



Securities Trust of Scotland

STS's high-quality global equity income approach has proven resilient over both the long and the short term...

Update

27 October 2022

Overview

Securities Trust of Scotland (STS) has performed well over the past 12 months, thanks to the quality-growth strategy employed by Troy since it took over management in November 2020 (see **Performance**). STS's managers James Harries and Tomasz Boniek prize capital preservation highly, and have a long track record of preserving investors' capital in rough periods on the open-ended Trojan Global Income Fund. With STS they implement the same strategy in the closed-ended space, and their portfolio is highly concentrated, with a focus on high-quality stocks whose returns have low correlation to the market's, thus delivering on STS's rising income and capital growth investment objectives.

STS also has strong **ESG** credentials. James and Tomasz are co-managers of the Trojan Ethical Global Income Fund and incorporate ESG into STS's investment process. This has been recognised by external parties: for example, amongst all global equity portfolios Morningstar rates the trust 'above average' for sustainability.

STS's **Dividend** was rebased in 2021, resulting in a current yield of 2.7%. This is at the lower end of the peer group's yields; however, James and Tomasz believe they have positioned the portfolio for strong, sustainable long-term earnings and dividend growth.

Finally, STS operates a **Discount** control mechanism (as is common across the trusts that Troy manages), which is enforced to improve liquidity and minimise discount volatility for the trust's shareholders.

Analyst's View

We think recent strong returns illustrate the potential for James and Tomasz's strategy to perform well in difficult markets. The focus on strong balance sheets, good management and sustainable earnings also looks like an attractive strategy in a troubled economic climate. We note that historically the managers' portfolios have tended to perform well in market drawdowns, which is likely to be reassuring given the risks that currently abound.

The trust's **Dividend** is not high when compared to those of its peer group, and therefore will not satisfy those only looking for a current high yield. However, we think the trust should appeal to those looking for a long-term income investment. The portfolio is tilted to where the managers think earnings growth will be strong and sustainable, and if they are right this should give a stable or rising income for many years. Additionally, the trust could appeal to those who want to benefit from the total return potential in reinvesting a growing dividend.

In the short term, some companies and industries that are less focussed on ESG factors have performed well. However, the Ukraine war has only reaffirmed the world's commitment to transition away from fossil fuels. The strong ESG credentials of the trust are an additional factor that should attract many investors, and may be accretive to financial returns over the long run.

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BULL

Capital preservation and absolute return focus is reflected through strong 12-month performance and greater downside protection

Dividend rebasing may increase the sustainability of dividend growth over the long term, increasing long-term suitability for income investors

Discount control mechanism should ensure liquidity for shareholders and reduced discount volatility

BEAR

Quality-growth style may lead to underperformance during rallies led by cyclical 'value' stocks

Dividend rebasing has led to a lower current yield versus the peer group

Current OCF is higher than the peer group average



Portfolio

Securities Trust of Scotland (STS) has gone through a significant overhaul since the board selected Troy to manage the trust's assets from November 2020. STS is managed by James Harries and Tomasz Boniek, who are experienced in implementing Troy's unique capital preservation and quality-growth strategy in the open-ended Trojan Global Income Fund which James has managed since 2016. STS's portfolio has been constructed in a way that reflects this strategy, with the core objective being to provide shareholders with rising income and long-term capital growth.

In practical terms the investment process used by all managers within Troy is truly bottom-up, and knowledge is shared across all strategies in an effort to identify high-quality companies at the right price. The team seek to identify exceptional companies through a benchmark-agnostic, unconstrained, absolute return-focussed approach – demonstrated since James and Tomasz took over the mandate by STS's relatively low beta of 0.77 to the MSCI ACWI compared to the sector median of 0.92. The pair seek companies that are able to demonstrate they can generate sustainable cash flows and strong balance sheets that can sustain growth with high returns on capital. Troy's investment team also believe persistent opportunities can be found in companies that are self-financing and do not require significant amounts of capital, with a preference for those that use no external capital at all. This naturally leads to companies that exhibit a competitive advantage, pricing power and the sustainability of margins and earnings that are less correlated to the cyclicity of the market.

The quality demands whittle down Troy's investable universe to a single buy list consisting of c. 170 companies. Inevitably this removes whole sectors, including those with significant cyclicity or capital intensity, or those which are currently exposed to significant structural challenges, such as construction, telecommunications, autos, airlines, retail, energy, and mining. From this universe James and Tomasz then select stocks with attractive enough

valuations that they deem appropriate for the delivery of the capital growth and income objective of STS.

The pair are highly selective in the businesses they invest in. This leads to one of the most concentrated global equity-focused portfolios with just 33 positions and 48.6% in the top ten holdings at the time of writing. The focus on the managers' quality criteria has led to persistent opportunities in sectors that have proven to be the most operationally resilient, including in terms of income, return on capital and return on equity (as shown in the table below). These opportunities include business software and services and healthcare, which exhibit less exposure to cost pressures and a greater predictability of revenues. In addition, James and Tomasz's allocation to consumer staples – including companies such as Procter & Gamble and Unilever, which supply goods that are repeatedly purchased by consumers throughout the market cycle – remains high at 40%. Although many companies in the sector are exposed to margin pressures induced by rising input costs, James suggests that they expect such companies to deliver margin expansion in the future as these cost pressures subside. In addition, STS's unrestricted global mandate allows the managers to allocate to the very strongest companies in terms of their financial performance and market positioning. This translates into a portfolio predominantly exposed to the US, with 49% of the portfolio's underlying revenues attributed to the region. While 30% of the portfolio is invested in UK equities, the majority of these companies generate global revenues, as demonstrated by the 7% underlying revenues attributed to the UK. STS has therefore benefitted from the recent sterling weakness, and particularly its weakness against the dollar, as this has increased the value of overseas investments and the dividends that they pay.

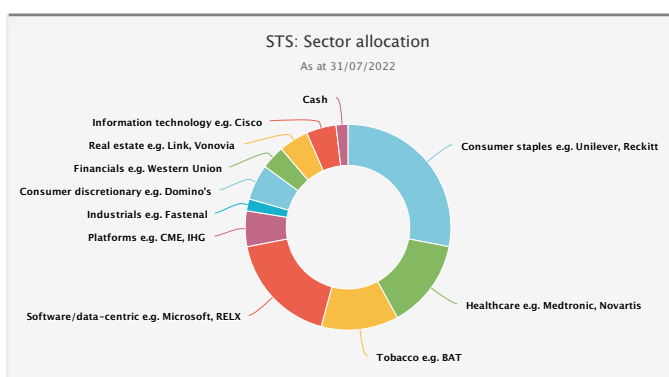
Portfolio Operating Metrics

	STS (%)	MSCI WORLD NR (£) (EXCL. FINANCIALS) (%)
Operating margin	27.6	13.8
Return on capital	19.4	10.3
Return on equity	33.8	18.3

Source: Troy Asset Management, as at 31/07/2022

The long-term buy-and-hold philosophy embedded within James and Tomasz's investment process helps facilitate the opportunity for investment ideas to compound and deliver absolute returns over the economic cycle. This strategy is reflected in the low turnover of c. 10% per annum (Source: Troy Asset Management), equivalent to an average holding period of ten years, with only a handful of new ideas being considered for entry into the buy list every year. The recent purchase of Nintendo typifies the type of company James

Fig.1: Sector Allocation



Source: Troy Asset Management, as at 31/07/2022



and Tomasz look for. Alongside an attractive dividend yield of 3.8% (as at 16/09/2022), Nintendo owns some of the most valuable intellectual property in the gaming industry. The strength of the company's balance sheet and cash flow generation is partly attributable to the continued expansion of gaming globally, but also to the success of the Switch console. This has a platform of over 100 million users as well as 40 million online accounts that can interact digitally, making it increasingly hard for new entrants or competitors to disrupt. Furthermore, this has provided a platform for the company's future growth opportunities as it looks to monetise its intellectual property outside of gaming and into alternative media platforms and even theme parks.

Through the investment process, James and Tomasz hope to identify strong management teams that are able to allocate capital in a thoughtful and efficient manner. However, it is important to note that their investment strategy does not mean that they are averse to adjusting the portfolio if the fundamentals relating to an investment evolve. As one example of this, recently a rare event took place in that Hargreaves Lansdown (HL) was purchased and then subsequently sold. The company had been purchased due to its excellent fundamentals and industry-leading position within the digital wealth management industry – a sector that has experienced significant tailwinds through retail clients' greater understanding of investing, leading to the democratisation of personal investments. However, in light of increasing competition from the likes of AJ Bell announcing its commission-free investment platform Dodl, James and Tomasz believe HL has underinvested in its digital capabilities. They term this 'tech debt', and believe this led to downward pricing pressures being subsequently reflected in HL's valuations. HL remains in Troy's investable universe.

James and Tomasz suggest that we are entering into a period that will be significantly different to the last ten years, which were characterised by periods of structurally rising equity markets alongside falling bond yields. Therefore, they believe capital markets are fully valued with few opportunities to generate an attractive long-term return. Furthermore, although interest rates are set to rise over the coming months, to combat persistent inflationary pressures, both short- and long-term rates remain historically low. This makes it challenging to generate income, particularly with the existence of newer, technology-driven entrants that tend to pay no or low dividends and look to disrupt mature incumbent businesses which tend to pay higher dividends.

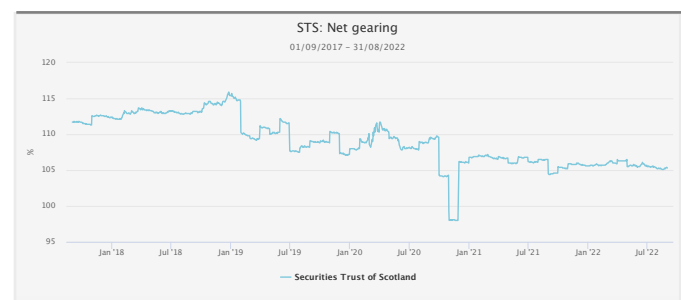
For James and Tomasz, the focus remains on the underlying quality of the businesses they invest in, which they hope will help them navigate through the structural challenges facing global income investors in search of real returns in a persistently elevated inflationary environment. Long-

term holding McDonald's is an example of a high-quality company that provides the trust with a dependable level of income in addition to its ability to demonstrate its resilience and competitive advantages. In this high inflationary environment the company's core offering represents an 'affordable treat' for consumers which has so far been reflected in a respective 12% and 10% increase in sales over Q1 and Q2 of 2022, alongside the dual revenue streams coming from rent and royalties tied to the brand, which provide some predictability to the company. Furthermore, the continued reinvestment into the maintenance of its store base has led to an enhanced customer experience for its daily customer base of 60 million. The addition of digital marketing incentives also demonstrates its future ambitions, which should lead to free cash flow generation and income growth for years to come. The goal for STS is to provide investors with a portfolio which consists of companies that are attractively valued, have sustainable cash flows to finance expansions and/or dividends, and are able to pass on the increased cost pressures. We believe that such characteristics may prove attractive for investors as inflationary pressures persist and interest rates continue to edge higher, and they have contributed to the last 12 months' strong **Performance.**

Gearing

The net gearing of STS was 5% as at 31/08/2022. As a policy, gearing is limited to 10% of NAV. However, James and Tomasz share the conservative philosophy of Troy, which aims to avoid unnecessary risk, preserve capital and invest with an absolute return mindset. In fact, STS is the only trust that Troy manages that uses gearing, broadly due to legacy borrowings from the previous manager. However, the board and James are happy to continue to run STS with a level of gearing at or near the present level. We understand it is unlikely that the level of gearing will be increased to beyond 10% in the future; however, it is possible it will be bolstered if equity markets become better valued and an attractive buying opportunity presents itself.

Fig.2: Five-Year Net Gearing



Source: Morningstar

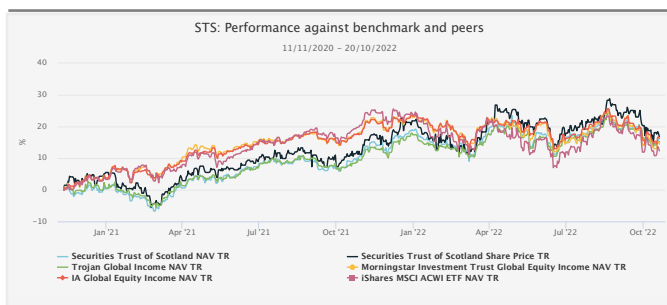


STS has total debt facilities available of £25m, with £15m drawn down as at the financial year end of 31/03/2022. This includes borrowings via a seven-year multi-currency banking facility with the Royal Bank of Scotland which pays fixed rates on three tranches of £1,500,000, €4,500,000 and US\$12,750,000. This loan was established in 2016. These tranches are fully drawn and expire in September 2023. Additionally, STS has a £10m revolving facility that pays a floating rate. This was renewed for another two years and expires at the end of September 2023 but was unutilised as at 31/03/2022. Gearing has been a useful tool for the managers to enhance the income earnings of the trust. Facilities will be renegotiated ahead of the September 2023 expiry date, and the new facilities will be more reflective of the managers' requirements.

Performance

Since James and Tomasz took over the portfolio in November 2020 STS has performed in line with its peers, generating an NAV total return of 14.5% versus the Morningstar Global Equity Income sector's return of 14.5% (as at 20/10/2022). In addition, STS has outperformed the broader global equity market, which has generated 12.3% over the same period, as illustrated in the graph below using the iShares MSCI ACWI ETF. We note that much of this strong relative performance has been achieved over the last 12 months, where STS has generated NAV total returns of 5.1% versus the peer group's -2.1% and the broader equity index's -5.6%.

Fig.3: Performance Since Troy Took Over As Manager



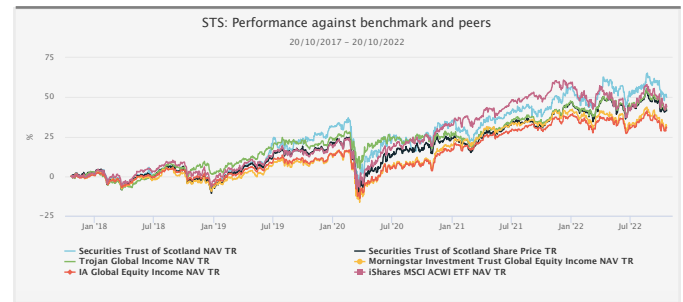
Source: Morningstar

Past performance is not a reliable indicator of future results.

Since Troy took over the mandate, the portfolio has been reshaped to broadly match that of James and Tomasz's open-ended strategy the Trojan Global Income Fund, which was launched on 01/11/2016. The close overlap of STS's current portfolio with that of the Trojan Global Income Fund allows us to examine the longer-term performance of the strategy. Over the past five years the Trojan Global Income Fund has generated NAV total returns of 44.3%, significantly outperforming the Morningstar Global Equity Income peer group and the IA Global Equity Income sector, which have generated an average NAV total return of 31.8%

and 30.7% respectively. We think this is testament to the managers' ability to maintain conviction in their long-term, high-quality strategy in the face of headwinds from the value rally after the coronavirus pandemic and the more recent outperformance of the energy sector over the first half of 2022. We note that STS has generated an NAV total return of 49.9% over five years, although this also reflects the performance of the previous manager.

Fig.4: Five-Year Cumulative Performance

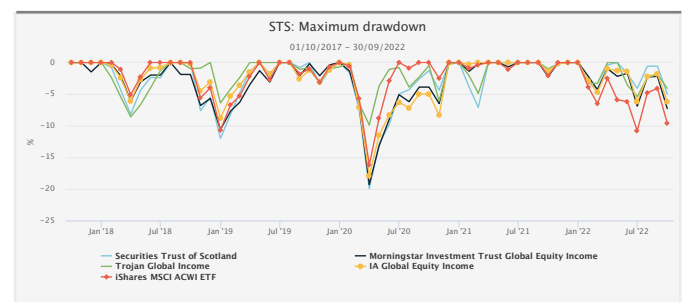


Source: Morningstar

Past performance is not a reliable indicator of future results.

As is a common feature amongst many of Troy's investment mandates, the protection of investors' capital is a core performance indicator, and STS has demonstrated an ability to protect investors' capital during periods of market volatility. The graph below illustrates the monthly drawdowns of the trust compared to its peer group and open-ended equivalents. It is clear to see that during periods of market turbulence James and Tomasz's broader global income strategy has been able to achieve this. Before November 2020 we can use the Trojan Global Income Fund as a proxy and see that towards the end of 2018, the fund lost 6.4% compared to the IA Global Equity Income sector's loss of 8.8% and the MSCI ACWI's loss of 10.7%. Then during the height of the coronavirus pandemic, the fund lost 6.5%, the IA sector lost 17.9% and the MSCI ACWI lost 16.2%. As the quality-growth strategy has been translated into the STS portfolio it has significantly improved the drawdown and volatility characteristics of the portfolio. In fact, so far this calendar year we have seen STS hold up significantly better than

Fig.5: Monthly Drawdown (Loss)



Source: Morningstar

Past performance is not a reliable indicator of future results.



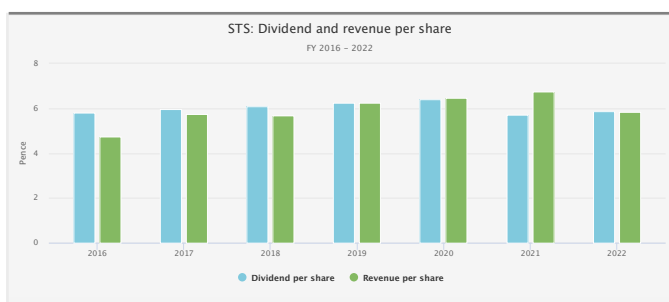
its open-ended counterpart, peer group and the MSCI ACWI with a maximum monthly drawdown of 5% versus 5.4%, 7.3% and 10.8% respectively. In our view this is testament to the managers' strategy and the unique capital preservation approach engrained within Troy's investment philosophy, and also to the more patient long-term investment structure of investment trusts more generally.

Dividend

STS currently yields 2.7% on a historical basis (as at 06/10/2022), which is at the lower end of the range of yields in the AIC Global Equity Income sector, which has a simple average yield of 3.5%. This lower current yield is unsurprising as the dividends were rebased after the appointment of Troy in November 2020. The previous manager had used option writing to enhance the income generated, whereas James and Tomasz take the approach of generating income only from the underlying dividend payments made by the portfolio holdings. Additionally, as discussed under **Portfolio**, the investment philosophy means that the quality and growth prospects of the portfolio will not be sacrificed to try to generate extra yield by investing in high-dividend-paying but poorer-quality stocks (such as capital-intensive oil majors). The approach lends itself to achieving the trust's objective of providing both capital and income growth, but the trade-off is the sacrifice of some current yield to improve the outlook for both, which in Troy's view will serve shareholders' interests better over the long term.

STS pays dividends in April, July, October and January to provide investors with a regular income, with the last of the four interim dividends tending to be larger. For the financial year (FY) ending 31/03/2022, STS paid out 5.875p per share, which represents an increase of 3.1% on the previous financial year's dividend of 5.7p, having been rebased from the FY 2020 dividend of 6.41p. However, revenue earned over FY 2022 was 19% lower than that of the previous financial year, reflecting the zero-income received from option writing and the lower overall yield of the portfolio constructed by the managers. This has resulted in an earnings per share (EPS) of 5.82p, which is 13.9% lower than for the previous financial year, and a dividend cover of 0.5x as at 31/03/2022.

Fig.6: Dividend And Earnings Per Share



Source: STS, Troy Asset Management

We note that the dividend rebasing was set to a level that will enable the rebuilding of the revenue reserves, from which the board would be expected to be able to enact a progressive dividend policy, although this will be a balancing act. However, the board recently declared a first interim dividend for the financial year to 31 March 2023 of 1.45p per share, which is a 5.5% increase on the equivalent dividend of 1.375p paid in respect of the previous financial year. The board further announced its intention to increase the remaining three interim dividends by "at least the same percentage" for this financial year. The board can pay dividends from the substantial realised capital gain reserves but would likely only do so as a last resort.

Management

STS has been managed by senior fund manager James Harries and assistant manager Tomasz Boniek since Troy Asset Management took formal control of STS's portfolio on 12/11/2020. Previous manager Martin Currie had been served notice by the board in June 2020 following the resignation of the trust's lead manager Mark Whitehead. A competitive tender process was carried out, and Troy was awarded the mandate in November 2020 following a pitch of the global equity income strategy managed by James and Tomasz within the Trojan Global Income Fund.

James is an experienced global equity investor with over 23 years' investment experience who has managed portfolios since 2002. James joined Troy in 2016 to establish the Trojan Global Income Fund. Prior to this James had been a fund manager at Newton Investment Management, where he established and managed the Newton Global Income Fund, which under his management grew to c. £4.5bn and was ranked first in its sector over ten years. James is also co-manager of the Trojan Ethical Global Income Fund.

James is assisted by Tomasz, who is also co-manager of the Trojan Ethical Global Income Fund and assistant manager of the Trojan Global Income Fund. Tomasz joined Troy in 2017, having had a background in hedge fund equity and credit strategies.

Discount

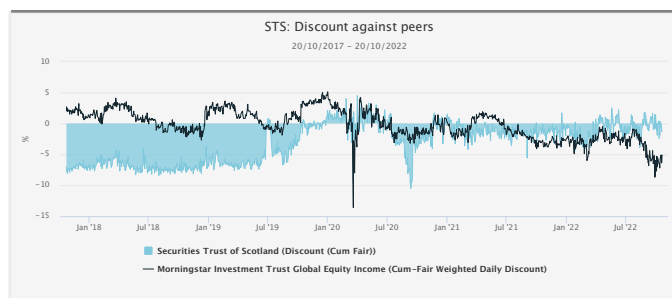
STS has predominantly traded on a discount over the last five years, and as at 20/10/2022 the trust is trading at a discount of 1.2%. This is significantly narrower than the Morningstar Investment Trust Global Equity Income peer group simple average discount of 5.1%.

STS's discount was resilient in the initial stages of the coronavirus pandemic. However, following the announcement that STS's board had parted ways with Martin Currie as the investment manager in June 2020, STS began trading on a considerable discount until September



2020 when it was announced that Troy Asset Management had been appointed as the new investment manager. Since 12/11/2020, when Troy officially began managing STS, it has traded on a simple average discount of 1.1%, less than the peer group's simple average discount of 2%.

Fig.7: Five-Year Discount



Source: Morningstar

Following the change in management, STS's board decided to implement a discount control mechanism (DCM). As is consistent with other trusts managed by Troy, the DCM has been designed to ensure that in normal market conditions STS's shares trade close to the NAV. The board is permitted to repurchase up to 20% of shares in issue when trading at a discount, and to issue shares only when they are trading at a premium. The DCM is designed to maintain a minimum level of discount volatility, which is consistent with Troy's general philosophy of capital and liquidity preservation for investors. In addition, the effect of any share buybacks (whether for cancellation or to be held in treasury) will be expected to enhance the net asset value of the remaining ordinary shares, as they will only be acquired at a cost that is less than their NAV.

Since the DCM was implemented on 16/11/2020, STS's board has repurchased c. 5.6 million shares (as at 01/09/2022).

However, as discussed in the **Performance section**, the strong NAV total returns generated by the strategy have resulted in some share issuance, with c. 1.3 million shares issued so far this year. This has resulted in a net repurchase of c. 3.7 million shares since the start of the DCM, or 3% of the number of shares in circulation at the start of the period.

Charges

STS currently has an ongoing charges figure (OCF) of 0.93%, which is slightly higher than the AIC Global Equity Income sector simple average of 0.79% (Source: JPMorgan Cazenove). As manager, Troy also receives an annual management fee which is included within the OCF. This is a tiered fee structure which is charged at 0.65% of the net assets up to the first £750m, 0.55% of net assets between £750m and £1bn, and 0.5% of net assets above

£1bn. At the time of writing the NAV is £235.7m, which means shareholders are yet to benefit from potential economies of scale; however, the management company maintains its ambitions to grow the net assets of the trust through strong performance and share issuance. Troy has demonstrated a track record of successfully growing other trusts such as Personal Assets and Troy Income & Growth, so investors may very well enjoy a fall in the OCF in due course.

The current Key Information Document Reduction in Yield figure (KID RIY) is 1.09%, which is materially lower than the simple peer group average of 1.49%, although we would caution that calculation methodologies can vary.

ESG

The long-term time horizons of Troy's buy-and-hold approach and the emphasis on quality naturally dovetail with an integrated approach to ESG. As a matter of course, James, Tomasz and their colleagues assess the quality of management and corporate governance for each investment case being considered (manager meetings being a key part of the stock selection process). Consideration is also given to long-term shifts in consumer and investor behaviour that could pose risks or present opportunities to companies in the coming years. The in-house fundamental research is supported by external research and data sourced from MSCI, ISS and Bloomberg.

Troy actively engages with portfolio companies to encourage better behaviours, the long holding periods allowing for progress to be tracked, and for engagements to properly be followed up on. For example, Troy approached Hershey about its lack of policies and disclosures regarding water usage (Hershey noted that Troy was the first asset manager to do so). Hershey subsequently included a section on water usage in its annual stewardship report.

James and Tomasz also co-manage the Trojan Ethical Global Income Fund, so one can expect the latest developments in Troy's ESG approach to be incorporated into STS's investment process. It should be noted that the engagements carried out at Troy are performed by the investment managers, and that there is no separate team to which this function is delegated.

The focus on overall quality, the integration of ESG and the effective exclusion of extractive industries mean that the portfolio has been given an 'above average' sustainability rating and low carbon designation from Morningstar Sustainalytics. STS does not have any exclusion criteria (e.g. it does invest in tobacco), so will not necessarily be a fit for investors with strict negative screening requirements. However, STS could prove suitable for investors inclined towards a lower-carbon, higher-ESG-rated portfolio.



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