

# The Merchants Trust

UK equity 'best ideas' with 5% dividend yield

The Merchants Trust (MRCH) is a concentrated portfolio of mainly larger UK companies, with a focus on producing a high income along with capital and income growth. It uses the FTSE 100 index as a performance measure, although around one-third of portfolio holdings are outside the index. Stock selection is mainly bottom-up but manager Simon Gergel assigns holdings to broad themes, including mega-caps and cyclical recovery or turnaround situations. The trust has raised its ordinary dividend in each of the past 33 years. A move from a premium to a discount over the past six months could be viewed as a buying opportunity, particularly as MRCH has one of the highest yields in the UK Equity Income peer group, at c 5%.

12 months ending	Share price (%)	NAV (%)	FTSE 100 (%)	FTSE 350 High Yield (%)	FTSE All-Share (%)
30/06/12	(6.9)	(1.1)	(2.7)	3.4	(3.1)
30/06/13	32.3	27.4	15.8	16.0	17.9
30/06/14	15.7	12.5	12.3	12.6	13.1
30/06/15	(3.4)	0.8	0.2	(3.6)	2.6

Source: Thomson Datastream. Note: Total return basis.

## Investment strategy: Research-based with value focus

MRCH manager Simon Gergel uses a bottom-up, research-driven approach to stock selection, drawing on Allianz Global Investors' large, global team of analysts (organised by sector) as well as its Grassroots research network. Fundamental analysis is used to assess company strength and industry dynamics, and the manager has a strong focus on valuation, both absolute and relative. Stocks may be sold where they reach valuation targets or if better opportunities are identified. The end result is a portfolio of c 40-50 mainly larger UK companies. Option-writing may be used to enhance income, and the trust is structurally geared.

## Market outlook: Equities still have relative appeal

The FTSE 100 has had a difficult spell recently amid uncertainty over the UK general election, the ongoing Greek debt crisis, the setback in the Chinese market and persistent geopolitical worries in the Middle East. At the same time, average valuations are towards the higher end of historical ranges, suggesting investors should tread carefully to avoid pockets of overvaluation. Positively, for income investors, equities look appealing compared with bond markets, and those with a longer time horizon can look beyond what may prove a volatile summer.

## Valuation: Recent discount begins to narrow

At 9 July MRCH's shares traded at a discount to cum-income NAV (with debt at market (fair) value) of 1.0%. This represents a narrowing in early July from a year-to-date average discount of 3.0%. Until the turn of the year, MRCH's shares had traded more or less consistently at a premium on a cum-fair basis since the middle of 2013, and with a yield of c 5%, based on a virtually covered dividend, the discount may compress further.

### Investment trusts

13 July 2015

**Price** 469.0p  
**Market cap** £509.9m  
**AUM** £642.6m

NAV\* 484.2p  
Discount to NAV 3.1%  
NAV\*\* 473.6p  
Discount to NAV 1.0%  
Yield 5.1%

\*Excluding income, debt at par value. \*\*Including income, debt at market (fair) value. Data at 9 July 2015.

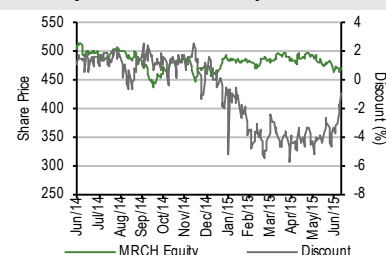
Ordinary shares in issue 108.7m

Code MRCH

Primary exchange LSE

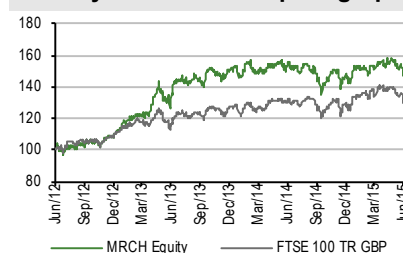
AIC sector UK Equity Income

### Share price/discount\* performance



\*NAV with debt at fair value, including income.

### Three-year cumulative perf. graph



52-week high/low 505.5p 435.3p

NAV\* high/low 519.1p 431.9p

\*Including income.

### Gearing

Gross 21.1%

Net 16.5%

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[Edison profile page](#)

**Exhibit 1: Trust at a glance**
**Investment objective and fund background**

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.

**Recent developments**

- 3 July 2015: First quarterly dividend of 6.0p declared for the year ending 31 January 2016; payable on 14 August.
- 14 April 2015: Final results for the year ended 31 January 2015. NAV TR (debt at par) +5.7% versus +7.4% for FTSE 100 index. Share price TR +3.3%.

**Forthcoming**

AGM	May 2016
Half year results	September 2015
Year end	31 January
Dividend paid	Quarterly
Launch date	February 1889
Continuation Vote	N/A

**Capital structure**

Ongoing charges	0.59%
Net gearing	16.5%
Annual mgmt fee	0.35% of assets
Performance fee	None
Trust life	Indefinite
Loan facilities	See page 7

**Fund details**

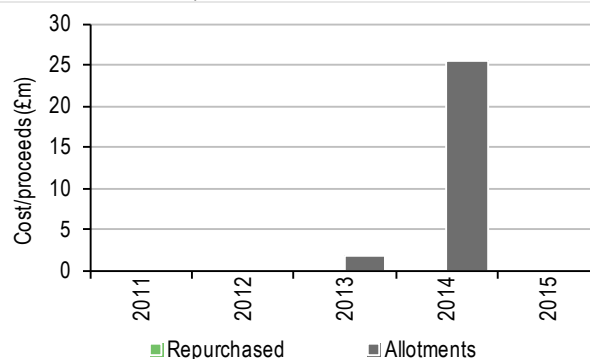
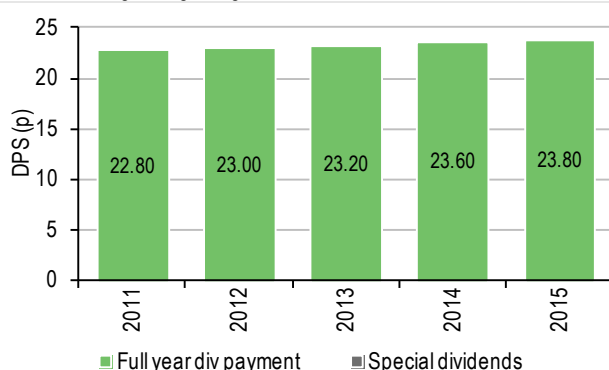
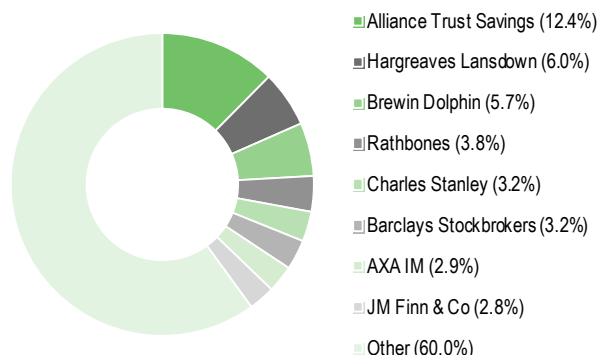
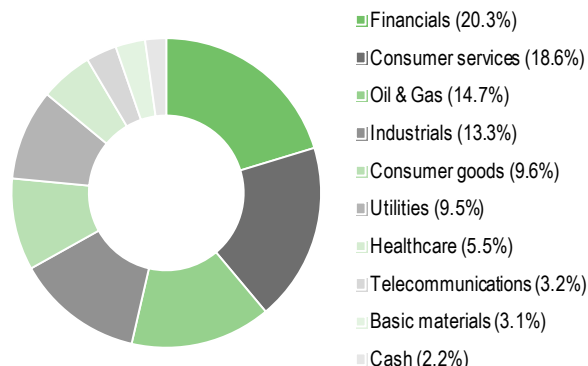
Group	Allianz Global Investors
Manager	Simon Gergel
Address	199 Bishopsgate, London EC2M 3TY, UK
Phone	+44 (0)800 389 4696
Website	<a href="http://www.merchantstrust.co.uk">www.merchantstrust.co.uk</a>

**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 June 2015)**

**Portfolio composition (as at 31 May 2015)**

**Top 10 holdings (as at 31 May 2015)**

Company	Sector	Active weight %	Portfolio weight %	
		31 May 2015	31 May 2015	30 November 2014
Royal Dutch Shell 'B'	Oil & gas	4.4*	7.1	8.0
HSBC	Banks	-0.6	6.1	6.6
GlaxoSmithKline	Healthcare	1.5	5.5	6.0
BP	Oil & gas	0.5	5.1	5.1
UBM	Media	4.5	4.5	N/A
British American Tobacco	Personal & household goods	0.4	4.2	4.7
Scottish & Southern Energy	Utilities	2.4	3.3	3.5
Inmarsat	Telecommunications	3.2	3.2	3.3
Standard Life	Insurance	2.4	2.9	N/A
Amec Foster Wheeler	Industrial goods & services	2.5	2.5	N/A
<b>Top 10 (% of portfolio)</b>			<b>44.4</b>	<b>46.5</b>

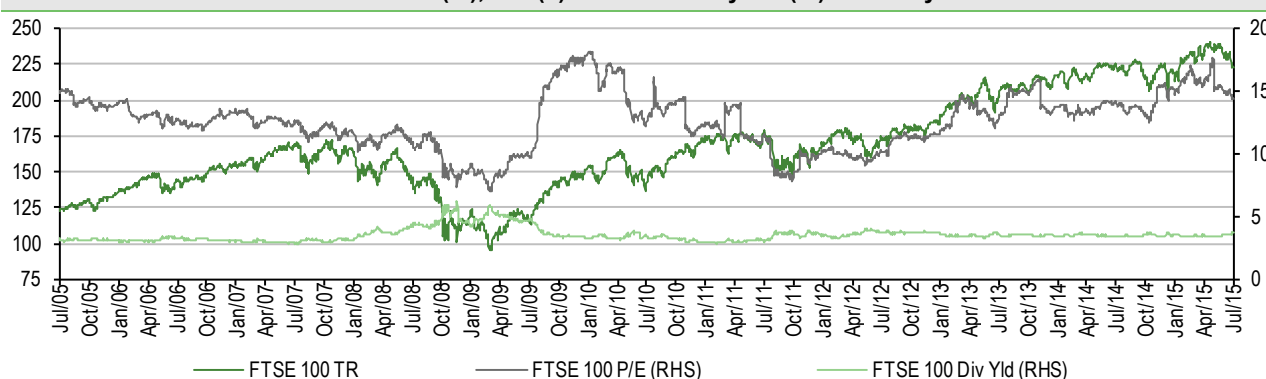
Source: The Merchants Trust, Edison Investment Research, Morningstar, Bloomberg. Note: \*Overweight relates to B shares only. Royal Dutch Shell A + B shares = 7.0% of FTSE 100 Index. N/A where not in top 10 at 30 November 2014.

## UK equity outlook: Less obvious value amid volatility

The summer of 2015 is looking like it may be a volatile one, with the ongoing Greek debt saga and the sharp fall in Chinese markets unsettling investors globally. The FTSE 100 index of leading UK shares produced a total return of just 0.2% in the 12 months to 30 June, reversing the new highs achieved in the early part of the year with a 6.4% fall in June alone.

Average valuations of UK shares are close to 10-year highs (Exhibit 2), while dividend yields remain at their long-term average level of c 3.5%, suggesting future total returns may be more muted. However, as MRCH manager Simon Gergel points out (See the manager's view section), average valuations do not tell the full story, with some very large stocks in out-of-favour sectors like oils and mining on low P/Es but with downside risk if commodity prices fall further, while 'quality' defensives look expensive and therefore offer limited upside. Between these two extremes there should still be opportunities for stock pickers to identify companies whose growth potential has been underappreciated by the market at large.

**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 6 July 2015.

## Fund profile: Income and growth from UK blue-chips

The Merchants Trust (MRCH) was set up in 1889 and is both the oldest and the largest of the three investment trusts managed by Allianz Global Investors (AllianzGI). It seeks to blend a high and growing income with the prospect of capital growth by investing in a focused portfolio of mainly large UK companies, and it currently has one of the highest yields in the AIC UK Equity Income sector (5.1% at 3 July). MRCH has grown its ordinary dividend in each of the last 33 years, and has been managed since 2006 by Simon Gergel, AllianzGI's chief investment officer for UK equities.

## The fund manager: Simon Gergel

### The manager's view: Equities still attractive in a low-yield world

Manager Simon Gergel says that while it has become harder to find value in the UK stock market, opportunities remain. "In aggregate the market is not expensive, but [FTSE 100] index valuations are distorted by very big stocks, such as oils, mining and banks, which are lowly rated but have underperformed the market, and quality defensives with solid growth prospects and good yields, which are highly rated," he explains.

The portfolio, while mainly the product of bottom-up stock selection, does display some high-level themes, and among those the manager currently favours are mega-caps and turnaround or cyclical

recovery stocks, both of which tend to offer better value than the market as a whole. “We find the best opportunities in areas where people are nervous and valuations are depressed – construction is a good example,” he says.

Gergel has concentrated recent portfolio activity on topping up companies he sees as having good prospects, and trimming those that have performed well. The top three contributors to performance over the 12 months to 30 April – Inmarsat, Friends Life/Aviva and BAE Systems – have all been trimmed as valuations have moved into more expensive territory, while the manager has added to holdings in Tate & Lyle, Sainsbury’s, recruitment firm SThree and construction company Kier (see current positioning section, below).

Although absolute value may be harder to come by, Gergel says that shares still offer good relative value. “With UK equities yielding 3.5%, bonds yielding 2% and cash yielding nothing, that’s looking attractive if you are a long-term investor,” he argues, adding that it would only require capital growth of 2.5% a year to make an attractive 6% return. However, he cautions that short-term volatility could dent returns, which is why equities should be viewed as a longer-term investment.

## Asset allocation

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### Investment process: Bottom-up, research-driven approach

To achieve MRCH’s objectives of an above-average, growing dividend income with the prospect of long-term capital growth, manager Simon Gergel uses a bottom-up, research-driven approach to stock selection. Potential buys are assessed for their fundamentals (industry dynamics, competitive position, financials and corporate governance), absolute and relative valuation, and whether they fit with the portfolio’s macro and industry themes. Although the trust has an income focus, purchase and sale decisions will be driven by total return considerations, not yield alone. Holdings may be sold when they achieve their target price, or if there are better opportunities elsewhere or a fundamental change in the investment case.

To support his stock picking, Gergel can draw on the extensive resources of Allianz Global Investors (AllianzGI). The firm has 83 investment analysts who are organised globally by sector and between them conduct more than 5,000 company meetings every year. In addition, AllianzGI’s Grassroots network of reporters and field investigators gather industry intelligence through market research, which can inform analysts’ and portfolio managers’ views at the stock or sector level.

While fundamentally an equity portfolio, MRCH can make selective use of option-writing to enhance income through the premiums received. All options are covered (that is, they are written over shares Gergel holds in MRCH’s portfolio). Options may be written over a maximum of 15% of the portfolio and the strategy adds c 5% to annual income, although this figure is variable and tends to be lower in less volatile markets.

### Current portfolio positioning

At 31 May MRCH had 45 equity holdings. This is more focused than the peer group average of 63 stocks, and the portfolio is also somewhat more concentrated, with 44.4% of assets in its largest 10 holdings, compared with a sector average of 37.2%.

Changes to the stock list in recent months have been minimal, with Australian-listed South32 entering the portfolio in May after being spun out of parent company BHP Billiton, and a small (1.3%) position taken in UK-listed Chilean copper miner Antofagasta because of a more favourable outlook for the copper price. Retail property specialist Hammerson and media stock Reed Elsevier were sold after they reached valuation targets. With few value opportunities in the market (see the

manager's view, above), Gergel has been concentrating on topping-up favoured stocks and trimming those where valuations are beginning to suggest limited further upside.

**Exhibit 3: Top 10 active stock positions at 31 May 2015**

Company	Portfolio weight (%)	FTSE 100 index weight (%)	Active weight (% points)
Royal Dutch Shell B	7.6	2.7	4.9*
UBM	4.5	0.0	4.5
Inmarsat	3.7	0.0	3.7
SSE	3.3	0.9	2.4
Amec Foster Wheeler	2.3	0.0	2.3
Standard Life	2.8	0.5	2.3
SThree	2.2	0.0	2.2
Carnival	2.4	0.3	2.1
William Hill	1.8	0.0	1.8
Pennon	1.8	0.0	1.8

Source: The Merchants Trust, Edison Investment Research. Note: \*Shell A + B = 7.0% of FTSE 100.

Although MRCH measures its performance against the FTSE 100, it does not use the blue-chip index as a benchmark for portfolio construction (see Exhibit 3), and at 31 May around half the stocks by number, or c 33% by assets, were outside the FTSE 100. One such stock is recruitment specialist SThree, which Gergel has been buying on dips in recent months. The manager says the market is yet to appreciate the evolution of the business, which is broadening its geographical focus from its core markets of UK/Benelux to include North America and Asia, diversifying the sectors to which it recruits from IT/computing and into science and engineering, and altering its business mix to include a more stable contractor base alongside its traditional focus on permanent recruitment.

**Exhibit 4: Sector allocations (at 31 May 2015 except where stated)**

	Trust weight % 31 May 2015	Trust weight % 30 Nov 2014	Benchmark weight %	Trust active weight	Trust weight/ benchmark weight
Consumer services	19.0	18.0	10.6	8.4	1.8
Industrials	13.6	12.3	7.5	6.1	1.8
Utilities	9.7	10.5	4.4	5.3	2.2
Oil & Gas	15.0	15.6	13.8	1.2	1.1
Technology	0.0	0.0	1.3	-1.3	0.0
Financials	20.8	20.5	22.9	-2.1	0.9
Telecommunications	3.3	3.4	5.9	-2.7	0.6
Healthcare	5.6	6.1	9.7	-4.1	0.6
Basic materials	3.2	2.8	7.3	-4.1	0.4
Consumer goods	9.8	10.9	16.7	-6.9	0.6
<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>0.0</b>	

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

One of the largest overweights on a sector basis (Exhibit 4) is to industrials, which includes not only support services stocks like SThree, but also construction, another area Gergel favours. Holdings include Kier Group, whose recent purchase of Mouchel gives it exposure to lucrative Highways Agency road building and maintenance contracts alongside its own local authority roads exposure, and Balfour Beatty, a turnaround story where the manager says new CEO Leo Quinn, formerly of QinetiQ, can make a real impact. The company's market cap is currently little more than the £1.3bn value of its PFI infrastructure assets, so Gergel points out that shareholders are effectively getting the construction business – which has operations in the US and Middle East as well as the UK – for nothing, providing potential upside should Quinn be successful in turning the company around.

The largest sector weighting is to consumer services, where the manager has done well out of stocks including Carnival, Cineworld, First Group and bookmaker William Hill. Retailers Mothercare and M&S – both bought as recovery stocks – have also performed positively, although consumer goods is the largest underweight relative to the FTSE 100.

Net gearing is currently 16.5% as a result of a slightly higher cash weighting than historical averages, although the manager points out this is as a result of sales/purchases and that cash is not held to take a timing view on markets.

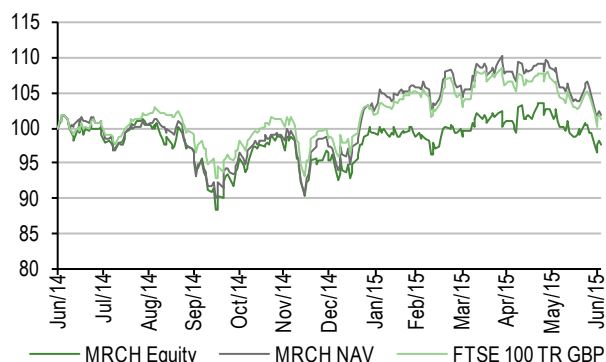
## Performance: Solid medium-term record

MRCH has performed strongly versus its FTSE 100 benchmark over the medium term (three and five years; Exhibit 5) but has lagged in a falling market over more recent periods, largely because of the effect and cost of gearing (see our [note](#) of June 2014). Over one year, in which gains on the FTSE 100 were largely negated after falls in June, the trust is slightly ahead in NAV total return terms but behind in share price terms because of a widening discount since the start of the year.

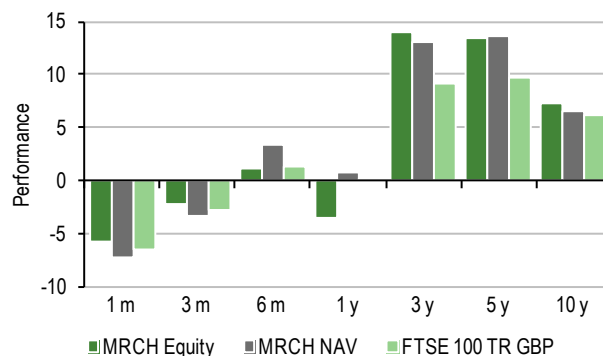
The total return performance of the MRCH portfolio, without including any of the effects of gearing, was 2.86% in the 12 months to 30 June, compared with 0.2% for the FTSE 100. Gergel says positive performance over the past year has come from contrarian calls, such as holdings in out-of-favour Resolution (which became Friends Life and was then bought by Aviva), BAE Systems and Inmarsat. Recent NAV total return underperformance versus the FTSE All-Share (Exhibit 6) is evidence of the post-election rally in mid and small-caps, which have done significantly better than the large-cap FTSE 100, as well as the gearing effect. Longer-term performance versus benchmark (Exhibit 7) has been on a largely improving trend since the financial crisis, albeit with a slight decline in 2014.

**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 June 2015 (%)**

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to FTSE 100	0.7	0.6	(0.2)	(3.6)	13.5	18.6	10.2
NAV relative to FTSE 100	(0.8)	(0.6)	2.1	0.6	10.8	19.4	3.6
Price relative to FTSE 350 Higher Yield	1.4	2.2	2.2	0.3	17.6	15.2	25.1
NAV relative to FTSE 350 Higher Yield	(0.0)	1.0	4.5	4.6	14.8	16.1	17.7
Price relative to FTSE All Share	(0.0)	(0.6)	(1.8)	(5.8)	8.1	12.8	2.3
NAV relative to FTSE All Share	(1.5)	(1.8)	0.4	(1.8)	5.5	13.6	(3.8)

Source: Thomson Datastream. Note: Geometric calculation.

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



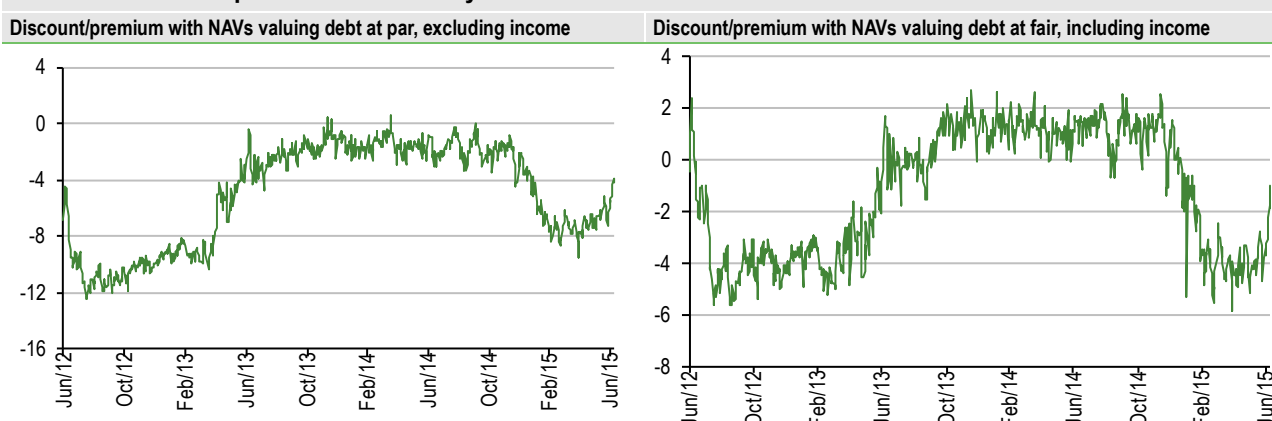
Source: The Merchants Trust, Thomson Datastream, Bloomberg, Edison Investment Research



## Discount: Close to medium-term average

MRCH's shares traded at a premium to cum income net asset value (with debt at market value) for most of the period from mid-2013 to the end of 2014, but moved to a discount in early 2015 as investment trust discounts widened in general. At 6 July the cum-fair discount stood at 3.1%, narrowing to 1.0% at 9 July, in line with the averages over one and three years (0.9% and 1.2% respectively), and narrower than both the 12-month high of 5.8% seen in late April shortly before the UK general election, and the year-to-date average of 3.0%. There may be scope for the discount to narrow further, particularly given MRCH's higher-than-average yield.

**Exhibit 8: Discount/premium over three years**



Source: Thomson Datastream, Edison Investment Research.

## Capital structure and fees

A conventional investment trust, MRCH has one class of equity, with 108.7m ordinary shares in issue at 7 July. The trust is structurally geared through two issues of debentures, with a total par value of £79.7m, as well as £29.5m of secured bonds and two small issues of perpetual debenture stock and cumulative preference shares. The first tranche of debentures, which have an effective interest rate of 11.125%, are due to be repaid in 2018, and MRCH's board is beginning to consider options for the repayment of this debt, which could include paying back the debt (broadly neutral in revenue terms) or refinancing it to a lower rate, which would be revenue-enhancing. Net gearing stood at 16.5% at 31 May 2015.

Allianz Global Investors receives an annual management fee of 0.35% of assets minus current liabilities, calculated quarterly. There is no performance fee and ongoing charges for the year ended 31 January 2015 were 0.59% (FY14: 0.66%).

## Dividend policy and record

MRCH pays dividends quarterly and aims to provide a high and growing income alongside capital growth. It has raised its payout for 33 years in a row, with the dividend for the year to 31 January 2015 standing at 23.8p (a yield of 5.1% based on the 6 July share price of 470p). A first interim dividend of 6.0p for FY16 was declared on 3 July; assuming the other three dividends are no lower, the FY16 dividend should be at least 24.0p. Revenue for FY15 was marginally up on the previous year but was 2.7% lower on a per-share basis because 5.2m new shares were issued during the year. Payment of the FY15 dividend required a very small transfer from the trust's substantial revenue reserve, which remains at 22.6p per share, or 95% of the latest full-year dividend.

## Peer group comparison

Of the 24 investment companies in the AIC's UK Equity Income sector, MRCH is the only one with a FTSE 100 benchmark. The focus on larger-cap stocks has led to underperformance versus the peer group over recent periods; figures from FTSE show a total return of 14.5% from the FTSE 250 and 8.0% for the FTSE Small-Cap over 12 months to 30 June, compared with 0.2% for the FTSE 100. MRCH's NAV total return over 12 months, while comfortably ahead of its benchmark, ranks it near the bottom of the peer group, and sixth out of the six large trusts shown in Exhibit 9. Over three years' performance is in the lower third quartile while over five years it is mid-table but below the weighted average for the sector. Risk-adjusted performance as measured by the Sharpe ratio is also below average over one and three years. MRCH has one of the highest yields in the peer group and one of the lowest ongoing charges. Its discount is wider than average while it also has a higher-than-average net gearing figure.

**Exhibit 9: UK Equity Income investment trusts with market capitalisations above £500m**

% 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
<b>The Merchants Trust</b>	<b>519.7</b>	<b>5.0</b>	<b>54.6</b>	<b>92.4</b>	<b>0.6</b>	<b>No</b>	<b>-3.4</b>	<b>118.0</b>	<b>5.1</b>	<b>0.6</b>	<b>1.4</b>
City of London	1225.8	10.1	58.2	98.5	0.4	No	2.5	106.0	3.7	1.2	1.7
Edinburgh Investment	1319.0	14.7	63.9	118.6	0.7	No	-0.1	109.0	3.6	1.7	1.7
Finsbury Growth & Income	663.3	17.6	85.7	140.9	0.8	No	1.0	103.0	2.1	1.4	2.0
Perpetual Income & Growth	978.3	13.4	79.2	125.4	0.9	Yes	1.2	117.0	3.5	2.0	2.3
Temple Bar	782.4	5.9	58.4	97.2	0.5	No	-3.2	97.0	3.4	0.7	1.7
<b>Sector weighted average</b>		<b>10.5</b>	<b>64.5</b>	<b>105.9</b>	<b>0.8</b>		<b>-1.3</b>	<b>110.6</b>	<b>3.6</b>	<b>1.2</b>	<b>1.8</b>
<b>MRCH rank out of 24</b>	<b>6</b>	<b>22</b>	<b>18</b>	<b>13</b>	<b>21</b>		<b>15</b>	<b>7</b>	<b>4</b>	<b>21</b>	<b>21</b>

Source: Morningstar, 3 July 2015, 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

There are five non-executive directors on MRCH's board. Simon Fraser joined the board in 2009 and became chairman in 2010. Mike McKeon, the senior independent director, has been a board member since 2008. Paul Yates was appointed in 2011, while the two newest directors, Sybella Stanley and Mary Ann Sieghart, joined the board in November 2014. The directors have backgrounds in investment management, corporate finance and the media.

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