EDISON

The Merchants Trust

High-yielding, focused UK portfolio

Investment trusts

The Merchants Trust (MRCH) is a concentrated portfolio (c 45 stocks) of mainly blue-chip equities, chosen for their potential to provide a high and growing income as well as long-term capital appreciation. The trust has raised its ordinary dividend in each of the last 32 years. With a high yield of c 5%, the trust trades on a slight premium and has been issuing shares to meet demand.

12 months ending	Share price (%)	NAV (%)	FTSE 100 (%)	FTSE 350 High Yield (%)	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

Source: Thomson Datastream. Note: Total return basis.

Investment strategy: Focus on cash flow

Manager Simon Gergel draws on the well-resourced research capabilities of Allianz Global Investors to construct a long-term, high-conviction portfolio of stocks chosen for their growth, value and yield characteristics. There is a focus on underlying cash flow as a measure of true performance and dividend-paying potential. While it is a stock picking portfolio, holdings are assigned to specific themes, with the greatest focus currently on mega caps and recovery situations. Although positions are actively managed, turnover is relatively low, with an average holding period of between three and four years.

Market outlook: Uncertain short-term picture

UK shares have struggled to advance so far in 2014, with the blue-chip FTSE 100 up just 3.5% year-to-date. The market has recovered from a recent sell-off, but P/E valuations look on the high side relative to history (forward P/E for the Datastream UK index was 20% above its 10-year average at 28 November). With geopolitical worries continuing and economic woes in Japan and Europe capable of producing negative surprises versus consensus expectations, equities may struggle to make progress in the short term, but dividend yields remain attractive at around 3.5% on average, compared with the record low base rate of 0.5% and inflation at 1.3%.

Valuation: Issuance keeps lid on premium to NAV

As one of the highest-yielding trusts in its UK Equity Income peer group (4.9% at 1 December), demand has been strong for MRCH's shares, which have traded on an average 1.2% premium to cum-income net asset value over the past 12 months. The slight discount of 0.3% at 1 December was towards the wider end of its one-year range (0.7% discount to 2.7%% premium). Having had to dip into the revenue reserve to maintain dividends between 2009 and 2012, the board had been reluctant to issue shares, to avoid diluting the remaining reserve. However, with dividends now covered by income and the reserve being rebuilt, 5.0m shares have been issued since October 2013, raising £24.1m. This has kept the premium largely within a 1-2% range over the past year.

4 December 2014

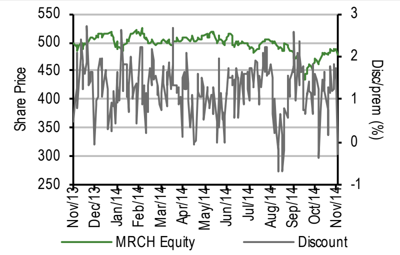
Price	**477.3p**
Market cap	**£516.9m**
AUM	**£638.9m**

NAV*	461.5p
Premium to NAV	3.4%
NAV**	478.7p
Discount to NAV	0.3%
Yield	4.9%

*Excluding income. **Including income. Data at 1 December 2014.

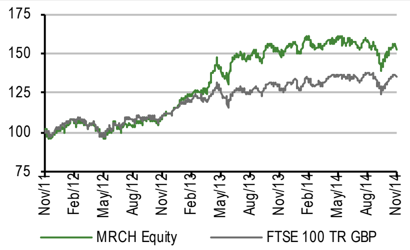
Ordinary shares in issue	108.3m
Code	MRCH
Primary exchange	LSE
AIC sector	UK Equity Income

Share price/discount* performance



*NAV with debt at fair value, including income.

Three-year cumulative perf. graph



52-week high/low	524.0p	435.3p
NAV* high/low	505.6p	424.9p

*Excluding income.

Gearing

Gross	21.4%
Net	20.2%

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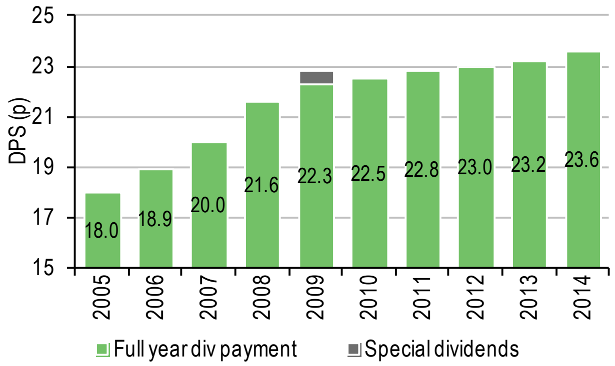
Edison profile page

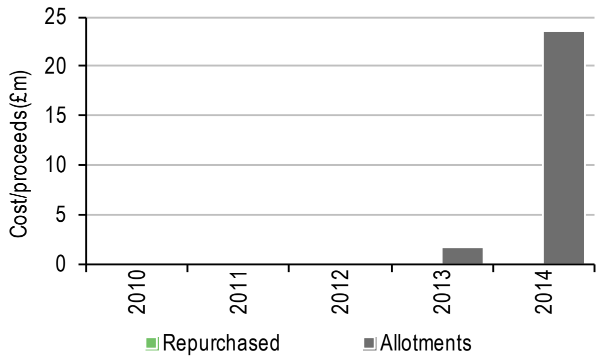
Exhibit 1: Trust at a glance

Investment objective and fund background	Recent developments
The Merchants Trust's (MRCH) 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.	■ 17 October 2014: Senior independent director Henry Staunton announces retirement from board. Two new board members appointed – Mary Ann Sieghart and Sybella Stanley. ■ 24 September 2014: Results for the half year ended 31 July. NAV TR +3.7% (debt at market); FTSE 100 TR +5.4%.

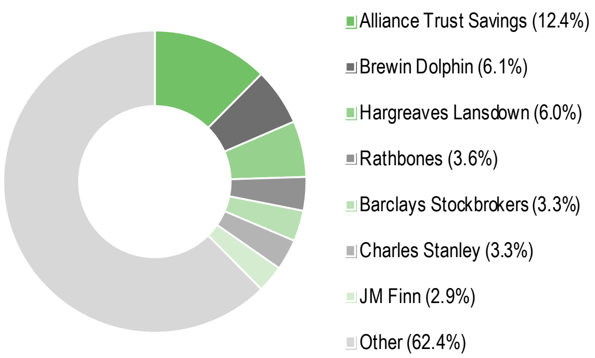
Forthcoming		Capital structure		Fund details	
AGM	May 2015	Ongoing charges	0.66%	Group	Allianz Global Investors
Preliminary results	April 2015	Net gearing	20.2%	Manager	Simon Gergel
Year end	31 January	Annual mgmt fee	0.35% of assets	Address	199 Bishopsgate, London EC2M 3TY, UK
Dividend paid	Quarterly	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	Share buyback policy and history
Quarterly dividends paid in February, May, August and November. MRCH aims to maintain a high and growing dividend.	Renewed annually, the trust has authority to purchase up to 14.99% and allot up to 5% of issued share capital.

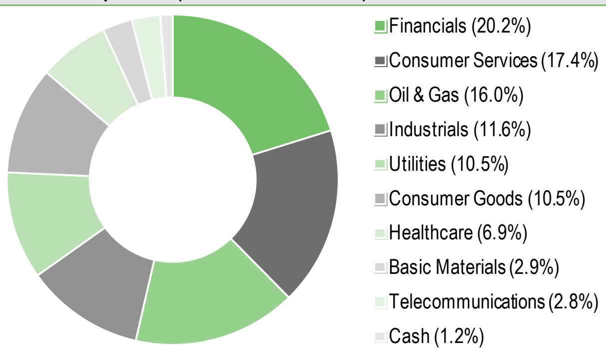




Shareholder base (as at 7 November 2014)



Portfolio composition (as at 31 October 2014)



Top 10 holdings (as at 31 October 2014)

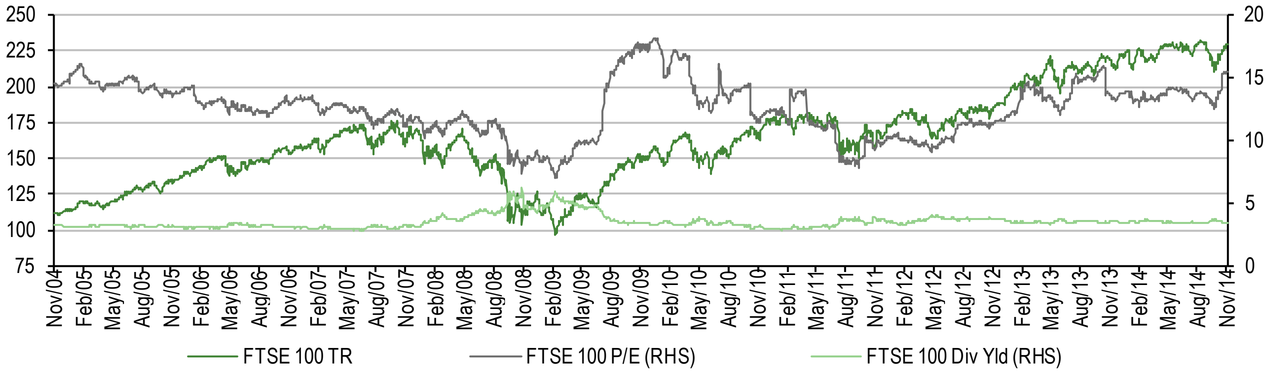
		Active weight %	Portfolio weight %	
Company	Sector	31 October 2014	31 October 2014	30 April 2014
Royal Dutch Shell 'B'	Oil & gas	4.9*	8.5	9.3
GlaxoSmithKline	Health care	2.7	6.8	7.6
HSBC	Banks	-0.3	6.8	6.2
BP	Oil & gas	0.0	5.0	6.4
British American Tobacco	Tobacco	0.6	4.5	4.3
BAE Systems	Aerospace & defence	2.9	3.8	3.6
Scottish & Southern Energy	Power utilities	2.6	3.5	3.2
BHP Billiton	Mining	0.7	2.9	3.3
Inmarsat	Telecoms	2.8	2.8	2.9
UBM	Media	2.7	2.7	3.1
Top 10 (% of portfolio)			**47.3**	**49.9**

Source: The Merchants Trust, Edison Investment Research, Morningstar, Bloomberg. Note: *Overweight relates to B shares only. Royal Dutch Shell A + B shares = 9.1% of FTSE 100 Index.

UK equity outlook: Time to focus on dividends?

UK stock market performance has been lacklustre in 2014, with the FTSE All Share Index up just 1.8% between 1 January and 1 December, and the blue-chip FTSE 100 Index faring slightly better with a rise of 2.1%, reflecting relatively weaker performance for small- and mid-cap stocks following a strong run in 2013. A sharp sell-off in mid-October had largely reversed by the end of the month. But the recent upward trend in the market has left valuations looking full – as shown in Exhibit 2, the FTSE 100 trailing P/E, while below its peak of early 2010, was c 23% higher than its 10-year average at the end of November, and the forward P/E for the Datastream UK Index was 20% above its 10-year average at the same date. However, the dividend yield has remained remarkably steady at around 3.5% for the past five years. This should provide a measure of support in an environment where real returns on cash are still negative. Geopolitical and economic worries – Russia and Ukraine, the Middle East, recessions in Japan and the eurozone and the end of QE measures in the US – could all feed through into increased risk aversion and market volatility in the near term. In such market conditions, an investment strategy that focuses on high and sustainable dividends as well as capital appreciation could provide a less bumpy ride than going all-out for growth.

Exhibit 2: FTSE 100 Index total return (%), P/E (x) and dividend yield (%) over 10 years



Source: Thomson Datastream. Note: Index rebased to 100. Data to 26 November 2014.

Fund profile: Blue-chip portfolio with 125-year history

Founded in 1889, The Merchants Trust is the oldest and largest of the three investment trusts managed by Allianz Global Investors. It aims to achieve a high and growing income and long-term capital growth from a portfolio of mainly blue-chip UK equities. MRCH has one of the highest yields in its peer group (4.9% at 1 December) and has grown its ordinary dividend in each of the last 32 years. It has been managed by Simon Gergel, Allianz's chief investment officer for UK equities, since April 2006.

The fund manager: Simon Gergel

The manager's view: Hard to call market in the short term

Manager Simon Gergel says one of the defining features of markets at the moment is low inflation. While high inflation is generally seen as bad for equities, the optimum level is 2-4% and the current UK inflation rate of 1.3% means many firms face problems with pricing power. While continued low interest rates are positive news for those with mortgages, a lack of wage growth means many consumers are keeping a close eye on discretionary spending. One way in which this manifests is the rising market share of discount supermarkets, which is weighing on major players such as

Tesco and Asda. Gergel sold Tesco earlier in the year (well before the recent corporate governance problems) and added to Sainsbury's, which he says is better placed on two counts: first, it has comparatively high market share in London and the South East, where the discounters have less traction; and second, it has begun a joint venture with Danish discounter Netto, meaning it can go head-to-head with Lidl and Aldi without diluting its own more 'upmarket' brand.

The divergence in monetary policy is another interesting phenomenon, says Gergel. While the US has ended its QE programme, and debate in both the US and UK is focused on when interest rates will rise from record lows, Japan and the eurozone have slipped back towards recession and are using more extraordinary monetary policy measures as a result. One effect of this is a rapid strengthening in the US dollar, which has helped the MRCH portfolio recently given the large number of FTSE 100 companies that report earnings and/or pay dividends in dollars. This reverses a situation earlier in the year where income was adversely affected by the strength of sterling.

The UK stock market has underperformed the world this year largely because of strong gains in the US, the largest component of world indices. While the UK is only inching ahead, it is hard to find real value at the stock level, as higher-quality growth stocks tend to be expensive. However, Gergel says equities still offer better potential returns than either bonds or cash, although it is hard to call the short-term direction of the market. "Understanding companies' true competitive advantage and pricing power is more important than ever," he says.

Asset allocation

Investment process: Research-intensive total return focus

MRCH has three principal objectives: a high dividend yield, growing income and long-term capital appreciation. To achieve these, manager Simon Gergel employs a bottom-up, research-driven approach to building a fairly concentrated portfolio, with a focus on underlying cash flow and a strong emphasis on valuation. While dividends are an important factor for stocks in the portfolio, with the manager targeting stocks that will yield at least in line with the market within 18 months, yield alone is never a sufficient reason for either buying or selling a share. All sales and purchases are driven by total return considerations, and stocks may be sold either when they have reached target valuations or if there has been a fundamental change to the investment case.

Gergel can draw on Allianz Global Investors' extensive team of investment analysts (83 in total, globally organised by sector), as well as the firm's Grassroots^{SM} network, which uses freelance journalists and field investigators to gather industry intelligence.

Selective use is also made of option-writing to enhance income. Gergel says that at present less than 5% of the portfolio has options written over it, versus an average level of 5-10%, because option premiums (and hence the extra income that could be received) are currently low owing to low volatility.

Current portfolio positioning

At 31 October MRCH had 47 holdings. This is more focused than the 66-stock weighted average for the AIC's UK Equity Income sector. With 47.3% of assets in the top 10 stocks, MRCH is also more concentrated than the sector average of 39.8%. The trust uses the FTSE 100 Index as a benchmark but has a high active share versus the index, and at 31 October, 24 of the 47 holdings (representing around one-third of assets) were outside the FTSE 100.

While stocks are chosen primarily on a bottom-up basis, there are a number of longer-term themes in the portfolio, including mega caps, recovery situations, growth stocks on reasonable valuations, exposure to emerging market consumers, inflation protection and non-bank financials. Of these themes, mega caps and recovery stocks are currently to the fore. The trust's five biggest holdings – Shell, GlaxoSmithKline, HSBC, BP and British American Tobacco – make up 29% of the FTSE 100's market cap and 34% of its dividend,[1] providing core mega-cap exposure. The recovery theme is split into two sub-themes: cyclical recovery, where the manager favours construction, recruitment, travel and leisure and industrial property; and turnaround situations, which are company-specific.

Exhibit 3: Top 10 active stock positions at 31 October

Company	Portfolio weight (%)	FTSE 100 index weight (%)	Active weight (% points)
BAE Systems	3.8	0.9	2.9
Inmarsat	2.9	0.0	2.9
UBM	2.8	0.0	2.8
GlaxoSmithKline	6.8	4.2	2.7
AMEC Foster Wheeler	2.3	0.0	2.3
SSE	3.2	0.9	2.3
Friends Life	2.5	0.3	2.2
Carnival	2.3	0.3	2.0
Centrica	2.7	0.9	1.8
Pennon Group	1.8	0.0	1.8

Source: The Merchants Trust, Edison Investment Research

At a sector level MRCH is most overweight consumer services stocks, particularly travel and leisure (+5.7 percentage points versus the benchmark). Exposure here includes bookmakers William Hill and Ladbrokes, the former a market leader and the latter bought as a turnaround stock for its potential to close the gap with Hill's superior online offering. Carnival Cruises is a cyclical recovery stock, benefiting directly from the lower oil price as well as indirectly from lower food and fuel prices feeding in to higher disposable incomes for holidaymakers. Fewer capacity increases also means Carnival has greater pricing power. Utilities and industrials are the other major overweights, with the latter focused on cyclical recovery areas such as construction and recruitment.

Exhibit 4: Sector allocations (at 31 October 2014 except where stated)

	Trust weight % 31 Oct 2014	Trust weight % 30 Apr 2014	Benchmark weight %	Trust active weight	Trust weight/ benchmark weight
Consumer Services	17.4	17.6	9.2	8.2	1.9
Utilities	10.5	11.0	4.6	5.9	2.3
Industrials	11.6	12.1	7.1	4.5	1.6
Oil & Gas	16.0	15.8	16.3	-0.3	1.0
Technology	0.0	0.0	1.0	-1.0	0.0
Telecommunications	2.8	3.0	5.1	-2.3	0.5
Financials	20.2	19.1	22.7	-2.5	0.9
Healthcare	6.9	7.6	9.7	-2.8	0.7
Consumer Goods	10.5	9.0	16.0	-5.5	0.7
Basic Materials	2.9	3.4	8.4	-5.5	0.3
Cash	1.2	1.4	0.0	1.2	n/a
Total	**100**	**100**	**100**	**0.0**	

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

Underweights include healthcare (the overweight in GlaxoSmithKline is offset by a lack of exposure to AstraZeneca or Shire), consumer goods (although new positions have been taken during 2014 in Tate & Lyle and Diageo) and basic materials, where the only stock held is BHP Billiton.

Alongside the new position in Diageo – a former holding bought back after its valuation slipped to an attractive re-entry point – Gergel has also bought Kier Group, a construction and services company with a diversified business model that gives it exposure to both the private and local authority sectors. Recent sales include BBA Aviation, which reached its price target after a strong run of performance, and bank note printer De La Rue, which was bought as a turnaround stock earlier this year but failed to win key contracts and thus looks unattractive on a medium-term view.

Structural gearing remains at c 20%. Gergel says he takes a long-term view and essentially runs a fully invested portfolio, as holding higher cash weightings or buying protection in weaker markets would reduce portfolio income.

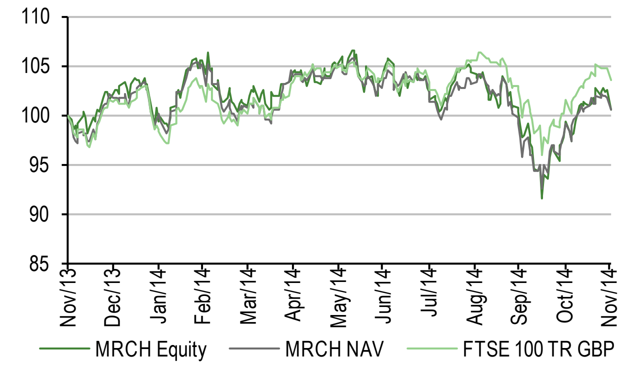
[1] Source for dividend figure: Capita UK Dividend Monitor, Q214.

Performance: Short-term blip in solid record

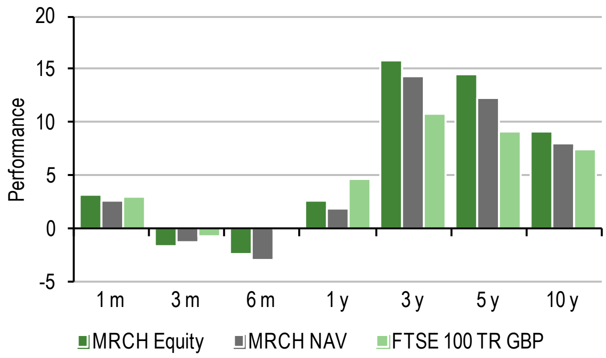
MRCH has a strong longer-term share price and NAV total return performance record, both in absolute terms and relative to the FTSE 100 benchmark (Exhibit 5, right-hand chart), with annualised returns of 10-15% over three and five years. The UK equity market has struggled somewhat in 2014, with the FTSE 100 producing a total return of 2.1% between 1 January and 1 December, compared with 11.7% for the FTSE All World Index. The trust has underperformed the benchmark over most periods of less than a year, and particularly over six months. This is partly owing to a lack of stand-out performers at the individual stock level (Man Group has performed best, up 61% over 12 months to 1 December, but is also the trust's smallest holding at 0.6% of the portfolio), but also because of some specific positioning, such as being underweight pharmaceuticals generally and owning GlaxoSmithKline (-7.9% from 1 January to 30 November) but not AstraZeneca (+33.7%) or Shire (+59.8%), both of which benefited from takeover speculation. In a concentrated portfolio with a high active share (see Current positioning section), some periods of underperformance are inevitable, but Gergel is happy with the trust's overall positioning, with outperformance possible particularly from some of the 'recovery' stocks held.

Exhibit 5: Investment trust performance

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



Price, NAV and benchmark total return performance (%)*



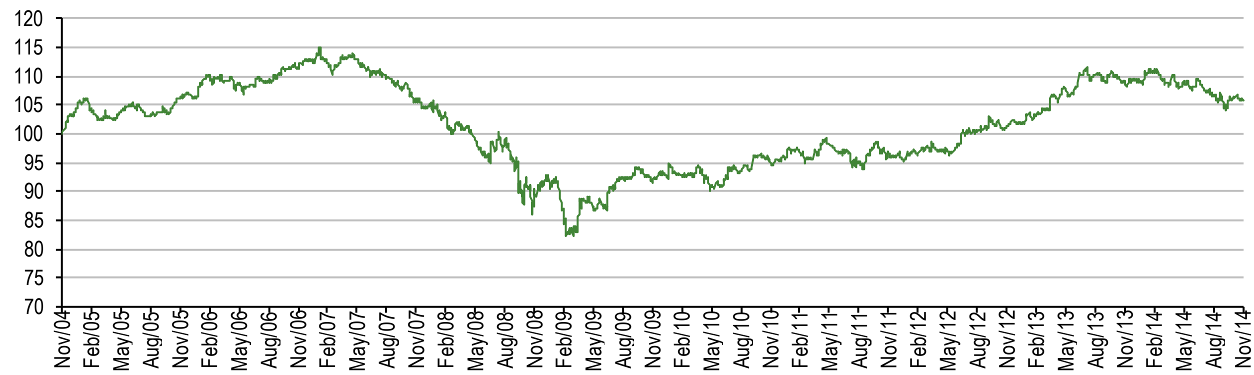
Source: Thomson Datastream. Note: *Three, five and 10 years annualised.

Exhibit 6: Share price and NAV total return performance relative to benchmarks, to 30 November 2014 (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to FTSE 100 index	0.1	(0.9)	(2.2)	(2.0)	14.4	27.7	16.9
NAV relative to FTSE 100 index	(0.4)	(0.6)	(2.9)	(2.7)	9.6	15.7	6.0
Price relative to FTSE 350 High Yield	0.8	0.3	(1.3)	(2.2)	13.3	25.8	25.5
NAV relative to FTSE 350 High Yield	0.4	0.6	(2.0)	(2.9)	8.6	14.0	13.8
Price relative to FTSE All Share	0.3	(1.0)	(2.2)	(2.0)	10.7	22.7	10.7
NAV relative to FTSE All Share	(0.2)	(0.7)	(2.9)	(2.7)	6.1	11.2	0.4

Source: Thomson Datastream. Note: Geometric calculation.

Exhibit 7: MRCH NAV total return vs benchmark total return, over 10 years, rebased to 100



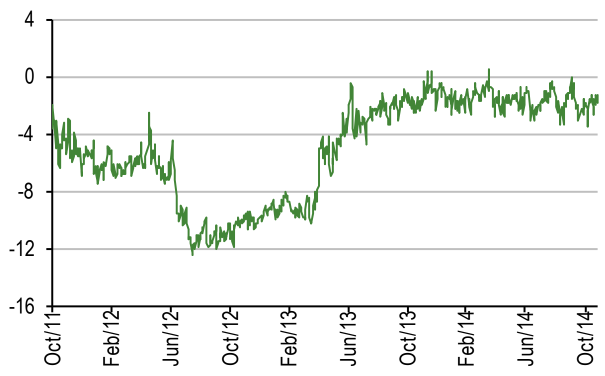
Source: The Merchants Trust, Thomson Datastream, Bloomberg, Edison Investment Research

Discount: Issuance keeps premium in narrow band

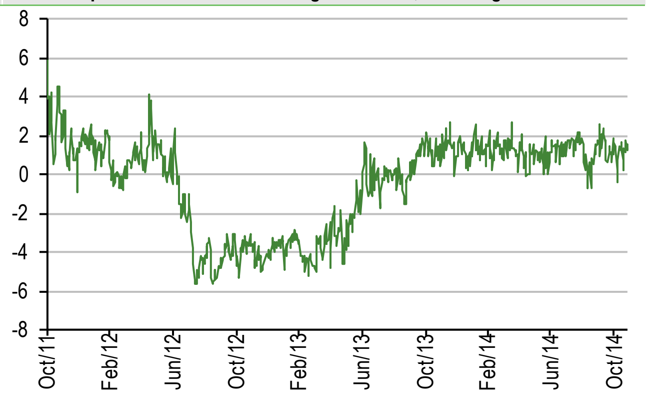
At 1 December MRCH's shares were trading at a 0.3% discount to NAV (cum-income and with debt at fair value). With debt at par value and excluding income, the shares were at a discount of 2.2%. In the past 12 months the shares have traded in a narrow band, from a 0.7% discount to a 2.7% premium on a cum-fair basis. The move to a tighter range (see Exhibit 8) has followed the board's decision to issue new shares to meet demand: since October 2013, 5.25m shares have been issued, raising £25.4m. The board had previously been reluctant to issue because of worries over diluting the revenue reserve, which was depleted from 2009-12 in order to maintain dividends. Interest rates look set to remain low for some time. As such, MRCH's high yield should support demand for the trust, and with the revenue reserve now rebuilt (see Dividend section below), it is likely that further shares may be issued to avoid the premium becoming too large.

Exhibit 8: Discount/premium over three years

Discount/premium with NAVs valuing debt at par, excluding income



Discount/premium with NAVs valuing debt at fair, including income



Source: Thomson Datastream, Edison Investment Research.

Capital structure and fees

MRCH is conventionally structured, with one class of equity share. At 1 December there were 108.3m ordinary shares in issue. The trust is structurally geared through a variety of long-dated and undated instruments, with £112m (par value) of debt outstanding at the 31 July half-year, equal to 20.6% of net assets. The first tranche of debt, a stepped interest rate loan of £34m (c 6% of net assets) with a current coupon of 14.75% and an effective interest rate of 11.125% (at 31 July) is repayable in 2018. As the maturity date approaches the market value will converge with the par value, providing an uplift to NAV. This 'pull to par' (see the last Edison note on MRCH for a fuller explanation) has boosted fair-value NAV by £8.8m or 1.6% in FY14, according to the trust.

Allianz Global Investors receives an annual management fee of 0.35% of MRCH's asset value, which is charged one-third to income and two-thirds to capital. Both the management fee and the ongoing charges (0.7% for FY14) are among the lowest in the UK Equity Income peer group.

Dividend policy and record

MRCH aims to provide an above-average and growing income. By focusing on higher-yielding companies it has been able to produce a dividend yield in excess of the FTSE 100 Index (5.0% vs 3.5% at 31 October) and has grown its ordinary dividend in each of the last 32 years. Dividends are paid quarterly, in February, May, August and November. For the year ended 31 January 2014 the total dividend was 23.2p, paid in four equal instalments of 5.9p. Dividends were fully covered by income and the revenue reserve was equivalent to one year's dividend (six months' after allowing

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for the last two quarterly payments). For FY15 the first two dividends have been maintained at 5.9p (again fully covered by income at the half-year, although earnings per share were down 3.7% on a year earlier).

Peer group comparison

There are 24 trusts in the AIC's UK Equity Income sector; Exhibit 9 below shows the seven with market cap exceeding £500m. MRCH is the only trust in the group with a FTSE 100 benchmark. NAV total returns are somewhat below the weighted average over one, three and five years. Gearing is the highest in the group shown below, and the fifth-highest for the whole sector. MRCH's dividend yield is comfortably higher than those of its large peers (third overall), which is also a factor in its trading at a premium to NAV (fourth-highest of the £500m+ trusts and ninth overall).

Exhibit 9: UK Equity Income investment trusts

% unless stated	Market cap £m	TR one year	TR three years	TR five years	Ongoing charge	Perf. fee	Discount (-) /premium	Net gearing	Yield	Sharpe NAV 1 year	Sharpe NAV 3 years
Merchants Trust	**521.9**	**0.8**	**48.4**	**72.4**	**0.7**	**No**	**0.6**	**120.0**	**4.9**	**-0.3**	**1.0**
City of London	1144.3	7.8	54.7	88.3	0.4	No	1.6	109.0	3.9	0.5	1.3
Edinburgh Investment	1277.0	14.3	59.9	111.5	0.7	No	-0.4	115.0	3.6	1.1	1.3
Finsbury Growth & Income	553.2	11.6	81.4	149.5	0.9	No	1.2	104.0	2.1	0.7	1.6
Murray Income Trust	535.4	3.7	43.3	73.3	0.7	No	0.0	108.0	4.0	0.1	1.0
Perpetual Income & Growth	937.9	12.0	76.1	122.5	0.9	Yes	0.1	117.0	3.0	1.1	1.8
Temple Bar	809.6	1.3	56.9	80.5	0.5	No	1.3	98.0	3.2	-0.1	1.3
Sector weighted average		**7.1**	**59.8**	**96.1**	**0.8**		**-0.1**	**112.1**	**3.5**	**0.4**	**1.4**
MRCH rank out of 24	**7**	**22**	**18**	**17**	**20**		**9**	**6**	**3**	**24**	**21**

Source: Morningstar, 2 December 2014, Edison Investment Research. Note: Only shows trusts with more than £500m market cap. TR = NAV total return. The Sharpe ratio is a measure of risk-adjusted return. The ratios we show 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 shown as total assets less cash/cash equivalents as a percentage of shareholders' funds.

The board

MRCH has five non-executive directors. Chairman Simon Fraser joined the board in 2009. Mike McKeon (appointed 2008) will become the senior independent director following the retirement in December 2014 of Henry Staunton. Paul Yates became a director in 2011. Two new board members, Mary Ann Sieghart and Sybella Stanley, were appointed in November 2014. The directors have backgrounds in investment management, corporate finance and the media.

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