RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity High Alpha Fund I Quarterly Report
March 2011

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UK Equity High Alpha Fund – Quarterly Report

Fund Aim

The investment objective of the Fund is to achieve capital growth by investing in a focussed portfolio of investments which shall primarily consist of UK equities which offer the prospect of superior long term growth.

Portfolio Summary

Strategy AUM		£426m
Strategy Capacity		£1.1bn
Number of stocks		123
Largest Holding	HSBC	5.78 %

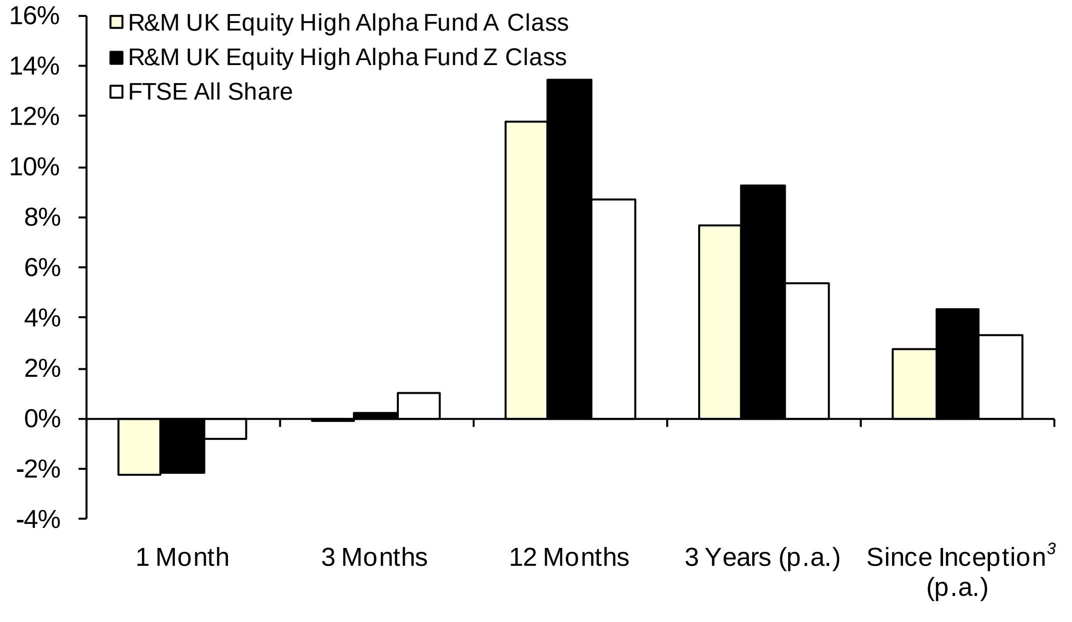
Risk Analysis Summary

Portfolio Volatility	19.36 %
Benchmark Volatility	17.73 %
Tracking Error	4.74 %
Portfolio Beta	1.06
Active Money	55.10 %

Performance to 31 March 2011

Retail "A" Class Shares	Fund[1]	Index*	Difference
1 Month	-2.24%	-0.81%	-1.43%
3 Months	-0.10%	1.03%	-1.13%
12 Months	11.82%	8.72%	3.10%
3 Years (p.a.)	7.65%	5.36%	2.29%
Since Inception[3] (p.a.)	2.80%	3.33%	-0.53%

Institutional "Z" Class Shares	Fund[2]	Index*	Difference
1 Month	-2.12%	-0.81%	-1.31%
3 Months	0.27%	1.03%	-0.76%
12 Months	13.44%	8.72%	4.72%
3 Years (p.a.)	9.23%	5.36%	3.87%
Since Inception[3] (p.a.)	4.32%	3.33%	0.99%



Source: River and Mercantile Asset Management LLP
**Index: FTSE All Share (Total Return)*
[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 date "A" and "Z" class shares is 28 Nov 2006

Quote for the Quarter

"Now is the winter of our discontent
Made glorious summer by this sun of York;
And all the clouds that lour'd upon our house
In the deep bosom of the ocean buried."

- 'Richard III', by William Shakespeare, circa 1591.

Key Observation

'For those of us who have grown up in dictatorship, the protests that have ignited throughout the Arab world feel like the fulfillment of a great promise. This promise was made to our parents and grandparents, to all those who fought for independence: that we would have the right to decide our future. Instead, our leaders delivered us into a world of silence and fear and told us that we must watch what we say and watch what we do. Our institutions were undermined or dismantled, our political parties were stifled or co-opted, their members disappeared or neutralized. And whenever we looked to the West for help, its presidents and prime ministers spoke with forked tongues, one moment lecturing us on democracy and another offering support to our dictators.

The young man who started this winter of discontent was Mohamed Bouazizi, a 26 year-old fruit vendor in Tunisia. He could afford neither the required cart license nor the bribes the police demanded whenever they saw him. The police harassed him until, in his despair, he set himself on fire in front of the government office in Sidi Bouzid. Is it any wonder that the unemployed college graduates took to the streets to demand change, or those professionals and trade unions joined the protests? After all, Bouazizi was not part of any political party, he was not brandishing a sign, he was not even asking for democratic reforms; he was simply trying to make a living. And if he could end up like this, so could all of them. Tunisia is full of Mohamed Bouazizis.'

From *'Winter of Discontent'* by Laila Lalami, published in *The Nation*, 21 February 2011.

The crucial story for last quarter was the Middle Eastern Spring, a popular out-pouring of desire for economic, social and political emancipation that has followed a long, hard Winter of Discontent in the Middle East and North Africa. In the short term the main economic impact of these popular uprisings on the world economy has been negative, the result of a higher oil price; however in the long term the awakening of large, youthful populations that want to be given the freedom to make a difference will be positive, and bring into the global economy another large, under-producing (apart from oil) part of the global economy. Of course as an investor I will focus on economic liberation – just think what Iran could do if they made proper use of all those brilliant scientists and entrepreneurs – but economic freedoms do bring social freedoms, as so many more choices are available for human kind when they are underpinned by economic progress. *Insha'Allah*, the Arab World will find its rightful, free and entrepreneurial role in this fast changing world of ours.

Market background

Quarter:

Even in these eventful times the developments that shaped the first quarter were extraordinary. The MENA uprising, the huge earthquake in Japan followed by a devastating tsunami and then a crippled nuclear reactor. Such was the drama that the ongoing turmoil in European credit markets almost went unnoticed.

However, markets which were not directly exposed to these historical events were remarkably resilient, with Global Equities actually showing a positive return during the quarter.

UK equities delivered a return of +1.0%. Whilst the overall market reaction was muted, the oil price spike had a significant impact on relative sector and stock returns, with the oil sector unsurprisingly leading the list of positive contributors during the quarter, and oil consumers, such as Carnival, leading the list of underperforming stocks. Risk aversion did increase during the period, allowing defensive sectors to perform better. Banks started the New Year more robustly than they finished the last, but this quickly faded as the old worries regarding onerous regulation returned. UK domestic stocks were under pressure, particularly those exposed to a weakened consumer.

Factor returns were not very material, with Value starting the year well but fading as volatility returned to the market. Growth and Momentum, which had a slow start to the year returned to form later in the quarter. There was not a noticeable size effect.

How did we perform and why?

Quarter:

We underperformed the market, returning 0.3%. The year began well, as Value had a good start and the UK banks performed better from the off. However, the oil price spike seemed to put paid to our relative performance, with our underweight exposure to the Oil sector (Royal Dutch Shell and BG in particular) compounded by overweight positions in the oil consuming stocks (Carnival and International Airlines). The weak performance of the UK banks (Lloyds) made this a miserable quarter for our larger company stock selection. Fortunately smaller companies continued to add value, led by Hogg Robinson which, almost out of nowhere, decided to go up over 50%, thus rewarding our patient application of capital to what had been a very lowly valued stock.

Longer Term Performance:

One year, two year, and three year absolute and relative returns remain strong.

Key performance contributors

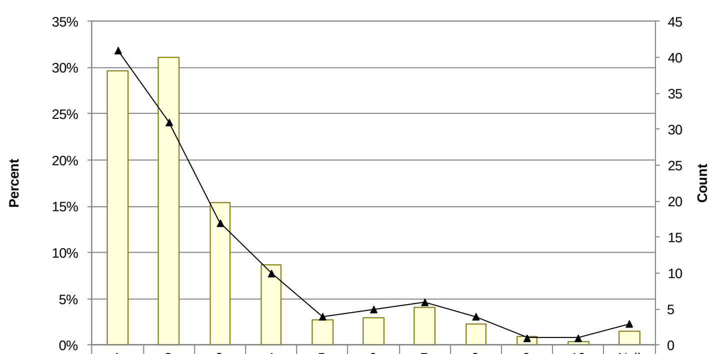
Quarter:

Positive: Small company stock picking (Hogg Robinson, Blinkx, e2v Technologies); no holding in Tesco which performed poorly.

Negative: Oil Sector underweight (Royal Dutch Shell and BG Group), overweight oil consumers (Carnival), UK bank overweight (Lloyds).

Does the portfolio reflect our philosophy and process?

The chart below shows that our strategy continues to have a strong skew towards high scoring stocks.



	1	2	3	4	5	6	7	8	9	10	Null
Weight	29.64%	31.13%	15.38%	8.66%	2.68%	2.94%	4.07%	2.27%	0.95%	0.36%	1.52%
Count	41	31	17	10	4	5	6	4	1	1	3

Source: River and Mercantile Asset Management LLP

What themes occupy us at the moment?

This quarter we will be completing the update of our *UK Equity Philosophy and Process* document. This 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.

The Equity Market PVT Today

We report in a systematic way on where we are in the equity market PVT cycle:

Potential – shareholder value growth is modestly above average at the moment as profit margins and return on capital continue to recover from their credit crunch lows. 2010 was 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. A risk to profit growth has emerged over recent months, namely the spike in oil prices, though most companies will have enough levers in place to offset these pressures. In the UK, growth in the domestic economy in 2011 will be constrained by fiscal drag and inflation so profit growth in the UK economy will need to be delivered through self-help.

Valuation – absolute valuations are supportive with the UK equity market on modest multiples of profits (10.5x 2011 earnings), EBITDA and PB; valuations relative to government bonds remain very attractive with the earnings yield trading at over twice the risk-free rate.

Timing – earnings revisions and share price technicals are modestly positive, and there are a number of fundamental timing catalysts including increasing M&A activity and falling corporate tax rates.

So, in summary, the market PVT remains supportive though, at the moment, capped by the oil price spike.

Portfolio Activity

We continued to slowly take profits in some of the most over-bought international cyclicals, and found a number of new, high conviction PVT stocks across our four categories.

New Investments (purchases)

We have progressed further with the later cycle theme we mentioned in our last quarterly review. With global growth continuing, inflationary pressures being exported from the developing world, and signs of buyer fatigue amongst some of the early cycle companies, we think now is the time to move the portfolio further in this direction.

Beneficiaries of this theme are the building materials related sectors which are only now starting to see their markets improve, and where consensus forecasts remain very cautious. Just look at US housing starts: the most bullish medium term analyst assumptions see the market going back to just two thirds of its very long term average. Purchases in this area included **SIG**, **Lupus Capital** (UK and US niche building products), **Keller** (global leader in ground engineering) and **CRH** (global leader in cement and aggregates), the latter being dual listed in London and Dublin. These investments will complement our existing large position in **Wolseley**. All these stocks are high scoring Recovery category stocks, led by Lupus (number 7 on our Recovery screen) and SIG (number 12) out of a total of over 500 stocks.

Real Estate (and asset backed stocks in general) are also late cycle, and we have added to this area which also benefits from being a solid inflation hedge. Our positions in **Segro** and **Songbird** have been increased and we have started a position in **Grainger**, the largest residential landlord in the UK. Residential rents are great inflation hedges, especially in the case of Grainger where their property is largely located in London and the South East where demand and supply fundamentals remain strong. Grainger are valued at a 50% discount to net assets.

Emerging inflationary pressures encouraged us to apply capital to the Utilities sector (which can normally pass on price rises to its consumers), our first serious investment of capital in this area for a number of years. Our favoured sub-sector is the electricity generators (where electricity prices have been subdued due to surplus global gas production) and electricity distributors. We think that power prices will firm up as surplus gas is absorbed by a stronger global economy and slower nuclear new build. We have purchased **National Grid** and added to our **International Power** holding.

We also bought an initial stake in **F&C Asset Management**. This is a second decile scoring Recovery stock, where any positive news on medium term profit potential being improved will move the shares to a first decile ranking and lead to us making this a high conviction (over 75 basis points) position. F&C is a well established, but historically under-managed, Asset Management franchise where activist investor, Ed Bramson, has taken a major stake and been elected to the Board with a remit to drive shareholder value. We think this is a strong fundamental catalyst for turning around the fortunes of the business, the upside being considerable given the relatively low profit margins achieved by F&C and the very low valuation (only 10x) put on these earnings.

Existing investments we have become more confident about (purchases)

We added to a number of performance laggards during the quarter. This included increasing our exposure to **Carnival** which came back sharply as the oil price spiked higher; at these lower prices we are paying less than 10 times recovery earnings for this dominant global player.

We also added to the UK banking exposure in **Lloyds, HSBC and RBS.** The sector has become hated again, despite clear improvements in underlying profitability and returns on new business being strong; the market is very worried about regulation and is using this as a reason to sell stocks down to big discounts to their book value. We are prepared to be longer term and to put more emphasis on the profit recovery potential at these enterprises and the very modest multiple (five times for Lloyds) of profits that one is having to pay at the moment.

Stocks that have delivered versus our PVT thesis (sale)

We continue to take profits in our Industrial, earlier cyclical stocks. This quarter our main sale was **Brammer**, the distributor of components required on production lines. The shares have gone up over five times from their credit crunch lows and look fully valued now.

Brammer is an illiquid stock so one needs to time one’s exit to coincide with investor popularity. We have also needed to consider this when taking some profits in **Hogg Robinson**, a stock which suddenly took off last quarter after having spent much of last year languishing on a PE of less than five times (despite good news flow). The shares have more than doubled over the last four months, and it has been right to reduce part of our large stake into this newly found market demand.

We sold out of the position in **Renesola** following further share price strength. This company moved its listing to the US towards the end of last year; we had asked for permission to temporarily hold this non-UK stock awaiting value maximisation. This was achieved.

We also sold out of **John Wood** as the excitement surrounding the fully priced sale of their Well Support business saw the share price move beyond our medium term valuation. The shares have more than tripled from their low point in 2009. Our Oil Services exposure is now focused on **Lamprell**, which has been a relative laggard.

We have also been slowly taking profits in the mining majors. Commodity prices are back to their bubble peaks that we saw in 2007, and too much capital and too many dreams are being invested in this part of the market. We don't know when the day of reckoning will be, nor do we want our performance to be dictated by this single factor. But increasing caution is warranted, hence our profit taking in **Xstrata** and **Rio Tinto**.

Stocks we have cut (sale)

Easyjet had a disappointing update early in the quarter, which included earnings downgrades and, more importantly, the new management team being unclear about medium term strategy and how to generate shareholder value. Our original thesis, which required clear insight and drive from the new team, was breached, and we decided to exit our investment at a modest loss.

Outlook

As we suggested at the beginning of the year, macro led volatility has continued to play a part. However, the relatively reasoned response of equity markets to events in the Middle East and Japan should actually reassure investors, especially as we suggest that the equity market PVT is supportive: corporate profit potential remains intact even with higher input prices; the UK equity valuation is attractive, particularly relative to government bonds; and timing is supported by positive corporate news flow and developing M&A activity**.**

Meanwhile the High Alpha 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, which has had a surprisingly disappointing last eighteen months, both leave the strategy with latent performance which we would expect to deliver as we go through the year.

Insha'Allah. Let all our gods be willing, and on the side of the economic, political and social freedoms that will allow the global economy to provide opportunities to all who inhabit this fast changing world.

Hugh Sergeant
Head of UK Equities

Fund Facts

Launch date	28 Nov 2006
Fund manager:	Hugh Sergeant
IMA sector:	UK All Companies
Benchmark:	FTSE All-Share (Total Return)
Tracking error range:	4-8%
Product capacity:	£1.1bn (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	Accumulation	Accumulation
Fund charges:			
Annual	1.50%	0.75%	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	B1DSZM4	B3D79W3	B1DSZP7
ISIN	GB00B1DSZM47	GB00B3D79W34	GB00B1DSZP77
Bloomberg	RMUKEHA LN	RMUKEHG	RMUKEAA LN

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