

RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Long Term Recovery Fund | Quarterly Report
September 2009

River and Mercantile

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Fund Aim

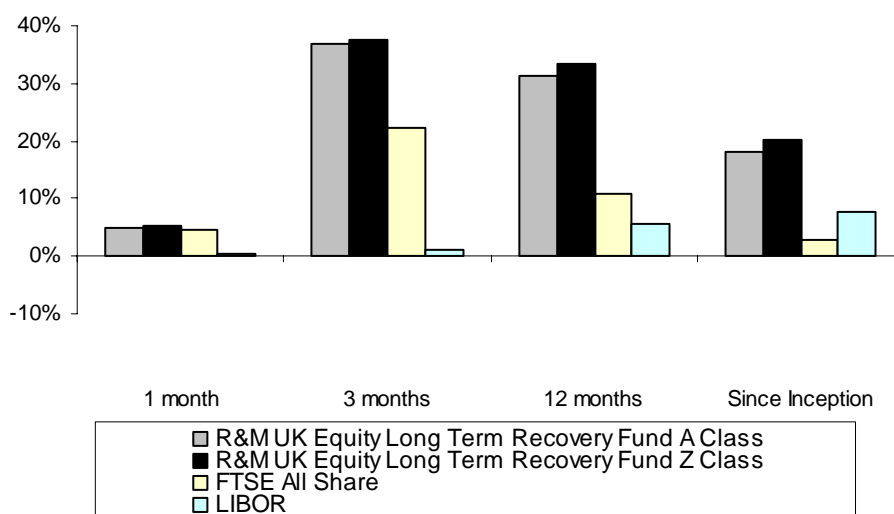
The investment objective of the Fund is to achieve capital growth through investing in a portfolio which will primarily consist of UK equities that meet the manager's recovery criteria of a turnaround in company profitability over the longer term. The Fund will not be restricted by reference to a benchmark,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

Portfolio Summary		Risk Analysis Summary	
Strategy AUM	£117.2m	Portfolio Volatility	19.76%
Strategy Capacity	£200m	Earnings Yield	9.03%
Number of stocks	131	Dividend Yield	3.11%
Largest Holding	HSBC 4.34%	Price to Sales	0.49
Average Return to Medium		Price to Book	1.02
Term Recovery Value	69%		

Performance as at 30 September 2009

Retail "A" Class Shares	Fund ¹	FTSE All Share	Difference	LIBOR
1 Month	4.95%	4.72%	0.23%	0.37%
3 Months	36.91%	22.38%	14.53%	1.15%
12 Months	31.22%	10.80%	20.42%	5.59%
Since Inception ³ (%p.a.)	18.04%	3.34%	14.70%	7.61%

Inst'l "Z" Class Shares	Fund ²	FTSE All Share	Difference	LIBOR
1 Month	5.11%	4.72%	0.39%	0.37%
3 Months	37.51%	22.38%	15.13%	1.15%
12 Months	33.49%	10.80%	22.69%	5.59%
Since Inception ³ (%p.a.)	20.08%	3.34%	16.74%	7.61%



Source: River and Mercantile Asset Management LLP

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 17th July 2008

Quarterly Comment

Quote for the Quarter

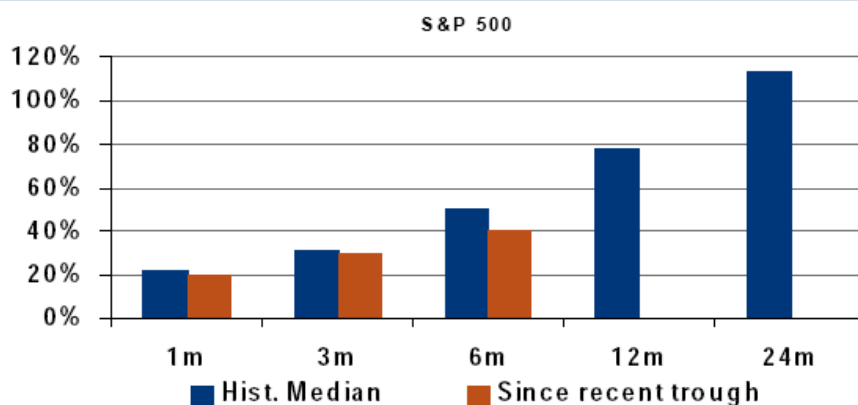
"It's like déjà-vu, all over again"

Yogi Berra

Key Observation

Few people can believe the speed of the equity market recovery, but as Yogi Berra (and our stock market cycle work) suggests, we have probably been here before. Indeed if one actually looks at the historical numbers, and Merrill Lynch have done just that, then the speed of this rally has been bang in line with the twenty recovery phases that have been observed since the 1930's. The key to this observation is the extent of the fall – the bigger the fall over the last eighty years, the larger the recovery – and the fall this time around was huge, so with the world no longer coming to an end, stock markets have been prepared to return towards more normal medium-term valuations.

Chart 1: Percentage of prior peak recovered over time



Source: BofA Merrill Lynch Global Research US Equity Strategy, Bloomberg, Standard & Poor's

My other déjà-vu, all over again moment is Healthcare investment. In the early nineties the recovery phase of the stock market cycle was similar to today - the recession was led by real estate, banks were in trouble, and cyclicals became very depressed so that when they bounced back they did so with a vengeance. The result was that some quality sectors just became sources of cash for the more exciting recovery stories, and the sector that de-rated most due to the US Democrats' desire for reform was healthcare - these stocks fell to half their historic valuation metrics, providing a great buying opportunity. I remember Tony Dye (PDFM) taking a huge stake in Wellcome and making a fortune for his clients in doing so. Fast forward to 2010, and I think there will be a similar opportunity. The sector is led by the US market; their healthcare companies are now trading 100% cheap relative to long-term valuations as again investors focus elsewhere and worry about Obama's reforms, their top-line is mature but with cost efficiencies and mergers they can protect their prodigious cashflow. When the recovery stage of the cycle is complete (in 2010) sectors like healthcare could repeat their mid-nineties trick of becoming the quality leaders of the pack. 'Deja-vu all over again'.

Market background

Quarter:

It has been a very strong quarter for equities. All the data has confirmed that we are in the recovery phase of the stockmarket cycle. Economies are growing again, company profits have bottomed-out and indeed are starting to surprise in a positive fashion, and risk premia are returning to more normal levels led by credit markets that have bounced back very strongly.

The UK equity market delivered a strongly positive return of 22.4%. The winners and losers were again pretty clear cut, and driven by top-down factors. Cyclicals 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 cap outperforming but more modestly. The value factor remained strong, whilst momentum was a poor contributor early in the quarter but then started to pick up.

How did we perform and why?

Quarter:

As predicted last quarter we have sustained our positive relative returns with the portfolio returning +37.5%, an outperformance of the equity benchmark of +15.1% and clearly materially ahead of LIBOR which returned 1.15%. From our assessment of indicators such as value spreads, and the performance of classic recovery shares, we are between one half and two thirds through the alpha generation possible during this stage of the cycle. Positive returns from here will likely be accumulated more slowly, with earnings progress becoming a more important driver than the compression of risk premiums.

Key performance contributors

Quarter:

Positive: overweight the Recovery category and Value factor both of which performed well. Strong multi-cap PVT stock picking with key positive contributions from Galiform, IQE, British Airways, Avis Europe, and Citigroup. Three of the top ten contributors were non-UK stocks, helping validate our strategy of buying out-of-favour global franchises.

Negative: the main negative contributors to performance were at the stock level, with both 888 and Luminar having disappointing trading updates. We have been reducing our exposure to both.

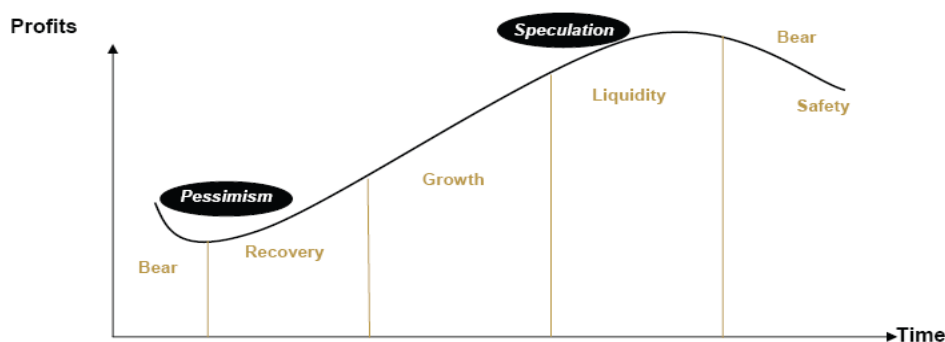
Longer Term Performance

Both the relative to benchmark and absolute returns are now robust since this strategy was launched fourteen months ago. Over this period the Fund has returned +24.7%, the FTSE All-Share +3.3% and Libor 7.6%. During the last leg of the recent bear market I was very grateful for the continued support of our investors, who deserve to have been handsomely rewarded for continuing to buy units as the discount to Medium Term Intrinsic Value widened to unprecedented levels.

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.

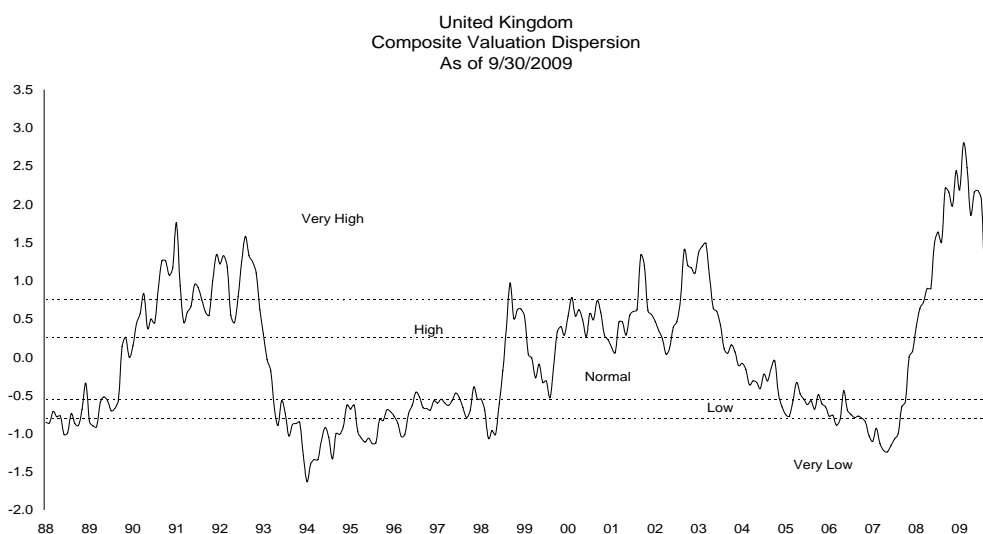


	STAGE 1 2003/4 1992/3 2009/10?	STAGE 2 2004/6 1994/8	STAGE 3 2006/7 1999/0	STAGE 4 2001/2 1991/2 2007/8
ECONOMIC GROWTH	Below Trend	Trend	Above Trend	Decelerating
MONETARY POLICY?	Loose	Neutral	Tightening	Loosening
CAPITAL?	Rationed	Sustainable	Mis-allocation	Withdrawal
RISK APPETITE?	Low	Neutral	High	Falling
VALUE SPREADS	High	Reducing	Low	Increasing
STYLE?	Value/Recovery	Growth	Momentum	Value/Quality
BUY?	Turnarounds	Where is growth?	Momentum	Earnings sustainability

Source: River and Mercantile Asset Management LLP

At the moment we are moving through the recovery stage of the cycle. Economies are now growing again but with the negative output gap being so large there is little pressure to tighten monetary policy. Risk appetite has returned, but value spreads are still above average (chart

below); return on capital is depressed but starting to recover, with profits now beating expectations. As a result earnings revisions have turned positive, a key driver for the equity market and recovery type shares in particular. Our scoring system for the cycle confirms that we are in the middle of the recovery stage.



Source: Bernstein

At this point you may well want to ask us what would constitute a warning bell regarding where we are in the cycle? The two key components of our analysis are the chart above, and the yield curve. So when value dispersion is modest, and the yield curve is flattening (i.e. short term interest rates moving up to par with long term government bond yields) then the recovery trade will be over. We are some way away from this yet.

Category exposure

Our hunting ground for new stocks to fit our objective of maximising long term wealth creation is evolving somewhat. Asset backed recovery stocks remain a productive source of new 100% return ideas, including Real Estate investments such as **Kenmore European** and **Songbird**. In addition to asset backed we are starting to find potential doublers amongst de-rated Growth and Quality stocks as investors focus their attention on more cyclical companies. We detail some examples in the activity section of this report.

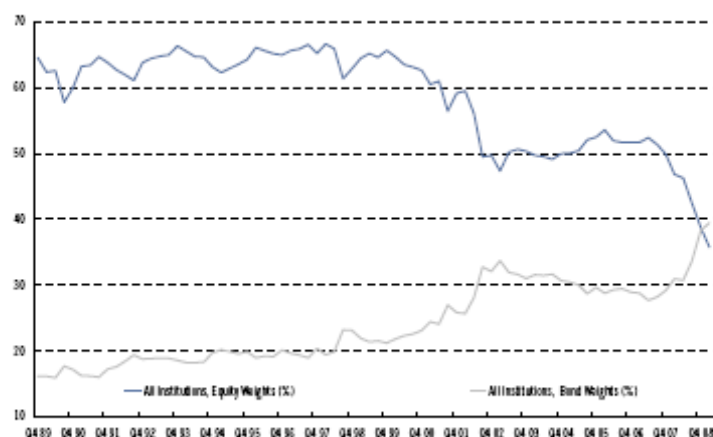
Equities – they are a good investment

Why does everyone hate equities, especially the UK variety? They don't like equities because they have gone up too much recently, they don't like them because they have gone up too little over the last ten years, they don't like them because they don't match liabilities, they don't like them because they are risky (unlike those fantastic risk-free government bonds!), and they especially don't like UK equities because they are not global. This list is a long one, and reflects what I have described in the past as an 'anti-bubble' in equities. The good thing about an 'anti-bubble' (for those rare supporters of equities) is that this is exactly the time to be strategically long of an investment class, when anti-sentiment prevails and, as a result, when VALUATIONS are attractive. Yes, this is the word I was looking for VALUATION. This is the key to long term returns from assets, not how well they did yesterday, not what the man in the street is telling you to do, not what pension fund regulators or bureaucrats in Brussels are forcing you to do (buy horribly expensive risk free assets). Just ask i) how cheaply you can buy shares today and ii) do you have the patience to hold them until the world is in love with UK equities again? My answer is i) very cheaply (even after the recent rally) and ii) yes.

As Jim O'Shaughnessy (author of 'What works on Wall Street') says, the flight from equities has become all pervasive, 'in many instances we hear that advisors are moving their stock allocation to just 15 percent...when we ask mutual fund wholesalers what they are selling, the answer is always "bond funds, bond funds, and more bond funds"'. And closer to home look at the chart below - UK Institutions (pension funds, life companies, mutual funds) now have more money in bonds than they do in equities, a cross-over that excites me almost as much as the equity versus gilt yield. The same report also noted that UK pension funds have more in cash (13.5%) than they do in UK Equities. This is pretty depressing for a UK Equity

manager, but at least I can reassure myself with the thought that it can't go much lower, can it?

Figure 17. UK Institutions – Equities Vs Bond Weights



Source: DataStream & CIRA

Back to Jim O'Shaughnessy for some wise counsel in these anti-equity times: "I believe that all these changes to asset allocation are coming at exactly the wrong time and that investors who follow this herd-like move to overweight bonds versus stocks will be bitterly disappointed. They are guilty of not looking at the long-term cycles of the market and therefore are blind to what has happened historically". And reading the FT as I write this, Jeremy Siegel backs all this up with some hard data: "For the 10 years ending last December stocks have offered a negative 3.1% for US investors, the fourth worst 10-year period since 1871. A look at history shows that the recent experience is not uncommon and excellent returns are available to those who survive rough patches...**without exception** for each 10-year return that fell in the bottom quartile, the following 10-year period yielded positive real returns and the median return exceeded the long-run average".

In conclusion, with a normalised earnings yield in excess of 10%, well over twice that available on government bonds and ten times cash returns, with a structural shift out of equities now largely done and with a ten year bear market behind us, the long-term investor should have lots of that hated thing, the UK equity.

The Timing Factor

The vast majority of investors and commentators are reluctant to believe in this market, with their mind-set more influenced by the credit crunch than the current recovery. This is normal for this phase of the stock market cycle as the pain is so recent (and the market rally so fast). But there is danger in this caution, as it causes a desire to aggressively profit take at what I would suggest is just the wrong time, to sell shares with emerging Momentum at the beginning of their upward trend. Just look at the recent returns to Momentum (terrible over the last six months) and one knows that the underperformance of this factor must soon come to an end. So whilst it is tempting to bank some winners this must not be at the cost of taking out too much T(iming) from our portfolios.

Consumer Leverage

Everyone is agreed, even the bulls, that the UK and US consumer are way over-leveraged. Just look at the charts that show how consumer credit versus income (or GDP) have evolved over the last few decades and we all really worry. BUT absolute credit is one-side (liability) of the story; the more than equal and opposite is the asset base (i.e. cash, investments, healthcare insurance, housing), and it is the net consumer balance sheet that is most relevant and this paints a different story. For example in the US, household debt as a proportion of disposable income has risen from 40% in 1953 to 130% today, but over the same period US household NET worth has increased from \$100bn to \$50,000bn, a fifty fold increase. Of course the savings ratio has been too low in the US and UK recently, and a natural cyclical response has seen it trend back to its long term average over the last year, but us consumers are not the basket cases that some commentators suggest.

Rolling back the State

The public has had enough of the State's interference in our daily lives – this is the big lesson of Gordon Brown's unpopularity (and President Obama's surprisingly low poll ratings). Too high public sector spending, ID cards, the lack of accountability of measures designed to protect our national security, the box ticking required to take our kids to football matches. We had had enough of Thatcherism when the Conservatives hit us with the poll tax; we have now had enough of the nanny state. The role of the Public Sector in our lives is now at a peak, and we need to bear this in mind when considering exposure to companies that depend on Government spending.

Portfolio Activity

We are passing through the recovery phase of the cycle. As a result we are taking some profits in the most over-bought, early cycle recovery stocks, but are also comfortable about running many of our winners. Asset Backed stocks have only just started to perform so we have continued to build up our exposure to this area. We are moving some of our attention to de-rated growth and quality category companies.

New Investments (purchases)

We have continued to build up our Asset Backed exposure so that it is now almost 14% of the portfolio. One new example of this is **Intermediate Capital Group**, a top decile scoring stock. It has a very strong market position in the provision of mezzanine finance to the private equity community, it has conservatively provisioned its credit book, and it has raised fresh equity to strengthen the balance sheet and allow it to write new business at the attractive margins that are now available. The shares were trading well below book value when we purchased them, a very attractive valuation considering the fact that over the long term they have generated a 20% Return on Equity.

A new area of real estate investment for the fund has been European Property Funds, such as **Kenmore European Industrial** and **Invista European**. These collective vehicles were launched close to the top of the property cycle and have models that operate with a reasonable amount of leverage. As a result they are treated with disdain by other investors, who always run away from funds launched at the peak just as the cyclical low point is reached. To us this presents an opportunity – these funds have a good quality spread of property across Europe, their Loan to Value ratios are manageable and well within covenants, and their shares are trading at less than 50% of net asset value. We have deliberately diversified our exposure through buying modest positions in a number of these vehicles.

Towards the end of the quarter we bought a small position in **Songbird**, the majority owner of the Canary Wharf estate. This is a high scoring Asset Backed stock which is in the middle of a major re-financing that will restore its fortunes. The balance sheet will now be far stronger, the estate remains world class, it is exposed to the improving fortunes of investment banks around the world, and the valuation of the property portfolio is now conservative. Our small stake allows us to participate in the refinancing on the attractive terms offered to those providing new capital.

We are currently attracted to Growth franchises that have been de-rated as investors focus on more cyclical enterprises. A great example of this is **CVS**, a top decile scoring operator of veterinary practices in the UK. It is the largest such operator in this country, has continued to see revenue growth even in the depths of the recession, and has a great model whereby it buys out local practices from their partners on relatively modest multiples and then, given its buying power, can immediately improve the practices' gross margins through bulk buying of drugs and other items. As a result the revenue and profit growth outlook is well above average, whilst the Valuation of only ten times earnings is modest.

There are of course still many new Recovery ideas - **St. James' Place** is a high scoring recovery stock with a strong franchise providing Life Assurance-wrapped investment products to the "decently well-off". Their fortunes have been closely linked to the stock market cycle, with a strong equity market providing a background conducive to more investment activity amongst its client base. The shares have lagged the market recovery, have become lowly valued as a result (discount to embedded value) and in expectation of improved sales activity we purchased a position.

Existing investments we have become more confident about (purchases)

We do believe that the current phase of the cycle will provide a great opportunity to take a major position in the healthcare sector. The sector is now mature especially as major drugs come off patent; however cost-cutting and merger activity is allowing the prodigious cash generation of pharmaceutical companies to be maintained. The free cash flow yields of **AstraZeneca**, **GlaxoSmithKline**, and **Pfizer** (a new position, the biggest pharmaceutical company in the world) are too high and we are adding to our position in the healthcare sector.

Despite recent strength we have increased our investment in UK banks (**Barclays**, **Lloyds**, **RBS**) – indeed we would argue that these banks would have performed a lot better if investor prejudice was less of an influence. This is because their profit fundamentals have been dramatically improving over the last few months. Funding costs have collapsed to low levels, pricing of products is firm, reflecting the lack of competition, and therefore lending margins are now very attractive, and perhaps most importantly default rates on secured loans in the UK have actually started to fall (did you know this?). These banks are on no more than 1x book value, valuations that reflect post-Lehman Armageddon rather than today's reality.

Global Stocks

Our non-UK stocks currently account for 19% of the portfolio. They are all recovery stocks, where share prices are depressed because of short-term pressure on their profits. And all their valuations were at multi-year lows at time of purchase. However they are all very robust franchises, in global or domestic market leadership positions. As a result you have exposure to a collection 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), **Harley Davidson** (the iconic motorcycle brand with a dominant position in heavyweight bikes), **Citigroup** (still the biggest bank 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) and **Nokia** (global share still over 30%). We bought all of these at around their cyclical lows.

Stocks that have delivered versus our PVT thesis (sale)

We continued to reduce exposure to early cycle consumer cyclicals following robust performance. This included the sale of our holding in **Kingfisher** and profit taking in smaller cap companies such as **Inchcape** and **Topps Tiles**.

A number of smaller company stocks in the Support Services sector were very strong as they delivered trading updates that were ahead of expectations. With their value gaps reducing we decided to reduce our exposure to stocks such as **Galiform** and **Northgate**.

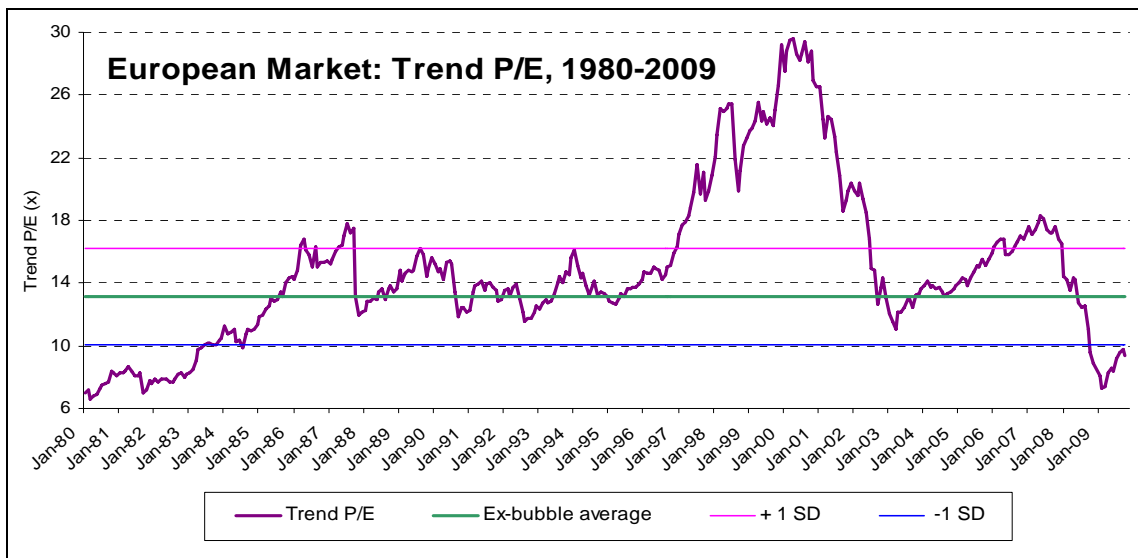
Arc was sold (too cheaply) as a US competitor exploited its bombed-out share price by bidding for the company. They have definitely bought this company on the cheap, and I told the Chairman and the advisors of Arc this but I'm afraid other investors seemed happy to take the money and run.

Stocks we have cut (sale)

With the vast majority of our stocks performing well in absolute terms over the last six months we have not had to cut too many positions. However **St. Ives**, the printing business was one company that we did sell-out of following a disappointing update. Perhaps printing is too difficult an industry within which to deliver a recovery strategy successfully.

Outlook

Whilst Equity markets have rallied strongly from their March nadir they are still well below recent peaks and remain attractively valued. The chart below shows the Graham and Dodd PE (trend earnings, stripping out the cyclical impact) for the European market. A trend PE of 9.5x, and earnings yield over 10% is very supportive. The UK market is even cheaper.



Source: Mirabaud

To complement an attractive valuation, the profit cycle has turned positive, with earnings upgrades ahead of expectations and the valuation dispersion within the UK equity market remains above average, suggesting continued upside returns for sensible PVT investments. Setting aside any worries associated with the speed of the recent rally and the outlook would seem positive. Add this to the valuation of your portfolio, at only 1.0 times book value and the proverbial 'Man from Mars' would most likely be a buyer than a seller.

Of course it goes without saying that nothing in life goes up in a straight line, but with the trend upwards, a "buying the dips" strategy would seem to make a lot of sense. In this respect this recovery stage of the cycle looks like being 'déjà-vu, all over again'.

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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