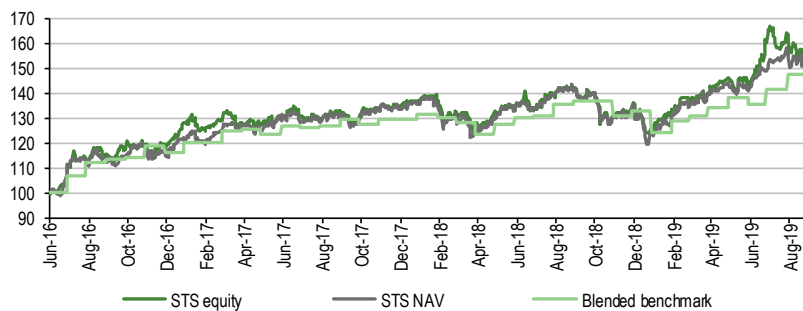


Securities Trust of Scotland

Focused on quality, income and capital growth

Securities Trust of Scotland (STS) aims to deliver both income and capital growth to shareholders over the long term. Since June 2016, STS has employed an investment mandate that is not constrained by index considerations. The manager, Mark Whitehead, follows a rigorous bottom-up approach to construct a relatively concentrated portfolio of 35–55 high quality, large-cap companies with sustainable earnings and dividend growth. Since the change in the trust's benchmark on 1 June 2016, STS has delivered an annualised NAV total return of 14.3% to end-August 2019. The board adopts a progressive dividend policy and refreshed the trust's marketing strategy last year, including the appointment of director, Sarah Harvey, who is a marketing specialist.

STS has outperformed since the adoption of the unconstrained mandate



Source: Refinitiv, Securities Trust of Scotland, Edison Investment Research

The market opportunity

Geopolitical events, such as the ongoing US/China trade dispute, have contributed to a cyclical global economic slowdown. Although geopolitics will likely continue to have a significant influence on the direction of markets in the near term, earnings expectations have adjusted to an extent that may provide some positive surprises, and present opportunities, particularly in the UK and Europe.

Why consider investing in STS?

- Rigorous investment process focused on the durability of long-term returns.
- A relatively liquid portfolio of high quality companies, which have been stress-tested for resilience to adverse market conditions. Portfolio companies rank highly against environmental, social and governance (ESG) criteria.
- An active board that is committed to promoting the trust and serving shareholders' interests.

Discount has scope to narrow

STS trades at a 3.5% discount to its cum-income NAV, which is below the three-year average of 6.2%. This is wider than its peers despite a respectable performance and dividend yield. The board is committed to promoting the trust and combined with the continuing solid performance since the change of manager and mandate, there is emerging evidence that the discount is on a narrowing trend.

Investment trusts
Global equity income

20 September 2019

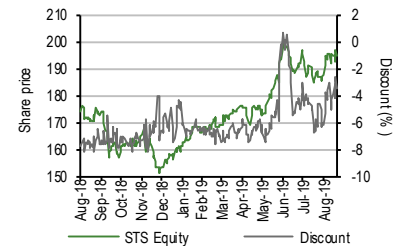
Price 195.0p
Market cap £203.4m
AUM £232.8m

NAV* 197.9p
Discount to NAV 1.4%
NAV** 202.1p
Discount to NAV 3.5%

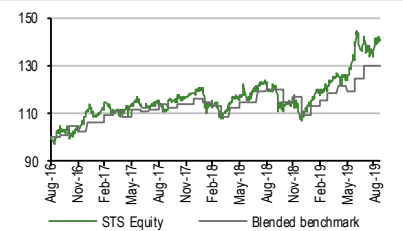
*Excluding income. **Including income. As at 18 September 2019.

Yield 3.2%
Ordinary shares in issue 104.3m
Code STS
Primary exchange LSE
AIC sector Global Equity Income

Share price/discount performance



Three-year performance vs index



52-week high/low 200.5p 151.0p
NAV** high/low 205.5p 159.7p

**Including income.

Gearing

Gross* 12.3%
Net* 7.9%

*As at 31 July 2019.

Analysts

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[Edison profile page](#)

Securities Trust of Scotland is a research client of Edison Investment Research Limited

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 from 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

- 17 September 2019: Rachel Beagles retired as chairman and director, succeeded with immediate effect by John Evans. Announcement of first interim dividend of 1.45p per share.
- 24 June 2019: annual results for 12 months ending 31 March 2019. NAV TR +11.4% versus peer group +8.5%. Share price TR +9.6%. Declared fourth interim dividend of 1.9p per share.
- 16 January 2019: announcement of third interim dividend of 1.45p per share.

Forthcoming

AGM	September 2020
Interim results	November 2019
Year end	31 March
Dividend paid	Quarterly
Launch date	28 June 2005
Continuation vote	None

Capital structure

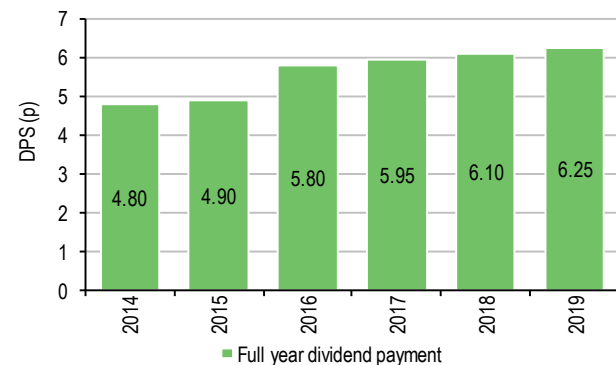
Ongoing charges	0.9%
Net gearing	7.9%
Annual mgmt fee	(see page 7)
Performance fee	None
Trust life	Indefinite
Loan facilities	£25m (see page 7)

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

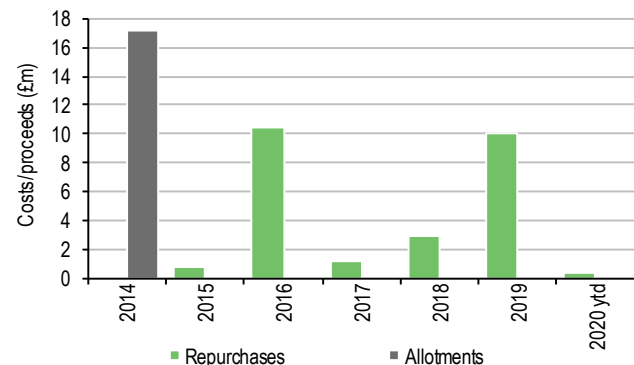
Dividend policy and history (financial years)

Dividends are paid quarterly in October, January, April and July. Dividends were increased in FY16 after the announcement of a new progressive dividend policy.

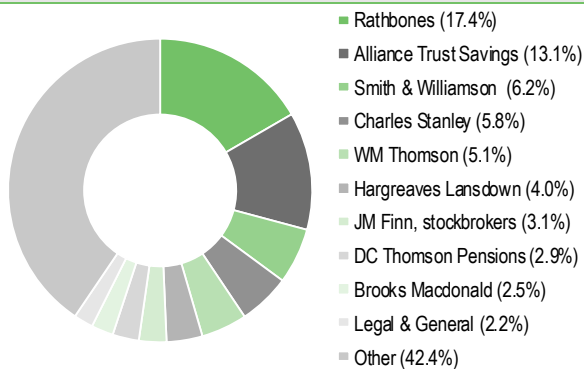


Share buyback policy and history (financial years)

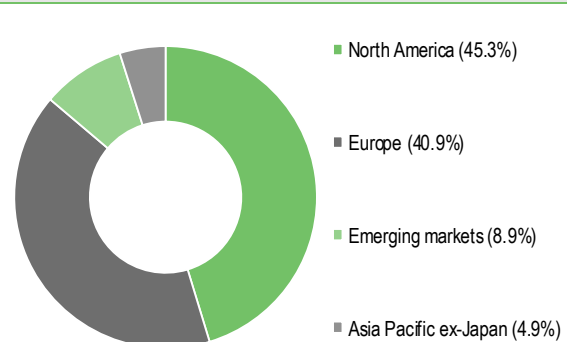
Renewed annually, the trust has authority to purchase up to 14.99% and allot up to 5% of issued share capital.



Shareholder base (as at 31 July 2019)



Portfolio exposure by geography (as at 31 July 2019, net of cash, gearing and option exposure)



Top 10 holdings (as at 31 July 2019)

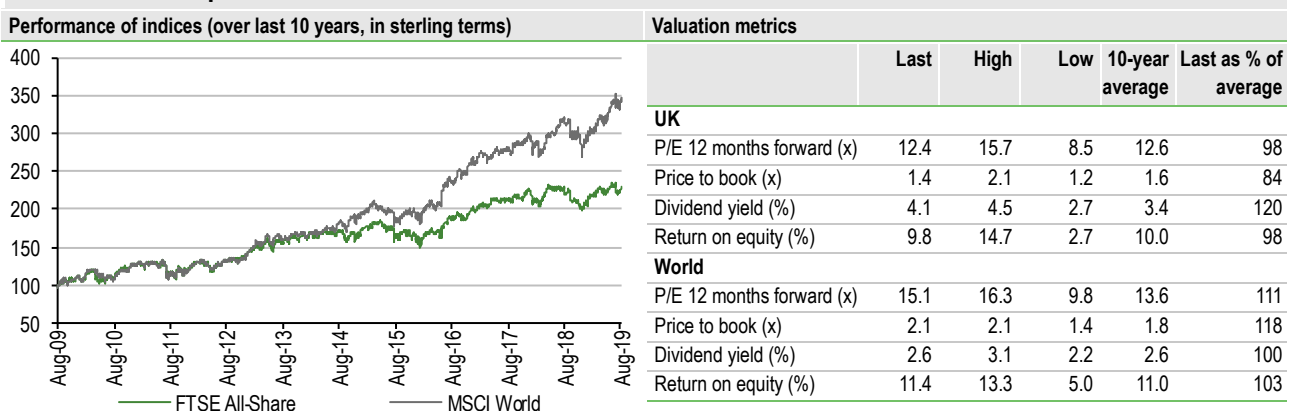
Company	Country	Sector	Portfolio weight %	
			31 July 2019	31 January 2019*
Microsoft	US	Information technology	6.2	5.3
Merck	US	Healthcare	3.8	5.2
Koninklijke DSM	Netherlands	Materials	3.8	N/A
Danone	France	Consumer staples	3.7	N/A
Zurich Insurance	Switzerland	Financials	3.5	3.4
Crown Castle	US	Real Estate	3.4	3.3
Transurban	Australia	Industrials	3.3	N/A
Airbus	France	Industrials	3.3	N/A
Taiwan Semiconductor	Taiwan	Information technology	3.1	N/A
Verizon Communications	US	Communication services	3.1	N/A
Top 10			37.2	38.9

Source: Securities Trust of Scotland, Edison Investment Research, Bloomberg, Morningstar. Note: *N/A where not in January 2019 top 10.

Market outlook: Heavily influenced by geopolitics

The backdrop for global equities has been deteriorating and leading economic indicators across most major countries are weakening. A cyclical slowdown, following a decade of unprecedented low interest rates and liquidity provision, has been building momentum for much of this year, in part a consequence of central banks' unwinding of quantitative easing and tightening monetary policy to dampen inflationary pressures. Geopolitical events and the ongoing US/China trade dispute, in particular, have amplified the slowdown, taking a significant toll on world trade. The global manufacturing purchasing managers' index, seasonally adjusted, is at its lowest level since 2012. Germany, the world's third largest economy, is on the brink of recession as data suggest the country may contract in Q319 for a second consecutive quarter. Meanwhile, the stimulus effects of President Trump's tax cuts in early 2018 are wearing-off, providing a high base for US economic comparisons this year. Governments are expected to respond to the deteriorating outlook with supportive policy. However, the magnitude of these measures may be limited given interest rates remain close to historic lows. Furthermore, the government of China, concerned about the country's high debt level, appears to be more modest than in the past in its approach to stabilise the economy. Geopolitical developments are likely to continue to influence the direction of markets for the time being. However, earnings revisions have adjusted sharply and may now be at levels that give scope for some positive surprises. As shown in Exhibit 2 (RHS), valuations do not seem stretched and some markets, such as the UK, appear attractively valued relative to its own history.

Exhibit 2: Market performance and valuation



Source: Refinitiv, Edison Investment Research. Note: Valuation metrics at 13 September 2019.

Fund profile: Diversified, selective and liquid

STS's objective is to deliver rising income and long-term capital growth by investing in a diversified portfolio of global equities. The manager, Mark Whitehead, follows a fundamental approach, unconstrained by benchmark considerations, to build a relatively concentrated portfolio of 35–55 high-conviction stocks. The trust is mainly invested in larger companies ie with market capitalisations over £1bn and therefore the portfolio's holdings tend to be highly liquid. The manager is permitted to use derivatives and Whitehead employs options strategies to help generate additional income, predominantly by selling puts. This approach is careful and controlled and puts are only sold on companies on the manager's approved stock list. Options income can account for c 10% of total portfolio income each year; as at end-July 2019 STS had active options exposure of 0.7%.

The current unconstrained mandate was adopted on 1 June 2016 and performance is measured against the median of all relevant open- and closed-ended peers (sourced from the Lipper Global – Global Equity Income and AIC Globally Equity Income sectors) on a rolling three-year basis.

The fund manager: Mark Whitehead

The manager's view: Invest for resilience through cycles

Whitehead turned cautious on the prospects for global economic growth in early 2018 and he reduced STS's exposure to cyclical stocks at a time when consensus earnings expectations and valuations were rising. His contrarian stance last year has helped the trust to deliver a positive performance in a weak market. The manager continues to expect uncertainty and weak economic conditions to prevail. He notes economic data appear to be getting worse and observes that c three-quarters of purchasing managers' indices around the world are indicating a contraction in activity and a risk of global recession. However, the manager does not make macroeconomic predictions; instead he focuses on investing in companies that are able to sustain long-term dividend growth and are resilient to adverse economic cycles. Whitehead believes this investment approach is particularly relevant in the current global equity market environment.

Asset allocation

Investment process: Fundamental and ESG focused

The manager believes that markets are myopic and can undervalue quality companies with growing and sustainable dividends. He believes his proprietary fundamental research can identify these opportunities to help generate capital growth, with a lower risk profile, over the long term. Whitehead leads a well-resourced team of four global equity income specialists and has access to the wider Martin Currie investment team of over 40 investment professionals to support his fundamental process. The global large-cap universe contains around 3,000 stocks and proprietary screens are used to filter these on key sustainability and quality criteria. Around 80 companies undergo rigorous proprietary analysis, including detailed accounting diagnostics, credit and industry analysis. Companies are also stress-tested to assess liquidity and financial resilience under adverse economic scenarios. The evaluation of environmental, social and governance (ESG) issues is an important part of the investment process and the team rank companies against c 50 metrics. Whitehead thinks that STS's objective to deliver sustainable and rising income is naturally aligned with seeking companies that practice good governance, manage risks and allocate capital responsibly, and he believes firms that score highly on ESG issues are more likely to have enduring dividend growth.

Current portfolio positioning

Exhibit 3 shows STS's sector exposures as at end-July 2019 and changes over the past six months. A notable shift in the portfolio over this period is a 5.4pp reduction in financials as, in the manager's view, an environment of slowing economic growth and declining interest rates is generally unfavourable for banks. Sales included HSBC (UK), Credicorp (Peru) and CaixaBank (Spain). The backdrop is particularly challenging for HSBC, with large trade finance and China exposures, and Whitehead believes the bank will find it tough to generate an attractive return on equity relative to its cost of capital. Although the company pays a high dividend, the manager thinks this is unlikely to grow in the foreseeable future. Long-held Peruvian bank Credicorp has performed well, vindicating the manager's investment thesis. However, Whitehead considers its valuation rich as emerging market conditions are becoming less favourable for the bank, and returns on assets

have been declining. CaixaBank was also sold on concerns over the regulator's recent change in stance on the industry's historic mortgage mis-selling practices, which may result in large claims against Spanish banks.

Over the past six months, STS reduced its exposure to North America by 4.9pp to 48.9%. Trump's tax reforms last year gave US equities a boost and the manager considers this market to be expensive compared with the UK and Europe. Whitehead sold Apple, which has been a strong performer; however, he questions whether growth can be sustained by its services business (as its products business matures). He thinks the company is also vulnerable to China trade tensions and competition from Chinese and Korean smartphone manufacturers. Furthermore, he is disappointed that the company has favoured share buybacks over higher dividends for shareholders. Whitehead has continued to reduce the portfolio's exposure to cyclicals and sold Canadian oil sands producer, Suncor Energy.

Exhibit 3: Portfolio sector exposure* (% unless stated)			
	Portfolio end-July 2019	Portfolio end-January 2019	Change (pp)
Consumer staples	16.6	13.8	2.8
Industrials	16.5	12.9	3.6
Information technology	14.3	12.1	2.2
Financials	10.8	16.2	(5.4)
Communication services	10.6	7.5	3.1
Healthcare	9.7	11.2	(1.5)
Materials	8.2	7.8	0.4
Utilities	6.4	8.4	(2.0)
Consumer discretionary	5.3	7.4	(2.1)
Real estate	5.1	5.3	(0.2)
Energy	4.5	7.6	(3.1)
Cash	4.4	3.8	0.6
Active options exposure	0.7	0.5	0.2
Gearing	(12.3)	(14.0)	1.7

Source: Securities Trust of Scotland, Edison Investment Research. Note: *Active options exposure means allocations may not total 100%.

Recent new purchases are mostly listed in the UK and Europe, including Paris-listed media multinational, Publicis Groupe. The manager believes the company to have the industry's best in class consulting operation and data assets and is thus best positioned for a changing media buying landscape over the longer term. Whitehead is looking for mid to high single-digit earnings per share growth and the company has an attractive dividend yield of around 5%. He also notes that Publicis trades on an attractive valuation, which is at a significant discount to its US peers. STS also invested in UK-listed Bunzl, a multinational distribution and outsourcing company. The manager believes investors' fears over technology disruption risk is overplayed. The business is relatively low margin, but its strong network and good execution provide a barrier to entry, giving the firm pricing power and the ability to maintain stable margins. Bunzl generates strong free cash flow, which has underpinned an impressive compound dividend growth rate of more than 10% pa over the past 26 consecutive years. STS also purchased Amsterdam-listed Philips. Over the past decade, the company has successfully transformed from being a consumer electronics business to a healthcare company. Whitehead observes that its diagnosis and treatment division, accounting for over 40% of revenues, is performing very well. He believes the company is innovative, has differentiated products and a large and growing addressable market, yet appears meaningfully undervalued compared to its US-listed peers.

Performance: Outperformed since new mandate

Since 1 June 2016, STS's benchmark is the median of all relevant open- and closed-ended peers (sourced from the Lipper Global – Global Equity Income and AIC Global Equity Income sectors respectively) on a rolling three-year basis. This date also marks the adoption of the trust's current

unconstrained mandate. Therefore, the most relevant performance periods to consider are three years and shorter. As shown in Exhibits 5 and 6, STS's NAV total return and share price have outperformed its benchmark over all these periods, with the exception of one month. Its NAV total return has also outperformed the FTSE All-Share index over these periods. Compared to the MSCI World Index, the trust's NAV total return has outperformed in the periods up to, and including one year, but lags over three years.

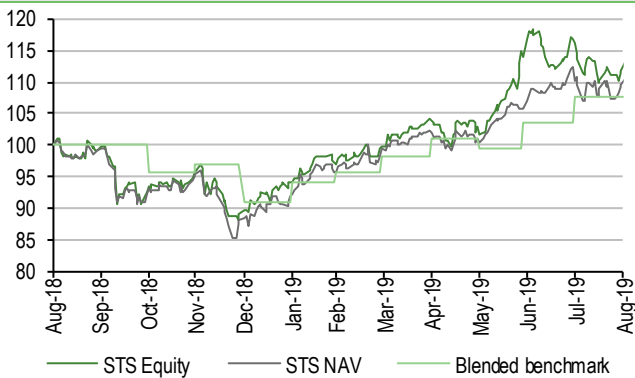
Exhibit 4: Five-year discrete performance data

12 months ending	Total share price return (%)	Total NAV return (%)	Blended benchmark (%)	FTSE All-Share (%)	MSCI World (%)
31/08/15	(3.8)	(2.5)	(1.5)	(2.3)	4.1
31/08/16	21.6	24.0	30.6	11.7	26.0
31/08/17	15.5	15.8	14.6	14.3	18.8
31/08/18	5.5	6.9	5.7	4.7	12.7
31/08/19	11.7	9.7	(5.8)	0.4	7.6

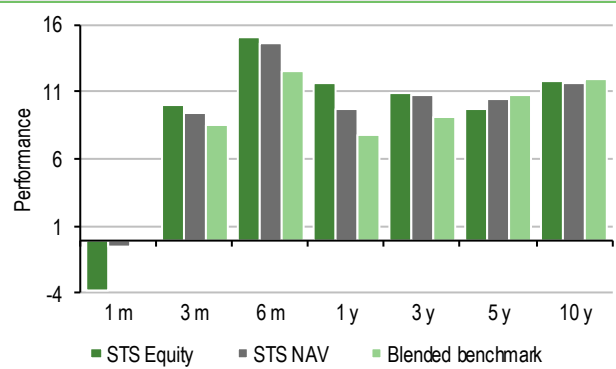
Source: Refinitiv. Note: All % on a total return basis in pounds sterling. Blended benchmark is FTSE All-Share Index until 31 July 2011, MSCI World High Dividend Yield Index until 31 May 2016 and the rolling three-year median return of open- and closed-ended peers thereafter.

Exhibit 5: Investment trust performance to 31 August 2019

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



Price, NAV and benchmark total return performance (%)



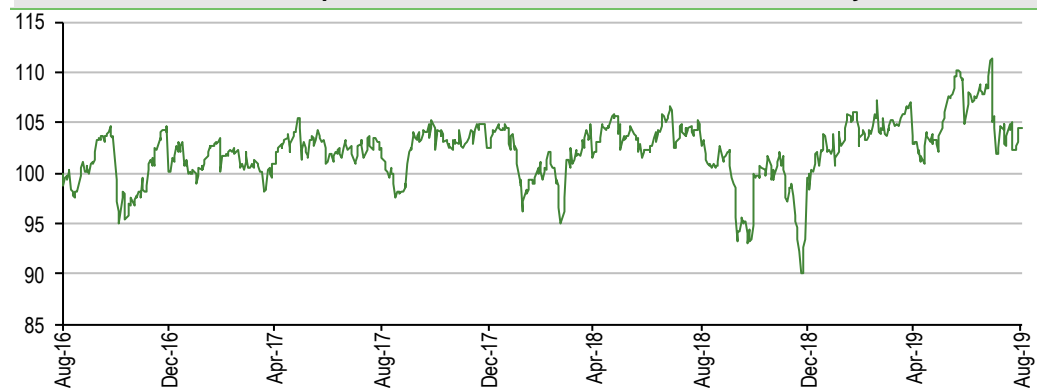
Source: Refinitiv, Edison Investment Research. Note: Three, five and 10-year performance figures annualised. Blended benchmark is FTSE All-Share Index until 31 July 2011, MSCI World High Dividend Yield Index until 31 May 2016 and the rolling three-year median return of open- and closed-ended peers thereafter.

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 blended benchmark	(3.8)	1.4	2.3	3.6	4.8	(4.6)	(1.0)
NAV relative to blended benchmark	(0.5)	0.8	1.8	1.7	4.5	(1.6)	(1.6)
Price relative to FTSE All-Share	(0.3)	7.9	10.4	11.2	13.3	21.4	35.6
NAV relative to FTSE All-Share	3.1	7.2	9.9	9.2	12.9	25.1	34.8
Price relative to MSCI World	(2.4)	1.2	1.3	3.8	(5.5)	(15.8)	(10.7)
NAV relative to MSCI World	0.9	0.6	0.8	1.9	(5.8)	(13.2)	(11.2)

Source: Refinitiv, Edison Investment Research. Note: Data to 31 August 2019. Geometric calculation.

Exhibit 7: NAV total return performance relative to benchmark over three years

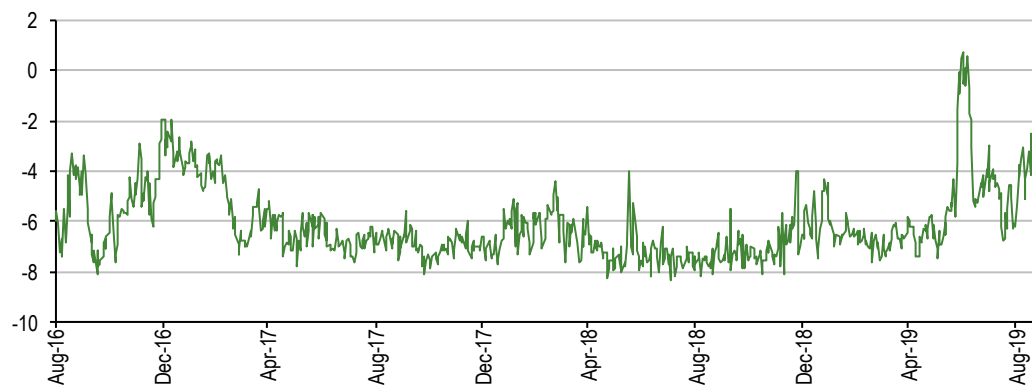


Source: Refinitiv, Edison Investment Research

Discount: Marketing efforts support narrowing

STS currently trades at a 3.5% discount to its cum-income NAV, which is below the three-year average of 6.2%. The board takes a proactive approach towards managing the trust's discount and reducing its volatility. It aims to manage the average ex-income discount below 7.5% in the last 12 weeks of the financial year, and if the average discount is greater than this level, shareholders have the right to redeem their shares. The board has the authority (renewable annually) to repurchase up to 14.99% of issued capital to help manage the discount and actively promotes the trust to increase demand for its shares. In August 2018, it announced a material increase in the marketing budget (provided by the manager), and a refresh of the company's strategy. During FY19, the company repurchased 5.9m shares at an average discount of 7.3%, representing 5.7% of the share base, however, the chairman notes that nearly three quarters of the repurchases took place in the first half of the financial year, prior to the new marketing efforts. STS's NAV discount is wider than its peers in the AIC Global Equity Income sector, suggesting there may scope for it to narrow further.

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



Source: Refinitiv, Edison Investment Research

Capital structure and fees

STS is a conventional investment trust with one class of share; there are 104.3m shares in issue and 18.0m shares held in treasury. In September 2016, the trust agreed a £15m seven-year multi-currency, fixed-rate facility, alongside a £10m two-year revolving credit facility with the Royal Bank of Scotland. Gearing is permitted up to 20% of net assets, and is mainly used to invest in global equities, but also for the tactical use of options. As at end-July 2019, net gearing was 7.9%.

The board introduced a tiered fee structure with effect from 1 April 2018, which pays Martin Currie Investment Management an annual management fee of 0.6% of net assets up to £200m, reducing to 0.4% of net assets above £200m (previously a single figure of 0.6%). The fee is split 65:35 between capital and income, reflecting the board's expected long-term split of returns between capital gains and income. As at end-March 2019, the trust's ongoing charges were 0.9% (unchanged from the previous year).

Dividend policy and record

The trust has a clear objective to deliver rising income as well as long-term capital growth. The board employs a progressive policy, aiming to grow the dividend at least in line with developed market inflation over a five-year rolling period. The annualised dividend growth achieved in the five years to end FY19 is 5.4%, largely reflecting the rise in revenue earnings and reduction in shares in

issue over this period. The board also has the ability to pay dividends out of retained capital reserves, if necessary, provide a rising and reliable income to shareholders. The total dividend for FY19 of 6.25p per share represents a 2.5% increase on 6.10p paid in the previous year. Dividends are paid four times a year in October, January, April and July.

Peer group comparison

Exhibit 9 shows the AIC Global Equity Income sector, which consists of six funds. As STS adopted its current investment mandate in June 2016, the most relevant performance periods to consider are one and three years. Its NAV total return ranks second over one year and third over three years. It is notable that these returns are also significantly higher than the open-ended peer group averages over all periods shown. The trust has the highest ongoing charge, which is partly a reflection of its relatively smaller size within the group; however, it does not charge a performance fee. Despite the trust's respectable performance, it has the widest discount amongst peers.

Exhibit 9: AIC Global Equity Income peer group as at 17 September 2019*										
% unless stated	Market cap/ fund size £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Discount (cum-fair)	Ongoing charge	Perf. fee	Net gearing	Dividend yield (%)
Securities Trust of Scotland	201.5	12.2	37.5	62.0	191.2	(4.6)	0.9	No	108	3.2
Henderson International Income	306.7	5.8	33.7	70.0		(0.5)	0.8	No	102	3.4
Invesco Perp Select Global Eq Inc	65.1	4.8	34.4	64.7	163.4	(2.0)	0.9	Yes	104	3.4
JPMorgan Global Growth & Income	454.9	6.2	43.2	80.4	215.2	3.7	0.6	Yes	102	3.8
Murray International	1,543.6	10.2	25.8	43.6	155.3	0.7	0.7	No	112	4.4
Scottish American	604.8	12.3	43.9	83.0	209.7	4.5	0.8	No	113	2.8
Simple average	529.4	8.6	36.4	67.3	187.0	0.3	0.8		107	3.5
STS rank in sector (six funds)	5	2	3	5	3	6	1		3	5
Open-ended peers simple average	352.2	7.6	29.0	53.5	147.3	N/A	1.4		N/A	3.5

Source: Morningstar, Edison Investment Research. Note: *Performance to 16 September 2019 based on ex-par NAV. TR=total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

The board

The STS board consists of five independent non-executive directors. Rachel Beagles retired as chairman and director of the trust at the AGM on 17 September following over nine years of service. She is immediately succeeded by John Evans (appointed in February 2016). Angus Gordon Lennox is the senior independent director (appointed in November 2013, he assumed his role in July 2017). The other directors and their dates of appointment are Mark Little (October 2014) and Sarah Harvey (October 2018).

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