

Securities Trust of Scotland

New manager driving improved performance

Securities Trust of Scotland (STS) aims to generate rising income and long-term capital growth from a relatively concentrated portfolio of 35 to 55 global equities. Since May 2016, the trust has been managed by Mark Whitehead, who heads up Martin Currie's income team. A new unconstrained, high-conviction investment approach was adopted on 1 June 2016, with performance measured against a peer group comprising both closed- and open-ended funds. STS has outperformed the peer group since the change in investment strategy. The trust actively uses gearing and has a progressive dividend strategy; its current dividend yield is 3.5%.

12 months ending	Share price (%)	NAV (%)	Blended benchmark (%)	FTSE All-Share (%)	MSCI World (%)
31/07/13	27.4	25.1	23.7	24.3	28.1
31/07/14	(4.4)	(1.0)	4.3	5.6	4.7
31/07/15	(2.9)	5.4	6.5	5.4	14.1
31/07/16	17.3	17.5	22.3	3.8	17.7
31/07/17	14.0	13.6	13.1	14.9	17.6

Source: Thomson Datastream. Note: All % on a total return basis in pounds sterling. Blended benchmark is FTSE All-Share Index until 31 July 2011, MSCI World High Dividend Yield Index until 31 May 2016 and the rolling three-year median return of open- and closed-ended peers thereafter.

Investment strategy: Improved fundamental approach

Since becoming manager of STS in May 2016, Whitehead has adopted a more rigorous fundamental approach to stock picking. While continuing to focus on quality companies with strong cash flows, which offer support for rising dividends and are trading below their assessed intrinsic value, the manager also undertakes credit and scenario analyses to understand the inherent risks in a company's business model. In September 2016, STS increased its structural gearing. Net gearing of up to 20% of net assets is permitted; at end-July 2017 it was 11.0%.

Market outlook: P/E valuations above 10-year average

Equities have continued to move higher so far in 2017, as investors shake off macro uncertainties and instead focus on improving global corporate earnings growth. On a forward P/E basis, equity valuations remain c 20% above their 10-year averages for both UK and global companies. In such an environment, investors may decide to focus on an actively managed fund with a diligent fundamental approach to stock picking.

Valuation: Discount wider than historical averages

STS's current 6.6% share price discount to cum-income NAV is higher than the averages of the last one, three, five and 10 years of 5.6%, 5.6%, 2.4% and 3.9%, respectively. In 2015, the board introduced a new higher-yielding and progressive dividend policy aiming to bring STS's yield more in line with the peer group. The FY16 annual dividend was 18.4% higher than in FY15 and was raised by a further 2.6% in FY17. Based on the current share price, STS has a 3.5% dividend yield.

Investment trusts

29 August 2017

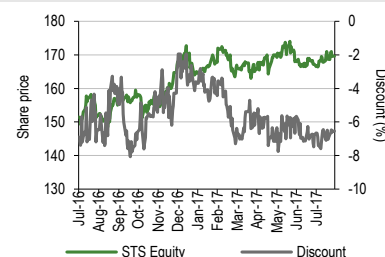
Price 169.6p
Market cap £190m
AUM £218m

NAV* 179.9p
Discount to NAV 5.7%
NAV** 181.5p
Discount to NAV 6.6%

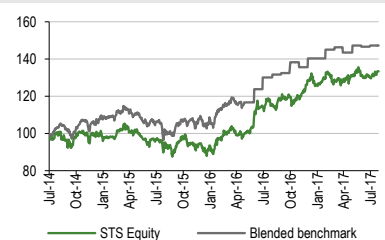
*Excluding income. **Including income. As at 24 August 2017.

Yield 3.5%
Ordinary shares in issue 112.1m
Code STS
Primary exchange LSE
AIC sector Global Equity Income

Share price/discount performance



Three-year performance vs index



52-week high/low 174.0p 148.5p
NAV* high/low 185.0p 158.3p

*Including income.

Gearing

Gross* 12.4%
Net* 11.0%

*As at 31 July 2017.

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. Following the adoption of an unconstrained mandate, from 1 June 2016 the trust measures its performance versus the rolling three-year median return of open- and closed-ended peers, as well as an absolute target to produce real growth in revenue and cum-income NAV on a rolling five-year basis.

Recent developments

- 21 July 2017: Andrew Irvine (senior independent director) retired at the 2017 AGM; he is replaced by Angus Gordon Lennox, who has served on the board for four years.
- 21 July 2017: Announcement of first interim dividend of 1.45p.
- 6 June 2017: Final results for 12 months ending 31 March 2017. NAV TR +26.7% versus peer group TR +26.1%. Share price TR +27.7%. Announcement of fourth interim dividend of 1.60p.

Forthcoming

AGM	July 2018
Interim results	November 2017
Year end	31 March
Dividend paid	Quarterly
Launch date	28 June 2005
Continuation vote	None

Capital structure

Ongoing charges	1.0%
Net gearing	11.0%
Annual mgmt fee	0.6% of net assets
Performance fee	None
Trust life	Indefinite
Loan facilities	£25m (see page 7)

Fund details

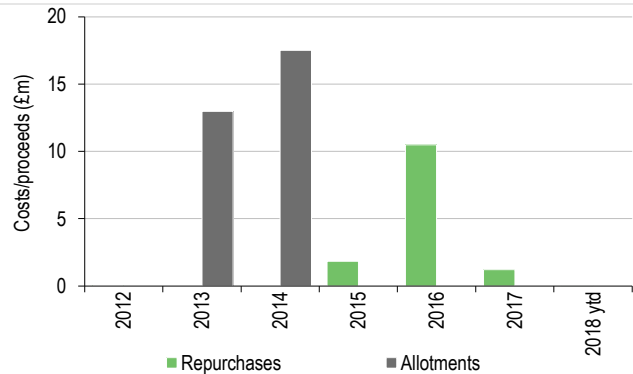
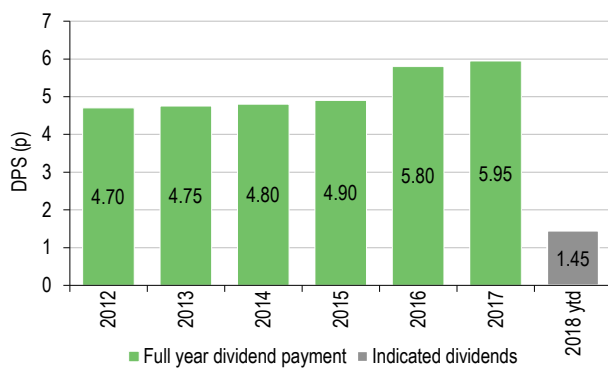
Group	Martin Currie Investment Mgmt (UK)
Manager	Mark Whitehead
Address	Saltire Court, 20 Castle Terrace, Edinburgh EH1 2ES
Phone	+44 (0) 131 229 5252
Website	www.securitiestrust.com

Dividend policy and history (financial years)

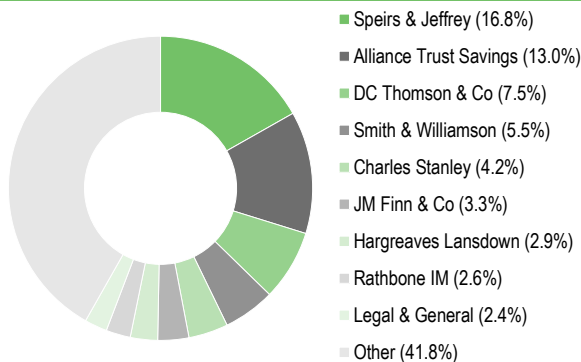
Dividends are currently paid quarterly in September, December, March and June, (October, January, April and July from 1 April 2018). Dividends were increased for FY16 after the announcement of a new progressive dividend policy.

Share buyback policy and history (financial years)

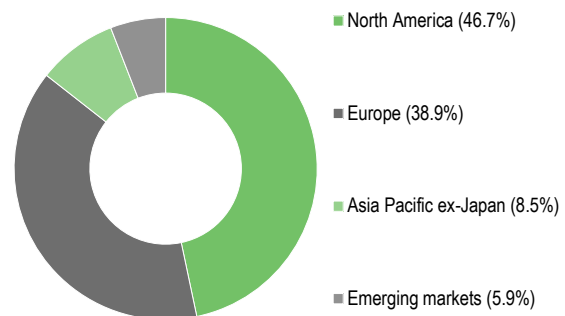
Renewed annually, the trust has authority to purchase up to 14.99% and allot up to 5% of issued share capital.



Shareholder base (as at 3 August 2017)



Portfolio exposure by geography (as at 31 July 2017, net of cash, gearing and option exposure)



Top 10 holdings (as at 31 July 2017)

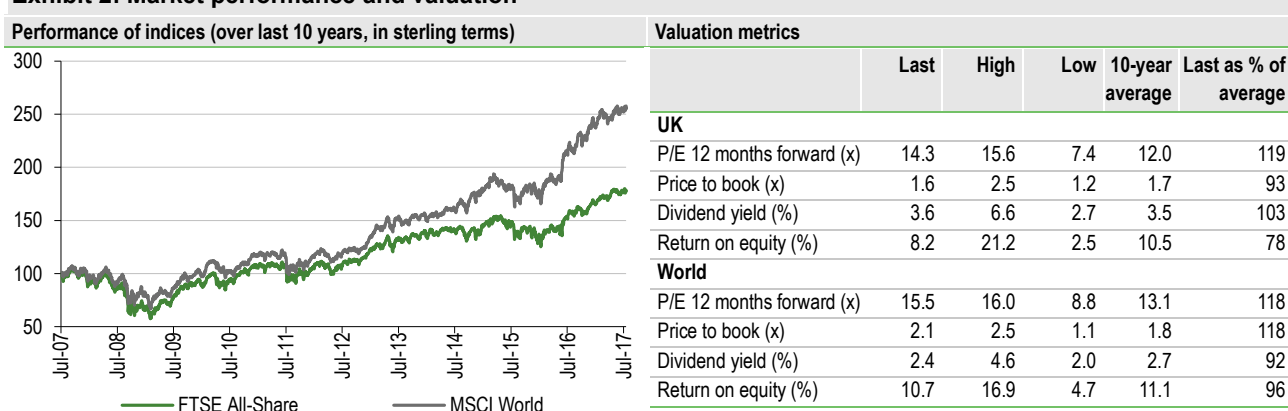
Company	Country	Sector	Portfolio weight %	
			31 July 2017	31 July 2016*
Apple	US	Information technology	3.7	N/A
Philip Morris International	US	Consumer staples	3.5	4.4
Roche	Switzerland	Healthcare	3.3	N/A
Banca Generali	Italy	Financials	3.1	N/A
ING Groep	Netherlands	Financials	2.9	N/A
Chevron	US	Energy	2.9	3.6
Givaudan	Switzerland	Materials	2.7	3.0
Microsoft	US	Information technology	2.6	N/A
Taiwan Semiconductor	Taiwan	Information technology	2.6	N/A
Waste Management	US	Industrials	2.6	3.0
Top 10			29.9	34.2

Source: Securities Trust of Scotland, Edison Investment Research, Bloomberg, Morningstar. Note: *N/A where not in July 2016 top 10.

Market outlook: Earnings multiples above average

The equity backdrop is broadly similar to when our last report was published in [February 2017](#). As shown in Exhibit 2 (left-hand side), over the last 10 years global equities have sharply outpaced UK equities. Over the past year or so, sterling weakness has boosted the value of international equities to UK-based investors. Since early 2016, investors have had significant macro events to consider such as the result of the UK's European referendum, the surprise election of US President Trump and a series of political elections in Europe. However, in a period of continued low interest rates and improved corporate earnings growth, equities have continued to move higher. As a result equity valuations, measured by forward P/E multiples, remain c 20% above their 10-year averages for both UK and global companies. Investors therefore may be interested in an actively managed fund, with a meaningful dividend yield, that has undergone changes that so far have led to improved investment performance.

Exhibit 2: Market performance and valuation



Source: Thomson Datastream, Edison Investment Research. Note: Valuation metrics as at 23 August 2017.

Fund profile: Global exposure to income and growth

Launched in June 2005, STS aims to generate rising income and long-term capital growth from a portfolio of global equities that is diversified by sector and geography. Since 11 May 2016, the trust has been managed by Mark Whitehead, who is head of Martin Currie's income team, which comprises seven income managers and analysts who have an average 18 years of investment experience. On 1 June 2016, STS moved to an unconstrained strategy measured against the median of all relevant open- and closed-ended peers, from the Lipper Global Equity Income and AIC Global Equity Income sectors, respectively, on a rolling three-year basis. In addition, the manager aims to grow the revenue earnings and the cum-income NAV in real terms over a rolling five-year period. STS has a relatively concentrated portfolio of 35-55 large and mid-cap positions, aiming for lower volatility and a high active share versus the broader market. (Active share is a measure of the percentage of holdings in a portfolio that differ from a benchmark.) The maximum size of a single holding is 7% and the total of all holdings over 5% may not exceed 40% of the whole portfolio. Net gearing of up to 20% of NAV is permitted; at end-July 2017 it was 11.0%.

The fund manager: Mark Whitehead

The manager's view: Marginally less positive on macro outlook

The manager remains constructive on equity markets. He says that corporate earnings growth has been strong in Q117 and Q217, with double-digits earnings growth in Q2 for the key US S&P 500

Index. However, he is marginally less positive on the macro environment than he was at the start of the year. He notes that US economic growth has slipped a little, and to a lesser extent in Europe. Whitehead expects central banks will continue to be accommodative – US Federal Reserve Bank Chairman Janet Yellen has stepped back from telegraphing another hike, which is positive for equities – but there is the potential for commodity prices to roll over, which would put pressure on cyclical stocks. Hence, STS now has higher exposure to structural growth sectors such as technology and consumer, where companies have issued positive earnings guidance for the balance of the year, so the manager believes that STS's portfolio is well positioned. Whitehead says that stock price volatility has been low and that he expects it to increase towards the end of the year. For the UK, Brexit discussions are ongoing, and there is still some risk that UK economic growth slows further, which is something that the manager is keeping a keen eye on.

Asset allocation

Investment process: More thorough fundamental research

The manager, who is able to draw on the resources of the experienced Martin Currie income team, seeks to invest in quality companies with the potential to generate growth in income and capital over the long term, and which are trading at a discount to their assessed intrinsic worth. According to data from Martin Currie, the shares of high-quality companies with higher-than-average dividend growth have outperformed both equities and bonds, on a risk-adjusted basis, over the long term. Companies considered for inclusion within the portfolio are likely to have sustainable sales growth, high cash flow generation and efficient capital management, which lead to attractive returns. Since taking over the portfolio in May 2016, the manager has repositioned the fund more towards companies that are growing and have a stronger degree of security regarding their dividend payouts, with less of a focus on higher-yielding stocks. The move to an unconstrained mandate has led to broader asset exposure and investment in selected smaller-cap companies. The manager has also started to use options to generate additional revenue (11.3% of total income in FY17). However, he notes that due to low stock market volatility there are currently fewer opportunities to generate income from selling options than there were in FY16.

The manager has revisited the investment case on every stock in the portfolio, which has led to a number of purchases and sales following extensive fundamental research, which now includes credit analysis and scenario testing to better understand the inherent risks in a company's business model, as well as an assessment of a company's corporate governance track record. Whitehead ensures that position sizes are larger for his highest-conviction holdings and that the combination of stocks is not reliant on a particular macro factor such as commodity prices or interest rates. Stocks may be sold if the original investment thesis has played out or is called into question, or if there are other higher-conviction investments ideas identified. A 20% fall from the original purchase price automatically triggers an in-depth review of a holding, which may lead to an exit or the manager taking advantage of share price weakness to add to the position.

Current portfolio positioning

At end-July 2017, the top 10 positions totalled 29.9% of the portfolio, which was a decrease in concentration compared to 34.2% at end-July 2016. Exhibit 3 shows STS's sector breakdown. Over the last 12 months, the largest increases in exposure are financials (including real estate, +10.0pp) and technology (+5.3pp), while the largest decreases are industrials (-5.7pp) and consumer staples (-4.9pp). A relatively new position in the financials sector is ING Groep; the manager believes that the company has a structural advantage, being more fintech than old-world banking, and is at the forefront of online consumer and commercial banking. ING has streamlined its operations as it has disposed of its insurance business. European economic growth is improving and the company is

better capitalised than a lot of European banks, is generating decent returns and improving profits, while trading on a reasonable valuation.

The manager considers that technology is an interesting area of the stock market as it has favourable growth characteristics and he believes that the sector is not overvalued, despite its relatively strong performance year to date. A recent addition to the portfolio is US semiconductor manufacturer Broadcom, which along with STS's other technology holdings, such as Apple and Microsoft, generates strong free cash flow, which underpins their dividends.

Within healthcare (the second largest sector exposure), US pharma company Pfizer was sold as the manager highlights the pressure on industry pricing. The pharma sector is always interesting for income funds because of the structural yield, but the manager suggests that the yield does not really grow and adds that in the last 10 years, the sector has found pipelines difficult to manage. It has been an interesting two or three years, with a lot of excitement about oncology, diabetes and Alzheimer's, but these are competitive therapies, with companies investing a lot of capital into research and development and not necessarily getting a good return. Hence the pharma companies have been reliant on price increases, which are now under threat.

US healthcare company Anthem has been added to the portfolio as the manager thinks that the company can become a market leader. It is the second largest US managed care organisation, providing medical insurance cover to corporates and individuals. It had a proposed merger with Cigna that fell through, but the manager believes that Anthem still has opportunities to continue to grow quite aggressively. He suggests that the failure to reform the Affordable Care Act is not a bad outcome for Anthem as it can continue to provide insurance to the Medicare/Medicaid programmes.

Exhibit 3: Portfolio sector exposure (% unless stated)			
	Portfolio end-July 2017	Portfolio end-July 2016	Change (pp)
Financials	23.5	22.2	1.3
Healthcare	11.3	14.0	(2.7)
Industrials	11.0	16.7	(5.7)
Information technology	10.9	5.6	5.3
Consumer discretionary	10.9	6.0	4.9
Materials	9.9	5.2	4.7
Consumer staples	8.9	13.8	(4.9)
Real estate*	8.7	N/A	N/A
Energy	6.9	7.5	(0.6)
Telecommunications	4.1	8.8	(4.7)
Utilities	4.0	7.0	(3.0)
Cash	1.4	2.6	(1.2)
Active options exposure	0.9	(0.1)	1.0
Gearing	(12.4)	(9.3)	(3.1)
	100.0	100.0	

Source: Securities Trust of Scotland, Edison Investment Research. Note: *Real estate was part of the financials sector in July 2016.

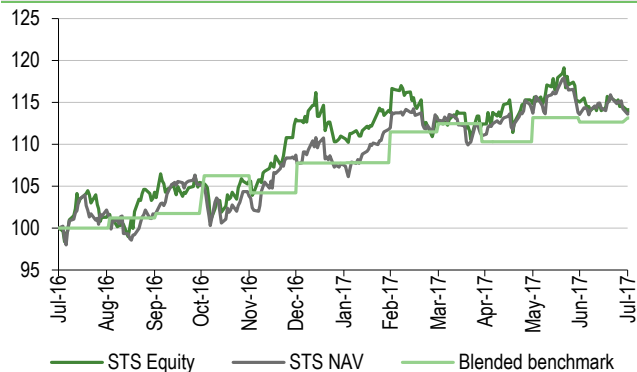
The manager has used the increased level of gearing to broaden the trust's asset exposure, buying companies with dividend yields in excess of STS's cost of debt, which also offer the potential for capital growth. Purchases include Civitas Social Housing (a housing REIT), Greencoat UK Wind (an investment trust invested in infrastructure) and Apax Global Alpha, which gives public-market access to Apax's private equity funds. It has a 14% pa target return including 5% in dividends.

Performance: Outperforming the new benchmark

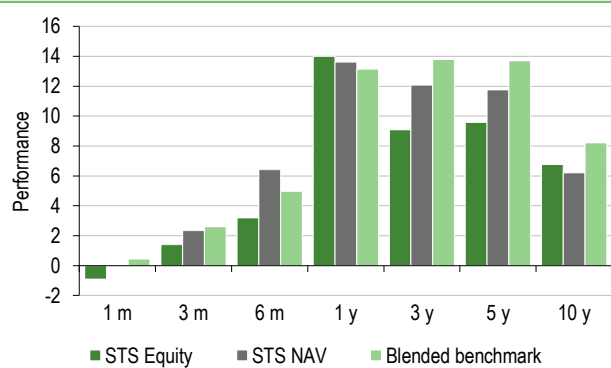
During FY17, STS's NAV and share price total returns of +26.7% and +27.7%, respectively, were modestly ahead of the peer-group benchmark total return of +26.1%. The largest positive contributors were US integrated energy company Chevron and tobacco companies Philip Morris and British American Tobacco, while the largest detractors included satellite companies Eutelsat Communications and Inmarsat.

Exhibit 4: Investment trust performance to 31 July 2017

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



Price, NAV and benchmark total return performance (%)



Source: Thomson Datastream, Edison Investment Research. Note: Three, five and 10-year performance figures annualised. Blended benchmark is FTSE All-Share Index until 31 July 2011, MSCI World High Dividend Yield Index until 31 May 2016 and the rolling three-year median return of open- and closed-ended peers thereafter.

STS's relative returns are shown in Exhibits 5 and 6, while details of its blended benchmark are included in the note below Exhibit 4. Since adopting the new unconstrained benchmark at the beginning of June 2016 to date, the trust has outperformed the peer-group benchmark by c 3.5pp, although relative performance has been more volatile.

Exhibit 5: 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 blended benchmark	(1.3)	(1.2)	(1.7)	0.8	(11.9)	(16.8)	(12.7)
NAV relative to blended benchmark	(0.4)	(0.3)	1.4	0.4	(4.4)	(8.2)	(17.1)
Price relative to FTSE All-Share	(2.0)	(1.5)	(3.6)	(0.8)	3.3	(4.2)	9.1
NAV relative to FTSE All-Share	(1.1)	(0.6)	(0.6)	(1.1)	12.0	5.7	3.6
Price relative to MSCI World	(1.8)	(1.7)	(2.6)	(3.1)	(17.8)	(25.4)	(23.7)
NAV relative to MSCI World	(0.9)	(0.8)	0.5	(3.4)	(10.9)	(17.7)	(27.6)

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-July 2017. Geometric calculation.

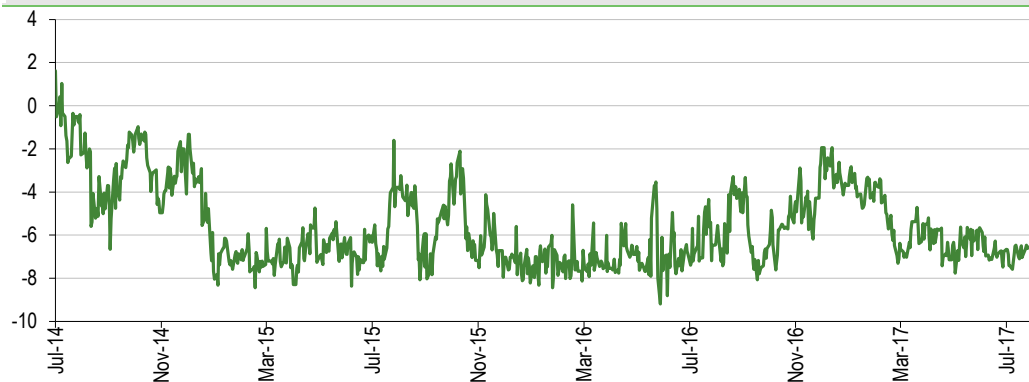
Exhibit 6: NAV total return performance relative to benchmark over three years



Source: Thomson Datastream, Edison Investment Research

Discount: Towards the wider end of historical range

The board operates a discount management policy aiming to keep the average discount below 7.5% in the last 12 weeks of the financial year. If the average ex-income discount is wider than 7.5% over this period, shareholders have the right to redeem their shares. There are also ad hoc share repurchases (see Exhibit 1). STS's current 6.6% share price discount to cum-income NAV is towards the top end of the 12-month range of a 1.9% to 8.1% discount, which occurred in October 2016 ahead of the US presidential election. It is also wider than the averages of the last one, three, five and 10 years (range of 2.4% to 5.6%).

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


Source: Thomson Datastream, Edison Investment Research

Capital structure and fees

STS is a conventional investment trust with one class of share; there are currently 112.1m ordinary shares in issue, with a further 10.2m shares held in treasury. In September 2016, taking advantage of prevailing low interest rates, STS increased its structural gearing from £17m to £25m in the form of a £10m two-year revolving credit facility and a seven-year multi-currency fixed facility with Royal Bank of Scotland split as follows: £1.50m at 2.1408%, €4.50m at 1.4175% and \$12.75m at 3.1925%. At the end of FY17, average borrowing costs were 1.94%. STS is permitted to gear up to 20% of net assets; at end-July 2017, net gearing was 11.0%. The gearing is being employed by investing the majority in global equities and also by the tactical use of options.

STS pays Martin Currie an annual management fee of 0.6% of net assets, split 65:35 between capital and income (which is the board's expected long-term split of returns between capital gains and income); no performance fee is payable. In FY17, the ongoing charge was once again at the targeted level of 1.0%; it has been at this figure since FY13.

Dividend policy and record

STS currently pays quarterly dividends in September, December, March and June; but from 1 April 2018, they will be paid in October, January, April and July. For FY16, the board adopted a progressive dividend policy, aiming to bring STS's dividend yield more in line with the peer group. The annual dividend of 5.80p was an 18.4% increase versus the prior year. In FY17, the annual dividend was increased again, by 2.6% to 5.95p. Based on the current share price, STS yields 3.5%. Under the new dividend policy, while the manager is focused on growing income over the longer term aiming to cover the dividend, payments may also be paid out of revenue reserves and capital if required. In FY17, just 3.5% of the dividend came from revenue reserves. At the financial year end, STS had a revenue reserve of £1.9m and a capital reserve of £70.5m versus an annual dividend payment of £6.7m.

Peer group comparison

In Exhibit 8, we compare STS to the other seven peers in the AIC Global Equity Income sector (which have a track record longer than 12 months), with an understanding that the trusts have a variety of mandates. STS's NAV total returns are below average over the periods shown, ranking seventh, fifth and sixth out of eight funds over one, three and five years, respectively, and fifth out

of five funds over 10 years. We also include the simple averages of the open-ended peers in the IA Global Equity Income sector. STS's NAV total returns are ahead of these averages over one and three years, while lagging over five and 10 years. STS trades at a wider-than-average discount, in a sector where more than half of the peers trade at a premium. Its ongoing charge is lower than average and its net gearing is broadly average. STS offers a lower-than-average dividend yield, but the peer group average is skewed by the large dividend yield of Blue Planet Investment Trust (which currently is predominantly invested in bonds); if this fund is excluded, STS's dividend yield is broadly in line with the closed-end peer group average.

Exhibit 8: AIC Global Equity Income peer group as at 25 August 2017*

% unless stated	Market cap/ fund size £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Discount (ex-par)	Ongoing charge	Perf. fee	Net gearing	Dividend yield (%)
Securities Trust of Scotland	190.2	14.8	41.9	75.3	92.1	(5.4)	1.0	No	111	3.5
Blue Planet Investment Trust	23.0	11.0	19.5	80.0		(10.3)	3.7	No	128	10.0
F&C Managed Portfolio Income	58.5	17.4	30.3	70.4		2.3	1.1	Yes	98	3.9
Henderson International Income	284.0	19.9	54.7	100.2		1.2	1.0	No	100	2.9
Invesco Perp Select Global Eq Inc	65.9	20.4	52.1	105.6	149.5	(1.9)	1.0	Yes	108	3.2
JPMorgan Global Growth & Income	390.9	24.8	60.0	116.0	193.6	0.2	0.6	Yes	106	3.9
Murray International	1,636.4	18.9	40.8	66.4	185.5	3.5	0.7	No	112	3.8
Scottish American	492.1	19.3	53.0	88.5	95.4	3.0	0.9	No	118	3.0
Simple average (8 funds)	392.6	18.3	44.0	87.8	143.2	(0.9)	1.2		110	4.3
STS rank in sector	5	7	5	6	5	7	4		4	5
Open-ended peers simple average	404.5	14.2	38.8	80.9	96.2		1.5			3.3

Source: Morningstar, Edison Investment Research. Note: *Performance to 24 August 2017. TR=total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

The board

Following the retirement of senior independent director Andrew Irvine at the 2017 AGM following 12 years' service, there are now four directors on the board of STS; all are non-executive and independent of the manager. The board considers that it has sufficient skills and experience to continue at its current size; although this will remain under review. Chairman Rachel Beagles was appointed in July 2010 and assumed her current role in July 2016. The senior independent director is now Angus Gordon Lennox; he joined the board in November 2013. The other two directors are Mark Little (appointed in October 2014) and John Evans (appointed in February 2016). All four directors hold shares in STS ensuring the interests of all shareholders are aligned.

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