Contents

The Merchants Trust

The Merchants Trust was incorporated on 16 February 1889. It was launched by Robert Benson & Co., predecessors of the current Manager, RCM (UK) Ltd, and originally invested mainly in American railroads. The initial capital was £2 million, of which half was subscribed.

Investment Policy

Investment Objective

To provide an above average level of income and income growth together with long term growth of capital through a policy of investing mainly in higher yielding UK FTSE 100 companies.

Benchmark

The Company's investment performance is assessed by comparison with other investment trusts within the UK Growth and Income sector. In addition, it is benchmarked against the FTSE 100 Index, reflecting the emphasis within the portfolio, as well as the FTSE 350 Higher Yield Index, reflecting the Company's higher yield objective.

Gearing

The Company's policy is to remain substantially fully invested.

The Company has the facility to gear – borrow money – with the objective of enhancing future returns. Historically, gearing has been in the form of long-term, fixed-rate debentures. The Board monitors the level of gearing and makes decisions on appropriate action based on the advice of the Manager and the future prospects of the Company's portfolio.

The Company's authorised borrowing powers set out in the Articles of Association state that the Company's borrowings may not exceed its called up share capital and reserves. In normal market conditions, it is unlikely that gearing (borrowings as a percentage of net assets) will exceed 35%.

Risk Diversification

The Company will aim to achieve a spread of investments, with no single investment representing more than 15% of assets. The Company will seek to diversify its portfolio into at least five industrial sectors, with no one sector comprising more than 35% of the portfolio.

Financial Summary

	For the year ended 31 January 2010	For the year ended 31 January 2009	% change
Revenue	£23,686,655	£31,729,754	-25.3
Net return attributable to Ordinary Shareholders†	£19,498,068	£28,017,898	-30.4
Net return attributable to Ordinary Shareholders#	£19,022,109	£26,211,995	-27.4
Earnings per Ordinary Share	18.91p	27.25p	-30.6
Ordinary dividends per Ordinary Share	22.50p	22.30p	+0.9
Special dividend per Ordinary Share	–	0.5p	n/a
Assets	**2010**	**2009**	**% change**
Total Assets*	£498,205,486	£428,277,126	+16.3
Net Assets	£384,747,214	£314,804,036	+22.2
Net Asset Value per Ordinary Share	372.8p	306.2p	+21.8
Ordinary Share Price	329.1p	282.0p	+16.7
Discount of Ordinary Share Price to Net Asset Value	11.7%	7.9%	n/a
Discount (Premium) (Debt at market value)	7.7%	(1.3%)	n/a
FTSE 100 Index (Capital Return)	5,188.5	4,149.6	+25.0
FTSE 350 Higher Yield Index (Capital Return)	2,879.1	2,434.0	+18.3

Notes

† Including a refund of VAT paid on management fees and associated interest income of £475,959 (2009 – £1,805,903).

Excluding refund of VAT paid on management fees and associated interest income.

* Net of current liabilities.

Chairman's Statement

Market and Portfolio Background

Last year saw a welcome recovery in share prices, but at the same time an almost unprecedented fall in the level of dividends declared by UK companies, particularly in the financial sector, as a result of the crisis which began in the Summer of 2007 and which is still not played out.

Results

The net asset value per share increased by 21.8% to 372.8p and the total return per share, including dividends paid, was 29.2%. This compares with the total returns of 30.4% and 24.7% recorded by the FTSE 100 Index and the FTSE 350 Higher Yield Index, respectively.

The full performance breakdown is shown on page 5. Over the year, the Trust's share price rose by 16.7% from 282.0p to 329.1p, having hit a low of 222.0p last March. At 6 April 2010, the Trust's ordinary shares yielded 6.1% compared with the yield on the FTSE 100 Index of 3.2%.

Earnings per share

Earnings per share fell by 30.6% to 18.91p, principally because of the dividend cuts to which I have already referred.

This year's earnings include a VAT refund amounting to £476,000 (including interest) (2009 – £1,806,000). Excluding the two VAT refunds, the net return attributable to Ordinary Shareholders fell by 27.4%.

Dividends

The Board is recommending a final ordinary dividend of 5.7p per share, payable on 14 May 2010 to Shareholders on the register on 16 April 2010. This payment would give a total of 22.5p for the year, an increase of 0.9% over the total for the previous year. In order to meet the payment it has been necessary to transfer £3,724,961 (3.6p per share) from our reserves. As at 31 January 2010 and after providing for this transfer, the Trust's reserves amounted to £14,408,093 (14.0p per share).

Gearing and Balance Sheet

The Trust has remained fully invested throughout the market's downturn and its subsequent recovery.

The investment objective of the Trust is clearly stated on the opposite page; it follows that in the Board's view the allocation of assets by shareholders as between equities and other forms of investment should be a matter for them and not for the Trust. Moreover, the principal long term aim of the Trust is to generate growth in dividends and a sale of part of the equity portfolio would compromise this objective, given the low levels of return currently available on cash deposits or UK government securities.

As a consequence of the Trust remaining fully invested, the book value of our long term debt as a percentage of our net assets rose to a peak of 46% in March of last year before falling back to just below 30% at the year end.

In the light of this, and as anticipated in my last Chairman's Statement, the Board directed the fund managers to make use of exchange-traded options, on a relatively modest scale, with the object of protecting the portfolio in the event of a substantial fall in the market. This was achieved through the sale of call options on a small part of our portfolio, the proceeds of which were used to purchase FTSE 100 put options at considerably lower than the then prevailing market levels. This strategy would have provided a measure of protection had the market fallen to below 2600 on the FTSE 100, so that even at this level the managers would have been able to invest the portfolio primarily with a view to maximising investment returns rather than maintaining the necessary asset covers for our debentures.

Towards the end of the year, the Board concluded that the short-term threat to the financial system had reduced and that the purchase of the 'deep out of the money' put options should be suspended. The proceeds from the sale of any call options now taken out will be applied as an addition to the Trust's income.

VAT

As mentioned above, we have received a refund of VAT in respect of the period 2000 to 2007 which, including interest, totals £1,249,000. This figure has been incorporated in our results for the financial period under review.

Issue and Repurchase of Shares

During the financial year we were able to issue 400,000 new shares at a premium to the net asset value. No shares were bought back for cancellation. However, as in previous years, the Board is proposing to renew the authority to repurchase shares at the forthcoming Annual General Meeting.

Chairman's Statement

The Board

Since the last Annual General Meeting, Simon Fraser has joined the Board. I am delighted that he has done so. He has had an exceptionally successful career in the fund management industry; he is Chairman-elect of Foreign & Colonial Investment Trust and since last year a non-executive director of Barclays.

This is my tenth annual statement to shareholders and it will be my last. I believe that now is the right time for me to step down and I will be retiring from the Board at the conclusion of the forthcoming Annual General Meeting. It is intended that Sir James Sassoon, currently Senior Independent Director and the Chairman of the Audit Committee, will succeed me as Chairman of the Trust.

Annual General Meeting

The Annual General Meeting of the Company will be held on Tuesday 11 May 2010 at 12.00 noon and we look forward to seeing as many shareholders then as are able to attend.

The ten years of my Chairmanship have not been all plain sailing. During the period we have experienced two vicious bear markets. Nevertheless, as indicated by the performance graph on page 15, over the decade the Merchants net asset value total return has been 4.67% per annum, compared with a total return from the FTSE 100 of 1.45% per annum. (We have not quite matched the return on our other benchmark, the FTSE 350 Higher Yield Index, but this index has an extremely high degree of inherent risk – three companies alone account for nearly half the index.)

Moreover we have been able to increase our dividend in every year and the Merchants dividend has grown in real, as well as nominal, terms.

I am very grateful to all those who have contributed to this record and who have supported the Trust in other ways during my Chairmanship and I wish them well.

Hugh Stevenson | Chairman
7 April 2010

Historical Record

Revenue and Capital for years ended 31 January

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Revenue (£'000s)	21,546	21,596	22,101	22,247	22,675	24,714	27,750	28,495	31,730	23,687
Earnings per Ordinary Share	16.35p	16.70p	17.26p	17.34p	17.58p	19.44p	22.17p	22.86p	27.25p	18.91p
Dividends per Share	16.40p	16.80p	17.20p	17.60p	18.00p	18.90p	20.00p	21.60p	22.80p	22.50p
Ordinary Dividend per Share	16.40p	16.80p	17.20p	17.60p	18.00p	18.90p	20.00p	21.60p	22.30p	22.50p
Special Dividend per Share	–	–	–	–	–	–	–	–	0.50p	–
Tax Credit per Share	1.82p	1.87p	1.91p	1.96p	2.00p	2.10p	2.22p	2.40p	2.53p	2.50p
Gross Dividend per Share	18.22p	18.67p	19.11p	19.56p	20.00p	21.00p	22.22p	24.00p	25.33p	25.00p
Total Net Assets attributable to Ordinary Capital (£'000s)	473,729	420,983	273,407	357,442	424,511▲	514,713	588,835	506,187	314,804	384,747
Net Asset Value per Ordinary Share	463.5p	412.3p	267.8p	350.1p	415.8p▲	504.1p	567.5p	492.3p	306.2p	372.8p
NAV Total Return (%)*	+25.8	-7.4	-30.9	+37.3	+20.8▲	+25.6	+16.4	-9.6	-33.4	+29.2
Retail Price Index Increases (%)**	+1.8	+2.6	+2.7	+2.4	+2.1	+2.3	+4.2	+4.1	+0.1	+4.6

Notes

* NAV total return reflects both the change in net asset value per ordinary share and the net ordinary dividends paid.

** RPIX – excludes the effect of mortgage rates.

▲ Restated in accordance with Financial Reporting Standards 25 'Financial Instruments: Disclosure and Presentation' and 26 'Financial Instruments: Recognition and Measurement'. Years prior to 2005 have not been restated.

Performance Attribution Analysis for the year ended 31 January 2010

	FTSE 100 Index %	FTSE 350 Higher Yield Index %
Capital return of index	25.0	18.3
Relative return from portfolio	(6.5)	0.2
Capital return of portfolio	**18.5**	**18.5**
Impact of gearing on portfolio	8.1	8.1
Revenue deficit*	(1.3)	(1.3)
Expenses charged to capital	(2.3)	(2.3)
Management fee VAT refund	0.2	0.2
Issue of Ordinary Shares	0.1	0.1
Other	(1.5)	(1.5)
Change in Net Asset Value per Ordinary Share	**21.8**	**21.8**

* Dividends paid on Ordinary Shares amounted to £23,589,084 (refer to Note 6). This exceeds the revenue return for the period by £4,091,016.

Investment Manager's Review

Economic Background

The year under review witnessed a major recession in most of the developed world as the full effects of the financial crisis were felt. Reduced availability of finance and lower confidence led consumers and businesses to cut spending, particularly on big ticket items and services. In response to lower demand, companies aggressively cut costs by reducing production, inventory levels and employment.

The severity of the recession was mitigated by an unprecedented level of government stimulus around the world. Interest rates were cut to near zero levels in the USA, UK, Eurozone and Japan. Liquidity was boosted by governments providing bank loan guarantees and via central bank purchases of assets through the "Quantitative Easing" process. Enormous government spending packages were introduced to support industries including banking and finance, automobiles and infrastructure investment. Unemployment rose but not by as much as would normally be expected as many companies reduced working hours and froze wages. Inflation was generally subdued in a weak demand environment.

As the year progressed the major economies gradually emerged from recession with the UK posting modest growth in the fourth quarter of 2009. However confidence remained fragile and significant areas of activity remained depressed, such as the important US housing market which saw 550,000 new housing starts compared to a fifty year average of 1.5 million and previous low of 1 million.

Several emerging markets managed to avoid recession, with China in particular delivering rapid growth on the back of a huge infrastructure investment programme and rapid credit expansion.

Arguably the biggest feature of the year was the government support of the global financial system which had been severely strained. However the costs of the rescue packages and measures to mitigate the recession were massive increases in the developed world's budget deficits and the ballooning of government debt levels.

Market Trends

Financial markets began the year in a state of turmoil and the stockmarket fell heavily in February amid continued concerns about the banking system and the health of the major economies. However in March the stockmarket began a sharp recovery with the approval of US stimulus packages pointing to a more credible government response to the economic crisis. Stockmarket recoveries often start at a point of great pessimism and market levels were depressed with many shares looking extremely cheap. After a slight pause in June and July the market rally continued until the beginning of January 2010 before a minor sell-off in the last few weeks of the financial year.

Overall the FTSE 100 Index delivered a total return of 30% for the year but there were significant differences at the stock and sector level. In general the more cyclical and higher risk parts of the stockmarket, which had suffered the most in the downturn, saw the sharpest recoveries. The mining sector more than doubled as commodity prices rebounded in response to a step up in Chinese infrastructure investment. Bank shares and general retailers rallied hard, rising by over 50% in the first half of the year before consolidating. There was also a marked outperformance by smaller companies, which tend to be more economically sensitive, with the FTSE 250 Mid Cap Index rising by over 50%.

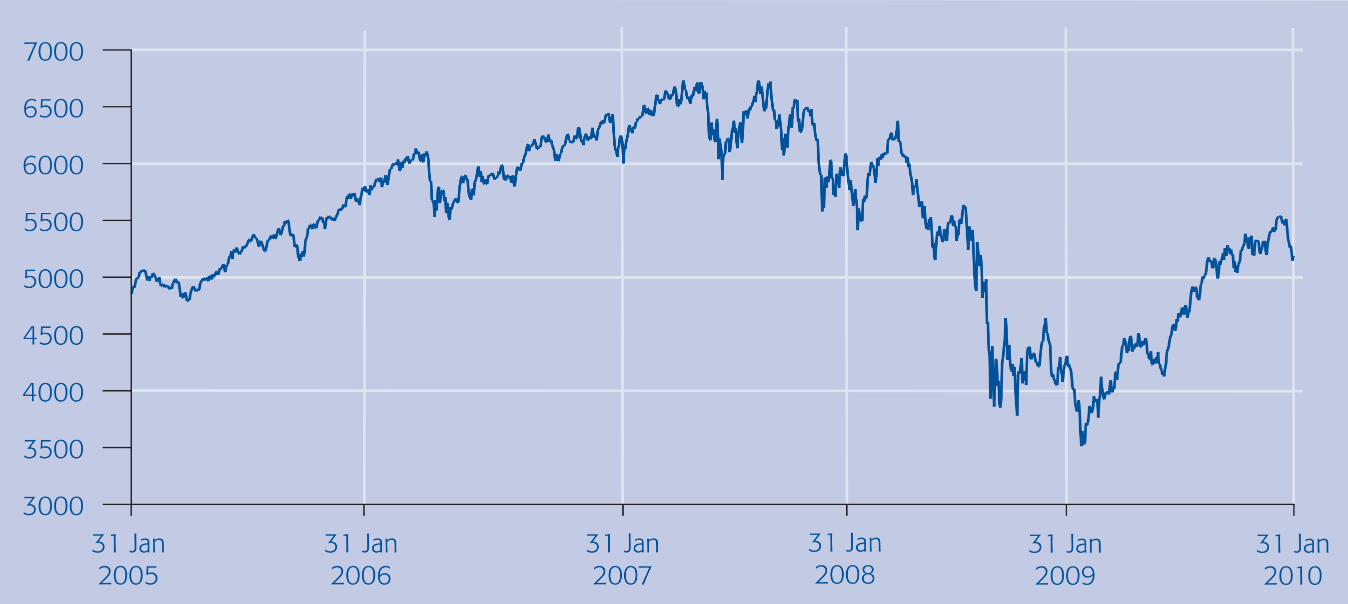
On the other hand many of the larger, more defensive shares lagged the market rally. The utilities and pharmaceutical sectors delivered total returns of 6% with virtually no capital gain and tobacco posted a 14% return. This made it a difficult year for income investors with the FTSE 350 Higher Yield Index returning "only" 25% as the market focused on recovery rather than dividend yield.

At the individual stock level the polarisation was even more extreme. Of the 100 constituents of the FTSE 100 Index at the start of the period, 5 produced negative returns and 30 were up less than 15%, whilst the top 30 performers were each up over 70% including 8 stocks that more than doubled.

Within the market there were a large number of dividend cuts and rights issues as companies focused on reducing debt levels as the credit crunch restricted the availability and raised the cost of bank finance.

Investment Manager's Review

FTSE 100 Price Index from 31 January 2005 to 31 January 2010



Souce: RCM/Datastream

Investment Performance

The Merchants Trust portfolio delivered a strong absolute performance in a rising market. As the Trust has a policy of investing in high yielding shares which generally lagged the market, performance was behind the total return of the FTSE 100 Index although it was in line with the FTSE 350 Higher Yield Index.

Looking at the individual stock contributions there was a standout performance from many of the more cyclical medium sized companies in the Trust. Even though the portfolio is predominantly invested in large companies, nine of the top ten positive stock contributions came from outside of the FTSE 100 Index with three of these more than doubling and another three returning over 90%. Performance further benefited from the decision to increase the Trust's holdings in many mid-caps at depressed levels during the market downturn. Certain of these stocks passed their dividends during the credit crunch but we decided to retain the holdings due to their compelling valuations. The only top ten contributor from within the FTSE 100 was Imperial Tobacco where the portfolio "benefited" from not owning the company as its shares lagged the market considerably.

Contribution to Investment Performance relative to FTSE 100 Index

Positive Contributions	%	Negative Contributions	%
Inchcape	1.1	Rio Tinto	-2.0
Melrose	0.8	BAE Systems	-1.5
Britvic	0.6	Xstrata	-1.2
International Personal Finance	0.6	Anglo American	-1.2
Meggitt	0.6	GlaxoSmithKline	-1.1
Dairy Crest	0.5	Reed Elsevier	-0.8
GKN	0.5	Scottish & Southern Energy	-0.8
IG Group	0.4	Standard Chartered	-0.7
Imperial Tobacco	0.4	HSBC	-0.6
Pendragon	0.3	Vodafone	-0.6

In terms of negative contributions, two themes dominate. Three of the four top negative stocks were mining companies. We had limited exposure to the sector during the year due to the low or zero dividend yields and our concerns about the industry outlook and valuation. Performance suffered from not owning these companies as the sector surged in the market rally. The second clear theme was the muted performance of several large, defensive companies like BAE Systems, GlaxoSmithKline, Reed Elsevier and Scottish & Southern Energy. Big positions in these high

Investment Manager's Review

yielding and lowly valued businesses held back the overall portfolio return. Two banks also featured in the top 10 negatives. The portfolio did not own Standard Chartered and had an underweight position in HSBC. As in the mining sector, these low yielding banks were re-rated on hopes for economic recovery, especially in the key Asian region.

Portfolio Changes

Extreme moves within the stockmarket can present both challenges and opportunities for investors. Activity within the portfolio was quite high, driven primarily by individual stock issues rather than broader industry considerations. However there were some changes at the sector level as we reduced the portfolio's exposure to commodities (oil and mining) and telecommunications whilst increasing exposure to financial services (including real estate) and support services. We added ten new companies to the portfolio and completely sold seven investments. As described in the interim report, several major market features influenced activity, namely, high volatility, extreme polarisation, dividend cuts and rights issues.

Volatility often presents opportunities to make investments or sales at particularly attractive levels but it can also reflect real risks. We devoted considerable resource during the economic downturn to stress test the business models of investee companies and to understand how macroeconomic developments might impact them. Our analysis prompted us to maintain certain positions or even increase them, whilst reducing or exiting others.

Regarding new additions, having not owned any real estate companies for about 12 months, we took advantage of the sector's weakness to buy Hammerson in February when they announced a rights issue to strengthen their balance sheet. We also bought British Land later in the period. With property yields well above gilt and cash yields and signs that the property sector was turning, these high yielding companies looked attractive.

Volatility also enabled us to buy the media conglomerate WPP and electricity generator International Power at particularly attractive valuations as described in the interim report. Another new investment was Premier Farnell, a high service distributor of electronic components. The shares were depressed after severe industry destocking and the valuation did not reflect either the potential for cyclical recovery or the fundamental restructuring being undertaken to cut costs and target three areas of potentially higher returns; sales over the internet, sales to research and design engineers and sales within emerging markets.

The extreme polarisation of market returns created opportunities. As investors focused on cyclical businesses, many defensive or higher growth businesses lagged behind the market rally and traded at compelling valuations. As well as Bunzl and Catlin which were purchased in the first half, we bought Reckitt Benckiser, a leading consumer products and healthcare business with brands such as Finish dishwasher tablets, Cillit Bang, Nurofen and Strepsils. Reckitts has an excellent record of growth and cash generation and has raised its dividend materially in recent years.

The remaining two new investments were in the financial services arena. We purchased Ashmore, an emerging market fixed income fund manager which is well placed to exploit the structural trend of greater investment allocations to emerging markets among bond investors. With a high net cash position on its balance sheet it is financially secure and offers an attractive dividend yield. Finally we purchased Friends Provident during its takeover by Resolution Plc as the latter is embarking on a strategy of consolidating and restructuring parts of the financial services industry.

There were many additions to existing positions reflecting the opportunities in the volatile and polarised market. Notable trades included adding to IG Group and International Personal Finance after material weakness with both shares subsequently more than doubling by year end. We significantly increased the holdings in Unilever, AstraZeneca and BAE Systems all of which are relatively well protected from a tough economic environment and, in our view, represented good value. We also added to a number of positions via right issues, such as HSBC, Inchcape and GKN.

Dividend cuts were a notable feature of the market, especially in the first half, and drove some of the sell decisions in the year. Although the Trust has a clear high income objective, we do not automatically sell shares when they cut or pass dividends. We review each situation on its own merits from a total return perspective, but we also need to consider the impact on the total portfolio yield. We retained positions in, among others, Barclays and Inchcape and we decided to sell Lloyds Banking Group and Anglo American with considerable uncertainty about the prospects for both businesses. We switched part of the Anglo holding into BHP Billiton our favoured mining company. Later in the period we bought back into a modest position in Lloyds Banking Group ahead of their rights issue aimed at avoiding the government's Asset Protection Scheme. Whilst Lloyds is not paying a dividend we believed the risk profile was significantly reduced by the share issue and it could offer substantial upside in the medium term.

Investment Manager's Review

During the year we reduced the portfolio's relatively high level of concentration. The biggest net sale was a reduction of the large BP position in several trades as the shares recovered and the dividend yield looked less enticing compared to other opportunities. We also reduced Royal Dutch Shell on similar considerations. With smaller reductions to the GlaxoSmithKline and Vodafone positions, the largest four investments accounted for under 31% of the portfolio at the year end, down from almost 39% a year earlier. This move reflects a wider range of available high yielding investment opportunities in a more stable economic and financial environment.

Other sales reflected the themes discussed earlier. The strong recovery of small and mid cap shares provided the opportunity to reduce and ultimately sell out of GKN (post rights issue), Dairy Crest and Marshalls at relatively full valuations. Amongst the more economically defensive stocks, Diageo and Sage had performed well and, with fairly muted short term prospects, they looked expensive compared to many better opportunities elsewhere. The final complete sale was water company Severn Trent. A draft determination from the regulator OFWAT looked set to put pressure on the industry's future dividends so we switched the investment into additional shares in utilities National Grid and Scottish & Southern Energy.

Elsewhere, having added to BT at depressed levels in February, we reduced the holding later in the year after the shares had been significantly re-rated and more fully reflected the restructuring opportunities in the business. We also started to sell down the Inchcape position into strength. After supporting the rights issue at 6p per share, we sold shares as they approached fair value at various levels from 19p up to 35p.

Outside of the top 10 net sales, we reduced positions in a wide range of companies as they rallied and offered less value. These included mid caps; Britvic, Halfords, Melrose, IG Group and Meggitt, as well as FTSE 100 companies; Home Retail Group, Man Group and Legal & General.

Largest Net Purchases	£m	Largest Net Sales	£m
Unilever	6.4	BP	7.8
British Land	5.5	BT	6.5
AstraZeneca	5.2	Anglo American	5.4
Premier Farnell	5.0	Sage	5.2
Reckitt Benckiser	4.6	GKN	4.9
Bunzl	4.5	Diageo	4.8
International Power	4.4	Dairy Crest	4.5
HSBC	4.3	Royal Dutch Shell "B"	4.4
BAE Systems	3.6	BHP Billiton	4.0
Catlin Group	3.3	Inchcape	3.8

Derivatives Strategy

As explained in the Chairman's Statement, we initiated a strategy of writing (selling) covered call options on a limited number of stocks within the equity portfolio and using the proceeds to buy out-of-the-money put options on the FTSE 100 Index. The call option purchaser can buy stock from the Trust at a pre-agreed price for a limited period. The put options are essentially an "insurance policy" to provide some downside protection if the market were to fall very significantly. In January 2010 the directors decided to suspend further purchases of put options. The fund managers will continue writing call options selectively in order to generate additional income for the Trust, rather than for the purpose of capital protection. Call options are only written on stocks owned within the portfolio and with a maximum exposure of 20% of gross assets at the time of writing.

Future Policy

A year ago the economy was in the deepest recession for a generation and the credit crunch had called into question the viability of many businesses and even the financial system. Compared with that desperate situation, the outlook today is much clearer with the developed world out of recession and corporate balance sheets and profits recovering. However compared to more normal times, the economic challenges and risks today remain immense.

Governments and central banks are walking along a delicate tightrope. On the one hand they need a loose monetary and fiscal policy to stimulate growth and turn a fragile recovery into a more sustainable upturn. On the other hand they need to reduce spending and raise taxes to bring budget deficits under control. Failure to sustain growth could lead to a double dip recession and even larger debt problems, whilst failure to cut deficits can lead to a loss of market confidence, rising bond yields, austerity packages, devaluations and in extremis government debt defaults. These pressures are evident even within the EU, with the Irish economy in a deep recession caused by austerity measures whilst Greece has

Investment Manager's Review

suffered a loss of confidence in its debt market with implications for the Euro. The UK is in a worse funding position than much of Europe, but a floating currency and independent interest rates allow greater flexibility of policy response.

Despite the risks, our central view is that the developed world will continue to see an economic recovery due to the economic stimuli and inflation will not be a major short term concern. However we expect growth to remain below the longer term trend for a considerable period as both consumers and governments struggle to reduce excessive debt levels. Several of the key emerging markets are performing better than the developed world, delivering higher growth with stronger financial balances. China in particular has benefitted from a huge infrastructure and investment boom. The challenge for China is to rebalance the economy from investment towards consumer spending without serious dislocation.

The equity market is not as cheap as it was a year ago but corporate balance sheets and cashflows have improved materially and aggregate valuations are still reasonable. There are many anomalies within the market as might be expected after a period of economic volatility and we have positioned the portfolio to take advantage of these. After two years where macro-economic themes and sector rotation have dominated market moves, a period of lower volatility could lead to a greater focus on company fundamentals. We think valuations, including dividend yields, are likely to be more important differentiators of stock performance. Sustainable profits growth may well be more highly rated in a muted economic environment and companies with strong, defendable market positions and pricing power are also likely to be more highly valued.

We continue to have a large exposure to big, multinational, well financed businesses that are not particularly cyclical and generally trade on low valuations with attractive dividend yields. Examples would include GlaxoSmithKline, Vodafone, BAE Systems, Royal Dutch Shell and National Grid. We have also built up exposure to higher growth businesses where these were available at attractive valuations and offered a reasonable dividend yield. Higher growth stocks in general look cheaper than they have been for many years and we have invested in Reckitt Benckiser, IG Group, Bunzl and Ashmore amongst others. Other themes we are exploiting include seeking companies with exposure to emerging market consumers, such as British American Tobacco, WPP, IPF and Unilever. Also we favour those companies that benefit from recovering asset values in real estate or credit markets, such as Hammerson, British Land and Aviva.

We are generally cautious about big ticket corporate spending in what is likely to be a relatively muted economic recovery so we have limited exposure to cyclical industrial companies, although we are becoming more positive on day to day spending in areas like advertising. We have a very low exposure to the mining industry, partly due to unattractive valuations and dividends, but also due to the risk to commodity prices as China slows down its investment spending. Amongst financials the portfolio has a modest exposure to banks, mainly via HSBC, but we see many opportunities in the broader financial sector. Banks are extremely difficult to value given the uncertain profile of any cyclical recovery and significant structural challenges including increased regulation, tighter capital restrictions and higher taxation.

Dividends

The Merchants Trust has a twenty eight year record of consistently raising its dividend and the portfolio is managed with a view to maintaining a high level of income. The revenue reserves have allowed the directors to maintain this track record at a time when there have been material dividend cuts across the wider market. The worst of the dividend cuts seem to be behind us with underlying market dividend growth now positive again. A year ago we mentioned four significant risks to income generation, namely; the depth and duration of the recession, financial asset values, the level of sterling, particularly against the dollar, and commodity prices, especially oil. Three of these factors have improved markedly. Only the US dollar moved against the Trust although even that has moderated recently. The value of the dollar affects the large amount of dividends paid in dollars when translated back into sterling.

Simon Gergel
7 April 2010

Listed Holdings at 31 January 2010

Name	Value (£)	Principal Activities
Royal Dutch Shell 'B' Shares	40,876,409	Oil & Gas Producers
GlaxoSmithKline	38,185,935	Pharmaceuticals & Biotechnology
Vodafone	37,449,638	Mobile Telecommunications
BP	33,726,136	Oil & Gas Producers
HSBC	29,338,374	Banks
AstraZeneca	20,859,554	Pharmaceuticals & Biotechnology
BAE Systems	20,538,561	Aerospace & Defence
Scottish & Southern Energy	19,914,400	Electricity
British American Tobacco	19,655,050	Tobacco
Unilever	18,612,750	Food Producers
BHP Billiton	16,607,400	Mining
Centrica	13,878,142	Gas, Water & Multiutilities
National Grid	13,608,000	Gas, Water & Multiutilities
Reed Elsevier	11,990,881	Media
Aviva	11,888,100	Life Insurance
BT Group	10,016,875	Fixed Line Telecommunications
Compass Group	6,958,250	Travel & Leisure
Britvic	6,933,833	Beverages
International Personal Finance	6,050,000	General Financial
Barclays	6,006,210	Banks
Hammerson	5,666,050	Real Estate Investment Trust
International Power	5,622,750	Electricity
Premier Farnell	5,540,370	Support Services
Reckitt Benckiser	5,362,500	Household Goods & Home Construction
Bunzl	5,339,475	Support Services
Meggitt	5,299,760	Aerospace & Defence
IG Group	5,278,882	General Financial
British Land	5,168,400	Real Estate Investment Trust
British Insurance	4,944,501	Non-life Insurance
Balfour Beatty	4,811,719	Construction & Materials
Legal & General	4,733,040	Life Insurance
Man Group	4,732,922	General Financial
WPP	4,389,342	Media
Rexam	3,784,024	General Industrials
Inchcape	3,646,636	General Retailers
Lloyds Banking Group	3,594,240	Banks
Arriva	3,537,946	Travel & Leisure
Halfords	3,511,104	General Retailers
Catlin	3,329,060	Non-life Insurance
Melrose	3,263,940	Industrial Engineering
Home Retail	3,135,098	General Retailers
Interserve	2,742,810	Support Services
Informa	2,263,800	Media
Resolution	2,157,300	Life Insurance
Ashmore	1,852,585	General Financial
Pendragon	1,484,339	General Retailers
Total Equities	**488,287,091**	

Listed Holdings at 31 January 2010

Listed Derivatives

Name	Value (£)
FTSE 100 Jun 2010 2600	49,875
FTSE 100 Sept 2010 2600	33,250
FTSE 100 Mar 2010 2600	–
Purchased Put Options	**83,125**
Royal Dutch Shell Feb 2010 2000	(750)
GlaxoSmithKline Feb 2010 1400	(1,000)
BHP Billiton Mar 2010 2400	(1,750)
National Grid Mar 2010 720	(1,900)
BHP Billiton Feb 2010 2200	(3,750)
BP Feb 2010 640	(4,250)
Vodafone Feb 2010 150	(4,500)
BP April 2010 680	(6,375)
Centrica Mar 2010 300	(11,250)
Reckitt Mar 2010 3400	(12,200)
BT Group Mar 2010 160	(13,125)
Reed Elsevier Mar 2010 540	(20,000)
BAE Systems Mar 2010 380	(21,000)
Written Call Options	**(101,850)**
Total Derivative Financial Instruments	**(18,725)**

Total Listed Investments	**488,268,366**

Distribution of Total Assets

Total Assets (less creditors due within one year) £498,205,486 (2009 – £428,277,126).

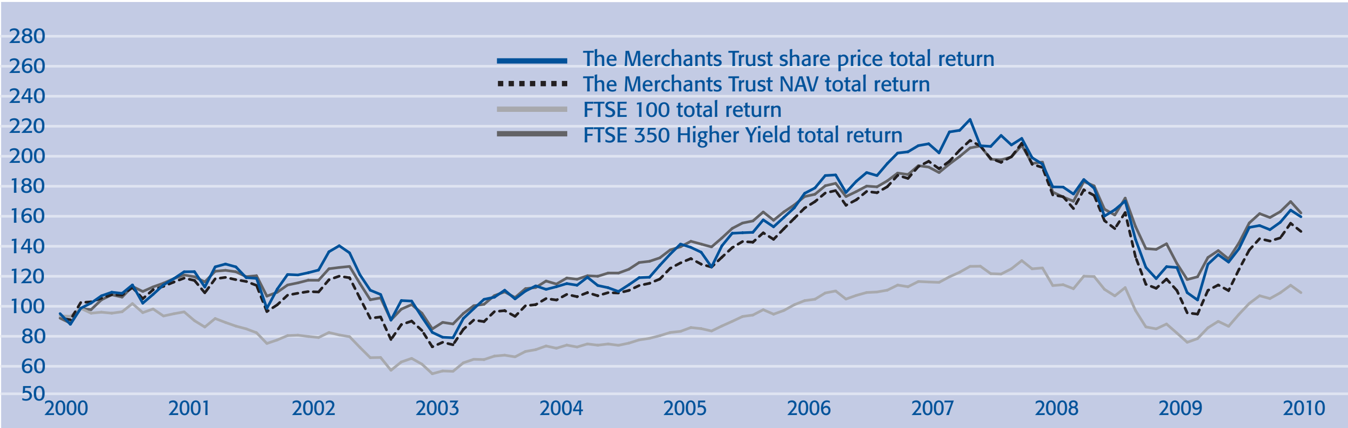
	Percentage of total assets at 31 January 2010	Percentage of total assets at 31 January 2009
Oil & Gas		
Oil & Gas Producers	15.0	18.8
	15.0	**18.8**
Basic Materials		
Mining	3.3	4.7
	3.3	**4.7**
Industrials		
Aerospace & Defence	5.2	5.2
Construction & Materials	1.0	0.7
General Industrials	0.8	0.9
Industrial Engineering	0.7	0.6
Support Services	2.7	0.5
	10.4	**7.9**
Consumer Goods		
Automobiles & Parts	–	0.5
Beverages	1.4	2.5
Food Producers	3.7	2.6
Household Goods & Home Construction	1.1	–
Tobacco	3.9	3.5
	10.1	**9.1**
Healthcare		
Pharmaceuticals & Biotechnology	11.8	12.6
	11.8	**12.6**
Consumer Services		
General Retailers	2.4	2.2
Media	3.7	3.2
Travel & Leisure	2.1	1.9
	8.2	**7.3**
Telecommunications		
Fixed Line Telecommunications	2.0	2.9
Mobile Telecommunications	7.5	9.0
	9.5	**11.9**
Utilities		
Electricity	5.1	4.0
Gas, Water & Multiutilities	5.5	6.3
	10.6	**10.3**
Financials		
Banks	7.8	5.3
General Financial	3.6	2.2
Life Insurance	3.8	3.6
Non-Life Insurance	1.7	1.3
Real Estate	2.2	–
	19.1	**12.4**

Distribution of Total Assets

	Percentage of total assets at 31 January 2010	Percentage of total assets at 31 January 2009
Information Technology		
Software & Computer Services	–	1.2
	–	**1.2**
Total Investments	**98.0**	**96.2**
Net Current Assets	**2.0**	**3.8**
Total Assets	**100.0**	**100.0**

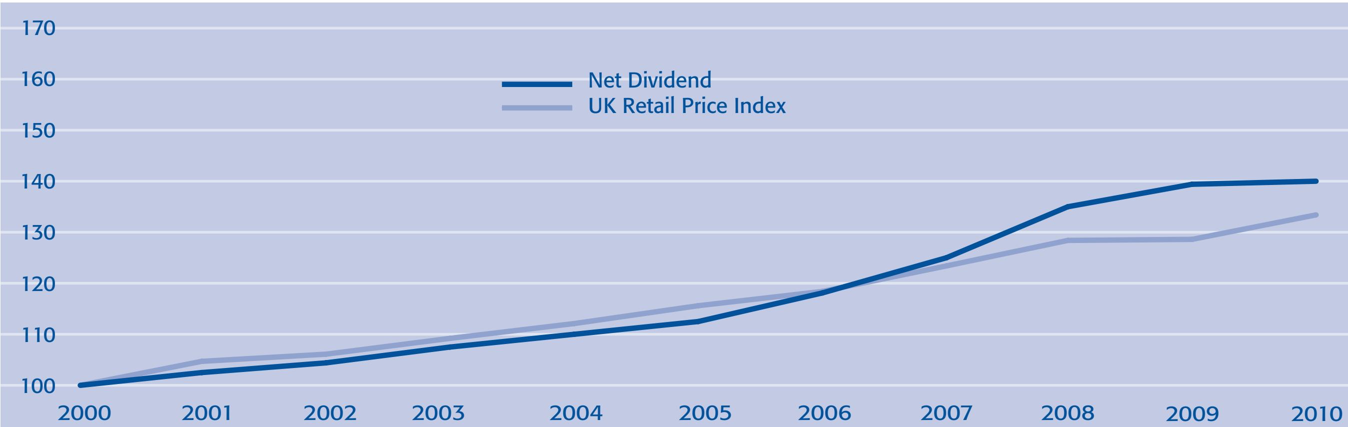
Performance Graphs 10 year record as at 31 January

The Merchants Trust 10 Year Cumulative Return compared to key UK equity indices



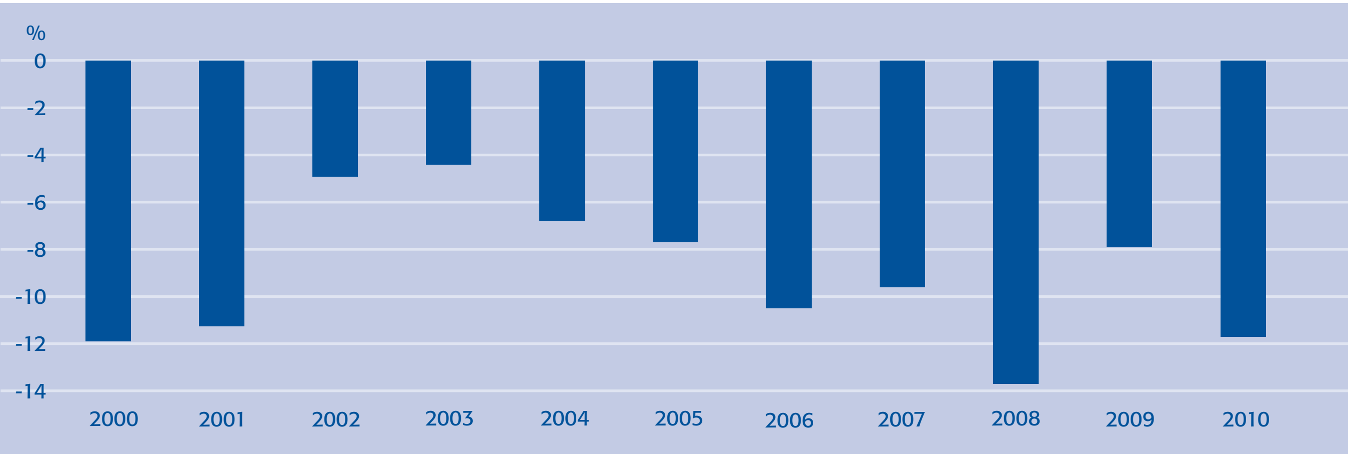
Source: Mellon
(Re-based to 100)

The Merchants Trust Net Dividend Growth compared to inflation



Source: RCM Datastream
(Re-based to 100)

The Merchants Trust Discount to Net Asset Value



Source: RCM Datastream

Directors

The current Directors' details are set out below. All Directors are non-executive and independent of the Manager.

Mr H. A. Stevenson (Chairman)
(Born September 1942) joined the Board in September 1999. Formerly Chairman of Mercury Asset Management Group plc and Equitas Limited, he is Deputy Chairman of the Financial Services Authority.

Mr R. A. Barfield
(Born April 1947) joined the Board in May 1999. Formerly Chief Investment Manager of Standard Life Assurance Company, he is a Chairman of The Baillie Gifford Japan Trust PLC and a Director of JPMorgan Fleming Overseas Investment Trust PLC, The Edinburgh Investment Trust PLC and Standard Life Investments Property Income Trust Limited. He is a member of The Professional Oversight Board, a Non-Executive member of the Pension Protection Fund Board and advises a number of pension funds.

Mr S. J. Fraser
(Born May 1959) joined the Board in August 2009. He is a non-executive director of and Chairman-elect of Foreign & Colonial Investment Trust PLC and a non-executive director of Barclays PLC, Barclays Bank PLC, Fidelity European Values PLC and Fidelity Japanese Values PLC. He spent his career at Fidelity International Limited, where he held a number of positions, including Chief Investment Officer from 1999-2005, President of Fidelity International's European and UK Institutional business and latterly President of the Investment Solutions Group. He stepped down from executive responsibilities at the end of 2008.

Mr M. J. E. McKeon
(Born October 1956) joined the Board in May 2008. He is Group Finance Director of Severn Trent plc and prior to that, from 2000 until 2005, he was Group Finance Director of Novar plc. He held various senior roles at Rolls-Royce plc from 1997 to 2000. He has extensive experience in a number of overseas positions, having worked at CarnaudMetalbox, Elf Atochem and PricewaterhouseCoopers. He is a Chartered Accountant.

Sir James Sassoon (Chairman of the Audit Committee)
(Born September 1955) joined the Board in July 2006. He is a Director of Nuclear Liabilities Fund Limited, a member of the Economic Recovery Committee of the Shadow Cabinet and a Trustee of the British Museum. He was formerly President of the Financial Action Task Force, Managing Director, Finance and Industry at HM Treasury and Vice Chairman, Investment Banking, at UBS Warburg. He is a Chartered Accountant.

Mr H. E. Staunton
(Born May 1948) joined the Board in May 2008. He is a non-executive director of Ladbrokes plc, Legal & General plc and Standard Bank Plc. He was previously Finance Director at ITV plc and Granada Group plc. He was also a non-executive director of Emap plc, BSkyB, Independent Television News Limited, Vector Hospitality plc and Ashtead Group plc, of which he was also Chairman between 2001 and 2004. He is a Chartered Accountant.

Manager and Advisers

Fund Manager RCM (UK) Limited, Represented by Simon Gergel, Portfolio Manager, and Simon White, Head of Investment Trusts

Secretary and Registered Office Kirsten Salt BA (Hons) ACIS, 155 Bishopsgate, London EC2M 3AD. Telephone: 020 7065 1513,
Email: kirsten.salt@uk.rcm.com

Independent Auditors PricewaterhouseCoopers LLP, Hay's Galleria, 1 Hay's Lane, London SE1 2RD

Bankers HSBC Bank, Barclays Bank

Stockbroker JPMorgan Cazenove

Legal Advisers Herbert Smith LLP

Directors' Report

The Directors present the annual financial report of the Company and give their report for the year ended 31 January 2010.

Business Review

Business and Status of the Company

The Company is an investment company as defined in Section 833 of the Companies Act 2006.

The Company carries on business as an investment trust and was approved by HM Revenue & Customs as an investment trust in accordance with Section 842 of the Income and Corporation Taxes Act 1988 for the year ended 31 January 2009. In the opinion of the Directors, the Company has subsequently conducted its affairs so that it should continue to qualify. The Company will continue to seek approval under Section 842 of the Income and Corporation Taxes Act 1988 each year. The Company is not a close company for taxation purposes.

Regulatory Environment

The Company is listed on the London Stock Exchange and is subject to UK company law, financial reporting standards, listing rules, tax law and its own Articles of Association. In addition to annual and half yearly financial reports published under these rules, the Company announces net asset values per share on a daily basis for the information of investors. It provides more detailed information on a monthly basis to the Association of Investment Companies, of which the Company is a member, in order for brokers and investors to compare its performance with its peer group. The Board of Directors is charged with ensuring that the Company complies with its own objectives as well as these rules. The Board has appointed RCM (UK) Limited to carry out investment management, accounting, secretarial and administration services on behalf of the Company. The Company has no employees or premises of its own.

Investment Objective and Policies

The Company's objective is to provide an above average level of income and income growth together with long term growth of capital through a policy of investing mainly in higher yielding UK FTSE 100 companies. The Company's investment performance is assessed by comparison with other investment trusts within the UK Growth and Income sector. In addition, it is benchmarked against the FTSE 100 Index, reflecting the emphasis within the portfolio, as well as the FTSE 350 Higher Yield Index, reflecting the Company's higher yield objective.

The Company pays quarterly dividends and the Board has a policy of making these progressive from year to year, in keeping with the Company's stated objective to provide an above average level of income and income growth. The dividend has increased every year for the past twenty seven years and details of historic dividend payments are set out on page 5.

Performance

In the year to 31 January 2010 the NAV per Share rose by 21.8%. This compares with the capital return on the Company's benchmark indices of 25.0% (FTSE 100) and 18.3% (FTSE 350 Higher Yield). At 31 January 2010 the value of the Company's investment portfolio was £488.3m. The Investment Manager's review on pages 6 to 10 includes a review of developments during the year as well as information on investment activity within the Company's portfolio.

Key Performance Indicators ("KPIs")

The Board uses certain financial KPIs to monitor and assess the performance of the Company. The principal KPIs are:

- *Performance against the benchmark indices*
  The Company's performance is benchmarked against the FTSE 100 Index and the FTSE 350 Higher Yield Index. These are the most important KPIs by which performance is judged.

- *Performance against the Company's peers*
  The Board also monitors the Company's performance with reference to its investment trust peer group.

- *Performance Attribution*
  The performance attribution is considered at each Board Meeting and enables the Directors to judge how the Company achieved its performance relative to the benchmark index and to see the impact on the Company's relative performance of factors including stock and sector allocation. A Performance Attribution Analysis for the year ended 31 January 2010 is given on page 5.

Directors' Report

- *Discount to net asset value ("NAV")*
  The Board has a share buy back programme which has a role to play in enhancing the NAV for existing shareholders, as shares are bought back at a discount, and in minimising the volatility of movements in the discount. In the year to 31 January 2010 the shares traded between a discount of -9.9% and a premium of +20.7% with debt at fair value.

- *Total expense ratio ("TER")*
  The most significant expense for the Company is the cost of the management fee and the costs of interest on the Company's borrowings. Other expenses include the costs of investment transactions, directors' fees and insurance, professional advice and regulatory fees and the costs of production of the reports to shareholders. The TER is calculated by dividing operating expenses, that is, the Company's management fee and all other operating expenses (including tax relief where allowable, but excluding interest payments and investment management fee VAT refund) as a percentage of total assets less current liabilities at the year end. The TER for the year ended 31 January 2010 was 0.45% (2009 – 0.58%).

Revenue

The return attributable to Ordinary Shareholders for the year amounted to £19,498,068 (2009 – £28,017,898).

Earnings per ordinary dividend amounted to 18.91p. The first and second interim dividends of 5.6p and 5.6p respectively have been paid during the year. Since the year end the third interim dividend of 5.6p has been paid. The final proposed dividend of 5.7p is payable on 14 May 2010. In accordance with FRS 21 'Events after the Balance Sheet Date', the third dividend and final dividend are not recognised as liabilities within the financial statements on the basis that they have not been paid and approved, respectively, by the shareholders.

Historical Record

The distribution of total assets is shown on pages 13 and 14, and the historical record of the Company's revenue, capital and invested funds over the past ten years is shown on page 5. Graphs appear on page 15 showing the performance on a total return basis over the past ten years of the Net Asset Value of the Company's Ordinary Shares against the Company's benchmark indices, the growth in net ordinary distributions made by the Company against the Retail Price Index, and the Company's discount to Net Asset Value over the same period.

Invested Funds

Sales of investments during the year resulted in net losses based on historical costs of £54,388,557 (2009 – £38,449,932). Provisions contained in the Finance Act 1980 exempt approved Investment Trusts from corporation tax on their chargeable gains. Invested funds at 31 January 2010 had a value of £488,295,791 (2009 – £411,795,591) before deducting net liabilities of £103,548,577 (2009 – £96,991,555).

Principal Risks and Uncertainties

With the assistance of the Manager the Board has drawn up a risk matrix which identifies the key risks to the Company. These key risks fall broadly under the following categories:

- Investment Activity and Strategy: An inappropriate investment strategy, e.g., asset allocation or the level of gearing, may lead to under-performance against the Company's benchmark index and peer group companies, and also in the Company's shares trading on a wider discount. The Board manages these risks by diversification of investments through its investment restrictions and guidelines which are monitored and on which the Board receives reports. RCM (UK) Limited ("RCM") provides the Directors with management information including performance data and reports and shareholder analyses. The Board monitors the implementation and results of the investment process with the investment manager, who attends all board meetings, and reviews data which show risk factors and how they affect the portfolio. The Board reviews investment strategy at each board meeting.

- Accounting, Legal and Regulatory: In order to qualify as an investment trust the Company must comply with Section 842 of the Income and Corporation Taxes Act 1988 ("Section 842"), and details are given above under the heading 'Business of the Company'. A breach of Section 842 could result in the Company losing investment trust status and, as a consequence, gains in the Company's portfolio would be subject to Corporation Tax. The Section 842 criteria are monitored by RCM and results are reported to the Board at each Board Meeting. The Company must comply with the provisions of the Companies Act 2006 ("Companies Act"), and, as the Company's shares are listed on the London Stock Exchange, the Company must comply with the UK Listing Authority's Listing Rules and Disclosure and Transparency Rules ("UKLA Rules"). A breach of the Companies Act could result in the Company and/or the Directors being fined or becoming the subject of criminal proceedings. Breach of the UKLA Rules could result in the suspension of the Company's shares which would in turn lead to a

Directors' Report

breach of Section 842. The Board relies on its company secretary and seeks advice from professional advisers to ensure compliance with the Companies Act and UKLA Rules.

- Corporate Governance and Shareholder Relations: Details of the Company's compliance with Corporate Governance best practice, including information on relations with shareholders, are set out in the Corporate Governance Statement on pages 21 to 25.

- Operational: Disruption to, or failure of, RCM's accounting, dealing or payment systems or the custodian's records may prevent accurate reporting and monitoring of the Company's financial position. RCM has contracted operational functions, principally relating to trade processing and investment administration, to The Bank of New York Mellon – London Branch. Details of how the Board monitors the services provided by RCM and other suppliers and the key elements designed to provide effective internal control are included within the Internal Control section of the Corporate Governance Statement on page 24.

- Financial: The financial risks associated with the Company include market risk (price and yield), interest rate risk, liquidity risk and credit risk. Further analysis of these risks can be found in Note 18 on pages 46 to 50.

Future Development

The future development of the Company is dependent on the success of the Company's investment strategy against the economic environment and market developments. The investment manager discusses his view of the outlook for the Company's portfolio in his report beginning on page 6.

Going Concern

The Directors have considered the Company's investment objective and capital structure and, having noted that the portfolio consists mainly of securities which are readily realisable, have concluded that the Company has adequate resources to continue in operational existence for the foreseeable future. For this reason the Directors continue to adopt the going concern basis in preparing the financial statements.

Net Asset Value

The Net Asset Value of the Ordinary Shares of 25p at the year end was 372.8p as compared with a value of 306.2p at 31 January 2009.

Share Capital

Details of the Company's share capital are set out in Note 11 on page 44.

Payment Policy

It is the Company's payment policy for the forthcoming financial year to obtain the best terms for all business and therefore there is no consistent policy as to the terms used. In general, the Company agrees with its suppliers the terms on which business will take place and it is our policy to abide by these terms. The Company had no trade creditors at the year end (2009 – £nil).

Donations and Subscriptions

There were no charitable donations and subscriptions in respect of the year (2009 – £nil). No political donations were made during the year.

Final Dividend

Subject to the final dividend being approved by shareholders at the Annual General Meeting, payment will be made on 14 May 2010 to shareholders on the Register of Members at the close of business on 16 April 2010 at the rate of 5.7p per Ordinary Share. Further details are provided in Note 6 on page 40.

Capital Structure

The Company's capital structure is summarised on page 44.

Directors' Report

Voting Rights in the Company's Shares

The voting rights at 31 March 2010 were:

Share class	Number of shares issued	Voting rights per share	Total Voting Rights
Ordinary shares of 25p	103,213,464	1	103,213,464
3.65% Cumulative Preference shares of £1	1,178,000	1	1,178,000
Total	**104,391,464**		**104,391,464**

These figures remained unchanged at the date of this report.

Interests in the Company's Share Capital

As at 6 April 2010 the following had declared a notifiable interest in the Company's issued share capital:

Ordinary Shares:

Name	Number of Shares	Percentage of Voting Rights
Rensburg Sheppards Investment Management Group Limited	4,017,845	3.9%
AXA S.A.	4,125,070	4.0%
Legal & General Group PLC	4,099,823	4.0%
Lloyds Banking Group PLC	4,086,614	4.0%

3.65% Cumulative Preference Stock:

Name	Number of Shares	Percentage of Voting Rights
P. S. & J. M. Allen	185,582	15.8%
Prudential plc	176,000	14.9%
Ecclesiastical Insurance Office plc	134,690	11.4%
F&C Asset Management plc	60,000	5.1%
D. J. Edwards	50,000	4.2%
J. Y. Miller	36,000	3.0%

The rules concerning the appointment and replacement of directors, amendment of the Articles of Association and powers to issue or buy back the Company's shares are contained in the Articles of Association of the Company and the Companies Act 2006.

There are no restrictions concerning the transfer of securities in the Company; no special rights with regard to control attached to securities; no agreements between holders of securities regarding their transfer known to the Company; no agreements which the Company is party to that might affect its control following a takeover bid; and no agreements between the Company and its directors concerning compensation for loss of office.

Directors and Management

All Directors listed on the next page served throughout the financial year under review.

The Directors retiring by rotation at the Annual General Meeting ('AGM') are Hugh Stevenson, Dick Barfield and Sir James Sassoon. Sir James Sassoon and Mr Barfield each offers himself for re-election and both have the full support of the Board in doing so. In addition, Simon Fraser, having been appointed since the last AGM, is standing for election at this year's AGM. The Board used an external recruitment consultant in the appointment of Simon Fraser. Hugh Stevenson is retiring from the Board and so does not offer himself for re-election. The Board confirms that, since the year end, the performances of all of the Directors have been subject to a formal evaluation and that each continues to be effective and committed to his role. The Board considers Mr Barfield to be independent, notwithstanding his length of service, and continues to be of the view that his extensive experience and active knowledge of industry and financial services are of great benefit to the Board.

Biographical details of the current Directors are on page 16.

Directors' Report

The current Directors and their beneficial interests in the share capital of the Company as at 31 January 2010 and 31 January 2009 are listed below:

	Ordinary Shares of 25p	
	2010	2009
H. A. Stevenson	25,000	25,000
R. A. Barfield	2,440	2,440
S. J. Fraser*	20,000	–
Sir James Sassoon	40,145	35,600
M. J. E. McKeon	450	450
H. E. Staunton	10,000	10,000

*Joined the Board on 1 August 2009.

No contracts of significance in which Directors are deemed to have been interested have subsisted during the year under review.

Contracts of service are not entered into with the Directors, who hold office in accordance with the Articles of Association.

Management Contract and Management Fee

The management contract with RCM (UK) Limited ('RCM') provides for a fee of 0.35% per annum (2009 – 0.35%) of the value of the assets, calculated quarterly, after deduction of current liabilities, short term loans under one year and any funds within the portfolio managed by RCM. The management contract is terminable at one year's notice (2009 – one year).

The Manager's performance under the contract and the contract terms are reviewed at least annually by the Management Engagement Committee. This committee consists of the Directors not employed by the management company in the past five years and therefore includes the entire Board. During the year, the committee met the Manager to review the current investment framework, including the Trust's performance, marketing activity and total expense ratio.

The committee also reviewed the terms of the management contract and considered the level of the management fee. The committee was satisfied with its review and believes that the continuing appointment of the Manager is in the best interests of shareholders as a whole.

Related Party Transactions

During the financial year no transactions with related parties have taken place which would materially affect the financial position or the performance of the Company.

Individual Savings Accounts

The affairs of the Company are conducted in such a way as to meet the requirements for an Individual Savings Account and it is the intention to continue to do so.

Corporate Governance Statement

The Board has considered the principles and recommendations of the Association of Investment Companies Code of Corporate Governance ("AIC Code") by reference to the AIC Corporate Governance Guide for Investment Companies ("AIC Guide"). The AIC Code, as explained by the AIC Guide, addresses all the principles set out in Section 1 of the Combined Code which was issued by the Financial Reporting Council in June 2008, as well as setting out additional principles and recommendations on issues that are of specific relevance to the Company.

The Board considers that reporting against the principles and recommendations of the AIC Code, and by reference to the AIC Guide, will provide better information to shareholders. The Company has complied with the recommendations of the AIC Code and the relevant provisions of Section 1 of the Combined Code, except in relation to the Combined Code provisions relating to: the role of the chief executive, executive directors' remuneration and the need for an internal audit function. For the reasons set out in the AIC Guide, and in the preamble to the Combined Code, the Board considers these provisions are not relevant to the Company as it is an externally managed investment company. The Company has therefore not reported further in respect of these provisions.

Directors' Report

The Board

The Board currently consists of six Directors, all of whom are non-executive and independent of the Company's investment manager. The Directors' biographies, on page 16, demonstrate a breadth of investment, industrial, commercial and professional experience.

The Chairman of the Company is a non-executive Director. Sir James Sassoon is the Senior Independent Director.

The Board follows the AIC Code and considers Dick Barfield to be independent, notwithstanding that he has served on the Board for more than nine years. The Board does not consider that length of service has diminished his independence and continues to be of the view that his extensive experience and active knowledge of the industry is of great benefit to the Board. The composition of the Board is reviewed regularly.

The Board's tenure policy is that new Directors stand for election at the first Annual General Meeting following their appointment and then at least one third of Directors retire by rotation at each Annual General Meeting. Every Director is required to seek re-election at least every three years and annually after nine years' service. The names of the Directors retiring by rotation and those other Directors retiring in accordance with the Articles of Association at this year's Annual General Meeting are given on page 20.

The Board meets at least six times a year and convenes other meetings as and when required. Between meetings, regular contact with the investment manager is maintained. The Board has a schedule of matters reserved for its approval to ensure it has full and effective control over appropriate issues. These issues include approval of the Company's investment policy, capital structure, share price and discount, committee membership and terms of reference, financial reporting, risk management, board appointments and removals, corporate governance, internal controls and contracts. A procedure has been adopted for Directors, in the furtherance of their duties, to take independent professional advice at the expense of the Company. The Directors have access to the advice and services of the Company Secretary, who is responsible to the Board for ensuring that Board procedures are followed and that the Company complies with applicable rules and regulations. When a new Director is appointed there is an induction process carried out by the investment manager. Directors are provided, on a regular basis, with key information on the Company's regulatory and statutory requirements and internal financial controls. Changes affecting Directors' responsibilities are advised to the Board as they arise.

During the year, the effectiveness of the Board and the performance of individual Directors was assessed through interviews conducted by the Chairman with each Director. The Chairman's own performance was evaluated by the other Directors in discussions with Sir James Sassoon as Senior Independent Director. The results of the effectiveness assessment and performance evaluation have been presented to the Nomination Committee.

The effectiveness assessment determined that with the planned recruitment of new Directors the balance of the Board was satisfactory.

The Board has contractually delegated to the investment manager the management of the investment portfolio, and the day to day accounting and company secretarial requirements. This contract was entered into after full and proper consideration by the Board of the quality and cost of services offered, including the financial control systems in operation, in so far as they relate to the affairs of the Company. The Board receives and considers reports regularly from the investment manager and ad hoc reports and information are supplied to the Board as required. The Board's statement on its review of the management contract appears on page 21.

Attendance by Directors at formal Board and committee meetings during the year was as follows:

Director	Board	Audit Committee	Nomination Committee	Management Engagement Committee
No. of meetings	6	2	1	1
H. A. Stevenson	6	2*	1	1
R. A. Barfield	6	2	1	1
S. J. Fraser~	2	–	–	–
Sir James Sassoon	6	2	1	1
M. J. E. McKeon	6	2	1	1
P. J. Scott Plummer#	2	–	–	–
H. E. Staunton	6	2	1	1

* Invited to attend meetings, although not a committee member.
~ Appointed to the Board in August 2009.
# Retired from the Board in May 2009.

Directors' Report

Conflicts of Interest

The Companies Act 2006 sets out directors' general duties with some changes from the previously existing law. A director must avoid a situation where he has, or can have, a direct or indirect interest that conflicts, or possibly may conflict, with the Company's interests. Since 1 October 2008, directors are able to authorise these conflicts and potential conflicts. The Board reports annually on the Company's procedures for ensuring that its powers of authorisation of conflicts are operated effectively and that the procedures have been followed.

Each of the Directors has provided a statement of all conflicts of interest and potential conflicts of interest relating to the Company. These statements have been considered and approved by the Board. The Directors have undertaken to notify the Chairman and Company Secretary of any proposed new appointments and new conflicts or potential conflicts for consideration, if necessary, by the Board. The Board has agreed that only Directors who have no interest in the matter being considered will be able to take the relevant decision and that in taking the decision the Directors will act in a way they consider, in good faith, will be most likely to promote the Company's success. The Board is able to impose limits or conditions when giving authorisation if it thinks this is appropriate.

The Board confirms that its powers of authorisation are operating effectively and that the agreed procedures have been followed.

Board Committees

Audit Committee

The Audit Committee consists of all of the independent non-executive Directors, with the exception of the Chairman, and has defined terms of reference and duties. The role of the Audit Committee is to assist the Board in relation to the reporting of financial information. The Audit Committee is chaired by Sir James Sassoon. The committee considers that, collectively, its members have sufficient recent and relevant financial experience to discharge their responsibilities fully. The committee meets at least twice each year and reviews the annual and half yearly financial statements and considers the Auditors' report on the annual accounts, the planning and the process of the audit and the Auditors' independence and objectivity. It has also considered the non-audit services provided by the Auditors and determined that they have had no impact on the Auditors' independence and objectivity. The Audit Committee reviews the Company's accounting policies and considers their appropriateness. The Committee also reviews the terms of appointment of the Auditors together with their remuneration. It meets representatives of the Manager twice-yearly and receives reports on the internal controls maintained on behalf of the Company and reviews the effectiveness of these controls. The Audit Committee continues to believe that the Company does not require an internal audit function of its own as it delegates its day to day operations to third parties from whom it receives internal controls reports.

As the Company has no employees it does not have a formal policy concerning the raising, in confidence, of any concerns about improprieties, whether in matters of financial reporting or otherwise, for appropriate independent investigation. The Audit Committee has, however, received and noted the Manager's policy on this matter.

Nomination Committee

The Nomination Committee meets at least once each year and makes recommendations on the appointment of new Directors and the re-election of existing Directors by shareholders. The committee also determines the process for the annual evaluation of the Board. The Committee is chaired by Hugh Stevenson, the Chairman of the Board. All Directors serve on the committee and consider nominations made in accordance with an agreed procedure.

Management Engagement Committee

The Management Engagement Committee meets at least once each year to review the Management Agreement and the Manager's performance. It has defined terms of reference and consists of the non-executive Directors and excludes any Directors previously employed by the Manager. It is chaired by Hugh Stevenson, the Chairman of the Board.

The Board has not constituted a Remuneration Committee; all Directors are non-executive and remuneration matters are dealt with by the whole Board.

Terms of Reference

The Terms of Reference for each of the committees may be viewed by shareholders on request and are published on the website www.merchantstrust.co.uk.

Financial Reporting

The Statement of Directors' Responsibilities in respect of the financial statements is on page 28.

The Independent Auditors' Report can be found on page 31.

Directors' Report

Auditors' Information

Each of the persons who is a Director at the date of approval of this report confirms that:

(a) in so far as the Director is aware, there is no relevant audit information of which the Company's auditors are unaware; and

(b) the Director has taken all the steps he ought to have taken as a Director in order to make himself aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

This confirmation is given and should be interpreted in accordance with the provisions of Section 418(2) of the Companies Act 2006.

Internal Control

The Directors have overall responsibility for the Company's system of internal control. Whilst acknowledging their responsibility for the system of internal control, the Directors are aware that such a system is designed to manage rather than eliminate the risk of a failure to achieve business objectives and can provide only reasonable but not absolute assurance against material misstatement or loss.

The Board has established an ongoing process for identifying, evaluating and managing the significant risks faced by the Company. This process is subject to review by the Board and accords with the Internal Control Guidance for Directors in the Combined Code published in September 1999 and revised by the Financial Reporting Council in October 2005 ("the Turnbull guidance"). The process has been fully in place throughout the year under review and up to the date of signing of this Annual Financial Report.

The key elements of the procedures that the Directors have established and which are designed to provide effective internal control are as follows:

- The Board, assisted by the Manager, undertook a full review of the Company's business risks and these are analysed and recorded in a risk matrix. Every six months the Board receives from the Manager a formal report which details any known internal controls failures, including those that are not directly the responsibility of the Manager. The Board continues to check that good systems of internal control and risk management are embedded in the operations and culture of the Company and its key suppliers.
- The appointment of RCM (UK) Limited ('RCM') as the Manager provides investment management, accounting and company secretarial services to the Company. The Manager therefore maintains the internal controls associated with the day to day operation of the Company. These responsibilities are included in the Management Agreement between the Company and the Manager. The Manager's system of internal control includes organisation arrangements with clearly defined lines of responsibility and delegated authority as well as control procedures and systems which are regularly evaluated by management and monitored by its internal audit department. RCM is regulated by the Financial Services Authority ('FSA') and its compliance department regularly monitors compliance with FSA rules. The Company receives reports at least annually from the manager on its internal controls. The Company, in common with other investment trusts, has no internal audit department, but the effectiveness of the Manager's internal controls is monitored by Allianz Global Investors' internal audit function.
- There is a regular review by the Board of asset allocation and any risk implications. There is also regular and comprehensive review by the Board of management accounting information including revenue and expenditure projections, actual revenue against projections and performance comparisons.
- Authorisation and exposure limits are set and maintained by the Board.
- The Audit Committee assesses the Manager's and Custodian's systems of controls by reviewing Internal Control reports provided by the Managers and third party service providers, including those of the Company's Registrars, Capita Registrars, and Custodian, HSBC Bank plc.

The Directors confirm that the Audit Committee has reviewed the effectiveness of the system of internal control. During the course of its review of the system of internal control, the Board has not identified nor been advised of any failings or weaknesses which it has determined to be significant.

Relations with Shareholders

The Board strongly believes that the annual general meeting should be an event which private shareholders are encouraged to attend. The annual general meeting is attended by the Chairman of the Board and the Chairman of the Audit Committee, and the Investment Manager makes a presentation at the meeting. The number of proxy votes cast in respect of each resolution will be made available at the annual general meeting.

The Manager meets with institutional shareholders on a regular basis and report to the Board on matters raised at these meetings.

All correspondence with shareholders is reviewed by the Board.

Directors' Report

Shareholders who wish to communicate directly with the Chairman, the Senior Independent Director or other Directors may write care of the Company Secretary at 155 Bishopsgate, London EC2M 3AD.

The Notice of Meeting sets out the business of the meeting and special resolutions are explained more fully in the Directors' Report. Separate resolutions are proposed for each substantive issue.

Corporate Social Responsibility and Environmental Policy

The Investment Manager has been directed by the Board to take account of companies' corporate social responsibility and environmental performance when taking investment decisions.

The Board has noted the Manager's views on Social Responsibility that it adheres to in engaging with the underlying investee companies and in exercising its delegated responsibilities in voting. These are that:

"We believe that good corporate governance includes the management of the company's impacts on society and the environment, as these are increasingly becoming a factor in contributing towards maximising long term shareholder value."

Exercise of Voting Powers

The Company's investments are held in a nominee name. The Board has delegated discretion to discharge its responsibilities in respect of investments, including the exercise of voting powers on its behalf, to the Manager.

The Board has noted the Manager's statement of its corporate governance aims and objectives, summarised as:

> "Our primary corporate aim is to maximise shareholder value through the securing of corporate performance whilst protecting this value through operating within established rules of conformance.
>
> Our primary investment management aim is to meet or exceed our clients' expectations through generating first class returns within the constraint of their risk tolerance.
>
> RCM votes in all markets wherever possible, and strives actively to encourage both improved levels of disclosure among companies and proper voting infrastructure among custodians and agents globally."

In the UK, RCM is a member of the National Association of Pension Funds (NAPF) and the International Corporate Governance Network (ICGN), and abides by these organisations' founding principles. These guidelines also take into account international codes of corporate governance from a number of sources, including Employment Retirement Income Security Act (ERISA) legislation and Department of Labor recommendations in the U.S. where appropriate.

Where Directors hold directorships on the boards of companies in which the Company is invested, they do not participate in decisions made concerning those investments.

An extract from the Company's voting record in the previous calendar year will be available for inspection at the annual general meeting each year.

Annual General Meeting

Adoption of new Articles of Association

In Resolution 9 in the Notice of Meeting on page 54 the Company proposes to adopt new Articles of Association ('new Articles') to replace the current Articles of Association ('current Articles'). The new Articles incorporate amendments to the current Articles to reflect the provisions of the Companies Act 2006 (the '2006' Act) and also the Companies (Shareholders' Rights) Regulations 2009 ("Shareholders' Rights Regulations"), and otherwise generally update the current Articles for current law, regulation and market practice. The new Articles, showing all the changes to the current Articles, are available for inspection at the registered office during normal business hours at the Company's Registered Office, 155 Bishopsgate, London EC2M 3AD from the date of this report up until the close of the AGM. Copies will also be available at 20 Moorgate, London EC2R 6DA being the place of the Annual General Meeting, for 15 minutes prior to, and during, the meeting.

The material changes necessary and recommended due to the entering into force of the Companies Act 2006 and the Shareholders' Rights Regulations include: removing the Chairman's casting vote at Shareholder meetings; the removal of the Company's ability to give notice of meetings by advertisement when the post is not available; the removal of references to authorised but unissued shares; the additional manner in which the Company's name can be changed by way of board resolution; the deletion of the ability to close the register; the removal of specific

Directors' Report

authorities no longer required on capital reduction or buy backs; the addition of a provision confirming that there is no requirement to check that the proxy is voting according to his instructions; provisions relating to the administration of the Company; and minor changes to proceedings at general meetings.

Purchase of Own Shares

The Board is proposing that the Company should be given renewed authority to purchase Ordinary Shares in the market for cancellation. The Board believes that such purchases in the market at appropriate times and prices are a suitable method of enhancing shareholder value. The Company would make either a single purchase or a series of purchases, when market conditions are suitable, with the aim of maximising the benefits to shareholders and within guidelines set from time to time by the Board.

Where purchases are made at prices below the prevailing net asset value of the Ordinary Shares, this will enhance net asset value for the remaining shareholders. It is therefore intended that purchases would only be made at prices below net asset value, with the purchases to be funded from the capital reserves of the Company (which are currently in excess of £250 million). The rules of the UK Listing Authority ('Listing Rules') limit the price which may be paid by the Company to 105% of the average middle-market quotation for an Ordinary Share on the five business days immediately preceding the date of the relevant purchase. The minimum price to be paid will be 25p per Ordinary Share (being the nominal value). Overall, this proposed share buy-back authority, if used, should help to reduce the discount to net asset value at which the Company's shares currently trade.

The Board considers that it will be most advantageous to shareholders for the Company to be able to continue to make such purchases as and when it considers the timing to be most favourable and therefore does not propose to set a timetable for making any such purchases.

Under the Listing Rules, the maximum number of shares which a listed company may purchase through the market pursuant to a general authority such as this is equivalent to 14.99% of its issued share capital. For this reason, the Company is limiting its renewed authority to make such purchases to 15,411,738 Ordinary Shares, representing 14.99% of the issued share capital, provided that there is no change in the issued share capital between the date of this report and the Annual General Meeting to be held on 11 May 2010.

The authority was previously in Section 166 of the Companies Act 1985 and the equivalent authority which is in Section 701 of the Companies Act 2006, will last until the Annual General Meeting of the Company to be held in 2011 or the expiry of 18 months from the date of the passing of this resolution, whichever is the earlier. The authority will be subject to renewal by shareholders at subsequent annual general meetings.

Allotment of New Shares and Disapplication of Pre-emption Rights

Approval is sought for the renewal of the Directors' authority to allot relevant securities, in accordance with Section 551 of the Companies Act 2006, up to a maximum aggregate nominal amount of £8,567,788, representing approximately 33% of the existing Ordinary Share capital. This authority is renewable annually and would expire at the conclusion of the Annual General Meeting in 2011. This authority is equivalent to the previous authority in Section 80 of the Companies Act 1985.

A resolution was passed at the Annual General Meeting held on 12 May 2009 under Section 95 of the Companies Act 1985, to authorise the Directors to allot Ordinary Shares for cash other than pro rata to existing shareholders. The authority is renewable annually and expires at the conclusion of the Annual General Meeting in 2010. The equivalent authority under the Companies Act 2006 is in Section 570. A Special Resolution is therefore proposed under special business at the forthcoming Annual General Meeting to renew this authority for a further year. This power is limited to the aggregate nominal amount of £2,570,336 Ordinary Share capital, being approximately 10% of the issued Ordinary Share capital of the Company as at the date of this report, provided that there is no change in the issued share capital between the date of this report and the Annual General Meeting to be held on 11 May 2010.

The Directors may allot shares under these authorities to take advantage of opportunities in the market as they arise but only if they believe it would be advantageous to the Company's existing shareholders to do so. The Directors confirm that no allotment of new shares will be made unless the lowest market offer price of the Ordinary Shares is at least at a premium to net asset value, valuing debt at market value.

Authority to hold a general meeting on 14 days' clear notice

This resolution is required to reflect the implementation in August 2009 of the EU Shareholder Rights Directive (the "Directive"), which has increased the notice period for all general meetings of the Company to 21 days' clear notice. The Company was previously able to call general meetings (other than an Annual General Meeting) on 14 days' clear notice and would like to preserve this ability. Under the Directive, Companies are permitted to seek shareholder approval, on an annual basis and by way of a special resolution, for general meetings (other than the annual general meeting) to be called on 14 days' clear notice. This authority will only be used if it is in the best interests of shareholders and will be

Directors' Report

effective until the Company's next Annual General Meeting, when it is intended that a similar resolution will be proposed. Furthermore, in order to use this authority, all shareholders must be given the opportunity (but not the obligation) to vote at such a general meeting by electronic means. Annual general meetings will continue to be held on at least 21 days' clear notice.

Auditors

The Directors will place a resolution before the Annual General Meeting to re-appoint PricewaterhouseCoopers LLP as Auditors for the ensuing year. A resolution to authorise the Directors to determine the Auditors' remuneration will also be proposed at the Annual General Meeting.

By Order of the Board
K. J. Salt | Secretary
7 April 2010

Statement of Directors' Responsibilities

The Directors are responsible for preparing the Annual Financial Report, the Directors' Remuneration Report and the financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year. Under that law the Directors have elected to prepare the financial statements in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law). Under that law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that period. In preparing these financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and accounting estimates that are reasonable and prudent;
- state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the financial statements respectively;
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the company will continue in business.

The Directors confirm that they have complied with the above requirements in preparing the financial statements.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the company's transactions and disclose with reasonable accuracy at any time the financial position of the company and enable them to ensure that the financial statements and the Directors' Remuneration Report comply with the Companies Act 2006. They are also responsible for safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

The financial statements are published on www.merchantstrust.co.uk, which is a website maintained by the Company's investment manager, RCM (UK) Limited. The Directors are responsible for the maintenance and integrity of the company's website. The work undertaken by the Auditor does not involve consideration of the maintenance and integrity of the website and, accordingly, the Auditor accepts no responsibility for any changes that have occurred to the financial statements since they were initially presented on the website. Visitors to the website need to be aware that legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

Statement under DTR 4.1.12

The Directors at the date of approval of this Report, each confirm to the best of their knowledge that:

- the financial statements, which have been prepared in accordance with United Kingdom Generally Accepted Accounting Practice (United Kingdom Accounting Standards and applicable law), give a true and fair view of the assets, liabilities, financial position and profit or loss of the company; and
- the Annual Financial Report includes a fair review of the development and performance of the Company and the position of the company, together with a description of the principal risks and uncertainties that it faces.

For and on behalf of the Board
Hugh Stevenson | Chairman
7 April 2010

Directors' Remuneration Report

This report is submitted in accordance with the Large and Medium Sized Companies and Groups (Accounts and Reports) Regulations 2008, Schedule 8, for the year ended 31 January 2010. An ordinary resolution for the approval of this report will be put to shareholders at the forthcoming Annual General Meeting.

The Board

The Board of Directors is composed solely of non-executive Directors and the determination of the Directors' fees is a matter dealt with by the whole Board. The Board has not been provided with advice or services by any person to assist it to make its remuneration decisions, although the Directors carry out reviews from time to time of the fees paid to the directors of other investment trusts.

Policy on Directors' Remuneration

No Director has a service contract with the Company. The Company's policy is for the Directors to be remunerated in the form of fees, payable half-yearly in arrears. There are no long term incentive schemes, bonuses, pension benefits, share options or other benefits and fees are not related to the individual Director's performance, nor to the performance of the Board as a whole.

The Company's Articles of Association limit the aggregate fees payable to the Board of Directors to a total of £150,000 per annum. Subject to this overall limit, it is the Board's policy to determine the level of Directors' fees having regard to the level of fees payable to non-executive Directors in the investment trust industry generally, the role that individual Directors fulfil, and the time committed to the Company's affairs. The Board believes that levels of remuneration should be sufficient to attract and retain non-executive directors to oversee the Company.

Directors' and officers' liability insurance cover is held by the Company. As permitted by the Company's Articles of Association, deeds of indemnity have been entered into with the Directors.

Remuneration

The policy is to review Directors' fees from time to time, but reviews will not necessarily result in a change to the rates. In accordance with this policy the Board reviewed the fees during the year and agreed not to increase the fees at that time. As disclosed in last year's report, with effect from 1 June 2008 the Directors were paid at a rate of £18,000 per annum, with an additional £3,000 payable to the Audit Committee Chairman, and the Chairman of the Board was paid at a rate of £27,500 per annum.

Directors' Emoluments (Audited)

The Directors' Emoluments during the year and in the previous year are as follows:

	Directors' fees	
	2010	2009
	£	£
H. A. Stevenson	27,500	26,667
R. A. Barfield	18,000	17,000
S. J. Fraser*	9,000	–
Sir Bob Reid†	–	4,269
M. J. E. McKeon	18,000	13,500
Sir James Sassoon	21,000	19,667
P. J. Scott Plummer~	5,358	17,000
H. E. Staunton	18,000	13,500
Totals	**116,858**	**111,603**

* Appointed to the Board 1 August 2009.

† Retired from the Board May 2008.

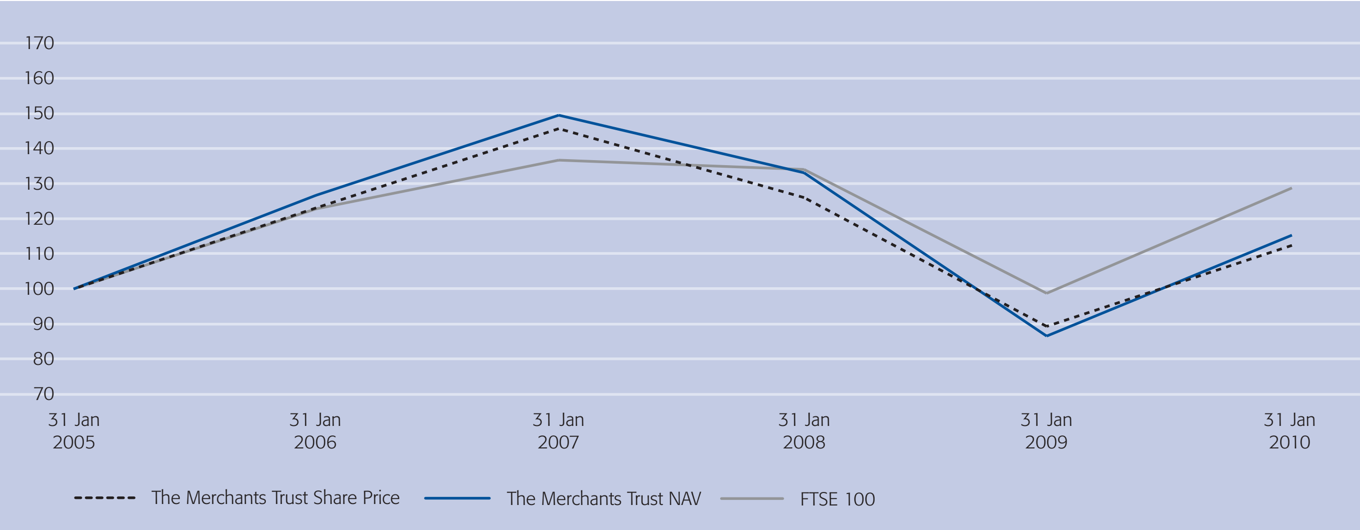
~ Retired from the Board May 2009.

Directors' Remuneration Report

Performance Graph

The graph below measures the Company's share price and net asset value performance against its benchmark index of the FTSE 100 Index and is re-based to 100.

The Company's performance is measured against the FTSE 100 Index as this is the most appropriate comparator in respect of its asset allocation. An explanation of the Company's performance is given in the Chairman's Statement and the Investment Manager's Review.



By Order of the Board
K. J. Salt | Secretary
7 April 2010

Independent Auditors' Report to the Members of The Merchants Trust PLC

We have audited the financial statements of The Merchants Trust PLC for the year ended 31 January 2010 which comprise the Income Statement, the Reconciliation of Movements in Shareholders' Funds, the Balance Sheet, the Cash Flow Statement, the Statement of Accounting Policies and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice).

Respective responsibilities of directors and auditors

As explained more fully in the Statement of Directors' Responsibilities set out on page 28, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinions, has been prepared for and only for the company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the company's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the directors; and the overall presentation of the financial statements.

Opinion on financial statements

In our opinion the financial statements:

- give a true and fair view of the state of the company's affairs as at 31 January 2010 and of its net return and cash flows for the year then ended;
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Opinion on other matters prescribed by the Companies Act 2006

In our opinion:

- the part of the Directors' Remuneration Report to be audited has been properly prepared in accordance with the Companies Act 2006; and
- the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following:

Under the Companies Act 2006 we are required to report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements and the part of the Directors' Remuneration Report to be audited are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Under the Listing Rules we are required to review:

- the directors' statement, set out on page 19, in relation to going concern; and
- the parts of the Corporate Governance Statement relating to the Company's compliance with the nine provisions of the June 2008 Combined Code specified for our review.

Ian Armfield (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London
7 April 2010

Income Statement for the year ended 31 January 2010

	Notes	2010 Revenue Return £	2010 Capital Return £	2010 Total Return £	2009 Revenue Return £	2009 Capital Return £	2009 Total Return £
Net gains (losses) on investments at fair value	8	–	79,416,688	79,416,688	–	(189,593,060)	(189,593,060)
Income	1	23,686,655	–	23,686,655	31,729,754	–	31,729,754
Investment management fee	2	(560,552)	(1,041,025)	(1,601,577)	(658,425)	(1,222,788)	(1,881,213)
Investment management fee VAT refund	2	416,080	772,720	1,188,800	966,622	205,850	1,172,472
Administrative expenses	3	(659,180)	(3,915)	(663,095)	(599,808)	(2,967)	(602,775)
Net return before finance costs and taxation		**22,883,003**	**79,144,468**	**102,027,471**	**31,438,143**	**(190,612,965)**	**(159,174,822)**
Finance costs: interest payable and similar charges	4	(3,384,935)	(6,206,422)	(9,591,357)	(3,420,245)	(6,271,962)	(9,692,207)
Net return on ordinary activities before taxation		**19,498,068**	**72,938,046**	**92,436,114**	**28,017,898**	**(196,884,927)**	**(168,867,029)**
Taxation	5	–	–	–	–	–	–
Net return on ordinary activities attributable to Ordinary Shareholders		**19,498,068**	**72,938,046**	**92,436,114**	**28,017,898**	**(196,884,927)**	**(168,867,029)**
Return per Ordinary Share (basic and diluted)	7	**18.91p**	**70.73p**	**89.64p**	**27.25p**	**(191.50p)**	**(164.25p)**

Dividends in respect of the financial year ended 31 January 2010 total 22.50p (2009 – 22.80p), amounting to £23,223,029 (2009 – £23,441,469). Details are set out in Note 6 on page 40.

The total return column of this statement is the profit and loss account of the Company. The supplementary revenue return and capital return columns are both prepared under the guidance published by the Association of Investment Companies.

All revenue and capital items in the above statement derive from continuing operations. No operations were acquired or discontinued in the year.

A Statement of Total Recognised Gains and Losses is not required as all gains and losses of the Company have been reflected in the above statement.

The Notes on pages 36 to 50 form an integral part of these Financial Statements.

Reconciliation of Movements in Shareholders' Funds
for the year ended 31 January 2010

	Notes	Called up Share Capital £	Share Premium Account £	Capital Redemption Reserve £	Capital Reserve £	Revenue Reserve £	Total £
Net Assets at 31 January 2008		25,703,366	7,527,047	292,853	448,003,467	24,660,480	506,187,213
Revenue Return		–	–	–	–	28,017,898	28,017,898
Dividends on Ordinary Shares	6	–	–	–	–	(22,516,148)	(22,516,148)
Capital Return		–	–	–	(196,884,927)	–	(196,884,927)
Net Assets at 31 January 2009		**25,703,366**	**7,527,047**	**292,853**	**251,118,540**	**30,162,230**	**314,804,036**
Net Assets at 31 January 2009		25,703,366	7,527,047	292,853	251,118,540	30,162,230	314,804,036
Revenue Return		–	–	–	–	19,498,068	19,498,068
Dividends on Ordinary Shares	6	–	–	–	–	(23,589,084)	(23,589,084)
Capital Return		–	–	–	72,938,046	–	72,938,046
Shares issued during the year	11	100,000	996,148	–	–	–	1,096,148
Net Assets at 31 January 2010		**25,803,366**	**8,523,195**	**292,853**	**324,056,586**	**26,071,214**	**384,747,214**

The Notes on pages 36 to 50 form an integral part of these Financial Statements.

Balance Sheet as at 31 January 2010

	Notes	2010 £	2010 £	2009 £
Fixed Assets				
Investments held at fair value through profit or loss	8		488,314,516	411,795,591
Current Assets				
Derivative financial instruments	8	83,125		–
Debtors	10	3,681,322		3,877,216
Cash at bank	10	8,911,182		14,511,020
		12,675,629		**18,388,236**
Creditors – Amounts falling due within one year				
Derivative financial instruments	8	(101,850)		–
Other creditors	10	(2,682,809)		(1,906,701)
		(2,784,659)		**(1,906,701)**
Net Current Assets			**9,890,970**	**16,481,535**
Total Assets less Current Liabilities			**498,205,486**	**428,277,126**
Creditors – Amounts falling due after more than one year	10		(113,458,272)	(113,473,090)
Total Net Assets			**384,747,214**	**314,804,036**
Capital and Reserves				
Called up Share Capital	11		25,803,366	25,703,366
Share Premium Account	12		8,523,195	7,527,047
Capital Redemption Reserve	12		292,853	292,853
Capital Reserve	12		324,056,586	251,118,540
Revenue Reserve	12		26,071,214	30,162,230
Equity Shareholders' Funds	13		**384,747,214**	**314,804,036**
Net Asset Value per Ordinary Share	13		**372.8p**	**306.2p**

The financial statements of The Merchants Trust PLC, company number 28276, were approved and authorised for issue by the Board of Directors on 7 April 2010 and signed on its behalf by:

Hugh Stevenson | Chairman

The Notes on pages 36 to 50 form an integral part of these Financial Statements.

Cash Flow Statement for the year ended 31 January 2010

	Notes	2010 £	2010 £	2009 £
Net cash inflow from operating activities	16		**25,230,795**	**27,864,495**
Returns on investment and servicing of finance				
Interest paid		(9,563,178)		(9,586,923)
Dividends on Cumulative Preference Stock		(42,997)		(42,997)
Net cash outflow from servicing of finance			**(9,606,175)**	**(9,629,920)**
Capital expenditure and financial investment				
Purchase of investments		(112,115,497)		(152,890,966)
Sale of investments		113,383,975		165,738,174
Net cash inflow from capital expenditure and financial investment			**1,268,478**	**12,847,208**
Dividends paid on Ordinary Shares	6		(23,589,084)	(22,516,148)
Net cash (outflow) inflow before financing			**(6,695,986)**	**8,565,635**
Financing				
Proceeds from issue of Ordinary Shares		1,116,000		–
Share issue costs		(19,852)		–
Net cash inflow from financing	11		**1,096,148**	**–**
(Decrease) Increase in cash	17		**(5,599,838)**	**8,565,635**

The Notes on pages 36 to 50 form an integral part of these Financial Statements.

Statement of Accounting Policies for the year ended 31 January 2010

1 The financial statements have been prepared under the historical cost basis, except for the measurement at fair value of investments, and in accordance with the United Kingdom Law and United Kingdom Generally Accepted Acounting Practice (UK GAAP) and the Statement of Recommended Practice - 'Financial Statements of Investment Trust Companies and Venture Capital Trusts' (SORP) issued in January 2009 by the Association of Investment Companies.

In order to better reflect the activities of an investment trust company and in accordance with guidance issued by the AIC, supplementary information which analyses the Income Statement between items of a revenue and capital nature has been presented alongside the Income Statement. In accordance with the Company's status as a UK investment trust company under sections 833 and 834 of the Companies Act 2006, net capital returns may not be distributed by way of dividend.

The accounting policies adopted in preparing the current year's financial statements are consistent with those of previous years.

The Directors believe it is appropriate to continue to adopt the going concern basis in preparing the financial statements as the assets of the Company consist mainly of securities which are readily realisable and significantly exceed liabilities. Accordingly, the Directors believe that the Company has adequate financial resources to continue in operational existence for the foreseeable future. The Company's business, the principal risks and uncertainties it faces, together with the factors likely to affect its future development, performance and position are set out in the Directors' Report, Business Review section on pages 17 to 19.

FRS 29 'Financial Instruments: Disclosures' introduces additional disclosures relating to financial instruments. This standard does not have any impact on the classification and/or valuation of the Company's financial instruments. The additional disclosures provided in accordance with the requirements of the standard are set out in Note 18 to the financial statements. Comparatives are not required.

2 Revenue – Dividends on equity shares are accounted for on an ex-dividend basis. UK dividends are shown net of tax credits.

Special dividends are recognised on an ex-dividend basis and treated as a capital or revenue item depending on the facts and circumstances of each dividend.

Where the Company has elected to receive its dividends in the form of additional shares rather than in cash, the equivalent of the cash dividend is recognised as income. Any excess in the value of the shares received over the amount of the cash dividend is recognised in capital reserves.

Deposit interest receivable and stocklending fees are accounted for on an accruals basis.

Commissions in respect of underwriting are recognised when the underwritten issue closes and are generally recognised within the Income Statement as revenue. Where, however, the Company is required to take up a proportion of the shares underwritten, the same proportion of the commission received is recognised as capital, with the balance recognised as revenue.

3 Investment management fees and administrative expenses – The investment management fee is calculated on the basis set out in Note 2 to the financial statements and is charged to capital and revenue in the ratio 65:35 to reflect the Board's investment policy and prospective split of capital and revenue returns. Other administrative expenses are charged in full to revenue, except custodian handling charges on investment transactions which are charged to capital. All expenses are recognised on an accruals basis.

4 Valuation – As the Company's business is investing in financial assets with a view to profiting from their total return in the form of increases in fair value, financial assets are designated as held at fair value through profit or loss in accordance with FRS 26 'Financial Instruments: Recognition and Measurement'. The Company manages and evaluates the performance of these investments on a fair value basis in accordance with its investment strategy, and information about the investments is provided on this basis to the Board of Directors.

Investments held at fair value through profit or loss are initially recognised at fair value. After initial recognition, these continue to be measured at fair value, which for quoted investments is either the bid price or the last traded price depending on the convention of the exchange on which the investment is listed.

Investment holding gains (losses) reflect differences between fair value and book cost. Net gains or losses arising on sale of investment are recognised in the capital column of the income statement and taken to the Capital Reserve.

Statement of Accounting Policies for the year ended 31 January 2010

5 Derivatives – Options are purchased or written over securities held in the portfolio for either generating or protecting capital returns, or for generating or maintaining revenue returns. Premium received on written options held to generate or maintain revenue returns, are amortised to revenue over the period to expiry. Where the purpose of the option is the maintenance of capital the premium is treated as a capital item. The value of the option is subsequently marked to market to reflect the fair value of the option based on traded prices. When an option is closed out the gain or loss is accounted for as capital. Unamortised premiums form part of the gain or loss. Gains or losses on exercised options are accounted for as capital.

6 Finance costs – In accordance with the FRS 25 'Financial Instruments: Disclosure and Presentation' and FRS 26 'Financial Instruments: Recognition and Measurement', long term borrowings are stated at the amortised cost being the amount of net proceeds on issue plus accrued finance costs to date. Finance costs are calculated over the term of the debt on the effective interest rate basis.

Where debt is issued at a premium, the premium is amortised over the term of the debt on the effective interest rate basis.

Finance costs net of amortised premiums are charged to capital and revenue in the ratio 65:35 to reflect the Board's investment policy and prospective split of capital and revenue returns.

Dividends payable on the 3.65% Cumulative Preference Stock are classified as an interest expense and are charged in full to revenue.

7 Taxation – Where expenses are allocated between capital and revenue, any tax relief obtained in respect of those expenses is allocated between capital and revenue on the marginal basis using the Company's effective rate of corporation tax for the accounting period.

Deferred taxation is recognised in respect of all timing differences that have originated but not reversed at the balance sheet date, where transactions or events that result in an obligation to pay more tax or a right to pay less tax in the future have occurred. Timing differences are differences between the Company's taxable profits and its results as stated in the financial statements.

A deferred tax asset is recognised when it is more likely than not that the asset will be recoverable. Deferred tax is measured on a non-discounted basis at the rate of corporation tax that is expected to apply when the timing differences are expected to reverse.

8 Foreign currency – In accordance with FRS 23 'The Effect of changes in Foreign Currency Exchanges Rates', the Company is required to nominate a functional currency, being the currency in which the Company predominately operates. The functional and reporting currency is sterling, reflecting the primary economic environment in which the Company operates. Transactions in foreign currencies are translated into sterling at the rates of exchange ruling on the date of the transaction. Foreign currency assets and liabilities are translated into sterling at the rates of exchange ruling at the balance sheet date. Profits and losses thereon are recognised in the capital column of the income statement and taken to the Capital Reserve.

9 Dividends – In accordance with FRS 21 'Events After the Balance Sheet Date', the final dividend proposed on Ordinary Shares is recognised as a liability when approved by shareholders. Interim dividends are recognised only when paid.

10 Shares repurchased and subsequently cancelled - Share Capital is reduced by the nominal value of the shares repurchased, and the Capital Redemption Reserve is correspondingly increased in accordance with Section 733 Companies Act 2006. The full cost of the repurchase is charged to the Capital Reserve.

11 Shares issued – Share Capital is increased by the nominal value of shares issued. The proceeds net of expenses are allocated to the Share Premium Account.

Notes to the Financial Statements for the year ended 31 January 2010

1. Income

	2010 £	2010 £	2009 £
Income from Investments:*			
Franked equity income from UK investments+		22,766,477	29,441,527
Unfranked equity income from UK investments		147,878	–
Stock dividends from UK investments		–	877,888
Equity income from overseas investments		80,360	–
		22,994,715	**30,319,415**
Other Income:			
Deposit interest	7,936		321,993
Other interest #	59,879		839,281
Premiums on derivative contracts	17,564		–
Underwriting commission	606,561		235,500
Stocklending fees	–		13,565
		691,940	**1,410,339**
Total income		**23,686,655**	**31,729,754**

* All equity income is derived from listed investments.
+ Includes special dividends of £nil (2009 – £170,891).
# Interest on investment management fee VAT refund for the period 2001 to 2007 (2009 – £839,281).

During the year, the Company received premiums totalling £113,928 for writing covered call options for the purpose of revenue generation, of which £17,564 were amortised to revenue (2009 – nil). All derivative transactions were based on FTSE 100 stocks or the related index. At the year end there were thirteen open option positions. Six of these were held to generate revenue returns and were valued at £74,450 (2009 – £nil).

2. Investment Management Fee

	2010 Revenue £	2010 Capital £	2010 Total £	2009 Revenue £	2009 Capital £	2009 Total £
Investment management fee	560,552	1,041,025	1,601,577	658,425	1,222,788	1,881,213
Investment management fee VAT refund:						
– financial years 1990 – 1994	–	–	–	(760,772)	–	(760,772)
– financial years 1995 – 1996	–	–	–	(205,850)	(205,850)	(411,700)
– financial years 2001 – 2007	(416,080)	(772,720)	(1,188,800)	–	–	–
	(416,080)	**(772,720)**	**(1,188,800)**	**(966,622)**	**(205,850)**	**(1,172,472)**
Total	**144,472**	**268,305**	**412,777**	**(308,197)**	**1,016,938**	**708,741**

The management contract with RCM (UK) Limited ('RCM'), terminable at one year's notice, provides for a management fee based on 0.35% (2009 – 0.35%) per annum of the value of the Company's assets calculated monthly after deduction of current liabilities, short term loans under one year and any funds within the portfolio management by RCM. Under the contract, RCM provides the company with investment management, accounting , secretarial and administration services.

As a consequence of the European Court of Justice ruling in the VAT case on 28 June 2007, VAT has not been charged on management fees since 1 May 2007. Following the ruling, settlement has been reached with RCM in respect of the recovery of overpaid VAT in past years. On 3 November 2009, a VAT refund for the period 2001 to 2007 totalling £1,188,800 along with interest of £59,879, was received from HM Revenue & Customs. These amounts are included in the Company's Income Statement for the year ended 31 January 2010.