

Securities Trust of Scotland

Global investment in income and growth

Securities Trust of Scotland (STS) aims to achieve a combination of rising income and long-term capital growth from a concentrated portfolio of global large- and mid-cap stocks. The board's revised dividend policy, announced in May 2015, enables the company to deliver more of its returns to shareholders in dividends, while maintaining the investment approach and avoiding a potentially risky move towards higher-yielding stocks; STS now offers a 4.4% yield. Manager Martin Currie has a commitment to income investing, one of its principal strategy types.

12 months ending	Total share price return (%)	Total NAV return (%)	Blended benchmark (%)	MSCI World High Yield (%)	FTSE All-Share TR GBP (%)
29/02/12	18.2	4.6	3.6	6.1	1.5
28/02/13	21.3	21.4	20.3	20.3	14.1
28/02/14	4.3	4.5	7.0	7.0	13.3
28/02/15	(0.0)	9.5	13.5	13.5	5.6
29/02/16	(1.5)	(0.5)	2.3	2.3	(7.3)

Note: Twelve-month rolling discrete £-adjusted total return performance. Blended benchmark index is the FTSE All-Share index until 31 July 2011 and the MSCI World High Yield Index thereafter.

Investment strategy: Seeking income and growth

STS is a concentrated portfolio of 40-60 stocks selected on a bottom-up basis. All holdings should have the ability to generate both growth and income. Manager Alan Porter works in a recently enlarged team of seven income investment professionals, where there is active collaboration and discussion. All potential investments are subject to rigorous fundamental analysis and will only be considered if the valuation is attractive. STS has 44 holdings, which is the most concentrated portfolio in the Global Equity Income peer group. It has a high active share of 86.9%, meaning there is just a 13.1% overlap with the benchmark MSCI World High Dividend Yield index.

Market outlook: Macro issues driving volatility

So far, 2016 has seen global stock markets exhibiting heightened levels of volatility. This is a result of macro issues including slowing global growth, (especially in China), weaker commodity prices and geopolitical concerns. Divergences in monetary policy are another source of uncertainty. Equity valuation in terms of the forward P/E multiple for the Datastream World index is higher than the five-year average. In an environment where equity capital returns could be more muted than in recent years, a portfolio of equities providing income with the potential for long-term capital growth may be appealing to investors.

Valuation: Discount wider than historical range

Having adopted a global mandate in mid-2011, STS traded at a premium until mid-2014. The share price discount to NAV is now 7.0%, which probably reflects heightened stock market volatility and near-term investment performance. The discount is at the wider end of its range over one and three years and STS has been actively repurchasing shares to help manage the level.

Investment trusts

9 March 2016

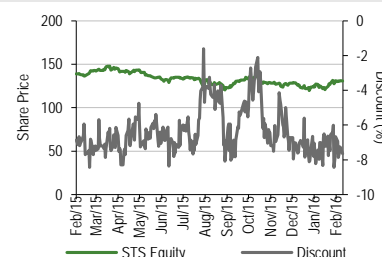
Price 131.0p
Market cap £149.4m
AUM £178.1m

NAV* 141.0p
Discount to NAV 7.1%
NAV** 140.9p
Discount to NAV 7.0%

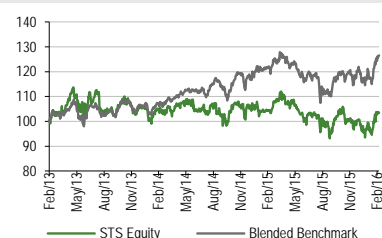
*Excluding income. **Including income as at 9 March 2016.

Yield 4.4%
Ordinary shares in issue 114.1m
Code STS
Primary exchange LSE
AIC sector Global Equity Income

Share price/discount performance



Three-year cumulative perf. graph



52-week high/low 148.0p 119.6p
NAV** high/low 159.0p 129.9p

**Including income.

Gearing

Gross* 10.6%
Net* 8.9%

*As at 31 January 2016.

Analysts

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Exhibit 1: Trust at a glance

Investment objective and fund background

Securities Trust of Scotland's investment objective is to provide rising income and long-term capital growth through a portfolio of global equities. Performance is measured against the MSCI World High Dividend Yield index (the FTSE All-Share index until 31 July 2011).

Recent developments

- 25 January 2016: appointment of John Evans as a non-executive director with effect from 1 February 2016.
- 21 January 2016: announcement of 1.45p third interim dividend for FY16.
- 6 November 2015: six-month report to 30 September 2015. NAV -10.7%, benchmark -9.1% and share price -12.5%.

Forthcoming

AGM	July 2016
Interim results	November 2016
Year end	31 March
Dividend paid	Quarterly
Launch date	28 June 2005
Continuation vote	None

Capital structure

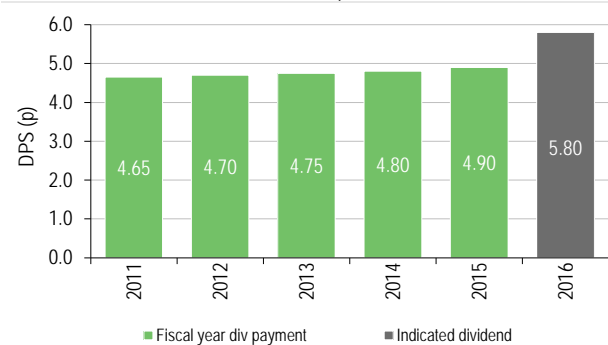
Ongoing charges	1.0% (as at 31 March 2015)
Net gearing	8.9%
Annual mgmt fee	0.6% of net assets
Performance fee	None
Trust life	Indefinite
Loan facilities	£17m revolving

Fund details

Group	Martin Currie Investment Mgmt. (UK)
Manager	Alan Porter
Address	Saltire Court, 20 Castle Terrace, Edinburgh EH1 2ES
Phone	+44 (0) 131 229 5252
Website	www.securitiestrust.com

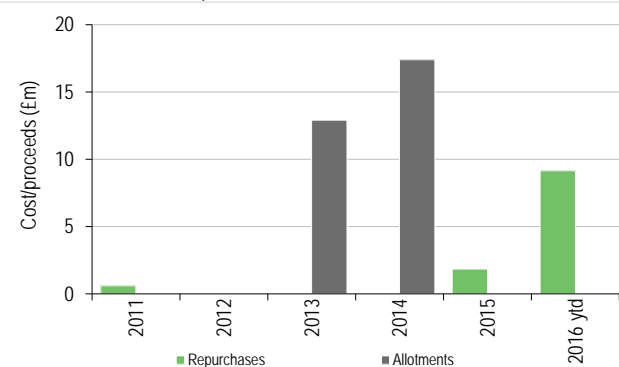
Dividend policy and history

Quarterly dividends paid in March, June, September and December. The board has announced a minimum dividend of 5.8p for 2016.

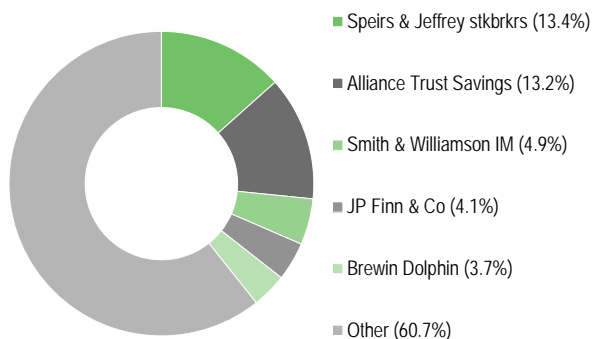


Share buyback policy and history

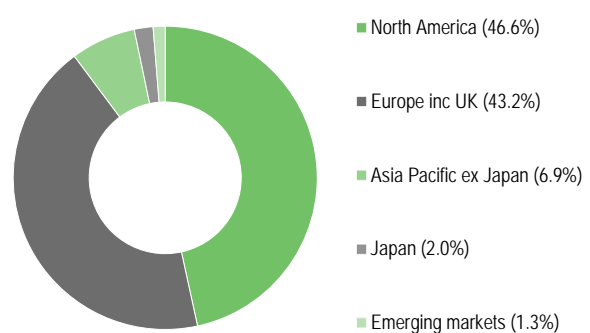
Renewed annually, the trust has authority to purchase up to 14.99%, and allot up to 5% of issued share capital.



Shareholder base (as at 1 March 2016)



Distribution of portfolio (as at 31 January 2016)



Top 10 holdings (as at 31 January 2016)

Company	Country of listing	Sector	Portfolio weight %	
			31 January 2016	31 January 2015*
British American Tobacco	UK	Tobacco	4.9	4.0
Philip Morris International	US	Tobacco	4.4	3.3
WEC Energy Group	US	Utilities	4.3	N/A
Chevron	US	Oil & gas	4.2	4.8
Pfizer	US	Pharmaceuticals	3.7	4.1
Roche	Switzerland	Pharmaceuticals	3.5	6.3
Novartis	Switzerland	Pharmaceuticals	3.3	N/A
Anheuser-Busch InBev	Belgium	Beverages	3.2	N/A
Verizon Communications	US	Telecommunications	3.2	3.5
United Parcel Services	US	Courier	3.1	N/A
Top 10			37.8	40.6

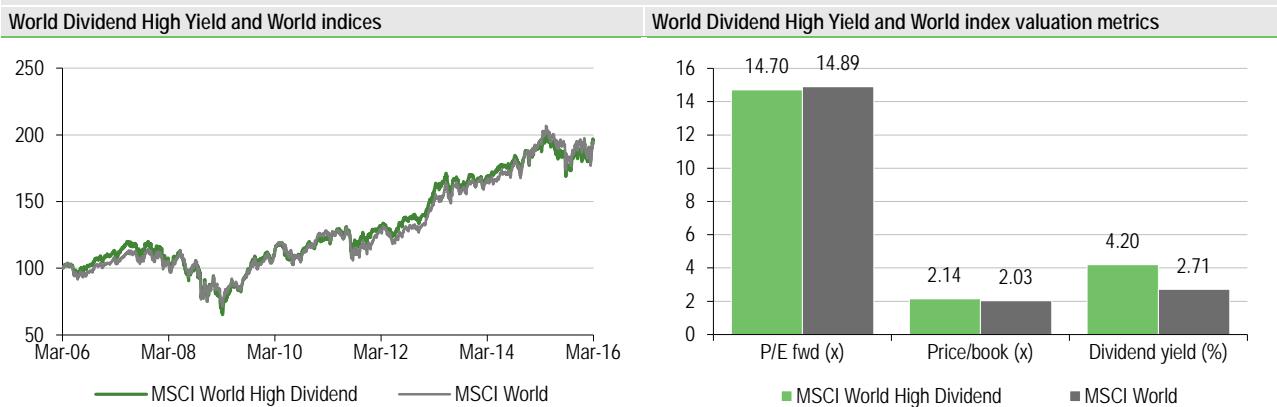
Source: Securities Trust of Scotland, Edison Investment Research, Morningstar, Thomson. Note: *N/A where not in January 2015 top 10.

Market outlook: Macro uncertainties, higher volatility

Global stock markets are in a period of heightened volatility. For example, year to date the CBOE Volatility index in the US is significantly above the averages of the last one, three and five years. Investor concerns centre on slowing global growth, weak commodity prices and geopolitical concerns. Until there is clarity on some of these macro issues, volatility in the stock markets may continue. However, forecasters such as the IMF look for growth to continue and global equity valuations in terms of forward P/E multiples are now more reasonable than the averages of the last 12 months.

For the first six weeks of 2016 the MSCI World High Dividend Yield index outperformed the MSCI World index by c 5% (-5.8% vs -10.6%); a partial clawback of the 10% total return underperformance of the high dividend yield index versus the broader market in the three-year period to the end of 2015. With similar valuations between the MSCI World High Dividend and MSCI World indices on both forward P/E and price/book multiples, investors may find the higher dividend yield of a fund investing in high-quality growth companies appealing.

Exhibit 2: Comparing MSCI World and World High Dividend Yield Indices



Source: Thomson Datastream, MSCI. Note: Index performance used is total return in sterling terms. Index data to end-February 2016, valuation data to end-January 2016.

Fund profile: Income and long-term capital growth

STS was incorporated in 2005 as part of the reconstruction of its namesake predecessor trust. It is managed by Martin Currie, which since October 2014 is an independently managed investment affiliate of Legg Mason. In 2011 the mandate was changed to focus on global rather than UK stocks and the MSCI World High Dividend Yield index was adopted as the benchmark. Manager Alan Porter seeks to invest in undervalued companies with rising income and the potential for long-term capital growth. In the current low-growth economic environment, the focus is on structural growth companies and those adopting self-help strategies. The portfolio consists of 40-60 stocks selected on a bottom-up basis. A revised dividend policy was announced in May 2015, whereby the trust will pay a higher dividend from both capital and income; the current yield is 4.4%.

The fund manager: Alan Porter

The manager's view: Equity yields are attractive vs other assets

Manager Alan Porter comments that economic activity was subdued in 2015. Emerging markets represent 70% of global growth but have seen declining growth for the last five years, while

developed markets are experiencing a modest recovery. He suggests there are three key transitions influencing the outlook: a slowdown in China and rebalancing from an investment to a consumption-led economy; lower commodity prices; and a gradual tightening of monetary policy in the US while several other advanced economy central banks continue to ease. A strong dollar has weighed on the performance of US exporters and affected emerging market economies with dollar-denominated debt.

Equity valuations are viewed as high but not extreme and dividend yields are attractive. On a sector basis, energy, material and utility earnings are under pressure. Consumer sectors are experiencing robust demand and benefit from lower commodity prices, but valuations are expensive. The MSCI World index is trading at c 15x forward earnings with most sectors trading around this level; outlying sectors are financials (c 10x), consumer staples (c 20x) and energy (where estimates are collapsing as a result of the weak oil price).

In a challenging macro environment, the manager is looking for long-term business models with sustainable revenues that should feed into profits, cash and dividend streams. Favoured investments are in companies with structural growth, self-help strategies or in a recovery mode where there is not an overreliance on strong economic growth.

Asset allocation

Investment process: Bottom-up stock selection

Stocks are selected on a bottom-up basis and are either large- or mid-cap. The investment process has three stages:

- Idea generation – stocks are selected on the basis of rising income and long-term capital growth. The benchmark MSCI World High Dividend Yield index is used in part as the basis for screening for dividend growth, persistence, yield and cover, while also highlighting strong balance sheets.
- Fundamental analysis and stock discussion – input from Martin Currie's regional specialists and global sector analysts is important and there is an emphasis on meeting companies. Potential investments undergo rigorous fundamental analysis including financial modelling. Areas of focus include cash flow, quality of management and valuation. The manager aims to invest in companies where the perceived value is not reflected in the current share price.
- Portfolio construction – the portfolio is constructed of 40-60 high quality, undervalued companies that have positive catalysts. Risk measures are in place to ensure adequate diversification, for example the maximum active stock weight is 5% (as at 31 January 2016, there were no single holdings in excess of 5%).

Following the appointment of Mark Whitehead in 2015, the Martin Currie income team is now comprised of seven people: four portfolio managers and three analysts focusing on global, European and UK portfolios. Manager Alan Porter stresses the benefits of the larger team, which has the resources to devote more time to company models and stress-testing investment assumptions, as well as encouraging more debate and generating investment ideas. The larger team illustrates the importance of income investment at Martin Currie, which forms one of the three pillars of the business.

Current portfolio positioning

As at 31 January 2016, STS held 44 stocks with the top 10 positions representing 37.8% of the portfolio compared to 40.6% at the end of January 2015. Six companies were in the top 10 list in both periods. Active share (a measure of the differentiation between the holdings in a portfolio

versus its benchmark) is high, currently at 86.9%. Over 20% of the portfolio is held in stocks that are not in the index.

Comparing STS's portfolio to the benchmark, the forward P/E multiple is modestly higher and the dividend yield is fractionally lower, this is partially due to the recent Kinder Morgan dividend cut. The debt to equity ratio is substantially higher, but the manager explains this is due to positions in REITs, for example Crown Castle, which carry a lot of debt and REITs are not included in the benchmark index.

Exhibit 3: Portfolio sector allocation vs benchmark (%) (as at 31 January 2016)

	Portfolio end Jan 2016	Portfolio end Jan 2015	Change	Index weight	Active weight vs index	Trust weight/ index weight
Financials	20.0	16.9	3.1	9.5	10.5	2.1
Healthcare	16.3	14.9	1.4	17.2	-0.9	0.9
Consumer staples	15.5	16.1	-0.7	18.5	-3.0	0.8
Industrials	12.1	7.0	5.1	8.8	3.4	1.4
Utilities	8.7	4.9	3.8	8.1	0.7	1.1
Telecommunications	7.9	7.9	0.0	5.8	2.1	1.4
Consumer discretionary	7.7	12.6	-4.9	6.9	0.8	1.1
Materials	4.7	11.0	-6.3	5.1	-0.4	0.9
Energy	4.3	6.4	-2.2	12.7	-8.4	0.3
Information technology	2.7	2.1	0.6	7.4	-4.7	0.4
	100.0	100.0		100.0		

Source: Securities Trust of Scotland, Edison Investment Research. Note: Ranked by active weight and adjusted for gearing. Rounding errors mean some figures may not sum.

On a sector basis, STS is overweight financials due to real estate exposure. A recent addition to the fund was Unibail-Rodamco – the largest commercial real estate company in Europe, which has solid mid-single digit revenue growth and strong cash generation. The portfolio is neutrally weighted in banks (although no US banks are held) and is underweight insurance. The underweight position in energy is due to the weak oil price and within IT the manager finds it difficult to find companies that fit the remit.

Exhibit 4: Geographic allocation (as at 31 January 2016)

	31-Jan-16	31-Jan-15	Change	MSCI AC World Dividend High Yield	Active weight vs index	Trust weight/ Index weight
North America	46.6	43.2	3.4	54.4	-7.8	0.9
Europe inc. UK	43.2	47.2	-3.9	37.5	5.7	1.2
Asia Pacific ex-Japan	6.9	4.1	2.8	6.1	0.8	1.1
Japan	2.0	2.7	-0.7	2.1	-0.1	1.0
Emerging markets	1.3	2.9	-1.6	0.0	1.3	N/A
	100.0	100.0		100.0		

Source: Securities Trust of Scotland, Edison Investment Research. Note: Ranked by active weight and adjusted for gearing. Rounding errors mean some figures may not sum.

Performance: Q415 was a tough period

STS did not keep pace with the benchmark in 2014 and 2015, which has weighed on the longer-term cumulative performance. In absolute terms, however, the NAV and share price total returns have been in excess of 7.5% a year over five years. Relative to the FTSE All-Share index, the trust's NAV has outperformed over all the periods shown in Exhibit 6.

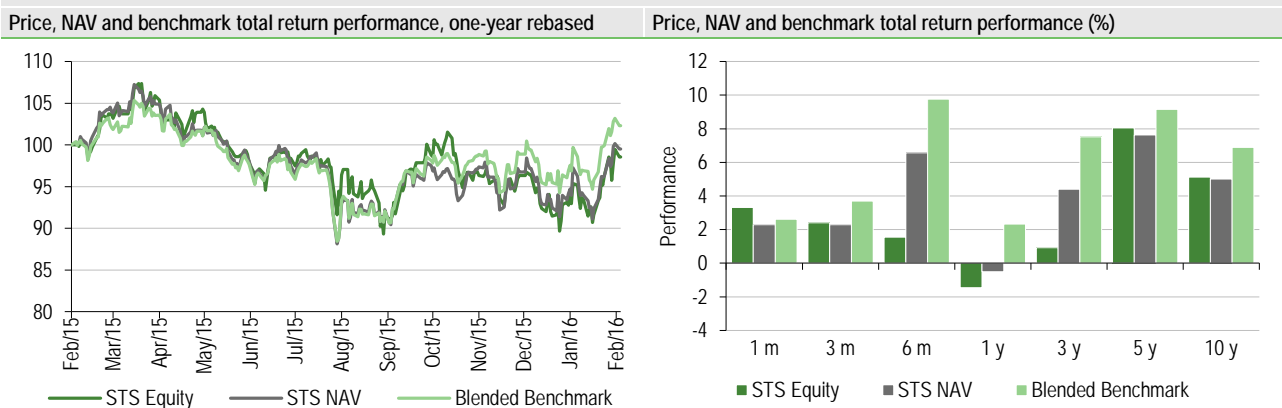
The manager comments that performance in 2015 was all about the fourth quarter, where the fund lagged the benchmark by 2.5%. This was due to four specific stocks:

- Kinder Morgan – investors have been concerned about the creditworthiness of debt-laden energy infrastructure companies and their ability to continue paying their dividends. Reassessing the stock following a 75% dividend cut the manager decided to maintain the position, believing that the share price did not factor in the value of the existing book of

business. Recently, the share price rose by 10% on news that Warren Buffett has taken a stake in the company.

- BHP Billiton – the investment was premised on reducing capex, deleveraging and cost cutting. However, sustained weakness in commodity prices and an expectation that the dividend would be cut meant the position was sold. Consensus earnings expectations are considered by the manager as being too high and if commodity prices recover, they could be to lower levels than seen in the recent super cycle.
- Meggitt – the position was sold following a profit warning in late 2015. The company has a strong position in a structural growth market (commercial aviation), but having spoken to management, STS’s manager believes there is a lack of visibility in the business.
- Hugo Boss – the long-term outlook for the company is viewed as favourable as retail operations are expanding and management is taking control of its franchisees. However, the position was reduced due to weakness in the Chinese luxury apparel market and price discounting in the US concessions.

Exhibit 5: Investment trust performance to 29 February 2016



Source: Thomson Datastream, Edison Investment Research. Note: Three, five and since inception (28 June 2005) performance figures annualised. Blended benchmark is FTSE All-Share until 31 January 2011, then MSCI World High Dividend Yield index.

Exhibit 6: Share price and NAV total return performance, versus indices (percentage points)

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to Blended Benchmark	0.7	(1.3)	(7.5)	(3.7)	(17.3)	(5.0)	(15.2)
NAV relative to Blended Benchmark	(0.3)	(1.4)	(2.9)	(2.8)	(8.4)	(6.8)	(16.2)
Price relative to MSCI World High Yield	0.7	(1.3)	(7.5)	(3.7)	(17.3)	(7.2)	(15.6)
NAV relative to MSCI World High Yield	(0.3)	(1.4)	(2.9)	(2.8)	(8.4)	(8.9)	(16.6)
Price relative to FTSE AllSh TR GBP	2.5	6.2	2.8	6.3	(7.3)	14.7	2.3
NAV relative to FTSE AllSh TR GBP	1.5	6.1	7.9	7.4	2.7	12.5	1.1

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-February 2016. Geometric calculation.

Exhibit 7: STS NAV return relative to blended benchmark return, over five years



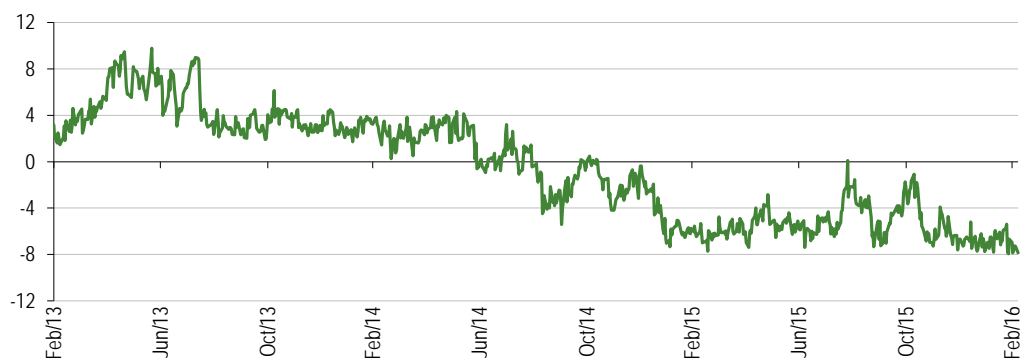
Source: Thomson Datastream, Edison Investment Research. Note: Using total returns.

Discount: Trading at the wider end of 12-month range

In August 2011, STS moved from a UK to a global mandate. The discount narrowed and the shares traded at a premium until mid-2014. STS's current share price discount to NAV of 7.0% is wider than the averages over the last one, three, five and 10 years. Over the past 12 months the discount has ranged from 1.6% to 8.4%.

STS's discount policy states that if the average discount during the 12 weeks before the trust's March fiscal year end exceeds 7.5%, a redemption opportunity is triggered. Over the year to date, the company has been actively repurchasing shares. The willingness to buy back shares to contain the discount is in keeping with the issuance of new shares to manage a premium (as shown in Exhibit 1).

Exhibit 8: Share price premium/discount to NAV (including income) over three years



Source: Thomson Datastream, Edison Investment Research. Note: Negative values indicate a discount, positive values a premium.

Capital structure and fees

STS has a simple capital structure with one class of share; as at 29 February there were 114.7m shares outstanding. Borrowing is via a £17m revolving loan facility with State Street, which expires on 25 September 2016. At 30 September 2015 it was fully drawn at an interest rate of 1.28%. Gross gearing of up to 15% is permitted; at 31 January it was 10.6%.

The annual management fee is 0.6% of net assets, payable quarterly, allocated 65% to capital and 35% to revenue, in accordance with the board's expected long-term split of returns in the form of capital gains and income. There is no performance fee following the board's decision to simplify the fee structure. Ongoing charges for FY15 were 1.0%, in line with the prior year.

Dividend policy

Dividends are paid quarterly in September, December, March and June. In May 2015, the board announced a change in its dividend policy to address the relatively low yield on which STS had traded relative to some of its peers. The dividend may now be paid in part from capital. This is deemed to be more attractive on a risk/reward basis than increasing the gearing or investing in higher-yielding stocks. Based on the current number of shares outstanding, at the end of September 2015, STS had distributable reserves of 108.9p per share: a special reserve of 89.0p per share, a capital reserve of 17.5p and a revenue reserve of 2.4p. A minimum annual dividend of 5.80p for FY16 was announced in advance, which implies that the final dividend will at least match

the three interim dividends already paid/announced (1.45p) and would represent an 18% increase versus the previous year.

Peer group comparison

There are 11 trusts in the Association of Investment Companies' Global Equity Income sector. STS's NAV total return is above the average over one, three and five years. It should be noted that the averages are skewed downwards by the Murray International Trust. In terms of risk-adjusted returns, STS has a higher Sharpe ratio over both one and three years. The discount is slightly wider than the peer group average and the ongoing charge is lower. Unlike some of the peers, there is no performance fee. Net gearing and dividend yield are modestly lower than the average.

Exhibit 9: Global Equity Income investment trusts as at 1 March 2016

% unless stated	Market Cap £m	NAV TR 1 Year	NAV TR 3 Year	NAV TR 5 Year	NAV TR 10 Year	Sharpe 1y (NAV)	Sharpe 3y (NAV)	Discount (ex-par)	Ongoing Charge	Perf. fee	Net Gearing	Dividend yield (%)
Securities Trust of Scotland	149.2	(0.5)	13.9	44.6	63.0	(0.8)	0.2	(7.0)	0.9	No	110.0	4.5
BlackRock Income Strategies	328.3	(8.6)	3.3	19.1	37.2	(1.5)	(0.1)	(7.8)	0.7	No	102.0	5.4
Blue Planet Investment Trust	15.2	(20.3)	3.6			(1.7)	(0.0)	(24.3)	3.8	No	152.0	9.2
F&C Managed Portfolio Income	46.8	(7.0)	11.2	39.1		(1.5)	0.1	1.4	1.2	Yes	93.0	4.6
Henderson International Income	91.3	0.1	24.2			(0.8)	0.5	(6.2)	1.1	No	108.0	4.0
Invesco Perp Select Glo Eq Inc	51.5	(1.6)	28.2	47.0		(0.7)	0.5	(0.0)	1.0	Yes	110.0	3.2
London & St Lawrence	95.5	(4.2)	18.3	46.5	76.0	(1.2)	0.3	(4.3)	0.9	Yes	99.0	4.3
Murray International B	927.9	(11.4)	(12.1)	16.0	92.6	(1.6)	(0.4)	(17.0)	0.7	No	116.0	6.2
Murray International	1,087.3	(6.7)	(6.7)	24.4	109.1	(1.2)	(0.4)	(2.7)	0.7	Yes	117.0	5.4
Scottish American	336.6	0.0	13.1	30.0	43.8	(0.8)	0.2	(2.6)	0.9	No	124.0	4.2
Seneca Global Income & Growth	55.1	(1.6)	15.6	37.5	41.8	(1.1)	0.2	(0.8)	1.5	No	110.0	4.2
Simple average	289.5	(5.6)	10.2	33.8	66.2	(1.2)	0.1	(6.5)	1.2	Yes	112.8	5.0
Rank	5	3	5	3	4	3	5	8	6		5	6

Source: Morningstar, Edison Investment Research. Note: Performance data to 29 February 2016. TR=total return. Sharpe ratio is a measure of risk-adjusted return. The ratios shown are calculated by Morningstar for the past 12- and 36-month periods by dividing a fund's annualised excess returns over the risk-free rate by its annualised standard deviation. Net gearing is total assets less cash and equivalents as a percentage of net assets.

The board

STS has six directors. Neil Donaldson was appointed chairman when the trust was reconstructed in May 2005; having served on the predecessor's company board since launch. Andrew Irvine (senior independent director) has the same tenure as Mr Donaldson. Rachel Beagles was appointed in July 2010, Angus Gordon Lennox in November 2013 and Mark Little in October 2014. The newest member of the board is John Evans; he was appointed in February 2016.

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