

Investment Rationale

Investing in large UK companies, The Merchants Trust PLC aims to provide an above average level of income which increases over time. The Trust is managed by Simon Gergel, a Director at RCM with 23 years' investment experience.

Fund Manager's Review

Simon Gergel



The Merchants Trust portfolio comprises predominantly high yielding, large capitalisation UK equities to match the objectives of delivering a high and rising level of income, together with capital growth. The structure of the portfolio has been defensively positioned for some time, with limited positions in cyclical natural resources and industrial businesses but with a higher exposure to less economically

sensitive sectors such as food producers, pharmaceuticals and utilities. This reflects both a cautious view about the prospects for economic growth in much of the developed world as well as the fundamental merits and valuation attractions of the companies we have selected.

Stock markets continued to rally in February after a strong January as economic news in America generally came in ahead of expectations. The Eurozone made gradual progress towards another Greek bailout and the second stage of bank liquidity was released under the Longer Term Refinancing Operation (LTRO) at the end of the month.

The FTSE 100 index produced a total return of almost 4%, with cyclical and financial stocks outperforming. Medium sized companies rose more than larger stocks with the FTSE 250 mid cap index delivering a 6.4% total return. The best performing sectors included banks, chemicals and industrial goods and services. The laggards were health care, telecommunications and, perhaps surprisingly, basic resources as investors worried about slowing growth in china reducing commodity demand.

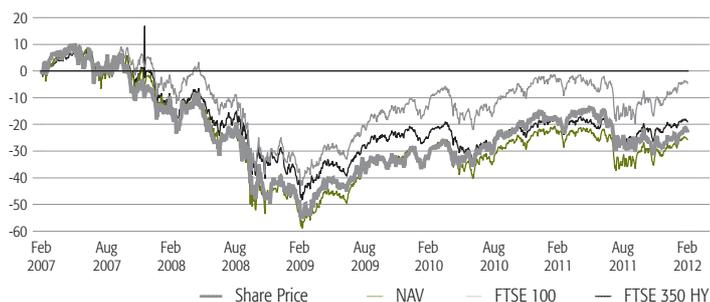
The portfolio performance was modestly behind the index in a month where higher yielding shares lagged the broader market. The limited exposure to the mining sector helped performance as mining shares fell back. We also saw gains in Britvic, Inmarsat and Bunzl which delivered double digit returns. However these positive factors were offset by having relatively little invested in the domestic banks which rallied significantly and also from underperformance in Resolution, IG Group and Daily Mail & General Trust.

There were two notable transactions in the month. We made an investment in BBA Aviation. This company provides a range of services to the business jet and general aviation industry in particular and profits have scope to grow in the medium term as traffic volumes and activity recover to previous levels. The valuation is modest, with a dividend yield over 4.5%, a p/e ratio of under 11x and strong cashflow. BBA has limited exposure to European economies where the outlook is particularly difficult.

AstraZeneca, the pharmaceutical company, was sold out of the portfolio. Although the valuation appears low, the company faces several years of probable profits decline as three key drugs, accounting for half of sales, face patent expiry in the US market by 2016. Even if Astra buys back a large number of shares, they are unlikely to prevent earnings being significantly lower in 2017 than today. A 6% dividend yield is not sufficient compensation for the risks the company faces.

Our investment strategy remains broadly unchanged. Although there are tentative signs of a recovery in the USA, we remain concerned over the medium term outlook for most economies given a high debt burden. We are however finding a few cyclical but fundamentally strong businesses, such as BBA Aviation, to supplement a broadly defensively positioned portfolio.

Performance (%)



Cumulative Performance (%)

	3 Months	6 Months	1 Year	3 Years	5 Years
Share Price	4.3	1.2	-5.6	56.1	-23.1
NAV	5.4	8.5	-4.8	57.8	-26.0
FTSE 100	6.7	8.8	-2.0	53.3	-4.9
FTSE 350 HY	3.5	7.5	-0.7	40.8	-19.2

Discrete Performance (%)

From To	29.12.06 31.12.07	31.12.07 31.12.08	31.12.08 31.12.09	31.12.09 31.12.10	31.12.10 30.12.11
Share Price	-9.5	-38.0	18.9	19.9	-11.2
NAV	-3.9	-40.4	20.0	8.5	-6.3
FTSE 100	3.8	-31.3	22.1	9.0	-5.6
FTSE 350 HY	-3.0	-30.7	12.7	1.6	0.7

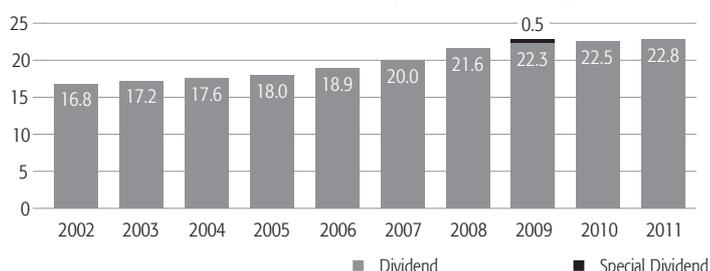
Source: Lipper, share price calculation percentage growth, mid to mid, capital return to 29.02.12.

Benchmark: FTSE 100 Index; FTSE 350 High Yield Index.

Past performance is not a reliable indicator of future performance. You should not make any assumptions on the future on the basis of performance information. The value of an investment and the income from it can fall as well as rise as a result of market fluctuations and you may not get back the amount originally invested. This investment trust charges 65% of its annual management fee to the capital account and 35% to revenue. This could lead to a higher level of income but capital growth will be constrained as a result. Your capital could also decrease if income paid out of capital exceeds the growth rate of the trust.

Dividend History

Ten Year Net Dividend Record in Pence (to year end 31 January)



Net Dividends Paid (financial year to date)

	Pay Date	XD Date	Payment
1st quarterly dividend	17.08.11	15.07.11	5.7p per share
2nd quarterly dividend	11.11.11	7.10.11	5.7p per share
3rd quarterly dividend	23.02.12	27.01.12	5.8p per share



Capital Structure

Total Assets:	£539.7m
Gearing (net):	26.7%
Shares in Issue:	103,213,464 (Ordinary 25p)
Share Price ¹ :	383.5p
Net Asset Value ² :	406.2p (371.8p – debt at market value)
Premium/-Discount to NAV ³ :	-5.6% (3.1% – debt at market value)
NAV Frequency	Daily
Dividend Yield ² :	5.97%

1. Source: Lipper as at 29.02.12, market close mid price.

2. Source: Datastream as at 29.02.12. Calculated using the latest full year dividend divided by the current share price.

3. A trust's net asset value (NAV) is calculated as available shareholders' funds divided by the number of shares in issue, with shareholders' funds taken to be the net value of all the company's assets after deducting liabilities. In line with current industry best practice NAVs are now shown to take into account the 'fair value' of debt. This means NAVs are calculated after allowing for the valuation of debt at fair value or current market price, rather than at final repayment value. NAVs with debt at market value provide a more realistic impact of the cost of debt, and thus a more realistic discount. It is the capital NAV that is shown, which excludes any income.

Key Information

Launch Date:	16 February 1889
AIC Sector:	UK Growth and Income
Benchmark:	FTSE 100 Index FTSE 350 High Yield Index
Annual Management Charge:	0.35%
Performance Fee:	No
Total Expense Ratio: ⁴	0.46%
Year end:	31 January
Annual Financial Report:	Final posted in April, Half-yearly posted in September
AGM:	May
Dividends:	February, May, August, November
Price Information:	Financial Times, The Daily Telegraph, www.rcm.com/investmenttrusts

Board of Directors:
Simon Fraser (Chairman), Mike McKeon (Chairman of the Audit Committee), Henry Staunton (Senior Independent Director), Paul Yates

Company Secretary	Kirsten Salt
Investment Manager	Simon Gergel, Director, UK Equity
Codes:	RIC: MRCH SEDOL: 0580007 ISIN: GB0005800072

4. Source: Annual Financial Report

Risks & Features

Investment trusts are quoted companies listed on the London Stock Exchange. Their share prices are determined by factors including the balance of supply and demand in the market, which means that the shares may trade below (at a discount to) or above (at a premium to) the underlying net asset value.

Merchants seeks to enhance returns for its shareholders through gearing, in the form of long-term, fixed rate debentures. Gearing can boost the Trust's returns when investments perform well, though losses can be magnified when investments lose value. You should be aware that this Trust may be subject to sudden and large falls in value and you could suffer substantial capital loss. Derivatives are used to manage the trust efficiently.

All data source RCM (UK) Limited as at 29.02.12 unless otherwise stated.

Issued by RCM (UK) Limited. Authorised and regulated by the Financial Services Authority. The information contained herein including any expression of opinion is for information purposes only and is given on the understanding that it is not a recommendation and anyone who acts on it, or changes their opinion thereon, does so entirely at their own risk. The opinions expressed are based on information which we believe to be accurate and reliable, however, these opinions may change without notice.

Portfolio Analysis

Top Ten Holdings	(%)	(%)	
Royal Dutch Shell "B" Shares	7.7	British American Tobacco	3.7
GlaxoSmithKline	7.4	BAE Systems	3.6
BP	7.2	Scottish & Southern Energy	3.4
HSBC	6.5	BT Group	3.1
Vodafone	5.4	National Grid	3.0
Total Number of Holdings		64	

Sector Breakdown	(%)
Financials	17.5
Oil & Gas	14.9
Consumer Services	14.2
Consumer Goods	13.3
Industrials	11.1
Telecommunications	9.2
Utilities	9.0
Health Care	7.4
Basic Materials	1.8
Cash	1.6

HOW TO INVEST?

The Trust is a UK public limited company traded openly on the stock market. You can purchase shares through a stock broker. Shares in the Trust can be held within an ISA and/or savings scheme and a number of providers offer this facility. A list of suppliers is available on our website or from the AIC at www.theaic.co.uk

CONTACT US

To download the Annual Financial Report, Trust brochure or watch an interview with the fund manager, please visit us online at www.rcm.com/investmenttrusts



If you have any queries regarding our investment trusts our Investor Services team can be contacted on:

0800 389 4696

e-mail: investment-trusts@uk.rcm.com

website: www.rcm.com/investmenttrusts