

RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Income Fund I Quarterly Report
September 2009

River and Mercantile

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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.

Portfolio Summary

Strategy AUM	£9.5m
Strategy Capacity	£1bn
Number of stocks	82
Largest Holding	HSBC 6.76%
Historic Yield	N/A

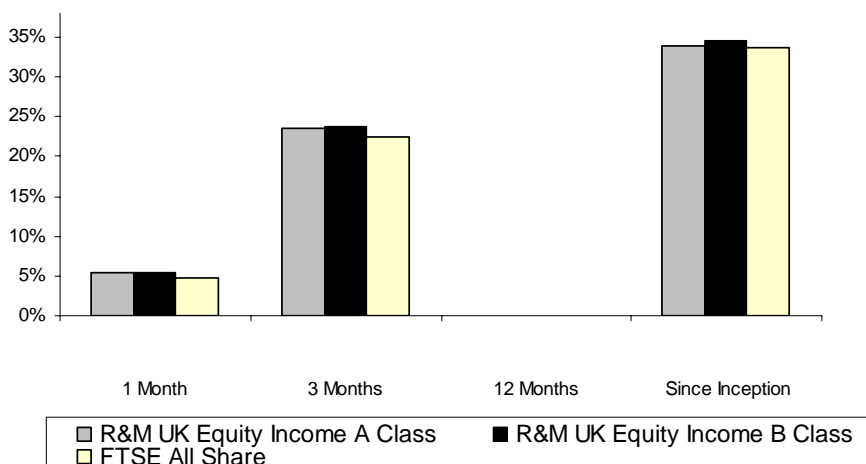
Risk Analysis Summary

Portfolio Volatility	17.29%
Benchmark Volatility	16.09%
Tracking Error	3.36%
Portfolio Beta	1.06
Prospective Historic Yield ³	5.20%

Performance as at 30 September 2009

Retail "A" Class Shares	Fund ¹	Index *	Difference
1 Month	5.32%	4.72%	0.60%
3 Months	23.60%	22.38%	1.22%
12 Months	-	-	-
Since Inception ²	33.98%	33.70%	0.28%

Asset Manager "B" Class Shares	Fund ²	Index*	Difference
1 Month	5.39%	4.72%	0.67%
3 Months	23.83%	22.38%	1.45%
12 Months	-	-	-
Since Inception ²	34.63%	33.70%	0.93%



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

²Inception date 3rd February 2009

³Yield based on the historic dividends of the current holdings of the Fund.

Market Overview

It appears the market's advance has been inspired by Usain Bolt, world records are being despatched faster than Norris McWhirter could have written them down. All economic data confirms that we are in the recovery phase of the stock market cycle. Economies are growing again, company profits have bottomed-out and indeed are starting to surprise in a positive fashion, and risk appetite is slowly returning to more normal levels led by credit spreads that have narrowed markedly from crisis levels. Large companies are even embarking on over-priced m&a; I wish Kraft Foods good luck in presenting their return on investment performance to shareholders in five years time on the purchase of Cadbury's on a 2008 Ebitda multiple of c.16x. However, as with Mr Bolt, we all knew he didn't really try his best for the full 100m when winning Olympic Gold and in short order went on to further world record success this year. This market doesn't appear to be trying its hardest yet either.

The FTSE All Share Index delivered a positive return of +22.4%. The winners and losers were again pretty clear cut, and driven by top-down factors. Cyclical and recovery stocks did well, led by the bombed-out financial sectors; defensives struggled with Utilities particularly weak. The size effect was less noticeable than in the second quarter, with small and mid caps out-performing modestly. The value factor remained strong, but was still driven by metrics such as Price-to-Book and not Dividend Yield which (like momentum factors) was a poor contributor early in the quarter but has now started to improve.

I remain convinced that relative to UK Government Gilts or returns on cash, the yield still represents an attractive entry point for UK equities, which should protect investors against inflation and offer real growth in returns over the medium-term. Bears are likely to have a further period of difficulty ahead of them, which may only be temporarily satisfied by a short-term alleviation of technically overbought conditions. "A fanatic is one who can't change his mind and won't change the subject." Sir Winston Churchill.

Performance

The fund outperformed the benchmark, the FTSE All-share Index, during the quarter by 1.19%, rising 23.83%. Recovering cyclicals were positive for performance such as Ashtead, Charter, and Daily Mail whilst self-help recovery situations also performed well such as Delta and Psion. Financials such as Legal & General and Lloyds were positive whilst Gold producer Peter Hambro Mining (re-named Petropavlovsk) moved materially higher. The positive market environment has meant generally defensive holdings have held back performance, such as Sainsbury's and British American Tobacco, but McBride, the private label consumer goods manufacturer was very helpful to performance in September. No exposure to benchmark heavyweights Standard Chartered and Cadbury was unhelpful during the period. However, being underweight BG was positive and I have added to the position into the stock's weakness on continued upbeat exploration updates. Other weaker holdings include the gambling companies 888 Holdings and William Hill, and public spending exposed holdings such as BAE Systems, Morgan Sindall, and RM.

Philosophy & process

The majority of capital within the fund remains allocated to the Quality category at 54%, this having fallen slightly over the quarter due to the continued strong performance of the Recovery category, now 34%. Early in the quarter I gained higher conviction in the Asset-backed category which now represents 5% of the fund. 75% of holdings are currently in the top 4 deciles indicating a slightly improved skew to high scoring stocks over the quarter. It shouldn't be a huge surprise to unit-holders that the 'Timing' factor has been of limited help to performance in 2009, indeed neither has a higher yield focused approach. However, I fervently believe that both these factors will return to long-term trend performance sooner rather than later and will provide a tail-wind rather than headwind to further outperformance of the benchmark in the future.

Year to date investment style performance by region (sorted by global performance %)

Investment Styles	Global	US	Eurozone	UK	Japan
Low versus high price to book	18.2	13.2	25.5	19.6	20.8
Small versus large market capitalisation	7.4	8.3	0.5	18.8	7.5
High versus low Year 2 EPS growth	7.1	20.2	2.3	-7.2	-15.1
High versus low historical EPS growth	4.5	4.5	0.3	4.2	10.8
Low versus high P/E ratios	3.9	3.5	12.9	5.1	-9.5
1-month price reversal strategy	2.1	0.6	8.4	0.7	-2.1
High versus low dividend yield	0.1	-11.0	14.3	0.3	17.6
High versus low historical EPS stability	-5.6	-10.1	-2.8	-9.1	7.6
High versus low long-term EPS growth	-8.2	-9.4	-2.3	-4.6	-15.4
High versus low relative price momentum (3m mav)	-11.8	-12.8	-17.2	-1.5	-7.1
High versus low EPS momentum	-15.3	-14.4	-12.4	-21.8	-17.5
High versus low Year 1 EPS growth	-15.3	-13.3	-11.8	-20.7	-23.2
Low versus high dispersion of analysts' forecasts	-21.0	-19.4	-21.7	-31.5	-17.7
Low versus high Beta	-24.1	-24.7	-25.3	-28.2	-17.1

Source: SG Quantitative Equity Strategy Research

Portfolio Income

59 holdings went ex-dividend during the quarter. Of these only 8 were down on the prior year, including the high profile HSBC, BT, Legal & General and property stocks. 12 holdings held their payments, a number being cyclicals where our analysis earlier in the year indicated their balance sheets and franchises and thus security of payout was much higher than the implied high yields suggested at the point of purchase such as Ashtead, Daily Mail, Charter, Psion and Fiberweb. This leaves the 39 holdings which raised their dividends during the quarter. I think it is worth reflecting on the negative slant many market commentators are making on cautious management "outlook" statements, rather than positive Board decisions to reward shareholders with a growing income in a low inflation environment based upon the medium-term earnings power of the business. Following on from the fund's 1.07p distribution earlier in the May, we will distribute a further 2.75p in November.

Portfolio Activity

New sales and purchases have been detailed in the previous monthly reports. To summarise I have built a diversified overweight sector position in Real Estate via purchases of Segro and Land Securities. I have materially narrowed the Mining underweight via adding to Rio Tinto and purchasing Anglo Pacific. I have gone overweight Pharmaceuticals via AstraZeneca and found other high quality attractive investments such as Sage and Cranswick. I have moved underweight HSBC after strong performance and switched the capital into the considerably cheaper Barclays and Intermediate Capital Group. I have partly switched Telecommunications exposure from large caps into small cap special situations such as Kcom and Daisy. I continue to find Recovery situations where despite having missed the 'bottom', the shares appear to have material further upside such as Regus, BBA Aviation, ITE and Laird. I exited Centrica taking Utilities from very little capital to Zero weight. I expect further bad news for income investors in this sector, particularly the water stocks as the implications of the latest regulatory review are further clarified.

During the quarter I booked significant profits via the sale of Mothercare, Restaurant Group, Rensburgs, RWS and Rightmove, valuation being the marginal driver of these decisions. The same cannot be stated for the sales of Novae and Hardy Underwriting whose sector remains under pressure and Management Consulting which warned on profits.

The fund remains overweight financials, with sector risk being concentrated in well capitalised General Financials, Life Insurance and Real Estate rather than Banks and a reduced weighting in Lloyds underwriters where the rating environment outlook is not as attractive as I expected. I remain overweight smaller cyclical sectors such as Technology, Industrial Engineering and Electronic equipment. Within defensives I favour Pharmaceuticals, Food producers and Defence rather than Utilities and Beverages. I have added to Resource positions but remain underweight as dividend

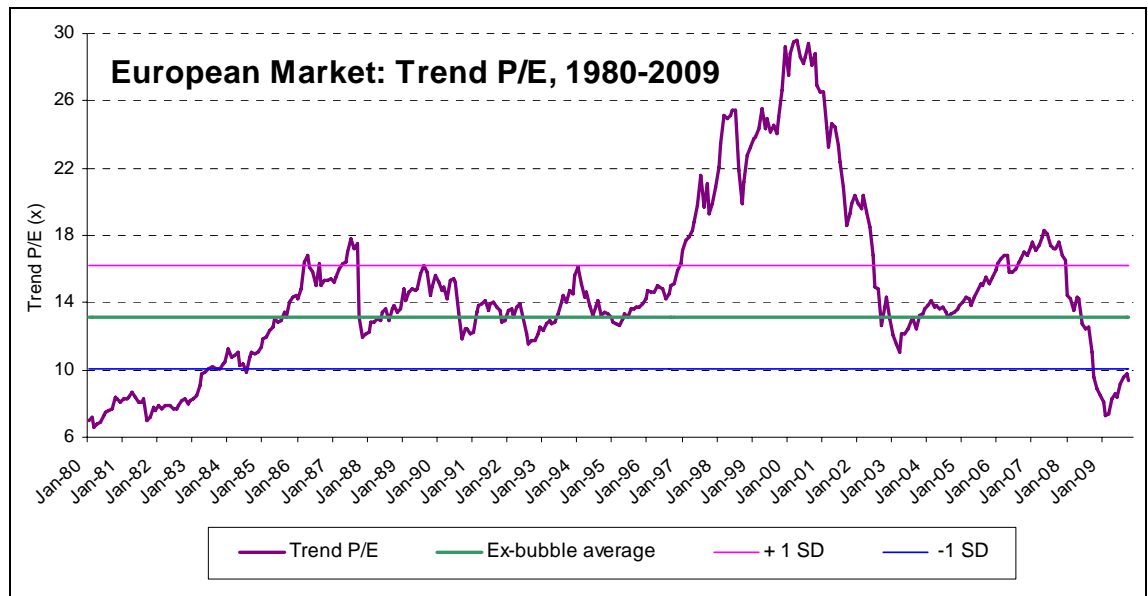
yield is hard to come by currently in this area apart from the Oil majors, however the prospects for very strong growth in payouts in the medium-term is improving markedly.

Market Outlook

There is increasing evidence that the world economy is beginning to respond to the fiscal and monetary stimuli implemented around the globe. Historical context suggests that the economic rebound will be sharp at first, providing “V-shaped” protagonists with a pat on the back. The market has clearly partly discounted this outcome but it clearly feels more comfortable for investors to question the rally from a negative rather than optimistic perspective at this stage. As I have stated before one must not forget the extent of the falls before the rebound when worrying about the percentage gains since the low point in the market, however I do expect the pace of positive market movement to slow like Mr. Bolt before going on to greater heights.

Behaviorally, I believe the frightening effects of last year’s crisis and their implications for livelihoods, asset pricing and wealth still remain fresh in the mind and most commentary remains overly focused on the wealth preserving “calling the top” of the rally and not the “wealth creating” potential of the full upside opportunity. Given the size of the negative output gap and consensus on avoidance of an extended deflationary experience “at all costs” by monetary authorities, it seems very clear to me that the monetary policy will remain highly accommodative for some time, thus supporting asset-inflation trends including equities. If the stimuli are over-egged we could have a Ben Johnson style after-shock.

On cyclically adjusted measures, markets remain undervalued based on the last 30 years and enough commentary has been made regarding the “hoards of cash” or non-equity based investments that could be reallocated in support for equities if investors fully return on mass. My concerns remain three-fold. I have detailed these before namely monetary policy error (West and East, biggest risks to East), resource-price bottle-necks and the effects of the necessary de-leveraging of the Anglo-Saxon economies which still remain ahead and not behind us.



Source Mirabaud

In the next 12 months though, fiscal support is likely to wane and private sector consumption and business investment needs to materially pick-up. It is the chance that this does not occur which will ensure monetary stimulus remains strong. On this basis the medium-term outlook is clearly getting more inflation prone, which is why, now that the market has digested the inevitable weakening of strategic resource buying in China that I was previously concerned about, I have added materially to the

Funds resources weighting. As the marginal key buyer of resources I have more faith in Chinese private sector and business investment picking up post stimuli than in the UK or US.

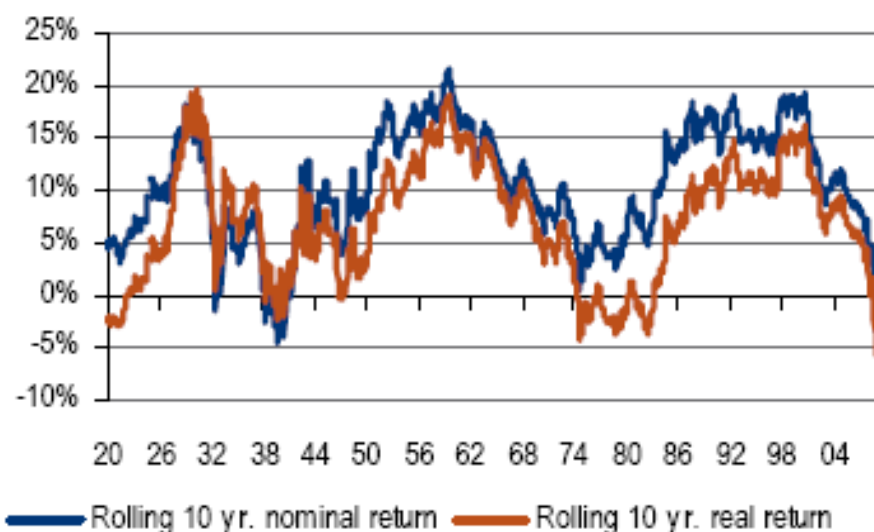
Taking a strong cue from credit spreads, I am comfortable that the funds 26% weighting in Financials is appropriate as valuations remain very depressed and that this area now has clear Timing attractions as well in addition to Recovery Potential and should continue to lead markets. However I remain comforted that 22% of the fund (and a higher proportion of Income) is derived from stalwart dividend payers such as Vodafone, BAT, GlaxoSmithKline, AstraZeneca, Unilever, BAE Systems and Sainsbury's in addition to the oil majors whose cash flow is generated predominantly globally.

It appears the political consensus has moved to accepting that public sector cost structures need addressing, I hope the speed at which this is tackled accelerates under the new government in 2010 to an Usain Bolt tempo. I'm afraid he will remain the man who (smartly) collected Gold assets rather than the current Prime Minister who, to quote Rowan Atkinson, is about "as useful as a one-legged man at an arse kicking contest."

Summary

I am pleased the Fund has generated 3.82% dividends in the first eight months since launch. This is well in excess of the income return in many other asset classes during the period. The Fund continues to avoid huge sector risks against the market and add value via stock selection across the market cap range. I continue to maximise the Small Cap exposure at c.15%, but do ensure that stock specific risks are mitigated by a diversified approach to best ideas in this area. In the short term, the market's direction is always tough to call consistently correctly, and as mentioned is technically due a pull-back from 'over-bought' conditions, which when occurring may frustrate the bears in its brevity and extent. However, over the last 90 years or so whenever the 10 year rolling return in the stock market has been negative it has resulted in positive real returns over the subsequent 10years. The chart below brings us up to date following the recent rally and still suggests that taking a medium term view should provide positive real returns for investors.

Chart 3: S&P 500 10yr annual returns



Source: BOS-ML

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

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