Kepler | Investment Companies Research

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Non-independent research

Update report:

Charter European Trust PLC

Sector:	Europe	Price @ 25/05/10:	199p
Ticker:	CPE.L; CPE LN	NAV @ 25/05/10:	229p
Mkt Cap:	£46m	Discount @ 25/05/10:	-13.1%
Total Assets:	£55m	Discount (1 yr ave.):	-9.3%

Summary

Charter European continues to outperform its benchmark through a high conviction stock picking approach. This year marks the Trust's third financial year of rapidly shifting market conditions in which this outperformance has been maintained. With a wide disparity of views on the Eurozone, we thought it would be useful if the main focus of this update centred on an interview with the manager.

Concentrated portfolio of high conviction stocks

- Mark Lovett runs Charter European Trust in a high conviction manner with a c.30 stock portfolio. He often takes a contrarian view, but always invests in companies he knows intimately and which he believes will deliver strong returns to shareholders. He aims to profit from taking a longer term view than the rest of the market.

Discount has widened out considerably to 13%

- Amongst the uncertainty in European markets, the discount on the trust has widened out considerably, which for the believers represents an opportunity to gain exposure at an opportune moment.

Mark has clear views of how he will profit from the current economic conditions

- We met up with Mark recently to discuss European markets, his view of the situation, how the portfolio is positioned and for an outlook on a situation that appears to continue to unfold. He views the current situation as serious, but one that throws up opportunities. His portfolio has been positioned for divergent economic growth within the Eurozone for quite some time and as such he believes Charter is well positioned. He has made few changes to the portfolio, other than adding to positions using cash on the balance sheet built up over the last month. He believes that with the companies he owns he does not have to worry about the prospects for European growth as a whole.

"conviction-led... global companies...on fabulous valuations"

- Mark summarises his view of Charter as "a conviction-led, bottom up built portfolio of global companies, on fabulous valuations, which I expect to benefit (amongst other things) from the positive knock-on effects of the weakening Euro".

Consistent outperformance of benchmark in 4/5 of past financial years

- Mark has consistently outperformed his benchmark in four out of the Trust's past five financial years. This year is shaping up to be a challenge, but Mark's very strong start to the current financial year means that he still remains 2.1% ahead of the benchmark so far this year.

Mark's consistent outperformance of the benchmark, together with the historically wide discount of c.13%, must make Charter European a good candidate for investors looking to take advantage of recent market weakness. Mark appears very confident of his positioning in these rapidly changing markets and with such a concentrated portfolio, he should be able to navigate the difficult conditions well for investors in the Trust.

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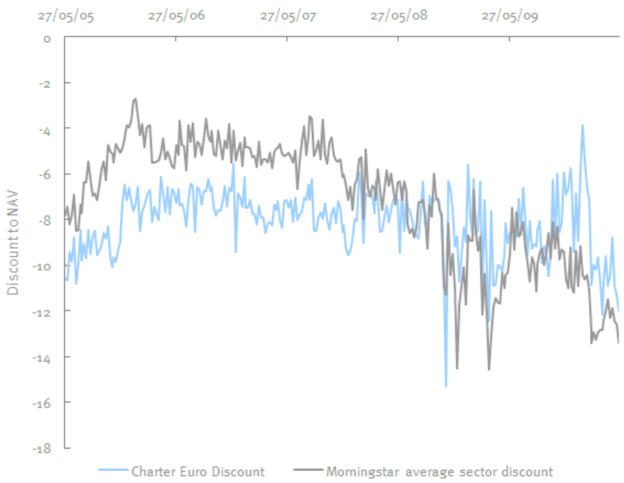
IMPORTANT DISCLOSURES ARE INCLUDED AT THE END OF THIS REPORT

Background

Charter European Trust (Charter) has the most concentrated portfolio in its peer group. Mark Lovett has been the manager since 2002, and has followed the focused stock-picking style since November 2004 since when it has been a strong performer relative to peers and the benchmark. The investment trust provides exposure to a handpicked portfolio of continental European companies managed in a contrarian manner, Mark always aiming to have a longer term view on stocks than the rest of the market.

Since our last research report of 18th February, the atmosphere in European equity and bond markets has changed significantly. Amongst this uncertainty, discounts on the European investment trust sector have widened out considerably.

FIG 1: 5 YEAR DISCOUNT HISTORY RELATIVE TO SECTOR



Source: Morningstar

Interview with Mark Lovett

We recently met up with Mark to try to establish whether investor's worst fears are likely to be realised, or whether there is reason to be optimistic.

We reproduce an edited version of our conversation:

Following the falls we have seen in equity markets, is this a good entry point for buying European companies?
Everyone is very downbeat, but it is important to remember that the countries causing the headlines are peripheral countries. The heart of Europe in terms of economic growth is Germany, France and Scandinavia. These countries are benefitting massively from the Euro devaluation. I believe that the export driven northern European countries will get quite a noticeable kicker to GDP growth from the euro weakness.

Is therefore the obvious trade to be long northern Europe and short (or avoid) southern Europe?
Certainly that has been the way to play it so far. However, the natural contrarian in me worries that as now everyone is talking about it, one has to be very careful if one were applying this investment philosophy.

Whilst I did not expect to see the extreme tensions now found within Europe, for a long while now I have been anticipating a large differential in growth between the European countries. What matters now is the duration of the problem. Country specific factors have not been an issue for the past 10 years, but now it's an incredibly powerful factor to take account of. For example you could get say four years of where the growth rates of the major economies could be materially different from the other countries in the Eurozone as the latter do what they need to do to stay within the euro. They need to reduce indebtedness, put austerity packages in place etc which means that growth rates in Southern Europe could be very low for an extended period.

What are your expectations on the value of the Euro?

If there is a perception that the southern European countries now "get it" and are seen to be taking the medicine, then there is a chance that the Euro could regain its status as a reserve currency. There are number of points of challenge before we get to that point. If it holds together, the Euro will definitely be perceived as being much stronger for having got through the crisis. In the short term however, the uncertainties around execution will remain a drag on the currency.

Certainly i don't think that the Euro needs to soften any further to give the northern European exporters the shot in the arm that i mentioned earlier. These exporters are already seeing a significant improvement in their terms of trade, particularly with the relative strength of the dollar (and other dollar based currencies). The southern European countries are not a big enough part of global trade to offset the benefit of the euro weakness on their northern brethren. The danger is their effect on the overall union, and the risk of contagion, rather than their effect on the global economy.

Are companies in Northern Europe therefore heavily represented in the Charter portfolio?

In managing Charter, country very much takes a far back-seat to individual stock selection. However, at present there happens to be a very heavy bias towards companies based in the northern European countries including Scandinavia. As i mentioned earlier, i have been anticipating quite a differential in growth rates between countries in the Eurozone for quite some time.

There remains in Charter, which has been a strong theme over the past two years, an emphasis on business to business spending and I have generally avoided companies exposed to consumption. However, I do have exposure in the portfolio to Asian and Emerging market consumer spending growth which i believe is very strong. I missed the Auto sector which has been an incredibly strong performer, but luxury goods companies that I own such as Swatch and Richemont have also been big beneficiaries of emerging market growth. I believe business to business spending is going to be a much more powerful driver over the next few years than public spending or consumption. Good examples include the media agencies (Publicis, GFK). Companies are starting to loosen the purse strings, whilst the consumer (particularly in the Anglo Saxon countries) still needs to reduce their overall level of indebtedness.

FIG 2: PORTFOLIO BREAKDOWN AS AT 30TH APRIL 2010

Top ten holdings	% of portfolio	Sector breakdown	% of portfolio
Intnl. Personal Finance	5.6	Financials	29.4
ASM International	5.5	Consumer Services	16.1
Credit Suisse	5.3	Technology	12.9
Eutelsat Communications	5.0	Industrials	10.7
Flsmidth & Co	4.9	Consumer Goods	10.6
Barco	4.5	Health care	7.3
Zurich Financial Services	4.4	Oil & Gas	4.8
GFK	4.4	Utilities	2.3
Unicredit	4.3	Telecoms	0
BNP Paribas	4.1	Basic Materials	0
Total	**48.0**	Cash	5.8

Source: RCM

In terms of your exposures to banks – what are your thoughts behind these?

We are underweight the banking sector generally, but I have focussed the portfolio heavily on banks who have strong balance sheets, a diversified stream of earnings, strong and prudent management and businesses that are not dependent on the wholesale market. That is why I have Credit Suisse, BNP and Unicredit only. These are not levered plays into a banking recovery, and as a result these banks will have a lower beta than the rest of the bank sector. I am more than happy to get less "bang for my buck" if it means i can own businesses that are in control of their own destiny. I don't see a major problem in the peripheral euro country debt that these companies hold in the quantities they hold it, provided you don't see the risk of a default in a major euro based economy such as Italy for example. Controlled defaults of Greece, Portugal and even Spain would not be big enough for the companies I own to cause a problem in terms of capital requirements.

Given your very flexible mandate you don't have to own any banks at all. So you must believe this is a good time to be in the banking business?
Significant capacity has come out of the banking market and the potential to earn very good returns is high. This is particularly the case if a bank can finance this activity itself, rather than dilute the returns by having to tap the capital markets. The banks I own are trading under book value and I have been deploying more capital here.

Have you changed the portfolio much to reflect the recent ructions?
The portfolio continues to evolve as it always has. There haven't been any dramatic re-weightings or changes in shape. We are fully invested at the current time, and the number of holdings has remained stable at around 30 stocks.

For UK investors who don't necessarily have to be in European equities, what are the pros and cons?
Pros

- Currency weakness puts exporters in a very strong position on the world stage
- Valuations – based on P/E's and free-cash flow yields, stocks are much cheaper than in the UK and the US
- Less issues of indebtedness both at corporate and consumer levels.
- Wide collection of Global leaders in a variety of differing markets and sectors with very good "growth" investment opportunities that you can't get in the more narrowly focussed UK market.

Cons (which you cannot hide away from)

- Risk that economic growth remains more subdued than in other economies – slower in, slower out. The Eurozone economy has to overcome the perception that it is a structurally lower growth region.
- The austerity programmes in peripheral regions will inevitably attract a lot of negative press which could negatively affect sentiment even though I believe these programmes are themselves likely to stimulate strong growth in the core European countries.

The great thing for me running a 30 stock portfolio is that i don't have to really worry about the prospects for European economic growth. I have bought what I consider 30 global leading companies on really attractive valuations which are not impaired by the fact that they might be overly domestically orientated. I've always had that view of wanting to buy companies that have global leading positions. And with the Euro weakness, their position has got even stronger.

How has your performance been over the recent period?
To the end of April it was a very good start to the year which i am delighted about, particularly in view of the consistency of outperformance over previous years. The fund was up nearly 6%, relative to a basically flat benchmark which gives shareholders a big cushion in relative performance terms for the volatility over the past few days in which I have given a little of this outperformance back.

Where has your relative outperformance come from?
It has been a range of different stocks, but the important thing is that the quantum of the winners has been much greater than the detractors. International Personal Finance (a UK equity, and thereby an "off-benchmark" position) has contributed the most, other notable winners have been ASM International (semi-conductor equipment business), and Barco (digital screens in medical and entertainment industries). In terms of the overall stock market, since the beginning of this year there has been a broadening out of the sector performance. Last year it was all about getting your sectors or themes right, whilst this year it is all about the stocks.

What is the outlook, as far as one is possible?

The EU package that has been provided is credible, very market focussed and substantial in size. The debt burden is not being eliminated, it is being shared around. There is no doubt the market is challenging the ECB's perceived conservative credentials; the actions of this organisation suggests a more expansive, and many would say more politicised, contribution to seeing us through this global credit crisis. With the IMF being involved, I am absolutely convinced that these austerity programmes will be put in place. They either get put in place or the Euro falls apart. I think that this guarantees that there will be economic divergence across Europe, as well as political and social unrest. Policy actions at the moment are not inflationary. In the long term they might be, but it is not something that I am factoring in or worrying about at the moment.

I don't manage the portfolio according to thematic views. However, the companies in which i have invested fit into five broad themes which i believe remain very strong drivers of returns in the future. These are business to business spending, the weakness of the Euro, structural growth and high financial returns where companies are rerated, contrarian opportunities and finally specific banks where the balance of risk /reward is so much better now.

How would you summarise Charter European Trust?

A conviction-led, bottom up built portfolio of global companies, on fabulous valuations, which I expect to benefit (amongst other things) from the positive knock-on effects of the weakening Euro.

Performance

Mark's performance remains consistently strong relative to the benchmark, a record that Mark has maintained in widely differing market conditions, including recent ructions. Mark has given back 1.7% of relative performance this month so far, but even after this, he remains 2.1% ahead of benchmark this financial year.

FIG 3: PERFORMANCE RECORD IN DISCRETE FINANCIAL YEARS (YEAR END DATE 30TH NOV)

	2004	2005	2006	2007	2008	2009	30th Nov 2009 - 25th May 2010
NAV total return	+10.0	+25.3	+14.6	+18.0	-32.8	+39.0	-7.6
Benchmark	+10.0	+18.7	+15.6	+14.4	-36.0	+31.2	-9.7
outperformance	0.0	6.6	-1.0	3.6	3.2	7.8	2.1

Source: RCM, Morningstar, Kepler Partners

Mark's performance relative to investment trust peers can be seen in the table below.

FIG 4: PERFORMANCE RECORD RELATIVE TO PEERS AS AT 25TH MAY 2010

	1mth	Rank /9	6mth	Rank /9	1yr	Rank /9	3yr	Rank /9	5yr	Rank / 8
BlackRock Greater Europe	-15.7	6	-9.2	6	22.3	2	-10.4	4	50.0	3
Charter European Trust	**-15.8**	7	**-9.0**	5	10.4	7	-5.7	3	47.2	5
F&C Eurotrust	-14.6	3	-7.8	3	12.5	5	-33.0	9	11.0	7
Fidelity European Values	-12.2	1	-7.8	3	9.3	9	-16.6	6	36.8	6
Gartmore European	-16.3	8	-12.5	8	10.3	8	-10.7	5	49.2	4
Henderson EuroTrust	-12.7	2	-4.9	2	11.4	6	-4.9	2	53.9	2
JPMorgan European Gwth	-16.4	9	-12.5	8	13.3	4	-27.5	8		
JPMorgan European Inc	-14.8	4	-10.3	7	17.5	3	-18.5	7		
Jupiter European Opps	-14.9	5	-2.6	1	32.1	1	-4.6	1	56.4	1
SR Europe	-15.7	6	-9.2	6	22.3	2	-10.4	4	50.0	3

Source: Morningstar / Kepler Partners

Other important details

Gearing

Mark is currently fully invested (up from 5.8% cash at end April), reflecting his conviction on valuations. However, his is not geared given the high volatility in markets. Mark is able to be up to 20% geared.

Benchmark

The board allow Mark a flexible mandate. Top-down controls include stock positions no larger than 500bps relative to the benchmark, with no minimum weighting. Mark must also have stocks in at least 5 different sectors. In all other respects the board give Mark his head to generate alpha from his highest conviction stocks. Importantly, Mark is also able to invest up to 20% of the portfolio in stocks in European countries that are not in the benchmark index.

Dividend

The board dipped into its revenue reserves to maintain the dividend last financial year, paying 4.05p in total from earnings per share of 3.94p. Happily, we estimate reserves at 7.7p (or 1.9x the annual dividend), which provides plenty of reassurance on dividend sustainability in future years. The dividend represents a yield on the current price of 2.04%.

Management fees

RCM is paid a basic management fee of 0.5% of net assets. In addition, the manager is entitled to a graduated performance fee of up to 0.75% of net assets depending on the outperformance of the benchmark on a rolling 3 year basis. The total fee payable in any one year is limited to 1.25% of net assets.

Conclusion

Mark's consistent outperformance of the benchmark, together with the historically wide discount of c. 13%, must make Charter European a good candidate for investors looking to take advantage of recent market weakness. Mark appears very confident of his positioning in these rapidly changing markets and with such a concentrated portfolio, he should be able to navigate the difficult conditions well for investors in the Trust.