RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Income Fund I Quarterly Report
December 2009

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UK Equity Income Fund – Quarterly Report

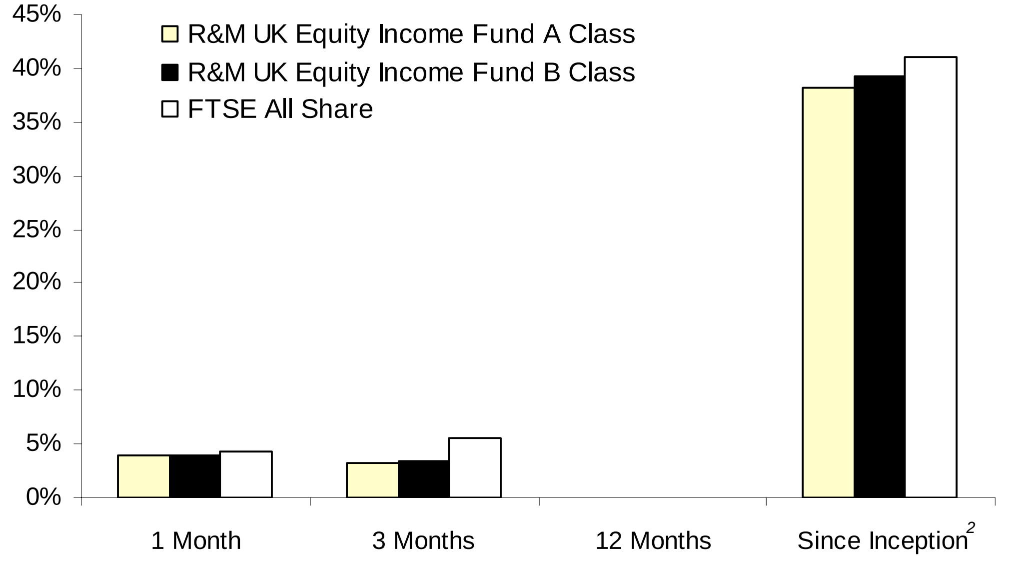
Fund Aim
The investment objective of the Fund is to generate a rising level of income combined with the potential for capital growth through investing in a portfolio which will primarily consist of UK equities.

Portfolio Summary			Risk Analysis Summary	
Strategy AUM		£12m	Portfolio Volatility	16.75 %
Strategy Capacity		£1bn	Benchmark Volatility	16.18 %
Number of stocks		72	Tracking Error	3.02 %
Largest Holding	BP	7.63 %	Portfolio Beta	1.02
Historic Yield		N/A	Prospective Historic Yield[3]	4.80 %

Performance to 31 December 2009

Retail "A" Class Shares	Fund[1]	Index*	Difference
1 Month	3.96%	4.34%	-0.38%
3 Months	3.19%	5.47%	-2.28%
12 Months	-	-	-
Since Inception[2]	38.26%	41.01%	-2.75%

Asset Manager "B" Class Shares	Fund[1]	Index*	Difference
1 Month	4.02%	4.34%	-0.32%
3 Months	3.40%	5.47%	-2.07%
12 Months	-	-	-
Since Inception[2]	39.21%	41.01%	-1.80%



Source: River and Mercantile Asset Management LLP
**Index: FTSE All Share (Total Return)*
[1]Performance calculated on a mid to mid basis at close of business, net of annual management charge
[2]Inception date 3 February 2009
[3]Yield based on the historic dividends of the current holdings of the Fund.

Market Overview

According to recent press reports more people voted in the recent ITV X-Factor final than voted Labour in the last General Election. The winner was ‘usurped’ from the obligatory ‘Christmas Number 1’ by an internet campaign reviving sales of “Rage Against the Machine”. Do these events tell us more about the success of Reality TV in the Noughties, the state of political apathy, or the ever-growing phenomenon of the Internet? I can, with some conviction, say one of the biggest risks to UK exposed companies in 2010 is a hung-parliament result; one only needs to peruse the market’s behaviour in 1974 to ascertain a likely response. Fortunately the UK market has significant overseas exposure, and there is quite the opposite to a hung parliament in both the US and China. However, I cannot study history to know the Internet’s response to a hung parliament: it didn’t exist back then.

Genuine long-term themes are clearly difficult to identify in advance, and even more difficult to value. Ten years ago I read many thematic investment reports suggesting that the Noughties would be the decade of the “grey pound”. The actual outcome is best summed up by a recent response to this Radio 2 quiz question:

Presenter: *“What is the name of the long-running TV comedy show about pensioners: Last of the...?”*
Caller: “*Mohicans*.”

Reality TV has indeed had a highly successful decade capped by the FT’s top 50 ‘Faces of the Decade’ including John de Mol, the developer of Big-Brother, alongside world leaders, the technology business gurus and Tiger Woods. I can only imagine that Mr De Mol, Jeff Bezos, Steve Jobs, Mark Zuckerberg, Larry Page and Sergey Brin had a better Christmas than Tiger. During the decade Tiger won 12 Major trophies, and Page and Brin grew revenues from $19m to $17bn. Google has delivered fantastic equity returns having floated post-bubble in 2004, however whilst long-term thematic reports in Q1 2000 correctly forecast the Internet’s growth, this was more than priced in to equities and investment returns have, in aggregate, been poor and the Nasdaq is still down 50% from its July 2000 high.

The final quarter of the decade was characterised by sector rotation and modest gains which accelerated in thinly traded markets, led by the resources sector, in the final weeks of the year. Risk appetite appeared to wane with marked contrasts between cyclical and defensive sectors and financials and resources in addition to clear size bias differentiation. The year, overall, was a strongly positive one for equities, rising 30%. The bear market lows are almost distant memories driving a huge 59% gain from the bottom, highlighting the weak start to 2009. The Noughties have been a volatile decade for UK equity investors, with two clear peaks and troughs each in investor sentiment, but were ultimately disappointing. As always with the stock market, the starting point for any time-series analysis and indeed starting valuation of any investment are critical. Equities were very expensive on 1 January 2000. They were not on 1 January 2010.

In a Recovery year, such as 2009, investors’ attention has been seemingly focused on Capital gains, with Income a secondary contributor to total return. Quantitative Style factor analysis suggests a focus on higher yield equities has been of limited positive influence on performance during the year; however there appear to be tentative signs of the factor picking-up in the fourth quarter. The Noughties represented a good period (as observed in most long-term studies) to remain biased to higher-yielding equities. I expect the next decade will be as well.

Based on current market consensus forecasts the prospective yield on the fund is c.4%. This remains attractive relative to other asset classes, the UK equity market’s own history and is predominantly driven by overseas profits which should grow, helping offset any inflationary impact on real returns.

Performance

The fund underperformed the benchmark FTSE All-share Index during the quarter by 2.07%, (mainly lost in November) rising 3.40% during the period. The fund was 1st quartile to the end of December since inception against peers. During December the factors affecting performance during the whole quarter continued i.e. a relative lack of exposure to 'global growth' stocks (underweight Multinational Consumer Goods and Mining). UK exposed holdings such as Home Retail, Holidaybreak and HMV were weak although Halfords and 888 were positive. Barclays had a difficult quarter, however very low exposure to RBOS and Lloyds mitigated this. In December Petropavlovsk gave back some of its recent gains as the Gold price pulled back from recent highs and Recovery holding Hogg Robinson was weak; both were positive contributors during the overall quarter. Relatively new holdings Kcom and Antofagasta have produced excellent early contributions to portfolio performance.

Philosophy & process

The majority of capital within the fund is allocated to the Quality category at 65.1%, which has grown markedly over the quarter from 53.6% due to a strategic portfolio construction decision to take profits in some financials stocks and other recovery holdings which were a mix of domestic-exposed companies or small companies. The Recovery category has been reduced to 21.8%; however I remain confident in significant future total returns from the stocks retained in this category. The portfolio improved its strong skew to the higher scoring stocks with 84% now in the top 4 deciles of Moneypenny.

Overall the Philosophy has weathered difficult headwinds in 2010 because, as in 2009, one key factor has been significantly weaker than its long-term historic contribution to performance. In 2010 it was 'Timing' due to a lack of market focus on earnings revisions and the breakneck switch in market price momentum. I continue to strongly believe that a measured, disciplined approach to selecting investments with a combination of 'Potential', 'Valuation' and 'Timing will yield the greatest, risk-adjusted returns over time. In line with a similar decision at the end of 2008 following a difficult period for the 'Valuation' factor, I have no plans to 'de-weight' or drop the use of our primary 'Timing' tools. It is my opinion that it is exactly when patience is lost that a factor will start working again. Below, one can see the long-term positive returns generated from focusing purely on earnings revisions.

Source: SG Quantitative Research

Portfolio Income

55 holdings went ex-dividend during the quarter. Of these only 14 were down on the prior year, and 11 holdings held their payments. This leaves the 30 holdings which raised their dividends during the quarter. This quarter I would like to touch on the outlook for dividend growth in 2010. It is my view that dividend growth will exceed current consensus expectations of 5-6% in 2010. The reasons for this are threefold.

Firstly, Resources and Financials are likely to generate material percentage growth from very depressed levels as their profitability begins to normalise. Secondly, following considerable efforts to sure-up balance sheets during 2009 and vastly improved banking system stability, companies should flex their payout ratios more (in-line with other down-cycles, but not this one to date because of the credit crisis). Finally the UK economy should return to modest growth, and Global growth (a more important driver of FTSE profits) will accelerate, which, when married with hacked cost bases, will drive decent profit recovery and, therefore, rising dividend income. Our analysis of current holdings suggest on a weighted basis dividends will grow by c.10%. The accuracy of this number is compromised by the use of consensus forecasts, differing reporting periods, and currency. Key market and portfolio contributors to growth, which are held in the fund, are Rio Tinto, HSBC, Barclays, and Tobacco stocks, although we also expect potential upside dividend surprises from companies such as Legal & General. What we can expect, obviously, is that UK equity income will grow much higher than the payouts from Gilts and Cash in 2010. At the end of December the fund prospective yield according to Reuters consensus was 117% of the benchmark yield of 3.5%.

Portfolio Activity

Monthly reports have detailed much of my activity during the quarter, which can be broadly summed up by the purchase of additional high quality franchises with material overseas earnings such as Reed, Aegis, De La Rue, IMI, and Aviva, the narrowing of the Resources underweight, by purchasing Antofagasta, the reduction in Financials exposure and the sale of mainly domestically focused, small & mid cap recovery stocks.

December's activity continued in this manner with purchases of high quality defensives Imperial Tobacco and International Power and the sale of mid/small caps Pace Micro Technology, HMV, and RM. I have also decided to complement the big-cap, high yield oil positions with some younger exploration and production companies. Growth Potential at North Sea focused, Valliant Petroleum and West African focused Afren is significant. Both well-capitalised businesses have material production assets coming on-stream which will be highly cash generative in 2010 at current oil prices. The current valuation multiples of these cash flows are only single-digit. Both businesses have very active exploration campaigns planned in the next 12-18 months, including drilling on some very large prospective structures.

Sector positioning shifted during the quarter. Financial weightings were reduced across General Financials (3.7% to 2%), Real Estate (3.9% to 2.6%) and Non-life insurance (2.3% to 1.5%). Increased overweight positions were built in Pharmaceuticals, Telecommunications and Food producers, and I moved overweight Tobacco (for the first time since Fund launch). I reduced the size of the underweight in Utilities, following sector underperformance, but remain very wary of Water stocks. The underweight in Oil & Gas narrowed to 2% from 3.4% due the purchases outlined above. At the margin, consumer sectors were reduced in favour of industrials.

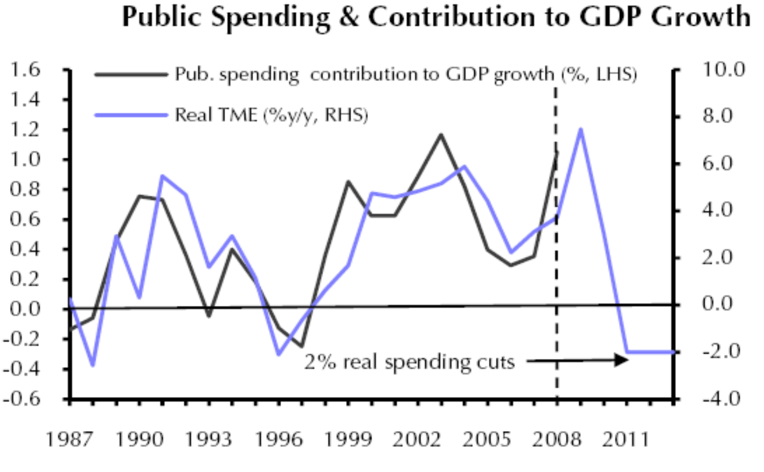
Market Outlook

At the end of the decade it feels natural to indulge in longer-term predictions of what the future may hold. In 2010 my primary aim will be to continue effectively executing our systematic process of identifying, verifying and then investing in companies which meet highly attractive PVT criteria. There remain considerable opportunities available. However, the big picture issues, which I believe will shape the next ten years will also, I expect, be a key determinant of market returns in the next twelve months. There are only a few bigger 'pictures' than "The Magnificent Seven", whose 50th Anniversary is this year, having been originally released in 1960. It seems fitting that its Golden Anniversary is marked by recent all-time highs in the precious metal.

So who are/were the Magnificent Seven?

1. The UK Fiscal Position, Harry Luck

Played by Brad Dexter, 'Harry Luck' joined 'Chris' (Yul Brunner) because he had 'gone broke' which seems a fitting link to this key issue for 2010 and beyond. The cost of the financial bailout and fiscal stimulus, the huge increase in public spending under Labour and the global recessionary impact on tax revenues has left Britain with a high Debt/GDP ratio, and concerns over our Sovereign credit rating. Sterling, unlike the Dollar, cannot rely on 'Reserve' currency status. Market confidence in a credible plan to resolve this issue will be paramount in 2010 and defined by political events. The Canadian experience offers hope for those concerned about inevitable crisis. Their 1992 budget deficit of 9% GDP had become a surplus by 1999 via a 10% cut in government spending to GDP helping drive a reduction in Debt/GDP from 70% to 42% in five years. Exports played a vital role in their recovery, UK politicians should take note. In any outcome UK trend growth has been impaired for the medium-term given the impending reversal of the supportive role public sector spending has been in the last 10 years. I have biased the fund to overseas earnings and have no public sector exposure.

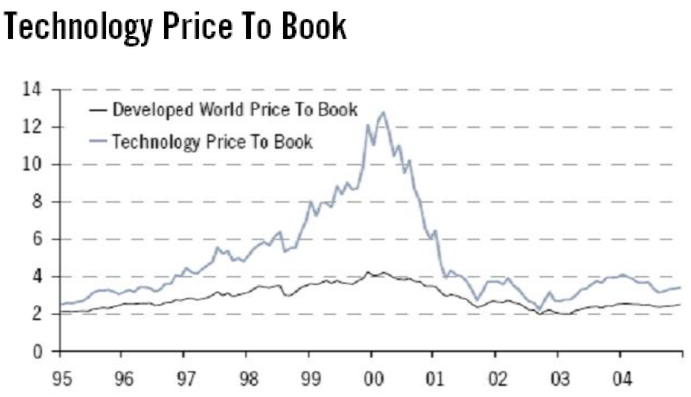


Source: HM Treasury

2. Financial Sector Recovery, Vin

Played by Steve McQueen, the highest paid actor in the world in the hung parliament year of 1974; 'Vin' was also 'broke' due to excessive gambling. No obvious link to this issue then. At the start of 2010 the Banks sector was c.13% of the UK market by capitalisation; General Financials, Insurance and Real Estate add a further 7%. Despite impressive rallies off the lows, Banking and Insurance shares remain on deep discounts to historic average valuations reflecting market concerns on their future cash flows and profitability. Regulation will surely play a huge part in the sector's ability to 'revert to mean', however when confidence returns, significant further equity gains are likely. I am currently unconvinced the conditions for that confidence to return on a sustained basis will emerge in 2010, although profits will be on the mend.

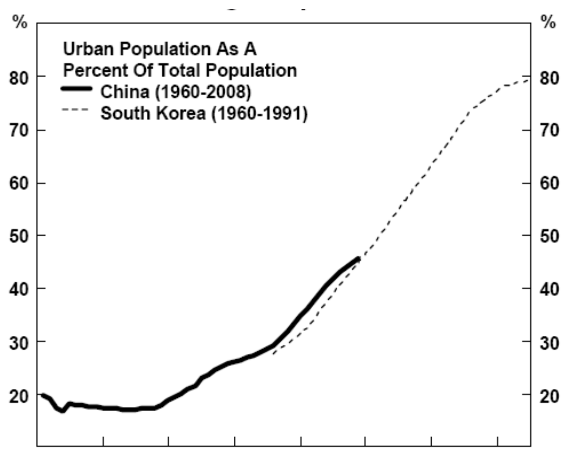
I am acutely aware of the ‘post-bubble’ equity valuation environment in Technology, or Japan, where investors have been broadly reluctant to re-value the ‘theme’ and am still concerned over the extent and nature of the impairment cycle in the UK. There remains material profit and valuation recovery potential over the longer term. Having participated in 2009’s financials recovery, I have, for now, moved tactically underweight the financials area.



Source: Citi Investment Research and Analysis

3. Chinese GBP Growth, Lee

Robert Vaughan’s career has shown astounding sustainability. Born in 1932, he still stars in ‘Hustle’ showing on BBC1 this year. Much is quite rightly being commentated upon at the moment about the huge growth in China’s economy over the last 10 years, and its resilience in 2009 given its massive (affordable) stimulus. GDP per capita is still only 7.6% of the US having risen over 400% during the decade, overtaking the Japanese economy in size. However, in 2010 fiscal support should wane, and the loose lending environment should tighten. The domestic economy will need to do its part in complementing China’s current export strength/dependency for growth to continue. During 2009 China overtook the US in car, refrigerators and desk-top computer sales by volume. The signs are encouraging. Chinese and other developing market growth will be the defining factor for Resources sector returns in 2010 and onwards. Short of the input materials for its urbanisation trend, the commodity supply response has been lacklustre. China’s copper consumption as a % of world consumption has increased from 11% in 1999 to a forecast 30% in 2009. In absolute terms their demand will continue to grow given the resource intensive stage of their development, whilst US consumption will gradually pick up as the cycle matures. I expect new all-time highs in the commodity complex in the next decade and currently allocate over 25% of the fund to Mining and Oil companies.



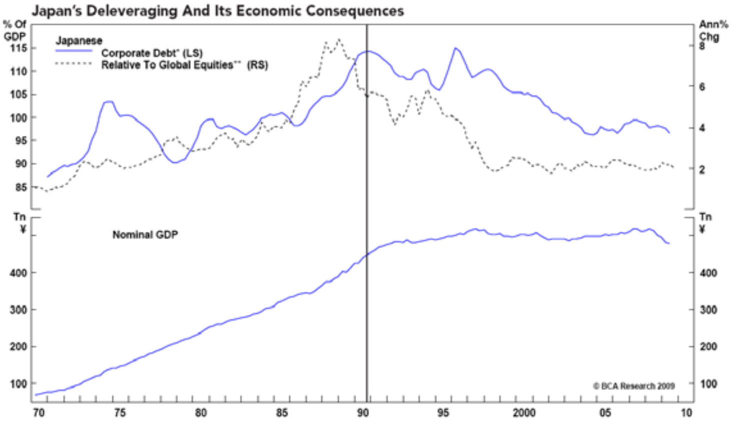
Source: BCA

4. The disruptive progress of technology, Britt

I think James Coburn's character vaguely sums up the perils of ignoring the on-going impact that technology has on society. Skilled with a switch-blade, this was of little use in a huge gunfight. One needs to utilise and master the latest technologies to survive. The Internet continues to have an incredible effect on global information flow, consumer buying habits, business communications and society. I have no doubt further evolution will be rapid and transformational in the next decade. In my mind the issue encompasses Alternative Energy developments, which are likely to progress and disrupt the way we live and how business operates in the next ten years, but relies heavily on innovation. Valuations in the TMT sectors are still a shadow of former multiples, yet the growth assumptions have largely played out (just over a longer time period). The fund has 15% allocated to 'TMT' and identifying 'Growth' Potential in this area will be a key task in the years ahead.

5. Inflation or Deflation? Chico

Many would argue this is the primary issue to anticipate correctly, from which all others derive, or influence in the next decade. Currently inflation expectations are well anchored, albeit gently rising. The Deflationary impacts of the de-leveraging process which key western economies such as the US and the UK need to go through will offset the record monetary stimuli being enacted to jump-start the velocity of money and investment markets. Chico's actor, Horst Buchholz, was from Germany, the country which provides the most horrific case study on a hyper-inflationary outcome. 'QE' is officially admitted to be an 'experiment', based on 'sound' theory. The longer term effect of Helicopter Ben's money printing is unknown, but it is clear that the success of any Fiat currency is ultimately based on confidence in the sponsor. The flip-flopping of market concern with deflation or inflation over the last decade will continue well into the next, and whilst one must consider the implications and take extremely seriously the probability of either taking hold with a vengeance, a far more likely actual outcome is somewhere in-between, a rather more uneventful outcome, like the rest of Buchholz's average acting career. The Japanese experience remains the deflationary case study, and one which I expect would be the greater of two evils for equity investors.



Source: MSCI Inc.

6. Change in global healthcare, Bernado

A key issue for the next decade will be the influence of healthcare policy, disease management and drug development. Obama's recently voted through US reforms will have a major impact on the countries public finances and healthcare infrastructure. The hidden long-term costs of Healthcare, in my opinion appear underplayed by Governments who are unwilling to address, during their terms of power, the impending issues of ageing populations, the availability of healthcare solutions and a sustainable funding/provision model. Equally, the requirement for China to develop a credible healthcare safety net for its growing and ageing (due to the one-child policy) 1.3bn population is essential to address global imbalances. Recent Gallup polls indicate (unsurprisingly) that the very high savings rate in China is due to concerns about healthcare provision in the future. If China can address these concerns, the savings ratio should fall, the domestic economy should grow markedly and global imbalances could begin to unwind.

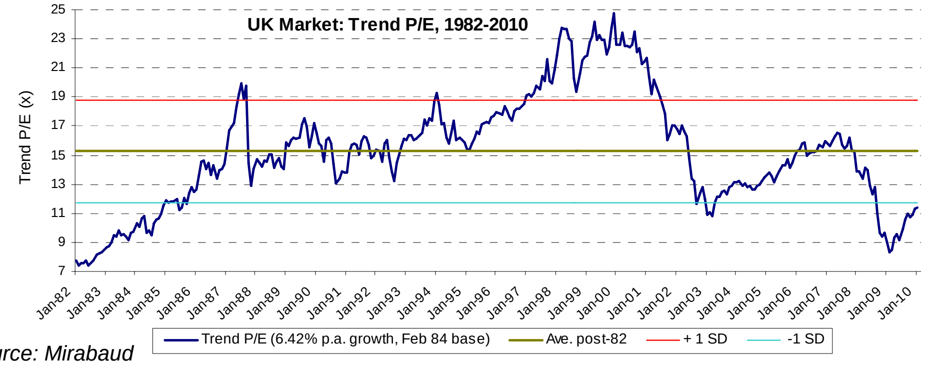
Charles Bronson, who played Bernado, was extremely successful in building a global acting franchise and adapting his career to changing movie tastes. His move from Westerns to the highly successful Death Wish series (no link here to healthcare, but coincidently premiered in the hung-parliament year of 1974), insured a long, highly lucrative career. The Global Pharmaceuticals sector is well-placed to achieve the same and benefit from these industry developments. The valuation of the sector is near all-time relative lows. New management teams have at last been adapting their business models to the next decade's outlook. The Fund has slightly below 10% invested.

7. Geo-political shocks & conflict, Chris

Last, but by no means least is gun-slinger Yul Brunner in the lead role. Geo-political shocks and conflict unarguably scar the Noughties and have had huge impact on investment outcomes and returns. The 'War on Terror', as a consequence of the 9/11 attacks, has defined the foreign policy' narrative and behaviour of the last decade. Behind the speeches, though, were the invasion and now quasi-control of Iraq's massive oil fields, where known Reserves are the 4th largest in the World and over 5x those of the US. Worryingly, Iran has even more reserves than Iraq, and China has even less than the US, despite only just having become petrol-heads. Further Middle-Eastern conflict appears likely in the next decade as control/safety of supply is secured. At the same time China's ascendancy, so far without any material territorial flare-ups or conflict, is at odds with other examples of successful nation-building. The next decade will see not only the building of the UK's new Aircraft-Carrier(s?), but also China's first. Their security of energy and other commodity supply is already causing tensions in Africa and elsewhere. We only need to look to Yul Brunner's birthplace, Sakhalin Island in Russia, to see how the rules can change in non-Western countries when resources are at issue. Interestingly, Russia, for so long a main player in global cold-war conflict, offers the longest-standing leadership of any BRIC (Putin was elected in 2000). If China's growth is sustained, fiscal deficits ignored and the US succumbs to a deflationary spiral, the already high probabilities of trade-related conflict will multiply. BAE Systems remains a top overweight position.

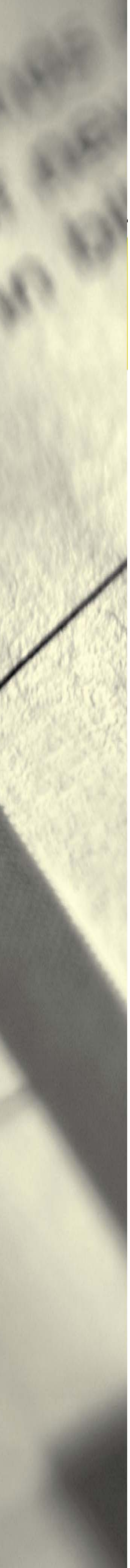
Summary

The Fund is built via a bottom-up stock selection process based upon our PVT philosophy. I have high conviction in the holdings which represent a diverse mix of high Quality, Growth, Recovery and Asset-backed names with attractive valuation credentials and positive Timing attributes. They are highly liquid securities with strong balance sheets in a deep, broad and attractively valued UK equity market which has significant profitability generated overseas. The Oscar nomination for "The Magnificent Seven" was not for any of the above performances. It was for Elmer Bernstein's outstanding film score. The mood music changed from scene to scene: so will sentiment towards the "Magnificent Seven" from quarter to quarter. However, the main, legendary theme remained constant throughout the film, as will my investment approach over the decade to come. John Sturge's (Director) budget was $3m. Recently released Avatar's pre-marketing budget was $300m. Will Avatar be releasing a 50th Anniversary DVD? Early viewing figures look strong but what will be the long-term Return on Investment? It's all about starting valuation...



Source: Mirabaud

Richard Staveley
Portfolio Manager



Fund Facts

Launch date	3 Feb 2009
Fund manager:	Richard Staveley
IMA sector:	UK Equity Income
Benchmark:	FTSE All-Share (Total Return)
XD dates:	1 April & 1 October
Dividend/Accumulation payment date:	31 May and 30 Nov
Product capacity:	£1 bn (pooled & segregated)

Share class:	A	B
Launch price (shares):	100.00p	250.00p
Share classification:	Retail	Institutional
Type of shares:	Income	Accumulation
Fund charges:		
Annual	1.50%	0.75%
Initial (up to)	5.25%	5.25%
Minimum investment		
Initial	£1,000	£2.5 million
Subsequent	£500	£25,000
Sedol	B3KQG33	B3KQG44
ISIN	GB00B3KQG330	GB00B3KQG447
Bloomberg	RMUKEIA	RMUKEIB

Important Disclosure:

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