

Securities Trust of Scotland

Focused on global growth and quality stocks

Securities Trust of Scotland (STS) aims to provide long-term growth in income and capital through investing in global equities. The current manager, Mark Whitehead, was appointed in May 2016 and adopted an unconstrained, bottom-up approach to identify high-quality companies that can be long-term structural winners. The portfolio holds a relatively concentrated number of high-conviction stocks, which the manager believes gives the portfolio both defensive characteristics, as well as delivering sustainable dividend growth. The board has a progressive dividend policy. In August 2018, it announced a refresh of the trust's marketing strategy, materially increasing its budget, and the appointment of a new non-executive director with extensive marketing expertise.

12 months ending	Share price (%)	NAV (%)	Blended benchmark (%)	FTSE All-Share (%)	MSCI World (%)
31/08/14	2.9	7.0	12.5	10.3	13.4
31/08/15	(3.8)	(2.5)	(1.5)	(2.3)	4.1
31/08/16	21.6	24.0	30.8	11.7	26.0
31/08/17	15.5	15.8	13.7	14.3	18.8
31/08/18	5.5	6.9	6.0	4.7	12.7

Source: Thomson Datastream. Note: All % on a total return basis in pounds sterling. Blended benchmark is FTSE All-Share Index until 31 July 2011, MSCI World High Dividend Yield Index until 31 May 2016 and the rolling three-year median return of open- and closed-ended peers thereafter.

Investment strategy: Rigorous and highly selective

Whitehead has a bottom-up, disciplined investment process to identify companies with attractive growth prospects and high-quality balance sheets that trade on reasonable valuations. The detailed fundamental analysis involves stress-testing candidate companies' financials against different adverse scenarios to determine their resilience through economic cycles. The process also incorporates an assessment of a company's environmental, social and governance (ESG) performance. From an investible universe of over 2,500 companies, the portfolio consists of 35–55 high-conviction investments. Whitehead is head of Martin Currie's well-resourced team of six investment professionals

Market outlook: More challenging conditions

World equities have performed strongly following the global financial crisis, fuelled by an exceptionally easy monetary environment and synchronous economic growth. Market conditions, however, have become more challenging. Interest rates have started to rise and central banks are shrinking their balance sheets, at a time when equity valuations are no longer cheap and earnings momentum is slowing in many major markets.

Valuation: Potential for narrower discount

STS currently trades on a 7.5% discount to cum-income NAV, which slightly deeper than the three-year average of 6.3%. The board is committed to managing the discount, and has recently announced increased efforts and resources for the trust's marketing strategy.

Investment trusts

26 September 2018

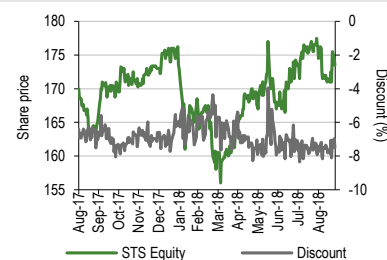
Price 173.5p
Market cap £184.4m
AUM £220.6m

NAV* 183.5p
Discount to NAV 5.4%
NAV** 187.6p
Discount to NAV 7.5%

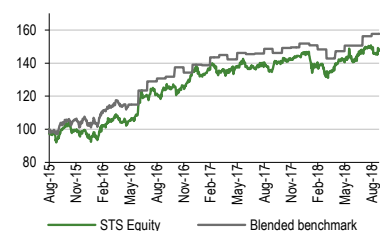
*Excluding income. **Including income. As at 24 September 2018.

Yield 3.5%
Ordinary shares in issue 106.3m
Code STS
Primary exchange LSE
AIC sector Global Equity Income

Share price/discount performance



Three-year performance vs index



52-week high/low 177.5p 156.0p
NAV** high/low 192.5p 167.3p

**Including income.

Gearing

Gross* 12.5%
Net* 8.9%

*As at 31 August 2018.

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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 from a portfolio of global equities. Following the adoption of an unconstrained mandate from 1 June 2016, the trust measures its performance versus the rolling three-year median return of open- and closed-ended peers, as well as an absolute target to produce real growth in revenue and cum-income NAV on a rolling five-year basis.

Recent developments

- 19 September 2018: Announcement of interim dividend of 1.45p per share.
- 20 August 2018: Announcement of the appointment of Sarah Harvey as non-executive director, effective 1 October 2018, and a refresh of the trust's marketing strategy, including a material increase in the marketing budget.
- 27 June 2018: Annual results for the year-ending 31 March 2018. NAV TR - 1.1% versus peer group -1.8%. Share price TR +0.2%. Declared fourth interim dividend of 1.75p per share.
- 27 June 2018: Announcement of change to management fee (see page 7).

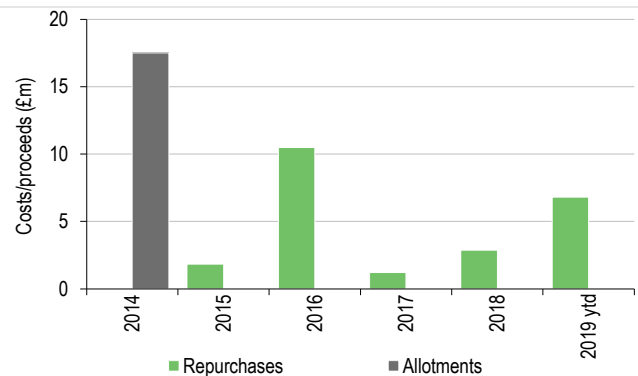
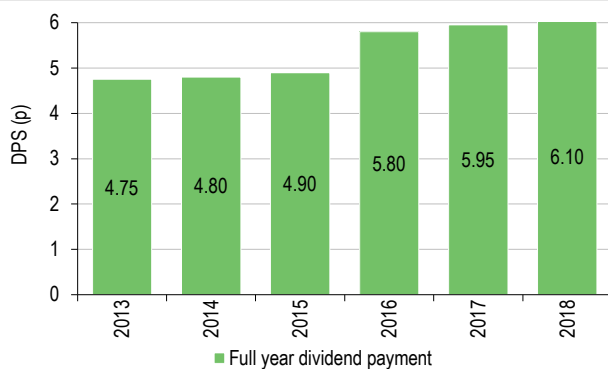
Forthcoming		Capital structure		Fund details	
AGM	19 September 2018	Ongoing charges	0.9%	Group	Martin Currie Investment Mgmt (UK)
Interim results	November 2018	Net gearing	6.1%	Manager	Mark Whitehead
Year end	31 March	Annual mgmt fee	(see page 7)	Address	Saltire Court, 20 Castle Terrace, Edinburgh EH1 2ES
Dividend paid	Quarterly	Performance fee	None	Phone	+44 (0) 131 229 5252
Launch date	28 June 2005	Trust life	Indefinite	Website	www.securitiestrust.com
Continuation vote	None	Loan facilities	£25m (see page 7)		

Dividend policy and history (financial years)

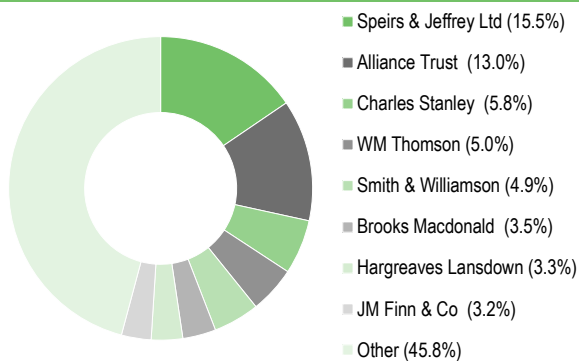
Dividends are currently paid quarterly in October, January, April and July. Dividends were increased for FY16 after the announcement of a new progressive dividend policy.

Share buyback policy and history (financial years)

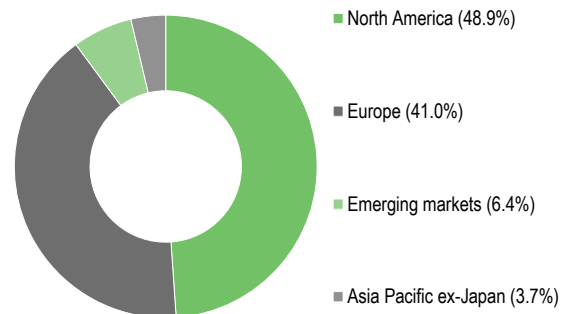
Renewed annually, the trust has authority to purchase up to 14.99% and allot up to 5% of issued share capital.



Shareholder base (as at 31 August 2018)



Portfolio exposure by geography (as at 31 August 2018, net of cash, gearing and option exposure)



Top 10 holdings (as at 31 August 2018)

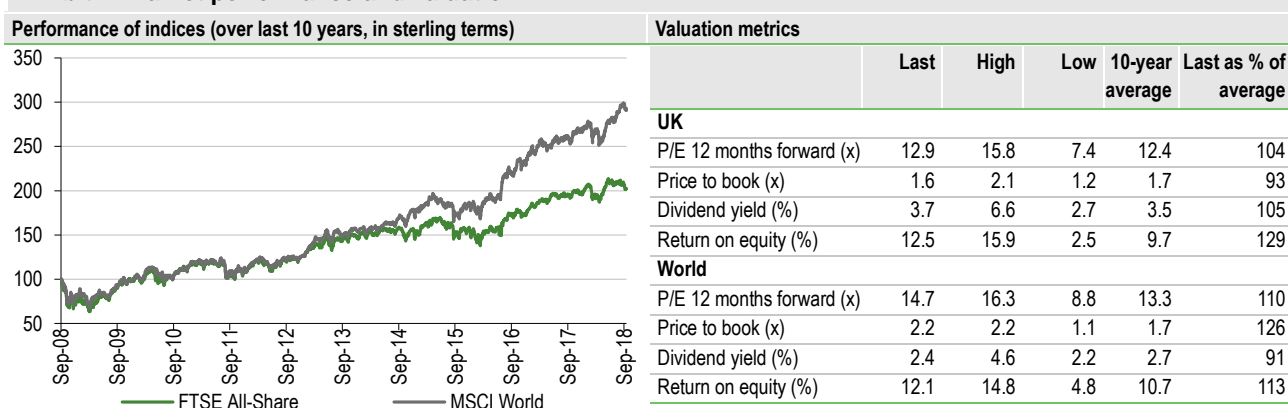
Company	Country	Sector	Portfolio weight %	
			31 August 2018	31 August 2017*
Microsoft	US	Information technology	5.0	2.7
Merck	US	Healthcare	4.4	N/A
Sanofi	France	Healthcare	3.7	N/A
Koninklijke DSM	Netherlands	Materials	3.1	N/A
Zurich Insurance	Switzerland	Financials	3.0	N/A
WEC Energy Group	US	Utility	2.8	N/A
Airbus	France	Industrials	2.7	N/A
Suncor Energy	Canada	Energy	2.7	N/A
Taiwan Semiconductor	Taiwan	Information technology	2.7	2.7
Air Products	US	Materials	2.6	N/A
Top 10			32.7	29.6

Source: Securities Trust of Scotland, Edison Investment Research, Bloomberg, Morningstar. Note: *N/A where not in Aug 2017 top 10.

Market outlook: Less benign than before

As shown in Exhibit 2 (LHS), world equities have performed strongly following the global financial crisis, fuelled by unprecedentedly low interest rates, favourable monetary conditions and, more recently, synchronous economic growth. Stock market volatility over the past few years (as measured by the VIX Index) was also exceptionally low, reflecting investors' perception of unusually benign market conditions. These trends have started, or are poised to, roll over at a time when global equity valuations are above their 10-year average. The continued strength in global equities this year has been led by the US market, where leading indicators and earnings continue to exceed expectations, helped by the positive effect of President Trump's tax reforms. Most major equity markets peaked in late January 2018 and only the US has continued to achieve new highs. Europe's recovery appears shorter and shallower than expected, while emerging markets equities have been particularly weak, correcting over 20% from their peak. Meanwhile, volatility has risen sharply since January 2018, signalling that investors have become more sensitive to risk and equities more vulnerable to negative news, including earnings disappointments and trade wars.

Exhibit 2: Market performance and valuation



Source: Thomson Datastream, Edison Investment Research. Note: Valuation metrics as at 21 September 2018.

Fund profile: Diversified large-cap, high conviction

STS aims to generate rising income and long-term capital growth through investing in a diversified portfolio of global equities. The manager is not constrained by benchmark considerations and focuses on identifying companies with high-quality sustainable income and earnings growth, to build a diversified, yet relatively concentrated portfolio of 35–55 high-conviction stocks. The investment approach is rigorous and fundamental, involving detailed financial analysis and stress-testing of companies under adverse economic scenarios. Most investments are in larger companies, typically with a market capitalisation of over £1bn.

The current unconstrained mandate was adopted on 1 June 2016 and Mark Whitehead has managed the trust since May 2016. Performance is measured against the median of all relevant open- and closed-ended peers (sourced from the Lipper Global Equity Income and AIC Global Equity Income sectors) on a rolling three-year basis. STS is permitted to have net gearing of up to 20% of NAV and can also use derivatives in a careful and controlled manner. The manager deploys a tactical options strategy, predominantly writing (selling) put options to generate income for the trust. This income can account for around 10–15% of total portfolio income pa. As at end-August 2018, STS had net gearing of 8.9% and active options exposure of 1.6%.

The fund manager: Mark Whitehead

The manager's view: Well-positioned for current environment

Whitehead believes market conditions for equities have become more challenging as monetary conditions tighten around the world and investors have turned more cautious. US bond markets have started to discount a recession and defensive sectors, which have been out of favour for some time, are starting to perform. The manager believes STS's focus on long-term structural winners, high-quality companies that can grow earnings and dividends through economic cycles, means the portfolio is naturally well-positioned for a more uncertain environment. He does not anticipate the need to make significant adjustments to the fund in response to cyclical changes in the economic outlook. Given the team's rigorous approach to analysis, including stress-testing companies' cash flows and balance sheets, STS's portfolio stocks are, by nature, defensive.

Asset allocation

Investment process: Rigorous fundamental analysis

Whitehead has a bottom-up and disciplined investment process seeking to identify companies with attractive growth prospects, high-quality characteristics, which are trading on reasonable valuations. Portfolio construction is not constrained by benchmark considerations, so the portfolio of 35–55 stocks is a reflection of the manager's highest-conviction stock picks. A global mandate means the investible universe of stocks is large (the MSCI All Country World Index has around 2,500 constituents) and STS has developed a propriety screen to help filter out companies that do not fit its investment criteria in terms of yield, growth and valuation measures. Candidate companies undergo rigorous fundamental analysis, including stress tests against adverse economic scenarios, to help build conviction on the sustainability of cash flows, and balance sheet resilience through an economic cycle. Detailed evaluation of ESG factors is a key part of the investment process, and the manager believes the companies that perform well in this regard also tend to outperform over time. The portfolio has a top rating from the United Nations-supported Principles for Responsible Investing organisation. STS's investment team consists of six equity income specialists, with an average of 18 years' experience.

Current portfolio positioning

The portfolio's largest geographical exposure as at end-August 2018 is to the US, followed by Europe (53.3% and 44.7%, respectively, including gearing and options exposures). Over the past 12 months, regional exposures have been relatively stable, with the most notable geographic change a 5.4pp reduction to Asia Pacific ex-Japan, to 4.0%. Sales include South Korea health appliance manufacturer, Coway, where growth has disappointed and competition is increasing; and Singapore telecom operator, Singtel.

As shown in Exhibit 3, the largest sector exposures in the portfolio at end-August 2018 are financials (18.4%), industrials (14.9%) and materials (13.1%). Over the past 12 months, the most significant shift has been a 4.6pp reduction to the financial sector. Bank of Montreal (Canada) was sold as the manager became more cautious on the outlook for the banking cycle in Canada, where the property market is looking overheated. ING Group (the Netherlands) and Banca Generali (Italy) were also sold, both appearing fully valued and relatively less attractive compared to opportunities elsewhere. Also within the financial sector, Zurich Insurance of Switzerland was purchased. The company offers a prospective yield over 6% and the manager expects this can grow above the rate of inflation over the next few years, as its margins expand and the bank deploys its excess capital.

Whitehead also notes Zurich scores very highly in ESG terms, which should help support long-term share-price performance.

Exhibit 3: Portfolio sector exposure* (% unless stated)			
	Portfolio end-August 2018	Portfolio end-August 2017	Change (pp)
Financials	18.4	23.0	(4.6)
Industrials	14.9	10.9	4.0
Materials	13.1	9.7	3.4
Information technology	12.4	12.9	(0.5)
Healthcare	9.7	10.9	(1.2)
Consumer discretionary	9.1	8.9	0.2
Consumer staples	8.5	8.9	(0.4)
Energy	7.8	6.6	1.2
Utilities	5.7	4.0	1.7
Telecommunications	4.9	3.9	1.0
Real estate	4.5	9.0	(4.5)
Cash	3.6	1.6	2.0
Active options exposure	1.6	2.0	(0.4)
Gearing	(12.5)	(12.3)	(0.2)

Source: Securities Trust of Scotland, Edison Investment Research. *Active options exposure means allocations may not total 100%.

The manager also reduced its real estate exposure by 4.5pp. This partly reflects the takeover of Buwog in Austria during Q118, at an 18% premium to the undisturbed share price, and the sale of Amsterdam-listed Unibail-Rodamco-Westfield. This is the largest shopping mall operator in Europe, which the manager expects to face mounting challenges as interest rates rise and online retailers continue to disrupt its bricks-and-mortar business model.

Over the past year, STS has increased its exposure to the industrials and materials sectors by 4.0pp and 3.4pp, respectively. New holding Air Products, listed in the US, is a supplier of industrial gases to a diverse range of manufacturing industries including petrochemicals, metals and electronics. The business model often involves dedicated supplier–user relationships, which are of long duration and result in strong and visible cash flow generation, after an initial investment phase. The business is significantly less cyclical than typical materials sector companies. Air Products is expanding its customer base and growing its presence in China, which Whitehead believes will help to underpin the company’s structural growth. STS also purchased the German-listed automotive company, Continental. The firm is most associated with its tyre manufacturing businesses, which accounts for around 40% of earnings; however, it has been investing in technology and more specialist areas of the industry, including autonomous driving and infotainment. The manager believes that, over time, Continental can become a higher-growth, leading player in the auto sector.

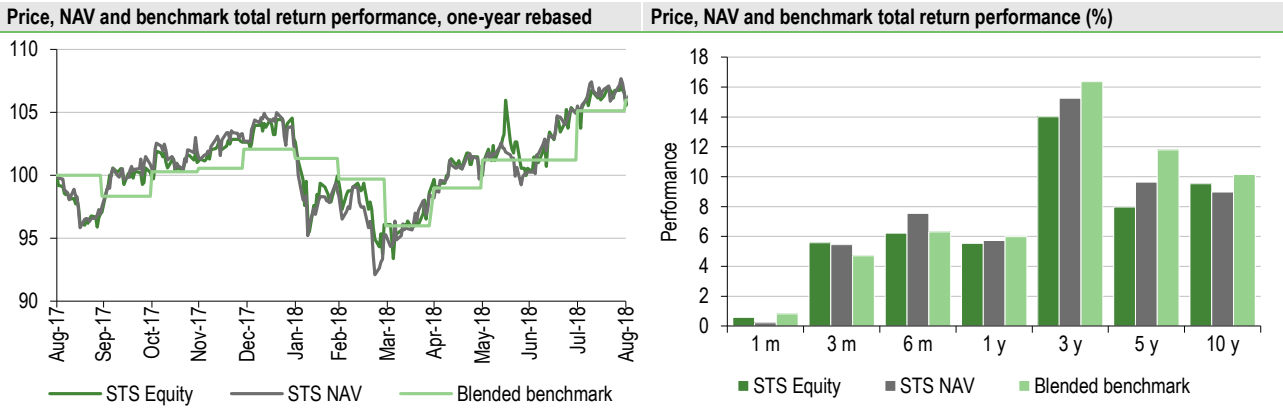
As stock markets have become more volatile, the manager has tactically raised the cash position in the portfolio to 3.6% as at end-August 2018. This enables STS to have greater flexibility to make opportunistic purchases without having to sell existing positions.

Performance: Broadly in line with benchmark

As the current manager and the new mandate commenced in mid-2016, the most relevant performance periods to consider in Exhibits 4 and 5 are one, three and six months, and one and three years. Over these periods, STS’s NAV total return has performed broadly in line with its benchmark, but has outperformed the FTSE All-Share index. The trust has lagged the MSCI World index, over these periods. The dominant country constituent in the MSCI World index is the US (>60%) and over the past few years, US stocks, and in particular low yielding technology stocks, have been particularly strong (this issue has afflicted global income focused funds across the board). Most major equity markets peaked in late-January 2018, whereas the US market has

continued to reach new highs. The manager has a long-term investment horizon and is not influenced by fluctuations in the shorter-term performance of the trust.

Exhibit 4: Investment trust performance to 31 August 2018



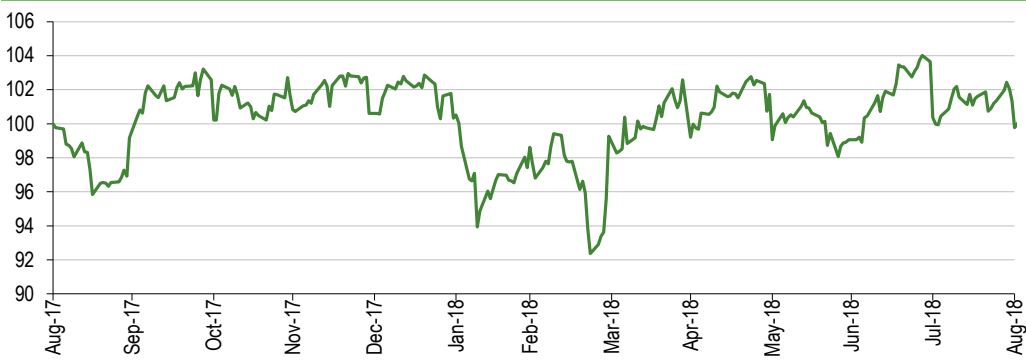
Source: Thomson Datastream, Edison Investment Research. Note: Three, five and 10-year performance figures annualised. Blended benchmark is FTSE All-Share Index until 31 July 2011, MSCI World High Dividend Yield Index until 31 May 2016 and the rolling three-year median return of open- and closed-ended peers thereafter.

Exhibit 5: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to blended benchmark	(0.2)	0.8	(0.1)	(0.4)	(5.9)	(16.0)	(5.6)
NAV relative to blended benchmark	(0.1)	0.7	1.8	0.9	(2.6)	(8.2)	(10.1)
Price relative to FTSE All-Share	3.4	7.4	0.6	0.8	10.8	1.8	20.9
NAV relative to FTSE All-Share	3.5	7.2	2.5	2.1	14.8	11.2	15.1
Price relative to MSCI World	(1.6)	(1.3)	(3.9)	(6.4)	(12.2)	(26.4)	(16.0)
NAV relative to MSCI World	(1.5)	(1.4)	(2.0)	(5.2)	(9.0)	(19.6)	(20.0)

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-August 2018. Geometric calculation.

Exhibit 6: NAV total return performance relative to benchmark over one year



Source: Thomson Datastream, Edison Investment Research

Discount: Marketing refresh may help narrow discount

STS currently trades on a 7.5% cum-income discount to NAV, which is slightly deeper than the three-year average of 6.3%. Over that period, the discount has ranged from 1.9% to 9.2%. Shareholders have the right to redeem their shares if the average discount to STS's ex-income NAV is greater than 7.5% over the 12 weeks preceding the financial year-end. The board actively manages the discount through the promotion of the trust, and has the ability to repurchase shares. During the year-ended March 2018, 1.2m shares were repurchased at a total cost of £2.9m (FY17: 0.8m shares at a cost of £1.1m). On 20 August 2018, the board announced plans to refresh the marketing strategy for the trust, which will include "a material increase in the company's marketing

budget". At the same time, it appointed a new non-executive director, Sarah Harvey, who has considerable marketing experience, to help ensure the effectiveness of the strategy.

Exhibit 7: Share price premium/discount to NAV (including income) over three years (%)



Source: Thomson Datastream, Edison Investment Research

Capital structure and fees

STS is a conventional investment trust with one class of share; there are currently 106.3m ordinary shares in issue and 16.0m held in treasury. In September 2016, taking advantage of low interest rates, the board agreed a seven-year, £15m multi-currency, fixed-rate facility, alongside a £10m revolving credit facility with the Royal Bank of Scotland. As at end-August 2018, STS had net gearing of 8.9%.

On 27 June 2018, the board announced a change in the management fee, payable quarterly to Martin Currie Investment Management. With effect from 1 April 2018, a fee of 0.6% applies to net assets up to £200m, reducing to 0.4% of net assets above £200m. The fee is split 65:35 between capital and income, reflecting the board's expected long-term split of returns between capital gains and income. No performance fee is payable. As at YE18 (31 March), the ongoing charge was 0.9% (slightly lower than the 1.0% at YE17).

Dividend policy and record

Aligned with the trust's objective to deliver rising income and long-term capital growth, the board adopted a progressive dividend policy from FY16, which allows the use of retained capital profits if necessary. The board believes this policy gives the manager greater flexibility to hold stocks with higher growth potential but slightly lower yields. The total dividend for FY18 was 6.1p per share, of which 0.27p was paid from capital (for the first time). This represents an increase of 2.5% over the previous year and, since the adoption of the new policy, the annual dividend has grown by an annualised 8.0%. As at end-March 2018, STS held revenue reserves of £1.6m and other distributable reserves of £154.8m. From April 2018, dividends will be paid in October, January, April and July, (previously September, December, March and June).

Peer group comparison

As shown in Exhibit 8, the AIC Global Equity Income peer group is relatively small with seven members, and average data for open-ended peers (consisting of 55 funds) has been included for comparative purposes. STS is one of the smaller trusts in the AIC sector, ranking fifth. The most relevant performance periods are one and three years, which encompasses the tenure of Mark

Whitehead and the current investment mandate. The trust's NAV total return ranks fourth over one year, and sixth over three years. By dividend yield, STS ranks fourth; however, Blue Planet Investment Trust's 11.4% yield is an outlier (it has over half its portfolio invested in bonds and high-yield instruments), and STS's 3.5% yield is comparable to the remaining peers. STS trades on the deepest ex-par discount to NAV among its peers.

Exhibit 8: AIC Global Equity Income peer group as at 25 September 2018*

% unless stated	Market cap/ fund size £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Discount (ex-par)	Ongoing charge	Perf. fee	Net gearing	Dividend yield (%)
Securities Trust of Scotland	184.5	8.5	56.0	54.0	163.4	(5.3)	0.9	No	109	3.5
Blue Planet Investment Trust	18.8	(6.2)	22.1	23.0		(11.8)	3.6	No	152	12.6
Henderson International Income	296.1	8.6	65.0	76.4		1.1	0.9	No	101	3.1
Invesco Perp Select Global Eq Inc	67.7	8.2	60.7	75.4	196.3	(1.3)	0.8	Yes	106	3.2
JPMorgan Global Growth & Income	425.7	11.8	72.6	90.4	264.1	1.1	0.6	Yes	106	3.8
Murray International	1,435.2	(2.1)	64.1	37.8	174.5	(0.2)	0.6	No	112	4.6
Scottish American	530.9	10.4	70.6	73.7	163.4	3.0	0.8	No	115	3.0
Simple average	422.7	5.6	58.7	61.5	192.4	(1.9)	1.2		114	4.8
STS rank in sector (seven trusts)	5	4	6	5	4	6	3		4	4
Open-ended peers simple average	399.3	8.0	49.2	58.3	140.1	N/A	1.4		N/A	3.1

Source: Morningstar, Edison Investment Research. Note: *Performance to 24 September 2018. TR=total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

The board

On 20 August 2018, the board announced the appointment of Sarah Harvey as a non-executive director, with effect from 1 October 2018. Harvey was previously UK managing director of Square, a US-listed fintech company, and brings extensive experience in corporate strategy, marketing and operations. Her appointment will bring the number of independent non-executive directors to five. The board is chaired by Rachel Beagles (appointed in 2010 and assumed her current role in 2016). Angus Gordon Lennox is the senior independent director (appointed in 2013 and assumed his current role in 2017). The other two directors are Mark Little (2014) and John Evans (2016).

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