Edison investment research

13 December 2011

Securities Trust of Scotland

12 months ending	Total share return* (%)	Total NAV return* (%)	Total return blended b'mark* (%)	Total return MSCI World Hi Yield* (%)	Total return FTSE All-Share* (%)
09/11/08	(35.6)	(38.6)	(31.8)	(25.0)	(31.8)
09/11/09	20.8	24.2	27.0	22.5	27.0
09/11/10	25.5	21.3	17.1	10.3	17.1
09/11/11	11.8	4.6	3.3	6.2	(2.4)

Note: *12 month rolling discrete performance.

Investment summary: New global mandate, new global manager

Securities Trust of Scotland (STS) is an income trust that pays quarterly dividends and currently offers a 4.1% yield. Following shareholder approval at the July AGM, the investment mandate was changed so that STS now invests in high-yield global (previously UK) equities. To reflect this change the benchmark has been changed to the MSCI World High Dividend Yield Index (previously FTSE All-Share) and Alan Porter was appointed portfolio manager from 1 August 2011. During the past 12 months STS has outperformed its blended benchmark, by 8.4% and 1.3% in terms of share price and NAV total return, respectively.

Investment strategy: High-yield global equities

STS is managed using a predominantly bottom-up investment style supported by macro analysis. Country, sector and stock market exposures are not formally restricted and the portfolio is relatively concentrated in 46 stocks. We believe this is sufficient to get a reasonable degree of diversification without tracking the index too closely. STS has a significant income requirement and the manager employs buy/sell disciplines based on yield. Portfolio candidates must have a yield greater than the MSCI World. Holdings are sold if the yield falls below 75% of that of the MSCI World.

Sector outlook: Valuations attractive over the longer term

Although the global macroeconomic outlook is very uncertain, looking at individual portfolio companies, the manager remains assured. By default, income portfolios tend to be relatively more defensive in nature than the average. Given balance sheet strength, as well as improvements to corporate profitability, the manager believes that portfolio companies are well positioned to weather further weakening in the economy and that they are mostly meeting earnings expectations. Valuations look attractive, in a historical context, but there is downside risk to earnings.

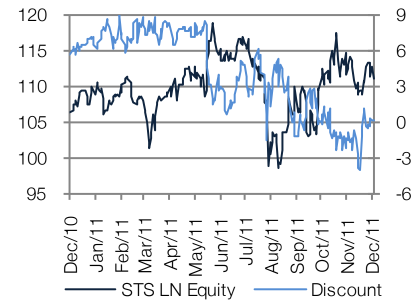
Valuation: Tight discount reflects yield

The trust has recently been trading at a premium to its peers and currently sits at a 0.2% discount to NAV. STS's yield at 4.1% is attractive relative to the market, although lower than most of its peers. We believe the current rating reflects the trusts performance during the past year or so, and consider that it may be of interest to those looking for a moderately geared exposure to international equities.

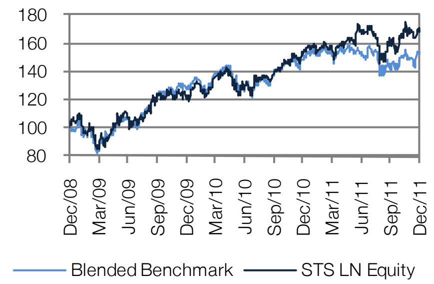
Price	112.8p
Market Cap	£113.1m
AUM	£125.6m
NAV	113.03p*
Discount to NAV	0.2%*
NAV	115.79p**
Discount to NAV	2.6%**
Yield	4.1%

*Excluding income, as at 9 December 2011.
**Including income, as at 9 December 2011.

Share price/discount graph



3-year cumulative performance graph



Share details

Code	STS
Listing	FULL
AIC Sector	Global Growth & Income
Shares in issue	100.3m

Price

52 week	High	Low
Price	118.87p	98.50p
NAV*	123.05p	101.80p

*Excluding income.

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Securities Trust of Scotland is a research client of Edison Investment Research Limited

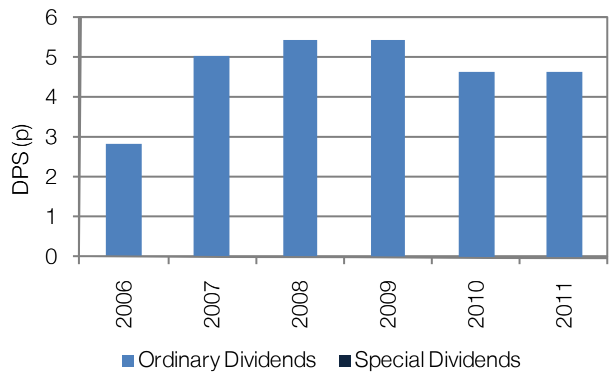
Exhibit 1: Trust at a glance

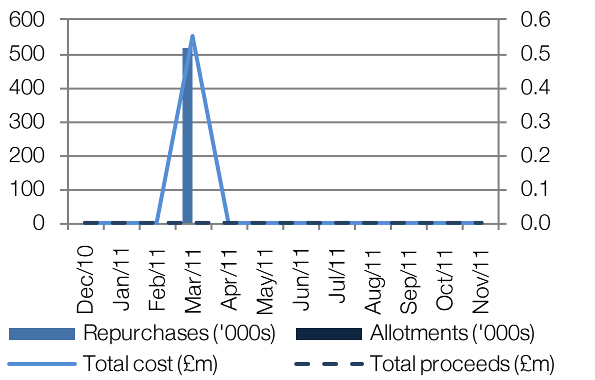
Note: *Total expense ratio including of performance fee is 1.1%. Total expense ratio excluding performance fee is 0.8%.

Investment objective and fund background	Developments last quarter
The investment objective of the company 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).	11 November 2011: Half yearly report released. 11 November 2011: Second interim dividend of 1.15p announced for year ending 31 March 2012. Dividend will be paid on 15 December 2011 to shareholders on the register at 25 November 2011.

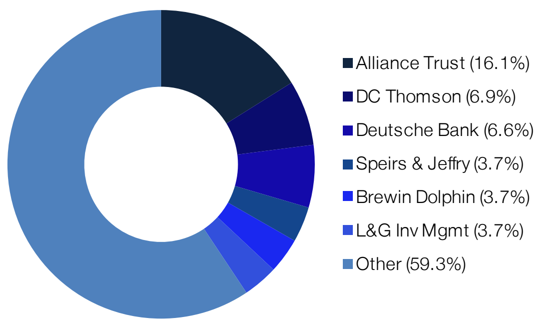
Forthcoming		Capital structure		Fund details	
AGM	July 2012	Total expense ratio	1.1%*	Group	Martin Currie Inv. Mgmt. Ltd.
Preliminary	May 2012	Net Gearing	4.4%	Manager	Alan Porter
Year end	31 March	Annual mgmt fee	See pg 7	Address	Saltire Court, 20 Castle Terrace, Edinburgh EH1 2ES
Dividend paid	Quarterly	Performance fee	See pg 7		
Launch date	June 2005	Trust life	Indefinite	Phone	0131 229 5252
Wind-up date	See pg 7	Loan facilities	See pg 7	Website	www.securitiestrust.com

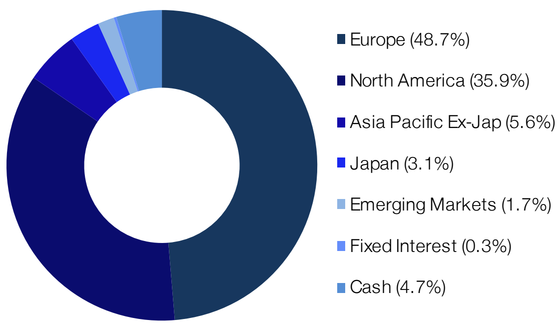
Dividend policy and history	Share buyback policy and history
Quarterly dividends paid in March, June, September and December.	Renewed annually, the trust has authority to purchase up to 14.99%, and allot up to 5% of issued share capital.



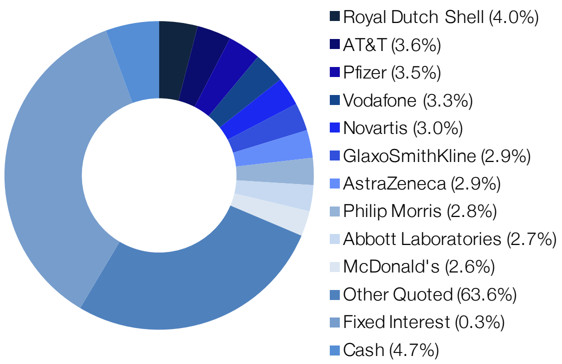


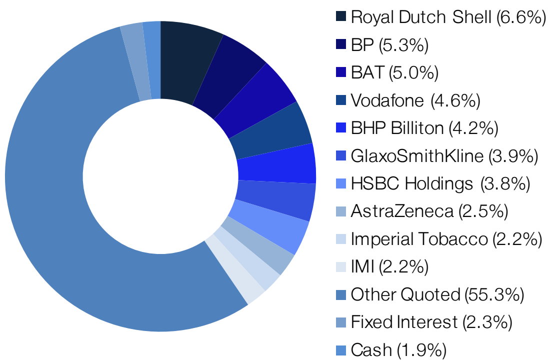
Shareholder base (as at 31 October 2011)	Geographic distribution of portfolio (as at 31 October 2011)





Portfolio composition (as at 31 October 2011)	Portfolio composition (as at 30 April 2011)

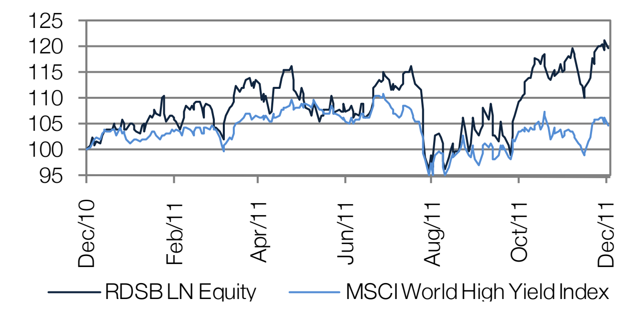




Source: Securities Trust of Scotland/Edison Investment Research

Exhibit 2: Top five overweight positions at a glance

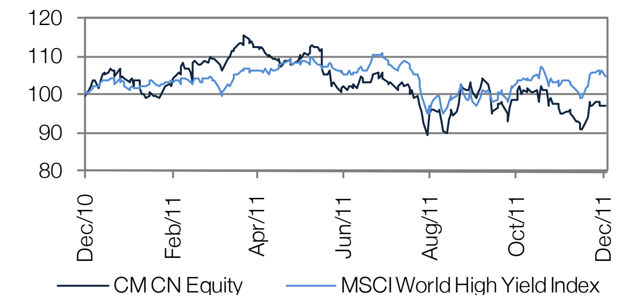
Royal Dutch Shell 'B'	Code: RDSB LN	Market Cap: £62,465m



Div Yield (trailing 12 m'ths)	4.49%
Industry/Sector	Oil & Gas Producers/Integrated
Listing	UK – FULL
Website	www.shell.com

Based in the Netherlands, Shell is a global group of energy and petrochemicals companies that employs 102,000 people in over 100 countries. Shell is revising its business structure into four new main areas: upstream international, upstream Americas, downstream and projects & technology. Shell has proven reserves of 18.1bn barrels of crude, 45,000 service stations worldwide and interests in 25 refineries.

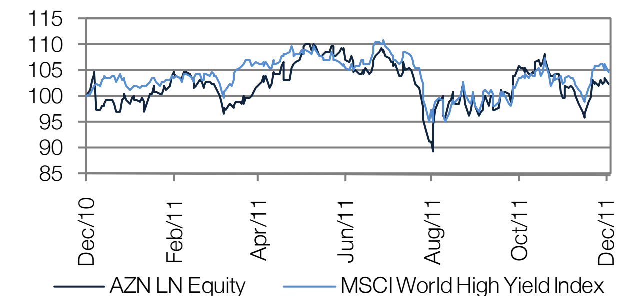
Canadian Imperial Bank of Commerce	Code: CM CN	Market Cap: C$28,813m



Div Yield (trailing 12 m'ths)	4.88%
Industry/Sector	Commercial Banks
Listing	Canada - TSX, NYSE, Frankfurt
Website	www.cibc.com

Based in Toronto, Canadian Imperial Bank of Commerce (CIBC) is a major Canadian Bank with a presence in both the retail and wholesale markets. CIBC employs over 42,000 people worldwide and has over 1,100 branches in Canada. The manager considers that, in the current climate, not all banks are equal and that CIBC is well managed, cash generative, well capitalised and has minimal exposure to European sovereign debt.

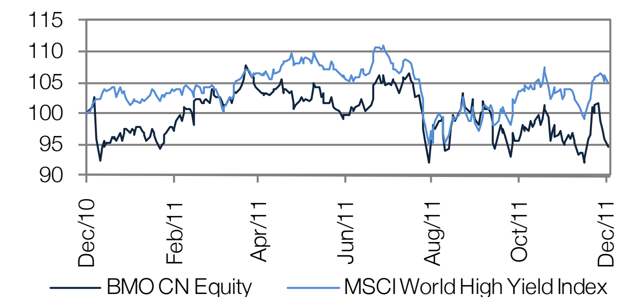
Astrazeneca	Code: AZN LN	Market Cap: £37,960m



Div Yield (trailing 12 m'ths)	6.31%
Industry/Sector	Pharma & Biotechnology/Pharma
Listing	UK – FULL
Website	www.astrazeneca.com

Based in the UK, Astrazeneca (AZN) is a global integrated biopharmaceutical company engaged in the discovery, development, manufacture and marketing of therapies for the therapeutic areas of: cancer, cardiovascular, gastrointestinal, infection, neuroscience, and respiratory and inflammation. The manager considers that AZN is very cash generative and is taking the steps necessary to refill its product pipeline.

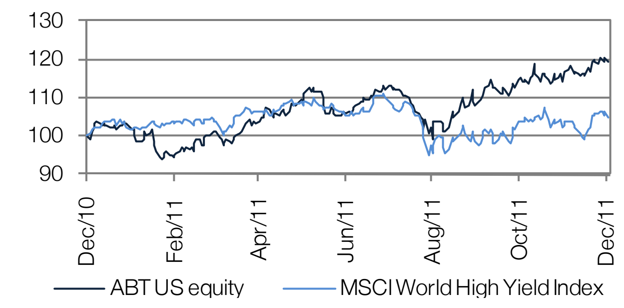
Bank of Montreal	Code: BMO CN	Market Cap: C$35,784m



Div Yield (trailing 12 m'ths)	5.00%
Industry/Sector	Commercial Banks
Listing	Canada – TSX, NYSE
Website	www.bmo.com

Canada's fourth largest bank by assets, Bank of Montreal (BMO) provides retail banking, investment banking and wealth management services. BMO employs over 47,000 people worldwide and has over 1,200 branches in Canada and the US. Like CIBC above, the manager considers that BMO is well managed, cash generative, well capitalised with minimal exposure to European sovereign debt.

Abbott Laboratories	Code: ABT US	Market Cap: US$84,545m



Div Yield (trailing 12 m'ths)	3.47%
Industry/Sector	Medical-Drugs
Listing	NYSE, Frankfurt, Swiss Six, Mexico
Website	www.abbott.com

Headquartered in the US, Abbott Laboratories (ABT) is a broad based healthcare company engaged in the discovery, development, manufacture and marketing of a diverse range of healthcare products. ABT has operations in over 60 countries, it employs c 90,000 worldwide and its products are sold in over 130 countries. It is organised around four key product segments: Pharmaceuticals, Diagnostic, Nutritional and Vascular.

Source: Thomson Datastream/Edison Investment Research

Fund profile

Launched in May 2005, as a vehicle for holders of the previous "Securities Trust of Scotland" to roll their holding into, STS is an income trust that pays quarterly dividends. The trust was managed by Ross Watson, a director of Martin Currie's investment team responsible for UK Growth & Income investments, from its launch in 2005 until August 2011. At the 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. Circa 70% of portfolio adjustments were made immediately, with the remainder delayed to capture August dividends. The portfolio transition was completed in the second week of September 2011.

The fund manager: Alan Porter

Manager's view

The global macroeconomic outlook is very uncertain, which has been reflected in recent market volatility. There is still no clear picture as to how the European sovereign debt crisis will unfold and the US debt ceiling remains an ongoing issue. Much of the recent global economic data that has emerged has been downbeat in nature, and most market commentators are suggesting that global growth is likely to flat line at best. The manager believes that the market is pricing in a significant economic downturn and believes there is significant value in the market, but for now is prudently focusing on businesses with strong balance sheets and good cash flow. However, despite the recent drama the manager believes that little has actually changed in terms of long-term fundamentals. Looking at individual portfolio companies, balance sheets are strong, margins are very healthy and cash generation is very good, although companies are not committing to capex, or making acquisitions, reflecting a cautious outlook in the near term. Against the broader market, valuations look attractive in a historical context and while there is clearly further downside risk to earnings, and thus short-term valuations, the manager sees good uplift potential as markets move back into a risk-on phase and could increase gearing to take advantage of this.

Asset allocation

Investment process – 3 steps: Identify, evaluate and exploit change

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 – what growth is expected in sales, margins, cash flows and earnings, how do these differ to market consensus and what are the risks?; iii) valuation – how does Martin Currie's intrinsic valuation compare 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. The classifications, illustrated in Exhibit 3, are used to distinguish between stocks held in the portfolio and buy and sell disciplines, based on yield, are employed.

Exhibit 3 Stock classifications based on dividend growth

Category	Criteria	Key risk
Fast growth	>7% three-year forecast dividend growth	Growth Slows
Medium growth	3-7% three-year forecast dividend growth	Valuation Falls
Slow growth	<3% three-year forecast dividend growth	Value traps
Cyclical	Volatile dividends	Misidentification
Special situations	Asset plays and turnaround situations	Bankruptcy

Source: Martin Currie

Overview

As at 31 October 2011, STS had 45 equity holdings and one fixed-income holding. The top 10 equity holdings account for 34.4% of net assets, fixed interest holdings for 0.3%, cash accounts for 5.2% and borrowings account for 9.6%, with the remaining equity investments accounting for 69.7% of net assets. In total asset terms, the top 10 holdings account for 31.4%, fixed interest accounts for 0.3%, cash accounts for 4.7% and the remaining holdings account for 60.6%. As displayed in Exhibit 4, STS's asset allocation has moderate differentials to the benchmark. Excluding fixed income and cash, the portfolio was fully invested in UK equities prior to the mandate change. However, as shown in Exhibit 1, the portfolio now has broad global diversification.

Exhibit 4: Sector allocations of equity portfolio, as at 31 October 2011

	Trust weight (%)	Benchmark weight (%)	Trust active weight (%)	Trust weight/ benchmark weight
Telecommunications	15.4	10.8	4.6	1.43
Healthcare	20.4	16.8	3.6	1.21
Information technology	3.5	1.7	1.8	2.06
Consumer discretionary	6.8	5.0	1.8	1.36
Consumer staples	17.6	16.9	0.7	1.04
Industrials	5.6	5.3	0.3	1.06
Financials	16.0	16.4	(0.4)	0.98
Materials	2.3	3.2	(0.9)	0.72
Utilities	8.9	11.0	(2.1)	0.81
Energy	7.8	13.0	(5.2)	0.60
Cash	5.2	0.0	(5.2)	N/A
Borrowing	(9.6)	0.0	(9.6)	N/A
Total	100.0	100.0	0.0	

Source: Securities Trust of Scotland/Edison Investment Research

Exhibit 5: Geographic allocations of equity portfolio, as at 31 October 2011

	Trust weight (%)	Benchmark weight (%)	Trust active weight (%)	Trust weight/ benchmark weight
Europe	52.8	44.8	8.0	1.18
Emerging markets	1.8	0.0	1.8	N/A
Asia	6.2	7.0	(0.8)	0.89
Japan	3.8	4.7	(0.9)	0.81
North America	40.3	43.3	(3.0)	0.93
Other	0.0	0.2	(0.2)	0.0
Total	100.0	100.0	0.0	

Source: Securities Trust of Scotland/Edison Investment Research

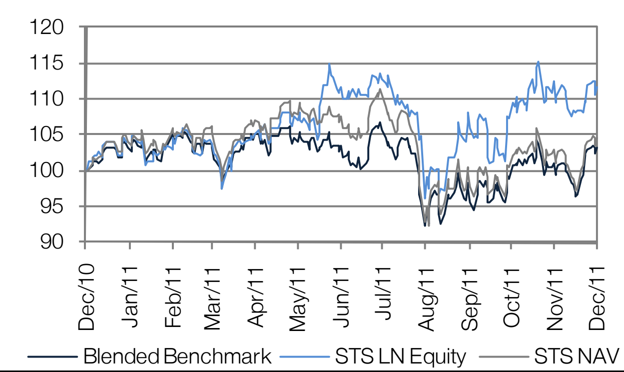
Underweights and overweights

STS's largest underweight is energy with an allocation 60% that of the benchmark. STS also has underweights in utilities and materials as well as a marginal underweight in financials. In terms of geographical allocations, versus the benchmark, STS has a small underweight in North America and marginal underweights in Japan and the rest of Asia. STS's largest active weight is telecommunications, followed by healthcare, information technology, consumer discretionary, consumer staples and industrials. The IT overweight is c 2x the benchmark allocation. Compared to the benchmark, STS is overweight Europe and Emerging Markets. Looking at STS's equity portfolio in isolation, the portfolio is marginally more defensive than the benchmark. The cash, in isolation, also has defensive characteristics but this is more than offset by the trust's borrowings.

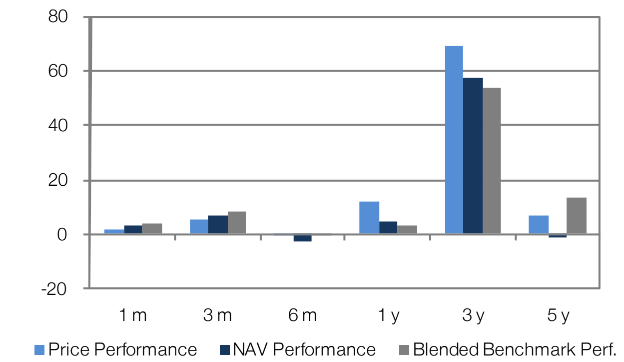
Recent performance

Exhibit 6: Investment trust performance

Price, NAV & benchmark total return performance 1 year rebased



Price, NAV & benchmark total return performance (%)



Source: Thomson Datastream/Edison Investment Research

Exhibit 7: Share price and NAV total return performance (sterling adjusted), relative to benchmarks

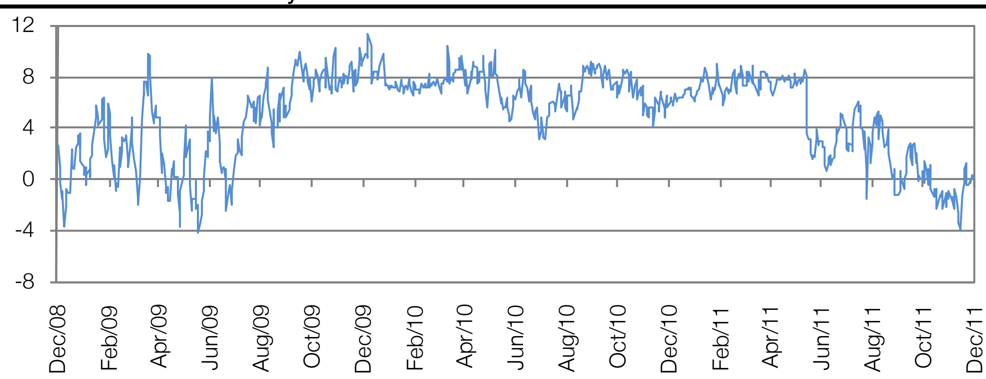
	1 month	3 months	6 months	1 year	3 years	5 years	Launch
Price relative to blended benchmark	(1.9)	(2.6)	0.1	8.4	15.7	(6.1)	3.0
NAV relative to blended benchmark	(0.2)	(1.0)	(2.7)	1.3	4.1	(14.5)	(11.9)
Price relative to MSCI World Hi Yield	(1.9)	(2.6)	0.0	5.5	25.8	(10.7)	4.6
NAV relative to MSCI World Hi Yield	(0.2)	(1.0)	(2.8)	(1.6)	14.1	(19.1)	(10.4)
Price rel. to FTSE All-Share	0.8	(0.2)	5.6	14.1	24.2	0.2	11.2
NAV rel. to FTSE All-Share	2.4	1.3	2.8	7.0	12.5	(8.2)	(3.8)

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

It is clearly early days for the new mandate, particularly as the transition was only completed in the second week of September. However, when compared to the blended benchmark STS has outperformed, in terms of both price and NAV total return, over the one-year and three-year periods.

Discount

Exhibit 8: Discount over three years



Source: Edison Investment Research

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. As Exhibit 8 illustrates, the discount volatility increased substantially from September 2008, arguably reflecting the prevailing financial climate. However, this was not accompanied by the general widening seen elsewhere in the sector. On 25 May 2011, STS announced its proposed change of investment mandate. The instantaneous price increase, and associated contraction in the discount, suggests that the proposals were well received by the market. The discount has broadly continued its path of contraction since and STS is currently trading at a small discount. As Exhibit 1 illustrates, STS has been active in the market for its own shares during the last 12 months, repurchasing 517k shares at a cost of £553k. All of these repurchases took place during the measurement period for the discount control mechanism, thus preventing the requirement to offer a redemption opportunity. The current discount of 0.2% shows STS to be more fully valued when compared to its longer-term discount averages of 5.1% and 5.6% over three- and five-year time horizons, respectively, and also when compared to the average discount, since the mandate change was announced of 1.4%.

Capital structure

STS is a conventional investment trust, having only one class of share in issue – 1p ords. The trust is able to gear up to 15% of total assets and reflecting this has an £11m loan facility with National Australia Bank, which expires 30 September 2012. As at 31 October 2011, STS had gross and net gearing of 9.6% and 4.4% of net assets, respectively. The management fee is calculated as 0.3% per annum of the company's net assets, payable quarterly in arrears. Historically, the manager has been entitled to a performance fee of 0.15% of net assets for each percentage point by which the percentage performance of the company's net asset value per share, adjusted for share buybacks, exceeds the percentage capital return of the FTSE All-Share index during the year. Reflecting the mandate change, the performance fee will now reflect outperformance against the MSCI World High Dividend Yield Index. Martin Currie earned, and has been paid, a performance fee of £372k for the period 1 April 2011 and 31 July 2011. Reflecting the transition, Martin Currie has waived any performance fee that might otherwise be accrued for the period 1 August 2011 to 31 March 2012. All other terms remain the same, namely, if the net asset value per share falls over the year, the share of any out-performance is reduced by 50%. The performance fee is subject to a cap of 0.75% of the year-end net assets. The manager is also entitled to a peer group performance fee based on the performance of STS's share price, in total return terms. The peer group is chosen by the company's board with advice from JPMorgan Cazenove and is reviewed at least annually. The manager receives a peer group performance fee of 0.25%, 0.1% or 0% of net assets, if STS's share price total return performance is first quartile, second quartile or third/fourth quartile, respectively. 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. The total expense ratio (TER), inclusive of performance fee, was 1.1% for the year ended 31 March 2011 (1.1% for the year ended 31 March 2010). 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 and record

Dividends are paid quarterly. The first interim dividend is paid in September (2011: 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 (2011: 1.20p). For the year ending 31 March 2011, STS paid a total dividend of 4.65p (2009: 4.65p). 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 year-on-year dividend of 14.7% to 4.65p. This was a result of extensive dividend cuts by UK companies witnessed during the period. For the year ended 31 March 2011, STS was able to maintain the dividend at 4.65p. As at 31 March 2011 STS had revenue reserves of 2.27p per share. STS earned a further 3.11p during the six months to 30 September 2011, but also paid a final of 1.2p. Accordingly, STS's revenue reserves, as at 30 September 2011, stood at 4.18p. As such, we expect that STS will at least be able to maintain the dividend for the year ending 31 March 2012 at the 2011 level. In terms of expense allocation, transaction costs relating to the purchase and sale of investments and associated exchange gains/losses are charged to capital. Management fees and interest payable are charged 35% and 65% to the revenue and capital accounts, respectively. Any performance fee is charged to capital.

Peer group comparison

Exhibit 9 illustrates the AIC Global Growth and Income sector. Prior to the mandate change, STS was a member of UK Growth and Income (the sector averages are provided at the bottom of Exhibit 9). Within the new peer group, STS ranks first over one year, third over three years and fifth over five years when considering share price total return.

Exhibit 9: Global growth and income sector, as at 12 December 2011

Company	Share price total return on £100			Total expense ratio	Disc/ prem	Net gearing (100= no gearing)	5-year dividend growth (%)	Div yield
	1 year	3 year	5 year					
Global Growth & Inc sector average	96.6	167.9	141.0	0.8	0.8	118	9.1	4.5
Securities Trust of Scotland	108.7	164.6	103.5	0.7	(2.9)	106	(1.6)	4.2
British Assets	88.5	151.8	103.9	0.6	(2.5)	122	1.4	5.4
F&C Managed Portfolio Income	92.1	158.7	N/A	1.5	(0.6)	107	N/A	4.9
Henderson International Income	N/A	N/A	N/A	N/A	0.6	100	N/A	4.4
London & St. Lawrence	99.9	141.1	109.4	0.6	(9.9)	94	2.2	4.7
Midas Income & Growth	95.1	135.6	82.5	1.7	(8.0)	112	2.4	6.2
Murray International	100.8	171.3	172.0	0.7	3.4	118	14.3	4.1
Scottish American	93.5	192.7	109.0	0.9	1.2	128	5.0	4.5
UK Growth & Income sector average	100.7	165.8	113.3	0.8	(0.6)	114	3.6	4.7

Source: The Association of Investment Companies

The board

All directors are non-executive and independent of the manager. They are: Neil Donaldson (chairman), Rachel Beagles, Charles Berry, Andrew Irvine and Edward Murray (directors). Excluding Rachel Beagles, all directors joined the board at launch. The average length of service is 5.5 years.