EDISON

The Merchants Trust

Quarterly income from value-focused portfolio

Investment trusts

The Merchants Trust (MRCH), managed by Simon Gergel, CIO UK Equities at Allianz Global Investors (AGI), has continued to outperform its FTSE 100 benchmark during the last 12 months, providing price and NAV total returns of 39.4% and 26.2% vs 16.7% for the FTSE 100. Dividends are paid quarterly, MRCH has an above-average yield (4.7%) and the recent interims suggest it is on track to provide 32 years of uninterrupted dividend growth. MRCH is managed using a value-driven investment style, and while the manager acknowledges it is currently more challenging to find value, he is identifying opportunities in the mega-caps (oils) and recovery stocks.

12 months ending	Total share price return* (%)	Total NAV return* (%)	Total return FTSE 100* (%)	Total return FTSE 350 High Yield* (%)	Total return FTSE All-Share* (%)
30/09/10	21.0	13.3	11.8	5.2	12.5
30/09/11	4.3	(2.2)	(4.4)	2.1	(4.4)
30/09/12	7.2	22.0	16.4	16.1	17.2
30/09/13	39.4	26.2	16.7	16.8	18.9

Note: *Twelve-month rolling discrete performance.

Investment strategy: Higher-yielding FTSE 100 co's

MRCH aims to provide an above-average level of income; the 4.7% yield compares with the FTSE 100 index yield of 3.5% and FTSE 350 High Yield index yield of 4.7%. It invests in higher-yielding equities, uses gearing (net gearing of 18%) and selectively writes covered out-of-the-money call options to generate additional revenue income. Revenue reserves have been used to support dividend payments over the last four years, but the gap has closed substantially as dividends on the underlying portfolio have increased. Management looks to invest in companies that offer at least a market yield on an 18-month view.

Outlook: Sentiment improving, valuations expanded

The UK equity market, as measured by the FTSE 100 Index, was up 16.7% over the past year (total return to 30 September 2013). The FTSE 100 reached its 10-year high in May, before falling c 13% between May and June. The index has since recovered roughly half of this correction (as at 9 October 2013), but is not as cheap as it has been previously. The current P/E for the FTSE 100 Index of 14.9x is c 30% above its 10-year average of 12.9x (see page 3). While there are signs that the economic backdrop is improving, the manager observes that actual activity levels are changing very slowly and considers that the market may be vulnerable to a further near-term correction. He has taken profits, particularly in aerospace and defence and consumer staples spaces, and has been adding selectively to certain turnaround/recovery situations.

Valuation: Discount narrowed over 12 months

MRCH's discount has broadly contracted during the last 12 months, so that with debt at fair value, MRCH has recently been trading at around NAV. Performance and yield are likely to have supported this move. The current cum-income premium, with debt at fair value, of 1.1%, compares with the one-year range from a premium of 1.8% to a discount of 5.3%.

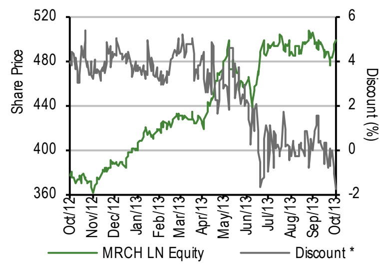
17 October 2013

Price	**494.8p**
Market cap	**£511m**
AUM	**£645m**
NAV*	507.70p
Discount to NAV	2.0%
NAV**	489.47p
Discount to NAV	1.1%
Yield	4.7%

*Adjusted for debt at par value, excluding income, as at 15 October 2013. **Adjusted for debt at market value, including income, as at 15 October 2013.

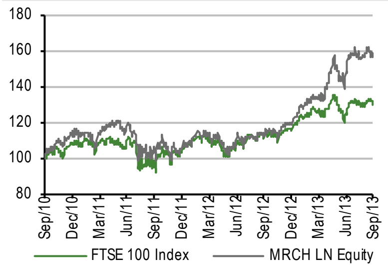
Ordinary shares in issue	103.2m
Code	MRCH
Primary exchange	LSE
AIC sector	UK Growth & Income

Share price/discount performance



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

Three-year cumulative perf. graph



52-week high/low	507.00p	361.50p
NAV* high/low	496.21p	364.66p

**Adjusted for debt at market value, Including income.*

Gearing

Gross	22%
Net	18%

Analysts

Matthew Read +44 (0)20 3077 5758
Andrew Mitchell +44 (0)20 3681 2500
investmenttrusts@edisongroup.com

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

Exhibit 1: Trust at a glance

Investment objective and fund background

MRCH'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

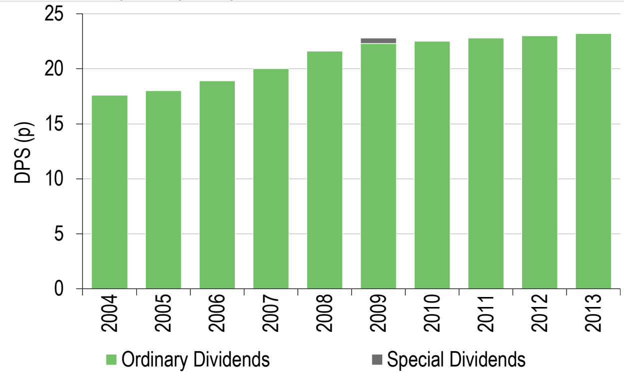
18 September 2013: Interim results for half year ended 31 July 2013 released. Second quarterly dividend for the year declared at 5.9p, going ex-dividend on 11 October 2013.

1 July 2013: First quarterly dividend for the year ending 31 January 2014 declared at 5.9p.

Forthcoming		Capital structure		Fund details	
AGM	May 2014	Ongoing charges	0.66%	Group	Allianz Global Investors
Preliminary results	March 2014	Net gearing	18%	Manager	Simon Gergel
Year end	31 January	Annual mgmt fee	0.35% of assets	Address	155 Bishopsgate, London EC2M 3AD, UK
Dividend paid	Quarterly	Performance fee	None		
Launch date	February 1889	Trust life	Indefinite	Phone	+44 (0)800 317 573
Continuation Vote	N/A	Loan facilities	See page 8	Website	www.merchantstrust.co.uk

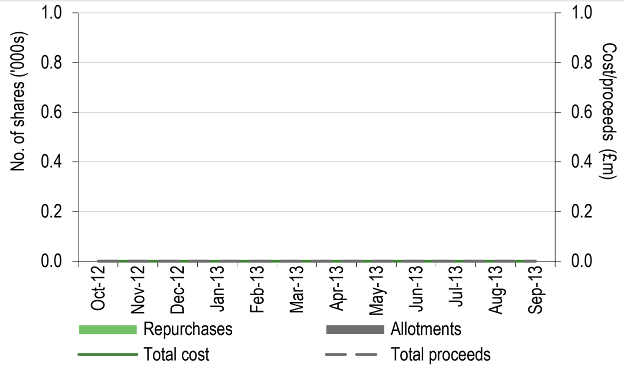
Dividend policy and history

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

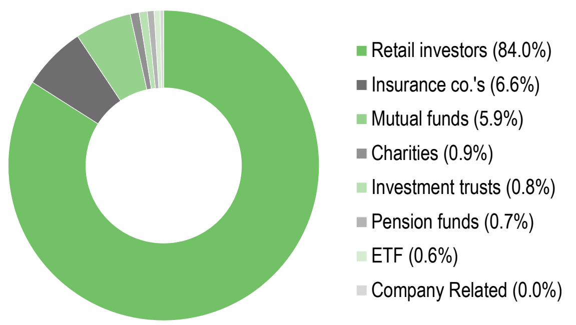


Share buyback policy and history

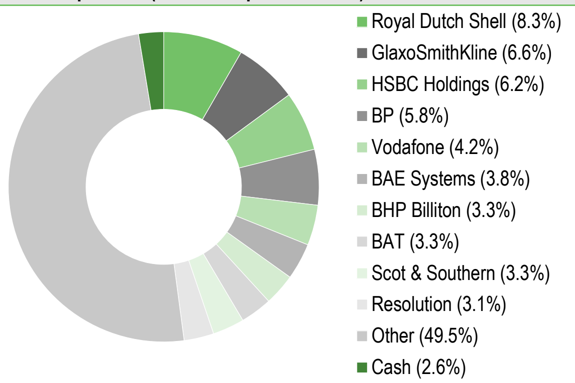
Renewed annually, the trust has authority to purchase up to 14.99% and allot up to 5% of issued share capital.



Shareholder base (as at 7 September 2013)



Portfolio composition (as at 30 September 2013)



Top 10 overweight positions (as at 30 September 2013)

			Active weight %	Portfolio weight %	
Company	Country	Sector	30 September 2013	30 September 2013	31 March 2013
BAE Systems	UK	Aerospace & defence	3.0	3.8	3.4
Resolution	Guernsey	Life insurance	3.0	3.1	2.8
UBM	UK	Media/publishing	2.7	2.7	1.9
Inmarsat	UK	Mobile telecommunications	2.5	2.5	1.9
SSE	UK	Conventional electricity	2.5	3.3	3.4
Pennon Group	UK	Gas, wtr & multi-util/water	2.5	2.4	1.6
GlaxoSmithKline	UK	Large pharmaceuticals	2.2	6.6	7.8
Balfour Beatty	UK	Heavy construction	2.0	2.0	0.9
Britvic	UK	Beverages/soft drinks	1.8	1.8	1.8
ICAP	UK	Investment services	1.6	1.5	1.2

Source: The Merchants Trust, Edison Investment Research

Outlook: Sentiment improving, valuations expanded

The UK equity market has provided a positive performance over the past year, with the trust's benchmark, the FTSE 100 Index, up 2.8% over six months and 16.7% over 12 months, in total return terms to 30 September 2013. The FTSE 100 reached its 10-year high in May, having returned c 17% since the beginning of the year, before falling c 13% between May and June. The index has since recovered roughly half of this correction (as at 9 October 2013), but prices have risen faster than earnings, so the index is not as cheap as it has been previously. The current P/E for the FTSE 100 Index of 14.9x is c 30% above its 10-year average (12.9x), c 19% below its 10-year high and at the upper end of its one-year trading range, as illustrated in Exhibit 2. While obviously not cheap on the numbers, the market could make further progress given continued economic improvement and an absence of negative events, as exemplified by the risks surrounding the current negotiations over the US fiscal and debt ceiling. In these circumstances, there would be potential for positive earnings surprises and hence more appealing P/Es.

Against an uncertain macro backdrop, exposure to a fund seeking income through investing in FTSE 100 stocks is likely to provide useful geographical diversification by virtue of the underlying exposures of the index constituents (c 70% of revenues are international). The index average yield (3.5%) also compares well with current 10-year UK government bond yields of 2.7% and deposit rates. Furthermore, while the risk may be modest, equities should fare better than bonds in the event of a significant increase in inflation.

Exhibit 2: FTSE 100 Index P/E over 10 years

Source: Thomson Datastream

Fund profile: Higher-yielding FTSE 100 companies

Managed by AGI and its predecessors since its launch in February 1889, MRCH is the oldest trust in the AGI stable. It is an income trust that pays quarterly dividends and has provided 31 years of uninterrupted dividend growth. Simon Gergel, CIO of UK Equities and head of AGI's value and income investment style team, has led the management of MRCH's portfolio since April 2006.

The fund manager: Simon Gergel

The manager's view: Markets vulnerable to near-term correction

The manager retains his central view that medium-term economic growth in the UK will be muted as debt is paid down. However, he acknowledges that there are signs that the economic backdrop is improving, but cautions that improvement will be gradual, and given the overall uplift in equity prices and valuations year to date, and ongoing macro uncertainty, considers that the market may be vulnerable to a further near-term correction triggered by valuation and adverse macro events. He also advises that, at current valuations, opportunities are proving harder to find, and reflecting this, has taken profits in many areas. He previously reduced exposure to many defensive stocks during the first half of 2013 on valuation grounds and still considers the defensive sectors to be broadly fully valued. However, he has also been reducing exposure to more economically sensitive areas, many of which were added to earlier this year, supporting MRCH's performance as markets rallied.

The trust's exposure to the theme of oversold aerospace and defence companies has been reduced significantly. Cobham has been sold in its entirety and all the remaining holdings reduced reflecting the re-rating these stocks have undergone, with the manager now seeing them as being fully valued. Similarly, exposure to consumer-related stocks (including media companies) has been reduced, particularly exposure to consumer staples, and while these stocks have subsequently seen their prices fall, the manager feels that valuations are not yet sufficiently cheap to consider adding to them again. Marston's has been sold in its entirety, while Sainsbury's, Cineworld, Daily Mail and General Trust have all been reduced.

In terms of additions, the manager has added a theme for the trust, identifying a number of turnaround/recovery stories that he considers to be attractive. There are two key strands. The first relates to an expected cyclical recovery in recruitment and UK construction after a difficult three years; an improving economic outlook and growing confidence are expected to be supportive of both areas. Reflecting this, the manager has added Sthree, which he expects to benefit from improved buoyancy in the employment market and strong growth prospects in its international platform. He has also added Balfour Beatty, which he expects will benefit from the uplift in UK housing, and with its substantial portfolio (c £700m) of cash-generative PFI assets, should be well positioned to support what is otherwise a cash-intensive business.

The second recovery strand relates to individual stocks that are addressing company specific problems, and the manager has added to Ladbrokes, Carnival and First Group. The manager considers that First Group's problems stemmed from overleverage and underinvestment in the business, but, post-rights issue, the company has a stronger balance sheet, with strong franchises, and the new management team is improving pricing and utilisation to drive up margins in the business.

The manager also likes the oil majors. These have faced a tough trading environment for the past three years, with various operational issues coming to the fore. However, the manager considers that the oil majors are less sensitive to the oil price than widely perceived and there has been considerable investment in longer-term assets such as gas liquification plants, from which there should be a cash flow benefit as these assets come onstream and the requirement for capex eases.

Otherwise, the following themes remain in place in the portfolio:

- Maintain large core holdings in well-financed larger cap names that remain attractively valued (including GlaxoSmithKline, Royal Dutch Shell and HSBC).
- Continue to limit exposure to mining (effects of muted recovery) and banks (uncertain regulatory environment and ongoing low dividend yields).
- Prefer non-bank financials (Hiscox, Resolution, ICAP, IG Group and Hansteen).
- Continue to look for companies with strong asset backing that gives them a competitive advantage and a hedge against a possible resurgence of inflation.

Asset allocation

Investment process: Bottom-up stock selection

MRCH is managed using a predominantly bottom-up investment approach, supported by macro analysis, using the fundamental research capability of AGI's UK equity team. The manager can also draw on the expertise of AGI's global team of 78 analysts. The performance of analyst recommendations is monitored and analysts are incentivised accordingly. In conducting the analysis, the manager can draw on AGI's Grassroots research function. This is a proprietary network of c 70 freelance investigative journalists who research and gather information on a variety of business-related topics, supported by a team of c 300 field investigators who specialise in conducting quantitative market research. AGI believes that Grassroots provides access to public data on company specific issues in a timely and value-creating manner.

When constructing the portfolio, the manager takes at least an 18-month view and is not driven by sector allocations. Instead the manager looks thematically for ideas, such as themes based on the macroeconomic outlook, stage of the business cycle, as well as industry and secular themes. In terms of stock selection, the manager looks for companies with favourable industry dynamics and strong competitive positions, as well as strong free cash flow and thus a good capacity to pay sustainable dividends. The manager also considers valuation in absolute terms, relative to history, to market and the dividend yield. The manager has a contrarian style and targets stocks with at least a market yield on an 18-month view, backing them with conviction. Yield in isolation is not a consideration for buying a stock and stocks are not automatically disposed of if the yield drops below the market average. Instead, purchase and sale decisions are driven by total return considerations. The manager has access to a range of metrics to manage portfolio risk.

Overview: FTSE 100-based, income-focused, geared fund

As at 30 September 2013, MRCH had 46 equity investments, while the top 10 holdings accounted for 47.6% of the portfolio, cash 2.6% and the remaining equity investments 49.8%. As displayed in Exhibit 3, MRCH's asset allocation can differ significantly from that of the FTSE 100, reflecting the actively managed nature of the trust. As shown in Exhibit 1, apart from the 2.6% of the portfolio held as cash, the remaining 97.4% of the portfolio is fully invested in the UK. Net gearing stood at 18%.

Derivatives strategy

The trust has continued to follow a policy of writing selected covered call options. This generates additional income for the trust. There is a maximum exposure of 15% of gross assets at the time of writing. The options usually have less than a four-month duration, and depending on the manager's views, the number of covered calls written on the portfolio can vary substantially. However, they typically range between five and 20. The positions taken are driven by fundamental views on the stocks, rather by any specific derivative strategy. For the year to 31 January 2013 call writing generated approximately £1.9m (similar to 2012) of additional revenue income and a net cost of £0.15m once the opportunity cost of exercised options is taken into account (profit c £0.95m 2012 and £0.48m 2011). For the six months ended 31 July 2013, call writing generated £0.71m of revenue income, although once the opportunity cost of exercised options is taken into account the strategy made a marginal loss.

Exhibit 3: Sector allocations (all data as at 30 September 2013 except where shown)

	Trust weight %	Trust weight % 31 March 2013	Benchmark weight %	Trust active weight	Trust weight/ benchmark weight
Consumer services	18.0	15.3	9.7	8.3	1.86
Industrials	14.1	11.4	7.7	6.4	1.83
Utilities	9.9	10.6	4.3	5.6	2.30
Technology	0.0	0.0	1.0	(1.0)	0.00
Telecommunications	6.7	8.0	7.9	(1.2)	0.85
Financials	18.8	18.0	20.3	(1.5)	0.93
Healthcare	6.6	7.8	8.6	(2.0)	0.77
Oil & gas	14.1	15.3	16.9	(2.8)	0.83
Basic materials	3.3	2.6	8.8	(5.5)	0.38
Consumer goods	5.9	8.5	14.8	(8.9)	0.40
Cash	2.6	2.5	0.0	2.6	N/A
Total	**100.0**	**100.0**	**100.0**	**0.0**	

Source: The Merchants Trust, Edison Investment Research

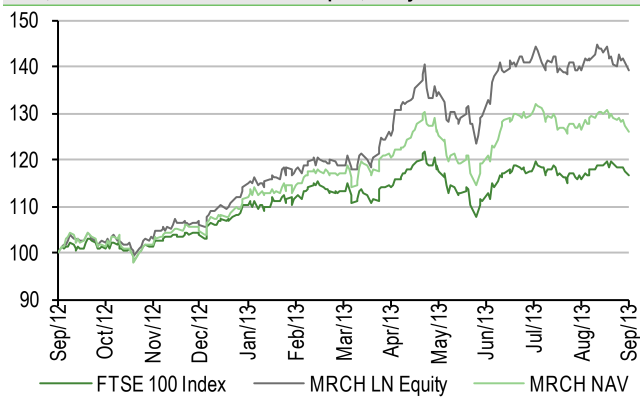
Current portfolio positioning

The main underweight positions remain basic materials and consumer goods, with smaller underweights in oil and gas, healthcare and financials. Telecommunications has moved from being a mild overweight to a mild underweight during the last six months. The financials underweight remains concentrated in the banks (active weight -7.7%), balanced in part by overweights in other financial service companies and REITS. The key overweight positions remain consumer services, industrials and utilities. Within consumer services, media, previously the predominant theme, is now rivalled by travel and leisure, which is dominated by turnaround/recovery stocks, Carnival and First Group. Within industrials, aerospace and defence companies, BAE and Meggitt, remain overweight, despite recent top slicing in the sector, but the largest overweight is to construction and materials, which is dominated by Balfour Beatty. The portfolio remains defensively positioned, with a predicted beta of 0.87. This has increased from c 0.8 at the beginning of the year. Exposure to non-benchmark companies has also increased during the last two years. Exposure to non-FTSE 100 companies, currently at 32% of the portfolio, is up from 23% 12 months ago and up from 16% two years ago. Reflecting this, MRCH's active share is now 57% vs 50% 12 months ago and 46% two years ago.

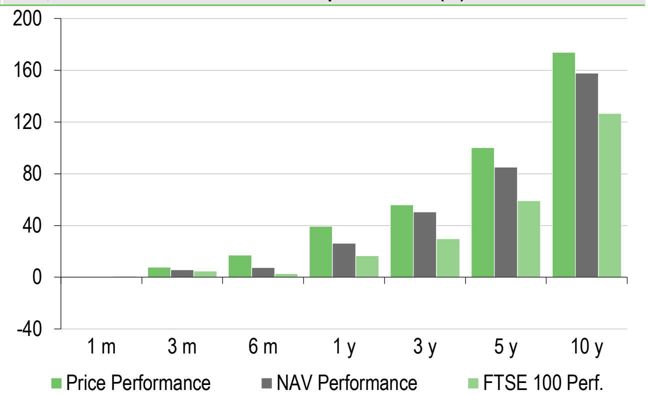
Performance: Outperformed benchmarks

Exhibit 4: Investment trust performance

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



Price, NAV and benchmark total return performance (%)



Source: The Merchants Trust, Thomson Datastream, Edison Investment Research

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Exhibit 5: Share price and NAV total return performance, difference vs benchmarks (% points), to 30 September 2013

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price vs to FTSE 100 Index	(0.8)	2.9	14.3	22.6	26.0	41.2	47.3
NAV vs to FTSE 100 Index	(1.0)	0.9	4.8	9.5	20.7	26.2	31.2
Price vs to FTSE 350 High Yield Index	(0.0)	4.0	13.7	22.6	17.4	46.9	56.6
NAV vs to FTSE 350 High Yield Index	(0.2)	2.1	4.2	9.4	12.1	31.9	40.6
Price vs to FTSE All-Share Index	(1.0)	2.2	13.3	20.4	22.5	34.1	33.6
NAV vs to FTSE All-Share Index	(1.2)	0.2	3.8	7.3	17.2	19.0	17.6

Source: The Merchants Trust, Thomson Datastream, Edison Investment Research

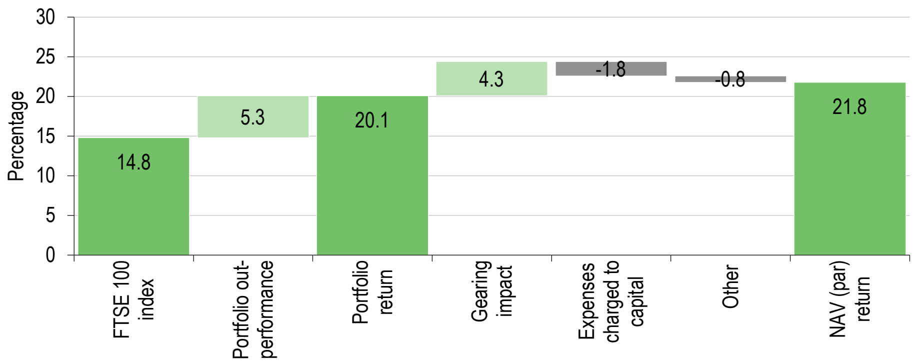
Exhibit 6: MRCH NAV total return vs blended benchmark total return, over five years, rebased to 100

Source: The Merchants Trust, Thomson Datastream, Bloomberg, Edison Investment Research

With the exception of the one-month period, MRCH has outperformed its benchmark index, the FTSE 100, as well as the FTSE 350 High Yield and broader FTSE All-Share indices (all on a total return basis), over all the periods shown in Exhibit 6, to 30 September 2013. MRCH's investment policy is to remain substantially fully invested and geared, which has affected performance during falling markets. This is partly evident in the more subdued outperformance seen in the 10-year period shown above, and more obviously in the underperformance recorded in CY08, when the financial crisis had an impact (-8.8% for NAV versus FTSE 100). Conversely, the policy has assisted during rising markets, as seen in the rally following the financial crisis.

Exhibit 7 illustrates an attribution analysis for the year ended 31 January 2013. During this period, MRCH's portfolio contributed outperformance of 5.3%, while gearing added 4.3% to the overall NAV return of 21.8%. Detailed attribution analysis is not provided at the interim stage. However, during the first half of 2013, the manager reduced the exposure to many defensive stocks that he considered to be fully valued and increased exposure to more economically sensitive stocks, which have benefited as the economic outlook has improved and markets have risen. More recently the manager has taken profits in these more economically sensitive areas, such as consumer discretionary, many of which have suffered more heavily as markets have corrected. During the six months to 31 July 2013, the manager advises that outperformance was driven by holdings in Aerospace and defence (now largely sold out), consumer sectors (also reduced), overweights in financials (although this was partially offset by underweights in the financials such as the banks, which the trust did not own), as well as being underweight mining.

Exhibit 7: Attribution analysis – total return to 31 January 2013



Source: The Merchants Trust

Quantitative easing has lowered borrowing costs and driven up the market value of corporate debt, MRCH's included. However, the most expensive debt, the £34.3m First Debenture Finance loan, expires in 2018. This will not only reduce the interest drag on the portfolio, but, being currently valued above par, its value will reduce as it moves closer to maturity. The total 'pull to par' is indicated in Exhibit 8 below, with a positive effect of c £3.8m pa on the fair value NAV equivalent to nearly one per cent of NAV with debt at market value.

Exhibit 8: Merchants Trust – debt repayment schedule, as at 30 September 2013

	Average coupon rate (%)	Maturity date	Repayment amount (£m)	Market value 31 January 2013 (£m)	Market value 30 September 2013 (£m)	Market value less par repayment amount (£m)	Time to expiry (years)	Average yearly decrease (£m)	% NAV (debt at market value)
First Debenture Finance loan	11.125	2018	34.3	46.8	44.9	10.6	4.5	2.4	0.5
Fixed int. rate loan Fintrust	9.25	2023	45.8	62.6	57.1	11.3	10	1.1	0.3
Secured bonds	5.875	2029	29.4	34.5	33.6	4.2	16	0.3	0.1
4% Perpetual debenture stock	4.0	N/A	1.4	1.0	0.9				
3.65% Cumulative preference shares	3.65	N/A	1.2	0.7	0.8				
Total			**112.1**	**145.6**	**137.3**	**26.1**	**N/A**	**3.8**	**0.9**

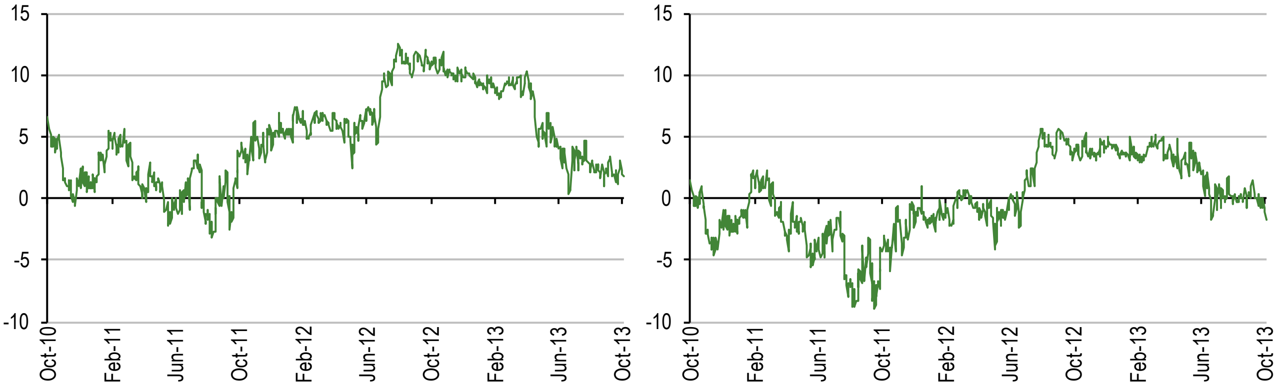
Source: The Merchants Trust

Discount: Narrowed during the last 12 months

MRCH has the authority, renewed annually, to allot up to 10% or make market purchases of up to 14.99% of issued share capital. This gives the manager a mechanism to influence the discount, although there is no explicit maximum or target level. Exhibit 9 illustrates the discount – the first graph is produced using NAVs calculated valuing debt at par and the second values debt at market. Under both measures, it can be seen that during the last 12 months MRCH's discount has broadly contracted, and with debt valued at market, MRCH has recently been trading at around NAV. This reverses an earlier expansion of the discount, which took place over the previous 12 months, including a sharp move in July 2012. During this period of discount expansion, the board chose not to utilise MRCH's repurchase authority as this would serve to increase the level of gearing in the trust, given MRCH's structural debt. However, it is also worth noting that between May 2010 and July 2012, when MRCH predominantly traded at a premium with debt valued at market, the board also chose not to utilise MRCH's allotment authority to issue new equity, partly reflecting concerns that new issuance could dilute MRCH's revenue reserve. The current cum-income premium, with debt at fair value of 1.1%, compares to its three- and five-year discount averages of 0.0% and 1.1% (one-year range is between a premium of 1.8% and a discount of 5.3%). Similarly, the current ex-income discount, with debt at par value of 2.0%, compares to its three- and five-year discount averages of 5.1% and 5.5% (one-year range 0.4% to 11.8%).

Exhibit 9: Discount/premium over three years

Discount/premium calculated with NAVs valuing debt at par, exc. income*	Discount/premium with NAVs valuing debt at market, inc. income*



Source: Morningstar, Edison Investment Research, Note: *Positive values indicate a discount; negative values indicate a premium.

Capital structure and fees: Conventional, fixed gearing

MRCH is a conventional trust, having only one class of share in issue – 25p ords. It uses a range of other debt instruments to gear up the trust: 3.65% cumulative preference stock, 4% perpetual debenture stock, 5.875% secured bonds expiring 2029, Fintrust Debenture 9.25125% loans expiring 2023 and a stepped-interest rate loan expiring January 2018. The stepped interest rate loan has an effective interest rate of 11.28%. The first portion of the two fixed-interest rate loans is for a principal amount of £30m with an effective interest rate of 9.51%. The second portion is for a principal amount of £12m with an effective interest rate of 6.00%. These structural debt elements are now relatively expensive when compared to current rates of interest. All have fair values above their par values as illustrated in Exhibit 8. Although profitable over the longer term, the interest cost is a drag on performance. MRCH's borrowings are not allowed to exceed its called-up share capital and reserves, which allows it considerable flexibility in choosing its gearing policy, and it currently has net gearing of 18%.

The management fee is 0.35% per year of the value of the assets, calculated quarterly after the deduction of any current liabilities, any loans under one year and any funds within the portfolio managed by AGI. There is no performance fee and the management contract can be terminated at one year's notice. MRCH's ongoing charges were 0.66% for the year ended 31 January 2013 (2012: 0.63%), which reflects the economies of scale offered by a trust of this size. As illustrated in Exhibit 12, MRCH's ongoing charges are competitive at 0.7% vs the sector average of 0.8%. MRCH has an indefinite life and there is no specific mechanism to wind up the company.

Dividend policy and record: Moving to full cover

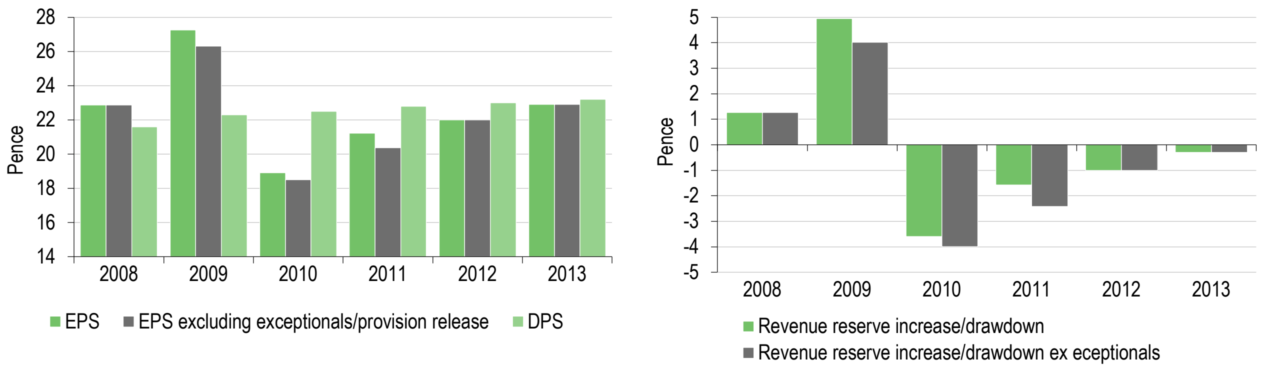
Dividends are paid quarterly and a key objective is to maintain a high and growing total dividend. For the year ending 31 January 2013, MRCH has proposed a final payment of 5.8p, giving an increased total dividend of 23.2p (23.0p, 2012), delivering 31 years of uninterrupted dividend growth since 1982. During this time, MRCH increased its dividend by a total of 1,020%, a compound annual growth rate of 8.1%. Because of its significant dividend obligations, the board carefully models dividend flows and reviews the income outlook six times a year.

As Exhibit 10 illustrates, MRCH has, for the last four years, dipped into revenue reserves to support the dividend payment. These shortfalls, which reflect both the dividend cuts by the banks post-2009 and the BP dividend cut following the Gulf of Mexico oil spill, have become progressively smaller as dividend income has recovered. With companies earning good margins, the market saw strong dividend growth during 2011/12. For the year ended 31 January 2013, the revenue reserve drawdown was only 0.3p. The manager and board are confident that MRCH is now moving back towards a position where the dividend will once again become covered. At 31 July 2013, MRCH had revenue reserves of 25.32p per share, or 19.42p after allowing for the second quarterly dividend of 5.9p (2012: 23.88p or 18.08p after payment of the second quarterly dividend of 5.8p).

Exhibit 11 provides an illustration of the components that made up MRCH's yield as at 14 June 2013. The excess yield of the trust's portfolio over the market of c 0.5% makes the largest single contribution to the overall one percentage point yield premium the trust offers. Derivative income, the effect of gearing and the price discount to the NAV are the other main factors contributing to this premium over the market yield.

Exhibit 10: Analysis of revenue reserve

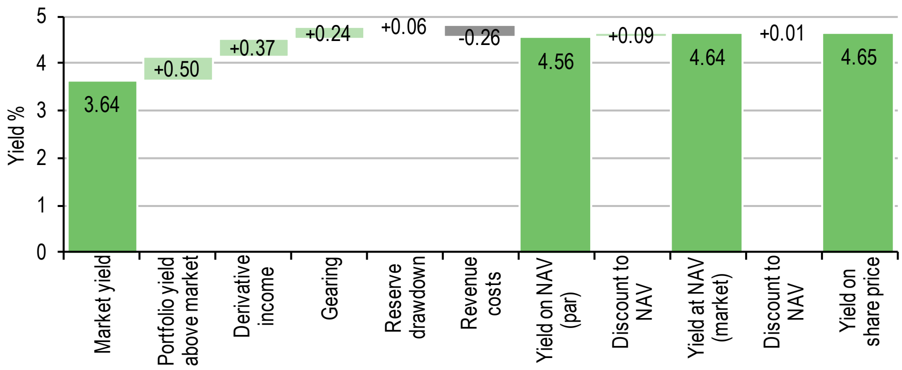
Comparison of EPS, DPS and EPS excluding exceptional | **Revenue reserve increase/drawdown including and excluding exceptionals**



Source: The Merchants Trust

The manager is positive on the outlook for dividend growth. He expects that corporate cash flows will continue to improve into 2014, with corporate debt continuing to edge downwards. Payout ratios are broadly in line with 40-year averages, which should provide scope for free cash to pass through to dividends. The manager has previously highlighted four key factors that could affect MRCH's dividend-paying capacity (namely a prolonged recession, a substantial financial markets fall, a weakening US dollar and the oil price falling significantly and staying depressed). The manager considers that while the US dollar has weakened against sterling recently, this effectively offsets earlier strengthening during the year and the scale of the movements is yet to cause any concern. With regard to the remaining factors, all have been positive year to date. Given MRCH's revenue reserves and the manager's view on the prospects for dividend growth from the underlying portfolio, we believe MRCH is on track to provide 32 years of uninterrupted dividend growth.

Exhibit 11: Dividend yield analysis as at 14 June 2013



Source: The Merchants Trust

Peer group comparison

Exhibit 12 provides a peer group comparison for the UK growth and income sector. There are 22 constituents with varied approaches evidenced in part by the different gearing levels and yields shown. The priority given to dividend payments at MRCH is evident in the dividend yield ranking, where it is fourth-highest. The geared structure that contributes to income generation also means the trust has the fourth-highest net gearing within the group.

In terms of share price total return, MRCH ranks fifth over one year, eighth over three years and sixth over five years. In terms of risk-adjusted returns, MRCH has the ninth highest one-year Sharpe ratio for price and twelfth highest Sharpe ratio for NAV in its peer group.

Exhibit 12: UK growth and income sector, as at 16 October 2013

Company	Share price total return on £100			Ongoing charges (%)	(Disc)/ prem.	Net gearing (100=no gearing)	Five-year dividend growth (%)	Div. yield	Sharpe ratio NAV one year	Sharpe ratio price one year
	One year	Three years	Five years							
Sector Average	**126.0**	**158.2**	**254.3**	**0.8**	**0.3**	**109.5**	**2.7**	**3.6**	**2.0**	**2.1**
Merchants Trust	**139.2**	**156.8**	**254.6**	**0.7**	**1.2**	**118.0**	**1.1**	**4.7**	**1.7**	**2.3**
BlackRock Income and Growth	118.1	125.3	197.4	1.2	(2.0)	105.0	1.3	3.5	0.9	1.1
British & American	132.8	154.6	200.7	3.4	15.3	154.0	2.9	8.8	0.1	1.6
City of London	121.5	149.6	240.1	0.4	2.4	107.0	3.3	4.0	1.6	1.7
Diverse Income Trust	135.0			1.8	1.3	99.0	0.0	2.8	5.5	3.7
Dunedin Income Growth	123.7	151.4	251.3	0.6	1.1	106.0	1.4	4.0	1.2	1.4
Edinburgh Investment	114.1	149.8	246.3	0.7	(1.0)	118.0	2.3	4.1	1.4	1.5
F&C Capital & Income	118.0	135.3	200.2	0.8	0.0	103.0	2.4	3.6	1.7	1.7
Finsbury Growth & Income	128.2	174.3	325.7	0.9	0.3	103.0	2.0	2.2	2.3	2.4
Invesco Income Growth	120.4	161.1	232.7	1.0	(4.9)	109.0	2.1	3.7	2.1	2.3
Investment Company	163.3	179.5	270.1	4.9	4.9	102.0	32.1	5.4	0.6	1.0
JPMorgan Claverhouse	136.0	143.9	228.3	0.8	(4.8)	118.0	2.8	3.3	1.9	2.4
JPMorgan Elect Managed Inc	123.0	138.8	198.4	0.7	(1.3)	99.0	(3.8)	3.7	1.8	1.7
Lowland	141.9	209.8	342.0	0.7	3.9	114.0	5.1	2.5	2.4	3.0
Murray Income Trust	119.9	150.0	227.7	0.8	1.1	107.0	2.1	4.0	1.7	1.6
Perpetual Income & Growth	128.4	167.0	249.7	0.9	(1.1)	111.0	6.8	3.4	2.3	2.3
Schroder Income Growth	130.2	151.0	221.7	1.1	0.9	103.0	2.0	3.8	1.9	1.8
Shires Income	116.4	152.4	245.5	1.1	(1.6)	120.0	(9.5)	5.1	1.5	1.4
Standard Life Equity Income	140.4	154.3	239.3	1.0	0.9	112.0	2.1	3.2	2.5	3.9
Temple Bar	127.5	168.7	293.8	0.5	2.0	100.0	2.5	3.1	2.2	2.5
Troy Income & Growth	110.5	139.9	185.2	1.2	0.3	97.0	(6.7)	3.5	1.0	1.0
Value & Income	143.4	173.7	255.0	1.4	(13.1)	122.0	2.1	3.3	2.5	3.0

Source: Morningstar

The board

All directors are non-executive and independent of the manager. They are SJ Fraser (chairman), HE Staunton (senior independent director), MJE McKeon and PT Yates (directors). The average length of director service is 4.4 years.

EDISON

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
245 Park Avenue, 39th Floor
10167, New York
US

Sydney +61 (0)2 9258 1162
Level 33, Australia Square
264 George St, Sydney
NSW 2000, Australia

Wellington +64 (0)4 8948 555
Level 15, 171 Featherston St
Wellington 6011
New Zealand