RIVER AND MERCANTILE
ASSET MANAGEMENT

# UK Equity Long Term Recovery Fund I Quarterly Report
June 2011

# River and Mercantile

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## UK Equity Long Term Recovery Fund – Quarterly Report

### Fund Aim

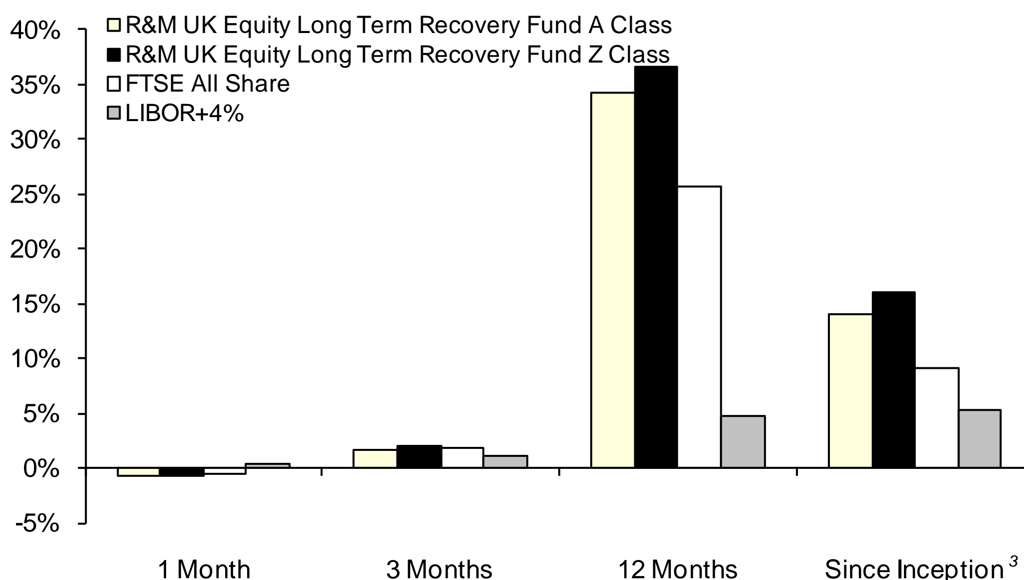
The investment objective of the Fund is to achieve capital growth through investing in a portfolio which will primarily consist of UK equities that meet the manager's recovery criteria of a turnaround in company profitability over the longer term. The Fund will not be restricted by reference to a benchmark, sector constraints or company size.

| Portfolio Summary | | | Risk Analysis Summary | |
|---|---|---|---|---|
| Strategy AUM | | £97.5m | Portfolio Volatility | 14.22 |
| Strategy Capacity | | £200m | Earnings Yield | 3.72 |
| Number of stocks | | 190 | Dividend Yield | 1.56 |
| Largest Holding | Rio Tinto | 3.78 % | Price to Sales | 0.81 |
| Average return to medium-term recovery value | | 52% | Price to Book | 1.27 |

### Performance to 30 June 2011

| Retail "A" Class Shares | Fund[1] | FTSE All Share | Difference | *LIBOR+4* |
|---|---|---|---|---|
| 1 Month | -0.80% | -0.45% | -0.35% | *0.38%* |
| 3 Months | 1.59% | 1.91% | -0.32% | *1.15%* |
| 12 Months | 34.22% | 25.63% | 8.59% | *4.66%* |
| Since Inception[3] (p.a.) | 14.03% | 9.13% | 4.90% | *5.31%* |

| Inst'l "Z" Class Shares | Fund[2] | FTSE All Share | Difference | *LIBOR+4* |
|---|---|---|---|---|
| 1 Month | -0.65% | -0.45% | -0.20% | *0.38%* |
| 3 Months | 2.03% | 1.91% | 0.12% | *1.15%* |
| 12 Months | 36.59% | 25.63% | 10.96% | *4.66%* |
| Since Inception[3] (p.a.) | 16.03% | 9.13% | 6.90% | *5.31%* |




*Source: River and Mercantile Asset Management LLP*
*[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 17 July 2008*

## 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 very 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 has broadly repeated 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 and Growth stocks did well, whereas Recovery and Asset Backed stock did poorly. Bid activity continues to trend upwards.

### How did we perform and why?

**Quarter**:

We marginally outperformed the market and LIBOR, returning 2.0%, 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, Cupid** and **Innovation Group**), non-UK holdings (**Rediff** and **Sky Deutschland**) and M&A activity (**Laird** and **Avis Europe**) did just enough to offset these headwinds.

**Calendar Year:**

Performance over 2011 to date has been ahead of the market and LIBOR Index (+5.0% for the Fund, for the +3.0% FTSE All-Share Index), a strong performance given the cautious market background and the poor performance of the biggest Value anomaly in the market, namely Banks. Our smaller company stock selection and non-UK positions helped deliver this robust performance.

**Longer Term Performance**

One year, two year, and since inception returns are strong, both in absolute and relative terms.

**Key performance contributors**

**Quarter:**

**Positive:** Small company stock picking (**Scapa, Cupid, Xaar**), non-UK holdings (**Rediff, Affymetrix**) and takeover activity (**Laird, Avis, Smartfocus**)

**Negative**: Underweight defensives (**BAT**), overweight UK banks (**Lloyds**), disappointing profit updates (**Wolfson, TomTom**), liquidity based risk aversion (**Synchronica**).

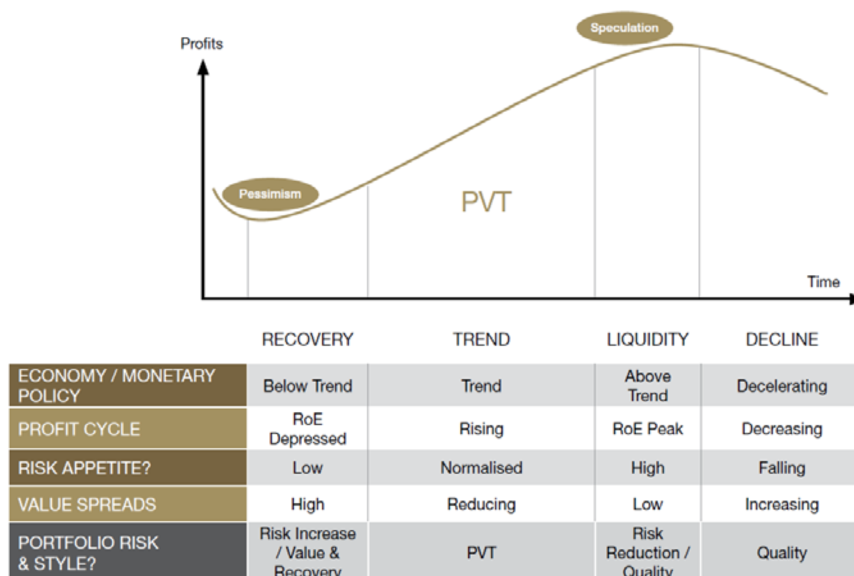
**Performance Outlook**

We are comfortable with our performance in the first half of the year, to be ahead of benchmark returns during a difficult period for Value and 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.

**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 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 now 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 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 3% 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 shares 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); 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 / Category Exposure**

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.

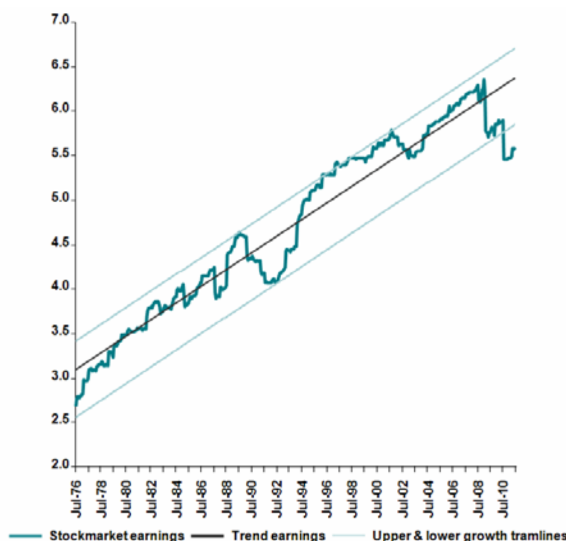
As a result of this our category exposure is slowly evolving, becoming more balanced in terms of allocation between our four categories, with Recovery exposure still the highest, but reducing (to 41%) while Growth (22%) and Asset Backed (16%) increase. This is natural at this point in the cycle.

It should be mentioned that the flexibility to invest outside of the London market does allow us to find other sources of recovery – and one such area we are spending quite a lot of time on at the moment, and have made some small initial investments, is in Chinese smaller companies, many of which have been sold off aggressively on the back of bear-raids on companies such as Sino-Forest. We are looking to identify the 'babies that have been thrown out with the bath water', a worthwhile task given that many of these companies are trading on low single figure multiples of earnings and have, at least historically, produced strong shareholder value growth.

**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. Where we have been buying is amongst the laggards in the FTSE100 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 (**Anglos**), and Indian Infrastructure (**Essar**). These purchases were funded from smaller companies, from taking profits in some defensive shares (**Tate & Lyle**), and from takeover activity (**Avis Europe, Smartfocus**).

**New Investments (purchases)**

We built an initial position in **Axis Shield.** 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 test 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 lipids test (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.

As part of increasing our Growth Category allocation we invested more capital in our favoured area of online franchises. Far from being a bubble, there remain many attractive digital franchises, which are still immature and on relatively modest Valuations compared to their medium term growth potential. Purchases here included **Cupid**, the UK based international online dating franchise which is growing very strongly through brand and regional expansion, and was modestly valued at the time of purchase (12x 2011 earnings).

Other new investments were quite thematic in nature: for example, we like the emerging Growth market of machine-to-machine (M2M) communication, the technology which allows devices to communicate with each other (i.e. fridge needs restocking with cokes). This market has been a bit slow to fulfil its potential, resulting in attractive valuations on two of the main players in this market (**Telit** and **Calamp Corp**, trading at less than 1x sales), which we have bought for the Fund - both these companies are starting to see increasing market traction for their products.

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

We topped-up a number of large cap laggards on the basis that short-term rotation, rather than a change in fundamentals, had impacted their share prices and made them more attractively valued. This included **BG Group, BP** and **ebay** in the US, the latter for its exposure to **PayPal,** a category killer in the field of digital payments and money transfers.

**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 also sold out of **Lookers, Ideal Shopping** and **Smartfocus** for the same reasons, 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** and **Yule Catto**.

**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, and 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**

## Fund Facts

| | |
|---|---|
| Launch date | 17 July 2008 |
| Fund manager: | Hugh Sergeant |
| IMA sector: | UK All Companies |
| Benchmark: | LIBOR Overnight Cash Rate |
| Tracking error range: | N/A |
| Product capacity: | £200m (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 | Income | Accumulation |
| Fund charges: | | | |
| Annual | 1.75% | 1.00% | 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 | B1YHLP5 | B614J05 | B1YJFW6 |
| ISIN | GB00B1YHLP55 | GB00B614J053 | GB00B1YJFW60 |
| Bloomberg | RMUKELA LN | RMUKEBBLN | RMUKELB LN |

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