EDISON

The Merchants Trust

High yield from focused UK equity portfolio

Investment trusts

The Merchants Trust (MRCH) offers one of the highest yields currently available on a mainstream equity investment trust (5.9% at 11 December), as well as the potential for capital growth. Manager Simon Gergel has positioned the trust with a tilt towards mega caps in areas such as banks, where dividend growth could come back strongly as legacy issues subside. The focused portfolio of 44 stocks also has exposure to UK economic growth via the industrial and consumer services sectors, and selected holdings in resources offer recovery potential. MRCH pays dividends quarterly and has a 33-year record of annual dividend growth. The discount has widened over the year as large caps have fallen from favour, with scope for it to narrow to a level more in line with long-term averages.

12 months ending	Share price (%)	NAV (%)	FTSE 100 (%)	FTSE 350 HY (%)	FTSE All-Share (%)
30/11/11	0.4	5.3	3.2	9.0	2.6
30/11/12	10.5	16.1	10.7	10.6	12.1
30/11/13	37.3	26.2	17.5	18.4	19.8
30/11/14	2.6	1.9	4.7	4.9	4.7
30/11/15	(5.5)	(1.1)	(1.9)	(6.2)	0.6

Note: Twelve-month rolling discrete total return performance.

Investment strategy: Research is fundamental

MRCH is managed by Simon Gergel, who makes use of Allianz Global Investors' (AllianzGI's) research-driven investment process. More than 5,000 company meetings a year are conducted by the global analyst team, who are organised by sector. Gergel seeks to identify stocks with a combination of attractive yields, solid dividend growth potential and low absolute and relative valuations. Potential buys are assessed on fundamentals such as competitive position, industry dynamics, financials and corporate governance.

Market outlook: Total return potential despite jitters

Volatile conditions for UK equities have persisted through the second half of the year, with the FTSE 100 index posting an 8.4% decline in total return terms from 1 July to 11 December. Investor concerns are focused on the likely trajectory of US interest rate increases, as well as falling commodity prices, a slowdown in China and geopolitical tension in the Middle East. While P/E valuations are towards the higher end of historical ranges, the large-cap UK index offers a higher dividend yield than its smaller brethren, providing a potential boost to total returns.

Valuation: Discount wider after large-cap sell-off

At 15 December, MRCH's shares traded at a 3.2% discount to cum-income NAV (with debt at market value). This is wider than the averages over one, three and five years (2.8%, 1.2% and 0.3% respectively), possibly as a result of recent weaker performance from the largest UK stocks, as well as the trust's relatively high level of fixed gearing. In the run-up to the first tranche of debt maturing in January 2018, the board will consider options regarding refinancing, which could potentially lead both to greater flexibility and to an uplift in the revenue account.

17 December 2015

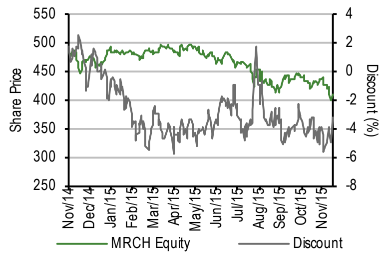
Price	**408.8p**
Market cap	**£444.4m**
AUM	**£593.8m**

NAV*	410.5p
Discount to NAV	0.4%
NAV**	422.3p
Discount to NAV	3.2%

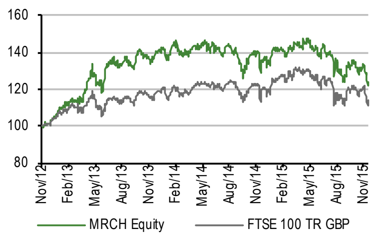
*Excluding income. **Including income.
Data to 15 December 2015.

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	497.8p	401.5p
NAV** high/low	519.1p	422.3p

**Including income.

Gearing

Gross*	21.8%
Net*	19.6%

*As at 31 October 2015.

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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

- 24 September 2015: half-yearly report for the six months ended 31 July. NAV TR +2.8% (debt at market value) versus benchmark TR +1.2%. Share price TR -1.1%.

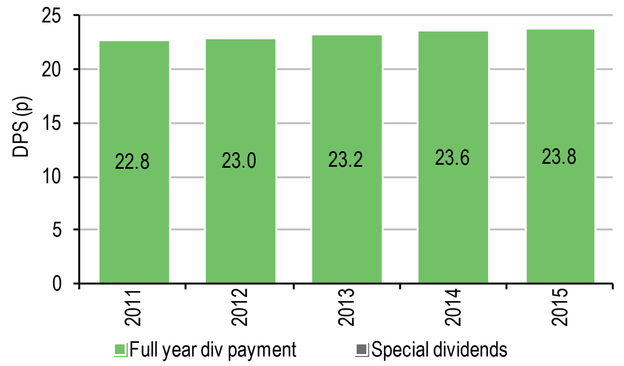
Forthcoming		Capital structure		Fund details	
AGM	May 2016	Ongoing charges	0.59%	Group	Allianz Global Investors
Final results	April 2016	Net gearing	19.6%	Managers	Simon Gergel
Year end	31 January	Annual mgmt fee	0.35%	Address	199 Bishopsgate, London, EC2M 3TY, UK
Dividend paid	Quarterly	Performance 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

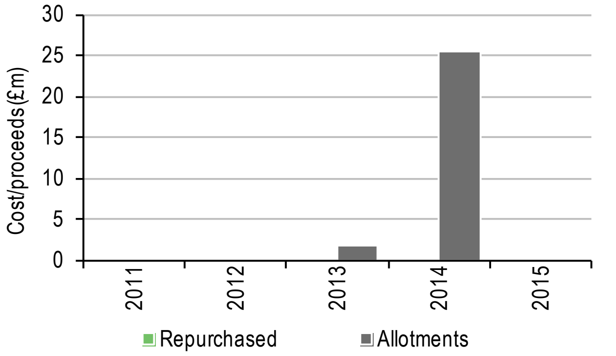
Dividend policy and history

Quarterly dividends paid in August, November, February and May. MRCH aims to maintain a high and growing dividend.

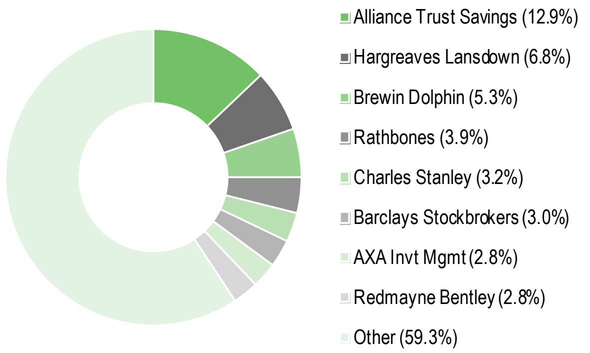
Share buyback policy and history

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

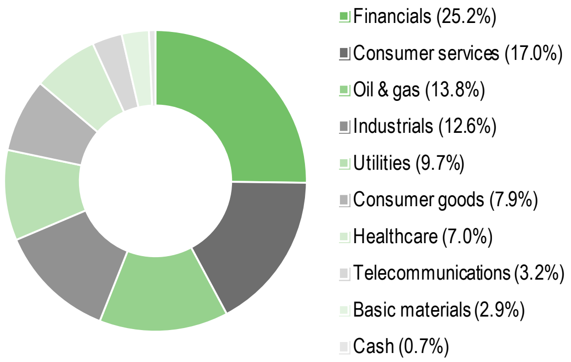




Shareholder base (as at 7 December 2015)



Portfolio exposure by market cap (as at 31 October 2015)



Top 10 holdings (as at 30 November 2015)

		Portfolio weight %	
Company	**Sector**	**30 Nov 2015**	**31 May 2015***
GlaxoSmithKline	Healthcare	6.8	5.5
Royal Dutch Shell 'B'	Oil & gas	6.6	7.1
HSBC	Banks	6.4	6.1
BP	Oil & gas	4.9	5.1
UBM	Media	4.5	4.5
Lloyds Banking Group	Banks	3.7	N/A
BAE Systems	Aerospace & defence	3.3	N/A
Inmarsat	Telecommunications	3.3	3.2
National Grid	Utilities	2.5	N/A
Pennon	Utilities	2.5	N/A
Top 10 (% of portfolio)		**44.4**	**44.4**

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

Market outlook: Positive potential from higher yields

At the time of writing there had been no 'Santa rally' for the FTSE 100, which has fallen in total return terms by 8.4% from the start of the second half of the year (1 July to 11 December). Investors seemed more focused on the negative implications of the imminent US interest rate rise (principally a stronger dollar, leading to concerns for emerging markets with dollar-denominated debt and outflows of funds causing markets to fall) than the positive signals of recovery in the world's largest economy. Falling commodity prices linked to a slowdown in China, as well as conflict in the Middle East and beyond, have added to the poor sentiment, outweighing news of a stronger UK economy with rising wages. However, early signs are that the 0.25% US rate rise announced as this note was being finalised has been received positively.

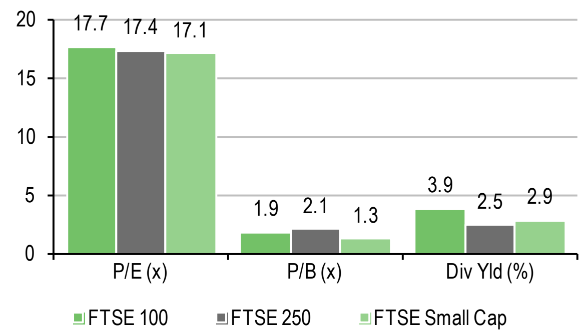
Oddly in the era of quantitative easing and ultra-low interest rates, when income-hungry investors have increasingly looked to the stock market to satisfy their yield requirements, higher-yield stocks (as measured by the FTSE 350 HY index, Exhibit 2) have underperformed the main UK index in total return terms. This is true not just over the whole 10-year period shown in the chart, but in the recovery period over the last three years (FTSE 100 total return of 11.9% versus 7.3% for FTSE 350 HY over three years to 11 December 2015).

In aggregate, no area of the UK stock market looks particularly compelling in terms of price/earnings valuation (right-hand chart, below; figures at end-November). The FTSE 100 P/E is c 37% above its five-year average, and in absolute terms is similar to the valuations of the mid-cap FTSE 250 and FTSE Small Cap indices. However, if high valuations suggest limited capital growth potential in the immediate term, it is important to note the role of dividends in total returns. While some concerns exist over dividend cover for FTSE 100 stocks (see The manager's view), the FTSE 100 dividend yield is comfortably above those of its smaller-cap peers, and also above five and 10-year averages.

Exhibit 2: Market performance and valuation

FTSE 100 vs FTSE 350 Higher Yield – 10 years

P/E*, price/book and dividend yields for FTSE 100, 250 and Small Cap



Source: Thomson Datastream, FTSE Russell, Edison Investment Research. * Note: Historic P/E based on latest company year-ends.

Fund profile: High-yielding UK equity specialist

Launched in 1889, The Merchants Trust has evolved throughout its history into an investment trust seeking a high and growing income from a portfolio of UK equities. It is managed by Simon Gergel, chief investment officer of UK equities at AllianzGI, and is both the largest and the oldest of the three trusts managed by AllianzGI. MRCH is differentiated from peers in the UK Equity Income sector by using the FTSE 100 index as a performance benchmark; the trust currently has a slant towards some of the largest stocks in the index, although it also has c 35% of assets invested in companies outside the 100 largest. MRCH is one of the highest-yielding equity investment trusts and has a 33-year record of annual dividend growth.

The fund manager: Simon Gergel

The manager's view: Bright spots in dividend outlook

Manager Simon Gergel points out that while recent years have not been kind to some of the largest companies in the FTSE 100, there is no reason to believe that problems such as the bursting of the TMT bubble, the financial crisis and the collapse in commodity prices – which in turn have affected telecoms companies, banks and oil and mining stocks – should recur. MRCH aims to provide a high yield as well as the prospect of growth in income and capital, and Gergel argues that companies in these out-of-favour areas are trading at more attractive valuations and at higher yields than in-demand sectors such as consumer staples.

With the aggregate dividend cover (the ratio of earnings to dividends) of the FTSE 100 declining over recent years, some commentators have raised concerns over the sustainability of dividends from large UK companies. Gergel expects modest dividend growth next year for the MRCH portfolio, which, though concentrated in a fairly small number of stocks, is diversified by industry and has about one-third of assets invested outside the FTSE 100. While dividend growth from the largest stocks (particularly oil and gas, currently c 14% of the portfolio) may be subdued, and there may be some dividend cuts, this should be offset by higher dividends from smaller stocks and names like Lloyds Banking Group, which is expected to resume significant dividend payments for the first time since the financial crisis. Overall, the manager expects MRCH's dividend growth to exceed that of the FTSE 100, particularly given the low level of exposure to under-pressure mining stocks. Gergel points out that in a world of low interest rates and low inflation, low dividend growth would be expected. However, several portfolio stocks across a range of sectors, including a trio of insurers (L&G, Aviva and Prudential), Pennon, Inmarsat, Kier and Britvic, are growing their dividends at a healthy rate.

Some 3.5% of the portfolio is in companies that are not immediately expected to pay dividends; this includes long-term holding Mothercare, where a continued turnaround in the UK would allow the rating to reflect strong growth overseas. Because MRCH is not constrained by only holding stocks that pay a dividend, it is able to hold positions such as this at modest valuations, providing the potential for superior capital growth as well as future income.

Asset allocation

Investment process: Research-based, fundamental approach

MRCH manager Simon Gergel aims to build a high conviction portfolio of c 40-50 stocks to achieve a high initial yield together with income growth and the possibility of capital appreciation. Stocks are chosen for their total return (not just income) potential. All holdings should yield at least in line with the market within 18 months, but this does not preclude those that do not currently pay dividends.

Potential holdings are assessed according to their fit with portfolio themes, absolute and relative valuation, and fundamentals such as industry dynamics, competitive position, corporate governance and financials. AllianzGI's large team of industry specialists conducts more than 5,000 company meetings each year, and Gergel can draw on their recommendations, as well as the output of Grassroots^{SM}, a proprietary research system with a network of analysts and field researchers. Stocks may be sold if they achieve their target price, if there is a change to the investment case, or if the manager sees better opportunities elsewhere. A fall in yield to below the market level (whether caused by a dividend cut or by an increase in price) will not necessarily lead to an exit.

The manager makes selective use of option-writing to enhance portfolio income. This facility is most likely to be used when market volatility is higher, as low volatility tends to translate to low option premiums. Options may be written over a maximum of 15% of the portfolio.

Current portfolio positioning

At 31 October 2015, MRCH had 44 holdings, with 44.4% of the portfolio held in the top 10 stocks. This compares with an average stock list of 58 and a top-10 concentration of 34% for the AIC UK Equity Income sector. Just under half the stocks by number, representing about one-third of the portfolio, are outside the benchmark FTSE 100 index. The short stock list means the portfolio is actively positioned versus the benchmark, as shown in Exhibit 3 below. However, Gergel's tilt towards mega caps (seven of the 10 largest UK stocks at 10 December are in the portfolio) means that there is also meaningful exposure to overall index movements.

Exhibit 3: Top five active positions vs benchmark (%)

	Portfolio end November 2015	FTSE 100 Index weight	Active weight (% pts)
UBM	4.5	0.0	4.5
Inmarsat	3.3	0.3	3.0
GlaxoSmithKline	6.8	4.0	2.8
Pennon	2.5	0.0	2.5
BAE Systems	3.3	1.0	2.3
	20.4	**5.3**	**15.1**

Source: The Merchants Trust, Edison Investment Research.

At an absolute level, the largest sector exposure is to financials (25.2% of the portfolio at 31 October), which includes the recent purchases of Lloyds, Barclays and Prudential. The largest overweights (Exhibit 4) are in consumer services and industrials, both areas that should benefit from an improving UK economy. Utilities – a high-yielding area – are also overweight, while the oil and gas exposure is largely in line with the benchmark. The biggest underweight is in consumer goods, where a flood of investors seeking 'bond proxies' has pushed up prices and valuations to historically high levels, resulting in lower dividend yields. Gergel says that rising interest rates will mean investors begin to question the value of these defensive stocks, and that a healing economy should feed through into greater interest in cyclical stocks.

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

	Portfolio end Oct 2015	Portfolio end April 2015	Change (% pts)	Index weight	Active weight vs index (% pts)	Trust weight/ index weight (x)
Consumer Services	17.0	17.7	-0.7	11.1	5.9	1.5
Industrials	12.6	12.8	-0.2	6.7	5.9	1.9
Utilities	9.7	9.0	0.7	4.5	5.2	2.2
Financials	25.2	20.3	4.9	22.6	2.6	1.1
Oil & Gas	13.8	15.4	-1.6	13.0	0.8	1.1
Technology	0.0	0.0	0.0	1.3	-1.3	0.0
Basic Materials	2.9	3.4	-0.5	5.5	-2.6	0.5
Telecommunications	3.2	3.7	-0.5	6.1	-2.9	0.5
Healthcare	7.0	5.8	1.2	10.0	-3.0	0.7
Consumer Goods	7.9	9.7	-1.8	19.3	-11.4	0.4
Cash	0.7	2.2	-1.5	0.0	0.7	N/A
	100.0	**100.0**	**0.0**	**100.0**	**0.0**	

Source: The Merchants Trust, Edison Investment Research. Ranked by active weight, excluding cash.

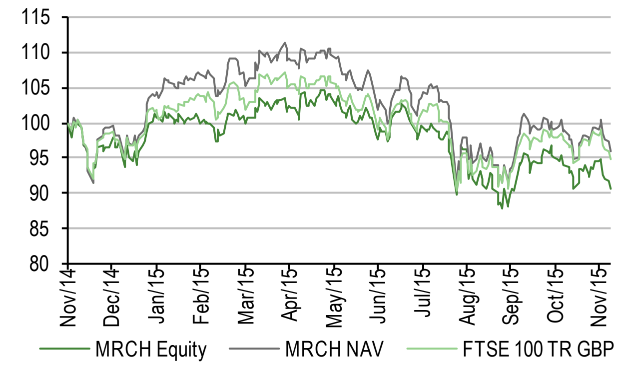
Recent changes to the portfolio include the increase in financials detailed above (+5pp over six months), as well as the purchases of financial support services firm Equiniti and low-cost accommodation booker Hostelworld at their IPOs. The latter is an example of a stock where Grassroots^{SM} research was used to assess the investment opportunity, with market research carried out in the UK and Germany. Sales include Cineworld, Unilever and retail property company Hammerson, all of which had performed strongly, and the underperforming oil services stock Amec Foster Wheeler and mining spin-off South32.

While the equity portfolio is entirely invested in UK stocks, the earnings of particularly the largest companies are international. Gergel says that while 70% of holdings report their earnings in sterling, with the majority of the remainder reporting in US dollars, the UK/overseas split of earnings for the portfolio is similar to that of the FTSE 100, with c 60-70% of earnings coming from outside the UK. This means the trust may also benefit from economic recovery in the US and Europe.

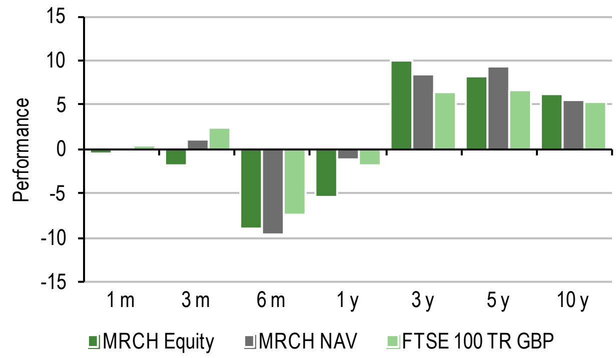
Performance: Longer-term record remains intact

Exhibit 5: Investment trust performance to 30 November 2015

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.

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

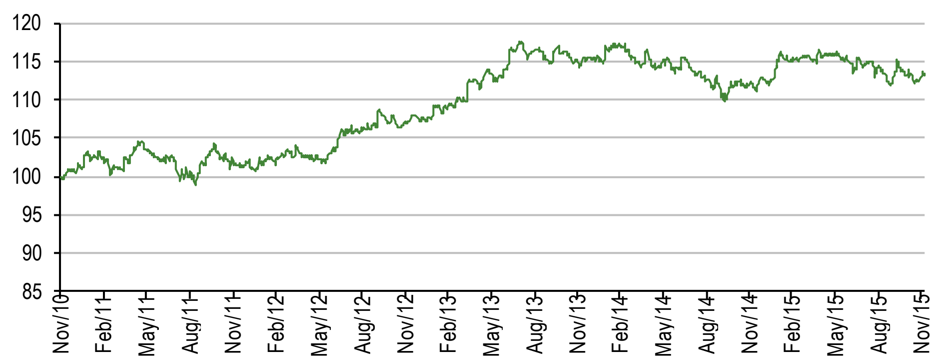
	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to FTSE 100	(0.8)	(4.2)	(1.7)	(3.6)	10.4	7.2	8.3
NAV relative to FTSE 100	(0.4)	(1.3)	(2.6)	0.8	5.4	12.8	0.8
Price relative to FTSE 350 High Yield	(0.6)	(3.5)	0.6	0.8	14.2	5.1	24.1
NAV relative to FTSE 350 High Yield	(0.2)	(0.6)	(0.3)	5.5	9.1	10.7	15.5
Price relative to FTSE All-Share	(1.0)	(4.1)	(2.6)	(6.1)	5.5	1.8	1.2
NAV relative to FTSE All-Share	(0.6)	(1.2)	(3.5)	(1.7)	0.8	7.1	(5.8)

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-November 2015. Geometric calculation.

MRCH has been hit by the sell-off in FTSE 100 stocks in the second half of 2015 (index total return -7.3% over six months to 30 November), exacerbated by the impact of gearing in a falling market. However, over three and five years and in most cases over 10 years, the trust has outperformed the FTSE 100, FTSE 350 Higher Yield and FTSE All-Share indices in both share price and NAV total return terms (Exhibit 6).

Gergel takes a long-term and value-focused approach to investment, and some more recent additions to the portfolio, such as copper miner Antofagasta and Lloyds and Barclays banks, remain quite depressed in share price terms. However, other holdings such as Mothercare, cruise operator Carnival (a double beneficiary of the low oil price owing to lower costs and higher disposable incomes) and brokerage ICAP (which recently announced a partial merger with rival firm Tullett Prebon) have contributed positively to the portfolio.

Exhibit 7: NAV performance relative to FTSE 100 index over five years



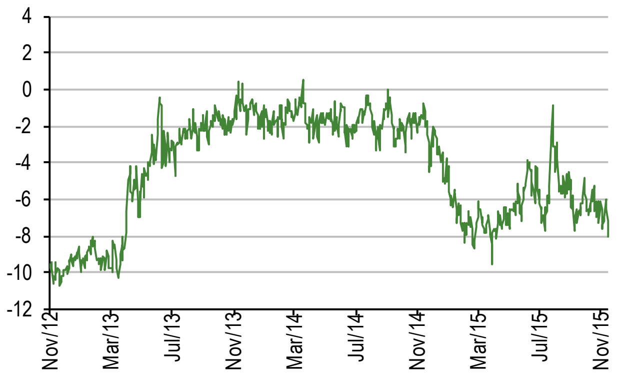
Source: Thomson Datastream, Edison Investment Research

Discount: Wider than average amid large-cap sell-off

At 15 December, MRCH traded at a 3.2% discount to its cum-income net asset value with debt at market value. (Because of the current low level of interest rates, the market value of the debt is higher than its par value; this boosts the NAV with debt at par, meaning the discount on this basis is wider, at 8.0%.) The current discount is wider than the one-, three- and five-year averages (2.8%, 1.2% and 0.3% respectively), possibly as a result of large-cap UK stocks being less favoured by investors, and there is scope for it to narrow, particularly given MRCH's high dividend yield.

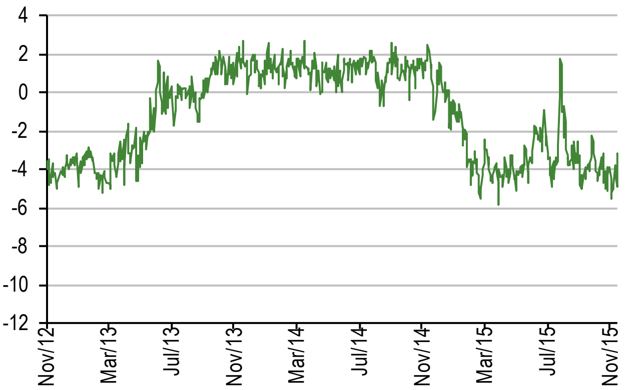
The trust may repurchase up to 14.99% and allot up to 5% of issued share capital annually, to manage a discount or a premium. So far in 2015, no shares have been issued or bought back.

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 (108.7m ordinary shares in issue at 11 December). Structural gearing of c 20% comes mainly from two issues of debentures totalling £79.7m (par value), repayable in January 2018 and May 2023, as well as £29.5m of secured bonds. With the repayment of the 11.125% 2018 debentures only two years away, the board is starting to consider options such as refinancing or repayment, the first of which could boost portfolio income by c 3-4% given the relatively high cost of debt servicing, while the second would be largely revenue neutral.

AllianzGI is paid an annual management fee of 0.35% of assets minus current liabilities. Ongoing charges were 0.59% for the year ended 31 January 2015.

Dividend policy and record

Dividends are paid quarterly, in August, November, February and May. For FY14/15 the total dividend was 23.8p, with the third and fourth quarterly dividends raised to 6.0p per share compared with 5.9p for the first two. For FY15/16 two dividends of 6.0p per share have so far been declared; if the third and fourth quarterly dividends are maintained at the same level the total dividend for the year would be 24.0p per share, an increase of 0.8%, extending the unbroken run of year-on-year dividend increases to 34 years. The payment of the FY14/15 dividend necessitated a small contribution from revenue reserves (0.2p per share), which remain large at 24.7p per share at H115/16, sufficient to cover a full year's dividends. Based on the 15 December share price of 408.8p and the FY14/15 dividend, MRCH currently has a yield of 5.9%.

Peer group comparison

The AIC's UK Equity Income peer group has 25 constituents; Exhibit 10 below shows the largest seven, with market capitalisations above £400m. MRCH is unusual in the group because it measures its performance against the FTSE 100 rather than the FTSE All-Share. The recent spell of more challenging performance has translated into below-average NAV total returns over one, three and five years. However, MRCH does have highest yield of the large funds and the fourth-highest in the whole sector, providing an important source of return during a period where positive capital returns from equities may be harder to come by. In a sector where 10 funds currently trade at a premium to NAV (driven by appetite for income-producing assets), it is significant to see one of the highest-yielding trusts on an above-average discount. This may be related to the relatively high level of structural gearing, which is the fifth-highest in the sector. Ongoing charges are broadly average and there is no performance fee.

Exhibit 10: UK Equity Income peer group (market cap above £400m) at 8 December

% unless stated	Market Cap £m	NAV TR 1 Year	NAV TR 3 Year	NAV TR 5 Year	Ongoing Charge	Perf. fee	Discount (ex-par)	Net Gearing	Dividend yield (%)	Sharpe 1y (NAV)	Sharpe 3y (NAV)
Merchants Trust	**458.8**	**-3.6**	**21.9**	**43.8**	**0.6**	**No**	**-4.3**	**122.0**	**5.7**	**0.0**	**0.6**
City of London	1207.4	2.8	36.3	66.8	0.4	No	1.5	111.0	4.0	0.4	1.0
Edinburgh Investment Trust	1410.7	8.9	57.3	97.5	0.6	No	3.0	114.0	3.3	1.0	1.5
Finsbury Growth & Income	681.2	8.6	58.7	107.5	0.8	No	0.6	104.0	2.1	0.7	1.3
Murray Income Trust	455.5	-4.3	20.8	41.2	0.7	No	-6.5	108.0	4.8	-0.2	0.7
Perpetual Income & Growth	975.1	5.4	58.6	98.6	0.7	Yes	1.3	117.0	3.5	0.8	1.7
Temple Bar	698.2	-6.2	22.5	49.9	0.5	No	-4.7	102.0	3.8	-0.3	0.7
Selected stock average		**3.3**	**43.6**	**78.4**	**0.6**		**-0.1**	**111.5**	**3.7**	**0.5**	**1.2**
Whole sector average		**3.7**	**43.2**	**73.3**	**0.7**		**-0.7**	**111.4**	**3.7**	**0.6**	**1.2**
MRCH rank in sector (out of 25 peers in total)	**6**	**22**	**22**	**20**	**21**		**17**	**5**	**4**	**22**	**22**

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

MRCH has five non-executive directors. Chairman Simon Fraser joined the board in 2009 and has held his current post since 2010. Mike McKeon has been a director since 2008, while Paul Yates was appointed in 2011. The newest directors, Mary Ann Sieghart and Sybella Stanley, joined the board in November 2014. The directors have backgrounds in investment management, industry, corporate finance and the media.