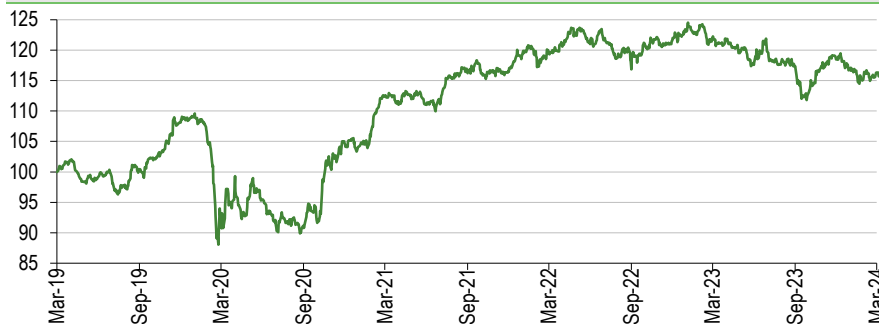


The Merchants Trust

Celebrating its 135th anniversary

The Merchants Trust's (MRCH's) manager, Simon Gergel at Allianz Global investors, is very excited about the number of reasonably priced opportunities available in the UK market. Also, good income generation from the trust's portfolio of high-quality companies with robust fundamentals enabled MRCH to record another consecutive dividend increase in FY24; it now has a 42-year track record. The trust's attractive 5.1% dividend yield is one of the highest in the 19-strong AIC UK Equity Income sector and its NAV total return over the last three, five and 10 years is superior versus the peers with a higher yield. MRCH could be seen as a good income play in a scenario of improving investor sentiment towards UK companies, which Gergel envisages given the more stable political environment (as the two main political parties' policies are now less divergent) and signs of improvement in the UK economy.

Notable NAV outperformance versus the benchmark over the last five years



Source: LSEG, Edison Investment Research

Why consider MRCH?

With the UK market close to the low end of its 20-year valuation range and a wide divergence between how individual UK companies are valued, Gergel is very upbeat about MRCH's prospects. The trust offers a diverse portfolio of around 50, primarily UK, stocks with an attractive, consistently above-market dividend yield and the manager has a solid medium- and long-term track record. The trust's NAV is ahead of its benchmark over the last three, five and 10 years and its NAV total return ranks second out of 19 funds in the AIC UK Equity Income sector over the last five years.

MRCH's 42-year record of consecutive higher annual payouts has earned the trust 12th place on the AIC's list of 20 dividend heroes, which are funds that have at least a 20-year unbroken record of dividend increases. The trust's income per share is now higher than pre-COVID-19 levels and its revenue reserves are equivalent to around 0.6x the annual dividend.

Despite an uncertain macroeconomic backdrop, which has seen many investment companies trading at wider discounts than their historical averages, demand for MRCH's shares has remained relatively robust. The trust regularly traded at a premium during FY24, allowing the board to issue shares from treasury. MRCH's share base increased by c 5.8% raising c £46.0m.

Investment trusts
UK equity income

30 April 2024

Price 560.0p
Market cap £831m
Total assets £933m

NAV* 563.2p

Discount to NAV 0.6%

*Including income. At 26 April 2024.

Dividend yield 5.1%

Shares in issue 148.3m

Code/ISIN MRCH/GB0005800072

Primary exchange LSE

AIC sector UK Equity Income

Financial year end 31 January

52-week high/low 579.0p 477.5p

NAV* high/low 575.9p 484.5p

*Including income.

Gearing

Net gearing* 11.7%

*Morningstar at 29 April 2024.

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). The benchmark is a broad UK stock market index.

Bull points

- Long-term record of outperformance versus the UK stock market.
- Attractive above-market dividend yield and commendable 42-year record of higher annual payments.
- Competitive fee structure.

Bear points

- The UK has been out of favour with global investors since the 2016 Brexit vote.
- A relatively high level of gearing should amplify capital losses in a falling market.
- Relative performance is likely to struggle in a growth/momentum-led market.

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MRCH: Prospects of income and income/capital growth

MRCH has a strong pedigree; having launched in February 1889, the trust is celebrating its 135th anniversary. Gergel aims to deliver a high and rising income and robust capital growth from a portfolio of reasonably priced, primarily UK equities. MRCH is one of just 20 companies in the AIC's list of dividend heroes, which have increased their annual dividend for at least 20 consecutive years. The trust has a long-term record of outperformance and a competitive fee structure.

Recent news

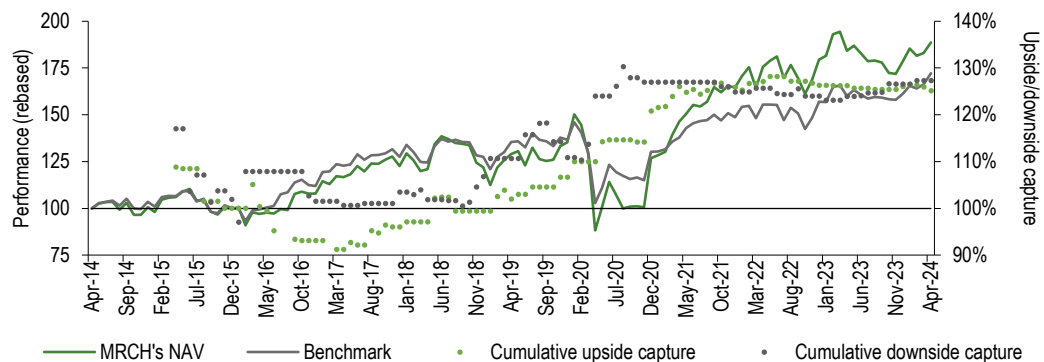
MRCH released its annual results; unfortunately, after two consecutive years of outperformance, in FY24, the trust's NAV and share price total returns did not keep up with the benchmark's total return. For more detail, please see the following Performance section. MRCH has a competitive fee structure, which ranks highly in the AIC UK Equity Income sector. In FY24, its ongoing charge of 0.55% was 1bp lower year-on-year. Due to strong demand for the trust's shares, they traded at a premium for a large part of FY24 and c 8.2m shares were issued (c 5.8% of the share base) raising c £46.0m.

Board changes – having each attained nine years of service, two of MRCH's directors retired, Mary Ann Sieghart on 25 January and senior independent director Sybella Stanley on 21 March 2024; her role has transitioned to Karen McKellar. There are two new independent directors. Lisa Edgar joined the board on 1 January 2024; she was previously chief customer officer at Saga and is founder/CEO of Big Window Consulting, which has meaningful experience in financial services. Mal Patel was appointed on 1 March 2024; he is head of investor relations at Spirax Group and has held a series of senior positions at large UK companies.

MRCH's upside/downside analysis

The trust's upside and downside capture rates over the last decade of 125% and 127% are well above 100%. This confirms the manager's unconstrained approach and his willingness to take stock and sector positions that deviate from the benchmark. With both rates broadly the same, it suggests that MRCH is likely to outperform by around a quarter of the market move when share prices are rising and underperform by a similar degree in a falling market.

Exhibit 1: MRCH's upside/downside capture over the last 10 years



Source: LSEG, Edison Investment Research. Note: Cumulative upside/downside capture calculated as the geometric average NAV total return (TR) of the fund during months with positive/negative reference index TRs, divided by the geometric average reference index TR during these months. A 100% upside/downside indicates that the fund's TR was in line with the reference index's during months with positive/negative returns. Data points for the initial 12 months have been omitted in the exhibit due to the limited number of observations used to calculate the cumulative upside/downside capture ratios.

MRCH's portfolio breakdown

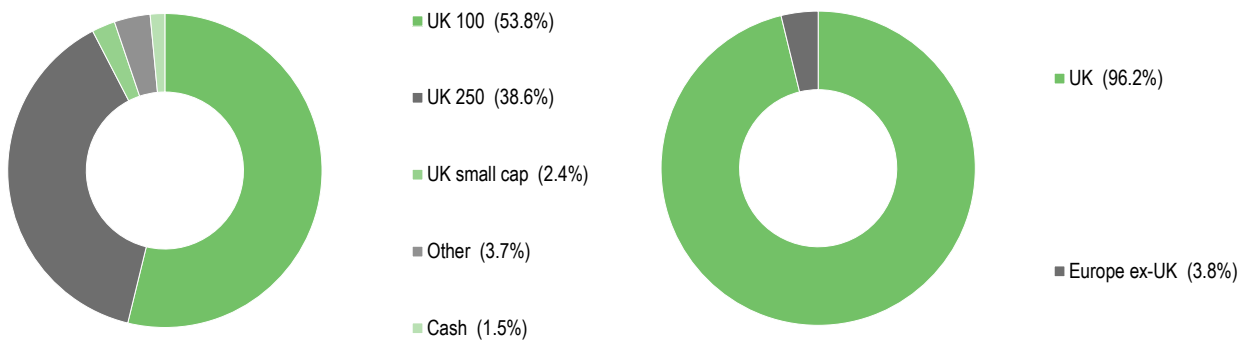
At the end of March 2024, MRCH's top 10 positions made up 35.9% of the portfolio (Exhibit 2), which was a higher concentration compared with 32.9% a year before; seven positions were common to both periods. The portfolio had 50 holdings (excluding derivatives), which was three less than 53 at the end of March 2023.

Exhibit 2: Top 10 holdings (at 31 March 2024)			
Company	Sector	Portfolio weight (%)	
		31 March 2024	31 March 2023*
GSK	Pharmaceuticals & biotechnology	5.4	4.2
Shell	Oil, gas & coal	4.6	4.2
British American Tobacco	Tobacco	4.2	3.7
Inchcape	Industrial support services	3.5	N/A
BP	Oil, gas & coal	3.3	3.2
Barclays	Banks	3.1	N/A
IG Group	Investment banking & brokerage	3.1	2.8
Lloyds Banking Group	Banks	3.0	N/A
Rio Tinto	Industrial metals & mining	2.9	3.3
SSE	Electricity	2.8	2.9
Top 10 (% of portfolio)		35.9	32.9

Source: MRCH, Edison Investment Research. Note: *N/A where not in end-March 2023 top 10.

In terms of market cap, the majority of the fund is invested in large and mid-cap companies, but over the 12 months to the end of March 2024, there was a notable 7.9pp higher weighting in mid-cap stocks (UK 250), with a 5.0pp reduction in exposure to the largest 100 UK companies. MRCH had a modest 3.8% invested in overseas firms compared with the maximum 10% permitted.

Exhibit 3: Portfolio market cap (left) and geographic (right) exposure (at 31 March 2024)



Source: MRCH, Edison Investment Research

In February 2024, Bank of Ireland was added to the portfolio as part of the move to gradually increase MRCH's bank exposure. The banking sector has been restructured since the global financial crisis, and bank margins are expanding in an environment of higher interest rates. Bank of Ireland operates in a consolidated market where there are just two major Irish banks. This position diversifies the trust's economic exposure, while the Irish housing market looks more resilient than the UK's. Bank of Ireland has an attractive valuation and a c 6% dividend yield.

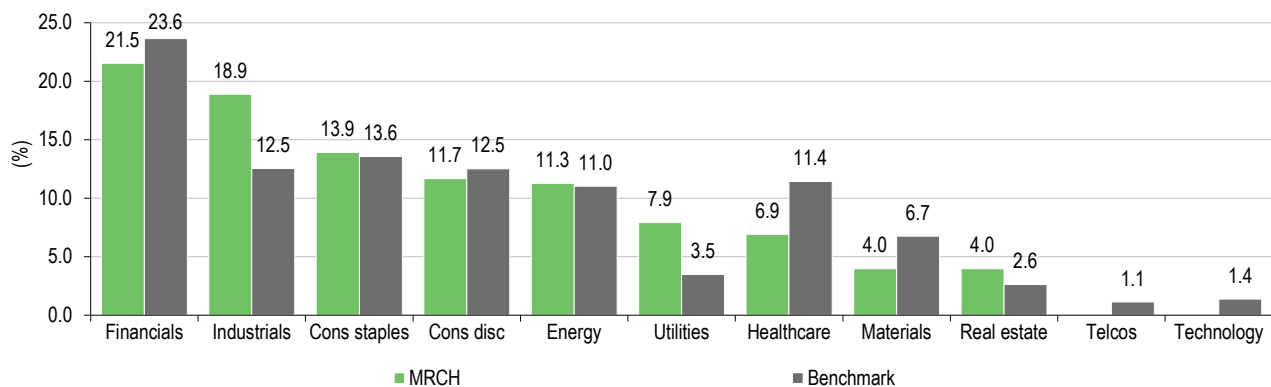
MRCH's holding in Bank of Ireland was funded by the sale of building materials company CRH, which has changed its listing twice, from Ireland to the UK and more recently to the US (where most of its revenues are generated). CRH re-entered the portfolio in 2022 and its share price subsequently doubled. While the company has delivered a strong operational performance and has good prospects, this has been reflected in its valuation, so the position was sold with the proceeds redeployed into higher-conviction holdings.

Exhibit 4: Portfolio sector exposure versus benchmark (% unless stated)

	Portfolio end-March 2024	Portfolio end-March 2023	Change (pp)	Active weight vs benchmark (pp)
Financials	21.5	21.3	0.2	(2.1)
Industrials	18.9	15.5	3.4	6.4
Consumer staples	13.9	14.8	(0.9)	0.3
Consumer discretionary	11.7	14.8	(3.1)	(0.8)
Energy	11.3	11.5	(0.2)	0.3
Utilities	7.9	7.0	0.9	4.4
Healthcare	6.9	7.3	(0.4)	(4.5)
Basic materials	4.0	4.0	(0.0)	(2.8)
Real estate	4.0	2.8	1.2	1.3
Telecommunications	0.0	1.0	(1.0)	(1.1)
Technology	0.0	0.0	0.0	(1.4)
	100.0	100.0		

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

There were modest changes in MRCH's sector exposure in the 12 months to the end of March 2024, the largest were a 3.1pp lower weighting in consumer discretionary stocks and a 3.4pp increase in the industrials weighting. Compared with the benchmark, MRCH's largest active weights were industrials (+6.4pp), utilities (+4.4pp) and healthcare (-4.5pp).

Exhibit 5: MRCH's sector exposure versus its benchmark at 31 March 2024


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

The manager's outlook

Gergel remains optimistic about the prospects for UK equities due to overall attractive valuations, a wide dispersion of individual company multiples and anticipated increased interest from overseas investors. While data suggest the UK economy was in recession at the end of 2023, if that proves to be the case, the downturn is likely to be shallow as there have not been widespread job losses, although specific industries have been under pressure. Within the market, a lack of clarity about the path of interest rates has added to share price volatility, with cyclical shares supported when the outlook is for lower rates and vice versa. This uncertainty has led to a narrow market leadership with investors favouring growth stocks that they believe can grow in any environment, and which are generally much more expensive.

The manager believes that this divergence in company valuations is providing opportunities to buy good businesses at discounted levels. He notes that the UK market is trading at close to a 20-year low forward P/E multiple and historical studies show that, on average, the lower the starting valuation multiple, the higher the subsequent equity returns, which adds to his bullish outlook.

While the UK market has been attractively valued for a prolonged period, Gergel believes there is potential for a change in attitude towards UK stocks. Since the June 2016 Brexit vote, the UK political environment has been seen as risky and now, although there is a general election looming, there is not a huge policy gap between the two main political parties. Also, they are both acutely aware of the market reactions to former prime minister Liz Truss's radical approach of unfunded tax

cuts to stimulate growth. UK economic data have been revised up showing that UK growth is not dissimilar to that in other advanced countries, while inflation is continuing to moderate. In addition, what may be overlooked by global investors is that most sales and profits of UK companies are generated overseas. A change in sentiment towards the UK market could provide meaningful support given there have been prolonged fund outflows, which have led to selling of smaller-cap stocks in particular. Recently, there has been a series of acquisitions of UK companies, which if the trend continues could provide further support to the UK market.

Performance: Outperformance over the long term

MRCH is one of 19 funds in the AIC UK Equity Income sector. Over the last year, the trust's NAV total return has been negatively affected by some stock-specific weakness and ranks 17th. However, MRCH's returns are above average over the last three, five and 10 years, ranking fourth, second and sixth respectively. On 29 April 2024, the trust had the second highest valuation in the sector and just one fund was trading at a premium. MRCH has a competitive ongoing charge, ranking sixth, a higher-than-average level of gearing, and an attractive dividend yield, which is c 20bp above the sector mean.

The trust is classified as a mid-cap value fund by Morningstar, along with four of its peers: abrdn Equity Income Trust, Invesco Select UK Equity, Lowland Investment Company and Shires Income. MRCH's NAV total returns rank fifth out of the five funds over the last year, first over three and five years and second over the last decade.

Exhibit 6: AIC UK Equity Income sector at 29 April 2024*

% 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	830.6	3.0	25.1	42.1	79.2	(1.6)	0.5	No	112	5.1
abrdn Equity Income Trust	145.7	3.1	3.1	(2.0)	27.1	(6.0)	0.9	No	111	7.5
BlackRock Income and Growth	37.8	4.4	20.6	27.0	81.4	(13.7)	1.3	No	107	3.9
Chelverton UK Dividend Trust	31.9	(1.3)	(19.5)	2.9	46.2	(3.3)	2.4	No	157	8.5
City of London	2,061.1	6.9	27.4	27.8	76.8	(1.9)	0.4	No	107	4.9
CT UK Capital and Income	328.5	10.5	15.6	24.7	89.8	(4.2)	0.7	No	106	3.8
CT UK High Income	70.0	9.1	9.1	20.6	53.5	(11.4)	1.0	No	113	6.7
Diverse Income Trust	280.3	5.5	(9.3)	19.5	65.0	(6.3)	1.1	No	100	4.6
Dunedin Income Growth	413.4	3.3	9.7	30.2	66.9	(9.7)	0.6	No	108	4.8
Edinburgh Investment	1,091.2	11.8	28.6	31.6	77.1	(9.1)	0.5	No	106	3.8
Finsbury Growth & Income	1,518.0	(5.4)	5.2	12.9	119.0	(7.6)	0.6	No	101	2.3
Invesco Select UK Equity	90.8	6.4	21.0	33.3	86.8	(18.1)	0.8	No	100	4.6
JPMorgan Claverhouse	405.0	11.1	14.1	26.0	75.2	(5.2)	0.7	No	107	5.0
Law Debenture Corporation	1,118.2	7.5	18.6	46.1	112.1	1.0	0.5	No	112	3.8
Lowland Investment Company	329.6	7.9	12.6	18.5	48.8	(13.3)	0.6	No	113	5.1
Murray Income Trust	914.0	5.4	16.6	32.7	76.2	(9.5)	0.5	No	109	4.4
Schroder Income Growth	195.1	5.4	19.8	29.3	77.4	(11.1)	0.8	No	113	4.9
Shires Income	95.8	8.1	13.8	27.2	74.7	(12.9)	1.0	No	115	6.1
Temple Bar	747.8	16.2	28.4	19.7	60.2	(7.1)	0.5	No	109	3.7
Sector average (19 funds)	563.4	6.3	13.7	24.7	73.3	(8.0)	0.8		111	4.9
MRCH rank	6	17	4	2	6	2	6		7	6

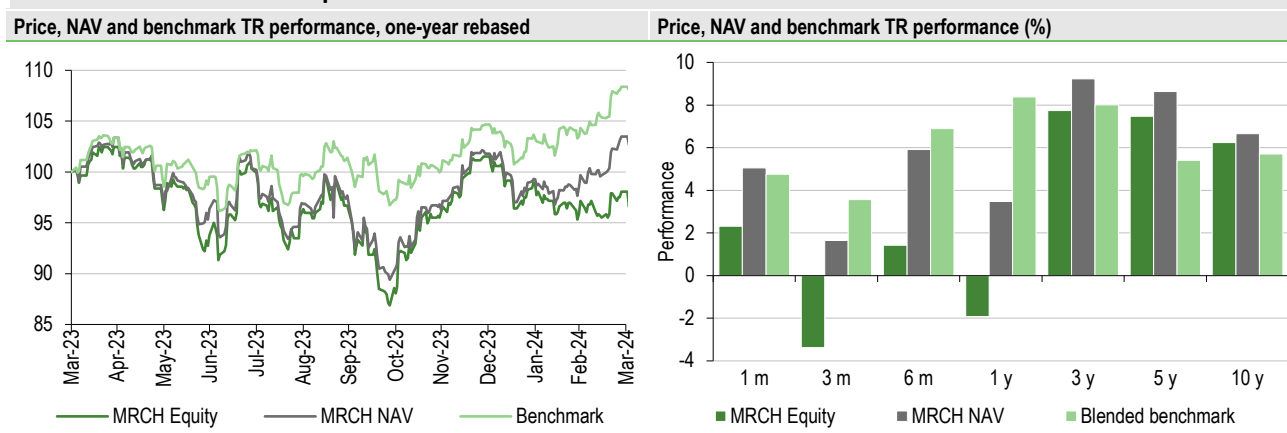
Source: Morningstar, Edison Investment Research. Note: *Performance to 26 April 2024. NAV with debt at par. TR, total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

In FY24, MRCH's NAV and share price total returns of -3.1% and -3.4% respectively lagged the benchmark's +1.9% total return. The trust's performance was negatively affected by an environment of higher interest rates and investor caution, which supported the performance of higher growth stocks. In aggregate, the shares of more cyclical and smaller-cap businesses underperformed. Also, there was a higher-than-average number of holdings with negative stock-specific issues. MRCH's sector allocation added to performance, such as an overweight position in construction and building materials, with a below-index exposure to metals and mining stocks. However, this was outweighed by individual stock price moves.

The largest negative contributor to the trust's relative performance was St. James's Place (-1.1pp) due to a change in its charging structure in response to regulatory developments and media scrutiny (the position was sold as the investment thesis had changed). Diversified Energy (-0.8pp) experienced lower gas prices and a tougher environment for its acquisition strategy as there was increased competition for target assets. Close Brothers (-0.7pp) was involved in a regulatory review surrounding commissions paid on car financing agreements, lower asset prices negatively affected its wealth management business, and investors had general concerns about the cyclical nature of the company's business. Not holding shares in RELX and Rolls Royce each detracted 0.7pp.

On a more positive note, the largest positive contributor to MRCH's relative performance was DCC (+0.8pp), whose capital markets day highlighted that its energy business is well positioned to help its customers transition away from fossil fuels. Not owning shares in Anglo American, Prudential and Diageo added 0.8pp, 0.6pp and 0.6pp respectively to the trust's relative performance.

Exhibit 7: Investment trust performance to 31 March 2024



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

MRCH's relative performance record is shown in Exhibit 8. It has lagged the benchmark over the last 12 months, but its NAV is ahead over the last three, five and 10 years.

Exhibit 8: 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*	(2.3)	(6.7)	(5.1)	(9.5)	(0.7)	10.2	5.1
NAV relative to blended benchmark*	0.3	(1.8)	(0.9)	(4.5)	3.4	16.3	9.4
Price relative to UK All-Share	(2.3)	(6.7)	(5.1)	(9.5)	(0.7)	10.2	4.8
NAV relative to UK All-Share	0.3	(1.8)	(0.9)	(4.5)	3.4	16.3	9.1
Price relative to UK 100	(2.4)	(7.1)	(4.7)	(9.5)	(5.6)	8.8	3.8
NAV relative to UK 100	0.2	(2.2)	(0.4)	(4.5)	(1.6)	14.9	8.1

Source: LSEG, Edison Investment Research. Note: Data to end-March 2024. Geometric calculation. *Blended benchmark is UK 100 Index until 31 January 2017 and UK All-Share Index thereafter.

Exhibit 9: Five-year discrete performance data

12 months ending	MRCH share price (%)	MRCH NAV* (%)	Benchmark (%)	UK 100 large-cap Index (%)
31/03/20	(20.4)	(24.0)	(18.5)	(18.4)
31/03/21	44.1	52.8	26.7	21.9
31/03/22	21.6	19.9	13.0	16.0
31/03/23	4.9	5.1	2.9	5.4
31/03/24	(1.9)	3.5	8.4	8.4

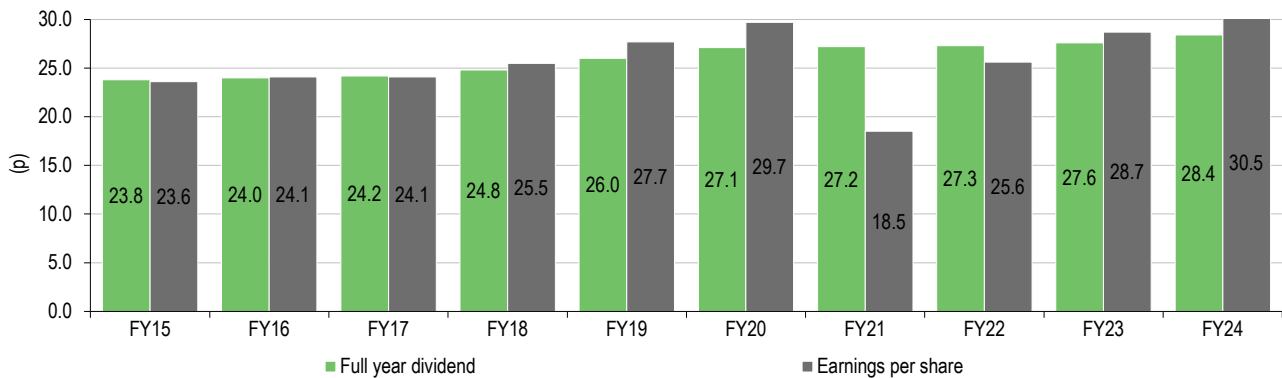
Source: LSEG. Note: All % on a total return basis in pounds sterling. *NAV with debt at market value.

Dividends: Progressive payments for 42 years

If the final dividend is approved by shareholders at the May 2024 AGM, MRCH's FY24 annual dividend will be 28.4p per share (c 1.1x covered), which is a 2.9% increase from 27.6p per share paid in respect of FY23. The trust now has a 42-year unbroken record of higher dividend payments; over this period, it has compounded at an annual rate of 6.4%, which is well above the 3.8% annual rate of UK inflation (based on the Consumer Prices Index), thereby providing real income growth to shareholders. MRCH ranks 12th on the AIC's list of 20 dividend heroes, which are funds that have raised their dividends for at least 20 consecutive years.

In FY24, MRCH's revenue earnings per share of 30.5p was 6.3% higher year-on-year, marking the third year of income recovery following COVID-19, and 1.8p per share was added to revenue reserves. These now total 18.1p per share, which is equivalent to c 0.6x the FY24 dividend.

Exhibit 10: Dividend and revenue history, last 10 years



Source: MRCH, Edison Investment Research. Note: FY24 dividend is subject to shareholder approval.

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