RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Long Term Recovery Fund I Quarterly Report
March 2010

River and Mercantile

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UK Equity Long Term Recovery Fund – Quarterly Report

Fund Aim

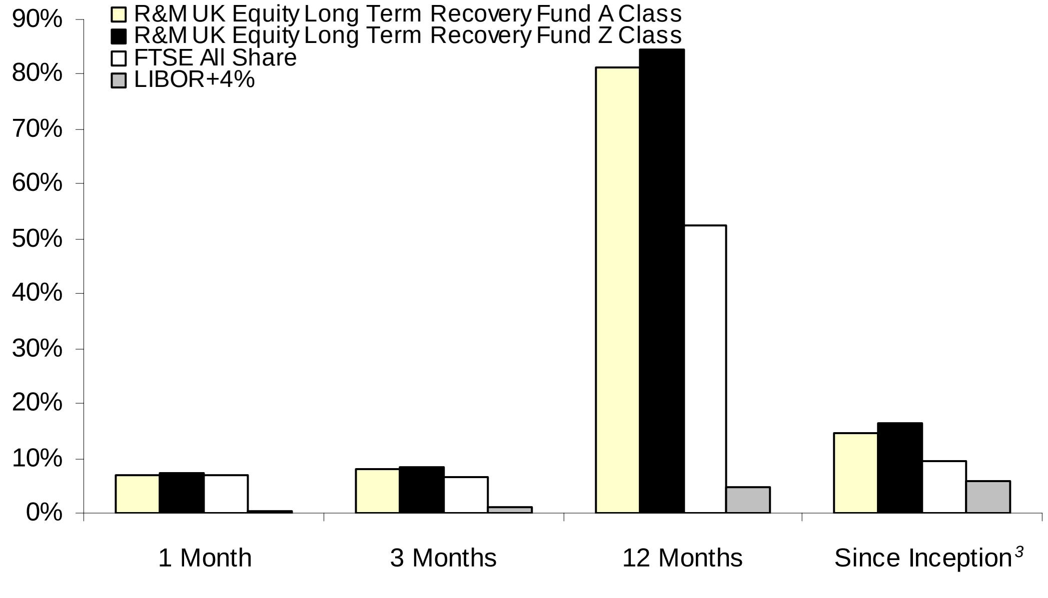
The investment objective of the Fund is to achieve capital growth through investing in a portfolio which will primarily consist of UK equities that meet the manager's recovery criteria of a turnaround in company profitability over the longer term. The Fund will not be restricted by reference to a benchmark,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

Portfolio Summary			**Risk Analysis Summary**	
Strategy AUM		£81m	Portfolio Volatility	20.04 %
Strategy Capacity		£200m	Earnings Yield	4.95 %
Number of stocks		148	Dividend Yield	1.91 %
Largest Holding	Rio Tinto	3.64 %	Price to Sales	0.59
Average return to medium-term recovery value		55%	Price to Book	1.09

Performance to 31 March 2010

Retail "A" Class Shares	Fund[1]	FTSE All Share	Difference	*LIBOR+4*
1 Month	7.01%	6.76%	0.25%	*0.39%*
3 Months	7.94%	6.42%	1.52%	*1.12%*
12 Months	81.30%	52.30%	29.00%	*4.63%*
Since Inception[3] (%p.a.)	14.40%	9.54%	4.86%	*5.78%*

Inst'l "Z" Class Shares	Fund[2]	FTSE All Share	Difference	*LIBOR+4*
1 Month	7.18%	6.76%	0.42%	*0.39%*
3 Months	8.41%	6.42%	1.99%	*1.12%*
12 Months	84.48%	52.30%	32.18%	*4.63%*
Since Inception[3] (%p.a.)	16.39%	9.54%	6.85%	*5.78%*



Source: River and Mercantile Asset Management LLP
[1]Performance calculated on a mid to mid basis at close of business, net of annual management charge
[2]Performance calculated on a mid to mid basis at close of business, gross of annual management charge
[3]Inception Date 17 July 2008

Quote for the Quarter

"To map out a course of action and follow it to an end requires courage".

- Ralph Waldo Emerson

Key Observation

One year on and history continues to repeat itself, and to provide much insight into where we go from here and what course of action to take. Courage has been required over the last few years, and will be needed in the future. However, there are now enough signs of economic and financial recovery to suggest this is the start of a more benign period. Indeed this *is* our view, that we are moving into the Trend phase of the stock market cycle, where economic growth, company profits and equity valuations move back towards their long term averages. Fortunately for us as Fund Managers and you as clients there remains much money to be made from this process, because many PVT investment anomalies remain. The biggest of these are to be found amongst companies that do business in the UK because, ahead of the election, they appear to have become temporarily un-investable and therefore hugely cheap. It is my contention that the UK economy is actually moving through a relatively standard cycle, and that anyone who is prepared to look beyond the short-term uncertainty of the election will make attractive returns from buying such unloved UK facing companies as our High Street Banks, Real Estate stocks, House builders and a whole host of Smaller Companies. The UK economy is being under-valued and we are happy to exploit that.

Market background

Quarter:

It has been another positive quarter for equities. Data has remained supportive - economies are growing again, a combination of improving sales and lower costs are allowing corporate profits to grow robustly and, with no obvious valuation constraint (i.e. shares remain cheap), equity prices are trending upwards. There is, of course, the 'wall of worry' that will cause volatility around this trend, the most recent being the acute difficulties in Greece and general fears surrounding sovereign debt, but these have not been material enough to disrupt the normal path taken by the stock market cycle.

The UK equity market delivered a return of +6.4% led by larger global growth related stocks (mining), international cyclicals (engineers such as **Rolls Royce**) and recovery category banks (**Lloyds**). UK domestic facing stocks, in particular smaller companies, did badly. The FTSE Small Cap Index (excluding Investment Trusts) returned only 1.8%. Factor returns were not as significant as they have been over the last few years though, interestingly, Momentum has started to become more effective.

How did we perform and why?

Quarter:

We returned to generating both positive absolute and relative performance, this despite the significant handicap presented by the ongoing under-performance of smaller companies. The Long Term Recovery portfolio returned 8.4%, an outperformance of 2.0% versus the FTSE All Share Index. Our large company selection was positive, with notable contributions from the recovery category banks (**Citigroup**, **Lloyds**), and from international cyclicals (**Cookson**). The non-UK stocks in the portfolio made a significant positive contribution (**Nintendo**). Smaller Companies contributed negatively as they lagged the market materially.

Year:

Performance over the last year, co-incident with the first year of recovery, was very strong, with the Long Term Recovery strategy returning 84.5% versus the FTSE All Share Index return of 52.3%, and versus Libor (plus 4%) at 4.6%. These are spectacular returns, though from a generationally low base. Value, Recovery and, more recently, Earnings Momentum, have been supportive. Smaller Companies, whilst strong at the start, have surprisingly lagged for the last couple of quarters. We suspect that this reflects a ‘UK political risk’ premium that will unwind over the next year. I will discuss this in more detail later in this report.

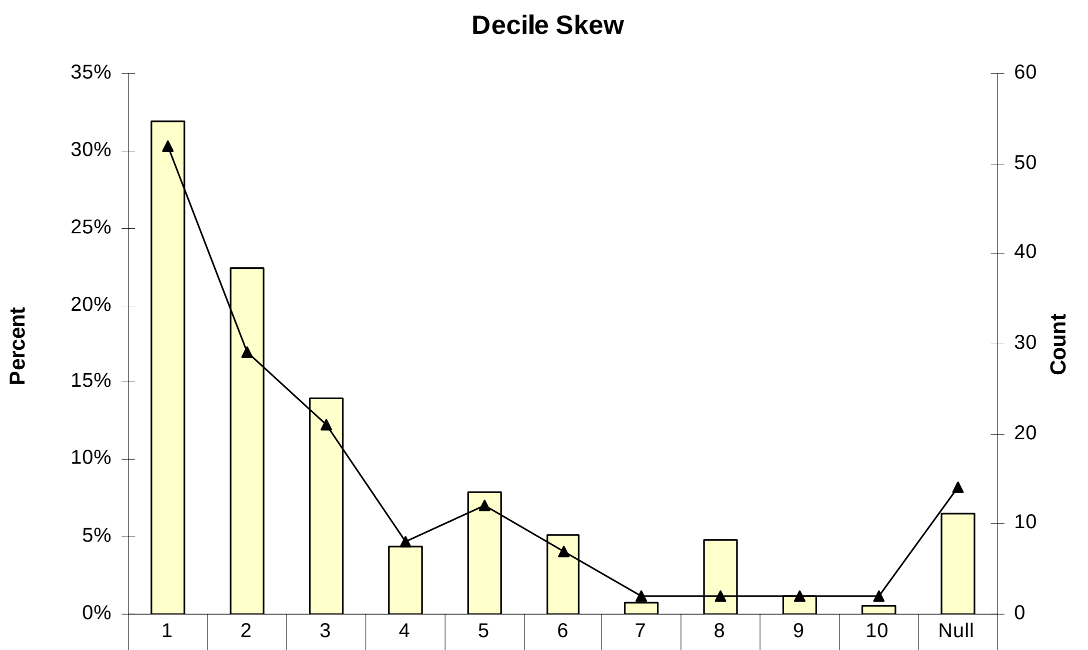
Key performance contributors over the quarter:

<u>Positive:</u> UK banks (**Royal Bank**, **Barclays** and **Lloyds**); International Cyclicals (**Wolseley**, **Cookson**, **BA**); Non-UK Stocks (**Citigroup**, **Nintendo**).

<u>Negative:</u> Smaller Companies (**Topps Tiles**, **BATM**); **Jarvis** valued at zero.

Does the portfolio reflect our philosophy and process?

The chart below shows that our strategy continues to have a strong skew towards high scoring stocks, though the scores of some of the mega-cap stocks (**HSBC**) have again become quite low due to modest T scores.



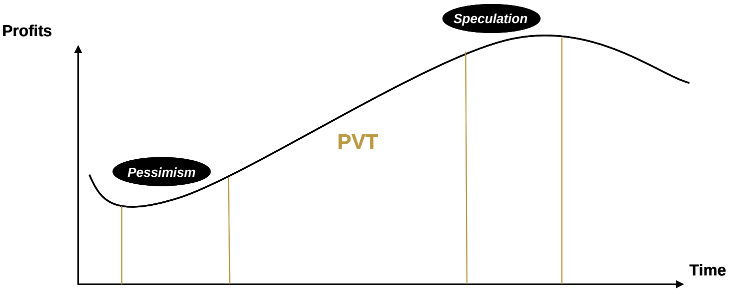
	1	2	3	4	5	6	7	8	9	10	Null
Weight	31.90%	22.42%	13.95%	4.42%	7.86%	5.07%	0.78%	4.81%	1.17%	0.54%	6.54%
Count	52	29	21	8	12	7	2	2	2	2	14

Source: River and Mercantile Asset Management LLP

What themes occupy us at the moment?

The stock market cycle

We continue to frame the current environment in the context of the stock market cycle.



	RECOVERY	TREND	LIQUIDITY	DECLINE
ECONOMY	Below Trend	Trend	Above Trend	Decelerating
MONETARY POLICY?	Loose	Neutral	Tightening	Loosening
RISK APPETITE?	Low	Normalised	High	Falling
VALUE SPREADS	High	Reducing	Low	Increasing
STYLE?	Value / Recovery	PVT	Risk Reduction	Quality

Source: River and Mercantile Asset Management LLP

Following much team discussion (and a formal review of the MoneyPenny returns since we launched the business) we have somewhat simplified the concept of the stock market cycle, to focus it even more on identifying the top (be cautious, focus on quality defensives) and bottom (increase risk, maximise exposure to recovery stocks) of the cycle. In between the bottom and the top of the cycle, which represents the majority of time, we have the trend period of the cycle, where economic growth, company profits and equity valuations move back towards their long term averages. All three PVT factors should work during this trend period, complementing each other.

Stock Market Cycle Thought Leadership – the Profit Cycle

A key component of the stock market cycle, and one that clearly helps drive relative share price performance, is the profit upgrade / downgrade cycle. At the top of the cycle, demand in most areas of the economy is above trend and the majority of companies are achieving peak levels of profitability. But, as the cycle starts to trend down, demand weakens and the profits of many companies are vulnerable – the earnings downgrade cycle has started, with the more cyclical and financially geared stocks likely to witness the biggest negative earnings revisions. Share prices always follow profits at this point, so the only place to be invested is in the more defensive, higher quality companies. Fast forward one to two years and return on capital across the corporate sector is now depressed, with many companies making cyclically low margins. But demand is now stabilising and, with costs having been cut, profitability has bottomed-out and, in many cases, is starting to beat what have become very negative expectations – the earnings upgrade cycle has begun. As demand strengthens, moving back towards trend, it becomes very easy for companies to grow profits again, as operational gearing kicks-in, and the more cyclical and financially geared corporations will trounce analysts’ expectations. Now is the time for these recovery type stocks, as this is where newsflow is at its most positive.

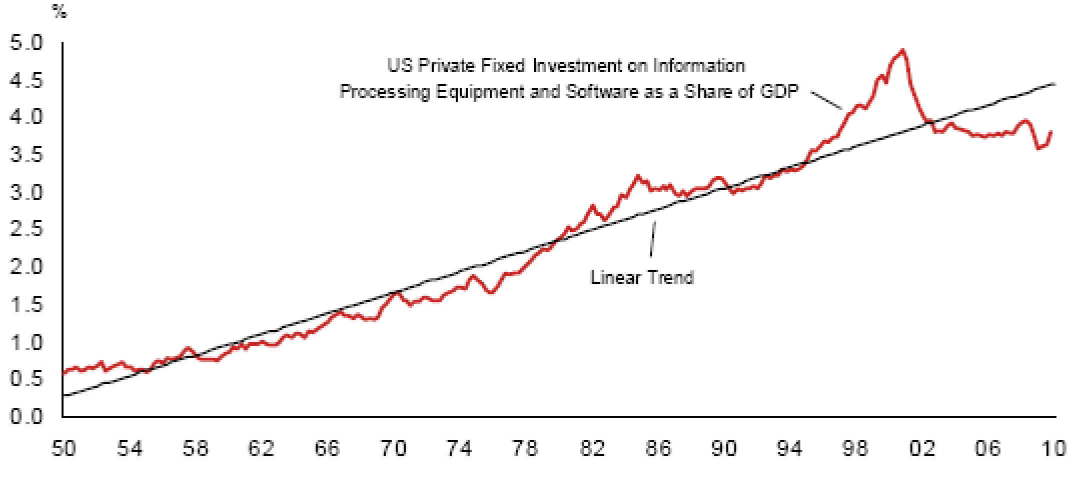
Company newsflow

Talking of which, corporate newsflow at companies in general, and our holdings in particular, is very reassuring and supportive of positive returns for equities and continued out-performance from the stocks we are invested in. The first quarter reporting season saw notable profit upgrades from a wide range of companies including **GKN** (40% upgrades for 2010), **RBS** (31%), **Persimmon** (52%), **Cookson** (18%), **ITV** (38%), **Lonmin** (over 100%), **Computacenter** (12%), and **Wolseley** (11%). Strong profits growth (Potential), attractive Valuations and, now, compelling Timing (upgrades) are in place across our portfolio and should drive attractive returns.

Technology – ten years on from the bursting of the TMT bubble

It is ten years since the biggest speculative investment frenzy of our generation, the TMT bubble, burst. Ten years on, and what is the outlook for technology stocks? We think it is positive for a number of reasons. Firstly, technology spending moves in long term cycles, the last of which 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 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 and superior cash 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, for example, smartphones becoming a mass market product. The result is that the demand outlook is picking-up for technology companies; this combined with cost bases that were managed down during the credit crunch, and business models that often have reasonable operational gearing, points towards a strong profits outlook, and likely positive earnings surprises.

As a result of these strong PVT characteristics, we are well overweight the IT Hardware and Software Sectors, with notable positions in **CSR** (global leader in semi-conductors for Bluetooth and Satellite Navigation), **Computacenter** (UK's largest supplier of PC hardware and services to the Corporate Sector), **Dell** (global leader in PC and laptop manufacturing), **Invensys** (global provider of technology systems to rail operators and process control companies), and **Nokia** (global leading handset provider).

Smaller Companies

Surprisingly, smaller companies have materially underperformed over the last six months. I say surprisingly as smaller companies are typically key beneficiaries of a market and economic upturn; they are more operationally geared to the economic cycle, and therefore see strong profits growth as economies come out of recession, and they are seen as higher risk, and therefore benefit as risk premiums fall. However, this time around, smaller companies have been held back by the negative sentiment towards the UK domestic economy, and also an emerging political risk premium as the prospects of a hung parliament have increased.

We think these two fears are exaggerated – the UK economy is recovering faster than the bearish consensus suggests, and with the uncertainty surrounding a hung Parliament now discounted in share prices, most of the possible election outcomes could well be more reassuring than investors expect. Meanwhile, the valuation of smaller companies in general looks attractive, trading on a prospective PE of 10 times, a modest absolute multiple and a discount to the rest of the market; and specifically the High Alpha Strategy is invested in a number of amazing bargains such as **Hogg Robinson** (PE 6), **GallifordTry** (0.7 times book value), **Invista European** (0.5 times Net Asset Value) and **Lookers** (PE 8). We would expect smaller companies to contribute more positively to the performance of the portfolio through the rest of the year.

Banks

Banks remain one of the most unloved and, as a result, undervalued sectors of the market. However, we are bullish, and have increased the Fund's exposure as the newsflow (Timing) materially improved during the quarter.

The Potential of the Banking sector is clear: with a return to a reasonable Return on Capital delivering a material uplift in profitability, the Valuation anomaly is material, with the UK's leading banks still trading at a discount to book value when 1.5 times book should be a low-end multiple given that they will be able to earn materially more than their cost of capital; but it is the improvement in Timing that makes one most confident. Net Interest Margins (the difference between the interest rate charged for lending and the cost of money to the banks) are trending upwards, as banks gain more control over what they charge for credit; costs have continued to be cut, in particular at Lloyds following its merger with HBOS, and bad debts have seemingly peaked as the assets against which banks have leant (such as houses) have stopped falling in price and because an improving economy and low interest rates are making debt more serviceable. As a result of these trends, profitability at the banking sector is recovering ahead of expectations. We are now overweight the sector, with significant positions in **Barclays**, **HSBC**, **Lloyds** and **RBS** as well as out-of-favour, market leading franchise banks outside of the United Kingdom, including **Bank of America**, **Citigroup** and **UBS**.

Portfolio Activity

This quarter we focused on increasing active capital in our highest conviction PVT stocks. To this effect, we increased the positions in **Lloyds** (following its positive update), **Cookson** (strong recovery coming through), **Intermediate Capital** (net assets have started to grow again), **Daily Mail** and **ITV** (advertising spend has turned positive), **CSR** (crazy valuation relative to US listed peers), and **Thomas Cook** (holiday volumes starting to pick-up).

New investments (purchases)

We have continued to look for undervalued growth investments, including participating in the IPO of **CPP**. They are the dominant provider of credit card and identity protection in the UK, and are growing internationally. Over the last few years they have been able to grow revenue and profits at well over 10% per annum, and they should be able to continue to grow at this pace as they take market share in existing geographies, and help grow the market for this product in new regions. The valuation at the time of listing was only a modest premium to the overall equity market, attractive for this level of cash generative growth.

We continue to find attractive Recovery stocks outside of the UK, and these positions have played a strong supporting role in the portfolio during a difficult period for UK smaller companies. A new addition to the fund was **Toyo Seikan Kaisha,** Japan's dominant manufacturer of beverage packaging. This is a great store of value - when we purchased it, the company was valued at less than two thirds of net current assets minus all liabilities (Ben Graham's definition of hard asset value); this bargain basement price, combined with a strong market position, and management that have delivered good shareholder value growth over the years.

Existing investments we have become more confident about (purchases)

This was the focus of our investment activity during the quarter, adding to positions as they became higher conviction on positive newsflow. This included adding to our positions in Media stocks, such as **Daily Mail** and **ITV** (and buying **UBM**) as a return to advertising growth is leading to a dramatic improvement in the profitability of these businesses.

We are also buying a more material position in **Xchanging**, a leading provider of out-sourced back office services. This company has continued to grow through the recession, delivering an increase of 6% in its revenue base in 2009. However, they have not been able to signup any really big contracts over the last eighteen months, as their potential clients have become risk-averse during these difficult times. As a result, the stock has been severely de-rated, trading on less than twelve times earnings and six times cash flow; this for a company that should be able to deliver annualised earnings growth of over 10%.

Stocks that have delivered versus our PVT thesis (sales)

We sold out of **Prudential**, following strong performance and a full realisation of our original PVT thesis. This sale was timely as it preceded their announcement regarding the acquisition of AIA. This looks like an attractive deal strategically, but at the wrong price. They will be issuing a huge amount of equity to pay for a business that is valued at a huge premium to their own; this is very dilutive for existing shareholders. For the time being, we prefer **Legal and General**, whose management team clearly understand shareholder value and are focused on significantly improving the cash flow generated from their insurance operation; this should lead to a re-rating back towards embedded value.

We also exited from **Delta** when it announced it had received a bid. This has been a successful investment for the Fund, and the management have done a good job over the years generating value for shareholders. We sold the shares at a premium to the value of the bid, as arbitrage investors were prepared to invest on the basis of their being a higher offer. We were happy to re-invest your capital elsewhere.

Stocks we have cut (sales)

We decided to exit from our position in **Treveria**. Whilst the valuation looks attractive, we have become less confident regarding the strength of the balance sheet and, as a result, decided to re-allocate capital to higher conviction ideas within the Real Estate sector.

Outlook

Our hopes at the beginning of 2010 were that it would be a ‘boring year’, observing that ’the current normalised market PE of less than twelve times, combined with a positive outlook for profits growth, justifies at least a modest double figure return, for a number of years’. These comments still apply – UK equities remain reasonable value, and profit growth is strong. This combination is producing decent returns for equity holders and will continue to do so until these factors become less compelling.

Within this reasonably strong equity market, companies that are focused on the UK economy have lagged due to extreme caution towards our domestic economy. Our view on this is that these fears are exaggerated, and have caused some of the classic Recovery stocks (smaller companies in particular) to lie dormant as the rest of the market has moved higher. However, as a more positive outlook for the UK economy emerges over the next few quarters, these shares will start to outperform.

In summary, the outlook for economies is robust, as the recovery phase takes hold around the world; corporate profits are growing robustly, as improving demand combines with a lower cost base to produce attractive levels of operational gearing; and the valuation of equities, particularly in the UK, remains supportive of positive returns. Last, but not least, the valuation of the Long Term Recovery portfolio is compelling, with a significantly higher level of support than the market from cash flow, assets and sales. This is truly a PVT, Long Term, and Recovery biased portfolio.

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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