

Securities Trust of Scotland

Large-cap equities, focused on dividend growth

Securities Trust of Scotland (STS) is an investment trust that invests primarily in large-cap global equities targeting both income and capital growth. Stocks are selected using a bottom-up, research-driven investment process and the manager is focused on finding companies that can grow dividends and earnings. Higher yielding global equities (measured by the MSCI World High Dividend Yield Index) have not risen as quickly as the broader market for two years, presenting a potential opportunity.

12 months ending	Total share price return (%)	Total NAV return (%)	Total return blended benchmark (%)	Total return MSCI World High Yield (%)	Total return FTSE All-Share (%)
31/03/11	14.3	12.2	8.7	7.3	8.7
31/03/12	17.7	6.3	5.0	4.4	1.4
31/03/13	24.4	23.1	23.0	23.0	16.8
31/03/14	2.2	3.4	5.8	5.8	8.8

Note: Blended benchmark index is the FTSE All-Share index until 31 July 2011 and the MSCI World High Dividend Yield Index thereafter.

Investment strategy: High-yield global equities

STS is managed using a predominantly bottom-up investment style, supported by macro analysis, with no formal country, sector or stock market restrictions on positioning. The portfolio is relatively concentrated and has recently become a little more so, with the 44 holdings as at 31 December 2013 being towards the bottom of the 40-60 range. STS has a strong focus on income, selecting investments with a sustainable prospective yield that is above that of the MSCI World Index, and seeking an exit if the yield falls below 75% of that of the index.

Outlook: Sentiment improving, valuations expanding

Global equity markets were strong in 2013 although volatility, particularly in reaction to talks of tapering, highlights that considerable uncertainty remains. Despite this, recent economic forecasts still suggest an improving outlook for global GDP, which in the absence of further destabilising events, should represent a favourable backdrop for equities. Valuations have risen from a low level, but the World-DS Market Index, at a historic P/E of 16.0x, is only modestly above the 10-year average, and the manager does not consider valuations to be particularly extended. STS's benchmark MSCI World High Dividend Yield (20.6% return) lagged the broader MSCI World index (25.0% return) for the second consecutive year in 2013. There have been two consecutive years of underperformance on three occasions since the mid-1990s, but never three consecutive years.

Valuation: Trading close to par

STS has consistently traded at a premium during the last two years, enabling the trust to grow by issuing new shares in a non-dilutive fashion. The current premium of 1.2% (on a cum fair basis) is lower than the average premium of 3.2% over the past year, below the sector average of premium of 2.0%, and down from a peak of 8.4% in June 2013. At 3.3% STS's yield is lower than the Global Equity Income sector average of 4.1%, but comparable to the market (MSCI World: 2.5%).

Investment trusts

4 April 2014

Price 144p
Market cap £177m
AUM £183m

NAV* 141.29p
 Premium to NAV 2.2%
 NAV** 142.60p
 Premium to NAV 1.2%
 Yield 3.3%

*Adjusted for debt at market value and excluding income, as at 3 April 2014. **Adjusted for debt at market value, including income, as at 3 April 2014.

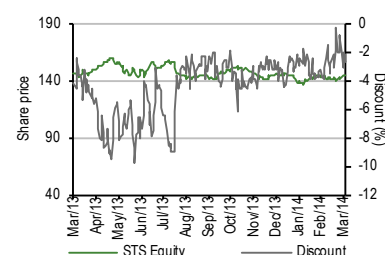
Ordinary shares in issue 122.3m

Code STS

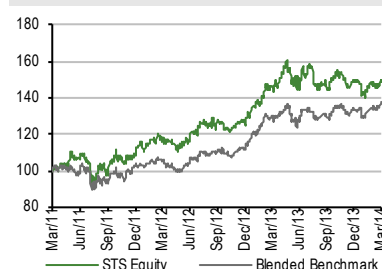
Primary exchange LSE

AIC sector Global Equity Income

Share price/discount performance*



Three-year cumulative perf. graph



52-week high/low 160.5p 136.5p

NAV* high/low 148.8p 132.92p

*Adjusted for debt at market value, excluding income.

Gearing

Gross 5.8%

Net 4.4%

Analysts

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[Edison profile page](#)

Exhibit 1: Trust at a glance

Investment objective and fund background

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

Recent developments

26 February 2014: Third interim dividend declared at 1.15p, payable 28 March 2014; XD=7 March 2014.

13 December 2013: Investec Nominee accounts hold 3.01% of STS shares.

8 November 2013: Interim report for the six months ended 30 September 2013 released.

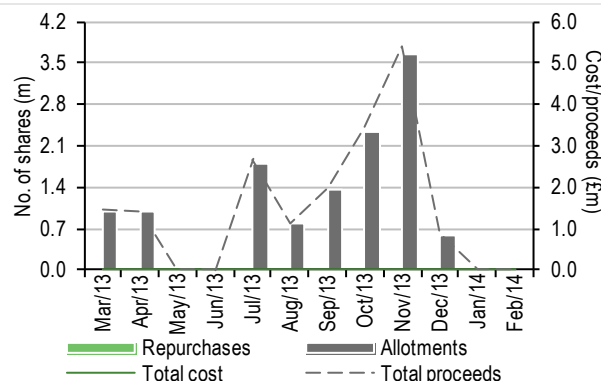
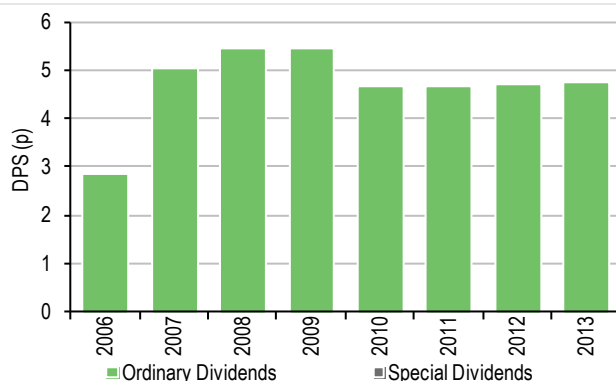
Forthcoming		Capital structure		Fund details	
AGM	July 2014	Ongoing charges	1.0% (Y/E 31 March 2013)	Group	Martin Currie Inv. Mgmt. Ltd (UK)
Annual results	June 2014	Net gearing	4.4%	Manager	Alan Porter
Year end	31 March	Annual mgmt fee	0.6% of net assets	Address	Saltire Court, 20 Castle Terrace, Edinburgh 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	£14m		

Dividend policy and history

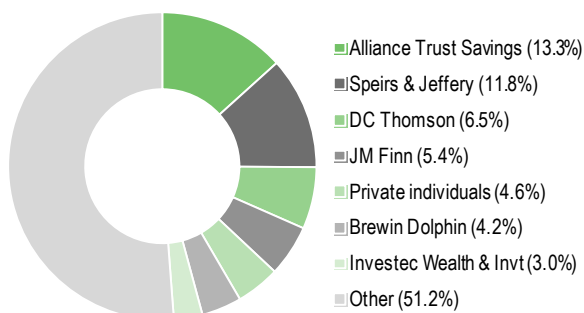
Quarterly dividends paid in March, June, September and December.

Share buyback policy and history

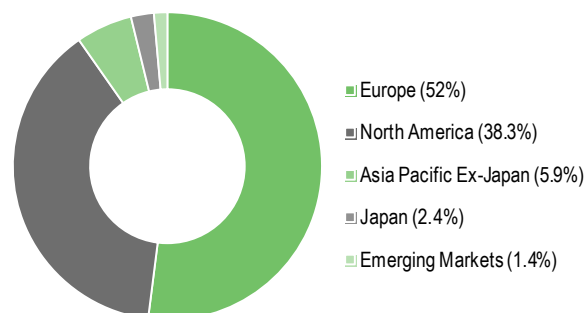
Renewed annually, the trust has authority to purchase up to 14.99%, and allot up to 5% of issued share capital.



Shareholder base (as at 21 March 2014)



Distribution of portfolio (as at 28 February 2014)



Top 10 holdings (as at 28 February 2014)

Company	Country	Sector	Portfolio weight %		Active weight %
			28 February 2014	31 August 2013	28 January 2013
Roche	Switzerland	Healthcare	6.7	4	4.0
Pfizer	US	Healthcare	5.5	4.8	2.9
Chevron	US	Energy	4.3	4.9	1.5
Total	France	Energy	4.2	3.9	2.5
AT&T	US	Telecoms	3.8	4.1	1.7
Sanofi	France	Healthcare	3.6	3.6	2.1
BHP Billiton	UK	Materials	3.4	N/A	2.6
Royal Dutch Shell	UK	Energy	3.3	3.1	1.6
Abbvie	US	Healthcare	3.2	N/A	2.2
HSBC	UK	Financials	3.2	N/A	3.2
Top 10			41.2	N/A	

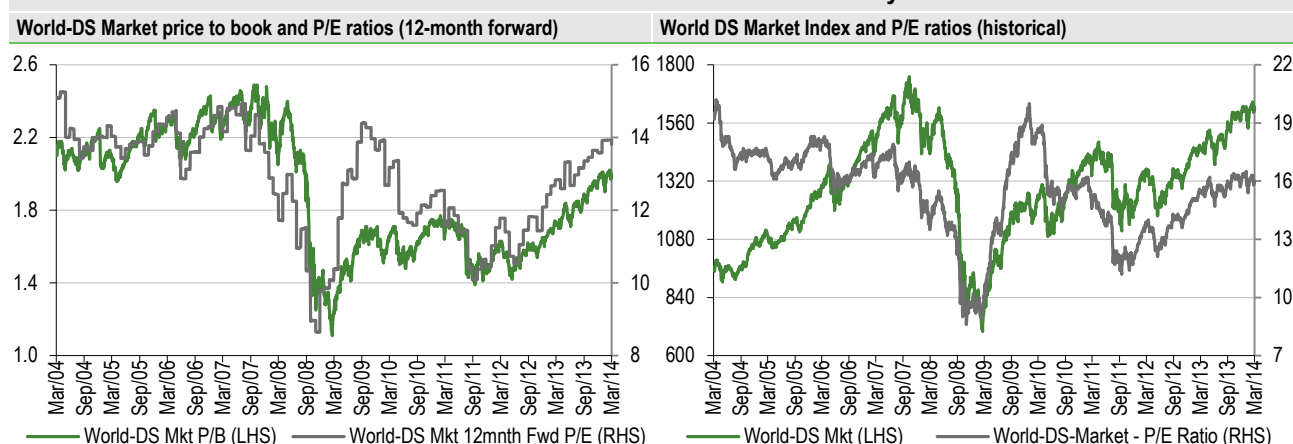
Source: Securities Trust of Scotland, Edison Investment Research

Outlook: Sentiment improving, valuations expanding

Against the backdrop of very low 'risk-free' returns that have prevailed since the financial crisis, and the easing of concerns regarding US fiscal imbalances and the eurozone, equity markets provided strong absolute returns in total during 2013 (the MSCI World Index and MSCI World High Dividend Yield returned 25.0% and 20.6% respectively in sterling-adjusted total return terms). Volatility during 2013 and early this year, particularly in reaction to the potential impact of tapering and concerns over China's growth, highlights that considerable uncertainty remains. But recent economic forecasts broadly suggest an improving outlook for global GDP, which in the absence of further destabilising events should represent a favourable backdrop for equities. The IMF's World Economic Outlook (updated January 2014) projects World GDP growth to increase from an estimated 3.0% in 2013, to 3.7% for 2014 and 3.9% in 2015.

Exhibit 2 shows that price rises have recently outpaced earnings increases, so that equities are not as cheap as they have been previously and, following a period of strength, the market may be more vulnerable to a correction. However, the World-DS Market Index is trading at a historical P/E of 16.0x, which is modestly above its 10-year average of 15.5x (10-year median 15.9x). The dividend yield at 2.5% is in line with its 10-year average. The approach of tapering, and the improved economic outlook that is a pre-requisite for this, has broadly led to a reduction of the yield premium offered by equities. Many investors still see the potential for superior performance if earnings surprise positively against an improving economic backdrop or there is a significant rise in inflation as key arguments in favour of equity exposure.

Exhibit 2: World-DS Market and MSCI World Index valuation metrics over 10 years



Source: Thomson Datastream

Fund profile: Global growth and income trust

STS is a global growth and income trust that pays quarterly dividends. At its July 2011 AGM, shareholders approved a change in the investment mandate from a focus on UK stocks to global stocks and, reflecting this, Alan Porter was appointed as manager from 1 August 2011. The portfolio transition was completed in September 2011.

The fund manager: Alan Porter

The manager's view: Focused on ability to grow dividends

The manager is cautiously optimistic about equity markets as a whole. Interestingly, he observes that looking back to the mid-1990s, high-yielding global equities have never underperformed the broader market for three consecutive years; during 2012 and 2013, the MSCI World High Dividend Yield Index (2012: +8.3%, 2013: +20.6%) has not performed as strongly as the World Index (2012: +11.4%, 2013: +25.0%). He views recent improvements in the global macroeconomic outlook as a positive, but considers that the continuing debt overhang and need for deleveraging remains one of the largest sources of uncertainty weighing on global equity markets. However, in general terms, corporate balance sheets and cash flow are strong, although the lack of confidence to increase investment is a concern. Earnings valuations have expanded, albeit from a low base, and while these may become a concern in time the manager does not yet see them as unduly extended. Meanwhile, the yield on equities relative to bonds remains attractive, if to lesser extent than a few months ago. He also takes comfort from that the cash balances of global asset managers have moved back to relatively high levels indications (source: Bank of America Merrill Lynch Global Fund Manager Survey – December 2013). Although the portfolio beta at c 1.08 is higher than it has been for some time (the long-term range is 0.95-1.05), the manager suggests that the maintenance of gearing at a low level is a better indicator of his conviction about market direction. As illustrated in Exhibit 3, STS's portfolio has a comparable yield and dividend cover to the benchmark and while debt levels are modestly higher, STS's portfolio has a prospectively higher than average return on equity and consensus expectations for earnings and dividend growth are higher.

Exhibit 3: STS risk profile as at 31 December 2013

Category	Trust	Benchmark	Difference
P/E (consensus)	13.3	13.4	(0.1)
Yield	4.1	4.0	0.1
Forecast earnings growth (consensus)	6.2	5.4	0.8
Forecast dividend growth	5.9	4.8	1.1
Return on equity (consensus)	17.8	16.5	1.3
Dividend cover (consensus)	1.8	1.9	0.0
Debt equity ratio	52.2	46.9	(5.3)

Source: Martin Currie and UBS PAS. Securities Trust of Scotland

Asset allocation

Investment process: Identify, evaluate and exploit change

Exhibit 4: Stock classifications based on dividend growth

Category	Characteristics	Key risk
Fast growth	>7% three-year forecast dividend growth (stock market winners, higher risk)	Growth slows
Medium growth	3-7% three-year forecast dividend growth (solid companies, low risk)	Valuation falls
Slow growth	<3% three-year forecast dividend growth (frequently high-yield stocks)	Value traps
Cyclical	Volatile dividends (held when coming out of a recession)	Misidentification
Special situations	Asset plays and turnaround situations (relatively few and far between)	Bankruptcy

Source: Martin Currie

The manager believes that the impact of positive change is underestimated in both size and duration and the investment process looks to capitalise on this. **Stage 1** – Idea generation – looks to identify sources of positive change. Ideas are sourced from portfolio managers, research analysts and company meetings. **Stage 2** – Research – evaluates and builds the investment case around stocks linked to an idea. Areas of focus are i) quality: balance sheet strength, strength and sustainability of cash flow generation, franchise strength and quality of management; ii) growth: expected growth in sales, margins, cash flows and earnings, and how these differ from consensus and what the risks are; and iii) valuation: how Martin Currie's intrinsic valuation compares to peers and history and what is already discounted in the current share price. **Stage 3** – Portfolio construction – looks to exploit

opportunities created by change. The manager aims to construct a portfolio of high-quality growing companies that offer good value and are experiencing positive change. Classifications, illustrated in Exhibit 4, are used to distinguish between portfolio stocks. Buy and sell disciplines, based on yield, are employed. The manager advises that as at the end of January 2014, the portfolio was underweight slow growth stocks, neutral to cyclical stocks and overweight fast and medium growth stocks.

Overview: Focused global equity portfolio

As at 28 February 2014, STS had 44 equity investments. The top 10 equity holdings accounted for 41.2% of the portfolio, cash 2.6% and borrowings -6.0%. STS's portfolio beta, with respect to the benchmark, is usually kept between 0.95 and 1.05 (currently 1.08). This ensures that, while the active share is in the region of 70% tracking error is limited and risk is predominantly stock specific. However, the benchmark MSCI World High Dividend Yield Index is inherently defensive when compared to global equity markets, itself having a beta of c 0.93 to its parent MSCI World Index.

Exhibit 5: Sector allocations (all data as at 28 February 2014 except where shown)

	Trust weight (%)	Trust weight (%) 31 August 2013	Change	Benchmark weight (%)	Trust active weight	Trust weight/ benchmark weight
Healthcare	20.8	20.3	0.5	21.7	-0.9	1.0
Financials	14.7	14.4	0.3	12.2	2.5	1.2
Consumer staples	14.2	15.5	-1.3	14.6	-0.4	1.0
Energy	13.6	14.6	-1.0	11.2	2.4	1.2
Telecommunications	11.6	11.3	0.3	6.1	5.5	1.9
Consumer discretionary	9.7	9.5	0.2	6.3	3.5	1.6
Materials	5.9	5.3	0.6	7.9	-2.0	0.7
Industrials	4.2	5.7	-1.5	8.1	-3.9	0.5
Utilities	3.6	1.7	1.9	7.4	-3.8	0.5
Information technology	1.7	1.7	0.0	4.5	-2.8	0.4
Total	100.0	100.0		100.0	0.0	

Source Securities Trust of Scotland, Edison Investment Research

Exhibit 6: Geographic allocations (all data as at 28 February 2014 except where shown)

	Trust weight (%)	Trust weight (%) 31 Aug 2013	Change	Benchmark weight (%)	Trust active weight	Trust weight/ benchmark weight
Europe	52.0	50.8	1.2	45.9	6.1	1.1
North America	38.3	38.8	-0.5	42.6	-4.3	0.9
Asia Pacific Ex-Japan	5.9	5.2	0.7	7.5	-1.6	0.8
Japan	2.4	2.9	-0.5	3.4	-1.0	0.7
Emerging markets	1.4	2.3	-0.9	0.0	1.4	n/a
Israel	0.0	0.0	0.0	0.6	-0.6	0.0
Total	100.0	100.0		100.0	0.0	

Source Securities Trust of Scotland, Edison Investment Research

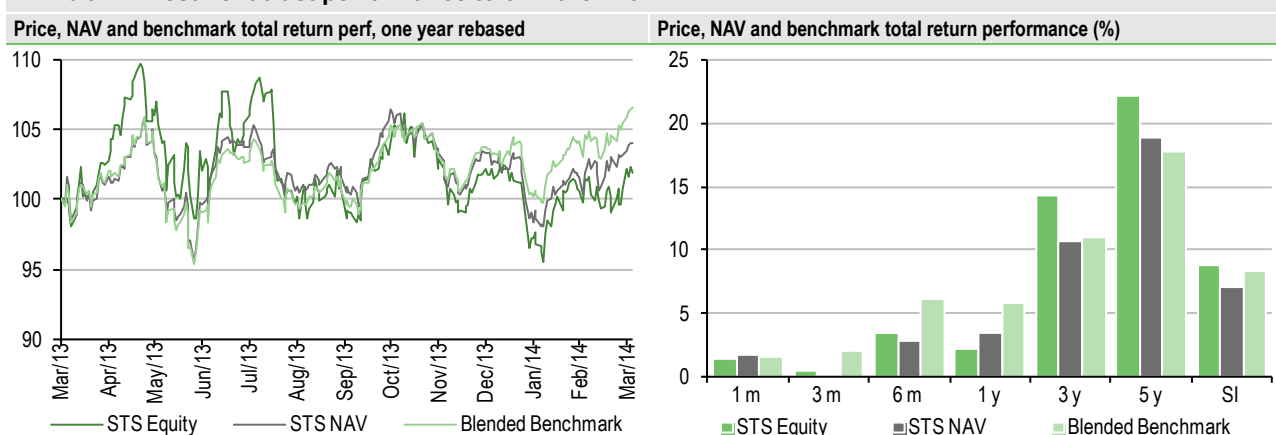
Recent activity and current portfolio positioning

Portfolio activity in the six months to 31 December 2013, has seen eight stocks sold and two new names added to the portfolio, with the number of holdings reduced from 50 to 44. The sales reflect a combination of stocks hitting the manager's valuation objectives, as well as a conscious decision to increase the focus on favoured holdings, largely within the same sectors, where conviction in the investment case is strongest. The sale proceeds from Novartis were used to increase holding size in Roche and Pfizer, while the sales of CIBC and Fifth Third funded increases in HSBC and PNC. Sales of Lockheed Martin, Taiwan Semiconductor and International Paper were all very much influenced by performance and valuation. China Mobile was exited because of concerns over its ability to grow dividends, and Worley Parsons on concerns over management's ability to control costs. The addition of Shin Corp reflects the manager's belief that its Thai mobile assets will benefit strongly from data growth, while Spanish operator Telefonica has been added as the manager is expecting a return to organic growth and improved profitability. As illustrated in Exhibit 1, although the number of stocks in the portfolio has been reduced overall, concentration among the largest holdings is actually slightly lower.

Performance: Reduced volatility under global mandate

Exhibit 9 shows the NAV total return of the trust versus the benchmark applicable at the time. The general trend of outperformance since 2009 continued after the mandate change in August 2011, although recent periods have seen spells of under-performance. As illustrated in Exhibit 8, the impact in share price terms more recently has been slightly higher, reflecting a narrowing of the premium during the period. The manager attributes the recent underperformance to a small number of stock-specific issues, as the concentrated, bottom-up nature of the portfolio would suggest, and also highlights the strong performance of some other stocks, including Lockheed Martin, Heinz (takeover) and Abbvie. The key detractors from performance have been Thai mobile operator Shin Corp (due to Thai domestic political difficulties), Nissan (whose poor Q3 results led to lower 2014 estimates) and a poor performance from Australian engineering consultancy Worley Parsons (subsequently divested).

Exhibit 7: Investment trust performance to 31 March 2014



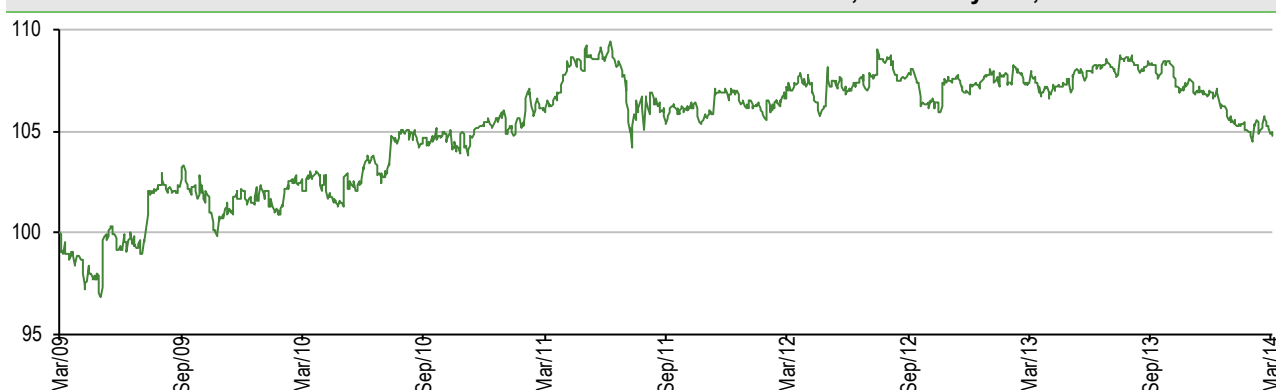
Source: Securities Trust of Scotland, Thomson Datastream, Edison Investment Research. 3 & 5 years and since inception annualised.

Exhibit 8: Share price and NAV total return performance versus benchmarks (% points), to 31 March 2014

	One month	Three months	Six months	One year	Three years	Five years	Launch
Price versus Blended Benchmark	(0.1)	(1.6)	(2.7)	(3.6)	12.9	45.4	8.2
NAV versus Blended Benchmark	0.1	(1.9)	(3.3)	(2.4)	(1.3)	11.1	(17.8)
Price versus MSCI World High Yield	(0.1)	(1.6)	(2.7)	(3.6)	13.7	49.3	10.3
NAV versus MSCI World High Yield	0.1	(1.9)	(3.3)	(2.4)	(0.5)	15.0	(15.7)
Price versus FTSE All Share	4.1	1.1	(1.2)	(6.6)	20.8	58.4	19.8
NAV versus FTSE All Share	4.3	0.8	(1.9)	(5.4)	6.6	24.1	(6.3)

Source: Securities Trust of Scotland, Thomson Datastream, Edison Investment Research

Exhibit 9: STS NAV total return relative to blended benchmark total return, over five years, rebased to 100

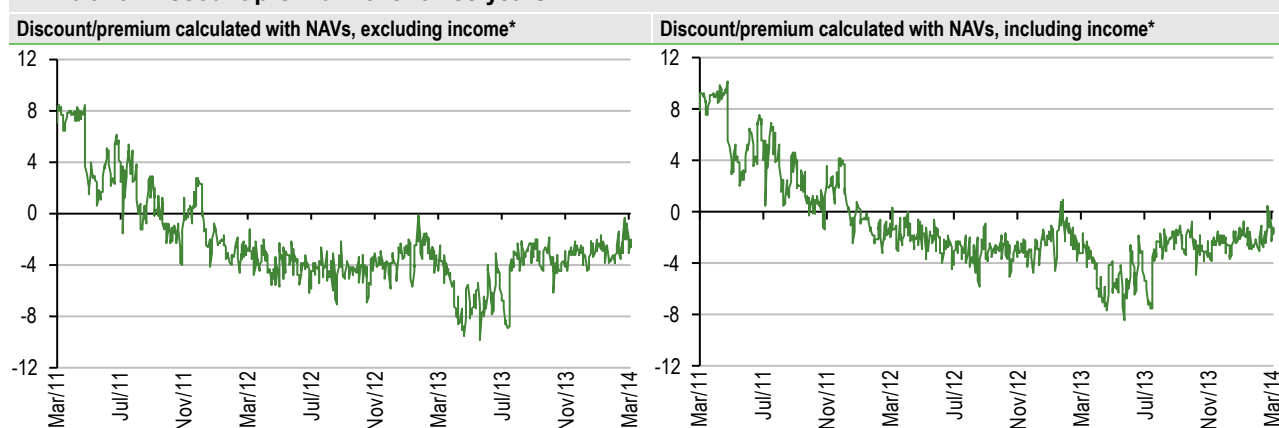


Source: Securities Trust of Scotland, Thomson Datastream, Bloomberg, Edison Investment Research

Discount: Trading at a modest premium recently

Coinciding with the announcement (in May 2011) of the intended move to a global mandate, the discount to NAV on which the shares had been trading began to narrow, and then move to a premium. This premium has been maintained over the past couple of years, reaching a maximum of 8.4% in June 2013. Over the past year the premium has averaged 3.2%, although at 3 April it had dipped to 1.2% and briefly traded at a discount during March (all cum fair value). STS has taken advantage of ongoing demand to allot new shares. In the past year 13.9m new shares have been issued, raising £20.2m, and an EGM held in August 2013 approved the issue of up to 100m new shares, providing considerable flexibility for this process to continue. Should circumstances change and a discount re-emerge, STS has mechanisms in place to manage this. There is no explicit commitment to maintain the discount at a particular level, but STS has been previously sought to maintain it within single figures, using share repurchases. If the average discount during the last 12 weeks of any financial year exceeds 7.5%, a redemption opportunity is triggered.

Exhibit 10: Discount/premium over three years



Source: Thomson Datastream, Edison Investment Research. Note: *Positive values indicate a discount; negative values a premium.

Capital structure: Conventional, modest gearing

STS has a simple capital structure, with one class of ordinary share. Gearing of up to 15% of total assets is permitted and as at 28 February 2014, gross and net gearing was 6.0% and 3.4% of net assets, respectively. Since 1 April 2012, the annual management fee has been set at 0.6% of net assets, with no performance fee. Ongoing charges were 1.0% for the year ended 31 March 2013 (2012: 1.0% inclusive of the old performance fee that was payable for that year, and 0.7% excluding performance fee). STS has an unlimited life.

Dividend policy: Quarterly dividend payments

Dividends are paid quarterly. The first interim dividend, paid in September (2013: 1.15p), has historically established the level for the second and third interims (in December and March), followed by a final dividend, typically larger, in June (2013: 1.30p). For the year-ended 31 March 2013, STS paid aggregate dividends of 4.75p (2012: 4.70p). STS seeks to provide rising income over time, and this has largely been achieved. Annual dividends per share were maintained or increased in each year since its launch (in 2005) with the exception of 2010. In 2010, dividend cuts by a number of higher-yielding stocks led STS to reduce its total dividend by 14.7% to 4.65p, and the impact can still be seen in the five-year dividend performance (-2.7%) contained in Exhibit 11. As at 30 September 2013, revenue reserves of 2.67p per share (2012: 3.12p), were equivalent to 1.52p (2012: 1.97p) after payment of the second quarterly dividend of 1.15p (2012: 1.15p).

Peer group comparison

Exhibit 11: Global Equity Income investment trusts

% unless stated	Market cap £m	TR one year	TR three years	TR five years	Ongoing charge	Perf. fee	Discount/ Premium	Net gearing	Yield	Sharpe NAV 1 year	Sharpe NAV 3 years
Securities Trust of Scotland	171.5	3.5	36.9	142.4	1.0	No	-0.5	105.0	3.4	0.5	0.8
Blue Planet Int Financials	20.5	28.4	--	--	3.8	No	-26.6	151.0	3.3	1.3	-0.4
British Assets Trust	393.6	4.3	24.0	121.3	0.7	No	-3.7	117.0	4.6	0.6	0.6
F&C Managed Ptf Income	32.0	6.7	38.3	139.6	1.3	Yes	1.4	105.0	3.9	0.9	0.8
Henderson Intl Income	76.8	7.0	--	--	1.4	Yes	-2.4	110.0	3.7	1.0	
Invesco Perp Select Global EI	45.7	11.7	37.4	106.4	1.1	Yes	-2.3	107.0	2.3	1.2	0.7
London & St Lawrence	101.8	11.9	43.7	101.5	0.7	Yes	-1.5	99.0	3.8	1.2	1.2
Midas Income & Growth Trust	52.2	6.8	30.7	98.4	1.5	No	-7.2	109.0	4.1	1.0	1.0
Murray International	1282.3	-7.0	25.9	114.5	0.7	Yes	6.0	116.0	4.1	-0.6	0.4
Scottish American	319.1	0.0	18.0	126.7	0.9	No	0.8	125.0	4.2	0.1	0.3
Sector weighted average		(1.3)	26.6	118.5	0.8		2.0	115.5	4.1	(0.0)	0.5
UK equity income sector weighted ave.		15.0	54.5	170.1	0.8		0.2	109.3	3.5	1.5	1.1

Source: Morningstar 24 March 2014. Notes: TR = total return. The Sharpe ratio is a measure of risk-adjusted return. The ratios we show are calculated by Morningstar for 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. Discount/premium is shown with debt at fair value, including income.

Share price total return is ahead of the Association of Investment Companies' Global Equity Income sector weighted average, over one, three and five years. However, prior to August 2011, when the mandate change came into effect, STS was a constituent of the UK Equity Income sector (averages shown at the bottom of Exhibit 11), and managed accordingly. Recent NAV underperformance versus the benchmark appears to be reflected in a shift down the Global Equity Income rankings (eighth out of 10 over one year compared with fourth of 10 over three years). Over one year, the volatility-adjusted NAV total return performance is similar, with a Sharpe ratio that positions the trust eighth out of 10.

The board

All directors are non-executive and independent of the manager. The average length of service is 6.0 years. The directors, with year of appointment as director in brackets, are Neil Donaldson (chairman, 2005 – at launch), Rachel Beagles (2010), Angus Gordon Lennox (2013), Andrew Irvine (2005 – at launch) and Edward Murray (2005 – at launch).

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