THE SCOTTISH Investment Trust

The CONTRARIAN AUTUMN 2017

ANALYSIS AND INSIGHT FROM **THE SCOTTISH INVESTMENT TRUST**

The Contrarian Case for Oil

It's been a gloomy year for oil. Despite a modest rebound since the lows of June, the price of Brent crude is still around the $50-dollar per barrel mark, with WTI crude below that. The MSCI ACWI energy sector is down some 11% for the year to date.*

To put this into context, we should remember that the oil price was comfortably above $100 just over three years ago. Optimism about concerted action to reduce the supply glut has subsided, as OPEC's recent cuts have failed to eliminate the surplus. Meanwhile, two OPEC countries that were exempted from the production cuts, Libya and Nigeria, are threatening to offset the fall in output elsewhere. The future of the cuts is uncertain, with compliance already slipping.

Nor is the outlook for US supply any rosier. The number of rigs operating in US fields has almost doubled over the past year, from 491 in August 2016 to 946 in August 2017. Shale producers are important here. Many shale wells have been taken offline because of the oil-price slump, but these can be brought back online very quickly – sometimes in as little as a week. As a result of cost restructuring and improvements in well technology, some shale producers can now pump profitably at $40 rather than the previous level of $65. That could constrain any upside in the oil price, because as soon as it reaches a profitable level, the shale producers can jump back in.

To most investors, all this gloom is a signal to stay away. The current consensus is that the oil price will be low for the foreseeable future, and so oil companies are unwise – or downright foolish – investments. There is also an ethical dimension, as a greater focus on sustainable clean energy sources is discouraging investment in fossil-fuel producers.

At The Scottish, we love consensus. We just don't like to be part of it.

That's because market consensus provides contrarian opportunities. Why do we see an opportunity in oil? Well, we think that investors are forgetting one vital point: the world still relies on fossil fuels. Yes, there's a lot of oil around at the moment. And yes, its price is not what it was. But just because a commodity is plentiful doesn't mean that it isn't needed.

*31 August 2017

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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 provides 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 profitability.

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 Limited. Authorised and regulated by the Financial Conduct Authority.

We recently wrote to members of our Savings Scheme to advise of transfer of SIT savings customers to AJ Bell. As you may know our investors can now buy shares in the Scottish Investment Trust in a wide range of AJ Bell products or consolidate other investments held to provide a single view of your savings. Here we set out some additional features that we didn't have room to mention in our letter:

Dealing Account

AJ Bell's dealing account is flexible and low cost. Invest as much as you want, whenever you want.

Lifetime ISA

Invest up to £4,000 per year in AJ Bell's Lifetime ISA and get a government bonus of up to £1,000.

Accounts for children

Build a nest egg for your children or grandchildren with AJ Bell's Junior ISA, Junior SIPP and Dealing Accounts for children.

Multiple Accounts

If your family has multiple accounts with AJ Bell Youinvest you can appoint an account lead who can have view only or dealing access to all accounts. For more information visit www.youinvest.co.uk/our-services/family-linking

Self Invested Personal Pension

Control and grow your pension with AJ Bell's SIPP. Get tax relief on contributions and enjoy freedom of choice when you retire.

Award-winning mobile dealing app

AJ Bell's award-winning FREE mobile dealing app allows you to keep track of your account whilst on the move and is available for iPhone, iPad and Android mobile devices.

Stocks and shares ISA

Invest up to £20,000 this tax year into a tax efficient ISA, it's a great way to save for the future.

Awards

AJ Bell's service has been recognised by them winning a number of awards this year - many of which are based on votes from our customers.

Shares Magazine

If you transfer a self-invested personal pension (SIPP), ISA or Dealing Account and maintain a balance of £4,000 or more, you'll get free access to **Shares magazine** (worth over £220 a year).

The information in this section does not constitute advice nor is a recommendation to invest in any of the above accounts. If you are unsure as to the suitability of any particular investment or product, you should seek professional financial advice. The value of investments and the income from them can go down as well as up as a result of market and currency fluctuations and investors may not get back the amount originally invested. Past performance is no indicator of future performance. The tax treatment of any investment depends on the individual circumstances of each investor and may be subject to change in the future.

Investment **INSIGHT**

Keeping active in the **age of ETFs**

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All industries are cyclical – and investment is no exception. The industry is currently undergoing a marked rotation away from active strategies towards passive funds. In this environment, active managers must adapt to survive.

In the past, the industry benefited from investors' lack of choice in gaining stock-market exposure. This allowed managers to charge high fees and perversely incentivised them to focus on relative performance and job preservation.

Enter the passive fund. These low-cost strategies aim to replicate the market with very low fees. Although passive strategies have been around for more than 40 years, they've really taken off in recent years with the rise of exchange-traded funds (ETFs). By lowering costs still further, ETFs have helped to increase the market share of passive funds significantly – resulting in headlines predicting the 'end of active'.

Meanwhile, the proliferation of analysts employed to spot stock-pricing discrepancies and the growing availability and quality of information have made the market much harder to beat. With their information advantage eroded, investment managers have struggled to deliver the superior performance for which they are paid. Most active managers do not beat the market consistently, making it hard to justify the fees they charge.

But the rise of passive means that the market is becoming more momentum-driven through the indiscriminate crowding of capital. That offers greater opportunities for genuinely active stock-pickers who recognise this market behaviour and are prepared to break with the consensus view.

The key point, though, is that many active managers don't buck the consensus, but back it. Any assessment of active managers' performance is clouded by the high number of notionally active investment funds that are actually passive 'index-huggers'. Essentially, these merely offer investors an expensive means of accessing the market. Many nominally active managers engage in index-hugging because they fear losing investors during periods of short-term underperformance. They're too scared to do what they're supposed to do – take appropriate risks on their investors' behalf.

So it's unsurprising that such strategies are losing out to cheaper passive equivalents. But that shouldn't count against active managers who differentiate themselves by disregarding the index entirely. Favouring unloved stocks and looking for undervalued opportunities at the low points in their cycles should provide valuable balance to a portfolio and the possibility of downside protection when markets turn sour.

Cost remains a key consideration. Bloated cost structures can provide a drag anchor when it comes to fees, but some fund structures can naturally address this. Funds that are free from the top-heavy group management structures of many large asset-management companies offer clear benefits here. There are also advantages to closed-ended funds, which allow their managers to take a longer view and prevent them from being forced to take detrimental action to meet redemptions.

Investors should remember that passive strategies aren't designed to beat the market. Instead, they essentially offer 'market minus costs'. That works well in a bull market – a rising market is what you get, after paying fees. But when markets fall, passive strategies offer no protection whatsoever. You get the full downturn with the fees on top. This lack of downside protection is a good argument for combining passive strategies with genuinely active approaches in a well-balanced portfolio.

Ultimately, the preference for passive versus active investment will remain cyclical as well as structural. Meanwhile, genuinely active investors should relish the opportunities that passive strategies provide.

All parts of the market have cyclical elements. Fundamentally healthy but out-of-favour stocks should at some point rise from their lows. Perhaps active managers should be considered in the same light.

The Contrarian Case for Oil

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What matters to the companies that produce it is not so much what the oil price is, but how they can stay competitive and – crucially – profitable.

The oil-price weakness has already flushed out many of the sector's weaker operators. That means that the surviving companies have already come through a fairly ferocious phase of natural selection. Indeed, the oil majors are fitter for purpose operationally than they have been for many years. They also enjoy considerable efficiencies of scale.

There are several examples in our portfolio, all of which we class as 'ugly ducklings' – unloved shares that most investors shun. In essence, they've been down so long that most investors can't see any way up. But we think that this consensus view is misplaced.

We might have to be patient while the valuations of these companies recover. But at least we're being paid to wait. The oil sector offers highly attractive dividend yields: indeed, the world's top six oil firms all pay out 4% or more.

We also think ethical concerns are likely to decrease. This is because the oil companies are taking their environmental responsibilities increasingly seriously.

Finally, we should remember that everything is cyclical. The oil sector is no exception. Given the world's reliance on fossil fuels, we know that the sector will come through its current tough times. And we can be confident that those companies that have weathered the downturn well will be best placed to benefit when things eventually look up.

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