European Smaller Companies

ESCT's manager follows the returns not the crowd...

Update
17 November 2023

Overview

European Smaller Companies Trust (ESCT) targets capital growth by investing in small and mid-sized European companies. Over 50% of the portfolio is invested in companies with a market capitalisation of less than €1bn, meaning ESCT has more of a bias to small companies than is average for its peer group. The **Portfolio** is diversified across c. 130 holdings and is not constructed using a single investment style, with holdings in growth, value, earlier stage, mature and turnaround businesses.

Over the last five and ten years, ESCT has outperformed both its benchmark and peer group, in both NAV and share price terms. Notably, during a five-year period when large caps have outperformed small caps, ESCT has also returned more than the closest equivalent large cap index.

ESCT's lead fund manager, Ollie Beckett, has been with Janus Henderson since 1998 and has managed the trust since 2011. Ollie is supported by portfolio manager Rory Stokes and associate portfolio manager Julia Scheufler, working within the European equities team. They take a style agnostic approach, investing across quality growth companies, turnaround situations, early-stage growth and more mature companies.

The trust is geared by c. 15%, and this has gradually increased in 2022 as the team see greater opportunities from lower valuations. The current yield is c. 3.3% which is relatively high for a small cap trust, but Ollie is keen to emphasise the main goal of ESCT is capital growth, and while the trust has a long record of progressive dividends, this isn't the main objective of the trust. ESCT trades on a c. 15% **Discount**, in line with its peer group, and very recently the board has begun to buy shares back in response to the discount.

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Analyst's View

We think investors mostly turn to smaller companies for their greater return potential, and accept that they come with more potential risk in exchange. It seems entirely consistent for a small cap manager to begin to increase gearing even as sentiment is very poor after some very tough times that have left small caps on very low valuations. In the **Portfolio section** we discuss the different categories Ollie and the team use to describe the portfolio, but in summary this is a pragmatic portfolio of small companies not bound by a particular investment style, but going wherever they believe the opportunities might be.

That's not to say that the team aren't aware of the risks that small caps come with, and the portfolio is diversified across c. 130 stocks. Although about half the portfolio is in sub-€1bn market cap stocks, there is generally still good liquidity, which means, for example, that gearing can be adjusted dynamically and share buy backs, which the board has just started implementing, can be undertaken without worrying about cash levels.

As Ollie notes, valuations for European small caps are around levels which, historically, have been followed by very strong three- and five-year returns, and while the team spend most of their time thinking about stocks and not macro factors, this is quite a compelling point. We think investors seeking to add some risk to portfolios after an extended period of risk reduction could find ESCT's diversified portfolio, relatively wide discount and tactical use of gearing very appealing.

BULL
European smaller companies are close to historical valuation lows which has previously led to strong returns in the following years
Strong track record even when small caps are out of favour
Very diverse portfolio limits single company risk

BEAR
Smaller companies are more risky
Gearing can amplify losses as well as gains
European economic indicators are very weak

Portfolio

Definitions of 'small cap' vary across different trusts in European Smaller Companies Trust (ESCT)'s peer group and the wider universe of European equity funds, but in terms of its immediate peer group ESCT typically has the lowest average market cap, with over half of the portfolio in stocks with a market cap of less than €1bn, illustrated in the table below. That said, this is not a micro-cap trust and portfolio liquidity is good enough to allow ESCT to consider buying shares back, which we discuss in the **Discount section**, and for dynamic adjustments to gearing. One of the key arguments for active management in small caps is that stocks tend to be less well-researched by third-parties than is the case for much larger companies, leading to more potential for mispricing, and this tends to be more true the further down the market cap spectrum one goes. So, while screens that utilise factors calculated using third-party forecasts are part of the ESCT team's investment process, these are tools to identify situations that require further analysis, rather than an end in themselves.

Market Cap Distribution

	TRUST (%)	BENCHMARK (%)
› £1bn	43	69
£500m to £1bn	32	20
Below £500m	36	12

Source: Janus Henderson, as at 31/08/2023

Ollie and the team like to build a portfolio with many smaller positions, rather than a focused, high conviction portfolio, and at time of writing the trust has c. 130 holdings. We've listened to arguments in favour of both approaches over the years and we've concluded that human beings aren't all the same and some are better at making a few high impact decisions and others are better at making many smaller decisions. As we look at in the **Performance section**, ESCT has outperformed its benchmark and peer group for at least ten years, and even in the last five years, when large cap indices have outperformed small caps, the trust has delivered stronger returns than large caps. This seems to be good evidence that the 'many smaller decisions' form of active management is working for the team.

In keeping with this diversified approach, the team don't focus on a single style or set of criteria in building the ESCT portfolio, and instead will consider making investments across all stages of a company's life cycle, from early-stage growth, quality growth, mature and turnaround. Another way of putting this is that they buy growth and value stocks, but the four categories are a good way to describe how they approach things. At time of writing, the portfolio has about 5% exposure to early-stage growth, 47% to quality growth, 25% to mature and 37% to turnarounds. These figures add up to more than 100% because ESCT is geared, which we discuss in the **Gearing section**. These figures can move around, and the portfolio was repositioned in 2021 and 2022 more defensively, but one should expect early-stage growth, for example, to remain a smaller percentage of the portfolio as these companies may be riskier, but equally they have the potential to make a large impact on returns from a relatively small amount invested.

Ollie believes that mature companies can become underappreciated by the market and can represent great opportunities, potentially with lower risk. The trust owns, for example, DFDS, which is a long-established European ferry operator that connects over 20 countries in Europe. Readers may know DFDS as one of the cross-channel ferry operators, but it is also a major operator in commercial freight, moving freight by sea and providing the logistics to do so on land. We know from, for example, the real estate world, that European logistics is a significant growth trend but it's easy to see how a mature, relatively unexciting-sounding business that has been operating for over 150 years might be underappreciated by the market. Ollie also mentions the Portuguese cork products manufacturer Corticeira Amorim. Again this is a very mature business, but cork has applications beyond the obvious bottle stopper as a natural product used in insulation and wall and floor coverings, as well as various composite materials, and managed correctly is a very sustainable material.

One of the examples Ollie gives of an earlier-stage company is Flex LNG, which is listed in Oslo and New York. This is a small shipping company and although earlier stage, is not a new company, having been operating since 2006. The company specialises in shipping liquified natural gas (LNG), which as many readers will know is an area seeing rapid growth in Europe, with LNG being used to gradually supplant gas supplies from Russia, and to power things such as flexible power generation, which forms part of the technology enabling the gradual transition to renewable power. The energy transition theme can also be seen in one of the portfolio's "turnaround" situations, Nexans. Ollie says that he sees changes in management as the most common catalyst for change in companies, and this is the case with Nexans, which is a cable manufacturer that has refined its strategy to focus on the electrification of Europe through renewable energy, providing cables for the whole chain, from generation to interconnects and distribution of power. Both these companies highlight that a great many of ESCT's holdings are in some way linked to sustainable themes, which Ollie sees as a significant area of opportunity for any investor, whether led by ESG concerns or not. Rounding things off, one of Ollie's examples of a quality growth company, GTT, is a French company which licences the equipment that allows for the safe transportation of LNG, and in fact Flex LNG, above, is a licensee.

Within small caps specifically, the table below shows how valuation can play a very important role in performance. The table records the last four dates when the forward P/E of ESCT's benchmark fell below 11x. Forward P/E is, of course, an average forecast and so this number can fall both because the market is falling, but also because forecasters are revising down their numbers. The combination of the two can be a powerful signal that sentiment can't get much worse, and this is followed by a gradual improvement. As the table shows, in all the last four cases, the subsequent five-year performances were very strong, even if investors would have had to endure another breach of the same forward P/E level along the way if they had bought in July 2008 or August 2011. According to the team, the current forward P/E on the benchmark is 11.8x, so not quite there yet, but they think that forecasts are still too high and we may soon see the 11x level breached just by dint of forecasts falling further. This is one of the key pieces of evidence that the team have used to support the decision to add more risk to the portfolio, both by rotating out of some more defensive names and by adding more gearing.

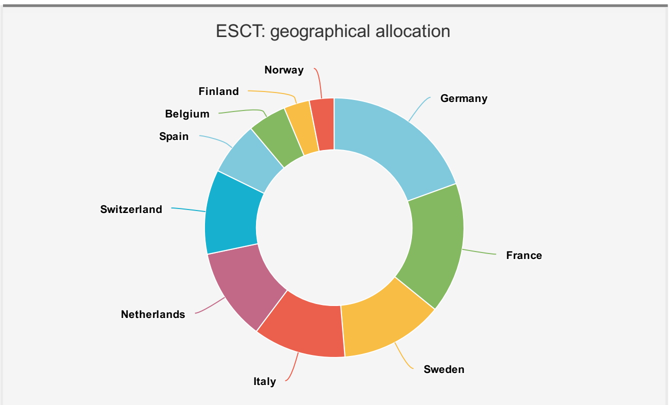
Small-Cap Performance From Valuation Low Points

DATE INDEX HIT 11X P/E	3-YEAR SUBSEQUENT RETURN (%)	5-YEAR SUBSEQUENT RETURN (%)
04-07-2008	11	28
26-09-2008	8	78
05-08-2011	69	108
18-05-2012	109	136
Average	**49**	**88**

Source:Janus Henderson

The chart below shows ESCT's geographic distribution, which serves to highlight the diversified approach that the team takes.

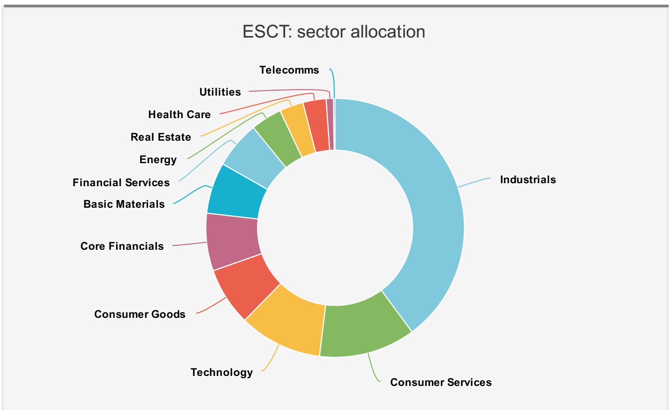
Fig.1: Geographical Allocation



Source: Janus Henderson, as at 31/08/2023

The sector chart highlights a similar point, and whereas 'industrials' is a big allocation, the same is true of the index, and most of the individual company examples given above, with very diverse business models, would fall into this category. It's also true to say that industrials as an overall category is very diverse.

Fig.2: Sector Allocation



Source: Janus Henderson, as at 31/08/2023

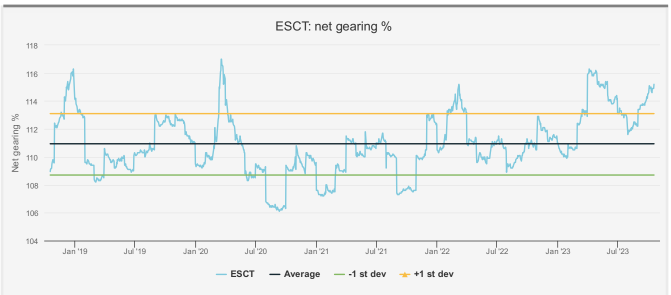
Overall, the ESCT portfolio is well diversified, and Ollie and the team's approach should see the portfolio respond to different market conditions over time, giving it the potential to generate returns during various market phases where one style or another might be more popular with investors.

Gearing

ESCT is currently geared c.15% , a little above its five year average of 10%. The chart below shows how Ollie has kept gearing mostly below average in recent years, in order to reduce overall risk. More recently he has been slightly increasing gearing as he feels there is a lot of negative sentiment toward the market and positive news for his portfolio companies isn't necessarily being rewarded. He isn't trying to call a turn for the market, but his view is if an equity investment trust is going to use gearing dynamically, this is an appropriate time to gradually increase gearing, when valuations are low and sentiment is negative.

ESCT uses short-term borrowings and has no long-term structural gearing. The board and manager can therefore choose to move gearing quite dynamically. Formally, the limit on borrowing at the time of investment is 30%.

Fig.3: Net Gearing

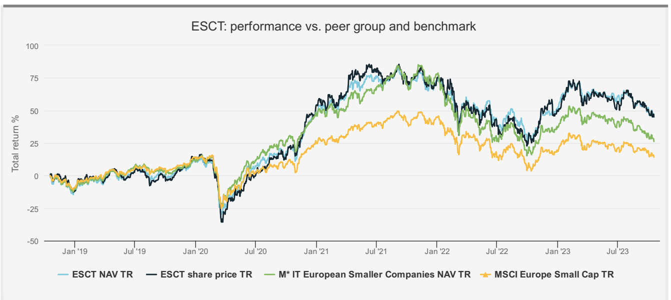


Source: Morningstar , as at 10/11/2023

Performance

ESCT's five-year performance is shown in the chart below. Over the last five years, the NAV and share price total return was c.46% and 40% respectively, compared to total returns of c. 21% and c.25% for the benchmark and peer group NAV total return respectively.

Fig.4: Five-Year Performance

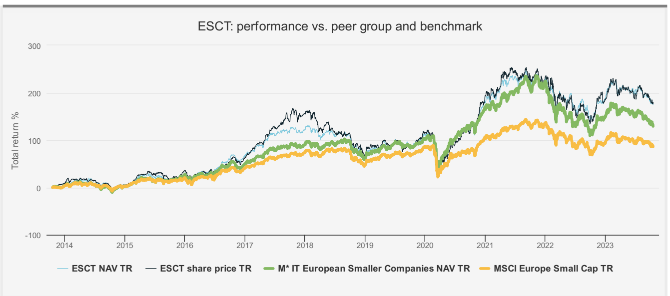


Source: Morningstar, as at 13/11/2023

Past performance is not a reliable indicator of future results.

Over ten years, shown below, ESCT's NAV and share price total return are almost identical to each other, at 171%, compared to 126% and 128% for the benchmark and peer group NAV total return. Ten years is a useful period to look at, as it provides a reminder that small caps have the potential to outperform large caps with the equivalent large cap index, the MSCI Europe ex. UK, providing a total return of c.86%. The last five years has seen the opposite of that, with large caps materially outperforming small caps in Europe and elsewhere, perhaps shifting attention away from the potential of small caps, leaving them on historically low valuations discussed in the **Portfolio section**. In fact, as we look at in more detail below, ESCT itself outperformed large caps over this five-year period.

Fig.5: Ten-Year Performance

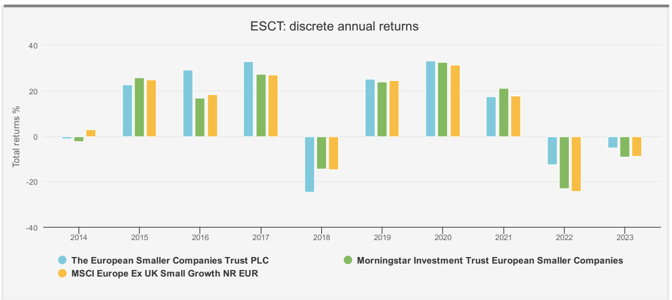


Source: Morningstar, as at 13/11/2023

Past performance is not a reliable indicator of future results.

The next chart breaks out returns into discrete calendar years. Although investors don't, or perhaps shouldn't, own small caps for their defensive capabilities in down markets, the chart shows that in 2021 and 2022, Ollie and the team did a good job of limiting the downside in a strategy where one wouldn't necessarily expect this, mainly as a result of good stock selection. There was a very different outcome in 2018, where ESCT had a tough time absolutely and relatively. Overall though, ESCT has produced its long-term outperformance in a variety of market conditions.

Fig.6: Discrete Annual Returns



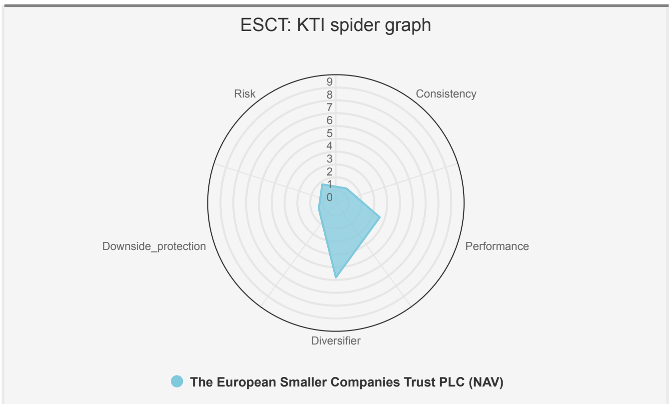
Source: Morningstar, as at 13/11/2023

Past performance is not a reliable indicator of future results.

In our proprietary spider chart below, we show how ESCT has performed versus an expanded peer group of all European and European Smaller Companies trusts over the past five years in some key categories. Each category is scored out of ten based on rolling 12-month returns over the last five years, 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.

As we note above in this section, small caps have underperformed large caps over the last five years, with ESCT's benchmark up c.21% against the large cap equivalent's c.39%. ESCT's own NAV total return over this period of c.49% does, however, beat the large cap benchmark, which itself is more indicative of the performance of the large cap trusts which ESCT is being compared to in our analysis. So while ESCT's 'performance' score in the chart below is quite respectable, the context is important, and against a purely small cap peer group the score would be higher. As discussed in the **Portfolio section**, ESCT operates lower down the market cap spectrum than even many of its peers, so it is an expected result that it scores well as a 'diversifier'.

Fig.7: KTI Spider Graph



Source: Kepler Trust Intelligence, Morningstar, as at 30/06/2023

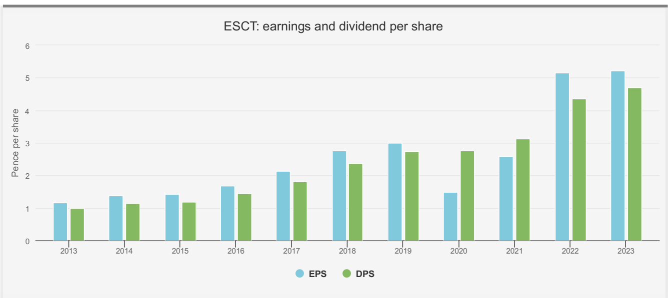
Past performance is not a reliable indicator of future results.

Dividend

ESCT currently yields c. 3.3%. Aside from European Assets, (EAT), which has a high dividend policy using a mixture of income and capital, ESCT is the highest yielding trust in the peer group. The chart below shows that ESCT has a long-standing progressive dividend, and in most years, the dividend is covered by earnings. Revenue reserves were used in 2020 and 2021, a period when many companies suspended or reduced dividend payments. At 30 June 2023, ESCT had approximately 8.2 pence per share in revenue reserves, compared to dividends paid in respect of the financial year of 5.22p, therefore ESCT has well over a year's worth of reserves available to smooth dividends in future.

At our recent meeting, however, Ollie was keen to point out that the trust is primarily targeting capital growth and the recent rise in dividends is a consequence of actions he took to reposition the portfolio more defensively in 2021 and 2022, rather than specifically targeting higher yielding companies. Athough we think it seems likely that the board will want to maintain the progressive dividend, we think the big increase in earnings and dividend between 2021 and 2022 should be seen as exceptional, rather than as part of a trend.

Fig.8: Earnings And Dividend Per Share



Source: ESCT

Management

Ollie Becket is ESCT's lead fund manager. He joined Janus Henderson in 1998 and was appointed lead fund manager of ESCT in 2011. He also manages the Janus Henderson Horizon Pan-European Smaller Companies fund, the Janus Henderson Pan-European Mid and Small Cap fund and the Janus Henderson European Smaller Companies fund, managing £1.59bn of which ESCT is £755.7m. Ollie first joined Henderson as an assistant portfolio manager for European equities 1998 and was named fund manager in 1999. He moved to the Global Technology Team in 2000. He left Henderson in 2003 to pursue other interests before returning to his current role with the firm in 2005. He has c. 28 years' experience.

On ESCT, he is supported by Rory Stokes and Julia Scheufler. Between the three, they don't divide the portfolio up by sectors, instead aiming to support and challenge each other in decision making. Ollie also notes that he places a lot of value in his informal network of other fund managers in the equities team, and he takes an active interest in what other teams in the UK and Europe are investing in.

Rory joined Henderson in 2013 as a European equity analyst. Prior to that he worked on the sell-side in small and mid-cap sales. He began his career at HOLT Value Associates as a research analyst in 2001, and this is one of the screening tools that the team use as part of their initial process of identifying opportunities.

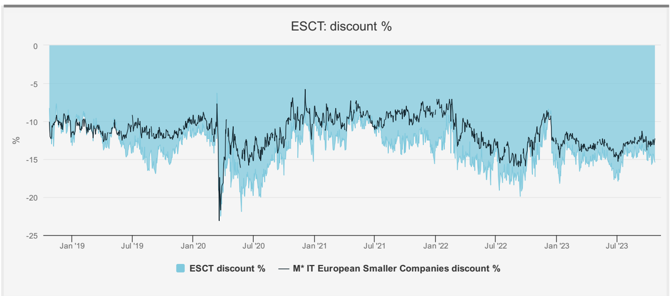
Julia Scheufler is an Associate Portfolio Manager on the European Equities Team at Janus Henderson Investors, a position she has held since 2022. Prior to this, she was a research analyst with the team from 2018. She was previously a sell-side analysis and also worked in a multi-asset fund management team.

Discount

ESCT currently trades at a c. 15% discount, in line with the peer group. Over the last five years ESCT has averaged a 13.5% discount and the peer group has averaged 11.4%.

ESCT's board takes powers to buy back 14.99% of shares each year. The board does not state a level at which it will buy shares back, but factors such as the discount compared to the peer group and the absolute level of the discount are considered when assessing whether a buyback should be executed. In our view, buyback policies should reflect the underlying assets, and although ESCT does have good portfolio liquidity, it is a small cap fund which could from time to time experience lower levels of liquidity in its underlying portfolio, and it also employs gearing. Therefore, we think keeping a flexible approach is appropriate. In October 2023, the board began buying shares back as the discount started to trend beyond 15%.

Fig.9: Five-Year Discount



Source: Morningstar, as at 13/11/2023

ESCT has a continuation vote held every three years, with the next vote scheduled for 2025. While investment trust shareholders do, from time to time, vote against continuation, this is usually in extreme circumstances, and more often than not continuation votes are a chance for the trust's board to consult with shareholders before the vote is held. As such we view continuation votes as a standard backstop protection for shareholders.

Charges

ESCT's ongoing charges figure (OCF) is 0.65% (excluding its performance fee, see below) compared to an average of 0.91% for the AIC European Smaller Companies peer group. The reduction in yield (RIY) figure is 1.39% compared to the average of 1.62% for the peer group, although RIY calculation methodologies do vary.

ESCT has a tiered management fee of 0.55% of net assets up to £800m and 0.45% thereafter. There is also a performance-related fee. Including the performance fee, the OCF for the year ending 30 June 2023 was 1.67%.

The performance fee is 15% of the positive difference between the average annual NAV total return and the average annual total return of the benchmark, measured on a rolling three-year basis.

- Total fees in any year are capped at 2.0% of NAV;
- A performance hurdle over the benchmark of 1.0% must be reached before any performance fee can be earned and is excluded from the performance fee itself should one be payable;
- Performance is measured solely on the basis of NAV total return relative to the total return of the benchmark index;
- No account is taken of whether the NAV grows or shrinks in absolute terms.

ESG

ESCT is assigned an overall "average" ESG score by Morningstar, which compares it to all similar funds, both investment trusts and open-ended funds. European equities as a group score better than average in a global context, so an "average" score within a peer group of European funds may still be slightly higher than the global average.

As we find is increasingly the case, ESG is integrated into the investment process. Ollie's view is, in summary, that he is broadly supportive of key ESG objectives such as the energy transition, and views them as investment opportunities, as these are real-world trends and many European smaller companies are involved directly or indirectly in supply chains or in providing services to companies at the forefront of these trends. As we discuss in the **Portfolio section**, ESCT is exposed to a number of companies operating in different areas of the energy transition, and this is likely to remain a key theme for the portfolio.

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