

The Merchants Trust

Finding high-quality, well priced opportunities

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.

Investment trusts
UK equity income

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

Mel Jenner +44 (0)20 3077 5720

Sarah Godfrey +44 (0)20 3681 2519

investmenttrusts@edisongroup.com

[Edison profile page](#)

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

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 trials. 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. CO₂ 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 of 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

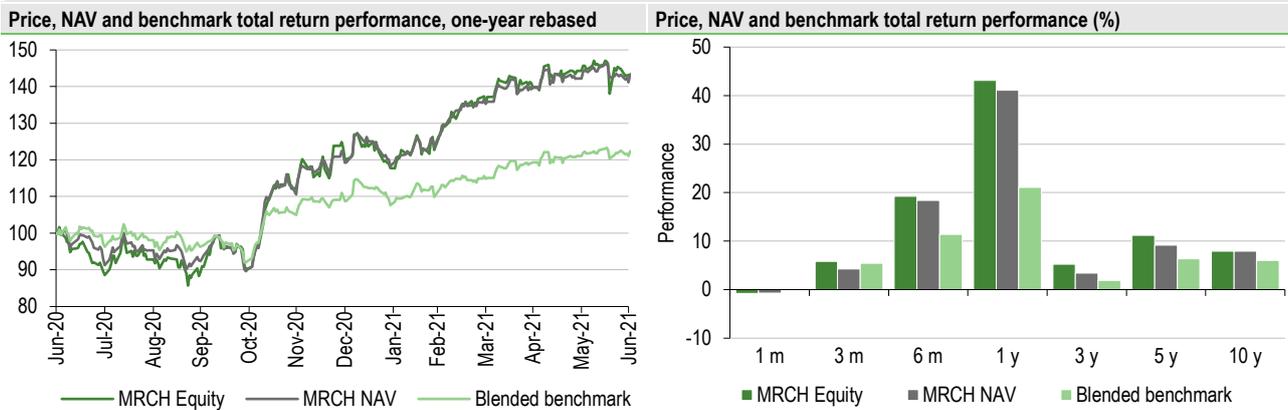
12 months ending	Share price (%)	NAV* (%)	Blended benchmark ** (%)	CBOE UK All companies (%)	CBOE UK 100 Companies (%)
30/06/17	24.8	21.1	17.7	18.1	16.9
30/06/18	17.0	15.6	9.0	9.0	8.7
30/06/19	(2.6)	(6.6)	0.6	0.6	1.6
30/06/20	(16.4)	(16.1)	(13.0)	(13.0)	(8.5)
30/06/21	43.1	41.1	21.1	21.1	17.7

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



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.

General disclaimer and copyright

This report has been commissioned by The Merchants Trust and prepared and issued by Edison, in consideration of a fee payable by The Merchants Trust. Edison Investment Research standard fees are £49,500 pa for the production and broad dissemination of a detailed note (Outlook) following by regular (typically quarterly) update notes. Fees are paid upfront in cash without recourse. Edison may seek additional fees for the provision of roadshows and related IR services for the client but does not get remunerated for any investment banking services. We never take payment in stock, options or warrants for any of our services.

Accuracy of content: All information used in the publication of this report has been compiled from publicly available sources that are believed to be reliable, however we do not guarantee the accuracy or completeness of this report and have not sought for this information to be independently verified. Opinions contained in this report represent those of the research department of Edison at the time of publication. Forward-looking information or statements in this report contain information that is based on assumptions, forecasts of future results, estimates of amounts not yet determinable, and therefore involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of their subject matter to be materially different from current expectations.

Exclusion of Liability: To the fullest extent allowed by law, Edison shall not be liable for any direct, indirect or consequential losses, loss of profits, damages, costs or expenses incurred or suffered by you arising out of or in connection with the access to, use of or reliance on any information contained on this note.

No personalised advice: The information that we provide should not be construed in any manner whatsoever as, personalised advice. Also, the information provided by us should not be construed by any subscriber or prospective subscriber as Edison's solicitation to effect, or attempt to effect, any transaction in a security. The securities described in the report may not be eligible for sale in all jurisdictions or to certain categories of investors.

Investment in securities mentioned: Edison has a restrictive policy relating to personal dealing and conflicts of interest. Edison Group does not conduct any investment business and, accordingly, does not itself hold any positions in the securities mentioned in this report. However, the respective directors, officers, employees and contractors of Edison may have a position in any or related securities mentioned in this report, subject to Edison's policies on personal dealing and conflicts of interest.

Copyright: Copyright 2021 Edison Investment Research Limited (Edison).

Australia

Edison Investment Research Pty Ltd (Edison AU) is the Australian subsidiary of Edison. Edison AU is a Corporate Authorised Representative (1252501) of Crown Wealth Group Pty Ltd who holds an Australian Financial Services Licence (Number: 494274). This research is issued in Australia by Edison AU and any access to it, is intended only for "wholesale clients" within the meaning of the Corporations Act 2001 of Australia. Any advice given by Edison AU is general advice only and does not take into account your personal circumstances, needs or objectives. You should, before acting on this advice, consider the appropriateness of the advice, having regard to your objectives, financial situation and needs. If our advice relates to the acquisition, or possible acquisition, of a particular financial product you should read any relevant Product Disclosure Statement or like instrument.

New Zealand

The research in this document is intended for New Zealand resident professional financial advisers or brokers (for use in their roles as financial advisers or brokers) and habitual investors who are "wholesale clients" for the purpose of the Financial Advisers Act 2008 (FAA) (as described in sections 5(c) (1)(a), (b) and (c) of the FAA). This is not a solicitation or inducement to buy, sell, subscribe, or underwrite any securities mentioned or in the topic of this document. For the purpose of the FAA, the content of this report is of a general nature, is intended as a source of general information only and is not intended to constitute a recommendation or opinion in relation to acquiring or disposing (including refraining from acquiring or disposing) of securities. The distribution of this document is not a "personalised service" and, to the extent that it contains any financial advice, is intended only as a "class service" provided by Edison within the meaning of the FAA (i.e. without taking into account the particular financial situation or goals of any person). As such, it should not be relied upon in making an investment decision.

United Kingdom

This document is prepared and provided by Edison for information purposes only and should not be construed as an offer or solicitation for investment in any securities mentioned or in the topic of this document. A marketing communication under FCA Rules, this document has not been prepared in accordance with the legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research.

This Communication is being distributed in the United Kingdom and is directed only at (i) persons having professional experience in matters relating to investments, i.e. investment professionals within the meaning of Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, as amended (the "FPO") (ii) high net-worth companies, unincorporated associations or other bodies within the meaning of Article 49 of the FPO and (iii) persons to whom it is otherwise lawful to distribute it. The investment or investment activity to which this document relates is available only to such persons. It is not intended that this document be distributed or passed on, directly or indirectly, to any other class of persons and in any event and under no circumstances should persons of any other description rely on or act upon the contents of this document.

This Communication is being supplied to you solely for your information and may not be reproduced by, further distributed to or published in whole or in part by, any other person.

United States

Edison relies upon the "publishers' exclusion" from the definition of investment adviser under Section 202(a)(11) of the Investment Advisers Act of 1940 and corresponding state securities laws. This report is a bona fide publication of general and regular circulation offering impersonal investment-related advice, not tailored to a specific investment portfolio or the needs of current and/or prospective subscribers. As such, Edison does not offer or provide personal advice and the research provided is for informational purposes only. No mention of a particular security in this report constitutes a recommendation to buy, sell or hold that or any security, or that any particular security, portfolio of securities, transaction or investment strategy is suitable for any specific person.

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
1185 Avenue of the Americas
3rd Floor, New York, NY 10036
United States of America

Sydney +61 (0)2 8249 8342
Level 4, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia