RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Smaller Companies Fund I Quarterly Report
June 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.

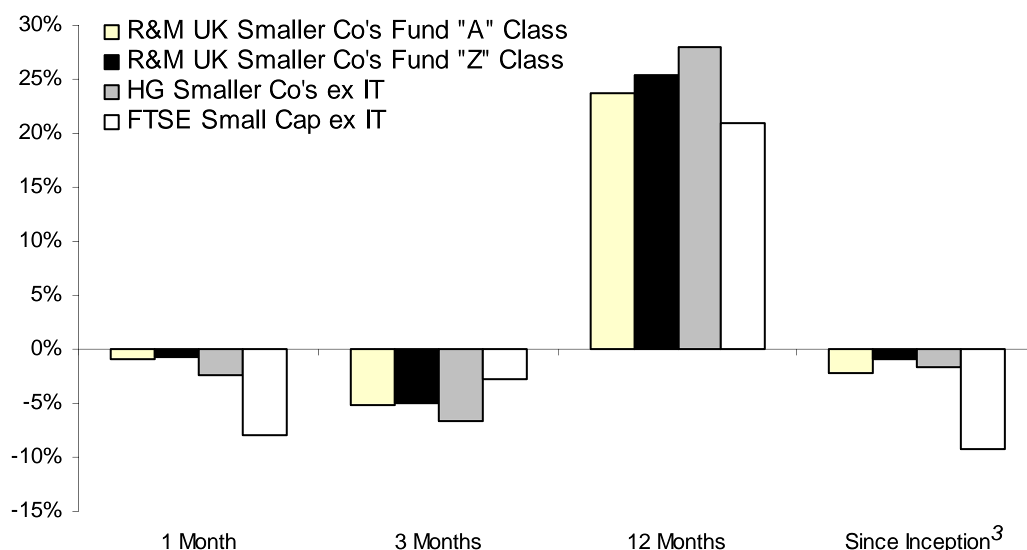
Portfolio Summary		
Strategy AUM		£30m
Strategy Capacity		£400m
Number of stocks		69
Largest Holding	Hogg Robinson	1.97 %

Risk Analysis Summary	
Portfolio Volatility	19.88 %
Benchmark Volatility	19.67 %
Tracking Error	5.65 %
Portfolio Beta	0.97
Active Money	82.70 %

Performance to 30 June 2010

Retail "A" Class Shares	Fund[1]	HG Index*	Difference	*FTSE Small Cap (ex IT)*
1 Month	-0.96%	-2.41%	1.45%	*-7.90%*
3 Months	-5.21%	-6.72%	1.51%	*-2.75%*
12 Months	23.73%	27.99%	-4.26%	*20.87%*
Since Inception[3] (%p.a.)	-2.27%	-1.69%	-0.58%	*-9.32%*

Inst'l "Z" Class Shares	Fund[2]	HG Index*	Difference	*FTSE Small Cap (ex IT)*
1 Month	-0.83%	-2.41%	1.58%	*-7.90%*
3 Months	-5.01%	-6.72%	1.71%	*-2.75%*
12 Months	25.38%	27.99%	-2.61%	*20.87%*
Since Inception[3] (%p.a.)	-0.87%	-1.69%	0.82%	*-9.32%*



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

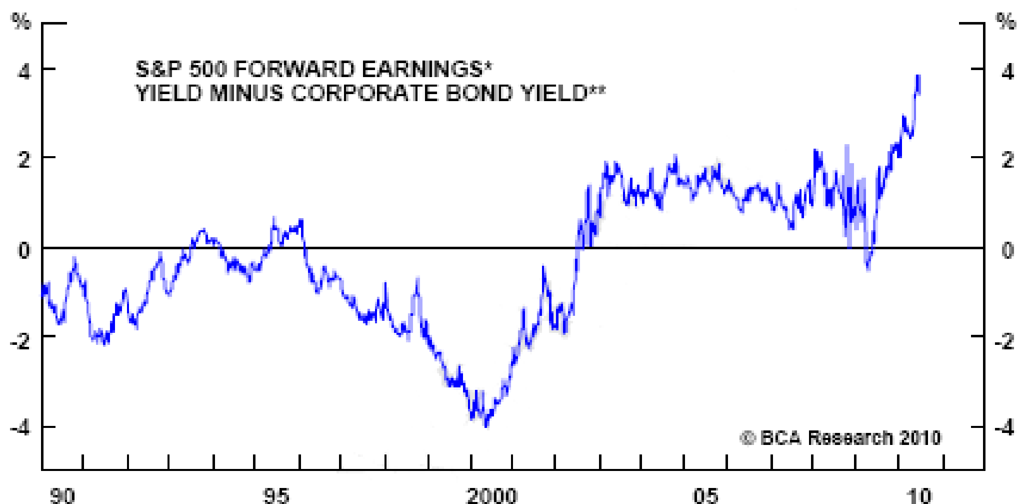
Market Overview

"I 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 overall delivered a return of -11.8%, led down by the Oil Producers (BP) and by cyclical (mining) and recovery sectors such as house builders which were particularly weak. UK domestic stocks continued to be weak. Defensive sectors such as Utilities and Pharmaceuticals did well, as did the global growth stocks. Smaller Companies (-6.7%) proved to be relatively defensive on the way down with limited exposure to hard hit sectors such as Banks, Oil Producers and Mining. 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.

The prospective dividend yield on the FTSE Small Cap index is c.3.8%, with FTSE 250 earnings growth forecast of c.15% in 2010, accelerating (optimistically, it appears) in 2011. The free cash flow yield on the FTSE 250 is now over 8%. This equity yield appears attractive when compared with corporate bonds.



Performance

The fund outperformed the benchmark by 1.71% during the quarter and is ahead of the benchmark since inception.

Asos was the star performer this quarter as the market has begun to recognise and de-risk the medium term growth prospects; we have reduced this position into strength, as expectations and valuation have increased materially. Industrial holdings continue to perform well and companies such as **Domino Printing**, **Fiberweb** and **Diploma** contributed positively to relative performance.

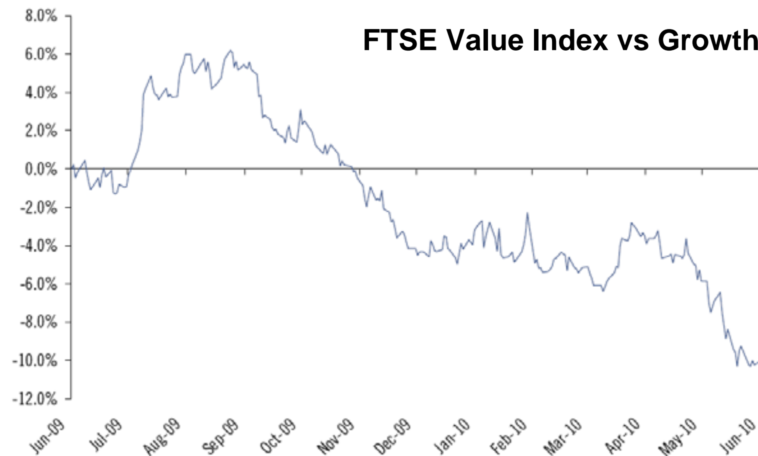
Despite Resources weakness, two growth company holdings, **Valiant Petroleum** and **Anglo Pacific Group**, outperformed during the period. They were offset by disappointing drilling at **Serica Energy** and we chose to exit during the period. Other disappointments were **CVS Group**, whose veterinary services have proven more cyclical than investors or management expected, and **Johnston Press**, where we have materially reduced the position.

Growth and M&A activity continued to grab headlines and our positions in **Synergy Healthcare** performed strongly on a more positive outlook.

Philosophy & Process

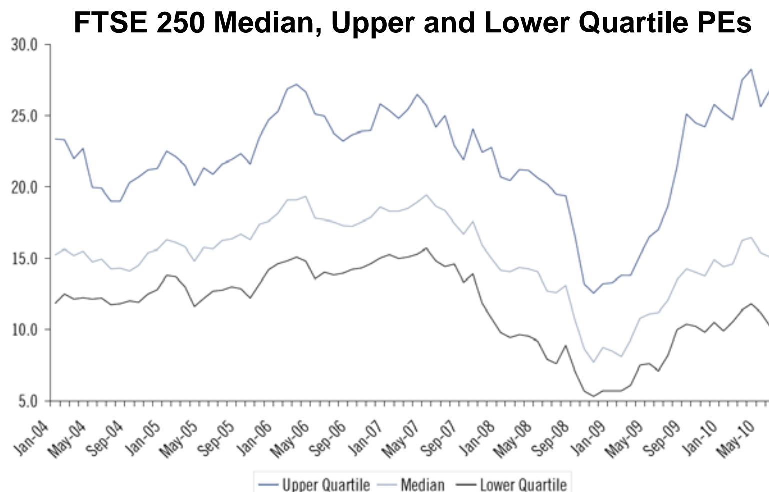
There has been little change to Category weightings. Quality represents 41.4% of the portfolio, Recovery 24.6%, and Growth 18.1%. The skew to high scoring stocks, as quantitatively measured by *Moneypenny*, our proprietary screening tool, has improved during the quarter. The proportion of stocks invested in the top three deciles is now circa 68%.

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.



Source: Citi Investment Research and Analysis

Portfolio Activity

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

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

Overseas sales generated by portfolio holdings are approximately 45% of the total. This is slightly below the benchmark market but, given our underweight in Basic Materials, 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 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 **Mitie**, the integrated outsourced services provider; **Paragon**, the buy-to-let lender; and **Barratt Developments**, the house builder. This final purchase should be considered in the context of our significant underweight position in house builders, which has served relative performance well, and the context of a stabilising housing market and the valuation of Barratt at less than half book value.

We are still, though, searching for overseas earnings where valuations are cheap and expectations low, the most recent example being the purchase of **4Imprint,** the international promotional marketing products business.

Rebuilding of Industrials weighting following takeover of **Delta** and the promotion to large-cap of **IMI**:

The overweight position in Industrials is serving the portfolio well. The focus now is on recycling capital into the cheaper laggards which have similar Timing characteristics. Examples include the purchases of **Elementis**, the speciality chemicals company; and **Charter**, the industrial engineering group, to complement existing holdings such as **Bodycote**.

The sale of investments due to weakening theses:

During the quarter we exited **888 Holdings**, **Regus**, **H&T** and a small number of public sector exposed companies (in April) due to weakening conviction in the Potential and deteriorating Timing characteristics. In the near term, these stocks have subsequently underperformed.

Sector positioning

There has been little change to the sector overweights during the quarter, apart from reduced weightings in Oil & Gas (sale of **Serica**) and Technology. Underweight sectors remain the same apart from the addition of Retail which now aligns with our underweight in other consumer areas such as House Builders and Travel & Leisure companies. We retain no exposure to Biotech stocks or Defence companies and limited exposure to Mining.

Market Outlook

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 sacrosanct. Markets have responded well to these intentions which should ensure the cost of servicing the country's massive debt remains low. Two key observations would be that: 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.

Quite simply, alongside consensus, we have genuine concerns over a deflationary outcome in Europe. Austerity packages are welcome, but must be accompanied by monetary expansion by the European Central Bank. The ECB 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.

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%. Market consensus is optimistic regarding 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 the underweight in Basic Materials. 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'.

Technology

How disruptive Apple's 'iPad' tablet will be is unclear. My personal experience to date has seen users' attention highlight a nosey Google Earth application, a 'live', interactive fish tank display, and piano teaching software. What is occurring, though, is that data usage is continuing to ramp up, which is positive for our large positions in **Anite** and **Spirent** 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. Both companies appear perfectly placed to sell the much needed testing software and products 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.

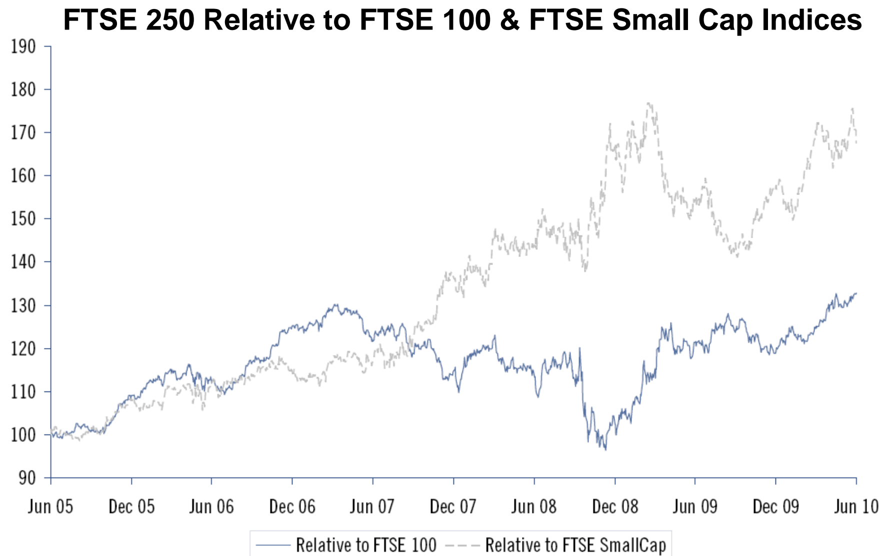
Eurozone capex as a share of GDP

Eurozone Nominal gross fixed investment % of GDP — average

Source: Eurostat

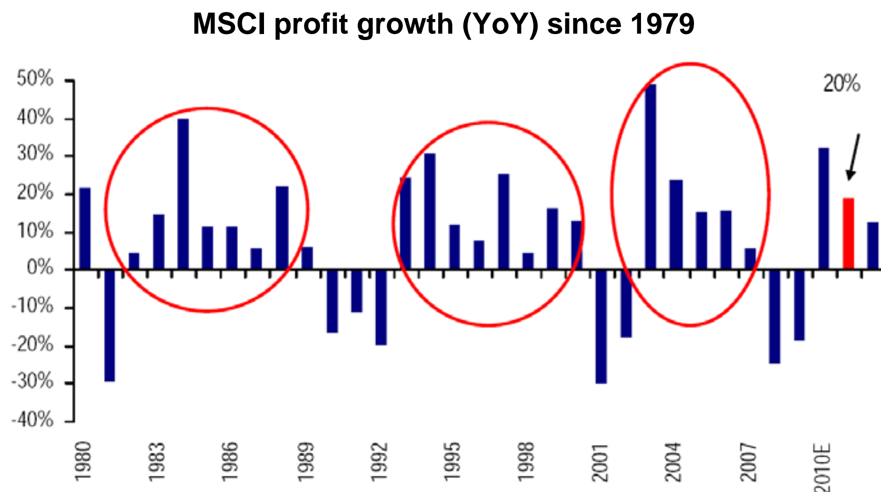
Summary

Small companies appear attractively valued given the growth prospects, earnings momentum and balance sheet strength. However, within this area of the market, the FTSE 250 appears expensive against smaller quoted stocks.



Source: Citi Research and Analysis, DataStream

It is unclear whether a 'double-dip' will transpire, but evidence such as the lack of an inverted yield curve, an expansionary ISM reading, the level of corporate profitability and the history of the length of economic and profit recoveries (see chart below) is as positive as recent weakening economic evidence, such as in US housing, is negative.



Source: IBES, Thomson Datastream, UBS estimates

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 positive Timing attributes. The Fund remains focused on delivering the long term performance attributes from a focus on smaller company investments.

Richard Staveley
Portfolio Manager

Fund Facts

Launch date	30 Nov 2006
Fund manager:	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 Disclosures:

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