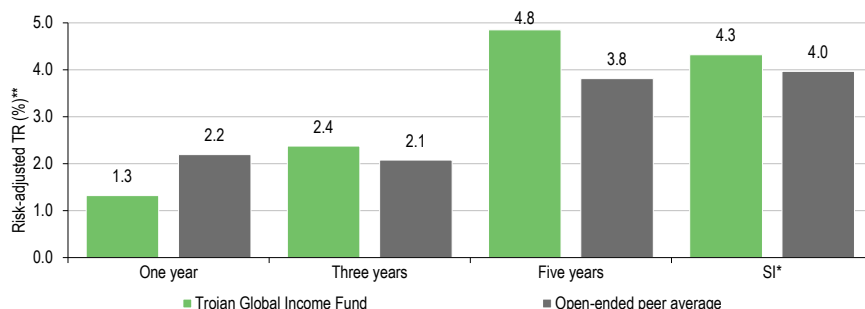


# Securities Trust of Scotland

## Compounding over time

Securities Trust of Scotland (STS) has been managed by James Harries and Tomasz Boniek of Troy Asset Management (Troy AM) since November 2020, when the board passed this mandate to Troy AM. The fund is structured and managed to produce consistent compounded returns with below average market volatility throughout the cycle. Troy AM's cautious approach has resulted in a steady mid-term performance. Since launch in November 2016, the Trojan Global Income Fund (STS's strategy, launched and run by James Harries) produced an annualised total return of c 9%, supported by a resilient income stream (2.6% yield). The chart below shows its superior risk-adjusted return since inception relative to peers.

**The Trojan Global Income Fund has outperformed peers on a risk-adjusted basis over three and five years and since launch (for details see page 5)**



Source: Morningstar, STS, Edison Investment Research. Data to end-November 2021.

Note: \*Since inception of the Trojan Global Income Fund on 1 November 2016 to 30 September 2021. STS's portfolio is almost identical to the Trojan Global Income Fund's, with the exception of two holdings. \*\*Total return divided by standard deviation.

## Why invest in STS for income and growth?

STS strives to pay dividends consistently and deliver capital growth using the same strategy as the open-ended Trojan Global Income Fund. The manager's ambition is to deliver a c 3% dividend yield and double STS investors' capital within the next 10 years. Given Harries' track record, we view this goal as achievable. The compound effect is enhanced by a relatively high income stream from investees.

## The analyst's view

Over the past 12 months to end-November 2021, STS delivered on its target to preserve and grow capital consistently, supplemented by a steady yield. Its 13.0% NAV total return (TR) was closer to the MSCI World High Yield Index (16.9%), which we perceive to be a better comparison in assessing STS's performance than the MSCI World Index (25.5%), given the fund's relatively high income. Owing to its conservative strategy, STS lagged growth-style peers, which rallied during the past 12 months (see pages 4–5). STS is trading at a 1.6% cum-fair discount, close to its three-year average discount of 2.3%. The managers' intention is to generate a strong performance for the trust to trade at a premium, issue shares and grow the size of the trust. Troy AM has succeeded in executing a similar strategy in relation to two other trusts since being appointed. It has grown shareholder funds in Personal Assets Trust from £149m in October 2008 to £1.7bn in November 2021 and in Troy Income & Growth Trust from £47m in 2009 to £253m in November 2021.

**NOT INTENDED FOR PERSONS IN THE EEA**

## Investment trusts Global equity income

13 December 2021

**Price** 227.5p

**Market cap** £226.3m

**AUM** £254.5m

NAV\* 227.8p

Discount to NAV 0.6%

NAV\*\* 230.3p

Discount to NAV 1.6%

\*Excluding income. \*\*Including income. As at 9 December 2021.

Yield 2.5%

Ordinary shares in issue 99.9m

Code STS

Primary exchange LSE

AIC sector Global Equity Income

52-week high/low\* 228.0p 185.0p

NAV\*\* high/low 230.6p 189.8p

### Gearing

Net gearing, 31 October 2021 7%

### Fund objective

Securities Trust of Scotland's investment objective is to achieve rising income and long-term capital growth through investment in a balanced portfolio constructed from global equities. Following the adoption of an unconstrained mandate from 1 June 2016, the trust measures its performance versus the Lipper Global – Global Equity Income Index.

### Bull points

- Proven top-quartile, long-term track record of Troy AM's global equity income manager; focus on sustainable income and quality capital growth.
- A discount control mechanism introduced aiming to ensure that the trust trades close to NAV.
- Almost identical portfolio to the robustly performing open-ended fund, run by Harries since launch in November 2016, with the closed-ended fund's ability to use gearing.

### Bear points

- Conservative quality approach has resulted in a bottom-half ranking within the peer group over the medium term.
- Performance has lagged peers over the past 12 months.
- Income-focused strategy might lag non-yielding growth-style funds in bull markets.

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## The manager's view and portfolio positioning

With the developed world experiencing rising inflation and questioning whether it will be long lasting, Harries and Boniek have stayed calm. Whether or not inflation persists, the managers are confident that STS's portfolio remains well positioned to deliver high single-digit to low double-digit total shareholder returns consistently throughout the cycle.

Harries explains that in the scenario of rising inflation, he believes interest rates will remain low due to high levels of government debt across developed economies. This would lead to low real interest rates and hence lower returns from high-risk assets, particularly growth equities. Noting that STS's TR consists of both income and growth elements, compounded over time, he believes that in this scenario the trust will be able to outperform the market over the short and medium terms. He compares STS to an index-linked bond and explains that in an inflationary scenario, such instruments will deliver rising and compounding returns.

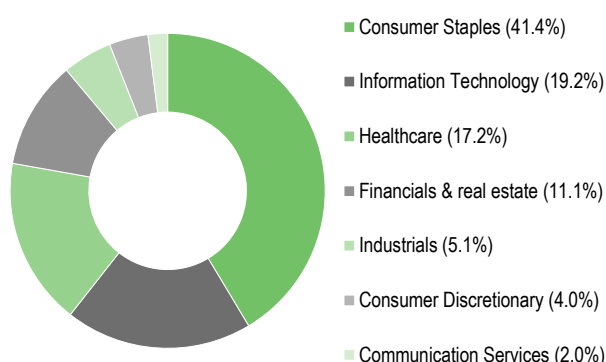
The manager highlights that inflationary effects might equally be temporary. Technological disruption, coupled with an ageing population, is likely to continue putting downward pressure on global demand, helping to stem inflation. The manager believes that STS's portfolio companies will also do well in a low interest rate and low inflation environment. Consistent and relatively high income, hard to come in this environment, will continue to flow from investees, explains Harries.

The managers also believe that in the long run, companies' sustainable cash flows and business growth will have much more of an impact on shareholder returns than either economic policies or politics. They continue to monitor the investible universe, typically consisting of companies with high resistance to macroeconomic and political shocks, such as those caused by the COVID-19 pandemic.

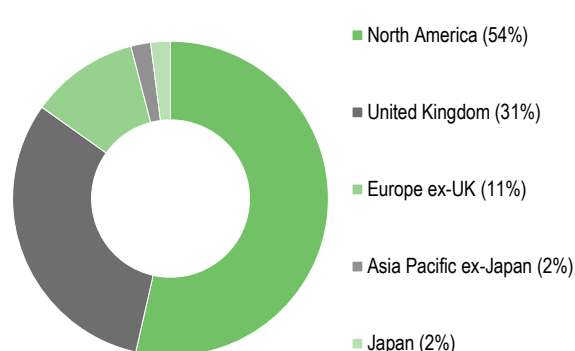
## Current portfolio positioning and activity

At 30 September 2021, the portfolio had 34 holdings (33 holdings at 31 December 2020). Exhibits 1 and 2 show STS's portfolio by sector and geography, respectively as at end-September 2021.

**Exhibit 1: Portfolio breakdown by sector**



**Exhibit 2: Portfolio by geography**



Source: STS, Troy AM, Edison Investment Research at 30 September 2021. Note: Rebased for cash.

Exhibit 1 illustrates that the portfolio continues to be focused on seven sectors – those deemed by the team to have a quality bias, with the top three being consumer staples (41.4%), information technology (19.2%) and healthcare (17.2%), similar to the portfolio at end-November 2020 of 42.0%, 18.4% and 19.5%, respectively.

Geographically, STS's portfolio has stocks in developed markets at its core (Exhibit 2), with the highest exposure to the US (54%) and Europe (including the UK: 42%). Asia Pacific ex-Japan and Japan each represent 2% of the portfolio.

Since their appointment on 12 November 2020 and restructuring the portfolio the following month (please see our [initiation note](#) for details about portfolio restructuring), Troy AM's managers have made some changes to the portfolio.

In December 2020, the team initiated a position in Fastenal (FAST US), a distributor of industrial products in the US (originally nuts and bolts, or fasteners, as they are known in the US). The managers chose it for its relatively high, consistent and dependable return on capital employed. The company achieves this high return by benefiting from economies of scale and dense distribution networks. Fastenal adapts quickly to change and provided PPE for the management of COVID-19. The company is upgrading its position in the value chain from distributor to supply chain provider.

In April 2021, the team initiated a position in Nintendo (7974 JT), the renowned Japanese developer and manufacturer of video games for indoor use. Its gaming franchises include Mario, Zelda and Pokémon. Troy believes the business is becoming more valuable, as more people experience and interact with its games. It also develops new products, including Nintendo Switch, launched four years ago. The managers believe that this development is on track to become one of the most successful consoles of all time. The team believes that a c 18x forward P/E multiple and a 3% dividend yield do not reflect Nintendo's potential or the vast intellectual property (IP) bank within the corporation, but consider it attractively valued.

The team also bought an equity stake in Chicago Mercantile Exchange (CME), perceived by the fund managers to be a structural beneficiary in the use of futures and options.

Exhibit 3 presents the top 10 holdings in STS's portfolio. The portfolio retains a defensive consumer staples and healthcare tilt, with some technology and, given the buy-and-hold long-term strategy, the changes to the top 10 since the managers took over STS's management have been relatively small. Seven of the top 10 holdings were in the portfolio in November 2020. The largest weighting change (0.9pp) was in Unilever, as its share price suffered during the COVID-19 pandemic. The team retains high conviction in the stock and it continues to feature in the top 10 holdings.

### Exhibit 3: Top 10 holdings

Company	Country	Sector	30-Sep-21	30-Nov-20	Change, pp
British American Tobacco	UK	Consumer staples	5.4	6.0	(0.6)
Paychex	US	Technology	5.3	4.6	0.7
Philip Morris International	US	Consumer staples	5.0	4.7	0.3
Unilever	Netherlands	Consumer staples	4.9	5.8	(0.9)
Automatic Data Processing	US	Technology	4.6	3.9	0.7
Reckitt Benckiser	UK	Consumer staples	4.6	4.5	0.1
CME Group	US	Financials	4.4	N/A	N/A
Diageo	UK	Consumer staples	4.3	N/A	N/A
Microsoft	US	Technology	4.3	N/A	N/A
PepsiCo	US	Consumer staples	4.3	4.5	(0.2)
Top 10			47.1		

Source: Securities Trust of Scotland, Troy AM, Edison Investment Research

The team switched Verizon Communications (VZ US), the holding inherited from the previous manager Martin Currie, into Boston Properties (BXP US) – a high-quality owner of A-grade properties in the US. The managers believe the company is discounted by the market due to concerns that office space will be used less frequently, following the pandemic and the widespread shift to remote working. Troy believes that prime US locations (on the coasts and in capital cities, where BXP's properties are) will still be in high demand.

FAST's purchase was funded by the sale in Emerson Electric (EMR US), as the team believed FAST was a better match for the portfolio. Other exits included IG Group (IGG LN), the UK's leading

spread betting platform, with a dominant market share and tight dealing spreads leading to competitive advantage. After the investee's management team allocated capital, part-funded by equity and without seeking shareholder approval, rather than using the funds to pay special dividends, Troy exited the stock in February 2021.

The trust is geared by approximately 7% (at 31 October 2021).

## ESG considerations

The managers strive to optimise the combination of value, quality and growth. In many sectors, particularly in the tobacco sector, returns are attractive and STS's top 10 portfolio holdings include world-leading tobacco companies Philip Morris International and British American Tobacco. To navigate and address ethical factors, Troy makes a distinction between ethical funds and ESG restrictions. Having no ethical restrictions, STS's portfolio seeks an optimum combination of holdings that have the potential to produce the best risk-adjusted return.

## Performance

STS's former manager, Mark Whitehead, was appointed in May 2016 and adopted the trust's current mandate on 1 June 2016 until Troy's James Harries took over in September 2020. Therefore, the most relevant performance figures to consider for the current manager are over one year and shorter periods.

We have also included the performance track record of the current fund manager, Harries, who assumed responsibility for STS on 12 November 2020. We highlight the Trojan Global Income fund, which was established in 2016 and has been managed by Harries since he assumed responsibility. Considering that the Trojan Global Income fund is an open-ended vehicle and does not employ gearing, its performance has been very robust. Exhibit 5 illustrates that STS's NAV outperformed the Trojan Global Income fund on a total return basis over one year by 0.4%, as it uses gearing, and we expect the closed-ended vehicle to outperform its open-ended sister fund with the same strategy during the rising equity market over a measured period. STS's portfolio is almost identical to Trojan Global Income Fund's, with the exception of two holdings: Domino's Pizza (not in STS) and Fever-Tree (only in STS).

**Exhibit 4: Five-year discrete performance data**

12 months ending	Total share price return (%)	Total NAV return (%)	MSCI World High Yield (%)	MSCI World (%)	Trojan Global Income O Accumulation (%)
30/11/17	12.5	14.8	12.2	16.0	9.6
30/11/18	(0.2)	0.5	4.6	4.7	8.3
30/11/19	26.4	16.8	13.3	14.6	12.8
30/11/20	2.6	3.8	(2.8)	9.8	2.2
30/11/21	12.3	11.9	16.5	27.9	11.5

Source: Refinitiv. Note: All % on a total return basis in pounds sterling.

**Exhibit 5: STS's share price and NAV total return performance, relative to indices and the open-ended fund (%)**

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price return	2.8	2.3	7.0	12.3	45.7	63.5	178.7
NAV return	0.7	1.2	7.0	13.0	36.9	57.9	5.5
Price relative to MSCI World High Yield	(1.3)	(0.3)	0.3	(3.6)	13.6	8.6	(6.5)
NAV relative to MSCI World High Yield	(3.3)	(1.3)	0.3	(3.9)	5.7	3.9	(9.7)
Price relative to MSCI World	(3.8)	(3.9)	(7.6)	(12.2)	(9.5)	(16.4)	(31.9)
NAV relative to MSCI World	(5.8)	(5.0)	(7.6)	(12.5)	(15.7)	(20.0)	(34.2)
Price relative to Trojan Global Income	0.9	0.6	(0.4)	0.7	13.3	7.1	N/A
NAV relative to Trojan Global Income	(1.2)	(0.5)	(0.3)	0.4	5.5	2.4	N/A

Source: Refinitiv, Edison Investment Research. Note: Data to 30 November 2021. Geometric calculation.

Exhibit 6 shows the AIC Global Equity Income sector, which consists of six funds. The open-ended peer group comprises 60 funds and we show their averages for comparative purposes. STS

remains one of the smallest funds among its peers, ranking fifth by fund size. The trust's performance from June 2016 to the end of November 2020 was principally down to Whitehead, Martin Currie's manager. The most relevant NAV total return performance periods to consider are one year and shorter periods. While STS lagged closed-ended peers over one year, with a NAV TR of 13% versus 19.3%, it has outperformed the peer group over the past six months (7.0% versus the 6.1% peer average, see Exhibit 6).

**Exhibit 6: AIC Global Equity Income peer group as at 30 November 2021\***

% unless stated	Market cap/ fund size £m	NAV TR 6 months	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	Discount (cum-fair)	Ongoing charge	Perf. fee	Net gearing	Dividend yield (%)
Securities Trust of Scotland	218.8	7.0	13.0	36.9	57.9	(1.6)	0.9	No	106	2.6
Henderson International Income	323.4	3.7	17.9	26.0	49.4	(8.2)	0.8	No	101	3.8
Invesco Perp Select Global Eq	61.2	8.8	27.0	40.2	61.6	(2.0)	0.8	No	110	2.9
JPMorgan Global Growth & Income	691.2	7.2	23.1	57.7	85.9	1.9	0.5	Yes	100	3.8
Murray International	1,384.6	3.6	13.4	21.4	35.6	(7.5)	0.6	No	113	5.0
Scottish American	905.1	9.5	21.6	57.6	99.0	0.5	0.7	No	110	2.4
<b>Simple average</b>	<b>597.4</b>	<b>6.1</b>	<b>19.3</b>	<b>40.0</b>	<b>64.9</b>	<b>(2.8)</b>	<b>0.7</b>		<b>107</b>	<b>3.4</b>
<b>STS rank in sector (six funds)</b>	<b>5</b>	<b>4</b>	<b>6</b>	<b>4</b>	<b>4</b>	<b>3</b>	<b>1</b>		<b>4</b>	<b>5</b>
Trojan Global Income Fund**	608.1	5.6	11.1	27.2	48.1	N/A	0.9	No	N/A	2.8
Open-ended peers simple average	360.0	16.6	16.6	30.7	49.6	N/A	N/A		N/A	3.8
Trojan GI Inc fund risk-adj. return		1.3	1.3	2.4	4.8					
Open-ended peers' risk-adj. return		2.2	2.2	2.1	3.8					

Source: Morningstar, Edison Investment Research. Note: \*Performance to 30 November 2021 based on ex-par NAV. TR = total return. Net gearing is total assets less cash and equivalents as a percentage of net assets. \*\*STS's strategy – Trojan Global Income Fund I Inc share class.

We have also shown the performance of the new fund manager, Harries, using his Trojan Global Income fund (STS's strategy). Its total return is competitive. Exhibit 6 also illustrates that the Trojan Global Income Fund's risk-adjusted returns over three and five years are superior to the open-ended peer average. STS's strategy performed very close to the average of 60 open-ended funds over three- and five-year periods in absolute terms, but with lower volatility.

STS's ongoing charge of 0.9% is closer to the high end of the group; but the new fee structure is likely to produce a lower charge going forward. There is no performance fee. The trust trades at a small discount to cum-fair NAV, ranking third on the date shown. The newly introduced discount control mechanism is likely to keep the share price at around the NAV level. STS ranks fourth on gearing and fifth in terms of dividend yield (2.6%).

## Valuation: Discount stabilised, trading close to NAV

STS is currently trading at a 1.6% discount to cum-income NAV. As shown in Exhibit 7, the trust has consistently traded around NAV. The average discounts over the past one and three years are 1.3% and 2.3%, respectively. The discount has been widening from June 2020 following the news that former Martin Currie manager, Mark Whitehead, had resigned, to September 2020, when the market received the announcement about Troy AM's appointment positively (see our [initiation note](#) for details). Between mid-September 2020 and start of October 2021, the discount has narrowed significantly and since then to date it has been trading around NAV.

At the time of the handover to Troy AM from Martin Currie in Q420 (see our [initiation note](#) for details), STS's board introduced a discount control mechanism aimed at maintaining the share price at around NAV. It has the authority (renewable annually) to repurchase up to 14.99% of issued capital and to allot up to 5% to help manage supply and demand for STS shares. During FY21, STS bought back 2.9m shares for a total cost of £6.0m (FY20: 0.4m at a cost of £0.8m). During FY22 to end-November, it repurchased 2.5m shares for a total consideration of £5.1m.

The board also intends to sustain the marketing initiatives to promote the trust.

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



Source: Refinitiv, Edison Investment Research

## Dividend policy and record

The investment philosophy of STS's management team is to find good-quality companies that offer both capital growth and an attractive dividend yield over the long term. The board reset the dividend for FY21 to 31 March to a level of at least 5.5p per share, which was deemed to be more sustainable, and the company distributed 5.7p per share (6.41p per share paid in FY20). Dividends are paid quarterly.

On 6 October 2021, the company announced its first interim dividend for FY22 to 31 March of 1.375p per share (1.375p per share for the corresponding quarter in FY21). While the board has not yet provided a target for the FY22 dividend, it anticipates steady growth in dividends from the revised level, thus employing a progressive dividend policy.

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