

Investment Rationale

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

Fund Manager's Review

Simon Gergel



The Merchants Trust portfolio comprises predominantly high yielding, large capitalisation UK equities to match the objectives of delivering a high and rising level of income, together with capital growth.

The structure of the portfolio has been defensively positioned for some time, with limited positions in cyclical natural resources and industrial businesses but with a higher exposure to less economically sensitive sectors such as food producers, pharmaceuticals and utilities. This reflects both a cautious view about the prospects for economic growth in much of the developed world as well as the fundamental merits and valuation attractions of the companies we have selected.

December saw a continuation of recent trends in macro-economic news flow with some improvement seen in the USA but further signs of pressure in most of the Eurozone and the UK, and mixed but generally deteriorating economic statistics in emerging markets. The European Central Bank cut interest rates by 0.25% and pumped liquidity into the banking system to ease pressures, whilst Eurozone politicians agreed in principle to greater fiscal integration. All these actions helped to stabilise financial markets.

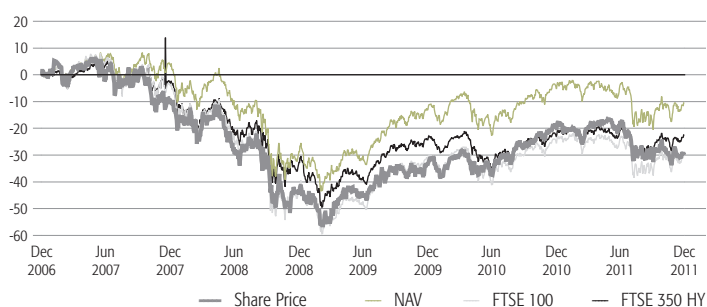
The UK Stock market was volatile but ended the month with a modest 1.2% gain in the FTSE 100 Index after a late rally. Over the 2011 calendar year the FTSE 100 Index produced a total return of -2.2% but medium sized companies performed worse than large companies with the FTSE 250 Index down 10%. In December, the themes within the market followed much of the pattern for the calendar year, with defensive sectors like tobacco and pharmaceuticals performing well, whilst metals and mining and more cyclical sectors were generally weak.

The Trust's NAV (+1.04%) was close to the FTSE 100 Index in December, benefitting from the low exposure to mining shares which were weak, offset by modest underperformance in certain media and financial stocks. Performance has been well ahead of the FTSE 100 Index in the first 11 months of the financial year, driven by the strong performance of many large, high yielding companies like GlaxoSmithKline, Unilever and SSE as well as from having only a modest exposure to the very weak mining and banking sectors which pulled back the index returns.

During the month we took some profits on the large positions in Unilever and Royal Dutch Shell which have been strong performers and approached fair value. We added to the real estate holdings Hammerson and London & Stamford (the latter during a share placing) after a pull-back in share prices brought these companies back to a large discount to asset value. We also introduced a new investment in Close Brothers, a specialist asset backed lending business. The company is benefitting from reduced competition as mainstream banks retrench to their historic core activities and the shares carry a well covered 7% dividend yield.

Despite signs of improving US economic momentum we remain concerned about medium term growth prospects in much of the developed world as high debt burdens are addressed by austerity measures. We continue to favour well financed, multinational companies in relatively defensive industries trading on modest valuation multiples, as well as companies offering higher structural growth provided they still offer reasonable value and a decent dividend yield. We are however finding some interesting opportunities among more cyclical stocks where specific companies' fundamental strengths are significantly under-priced on a medium term view.

Performance (%)



Cumulative Performance (%)

	3 Months	6 Months	1 Year	3 Years	5 Years
Share Price	-0.35	-12.70	-11.24	26.54	-28.99
NAV	8.04	-7.72	-6.32	21.87	-30.19
FTSE 100	8.65	-6.28	-5.55	25.67	-10.43
FTSE 350 HY	8.21	-1.78	0.71	15.31	-22.52

Standardised Past Performance (%)

From To	29.12.06 - 31.12.07	31.12.07 - 31.12.08	31.12.08 - 31.12.09	31.12.09 - 31.12.10	31.12.10 - 30.12.11
Share Price	-9.51	-37.98	18.86	19.94	-11.24
NAV	-3.86	-40.41	19.95	8.45	-6.32
FTSE 100	3.80	-31.33	22.07	9.00	-5.55
FTSE 350 HY	-3.00	-30.73	12.72	1.57	0.71

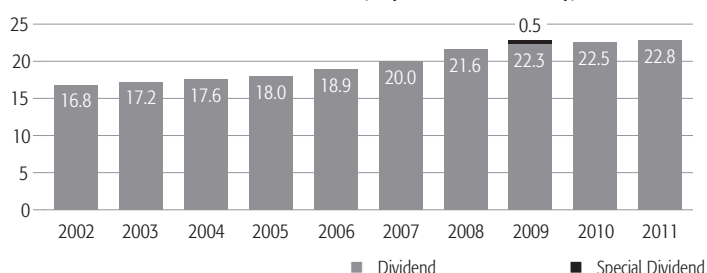
Source: Lipper, share price calculation percentage growth, mid to mid, capital return to 30.12.11.

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

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

Dividend History

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



Net Dividends Paid (financial year to date)

	Pay Date	XD Date	Payment
1st quarterly dividend	17.08.11	15.7.11	5.7p per share
2nd quarterly dividend	11.11.11	7.10.11	5.7p per share



Capital Structure

Total Assets:	£523.7m
Gearing (net):	24.8%
Shares in Issue:	103,213,464 (Ordinary 25p)
Share Price ¹ :	376.5p
Net Asset Value ² :	389.4p (351.7p – debt at market value)
Premium/-Discount to NAV ³ :	-3.3% (7.1% – debt at market value)
NAV Frequency	Daily
Dividend Yield ² :	6.23%

1. Source: Lipper as at 30.12.11, market close mid price.

2. Source: Datastream as at 30.12.11. Calculated using the latest full year dividend divided by the current share price.

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

Key Information

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

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

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

4. Source: Annual Financial Report

Risks & Features

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

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












All data source RCM (UK) Limited as at 30.12.11 unless otherwise stated.

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Portfolio Analysis

Top Ten Holdings	(%)	(%)	
Royal Dutch Shell "B" Shares	8.9	Unilever	3.8
GlaxoSmithKline	7.4	BAE Systems	3.6
BP	6.9	British American Tobacco	3.3
Vodafone	5.9	Scottish & Southern Energy	3.2
HSBC	5.0	National Grid	3.1
Total Number of Holdings			59

Sector Breakdown (%)

Financials	16.09	
Oil & Gas	15.81	
Consumer Services	14.40	
Consumer Goods	13.11	
Telecommunications	9.99	
Industrials	9.73	
Health Care	9.14	
Utilities	8.23	
Cash	1.82	
Basic Materials	1.67	
Other	0.01	

HOW TO INVEST?

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

CONTACT US

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



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

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