above, since Q222, JEDT's managers have adopted a balanced investment approach, which targets quality stocks best-placed to continue performing well in the new high-inflation, high-rate environment. Specifically, they target market leaders with strong balance sheets, possessing higher barriers to entry and associated pricing power and high returns on capital, at conservative valuations. Acquisitions included Sanlorenzo, an Italian luxury yacht manufacturer now featuring in the trust's top 10 holdings, and Melexis, a Belgian producer of automotive semi-conductors. Both these stocks have contributed to recent performance, as discussed above.

Exhibit 11: Top 10 holdings

Company	Country	Sector	Portfolio weight		
			End July 2023, %	End July 2022, %*	Change in portfolio weight (pp)
Sanlorenzo	Italy	Consumer discretionary	2.7	2.9	(0.2)
Alten	France	Technology	2.6	2.7	(0.1)
SPIE	France	Industrials	2.4	3.4	(1.0)
CTS Eventim	Germany	Consumer discretionary	2.3	N/A	N/A
SEB	Sweden	Financials	2.2	N/A	N/A
Royal Vopak	Netherlands	Industrials	2.2	N/A	N/A
Verallia	French	Industrials	2.1	N/A	N/A
Thule Group	Sweden	Consumer discretionary	2.0	N/A	N/A
Bravida	Sweden	Industrials	2.0	2.7	(0.7)
Technogym	Italian	Consumer discretionary	1.9	N/A	N/A
Top 10 (% of portfolio)			**22.4**	**29.6**	

Source: JPMorgan European Discovery Trust, Edison Investment Research. Note: *N/A where not in end-July 2022 top 10.

…at an attractive price

Valuations are also a key consideration for the JEDT team, so they seek out stocks that tend to be out of favour with the market and thus temporarily cheap. The team judges a stock's value on several metrics, including its free cash flow yield and P/E ratio. Ipsos, a French market research company, is one of the trust's value holdings. The managers believe the market is undervaluing this stock (current 12-month forward P/E is 9.0x), viewing it as simply a purveyor of raw data, whereas, in reality, it provides clients with market intelligence that is especially valuable in the new, unfamiliar post-pandemic world. Verallia is another stock purchased for its value credentials (12-month forward P/E of 8.0x). It is a French producer of glass packaging for food and beverages. The energy-intensive nature of Verallia's production process saw its share price decline sharply in early 2022, when energy prices surged. However, glass's weight and fragility mean that it is difficult to transport long distances, creating local monopolies and bestowing associated pricing power on producers. JEDT's managers also rate Verallia's management team highly. For example, the company has been astute at hedging energy costs, so its share price sell-off created a buying opportunity. The stock price has since rebounded strongly.

Earnings momentum also key

The final criteria in the managers' stock selection process is positive momentum, by which they mean stocks in structurally growing but fragmented markets, with disruptive technologies, and plans to grow market share via bolt-on acquisitions, but whose earning power is underappreciated by the market. Such stocks need to be distinguished from high-growth stocks, which tend to be expensive. The managers argue that even stocks offering potential earnings growth of 3–4% pa will see share price appreciation in cases where no earnings growth is forecast. One such recent purchase is Brembo, an Italian auto parts producer mentioned above, which is seeing increasing demand from developers of automated warehouses.

Not all of JEDT's portfolio holdings possess all three characteristics of quality, value and earnings momentum, but SPIE, a French technical services company, does. As mentioned above, SPIE is benefiting from the transition to renewable energy sources. Its strong cash flows have allowed it to reduce debt and it boasts a high return on invested capital, thanks to sound capital allocation decisions. It is therefore not surprising that SPIE is currently JEDT's largest position, and a positive contributor to recent performance.

Industrials and consumer discretionary names dominate at the sector level

SPIE is only one of several portfolio holdings whose business focuses on the transition to renewable energy and the associated themes of electrification and energy efficiency. Others include Prysmian, an Italian cable maker and top 10 holding mentioned above, Bravida, a Swedish construction company specialising in the refurbishment of buildings to meet higher energy standards, and Aalberts, a Dutch manufacturer of piping systems focused on energy efficient solutions. Together, JEDT's exposure to these and other industrial companies comprise its largest sector overweight (Exhibit 12).

Exhibit 12: Portfolio sector exposure (% unless stated)

	Portfolio			Index weight %	Active weight vs index (pp)
	End-July 2023	End-July 2022	Change (pp)		
Industrials	32.2	35.7	(3.5)	28.9	3.3
Consumer discretionary	24.3	16.6	7.7	11.6	12.7
Technology	11.2	8.8	2.4	11.1	0.1
Financials	9.9	7.9	2.0	14.1	(4.2)
Consumer staples	5.1	1.0	4.1	5.3	(0.2)
Real estate	3.5	9.5	(6.0)	7.3	(3.8)
Basic materials	3.1	0.0	3.1	5.5	(2.4)
Healthcare	1.3	6.3	(5.0)	8.0	(6.7)
Energy	0.0	0.0	0.0	3.6	(3.6)
Utilities	0.0	5.4	(5.4)	2.8	(2.8)
Telecommunications	0.0	0.0	0.0	1.8	(1.8)
Cash	9.4	8.8	0.6	0.0	N/A
	100.0	**100.0**		**100.0**	

Source: JPMorgan European Discovery Trust, Edison Investment Research

The trust also has a significant overweight to consumer durables. The managers believe many stocks in this sector are undervalued, especially now that consumer confidence appears to have bottomed. They have recently opened a position in CTS Eventim, a German company specialising in ticketing for live events. This company has seen very strong earnings growth following the easing of pandemic restrictions and improving consumer sentiment should support earnings further. The team has also topped-up holdings in Italian gym equipment manufacturer Technogym, French household appliance maker SEB and German fashion brand Hugo Boss, which is expected to benefit from China's reopening.

Recent sales have been motivated by profit-taking on investments in insurance companies and some Italian banks, which were acquired last year as a play on rising interest rates. The managers sold Swiss insurer Baloise following a disappointing performance.

As a result, the portfolio is now almost neutral insurance companies, relative to the benchmark, and has a notable underweight to banks, although its largest underweights are to pharmaceuticals and real estate. The managers dislike drug companies in general, as they require highly specialist knowledge to assess, so it is hard to judge potential successes, while real estate companies are being challenged by rising rates, which increase the cost of funding and construction, while also undermining valuations.

Active management of gearing has added alpha over time

JEDT's managers are active users of gearing, which has enhanced returns over time. They have scope to vary gearing between 20% cash and 20% debt. Over the course of the past financial year, gearing was increased because valuations were low, and the managers saw many attractive investment opportunities. Gearing peaked at 10.4%; however, it has since declined and was 6.7% at end June 2023.

For details of the trust's profile, investment policy and fees, see our July 2022 report.

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