RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Smaller Companies Fund I Quarterly Report
March 2010

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 through 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

Strategy AUM		£37m
Strategy Capacity		£400m
Number of stocks		73
Largest Holding	CVS	2.04 %

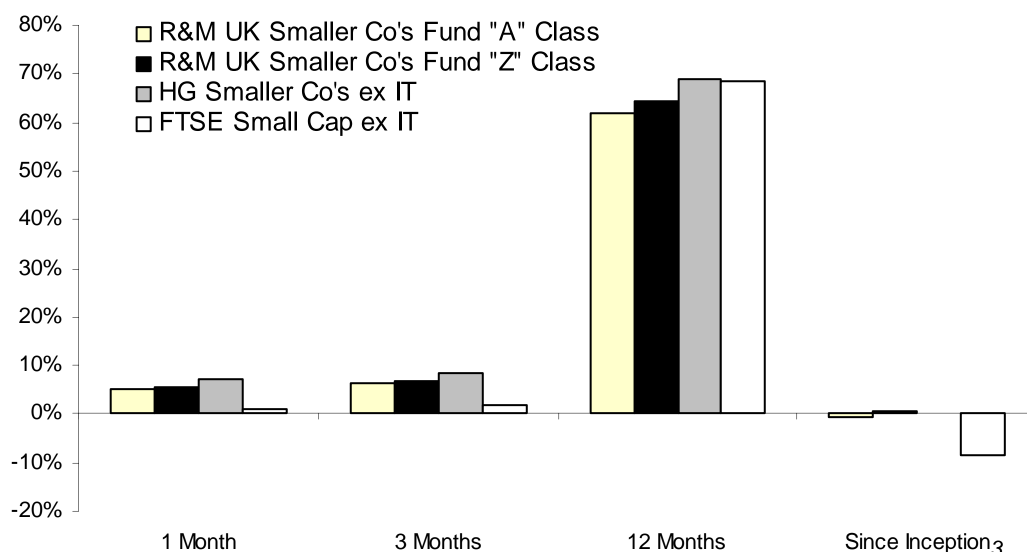
Risk Analysis Summary

Portfolio Volatility	18.71 %
Benchmark Volatility	19.86 %
Tracking Error	5.83 %
Portfolio Beta	0.90
Active Money	83.40 %

Performance to 31 March 2010

Retail "A" Class Shares	Fund[1]	HG Index*	Difference	*FTSE Small Cap (ex IT)*
1 Month	5.23%	7.24%	-2.01%	*1.10%*
3 Months	6.30%	8.48%	-2.18%	*1.83%*
12 Months	61.99%	69.01%	-7.02%	*68.66%*
Since Inception[3] (%p.a.)	-0.86%	0.26%	-1.12%	*-8.68%*

Inst'l "Z" Class Shares	Fund[2]	HG Index*	Difference	*FTSE Small Cap (ex IT)*
1 Month	5.37%	7.24%	-1.87%	*1.10%*
3 Months	6.70%	8.48%	-1.78%	*1.83%*
12 Months	64.43%	69.01%	-4.58%	*68.66%*
Since Inception[3] (%p.a.)	0.61%	0.26%	0.35%	*-8.68%*



Source: River and Mercantile Asset Management LLP
**Index: Hoare Govett Smaller Companies ex IT*
[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 30 November 2006

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.

We 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. We hope, as always, our quarterly report gives you a more open appraisal of how we 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 (ex IT) Index up 1.8%, mid caps up 10%, and the Hoare-Govett up 8.5%.

The median smaller company has lagged in 2010 following strong outperformance during 2009. Wider market commentary appears to suggest that this is due to the 'Made in UK' tag, which we feel unfairly reflects the diversity of equities and changing geographical exposures of the average company. Having made this point again, we perceive UK exposed companies are becoming relatively attractive again on valuation terms.

Performance

The fund underperformed the benchmark by 1.78% during the quarter.

Underperformance was due to a combination of zero exposure to two benchmark heavyweights where takeover bids emerged, namely **Arriva** and **VT Group**, and huge outperformance from one large benchmark company, the 51% Ukrainian founder owned, iron-ore miner **Ferrexpo**. At time of writing it has a £2.1bn market capitalisation and increased 89% during the quarter buoyed by the underlying strength in its single commodity and the resultant improvement in its stretched financial position. We remain underweight the largest companies in the Hoare Govett Index, identifying opportunities across the small cap spectrum.

However, we did have some own-goals aswell and two of 2009's key winners totally reversed their earnings momentum and hurt performance, namely **BATM** and **Intec Telecom**. We have exited both stocks.

Fiberweb also had a weak quarter. We played a very active role (which is quite rare for us) in ensuring a proposed value-destructive deal was aborted during the period. We have considerable confidence in the Recovery Potential of the company, are confident in the current under-valuation of the shares and expect Timing attributes to improve over the rest of 2010.

The announcements of takeover approaches for **Delta** and **Rensburg Shepherds** from overseas buyers were beneficial. Other Industrials performed very well without bids emerging, such as **Bodycote**, **IMI**, **Domino Printing** and **Spirent**.

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 to the Category weightings slice since the start of the year. Quality exposure remains the highest allocation of capital with Recovery and Growth Potential evenly split at just over 22% and Asset Backed at 10%, providing, as the Philosophy intends, a good mix. The portfolio retains a strong skew to high scoring stocks as ranked by MoneyPenny, our proprietary quantitative screen, with 70% in the top four deciles.

The portfolio continues, per Style Research, to have a positive value bias, below average beta, and low leverage.

Portfolio Activity

Monthly reports have detailed much of our activity during the quarter, however to summarise:

We sold **BATM** and **Intec Telecom** following negative trading updates. We sold **Delta** and **Rensburg Shepherds** following takeover approaches.

Within Quality we exited **IMI** and **Aegis** following their promotion out of the benchmark and also exited **De la Rue**, **Hill & Smith** and **Dechra Pharmaceuticals** as the scores fell and theses weakened relatively. We purchased four new Quality holdings, namely **Hiscox** (a leading Lloyds Underwriter), **Robert Wiseman** (the market leader in UK milk production), **Xchanging** (the business process outsourcing company) and participated in the IPO of **CPP** the highly cash-generative, market leading, credit-card and identity protection business.

Within Growth we exited **McBride** (private label goods) and **Booker** (grocery wholesaler), booking material profits in the process, and purchased **Synergy Healthcare** (Hospital out-sourcing services) and **CSF** (Asian data-hosting).

Within Recovery we exited **Lookers** (UK car retail), **Brammer** (industrial fasteners), **MBE** (outsourced office space), **Centaur Media** (B2B) and **Morgan Sindall** (construction and office fit-out) and purchased **Collins Stewart** (wealth management and stock-broking), **UK Mail** (business post services) and **SIG** (building insulation distributer).

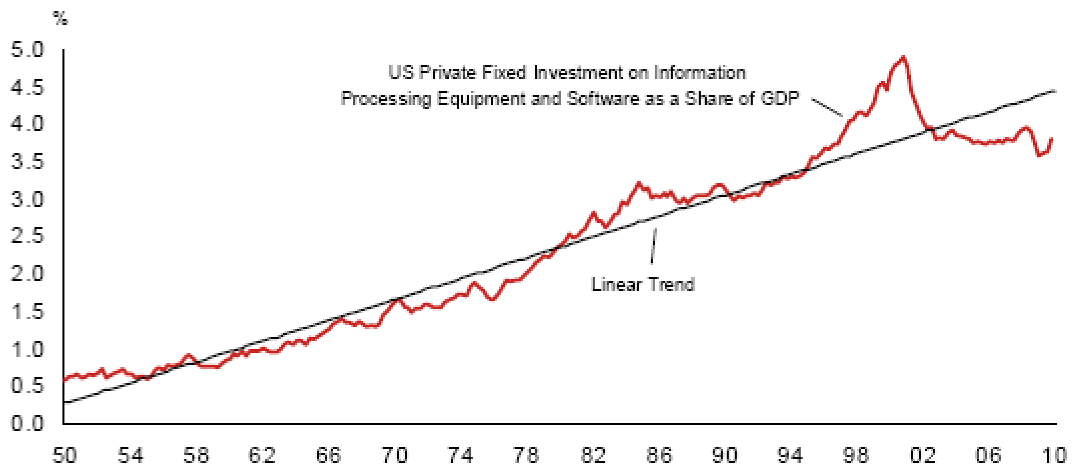
Sector positioning

There has been little change to our sector positioning during the quarter. Four out of the top five overweights in December remain (Support services, Technology, Telecommunications, Oil & Gas), whilst Industrial Engineering has fallen away due to the sale of **IMI** and **Delta**. The new top five overweight is Healthcare due to the purchase of **Synergy Healthcare**. Three out of the top five underweights remain (Travel & Leisure, Housebuilders & Defence), with the two changes due to relative performance over the period such as the extremely strong Industrial Mining sector becoming a bigger underweight.

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), **Spirent** (global provider of telecommunications network testing), **Psion** (Global leader in rugged mobile technology), and **Innovation Group** (Software and BPO services to the Insurance industry). We have also purchased a position in **CSF**, a leading Asian based data-hosting company to blue-chips clients such as Google. In total, we have over 10% in Technology shares.

Oil Exploration and Production

We have invested in a small number of emerging mid-cap exploration and production companies. 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 **Serica Energy**.

All four have recently entered the production phase on key assets. This is a critical 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 and Serica's production is in SE Asia, Afren's Nigeria and Valliant's the North Sea; all very low risk, proven, prolific production basins. 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 and South East Asia. In total we have c.6% 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 outcomes are less relevant than drilling success.

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.

Fortunately the UK stock market, including smaller companies, is not dominated by such domestic events. 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. We retain limited exposure to UK house builders.

Summary

The Fund is built via a bottom-up stock selection process based upon our PVT philosophy. We 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.

Richard Staveley & Dan Hanbury
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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