

RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Smaller Companies Fund I Quarterly Report
March 2011

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

Strategy AUM	£35.3m
Strategy Capacity	£400m
Number of stocks	81
Largest Holding	RPC Group 2.4 %

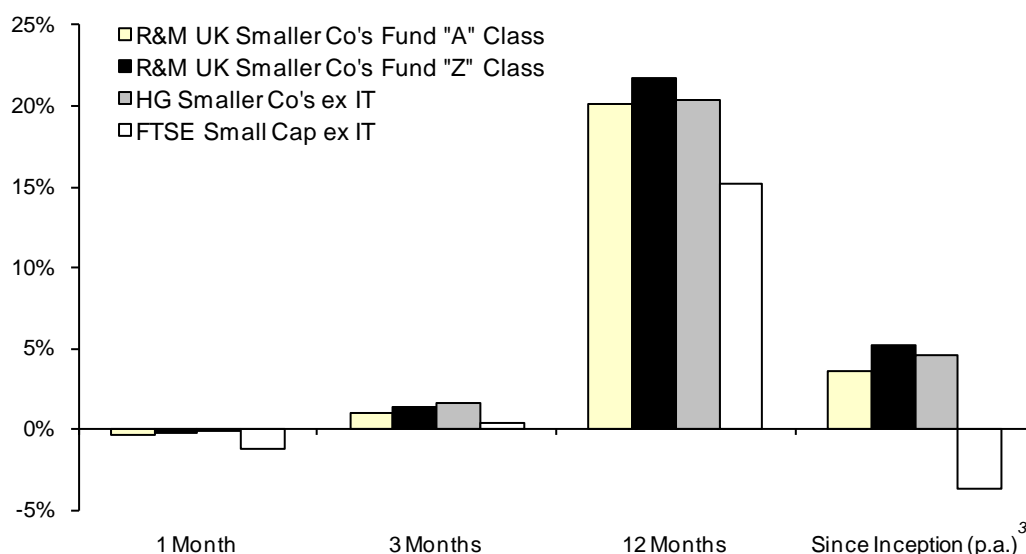
Risk Analysis Summary

Portfolio Volatility	20.60 %
Benchmark Volatility	19.98 %
Tracking Error	5.89 %
Portfolio Beta	0.99
Active Money	80.60 %

Performance to 31 March 2011

Retail "A" Class Shares	Fund ¹	HG Index*	Difference	FTSE Small Cap (ex IT)
1 Month	-0.40%	-0.05%	-0.35%	-1.18%
3 Months	1.00%	1.61%	-0.61%	0.33%
12 Months	20.11%	20.35%	-0.24%	15.17%
Since Inception ³ (%p.a.)	3.63%	4.58%	-0.95%	-3.65%

Inst'l "Z" Class Shares	Fund ²	HG Index*	Difference	FTSE Small Cap (ex IT)
1 Month	-0.27%	-0.05%	-0.22%	-1.18%
3 Months	1.37%	1.61%	-0.24%	0.33%
12 Months	21.72%	20.35%	1.37%	15.17%
Since Inception ³ (p.a.)	5.13%	4.58%	0.55%	-3.65%



Source: River and Mercantile Asset Management LLP

*Index: Hoare Govett Smaller Companies ex IT

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

²Performance calculated on a mid to mid basis at close of business, gross of annual management charge

³Inception 30 November 2006

Market Overview

"We are ready for any unforeseen event that may or may not occur"
- Dan Quayle, 44th Vice President of the United States, 22 September 1990

The first quarter of 2011 delivered a 1% upward move in the FTSE All-Share Index. The Hoare-Govett Small Cap (Ex IT) Index rose 1.6% with a mixed size bias within small caps as the FTSE Small Cap Index rose a paltry 0.3% and FTSE AIM actual fell 3.3%. How many investors would have predicted that outcome after a strong fourth quarter in 2010 (December All-Share +7.1%) and given 'inside-information' at a New Year's Eve party that Japan would have a devastating earthquake, tsunami and nuclear disaster, Egypt would have a successful populist revolution and other Arab (oil producing) countries would attempt it, UN supported Western forces would be involved in a civil war in Libya, Portugal would request a European sovereign bailout, UK GDP for the prior quarter would be released as negative and the UK government would announce incrementally negative taxation and regulation for the large Oil & Gas and Banks sectors?

Attempting to predict short-term moves in markets is pure folly and a waste of intellectual energy and valuable thinking time which could be much better allocated to searching out and verifying high conviction medium-term PVT stock-picking anomalies. The recent positive advance in markets has been because none of these events, either individually or collectively, are material for the main drivers of markets. Libya is not Saudi Arabia. Muammar Muhammad al-Gaddafi is not King Abdullah bin Abdul-Aziz. Portugal is not Germany. Fukushima is not Tokyo. UK GDP is not US GDP. The UK taxation regime is not the Global taxation regime. The economy is not the stock market. The only country where it's business as usual is Italy.

"If the Queen asks you to a party, you say yes. If the Italian prime minister asks you to a party, it's probably safe to say no." – David Cameron, Prime Minister

"I'm 74 years old and even though I may be a bit of a rascal ... 33 girls in two months seem to me too much even for a 30-year-old." – Silvio Berlusconi, Italian Prime Minister

Global events generated significant, generally unforeseen, headlines, however most key economic indicators (e.g. ISM survey at a seven year high) progressed positively, helped by ongoing monetary stimulus. Nevertheless, the pace of aggregate analyst revisions has slowed, Chinese economic growth is slowing, monetary tightening is imminent (ECB and the end of 'QE2') and profit margins in a number of industries are clearly normalising and, in some instances, already beyond or at previous peaks. A range of input prices are putting pressure on suppliers, consumers and finished-goods prices.

Despite these concerns, economic recovery has, historically, never been a purely two year affair (i.e. 2010-2011), economic output is still below trend and monetary tightening will still be at very 'loose' levels. For portfolio holdings, given the profit growth prospects, valuations appear attractive relative to other asset classes, large-caps and history.

Performance

The Fund lagged the Hoare-Govett Smaller Companies (Ex IT) Index by 0.2%, rising 1.4%, but was well ahead of the FTSE Small Cap and AIM markets despite the majority of capital being invested in these areas. There was some style factor volatility during the period but, overall, there were limited effects.

Sector positioning versus the benchmark was neutral during the quarter, with stock selection causing the lag; specifically **Blacks Leisure** and **CPP** disappointingly cost the Fund over 1% of relative performance between them. Blacks, which started the year in takeover talks, failed to receive an acceptable offer to the Board and discussions were terminated causing price

weakness. Shortly afterwards Neil Gillis, the CEO, whom we had backed to produce a recovery at Blacks, resigned, which we are extremely disappointed with given the job has not been completed and an appropriate level of profitability not yet achieved for the franchise's very significant sales levels of c. £180m. Retail is the Fund's largest underweight for good reason. The quarter provided very weak trading across the sector (we avoided **Dixons**, **HMV**, **Carpentry** and **Mothercare**) with the UK consumer suffering from cost pressures, public sector employment cuts and weak confidence. CPP announced, unexpectedly, that the FSA were investigating their sales practices for key products across the group, causing significant price weakness. Earnings momentum for the business had been waning and we had been reducing our position in recent months. The lack of clarity and potential materiality of the issue has resulted in a full sale of the position.

On the positive side, positions in a range of sectors performed very well including **Hogg Robinson** (corporate travel services), rising 48% during the period; **Advanced Medical Solutions** (wound care), rising 31%; **Capital Drilling** (mining services), up 19%; **Diploma** (specialist distribution), up 15%; **Hill & Smith** (Galvanising and Infrastructure services), up 23%; **RWS** (Patent translation), up 14%, and **Alternative Networks** (Telecommunications) up 19%.

Philosophy & Process

The split between Category weightings has become more even during the quarter. Quality is now 29.8%, with capital allocated to the Growth and Recovery categories rising to 26.6% and 29.1% of the portfolio respectively. There is, therefore, a very balanced spread of Potential within the portfolio with the most capital allocated to Quality. Our Stock Market Cycle work, explained in detail in the last quarterly report, suggests we remain in the 'trend' phase of the market cycle where positive returns can be generated from all categories of Potential, hence the current diversification across Categories. The skew to high scoring stocks, as quantitatively measured by *MoneyPenny*, our proprietary screening tool, has improved during the quarter with an increase of 8% in the top 3 deciles..

We will shortly be completing the updated edition of our *UK Equity Philosophy and Process* (P&P) document, which is available to clients on request (mt@riverandmercantile.com). 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 background to the P&P update is that our investment philosophy defines our set of beliefs regarding the key drivers of stock prices. It also explains why those beliefs can be harnessed through our investment process to create a competitive advantage and allow us outperform over a reasonable timeframe. Our Philosophy is backed up by a combination of theory, advice from other great investing practitioners and through a history of our own pragmatic experience. We explain our approach to valuing and analysing companies at different stages in the company lifecycle and include, for the first time, a detailed explanation of the Stock Market Cycle and how we are using it to help to manage risk. With new lessons learnt through the volatile years of 2007 – 2010 we have aimed to mitigate underperformance at future turning points in the Stock Market Cycle. In no way have our core beliefs changed or, indeed, any of the fundamental building blocks of our investment process been altered, but we have simply adapted a component of our risk analysis to ensure a better chance of managing downside when style factors work against us in future. This will in no way jeopardise our ability to take strong investment views that are contrary to consensus.

Quarterly Portfolio Activity

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

Overseas corporate earnings, for good reason, have been keenly sought after by investors (including ourselves) since the financial crisis as demand has bounced back stronger and quicker, deleveraging is less of a headwind, and underlying growth rates have been structurally higher. When these attractions are fully, and more than, represented in valuations relative to domestically exposed companies, investors' capital should start to become more discerning. If relative earnings momentum were to wane, attentions may switch quite aggressively. During the quarter, some predominantly domestically exposed companies were purchased for the portfolio whose profit growth is clearly well above average and which will eventually benefit strongly from a sustained recovery in the UK.

An early purchase of high **Quality** consumer franchise **William Hill**, on a <10x PE was rewarded by a subsequent trading update confirming positive earnings momentum and overly cautious market expectations. **Interserve**, the construction services group is also an extremely cheap equity, yielding over 6% and on a spot PE of <7x. Scoring top decile **Recovery**, we have been monitoring the stock looking for an improving Timing catalyst for some time. This was delivered via an excellent trading update in January with significantly improved cash generation highlighted. **Hill & Smith** returned to the portfolio following a significant period of market underperformance. Again, the valuation is highly attractive on a spot PE of <8x whilst gradual **Recovery** in its end markets is more assured. Earnings momentum has yet to be established fully, but a recent upbeat company update appears to have enabled medium-term forecasts to bottom out. High quality **Close Brothers**, the growing specialist mid-tier banking and asset management group, was acquired on a 5.1% dividend yield. Well capitalised (+13% Core Tier 1 ratio), they are able to grow the loan book selectively and highly profitably in current market conditions. **Asset-backed Safestore**, the leading self-storage company, was bought for its strong asset-backing and emerging profit momentum on a wide discount to book value. **Growth** company **Software Radio Technology** has also been purchased, whose strong product offering in maritime communications is delivering significant sales growth with a huge opportunity for global adoption ahead of it.

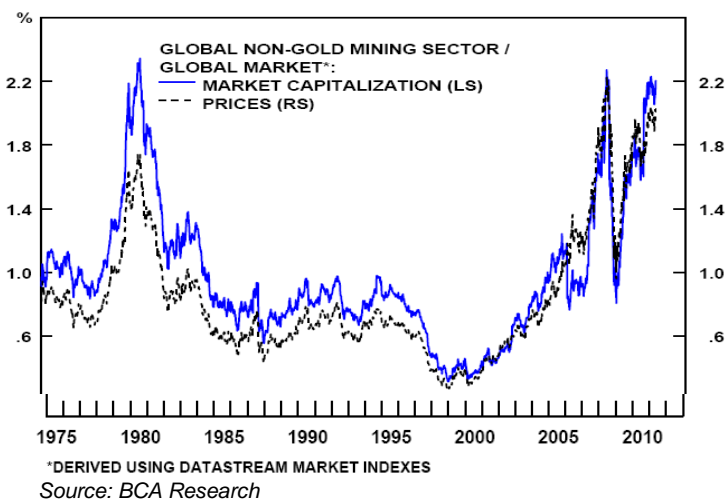
A number of holdings experienced deteriorating **Timing** credentials during the quarter and have been sold: **Caretech**, where conviction levels fell in both the management team, following the discovery of some aggressive accounting, and the outlook for fee re-negotiations with local authorities. **Mears** was exited given the outlook for its specific public sector exposure, and higher conviction opportunities elsewhere. **UK Mail** issued a weak update, where initial profit revisions appeared too light; following the sale further disappointing statements have been released. Conviction in **Halfords** failed to hold up as a number of problems recently (e.g. bike range/stock issues), combined with the extent of weak consumer activity levels, impacted our expectations of the profit outlook. All these stocks have gone on to materially underperform post-sale.

The highly successful investment in **Elementis** has concluded as profit margins have exceeded prior peaks and 'Industrials' sentiment has driven the valuation to levels ahead of the market, peers and the company's own history. Hoare-Govett benchmark year-end changes/promotions' have resulted in the sales of **Cookson**, **Melrose**, **Afren**, **United Business Media** and **Intermediate Capital**, which are simply not 'small-cap' in our view anymore.

Sector and size positioning

There was little change to the sector stance during the quarter. The largest overweight remains the diverse Support Services sector at +6.4%, 17.9% of the portfolio. Technology is +7.8% at 16% of the portfolio. Key underweight sectors remain the same, however capital allocated to Industrial sectors (Engineering, Electronics & Electrical Equipment, Chemicals and General Industrials) has been reduced to 4.8% from 8.7%, an underweight stance of 3.7%. Whilst top-line growth should continue, margins in most of these clearly cyclical companies in these areas have reached prior peaks or are expected to improve further and earnings momentum in 2010 has been accompanied by valuation re-ratings. Domestic consumer sectors still have low relative weightings in the portfolio (Retail -5.2%, Travel & Leisure -4.1%, and Housebuilders -2.8%). Mining shares remain a small part (4.3%) of the portfolio.

Miners Market Share: Rising



'QE1' and 'QE2' have led to inevitable supportive commentary and money growth for 'hard asset' prices, yet the last scheme is scheduled to conclude in June, emerging market monetary tightening is accelerating and Chinese economic growth momentum appears to be slowing which is likely to be exacerbated by recent oil price moves. China's bank lending growth appears to have been normalising from excessive conditions but risks to further falls in 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. At the same time, the inevitable global supply response to the huge increase in commodities prices over the last eight years is beginning to occur. Calling "the top" in this sector has been a painful exercise for many investors for some time which is why an extreme position of zero exposure has not been adopted at this stage.

Market Outlook

The portfolio continues to have a low exposure: 9.8% of capital vs. 30% of FTSE All-Share Index, allocated to Resources stocks (Mining, early stage pre-production projects and Oil & Gas producers). Within the Oil & Gas sector it is possible to find companies whose production assets have development prospects and whose exploration portfolio offers significant upside in all oil price environments, which is why the majority of the Fund's Resources weighting is within these types of companies (namely **Salamander**, **Gulfsands**, **Valliant**, **Enquest** and **Heritage**). The rotation from paper to hard assets began on 16 July 1999, where price leadership was handed from the S&P 500 to the CRB Commodities Futures Index. The sectors that have performed best over the past decade (Mar 2001 – Mar 2011) on a total return basis have been those most exposed to the commodity markets. Mining shares are more than double the S&P sector weight in the FTSE All-Share benchmark.

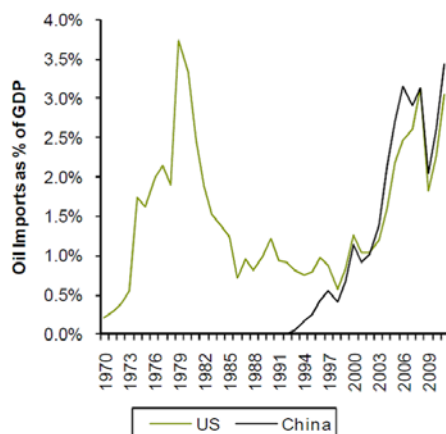
Easy money has been a multiplier for the paper to hard asset trade, favouring the latter. The decline since 2000 of stocks relative to commodities is as powerful as any past cycle. Commodity sentiment has migrated from 'deep cyclical' to 'growth', fuelling extractive industry investment. Yet centuries of data support the fact that commodity production is a price-taking, high fixed-cost, capital-intensive, deep cyclical industry, with periodic bouts of pricing power that lure new capital into the industry only to be dashed against the rocks when commodity prices prove cyclical. From 1995 -2007 commodities were lifted by easy credit as Asian excess savings were funnelled into US dollars, enabling credit growth that tripled money supply, since banks create money by making loans (fractional reserve banking system). When QE started in 2009 commodities resumed their upward trend with gusto.

China has been the major driver of incremental commodity demand since 2002 (and should remain so, albeit with increasing cyclicality). A high savings rate is typical of emerging countries, with capital deepening via fixed investment the result. China has utilized fixed investment (construction, etc.) to generate GDP, creating an extraordinary investment/consumption imbalance. Construction, in general, often features corruption and heavily displaces people, and fixed investment builds up a bank of potentially negative operating leverage (high fixed costs, large swings in GDP). Unrest in China could be the result, and this remains a fear of the government. Transitioning to a 'consumer' economy and away from a reliance on fixed investment is unlikely to be a smoothly managed affair.

Overall I expect this quarter's oil price rises to be relatively temporary as they seem led by supply rather than demand. However, the impact on China's growth of higher prices may accelerate a slowdown already taking place but not yet reflected in wider commodity price performances. As I have repeatedly written in Fund reports, the markets' belief in China's ongoing ability to 'control' its actual, real growth rate, is too optimistic. Libya, to be clear, was 2.1% of 2009 global oil output. This compares with Iran's 4.9%, Saudi's 11.6%, UAE's 3.3%, Kuwait's 3% and the fast growing Iraq at 2.8% (HSBC, IEA). In itself, therefore, Libya has had a modest, presumably temporary, impact on the supply/demand imbalance. In the West there is less dependence on oil now than before. Since 1970 the number of barrels of oil consumed has grown by 1.6% per year while global real GDP has grown by 3.5% per year. It would take about 500 barrels of oil to produce \$1m worth of real global GDP this year. The equivalent \$1m of GDP in 1970 would have required more than 1000 barrels of oil (BP statistical Review, IMF, Citigroup).

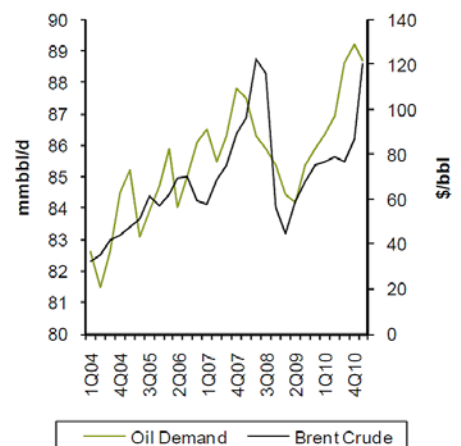
Whilst hard-pressed school-run mums and hacked off cabbies make good TV, the effect on China and Asia of high oil prices is also significant these days. Chinese oil imports in January had risen to over 5 million barrels per day (Libya's daily production in '09 was 1.8m barrels). Crude imports that month were up 27%, far greater than nominal GDP growth, so that the actual 'oil burden' on the Chinese economy is now at a higher level than the US. Oil demand clearly correlates to the oil price and thus 'demand destruction' cannot be too far off – in *both* countries.

Oil Burden – US and China



Source: BP Statistical Review, Bernstein Analysis

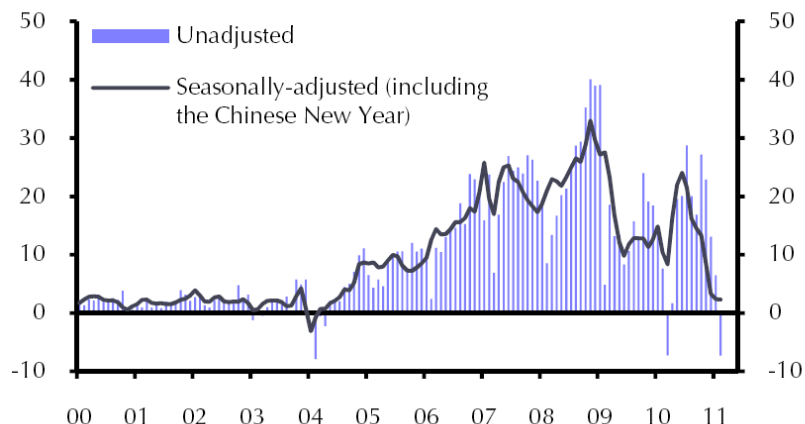
Oil Demand vs Oil Price



Source: IEA, Bernstein Analysis

This can be absorbed by China for now given the large current account surplus and low expenditure on oil as a proportion of disposable income, but will nevertheless impact activity levels.

Trade Surplus (\$bn)

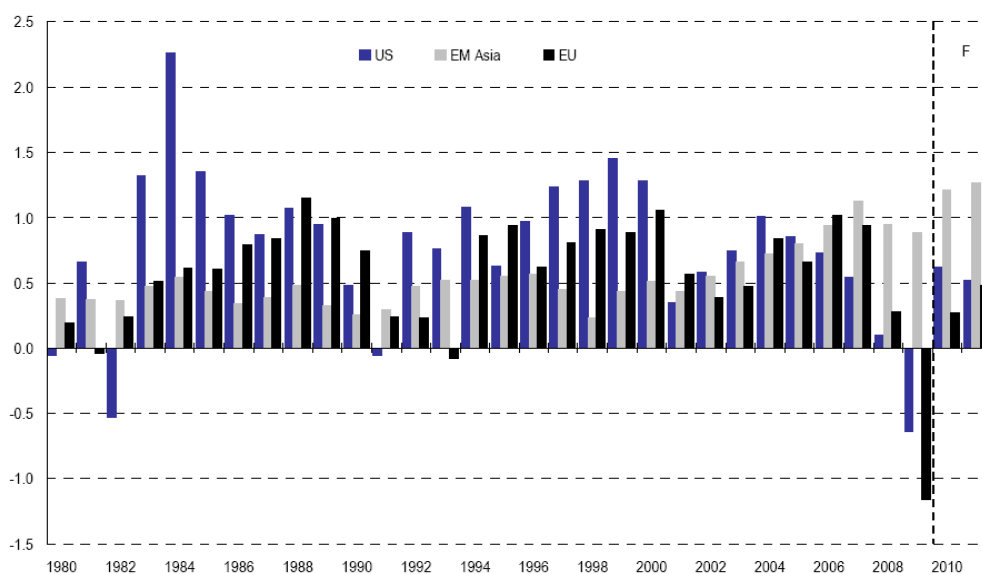


Source: Capital Economics

As can be seen above, China's unexpected trade deficit in February (only the second time since February 2004) indicates how high commodity prices are impacting on China's import bill. Imports have picked up, relative to exports, due to prices and not volumes. Clearly the trade balance rebounded last year in the second half when exports were much stronger; the Chinese, therefore, need the US recovery to continue in the second half of this year, or for prices to fall, to get back into surplus.

Leaving arguments regarding the impact on hard asset price levels by monetary expansion to one side, the strength of Chinese growth and its resource intensity is entirely linked to the imbalance in supply and demand we have seen in recent years. China now consumes 38% of world copper production. We can see the huge change in the contribution Asian growth is making to incremental world growth below.

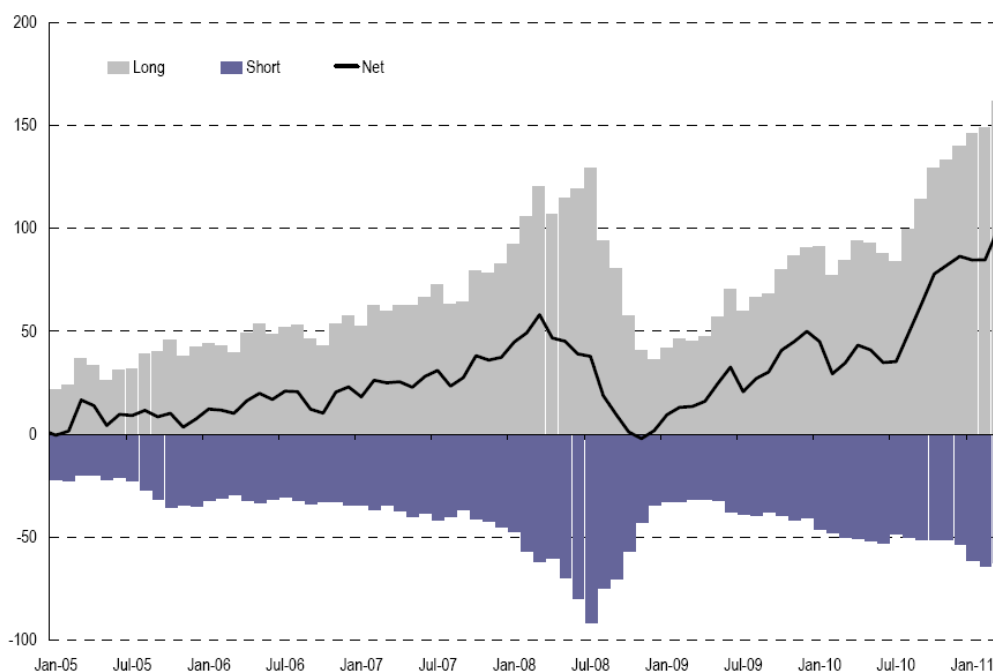
Contribution to Global GDP Growth (%), 1980 - 2011



Source: Citi Investment Research and Analysis and Haver Analytics

The risks of the Chinese slowdown, 'hard' or 'soft', impacting materially on commodity price levels has risen due to the relative size of their resource usage. This should be exacerbated by the inevitable supply response which is developing (the 'Big 4' miners have recently confirmed plans to increase capital expenditure by 70% year-on-year to \$45bn in 2011). Volatility will be augmented by financial market interest in the sector. A concerning trend which has given warning signals before other 'price peaks' (e.g. equities 2000, credit 2007).

Investor/Speculator Positions in Commodity Futures



Source: Citi Investment Research and Analysis

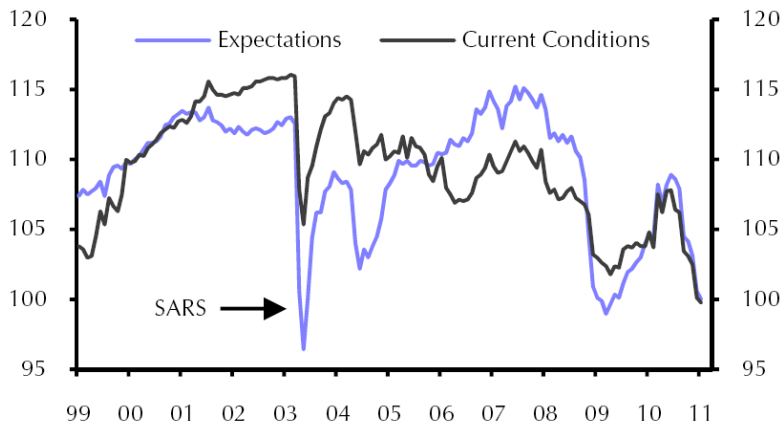
Clearly an ongoing slowdown is sought by the Chinese authorities and targeted via their increasing reserve ratio requirements, state lending volume reductions and other command-type actions, such as limiting secondary property ownership. 'Face' should remain intact, supported by the official 'twelfth 5 year plan' of a reduction in targeted growth to 7% (well below recent achieved rates). Slower growth is needed to allow measured economic progression without excessive economic speculation or social imbalances. Impact on commodity prices will be compounded by less resource hungry growth. "We expect a slower but more sustainable economic growth model to lead to a reduction in resource intensity per unit of GDP" (Source BHP Result February 2001). The slowdown is occurring; see the Chinese consumer confidence (not UK!) below, and more telling power-output figures (than official GDP statistics) whilst commodity prices make new all time highs. Significant property space under construction also appears rather concerning.

2010 Chinese GDP vs Power Output

	GDP	Power Output
1Q10	11.9%	22.7%
2Q10	10.3%	18.0%
3Q10	9.6%	11.0%
4Q10	9.8%	5.5%

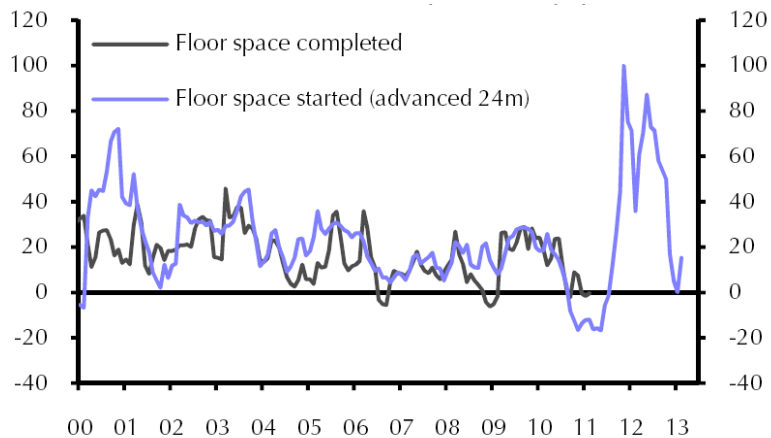
Source: Simon Hunt Services

Consumer Confidence



Source: Capital Economics, Chinese Consumer Confidence

Real Estate Activity (3m % year on year)



Source: Capital Economics, Chinese Real Estate Activity

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 generally liquid securities with strong balance sheets in a broad and attractively valued UK small cap equity market which has significant profitability generated overseas. The UK small cap market has a significant number of domestically focused businesses and is underweight (apart from AIM) the Resources sectors relative to the FTSE 100. A loss of confidence in the outlook for China's growth and falls in commodity prices could, and should, lead to relative outperformance.

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

Important Disclosures:

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