THE SCOTTISH Investment Trust

The CONTRARIAN

SUMMER 2018

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

Back in black: banks' long road to recovery

Those who invest in banks will know it can be a rocky road. A reminder of this fact, if it was needed, came as Italy's latest political storm rattled shares in the sector. However, a look back at the decade since the depths of the financial crisis, when banks seemed doomed, shows just how far they have come.

Ten years ago, many of the world's banks were essentially bust. The global financial crisis was in full swing and banks were facing their comeuppance for employing huge amounts of leverage to boost returns. This practice worked for a while, but such precarious methods never end well.

The crisis exposed banks' capital buffers as dangerously thin. Their equity was effectively wiped out. Such was the anxiety over the banks' solvency that UK politicians seriously contemplated putting troops on the street, should the need arise to quell an understandably angry population if banks became unable to dispense cash. For many, at that time, the banks were entirely uninvestable.

We have come a long way since. European and US banks have been heavily punished, with regulators collecting hundreds of billions of dollars in fines. The Dodd-Frank Act in the US brought far-reaching reforms, with tighter rules governing the amount and quality of capital required to guard against a future crisis.

Let loose from the noose

Today, the period of punishment is ending and the regulatory environment is more settled, with much stricter oversight. After considerable delay, one of the final planks of global bank governance was agreed last December – the so-called Basel 4 reforms. The new environment constrains banks' activities but with the rules of the game largely agreed, the banks can plan accordingly.

Back on track

Banks are in much better shape following the recapitalisation of the last decade. With bad debts largely written down or disposed of, their balance sheets are also much cleaner. Admittedly, returns on equity are lower than before the crisis, but that's because banks must carry more equity. Overall, the outlook for cash returns from bank stocks has improved.

The macroeconomic environment is also more favourable. Following the crisis, interest rates were cut to historic lows to prop up the economy and asset prices. Now they are rising again – allowing banks to widen margins on lending. After six rate rises, the US is well on its way. Although the trend is upwards, it is likely that the rest of the world will be slower to hike than the US. That said, Europe could be next and even the Bank of Japan may look at moving from negative interest rates. Rates remain low in a historical context but banks are not sitting on their hands, with most focusing on cost-cutting to improve profitability.

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 above-average investment returns over the longer 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 34 years. Our independently managed, closed-ended fund structure allows us to be patient with our investments.

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. Investment trusts are listed companies 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.

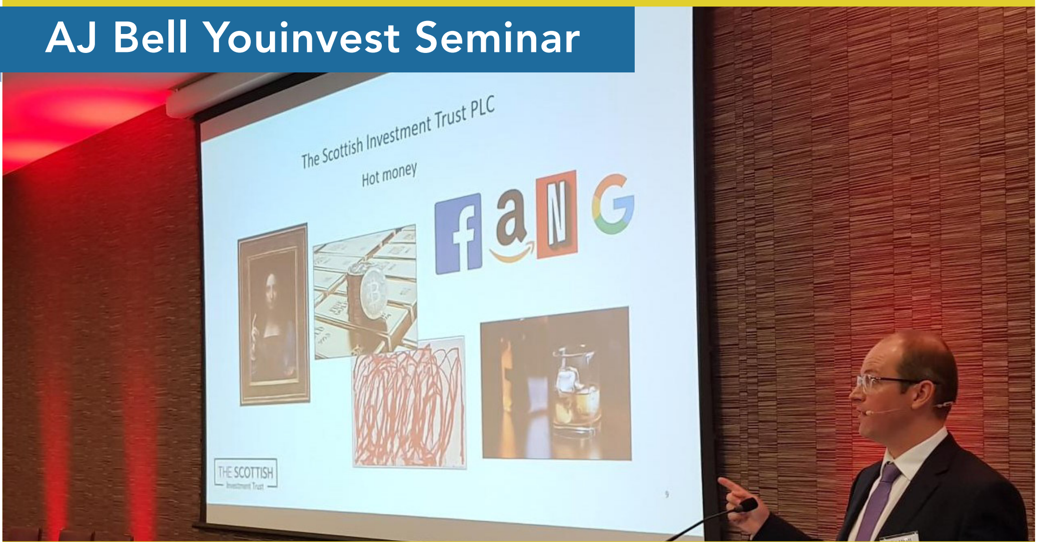
CONTRARIAN INSIGHTS

At The Scottish, it is important to us that we stay in touch with you. We believe that our contrarian approach differentiates us clearly from other investment styles on offer and we are keen to discuss it further. As you may know, we have launched multiple initiatives both online and offline in order to provide you the widest range of access to our regular updates, opinions and contrarian thoughts. You may have already visited our refreshed website, subscribed to our monthly email or followed The Scottish Investment Trust on **LinkedIn** and on **Twitter @ScotInvTrust.**

On our website you can read press coverage, see details of any events we will be presenting at, keep up to date on performance and portfolio statistics, browse through annual and interim reports and access other key shareholder information.

Read on to find out what we have been doing lately:-

AJ Bell Youinvest Seminar



On the 23rd of May, AJ Bell Youinvest held a seminar in London for their investors addressing 'How fund managers pick stocks'.

Alasdair McKinnon, manager of The Scottish, presented on the merits of active investing using a contrarian approach for the longer term. To see a video of his presentation, which focuses on the art of 'thinking differently' when it comes to making investment decisions, see our website's News & views item – **'Active Investing - A Contrarian Approach'.**

Ally's thought provoking and engaging presentation brought a highly successful and interesting evening to a close.

We would encourage our investors to look out for opportunities to take advantage of similar events in the future.

VIDEO Series

In this digital age, we know that video is an effective and appreciated format for our online viewers. In recognition of this, we are delighted to announce the upcoming release of our new video series – 'Contrarian Insights'.

In a sequence of video shorts, we will share our views on a diverse range of contrarian investment related topics. In the initial series, Alasdair McKinnon will elaborate on UK food retail, global banking and give his distinct perspective on the subject of gold. We would be delighted to have your feedback on these and urge you to visit the website in order to view them. You can also watch them on The Scottish Investment Trust **YouTube channel.**

Banks' long road to recovery

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Populist governments are willing to spend money, which should be good for banks' profits. In the US, President Trump has cut taxes. This should not only fatten bank profits but also put more money into consumers' pockets, which in turn helps the banks. Of course, populism has its downsides too. Stockmarkets hate the uncertainty that comes with maverick leaders while unrestrained public spending, though popular with some, could derail economic stability.

Room for recovery

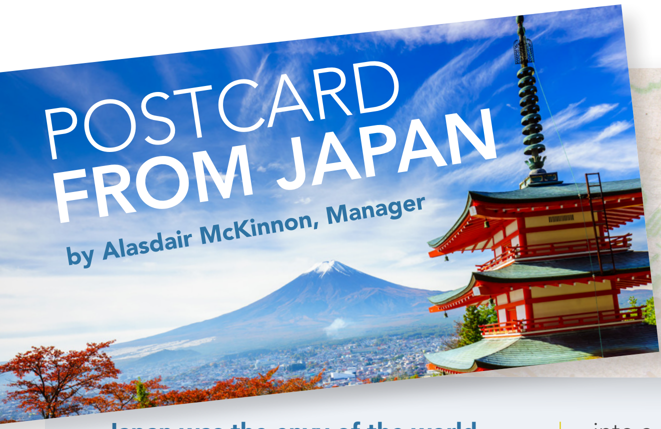
In the US, much of this good news has been acknowledged in share prices. After rallying in anticipation of the spoils of a Trump presidency, US bank shares are close to their pre-crisis highs. But not all banks have recovered as much. The MSCI Europe Banks Index is still more than 60% below its 2007 peak. However, history teaches us there could be many ups and downs along the way.

Ugly ducklings

So where do we see opportunities in the banking sector? Well, one is perhaps the UK's most infamous name of the financial crisis. After expanding aggressively at the peak of the market, RBS became the poster child for banking failure. But the company is now on its way to putting the crisis behind it. RBS has succeeded in deleveraging its balance sheet, is refocusing on its core UK market and is close to settling one of its last major fines. That could clear the way for the company to restart dividends. Its latest results showed a tripling of profits, suggesting real progress. We categorise the company as an 'ugly duckling' – a stock whose transformation could take the market by surprise.

Another 'ugly duckling' is Sumitomo Mitsui Financial Group. Japan's banks went through their own crisis in the 1990s, but are in much better shape today. They remain out of favour with investors because of Japan's negative interest rates. But with change afoot in Japan, any improvement in the economy is likely to benefit its banking sector.

Finally, Citizens Financial is a US bank that regained independence when RBS retreated to the UK. Given RBS's numerous preoccupations closer to home, its US operation was not efficiently run. The spin-off created an opportunity to run the business more effectively and Citizens has performed well, as it demonstrated its ability to steadily improve its profitability.



POSTCARD FROM JAPAN

by Alasdair McKinnon, Manager

I recently returned from a round of company visits in Japan. The country is always a mix of the familiar and the strange, the innovative and the traditional. It's also a fascinating case study for contrarian investors. Japan's recent economic history illustrates just how dramatically things can change – and how surprised most people are when they do.

Japan was the envy of the world

Just over 30 years ago, Japan was the world's largest equity market, accounting for around half of global market capitalisation. Its business practices were regarded with awe and investors couldn't get enough of its stocks. Japan was the future.

But Japan's rise was a direct result of its ruinous state after the Second World War. People, Japan's key resource, were prepared to work for next to nothing, and a weak yen rendered their products remarkably cheap. The US eventually found itself running a huge trade deficit and struggling to compete with Japanese goods. Meanwhile, Japan's living standards rose rapidly, and it shifted from aping Western products to surpassing them. 'Made in Japan' was once synonymous with poor quality but came to be a mark of high-end goods.

Japan's boom and bust

Ultimately, US displeasure led to the Plaza Accord in 1985, with the largest Western economies and Japan intervening in the currency markets to weaken the US dollar. The yen rocketed higher – and people assumed that it would sustain its upward trajectory forever. The money that flooded into Japanese assets created a bubble of prodigious proportions in the equity and property markets. To make matters worse, the central bank sat on its hands, further exacerbating booming asset valuations.

Although the bubble eventually burst in 1990, Japanese society wouldn't stomach the appropriate policy response as it would have meant that, the banks and companies that had loaded up with debt would have collapsed.

In a society in which a job for life was the norm, this was unacceptable. Interest rates were slashed to near zero and Japan lurched on with zombie companies only kept alive by zombie banks. A further result of this was that the population started saving more and spending less, plunging the country into a deflationary spiral.

This was the country's 'lost decade', in which the economy failed to grow and the stock market languished. Some observers note that it was really two lost decades, as the economy remained subdued through the 2000s.

A consequence of the era of economic gloom is that the birth rate has fallen. Japan now has a lower fertility rate than China – despite the latter having only recently abandoned its one-child policy. This has profound implications on Japan's population which is set to decline by more than 5%, and its workforce by a full 18%, by 2030.

Lessons to be learned

As Mark Twain is reputed to have said, "history doesn't repeat itself but it often rhymes". Japan's recent history offers parallels with Western economies today. The rest of the world has enjoyed an asset boom which, some might argue, relies heavily on debt taken out at historically low interest rates. Although confidence is high that imbalances can be corrected by central-bank sleight of hand, Japan has shown that this may not be as easy as assumed.

Since 2012, Shinzo Abe's government has taken drastic steps to turn Japan's economic prospects around, devaluing the currency and attempting to erode the country's debt burden by creating inflation. 'Abenomics' has succeeded in reigniting the economy, but inflation has so far proved elusive.

Is there any reason to believe that other central banks will be more successful than the Bank of Japan in creating the inflation required to level the debt mountain? If not, then Japan's past and present may offer a depressing roadmap for the West. Perhaps they will react more timeously.

It's possible, however, that Japan will manage to escape the deflation trap. Japan's policymakers have shown commitment towards that goal and the electorate have backed them. Should Abenomics succeed, the benefits for Japanese shares could be extraordinary. At the moment, investors appear to have largely written off this prospect. That's a signal for contrarians like us to look more closely.

Contrarian opportunities

So where are the contrarian opportunities in Japan? At present, we are particularly positive about the potential for improvement in Japan's banks. Once the world's biggest, these all but went bust in the early 1990s. But they have now been solvent for 15 years and came through the 2008 financial crisis relatively unscathed. With Japan's negative interest rates, they effectively have more money than they know what to do with. A catalyst may be required for this to be put to the service of shareholders, but there's considerable potential for lucrative returns. We hold both Sumitomo Mitsui Financial Group and Bank of Kyoto – stocks that most investors have given up on.

Nor should we forget Japan's capacity for innovation. In recent years, we've done very well from our holdings Nintendo and Sony. Nintendo suffered losses as earnings matured for its older gaming devices but the company has continued to excite consumers with the successful launch of its Switch console. For Sony, the company has restructured loss-making businesses and returned to profitability amid rising demand for its leading-edge image sensors and games consoles. With their global reach and long record of innovation, these companies delivered regardless of the domestic economy.

Things don't stay the same

In the years ahead, we'll gain greater clarity on whether Western countries are following in Japan's painful footsteps and on the ultimate success of Abenomics. But when we consider Japan's zigzag path from post-war ruin to global leadership to deflationary stagnation, the one lesson we should draw is that things don't stay the same. As contrarian investors, we must always strive to expect the unexpected – and position our portfolio accordingly.

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. You may not get back the amount you invest.

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Alasdair McKinnon accepts AIC award from Chairman of the Judging Panel, Charles Cade

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