

ScotGems

Investment Update

July 2018 | For Institutional and Retail Investors in the UK

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- **The value of investments and any income from them may go down as well as up and are not guaranteed. Investors may get back significantly less than the original amount invested.**
- Currency risk: the Company invests in assets which are denominated in other currencies; changes in exchange rates will affect the value of the Company.
- Emerging market risk: Emerging markets may not provide the same level of investor protection as a developed market; they may involve a higher risk than investing in developed markets.
- Smaller companies risk: the Company invests in smaller company shares which can be more unpredictable and more difficult to sell than those of larger company shares.
- Concentration risk: the Company typically invests in a concentrated portfolio of investments and should a particular investment decline in value, this will have a pronounced effect on the overall value of the Company.
- The Company’s share price may not fully reflect net asset value.

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For an overview of the terms of investment, risks, returns and costs and charges please refer to the Prospectus and Investor Disclosure Document. **If you are in any doubt as to the suitability of the Company for your investment needs, please seek investment advice.**

Cyient (India)

Investing in smaller companies in emerging markets is risky in nature and can lead to the permanent loss of capital. As outsiders we only see a fraction of what really goes on within a listed company; financial accounts can be manipulated and minority shareholders often suffer poor returns.

We spend our days worrying about such risks, and believe the best way to protect shareholders' capital is to understand the owners and managers of the businesses in which we invest. There's less chance of being disadvantaged if we invest alongside conservative people with strong business ethics.

Our focus on people helps the process of generating new investment ideas. If an individual we respect moves to a new company or lends his or her reputation to another company in the form of a board position then we take note. Similarly, we are wary of companies that associate themselves with unsavoury characters.

As an example we have known and invested alongside the Murugappa Group for a long time. It is a South Indian family conglomerate of businesses with a reputation for the highest ethical values.

We noticed that the Chairman of the Murugappa Group, MM Murugappan, also sat on the board of a small Indian company that we had never heard of before called Cyient.

The business of Cyient is engineering outsourcing. It started as a simple body shop for multinational engineering firms like Pratt & Whitney, Caterpillar, and Bombardier, who wished to save costs by outsourcing lower margin work to India.

It transpired that MM Murugappan was a university classmate of Cyient's founder Mohan Reddy. In addition the broader board of directors at Cyient contained a number of high quality individuals who had spent their careers with reputable groups such as Tata.

We then studied the history of Cyient to determine whether or not the business was built on solid foundations. We always look to avoid businesses that have taken shortcuts or benefitted from wrongful practices, and there was no such evidence in the case of Cyient.

Our meeting with Krishna Bodanapu, the second-generation CEO who had taken over from his father, was incrementally positive too. We discussed the ethical risks of doing business in industries such as aerospace and defence, and he appeared to demonstrate the same conservative qualities as his father.

Assessing the ethics of a company is a reasonably objective task, and certainly easier than judging the competence of a set of owners and managers. With Cyient we are satisfied that Krishna Bodanapu is capable of balancing the different interests as an owner and manager.

Since taking charge in 2015 he has invested in the organisation in a bid to give the business a chance of becoming a much larger franchise. In practical terms this meant restructuring the business into smaller autonomous industry-focused units and strengthening domain knowledge via acquisitions. Professional managers were empowered, accountable and provided growth opportunities, which in turn enabled Cyient to recruit higher quality people.

It takes time for such changes to show up in a company's financial results, and to outside observers Cyient's performance has been dull. Only recently have the impact of these people-led changes become more obvious as the company's financial results have picked up.

We may be too early sometimes with our timing but we believe that by backing high quality individuals we can make good investments in smaller companies.

Tom Allen

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