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# The Merchants Trust PLC

Annual Financial Report for the year ended 31 January 2011

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## The Merchants Trust

The Merchants Trust was incorporated on 16 February 1889. It was launched by Robert Benson & Co., predecessors of the current Investment 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 market sectors, with no one sector comprising more than 35% of the portfolio.

## Financial Summary

	For the year ended 31 January 2011	For the year ended 31 January 2010	% change
Income	£25,740,859	£23,686,655	+8.7
Net revenue return attributable to Ordinary Shareholders†	£21,900,146	£19,498,068	+12.3
Net revenue return attributable to Ordinary Shareholders	£21,900,146	£19,022,109#	+15.1
Revenue return per Ordinary Share	21.22p	18.91p	+12.2
Ordinary dividends per Ordinary Share	22.80p	22.50p	+1.3
<b>Assets</b>	<b>2011</b>	<b>2010</b>	<b>% change</b>
Total Assets less Current Liabilities	£552,031,290	£498,205,486	+10.8
Net Assets	£440,846,016	£384,747,214	+14.6
Net Asset Value per Ordinary Share	427.1p	372.8p	+14.6
Ordinary Share Price	406.9p	329.1p	+23.6
Discount of Ordinary Share Price to Net Asset Value	4.7%	11.7%	n/a
Discount (Premium) (Debt at market value)	0.1%	7.7%	n/a
FTSE 100 Index (Capital Return)	5,862.9	5,188.5	+13.0
FTSE 350 Higher Yield Index (Capital Return)	3,087.2	2,879.1	+7.2

#### Notes

† Including a refund of VAT paid on management fees and associated interest income of £nil (2010 – £475,959)

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

## Chairman's Statement

### Market Background

This is my first report to you as Chairman of The Merchants Trust PLC and I am pleased to report that we have performed well, with our total return exceeding 20% and our share price rising more than 23%

Global uncertainties continued to build throughout the year. We first had the crisis in the Euro and in particular in Greece and Ireland requiring massive intervention from the ECB and the IMF. More recently we have had significant uncertainty building in the Middle East leading to Western intervention in Libya. And of course we have had the tragic East Japan earthquake followed by the devastating tsunami and the huge risks of a nuclear meltdown at the Fukushima plant.

In the UK we have had a change of Government and the introduction of a significant fiscal austerity programme designed to bring the deficit under control. At the same time we have seen a meaningful pick-up in inflationary pressures on the back of the dramatic rise in oil and other commodity prices.

Against this uncertain backdrop, the UK equity market has recovered further ground and made up much of the loss suffered since the start of the financial crisis in 2007. Merchants performed well in both absolute and relative terms as well as compared to most of our peers, helped by strong stock-selection in a number of mid-cap companies.

### Results

The Net Asset Value per share increased by 14.6% to 427.1p and the total return per share, including dividends paid, was 20.7%. This compares with the total returns of 16.8% and 12.2% 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 23.6% from 329.1p to 406.9p, having reached its highest level in the year of 425.0p on 6 January 2011. At 4 April 2011, the Trust's ordinary shares yielded 5.5% compared with the yield on the FTSE 100 Index of 3.0%.

There is more detail on the major contributors to our performance in our Investment Manager's Review starting on page 6.

### Net Revenue Return per share

Net Revenue Return per share rose by 12.2% to 21.22p. This year's earnings include a release of a provision of £862,086 against finance costs in First Debenture Finance PLC and there are details of this on page 38.

### Dividends

The Board is recommending a final ordinary dividend of 5.7p per share, payable on 13 May 2011 to Shareholders on the register on 15 April 2011. This payment would give a total of 22.8p for the year, an increase of 1.3% over the total for the previous year. In order to meet the payment it has been necessary to transfer £1,632,522 (1.6p per share) from our reserves, compared to a transfer of £3,724,961 (3.6p per share) last year. As at 31 January 2011 and after providing for this transfer, the Trust's reserves amounted to £12,775,572 (12.3p per share).

This will be our twenty-ninth year of rising dividends. The Board and the Manager continue to remain focused on providing long-term steady income growth.

### Derivatives

As set out in the previous report, we have continued our policy of selectively writing call options on a limited number of the Trust's holdings. Writing options has provided helpful additional income in a period where revenues have been under pressure following the temporary suspension of BP's dividend. A more detailed explanation is set out in the Investment Manager's Review.

### Stewardship Code

During the year the Stewardship Code was signed up to by our Manager, RCM (UK), and we report on this on page 24 of this Annual Report.

### Gearing

The Trust continues to have long-term debt amounting to £111 million. This is all deployed in the market for investment purposes. At the end of the year our gearing level was 25.2% compared to 29.5% at the start of the year.

## **Chairman's Statement**

### **The Board**

At last year's AGM Lord Sassoon took on the Chairmanship of the Trust following Sir Hugh Stevenson's retirement. Hugh had been Chairman of the Trust for 10 years. Following the General Election James was asked by the new coalition Government to become Treasury Secretary and a member of the House of Lords. As a result James was obliged to stand-down from all his commercial responsibilities including the Board of Merchants. I would like to thank Hugh and James very much for their significant contribution to Merchants over many years.

Dick Barfield has announced his retirement as a Director which will take place at the conclusion of this year's Annual Meeting. We have benefited greatly from his in depth knowledge of the investment industry and good advice over his many years on the Board and he will be greatly missed. We have recently appointed Paul Yates as a Director and I am pleased he has joined the Board. His biography is included with those of the other directors on page 16 and we support his election to the Board.

### **Annual General Meeting**

The Annual General Meeting of the Company will be held on Tuesday 10 May 2011 at 12.00 noon and we look forward to seeing as many shareholders then as are able to attend.

### **Outlook**

The headlines will undoubtedly remain dominated by the huge uncertainties outlined in my introductory remarks. However, underlying economic activity is still robust in much of the world and the corporate sector is financially strong. A carefully selected portfolio of UK companies with globally diversified business models combined with a focus on strong and rising dividend income should continue to weather the storms well. Merchants will remain committed to long-term growth in capital and income.

Simon Fraser | Chairman  
4 April 2011

**Historical Record****Revenue and Capital** for years ended 31 January

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Income (£'000s)	21,596	22,101	22,247	22,675	24,714	27,750	28,495	31,730	23,687	25,741
Net Revenue Return per										
Ordinary Share	16 70p	1726p	1734p	1758p	19 44p	22 17p	22 86p	2725p	18 91p	21 22p
Dividends per Share	16 80p	1720p	1760p	18 00p	18 90p	20 00p	21 60p	22 80p	22 50p	22 80p
Ordinary Dividend per Share	16 80p	1720p	1760p	18 00p	18 90p	20 00p	21 60p	22 30p	22 50p	22 80p
Special Dividend per Share	-	-	-	-	-	-	-	0 50p	-	-
Tax Credit per Share	1 87p	1 91p	1 96p	2 00p	2 10p	2 22p	2 40p	2 53p	2 50p	2 53p
Gross Dividend per Share	18 67p	19 11p	19 56p	20 00p	21 00p	22 22p	24 00p	25 33p	25 00p	25 33p
Total Net Assets attributable										
to Ordinary Capital (£'000s)	420,983	273,407	357,442	424,511*	514,713	588,835	506,187	314,804	384,747	440,846
Net Asset Value per										
Ordinary Share	412 3p	2678p	350 1p	415 8p*	504 1p	5675p	492 3p	306 2p	372 8p	427 1p
NAV Total Return (%)*	-74	-30 9	+37 3	+20 8*	+25 6	+16 4	-9 6	-33 4	+29 2	+20 7
Retail Price Index Increases										
(%)**	+2 6	+2 7	+2 4	+2 1	+2 3	+4 2	+4 1	+0 1	+4 6	+5 1

## 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 2011

	FTSE 100 Index %	FTSE 350 Higher Yield Index %
Capital return of index	13 0%	7 2%
Relative return from portfolio	1 0%	6 8%
<b>Capital return of portfolio</b>	<b>14 0%</b>	<b>14 0%</b>
Impact of gearing on portfolio	4 4%	4 4%
Revenue deficit*	-0 4%	-0 4%
Expenses charged to capital	-1 6%	-1 6%
Other	-1 8%	-1 8%
<b>Change in Net Asset Value per Ordinary Share</b>	<b>14 6%</b>	<b>14 6%</b>

\* Dividends paid on Ordinary Shares amounted to £23,429,454 (refer to Note 6). This exceeds the revenue return for the period by £1,529,308

## Investment Manager's Review

### Economic Background

In 2010, the major Western economies continued to recover from the deep recession of 2008-9, but they had to navigate through a challenging environment. Recovery was aided by stimulative central bank policies of almost zero interest rates and quantitative easing, coupled with supportive fiscal policies. However, with extremely high government and consumer debt levels, the strains on the system were enormous. Certain smaller economies, like Ireland and Greece, had to employ severe fiscal austerity measures in order to restore their finances whilst being supported by the international financial community.

The correct policy response in this environment has been widely debated. Should governments rein in spending to reduce their budget deficits or should they stimulate the economy to drive stronger economic growth and thus greater tax revenues and lower benefits costs? This debate took centre stage in the UK general election. The winning Conservative-Liberal coalition announced major spending cuts in order to bring the country's finances under control. Economic growth slowed in late 2010 with a fourth quarter contraction of -0.6%, influenced by heavy December snowfalls, arguably painting a worse picture than reality. However, the modest rate of economic growth does highlight the fragility of the economic situation.

In contrast to the UK and much of Europe, the USA has kept its foot firmly on the pedal, with further tax cuts and extra spending initiatives as well as a second round of quantitative easing. US economic growth picked up in response to the stimulus but aggregate debt levels continued to rise. Government bond yields rose sharply in the latter few months of the period, potentially making matters increasingly difficult for policymakers. Tensions were high within the single currency Eurozone with divergent growth rates between stronger economies like Germany and weaker EU members like Portugal, Ireland, Greece and Spain. The European Financial Stability Facility was established with €440bn to support the weaker economies and reassure government bond holders.

Emerging markets generally delivered strong growth rates with superior fiscal positions, led by the surging Chinese economy, undergoing an investment boom. This resource heavy growth, coupled with a recovering worldwide economy led to resurgent commodity prices with the oil price touching \$100 at the end of January. Food and other agricultural commodities also saw price spikes, exacerbated by unusual weather patterns. Together these commodity prices started to raise inflation concerns and, in some cases, social unrest.

At home inflation also remained stubbornly high with January's UK CPI recording a 4.0% gain, twice the Bank of England Monetary Policy Committee's target of 2.0%. However interest rates were held at 0.5% throughout the period as there was little sign of higher inflation feeding through into wage settlements, whilst growth concerns generally took precedence over inflation fears.

### Market Trends

Despite significant volatility in the first six months on fears over the health of peripheral European economies in particular, stock markets posted strong gains over the year. A sharp rally from July until mid January was driven by improving investor confidence in the sustainability of the economic recovery and a second round of US quantitative easing. The FTSE 100 Index produced a total return of 16.8% in the period. The market was led, as in the previous year, by more cyclical sectors such as technology, mining, general financials, oil services and media, although telecoms also performed well. Conversely many of the more defensive sectors lagged the market with food retail, pharmaceuticals, tobacco and food producers only managing to deliver single digit returns.

Medium sized companies which tend to be more economically sensitive once again significantly outperformed the FTSE 100 Index. Higher yielding shares lagged behind materially with the FTSE 350 Higher Yield Index producing a total return of only 12.2%. This index was particularly affected by BP whose shares halved between April and July after the accident in their Macondo oil well in the Gulf of Mexico. By the end of the year, BP had recovered much of its loss to post a total return of -17%, taking about 3% off the Higher Yield Index in the year.

## Investment Manager's Review

### Investment Performance

The Merchants Trust portfolio delivered a total return ahead of the FTSE 100 Index and thus well ahead of the FTSE 350 Higher Yield Index. This is noteworthy in a period when returns were high as the portfolio has typically had a significantly lower volatility and beta (the expected gearing to market moves) than the wider market. The strong equity performance helped The Merchants Trust to deliver one of the highest investment trust returns in the UK Growth & Income Sector.

No one sector dominated performance but, as in the previous year, strong stock selection amongst medium sized companies made a big impact benefitting from their greater linkage to recovering economic prospects. Despite the portfolio being heavily biased to larger companies, seven of the top ten contributors to outperformance compared to the FTSE 100 Index were mid-caps, with returns ranging between **Meggitt's** 42% and **Melrose's** 96%. This included two companies, **Arriva** and **Brit Insurance**, which received takeover bids. Among the larger companies contributing to performance, the operational recovery in **BT** continued and they also benefitted from a shrinking pension fund deficit. Having less than an index position in **HSBC** and **Tesco** was also beneficial as their shares significantly lagged the market.

The largest negative performance factor was not owning three large mining companies, **Rio Tinto**, **Anglo American** and **Xstrata**. The portfolio had a low exposure to the mining sector due to unattractive dividend yields and concern over the sustainability of commodity prices. Elsewhere a number of relatively defensive companies lagged behind the strong market with stocks like **GlaxoSmithKline**, **BAE Systems** and **Unilever** returning close to zero. Not owning **ARM** shares which rallied by 164% was also a factor. Finally **Resolution** and **Home Retail Group** were both poor performers.

#### Contribution to Investment Performance relative to FTSE 100 Index

Positive Contributions	%	Negative Contributions	%
Premier Farnell	0.6%	Rio Tinto	-0.9%
Arriva	0.5%	GlaxoSmithKline	-0.6%
Brit Insurance	0.4%	BAE Systems	-0.5%
Melrose	0.4%	Unilever	-0.4%
BT	0.4%	Anglo American	-0.4%
Meggitt	0.4%	Xstrata	-0.3%
International Personal Finance	0.4%	Scottish & Southern Energy	-0.3%
Tesco	0.3%	Arm	-0.3%
HSBC	0.3%	Resolution	-0.2%
United Business Media	0.3%	Home Retail	-0.2%

The Trust's derivatives strategy, described later in this report, made a positive contribution both to the income generation and the performance of the portfolio. Over the twelve months the performance contribution was approximately £480,000 or 0.1% of the average portfolio value.

### Portfolio Changes

As reported at the interim stage, activity in the first half of the year was quieter than the high levels in the previous two years due to a less extreme level of economic and market volatility creating fewer compelling reasons to switch investments. However as the year progressed into the autumn, the bull market recovery continued well into its second year and this created many more opportunities. In particular there were several companies that had recovered from the recession whose share prices approached our estimate of full valuation. These holdings were either reduced or sold entirely depending on their future prospects. Conversely there were many companies left behind in the stock market recovery, often in less cyclical industries, leaving valuations more compelling on an absolute and relative basis. We increased investment in several of these that were already in the portfolio and we added a number of new positions.

In total there were nine new companies added to the portfolio, seven in the second half of the year, and seven sold completely, leaving a portfolio with forty eight stocks at the year end. The portfolio concentration has continued to decline with the top four holdings now representing under 29% of total equity assets. The table below lists the ten largest net purchases and sales and includes most of the new holdings and complete sales.

## Investment Manager's Review

### Largest Net Purchases

Resolution
HSBC
Imperial Tobacco
Daily Mail & General Trust
United Business Media
Inmarsat
Hays
Cobham
BP
Tesco

### Largest Net Sales

	£m		£m
10.9	Vodafone	16.7	
10.8	Centrica	12.1	
9.7	International Personal Finance	8.3	
6.6	AstraZeneca	6.7	
6.1	International Power	6.4	
5.6	Royal Dutch Shell 'B'	5.8	
5.5	Arriva	5.5	
5.4	Inchcape	4.8	
5.4	Halfords	4.6	
5.2	Rexam	4.1	

As explained at the interim stage we added two new companies within the media sector, **United Business Media** and **Daily Mail & General Trust**. The media sector is well positioned to benefit from a recovery amongst its corporate customer base where, unlike in the consumer and government sectors, debt levels are generally comfortable. As businesses look to grow in a testing economic environment they are spending more on advertising, trade shows, exhibitions and other services provided by media companies. The two stocks we purchased were both lowly rated and had strong fundamental attractions.

Another cyclical company exposed to a similar theme that we bought is **Hays**, the temporary and permanent staff recruitment company. Hays is well placed to benefit from recovery amongst its business customers. The company's UK operations have been under pressure, in particular in the public sector, which has suffered from a severe decline in government recruitment. However, whilst this issue dominated investor sentiment, the UK public sector represents under 10% of sales and such concerns left the shares significantly undervalued. There is a strong recovery coming through amongst corporate customers especially in Hays' large and fast growing international operations. In most overseas countries outsourced recruitment is a relatively immature business with rapid, albeit cyclical growth in much of Europe and Asia.

The other new investments were split between defensive, or less cyclical businesses, and companies that we believe offer good long term growth prospects yet still have an attractive dividend yield. There were numerous opportunities amongst defensive shares as the market favoured businesses with greater leverage to the improving economic cycle. We bought **Imperial Tobacco**, which had significantly underperformed both the market and its industry peer **British American Tobacco (BATS)**. We had previously preferred BATS' far greater exposure to emerging markets, where there is more potential for consumers to trade up to higher priced Western brands, compared with Imperial's higher exposure to mature Western European markets. However the gap between the two stocks became compelling with Imperial offering exceptional value and robust cashflow. We reduced the BATS position as its shares performed well, partly to finance these purchases.

Food retailer **Tesco** was also added in the second half of the year. Tesco shares had languished on general concerns over the outlook for UK consumer spending, the level of competitive intensity and some signs of a loss of momentum in their own UK operations. However whilst we share many of the market's concerns we also see significant potential in Tesco's substantial overseas operations, their nascent financial services business and their immature non-food offering. Considering the low valuation of the shares in absolute terms and relative to their own history, we decided to make an initial investment. Elsewhere amongst defensives, we made numerous additions to existing holdings including the food and household products companies **Unilever** and **Reckitt Benckiser**, and utility **National Grid**, mainly around the time of its rights issue.

In the Lloyds-of-London Insurance sub-sector we introduced **Hiscox**, a broadly based insurer with a strong record of achieving high returns on capital, and we added to **Catlin**. Both these positions will broadly replace **Brit Insurance** which has been taken over by a private equity house. The Lloyds insurers are attractive as they generate high returns and have good dividend yields, low valuations and a risk profile that is largely uncorrelated to the wider market.

Among higher growth companies we purchased **Inmarsat** and **Cobham**. Inmarsat is a leading satellite communications company with a particularly strong position in maritime communications but also in land based and increasingly aircraft based activities. The satellite industry has significant barriers to competitive entry, including licenses, spectrum, an expensive satellite fleet and a large customer base with dedicated equipment. Inmarsat offers above average growth with a high yield backed by strong underlying cashflow. We took advantage of a share sale by their largest shareholder, a private equity company in need of cash, to buy at an attractive valuation.

**Cobham** is a defence equipment company with particular strengths in communications technology as well as cyber-security and flight refuelling. It has historically grown fast but has recently suffered order delays and deferrals, especially in the USA which is its dominant market. These delays

## Investment Manager's Review

brought the shares down to an unusually low valuation. Whilst growth in defence spending is likely to be slower than in recent years, Cobham is exposed to many attractive areas with future potential, such as the huge Joint Strike Fighter programme and the replacement of the US in-flight refuelling tanker fleet.

The final new holding added was **Greene King**, the brewer and pub company. Greene King has a well invested freehold estate of pubs with a significant bias to the more prosperous South East of England as well as the strong Belhaven portfolio in Scotland. The management have successfully managed the business through the disruption of the smoking ban and the recession with a consistent strategy of focusing on delivering value, improving the food offering and widening the appeal to families. Whilst the short term outlook for the industry is uncertain, the company is growing profits and it stands to benefit from problems at weaker peers. We believe the low valuation is attractive given that the longer term trend to eating out should continue and Greene King has significant value in its freehold property portfolio.

Other notable investments included significant additions to life assurer **Resolution**, particularly around the time of its rights issues when the shares were trading at depressed levels. We added to **BP**, after the shares fell in response to their explosion and oil leak in the Gulf of Mexico. We also made significant additions to **HSBC** as the shares fell back to a more attractive level.

There were four complete disposals in the portfolio in the first half of the year, detailed at the interim stage. These were **Arriva** that was taken over by Deutsche Bahn, **Rexam**, **Halfords** and **Informa**. In the second half we sold three further holdings completely: **International Power**, **Inchcape** and **International Personal Finance**.

Although **Inchcape** and **International Personal Finance** are very different businesses, they share a similar history as investments for the Trust. Both companies suffered in the global recession and their share prices fell heavily, partly due to strained financial positions. After considerable analysis, we backed our conviction in the strength of their business franchises with significant further investments at depressed levels, including supporting the Inchcape rights issue which transformed its balance sheet. Both companies subsequently rose several fold in price and made a major contribution to performance. We gradually reduced the holdings and finally sold out completely as the shares approached our assessment of fair value.

**International Power**, a builder and operator of power generating plants, attracted interest from GDF Suez and agreed a merger on favourable terms for International Power's shareholders. We decided to sell the shares at a reasonable valuation rather than to maintain a holding, partly due to the effective control by the French Government going forwards.

Partial sales from the portfolio included many opportunities for profit taking in more cyclical companies which had performed well coming out of the recession and thus offered less upside. Examples here included **BHP Billiton**, **Melrose**, **Premier Farnell** and **Legal & General**.

Among the top ten net sales there were also several large defensive companies. Although many defensives performed relatively poorly, there were notable exceptions. **Vodafone** was re-rated from low levels on hopes that it might rationalise its international portfolio of activities as well as on slightly more optimism about trading prospects. We made several reductions to the Trust's large holding into rising prices. Similarly **Royal Dutch Shell** and **Centrica** outperformed their sectors materially and offered less upside potential prompting us to reallocate money from these positions into other stocks. The reduction in the pharmaceutical company **AstraZeneca** was partly in response to a strong share price early in the year. However there was also a sale later on to reflect a lowering in our conviction on their longer term prospects following disappointing news on a key drug in their thin pipeline.

## Derivative Strategy

This is the first full year that the Trust has been running a covered call overwriting strategy on a limited proportion of the portfolio to generate additional income. In "writing" or selling an option, the Trust gives the purchaser the right to buy a specific number of shares in a company at an agreed "strike" price within a fixed period. In exchange the Trust receives an option premium which is taken to the income account. The Trust gets the full benefit of any move in the share price up to the strike price but not beyond. If the share price rises above the strike price, there is a potential "opportunity" cost (but not cash cost) to the Trust as the option holder can exercise their option to buy the shares at the strike price. The total exposure to call options is closely monitored and limited to 20% of the portfolio value with all option positions "covered" by shares held within the portfolio.

Over the year, the call overwriting strategy generated over £2m of additional income and a net profit of around £480,000 taking into account the opportunity cost associated with any exercised options. Our approach to option writing is very selective and driven by the investment fundamentals on each stock rather than by a separate derivatives rationale. We write calls on portions of share holdings that we would be happy

## Investment Manager's Review

to sell at the strike price, provided that the premium income received is sufficiently attractive. The options written are typically short dated with most under 4 months duration. The total exposure typically runs at under 10% of the overall portfolio.

### Future Policy

Rising share prices and relatively low bond yields in the major economies suggest that a sustainable economic recovery is starting to take root. Indeed there are many reasons for optimism. The financial system is functioning well with the major Western banks significantly recapitalised, economic growth has rebounded, corporate profitability and balance sheets have recovered rapidly, surveys of industrial confidence are very positive and unemployment trends have improved in many countries. However major risks remain due to unprecedented debt levels and severe global imbalances. The problems vary from one region to another and the policy choices are often diametrically opposed.

In the USA, the authorities' remain fully committed to stimulating growth to create jobs and breathe life into the moribund housing market. So far global investors have held their faith in US dollar denominated assets and allowed this policy to continue but a loss of confidence and sharply rising bond yields pose a potential risk. In the Eurozone, confidence has already been lost in a number of peripheral economies which are now being supported by their stronger single currency neighbours. Differential growth rates, large deficits, high debt levels and fragile political support for many incumbent politicians are creating an unpredictable and unstable outlook. In China, the engine of growth for the world in recent years, the main problem is rising commodity price inflation, particularly in energy and food prices, which risks causing social unrest. As we have seen in Egypt and elsewhere in the Middle East social pressures can lead to rapid change to the status quo, particularly with the availability of information in the internet age. Chinese authorities are raising interest rates and taking other action to contain inflation. However if economic growth slows too rapidly the consequences will be felt well beyond their borders, not least in the buoyant commodities markets. The recent tragic earthquake, and tsunami in Japan raise further uncertainties for Asian growth, with the nuclear reactor incidents potentially having significant and lasting ramifications for energy markets. The oil price has continued to rise this year on Middle Eastern concerns and any reduced appetite for nuclear power station construction can only cause further important pressure to this critical commodity.

The UK is facing a difficult squeeze between rising inflation and low growth as government spending is cut back, increasing the risks of stagflation. A key debate remains around whether inflation is largely transitory, due to commodity prices and increased VAT, where the effects will wash out, or more structural, potentially leading to rising wage pressures. Monetary policy so far remains accommodative but there is increasing risk of either a double-dip recession or high inflation. Fortunately for investors in UK companies, particularly within the FTSE 100 index, global conditions are more important than those in the UK. Overall our central view has not changed significantly. We anticipate a prolonged period of positive but muted economic growth for most Western economies as high debt levels are addressed, with higher growth in emerging markets. However, at the very least, there are likely to be periods of volatility when less benign outcomes seem more likely.

Equity valuations, particularly in the UK, are close enough to long term averages to have little predictive power. With corporate profitability having already recovered significantly, there is less scope for significant positive surprises in the future but there is also little sign of investor over-confidence, which would be a concern. Money flows seem to be starting to come back into equities from bond markets, after a 30 year bond market rally, but it could be premature to rely on this encouraging trend continuing. In short, the equity market direction is as hard as ever to predict, although we have a strong preference for equities over fixed income investments. We see many attractive investment opportunities within the equity market and our focus remains on identifying and exploiting these situations.

Many of the biggest companies in the market trade on modest valuations and we continue to favour large, well financed, globally spread businesses with strong cashflows and high dividend yields. Stocks like Royal Dutch Shell, GlaxoSmithKline, Unilever and Vodafone continue to form the bedrock of the portfolio and are well suited to uncertain economic circumstances. Given our central view of only modest economic growth we believe that companies capable of higher sustained growth should demand above average valuations. We like reasonably priced companies that operate in growth industries, for example Inmarsat, Hays, IG Group and Man Group, or those exposed to the superior growth of emerging markets, such as Ashmore, United Business Media and British American Tobacco. Within this latter theme, global food and household products companies like Unilever and Reckitt Benckiser, look particularly attractive after a recent sell-off on commodity cost pressures and we have built up positions further. Another theme in the portfolio is owning businesses exposed to public sector spending as in many cases the stock market has more than discounted the likely impact of spending cuts, leaving significant potential upside. Examples in the defence sector include BAE Systems and Cobham and within construction and support services, Balfour Beatty and Interserve.

Despite the obvious linkage of mining and other commodity companies to the growth in emerging market spending, the portfolio only contains BHP Billiton within the mining sector and only the large diversified oil majors, BP and Royal Dutch Shell, within the oil & gas sector. As well as the limited dividend yields available from most commodity related stocks, we remain concerned about the sustainability of high commodity prices given some of the risks to world growth. There is also the risk of a reversal to the apparently high level of speculative money and financial

## **Investment Manager's Review**

investment flows driving certain commodity markets. Within the financial sectors we have a preference for insurance, real estate and general financial businesses over banks. Among the banks we favour the diversified major HSBC, with an attractive developing market franchise, a strong balance sheet, a robust funding position and a reasonable valuation, although the domestic banks offer potentially higher returns with commensurately higher risks.

### **Dividends**

The Merchants Trust has a twenty nine year record of consecutive dividend increases and the portfolio is managed with a view to generating a high level of income. The revenue reserves have allowed the directors to maintain this track record during a period that has seen substantial dividend cuts across the stock market. Whilst there remain risks to future income generation, the outlook has improved gradually over the last year, with the notable exception of the situation at BP. Dividends have now started to rise again in the wider market and forecasts for dividend growth are healthy. The strength of Sterling against the dollar is the only one of four key risk factors that we have previously highlighted to have become a modest headwind. Currencies remain important but largely unpredictable factors given the amount of income coming from abroad.

**Simon Gergel**

For and on behalf of RCM (UK) Limited

4 April 2011

**Listed Holdings** at 31 January 2011**Equities**

<b>Name</b>	<b>Value (£)</b>	<b>% of Listed holdings</b>	<b>Principal Activities</b>
Royal Dutch Shell 'B' Shares	46,531,043	8.6	Oil & Gas Producers
HSBC	40,711,219	7.5	Banks
GlaxoSmithKline	35,423,615	6.5	Pharmaceuticals & Biotechnology
BP	32,469,320	6.0	Oil & Gas Producers
Vodafone	29,464,862	5.4	Mobile Telecommunications
Unilever	20,146,500	3.7	Food Producers
BAE Systems	20,058,088	3.7	Aerospace & Defence
Scottish & Southern Energy	19,760,950	3.6	Electricity
BHP Billiton	18,254,600	3.4	Mining
British American Tobacco	18,077,885	3.3	Tobacco
<b>Top Ten Holdings</b>	<b>280,898,082</b>	<b>51.7</b>	
National Grid	16,692,480	3.1	Gas, Water & Multiutilities
Aviva	15,051,800	2.8	Life Insurance
AstraZeneca	15,047,527	2.8	Pharmaceuticals & Biotechnology
Reed Elsevier	13,516,581	2.5	Media
Resolution	13,363,197	2.5	Life Insurance
BT Group	10,995,826	2.0	Fixed Line Telecommunications
Compass Group	10,545,000	1.9	Travel & Leisure
Imperial Tobacco	8,558,400	1.6	Tobacco
United Business Media	8,441,025	1.6	Media
Reckitt Benckiser	8,312,850	1.5	Household Goods & Home Construction
Man Group	8,083,927	1.5	General Financial
Hammerson	7,918,740	1.5	Real Estate Investment Trust
Daily Mail & General Trust	7,777,050	1.4	Media
Meggitt	7,409,229	1.4	Aerospace & Defence
Balfour Beatty	7,385,984	1.4	Construction & Materials
Premier Farnell	6,728,000	1.2	Support Services
Hays	6,599,950	1.2	Support Services
Barclays	6,521,250	1.2	Banks
Bunzl	6,498,000	1.2	Support Services
Inmarsat	5,974,429	1.1	Mobile Telecommunications
IG Group	5,725,276	1.1	General Financial
Cobham	5,670,000	1.0	Aerospace & Defence
British Land	5,594,400	1.0	Real Estate Investment Trust
Britvic	4,892,432	0.9	Beverages
Tesco	4,832,400	0.9	Food & Drug Retailers
Catlin Group	4,733,440	0.9	Non-life Insurance
WPP	4,669,295	0.9	Media
British Insurance	4,572,742	0.8	Non-life Insurance
Greene King	4,008,600	0.7	Travel & Leisure
Melrose	3,602,406	0.7	Industrial Engineering
Interserve	3,512,688	0.6	Support Services
Centrica	3,457,681	0.6	Gas, Water & Multiutilities
Lloyds Banking Group	3,171,636	0.6	Banks
Legal and General	2,985,900	0.5	Life Insurance
Home Retail	2,969,931	0.5	General Retailers
Hiscox	2,821,500	0.5	Non-life Insurance
Ashmore Group	2,650,164	0.5	General Financial
Pendragon	1,022,233	0.2	General Retailers
<b>Total</b>	<b>543,212,051</b>	<b>100.0</b>	

## Listed Holdings at 31 January 2011

### Written Call Options\*

<b>Name</b>	<b>Value (£)</b>
GlaxoSmithKline Mar 2011 1350	(850)
British American Tobacco Feb 2011 2500	(1,150)
Compass Group Mar 2011 640	(1,875)
WPP Mar 2011 840	(7,647)
HSBC Apr 2011 760	(16,000)
Scottish & Southern Energy Mar 2011 1250	(25,300)
Vodafone Apr 2011 190	(37,500)
Royal Dutch Shell Mar 2011 2200	(43,875)
Aviva Feb 2011 410	(173,750)
<b>Total</b>	<b>(307,947)</b>

\*Valued in accordance with Note 5 of the Accounting Policies on page 35

## Distribution of Total Assets

Total Assets (less creditors due within one year) £552,031,290 (2010 – £498,205,486)

	Percentage of total assets at 31 January 2011	Percentage of total assets at 31 January 2010
<b>Oil &amp; Gas</b>		
Oil & Gas Producers	14.3	15.0
	<b>14.3</b>	<b>15.0</b>
<b>Basic Materials</b>		
Mining	3.3	3.3
	<b>3.3</b>	<b>3.3</b>
<b>Industrials</b>		
Aerospace & Defence	6.0	5.2
Construction & Materials	1.3	1.0
General Industrials	–	0.8
Industrial Engineering	0.7	0.7
Support Services	4.2	2.7
	<b>12.2</b>	<b>10.4</b>
<b>Consumer Goods</b>		
Beverages	0.9	1.4
Food and Drug Retailers	0.9	–
Food Producers	3.6	3.7
Household Goods & Home Construction	1.5	1.1
Tobacco	4.8	3.9
	<b>11.7</b>	<b>10.1</b>
<b>Healthcare</b>		
Pharmaceuticals & Biotechnology	9.2	11.8
	<b>9.2</b>	<b>11.8</b>
<b>Consumer Services</b>		
General Retailers	0.7	2.4
Media	6.2	3.7
Travel & Leisure	2.7	2.1
	<b>9.6</b>	<b>8.2</b>
<b>Telecommunications</b>		
Fixed Line Telecommunications	2.0	2.0
Mobile Telecommunications	6.4	7.5
	<b>8.4</b>	<b>9.5</b>
<b>Utilities</b>		
Electricity	3.6	5.1
Gas, Water & Multiutilities	3.7	5.5
	<b>7.3</b>	<b>10.6</b>
<b>Financials</b>		
Banks	9.1	7.8
General Financial	3.0	3.6
Life Insurance	5.7	3.8
Non-Life Insurance	2.2	1.7
Real Estate	2.4	2.2
	<b>22.4</b>	<b>19.1</b>
<b>Total Investments</b>	<b>98.4</b>	<b>98.0</b>
<b>Net Current Assets</b>	<b>1.6</b>	<b>2.0</b>
<b>Total Assets</b>	<b>100.0</b>	<b>100.0</b>

## Directors

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

### Mr S J Fraser (Chairman)

(Born May 1959) joined the Board in August 2009. He is Chairman 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 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 The Edinburgh Investment Trust PLC and Standard Life Investments Property Income Trust Limited. He is a Non-Executive member of the Pension Protection Fund Board and advises a number of pension funds.

### Mr M J E McKeon (Chairman of the Audit Committee)

(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.

### Mr H E Staunton (Senior Independent Director)

(Born May 1948) joined the Board in May 2008. He is a non-executive director of Legal & General plc, Standard Bank Plc, Capital and Counties Properties plc and W H Smith PLC. He was previously Finance Director at ITV plc and Granada Group plc. He was also a non-executive director of Ladbrokes plc, 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.

### Mr P T Yates

(Born June 1957) joined the Board in March 2011. He has had a long career in investment management beginning at Samuel Montagu & Co in 1980. He joined Phillips and Drew in 1985 – the year that it was acquired by UBS. He held a number of positions at UBS, covering management, portfolio management, pensions, strategy and client service. He was CEO of UBS Global Asset Management (UK) Ltd between 2001 and 2005. After undertaking a number of global roles at UBS he retired in 2007. Paul is a non-executive partner of 33 St James's.

## Investment Manager and Advisers

**Investment 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 Securities

**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 2011

### 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 1158 of the Corporation Taxes Act 2010 for the year ended 31 January 2010. 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 1158 of the Corporation Taxes Act 2010 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 nine years and details of historic dividend payments are set out on page 5.

#### Performance

In the year to 31 January 2011 the NAV per Share rose by 14.6%. This compares with the capital return on the Company's benchmark indices of 13.0% (FTSE 100) and 7.2% (FTSE 350 Higher Yield). At 31 January 2011 the value of the Company's investment portfolio was £543.2m. The Investment Manager's review on pages 6 to 12 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 2011 is given on page 5.
- *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 2011 the shares traded between a discount of -7.7% and a premium of 6.9% with debt at fair value.

## Directors' Report

- *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 2011 was 0.46% (2010 – 0.45%).

### Revenue

The return attributable to Ordinary Shareholders for the year amounted to £21,900,146 (2010 – £19,498,068).

Revenue return per ordinary dividend amounted to 21.22p. The first and second interim dividends of 5.7p and 5.7p respectively have been paid during the year. Since the year end the third interim dividend of 5.7p has been paid. The final proposed dividend of 5.7p is payable on 13 May 2011. 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 page 15, 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 7 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 gains based on historical costs of £25,156,875 (2010 – losses of £54,672,814). Provisions contained in the Finance Act 1980 exempt approved Investment Trusts from corporation tax on their chargeable gains. Invested funds at 31 January 2011 had a value of £542,931,529 (2010 – £488,295,791) before deducting net liabilities of £102,085,513 (2010 – £103,548,577).

### 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 1158 of the Corporation Tax Act 2010 ("Section 1158"), and details are given above under the heading 'Business of the Company'. A breach of Section 1158 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 1158 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 breach of Section 1158. 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** Shareholder discontent could arise if there is weak adherence to best practice in corporate governance and which could result in potential reputational damage to the Company. The Board receives reports on shareholder activity and on shareholder sentiment on a regular basis and contact is maintained with major shareholders. 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.

## Directors' Report

- 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 pages 23 and 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 17 on pages 44 to 49

### 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 4271p as compared with a value of 372 8p at 31 January 2010

### 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 (2010 – Enil)

### Donations and Subscriptions

There were no charitable donations and subscriptions in respect of the year (2010 – Enil) 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 13 May 2011 to shareholders on the Register of Members at the close of business on 15 April 2011 at the rate of 5 7p per Ordinary Share Further details are provided in Note 6 on page 39

### Capital Structure

The Company's capital structure is summarised on page 43 The details of the 4% Perpetual Debenture Stock and the 3 65% Cumulative Preference Stock are provided in Notes 10(iv) and 10(v) respectively on page 42

### Voting Rights in the Company's Shares

The voting rights at 31 March 2011 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 stock of £1	1,178,000	1	1,178,000
Total	104,391,464		104,391,464

The voting rights of the Ordinary Shares on a poll are one vote for every share held

There are no restrictions on the transfer of the Company's share capital and there are no shares which carry specific rights with regard to control of the Company

## Directors' Report

### Interests in the Company's Share Capital

As at 4 April 2011 the following had declared a notifiable interest in the Company's issued share capital

#### Ordinary Shares

Name	Number of Shares	Percentage of Voting Rights
Legal & General Group PLC	4,099,823	3.9
Lloyds Banking Group PLC	4,086,614	3.9
Rensburg Sheppards Investment Management Group Limited	4,017,845	3.9
AXA S A	3,664,667	3.5

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 in the table on page 22, except where noted, served throughout the financial year under review

The Directors retiring by rotation at the Annual General Meeting ('AGM') are Mike McKeon and Henry Staunton and each offers himself for re-election and both have the full support of the Board in doing so. In addition, Paul Yates, 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 Mr Yates. Dick Barfield 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.

Biographical details of the current Directors are on page 16

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.

The current Directors and their beneficial interests in the share capital of the Company as at 31 January 2011 and 31 January 2010 are listed below

	Ordinary Shares of 25p	
	2011	2010
S J Fraser	20,000	20,000
R A Barfield	2,440	2,440
M J E McKeon	450	450
H E Staunton	10,000	10,000

There have been no changes to directors' interests since the year end. Paul Yates, appointed to the Board on 21 March 2011, has a holding of 1,000 shares.

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

## Directors' Report

### Management Contract and Management Fee

The management contract with RCM (UK) Limited ("RCM") provides for a fee of 0.35% per annum (2010 – 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 (2010 – 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.

### 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.

### The Board

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

The Chairman of the Company is a non-executive Director. Henry Staunton is the Senior Independent Director. The Senior Independent Director can provide a sounding board for the Chairman and serve as an intermediary for the other directors when necessary, as well as providing another point of contact for Shareholders.

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. New Corporate Governance rules which will apply in the next financial year require that all the directors stand for re-election annually, or for the Board to explain why they do not.

The Board met six times in the year and also held a strategy meeting. 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

## Directors' Report

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 also discussed individual training and development needs with each Director. The Chairman's own performance was evaluated by the other Directors in discussions with Henry Staunton 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 a new director the balance of the Board was satisfactory. As part of the recruitment process, consultants were appointed to draw up a shortlist to include as wide a spectrum of candidates as possible, including taking gender into account.

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
S. J. Fraser	6	2*	1	1
R. A. Barfield	6	2	1	1
M. J. E. McKeon	6	2	1	1
H. E. Staunton	6	2	1	1
Lord Sassoon#	2	-	-	-
Sir Hugh Stevenson#	1	-	-	-

\* Invited to attend meetings, although not a committee member

# Retired from the Board in May 2010

### 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.

## Directors' Report

### 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 Mike McKeon. 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 Simon Fraser, the Chairman of the Board. All Directors serve on the committee and consider nominations made in accordance with an agreed procedure. The recruitment process for new directors is for the Board to appoint external consultants to nominate candidates for the committee to consider.

#### 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 would exclude any Directors previously employed by the Manager. It is chaired by Simon Fraser, the Chairman of the 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](http://www.merchantstrust.co.uk)

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

#### Financial Reporting

The Statement of Directors' Responsibilities in respect of the financial statements is on page 27.

The Independent Auditors' Report can be found on page 30.

#### 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.

## Directors' Report

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 reports to the Board on matters raised at these meetings. The Chairman and, where appropriate, other Directors, are available to meet with shareholders to discuss governance and strategy and to understand their issues and concerns. All correspondence with shareholders is reviewed by the Board.

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.

### The UK Stewardship Code and 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, RCM (UK) Limited (RCM). Following a consultation by the Financial Reporting Council (the "FRC") the UK Stewardship Code (the "Stewardship Code") was published in July 2010. It aims to enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities. The Stewardship Code sets out good practice on engagement with investee companies. It provides an opportunity to bring together UK and overseas investors committed to the high quality dialogue with companies needed to underpin good governance.

## Directors' Report

By creating a sound basis of engagement it should create a much needed stronger link between governance and the investment process, and support the concept of "comply or explain" as applied by listed companies. The FRC therefore sees it as complementary to the UK Corporate Governance Code for listed companies, as revised in June 2010. The FRC encouraged all institutional investors to publish on their websites by the end of September 2010 a statement about the extent to which they had complied with the Stewardship Code and to notify the FRC when they had done so. The Company's Manager, RCM (UK) Limited, has complied with this and its policy statement on the Stewardship Code can be found on its website [www.rcm.com/london/pdf/Stewardship\\_Policy.pdf](http://www.rcm.com/london/pdf/Stewardship_Policy.pdf). The Board has reviewed this policy statement and is satisfied that the Company's delegated voting powers are being properly executed. 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.

### 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 US 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

### 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 number of 34,401,047 Ordinary Shares, representing approximately 33% of the existing Ordinary Share capital. This authority is renewable annually and will expire at the conclusion of the Annual General Meeting in 2012.

A resolution was passed at the Annual General Meeting held on 11 May 2010 in accordance with Section 570 of the Companies Act 2006, 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 2011. 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 a maximum number of 10,321,346 Ordinary Shares, 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 10 May 2011.

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.

## Directors' Report

### 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 £380 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 15,471,698 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 10 May 2011.

The authority in accordance with Section 701 of the Companies Act 2006, will last until the Annual General Meeting of the Company to be held in 2012 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.

### 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 effective until the Company's next Annual General Meeting, when it is intended that a similar resolution will be proposed. In order for this authority to be used, 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

4 April 2011

## 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 net return 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

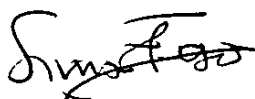
The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the company's transactions and disclose with reasonable accuracy at any time the financial position of the company and enable them to ensure that the financial statements and the Directors' Remuneration 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](http://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 net return 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  
Simon Fraser | Chairman  
4 April 2011

## 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 2011. 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.

### Remuneration

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. 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 to increase the fees with effect from 1 February 2011 to reflect current market rates for directors in comparable investment funds. From that date, the Chairman's fees are £30,000 per annum, the Directors' fees are £20,000 per annum and an additional £3,000 is paid to the Audit Committee Chairman.

### Directors' Emoluments (Audited)

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

	Directors' fees	
	2011	2010
	£	£
S J Fraser	24,543	9,000
R A Barfield	18,000	18,000
M J E McKeon	20,115	18,000
H E Staunton	18,000	18,000
Lord Sassoon*	6,556	21,000
Sir Hugh Stevenson*	7,615	27,500
P J Scott Plummer†	-	5,358
<b>Totals</b>	<b>94,829</b>	<b>116,858</b>

\* Retired from the Board May 2010

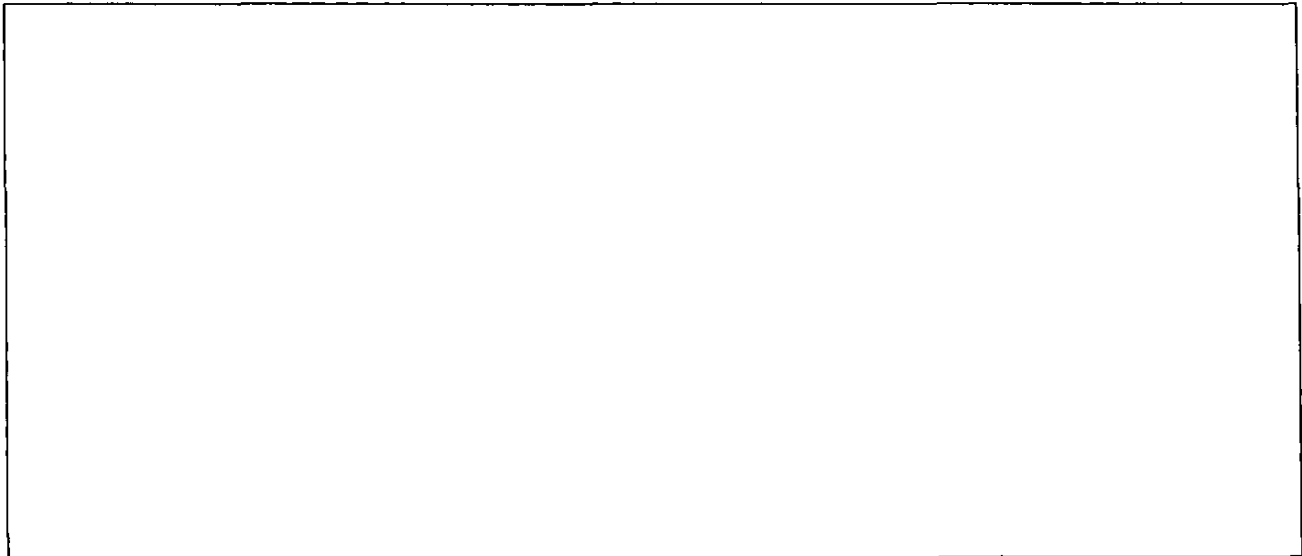
† Retired from the Board May 2009

## 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  
4 April 2011

## 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 2011 which comprise the Income Statement, the Reconciliation of Movements in Shareholder's 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 27, 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 and express an opinion on 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 2011 and of its net return 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,
- the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements, and
- the information given in the Corporate Governance Statement set out on pages 23 and 24 with respect to internal control and risk management systems and about share capital structures 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, or
- a corporate governance statement has not been prepared by the company.

Under the Listing Rules we are required to review

- the directors' statement, set out on page 19, in relation to going concern,
- the parts of the Corporate Governance Statement relating to the company's compliance with the nine provisions of the June 2008 Combined Code, and
- certain elements of the report to shareholders by the Board on directors' remuneration.



Kelvin Laing-Williams (Senior Statutory Auditor)  
for and on behalf of PricewaterhouseCoopers LLP  
Chartered Accountants and Statutory Auditors  
London  
4 April 2011

**Income Statement** for the year ended 31 January 2011

		2011	2011	2011	2010	2010	2010
	Notes	Revenue Return £	Capital Return £	Total Return £	Revenue Return £	Capital Return £	Total Return £
Net gains on investments at fair value	8	-	63,626,410	63,626,410	-	79,416,688	79,416,688
Income	1	25,740,859	-	25,740,859	23,686,655	-	23,686,655
Investment management fee	2	(634,796)	(1,178,909)	(1,813,705)	(560,552)	(1,041,025)	(1,601,577)
Investment management fee VAT refund	2	-	-	-	416,080	772,720	1,188,800
Administration expenses	3	(714,775)	(3,442)	(718,217)	(659,180)	(3,915)	(663,095)
<b>Net return before finance costs and taxation</b>		<b>24,391,288</b>	<b>62,444,059</b>	<b>86,835,347</b>	<b>22,883,003</b>	<b>79,144,468</b>	<b>102,027,471</b>
Finance costs interest payable and similar charges	4	(2,491,142)	(4,815,949)	(7,307,091)	(3,384,935)	(6,206,422)	(9,591,357)
<b>Net return on ordinary activities before taxation</b>		<b>21,900,146</b>	<b>57,628,110</b>	<b>79,528,256</b>	<b>19,498,068</b>	<b>72,938,046</b>	<b>92,436,114</b>
Taxation	5	-	-	-	-	-	-
<b>Net return on ordinary activities attributable to Ordinary Shareholders</b>		<b>21,900,146</b>	<b>57,628,110</b>	<b>79,528,256</b>	<b>19,498,068</b>	<b>72,938,046</b>	<b>92,436,114</b>
<b>Return per Ordinary Share (basic and diluted)</b>	7	<b>21 22p</b>	<b>55 83p</b>	<b>77 05p</b>	<b>18 91p</b>	<b>70 73p</b>	<b>89 64p</b>

Dividends in respect of the financial year ended 31 January 2011 total 22 80p (2010 - 22 50p), amounting to £23,532,668 (2010 - £23,223,029) Details are set out in Note 6 on page 39

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.

## Reconciliation of Movements in Shareholders' Funds for the year ended 31 January 2011


	Notes	Called up Share Capital £	Share Premium Account £	Capital Redemption Reserve £	Capital Reserve £	Revenue Reserve £	Total £
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
Ordinary Shares issued during the year		100,000	1,016,000	-	-	-	1,116,000
Transaction costs on Ordinary Shares issued		-	(19,852)	-	-	-	(19,852)
<b>Net Assets at 31 January 2010</b>		<b>25,803,366</b>	<b>8,523,195</b>	<b>292,853</b>	<b>324,056,586</b>	<b>26,071,214</b>	<b>384,747,214</b>
Net Assets at 31 January 2010		25,803,366	8,523,195	292,853	324,056,586	26,071,214	384,747,214
Revenue Return		-	-	-	-	21,900,146	21,900,146
Dividends on Ordinary Shares	6	-	-	-	-	(23,429,454)	(23,429,454)
Capital Return		-	-	-	57,628,110	-	57,628,110
<b>Net Assets at 31 January 2011</b>		<b>25,803,366</b>	<b>8,523,195</b>	<b>292,853</b>	<b>381,684,696</b>	<b>24,541,906</b>	<b>440,846,016</b>

The Notes on pages 37 to 49 form an integral part of these Financial Statements

**Balance Sheet** as at 31 January 2011

	Notes	2011 £	2011 £	2010 £
<b>Fixed Assets</b>				
Investments held at fair value through profit or loss	8		543,239,476	488,314,516
<b>Current Assets</b>				
Derivative financial instruments	8	-		83,125
Debtors	10	2,034,330		3,681,322
Cash at bank		9,257,041		8,911,182
		<b>11,291,371</b>		<b>12,675,629</b>
<b>Creditors – Amounts falling due within one year</b>	10	<b>(2,191,610)</b>		<b>(2,682,809)</b>
Derivative financial instruments	8	(307,947)		(101,850)
		<b>(2,499,557)</b>		<b>(2,784,659)</b>
<b>Net Current Assets</b>			<b>8,791,814</b>	<b>9,890,970</b>
<b>Total Assets less Current Liabilities</b>			<b>552,031,290</b>	<b>498,205,486</b>
<b>Creditors – Amounts falling due after more than one year</b>	10		<b>(111,185,274)</b>	<b>(113,458,272)</b>
<b>Total Net Assets</b>			<b>440,846,016</b>	<b>384,747,214</b>
<b>Capital and Reserves</b>				
Called up Share Capital	11		25,803,366	25,803,366
Share Premium Account	12		8,523,195	8,523,195
Capital Redemption Reserve	12		292,853	292,853
Capital Reserve	12		381,684,696	324,056,586
Revenue Reserve	12		24,541,906	26,071,214
<b>Equity Shareholders' Funds</b>	13		<b>440,846,016</b>	<b>384,747,214</b>
<b>Net Asset Value per Ordinary Share</b>	13		<b>4271 p</b>	<b>372 8p</b>

The financial statements of The Merchants Trust PLC, company number 28276, were approved and authorised for issue by the Board of Directors on 4 April 2011 and signed on its behalf by



Simon Fraser | Chairman

## Cash Flow Statement for the year ended 31 January 2011

	Notes	2011 £	2011 £	2010 £
Net cash inflow from operating activities	15		22,695,223	25,230,795
Returns on investment and servicing of finance				
Interest paid		(9,537,094)		(9,563,178)
Dividends on Cumulative Preference Stock		(21,498)		(42,997)
Net cash outflow from servicing of finance			(9,558,592)	(9,606,175)
Capital expenditure and financial investment				
Purchase of investments		(131,542,358)		(112,115,497)
Sale of investments		142,181,040		113,383,975
Net cash inflow from capital expenditure and financial investment			10,638,682	1,268,478
Dividends paid on Ordinary Shares	6		(23,429,454)	(23,589,084)
Net cash inflow (outflow) before financing			345,859	(6,695,986)
Financing				
Proceeds from issue of Ordinary Shares		–		1,116,000
Transaction costs on Ordinary Shares issued		–		(19,852)
Net cash inflow from financing			–	1,096,148
Increase (decrease) in cash	16		345,859	(5,599,838)

The Notes on pages 37 to 49 form an integral part of these Financial Statements

## Statement of Accounting Policies for the year ended 31 January 2011

- 1 The financial statements have been prepared under the historical cost basis, except for the measurement at fair value of investments and derivative financial instruments, and in accordance with the United Kingdom Law and United Kingdom Generally Accepted Accounting 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. 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.

- 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 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 or last traded price depending on the convention of the exchange on which the investment is listed. Gains or losses on investments are recognised in the capital column of the Income Statement. Purchases and sales of financial assets are recognised on the trade date, being the date which the Company commits to purchase or sell the assets.

- 5 Derivatives – Options may be purchased or written over securities held in the portfolio for generating or protecting capital returns, or for generating or maintaining revenue returns.

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 or exercised the gain or loss is accounted for as capital.

## Statement of Accounting Policies for the year ended 31 January 2011

Where the purpose of the option is the generation of income, the premium is treated as a revenue item. The value of the option is subsequently marked to market to reflect the fair value of the option based on traded prices. Premiums received on written options are amortised to revenue over the period to expiry. Unamortised premiums on exercise date are taken to 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 Exchange 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 monetary 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 2011

### 1. Income

	2011	2011	2010
	£	£	£
<b>Income from Investments *</b>			
Franked equity income from UK investments		22,729,612	22,766,477
Unfranked equity income from UK investments		205,075	147,878
Equity income from overseas investments		580,702	80,360
		<b>23,515,389</b>	<b>22,994,715</b>
<b>Other Income</b>			
Deposit interest	-		7,936
Other interest #	-		59,879
Premiums on derivative contracts	2,059,837		17,564
Underwriting commission	165,633		606,561
		<b>2,225,470</b>	<b>691,940</b>
<b>Total income</b>		<b>25,740,859</b>	<b>23,686,655</b>

\* All equity income is derived from listed investments

# Interest on investment management fee VAT refund for the period 2001 to 2007

During the year, the Company received premiums totalling £2,124,301 for writing covered call options for the purpose of revenue generation, of which £2,059,837 were amortised to income (2010 – £17,564). All derivative transactions were based on FTSE 100 stocks. At the year end there were nine open positions with a net liability value of £307,947 (2010 – £18,725).

### 2. Investment Management Fee

	2011	2011	2011	2010	2010	2010
	Revenue	Capital	Total	Revenue	Capital	Total
	£	£	£	£	£	£
Investment management fee	634,796	1,178,909	1,813,705	560,552	1,041,025	1,601,577
Investment management fee VAT refund - financial years 2001 – 2007	-	-	-	(416,080)	(772,720)	(1,188,800)
<b>Total</b>	<b>634,796</b>	<b>1,178,909</b>	<b>1,813,705</b>	<b>144,472</b>	<b>268,305</b>	<b>412,777</b>

The management contract with RCM (UK) Limited ('RCM'), terminable at one year's notice, provides for a management fee based on 0.35% (2010 – 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.

Due to the European Court of Justice ruling in the VAT case brought by JP Morgan Fleming Claverhouse Trust plc in conjunction with the AIC on 28 June 2007, VAT has not been charged on management fees since 1 May 2007.

Following the ruling of the European Court of Justice, settlement has been reached with RCM in respect of the recovery of overpaid VAT in past years. During the previous financial year a refund of £1,188,800 was paid to the Company in relation to VAT paid previously, together with interest of £59,879 from HM Revenue and Customs. The VAT refund has been applied to revenue and capital in accordance with how the fees to which it relates were charged in the relevant period. These amounts are included in the Company's Income Statement.

## Notes to the Financial Statements for the year ended 31 January 2011

### 3. Administration Expenses

	2011 £	2010 £
Auditors' remuneration		
for audit services	23,949	21,464
for accounting advice	-	6,000
for certification of borrowing covenants	3,020	3,000
for legal advice on recovery of VAT	-	35,870
VAT on auditors' remuneration	5,294	10,486
	<b>32,263</b>	<b>76,820</b>
Directors' fees	94,829	116,858
Marketing costs	234,451	119,928
Other administration expenses	353,232	345,574
	<b>714,775</b>	<b>659,180</b>

- (i) The above expenses include value added tax where applicable
- (ii) Directors' fees are set out in the Directors' Remuneration Report on page 28
- (iii) In addition to the above, custodian handling charges of £3,442 were charged to capital (2010 – £3,915)

### 4. Finance Costs: Interest Payable and Similar Charges

	2011 Revenue £	2011 Capital £	2011 Total £	2010 Revenue £	2010 Capital £	2010 Total £
On Stepped Rate Interest Loan repayable						
after more than five years	1,361,040	2,527,647	3,888,687	1,396,733	2,593,933	3,990,666
Release of provision (see below)	(862,086)	(1,331,625)	(2,193,711)	-	-	-
	<b>498,954</b>	<b>1,196,022</b>	<b>1,694,976</b>	<b>1,396,733</b>	<b>2,593,933</b>	<b>3,990,666</b>
On Fixed Rate Interest Loan repayable						
after more than five years	1,304,676	2,422,970	3,727,646	1,301,156	2,416,434	3,717,590
On 4% Perpetual Debenture Stock repayable						
after more than five years	19,250	35,750	55,000	19,250	35,750	55,000
On 5.875% Secured Bonds repayable						
after more than five years	625,265	1,161,207	1,786,472	624,780	1,160,305	1,785,085
On 3.65% Cumulative Preference Stock						
repayable after more than five years	42,997	-	42,997	42,997	-	42,997
On Sterling overdraft	-	-	-	19	-	19
	<b>2,491,142</b>	<b>4,815,949</b>	<b>7,307,091</b>	<b>3,384,935</b>	<b>6,206,422</b>	<b>9,591,357</b>

A provision in respect of a deferred tax liability accruing to First Debenture Finance ("FDF") as a result of the redemption or earlier transfer of the Stepped Rate Loan Notes and Bonds held by FDF has been released by the Company. The release of this provision is a result of the election by the Directors of FDF to be taxed under the Securitisation Companies Regulations 2006 for the accounting period commencing 1 October 2007 and all subsequent accounting periods. Cumulative amounts charged in current and prior periods of £862,086 and £1,331,625 have been written back to revenue and capital respectively.

## Notes to the Financial Statements for the year ended 31 January 2011

### 5. Taxation

	2011 Revenue	2011 Capital	2011 Total	2010 Revenue	2010 Capital	2010 Total
	£	£	£	£	£	£
Overseas taxation	-	-	-	-	-	-
Current tax charge	-	-	-	-	-	-
<b>Reconciliation of tax charge</b>						
Return on ordinary activities before taxation	21,900,146	57,628,110	79,528,256	19,498,068	72,938,046	92,436,114
Tax on return on ordinary activities at 28% (2010 – 28%)	6,132,041	16,135,871	22,267,912	5,459,459	20,422,653	25,882,112
<b>Reconciling factors</b>						
Non taxable income	(6,526,888)	-	(6,526,888)	(6,397,114)	-	(6,397,114)
Non taxable capital gains	-	(17,815,395)	(17,815,395)	-	(22,236,673)	(22,236,673)
Disallowable expenses	(220,590)	(357,433)	(578,023)	30,371	25,586	55,957
Excess of allowable expenses over taxable income	615,437	2,036,957	2,652,394	907,284	1,788,434	2,695,718
<b>Current tax charge</b>	-	-	-	-	-	-

The Company's taxable income is exceeded by its tax allowable expenses, which include both the revenue and capital elements of the management fee and finance costs. As at 31 January 2011, the Company had accumulated surplus expenses of £142.8 million (2010 – £133.3 million).

At 31 January 2011, the Company has not recognised a deferred tax asset of £38.5 million (2010 – £37.3 million) in respect of the accumulated expenses. Provided the Company continues to maintain its current investment profile, it is unlikely that these expenses will be utilised and that the Company will obtain any benefit from this asset.

The Company will continue to seek approval under Section 1158 of the Corporation Taxes Act 2010 for the current year and the foreseeable future. The Company has not therefore provided deferred tax on any capital gains and losses arising on the disposal of investments.

### 6. Dividends on Ordinary Shares

	2011 £	2010 £
Dividends on Ordinary Shares of 25p		
Third interim dividend 5.6p paid 19 February 2010 (2009 – 5.6p)	5,779,954	5,757,554
Final dividend 5.7p paid 14 May 2010 (2009 – 5.6p)	5,883,166	5,757,554
Special dividend nil (2009 – 0.5p)	-	514,068
First interim dividend 5.7p paid 20 August 2010 (2009 – 5.6p)	5,883,167	5,779,954
Second interim dividend 5.7p paid 11 November 2010 (2009 – 5.6p)	5,883,167	5,779,954
	<b>23,429,454</b>	<b>23,589,084</b>

Dividends payable at the year end are not recognised as a liability under FRS 21 'Events After Balance Sheet Date' (see page 36 – Statement of Accounting Policies). Details of these dividends are set out below.

	2011 £	2010 £
Third interim dividend 5.7p paid 18 February 2011 (2010 – 5.6p)	5,883,167	5,779,954
Final proposed dividend 5.7p payable 13 May 2011 (2010 – 5.7p)	5,883,167	5,883,167
	<b>11,766,334</b>	<b>11,663,121</b>

The proposed final dividend is based on the number of shares in issue at the year end. However, the dividend payable will be based on the numbers of shares in issue on the record date and will reflect any purchases and cancellations of shares by the Company settled subsequent to the year end.

## Notes to the Financial Statements for the year ended 31 January 2011

### 7. Return per Ordinary Share

	2011 Revenue £	2011 Capital £	2011 Total Return £	2010 Revenue £	2010 Capital £	2010 Total Return £
Return after taxation attributable to						
Ordinary Shareholders	21,900,146	57,628,110	79,528,256	19,498,068	72,938,046	92,436,114
Return per Ordinary Share	21 22p	55 83p	7705p	18 91p	70 73p	89 64p

The weighted average number of shares in issue during the year was 103,213,464 (2010 – 103,117,026)

### 8. Investments

	2011 £	2010 £
Listed on the London Stock Exchange at market valuation	543,212,051	488,287,091
Unlisted at fair value	27,425	27,425
<b>Fixed asset investments</b>	<b>543,239,476</b>	<b>488,314,516</b>
Derivative financial instruments – purchased put options	–	83,125
Derivative financial instruments – written call options	(307,947)	(101,850)
<b>Total investments</b>	<b>542,931,529</b>	<b>488,295,791</b>
Market value of investments brought forward	488,295,791	411,795,591
Investment holding losses brought forward	476,634	134,498,602
Derivative holding losses brought forward	216,723	–
<b>Cost of investments held brought forward</b>	<b>488,989,148</b>	<b>546,294,193</b>
Additions at cost	130,908,403	112,749,452
Disposals at cost	(115,070,087)	(170,054,497)
<b>Cost of investments held at 31 January</b>	<b>504,827,464</b>	<b>488,989,148</b>
Investment holding gains (losses) at 31 January	38,259,082	(476,634)
Derivative holding losses at 31 January	(155,017)	(216,723)
<b>Market value of investments held at 31 January</b>	<b>542,931,529</b>	<b>488,295,791</b>
<b>Net gains on investments</b>		
Net gains (losses) on sales of investments based on historical costs	25,156,875	(54,672,814)
Adjustment for net investment holding (gains) losses recognised in previous years	(2,001,815)	77,965,659
<b>Net gains on sales of fixed asset investments based on carrying value at previous balance sheet date</b>	<b>23,155,060</b>	<b>23,292,845</b>
Net (losses) gains on derivative financial instruments	(327,887)	284,257
<b>Net gains on sales of investments based on carrying value at previous balance sheet date</b>	<b>22,827,173</b>	<b>23,577,102</b>
Net investment holding gains arising in the year	40,737,531	56,056,309
Net derivative holding gains (losses) arising in the year	61,706	(216,723)
<b>Net gains on investments</b>	<b>63,626,410</b>	<b>79,416,688</b>

Transaction costs and stamp duty on purchases amounted to £773,955 (2010 – £647,513) and transaction costs on sales amounted to £154,872 (2010 – £144,771)

## Notes to the Financial Statements for the year ended 31 January 2011

### 9. Investments in Other Companies

The Company held more than 3% of the share capital of the following companies, both of which are incorporated in Great Britain and registered in England and Wales

Company	Total Net Assets* £	Class of Shares held	% of Class held	% Equity
First Debenture Finance PLC ('FDF')	(353,141)	'A' Shares	39.2	
		'B' Shares	59.2	49.2
		'C' Shares	45.6	
		'D' Shares	53.3	
Fintrust Debenture PLC ('Fintrust')	19,480	Ordinary	50.0	50.0

\* As at the date of the latest published financial statements of FDF or Fintrust, as appropriate

In the opinion of the Directors, the Company is not in a position to exert significant influence over the financial operating policies of FDF or Fintrust, either through voting rights or through agreement with those companies' other shareholders, due to provisions in FDF and Fintrust's Articles of Association and in certain contracts between the Company and each of FDF and Fintrust. Accordingly, FDF and Fintrust are not considered to be associate undertakings as per FRS9 and are therefore included in the balance at the Director's valuation. FDF and Fintrust are the lenders of the Company's Stepped Rate Interest Loan and Fixed Rate Interest Loan, as detailed in Notes 10(i) and 10(ii), respectively. Apart from the finance costs, there were no other transactions between FDF, Fintrust and the Company during the year.

### 10. Current Assets and Creditors

	2011 £	2010 £
<b>Debtors</b>		
Sales for future settlement	–	2,281,965
Accrued income	1,995,817	1,360,380
Other debtors	38,513	38,977
	<b>2,034,330</b>	<b>3,681,322</b>
<b>Creditors – Amounts falling due within one year</b>		
Purchases for future settlement	–	633,955
Other creditors	850,846	729,587
Interest on borrowings (see below)	1,340,764	1,319,267
	<b>2,191,610</b>	<b>2,682,809</b>
<b>Interest on outstanding borrowings consists of</b>		
Stepped Rate Interest Loan	313,728	313,728
Fixed Rate Interest Loan	783,545	783,546
5.875% Secured Bonds 2029	208,243	208,243
4% Perpetual Debenture Stock	13,750	13,750
3.65% Cumulative Preference Stock	21,498	–
	<b>1,340,764</b>	<b>1,319,267</b>
<b>Creditors – Amounts falling due after more than one year</b>		
Stepped Rate Interest Loan	10(i) 34,034,112	36,152,901
Fixed Rate Interest Loan	10(ii) 45,457,833	45,635,714
5.875% Secured Bonds 2029	10(iii) 29,140,329	29,116,657
4% Perpetual Debenture Stock	10(iv) 1,375,000	1,375,000
3.65% Cumulative Preference Stock	10(v) 1,178,000	1,178,000
	<b>111,185,274</b>	<b>113,458,272</b>

## Notes to the Financial Statements for the year ended 31 January 2011

- (i) The Stepped Rate Interest Loan of £34,034,112 (2010 – £36,152,901) comprises adjustable Stepped Rate Interest Loan Notes of £5,133,520, Stepped Rate Interest Bonds of £20,534,079 and a provision in respect of a deferred tax liability accruing to First Debenture Finance PLC ('FDF') of Enil (2010 – £2,118,789) issued in 1987 at 97.4%. The Loan Notes and Bonds were issued in 1987 at 97.4% and are repayable on 2 January 2018, together with a premium of £8,366,513

The initial interest rate on the Loan Notes and Bonds was 7.16% per annum. This increased annually by 75% compound until January 1998 when it reached its current rate of 14.75%. This stepped interest rate, when combined with the accrual of the premium, results in an effective interest rate of 11.28% per annum.

Interest on the Loan Notes and Bonds is payable in January and July each year. Interest on the Loan Notes is variable in accordance with the terms of the agreement with the lender, FDF.

FDF has a liability to repay principal and interest on its £52.2 million of 11.125% Severally Guaranteed Debenture Stock 2018. The Company has guaranteed the repayment of principal and interest on £34.0 million to the Debenture Stockholders, in proportion to the relative principal amounts raised in respect of the Loan Notes and Bonds. There is a floating charge on all the Company's present and future assets to secure this obligation. The Company has also agreed to meet its proportionate share of any expenses incurred by FDF, including any tax liability.

- (ii) The Fixed Rate Interest Loan of £42,000,000 is due to Fintrust Debenture PLC ('Fintrust'). It comprises a principal amount of £30,000,000 taken out in 1993, and a further amount of £12,000,000 assumed in 1998 from another of Fintrust's borrowers. The loan is repayable on 20 May 2023 and carries interest at 9.25125% per annum on the principal amount. Interest is payable in May and November each year.

As security for the loan, the Company has granted a floating charge over its assets in favour of the lender. This charge ranks *pari passu* with the floating charge noted in 10(i) above.

The principal of £30,000,000 taken out in 1993 is stated at £29,896,568 (2010 – £29,892,483), being the net proceeds of £29,858,947 plus accrued finance costs of £37,621 (2010 – £33,536). The effective interest rate of this portion of the loan is 9.51%.

In addition to assuming the additional borrowing of £12,000,000 in 1998, at the same time the Company also received a premium of £5,286,564 in order that the finance costs on this new borrowing was comparable to existing market interest rates. This premium is being amortised over the remaining life of the loan. At 31 January 2011, the loan is stated at £15,561,265 (2010 – £15,743,231), being the principal amount of £12,000,000 plus the unamortised premium of £3,561,265 (2010 – £3,743,231). The effective interest rate of this portion of the loan is 6.00%.

- (iii) The £30,000,000 of 5.875% Secured Bonds is stated at £29,140,329 (2010 – £29,116,657), being the net proceeds of £28,942,800 plus accrued finance costs of £197,529 (2010 – £173,857). The Bonds are repayable on 20 December 2029, and carry interest at 5.875% per annum on the principal amount. Interest is payable in June and December each year. The effective interest rate of this loan is 6.23% per annum.

As security for this loan, the Company has granted a floating charge over its assets ranking *pari passu* with the floating charges referred to in Note 10(i) and 10(ii) above.

- (iv) The 4% Perpetual Debenture Stock of £1,375,000 is secured by a floating charge on the assets of the Company, which ranks prior to any other floating charge. Interest is payable in May and November.
- (v) The 3.65% Cumulative Preference Stock is recognised as a creditor due after more than one year under the provisions of FRS25 'Financial Instruments: Disclosure and Presentation'. The right of the Preference Stock to receive payments is not calculated by reference to the Company's profits and, in the event of a return of capital is limited to a specific amount, being £1,178,000. Dividends on the Preference Stock are payable on 1 August and 1 February each year.

## Notes to the Financial Statements for the year ended 31 January 2011

### 11. Called up Share Capital

	2011	2010
	£	£
Alotted and fully paid		
103,213,464 Ordinary Shares of 25p (2010 – 103,213,464)	25,803,366	25,803,366

The Directors are authorised by an ordinary resolution passed on 11 May 2010 to allot relevant securities, up to a maximum of 34,401,047 Ordinary Shares of 25p each. This authority expires on 10 May 2011 and accordingly a renewed authority will be sought at the Annual General Meeting on 10 May 2011.

During the year the Company did not repurchase any Ordinary Shares for cancellation or holding in treasury, nor have any Ordinary Shares been repurchased since the year end.

### 12. Reserves

	Share Premium	Capital Redemption Reserve	← Capital Reserve →		Revenue Reserve
			Gains on sales of Investments	Investment holding – gains (losses)	
	£	£	£	£	£
Balance at 1 February 2010	8,523,195	292,853	324,749,943	(693,357)	26,071,214
Net gains on sales of fixed asset investments	–	–	23,155,060	–	–
Net losses on derivative financial instruments	–	–	(327,887)	–	–
Net movement in fixed asset investment holding gains	–	–	–	40,737,531	–
Net movement in derivative holding gains	–	–	–	61,706	–
Transfer on sale of investments	–	–	2,001,815	(2,001,815)	–
Investment management fee	–	–	(1,178,909)	–	–
Finance costs of borrowings	–	–	(4,815,949)	–	–
Other capital expenses	–	–	(3,442)	–	–
Dividends paid on Ordinary Shares	–	–	–	–	(23,429,454)
Revenue return for the year	–	–	–	–	21,900,146
Balance at 31 January 2011	8,523,195	292,853	343,580,631	38,104,065	24,541,906

### 13. Net Asset Value per Share

The net asset value per share was as follows

	Net Asset Value per Share attributable	
	2011	2010
Ordinary Shares of 25p	4271p	372.8p
	Net Asset Value attributable	
	2011	2010
Ordinary Shares of 25p	£440,846,016	£384,747,214

The net asset value per ordinary share is based on 103,213,464 ordinary shares in issue at the year end (2010 – 103,213,464)

### 14. Contingent Liabilities and Commitments

At 31 January 2011 there were no outstanding contingent liabilities or capital commitments (2010 – nil)

Details of the guarantee provided by the Company as part of the terms of the Stepped Rate Interest Loan are provided in Note 10(i) 'Current Assets and Creditors' on page 42.

## Notes to the Financial Statements for the year ended 31 January 2011

### 15. Reconciliation of Return on Ordinary Activities before Finance Costs and Taxation to Net Cash Flow from Operating Activities

	2011 £	2010 £
Net return before finance costs and taxation	86,835,347	102,027,471
Less Net gains on investments at fair value	(63,626,410)	(79,416,688)
	<b>23,208,937</b>	<b>22,610,783</b>
(Increase) decrease in debtors	(634,973)	2,477,859
Increase in creditors	121,259	142,153
Net cash inflow from operating activities	<b>22,695,223</b>	<b>25,230,795</b>

### 16. Reconciliation of Net Cash Flow to Movement in Net Debt

#### (i) Analysis of net debt

	Cash £	Stepped and Fixed Rate Loans £	5.875% Secured Bonds 2029 £	4% Perpetual Debenture Stock £	3.65% Preference Stock £	Net Debt £
At 1 February 2010	8,911,182	(81,788,615)	(29,116,657)	(1,375,000)	(1,178,000)	(104,547,090)
Movement in year	345,859	2,296,670	(23,672)	-	-	2,618,857
At 31 January 2011	<b>9,257,041</b>	<b>(79,491,945)</b>	<b>(29,140,329)</b>	<b>(1,375,000)</b>	<b>(1,178,000)</b>	<b>(101,928,233)</b>

#### (ii) Reconciliation of net cash flow to movement in net debt

	2011 £	2010 £
Net cash inflow (outflow)	345,859	(5,599,838)
Decrease in long term loans	2,272,998	14,818
Movement in net funds	2,618,857	(5,585,020)
Net debt brought forward	(104,547,090)	(98,962,070)
Net debt carried forward	<b>(101,928,233)</b>	<b>(104,547,090)</b>

### 17. Financial Risk Management policies and procedures

The Company invests in equities and other investments in accordance with its investment objective as stated on page 2. In pursuing its investment objective, the Company is exposed to certain inherent risks that could result in either a reduction in the Company's net assets or a reduction in the profits available for distribution by way of dividends.

The main risks arising from the Company's financial instruments are market risk (price and yield), liquidity risk and credit risk. The Directors determine the objectives and agree policies for managing each of these risks, as set out below. The Investment Manager, in close co-operation with the Directors, implement the Company's risk management policies. The Company's policy allows the use of derivative financial instruments to moderate risk exposure and to generate additional revenue. These policies have remained unchanged during the current and preceding period.

#### Market Risk

The Investment Manager assesses the exposure to market risk when making each investment decision, and monitors the risk on the investment portfolio on an ongoing basis. Market risk comprises market price risk (price and yield), foreign currency risk and interest rate risk.

##### (i) Market Price Risk

Market price risk arises mainly from the uncertainty about future prices of financial instruments held. It represents the potential loss the Company might suffer through holding market positions in the face of price movements.

Where call options are sold (written), in all cases a sufficient position is maintained in the underlying equity to cover any potential option exercise. Whilst the option value can be volatile, price movements should to some extent be offset by opposing movements in the value of the underlying.

## Notes to the Financial Statements for the year ended 31 January 2011

equity. If options are retained until expiry they will either expire worthless or be exercised. The effect of any option exercise is to sell the underlying shares at the strike price of the option. A schedule of the Company's listed holdings is shown on pages 13 and 14.

Where put options are purchased, the market value of such options can be volatile but the maximum realised loss on any contract is limited to the original investment cost.

Further explanation of this derivative strategy is included in the Investment Manager's Review on pages 10 and 11.

Falls in stock market valuations lead to changes in gearing ratios. The Board's procedure for monitoring the gearing of the Company is set out in Note 18 on page 49. This takes into account the Investment Manager's view on the market, covenant requirements and the future prospects of the Company's performance.

### Market price risk sensitivity

The value of the Company's listed investments (i.e. fixed asset investments, excluding unlisted equities) which were exposed to market price risk as at 31 January 2011 was as follows:

	2011 £	2010 £
Listed investments held at fair value through profit or loss	543,212,051	488,287,091
Derivative financial instruments – purchased put options	–	83,125
Derivative financial instruments – written call options	(307,947)	(101,850)
<b>Total listed investments</b>	<b>542,904,104</b>	<b>488,268,366</b>

The following illustrates the sensitivity of the return and the net assets to an increase or decrease of 20% (2010 – 20%) in the fair values of the Company's listed investments. This level of change is considered to be reasonably possible based on observation of market conditions in the year. The sensitivity analysis is based on the impact of a change to the value of the Company's listed equity investments at each balance sheet date and the consequent impact on the investment management fees for the year, with all other variables held constant.

	2011 20% Increase in fair value £	2011 20% Decrease in fair value £	2010 20% Increase in fair value £	2010 20% Decrease in fair value £
<b>Revenue return</b>				
Investment management fees	(133,087)	133,087	(119,626)	119,626
<b>Capital return</b>				
Net gains (losses) on investments at fair value	108,580,821	(108,580,821)	97,653,673	(97,653,673)
Investment management fees	(247,161)	247,161	(222,162)	222,162
<b>Change in net return and net assets</b>	<b>108,200,573</b>	<b>(108,200,573)</b>	<b>97,311,885</b>	<b>(97,311,885)</b>

### Management of market price risk

The Directors meet regularly to consider the asset allocation of the portfolio in order to minimise the risk associated with particular industry sectors. A dedicated investment manager has the responsibility for monitoring the existing portfolio selection in accordance with the Company's investment objectives and to ensure that individual stocks meet an acceptable risk reward profile. Call options are only written on stock owned within the portfolio with a maximum exposure of 20% of gross assets at the time of writing.

### (ii) Market Yield Risk

Market yield risk arises from the uncertainty about the Company's ability to maintain its income objectives due to systematic decline in corporate dividend levels.

### Management of market yield risk

The Directors regularly review the current and projected yield of the investment portfolio, and discuss with the investment Manager the extent to which it will enable the Company to meet its investment income objective.

### (iii) Foreign Currency Risk

Foreign currency risk is the risk of the movement in the values of overseas financial instruments as a result of fluctuations in exchange rates.

## Notes to the Financial Statements for the year ended 31 January 2011

### Management of foreign currency risk

The Company invests predominantly in UK listed equities and has no significant exposure to currencies other than sterling (2010 – no significant exposure)

Any income denominated in foreign currency is converted into sterling on receipt. The Company does not use financial instruments to mitigate the currency exposure in the period between the time that income is included in the financial statements and its receipt

### (iv) Interest Rate Risk

Interest rate risk is the risk of movements in the value of financial instruments as a result of fluctuations in interest rates

#### Interest Rate Exposure

The table below summarises in sterling terms the financial assets and financial liabilities whose values are directly affected by changes in interest rates

	2011 Fixed rate interest £	2011 Floating rate interest £	2011 Nil interest £	2011 Total £	2010 Fixed rate interest £	2010 Floating rate interest £	2010 Nil Interest £	2010 Total £
Financial Assets	–	9,257,041	543,239,476	552,496,517	–	8,911,182	488,397,641	497,308,823
Financial Liabilities	(111,185,274)	–	(307,947)	(111,493,221)	(113,458,272)	–	(101,850)	(113,560,122)
<b>Net Financial</b>								
<b>(Liabilities) Assets</b>	<b>(111,185,274)</b>	<b>9,257,041</b>	<b>542,931,529</b>	<b>441,003,296</b>	<b>(113,458,272)</b>	<b>8,911,182</b>	<b>488,295,791</b>	<b>383,748,701</b>
Short term debtors and creditors	–	–	–	(157,280)	–	–	–	998,513
<b>Net (Liabilities) Assets per Balance Sheet</b>	<b>(111,185,274)</b>	<b>9,257,041</b>	<b>542,931,529</b>	<b>440,846,016</b>	<b>(113,458,272)</b>	<b>8,911,182</b>	<b>488,295,791</b>	<b>384,747,214</b>

As at 31 January 2011, the interest rates received on cash balances or paid on bank overdrafts, was nil and 1.35% per annum respectively (2010 nil and 1.35% per annum)

The fixed rate interest bearing liabilities bear the following coupon and effective rates as at 31 January 2011 and 31 January 2010

	Maturity date	Amount borrowed £	Coupon Rate	Effective rate since inception*
First Debenture Finance PLC ('FDF') – Loan Notes and Bonds	02/01/2018	25,667,599	14.75%	11.28%
Fintrust Debenture PLC ('Fintrust') – Original Loan	20/11/2023	30,000,000	9.25125%	9.51%
Fintrust Debenture PLC ('Fintrust') – New Loan	20/11/2023	12,000,000	9.25125%	6.00%
5.875% Secured Bonds 2029	20/12/2029	30,000,000	5.875%	6.23%
4% Perpetual Debenture Stock	n/a	1,375,000	4.00%	4.00%
3.65% Cumulative Preference Stock	n/a	1,178,000	3.65%	3.65%
		<b>100,220,599</b>		

\* The effective rates are calculated in accordance with FRS 26 'Financial Instruments Recognition and Measurement' as detailed in the Statement of Accounting Policies

The details in respect of the above loans have remained unchanged since the previous accounting period

The weighted average effective rate of the Company's fixed interest bearing liabilities (excluding the 3.65% Cumulative Preference Stock and the 4% Perpetual Debenture Stock) is 8.54% (2010 – 8.54%) and the weighted average period to maturity of these liabilities is 13.2 years (2010 – 14.2 years)

## Notes to the Financial Statements for the year ended 31 January 2011

The above year end amounts are reasonably representative of the exposure to interest rates during the year, as the level of exposure does not change materially. The Company's net return and net assets are not significantly affected by changes in interest rates.

### Management of interest rate risk

The Company invests predominantly in equities, the values of which are not directly affected by changes in prevailing market interest rates. In the year to 31 January 2011, the Company held no fixed interest securities. The Company's policy is to remain substantially fully invested and does not expect to hold significant cash balances. The financial assets therefore have minimal exposure to interest rate risk.

The Company finances its operations through a mixture of share capital, retained revenue return and long term borrowings. Movement in interest rates will not have a material effect on the finance costs and financial liabilities of the Company as all the borrowings of the Company are subject to fixed rates of interest.

### Liquidity risk

Liquidity risk relates to the capacity to meet liabilities as they fall due and is dependent on the liquidity of the underlying assets.

### Maturity of financial liabilities

The table below presents the future cash flows payable by the Company in respect of its financial liabilities.

Cash flows in respect of the principal and interest on the Stepped Rate Interest Loan, Fixed Rate Interest Loan and 5.875% Secured Bonds 2029 reflect the maturity dates as set out in Note 10 on page 42. Cash flows in respect of the 4% Perpetual Debenture Stock and 3.65% Cumulative Preference Stock, which have no fixed repayment date, assume maturity of 20 years from the balance sheet date. Cash flows have not been discounted.

	Three months or less	Not more than one year	Between one year and five years	More than five years	Total
	£	£	£	£	£
<b>2011</b>					
<b>Creditors – Amounts falling due within one year</b>					
Finance costs of borrowings	–	9,531,970	–	–	9,531,970
Other creditors	850,846	–	–	–	850,846
Derivative financial instruments	307,947	–	–	–	307,947
<b>Creditors – Amounts falling due after more than one year</b>					
Amounts payable on maturity of borrowings	–	–	–	108,587,112	108,587,112
Finance costs of borrowings	–	–	38,170,877	64,796,902	102,967,779
	1,158,793	9,531,970	38,170,877	173,384,014	222,245,654

	Three months or less	Not more than one year	Between one year and five years	More than five years	Total
	£	£	£	£	£
<b>2010</b>					
<b>Creditors – Amounts falling due within one year</b>					
Finance costs of borrowings	–	9,560,090	–	–	9,560,090
Other creditors	1,363,542	–	–	–	1,363,542
Derivative financial instruments	101,850	–	–	–	101,850
<b>Creditors – Amounts falling due after more than one year</b>					
Amounts payable on maturity of borrowings	–	–	–	108,587,112	108,587,112
Finance costs of borrowings	–	–	38,170,877	74,230,875	112,401,752
	1,465,392	9,560,090	38,170,877	182,817,987	232,014,346

## Notes to the Financial Statements for the year ended 31 January 2011

### Management of liquidity risk

Liquidity risk is not considered to be significant as the Company's assets mainly comprise realisable securities, which can be sold to meet funding requirements if necessary and significantly exceed liabilities. Short term flexibility can be achieved through the use of overdraft facilities, where necessary. As at the 31 January 2011, the Company had an undrawn committed borrowing facility of £10 million (2010 – £10 million).

### Credit Risk

Credit risk is the risk of default by a counterparty to discharge its obligations under transactions that could result in the Company suffering a loss.

### Management of credit risk

Outstanding settlements are subject to credit risk. Credit risk is mitigated by the Company through its decision to transact with counterparties of high credit quality. The Company only buys and sells investments through brokers which are considered to be approved counterparties, thus minimising the risk of default during settlement.

The Company is also exposed to credit risk through the use of banks for its cash position. Bankruptcy or insolvency of banks may cause the Company's rights with respect to cash held by banks to be delayed or limited. The Company's cash balances are held by HSBC Bank PLC, rated Aa2 by Moody's rating agency. The Directors believe the counterparties the Company has chosen to transact with are of high credit quality, therefore the Company has minimal exposure to credit risk.

The table below summarises the credit risk exposure of the Company as at 31 January

	<b>2011</b>	<b>2010</b>
	<b>£</b>	<b>£</b>
<b>Debtors</b>		
Outstanding settlements	–	2,281,965
Accrued income	1,995,817	1,360,380
Other debtors	38,513	38,977
Cash at bank	9,257,041	8,911,182
	<b>11,291,371</b>	<b>12,592,504</b>

### Fair Values of Financial Assets and Financial Liabilities

With the exception of those financial liabilities measured at amortised cost, the financial assets and financial liabilities are either carried at their fair value, or the balance sheet amount is considered to be a reasonable approximation of their fair value. The financial liabilities, including accrued interest, measured at amortised cost have the following fair values\*

	<b>2011</b>	<b>2011</b>	<b>2010</b>	<b>2010</b>
	<b>Book value</b>	<b>Fair value</b>	<b>Book value</b>	<b>Fair value</b>
	<b>£</b>	<b>£</b>	<b>£</b>	<b>£</b>
Stepped Rate Interest Loan	34,347,840	46,039,027	36,466,629	45,923,101
Fixed Rate Interest Loan	46,241,378	56,017,459	46,419,260	55,584,569
5.875% Secured Bonds 2029	29,348,572	29,323,808	29,324,900	28,601,651
4% Perpetual Debenture Stock	1,388,750	908,553	1,388,750	895,510
3.65% Cumulative Preference Stock	1,178,000	705,326	1,178,000	695,130
	<b>112,504,540</b>	<b>132,994,173</b>	<b>114,777,539</b>	<b>131,699,961</b>

The net asset value per Ordinary Share, with the FDF and Fintrust loans at fair value is 407.3p (2010 – 356.4p)

\* The fair value has been derived from the closing market value of the debt and accrued interest as at 31 January 2011 and 31 January 2010.

FRS 29 'Financial Instruments - Disclosures' has been expanded to include a fair value hierarchy for the disclosure of fair value measurement of financial instruments.

## Notes to the Financial Statements for the year ended 31 January 2011

As at 31 January 2011, the financial assets at fair value through profit and loss of £542,931,529 (2010 – £488,295,791) are categorised as follows

	2011	2010
	£	£
Level 1	542,904,104	488,268,366
Level 2	–	–
Level 3	27,425	27,425
	<b>542,931,529</b>	<b>488,295,791</b>

Categorisation within the hierarchy has been determined on the basis of the lowest level input that is significant to the fair value measurement of the relevant assets as follows

Level 1 – valued using quoted prices in active markets

Level 2 – valued by reference to valuation techniques using observable inputs other than quoted prices included in level 1

Level 3 – valued by reference to valuation techniques using inputs that are not based on observable market data

### Hedging Instruments

At the year end, the Company had no hedging arrangements in place (2010 – nil) The Company does not enter into speculative interest contracts

## 18. Capital Management Policies and Procedures

The Company's objective is to provide an above average level of income and income growth together with long term capital growth

The Company's capital at 31 January 2011 comprises

	2011	2010
	£	£
<b>Debt</b>		
Creditors Amounts falling due after more than one year	111,185,274	113,458,272
	<b>111,185,274</b>	<b>113,458,272</b>
<b>Equity</b>		
Called up Share Capital	25,803,366	25,803,366
Share Premium Account and Other Reserves	415,042,650	358,943,848
	<b>440,846,016</b>	<b>384,747,214</b>
<b>Total Capital</b>	<b>552,031,290</b>	<b>498,205,486</b>
<b>Debt as a percentage of total capital</b>	<b>20.1%</b>	<b>22.8%</b>

The Board, with the assistance of the Investment Manager, monitors and reviews the broad structure of the Company's capital on an ongoing basis. The level of gearing is monitored, taking into account the Investment Manager's view on the market and the future prospects of the Company's performance. Capital management also involves reviewing the difference between the net asset value per share and the share price (i.e. the level of share price discount or premium) to assess the need to repurchase shares for cancellation.

The Company is subject to externally imposed capital requirements: the bank borrowings under the overdraft facility are not to exceed £10m, and as a public company the minimum share capital is £50,000. The Company's objective, policies and processes for managing capital are unchanged from the preceding accounting period, and the Company has complied with them. The terms of the debenture trust deeds have various covenants which prescribe that moneys borrowed should not exceed the adjusted total of capital and reserves. These are measured in accordance with the policies used in the annual financial statements.

## **Investor Information & Contact Details**

### **The Manager**

RCM (UK) Limited, which is authorised and regulated by the Financial Services Authority, is part of Allianz Global Investors, one of the largest fund managers in the world. As at 31 December 2010, Allianz Global Investors had combined assets under management of €1,499 billion. RCM (UK), through its predecessors, has a heritage of investment trust management expertise in the UK stretching back to the nineteenth century and at 31 March 2011 it had £1.07 billion assets under management in a range of investment trusts.

Website [www.rcm.co.uk](http://www.rcm.co.uk)

**Registered Number** 28276

### **Results**

Half-year Report posted to shareholders in September  
Annual Financial Report posted to shareholders in April  
Annual General Meeting held in May

### **Ordinary Dividends**

First quarterly paid in August  
Second quarterly paid in November  
Third quarterly paid in February  
Final usually paid in May

Ordinary dividends paid by the Company carry a tax credit at a rate of 10%. The credit discharges the tax liability of shareholders subject to income tax at less than the higher rate. Shareholders liable to pay tax at the higher rate will have further tax to pay.

### **Preference Dividends**

Payable half-yearly on 1 August and 1 February

### **Market and Portfolio Information**

The Company's Ordinary Shares are listed on the London Stock Exchange. The market price, price range, gross yield and net asset value are shown daily in The Financial Times and The Daily Telegraph. The net asset value of the Ordinary Shares is calculated daily and published through the London Stock Exchange Regulatory News Service. The geographical spread of investments and ten largest holdings are also published monthly by the London Stock Exchange Regulatory News Service. They are also available from the Investment Manager's Investors Helpline on 0800 389 4696 or via the Manager's website [www.rcm.com/investmenttrusts](http://www.rcm.com/investmenttrusts)

### **Share Price**

The share price for 31 January 2011 was 406.9p

### **Website**

Further information about the The Merchants Trust PLC, including monthly fact sheets, daily share prices and performance, is available on the Manager's website [www.rcm.com](http://www.rcm.com), which can also be reached via [www.merchantstrust.co.uk](http://www.merchantstrust.co.uk)

### **Association of Investment Companies (AIC)**

The Company is a member of the AIC, the trade body of the investment trust industry, which provides a range of literature including fact sheets and a monthly statistical service. Copies of these publications can be obtained from the AIC, 9th Floor, 24 Chiswell Street, London EC1Y 4YY, or at [www.theaic.co.uk](http://www.theaic.co.uk)

AIC Category UK Growth and Income

## Investor Information & Contact Details

### How to invest

Alliance Trust Savings Limited ("ATS") is one of a number of providers offering a range of products and services, including Share Plans, ISAs and pension products. ATS also maintains services including online and telephone-based dealing facilities and online valuations. More information is available from Allianz Global Investors either via Investor Services on 0800 389 4696 or on the Managers' website [www.rcm.com/investmenttrusts](http://www.rcm.com/investmenttrusts), or from Alliance Trust Savings Customer Services Department on 01382 573737 or by e-mail [contact@alliancetrust.co.uk](mailto:contact@alliancetrust.co.uk)

A list of other providers can be found on the RCM Investment Trusts website [www.rcm.com/investmenttrusts](http://www.rcm.com/investmenttrusts)

### Registrars

The Company's Registrars, Capita Registrars, can be contacted at The Registry, 34 Beckenham Road, Beckenham, Kent BR3 4TU

### Payment of Dividends Direct to Bank Accounts

Cash dividends will be sent by cheque to first-named shareholders at their registered address together with a tax voucher. Dividends may be paid directly into shareholders' bank accounts. Details of how this may be arranged can be obtained from the Registrars, Capita Registrars. Dividends mandated in this way are paid via BACS (Bankers' Automated Clearing Service). Tax vouchers will then be sent directly to shareholders at their registered address unless other instructions have been given.

### Dividend Reinvestment Plan for Ordinary Shareholders

A Dividend Reinvestment Plan is operated by the Company's Registrars, Capita Registrars. The Plan offers Ordinary Shareholders the opportunity to use their cash dividend to buy further shares in the Company under a low-cost dealing arrangement. Capita enclose a copy of the Terms and Conditions and a personalised application form with each dividend payment.

### Share Dealing Services and Share Portal

Capita Registrars, the Company's Registrars, operate an on-line and telephone dealing facility for UK resident shareholders with share certificates. Stamp duty may also be payable on purchases.

For further information on these services please contact [www.capitadeal.com](http://www.capitadeal.com) for on-line dealing or 0871 664 0454 for telephone dealing. Lines are open 8.00 a.m. to 4.30 p.m. Monday to Friday. Calls to the 0871 664 0454 number are charged at 10 pence per minute plus any of your service providers' network extras. Different charges may apply to calls made from mobile telephones and calls may be recorded and monitored randomly for security and training purposes.

Capita Registrars offer shareholders a free on-line service called The Share Portal, enabling shareholders to access a comprehensive range of shareholder related information. Through The Share Portal, shareholders can view their current and historical shareholding details, obtain an indicative share price and valuation, register for e-comms, amend address details, view details of dividend payments, and apply for dividends to be paid directly to a bank or to change existing bank details.

Shareholders can access these services at [www.capitashareportal.com](http://www.capitashareportal.com) and selecting Share Portal (Shareholders) from the drop down menu, or alternatively via the Portals Quick Links, and selecting Share Portal. Shareholders will need to register for a Share Portal Account by completing an on-screen registration form. An email address is required.

### Shareholders' Enquiries

Capita Registrars are the Company's registrars and maintain the share register. In the event of queries regarding their holdings of shares, lost certificates, dividend cheques, registered details, etc., shareholders should contact the registrars on 0871 664 0300 or +44 20 8639 3399 if calling from overseas. Lines are open 8.30 a.m. to 5.30 p.m. (London time) Monday to Friday. Calls to the 0871 664 0300 number are charged at 10 pence per minute plus any of your service providers' network extras. Calls to the helpline number from outside the UK are charged at applicable international rates. Different charges may apply to calls made from mobile telephones and calls may be recorded and monitored randomly for security and training purposes. Capita Registrars can also be contacted at [ssd.capitaregistrars.com](http://ssd.capitaregistrars.com)

Changes of name and address must be notified to the registrars in writing.

Any general enquiries about the Company should be directed to the Company Secretary, The Merchants Trust PLC, 155 Bishopsgate, London EC2M 3AD.

Telephone 020 7065 1513 Email [kirsten.salt@uk.rcm.com](mailto:kirsten.salt@uk.rcm.com)

## Investor Information & Contact Details

### Analysis of Share Register

	Shareholder Accounts				Ordinary Shares held			
	Number		%		000's		%	
	2011	2010	2011	2010	2011	2010	2011	2010
Private holders	6,970	7,326	67.3	67.9	18,904	19,755	18.3	19.1
Nominees	3,147	3,213	30.4	29.8	78,787	78,053	76.3	75.6
Limited Companies	132	138	1.3	1.3	2,758	2,768	2.7	2.7
Investment Trusts and Funds	28	37	0.3	0.3	445	490	0.4	0.5
Bank and Bank Nominees	10	11	0.1	0.1	1,651	1,871	1.6	1.8
Insurance Companies	8	8	0.1	0.1	48	49	0.1	0.1
Pension Funds	3	4	0.0	0.0	13	20	0.0	0.0
Other holders	53	57	0.5	0.5	607	207	0.6	0.2
	10,351	10,794	100.0	100.0	103,213	103,213	100.0	100.0

Based on an analysis of the Ordinary Share register at 31 March 2011 (2010 – 31 March)

### CREST Proxy Voting

Shares held in uncertificated form (i.e., in CREST) may be voted through the CREST Proxy Voting Service in accordance with the procedures set out in the CREST manual

### Warning to Shareholders

We are aware that some shareholders may have received unsolicited telephone calls or correspondence concerning investment matters. These are typically from overseas based organisations who target UK shareholders offering to sell them what often turn out to be worthless or high risk shares in US or UK investments. They can be extremely persistent and extremely persuasive. Shareholders are therefore advised to be very wary of any unsolicited advice or offers to buy shares at a discount.

Please note that it is most unlikely that either the Company or the Company's Registrar, Capita Registrars, would make unsolicited telephone calls to shareholders. Any such calls would only ever relate to official documentation already circulated to shareholders and never in respect of investment 'advice'.

If you are in any doubt about the veracity of an unsolicited telephone call, please call either the Company Secretary or the Registrar at the numbers provided on pages 16 and 51 of this Report.

## Notice of Meeting

Notice is hereby given that the Annual General Meeting of The Merchants Trust PLC will be held at 20 Moorgate, London EC2R 6DA, on Tuesday 10 May 2011 at 12 noon to transact the following business

### Routine Business

- 1 To receive and adopt the Report of the Directors and the Financial Statements for the year ended 31 January 2011 together with the Auditors' Report thereon
- 2 To declare a final dividend of 5 7p per Ordinary Share
- 3 To re-elect Mr Mike McKeon as a Director
- 4 To re-elect Mr Henry Staunton as a Director
- 5 To elect Mr Paul Yates as a Director
- 6 To approve the Directors' Remuneration Report
- 7 To re-appoint PricewaterhouseCoopers LLP as Auditors of the Company, to hold office until the conclusion of the next general meeting at which financial statements are laid before the Company
- 8 To authorise the Directors to determine the remuneration of the Auditors

### Special Business

To consider and if thought fit to pass the following resolutions Resolution 9 will be proposed as an Ordinary Resolution and Resolutions 10, 11 and 12 as Special Resolutions

- 9 That for the purposes of Section 551 of the Companies Act 2006 the Directors be generally and unconditionally authorised to exercise all the powers of the Company to allot relevant securities (within the meaning of the said Section) up to a maximum number of 34,401,047 Ordinary Shares provided that
  - (i) the authority granted shall expire five years from the date upon which this Resolution is passed but may be revoked or varied by the Company in general meeting and may be renewed by the Company in general meeting for a further period not exceeding five years, and
  - (ii) the authority shall allow and enable the Directors to make an offer or agreement before the expiry of that authority which would or might require relevant securities to be allotted after such expiry and the Directors may allot relevant securities in pursuance of any such offer or agreement as if that authority had not expired
- 10 That the Directors be empowered in accordance with Section 570 of the Companies Act 2006 to allot equity securities (within the meaning of Section 560 of the Act) for cash pursuant to the authority conferred by Resolution 10 as if sub-section (1) of Section 561 of the Act did not apply to any such allotment provided that
  - (i) the power granted shall be limited to the allotment of equity securities wholly for cash up to a maximum number of 10,321,346 Ordinary Shares,
  - (ii) the power granted shall (unless previously revoked or renewed) expire at the conclusion of the next Annual General Meeting of the Company after the passing of this resolution, and
  - (iii) the said power shall allow and enable the Directors to make an offer or agreement before the expiry of that power which would or might require equity securities to be allotted after such expiry and the Directors may allot equity securities in pursuance of such offer or agreement as if that power had not expired
- 11 That the Company be and is hereby generally and unconditionally authorised in accordance with Section 701 of the Companies Act 2006 (the 'Act') to make market purchases (within the meaning of Section 693(4) of the Act) of Ordinary Shares of 25p each in the capital of the Company ('Ordinary Shares'), provided that
  - (i) the maximum number of Ordinary Shares hereby authorised to be purchased shall be 15,471,698,

## Notice of Meeting

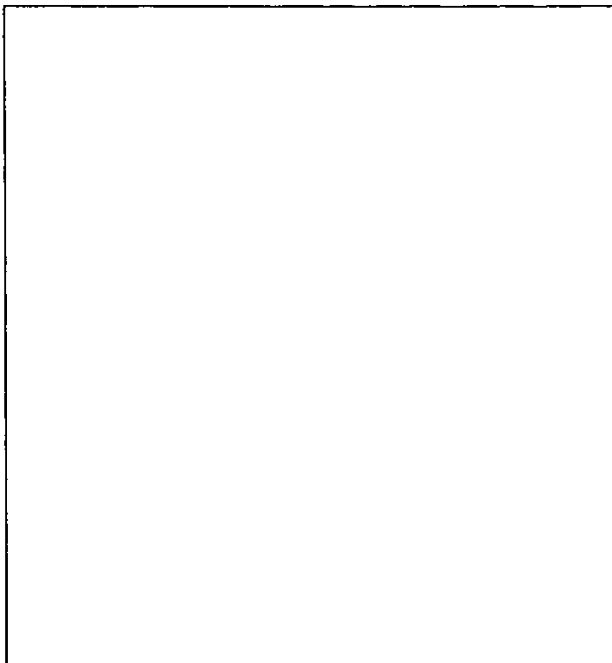
- (ii) the minimum price which may be paid for an Ordinary Share is 25p,
- (iii) the maximum price which may be paid for an Ordinary Share is an amount equal to 105% of the average of the middle-market quotations for an Ordinary Share taken from the London Stock Exchange Official List for the five business days immediately preceding the day on which the Ordinary Share is purchased or such other amount as may be specified by the London Stock Exchange from time to time,
- (iv) the authority hereby conferred shall expire at the conclusion of the Annual General Meeting of the Company in 2012 or, if earlier, on the expiry of 18 months from the passing of this resolution, unless such authority is renewed prior to such time, and
- (v) the Company may make a contract to purchase Ordinary Shares under the authority hereby conferred prior to the expiry of such authority which will or may be executed wholly or partly after the expiration of such authority and may make a purchase of Ordinary Shares pursuant to any such contract

12 That a general meeting, other than an annual general meeting, may be called on less than 14 days' clear notice

155 Bishopsgate  
London EC2M 3AD  
4 April 2011

By Order of the Board  
K J Salt  
Secretary

## Annual General Meeting Venue



## Notice of Meeting

### Notes

- 1 Members entitled to attend and vote at this Meeting may appoint one or more proxies to attend, speak and vote in their stead by completion of a personalised form of proxy. Full details on how to complete the form of proxy are set out on the form of proxy. The proxy need not be a Member of the Company.
- 2 A proxy must vote in accordance with any instructions given by the member by whom the proxy is appointed. A proxy has one vote on a show of hands in all cases (including where one member has appointed multiple proxies), except where he is appointed by multiple members who instruct him to vote in different ways, in which case he only has one vote for and one vote against the resolution.
- 3 A personalised form of proxy is provided with the Annual Financial Report. Any replacement forms must be requested direct from the Registrar.
- 4 Completion of the form of proxy does not exclude a Member from attending the Meeting and voting in person.
- 5 Duly completed forms of proxy must reach the office of the Registrars at least 48 (excluding non-business days) hours before the Meeting.
- 6 Shares held in uncertificated form (i.e. in CREST) may be voted through the CREST Proxy Voting Service in accordance with the procedures set out in the CREST manual on the Euroclear website ([www.euroclear.com/CREST](http://www.euroclear.com/CREST)).
- 7 To be entitled to attend and vote at the Meeting (and for the purpose of determination by the Company of the number of votes they may cast), Members must be entered on the Company's Register of Members by close of business on Friday 6 May 2011 ("the record date").
- 8 If the Meeting is adjourned to a time not more than 48 hours after the record date applicable to the original Meeting, that time will also apply for the purpose of determining the entitlement of Members to attend and vote (and for the purpose of determining the number of votes they may cast) at the adjourned Meeting. If, however, the Meeting is adjourned for a longer period then, to be so entitled, Members must be entered on the Company's Register of Members at the time which is 48 hours before the time fixed for the adjourned Meeting or, if the Company gives new notice of the adjourned Meeting, at the record date specified in that notice.
- 9 The right to appoint a proxy does not apply to persons whose shares are held on their behalf by another person and who have been nominated to receive communications from the Company in accordance with Section 146 of the Companies Act 2006 ("nominated persons"). Nominated persons may have a right under an agreement with the registered shareholder who holds the shares on their behalf to be appointed (or to have someone else appointed) as a proxy. Alternatively, if nominated persons do not have such a right, or do not wish to exercise it, they may have a right under such an agreement to give instructions to the person holding the shares as to the exercise of voting rights. Nominated persons should contact the registered member by whom they were nominated in respect of these arrangements.
- 10 Corporate representatives are entitled to attend and vote on behalf of the corporate member in accordance with Section 323 of the Companies Act 2006. Pursuant to the Companies (Shareholders' Rights) Regulations 2009 (SI 2009/1632), multiple corporate representatives appointed by the same corporate member can vote in different ways provided they are voting in respect of different shares.
- 11 Members have a right under Section 319A of the Companies Act 2006 to require the Company to answer any question raised by a member at the AGM, which relates to the business being dealt with at the meeting, although no answer need be given (a) if to do so would interfere unduly with the preparation of the meeting or involve disclosure of confidential information, (b) if the answer has already been given on the Company's website, or (c) it is undesirable in the best interests of the Company or the good order of the meeting.
- 12 Members satisfying the thresholds in Section 527 of the Companies Act 2006 can require the Company, at its expense, to publish a statement on the Company website setting out any matter which relates to the audit of the Company's accounts that are to be laid before the meeting. Any such statement must also be sent to the Company's auditors no later than the time it is made available on the website and must be included in the business of the meeting.
- 13 As at 4 April 2011, the latest practicable date before this Notice is given, the total number of shares in the Company in respect of which members are entitled to exercise voting rights was 103,213,464 Ordinary Shares of 25p each and each Ordinary Share carries the right to one vote. There are also 1,178,000 3.65% Cumulative Preference Shares and each Preference Share carries the right to one vote in certain circumstances. Therefore the total number of shares having voting rights in the Company is 104,391,464.
- 14 Further information regarding the meeting which the Company is required by Section 311A of the Companies Act 2006 to publish on a website in advance of the meeting (including this Notice), can be accessed at [www.rcm.com/investmenttrusts](http://www.rcm.com/investmenttrusts).
- 15 Contracts of service are not entered into with the Directors, who hold office in accordance with the Articles of Association.

