

RIVER AND MERCANTILE  
ASSET MANAGEMENT

UK Equity Long Term Recovery Fund | Quarterly Report  
December 2010

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# River and Mercantile

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## UK Equity Long Term Recovery Fund – Quarterly Report

### Fund Aim

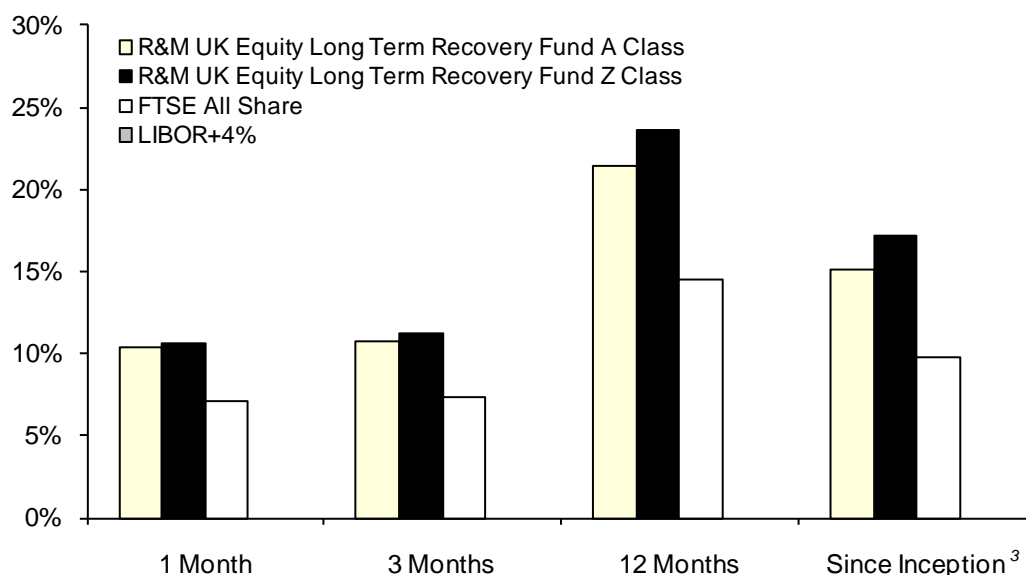
The investment objective of the Fund is to achieve capital growth through investing in a portfolio which will primarily consist of UK equities that meet the manager's recovery criteria of a turnaround in company profitability over the longer term. The Fund will not be restricted by reference to a benchmark,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

Portfolio Summary		Risk Analysis Summary	
Strategy AUM	£83.9m	Portfolio Volatility	21.49
Strategy Capacity	£200m	Earnings Yield	4.44
Number of stocks	174	Dividend Yield	1.56
Largest Holding	Rio Tinto 3.74 %	Price to Sales	0.80
Average return to medium-term recovery value	52%	Price to Book	1.44

### Performance to 31 December 2010

Retail "A" Class Shares	Fund <sup>1</sup>	FTSE All Share	Difference	LIBOR+4
1 Month	10.44%	7.14%	3.30%	0.39%
3 Months	10.80%	7.38%	3.42%	1.15%
12 Months	21.46%	14.51%	6.95%	4.65%
Since Inception <sup>3</sup> (p.a.)	15.17%	9.74%	5.43%	5.44%

Inst'l "Z" Class Shares	Fund <sup>2</sup>	FTSE All Share	Difference	LIBOR+4
1 Month	10.61%	7.14%	3.47%	0.39%
3 Months	11.29%	7.38%	3.91%	1.15%
12 Months	23.66%	14.51%	9.15%	4.65%
Since Inception <sup>3</sup> (p.a.)	17.20%	9.74%	7.46%	5.44%



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

*"Buy when everyone is selling and hold until everyone else is buying. That's not a catchy slogan. It's the very essence of successful investing."*

- J. Paul Getty

### Key Observation

Equity returns from the depth of the credit crunch have been very attractive, another reminder for us all to buy when everyone else is selling.

Where do we go from here?

The crucial story for last quarter was that capital started flowing from the bond markets into equities. As I said in my last report, *"the relationship between government bonds and equities is wrong at the moment, and when this starts to normalise a 'wall of money' could find its way into equities."* This process has started and will be supportive of equities through 2011. It seems too early for me to become cautious: profit potential remains positive, valuations are still attractive, and timing is aided by the emergence of capital flowing into equities. So I am a very happy holder, at least until 'everyone else is buying'.

### Market background

#### Quarter:

Markets were strong during the quarter, culminating in a very merry 'Santa Rally' December, one of the best on record. The aftershocks from the credit crunch continued (in the form of European sovereign debt divergence) but each successive shock has had a more modest impact.

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 (**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. Factor returns were not as material as they have been, perhaps surprisingly given the strength of the market. Growth and Momentum continued to lead the way but, with low price-to-book stocks finishing the year strongly, the value factor actually had a reasonable quarter. 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.

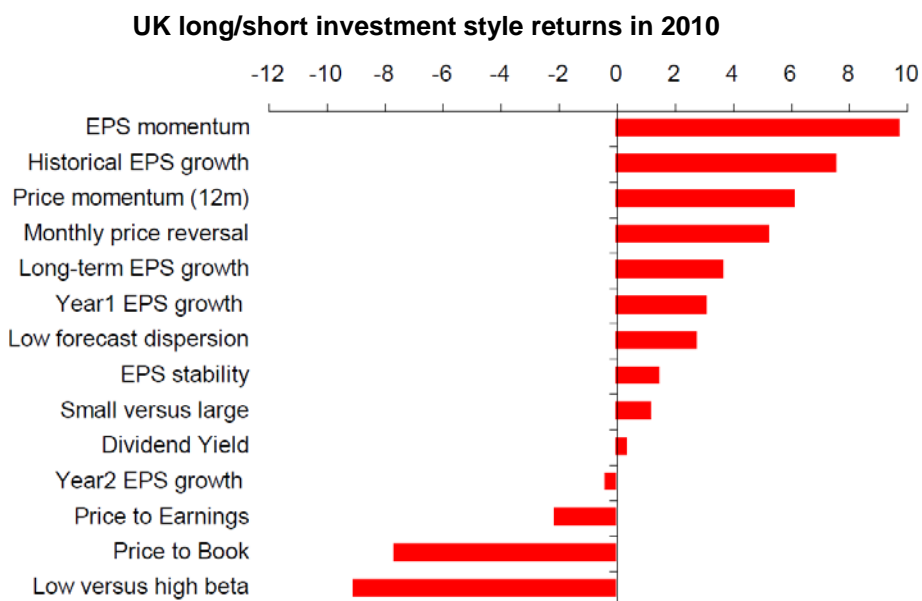
### How did we perform and why?

#### Quarter:

We outperformed the market and LIBOR, returning 11.3%. Good stock picking drove our positive returns, with smaller company stock selection (**Synchonica**, **IQE**) particularly beneficial. Value (**Vedanta**) and Small Companies (**Scapa**) contributed materially in December. We also benefited from on-going M&A activity (**Lavendon**, the biggest positive contributor in the quarter). Our non-UK stocks did well, lead by **Rediff**, a leading Indian internet portal. Negative contributors were dominated by the UK banks (**Lloyds** and **RBS**), and a lack of exposure to **BHP Billiton**.

## Year:

Performance over 2010 was strong, both in absolute and relative terms. This was all the more pleasing in a year that favoured growth and momentum over traditional value investing:



Source: SG Cross Asset Research

The Long Term Recovery strategy returned 23.7%, an outperformance of the FTSE All-Share Index of 9.2% (and Libor+4 of 19.0%). Returns were driven by strong stock picking rather than returns to factors or size. Our Growth category stocks, smaller technology ones in particular (**IQE, Xaar, Blinkx**) have been the best performers, then our industrial cyclicals (**GKN, Oxford Instruments**) which were complemented later in the year by a return to form of a number of recovery stocks, such as **Wolseley** and **Scapa**. M&A activity also played a positive role (**Inteltek**), as did our zero position in **BP** as the Gulf of Mexico disaster emerged. The main negative contributions came from UK domestic recovery stocks (**Yell, Barratt Homes**), which remained out of favour for most of the year, and companies where earnings updates were disappointing (**BATM, 888, CVS**).

## Longer term performance:

It is pleasing to see that both absolute and relative returns are decently positive over all time periods since the Fund was launched in 2008, the two year (100% return, 41.8% p.a. absolute, 19.8% p.a. relative) and since inception returns (17.2% p.a. absolute, 7.5% p.a. relative) being particularly strong. Of course, these types of returns are only available when exploiting the type of extreme risk aversion that we saw in 2008/9, a key reason why we launched the Fund when we did.

## Key performance contributors

### Quarter:

**Positive:** Stock picking dominated, particularly from smaller companies (**Synchronica, Scapa, IQE**) takeover activity (**Lavendon**), and non-UK stocks (**Rediff**). The Fund also benefited from having no **AstraZeneca** or **Standard Chartered**.

**Negative:** UK Banks (**Lloyds** and **RBS**), underweight **BHP Billiton**.

## What themes occupy us at the moment?

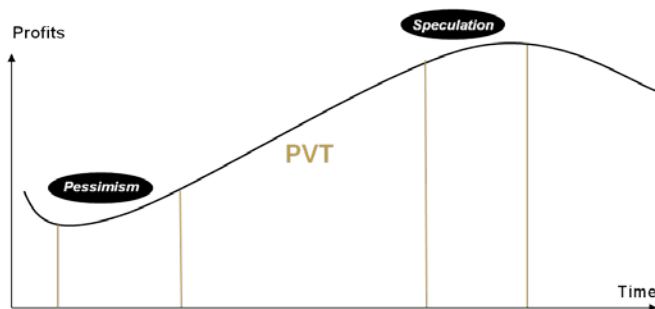
This quarter we will be re-issuing our *UK Equity Philosophy and Process* document, which is a re-confirmation of our PVT Philosophy together with a comprehensive explanation of our stock market cycle approach to managing portfolio construction risks and opportunities. This, clients will remember, was a response to the macro (credit crunch) dominated markets that we witnessed following the launch of R&M. I include part of this below and would welcome feedback before we publish (hs@riverandmercantile.com).

### 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	PVT	Risk Reduction / Quality	Quality

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

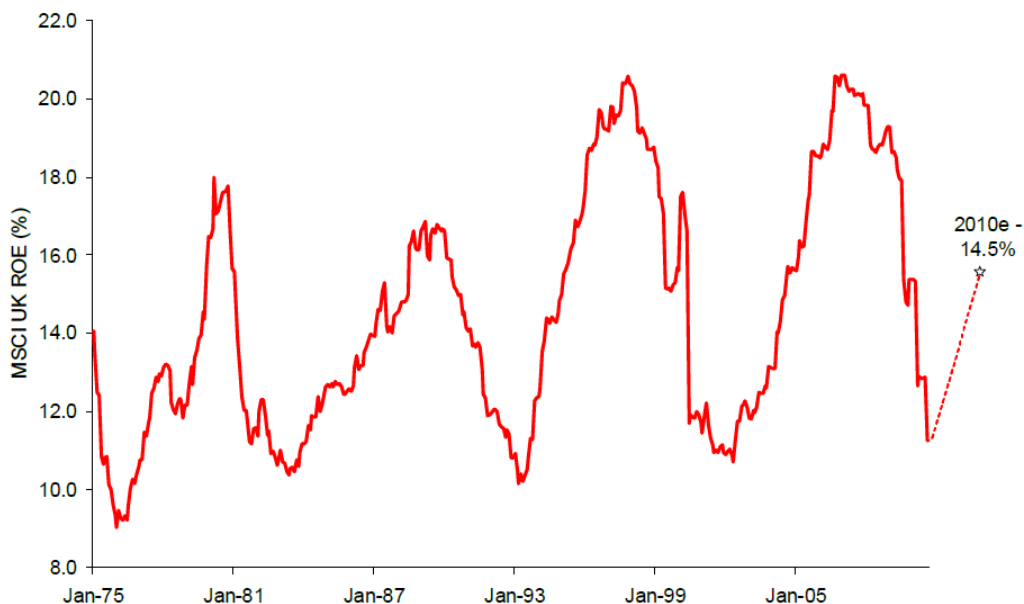
### Economic Cycles

The economic cycle needs no introduction. As we all know economies do not grow at an even pace. They have 'normal' times (when they grow in-line with trend), they have periods of overheating (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.

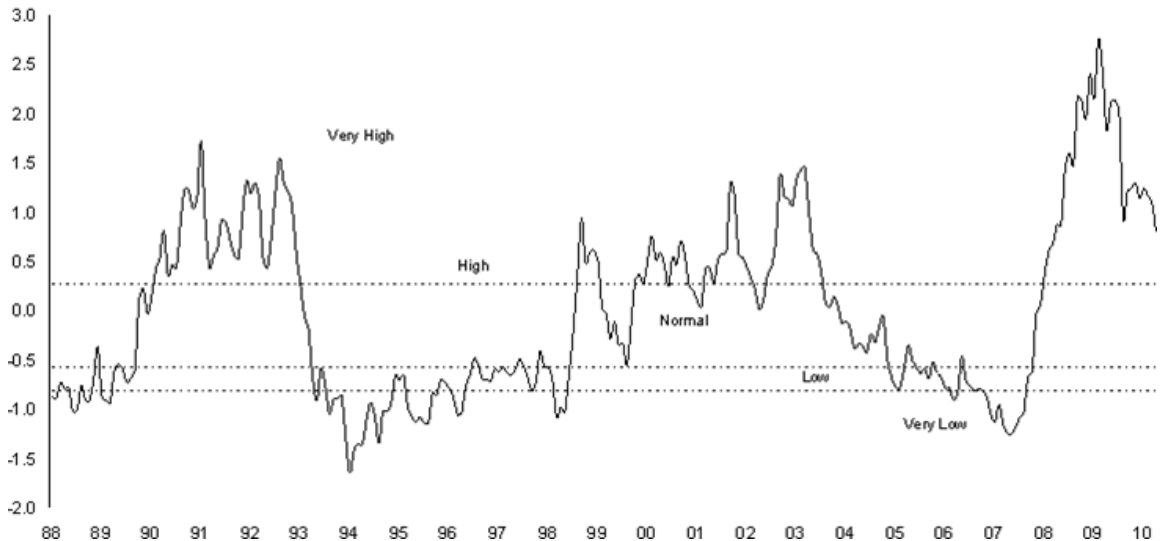
Fast-forward one or two years and return on equity across the corporate sector is now depressed, with many companies making cyclically low margins. But demand is now stabilising and, with costs having been cut, profitability has bottomed-out and, in many cases, starts to beat what have become very negative 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 on the following page shows (composite valuation spread, measured in standard deviations between cheap and expensive stocks), value does have a cycle.

## UK Equity Valuation Spreads



Source: Bernstein

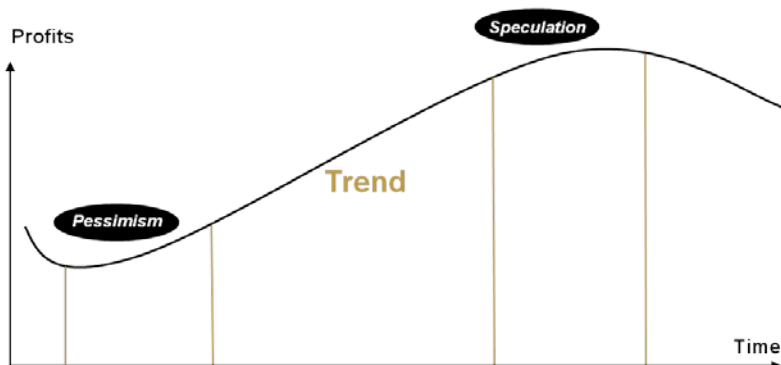
### **P.S. Don't put too much of your recovery money into 'the bubble has burst' stocks**

It is tempting at the bottom of the profits cycle, especially when wearing one's value hat, 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 I am 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



PROFIT POTENTIAL	RoE LOW, POTENTIAL HIGH		RoE HIGH, POTENTIAL LOW	
VALUATION	RISK AVERSE, VALUATIONS LOW		RISK HUNGRY, VALUATIONS HIGH	
TIMING	KEY INDICATORS IMPROVING		KEY INDICATORS DETERIORATING	

Source: River and Mercantile Asset Management LLP

That's the theory, and our updated *Philosophy & Process* document will develop this further and include third party references.

But where are we in practice today?

### 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.

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.

Value spreads are in line with long term averages.

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

### The Equity Market PVT today

**Potential** – 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.

**Valuation** – absolute 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.

**Timing** – 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.

So, in summary the market PVT is positive.

### **M&A activity continues to pick-up**

M&A activity continues to accelerate, benefiting the portfolio through our holdings in **Wellstream, Lavendon** and **888**.

**Lavendon** is another interesting example of the different valuations put on companies by corporate acquirers rather than equity investors. Trading at around 60p before the bid, the stock market valued Lavendon at only half its asset value and a recovery PE of less than 5 times. The value of the bid from TVH, a private company based in Belgium, is currently 111p, could well go higher but will probably still undervalue Lavendon's recovery potential. The stock market was at least 100% wrong prior to the bid.

We have added to our E&P exposure, partly because this sector is likely to see substantial bid activity in the coming year, as the oil majors' hunt for more production assets is complemented by the national oil companies becoming strategic investors in these assets. **Heritage Oil** was added to the portfolio for this very reason.

For other obvious M&A candidates in the portfolio I would continue to look no further than **Cookson** (global leader in steel production consumables), **Lonmin** (strategic position in the platinum industry), **CSR** (global leader in Bluetooth and sat-nav semiconductors), **Hogg Robinson** (a top three global business travel management company), and the **London Stock Exchange** (the longest established, most blue-chip exchange, at the heart of the world's traditional financial district). Your fund continues to be well positioned for the return of M&A.

### **Stocks: what number is the right number**

My own view has consistently been that the number of stocks a fund manager holds is irrelevant when it comes to generating performance, just look beyond the simplistic observations of industry commentators and consultants who have claimed that portfolio concentration is better than what the best fund managers actually do. And the reality is that the number of stocks just depends on the approach of the fund manager in question: some fund managers have ideas all the time, as a result they have a large number of holdings, and build conviction positions as the theses behind these ideas are confirmed by news flow; other fund managers have a clear scoring system that eliminates a lot more ideas before they get into portfolios. This is a more systematic, high, and many hurdled approach that leads to a more concentrated portfolio. Both approaches, if executed by talented fund managers, can generate great returns.

Here is the evidence from a number of successful fund managers:

At one extreme, **Peter Lynch**, from *'One Up on Wall Street'*: *"In my view it's best to own as many stocks as there are situations in which: (a) you've got an edge; and (b) you've uncovered an exciting prospect that passes all the tests of research.. Although I own 1,400 stocks in all, half of my fund's assets are invested in 100 stocks, and two-thirds in 200 stocks. One percent of the money is spread out among 500 secondary opportunities... if something happens to one of the secondaries to bolster my confidence, then I'll promote it to a primary selection"*. As all students of investing know, Peter Lynch's *Magellan Fund* thrashed the index return by over 13% per annum during his tenure.

At the other extreme, Warren Buffett, in an interview with *Forbes Magazine* in 1974, said: "I call investing the greatest business in the world because you never have to swing. You stand at the plate; the pitcher throws you General Motors at 47! U.S. Steel at 39! And nobody calls a strike on you. There's no penalty except opportunity lost. All day you wait for the pitch you like; then when the fielders are asleep, you step up and hit it... you wait for a pitch you like." As we all know, Buffett has made a fortune from taking large positions in a small number of high conviction investments.

But one of Warren Buffett's own examples of great investors, Walter Schloss, had a more diversified approach. Quoting Buffett's famous appendix to Ben Graham's *Intelligent Investor*, 'The Superinvestors of Graham-and-Doddsville': "Walter has diversified enormously, owning well over 100 stocks currently. He knows how to identify securities that sell at considerably less than their value to a private owner. And that's all he does... over and over again." Schloss beat the S&P index by 5.3% per annum (after partnership fees) during a 45 year period of managing money.

And Anthony Bolton went from wanting to manage a relatively concentrated portfolio at the start of his career to managing a fund with a large number of holdings, performing very well throughout his career, and actually having a more consistent record when he had a larger number of investments: "Looking back at the early reports I reported that 'a large number of ideas are sifted by the Investment Manager to arrive at a concentrated portfolio of about 30-40 shares'... over the years I have had to increase the number of holdings. Today I have about 200 holdings in the fund". From 'Investing with Anthony Bolton'.

And one of the great investment stories of all time was when one of the twentieth century's investing legends, Sir John Templeton, instructed his broker in 1939 to "purchase all the stocks trading below \$1 on both exchanges in the United States... By purchasing many stocks (104), instead of just a few, Uncle John was diversifying his risk." From 'Investing the Templeton Way' by Lauren Templeton. Actually Sir John's great-niece slightly misses the point. The number of stocks was an irrelevance to the investment idea; the big idea was Sir John's belief that the world, and the US in particular, would survive the Second World War and the best leverage to this view came from the most beaten-up stocks in the US market.

So five great investors, five different approaches to portfolio construction, and the number of stocks? Not relevant!

As for me, you know I have a diversified, idea rich approach to investing – always have, always will. More Lynch than Buffett which, as you know, is fully reflected in the approach taken for the Long Term Recovery strategy.

### **A different perspective on the first decade of this century**

There is often a huge gap between perception and reality... exploiting these gaps, and identifying when they will close is a skill the best fund managers have. Take the last decade, not a great one if you ask 'the man in the street'. A huge financial crisis, two long wars, two recessions, 9/11... the list can go on. But according to data from Harvard University, the past decade actually saw the lowest number of deaths in war since records began and the fastest ever reduction in global income inequality. For the developing economies, where the vast bulk of the world's population lives, this has been perhaps their best ever decade. Perception versus reality – where are the gaps and how can we exploit them? An example today is Technology.

### **Technology**

I think that the technology bubble legacy still creates a gap between perception (expensive, risky growth stocks) and reality (low valuations on a hugely innovative cash generative and fast growing part of the global economy) which we are positioned to exploit. Ten years on from the TMT bubble and tech stocks are as cheap as they have ever been, and many of them are exploiting areas of strong growth with the global economy as their market place. A new theme

for us is mobile banking, the use of smartphones to make electronic payments. Now in its infancy, this will be a huge market which we are looking to exploit through our ownership of stocks such as **Monitise**, a UK leading provider of mobile banking and payment services that has a venture with Visa to roll out their technology platform globally, and by our purchase of **Fiserv**, the leading global provider of IT services to the banking industry with a top rated mobile banking product offering.

### **Asset Backed Stocks**

With low PB strategies performing poorly during 2010 the valuation dispersion on a PB basis remains at high levels (our standard dispersion measure includes a number of valuation metrics). This suggests that as the cycle matures low PB stocks should start to outperform (indeed this is the usual pattern, the asset backed category being later cycle). So whilst these types of stocks have yet to perform for us we will continue to hold a material position, at 14.5% of the portfolio, in many top-decile *MoneyPenny* scoring stocks such as **Laird, Royal Bank of Scotland, Barratt Developments, Segro, Home Retail, Fiberweb, Lloyds and Scapa**.

### **Portfolio Activity**

We took profits in some of the most over-bought international cyclicals, and found a number of new, high conviction PVT stocks across our recovery and growth categories. We also switched some capital from large into smaller cap stocks, looking for increased discounts to medium-term intrinsic value.

### **New Investments (purchases)**

With the recovery phase of the economic cycle maturing we have looked to purchase some later cycle companies, notably the building stocks **SIG** and **Italmobiliare**. These are high scoring recovery stocks which are late cycle because demand for their services only picks up when businesses feel confident enough to invest. **SIG** is a leading European supplier of insulation products, and they should benefit from increasing private sector building and maintenance activity as we head into 2011. **Italmobiliare** is an Italian family holding whose largest position is majority control of Italcementi, the fifth largest global cement company. The cement market is currently very depressed and, as a result, Italcementi are on a low multiple of bottom-of-the-cycle profits, with huge recovery potential. Meanwhile Italmobiliare is valued at a big discount to the value of their stake in Italcementi, and we have purchased the savings shares which themselves are trading over 30% below the ordinary shares – so a discount, to a discount, to a cheap share! What fun (and thanks to my global colleagues for pointing this one out to me)!

We added to our position in the **Life Assurance** sector, following weak, sovereign debt related share price performance. The sector is a top scoring Quality sector in *MoneyPenny*, the valuations have become very attractive following the recent correction, and we think that management teams across the sector have made their balance sheets less risky over the last few years and are now far more focused on cash generation and shareholder value. Our focus of buying in the sector was **Prudential**, a new holding. The company generates an attractive 15% return on capital with their market leading Asian business estimated to produce a 25% return. The stock now trades on only 10.5x 2011 price/earnings and 0.7x 2011 embedded value. Current share price levels value the Asian business at less than 1.0x embedded value, which is a significant discount to listed Asian peers and particularly notable given the strong share price performance from AIA since its recent IPO.

We continue to believe that the leading UK banks, **Lloyds Bank** in particular, have substantial profits and share price recovery potential. However, as I suggest in my earlier commentary on the likelihood of a delayed recovery in 'the bubble has burst stocks', we may well have to wait longer than I originally expected before the likes of Lloyds actually recover to their fair value of 125p. The problem these companies have is historic baggage, whether it be from regulators

(who focus on the rear view mirror) or investors who find it hard to look beyond the legacy book of business (Ireland). So whilst we are committed to holding our substantial positions in these domestic recovery banks we have decided to focus additional 'banking recovery' capital on **Close Brothers**. Their bank represents a majority of their value and has no legacy issues given that they lent sensibly leading up to the credit crunch and kept a very strong balance sheet. They are now benefiting from the significant improvement in net interest margins that all lenders have seen as competitive capital has been withdrawn from the market but without the need that other banks have had to repair their balance sheet, meaning they can lend more on these favourable terms. The result is that they are growing robustly and profitably – asset growth of over 20%, which is internally funded, and profit growth well in excess of this. And for a growth stock the valuation is very attractive, a PE of less than 10 times next year's earnings and a yield of over 5%. We started a position.

We continue to see a lot of potential from our smaller company exposure, adding to a number of existing positions such as **Hogg Robinson, Scapa** and **Xaar** (take a look at the share price graphs of these three companies, really starting to show strength from depressed levels) as company announcements confirmed our PVT theses, and looking for new investments including the purchase of **GB Group**, an interesting growth stock with a UK market leadership position in electronic identity management, a critical requirement in this age of e-commerce and financial services regulation. They are seeing 10% per annum revenue growth (with a majority of the sales recurring), margins should increase from the current 5% level, cash generation is strong and all this is available on a lowly 1x sales, 8x cash flow, with a third of the market cap in cash and tax assets.

#### **Existing investments we have become more confident about (purchases)**

An area where there is a gap between perception and reality is Africa. Here the last decade has been much better for the Continent than the ongoing popular impression of war and famine might suggest. According to a *McKinsey Global* report on African growth published earlier this year, the Continent grew at a real rate of 4.9% per annum between 2000 and 2008, with natural resources only accounting for a third of this growth; the majority due to the development of internal sectors such as transport, telecoms and manufacturing. We are also more positive on Africa than consensus and, through the new look **Lonhro**, have found an interesting way of backing this theme. They are unashamedly a conglomerate with interests that include agriculture (supplying fruit and veg to the developed world), ports (the freeport of Luba, a logistics hub for the developing oil industry in Western Africa), airlines (Fly540, an African low cost airline), hotels and IT. We increased our investment.

We have also added to our position in **Carnival**, becoming higher conviction following a positive trading update from their only significant competitor, Royal Caribbean. Carnival is a recovery (with long term growth) thesis. The recovery comes from profits and the share price being depressed due to the recession; growth comes from the long term dynamics of the cruise industry, increasing its share of the global leisure wallet due to its strong value proposition, appeal to an ageing population, and geographical expansion. Valuation is supported by a modest recovery PE of 8.5, and an Enterprise Value / Invested Capital ratio that is only just above one. Timing is significantly improving with earnings being upgraded as yields (revenue per passenger) start to improve. As well as being a strong PVT thesis, Carnival is a good way of getting exposure towards improving US consumer sentiment.

Solar power stocks were weak during the quarter due to fears about volume growth in 2011, but we saw this as a good opportunity to increase our exposure to a sector that becomes more competitive by the day (cheaper production, other fuels becoming more expensive) and which is going through a period of huge medium-term growth. We added to **Renosola** and bought **LDK Solar**, both low cost China based manufacturers.

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

We continue to benefit from more than our fair share of bids.

We sold out of **Wellstream** as GE confirmed their offer valued at 786p. This was a greater than 50% premium to the average price we have paid over the last year.

We also took some profits in a number of our earlier cycle recovery stocks as they strengthened further into the final quarter of the year. This included reducing our **Cookson**, **GKN** and **Bodycote** positions.

We looked to reallocate capital from some recently performing large companies into smaller enterprises with a more meaningful gap between current prices and medium-term intrinsic value. This included a timely sale of **AstraZeneca** following a period of strong performance, and profit taking in **Vodafone**.

## Stocks we have cut (sale)

We now have almost no exposure to stocks that are dependent on the public sector. Whilst stocks in this area look superficially cheap, they are likely to be value traps, with public sector spending inevitably being below trend for at least the next five years.

We also sold out of **Drax** on the basis that we had stronger ideas elsewhere, and that the Timing of the turnaround and, therefore, value realisation at this operator of the UK's largest coal-fired power station remained uncertain.

## Non-UK Holdings

We continue to be excited by our global stocks, which combine great upside potential with attractive elements of portfolio diversification. Our *MoneyPenny* screen is able to throw up smaller growth stocks alongside the large recovery plays including **Rediff**, a leading Indian internet portal operator that has no mainstream broker coverage, and **Sina**, a leading Chinese online operator whose *Weibo* business (the Chinese *Twitter*) is taking the China market by storm. Regarding global recovery plays, we became high conviction on **Sky Deutschland** (German Pay-TV leader) as evidence emerged that they were starting to see a re-acceleration in their subscriber base, and **TomTom** (Global leader in Sat-Nav technology) which is seeing in-car fitted devices replacing reduced revenue from the direct to consumer market and increasing sales of revenues related to mapping and traffic services, the latter repeat revenue so more valuable than hardware sales. Both these stocks are so cheap that they will at least double on delivery of just modest growth.

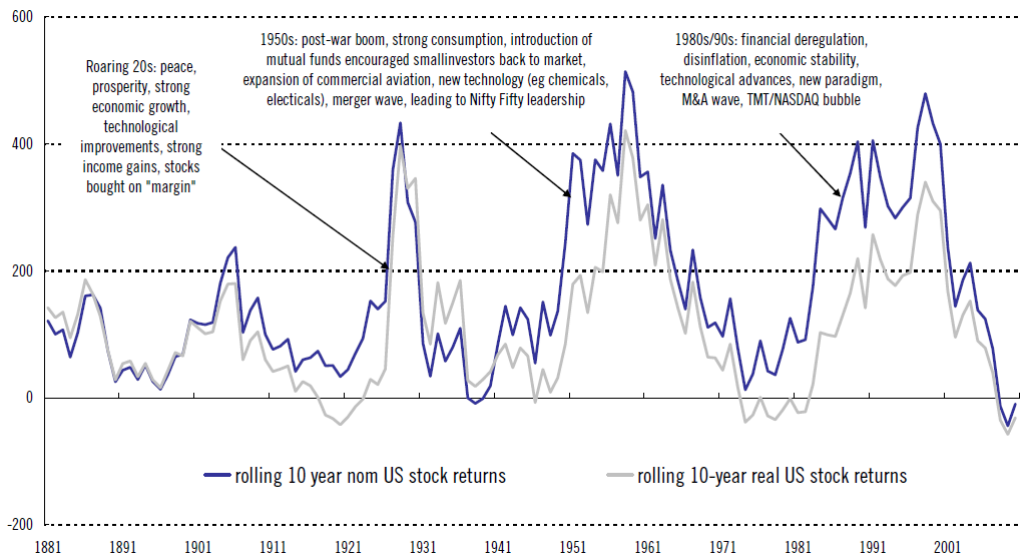
## Outlook

Looking forward to 2011 we think we are in the trend phase of the stock market cycle which is re-assuring. Macro-led volatility will continue to play a part, with European sovereign debt divergence to the fore but the reducing likelihood of an economic double-dip and the robustness of the corporate sector should provide comfort.

The equity market PVT is supportive: corporate profit potential remains material given that we are only in the second year of profit recovery; the UK equity valuation is attractive, particularly relative to government bonds; and timing is supported by positive corporate news flow and increasing M&A activity.

I have mentioned before that poor historic ten year rolling equity returns (such as the last ten years) are good predictors of better things to come. There is no reason why this pattern will not be repeated over the coming decade:

## 10-Year Rolling US Stock Returns



Source: Citi Investment Research and Analysis, Global Financial Data and DataStream

Last year I said "Our hopes for 2010 are that it is a boring year. What we need are sensible AND sustainable returns on equity investments. The current normalised market PE of less than twelve times, combined with a positive outlook for profits growth justifies at least a modest double figure return, for a number of years. These types of sustainable returns would help restore the case for equity investment and answer the UK equity markets critics." My hopes were largely met, and I see no reason why 2011 won't see more of the same. Big picture induced volatility remaining, but positive corporate developments and attractive valuations, combined with an under-owned equity market, and plenty of capital that could flow from government bonds to equities again, allowing at least a 10% return.

Meanwhile the Long Term Recovery portfolio continues to have attractive PVT characteristics: better than average profit potential, lower through-the-cycle valuations, and positive timing both in terms of share price technicals and robust news flow from the companies we hold. Smaller Companies (still 35% below their 2007 peak) and Value, both of which have had a surprisingly dull year, have latent potential and we would expect this to benefit our strategy in 2011. As a result, we continue to see scope to outperform the market and cash.

Again, thank you so much for your ongoing support and may 2011 be a happy and prosperous year.

**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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### River and Mercantile Asset Management LLP

30 Coleman Street  
 London EC2R 5AL  
 Telephone: +44 (0)20 7601 6262  
 Facsimile: +44 (0)20 7600 2462  
 Email: enquiries@riverandmercantile.com  
 www.riverandmercantile.com