

RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Smaller Companies Fund I Quarterly Report
September 2009

River and Mercantile

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UK Equity Smaller Companies Fund – Quarterly Report

Fund Aim

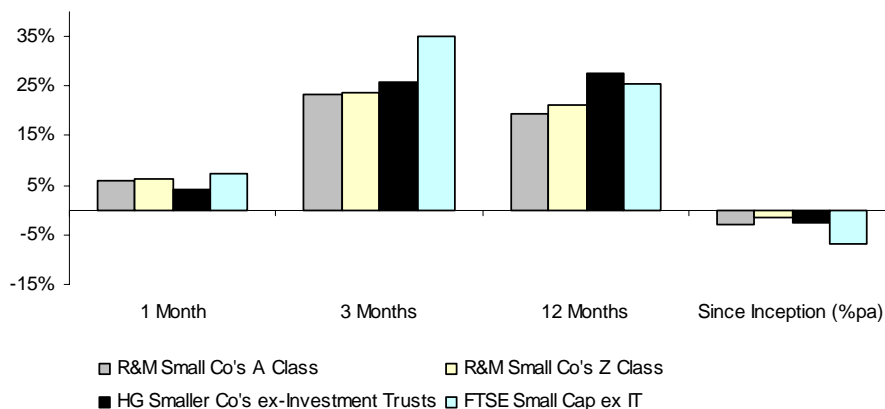
The investment objective of the Fund is to achieve capital growth by investing in a portfolio of investments which shall primarily consist of UK equities which reside in the bottom 10% of the UK stock market in terms of market capitalisation.

Portfolio Summary		Risk Analysis Summary	
Strategy AUM	£39.5m	Portfolio Volatility	20.19%
Strategy Capacity	£400m	Benchmark Volatility	19.36%
Number of stocks	91	Tracking Error	5.64%
Largest Holding	Fiberweb 2.06%	Portfolio Beta	1.00
		Active Money	82.06%

Performance as at 30 September 2009

Retail "A" Class Shares	Fund ¹ (%)	HG Index* (%)	Difference (%)	FTSE Small Cap (%)
1 Month	6.06%	4.17%	1.89%	7.38%
3 Months	23.30%	25.96%	-2.66%	35.20%
12 Months	19.56%	27.51%	-7.95%	25.49%
Since Inception ³ (%p.a.)	-2.98%	-2.68%	-0.30%	-6.77%

Institutional "Z" Class Shares	Fund ² (%)	HG Index* (%)	Difference (%)	FTSE Small Cap (%)
1 Month	6.20%	4.17%	2.03%	7.38%
3 Months	23.77%	25.96%	-2.19%	35.20%
12 Months	21.37%	27.51%	-6.14%	25.49%
Since Inception ³ (%p.a.)	-1.55%	-2.68%	1.13%	-6.77%



Source: River and Mercantile Asset Management LLP

*Index: Hoare Govett Smaller Companies ex IT

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 30 November 2006

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; We 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 Hoare-Govett Smaller Companies Index an even greater +25.96%. 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. The value factor remained strong, while momentum factors were poor contributors early in the quarter but have now started to improve.

The outperformance trend over large-cap by mid and small cap stocks appears to have positive momentum, however the relative valuation attractions so clear at the start of the year have narrowed greatly and stock selection will become ever more important. We continue to find significant numbers of attractive investment opportunities.

Performance

The fund underperformed the benchmark during the quarter by 1.74%, rising 23.77%. Underperformance was primarily due to public sector exposed holdings such as Idox, RM, Cohort and Morgan Sindall. No exposure to strongly performing benchmark heavyweight New World Resources was unhelpful. Our overweight in Lloyds underwriters has also been disappointing, however rates remain stable and the claims experience appears at this stage of the 'hurricane season' to be favourable.

However, underperformance was front-end loaded as we outperformed during September by +1.95%. September's outperformance was driven by strong performances from high conviction positions in CVS group, the veterinary group, McBride, the private label household goods manufacturer, May Gurney, the infrastructure maintenance services business and a takeover battle for Goldshield, the pharmaceuticals business. Key recovery holdings continued to deliver positive contributions throughout the quarter such as Delta, Hogg Robinson, Galiform and Fiberweb. Gold producer Peter Hambro benefited from rising gold prices and improving operational performance. Other successful investments have been Psion and Ashtead.

Philosophy & process

The majority of capital within the fund remains allocated to the Quality category and this has risen over the quarter at the expense of recovery and growth categories. Early in the quarter we gained higher conviction in the Asset-backed category which now represents 9.4% of the fund. 81% of holdings are currently in the top 4 deciles indicating a strong skew to high scoring stocks. It shouldn't be a huge surprise to shareholders that the 'Timing' factor has been of limited help to our performance in 2009, however the portfolio continues to benefit from a value discipline, highlighted again at quarter-end by Style analysis. However, we fervently believe that the Timing factor will return to long-term trend performance sooner rather than later and will provide a tail-wind rather than headwind to 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 Activity

During the quarter Celsis was taken-over, some of the proceeds were channelled into Dechra Pharmaceuticals and CVS. Within Financials, profits were taken in Henderson Group and capital rotated into St James Place and Intermediate Capital Group, both of which have higher Money Penny scores, and more valuation support. We took profits following a blistering run in Mothercare and alongside selling Restaurant Group funded a new position in fast-growing online retailer ASOS. We recycled capital from Cyclical winners into laggards. This resulted in the sales of Cookson, Aveva and Charter and further adding to existing positions in Laird, BBA Aviation, Regus and Domino Printing. As detailed in monthly reports, we added to our real estate holdings early in the quarter, favouring those strongly capitalised to exploit the cycle. Investments included supporting the capital raisings of Hansteen, London & Stamford and Conygar. We purchased a new position in the global leader in travel Hogg Robinson during September. The business has proven its resilience in the last 12 months and shown how the business model has been de-risked. Cash generation has been strong and the shares remain very depressed on a very cheap valuation. Timing appears supportive as corporate travel budgets appear to have troughed.

The fund remains overweight the Technology sector due to cheap valuations, positive growth momentum and high returns, strong balance sheets and positive earnings and price momentum. The General Retail overweight is not so much a reflection of a strong sector view but driven by an abundance of bottom up opportunities such as H&T, the pawnbroker, CVS and Halfords. Financials sector risk is being concentrated in Insurance, where we have added the high quality St James Place and mainly cash rich Real Estate holdings.

The portfolio remains cautious on leverage and is underweight the geared benchmark constituents which have been chased higher as risk appetite has risen and credit spreads narrowed. The requirement to eventually pay back capital will remain an issue for many of these companies for some time and if cashflows disappoint they will inevitably require further dilutive equity issuance. Many of these stocks sport the highest Betas and combined with an underweight position in Financials the fund remains low Beta relative to the index.

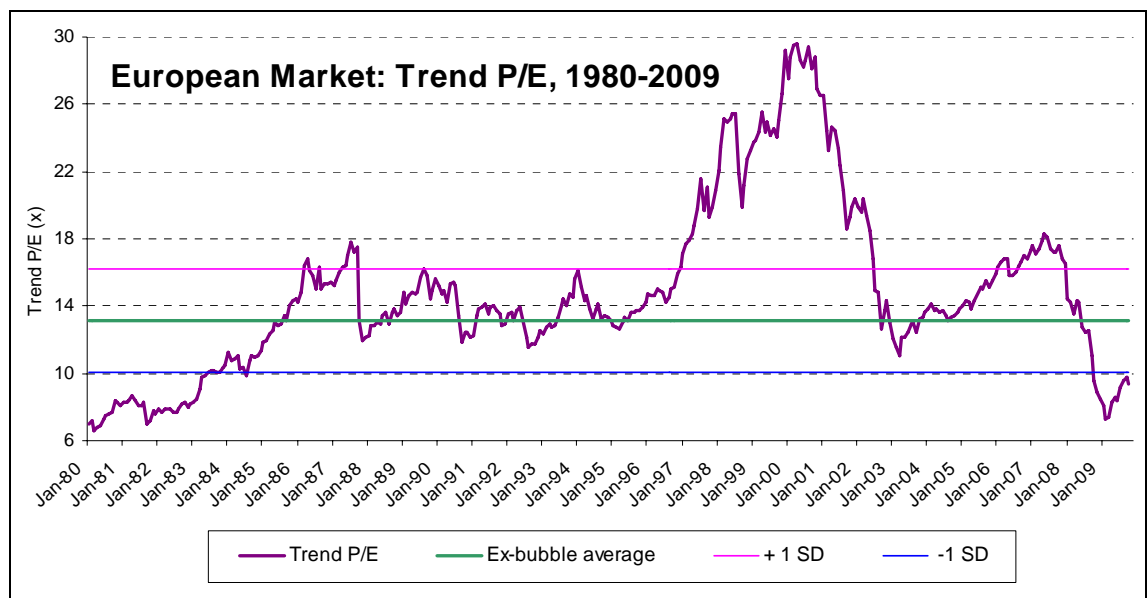
Market Outlook

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 we 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 we do expect the

pace of positive market movement to slow like Mr. Bolt before going on to greater heights.

Behaviorally, 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 clear that 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. Some of our remaining concerns include the potential for 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 getting more inflation prone, which will need to be reflected in portfolio construction. We have more faith in Chinese private sector and business investment picking up post stimuli than in the UK or US.

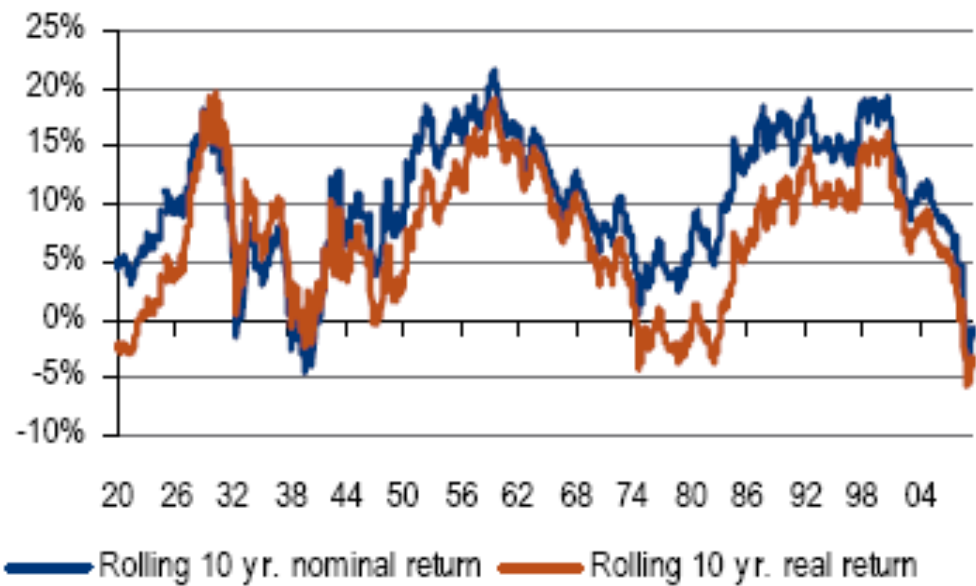
It appears the political consensus has moved to accepting that public sector cost structures need addressing, we hope the speed at which this is tackled accelerates under the new government in 2010 to a Usain Bolt tempo. I'm afraid he will remain the man who (smartly) collected Gold assets rather than the current Prime Minister whose sales may only be matched in poor timing by the potential fire-sale of surplus state real estate in the near future. We are attempting to minimise exposure to those most affected, however the market in some cases appears to have been too broadbrush; certain budgets will be relatively unscathed, many business have private and overseas exposures and indeed gaining market share can offset headline cuts in spending. Some portfolio holdings such as Idox and RM Group also have

considerable strategic value and the government outsourcing trend is likely to accelerate.

Summary

In the short term, the market's direction is always tough to call consistently correctly, and is technically due a pull-back from 'over-bought' conditions, which may, when occurring, frustrate those positioned for a very material and protracted fall. 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

Dan Hanbury & Richard Staveley
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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River and Mercantile Asset Management LLP
30 Coleman Street
London
EC2R 5AL
Telephone: +44 (0)20 7601 6262
Facsimile: +44 (0)20 7600 2462
Email: enquiries@riverandmercantile.com
www.riverandmercantile.com