

Securities Trust of Scotland

Focus on yield and ability to grow dividends

Securities Trust of Scotland (STS) is an investment trust that invests primarily in large-cap global equities with an income and growth mandate. The manager seeks to add value through stock selection rather than by making a call on the market. Stock selection is driven by bottom-up fundamental analysis and the manager is focusing on finding companies that can grow dividends and earnings. Current portfolio averages show a prospective gross yield of 4% and dividend per share growth of c 6% over the next 12 months.

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 * (%)
30/06/10	16.8	25.9	21.1	22.9	21.1
30/06/11	37.5	32.1	25.6	24.7	25.6
30/06/12	9.7	2.1	3.6	1.7	(3.1)
30/06/13	26.1	22.3	21.3	21.3	17.9

Note: *Twelve-month rolling discrete performance.

Investment strategy: High-yield global equities

STS is managed using a predominantly bottom-up investment style, supported by macro analysis. There are no formal country, sector or stock market restrictions and the portfolio is relatively concentrated in 50 stocks. STS has a significant income requirement and the manager employs buy/sell disciplines based primarily on sustainable yield. Portfolio holdings must have a prospective yield greater than the MSCI World, which currently yields 2.7%. Holdings are sold if the yield falls below 75% of that of the MSCI World.

Outlook: Sentiment improving, valuations average

Despite recent market volatility, global equities have provided a very positive performance over the past year. The MSCI World High Dividend Yield Index has returned 21.3%, in sterling adjusted total return terms, while the MSCI World and FTSE All-Share have returned 23.7% and 17.9% respectively. There is evidence to suggest the global macro outlook is improving, but the recent tick up in volatility is a reminder that considerable uncertainty remains. Although there has been some progress, the manager sees the macroeconomic backdrop as the main risk for the market. The main positive is the absence of a more attractive alternative to equities. The current market P/E of the MSCI World Index, at 17.1x, is in line with long-run averages (see page 3). While there are pockets of overvaluation, the manager sees no evidence of this in higher-yield equities overall.

Valuation: Consistently trading at a premium

The trust has traded at a gradually rising premium during the past 18 months. STS now trades at a fair ex-premium of 4.4% (three- and five-year averages are discounts of 0.3% and 2.4% respectively). STS's premium compares against an average discount for the global growth and income sector of 11.3%. STS's yield at 3.1% remains attractive relative to the market, although lower than the growth and income sector average of 3.5%. In view of demand, STS is convening an EGM on 23 August to seek shareholder approval to allot up to 100m shares over 12 months.

Investment trusts

26 July 2013

Price 151p
Market cap £171m
AUM £174m

NAV* 144.65p
 Premium to NAV 4.4%
 NAV** 146.58p
 Premium to NAV 3.0%
 Yield 3.1

*Adjusted for debt at market value and excluding income, as at 24 July 2013. **Adjusted for debt at market value, including income, as at 24 July 2013.

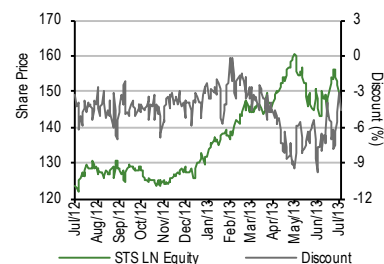
Ordinary shares in issue 113.1m

Code STS

Primary exchange LSE

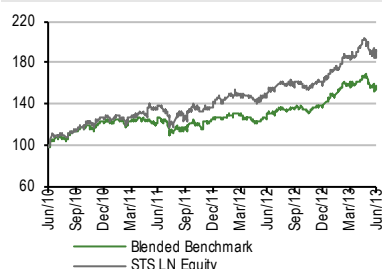
AIC sector Global Growth & Income

Share price/discount performance



Positive values indicate a discount; negative values indicate a premium.

Three-year cumulative perf. graph



52-week high/low 160.5p 122.0p

NAV* high/low 148.8p 116.5p

*Adjusted for debt at market value, excluding income.

Gearing

Gross 6.2%

Net 3.2%

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 (MSWRDHY).

Recent developments

19 July 2013: Announcement that STS is convening an EGM on 23 August 2013 to seek shareholder approval to allot up to 100m shares (89.4% of issued share capital as at 18 July 2013) over 12 months.

16 May 2013: Annual report for the year ended 31 March 2013 released.

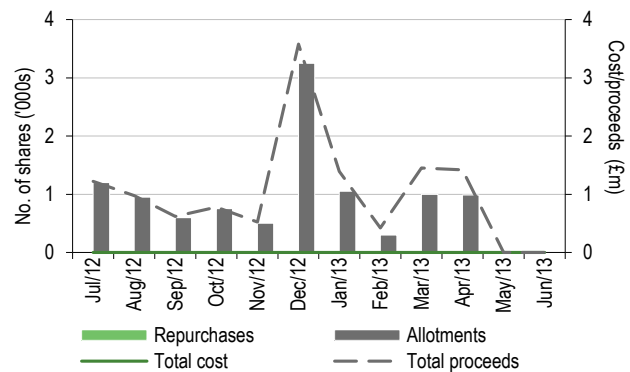
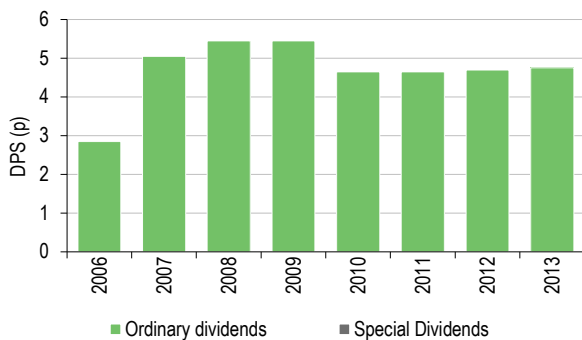
Forthcoming		Capital structure		Fund details	
AGM	July 2013	Ongoing charges	1.0%	Group	Martin Currie Inv. Mgmt. Ltd (UK)
Interim results	November 2013	Net gearing	3.2%	Manager	Alan Porter
Year end	31 March	Annual mgmt fee	0.6% of net assets	Address	Saltire Court, 20 Castle Terrace, Edinburgh EH1 2ES
Dividend paid	Quarterly	Performance fee	None	Phone	+44 (0) 131 229 5252
Launch date	June 2005	Trust life	Indefinite	Website	www.securitiestrust.com
Continuation Vote	None – see page 7	Loan facilities	£14m		

Dividend policy and history

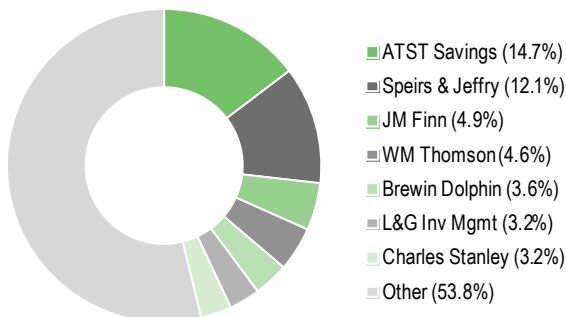
Quarterly dividends paid in March, June, September and December.

Share buyback policy and history

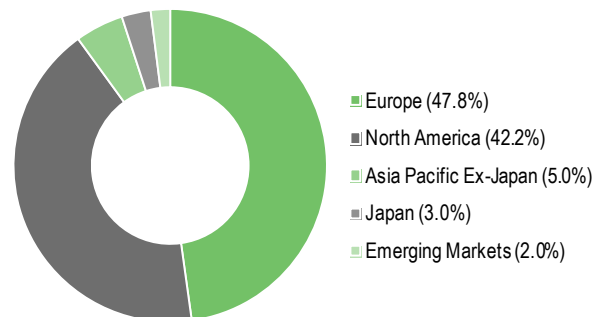
Renewed annually, the trust has authority to purchase up to 14.99%, and allot up to 5% of issued share capital.



Shareholder base (as at 30 June 2013)



Distribution of portfolio (as at 30 June 2013)



Top 10 holdings (as at 30 June 2013)

Company	Country	Sector	Portfolio weight %		Active weight %
			30 June 2013	31 December 2012	30 June 2013
AT&T	US	Telephone-Integrated	5.1	3.6	2.5
Pfizer	US	Medical-Drugs	4.9	4.6	2.2
Chevron	US	Oil Comps-Integrated	4.2	4.1	1.1
Sanofi	France	Pharma/Medical-Drugs	3.9	3.7	2.3
Novartis	Switzerland	Pharma/Medical-Drugs	3.9	3.2	1.7
Nestlé	Switzerland	Food-Misc/Diversified	3.6	3.6	0.8
Royal Dutch Shell	UK/Holland	Integrated Oil & Gas	3.5	3.7	2.4
Roche	Switzerland	Large Pharmaceuticals	3.4	N/A	1.0
Philip Morris International	US	Cons. Products/Tobacco	3.2	3.2	1.4
Total	France	Oil Comps-Integrated	3.0	3.4	1.6
Top 10			38.7	36.4	
Cash			1.6	1.7	
Borrowings			(6.4)	(10.6)	

Source: Securities Trust of Scotland, Edison Investment Research

Outlook: Sentiment improving? Valuations average

Despite very recent market volatility, global equities have provided positive performance over the past year, with the trust's benchmark, the MSCI World High Dividend Yield Index, up by 15.1% and 21.3% over six and 12 months respectively. While there is evidence to suggest the global economic outlook is improving, considerable uncertainty remains. More bearish investors can point to low growth in European economies, fiscal deficits in the US, the potential inflationary effects of quantitative easing, falling growth in emerging markets and the confidence sapping effect of recent market turbulence as negative factors for global equities. More bullish investors can point to progress being made in the US economy, signs that Japan may be moving away from its deflationary past, China's moving to a more sustainable growth rate, and the ECB's ongoing commitment to support the eurozone, as supportive of global equities. Moreover a falling gold price also suggests that confidence in the global economy is improving and that inflationary concerns may also be abating. While there is variation within markets and regions, in historical terms, average P/E valuations for global equities do not look overstretched (see Exhibit 2). Currently at 17.1x, the average P/E ratio over the past 10 years for the MSCI World Index is 17.9x.

Exhibit 2: MSCI World Index P/E over 10 years



Source: Bloomberg

Fund profile: Global growth and income trust

Launched in June 2005, as a roll-over vehicle for holders of the previous "Securities Trust of Scotland", 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 seeks to add value through stock selection rather than by trying to call the market. The portfolio is relatively concentrated by number of holdings (c 50) and gearing is modest at c 3%.

In response to the question "is the performance of global income stocks a short-term thing?" the manager points to sustained periods of outperformance by the benchmark MSCI High Dividend Yield Index versus the MSCI World Index. The High Dividend Yield Index has outperformed the World Index over three-, five-, and 10-year periods to end June 2013 with similar standard deviation and hence higher risk-adjusted returns.

In a low rate environment, where the market is searching for return, another question the manager is frequently asked is whether income stocks are becoming a crowded trade. He acknowledges that this could be a concern for the future and that there are pockets of expensive stocks, which he avoids. Currently, the medium dividend growth stocks that constitute the majority of the trust portfolio continue to offer good opportunities: as an indication of relative valuations, the High Dividend Yield Index trades on a prospective P/E of 12.1x compared with 13.1x for the World Index, while offering a yield of 4.1% vs 2.7% (end-June figures, MSCI).

The manager is targeting companies that can grow dividends and earnings. Current portfolio averages show a prospective gross yield of 4% and dividend per share growth of c 6% over the next 12 months. The manager believes he has been able to assemble a portfolio with below average debt levels, a prospectively higher than average return on equity and earnings with a supportive yield and dividend growth prospects, as illustrated in Exhibit 3.

Exhibit 3: STS risk profile as at 30 June 2013

Category	Trust	Benchmark	Difference
P/E (consensus)	12.1	12.1	(0.1)
Yield	4.3	4.3	(0.0)
Forecast earnings growth (consensus)	5.8	4.5	1.3
Forecast dividend growth	6.1	4.8	1.4
Return on equity (consensus)	19.0	17.5	1.5
Dividend cover (consensus)	1.9	1.9	0.0
Debt equity ratio	44.1	50.5	(6.4)

Source: Martin Currie

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; 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.

Overview: Focused global equity portfolio

As at 30 June 2013, STS had 50 equity investments. The top 10 equity holdings accounted for 38.7% of the portfolio, cash 1.6% and borrowings -6.4%, while the remaining equities accounted for 66.1% of the portfolio. As shown in Exhibit 5, STS's asset allocation has moderate differentials to the benchmark and, as shown in Exhibit 6, the portfolio has broad global diversification. The portfolio's

beta, with respect to the benchmark, is kept between 0.95 and 1.05 (currently 1.05), although the active share is c 70% so that tracking error is limited and risk is predominantly stock specific.

Exhibit 5: Sector allocations as at 30 June 2013

	Portfolio weight (%)	Benchmark weight (%)	Trust active weight (%)	Trust weight/benchmark weight
Telecommunication services	11.1	7.3	3.8	1.52
Financials	14.4	11.5	2.9	1.25
Consumer discretionary	9.0	6.4	2.6	1.41
Energy	13.8	11.5	2.3	1.20
Consumer staples	17.4	16.1	1.3	1.08
Industrials	8.5	8.0	0.5	1.06
Healthcare	21.5	21.5	0.0	1.00
Materials	4.6	5.7	(1.1)	0.81
Information technology	2.7	4.0	(1.3)	0.68
Utilities	1.8	7.9	(6.1)	0.23
Cash	1.6	0.0	1.6	N/A
Borrowing	(6.4)	0.0	(6.4)	N/A
	100.0	100.0	0.0	

Source Securities Trust of Scotland, Edison Investment Research

Exhibit 6: Geographic allocations as at 30 June 2013

	Portfolio weight (%)	Benchmark weight (%)	Trust active weight (%)	Trust weight/benchmark weight
Europe	50.1	45.0	5.1	1.11
Emerging Asia	2.1	0.0	2.1	N/A
Japan	3.1	2.8	0.3	1.12
Asia	5.2	6.3	(1.1)	0.83
North America	44.2	45.9	(1.7)	0.96
Cash	1.6	0.0	1.6	N/A
Borrowing	(6.4)	0.0	(6.4)	N/A
	100.0	100.0	0.0	

Source: Securities Trust of Scotland, Edison Investment Research

Recent activity and current portfolio positioning

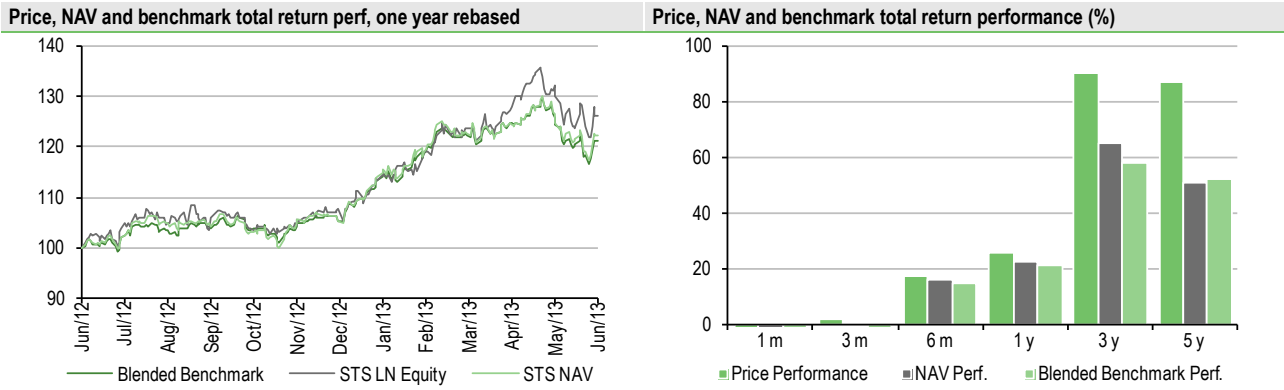
Portfolio activity year-to-date has seen three stocks sold and five new names added to the portfolio. Watsco was exited, following a restructuring of its dividend payments, as it has become a low yielding stock. Heinz was sold due to the takeover and in April German TV channel operator ProSieben was sold as it had reached its target price. BNP Paribas and Nissan have been added as the manager considers they offer a cyclical growth opportunity. Scandinavian TV company Modern Times Group and media company Eutelsat have been added as the manager expects capital expenditure and M&A will be limited for both and that improvements in profitability will fund faster dividend growth. US energy transportation and storage company Kinder Morgan is a medium growth company where the manager also sees a cyclical growth opportunity as the US economy recovers. The portfolio retains its utilities underweight, reflecting the manager's view that the sector offers very limited growth prospects. The portfolio has moved from having a c 2% active underweight to a c 3% active overweight for financials, reflecting the manager's view that the sector offers value as well as the manager taking a less mildly less bearish stance.

Performance: Reduced volatility under global mandate

The portfolio's transition to reflect the change to the global (previously UK) equities mandate was completed in September 2011. As illustrated in exhibits 7, 8 and 9, NAV progression has broadly followed that of the benchmark since this time, while the share price has seen the strongest benefit. This is reflected in a tightening of the discount during the period so that STS now predominantly trades at a premium. Between the end of September 2011 and the end of June 2013, STS has returned 31.4% in terms of NAV total return and 41.0% in terms of share price total. These are both ahead of the benchmark, which returned 28.8%. Exhibit 9 also illustrates that, following the transition, STS has provided investors with lower relative return volatility. During the last 12 months,

the key contributors have been US stocks. The largest contributor has been Heinz, following its acquisition by a consortium led by Berkshire Hathaway. The second has been Abbvie, which has returned c 30% since its demerger from Abbott Labs at the beginning of the year. The two key detractors from performance have been the decisions not to hold US multinational Johnson & Johnson and global bio-pharmaceutical company Bristol-Myers Squibb. Both have performed well, but the manager considers their dividend growth prospects are unattractive.

Exhibit 7: Investment trust performance to 30 June 2013



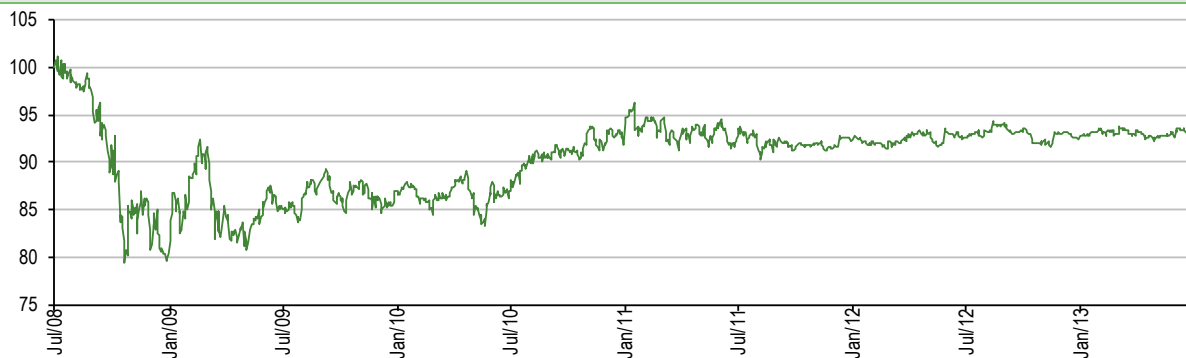
Source: Securities Trust of Scotland, Thomson Datastream, Edison Investment Research

Exhibit 8: Share price and NAV total return performance, relative to benchmarks (%), to 30 June 2013

	One month	Three months	Six months	One year	Three years	Five years	Launch
Price relative to blended benchmark	(1.0)	3.0	2.1	4.9	32.4	34.8	20.8
NAV relative to blended benchmark	0.4	0.6	1.2	1.0	7.2	(0.8)	(11.8)
Price relative to MSCI World High Yield	(1.0)	3.0	2.1	4.9	36.5	21.4	22.8
NAV relative to MSCI World High Yield	0.4	0.6	1.2	1.0	11.3	(14.2)	(9.8)
Price relative to FTSE All-Share	1.4	3.7	9.1	8.2	46.7	48.6	37.8
NAV relative to FTSE All-Share	2.7	1.3	8.2	4.4	21.5	13.0	5.3

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

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



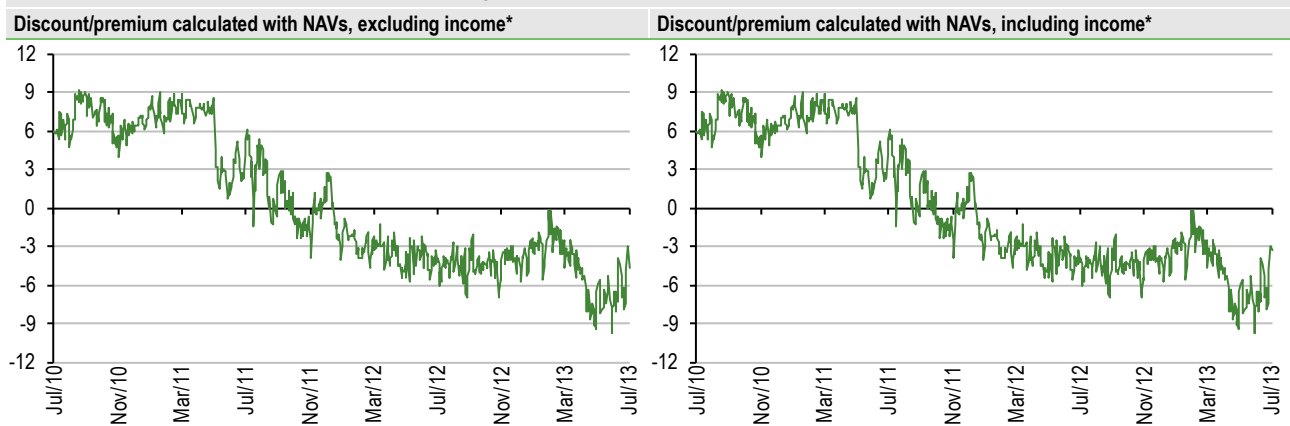
Source: Securities Trust of Scotland, Thomson Datastream, Bloomberg, Edison Investment Research

Discount: Sustained narrowing during the past 3 years

STS has authority to both repurchase and allot its ordinary shares, although an explicit commitment to maintain the discount at a particular level has not been provided. However, if the average discount during the last 12 weeks of the financial year exceeds 7.5%, a redemption opportunity is triggered. A redemption opportunity was not triggered for 2013 (average premium during measurement period = 3.0%). In May 2011, STS announced its proposed change of investment mandate to move to a global portfolio. As illustrated in Exhibit 10, an instantaneous price increase, and associated contraction in the discount, followed and the discount has broadly continued its path of contraction since (STS has traded at an average premium of 4.5% during the last 12 months). Under these circumstances, STS has not needed to utilise its repurchase authority and, with the

trust trading at a premium during the last year, STS continues to take the opportunity to allot shares (during the last 12 months STS has allotted 11.1m shares raising £13.0m, as illustrated in Exhibit 1). In view of investor demand, STS is convening an EGM on 23 August to seek shareholder approval to allot up to 100m shares (89.4% of issued share capital as at 18 July 2013) over 12 months. The current fair ex premium¹ of 4.4% shows STS to be more fully valued when compared to its three- and five-year discount averages of 0.3% and 2.4%, respectively, and also when compared to the average premium, since the mandate change was announced, of 3.0%.

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 is a conventional investment trust with one class of ordinary share in issue. STS can gear up to 15% of total assets and as at 30 June 2013, had gross and net gearing of 6.4% and 4.8% of net assets, respectively. New fee arrangements were adopted from 1 April 2012 under which Martin Currie receives a management fee of 0.6% per annum of net assets calculated and paid quarterly in arrears. Details of the historical fee arrangements can be seen in the [Edison note](#) of December 2011. The investment management and company secretarial agreements can be terminated immediately and without penalty if Martin Currie ceases to be capable of carrying out investment business. If cancelled under any other circumstances, Martin Currie is entitled to compensation equal to twice the quarterly fee payable immediately prior to cancellation. STS's ongoing charges were 1.0% for the year ended 31 March 2013 (2012: 1.0% inclusive of performance fee, 0.7% excluding performance fee). STS does not have a fixed life. However, if the average discount during the 12 weeks prior to the financial year end exceeds 7.5%, a redemption opportunity is triggered.

Dividend policy: Quarterly dividend payments

Dividends are paid quarterly. The first interim dividend is paid in September (2012: 1.15p), which has historically established the level for the second and third interims in December and March. This is typically followed by a larger final dividend in June (2013: 1.30p). For the year-ended 31 March 2013, STS paid a total dividend of 4.75p (2012: 4.70p). Part of STS's investment objective is to provide rising income and, as such, we would expect STS to aim to maintain, and where possible provide moderate increases in, its total dividend payment. STS's dividend payment history is illustrated in Exhibit 1. 2010 saw a reduction in the total dividend of 14.7% to 4.65p as a result of extensive dividend cuts during the period. The dividend was maintained at 4.65p for 2011, increased by 1.1% to 4.70p for 2012, and by 1.1% to 4.75p for 2013. As at 31 March 2013, STS

¹ Fair ex premium/discount calculated using NAVs with debt at fair value excluding current year revenue income.

had revenue reserves of 2.61p per share (2012: 2.85p), which is equivalent to 1.55p (2012: 1.60p) after payment of the final quarterly dividend of 1.30p (2012: 1.25p).

Peer group comparison

Prior to the mandate change in August 2011, STS was a member of the UK Growth and Income sector (averages at the bottom of Exhibit 11). Within the 11-strong new peer group, Global Growth and Income, STS ranks eighth over one year, first over three years, and third over five years when considering share price total return. For dividend yield and five-year dividend growth, STS ranks eighth and ninth respectively. In terms of risk-adjusted returns, STS has the sixth highest one-year Sharpe ratio for price, and ninth highest Sharpe ratio for NAV, in its peer group.

Exhibit 11: Global growth and income sector, as at 19 July 2013

Company	Share price total return on £100			Ongoing charges (%)	(Disc)/ prem.	Net gearing (100=no gearing)	Five-year dividend growth (%)	Div. yield	Sharpe ratio NAV One year	Sharpe ratio price One year
	One year	Three years	Five years							
Sector average	126.6	163.3	206.5	0.8	11.3	112.3	9.1	3.5	3.0	4.1
Securities Trust of Scotland	123.2	178.4	192.1	0.7	3.1	105.0	(2.9)	3.1	2.6	3.3
Blue Planet Intl. Financials	172.4			0.0	(23.1)	144.0	0.0	3.7	(2.3)	(1.4)
British Assets	119.4	136.7	163.0	0.7	(4.5)	119.0	0.9	4.6	3.0	3.1
F&C Managed Portfolio Income	133.9	150.1	190.7	1.4	1.6	103.0	1.1	3.8	5.6	4.4
Henderson Intl. Income	125.3			1.5	4.0	114.0	0.0	3.4	4.1	3.2
Invesco Perp. Sel Gbl Eqty	149.7	152.3	170.3	1.2	(0.1)	100.0	7.3	2.2	3.8	2.9
London & St. Lawrence	136.2	158.1	186.7	0.7	0.4	99.0	3.2	3.7	4.5	4.2
Midas Income & Growth	130.7	136.0	136.2	1.8	(10.0)	110.0	(4.2)	4.1	5.8	3.2
Murray International	122.9	160.6	210.6	0.7	11.9	111.0	12.6	3.6	2.9	3.5
Murray International B	130.7	176.6	226.1	0.7	19.6	111.0	11.5	3.2	2.9	5.2
Scottish American	124.8	144.5	176.1	0.9	3.9	125.0	2.7	3.9	3.7	3.7
UK Growth & Income sector average	131.4	173.4	208.6	0.8	1.0	160.2	2.1	3.6	3.9	4.1

Source: Morningstar

The board

All directors are non-executive and independent of the manager. They are Neil Donaldson (chairman), Rachel Beagles, Andrew Irvine and Edward Murray. Excluding Rachel Beagles, all directors joined the board at launch in 2005. The average length of service is 6.9 years.

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