

RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity High Alpha Fund | Quarterly Report
September 2010

River and Mercantile

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UK Equity High Alpha Fund – Quarterly Report

Fund Aim

The investment objective of the Fund is to achieve capital growth by investing in a focussed portfolio of investments which shall primarily consist of UK equities which offer the prospect of superior long term growth.

Portfolio Summary

Strategy AUM	£353m
Strategy Capacity	£1.1bn
Number of stocks	115
Largest Holding	HSBC 5.89 %

Risk Analysis Summary

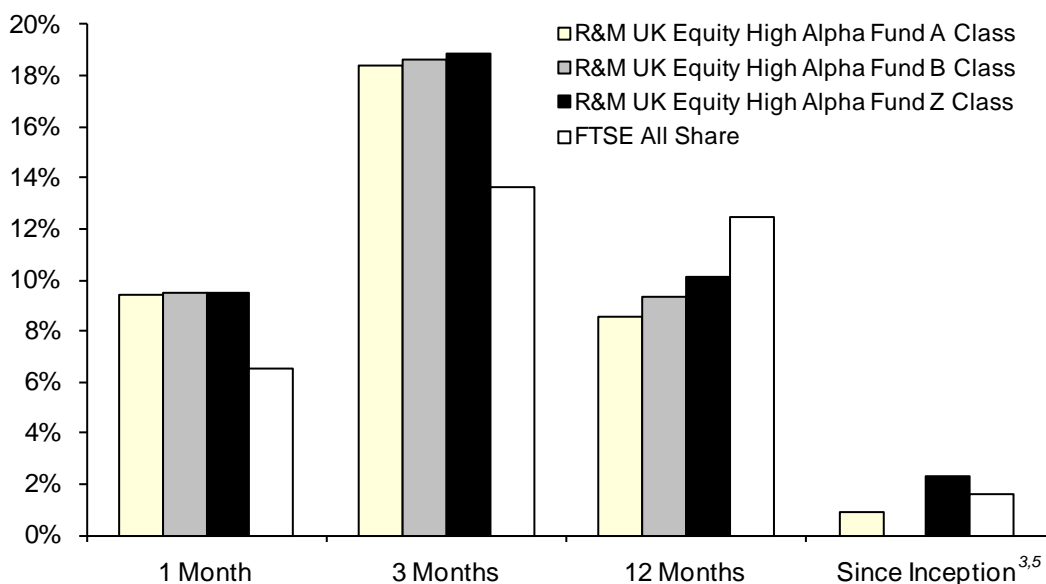
Portfolio Volatility	19.61 %
Benchmark Volatility	17.70 %
Tracking Error	4.67 %
Portfolio Beta	1.08
Active Money	55.70 %

Performance to 30 September 2010

Retail "A" Class Shares	Fund ¹	Index*	Difference
1 Month	9.39%	6.54%	2.85%
3 Months	18.43%	13.63%	4.80%
12 Months	8.52%	12.49%	-3.97%
Since Inception ³ (%p.a.)	0.86%	1.60%	-0.74%

Asset Manager "B" Class Shares	Fund ¹	Index*	Difference
1 Month	9.46%	6.54%	2.92%
3 Months	18.66%	13.63%	5.03%
12 Months	9.32%	12.49%	-3.17%
Since Inception ⁴ (%p.a.)	29.56%	22.22%	7.34%

Institutional "Z" Class Shares	Fund ²	Index*	Difference
1 Month	9.53%	6.54%	2.99%
3 Months	18.88%	13.63%	5.25%
12 Months	10.14%	12.49%	-2.35%
Since Inception ³ (%p.a.)	2.34%	1.60%	0.74%



Source: River and Mercantile Asset Management LLP

*Index: FTSE All Share (Total Return)

¹Performance calculated on a mid to mid basis at close of business, net of annual management charge

²Performance calculated on a mid to mid basis at close of business, gross of annual management charge

³Inception date "A" and "Z" class shares is 28 Nov 2006, ⁴Inception date "B" class shares is 20 Oct 2008

⁵"B" class shares are not included in this category due to the later inception date of this share class

Quote for the Quarter

"The last time they [stocks] were this cheap relative to bonds was 1951. I was one year old then, but did not have then sufficient sentience or capital to invest. I do now, and if you are reading this, so do you."

- Bill Miller, July 2010.

Key Observation

Markets climbed the proverbial 'wall of worry' during the third quarter. Nearly everyone seemed to be gloomy but markets still went up. That's because they have good **P**otential (profits are growing); great **V**alue (equities are cheap in absolute terms, and bargain basement versus bubbly bonds), and supportive **T**iming (earnings upgrades are positive, and there are loads of other catalysts such as M&A activity). Whilst a pause for breath for the rest of the year is very possible it is not inevitable. That is because the relationship between bonds and equities is wrong at the moment, and when this starts to normalise a 'wall of money' could find its way into equities.

I explained the bizarre bond / equity relationship in my last [blog](#):

"These are crazy times in the relationship between bonds and equities. So crazy that a company like Microsoft, that is sitting on over \$30bn of cash, feels that it is worth their while to issue new debt in order to repurchase chunks of their equity. And the crazy thing is that it does make sense – Microsoft can borrow money for next to nothing (2%) and use this to buy in stock with an earnings yield that is four times this cost of debt. The arbitrage is huge (a generational high) and is very shareholder value accretive.

And of course Microsoft is not, and will not be, alone. The longer this crazy gap between the earnings yield on equities and the yield payable on bonds persists then the more inclined companies will be to exploit it – to increase their dividends, buy back shares, and buy out competitors through takeovers.

What is the message for investors? Forget bonds, they have had their generational run and represent bad value; instead follow Steve Ballmer and buy equities, they have had their generational poor returns and now look great value. What part of Microsoft's message, that equities represent better value than bonds, don't stock market participants understand?"

Market background

Quarter:

Equity markets were strong during the quarter, rebounding with vigour from the difficult second quarter. The 'all news is bad news' mentality we saw earlier in the year was replaced by a more balanced response to news flow. Whilst macro updates seemed to confirm a growth slowdown they did not point to a 'double dip'; this was supportive of an equity market rally, as was a robust company reporting season and increasing levels of M&A activity. The UK market was aided by BP successfully capping its Gulf of Mexico liability.

UK equities 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 investors 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.

How did we perform and why?

Quarter:

We significantly outperformed the market returning +18.9%. It was particularly pleasing to deliver this return at a time when the Value factor struggled and, in particular, when domestic recovery stocks, where we are overweight, were conspicuously dull. Good stock picking drove our positive returns and we got a quick pay-back on the additional capital we allocated to Growth category stocks earlier in the year. Smaller technology stocks, such as **Blinkx**, **IQE** and **Wolfson** were the stand-out performers. **Oxford Instruments**, a niche manufacturer of process equipment, also did very well. We benefited from the bid for **Wellstream**, which we had always identified as a strategic asset.

Year:

Performance over 2010 to date has been ahead of the market (a return of +10.4% compared to the benchmark +6.7%), driven by strong stock picking rather than returns to factors or size. Our Growth category stocks, smaller technology ones in particular, have been the best performers.

Key performance contributors

Quarter:

Positive: Stock contributions dominated (**Blinkx**, **IQE**, **Oxford Instruments**, **Lloyds**, **Scapa**, **Renesola**, **Lamprell**), takeover activity (**Wellstream**).

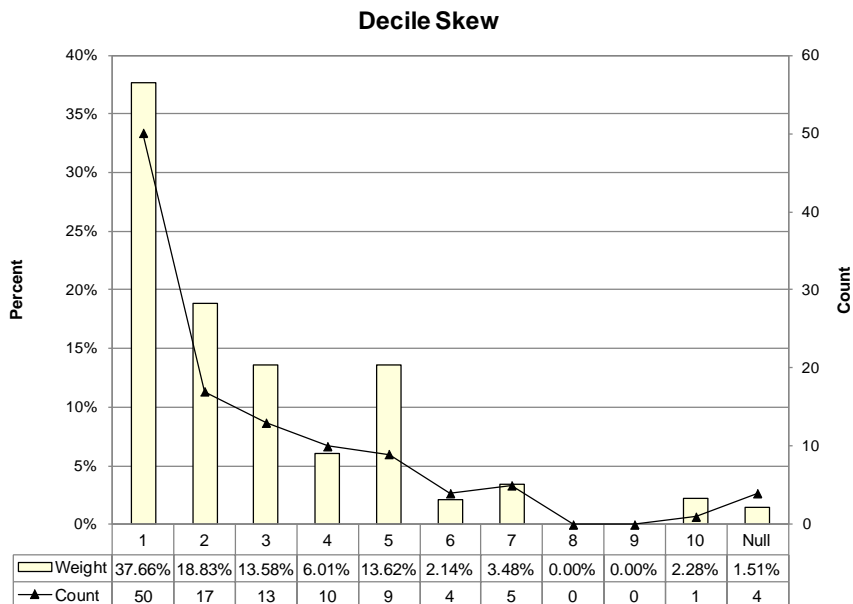
Negative: Public Sector exposed stocks (**Xchanging**, **RM**).

Performance Outlook

It is interesting to note that with the Value factor, UK domestic stocks and Smaller Companies yet to perform, there remains a lot of latent outperformance in the portfolio.

Does the portfolio reflect our philosophy and process?

The chart below shows that our strategy continues to have a strong skew towards high scoring stocks.



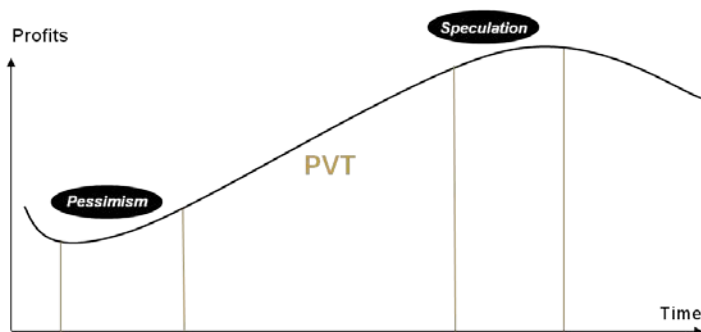
Source: River and Mercantile Asset Management LLP

We continued to add to the Growth category. This is now over 13% of the portfolio, an underestimate as a number of the Recovery category stocks have top-line growth characteristics (**Lamprell, Neovia, Wolfson**). The strategy now has quite a strong style bias towards profit growth.

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.



	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

With some risk appetite returning, and macro data suggesting continued (though slower) economic growth, we remain confident that we continue to be in the trend phase of the stock market cycle.

Equity Market PVT

As a standard from now on we will provide a brief PVT based analysis of the overall equity market. This complements the above stock market cycle commentary and our PVT approach to stock picking.

Potential – shareholder value growth is well above average at the moment as profit margins and return on capital recover from their credit crunch lows. 2010 is the first, and most dramatic, year of profit recovery, but growth will (unless there is a double dip) continue into 2011 and 2012 with the latter year seeing profits return towards previous peaks.

Valuation – absolute valuations are supportive with the UK equity market on modest multiples of profits, EBITDA and free cash flow; valuations relative to government bonds are very attractive with equities yielding more than long-term Gilts and the equity earnings yield trading at three times the risk-free rate.

Timing – earnings revisions and share price technicals are positive and there are many fundamental timing catalysts including increasing M&A activity, director buying, falling corporate tax rates, and an improving outlook for dividends.

Key Reasons for Owning UK Equities

1) The market is good value

One factor which provides considerable support to equities is valuation. UK equities are not as absolutely cheap as they were when I was banging the table in July, but are still worth tucking away. The prospective PE multiple remains (just) in single figure territory, the prospective dividend yield is 3.7%, and the price to gross cash flow is less than 7 times.

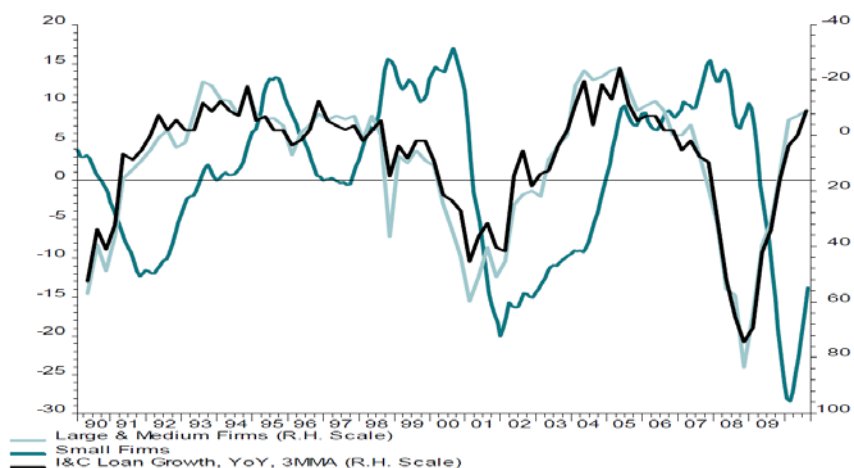
But it is versus the Government Bond market that equities look a steal, with earnings yields on stocks trading at over three times that of longer term Gilts. As for the shorter end of the Government Bond market – forget it – how any sane investor can put money to work at less than a 2% return (which is a negative real return in the UK) is beyond me. This is a risk aversion driven bubble, investors are buying government debt because they fear everything else but, in this very act, they are exposing themselves to a huge risk of losing money in both absolute and relative terms. When they realise this they could well flood out of bonds and into equities – a possible ‘wall of money’ could drive equities up quickly. This is not what I want, I would far prefer the steady 10% per annum return that an earnings yield of 10% would suggest, but markets are not usually that convenient.

2) Global economies are growing

The Global economy is growing robustly, that is a fact. Credit-dominated economies in the West are seeing a more muted recovery, as deleverage continues to impact on demand and credit creation; however with such accommodative monetary policy it remains unlikely that they will return to a period of contraction in output. Meanwhile there remain huge blocks of population in the world that are seeing their incomes trend-up towards developed world norms; China, India, South America and now Africa are in the middle of a multi-year increase in output which will ensure the Global economy remains in a growth phase and not one of Japanese style stagnation. I must apologise for being too contrary in my view on this subject in the past – I am not saying that emerging markets are buys; the starting valuation will always remain key – but my inclusion of global stocks in the Long Term Recovery Fund has made me read more on the subject (*Supertrends* by Lars Tvede, who is an acute observer of investment cycles), and look closely at the growth dynamics of companies such as CNInsure in China (Anthony Bolton top-tip). It is very likely that the developing world will remain a strong source of growing demand for many years to come.

For the moment the double-dip does not seem to be happening. Whilst quite a bit of data points to a slowdown in growth, none of the key surveys are pointing to a renewed economic contraction. The most apparent slowdown is in the growth of industrial production, but this was from very high levels; perhaps most importantly there is growing evidence that the banking sector is feeling a lot more robust and credit growth, though modest, is returning as is evidenced in the chart below from the Fed Officers Loan Survey. Politicians are right to say that smaller companies are not being looked after, but even this picture is improving.

The Fed Loan Officers' Survey and YoY Loans Growth



Source: Datastream

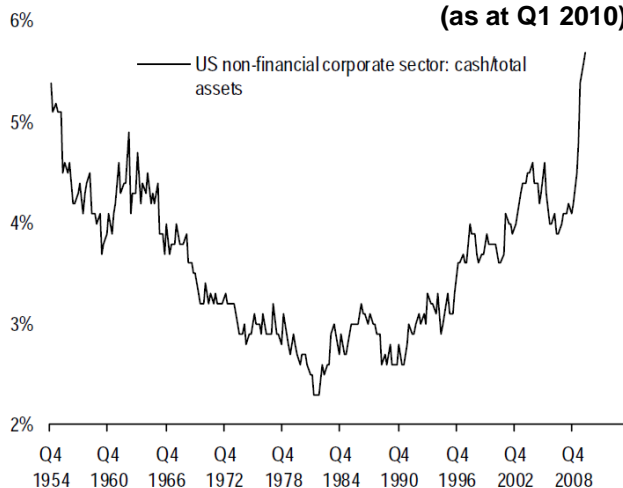
3) Companies are in great shape

Rarely in my investment career have I seen companies in such good shape. Profits are growing, cash is being thrown off at a rate of knots, return on capital is above the cost of capital, balance sheets are strong, accounting is now clean and conservative. And throw in low equity valuations and it is easy for corporates to enhance value through share buy-backs, increasing dividends, or buying out competitors.

4) M&A activity is picking-up

As I suggested in my July monthly comments it is inevitable that we see a return of significant M&A activity. As the chart below shows, companies have never had so much cash nor has the cost of what they might want to buy been cheaper in comparison to their cost of credit. Assuming a minimum takeover premium of 30% there are many companies that could be taken-over on normalised earnings yields of 10%, a no-brainer for larger companies where the cost of credit is well below half that level.

**US cash on the balance sheet is at an all-time high
(as at Q1 2010)**



Source: Thomson Reuters, Credit Suisse Research

For an obvious candidate in the portfolio look no further than **Cookson**. Here is a company that, whilst cyclical, has a very strong, global position in supplying consumables into the world's steel industry. This global number one position is valued at only nine times earnings, or an earnings yield of two times the cost of debt to a larger European or US industrial company, or indeed a Chinese strategic buyer. Unless Cookson re-rates it will be gobbled up. As will **Lonmin** (strategic position in the platinum industry), **CSR** (global leader in Bluetooth and sat-nav semiconductors, available at less than six times gross cash flow), **Hogg Robinson** (top three global business travel management company available for less than five times profits), and the **London Stock Exchange** (the longest established, most blue-chip exchange at the heart of the world's traditional financial district available for only ten times free cash flow to all interested parties from developing markets around the world – apply here!). Your Fund is well positioned for the return of M&A.

Portfolio Activity

We have continued to look for undervalued growth investments, whilst topping-up our value stocks if share prices drifted lower.

New Investments (purchases)

We purchased **Iomart**, a UK leading provider of 'cloud computing' services. They are focused on value added services in the high growth IT Hosting market. It has a well established and solid management team, a high cash flow positive business model and modest top line growth expectations given current run-rates providing a lot of scope for upgrades. With minimal requirement for expansion capex the drop through to profits and cash will be significant.

We added to our mining sector exposure through the purchase of **Vedanta**. This stock has been significantly de-rated since its interest in Cairn India was announced, and as a result is now the cheapest London quoted mining stock trading on five times 2011 earnings and only three times gross cash flow. Whilst the Cairn purchase looks fully valued in the short term, Vedanta's chairman Anil Agarwal has built the business to be one of India's largest companies through long-term strategic acquisitions, and without doubt the cash flow from Cairn will allow significant expansionary investment to be made in other areas of Indian infrastructure, such as power generation and ports. This company is an attractively valued Indian based conglomerate, with a strong growth outlook. This is a good buying opportunity.

Another Growth stock we bought was **Partygaming**. We have followed the internet gaming market for some time now, though regulatory hurdles have prevented what is a strong long term growth market from making money for shareholders. However, regulation is becoming far clearer, providing growth opportunities in more and more markets around the world and UK listed stocks are the global leaders. Indeed Partygaming, following its merger with BWIN, will be **the** biggest with leading shares in all the key areas of gaming (sports, poker and casino) in all the big European markets. With a gross cashflow multiple of less than nine times after synergies and strong secular growth opportunities, we have taken a new position in this stock.

A top decile scoring Quality stock we purchased was **Smith & Nephew**. They are one of four big global players in the orthopaedic and wound management markets. With strong market positions in products that require a lot of proprietary knowhow they are able to command attractive prices and earn high operating margins and return on capital. In the past this has meant Smith & Nephew has traded on a high multiple of earnings. However, a combination of the recession and healthcare reforms has led to a considerable slowing in their sales momentum, and a big de-rating of the whole global healthcare segment. This market, though, will continue to have good long term growth dynamics, driven by the demand from an ageing population. As a result this short term market slow down and stock de-rating is a good buying opportunity. Warren Buffett has been topping up his Johnson & Johnson holding, a company affected by similar dynamics. What is good enough for Buffett is good enough for the High Alpha strategy!

Existing investments we have become more confident about (purchases)

We added to a number of existing investments as news flow confirmed our initial thesis, or falling share prices made the valuation anomaly even more obvious.

A focus of our additions was the **Technology** sector, as announcements from individual companies made us more bullish about prospects. We added to the top decile scoring Growth stock **IQE** when it did a share placing to fund the purchase of a company that further cemented its position as the leading supplier of compound semiconductor wafers globally. The acquisition, Galaxy, is focused on infrared applications that allow night vision and sell into the US Department of Defence, a new market for the company. IQE is a fast growing company, exposed to the ramp-up in the smart phone sector, with plenty of room for profits to beat expectations.

We also added to our position in **Wolfson** (their semiconductors, which focus on delivering high quality sound, are now in a huge range of electronic products) as they announced growth ahead of expectations. And we are building up our **Anite** position as news flow from this company (that has underwhelmed in the past) is now stable and in anticipation of a significant increase in sales for their Mobile 4G testing equipment as telecom operators have to ramp-up their infrastructure investment to enable the delivery of video streaming across their networks.

New Investments (purchases)

On the subject of topping-up our value stocks when share prices drifted, we added to our position in the top decile Recovery stock **Hogg Robinson**. They are a top three global provider of travel services to the corporate sector and should be benefiting from the same return in demand from the corporate traveller that British Airways is seeing. It is generating lots

of cash to help reduce its relatively high gearing, has two big strategic investors (one the sister company of Emirates Airline), and all this is available on less than five times earnings. Crazy or what?!

Stocks that have delivered versus our PVT thesis (sale)

We continue to benefit from more than our fair share of bids. One of the top decile Growth stocks we bought last quarter, **Dimension Data**, was bid for by NTT, the Japanese telecom operator. We sold our position at a premium to the agreed bid price, realising an attractive and rapid return on our investment.

We also sold out of **Scott Wilson** following the bid it received last quarter.

Sainsbury was very strong during the quarter, benefiting from robust trading and a return of positive food inflation. However, we are concerned about the ongoing supply of more and more supermarket space into the already well supplied UK market, and think that this will negatively impact returns over the medium term. We decided to take profits.

Blinkx continued to be strong through the quarter, becoming a five bagger (up five times from purchase) in the process. It is not impossible that this stock becomes my first R&M ten bagger given the video search market is growing so robustly; however it did become too large a part of the portfolio during the period and, as a result, we decided to take some profits, reducing the position to 1% of the portfolio.

Stocks we have cut (sale)

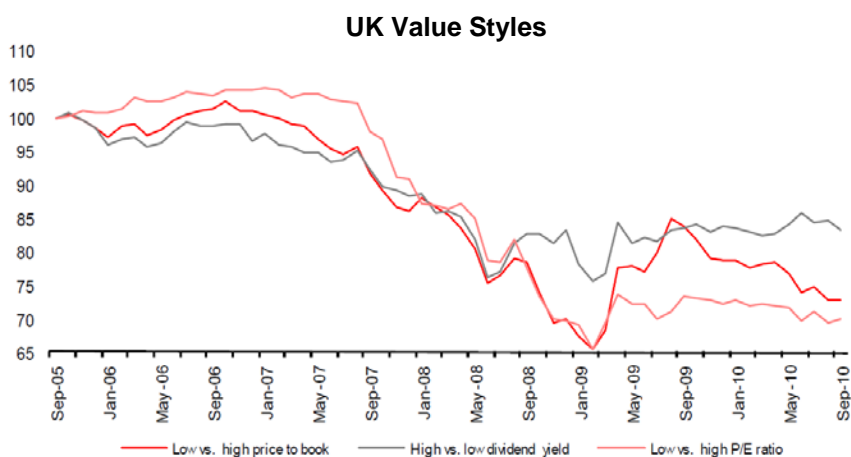
We decided to exit from our position in **Logica**. The original thesis on the stock has not been challenged, just that our level of conviction is lower than the rest of our holdings due to the fact that, because they do not dominate their markets, they may suffer more than their competition as public sector spending on IT projects is reigned in. We decided to apply our capital elsewhere.

Outlook

It is interesting to note that with the Value factor and Smaller Companies yet to perform there remains a lot of latent outperformance in the portfolio.

Value

The High Alpha strategy remains a committed value style portfolio, with strong value characteristics. However, this has not been a 'normal' cyclical recovery for value type stocks. They did well in 2009 but, as the chart below shows, both low PE and particularly low PB stocks have drifted off in the current year.



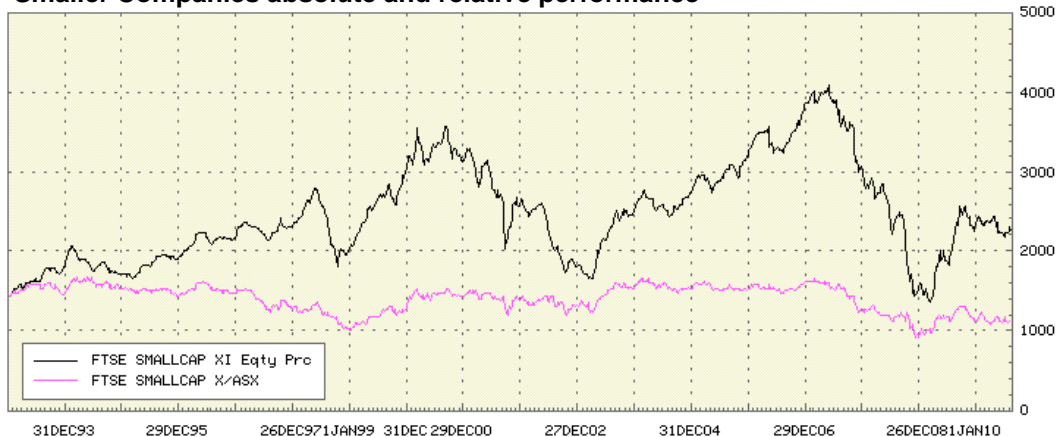
Source: SG Cross Asset Research

The reason for this is the market identifying a greater gap than normal between the apparently robust prospects for global growth stocks and the more muted outlook for Western economy based value type investments. Our view, however, is that these latter stocks will actually, through self-help, drive strong shareholder value growth over the next few years making their current very lowly entry valuations look ridiculous. Examples of this would include banks such as **Lloyds**, still trading at its book value despite evidence that it will return quite rapidly to a mid-teens return on capital; and **Wolseley** which, through cost cutting and disposals of poorer businesses, is seeing a strong earnings and cash flow recovery despite weak end-markets, and is trading at less than eight times recovery earnings per share.

The Value in the portfolio is storing up future outperformance, and the same can be said for:

Smaller Companies, which as the chart below shows have had an extended period of mediocre performance, culminating in a disappointing credit crunch and surprisingly muted subsequent recovery.

Smaller Companies absolute and relative performance



Source: Bloomberg

As a result of this underperformance smaller companies now look compelling value, at less than ten times prospective earnings with a much higher than normal dividend yield relative to the rest of the UK market. This modest valuation, when combined with a strong profits outlook and a longer term trend of smaller companies being able to generate superior growth than their larger brethren, makes us very comfortable with our almost 20% allocation to this size of companies.

In conclusion, whilst equity anomalies are not quite as great as they were when I wrote my last quarterly report, they still look attractive and are possible recipients of funds that are likely to flow away from the over-bought Government Bond market. Positive absolute returns remain more likely than not from current levels of valuation and we should be able to generate good relative returns as Value does better, as Smaller Companies attract more interest, and as our Growth companies continue to generate superior increases in shareholder value.

Again, thank you so much for your continuing support.

Hugh Sergeant
Head of UK Equities

Fund Facts

Launch date	28 Nov 2006
Fund manager:	Hugh Sergeant
IMA sector:	UK All Companies
Benchmark:	FTSE All-Share (Total Return)
Tracking error range:	4-8%
Product capacity:	£1.1bn (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	Accumulation	Accumulation
Fund charges:			
Annual	1.50%	0.75%	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	B1DSZM4	B3D79W3	B1DSZP7
ISIN	GB00B1DSZM47	GB00B3D79W34	GB00B1DSZP77
Bloomberg	RMUKEHA LN	RMUKEHG	RMUKEAA LN

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