

# Securities Trust of Scotland

## Finding income and growth, globally

Securities Trust of Scotland (STS) aims to achieve rising income and long-term capital growth by investing in a relatively concentrated portfolio of mainly large-cap global companies. The portfolio is managed with an emphasis on fundamental stock selection rather than taking a market view (beta neutral). The shares have moved back from the small premium they had traded on previously and offer a yield of over 3% from a geographically diversified portfolio.

12 months ending	Share price (%)	NAV (%)	Blended benchmark (%)	MSCI World High Div Yld (%)	FTSE All-Share (%)
31/10/11	14.2	5.4	4.3	5.0	0.6
31/10/12	15.2	10.9	10.9	10.9	9.8
31/10/13	24.3	26.0	23.5	23.5	22.8
31/10/14	(2.5)	1.5	7.3	7.3	1.0

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

### Investment strategy: Stock-focused process

STS is managed on a primarily bottom-up basis with the intention that the stock selection process should result in a portfolio of 40-60 holdings, all of which have the potential to deliver both income and growth (the manager does not select stocks for income alone). With 43 holdings currently, STS has the most focused portfolio within its global equity income peer group and the active share (a measure of the portfolio's difference from its benchmark, the MSCI World High Dividend Yield Index) is typically high at around 70%.

### Outlook: Uncertainties but still potential upside

The current year has seen some potentially significant headwinds for equity markets in the shape of adverse geopolitical developments (Ukraine, Middle East), reduced estimates for global GDP growth and continuing uncertainty over the pace of US monetary policy normalisation. Even so global markets as a whole have made further progress with STS's benchmark delivering a total return of nearly 10% year to date. Earnings growth has not kept pace with share prices so prospective multiples have expanded and for many markets are above long-term averages. Nevertheless, economic recovery now seems well established in the US and UK providing an environment in which further, more modest, market gains could indeed be underpinned by earnings. Against this background a portfolio of companies chosen to provide sustainable growth in income may well be an appealing option for many investors.

### Valuation: Now trading at a narrow discount

After trading at a premium to its NAV for over two years, STS shares moved back to a modest discount from the middle of this year, probably reflecting some near-term relative weakness and greater market volatility. Removal of the premium is a positive factor for potential investors.

## Investment trusts

25 November 2014

<b>Price</b>	<b>145p</b>
<b>Market cap</b>	<b>£177m</b>
<b>AUM</b>	<b>£197m</b>

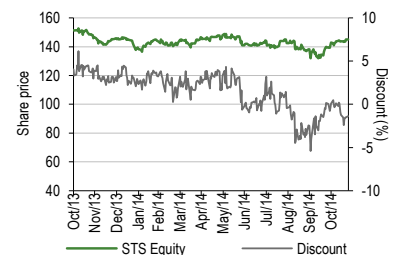
NAV*	147.23p
Discount to NAV	1.5%
NAV**	149.59p
Discount to NAV	3.1%
Yield	3.3%

\*Adjusted for debt at market value and excluding income.

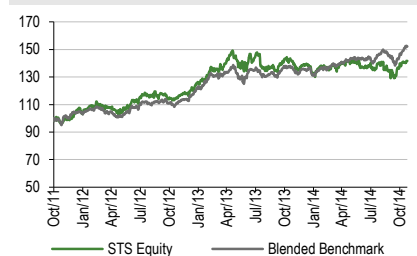
\*\*Adjusted for debt at market value, including income, both as at 21 November 2014.

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	149.0p	132.0p
NAV* high/low	147.23p	134.21p

\*Adjusted for debt at market value, excluding income.

### Gearing

Gross	9.6%
Net	7.2%

### 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 (the FTSE All-Share index until 31 July 2011).

### Recent developments

1 October 2014: Mark Little appointed as non-executive director.

26 September 2014: first interim dividend paid (1.15p).

15 August 2014: interim management statement for three months to end June.

### Forthcoming

AGM	July 2015
Annual results	June 2015
Year end	31 March
Dividend paid	Quarterly
Launch date	28 June 2005
Continuation Vote	None

### Capital structure

Ongoing charges	1.0% (Y/E 31 March 2014)
Net gearing	7.2%
Annual mgmt fee	0.6% of net assets
Performance fee	None
Trust life	Indefinite
Loan facilities	£17m

### Fund details

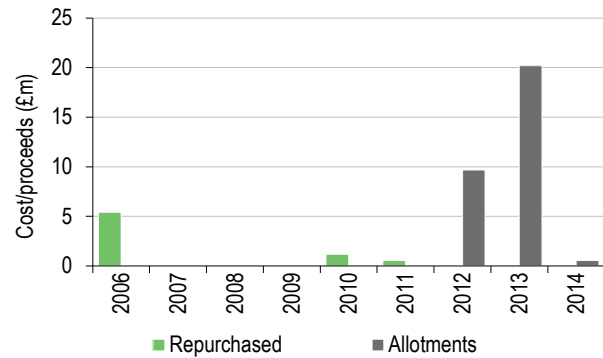
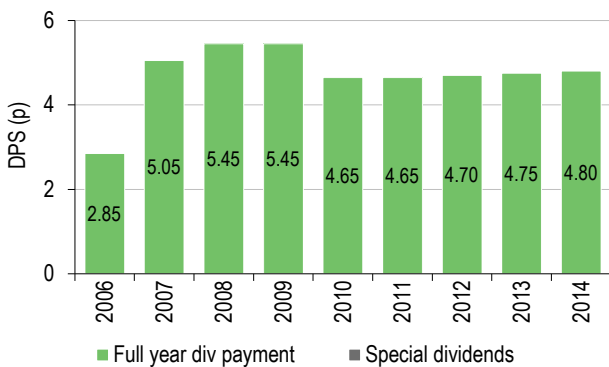
Group	Martin Currie Inv. Mgmt. Ltd (UK)
Manager	Alan Porter
Address	Saltire Court, 20 Castle Terrace, Edinburgh EH1 2ES
Phone	+44 (0) 131 229 5252
Website	<a href="http://www.securitiestrust.com">www.securitiestrust.com</a>

### Dividend policy and history

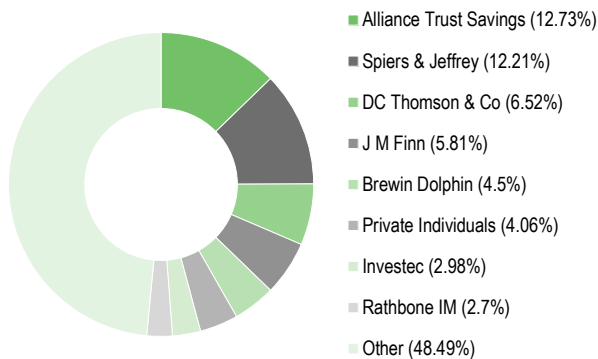
Quarterly dividends paid in March, June, September and December.

### Share buyback policy and history

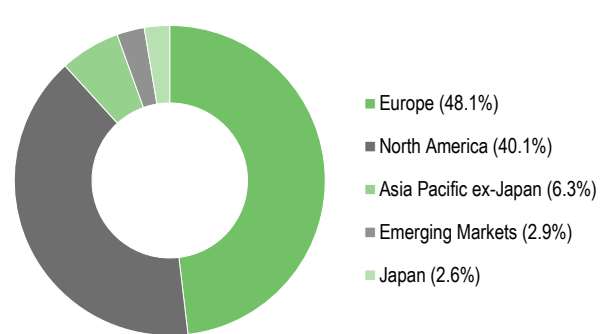
Renewed annually, the trust has authority to purchase up to 14.99%, and allot up to 5% of issued share capital.



### Shareholder base (as at end October 2014)



### Distribution of portfolio (as at 31 October 2014)



### Top 10 holdings

Company	Country	Sector	Portfolio weight %		Active weight %
			31 October 2014	31 October 2013*	31 October 2014
Roche	Switzerland	Healthcare	7.1	4.1	4.5
Chevron	US	Energy	5.3	4.5	2.5
Philip Morris International	US	Consumer Staples	4.5	3	2.8
Total	France	Energy	4.2	4	2.7
Abbvie	US	Healthcare	4.2	3.1	2.9
British American Tobacco	UK	Consumer Staples	3.8	N/A	2.5
Pfizer	US	Healthcare	3.7	4.9	1.4
Royal Dutch Shell	UK	Energy	3.7	N/A	0.9
Verizon	US	Telecommunication	3.6	N/A	3.6
McDonalds	US	Consumer Discretionary	3.2	N/A	2.1
<b>Top 10</b>			<b>43.5</b>	<b>38.1</b>	

Source: Securities Trust of Scotland, Edison Investment Research, Bloomberg. Note \* Top 10 N/A where not in top 10 at end October 2013.

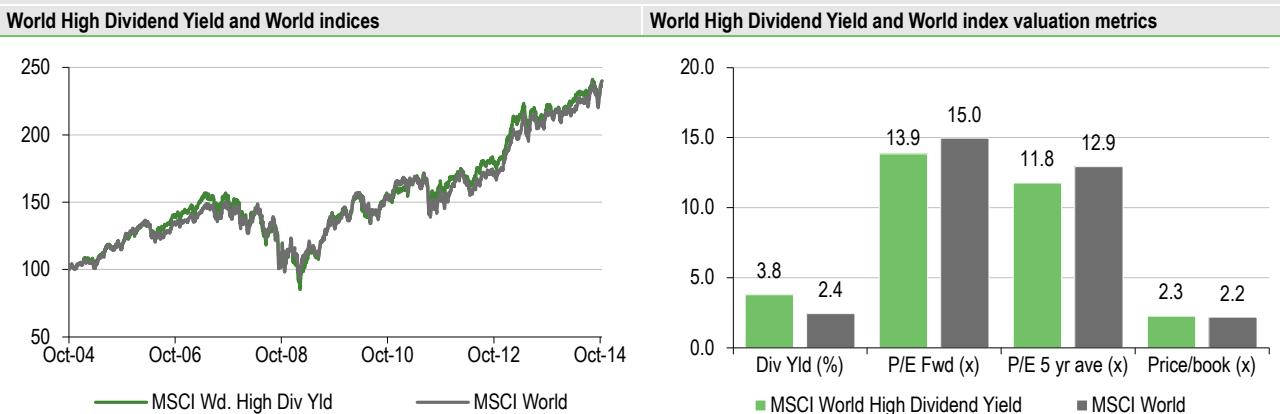
## Outlook: Potential upside despite uncertainties

The trust's current benchmark, the MSCI World High Dividend Yield Index, has delivered a total return of nearly 10% this year despite a range of economic and geopolitical concerns. Important uncertainties are still in place with changing expectations for the pace of monetary policy normalisation in the US, the degree of deceleration of China's growth and how the situations in Ukraine and the Middle East will play out. Economic forecasts have been trimmed during the year with the outlook for Europe becoming markedly weaker. Despite this, estimates, such as those of the IMF, still look for global GDP growth to increase from an estimated 3.3% in 2014 to 3.8% for 2014 and 4.0% in 2016. The IMF refers to "clouds" and uncertainties but accommodative moves by the Japanese and European central banks should be helpful for these weaker economies.

The left-hand chart in Exhibit 2 illustrates the similarity of performance of the MSCI World High Dividend Yield and World indices over the last 10 years, although the High Dividend Yield index has both outperformed over the longer period since end June 1995 (+9.5% versus +7.3% pa) and recorded a Sharpe ratio above that of the broader index. The chart also shows that the correction in September/October this year was small in the context of the post-financial crisis recovery.

Looking ahead, we may experience more of the same in the sense that intermittent bouts of risk aversion could cause corrections but, providing economic growth and corporate earnings are not significantly dented, markets could continue to make progress, albeit at a more moderate pace. Valuations (see right-hand chart Exhibit 2) as captured by the forward P/E are high compared with their five-year averages, but the high yield index trades on a lower multiple and, by design, offers a relatively high income return. In an environment where volatility may well spike again and interest rates remain low, a fund selecting for income and growth among large-cap companies globally could match the requirements of many investors.

**Exhibit 2: Comparing MSCI World and World High Dividend Yield Indices**



Source: Thomson Datastream. Note: index performance used is total return in sterling terms.

## Fund profile: Global growth and income trust

STS is a global growth and income trust that pays quarterly dividends. It was incorporated in 2005 as part of the reconstruction of its namesake predecessor trust. 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 manager follows a bottom-up stock selection process to form a relatively focused portfolio of 40-60 global stocks deemed capable of delivering both attractive income and long-term growth.

## The fund manager: Alan Porter

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### The manager's view: Shifting focus to find income and growth

While the manager acknowledges the risks that exist in the economic and market background (see our Outlook comments, page 3) he notes the progress that has been made since the global financial crisis and shares the view that the US and UK economies in particular are starting to leave the crisis behind, even though monetary policies have yet to normalise. On balance, therefore, Porter describes the macro environment as neutral.

At the corporate level he highlights that balance sheets are generally strong, providing the scope to finance investment in capital expenditure and M&A once excess capacity is absorbed and confidence increases. Capital spending trends are one of the metrics the manager monitors closely. Turning to valuation, Porter sees current earnings multiples, while above longer-term averages, as within historical ranges and therefore overall not sending a strong signal.

Looking at some of the changes made in the portfolio this year these have included purchases of companies where the manager sees potential for growth through self-help measures and opportunistic buys when markets have corrected. Among the self-help companies, Procter & Gamble is working on productivity improvements and adjusting its portfolio to enhance growth with top-line growth in the near-term currently indicated to be in the low single digits. The announcement of the sale of its Duracell batteries business underlines that the company is actively reviewing its businesses. An example of a purchase in the opportunist category was Verizon, the US mobile operator, where the transaction with Vodafone and sales by UK holders who received shares in Verizon depressed the price and provided the manager with the opportunity to switch from AT&T into Verizon, which was seen as offering better value. Prospectively, among the ideas for new investment, some quality cyclical companies have emerged as offering attractive value/income.

While Porter remains consistent in his investment approach (see next section), he has recently introduced the idea that members of the team should make short pitches of stock ideas after carrying out preliminary work. This may help generate a wider range of ideas and should allow more efficient use of time by filtering candidate investments more quickly before more detailed work is carried out.

## Asset allocation

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### Investment process: Identify, evaluate and exploit change

The portfolio is managed using a bottom-up stock-picking approach with the intention that risk and return are dominated by stock selection rather than making calls on the market. The investment process can be broken into three stages:

- **Idea generation** – there is a focus on identifying companies where positive change is underway and stocks that are capable of delivering both yield and growth. The MSCI World High Dividend Yield index is used as a screening and profiling tool. Ideas are sourced from portfolio managers, research analysts and company meetings.
- **Stock evaluation** – research is undertaken to test the investment case for candidate stocks. Areas of focus include: quality as indicated by financial strength, cash flow and management approach; potential profitable growth and whether this has been recognised by the market; and valuation with reference to the team's intrinsic valuation assessment.
- **Portfolio construction** – the manager aims to construct a portfolio of 40-60 high-quality growing companies that offer good value and are experiencing positive change. Classifications, illustrated in Exhibit 3, are used to distinguish between portfolio stocks. Buy and sell disciplines, based on yield, are employed. The manager notes that as at the end of October 2014, the portfolio was underweight slow-growth and cyclical stocks, and overweight fast and medium-growth stocks.

**Exhibit 3: Stock classifications based on dividend growth**

Category	Characteristics	Key risk
Fast growth	>7% pa three-year forecast dividend growth (stock market winners, higher risk)	Slowing growth
Medium growth	3-7% pa 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

Source: Securities Trust of Scotland

## Current portfolio positioning

At the end of October there were 43 holdings in the STS portfolio, the lowest in its AIC peer group, which has an average of 92 holdings. Concentration, as measured by the percentage in the top 10 holdings, was also relatively high at 43.5% versus 32.5% for the peer group. The portfolio beta is normally kept close to a neutral position (as currently) since the manager does not aim to make calls on the market and seeks to avoid unwanted factor risks.

Looking at the sector analysis of the portfolio, active weights range between +6.6 percentage points (Consumer Discretionary) and -6.2 percentage points (Healthcare). In the case of healthcare the manager remains cautious given the very strong run the sector has enjoyed and the lack of yield available; as shown in Exhibit 4 the weighting in this sector has been reduced by 4.5 percentage points since the end of April, which is the largest sector change over the period.

**Exhibit 4: Sector allocations (all data as at 31 October 2014 except where shown)**

	Trust weight (%)	Trust weight (%) end April 2014	Change	Benchmark weight (%)	Trust active weight	Trust weight/benchmark weight
Consumer Discretionary	13.3	11.4	1.8	6.7	6.6	2.0
Energy	15.0	14.9	0.1	10.9	4.1	1.4
Financials	14.7	14.5	0.2	12.4	2.3	1.2
Consumer Staples	16.7	15.8	1.0	14.6	2.2	1.1
Telecom Services	7.3	7.5	-0.2	5.8	1.5	1.3
Industrials	6.1	4.5	1.7	7.2	-1.1	0.8
Materials	4.3	5.7	-1.4	7.3	-3.0	0.6
Information Technology	2.1	1.7	0.4	5.3	-3.2	0.4
Utilities	4.8	3.9	0.9	8.0	-3.2	0.6
Healthcare	15.6	20.2	-4.5	21.9	-6.2	0.7
<b>Total</b>	<b>100.0</b>	<b>100.0</b>		<b>100.0</b>	<b>0.0</b>	

Source: Securities Trust of Scotland, Edison Investment Research

**Exhibit 5: Geographic allocations (all data as at 31 October 2014 except where shown)**

	Trust weight (%)	Trust weight (%) end April 2014	Change	Benchmark weight (%)	Trust active weight	Trust weight/benchmark weight
Europe	48.1	53.1	-5.0	42.0	6.1	1.1
Emerging Markets	2.9	1.5	1.4	0.0	2.9	N/A
Japan	2.6	2.4	0.3	3.1	-0.5	0.8
Israel	0.0	0.0	0.0	0.6	-0.6	0.0
Asia Pacific ex-Japan	6.3	6.1	0.2	8.4	-2.1	0.7
North America	40.1	37.0	3.1	45.8	-5.7	0.9
<b>Total</b>	<b>100.0</b>	<b>100.0</b>		<b>100.0</b>	<b>0.0</b>	

Source: Securities Trust of Scotland, Edison Investment Research

Geographically, Europe- and North America-based companies account for approaching 90% of the portfolio though the international nature of many companies' operations means economic exposure will be more diverse. The portfolio has a modest (off-benchmark) direct emerging market exposure including the purchase of a holding in the Mexican REIT, Fibrá Uno, which is seen as providing good exposure to the development of the Mexican economy. Regionally the largest active weights at end October were Europe (+6.1 percentage points) and North America (-5.7 percentage points). In this context it is worth noting that the benchmark MSCI High Dividend Yield Index has a lower weighting in North America at 45.9% compared with the broader MSCI World Index at 61.4% so there would be a much more marked underweight relative to the latter index.

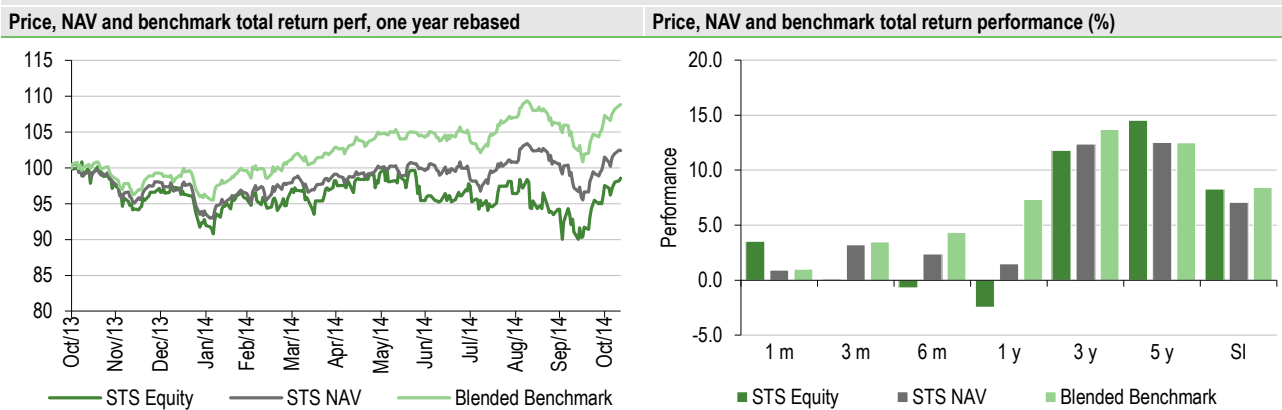
In addition to the stock purchases already mentioned (Procter & Gamble, Verizon and Fibrá Uno) the other main additions this year have been SSE, Aurizon, Hugo Boss and Meggitt. Among these Meggitt and SSE were both opportunistic purchases on price setbacks while Aurizon and Hugo

Boss fell into the self-help category mentioned earlier; the companies are taking measures that should deliver growth that is less dependent on the macro environment.

## Performance: Reduced volatility under global mandate

Exhibit 8 shows the NAV total return of the trust versus the benchmark index applicable at the time (FTSE All-Share prior to 1 August 2011, MSCI World High Dividend Yield thereafter). The general trend of outperformance since 2009 continued after the mandate change in August 2011, although the last year has seen a period of underperformance. Two stocks in particular have acted as a drag: SJM Holdings, the Hong Kong-listed Macau casino company and Modern Times, a Stockholm-listed media company. The casino business has been affected by the crackdown on corruption in China while the fact that Modern Times has interests in Russian media has impacted the shares. The manager has reassessed both and now views SJM as more of a cyclical stock, yet still offering value, while taking a more circumspect view on Modern Times. The bias of the portfolio towards larger-cap and quality companies was also a negative relative factor in the short term but, unsurprisingly, there is no plan to change the approach to stock selection.

**Exhibit 6: Investment trust performance to 31 October 2014**



Source: Securities Trust of Scotland, Thomson Datastream, Edison Investment Research. Note: Three and five years and since inception annualised.

**Exhibit 7: Share price and NAV total return relative performance (%) to 31 October 2014**

	One month	Three months	Six months	One year	Three years	Five years	Launch
Price versus Blended Benchmark	2.5	(3.3)	(4.8)	(9.1)	(4.9)	9.3	(1.3)
NAV versus Blended Benchmark	(0.1)	(0.2)	(1.9)	(5.4)	(3.5)	0.1	(11.0)
Price versus MSCI World High Yield	2.5	(3.3)	(4.8)	(9.1)	(4.9)	10.5	(0.3)
NAV versus MSCI World High Yield	(0.1)	(0.2)	(1.9)	(5.4)	(3.5)	1.2	(10.1)
Price versus FTSE All Share	4.2	1.5	0.9	(3.5)	2.6	22.3	10.4
NAV versus FTSE All Share	1.6	4.6	4.0	0.5	4.2	12.0	(0.5)

Source: Securities Trust of Scotland, Thomson Datastream, Edison Investment Research. Note: Geometric calculation

**Exhibit 8: STS NAV total return relative to blended benchmark total return, over five years, rebased to 100**

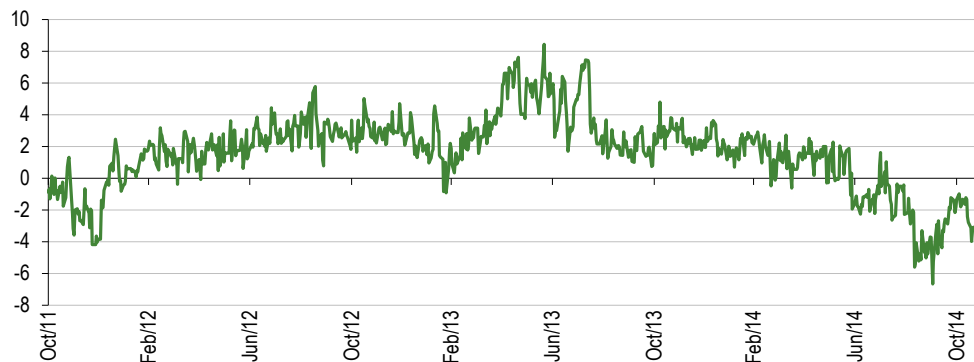


Source: Securities Trust of Scotland, Thomson Datastream, Bloomberg, Edison Investment Research

## Discount: Trading at a modest premium recently

Following the trust's move from a UK to a global mandate (August 2011), the share price discount to NAV narrowed and then moved to a premium. An EGM in August 2013 approved the issue of up to 100m new shares and since the EGM 9.15m have been issued, raising £13.4m. If the average discount during the last 12 weeks of any financial year exceeds 7.5%, a redemption opportunity is triggered and the company has a policy of maintaining the discount below this level. In practice the shares traded at an average premium of 2.85% in the latest 12-week period. In the wake of greater market volatility and softer near-term relative performance the shares have moved back to a modest discount. On a five-year view the average discount has been 2%.

**Exhibit 9: Discount/premium to cum-income NAV over three years**



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

## Capital structure and fees

STS has a simple capital structure, with one class of ordinary share. Gearing of up to 15% of total assets is permitted and when the annual borrowing facility was renewed at the beginning of October the absolute amount was increased to £17m (equivalent to c 10% of net assets). At end October gross and net gearing was 9.6% and 7.2% 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 last two financial years (to end March). STS has an unlimited life.

## Dividend policy: Quarterly dividend payments

Dividends are paid quarterly in September, December, March and June. The first interim dividend, paid in September (FY15: 1.15p), has historically established the level for the second and third payments, followed by a, typically larger, fourth dividend (FY14: 1.35p). For the year to 31 March 2014, STS paid aggregate dividends of 4.80p (+1%). STS seeks to provide rising income over time, and this has largely been achieved. In 2010, dividend cuts by a number of higher-yielding stocks led STS to reduce its total dividend by 14.7% to 4.65p. At the end of March, revenue reserves were 2.32p per share or 0.97p after allowing for payment of the fourth quarterly dividend payment.

## Peer group comparison

**Exhibit 10: Global Equity Income investment trusts**

% unless stated	Mkt cap/fund size £m	TR 1 year	TR 3 year	TR 5 yr	Sharpe one yr	Sharpe three yr	Discount (cum fair)	Ongoing Charge	Perf Fee	Net Gearing	Yield (%)
Blue Planet Investment Trust	18.1	5.4			0.6	-0.4	-31.3	4.2	No	145.0	6.3
British Assets	398.0	2.8	44.9	49.8	0.7	1.1	-4.6	0.7	No	117.0	4.6
F&C Managed Portfolio Income	34.5	5.8	56.2	74.2	0.8	1.5	1.9	1.2	Yes	99.0	4.1
Henderson International Income	89.9	9.3	60.5		0.8	1.6	-4.1	1.4	No	106.0	3.7
Invesco Perp Select Glo Eq Inc	47.8	9.5	66.7	68.0	1.1	1.4	-2.4	1.1	Yes	115.0	2.3
London & St Lawrence	108.3	7.5	55.3	72.3	1.1	1.5	1.7	0.9	Yes	99.0	3.7
Murray International	1380.8	6.0	41.7	68.9	0.3	0.9	4.9	0.7	Yes	113.0	4.0
Scottish American	330.0	4.9	38.9	60.7	0.5	1.1	-1.7	0.9	No	123.0	4.2
<b>Securities Trust of Scotland</b>	<b>177.3</b>	<b>5.4</b>	<b>54.2</b>	<b>79.8</b>	<b>0.6</b>	<b>1.3</b>	<b>-2.9</b>	<b>0.9</b>	<b>No</b>	<b>107.0</b>	<b>3.3</b>
Seneca Global Inc. & Growth	54.0	3.7	42.0	55.1	0.5	1.4	-4.9	1.5	No	110.0	4.0
<b>Weighted average</b>		<b>5.5</b>	<b>44.5</b>	<b>65.5</b>	<b>0.5</b>	<b>1.1</b>	<b>1.1</b>	<b>0.8</b>		<b>113.6</b>	<b>4.0</b>
STS Rank		7	5	1	6	6	6	7		7	9
Count		10	9	8	10	10	10	10		10	10

Source: Morningstar 25 November 2014. Note: TR = total returns of NAV for investment trusts. The Sharpe ratio is a measure of risk-adjusted return. The ratios we show are calculated by Morningstar for the past 36-month period by dividing a fund's annualised excess returns over the risk-free rate by its annualised standard deviation. Net gearing is total assets less cash/cash equivalents as percentage of shareholders' funds.

The NAV total return for STS has been similar to or ahead of the AIC Global Equity Income sector weighted average, over one, three and five years. (Note that prior to August 2011 the trust was run under a UK equity income mandate.) Recent NAV underperformance versus the benchmark has probably contributed to some slippage in ranking but STS has still virtually matched the weighted average sector performance. Comparison of Sharpe ratios, a measure of risk-adjusted returns, shows the trust standing slightly above the average, with a middle ranking.

## The board

All directors are non-executive and independent of the manager. 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, senior independent director), Edward Murray (2005 – at launch) and Mark Little, who was appointed on 1 October 2014. The board members have a range of general business, financial sector, accounting, investment trust and research experience.

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