RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Smaller Companies Fund I Quarterly Report
December 2009

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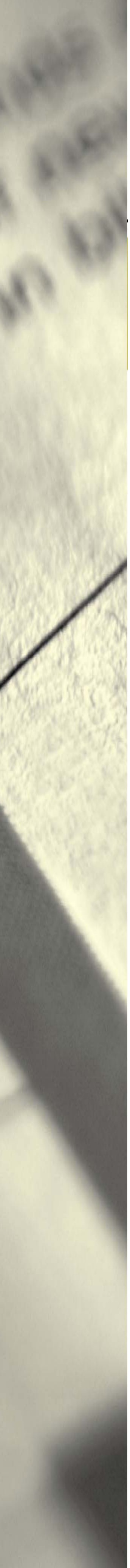
UK Equity Smaller Companies Fund – Quarterly Report



Fund Aim

The investment objective of the Fund is to achieve capital growth through investing in a portfolio of investments which shall primarily consist of UK equities which reside in the bottom 10% of the UK stock market in terms of market capitalisation.

Portfolio Summary

Strategy AUM		£38m
Strategy Capacity		£400m
Number of stocks		86
Largest Holding	CVS	1.98 %

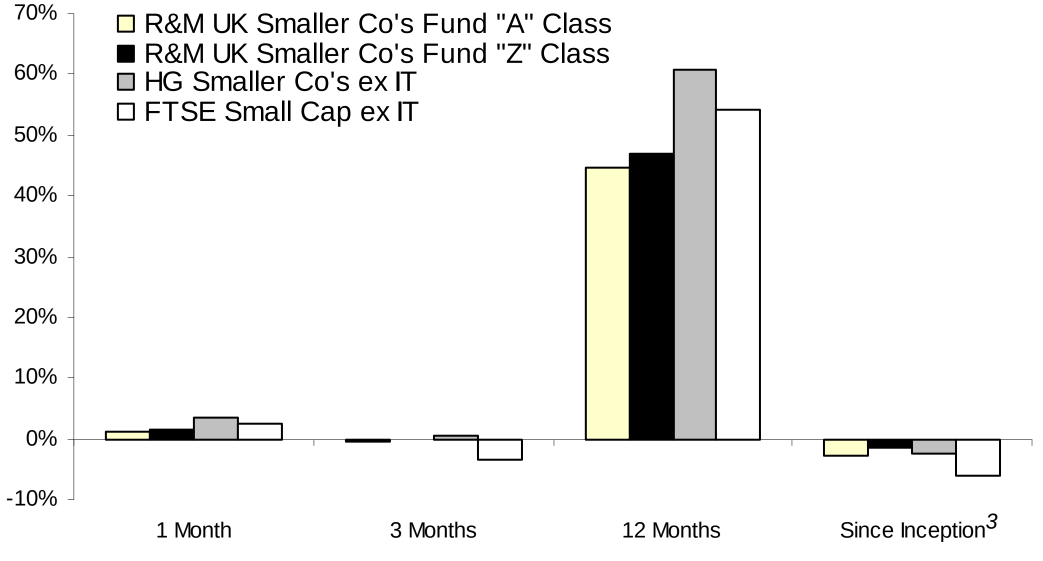
Risk Analysis Summary

Portfolio Volatility	20.34 %
Benchmark Volatility	19.81 %
Tracking Error	5.41 %
Portfolio Beta	0.99
Active Money	82.20 %

Performance to 31 December 2009

Retail "A" Class Shares	Fund[1]	HG Index*	Difference	*FTSE Small Cap*
1 Month	1.31%	3.53%	-2.22%	*2.37%*
3 Months	-0.41%	0.42%	-0.83%	*-3.31%*
12 Months	44.76%	60.73%	-15.97%	*54.27%*
Since Inception[3] (%p.a.)	-2.87%	-2.33%	-0.54%	*-6.00%*

Inst'l "Z" Class Shares	Fund[2]	HG Index*	Difference	*FTSE Small Cap*
1 Month	1.44%	3.53%	-2.09%	*2.37%*
3 Months	-0.05%	0.42%	-0.47%	*-3.31%*
12 Months	46.94%	60.73%	-13.79%	*54.27%*
Since Inception[3] (%p.a.)	-1.44%	-2.33%	0.89%	*-6.00%*



Source: River and Mercantile Asset Management LLP
**Index: Hoare Govett Smaller Companies ex IT*
[1]Performance calculated on a mid to mid basis at close of business, net of annual management charge
[2]Performance calculated on a mid to mid basis at close of business, gross of annual management charge
[3] Inception 30 November 2006

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? We can, with some conviction, say one of the biggest risks to UK Small & Mid cap equity returns in 2010 is a hung-parliament result; one only needs to peruse the market’s behaviour in 1974 to ascertain a likely response. However, we cannot study history to know the Internet’s response: it didn’t exist then.

Genuine long-term themes are clearly difficult to identify in advance, and even more difficult to value. Ten years ago there were 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’s 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. We 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 small cap equities, rising 54.3%, mid-caps 50.6%. The Hoare-Govett return of 60.7% was the best year in the decade and the sixth best absolute return in the last 50 years. The bear market lows are almost distant memories driving a huge 73.1% 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.

Performance

The fund underperformed the benchmark HG Small Cap Index during the quarter by 0.47%, falling 0.05%. December was a weak month with Petropavlovsk giving back part of its recent significant gains (we have now exited). Cyclical holdings such as Topps Tiles, Brammer, and Hogg Robinson were weak whilst benchmark heavyweights Aquarius Platinum (we exited too early) and Rentokil continued to make ground (they have both now left the index). Disappointing statements from Cohort (we have now exited) and Anite, also impacted performance. In December consumer holdings Asos, Blacks Leisure and H&T were helpful. Deeply undervalued Oil & Gas company Serica was December’s largest positive contributor. Overall, during the quarter, the takeover of Novera Energy was beneficial and resources holdings Salamander, Petropavlovsk and Anglo Pacific contributed to performance. Underperformance was driven by weakness in larger Recovery holdings Delta, Fiberweb, Laird and Holidaybreak (which started to reverse in December) in addition to disappointment at Tribal. Sector positioning had limited impact on performance.

Philosophy & process

The majority of capital within the fund is allocated to the Quality category at 41.8%, which has grown by c.5% over the quarter due to a strategic portfolio construction decision to take profits in some recovery holdings. The Recovery category has been reduced to 25.8%; however we remain confident in significant future total returns from the stocks retained in this category. The portfolio retains a strong skew to the higher scoring stocks with 70.4% in the top 3 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. We 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. It is our 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 Activity

Monthly reports have detailed much of our activity during the quarter, however to summarise we sold strongly recovering Mining stocks Petropavlovsk and Aquarius Platinum and underperformer Cohort. We exited +£1bn market cap Recovery holdings GKN, Inchcape and Persimmon. We sold the domestic, consumer focused William Hill and HMV. We purchased high quality media companies Aegis and United Business Media. We also purchased high quality De la Rue, Cranwick, IMI, International Personal Finance and Filtrona and also added to high quality existing holdings Beazley and Chesnara. We bought Recovery stock Kcom and helped re-finance the asset-backed MWB.

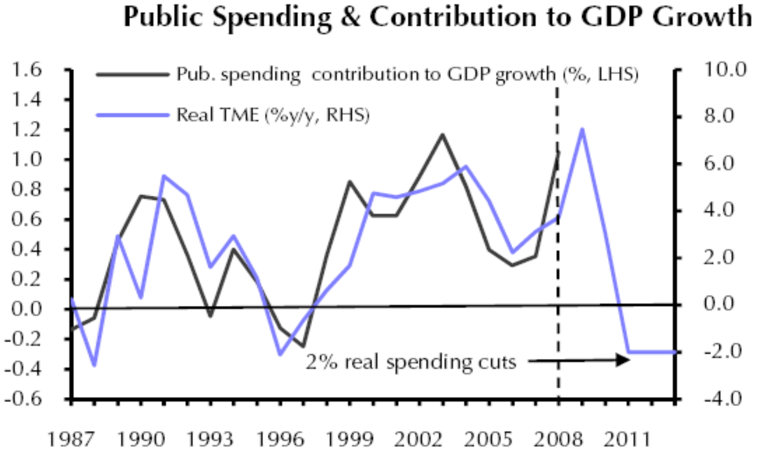
Market Outlook

At the end of the decade it feels natural to indulge in longer-term predictions of what the future may hold. In 2010 our 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 we believe will shape the next ten years, will also, we 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 very 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. We have biased the fund to overseas earnings and have limited, highly selective public sector exposure.

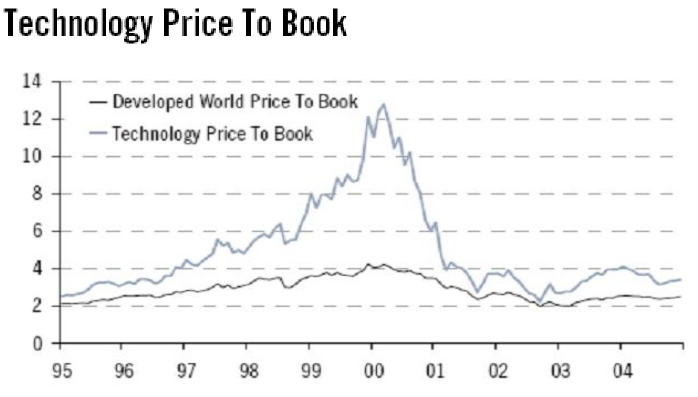


Source: HM Treasury

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. We are currently unconvinced the conditions for that confidence to return will emerge in 2010, although profits will be on the mend.

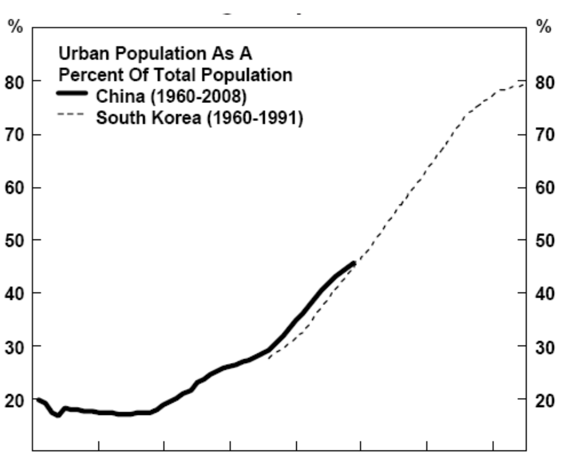
We are acutely aware of the ‘post-bubble’ equity valuation environment in Technology, or Japan, where investors have been broadly reluctant to re-value the ‘theme’ and are still concerned over the extent and nature of the impairment cycle in the UK. There remains material profit and valuation recovery potential over the longer term. We are underweight Financials, have been gradually building our overweight Real Estate exposure but being a small cap fund have no exposure to Banks.



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. We expect new all-time highs in the commodity complex in the next decade and currently allocate over 8% of the fund to Mining and Oil companies.



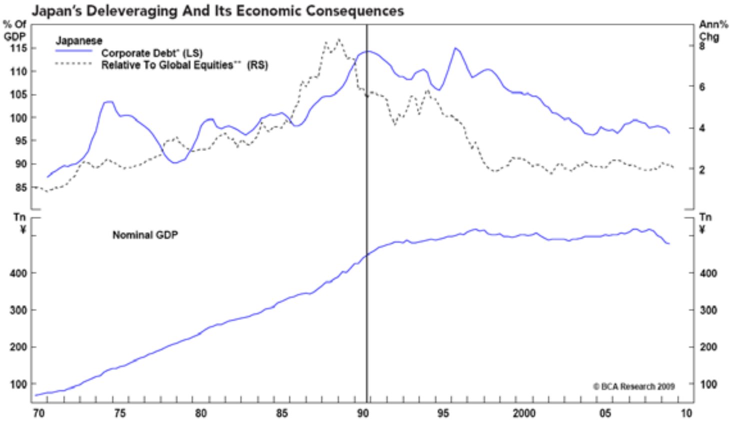
Source: BCA

4. The disruptive progress of technology, Britt

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. We have no doubt further evolution will be rapid and transformational in the next decade. 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 on 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 21% allocated to 'TMT' and continuing to identify '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, another outcome could be 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 we 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 our 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.

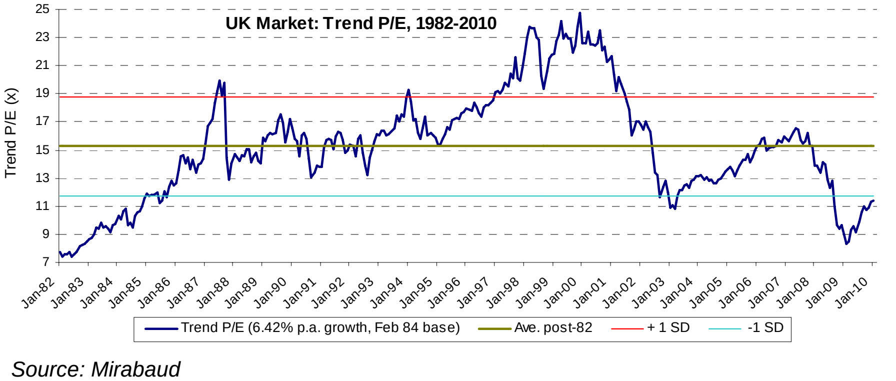
Charles Bronson, who played Bernado, was extremely successful in building a global acting franchise and adapting his career to changing movie tastes. His move from Westerns to the highly successful Death Wish series (no link here to healthcare, but coincidently premiered in the hung-parliament year of 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 this large cap sector is near all-time relative lows. New management teams have at last been adapting their business models to the next decade's outlook.

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.

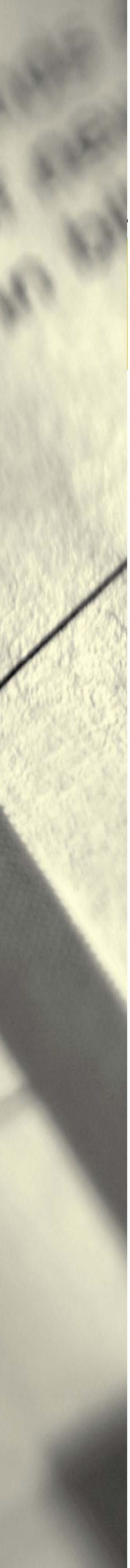
Summary

The Fund is built via a bottom-up stock selection process based upon our PVT philosophy. We 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 have 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 our investment approach over the decade to come. John Sturge's (Director) budget was $3m. Recently released Avatar's pre-marketing budget was $300m. Whilst initial viewing figures appear good, will it release a 50th anniversary boxset? Which will have the best long-term return on investment? It's all about starting valuation...



Source: Mirabaud

Richard Staveley & Dan Hanbury
Portfolio Managers



Fund Facts

Launch date	30 Nov 2006
Fund manager:	Dan Hanbury & Richard Staveley
IMA sector:	UK Smaller Companies
Benchmark:	HG Smaller Companies ex-IT
Tracking error range:	4-10%
Product capacity:	£400m (pooled & segregated)
XD dates:	1 April & 1 October
Dividend/Accumulation payment date:	31 May and 30 Nov

Share class:	A	Z
Launch price (shares):	100.00p	500.00p
Share classification:	Retail	Institutional
Type of shares:	Income	Accumulation
Fund charges:		
Annual	1.50%	0.00%*
Initial (up to)	5.25%	5.25%
*AMC charged outside the Fund		
Minimum investment		
Initial	£1,000	£5 million
Subsequent	£500	£50,000
Sedol	B1DSZR9	B1DSZS0
ISIN	GB00B1DSZR91	GB00B1DSZS09
Bloomberg	RMUKSAI LN	RMUKSEA LN

Important Disclosure:

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