BlackRock Greater Europe

Kepler GROWTH RATING

BRGE offers investors an unconstrained approach to European equities and has generated sector-leading performance...

Update
09 June 2021

Summary

BlackRock Greater Europe (BRGE) offers investors a **portfolio** of pan-European equities, allocated through a high-conviction and wholly bottom-up process. BRGE is led by Stefan Gries, who manages the developed Europe allocation, and Sam Vecht, who manages the emerging Europe allocation (currently 9% of BRGE's portfolio). The managers benefit from BlackRock's substantial roster of dedicated European equity analysts.

Stefan and Sam's philosophy is one of long-term bottom-up investing, with little attention paid to macroeconomic or country-specific risk factors. They also approach investing as if they were business owners, with particular attention paid to a company's earnings and cash flow, as well as its ability to offer a unique business proposition. While BRGE's one-year turnover has begun to normalise to its pre-pandemic norm, the team have taken advantage of the global rotation to value from growth to add new positions in growth stocks at reduced valuations. The managers are generally bullish around the recovery in Europe's consumer spending, highlighting the increased tailwinds from the post-crisis stimulus.

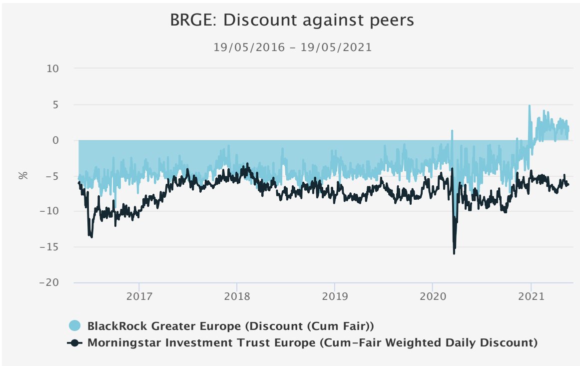
BRGE has taken the crown of the best-performing European investment trust over one, three and five years. This has been a period of impressive risk-adjusted performance, whereby its five-year Sharpe ratio of 0.92 far exceeds the benchmark's Sharpe of 0.58. Likewise, its high alpha and information ratio show to us the successful stock-picking of the team. We cover this in more detail in the **Performance section**. BRGE is now one of the few European trusts trading at a premium, likely as a result of its sector-leading performance and the tailwinds supporting the European economy, as we describe in the **Discount section**.

Analysts:

David Johnson

Key Information:

Price (p)	605
Discount (%)	1.96
OCF (%)	1.01
Gearing (%)	104
Yield (%)	1.07
Ticker	BRGE
Market cap (£)	536,532,761



Kepler View

In our view, BRGE's success is built on some of the classic properties of a successful bottom-up strategy. This is not just due to the substantial resources available to the trust thanks to its being managed by one of the largest analyst teams at the world's largest asset manager, or thanks to the team's sophisticated strategy. It is also due to their disciplined approach to long-term investing, maintaining conviction through the market cycle and thus being willing to hold stocks through periods of enhanced volatility.

While past performance should not be used to extrapolate future results, BRGE's consistent outperformance across both the near and the long term is, in our opinion, evidence of Stefan and Sam's successful execution across various market environments. It also demonstrates that even though BRGE's process can be associated with higher volatility, it has been more than compensated for by its superior returns.

We believe investors can utilise BRGE in two ways, both as a core exposure to Europe given its ability to invest in both developed and emerging Europe, and as a source of alpha thanks to Stefan and Sam's successful benchmark-agnostic approach to stock-picking. Investors should also be conscious of the clear quality growth bias of the portfolio, a style which may underperform in a prolonged value rally or rising interest rate environment.

BULL
Sector-leading performance, with strong evidence of successful stock-picking
Disciplined and high-conviction approach to long-term investing
Able to invest across the entire continent

BEAR
Currently trades at a premium to its peers
May underperform during value-driven markets
Investment approach can lead to higher volatility

Portfolio

BlackRock Greater Europe (BRGE) offers investors a concentrated portfolio of European equities, invested across the full range of market caps in both developed and emerging Europe. BRGE is managed by Stefan Gries and Sam Vecht, with Stefan focusing on developed Europe and Sam on emerging Europe. While the trust can invest up to 25% in emerging Europe, the typical allocation is c. 10%, with a current allocation of 9.3%; as a result Stefan will take the leading role in the BRGE's allocation given his larger remit. The duo are able to utilise BlackRock's substantial bank of dedicated European equity analysts, a 18-strong team which is one of the largest and most experienced at BlackRock. These analysts are separated into four sector silos: consumer services, financials, industrials and healthcare. The team also contains an individual dedicated to the analysis of big data, allowing for the incorporation of unconventional sources of information into company analysis.

BRGE is in our view a prime example of a long-term bottom-up strategy. Stefan and Sam follow an entirely bottom-up process to stock selection, investing with a high conviction then holding their companies over the long term and, at times, through periods of substantial volatility. Rarely is it that Stefan and Sam will utilise a top-down view to investing, and they are unlikely to make 'tactical' changes to their portfolio based around short-term economic data (even around such extreme events as the current pandemic). As demonstrated in the **Performance section**, the team have been rewarded for their patience and conviction. Stefan also brings with him his experience as a long/short manager, and, while BRGE is a long-only fund, his knowledge and experience of shorting stocks provides balance and perspective when looking at the attributes and potential pitfalls of companies across geographies, sectors and market environments.

Stefan and Sam approach investing as if they were business owners, which has led to their long-time horizon, with stocks usually being held for between three and five years. Stocks are selected through a combination of the work done by the European analyst team, through which a company is assigned a quantitative quality score and target valuation, and the identification of the team's preferred company characteristics. Typically, a company has to embody four investment criteria for Stefan and Sam to consider it for inclusion. Firstly, it should have a high and predictable return on equity (ROE) which can be consistently converted into cash. It should also have a clear growth trajectory through which cash can be profitably reinvested. The team also believe that quality management should lead each company, with clear paths of value creation and a strong track record of delivering returns. Finally, there should also be a unique aspect to the business in order to prevent competitors from eating away at market share, e.g. having a strong brand or market-leading product.

While BRGE is an entirely bottom-up process, Stefan and Sam utilise a creative approach to portfolio construction by employing a bottom-up approach to macro analyses. Rather than incorporating top-down factors (such as central bank policy or macroprudential expectations), they instead use their own analysis of a company's earnings projections and interactions with management in order to formulate sector outlooks. This analysis shapes Stefan and Sam's understanding of earnings and cash flow growth, rather than economic growth, as well as helping them to identify structural growth opportunities. Stefan and Sam will correspondingly construct their portfolio to reflect the companies which they believe will have the greatest long-term earnings growth, and thus those companies in which they have the highest conviction. While the team aim to take advantage of opportunities in emerging Europe, the regional allocation of BRGE is merely a reflection of the domicile of their companies rather than a specific economic advantage presented by any single country. Stefan and Sam are able to invest across the entire market-cap space, although the strategy is predominantly a large-cap strategy, with 60% of the portfolio in stocks with a market cap of over €25bn. As with the regional allocation, Stefan and Sam do not have an explicit target for the market-cap structure, and their allocation instead reflects the nature of the companies which they find most attractive over the long term.

Recently Stefan and Sam have become increasingly excited about the opportunities being presented due to the increase in global trade and consumption, highlighting that their positions in logistics companies like DSV and high-end retailers like Kering and Hermès have done increasingly well on the back of strong overseas demand for European products. Conversely, Stefan and Sam have been reducing their exposure to European banks since **our last note**. It is their opinion that the European banks are in general a shorter-term trade, and that, while they can find individually compelling banks, as a sector it is merely a play on Europe's economic recovery and rising interest rates. They believe that the industry is currently too fragmented, with customers having little brand loyalty, factors which are the antithesis of what the team look for in a company.

Active Sector Positions Vs Benchmark

SECTOR	TOP THREE OVERWEIGHTS	SECTOR	TOP THREE UNDERWEIGHTS
Technology	17.3%	Financials	-11.1%
Consumer Discretionary	7.6%	Utilities	-4.7%
Industrials	7.5%	Consumer staples	-3.6%

Source: BlackRock, as at 31/03/2021

This bottom-up approach to portfolio construction, coupled with the team's agnosticism for conventional top-down analysis, can lead them to hold companies through periods of enhanced volatility as they are unlikely to sell due to short-term market 'noise'. This conviction is best exemplified by their holding of ASML, the semiconductor equipment manufacturer. ASML has been a major holding for BRGE since 2016, a period which saw both the US–China trade war and the pandemic crash, two major external market shocks for the global economy. Given that ASML has become a global leader in the production of semiconductor systems, major hindrances to global consumption could have been seen as a sell trigger because of the implied reduction in semiconductor demand. Yet the team point out that every major crash or external shock which has led to short-term declines in ASML's share price would have been the wrong time to sell. This has been borne out by ASML's continuing outperformance and increasing market dominance, and it has been one of the major contributors to BRGE's performance over the last three years. ASML continues to offer the same high barriers to entry that the team observed when they first invested in it, thanks to its being the sole producer of cutting-edge photolithography systems, the most advanced equipment critical to modern chipmaking. The demand for ASML's products is so great that its 2022 order book has now been completely filled, and with the global shortage of semiconductors continuing ASML's demand trajectory looks to Stefan and Sam unlikely to taper off.

Top Ten Holdings

NAME	SECTOR	WEIGHT (%)
ASML	Technology	7.9
Sika	Basic materials	5.6
Kering	Consumer discretionary	5.4
DSV Panalpina	Industrials	4.9
Novo Nordisk	Healthcare	4.2
Lonza Group	Healthcare	4.2
Royal Unibrew	Consumer staples	4.1
Safran	Industrials	3.5
RELX	Technology	3.4
Hexagon	Industrials	3.4
TOTAL		**46.6**

Source: BlackRock, as at 30/04/2021

BRGE's turnover has begun to normalise since our last note, having fallen from 40% in 2020 to 5% so far this year. However, there have been a number of adjustments to the portfolio, in part because of the team's analysis identifying new opportunities and in part because of the broader growth/value rotation offering several opportunistic valuations which the team have looked to capitalise on. A perfect example of the latter is Stefan and Sam's recent investment in Logitech, the leading supplier of peripheral devices for computers. Over Q1 2021 the stock fell almost 25% from its peak of 106 CHF to a low of 86 CHF. Part of the investment rationale behind the position in Logitech was the team's incorporation of 'big data', whereby the team can incorporate huge sets of data – such as internet searches of the word 'Logitech' – to gain an understanding of the consumer trends in demand for both Logitech's products and the broader computer component market. Outside of the data-driven market trends, Stefan and Sam also believe that business travel is unlikely to recover to its pre-COVID-19 levels after having spoken to company managements about the cost savings brought about by the suspension of in-person meetings. It takes approximately €3,000 to outfit a conference room for high-quality video calls using Logitech equipment, a significant saving compared to the cost of repeated international travel.

Stefan and Sam have also made some adjustments to their emerging Europe portfolio. They have recently added a new position in Fix Price Group, the Russian discount store, and another in Ozon, a Russian e-commerce business, where they highlight the encouraging growth in Russian consumer spending. When compared to the developed market portion of BRGE's portfolio, Stefan and Sam take a much more price-sensitive approach to emerging market equities. This is because of the increased volatility in the sector, which they note not only increases the overall risk of the portfolio but can also lead to their holdings rapidly reaching a price target only to subsequently fall from that level in a short time. Stefan and Sam have sold off the leading Russian lender Sberbank as it hit their price target, triggering a sale of the entire position.

Though Stefan and Sam pay little attention to stylistic factors in their allocation, typically avoiding investing solely due to market sentiment around 'growth' or 'value' stocks, BRGE's portfolio currently shows signs of 'quality growth' allocation. The 'growth' element can be seen in BRGE's higher valuation ratios when compared to its reference index the FTSE World Europe ex UK Index, indicating a more expensive portfolio which has priced in higher growth expectations. This is matched by BRGE's superior quality metrics, showing its holdings have stronger balance sheets and better profitability. We believe that the reason behind this is twofold. Firstly, Stefan and Sam place a strong focus on quality. Given their long holding periods and track record of successful stock-picking, it is likely that over a long enough time period the market will increasingly price in the growth potential originally identified by Stefan and Sam, as happened with ASML. Stefan and Sam own views around sectoral growth trends have also led to the quality growth bias – specifically through their preference for technology and semiconductor manufacturers, the poster children of growth investing, and their aversion to financials, an industry made up of predominantly value stocks.

Fig.1: Value And Quality Metrics

	BlackRock Greater Europe	iShares Continental European Equity ETF	
P/E Ratio	37.11	21.66	Value
P/B Ratio	5.00	2.06	
P/S Ratio	3.90	1.63	
ROA %	8.35	5.59	Quality
ROE %	22.70	13.16	
ROIC	14.76	10.08	

Source: Morningstar, as at 19/05/2021

Gearing

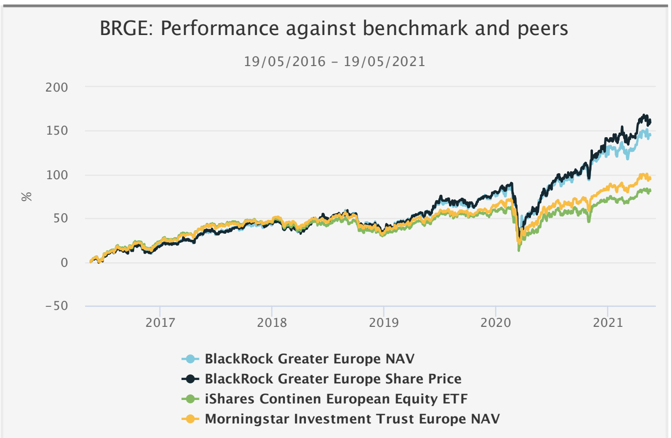
The managers have the ability to deploy gearing of up to 15% of NAV, with current net gearing of 4%. Stefan concedes that it is difficult to time the market, and that this is not something he wishes to pursue. Instead, he uses gearing as an extension of his conviction, investing in companies he would not otherwise have the capital available to access. Gearing had previously been used to purchase financial stocks during the post-COVID-19 rally. Given that he has since exited these positions the trust's gearing has fallen accordingly, which has brought BRGE closer to its five-year average gearing ratio of 3%.

Performance

BRGE is currently the best-performing European equity trust over the last one, three and five years, beating all of its peers over each observed period (as at 19/05/2021). Over the last five years BRGE has generated an NAV total return of 144.7% and a share price total return of 159.3%, far in excess of its peer group's simple average 94.6% NAV total return and the 81.0% return of its reference index, the FTSE World Europe ex UK Index (proxied by an ETF here). BRGE has also easily exceeded the returns of its open-ended peers, beating the 74.3% of the Europe ex UK funds (as defined by Morningstar). While Europe has seen more than its share of economic shocks during the last five years, BRGE's returns have been overwhelmingly driven by stock selection rather than sector allocation, with the managers reporting that stock selection being the primary contributor to its alpha.

As would be expected from a successful and highly active strategy, BRGE's alpha and information ratio have been impressive, showing successful stock selection by the managers. Over the last five years BRGE has generated annualised alpha of 6.5%, and an annualised information ratio of 1.49. BRGE also has a five-year Sharpe ratio of 0.92, above the 0.58 of its reference index. This is despite the trust also having higher five-year volatility than its benchmark, at 14.2% compared to 13.7% annualised for the reference index (a consequence of holding large off-benchmark positions during periods of enhanced volatility), showing us that BRGE has an overall superior risk/return profile to its reference index.

Fig.2: Five-Year Performance

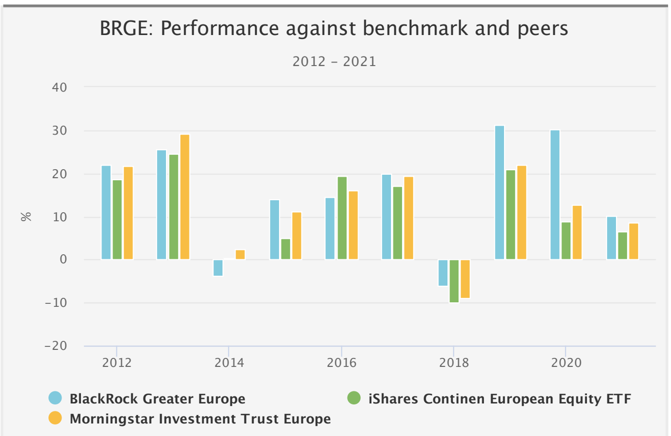


Source: Morningstar

Past performance is not a reliable indicator of future returns

While BRGE's risk stats provide evidence of the success of Stefan and Sam's stock-picking, BRGE's discrete annual performance may provide a more tangible example of the benefits of the team's approach. In seven of the last ten years BRGE has outperformed both its peers and reference index, and has done so consistently over the last five. While investors should not use past performance as a basis for future predictions, this nonetheless suggests to us that Stefan and Sam have been able to effectively execute a stock-picking-focused strategy across varying market environments.

Fig.3: Discrete Annual Performance



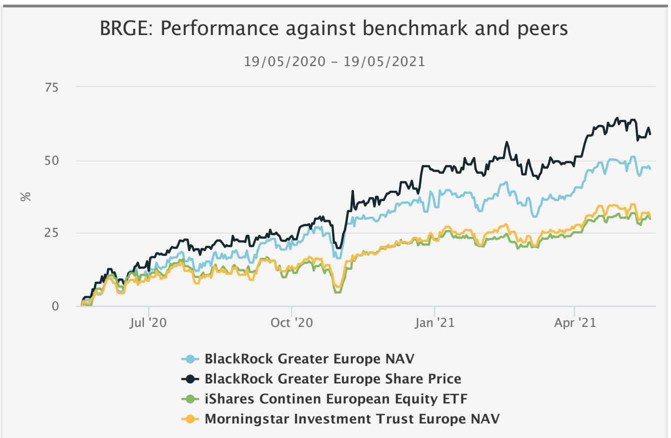
Source: Morningstar

Past performance is not a reliable indicator of future returns

The last 12 months (to 19/05/2021) have been an interesting period for BRGE. The trust generated an NAV total return of 47% and share price return of 58.9%, easily surpassing the 30.6% NAV return of its equally weighted average of its peers and the 29.8% of its reference index.

Although BRGE has performed strongly over 2021, it had initially treaded water at the start of the year as the market held its breath due to the slow vaccine roll-out in Europe and potential 'third wave' of infections. BRGE then rallied strongly on the back of Q1 earnings announcements, the catalyst for its surging performance in April. However, suggested to us that the team had identified growth in companies prior to the market. The single biggest overall contributor to BRGE's 12-month returns has been stock selection within the technology sector, in particular the overweight to semiconductor manufacturers.

Fig.4: 12-Month Performance



Source: Morningstar

Past performance is not a reliable indicator of future returns

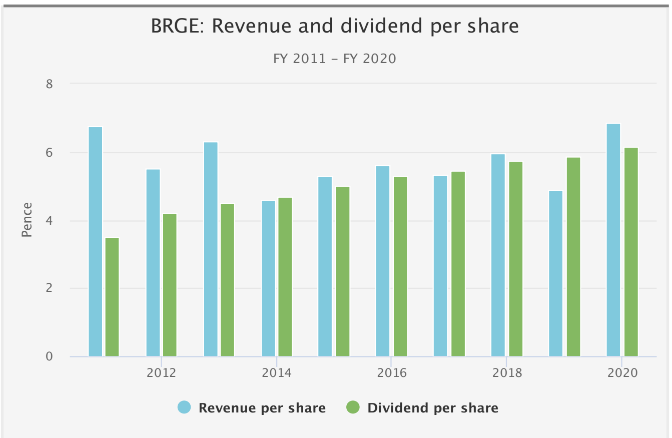
Looking forward Stefan and Sam believe investors should no longer focus on year-on-year growth but rather on how companies' future trajectories will compare to those of the pre-COVID-19 world. In doing so they believe they can understand the changes in sectoral trends, as well as being able to identify companies which are either materially impaired or due to be positively re-rated. The managers believe that the next few quarters will be positive, and have slightly tilted their portfolio towards cyclical stocks to capitalise on increasing economic activity. Their bullish outlook is because of a combination of stock-specific factors (such as the surging demand for semiconductors), the commencement of Europe's vaccine roll-out, the increasingly strong European consumer, and the roll-out of the European recovery fund. However, Stefan and Sam do advise caution around potential 'noise' in the market resulting from increased speculation about a potential rise in inflation and the potential outbreak of a new variant of COVID-19. While they believe that over the long term inflation will remain benign, they believe that a new COVID-19 variant is the largest risk facing Europe's markets in the near term, with Stefan and Sam remaining in contact with the management of vaccine producers to gain an understanding of the pandemic trajectory and the ability of Europe to respond.

Dividend

The primary objective of BRGE is the growth of capital, and so growth in dividends is not a consideration in the investment process, and any dividends which are paid are a by-product of the strategy. However, the trust does operate with a progressive dividend policy, having increased the annual distribution each year since the trust launched in 2004.

The board has noted that the issues many companies within the portfolio have had with paying dividends during the ongoing pandemic have been offset by the positive outcome of a tax ruling in relation to overseas dividends in the UK. This led to a 2020 full-year dividend of 6.15p per share, an increase of 5.1% on last year's 5.85p per share. We estimate that the trust has revenue reserve cover of 2.2x and a current dividend yield of 1.1%, below the 1.7% simple average of its peers (Source: JPMorgan Cazenove, as at 24/05/2021).

Fig.5: Revenue And Dividend Per Share



Source: BlackRock

Past performance is not a reliable guide to future returns

Management

The original team managed BRGE from 2008, when a group of managers from Scottish Widows moved to BlackRock. Vincent Devlin handed over leadership of the strategy to Stefan Gries in June 2017.

Stefan also co-manages the open-ended BlackRock Continental European Fund (which currently has c. £924m of assets), as well as the team's pan-European strategies (with roughly £2.7bn of assets) and a long/short alternative UCITS strategy (BlackRock European Absolute Return Fund, with assets of c. €1.5bn).

Stefan started his career in 2005 as a European equity analyst and portfolio assistant at Scottish Widows Investment Partnership. He joined BlackRock's European equity team in 2008 as part of the consumer research pod, working as a dedicated analyst in most sectors prior to becoming a portfolio manager. Sam Vecht acts as co-manager, with responsibility for emerging Europe stocks. Sam is co-head of the BlackRock global emerging markets team, co-manager of BlackRock Frontiers Investment Trust and also co-manager of BlackRock Latin American Investment Trust. Given BRGE's predominantly developed Europe allocation, Stefan leads the majority of decisions around the trust's allocation.

Stefan and Sam are also supported by a vast European equity team. Within the developed Europe equity team there are 16 portfolio managers/sector analysts (excluding Stefan and Sam), one data scientist, one graduate, six product strategists and four core portfolio managers. Since our last meeting there have been two new analysts added to the team. Alongside these team members, there are a further seven emerging Europe analysts. Having such a large team is vital to the strategy's in-depth investment approach, and a differentiating factor relative to some peers.

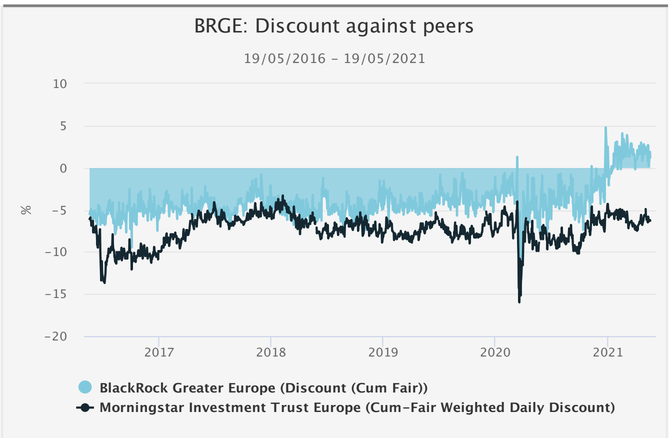
Discount

BRGE currently trades on a 2.0% premium, compared to the peer group's simple average discount of 7.1%. In fact, at the time of writing BRGE is the only trust in the AIC Europe sector to trade at a premium. BRGE's current premium is in contrast to recent history, as over the last five years the trust has traded on a 3.9% discount.

As we highlighted in **our prior note**, Europe has generally seen a strong degree of aversion by investors due to the region's relative underperformance against the American market. Stefan has previously stated that there needs to be an alignment of confidence in three factors: confidence in the manager, confidence in performance and confidence in the sector. It would appear that all three factors have indeed aligned. BRGE is now the best-performing European trust over the last five years, having been able to consistently outperform its peers and reference index, a rare occurrence for an active fund manager. When coupled with the incoming tailwinds supporting the European economic recovery, specifically the vaccine roll-out and incoming stimulus, we think this does much to explain why BRGE now trades at a premium.

The board has begun to take advantage of this premium to grow the size of the trust for the benefit of its shareholders, by improving liquidity and reducing the impact of fixed costs. Since the start of 2021 the board has been issuing shares, with a total of four million shares having been issued, representing 4.6% of the current shares in issue and enhancing the current liquidity of BRGE. The board is aware of the importance of BRGE not to be trading at a significant discount, and in such a situation it operates discount control measures. The board is able to buy back shares and/or operate a six-monthly tender, which is offered under normal market conditions and if BRGE were to trade at a discount. The tender was not utilised in May 2021, with the next possible offering being November 2021.

Fig.6: Five-Year Discount



Source: Morningstar

Charges

BlackRock Greater Europe has an ongoing charges figure (OCF) of 1.01%, which includes a management fee of 0.85%. This compares with the peer group's simple average OCF of 0.87% (Source: JPMorgan Cazenove, as at 17/12/2020). The trust does not pay a performance fee.

The KID RIY for the trust is 1.49%, compared to a sector simple average of 1.27%. Please note that calculation methodologies can vary between trusts.

ESG

ESG is a core part of any assessment made by BRGE's analysts and factors into the analysis of each company. An analyst's understanding of ESG is a multifaceted process, incorporating their own beliefs and the input of BlackRock's sustainable investment team, as well as ESG data provided by MSCI. In early 2020 BlackRock placed an increased impetus on integrating ESG analysis, with ESG now being viewed as a conventional risk factor (e.g. making it on par with default risk), and additional scrutiny is required in the ESG analysis of high-risk industries.

ESG analysis occurs even without analyst input, through the incorporation of ESG data provided by MSCI. MSCI provides a comprehensive solution through an initial ESG screen, allowing the incorporation of not just primary ESG factors like emissions and waste management, but secondary and tertiary ESG factors too (e.g. the assessment of companies further along the supply chain). This data screen serves to flag up ESG issues for the analysts when they begin to assess companies. However, ESG integration is not a mechanical exercise for it is an analyst's overall assessment of a company's ESG credentials which will determine that company's overall quality. Despite BRGE's detailed integration of ESG analysis it is not an explicit ESG fund, Stefan and Sam do not intend to apply an onerous ESG exclusion policy. Instead BlackRock ultimately wants to be part of the ESG transformation process, and is open to purchasing companies of lower ESG quality so long as their path to improvement is clear.

That being said, the investment process used by Stefan and Sam typically avoids poor ESG companies by design, as such companies would not be conducive to a five-year investment time horizon given the heightened risks. One example is their avoidance of Volkswagen, where their identification of poor corporate governance prevented Stefan and Sam from owning it, even before the 'Dieselgate' scandal broke. It is also important to note that, as the managers note, in general European companies are naturally more ESG-aligned than those of other regions, as a result of company managements' more acute awareness of ESG issues and government initiatives to promote corporate sustainability.

Morningstar sustainalytics rates BRGE as above average for sustainability when compared to its peers in Morningstar's European Equity Large cap sector (which includes both open- and closed-ended funds), placing it in the top quartile. We think this is an impressive feat, not simply because of the positive nature of this ranking but also because as a region Europe has innately strong ESG credentials thanks to the implication of pro-ESG policies by governments and companies' openness to adopt sustainability initiatives. As a result, a strategy's rank in the European Large cap sector is very sensitive to even a slight deterioration in ESG credentials, with the better strategies in this sector likely to represent some of the world's most ESG-compliant.

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