

Scottish Oriental Smaller Companies

Long-established Asian small-cap specialist

Scottish Oriental Smaller Companies Trust (SST) was launched in 1995 with the objective of generating long-term capital growth from investing in smaller companies listed in Asia (excluding Japan and Australasia). Its long-term 10-year performance record continues to be strong, although in more recent years SST has lagged the performance of the comparative MSCI AC Asia ex-Japan Index, which has been driven by large-cap and technology stocks in particular. Since Vinay Agarwal became acting (now formal) lead manager in July 2016, the portfolio has become more concentrated and growth orientated. Agarwal believes the trust is well positioned with reasonably valued, quality companies that can grow structurally through economic cycles.

12 months ending	Share price (%)	NAV (%)	MSCI AC Asia ex-Japan (%)	MSCI AC Asia ex-Japan Small Cap (%)	FTSE All-Share (%)
31/12/13	5.2	9.1	1.4	5.2	20.8
31/12/14	6.0	11.3	11.7	8.9	1.2
31/12/15	(8.3)	(2.0)	(3.6)	2.3	1.0
31/12/16	25.3	24.4	26.2	16.8	16.8
31/12/17	16.9	15.1	29.8	22.3	13.1

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

Investment strategy: Fundamental stock selection

SST's investment objective is to achieve long-term capital growth by mainly investing in smaller Asian-listed companies, excluding Japan and Australasia. Its approach is bottom-up, aiming to identify high-quality, well-managed companies in which it can invest with a five-year or longer time horizon. The manager and a well-resourced equity team conduct over 1,000 direct company meetings a year as part of their analytical, absolute return mindset approach. There are no sector and country weighting constraints. Since Agarwal became acting (now formal) lead manager, the portfolio has become more concentrated with around 60 holdings, with more focus on stocks with structural growth potential.

Market outlook: Outperformance has been polarised

Asian equities performed strongly in 2017; the MSCI AC Asia ex-Japan Index rose by 29.8% in sterling terms. This performance was polarised towards large-cap stocks, led by the technology sector in particular, but also exacerbated by inflows from ETFs, which tend to buy the largest names in the index. Valuations are no longer cheap, although continue to look relatively attractive compared with global equities Asian stocks. Meanwhile, International Monetary Fund (IMF) forecasts for Asian economic growth over the next five years are significantly higher than for global GDP growth.

Valuation: 10.8% discount, slightly below average

SST currently trades at a 10.5% discount to cum-income NAV; slightly below its 11.5% three-year average (range of 1.7% to 16.7%). The board does not have a formal discount management policy, although it actively promotes the trust and has the ability to repurchase shares.

Investment trusts

10 January 2018

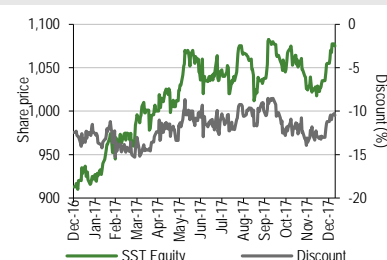
Price 1,075.0p
Market cap £332.7m
AUM £371.6m

NAV* 1,200.6p
Discount to NAV 10.5%
NAV** 1,201.0p
Discount to NAV 10.5%

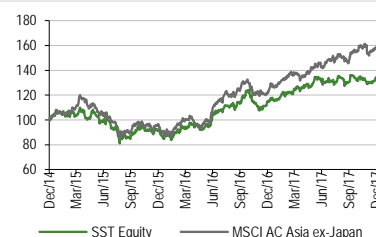
*Excluding income. **Including income. As at 8 January 2018.

Yield 1.1%
Ordinary shares in issue 30.9m
Code SST
Primary exchange LSE
AIC sector Asia Pacific ex-Japan
Benchmark MSCI AC Asia ex-Japan

Share price/discount performance



Three-year performance vs index



52-week high/low 1,082.5p 915.5p
NAV** high/low 1,216.1p 1,045.2p

**Including income.

Gearing

Gross* 0.0%
Net cash* 7.8%

*As at 30 November 2017.

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Exhibit 1: Trust at a glance
Investment objective and fund background

SST's objective is to provide shareholders with long-term capital growth through investment in smaller Asian (excluding Japanese and Australasian) quoted companies. Its assets are invested in a diversified portfolio of equities. While the manager takes account of cultural, political and economic factors, stock-specific features are the main driver of portfolio selection, with the aim of identifying good-quality companies with solid long-term growth prospects.

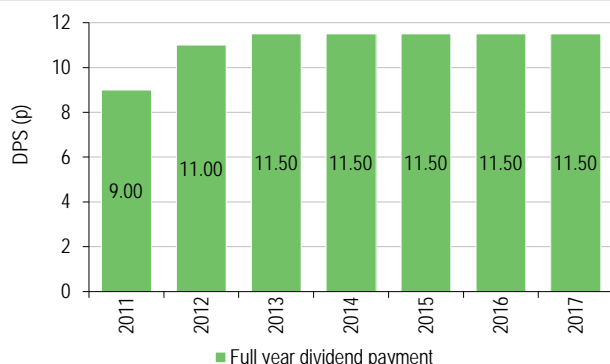
Recent developments

- 30 October 2017: annual report for 12 months to end-August 2017. NAV TR +15.7% versus benchmark TR +27.2%. Share price TR +19.4%. Announcement at December 2017 AGM that director Janet Morgan will retire.
- 29 June 2017: appointment of Andrew Baird as non-executive director.
- July 2017: Vinay Agarwal assumes permanent role as lead manager. Former lead manager Wee-Li Hee will return from maternity leave as co-portfolio manager.

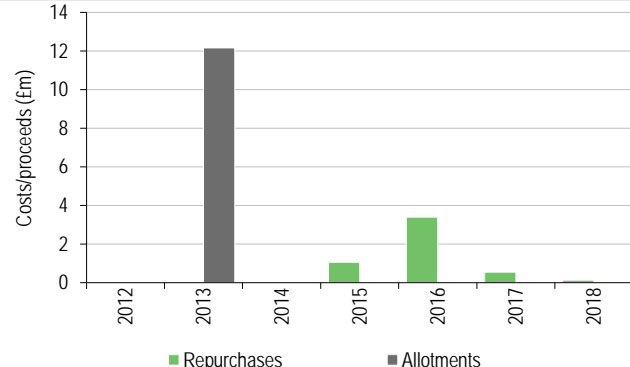
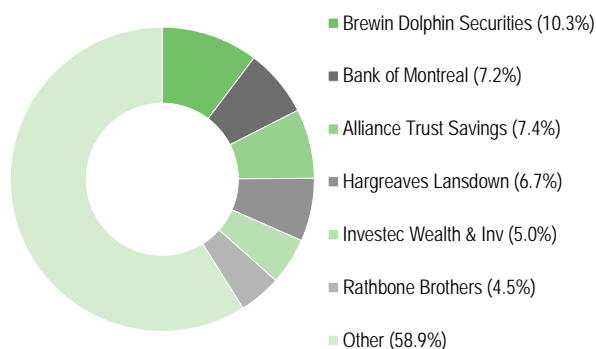
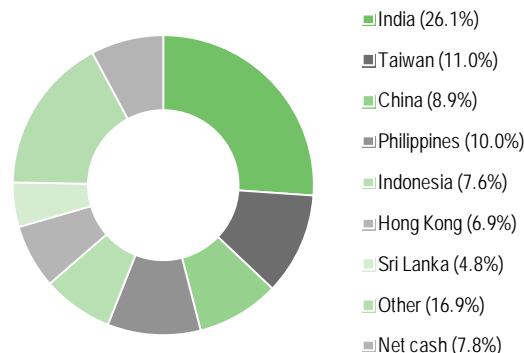
Forthcoming		Capital structure		Fund details	
AGM	December 2018	Ongoing charges	0.99% (FY17)	Group	First State Stewart
Interim results	April 2018	Net cash	7.8%	Manager	Vinay Agarwal
Year end	31 August	Annual mgmt fee	0.75%	Address	10 St Colme Street, Edinburgh, EH3 6AA
Dividend paid	January/February	Performance fee	Yes (see page 7)	Phone	+44 (0) 131 473 2200
Launch date	March 1995	Trust life	Indefinite	Website	www.scottishoriental.co.uk
Continuation vote	None	Loan facilities	None (see page 7)		

Dividend policy and history (financial years)

Dividends paid annually. The board intends to at least maintain the level of dividend, using reserves if necessary, unless company distributions fall sharply.


Share buyback policy and history (financial years)

Renewed annually, the board has authority to repurchase up to 14.99% and allot up to 10% of shares outstanding.


Shareholder base (as at 27 October 2017)

Portfolio exposure by geography (as at 30 November 2017)

Top 10 holdings (as at 30 November 2017)

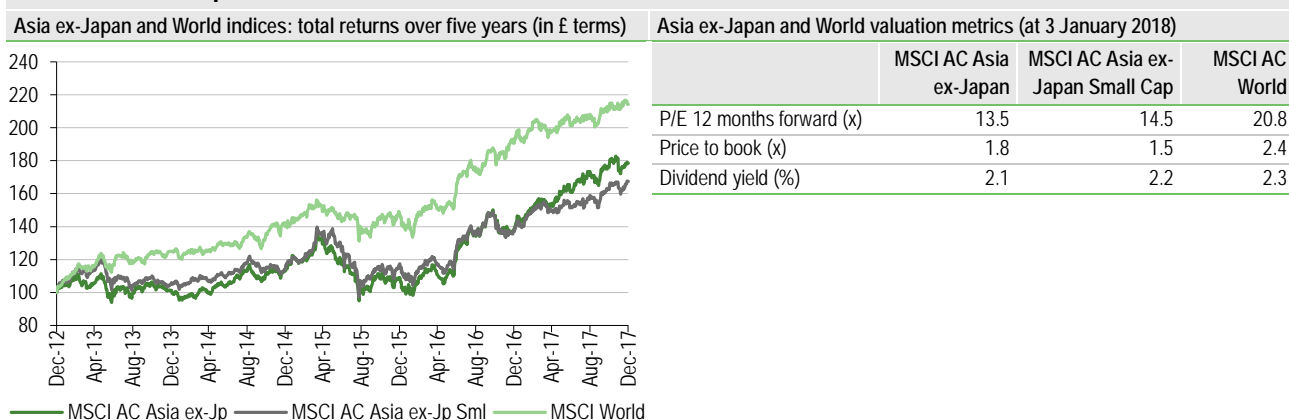
Company	Country	Sector	Portfolio weight %	
			30 November 2017	30 November 2016*
SKF India	India	Industrials	3.2	N/A
Concepcion Industrial	Philippines	Industrials	2.9	N/A
Sinbon Electronics	Taiwan	Information technology	2.8	N/A
Towngas China	China	Utilities	3.3	2.6
Blue Star	India	Industrials	2.5	N/A
China Banking	Philippines	Financials	2.5	N/A
Uni-President China	China	Consumer staples	2.3	N/A
Healthcare Global Enterprises	India	Healthcare	2.3	N/A
Raffles Medical Group	Singapore	Healthcare	2.2	2.4
Vitasoy International	Hong Kong	Consumer staples	2.2	2.4
Top 10			25.6	26.4

Source: Scottish Oriental Smaller Companies, Edison Investment Research, Bloomberg, Morningstar. Note: *N/A where not in November 2016 top 10.

Market outlook: Challenging equity valuations

As shown in the left-hand chart of Exhibit 2, Asian and global equities have performed strongly over the past 18 months and many indices are at, or near, all-time highs. This has been in response to synchronous global growth and an unprecedented, extended period of low interest rates. Central banks, including in the US and the UK, have started to increase interest rates; however, market expectations are for monetary conditions to remain reasonably accommodative. Nevertheless, monetary conditions appear to have little scope to become more favourable, while equities valuations are not cheap. As shown in the right-hand chart, Asian equity valuations, however, are lower than global valuations on both P/E and price-to-book measures, while IMF forecasts predict faster compound annual GDP growth in Asia of 5.9% between 2017 and 2022, compared to 3.7% for global GDP growth. Investors looking for exposure to faster-growing economies may be interested in a fund with a bottom-up and disciplined approach to investing in companies on reasonable valuations.

Exhibit 2: Market performance and valuation



Source: Thomson Datastream, Bloomberg, MSCI, Edison Investment Research

Fund profile: High conviction, small caps

SST aims to achieve long-term capital growth by investing mainly in smaller Asia ex-Japan listed companies with market capitalisations under \$1.5bn at the time of investment. The investment approach is high-conviction and fundamental to building a portfolio of quality companies that can be held for the long term, ideally for five years or more. Vinay Agarwal formally assumed the role of lead portfolio manager in July 2017, having been acting lead manager during Wee-Li Hee's maternity leave since July 2016. Since her return in July 2017, Hee has assumed the role of co-portfolio manager, in accordance with her wishes, thus providing continuity of the portfolio management team. Agarwal has not changed the investment philosophy and process, although there has been a shift in the portfolio, which has become more concentrated. There are currently around 60 holdings in the portfolio, down from over 80 stocks c 18 months ago, and the manager expects this to settle soon at around 50 stocks. Portfolio turnover has therefore been uncharacteristically high, above 50% in the past year, although should return to the previous norm of 20% or less once restructuring is complete.

Although gearing is permitted, up to 50% of net assets, this has been little used, and as at end-November 2017, the fund had net cash of 7.8%. A £20m loan facility was repaid early in June 2017.

The fund manager: Vinay Agarwal

The manager's view: Opportunities in smaller markets

Following strong performance by Asian stock markets in 2017, the manager finds it challenging to find attractively valued, high-quality companies. This is reflected in the portfolio's relatively high cash position of 7.8% as at end-November 2017, and the decision to repay early a £20m loan facility, originally designed to give the fund flexibility to acquire positions opportunistically should markets fall to attractive levels.

Agarwal believes earnings growth has been "lacklustre" outside of a relatively narrow group of mainly technology names, with a trend for margin expansion being driven by falling input prices, which he views as unsustainable. Meetings with companies conducted by the manager and his team have revealed weak volume growth and poor pricing power given consumers' low inflation expectations. Meanwhile, 'cheap money' has resulted in capital misallocations and increased competition, while pushing up levels of household debt. Agarwal notes debt levels are now more worrying in Korea and China and could become a constraint on growth. Leverage is more modest, however, in India, Indonesia, the Philippines and Sri Lanka, which together accounted for 48.5% of the portfolio as at end-November 2017. Agarwal continues to favour domestically oriented companies that have plenty of scope for structural growth, and are less influenced by external factors. He also finds more interesting opportunities in underpenetrated markets where good prospects for volume growth and premiumisation (whereby rising disposable income permits consumers to upgrade to higher-value products and services) can support sustainable long-term earnings growth.

Asset allocation

Investment process: Bottom-up focus on companies

The most significant source of investment ideas comes through country and company visits. The equity team conducts over 1,000 direct company meetings throughout the year to identify those that meet their criteria to allow them to invest with high conviction over a five-year or longer-term time horizon. Company founders and management teams are scrutinised for their integrity, risk awareness and the ability to deploy capital successfully. SST seeks high-quality franchises that have predictable and sustainable growth prospects, at reasonable valuations with a five-year perspective. Macroeconomic and political considerations are not expressly considered, as the manager is looking for well-managed, strong franchises that can perform well through economic cycles. There are no country and sector weighting constraints to portfolio construction, and portfolio risk is mitigated through the team's in-depth knowledge of its companies and managements and a mind-set to protect capital, generating absolute, not relative returns.

Current portfolio positioning

SST's managers are focused on stock selection and the portfolio can diverge significantly from its benchmark, as shown in Exhibits 3 and 4. Exhibit 4 also includes sector weights within the MSCI Asia ex-Japan Small Cap Index as a comparator. The portfolio comprises around 60 stocks, well-diversified across countries and sectors.

SST continues to favour industrials (18.6%) and consumer-related sectors (29.1% discretionary and staples combined). At end-November 2017, compared to the previous year, the consumer discretionary sector weight increased by 2.1pp to 17.8%, while consumer staples declined by 3.9pp to 11.3%. This shift reflects Agarwal's preference for higher growth stocks over lower growth, value stocks in the staples sector. The information technology sector has also declined significantly, by

3.5pp to 9.8%. This is the portfolio's most significant sector underweight relative to the index weight of 32.3%. Broadly, technology stocks in Asia have performed very strongly and, in the manager's view, command unjustifiably rich valuations.

Exhibit 3: Portfolio sector exposure vs Asia ex-Japan indices (% unless stated)

	Portfolio end-Nov 2017	Portfolio end-Nov 2016	Benchmark weight	Active weight vs benchmark (pp)	MSCI AC Asia ex-Japan Small Cap	Active weight vs small-cap index (pp)
Industrials	18.6	16.2	6.9	11.7	13.4	5.2
Consumer discretionary	17.8	15.7	9.3	8.5	16.6	1.2
Consumer staples	11.3	15.2	4.4	6.9	5.2	6.1
Information technology	9.8	13.3	32.3	(22.5)	20.7	(10.9)
Financials	9.3	8.1	23.2	(13.9)	8.7	0.6
Healthcare	8.3	7.0	2.2	6.1	9.2	(0.9)
Utilities	7.0	6.7	2.9	4.1	2.6	4.4
Materials	6.5	5.8	4.5	2.0	9.2	(2.7)
Real estate	2.1	2.1	5.9	(3.8)	11.4	(9.3)
Telecom services	1.4	1.5	4.3	(2.9)	0.8	0.6
Energy	0.0	0.0	4.2	(4.2)	1.9	(1.9)
Net cash	7.9	8.4	0.0	7.9	0.0	7.9
	100.0	100.0	100.0		100.0	

Source: Scottish Oriental Smaller Companies Trust, Edison Investment Research

The biggest country weight changes over the past year to end-November 2017 are reductions in China (-5.7pp) and Singapore (-5.3pp) in favour of the Philippines (+4.9pp) and India (+3.2pp). SST also invested, for the first time, in Pakistan and continued to build on initial positions in Bangladesh and Vietnam. These changes reflect the manager's observations that the more developed countries within Asia have higher household leverage, and growth prospects for companies are more challenged compared to countries with relatively low levels of debt, in particular India, Indonesia and the Philippines. The less-developed countries also have significantly lower levels of penetration of consumer goods and services, which augurs well for long-term structural growth prospects. Recent new purchases reflect these views, including Delta Brac and Indus Motor.

Exhibit 4: Portfolio geographic exposure vs benchmark (% unless stated)

	Portfolio end-Nov 2017	Portfolio end-Nov 2016	Change (pp)	Benchmark weight	Active weight vs benchmark (pp)	Trust weight/benchmark wgt (x)
India	26.1	22.9	3.2	9.9	16.2	2.6
Taiwan	11.0	10.9	0.1	13.1	(2.1)	0.8
Philippines	10.0	5.1	4.9	1.3	8.7	7.7
China	8.9	14.6	(5.7)	34.5	(25.6)	0.3
Net cash	7.8	8.4	(0.6)	0.0	7.8	N/A
Indonesia	7.6	7.2	0.4	2.5	5.1	3.0
Hong Kong	6.9	6.5	0.4	11.3	(4.4)	0.6
Sri Lanka	4.8	3.8	1.0	0.0	4.8	N/A
Singapore	4.3	9.6	(5.3)	4.4	(0.1)	1.0
South Korea	2.9	3.6	(0.7)	17.9	(15.0)	0.2
Malaysia	2.9	1.1	1.8	2.5	0.4	1.2
Thailand	2.3	5.3	(3.0)	2.6	(0.3)	0.9
Vietnam	1.7	0.5	1.2	0.0	1.7	N/A
Bangladesh	1.4	0.5	0.9	0.0	1.4	N/A
Pakistan	1.3	0.0	1.3	0.1	1.2	13.0
	100.0	100.0		100.0		

Source: Scottish Oriental Smaller Companies Trust, Edison Investment Research

Housing finance company, Delta Brac is SST's maiden position in Bangladesh. It is the largest mortgage lender with a 22% market share, where mortgages are 4% of GDP versus 9% in India, and 56% in Singapore. The company was founded by India's blue-chip, premier housing finance company, HDFC, which is well-known to and highly regarded by the manager. HDFC owns around 15% of Delta Brac and is actively engaged with the company as a strategic shareholder, including the training of its management and assistance in the development of robust risk systems.

SST's first investment in Pakistan is Indus Motor, a joint-venture with Japanese company Toyota and the country's largest automotive company with 44% market share. Pakistan has 15 passenger

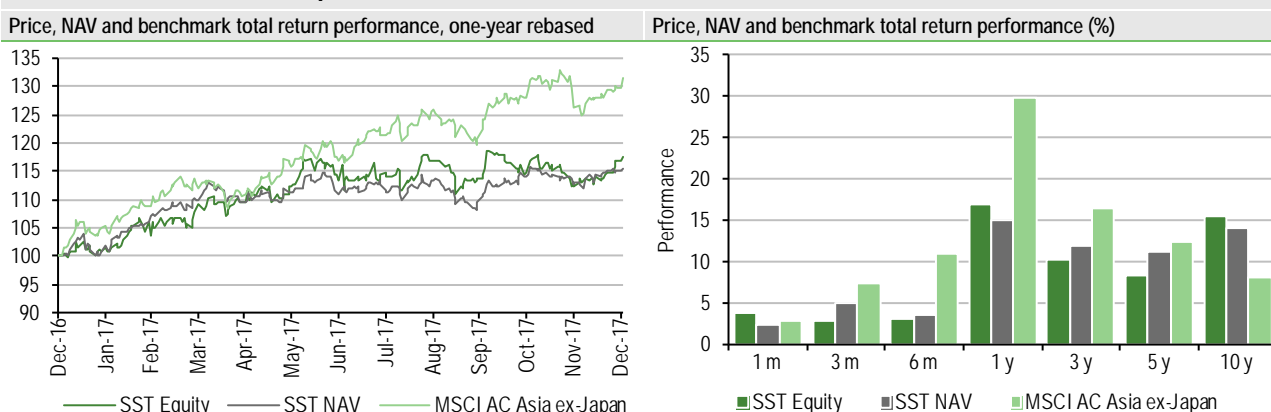
vehicles per 1,000 people, indicating significant scope for growth, compared to 22 in India and 47 in Indonesia. Indus Motor's valuations are attractive at around a 9x forward P/E multiple and a dividend yield of c 7%.

Agarwal is pleased with the portfolio's positioning, which is now more skewed towards higher-growth profile companies than before, with attractive long-term prospects over a five-year or longer time horizon. His valuation discipline and the low liquidity levels of some of the new positions demand patience, although he is optimistic that the repositioning process is nearly complete.

Performance: Solid long-term performance

The MSCI AC Asia ex-Japan Index performance over the past few years has been significantly skewed by the strong performance of technology stocks, in particular in South Korea and China, and by ETF inflows, which polarise purchases towards large-cap stocks. These trends have been unfavourable for SST's relative performance and its NAV total return lags its comparative benchmark over one, three and five years. The trust's 10-year performance remains strong, showing significant outperformance over its benchmark as well as over the MSCI AC Asia ex-Japan Small Cap and FTSE All-Share indices.

Exhibit 5: Investment trust performance to 31 December 2017



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 MSCI AC Asia ex-Japan	1.0	(4.2)	(7.2)	(9.9)	(14.9)	(16.3)	92.9
NAV relative to MSCI AC Asia ex-Japan	(0.5)	(2.3)	(6.7)	(11.3)	(11.1)	(4.7)	71.1
Price relative to MSCI AC Asia ex-Japan Small Cap	1.3	(5.7)	(6.8)	(4.4)	(8.2)	(10.7)	112.2
NAV relative to MSCI AC Asia ex-Japan Small Cap	(0.3)	(3.8)	(6.3)	(5.9)	(4.0)	1.7	88.1
Price relative to FTSE All-Share	(0.9)	(2.0)	(3.9)	3.3	0.7	(8.2)	130.2
NAV relative to FTSE All-Share	(2.4)	(0.0)	(3.4)	1.7	5.2	4.5	104.1

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-December 2017. Geometric calculation.

Discount: Narrower than average

SST currently trades at a 10.5% discount to cum-income NAV, slightly below its three-year average of 11.5% but towards the higher end of the range of 1.7% to 16.7% over this period. As shown in Exhibit 8, this is one of the deeper discounts among its peers, although similar to that of its most comparable peer, Aberdeen Asian Smaller Companies Investment Trust (11.0%). The board does not have a formal discount management policy, although has the ability to help manage the discount through the repurchase of shares and active promotion of the trust.

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



Source: Thomson Datastream, Edison Investment Research

Capital structure and fees

SST is a conventional investment trust with one class of share; there are currently 30.9m ordinary shares in issue. During FY17, the company bought back 60,000 shares at a cost of £542k, and subsequent to end-August 2017, a further 12,000 shares have been repurchased. There are 465,500 shares currently held in treasury.

In June 2017, the company repaid early its August 2019 £20m fixed-rate loan with National Australia Bank as its purpose to facilitate opportunistic purchases is unlikely to be utilised, given the manager's view of unattractive market valuations and the short duration to maturity. After breakage costs, net savings to the company for the remaining term of the loan is £732,000.

First State Investment Management (UK) is paid an annual management fee of 0.75% net assets. In addition, a performance fee is payable if SST's share price total return exceeds that of the benchmark by 10% over a rolling three-year period, capped at 1.5% of net assets. No performance fee was payable in FY17. The ongoing charge in FY17 was 0.99%, which was a 5bp reduction versus FY16.

Dividend policy and record

The dividend has been maintained at 11.5p per share for FY17, payable on 19 January 2018. The board's intention is to at least maintain annual dividends by building up revenue reserves when income permits, and draw on them when necessary to accommodate this policy. Income per share in FY17 of 6.77p (9.50p in FY16) represents 59% dividend cover, although revenue reserves at end-August 2017 are 1.4x the annual dividend, reflecting additions to reserves in recent years in FY15 and FY13. Based on the current share price, SST's dividend yield is 1.1%.

Peer group comparison

Exhibit 8 shows a selected peer group of investment trusts, which are members of the AIC Asia Pacific ex-Japan sector, with market capitalisations over £50m. Within this group, there are many different mandates, including trusts that invest in the Pacific region, as well as income-focused funds. SST has the strongest 10-year NAV total return within this peer group. The discount to ex-par NAV ranks 11th, although this is broadly in line with its most comparable peer, Aberdeen Asian Smaller Companies Trust.

Exhibit 8: Selected peer group as at 9 January 2018*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Discount (ex-par)	Ongoing charge	Performance fee	Net gearing	Dividend yield (%)
Scottish Oriental Smaller Cos	332.7	14.7	37.6	66.0	282.8	(10.4)	1.0	Yes	92	1.1
Aberdeen Asian Income	410.3	15.6	36.1	43.0	199.9	(6.1)	1.2	No	107	4.0
Aberdeen Asian Smaller	366.7	9.7	26.5	46.8	270.2	(11.5)	1.7	No	111	1.1
Aberdeen New Dawn	283.8	28.5	46.2	55.1	153.2	(11.7)	0.9	No	108	1.6
Edinburgh Dragon	720.0	24.2	44.8	53.9	161.8	(11.1)	1.0	No	104	0.9
Fidelity Asian Values	270.6	10.2	55.0	96.9	159.0	(4.6)	1.3	No	100	1.1
Henderson Far East Income	464.5	17.2	36.8	55.2	124.3	2.7	1.1	No	103	5.4
Invesco Asia	220.2	32.6	70.2	107.8	203.5	(9.2)	1.0	No	96	1.4
JPMorgan Asian	356.1	38.2	67.1	93.6	97.7	(9.1)	0.7	No	100	3.7
Martin Currie Asia Unconstrained	146.8	23.3	45.4	58.9	69.1	(11.2)	1.1	No	103	1.9
Pacific Assets	316.5	15.4	42.3	87.1	101.1	(3.1)	1.3	No	100	1.0
Pacific Horizon	182.3	51.2	71.3	101.2	124.2	(7.7)	1.1	No	99	0.0
Schroder Asia Pacific	811.0	37.9	74.1	100.2	195.6	(9.0)	1.0	No	113	1.2
Schroder Asian Total Return	316.6	34.5	77.0	89.4	136.1	6.1	1.0	Yes	102	0.0
Schroder Oriental Income	654.8	15.5	51.1	74.6	203.5	0.4	0.9	Yes	107	3.5
Simple average	390.2	24.6	52.1	75.3	165.5	(6.4)	1.1		103	1.9
SST rank in sector	8	13	12	9	1	11	11		15	11

Source: Morningstar, Edison Investment Research. Note: *Performance data to 8 January 2018. TR = total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

The board

Following the resignation of Dr Janet Morgan, who retired from the board at the December 2017 AGM, SST's board comprises five independent non-executive directors. Chairman James Ferguson and Alexandra Mackesy were appointed in 2004, and Anne West in 2010. Two new appointments were made in 2017: Jeremy Whitley was appointed in March and Andrew Baird was appointed in June – both bring significant Asian investment experience.

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