

# The Scottish Investment Trust

## Contrarian approach begins to reap rewards

The Scottish Investment Trust (SCIN), founded in 1887, is a self-managed global equity investment trust. It has recently taken steps to modernise and streamline its operations, and in October 2015 put in place a focused, contrarian investment process under a new management team. It aims to exploit the behavioural biases of market participants by identifying three types of company: the very out-of-favour; those where improvements have not been appreciated by the consensus; and good companies that could still do better. Recent performance has been strong, but the discount remains wider than average, perhaps reflecting a lack of awareness of the process and team changes. In H215 the trust repaid some of its long-term borrowings, further reducing costs; it now has one of the lowest expense ratios in its peer group, as well as a 34-year track record of dividend growth.

12 months ending	Share price (%)	NAV (%)	FTSE All-World (%)	FTSE All-Share (%)	MSCI World (%)
31/10/12	8.4	9.2	9.4	9.8	10.3
31/10/13	28.7	23.8	24.3	22.8	26.8
31/10/14	1.4	1.8	8.8	1.0	9.7
31/10/15	3.7	3.3	4.2	3.0	6.0
31/10/16	30.1	29.9	30.0	12.2	28.8

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

## Investment strategy: Independent thinking

SCIN's investment team employs a range of information sources to help generate investment ideas from the global universe of stocks, but the central part of the process is an assessment of cycles of earnings, capital deployment and market sentiment. The team seeks out-of-favour companies, those where improvements are underrated by the consensus, and well-liked stocks that still have further upside potential. The portfolio is constructed without reference to any index; the current bias towards the UK is predicated on attractive opportunities in international firms listed in London, higher-than-average dividend yields and the weakness of sterling.

## Market outlook: Near-term uncertainty

With many global stock markets at or close to historically high levels, further price appreciation may be limited in the near term, particularly given macro uncertainty from factors such as the UK's negotiations on leaving the European Union, and the surprise outcome of the US presidential election. With valuations also looking high versus long-term averages, investors may prefer to take a more selective and non-consensus approach, focusing on less favoured stocks rather than following an index.

## Valuation: Scope for discount to narrow

At 15 November, SCIN's discount to fair value cum-income NAV was 11.0% (9.0% for fair value ex-income NAV). This is broadly in line with short- and longer-term averages and not far from the target of 9%. The discount widened in September after a period of strong NAV performance, but the share price has since caught up. Buy-backs are used to manage the discount and there is scope for it to narrow naturally if the improvement in performance under the new investment strategy is sustained.

Initiation of coverage

Investment trusts

18 November 2016

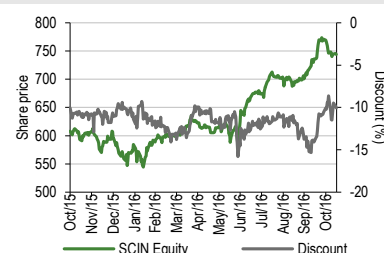
**Price** 744.0p  
**Market cap** £716.6m  
**AUM** £915.9m

NAV\* 818.0p  
Discount to NAV 9.0%  
NAV\*\* 836.4p  
Discount to NAV 11.0%

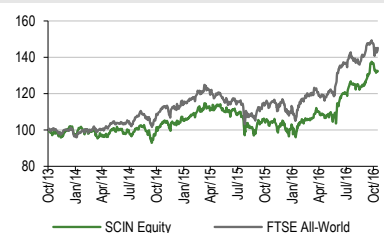
\*Excluding income. \*\*Including income. Data at 15 November 2016.

Total dividend yield 2.2%  
Ordinary shares in issue 96.3m  
Code SCIN  
Primary exchange LSE  
AIC sector Global

### Share price/discount performance



### Three-year performance vs index



52-week high/low 774.0p 544.5p  
NAV\*\* high/low 850.9p 603.3p

\*\*Excluding income.

### Gearing

Gross\* 10.6%  
Net\*\* 5.0%

\*As at 15 November/\*\*as at 30 September 2016.

### Analysts

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**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**

- 31 May 2016: Half-year results for the period ended 30 April 2016. NAV TR +4.0% (with borrowings at market value). Share price TR +4.4%. Interim dividend of 5.25p declared, up 5% on H115.
- 29 April 2016: Director Jane Lewis appointed to the board of BlackRock World Mining Trust.

**Forthcoming**

AGM	February 2017
Annual results	January 2017
Year end	31 October
Dividend paid	February, July
Launch date	November 1887
Continuation vote	No

**Capital structure**

Ongoing charges	0.52%
Gearing	5.0%
Annual mgmt fee	N/A (self-managed)
Performance fee	N/A (self-managed)
Trust life	Indefinite
Loan facilities	£104.4m (see page 10)

**Fund details**

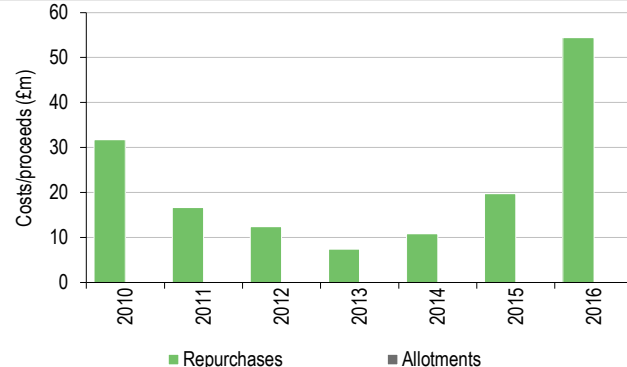
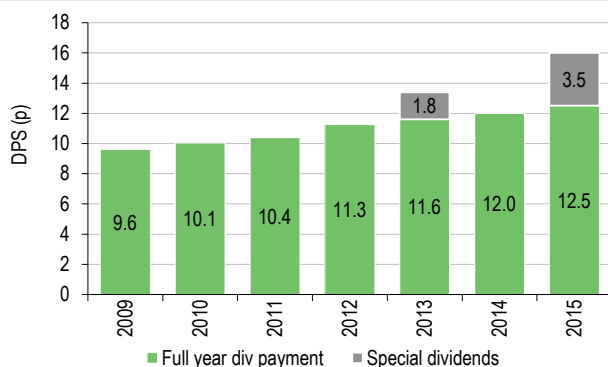
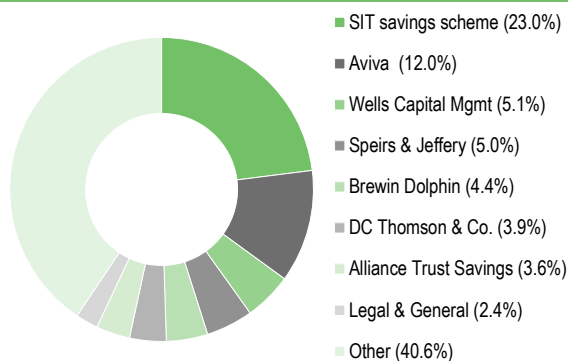
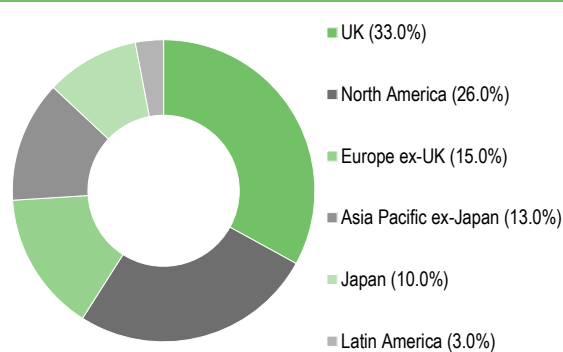
Group	SIT Savings Ltd (AIFM)
Manager	Alasdair McKinnon
Address	6 Albyn Place, Edinburgh, EH2 4NL
Phone	+44 (0) 131 225 7781
Website	<a href="http://www.sit.co.uk">www.sit.co.uk</a>

**Dividend policy and history**

Dividends are paid twice a year and a special dividend may be paid alongside the final dividend. SCIN has grown or maintained its dividend every year since 1982.

**Share buyback policy and history**

SCIN has the authority to buy back up to 14.99% of shares annually, and targets a maximum discount (based on ex-income NAV with borrowings at par value) of 9%.


**Shareholder base (as at 20 October 2016)**

**Portfolio exposure by geography (as at 30 September 2016)**

**Top 10 holdings (as at 30 September 2016)**

Company	Country	Sector	Portfolio weight %	
			30 September 2016	30 September 2015*
Treasury Wine Estates	Australia	Consumer goods	4.3	N/A
Sands China	Hong Kong	Consumer services	3.4	N/A
Severn Trent	UK	Utilities	3.3	2.4
GlaxoSmithKline	UK	Healthcare	3.3	3.3
Microsoft	US	Technology	3.3	N/A
Rentokil Initial	UK	Industrials	3.2	2.3
ING	Netherlands	Financials	2.2	N/A
Royal Dutch Shell	UK	Oil & gas	2.2	N/A
Kingfisher	UK	Consumer services	2.2	2.4
Standard Chartered	UK	Financials	2.2	1.9
<b>Top 10 (% of portfolio)</b>			<b>29.6</b>	<b>24.4</b>

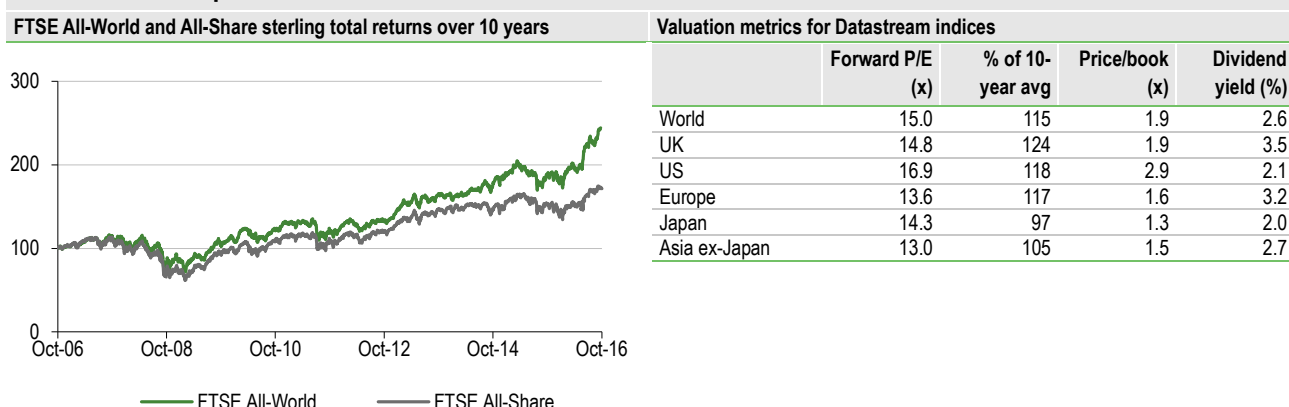
Source: Scottish Investment Trust, Edison Investment Research, Bloomberg, Morningstar. Note: \*N/A where not in September 2015 top 10.

## Market outlook: Climbing a wall of worry

So far in 2016, global stock markets have been volatile, but many indices are trading at or close to historical highs, suggesting that the protracted low interest rate environment and monetary accommodation is continuing to force investors into risk assets in order to secure a return. As shown in Exhibit 2 below (left-hand chart), total returns from the main UK and World indices over the last four years have been sufficient to make the pain of the global financial crisis look little more than a blip. UK-based investors have seen a particular boost to the value of overseas holdings owing to the weakness of sterling since the EU referendum in June.

As shown in the right-hand table, however, 12-month forward P/E valuations across most regions are well above long-term averages, with only Asia and Japan close to or below the 10-year mean. With stock markets arguably looking expensive in aggregate, investors may prefer an actively managed fund, where managers can avoid pockets of overvaluation in favour of stocks with greater recovery potential, rather than an index-tracking fund. Dividend yields in all markets remain attractive relative to cash and bonds, and could provide an important source of return in an environment where further price appreciation may be harder to achieve.

**Exhibit 2: Market performance and valuation**



Source: Thomson Datastream, Edison Investment Research. Note: Data to 31 October 2016.

## Fund profile: Venerable trust with new direction

The Scottish Investment Trust (SCIN) was established in 1887 in Edinburgh. It began with assets of £500,000 and invested in a global portfolio of bonds and shares, including significant exposure to Latin America and railway stocks. Some of the original investments will be familiar to investors today, including Standard Life and the investment trusts Scottish American and Mercantile.

Still based in Edinburgh, the trust is self-managed and also operates a savings scheme, through which its investors can hold SCIN shares in a range of wrappers including ISAs and children's savings plans. Over the last three years, the trust has streamlined its operations, cutting costs, outsourcing administrative functions and reducing the size of its investment team to four, which the manager says has facilitated the new, more focused investment approach (see page 4). SCIN's manager Alasdair McKinnon, who has been with the trust since 2003, is supported by deputy manager Martin Robertson (who joined in 2004) and investment analysts Sarah Monaco and Mark Dobbie, both of whom have worked at SCIN since 2000.

SCIN aims to achieve above-average returns by investing in an international portfolio of equities, and also aims to grow its dividend ahead of the rate of UK inflation. Dividends have been maintained or increased every year since 1982. The new investment approach, in place since

October 2015, is centred on a contrarian view, with the manager seeking to exploit the behavioural biases of investors and, to echo the words of Warren Buffett, “be greedy when others are fearful and fearful when others are greedy”. There are typically 70-120 stocks in the portfolio.

There is no formal benchmark, but the trust uses the FTSE All-World and FTSE All-Share as reference indices, and also measures its performance against a group of global peers.

## **The fund manager: Alasdair McKinnon**

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### **The manager’s view: Time to shake off post-crisis malaise**

Manager Alasdair McKinnon describes the recent changes to the SCIN team and process as a way of addressing the need for the trust to evolve for the next hundred years. Having a more focused team and a smaller cost base is seen as positive for the trust’s shareholders, both from the point of view of a reduction in ongoing charges, and the organisational benefits of having a close-knit team who understand how each stock fits into the portfolio and are focused on maximising returns.

While portfolio construction is driven by stock selection, the cycles of sentiment and capital that the manager considers when choosing stocks are influenced by the macro environment as well as company-specific factors. For the SCIN team, the biggest macro challenges centre on the global financial system and high levels of debt. McKinnon points out that since the financial crisis, accommodative monetary policy has benefited asset prices but not wages, leading to high levels of disaffection in the workforces of deindustrialised western economies, which finds expression in support for populist political movements.

The manager sees no imminent prospect of a normalisation in interest rates, given the role of debt in the global economic recovery so far; raising rates could choke off the improvement as well as cause a debt crisis, as seen in the eurozone in 2011. Any sign of weakness in the economy or stock markets tends instead to be met with further accommodation, as with the post-Brexit rate cut by the Bank of England.

McKinnon says inflation may be the key to shaking off the lingering post-crisis malaise, with the first signs of a retreat from the low-inflation mantra visible in the increased willingness of the UK, US and Japanese governments to boost the economy through fiscal rather than monetary expansion. A degree of inflation in the system would be positive for both companies and consumers, leading to higher wages and easing the burden of debt servicing.

## **Asset allocation**

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### **Investment process: Bottom-up, contrarian approach**

SCIN’s investment process has been refreshed under the new management team in place since late 2015 and the trust now follows an investment style the manager describes as ‘global contrarian investing’. Broadly, this indicates a focus on companies that have been overlooked by other investors and the investment team uses behavioural finance analysis to identify points in the cycle where market sentiment may be unduly optimistic or pessimistic. McKinnon says investors have a tendency to fall in love with companies that have done well and avoid those that have done badly; SCIN’s approach is to seek to do the opposite and buy those stocks that are out of favour but have the potential to become more loved, while selling those that have less scope to do so.

The four-strong investment team monitors the global stock universe, using inputs such as newspaper articles and broker communications, as well as meeting companies, attending conferences and simply observing the world around them. They explain that their Edinburgh base

provides a wealth of opportunities, as many company management teams visit the city but there is less competition for meetings than in London.

As SCIN is a low-turnover portfolio (c 15% year-to-date), McKinnon points out that the investment team is not seeking to identify a large number of new investment ideas at a time, although they may keep some in reserve. “The biggest cost and the reason most active managers underperform is that they trade too much,” he says, adding that fund managers tend to do better when they stick to their guns and avoid any pressure to ‘do something’.

When an interesting idea is identified, the team starts with an assessment of the stock’s position in the cycle of sentiment (from optimism to euphoria; anxiety, denial and panic to capitulation; despondency and depression to hope, relief and back to optimism). They seek to understand where other investors are in the cycle before taking a position, and will tend to avoid those companies that are universally loved, preferring to invest at the point of maximum pessimism. The team also identifies the position of a company in its capital cycle, which is a means of assessing the behaviour of management.

If the entry point is judged to be attractive, the team will undertake valuation work on the stock, identify the drivers of the business, the yield and sustainability of the dividend, P/E ratio and the cyclical earnings position. As a small team, all the members are expected to understand each of SCIN’s holdings, although one team member will take the lead for each stock or idea, undertaking the detailed modelling work. The end portfolio typically contains 70-120 stocks, although McKinnon says the preference is to keep to the lower end of the range in order that each stock can have a meaningful impact.

The investment team split the stocks they invest in into three broad categories:

- **‘Ugly ducklings’.** These are the most out-of-favour companies, where operating performance has been poor and the near-term outlook remains negative. The manager comments that this is a fertile hunting ground, particularly for larger companies, which can go dramatically out of fashion. Cyclical businesses such as oil and mining companies may be vulnerable to swings in the willingness of investors to provide capital, and also to the attitude of management, which may react to a period of rising resource prices by overspending on capital projects just as the cycle begins to turn, leading to oversupply and falling prices. The belt-tightening that follows causes production to fall, which eventually leads to rising prices and another cyclical upturn. SCIN’s manager comments that the time to invest is when investors are despondent and capitulating, and company managements are bearish. However, as the timing of an improvement in the consensus towards an out-of-favour company can be very uncertain, the investment team will seek compensation such as a high dividend yield so that they can be ‘paid to wait’ for an improvement in the share price.

Examples of ‘ugly duckling’ stocks in the portfolio include top 10 holdings GlaxoSmithKline (GSK) and Sands China. McKinnon comments that GSK has performed poorly for more than a decade, following a wave of patent expiries on its leading drugs and a lack of new blockbusters to take up the slack. Innovation cycles in pharmaceuticals can be protracted, owing to the time it takes to develop and test new treatments. However, SCIN’s manager sees potential in GSK’s pipeline, which could boost earnings from their current depressed level, and meanwhile its dividend yield of c 5% is attractive. While there was a consensus view in the market that the dividend might be under pressure, the SCIN team analysed GSK’s financial position in depth and was satisfied it could be sustained for a number of years, giving them the confidence to take a significant position in the company. GSK has performed strongly since the EU referendum (+16.5% in share price terms from 23 June to 19 October), owing to its large proportion of foreign earnings; SCIN’s manager says this illustrates how quickly sentiment towards very out-of-favour companies can turn, even in the absence of any particular operational newsflow.

Sands China operates casinos in Macau, an area that had performed very strongly until the slowdown in the Chinese economy and the government's clampdown on corruption, which has affected areas connected with what might be viewed as conspicuous consumption. In the long term, SCIN's manager views the development of Macau as a holiday destination on a par with Las Vegas as an attractive structural story, supported by infrastructure improvements such as the construction of a bridge to Macau from Hong Kong. In the meantime, Sands has a dividend yield of c 6%, which the investment team is confident can be sustained, and which may prove sufficiently attractive to the market to prompt a reassessment of the company's prospects.

- **'Change is afoot'**. These are companies where operational improvements are in evidence but investors doubt the sustainability of the recovery. Examples include largest holding Treasury Wine Estates (TWE) and top 10 stock Rentokil Initial. TWE was bought as an 'ugly duckling' stock with a c 4% dividend yield following a demerger from beer company Foster's. Australian wine had been uncompetitive in the global market because of the strength of the Australian dollar, and the consensus view was that TWE was at the mercy of cost-conscious supermarkets. Instead, the company's new management team focused on exporting to China, building its global profile, which meant it was able to negotiate with the supermarkets from a position of strength as there was consumer demand for its brands. The fall in the Australian dollar in the past couple of years has added a cyclical benefit to the structural story, and SCIN's manager says the recovery has prompted a reassessment by analysts, with around half of recommendations now being in favour of the company.

Rentokil Initial was bought in 2015 following a restructuring that saw it refocus on its core pest control business. Competitors in the US trade on much higher ratings and have followed a strategy of buying up independent businesses and consolidating them on a state-wide basis, which is something Rentokil is now doing. Filling the gaps in its network through acquisition will make the company more competitive, and should result in a rerating to a level comparable to its peers. The company had suffered from negative perceptions as a formerly high-growth stock that had expanded too aggressively into new business areas in the 1990s.

- **'More to come'**. Some holdings represent a less contrarian view, in that they are viewed favourably by a majority of investors. Where these appear in the SCIN portfolio, it may be because they have moved up through the other categories, or because the investment team feels the market is still underestimating the scale of the opportunity. Examples include top 10 holdings Microsoft and Severn Trent. With Microsoft, McKinnon argues that many investors still see it primarily as a software provider that is dependent on the PC replacement cycle. However, it is now one of the leaders in cloud technology, and investors should not underestimate how embedded it is in enterprise, with demand from business as well as personal users likely to continue to increase for its cloud-fed subscription software model through products such as Office 365.

UK water companies offer a clear, transparent and non-political regulatory model and RPI-linked dividends. Infrastructure as a whole is in favour with investors because revenues are predictable for years to come and are guaranteed by government. However, McKinnon points out that increasingly utilities are finding a home in infrastructure or private equity funds rather than as quoted entities, with only three out of the 10 originally privatised UK water companies still listed on the stock market. In time, the manager says it may be more efficient for Severn Trent and United Utilities (also in the SCIN portfolio) to be owned by a private equity or infrastructure fund, which could lead to attractive takeover premiums; in the meantime both companies have dividend yields of c 4%.

The sell discipline is the opposite of the path to buying a stock: if the earnings cycle, management and investors are all optimistic, there is little margin for error and there are likely to be better opportunities elsewhere. Holdings may also be sold on the basis of fundamental issues. Recent sales include UK housebuilder Persimmon, sold before the EU referendum because of the downside risk from a vote to leave; Danish jewellery firm Pandora, which the manager felt had

become expensive and was vulnerable to changing fashions; and Associated British Foods, which was highly priced, vulnerable to Brexit sentiment and faced a static couple of years because of heavy investment in expanding Primark into the US.

## Current portfolio positioning

At 30 September, SCIN was positioned at the lower end of its range of c 70-120 stocks. This ranks it as one of the more concentrated portfolios in its peer group of global funds. The top 10 stocks made up 29.6% of the total portfolio, which is slightly above the peer group median.

The portfolio is not constructed with reference to a benchmark in terms of either sector or country weightings, but is instead an expression of the team's best ideas globally. This is evident in the sector weightings shown in Exhibit 3, which differ widely from the FTSE All-World index weightings. Oil & gas, telecoms and utilities are notably overweight, while there are underweights in technology, financials, healthcare and consumer goods.

**Exhibit 3: Portfolio sector exposure vs FTSE All-World index (% unless stated)**

	Portfolio end- Sept 2016	Portfolio end- Sept 2015	Change (pts)	FTSE All-World index weight	Active weight vs index (pts)	Trust weight/ index weight (x)
Financials	16.0	11.0	5.0	21.2	-5.2	0.8
Industrials	13.0	6.0	7.0	12.7	0.3	1.0
Oil & gas	13.0	8.0	5.0	6.8	6.2	1.9
Consumer goods	13.0	14.0	-1.0	13.9	-0.9	0.9
Consumer services	11.0	9.0	2.0	10.8	0.2	1.0
Healthcare	9.0	13.0	-4.0	11.1	-2.1	0.8
Technology	7.0	7.0	0.0	12.0	-5.0	0.6
Utilities	6.0	6.0	0.0	3.4	2.6	1.8
Telecommunications	6.0	19.0	-13.0	3.6	2.4	1.7
Basic materials	6.0	7.0	-1.0	4.7	1.3	1.3
	<b>100.0</b>	<b>100.0</b>		<b>100.0</b>		

Source: Scottish Investment Trust, Edison Investment Research

In geographical terms, there is a bias to the UK, which makes up nearly one-third of the portfolio compared with less than 10% for most global indices. The manager points out that most of the UK holdings are international businesses where, for example, a US competitor could as easily be held, but two factors favouring an overweight UK position are the higher dividend yield and the current weakness of sterling, which benefits companies with overseas earnings. The flipside to the UK overweight is a large underweight to the US, which makes up more than half of most global indices.

**Exhibit 4: Portfolio geographic exposure vs FTSE All-World index (% unless stated)**

	Portfolio end- Sept 2016	Portfolio end- Sept 2015	Change (pts)	FTSE All-World index weight	Active weight vs index (pts)	Trust weight/ index weight (x)
UK	33.0	29.0	4.0	6.5	26.5	5.1
North America	26.0	28.0	-2.0	55.0	-29.0	0.5
Europe ex-UK	15.0	23.0	-8.0	15.3	-0.3	1.0
Asia Pacific ex-Japan	13.0	8.0	5.0	12.0	1.0	1.1
Japan	10.0	9.0	1.0	8.5	1.5	1.2
Latin America	3.0	2.0	1.0	1.3	1.7	2.2
Middle East & Africa	0.0	1.0	-1.0	1.2	-1.2	0.0
	<b>100.0</b>	<b>100.0</b>		<b>100.0</b>		

Source: Scottish Investment Trust, Edison Investment Research

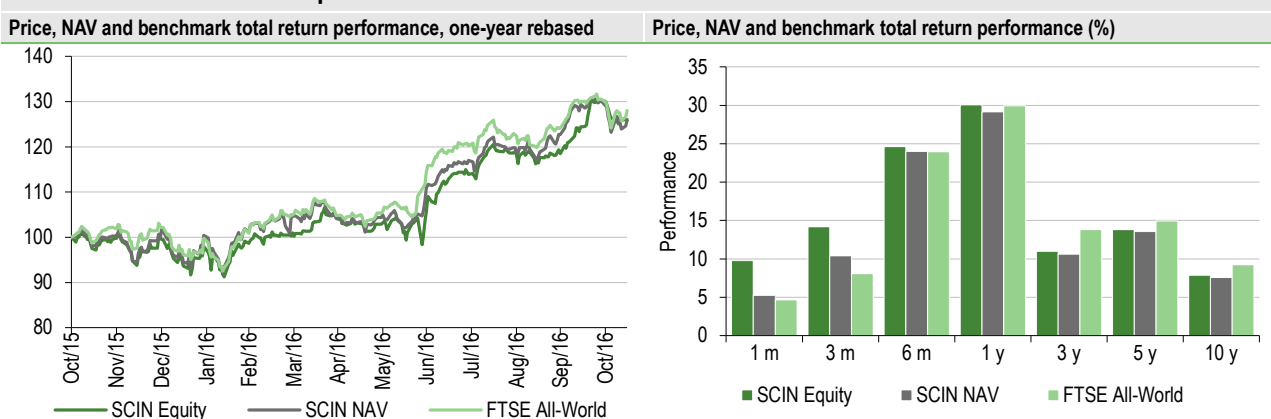
While stock selection is bottom-up, there are certain themes in the portfolio. These include e-gaming, where the team has bought Nintendo in preference to the more highly rated US competitor, Electronic Arts or graphics chip maker, NVIDIA. With the decline in mass TV and increased broadband penetration, online gaming is rising in popularity as a leisure activity, and McKinnon sees it as having the potential to be the 'next Hollywood'. Having been out of favour for many years, partly owing to a poor performance in consoles, Nintendo has performed well recently on the back of its connection with Pokémon Go, and the launch of a new Super Mario game for the iPhone underlines the value of the company's intellectual property. Nintendo is also a factor in SCIN's holding in Bank of Kyoto, part of a Japanese financials theme. The bank has a large equity

portfolio, the value of which was equal to its entire market capitalisation when SCIN bought the position, and its largest holding is a 4% stake in Nintendo. McKinnon comments that at the purchase price, “we were essentially getting the banking operations for nothing”.

Since the change in investment approach, sales include Alphabet (the parent company of Google), Apple and Amazon, as well as a number of smaller tech stocks that were plays on the Apple and Android supply chain. With smartphone penetration at high levels and new models offering only small incremental improvements, McKinnon says the boom for the sector is over, and the likely slowdown in sales could bring to light problems of overinvestment at some companies.

## Performance: Strong absolute track record

**Exhibit 5: Investment trust performance to 31 October 2016**



Source: Thomson Datastream, Edison Investment Research. Note: Three, five and 10-year performance figures annualised.

**Exhibit 6: Share price and NAV total return performance, relative to indices (%)**

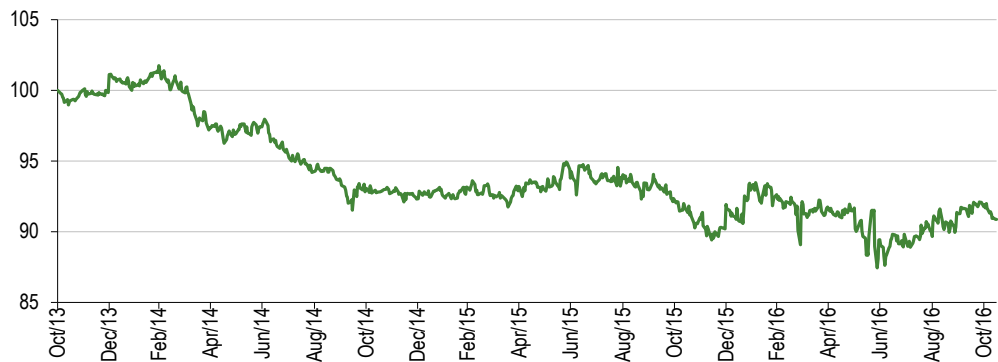
	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to FTSE All-World	4.9	5.7	0.5	0.1	(7.2)	(4.8)	(11.8)
NAV relative to FTSE All-World	0.6	2.2	0.0	(0.6)	(8.2)	(5.9)	(14.2)
Price relative to FTSE All-Share	9.2	9.6	11.1	15.9	17.1	21.3	24.7
NAV relative to FTSE All-Share	4.7	6.0	10.5	15.1	15.9	19.9	21.3
Price relative to MSCI World	5.2	6.3	1.3	1.0	(8.7)	(8.9)	(11.8)
NAV relative to MSCI World	0.9	2.8	0.8	0.3	(9.7)	(9.9)	(14.2)

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-October 2016. Geometric calculation.

SCIN does not have an official benchmark, but measures its performance with reference to the FTSE All-World and FTSE All-Share indices. Neither is a perfect comparator; while the FTSE All-World index is a global index covering both developed and emerging markets, which chimes with SCIN's investment approach, it has only 6.5% in the UK, compared with 32.8% for the SCIN portfolio.

As shown in Exhibit 5, in absolute terms performance has been positive over both the short and longer term, with share price and NAV total returns of c 11-13% a year over three and five years. Performance has been particularly strong over six months and one year, buoyed by the fall in sterling, which has increased the value of overseas assets for UK-based investors.

As shown in Exhibit 6, SCIN has outperformed the FTSE All-Share in both share price and NAV total return terms over all periods shown, underlining the value for UK investors of allocating some of their assets to overseas markets. Exhibits 6 and 7 show a more mixed track record versus global indices, although recent performance has been favourable.

**Exhibit 7: NAV performance relative to FTSE All-World index over three years**


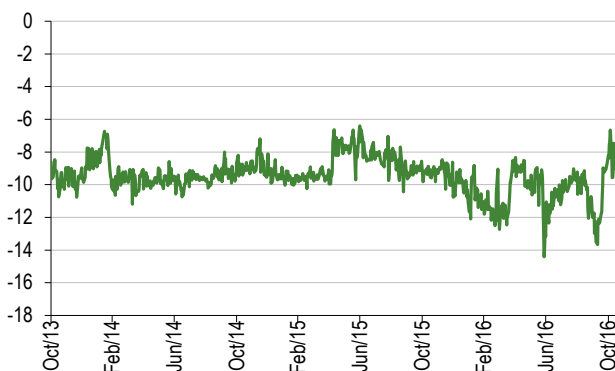
Source: Thomson Datastream, Edison Investment Research

## Discount: Recent widening gives scope to narrow

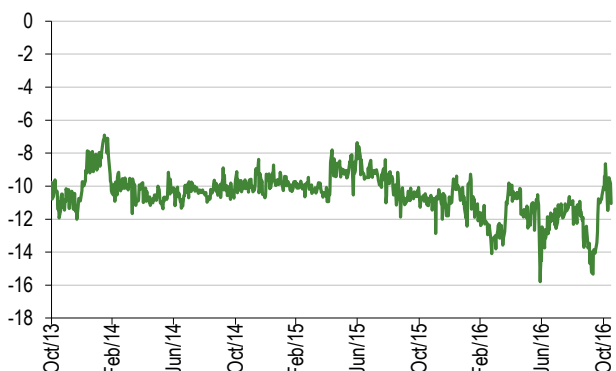
At 15 November 2016, SCIN's shares traded at an 11.0% discount to cum-income NAV with borrowings at fair value, or a 9.0% discount to ex-income NAV with borrowings at fair value. As noted below, the low level of interest rates causes the market value of the trust's fixed borrowing to rise, which reduces the NAV; therefore the discount with borrowings at fair or market value is narrower than the discount with borrowings at par or book value.

SCIN uses share buybacks to narrow the discount when it exceeds c 9% (based on the ex-income NAV with borrowings at fair value). In the past 12 months the trust has bought back and cancelled 9.2m shares at a cost of £59.9m. Over this period the ex-income discount has averaged 10.2%, a little wider than longer-term averages (c 9-9.5% over three, five and 10 years).

Somewhat perversely, strong performance caused the discount to widen in September and early October, as the share price lagged the rising NAV. However, the share price has now caught up and since the UK's EU referendum on 23 June, the NAV total return has been 20.5%, the share price total return has been 21.0% and the ex-income discount has averaged 10.4%. Given the relatively recent adoption of the new investment strategy, it may be the case that investor perceptions are still based on the longer-term performance record, which had been lacklustre. If the improvement in performance can be sustained, there is scope for the discount to narrow from the current level, further supported by the board's willingness to act through share buybacks.

**Exhibit 8: Three-year discount to NAV (ex-income, borrowings at fair or market value)**


Source: Thomson Datastream, Edison Investment Research

**Exhibit 9: Three-year discount to NAV (cum-income, borrowings at fair or market value)**


Source: Thomson Datastream, Edison Investment Research

## Capital structure and fees

A conventional investment trust with a single class of share, SCIN had 96.3m ordinary shares in issue at 15 November 2016. The trust has the authority to buy back up to 14.99% of the share capital annually in order to manage a discount to NAV, and employs these powers with the aim of maintaining the discount (based on ex-income NAV with borrowings at fair value) at or below 9% in normal market conditions.

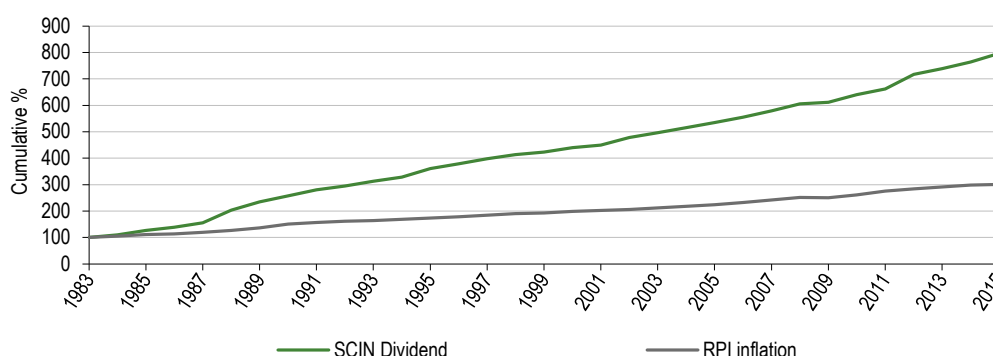
Gearing is principally via a 30-year issue of secured bonds, taken out in 2000 for £150m with a coupon of 5.75%. (There is an additional £2m of perpetual debenture stock with coupons of between 4% and 5%.) As part of a tender offer in 2006, £42m nominal of the secured bonds were bought back, and in H116 a further £21m nominal, or 20% of the outstanding borrowing, was bought back at a cost of £28.2m. While the coupon on the secured bonds looks relatively competitive compared with the long-standing debt of some investment trust peers (particularly those facilities arranged in the 1990s), the continued low interest rate environment has the effect of increasing the market value of the borrowings, which puts downward pressure on the fair value NAV. At H116, the par value of the borrowings was £83.6m, meaning that the gross gearing (based on 15 November net assets) is c 10.1%, compared with a ceiling of 20%. Net gearing at 30 September was 5.2%.

SCIN delegates the role of Alternative Investment Fund Manager (AIFM) to its subsidiary SIT Savings, to which the investment team (all employees of the trust) are seconded. Because it is self-managed, SCIN does not pay a management fee. Its total expenses for FY15, including staff costs, administration, legal and professional fees, were £4.9m, translating to an ongoing charges figure (OCF) of 0.52%. During H116, the trust outsourced some of its administrative functions, which should result in a further reduction of costs for FY16. SCIN already has one of the lowest OCFs in the investment trust universe.

## Dividend policy and record

SCIN pays dividends twice a year, in July and January/February. Dividend growth is a key part of the investment objective and the trust aims to increase its dividend year-on-year by more than the rate of UK inflation. SCIN has maintained or grown its regular dividend each year since 1982 and has also paid special dividends in 1999, 2002, 2007, 2008, 2013 and 2015. As shown in Exhibit 10 below, long-term regular dividend growth has been well ahead of inflation, beating RPI in all but two years since 1982 – in 1990 and 2011, both years when inflation was high in relation to stock market returns.

**Exhibit 10: Cumulative growth of SCIN regular dividend vs RPI inflation since 1982**



Source: The Scottish Investment Trust, Edison Investment Research

For FY15, a regular dividend of 12.5p was paid (5.0p interim and 7.5p final), with a 3.5p special dividend bringing the total to 16.0p. This equates to a yield of 2.15% based on the 15 November share price of 744p. So far for FY16, an interim dividend of 5.25p has been paid, an increase of 5.0% on the same period last year. At the half-year to 30 April 2016, SCIN reported that sterling weakness had boosted its income by 15.7% compared to a year previously; the fact that the pound has fallen further since then suggests that income for the full year may also be higher than FY15, so it is reasonable to assume that total dividends for FY16 will be at least as high as for the previous year.

While the trust is classified in the AIC Global (formerly Global Growth) sector, SCIN's investment team does consider the dividend yield on stocks when assessing potential investments, particularly in the most out-of-favour ('ugly and hated') stocks, where a high yield means they will be 'paid to wait' for a recovery in the share price.

SCIN's dividends (regular and special) have been fully covered by income in four of the last five financial years, and the trust had revenue reserves (after allowing for the final and special dividends) of £39.8m at FY15, sufficient to fund the regular dividend at the same level for more than four years.

## Peer group comparison

SCIN is a member of the Association of Investment Companies' Global sector, a large peer group of 26 funds with almost £20bn of assets. Exhibit 11 below shows a subset of the sector (the group against which SCIN measures itself), made up of some of the longest-established and largest peers. While all the peers invest internationally, they differ widely in focus, with between c 3% and c 40% invested in the UK and c 25-60% in the US. SCIN's UK exposure is towards the top end and its US exposure towards the bottom end of this range.

While its longer-term returns lag the peer group, SCIN's more focused and contrarian investment approach is arguably becoming evident in its shorter-term performance, where it ranks second for NAV total returns over one year. Risk-adjusted performance as measured by the Sharpe ratio is above peers over one year and a little behind over three years. SCIN's dividend yield (including special dividends) is among the highest in the group, while its ongoing charges (which have fallen as a result of streamlining the investment team) are the joint-lowest; there is also no performance fee. Net gearing is a little below average. The discount to NAV, which is the third-widest in the group, may reflect SCIN's relatively expensive structural borrowings – a feature shared by the one trust currently at a wider discount – or a perception lag given the relatively recent revamp of the team and investment process.

**Exhibit 11: AIC Global sector peer group as at 31 October 2016**

% unless stated	Market cap £m	NAV TR 1 Year	NAV TR 3 Year	NAV TR 5 Year	Ongoing charge	Perf. fee	Discount (ex-par)	Net gearing	Dividend yield (%)	Sharpe 1y (NAV)	Sharpe 3y (NAV)
<b>Scottish Investment Trust</b>	<b>740.2</b>	<b>30.6</b>	<b>37.4</b>	<b>85.8</b>	<b>0.5</b>	<b>No</b>	<b>(11.7)</b>	<b>105</b>	<b>2.1</b>	<b>0.2</b>	<b>0.1</b>
Alliance Trust	3,060.2	23.6	38.8	84.8	0.8	No	(10.9)	107	1.9	(0.2)	0.2
Bankers	848.4	22.0	37.6	91.0	0.5	No	(7.4)	102	2.3	(0.3)	0.1
Brunner	259.8	22.2	30.8	81.6	0.8	Yes	(19.5)	106	2.5	(0.2)	0.0
Edinburgh Worldwide	235.7	18.0	27.9	83.9	0.9	No	(11.8)	108	0.0	(0.4)	(0.0)
Foreign & Colonial Investment Trust	2,859.0	25.9	46.4	98.3	0.7	No	(9.9)	106	1.9	(0.1)	0.4
Martin Currie Global Portfolio	211.7	27.3	41.1	89.2	0.7	Yes	1.3	100	1.9	0.0	0.2
Mid Wynd International Investment	123.1	25.9	53.9	93.6	0.8	No	0.3	101	1.1	(0.1)	0.5
Monks	1,164.6	29.6	35.8	68.7	0.6	No	(8.5)	106	0.3	0.2	0.1
Scottish Mortgage	4,421.1	31.2	66.7	145.0	0.5	No	1.9	109	0.9	0.3	0.6
Witan	1,558.6	23.1	39.5	99.1	0.8	Yes	(8.1)	108	2.1	(0.2)	0.2
<b>Peer group weighted average</b>		<b>26.8</b>	<b>47.7</b>	<b>105.2</b>	<b>0.6</b>		<b>(6.3)</b>	<b>107</b>	<b>1.5</b>	<b>(0.0)</b>	<b>0.3</b>
<b>SCIN rank in peer group</b>	<b>7</b>	<b>2</b>	<b>8</b>	<b>7</b>	<b>10</b>		<b>9</b>	<b>8</b>	<b>4</b>	<b>2</b>	<b>7</b>

Source: Morningstar, Edison Investment Research. Note: TR=total return. Sharpe ratio is a measure of risk-adjusted return. The ratios shown are calculated by Morningstar for the past 12- and 36-month periods by dividing a fund's annualised excess returns over the risk-free rate by its annualised standard deviation. Net gearing is total assets less cash and equivalents as a percentage of net assets (100 = ungeared).

## The board

SCIN has six non-executive directors, four of whom have been appointed in the past three years as part of the process of modernising the trust. Chairman James Will joined the board in 2013 and assumed his current role in January 2016 following the retirement of Douglas McDougall. Hamish Buchan has been a director since 2003, while Russell Napier was appointed in 2009. Ian Hunter joined the board in 2014 and the two newest directors, Jane Lewis and Mick Brewis, were appointed in 2015. The directors have backgrounds in stockbroking, investment management, accountancy and law and most have professional experience in the investment companies sector.

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