

RIVER AND MERCANTILE  
ASSET MANAGEMENT

UK Equity Long Term Recovery Fund | Quarterly Report  
September 2010

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# River and Mercantile

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## UK Equity Long Term Recovery Fund – Quarterly Report

### Fund Aim

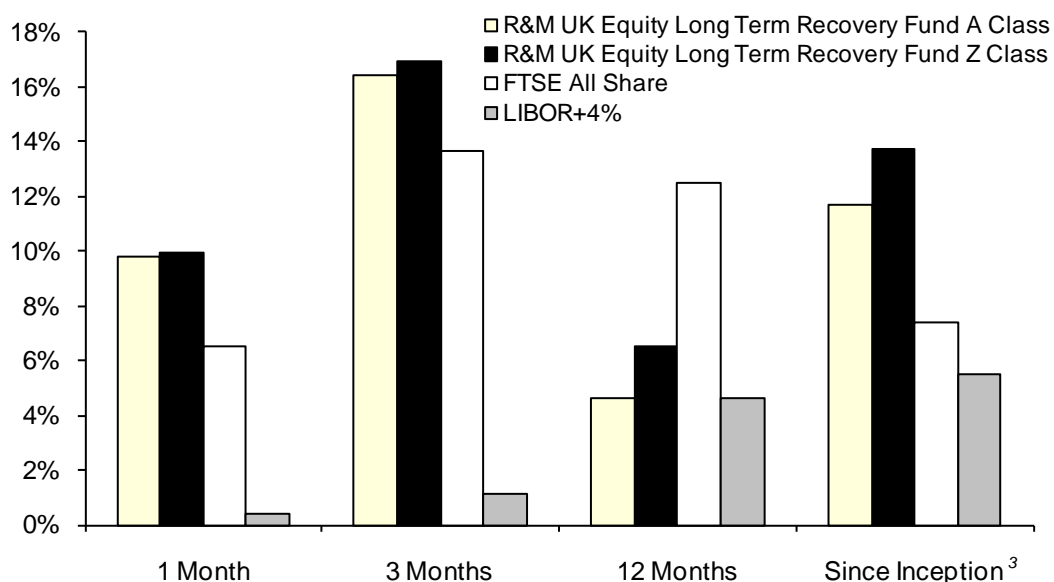
The investment objective of the Fund is to achieve capital growth through investing in a portfolio which will primarily consist of UK equities that meet the manager's recovery criteria of a turnaround in company profitability over the longer term. The Fund will not be restricted by reference to a benchmark, sector constraints or company size.

Portfolio Summary		Risk Analysis Summary	
Strategy AUM	£74.1m	Portfolio Volatility	20.40
Strategy Capacity	£200m	Earnings Yield	5.67
Number of stocks	166	Dividend Yield	1.88
Largest Holding	BP 3.57 %	Price to Sales	0.72
Average return to medium-term recovery value	61%	Price to Book	1.26

### Performance to 30 September 2010

Retail "A" Class Shares	Fund <sup>1</sup>	FTSE All Share	Difference	LIBOR+4
1 Month	9.77%	6.54%	3.23%	0.37%
3 Months	16.43%	13.63%	2.80%	1.15%
12 Months	4.63%	12.49%	-7.86%	4.63%
Since Inception <sup>3</sup> (%p.a.)	11.73%	7.40%	4.33%	5.53%

Inst'l "Z" Class Shares	Fund <sup>2</sup>	FTSE All Share	Difference	LIBOR+4
1 Month	9.93%	6.54%	3.39%	0.37%
3 Months	16.94%	13.63%	3.31%	1.15%
12 Months	6.53%	12.49%	-5.96%	4.63%
Since Inception <sup>3</sup> (%p.a.)	13.71%	7.40%	6.31%	5.53%



Source: River and Mercantile Asset Management LLP

<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 17 July 2008

### 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 **Potential** (profits are growing); great **Value** (equities are cheap in absolute terms, and bargain basement versus bubbly bonds), and supportive **Timing** (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, which 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 produced a very attractive absolute gain (and significantly outperformed the market), returning +16.9%. 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 have a material position, 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 **IQE**, **Blinkx** 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 strong both in absolute and relative terms (a return of +11.1% compared to the benchmark +6.7%), driven by strong stock picking rather than returns to factors or size. Our recovery stocks with top-line growth characteristics, smaller technology ones in particular, have been the best performers. As you will be aware, this year's strong return follows a gain of more than 60% in 2009.

### Key performance contributors

#### Quarter:

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

**Negative:** Public Sector exposed stocks (**RM**); domestic recovery stocks lagged (**Aukett**)

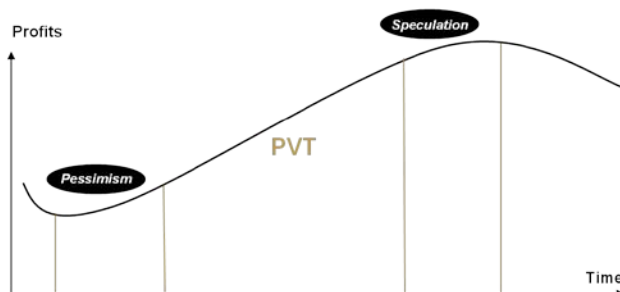
### Performance Outlook

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

## 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 seven times.

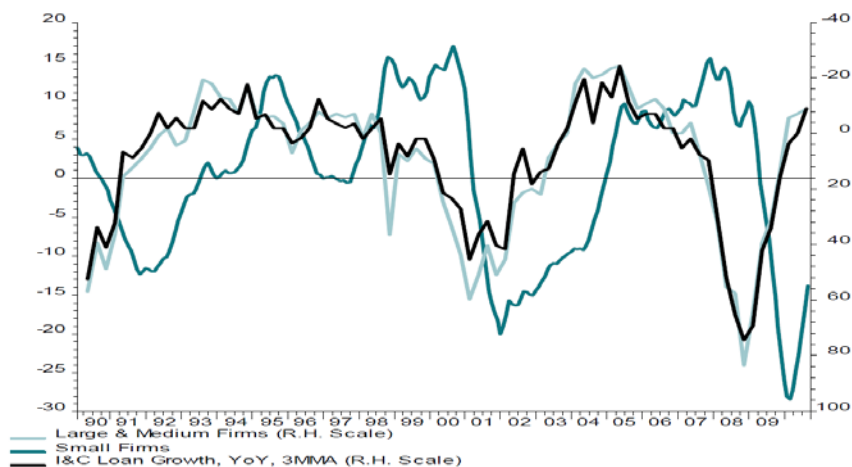
But it is versus the Government Bond market that equities look a steal, with earnings yields on stocks trading at over three times that of longer term Gilts. As for the shorter end of the Government Bond market – forget it – how any sane investor can put money to work at less than a 2% return (which 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, and now in this portfolio!). 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

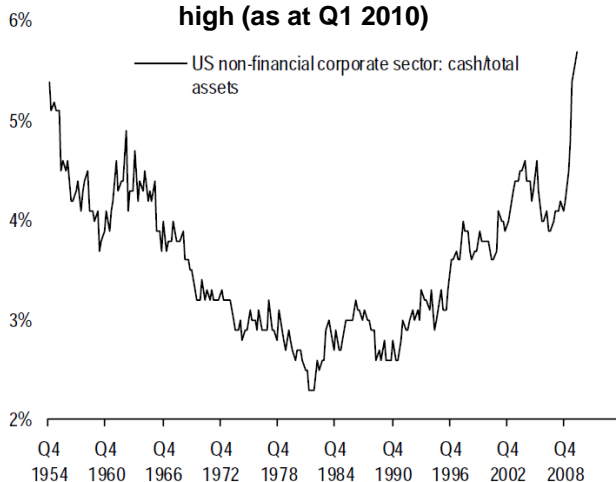
### 3) Companies are in great shape

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, and 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 recovery investments with strong secular growth characteristics, whilst topping-up our value recovery stocks if share prices drifted lower. We are also increasing our smaller company exposure – this is very much the source of our best new ideas, combining attractive recovery type valuations with good shareholder value growth potential. There seems to be more interest in smaller company shares within the market and this is ensuring that fundamental progress is beginning to be rewarded by share price appreciation.

### New Investments (purchases)

We developed three recovery themes, with above average secular growth:

**Cement** – cement stocks are all bombed out, as they are late cycle and have been exposed to falling global construction activity. However, the industry is an attractive one; because its highly consolidated nature provides the operators with pricing power in years of normal demand; because all the big players have developed fantastic emerging market exposure ensuring strong, longer-term growth characteristics; and because trading has been difficult, all the operators have seen their shares fall towards or below book value. There are no UK listed cement companies anymore; instead we purchased **Holcim** (Global number one, huge EM exposure, trading at book value); **China National Building** (leading producer in China, with a strong growth outlook, valued at only a modest premium to book at time of purchase); and **Buzzi Unicem** (Italian major, with strong positions in emerging Europe, trading at 0.5 times book).

**On-Line franchises** – we continue to look for out-of-favour internet based businesses, because we still love the strong secular growth (with huge free cash flow) nature of these enterprises, but we do make sure we buy them when they are out-of-favour. We have added to our Internet Gaming exposure through **Partygaming** (as detailed below); and we have added to our Internet Portal exposure, with this part of the online market out-of-favour due to its exposure to the advertising cycle. Here the market is being far too short term, forgetting the huge amount of traffic that these sites get, traffic that will be further monetised over time. We bought **Sina** and **Sohu** (two top portals in China) and added to the **Yahoo** position.

**Solar** – solar power is a massive long-term growth market as the desire for clean energy meets much lower costs of production to produce a massive ramp-up in demand; however all the solar manufacturers have seen their share prices fall significantly as short-term supply has exceeded credit crunch impacted demand causing falling prices for solar panels. However, we view this as an opportunity to buy fast growing companies at bargain basement prices (again often below book value). We have purchased **Renesola** and **LDK Solar** (Western listed but based in China) and added to our position in **PV Crystalox**.

In addition we purchased **lomart**, 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.

As mentioned above we also bought **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 cash flow multiple of less than nine times after synergies and strong secular growth opportunities, we have taken a new position in this stock.

On the subject of adding to our value recovery stocks we bought a 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?!

### **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 **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.

We also added to our US technology exposure, buying bombed-out market leaders. **Nvidia**, the dominant producer of graphic chips, was purchased for less than one times sales, and only seven times gross cash flow; **Symantec**, which dominates the internet security market with its Norton brand, was bought for less than ten times earnings. Both these stocks could be gobbled up by larger players in the industry.

## Stocks that have delivered versus our PVT thesis (sale)

We continue to benefit from more than our fair share of bids. This included an offer for **Nestor**, a three bagger since purchase. We sold out of our position.

We have been taking profits in **Vodafone**, following strong performance. This mega-cap stock no longer fits our key criteria of being able to double over the medium term. It has provided a good source of capital to re-invest in high conviction smaller company ideas.

## Stocks we have cut (sale)

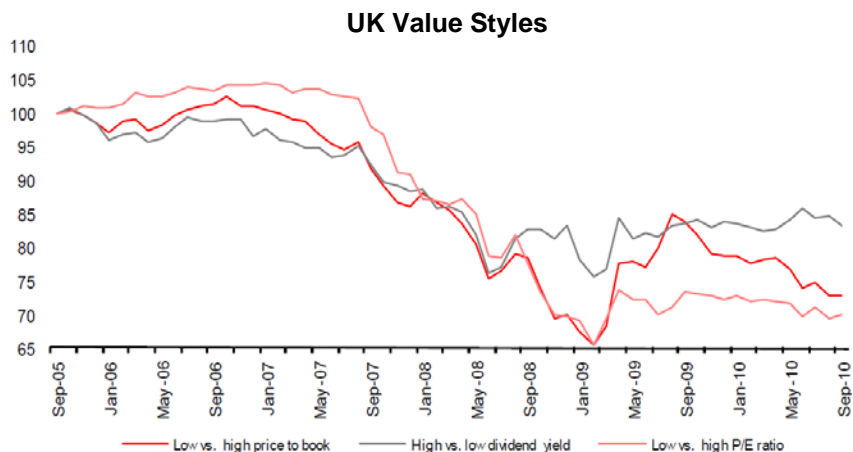
We decided to exit from our position in **Alpha Pyrenees**, the European real estate vehicle. It has not been a poor performer, only we have decided that it is really too small and a bit too leveraged to really generate strong shareholder value increases.

## 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 Long Term Recovery strategy remains a committed value style portfolio, with strong recovery 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.



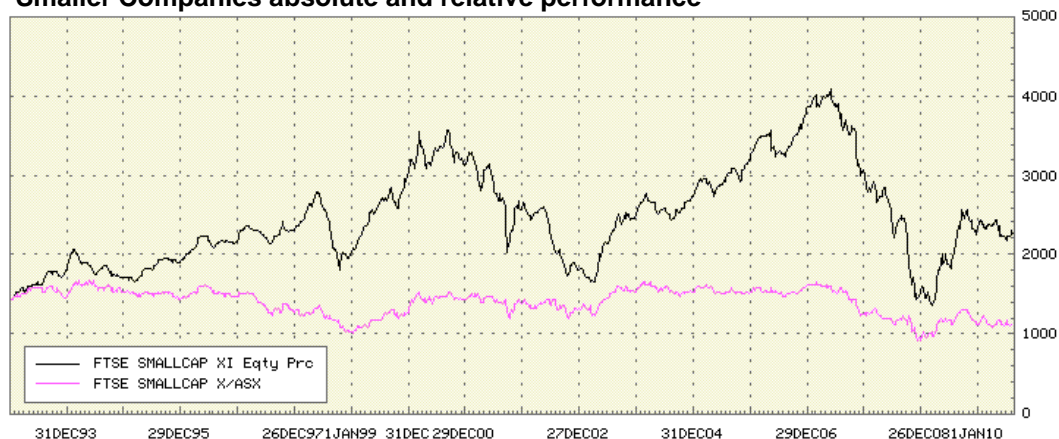
Source: SG Cross Asset Research

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 greater than 30% allocation to this size of company.

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	17 July 2008		
Fund manager:	Hugh Sergeant		
IMA sector:	UK All Companies		
Benchmark:	LIBOR Overnight Cash Rate		
Tracking error range:	N/A		
Product capacity:	£200m (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	Income	Accumulation
Fund charges:			
Annual	1.75%	1.00%	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	B1YHLP5	B614J05	B1YJFW6
ISIN	GB00B1YHLP55	GB00B614J053	GB00B1YJFW60
Bloomberg	RMUKELA LN	RMUKEBBLN	RMUKELB LN

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