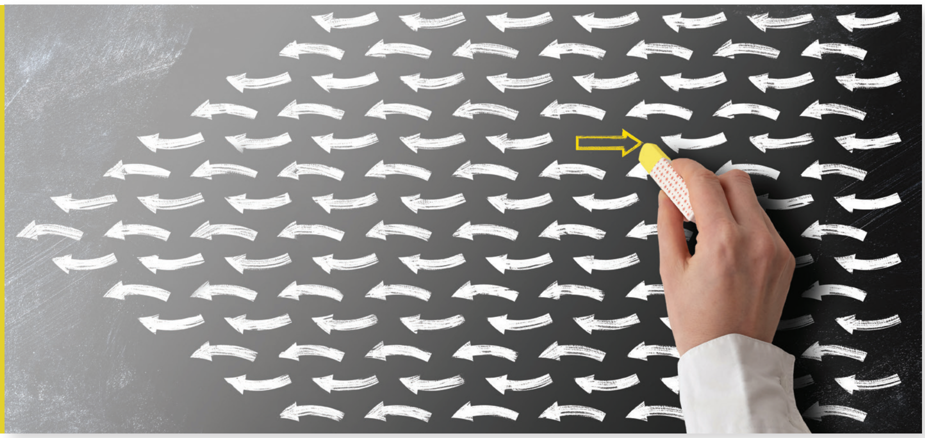
THE SCOTTISH Investment Trust

The CONTRARIAN WINTER 2019

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



The Uncertainty Principle: why momentum matters

Physics buffs will be familiar with Heisenberg's Uncertainty Principle. For the rest of us, it seemingly states that: the more accurately we can observe a particle's momentum, the less accurately we can know its position.

In other words, the very act of carrying out certain scientific methods inevitably interferes with the result, defeating the original purpose. It therefore enshrines into science the uncomfortable notion that not everything can be neatly explained by a formula.

Admittedly we, at The Scottish, rarely have discussions on such abstruse aspects of quantum physics. However, 'momentum' is something that matters greatly for stockmarkets, and Werner Heisenberg's thought provoking idea echoes the counter -intuitive way that modern markets behave.

The fashion for formulas

Investing based on opaque formulas is on the rise. A mechanical, mathematical approach is already behind many of the most fashionable investment strategies today and has the superficial appeal that it can be done relatively cheaply, or with the hope of gaining a slight edge over other investors.

Therefore, terms like 'passive investing', 'smart beta' and 'factor investing' are increasingly commonplace. Each of these approaches invests money as dictated by a formula, without regard for the prospects of the business.

It is unclear whether any of these methods will work as hoped in the long run, but they have important implications for the behaviour of stockmarkets in the near-term as they become increasingly influential buyers and sellers of shares.

In the past 10 years, passive funds (which are formulated to mirror a popular index)

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

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have doubled their ownership of shares in both the US and the UK. In the US, assets in passive funds outweighed those in active funds for the first time this August.

'Factor investing' is another approach that has been particularly influential in recent times. The idea is to break market forces down into component 'factors' such as 'momentum', 'value' and 'growth', allowing investors to bet on which will be the dominant force.

However, this sort of 'scientific' approach to investment now appears to be having unintended consequences. As more automatic buyers and sellers of shares crowd around the same trades, capital chases the same themes. This interferes with the normal balance of the market – creating a feedback loop that produces bubbles of overpriced shares and pockets of depressed shares. In effect, it exaggerates the stockmarket trends that it seeks to track. And may well exaggerate the reversal when trends eventually change.

Momentum mania

For the past six years, stockmarkets have known little other than 'momentum'. In other words, stocks that have gone up have continued to go up, and those that have gone down have often remained that way.

Stretched valuations and sometimes shaky corporate governance among some of the biggest winners haven't slowed this surge in momentum stocks.

Momentum stocks have typically been those of companies perceived as offering high growth – particularly in the technology sector – but, more recently, this has extended to slow-and-steady consumer staples.

The initial rush into growth stocks was a rational response to the low growth environment that has persisted since the end of the financial crisis. But with all the passive, smart beta and factor money backing these stocks, their valuations now look overextended – and their share prices ripe for correction, in our view.

Value volte-face

At the same time, 'value' has been resolutely out of favour. Value stocks – those that look cheap relative to their underlying financials – have been subdued for an unusually long period.

In September, however, we saw a brief but dramatic shift. The share prices of 'momentum' stocks fell sharply, with a corresponding rally in 'value'. Various explanations were offered by market commentators, but this event reminds us that when trends change, they often take observers by surprise and the speed of change can be rapid.

Many will recall the hasty swing that followed the previous major bull market for growth stocks – the dotcom bubble. Then, a shift back to unfashionable but attractively valued investments caught many investors flat-footed.

Formula based investments may be vulnerable to such sudden moves. If momentum stalls, then these strategies will automatically follow suit.

We believe that this creates an opportunity for active investors who are wary of fashionable trades and prepared to venture where the crowd do not.

Ready for change

We see the greatest risk in situations where many investors are positioned the same way – whether that is mechanical processes that are more aligned than people think, or simply people taking comfort by investing with the crowd. When a crowded trade runs out of steam, the rush towards the exit door can be particularly damaging for investors.

With change often taking investors by surprise, there is much to be said for preparing for a shift. Our portfolio of carefully selected shares in unloved but robust companies is designed to anticipate such change.

So, with so much resting on momentum, we are content to recall the Uncertainty Principle – and remain focused on knowing our positions as accurately as possible.

29 November 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.

Award SUCCESS

2019 Shares Awards

The Scottish was named 'Best Investment Trust' in the Shares Awards 2019. This is the Trust's second consecutive win in these awards.

The team has worked hard to bring its contrarian message to its growing following. We'd like to thank those who gave their votes to The Scottish.

SHARES AWARDS 2019
WINNER
Best Investment Trust

The snowball effect of dividends

If you're a regular reader, you'll know that we often talk about dividends. That's because they can make a big difference to your long-term investments. In this article we go back to basics and explore the role of dividends.

Making dividends work for you

If you're a shareholder in a company, you may receive a dividend from that company's profits – as a reward for entrusting it with your capital. As with all investment trusts, The Scottish's main source of income used to pay dividends to its investors are the dividends received from its portfolio of holdings. You may not be aware that we deliver one of the highest dividend yields in the AIC Global peer group. This is important because, in conjunction with share price movements, dividend income forms a substantial part of an investor's total return.

Compounding occurs as dividends are used to buy more shares which, in turn, earn dividends on their own. These reinvested dividends would then gain or lose in line with the movement of the share price. For example, over 25 years to 30 September 2019, the share price of The Scottish increased by 289%. The share price plus dividends taken as cash would raise this to 420% over the same period and, if those dividends had been reinvested, the total return would have been 599% (all before any dealing expenses). It's important to remember, of course, that markets can be volatile and shares (and the income from them) can go down as well as up.

Why a contrarian approach can pay dividends

As we've demonstrated, dividends can play an integral part in the return on your investments over the long term. We're pleased to say that we've increased our regular dividend for the last 36 consecutive years which makes us a 'dividend hero' according to the AIC. Though remember that dividends are not guaranteed and they can fall as well as rise.

In this context, how does our contrarian style come into play? It guides us to look for what we call 'ugly ducklings' – unfashionable and unpopular investments. The share price of such investments typically reflects their 'unloved' status, often written off by other investors. By contrast, we research these companies to ascertain if they are ripe for improvement. Has there been a change in their business model, or to senior management? Are there nascent opportunities in the markets in which they operate? If we believe we can see a change, and the company presents a credible plan for recovery, we'll consider investing. However, we also take a 'belt and braces' approach to our investment – which brings us back to dividends.

One of the things we may consider before investing in an 'unloved' company is if it has sufficient cash to pay dividends throughout its turnaround. As our approach is based on long-termism and patience, a sustainable dividend may make it easier for us to hold the stock while the business is recovering. A good example of this is our investment in Dutch telecoms group KPN. Deemed unexciting by many, we view the steadiness of this business as a virtue. It fits our 'unloved' criteria, because shrinking revenues have set investors' expectations low. The company has a credible plan to improve its fortunes. As we wait for positive development, we can enjoy the dividend – the belt to the braces.

What if the company doesn't pay a dividend?

If dividends are so useful, does that mean we'll shun companies that don't pay one? Not necessarily. When a company is putting its house in order, it might choose to stop paying a dividend, conserving its cash to allow it to improve the business (investing in new technology or changing its business model, for example). Indeed, this was the case with Tesco, which suspended its dividend before we invested. Tesco addressed areas of concern, made improvements to its business – then restarted its dividend. We see the reinstatement of a dividend as an important signal that a company's rehabilitation is underway. Another example is Royal Bank of Scotland, which was forced to cease dividends during the financial crisis. Similarly, the company restarted dividends when its financial position improved.

As you can see, dividends can tell us a lot about a company's health – and its future prospects. We always pay close attention to a company's dividends when we're considering investing – both its ability to pay them and its track record of doing so, because dividends can make a difference to long-term investors.

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.

Have you seen our videos?

As contrarian investors, we don't get swayed by the latest fashions. However, like everyone we do love to use all things digital.

As online video is becoming more popular, we have created a wealth of new material, in which the team at The Scottish share their contrarian views on a broad range of subjects. Our video content can be now found in Blog on our website as well as social media channels such as YouTube, LinkedIn and Twitter.

To catch up on some of our new videos you may sign up for our monthly email via www.thescottish.co.uk, or subscribe to our YouTube channel to receive alerts as the videos are published.

If you enjoy our videos – please remember to like and share them!

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