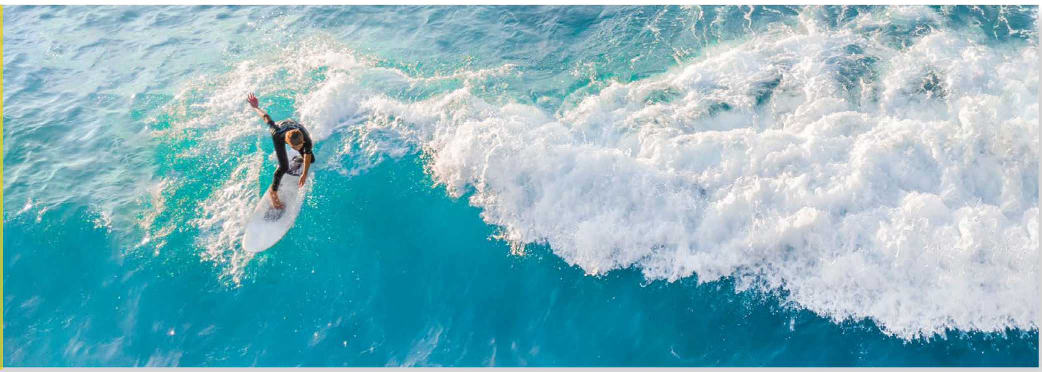
THE SCOTTISH
Investment Trust

The CONTRARIAN WINTER 2018

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



Value investing: is the tide turning?

Growth or value? That has been the question on many investors' minds as markets took a turbulent turn through the autumn months. They represent the two main schools of thought when it comes to investing and investors often try to lump stocks into one or other of the two categories. Of course, it's not so clear cut as Box A for fast-growing glamour stocks and Box B for dowdy, old cheap shares – the lines are often blurred. Both have their draws. Growth stocks inspire hopes and dreams, and investors strap themselves into the love train, usually paying up for the thrill. Value stocks, on the other hand, are the lonely singletons of the stockmarket world – they are priced for their less obvious charms and astute investors can pick up a hidden gem without betting the farm. Of course, investing is full of ups and downs and no style is 'right' or 'wrong' all of the time – they go in and out of fashion. This raises an interesting question – as the rally in growth stocks gets long in the tooth, are the value stocks that have been long overlooked a budding contrarian opportunity?

Cheap money

For over a decade, growth stocks have been cresting the wave of loose monetary policy leaving value stocks languishing in the doldrums. The tide may be turning and, as contrarians, we've been keeping a watchful eye on these contrasting fortunes.

Firstly, let's consider why growth stocks have fared so well. It's not by chance that the strong performance over the last 10 years coincides with the decade following the global financial crash. The conditions that ensued have been unusually flattering for growth investments.

Stunned by the severity of the crisis, central bankers took the unprecedented action of cutting interest rates to near zero and launching quantitative easing (QE) – a scheme that injected cash into the financial system via the central bank purchase of, mostly, government bonds. As growth stocks are often valued by discounting their future cash flows into a 'present value' and, given that most of their profits will be earned in the future, lower interest rates made these stocks look far more appealing to investors using this measure.

Turning off the tap

But 10 years on, the fuel for this cheap money appears to be running out. The US has begun withdrawing QE, while the European Central Bank plans to make no more purchases beyond December. Central banks' withdrawal of accommodative policies, alongside rising yields, creates an environment less supportive for growth stocks, effectively reversing the valuation argument described above.

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 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 34 years. Our independently managed, closed-ended fund structure allows us to be patient with our investments.

Value investing: is the tide turning?

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The trend of increasing interest rates is exacerbated by the rise of populist politicians to power, who are throwing budgetary caution to the wind to satisfy their voter bases. We have seen this lately in Italy, where the country's anti-establishment government announced a budget that will conflict with the EU's rules.

There's also the question of market cycles. The post financial crisis conditions we discussed earlier have prolonged the bull market for growth stocks – we believe that a number of growth companies are in bubble territory. They're 'priced for perfection' and even the smallest disappointment could lead to a share price correction. Some of the internet and technology stocks, characterised by the FANGs, fit this bill. If these companies do fall off their perch, value stocks may well benefit from a rotation of investment flows. Certainly, the balance between risk and reward of growth stocks is less favourable.

Looking at value through a contrarian lens

Contrarian investment is distinct from value investing, but the two styles do have some things in common at this point in time. Both aim to identify undervalued stocks that have the potential for an improvement in circumstances. However, as contrarians, we also specifically seek out unfashionable and unloved stocks where we believe sentiment is overly pessimistic. As we know, market sentiment towards a company can quickly change and that the sentiment cycle tends to swing too far, thereby creating investment opportunities. Part of our job is to identify and investigate these opportunities, looking for tangible signs of positive change. For example, these could include new management, a turn in the industry cycle or other factors that the broader market has overlooked and underestimated.

Our 'belt and braces' approach means that, as well as being unloved, we like companies to have strong balance sheets that facilitate planned change and support dividends to provide us with income while we wait for the tide to turn. In the current climate, there are many interesting opportunities for contrarian investors. Areas such as Brexit blighted Britain, Europe and recently battered emerging markets may all prove fruitful hunting grounds.

Taking a contrarian position can be uncomfortable – it often takes time for change to be recognised, meaning that patience is a necessity. Because ours is an independent, closed-ended fund, we have the freedom to commit to this long-term approach for our investors. We're in pursuit of the most compelling contrarian investments and those are not found in asset bubbles or 'hot trades'. Value stocks might appear out of favour now, but when the sea change comes, these could become fashionable again.

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.

DIVIDEND **REINVESTMENT**

Certificated Shareholders

Certificated shareholders who would like to have their dividends automatically reinvested into further purchases of Scottish Investment Trust shares, can arrange this by joining the **Dividend Reinvestment Plan**.

Details of the Dividend Reinvestment Plan, together with an application form, can be found on our website **www.thescottish.co.uk/drip** or obtained by telephoning our Registrar, Computershare Investor Services PLC, on **0370 703 0195**.

Other Shareholders

If your shares are held elsewhere, such as with a broker or platform provider, you should refer to them for details of their dividend reinvestment facilities. You should establish the cost of any facility with your provider.

If you are unsure of the most appropriate arrangement for your circumstances, you should consult a suitably qualified financial adviser.

UPCOMING DIVIDEND PAYMENT DATES

Final 2018	**February 2019**
First Interim 2019	**May 2019**
Second Interim 2019	**August 2019**
Third Interim 2019	**November 2019**

Please note that the value of investments, and any income from them, can go down as well as up and you may not get back your original investment. Past performance is not a guide for future performance. We do not offer financial advice.

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A contrarian approach can pay dividends

As contrarian investors, we prefer to plot our own course rather than follow the herd. We often speak about our quest to find 'ugly ducklings', companies that are shunned by others but offer a real prospect of improvement. And while the obvious upside to this approach is the potential for share price appreciation, it can also offer another valuable source of returns as unfashionable companies often have higher than average dividend yields.

Seeing the value in ugly ducklings

It goes without saying that the 'ugly ducklings' we choose are unloved, but we believe that they have the potential to improve their businesses. The ability to adapt and thrive over the longer term often comes down to how much flexibility or control the company has to make needed change. A sustainable dividend from such companies is attractive to us as it offers a return while we wait for our thesis to unfold.

Of course, not every investment in our portfolio pays dividends and we wouldn't necessarily overlook a prospective investment for that reason. A company navigating the low point in its cycle might opt to forgo a dividend to reinvigorate its business. This prudent approach can hasten the company's recovery and potentially allow more sustainable dividend payments to recommence. Indeed, a dividend reinstatement can be an important signal that the company's rehabilitation is gaining traction.

This scenario is currently playing out at Tesco, one of our biggest holdings. Tesco cut its dividend after a difficult period, during which profits fell and discounting rivals gained market share. Since then, the company has regained its footing, allowing management to reintroduce the dividend.

As long-term investors, we have time on our side as we wait for a nascent recovery to become established. Patience is key to contrarian investing. A certain fortitude is also required to withstand the anxiety and negativity of the market, while holding steadfastly to our convictions. But the potential pay-off can be more than worth the wait.

From sour grapes to an exceptional vintage

A great example is Treasury Wine Estates, formerly the biggest holding in our portfolio. We invested in this company in August 2015, when it was very much out of favour. The catalyst for change was a new management team, whose strategy transformed the business from an 'ugly duckling' to an elegant swan before, we decided to sell our stake (or, to continue with the metaphor, it flew our nest) leaving a £39 million profit – almost three times our original investment. Not all of our investments are fruitful but examples such as this demonstrate the potential pay-off from being patient.

Retail – down, but not out

Another example is the retail sector. The popular view is that the high street is on its last legs with several prominent names succumbing to difficult trading conditions in recent months. By contrast, some online retailers such as Amazon are hugely in favour (though perhaps less so lately with the British Chancellor).

For some time, we've been sifting through prospective investments in the retail sector that meet our unloved criteria. Two such companies currently are Marks & Spencer and Macy's, where we believe signs of improvement are starting to appear. Macy's has delivered sales that were surprisingly strong and has shown a more disciplined approach to discounting. Meanwhile, Marks & Spencer has been revitalising its product lines and overhauling its pricing strategy. Both have the potential to be strongly cash generative which provides their management teams with a wider range of strategic options.

> "...a return while we wait for our thesis to unfold"

Enduring growth

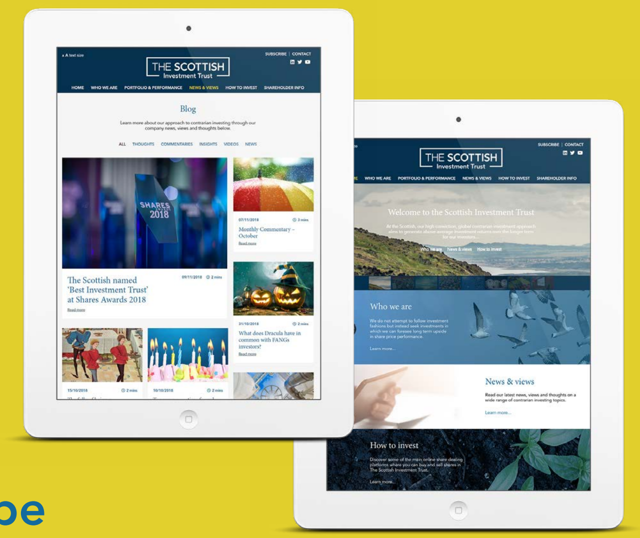
Paying dividends to our own shareholders has also been part of our 131 year heritage. We've recently increased the frequency of our dividend payment to quarterly, aligning more with the desires of the majority of our shareholders. One of our aims is to grow the dividend ahead of UK inflation and this is supported by a record of raising or maintaining our regular dividend at least each year since the Second World War.

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.

CONTRARIAN **INSIGHTS**

Come and visit us online. We have regular updates, insights, videos and contrarian thoughts to share with you – and if you'd like these delivered to your inbox – register at

www.thescottish.co.uk/subscribe



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