

Directors' Report

Business Review

Objective

The company carries on business as an investment trust. Its objective is to provide investors, over the longer term, with above average returns through a diversified portfolio of international equities and to achieve dividend growth ahead of UK inflation.

A detailed description of the extent to which this objective has been achieved is given in the Chairman's statement on pages 4 and 5 and the Management Review on pages 8 to 14.

Principal Risks and Uncertainties

The principal risks and uncertainties facing the business are as follows:

- Investment and market price risk
- Interest rate risk
- Liquidity risk
- Foreign currency risk

These and other risks facing the company are reviewed regularly by the audit committee and the board. Further information is given in note 18 to the accounts on page 36.

Investment Approach

The Scottish Investment Trust is a global investment fund with the following characteristics:

- The investments are managed as an integrated, single, global portfolio which is constructed primarily through a systematic investment process whereby assets are allocated to individual investments rather than to different regions or themes.
- The fund is actively managed and, while performance is compared to major global and UK indices, no consideration is given to the composition of any index when constructing the portfolio.
- Consequently, it is intended that the company's investment performance should deviate from the comparator indices.
- While the fund is relatively concentrated in terms of holdings, it is still demonstrably diversified both by industrial sector and by geographical location of investments.

Gearing

The company has a policy of borrowing long-term money to invest in equities in the expectation that this will improve returns for stockholders. The levels of effective and potential gearing are monitored

closely and are discussed by the board and management at every board meeting.

Performance

The management provides the board with detailed information on the company's performance at every board meeting. Performance is measured in comparison with the company's peer group and comparator indices.

Key Performance Indicators (KPIs) including the following are used:

- NAV total return
- NAV total return against comparators
- NAV and share price total return against peers
- Discount with debt at market value
- Dividend growth against RPI
- Total Expense Ratio

Dividend

The directors recommend a final dividend of 4.57p and a special dividend of 2.00p per ordinary stock unit, both payable on 9 February 2007. With the interim dividend of 4.15p already paid, this makes a total of 10.72p for the year. The total dividend absorbs £15,423,000 based on the number of ordinary stock units in issue at 31 October 2006.

Status

The company is a self-managed investment trust and it is registered as an investment company within the meaning of the Companies Act 1985.

HM Revenue & Customs has approved the company as an investment trust for the purposes of S842, Income and Corporation Taxes Act 1988 up to the accounting period ending 31 October 2005. The company has subsequently continued to satisfy the conditions for such approval.

Tender Offer

At an Extraordinary General Meeting of the company held on 27 January 2006, stockholders approved a resolution implementing a Tender Offer for up to 40% of the company's ordinary stock at a discount of 9% to the company's NAV with borrowings at par. Applications under the Tender Offer were made in respect of 27.75% of the ordinary stock in issue and, on 7 February 2006, 57,972,303 ordinary stock units were repurchased.

Stock Buybacks

The board introduced a stock buyback policy in January 2006 under which the company has bought

Directors' Report

back for cancellation a total of 7,790,600 ordinary stock units, representing 5.2% of the ordinary stock in issue immediately after the Tender Offer, at a cost of £34,314,000.

Directors

The directors of the company at 31 October 2006 and their biographical details are shown on page 6. All directors served throughout the year.

The following table shows the attendance of directors at board and committee meetings during the year to 31 October 2006.

	Board	Audit	Remuneration	Nomination
Number of meetings	8	3	3	1
D C P McDougall	8	3	3	1
Sir George Mathewson	6	n/a	n/a	1
D F K Finlay	8	n/a	n/a	1
I H Leslie Melville	5	n/a	3	0
H N Buchan	8	3	3	1
J S MacLeod	7	3	n/a	1

The performance of each director has been appraised by the chairman in individual interviews during the year. The chairman's performance has been appraised in his absence by the other directors and the results have been communicated to him. The board believes that each director is independent of the management in character and judgement and that there are no relationships with the company or its employees which might compromise their independence.

Four directors are standing for re-election at the AGM. Sir George Mathewson and Francis Finlay have served as directors for more than nine years and therefore retire on an annual basis. Hamish Buchan is standing because it is three years since he was elected as a director. After formal performance evaluation, the chairman confirms that all directors continue to perform effectively and with great commitment and he recommends their re-election. Douglas McDougall is also standing as it is three years since he was re-elected as a director. Hamish Leslie Melville will be retiring at the AGM and will not be standing for re-election.

The appointments of Sir George Mathewson and Francis Finlay as directors run for one year at a time. Douglas McDougall was appointed for a fixed term of three years in September 1998 which was renewed in September 2001 and September 2004 for a further three years. Hamish Buchan was appointed

in November 2003 and Jim MacLeod was appointed in September 2005 both for initial terms of three years. Hamish Buchan's appointment was renewed in November 2006. Directors' letters of appointment will be available for inspection at the AGM.

The company maintained liability insurance for its directors and officers throughout the year.

Directors' Interests

The interests of the directors and their families in the company's capital are as follows:

	Ordinary stock units of 25p	
	31 October 2006	1 November 2005
Beneficial interests		
D C P McDougall	60,000	60,000
Sir George Mathewson	57,983	57,983
D F K Finlay	60,000	60,000
I H Leslie Melville	60,000	60,000
H N Buchan	20,000	20,000
J S MacLeod	15,000	15,000
Non-beneficial interests		
Sir George Mathewson	26,500	26,500

Sir George Mathewson and his family purchased 7,400 ordinary stock units at a price of 457.5p each on 14 November 2006.

There have been no other changes in the directors' interests between 31 October 2006 and 8 December 2006.

Corporate Governance

Compliance

The board has considered the principles set out in the Combined Code on Corporate Governance ("the Combined Code") and believes that the way the company is governed is consistent with those principles. Throughout the year the company has complied with the provisions of the Combined Code except that there is no senior independent director. The directors consider that, where all directors are independent and non-executive, there is no compelling case for having a senior independent director.

Directors

The board normally meets eight times throughout the year while the audit and remuneration committees meet three times each. The nomination committee meets annually.

There is a schedule of matters reserved for the board which include investment strategy, accounting and financial controls, dividends and announcements, capital structure, gearing and major contracts.

Directors' Report

All six members of the board are non-executive and are independent of the company's management.

Day to day management, including the selection of investments, is delegated to the company's executive management which reports directly to the board.

All directors have been appointed for fixed terms not exceeding three years. All directors are required to retire by rotation at their first AGM and at intervals of not more than three years thereafter. No compensation is payable to a director who leaves the board before the expiry of his term of office. No director has a service contract with the company. No contract or arrangement entered into by the company in which any director is interested has subsisted during the year.

The company has a policy on tenure which is shown on its website. It states that:

"All non-executive directors will be appointed for fixed terms of three years. Each director will be subject to re-election by the company in general meeting at least once every three years up to and including the ninth anniversary of his appointment.

"The performance of each director will be appraised by the nomination committee annually and prior to the renewal of a three year term. A more rigorous appraisal will take place prior to the second or subsequent renewal of a three year term.

"The directors recognise that independence is not a function of service or age and that experience is an important attribute within the board. The directors may decide to recommend a director with more than nine years service for re-election. In such a case, shareholder approval will be sought annually."

Prior to each board meeting directors are provided with a comprehensive set of papers giving detailed information on the company's transactions, financial position and performance. There is a procedure for directors to seek independent professional advice at the expense of the company and training is available to directors as required.

There is a nomination committee comprising the whole board for the purpose of selecting and appointing new directors and appraising board performance. It has written terms of reference which are shown on the company's website.

Remuneration

The board has appointed a remuneration committee to recommend pay and conditions for the board and employees. It has written terms of reference which are shown on the company's website.

Directors' fees are set with a view to attracting individuals of appropriate calibre and experience, taking into account the level of fees paid by similar investment trusts. No other benefits are provided to directors. Fees recommended by the remuneration committee are subject to approval by the board and stockholders.

With regard to its employees, the company aims to provide levels of remuneration in line with similar organisations and to reward responsibility and achievement. Basic salaries are compared annually with those of equivalent employees in a group of comparable fund management organisations operating in Scotland. Remuneration consists of basic salary, a performance-related bonus and benefits including a contributory pension scheme.

Relations with stockholders

The company recognises the value of good communications with its stockholders. The management meets regularly with private client stockbrokers and the company's major institutional stockholders. The board receives regular briefings from the company's brokers. Newsletters are sent to stockholders during the year and are posted on the company's website. Stockholders are encouraged to attend the AGM and ask questions of the board and management. Any stockholder wishing to raise questions at other times should write to the chairman. Proxy voting figures for each resolution are announced to the meeting after voting on a show of hands. Separate items of business are proposed as separate resolutions including the receipt of the report and accounts and the approval of the directors' remuneration report. The annual report is sent to stockholders at least 20 working days before the AGM.

Accountability and audit

The respective responsibilities of the directors and the auditors in respect of the financial statements are given on pages 20 and 23.

The audit committee has written terms of reference which are shown on the company's website. Its duties include risk assessment, reviewing internal controls, the company's accounting policies, financial statements prior to their release and the company's procedures on whistleblowing. The committee is also responsible for all aspects of the company's relationship with its external auditors including reviewing the scope and effectiveness of the annual audit, the auditors' remuneration, the terms of engagement and the level of non-audit work, if any, carried out by the auditors. The committee will also ensure that the level of non-audit work does not compromise the auditors' independence.

Directors' Report

The directors continue to believe that the financial statements should be prepared on a going concern basis as the assets of the company consist mainly of readily realisable securities.

The company does not have an internal audit function as the audit committee believes that the company's straightforward structure and small number of employees do not warrant such a function. This is reviewed by the committee every year.

The board is responsible for ensuring that the company has in place an effective system of internal controls designed to maintain the integrity of accounting records and to safeguard the company's assets.

The board has applied Principle C.2 of the Combined Code by establishing a continuous process for identifying, evaluating and managing the significant risks the company faces. This process, which has been in place throughout the year and up to and including the date of approval of this report, is in accordance with Internal Control: Guidance for Directors on the Combined Code published in September 1999 (The Turnbull Guidance).

In compliance with Provision C.2 of the Combined Code, the board reviews the effectiveness of the company's system of internal control at six-monthly intervals. The board's monitoring covers all controls, including financial, operational and compliance controls and risk management. It is based principally on reviewing reports from management, considering whether significant risks are identified, evaluated, managed and controlled, and whether any significant weaknesses are promptly remedied or require more extensive monitoring. The audit committee assists the board in discharging its review responsibilities.

Detailed procedures are in place to ensure that:

- all transactions are accounted for accurately and reported fully to the board;
- the management observes the authorisation limits set by the board;
- there is a clear segregation of duties so that no investment transaction can be completed by one person;
- control activities are regularly checked;
- compliance procedures are in place for legal and regulatory obligations.

The board recognises that such systems can only provide reasonable, not guaranteed, assurance against material misstatement or loss.

Directors' responsibilities

United Kingdom company law requires the directors to prepare financial statements for the year to 31 October 2006 which give a true and fair view of the state of affairs of the company and of the revenue and cash flows for that year. In preparing those financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent;
- state whether applicable accounting standards have been followed subject to any material departures disclosed and explained in the financial statements;
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the company will continue in business.

The directors are responsible for keeping proper accounting records which disclose with reasonable accuracy at any time the financial position of the company and enable them to ensure that the financial statements comply with the Companies Act 1985. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the company and to prevent and detect fraud and other irregularities.

The audit committee has reviewed the matters within its terms of reference and reports as follows:

- it has approved the financial statements for the year to 31 October 2006;
- it has reviewed the effectiveness of the company's internal controls and risk management;
- it has reviewed the need for a separate internal audit function;
- it has recommended to the board that a resolution be proposed at the AGM for the reappointment of the external auditors and it has considered the proposed terms of their engagement;
- it has satisfied itself as to the independence of the external auditors;
- it has satisfied itself that the terms of the business review are consistent with the accounts.

Directors' Report

Substantial Stockholdings

At 8 December 2006 the company had been notified of the following holdings in excess of 3% of its ordinary stock.

	Ordinary stock units	% of issue
AXA Group	14,574,054	10.2
D C Thomson	5,400,000	3.8
Legal & General	5,330,083	3.7

Annual General Meeting

A resolution relating to the following item of special business will be proposed at the forthcoming annual general meeting:

Repurchase of the company's own ordinary stock

At the annual general meeting of the company held on 27 January 2006 stockholders passed a resolution giving the company authority to make purchases of up to 22,625,638 ordinary stock units, being 14.99% of the then issued ordinary stock of the company. The authority is due to expire on 26 April 2007.

Resolution number 11 set out in the notice of annual general meeting on page 41 seeks to renew the authority to repurchase ordinary stock until 25 April 2008. The principal reasons for such repurchases are to enhance the net asset value of the ordinary stock by repurchasing ordinary stock at prices which, after allowing for costs, represent a discount to the prevailing net asset value and to allow implementation of the company's stock buyback policy set out in the chairman's statement.

Under the Listing Rules of the UK Listing Authority, the maximum price that may be paid on the exercise of the authority must not exceed the higher of (i) 105% of the average of the middle market quotations for the ordinary stock over the five business days immediately preceding the date of purchase, (ii) the price of the last independent trade and (iii) the highest current independent bid. The minimum price which may be paid is 25p per ordinary stock unit.

The directors consider that it is in the best interests of the company and of stockholders as a whole to renew the authority to repurchase ordinary stock and recommend that stockholders vote in favour of the resolution. The directors also consider that the resolutions constituting ordinary business are all in such best interests, and recommend that stockholders vote in favour of them.

Voting Policy

The management reviews the business to be conducted at general meetings of the companies in which it invests and, wherever practicable, will cast its vote, usually by proxy.

Socially Responsible Investing

When investments are made, the primary objective is to achieve the best investment return while allowing for an acceptable degree of risk. In pursuing this objective, various factors that may impact on performance are considered and these will include socially responsible investment issues. If it is considered that a company's social, environmental or ethical record will adversely affect financial performance and result in poor returns, then an investment will not be made in the company.

Auditors

A resolution to re-appoint Deloitte & Touche LLP as the company's auditors, and to authorise the directors to fix their remuneration, will be proposed at the forthcoming annual general meeting.

Disclosure of Information to Auditors

It is the company's policy to allow the auditors unlimited access to its records. The directors confirm that, so far as each of them is aware, there is no relevant audit information of which the company's auditors are unaware and that they have taken all the steps which they should have taken as directors in order to make themselves aware of any relevant audit information and to establish that the company's auditors are aware of that information.

Payment of Creditors

It is the company's policy to agree in advance the terms of business with suppliers and then to abide by those terms.

As the company has no trade creditors, no disclosure can be made of creditor days at the year end.

Donations

No charitable or political donations were made during the year.

By order of the board



I M Harding

Secretary
8 December 2006