Investment Trust Review

Edison investment research

3 April 2012

The Merchants Trust

12 Months Ending	Total Share Return* (%)	Total NAV Return* (%)	Total Return FTSE 100* (%)	Total Return FTSE 350 Hi Yield* (%)	Total Return FTSE All-Share* (%)
30/03/09	(40.2)	(43.6)	(31.0)	(30.8)	(31.9)
30/03/10	69.4	77.2	56.7	47.9	58.3
30/03/11	22.2	11.4	8.3	7.4	9.6
30/03/12	(2.1)	2.6	0.6	4.5	0.7

Note: * 12-month rolling discrete performance.

Investment summary: 30 successive years of dividend growth

The Merchants Trust (MRCH) has again increased its total year-on-year dividend, reaching the 30th year of providing investors with uninterrupted dividend growth. The underlying portfolio beat the FTSE 100, in total return terms for the year ended 31 January, by 1.5% (the FTSE 100 rose by 0.4%). Gearing subtracted 0.9% from performance, but an expensive tranche of debt, currently valued above par, expires in 2018. The trust pays quarterly dividends, is managed using a value-driven investment style and remains defensively positioned.

Investment strategy: Higher-yielding FTSE 100 companies

MRCH aims to provide an above-average level of income; it currently yields 6.0% compared with the FTSE 100 index yield of 3.5%. It invests in higher-yielding equities, uses gearing (25.1% as at 29 February 2012) 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 three 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.

Sector outlook: Strong dividend during 2012

The manager believes it is still correct for the portfolio to be defensively positioned, given current market uncertainties, but acknowledges that he is becoming less defensive, reflecting a devaluation of cyclical and financial shares. MRCH experienced strong dividend growth during 2011, underpinned by improvements to corporate profitability, which the manager expects to continue into 2012.

Valuation: Fair value premium has moved closer to par

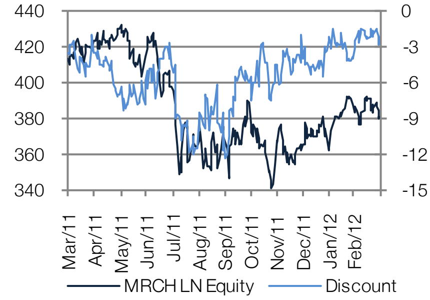
With discount widening/premium contraction over the last six months, MRCH's current discount of 6.3% (debt valued at par) and premium of 2.1% (debt valued at market) are comparable to its five-year discount averages of 6.3% and 0.1% respectively. At 6.0% the yield remains strong, and so we consider that MRCH should continue to be attractive to investors favouring a defensive portfolio with regular income at a decent yield, or those looking for geared exposure to the FTSE 100.

Price	381.0p
Market Cap	£393.2m
AUM	£541.6m
NAV	406.62p*
Discount to NAV	6.3%*
NAV	373.19p**
Premium to NAV	2.1%**
Yield	6.0%

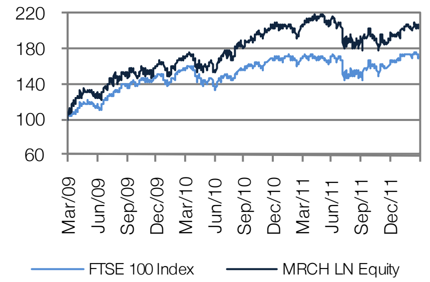
** Adjusted for debt at par value and excluding income, as at 30 March 2012.*

*** Adjusted for debt at market value, excluding income, as at 30 March 2012.*

Share price/discount graph



3-year cumulative performance graph



Share details

Code	MRCH
Listing	LSE
AIC Sector	UK Growth & Income
Shares in issue	103.2m

Price

52 week	High	Low
Price	431.80p	341.50p
NAV*	411.14p	314.05p

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

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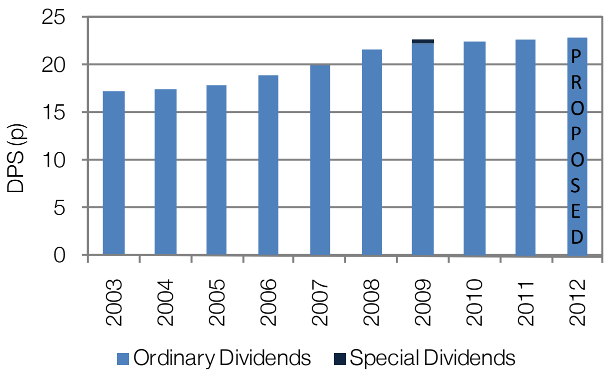
The Merchants Trust is a research client of Edison Investment Research Limited

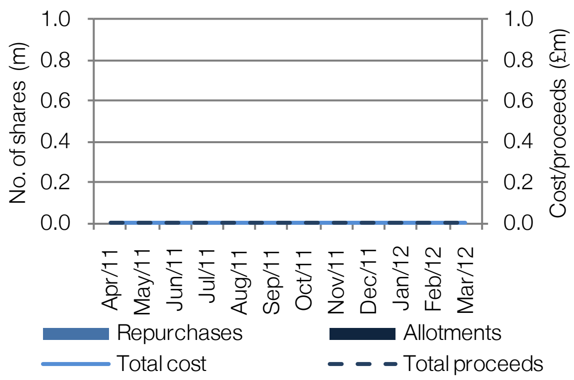
Exhibit 1: Trust at a glance

Investment objective and fund background	Developments last quarter
The investment objective of the Merchants Trust 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.	30 March 2012: Annual results for the year ended 31 January 2012 announced, including a proposed final quarterly dividend of 5.8p (total for year 23.0p) providing 30 successive years of dividend growth. 23 February 2012: Third interim dividend of 5.8p paid.

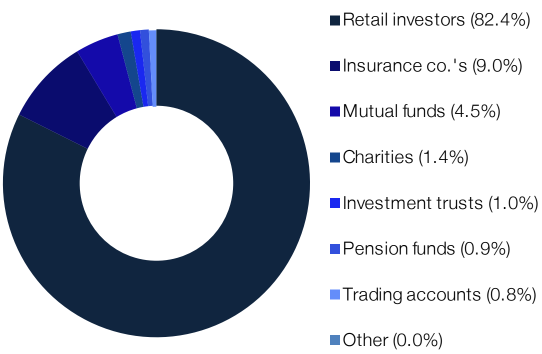
Forthcoming		Capital structure		Fund details	
AGM	May 2012	Total expense ratio	0.47%	Group	Allianz Global Investors/RCM (UK)
Preliminary	April 2013	Net Gearing	25.1%	Manager	Simon Gergel
Year end	31 January	Annual mgmt fee	See pg 7	Address	155 Bishopsgate, London EC2M 3AD
Dividend paid	Quarterly	Performance fee	None		
Launch date	February 1889	Trust life	Indefinite	Phone	+44 (0)800 317 573
Wind-up date	N/A	Loan facilities	See pg 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 10% of issued share capital.

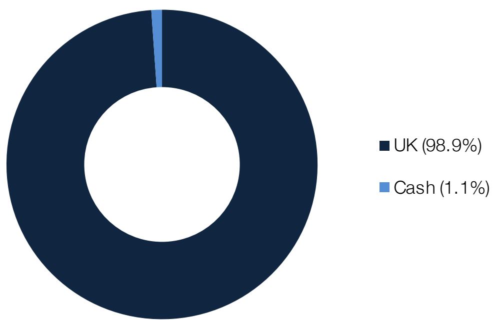




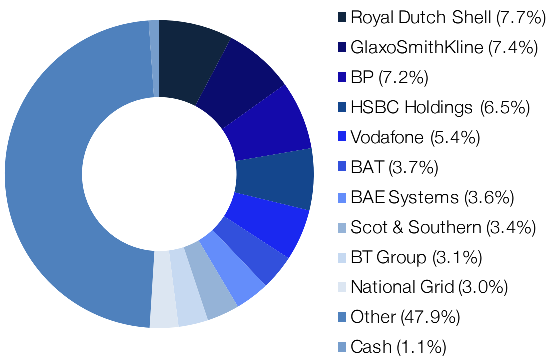
Shareholder base (as at 7 March 2012)



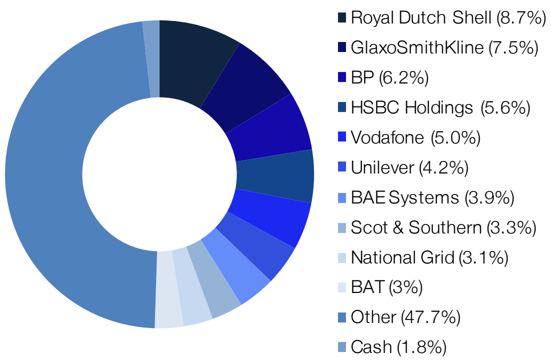
Geographic distribution of portfolio (as at 12 March 2012)



Portfolio composition (as at 12 March 2012)



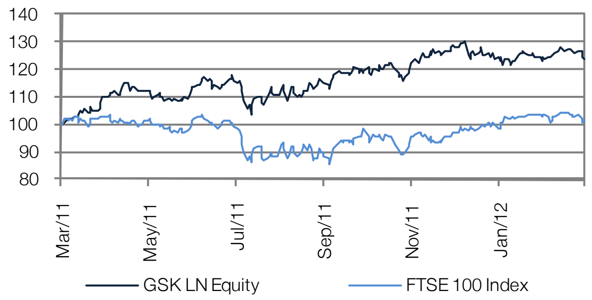
Portfolio composition (as at 31 August 2011)



Source: The Merchants Trust/Edison Investment Research

Exhibit 2: Holdings in portfolio themes at a glance

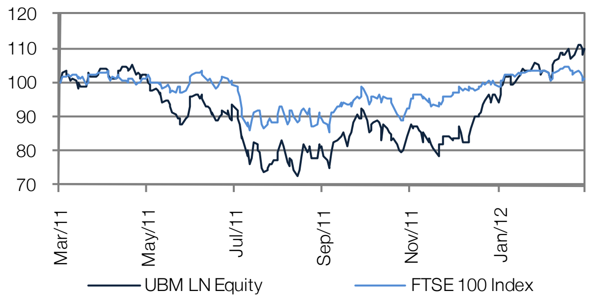
GlaxoSmithKline | **Code: GSK LN** | **Market Cap: £71,752m**



Div Yield (trailing 12 mths)	4.92%
Industry/Sector	Pharmaceuticals & Tech./Pharma
Listing	UK – FULL
Website	www.gsk.com

At 7.4% of the portfolio, GlaxoSmithKline (GSK) is one of MRCH's core holdings. This reflects management's views that GSK's valuation is attractive and, as a bedrock, MRCH retains a number of large core holdings in strong multinational businesses that are well financed and offer good yields. GSK, currently MRCH's largest holding, made the single biggest contribution to performance during the year ended 31 January 2012.

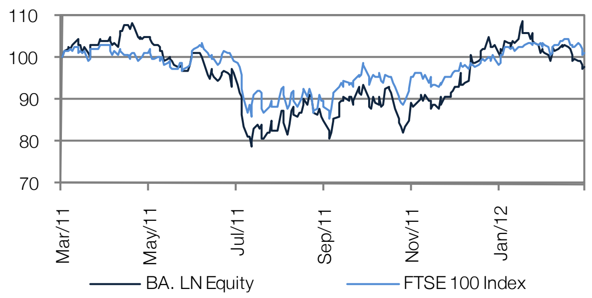
United Business Media | **Code: UBM LN** | **Market Cap: £1,535m**



Div Yield (trailing 12 mths)	4.19%
Industry/Sector	Media/Publishing
Listing	UK – FULL
Website	www.unitedbusinessmedia.com

United Business Media (UBM), at 2.3% of the portfolio, is one of a number of holdings that provides MRCH with exposure to corporate expenditure through media and advertising. Having restructured, the manager considers that UBM has a strong core business that has moved well beyond print media. Around 60% relates to exhibitions. UBM also has a substantial exposure to emerging markets and the data business is performing well.

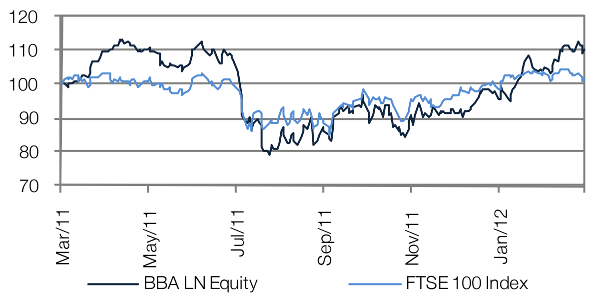
BAE Systems | **Code: BA. LN** | **Market Cap: £9,747m**



Div Yield (trailing 12 mths)	6.25%
Industry/Sector	Aerospace & Defence/Defence
Listing	UK – FULL
Website	www.baesystems.com

At 3.6% of the portfolio, BAE Systems is both a core holding (ie, a well-financed multinational business that offers a good yield) and a stock that has been oversold on defence cuts. The manager considers the valuation remains attractive and that BAE is performing well. The manager believes that half the business is maintaining existing fleets and that many of its contracts are long-term and there are export opportunities.

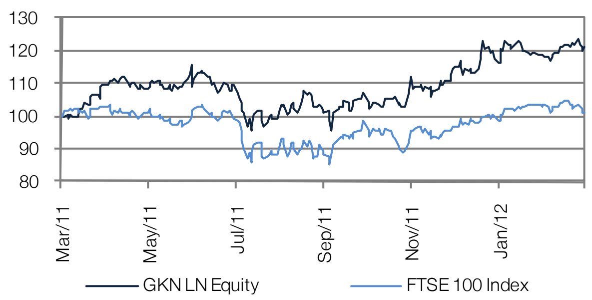
BBA Aviation | **Code: BBA LN** | **Market Cap: £1,031m**



Div Yield (trailing 12 mths)	2.88%
Industry/Sector	Industrial Transportation/Services
Listing	UK – FULL
Website	www.bbaaviation.com

At 1.1% of the portfolio, BBA Aviation (BBA) is an example of a company exposed to an improving civil aviation cycle. BBA provides on-airport support services to owners of business and commercial aircraft, employing over 11,000 people at over 200 sites globally. The manager considers the general and business aviation market, in which BBA operates, is recovering, and that the business is well managed and very cash generative.

Greene King | **Code: GKN LN** | **Market Cap: £1,114m**



Div Yield (trailing 12 mths)	4.58%
Industry/Sector	Travel & Leisure/Restaurant & Bars
Listing	UK – FULL
Website	www.greeneking.co.uk

MRCH's Greene King (GKN) holding, at 1.0% of the portfolio, is an example of a consumer stock oversold regarding concerns over disposable income. The manager considers GKN is a very solid business, generating decent cash and growth, which has been bolstered during the downturn as consumers have 'traded down' from restaurants to pubs. GKN also has a valuable portfolio of freehold sites, which offer some inflation protection.

Source: Thomson Datastream/Edison Investment Research

Fund profile

Managed by RCM, a company of Allianz Global Investors, and its predecessors since its launch in February 1889, MRCH is the oldest trust in the RCM stable. It is an income trust that pays quarterly dividends and has provided 30 years of uninterrupted dividend growth. Simon Gergel, head of RCM's value and income investment style team, has led the management of MRCH's portfolio since April 2006.

The fund manager: Simon Gergel

Manager's view

The manager considers that share price movements are polarised, with divergent performance between defensive and cyclical equities, as markets move between 'risk-on' and 'risk-off' phases. This makes portfolio construction challenging but the manager believes it is still correct for MRCH to have a defensively positioned portfolio, focusing on higher yielding stocks given current market uncertainties, but acknowledges that he is becoming less defensive reflecting a devaluation of cyclical and financial shares. The manager expects strong dividend growth into 2012 underpinned by improvements to corporate profitability, which have already been seen. While inflation remains a long-term risk, it is not an issue and capacity constraints are not evident. The following themes are employed in managing the portfolio:

- Retain large core holdings in large well-financed multinational businesses with good yields, such as GlaxoSmithKline, Royal Dutch Shell, Vodafone, Scottish & Southern Energy and National Grid.
- Certain management turnaround and recovery situations remain attractive – Unilever, Compass, Resolution and Daily Mail and General Trust.
- Continue to limit exposure to mining (because of the effects of a slowdown/muted recovery) and banks (because of ongoing low dividends).
- Purchase high-quality growth stocks on modest valuations with reasonable dividend yields – Reckitt Benckiser, United Business Media and IG Group.
- Seek companies with exposure to emerging market consumers – GlaxoSmithKline, British American Tobacco, Unilever and Mothercare.
- Corporate profits look healthy and the outlook for day-to-day for expenditure, in particular advertising and media, remains positive, for example United Business Media, Daily Mail and General Trust and Reed Elsevier.
- Many companies exposed to defence spending were oversold, in the manager's opinion, on the back of concerns about defence cuts. In addition, the civil aviation outlook is improving. The manager sees opportunities in companies such as BAE Systems, BBA Aviation and Cobham.
- Selectively overweight certain consumer-related stocks, which have been oversold (in spite of the obvious pressures on disposable income) such as Sainsbury's, Carnival and Greene King. The manager believes the oil price is vulnerable to a growth slowdown, which could revive consumer spending and the sector.

Asset allocation

Overview

MRCH has 46 equity investments. The top 10 holdings account for 51.0% of the portfolio, cash 1.1%, with the remaining 36 equity investments accounting for 47.9% as at 12 March 2012. As displayed in Exhibit 3, MRCH's asset allocation can differ substantially to that of the FTSE 100, reflecting the actively managed nature of the trust. As shown in Exhibit 1, apart from the 1.1% of the portfolio held as cash, the remaining 98.9% of the portfolio is fully invested in the UK.

Derivatives strategy

The manager is permitted to write selective covered call options to generate 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 vary between five and 20. For the year ended 31 January 2012 (the second full year the strategy has been in use) call overwriting generated over £1.9m (2011: £2.0m) of additional revenue income and a net profit of c £950k (2011: £480k) once the opportunity cost of any exercised options was taken into account.

Underweights

MRCH remains underweight basic materials, oil & gas and technology. Within the financials allocation, the portfolio retains a significant underweight in banks, which is still offset by overweights in financial services, non-life insurance and life assurance. The manager remains underweight banks as he considers they remain difficult to value and yields remain low. Healthcare, previously a mild overweight, is now a small underweight.

Overweights

MRCH remains overweight consumer services, utilities, industrials and telecommunications. Consumer services, largely driven by media, is MRCH's largest active overweight and second largest relative overweight at 1.8x the benchmark allocation. The industrials overweight (1.6x the benchmark allocation) is largely driven by holdings in aerospace and defence.

Exhibit 3: Sector allocations, as at 12 March 2012

	Trust weight (%)	FTSE 100 weight (%)	Trust active weight (%)	Trust weight/ FTSE 100 weight
Consumer services	14.7	8.0	6.7	1.84
Utilities	9.1	4.3	4.8	2.12
Industrials	10.9	6.8	4.1	1.60
Telecommunications	9.2	6.7	2.5	1.37
Financials	17.6	17.7	(0.1)	0.99
Technology	0.0	0.8	(0.8)	0.00
Healthcare	7.5	8.4	(0.9)	0.89
Consumer goods	13.4	15.1	(1.7)	0.89
Oil & gas	14.8	20.5	(5.7)	0.72
Basic materials	1.7	11.9	(10.2)	0.14
Other assets/liabilities inc cash	1.1	0.0	1.1	N/A
Total	100.0	100.0	0.0	N/A

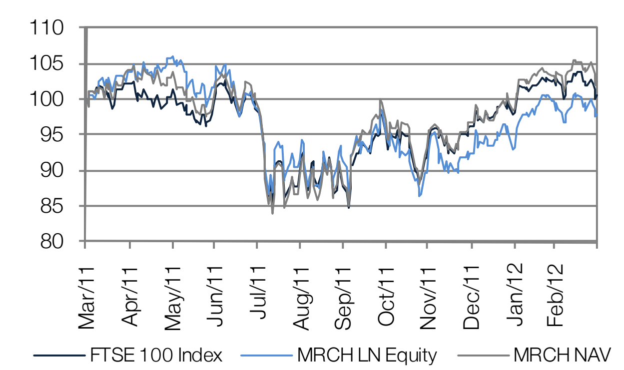
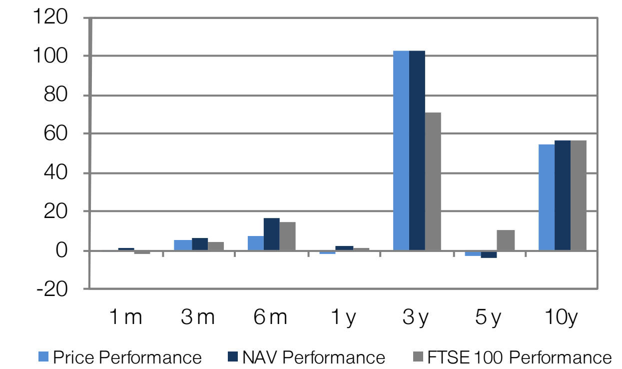
Source: The Merchants Trust/Edison Investment Research

Current portfolio positioning

As Exhibit 3 illustrates, the investment manager has given MRCH a more defensive allocation than the benchmark by overweighting defensive and underweighting cyclical sectors.

Recent performance

Exhibit 4: Investment trust performance

Price, NAV & benchmark total return performance 1 year rebased	Price, NAV & benchmark total return performance (%)
	

Source: Thomson Datastream/Edison Investment Research

Exhibit 5: Share price and NAV total return performance (sterling adjusted), relative to benchmarks as at 28 March 2012.

	1 month	3 months	6 months	1 year	3 years	5 years	10 years
Price relative to FTSE 100	0.7	1.2	(7.3)	(2.7)	31.9	(13.1)	(2.1)
NAV relative to FTSE 100	1.5	1.4	1.9	2.1	31.9	(13.8)	59.1
Price relative to FTSE 350 High Yield	(0.5)	3.6	(4.5)	(6.6)	36.7	(3.3)	0.9
NAV relative to FTSE 350 High Yield	0.3	3.8	4.7	(1.8)	36.8	(4.0)	56.1
Price relative to FTSE All Share	0.3	(0.3)	(7.9)	(2.8)	27.9	(12.4)	(11.4)
NAV relative to FTSE All Share	1.1	(0.1)	1.4	1.9	27.9	(13.1)	68.4

Source: Thomson Datastream/Edison Investment Research

As Exhibit 4 illustrates, MRCH's performance has tended to follow that of its benchmark, the FTSE 100 index. The underperformance, apparent in more recent periods and the five-year period, reflects MRCH's investment policy to remain substantially fully invested and geared, which has affected performance during falling markets. In terms of performance for the year ended 31 January 2012, attribution analysis shows that total return on the index was 0.4%, while the relative return of the portfolio added 1.5%. Furthermore gearing and expenses charged to capital subtracted 0.9% and 1.7%, while other items added 0.2%. It is noteworthy that the portfolio return was accretive but that the impact of the structural gearing was negative. Quantitative easing has lowered borrowing costs and driven up the market value of corporate debt, MRCH's included. However, the most expensive debt, the £52.2m of severally guaranteed debenture stock at 11.125%, 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 with a positive effect on NAV.

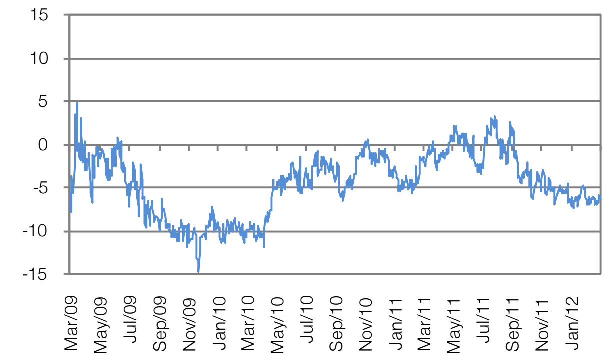
Discount/premium

MRCH has the authority, renewed annually, to allot up to 10% or make market purchases of up to 14.99% of issued share capital, which provides the manager with a mechanism to influence the discount, although there is no explicit maximum or target level. Exhibit 6 illustrates the discount – the first graph is produced using NAVs calculated valuing debt at par and the second values debt at market. It can be seen that, under both measures, the general trend between November 2009 and September 2011 was one of a discount tightening, although the last six months have seen the discount moving out again. Nonetheless MRCH has, since the end of May 2010, predominantly traded at a premium with debt valued at market. As such, there continues to be no need for the trust to use its repurchase authority and, as illustrated in Exhibit 1, MRCH has not undertaken any repurchases during the last four years. With MRCH trading at a small premium, with debt valued at market, we do not anticipate use of the repurchase authority in the immediate future.

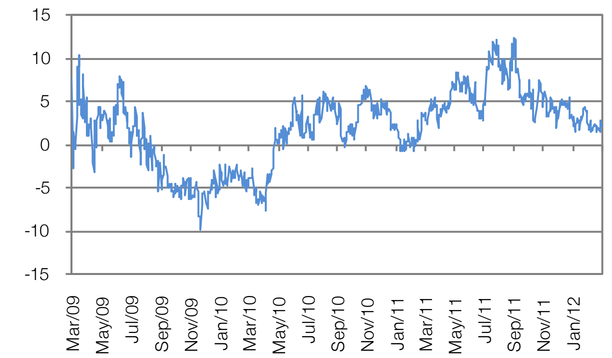
Exhibit 6: Discount/premium over three years

Note: Positive values indicate a premium; negative values indicate a discount.

Discount/Premium calculated using NAVs valuing debt at par



Discount/Premium calculated using NAVs valuing debt at market



Source: Thomson Datastream/Edison Investment Research

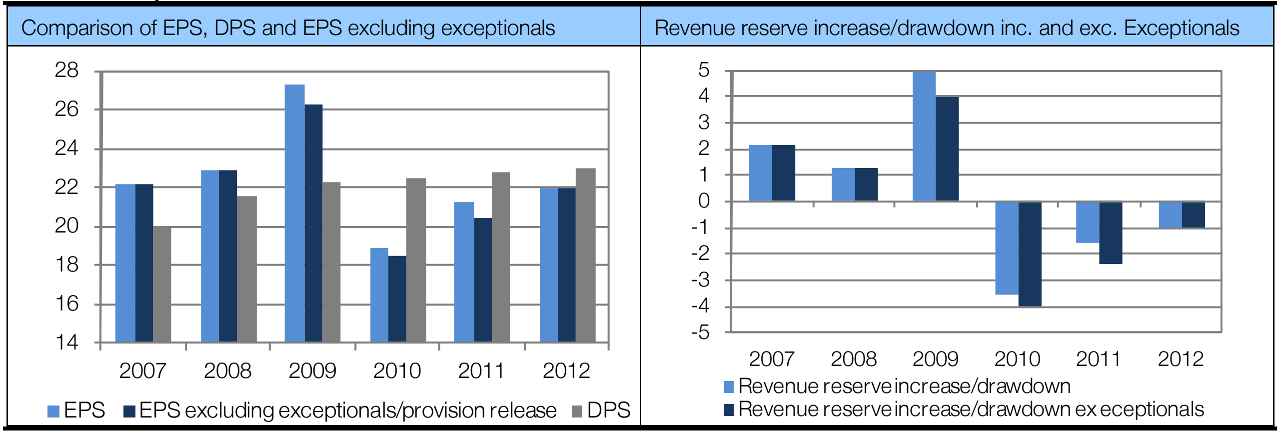
Capital structure

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, 5.88% secured bonds expiring 2029, a fixed-interest-rate loan expiring 2023 and a stepped-interest-rate loan expiring January 2018. MRCH's borrowings are not allowed to exceed its called up share capital and reserves, allowing considerable flexibility in choosing its gearing policy. MRCH currently has net gearing of 25.1%. 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 RCM. There is no performance fee and the management contract can be terminated at one year's notice. The total expense ratio (TER) was 0.47% for the year ended 31 January 2012 (2011 = 0.46%), which reflects the economies of scale offered by a trust of this size. As illustrated in Exhibit 8, MRCH's TER ranks fourth out of 19 when compared to its peers. MRCH has an indefinite life and there is no specific mechanism to wind up the company.

Dividend policy and record

Dividends are paid quarterly and a key objective is to maintain a high and growing total dividend. For the year ending 31 January 2012, MRCH paid a total dividend of 23.0p, providing 30 years of uninterrupted dividend growth since 1982. During this period MRCH increased its dividend by a total of 1,011%, an average yearly increase of 8.6%, or 8.4% annualised. Because of its significant dividend obligations, the board carefully models dividend flows and reviews the income outlook six times annually. As Exhibit 7 illustrates MRCH has, for the last three years, dipped into revenue reserves to support the dividend payment. These shortfalls, which reflect both the dividend cuts by the banks post 2009 as well as the BP dividend cut following the Gulf of Mexico oil spill, have become progressively smaller as dividend income has recovered. With companies earning very good margins, the market has seen strong dividend growth during 2011, which the manger expects to continue in 2012. The manager and board are confident that MRCH is now moving back towards a position where the dividend will once again become covered. The recent results indicate that, as at 31 January 2012, MRCH had revenue reserves of 23.0p per share; or 11.4p after deducting the third and fourth dividends of 5.8p each. MRCH generated 11.6p of revenue reserves during the first half of 2011 and so, assuming similar income during 2012, we expect that MRCH will be able to maintain the current dividend for 2013 and is likely to be able to continue its path of steady dividend growth.

Exhibit 7: Analysis of revenue reserve



Source: Merchants Trust

Peer group comparison

As Exhibit 8 illustrates, the AIC sector UK Growth and Income is a comprehensive peer group with 19 constituents (a sample is given below). Within this group, MRCH ranks 18th over one year, 10th over three years and 13th over five years when considering share price total return.

Exhibit 8: UK growth and income sector, as at 30 March 2012

Company	Share price total return on £100 One year	Three years	Five years	Total Expense Ratio	(Disc)/ Prem	Net Gearing (100 = no gearing)	5 Year Dividend Growth (%)	Div yield
Sector average	108.4	202.1	118.7	0.75	0.8	113	2.6	4.3
Merchants Trust	97.9	202.6	97.1	0.64	2.0	124	1.3	6.0
City of London	106.1	184.2	121.2	0.46	3.4	110	5.9	4.7
F&C Capital & Income	103.0	172.8	111.0	0.91	2.0	103	3.5	4.0
Finsbury Growth & Income	111.8	233.7	127.0	1.09	1.3	105	0.9	2.7
Lowland	112.2	261.9	103.5	0.62	(5.8)	115	3.6	3.1
Perpetual Income & Growth	110.4	187.0	130.9	1.04	0.6	116	5.0	3.7
Temple Bar	108.5	213.7	133.9	0.52	3.0	110	2.6	3.8
Value and Income	100.0	248.1	90.7	0.92	(20.4)	129	1.1	4.3

Source: The Association of Investment Companies

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 P T Yates (directors). The average length of director service is 2.4 years.

Edison Investment Research
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