RIVER AND MERCANTILE
ASSET MANAGEMENT

# UK Equity High Alpha Fund I Quarterly Report
June 2011

# River and Mercantile

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## UK Equity High Alpha Fund – Quarterly Report

### Fund Aim

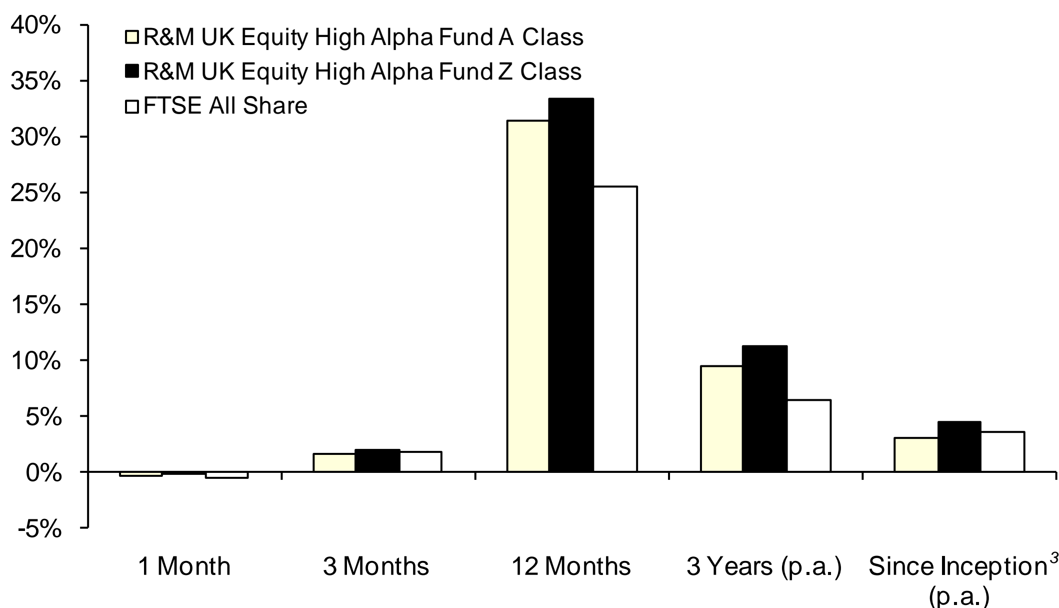
The investment objective of the Fund is to achieve capital growth by investing in a focussed portfolio of investments which shall primarily consist of UK equities which offer the prospect of superior long term growth.

| Portfolio Summary | | | Risk Analysis Summary | |
|---|---|---|---|---|
| Strategy AUM | | £432m | Portfolio Volatility | 14.93 % |
| Strategy Capacity | | £1.1bn | Benchmark Volatility | 15.19 % |
| Number of stocks | | 128 | Tracking Error | 2.81 % |
| Largest Holding | HSBC | 5.26 % | Active Money | 54.00 % |

### Performance to 30 June 2011

| Retail "A" Class Shares | Fund[1] | Index* | Difference |
|---|---|---|---|
| 1 Month | -0.20% | -0.45% | 0.25% |
| 3 Months | 1.68% | 1.91% | -0.23% |
| 12 Months | 31.40% | 25.63% | 5.77% |
| 3 Years (p.a.) | 9.61% | 6.55% | 3.06% |
| Since Inception[3] (p.a.) | 3.03% | 3.58% | -0.55% |

| Institutional "Z" Class Shares | Fund[2] | Index* | Difference |
|---|---|---|---|
| 1 Month | -0.07% | -0.45% | 0.38% |
| 3 Months | 2.06% | 1.91% | 0.15% |
| 12 Months | 33.39% | 25.63% | 7.76% |
| 3 Years (p.a.) | 11.24% | 6.55% | 4.69% |
| Since Inception[3] (p.a.) | 4.55% | 3.58% | 0.97% |




*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

*"It's déjà vu all over again"* *Yogi Berra*

## Key Observation

A year ago I wrote this about the second quarter:

*"It has been a difficult quarter for equities. Top-down fears dominated the period as macro-political risk, in the form of the Sovereign Debt crisis, broadened out to renewed fears of an economic double dip. Whilst there was clear evidence that the economic recovery is slowing, there was little balance in the market's response to data releases – the mindset of investors has switched back to all news being bad news. As a result, equity risk premiums moved upwards … and in general there was a move towards lower risk investments."*

Despite the quarter-end rally, history is broadly repeating itself with almost identical comments applicable to the most recent period. Equity markets have not been as weak as they were a year ago, but the same level of fear and focus on the negatives appears to prevail. A bull market in equities there is not, a bull market in pessimism there is. To quote Simon English from the Evening Standard last month "They say you spot a stock market bubble when you start getting tips from your waiter. So what does it mean when you are getting predictions of financial Armageddon from your taxi driver?" I suspect it means that we are close to another buying opportunity for equities in general and for those where risk premiums have increased over the last quarter.

## Market background

**Quarter:**

With a very late rally the UK equity market delivered a return of +1.9%. However, the cautious approach that dominated the quarter was reflected in the leader board, with investors favouring defensive sectors such as Utilities, Pharmaceuticals and Tobacco, and selling down riskier parts of the market, notably Banks, Resources and Builders. Smaller Companies proved to be reasonably defensive as the market fell, but did not really participate in the late rally. Factor returns again favoured Momentum over Value. Quality stocks did well, whereas Recovery and Asset Backed stocks did poorly. Bid activity continues to trend upwards.

## How did we perform and why?

**Quarter**:

We marginally outperformed the market returning 2.1%, a good return in the context of our underweight exposure to strongly performing defensives (**British American Tobacco**) and our overweight position in the weak banking sector (**Lloyds**). Our smaller company selection (**Scapa** and **Innovation Group**) and M&A activity (**Laird** and **Avis Europe**) did enough to more than offset these headwinds.

**Calendar Year:**

Performance over 2011 to date has been modestly behind the market (+2.3% for the Fund, +2.9% for the FTSE All-Share Index), a similar relative position to where we found ourselves at the halfway stage last year. Returns (as in 2010) have been dominated by top-down swings in sentiment and factor volatility, with stock specific selection actually positive.

**Longer Term Performance**

One year, two year, and three year returns are very strong, both in absolute and relative terms.

**Key performance contributors**

**Quarter:**

**Positive:** Takeover activity (**Laird, Avis**) and small company stock picking (**Scapa, Innovation Group, Anite, Spark Ventures**).

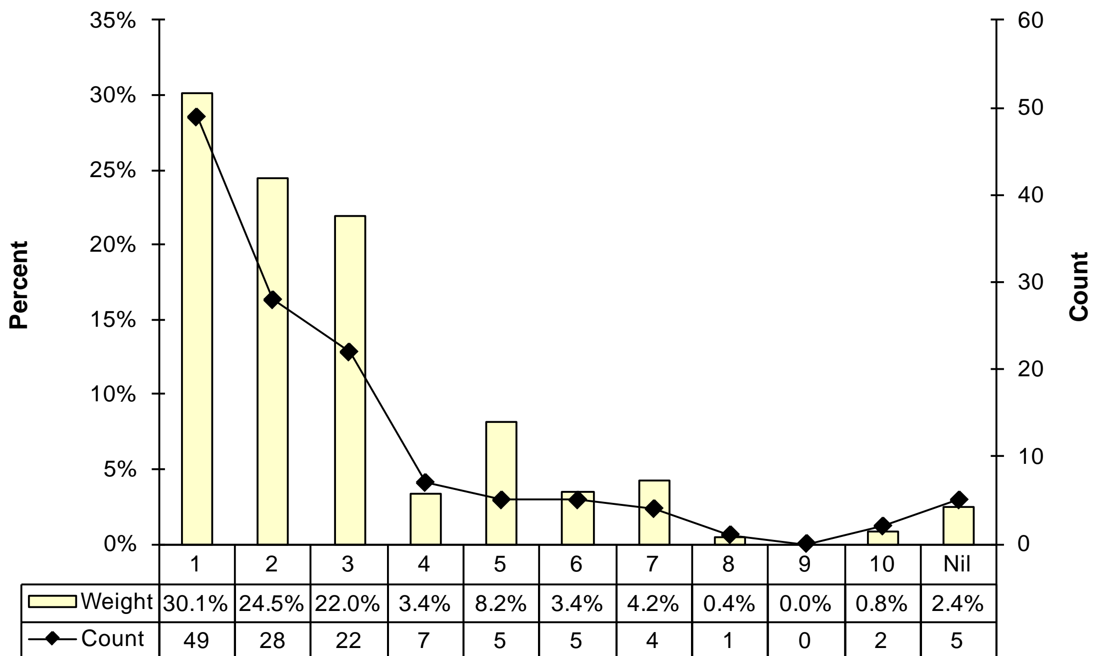
**Negative**: Underweight defensives (**BAT**), overweight UK banks (**Lloyds**), disappointing profit updates (**Wolfson**).

**Performance Outlook**

We are broadly comfortable with our performance in the first half of the year, to be only modestly below the benchmark return during a difficult period for Value and with our negative 'expensive defensives' stance. As risk appetite bounces back we would expect to return to adding value, in line with the pattern witnessed in the second half of last year.

**Does the portfolio reflect our philosophy and process?**

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




| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | Nil |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Weight | 30.1% | 24.5% | 22.0% | 3.4% | 8.2% | 3.4% | 4.2% | 0.4% | 0.0% | 0.8% | 2.4% |
| Count | 49 | 28 | 22 | 7 | 5 | 5 | 4 | 1 | 0 | 2 | 5 |

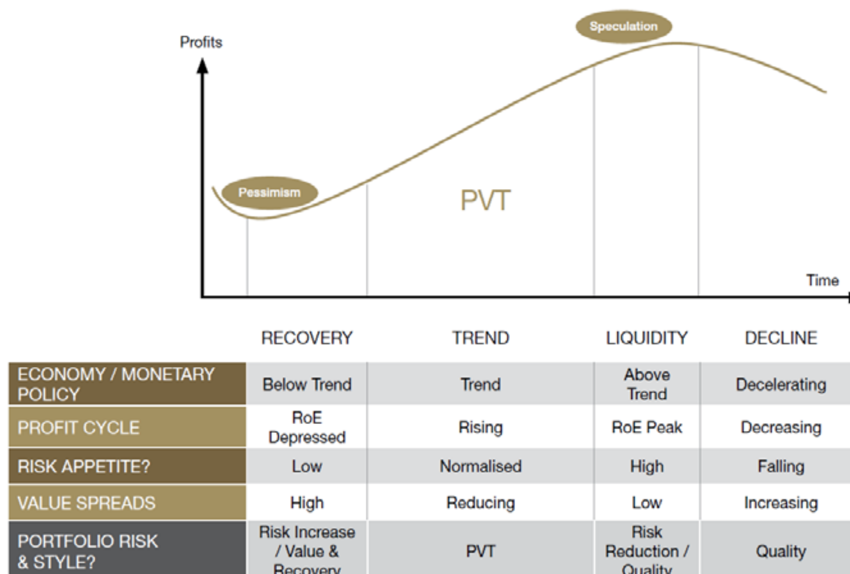
*Source: River and Mercantile Asset Management LLP*

Our category exposure is slowly evolving and becoming increasingly balanced in terms of allocation between our four categories. This is natural at this point in the cycle.

## What themes occupy us at the moment?

### 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 |

*Source: River and Mercantile Asset Management LLP*

We continue to believe we are in the trend phase of the cycle; whilst economic growth is moving through a dull patch, monetary policy remains highly accommodative and is not suggestive of a move back into recession; risk appetite remains muted; return on equity is mid-cycle, and the style and size cycles are supportive.

### 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 remains above average (running at over 10% in 2011) 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 through 2011 and into 2012, with the latter year seeing profits return towards previous peaks. The short term risk to profit growth mentioned last quarter, namely the oil price spike, has abated, but has been replaced by somewhat weaker nominal growth. At present this threatens the pace of growth but not the direction. Within the UK, growth in the domestic economy during 2011 will continue to be constrained by fiscal drag and inflation so profit growth in the UK economy will need to be self-help driven. 2012 should see an improvement in domestic conditions.

**Valuation** – absolute valuations are supportive with the UK equity market on modest multiples of profits (10.6x 2011 earnings), EBITDA and PB; valuations relative to government bonds have become increasingly attractive as bond yields have fallen this quarter. Equities have been materially de-rated this year, as a flat return for shares compares with price inflation of 5% and earnings growth in excess of 10%.

**Timing** – earnings revisions and share price technicals are neutral at the moment, but there remain a number of fundamental timing catalysts, including increasing M&A activity and falling corporate tax rates. In addition, short-term sentiment is becoming depressed and due a rally.

So, in summary the market PVT remains supportive, with the Valuation of UK Equities particularly compelling.

## Double-Dips

As I said this time last year, I am afraid I don't really know if we are going into a global 'double-dip' or not. I can say that I think it is unlikely (very, very loose monetary policy and private sector cash surplus feeding through into investment) but I can't be certain. However, what I can be certain about is that investment sentiment is now close to assuming a double-dip, just look at the papers and the performance of financially sensitive shares (**Lloyds Bank** has fallen 35% over the last six months). And if sentiment changes on this subject (and these days it seems to be sentiment, not reality, that dictates macro views) then one can be sure that all the stocks in my portfolio that are trading on discounts to book value will be off to the races.

## Value: Factor Performance

Value as a single factor has been really quite disappointing since the post-Armageddon Value rally in 2009. According to Collins Stewart, their Value factor (broad based metrics) has underperformed for 7 successive quarters at a time, when you might have expected cheap shares to do well. However, cheapness in isolation has not led to performance: it has had to be combined with earnings momentum (a strongly performing factor). Why has cheapness not worked? For a number of reasons: i) the short term nature of the market has been accentuated by the credit crunch, making investors reluctant to take positions in long term stores of value; ii) the importance of the banking sector within the universe of value stocks has acted as a drag, with banks struggling to move on from post credit-crunch worries; iii) mega caps, which are also over-represented in the Value universe, have struggled to perform in a market that has been hunting for superior growth; and iv) domestic Value stocks have struggled to get attention compared to their faster growing emerging market Growth stocks.

We have managed to perform over the last 18 months despite the travails of the Value factor; that said, we would do better if it came back into favour (**Lloyds**, where we have over 2.5% of your capital could double on a return to value), we have, of course, kept the faith and continue to have a clear skew towards value (on a sales and book value basis in particular, where we have 30% more Value than the market), and would note that Collins Stewart suggest that this is the longest streak of Value struggling since their records began, so probability would suggest a better period for Value ahead.

One reason for V doing better from here is the M&A cycle:

## M&A Activity

Bid activity is ticking-up and the portfolio was a direct beneficiary of this. **Avis Europe** has for some time been an obvious strategic target of the separately listed Avis business in the US - because of significant synergies in putting these two businesses together the latter were happy to pay a 65% premium.

Because companies are now more confident and generating a lot of cash which they would like to invest, we see them continuing to buy out their competitors, especially if there is a straightforward Value case to be made (i.e. relatively modest pre-bid price).

Many of the strategically valuable companies in my portfolio have become cheaper over the last six months and, therefore, even more attractive: **Lonmin** (irreplaceable position in platinum production) is trading close to its credit-crunch lows; **Cookson**, looking ridiculously cheap for a company with over 50% global market share in its key products (the Chinese must be thinking about this one), **Songbird,** which, through its Canary Wharf subsidiary owns a great and easy to manage chunk of London real estate (the Kuwaitis and Chinese are already investors). We have also bought into a number of new investments, partly because of their strategic value: **Sage**, top decile Quality but also has a strategically attractive position in supplying software to global SMEs; and **Millennium & Copthorne**, second decile Asset Backed which owns a global portfolio (Singapore, London, Taiwan, New York) of valuable hotels, and, as I write this (June 29), a bid for **Charter** has been announced from Melrose who are clearly a lot better at valuing Charter's global market positions in welding and air handling than the short-termist stock market!

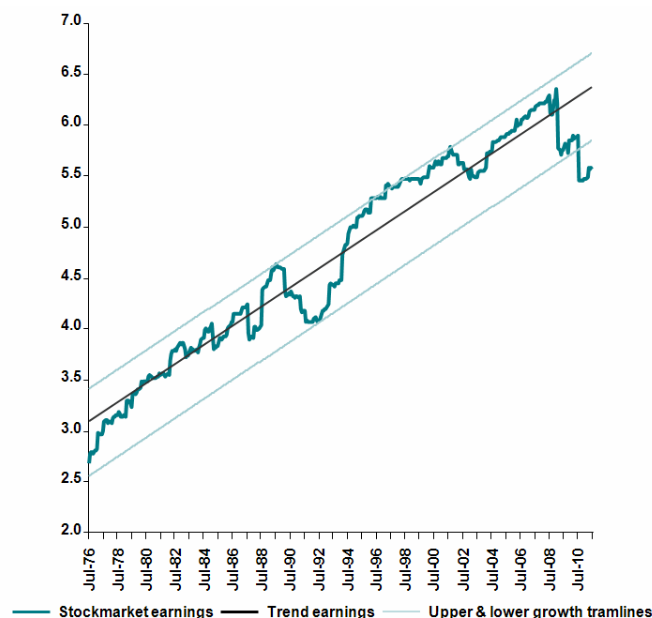
**Recovery Stocks**

We have come to a point in the cycle where we are not inclined to buy many new Recovery stocks. Whilst we are happy to add to existing Recovery investments on pull-backs the pool of new Recovery stocks are becoming lower quality (businesses), with more modest market shares than my existing holdings.

**Banks**

One existing area of Recovery investment that has yet to reward us is the banking sector. It has been very weak this year, led down by our favoured long term recovery franchise **Lloyds**. The pressure on bank shares has come from a number of sources: somewhat worsening medium term fundamentals as recovery profits have been reduced by a need to make the balance sheet more conservative (more equity, lower ratio of loans to deposits), shorter term hits to profitability from the need to aggressively impair assets, and ongoing pressure from the regulator and sovereign debt restructuring. This has driven share prices down to unsustainably low levels, in the case of Lloyds to a 30% discount to book value, which is crazy in the context of the very sensible business case outlined by the new Chief Executive, Antonio Horta-Osorio, just as the quarter closed; this will see Lloyds focus on its market leading UK franchise, grow the business in lower capital intensive areas such as protection and wealth management, reduce costs further, complete their balance sheet deleveraging without any further impact on their margins, strengthen their capital position beyond the demands of their regulator and all from internal cash flow and, most importantly, generate a return on equity of 12.5% to 14.5%, well above their cost of capital. For **Lloyds** the normalised EPS should be at least 8.5p, justifying a share price of double where it fell to during the quarter.

**UK Banking sector earnings versus trend**




*Source: Thomson Datastream, Evolution Securities*

## Portfolio Activity

Our activity this quarter has been quite different from previous periods when risk (uncertainty) has sold off. This is because small and mid-caps held up well during the more difficult market, with our smaller company stock selection continuing to be strong. As a result we have not been bottom-fishing in smaller companies and, indeed, have had a bias towards reducing our

exposure here. Where we have been buyers is amongst the laggards in the FTSE 100 Index, not just the banks (which are, on a risk-adjusted basis, as hated now as they were in Q1 2009), but Fund Managers (**Schroders**), Oil & Gas Exploration & Production (**BG**), Mining (**Lonmin**), Healthcare (**Smith & Nephew**), Food Retail (**Sainsbury**), Industrials (**Smiths Group**) and Indian Infrastructure (**Essar**). These purchases were funded from the above smaller companies, from taking profits in some defensive shares (**Tate & Lyle**), and from takeover activity (**Avis Europe**).

**New Investments (purchases)**

**Morgan Crucible** is a top-decile MoneyPenny Growth stock. It has global market leading positions in ceramic components for a range of industries, from which they should be able to drive above average top-line growth due to a combination of an attractive geographical spread, high spec products, and the ability to leverage their market position to grow share. In addition to attractive revenue growth, their margins can be increased significantly further from the 9.2% they delivered last year. The valuation remains supportive on a PEG basis and on 1x sales versus margins that should be sustainable in the low teens. The management have given themselves a target of doubling underlying profits by 2013, which would equate to 36p of EPS, which is attractive versus a share price of 300p. Timing is very strong with positive share price technicals, earnings momentum, and positive news flow from the company and their end markets.

We also started to build a position in **Axis Shield**, though patience is required here due to the shares' illiquidity. Despite having a strong market position in diagnostic tests, the company has struggled somewhat over the last few years as it has been at the investment stage in terms of new equipment and related tests. However, revenue and profits seem poised for an acceleration in growth, as their Afinion test platform now has a very large footprint and their new lipid test (for heart disease) appears to be a superior offering. The valuation has been depressed by historic under-delivery, with the shares trading 50% cheaper relative to their peers. A delivery of growth would lead to a material re-rating.

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

We topped-up a number of FTSE 100 Index laggards on the basis that short-term rotation, rather than a change in fundamentals, had impacted their share price and made them more attractively valued. This included **BG Group, Royal Dutch Shell**, **Smith & Nephew** and **Essar**.

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

We took profits in a number of our holdings that were subject to bid activity; we sold out of **Avis Europe** in its entirety with the shares trading very close to their agreed bid price; we sold about half our position in **Lookers** due to uncertainty regarding the intent of the bid consortium led by Treffick; and we took profits in a small part of our **Laird** position which has been trading above the preliminary offer price, though we do see this first bid as a sighting shot.

We also took profits in a number of strongly performing smaller companies where value gaps were becoming more modest. This included **Scapa**, **Hogg Robinson**, **Yule Catto** and **Anite.**

**Stocks we have cut (sale)**

We decided to exit from our position in **PV Crystalox**. Whilst this is a lowly valued stock with a strategic position in the production of the silicon for solar panels, it is clearly under profit pressure from a short-term fall-off in demand, just as Chinese production ramps up. With poor Timing support we felt our thesis had been undermined. We were fortunate in our timing, selling our stake earlier in the quarter before they announced a profit warning.

## Outlook

A key driver of performance over the balance of the year will be the relative returns of **Lloyds** (extreme Value) compared to **British American Tobacco** (expensive defensive). The chart below shows that Lloyds is almost back to its credit crunch lows – this is not a sustainable relative relationship from a fundamental medium-term outlook nor from relative valuation. I do not believe that the world is as bad a place as it was at the beginning of 2009 and, therefore, it is wrong for share prices to suggest that it is. The inevitable recovery of Value stocks such as Lloyds will benefit this portfolio.

**Lloyds vs. British American Tobacco:**

*Source: Bloomberg*

We will also benefit from a return to positive performance from the equity market. Shares have been de-rated over 2011 to date, significantly lagging inflation, as well as profit and cash growth at companies. As short term sovereign debt and economic slowdown worries peak, we anticipate the equity market playing catch-up with underlying earnings growth, suggesting a positive return of about 10% for the second half of the year. We would hope to do a bit better than that.

**Hugh Sergeant**
**Head of UK Equities**

#### A note on risk analysis data

We have invested in a change of risk analysis and performance attribution provider, moving from Style Research to FactSet. This has improved the risk and performance information that is available to us and our clients, and also allows us to customise our analysis so that it is reflective of our stock picking approach. The new system provides greater flexibility for both attribution and factor analysis. As a consequence of this change of provider, the basis of calculation of some of our risk analysis measures has changed as a consequence of using a shorter history that is more reflective of current market conditions.

## 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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