

RIVER AND MERCANTILE  
ASSET MANAGEMENT

UK Equity Income Fund | Quarterly Report  
December 2010

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# River and Mercantile

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## UK Equity Income Fund – Quarterly Report

### Fund Aim

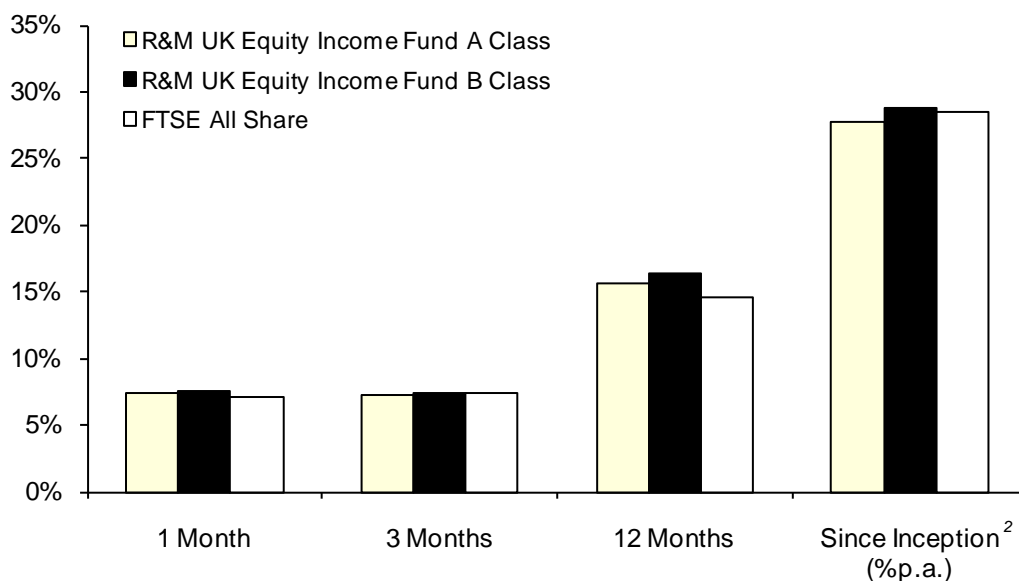
The investment objective of the Fund is to generate a rising level of income combined with the potential for capital growth through investing in a portfolio which will primarily consist of UK equities.

Portfolio Summary		Risk Analysis Summary	
Strategy AUM	£43.5m	Portfolio Volatility	18.43 %
Strategy Capacity	£1bn	Benchmark Volatility	18.09 %
Number of stocks	72	Tracking Error	3.32 %
Largest Holding	HSBC 7.19 %	Portfolio Beta	1.00
Historic Yield	3.78 %	Prospective Historic Yield <sup>3</sup>	4.00 %

### Performance to 31 December 2010

Retail "A" Class Shares	Fund <sup>1</sup>	Index*	Difference
1 Month	7.47%	7.14%	0.33%
3 Months	7.24%	7.38%	-0.14%
12 Months	15.59%	14.51%	1.08%
Since Inception <sup>2</sup> (%p.a.)	27.77%	28.47%	-0.70%

Asset Manager "B" Class Shares	Fund <sup>1</sup>	Index*	Difference
1 Month	7.53%	7.14%	0.39%
3 Months	7.45%	7.38%	0.07%
12 Months	16.43%	14.51%	1.92%
Since Inception <sup>2</sup> (%p.a.)	28.72%	28.47%	0.25%



Source: River and Mercantile Asset Management LLP

\*Index: FTSE All Share (Total Return)

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

<sup>2</sup>Inception date 3 February 2009

<sup>3</sup>Yield based on the historic dividends of the current holdings of the Fund.

### Market Overview

*I may die! I may die! I may live! I may live!  
I may die! I may die! I may live! I may live!  
This is the hairy man  
Who brought the sun and caused it to shine  
A step upward, another step upward!  
A step upward, another... the sun shines!  
Rise!*

*- translated from 'Ka Mate' (The New Zealand All-Blacks 'Haka') by Te Rauparaha*

For many people around the world, including myself, there is only one event of note expected in 2011, and it's not Prince William's Royal Wedding. This autumn will see squads from around the globe assembling in New Zealand for the fiercest, most physical team sport on the planet, when the Rugby World Cup kicks off in September. Constructing an equity portfolio is very much like selecting a rugby team: each position has a critical, yet highly differentiated, role. Selected players must be fit, motivated and on form. As players tire or underperform they need to be replaced. Certain attributes are better placed for certain oppositions. Outstanding core skills, like the components of a clear investment philosophy, need to permeate every selection choice to ensure consistency of success. The opposition and conditions are constantly changing (indeed, over the years, like investment, even the rules also change frequently), and adaptability has been the key to success. Yet in order to win, the fat boys and fast boys need to perform together.

Q4 2010 delivered another strong quarter for equities despite Sovereign debt concern within the Euro area. Double-dip commentary has been shoved under the carpet and equity market bears have moved onto Euro break-up potential, peripheral default scenarios and further banking sector contagion. China has been publicly applying the brakes to areas of its economy via higher bank reserve requirements, interest rates and other administrative measures, whilst preparing the imminent details of its next five year plan which starts this year. In the UK and US, most economic indicators are progressing positively (indeed, strongly in Germany), helped by ongoing monetary stimulus and currency weakness, whilst inflation, although above target, seems broadly under control.

The UK equity market delivered a return of +7.4% led by Resources and international cyclicals, such as Industrials and Chemicals. The Irish sovereign debt crisis and contagion fears caused weakness in Financials and UK domestic areas such as Retail, and Real Estate remained weak. Value continues to perform poorly and Momentum a powerful performance driver. Growth stocks had a great 2010.

Based on current market consensus dividend forecasts, the prospective yield on the Fund is c.4%. 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. I remain positive on the outlook for the portfolio with strong balance sheets, improving profitability and low valuations.

### Performance, *Final Score*

*"This looks a good team on paper; let's see how it looks on grass."  
– Nigel Melville, former England Captain and scrum-half, 1984*

The Fund matched the benchmark during the quarter and rose 15.6% during 2010, beating the index by 1.1%. It remains ahead of the benchmark since inception and is ranked first quartile amongst its peers over the same period. The biggest impediment to greater outperformance has been the weakness in the Value factor over the last year and the underweight position in the low yielding Resources sector.

Sector positioning vs. the benchmark was mixed during the quarter, although key changes in Q3 such as moving underweight Tobacco and narrowing the Resources underweight were timely. Underweight positions in Financials and Utilities were positive for relative performance as was an overweight stance on Industrials and Technology. Offsetting this has been a weak performance from the overweight Pharmaceuticals position. I remain resolute in this stance as the high, growing dividend yields in this sector have considerably more attractive and safer drivers than those within Utilities. Being underweight Mining has impacted relative performance; however, my measured approach to sector risk has meant that the effect of this stance was not extreme.

At a stock level, unsurprisingly given the sector stance above, the major detractors were the resource majors, where I have no exposure, such as **Xstrata** and **BG Group** and the overweight position in **AstraZeneca**. The Timing into recent new holding **PartyGaming** was poor, and European regulatory concerns caused weakness which I have used to add further in anticipation of a successful merger with Bwin and a gradual reversal of the US ban on online gaming. **Cable & Wireless Communications** was also unhelpful during the quarter. Having recently de-merged, this collection of unique international telecommunications assets has had mediocre trading, and management have yet to convince markets that future cash flows will support the high dividend payout policy or demonstrate the strategic value of group assets via portfolio management.

A range of mid and small-cap holdings delivered the best attribution during the period. These included the mid-cap Oil & Gas companies **Heritage Oil** and **Afren**. Also of note was the hugely successful investment in **Elementis**, the speciality Chemicals business, which continued to beat expectations. Small-cap value stocks, despite a wider lack of interest in the factor, performed well, such as **Hogg Robinson**, global leader in travel services, and **Fiberweb**, the non-woven fabric manufacturer. Both stocks remain outstanding value despite strong runs and I hope to see further performance in 2011. Finally, my most disappointing sale of 2011 was **BT**, which has gone on to perform well, particularly in the context of other defensive stock-relative weakness. Fortunately, high conviction holding **Kcom** and an overweight position in **Vodafone** has more than compensated during the year.

## Philosophy & Process

*"The whole point of rugby is that it is, first and foremost, a state of mind, a spirit"*

*- Jean-Pierre Rives, Flanker, who won 59 caps playing for France, 34 as captain, a still unbeaten record*

During the quarter, stock selection decisions influenced the category weightings with a reduction in Growth of c. 2% and a corresponding increase in Quality. Quality remains the largest part of the portfolio at c. 64%. The Recovery category is now 23.1% 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 improved during the quarter, with over 70% of the Fund in the top four deciles of *MoneyPenny*, our proprietary quantitative screen. 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.

## Quarterly Portfolio Activity, Team Selection Decisions

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

### Purchase of 'later-cycle' exposed companies:

Some businesses only benefit when business confidence returns to a level which allows expansionary investment. We are close to that point in the cycle where, for instance, hiring picks up and new construction projects are authorised. During the period, positions were established in **Keller**, the leading international ground engineering specialist, **Hays**, the international recruiter, and **SIG**, the building insulation company.

### **Sale of successful investments:**

Some successful investments were exited during the quarter as relative yield attractions have diminished and I believe higher, risk-adjusted upside is available elsewhere. This would include **Ashtead** (c. 166% return since purchase), **Sage** (buoyed by takeover rumours) and **International Power**.

### **The sale of investments due to weakening theses:**

**Valiant Petroleum, Petropavlovsk** and **Cobham** fall into this category due to weakening conviction in their Potential as a result of poor operational management and deteriorating Timing credentials. In the near-term, these stocks have subsequently underperformed. My relative conviction also fell in **Anglo American** and **Chesnara** during the quarter. The former's capital was rotated into **BHP Billiton** on news that the Potash acquisition was aborted (leading to likely higher cash returns to shareholders) and the latter into higher Potential new ideas within financials, discussed below.

### **Other PVT opportunities:**

Three further investments were made in the quarter: I repurchased **Daily Mail & General Trust** for the Fund, as operational progress and earnings momentum have improved further in their B2B activities (e.g. *Euromoney*), yet the deserved re-rating has lagged the recent market rise. Secondly, high Quality interdealer broking franchise, **Tullet Prebon**, offers both excellent cash generation and a low valuation, combined with a cash rich balance sheet. Finally, the Asset-backed special situation, **Trading Emissions**, was purchased, a specialist in carbon markets, valued at a considerable discount to a conservative NAV.

### **Sector and size positioning, Game tactics and strategy:**

There has been a small change to the size distribution of the portfolio: an increase in the underweight to the FTSE 100 Index of c. 2% to 20%, although nearly two-thirds of capital is invested in this index. A decent weighting of c. 14% remains in small-caps.

The strategy continues to take limited sector risk vs. the market, with the largest overweight still Media at 4.2% and the largest underweight in Mining at -3.6%. 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 further risks to 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 of c. 10%.

Leading overweight sectors remain Industrial Transportation (+1.9%), the diverse Support Services (+2.5% - increased by 1%), Technology (+2.1% - reduced by 1% due to the sale of **Sage**) and defensive sectors Pharmaceuticals (+1.5%) and Food Producers (+1.6%).

The main change to sector weightings was a further reduction in Utilities exposure via the sale of **International Power** after excellent market and sector relative performance. Other positioning changes have been a move to underweight the budgetary challenged Defence sector and the Life Insurance sector. Capital from the latter was rotated into Banks (on price weakness), where conviction levels have improved and my underweight has narrowed to -1.3%. Finally, improved conviction on a higher oil price environment has caused a narrowing of this sector underweight as well.

*"You have an awesome responsibility on the eight individual forwards' shoulders, awesome responsibility. This is your Everest, boys. Very few ever get a chance in rugby terms to get to the top of Everest. You have the chance today. To win for the Lions in a Test match is the ultimate, but you'll not do it unless you put your bodies on the line. Every one jack of you for 80 minutes. Defeat doesn't worry me. I've had it often and so have you. It's performance that matters. If you put in the performance, you'll get what you deserve. No luck attached to it. If you don't put it in, then we're second-raters. They don't respect you. They don't rate you. The only way to be rated is to stick one on them, to get right up in their faces and turn them back, knock them back. Out-do what they do. Out-jump them, out-scrum them, out-ruck them, out-drive them, out-tackle them, until they're sick of you. Remember the pledges you made. Remember how you depend on each other at every phase, teams within teams, scrums, line-outs, ruck ball, tackles. They are better than you've played against so far. They are better individually or they wouldn't be there. So it's an awesome task you have and it will only be done if everybody commits themselves now. You are privileged. You are the chosen few. Many are considered but few are chosen. No one's going to do it for you. You have to find your own solace — your own drive, your ambition, your own inner strength, because the moment's arrived for the greatest game of your life."*

– *Lion's Coach Jim Telfer's speech (expletives deleted!) to his forwards before the 1997 series win.*

## Portfolio Income

31 stocks went ex-dividend during the quarter including 19 increases, 10 unchanged payouts, 1 cut, and the Fund's second Special Dividend receipt from Lloyds underwriter, **Novae**. No dividends were received during the period from material positions in **BP** or **Lloyds Bank**, although the former contributed materially to the capital appreciation of the Fund and will contribute, along with Lloyds, to income in the future. The Fund's current consensus-based prospective yield of 3.7% is 113% of the market yield and is greater than the yield from non inflation-linked income offered by 10 year UK Gilts.

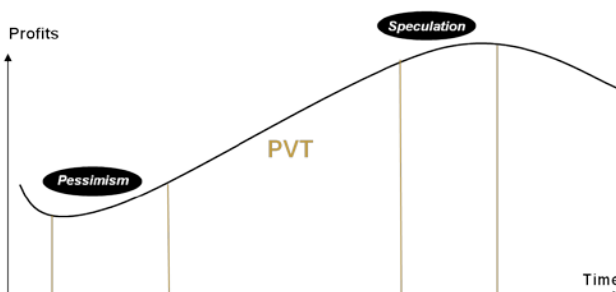
## Market Outlook

### Our stock market cycle thesis

Everything in investment has cycles – good times, and bad times. We have learnt over the years that one needs to understand these cycles to effectively manage portfolio construction opportunities and, most importantly, portfolio construction risks. At the bottom of the stock market cycle, when opportunities are well above average and risk premiums are high, be prepared to construct portfolios to maximise returns. At the top of the stock market cycle, when opportunities are limited and risk premiums modest, then focus on protecting portfolios.

### The stock market cycle

*"To buy when others are despondently selling and to sell when others are avidly buying requires the greatest fortitude and pays the greatest ultimate rewards."* - Sir John Templeton.



	RECOVERY	TREND	LIQUIDITY	DECLINE
ECONOMY / MONETARY POLICY	Below Trend	Trend	Above Trend	Decelerating
PROFIT CYCLE	RoE Depressed	Rising	RoE Peak	Decreasing
RISK APPETITE?	Low	Normalised	High	Falling
VALUE SPREADS	High	Reducing	Low	Increasing
PORTFOLIO RISK & STYLE?	Risk Increase / Value & Recovery	<b>PVT</b>	Risk Reduction / Quality	Quality

What are the key cyclical components of the stock market that we monitor?

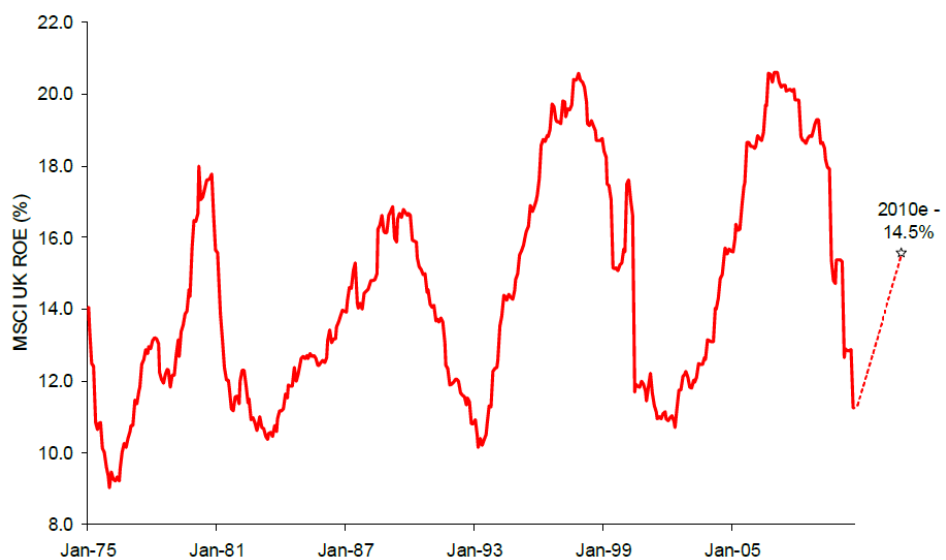
## Economic cycles

Economies do not grow at an even pace. They have 'normal' times (when they grow in-line with trend), they have periods of over-heating (when Schiller's 'animal spirits' take over, and growth is too fast and inflationary), and then they have periods of contraction (when economies respond to the tightened monetary policy put in place during the periods of excess). These economic cycles have always existed in the past, and will do so in the future. The ups and downs of economies have a noticeable impact on equity markets, on the desire to own and, therefore, the price of risk assets, and most importantly on the profit cycle.

## Profit cycles

As well as individual companies having an ebb and flow in their profits so there is a cycle in overall corporate profitability as the chart below shows. This is the main instance where the economic cycle has a material impact on the fortune of investors, and provides a degree of insight into how to manage portfolio construction risk.

## UK PLC Return on Equity



Source: MSCI, Datastream, IBES, FactSet, Morgan Stanley Research

At the top of the profit cycle (usually coincidental with the peak of the economic cycle) demand in most areas of the economy is above trend and the majority of companies are achieving peak levels of profitability. But, as the cycle starts to trend down, demand weakens and the profits of many companies are vulnerable – the earnings downgrade cycle has started, with the more cyclical and financially geared stocks likely to witness the biggest negative earnings revisions. Share prices always follow profits at this point, so the best place to be invested is in the more defensive, higher quality companies.

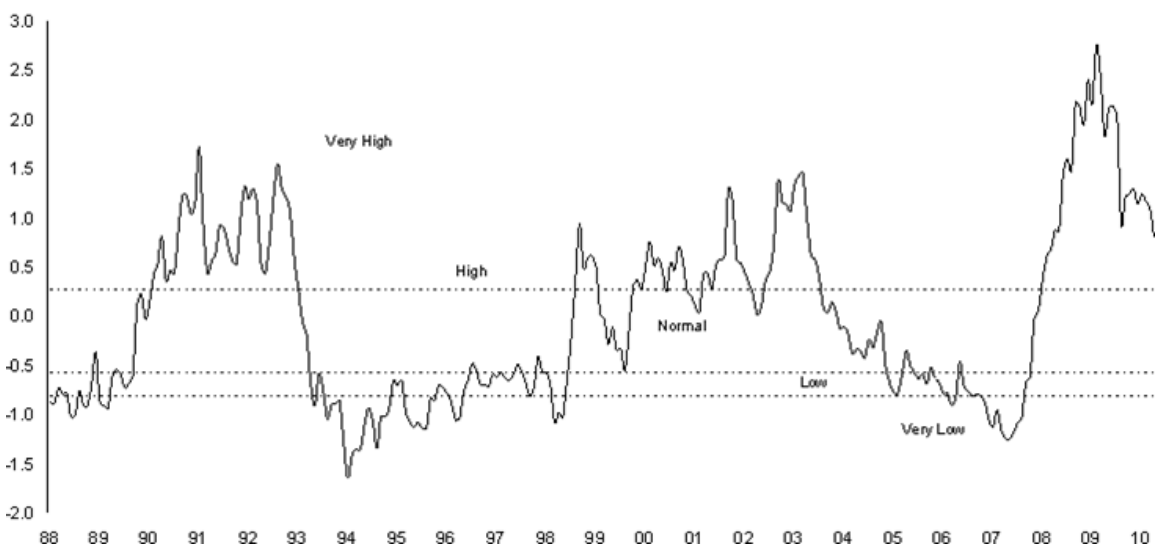
Fast-forward one or two years and return on equity across the corporate sector is now depressed, with many companies making cyclically low margins. But demand is now stabilising and, with costs having been cut, profitability has bottomed-out and, in many cases, starts to beat what have become very negative expectations – the earnings upgrade cycle has begun. As demand strengthens, moving back towards trend, it becomes easy for companies to grow profits again as operational gearing kicks in and the more cyclical and financially geared corporations will trounce analysts' expectations. Now is the time for recovery type stocks, as this is when news flow is at its most positive.

## Style Cycles

To us the Value factor is critical. Like Ben Graham, we want to buy things for 50p in the Pound. But we have learnt that having a cheap portfolio does not always work, that's why value focused managers do have some down years. Low price-to-earnings and low price-to-book stocks do not protect capital after the profit cycle has peaked – a lowly valued steel stock is only headed in one direction when corporate profits come under pressure, and that is down. The characteristic that really works at this point is defensiveness, with only modest reference to the price paid for stable earnings. Of course, if you can buy defensive stocks on low valuations at the top of the profit cycle then that is fantastic. And, of course, this is what you could have done at the top of the TMT bubble; you could buy defensive tobacco stocks such as British American Tobacco on earnings multiples of five, a no-brainer, and stocks like this actually went up in price when everything else was falling.

The other time to be wary of owning a cheap portfolio is when the difference in valuations between cheap and expensive (high and low PB or PE) stocks is narrow compared to history. As the chart below shows (composite valuation spread, measured in standard deviations between cheap and expensive stocks), value does have a cycle:

### UK Equity Valuation Spreads



Source: Bernstein

It is tempting at the bottom of the profits cycle, especially when attracted to cheap valuations, to go really long the beaten-up stocks that resulted from the bursting of the previous cycles' bubbles. However, whilst these stocks will bounce during the recovery stage, they will have too many residual issues to be the core drivers of performance.

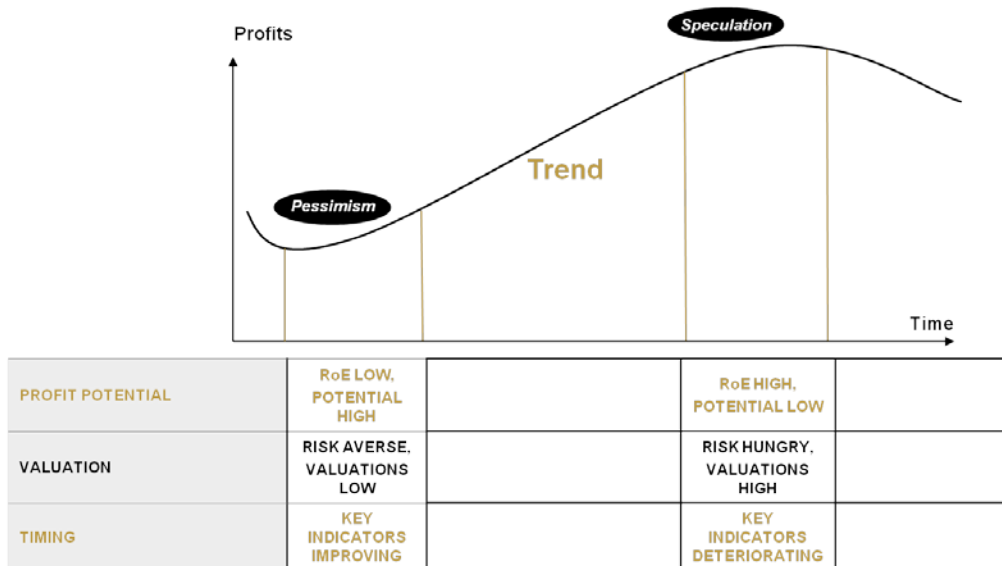
Here we are thinking of TMT stocks post the bursting of the 2000 bubble, or banks following the recent credit crunch, or housing stocks after the 1991 property crash. Demand in these bubble markets can take a long time to return, regulators will apply 'knee-jerk' new laws that also constrain the top line, and there are never enough really brave investors to push share prices back to long term average valuation levels (at least not for many years).

Not to say that fortunes aren't made by going long these really hated parts of the market, just to say they won't be the best source of returns in the first couple of years. So, for example, the best stocks to own post the credit crunch have been industrial and resource related stocks. They weren't part of the credit bubble, but their stocks became very depressed in the profit downturn; however, because they had no structural issues to contend with during the recovery phase they have been able to return to full profitability quickly and, as a result, have done a lot better than banks over the first years of the recovery.

## Market PVT and the stock market cycle

A logical extension of this stock market cycle work is to apply our PVT framework to understanding where we are in the market cycle. We ask what is the market PVT? Potential: are market aggregate profits below or above trend? Valuation: are equity markets cheap or expensive versus history? Timing: is corporate news flow improving/positive or deteriorating/negative? This approach has the added benefit of allowing us to comment (to you) in a consistent fashion on the attractions of equity investment.

### Market PVT Analysis



Source: River and Mercantile Asset Management LLP

### The stock market cycle today

Economies are only moving into their second year of recovery so, with interest rates remaining very low, companies being confident enough to increase investment and consumers showing some signs of life, the likelihood of continuing economic recovery remains high. In a global context, developing market dynamism should offset ongoing tensions in the Eurozone and there is much evidence that the US economy is growing robustly, with the US yield curve steepening materially over the last quarter.

Shareholder value growth remains above average at the moment as profit margins and return on capital continue to recover from their credit crunch lows. 2010 has been the first, and most dramatic year of profit recovery, but growth will continue into 2011 and 2012 with the latter year seeing profits return towards previous peaks. The average profit cycle (bottom to top) of the last three decades has been six years.

Risk appetite has been returning but, other than in some developing markets and resources related parts of the global economy, there is little evidence of 'over-heating' or excessive risk taking. Central banks have to be wary of this as, whilst there is a desire to support asset prices (wealth effect), there is no desire to see central bank induced liquidity create irrational markets or irresponsible financial structures.

Valuations are supportive with the UK equity market on modest multiples of profits (10.5x forward earnings), EBITDA and PB; valuations relative to government bonds remain very attractive with the earnings yield trading at almost three times the risk-free rate. Value spreads are in-line with long term averages.

Earnings revisions and share price technicals are positive, and there are many fundamental timing catalysts including increasing M&A activity, falling corporate tax rates, an improving outlook for dividends and, most importantly, evidence that investors and asset allocators have, *en fin*, become buyers of equities. There is a huge amount of capital parked in low returning bonds, so any switches into equities will be, technically, very supportive.

In summary, our key indicators suggest that we remain in the trend phase of the stock market cycle.

*"Rugby football is a game I can't claim absolutely to understand in all its niceties, if you know what I mean. I can follow the broad, general principles, of course. I mean to say, I know that the main scheme is to work the ball down the field somehow and deposit it over the line at the other end and that each side is allowed to put in a certain amount of assault and battery and do things to its fellow man which, if done elsewhere, would result in 14 days, coupled with some strong remarks from the Bench."*

- P. G. Wodehouse, 'Very Good, Jeeves', 1930

The words of the *Haka* have inspired many an All-Black and opposition team. Whilst I suspect the UK stock market will take 'another step upward' ("*Ka Upane!*"), the hairy man can only be Fran Cotton, below, playing the mighty New Zealanders in 1979.



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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