RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Smaller Companies Fund I Quarterly Report
June 2011

River and Mercantile

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UK Equity Smaller Companies Fund – Quarterly Report

Fund Aim

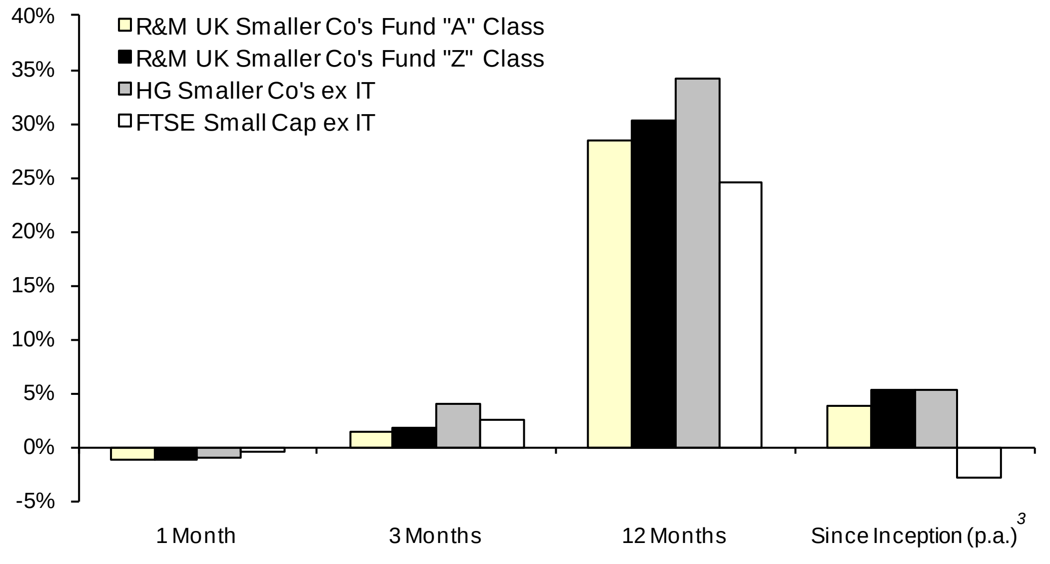
The investment objective of the Fund is to achieve capital growth through investing in a portfolio of investments which shall primarily consist of UK equities which reside in the bottom 10% of the UK stock market in terms of market capitalisation.

Portfolio Summary			Risk Analysis Summary	
Strategy AUM		£36.3m	Portfolio Volatility	9.55 %
Strategy Capacity		£400m	Benchmark Volatility	11.60 %
Number of stocks		84	Tracking Error	5.04 %
Largest Holding	Innovation	2.24 %	Active Money	81.30 %

Performance to 30 June 2011

Retail “A” Class Shares	Fund[1]	HG Index*	Difference	*FTSE Small Cap (ex IT)*
1 Month	-1.24%	-1.03%	-0.21%	*-0.40%*
3 Months	1.30%	4.04%	-2.74%	*2.44%*
12 Months	28.36%	34.24%	-5.88%	*24.56%*
Since Inception[3] (%p.a.)	3.73%	5.24%	-1.51%	*-2.95%*

Inst’l “Z” Class Shares	Fund[2]	HG Index*	Difference	*FTSE Small Cap (ex IT)*
1 Month	-1.12%	-1.03%	-0.09%	*-0.40%*
3 Months	1.68%	4.04%	-2.36%	*2.44%*
12 Months	30.29%	34.24%	-3.95%	*24.56%*
Since Inception[3] (p.a.)	5.23%	5.24%	-0.01%	*-2.95%*



Source: River and Mercantile Asset Management LLP
**Index: Hoare Govett Smaller Companies ex IT*
[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 30 November 2006

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. The Hoare-Govett Small Companies (ex IT) Index rose 4.0% with the FTSE Small Cap Index continuing to lag, up 2.4%. Certainty, not cyclicality, was in demand in the FTSE 100 during the quarter with Utilities, Pharmaceuticals, and Tobacco leading the large cap market. In stark contrast in the Hoare-Govett Index, Industrials, Mining, Financials, and House builders led the performance tables. The portfolio is much more cautiously positioned, given material risks to the profit cycle in all of the above sectors, and in many cases stretched valuations. These underweights, combined with a small number of disappointments in some larger Fund positions, made for a difficult quarter. However, I remain positive on the outlook for the portfolio with holdings exhibiting strong balance sheets, improving profitability, very low valuations, and conviction that current sector positioning is prudent.

Performance

The Fund lagged the benchmark Hoare-Govett Index by 2.3%, and the FTSE Small Cap Index by 0.8%. The majority of underperformance was experienced in April.

Sector positioning overall verses the benchmark was positive during the quarter, held back by the overweight in Oil & Gas, with stock selection causing the majority of underperformance. There were four main stock disappointments (**Keller, Wilmington, Wolfson Microelectronics,** and **Gulfsands Petroleum**) whilst **Fiberweb** (input cost pressures), **Topps Tiles** (retail sentiment), and **Advanced Medical Solutions** (unwind quarter one performance) were larger holdings that were generally weak during the period without updating the market materially negatively. Four large unheld benchmark constituents (**Sports Direct, Berkeley, Misys** and **Kenmare Resources**) contributed almost 1% of the underperformance.

Of the main disappointments, Keller's stock thesis appears incorrect as US trading conditions have not stabilised and, therefore, the position has been substantially sold down. **Wilmington** and **Wolfson**, on the other hand, still retain strong Potential (Wilmington through their high returning niche's in professional training and publishing, and **Wolfson** through their ongoing well above average, growth rate). With conditions ripe for increased corporate activity, great care must be taken not to fully exit positions on weak trading updates for reasons that should prove temporary, particularly when (as is the case with both these companies) they have considerable strategic value to a range of competitors. **Gulfsands Petroleum** has suffered as its main operations are in Syria, where the market is clearly re-appraising the price of, and amount of, political risk. Any regime change is unlikely to materially change the fiscal conditions/ownership rights, in my view, given a wide range of foreign governmental and multi-national company investments in this important industry sector that requires foreign capital and expertise to develop.

On the positive side, positions in a range of sectors performed very well including **Hogg Robinson** (corporate travel services) and **RPC** (Rigid Plastic Containers), rising a further 18% and 29% respectively during the period, issuing robust final results. **Innovation Group**, a top five Fund active position, rose 40% with a slew of contract wins. Telecommunications holdings provided excellent returns with **Alternative Networks** up 27%, **Kcom**, up 30%, and **Daisy**, up 36%. The undervaluation of long held **Laird** was finally recognised by US corporate Cooper Industries, indicating takeover interest, and sending the shares up 52%. First quarter investment **Interserve** announced further positive trading results and rose 23%.

There is no doubt that, so far in 2011, the Fund has experienced too high a level of disappointing trading updates which have been treated harshly by the market. In the vast majority of instances I have sold and moved on to higher conviction PVT investment ideas generated by the team here at River and Mercantile. For now my caution on the relative overvaluation of FTSE 250 Index stocks versus smaller capitalisation is not being rewarded and, in particular, no benefit has yet accrued from selling down Industrial holdings, where valuations and profits are over extended. However, I am confident, and definitely not complacent, about the future performance prospects for the Fund, particularly given discipline on valuation which will eventually be rewarded.

Philosophy & Process

There remains good diversification between Category weightings in the portfolio. Quality has grown to 31.1% of the Fund (largest allocation), with capital allocated to Growth slightly up to 27.7%, both at the expense of Recovery, which has reduced to 26.6%. Asset-Backed situations represent 13% of the Fund. Our stockmarket 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 across Categories. However, recent weakness is some lead-indicators makes me reluctant to grow the Recovery weighting any higher at his stage. The skew to high scoring stocks, as quantitatively measured by MoneyPenny, our proprietary screening tool, has improved during the quarter with an increase to 71% in the top four deciles. The Value factor, a key component of our Philosophy, continues to remain out of synchronisation with the longer term outperformance of the factor. I remain focused on ensuring the portfolio benefits strongly when this reverts back to trend.

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

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

Seven new UK focused stocks have been purchased during the second quarter, all have strong franchises, and are significantly undervalued, whilst appearing to have stabilised trading in a very difficult UK consumer environment.

STV (ITV in Scotland) grew profits 57% in 2010, improving margins to 12.9% in this regional media group, which will continue to benefit from improving advertising conditions, helping reduce debt levels. The shares are currently valued on a PE 3.5x, EV/EBITDA 5x and is top decile **Recovery**.

LSL also grew its profit materially, by 52% in 2010, improving margins to 19.3%. It 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 top decile **Quality** improving returns. A strong balance sheet, PE of 10.5x, and excellent long-term recovery prospects are highly attractive.

Workspace, second decile **Asset-Backed**, which specialises in London-based, small business, flexible, working space grew trading profits by 31% in 2010, increasing their NAV by 10%. 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.

Trinity Mirror is a thoroughly hated equity; this is despite increasing profits by 17% in 2010, improving margins to 16.2%. Despite huge ongoing (but structurally challenged) cash generation, the market refuses to value the business at more than 2-3 years of cash flow, with a PE of 2x, Ev/Ebitda 2.8x. The advertising audience remains considerable, and industry consolidation which would create a lot of value is unavoidable. It is second decile **Recovery**.

Vertu Motors increased its profits by 22% in 2010, growing tangible net assets by 7.5% to 40.1p, to which the shares trade at a 22% discount. It has, relatively quietly, developed a material industry position in car distribution in the UK. Extremely well run, as demonstrated by reported operational, financial, and KPI metrics, the balance sheet is well placed to further grow its scale and returns, benefiting from economies of scale through acquisition. Currently valued at 9.8x PE, 3.9x EV/EBITDA.

Cineworld is the UK market leader in cinemas with 26.2% market share. Stable but growing, revenues should start to accelerate in H2 as a number of profit drivers from on screen advertising to improving release schedules should increase profit growth and returns on capital given high operational gearing. A PE of 10.3x and dividend yield of 5.7% are again attractive.

Speedy Hire, the equipment rental business, offers very strong **Recovery** potential (top decile). The latest results indicate a move from losses, into a break-even situation, with portfolio restructuring being the catalyst for the Fund's purchase when the sale of the Accommodation Hire business reduced Debt/EBITDA to a pro-forma 1.3x, and removed a loss-making burden on the group. An imminent re-financing of the businesses debt facilities, and a normalisation of margins, should create significant outperformance given an EV/Ebitda of 4x.

Other PVT opportunities

During the quarter a range of other investment opportunities emerged, namely: **Novae** (Lloyds Underwriter, demonstrating materially improved returns, yet trading on 0.8x book value, a significant discount to the sector); **Ultra Electronics** (Defence Electronics, a well established international business formed from a number of added value niches where concerns over overall defence spending have caused a de-rating for this very high quality business); **Atkins**, the leading engineering consultant, adversely affected by UK public sector cut-backs but also exposed to strongly recovering international markets, and fast growing energy sectors, valued on 10.2x PE; **Immunodiagnostic Systems**, a fast growing medical diagnostics business, where placement growth of its relatively new machine has real traction (in the US and Europe) due to key intellectual property in Vitamin B12 testing. Expectations have consistently been too cautious.

Sales

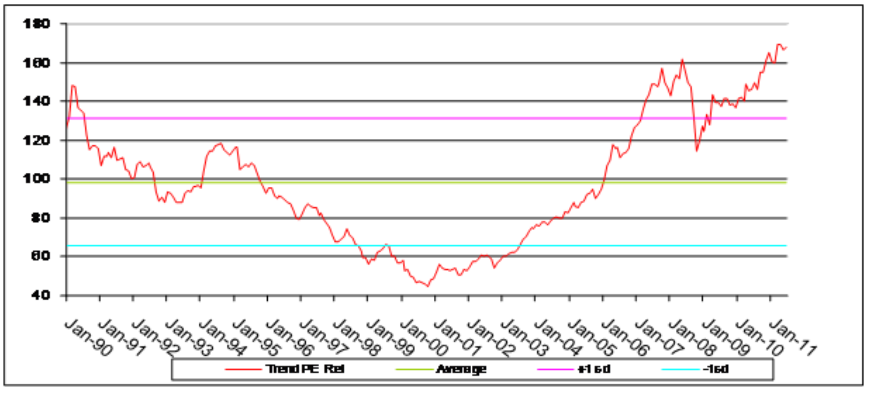
A number of holdings experienced deteriorating **Timing** credentials during the quarter and have been sold: **Mitie's** growth rate appears under threat, given the austerity environment in the UK, and there is growing concern over the outlook for margins. **Valliant Petroleum,** having demonstrated little in the way of success from the drill-bit since listing was further impacted by the negative change to fiscal terms in the North Sea. **PV Crystalox** was sold after a simply terrible meeting their with management; the shares have fallen over 50% since.

The remainder of positions exited during the quarter have all been highly successful investments, where market expectations now appear stretched, have a decent element of economic cyclicality (and thus risk) to their returns, and where the valuation anomaly has almost fully unwound, or is relatively unattractive when compared with the stocks purchased above. Sales included **Bodycote** (Recovery, Industrial Engineering), **Filtrona** (Quality, General Industrial), **Lamprell** (Growth, Oil Services) and **Spirent** (Quality, Technology)

Sector and size positioning

There were a few changes to sector positioning during the quarter, the largest overweight remaining the diverse support services sector at +5.7%, 17.4% of the portfolio. Technology is +6.6% at 15% of the portfolio. The only significant change to overweight stances has been a 3% increase and move to second highest active position in Media, where relative valuations appear attractive, advertising outlooks should steadily improve, and underlying returns on capital are broadly high. Key underweight sectors remain the same, however, capital allocated to Industrial sectors has fallen further (Engineering, Electronics & Electrical Equipment, Chemicals and General Industrials) from 8.7% at the start of the year to 4.8% at the end of the first quarter and is now 2.8%, an underweight stance of 6.3%. Whilst top-line growth should continue, margins in most of these clearly cyclical companies in these areas have reached prior peaks, or are expected to improve further and earnings momentum in 2010 has been accompanied by valuation re-ratings.

Industrial Engineering Sector Trend Valuation



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

Source: Mirabaud Securities

Domestic consumer sectors still have low relative weightings in the portfolio (Retail -4.5%, Travel & Leisure -4.3%, and Housebuilders has widened since Q1 to -3.5% following profit-taking in **Persimmon** and **Barratt Developments** on surprisingly strong relative outperformance during year-to-date). Mining shares remain a small part (4.4%) of the portfolio. Other smaller changes, cumulatively 'defensive' in nature, but all as a result of bottom-up stock selection decisions, include a move to neutral in Aerospace & Defence, a move overweight in Non-life Insurance, and a move underweight in Construction. The Fund remains significantly underweight FTSE 250 Index stocks in relation to the make-up of the Hoare Govett Index, with 35.2% of portfolio capital in mid-caps versus 74% of the benchmark. AIM holdings account for 23% of the Fund represented by a wide range of Healthcare, Technology, Telecommunications, and Service company investments.

Market Outlook

The Fund is built via a bottom-up stock selection process based upon our PVT philosophy. I have high conviction in the holdings, which represent a diverse mix of high Quality, Growth, Recovery, and Asset-Backed names, with attractive Valuation credentials and positive Timing attributes. They are generally liquid securities with strong balance sheets in a broad, and attractively, valued UK Small Cap equity market, which has significant profitability generated overseas. The UK Small Cap market has a significant number of domestically focused businesses, and is underweight (apart from AIM) in the Resources sectors, relative to the FTSE 100 Index. A loss of confidence in the outlook for China's growth, and falls in commodity prices, could, and should, lead to relative outperformance.

Richard Staveley
Portfolio Manager

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	30 Nov 2006
Fund manager:	Richard Staveley
IMA sector:	UK Smaller Companies
Benchmark:	HG Smaller Companies ex-IT
Tracking error range:	4-10%
Product capacity:	£400m (pooled & segregated)
XD dates:	1 April & 1 October
Dividend/Accumulation payment date:	31 May and 30 Nov

Share class:	A	Z
Launch price (shares):	100.00p	500.00p
Share classification:	Retail	Institutional
Type of shares:	Income	Accumulation
Fund charges:		
Annual	1.50%	0.00%*
Initial (up to)	5.25%	5.25%
*AMC charged outside the Fund		
Minimum investment		
Initial	£1,000	£5 million
Subsequent	£500	£50,000
Sedol	B1DSZR9	B1DSZS0
ISIN	GB00B1DSZR91	GB00B1DSZS09
Bloomberg	RMUKSAI LN	RMUKSEA LN

Important Disclosures:

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River and Mercantile Asset Management LLP
30 Coleman Street
London EC2R 5AL
Telephone: +44 (0)20 7601 6262
Facsimile: +44 (0)20 7600 2426
Email: enquiries@riverandmercantile.com
www.riverandmercantile.com