

THE SCOTTISH Investment Trust

The **CONTRARIAN**

SPRING 2017

ANALYSIS AND INSIGHT FROM THE SCOTTISH INVESTMENT TRUST



Ugly ducklings on the high street - opportunities in unloved UK retail

Significant evolution of the high street has been underway for some time now and retailers across the country are having to adapt to new consumer demands.

The shift towards online shopping and the search for a bargain are among the factors impacting spending habits. Investors are wary of the sector, with particular concerns including inflationary pressures and a lack of visibility following the UK's vote to leave the EU. Despite this, we see the UK retail sector as providing one of the most interesting investment opportunities now available. Currently, retail generally falls within our 'ugly ducklings' investment category, comprised of unloved shares that the majority of investors have shunned.

Companies in this category tend to be regarded with pessimism by the market, but have the potential to perform ahead of average expectations. These companies have often endured an extended period of poor operating performance and, for the majority, the near-term outlook is uninspiring. However, we view this out-of-favour status as an opportunity, especially where we envision circumstances in which a stock will surprise on the upside. We look to invest in companies

that have the potential to transition from ugly duckling to fully fledged swan. If they also have a strong sustainable dividend so much the better.

Swans in the making

We anticipate that some dominant UK retailers will be able to endure current challenging conditions and will thrive again thanks to new leadership with a mandate for change and the will to execute a sensible strategic recovery plan.

Two examples of companies that we believe possess the qualities to succeed over the longer term are Marks & Spencer and Tesco. Challenges will continue to present, as recovery tracks are rarely in a straight line. However, both companies possess strong brands, a degree of dominance in their respective markets and a new 'man with a plan' at the helm. Both of these companies could currently be considered ugly ducklings.

Marks & Spencer

Meaningful change has commenced in earnest under the new leadership of Steve Rowe – an experienced retailer. M&S is seen as an enduring

Continued overleaf

ABOUT

The Scottish Investment Trust

At The Scottish, our experienced team actively manages a high conviction, global investment portfolio with the aim of generating superior investment returns over the long-term for our investors.

Our contrarian approach is benchmark agnostic and aims to benefit from profitable opportunities in any market environment. Founded in 1887, the trust has a long tradition of providing shareholders with an accessible, low cost way to invest in companies from around the world, whilst further boosting returns through the provision of a growing dividend. The Scottish has grown its regular dividend every year for the last 33 years.

Our independently managed, closed-end fund structure allows us to be patient with our investments allowing them to mature profitably.

Please remember that past performance may not be repeated and is not a guide for future performance. The value of shares and the income from them can go down as well as up as a result of market and currency fluctuations. You may not get back the amount you invest. The Scottish Investment Trust PLC has a long-term policy of borrowing money to invest in equities in the expectation that this will improve returns for shareholders. However, should markets fall these borrowings would magnify any losses on these investments. This may mean you get back nothing at all. Investment trusts are listed on the London Stock Exchange and are not authorised or regulated by the Financial Conduct Authority. Please note that SIT Savings Ltd. is not authorised to provide advice to individual investors and nothing in this promotion should be considered to be or relied upon as constituting investment advice. If you are unsure about the suitability of an investment, you should contact your financial advisor. This promotion is issued and approved by SIT Savings Ltd. authorised and regulated by the Financial Conduct Authority.

For an inside view on the Scottish Investment Trust, we talk to Alasdair McKinnon



ALASDAIR
MCKINNON

*Manager of
The Scottish
Investment Trust*

What has changed at the Trust in the last two years?

We have made some significant changes over the last 18 to 24 months. The most fundamental of which was the restructuring of our investment team and the adoption of a new contrarian investment approach. We believe that these were necessary to make The Scottish attractive and relevant for our shareholders.

What are the reasons behind these changes?

The board and the management team were aware of the pressures facing the active management fund industry and recognised the need to change. We want to be genuinely active and low cost; the changes we have made reflect this desire.

How has the strategy changed?

The new strategy has a high-conviction, global contrarian approach to investment which seeks to find value in companies that have become overlooked or unloved. We think that this approach will deliver better returns for our investors over the long-term.

So how would you describe your investment style?

First and foremost, we are stock pickers. The portfolio is constructed without reference to any index, regional or sector weighting. This gives investors access to true active management which we believe is essential to achieve our aim of delivering superior investment returns.

As contrarians, we ask ourselves 'Is this company being unfairly disregarded by other investors?'

How will these changes benefit shareholders?

We expect our new approach to help us deliver above-average returns over the longer term. The dividend is also very important and the board has stated that they wish to maintain both the long track record of dividend increases and the aim to grow the dividend ahead of UK inflation over the longer term. We also have healthy revenue reserves which could cover more than four years of the regular dividend.

What results have these changes brought?

We have seen the new investment strategy deliver encouraging results since its introduction. Our aim, of course, is to produce above-average returns over the longer term.

What is your ambition for the future?

Our ambition is to continue to deliver strong performance for our shareholders, through our high-conviction, global contrarian approach. This means identifying the right investments by finding value in under appreciated companies that have become unfairly overlooked or unloved. We believe it is not possible to be an active manager by simply following the herd.

Opportunities in unloved UK retail

Continued from front cover

and robust brand. The food department is still top notch and changes in apparel are encouraging. While lacklustre high street clothing sales have been the perennial bugbear for previous senior executives, Rowe has adopted a more appealing pricing strategy. We believe the company now has a strong successful multi-channel offering, suitable for the industry's new structural reality.

Tesco

Tesco remains a leading multi-format retailer and, like M&S, has also seen a change in leadership. The chief executive, Dave Lewis, has a mission to rebuild profitability, halt market share declines and regain the trust of consumers and investors alike. Recent data suggests to us that early efforts are beginning to bear fruit.

Food price deflation has squeezed growth and earnings for some time but seems to be abating in light of sterling weakness. Tesco's scale and ability to cut costs are seen as advantages in the current environment.

The retail sector clearly continues to face challenges and a degree of post Brexit uncertainty. However, our contrarian investment approach is designed to seek out profitable opportunities created by short-term over reactions in sentiment towards changeable market conditions.

At present we view M&S and Tesco as interesting participants in the recovery of this sector.

Upcoming **EVENTS**

2017

Interim **RESULTS** - JUNE

Interim **DIVIDEND** - JULY

Investment **INSIGHT**



Finding opportunity with a Contrarian Approach

At The Scottish, we take a contrarian approach to global stock markets.

We are high-conviction investors and focus on stocks that are unfashionable with the mainstream, as we believe these offer the greatest potential for long-term gains.

At the core of our approach is a simple but often overlooked reality: popular stocks tend to be overvalued and out-of-favour stocks tend to be undervalued. A company that has been badly managed or that has suffered a poor run of fortune is understandably under appreciated by other investors. However, this pessimism creates the potential for improvement and, eventually, attractive returns.

As contrarian investors, we see three distinct investment categories.

The first of these is **ugly ducklings** – unloved companies that most investors shun. These firms face fundamental challenges, and the market has become extremely pessimistic about their prospects. However, we see their out-of-favour status as an opportunity.

A good example of an ugly duckling is Australian wine firm, Treasury Wine Estates. Prior to our purchase, the firm had been a source of disappointment to investors. New leadership changed the strategy, and began treating their product as a branded consumer good which changed the commodity producer ethos of the company. We made our initial investment with the safety net of a 4% dividend yield and the company has gone from strength to strength. Treasury Wine Estates remains the largest holding in our portfolio, although it has since moved out of the ugly duckling category.

The second category is where **change is afoot**. These companies have managed to significantly change their prospects, but the improvements are not yet recognised by

the market. Thus, while other managers continue to steer clear, we see the potential for profit.

An example from this category is our holding in Rentokil. Rentokil had a chequered history, prior to our purchase, having been a 1990's stockmarket darling that later soured. Even when new management refocused the company, other investors continued to judge it on past mistakes. We believed that the changes introduced would bear fruit and bought shares. These shares have performed well as Rentokil's reputation has been rehabilitated.

In the third category are companies that have **more to come**. Unlike the first two categories, these companies are generally recognised as good businesses, but we see an opportunity as we believe that the market has failed to appreciate the full scope of that potential.

Our holding in Microsoft sits within this category and in the recent past was thought to be in terminal decline, due to falling PC sales. However, the company changed its business model to incorporate a recurrent annual subscription for its software rather than the traditional one off payment model, which has transformed its prospects.

To identify the right opportunities within these categories we carefully assess any management change and restructuring action and consider the likely extent of any earnings recovery. The companies in our portfolio can move along an axis from ugly ducklings to change is afoot and then to more to come. When ugly ducklings become fully fledged swans, we contemplate selling. Until then, we aim to keep portfolio turnover to a minimum.

Our **PEOPLE**



ALASDAIR MCKINNON
Manager



MARTIN ROBERTSON
Deputy Manager



SARAH MONACO
Investment Manager



MARK DOBBIE
Investment Manager

An inflation-beating dividend

The Scottish has grown its regular dividend every year for the last 33 years. We have also put away some of our income for use, if required, in the future.

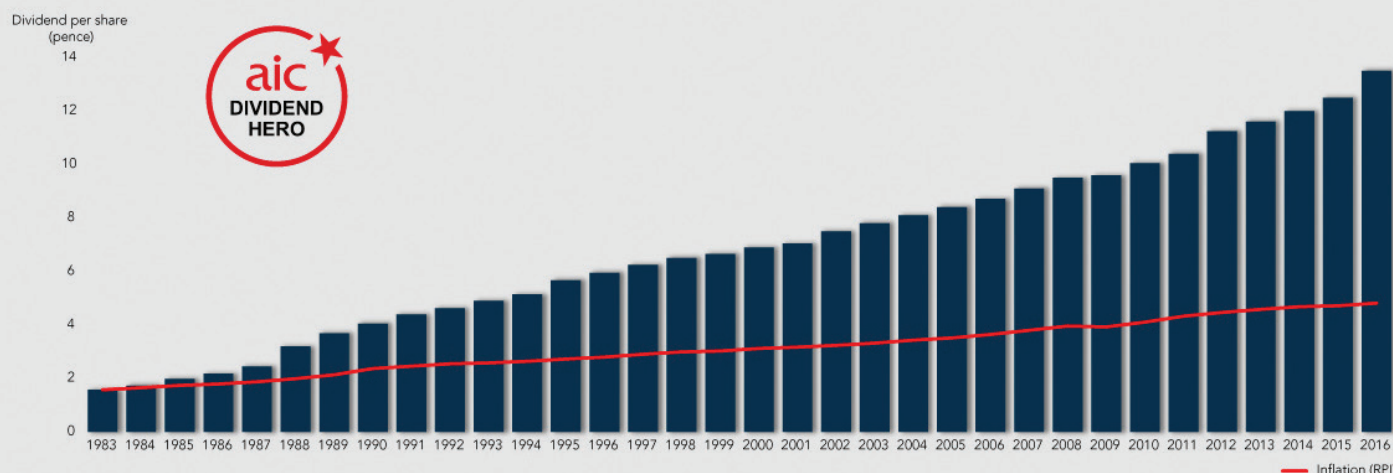
Consequently, we now have revenue reserves to cover over four years of the regular dividend. This means, that looking forward, we have the ability to continue to grow our regular dividend.

We also like to pay out a bit extra when times are good. A special dividend is never guaranteed but is always a welcome bonus.

Please remember that past performance may not be repeated and is not a guide for future performance.

The value of shares and the income from them can go down as well as up as a result of market and currency fluctuations. You may not get back the amount you invest.

Increasing our regular dividend for 33 consecutive years



Contact **US**

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