

RIVER AND MERCANTILE  
ASSET MANAGEMENT

UK Equity Unconstrained Fund I Quarterly Report  
June 2010

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# River and Mercantile

June 2010

## UK Equity Unconstrained Fund – Quarterly Report

### Fund Aim

The investment objective of the Fund is to achieve capital growth through investing in a concentrated portfolio which will primarily consist of UK equities. The Fund will not be restricted by reference to a benchmark, sector constraints or company size.

### Portfolio Summary

Strategy AUM	£149m
Strategy Capacity	£1bn
Number of stocks	34
Largest Holding	GlaxoSmithKline 5.72 %

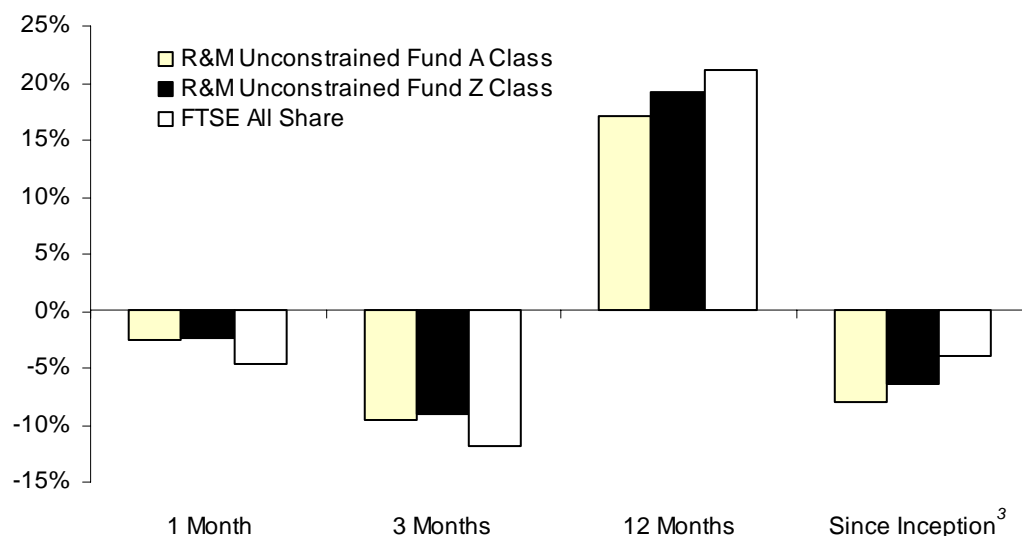
### Risk Analysis Summary

Portfolio Volatility	15.39 %
Benchmark Volatility	16.58 %
Tracking Error	5.21 %
Portfolio Beta	0.88
Active Money	60.60 %

### Performance to 30 June 2010

Retail "A" Class Shares	Fund <sup>1</sup>	Index *	Difference
1 Month	-2.53%	-4.62%	2.09%
3 Months	-9.48%	-11.80%	2.32%
12 Months	17.11%	21.14%	-4.03%
Since Inception <sup>3</sup> (%p.a.)	-8.00%	-3.94%	-4.06%

Institutional "Z" Class Shares	Fund <sup>2</sup>	Index *	Difference
1 Month	-2.37%	-4.62%	2.25%
3 Months	-9.08%	-11.80%	2.72%
12 Months	19.18%	21.14%	-1.96%
Since Inception <sup>3</sup> (%p.a.)	-6.39%	-3.94%	-2.45%



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 22 March 2007

### Quote for the Quarter

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

### Market background

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 recession. 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. In the UK the 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.

As a result of the increased macro, economic policy and regulatory risks, the UK equity market delivered a return of -11.8%, led down by the Oil Producers (BP) and Mining shares as well as Financials. UK domestic stocks continued to be weak despite the initial 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. Factor returns were again significant, with Quality and Price Momentum becoming increasingly effective.

### How did we perform and why?

#### Over the quarter

The UK Unconstrained Fund outperformed the FTSE All Share Index by 2.7% but, nonetheless, saw it drop over 9% in value during one of the worst quarters of the past 25 years for UK Equities. Best performing stocks in the Fund were the undervalued non-life insurance stocks **Amlin** and **Hiscox** as well as large cap defensive quality stocks such as **AstraZeneca** (successfully defended its *Crestor* patent) and **Smith & Nephew**. **BSkyB** was subject to a bid from Rupert Murdoch's NewsCorp and **Xchanging**, a leading outsourcing company, began to recover and win significant new contracts.

Poorly performing stocks included mid cap **Micro Focus**, after the FD announced his departure; and our conviction mining position, **Anglo American**, which fell in line with the sector.

At a sector level, Health Care and Non-Life Insurance stocks performed well where we have significant exposure. However, the defensive Beverages and Utilities stocks also performed strongly during the quarter where we had no exposure.

### Does the portfolio reflect our Philosophy & Process?

The portfolio is currently tilted towards high quality undervalued companies which have the best chance of outperforming through an uncertain global economic outlook. During the quarter we made little change to the allocation of our four categories. We continue to rotate the portfolio to strong PVT ideas where we see medium term potential for companies to create significant shareholder value, on low valuations and where earnings expectations are likely to be beaten in the future.

## What themes occupy us?

### Lead Indicators and investor timeframes

One of the indicators with the best record is the ECRI lead indicator. The growth rate of the ECRI Weekly Leading Index has now declined to -6.9%. In the past 42 years this level has signified an approaching recession on 8 out of 9 occasions – the exception being 1988. These low readings make a recession by no means certain but nonetheless raise the risk of a significant slowdown. More general commentary from the ECRI team themselves suggests they expect a decade of below-trend growth in western economies with frequent recessions due to the ongoing deleveraging. The US and Europe are in danger of re-entering recession later this year.

Economist and hedge fund manager John Hussman's analysis of the situation is done over a sensible longer timeframe, unlike much of the shorter term analysis pervading the current market commentary. He observes that one of the greatest risks to investors here is the temptation to form investment expectations based on the behaviour of the US stock market and economy over the past three or four decades. The credit strains and deleveraging risks we currently observe are, from that context, wildly "out of sample." To form valid expectations of how the economic and financial situation is likely to resolve, it's necessary to consider data sets that share similar characteristics. Fortunately, the US has not observed a systemic banking crisis of the recent magnitude since the Great Depression. Unfortunately, that also means that we have to broaden our data set in ways that investors currently don't seem to be contemplating.

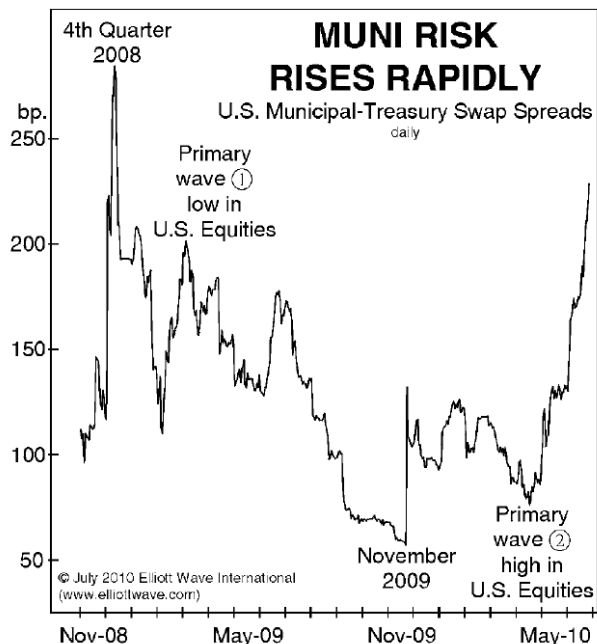
On this front, perhaps the best single reference is a somewhat academic book on economic history with the intentionally sardonic title, *This Time Is Different*, by economists Kenneth Rogoff (Harvard) and Carmen Reinhart (University of Maryland). The book presents lessons from a massive analysis of world economic history, including recent data from industrialized nations, as well as evidence dating to twelfth century China and medieval Europe. Reinhart and Rogoff observe that the outcomes of systemic credit crises have shown an astonishing similarity both across different countries and across different centuries. These lessons are not available to investors who restrict their attention to the past three or four decades of US data.

Reinhart and Rogoff observe that following systemic banking crises, the duration of housing price declines has averaged roughly 6 years, while the downturn in equity prices has averaged about 3.4 years. On average, unemployment rises for almost 5 years. If we mark the beginning of this crisis in early 2008 with the collapse of Bear Stearns, it seems rather hopeful to view the March 2009 market low as a durable "V" bottom for the stock market, and to expect a sustained economic expansion to happily pick up where last year's massive dose of "stimulus" spending now trails off. The average adjustment periods following major credit strains would place a stock market low closer to mid 2011, a peak in unemployment near the end of 2012, and a trough in housing perhaps by 2014. Given current equity valuations, widening credit spreads, deteriorating market internals, and the rapidly increasing risk of fresh economic weakness, there is little in the current data to rule out these extended time frames.

From a valuation standpoint, a further market trough would not be "out of sample" in post-war data. Based on standard valuation methods, the US market would have to halve to match historical post-war points of secular undervaluation, such as June 1950, September 1974, and July 1982. We do not have to contemplate outcomes such as April 1932 (when the S&P 500 dropped to just 2.8 times its pre-Depression earnings peak) to allow for the possibility of further market difficulty in the coming years. Even strict post-war data is sufficient to establish that the lows we observed in March 2009 did not represent anything close to generational undervaluation. We face real, structural economic problems that will not go away easily, and it is important to avoid the delusion that the average valuations typical of the recent bubble period represent sustainable norms.

## US Municipal Bond market

There has been a reasonable focus on the European Sovereign debt crisis during the past quarter and, as it is behind us, I shall make no further comment. However, of more interest is an equally large crisis brewing in the US – of which little has been written in the face of a supposed US recovery – that of the Municipal Bond market. California is mired in a huge fiscal crisis, New York is attempting to avert a complete shutdown of state government by instituting a \$1.60-a-pack tax increase on cigarettes (raising the cost to \$11 per pack); Illinois is teetering on the brink of default and 43 other states are facing Greek-style deficits. With all this going on, one might expect investors to be avoiding Municipal bonds but they have, in fact, become as popular as ever with record inflows from foreigners in the first half of 2010 and US investors taking their holdings to over \$1 trillion for the first time. This supposed tax exempt safe haven is about to cause a lot of pain to investors, which could have similar ramifications in the US as the PIIGS Government debt crisis has had in Europe. The first signs of stress can be seen as municipal bond spreads have widened quite sharply in the past six weeks.



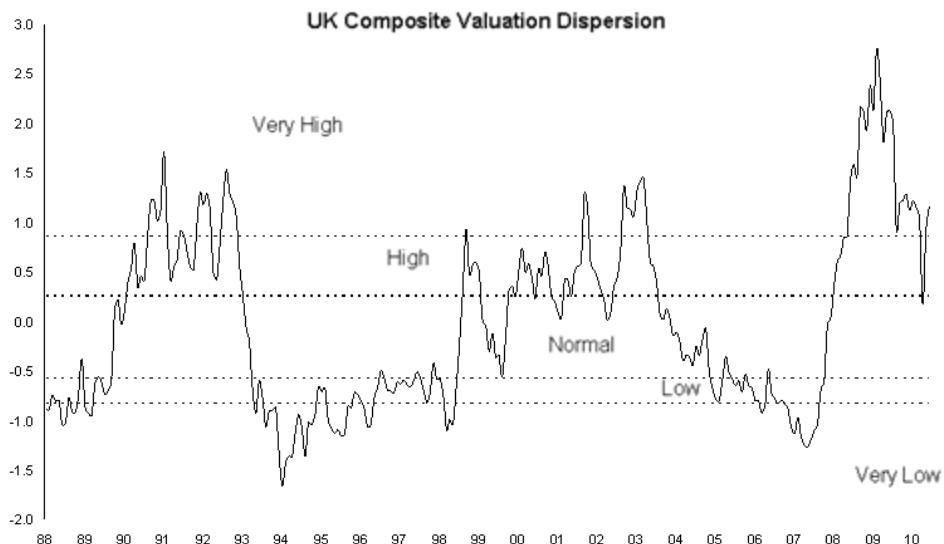
Source: *Elliott Wave International*

## Financial Reforms

Financial reforms are always introduced post a crisis and this one is no different. Similar to the Glass-Steagall measures of 1933, reforms are designed to prevent a crash that has already happened. In this case, they have set the stage for another crash by forcing derivatives onto exchanges, reining in brokerage industry proprietary trading, imposing risk based capital standards and eliminating debit card fees that now go to banks that issue these cards. The measures will help squeeze the life out of the banks in a period when balance sheets are shrinking. The Government is doing what it has always done during bear markets, sweeping in behind the curve to amplify the pain. We remain underrepresented in domestic banks where low price/book multiples are likely to remain low due to shrinking book values, despite improving ROEs helped by the steep yield curve.

## Value Dispersion

As can be seen by the graph on the following page, dispersion reduced significantly during the market rally but remains high with the market still uncertain about future earnings trends. In the medium term this should favour a bias toward cheap stocks although, of late, investors have been happy to pay up for the perceived certainty of growth.



Source: Bernstein, as at 30 June 2010

## Portfolio Strategy

All is not lost in the face of these economic headwinds. We are focused on finding high quality growth PVT situations, with pricing power, strong cash flow and balance sheets, as well as low analyst expectations. A more systematic evaluation of gross margin and, indeed, accounting quality will also, in all likelihood, help us to identify the companies for inclusion. I anticipate adding more smaller company names to the portfolio, where appropriate, in future quarters as there are many high quality stocks on big discounts to fair value which represent a real opportunity.

## Portfolio Activity

### Key Purchases and additions

**Shire** is a Growth stock. It is an immature pharmaceutical company deriving revenue from a limited number of drugs but with a strong pipeline that is likely to deliver strong growth out to 2015 and beyond. As their largest drug *Adderall XR* has become generic this year, growth rates for 2010 have looked somewhat depressed but, beyond this, growth will accelerate to circa 30%pa out to 2015. Stock characteristics are attractive. High potential for future double digit growth, with high and rising CFROCs, a strong pipeline giving revenue visibility, strong balance sheet, conservative estimates (low expectations) due to switch from *Adderall XR* to their newer *Vyvanse* (ADHD drug) being initially quite slow, sharp earnings upgrades (40% in past six months) and positive share price trend. Shire has outstanding growth potential compared to any of the major pharmaceutical companies targeting mid to high teens growth for a number of years. This makes them potentially an attractive bid target for the likes of AstraZeneca or Pfizer where pipelines are less certain. In addition to their patent protected growth drivers, there is a significant potential margin uplift to come from their speciality biologics business HGT which is expected to drive EBITDA margin expansion. Valuation looks attractive on the CFROC model and on a PEG basis but trades at a premium to the other pharmaceutical companies on a PE basis due to the much higher growth rates. Timing is positive although there is significant US dollar exposure.

**Petropavlovsk** is a significant Russian based Gold producer with strong PVT Growth characteristics. The growth in profitability is due to the development of new mining projects bringing significant cash flow to the group given low cost of production compared to current gold prices. Valuation is attractive. Timing is positive with positive trends and earnings revisions. We wrote about some of the reasons for maintaining exposure to gold in our previous report – deficit spending, etc. – which we shall not cover again here. Key risks are

Russian exposure (asset-stealing), and production delays (earnings downgrades). Key upside features include a diverse exploration portfolio to further production growth and replace reserves in the longer run, particularly the Albyn and Tokur projects. Petropavlovsk is knocking on the door of the FTSE100, has good disclosure/transparency and has grown sales significantly from IPO in 2002.

We also added to our position in **Micro Focus** during the quarter.

### **Key Sales and reductions**

We sold our position in recovery stock **Inchcape** at the start of the quarter. Inchcape was a decent motor retailing franchise available at a very low price due to its exposure to the economic downturn last year. We purchased shortly after the rights issue in the second quarter of 2009. Inchcape is one of few genuinely global motor retailers, with scale in seven developed markets and broad exposure to emerging markets. It earns higher margins than peers due to this scale. However, the valuation gap has closed now so we have elected to move on.

We reduced further our exposure to the miners through **Rio Tinto** and **Anglo American** as valuations got stretched, selling the former once again above £40 – amazing given it peaked in 2007 at £70 but has since had a diluting rights issue.

### **Outlook**

The global economy once again looks vulnerable with any second phase of weakness likely to contribute to more problems in the mortgage market and higher unemployment. The deleveraging process in western economies will continue to restrict the pace of economic recovery and limit trend growth in the future. Aggressive austerity measures, particularly in the UK and Europe, may plunge us back into recession so do not rule out a second wave of stimulus in the coming years. Policy makers look set to defend bond holders' interests (namely at the banks) in the face of any renewed economic weakness, which will likely push government debt to a level that is untenably high and ultimately leading to long term loss of purchasing power, i.e. inflation (though as I noted in our previous report, the near term effects of credit crises are almost invariably deflationary first).

We own a portfolio of companies with strong prospects and, as in the previous quarter, I expect PVT stock selection to improve. In particular, I expect Quality stocks with valuation support and earnings visibility to outperform as we move through the year. The focus is firmly on quality companies capable of growing on good valuations. I continue to be high conviction on Pharma and Healthcare stocks (**GlaxoSmithKline**, **AstraZeneca**, **Smith & Nephew**), Non-Life (**Amlin**, **Hiscox** and **RSA**), defensive growth stocks like **Booker** and **Babcock**, as well as high quality stocks on low valuations that have lagged the 2009 rally such as **BAE Systems**, **Reed Elsevier**, **Bunzl** and **BG**. In the mining stocks I am focused on stock selection with positions in **Anglo American** and **Petropavlovsk** of note rather than being overweight this popular area of the market.

Performance over the last three years has been inconsistent and, in the main, poor, due to a range of factors. However, the portfolio is represented by high quality businesses on attractive valuations with strong balance sheets. This, combined with improving factor performance for my approach, should see performance improve going forward. We are sticking to our course of action, to the approach that has made us money in the past and expect to reap the dividends soon. Thank you for your ongoing support.

**Dan Hanbury**  
**Portfolio Manager**

## Fund Facts

Launch date	22 March 2007	
Fund manager:	Dan Hanbury	
IMA sector:	UK All Companies	
Benchmark:	FTSE All-Share (Total Return)	
Tracking error range:	N/A	
Product capacity:	£1bn (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	1.75%	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	B1NG829	B1NGCT4
ISIN	GB00B1NG8296	GB00B1NGCT49
Bloomberg	RIVMERA LN	RIVMERZ LN

### Important Disclosures:

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