Jupiter European Opportunities

Update
22 October 2019

Summary

Jupiter European Opportunities (JEO) offers investors exposure to a portfolio of European companies that offer good prospects for capital growth; irrespective of short-term economic trends and the business cycle.

The portfolio is run by Alexander Darwall, one of the most successful fund managers in the investment trust space in recent years. The results of Alexander's long-term, high conviction view and stock-picking approach can be seen in the performance numbers.

Over a five year period, JEO boasts an alpha of 6.25 and a Sharpe ratio of 1.08. In NAV terms, JEO remains amongst the best performers in the European equities investment trust peer group over three, five and ten years.

JEO has consistently traded at a premium rating relative to the rest of its peer group. Recent uncertainty relating to its continuing management arrangements has, however, resulted in a small discount of 2.5% as at the time of writing.

Analysts View

Alexander Darwall is a world-renowned manager with one of the strongest track records across the investment trust universe. Over his 19 years at the helm of JEO, performance has been exceptional; the NAV total return from launch on 20 November 2000 to 30 September 2019 is 863.5%. This compares with a total return of 198.8% on JEO's benchmark, the FTSE World Europe ex UK index, and a total return of 179.4% on the FTSE World Europe inc UK index.

Recently JEO has spent a great deal of time in the limelight. In early 2019, JEO featured in the press following Financial Times allegations of accounting irregularities at digital payments company Wirecard, currently the largest holding in the portfolio. As a result the discount widened. Alexander maintains his confidence in Wirecard, highlighting that it has delivered on all expectations during the course of 2019. Although the holding has recovered strongly, Wirecard has continued to lag JEO's benchmark index returns over the past twelve months. The announcement of Alexander's intention to leave JEO to form Devon Equity Management in July 2019 also resulted in a widening of the discount. Despite this, there will be no change to the management strategy for JEO at Devon. Additionally, within a separate management entity, Alexander and his team's primary focus will be on JEO for the foreseeable future. Consequently, we view the current discount as a buying opportunity and think it could prove an attractive entry point into the trust. Alexander's long-term track record is difficult to ignore, and the trust has only been available at a discount of this level a handful of times since the financial crisis in 2009.

The travails of Woodford Investment Management (WIM) are specific to that manager, in our view. By contrast, Devon has implemented a compelling risk management infrastructure around Alexander, and has further committed not to invest in any unlisted equities or derivative instruments for their clients.

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Analysts View

BULL	BEAR
Exceptional long-term track record	Wirecard coverage draws attention to the fact that this is a highly concentrated portfolio, and the risks that this brings
High conviction, stock-picking manager	Short-term performance has lagged the benchmark (over one year)
Pragmatic mandate enables manager to look for best 'European' opportunities	Devon Equity Management is a young company

Portfolio

Since launching JEO in 2000, Alexander has applied exactly the same tried and tested approach to managing the trust. He is a bottom-up investor; using rigorous fundamental analysis to identify companies that can retain their high growth characteristics and profitability for much longer than many other investors expect. Alexander prefers companies that have less capital intensity, use digital channels and have a large amount of intellectual property. His focus does not, however, include start-ups or 'pre-profitability' companies. Finding these companies is no mean feat. Over any 12 month period, Alexander will buy between 10-15 new companies on average, which will represent around 0.5% of the portfolio each. Once a company has been identified as a suitable investment, Alexander and Luca Emo research the company's management teams to better understand them. He will then further add to the position as his confidence in the investment thesis increases. Until he believes that the growth 'runway' has shortened or expired, Alexander will continue to hold the position. A key part of this process involves meeting the management teams – in the last year alone Alexander and Luca met around 190 companies.

The tendency is to select only a few new investments each year, with the intention of continuing with even fewer and only running those that are the most successful. This means that portfolio concentration is relatively high. As at 30 September 2019, 71% of JEO's total assets were invested in the top ten holdings, which is highly concentrated relative to many other funds and trusts. In fact, there are four holdings within the portfolio which account for close to 40% of the NAV, three of which have been part of the portfolio for more than twelve years: Novo Nordisk, Dassault Systemes and Wirecard.

Alexander is benchmark-agnostic, with few restrictions. His focus is on ensuring that the companies in the portfolio will undertake a substantial proportion of their business activities within Europe. Exemplifying this, Alexander has run the portfolio with a consistently high active share relative to his benchmark index of around 90% since launch.

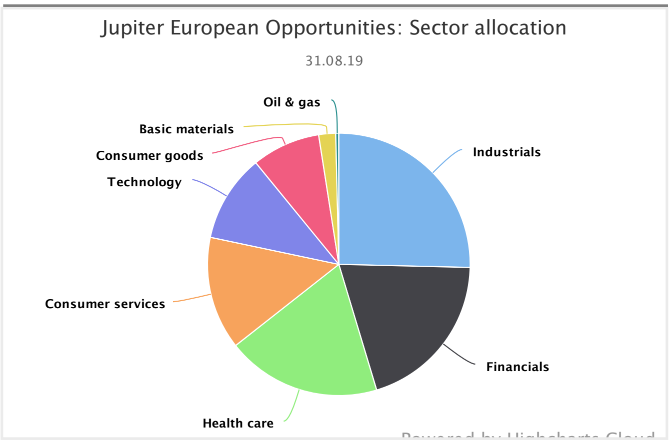
Top Ten Holdings As At 30/09/19 As % Of Total Assets (Inc Drawn Down Bank Debt)

	%
Wirecard	14.1
RELX	8.6
Novo Nordisk	8.4
Experian	8.1
Deutsche Boerse	7.6
Adidas	5.2
Intermediate Capital	5.2
Amadeus	4.8
Dassault Systemes	4.8
Grenke	4.5
Total	**71.3**

Source: Jupiter Asset Management

The portfolio typically trades at a premium to the benchmark (FTSE World Europe ex UK TR). Currently the forward P/E of the portfolio on next year's earnings is 26.4X, against the index P/E of 19.8X. Furthermore, the weighted average price to cash flow ratio is 25.7X, relative to the index of 15.3X. Alexander has been justified in owning higher rated companies, given that these more expensive companies (on a weighted average basis) have grown twice as fast as the market; over three years growing EPS by 14.6%, against the market's growth of 4.5%. The portfolio also has a bias towards large and mid-cap companies (a weighted average market cap of around €25.9bn), which can benefit from efficiencies of scale. There are some sectors that Alexander will typically steer clear of, including real estate, utilities and commodities, as they do not exhibit the characteristics he looks for in companies. Instead, the majority of his ideas typically come from the technology, healthcare items, industrials and media sectors. The current breakdown can be seen in the graph below.

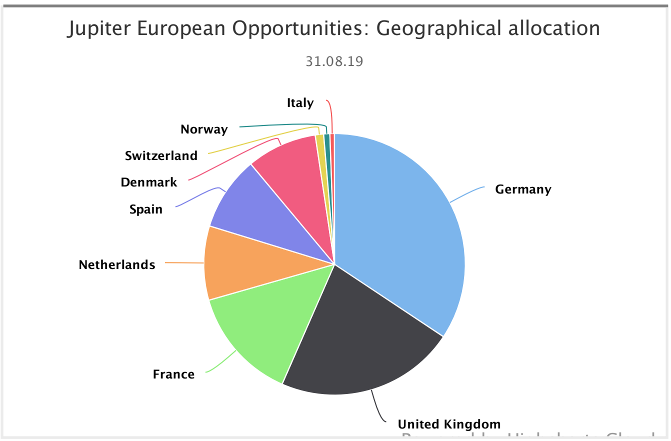
Fig.1: Sector Allocation As At 30/09/19



Source: Jupiter Asset Management

As previously mentioned, Alexander has full flexibility to invest in companies listed outside of mainland Europe, unlike others in the AIC Europe sector. Currently around 22.6% of assets are invested in UK listed companies, although the largest geographical weighting comes from Germany at 34.3%. The country where a company is listed plays no part in Alexander's investment process.

Fig.2: Geographical Allocation



Source: Jupiter Asset Management

Wirecard remains a very large holding for the trust. The rollercoaster ride experienced by investors is discussed in the performance section. Needless to say, Alexander's investment process revolves around his own research, and not listening to 'noise' in the media or the market. It would appear that he has been vindicated in not selling a single share in Wirecard for JEO in the year to date. The JEO board has subsequently been exonerated too, for not forcing him to cut what has grown to become a very large position in the portfolio.

A big contributor to returns over the past few years has been Adidas, as discussed with the management team when we spoke to them recently. The affiliation with Adidas reflects the investment process well. Alexander has followed the company for many years and towards the end of 2017, following a change of management, he initiated a position at 0.5% of NAV. The clear management focus on Adidas's European operations has led to a marked improvement in the performance of the business there. The company has started selling products direct, which has boosted margins and – with further additions and share price performance – is now a 6% holding.

Gearing

Overall, Alexander's philosophy aims to increase gearing in JEO at times of low valuations, and decrease it in stronger markets. To support this, he has permission from the board to vary the level of gearing up to 20% of total assets.

According to the manager, gearing has averaged 15% over the past 19 years since the launch of JEO, until recently, when at times it has been lower. Gearing has, nonetheless, remained relatively stable over 2019, reaching highs of 10% and lows of 4.5%. As at 30 September net gearing was at 7%, towards the lower end of the historic range.

Returns

JEO has long been one of the standout trusts across the AIC Europe peer group, and the entire investment trust universe for that matter. Undoubtedly, this is largely due to Alexander's successful management. Since 2001, the first full calendar year in which Alexander ran JEO, he has only underperformed the benchmark in two years – 2008 and 2016 – both of which were rather momentous and challenging years for active management. He has also outperformed the average open-ended European equities fund in every calendar year except the two years mentioned.

The compounding effect of Alexander's outperformance has meant that the trust has delivered a stellar result for shareholders. Over the past ten years (up until 30 September 2019) the trust has delivered NAV total returns of 380.5% against a benchmark return of 115.9%, and the Morningstar Europe investment trust peer group average return of 168.7%.

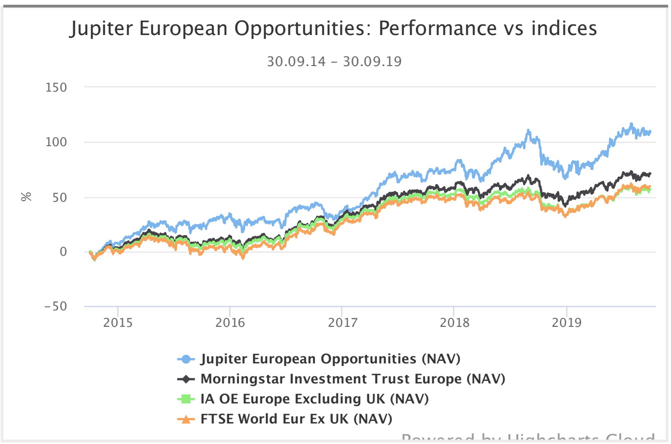
Fig.3: Nav Calendar Year Returns

Source: Morningstar

Over the medium term, JEO's results are equally impressive. Over five and ten year periods, Alexander has comfortably the highest levels of alpha in the peer group at 4.22% and 6.25% p.a. respectively. This record has not been without volatility, however, and over the same time periods JEO has displayed standard deviation of 24.8% and 20.9% respectively. In comparison, the peer group average has been 16.6% and 18.54%.

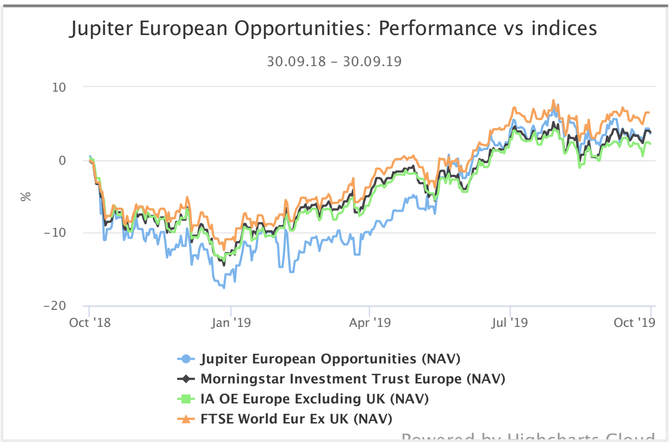
JEO's performance has been more variable over the past year. Up until 30 September 2019, JEO generated NAV total returns of 3.3%. This compares to 6.4% from the benchmark and 3.4% and 2.2% from the AIC and IA peer groups respectively. Although these are not bad returns, JEO was hit hard at the start of the year by allegations of accounting irregularities against Wirecard, the largest holding in the portfolio, constituting approximately 15% of NAV. These allegations resulted in the shares in Wirecard falling by around 40%. Alexander has continued to undertake a great deal of due diligence into the company and the accusations laid before it; and he maintains his confidence that the investment proposition has remained intact. In turn the JEO board has maintained its confidence in Alexander's convictions and, aside from preventing him from adding to his already large stake, did not oblige him to sell any shares. Consequently, not a single Wirecard share has been sold by JEO in the year to date, and JEO has been able to benefit from a significant subsequent share price recovery. Wirecard has also recently announced (October of 2019) that KPMG will be conducting an independent audit of the company to help calm investors. Alongside this, Alexander has noted that Wirecard has delivered good results in line with its own forecasts over 2019 and he anticipates that earnings guidance will be raised again later this year.

Fig.4: Five-Year Performance



Source: Morningstar

Fig.5: Performance



Source: Morningstar

Dividend

JEO is a capital growth focused trust. Any dividends it has paid historically have come solely from the need to distribute 85% of the distributable income it receives in order to maintain investment trust status with HMRC. At the current dividend level, 5.5p for the financial year ended 31 May 2019, the shares yield 0.7%.

Management

Alexander joined Jupiter Asset Management in 1995 from the sell-side at Goldman Sachs. In the same year he took over Jupiter European Investment Trust PLC, which was reconstructed into JEO in November 2000. For the past twelve years Alexander has been supported by fund manager Luca Emo. Together they have been running a number of funds at JEO, including a £5.3bn European unit trust and a £2.4bn European Growth Luxembourg SICAV. In April 2019 it was announced that Alexander would be stepping down as manager of these funds in order to focus solely on the investment trust.

It was subsequently announced, in July 2019, that Alexander would be leaving Jupiter to launch his own fund management business, Devon Equity Management. The JEO board has since consulted with major shareholders and appointed a firm of specialist professional advisers. These advisers will conduct due diligence into both Devon and a proposed new Alternative Investment Fund Manager, FundRock Management Company. Under the appointments, which have now been confirmed by the JEO board, FundRock will act as the AIFM and Devon as the delegated investment manager to the company. It is anticipated that the appointments will take effect on 15 November 2019.

We understand that Devon will represent a 'back to basics' approach for Alexander. He wants to remain focused on companies that produce fabulous products and services for customers, first and foremost. As part of its FCA application process, we understand that Devon is prohibiting itself from investing in unlisted companies, and avoiding the use of derivatives. Alexander's investment philosophy has always been to stay away from the 'noise', focusing on fundamentals and what companies are saying rather than brokers' announcements. We therefore see no reason why Alexander should not continue to operate as he has, and to generate the strong returns he has achieved, outside of a large fund management organisation.

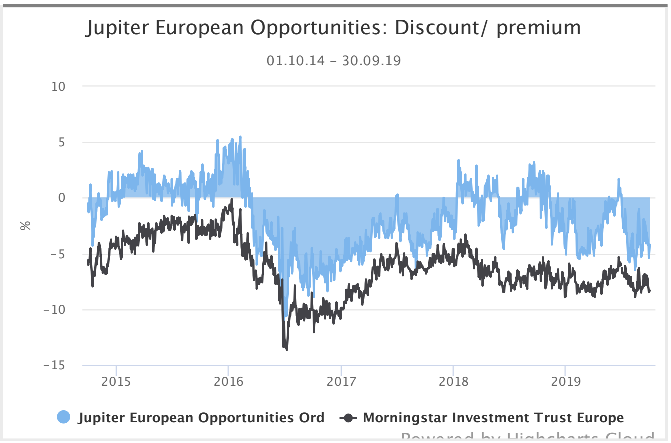
Discount

Over the past five years, JEO has consistently traded at a premium rating compared to the rest of the European investment trust peer group. In terms of discount, European investment trusts across the board have recovered much of the ground lost since the referendum. JEO is no exception, having come back from a low point of a near 14% discount to its current rating.

Throughout 2019 we have seen volatility in the discount – largely thanks to Wirecard and uncertainty around Alexander's future – and currently the trust is trading at a discount of around 2.5%. The ordeal with Wirecard illustrates the risks of investing in a highly concentrated portfolio. It has also highlighted the risks of investing in investment trusts at premiums; where a relatively poor period of NAV performance can be exacerbated for shareholders by a simultaneous widening of the discount. Soon after the discount narrowed, when the shares were trading on a small premium, the announcement came that Alexander would be leaving Jupiter to set up his own investment management business. The uncertainty, potentially intensified by the travails of Woodford Investment Management (WIM), has led to the discount widening once again.

We understand that Devon has committed to not investing in unlisted equities, and any changes to the relatively low turnover approach should provide an early warning of 'style drift'. The JEO board has the ability to buy shares back, but it last did so in 2011 when the trust was trading on a discount of around 11%.

Fig.6: Discount



Source: Morningstar

Charges

Jupiter Asset Management has previously charged a fee of 0.75% of gross assets, i.e. including any drawn down bank debt. Additionally, the manager has been entitled to a performance fee of 15% of NAV outperformance of the benchmark. This equated to 0.8% of net assets over the financial year to 31 May 2019. Currently, the OCF of the trust stands at 0.9% (excluding the performance fee), relative to a sector weighted average of 0.89%. Under its new management arrangement, with effect from 1 June 2020, Devon and FundRock will be paid management fees of 0.9% per annum of net assets (i.e. excluding drawn down bank debt) up to £1bn; and 0.8% per annum on net assets over this amount. No performance fee will be payable. During the transition period from 15 November 2019 until June 2020, again, no performance fee will be payable. In addition, however, to the quarterly management fee continuing to be paid to Jupiter for the term of its notice period, the JEO board has agreed to pay a fee of 0.03% p.a. of net assets to FundRock, and a base management fee of 0.1% p.a. of net assets to Devon.

ESG

As we discuss in this article, published in September, by focusing on a portfolio – i.e. the output of an investment manager's investing process – many statistical analysis tools relating to environmental, social and governance (ESG) fail to accurately capture the ESG inputs into an investment process. The perils of following a statistical approach to ESG investing are illustrated by JEO. Alexander has paid great attention to board and company governance for a long time, seeing it as a key determinant of strong business performance. He does, however, openly state that he invests for profit rather than a 'higher purpose'. In his presentation he even states that he believes ESG can subvert the aims of business and investment, sometimes driving companies into the hands of private equity (who traditionally have held fewer qualms about ESG issues). Despite this, Alexander's portfolio scores relatively well, in absolute terms, on output-based ESG; though clearly his ESG input is relatively low. Without knowing what a manager thinks or believes in (regarding ESG themes), an investor might unwittingly find themselves exposed to a fund that is unrepresentative of their ESG aims and objectives. In this context, JEO might be exactly that sort of fund.

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