RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Income Fund I Quarterly Report
September 2010

River and Mercantile

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UK Equity Income Fund – Quarterly Report

Fund Aim

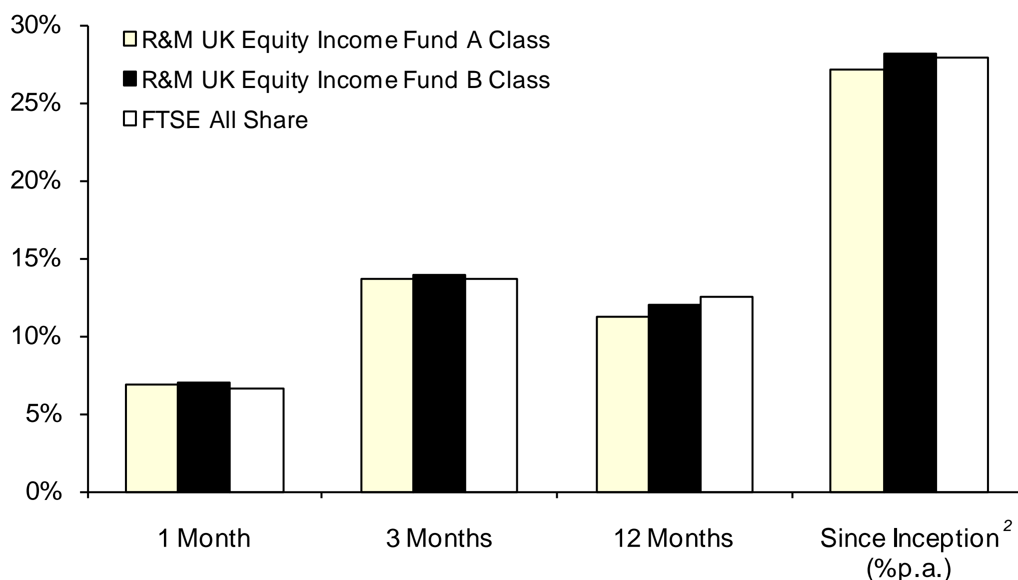
The investment objective of the Fund is to generate a rising level of income combined with the potential for capital growth through investing in a portfolio which will primarily consist of UK equities.

Portfolio Summary			Risk Analysis Summary	
Strategy AUM		£31.4m	Portfolio Volatility	17.89 %
Strategy Capacity		£1bn	Benchmark Volatility	17.70 %
Number of stocks		72	Tracking Error	3.22 %
Largest Holding	HSBC	7.29 %	Portfolio Beta	0.99
Historic Yield		3.80 %	Prospective Historic Yield[3]	4.20 %

Performance to 30 September 2010

Retail "A" Class Shares	Fund[1]	Index*	Difference
1 Month	6.90%	6.54%	0.36%
3 Months	13.67%	13.63%	0.04%
12 Months	11.22%	12.49%	-1.27%
Since Inception[2] (%p.a.)	27.16%	27.87%	-0.71%

Asset Manager "B" Class Shares	Fund[1]	Index*	Difference
1 Month	6.97%	6.54%	0.43%
3 Months	13.88%	13.63%	0.25%
12 Months	12.05%	12.49%	-0.44%
Since Inception[2] (%p.a.)	28.10%	27.87%	0.23%



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]Inception date 3 February 2009
[3]Yield based on the historic dividends of the current holdings of the Fund.

Market Overview

"Always look ahead, but never look back." - Miles Davis

Next year marks the twentieth anniversary of Miles Davis's death. I've generally found that people fall into two camps regarding Miles. They have either 'heard of him' but not 'heard' him or they regard him as one of the creative geniuses of the twentieth century. I'm in the second camp. This isn't because, as a fellow trumpeter, I have some particular musical insight into his technique or creativity, but mainly because Miles represented to me the epitome of forward thinking. He consistently challenged the status quo and successfully innovated in an ever-shifting environment over forty years. His music from "Birth of the Cool" to "Kind of Blue" to "In a Silent Way" through to "Bitches Brew" and "On the Corner" is a creative journey that, in my opinion, almost no other musician in any genre, living or dead, has achieved. Buy any of these albums and you will not be disappointed but surprised, challenged and, eventually, won over like millions of others. Miles, unlike current financial market sentiment, spent his time focusing on the future rather than the past, he retained no 'baggage' and then performed with conviction, again and again, ground breaking music.

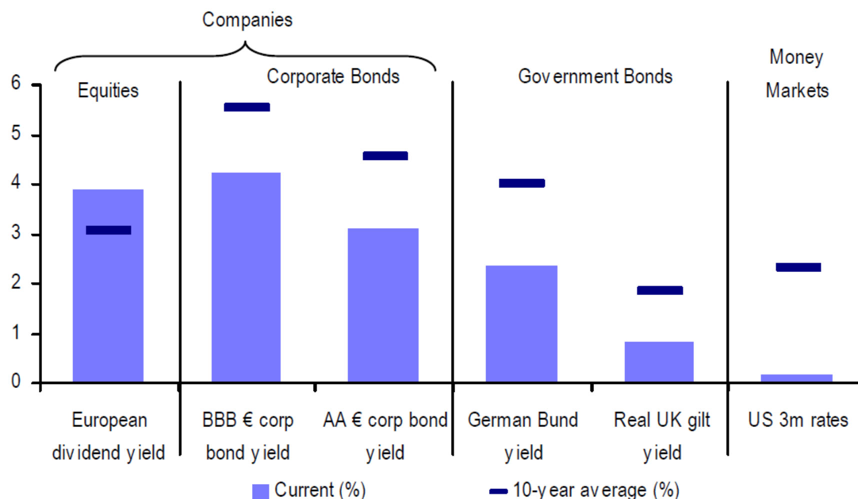
"*Don't play what's there, play what's not there.*" - Miles Davis

Q3 2010 was a strong quarter for equities, rebounding from the previous period. The balance of opinion seemed to be moving away from a 'double-dip' mentality as ongoing patchy economic news, whether ISM numbers from the US, Chinese CPI data or German economic releases, provided little to raise stress levels further. Banking regulatory frameworks continued to evolve, though for many the 'lack-lustre' recovery is pointing to further US quantitative easing most clearly expressed in the buoyant Dollar Gold price.

The UK equity market delivered a return of +13.6% led by growth sectors such as Technology and Oil Services and international cyclicals such as Industrials and Chemicals. Mining stocks performed well in the second half of the quarter. UK domestic areas such as Retail and Real Estate remained weak. Many high yielding 'defensive' sectors lagged, such as Utilities and Telecommunications. Factor returns were less significant than the prior quarter, though Value continues to perform poorly and Momentum became increasingly effective. Growth stocks are having a good 2010.

Based on current market consensus dividend forecasts, the prospective yield on the fund is c.4.0%. This is attractive relative to other asset classes, the current UK equity market and its history, and is predominantly driven by overseas profits, which should grow, helping offset any inflationary impact on real returns. Later in this report I will reiterate in detail my view that there is currently a huge medium-term investment opportunity in UK equity income.

In a low-income world, companies offer more



Source: Thomson Datastream, UBS European Equity Strategy

Performance

The Fund slightly outperformed the benchmark (by 0.25%) during the quarter and remains ahead of the benchmark since inception. Performance against peers was 1st quartile over the quarter.

Whilst **BP**'s bounce-back in July contributed to overall quarterly performance, the shares have done little since and I remain overweight. Financials stock selection has been positive via an overweight in **Lloyds** and an underweight in **Barclays**. The underweight in **HSBC** was also mildly helpful; however, relative to fundamentals, underperformance has gone too far and I moved overweight near the end of the quarter. Life Insurance positions in **Aviva** and **Legal & General** were positive and specialist holdings in **Paragon**, **Intermediate Capital** and **Collins Stewart** also contributed.

FTSE 250 holdings in **Ashtead** (US construction), **Elementis** (Global Speciality Chemicals) and **Laird** (Mobile phone electronics) performed strongly and **Afren** (Nigerian oil producer) responded well to a recent diversifying acquisition. Small company Recovery stocks **Anite** (Telecoms testing) and **Fiberweb** (Non-woven fabrics) were clear winners, and retain further significant upside as detailed in previous reports.

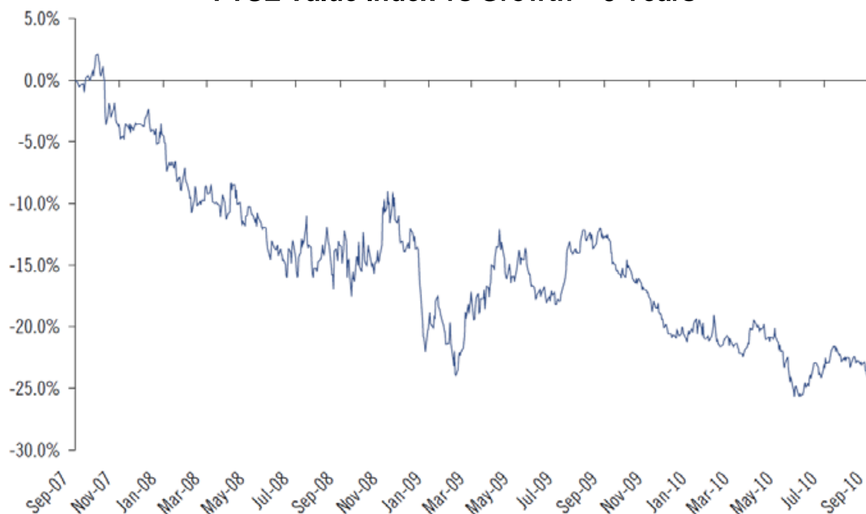
The large underweight in Mining was a headwind to relative performance during the period, with no exposure to **Xstrata** in particular; this was mitigated midway during the quarter by a reduction in the size of the sector underweight. **Petropavlovsk** unwound some of the prior quarter sector outperformance with further downgrades to growth expectations, which was frustrating given gold's performance. The Technology overweight has been positive, despite weakness at **CSR**. With the exception of Food Retail holdings, consumer positions such as **Holidaybreak** and **Home Retail** were weak. The timing of the **Halfords** sale was good, booking c. 108% capital gain pre-dividend receipts, since purchase at Fund launch and prior to a disappointing trading statement. Public sector exposed stock **Mitie** was weak in line with peers, however **BAE Systems** started to perform in September; patience here may be beginning to pay off. The stand-out disappointment of the quarter was **Robert Wiseman Dairies**. A supermarket driven price war for milk was not in our thesis, and the resultant downgrades to market expectations are therefore concerning, particularly at a time when a number of industry participants, including Wiseman, are adding additional capacity. I have sold.

Philosophy & Process

During the quarter, I felt sentiment was becoming too negative and consensus too risk-averse given the now established recovery and gradually improving banking environment. As a result the Recovery weighting has increased during the quarter by 3.3%. It is critical to remember, though, that Recovery Potential does not solely depend upon economic recovery, a clear example of this being the new position in defensive food manufacturer **Tate & Lyle**. Quality remains the largest part of the portfolio, Recovery category is now 23.6% of the portfolio, and is a mix of mainly self-help situations across sectors and the Fund's Financials positions in Life Insurance and Domestic Banks.

The skew to high scoring stocks, as quantitatively measured by *MoneyPenny*, our proprietary screening tool, has fallen during the quarter. This is primarily due to the decile ranking of **Vodafone** and **HSBC** dropping to 5. For these mega-caps, I don't think this is a fair reflection of their PVT relative characteristics and dividend growth potential, and expect scores to improve. Value factors continue to struggle, contrary to long-term historical returns data, and when this inevitably reverses I would expect relative performance to improve further.

FTSE Value Index vs Growth – 3 Years



Source: Datastream

Portfolio Income

The Fund's interim ex-dividend date is 1 October. I am delighted to increase this year's payment by 10% on 2009 to 2.75p (B-shares). The percentage growth rate for the final payment is projected to be even higher.

43 stocks went ex-dividend during the quarter including 27 increases, 3 returns to the dividend list (all Mining stocks), 9 unchanged payouts, 2 cuts, 1 maiden dividend from 2010 IPO holding **CPP** and the Fund's first Special Dividend receipt from successful oil & gas explorer, **Heritage Oil**. No dividends were received during the period from material positions in **BP** or **Lloyds Bank,** however both contributed to the capital appreciation of the Fund and will contribute to dividend growth in the future. The Fund's current consensus-based prospective yield of 4.0% is 114% of the market yield.

Quarterly Portfolio Activity

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

Continued adding selectively 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 66% of the total. This is fractionally below the UK market but, given my significant underweight in Resource companies, 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 I feel the relative valuation of some domestically focused stocks, in combination with low expectations, has become attractive. Further purchases (following **Lloyds Bank**, **WM Morrison**, **Moneysupermarket.com**, and **Balfour Beatty** in Q2), were **ITV**, leading mass-market broadcaster, and **Paragon**, leading buy-to-let lender.

Sale of successful investments:

Some successful investments were exited during the quarter as I believe higher risk-adjusted upside is available elsewhere and where the relative yield attractions have diminished. This would include **IMI**, **Cranswick**, **Centrica** and **Amlin**. This final sale funded the purchase of **Novae**, another Lloyd's underwriter, which is valued on a considerable, and increasingly unjustified, discount to its larger peer.

The sale of investments due to weakening theses:

Robert Wiseman Dairies and **Halfords** fall into this category due to weakening conviction in their Potential and deteriorating Timing characteristics. In the near-term these stocks have subsequently underperformed. Capital was switched within their sectors into high scoring names with mainly self-help driven Recovery potential of international **Tate & Lyle** and **Kingfisher**, both under relatively new management teams.

Undervalued Growth:

Four strong PVT Growth opportunities emerged during the quarter. They have been purchased at historically low valuations; mainly it appears because near-term growth expectations have slowed relative to history. Fundamental analyses suggest the secular and structural drivers of above-average profit growth actually remain in place and I see significant scope for above-average dividend growth well ahead of current market expectations. The companies are **Smith & Nephew**, the orthopaedics and wound care manufacturer, **Cobham**, the avionics and defence electronics specialist, **PartyGaming**, the online betting world leader, and **4Imprint**, an international fast growing promotional marketing specialist.

The final new holding is **BSkyB**, which I purchased following the rejected initial takeover approach. The company's medium-term to long-term growth is clearly recognised by its minority shareholder and the Board should ensure that a fairer price is eventually paid to those shareholders with patience.

Sector and size positioning

There has been almost no change to size distribution of the portfolio, with just over two-thirds in the FTSE 100 and a decent weighting of c. 12% in small-caps.

The strategy continues to take limited sector risk vs. the market, with the largest overweight at 3.2% in Media, a material increase during the quarter, and the largest underweight now Oil & Gas at -3.3% following a significant reduction in the **Royal Dutch Shell** position due to a falling *MoneyPenny* score and higher conviction in other sectors. Whilst 'QE2' leads to inevitable supportive commentary for 'hard assets', my Resource underweight remains due to the risks regarding the market's view on China's growth momentum. China's bank lending growth appears to have been normalising from excessive conditions but risks to further falls in property prices remain. Infrastructure investment, the dominant driver for resources imports, appears to be heading West within mainland China and the inevitable shift to increased private consumption is the natural next leg to growth, albeit nascent at this stage. Dividend growth expectations for the mining majors are accelerating and I am comfortable with a significant capital allocation.

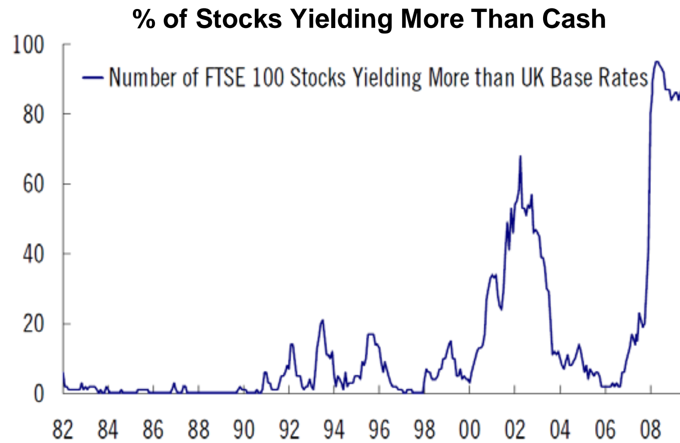
Leading overweight sectors remain Industrial Transportation +2.1% (**Clarkson**, world-leading ship-broker, **BBA Aviation**, flight support services, and **UK Mail**), Technology +3.4% and preferred defensive sectors Electricity +1.9%, Pharmaceuticals +1.5% and Food Producers +1.4%. The Fund remains overweight Real Estate but has scaled back this position due to lower conviction in the sector relative to future returns. This resulted in the sale of smaller company holdings **Hansteen** and **Alpha Pyrenees**.

Tobacco positioning moved to underweight following the sale of **Imperial Tobacco**, whose timing characteristics had deteriorated, and the capital was used to reduce the Mining underweight to -3.1% from -4.7%. The other largest underweight sectors have not changed over the quarter, though the extent has been scaled back in Banks to -2.8% but increased further in Gas and Water Utilities to -2.7% following the sale of **Centrica**.

Market Outlook

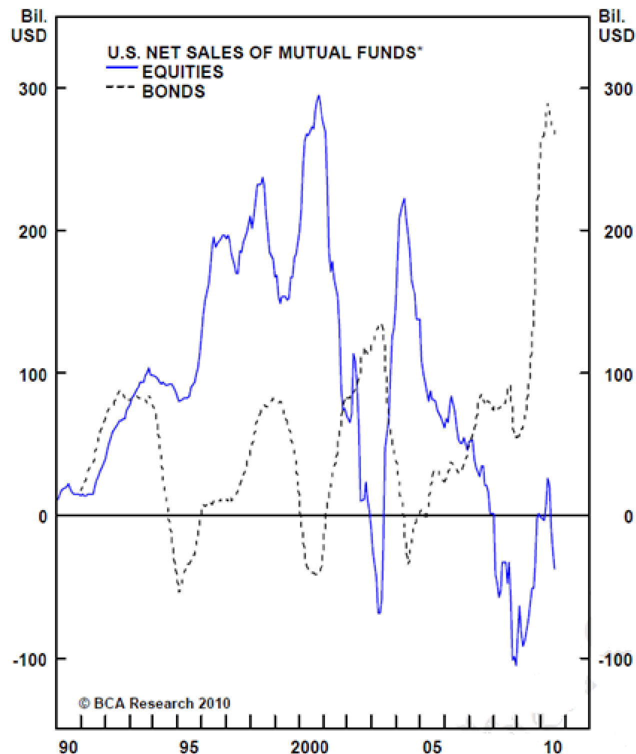
We are currently having a generational opportunity to buy UK income-producing equities. Don't look backward at the last ten years of returns, look forward like Miles. The components of the band or economy may be the same (drums, bass, piano, and trumpet vs. monetary authorities, governments, consumers and businesses) but the outcomes are very different as players choose to interpret the music differently.

% of Stocks Yielding More Than Cash



Source: Datastream & CIRA

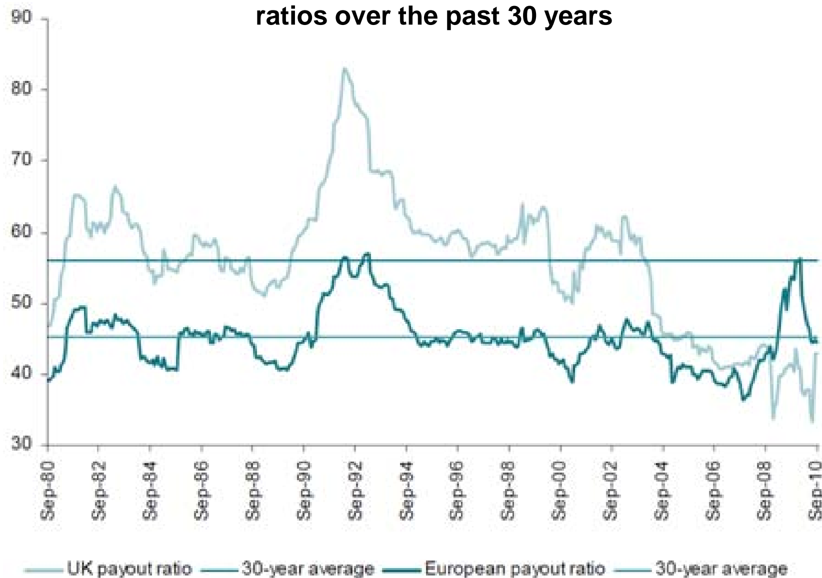
Record Divergence Between Equity and Bond Flows



Source: Investment Company Institute; shown as 12-month moving totals

Many commentators have decomposed the returns delivered by the UK equity market over the long-term, demonstrating that, between 1965 and 2010, the largest part of the return was driven by yield and dividend growth. In a period of subdued aggregate domestic growth and limited inflation-protected income offered elsewhere, the value of above-average dividend growth driven by overseas earnings, recovering profitability and enhanced payouts will drive a material relative re-rating of these stocks and those that provide a higher level of income.

European dividends, having fallen 23% between 2007 and 2009, will now continue to grow for some time. The improvement in corporate profitability will feed through to increased distributable reserves. Corporate balance sheets are now fortified (to the point of excess capital, yielding little for shareholders in the bank). The market payout ratio remains below average and will increase as confidence returns, dividend cover should be touching 2x by the end of 2011.



Source: Thomson Datastream, Evolution Securities

A number of current non-contributors to the fund will rejoin the dividend list in 2010-11 such as **Rio Tinto**, **Rentokil**, **Wolseley**, **Invensys**, and **Smith & Nephew** where cover on current expected payouts is 8x, 4.4x, 5x, 6x, and 4.4x respectively. The ongoing improvement in profitability and clarity of regulatory environment will lead to a gradual normalisation of financial sector shareholder distributions. Banks were 28% of UK market dividends and now represent just 10%. **HSBC** has considerable scope to increase its dividends. Mining is a much more material part of the market but currently yields a lot less and lacks enough organic opportunities to deploy its significant cash flows at current resource price levels; **Anglo-American** has considerable scope to increase its dividends.

Downside risks and 'tail' risk exposure still appear to dominate sentiment, however risks to the dividend streams of international companies such as the Pharmaceuticals, Consumer brands (**Diageo**, **Unilever**, **BAT**, **Vodafone**), **BAE Systems**, **Balfour Beatty** and **International Power**, are low. However, I believe the bigger tail-risk that investors are under-appreciating is the upside risks to dividend growth from holdings such as **ITV**, **Rentokil**, **Invensys**, Domestic Banks and Mining companies over the next few years.

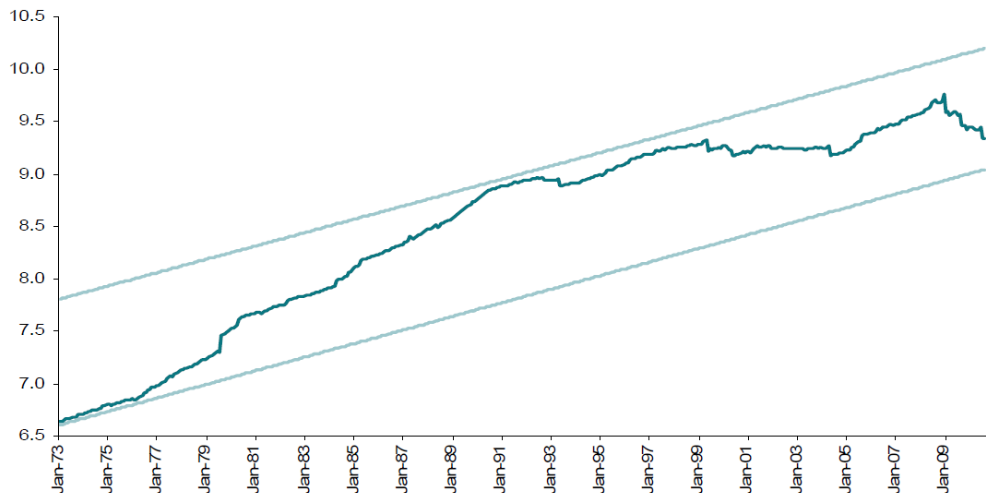
The starting yield for purchasing units in this Fund (as I myself am doing) is extremely attractive given the low returns offered by other assets, and is highly likely to grow in real terms over the next few years, materially, as outlined. The fact is that dividend payments are already increasing and the stocks in this Fund are geared into huge medium-term profit growth, which will translate to continued dividend growth in the years to come. The valuation of this income stream is mispriced due to misplaced fears for the future, backward looking emotional biases, and elementary momentum buying of other asset-classes.

Yielding equity assets are being passed over for non-yielding assets such as gold. Global equity funds are receiving support whilst UK listed companies, driving material dividend growth from their business franchises overseas, are passed over despite often possessing much reduced levels of risk. The current prospective Fund yield of 4% includes material positions in companies such as **BP**, **HSBC**, **Lloyds Bank**, and **Rio Tinto,** whose dividend growth potential is massive.

Despite the fund having delivered a 50.9% total return since launch, the above thesis has yet to occur. Higher dividend stocks, on average, have been underperforming. Inflation-linked equities have been underperforming fixed-coupon bonds. These re-rating benefits are yet to come to this Fund.

The hunt for income should be an inflation-protected hunt. The lack of inflation in recent decades has wooed investors into thinking that bond coupons will maintain their spending power in the future. When inflation returns (note that I am not using '*if*') there could be a scramble for income streams that grow. Dare I suggest UK equities?

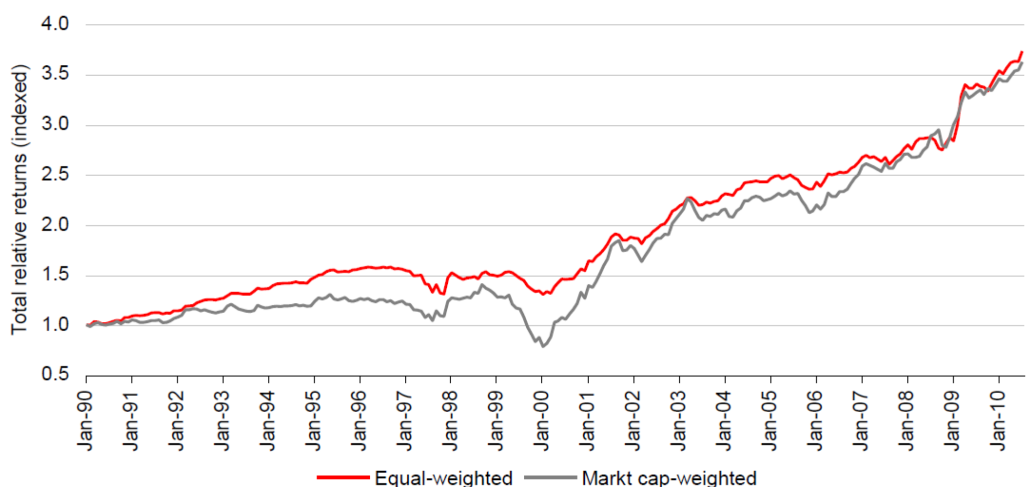
UK stock market dividends versus their long term growth bands since 1973



Source: Thomson Datastream, Evolution Securities

To date, yield factors have little impact in the UK market in 2010. Despite this our PVT approach has enabled a +1.7% performance vs. the market since the beginning of the year. For those concerned about deflation, the chart below shows the historic returns from focusing on higher yields in Japan since their bubble burst and deflation set in.

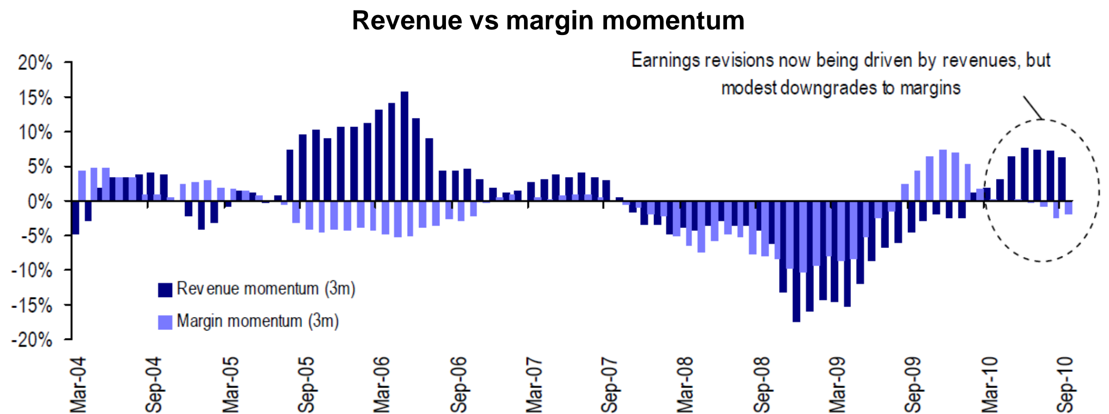
Relative performance of a high dividend yield portfolio in Japan



Source: SG Cross Asset Research

Current prospective valuation multiples for 2011, upon which many investors will begin to cast their eye in the next few months as 2010 draws to a close, have the FTSE 100 Index on a PE of 9.8x and the FTSE Small Cap Index on a PE of 9.9x, a c.10% discount to the FTSE 250 Index. Market expected earnings growth numbers for the All-Share Index are currently c.16%.

Those investors concerned about the extent of margin expansion need only look at the revenue upgrades coming through in recent months to see what will drive further profit expansion.



Source: IBES, MSCI, Thomson Datastream, UBS European Equity Strategy

Investing is similar to jazz in many ways. The soloist is required to improvise, provide their own personal interpretation, given a structured sequence of chords and changing rhythm. It may sound discordant at times and rehearsed at others but the music is live. I am passionate about Jazz, however I suspect that hardly anyone under 24 years old has listened to barely any Jazz in at least a couple of decades. This is unlikely to change, but I believe that the interest in higher yielding UK equities will. The former will be a shame; the latter, if missed, will be a tragedy.

The Fund is built via a bottom-up stock selection process based upon our PVT philosophy. I 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. They are highly liquid securities with strong balance sheets in a deep, broad and attractively valued UK equity market which has significant profitability generated overseas. The Fund remains focused on achieving an above-average income from UK equities and a Total Return ahead of the market with active risk control at a sector and size level.

Richard Staveley
Portfolio Manager

Fund Facts

Launch date	3 Feb 2009
Fund manager:	Richard Staveley
IMA sector:	UK Equity Income
Benchmark:	FTSE All-Share (Total Return)
XD dates:	1 April & 1 October
Dividend/Accumulation payment date:	31 May and 30 Nov
Product capacity:	£1 bn (pooled & segregated)

Share class:	A	B
Launch price (shares):	100.00p	250.00p
Share classification:	Retail	Institutional
Type of shares:	Income	Accumulation
Fund charges:		
Annual	1.50%	0.75%
Initial (up to)	5.25%	5.25%
Minimum investment		
Initial	£1,000	£2.5 million
Subsequent	£500	£25,000
Sedol	B3KQG33	B3KQG44
ISIN	GB00B3KQG330	GB00B3KQG447
Bloomberg	RMUKEIA	RMUKEIB

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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