

The Scottish Investment Trust

Daring to be different

The Scottish Investment Trust (SCIN) seeks to avoid the ‘madness of crowds’, investing away from the herd in stocks that may be entirely out of favour with the market (‘ugly ducklings’), on the verge of significant improvement (‘change is afoot’), or still undervalued despite being more widely appreciated (‘more to come’). This leads manager Alasdair McKinnon and his team into areas of the market such as banks, food retail and oil companies, which have been somewhat left behind in a stock market rally that may in future be known as the ‘second internet bubble’. McKinnon reports that in spite of average market valuations being at high levels, there is still an abundance of global opportunities for contrarian investors. SCIN’s portfolio is modestly geared on a net basis and has an above-average yield compared with its close peer group.

12 months ending	Share price (%)	NAV (%)	MSCI AC World (%)	MSCI UK All-Cap (%)	FTSE All-World (%)
28/02/14	8.4	9.9	7.6	13.1	7.4
28/02/15	8.7	7.5	17.2	4.8	17.5
29/02/16	(4.2)	(2.7)	(2.2)	(7.8)	(2.1)
28/02/17	39.0	33.0	37.5	23.2	37.7
28/02/18	7.1	6.1	7.8	4.4	7.8

Source: Thomson Datastream. Note: All % on a total return basis in GBP.

Investment strategy: Contrarians with conviction

As contrarian investors, SCIN’s managers seek global stocks that are out of favour with investors but have potential to improve. After evaluating sentiment and capital cycles, they analyse companies based on factors such as drivers of the business, yield and sustainability of dividends, P/E ratio and cyclical earnings position. They are prepared to hold stocks for the long term to allow improvements to come through, and many holdings now in the ‘more to come’ category first entered the portfolio as ‘ugly ducklings’. Compared with global indices, SCIN is overweight the UK, energy and materials, and underweight the US and technology stocks.

Market outlook: Pockets of value still exist

While equity market volatility has recently picked up from the historic lows seen in 2017, global stock market indices are still at high levels, buoyed by momentum in technology and internet stocks, which have helped propel average valuations well above historical norms. However, pockets of value still exist in areas that are less favoured, with the added benefit in many cases of higher dividend yields, meaning investors are ‘paid to wait’ for a rerating.

Valuation: Discount below long-term averages

At 15 March 2018, SCIN’s shares traded at a 7.9% discount to cum-income NAV, wider than the year-to-date average but narrower than the averages over one, three, five and 10 years (a range of 9.0% to 10.1%). Shares may be bought back if the discount to cum-income NAV exceeds 9.0%. SCIN’s discount remains wider than the average of its close peers, in spite of having the highest dividend yield at 2.5%.

Investment trusts

19 March 2018

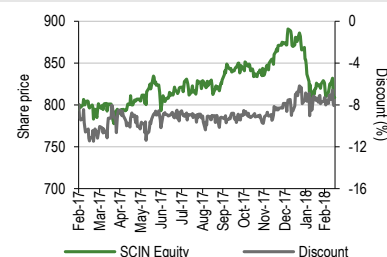
Price 809.0p
Market cap £636.0m
AUM £791.7m

NAV* 871.6p
Discount to NAV 7.2%
NAV** 878.7p
Discount to NAV 7.9%

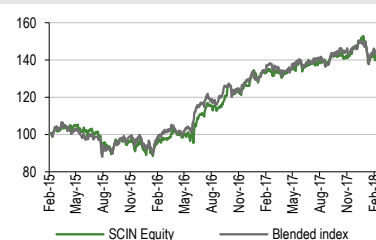
*Excluding income. **Including income. As at 15 March 2018.

Yield 2.5%
Ordinary shares in issue 78.6m
Code SCIN
Primary exchange LSE
AIC sector Global

Share price/discount performance



Three-year performance vs index



52-week high/low 891.0p 777.5p
NAV** high/low 970.4p 855.1p

**Including income.

Gearing

Gross* 11.3%
Net* 4.2%

*As at 31 January 2018.

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Exhibit 1: Trust at a glance

Investment objective and fund background

The Scottish Investment Trust's objective is to provide investors, over the longer term, with above-average returns through a diversified portfolio of international equities, and to achieve dividend growth ahead of UK inflation. The manager takes a patient approach and seeks to invest in undervalued, unfashionable companies that are ripe for improvement.

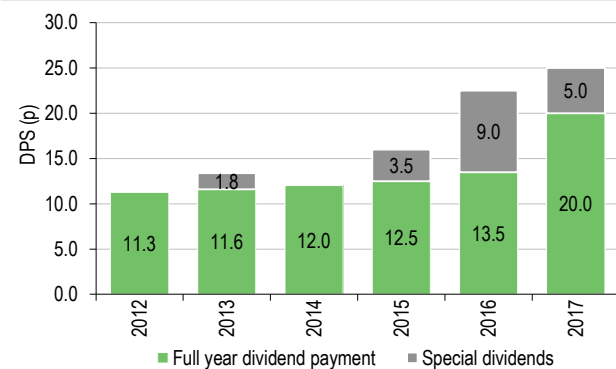
Recent developments

- 2 February 2018: All resolutions passed at AGM. As previously announced, Hamish Buchan has retired from the board.
- 11 December 2017: Annual results for the year ended 31 October. NAV TR +11.8% and share price TR +12.8%. Final dividend of 14.5p per share brings total regular dividend to 20.0p (FY16: 13.5p), plus a 5p special dividend (FY16: 9.0p). Step-change in regular dividend policy, with a higher quarterly regular dividend and special dividends likely to be less prominent in future.

Forthcoming		Capital structure		Fund details	
AGM	February 2019	Ongoing charges	0.49%	Group	SIT Savings Ltd (AIFM)
Interim results	June 2018	Net gearing	4.2%	Manager	Alasdair McKinnon and team
Year end	31 October	Annual mgmt fee	N/A (self-managed)	Address	6 Albyn Place, Edinburgh, EH2 4NL
Dividend paid	Quarterly	Performance fee	N/A (self-managed)	Phone	+44 (0) 131 225 7781
Launch date	July 1887	Trust life	Indefinite	Website	www.thescottish.co.uk
Continuation vote	No	Loan facilities	£83.7m (see page 7)		

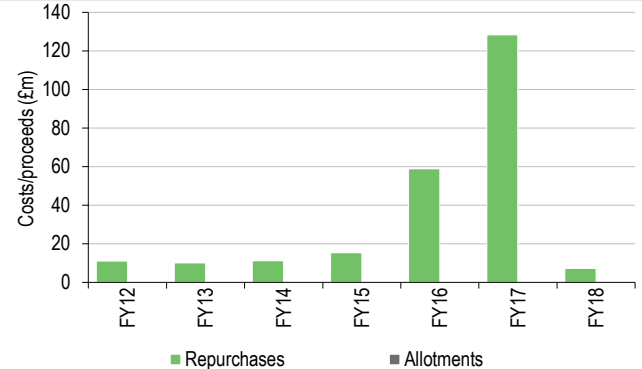
Dividend policy and history (financial years)

Dividends historically paid twice a year in July and February, with special dividends (where applicable) paid alongside the final dividend. From FY18 dividends will be paid quarterly. SCIN has grown its regular dividend every year since 1983.

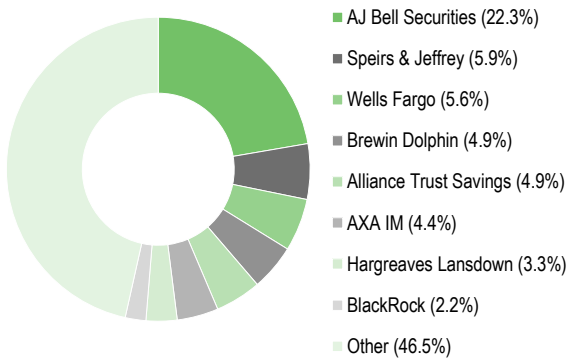


Share buyback policy and history (financial years)

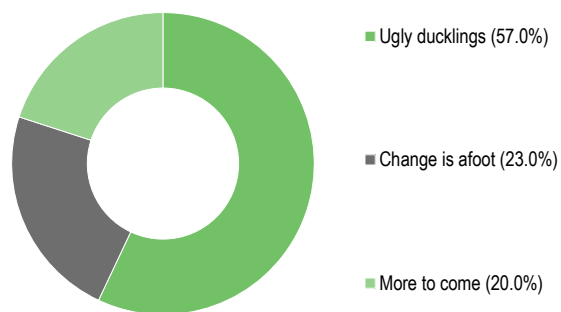
SCIN has the authority to buy back up to 14.99% of shares annually, and targets a maximum discount (based on cum-income NAV with borrowings at market value) of 9%. Buyback figures for FY17 below include the repurchase of the Aviva shares.



Shareholder base (as at 16 January 2018)



Portfolio exposure by category (as at 31 October 2017)



Top 10 holdings (as at 31 January 2018)

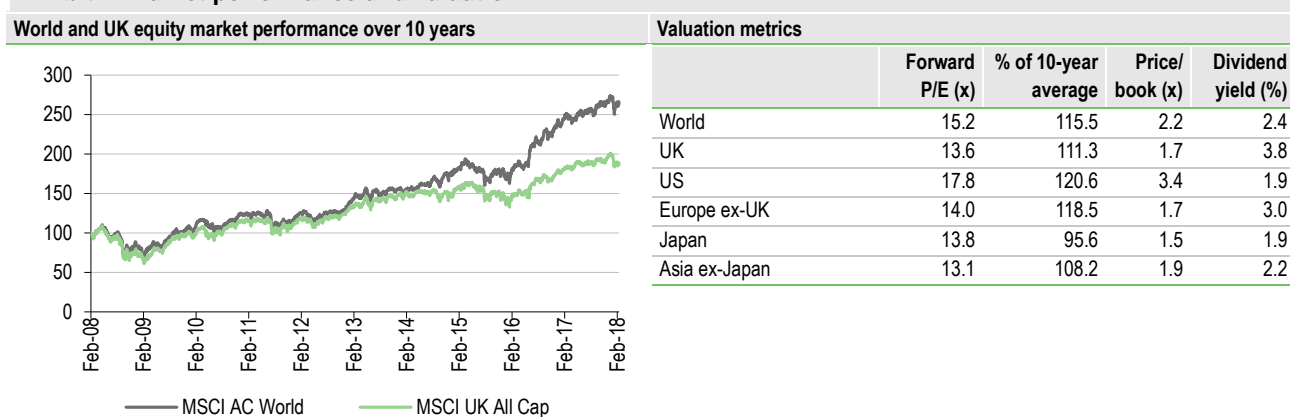
Company	Country	Sector	Portfolio weight %	
			31 January 2018	31 January 2017*
Rentokil Initial	UK	Industrials	4.0	3.3
Tesco	UK	Consumer staples	3.8	2.8
Standard Chartered	UK	Financials	3.7	2.6
ING	Netherlands	Financials	3.6	2.6
Newcrest Mining	Australia	Materials	3.5	N/A
Gap	US	Consumer discretionary	3.3	N/A
Royal Dutch Shell	UK	Energy	3.0	N/A
Suncor Energy	Canada	Energy	2.8	N/A
Sumitomo Mitsui Financial	Japan	Financials	2.8	2.5
GlaxoSmithKline	UK	Healthcare	2.7	3.0
Top 10 (% of portfolio)			33.2	31.6

Source: The Scottish Investment Trust, Edison Investment Research, Bloomberg, Morningstar. Note: *N/A where not in January 2017 top 10.

Market outlook: Avoid the herd to find value

Despite a recent rise in equity market volatility, global stock markets continue to perform strongly, leading to forward P/E valuations that are in most cases well above long-term averages (Exhibit 2, right-hand side). The US – which makes up more than half of the total world stock market capitalisation – is the most notably extended, with an average forward P/E ratio 20.6% above the 10-year average, and price/book valuations at 41.4% above average. Six of the 10 largest US stocks (Apple, Microsoft, Amazon, Facebook, and the two share classes of Alphabet, aka Google) are now technology- or internet-related; they also appear as six of the 10 largest stocks globally, where they are joined by Chinese internet giant Tencent. The fact that these companies trade on price/book valuations of between 5.2x (Alphabet) and 27.7x (Amazon) shows just how much investors are prepared to pay to be involved in the internet theme. Those who do not subscribe to the theory that ‘what goes up, must go up’ may find value in a more contrarian approach, with out-of-favour but cash-generative ‘real world’ stocks also offering the benefit of higher dividend yields.

Exhibit 2: Market performance and valuation



Source: Thomson Datastream, Bloomberg, Edison Investment Research

Fund profile: Focused, contrarian global portfolio

The Scottish Investment Trust (SCIN) was launched in 1887 in Edinburgh, where it is still based. A self-managed investment trust, it has significantly refocused its business in the past three years, adopting a high-conviction, contrarian investment process, streamlining its portfolio management team, outsourcing its administrative functions and, most recently, closing its in-house savings scheme, with the majority of investors transferring to platform AJ Bell Youinvest. As a result of these changes, ongoing charges are now only 0.49% a year. Under the revamped investment process, the five-strong management team, headed by Alasdair McKinnon, takes a high-conviction approach to building a focused global portfolio of 50-100 unloved stocks with the potential to rerate as a result of operational improvements. The trust aims to provide capital appreciation and above-inflation dividend growth, and has raised its dividend for 34 years in a row. There is no formal benchmark, but SCIN uses the MSCI AC World and MSCI UK All-Cap indices to provide context to performance, and is a member of the AIC Global sector. Gearing is permitted up to 20% of net assets.

The fund manager: Alasdair McKinnon and team

The manager’s view: Keeping it real-world

McKinnon comments that although ‘hot money’ has pushed valuations of technology and particularly internet stocks to levels far beyond what is justified by fundamentals, there is still plenty of value to

be found in global stock markets. Fears of a secular shift to online shopping mean investors are shunning 'real world' retail stocks, while many major oil companies remain cheap in spite of a significant rise in the oil price. Utilities are under political pressure on pricing, but many now offer attractive yields, says McKinnon. Telecommunications is another interesting area, while major pharmaceutical companies are also unloved as a result of patent expiries on blockbuster drugs.

The manager has recently added to his holding in Tesco, still an 'ugly duckling', but with the potential to improve operationally under new management. Also in retail, the perennially unloved Marks & Spencer offers an attractive dividend yield and could rerate as the 'hands-on' new chairman, Archie Norman, gets to work on reforms. Meanwhile, Treasury Wine Estates, formerly the largest holding in the portfolio, has been reduced dramatically as analyst 'buy' ratings have increased in number. McKinnon comments that the team prefers to own companies where expectations are low, as the potential for positive surprises is greater. "When people start to love a company, then it *has* to do well, and that is when we want to get out," he adds.

Asset allocation

Investment process: From ugly ducklings to swans

In October 2015, SCIN adopted a high-conviction, 'global contrarian' investment process, based on behavioural finance principles. The approach is implemented by portfolio manager Alasdair McKinnon, supported by deputy manager Martin Robertson, investment managers Sarah Monaco and Mark Dobbie, and analyst Igor Malewicz, who joined the team in 2017. McKinnon explains the process as one of finding investment opportunities in out-of-favour companies that have been left behind by investors' desire to be part of a crowd. This 'herding' instinct pushes the prices of popular stocks ever higher, regardless of future return potential, while unpopular stocks are shunned, even though their operational performance may be improving. McKinnon and the team aim to capture superior returns by buying unloved companies with recovery potential while they are trading at low valuations. These may be held for a long period while the market perception catches up, but are likely to be sold once they reach the stage where they can 'do no wrong' in investors' eyes.

As investor sentiment and company capex are both cyclical, stocks are initially assessed on their position in these cycles. Those where the entry point looks favourable are then analysed on metrics such as business drivers, yield and the sustainability of the dividend, earnings and P/E ratio. The team splits its investments into three groups based on how out-of-favour they are. Stocks may move through the categories during the holding period.

- **Ugly ducklings** (57% of the portfolio at 31 October 2017). These are companies where investor perception is very negative and operational performance is also challenged. Valuations are low and good news from an operating perspective may not be rewarded by a rerating. However, as these companies improve, investor perceptions will eventually adjust and share price gains may be significant once this begins to happen. An example of an 'ugly duckling' stock is Tesco. Once a stock market darling, the UK's largest supermarket has suffered a string of setbacks over the past seven years, including a failed expansion into the US, an accounting scandal in 2014, and continuing loss of market share to discounters Aldi and Lidl. McKinnon says that Tesco may never regain its previous margins, given the more competitive nature of food retailing, but as the scale player in the UK market, it is well placed to increase margins substantially as the improving economy sees time-poor shoppers returning to a 'one-stop shop'. The recent acquisition of foodservice company Booker did not initially go down well with the market, but it diversifies the business and has also brought an impressive CEO-in-waiting in former Booker boss Charles Wilson, who took the company "from distress to success".
- **Change is afoot** (23% of the portfolio at 31 October 2017). These are stocks where operational improvement is becoming evident but is still largely ignored by investors. An

example is Dutch bank ING, bought in April 2015. After a successful period of restructuring, ING now benefits from a strong capital position and a growing, high-quality loan book. While investors may focus on industry headwinds such as low interest rates, political risks and regulatory burdens, McKinnon points to increasing operating leverage from the bank's digital transformation and cost reduction programme; opportunities for its higher-margin online challenger bank; and improving fundamentals in energy and shipping (areas where ING is exposed and which had previously been cause for concern), supporting credit quality. Management has so far omitted to return excess capital to shareholders, which could point to higher future dividend payouts.

- **More to come** (20% of the portfolio at 31 October 2017). Stocks where market sentiment is generally favourable make up a smaller part of the portfolio given the contrarian approach, and have usually moved up through the other categories. These are companies where the team believes future operating prospects are still underappreciated even though the shares are no longer out of favour. Examples include Treasury Wine Estates, bought as an ugly duckling and now mostly exited after very strong performance and a marked rerating; Nintendo, which has also been reduced after moving up from the 'change is afoot' category; and Rentokil Initial, which has refocused on its roots in pest control and is now SCIN's top holding, having performed very strongly in 2017.

Current portfolio positioning

SCIN had 55 holdings at 31 January 2018, towards the lower end of its permitted range of c 50 to 100. In line with its high-conviction approach, the top 10 holdings made up 33.2% of the portfolio, compared with 31.6% a year earlier. Portfolio construction is unconstrained by index weightings; this is reflected in the geographical breakdown (Exhibit 4), where the UK exposure is more than 20pp higher than in most global indices, and the North American weighting is c 30pp lower.

Sector weightings (Exhibit 3) reflect the availability of unloved and undervalued companies. While the portfolio is diversified across a spread of sectors, the team finds fewer attractive opportunities in areas such as information technology (5% of the portfolio versus 19% of the MSCI AC World index), and more in areas such as energy and materials (respectively 10.0pp and 4.6pp above the index weightings). McKinnon comments that while the oil sector has recovered from the extreme pessimism it was suffering when he built the energy exposure (oil prices of \$30-40 and a lack of demand from emerging markets), the companies that survived the downturn are now largely cash flow positive and paying good dividends. Holdings in the materials sector include recent purchase Newcrest Mining (now in the top 10), a gold miner that offers a hedge against inflation if the global economy continues to be strong, and defensive characteristics (as gold is seen as a 'safe haven' store of value) if the opposite occurs. The largest sector exposure is to financials, where holdings include banks in the US, Europe and Japan.

Exhibit 3: Portfolio breakdown by sector

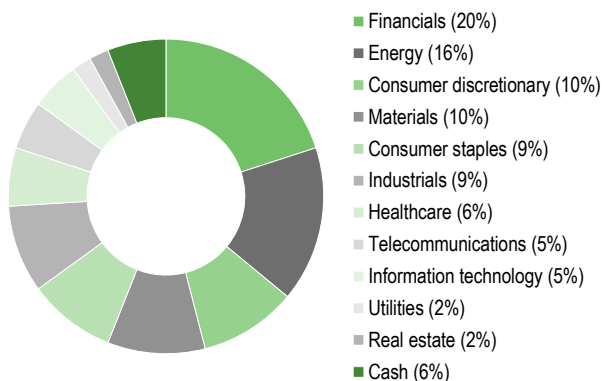
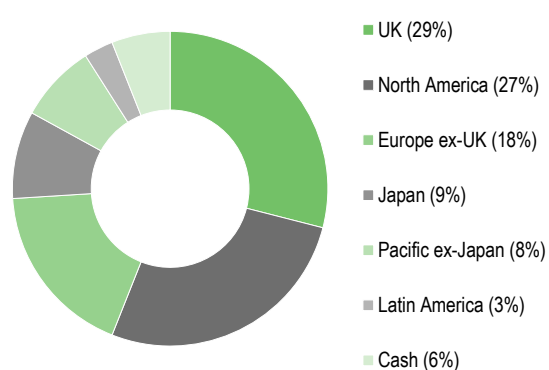


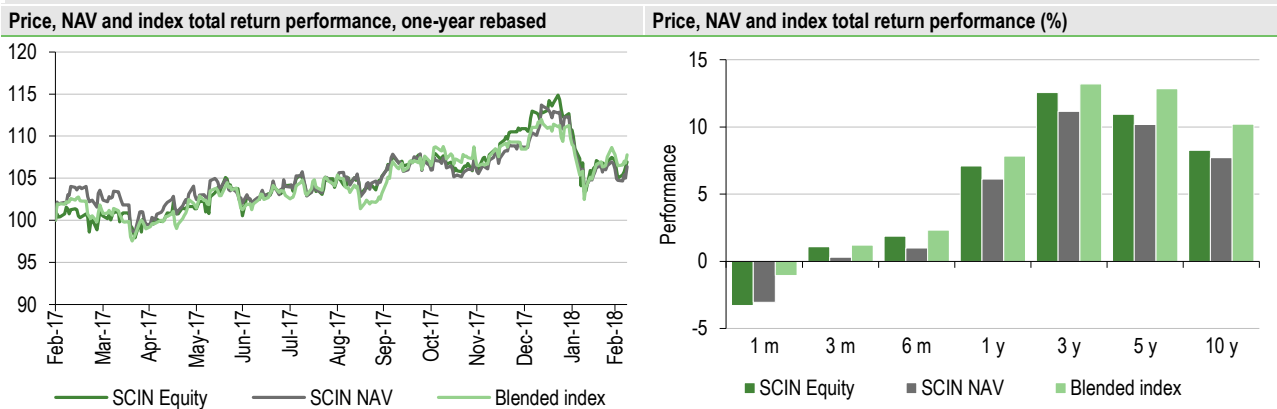
Exhibit 4: Portfolio breakdown by geography



Source: The Scottish Investment Trust, Edison Investment Research. Note: Data at 31 January 2018.

Performance: Solid medium-term performance

Exhibit 5: Investment trust performance to 28 February 2018



Source: Thomson Datastream, Edison Investment Research. Note: Three, five and 10-year performance figures annualised. Blended index is FTSE All-World index until 31 October 2016 and MSCI AC World index thereafter.

Exhibit 6: 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 MSCI AC World	(2.2)	(0.0)	(0.3)	(0.7)	(1.6)	(8.1)	(16.3)
NAV relative to MSCI AC World	(2.0)	(0.8)	(1.2)	(1.6)	(5.2)	(11.2)	(20.3)
Price relative to FTSE All-World	(2.2)	(0.1)	(0.4)	(0.7)	(1.9)	(8.4)	(17.0)
NAV relative to FTSE All-World	(2.0)	(0.9)	(1.3)	(1.6)	(5.5)	(11.5)	(21.0)
Price relative to MSCI UK All Cap	0.0	1.6	2.8	2.6	20.3	19.6	17.2
NAV relative to MSCI UK All Cap	0.3	0.8	1.9	1.7	15.9	15.6	11.6

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

SCIN has produced positive share price and NAV total return performance over all but the most recent periods shown (Exhibit 5), with the one-month numbers reflecting a sharp sell-off in world equity markets during February 2018. Over three years, covering the period for which the current investment policy has been in operation, annualised share price and NAV total returns have been 12.6% and 11.2%, respectively. While performance has lagged global indices (Exhibit 6) – reflecting the trust's contrarian investment style and avoidance of 'hot money' stocks such as the 'FAANGs' in the US and Baidu, Alibaba and Tencent in China – NAV and share price total returns have matched or beaten the return on UK equities over all periods shown, illustrating the value of taking a global approach. Contributors to performance in FY17 (to 31 October) included Rentokil Initial and Nintendo (both up c 50%), Treasury Wine Estates and Citigroup (both up c 40%). Detractors included General Electric, BT and oil services firm Baker Hughes (down c 25-35%). The impact of the 10 strongest contributors (+£70m) far outweighed the impact of the 10 largest detractors (-£27.5m), however.

Exhibit 7: NAV total return performance relative to blended index over three years

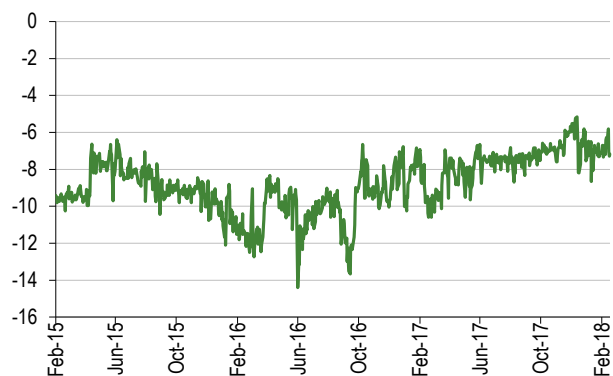


Source: Thomson Datastream, Edison Investment Research

Discount: Narrower and stabilising

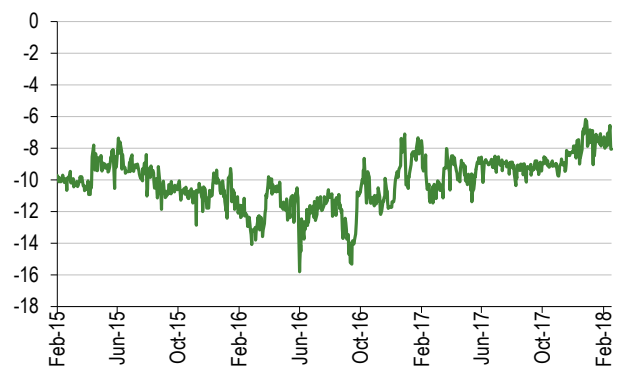
At 15 March 2018, SCIN's shares traded at a 7.9% discount to the cum-income NAV (with debt at fair value). This is narrower than the averages over one, three, five and 10 years, which range from 9.0% to 10.1%. SCIN targets a discount of 9% or less, above which it may buy back shares, and during FY17 moved the calculation basis from ex-income to cum-income NAV. In FY17, 16.9m shares were repurchased, including a large block transaction (11.5m shares) to facilitate the exit of Aviva from the share register. However, the discount has been broadly below 9% since mid-2017 and no shares have been repurchased since December.

Exhibit 8: Three-year discount to NAV (ex-fair)



Source: Thomson Datastream, Edison Investment Research

Exhibit 9: Three-year discount to NAV (cum-fair)



Source: Thomson Datastream, Edison Investment Research

Capital structure and fees

SCIN has one class of share, with 78.6m ordinary shares in issue at 13 March 2018. A buyback policy aims to keep the discount below 9.0% in normal market conditions, and 5.4m shares have been repurchased in the past 12 months. The trust is geared via a 30-year issue of secured bonds, maturing in 2030, with a coupon of 5.75%. At end-FY17, the par value of the outstanding debt was £83.7m, equating to gross gearing of 12.1% at 15 March 2018, compared with a limit of 20.0%. Net gearing was lower at 4.2% (31 January 2018). SCIN is self-managed and as such does not pay a management fee. For FY17, total expenses (including staff and directors' costs, legal, administration and professional fees) were £3.5m, equating to an ongoing charges figure of 0.49%.

Dividend policy and record

SCIN is moving to quarterly dividends, having historically paid twice a year. It has also announced a step-change in its dividend policy, increasing the regular dividend in preference to special dividends, which were paid in four of the last five years. For FY17, an interim of 5.5p and a final dividend of 14.5p were paid, making total regular dividends of 20.0p, a 48.1% increase on FY16's regular dividend of 13.5p. With a 5.0p special dividend having been paid in respect of FY17, compared with 9.0p for FY16, the increase in total dividends (25.0p versus 22.5p) was 11.1%. SCIN's board has guided that FY18 dividends will be at least equal to FY17's regular dividends of 20.0p, with three quarterly dividends of 5.0p (May, August and November) and a final dividend of at least 5.0p. Given the trust has a 34-year track record of year-on-year dividend increases and targets dividend growth ahead of UK inflation, it is reasonable to assume that total dividends for FY18 will exceed 20.0p.

SCIN has the benefit of a large revenue reserve (70.6p per share at 31 October 2017), meaning that the investment manager is not constrained by the need to achieve a certain level of income in order to fulfil the remit of dividend growth. However, regular dividends have been fully covered by

income in four of the last five years, and earnings per share have so far been higher since adopting the contrarian investment strategy, suggesting the need to dip into reserves may be limited.

Peer group comparison

SCIN is a member of the AIC's Global sector. In Exhibit 10 below we present a subset of the sector that SCIN's board and managers currently consider to be most comparable, although they do not measure performance with reference to any index or peer group. SCIN's NAV total return performance is below average over all periods shown (arguably as a result of a lack of exposure to technology, which features heavily in the top-performing funds) although its 2.4% dividend yield is the highest in the group, providing support to total returns in less favourable market conditions. Its ongoing charges are among the lowest and, like most of the peers, it does not charge a performance fee. Gearing is below average, and the discount is currently the second-widest in the group.

Exhibit 10: Selected AIC Global sector peer group as at 8 March 2018*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Ongoing charge	Perf. fee	Discount (cum-fair)	Net gearing	Dividend yield (%)
Scottish Investment Trust	648.6	2.9	33.5	54.8	124.1	0.5	No	(7.2)	103	2.4
Alliance Trust	2,525.0	8.4	44.6	72.6	145.7	0.5	No	(5.9)	102	1.8
Bankers	1,080.2	10.2	43.1	80.4	161.6	0.4	No	0.8	105	2.2
Brunner	318.5	7.6	34.8	60.7	117.4	0.7	No	(11.6)	108	2.2
Edinburgh Worldwide	397.7	29.0	60.0	110.9	209.8	0.9	No	1.1	107	0.0
Foreign & Colonial Investment Trust	3,529.6	8.3	44.7	81.7	161.6	0.5	No	(3.4)	107	1.6
Martin Currie Global Portfolio	219.0	2.2	36.9	69.8	129.5	0.7	Yes	(1.3)	100	1.8
Mid Wynd International	164.7	10.0	48.4	93.4	186.2	0.7	No	1.5	100	1.0
Monks	1,728.4	19.0	62.2	93.3	134.0	0.6	No	3.5	105	0.2
Scottish Mortgage	6,594.5	35.2	85.0	171.6	321.1	0.4	No	0.4	103	0.6
Witan	1,868.7	8.3	41.2	77.9	182.1	0.8	Yes	(2.4)	106	2.2
Peer group unweighted average	1,734.1	12.8	48.6	87.9	170.3	0.6		(2.2)	104	1.4
SCIN rank in peer group (11 trusts)	7	10	11	11	10	9		10	7	1

Source: Morningstar, Edison Investment Research. Note: *Performance to 7 March 2018. TR=total return. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

The board

SCIN has five non-executive directors. James Will joined the board in 2013 and became chairman in January 2016. Russell Napier became a director in 2009, and both Jane Lewis and Mick Brewis were appointed in December 2015. The newest director, Karyn Lamont, joined the board in October 2017. Hamish Buchan retired at the February 2018 AGM. The directors all have professional backgrounds related to financial services.

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