

RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Fund I Quarterly Report
December 2010

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UK Equity Fund – Quarterly Report

Fund Aim

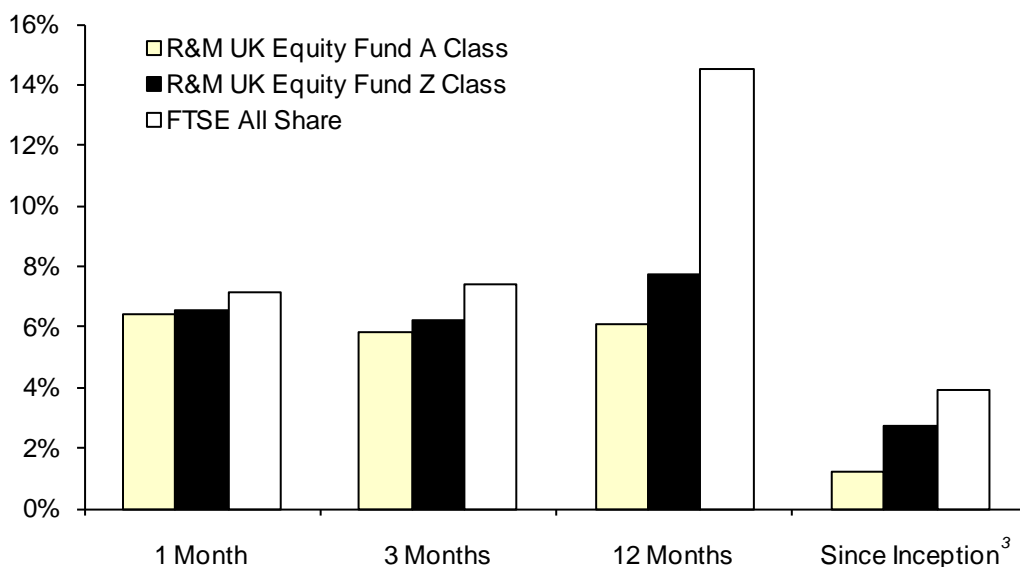
The investment objective of the Fund is to achieve capital growth by investing in the equities of established UK companies which offer the prospect of long term capital growth within a portfolio that has a balanced risk profile.

Portfolio Summary		Risk Analysis Summary	
Strategy AUM	£246.9m	Portfolio Volatility	15.34 %
Strategy Capacity	£2bn	Benchmark Volatility	18.09 %
Number of stocks	64	Tracking Error	3.82 %
Largest Holding	Royal Dutch Shell 5.86 %	Portfolio Beta	0.84
		Active Money	41.90 %

Performance to 31 December 2010

Retail "A" Class Shares	Fund ¹	Index*	Difference
1 Month	6.41%	7.14%	-0.73%
3 Months	5.83%	7.38%	-1.55%
12 Months	6.12%	14.51%	-8.39%
Since Inception ³ (%p.a.)	1.22%	3.95%	-2.73%

Institutional "Z" Class Shares	Fund ²	Index*	Difference
1 Month	6.55%	7.14%	-0.59%
3 Months	6.23%	7.38%	-1.15%
12 Months	7.74%	14.51%	-6.77%
Since Inception ³ (%p.a.)	2.75%	3.95%	-1.20%



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 25 February 2008

Market background

Through to mid-September 2010, the stock market was essentially a rollercoaster with few net gains for the year, but the last quarter saw a speculative burst that was heavily skewed toward cyclicals, small-caps, commodities, and shares characterised by low stability of earnings and high sensitivity to market risk. UK equities delivered a return of +7.4%, led as they have been for much of the year by the growth sectors (electrical equipment, oil services) and international cyclicals (mining, chemicals and industrials). Developed market recovery stocks (e.g. **Wolseley**) started to perform better as the quarter progressed. In a buoyant market, defensive sectors (food retailers and pharmaceuticals) struggled to keep pace, whilst the banking sector failed to recover from its European sovereign debt related sell-off. Growth and Momentum continued to lead the way, but with low price-to-book stocks finishing the year strongly too. The size effect was modestly positive, with the FTSE Small Cap Index (+9.1%) slightly ahead of the overall market, though the AIM market was stronger (+19.6%), buoyed by the performance of small resources plays.

How did we perform and why?

Over the quarter

In the final weeks of 2010, it was frustrating to see stocks characterised by low-quality, low yield and high risk, persistently outperform those ranked higher in quality, yield and stability. The result was a series of small but relentless day-to-day relative pullbacks in the Fund, while the major indices registered a series of marginal new highs for the year. The UK Equity Fund underperformed the index returning 6.2% against the FTSE All Share Index return of 7.4%. Best performing stocks in the market were the miners and so our overweight in preferred stock **Anglo American** was a positive contributor but more than offset by underweights in the other mining majors - **Xstrata**, **Rio Tinto** and **BHP Billiton**. High quality growth stocks **ITE** and **Smith & Nephew** performed well, the latter being the subject of bid speculation. **Smith & Nephew's** market position and associated cash flows continue to look undervalued. Poorly performing stocks included **AstraZeneca**, after ongoing concerns over their drug pipeline; **WM Morrison**, with concerns that trading may get more difficult in the UK, and a number of the other large cap defensives where we have overweights. At a sector level, the underweight in Miners and the overweight in Healthcare stocks were the greatest detractors. At a factor level, the quarter was all about earnings and price momentum with both quality and value stocks (Price/Book aside) underperforming.

Over the year

Last year was my second full year of underperformance in ten years of managing money. Given the market conditions and the styles driving the market I would have hoped to have done better and the extent of the underperformance is disappointing. What did I get wrong and what I can I learn from the experience?

I have analysed factor returns extensively in previous reports and do not intend to repeat that here, except to say that an improvement in the performance of momentum factors, despite value not working, should have seen a better result in conjunction with improving growth factors (although less so Quality, which barely improved). Through the year, our underweight in the more expensive growth momentum stocks and China plays hurt for a second year running. My continued focus on high return on capital undervalued stocks rather than growth, *per se*, resulted in a negative contribution.

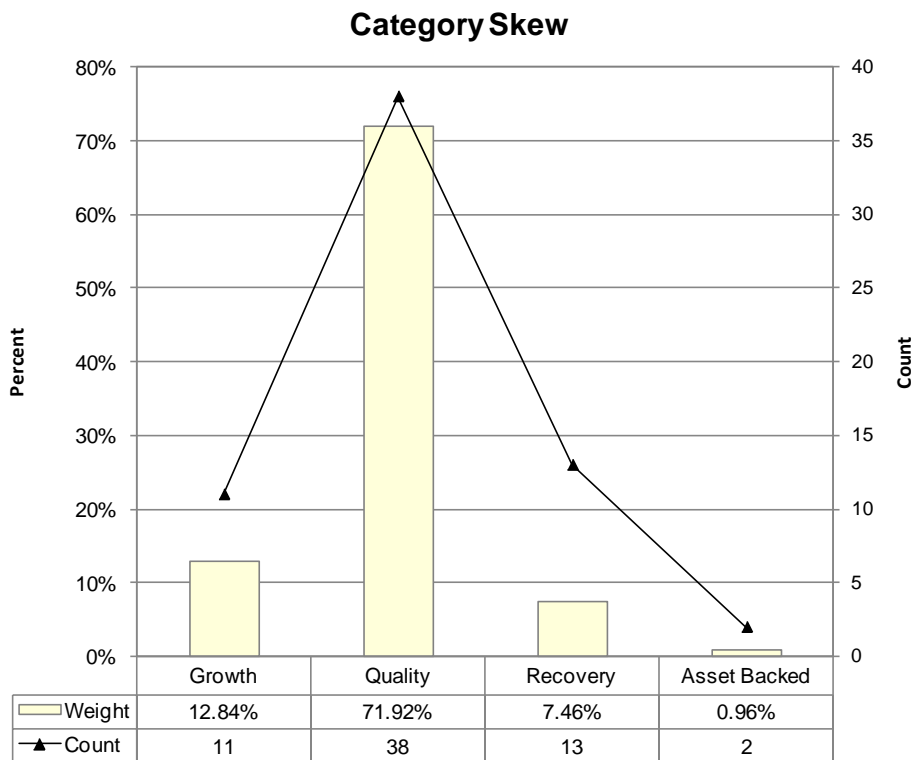
Reflecting again on what was written in previous quarterly reports from 2008 through to 2010; empirical data had suggested that when we reached the point that the historic earnings multiple contracted during a recovery phase, high margin quality stocks were likely to take up the running. Whilst some of the high quality growth stocks improved this did not pan out for

most quality sectors in 2010 with Tobacco, Healthcare, Defence and Non-Life Insurance all underperforming. The high beta cyclical growth stocks have been an uncomfortable focus for me, particularly remaining underweight the mining stocks and associated industrials, whilst staying defensive has been painful on a relative basis. Some stock selection errors over the summer compounded the underperformance. What have I learnt? That it was too simplistic to just look for high returning stocks which were undervalued. It is not high return on capital that necessarily makes you money, but it is the improvement in return on capital which creates the outperformance. High returns simply bring more stability rather than volatility that must be coupled with a cheap valuation and the prospect of rising returns relative to the market. Despite this, I still believe in the portfolio of stocks and our positioning, and feel confident the portfolio has every chance of delivering strong relative returns on a multi-year basis from here. As before, a continued focus on PVT and strong execution will be my aim for 2011.

We enter 2011 at a point where investors have pushed risk assets to a speculative extreme, in the belief that the Fed has provided a 'backstop' against losses. While there's no assurance that we won't see a further extension of this over the short-term, in my experience I have found, more often than not, that speculative setups, with opinion so one-sided in the financial markets, are followed by a striking move in the opposite direction.

Does the portfolio reflect our Philosophy & Process?

The portfolio is currently tilted towards high quality defensive companies which have the best chance of outperforming through a deteriorating global economic outlook. During the quarter we took profits in a number of the more expensive cyclical growth stocks which were in the portfolio and added a number of cheaper cyclical value stocks (we are already heavily biased to low beta, high quality defensives). In all cases we continue to rotate the portfolio in to strong PVT ideas where we see medium term potential for companies to create significant shareholder value, on low valuations and where earnings upgrades are more likely to occur in future.



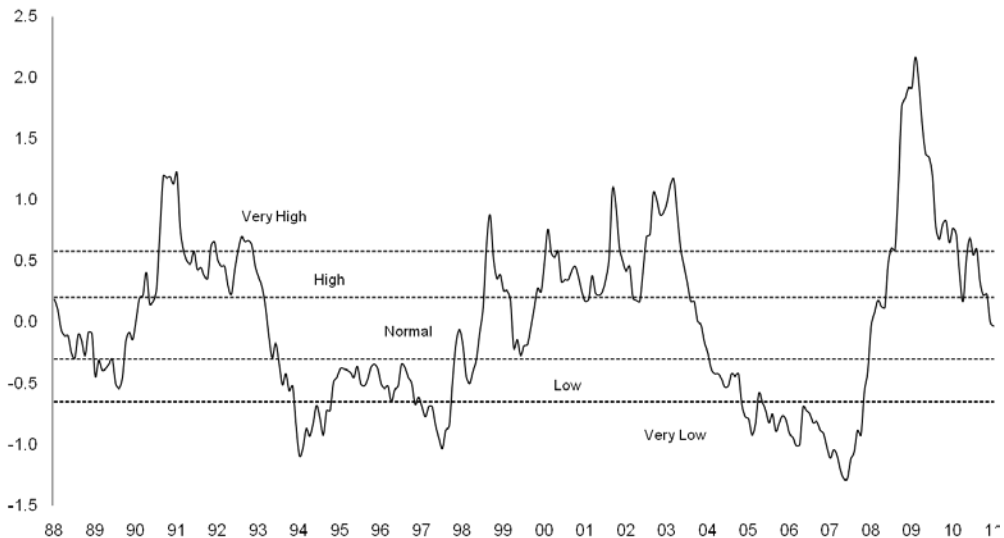
Source: River and Mercantile Asset Management LLP

What themes occupy us?

Value Dispersion

Dispersion continued to reduce during the market rally but, unusually, many value measures, such as low PE stocks, underperformed in 2010 with the upgrade cycle in cyclical growth stocks being a more dominant factor. There is a more normal dispersion as we head into 2011 which, in isolation, implies value strategies should work in line with their long run outperformance - no more or no less.

UK Equity Valuation Spreads



Source: Bernstein

Big Picture: the US dollar

I would like to highlight two views that manifest themselves in my portfolios, one with regard to the US dollar and one with regard to China. I believe that the recent rise in global asset prices has largely been a mechanical reflection of the pool of US\$ liquidity. That means that if the dollar, as the denominator in that equation, rallies, it undermines the size of the investable pool and, in turn, global assets. The flipside of being bullish of the dollar is that I find myself negative on the most popular investments in the market – namely emerging markets and resources. One of the reasons to be bullish on the dollar is that, in real economic terms, it has now reached a level (see chart) where history (since 1972) suggests that the world cannot cope and something must break. In 1979, market conditions led to the largest weekly drop in the Dow Jones Industrial Average Index; in 1994/95, the Tequila Crisis was followed by Japan crumbling and resorting to massive intervention to stop the yen's appreciation; while in 2008 we all know that the financial world imploded. History suggests that, at these levels, the dollar rallies because we have a crisis and not because we love the US\$.



Source: Bloomberg

As we enter 2011, the dollar is bouncing off the same pivotal level and we are not exactly short of potential problems. In Europe, the sovereign debt crisis continues to escalate with Portugal now looking like it will follow in Ireland's footsteps. Spain does not look much better. Germany aside, Europe simply cannot cope with a strong euro. In Japan, the strong yen has ensured the economy remains firmly in the deflationary doldrums. Finally, and perhaps most importantly, the opposite problem is now occurring in China and the Emerging Markets where, due to the dollar peg, inflation is rapidly rising and we are now seeing rate tightening action in full flow. Some of the frothy Emerging Market equity markets have been some of the biggest beneficiaries of the weak dollar and are now starting to crack under the strain of weak dollar induced inflation. Indeed, the New Year saw riots in Bangladesh following stock market falls as the central bank were forced to raise interest rates. It is, perhaps, unsurprising that not only have Western investors piled in but so have the locals. India is also already off 10% year to date as I write this in the second week of the year. Effectively, the world has gone 'all in' and, if the dollar rallies, this is bad news.

China

One of the many reasons for my underperformance last year was failing to recognize just how quickly investors would fall back in love with the China and Emerging Markets growth theme following the credit crisis. After 34 years of consistently high growth, starting in 1974, I believed 2007 marked an intermediate term top for China and its markets and that a bear phase had begun.

The current bull argument goes that QE2 will ensure money flows from America to China, where asset prices are lower, because of the dollar peg. But, instead of simply pushing up share prices, the flood of money is actually pushing up inflation, just at the wrong moment in history for their economy. A strong argument can be made that the great Chinese growth story is about to become unhinged.

Two factors drove Chinese growth – exports and a massive level of internal investment. With regard to their exports; in the past two decades, world trade expanded as Western Societies were quite happy to run up debts in order to buy Chinese goods, allowing it to accumulate a huge balance of payments surplus. Things have changed considerably now; with austerity programs in the West, China's end markets are drying up.

The second issue is that China has been investing an incredible 48% of GDP, not because it needs to, but because its high savings ratio and low levels of domestic consumption mean it can. However, Lombard Street Research estimate that investment at that level is wasteful, and China could meet its need investing just 35% of GDP. Unfortunately, moving from the higher to lower level would mean investment growth falling to around a third of current levels. Obviously, China is trying to extricate itself from this predicament by targeting an increase in domestic consumption but that is also a 10-20+ year story and it will come too late to take up the slack in the near-term. The drop in exports and plunge in investment could see China's growth rate halving from 10% to 5% in the next few years. Critics argue that the Chinese government would undergo another round of stimulus in that scenario. It would order its banks to go out and lend again but, unfortunately, this time round fiscal stimulus would surely exacerbate the already high and rising inflation rates.

The problem more globally is that the Fed's latest attempt to stimulate the economy is just causing investors' money to pour in to commodity markets, thwarting attempts to stimulate the economy other than through rhetoric. Commodities are up 25% since the first mention of QE2 at the meeting in Jackson Hole during August. Higher prices take a bite out of consumer spending and the effect is more dramatic in China, where food accounts for roughly 40% of the Chinese CPI. Higher prices are forcing the Chinese to raise reserve requirements at the banks to curb credit and slow things down. This, in turn, will lead to the lower growth rate which represents a significant shock to current expectations in markets. In the meantime, China bulls continue to expect growth to exceed current economist projections and bid highly speculative resources stocks up.

Portfolio Strategy

We shall likely see a slowing in estimate upgrades across the market as we move through the first half of 2011. Earnings growth expectations are now priced to be significant so a focus on achievability of earnings estimates remains a priority. This, in combination with investing in companies with pricing power (i.e. companies able to pass on price rises to customers), has been proven to be a good investment strategy in most market environments and will remain so going forward. Capacity utilisation rates remain very low globally as do savings rates and, in an effort for companies to drive greater volumes, they are likely to compete on price. Whilst longer term inflation is of great concern for a myriad of reasons, I believe pricing for companies will become difficult in the next couple of years. Companies with strong market positions with the ability to expand gross margins should be in the strongest position to re-rate against the market.

The above analysis suggests we shall get more joy from our PVT strategy in 2011 than last year. High scoring PVT stocks with overweights in defensives, as well as a limited exposure to deep cyclicals (energy and miners), is where we are positioned. We remain underweight financials and consumer cyclicals.

Portfolio Activity

Purchases

Purchases and sales can be grouped into a range of categories. The more defensive mega-cap oils were increased through additional purchases of **BP** and **BG Group** early in the quarter, as well as late cycle global industrials, **Rolls Royce** and **Smiths Group**. Small positions in a range of cheap cyclical value, such as **ITV** and **Electrocomponents**, were bought, replacing more expensive cyclicals that had already done well in the portfolio. Within the defensive end of the market, **Severn Trent** (Water Utility) was bought, and **National Grid** was added to.

Sales and reductions

Within the resources sector we sold **Wood Group**, a global oil services company, on valuation grounds after strong outperformance. We held it as the most conservative of the large and mid-caps in terms of contract accounting and guiding to modest growth expectations versus peers. Gold miner **Petropavlovsk** was also sold, with risks to production forecasts. The proceeds were recycled into the big oils. We received proceeds from the **SSL** bid and sold **Homeserve** on valuation grounds. Profits were taken in growth stocks **Booker** (UK Food wholesale), **ITE** (Event marketing) and **Compass Group** (Contract catering). We reduced our position in **RSA Insurance** due to concerns over exposure in their portfolio to Southern Europe sovereign debt risk and excess personal injury claims in their car insurance business in the UK. In industrials we sold cyclical **Halma** after good performance, in line with the engineering sector and also on valuation grounds. We also sold UK Defence outsourcer, **Babcock**, as we reasoned that their over-indebted position following the acquisition of **VT Group** would handicap future growth aspirations. Finally, small positions in **McBride** (Household goods) and **Micro Focus International** (Software services) were disposed of after they had recovered some of their underperformance in Q3 but operational momentum appeared still to be slowing.

Outlook

On the back of high optimism across many markets, 2011 may be setting up to be a disappointing year for investors in emerging market equities and commodities alike. Why? Because expectations are sky-high with almost every City strategist predicting another year of double digit returns. In the UK equity market, it is less clear but, with markets which are once again overbought, over bullish, overvalued, and in a rising treasury yield environment, it is a combination which brings high risks with it. Leveraged economies (low savings ratio and large government deficits) suggest continuing volatility in GDP growth expectations and, by definition, stock markets. This year looks to be no different with economies now vulnerable to any fall in stimulus, particularly China. A deflationary shock remains the greater risk for 2011 with consensus inflation expectations having already risen considerably. Markets appear, once again, to be pricing in a benign scenario and it suggests that the market should begin paying a premium for quality as we move through the year.

I expect PVT stock selection to improve and we own a portfolio of companies with strong prospects. In particular, I expect Quality stocks with valuation support and earnings visibility to outperform as we move through the year. The focus is firmly on Quality and Growth stocks, capable of growing on good valuations. I continue to be high conviction on Pharmaceutical and Healthcare stocks (**GlaxoSmithKline**, **AstraZeneca**, **Smith & Nephew**), Non-Life (**RSA Insurance & Hiscox**), as well as high quality stocks on low valuations that have lagged the 2009 rally, such as **Reed Elsevier** and **BAE Systems**. This has to be balanced with the prospect of continuing global deflation. The market has narrowed into Asian growth and resource stocks, bringing back memories of early 2007 and, as such, I am focused on large-cap oil stocks rather than being overweight the mining sector.

Thank you for your patience and support.

Dan Hanbury
Portfolio Manager

Fund Facts

Launch date	25 February 2008	
Fund manager:	Dan Hanbury	
IMA sector:	UK All Companies	
Benchmark:	FTSE All-Share (Total Return)	
XD dates:	1 April & 1 October	
Dividend/Accumulation payment date:	31 May and 30 Nov	
Tracking error range:	2-6%	
Product capacity:	£2 bn (pooled & segregated)	
Share class:	A	Z
Launch price (shares):	100.00p	500.00p
Share classification:	Retail	Institutional
Type of shares:	Income	Accumulation
Fund charges:		
Annual	1.50%	0.00%*
Initial (up to)	5.25%	5.25%
*AMC charged outside the Fund		
Minimum investment		
Initial	£1,000	£5 million
Subsequent	£500	£50,000
Sedol	B1NG777	B1NG7KO
ISIN	GB00B1NG7777	GB00B1NG7K01
Bloomberg	RVMUKEA LN	RVMUKEZ LN

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