

RIVER AND MERCANTILE  
ASSET MANAGEMENT

UK Equity Long Term Recovery Fund | Quarterly Report  
December 2009

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# River and Mercantile

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## UK Equity Long Term Recovery Fund – Quarterly Report

### Fund Aim

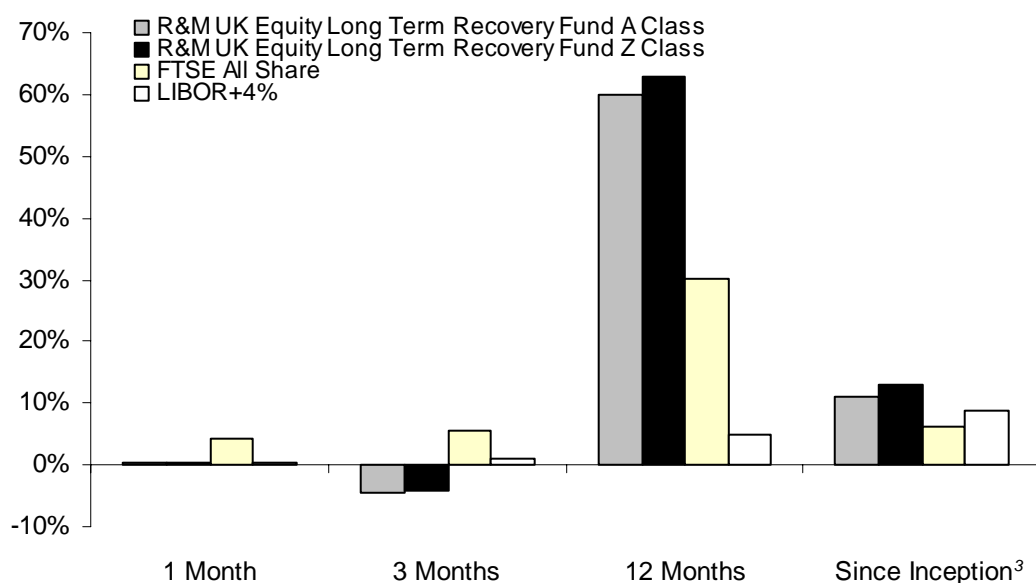
The investment objective of the Fund is to achieve capital growth through investing in a portfolio which will primarily consist of UK equities that meet the manager's recovery criteria of a turnaround in company profitability over the longer term. The Fund will not be restricted by reference to a benchmark, sector constraints or company size.

Portfolio Summary		Risk Analysis Summary	
Strategy AUM	£82m	Portfolio Volatility	19.32 %
Strategy Capacity	£200m	Earnings Yield	8.76 %
Number of stocks	139	Dividend Yield	3.19 %
Largest Holding	HSBC 3.43 %	Price to Sales	0.48
Average return to medium-term recovery value	66%	Price to Book	0.91

### Performance to 31 December 2009

Retail "A" Class Shares	Fund <sup>1</sup>	FTSE All Share	Difference	LIBOR+4
1 Month	0.24%	4.34%	-4.10%	0.38%
3 Months	-4.55%	5.47%	-10.02%	1.14%
12 Months	59.97%	30.12%	29.85%	4.80%
Since Inception <sup>3</sup> (%p.a.)	11.09%	6.09%	5.00%	8.83%

Inst'l "Z" Class Shares	Fund <sup>2</sup>	FTSE All Share	Difference	LIBOR+4
1 Month	0.39%	4.34%	-3.95%	0.38%
3 Months	-4.13%	5.47%	-9.60%	1.14%
12 Months	62.76%	30.12%	32.64%	4.80%
Since Inception <sup>3</sup> (%p.a.)	13.01%	6.09%	6.92%	8.83%



Source: River and Mercantile Asset Management LLP

<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 17 July 2008

### 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 performance came to an abrupt end last quarter, with the Long Term Recovery portfolio returning -4.1%, an underperformance of 9.6% versus the equity benchmark and well below LIBOR (-5.3% relative). There were relatively 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 Long Term Recovery strategy returning 62.8%, beating the FTSE All-Share Index by 32.7% and LIBOR(+4) by 58.0%.

## Key performance contributors

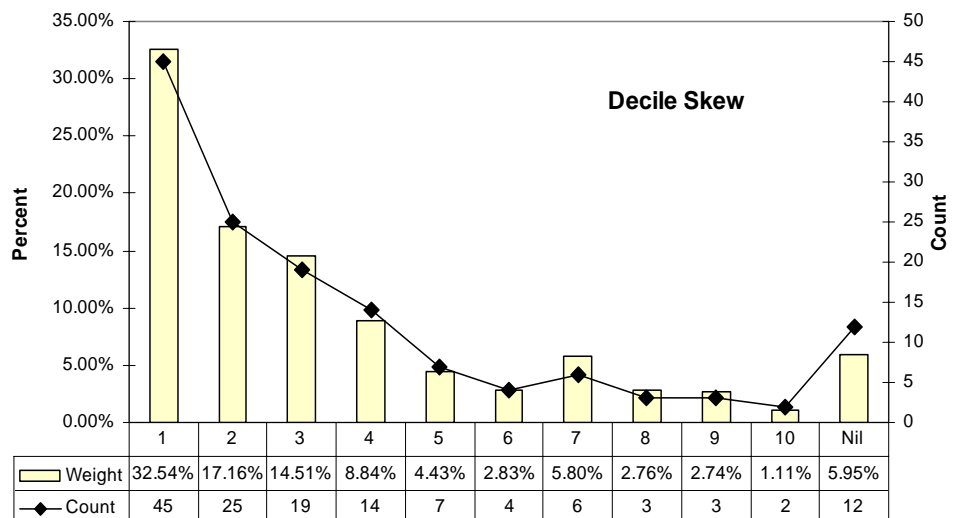
### Quarter:

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

**Negative:** Small Company drag; recovery stocks move from short-term overbought to oversold; stock specifics the balance, in particular bank weakness (Citigroup, RBS and Lloyds).

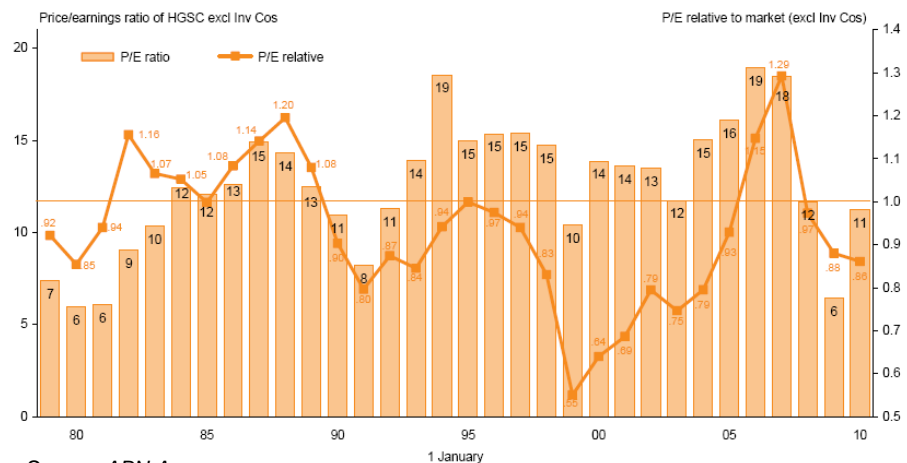
### Does the portfolio reflect our philosophy and process?

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



Source: River and Mercantile Asset Management LLP

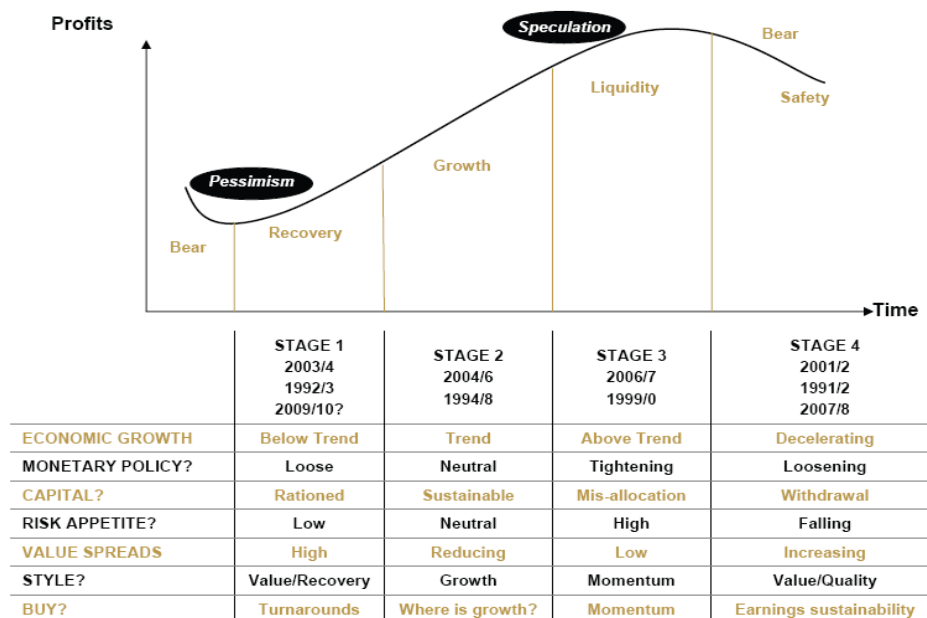
Our Smaller Company exposure was pretty stable over the quarter, at a bit over 30% of the Strategy. Smaller Companies retraced almost half their years' outperformance during the period, leaving many of our investments on very attractive valuations again; as a result we topped-up existing positions. As the HGSC data below suggests, in aggregate, smaller companies remain attractively valued.



## 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.



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?'

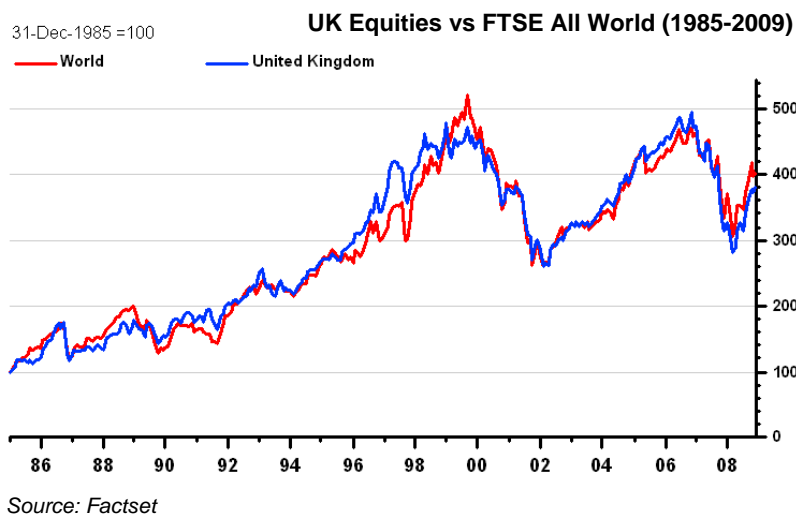
The 'killer blow' for UK equities at the moment is our economy – we all owe far too much, the Government and Individuals are borrowed to the hilt and, as a result, our economy will struggle to grow and equities can't do well in this environment, can they? Actually study after study has shown that there 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 PEs at such a level, on average, produce ten year returns in double figures.

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.



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 remains in place the short-term and premature setback in this area has meant that we have actually returned to topping-up some of these core 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) 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 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, 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, and bought into **Rurelec**, Bolivia's largest electricity producer, valued at only £35m.

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.

We made our first investments into the Japanese market, where valuations for market leading recovery type franchises are particularly compelling, typically trading below book value. **Mitsubishi UFJ** (Japan's largest bank) was purchased on 0.8x book, **Mitsubishi Chemical** (Japan's largest Petrochemical business) 0.9x book, and **Seven Eleven** (Japan's biggest grocer) saw us pay less than 5 times EBITDA.

We have also gained exposure to a recovery in the global **shipping and services** industry. Shipping rates have started to recover as global trade picks-up, and shipping related equities have been trading at discounts to book value and low multiples of recovery earnings. For example we purchased **AP Moller Maersk** on 0.7x book, for its exposure to a container shipping recovery but also for shareholder value realisation based on the market recognising the significant value in its large oil services business.

#### **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 remain high conviction regarding the Global component of the portfolio, and where appropriate we topped up these positions. As I mentioned last quarter these investments provide a portfolio of fantastic international franchises at rock bottom prices, including **GE** (world's largest electrical engineer, power equipment manufacturer and aerospace engine producer), **eBay** (world's largest online trading community), **UnitedHealth** (US leader in Health Management serving over 70m customers), **Pfizer** (world's largest drugs company), **Harley Davidson** (the iconic motorcycle brand with a dominant position in heavyweight bikes), **Citigroup** (still one of the biggest banks in the world by net interest income), **Fidelity National Finance** (40% US market share in residential home title insurance), **Nasdaq** (three times more market share than the LSE), **Lufthansa** (world's largest airline), **Gazprom** (four times the size of the second largest gas supplier on this planet), **Nokia** (global share still over 30%), **Nintendo** (world's largest producer of gaming hardware and software), **Mitsubishi Estates** (owns Marunouchi, the best real estate in Japan) and **Yahoo** (the well known internet brand). We bought all of these at around their cyclical lows, on very modest valuations.

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

This quarter our focus of profit taking was global growth related recovery 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**.

We sold out of our position in **KCOM** following a significant re-rating which took its valuation back to the level of the telecom majors.

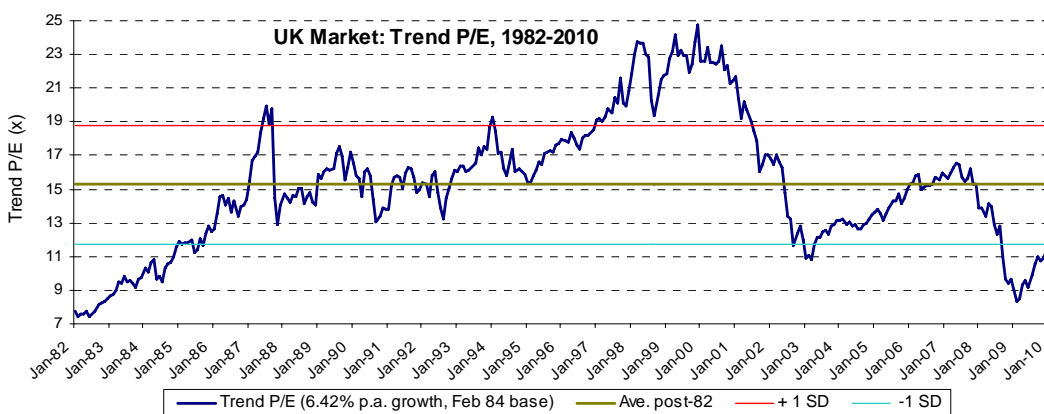
We also continued to reduce our exposure to the retail sector, one of the best performing sectors of the market in 2009. This included selling out of **Clinton Cards** following a doubling of the share price.

## Stocks we have cut (sale)

We exited from our holding in **Aer Lingus** as we reconsidered their ability to deliver on their recovery plan in the context of the on-going pressure on the Irish economy and their relatively thin balance sheet. We decided to focus our airline recovery exposure on BA and Lufthansa, much larger enterprises.

## 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 Long Term Recovery 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 region but we also have many robust, and hopefully well articulated, views. The portfolio remains lowly valued, with a single figure normalised PE multiple, over 100% asset backing, 200% sales backing and an upside to medium-term intrinsic value of 66%. This low valuation will be complemented by above market profits growth over the next two years as margins are restored back towards trend. 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	17 July 2008		
Fund manager:	Hugh Sergeant		
IMA sector:	UK All Companies		
Benchmark:	LIBOR Overnight Cash Rate		
Tracking error range:	N/A		
Product capacity:	£200m (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	Income	Accumulation
Fund charges:			
Annual	1.75%	1.00%	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	B1YHLP5	B614J05	B1YJFW6
ISIN	GB00B1YHLP55	GB00B614J053	GB00B1YJFW60
Bloomberg	RMUKELA LN	RMUKEBBLN	RMUKELB LN

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