Edison investment research

3 October 2011

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* (%)
30/09/08	(29.6)	(32.2)	(21.2)	(22.3)	(22.3)
30/09/09	6.2	8.6	9.5	5.3	10.8
30/09/10	21.0	13.3	11.8	5.2	12.5
30/09/11	4.3	(2.1)	(4.4)	2.1	(4.4)

Note: * 12-month rolling discrete performance.

Investment summary: Quarterly income and a 6.2% yield

During the last 12 months, the Merchants Trust (MRCH) has outperformed its benchmark index, the FTSE 100, by 8.7% in terms of share price total return and 2.3% in terms of NAV total return. The trust pays quarterly dividends and, with its recent interims, has indicated that it is in line to provide investors with 30 years of uninterrupted dividend growth. MRCH 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 6.4% compared with the FTSE 100 index yield of 3.6%. It invests in higher-yielding equities, uses gearing (currently 29%) and selectively writes covered calls to generate additional income. The board anticipates that revenue reserves will be needed to support dividend payments in the second half of the financial year, but is planning for this gap to close as dividends increase on the underlying portfolio. Of course, this cannot be guaranteed.

Sector outlook: Strong dividend growth into 2012

While MRCH's portfolio has moved to a more defensive position during the last two months, reflecting the deterioration in the macro outlook, the manager is not overly bearish on equities. He considers that, compared to 2008, the economy is starting from a less elevated base and inventory levels are lower. In addition, monetary policy is accommodative and valuations are low in a historical context. The manager expects strong dividend growth into 2012 underpinned by improvements to corporate profitability, which have already been seen.

Valuation

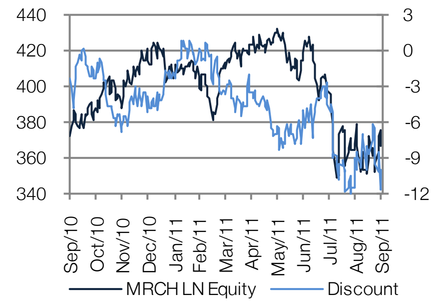
The current rating, a premium of 0.2% (debt valued at par) and premium of 9.2% (debt valued at market), is higher than MRCH's five-year rating (discount averages of 6.5% and 0.5% respectively). The yield also remains strong, and MRCH may continue to be attractive to investors looking for regular income at a decent yield, or those looking for geared exposure to the FTSE 100.

Price	367.0p
Market Cap	£378.8m
AUM	£496.2m
NAV	366.14p*
Premium to NAV	0.2%*
NAV	336.22p**
Premium to NAV	9.2%**
Yield	6.2%

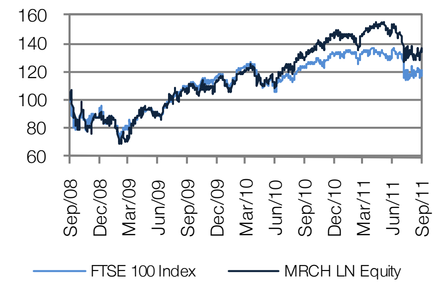
** Adjusted for debt at par value and excluding income, as at 29 September 2011.*

*** Adjusted for debt at market value, excluding income, as at 29 September 2011.*

Share price/discount graph



3-year cumulative performance graph



Share details

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

Price

52 week	High	Low
Price	431.80p	348.70p
NAV*	436.02p	343.10p

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

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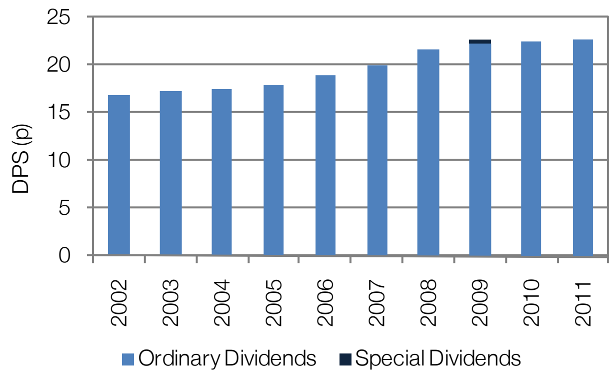
The Merchants Trust is a research client of Edison Investment Research Limited

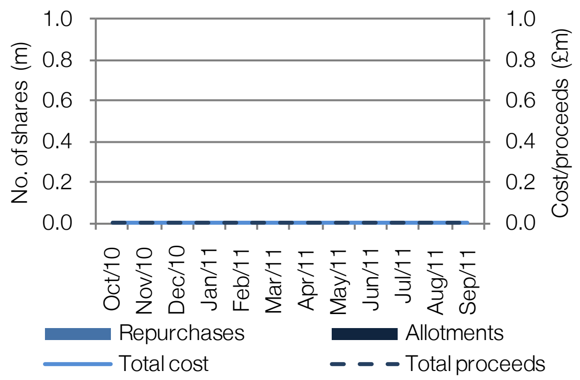
Exhibit 1: Trust at a glance

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.	15 September 2011: Interim results announced. 17 August 2011: 1st interim dividend of 5.7p paid 31 July 2011: Half-year end.

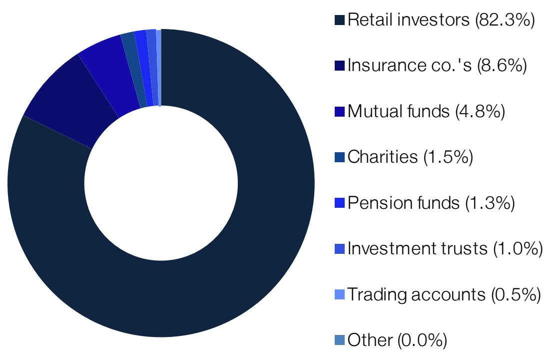
Forthcoming		Capital structure		Fund details	
AGM	May 2012	Total expense ratio	0.46%	Group	Allianz Global Investors/RCM (UK)
Preliminary	April 2012	Net Gearing	29%	Manager	Simon Gergel
Year end	31 January	Annual mgmt fee	See pg 7	Address	155 Bishopsgate, London EC2M 3AD
Dividend paid	Quarterly	Performance 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.

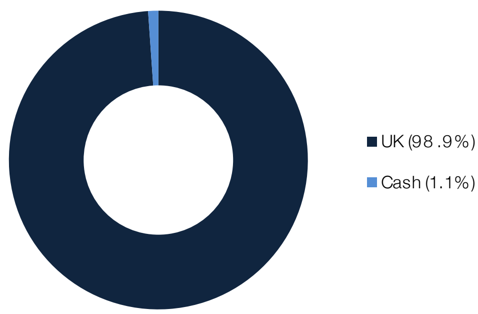




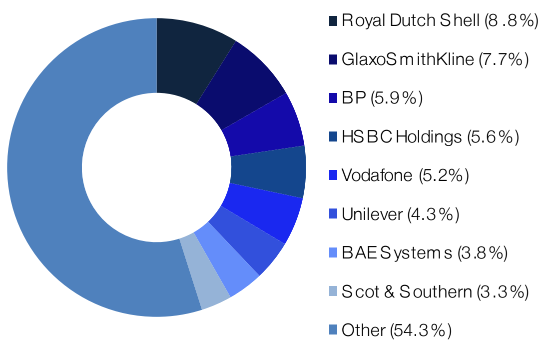
Shareholder base (as at 7 September 2011)



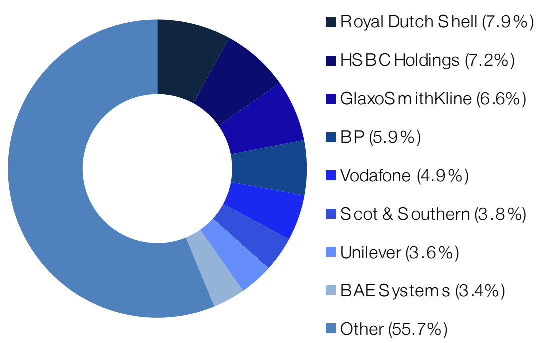
Geographic distribution of portfolio (as at 5 September 2011)



Portfolio composition (as at 5 September 2011)



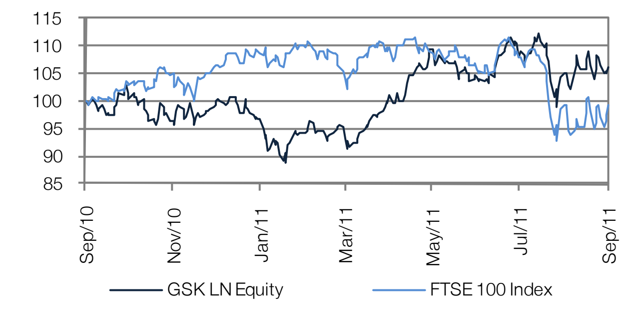
Portfolio composition (as at 28 February 2011)



Source: The Merchants Trust/Edison Investment Research

Exhibit 2: Holdings in portfolio themes at a glance

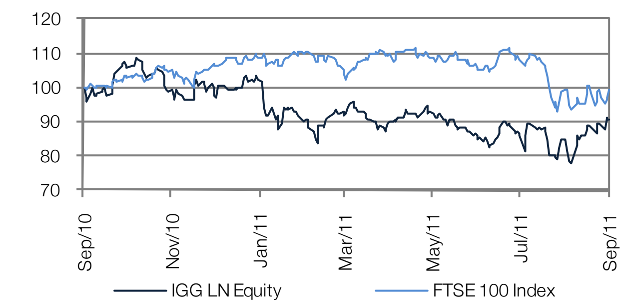
GlaxoSmithKline | **Code: GSK LN** | **Market Cap: £66,638m**



Div Yield (trailing 12 mths)	5.68%
Industry/Sector	Pharmaceuticals & Tech./Pharma
Listing	FULL
Website	www.gsk.com

At 7.7% 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. During the first half GSK made a positive contribution to performance and, with its defensive qualities, is well suited to the current economic climate.

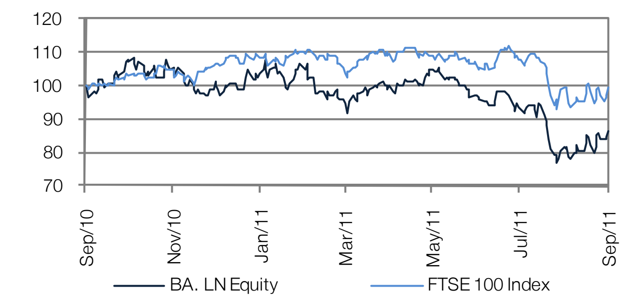
IG Group | **Code: IGG LN** | **Market Cap: £1,597m**



Div Yield (trailing 12 mths)	5.04%
Industry/Sector	General Financial/Speciality Finance
Listing	FULL
Website	www.iggroup.com

MRCH's IG Group holding, at 1.1% of the portfolio, is an example of what the manager considers to be a high-quality growth stock that is available at a modest valuation. IG is well established in the UK and Australia, and is now growing in six new countries. The manager maintains the view that IG is cash generative, has good long-term growth prospects and that IG is one of the few companies to directly benefit from recent market volatility.

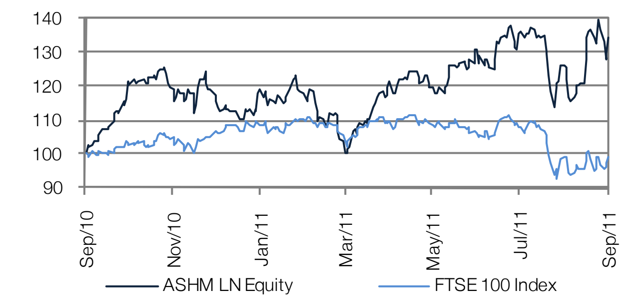
BAE Systems | **Code: BA. LN** | **Market Cap: £8,676m**



Div Yield (trailing 12 mths)	7.50%
Industry/Sector	Aerospace & Defense/Defense
Listing	FULL
Website	www.baesystems.com

At 3.8% 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 fears over government expenditure. 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.

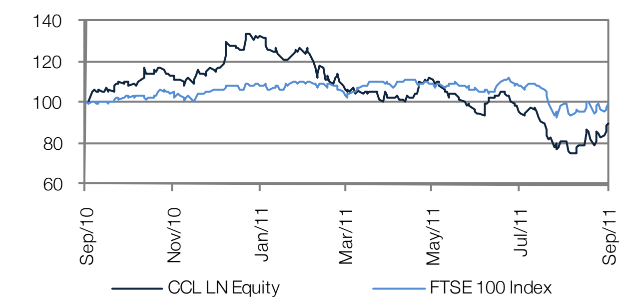
Ashmore Group | **Code: ASHM LN** | **Market Cap: £2,241m**



Div Yield (trailing 12 mths)	4.74%
Industry/Sector	Financial Services/Asset Managers
Listing	FULL
Website	www.ashmoregroup.com

At 0.5% of the portfolio, Ashmore Group (ASHM), is an example of a company exposed to emerging market growth. ASHM is a specialist investment manager with a primary focus on emerging market debt. With ongoing concerns regarding developed markets, ASHM continues to benefit from an increasing interest in emerging markets, which has led to strong inflows into its funds, raising its AUM and increasing its management fees.

Carnival | **Code: CCL LN** | **Market Cap: £16,229m**



Div Yield (trailing 12 mths)	3.01%
Industry/Sector	Travel & Leisure/Recreational Serv's
Listing	FULL
Website	www.carnival.com

MRCH's Carnival holding, at 1.1% of the portfolio, is an example of a consumer stock that could benefit from both reduced costs and increased demand if the oil price falls. The global cruise market is an oligopoly and Carnival has a 50% share. Carnival has modern ships and the dividend has been reinstated. The downturn saw supply growth trimmed from the market, leaving Carnival well positioned with the capacity to grow dividends.

Source: Thomson Datastream/Edison Investment Research

Fund profile

Managed by the RCM group of companies 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 29 years of uninterrupted dividend growth. Simon Gergel, head of RCM's value investment style team, has led the management of MRCH since April 2006.

The fund manager: Simon Gergel

Manager's view

While MRCH's portfolio has moved to a more defensive position during the last two months, reflecting the deterioration in the macro outlook, the manager is not overly bearish on equities but acknowledges that significant economic challenges and risks remain. Emerging markets are not immune to the global slowdown. In the developed world, striking the balance between the current need for looser monetary and fiscal policy to restore the recovery, versus the need to raise taxes and control budget deficits is proving to be a very difficult task for governments. However, the manager considers that compared to 2008, the economy is starting from a less elevated base and inventory levels are much lower. In addition, sterling is now more appropriately valued, monetary policy is accommodative and valuations are low in a historical context. The manager also 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, Bunzl, Inmarsat, United Business Media and IG Group.
- Seek companies with exposure to emerging market consumers – British American Tobacco, Unilever, Ashmore and Mothercare.
- Remain cautious on 'big ticket' corporate expenditure (because of the effects of a slowdown/muted recovery). However, 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 public spending were oversold in the manager's opinion, on the back of concerns about the implementation of public sector cuts. The manager considers that, due to inherent resistance in the system, implementation of the cuts these has not been as quick or as severe as the market expects. Moreover this continues to be the case, creating opportunities such as BAE Systems, Balfour Beatty, Hays and Interserve.
- Selectively overweight certain consumer-related stocks, which have been oversold (in spite of the obvious pressures on disposable income) such as Sainsbury's and Carnival. 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 50.9% of the portfolio, cash accounts for 1.1% of the portfolio, with the remaining 36 equity investments accounting for 48.0% of the portfolio. 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 20% of gross assets at the time of writing. The options usually have less than 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 2011 (the first full year) the strategy generated over £2m of additional revenue income and a net profit of c £480k once the opportunity cost of any exercised options was taken into account. For the six months ended 31 July 2011, the strategy contributed £790k of income and made a positive contribution after adjusting for opportunity costs.

Underweights

MRCH remains underweight basic materials, oil & gas, technology and financials. 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. Consumer goods, previously a mild overweight, is now a small underweight.

Overweights

MRCH's largest absolute and relative overweight is industrials, at c 2.3x the benchmark allocation (down from 2.7x at the end of March 2011) which is largely driven by holdings in aerospace and defence. Consumer services remains MRCH's second largest absolute overweight and third largest relative overweight. MRCH remains overweight in utilities and healthcare, both defensive allocations, as well as telecommunications.

Exhibit 3: Sector allocations, as at 5 September 2011

	Trust weight (%)	FTSE 100 weight (%)	Trust active weight (%)	Trust weight/ FTSE 100 weight
Industrials	10.9	4.7	6.2	2.32
Consumer services	14.3	8.3	6.0	1.72
Utilities	8.1	4.5	3.6	1.80
Telecommunications	8.9	7.1	1.8	1.25
Healthcare	9.4	8.9	0.5	1.06
Financials	17.7	17.9	(0.2)	0.99
Technology	0.0	1.2	(1.2)	0.00
Consumer goods	13.0	14.5	(1.5)	0.90
Oil & gas	14.7	19.4	(4.7)	0.76
Basic materials	1.9	13.4	(11.5)	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. However, MRCH's portfolio would ultimately benefit from an increase in domestic and global economic activity.

Top holdings

During the 12 months to 30 September 2011, the FTSE 100 index fell 4.4%. As Exhibit 4 shows, seven of MRCH's current top 10 holdings have outperformed the benchmark during this period. During the same period, seven of MRCH's top 10 holdings have outperformed both the FTSE 350 High Yield Index and FTSE All-Share Index.

Exhibit 4: 10 largest equity holdings as at 5 September 2011

Note: FTSE 100 Index one-year performance to 30 September 2011 = -4.4%.

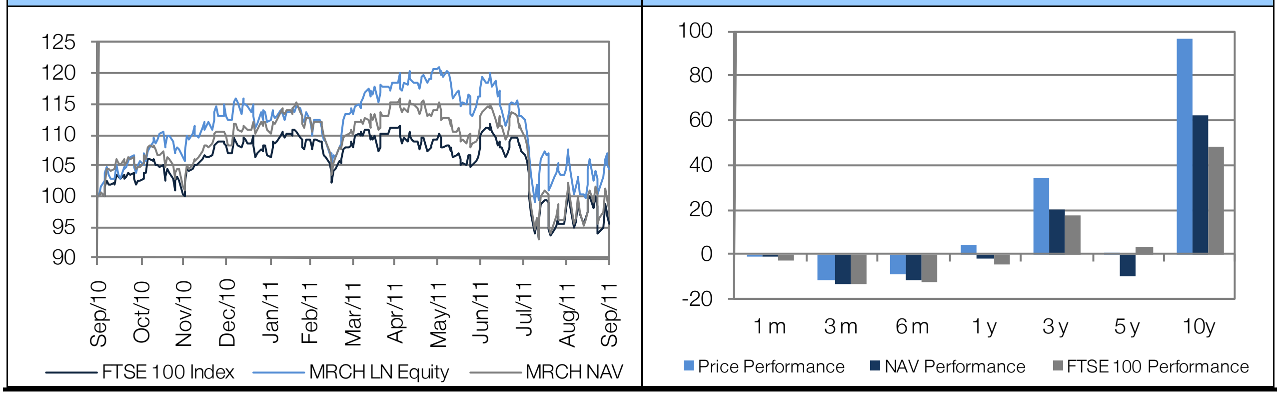
Holding	%	One year total return price performance (%)	Performance relative to FTSE 100 Index (%)
Royal Dutch Shell 'B'	8.8	13.8	18.2
GlaxoSmithKline	7.7	12.0	16.5
BP	5.9	(6.6)	(2.2)
HSBC Holdings (UK)	5.6	(20.0)	(15.6)
Vodafone Group	5.2	11.7	16.1
Unilever (UK)	4.3	14.2	18.6
BAE Systems	3.8	(17.8)	(13.4)
Scottish & Southern Energy	3.3	22.7	27.1
National Grid	3.1	20.4	24.8
British American Tobacco	3.2	25.8	30.2
Total	50.9		

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

Recent performance

Exhibit 5: 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 6: Share price and NAV total return performance (sterling adjusted), relative to benchmarks

	1 month	3 months	6 months	1 year	3 years	5 years	10 years
Price relative to FTSE 100	2.3	1.8	3.5	8.7	16.9	(3.4)	48.0
NAV relative to FTSE 100	1.4	(0.3)	0.5	2.3	3.4	(13.1)	14.5
Price relative to FTSE 350 High Yield	0.1	(2.9)	(2.2)	2.2	20.9	5.0	37.7
NAV relative to FTSE 350 High Yield	(0.8)	(5.0)	(5.2)	(4.2)	7.4	(4.7)	24.8
Price relative to FTSE All Share	2.5	2.3	3.8	8.7	14.8	(3.8)	37.4
NAV relative to FTSE All Share	1.6	0.2	0.8	2.3	1.3	(13.5)	25.1

Source: Thomson Datastream/Edison Investment Research

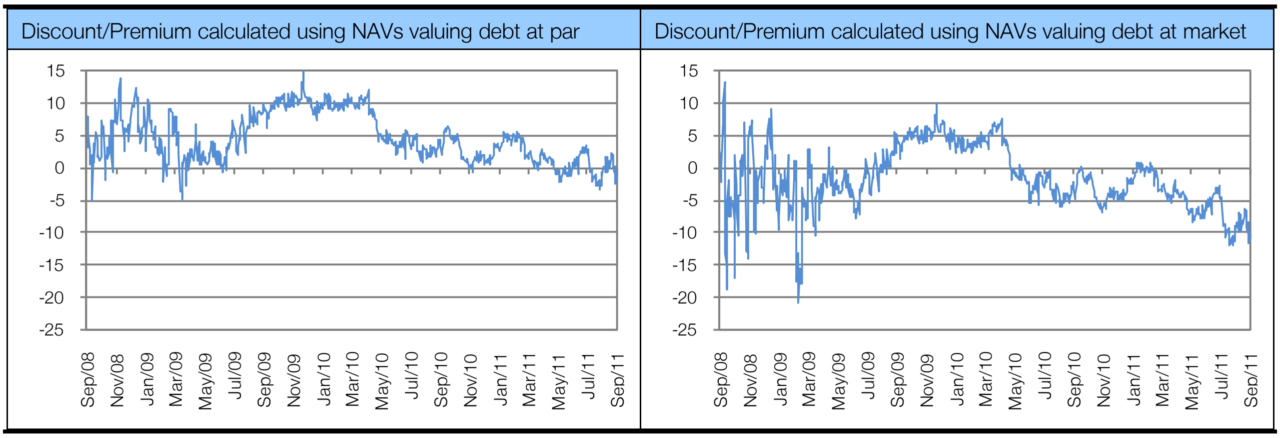
As Exhibit 5 illustrates, MRCH's performance has tended to follow that of its benchmark, the FTSE 100 index. The underperformance, apparent in more recent periods and the five-year period, reflects MRCH's investment policy to remain substantially fully invested and geared, which has affected performance during falling markets. Equally, this policy has assisted performance during rising markets. In terms of price total return, MRCH has outperformed the FTSE 100 over one month, three months, six months, one year, three years and ten years. In terms of NAV total return, MRCH has outperformed the FTSE 100 over one month, six months, one year, three years and ten years. It should also be noted that MRCH is predominantly held by private investors, as illustrated in Exhibit 1, many of whom are believed to hold it for its regular dividend and robust yield. When compared to its peers in terms of dividend yield, MRCH ranks third out of 19, as shown in Exhibit 8.

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 7 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 during the last two years has been one of a discount tightening. However, since the end of May 2010, MRCH has predominantly traded at a premium with debt valued at market. As such, there has been no recent need for the trust to use its repurchase authority and, as illustrated in Exhibit 1, MRCH has not undertaken any repurchases during the last three years. With MRCH trading at a moderate premium, we do not anticipate use of the repurchase authority in the immediate future.

Exhibit 7: Discount/premium over three years

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



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 29%. 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 0.46% for the year ended 31 January 2011 (2010 = 0.45%), which reflects the economies of scale offered by a trust of this size. As illustrated in Exhibit 8, MRCH's TER ranks third out of 18 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 2011, MRCH paid a total dividend of 22.8p, providing 29 years of uninterrupted dividend growth since 1982. During this period MRCH increased its dividend by a total of 1,001%, an average yearly increase of 8.9%, or 8.6% annualised. Because of its significant dividend obligations, the board carefully models dividend flows and reviews the income outlook six times annually. The interims indicate that, as at 31 July 2011, MRCH had revenue reserves of 24.0p per share; or 12.6p after deducting the first and second dividends each of 5.7p. MRCH generated 11.6p of revenue reserves during the first half and so, after paying the first two dividends, has added 0.2p to revenue reserves. The board expects MRCH will dip into revenue reserves to support second half distributions but they consider this appropriate when a shortfall occurs. With 12.6p of reserves available as at 31 July 2011, to support the third and fourth dividends, we are comfortable that MRCH will be able to maintain the dividend for the current financial year while retaining the capacity to smooth dividends. MRCH's policy is to invest in companies that provide at least a market yield (current yield on FTSE 100 = 3.6%). However, the ability to maintain the dividend will depend on the performance of the underlying holdings. With regard to the manager's concerns highlighted in relation to the dividend, (namely a prolonged recession, a substantial financial markets fall, a weakening US dollar and the oil price falling and staying below $40 a barrel), the manager considers that, while the outlook has deteriorated, the slowdown is not expected to be as deep as 2008, market levels and the US dollar are not immediate concerns, and an oil price fall would currently be a net benefit. Consensus opinion is for strong dividend growth into 2012.

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 10th over one year, ninth over three years and 14th over five years when considering share price total return.

Exhibit 8: UK growth and income sector, as at 30 September 2011

Company	Share price total return on £100			Total Expense Ratio	(Disc)/ Prem	Net Gearing (100 = no gearing)	5 Year Dividend Growth (%)	Div yield
	One year	Three years	Five years					
Sector average	106.7	141.5	116.3	0.76	1.3	115	3.5	4.7
Merchants Trust	104.3	134.0	100.1	0.64	5.9	127	2.7	6.2
British & American	97.0	108.9	85.4	1.78	(3.1)	156	4.0	10.6
City of London	101.7	133.8	116.4	0.49	2.1	110	5.4	5.1
F&C Capital & Income	100.0	120.3	107.9	0.91	5.6	109	3.1	4.2
Finsbury Growth & Income	106.5	174.3	122.6	1.09	1.3	107	0.4	3.0
Lowland	112.8	139.7	102.3	0.74	(6.2)	115	3.2	3.6
Perpetual Income & Growth	107.0	134.4	123.4	1.04	(1.2)	120	8.6	4.1
Value and Income	112.6	143.4	100.6	0.92	(17.5)	147	2.6	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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