

RIVER AND MERCANTILE  
ASSET MANAGEMENT

UK Equity High Alpha Fund I Quarterly Report  
December 2009

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# River and Mercantile

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## UK Equity High Alpha Fund – Quarterly Report

### Fund Aim

The investment objective of the Fund is to achieve capital growth by investing in a focussed portfolio of investments which shall primarily consist of UK equities which offer the prospect of superior long term growth.

### Portfolio Summary

Strategy AUM	£328m
Strategy Capacity	£1.1bn
Number of stocks	118
Largest Holding	HSBC 7.14 %

### Risk Analysis Summary

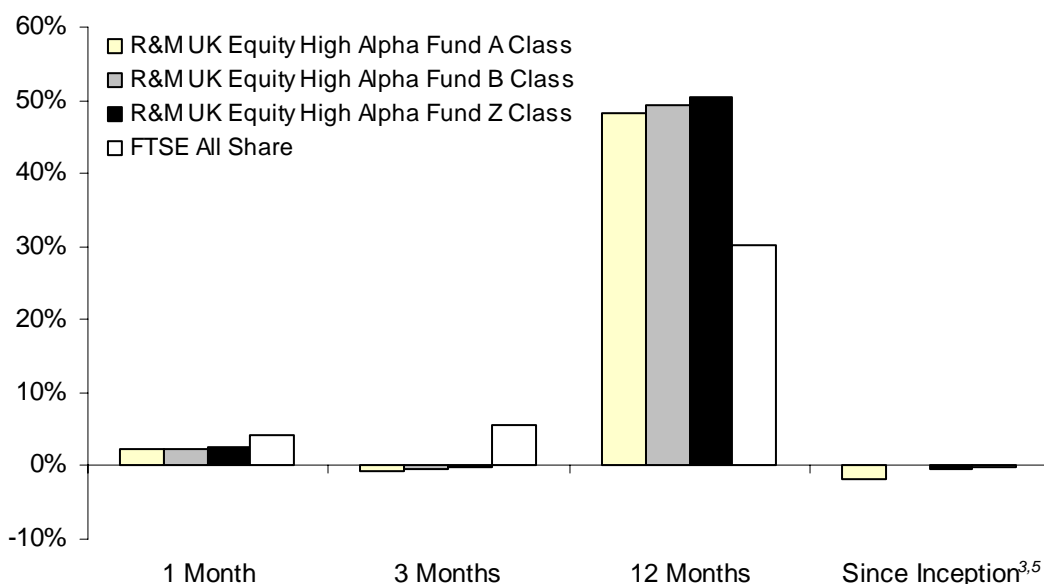
Portfolio Volatility	18.04 %
Benchmark Volatility	16.18 %
Tracking Error	4.64 %
Portfolio Beta	1.08
Active Money	48.80 %

### Performance to 31 December 2009

Retail "A" Class Shares	Fund <sup>1</sup>	Index*	Difference
1 Month	2.32%	4.34%	-2.02%
3 Months	-0.62%	5.47%	-6.09%
12 Months	48.28%	30.12%	18.16%
Since Inception <sup>3</sup> (%p.a.)	-1.77%	-0.12%	-1.65%

Asset Manager "B" Class Shares	Fund <sup>1</sup>	Index*	Difference
1 Month	2.39%	4.34%	-1.95%
3 Months	-0.39%	5.47%	-5.86%
12 Months	49.35%	30.12%	19.23%
Since Inception <sup>4</sup> (%p.a.)	41.01%	31.35%	9.66%

Institutional "Z" Class Shares	Fund <sup>2</sup>	Index*	Difference
1 Month	2.46%	4.34%	-1.88%
3 Months	-0.20%	5.47%	-5.67%
12 Months	50.43%	30.12%	20.31%
Since Inception <sup>3</sup> (%p.a.)	-0.32%	-0.12%	-0.20%



Source: River and Mercantile Asset Management LLP

\*Index: FTSE All Share (Total Return)

<sup>1</sup>Performance calculated on a mid to mid basis at close of business, net of annual management charge

<sup>2</sup>Performance calculated on a mid to mid basis at close of business, gross of annual management charge

<sup>3</sup>Inception date "A" and "Z" class shares is 28 Nov 2006, <sup>4</sup>Inception date "B" class shares is 20 Oct 2008

<sup>5</sup>"B" class shares are not included in this category due to the later inception date of this share class

### Quote for the Quarter

"The farther backward you can look the farther forward you can see". Winston Churchill.

### Key Observation

History is a far better guide to the investment future than current consensus. As a nation we appear to be in a funk about the UK economic outlook and a knock-on from this is a lack of appetite for investing in UK equities. But we have been here before. In fact as Winston Churchill might have observed, we have had it far worse and, in this context, historic data is reassuring. The UK economy has re-invented itself many times in the past, and will do so in the future. Nearly all economic recoveries in the past have been more vigorous than current consensus would imply. And medium-term UK equity returns, from current levels of valuation, have almost always been decently positive. I explore the case for UK equities in greater depth later in this report.

### Market background

#### Quarter:

It has been another positive quarter for equities. Investment related data has continued to be positive - economies are growing again, company profits are starting to recover, and risk premia are trending back to normal levels.

The UK equity market delivered a return of +5.5%. Having had six months of rotation into recovery and value stocks the last quarter of the year saw a dramatic change of tack, with the focus moving towards global growth counters. Large companies with significant overseas earnings did well, small cap domestic recovery stocks lost up to 50% of their post-March rally. Why this change of direction so early in the recovery phase of the stock market cycle? Three key reasons: panic about the UK economic outlook (and a love of emerging markets), the technically over-bought nature of quite a few recovery stocks as we went into the final quarter, and a significant wave of re-financings into the end of the year that used up a lot of risk capital. We would expect these factors to be only a temporary drag on recovery type stocks; re-financings are largely at an end, these stocks now look over-sold versus trend, and the UK economic outlook is unlikely to be quite as bearish as consensus would suggest.

### How did we perform and why?

#### Quarter:

Our period of strong relative performance came to an abrupt end last quarter, with the High Alpha portfolio returning -0.2%, an underperformance of 5.7%. There were very few material stock-specific events to explain this performance, just collective drift away from the factors that had served us so well from the bottom of the stock market cycle. As a result of the year-end correction in these factors (recovery, value and smaller companies) I would expect 2010 performance to be that much more robust.

#### Year:

Performance over the year was very strong, with the High Alpha strategy returning over 50%, beating the FTSE All-Share Index by 20%. This was my best ever absolute return (next best 42.9% in 1993 and 42.1% in 2003, both recovery years) and second best relative return (21.2% in 2003).

## Key performance contributors

### Quarter:

**Positive:** Mining stocks, in particular exposure to platinum producers (Aquarius & Lonmin).

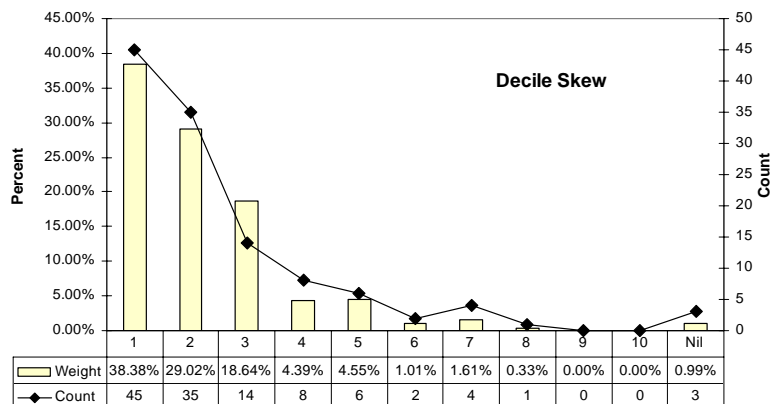
**Negative:** Small Company drag equivalent to 2% of underperformance; recovery stocks move from technically overbought to oversold accounted for another 2% drift; stock specifics the balance, in particular UK bank weakness (RBS and Lloyds).

### Longer Term Performance

It is re-assuring to see that this strategy has added value relative to the Index in eight of the last ten years, with annualised out-performance of 5% per annum.

### Does the portfolio reflect our philosophy and process?

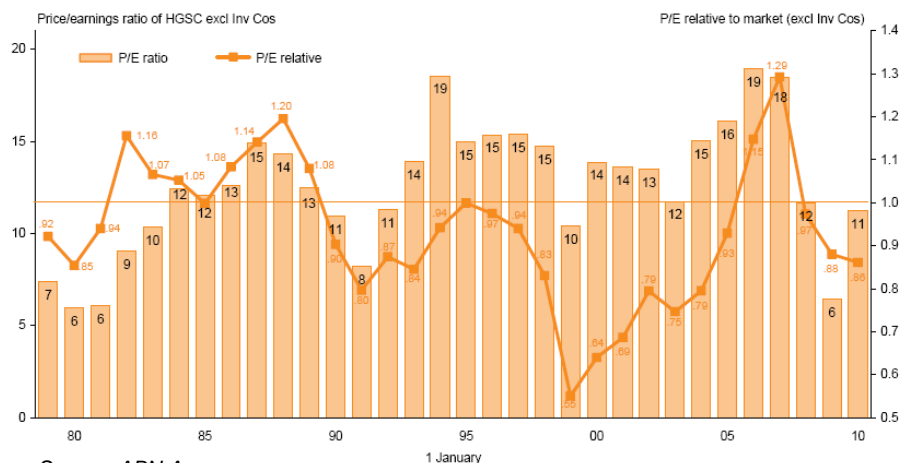
The chart below shows that our strategy continues to have a strong skew towards high scoring stocks.



Source: River and Mercantile Asset Management LLP

Our category exposure is pretty similar to last quarter - a high and increasing exposure to Quality, a high but slowly reducing exposure to Recovery, and Asset Backed remaining at the top end of its range. We continue to think about the next stage of the stock market cycle, with a desire for more growth exposure though short term this has been tempered by the material and premature set back in recovery type stocks.

Our Smaller Company exposure was pretty stable over the quarter, at just under 20% of the Strategy. Smaller Companies retraced almost half their years' out-performance during the period, leaving many of our investments on very attractive valuations again; as a result we topped-up existing positions. As the HGSC data below suggests, in aggregate, smaller companies remain attractively valued.

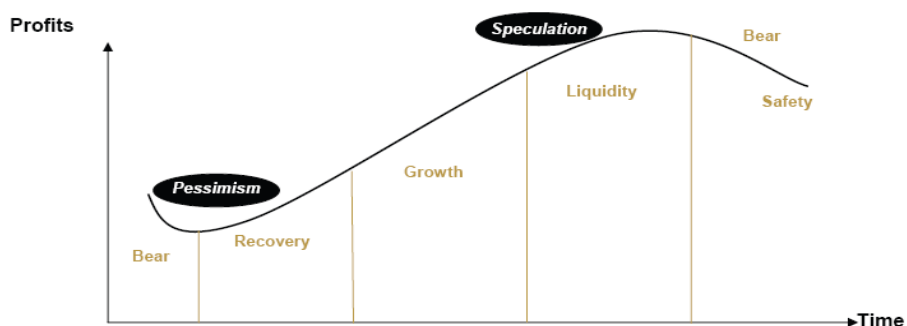


Source: ABN Amro

## What themes occupy us at the moment?

### The Stockmarket Cycle

We continue to frame the current environment in the context of the stock market cycle.



	STAGE 1 2003/4 1992/3 2009/10?	STAGE 2 2004/6 1994/8	STAGE 3 2006/7 1999/0	STAGE 4 2001/2 1991/2 2007/8
ECONOMIC GROWTH	Below Trend	Trend	Above Trend	Decelerating
MONETARY POLICY?	Loose	Neutral	Tightening	Loosening
CAPITAL?	Rationed	Sustainable	Mis-allocation	Withdrawal
RISK APPETITE?	Low	Neutral	High	Falling
VALUE SPREADS	High	Reducing	Low	Increasing
STYLE?	Value/Recovery	Growth	Momentum	Value/Quality
BUY?	Turnarounds	Where is growth?	Momentum	Earnings sustainability

Source: River and Mercantile Asset Management LLP

At the moment we are moving through the recovery stage of the cycle.

### Can you afford to ignore UK Equities?

UK Equities have become unfashionable. Just ask our Pension Funds – they have just 14% of their assets in UK shares, compared to almost 50% only ten years ago. Just ask Life Companies – they now have less than a fifth of their liabilities covered by London quoted equities. Just ask your average retail investor and they have been putting money to work in anything other than UK Companies – corporate bonds, Gold and Emerging Markets. The outlook is better elsewhere isn't it, so we can afford to ignore UK equities, can't we?

The answer actually lies in the question. As we now know this is what Gordon Brown thought when he sold off half our gold reserves in 1999, we could afford to ignore the yellow metal. Since then gold has gone up over three times in price. And this is also what investors said in 1998, after the Asian crisis – that emerging markets could be ignored, their economies were too unstable. Since then the Brazilian market, for example, has gone up over ten times. And of course we could all afford to ignore UK Gilts in 1992 when they yielded almost 10% because investors had lost faith in the UK government. Since then Gilts have generated a real return of 6% per annum. The list could go on but the message from investment history is simple: buy something when it is unfashionable, buy something when the question being asked is 'Can't I afford just to ignore this investment?'

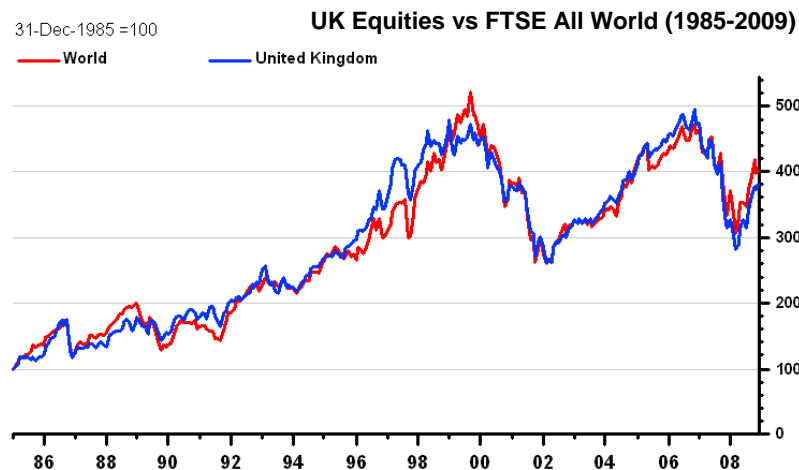
The 'killer blow' for UK equities at the moment is our economy – we all owe far too much, the Government and Individuals are borrowed to the hilt and, as a result, our economy will struggle to grow and equities can't do well in this environment, can they? Actually study after study has shown that there is little correlation between equity returns and economic growth. Just look at the ten year return on US equities between 1999 and the end of 2008, a negative return during the 'golden age' of the global economy.

A much better determinant of equity returns is current valuation. Low valuations (alongside low levels of optimism about the outlook) produce the best long term returns. This is because if valuations are low your starting return on investment is going to be higher – for example if you pay ten times earnings for a stock you get your investment back in profits over only ten years, if you pay twenty times your payback period is twice as long.

Looking at UK equities today the valuation looks attractive. The PE of the All-Share (adjusting for cyclically depressed earnings) is less than 12 times. Starting PE's at such a level on average produce ten year returns in double figures. As for my own portfolio the value support is much higher than the average during my twenty year career – my High Alpha portfolio has a PE of only 10 times, is 90% backed by assets, and 180% covered by revenue.

As for the UK economy the outlook is likely to be better than consensus. Maybe not brilliant, but consensus at only 1% growth for 2010 is very capable of being beaten. In fact every significant recovery year since the 1920's has been better than 1%.

But of course you may believe the above and still say that the rest of the world is a superior place to be, global returns will be better in the future because have they not been so in the past? But again referencing historical fact, UK equities have actually performed as well as global equities; indeed of all stock markets around the world the UK has had the highest correlation of all with the aggregate global return.



Source: Factset

This is because we are, in fact, not a nation of domestic shopkeepers - we are a nation of global mining and oil companies, of international pharmaceutical enterprises, a nation where our largest quoted bank makes most of its money far from this green and pleasant land. And we understand the global economy in London; that is why we have a competitive advantage in financial services that will only be temporarily eroded by the political and regulatory backlash from the credit crunch. The UK, because we are a small island, has always had to look outside our shores. For centuries our success has been based on understanding and exploiting global commerce, today it is no different and our stock market reflects this. Well over 50% of the All-Share's profits come from outside of the UK economy.

There are other reasons why the inhabitants of the UK should not give up on their domestic market. You have a competitive advantage when you invest in UK companies – they are familiar, you understand them, you know how they are likely to be managed, audited and regulated – and you should look to exploit this competitive advantage. And if you would rather delegate your investments to us fund managers then there is a lot of intellectual capital investing in our domestic market. Anthony Bolton may have retired from these shores but you can still find some of the best income, growth or value managers in the world managing UK funds. And from my own perspective there are a huge number of good quality value opportunities in the UK, the ownership of which should produce superior returns to the UK Index over the medium-term.

It should also not be forgotten that the vast majority of your liabilities, such as your mortgage or your pension are denominated in sterling and, therefore, unless you want to hedge your currency exposure, you should have a decent part of your assets on-shore.

To conclude I said at the beginning of this piece that the answer lies in the question. The mere fact that so many people are asking 'why bother with UK equities?' significantly increases the likelihood that the next ten years is a good period for our domestic market. Emerging markets, gold and bonds have already done their bit, their returns over the last ten years have been so good as to make it likely they have a slower period. Meanwhile, closer to home, the starting valuation of UK equities is attractive, our stock market gives you exposure to all sorts of global trends at a modest price, and our own economy is likely to do better than the current modest expectations imply. Now is not the time to ignore UK equities.

## Portfolio Activity

Last quarter we were taking profits in a number of the earlier cycle recovery stocks, particularly where they were technically most over-bought. Whilst this medium-term trend, to reduce recovery exposure remains in place the short-term and premature setback in this area has meant that we have actually returned to topping-up some of our core recovery stocks. Examples of this included **Avis** (over 25% share of the European car rental market), **CSR** (global leader in the technology for Bluetooth and SatNav semiconductors), **Intermediate Capital** (European leader in mezzanine finance), **London Stock Exchange** (leading European stock exchange) and **Thomas Cook** (one of two dominant European travel companies).

Re-financing activity peaked in the final quarter; we supported a number of these, including **Barratt Developments** (trading at only 0.6 times written down book value), **Lloyds Banking Group** (trading at only 0.8 times book) and **Invista European** (trading at a 60% discount to diluted asset value). All these stocks are capable of doubling over the medium term.

Having bought **mining stocks** very well at the bottom of the cycle we have turned somewhat more cautious. All mining stocks have at least doubled, many returning to levels seen in the bubble period for commodities in 2007. Some metal prices, such as copper may be vulnerable to profit taking and normalised valuations are no longer attractive. We have been taking profits across the board.

## New Investments (purchases)

I have become high conviction regarding the recovery prospects at **ITV**, a top decile MoneyPenny stock. There are clear signs that the market position of ITV and its sister channels and website are starting to see a stabilising share of audience in what is now a fully, multi-channel world. This stability of viewership, together with month-on-month improvements in advertising revenue (and December was the first positive growth month in this cyclical downturn) is allowing profit forecasts to bottom-out and, indeed, start to grow again. Costs have been cut, the regulatory environment is being relaxed, the balance sheet and pension fund issues are becoming more manageable and the great Archie Norman has taken over as Chairman. The recovery PE is mid-single digit, timing is now supportive and I have bought a full position.

The UK Non-Life insurance stocks have suffered a severe de-rating over the last year due to both a downturn in the insurance cycle and a lack of cyclical exposure. However, the best companies in this sector are able to sustain above average returns on capital through the cycle, and have as a result scored consistently well within our Quality screen. With Valuations of these stocks having fallen back towards book value we bought an initial position in **RSA** and topped up our investment in **Hiscox**.

The power generation market is of significant medium term interest to us. In the short term profitability and share prices at the electricity generators have been depressed by low electricity prices, the result of cyclically depressed demand and LNG (a substitute energy source) being dumped on global markets. But whilst the short term outlook has been poor, the medium term picture is dominated by insufficient generation capacity being built, in the UK in particular which, in turn, will lead to a hardening of electricity prices. With power generation shares trading at bargain basement prices we topped up our position in **Drax**, valued at only £1.3bn for a company that generates 7% of the UK's electricity, and took a new position in **International Power**, a business that operates on a global basis and will benefit from expansion in developing power markets as well as recovery in more established regions.

One stock that retraced quite a lot of its 2009 performance in the last quarter of the year was **Computacenter**. As a result of this inexplicable share price weakness we took the opportunity to buy-back quite a material position in this high scoring recovery stock. The company, the UK's leading provider of office technology (PCs) and related services, is at an interesting stage of its Life Cycle. Through its migration from a box shifter to a value-added provider of technology services, the company is seeing a gradual but consistent improvement in margin, cash flow and return on capital. This improving trend is likely to persist for many years to come, and when combined with a very modest starting valuation the case for buying back the stock was compelling.

#### **Existing investments we have become more confident about (purchases)**

As mentioned above we topped up many of our core recovery stocks, following a weak fourth quarter performance. We saw the share price set-back in stocks such as **CSR** as temporary, and with their profits likely to increase materially in 2010, and with valuations falling back to very attractive levels again (i.e. CSR fell back to less than 1 times sales, very low for a global technology leader) share price upsides of at least 50% are once again common in this category of the market.

We also took a far more material position in **BG**, a Gas (and Oil) producer that has consistently grown its production assets faster than the Oil Majors. In the past this growth has been too highly rated by the stock market but, following a period of share price underperformance, particularly relative to other commodity related growth stocks, the valuation has become more attractive.

#### **Stocks that have delivered versus our PVT thesis (sale)**

This quarter our focus of profit taking was global growth related stocks, where long-term prospects may be attractive but, with consensus commentary very focused on this being the only place to be, and with valuations looking full, we were inclined to reduce exposure. We reduced mining exposure (**Aquarius**, **Anglo American** and **Xstrata**), and also **HSBC** and **Unilever**.

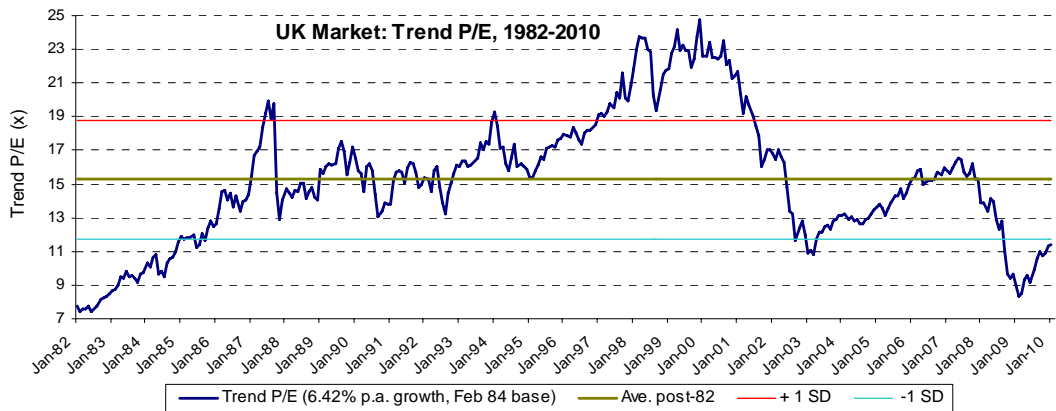
We also continued to reduce our exposure to the retail sector, one of the best performing sectors of the market in 2009. Following strong share price performance we sold out of **Marks & Spencer**.

#### **Stocks we have cut (sale)**

We exited from our holding in **Costain**. Whilst we have not lost absolute money from our investment in this stock, we are concerned that our original recovery based thesis in the stock is now unlikely to be delivered against the background of significant public sector expenditure cuts.

## Outlook

Our hopes for 2010 are that it is a boring year. What we need are sensible AND sustainable returns on equity investments. The current normalised market PE of less than twelve times, combined with a positive outlook for profits growth, justifies at least a modest double digit return for a number of years. These types of sustainable returns would help restore the case for equity investment and answer the UK equity market's critics.



Source: Mirabaud

Of course we all know that the outlook for the UK economy is difficult, even the politicians are telling us so. My point would be that this is a “known known” and, as a result, the risks regarding our economy relative to expectations are therefore on the upside. Consumers will be cautious about spending, but we have already rebuilt savings back up to almost 10% of income so we don't need to become more cautious; Government spending will be reduced, but most of us would agree that our taxpayers' money should be spent more efficiently. Meanwhile there are some significant positives: Sterling has been very weak, making us more competitive as a nation; interest rates have remained very low, improving individual and corporate cash flow; and corporate inventory and investment are very depressed and starting to rebound. Perhaps the UK economy will pleasantly surprise us pessimistic Brits.

Meanwhile the High Alpha strategy feels to me to be well positioned. We are invested in many great companies on bargain basement valuations. We have a sensible level of diversification by stock, sector, factor and category but we also have many robust, and hopefully well articulated, views. The portfolio remains lowly valued, with a single figure normalised PE multiple, 90% asset backing and 180% sales backing. This low valuation will be complemented by above market profits growth over the next two years as margins are restored in the recovery component of the portfolio. Last year was a strong one for this approach; 2010 will of course see lower absolute returns but robust relative returns should remain the order of the day.

Thank you for your continuing support.

**Hugh Sergeant**  
**Head of UK Equities**

## Fund Facts

Launch date	28 Nov 2006
Fund manager:	Hugh Sergeant
IMA sector:	UK All Companies
Benchmark:	FTSE All-Share (Total Return)
Tracking error range:	4-8%
Product capacity:	£1.1bn (pooled & segregated)
XD dates:	1 April & 1 October
Dividend/Accumulation payment date:	31 May and 30 Nov

Share class:	A	B	Z
Launch price (shares):	100.00p	250.00p	500.00p
Share classification:	Retail	Asset Manager	Institutional
Type of shares:	Income	Accumulation	Accumulation
Fund charges:			
Annual	1.50%	0.75%	0.00%*
Initial (up to)	5.25%	5.25%	5.25%
*AMC charged outside the Fund			
Minimum investment			
Initial	£1,000	£2.5 million	£5 million
Subsequent	£500	£25,000	£50,000
Sedol	B1DSZM4	B3D79W3	B1DSZP7
ISIN	GB00B1DSZM47	GB00B3D79W34	GB00B1DSZP77
Bloomberg	RMUKEHA LN	RMUKEHG	RMUKEAA LN

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