RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Unconstrained Fund I Quarterly Report
March 2011

River and Mercantile

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UK Equity Unconstrained Fund – Quarterly Report

Fund Aim

The investment objective of the Fund is to achieve capital growth through investing in a concentrated portfolio which will primarily consist of UK equities. The Fund will not be restricted by reference to a benchmark, sector constraints or company size.

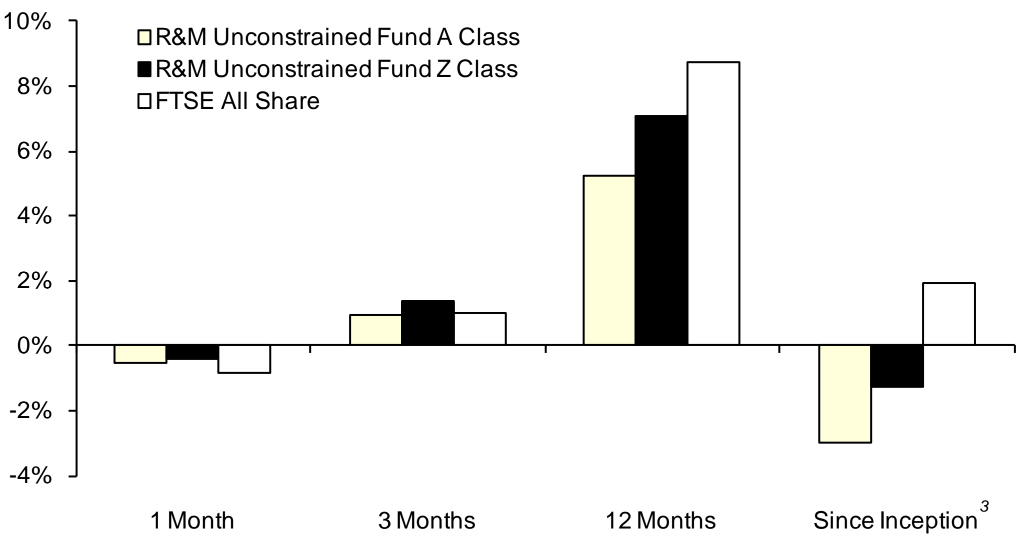
Portfolio Summary		
Strategy AUM		£13.7m
Strategy Capacity		£1bn
Number of stocks		38
Largest Holding	Vodafone	5.61 %

Risk Analysis Summary	
Portfolio Volatility	14.15 %
Benchmark Volatility	17.73 %
Tracking Error	6.28 %
Portfolio Beta	0.76
Active Money	61.00 %

Performance to 31 March 2011

Retail "A" Class Shares	Fund[1]	Index *	Difference
1 Month	-0.54%	-0.81%	0.27%
3 Months	0.93%	1.03%	-0.10%
12 Months	5.22%	8.72%	-3.50%
Since Inception[3] (%p.a.)	-2.99%	1.95%	-4.94%

Institutional "Z" Class Shares	Fund[2]	Index *	Difference
1 Month	-0.39%	-0.81%	0.42%
3 Months	1.37%	1.03%	0.34%
12 Months	7.09%	8.72%	-1.63%
Since Inception[3] (%p.a.)	-1.29%	1.95%	-3.24%



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 22 March 2007

Key observation

The crucial story for last quarter was the Middle Eastern Spring, a popular outpouring 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 investors we should focus on economic liberation – just think what Iran could do if they made proper use of all their 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.

Market background

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 a bit 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.

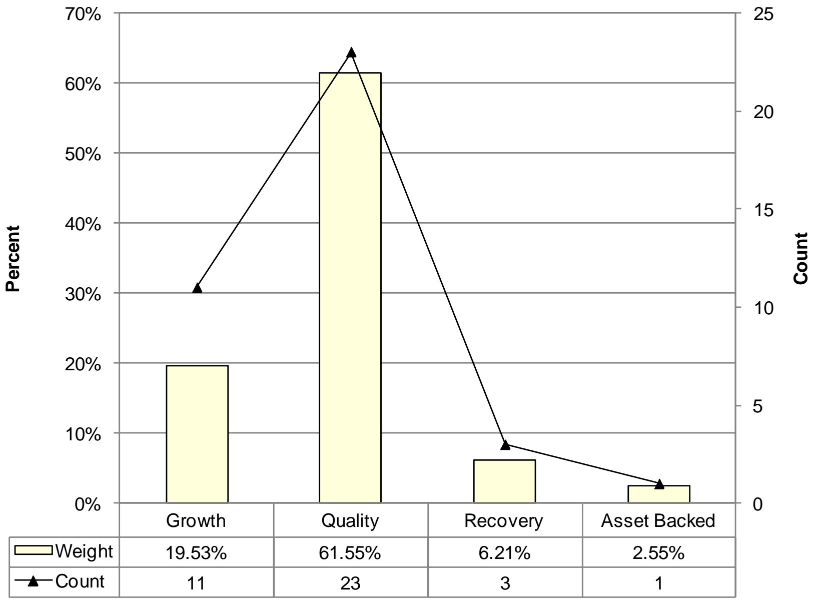
How did we perform and why?

Over the quarter

We returned 1.4%, modestly outperforming the benchmark FTSE All Share Index. Positive contributions were made via stock selection in the Mining sector and by virtue that we were underweight the sector. Domestically exposed General Retail and Travel & Leisure stocks suffered during the quarter as consumers reigned in spending. The portfolio benefited from being underweight that area of the market. At a stock level, good performances came from **Shire** and **BSkyB**, whilst a negative contribution came from a poor reaction to **Inmarsat**'s results and further underperformance from **Tesco**. Within the Oil & Gas sector, a strong performance from **BG Group** was to some extent offset by having no exposure to a number of other FTSE oil companies – **Royal Dutch Shell**, **Cairn** and **Tullow** – which all responded well to the rising oil price.

Does the portfolio reflect our Philosophy & Process?

The portfolio is currently tilted towards high quality companies which have a strong chance of outperforming through a decelerating global economic growth outlook. We also have exposure, mainly through several small caps, to a number of growth themes such as cloud computing. We have limited recovery and asset backed exposure at this stage of the cycle. In all cases we continue to rotate the portfolio in to strong PVT ideas where we see medium term potential for companies to create significant shareholder value, on low valuations and where earnings upgrades are more likely to occur in future.



Source: River and Mercantile Asset Management LLP

What themes occupy us?

Investment Philosophy and Process

This quarter we will be updating our *UK Equity Philosophy and Process* (P&P) 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. In future reports I intend to explain my own high quality and low beta stylistic biases in a little more detail too.

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 to 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 analyzing 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. We suggest that according to individual managers style bias, there are periods when they are more likely or less likely to outperform whilst implementing our investment process. With 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 jeapordise our ability in future to take strong investment views that are contrary to consensus.

The original screens used within our investment process were fully back tested and compared against competing screens in the market as well as back tests from sell-side third parties. We recognise the limitations of back tests but we have continued to measure the results from the different elements of our investment process on an ongoing basis seeking to understand exactly where alpha has been generated in our portfolios. Performance has often tended to be dominated by positioning in the most cyclical and largest sectors within the market - namely financials and resources in recent years. However, it is not satisfactory to simply measure outcomes and, following our screen analysis, we have sought to improve one alpha generation source – that of systematically identifying genuine secular growth stocks. Cyclical growth stocks are already captured through both our recovery and quality screens. We are ever mindful that we must stay true to our core investment beliefs but also recognize that within today's active fund management industry some alpha opportunities do get arbitraged away in the short term whilst others will likely always remain due to human behavioural biases. We believe, in today's global markets, it is not good enough to simply dig your heels in after a period of underperformance or rest on your laurels after a period of outperformance. We must continue to strive to have a best in class investment philosophy and a world class platform to deliver our investment process ensuring sustainable value creation in the future.

Commodities

The largest contribution to my marginal tracking error over the past couple of years has been in the commodity space and, once again this quarter, we have seen the rising oil price somewhat dominate relative returns within the UK stock market. This quarter I would like to include a few long term charts to explain our ongoing underweighting of this area of the market.

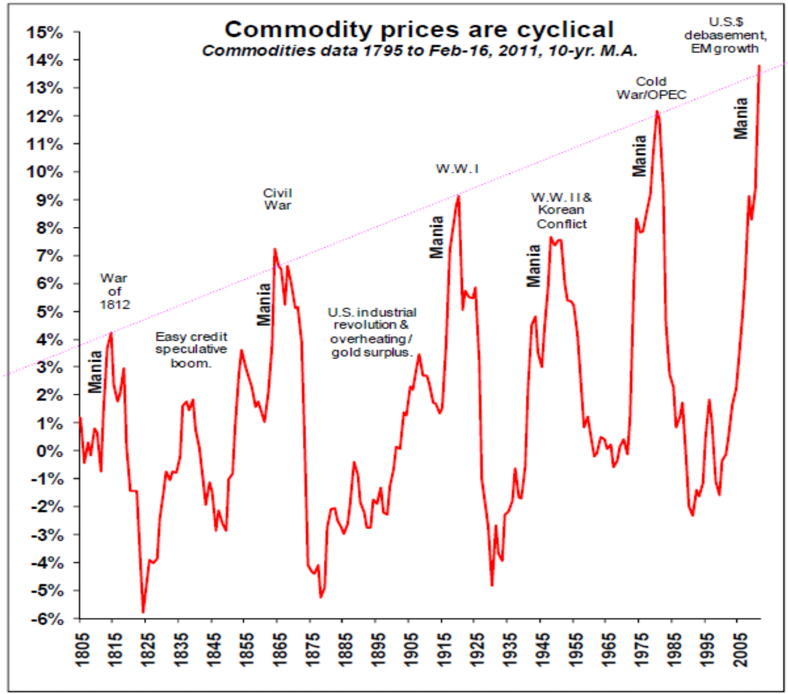
The rotation from paper to hard assets began on 16 July1999 when price leadership was handed from the stock market to the CRB Commodities Futures Index. The sectors that have performed best over the past decade (Mar 2001 – Mar 2011) on a total return basis have been those most exposed to the commodity markets, shown in the table below. The out of favour and perhaps 'value' categories are at the bottom of the table below. This sector data is from the US market but the implications for the UK market are even more marked as 30% of the FTSE All-Share Index is now made up of Oil and Mining companies. I managed to overweight the commodity sectors for the first seven years of that period and managed to move underweight in year eight ahead of the banking crisis but have struggled to justify returning overweight in the past two years as commodities have gone parabolic following the onset of quantitative easing (QE).

Factset Industry Categories
Total return (price + dividend) indices, Mar-2001 to Mar-2011

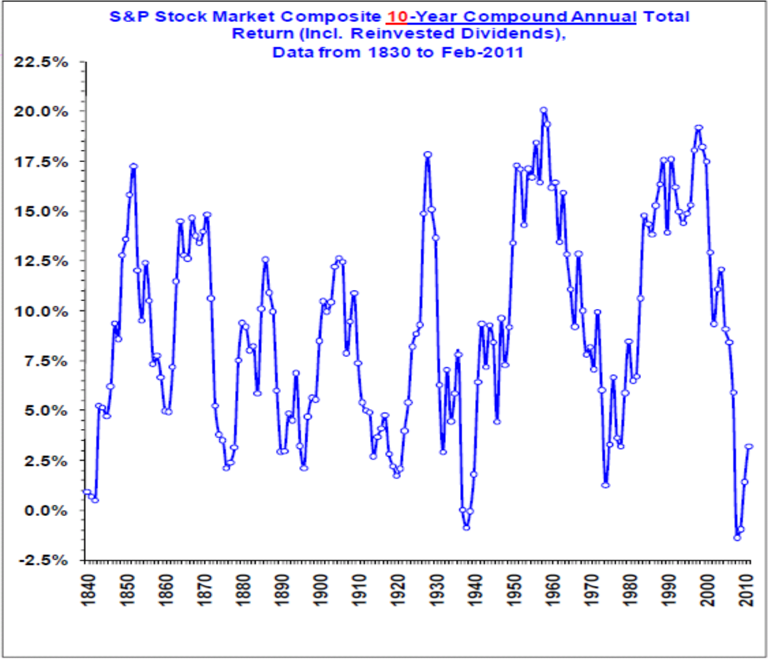
	10-Yr. Total Return	Annualized Total Return
Non-Energy Minerals	482.4%	19.3%
Energy Minerals	263.2%	13.8%
Process Industries	211.9%	12.0%
Consumer Non-Durables	179.8%	10.8%
Health Services	175.8%	10.7%
Consumer Services	135.6%	8.9%
Distribution Services	123.9%	8.4%
Transportation	116.9%	8.0%
Industrial Services	113.6%	7.9%
Retail Trade	87.6%	6.5%
Technology Services	85.4%	6.4%
Producer Manufacturing	81.1%	6.1%
Utilities	69.4%	5.4%
Consumer Durables	64.2%	5.1%
Electronic Technology	43.9%	3.7%
Communications	32.3%	2.8%
Finance	31.7%	2.8%
Health Technology	28.7%	2.6%
Commercial Services	21.7%	2.0%

Source: FactSet

Commodity prices have now reached the highest 10 year rolling return in 200 years (first chart below), while the S&P 500 (price + dividend) just bounced off a 180 year low in 2008 (second chart below). The value asset is stocks, the momentum asset is commodities. As a value and momentum investor this provides somewhat of a dilemma. However, in the past year or so I have tended to favour the value option of underweighting commodity related equities, simply because these momentum trends are so far extended on a 180 year view, let alone a 5 or 10 year view. The reason I have been cautious of equity markets is simply that, at the point commodities turn lower, it will signal a loss of traction in global growth and equity markets are likely to respond negatively to that in the first instance too.

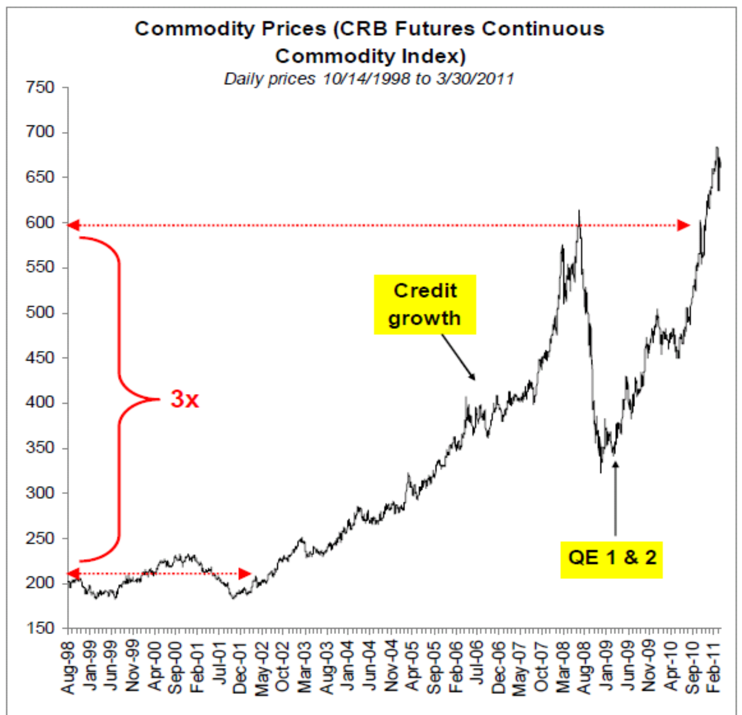


Source: FactSet



Source: FactSet

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 went parabolic.



Source: FactSet

China has been the major driver of incremental commodity demand since 2002 (we also discussed China in our last quarterly report). 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 has been the result, and this remains a fear of the government. I expect China to have a difficult time transitioning to a "consumer" economy and away from a reliance on fixed investment.

Portfolio Strategy

We are starting to see a slow down in consensus estimate upgrades across the market as we move into the second quarter of 2011. Earnings growth expectations are now priced to be significant so a focus on achievability of earnings estimates remains a priority.

The above analysis suggests we shall get more joy from our PVT strategy than last year. High scoring PVT stocks with overweights in defensives as well as only limited exposure to deep cyclicals (energy and miners) is where we are positioned. The second largest contribution to our tracking error has been our underweighting of the financials and, in particular, banks. We

remain underweight as we believe that earnings improvement will disappoint relative to previous recoveries. However, some consumer stocks are starting to look more interesting for the first in a number of years with many trading at large value discounts. We recently purchased William Hill on a very low rating after they beat expectations at their recent results.

Q4 Portfolio Activity

Purchases

We purchased **Inmarsat**, a leading provider of mobile satellite services for portable voice and data services. Inmarsat is a world class satellite service operator with good management, a solid strategic position and multiple options for value realisation. The company has multiple areas of growth, all driven by the launch of its new satellite constellation over the last few years. It operates maritime, land and aeronautical communications and has a large amount of global spectrum, giving rise to several potential growth strategies. The shares had underperformed in the second half of 2010 due to fears over a rising capex program over the next few years as well as due to a perceived overhang in the market with one of their largest shareholders selling down a stake. This enabled us to buy the shares on an attractive valuation given the long term growth prospects for the company.

We added to our position in Non-life Insurance with the purchase of **Jardine Lloyd Thompson**. JLT is a top 10 Global Insurance Broker. It generates high returns and above-GDP organic top-line growth. Insurance broadly tracks Global GDP. JLT is taking market share from the Big Three competitors but trades at a discount valuation. They have a broad and attractive geographical exposure suggesting they should grow faster than the peers. Forecasts appear to be conservative, held back by the weak dollar and an investment phase in the business where they have hired several teams from competitors. As a result, EPS momentum has been steady but not spectacular over the past couple of years. The strong balance sheet and technicals are favourable. Early in the quarter we also added to existing positions, **Unilever** and **BG Group**, as well as switching our holding in **Rio Tinto** to the higher quality, more diversified, **BHP Billiton**.

Finally we purchased **EMIS**, a small cap technology growth stock. The potential for EMIS lies in the fact that there is continued IT spending in the Healthcare sector, particularly on patient records. EMIS have the leading market share and they are now rolling out 'EMIS web' to their already installed base of GP customers via SaaS (cloud computing principles – namely Software as a Service). They continue to win market share. This is an investment in NHS productivity improvement via IT and is dependent on the security of patient information. Limiting factors of the past have been overcome to provide shared patient information to all relevant health professionals in the NHS. The company is profitable and generates good cash flow (75% recurring revenue). The valuation looks very reasonable so buying into the story relies on the fact that forecasts are conservative and we are likely to see significant EPS momentum and growth through 2011 and beyond to drive the shares further.

Sales and reductions

We sold the cyclical recruitment stock **Hays** after a decent early return as well as exiting our position in **Standard Chartered** following a slowdown in Asian growth. We sold Technology stock **Pace** as our conviction levels fell with developments in alternative internet based technologies creating a new competitive threat. We also took profits in **Amlin** and **Bunzl.**

Outlook

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 has rightly or wrongly reassured investors. My outlook has not changed from the previous period. Expectations remain high with most predicting another year of double digit returns but conditions in markets look eerily similar to late 2007. Equity markets are once again overbought, over bullish and, in a rising yield environment, it is a combination which brings high risks with it. A deflationary shock remains the greater risk for 2011 with consensus inflation expectations having already risen considerably. Markets appear, once again, to be pricing in a benign scenario and it suggests that the market should begin paying a higher premium for quality as we move through the year. Today the source of credit has changed from investment bankers to central bankers but the result has been the same – to drive risk assets and high beta, cyclical growth stocks up sharply. This has left many high quality large cap names on very attractive multiples which is where our Fund is currently tilted towards.

The UK Unconstrained portfolio continues to have attractive PVT characteristics. I expect PVT stock selection to improve and we own a portfolio of companies with strong prospects. In particular, I expect Quality stocks with valuation support and earnings visibility to outperform as we move through the year. The focus is firmly on quality stocks, capable of growing on good valuations. I continue to be high conviction on Pharmaceutical and Healthcare stocks (GlaxoSmithKline, AstraZeneca, Smith & Nephew and Shire), Non-Life (JLT & Hiscox) as well as high quality stocks on low valuations that have lagged the 2009 rally such as BAE Systems and British American Tobacco. This has to be balanced with the prospect of continuing global reflation. The market has narrowed into Asian growth and resource stocks bringing back memories of 2007 and, as such, I am focused on stock selection rather than being overweight this area of the market. Once again, thank you for your support.

Dan Hanbury
Portfolio Manager

Fund Facts

Launch date	22 March 2007
Fund manager:	Dan Hanbury
IMA sector:	UK All Companies
Benchmark:	FTSE All-Share (Total Return)
Tracking error range:	N/A
Product capacity:	£1bn (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	1.75%	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	B1NG829	B1NGCT4
ISIN	GB00B1NG8296	GB00B1NGCT49
Bloomberg	RIVMERA LN	RIVMERZ LN

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