EDISON

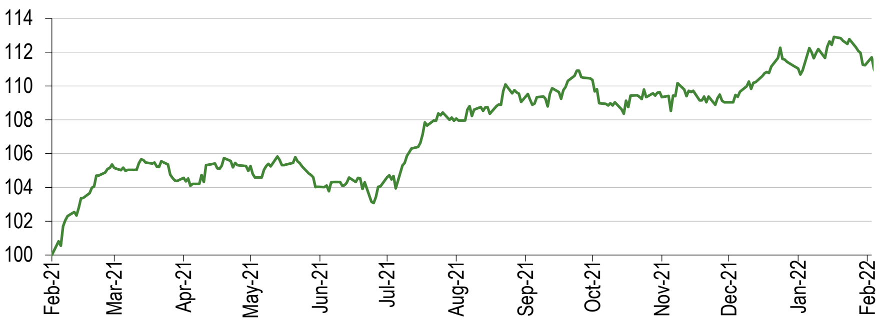
The Merchants Trust

Successfully navigating market uncertainty

Investment trusts
UK equity income

The Merchants Trust (MRCH) is managed by Allianz Global Investors' chief investment officer, UK equities, Simon Gergel. He is very pleased by how the trust's income has recovered as companies have returned to paying dividends. With an uncertain economic and investment backdrop, which has been exacerbated by the Russian invasion of Ukraine, the manager stresses the importance of focusing on companies' long-term prospects. Gergel considers MRCH's balanced portfolio of attractively valued cyclical and defensive stocks, with both domestic and international businesses, is relatively well positioned for the current environment. The trust has a commendable performance track record, having outperformed its UK benchmark over the last one, three, five and 10 years, while its NAV total return now ranks first or second versus its 16 largest peers in the AIC UK Equity income sector over the last one, three and five years.

MRCH's NAV versus the UK market over 12 months to the end of Feb 2022



Source: Refinitiv, Edison Investment Research

The analyst's view

Gergel is encouraged by MRCH's improved relative performance, which has been achieved via successful stock picking, especially given investors' preference for growth stocks for much of the last decade. However, the manager is not complacent and continues to seek high-quality, reasonably valued stocks, primarily in the UK, although the trust now has a broader income opportunity set as 10% of the fund can be invested in overseas equities. With the recent initiation of a holding in BMW, MRCH has investments in five European companies in the portfolio, which together make up c 6% of the portfolio. The trust's absolute returns have been particularly strong over the 12 months to end-February 2022, with its NAV up by 30.4% and its share price 31.6% higher, which compares with the 16.7% benchmark total return.

Regular share issuance to satisfy high demand

MRCH's shares are currently trading at a 1.8% premium to NAV, which compares to a range of an average 0.5% premium to a 2.0% discount over the last one, three, five and 10 years. Strong investor demand for the trust's shares has meant that the share base increased by 5.6% in FY22, and by a further 1.5% so far in FY23. MRCH is on track to deliver 40 consecutive years of dividend growth and offers an attractive, above-market 4.8% yield.

NOT INTENDED FOR PERSONS IN THE EEA

23 March 2022

Price	**567.0p**
Market cap	**£735m**
AUM	**£796m**
NAV*	556.8p
Premium to NAV	1.8%

*Including income. At 21 March 2022.

Dividend yield	4.8%
Shares in issue	129.6m
Code	MRCH
Primary exchange	LSE
AIC sector	UK Equity Income

52-week high/low	587.0p	492.5p
NAV* high/low	580.0p	485.9p

*Including income.

Gearing

Net gearing*	11.9%

*As at 28 February 2022.

Fund objective

The Merchants Trust's investment objective is to provide an above-average level of income and income growth, together with long-term growth of capital, through investing mainly in higher-yielding large-cap UK companies (up to 10% of the fund may be invested in overseas equities). With effect from 1 February 2017, the benchmark is a broad UK stock market index (previously an index of the 100 largest UK companies).

Bull points

- Attractive above-market dividend yield and revenue reserves equivalent to around 0.6x the last annual distribution.
- Long-term record of outperformance versus the UK stock market.
- Competitive fee structure.

Bear points

- Relative performance is likely to struggle in a growth/momentum-led market.
- FY21 dividend was not fully covered.
- UK economy is burdened by the government's heavy debt load.

Analysts

Mel Jenner	+44 (0)20 3077 5700
Sarah Godfrey	+44 (0)20 3077 5700

investmenttrusts@edisongroup.com

Edison profile page

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The manager's view: Navigating choppy waters

Gergel explains that over the last few years, he has focused on the medium to long term, looking through short-term events; however, he suggests this is difficult now, with the Russian invasion of Ukraine. 'The UK economy is improving, companies are doing well and dividends are coming back nicely', the manager reports, although higher inflation has meant the Bank of England is expected to raise interest rates. However, Gergel says that with spiking energy prices as a result of Russia's invasion of Ukraine, economic assumptions need to be revised and the risk of an inflationary shock and subsequent recession has increased; he suggests that whatever the outcome of the conflict, economic growth will undoubtably slow.

The manager comments that MRCH's portfolio is balanced and is not biased towards cyclical shares, as he is finding attractively priced defensive as well as cyclical companies. With the war as a backdrop, Gergel is considering the implications for individual investee companies and the fund as a whole; he believes there are still compelling investment cases at the stock level. Unsurprisingly, the trust's energy stocks have performed relatively well recently, as has its defensive positions and defence company BAE Systems. 'These companies are providing solid security during a time of high uncertainty', reports the manager. MRCH owns shares in five energy companies: BP, Diversified Energy Company, Energean, Shell and TotalEnergies.

Data from MRCH show that in the US, high dividend yield stocks have underperformed those with lower yields over the last decade, which is the exception to the rule; hence, Gergel believes there is good potential for MRCH's higher yielding portfolio to perform relatively better in the coming years. He comments there is a 'massive valuation polarisation within the UK', illustrating that across the broad UK market, c 20% of stocks are trading on forward P/E multiples of less than 8x, while c 15% are trading on multiples above 24x. The manager says that in aggregate, the UK is one of the most attractively valued major markets, with a good selection of companies trading on very attractive multiples.

Portfolio construction and activity

At the end of February 2022, MRCH's top 10 holdings made up 36.4% of the fund, which was a modestly lower concentration compared with 38.1% a year earlier; seven positions were common to both periods.

Exhibit 1: Top 10 holdings (at 28 February 2022)

Company	Sector	Portfolio weight %	
		28 February 2022	28 February 2021*
GlaxoSmithKline	Pharma & biotech	4.7	4.9
British American Tobacco	Tobacco	4.2	4.2
Imperial Brands	Tobacco	4.2	4.3
Shell	Oil & gas producers	3.7	3.9
Scottish & Southern Energy	Gas, water & multi-utilities	3.5	3.4
Vodafone	Telecommunications	3.4	N/A
BAE Systems	Aerospace & defence	3.3	3.4
National Grid	Gas, water & multi-utilities	3.2	N/A
WPP	Media	3.1	3.3
Drax Group	Renewable energy	3.1	N/A
Top 10 (% of portfolio)		**36.4**	**38.1**

Source: MRCH, Edison Investment Research. Note: *N/A where not in end-February 2021 top 10.

We are unable to provide a year-on-year comparison of MRCH's sector exposure in Exhibit 2 as the index sector classifications have changed during the last 12 months. The trust's largest active weights at the end of February 2022 were an above-market weighting in utilities (+6.4pp) and a below-market weighting in basic materials (-5.4pp).

Exhibit 2: Portfolio sector exposure vs benchmark (% unless stated)

	Portfolio end-February 2022	Index weight	Active weight vs index (pp)	Trust weight/ index weight (x)
Financials	21.6	22.4	(0.8)	1.0
Consumer discretionary	15.6	11.5	4.2	1.4
Consumer staples	14.7	15.3	(0.6)	1.0
Industrials	12.7	12.4	0.3	1.0
Energy	10.1	9.5	0.6	1.1
Utilities	9.9	3.5	6.4	2.8
Healthcare	6.1	10.1	(4.0)	0.6
Telecommunications	3.4	2.3	1.1	1.5
Basic materials	3.0	8.4	(5.4)	0.4
Real estate	2.0	3.2	(1.2)	0.6
Technology	0.0	1.4	(1.4)	0.0
Cash	0.9	0.0	0.9	N/A
	100.0	**100.0**		

Source: MRCH, Edison Investment Research. Note: Numbers subject to rounding.

Gergel highlights a couple of the themes represented in MRCH's portfolio. Within 'digital winners', investee company IG Group generates operating margins of 50%+. It is the market-leading UK online trading platform and is benefiting from increased volumes due to high levels of market volatility. The company generated strong results in its FY21 (ending May 2021), but its H122 numbers were higher year-on-year despite tough comparisons. Its stock is attractively priced according to the manager, with a forward P/E multiple of c 8x and c 5.5% dividend yield, and has net cash on its balance sheet. Gergel suggests the inexpensive valuation may be down to the fact that IG Group's earnings can be volatile and hard to forecast, while its business is likely to moderate in a calmer stock market environment. Its peers such as Plus500's and CMC Market's businesses are even more volatile, so IG Group may be being tarred with the same brush. Its business has become highly regulated so risks from increased supervision should now be more manageable.

The manager says that 'uncorrelated value' is an interesting theme, especially during periods of market uncertainty. Man Group is an alternative fund manager whose business has a low correlation to the stock market, its range of products include market-neutral hedge funds, while Conduit Holdings is a reinsurance company that operates in an industry that has its own cycle rather than performing in line with the economy.

In January 2022, Gergel sold MRCH's position in BHP, which had performed well, reinvesting the proceeds into Rio Tinto, which had lagged significantly. BHP had benefited from a re-rating of its oil and gas operations and was more fully valued ahead of its planned share class unification, meaning it is delisting from the UK and is also merging its energy operations with those of Australia-listed Woodside Petroleum. The manager explains the mining industry is benefiting from the rally in commodity prices, but he believes Rio Tinto still offers good value, even if prices normalise in the future. Gergel says that when investing in mining companies it is essential to understand the environmental drivers of the business. Rio Tinto's main commodity exposures are iron ore (c 70% of revenues), aluminium and copper. Aluminium and copper are both essential elements in facilitating the energy transition, hence there is high demand for these metals. Aluminium is lightweight, strong and, like copper, has good electrical conductivity properties. However, smelting aluminium requires a large amount of electricity, with much of the world's supply powered by coal in China. Rio Tinto has a structural advantage, with 80% of its production using renewable hydroelectric power in Canada making it a low-cost and low-emission producer.

Also In January 2022, Gergel initiated a position in Energean, which is a Mediterranean, predominantly natural gas (c 90%) exploration and development company listed on both the London and Tel Aviv stock exchanges. The company is soon to commission two large gas fields off the coast of Israel, which could quadruple production over the next 18 months and lead to strong cash generation well into the future. Israel has a stated objective to reduce greenhouse gas emissions by phasing out its coal generation by 2025 and Energean's gas fields are important projects to facilitate this process; they are due to come onstream this year. The company has been waiting for a bespoke floating production storage and offloading vessel to be delivered from a Singaporean shipyard as the project has been delayed. However, the manager believes that Energean is a relatively low-risk exploration and development business due to its long-term contracts with utility companies.

In February 2022, Gergel initiated a holding in BMW, bringing MRCH's overseas exposure to above 6%. The company has three brands: BMW, Mini and Rolls Royce. A global shortage of semiconductors means that premium brands have been given priority in terms of supply, while BMW has benefitted from the sharp rise in second-hand car prices and has switched production to its high-margin premium models. As the tight supply of semiconductors eases, BMW's level of profitability could decline. However, the company is strongly committed to growing its Chinese business. It has extended its joint venture with China Brilliance Automotive until 2040 and has a joint venture with Great Wall Motor Company, which should see production start in 2023; BMW aims to generate a quarter of its Chinese revenues from electric vehicles. The manager is expecting BMW to generate strong cash flow and it has a robust balance sheet, with 14% of its assets held in cash. While some investors are sceptical about BMW's range of electric vehicles and technology, Gergel believes the company has good driving technologies and its electric vehicle plans are well developed; by 2023, 90% of its model range should include an electric version. BMW has flexible manufacturing lines that can switch between electric or combustion engines meaning the company should be well positioned for the future.

The manager also sold the residual holding in Antofagasta, using to proceeds to top up the Rio Tinto position. There are concerns that the Chilean government will increase the copper royalties paid by miners, which would be a meaningful hit to the company's earnings.

Performance: Building on positive long-term record

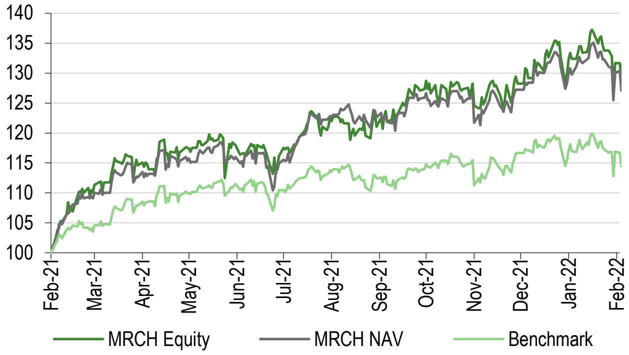
Exhibit 3: Five-year discrete performance data

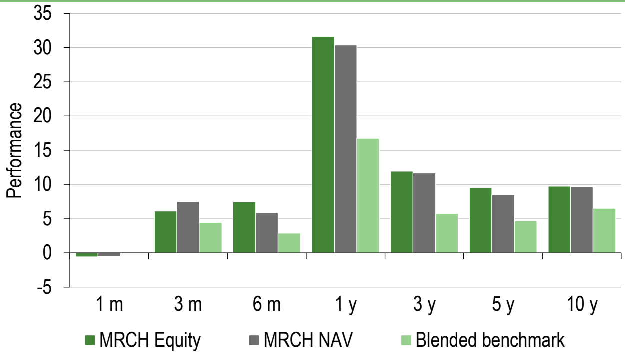
12 months ending	Share price (%)	NAV* (%)	Blended benchmark (%)	CBOE UK All companies (%)	CBOE UK 100 Companies (%)
28/02/18	5.5	6.5	4.4	4.4	3.4
28/02/19	6.7	1.4	1.7	1.7	2.1
29/02/20	4.3	1.6	(1.4)	(1.4)	(2.7)
28/02/21	2.1	5.1	2.8	2.8	6.9
28/02/22	31.6	30.4	16.7	16.7	19.4

Source: Refinitiv. Note: All % on a total return basis in pounds sterling. *NAV with debt at market value.

Gergel explains that in the 12 months to the end of January 2021, the trust had very strong performance due to positive stock selection. The largest positive contributors were Meggitt (received a takeover bid at a large premium to its pre-bid stock price), not holding Unilever (a relative underperformer over the period) and Drax Group (with rising energy prices, there is an increasing realisation about the importance of energy security; its business is supported by a stable supply of biomass woodchips and pellets). The largest detractors were a lack of exposure to HSBC Holdings and Glencore and MRCH's holding in Homeserve, which has continued to weaken despite a lack of negative newsflow.

Exhibit 4: Investment trust performance to 28 February 2022





Source: Refinitiv, Edison Investment Research. Note: Three-, five- and 10-year performance figures annualised.

Gergel has continued to build on MRCH's long-term record of outperformance, it is now ahead of its benchmark over all periods shown in Exhibit 5, except the last month. Year-to-date performance has been helped by a rotation towards low-valued stocks; positive contributors have included the trust's energy, tobacco and utility stocks. At the stock level, BAE Systems, British American Tobacco, Drax and Vodafone are among those stocks that have performed relatively well. British American Tobacco announced a share repurchase programme and its next-generation products are growing strongly. On the other side of the ledger, one of the underperforming positions is St James's Place, whose shares are market sensitive and declined during a period of stock market weakness. Not holding major mining companies Anglo American and Glencore has also detracted from MRCH's performance as these stocks have performed very well this year.

Exhibit 5: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to blended benchmark*	(0.5)	1.6	4.4	12.8	18.6	25.7	34.9
NAV relative to blended benchmark*	(0.5)	2.9	2.9	11.7	17.8	19.7	34.6
Price relative to CBOE UK All Companies	(0.5)	1.6	4.4	12.8	18.6	25.7	29.9
NAV relative to CBOE UK All Companies	(0.5)	2.9	2.9	11.7	17.8	19.7	29.7
Price relative to CBOE UK 100	(1.2)	(0.3)	1.1	10.2	12.8	20.2	29.1
NAV relative to CBOE UK 100	(1.2)	1.0	(0.4)	9.2	12.0	14.5	28.9

Source: Refinitiv, Edison Investment Research. Note: Data to end-February 2022. Geometric calculation. *Blended benchmark is UK 100 Index until 31 January 2017 and UK All-Share Index thereafter.

Exhibit 6: NAV total return performance relative to the benchmark over three years

Source: Refinitiv, Edison Investment Research

Peer group comparison

MRCH is one of 22 funds in the AIC UK Equity Income sector; in Exhibit 7, we show the largest 17 with market caps greater than £100m. The trust stacks up very well versus its peers with its NAV total return exceeding the selected group average over all periods shown. MRCH ranks first over one year, second over three and five years and fifth over the last decade.

The recent rotation towards value stocks has been positive for the trust's relative performance; however, Gergel is not complacent, and he recognises that MRCH has several strong competitors in the sector. While the manager knows he needs to continue to deliver successful stock selection, Gergel is nevertheless pleased by what has been achieved over the last year. Looking back to the MRCH review that we published on 8 March 2021, the trust ranked second, sixth and seventh out of 17 funds over one, three and five years respectively, and 11th out of 16 funds over 10 years.

At 22 February 2022, MRCH was one of four funds in the selected peer group trading at a premium to NAV, reflecting strong demand for its shares. Responding to this demand, the trust's board is regularly issuing shares at a small premium. In FY22 (ending 31 January), MRCH's shares in issue increased by 5.6% and so far in FY23 the share base has increased by a further 1.5%. The trust has a competitive ongoing charge and, in line with its peers, no performance fee is payable. Its level of gearing is above average and MRCH offers the third-highest dividend yield in the selected peer group (0.8pp above the mean).

Exhibit 7: Selected peer group at 22 February 2022*

% unless stated	Market cap £m	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Discount (cum-fair)	Ongoing charge	Perf. fee	Net gearing	Dividend yield
Merchants Trust	734.7	17.7	33.0	42.4	128.1	1.4	0.6	No	112	4.8
Aberdeen Standard Equity Inc Trust	174.8	10.9	0.3	6.4	89.7	(3.4)	0.9	No	115	6.0
BMO Capital & Income	332.1	7.0	12.3	25.0	108.9	(2.7)	0.6	No	107	3.7
BMO UK High Income Units	105.8	(2.0)	6.2	7.2	71.0	(11.6)	1.0	No	101	4.8
City of London	1,835.8	14.3	12.3	20.4	109.9	1.4	0.4	No	110	4.7
Diverse Income Trust	382.7	1.3	31.2	38.8	201.1	(3.7)	1.1	No	100	3.6
Dunedin Income Growth	444.8	2.3	18.5	28.8	100.2	0.5	0.6	No	109	4.3
Edinburgh Investment	1,093.2	12.7	12.0	8.9	102.9	(7.6)	0.4	No	104	3.8
Finsbury Growth & Income	1,837.8	4.4	13.7	39.6	210.1	(6.0)	0.6	No	101	2.1
Invesco Select UK Equity	136.8	17.3	28.6	29.1	172.2	(7.0)	0.9	No	110	3.6
JPMorgan Claverhouse	436.5	7.8	14.5	22.7	120.0	0.0	0.7	No	114	4.2
Law Debenture Corporation	997.3	12.8	37.3	50.4	175.2	1.3	0.5	No	113	3.6
Lowland	345.8	9.1	11.2	9.7	107.1	(8.8)	0.6	No	114	4.7
Murray Income Trust	1,016.4	9.8	20.9	32.0	110.9	(5.5)	0.5	No	110	4.0
Schroder Income Growth	211.9	11.6	16.6	23.1	122.4	(2.6)	0.8	No	112	4.2
Temple Bar	770.2	5.4	(0.1)	10.0	84.2	(3.2)	0.5	No	107	3.4
Troy Income & Growth	231.6	9.4	7.3	15.3	98.2	(1.2)	0.9	No	100	2.6
Selected group average (17 funds)	**652.2**	**8.9**	**16.2**	**24.1**	**124.2**	**(3.4)**	**0.7**		**108**	**4.0**
MRCH rank	**7**	**1**	**2**	**2**	**5**	**2**	**8**		**6**	**3**

Source: Morningstar, Edison Investment Research. Note: *Performance to 21 February 2022. NAV with debt at par. TR, total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

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Frankfurt +49 (0)69 78 8076 960	London +44 (0)20 3077 5700	New York +1 646 653 7026	Sydney +61 (0)2 8249 8342
Schumannstrasse 34b	280 High Holborn	1185 Avenue of the Americas	Level 4, Office 1205
60325 Frankfurt	London, WC1V 7EE	3rd Floor, New York, NY 10036	95 Pitt Street, Sydney
Germany	United Kingdom	United States of America	NSW 2000, Australia