

Scottish Oriental Smaller Companies

Asian small-cap specialist, unloved asset class

Scottish Oriental Smaller Companies Trust (SST) aims to deliver long-term capital growth from investing in smaller companies listed in Asia ex-Japan. The investment approach is bottom-up to find quality companies with sustainable growth that are reasonably valued. Unconstrained by the benchmark, the well-diversified portfolio of c 60 stocks represents the manager's highest-conviction ideas, with a preference for domestically oriented businesses in less-developed economies, which can benefit from structural growth drivers. SST has a strong, long-term performance track record and over 10 years has delivered an annualised NAV total return of 18.5%. The trust's current 14.9% discount to cum-income NAV is deeper than its three-year average, in part reflecting a more risk-averse market sentiment. There is scope for this discount to narrow should sentiment towards Asian equities, and small-caps in particular, improve.

12 months ending	Share price (%)	NAV (%)	MSCI AC Asia ex-Japan (%)	MSCI AC Asia ex-Japan Small Cap (%)	FTSE All-Share (%)
31/10/14	1.8	9.2	6.4	5.6	1.0
31/10/15	(9.8)	(5.3)	(3.6)	(1.7)	3.0
31/10/16	33.8	34.6	35.2	28.3	12.2
31/10/17	6.2	8.3	20.3	11.7	13.4
31/10/18	(14.3)	(11.2)	(10.0)	(14.8)	(1.5)

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

Investment strategy: Disciplined approach

The manager, Vinay Agarwal, has a rigorous bottom-up approach that involves an intensive schedule of over 1,600 company visits every year, and fundamental analysis to identify high-quality, well-managed companies with a good track record of capital allocation. Robust balance sheets, strong cash flows and reasonable valuations are also important criteria, and the manager has an investment horizon of three to five years. The manager is supported by First State Stewart Asia's well-resourced team of 21 investment professionals located in Singapore, Hong Kong and Edinburgh.

Market outlook: Long-term prospects remain good

The MSCI Asia ex-Japan index has corrected c 13% in sterling terms since its peak in January 2018 and, reflecting a perceived higher risk associated with smaller companies, the MSCI Asia ex-Japan Small Cap index has fallen c 20%. Valuations have moderated and Asian equities appear attractively priced relative to global equities. Meanwhile, a robust outlook for Asia ex-Japan's long-term GDP growth could be supportive for its equity markets' prospects over time.

Valuation: Improved sentiment may narrow discount

SST's current 14.9% discount to cum-income NAV is wider than the three-year average of 12.9%. The sharp correction in Asian equities has also afflicted most of SST's peers and discounts have widened across the group. There may be scope for the discount to narrow should sentiment towards Asian equities improve.

Investment trusts

22 November 2018

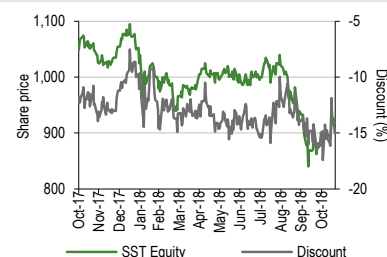
Price 918.0p
Market cap £274.0m
AUM £320.0m

NAV* 1,066.0p
Discount to NAV 13.9%
NAV** 1,078.1p
Discount to NAV 14.9%

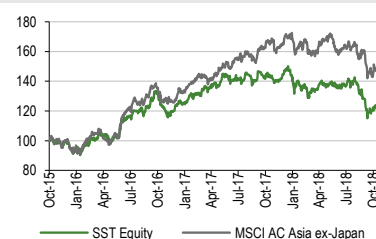
*Excluding income. **Including income. As at 20 November 2018.

Yield 1.3%
Ordinary shares in issue 29.9m
Code SST
Primary exchange LSE
AIC sector Asia Pacific ex-Japan
Benchmark MSCI AC Asia ex-Japan

Share price/discount performance



Three-year performance vs index



52-week high/low 1,095.0p 840.0p
NAV** high/low 1,203.6p 1,000.4p

**Including income.

Gearing

Gross* 0.0%
Net* 6.7%

*As at 30 September 2018.

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Exhibit 1: Trust at a glance

Investment objective and fund background

SST's objective is to provide shareholders with long-term capital growth through investment in smaller Asian (excluding Japanese and Australasian) quoted companies. Its assets are invested in a diversified portfolio of equities. While the manager takes account of cultural, political and economic factors, stock-specific features are the main driver of portfolio selection, with the aim of identifying good-quality companies with solid, long-term growth prospects.

Recent developments

- 16 October 2018: annual report for 12 months to end-August 2018. NAV TR - 2.4% versus benchmark TR +2.2%.
- 16 October 2018: the board announced proposal to raise the permitted market capitalisation limit in the investment policy (see page 3).
- 16 October 2018: the board declared an annual dividend of 11.5p per share.
- 20 April 2018: interim report for six months to end-February 2018. NAV TR -2.3% versus benchmark TR +3.4%.

Forthcoming

AGM	December 2018
Interim results	April 2018
Year end	31 August
Dividend paid	January/February
Launch date	March 1995
Continuation vote	None

Capital structure

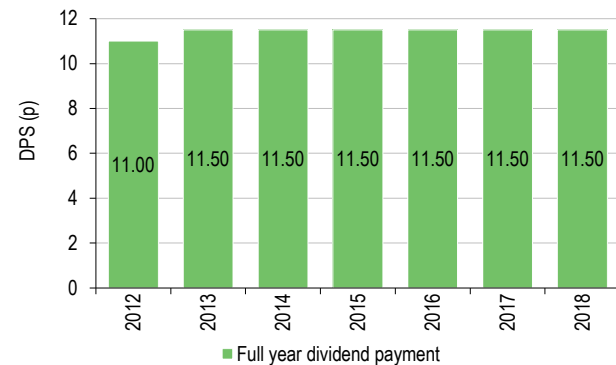
Ongoing charges	1.0% (FY18)
Net cash	6.7%
Annual mgmt fee	0.75%
Performance fee	Yes (see page 7)
Trust life	Indefinite
Loan facilities	None (see page 7)

Fund details

Group	First State Stewart
Manager	Vinay Agarwal
Address	10 St Colme Street, Edinburgh, EH3 6AA
Phone	+44 (0) 131 473 2200
Website	www.scottishoriental.co.uk

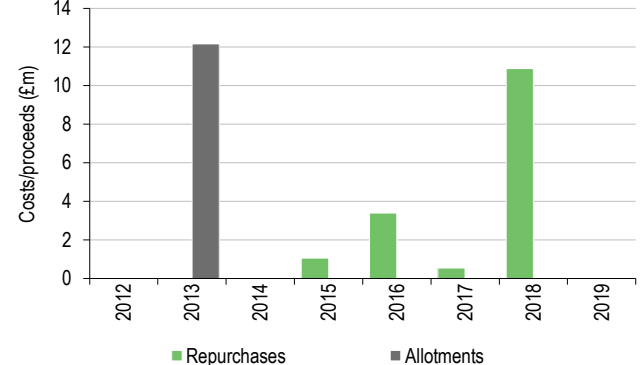
Dividend policy and history (financial years)

Dividends paid annually. The board intends to at least maintain the level of dividend, using reserves if necessary, unless company distributions fall sharply.

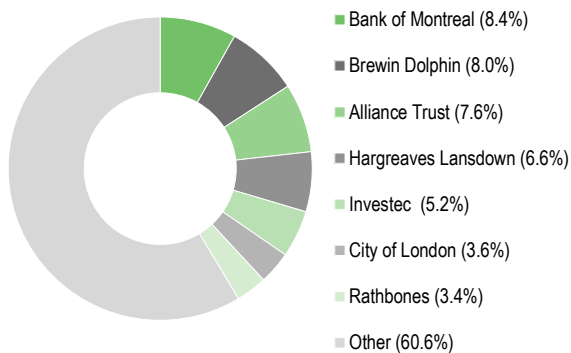


Share buyback policy and history (financial years)

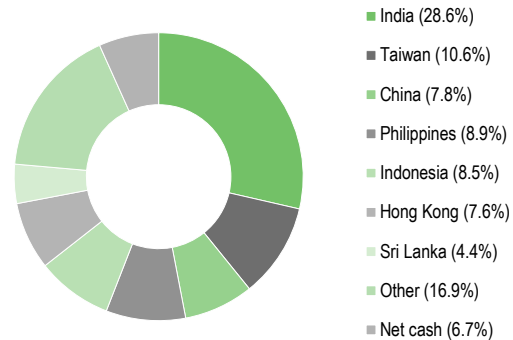
Renewed annually, the board has authority to repurchase up to 14.99% and allot up to 10% of shares outstanding.



Shareholder base (as at 15 October 2018)



Portfolio exposure by geography (as at 31 October 2018)



Top 10 holdings (as at 31 October 2018)

Company	Country	Sector	Portfolio weight %	
			31 October 2018	31 October 2017*
SKF India	India	Industrials	3.8	3.1
Vitasoy International	Hong Kong	Consumer staples	3.6	N/A
Concepcion Industrial	Philippines	Industrials	3.2	2.9
Haw Par	Singapore	Consumer staples	3.1	2.2
Sinbon Electronics	Taiwan	Information technology	3.1	2.8
Delta Electronics	Thailand	Industrials	2.9	N/A
Towngas China	China	Utilities	2.9	3.3
Raffles Medical	Singapore	Healthcare	2.9	N/A
Blue Star	India	Industrials	2.8	2.8
Jyothy Laboratories	India	Healthcare	2.7	N/A
Top 10			30.9	26.2

Source: Scottish Oriental Smaller Companies Trust, Edison Investment Research, Bloomberg, Morningstar. Note: *N/A where not in October 2017 top 10.

Market outlook: Relatively attractive over long-term

The MSCI Asia ex-Japan index performed strongly between early 2016 and early 2018, fuelled by synchronous global growth, exceptionally accommodative monetary conditions and positive earnings momentum. Many of these factors are now reversing as interest rates rise, while global leading economic indicators have started to roll over (although they remain strong in the US, underpinned by the impact of recent tax reforms). Expectations for Asian earnings growth have also moderated considerably, following an exceptionally strong 2017. Consensus forecasts for the MSCI Asia ex-Japan index earnings in 2018 started the year at c 15%, and are currently around 6–7%. Headwinds for the region include higher oil prices (Asia is a net importer of oil) and escalating trade tensions between China and the US. These challenges have been reflected in a correction in Asian equities, with smaller-caps faring worse as they are perceived to be riskier than larger-caps. As shown in Exhibit 2 (LHS), since the January 2018 peak for Asian equities, the MSCI Asia ex-Japan Small Cap index has fallen c 13% in sterling terms and the MSCI Asia ex-Japan index has fallen c 20%. Meanwhile, MSCI World has been more resilient, bolstered by the strength of US equities, leaving the Asia's equity valuations looking relatively modest, as shown in Exhibit 2 (RHS). Meanwhile, prospects for economic growth in Asia ex-Japan remain higher than for the world and advanced economies, which may help underpin superior equity returns over the long run. According to the International Monetary Fund's World Economic Outlook in October 2018, the Asia ex-Japan region is expected to grow at 5.7% pa between 2018 and 2023. Over the same period, it expects world growth of 3.6% pa and 1.8% pa for advanced economies.

Exhibit 2: Market performance and valuation



Source: Thomson Datastream, Bloomberg, MSCI, Edison Investment Research

Fund profile: Fundamental approach to small-caps

SST was launched in March 1995 with the objective to achieve long-term capital growth by investing mainly in smaller Asian (excluding Japan) companies, primarily with market capitalisations below US\$1.5bn at the time of investment. At present, the trust is permitted to invest up to 20% of the portfolio in companies with market capitalisations between US\$1.5bn and US\$3bn. The board is seeking shareholders' approval at the December 2018 AGM to amend the investment policy such that SST can primarily invest in companies with market capitalisations below \$3bn at the time of investment, and be permitted to invest up to 20% of the fund in companies with market capitalisations of US\$3bn to US\$5bn. The current limits were set in September 2013 and since then, the average market capitalisations of the benchmark's constituents have more than doubled, meaning many small-cap companies are now above the investment policy ceiling and unavailable to SST as potential investments. The board believes it is appropriate for the investment policy to be amended, to allow the manager flexibility to invest in larger companies than currently permitted,

with no change to SST's investment process. Gearing of up to 50% of net assets is permitted; however, the manager is wary of Asian equity valuations and a £20m loan facility was repaid early in June 2017. As at end-September 2018, the trust had a 6.7% net cash position.

Vinay Agarwal formally assumed the role of lead manager from Wee-Li Hee in July 2017, after a year as acting lead manager during her maternity leave. Hee has returned as a co-portfolio manager, ensuring continuity in the team.

The fund manager: Vinay Agarwal

The manager's view: Good companies survive difficult markets

Agarwal is cognisant of challenging market conditions. Currencies in several Asian countries have weakened, higher oil prices are not helpful for a region that is a net importer of the commodity, and politics have been a destabilising force for some markets (for example, the dissolution of parliament in Sri Lanka). The manager notes that Asia, over time, has consistently experienced challenging periods and he does not view the current environment to be unusually hostile. He says that history shows high quality, well-managed businesses with strong cash flows, can survive difficult conditions, and generate rewarding returns over the long-run. Agarwal does not forecast outcomes for shorter-term issues; instead he remains focused on picking companies that can deliver growth over the long term. These are typically domestically oriented companies with businesses in underpenetrated sectors, low debt and able to self-fund their growth plans. Valuation discipline is important and despite the correction in Asia's equity markets, Agarwal thinks, overall, they are still a bit expensive for the quality companies he favours, although some opportunities are arising.

Asset allocation

Investment process: Bottom-up, focused on quality

SST follows a bottom-up approach to find high-quality companies with sustainable and predictable growth, investing with a long-term horizon of three to five years or more. First State Stewart Asia's team consists of 21 investment professionals located in Hong Kong, Singapore and Edinburgh. The size and the depth of the team support an intensive schedule of over 1,600 company visits pa, and rigorous evaluation of companies. The team looks for strong management, those with integrity and a good track record of capital allocation. They also seek to identify companies that have quality franchises with high barriers to entry, have sustainably attractive returns on capital employed and that are not dependent upon favourable regulation or political patronage. Valuation discipline is also an important part of the investment process and the manager is patient, building positions gradually, especially as small-caps can be illiquid and share price movements more sensitive to market transactions.

Current portfolio positioning

The shape of SST's portfolio almost entirely reflects the manager's high-conviction stock selection. The investment process does not involve asset allocation against sectors and countries, although they are part of the consideration to ensure a sufficiently well-diversified portfolio to help mitigate risk. As shown in Exhibit 3, as at end-September 2018 SST is most notably overweight India (18.5pp) and the Indian subcontinent accounts for 36.7% of the portfolio. Also of note is an 8.2% exposure to non-index countries in the frontier markets of Sri Lanka, Vietnam and Bangladesh. SST is also overweight some of the smaller countries within the index (such as the Philippines and Indonesia). These positions reflect the manager's preference for investing in businesses in underpenetrated markets, with multi-year structural growth opportunities that are reasonably

valued. Such companies are typically less well-known to the broader investment community. Agarwal is keen to find firms that can benefit from the trends in rising incomes and urbanisation, and often finds these characteristics in consumption-related stocks. As shown in Exhibit 4, the portfolio is overweight the consumer discretionary and consumer staples sectors, and many of the companies within the industrials sector are effectively exposure to the consumption theme. Examples include home appliances companies Concepcion and Blue Star, listed in the Philippines and India, respectively. Both companies are leading manufacturers of air conditioners within their respective markets, where they are gaining market share. They are also beneficiaries of the long-term structural growth potential for their products as their markets are very underpenetrated. The manager says that air conditioner penetration in India and the Philippines is at 8% and 11% respectively, compared with 74% in China.

Exhibit 3: Portfolio geographic exposure vs benchmark (% unless stated)						
	Portfolio end- Sept 2018	Portfolio end- Sept 2017	Change (pp)	Benchmark weight	Active weight vs benchmark (pp)	Trust weight/ benchmark wgt (x)
India	28.6	26.1	2.5	10.1	18.5	2.8
Taiwan	10.6	10.6	0.0	13.8	(3.2)	0.8
Philippines	8.9	9.2	(0.3)	1.2	7.7	7.4
Indonesia	8.5	7.7	0.8	2.4	6.1	3.5
China	7.8	9.6	(1.8)	35.0	(27.2)	0.2
Hong Kong	7.6	6.6	1.0	11.1	(3.5)	0.7
Singapore	6.0	4.3	1.7	4.1	1.9	1.5
Sri Lanka	4.4	5.0	(0.6)	0.0	4.4	N/A
Thailand	2.9	2.4	0.5	2.9	0.0	1.0
Vietnam	1.9	1.4	0.5	0.0	1.9	N/A
Bangladesh	1.9	1.3	0.6	0.0	1.9	N/A
Pakistan	1.8	1.3	0.5	0.1	1.7	18.0
Malaysia	1.2	3.3	(2.1)	2.9	(1.7)	0.4
South Korea	1.0	3.3	(2.3)	16.3	(15.3)	0.1
Net cash	6.7	7.9	(1.2)			
	100.0	100.0		100.0		

Source: Scottish Oriental Smaller Companies Trust, Edison Investment Research

Exhibit 4: Portfolio sector exposure vs Asia ex-Japan indices (% unless stated)						
	Portfolio end- Sept 2018	Portfolio end- Sept 2017	Change (pp)	Benchmark weight	Active weight vs benchmark (pp)	Trust weight/ benchmark wgt (x)
Consumer discretionary	22.9	17.9	5.0	8.1	14.8	2.8
Industrials	18.9	18.2	0.7	6.9	12.0	2.7
Consumer staples	14.3	12.6	1.7	5.0	9.4	2.9
Information technology	8.4	9.5	(1.1)	29.6	(21.2)	0.3
Financials	7.9	9.4	(1.5)	24.0	(16.1)	0.3
Healthcare	7.2	7.8	(0.6)	3.0	4.2	2.4
Materials	4.8	6.1	(1.3)	4.8	0.0	1.0
Utilities	4.7	6.8	(2.1)	3.4	1.3	1.4
Real estate	2.7	3.0	(0.3)	5.9	(3.2)	0.5
Telecommunications	1.4	1.4	0.0	4.4	(3.0)	0.3
Energy	0.0	0.0	0.0	5.0	(5.0)	0.0
Cash	6.7	7.0	(0.3)		6.7	
	100.0	100.0	100.0		100.0	

Source: Scottish Oriental Smaller Companies Trust, Edison Investment Research

Relative to the index, SST is most underweight China (-27.2pp), and is generally underweight the more developed countries including South Korea (-15.3pp) and Hong Kong (-3.5pp). These markets are relatively well-researched and have a larger proportion of their stocks above SST's market capitalisation cap (currently \$3bn). In terms of sectors, the portfolio is most underweight technology (-21.2pp) and financials (-16.1pp). Companies within these sectors tend to be very large-cap and outside of SST's investment universe. The technology companies often trade on lofty valuations, while the financials tend to be state-owned and long-term prospects can be dependent upon government policy and political patronage. The manager finds these characteristics to be unattractive.

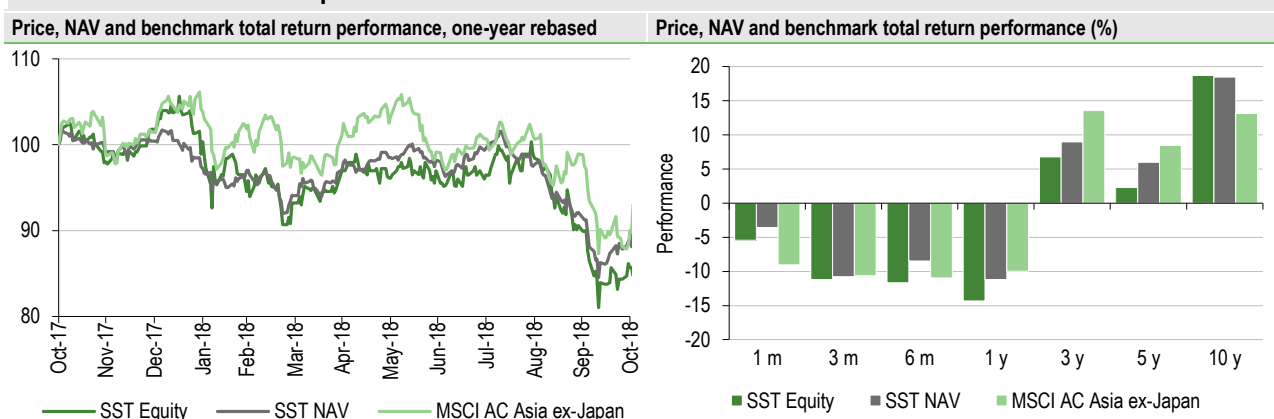
The most significant recent portfolio activity has been additions to existing holdings as stock price corrections presented opportunities. These have included Towngas China, which fell on rumours of the removal of connection fees for new gas users, an important source of its revenue. Agarwal evaluated this event to be unlikely and took advantage of Towngas's weak share price to increase SST's position. The market pullback allowed SST to add to Vitasoy, a Hong Kong-listed beverage company, which the manager believes has excellent management and potential to grow in China. It has one of the strongest beverage brands in the Greater China market, and a mature, highly cash-generative business in Hong Kong that can help to fund the company's expansion plans.

SST's portfolio has been repositioned over the past two years, shifting in favour of higher-growth companies and selling out of those Agarwal viewed as low-growth 'value traps' (shares that appear cheaply valued but are unlikely to appreciate). The number of holdings has also been reduced to allow an individual stock to contribute more meaningfully to performance. As at end-August 2018, SST held 57 stocks, down from 76 at end-August 2016. The estimated three-year earnings growth of new purchases over this period is c 17% compared to 11% for companies sold. The manager is very excited about the portfolio, which he believes consists of companies with strong and resilient structural growth drivers that can deliver performance over the long term.

Performance: Strong long-term performance

As shown in Exhibits 5 and 6, SST has a strong long-term performance track record and over 10 years, its NAV total return has significantly outperformed the MSCI Asia ex-Japan, MSCI Asia ex-Japan Small Cap and the FTSE All-Share indices. Over all periods shown, its NAV has also outperformed the MSCI Asia ex-Japan Small Cap index, arguably the more relevant comparator index for SST. It has underperformed its benchmark MSCI Asia ex-Japan index over shorter periods of one, three and five years, during which time index gains were dominated by large-cap names, especially in the Chinese internet sector, which are outside the portfolio's investible universe.

Exhibit 5: Investment trust performance to 31 October 2018



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

Exhibit 6: Share price and NAV total return performance, relative to indices (%)

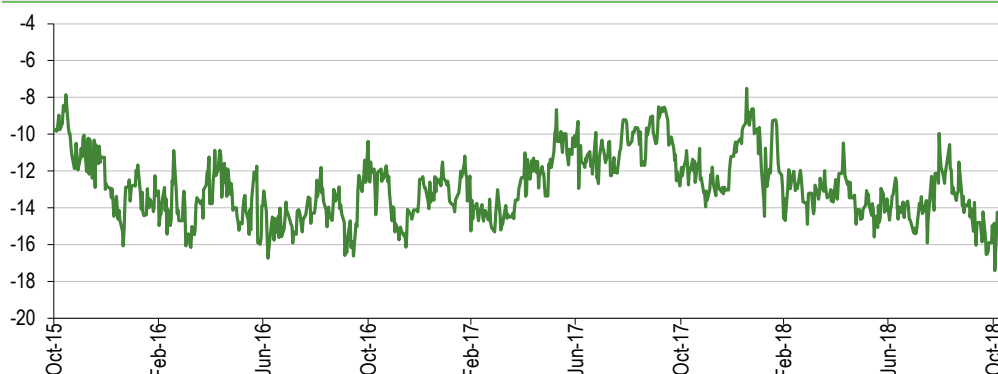
	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to MSCI AC Asia ex-Japan	3.9	(0.6)	(0.8)	(4.8)	(16.8)	(25.5)	61.8
NAV relative to MSCI AC Asia ex-Japan	6.0	(0.2)	2.8	(1.3)	(11.6)	(10.9)	58.7
Price relative to MSCI AC Asia ex-Japan Small Cap	5.3	3.2	4.7	0.5	(0.3)	(11.7)	53.9
NAV relative to MSCI AC Asia ex-Japan Small Cap	7.4	3.7	8.5	4.2	6.0	5.6	51.0
Price relative to FTSE All-Share	(0.3)	(4.3)	(8.4)	(13.0)	(2.9)	(14.3)	116.1
NAV relative to FTSE All-Share	1.7	(3.9)	(5.1)	(9.9)	3.2	2.6	112.0

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-October 2018. Geometric calculation.

Discount: Deeper than the three-year average

SST currently trades at a discount to cum-income NAV of 14.9% which is deeper than its three year average of 12.9%. The sharp correction in Asian equities, which has been more acute for smaller-caps, has affected many Asian funds and discounts to NAV have widened across the peer group. The board does not have a formal discount policy, but actively promotes the trust and regularly monitors its discount to NAV. It has the authority (renewed annually) to repurchase shares, if it believes this to be in the best interests of shareholders as a whole.

Exhibit 7: Share price discount to NAV (including income) over three years (%)



Source: Thomson Datastream, Edison Investment Research

Capital structure and fees

SST is a conventional investment trust with one class of share; there are currently 29.9m ordinary shares in issue and 1.5m are held in treasury. The board has the authority, renewable annually to repurchase up to 14.99% of shares outstanding and, during FY18, 1.1m shares were bought back at a cost of £10.9m.

First State Investment Management (UK) is paid an annual management fee of 0.75% of SST's net assets. A performance fee is also payable subject to SST's share price total return, exceeding the MSCI AC Asia ex-Japan index by 10 percentage points over a three-year period. The total fee payable to the investment manager is capped at 1.5% pa of the trust's net assets.

Dividend policy and record

The trust's primary objective is to generate capital gains rather than income. SST pays a dividend annually, which the board intends to at least maintain at the same level as the prior year. The FY18 dividend of 11.5p per share, unchanged from FY17, represents a yield of 1.3%. This was in excess of the income per share of 9.2p, with the shortfall taken from the revenue reserve, in line with the board's policy to utilise these to help smooth dividend payments.

Peer group comparison

Exhibit 8 shows the AIC Asia-Pacific ex-Japan peer group of investment trusts with market capitalisations over £100m. This is a diverse group of members, including funds that invest in Australasia and those with an income focus – therefore, direct comparisons may not be meaningful. The trust ranks first for NAV total return performance over 10 years. Over one, three and five years,

it has lagged the peer group averages and ranks 11th, 15th and 10th, respectively. However, the MSCI Asia ex-Japan Small Cap index has lagged the MSCI Asia ex-Japan index over all these three periods, and funds with a small-cap mandate such as SST have tended to underperform within this peer group.

Exhibit 8: AIC Asia Pacific ex-Japan peer group as at 20 November 2018*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Discount (ex-par)	Ongoing charge	Performance fee	Net gearing	Dividend yield (%)
Scottish Oriental Smaller Cos	273.6	(9.7)	34.0	39.7	485.1	(14.7)	1.0	Yes	100	1.3
Aberdeen Asian Income	342.3	(4.4)	46.9	30.3	268.9	(10.9)	1.1	No	110	4.7
Aberdeen Standard Asia Focus	345.5	(5.1)	41.0	30.4	422.1	(13.9)	1.2	No	114	1.3
Aberdeen New Dawn	236.7	(7.0)	52.9	38.8	282.8	(14.2)	0.8	No	112	2.0
Edinburgh Dragon	641.5	(6.5)	49.3	40.8	261.6	(11.7)	0.8	No	104	1.2
Fidelity Asian Values	278.1	(2.2)	55.2	72.3	393.0	3.0	1.2	No	100	1.4
Henderson Far East Income	408.8	(5.3)	44.0	38.5	211.6	0.5	1.1	No	102	6.8
Invesco Asia	182.3	(10.6)	56.0	72.3	356.2	(12.3)	1.0	No	100	2.1
JPMorgan Asian	305.8	(7.7)	71.9	76.8	292.1	(10.9)	0.7	No	100	4.8
Martin Currie Asia Unconstrained	123.1	(9.7)	48.7	34.8	151.3	(15.3)	1.1	No	104	2.4
Pacific Assets	314.1	1.9	49.2	74.3	377.1	(2.3)	1.3	No	100	1.0
Pacific Horizon	175.6	(16.2)	58.7	61.2	310.5	1.1	1.0	No	100	0.2
Schroder Asia Pacific	660.2	(12.6)	59.6	71.8	408.9	(12.5)	1.0	No	109	1.4
Schroder Asian Total Return	296.9	(9.6)	65.4	82.0	338.6	2.1	1.0	Yes	106	1.5
Schroder Oriental Income	591.2	(4.8)	44.1	54.0	428.4	0.3	0.9	Yes	105	4.2
Simple average	345.0	(7.3)	51.8	54.5	332.5	(7.5)	1.0		104	2.4
SST rank in sector	11	11	15	10	1	15	9		11	12

Source: Morningstar, Edison Investment Research. Note: *Performance data to 19 November 2018. TR = total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

The board

SST's board consists of five directors, all of whom are independent and non-executive. Chairman James Ferguson and Alexandra Mackesy were appointed in 2004, and Anne West in 2010. Jeremy Witley and Andrew Baird were both appointed in 2017. Dr Janet Morgan resigned from the board in December 2017, having served since the trust's launch in 1995.

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