

RIVER AND MERCANTILE  
ASSET MANAGEMENT

UK Equity Income Fund I Quarterly Report  
March 2010

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# River and Mercantile

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## UK Equity Income Fund – Quarterly Report

### Fund Aim

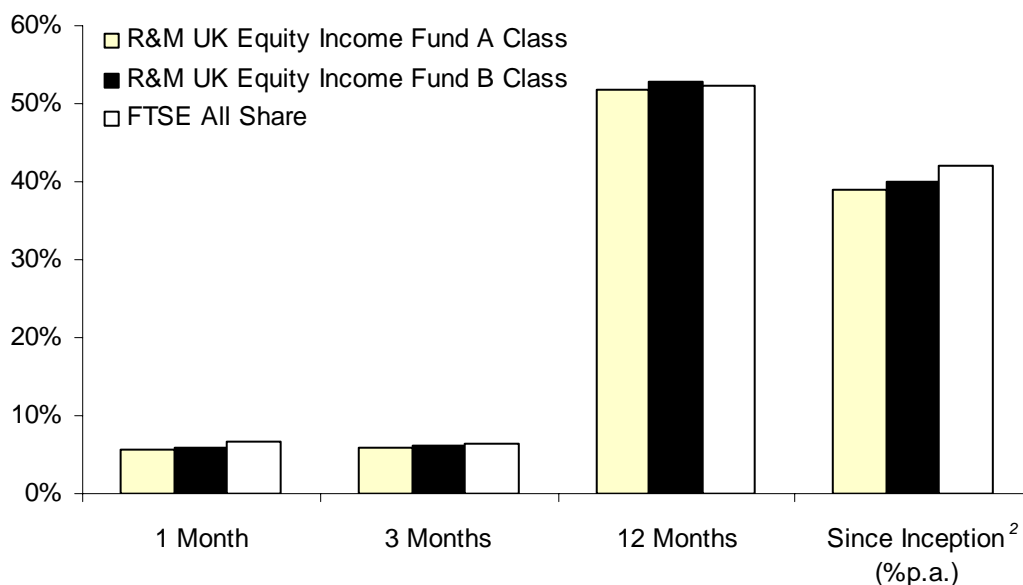
The investment objective of the Fund is to generate a rising level of income combined with the potential for capital growth through investing in a portfolio which will primarily consist of UK equities.

Portfolio Summary			Risk Analysis Summary	
Strategy AUM	£14m		Portfolio Volatility	17.14 %
Strategy Capacity	£1bn		Benchmark Volatility	16.97 %
Number of stocks	70		Tracking Error	3.06 %
Largest Holding	HSBC	5.79 %	Portfolio Beta	0.99
Historic Yield	N/A		Prospective Historic Yield <sup>3</sup>	4.80 %

### Performance to 31 March 2010

Retail "A" Class Shares	Fund <sup>1</sup>	Index*	Difference
1 Month	5.73%	6.76%	-1.03%
3 Months	5.89%	6.42%	-0.53%
12 Months	51.71%	52.30%	-0.59%
Since Inception <sup>2</sup> (%p.a.)	38.98%	41.97%	-2.99%

Asset Manager "B" Class Shares	Fund <sup>1</sup>	Index*	Difference
1 Month	5.80%	6.76%	-0.96%
3 Months	6.09%	6.42%	-0.33%
12 Months	52.86%	52.30%	0.56%
Since Inception <sup>2</sup> (%p.a.)	40.02%	41.97%	-1.95%



Source: River and Mercantile Asset Management LLP

\*Index: FTSE All Share (Total Return)

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

<sup>2</sup>Inception date 3 February 2009

<sup>3</sup>Yield based on the historic dividends of the current holdings of the Fund.

### Market Overview

*"I don't want to talk to you no more, you empty headed animal food trough wiper. I fart in your general direction. Your mother was a hamster and your father smelt of elderberries".*

*from 'Monty Python and the Holy Grail', 1975.*

I suspect that the various leaders of the main British political parties did not reveal their real opinions of each other during the inaugural television debate. I hope, as always, this quarterly report gives you a more open appraisal of how I see the past, the current state of affairs and the future outlook for the portfolio.

During the first quarter of 2010 the market began tentatively, with a 5.9% fall in the FTSE All Share through to the year's low in early February, but has since staged an impressive rally of 12%, finishing the quarter up 6.4%. Trade weighted Sterling depreciated a further 3% in Q1 and cyclical, mainly overseas earners, in sectors such as Mining, Industrials and Technology, have delivered robust performances. These overshadowed modest absolute gains from defensive sectors such as Healthcare and Utilities. There was marked contrast between size within the market with the FTSE Small Cap Index up 4% and mid caps up 10%.

Based on current market consensus forecasts, the prospective yield on the Fund is c.4.2%. This remains attractive relative to other asset classes, the UK equity market's own history, and is predominantly driven by overseas profits which should grow, helping offset any inflationary impact on real returns.

### Performance

The fund underperformed the benchmark by 0.53% during the quarter. Performance versus peers has been encouraging, though, with first quartile performance in both the year to March 2009 and since inception.

Whilst **Barclays**, a top ten overweight position, had a storming quarter after good results, underweight positions in **Standard Chartered**, **Lloyds** and **RBS** more than offset this within Banks. Overall, financials were neutral to performance as a complete sale of **Prudential**, having been overweight for a year, proved timely, given the fall post the AIG announcement. **Chesnara** also continued to produce excellent total returns for the fund.

A takeover approach for **Delta** was beneficial. Other Industrials performed very well without bids emerging, such as **Bodycote**, **Domino Printing** and **IMI**, although I would not rule out further corporate activity in the portfolio throughout the rest of 2010 in this area. Technology holdings were generally disappointing during the quarter, apart from **Spirent** which I sold, booking a 197% profit. **Psion** and **CSR** have lagged the market and **BATM** issued a profit warning, upon which I exited. Defensive large-cap holdings such as Pharmaceuticals, **Sainsbury's** and **Unilever** have been relatively weak whilst the underweight position in Mining stocks has also impacted performance despite positive stock selection within the sector.

March itself was an encouraging month for a number of mid-cap positions: **Halfords**, **Regus**, **United Business Media**, **Diploma** and **BBA Aviation** all released excellent results, positive outlook statements and generated upgrades, driving strong performances into the end of the quarter.

## Philosophy & Process

There has been little change (but in the same direction as indicated in Q4 2009) to Category weightings. Quality has increased by 1.8% to just over two-thirds of the portfolio, and this change is basically explained by the move in categorisation of **Rio Tinto** from Recovery to Quality. This rarely happens. However, we would argue strongly that a year ago Rio Tinto was offering Recovery Potential, while it now offers Quality Potential by generating improving, cash flow returns on investment well-above the average company. This contributed to a further reduction in the Recovery category, now 18.4% of the portfolio. The skew to high scoring stocks, as quantitatively measured by MoneyPenny, our proprietary screening tool, has actually deteriorated during the quarter. The percentage of capital invested in the top four deciles has reduced from 84% to 58%. This is primarily due to the fall in scores of relatively defensive index heavyweights **Vodafone, HSBC, BP** and **Shell**. I am now underweight the latter three of these stocks (BP reduced this Quarter) and believe that Vodafone's weak Timing score (relative earnings and price momentum) is likely to be compensated by impending positive news flow on their Verizon stake. Two-thirds of the fund by number of holdings is in the top four deciles.

## Portfolio Income

Market consensus for dividend growth in 2010 appears to be catching up with my assertion at the start of the year that, at 5-6%, it was too low. Consensus is now 10.6% and I suspect, given corporate outlook commentary in the results season just passed, the ongoing economic recovery and eased credit environment, that my original conservative forecast of at least 10% will be now beaten and the eventual outcome could be 13% or more. The Dollar will be a material swing factor. Robust dividend growth certainly shouldn't be a problem for **British American Tobacco, Centrica, Diageo, Unilever, GlaxoSmithKline, Sage, Scottish & Southern Energy, Shell, Imperial Tobacco** and **Vodafone** which in total sum to over 28% of the Fund: all are members of a small 'elite' group of shares which have increased their dividends every year for at least the last ten years. No mean feat given what has occurred.

29 stocks went ex-dividend during the quarter including 18 increases, 2 unchanged payouts and 9 cuts, 2 of which were oil majors and the result of \$ translation rather than company fundamentals. The Fund's current consensus based prospective yield of 4.2% is 120% of the market yield. The Fund went ex-final distribution of 2.86p on 1 April, driving a total payout of 6.42p (6.4%) since launch 14 months ago.

## Portfolio Activity

Monthly reports have detailed much of my activity during the quarter. However, to summarise:

### Change to position hierarchy within Resources:

I have moved underweight **Rio Tinto** (halving the weighting) and re-purchased **Anglo-American**. I suspect that asset-exposure changes at Anglo have not been fully appreciated by the market and some investors will be surprised that they now actually have the same iron-ore exposure as **BHP Biliton** (c.38% Ebit, but less than Rio's 49%). The main additional 'mix' effect of this change is essentially swapping Rio's Aluminium exposure for Coal, Platinum and Copper exposure. The stock has underperformed Rio's since June last year.

Secondly, I have moved underweight **BP** in favour of **Shell**, following material relative outperformance, whose refining exposure is becoming more attractive. The underperforming **BG** position has been halved and capital re-allocated to emerging exploration companies **Salamander Energy** and **Heritage Oil**, whose sub-sector I will discuss in detail later.

## Rotation of successful Quality franchise investments into better value alternatives:

The valuation in a number of highly successful positions since launch such as **McBride**, **Spirent**, **Homeserve** and **Daily Mail** are becoming stretched. I have taken profits and re-invested in some more defensive large cap Quality names, mainly world-wide spirits leader **Diageo**, but also **Imperial Tobacco** and **Scottish & Southern Energy**. For the same reason within Food Producers I have moved underweight **Unilever** and purchased market leading milk-producer **Robert Wiseman**. The Fund also participated in its first IPO, of market-leading credit-card and identity protection provider **CPP**. This highly cash generative, well-established, mid-cap growth company has material opportunities over the medium-term to increase shareholder value and was listed on an attractive valuation with conservative expectations relative to its history.

**The sale of weakened theses such as BT (Pension Fund and debt-providers take control of cashflows), Prudential (Valuation stretched relative to sector), and BATM (profit warning).**

## Tactical switch of defensive small cap investments into Recovery theses:

With significant relative value returning to large-cap defensive names I have chosen to switch holdings such as **Caretech** (residential care), **Daisy** (telecommunications) and **Hilton Foods** (European meat-packing) into companies with more depressed profitability and valuations. I purchased **Cambridge Silicon Radio**, the world leading Bluetooth and GPS chip provider valued on EV/Sales of c.1x, **Game Group**, the leading computer games retailer near a cyclical industry low-point, **UK Mail**, a UK leading postal services business undergoing a self-help turnaround, and **Collins Stewart**, the out of favour wealth manager and stockbroker. All four businesses have significant profit recovery potential, material valuation upside, net cash balance sheets and recent positive results. Total small-cap exposure is c.11%, below the maximum of 15% for the strategy.

Clients should be aware that **Afren** and **Hansteen** joined the FTSE 250 Index during the quarter, **Cable & Wireless** demerged; I have sold the UK based business and switched all capital into the overseas monopoly provider (Macao, Monaco, Panama etc, yielding c.10%).

## Sector positioning

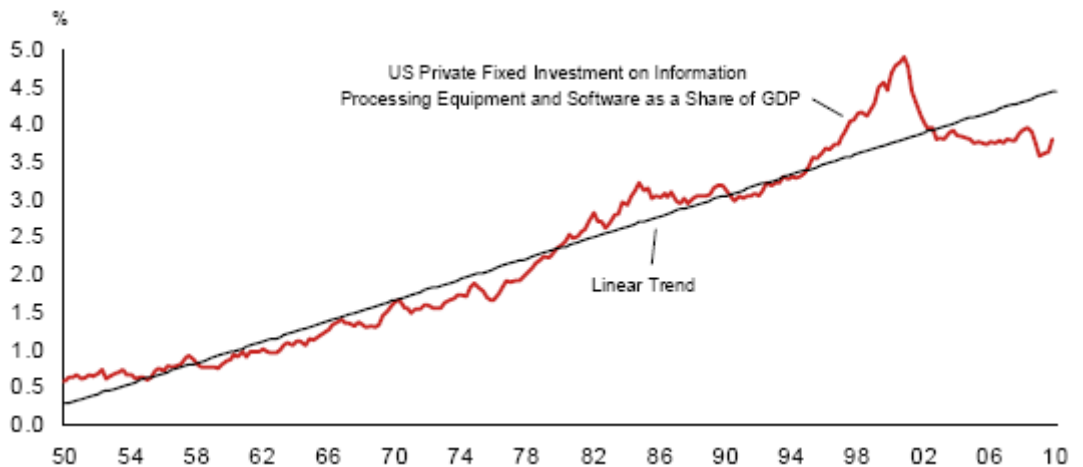
The strategy continues to take limited sector risk vs. the market with the largest overweight now Industrial Transportation at +1.89% (**Clarkson**, world-leading ship-broker, **BBA Aviation**, flight support services and **UK Mail**) and the largest underweight being Banks at -3.79% (No **Standard Chartered**, **RBS** or **Lloyds**).

Overweight cyclical sectors continue to be Technology, Electronics and Engineering. Overweight defensive sectors continue to be Pharmaceuticals, Tobacco. Food Producers and Telecommunications (albeit this has reduced due to the sale of **BT**), to which I have added the Electricity sector. Other meaningful changes since year-end have been the significant narrowing of the Beverages underweight due to the purchase of **Diageo** and the reduction in Life Insurance, offset by an increase in General Financial Services.

## Technology

It is ten years since the biggest speculative investment frenzy of our generation, the TMT bubble, burst. We think the outlook now is positive for a number of reasons. Firstly, technology spending moves in long term cycles: the last peaked in 2000 with the TMT bubble, the bottom appears to have occurred in 2009, as companies slashed investment to ensure they had the financial strength to withstand the credit crunch. Spending on technology is now at a generationally low level. US IT business investment, however, started picking up in Q2 2009 and in Q4 grew at a +25% annualised rate:

## US Spending on Technology as % of GDP



Source: Bureau of Economic Analysis, Datastream, Nomura Strategy Research

Secondly, after a ten year de-rating, technology stocks are now very attractively valued, trading at a Price to Earnings ratio that is little more than the overall market, this despite their robust profit outlook, strong balance sheets and superior cash generation characteristics:

## Global Technology sector 12 month forward PE relative



Source: IBES, Exshare, FTSE, Nomura Strategy Research

Thirdly, the Timing for Technology looks right. Company profits and cash flow are now very robust making them more likely to invest in productivity enhancing technology, and also replace dated hardware; consumers remain extremely attracted to new, functionally rich products with Smartphones and mobile Internet a crucial driver at a clear inflection point. There are 2x as many mobile devices globally as Internet users with the investment in fixed internet connectivity in rural (US) and emerging markets prohibitive. Mobile broadband will be the world-wide solution. Furthermore, HD penetration (still only 14% in the US) and the emerging networked home environment are creating massive drivers to data volumes. This remains an opportunity to monetise. India is only this month conducting its 3G spectrum auction. Apple has the Apps. The result is that the demand outlook is picking-up for technology companies which, combined with cost bases that were managed down during the credit crunch, and business models that often have reasonable operational gearing, should lead towards a strong profits outlook, and likely positive earnings surprises.

As a result of these strong PVT characteristics, we are overweight the IT Hardware and Software Sectors, with notable positions in **CSR** (global leader in semi-conductors for Bluetooth and Satellite Navigation), **Invensys** (global provider of technology systems to rail operators and process control companies), and **Sage** (Global leader in providing software and services to the SME market). I also have purchased a position in **CSF**, a leading Asian based data-hosting company to blue-chips clients such as Google.

### **Oil Exploration and Production**

In addition to an investment in **BG**, the "E&P major", I have invested in a small number of emerging mid-cap exploration and production companies. The short-term prospects for income from these holdings is slim, however the Potential for capital returns as a result of Growth via the drill-bit is excellent. The four companies are **Salamander Energy**, **Afren**, **Valliant Petroleum** and **Heritage Oil**.

The first three have all recently entered the production phase on key assets. This is a key investment stage as (assuming the costs of production are economic, which they all are) the companies then become self-funding, to an extent, for on-going exploration activity without recourse to shareholders. Salamander's production is in SE Asia, Afren's Nigeria and Valliant's the North Sea; all very low risk, proven, prolific production basins. Heritage does not have production flows, but has recently agreed the sale of its highly successful Uganda assets for up to \$1.5bn cash (two-thirds of market cap). At current oil prices the value of the 'core' producing/development assets of these four holdings are not dissimilar to the current stock market values for each company. However, this, in effect, implies that as an investor one is paying very little for the upside from exploration success.

All four companies have very active drilling programmes over the next 12 months, which all have significant potential materiality to the shares (unlike the majors). Drilling is always risky, however all four are drilling in proven regions and the Fund will get the blended results from the mix effect without attempting to 'rifle-shoot' the most lucky one. This is not the Falkland Islands. This is the North Sea, Nigeria, Kurdistan. In total I have 4% of the fund invested across these holdings.

Clearly the direction of oil prices will have a bearing on these holdings but, over the medium term, most likely outcomes are less relevant than drilling success.

Currently I believe that the ongoing recovery of global oil demand will be mitigated by supply increases in Iraq and Kurdistan and by the structural price impact of the emerging LNG market.

## Market Outlook

*"What have the Romans ever done for us?"*

*"They've bled us dry the bas\*\*\*ds, they've taken everything we've had and not just from us, from our fathers and from our fathers' fathers"*

*"And our fathers' fathers' fathers"*

*"Yep"*

*"And our fathers' fathers' fathers' fathers"*

*"Alright Stan, don't labour the point, and what have they ever given us in return?"*

*"The aqueduct"*

*"What?"*

*"The aqueduct"*

*"Oh, yes, they did give us that"*

*"And the sanitation"*

*"Oh yes Reg, remember what the city used to be like?"*

*"Alright I grant you those are two things the Romans have done"*

*"And the roads"*

*"Well obviously the roads, the roads go without saying don't they"*

*"Irrigation"*

*"Medicine"*

*"Education"*

*"Yeh, yeh, alright, fair enough"*

*"And the wine"*

*"Yes Reg, that's certainly something we'd miss if the Romans left"*

*"Public baths"*

*"And it's safe to walk the streets now Reg"*

*"Yes they certainly know how to keep order"*

*"Ok, alright, well apart from the Sanitation, the Medicine, Education, Wine, Public Order, Irrigation, Roads, the Fresh water system, and Public Health, what have the Romans ever done for us?"*

*"Brought peace?"*

*"Oh Peace... shut up..."*

*from 'Monty Python's Life of Brian', 1979*

Next Quarter's report will be written following the election result where the electorate will judge the past achievements of the current 13 year administration and the potential alternatives. Between 2000-2009 real, UK government spending growth compounded at 4.6% per annum, 270bps above the 1970-1999 average of 1.9%. Of the total forecast government spending in the 2009-2010 year of £676bn, "Social Protection" constitutes £190bn, "Personal Social Service" £29bn, Health £119bn, Education £88bn, Defence £38bn, Housing £30bn and Debt Interest now £30bn. Previous year tax receipts of c. £498bn included £140bn Income tax, £95bn National Insurance, £34bn corporation tax and £24bn business rates, VAT £67bn and Excise £44bn.

The sums don't come anywhere close to adding up. Material change is ahead irrespective of the outcome. Both sides of the equation need addressing. Given that those generating the smaller number are paying for the larger number, I personally hope the larger number is the main focus for radical change in order to deliver medium term equilibrium and that, in the mainstream discourse, it is not forgotten that tax receipts can increase without tax rates going up.

More importantly for the prospects for the UK stock market are, fortunately, events elsewhere. In this regard there is much to be encouraged by. The ISM manufacturing series hit a five and a half year high of 59.6 and the New Orders component increased. The US economic recovery continues to build. The IFO survey has also been positive. Monetary conditions remain highly stimulative, however overall Inflation expectations remain subdued as indicated by bond markets, household and company expectations or economic consensus.

China continues to grow aggressively as indicated by cargo traffic through their major seaports being up 30% year-on-year in January-February, national electricity production was up 25% in Q1 and forecasters are moving towards a +12% expected GDP growth rate for the quarter. Chinese Lead Indicators, however, appear to be softening, with the authorities keen to control growth and, interestingly, I noted that the minimum wage in the key Guangdong province was recently increased by 20%. During the quarter China actually moved into a net trade deficit with American exports to China up 65% since January 2009.

Consensus forecast UK GDP growth for 2010 at 1.3% and 2.1% 2011 appears conservatively set given ongoing monetary stimulus and material currency benefits to exporters. However, for both the US and UK, recent housing related data has been mixed at best and this key aspect of household wealth remains fragile. Combined with the size of the output gap and subdued inflation (4% o.k now per IMF?) should ensure premature aggressive tightening of monetary policy is avoided.

## **Summary**

The Fund is built via a bottom-up stock selection process based upon our PVT philosophy. I 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 improving Timing attributes. They are highly liquid securities with strong balance sheets in a deep, broad and attractively valued UK equity market which has significant profitability generated overseas. The Fund remains focused on achieving an above-average income from UK equities and a Total Return ahead of the market with active risk control at a sector and size level.

**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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