RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Income Fund I Quarterly Report
June 2011

River and Mercantile

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UK Equity Income Fund – Quarterly Report

Fund Aim

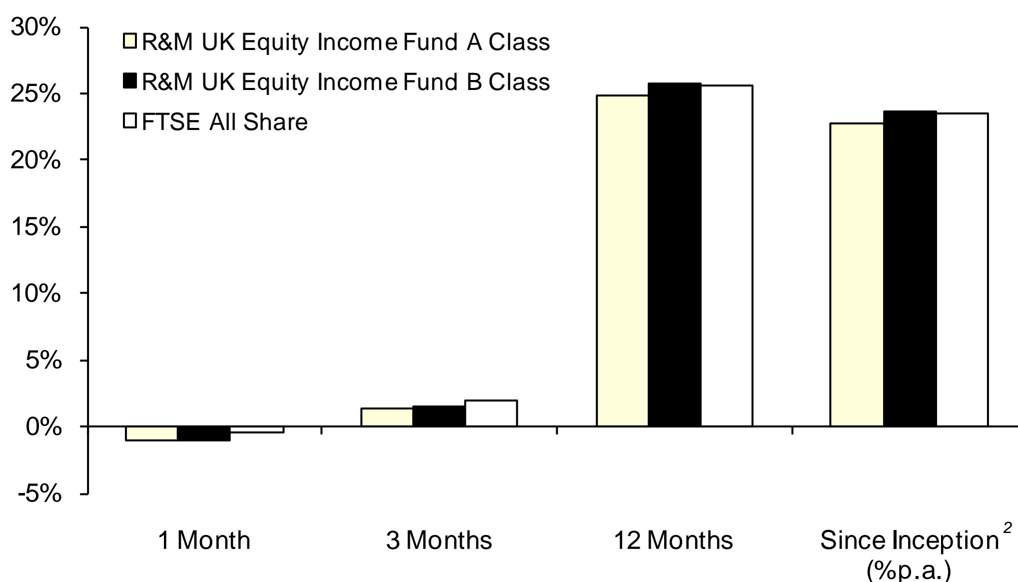
The investment objective of the Fund is to generate a rising level of income combined with the potential for capital growth through investing in a portfolio which will primarily consist of UK equities.

Portfolio Summary			Risk Analysis Summary	
Strategy AUM		£62.5m	Portfolio Volatility	12.52 %
Strategy Capacity		£1bn	Benchmark Volatility	15.19 %
Number of stocks		71	Tracking Error	3.91 %
Largest Holding	HSBC	7.32 %	Prospective Portfolio Yield[4]	4.00 %
Historic Yield[3]		4.03 %		

Performance to 30 June 2011

Retail "A" Class Shares	Fund[1]	Index*	Difference
1 Month	-1.07%	-0.45%	-0.62%
3 Months	1.38%	1.91%	-0.53%
12 Months	24.84%	25.63%	-0.79%
Since Inception[2] (%p.a.)	22.75%	23.56%	-0.81%

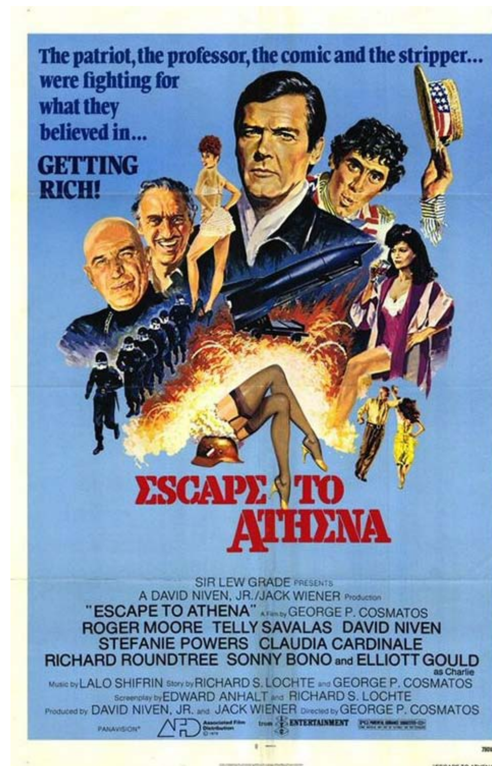
Asset Manager "B" Class Shares	Fund[1]	Index*	Difference
1 Month	-1.01%	-0.45%	-0.56%
3 Months	1.57%	1.91%	-0.34%
12 Months	25.77%	25.63%	0.14%
Since Inception[2] (%p.a.)	23.66%	23.56%	0.10%



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]Inception date 3 February 2009
[3]Yield based on the dividends paid in the preceding 12 months as a % of current price
[4]Yield based on current yield of the portfolio holdings

Market Overview

"*The patriot, the professor, the comic and the stripper...were fighting for what they believed in...getting rich!" Escape to Athena, 1979.*



Whilst the marketing strap line for the legendary film *Escape to Athena* appears to be an accurate description of the personalities that have managed the Greek economy for the last few years, I suspect that the sub-plot of this great film, in which Major Otto Hecht (played by Roger Moore) is secretly dispatching architectural treasures to his sister in Switzerland, transferring assets out of the country, has more resonance with recent market/economic trends escaping *from*, and not *to*, Athena. Significant editorial and market commentary has covered every aspect of the Greek financial crisis, yet it is the precedent (and its impact on Bank assets) any resolution may set for other larger over-indebted sovereigns in Europe which has clearly impacted risk appetite during the quarter. The absolute size of the Greek fiscal issues in the context of financial market assets, European Banking capitalisation or GDP, is relatively small.

It seems strange that markets had not already priced in the likely default which Greece needs, given their well known attitude to austerity, summed up by their greatest export to the UK, the Duke of Edinburgh, who celebrated his ninetieth birthday during the quarter. Commenting upon the Royal finances in 1969 he declared *"If we go into the red next year ... I shall probably have to give up polo*". I was not surprised to read that only five thousand people in a country of twelve million admitted earning more than £90,000 per year, but when you combine this terrible lack of tax revenue collection with public sector excesses such as a £500m wage bill for the national railways, but only £80m of ticket sales, one can see how significant reform is possible to eventually alleviate the country's running fiscal imbalance. The interest burden on the current capital amount of outstanding debt appears, at least, to overwhelm the medium-term effect of any fiscal restructuring and, therefore, the political and financial pain of a default should be accepted and not delayed any further without a temporary compromise.

Alongside Europe's sovereign-debt woes there were other developments to impede meaningful market progress. Leading Indicators (UK Bank of England, ECRI, and OECD) rolled over and, when combined with ongoing input cost pressures across a range of industries, analyst revisions broadly moved negative (apart from dividend expectations). In the UK, disposable income remains very weak for now, house prices flat, employment growth benign, and consumer confidence weak. Inflation remains higher than target and there were further tightening rounds across the globe, most noteworthy being at the ECB, but also further tightening in China and Australia. However, these countries' economies are strong, unlike the UK or US at the moment, where there appears, quite rightly, a limited desire to raise interest rates in either. Brighter signs of ongoing grinding recovery were highlighted by the continued expansionary indicators of the important ISM and IFO surveys.

The FTSE All-Share Index finished the quarter up 1.9%, but just less than 1.5% of this was gained on the last day of the quarter. Certainty, not cyclicality, was in demand during the quarter and Utilities, Pharmaceuticals, and Tobacco led the market. **Glencore**, the commodity marketing and mining concern which has benefited hugely from recovering commodity prices, joined the FTSE 100 Index via an IPO, enriching the employee-shareholders to levels unheard of in investment banking.

For this portfolio, based on the current market consensus dividend forecasts, the prospective yield is c.4.0%. This is attractive relative to other asset classes, the current UK equity market and its history. Distributions should grow, helping offset any inflationary impact on real returns. I remain positive on the outlook for the portfolio with holdings exhibiting strong balance sheets, improving profitability and low valuations.

Performance

The Fund underperformed during the quarter, rising 1.6%, lagging the FTSE All-Share Index by 0.3% but remaining ahead of the benchmark since inception. Performance against peers is first quartile since inception.

This was a frustrating quarter in relation to performance; stock selection attribution was weak relative to normal, whilst sector strategy was positive for performance. High conviction mega-cap investments **HSBC** and **Vodafone** both underperformed the market, whilst a number of 'defensive growth' holdings did not produce relative performances in line with stocks with similar attributes, for example; **Centrica** underperforming **National Grid**, or **Reed Elsevier** underperforming **Pearson**. The Fund ideally needed more sector risk invested in its positioning to generate higher returns. Whilst there were, as usual, a good number of 'winners' this quarter, there were too many individual disappointments which, in a nervous, low volume market environment, were treated harshly.

Sector positioning overall versus the benchmark was again positive during the quarter. Our underweight in Resources aided performance, as did our overweight in Healthcare, Consumer, and Support Services. However, the Fund is underweight Utilities and Tobacco which posted strong gains (e.g. **Imperial Tobacco**). Unfortunately, the benefits of being underweight Financials was more than offset by weak stock selection within the sector during the period. **Segro** has materially lagged the Real Estate majors, **Collins Stewart** has failed to attract market interest yet (only one sell-side analyst), and despite de-risking the Banks position in Q1 via a sale of **Barclays** and a reduction in the size of the **Lloyds** overweight, the performance of the stock has been far worse than expected, falling 16% to a P/B of 0.7x. FTSE 250 Index specialist financial positions such as **IG Group**, **Close Brothers**, **Intermediate Capital** and **Tullet Prebon** were all weak, and **Trading Emissions** has guided down expectations for the proceeds of its wind up. It now trades at a c.20% discount to estimated NAV (likely to be realised in the next 6 months). At a stock level, a number of small cap holdings disappointed on profits: Recovery stock **Keller**, where my thesis that their US construction activity had stabilised and their profit expectations were reasonable, was wrong, and therefore I have sold the position.

Wilmington's legal training business slowed in its final quarter of the year and its remaining print based products have been weak (over 70% of product is now digital). My thesis remains that the high quality of their returns, due to excellent niche markets, are substantially undervalued by the market; a further 21% fall has left them yielding over 6%. **Fiberweb** also fell 21% as raw material price pressure temporarily squeezes profitability, this effect will be partially mitigated by cost-cutting and eventually passed through in pricing. However, the market chooses to ignore both this and the stock's PE of 6.1x. Finally, **Wolfson Electronics** guided down revenue growth expectations to 10-20% for 2011. The market had wanted more, given their exposure to smartphones and tablets, however, to me this remains a very high growth rate and with a 50% gross profit margin and a cash rich balance sheet, it is only a matter of patience before profitability increases materially. All of the above small caps have considerable strategic value to competitors globally and, given ripe conditions for corporate activity, I am exercising particular care regarding fully exiting holdings where trading issues should prove short-lived given that I am preconditioned to reduce/sell if earnings momentum wanes.

There continued to be a good number of investment successes this quarter, the most notable being the takeover interest expressed by US company Cooper Industries in **Laird**, which rose 59%. Clearly *someone* is noticing UK small cap companies appear cheap and doing something about it. **RPC** continued upwards, rallying 29% with robust final results and signs that key input costs (unlike **Fiberweb**) are already actually easing for them. **Kcom** and **Anite** also continued to perform, up 30% and 21% respectively. New holdings established in the first quarter also delivered, giving me confidence that stock selection attribution should improve, such as **William Hill**, up 30%, **Inchcape**, up 22%, **Innovation Group**, up 40% and Interserve, up 22%. **GlaxoSmithKline** was a decent large-cap contributor to performance, rewarding the large active position in this holding.

I am confident, but not complacent, about the future performance outlook. Megacap positions such as **Vodafone** and **HSBC** look pregnant with alpha given their considerable value and likely significant dividend growth. A number of more defensive holdings should 'catch-up' with recent outperformers, whilst stock-selection should improve/normalise. The Fund was running ahead of the Index until the 'beta' rally of the last day of the quarter.

Philosophy & Process

During the quarter, stock selection decisions influenced the Category weightings with an increase in exposure to the Growth category, at the expense of the Recovery allocation. I have been comfortable switching capital into proven, steady, above average 'Growth' companies given the current 'soft patch' in macroeconomic momentum. Quality capital allocation remained steady and is still the largest part of the portfolio at 61.5%. The Recovery category weighting reduced by 4% to 21.5% of the portfolio (having peaked at 44% in April 2009) and is a mix of self help situations across a range of sectors. Growth has increased to 11.3%.

The skew to high scoring stocks as quantitatively measured by MoneyPenny our proprietary screening tool, has remained steady all year now, with over 70% of the Fund in the top four deciles. Our stock market cycle work 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.

Shortly we will be issuing the second edition of our UK Equity Philosophy and Process document (P&P), 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 to outperform over a reasonable time frame. 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 lifecycle, 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 lifecycle. 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

PVT opportunities:

A number of high conviction PVT opportunities were identified during the quarter:

FTSE 100 Index constituent **Royal Sun Alliance** is a high **Quality** company selling insurance around the globe with key operations in the UK, Canada, Scandinavia, and a growing emerging market presence. Under CEO Andy Haste, significant restructuring over a number of years has materially improved returns, whilst accelerating rate increases are helping improve profitability further. 2011 should deliver returns on tangible net assets of nearly 25%, whilst the valuation is on 1.9x Price/TNAV, and shares offer a rich dividend yield of c.6.8%. This position was partly funded by the successful sale of **Legal & General,** which has risen 109% since purchase at this Fund’s launch in February 2009. This contrasts with RSA whose share price has not increased since February 2009.

FTSE 250 Index constituent **IG Group** has delivered steady, above average, **Growth** in profits for a number of years through the increasing demand for professional spread-betting which, via strategic acquisitions and green-field start-ups, IG is now offering around the world. Their experience, scale, and market leadership has resulted in significant cash generation. Currently yielding c.4.7%, recent market volatility and ongoing overseas organic growth support further progress.

FTSE Small Cap Index constituent **LSL Property Services** has, relatively quietly, almost quadrupled its market share in UK valuation, surveys for housing transactions to c.40%. Market volumes remain very depressed, for now, but even at these levels LSL is decently profitable, generating high **Quality** returns. A strong balance sheet, low valuation and excellent long-term recovery prospects are highly attractive.

Sale of successful investments:

Some successful investments were exited during the quarter where I believe higher risk-adjusted upside is available elsewhere, and where the relative yield attractions have diminished. This quarter’s activity was dominated by the sale of economic cyclical holdings **Bodycote, Invensys** and **Wolseley**. All three have delivered high returns to the Fund. However, when purchased, these companies’ profits were depressed and market expectations of economic recovery were low. With economic data now mixed, after a significant profit recovery, and valuations much higher, I have de-risked exposures. Having purchased **Bodycote** at c.123p, the valuation anomaly has almost fully unwound and I have exited on average at c.379p, having receivied good dividends since launch of the Fund. **Invensys** has also provided strong capital gains, but with less income, rising from an average purchase price of 151p and sold at an average of 331p. Finally, **Wolseley** was sold, booking a c.32% gain over the last twelve months.

Within the Asset-backed category, **Land Securities** has produced a decent relative performance for the portfolio and delivered a steady stream of dividends; however, the scope

for NAV growth is higher at the smaller property company **Workspace**, which specialises in London based small business flexible working space, and the valuation is cheaper. As the capital city continues to provide the main source of economic resilience within the UK, and its property valuations benefit from overseas and other investment interest, Workspace has considerable development potential in conjunction with rental and occupancy improvement opportunities.

Anglo Pacific has been a strong investment for the Fund, rising 114% since purchase. The shares moved to a yield discount from a yield premium and, during the holding period, I switched the capital into **London Mining,** a c. £425m company with a range of projects across the globe, dominated currently by a significant iron ore project which is entering production in the second half of this year. Iron ore supply at a market level has failed to keep up with demand, with ongoing new supply delays, and thus prices have remained robust (unlike a number of other commodities such as copper, possibly because the iron ore market is less susceptible to financial market flows/influence). A 0.7% position has been established and the Fund should benefit either from the prodigious growth in cash flows expected from the company in the next few years, or from strategic interest in the company.

Purchase of selected UK Domestic Recovery exposed businesses

Overseas corporate earnings, for good reason, have been keenly sought after by investors since the financial crisis, as demand has bounced back stronger and quicker, de-leveraging 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 corporates, investors' capital should start to become more discerning. If relative earnings momentum were to wane, attentions may switch quite aggressively. During the quarter further predominantly domestically exposed companies were purchased for the portfolio, whose profit growth is clearly above average and which will eventually benefit strongly from any recovery in the UK.

In addition to **LSL** described earlier, **Marks & Spencers** and **Cineworld** have been purchased for the portfolio. My thesis is that significant 'self-help' is being executed at M&S under the new CEO Marc Bolland (ex-Morrisons) and his new senior management team and there exists an opportunity to improve profitability further at the group, which will be accentuated by an eventual improved UK consumer environment than the current one. The medium-term upside relies upon a further improvement in margins which will be delivered through a combination of supply-chain and logistical improvements/cost-savings, better sales densities via increased 'style', enhanced store environments, ongoing growth in the successful Food business, more international focus, and a realisation of their online potential. The valuation reflects past company disappointments, market sentiment to the UK consumer, and results in a PE of 10x and a yield of 4.6%. I'm not expecting fireworks as I am expecting a difficult current trading environment, but I also believe profits in three years time will be significantly higher than the last set of results, and higher than current market expectations.

The sale of investments due to weakening theses:

During the quarter our theses weakened markedly for three holdings and, as a result, I have sold and re-invested capital into higher conviction and higher scoring PVT stocks. **CSR**, whilst cash-rich and on a very depressed valuation, has failed to retain my faith that their Recovery Potential is coming through. Currently in merger talks with Zoran, the target has warned on profits during the transaction and overall industry data appears volatile**. Keller,** like CSR, appears to have strategic value within its industry sector; however, 'waiting for the inevitable bid' can be a painful process and is not part of our core Philosophy so I chose to exit after the business materially warned on profits, shortly after they suggested that the market was stable. **Tullet Prebon** has also had to guide down expectations and, without convincing Timing characteristics, again I have moved on. Frustrating, and disappointing as all three of these investments have been, one cannot linger when the latest data-point is worse than expected, the thesis appears materially challenged and new, strong PVT opportunities are presenting themselves.

Sector and size positioning

The FTSE 100 Index weighting has increased by 1% (having dropped c.4% in the last two quarters) to 63.3%. Exposure to the FTSE 250 Index has reduced by 3%, and exposure to Small Companies has grown to 15.6%. This will fall very shortly, as **Trading Emissions** is in the process of returning all capital to shareholders.

In relation to the 'Mega-caps' (the top twenty stocks in the UK market by capitalisation) the Fund weighting was 43.6% at the end of the quarter, a reduction of 1.2% and a large underweight of -14.2%. The Fund has no exposure to eight of these twenty companies. During the quarter the active underweight in **Royal Dutch Shell** increased further as capital was tactically allocated to **BG Group**, managing sector risk after relative weakness. Other than this there has been limited movement in this part of the portfolio, except modest increases to positions in relative outperformers **GlaxoSmithKline** and **Rio Tinto**, and reductions in **Unilever** and **BAT**. Additionally, I have used recent weakness to add gradually to **HSBC**, **Lloyds** and **Vodafone**.

The strategy continues to pursue limited sector risk versus the market, with the largest overweights at +3.9% and +3.5% still Media and Financial Services respectively. There has been some movement of sector rankings, though, with the purchase of **RSA** moving Non-life Insurance into third position at +2% and growth in the size of the General Retail and Pharmaceuticals overweights to +1.9% and +1.8%. The latter accompanies other, more defensive, sector overweights such as Food Producers, Telecommunications and Healthcare. The Support Services allocation has fallen due to the sale of **Mitie** and **Wolseley**. Overall, I remain overweight Technology stocks at +2.9%, but the sale of **CSR** has reduced this marginally. The top six underweight sector stances remain the same, led by Resource sectors and Banks, however the size of the Banks underweight has narrowed to -2.3% as mentioned above, partly funded by switching out of the buy-to-let lender **Paragon**, after a gain of c.56%.

'QE1' and 'QE2' have led to inevitable supportive commentary and money growth for 'hard asset' prices, yet the last scheme has now concluded, emerging market monetary tightening is accelerating and Chinese economic growth momentum is slowing. 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. The Fund's risk management framework will ensure the size of the current underweight is not excessive (-6.4%) if a final mania phase occurs before the ensuing downturn happens. Having written extensively on the sector thesis supporting this underweight position in last quarter's report (available on our website), I will only add that market commentary regarding the risks of a 'hard landing' has increased of late, there is clearer evidence of macro slowing (Chinese PMI data for instance), and government comments about "beating inflation" sit interestingly aside subsequent increased bank reserve-ratio requirements.

Portfolio Income

Thirty nine stocks went ex-dividend during the quarter, including thirty-two increases on 2010, three unchanged payouts, two falls (**BP** & **Shell**), one maiden (**CSF**, the Asian data-hosting company), and one return (**Inchcape**, the global car distributor returning to the dividend list now that profitability has recovered). It is worth noting that a good range of the Fund's holdings have materially increased their distributions on last year, such as **Legal & General** (Life Insurance, +25.3%), **Centrica** (Utilities, +14.4%), **Collins Stewart** (Financial Services, +30.7%), **Morrisons** (Food Retail, +17.5%), and **Kcom** (Telecommunications, +100%). **Vodafone** (+7.1%) and **HSBC** (+12.5%) managed respectable, yet more modest, increases, however, I am highly confident these two companies will provide patient shareholders with much higher distributions in the coming years. The Fund's current consensus based prospective yield of 4% is 114% of the market yield, and is greater than the yield from non

inflation linked income offered by ten year UK Gilts. Our analysis suggests that the Fund's underlying holdings are growing their distributions at c. 8.5% per annum on average; however, I suspect this will prove a conservative forecast given the rapidly recovering profitability of the companies, their low payout ratios, strong balance sheets, and robust cash generation.

Market & Fund Outlook

On balance, I believe the evidence suggests markets are in a classic mid-cycle 'soft-patch'. This 'cloudy' environment is creating reasonable levels of contradictory evidence, thus feeding 'bulls' and 'bears' and, at least to me, not providing any clear steer that the next 'major' move in markets will be either down or up. In this context, it is important to set one's risk budget accordingly, without biasing the portfolio performance outcome too heavily to one scenario or the other, and rely on stock-selection to enhance returns. It is at these points that I get great sustenance from our 'bottom-up' stock selection Philosophy, which continues to highlight attractive individual company investments in a range of sectors with different betas and risk profiles, but which all represent high Quality, Growth, Recovery or Asset Backed situations. Earnings revisions and price momentum continue to be rewarding factors, and, therefore, merit ongoing careful attention. However, Valuation seems to be an ongoing weak contributor to Alpha, out of synchronisation with longer-term trends. This is an opportunity in my view, and I remain committed to ensuring that, when this factor reasserts its long-term performance attributes, the Fund will benefit. In this context, painful as it may feel, consumer sectors and Banks offer strong Value characteristics and, thus, careful risk management of exposures is critical. Healthcare also offers Value in abundance, which has been less painful of late.

I would encourage clients to view the Fund through the 'lens' of *our* Philosophy of the different categories of potential and aggregate exposures to Potential, Valuation and Timing. To aid understanding of current positioning I will comment on the four main areas of interest for the market and portfolio, namely: Quality/Defensive Growth, Overseas Industrials versus Domestic Consumers, Financials, and Resources.

Quality/Defensive Growth

The backbone of the portfolio is invested in companies where ongoing improvement in profitability and returns on capital are likely. I am overweight Pharmaceuticals, with both **GlaxoSmithKline** and **AstraZeneca** amongst the largest active positions in the Fund. They are joined by global leader **Smith & Nephew** in Healthcare, an industry where M&A activity has been increasing. This is a sector where the issues and problems of the industry are well known, though the high returns are less lauded.

In addition, a range of consumer-facing global franchises also offer great Potential such as **Unilever**, **British American Tobacco** and **Diageo,** where recent share price performances have been good. However, a number of the Fund's 'low risk' steady investments have yet to deliver 'defensive' relative performance in 2011 and, as a result, I expect strong returns in the future. These include **BAE Systems** yielding 5.9%, **Sainsbury's** yielding 4.9%, (both of these have grown EPS each year from 2005-2010), **Centrica** yielding 4.8%, **Vodafone** yielding 5.8% and **Reed Elsevier** 3.9%. The risk to the cash flows and dividend streams of all of the above companies appear materially undervalued (especially when compared to Gilts), given their likely growth rates.

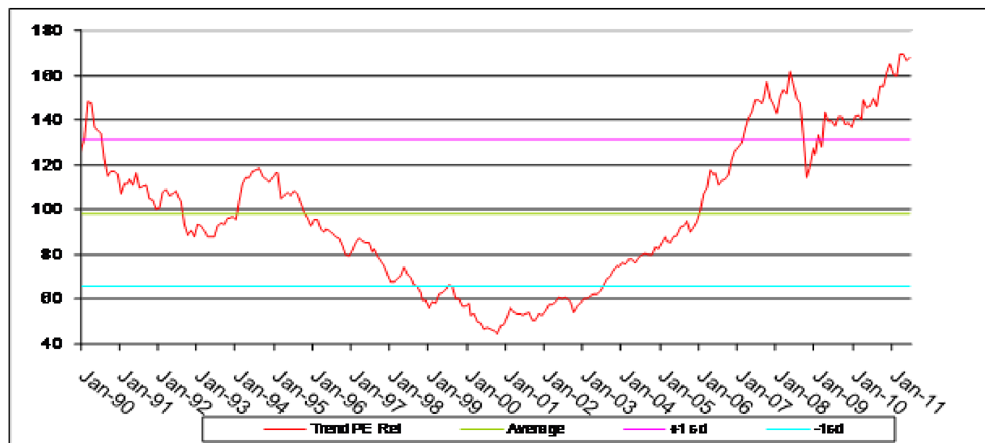
Overseas Industrials vs Domestic Consumers

From a FTSE All-Share Index perspective, the sectors representing these two areas are relatively small. However, as with this portfolio, a far greater percentage of performance in the last couple of years has been accrued in overseas, recovering industrials. The Fund has enjoyed material success in this area, however, I have now sold all engineering and electronics holdings except for **Melrose** and **Laird**. The latter, as referred to above, has received takeover interest and (given other takeover activity, e.g. **Charter**) missing out on takeover premiums in these sectors is a key risk to this change in stance. **Charter** did actually warn on profits prior to the bid approach and there have been a few other disappointing

updates from a number of Industrial stocks in Europe emerging. Investors have not had to deal with this for some time, a situation diametrically opposite to consumer stocks, where trading performances have been battling headwinds for some time.

Valuations of Industrials appear stretched and the relative confidence of Industrials versus Consumers even more so:

Industrial Engineering Sector Trend Valuation



EU: Industrials' "excess confidence", 1985 - 2011

Source: Mirabaud Securities

I have been encouraged by the relative performances of the first few conviction positions in consumer areas such as **Kingfisher**, **William Hill**, **Inchcape**, and **Morrisons,** and have added new positions as detailed above.

Financials

Financials make up, and will continue to make up, a very significant part of economic activity and market capitalisation. The Fund holds an eclectic mix of specialist Financials stocks with strong PVT credentials, and is focused on risk management in the large Banks and Insurance sectors when there is a paucity of PV *and* T opportunities.

The threat to financial stability that the financial system represented in 2007 is long behind us. Financial risk now lies in the pricing and valuation of sovereign debt instruments. The banks that failed, and the 'shadow' banking system that represented most of the problems, are long

gone. The surviving banks have raised equity of nearly £150bn, termed out their funding structures, shrunk material concentration risks, written off a huge amount of problem loans and now, on average, have 3x the liquidity. Risks remain, given that some European Banks have too much exposure to the 'PIGS' and that over-regulation further impacts future profitability and growth. Valuations are almost back to all time lows, though, and in the Fund's two holdings of banks, **HSBC** and **Lloyds**, credible, medium-term strategies and financial objectives have been put in place that seem destined to 'over-delivery' in the medium term. The leverage in the financial sector is less now than pre-crisis, but is still higher than any other sectors, resulting in the ongoing weak sentiment and 'fear'. I remain underweight in both Banking and Life Insurance sectors, however, at this point cannot justify an extreme underweight position (as in Mining), given the low valuations, huge profit, dividend recovery prospects, and management changes experienced. Separately, the future for returns, growth, profits and dividends at **IG Group**, **Close Brothers**, **Intermediate Capital** and **Collins Stewart Hawkpoint** look attractive and the valuations even more so.

Resources

The last quarterly report highlighted my view on this area in great detail. To summarise my stock positioning, though, I remain overweight **BP**, as the valuation appears to reflect a reasonable probability of 'gross negligence' in respect of the Macondo incident. Recent settlements with BP by Mitsui and Weatherford suggest this is not the case. I am underweight the other mega-caps, **BG Group** and **Royal Dutch Shell**. However, following strong attribution from this stance in **BG Group**, I have recently closed the extent of the underweight for risk management purposes. Subsequently, the company has revised up its reserve estimates for its Brazilian acreage, suggesting that the growth that has sustained **BG's** premium rating for many years is more likely to continue than peter out. Even higher production growths on much lower valuations are available in **Salamander Energy** and **Afren**, and these are high conviction Growth theses in the mid-cap arena.

In mining, I am biased to iron ore and strong balance sheets; I have a large sector underweight overall and own **Rio Tinto**, **BHP Billiton**, and the new small holding, **London Mining**.

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 highly liquid securities with strong balance sheets in a deep, broad, and attractively valued UK equity market which has significant profitability generated overseas. The Fund remains focused on achieving an above-average income from UK equities, and a Total Return ahead of the market with active risk control at a sector and size level.

Richard Staveley
Portfolio Manager

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	3 Feb 2009
Fund manager:	Richard Staveley
IMA sector:	UK Equity Income
Benchmark:	FTSE All-Share (Total Return)
XD dates:	1 April & 1 October
Dividend/Accumulation payment date:	31 May and 30 Nov
Product capacity:	£1 bn (pooled & segregated)

Share class:	A	B
Launch price (shares):	100.00p	250.00p
Share classification:	Retail	Institutional
Type of shares:	Income	Income
Fund charges:		
Annual	1.50%	0.75%
Initial (up to)	5.25%	5.25%
Minimum investment		
Initial	£1,000	£2.5 million
Subsequent	£500	£25,000
Sedol	B3KQG33	B3KQG44
ISIN	GB00B3KQG330	GB00B3KQG447
Bloomberg	RMUKEIA	RMUKEIB

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