

Scottish Oriental Smaller Companies

Selecting quality small-cap stocks in Asia

Scottish Oriental Smaller Companies Trust (SST) aims to achieve long-term capital growth through investing in smaller Asian companies. The approach is primarily bottom up with an emphasis on quality and attention paid to the potential to deliver absolute returns. This, the managers' wary view of both market risks and valuations, and a record of outperforming down markets suggests the fund could appeal to those looking for smaller-cap exposure in Asia without undue volatility.

12 months ending	Total share price return (%)	Total NAV return (%)	MSCI AC Asia ex-Japan TR £	MSCI AC Asia ex-Japan Small Cap TR £	FTSE All-Share TR £
31/10/11	(4.0)	(3.7)	(7.4)	(17.2)	0.6
31/10/12	26.8	23.4	7.0	4.2	9.8
31/10/13	26.0	19.6	10.8	15.3	22.8
31/10/14	1.8	9.5	6.4	5.6	1.0

Note: Twelve-month rolling discrete performance.

Investment strategy: Selecting for quality/growth

The investment approach focuses on selection of stocks rather than macro-driven allocation to a sector or country. Managers Wee-Li Hee and Angus Tulloch look for businesses with management who will act as good stewards of shareholders' money and where there is a sound franchise supporting prospects for sustainable real growth. Financial strength and cash flow generation are important considerations. Sector and country allocations can differ significantly from the benchmark, but the portfolio is managed to ensure reasonable diversification. Estimated fair values provide a valuation discipline.

Outlook: Risk aware but still opportunities

Global economic forecasts have been trimmed back this year but on a medium-term view the Asian region is still expected to outpace the developed markets significantly (page 3). While not directly linked to corporate earnings or share prices, this should provide a positive background for a fund focused on smaller-cap shares in the region.

The managers take a cautious view on economic and geopolitical risks and see valuations as generally elevated. Nevertheless, they are still finding attractive opportunities to invest and we note that the Asian region forward P/E multiple is cheaper relative to history than, for example, the US. Currently the managers have increased their focus on quality industrial and cyclical stocks where some valuations are less stretched.

Valuation: Discount has narrowed

The three-year average cum-income discount is just over 3%, but during 2013 the shares tended to trade at a premium. Greater market volatility associated with changing perceptions of US monetary policy prompted a move back to a cum-income discount, which currently stands at 4.7%: not dissimilar to the long-term average discount (10-year average 4.6%).

Investment trusts

18 November 2014

Price 872.5p
Market cap £276m
AUM £307m

NAV* 903.09p
Discount to NAV* 3.4%
NAV** 915.63p
Discount to NAV** 4.7%
Yield 1.3%

*Excluding income. **Including income. (as of 17/11/14)

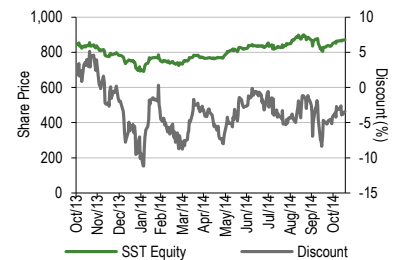
Ordinary shares in issue 31.6m

Code SST

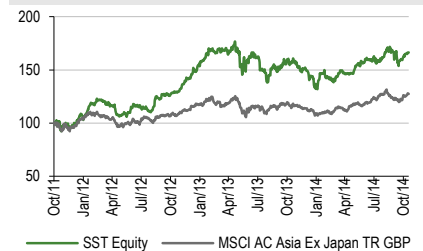
Primary exchange LSE

AIC sector Asia Pacific – ex-Japan

Share price/discount performance*



Three-year cumulative perf. graph



52-week high/low 900p 691p

NAV* high/low 928.0p 767.6p

*Excluding income.

Gearing

Gross 7.1%

Net cash -4.8%

Analysts

Andrew Mitchell +44 (0)20 3681 2500

Sarah Godfrey +44 (0)20 3077 5758

investmenttrusts@edisongroup.com

[Edison profile page](#)

Exhibit 1: Trust at a glance
Investment objective and fund background

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

Recent developments

4 November 2014: Annual report. NAV total return 13.5% vs MSCI AC Asia ex-Japan 13.2%.
 May 2014: Wee-Li Hee returns from maternity leave reassuming role as co-manager of SST portfolio 1 July 2014.

Forthcoming

AGM	19 February 2015
Interim results	April 2015
Year end	31 August
Dividend paid	February
Launch date	March 1995
Continuation vote	No

Capital structure and fees

Ongoing charges	1.36% (incl. performance fee)
Net gearing	-4.8%
Annual mgmt fee	0.75%
Performance fee	Yes (see page 7)
Trust life	Indefinite
Loan	£20m 3.135% (see page 7)

Fund details

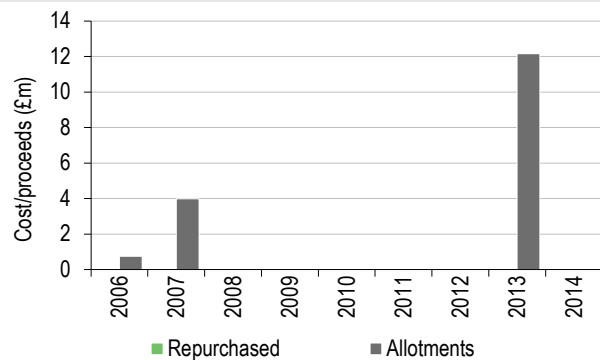
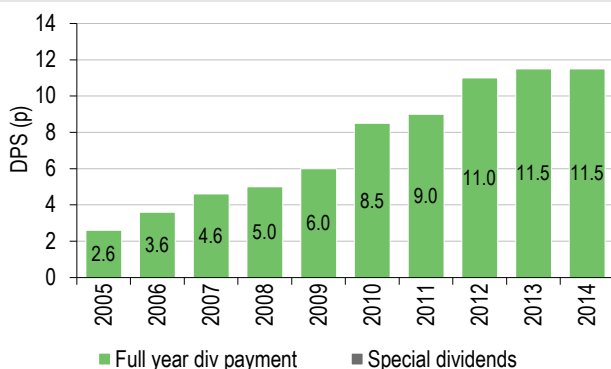
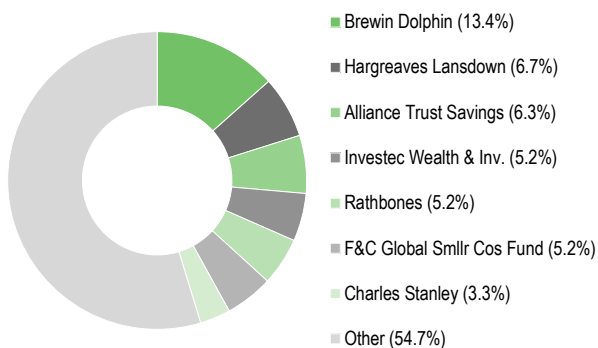
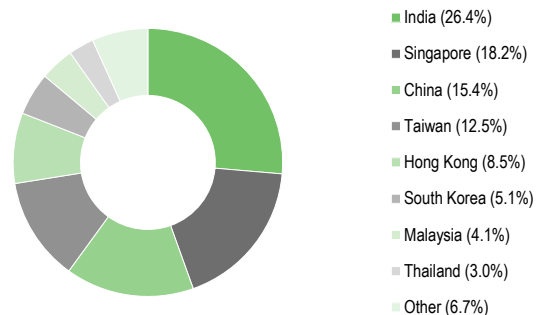
Group	First State Stewart
Managers	Wee-Li Hee, Angus Tulloch
Address	10 St Colme Street, Edinburgh, EH3 6AA
Phone	+44 (0) 131 473 2200
Website	www.scottishoriental.co.uk

Dividend policy and history

One annual dividend paid in February. The board intends to at least maintain this level of dividend, using reserves if necessary, unless company distributions fall sharply.

Share buyback policy and history

The board has a repurchase authority (14.99%), which can be used where it judges it is necessary to manage the discount.


Shareholder base (as at 4 November 2014)

Geographical allocation of portfolio (as at 31 October 2014)

Top 10 holdings (as at 31 October 2014)

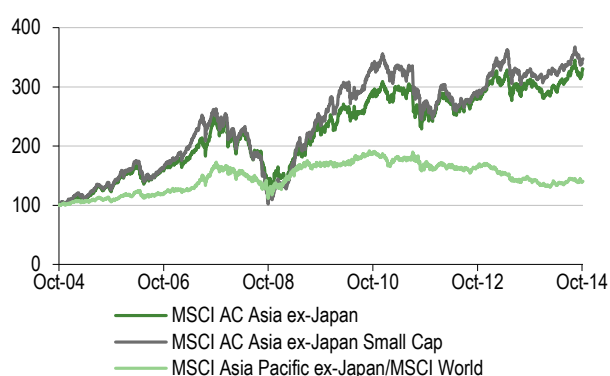
Company	Country	Sector	Portfolio weight %	
			31 October 2014	31 October 2013
Marico	India	Household products	3.5	N/A
Amorepacific	Korea	Household products	2.7	N/A
CMC	India	IT services	2.7	2.1
Towngas China	China	Utility networks	2.6	2.0
Taiwan Familymart	Taiwan	Food and drug stores	2.5	1.8
M1	Singapore	Telecom carrier	2.4	N/A
Tata Global Beverages	India	Beverages	2.4	2.6
Raffles Medical Group	Singapore	Healthcare facilities	2.3	N/A
Chroma ATE	Taiwan	Measurement instruments	2.2	2.1
Minth Group	Hong Kong	Auto parts	2.2	N/A
Top 10			25.5	20.5

Source: Scottish Oriental Smaller Companies Trust, Thomson Datastream, Edison Investment Research

Market outlook: Risks, but relatively well placed

The recent performance of the trust's benchmark is shown in Exhibit 2, highlighting the periods of significant strength for the MSCI Asia ex-Japan Index (and equivalent smaller companies index) before the financial crisis and in the post-crisis bounce. After a soft period coinciding with particular strength in the US market, the Asian index has kept pace with the world market year to date (both up c 10%). On a longer view, despite the relative setback during the financial crisis, both Asian indices have outperformed the world index by more than 35% over 10 years.

Exhibit 2: Asia ex-Japan and world indices



Source: Thomson Datastream

Exhibit 3: Asia ex-Japan valuation metrics compared

End October	SST portfolio	MSCI AC Asia ex-Japan	MSCI AC Asia ex-Japan Small Cap	MSCI AC World Small Cap
P/E year forward (x)	14x	11.4	12.1	16.7
Price/book (x)	2.3	1.5	1.3	1.8
Dividend yield	2.1%	2.5%	2.5%	2.0%

Source: MSCI, Scottish Oriental Smaller Companies Trust

Looking ahead, even though economic forecasts have been trimmed this year and a well-rehearsed list of geopolitical and economic concerns remain, widely followed estimates such as those of the IMF still look for a significant growth premium in the Asian region with projected GDP compound growth of 6.1% (2014-19) compared with 2.4% for advanced economies. This is unlikely to transmit smoothly into equity markets in the region, but over time has the potential to contribute to superior earnings growth, particularly for a fund aiming to filter for companies with sustainable growth potential and management aligned with shareholder interests.

In terms of valuation, while trading on prospective P/Es ranging from 6.0x (China) to 17.2x (Philippines), the Asian markets on average appear relatively attractive when compared with the world market or the US, for example. The world and US market forward P/Es stand c 10% and 15% above their 10-year averages, the trust's benchmark Asia ex-Japan index trades 7% below its historical average at 11.4x. As Exhibit 3 illustrates, the SST portfolio trades on more expensive multiples than the Asian index averages shown, consistent with the quality emphasis that emerges from the stock selection approach.

We would conclude that, while there are risks both globally and in Asia, the long-term attractions of investing in the region remain valid and within this the potential for an actively managed fund to generate good returns by selecting from the smaller-cap universe seems appealing.

Fund profile: Focus on small caps in a growth region

SST was launched in March 1995 and has a focus on small caps (mainly sub-\$1.5bn) in the Asia ex-Japan region (also excludes Australia). Managed by members of First State Stewart's Asian team, the research process seeks to identify companies with strong franchises that can deliver sustainable cash flows. Wee-Li Hee and Angus Tulloch are co-managers with Hee taking primary responsibility for stock selection; Tulloch is head of Asia Pacific ex-Japan equities and has previously been manager for the fund from its inception until October 2000 and then for a period following Susie Rippingall's retirement as manager in April 2013. Tom Allen is deputy manager.

The fund managers: Wee-Li Hee and Angus Tulloch

The managers' view: Cautious but still finding opportunities

The managers have a cautious view on the market, pointing to an uncertain background as monetary policy begins to normalise in the US, demand growth slows and some sectors suffer from overcapacity. Adding to this wary view are geopolitical risks and elevated asset values.

The most salient change in the portfolio over the last year has been the increase in exposure to India (26.4% of portfolio at end October). This reflected additions to existing holdings and new investments. The managers identified a number of very good companies with long track records and took a view that the macro background was more likely to improve than worsen. In the event the victory of Modi in the presidential election provided a substantial boost to the market and in the managers' view is positive for the longer-term outlook in India. Hence, while some profits have been taken post-election, the portfolio retains its high exposure to the country.

While the managers comment that "nowhere can current valuations be deemed especially attractive" they are still finding opportunities for investment and have a greater focus currently on the cyclical and industrial sectors, which are less popular and therefore offer greater value. Examples of industrial stocks that Wee-Li Hee has added to the portfolio include Taiwanese companies Flytech, a point of sale hardware manufacturer, and AirTAC, which manufactures pneumatic components and is therefore a beneficiary of the growing trend towards industrial automation in China.

Hee notes that she is happy to increase position sizes modestly so that the top 10 holdings could account for around 30% compared with nearer 20% historically. Her view is that these are proven companies that they have known for a long time warranting somewhat greater concentration.

Asset allocation

Investment process: Selecting stocks for quality and growth

The manager, First State Stewart, has a 36-strong investment team, of whom approaching half are based in Hong Kong and Singapore with the balance in Edinburgh and London. They manage assets of nearly £36bn, primarily in the Asia-Pacific region but also emerging markets and global funds. The SST portfolio is managed using a bottom-up approach, with the aim of generating absolute returns, as well as outperformance of the benchmark. Turnover is normally around 20-25% pa, but last year was 39%, still reflecting a review of all holdings following the change in lead manager when Susie Rippingall retired in April 2013. Portfolio constituents will typically have a market cap below \$1.5bn at the time of acquisition although the managers are permitted to allocate up to 20% of the fund in stocks with market caps between \$1.5bn and \$3bn.

The managers seek to identify companies with quality in terms of management, franchise and financial position. Track record, alignment with investor interests, clarity of strategy and attitude to risk are among the management characteristics assessed, while franchise strength is judged through brand profile, pricing power and competitive advantage. The managers are also looking for sustainable real earnings growth of 5-10% and take account of the impact of cyclical, management or structural change underway. The companies they invest in will typically have lower levels of gearing, stronger cash flows and lower earnings volatility than the average. The managers place great emphasis on meeting companies, and over the years they have built up an extensive database of company meeting notes. They form a view of a sensible price taking into account both financial and non-financial measures and a macro overlay. Having a fair value for each stock (based in part on historical trading ranges for comparable companies) provides a discipline that may prompt the managers to trim or add to holdings as appropriate. Sales may also be triggered by

a perceived deterioration in the quality of a portfolio company such as an adverse change in its management or business model.

While the managers aim to ensure that SST's portfolio is adequately diversified, it is constructed without any emphasis on sector and country weights within SST's benchmark, the MSCI Asia AC ex-Japan Index.

Current portfolio positioning

At the end of September there were 77 holdings in the portfolio, above the 65-holding average for SST's peer group but below the c 90 level at the same time last year. The concentration of the portfolio, as measured by the percentage of assets accounted for by the top 10 holdings, was accordingly lower at 25.5% (end October) versus 33% for the peer group. At the end of October, the trust held 11.9% in net cash.

	Portfolio 31 Oct 2014	Portfolio 31 Oct 2013	MSCI AC Asia Pacific ex- Japan Oct 14	Active weight vs benchmark	Small-cap index end Oct 2014	Active weight vs small-cap index
Consumer staples	19.1	13.2	5.4	13.7	5.8	13.3
Consumer discretionary	18.8	22.8	9.2	9.6	18.5	0.3
Industrials	14.5	13.4	8.4	6.1	14.8	-0.3
Healthcare	6.7	10.5	1.9	4.9	6.6	0.1
Materials	8.3	5.1	5.0	3.3	9.0	-0.7
Utilities	3.8	3.1	4.3	-0.5	2.6	1.2
Energy	2.7	3.4	5.6	-2.8	2.7	0.1
Telecom services	3.9	1.0	6.8	-2.9	1.0	2.9
Information technology	9.6	9.2	21.3	-11.7	18.6	-9.0
Financials	12.6	18.1	32.3	-19.7	20.5	-7.9
	100.0	100.0	100.0	0.0	100.0	0.0

Source: Scottish Oriental Smaller Companies Trust, Edison Investment Research. Note: *Benchmark is MSCI Asia ex-Japan and small-cap index is MSCI Asia (ex-Japan) Small Cap Index.

As Exhibit 4 shows, the result of stock selections is that the largest active weights compared with the trust benchmark index (MSCI Asia ex-Japan) are in the consumer staples and consumer discretionary sectors (together nearly 38% of the portfolio). The main underweights are financials and information technology. Note that the underweight to financials is much lower when compared with the small-cap index. Changes over the last year include a reduction in the financials, consumer discretionary and healthcare weightings, with the main increase seen in consumer staples.

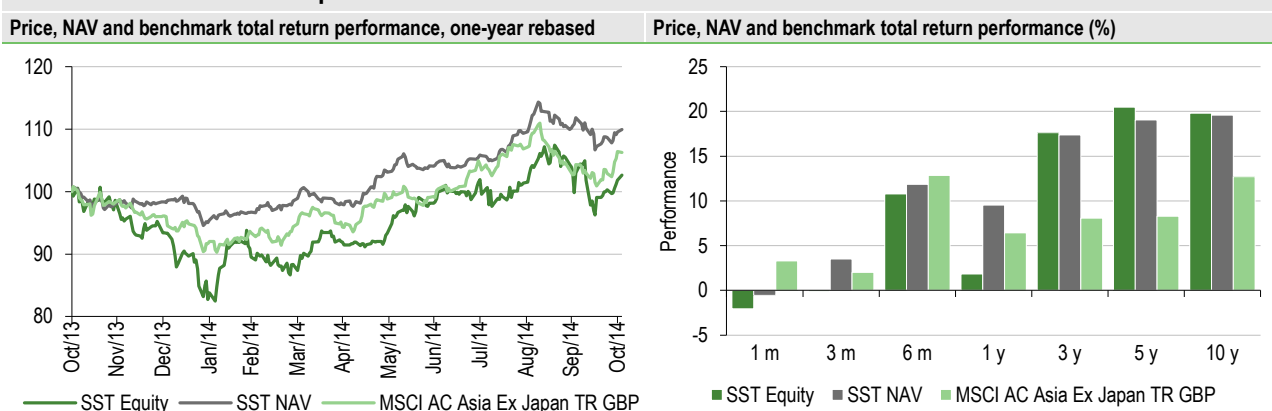
	31 October 2014	31 October 2013	Change from 2013	Benchmark 31-Oct-14	Active weight vs index	Trust weight / Index weight
China	15.4	17.5	-2.1	25.3	-9.9	0.6
Hong Kong	8.5	10.5	-2.0	12.8	-4.3	0.7
Taiwan	12.5	16.0	-3.5	15.4	-2.9	0.8
India	26.4	17.2	9.2	9.2	17.2	2.9
Indonesia	2.6	3.9	-1.2	3.4	-0.8	0.8
Malaysia	4.1	5.3	-1.2	5.0	-0.9	0.8
Philippines	1.1	2.8	-1.8	1.5	-0.4	0.7
Singapore	18.2	12.3	5.9	6.1	12.1	3.0
Sri Lanka	3.0	2.6	0.4	0.0	3.0	N/A
South Korea	5.1	7.1	-1.9	18.3	-13.2	0.3
Thailand	3.0	4.8	-1.7	3.0	0.0	1.0
	100.0	100.0	0.0	100.0	0.0	1.0

Source: Scottish Oriental Smaller Companies Trust, Edison Investment Research. Note: Benchmark is MSCI Asia (ex-Japan) Index.

The geographical exposure in terms of the company base is shown in Exhibit 5. Here the China region, including China, Hong Kong and Taiwan, accounts for 36% of the portfolio but collectively an active underweight of over 17% versus the benchmark. The other notable underweight is South Korea (c 13%), a highly concentrated market, where the manager has governance reservations. The key change over a year has been the increase in exposure to India reflecting increased holdings and market strength.

Performance: Ahead of benchmark

Exhibit 6: Investment trust performance



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

Exhibit 7: Share price and NAV total return relative performance (geometric, percentage points)

To end October 2014	One month	Three months	Six months	One year	Three years	Five years
Price versus MSCI AC Asia ex-Japan	(5.2)	(2.1)	(1.8)	(4.3)	28.9	70.4
NAV versus MSCI AC Asia ex-Japan	(3.8)	1.4	(0.9)	2.9	28.1	60.5
Price versus MSCI AC Asia ex-Japan Small Cap	(1.5)	(1.6)	2.4	(3.6)	28.3	73.6
NAV versus MSCI AC Asia ex-Japan Small Cap	0.0	1.9	3.4	3.7	27.4	63.6
Price versus FTSE All-Share	(1.4)	1.3	12.6	0.8	19.5	57.6
NAV versus FTSE All-Share	0.1	4.9	13.6	8.4	18.7	48.5

Source: Thomson Datastream, Edison Investment Research. Note: All indices in sterling terms.

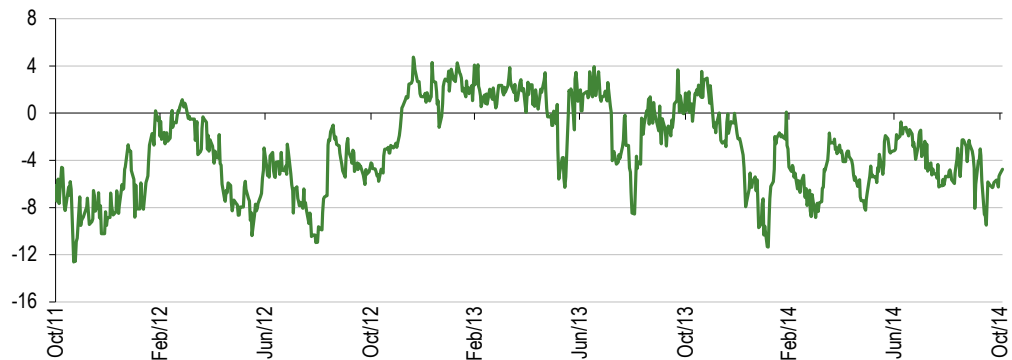
The MSCI AC Asian ex-Japan Index is up c 6% over a year, although there has been volatility linked primarily to changing expectations over US monetary policy (see left-hand chart in Exhibit 6). This has meant fluctuating near-term relative performance for SST (Exhibit 6), but, on a longer view, the trust's NAV total return relative performance has been ahead of its benchmark over one, three, five and (not included in this table) 10 years. Over 10 years SST's annualised total NAV return was 19.6% compared with 12.7% for the broad Asia ex-Japan benchmark and 13.2% for the MSCI AC Asia ex-Japan Small Cap Index. Neither index is an ideal comparator for the SST portfolio given differences in market cap and geographical coverage. To provide a familiar measure for UK investors we have also shown the relative performance against the FTSE All-Share Index.

SST has tended to outperform in weaker markets and underperform in stronger markets, something that could be attributed to the bias towards quality in stock selection and concern with absolute returns. Data from First State Investments (from 28 March 1995 to end September 2014) shows that SST outperformed in 84.3% of months in down markets compared with 40.5% of months in up markets. The overall average was outperformance in 60.7% of the 234 months in this period.

Discount: At a moderate discount currently

Over the last three years the discount (on NAV cum income) has averaged 3%, but in late 2013 and early 2014 the shares traded at a premium. Greater market volatility since then has been accompanied by a move to a moderate discount range of 0-8% (see Exhibit 8).

Exhibit 8: Discount over three years (NAV cum income, %)



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

Capital structure and fees

SST has one class of share with 31.6m ordinary shares in issue. While the company is authorised to buy back up to 14.99% of the issued share capital, this power has yet to be employed. The board may also issue new shares equivalent to up to approximately 5% of the outstanding share capital.

Over the last 10 years, the trust has had average net cash equivalent to 6% of shareholders' funds. In its accounts dated 4 November the company reported net cash of £18.7m (c 6.5% of NAV) available for investment as opportunities arise. Following the expiry of a previous loan, the trust agreed a £20m five-year loan expiring August 2019 at a rate of 3.135% (versus 2.191% previously). While the trust is unlikely to gear substantially, the manager wishes to maintain a liquidity buffer and believes that, over the five-year period, the gearing can be employed profitably; in the meantime the interest cost is only a modest drag on performance (c 20bps per annum).

First State's management fee is 0.75% of net assets paid from revenue. There is an annual performance fee (charged to capital) equivalent to 10% of any total share price return that exceeds the benchmark return plus 10%, measured over a three-year period. The total fee is capped at 1.5% of the company's net assets. Ongoing charges for the year to 31 August 2014 were 1.03% or 1.36% including the performance fee; the five-year average charges were 1.02% and 1.80% respectively. The management contract can be terminated on one year's notice by either side.

Dividend policy

SST's investment objective is to provide capital growth and there is no specific aim to grow SST's dividend. The dividend for the last financial year was unchanged and partly paid from the revenue reserve (dividend 11.5p, revenue return 9.59p). Over 10 years the dividend has grown fourfold. Adjusting for the proposed dividend, the revenue reserve at the financial year end was 18.2p.

Peer group comparison

Compared with its Asia Pacific ex-Japan investment company peer group, SST's performance ranks in the top five over one, three and five years and second in terms of its Sharpe ratio (a measure of risk-adjusted return) over the same periods. In terms of yield it is above the average (1.2%) once the companies with income mandates are stripped out. Similarly, its discount would be below the peer group average (8.4%) if we exclude the income mandates.

Exhibit 9: Asia ex-Japan investment trusts (% except where shown)

Fund name	Market cap £m	NAV TR 1 Year	NAV TR 3 Year	NAV TR 5 Year	Sharpe ratio 1 year (NAV)	Sharpe ratio 3 year (NAV)	Discount (Cum Fair)	Ongoing charge	Perf Fee	Net Gearing	Yield
Aberdeen Asian Income	399.8	3.4	37.5	93.4	0.3	1.0	1.1	1.2	No	106.0	3.8
Aberdeen Asian Smaller	366.2	7.4	69.0	159.2	0.7	1.4	-2.1	1.5	No	109.0	1.0
Aberdeen New Dawn	227.4	6.7	30.3	60.4	0.5	0.7	-10.3	1.1	No	107.0	2.0
All Asia Asset Capital Limited	40.9	-4.1			-0.4			11.6	No	100.0	0.0
Asian Total Return Inv Co.	143.5	11.3	27.2	29.2	1.0	0.6	-7.1	0.8	Yes	98.0	1.7
Edinburgh Dragon	542.0	7.4	29.0	61.6	0.5	0.7	-10.7	1.2	No	109.0	0.8
Fidelity Asian Values	160.0	11.1	37.4	55.9	1.0	0.9	-8.7	1.5	No	111.0	0.5
Henderson Far East Income	353.4	6.3	38.5	50.4	0.4	0.9	1.5	1.3	No	102.0	5.6
Invesco Asia	166.3	17.8	40.6	67.8	1.2	0.9	-11.0	1.1	No	102.0	1.8
JPMorgan Asian	213.4	9.1	25.5	30.1	0.5	0.6	-11.4	0.8	Yes	100.0	1.2
Martin Currie Pacific	118.6	2.3	23.3	38.9	0.1	0.6	-12.8	1.3	No	95.0	2.2
Pacific Assets	227.6	23.6	68.0	84.5	1.9	1.7	-1.2	1.2	Yes	88.0	1.3
Pacific Horizon	124.7	13.6	32.5	48.6	1.2	0.8	-9.4	1.0	No	101.0	0.8
Schroder Asia Pacific	469.0	15.1	43.9	81.0	1.0	0.9	-10.3	1.1	No	98.0	1.2
Schroder Oriental Income	426.5	10.7	56.9	113.6	0.6	1.2	-1.3	1.0	Yes	103.0	4.0
Scottish Oriental Smaller Cos	273.3	13.4	62.2	138.1	1.7	1.6	-5.6	1.0	Yes	94.0	1.3
Weighted average		10.0	43.4	82.0	0.8	1.0	-5.8	1.3		102.4	2.1
Rank		5	3	2	2	2	6	12		15	9
Count		16	15	15	16	15	16	16		16	16

Source: Morningstar, 18 November 2014. Notes: TR=total return. The Sharpe ratio is a measure of risk-adjusted return. The ratios we show 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 shown here as total assets less cash/cash equivalents as a percentage of shareholders' funds.

The board

All directors are non-executive and all are considered to be independent of the manager. James Ferguson is chairman of the company, having joined the board in 2004. He was a director of the company's investment manager until 2000, but the board believes sufficient time has elapsed since 2000 for him to be considered independent. The other directors, with year of joining in brackets, are Alexandra Mackesy (2004), Dr Janet Morgan (1995) and Anne West (2010). The directors have letters of appointment that provide for them to serve three-year terms.

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