

Securities Trust of Scotland

Investing globally for sustainable dividend growth

Securities Trust of Scotland (STS) aims to generate rising income and long-term capital growth through investment in quality companies across the globe, with sustainable dividends supported by robust earnings growth. STS appointed a new lead manager in May 2016 and adopted an unconstrained investment approach, allowing the portfolio to reflect the manager's highest-conviction stock picks in a relatively concentrated portfolio of 35-55 holdings. STS's performance has since been positive relative to its new peer-based benchmark, while it has a comparable dividend yield of 3.5%, following an increased payout from FY16. It is one of two trusts in the peer group to trade on a discount to cum-income NAV, providing scope for the discount to continue to narrow.

12 months ending	Share price (%)	NAV (%)	Blended benchmark (%)	FTSE All-Share (%)	MSCI World (%)
31/01/14	4.8	5.8	8.2	10.1	12.6
31/01/15	1.7	12.0	16.2	7.1	17.7
31/01/16	(2.5)	(1.9)	1.0	(4.6)	1.1
31/01/17	34.4	26.7	29.5	20.1	32.8
31/01/18	9.1	11.7	8.3	11.3	11.9

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: Fundamental and in-depth

STS targets a balanced, diversified portfolio of global equities, the majority of which have market capitalisations over £1bn. The manager's investment approach is fundamental, utilising proprietary screening as well as in-depth research involving credit analysis and the stress-testing of balance sheets. Net gearing of up to 20% of NAV is permitted, and there is an ability to use options to enhance income. As at end-January 2018, STS had net gearing of 9.8%.

Market outlook: Robust global growth

Global equities had a strong start to 2018. Leading indicators continue to support an environment of accelerating, synchronous growth and the IMF recently revised upwards its forecasts for global economic growth in 2018 and 2019. Equities valuations look stretched compared to history; however, earnings revisions have surprised on the upside. Nevertheless, equities markets could be vulnerable to correction if interest rates rise more quickly than expected, or earnings disappoint.

Valuation: Scope for discount to narrow

STS is currently trading on a 5.0% discount to cum-income NAV, and is one of two among its peer group with a discount. In 2016, a new manager was appointed and the trust adopted the current investment approach, following which performance has been above its new benchmark. The board increased the dividend from FY16 and adopted a progressive dividend policy. At the current share price, STS is yielding 3.5%.

Investment trusts

28 February 2018

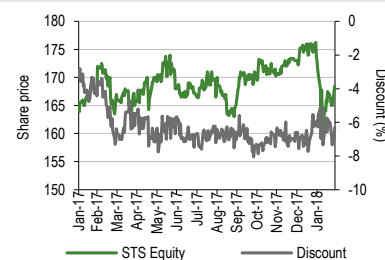
Price 168.5p
Market cap £186.8m
AUM £215.5m

NAV* 177.4p
Discount to NAV 4.2%
NAV** 177.1p
Discount to NAV 5.0%

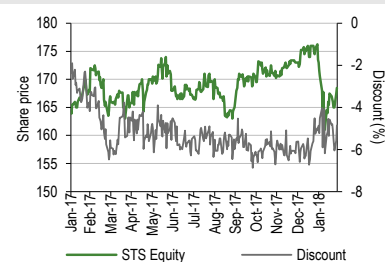
*Excluding income. **Including income. As at 15 February 2018.

Yield 3.5%
Ordinary shares in issue 111.1m
Code STS
Primary exchange LSE
AIC sector Global Equity Income

Share price/discount performance



Three-year performance vs index



52-week high/low 176.3p 161.0p
NAV** high/low 189.5p 172.0p

**Including income.

Gearing

Gross* 11.7%
Net* 9.8%

*As at 31 January 2018.

Analysts

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[Edison profile page](#)

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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

- 17 January 2018: Announcement of third interim dividend of 1.45p per share
- 10 November 2017: Interim results for six months ending 30 September. NAV TR +1.4% versus peer group +0.8%. Share price TR 1.2%. Announcement of second interim dividend of 1.45p per share.
- 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.

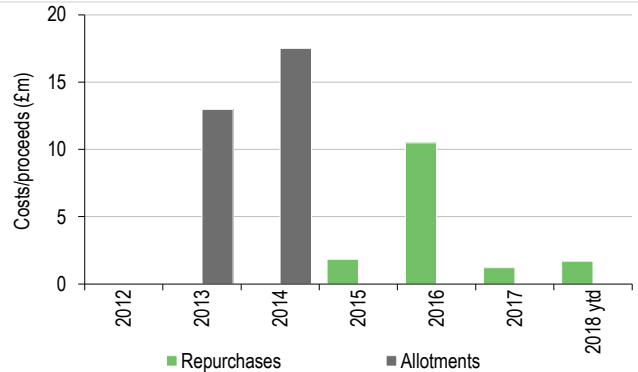
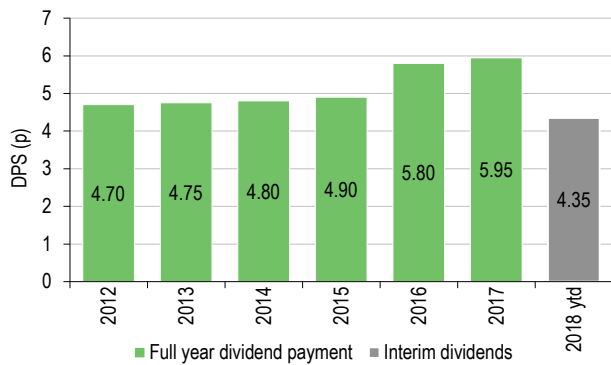
Forthcoming		Capital structure		Fund details	
AGM	September 2018	Ongoing charges	1.0%	Group	Martin Currie Investment Mgmt (UK)
Final results	June 2018	Net gearing	9.8%	Manager	Mark Whitehead
Year end	31 March	Annual mgmt fee	0.6% of net assets	Address	Saltire Court, 20 Castle Terrace, Edinburgh EH1 2ES
Dividend paid	Quarterly	Performance fee	None	Phone	+44 (0) 131 229 5252
Launch date	28 June 2005	Trust life	Indefinite	Website	www.securitiestrust.com
Continuation vote	None	Loan facilities	£25m (see page 7)		

Dividend policy and history (financial years)

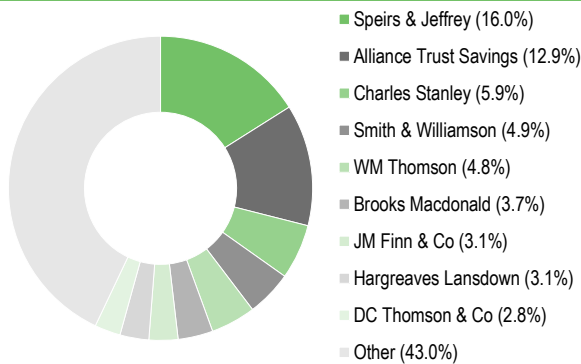
Dividends are currently paid quarterly in September, December, March and June, (October, January, April and July from 1 April 2018). Dividends were increased for FY16 after the announcement of a new progressive dividend policy.

Share buyback policy and history (financial years)

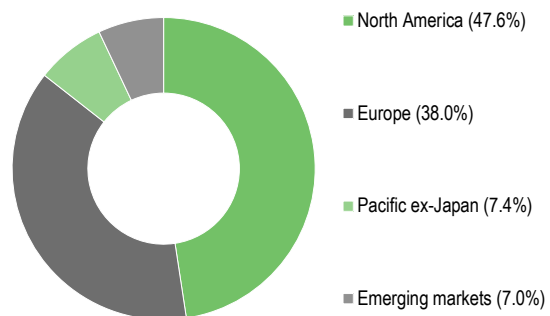
Renewed annually, the trust has authority to purchase up to 14.99% and allot up to 5% of issued share capital.



Shareholder base (as at 27 February 2018)



Portfolio exposure by geography (as at 31 January 2018, net of cash, gearing and option exposure)



Top 10 holdings (as at 31 January 2018)

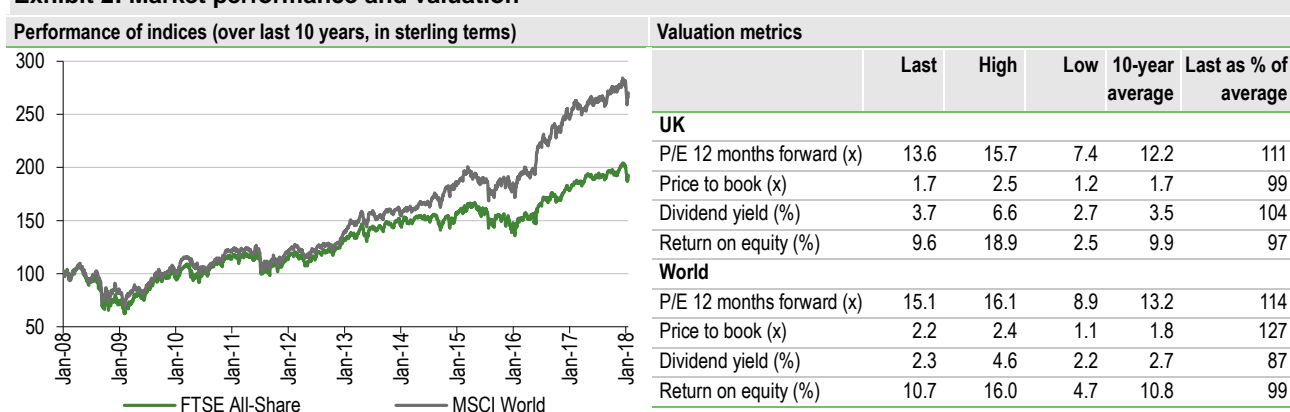
Company	Country	Sector	Portfolio weight %	
			31 January 2018	31 January 2017
Microsoft	US	Information technology	4.1	N/A
Chevron	US	Energy	3.4	3.9
Philip Morris International	US	Consumer staples	2.9	3.2
ING Groep	Netherlands	Financials	2.8	N/A
Givaudan	Switzerland	Materials	2.8	N/A
Huntingdon Bancshares	US	Financials	2.7	2.8
Koninklijke DSM	Netherlands	Materials	2.7	N/A
Manulife Financial	Canada	Financials	2.7	N/A
Schneider Electric	France	Industrials	2.7	N/A
Merck	US	Healthcare	2.5	N/A
Top 10			29.3	31.8

Source: Securities Trust of Scotland, Edison Investment Research, Bloomberg, Morningstar. Note: *N/A where not in January 2017 top 10.

Market outlook: Looking for earnings growth

Global equity markets had a strong start to 2018, many achieving new highs as interest rates remained low and leading indicators continued to reaffirm prospects for accelerating, synchronous growth. The IMF has recently upgraded its forecasts again for global growth by 0.2pp for each of 2018 and 2019 to 3.9%. As shown in the right hand table of Exhibit 2, valuations already reflect a rosy outlook, and global equities are expensive relative to history, especially in forward P/E and price to book multiple terms. Earnings momentum, however, has been supportive and analysts' estimate revisions have been positive since the beginning of the year. Recent market volatility suggests investors are less complacent than they have been over the past few years, and global equities could be vulnerable to a correction should interest rates rise faster than expected and/or earnings disappoint.

Exhibit 2: Market performance and valuation



Source: Thomson Datastream, Edison Investment Research. Note: Valuation metrics as at 15 February 2018.

Fund profile: Sustainable income and growth

STS's primary objective is to achieve rising income and long-term capital growth through investment in a balanced, diversified portfolio of global equities. Since May 2016, STS has been managed by Mark Whitehead, supported by a team of six highly experienced, global income specialists. They have a disciplined and fundamental approach to identify stocks with sustainable dividend prospects, including using credit analysis and stress-tests on companies' financials. The manager targets holding 35-55 investments, the majority of which are larger companies with market capitalisations over £1bn. On 1 June 2016, STS adopted an unconstrained mandate, and performance is measured against the median of all relevant open- and closed-ended peers (sourced from the Lipper Global Equity Income and AIC Global Equity Income sectors, respectively) on a rolling three-year basis. Net gearing of up to 20% of NAV is permitted and is mostly employed to invest in global equities, but also for the tactical use of options, in a careful and controlled manner. As at 31 January 2018, STS had net gearing of 9.8% and active options exposure of 1.6%.

The fund manager: Mark Whitehead

The manager's view: Backdrop favours Europe

Whitehead believes conditions remain favourable for global equities, although earnings will need meet investors' expectations to justify the stock market's current "heady levels". He believes it would be normal now to see a period of consolidation or some correction in price levels; however,

he does not see signs of recession on the horizon to derail an overall supportive environment for global equities.

Regionally, the manager believes the US equity market bull run to be relatively mature; however, President Trump's recent tax reforms have "thrown fuel on the fire" and extended valuations further. European equities have lagged, despite posting stronger economic growth, reflecting its earlier-stage cyclical recovery. Reasons could include political uncertainty; for example, Chancellor Merkel's weakening political position, and newsflow diverting investors' attention towards the US (such as the aforementioned tax reforms). The manager is finding opportunities in Europe with upside to intrinsic valuations and expects this region to rebound. Whitehead is also more cautious on emerging markets following strong performance, although China's growth agenda is supportive of the asset class, and he is uncovering interesting ideas.

The manager believes accelerating global growth will be most positive for cyclical sectors, in particular technology, materials, energy and financials. Technology companies have traditionally had a low weighting in STS, in part due to the sector's historically low dividend yield. Whitehead notes a change to this trend as companies are becoming more investor friendly, paying out more meaningful dividends, which should be well underpinned by the sectors' ability to grow cash flows. Since Whitehead's tenure as manager, STS's exposure to this sector has risen steadily from around 2% to c13% at end-January 2018. He recently purchased US-listed semiconductor manufacturer Broadcom, which declared a quarterly dividend of \$1.75 in December 2017, an increase of 71.6% over the previous year. Broadcom has grown through accretive acquisitions over time, proving its ability to allocate capital effectively.

The manager believes financial companies are natural beneficiaries of rising interest rates, and expects central banks to gradually reverse unprecedented loose monetary conditions. He prefers banks with limited or no exposure to investment banking, unfettered by legacy issues and regulatory pressure. STS's financial holdings include Huntingdon Bancshares, a US provincial bank, now a top 10 position following strong performance; and recently purchased BB&T, another US regional bank. Whitehead also sees Europe offering interesting investment ideas in this sector.

The manager is less positive, however, on consumer-related sectors, outside of leisure and travel. In particular, he sees challenges for the retail, apparel, media and advertising sectors where traditional business models are being disrupted by internet companies, such as Amazon, Facebook and Alphabet (Google).

Asset allocation

Investment process: Bottom-up, quality

The manager has a disciplined, bottom-up approach to identify stocks that exhibit quality, with sustainable growth prospects to support dividends. STS is not constrained by a benchmark, and the relatively concentrated portfolio of 35-55 stocks represents high-conviction selection.

A global mandate means a large universe of stocks and MSCI All Country World Index consists of around 2,500 constituents. STS has developed a proprietary screen, which helps eliminate many stocks that do not fit its investment criteria, leaving around 800-900 stocks to consider. Utilising the depth and experience of a seven-member team of global equity income specialists, potential portfolio candidates are subject to fundamental, "under the bonnet" analysis. This includes meeting company managements, environmental, social and governance (ESG) considerations, and the use of credit analysis and stress-tests to determine the resilience of businesses through an investment cycle. The manager also ensures broad diversification across countries and sectors.

Current portfolio positioning

Exhibit 3 shows STS's sector exposures as at end-January 2018 and 2017. Reflecting the manager's positive views on cyclical sectors discussed above, the portfolio's largest weights are to financials, information technology, industrials and materials. Over the past year, the fund has increased exposure to all four sectors, most notably financials, which increased by 9.6pp to 25.7%. By geography, the portfolio remains most exposed to North America at 52.3% (including gearing and options exposure), followed by Europe at 40.7%. However, the portfolio has shifted towards Europe over the year by 6.0pp, while North American exposure has reduced by 6.6pp. This is consistent with the manager's views that Europe has greater exposure to cyclical sectors, and relatively attractively valued companies, compared to their US counterparts.

Exhibit 3: Portfolio sector exposure (% unless stated)			
	Portfolio end-January 2018	Portfolio end-January 2017	Change (pp)
Financials	25.7	16.1	9.6
Information technology	12.6	10.7	1.9
Industrials	12.3	12.0	0.3
Materials	10.6	9.1	1.5
Healthcare	8.4	10.9	(2.5)
Consumer staples	7.9	9.7	(1.8)
Energy	7.5	9.1	(1.6)
Consumer discretionary	7.4	9.2	(1.8)
Telecommunications	6.1	8.1	(2.0)
Real estate	6.0	9.0	(3.0)
Utilities	3.7	5.4	(1.7)
Cash	1.9	3.4	(1.5)
Active options exposure	1.6	0.6	1.0
Gearing	(11.7)	(13.3)	1.6
	100.0	100.0	

Source: Securities Trust of Scotland, Edison Investment Research.

Recent purchases include French company, Schneider Electric, a global specialist in energy management and automation solutions. Its businesses should be beneficiaries of the cyclical uptick in global economic activity. However, the manager also believes its products, such as switches and smart meters, are well placed to benefit from the structural rise of 'the internet of things'. The company has a solid balance sheet, pays an attractive dividend, while trading at lower valuations compared to US peers.

STS also purchased Manulife of Canada, a well-managed, well-capitalised insurance and financial services company, with entrenched franchises in North America. The company is also one of the industry leaders in under-penetrated, fast growing regions in the Far East and South East Asia.

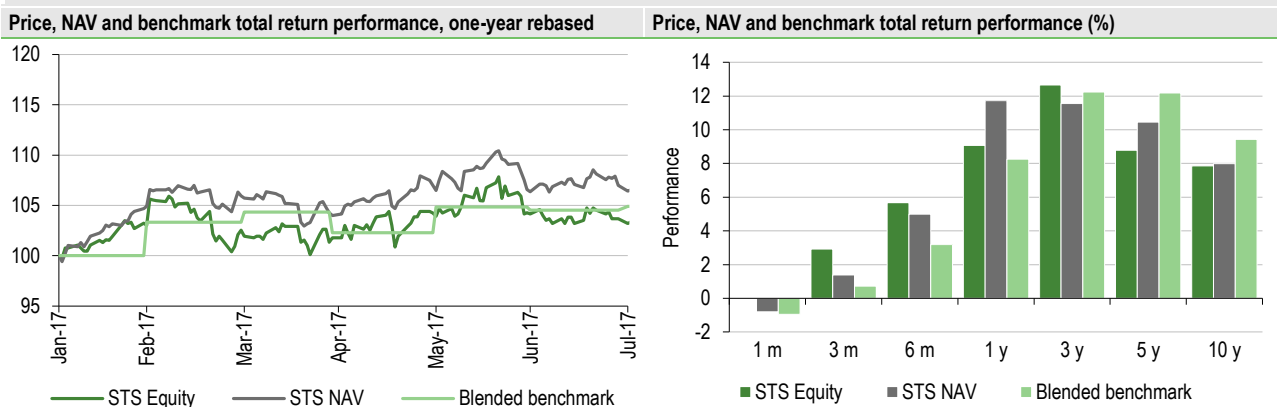
Utilising its flexible investment mandate, STS has recently written put options on Continental of Germany, Europe's largest listed automotive supplier. The manager is positive on the company's exposure to a cyclical recovery in the region, as well as longer-term developments in the industry, such as assisted driving. STS would look to purchase the stock outright at more attractive valuations, but meanwhile took advantage of share price volatility to sell options, generating income for the trust. The manager estimates around 10% of STS's income is currently derived from writing put options.

Recent sales include Cinemark, which despite strong presences in the US and Latin America, is vulnerable to the shift in the way people watch films, abandoning trips to the cinema in favour of streaming services, such as Netflix and Amazon Video. The manager expects the traditional 'window' (exclusive period) for cinemas to be severely reduced, possibly from around 90 days to 30 days, with damaging implications for their profitability.

Performance: Good absolute returns

Since 1 June 2016, STS measures its performance against the median of all relevant open- and closed-ended peers (sourced from the Lipper Global Equity Income and AIC Global Equity Income sectors, respectively) on a rolling three-year basis. Previously, its benchmark was the MSCI High Dividend Yield index. In addition, given the change in investment mandate and manager from May 2016, the most relevant performance periods for STS in Exhibit 5 are one, three and six months, and one year. Over these periods, STS's NAV and share price total returns have been above the blended benchmark.

Exhibit 4: Investment trust performance to 31 January 2018



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.

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	0.9	2.2	2.4	0.7	1.1	(14.3)	(13.4)
NAV relative to blended benchmark	0.1	0.6	1.7	3.2	(1.8)	(7.4)	(12.3)
Price relative to FTSE All-Share	2.0	1.9	1.7	(2.0)	12.2	1.4	7.6
NAV relative to FTSE All-Share	1.2	0.3	1.0	0.4	9.0	9.5	8.9
Price relative to MSCI World	(0.2)	1.0	0.0	(2.6)	(4.9)	(23.5)	(22.7)
NAV relative to MSCI World	(1.0)	(0.5)	(0.6)	(0.2)	(7.6)	(17.4)	(21.7)

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

Exhibit 6: NAV total return performance relative to benchmark over one year



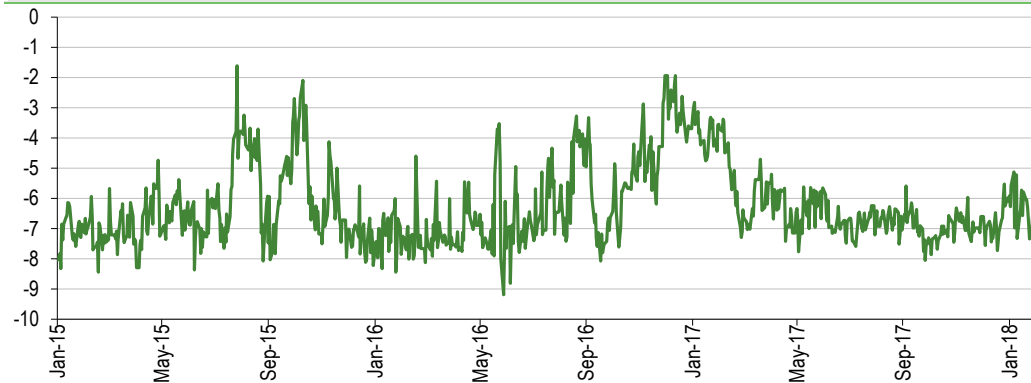
Source: Thomson Datastream, Edison Investment Research

Discount: Actively managed

STS currently trades at a 5.0% discount to cum-income NAV, which is narrower than its three-year average of 6.3% and slightly below the mid-point of the period range of 1.6% to 9.2% discount. The

board aims to maintain the ex-income discount below 7.5%, and if the average discount is below this level over the 12 weeks preceding the financial year end, shareholders have the right to redeem their shares. The board has the ability to conduct share repurchases to help manage the discount.

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 111.1m ordinary shares in issue and 11.2m shares held in treasury. In September 2016, taking advantage of low interest rates, the board agreed a seven-year £15m multi-currency fixed rate facility, alongside a £10m revolving credit facility, with the Royal Bank of Scotland. As at end-January, STS had net gearing of 11.7%. It pays Martin Currie an annual management fee of 0.6% of net assets, split 65:35 between capital and income, reflecting the board's expected long-term split of returns between capital gains and income. No performance fee is payable. As at year-end 31 March 2017, the ongoing charge was 1.0%.

Dividend policy and record

In FY16, the board adopted a progressive dividend policy aligned with the trust's objective to deliver rising income and long-term capital growth. The FY16 total dividend paid was increased by 18% to 5.80p, bringing the yield more in line with its peers. The FY17 dividend increased by 2.6% versus FY16 and, based on the current share price, STS's yield is 3.5%. Dividends have been paid quarterly in September, December, March and June, but from 1 April 2018, they will be paid in October, January, April and July.

The board intends for the majority of the dividend to be funded from earnings, although it has the flexibility to fund payments from revenue and capital reserves, if necessary. In FY17, the revenue return per share of 5.74p largely covered the dividend per share of 5.95p, with the remainder funded out of revenue reserves. As at 30 September 2017, STS held revenue reserves of £2.2m and other distributable reserves of £165.4m.

Peer group comparison

Exhibit 8 shows the AIC Global Equity Income peer group (which have a track record over more than 12 months). Within this relatively small group, there is a broad range of investment mandates and direct comparisons are not overly informative. We have included simple averages data for the

larger, 49 member, open-ended peer group in the IA Global Equity income sector as supplementary information. STS's dividend yield is below its peer group average, where Blue Planet Investment Trust's 10% yield skews the average (it has over half its portfolio in bonds and high yield preference shares). It is comparable to the rest of the peer group and above the average yield for the open-ended peers. STS's NAV TR performance over one year, the most relevant period to reflect its new manager and mandate, is below average among its peers and average compared to the open-ended peer group.

Exhibit 8: AIC Global Equity Income peer group as at 27 February 2018*

% 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	186.8	4.4	33.7	55.4	101.7	(4.5)	1.0	No	110	3.5
Blue Planet Investment Trust	23.0	(6.2)	6.0	40.3		(1.5)	3.7	No	124	10.1
Henderson International Income	287.3	10.9	42.2	78.3		0.7	0.9	No	101	3.2
Invesco Perp Select Global Eq Inc	68.3	10.5	40.7	85.2	145.5	(1.2)	1.0	Yes	106	3.1
JPMorgan Global Growth & Income	420.6	8.6	48.8	95.1	198.4	1.8	0.6	Yes	94	3.7
Murray International	1,597.3	5.4	37.1	39.0	154.8	6.1	0.7	No	112	4.0
Scottish American	511.6	12.0	49.5	70.7	102.1	4.0	0.9	No	117	3.0
Simple average (7 funds)	442.2	6.5	36.9	66.3	140.5	0.8	1.2		109	4.4
STS rank in sector	5	6	6	5	5	7	3		4	4
Open-ended peers simple average	474.1	4.4	29.2	60.7	95.6		1.5			3.3

Source: Morningstar, Edison Investment Research. Note: *Performance to 26 February 2018. TR=total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

The board

STS's board consists of four independent non-executive directors. Following 12 years of service, since the fund's inception, Andrew Irvine retired as director and senior independent director in July 2017. The board is satisfied it has the necessary breadth of skills and experience to continue to be effective with four members, without adding to costs, although this will remain under review.

Chairman Rachel Beagles was appointed in 2010, and assumed her current in role 2016. Angus Gordon Lennox (appointed in 2013) assumed the role of senior independent director upon Irvine's retirement. The other two directors are Mark Little (2014) and John Evans (2016).

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