RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Income Fund I Quarterly Report
June 2010

River and Mercantile

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UK Equity Income Fund – Quarterly Report

Fund Aim

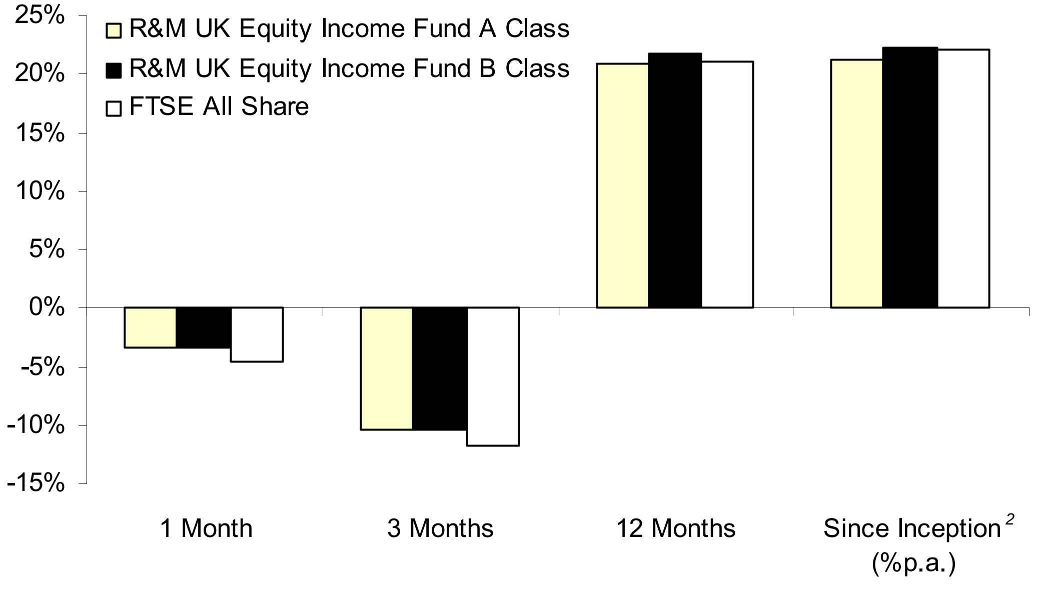
The investment objective of the Fund is to generate a rising level of income combined with the potential for capital growth through investing in a portfolio which will primarily consist of UK equities.

Portfolio Summary			**Risk Analysis Summary**	
Strategy AUM		£24m	Portfolio Volatility	16.43 %
Strategy Capacity		£1bn	Benchmark Volatility	16.58 %
Number of stocks		71	Tracking Error	3.26 %
Largest Holding	Royal Dutch Shell	7.24 %	Portfolio Beta	0.97
Historic Yield		3.90 %	Prospective Historic Yield[3]	4.51 %

Performance to 30 June 2010

Retail "A" Class Shares	**Fund[1]**	**Index***	**Difference**
1 Month	-3.42%	-4.62%	1.20%
3 Months	-10.46%	-11.80%	1.34%
12 Months	20.94%	21.14%	-0.20%
Since Inception[2] (%p.a.)	21.28%	22.11%	-0.83%

Asset Manager "B" Class Shares	**Fund[1]**	**Index***	**Difference**
1 Month	-3.35%	-4.62%	1.27%
3 Months	-10.31%	-11.80%	1.49%
12 Months	21.83%	21.14%	0.69%
Since Inception[2] (%p.a.)	22.18%	22.11%	0.07%



Source: River and Mercantile Asset Management LLP
**Index: FTSE All Share (Total Return)*
[1]Performance calculated on a mid to mid basis at close of business, net of annual management charge
[2]Inception date 3 February 2009
[3]Yield based on the historic dividends of the current holdings of the Fund.

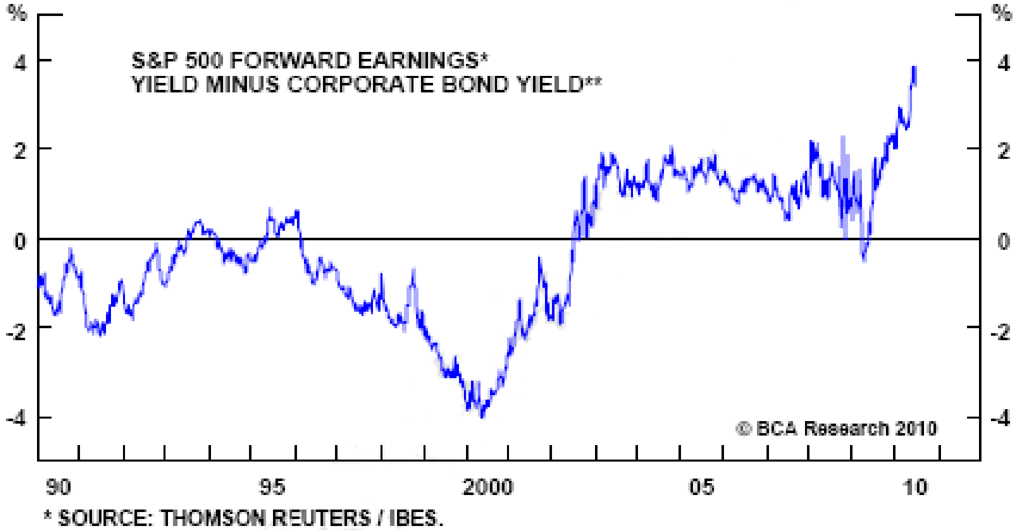
Market Overview

"I always tried to turn every disaster into an opportunity."
- John D. Rockefeller

Q2 2010 was the eleventh worst quarterly performance in 25 years in the UK market. 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. 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 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. Defensive sectors such as Utilities and Pharmaceuticals did well, as did the global growth stocks like Arm, SABMiller 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.

Based on current market consensus dividend forecasts (which reflect BP's 'temporary' omission), the prospective yield on the fund is c.4.4%. 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. Indeed, the spread against corporate bond yields is at extreme levels again.



* SOURCE: THOMSON REUTERS / IBES.
** SOURCE: BANK OF AMERICA MERRILL LYNCH.

Performance

The Fund outperformed the benchmark by 1.49% during the quarter and is now ahead of the benchmark since inception.

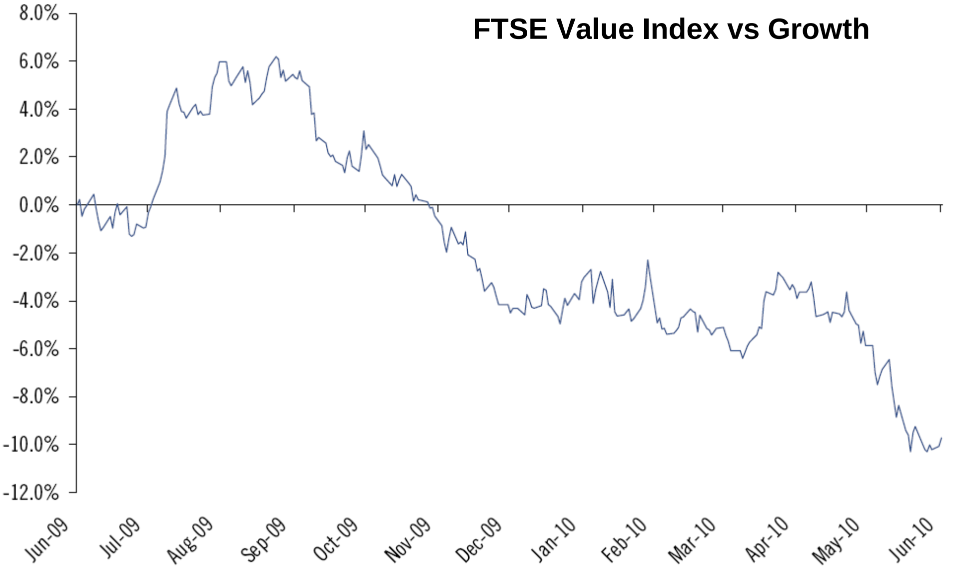
Whilst BP is the talk of the town, its individual contribution to relative performance does not make the portfolio's top ten. My holding here has hurt the absolute performance, as did opportunistic, but premature, adding to that holding during the quarter. However, I remain focused on managing the risks of this position and would hope for it to be a positive contributor, given time, to relative and absolute performance. Ironically, frustrating news that the Ugandan government were breaking all historical precedents and known agreements by requesting Heritage Oil to pay tax on its successful asset sales resulted in the quarter's biggest detractor. Other negative contributors were bank positions, Lloyds and Barclays, and Invensys, which has been disappointing relative to other industrials.

The positive relative performance of the Fund produced more winners than losers, though, and I would highlight, in particular, continued positive contributions from Industrials positions. I have now booked profits in Domino Printing, up 133% since first purchase in February 2009. Top ten large cap active positions such as Vodafone and Reed Elsevier were strong whilst overweight positions in Electricity, Tobacco, Food Producers and Pharmaceutical sectors were beneficial. The large underweight in Mining has worked well; indeed stock selection within the sector has also been strong with Anglo Pacific and Petropavlovsk significantly outperforming the market and sector. I remain committed to my approach to sector risk which is designed to reduce volatility against the market and avoid sector strategy having a higher influence on performance than stock selection. The typical maximum under and overweight positions are -/+4%, and the limits are -/+8%. Currently, apart from the Mining sector, I feel insufficient conviction elsewhere to position outside the typical range. During the quarter the relative performance differential between the Gas, Water and Multi-utilities sector and Oil & Gas Producers was 23.5%.

Philosophy & Process

There has been little change to Category weightings. Quality is just under two thirds of the portfolio, Recovery category is 20.3% of the portfolio, and is a mix of mainly self help situations in Industrials and Technology and the Fund's Financials positions in Life Insurance and Domestic Banks. The skew to high scoring stocks, as quantitatively measured by *Moneypenny*, our proprietary screening tool, has improved during the quarter. The weighting of stocks invested in the top 4 deciles has increased to 73%.

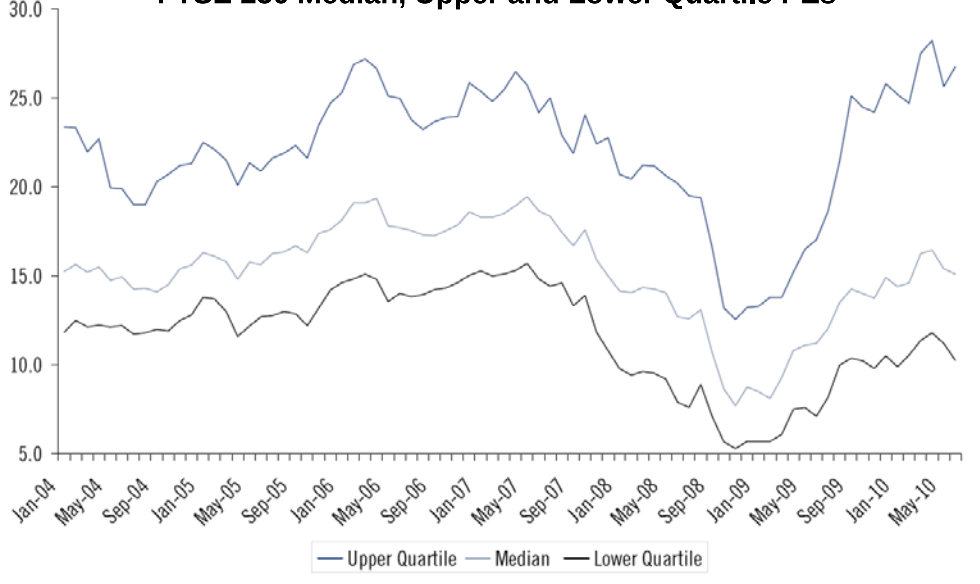
Within the key elements of our Investment Philosophy, the Valuation factor has been performing poorly during the quarter whilst Timing factors have started to improve.



Source: DataStream

The market, it seems, is chasing ‘Growth’, whether it be industrial cyclical growth, overseas growth or secular, and, as is often the case with this desire, valuation discipline is quietly being pushed to one side. This can be seen quite clearly in the FTSE 250 PE dispersion chart below, where the ‘expensive’ are becoming even more so. Buyers should beware as Growth investing appears to only work when anticipated growth is below realised growth. Expectations are all too often disappointed or already reflected in market prices.

FTSE 250 Median, Upper and Lower Quartile PEs



Source: Citi Investment Research and Analysis

Portfolio Income

Market consensus for dividend growth in 2010 has been dealt a hammer blow by the temporary cessation of dividend payments by BP. This was politically expedient but financially unnecessary in my view. The Board did not remember legendary oilman John D. Rockefeller’s statement “Do you know the only thing that gives me pleasure? It’s to see my dividends coming in”. Ex-BP, market dividend expectations are consistently being revised upwards. My objective is for the Fund to produce a rising level of income over time but I have not committed to a sacrosanct yearly rise, although it remains possible that this year’s distribution **is** higher despite this issue. BP will return to the dividend list in due course and our analysis suggests the likely distributions would imply a very high yield on the current share price. I will not be selling BP at the bottom for reasons to do with short term dividend income.

BP has highlighted the concentration issues within the UK market. For our Fund the other top six holdings are expected to combine to contribute c.42% of the prospective yield. No other holding (64 stocks) represents more than 2.5% of the Fund’s yield. What are the risks to the remaining top six?

- Vodafone’s distribution capability is actually intrinsically much better than the current cash flow statement implies because their material Verizon minority does not (yet) deliver dividends. Longer term capital requirements are the main headwind to cash flows. During the quarter management committed to a 7% dividend growth rate.

- The current cash flow generation of GlaxoSmithKline and AstraZeneca significantly exceeds their distributions, so much so that both are expected to enhance distributions to shareholders by supplementary buy-backs. Both face patent expiries for key drugs over the next few years, and their challenge is to replace these lost cash flows with new drugs (progress improving), new geographies (emerging market sales accelerating) and cost-cutting (ahead of expectations).

• HSBC rebased its dividend last year, and is one of the best capitalised global banks in the world now, with clearly improving profitability.

• British American Tobacco faces ongoing regulatory pressures, yet its economies of scale, price inelastic product and global (growing) customer base suggest its long history of dividend growth should continue.

• Finally, Royal Dutch Shell, where the possibility of an oil spill cannot be dissimilar from BP. I could provide data on their diverse geographic locations or mix of gas and refining assets and safety record relative to BP, but suspect that worrying about a spill and their dividend payout would be like breaking the lease on a skyscraper on September 12, 2001. My main concern remains that, given a break-even oil price for Shell, reportedly at c. $60, a sustained or dramatic fall in the key commodity price is a far greater risk to the dividend. Currently, I do not perceive this to be a material risk.

43 stocks went ex-dividend during the quarter including 27 increases, 11 unchanged payouts and 5 cuts, of which 2 were oil majors. Of the increases it is worth noting Vodafone +8.6%, Halfords +28%, Sainsbury's +6.2%, GlaxoSmithKline +7.1%, Bae Systems +10.3%, and Legal & General +33%. The Fund's current consensus based prospective yield of 4.4% is 117% of the market yield.

Portfolio Activity

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

<u>Increase to UK Domestic exposure as poor economic outlook becomes reflected in forecasts and relative valuations too stretched:</u>

Overseas sales generated by portfolio holdings are approximately 64% of the total. This is slightly below the UK market but, given my significant underweight in Mining companies, represents a bias to overseas earnings across the rest of the Fund. This has historically been driven by the now consensual view that the overseas growth outlook is better and lower risk than the UK's. Valuations have been driven up by the market seeking out this investment theme and I feel the relative valuation of some domestically focused stocks, in combination with low expectations, has become attractive, especially now that the strength of global growth expectations are being questioned. Example purchases in the last quarter have been Morrisons, the steady growing food retailer; Lloyds Bank; Moneysupermarket.com, the internet price comparison site; Mitie, the integrated services provider; and Balfour Beatty, the construction and services company.

<u>Rotation of successful industrial cyclical investments into better value laggards:</u>

The overweight position in Industrials is serving the portfolio well and has been made up of a number of FTSE 250 companies. I have booked profits in those whose valuations have become stretched, and where dividend yields are now sub-market, and recycled capital into cheaper laggards which have similar Timing characteristics. Examples include the purchases of Elementis, the speciality chemicals company, Melrose, the industrial engineering group and Electrocomponents, the distributor, funded by the profitable exits of Diploma and Domino Printing.

<u>The sale of investments due to weakening theses:</u>

During the quarter I exited 888 Holdings, Regus, Game Group and the LSE due to weakening conviction in the Potential and deteriorating Timing characteristics. In the near term all stocks have subsequently underperformed.

<u>BP:</u>

At the end of March 2010 I had 5.6% in BP, a large underweight versus the benchmark. The tragic oil spill and rig failure in the Gulf of Mexico has had a massive impact upon the current market valuation of BP's future cashflows. I do not intend to add to the huge volume of commentary already on this situation, other than to inform clients that during the quarter I began adding to our shareholding in BP at increasingly lower market prices and have exited the quarter with a 5% weighting which is an overweight position relative to benchmark of c.100bps. The range of potential outcomes is more than reflected in the market price. In the short-term my purchases appear premature, however I strongly believe that the future cashflows available to shareholders from BP's world leading and global assets, despite the impact of this incident, are undervalued. The ongoing situation and its impact on fundamentals and the market price need to be carefully monitored.

Sector positioning

The strategy continues to take limited sector risk vs. the market with the largest overweight still Industrial Transportation at +2.05% (Clarkson, world leading ship broker; BBA Aviation, flight support services; and UK Mail) and the largest underweight being Mining at -4.7%. Sector positioning has been broadly positive during the quarter.

Overweight cyclical sectors continue to be Technology, Media, Electronics and Engineering. Overweight defensive sectors continue to be Pharmaceuticals, Tobacco, Food Producers, Telecommunications and Electricity. Key underweights, in addition to Mining, include Asian Banks and Consumer sectors such as Leisure, Retail and House Builders.

Market Outlook

I introduced my concept of the "Magnificent Seven" at the start of the year on the likely defining investor themes for the next decade. At the half-year mark I think a brief view on each is appropriate.

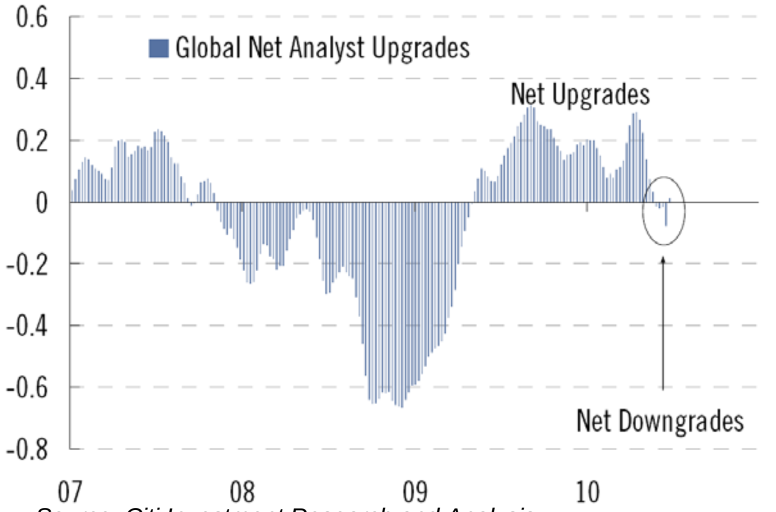
1. The UK Fiscal Position - *Harry Luck*

The new government has gambled its economic credibility on material deficit reduction over the life of this Parliament. Biscuit budgets, quangos, public sector pay, nothing appears immune. Markets have responded well to these intentions which should ensure the cost of servicing the country's massive debt remains low. My two key observations would be: Firstly, this approach will ensure ongoing loose monetary conditions for an extended period, which should be positive for risk assets. Secondly the pressures on aggregate household spending will mean growth is anaemic at best and thus investment exposure to Potential in these areas should bias to either self-help or secular growth.

2. Financial Sector Recovery - *Vin*

Bond markets imply Greece will eventually default despite the politicians' efforts. Interbank spreads have widened to reflect the heightened risk of sovereign defaults impacting Banks' balance sheets. The imminent Stress Test results provides a welcome final opportunity for 'cleansing', an opportunity missed by the Japanese monetary authorities two decades ago resulting in an outcome which Europe must avoid. Bank-bashers are getting their heightened regulatory impulses off their chests, with most likely measures already reflected in expected future returns profiles for the industry. Meanwhile, banks' financial results have been strong with declining impairments ahead of expectations and spreads at profitable levels. This emerging relative earnings momentum is positive in the context of the global aggregate data rolling over.

Global Net Earnings Estimate Upgrades



Source: Citi Investment Research and Analysis

3. Chinese GDP Growth - *Lee*

China's measures to temper property speculation and slow monetary expansion are working, with the data available (accuracy questionable) suggesting the desired impact is occurring and Chinese GDP forecasts are pulling back to nearer 10%. I currently believe market consensus has too high a belief in the Chinese authorities' ability to manage economic growth in the future, despite a strong track record relative to Western authorities in recent decades. If the desired slowdown is contained, an opportunity should open up to unwind my tactical Mining underweight. However, currently there is as great a risk that the slowdown accelerates, putting renewed downward pressure on resource prices and testing investor sentiment towards 'global growth'.

4. The disruptive progress of technology - *Britt*

How disruptive Apple's iPad tablet will be is unclear. My personal experience to date has seen users' attention highlight nosey Google Earth applications, a 'live', interactive fish tank display and piano teaching. What is occurring, though, is that data usage is continuing to ramp up, which is positive for our large position in Vodafone and should ensure industry rollout of LTE ('4G') over the next 3-4 years. This next generation technology essentially allows network operators to handle this ever increasing data demand with likely speeds of up to 100mbps over wireless broadband. Anite appears perfectly placed to sell the much needed testing software which global operators will require. Technology investment, alongside generalised capital expenditure, remains paltry relative to history, suggesting significant medium-term upside to sectors exposed to its eventual recovery.

Eurozone capex as a share of GDP

Source: Eurostat

5. Inflation or Deflation? - *Chico*

Quite simply, alongside consensus, I am more worried about a deflationary outcome in Europe than I have been for some time. Austerity packages are welcome, but must be accompanied by monetary expansion by the European Central Bank, which still appears reluctant relative to the US or UK to expand its balance sheet at a level conducive to ensuring the region does not descend into a long term deflationary spiral.

6. Change in Global Healthcare - *Bernardo*

The Pharmaceutical sector is showing signs of relative performance. Could this at last be the beginning of a positive trend? AstraZeneca's Crestor news was clearly positive and we await imminent news flow on Avandia for Glaxosmithkline, where I believe a negative outcome is already reflected in the valuation.

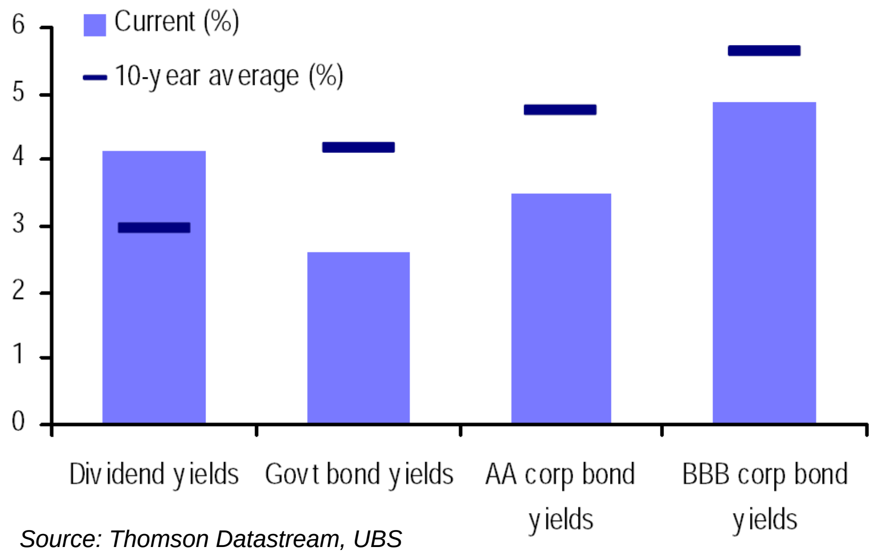
7. Geo-political Shocks & Conflict - *Chris*

Korea is a wildcard, whilst the managed withdrawal from Afghanistan thankfully seems to be starting. I remain concerned that the years of 'austerity' ahead raise the likelihood or 'tail-risk' of geo-political shocks such as the breakup of the Eurozone.

Summary

The attractions of Equity Income were much debated before the market bottomed in 2009, particularly in the context of the high yields available on corporate bonds at that time. The spread between the two after the recent market correction, despite the loss of BP, suggests equity income is relatively attractive in my opinion.

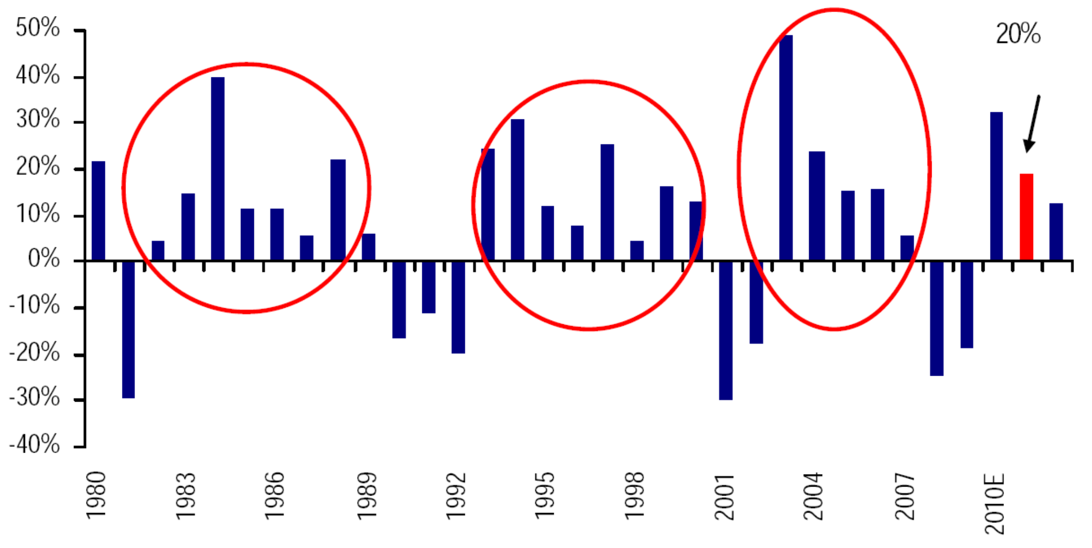
European dividends (forward) relative to historical average versus government and corporate bonds



Source: Thomson Datastream, UBS

It is unclear whether a 'double-dip' will transpire. Evidence such as the lack of an inverted yield curve, an expansionary ISM reading, the sub-peak level of corporate profitability and the typical length of economic and profit recoveries (see chart on following page) is as positive as recent weakening economic evidence, such as in US housing, is negative. Valuation levels seem to suggest a disappointing outcome is being priced in.

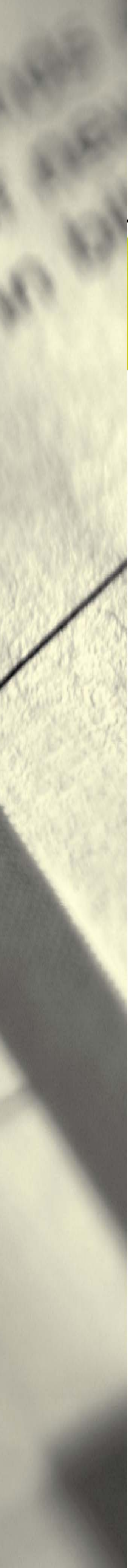
MSCI profit growth (YoY) since 1979



Source: IBES, Thomson Datastream, UBS estimates

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 positive 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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