The Merchants Trust

High and growing income

Investment trusts

The Merchants Trust (MRCH) is a very well-established trust investing in UK equities, primarily in higher-yielding, large-cap companies, which aims to produce high income and long-term growth in capital and income. While recent months have been a difficult period for investing in this area, the manager sees good value in the portfolio across a range of themes. MRCH ranks highly in the AIC UK Equity Income sector in terms of dividend yield (c 6.0% vs 4.5% sector average) and the annual dividend has increased in each of the last 34 years, providing investors with an important source of total return in an environment of low earnings growth. The latest annual dividend was more than covered by income.

12 months ending	Total share price return (%)	Total NAV return (%)	FTSE 100 (%)	FTSE All-Share (%)
30/06/12	(6.9)	(1.1)	(2.7)	(3.1)
30/06/13	32.3	27.4	15.8	17.9
30/06/14	15.7	12.5	12.3	13.1
30/06/15	(3.4)	0.8	0.2	2.6
30/06/16	(8.3)	(4.4)	3.8	2.2

Note: Twelve-month rolling discrete £-adjusted total return performance.

Investment strategy: Income and capital growth

The manager runs a focused portfolio of c 40-50 stocks (44 at the end of May 2016) investing in themes such as well-financed, global mega-cap companies with strong franchises, turnaround situations and growth at a reasonable price. Fundamental research and a focus on valuation are essential elements of the manager's investment process; he is able to draw on the wider investment team at Allianz Global Investors (AllianzGI), as well as its proprietary market research resource. Gearing is targeted between 10-25% of net assets and writing options may be used to generate a higher level of income.

Market outlook: Favourable dividend yield

The FTSE 100 index, along with other global indices, has experienced a volatile start to 2016. As well as uncertainty surrounding the Brexit vote, investor concerns have included slowing global growth and geopolitical issues. In the UK large-cap market, although there have been question marks over the ability of some sectors to continue paying generous dividends, the overall dividend yield is higher than the average of the last five years. In this environment, investors may be attracted to a fund investing primarily in UK large-caps that has a detailed fundamental approach to picking stocks and a focus on high and growing dividend income.

Valuation: Discount wider than average

MRCH's current 5.4% share price discount to cum income NAV with debt at market value is wider than the averages of the last three, five and 10 years (range of 1.1% to 1.7%). This is not unusual in the investment trust sector, where discounts have recently been in a widening trend as a result of heightened investor risk aversion. For FY16, MRCH announced a 0.8% increase in the annual dividend, bringing the number of consecutive annual dividend increases to 34; based on the current share price, the dividend yield is 5.9%.

7 July 2016

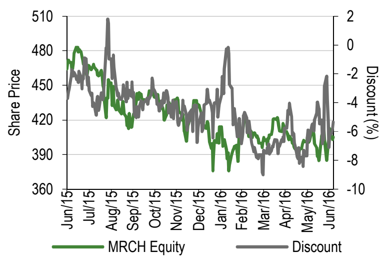
Price	**405.0p**
Market cap	**£440m**
AUM	**£582m**

NAV*	439.5p
Discount to NAV	7.8%
NAV**	427.9p
Discount to NAV	5.4%

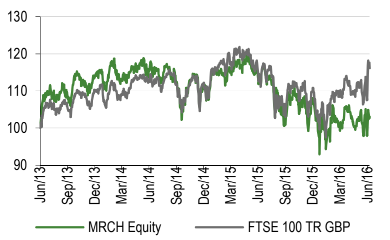
*Excluding income. **Including income. As at 5 July 2016.

Yield	5.9%
Ordinary shares in issue	108.7m
Code	MRCH
Primary exchange	LSE
AIC sector	UK Equity Income

Share price/discount performance



Three-year cumulative perf. graph



52-week high/low	483.0p	376.0p
NAV** high/low	494.3p	378.3p

**Including income.

Gearing

Gross*	22.5%
Net*	21.1%

*As at 31 May 2016.

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Edison profile page

The Merchants Trust is a research client of Edison Investment Research Limited

Exhibit 1: Trust at a glance

Investment objective and fund background

The Merchants Trust's investment objective is to provide an above-average level of income and income growth, together with long-term growth of capital through investing mainly in higher-yielding UK FTSE 100 companies. The benchmark index is the FTSE 100 index.

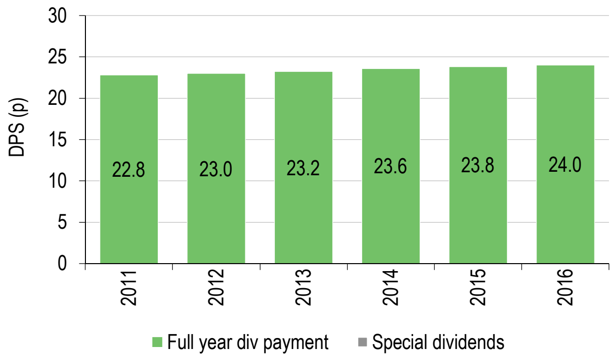
Recent developments

- 4 July 2016: First interim dividend of 6.0p declared.
- 30 March 2016: Annual results for 12 months ended January. NAV TR -5.0% versus benchmark -6.5%. Share price TR -9.5%. Final dividend of 6.0p proposed.
- 20 January 2016: Third interim dividend of 6.0p declared.

Forthcoming		Capital structure		Fund details	
AGM	May 2017	Ongoing charges	0.58%	Group	Allianz Global Investors
Interim results	September 2016	Net gearing	21.1%	Manager	Simon Gergel
Year end	31 January	Annual mgmt fee	0.35%	Address	199 Bishopsgate, London, EC2M 3TY, UK
Dividend paid	Quarterly	Performance fee	None		
Launch date	February 1889	Trust life	Indefinite	Phone	+ 44 (0)800 389 4696
Continuation vote	N/A	Loan facilities	See page 7	Website	www.merchantstrust.co.uk

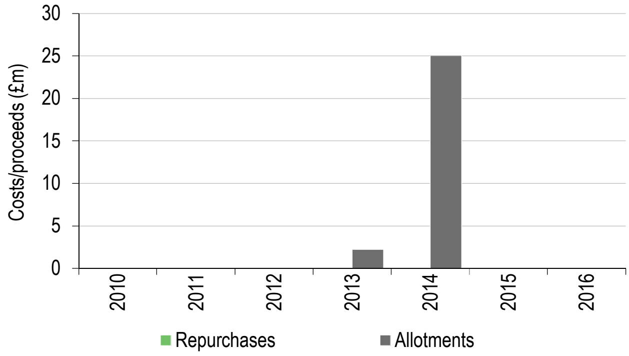
Dividend policy and history

Dividends are paid quarterly in August, November, February and May. The annual dividend has increased for 34 consecutive years.

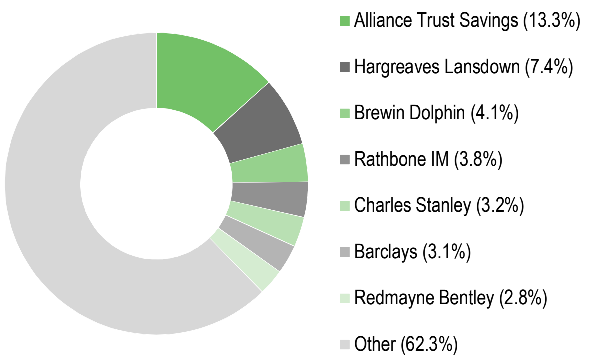


Share buyback policy and history

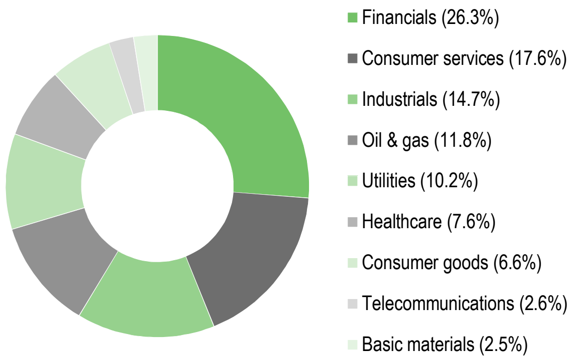
Renewed annually, the trust has authority to purchase up to 14.99% and allot up to 5% of issued share capital. Financial years shown.



Shareholder base (as at 7 June 2016)



Portfolio exposure by sector (excluding cash, as at 31 May 2016)



Top 10 holdings (as at 31 May 2016)

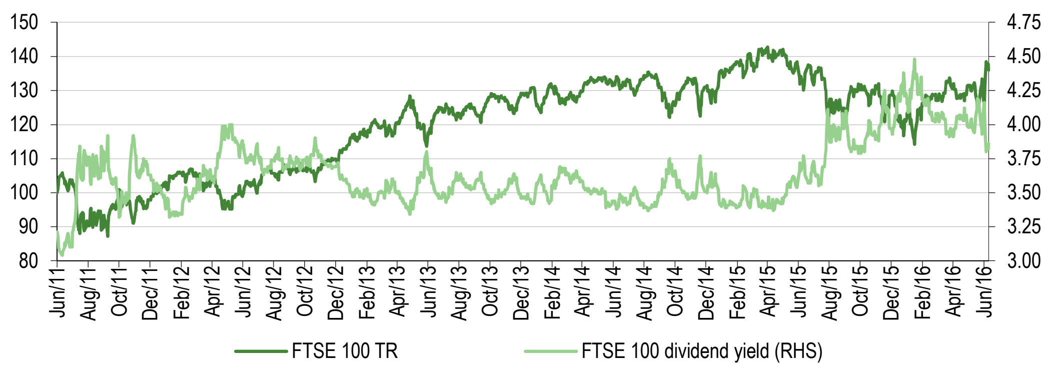
		Portfolio weight %	
Company	**Sector**	**31 May 2016**	**31 May 2015***
GlaxoSmithKline	Healthcare	7.5	5.5
Royal Dutch Shell 'B'	Oil & gas	6.9	7.1
HSBC	Banks	5.6	6.1
UBM	Media	4.9	4.5
BP	Oil & gas	4.7	5.1
Lloyds Banking Group	Banks	4.1	N/A
Centrica	Utilities	3.5	N/A
BAE Systems	Aerospace & defence	3.2	N/A
Tate & Lyle	Consumer goods	3.0	N/A
Scottish & Southern Energy	Utilities	2.7	N/A
Top 10		**46.0**	**44.4**

Source: The Merchants Trust, Edison Investment Research, Bloomberg, Morningstar, Thomson. Note: *N/A where not in May 2015 top 10.

Market outlook: Attractive dividend yield

At the time of writing, the UK equity market is experiencing high levels of investor risk aversion as a result of the referendum vote to pull out of the EU. This is a continuation of a period of volatile global stock markets since the beginning of the year, influenced by concerns including slowing global growth, weak commodity prices and geopolitical developments. As shown in Exhibit 2, while a positive five-year trend is evident, total returns of the FTSE 100 index have been essentially flat over the last three years. However, the dividend yield is looking more attractive; the FTSE 100 is currently yielding 3.9% compared to the average of the last five years of 3.5% and this is well above the yield available on the benchmark government bond. In an uncertain period for investors, a fund with a focus on dividend yield and growth with a disciplined investment process may hold appeal.

Exhibit 2: FTSE 100 total return and dividend yield (last five years)



Source: Thomson Datastream, Edison Investment Research

Fund profile: Income and growth from UK equities

MRCH is one of the oldest LSE-listed investment trusts, incorporated in February 1889, originally investing in fixed interest securities of railroad companies in North and South America. The trust currently has two objectives: a high and growing dividend yield and a good annual total return for investors by investing mainly in higher yielding UK FTSE 100 companies. Simon Gergel is chief investment officer of UK equities at AllianzGI and has run the trust since joining the company in April 2006. The trust is actively managed and the portfolio relatively concentrated, holding c 40-50 positions. MRCH is differentiated from its peers in the AIC UK Equity Income sector by using the FTSE 100 index as its benchmark although, at the end of May, roughly one third of its assets held were outside the index. MRCH has one of the highest dividend yields in the sector and the annual dividend has increased for 34 consecutive years. The gearing policy was recently changed to a range of 10-25% at the time that debt is drawn down, from up to 35% in normal market conditions.

The fund manager: Simon Gergel

The manager's view: Exciting areas of value in the portfolio

Ahead of the Brexit vote, the manager opined that he expected the low growth environment to continue, a sentiment that was echoed by company managements in their commentaries post Q116 earnings. In this environment, he stresses the importance of income and the fact that, over the long term, dividends and reinvested income make up the bulk of share price total returns. He comments that historically, high-yielding shares have performed well relative to the wider market. However, although he likes the discipline of selling lower-yielding shares and reinvesting the proceeds in higher-yielding companies, he considers the total return potential, rather than just focusing on the yield. Although investors tend to avoid companies that are likely to cut their dividends, the manager points to a study by investment bank Morgan Stanley, which suggests that companies tend to underperform ahead of a dividend cut and outperform thereafter; the higher the dividend and the worse the relative share price performance before the dividend cut, the higher the relative share price performance tends to be once the dividend has been reduced.

While certain areas of the market have been re-rated as investors are willing to pay up for stable perceived growth in a low growth environment such as tobacco and household goods companies, the manager suggests other areas of the market are looking very attractive on a valuation basis, such as mega-cap company HSBC, considered to be one of the strongest banks in the world. However, it is currently yielding c 7.5% and its price-to-book valuation is lower than during the financial crisis. Another mega-cap company in the portfolio is Royal Dutch Shell; its shares were trading below asset value for the first time in 30 years and currently yield c 6.0%. The share price is recovering as investors gain more confidence in the company's strategy, which includes cost cutting and the integration of BG Group, which should result in significant synergies.

The manager is finding opportunities in stocks that he considers are 'growth at a reasonable price' such as satellite company Inmarsat, which has high barriers to entry and is a beneficiary of growing demand for bandwidth. There are also turnaround situations in the portfolio that the manager considers can deliver strong relative performance in the medium to long term such as gaming company Ladbrokes and infrastructure company Balfour Beatty.

Asset allocation

Investment process: Disciplined fundamental approach

MRCH aims to provide an above average level of income and income growth, along with long-term capital appreciation by investing mainly in higher-yielding UK companies in the large-cap FTSE 100 index. The manager adopts a value-driven approach. The process is centred around three pillars: fundamentals, valuation and themes. Fundamental analysis takes account of dynamics within an industry, a company's competitive position and its corporate governance record. When looking at a company's financials, the manager focuses on cash flow as an indicator of performance and the potential for future dividend payments. Themes are analysed in terms of the macroeconomic outlook, the stage of the business cycle, coupled with industry and secular trends. Valuation considerations are a very important element of the investment process, both in absolute and relative terms and, as befits an income trust, the current and potential dividend yield is assessed. The manager is able to draw on the wider analyst resources at AllianzGI, including the output of Grassroots^{SM}, a proprietary market research network.

A consistent sell discipline is maintained with a position sold if its target price is achieved, there is a change in the outlook so that the original buy thesis no longer holds true, or better investment opportunities are identified. Portfolio companies are not automatically sold if the dividend falls below a certain level; there are a few positions in the portfolio that are not yet paying a dividend, but the assumption is that dividends will be paid in the future. The portfolio is diversified across the yield spectrum; two-thirds has an historic yield less than 5% and within that 15% of the portfolio yields less than 3%, but offers potential for future income growth. Selected writing of call options is used to enhance income, up to a maximum of 15% of the portfolio.

Current portfolio positioning

At the end of May 2016, the top 10 holdings accounted for 46.0% of the portfolio, a modest increase in concentration versus 44.4% a year before. Although the trust is benchmarked against the FTSE 100 index, as shown in Exhibit 3, roughly a third of the portfolio is invested outside this index. The structure of the portfolio in terms of market cap exposure is very similar to the prior year.

Exhibit 3: Market cap breakdown (%)

	Portfolio end-May 2016	Portfolio end-May 2015	Change (% pts)
FTSE 100	65.5	66.3	-0.8
FTSE 250	27.0	26.8	0.2
FTSE Smaller Companies	6.1	6.1	0.0
Cash	1.4	0.8	0.6
Total	**100.0**	**100.0**	

Source: The Merchants Trust, Edison Investment Research

Considering the portfolio in terms of sector exposure (Exhibit 4), over the last 12 months the largest increases were in financials and healthcare, while the largest decreases were in oil & gas and consumer goods, a sector that the manager views as expensive and having by far the largest underweight position versus the benchmark. The largest overweight positions are in utilities, a sector that historically has a higher than average yield, and consumer services where the manager particularly favours selected travel and leisure companies such as Carnival and Green King, along with media company UBM.

Exhibit 4: Portfolio sector exposure vs benchmark (% unless stated)

	Portfolio end-May 2016	Portfolio end-May 2015	Change	Index weight	Active weight vs index (pts)	Trust weight/ index weight (x)
Financials	25.9	20.3	5.6	24.6	1.4	1.1
Consumer services	17.4	18.6	-1.2	12.5	4.9	1.4
Industrials	14.5	13.3	1.2	10.7	3.8	1.4
Oil & gas	11.6	14.7	-3.1	10.4	1.2	1.1
Utilities	10.1	9.5	0.6	4.0	6.1	2.5
Healthcare	7.5	5.5	2.0	8.7	-1.2	0.9
Consumer goods	6.5	9.6	-3.1	17.5	-11.0	0.4
Telecommunications	2.6	3.2	-0.6	5.2	-2.6	0.5
Basic materials	2.5	3.1	-0.6	4.8	-2.3	0.5
Technology	0.0	0.0	0.0	1.6	-1.6	0.0
Cash	1.4	2.2	-0.8	0.0	1.4	N/A
	100.0	**100.0**		**100.0**		

Source: The Merchants Trust, Edison Investment Research

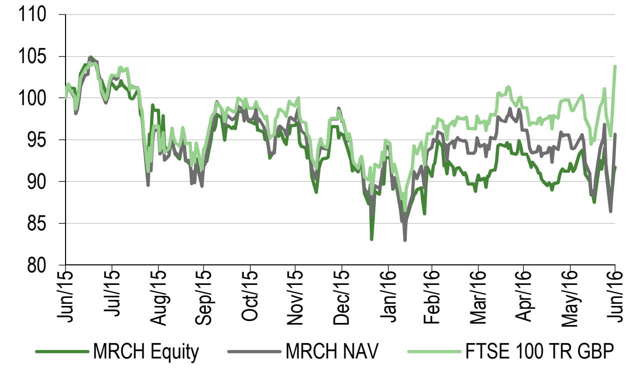
Within financials, there is a new holding in Lloyds Banking Group. The sector has had a tough decade, but the manager believes the regulatory position has improved, reasonable cash flow generation is being masked by PPI claims and the company has resumed dividend payments. Life insurer Prudential is another new holding, which the manager considers is in a strong operational position. The stock was historically viewed as too expensive due to its higher-growth emerging market and Asian businesses. However, concerns about emerging market growth, the Solvency II directive and US legislative changes caused a pullback in the stock, which the manager considered was an overreaction, with the company's structural growth drivers remaining in place.

Performance: Near-term periods have been challenging

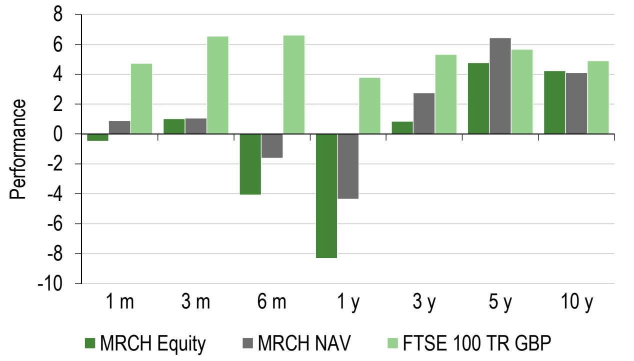
In the 12 months to the end of MRCH's financial year at 31 January 2016, the return on the underlying portfolio was ahead of the benchmark, but the effect of gearing and a widening in the discount meant that the NAV and share price total return both underperformed the benchmark. Over the period, there was a wide divergence of returns within the UK market. Defensive sectors, bond proxies, construction and media companies were strong, while resources, industrial cyclical companies and banks were weak. The top contributors to MRCH's performance were an overweight position in Inmarsat and the lack of exposure to miners Glencore, Rio Tinto and Anglo American. The largest detractors to performance were a position in miner Antofagasta and not holding Imperial Tobacco, which was a significant outperformer in the index over the period.

Exhibit 5: Investment trust performance to 30 June 2016

Price, NAV and benchmark total return performance, one-year rebased



Price, NAV and benchmark total return performance (%)



Source: Thomson Datastream, Edison Investment Research. Note: Three-, five- and 10-year performance figures annualised.

MRCH's performance since the end of the financial year has remained challenging. Some strongly performing share prices in FY16 have rolled over, such as Inmarsat. However, the manager believes in the long-term prospects of the company and has been taking advantage of the share price weakness to add to his position. Following weakness in 2015, the mining sector has rallied strongly; MRCH has been increasing exposure, but remains underweight versus the benchmark. In addition, there are a number of companies that have had poor newsflow such as Marks and Spencer, Mothercare and William Hill, which has since been sold. Notwithstanding near-term performance pressures, MRCH's NAV total return has outperformed the benchmark over five years. The manager remains committed to his high-conviction stock-picking approach.

Exhibit 6: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to FTSE 100	(5.0)	(5.2)	(10.0)	(11.7)	(12.3)	(4.1)	(6.3)
NAV relative to FTSE 100	(3.7)	(5.2)	(7.7)	(7.9)	(7.2)	3.7	(7.4)
Price relative to FTSE All-Share	(3.2)	(3.5)	(8.0)	(10.3)	(13.6)	(6.8)	(10.4)
NAV relative to FTSE All-Share	(1.9)	(3.5)	(5.7)	(6.4)	(8.6)	0.8	(11.5)

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-June 2016. Geometric calculation.

Exhibit 7: NAV performance relative to benchmark over five years

Source: Thomson Datastream, Edison Investment Research

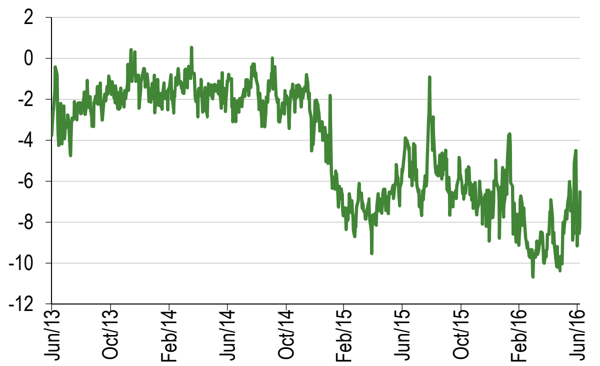
Discount: In a widening trend

MRCH is currently trading at a 5.4% share price discount to cum-income NAV with debt at market value. This compares to the average of the last 12 months of 4.6% (range of a 1.8% premium to a 9.0% discount). The current discount is also wider than the averages of the last three, five and 10 years of 1.6%, 1.1% and 1.7% respectively. The wider than average discount is not unique to

MRCH, as investment trust discounts have generally widened in recent months in an environment of higher investor risk aversion. With the low level of interest rates, the market value of MRCH's debt is higher than its par value, which means that the share price discount to NAV with debt at market value is narrower than versus the discount to NAV with debt at par value.

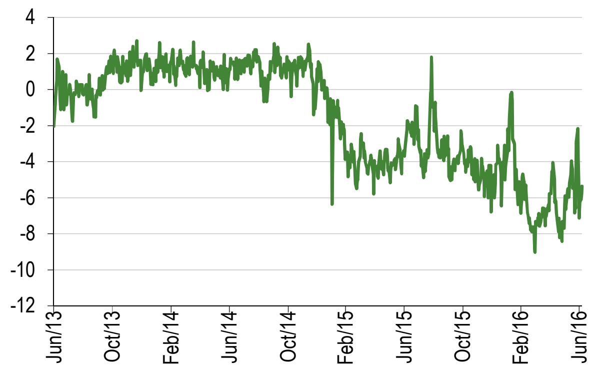
Renewed annually, the trust has authority to purchase up to 14.99% and allot up to 5% of issued share capital. No shares have been issued or repurchased since FY14, although the board monitors the discount.

Exhibit 8: Three-year discount to NAV (debt at par or book value)



Source: Thomson Datastream, Edison Investment Research

Exhibit 9: Three-year cum-income discount (debt at fair or market value)



Source: Thomson Datastream, Edison Investment Research

Capital structure and fees

MRCH is a conventional investment trust with one class of share; there are currently 108.7m ordinary shares outstanding. At the January financial year end, it held £110m of debt (at book value) with average maturity of seven years and an average interest charge of 8.5%. The first tranche repayable is a £34m 11.125% January 2018 debenture. The board is considering options; if the debt is refinanced at current levels of interest rates, it would add 3-4% to earnings per share. Share price and NAV returns have been affected by the level of gearing as the FTSE 100 index has been essentially flat for the last three years, with all the returns coming from income. As bond yields have come down to record lows, the value of MRCH's debt has increased, which has offset the benefit of pull to par as some of the debt nears maturity.

For FY16, the annual management fee was 0.35% of net assets, which was in line with the prior year. The ongoing charge was 0.58% versus 0.62% in FY15.

Dividend policy and record

MRCH has a progressive dividend policy; the annual dividend has increased for the last 34 consecutive years. Dividends are paid quarterly in August, November, February and May. In FY16, the annual dividend was 24.0p per share; a 0.8% increase versus the previous year. It was fully covered by earnings, while revenue reserves at the financial year-end stood at £24.6m, equating to 94% of the FY16 annual dividend. Based on the share price at 28 June, MRCH had a dividend yield of 6.1%, ranking fourth out of 23 trusts in the AIC UK Equity Income sector.

Peer group comparison

Exhibit 10 shows a comparison of the funds in the AIC UK Equity Income sector with market caps above £400m. MRCH is unique among peers as it measures its performance against the FTSE 100 rather than the FTSE All-Share index. The more challenging performance over the last year has led to the trust lagging its peers over the periods shown below. However, MRCH has a higher yield than both the selected peer group and sector averages; ranking fourth out of 23 funds. This provides investors with an important source of total return in an overall environment of low earnings growth. MRCH has one of the highest levels of gearing in the sector, which may partly explain why the discount is wider than the peer group average. Its ongoing charge is in line with the selected peers, but lower than the whole sector average; there is no performance fee payable.

Exhibit 10: UK Equity Income peer group (market cap above £400m) at 28 June 2016

% unless stated	Market cap £m	NAV TR 1 Year	NAV TR 3 Year	NAV TR 5 Year	NAV TR 10 Year	Sharpe 1y (NAV)	Sharpe 3y (NAV)	Discount (ex-par)	Ongoing charge	Perf. fee	Net gearing	Dividend yield (%)
Merchants Trust	425.4	(14.1)	1.2	31.4	43.3	(0.8)	0.1	(6.1)	0.6	No	123	6.1
City of London	1,187.8	(5.8)	18.0	52.0	93.3	(0.5)	0.5	2.7	0.4	No	110	4.2
Edinburgh Investment Trust	1,260.1	(1.2)	30.1	74.6	114.6	(0.3)	0.8	(3.0)	0.6	No	116	3.7
Finsbury Growth & Income	788.7	0.9	37.2	94.7	186.0	(0.2)	0.9	1.1	0.8	No	103	2.1
Murray Income Trust	435.4	(4.3)	9.7	38.2	62.7	(0.7)	0.2	(7.6)	0.7	No	108	4.9
Perpetual Income & Growth	837.7	(6.6)	25.2	73.4	128.9	(0.7)	0.7	(6.3)	0.7	Yes	119	4.1
Temple Bar	663.4	(9.8)	6.7	43.9	99.8	(0.8)	0.2	(7.6)	0.5	No	104	4.8
Selected stock average	**799.8**	**(5.8)**	**18.3**	**58.3**	**104.1**	**(0.6)**	**0.5**	**(3.8)**	**0.6**		**112**	**4.3**
Sector average (23 peers)	**351.0**	**(7.9)**	**19.7**	**52.4**	**73.7**	**(0.6)**	**0.6**	**0.1**	**1.1**		**118**	**4.5**
MRCH rank (out of 23 peers)	**7**	**21**	**23**	**22**	**19**	**21**	**23**	**15**	**19**		**5**	**4**

Source: Morningstar, Edison Investment Research. Note: TR=total return. Sharpe ratio is a measure of risk-adjusted return. The ratios shown are calculated by Morningstar for the past 12- and 36-month periods by dividing a fund's annualised excess returns over the risk-free rate by its annualised standard deviation. Net gearing is total assets less cash and equivalents as a percentage of net assets.

The board

There are five members on the board at MRCH, all of whom are independent. Chairman Simon Fraser joined in 2009 and was elected to his current position in 2010. Senior independent director Mike McKeon was appointed in 2008. The other three board members are Paul Yates (appointed in 2011), Mary Ann Sieghart and Sybella Stanley (both appointed in 2014).

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