

# The Merchants Trust – Investing for long term income growth

Economic slowdown is providing a challenging environment for income growth managers. In this interview, RCM's Simon Gergel explains that when it comes to constructing a balanced portfolio, there is no substitute for fundamental research.

The Merchants Trust was incorporated in February 1889 and has total assets of more than £500 million\*, making it the oldest – and largest – of the investment trusts in the RCM stable. Merchants' focus is income and it has grown its dividend for 26 consecutive years.

## Simon, how have you adapted your investment approach in the current economic slowdown?

In a more difficult trading environment, it's extremely important to focus on the sustainability of a company, both from a cash-flow perspective and in terms of the business franchise. We pay particular attention to the cash-flow of a business as that determines its ability to invest for the future and pay dividends to shareholders. In troubled times, we look for a margin of safety in cash flow and financial ratios. Regarding the business franchise, we look for companies with a strong and defensible market position, or what Warren Buffett refers to as a "wide moat". Typically these businesses have been around for a long time and have assets that cannot be easily replicated such as brands, technology, intellectual property, or perhaps customer and supplier relationships.

I have also biased Merchants' portfolio towards businesses that are less exposed to the economic cycle where we can buy these on sensible valuations, such as pharmaceutical companies, telecoms, utilities and defence companies. In a tough environment it's better to buy a great business at an average price, than an average business at a great price; though that will not stop me looking for great businesses at great prices!

## What similarities and differences do you see between the current slowdown and previous recessions?

Most of the economic downturns in the last 50 years have been caused by a slowdown in consumer and corporate demand, typically in response to a high interest rate policy. The current slowdown is more "supply" led, with a shortage of funding available in the banking system leading to a reluctance to lend which

in turn has led, for example, to a big drop in housing transactions and house prices.

In the former type of downturn, cutting interest rates can ease the pressure on people's budgets and ultimately lead through to economic recovery. In this "credit crunch" cycle, we need to see liquidity return to bank funding markets before activity can accelerate significantly. It is harder to see the mechanism for this to take place - or how long it might take - but there's no doubt that the authorities are committed to achieving it after the effective nationalisation of US mortgage lenders Fannie Mae and Freddie Mac and the rescue of AIG.

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## In terms of sectors, which areas have you avoided recently and which sectors are you looking to build up?

Our caution on UK consumer spending and the domestic economic cycle have prompted us to avoid certain industries. In particular we do not currently own any pub or restaurant companies, newspaper publishers, airlines, real estate investment companies, gambling companies or clothing retailers. We also do not own any food retailers although this is primarily for valuation reasons rather than because of trading concerns. Elsewhere we have reduced exposure to the natural resources sectors recently on fears that slowing demand could threaten the tight demand/supply balance which has led to high commodity prices.

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Earlier in the year we added to relatively defensive sectors like utilities and telecoms and we bought several companies with good long term growth prospects when they were on sensible valuations. In the current volatile market we are continuously reassessing the companies in all sectors to identify potentially interesting investment opportunities. In particular we are looking for soundly financed businesses with strong competitive positions that offer excellent long term value, even if the next year or two will be challenging. This process is very much stock specific although at the sector level we have added small investments in certain non-clothing retailers.

## Why are you so focused on dividends and dividend growth?

Merchants aims to provide an above average level of income and income growth and we clearly want to try to meet those objectives. Shareholders may need a high level of income to meet their own needs, or they may simply find this investment approach attractive. Perhaps the most compelling reason for following a high yield investment approach is that we believe over the long term, buying companies with above average yields has generated better total returns than the stock market index. This may seem counter-intuitive. However investors on average tend to overestimate their ability to forecast future growth and tend to pay too much for low yielding shares at the top of the cycle (as in the technology, media and telecoms bubble at the turn of the century). This leaves higher yielding shares languishing at low valuations from which they can generate superior returns to investors as the bubble deflates.

It's also worth bearing in mind that, from a long term point of view, a large portion of the return investors have historically generated from equity investments has come from dividend payments.

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**Simon Gergel**  
Fund Manager  
RCM, the global equity company of  
Allianz Global Investors

Simon Gergel has managed The Merchants Trust since joining RCM, the global equity company of Allianz Global Investors, in April 2006. Simon joined from HSBC Halbis Partners where he managed over £900m in high income funds. Prior to HSBC, Simon worked for 14 years at UBS Asset Management (formerly Phillips & Drew Fund Management). He graduated in 1987 from Cambridge University with an honours degree in mathematics and is an associate of the UK Society of Investment Professionals. Simon has twenty years investment experience.

\* Source RCM as at 30/08/08

## Contact

For more information about The Merchants Trust, please call **0800 317 573** or visit [www.merchantstrust.co.uk](http://www.merchantstrust.co.uk)

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