EDISON

The Scottish Investment Trust

Greater conviction for global contrarian

Investment trusts

The Scottish Investment Trust (SCIN) invests globally, with the aim of achieving capital appreciation and above-inflation dividend growth. A self-managed trust with a 130-year history, SCIN follows a contrarian investment style, with a high conviction portfolio of 50-100 stocks drawn from three categories: 'ugly ducklings', 'change is afoot' and 'more to come'. The four-strong management team, led by Alasdair McKinnon, uses behavioural finance techniques to exploit the tendency of investors to 'follow the crowd'. By focusing on stocks that are very unloved, those with operational improvements that have been overlooked, and more popular stocks that can continue to do better, they build in a margin of safety. There is an active discount management programme and the trust has recently announced a move to quarterly dividends from FY18.

12 months ending	Share price (%)	NAV (%)	Blended index* (%)	MSCI AC World (%)	MSCI UK All-Cap (%)	FTSE All-World (%)
30/06/13	25.1	25.1	21.4	21.2	17.4	21.4
30/06/14	8.1	7.1	9.6	9.6	13.0	9.6
30/06/15	9.9	6.1	10.2	10.1	1.8	10.2
30/06/16	1.1	8.7	14.0	13.9	2.2	14.0
30/06/17	30.5	24.1	22.9	22.9	17.8	23.0

Source: Thomson Datastream. Note: All % on a total return basis in GBP. *Blended index is FTSE All-World Index until 31 October 2016 and MSCI All-Country World Index thereafter.

Investment strategy: From ugly ducklings to swans

SCIN's management team first evaluate sentiment and capital cycles to determine whether they favour a contrarian investment in a stock, and then undertake valuation work to analyse factors such as the drivers of the business, the yield and sustainability of the dividend, P/E ratio and cyclical earnings position. They are prepared to be patient, long-term investors in unloved stocks that it may take time for the market to re-evaluate. Recently there has been a move to a shorter stock list of 50-100 stocks (previously 70-120), to ensure that only 'best ideas' are represented.

Market outlook: Value may exist on a selective basis

Global stock markets have continued to perform strongly in spite of the increasing signs of an end to extraordinary monetary policy and the consequent likelihood of a normalisation of bond yields. With aggregate forward P/E valuations in all major regions above 10-year averages, the risks at an index level are arguably to the downside in the near term. Against such a backdrop, investors may favour a more selective approach to finding value in individual companies.

Valuation: Discount broadly stable

At 21 July 2017, SCIN's shares traded at a 9.0% discount to cum-income NAV. This is narrower than both short- and longer-term averages of c 10%. Downside from this level is limited by an active buyback policy targeting a maximum discount of 9% in normal market conditions. During the year there was a large buyback from Aviva; this has further orientated the share register in favour of private and discretionary investors, which may be a more stable source of demand. SCIN currently yields 2.8% (1.7% excluding special dividends).

26 July 2017

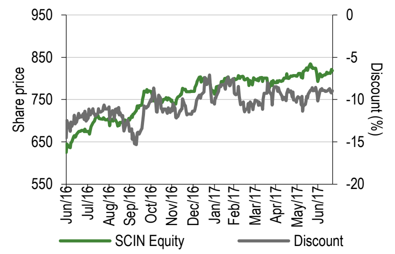
Price	**818.5p**
Market cap	**£673.8m**
AUM	**£854.9m**

NAV*	899.2p
Discount to NAV	9.0%
NAV**	885.4p
Discount to NAV	7.6%

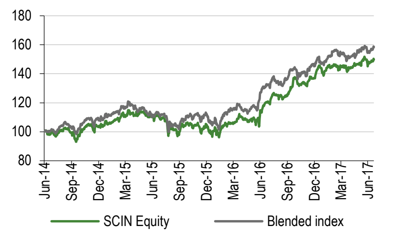
*Including income. **Excluding income. Data at 21 July 2017.

Total dividend yield	2.8%
Ordinary shares in issue	82.3m
Code	SCIN
Primary exchange	LSE
AIC sector	Global

Share price/discount performance



Three-year performance vs index



52-week high/low	834.5p	668.0p
NAV* high/low	917.0p	755.5p

*Including income.

Gearing

Gross*	11.1%
Net*	5.8%

*As at 30 June 2017.

Analysts

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Edison profile page

The Scottish Investment Trust is a research client of Edison Investment Research Limited

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. Assets are primarily allocated on the basis of the investment merits of individual stocks rather than those of regions, sectors or themes.

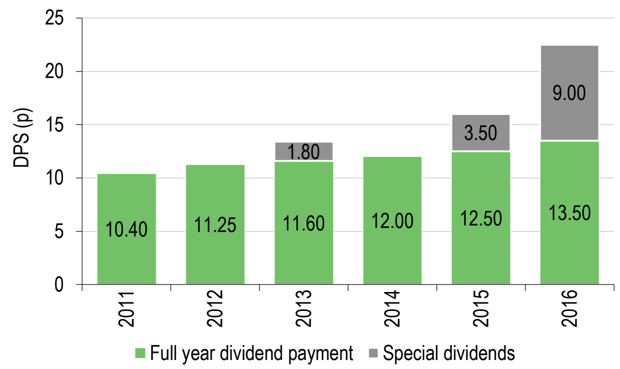
Recent developments

- 19 June 2017: Half-year report for the six months ended 30 April. NAV total return 3.0% and share price total return 5.0% versus 5.5% for the MSCI AC World Index and 7.0% for the MSCI UK All-Cap Index. Interim dividend increased by 4.8% and announcement of move to quarterly dividends from FY18.
- 8 March 2017: Repurchase of 11.4m shares from Friends Life (the Aviva shares).
- 3 February 2017: All resolutions passed at AGM.

Forthcoming		Capital structure		Fund details	
AGM	February 2018	Ongoing charges	0.49%	Group	SIT Savings Ltd (AIFM)
Annual results	December 2017	Net gearing	5.8%	Manager	Alasdair McKinnon
Year end	31 October	Annual mgmt fee	N/A (self-managed)	Address	6 Albyn Place,
Dividend paid	Quarterly from FY18	Performance fee	N/A (self-managed)		Edinburgh, EH2 4NL
Launch date	July 1887	Trust life	Indefinite	Phone	+44 (0) 131 225 7781
Continuation vote	No	Loan facilities	£83.7m (see page 7)	Website	www.thescottish.co.uk

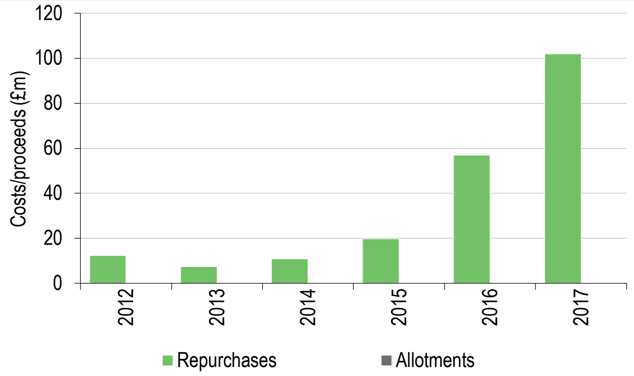
Dividend policy and history (financial years)

Dividends are paid twice a year in February and July and a special dividend may be paid alongside the final dividend. SCIN has grown its dividend every year since 1983. From FY18, dividends will be paid quarterly.

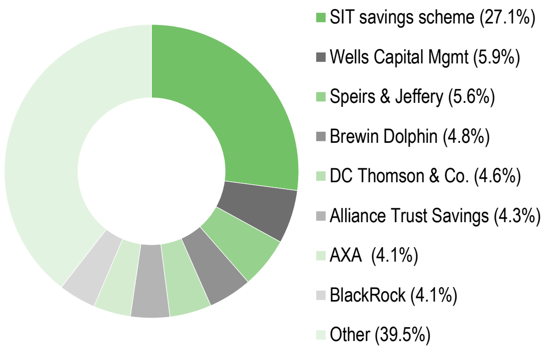


Share buyback policy and history (calendar years)

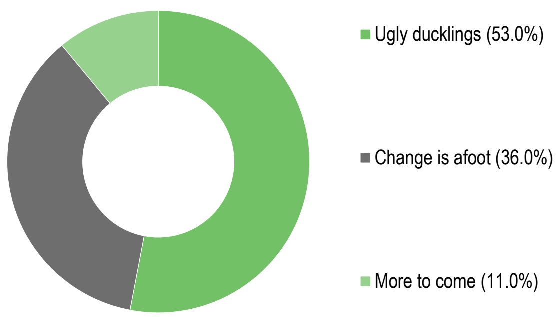
SCIN has the authority to buy back up to 14.99% of shares annually, and targets a maximum discount (based on cum-income NAV with borrowings at market value) of 9%. Buyback figures for 2017 below include the repurchase of the Aviva shares.



Shareholder base (as at 17 May 2017)



Portfolio exposure by category (as at 30 June 2017)



Top 10 holdings (as at 30 June 2017)

			Portfolio weight %	
Company	**Country**	**Sector**	**30 June 2017**	**30 June 2016***
Treasury Wine Estates	Australia	Consumer staples	5.7	3.7
Rentokil Initial	UK	Industrials	4.3	3
Sands China	Hong Kong	Consumer discretionary	3.9	2.8
Nintendo	Japan	Technology	3.8	N/A
Standard Chartered	UK	Financials	3.4	2.1
ING	Netherlands	Financials	3.3	N/A
GlaxoSmithKline	UK	Healthcare	3.3	3.5
Marks & Spencer	UK	Consumer discretionary	2.9	N/A
Tesco	UK	Consumer staples	2.6	N/A
Sumitomo Mitsui Financial	Japan	Financials	2.6	N/A
Top 10			**35.8**	**28.8**

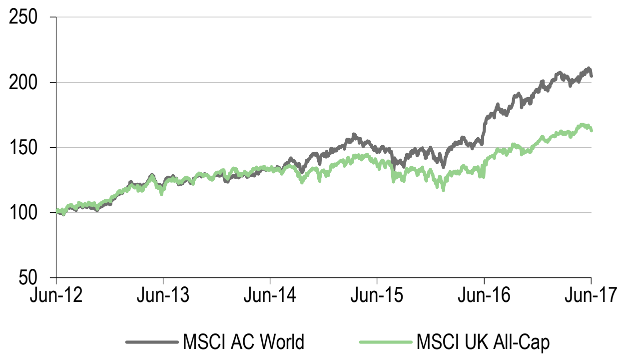
Source: The Scottish Investment Trust, Edison Investment Research, Bloomberg, Morningstar. Note: *N/A where not in June 2016 top 10.

Market outlook: Balance of risks favours selective view

In spite of the growing consensus towards the end of extraordinary monetary policy in the US, UK and Europe, world stock markets have continued to perform strongly (Exhibit 2, left-hand chart), with a divergence between the UK and the rest of the world since the EU referendum in June 2016 helped by the boost to overseas asset values from the weakness of sterling. Forward P/E valuations in all major regions are now above 10-year averages (right-hand table), although they are less extended in Japan and Asia. Dividend yields remain attractive relative to cash and bonds, although any significant increase in bond yields could dampen investor enthusiasm for risk assets. With the risks arguably to the downside, investors may prefer an approach that focuses on finding under-appreciated value rather than following indices that may be vulnerable to a correction.

Exhibit 2: Market performance and valuation

World versus UK index performance over five years



Valuation metrics (Datastream indices)

	Forward P/E (x)	% of 10-year average	Price/book (x)	Dividend yield (%)
World	15.5	119	2.1	2.4
UK	14.3	119	1.7	3.6
US	18.0	124	3.2	2.0
Europe	14.3	123	1.7	2.9
Japan	14.9	103	1.4	1.9
Asia ex-Japan	13.1	107	1.7	2.5

Source: Thomson Datastream, Edison Investment Research

Fund profile: Global contrarian for growth and income

The Scottish Investment Trust (SCIN) is one of the longest-established investment trusts, launched in 1887 and celebrating its 130th anniversary this year. It remains based in Edinburgh and is self-managed. In the last three years the trust has streamlined its operations, outsourcing the majority of its administrative functions and reducing its investment team to four members, who have revamped the investment process to take a high-conviction, contrarian approach to global equity investment. The trust aims to achieve capital appreciation and above-inflation dividend growth.

Because of the unconstrained and contrarian nature of the management style, the trust does not have a formal benchmark. However, in order to provide context to performance, SCIN uses the MSCI AC World and MSCI UK All-Cap indices (previously the FTSE All-World and FTSE All-Share) in communications with shareholders. Gearing is permitted up to 20% and the trust has an active discount management policy.

The fund manager: Alasdair McKinnon

The manager's view: Find hidden gems with a margin of safety

Fund Manager Alasdair McKinnon explains SCIN's contrarian approach as taking advantage of the opportunities that arise from the 'crowd mentality' of many investors: "When things are going well in the markets, you get commentary telling people they must be involved, and vice-versa when things are going badly. People often end up buying at the top and selling at the bottom. We think our job is to avoid that mistake – to take a lateral thinking approach and analyse stocks on a more realistic way of thinking." A key part of this is to take as little notice as possible of index weightings; "if you start comparing to anything, it can influence how you think and behave," says McKinnon. He points out that the increased prevalence of passive investment strategies can provide great opportunities for contrarian or value-biased active managers, with passive money flowing in and out of baskets of stocks based on factors such as how the Brexit negotiations are deemed to be proceeding, and comparatively little effort being made to unearth hidden gems. Furthermore, the focus on out-of-favour stocks with good dividends or strong cash flows means there should be an element of downside protection in any wider market setback, as the most heavily backed stocks are likely to be hit harder when sentiment turns negative.

Asset allocation

Investment process: Avoiding the madness of crowds

SCIN follows a high-conviction, 'global contrarian' investment approach. Fund Manager Alasdair McKinnon, who is supported by Deputy Manager Martin Robertson and investment managers Sarah Monaco and Mark Dobbie, explains that the approach is informed by behavioural finance techniques, and specifically tries to spot investment opportunities that arise as a result of the human desire to be part of a crowd. This instinct has its roots in prehistory, where people's safety and survival may have depended on sticking together and following rules and norms. However, McKinnon points out that it can often be observed in equity markets, where 'herding' behaviour causes investors to continue to back popular stocks long past the point where future returns are limited, and to shun those that have done poorly, even when the seeds of improvement may already have been sown. The core of the SCIN process is, essentially, to do the opposite, which can lead to superior returns through buying unloved stocks with recovery potential at low valuations. The process is necessarily index-agnostic, given that index weightings reflect past performance rather than future prospects. Stocks are initially assessed based on their position in sentiment and capital cycles; where the entry point is judged to be favourable, the team undertakes valuation work to analyse the drivers of the business, the yield and sustainability of the dividend, P/E ratio and cyclical earnings position.

McKinnon splits the portfolio into three categories of company:

- **Ugly ducklings** (53% of the portfolio at 30 June 2017). These are companies where operating performance is challenged and market sentiment is pessimistic, leading to low share valuations. Because such companies are shunned by the majority of investors, even good news from an operating perspective may not be rewarded by a rerating. However, when sentiment does pick up and the market catches on to the improvement, share price gains may be significant. Given the uncertain timeframe, the SCIN team is prepared to hold such stocks for the long term, although they may be sold if there is little sign of the investment thesis playing out as expected. Examples of 'ugly duckling' stocks currently in the SCIN portfolio include Marks & Spencer, where successive management changes and initiatives have so far failed to halt the decline in its womenswear business. However, McKinnon points out that new CEO Steve Rowe and incoming Chairman Archie Norman are both experienced retailers, who may have more success in effecting a turnaround that builds on the buoyant food business, at the same time as refocusing the store portfolio to provide a better shopping experience in non-food. Although M&S has suffered several false dawns in recovery terms and there is no guarantee that the new initiatives will succeed, a 6% dividend yield means the manager is getting 'paid to wait' until the situation becomes clearer, which could then prompt a market reassessment of the stock and consequent share price rises.
- **'Change is afoot'** (36% of the portfolio at 30 June 2017). These are stocks where operating improvements have been largely overlooked and investors are still reluctant to take a more positive view. In many cases, such stocks will have entered the portfolio as 'ugly ducklings' (Treasury Wine Estates, the largest holding, is an example of this). McKinnon uses the

example of Nintendo, which had been marked down as a result of a prevailing view that smartphones, rather than specialist handheld or console devices, were the future of gaming. Nintendo had had difficulty in monetising its intellectual property, and its smartphone games had been seen as mediocre. The release of Pokémon Go (ironically not a Nintendo product) re-energised the brand, and the new Switch console, which bridges the gap between handheld and console-based gaming, has exceeded the company's demand expectations, which may have been low following the disappointing performance of its last console, the Wii U. McKinnon points out that in addition to the improved operating performance, Nintendo also has net cash on its balance sheet and is an interesting and potentially very valuable business, in spite of low market expectations.

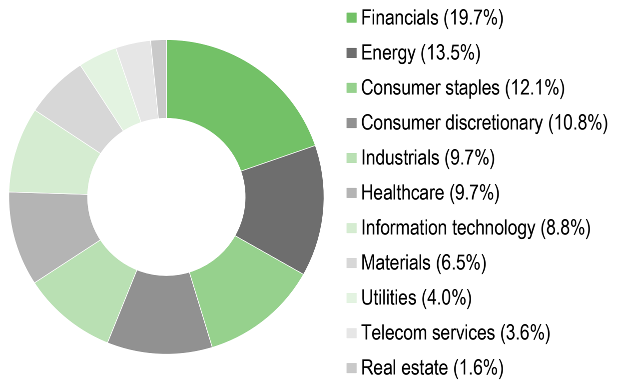
- 'More to come' (11% of the portfolio at 30 June 2017). A smaller part of the portfolio, these are stocks where market sentiment is favourable but future operating prospects are still under-appreciated. An example is PepsiCo, where pressure on the sugary drinks business is offset by good performance in snacks, where brands include Walker's and Doritos. Pressure from an activist investor to split the business in two was resisted by the company, but cost cuts achieved as a result have fed into solid top-line performance, and the stock has a decent dividend yield. Stocks in this category are most likely to be sold as already positive sentiment becomes a consensus view that the good times will roll on forever. Recently the manager has reduced the holding in Microsoft, as well as selling out of US cable and broadband operator Comcast.

Current portfolio positioning

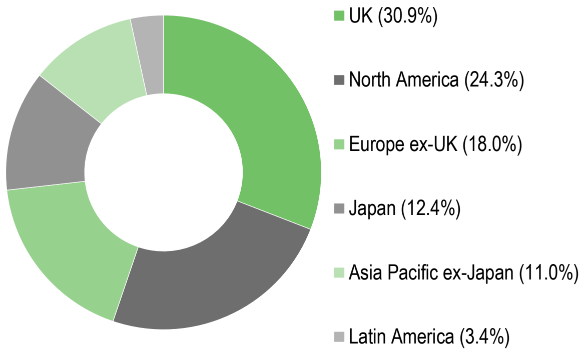
At 30 June 2017, SCIN had 54 holdings. This is a significant drop compared with 69 a year previously, and reflects a fall in the typical number of stocks from 70-120 to 50-100, underscoring the higher-conviction approach. This has resulted in a temporary increase in the normally low level of turnover. The team used the Aviva transaction (for which it was necessary to raise funds in order to repurchase shares) as a means of increasing portfolio concentration, selling out of holdings where the level of conviction was lower, rather than reducing holdings across the portfolio. As shown in Exhibit 3, the largest sector weightings are in financials (where many 'ugly duckling' banks have performed well), energy and consumer sectors. Both sector and geographical weightings reflect bottom-up stock selection rather than top-down allocation. The low weighting in the US compared with most global indices reflects the generally high level of valuations across the market, while the UK has proved a better source of out-of-favour stocks. Geographical weightings are broadly stable compared with 12 months previously.

Exhibit 3: Portfolio analysis

Sector breakdown at 30 June 2017



Geographical breakdown at 30 June 2017

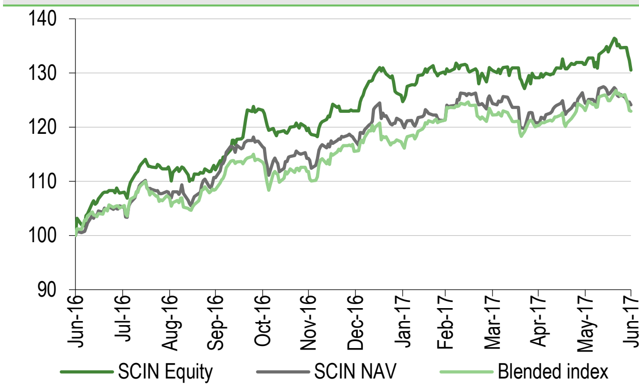


Source: The Scottish Investment Trust, Edison Investment Research

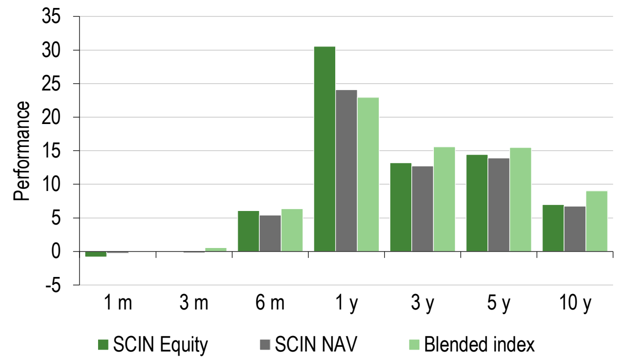
Performance: Strong medium-term absolute record

Exhibit 4: Investment trust performance to 30 June 2017

Price, NAV and benchmark total return performance, one-year rebased



Price, NAV and benchmark total return performance (%)



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 the MSCI All-Country World Index thereafter.

SCIN has produced strong absolute returns, with 12-month share price and NAV total returns of 30.5% and 24.1%, respectively, and annualised total returns of c 12-15% over three and five years (Exhibit 4). The share price has also outperformed world equity indices over the past 12 months, although the manager is keen to stress that the portfolio is run without reference to benchmarks, as this tends to skew investors towards targeting relative rather than absolute performance. Contributors to recent performance include 'ugly ducklings' from within the banking sector, which saw a rerating following the election of President Trump, and a variety of holdings in the 'change is afoot' category, including largest holding Treasury Wine Estates, Rentokil Initial and Citizens Financial. Within the 'more to come' group, Microsoft and Comcast (the latter no longer in the portfolio) did well in H117.

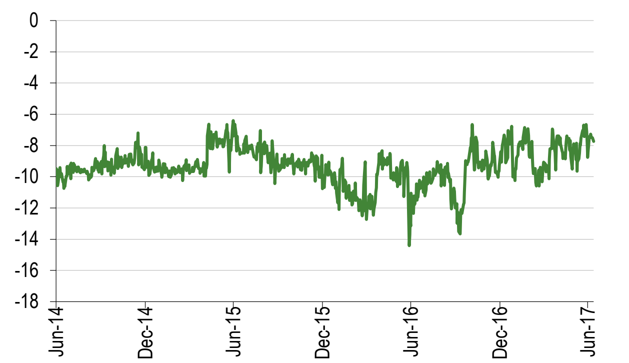
Exhibit 5: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years*
Price relative to MSCI AC World	(0.7)	(0.5)	(0.3)	6.2	(5.8)	(4.1)	(16.2)
NAV relative to MSCI AC World	(0.1)	(0.7)	(0.9)	1.0	(7.1)	(6.3)	(18.2)
Price relative to MSCI UK All-Cap	1.8	(1.2)	0.7	10.9	18.4	20.6	N/A
NAV relative to MSCI UK All-Cap	2.4	(1.4)	0.1	5.4	16.8	17.9	N/A
Price relative to FTSE All-World	(0.6)	(0.4)	(0.2)	6.2	(6.0)	(4.5)	(17.2)
NAV relative to FTSE All-World	(0.1)	(0.7)	(0.8)	0.9	(7.3)	(6.7)	(19.1)

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-June 2017. Geometric calculation. *N/A where data is not available – MSCI UK All-Cap Index began on 30 November 2007.

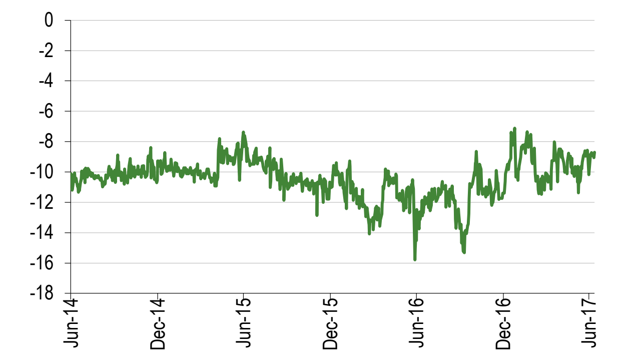
Discount: Back within longer-term range

Exhibit 6: Three-year discount to NAV (ex-fair)



Source: Thomson Datastream, Edison Investment Research

Exhibit 7: Three-year discount to NAV (cum-fair)



Source: Thomson Datastream, Edison Investment Research

At 21 July 2017, SCIN's shares traded at a 9.0% discount to cum-income NAV and a 7.6% discount to ex-income NAV (both with debt at fair or market value). This is narrower than both short- and longer-term averages. Under the trust's discount control policy, shares may be bought back if the discount exceeds 9%; the presence of this cushion has maintained the discount within a narrow band, and average figures range from 10.6% over one year to 9.9% over 10 years. Excluding the Aviva transaction (see below), c 6m shares have been bought back in the past 12 months.

In common with most investment trusts, SCIN's discount widened immediately after the UK's EU referendum in June 2016, and again just before the US election in November (Exhibits 6 and 7). Since then, the discount has returned to its longer-term range.

Capital structure and fees

A conventional investment trust, SCIN has a single share class, with 82.3m ordinary shares in issue at 21 July 2017. A discount control policy sanctions the use of share buybacks (up to 14.99% pa) to maintain the discount at or below 9% in normal market conditions. During FY17, the calculation basis for the purposes of this target has been changed from the ex-income to the cum-income NAV with borrowings at fair or market value. The number of shares in issue reduced by 18% over the 12 months to 30 June 2017, partly as a result of the discount management programme, but mainly because of a special transaction to facilitate the exit from the share register of Aviva, which owned a 12% stake in SCIN as a result of its acquisition of Friends Life. SCIN uses gearing via a 30-year issue of secured bonds, arranged in 2000 with a coupon of 5.75%, as well as £2m of perpetual debenture stock. Some of the original £150m bond issue has been paid back, and £83.7m of debt (based on par values) was outstanding at end-H117, representing gross gearing of c 11%. Net gearing was 5.8% at 30 June 2017 versus a maximum permitted level of 20%.

As a self-managed investment trust, SCIN does not pay a management fee, and there is also no performance fee. For FY16, total expenses (including staff costs, administration, legal and professional fees) were £4.1m, equating to an ongoing charges figure of 0.49%.

Dividend policy and record

SCIN currently pays dividends twice a year, in July and February. However, in view of investor appetite for a more regular income, quarterly dividends will be paid from FY18. Part of SCIN's investment objective is to achieve dividend growth ahead of UK inflation. The trust has grown its annual dividend each year since 1983, a record bettered by only 13 other investment companies, and long-term dividend growth is also well ahead of UK inflation. The board aims to grow the regular dividend in a steady manner; as such, in years when portfolio income is high, a special dividend may be paid (as it has been in three out of the last four financial years). A large revenue reserve – in excess of four years of the FY16 regular dividend at end-H117 – gives the board the flexibility to continue to grow the regular dividend if portfolio income is lower. So far in FY17, an interim dividend of 5.5p has been declared, a 4.8% increase on the H116 interim. For FY16, an annual dividend of 13.5p (5.25p interim plus 8.25p final) was augmented by a 9.0p special dividend. Based on dividends for the last 12 months and the current share price, SCIN has a dividend yield of 1.7% excluding or 2.8% including the special dividend.

Peer group comparison

SCIN sits in the AIC's Global sector, which contains many of the largest and longest-established investment trusts. Below in Exhibit 8, we show a subset of the 23-strong peer group that SCIN's board and managers currently consider to be most comparable. However, it is important to underline that SCIN does not measure its performance with reference to any index or peer group. In NAV total return terms, SCIN ranks towards the lower end of the peer group over one, three, five and 10 years, although the impact of overhauling the investment approach may be becoming evident in the shorter-term figures, which are closer to the peer group unweighted average (weighted averages are skewed by the strong performance of the giant £5.6bn Scottish Mortgage trust). The peers differ widely in focus, and SCIN has the third-highest UK weighting and the lowest US weighting in the group, which will have had an impact on relative returns against a backdrop of weak sterling and strong US market performance. Ongoing charges are competitive (among the lowest in the investment trust universe, not just within this peer group), and SCIN does not charge a performance fee. Gearing is broadly in line with the average, while the discount is towards the wider end. SCIN's dividend yield (based on FY16 dividends, including special dividend) is the highest in the group; excluding the special dividend, the yield of 1.7% is still above average.

Exhibit 8: Selected AIC Global sector peer group as at 24 July 2017*

% 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	**671.4**	**20.2**	**49.3**	**87.4**	**100.3**	**0.5**	**No**	**(8.6)**	**106**	**2.7**
Alliance Trust	2,515.8	24.6	60.7	99.6	111.9	0.5	No	(5.7)	104	1.8
Bankers	996.8	25.5	57.7	108.9	123.1	0.5	No	(3.3)	102	2.1
Brunner	314.6	21.9	41.2	88.6	89.8	0.8	Yes	(8.9)	106	2.2
Edinburgh Worldwide	307.3	29.5	72.8	125.0	150.1	0.9	No	(7.2)	105	0.0
Foreign & Colonial Investment Trust	3,258.7	23.6	62.1	111.6	130.8	0.5	No	(6.9)	106	1.7
Martin Currie Global Portfolio	221.0	18.6	53.3	93.8	115.7	0.7	Yes	(1.0)	100	1.8
Mid Wynd International Investment	146.2	20.5	70.5	112.3	161.7	0.8	No	(0.8)	100	1.0
Monks	1,508.4	33.8	69.7	105.1	113.1	0.6	No	(0.6)	106	0.2
Scottish Mortgage	5,655.8	39.0	91.4	202.0	239.1	0.4	No	0.9	107	0.7
Witan	1,828.3	24.5	57.4	121.8	143.2	0.8	Yes	(2.4)	111	1.9
Peer group unweighted average	**1,584.0**	**25.6**	**62.4**	**114.2**	**134.4**	**0.6**		**(4.1)**	**105**	**1.5**
SCIN rank in peer group	**7**	**10**	**10**	**11**	**10**	**10**		**10**	**3**	**1**

Source: Morningstar, Edison Investment Research. Note: *Performance data to 21 July 2017. TR=total return. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

The board

There are six non-executive directors on the board of SCIN. Chairman James Will has been a director since 2013 and has been in his current role since January 2016. Hamish Buchan joined the board in 2003 and will retire at the 2018 AGM. Russell Napier was appointed in 2009 and Ian Hunter, chairman of the audit committee, became a director in 2014. The newest directors, Jane Lewis (chairman of the remuneration committee) and Mick Brewis, joined the board in December 2015. The directors have backgrounds in stockbroking, investment management, accountancy and law, and most have professional experience in the investment company sector.

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