Edison investment research

Strong dividend growth

Investment trusts

City Natural Resources High Yield Trust (CYN) is one of just three UK investment trusts to focus exclusively on natural resources. Economic growth concerns led the sector to underperform the broader market in recent months, particularly between March and May. Some mining project cost issues also became prominent. CYN has experienced a rare period of weakness against its benchmark. Favoured companies were added to and the manager believes this, an improved emphasis on shareholder returns by mining companies and QE expansion will support performance. Since New City became manager in 2003 CYN has returned 497.5% (NAV total return) and 414.0% (share price total return) vs total returns of 251.9% and 98.0% from its composite benchmark and FTSE World indices. Total dividends for the last financial year grew 14.5% and CYN has over a year of revenue reserves. The board expects continued dividend growth.

12 months ending	Total share price return* (%)	Total NAV return* (%)	Total return Composite B'mark* (%)	Total return HSBC Global Mining* (%)	Total return FTSE World Index* (%)
21/09/2009	24.7	35.0	17.4	15.7	4.9
21/09/2010	36.4	39.1	24.5	24.7	11.0
21/09/2011	27.2	24.3	3.1	2.6	(1.4)
21/09/2012	(18.8)	(21.5)	(9.1)	(13.3)	15.7

Note: *Twelve-month rolling discrete performance.

Investment strategy: Diversified natural resources exposure

CYN is a global fund that invests in equity and debt securities of mostly quoted companies in the mining and natural resources sectors and supporting industries. It is managed using a mixture of top-down and bottom-up strategies and maintains an extensively diversified portfolio of about 200 securities. Gearing is employed with a view to enhancing returns over the longer term with existing debt fixed at 3.5%.

Sector outlook: Long-term positive for natural resources

Despite a global slowdown and difficulties in the US and Europe, global GDP is still expected to continue to grow. In June, The World Bank estimated GDP growth for 2012 at 2.5% and forecast GDP growth for 2013 and 2014 at 3.0% and 3.3% respectively. The engine of growth is the developing economies. The manager is focused on what should be positive long-term fundamentals of continued demand growth, and limited supply, with a bias towards the more immediate and certain cash flows of producing assets over those in exploration and development. These investments are better position to support shareholder returns through dividends.

Valuation: Discount in line with longer-term averages

The discount, at 15.6%, is in line with its three- and five-year averages of 15.0% and 15.6% respectively. It currently trades at a small discount to the sector average, despite a very strong long-term performance record. As such, we believe the trust may offer value to investors looking for a diversified global natural resources exposure, with the potential for dividend growth.

24 September 2012

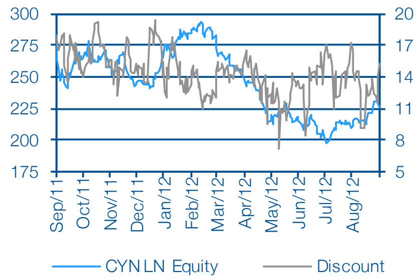
Price	225.0p
Market cap	£151m
AUM	£217m
NAV*	266.50p
Discount to NAV	15.6%
NAV**	267.18p
Discount to NAV	15.8%
Yield	2.1%

* Adjusted for debt at market value, excluding income, as at 19 September 2012.

** Adjusted for debt at market value, including income, as at 19 September 2012.

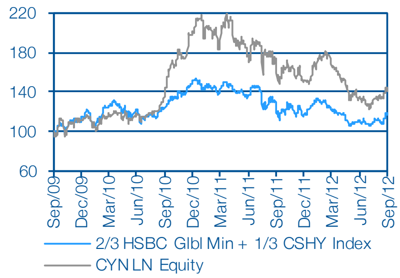
Ordinary shares in issue	66.9m
Code	CYN
Primary exchange	LSE
AIC Sector	Commodities & Natural Resources

Share price/discount performance



* Positive values indicate a discount; negative values indicate a premium.

Three-year cumulative perf. graph



52-week high/low	296.50p	197.00p
NAV* high/low	348.15p	234.52p

*Excluding income.

Gearing

Gross	21.2%
Net	18.8%

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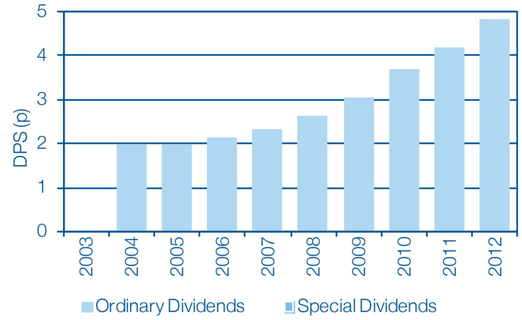
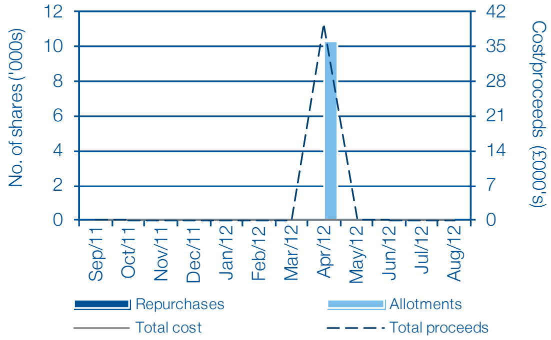
Exhibit 1: Trust at a glance

Investment objective and fund background	Developments last quarter
City Natural Resources High Yield Trust's investment objective is to provide shareholders with capital growth and income from a portfolio of mining and resource equities, resources and industrial fixed interest securities.	30 August 2012: Reminder for September 2012 CULS conversion opportunity issued. 30 July 2012: Fourth interim dividend of 2.52p for year ended 30 June 2012 declared (total dividend for year: 4.83p).

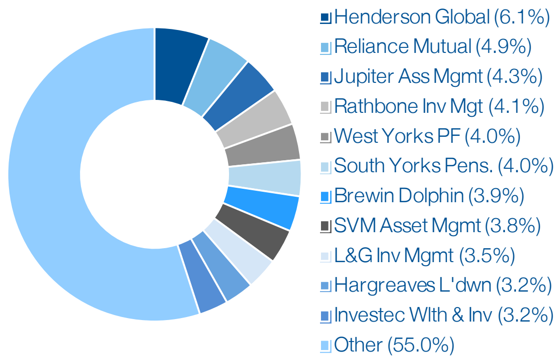
Forthcoming		Capital structure		Fund details	
AGM	December 2012	Total expense ratio	1.50%	Group	New City Investment Managers
Preliminary results	September 2012	Net gearing	(18.8%)	Manager	Will Smith and Ian Francis
Year end	30 June	Annual mgmt fee	1.2% of net assets	Address	New City Inv Mgrs, 5th Floor, 33 Chester St., London SW1X 7LB
Dividend paid	Quarterly	Performance fee	None		
Launch date	1994	Trust life	Indefinite	Phone	+44 (0)20 7201 6900
Wind-up date	See page 7	Loan facilities	See page 7	Website	www.ncim.co.uk

Dividend policy and history	Share buy-back policy and history
Quarterly dividends (paid November, February, May, August). CYN is managed with a view to progressing the total annual dividend.	Renewed annually, the trust has authority to purchase up to 14.99%, and allot up to 9.99% of issued share capital.

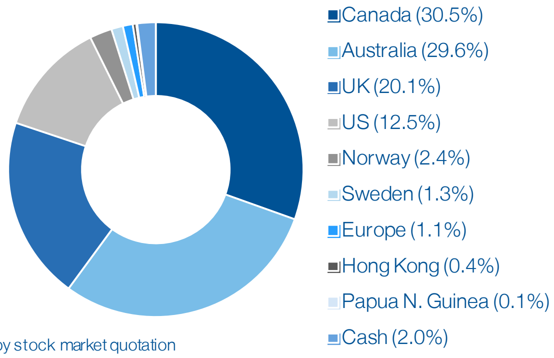




Shareholder base (as at 31 August 2012)

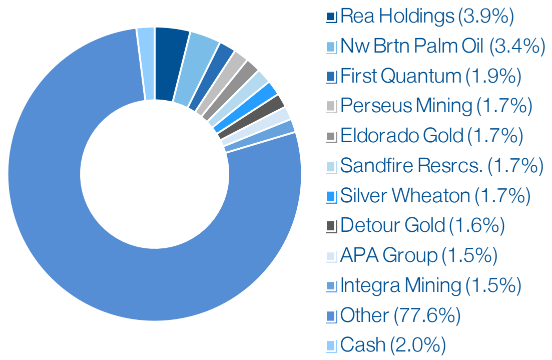


Geographic distribution of portfolio (as at 31 August 2012)*

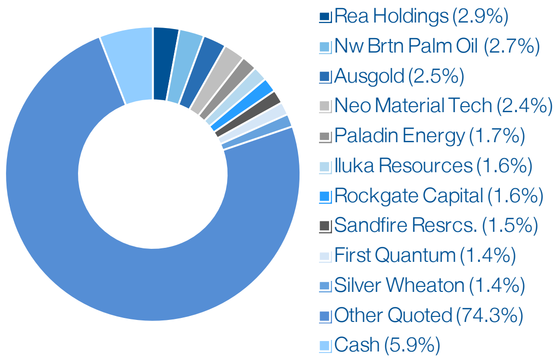


*by stock market quotation

Portfolio composition (as at 31 August 2012)



Portfolio composition (as at 29 February 2012)



Source: City Natural Resources High Yield Trust, Edison Investment Research

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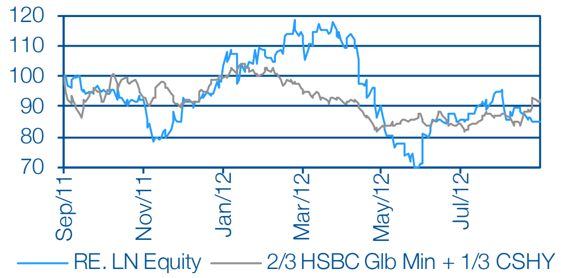
Exhibit 2: Top five overweight positions at a glance

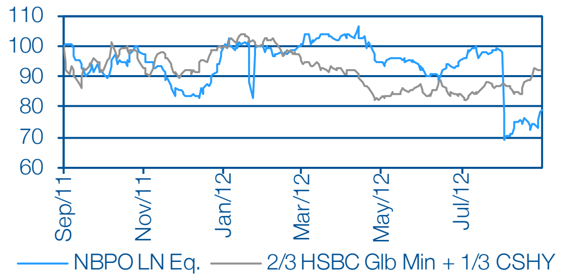
REA Holdings	Code: RE. LN	Market cap: £174m



Div Yield (trail. 12 months)	1.25%
Industry/Sector	Food Producers/Farming & Fishing
Listing	LSE – Premium Listing
Website	www.rea.co.uk

REA's principal activities are cultivating oil palms and producing crude palm oil and crude palm kernel oil, in the Indonesian province of East Kalimantan. REA has agricultural land allocations of 98k hectares (71k fully titled), operates two oil mills, a transhipment terminal and a fleet of barges for transporting its end products. The manager considers that REA is very well managed, continues to offer decent growth prospects and believes increasing demand will stimulate palm oil prices.

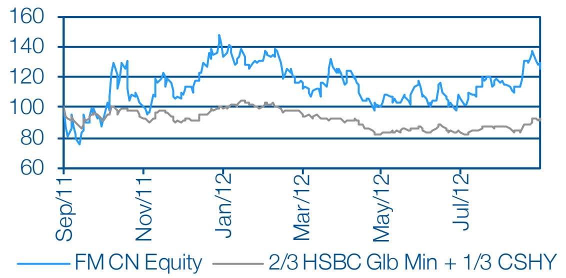
New Britain Palm Oil	Code: NBPO LN	Market cap: £994m



Div Yield (trail. 12 months)	2.18%
Industry/Sector	Food Producers/Farming & Fishing
Listing	LSE – Premium Listing
Website	www.nbpol.com.pg

New Britain Palm Oil (NBPO) is Papua New Guinea's largest oil palm plantation and milling operator. The company's primary focus is the cultivating and processing oil palm into crude palm oil, palm kernel oil and palm kernel expeller, which it sells to the UK, Europe and Australia. The manager considers that NBPO is very well managed, is located in a very good jurisdiction and offers good growth prospects.

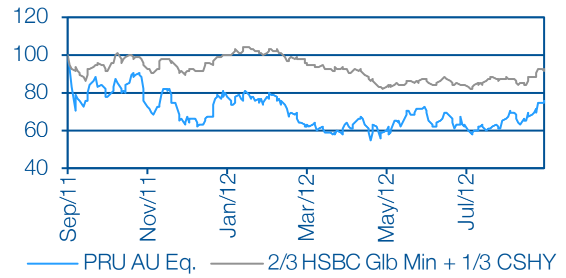
First Quantum Minerals	Code: FM CN	Market cap: C$9,964m (£6,279m)



Div Yield (trail. 12 months)	0.90%
Industry/Sector	Ind. Metals & Mining/Nonferrous
Listing	Canada – TSX, LSE – Standard
Website	www.first-quantum.com

First Quantum Minerals (FM) is primarily a copper producer. It has three mines in operation: Kansanshi (Zambia - 80% owned), Guelb Moghrein (Mauritania - 100% owned) and Ravensthorpe (Australia - 100% owned), as well as four projects in development. Its products include LME grade 'A' copper cathode, copper in .concentrate, nickel, gold and sulphuric acid. The manager considers FM is well managed, well financed and that its projects are performing well.

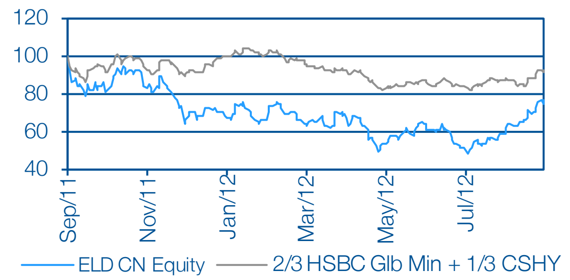
Perseus Mining	Code: PRU AU	Market cap: A$1,301m (£834m)



Div Yield (trail. 12 months)	N/A
Industry/Sector	Gold Mining
Listing	Australia – ASX, Canada - TSX
Website	www.perseusmining.com

Perseus Mining (PRU) is engaged in gold exploration in West Africa. PRU has three projects: 1) the Edikan Gold Mine (Ghana) began commercial production in January 2012, 2) Grumesa's (Ghana) evaluation continues and PRU has applied for a mining lease, and 3) Tengrela (Ivory Coast), which has seen significant resource expansion during 2012 with production expected to start in 2013. The manager considers PRU is well managed and offers very good growth prospects.

Eldorado Gold	Code: ELD CN	Market cap: C$10,817m (£6,817m)



Div Yield (trail. 12 months)	0.79%
Industry/Sector	Gold Mining
Listing	Canada –TSX, NYSE
Website	www.eldoradogold.com

Eldorado (ELD) is a gold producer with operations in China, Turkey, Brazil, Greece and Romania. ELD has seven operating mines, three mines under construction and three other projects in development. The manager considers that Eldorado has a low cost or production, very high grade reserves and offers very strong growth prospects. The company is targeting annual production of 1.7m ounces of gold by 2016.

Source: City Natural Resources High Yield Trust, Thomson Datastream, Edison Investment Research

Fund profile

CYN is one of only three UK-registered investment trusts to focus exclusively on the natural resources sector. Following an EGM in June 2003, the trust underwent a major reorganisation, which saw a complete change of investment focus, a change of investment manager and the introduction of an income component in the form of quarterly dividends. Will Smith, co-manager since March 2008 is assisted by Ian Francis, another long-time member of the New City team. Ian primarily focuses on the fixed income side of the portfolio.

Reflecting its investment mandate, CYN has a composite benchmark index that comprises two-thirds HSBC Global Mining Index and one-third Credit Suisse High Yield Index. Both components are sterling adjusted and performance is evaluated on a total-return basis using a base date of 1 August 2003, the date the transition to the natural resources portfolio was considered complete. Using this measure, since 1 August 2003 CYN has outperformed its composite benchmark by 245.6% in terms of NAV total return and 162.1% in terms of share price total return. In September 2011 CYN issued £40m of 3.5% convertible unsecured loan stock (CULS). The CULS has a fixed seven-year life until 2018 and interest payments are made semi-annually on 31 March and 30 September each year. The conversion price is 377.2p, which is a 10% premium to CYN's NAV as at 20 September 2011.

The case for commodities and natural resources

Despite a global slowdown and difficulties in the US and Europe, global GDP is still expected to continue to grow. In June, the World Bank's estimated GDP growth for 2012 at 2.5% and forecast GDP growth for 2013 and 2014 at 3.0% and 3.3% respectively. Much of this growth is expected to be fuelled by developing economies, where demand for commodities and natural resources continues to grow; a trend that is expected to continue. Looking to the supply side, supply of both renewables and non-renewables are constrained over the longer term, exerting upward pressure on prices. The trend for non-renewables is one of increasing difficulty in finding and extracting resources and for renewables climate change and population growth are frequently a check on their expansion.

The fund managers: Will Smith and Ian Francis

The manager's view

The US economy is continuing to show tentative signs of recovery and there is evidence that the situation in Europe maybe starting to stabilise. Clearly there is the potential for setbacks in the short term but the manager remains very bullish on the long-term outlook for the sector. The key themes currently employed in managing the portfolio are:

- The portfolio will remain overweight gold until there is a return to positive real interest rates and growth in OECD countries and until the sovereign debt crisis is properly resolved. All the major central banks are printing money and, while banking systems are not functioning properly, the velocity of money is expected to remain low. This will not remain the case indefinitely. The manager believes that inflation will pick up and, when it does, policy makers will not remove liquidity from the financial system fast enough. This will drive inflation up eroding the value of monetary assets. Gold may fall back in the short term but the long-term outlook for gold remains positive. The shares of gold miners have de-rated during the last six months but the manager believes current valuations will drive consolidation in the space.
- Investment in the oil sector has been strong during the last 20 years, and reserves have been exploited to the point that capacity in the market is not expanding. New production is purely

replacing that which is being lost in the Middle East. Energy demands are ever increasing, particularly from emerging economies, and the manager considers that these factors will stimulate the oil price over the long term.

- The outlook for base metals is difficult to determine as, while demand from the large industrialising emerging markets such as China, India and Brazil continues, there is concern over a slow down and, consequently, CYN's weighting is small.
- The manager likes uranium and considers that nuclear power will still be crucial to maintaining a secure energy supply in an increasingly carbon-conscious world. Moreover, demand is not expected to be driven by the western world, but rather by emerging markets and in particular China, India and Russia, where there is little to suggest that the Fukushima disaster has changed the nuclear consensus. The last 12 months have been difficult for uranium stocks but the manager now sees considerable upside potential. Reconstruction and growth require energy and, with the oil price rising as the yen has been weakening, Japanese authorities have been under pressure and have decided to switch two reactors back on. Another 54 remain idle, so a positive catalyst may be moves to return a significant number of the remaining idle reactors to generation. Reflecting these shifts, there has been consolidation in the uranium space and the manager expects demand to exceed supply once the US-Russian HEU Agreement ends in 2013.
- Palm oil, particularly sustainable palm oil, is an area with strong growth potential. This has notable relevance to China where the government is making tentative progress to refocus on domestic demand rather than capital investment.
- Rare earths, used primarily in electrical component manufacturing, are expected to see continued strong demand from the Far East, particularly Japan. China controls c 90% of existing output.

Asset allocation

Investment process – Bottom-up stock selection

CYN is managed using a mixture of top-down and bottom-up investment strategies. The process begins with identifying sectors and geographical areas that the manager favours to varying degrees. This serves as a guide to the evolution of the portfolio. However, the portfolio is not managed with specific reference to geographic or sector allocation targets or with reference to those of the underlying benchmark. Instead, the New City team focuses its efforts on the fundamental analysis of investment opportunities, meeting on average 20 companies a week. Once included in the portfolio, the team continues to assess stocks to ascertain whether the level of holding remains appropriate. It is the trust's policy not to attempt to hedge currency exposure. However, this is mitigated by the number and spread of holdings in the portfolio.

Overview

Exhibit 3: Sector allocations as at 31 August 2012

	Trust weight (%)
Gold and precious metals	33.6
Energy	27.0
Base metals	5.6
Uranium	9.5
Soft commodities	9.9
Rare earths	9.3
Other	3.1
Cash	2.0
Total	**100**

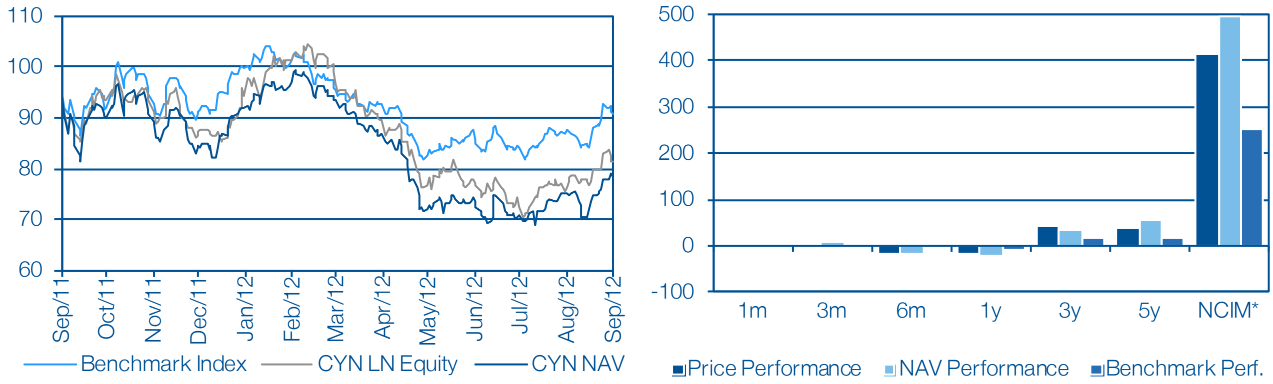
Source: City Natural Resources High Yield Trust, Edison Investment Research

CYN has over 180 holdings. The top 10 holdings account for 20.4% of the total assets, cash accounts for 2.0% and unquoteds account for 5.1%. The manager seeks to leverage its sector knowledge to invest in high-yield fixed interest, often unrated, debt where it can achieve equity like returns. The 20.6% allocation is similar to six months ago. Exhibit 3 illustrates CYN's sector allocations as at 31 August 2012. The significant gold allocation reflects the manager's views and, as illustrated in Exhibit 1, CYN offers a broad international exposure for those wishing to diversify outside the pound.

Recent performance

Exhibit 4: Investment trust performance

Price, NAV and benchmark total return perf, one year rebased | Price, NAV and benchmark total return performance (%)



Source: City Natural Resources High Yield Trust, Datastream, Edison Investment Research

Exhibit 5: Share price and NAV total return performance (sterling adjusted)

	1 month	3 months	6 months	1 year	3 years	5 years	NCIM*
Price relative to Benchmark Index	2.7	(0.7)	(11.1)	(9.6)	24.3	21.7	162.1
NAV relative to Benchmark Index	0.7	0.8	(10.9)	(12.4)	19.1	36.3	245.6
CYN Price	6.3	5.4	(16.1)	(18.8)	40.9	40.3	414.0
CYN NAV	4.3	6.9	(15.9)	(21.5)	35.7	54.9	497.5
HSBC Global Mining	4.6	7.3	(7.1)	(13.3)	10.9	7.9	317.9
Credit Suisse High Yield	2.7	5.5	6.7	15.6	45.4	53.2	122.3
FTSE World Index	0.6	7.2	0.6	15.7	26.5	19.7	98.0
FTSE All-Share Index	0.6	6.7	1.9	15.6	28.4	10.7	107.9

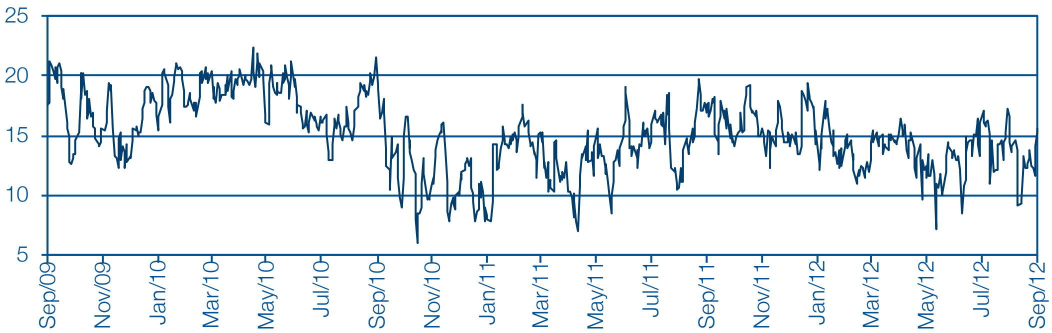
Source: City Natural Resources High Yield Trust, Thomson Datastream, Edison Investment Research. Note: *NCIM measurement period is from 1 August 2003 when it considers portfolio adjustments were complete, following their appointment as manager on 26 June 2003.

As Exhibits 4 and 5 illustrate, performance has picked up during the last three months, after weakness between March and May; a period when equity market performance was negatively affected by growth concerns, particularly over China and the eurozone. Additional concerns over project costs, particularly among the gold miners, became a prominent issue for the sector and open-ended funds (particularly North American funds) suffered considerable redemptions further depressing prices. During this period, CYN underperformed both components of its composite benchmark and global markets at large, possibly as a result of its bias away from the majors. This has also impacted the one-year numbers although the longer-term performance record remains intact. The market weakness was used as an opportunity to add to favoured companies. The manager believes that renewed focus on capital discipline in investee companies (with some projects deferred or cancelled) coupled with continuing monetary expansion (QE), will benefit CYN. It should be noted that CYN is not managed with reference to its benchmarks sector allocations and it is quite plausible that both its near and long term performance can differ substantially from the benchmark. However, in terms of evaluating CYN's performance, we consider that the longer-term horizons are the most relevant.

Discount

Despite having the authorities to allot up to 9.99% or make market purchases of up to 14.99% of issued share capital, CYN does not have an explicit discount maintenance policy and has not, to date, undertaken any repurchases of its shares, as illustrated in Exhibit 1. 42.9m shares were issued in October 2003 as part of the trust's reorganisation. Changes in share capital since have been limited to 4m shares issued between November 2006 and 2009 in relation to warrant exercise and, in April 2012, 10k shares were issued in relation to the first CULS conversion. Exhibit 6 shows the discount over the past three years. CYN's discount increased substantially following the financial crisis and reached its five-year high of 36.1% in January 2009, before tightening substantially between February and May 2009. Since May 2009 the discount has broadly followed a path of gradual tightening. At 15.6% the discount is in line with its three- and five-year averages of 15.0% and 15.6% respectively.

Exhibit 6: Discount over three years



Source: Thomson Datastream, Edison Investment Research

Capital structure

CYN is a conventional investment trust with only one class of equity share in issue – 25p ords. The trust is able to gear up to 25% of the shareholders' funds, which gives CYN flexibility in choosing its gearing policy. As at 31 August 2012, CYN had gross gearing of 21.2% and net gearing of 18.8%. All current gearing is provided by CYN's CULS, issued in September 2011. The management fee is calculated monthly as 0.1% of the company's net assets (excluding any borrowings), payable in arrears, which is equivalent to 1.19% per year. There is no performance fee and the management contract can be terminated at 12 months' notice by either side. The total expense ratio (TER) was 1.50% for the year ended 30 June 2011 (1.50% for the year ended 30 June 2010). Although CYN does not have a fixed life, a resolution to allow the company to continue in existence as an investment trust is put to shareholders at each AGM.

Dividend policy and record

CYN pays quarterly dividends. The first interim dividend is paid in November (2011: 0.77p; 2010: 0.69p), which establishes the level for the second and third interims in February and May respectively. This is followed by a larger final dividend in August (2012: 2.52p, 2011: 2.15p). For the year ending 30 June 2012 CYN paid a total dividend of 4.83p (2011: 4.22p). CYN has, for a number of years, been managed with a view to enhancing income, and progressing the dividend and, since it began paying ordinary dividends in 2004, the trust has maintained or increased its dividend every year, as is illustrated in Exhibit 1. During this eight-year period the trust increased its dividend by 141.5%. This is an average increase of 11.8% per year, or 11.7% per year annualised, which is well above the rate of inflation. Between 2011 and 2012, total dividend increased by 14.5% year-on-year, which is above the long-term growth rate. The manager and board have indicated that they remain confident CYN can provide double-digit dividend growth over the next two years. Assuming a base case of a 10% increase in total dividend (the minimum required to provide double-digit growth) a total dividend of 5.313p would be required in 2013. As at 31 December 2011, CYN had revenue reserves equal to 6.8p per share (up from 5.9p in 2010). Although figures for the year ended 30 June 2013 have yet to be released, the board has indicated that, after payment of the 2012 dividend, CYN retains over a year of revenue reserves and that revenue income has seen decent growth during the period –driven by production companies returning to the dividend list. Management fees and interest payable are charged 25% and 75% to the revenue and capital accounts, respectively, reflecting the board's view as to the long-term distribution of portfolio returns.

Peer group comparison

As Exhibit 7 illustrates, the AIC Commodities and Natural Resources specialist sector is a relatively small peer group, with eight constituents, the investment focuses of which can vary markedly. Within this peer group, CYN ranks fifth, second and first over the one, three and five years when considering share price total return.

Exhibit 7: Sector Specialist – Commodities and natural resources sector, as at 21 August 2012

Company	Share price total return on £100			Ongoing charges (%)	(Disc)/ prem.	Net gearing (100=no gearing)	Five-year dividend growth (%)	Div. yield
	One year	Three years	Five years					
Sector average	**89.4**	**129.7**	**104.2**	**1.56**	**(13.5)**	**106**	**30.3**	**2.6**
City Natural Resources Hi. Yld.	**81.2**	**140.6**	**140.0**	**1.45**	**(17.6)**	**120**	**12.8**	**2.2**
Baker Steel Resources	91.2	N/A	N/A	2.36	(13.0)	102	N/A	N/A
BlackRock Commodities Inc.	104.5	122.2	112.0	1.32	2.1	99	1.8	4.6
BlackRock World Mining	90.3	126.8	99.7	1.31	(12.8)	105	36.1	2.4
El Oro	104.0	172.0	N/A	1.26	(23.6)	123	N/A	4.1
Geiger Counter	50.0	56.2	36.2	2.63	(23.7)	103	N/A	0.0
International Oil & Gas Tech.	75.6	54.0	N/A	4.80	(52.4)	77	N/A	2.0
New City Energy	80.6	112.5	N/A	2.65	(25.2)	125	N/A	4.3

Source: The Association of Investment Companies

The board

All directors are non-executive and, with the exception of Adam Cooke, are independent of the investment manager. They are Geoffrey Burns (chairman), Adrian Collins, Adam Cooke, Michael Coulson and Richard O Prickett (directors). The average length of service is 9.7 years.

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