RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Smaller Companies Fund I Quarterly Report
December 2010

River and Mercantile

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UK Equity Smaller Companies Fund – Quarterly Report

Fund Aim

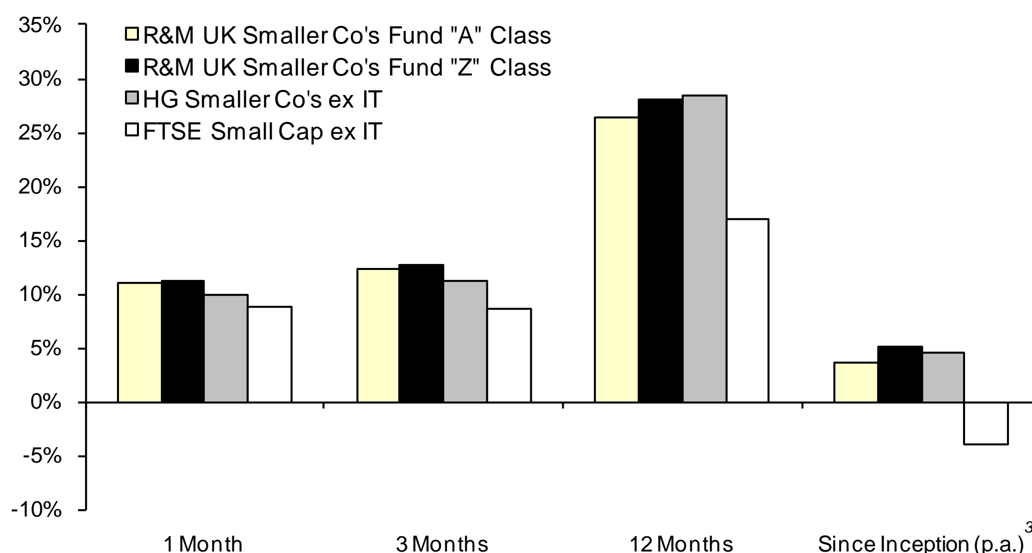
The investment objective of the Fund is to achieve capital growth through investing in a portfolio of investments which shall primarily consist of UK equities which reside in the bottom 10% of the UK stock market in terms of market capitalisation.

Portfolio Summary			Risk Analysis Summary	
Strategy AUM		£35m	Portfolio Volatility	20.63 %
Strategy Capacity		£400m	Benchmark Volatility	19.89 %
Number of stocks		79	Tracking Error	5.68 %
Largest Holding	Anite	2.38 %	Portfolio Beta	1.00
			Active Money	80.80 %

Performance to 31 December 2010

Retail "A" Class Shares	Fund[1]	HG Index*	Difference	*FTSE Small Cap (ex IT)*
1 Month	11.10%	9.97%	1.13%	*8.71%*
3 Months	12.33%	11.26%	1.07%	*8.56%*
12 Months	26.42%	28.49%	-2.07%	*16.90%*
Since Inception[3] (%p.a.)	3.61%	4.46%	-0.85%	*-3.96%*

Inst'l "Z" Class Shares	Fund[2]	HG Index*	Difference	*FTSE Small Cap (ex IT)*
1 Month	11.24%	9.97%	1.27%	*8.71%*
3 Months	12.75%	11.26%	1.49%	*8.56%*
12 Months	28.11%	28.49%	-0.38%	*16.90%*
Since Inception[3] (p.a.)	5.10%	4.46%	0.64%	*-3.96%*



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

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. The Hoare-Govett Smaller Companies (Ex-IT) Index rose 11.3% during the period, but the FTSE Small Cap (Ex-IT) Index lagged at +8.6%.

Performance

The Fund outperformed the benchmark by 1.5% during the quarter (c. 4.2% ahead of the FTSE Small Cap (Ex-IT) Index) and December was strong. The Fund remains ahead of the benchmark since inception.

Performance was aided during the period by takeover approaches for oil services provider **Velosi**, equipment rental business **Lavendon** and Lloyds underwriter **Hardy Underwriting**.

Positive contributors during the quarter included Industrial holdings such as **Elementis** (Chemicals) and **Fiberweb** (Non-woven fabrics). **Anite** (Telecoms testing) continues to re-rate, **Ashtead** (US Plant-Hire) performed well, as did **RWS** (Patent translation). Managing the risk with our underweight stance on Housebuilders proved helpful with relatively recent new positions in **Persimmon** and **Barratt Developments** rallying hard as negative sentiment got exhausted. A consumer stock, **Topps Tiles,** entered the leader board for the Fund's attribution for the first time in a while which was encouraging.

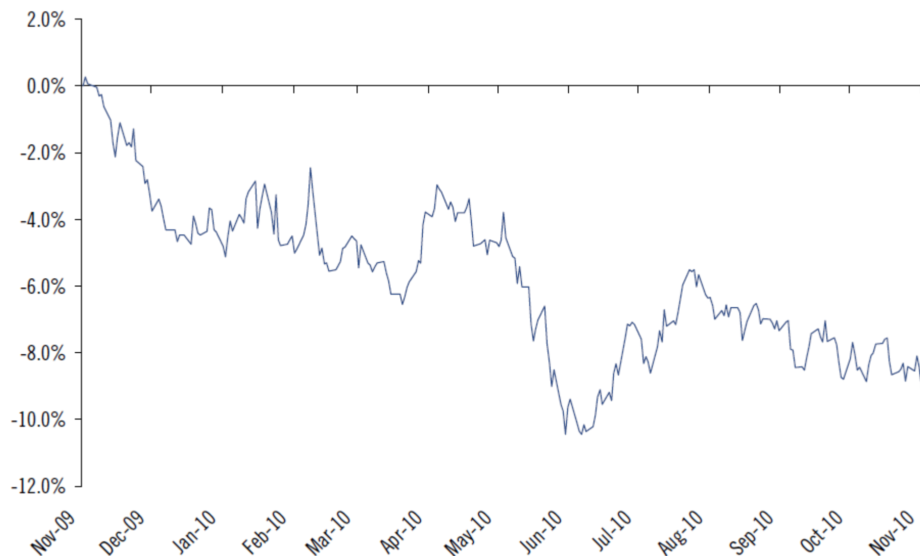
Disappointments related to resource holdings **Valiant Petroleum,** which delivered little from its exploration programme, and **Lamprell,** which re-guided on margins, unwinding outperformance in Q3. A lack of exposure to Resources generally, including larger benchmark constituents, was frustrating given their strength during the period. Finally, high conviction Asian hosting company **CSF** drifted back on low market volumes. Key overall detractors this year have been a value bias relative to growth in the portfolio and not enough resource investments. 2010's performance of +28.1% during the year (0.4% behind the Hoare-Govett but 11.2% ahead of the FTSE Small Cap) should be reviewed in this context.

Philosophy & Process

There has been some change to category weightings. Quality has reduced by 3.7% to 32.6% in favour of further investment into the strongly performing Growth category, now 24.6%, and the Recovery category, now 28.3% of the portfolio. There is, therefore, a very balanced spread of Potential within the portfolio with the most capital allocated to Quality. The skew to high scoring stocks, as quantitatively measured by *MoneyPenny*, our proprietary screening tool, remains strong.

Within the key elements of our Investment Philosophy, the Valuation factor has been performing poorly all year. When this inevitably reverses, relative performance should improve. Timing factors have continued to improve.

FTSE Value Index vs. Growth – 1 Year



Source: Citi Investment Research and Analysis, DataStream

The market, it seems, is seeking 'Growth', whether it be industrial cyclical growth, overseas growth or secular, and, as is often the case with this desire, valuation discipline is quietly being pushed to one side. Buyers, including ourselves, should beware as 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:

Rotation of successful investments into better value opportunities:

Partly driven by the yearly re-balancing of the Hoare-Govett, we have exited successful investment in **United Business Media** and **Homeserve**. Capital has been re-invested into similarly high quality PVT stocks, such as media companies **moneysupermarket.com**, **Wilmington** and emerging Growth company **GB Group**, a leader in ID software and analysis. Highly successful Recovery stock **Ashtead** has gone from hated to loved by the market, despite the price being multiples higher now, and we exited in favour of a modest purchase in attractively valued, industrial concern **Cookson,** which has lagged its peers in performance terms to date.

Purchase of 'later-cycle' Recovery opportunities:

During the period, new positions were established in white-van rental company, **Northgate**, International ground engineering specialist, **Keller**, and equipment hire company, **Lavendon**, which has subsequently attracted opportunistic takeover approaches.

The sale of investments due to weakening theses or corporate activity:

Pace Micro Technology has been a solid investment for us, but appears challenged given the fast-moving world of TV and potential internet threats to the set-top box industry. We have moved on. We exited both **Velosi** and **Hardy Underwriting** following takeover approaches.

Sector positioning

There has little change to the sector stance during the quarter. The largest overweight remains the diverse support services sector at +8.5%, 20% of the portfolio. Technology is +6.4% at 13.3% of the portfolio and exposure to Mining and Oil & Gas is c. 8.7% of the portfolio (only +1.3% relative). Underweight sectors remain the same, although the size of the non-life insurance underweight has increased to -3.4% as a result of the sale of **Hardy Underwriting**. Domestic consumer sectors still have low relative weightings in the portfolio.

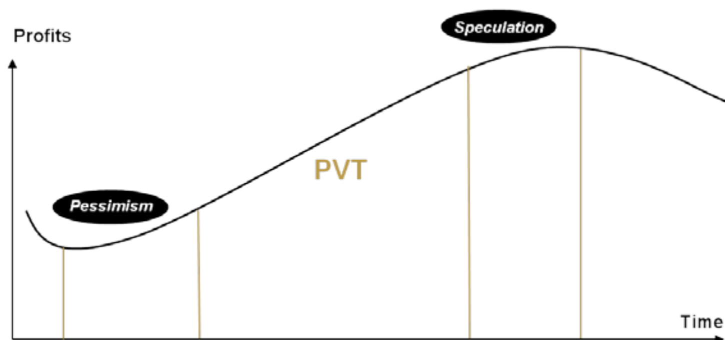
Market Outlook

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	PVT	Risk Reduction / Quality	Quality

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

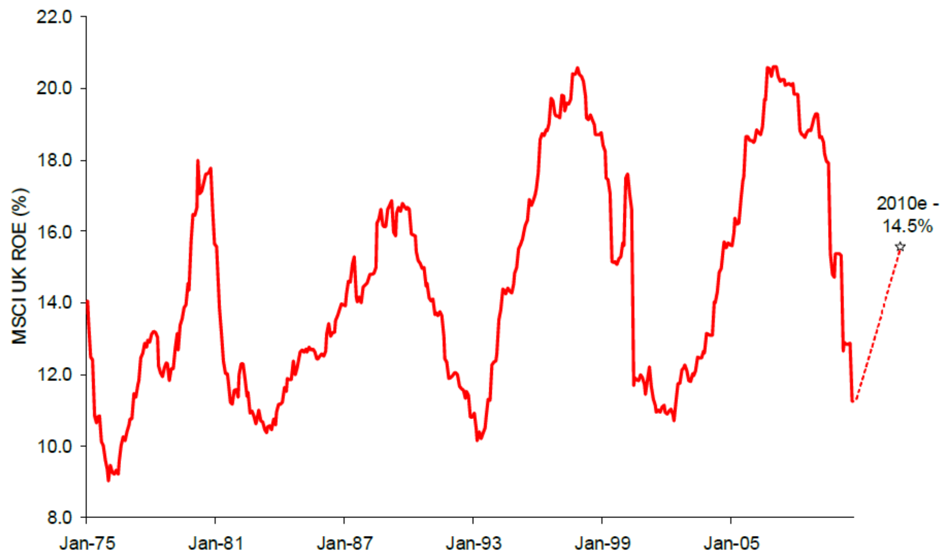
Economic cycles

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.

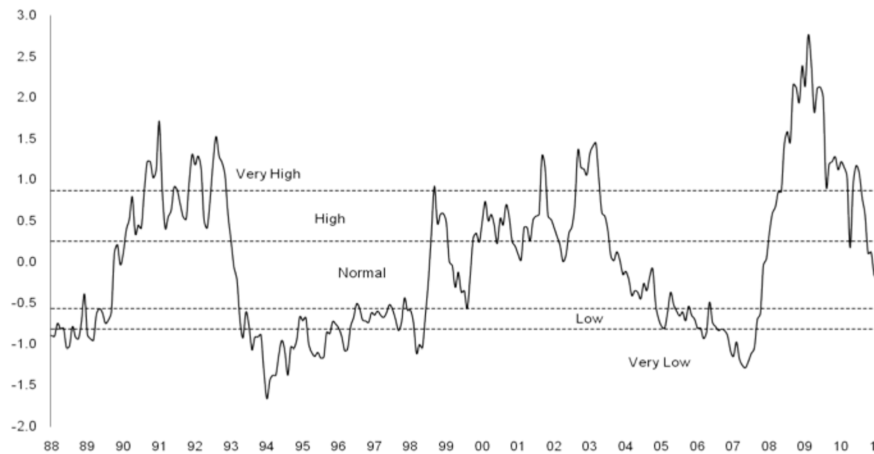
Fast-forward one or two years and return on equity across the corporate sector is now depressed, with many companies making cyclically low margins. But demand is now stabilising and, with costs having been cut, profitability has bottomed-out and, in many cases, starts to beat what have become very negative 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 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

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.

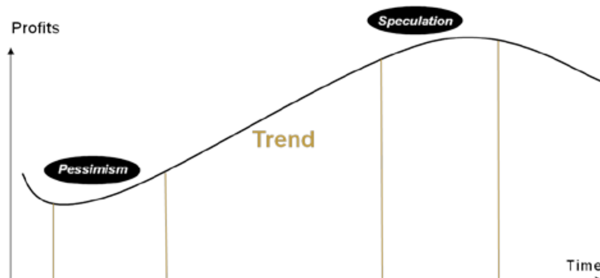
Here we are thinking of TMT stocks post the bursting of the 2000 bubble, or banks following the recent credit crunch, or housing stocks after the 1991 property crash. Demand in these bubble markets can take a long time to return, regulators will apply 'knee-jerk' new laws that also constrain the top 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



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	

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.

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. 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 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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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