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Background Report *21 January 2008*

Securities Trust of Scotland plc 123p

Securities Trust of Scotland ('STS' or 'the Trust') was launched in June 2005 following a reconstruction of one of the UK's oldest investment trusts. **Its investment objective is to achieve rising income and long-term capital growth by investment in the United Kingdom, with the emphasis on identifying companies with the potential for strong earnings and dividend growth.** Its benchmark is the FTSE All-Share Index and its Association of Investment Companies' sector is UK Growth & Income.

The 'new' Securities Trust of Scotland has put in a relatively strong performance since mid 2005. **STS outperformed its benchmark in the 2005/06 and 2006/07 financial periods**. The first half of 2007/08 has proven to be much more volatile, however, and the Trust's Total Return failed to match its benchmark. Although disappointing, it has to be said that none of STS's peer group in the AIC Growth & Income sector did any better and all undershot their benchmarks (which were driven by a modestly positive return from the FTSE 100 and a negative performance from the FTSE 250). That said, it would seem that the changes put through two years ago, which were designed to enhance shareholder returns and make the Trust a more attractive vehicle for the private investor, have paid off. Relative to the peer group a more modest amount of gearing, a better two year performance and a share register largely devoid of institutional shareholders have kept the discount below 5.0%, whereas other trusts in the peer group have seen a more significant widening. As a result STS no longer offers the highest yield in the peer group but shareholders have benefited in that their shares have suffered less volatility.

The manager, Martin Currie Investment Management Limited, is Edinburgh-based and manages around £15.7 billion of assets. It is independent and the majority of the company's equity is owned by its directors and staff. **Martin Currie uses a highly disciplined stock selection methodology focused on screening stocks for quality, value, growth and change criteria.**

This is an ideal vehicle for the private client investor seeking income and capital growth over the medium to longer term. The discount control mechanisms, a market beating yield of 4.3% (based on our expectation of a dividend of at least 5.3p for 2007/08) and the manager's record are strong positives.

Analyst: Thorold Mackie

Sector: UK Investment Companies
Website: www.securitiestrust.com

RIC Code: STS
Market Cap: £125.5m

Background

Securities Trust of Scotland plc emerged in June 2005 from the former company of the same name, which itself was one of the UK's oldest surviving investment trusts, having been founded in 1889. The management contract has been held by Martin Currie Investment Management Limited ('Martin Currie') since 1972. At that stage the Trust could be categorised as being an international income trust, although this was later redefined with the Trust becoming a UK growth and income investment trust. The present objective of the Trust is to achieve rising income and long-term capital growth by investment in the United Kingdom, with the emphasis on investing in companies with the potential for strong earnings and dividend growth. The performance of the Trust is measured against the FTSE All-Share Index.

From the mid 1990s the performance of the Trust was weighed down by excessive debt and equally excessive coupons on the debt, which hit the Trust particularly hard during the 2000-2003 bear market. Clearly this underperformance was unacceptable, and the Board of STS began to change strategy. While this process was underway, Perpetual Income and Growth Investment Trust made an unsolicited bid for STS. Ultimately this bid failed, although the bid left its mark in terms of the size of the Trust and its strategy. The change in strategy involved a number of measures – the repayment of the £25.0m of high coupon debenture stock in September 2004, the appointment of a new manager (Ross Watson) charged with running a more concentrated portfolio in a less restrictive manner, the introduction of a performance fee element to the management contract and the abandonment of an expensive savings plan. The major part of the reconstruction was a restructuring of the share capital, whereby shareholders owning 177.0m shares opted to accept a cash offer for their shares and shareholders owning 19.5m shares rolled over their holdings into an alternative income and growth trust. Those shareholders who remained with STS have seen the Trust's Board implement the strategy in full and have enjoyed a period of superior relative performance. Indeed the Trust has had its best rate of outperformance relative to its benchmark since 1995.

As a result of the restructuring the issued share capital contracted from 310.3m shares prior to the bid to 102.0m now, with 6.2m shares being bought back and cancelled since flotation in June 2005. The latest reported NAV per share is 128.4p, giving a discount of 4.2%.

The manager of the Trust is Ross Watson, who has over 20 years' experience in managing income and growth portfolios, starting with Dundee-based Belsize House in 1983 before moving to Edinburgh-based Dunedin Fund Managers, Gartmore and latterly Aberdeen Asset Managers. He joined Martin Currie in 2005 to manage STS. He is assisted by Scott McKenzie, who moved to Martin Currie from Morley Investment Management in 2005. At Morley Scott managed equity income portfolios, and prior to that he managed high yield portfolios for Britannia Asset Management. The third member of the team is Jennifer Walker, who has been with Martin Currie since 1997. She conducts research for the UK growth and income team, particularly small and mid cap stocks that fall below the radar screen of the sector managers, who conduct the bulk of the research at Martin Currie.

UK Market Background

2007 was a year of distinct halves for the UK economy and stockmarket. The year started with concerns about the state of the US economy and the exposure of larger UK corporates to the weakening US dollar. That said, the UK itself continued with a good rate of economic growth (3% year-on-year) bolstered by high government spending, a strong UK housing market and buoyant consumer expenditure. In response the FTSE All-Share achieved an all time high in June 2007. Despite interest rates rising to 5.75%, corporate earnings matched expectations and market sentiment continued to be buoyed up by strong dividend growth and share buy backs.

The market then cracked at the half year. The US dollar had begun to weaken, and this fed through to consideration as to how earnings of those FTSE companies in particular which had dollar earnings or reported in dollars would have their earnings impaired. In July the repercussions of the US sub-prime crisis began - belatedly - to work their way to UK banks. The freezing of wholesale banking markets had an immediate impact on Northern Rock and the top end of the private equity industry. By August 2007 the market had fallen 10%, although it later recovered some of the lost ground before heading lower again. As we enter 2008 the general mood seems to be one of caution. The market offers reasonable value, sitting as it does on a prospective PE of 10.9x with a prospective yield of 3.5%. However it is vulnerable to downgrades to profits and dividend estimates for 2008 despite assistance from a weakening of sterling against the US dollar and the €uro and a likely fall in UK interest rates over 2008.

Recent Performance of STS

The Trust was effectively created on 24th June 2005, when funds were moved across from 'old' STS to 'new' STS with some shareholders choosing to roll over their investment into an alternative growth and income investment trust and others opting for the new STS vehicle.

In the initial reporting period of the 'new' Trust to 31st March 2006 STS's NAV outperformed the FTSE All-Share by 3.0%. The Index gained 22.7% and the STS portfolio gained 25.7% in the 41 week period between the legal formation of the 'new' STS and the period end. This outperformance was largely due to stock selection, with gearing making only a modest contribution. In the following period to 31st March 2007, this one being for a full 52 weeks, the Trust again beat its benchmark, with the NAV Total Return being 13.6% against 11.1% from the FTSE All-Share Index. The relative performance earned Martin Currie a performance fee in its first year of introduction. The first half of 2007/08 was more difficult, however, in demanding conditions for UK fund managers; in the six months to 30th September 2007 the NAV Total Return was only 0.9% against 2.7% for the Index. As the calendar year closed the Trust and Index sank into negative territory, with STS falling 5.0% against a fall of 2.1% for the FT All-Share. The issue was essentially one of sector rather than stock selection, with the low-yielding mining sector up no less than 33%. Excluding this sector the FTSE 100 fell marginally.

The key challenges for a portfolio such as this, with its requirements for an above average level of dividend income and growth in that income at a rate in excess of inflation, is not to lose sight of capital performance at the same time and, equally, not to overlook what is happening to the benchmark as a whole. Inevitably the portfolio has to have some orientation towards higher yielding stocks, and this means that the capital performance can fall behind the market averages at times when the lower yielding, more growth-orientated stocks, outperform. This was especially true in the last six months of 2007, when the FTSE 350 Higher Yield Index markedly underperformed the FTSE 350 Lower Yield equivalent. The benchmark is equally important, even though the manager has a relatively free hand, and with the low yielding mining sector now accounting for 9% of the Index it cannot be ignored, particularly as it outperformed the Index by such a wide margin over the last six months of 2007. A full weighting in this sector could only be achieved at a cost to the Trust's revenue account.

In current market conditions stock selection calls for some strong contrarian stock picking skills. Some sectors – banks, real estate, retailers, housebuilders – offer the sort of income a Trust like STS requires. However the key skill is in timing the bottom of the valuation cycle of such sectors (which may be 12 months or more ahead of the sector's economic cycle). That sort of opportunity may be about to present itself in real estate but may still be premature for banks or housebuilders. A second skill is in constant monitoring of portfolios to separate stocks which might succumb to the economic cycle from those companies which might be best insulated or have the financial strength to keep moving the dividend ahead even though earnings growth may falter.

With an emphasis upon individual stocks the portfolio is managed without much regard to whether weightings in FTSE 100 stocks are either above or below that of the market. The portfolio is currently modestly underweight the FTSE 100 (the weighting was 71% at 31st March 2007 against 81% for the Index), and slightly overweight in the FTSE 250 (20% against 15%). Some of the prominent midcaps in the portfolio are Halfords, Savills, First Choice and Wincanton. The smallest holding in the portfolio is Davenham, a car leasing business.

The Trust can have up to 10% of the portfolio in fixed interest stocks, but the level at 30th September 2007 was only 4%. Preference shareholdings include Abbey National and HBOS. The 9% of the portfolio in smallcaps and non-index stocks has edged lower over the year on disposals and the manager's wariness on liquidity. Such holdings include Summit Germany, a German commercial property business, and Mapeley, a UK commercial property concern.

The Trust currently (31st December 2007) has 56 holdings, with the top ten holdings representing 45.7% of the portfolio. Sector weightings and the portfolio's main investments are as follows:

Allocation of STS Portfolio and FTSE All-Share by Sector

Sector	STS Weighting at 31/12/2007	FTSE All-Share at 30/9/07
Oil & Gas	13.1%	15.5%
Consumer Services	10.5%	11.3%
Consumer Goods	11.3%	9.5%
Industrials	9.4%	7.4%
Utilities	5.5%	4.1%
Telecoms	7.6%	6.8%
Healthcare	3.3%	6.9%
Basic Materials	8.8%	10.0%
Financials	29.4%	27.5%
Technology	1.1%	1.0%
Total	100.0%	100.0%

Source: STS. Rounding error may occur

In term of holdings within each FTSE sector, given the size of the Trust and the limited number of holdings, there are often only one or two stocks constituting the Trust's exposure to a particular sector. The Trust has been relatively underweight in *Oil & Gas* for some time with no E & P representation and the exposure concentrated in the undervalued BP and Royal Dutch Shell. In *Consumer Services* the Trust's main holdings are in media stocks Informa and Johnston Press, where corporate activity and strong free cashflow respectively are expected to be beneficial. In the *Consumer Goods* sector beverages and tobacco have overweight positions, with stocks such as SAB Miller and BAT. There is also a holding in Premier Foods, which has disappointed. In *Industrials*, where an equal weighting is maintained, there are holdings in BAE, Smiths Group, IMI and Foseco. With *Telecoms* the Trust is overweight overall; the two holdings are in BT Group, where dividend growth is expected despite the weak share price, and Vodafone on the basis of its strong overseas earnings base. The Trust is also overweight in *Healthcare*. The preferred stock is GlaxoSmithKline. With *Basic Materials* STS is underweight. Poor performances from chemical companies Croda and Elementis have to some extent been compensated for by strong returns from Xstrata and Rio Tinto. The mining sector alone, accounts for over 9% of the Basic Materials 10% weighting. In *Financials* the Trust is overweight and holds retail as opposed to mortgage banks (HSBC, Barclays, Royal Bank of Scotland Group, Lloyds TSB). The other big holding is Aviva, where dividend growth expectations are strong. A previous holding in Resolution has been sold on takeover. There are also some smaller holdings in Admiral and Hiscox, both non-life insurance companies. The *Technology* sector is represented by a holding in Sage, purchased after the company decided to double its dividend, the potential for that move having long been identified by Martin Currie's screening process.

Gearing & Dividends

In common with all the investment trusts in its AIC Growth & Income peer group STS carries gearing. In the case of STS this was 7.5% at 31st December 2007 (the exact disaggregation of the portfolio was equities 14.9%, fixed interest 2.6% and net debt 7.5%), but since then it has moved down to 3% in line with the manager's cautious view of short term prospects for the market. This is a long way below the level of four years ago when both gearing and coupon rate were both punitively high at 46% and 11.5%/12.0% respectively. The debt is in the form of a revolving credit facility at 28.63 basis points over LIBOR (currently 5.585%). The lender is Lloyds TSB. Thus the rate is presently circa 5.9%. The Board has limited STS's gearing to 15%.

Dividends are paid quarterly at the end of September, December, March and June. The Board has already announced two interim dividends of 1.10p (increases of 4.8%) which suggest the full year dividend will be at least 5.3p (2006/07 – 5.05p).

The Discount

The two-pronged strategy to address the discount was one of the issues reviewed by the Board in 2006. A discount protection mechanism was then introduced which operates in the last three months of the Trust's financial year. If the average discount in this period exceeds 7.5%, then shareholders will be offered a redemption opportunity. In addition the Board may authorise the purchase of shares at any time. Since flotation in June 2005 approximately 6.2m shares have been purchased for cancellation. With two years of good relative performance it is no surprise that the level of the discount moved steadily closer to the sector average. Surprisingly, despite the recent underperformance relative to the benchmark, the general widening of investment trust discounts over 2007 and the absence of buying-in of the Trust's shares by the Trust itself, the discount has not widened to the extent experienced by some in its peer group and has come back below 5.0% (the average discount for the AIC sector is 10.3% and for the peer group 7.7%). The reason for this is probably the nature of the shareholder register, which is now almost totally private investor orientated. There is only one shareholder (Legal & General Group) owning more than 3.0% of the Trust's equity and it has been a long term investor.

Management Fees and Costs

The performance fee, introduced (and earned) for the first time in 2006/07, has been designed to align the interests of shareholders and the manager. The manager has been incentivised to outperform in absolute terms but is only partially rewarded for relative outperformance (i.e. when the portfolio falls by a lesser amount than the Index) and will only merit the base fee for in line or underperformance. If no performance fee is earned in any period the base fee is 0.3%. This is the lowest base fee in the AIC UK Growth & Income sector.

To incentivise the manager Martin Currie can earn up to 15% of any outperformance of its benchmark by the NAV per share. Should the NAV per share fall in any period but still outperform the benchmark the 15% share is cut back to 7.5%. Moreover in order to gain the full performance fee there are three separate tests, each of which must be met: the discount must be lower than at the prior year-end, revenue return per share must be higher than in the prior period and NAV per share total return performance must exceed that of the AIC UK Growth & Income peer group average. For each of these tests that the annual outcome fails to meet, the performance fee is reduced by 25%. The maximum performance fee is capped at 1.0% of NAV. The contract is subject to six-months notice by either party.

This performance element is demanding and even with a very good outcome last year Martin Currie did not earn the full 1.0% maximum performance fee. The Board has been evaluating its operation and it would not be a surprise if some of the hurdles were altered.

The Total Expense Ratio itself is 0.8%, just below the AIC sector average of 0.88%.

The Board of STS

STS has a wholly independent Board of five directors, blending commercial and financial services experience. The Board meets formally six times a year; in addition it has Audit, Management Engagement, Nominations and Marketing & Communications committees on which all the directors sit. The Board also meets regularly on an informal basis.

The Chairman is *Neil Donaldson*. He is chief executive of James Donaldson & Sons, a family-run timber merchant based in Fife. He is also a director of a number of other companies and organisations. *Edward Murray* has spent his working life in corporate finance, having been a director of British Linen Bank and its successor company, British Linen Advisers. He is a director of Artemis AiM VCT 2 and of AiM listed Renova Energy as well as being a director W A Baxter & Sons (Holdings). *Charles Berry* by contrast has a background in industry. His last executive position was an executive director of Scottish Power and chairman of Thus. Prior to that he was development director of Norwest Holst. He is a director of Impax Environmental Markets, Eaga and Drax Group. *Anita Frew's* background is in investment management, investor relations, strategic marketing and corporate development. She was head of UK equities at Scottish Provident before founding her own IR consultancy. She later became an executive director at WPP Group and then Abbot Mead Vickers; she is also a director of IMI, Aberdeen Asset Management, Victrex, Northumbrian Water and City of London Investment Trust. *Andrew Irvine* is chairman of the Scottish business of Jones Lang LaSalle, the New York-based international property consultants. He is also chairman of Montanaro European Smaller Companies Trust. He is a past captain of both the Scottish and the British & Irish Lions rugby union sides.

In addition to regular board meetings and more informal meetings of directors the Trust has an Audit Committee, which Edward Murray chairs, and a Nominations Committee, chaired by Andrew Irvine. A Management Engagement Committee is chaired by Charles Berry. Somewhat unusually for an investment trust STS also has a Marketing & Communications Committee, chaired by Anita Frew. It concentrates on the marketing of the Trust to private client fund managers.

The AIC UK Growth & Income Investment Trust Peer Group

The AIC Growth & Income Trust sector is the largest in the AIC classification. It contains 25 trusts, although not all of these can be considered as rightful comparators for STS. Eight of these are split capital trusts. Two others - Shires Income and British American Trust - are high yielding trusts which offer little by way of capital growth. A further three – Lowland Investment Company, Finsbury Growth & Income Trust and Value and Income Trust - offer capital rather than income (with a yield of only 2.8%), has too concentrated a portfolio or has one third of its portfolio in property respectively.

Thus the true peer group for STS are those 12 trusts which at least offer the approximate historic yield on the FTSE All-Share, which is currently 3.3%. This list includes Securities Trust of Scotland, City of London Investment Trust, Dunedin Income Growth Investment Trust, Edinburgh Investment Trust, F&C Capital & Income, Invesco Income Growth, JPMorgan Income & Growth Investment Trust, Merchants Trust, Murray Income Trust, Perpetual Income & Growth Investment Trust, Schroder Income Growth Fund, Standard Life Equity Income Trust and Temple Bar Investment Trust. For the UK investor interested in closed end funds a selection from these trusts should be the bedrock of his/her portfolio.

Martin Currie

Martin Currie Investment Management Limited is the main operating subsidiary of Martin Currie Limited, the Edinburgh-based fund management group. The group also has offices in London, New York and Shanghai, and employs 264 people. Martin Currie is 100% owned and managed by its directors and staff. This provides a level of stability that clients like, and enables the firm to attract and retain some of the most talented people in the industry.

Martin Currie was founded in 1881 and celebrated its 125th year in 2006. The firm has consistently been more innovative than its traditional Scottish-based peer group, preferring to develop a wider spread of financial products than merely concentrating on investment trusts. In recent years it has concentrated its strengths on a number of key areas, recognising that a medium sized fund manager cannot excel in all markets and asset classes. An equity specialist, Martin Currie's main strengths lie in UK, Europe, Asia, Japan, China, North America, hedge funds and alpha funds. Martin Currie has sold or wound down its previous exposure to UK smallcaps, and sold its private clients and private equity businesses. As a result Martin Currie is more focussed in terms of achieving investment returns and better recognised by key financial decision makers such pension fund consultants, the financial press and institutions wishing to follow a multi-manager approach to managing funds.

At 31st December 2007 Martin Currie managed £15.7 billion of funds for a wide range of clients – investment trusts, pension funds, pooled retail funds, financial institutions, and charities funds. STS is one of three investment trusts managed by the firm, the others being Martin Currie Portfolio Investment Trust (a global growth trust with significant exposure to overseas stocks and to UK private equity, with net assets of £203m) and Martin Currie Pacific Trust (a trust which targets capital growth in Japan, Asia and Australasia, with net assets of £146m).

Martin Currie's Investment Approach

The key investment personnel within Martin Currie are its 49 investment managers, of whom 5 are devoted to UK portfolios, and 15 are sector research managers. The sector managers operate as Martin Currie's in-house research team. They are allocated sectors with the dual role of monitoring developments in their respective sector and for identifying best investment ideas for that sector. The entire investment team are located in close proximity to each other and so Ross Watson, in common with all of the other fund managers, is in daily contact with numerous sector managers. In addition to this informal contact there are frequent meetings to discuss stocks deemed to be of interest, initiated either by the sector managers or individual fund managers.

For the income-biased portfolios of the UK Growth & Income team, including STS, the ability of a company to provide good consistent dividend growth, rather than the highest starting yield, is very important. The manager believes that this is the way to provide good consistent performance from an income-biased portfolio such as STS. The team use its own dedicated screening tool, the Core Screen Matrix, in addition to the Dynamic Stock Matrix described below. This focuses more upon cash-based measures including free cash flow yields and forecast dividend growth. The process is by no means automated, but the screening tools provide a very efficient way to highlight stocks that merit further attention. Meeting management of listed companies remains an important way of assessing quality in a company and the team meet as many companies as possible, particularly small and midcap companies.

The Core Screen Matrix is one of the two screens used by Martin Currie, and for the income-orientated portfolios it is the key screen used. It focuses on *Quality*, *Value*, *Growth* and *Change* criteria and builds on the Dynamic Stock Matrix for the income requirements of the STS manager. *Quality* focuses on the quality of profitability and its ability to support a dividend. *Value* considers balance sheet strength, dividend yield, the dividend payout ratio and free cash flow yield (cash generated from operations after capital expenditure, but before dividends and acquisitions as a percentage of capital employed). The *Growth* criteria takes in a two year dividend growth estimate as a measure of future dividend growth, whilst *Change* focuses on forecast changes in return on invested capital as the basis for future shareholder value creation. These screening tools are designed for the largest UK stocks, whereas the manager of the STS portfolio does invest in some (but not many) smaller UK midcaps and small caps. It has its own research capability to analyse lower midcaps and smallcaps in a similar manner.

As Martin Currie is also a growth orientated investment house, the company has developed a Dynamic Stock Matrix to generate and monitor stock ideas for all of its developed markets, the UK one covering the FTSE

350 Index stocks. Like the Core Screen Matrix it is basically a stock screening model, assessing stocks for the same four criteria of *Quality*, *Value*, *Growth* and *Change*. The *Quality* criterion looks at the health of a company's balance sheet using Altman's Z-Score (a financial model which combines five different financial ratios to determine the likelihood of bankruptcy amongst companies). Martin Currie insists on a Z-Score 1.5 points below the average. On *Value* Martin Currie focuses on the PE ratio as the most widely used indicator of relative value. With *Growth* a company's sales and profits/earnings growth are identified as measures of a company's overall growth. With *Change* the model isolates some of the key drivers which drive share price appreciation such as upgrades in earnings forecasts, share price momentum and insider ownership of the company's stock as indicators of future positive news flow.

Data is fed into the matrix by way of objective assessments of the criteria mentioned above, each assessment put in a tertile group (ie 1, 0 and -1). These marks are then summed to give an overall score, indicating the most attractive investment opportunities within the sector. The models are used to identify stocks deserving of further research and to test the validity of retaining existing portfolio holdings. Thus potential new holdings challenge existing investments for a place in the portfolio, and existing investments must justify retention.

Risk management is an integral part of investment management. Portfolios are monitored regularly, so that the fund manager can understand the risk/return trade-offs with the portfolio and with potential changes to the portfolio. In particular the risk management unit within Martin Currie quantifies index risk, monitors the investment style of the fund manager and ensures that the Trust's objectives in terms of risk are being achieved.

Contact

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