RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Smaller Companies Fund I Quarterly Report
September 2010

River and Mercantile

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UK Equity Smaller Companies Fund – Quarterly Report

Fund Aim

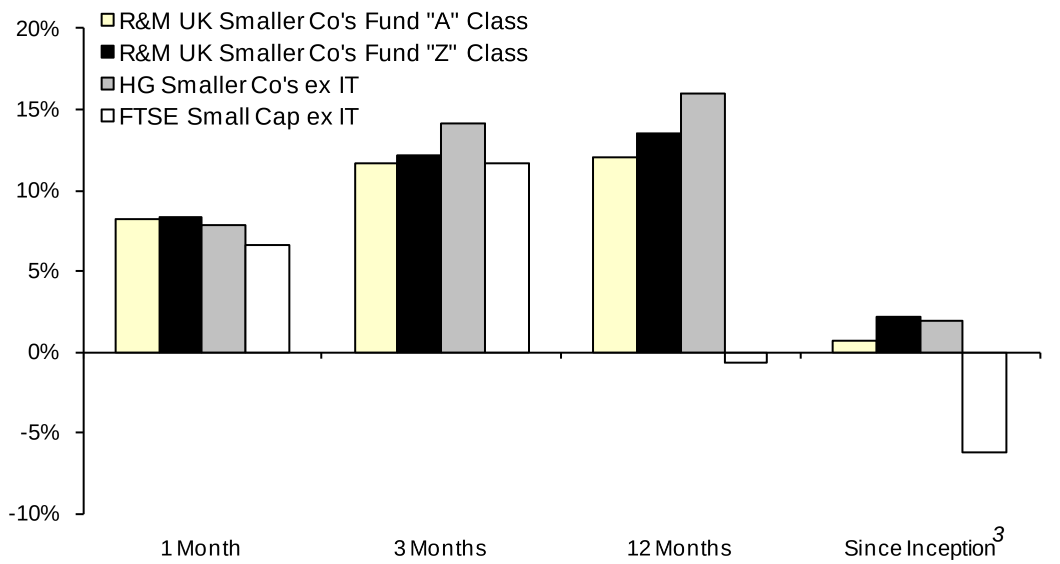
The investment objective of the Fund is to achieve capital growth through investing in a portfolio of investments which shall primarily consist of UK equities which reside in the bottom 10% of the UK stock market in terms of market capitalisation.

Portfolio Summary			Risk Analysis Summary	
Strategy AUM		£32m	Portfolio Volatility	20.04 %
Strategy Capacity		£400m	Benchmark Volatility	19.94 %
Number of stocks		75	Tracking Error	6.03 %
Largest Holding	Anite	2.37 %	Portfolio Beta	0.96
			Active Money	80.10 %

Performance to 30 September 2010

Retail "A" Class Shares	Fund[1]	HG Index*	Difference	*FTSE Small Cap (ex IT)*
1 Month	8.25%	7.87%	0.38%	*6.65%*
3 Months	11.69%	14.14%	-2.45%	*11.65%*
12 Months	12.08%	15.98%	-3.90%	*-0.62%*
Since Inception[3] (%p.a.)	0.74%	1.88%	-1.14%	*-6.23%*

Inst'l "Z" Class Shares	Fund[2]	HG Index*	Difference	*FTSE Small Cap (ex IT)*
1 Month	8.38%	7.87%	0.51%	*6.65%*
3 Months	12.11%	14.14%	-2.03%	*11.65%*
12 Months	13.57%	15.98%	-2.41%	*-0.62%*
Since Inception[3] (%p.a.)	2.19%	1.88%	0.31%	*-6.23%*



Source: River and Mercantile Asset Management LLP
**Index: Hoare Govett Smaller Companies ex IT*
[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 30 November 2006

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. The Hoare-Govett Index slightly outperformed large caps rising 14.1%, but the FTSE Small Cap Index underperformed, rising 11.6%. Mining stocks performed well in the second half of the quarter. UK domestic areas such as Retail, Leisure, House Builders and Real Estate remained weak. Many large cap, 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.

Performance

The Fund underperformed the benchmark by 2% during the quarter (c.0.5% ahead of the FTSE Small Cap Index), although performance was ahead during September. The Fund remains ahead of the benchmark since inception.

Underperformance has been due to a mix of size exposure (underweight FTSE 250 stocks at the top of the Hoare-Govett Index e.g. takeover candidate **Dana Petroleum** and Chemicals stock **Croda**), and weak stock selection within mainly the Consumer areas. During the quarter we were impacted by disappointing trading updates from **CVS Group** (the domestic veterinary services group), **Blacks Leisure** (outdoor retail), and **Xchanging** (business process outsourcing) and the emergence of a supermarket price war at **Robert Wiseman** (milk production). In all these cases the negative market reaction was hard and swift and has overwhelmed our actual general caution of the Consumer areas and material sector underweight. Sector positioning has been positive for performance overall, but Real Estate holdings lagged the market and we have limited Basic Resources exposure.

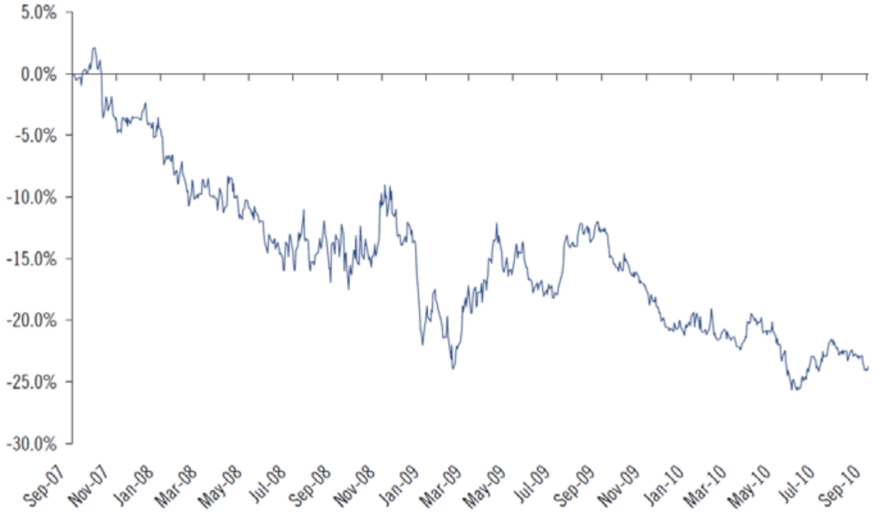
Positive contributors during the quarter were mainly Industrial holdings such as **Elementis** (chemicals), **Laird** (mobile phone electronics), **Bodycote** (industrial engineering) and **Fiberweb** (non-woven fabrics). However, our patience with **Anite** (telecoms testing) is paying off, **Ashtead** (US plant hire) performed well as did **Paragon** (buy-to-let lending). We are also pleased that almost all new holdings purchased during the quarter started contributing early to relative performance such as **Lamprell**, **Wolfson Microelectronics** and **Millenium & Copthorne Hotels**.

Philosophy & Process

There has been some change to Category weightings. Quality has reduced by 5.1% to 36.3% in favour of further investment into the strongly performing Growth and Recovery categories, now 21.4% and 26.5% of the portfolio respectively. This means there is a more balanced spread of Potential within the portfolio with the most capital allocated to Quality. The skew to high scoring stocks, as quantitatively measured by our proprietary screening tool *MoneyPenny*, remains strong with the proportion of stocks invested in the top three deciles now standing at 65%.

Within the key elements of our Investment Philosophy, the Valuation factor performed poorly during the quarter. When this inevitably reverses, relative performance should improve. Timing factors have continued to improve.

FTSE Value Index vs Growth – 3 Years



Source: Datastream

The market, it seems, is seeking ‘Growth’, whether that be industrial cyclical growth, overseas growth or secular growth and, as is often the case with this desire, valuation discipline is quietly being pushed to one side. Buyers, including ourselves, should beware – Growth investing appears to only work when anticipated growth is below realised growth. Expectations are all too often disappointed or already reflected in market prices.

Portfolio Activity

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

Rotated successful Industrial investments into better value laggards

During the quarter I sold successful Industrial holdings, where valuation and expectations have become stretched, such as **Domino Printing** and **Charter,** and capital was rotated into better value with better Timing characteristics such as **Senior** and **Melrose**.

Seeking good value Growth Potential

New Growth investments were identified where there is also valuation support. **Capital Drilling** was a recent IPO providing outsourced mine and exploration drilling services to a range of blue-chip customers around the world; **Advanced Medical Solutions** is a well established wound care manufacturer with leading products being launched into huge new end-markets such as the US; and **Iomart** is a leading value-added data hosting business benefiting from ‘cloud’ computing trends. During the quarter profits were booked in fast growing **Asos** and **Clapham House Group**, the latter as a result of a takeover approach.

The sale of investments due to weakening theses:

The lack of significant insurance events during 2010 is likely to put further pressure on a deteriorating rates environment. Conviction in non-life insurance holdings has consequently fallen with **Beazley** being reduced and more expensive **Hiscox** sold. Ostensibly ‘defensive’ investments, such as milk producer **Robert Wiseman,** are not meant to ruin an investor’s quarter. However, the onset of aggressive price competition led by non-Wiseman supplied **Asda** has resulted in significant margin pressure. This was not expected in the thesis and, given the additional capacity that both Wiseman and the industry are creating in the next two years which can only exacerbate the situation, we sold. Significant reductions have been made so far in other disappointing positions such as **Xchanging** and **CVS**.

New PVT investments

MoneyPenny continue to provide a range of new, potentially exciting ideas across a range of Potential. New holdings during the quarter included highly operational geared Recovery stocks **Wolfson Microelectronics** (fabless semi-conductors) and **Lamprell** (oil rig and wind turbine construction), where trading has clearly turned a corner for both though valuations were still depressed. In Quality, the leading Inter-dealer broker **Tullet Prebon** was purchased, offering high and improving cash flow returns on investment, an attractive Valuation and Momentum. Finally, in Asset-backed, the material mispricing of the hotel and land asset base of international group **Millennium & Copthorne** was identified just as bookings in key ‘gateway’ hotels across the world has begun to improve.

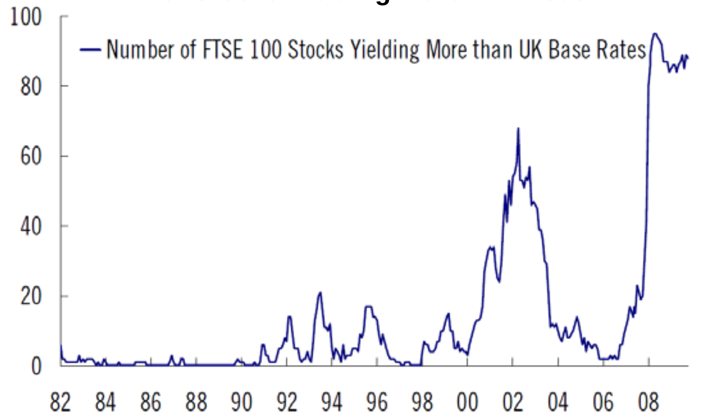
Sector positioning

There has been little change to the sector overweights during the quarter. The largest remains Support Services at +9.8%, 21.2% of the portfolio. Technology has increased to +7.4% and Financial Services has moved overweight as a result of the relative performance of **Paragon**, **Collins Stewart**, **Intermediate Capital** and the purchase of **Tullet Prebon**. Underweight sectors remain the same, although the size of the retail underweight has increased to -4% (complementing our underweight in House Builders and Leisure & Travel companies).

Market Outlook

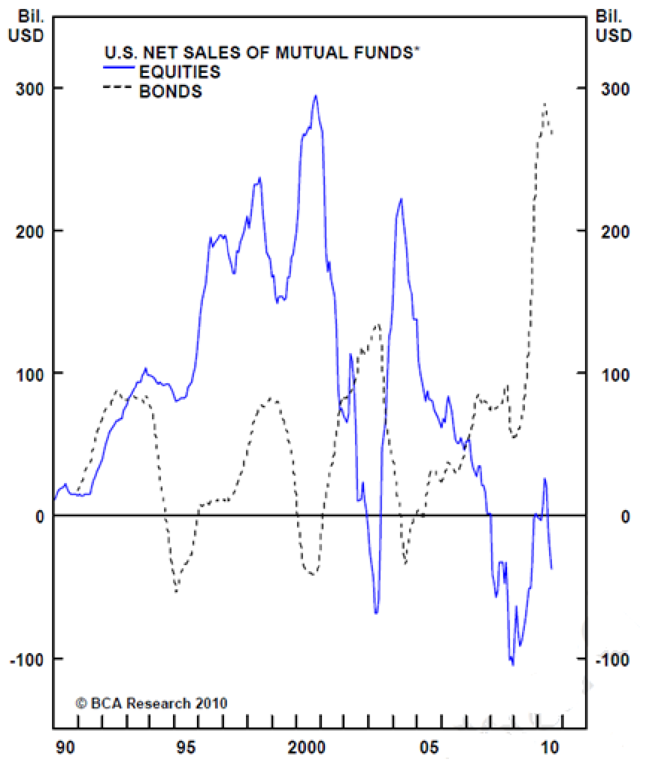
We are currently having a generational opportunity to buy UK income-producing equities. Don't look backward at the last ten years of returns, look forward like Miles. The components of the band or economy may be the same (drums, bass, piano, and trumpet vs. monetary authorities, governments, consumers 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 secular growth, overseas earnings, recovering profitability and enhanced payouts will drive a material relative re-rating of these stocks.

The improvement we are seeing 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.

24.8% of our holdings are yet to commence (or re-commence) dividend payments, yet the prospective yield of the fund is c.2.5% vs. 2.8% for 10 Year Gilts (at time of writing). The income growth potential of this UK Smaller Companies Fund is significant. These attractions could be significantly re-rated when inflation returns. In a low growth world with little income on offer from other asset classes, the attractions of UK smaller companies will become more apparent.

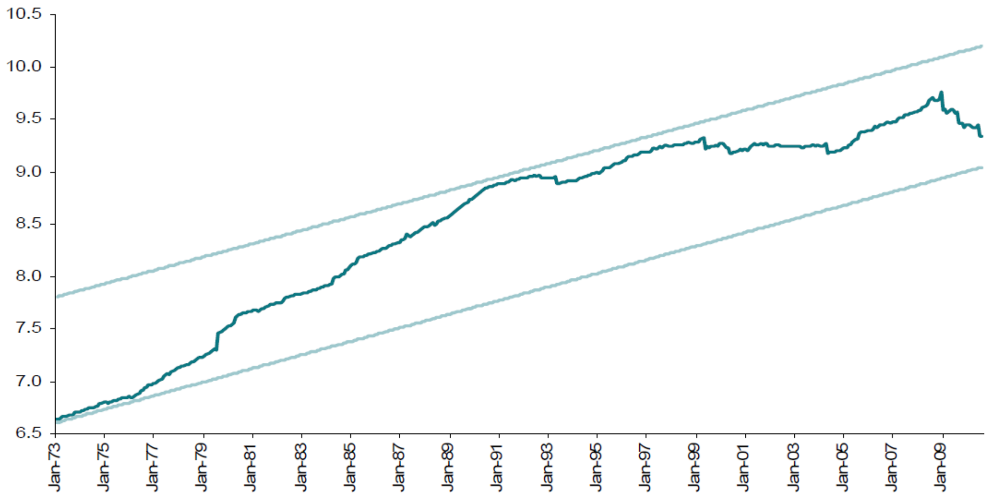
Downside risks and 'tail' risk exposure still appear to dominate sentiment; however risks to the dividend streams of many of the portfolio holdings are low, such as **Mitie**, **Cranswick**, **Kcom**, **Diploma**, **UBM**, **Psion**, and **BBA**. However, I believe the bigger tail-risk that investors are under-appreciating is the upside risk to dividend growth from holdings such as **SIG**, **Topps Tiles**, **Lamprell**, **Senior** and **Mears**.

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 in 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. Inflation-linked equities have been underperforming fixed-coupon bonds. Emerging Market equities funds are receiving support whilst Smaller UK listed companies, driving material dividend growth from their business franchises overseas, are passed over despite often much reduced levels of risk. I am not bearish on Emerging Market economic growth prospects, but the evidence suggests it is the starting valuation which drives medium-term returns in any sub-asset class, not the underlying economic growth rate. Furthermore, the dynamics of 'liquidity', the daily bedfellow of any small company investor, apply to emerging stock markets in the same way: it dries up just when you least want it to.

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

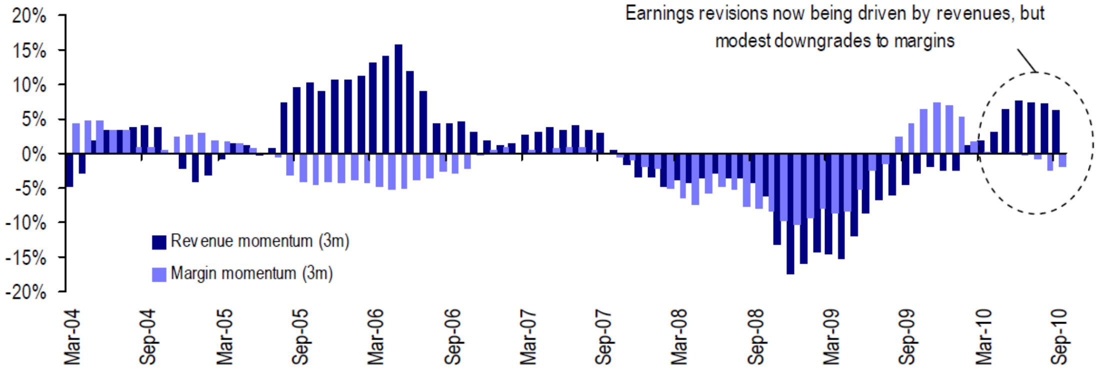


Source: Thomson Datastream, Evolution Securities

My view is that UK smaller companies will produce higher dividend growth rates than large caps during the years following the normalisation of distributions form the Banks and Mining sectors.

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. We are overweight the FTSE Small Cap. Free cash flow to equity in the FTSE 250 is 8.5%. Market expected earnings growth numbers for the All-share 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.

Revenue vs margin momentum



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 have strong balance sheets in a broad, well regulated, highly transparent and attractively valued UK equity market which has significant profitability generated overseas. The Fund remains focused on finding the very best risk-adjusted medium-term opportunities in the UK smaller companies universe.

Richard Staveley
Portfolio Manager

Fund Facts

Launch date	30 Nov 2006
Fund manager:	Richard Staveley
IMA sector:	UK Smaller Companies
Benchmark:	HG Smaller Companies ex-IT
Tracking error range:	4-10%
Product capacity:	£400m (pooled & segregated)
XD dates:	1 April & 1 October
Dividend/Accumulation payment date:	31 May and 30 Nov

Share class:	A	Z
Launch price (shares):	100.00p	500.00p
Share classification:	Retail	Institutional
Type of shares:	Income	Accumulation
Fund charges:		
Annual	1.50%	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	B1DSZR9	B1DSZS0
ISIN	GB00B1DSZR91	GB00B1DSZS09
Bloomberg	RMUKSAI LN	RMUKSEA LN

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