

RIVER AND MERCANTILE  
ASSET MANAGEMENT

UK Equity High Alpha Fund I Quarterly Report  
June 2010

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# River and Mercantile

June 2010

## UK Equity High Alpha Fund – Quarterly Report

### Fund Aim

The investment objective of the Fund is to achieve capital growth by investing in a focussed portfolio of investments which shall primarily consist of UK equities which offer the prospect of superior long term growth.

### Portfolio Summary

|                   |             |
|-------------------|-------------|
| Strategy AUM      | £298m       |
| Strategy Capacity | £1.1bn      |
| Number of stocks  | 114         |
| Largest Holding   | HSBC 6.36 % |

### Risk Analysis Summary

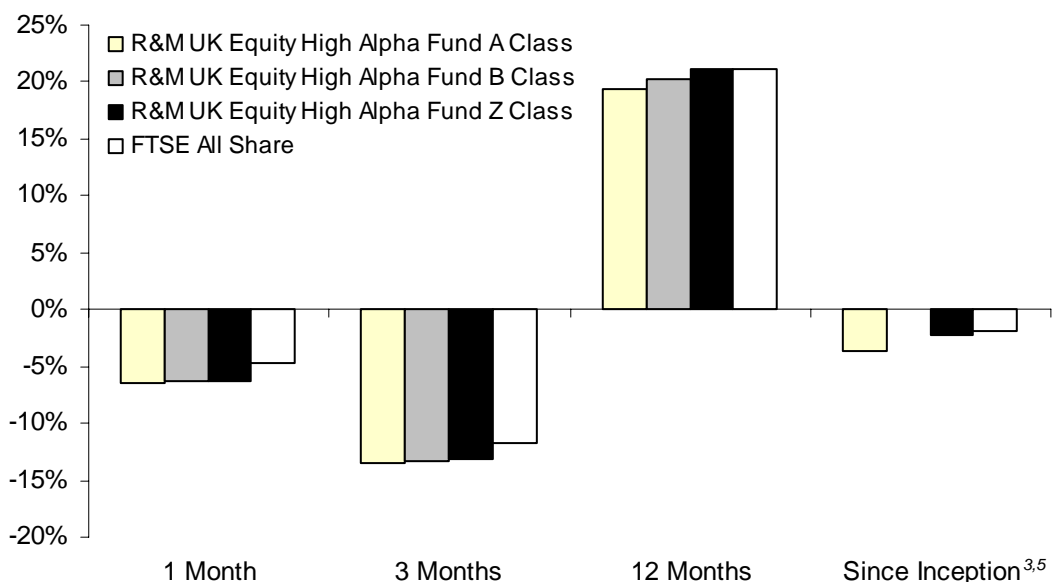
|                      |         |
|----------------------|---------|
| Portfolio Volatility | 18.55 % |
| Benchmark Volatility | 16.58 % |
| Tracking Error       | 5.02 %  |
| Portfolio Beta       | 1.08    |
| Active Money         | 56.10 % |

### Performance to 30 June 2010

| Retail "A" Class Shares              | Fund <sup>1</sup> | Index*  | Difference |
|--------------------------------------|-------------------|---------|------------|
| 1 Month                              | -6.39%            | -4.62%  | -1.77%     |
| 3 Months                             | -13.48%           | -11.80% | -1.68%     |
| 12 Months                            | 19.45%            | 21.14%  | -1.69%     |
| Since Inception <sup>3</sup> (%p.a.) | -3.74%            | -1.85%  | -1.89%     |

| Asset Manager "B" Class Shares       | Fund <sup>1</sup> | Index*  | Difference |
|--------------------------------------|-------------------|---------|------------|
| 1 Month                              | -6.33%            | -4.62%  | -1.71%     |
| 3 Months                             | -13.36%           | -11.80% | -1.56%     |
| 12 Months                            | 20.26%            | 21.14%  | -0.88%     |
| Since Inception <sup>4</sup> (%p.a.) | 21.79%            | 16.83%  | 4.96%      |

| Institutional "Z" Class Shares       | Fund <sup>2</sup> | Index*  | Difference |
|--------------------------------------|-------------------|---------|------------|
| 1 Month                              | -6.27%            | -4.62%  | -1.65%     |
| 3 Months                             | -13.20%           | -11.80% | -1.40%     |
| 12 Months                            | 21.16%            | 21.14%  | 0.02%      |
| Since Inception <sup>3</sup> (%p.a.) | -2.33%            | -1.85%  | -0.48%     |



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>Performance calculated on a mid to mid basis at close of business, gross of annual management charge

<sup>3</sup>Inception date "A" and "Z" class shares is 28 Nov 2006, <sup>4</sup>Inception date "B" class shares is 20 Oct 2008

<sup>5</sup>"B" class shares are not included in this category due to the later inception date of this share class

### Quote for the Quarter

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

- Ralph Waldo Emerson

### Key Observation

Volatility and fear has returned to equity markets courtesy of sovereign debt worries. As a result, equity risk premiums have moved back up towards their historic highs, and risk adjusted valuation anomalies have become almost as profound as they were at the height of the credit crunch. The risk adjustment I refer to is at the corporate level, where a year of improving business and financial market conditions has allowed companies to de-risk both their profit and loss accounts through cost cutting, and their balance sheets through cash generation and equity finance. The result of persistent low valuations and improved company fundamentals will be higher levels of M&A activity, often at significant premiums to the equity market quote. For example, at the end of last quarter Scott Wilson received a bid at a 300% premium to its pre-bid price. This size of mispricing by the stock market should not be possible but, as long as short-term, macro driven sentiment continues to dominate equity prices (and it now seems that this type of environment could last a long time), then these crazy anomalies will continue to exist. We remain resolute in our course of action, to continue to exploit the large number of anomalously priced, high conviction PVT stocks that are out there.

### Market background

#### Quarter:

It has been a very difficult quarter for equities. Top-down fears dominated the period as macro-political risk, in the form of the sovereign debt crisis, broadened out to renewed fears of an economic double dip. Whilst there was clear evidence that the economic recovery is slowing, there was little balance in the market's response to data releases – the mindset of investors has switched back to all news being bad news. As a result, equity risk premiums moved sharply upwards, volatility returned towards the levels witnessed during the credit crunch and, in general, there was a move towards lower risk investments. The UK market had to contend with a halving in the price of one of its largest companies, as the oil spill in the Gulf of Mexico and the subsequent political response led to significant uncertainty about the ongoing value of BP's operations in the United States. The result of the UK election, and subsequent formation of the first coalition in a generation, was greeted reasonably warmly by markets, as the clear focus on putting the UK economy on a more sustainable path through fiscal responsibility led to a strengthening of both sterling and gilts.

The UK equity market delivered a return of -11.8%, led down by the Oil Producers (BP) and by cyclical (mining) and recovery sectors (housing). UK domestic stocks continued to be weak despite the reassuring response from markets to the new Government. Defensive sectors such as Utilities and Pharmaceuticals did well, as did the global growth stocks like Arm and Aggreko. Smaller Companies proved to be reasonably defensive on the way down. Factor returns were again significant, with Value performing poorly and Momentum becoming increasingly effective. Quality and Growth stocks did well, Recovery and Asset Backed poorly. Bid activity is starting to play a more material roll in performance, with BSKyB in the FTSE100 receiving a buy-out offer for the minority shareholding not owned by News Corp, and a number of bids occurring amongst smaller companies.

## How did we perform and why?

### Quarter:

We underperformed the market returning -13.2%. The Fund was hurt by lower than market exposure to defensive sectors and its overweight exposure to Value and Recovery stocks. Again, top-down factors dominated performance, with stock level performance actually supportive with two materially positive stock picks; **Blinkx** more than doubled following good results and **Scott Wilson** tripled in response to a bid.

### Year:

Performance over 2010, to date, has been modestly behind the market, as the anti-anomaly trade reared its frightening head towards the end of the period. Incorrectly valued stocks became cheaper through May and June causing the High Alpha strategy to lag the Index, returning -7.2% for the six months period versus the FTSE All-Share Index return of -6.2%. Returns have been dominated by top-down swings in sentiment and factor volatility with stock specific selection actually positive. Over the twelve months to 30 June, the High Alpha strategy has performed in line with the Index. This masks some degree of volatility in relative performance, notably in the second half of 2009.

## Key performance contributors

### Quarter:

**Positive:** Stock contributions (**Blinkx**), take-over activity (**Scott Wilson**), underweight mining stocks (**BHP**)

**Negative:** Underweight defensives (**BAT**), overweight recovery and UK domestics (**Johnston Press**), disappointing profit updates (**888**).

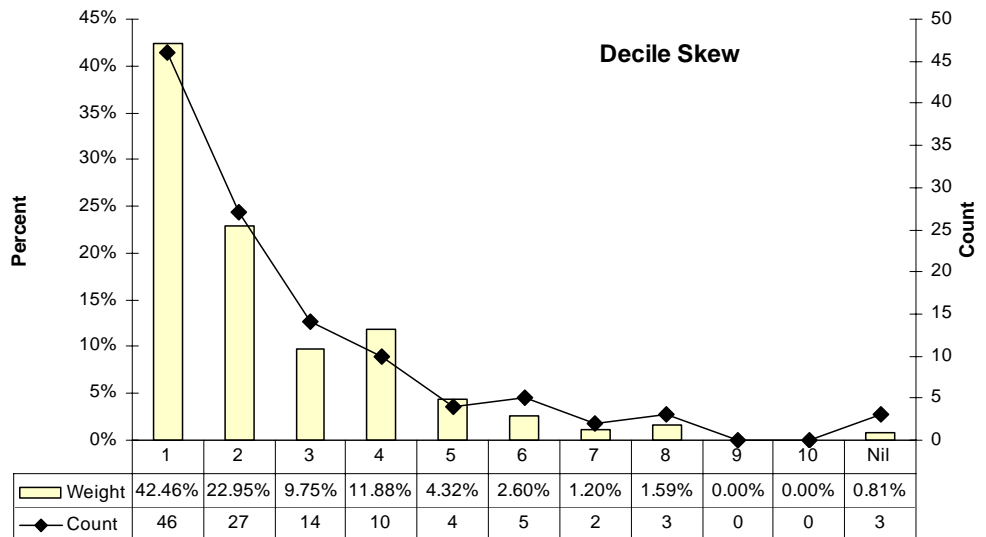
## Performance Outlook

Whilst the relative returns so far this year have been somewhat disappointing (especially as we had been ahead of benchmark for most of the year) we have a lot of confidence about being able to generate superior returns from here. The opportunity set is not that different from Q2 2009, with many good quality franchises back to ridiculously low levels of valuation due to the disappearance of risk appetite. Given that these companies have already come through a severe recession in good shape and, indeed, have strengthened their P&L's and balance sheets over the last eighteen months, they will survive another slowdown in the global economy. As soon as the stock market and investors realise this their share prices will strengthen considerably. As John Templeton once said "The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell".

## Does the portfolio reflect our philosophy and process?

Our category exposure is slowly evolving, with a continued desire to add to the Growth category. Whilst we have been committed to this strategy for a few quarters now, we have found it quite hard to find Growth potential that is not cyclical and not highly valued. However, the recent market setback has increased the hunting ground for this type of stock, allowing us to take initial positions in a number of secular growth stocks (more on this later) and taking our weight in this category up to 12%.

The chart overleaf shows that our strategy continues to have a strong skew towards high scoring stocks.

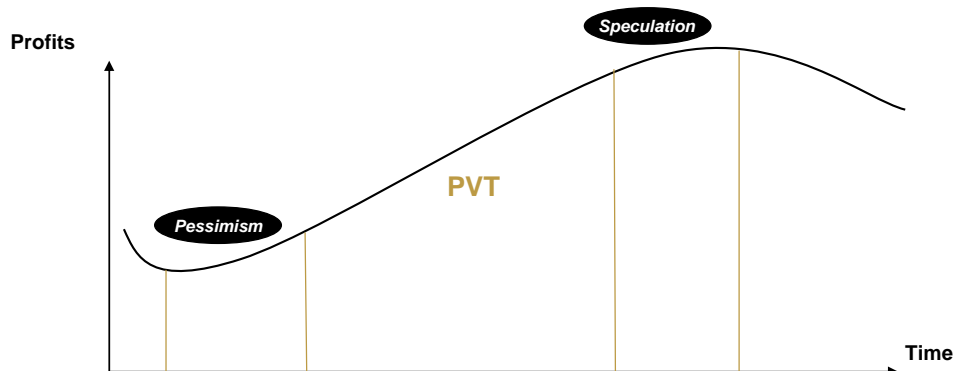


Source: River and Mercantile Asset Management LLP

## 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.



|                  | 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      |

As a quick reminder, 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.

Our current view is that, whilst there has been a setback in risk appetite and the pace of the economic recovery, we would see this as temporary rather than a permanent move back to the decline phase of the stock market cycle.

## **Valuations – The ‘Sale of the Century’**

With the recent market setback the ‘Sale of the Century’ has returned, and this is more than reflected in the High Alpha portfolio. As students of the great Ben Graham will know, one of his key valuation metrics was the relationship of the Earnings Yield (inverse of the simple Price Earnings Ratio) to the Risk Free Rate; anything over two times (normalised) was considered good value, especially if it was complemented by a robust balance sheet. So hopefully you will be relieved to hear that 20% (by number of stocks, earnings normalised) of your portfolio is invested in stocks with an EY five times the RF rate, 45% in stocks with an EY four times the RF rate, and 70% in stocks with an EY three times the RF rate. The portfolio has very few stocks where the EY is less than two times the RF rate. Hopefully Ben Graham would be a buyer of this portfolio – I have been!

### **BP**

I have covered the BP story extensively over recent monthly reports; here I will focus on what we have done in response.

Our starting point has been to be cautious about the Oil Majors, and this has been reflected in the Oil sector consistently being the largest underweight position in the High Alpha strategy over the last few years. The reason for this is that we are concerned about the fundamentals of Big Oil – because the national oil companies dominate the biggest and easiest reserves, the international oil companies such as BP and Shell have to operate in frontier, more expensive regions and, even then, they struggle to find enough oil to replace what they are producing; as a result they are low growth, asset intensive businesses - hence our caution.

Amongst the Oil Majors we have favoured BP rather than Shell, because it has been more efficiently run and because it has been better at growing its production, no doubt partly due to its more entrepreneurial approach. However, despite favouring BP, we were 2% underweight the stock before the Gulf of Mexico oil spill. As the extent of the oil spill unfolded, and the shares started to fall dramatically, our somewhat premature interpretation was that the market was overreacting. Conservative estimates from leading sell-side brokers suggested a cost of up to \$10bn, an amount easily affordable given the strength of BP’s balance sheet and strong cash flow; as a result we significantly reduced our underweight position, seeing this as a good opportunity to purchase a ‘quality’ mega-cap stock (where we are significantly under-exposed) at a very attractive price.

As we now know, news flow continued to deteriorate, and the stock market started to panic as US politicians became heavily involved. The size of the potential liability accelerated as the size of the spill increased, forcing BP to commit to a \$20bn make-good escrow account and causing the shares to fall by more than 50% and trade at an unheard of discount to book value.

Where we are today is that the well should be plugged within the next month, the liabilities should be capped through legal and strategic means (BP are under no obligation to have a completely open cheque book), the financial strength of the company should be sufficient to meet these large, but capped liabilities, and the intrinsic value of BP including potential liabilities is significantly higher than the current share price. That said there are significant uncertainties and, as a result, we decided that we wanted to limit our exposure to the stock to a 50 basis point active position. This is where we are today. The net relative result of the portfolio’s position and activity in BP has been modestly positive, though of course the absolute impact has been more material, for this fund and the UK investment industry in general.

### **UK Economic Outlook, the Budget and Macro Prudential Management**

Everyone in the UK, apart from a handful of Labour politicians, has accepted that we have been living beyond our means and that this could not go on forever. A structural balancing of the books must surely be the only sensible approach; of course the Government and fiscal policy needs to kick in when the private sector goes into recession, this balancing approach to

fiscal policy is entirely sensible. But the Public Sector needs to step back (at an appropriate pace) as the Private Sector recovers. This is what the coalition Government is aiming to do and, at the same time, is looking to materially improve the productivity of the Public Sector. This, in my view, was the biggest mistake of the Labour Government – they quite rightly increased the investment in public services at a time when schools, hospitals and our transport infrastructure desperately needed updating. However, Gordon Brown refused to countenance the reforms that Tony Blair (advised by Frank Field, who is now working for the coalition) wanted to put in place to ensure that money was spent productively.

Of course, the short term growth outlook in the UK will be more muted given the fiscal cuts, however medium term growth should be higher and certainly more sustainable, and the risks of a flight of liquidity away from the UK have been greatly reduced.

As for Macro Prudential Management, I am a great supporter, and indeed have written about this very subject in past Quarterly Reports. My argument has been that RPI and CPI have been too narrow definitions of inflation and therefore potential macroeconomic threats; it has been asset inflation that has been the great destabiliser of economies over the last several decades, from housing bubbles to TMT bubbles, the credit created and then destroyed as a result of these manias have been hugely destructive. So a Financial Policy Committee with a remit to identify and respond to future bubbles seems like a great idea. As Mervyn King said at the Lord Mayor's banquet "It is not difficult to see what role a macro prudential regime might have played in the run-up to the crisis. A progressive tightening of capital standards, for example, would have helped rein in the near-tripling of UK bank balance sheets between 2002 and 2007. The Bank's sermons on the storms ahead would have had more influence if at the same time a collection plate was passed round the congregation so that money was available in the event that the church roof had to be replaced."

### **Double Dips**

I am afraid I don't really know if we are going into a double dip or not. I can say that I think it is unlikely (very low interest rates, private sector cash surplus feeding through into investment, manufacturing picking-up and exports strong) but I can't be certain. However, what I can be certain about is that investment sentiment is now assuming a double dip; just look at the papers and the performance of economically sensitive shares (house builders have halved over the last six months). And if sentiment changes on this subject (and these days it seems to be sentiment, not reality, that dictates macro views) then one can be sure that all the stocks in this portfolio that are trading on discounts to book value will be off to the races.

### **Portfolio Activity**

This quarter's market setback has provided the opportunity to add to existing high conviction positions at lower prices.

We have also continued to look for undervalued Growth investments, and these were the focus of our new purchases during the quarter. We started positions in high scoring (MoneyPenny) Growth stocks including **Dimension Data**, **Fidessa**, **IG Group**, **Renesola** and **Wolfson**. A number of our purchases were in the technology sector where we continue to see very attractively priced, growth oriented enterprises with a positive demand outlook due to a combination of the innovation cycle and improving corporate demand for productivity enhancing investment.

### **New Investments (purchases)**

**Dimension Data** is a global leading supplier of internet networking equipment and services. This is a growth market and Di Data has a global footprint, with strong market positions in Europe, Asia and Africa. The Management team under Bret Dawson has done a great job running the business over the last couple of years, both growing the revenue line but also improving the operating margin. However the investment story is not over yet; growth should

continue in response to the huge demand for internet data, margins should continue to build, and the company's strong cash flow can be applied to bolt-on acquisitions. The valuation, in particular on an EV to gross cash flow basis, is attractive.

**Fidessa** is a high scoring, world leading supplier of trading systems, market data and connectivity solutions to financial market participants. It has grown robustly and consistently over the years and, through high levels of ongoing investment in functionality and regional expansion, has been able to take market share from its main competitors. The business model is focused on organic growth, an approach that ensures high returns to shareholders; its robust cash generation results in regular pay-backs to its owners. Its reliance on financial services businesses has led to something of a de-rating over the last few years, providing the opportunity to purchase shares in Fidessa at an attractive price.

The market setback also enabled us to increase our international industrial exposure, notably adding **Charter** which has two global leading businesses in welding, cutting and automation (ESAB), and air and gas handling (Howden). Howden has proven to be stable during the global recession; ESAB, with its exposure to the construction market, has good recovery potential, the balance sheet is robust with net cash and the valuation is modest, trading on less than 10 times earnings.

A new Recovery stock that we started to buy late in the quarter was **Tate & Lyle**. Over the years this global leading sugar and sweeteners business has had a volatile and capital intensive earnings profile due to the commodity nature of its sugar business. However, a new management team has been installed under the leadership of Javed Ahmed, who has come from Reckitt Benckiser. He is robustly applying the shareholder value approach he learnt there to improving returns at Tate & Lyle. The commodity focused, asset intensive businesses such as the original sugar processing operations are being sold; value-added higher return ingredients businesses are being invested in, and working capital requirements have been shrunk. Sustainable ROIC has already been improved as a result, but this will be a multi-year improvement programme and this is not reflected in the valuation, with an earnings yield of 9%, dividend yield of 5% and attractive gross and free cash flow support.

#### **Existing investments we have become more confident about (purchases)**

We added to a large number of existing investments as news flow confirmed our initial thesis and the falling market provided opportunities to 'pound cost average'.

**Wolseley** was weak into the end of the quarter as US housing data disappointed. However this is a multi-year self-help story, where management continue to re-shape the business to improve long term returns on capital, and have cut costs to ensure profitability picks up. The shares are worth £23, a 70% premium to the current price.

**Lonmin** fell with other mining stocks during the period. However, this is another management story with the new team improving the operational performance of the world's third largest platinum producer. There is significant strategic value in this business, with platinum producers likely to want to consolidate in line with the structure in other metals markets. We would expect Lonmin to be bid for, especially as Xstrata already has a strategic stake.

We also added to our position in **Invensys** after the correction, again, provided the opportunity. This company has been really well managed for a number of years now but is still remembered for its historic legacy of weak financials. However, Invensys is now a transformed business, with strong market positions in Rail Systems and Process Controls, a robust balance sheet with net cash, and margins that are capable of sustained improvement. At some point this company will get the reputation and valuation it deserves; if not then it too will attract corporate interest.

## Stocks that have delivered versus our PVT thesis (sale)

Early in the quarter, during a robust period for both the market and our stocks, we took profits in a number of companies. This included a full exit from **Regus** following strong performance, and profit taking in **Inchcape**.

Later in the quarter we took profits in strongly performing defensive stocks, such as **Centrica** and **Hiscox** to fund increased positions in stocks such as **Wolseley**.

We sold out of our position in **Scott Wilson** as it received a number of competing bids from US based predators, the final agreed price being 290p compared with a pre-bid price of 70p. The huge gap between the stock market quote and the value of the business in the eyes of a competitor just confirms how ridiculously short term the equity market is at the moment, pricing good quality franchises at such big discounts to their medium term worth. We would expect more M&A activity aimed at exploiting these huge valuation gaps.

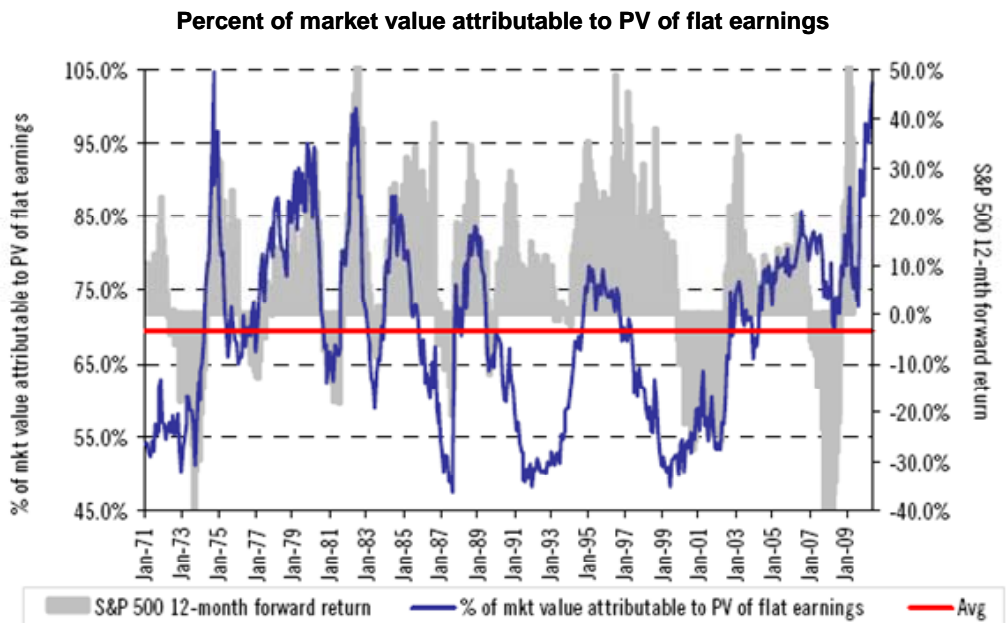
## Stocks we have cut (sale)

We decided to exit from our position in **JJB**. The turnaround strategy that we backed at the time of its refinancing is taking a lot longer to deliver than first expected. As this has undermined our original thesis we decided to refocus capital towards higher conviction recovery stocks.

## Outlook

Our hopes at the beginning of 2010, that it would be a 'boring year', have been dashed. Volatility, risk aversion and not a little panic have returned.

As a result of recent setbacks, equity markets around the world are now discounting zero or negative levels of earnings growth into perpetuity. As the chart below shows the value of the current level of profits from US companies justifies **over** 100% of the US market by value.



Source: Haver Analytics and CIRA – US Equity Strategy

The last time the US Equity market was discounting zero growth was at the beginning of the 1980s, and we all know now that this was the start of a great period for equity returns. Buying equities cheaply, particularly in comparison with the risk free rate, will always produce attractive returns.

Meanwhile our performance over the last three years has been inconsistent, and below my long term average of adding 4% per annum to the benchmark. However, for well rehearsed reasons the background has been unfavourable to my approach, with valuation anomalies, smaller companies and the Recovery category struggling to produce their normal share price appreciation. That said, the starting valuation today on the portfolio is amazingly attractive; the business franchises that are represented in the portfolio are strong, and balance sheets are robust. This combined with the inevitability (history does repeat itself when it comes to Investment) of the factors that have served this strategy well in the past coming back to favour means that I am sure that positive returns will soon be back. I am sticking to my course of action, to what has made money for my approach in the past and am backing my funds with more of my own capital.

Thank you for your ongoing support.

**Hugh Sergeant**  
**Head of UK Equities**

## Fund Facts

|                                     |                               |
|-------------------------------------|-------------------------------|
| Launch date                         | 28 Nov 2006                   |
| Fund manager:                       | Hugh Sergeant                 |
| IMA sector:                         | UK All Companies              |
| Benchmark:                          | FTSE All-Share (Total Return) |
| Tracking error range:               | 4-8%                          |
| Product capacity:                   | £1.1bn (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       | Accumulation  | Accumulation  |
| Fund charges:                 |              |               |               |
| Annual                        | 1.50%        | 0.75%         | 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                         | B1DSZM4      | B3D79W3       | B1DSZP7       |
| ISIN                          | GB00B1DSZM47 | GB00B3D79W34  | GB00B1DSZP77  |
| Bloomberg                     | RMUKEHA LN   | RMUKEHG       | RMUKEAA LN    |

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