

RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Unconstrained Fund I Quarterly Report
December 2009

River and Mercantile

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UK Equity Unconstrained Fund – Quarterly Report

Fund Aim

The investment objective of the Fund is to achieve capital growth through investing in a concentrated portfolio which will primarily consist of UK equities. The Fund will not be restricted by reference to a benchmark, sector constraints or company size.

Portfolio Summary

Strategy AUM	£281m
Strategy Capacity	£1bn
Number of stocks	37
Largest Holding	BP 6.02 %

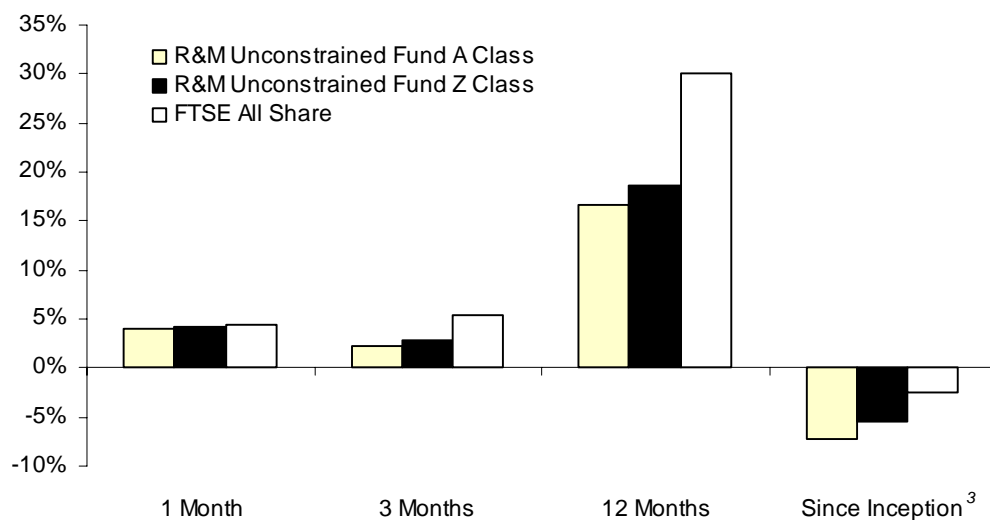
Risk Analysis Summary

Portfolio Volatility	15.79 %
Benchmark Volatility	16.18 %
Tracking Error	5.06 %
Portfolio Beta	0.93
Active Money	56.70 %

Performance to 31 December 2009

Retail "A" Class Shares	Fund ¹	Index *	Difference
1 Month	4.10%	4.34%	-0.24%
3 Months	2.30%	5.47%	-3.17%
12 Months	16.57%	30.12%	-13.55%
Since Inception ³ (%p.a.)	-7.16%	-2.41%	-4.75%

Institutional "Z" Class Shares	Fund ²	Index *	Difference
1 Month	4.26%	4.34%	-0.08%
3 Months	2.74%	5.47%	-2.73%
12 Months	18.63%	30.12%	-11.49%
Since Inception ³ (%p.a.)	-5.54%	-2.41%	-3.13%



Source: River and Mercantile Asset Management LLP

*Index: FTSE All Share (Total Return)

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

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

³Inception date 22 March 2007

Market Background (Q4 and 2009)

The UK equity market put in another strong performance in Q4, climbing by 5.5%. The out and out recovery trade (financials and cyclicals) gave way to global growth stocks driving the market, whilst domestic consumer cyclicals and financials gave back some of their recent gains. A more general rotation from pure value back into growth and quality (both cyclical and defensive) also occurred at an aggregate level. At the stock level, the best-performing companies and sectors in the market were resources stocks.

For 2009 as a whole the MSCI Developed Market World Index finished up 27% in Dollar terms, its best annual performance since 2003. However, the Index was down 25% by early March, and has since rocketed upwards by almost 70% – so most will register 2009 as a remarkable year. The UK market climbed 30%, the lower return reflecting the weaker dollar which is the currency in which the majority of the UK market's profits are earned, but nonetheless a strong return.

Most emerging market countries outperformed developed ones, with the MSCI Emerging Market Index up 59% during 2009. The best buy strategy for 2009 was simply to play price reversals, as those sectors that performed terribly during the slump in 2008 generally enjoyed the best rebound. Mining and Oil Equipment & Services led the way. Among the laggards, Utilities, Non-life Insurance and Telecoms stand out as the poor performers. These sectors lost significant amounts during 2008 and failed to make a strong bounce back in 2009. Other weak performers such as Pharmaceuticals were laggards in 2009 but much of this was simply because they fell the least during the slump. On a two year view Pharmaceuticals rank among the best performing sectors.

How did we perform and why?

Quarter:

The UK Unconstrained Fund underperformed, returning 2.7% against the FTSE All Share Index return of 5.5%. Best performing stocks in the fund were the miners as well as growth stocks Chemring, Booker and newly purchased Smith & Nephew. Poor performing stocks comprised mainly financials; non-life insurers Hiscox and Amlin, Barclays and LSE, as well as our technology stocks Pace and Logica which gave back some earlier gains. Dana Petroleum underperformed an otherwise strong oil E&P sector due to hitting a number of dry wells. At a sector level, stock selection in the financials and oil & gas sectors were the greatest detractors.

Year:

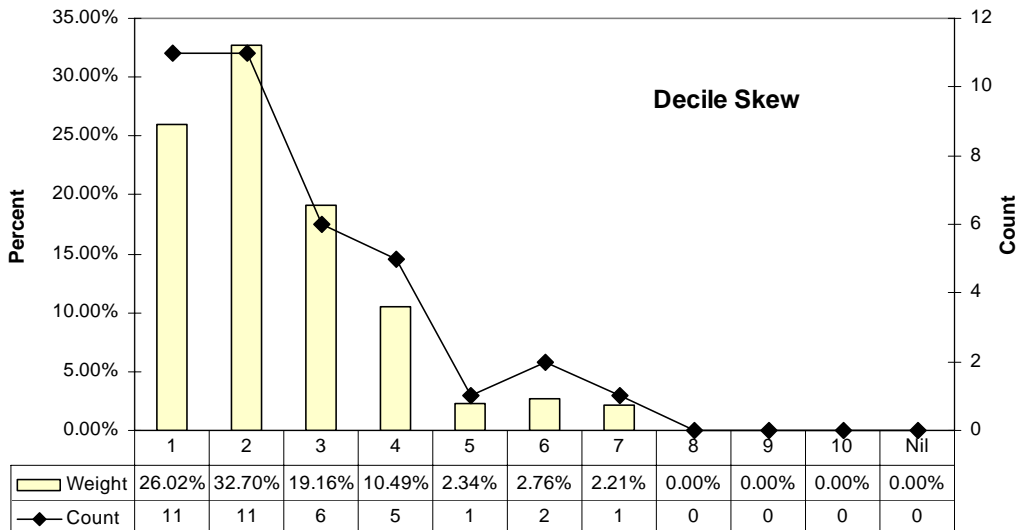
Last year was my first full year of underperformance in 10 years of managing money. Given the market conditions and the styles driving the market I would have expected, in hindsight, to underperform but the extent of the underperformance is extremely disappointing (11.49% relative to the FTSE All Share). What did I get wrong and what can I learn from the experience?

I have analysed factor returns in previous reports and do not intend to repeat that here except to say some quality factors began to work better whilst momentum was again negative during Q4. Being whipsawed throughout the year by reversing technical momentum was the greatest detractor, which was exacerbated by an overly cautious view of the rebound in the Chinese economy. The combination of high beta, low quality cyclicals and financials has been an uncomfortable focus for me and my timing in and out of those stocks has been found wanting. However, I believe the recovery phase of the cycle is ending (see *Portfolio Strategy*) and feel confident the portfolio will deliver strong relative returns in future.

Factors are starting to work in my favour as the market moves into a growth phase in the cycle. As a result, a greater focus on PVT stock selection and better execution will be my focus for 2010.

Does the portfolio reflect our Philosophy & Process?

The portfolio is currently tilted towards high quality, undervalued companies which have the best chance of outperforming through an uncertain global economic outlook. During the quarter we reduced our exposure to recovery stocks and asset backed stocks. In all cases we continue to rotate the portfolio into strong PVT ideas where we see medium term potential for companies to create significant shareholder value, on low valuations and where earnings upgrades are more likely to occur in future.

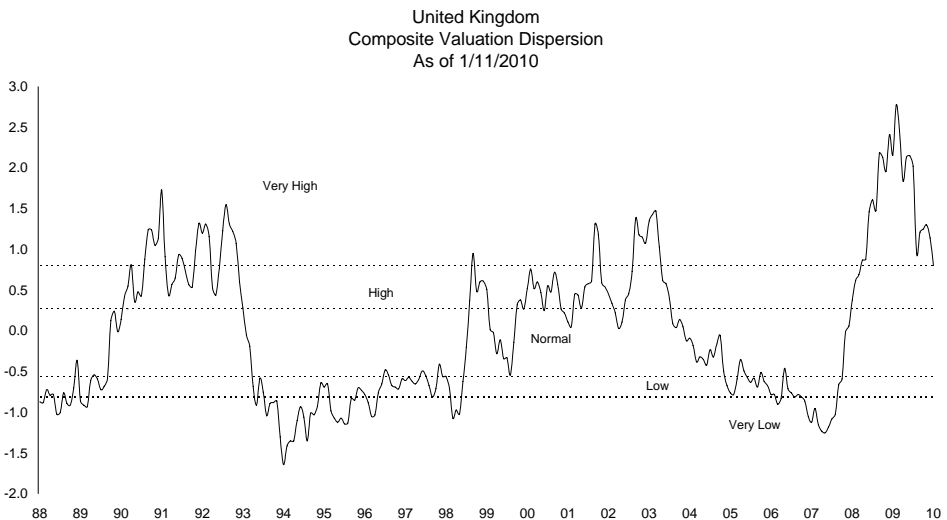


Source: River and Mercantile Asset Management LLP

What themes occupy us at the moment?

Value Dispersion

Dispersion (the gap between high and low rated stocks) within the UK market has reduced significantly during the market rally but remains reasonably high with the market still uncertain about future earnings trends. In the medium term this should favour a continued bias to cheap stocks from here.



Source: Bernstein Research

Savings Ratios

My only economic comment this quarter is around savings ratios. Much of the earnings rebound in 2009 and 2010 will have been driven by company cost-cutting to repair margins, but at some point we need to see some top-line recovery. Despite the growing influence of China, end demand for many companies, directly or indirectly, remains heavily dependent on US consumption. Whilst the US savings ratio spiked in the middle of 2009, we have recently seen a reversal. It is still at <4% when the long run average is nearer 8%. In the UK the savings ratio has recently risen to over 8% but consumer retrenchment in the US, which will reduce the ultimate end demand, has a long way to go in order to deleverage stretched balance sheets. Once again this retrenchment has been delayed by the actions of central banks as it was between 2002 and 2007. Overall market returns are negatively correlated with changes in the savings ratio, such that a rise in the US savings ratio during 2010 could make meeting the market's high/medium term growth expectations difficult.

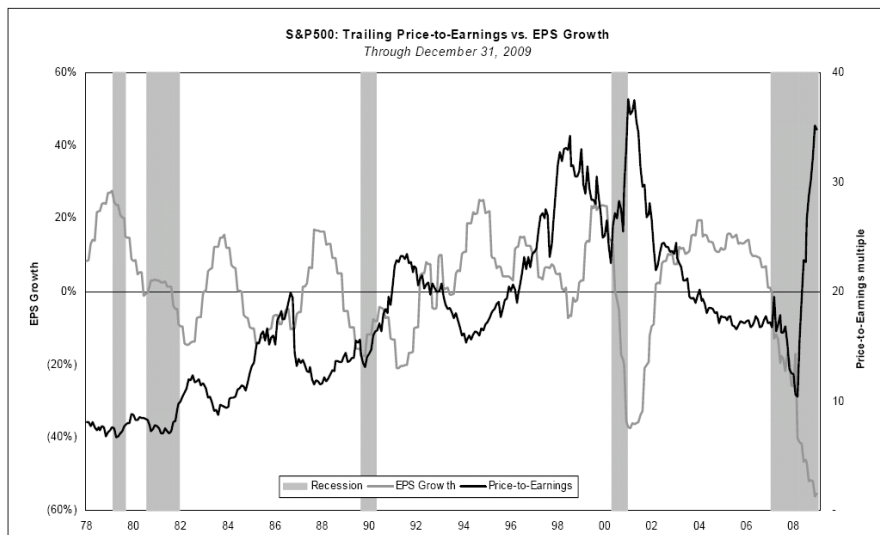


Source: Bernstein Research

Portfolio Strategy

Sector and factor returns

The re-rating of the market in the past 12 months has been aggressive but we are at an inflection point; every time earnings growth accelerates, the market multiple contracts.



Source: Factset, Bernstein Research

Sectors

A study of empirical data when the PE/market multiple contracts reveals that, at a sector level, high quality, more defensive, sectors tend to outperform, including utilities, healthcare, energy and defence.

Relative Sector Performance during Periods of Significant (>5%) Multiple Expansion / Contraction														
Annualized Average Monthly Returns (1965 - December 2009)														
	Outperformers						Underperformers							
	Utilities	HC Srvcs	Cons Stpls	Energy	HC Prods	Defense	Trans-ports	Telecom	Commo-dities	Fins	Cap Eqpmt	Cons Cycl	Auto & Hsng	Tech-nology
Expansion	(33.2%)	(4.0%)	(13.4%)	(13.6%)	(9.2%)	1.9%	3.8%	(18.8%)	4.1%	9.2%	13.1%	10.7%	14.6%	19.7%
Current Expansion	(28.3%)	1.6%	(11.6%)	(10.0%)	(14.7%)	0.6%	9.1%	(27.2%)	12.6%	22.8%	19.4%	(2.0%)	45.0%	11.5%
Contraction	35.7%	23.7%	14.8%	13.7%	13.6%	5.3%	0.0%	(0.5%)	(5.9%)	(7.4%)	(7.6%)	(10.3%)	(11.7%)	(18.2%)

Source: Factset, Bernstein Research

Factors

At a factor level, earnings revisions also matter when the market multiple contracts, and cheap stocks with good trends are also rewarded.

Efficacy of Selected Quant Model Factors during Periods of Significant (>5%) Sequential Multiple Expansion / Contraction										
Average Annualized Monthly Q1 - Q5 Spread (1965 - December 2009)										
	Selected Factors									
	Overall Model	Super Factor			Valuation			Capital Use	Growth	
		Valuation	Capital Use/ Profitability	Dynamics/ Investor Sentiment	Forward P/E	EV to EBITDA	Total Yield	ROE	3-Month Smoothed Revisions	ROE Vol
Expansion	3.8%	8.9%	(1.1%)	(3.0%)	(6.2%)	1.4%	(20.8%)	(2.1%)	(6.8%)	(25.1%)
Contraction	30.8%	33.4%	17.1%	5.5%	47.6%	44.7%	52.6%	27.9%	20.4%	41.5%
Overall	14.6%	11.3%	9.0%	7.1%	6.6%	9.6%	4.8%	4.7%	8.8%	(0.3%)
Current	(8.3%)	39.7%	(15.6%)	(70.2%)	6.30%	32.7%	10.9%	(45.3%)	(69.8%)	(34.4%)

Source: Factset, Bernstein Research

We are likely to see strong estimate upgrades across the market as we move through the first half of 2010. However, earnings growth expectations are now priced to be significant so a focus on achievability of earnings estimates remains a **priority**. This, in combination with investing in companies with pricing power (i.e. companies able to pass on price rises to customers), has been proven to be a good investment strategy in most market environments and will remain so going forward. Capacity utilisation rates remain very low globally and, in an effort for companies to drive greater volumes, they are likely to compete on price. Whilst longer term inflation is of great concern for a myriad of reasons, I believe pricing for companies will become difficult this year and next. Companies with strong market positions and the ability to expand gross margins should be in the strongest position to re-rate against the market.

The above analysis suggests we should get more joy from our PVT strategy than last year. High scoring PVT stocks with overweights in quality defensives, defensive growth as well as some exposure to deep cyclicals (energy and miners) is where we are positioned. We are underweight financials, consumer and industrial cyclicals.

Portfolio Activity

Purchases

Purchases and sales can be grouped within a range of themes. Global cyclical growth - **Anglo American** was added to (an opportunity for significant self help and restructuring), **Antofagasta** purchased (high quality growth – the strongest production growth for the next 5 years of the majors), **Wood Group** was purchased, a global oil services company (most conservative of the large and mid caps in terms of contract accounting and modest growth expectations versus peers). **Wolseley Group** was the only recovery stock added to during the period – an undervalued building merchant with leading market positions globally. Within the defensive and defensive growth end of the market **Smith & Nephew** (a high quality medical equipment company) was bought, **Unilever** (a high quality food producer) was added to, as was **Imperial Tobacco** (high quality defensive). Larger positions have been going into high quality defensives.

Sales and reductions

Several of our financials stocks were sold or reduced during the period. **Lloyds** was reduced ahead of expected future fund raisings (recovery), **Legal & General** (UK Life Insurance) sold following doubts around the impact of regulatory changes, **Close Brothers** was sold after data continued to point to weak loan growth and tight credit conditions for UK SMEs, where Close has an especially high exposure. **London Stock Exchange** was sold (a high returning business but with deteriorating fundamentals) as well as **Home Retail** (a domestic retailer), **British Land** (domestic property), **Land Securities** (domestic property - reduced), **Daily Mail** (domestic media – reduced) and **BSKYB** (domestic growth – reduced on valuation grounds).

Outlook

Equity valuations in the UK market remain reasonable in an historic context but not cheap. Much of the value dispersion has unwound but there continue to be value opportunities at a stock level. Leveraged economies (low savings ratio and large government deficits) suggest continuing volatility in GDP growth expectations and, by definition, stock markets. This year looks to be no different with economies now vulnerable to any fall in stimulus. Forecasting is folly, but a deflationary shock remains the greater risk for 2010 and understanding the risks remains paramount, whilst being mindful of the widely reported risks of inflation from deficit spending and monetary debasement. Sentiment has moved to being reasonably optimistic following the rally into the end of 2009. Markets appear to be once again pricing in a benign scenario which suggests the market may start paying a premium for quality as we move through 2010.

I expect PVT stock selection to improve and we own a portfolio of companies with strong prospects. In particular, Quality stocks with valuation support and earnings visibility to outperform as we move through the year. My focus is firmly on Quality and Growth stocks, capable of growing on cheap valuations. I continue to have high conviction in Pharmaceutical and Healthcare stocks (Glaxo, AstraZeneca, Smith & Nephew), Non-Life Insurance (Amlin and Hiscox), defensive growth stocks like Booker and Xchanging, as well as high quality stocks on low valuations that have lagged the 2009 rally, such as BAE Systems, Reed Elsevier, British American Tobacco and, more recently, BG. This has to be balanced with the prospect of continuing global deflation. The strong performance in Asian growth and resources stocks is bringing back memories of early 2007 and, as such, I am focused on stock selection rather than being overweight this popular area of the market.

Dan Hanbury
Portfolio Manager

Fund Facts

Launch date	22 March 2007	
Fund manager:	Dan Hanbury	
IMA sector:	UK All Companies	
Benchmark:	FTSE All-Share (Total Return)	
Tracking error range:	N/A	
Product capacity:	£1bn (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	1.75%	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	B1NG829	B1NGCT4
ISIN	GB00B1NG8296	GB00B1NGCT49
Bloomberg	RIVMERA LN	RIVMERZ LN

Important Disclosure:

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