The Scottish Investment Trust

Portfolio reset for a ‘multi-year recovery’ ahead

Investment trusts
Global equities

The Scottish Investment Trust (SCIN) seeks to provide investors with above-average long-term returns, by investing in undervalued international companies. The trust also targets regular dividend growth ahead of UK inflation. SCIN’s team, led by manager Alasdair McKinnon, are contrarian, value-focused investors who believe the market is significantly underestimating the strength of the post-pandemic recovery and its capacity to support cyclical and value-type stocks. In February, he revamped the portfolio to take advantage of what he sees as the many ‘tremendous opportunities’ among unloved areas of the market that he believes will benefit from the multi-year economic rebound he foresees. There are very early signs that these changes are having a positive impact on performance (see chart).

NAV performance versus MSCI AC World index over one year

Source: Refinitiv, Edison Investment Research. Total returns in sterling.

Why invest in global value and cyclical stocks now?

After a long period in which growth and momentum stocks have outperformed, there are signs that value and cyclical stocks are returning to favour, prompted by the improvement in the economic outlook. The performance gap between growth and value indices remains wide and equity markets may still only be on the cusp of a much more significant rotation back towards value stocks.

The analyst’s view

SCIN may find favour with investors who see merit in the manager’s contrarian, value-focused approach and share his expectation of a further rotation into value and cyclical stocks. Investors concerned about inflation risks may also be attracted to SCIN’s significant exposure to gold, while the board’s commitment to a growing regular dividend will appeal to investors seeking steady, regular income.

Revamp and value rotation may narrow discount

SCIN’s share price is trading at a 9.0% discount to cum income NAV, slightly lower than its long-term average around 10% and there is scope for the discount to narrow from its current level if the trust’s recent revamp lifts performance and/or value-focused strategies return to favour with investors. The trust offers a yield of 3.1% (based on current share price and the FY20 dividend).

NOT INTENDED FOR PERSONS IN THE EEA

23 March 2021

Price		**756.0p**
Market cap		**£507.4m**
AUM		**£669.6m**
NAV*		832.0p
Discount to NAV		9.1%
NAV**		841.3p
Discount to NAV		9.0%

*Excluding income, with debt at fair value. **Including income, with debt at fair value. As at 22 March 2021.

Yield		3.1%
Ordinary shares in issue		67.1m
Code		SCIN
Primary exchange		LSE
AIC sector		Global
52-week high/low	773.0p	593.0p
NAV* high/low	851.6p	726.0p

*Including income

Gross gearing*	15%
Net gearing*	7%

*As at 26 February 2021

Fund objective

The Scottish Investment Trust’s objective is, over the longer term, to provide investors with above-average returns through a diversified portfolio of international equities and to achieve dividend growth ahead of UK inflation. The manager takes a patient approach and seeks to invest in companies that are undervalued, unfashionable and ripe for improvement.

Bull points

- Early signs that a rotation back into value and cyclical stocks is supporting trust’s performance.
- On track to increase regular dividend for the 38th successive year.
- Very competitive fees.

Bear points

- Investment strategy is partially reliant on a continued rotation into value stocks.
- There are still many uncertainties related to the virus and the ability of vaccines to allow economic activity to return to normal.
- Inflation risks may be lower than the manager forecasts.

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Market outlook: Uneven market rally, with inflation risk

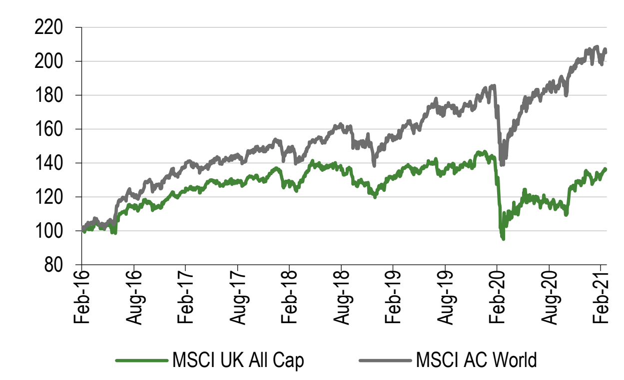
The global economic outlook brightened considerably in the last couple of months of 2020 and early 2021, thanks to the arrival and roll-out of several viable vaccines, which have cleared the way for economies to re-open. Equity markets around the world responded positively, with several markets surpassing pre-pandemic highs. And, after a long period during which growth and momentum stocks have outperformed, there have been signs that value and cyclical stocks are returning to favour. From the beginning of November 2020 until 19 March 2021, the MSCI World Value Index returned 18.9%, compared to a return of 6.7% in the MSCI World Growth Index. However, the performance gap between growth and value indices remains wide compared to long-term measures and there is widespread conjecture that equity markets are on the cusp of a much more significant rotation back towards value stocks. In the meantime, many such stocks remain significantly below their pre-pandemic levels, under-appreciated and overlooked in the recent rally.

The prospect of stronger economic growth, together with confirmation of further aggressive fiscal stimulus from the new US administration, have ignited inflation fears and bond yields have increased sharply in recent weeks. The US Treasury 10-year bond yield has risen from around 0.90% at the beginning of the year to 1.7% in late March. However, central banks appear sanguine about the risk of higher inflation. Rather, they seem intent on maintaining interest rates at their current historic lows and implementing additional quantitative easing to cap rises in bond yields. In recent months, the US Federal Reserve, the Bank of England, the European Central Bank and the Reserve Bank of Australia have all extended their asset-purchasing programmes.

For investors with a contrarian bias who think differently from the crowd and are reluctant to rush into already crowded trades, the current market environment is ripe with opportunities to invest in unloved, but fundamentally sound, companies at attractive valuations. Economically sensitive stocks such as oil companies, banks, traditional retailers and restaurants, which are most exposed to the state of the economy, may benefit particularly as the global recovery gathers pace, while stocks that provide a hedge against inflation will also appeal to investors concerned about medium-term inflation risks.

Exhibit 1: Market performance and valuation

Total return performance of world and UK equities over five years (£)



Valuation metrics of Datastream indices (at 22 March 2021) forward P/Es

	Last	High	Low	10-year average	Last as % of average
World	19.1	19.8	10.0	14.3	133
UK	14.4	15.7	8.5	13.0	111
US	22.8	24.0	11.2	16.5	138
Europe	16.9	17.5	8.0	12.7	132
Japan	18.2	18.6	10.5	13.9	131
Asia	16.1	17.3	10.3	12.6	128

Source: Refinitiv, Edison Investment Research

The fund manager: Alasdair McKinnon

The manager's view: Re-positioning for a multi-year turnaround

For SCIN's manager, Alasdair McKinnon, the arrival of viable vaccines dramatically improved the medium-term economic outlook. He expects a 'multi-year turnaround' in both economic growth and in equity markets as economies re-open and commercial and social activities return to more normal levels. In his view, 'consumers are champing at the bit' to spend – to eat out, go shopping and travel, and there is, accordingly, much greater potential than most investors perceive, for many overlooked cyclicals and value-type stocks temporarily impacted by the pandemic, to benefit from this recovery. In February this year, McKinnon implemented some significant portfolio changes to take advantage of the many compelling opportunities he sees. He reduced the portfolio's holdings of defensive stocks and increased exposure to energy stocks, banks and several consumer-related companies that, unlike some of their competitors, have survived the worst of the pandemic and, he believes, have the ability to 'win market share, push on to new highs and pay good dividends'.

McKinnon's contrarian investment approach is also manifested in his view on inflation. He now sees the potential for inflation as 'enormous'. 'Government and central bank support that began at the time of the global financial crisis and expanded rapidly over the past year will, eventually, find its way into the real economy, triggering inflation', he says. In his assessment, recent indications of central banks' willingness to use asset purchases to limit bond yield rises are evidence of their intention to 'let inflation run hot' to boost economic activity and deflate the value of governments' mounting debt burdens. These concerns about inflation have reinforced McKinnon's long-held conviction in the merits of gold as a currency, a store of value and an inflation hedge. The trust has held an exposure to gold via positions in gold mining companies for several years, as the manager views gold miners as a low-priced means of gaining exposure, while also offering attractive dividend payments.

McKinnon believes the recent changes he had made to SCIN's portfolio mean the trust is now very well positioned to benefit from the multi-year recovery he foresees, while its exposure to gold should also do well as inflation pressures become evident. This leaves him confident the trust will be able to meet its commitment to deliver above-average returns and competitive, growing dividends to patient investors over the longer term.

Asset allocation

Current portfolio positioning

The equity market rally that began in November last year, with the arrival of vaccines, has still left many cyclical stocks behind, as investors remained sceptical of their capacity to recover. SCIN's manager began making small additions to what he refers to as 'real-world recovery stocks' including oil companies, banks and retailers. And in the second week of February this year, he implemented a programme of more significant, strategic changes in the portfolio to better position it for the multi-year recovery he foresees. He increased exposure to energy stocks, buying Exxon Mobil, and added to an existing position in Total. Both these companies are now among SCIN's top 10 holdings (Exhibit 2). The manager also added to existing positions in Halliburton, Royal Dutch Shell and BP within the energy sector and opened or added to positions in several banks, including Wells Fargo and Banco Santander (both are now top 10 holdings), Mitsubishi UFJ Financial, HSBC, Itau Unibanco and Intesa Sanpaolo. McKinnon also made new acquisitions of several consumer discretionary names, including the US family restaurant chain, Cheesecake Factory, which is now the portfolio's sixth biggest holding. He expects consumers' pent-up demand for eating out will also benefit another recent acquisition, Whitbread, the UK pub, restaurant and hotel chain. The manager expects a new position in the Swedish fashion company, H&M, to do well as consumers return to the high street, especially in the UK, as many of their high-profile competitors such as Debenhams and Topshop have closed their stores. The UK engineering company Babcock International is another recent addition to the portfolio. McKinnon believes this stock is ripe for recovery. The company plays an integral role in the UK's defence fulfilment, especially its nuclear capability but its stock price has been in steady decline for several years on concerns about unprofitable contracts.

However, the manager believes Babcock's new management team, including a well-respected audit committee chairman, is now addressing the company's problems.

The trust maintains its overweight position in gold via positions in several gold miners, although the manager trimmed holdings of Newmont and Barrick Gold and added to positions in two South African gold miners, AngloGold Ashanti and Gold Fields, which were particularly attractively priced. In McKinnon's view, both these internationally diversified companies are undervalued because some of their gold reserves are deep underground and thus expensive to mine and because their image has been unjustifiably tarnished by outmoded views that gold mining companies are empire builders rather than profit maximisers. At the end of February, gold mining companies continued to dominate SCIN's top 10 holdings, as they have done for some time. Newcrest Mining, Newmont and Barrick Gold occupied the top three places on the list and between them comprise 14.2% of the portfolio, while AngloGold Ashanti and Gold Fields, outside the top 10 listing, represented a further 2.5% and 1.8% of the portfolio, respectively, leaving the total gold exposure to 18.5%, marginally higher at end February 2021 than at the same time the previous year (see the Materials sector weightings in Exhibit 3, where gold miners represent the only sectoral exposure during both periods).

Exhibit 2: Top 10 holdings (at 28 February 2021)

			Portfolio weight %	
Company	**Country**	**Sector**	**28 February 2021**	**29 February 2020***
Newcrest Mining	Australia	Materials	5.2	4.3
Newmont	US	Materials	4.7	5.1
Barrick Gold	Canada	Materials	4.3	4.9
East Japan Railway	Japan	Industrials	3.4	N/A
Exxon Mobil	US	Energy	3.2	N/A
Cheesecake Factory	US	Consumer discretionary	3.2	N/A
Wells Fargo	US	Financials	3.1	N/A
BT	UK	Communication services	3.1	2.8
Banco Santander	Spain	Financials	3.0	N/A
Total	France	Energy	3.0	N/A
Top 10 (% of portfolio)			**36.2**	**35.5**

Source: The Scottish Investment Trust, Edison Investment Research. Note: *N/A where not in end-February 2020 top 10.

Exhibit 3: Portfolio sector exposure vs MSCI AC World Index (% unless stated)

	Portfolio end-Feb 2021	Portfolio end-Feb 2020	Change (pp)	Index weight	Active weight vs index (pp)	Trust weight/ index weight (x)
Financials	21.1	6.9	14.2	13.6	7.5	1.6
Materials*	18.5	18.4	0.1	4.6	14.0	4.1
Energy	16.4	9.2	7.2	3.2	13.2	5.1
Consumer discretionary	10.8	3.4	7.3	12.0	(1.2)	0.9
Communication services	8.0	17.2	(9.3)	9.2	(1.2)	0.9
Healthcare	7.9	16.1	(8.2)	12.5	(4.7)	0.6
Consumer staples	7.8	17.2	(9.5)	7.0	0.8	1.1
Industrials	7.1	2.3	4.8	10.5	(3.4)	0.7
Utilities	2.5	8.0	(5.6)	2.9	(0.4)	0.9
Real estate	0.0	1.1	(1.1)	2.7	(2.7)	0.0
Information technology	0.0	0.0	0.0	21.9	(21.9)	0.0
	100.0	**100.0**		**100.0**		

Source: The Scottish Investment Trust, Edison Investment Research. Note: *Exposure to gold miners.

To make room for these new acquisitions, in addition to trimming some existing holdings already mentioned, the manager also reduced exposure to defensive stocks and several pharmaceutical companies including Pfizer and Bristol-Myers Squibb and sold GlaxoSmithKline and Roche outright. Complete sales also included Chevron, Japan Tobacco and Tesco.

As a result of the recent portfolio changes, the portfolio now has significant new overweight positions in energy stocks and financials (Exhibit 3). Its exposure to gold accounts for the overweight position in materials, while the most notable underweight positions are in technology, where the trust has no exposure, and in healthcare and industrials. The portfolio remains well diversified geographically, as shown by Exhibit 4. Portfolio turnover, which stood at an annualised

26% at the end of FY20 (versus 22% at end FY19), rose in February due to the portfolio shifts, but with the portfolio changes now complete, turnover is expected to return to more usual levels.

Exhibit 4: Portfolio geographic exposure (%)

	Portfolio end-Feb 2021	Portfolio end-Feb 2020	Change (pp)
North America	38.0	34.5	3.6
UK	20.4	24.1	(3.8)
Europe ex-UK	19.0	17.2	1.7
Japan	8.5	11.5	(3.0)
Middle East & Africa	5.3	2.3	3.0
Pacific ex-Japan	5.2	10.3	(5.2)
Latin America	3.7	0.0	3.7
	100.0	**100.0**	

Source: The Scottish Investment Trust, Edison Investment Research

Performance: Revamp may be starting to pay off

Exhibit 5: Five-year discrete performance data

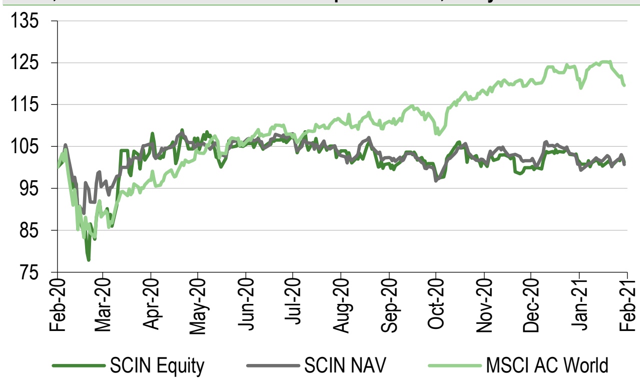
12 months ending	Share price (%)	NAV (%)	MSCI AC World net (%)	MSCI UK All Cap net (%)
28/02/17	39.0	33.1	37.5	23.2
28/02/18	7.1	6.0	7.8	4.4
28/02/19	(0.8)	(0.4)	3.3	1.4
29/02/20	(6.7)	(5.1)	8.8	(2.3)
28/02/21	1.2	0.7	19.6	2.3

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

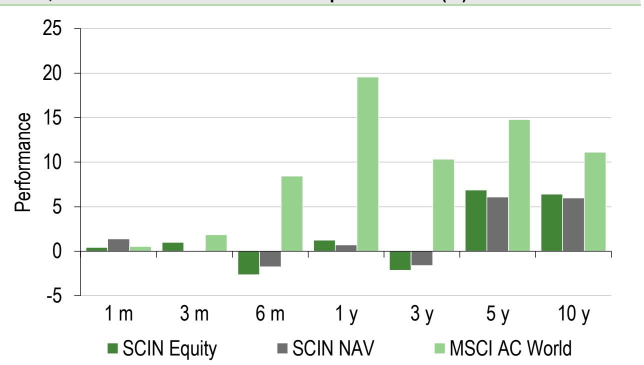
SCIN's performance was disappointing in 2020. The manager's contrarian, value-focused approach has been out of favour with investors for some time and technology-heavy growth and momentum strategies have outperformed markedly. McKinnon acknowledges that the portfolio was too defensively positioned in November at the onset of the vaccine-inspired rally, and a number of its holdings did not participate in the market recovery. Positions in tobacco, telecoms, utilities and gold miners all lagged. In the six months to end February 2021, the trust returned -2.6% on a share price basis and declined 1.7% in NAV terms, compared to a return of 8.5% on the MSCI AC World Index (Exhibit 6).

Exhibit 6: Investment trust performance to 28 February 2021

Price, NAV and benchmark total return performance, one-year rebased



Price, NAV and benchmark total return performance (%)



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

However, there are very early signs that the significant portfolio changes the manager implemented in February, which increased the trust's exposure to cyclical and value stocks across several sectors, may already be starting to pay off. In February, the trust returned 0.4% on a share price basis and 1.3% in NAV terms, compared to a comparator index return of 0.5%, and performance continued to improve in early March (Exhibit 8). These recent returns have been driven by contributions from several sectors. Within the energy sector, Halliburton, Helmerich & Payne, BP, Royal Dutch Shell, Total, Exxon Mobil all added to returns, as did several banks, including Wells

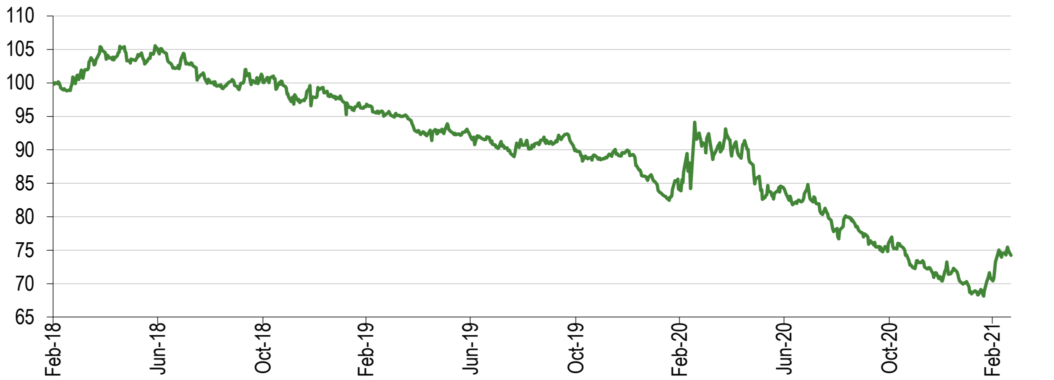
Fargo, Lloyds, HSBC and First Horizon. Insurers Aegon and Aviva also contributed. The trust's positions in consumer discretionary companies such as Cheesecake Factory, Six Flags Entertainment, Whitbread, H&M, Capri Holdings and Kingfisher also enhanced performance, while not owning any tech stocks assisted relative performance. These contributors more than offset the adverse performance impact of gold miners Barrick Gold, Newmont, consumer staples Kirin, and Ambev and United Utilities.

Exhibit 7: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to MSCI AC World	(0.1)	(0.9)	(10.2)	(15.3)	(30.2)	(30.0)	(34.9)
NAV relative to MSCI AC World	0.8	(1.9)	(9.4)	(15.8)	(29.1)	(32.5)	(37.7)
Price relative to MSCI UK All Cap	(1.8)	(4.2)	(13.2)	(1.0)	(7.4)	7.1	13.2
NAV relative to MSCI UK All Cap	(0.8)	(5.2)	(12.4)	(1.5)	(6.0)	3.2	8.4

Source: Refinitiv, Edison Investment Research. Note: Data to end-February 2021. Geometric calculation.

Exhibit 8: NAV performance versus MSCI AC World index (net) over three years



Source: Refinitiv, Edison Investment Research

Peer group comparison

Exhibit 9: Selected peer group as at 22 March 2021*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Ongoing charge	Perf. fee	Discount (cum-fair)	Net gearing	Dividend yield
Scottish Investment Trust	507.4	15.7	6.9	42.5	102.5	0.5	No	(9.0)	107	3.1
Aberforth Smaller Companies	1,306.0	108.1	10.4	45.9	162.4	0.8	No	(2.6)	105	2.3
AVI Global Trust	992.3	85.5	36.5	116.8	141.4	0.9	No	(8.1)	107	1.7
Bankers	1,422.0	39.9	34.9	97.6	201.3	0.5	No	0.5	100	2.0
EP Global Opportunities	108.8	19.2	2.2	43.1	104.7	1.0	No	(7.2)	100	2.1
Fidelity Special Values	805.9	79.0	10.0	47.0	160.6	1.0	No	1.6	103	2.2
Law Debenture Corporation	866.9	68.9	23.4	62.8	153.4	0.6	No	2.4	108	3.8
Lowland	334.4	61.1	(3.8)	21.2	115.7	0.6	No	(6.5)	113	4.8
Majedie Investments	126.2	40.8	4.0	29.3	100.6	1.2	Yes	(17.6)	111	4.8
Miton Global Opportunities	85.2	69.8	19.1	85.0	120.4	1.3	Yes	(3.5)	100	0.0
Temple Bar	773.0	79.1	2.8	26.0	94.4	0.5	No	(0.3)	110	3.3
Value and Indexed Property Income	96.5	25.3	(7.3)	4.5	60.4	1.4	No	(12.5)	128	5.5
Simple average (12 funds)	**618.7**	**57.7**	**11.6**	**51.8**	**126.5**	**0.9**		**(5.2)**	**108**	**3.0**
SCIN rank in peer group	**7**	**12**	**7**	**8**	**9**	**2**		**10**	**6**	**6**

Source: Morningstar, Edison Investment Research. Note: *Performance as at 19 March 2021 based on ex-par NAV. TR = total return. TER = total expense ratio. Net gearing is total assets less cash and equivalents as a percentage of net assets.

SCIN is a member of the Association of Investment Companies' Global sector, a diverse group that includes some of the largest and most well-established investment trusts. Many of the members of this sector adopt growth- and momentum-focused strategies, completely different to SCIN's contrarian, value-oriented investment approach. So, to give a more meaningful comparison of SCIN's performance against its true peers, Exhibit 9 shows a selection of value-oriented trusts from several AIC sectors, including the AIC Global, UK All-Companies, UK Smaller Companies, UK Equity Income, Europe and Flexible Investment categories. SCIN's contrarian style distinguishes it from some members of this group, as does its exposure to gold miners, which is not typically common among value trusts. Conversely, unlike some value focused trusts, SCIN has no exposure to technology stocks.

Bearing these differences in mind, the table shows that SCIN has underperformed the average of this value peer group over one, three, five and 10 years, on an NAV total-return basis. However, returns have been solidly positive in absolute terms over five and 10 years and its dividend yield, at 3.1% (based on the current share price and the FY20 dividend), exceeds the average of the group. SCIN's charges are amongst the lowest – very competitive for an active manager – and like most of this group, it does not charge a performance fee. Its discount to NAV is wider than the average, while it adopts a more conservative approach to gearing than the average of its peers.

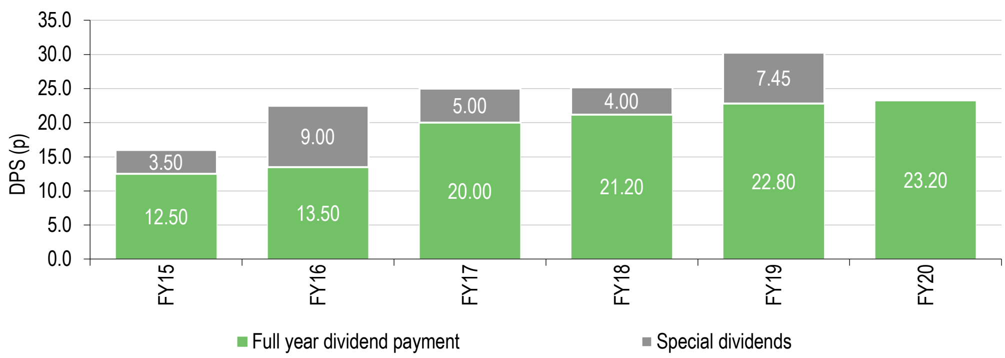
Dividends

During the fiscal year ended 31 October 2020 (FY20), SCIN's earnings per share fell by 27.1% to 21.7p (from 29.8p in FY19), due to lower dividend receipts, as some of the trust's holdings ceased or reduced dividend payments to protect their balance sheets or comply with regulatory guidance. In anticipation of such disruption to revenues, the trust has built a substantial revenue reserve and it used a small portion of this reserve to cover the regular dividend payment for FY20 (23.2p). However, the revenue reserve remains substantial, at 60.8p per share, equivalent to more than 2.5x the targeted annual dividend for the year ended 31 October 2021 (FY21).

In addition, the outlook for dividend receipts is improving. All the trust's UK and European banks have declared dividends, although there are some payout caps still in place. Carrefour, the French supermarket chain that halved its dividend payment in 2020, now intends to reinstate it and dividend growth amongst the trust's gold miners is strong due to year-on-year growth in revenues and profits.

SCIN's board recently reiterated its desire to continue the long track record of annual dividend increases and the aim of the company to provide dividend growth ahead of UK inflation over the longer term. At end FY20, the trust raised its regular dividend for the 37th consecutive year. Dividends are paid quarterly, in May, August, November and February (Exhibit 10). For FY20, three quarterly interim dividends of 5.7p were followed by a final dividend of 6.1p, making the total regular dividend for FY20 23.2p, 1.8% higher than the regular dividend for FY19.

Exhibit 10: Dividend history since FY15



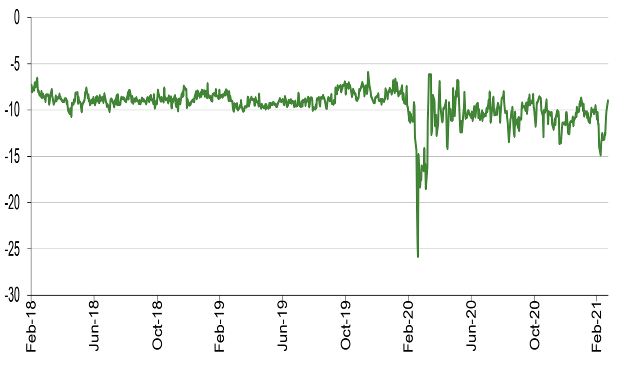
Source: Edison Investment Research

For FY21, the board's target is to declare three quarterly interim dividends of 5.8p and recommend a final dividend of at least 5.8p for shareholder approval at the February 2022 AGM. With a revenue reserve more than sufficient to cover this target, SCIN appears capable of continuing to fulfil its stated dividend policy and build on its long-term record of regular dividend growth. Based on the current share price and the FY20 regular dividend, SCIN's yield is 3.1%.

Discount: Scope to narrow from long-term average

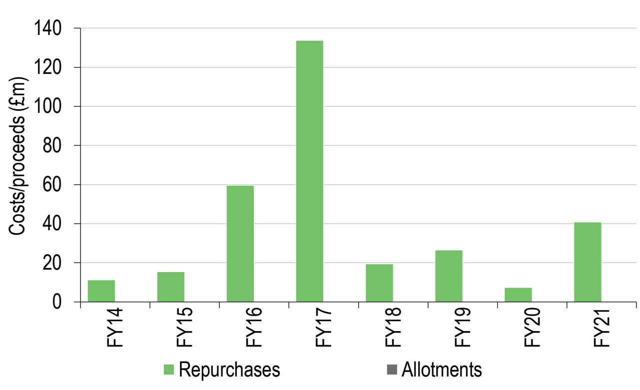
SCIN's share price discount widened briefly during the market declines of March 2020, but since then it has mainly traded close to its long-term trading range around 10% (Exhibit 11). At 22 March 2021, the discount stood at 9%. The trust actively manages the discount through share buybacks, with the aim of capping it at 9%. Recent activity on this front is discussed in the Capital Structure section below. There is scope for the discount to narrow if the trust's recent re-structuring lifts performance decisively and/or value-focused strategies return to favour with investors. SCIN has also made significant efforts in marketing, especially through its website (www.thescottish.co.uk), with the aim of broadening its appeal to a wider range of investors.

Exhibit 11: Discount over three years



Source: Refinitiv, Edison Investment Research

Exhibit 12: Buybacks and issuance



Source: Morningstar, Edison Investment Research

Fund profile: A global contrarian with a value focus

SCIN employs a global contrarian, value-focused investment approach. Its manager and his four-person investment team aim to provide long-term capital appreciation and dividend growth ahead of UK inflation. The trust has realised its regular dividend goal over the last 37 consecutive years and it is on track to do so again for FY21. It currently offers a yield of 3.1% (based on FY20's total regular dividends).

The trust has been based in Edinburgh since its launch in 1887. Holdings are selected on the basis that they are deemed by the manager to be undervalued but possess the potential to re-rate over the longer term due to cyclical or operational improvements. The trust does not have a formal benchmark, as the portfolio does not resemble any index, although the manager uses the MSCI AC World Index as a broad comparator of performance. The portfolio's unique composition means that its performance is likely to differ markedly from the performance of this index at any given time.

As SCIN is a self-managed investment trust, it does not pay management fees. The trust is one of the lowest-cost funds amongst its peers, with ongoing charges of 0.52% (at 31 October 2020).

Investment process: Value search away from the crowd

McKinnon heads an investment team comprising deputy manager Martin Robertson, investment managers Mark Dobbie and James Webb, and analyst Igor Malewicz. The team employs an active but patient bottom-up contrarian investment approach, seeking out unpopular, undervalued stocks with the potential to re-rate. Rooted in the principles of behavioural finance, the approach rejects the tendencies of most investors to follow the crowd, pursuing returns from companies that have already performed well. Instead, SCIN uses fundamental analysis to identify value in overlooked parts of the market.

The trust's investment process is clearly defined. The team meets regularly to discuss ideas generated from fundamental analysis and various internal and external sources. Discussions are intended to identify companies that possess a catalyst for recovery. Companies are allocated to one of three categories:

Ugly ducklings – operationally challenged companies the market shuns, but that the management team believes will exceed market expectations. The out-of-favour status of these companies provides an opportunity to purchase them at a relatively low cost. They comprise about 67% of the portfolio, up significantly from the usual level of around 40%. Examples include Cheesecake Factory, Wells Fargo and Exxon Mobil.

Change is afoot – companies that have also endured a long period of poor operational performance, but whose prospects have recently improved significantly, without attracting more favourable assessments from the market. Presently comprising around 33% of the portfolio, almost half the usual level, stocks in this category include Newmont Mining, East Japan Railway and H&M.

More to come – companies that have graduated from other categories and are now generally recognised as good businesses with solid prospects. However, the team sees scope for further upside in performance and price, not yet fully recognised by the market. Such stocks usually comprise only a small portion of the portfolio, but presently there are no names in this category.

Stocks are sold once the forecast improvement in performance is fully realised. Positions may also be closed if there is a deterioration in a holding's fundamentals. Because of the long-term nature of this strategy, turnover tends to be low. This approach delivers a global equity portfolio of between 50 and 100 stocks, spread across multiple regions and sectors, providing diversification of both risk and income sources. While the team acknowledges its approach will not always be in fashion, it believes it is can generate above-average investment returns and rising dividends over the longer term, defined as at least five years.

SCIN's approach to ESG

Environmental, social and governance (ESG) factors are an important part of SCIN's investment process. McKinnon believes poor ESG practices can have an adverse effect on the value of existing holdings and potential investments. The team does not use prescriptive criteria to screen potential investments, but rather considers these issues as part of the due diligence of each company, according to its circumstances and specific factors which may impact performance. For example, labour practices have always been a potential problem in the garment industry, so the investment managers monitor the behaviour of existing holdings and looks to invest in companies which are improving their sourcing.

Gearing

The trust has access to gearing via secured bonds issued with an initial maturity of 30 years (maturing in 2030), with a fixed coupon of 5.75%. It has scope to use gearing up to 20% of net assets. At the onset of the pandemic, in anticipation of a severe economic downturn, the manager reduced gearing from its 31 October 2019 level of 1%, to a net cash position of around 5% (ie, the trust held all its borrowings and an additional 5% of net assets in cash). This move was intended to shelter the portfolio from market declines and preserve capital to take advantage of opportunities that would arise as the economy began to recover. By end October 2020, net gearing had been raised to 0% and as at end February 2021, it stood at 7%. The current level of gearing reflects the manager's conviction in the outlook for the portfolio's holdings and the many opportunities he sees.

Capital structure

SCIN is a conventional investment trust with a single share class. The board regularly repurchases shares, up to 14.99% of shares in issue, with the intention of trying to cap the share price discount to NAV at 9%. At 30 October 2020, there were 72.9m ordinary shares in issue and share repurchases since then have reduced this to 67.1m (at 22 March 2021). Share repurchases in FY20 totalled 1.0m and at 22 March 2021, share repurchases so far in FY21 have totalled 5.8m (Exhibit 12).

The board

Exhibit 13: SCIN's board of directors

Board member	Date of appointment	Fee in FY20	Shareholdings at end-FY20
James Will (Chairman)	May 2013 (January 2016)	£60,000	10,000
Karyn Lamont (Chair, Audit Committee)	October 2017	£37,500	2,500
Jane Lewis	December 2015	£32,500	2,500
Mick Brewis	December 2015	£32,500	10,000
Neil Rogan	September 2019	£32,500	10,352*

Source: The Scottish Investment Trust. Note: *8,456 held personally, 1,896 by members of his family.

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