RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Fund I Quarterly Report
September 2010

River and Mercantile

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UK Equity Fund – Quarterly Report

Fund Aim

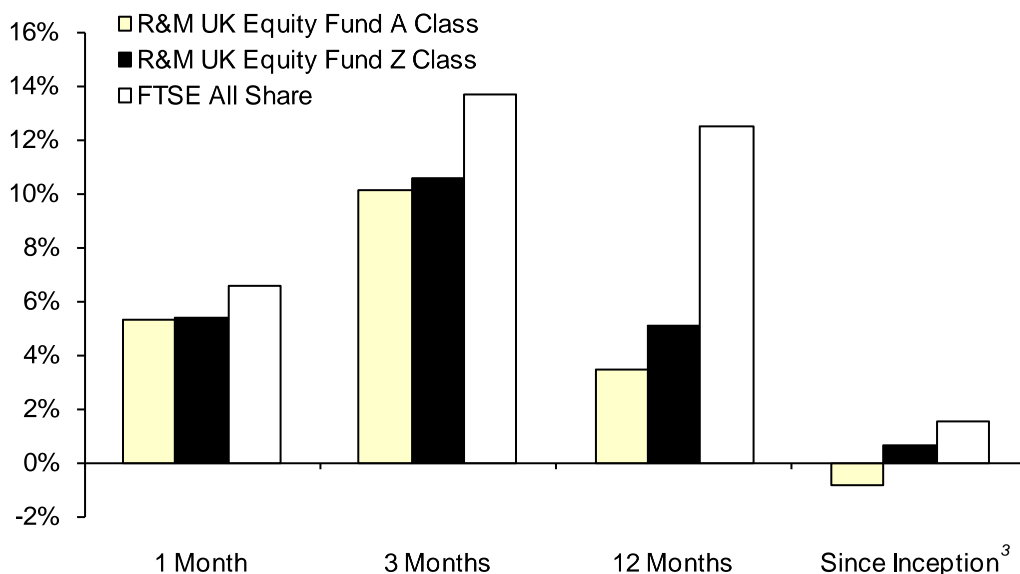
The investment objective of the Fund is to achieve capital growth by investing in the equities of established UK companies which offer the prospect of long term capital growth within a portfolio that has a balanced risk profile.

Portfolio Summary		Risk Analysis Summary	
Strategy AUM	£153.3m	Portfolio Volatility	15.47 %
Strategy Capacity	£2bn	Benchmark Volatility	17.70 %
Number of stocks	66	Tracking Error	3.62 %
Largest Holding	HSBC 6.03 %	Portfolio Beta	0.86
		Active Money	44.00 %

Performance to 30 September 2010

Retail "A" Class Shares	Fund[1]	Index*	Difference
1 Month	5.27%	6.54%	-1.27%
3 Months	10.11%	13.63%	-3.52%
12 Months	3.48%	12.49%	-9.01%
Since Inception[3] (%p.a.)	-0.85%	1.53%	-2.38%

Institutional "Z" Class Shares	Fund[2]	Index*	Difference
1 Month	5.40%	6.54%	-1.14%
3 Months	10.52%	13.63%	-3.11%
12 Months	5.06%	12.49%	-7.43%
Since Inception[3] (%p.a.)	0.65%	1.53%	-0.88%



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]Performance calculated on a mid to mid basis at close of business, gross of annual management charge
[3]Inception date 25 February 2008

Quote for the Quarter

"If you can keep your head when all about you
Are losing theirs and blaming it on you
If you can trust yourself when all men doubt you
But make allowance for their doubting too"

- Rudyard Kipling

Market background

Equity markets were strong during the quarter, rebounding with vigour from the difficult second quarter as the reflation trade went back on. Whilst macro updates continued to confirm a growth slowdown, fears of renewed recession ebbed away and this was supportive of an equity market rally, as was a robust company reporting season and increasing levels of M&A activity. In fact, Global M&A for Q3 was the highest it has been since the peak in Q3 2008. The UK market was aided by BP successfully capping its Gulf of Mexico oil spill.

The UK equity market delivered a return of +13.6% led by growth sectors (Technology, Oil Services) and international cyclicals (Chemicals and Industrials). UK domestic stocks (Retailers and Real Estate) continued to be weak as the market worried about the impact of the October spending review and, in a strong market, defensive sectors (Food Producers and Telecoms) struggled to keep pace. Factor returns were not as material as they have been, perhaps surprisingly given the strength of the market. Value was quite a weak performer, with Growth and Momentum dominating the best performers. The size effect was not material, with the FTSE Small Cap Index modestly underperforming the wider market.

How did we perform and why?

Over the quarter

The UK Equity Fund underperformed the FTSE All-Share Index by 3.1% but, nonetheless, rose over 10% in value during one of the strongest recent quarters for UK Equities. Best performing stocks in the Fund were **Sportingbet** which, after it settled with the Department of Justice in the US as expected, leaves it vulnerable to consolidation in Europe; **McBride** recovering after a positive update to the market; growth stocks **ITE** and **International Power**, as well as cyclicals **John Wood** and **Melrose**. Poorly performing stocks included mid caps **Xchanging** (outsourcing), **Micro Focus** (software services) and **Robert Wiseman** (milk) which all warned sales growth was slowing. In the light of concern over forthcoming austerity-led cuts, underperformance from our Healthcare stocks, in particular **Smith & Nephew**, also detracted. We were also underweight the high beta cyclicals like **Lloyds Bank** as it recovered and **Rio Tinto** as fears over a China hard landing reduced. At a sector level our overweights in the big defensive sectors – Healthcare and Pharmaceuticals, Tobacco and Non-life Insurance – all detracted, as well as being underweight the higher beta cyclical Basic Materials and Financials. Stock selection at a portfolio level was impacted overall by a bias to high returns and low beta, and too little cyclical growth as the market once again bet on a normal global recovery.

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 a more challenging global economic outlook than consensus is currently expecting. These are companies that have historically generated strong returns and growth for their shareholders but which have had modest earnings growth

expectations. During the quarter we made some small changes to the allocation of our four categories. We added a little Growth at the expense of Quality. We continue to rotate the portfolio in 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 future.

What themes occupy us?

<u>QE2: Central Banks vs the Long Wave Credit Cycle</u>

Why have I remained more defensive? What is the deflationary tail risk which is not being ignored in the bond market and is too big to ignore in the equity market?

In QE1, between 2007 and 2009, Federal Reserve Chairman Bernake temporarily prevented a global deflationary debt and economic demand collapse brought on by the end of the Long wave (K Wave) credit cycle. It remains to be seen whether QE1 and the trillions it will cost US taxpayers will change the ultimate outcome but, either way, round two has just begun.

During 2008 the global banking and financial system, built on inflated mortgage debt, was sent reeling. Many thought the global financial system was going down but Bernanke, armed with almost $2 trillion dollars of monetary stimulus backed up by fiscal stimulus, and aided by the natural bounce of a business cycle inventory rebuild, created the impression that the global financial system has stabilized. Most economists and analysts only believe that Bernanke is fighting a tougher than normal business cycle but he is actually fighting a once in a generation debt bust depression. Few understand the remarkable and powerful force of the K Wave long boom and bust cycle. It is a global cycle marked by distinct periods of inflationary expansion and deflationary contraction. In the past four deflationary contractions, reflationary policies have not worked.

In addition to QE1, dropping interest rates isn't producing the economic traction that Bernanke and others hoped it would. The fact is that rates have been going down for a long time, since the Kondratieff long wave peaked in the early 1980s. The chart below demonstrates that Kondratieff has been delivering a steady and consistent disinflationary, and sometimes deflationary, bias to the global economy for years. Interest rates are the price of credit. This brings up the issue of whether central banks really control long-term interest rates at all. They can adjust short-term rates. However, they cannot really control long-term rates. Interest rates have been trending down since their peak in 1981. Does the chart of the 10 Year US Treasury, below, look like the central banks of the world are really behind the wheel? The long wave pattern is clear.

Central bank rate manipulation only makes the regular business cycles longer and more harmful than they have to be to capital formation. Businesses cannot get a clear picture of demand due to artificial stimulus and overconsumption. Central bank 'loose' money which, coupled with government fiscal stimulus, has created massive oversupply in the global economy. You name it – houses, cars, refrigerators, HDTVs, and the list could go on. Massive oversupply is swamping the world with overcapacity, driving down prices and triggering protectionism and the currency trade wars erupting around the globe.

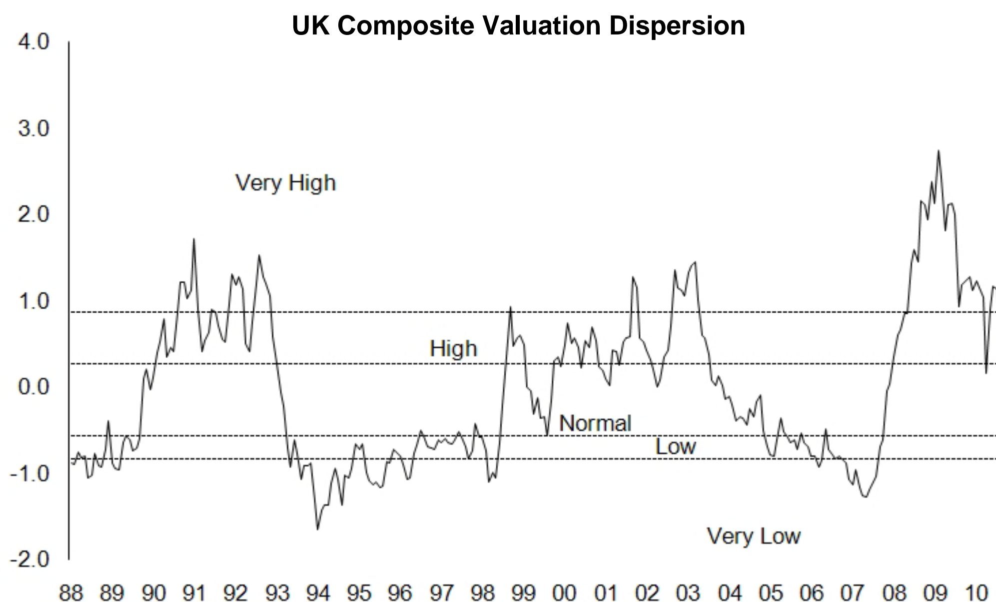
Global equity markets rallied in September partly in the belief that QE2 will counter the Kondratieff long wave deflationary forces at work, and not just in the US but globally. There is widespread conviction that QE2, plus QE Lite (mortgage payments to the Fed recycled into more government debt), will halt the deflationary trends. Unfortunately there is north of $30 trillion in public and private debt in the US economy. If you add unfunded liabilities you can get over $50 trillion of dollar denominated debt. In light of the amount of total debt that is exerting a deflationary drain on demand and asset prices, the long wave deflation forces that are already in play will just soak up another few trillion in QE. Deflation destroys corporate profits. The chart below is the Kondratieff long wave map for equity returns that points to a difficult period for global equities into 2012. The final business cycle of this long wave appears to be topping.

Bernanke's impressive efforts in QE1 have given the world time to contemplate what deleveraging entails, and for investors to get their financial house in order. It is not just in the US but the entire global economy. The history and evidence for the Kondratieff long wave suggests Kondratieff and deflation have the upper hand for QE2. Some central bankers in the world, e.g. Germany, have realised that they need to let the global economy take the natural dose of long wave deflation and debt liquidation body blows that it has coming. Once the inevitable long wave debt liquidations are shaken off, a new long wave expansion will begin. QE2 will likely result in an escalation of the global currency trade war. Inflating the dollar is a beggar-thy-neighbour policy that is exporting US deflation to their trading partners, and they are growing tired of it. US trading partners have been pushed to the limit and will devalue their own currencies in defence against a cheap dollar. The new political wave of fiscal conservatism and austerity that is coming to Washington and much of the world will ultimately demand that Bernanke defends the dollar.

Perceived wisdom is that QE2 will cause an emerging markets and resources bubble and, in the short term, we have to be tactical in relation to this within the portfolio. But the other problem with QE2 is that it is even under discussion. If QE1 worked so well, why does the Fed feel the need to institute QE2? The Fed is considering it because QE1 failed to deliver the economic results that it expected. The depth of the failure is visible in the difference between the original amount of quantitative easing and the credit growth it was supposed to generate. From September 2008, when QE1 started, to June 2010, a $2.46 trillion ($1.43 trillion in assets and $1.03 trillion in excess reserves) increase in the Fed's balance sheet coincided with a decline of $296 bn in total US credit market debt outstanding. Consider also that, up until 2008, total credit market debt had risen for 63 consecutive years. Deflation stopped that growth in its tracks and, despite all its efforts, the Fed is struggling to expand credit again.

Value Dispersion

Dispersion has fallen during the latest market rally but remains quite high with the market still uncertain about future earnings trends. In the medium-term this should favour a bias to the undervalued stocks we hold in our portfolio although, of late, investors have been happy to pay up for the *perceived* certainty of growth.



Source: Bernsteins, as at 24 September 2010

Portfolio Strategy

We continue to pursue our medium to long-term strategy of focusing on finding high quality growth PVT situations, with pricing power, strong cash flow and balance sheets, as well as low analyst expectations. These are the companies we believe should outperform in what we still believe will be, at best, a low growth environment with huge deflationary headwinds. We did tactically add some more cyclical names at the beginning of Q3, as markets had become oversold, such as **L&G** (Life insurance), **ITE** (growth media) and **Melrose** (industrial), all of which outperformed during the quarter, but we have already recently taken profits as they quickly price in earnings recovery.

It is at a sector level that my positioning has been most unhelpful over the past 18 months so it is important I briefly explain my position here. In short, the Financials sector is unlikely to be the beneficiary of any renewed quantitative easing and the reflationary bounce in Resources and Industrials stocks is at risk of running into a profits disappointment driven by a fast approaching margin squeeze. The FOMC is seriously concerned about deflation and so am I.

Lack of pricing power and a downward pressure on wages will undermine the earnings growth potential of many companies, not least the banks. Deleveraging, and shrinking of the asset bases, has improved RoA, rewarding bondholders with cleaner balance sheets. However, the dilutive increase in equity capital will result in ongoing poor RoEs and that should manifest itself in the coming quarters with lowering of profit expectations. Most banks continue to have significant exposure to property and a renewed leg down in prices would have grave consequences. We favour well capitalised insurance stocks with their defensive and stable earnings streams in the Financials sector. Meanwhile, sentiment in the Materials sector is excessively bullish with the sector typically trading two standard deviations above long-term performance trends, profit growth expectations are well above the broader market. This will be challenged as input costs and wage inflation rises – profits generally follow global lead indicators and they have fallen over the summer. The falling Shanghai property index and surging inventories in a number of key markets such as housing, autos and steel highlight the ongoing risks. In contrast, the more defensive sectors have modest earnings growth expectations and look undervalued in this context.

Portfolio Activity

Key Purchases and additions

Key buys

Whilst our emphasis is on defensives, there was an opportunity for selective additions after the market sell off in Q2. Most of the purchases were made at the start of this quarter as we tactically added some cheap cyclical Value (**Melrose** and **L&G**) and Growth (**ITE** and **Standard Chartered**) exposure to the portfolio. We have already taken profits in several of these names in the last couple of weeks, following strong performance and the value gaps are closing. The purchase of **Legal & General,** a leading UK life insurer, reduced our relatively large negative bet in the Life Insurance sector. **L&G** was not only the highest scoring Recovery stock in *MoneyPenny* but its superior returns to many of its peers also ensured it scored well in our Quality screens too.

Partly funded from Barclays, we also added to our Financials weighting by building a position in growth bank **Standard Chartered** as the shares fell into the end of Q2. I felt it necessary to re-address the largest negative stock bet in the portfolio (Standard Chartered is over 2% of the FTSE All-Share Index) after we revisited the investment case. Whilst the company always looked expensive in a UK context it appears that, relative to many other Asian and Emerging Market banks, it is considerably cheaper and of higher quality. It is not, as one may have believed, overly exposed to China (and the potential property bubble) with less than 7% of its lending directly into China.

ITE is a high quality growth stock with strong cash flow and net cash on the balance sheet. The group organises B2B (business to business) trade fairs and exhibitions. It has operations in Central Asia, Europe, Russia and Northern Africa. It primarily concentrates on emerging markets with higher growth possibilities. Key end markets include construction, energy, travel, food and motors. Over the last 10 years or so that I have been following the company they have had very reliable profits with good earnings visibility. Analyst forecasts continue to factor in very modest growth which provides strong upgrade potential on a modest rating.

Melrose is an industrial conglomerate – primarily the old FKI – which is being turned around by the ex Wassall management team (expert turnaround specialists). It is a cheap stock. Each of the businesses has strong market positions in its own right but the company had previously failed to generate the returns and growth expected. The new management team is having a positive impact on pushing up margins and improving return on capital as well as now seeing growth in their oil related and general industrial end markets.

We added one recovery situation in the form of **Tate & Lyle**. The potential for Tates is for the new CEO (ex Reckitts) to restructure what is a conglomerate of sugar, starch and food ingredients businesses. Historically they have been relatively low return on capital and cyclical, and the aim is to drive productivity gains. In particular, reductions in working capital to improve cash flow are a key focus and something in which there has already been significant improvement. The focus on driving higher return on capital and investing new capital in higher growth markets is encouraging for future ROC trends. This is coupled with a relatively depressed valuation, reasonable against its own history but very cheap versus its higher returning peers. Timing has improved with upgrades to earnings forecasts, improving price relative chart and the twin catalysts of the new CEO and the first significant disposal of the low returning European Sugar operations which had the effect of improving group returns and improving the balance sheet to a stronger position.

Key Sales and reductions

We took profits in **Booker** and **International Power** after good performance. Early in the quarter we sold IT Services giant **Sage** on valuation grounds. We also cut losses after **Robert Wiseman**, **Xchanging** and **Micro Focus** all warned that sales growth was slowing. Despite purchasing it last quarter, we exited **G4S** on the basis of the public sector exposure risks not in the original forecasts.

Outlook

My view remains the same despite stock market actions of the past 18 months and I maintain a long-term view. Leading economic indicators have rolled over and indicate another slowdown and we face a muted economic recovery at best with risks of a return to recession still elevated depending on the speed that fiscal stimulus is withdrawn. As banks continue to rebuild their balance sheets, credit growth remains limited and, as such, private sector demand will be muted. Housing markets in both the US and the UK face further falls – I would expect a minimum of a 5% drop per annum over the next two to three years due to overvaluation, unemployment remaining stubbornly high and limited mortgage lending. This will act as a drag on consumer confidence and spending. Consumers, where employed, also remain under pressure due to income growth being constrained. Underlying inflation will remain low in the short-term. This has been a serious balance sheet recession caused by a banking crisis and history teaches us that, in every case in the past, economic recovery is weak and economic growth remains weak for at least five to six years. In that environment it is the undervalued companies with less economic sensitivity, highest earnings visibility and low valuations which remain the preferred route to relative outperformance.

Whilst the UK equity market is indeed under-owned by institutions, on a cyclically adjusted PE basis valuations remain high, despite bulls pointing to low spot PEs. In periods of secular de-rating post the bursting of the largest credit bubble in history, cheap markets can get much cheaper, as in the case of Japan. However, as we saw in both the last quarter and back in 2003, overvalued markets can also go up significantly in the short term as valuation tells you very little about short-term market action. As Western economies continue to de-lever in the next few years, the deflationary impact of that will keep earnings growth in check and may cause equity markets to struggle despite the efforts of central banks. Currently markets are rising in the belief that reflation will feed through to strong earnings growth, particularly from emerging markets. The problem for Asian economies is that, as they move to head for domestic driven growth, as they have to given that 40% of the world's population cannot get rich selling to the other 14%, they are going to need to control their own currencies. They will want stronger currencies to help deal with inflation, not lower ones to boost exports which they are currently wanting as the US devalues the dollar. I expect one more deflation scare to pass, possibly driven by a Western sovereign debt crisis or further problems in the US mortgage market. When this occurs, the cyclically adjusted PE on markets is likely to move to new lows, providing a great buying opportunity.

In the meantime I expect PVT stock selection to improve and we own a portfolio of companies with strong prospects. 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 Pharmaceuticals and Healthcare stocks (**GlaxoSmithKline**, **AstraZeneca**, **Smith & Nephew**), Non Life (**Amlin**, **Hiscox** and **RSA**), defensive growth stocks like **Booker** and **Tesco**, 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 rather than being overweight this popular area of the market.

Performance over the last 18 months has been poor due to a range of factors, not least avoiding the reflation plays. However, the portfolio is represented by high quality businesses on attractive valuations. This, combined with the cycle beginning to move away from expensive growth towards cheaper, quality stocks, should see performance improve going forward. As Kipling advocates, I am keeping my head and trusting in my strategy which I ultimately believe will be in the best interest of my clients. This approach has made my clients money in the past and I expect we shall reap the dividends soon. Thank you for your patience.

Dan Hanbury
Portfolio Manager

Fund Facts

Launch date	25 February 2008
Fund manager:	Dan Hanbury
IMA sector:	UK All Companies
Benchmark:	FTSE All-Share (Total Return)
XD dates:	1 April & 1 October
Dividend/Accumulation payment date:	31 May and 30 Nov
Tracking error range:	2-6%
Product capacity:	£2 bn (pooled & segregated)

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	B1NG777	B1NG7KO
ISIN	GB00B1NG7777	GB00B1NG7K01
Bloomberg	RVMUKEA LN	RVMUKEZ LN

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