CAPITAL

Over the year to 31 October 2004 net asset value per ordinary unit rose by 2.6%, or by 5.7% excluding the cost of the repayment of borrowings in July 2004. The adjusted return was slightly ahead of the 5.6% benchmark return and reflects a strong investment performance since January when significant changes were made to the portfolio and investment approach.

The global equity portfolio outperformed over the year by 0.8% and by 2.0% from end January. Stock selection has been strong since January with all regions outperforming with the exception of Japan which narrowly underperformed.

Excluding debt repayment costs, the NAV outperformed by 1.5% between end January and 31 October 2004. The share price rose by 6.3% over the year.

In last year's statement I observed that the strong rebound phase from the equity market lows of March 2003 had run its course and that we saw good relative value in higher quality companies which had lagged. This relative value was realised over 2004 to the benefit of our portfolio with performance enhanced by a more focused approach to stock selection following restructuring in January.

In local currency terms, regional returns across the world were broadly similar at 7–9% with the exception of Japan which returned only 4%. However, the weakness of the US dollar meant that only the UK and Europe produced meaningful returns in sterling (rising 8.1% and 11.2% respectively).

Global markets rose steadily over the first half of our year to leave our benchmark 4.1% ahead. However, concerns over high oil prices, softer growth from the US, indications that the global interest rate cycle had bottomed and fears over a sudden sharp slowdown in China prompted a setback in markets in May and July. The US Federal Reserve Bank joined the UK authorities in raising interest rates, in the case of the US from abnormally low levels. Since August, global equities have been firm, reflecting moderating interest rate expectations and an easing in oil prices which had risen by almost 80% over the course of our year. The management review on page 8 provides a more detailed account of developments over the year.

INCOME

Despite the impact of a weak US dollar on the material proportion of our total dividend income which is received in dollars, earnings per ordinary stock unit were almost unchanged at 9.29p (9.28p).

The board is recommending an increase of 3.8% in the dividend for the year to 8.10p per stock unit, which compares with UK RPI inflation of 3.3%. We have increased our annual dividend in each of the last 21 years and it is a stated objective of the company to increase the dividend ahead of the UK rate of inflation.

BORROWINGS

Over the year, gearing employed in equities averaged £90.7m, giving an average effective gearing ratio (with debt valued at par) of 112.6%. We started the year with effective gearing of 116.0%, and maintained a range of 112–117% for the first half. Effective gearing was lowered subsequently to end the year at 106.6%.

During the year, the company adopted the new AITC standard of carrying debt at fair value rather than at par value in its published NAV.

In July, we arranged for the repayment of two unlisted debentures with total nominal value of £75m – £50m nominal of 7.75% debenture stock 2013 and £25m nominal of 10.875% debenture stock 2019. The repayment cost of £97.4m was at a premium to the estimated fair value of the debentures of £89.1m. Consequently, the premium paid reduced the fair value NAV per share by approximately 1.2%. Historic NAV performance data is still computed using debt at par value and on that basis the impact on NAV per stock unit was more significant at –3.2%. This explains the underperformance of our NAV return with borrowings at par.

As a result of the repayments, potential gearing fell from 132% to 122% (with debt valued at par). Due to the company's accounting policy of charging interest and expenses partially to capital, there will be a positive future impact on the capital account because of the absence of interest charges on the debt repaid. The company's cash flow will also benefit.

In taking the decision to incur the premium to repay the higher coupon debentures, the board recognised that the company's potential gearing was too high and was hindering the efficient management of the company. In view of the board's stated strategic ceiling for effective gearing of 120%, the company's available capital is now more closely aligned with its expected needs. Moreover, with an average weighted cost of borrowings of 5.9%, the company is well placed to employ this debt to the benefit of shareholders over the long term.

SHARE BUYBACKS

During the year, we repurchased 1.4m shares at an average discount (with debt valued at par) of 20.5%, which added slightly to NAV performance. The company will continue to buy in ordinary stock when the board considers that this serves the interests of continuing shareholders. A resolution to renew the buyback authority will be put to shareholders at the annual general meeting.

DISCOUNT

The company's share price discount to NAV (with debt at fair value) narrowed over the year, with a peak in February at almost 20%, to end the year at 14.7%. The board recognises the importance of a sustained improvement in investment performance in tightening discounts.

MARKETING

Through our subsidiary company, SIT Savings Ltd, we launched a new version of our investing for children product STOCKPLAN: A Flying Start. This now allows investors to invest on behalf of a child in one of two ways, as a designated plan or, more formally, as a bare trust. Investing for children continues as a strong theme among our investors.

DIRECTORS AND MANAGEMENT

As reported in last year's statement, Mr Hamish Buchan joined the board in November 2003 bringing with him the experience of a long career in the investment trust industry. He was duly elected at the 2004 AGM. Sir Paul Nicholson retires by rotation at the AGM and is not seeking re-election. I thank him for his contribution to the company since he joined the board in 1998, especially for his rigorous chairing of the audit committee.

At the beginning of January, John Kennedy replaced Ian McLeish who retired after 30 years service of which 17 were as manager or joint manager. Two long-serving investment managers, Ian Anderson and Michael Dick, also retired during the year and I thank them for their service to the company. In their place, we have recruited two experienced fund managers, Hugh Duff and Martin Robertson, who have been appointed joint assistant managers.

Following a review of strategy by the board, we took advantage of the change in manager and personnel to implement some fundamental changes in the approach to management of the portfolio. Beginning in January 2004, the manager restructured the investment portfolio, reducing the number of holdings and merging the regional portfolios into one global portfolio. While our stock selection has been good in recent years, these changes have been made to improve NAV performance by giving more emphasis to our best stock selection ideas from around the world. The reduced burden from interest charges should also help to improve NAV performance. The investment team remains organised on a geographical basis and is using a consistent analytical approach. While the new structure has yielded some early positive results, work continues to refine the global portfolio and further reduce the number of holdings.

OUTLOOK

By the end of October 2004, the UK FTSE All-Share Index had rallied over 40% from the lows of March 2003. This advance was echoed in markets worldwide as extraordinary monetary and fiscal stimulus in the US fuelled an economic recovery which is now in its third year. 2004 appears likely to be the peak year of growth for this cycle and corporate profits have recovered sharply to stand at levels some way above normal cyclical highs.

With economic indicators now implying a moderation in economic growth, the best of the recovery in corporate profits is probably behind us. Interest rate expectations are easing as 2005 looks like being a year of reasonable economic growth with subdued inflation. Recent high oil prices will act as a brake on growth. At current levels, stock markets are vulnerable to the persistent imbalances in the global economy, the most pressing of which relate to the US economy and the outlook for the US dollar. A sharp slowdown in China, further instability in the Middle East and renewed strength in oil prices are risks which will have to be weathered. If there is no dramatic financial or political shock to markets, further modest advances in line with corporate profits growth are achievable next year, supported by a good level of dividend growth around the world.

Douglas McDougall

13 December 2004