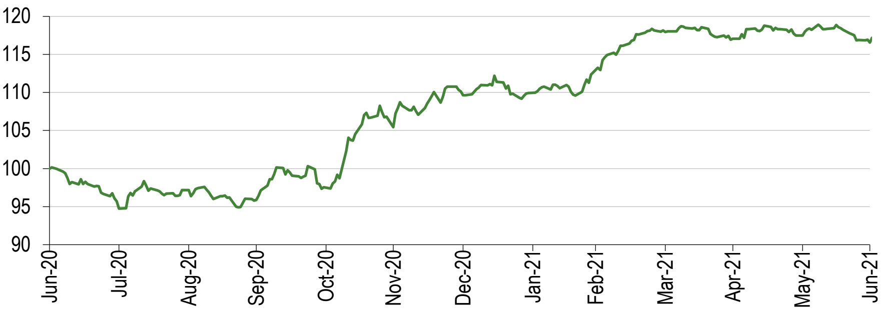
The Merchants Trust

Finding high-quality, well priced opportunities

Investment trusts
UK equity income

The Merchants Trust (MRCH) is managed by Simon Gergel who is chief investment officer, UK equities, at Allianz Global Investors. He stresses that being a value investor does not mean buying bad businesses, and the polarised UK market is enabling him to invest in high-quality companies at reasonable prices. While the manager experienced a tough period of relative performance during the coronavirus-led market sell-off in early 2020, he adhered to his long-term, high-conviction process, which was the correct strategy as shown by the meaningful performance improvement in the chart below. MRCH consistently offers an above-market dividend yield (currently 5.3%).

MRCH's NAV versus the UK market over 12 months to the end of June 2021



Source: Refinitiv, Edison Investment Research

The analyst's view

MRCH now has a broader remit as it is able to invest up to 10% of the fund in overseas equities. Gergel has taken advantage of this feature by investing in four European companies (so far, he has not considered it necessary to look further afield): Sanofi (pharma), SCOR and Swiss Re (both reinsurance) and TotalEnergies (energy), which in aggregate make up c 5% of the portfolio. The trust offers shareholders a diversified fund of high-quality, attractively valued businesses and an above-average dividend yield. In recent months, MRCH's relative performance has benefited from an increased investor interest in value/cyclical shares as confidence has grown about a post-pandemic economic recovery following successful COVID-19 vaccine trials in early November 2020, and the trust has outperformed its benchmark over the last one, three, five and 10 years. The prospects for MRCH's income have improved as company balance sheets are strengthening as we return to a more normal living environment, and the board is committed to growing the trust's annual dividend, which has occurred for the last 39 consecutive financial years.

Regularly issuing shares

MRCH's shares are currently trading at a 0.7% premium to NAV, which compares to a 0.2% to 2.4% range of average discounts over the last one, three, five and 10 years. High demand for the trust's shares has meant that so far in FY22 (January year-end) an additional c 3.6m shares (c 3.0% of the base) have been issued; c 8.1m (c 7.2% of the base) were issued in FY21.

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26 July 2021

Price	**509.0p**
Market cap	**£634m**
AUM	**£716m**
NAV*	505.6p
Premium to NAV	0.7%
*Including income. As at 23 July 2021.	
Dividend yield	5.3%
Shares in issue	124.6m
Code	MRCH
Primary exchange	LSE
AIC sector	UK Equity Income

52-week high/low	532.0p	325.0p
NAV* high/low	528.1p	333.2p

*Including income.

Gearing

Net gearing* 14.2%

*As at 30 June 2021.

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 two-thirds of 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 uncovered.
- UK economy is burdened by the government's heavy debt load.

Analysts

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The manager's view: UK market is attractively valued

Gergel highlights the importance of dividends, which have provided the bulk of total returns in the UK market over the last 20 years. He explains that while the investment backdrop is now quieter, at the end of 2020 there was a big rotation from higher-growth/quality stocks into value names due to increased confidence about an economic recovery following positive COVID-19 vaccine trails. The more intense investor focus on valuation has been beneficial for MRCH's relative performance; sectors that have performed well in recent months include banks and housebuilders, both of which are represented in the trust's portfolio.

The manager notes that, in aggregate, UK stocks are inexpensive compared with other major markets, with the UK market at a 40-year extreme discount versus European stocks despite receding Brexit risks. Hence, he considers there is a big opportunity in selected UK shares. Gergel explains that the UK market remains polarised, with value shares trading at a significant discount to growth stocks, meaning he is still able to buy good companies at a discount to their intrinsic value despite their share prices rallying in recent months. The manager says that there are a significant number of UK companies trading on high or low forward P/E multiples 'with not much in the middle'. MRCH's portfolio is skewed towards stocks trading on lower valuations (in aggregate, around a 20% discount versus the benchmark).

Gergel can now invest up to 10% of MRCH's portfolio in overseas equities. The trust was originally launched as an international fund, but over the last 20 years or so has solely invested in UK equities (although it should be noted that the majority of UK companies' sales and profits are generated overseas). The manager explains that during the pandemic the opportunity set to invest in higher-yielding UK companies declined as a number of firms cut their dividends. With a more concentrated UK market the board considered it prudent to allow investment in overseas equities, opening up more opportunities to diversify the portfolio and MRCH's income stream.

Recent company meetings have involved discussions about inflationary pressures stemming from material shortages and logistics problems such as a lack of available shipping containers. Gergel says that there are initial signs of wage inflation, and it is an important issue for him to determine which firms will be able to pass on higher costs; he comments that so far, higher prices have been neutral or beneficial, rather than a problem, for portfolio companies.

The manager highlights some of the themes represented in MRCH's portfolio: environmental change enablers, undervalued growth and uncorrelated value.

- Environmental change enablers: undervalued environmental, social and governance (ESG) plays – Gergel believes that decarbonisation companies such as Drax and SSE are likely to achieve premium valuations. He says that while many businesses within this theme are already expensive, there are some attractive opportunities available.
- Undervalued growth: misunderstood growth potential – the manager is focused on companies that he deems to be sensibly priced such as market-leading St James's Place and Legal & General, whose saving and investment businesses are benefiting from higher wealth creation. Gergel explains that SThree's recruitment operations performed relatively well in the latest economic downturn by providing staff to the IT and life sciences sectors; its STEM (science, technology, engineering and maths) focus is serving the company well and over the last six months its business has rebounded to above pre-pandemic levels.
- Uncorrelated value: defensive and differentiated – the manager suggests that investors do not pay enough attention to companies' idiosyncratic exposure, which offers diversification away from economic and market cycles, such as reinsurance companies. Man Group is an asset manager but has market-neutral and trend-following strategies, which have low correlations to equity and bond markets. Diversified Gas & Oil buys up energy companies' non-core North

American wells (broadening its portfolio brings economies of scale) and hedges its production, making its business less susceptible to energy price moves. The firm is generating strong cash flow and has an attractive dividend yield.

Portfolio construction and activity

Exhibit 1: Portfolio sector exposure vs benchmark (% unless stated)

	Portfolio end-June 2021	Index weight	Active weight vs index (pp)	Trust weight/ index weight (x)
Financials	19.2	22.7	(3.5)	0.8
Industrials	17.7	12.7	5.0	1.4
Consumer staples	15.9	15.7	0.3	1.0
Consumer discretionary	14.7	12.3	2.4	1.2
Energy	9.5	7.5	1.9	1.3
Utilities	8.4	3.0	5.4	2.8
Healthcare	6.5	9.3	(2.7)	0.7
Telecommunications	3.4	2.3	1.1	1.5
Basic materials	2.3	9.5	(7.2)	0.2
Real estate	1.3	3.1	(1.8)	0.4
Technology	0.0	2.0	(2.0)	0.0
Cash	1.0	0.0	1.0	N/A
	100.0	**100.0**		

Source: The Merchants Trust, Edison Investment Research. Note: Numbers subject to rounding.

MRCH's sector exposure is shown in Exhibit 1, it is not possible to compare the weightings year-on-year due to a recent change in index classifications. Gergel's active approach is illustrated by the trust's largest divergencies to its benchmark with overweight exposures to utilities (+5.4pp) and industrials (+5.0pp), with below-index weightings in basic materials (-7.2pp) and financials (-3.5pp).

There have been quite a lot of changes within the portfolio since our last published note in March 2021, and the manager has taken the opportunity to lock in profits in some of MRCH's cyclical holdings that have performed well. He sold the positions in BT and CRH as their shares had re-rated, and also Hammerson once its share price recovered, along with the small remaining holding in Standard Life Aberdeen (now known as abrdn), whose operational turnaround has proved to be problematic.

There is a lack of UK reinsurance companies in which to invest, so Gergel has initiated positions in France-listed SCOR and Swiss Re. He says that the reinsurance pricing cycle is favourable – natural catastrophes in recent years have led to significant industry losses, which in turn leads to firmer pricing. The manager says that SCOR and Swiss Re are modestly valued and offer attractive dividend yields. France-listed pharma company Sanofi was added to the portfolio; it is not dissimilar to GlaxoSmithKline as it also has a large consumer unit. The manager believes that the company has good growth prospects such as monoclonal antibody Dupixent for the treatment of allergic diseases including eczema and asthma, but is trading at an attractive valuation. He says that Sanofi is being managed more aggressively; as an example, the number of stock keeping units in the consumer division has been reduced in order to focus on the company's stronger brands. Another new position is France-listed TotalEnergies which, like BP and Royal Dutch Shell, is transitioning its business into renewable energy. However, unlike its peers, TotalEnergies has maintained the level of its dividends. Gergel is optimistic about the company's high cash flow generation and prospects for the oil & gas sector, which he considers to be undervalued and out of favour with investors despite a rising oil price.

There is a new holding in RELX. The manager says that this position provides exposure to strong businesses with good growth potential at a sensible price. The company is a global provider of information and data services to the STEM, risk and legal sectors plus it has an exhibition business. Over the last 20 years, RELX has been transitioning its operations from print to digital distribution, which is accelerating its growth rate. It is the number one global scientific publisher (including The

Lancet medical journal) and the second largest legal publisher with a significant operation in the US. The company's risk businesses are growing rapidly in areas such as insurance and cyber information. RELX's exhibition division has been hit hard by the global pandemic, but the manager expects this business to recover despite underlying industry changes. The company has a c 5% free cash flow yield and at the time of purchase offered a 3% dividend yield.

In June 2021, Gergel initiated two new positions in leading UK supermarket Tesco and Drax. Food retailers have experienced strong business trends during the pandemic and have responded well to the competitive threats from low price operators Aldi and Lidl, which lack significant online operations. Tesco on the other hand has ramped up its delivery service and is also the UK's largest wholesaler following its 2018 acquisition of Booker. The company's catering and banking businesses are improving, and Tesco has sold its Asian and Polish divisions to refocus on its UK, Irish and other Eastern European operations. Tesco has modest capex requirements and is generating high levels of free cash flow. Its shares have derated, despite the company's market leadership position, and are trading on a c 13x forward P/E multiple, and the firm has a c 9% free cash flow yield. There has been increased investor interest in the food retailing sector recently following bids for competitor Morrisons.

Drax operated the UK's biggest coal-fired power station, but it was retrofitted to use biomass wood chips and pellets; earlier this year the company acquired Canada-based wood pellet producer Pinnacle Renewable Energy. Drax also has hydroelectric assets, so there is more than one strand to its business. It has very low carbon emissions as carbon is absorbed by its growing forests. Most of the timber produced in North America is used in the construction industry, while sawdust and unused small pieces of wood are used for biomass. The company is generating significant cash flow and profits due to attractively priced contracts extending out to 2027. Investors question what happens after Drax's long-term contracts expire; however, Gergel believes that the company's downside risk is limited if they are not renewed given its hydroelectric assets, wood pellets business and a power system stability contract with National Grid. He also considers that Drax has significant upside potential due to its bioenergy carbon capture and storage system. CO_2 is pumped into the ground (into old oil wells) and the business is carbon negative; these types of projects will be necessary for the UK to reach its 2050 carbon-neutral targets. Drax's operation will require subsidies from the UK government, which considers carbon neutrality one its high-profile objectives. The company provides one of the few ways that this can be achieved in scale. News about government subsidies is likely in the next 12–18 months, which the manager suggests could transform the economics of Drax's business. As one of the few carbon-negative plays in the UK stock market, he believes the company could attract significant investor interest.

Performance: Successful start to 2021

Exhibit 2: Five-year discrete performance data

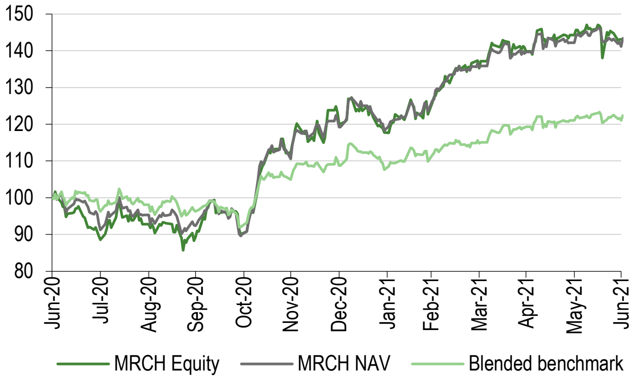
12 months ending	Share price (%)	NAV* (%)	Blended benchmark **(%)	CBOE UK All companies (%)	CBOE UK 100 Companies (%)
30/06/17	24.8	21.1	17.7	18.1	16.9
30/06/18	17.0	15.6	9.0	9.0	8.7
30/06/19	(2.6)	(6.6)	0.6	0.6	1.6
30/06/20	(16.4)	(16.1)	(13.0)	(13.0)	(8.5)
30/06/21	43.1	41.1	21.1	21.1	17.7

Source: Refinitiv. Note: All % on a total return basis in pounds sterling. *NAV with debt at market value. **Blended benchmark is UK 100 Index until 31 January 2017 and UK All-Share Index thereafter.

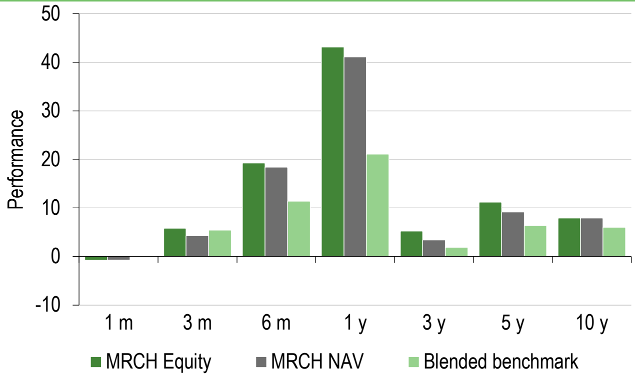
MRCH's relative return record has progressed nicely, and the trust is ahead of its benchmark in both NAV and share price terms over almost all of the periods shown in Exhibit 4. Gergel explains that economic recovery and higher investor confidence have been beneficial for the trust's performance over the last six months. Positive contributors this year include Tyman, Barclays, SThree, WPP, Man Group, St James's Place and DFS; these are cyclical businesses that are benefiting from a stronger economy. Companies that have detracted from MRCH's relative performance include not holding positions in Lloyds, Glencore and Anglo American. The manager is encouraged that there have not been any 'blow-ups' in the portfolio so far in 2021.

Exhibit 3: Investment trust performance to 30 June 2020

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



Price, NAV and benchmark total return performance (%)



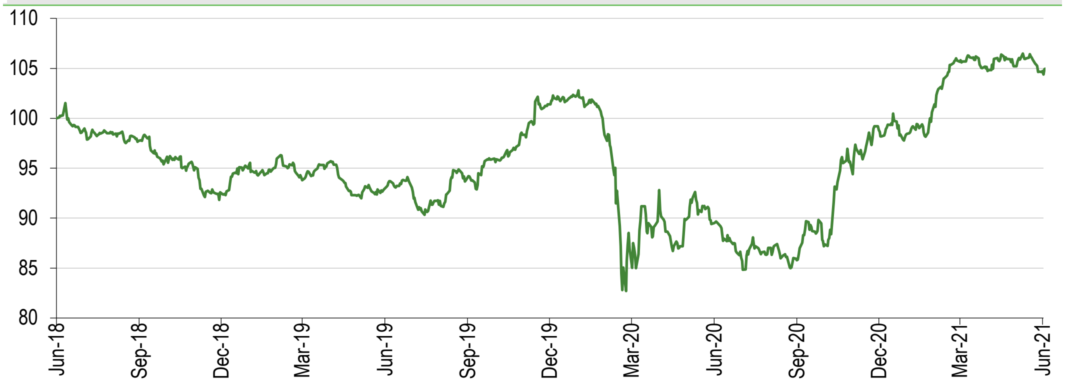
Source: Refinitiv, Edison Investment Research. Note: Three-, five- and 10-year performance figures annualised.

Exhibit 4: 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	(0.8)	0.4	7.1	18.2	10.1	25.3	20.1
NAV relative to blended benchmark	(0.8)	(1.1)	6.3	16.6	4.4	14.0	20.0
Price relative to CBOE UK All Companies	(0.8)	0.4	7.1	18.2	10.1	24.8	16.3
NAV relative to CBOE UK All Companies	(0.8)	(1.1)	6.3	16.6	4.4	13.5	16.2
Price relative to CBOE UK 100	(1.1)	0.4	7.5	21.6	6.6	22.5	17.4
NAV relative to CBOE UK 100	(1.0)	(1.1)	6.8	19.9	1.1	11.4	17.3

Source: Refinitiv, Edison Investment Research. Note: Data to end-June 2021. Geometric calculation.

Exhibit 5: NAV total return performance relative to the benchmark over three years



Source: Refinitiv, Edison Investment Research

Peer group comparison

There are 22 funds in the AIC UK Equity Income sector. In Exhibit 6, we show the 17 largest that have market caps above £100m. MRCH's NAV total return is above the selected group average over one, three and five years, ranking first, seventh and seventh respectively, while trailing over the last decade, ranking 12th. The trust's NAV total returns rank favourably versus other value strategy funds such as Edinburgh Investment and Temple Bar. Due to strong investor demand, MRCH now often trades at a small premium, unlike the majority of its peers, and there has been active share issuance, thereby spreading costs over a larger base and increasing liquidity. The trust has a competitive ongoing charge, and no performance fee is payable; its level of gearing is above the mean. Gergel explains that some of MRCH's peers have either maintained or cut their dividends (Temple Bar and Troy Income & Growth), whereas the trust has a growing distribution, and the board has stressed its commitment to this strategy. Based on its current share price, MRCH offers a 5.3% dividend yield, which is the second highest in the selected peer group (1.4pp above average).

Exhibit 6: Selected peer group as at 23 July 2021*

% 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	634.4	40.3	10.7	46.9	107.9	0.7	0.6	No	114	5.3
Aberdeen Standard Equity Inc Trust	168.7	30.5	(7.3)	19.0	82.6	(8.3)	0.9	No	111	5.9
BMO Capital & Income	353.5	30.3	10.3	48.9	116.0	(0.9)	0.6	No	105	3.6
BMO UK High Income Units	125.6	21.4	7.0	27.2	88.1	(5.5)	1.0	No	111	4.1
City of London	1,770.6	18.7	4.9	24.7	102.7	1.8	0.4	No	107	4.8
Diverse Income Trust	411.7	32.6	25.8	62.4	235.6	(2.4)	1.1	No	100	3.2
Dunedin Income Growth	466.7	18.6	25.5	48.4	114.1	(3.4)	0.6	No	105	4.1
Edinburgh Investment	1,036.5	25.3	(2.7)	9.7	103.9	(8.5)	0.4	No	107	4.0
Finsbury Growth & Income	2,060.9	14.1	19.1	61.4	240.8	(3.2)	0.6	No	101	1.8
Invesco Select UK Equity	149.4	32.9	12.3	33.3	165.8	(6.0)	0.9	No	111	3.7
JPMorgan Claverhouse	441.1	28.7	6.5	42.5	112.7	0.2	0.7	No	116	4.2
Law Debenture Corporation	914.6	36.5	24.8	63.8	161.1	0.6	0.6	No	111	3.8
Lowland	362.7	39.2	(0.3)	29.3	108.5	(4.4)	0.6	No	115	4.5
Murray Income Trust	1,045.2	21.0	23.7	49.3	121.6	(7.4)	0.6	No	110	3.9
Schroder Income Growth	215.0	31.3	9.3	37.5	122.2	(0.6)	0.9	No	109	4.1
Temple Bar	696.8	33.6	(9.0)	15.2	80.3	(7.2)	0.5	No	108	3.7
Troy Income & Growth	251.9	10.1	10.0	22.2	109.8	(1.6)	0.9	No	100	1.9
Selected group average (17 funds)	**653.3**	**27.4**	**10.0**	**37.8**	**127.9**	**(3.3)**	**0.7**		**108**	**3.9**
MRCH rank	**7**	**1**	**7**	**7**	**12**	**2**	**12**		**3**	**2**

Source: Morningstar, Edison Investment Research. Note: *Performance to 22 July 2021. 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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