RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Long Term Recovery Fund I Quarterly Report
June 2010

River and Mercantile

June 2010

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

Strategy AUM		£60m
Strategy Capacity		£200m
Number of stocks		156
Largest Holding	Rio Tinto	3.3 %
Average return to medium-term recovery value		55%

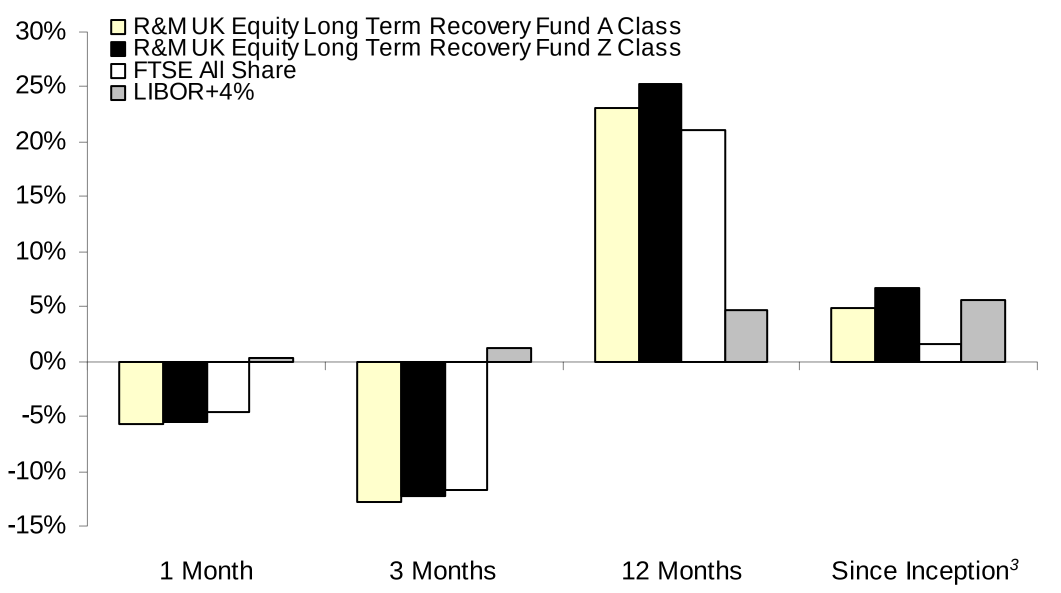
Risk Analysis Summary

Portfolio Volatility	19.60 %
Earnings Yield	6.03 %
Dividend Yield	2.31 %
Price to Sales	0.58
Price to Book	1.02

Performance to 30 June 2010

Retail "A" Class Shares	Fund[1]	FTSE All Share	Difference	*LIBOR+4*
1 Month	-5.72%	-4.62%	-1.10%	*0.37%*
3 Months	-12.78%	-11.80%	-0.98%	*1.14%*
12 Months	23.03%	21.14%	1.89%	*4.63%*
Since Inception[3] (%p.a.)	4.88%	1.55%	3.33%	*5.64%*

Inst'l "Z" Class Shares	Fund[2]	FTSE All Share	Difference	*LIBOR+4*
1 Month	-5.54%	-4.62%	-0.92%	*0.37%*
3 Months	-12.35%	-11.80%	-0.55%	*1.14%*
12 Months	25.26%	21.14%	4.12%	*4.63%*
Since Inception[3] (%p.a.)	6.74%	1.55%	5.19%	*5.64%*



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

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 Intelek received a bid at a 100% 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:

The Fund returned -12.45%, underperforming the market modestly and LIBOR by a greater amount. The Fund was hurt by low 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 a big positive contribution from **Intelek,** which was taken over at twice the market price, and from an underexposure to **BP**.

Year:

Performance over 2010, to date, has been somewhat ahead of the market, though compressed in the latter part of Q2 as the anti-anomaly trade reared its frightening head again. Returns have been dominated by top-down swings in sentiment and factor volatility with stock specific selection decently positive.

Key performance contributors over the quarter

Positive: Take-over activity (**Intelek**), underweight **BP**

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

Performance Outlook

Whilst the relative returns so far this year have been somewhat disappointing, 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".

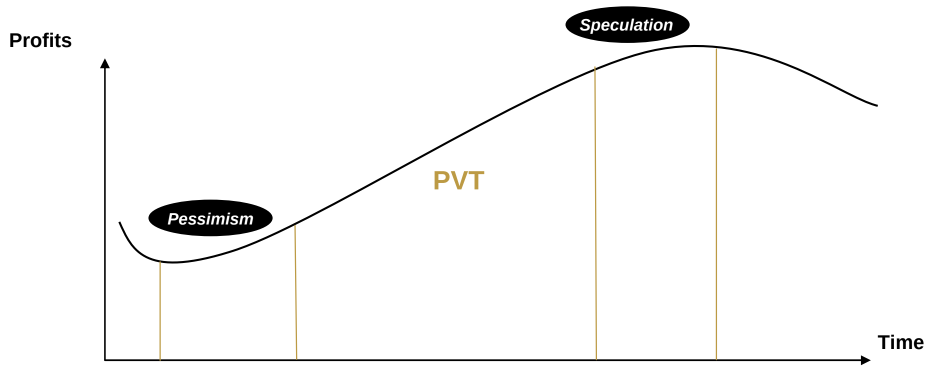
What themes occupy us at the moment?

The Stock Market Cycle

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

As a quick reminder, we have somewhat simplified the concept of the stock market cycle (as shown on the following page) 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.



	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

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 Long Term Recovery 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 30% (by number of stocks, earnings normalised) of your portfolio is invested in stocks with an EY five times the RF rate, 60% in stocks with an EY four times the RF rate, and over 90% 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 being a very modest position in the Long Term Recovery strategy since launch. 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. 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 started to build a position.

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 250 basis point position. This is where we are today. The net relative result of the portfolio's position and activity in BP has been 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 recovery stocks with secular growth characteristics. 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)

The market setback enabled us to add to 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.

Again within the Industrial sector we purchased **Oxford Instruments**. They provide high technology tools and systems for industrial and research markets, based on an ability to analyse and manipulate matter at the smallest scale. Their shares were hit by the cycle related fall off in industrial production and capital expenditure, but the new management team used this as an opportunity to cut costs, emerging now with a more profitable business, with leading edge technology and an ability to generate far higher returns than they have in the past.

Perhaps belatedly I have come to the opinion that the so-called 'lost continent', Africa, is finding a significant role in the Global Economy as a key supplier of raw materials, agricultural products and other goods to the BRIC economies. This role has allowed a sustained period of economic growth, one that should continue into the future. I have gained exposure to this theme through two recovery type stocks, **Lonrho** which has re-emerged as a Sub-Saharan conglomerate with interests in ports, budget airlines, agribusiness and hotels; and **Standard Bank,** which combines recovery potential from an improvement in the credit cycle with the largest footprint of any bank in retail banking across the Continent.

Another Recovery theme we have looked to exploit has been the global shipping and transport related industries. In the aftermath of the credit crunch, trade collapsed, impacting the profitability and share prices of companies exposed to this crucial part of the global economy. With trade recovering there are a number of potentially rewarding investments in this area. We have purchased **Clarkson**, the world's largest ship broker, **Maersk**, the largest container shipping company which has interests in a number of areas and is being re-invigorated by new management, and **Hamburger Hafen**, the Port of Hamburg which should be a big beneficiary of Germany's even more competitive (because of the weak €) industrial base.

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 reshape 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, Standard Chartered** and **888 Holdings** following strong performance, and profit taking in **Inchcape**.

We sold out of our position in **Intelek** as it received a bid at 32p versus a pre-bid market quote of less than 15p.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 being at the moment in 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)

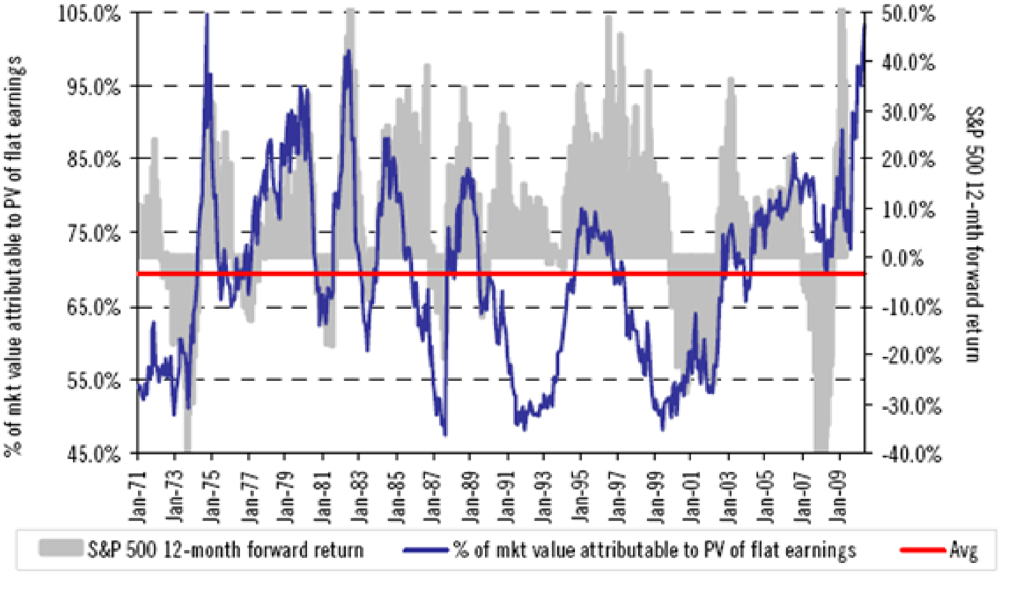
We decided to exit from our position in **JJB**. The turnaround strategy that we backed at the time of its refinancing is taking a lot longer to deliver than first expected. As this has undermined our original thesis we decided to refocus capital towards higher conviction recovery stocks.

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.

Percent of market value attributable to PV of flat earnings



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.

As for the portfolio the business franchises that are represented are strong, balance sheets are robust and valuations are ridiculously low. I am sticking to my course of action, to buying out-of-favour, but strong, franchises at big discounts to their medium term worth, and am convinced that this portfolio will return to generating strong absolute and relative performance. I have been adding to my own investment in the Long Term Recovery Fund.

Thank you for your ongoing support.

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

Important Disclosures:

The information in this document has been prepared and issued by River and Mercantile Asset Management LLP (R&M) and is directed at professional clients only. Retail clients should not rely on the information provided for this investment product. Retail clients requiring any information should seek the advice/assistance of a Financial Advisor. R&M is authorised and regulated by the Financial Services Authority in the United Kingdom. The information contained in this document is strictly confidential and may not be reproduced or further distributed.

The value of investments and any income generated may go down as well as up and is not guaranteed. An investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance. Changes in exchange rates may have an adverse effect on the value, price or income of investments. Please refer to the River and Mercantile ICVC principal prospectus for further details of the financial commitments and risks involved in connection with an investment in this Fund. The information and opinions contained in this document are subject to updating and verification and may be subject to amendment.

The information and opinions do not purport to be full or complete. No representation, warranty, or undertaking, express or limited, is given as to the accuracy or completeness of the information or opinions contained in this document by R&M, its partners or employees. No liability is accepted by such persons for the accuracy or completeness of any such information or opinions. As such, no reliance may be placed for any purpose on the information and opinions contained in this document.

The Industry Classification Benchmark is a joint product of FTSE International Limited and Dow Jones & Company, Inc. and has been licensed for use.

River and Mercantile Asset Management LLP
30 Coleman Street
London EC2R 5AL
Telephone: +44 (0)20 7601 6262
Facsimile: +44 (0)20 7600 2462
Email: enquiries@riverandmercantile.com
www.riverandmercantile.com