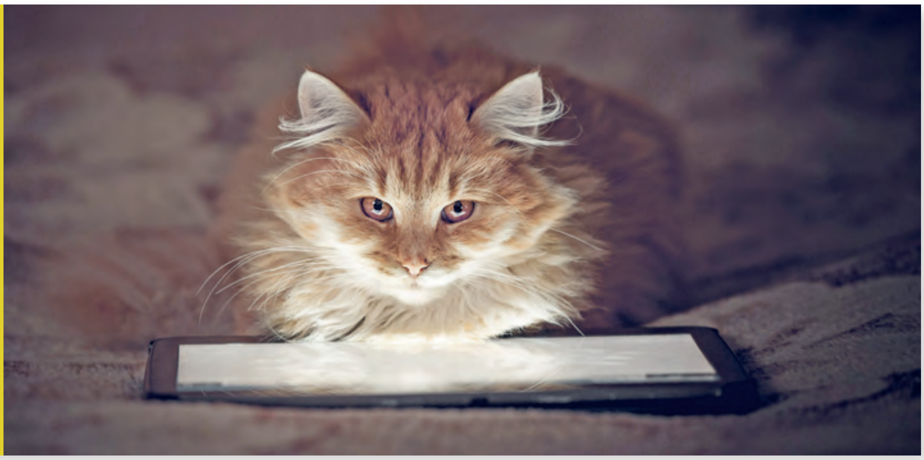
THE SCOTTISH Investment Trust

The CONTRARIAN

SUMMER 2019

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



A game of phones

Does the abbreviation TMT ring any bells? Twenty years ago, TMT – telecommunications, media and technology – was the hot investment theme. Telecom companies were seen – rightly – as an integral part of a brave new digital world. As dotcom mania took hold, their shares were dialled up to extraordinary levels. It couldn't last, of course, and when the bubble burst, investors hung up. Telecom shares have been on hold ever since, languishing well behind the broader market. We believe it's about time this out of favour sector was reappraised.

Change is afoot

With cheap money and speculative trends driving the market since the 2008 financial crisis, telecom shares have suffered from being viewed as dull and defensive – the less eligible sibling of the technology and media stockmarket darlings. However, political machinations have been one of the biggest factors in their underperformance.

That's because telecommunications – and especially the internet – are now a crucial part of our lives. We rely on the internet in almost every aspect of life - to work, learn, communicate, socialise and entertain ourselves. An internet connection is now almost as essential as electricity. It is, in many ways, a utility. Utilities always attract regulation. Consequently, telecom companies have been shackled by onerous constraints. Regulators in many countries have long taken a dim view of mergers in the belief that competition would keep prices down for consumers. That has largely proved correct.

While that may seem like welcome news for billpayers, it masks other costs. By duplicating expenditure and spreading it over a smaller base, service providers are less efficient at serving us than they ought to be. Furthermore, the threat of price-focused overseers changing the rules of the game has stymied investment.

The 'digital economy' will rely on ultrafast networks based on 5G and FTTP (fibre to the premises) which will require massive spending on the part of the telecom companies. A fair return on investment is vital to encourage the development of the next-generation of infrastructure upon which our economy depends.

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

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Regulators seem to be waking up to this. For example, the European Union recently approved the merger of Deutsche Telekom and Tele2's Dutch operations, reducing the number of mobile operators in the Netherlands from four to three. If this heralds a more relaxed regulatory approach overall, investors in telecom companies also stand to benefit.

Growth opportunity

Additionally, next generation networks could provide an opportunity for the industry to return to growth. On the horizon is 5G - shorthand for the fifth generation of mobile networks, which will succeed the decade-old 4G standard as the leading network technology. It is expected to be up to 100 times faster.

But being able to load web pages a bit quicker is perhaps the least interesting advantage. Once 5G is introduced, demand on telecoms networks is forecast to surge as a greater number of internet-connected devices emerge – from smart traffic lights to self-monitoring industrial equipment to internet-connected cat collars! It may also help realise some of the big ideas that could transform our lives – such as remote healthcare, smart cities and self-driving cars.

Winter is coming

Besides the potential that could be unleashed by changing regulation and heightened demand, telecoms companies offer other intrinsic attractions. With the great quantitative-easing experiment potentially coming to an end, markets appear to be entering a more uncertain phase. In this environment, the defensive qualities of telecoms firms – with robust finances and attractive valuations – look ripe for reassessment.

Healthy dividends present another attraction. Because they're steady, 'unexciting' businesses, many telecoms companies are able to sustain attractive dividends. When stockmarkets are soaring, reliability can be an easily overlooked characteristic. So much of the growth boom in 'exciting' sectors has been driven by debt. In the long term, that's likely to prove unsustainable. When the macroeconomic tides recede, we may, in Warren Buffet's words, see who's been swimming naked.

Going Dutch

We've recently added several telecoms investments to our portfolio, including KPN and Tele2.

KPN is the leading Dutch telecoms provider. Expectations for the business are low following a decade of shrinking revenue. A change of leadership often brings improving fortunes and KPN's new CEO has set out a credible plan to return the company to growth. New network technology will be key to those plans and recent consolidation provides a platform to capitalise on that opportunity.

Tele2 operates throughout Europe but the bulk of its sales come from its home country of Sweden, where it recently completed a merger with cable operator Com Hem. This tie-up should offer significant financial benefits. Meanwhile, the merger of their Dutch operations with Deutsche Telekom creates the prospect of a lucrative exit from the Netherlands in the coming years.

Patient opportunities

These companies exemplify the opportunities that we see in the telecoms sector. (Social) media and technology have been the toast of the market in recent years, but we think that many investors are forgetting that they depend on the other T in the old TMT triangle. With opportunities for growth, and political change looking more likely, that dependence could well provide a pay off for patient, contrarian investors.

12 June 2019

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.

Catching up with Alasdair McKinnon

How would you introduce yourself to the reader?

I'm Alasdair McKinnon, as Manager of the Scottish Investment Trust, I oversee our stock picking process. I've been a stockmarket enthusiast for longer than I can remember.

Could you explain the contrarian investment approach?

Our contrarian style is based on a belief that markets are driven by emotion, resulting in stocks becoming mispriced – unduly hated or overly loved. Contrarian investors look for signs of such overexuberance among other investors, avoid following fashions and investing in hot themes which often turn out to be overvalued. Instead, contrarians look for opportunities where investors are being unfairly downbeat, and seek out companies that are generally unloved but have potential to recover.

What are some common attributes of these 'unloved stocks'?

There are three key criteria we aim to find in a contrarian investment. We generally look for companies that are regarded as unfashionable and, while these are relatively plentiful, they must also be ripe for improvement – which can be driven by a change in the respective business cycle or a new approach, or often, both. So, secondly, we're looking for a credible plan for their recovery.

Thirdly, we like to take a belt and braces approach to our investment. This gives us a plan B – which may be substantial asset backing or an attractive dividend yield while we wait for our investment thesis to play out.

What are the long-term investing benefits associated with contrarian investing?

As active managers, we have an in-depth knowledge of the companies that form our portfolio. This allows us to retain our convictions through difficult spells and avoid getting caught up in the vicious cycle of emotion, endemic in the stockmarkets. If the share price of an investment falls, of course, we evaluate why this has happened and, if our investment case is intact, we may buy even more of that stock. Contrarian investments are well placed to appreciate in the long-term, weather the bad times and, ideally, be rewarded with income which helps us to pay dividend to our shareholders.

What are some of the fashions that you currently observe in the stockmarket?

One of the most fashionable sectors is technology. We believe that the share prices of these companies, namely the FANGs, are fuelled by investors' hopes that their rise will continue indefinitely. In this context, any disappointment (a shortfall in user growth, misuse of data) may lead to their prospects being radically reappraised.

As contrarians, we prefer investments that offer a more favourable balance between risk and reward. The flipside of stockmarket fashions is that there can be opportunities to buy at attractive valuations when certain stocks go out of style. One area where we currently see unfashionable opportunities is in the gold mining sector which we think is primed for a revival of fortunes.

It's all about risk and reward

When it comes to investment decision making, is there a place for emotion? You might be surprised to learn that a lot of the behaviour in markets is emotionally charged, with investors favouring information that supports their entrenched views.

The contrarian investor's job is to be aware of the emotions involved in investment decisions, to challenge accepted thinking, be sceptical of trends and remain open-minded when other investors walk away.

Often, investors become emotionally attached to stocks and their stories – which can be dangerous. When an investment is universally loved, even a small disappointment can upset the share price. When the expectation bar is high, a company needs dazzling results to exceed expectations.

So-called pariah stocks are also a product of emotional investing. Having been disappointed in the past, investors can be reluctant to see signs of improvement. Contrarian investors examine the stocks shunned by the wider market because they can be undervalued and rational investments: with little good news reflected in the share price, even an incremental improvement can beat expectations.

One well-known speculative 'hot theme' that investors fell for was Bitcoin. Launched in 2009, the cryptocurrency was the next big and overhyped thing, quickly gaining a cult following. The value of Bitcoin surged to nearly $20k in December 2017. However, this meteoric rise didn't reflect any fundamental increase in its value. One attraction was Bitcoin's finite nature – only 21 million Bitcoins were to be produced. But in 2018, a *de facto* parallel currency cast doubt on Bitcoin as a value store. Bitcoin then dropped considerably – below $3.3k. Clearly, an emotional element drove these extreme movements.

In contrast, for centuries gold's appeal has been its ability to retain its purchasing power. The Scottish has exposure to gold via Newcrest Mining, Newmont Goldcorp and Barrick Gold. Before our purchase, investors had punished these companies for overexpansion, but they took action by cutting costs and reducing debt. When it comes to investing, popularity isn't everything and emotions can be a hazard.

Read on for five key points to consider in the quest to buy low and sell high.

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.

1: Don't follow the crowd

Markets and stocks can become overbought or oversold - a consequence of the cycle of 'greed and fear' when news is good or bad. Don't get sucked in or out of investments at these times, especially when everyone is buying or selling. A rational, evidence-based, unemotional approach is essential.

2: What can improve?

Being a contrarian is not about seeking out the most hated stocks. These are only interesting when change is afoot. This can come from new management, a new strategy, activist involvement, or merger and acquisition activity. A contrarian finds overlooked signs of improvement, as these may bring positive share price moves.

3: Emotions matter

Investors are human; they can fall in love with stocks and then only hear information that supports their emotions. Contrarian investing seeks to take advantage of this in an objective way.

4: Belt and braces

The financial fundamentals of an unloved stock need to be solid. Is there asset backing? Can the company pay a dividend while waiting for improvement? Is the balance sheet stretched? Do management have control over their destiny? The contrarian needs to be comfortable with the answers.

5: When to sell

Having a strong sell discipline is the corollary to a disciplined buying process. It means avoiding behavioural biases and allowing money to be recycled into new and better ideas.

Rigour, patience and a long time horizon are requisites of a contrarian. The crowd is not easily ignored, but following these steps could help uncover a true contrarian opportunity.

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Our learning hub

We believe that financial literacy is an area that deserves more interest and coverage. It seems that even as easy, low-cost access to the stockmarkets has increased thanks to the development of the internet, financial education and literacy in our society has failed to keep up.

Being able to invest for a secure future affects us all, perhaps for a retirement free from money worries or – given the generational wealth imbalance in our country – to help younger members of the family get on the housing ladder. Worryingly, there are a number of social or demographic groups that still lack even basic knowledge and confidence in managing their personal finances. This is also problematic when house prices feel like they are ever rising just out of reach and the returns on lower risk savings remain stubbornly low.

When it comes to equity investment, we think that we are particularly good at asking awkward questions and uncovering *Emperor's new clothes* type stories. It's inherent in our contrarian style. We hope that the materials we will be sharing will give viewers the confidence to ask questions and to challenge the assumptions and behaviour around them on their own investment journeys.

As well as our own material we are delighted to be able to offer some of the AIC's education resources on the hub. These cover investing basics and provide an understanding of why investment trusts can be an excellent investment option for the long term.

'Money...what's it all about?'

We have launched our learning hub with a series of videos presented by Iona Bain, a highly regarded freelance money blogger in the UK, with a strong reputation for championing young people in the area of finance and financial education. Her accessible, quirky, irreverent style fits well with our own independent, contrarian perspective.

We wanted to examine something that everyone knows about in day-to-day life and see if we could reveal some new thoughts and ideas, possibly closing some knowledge gaps.

'Money… what's it all about?' video series takes the viewer on a journey from the pound in their pocket through to the impact of global central banks activity on world economies. Iona looks at the evolution and importance of money, its management, and how investors might patiently weather the vagaries of the stockmarket.

www.thescottish.co.uk/learning-hub

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