

PRESENTER: Well joining me now is Simon Gergel, Manager of the Merchants Trust. So, Simon, good to have you back with us today. So unusual, volatile, challenging, are they the words you'd use to describe managing the Merchants Trust in 2018, and what would you say were the key challenges?

SIMON GERGEL: Well thanks Jenny. I think there's been quite a contrast actually between the real economy and companies we look at, which actually has been pretty robust, and many companies have been performing quite well. And the way the stock market has been behaving, which has been quite volatile, quite choppy, and quite erratic. And so the key challenge I think has been to focus on the underlying fundamentals of businesses and the economy, and take advantage of that volatility without getting carried away by it, and not getting too optimistic or pessimistic as the sentiment swings around.

PRESENTER: So how would you characterise the performance of the Merchants Trust in 2018, and did find it difficult to find good stocks to invest in?

SIMON GERGEL: Yes. There's been a lot of opportunities to buy good companies at really attractive prices because of the volatility, so the overall performance has been solid. I think broadly over 2018 the performance at the portfolio level was in line with the market. The income generation's been good, and we may come to that. But we've taken advantage of these big swings in sentiment to buy some really good companies at attractive prices, and to let go of others or reduce positions where valuations have held up better.

PRESENTER: And was Brexit the key factor holding back UK markets?

SIMON GERGEL: I don't think it was. Maybe at the beginning of the year Brexit was a big factor, but later in the year the main factors have been US trade with China, tariffs, the US interest rate cycle; the move from quantitative easing to perhaps tightening in Europe. I think those have been much bigger effects on overall markets generally on equities more broadly, and that's swept up the UK with it. So definitely the UK's been out of favour with foreign investors, but the biggest part of the move, certainly the down move in the second half of the year was more to do with international factors and worries about trade.

PRESENTER: Well some of the UK's leading companies that are leveraging very high yields by historic standards, what's the story behind these figures?

SIMON GERGEL: Well it's partly because the UK market is so out of favour that valuations have come down and yields have gone up. But also there are certain industries and certain companies where the cashflow is under pressure, there are structural changes and challenges. So you've got to be very careful. Some of those companies' yields aren't necessarily sustainable, and some of those companies are under pressure, and investors are questioning whether those dividends can be sustained.

Therefore the high yield is partly a reflection of low valuation, but in some cases it's a mark of where there's high risk.

PRESENTER: Now, the Merchants Trust is one of the AIC's dividend heroes now. It's been increasing dividends for 36 consecutive years. Now other trusts do have a longer track record, but the Merchants Trust current yield, none of them can match that. Why would you say that is?

SIMON GERGEL: I think it's because we focus on high yield in companies. So many funds will have a core portfolio, and then they'll have some income stocks on the side to generate income. We believe in looking to buy companies that have a good yield, and then we try and buy good companies within that part of the market. And that means that we expect all of our companies to generate income and contribute to that dividend. And therefore we tend to have a higher yield than others. Plus the gearing in the trust allows us to generate a little bit more income as well.

PRESENTER: So with so much emphasis on income yielding stocks, does this come at the expense of capital growth?

SIMON GERGEL: Well that's a great question, and this is the remarkable thing about income, is you would think that if you pay a high, if a company pays a higher yield today, they would make a lower total return. Historically it's the other way round. The companies on average that have paid higher yields have tended to produce better total returns over the long term. So actually you can have your cake and eat it. You can have a higher yielding portfolio, and expect or hope to achieve a better total return as well, which means you're not really sacrificing total return by buying high income shares in general.

PRESENTER: And are you confident that the dividend track record can continue?

SIMON GERGEL: Well we put, both the

managers ourselves and the board places a huge amount of emphasis on trying to continue that dividend, progressive dividend policy out into the future. We look very closely at the income generation within the portfolio, and the outlook for that, and we have significant dividend reserves. So the Merchants Trust has almost a year of dividends in reserve. So if we do get a dip in income or some pressure somewhere, we can ride through that with the reserves. So we're very confident, and certainly given the outlook we see at the moment we're very confident in continuing that trend. PRESENTER: Now yours is a relatively concentrated portfolio, around 40 or 50 stocks, how do you choose which companies to invest in? SIMON GERGEL: Well it's a good question. We look at three things. So we look at the fundamentals of the business, how strong a company, how attractive are the products and the services the company produces, how robust is the financial situation, how is the company governed, the board and their experience and so on – all the traditional factors. The second thing we look at is the valuation, and we ask how cheap is this company, and that's fairly straightforward. Then we can compare it to its history and other investments in the market. The third we ask, which is slightly nuanced, is what's going to change? So we've got a decent company which looks very cheap, why is it cheap? What's going to change? What are the structural pressures or opportunities for this business, and what are the cyclical themes? And we try and find good companies or sound companies that are lowly rated, where actually there's a supportive thematic environment, a supportive technological change, or at the very least not a negative environment. PRESENTER: So would you describe yourself as a contrarian investor? SIMON GERGEL: Well inevitably if we're trying to buy decent companies on low valuations, the only way you can do that really is by being a bit contrarian. Because we don't set out to be contrarian, I'd love to buy companies that everyone else wants to own if they were fairly price. But in reality the opportunities usually come when companies are a bit out of favour, and people are worried about a particular risk or other. And by doing deep analysis, by really getting to the bottom of what's going on, we can sometimes identify companies where it's actually a good business, and it's a supportive environment. It's just the market we think has got it wrong. So we do tend to be quite contrarian in our approach. PRESENTER: So within your portfolio, what's the split between those holdings with domestic demands and those that are more international? SIMON GERGEL: It's around about two thirds international and one third domestic in terms of the earnings. Now within that one third domestic there's maybe a quarter that are fully domestic and then others that are more hybrid, but if you think two thirds one third in terms of where the more earnings come from overseas you won't be far off. PRESENTER: So how worried do you think UK investors should be about things such as China we've seen with the trade wars and what else is happening there? SIMON GERGEL: Well I think global trade and global growth is very important for all companies, and particularly given how international the UK market is. The global economic environment is critical. And China has been a major part of the global growth for a decade or more, and it's also probably the part that can change the quickest in terms of the rate of change of that growth. So I think the relationship between China and America, and the whole trend of globalisation is important. That's not to say that it's critical for every single company in the portfolio, but I think we've had a fairly benign environment for a decade in terms of global growth, and it's important that that continues really going forward. PRESENTER: So the structure of investment trusts allows for long-term conviction investing, can you explain this? SIMON GERGEL: Yes, I mean the good thing about investment trusts is you have a fixed number of shares in issue. So that you can invest for a very long term, and you know you're not going to be forced to sell those shares at what might be an inopportune time. So if the market comes down you're not forced to sell shares for investors who want their money back, because investors have given you, or given the company money on a permanent basis. That's very different to running a unit trust, where you can find in a difficult environment people are taking their money out and you're being forced to sell shares at the wrong price. So having an investment trust allows you to take a long-term view. Plus on top of that you've got a board of directors that can change

the strategy, can change the policy to react to different circumstances. So over the life of Merchants Trust, which is 130 years, the board will have at times changed the strategy to adapt to circumstances and what shareholders want. PRESENTER: Now finally staying on the long-term view and Merchants Trust. It was founded in 1889, so this year marks a big anniversary for the trust. So how much of an achievement do you feel it is reaching this 130-year mark? SIMON GERGEL: I think it's a great achievement for the trust, and I'm very proud to be the manager at this time. And it does actually give you a great sense of perspective, both in terms of if you think back over 130 years, two world wars, hyperinflation or very high inflation in the 1970s, we've had lots of different scenarios in which Merchants Trust has come through that, and been a very effective mechanism or medium for the shareholders in the past. But it also gives you a sense of perspective. In the future we are absolutely determined to continue the trend of growing the dividend every year and providing a good home for investors' money. And therefore we can think with a long-term perspective and not get buffeted around too much by the noise in the day-to-day market, so yeah, it's a wonderful achievement. PRESENTER: Simon, thank you. SIMON GERGEL: Thank you.