

RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Unconstrained Fund I Quarterly Report
June 2011

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UK Equity Unconstrained Fund – Quarterly Report

Fund Aim

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

Portfolio Summary

Strategy AUM	£14m
Strategy Capacity	£1bn
Number of stocks	39
Largest Holding	GlaxoSmithKline 5.64 %

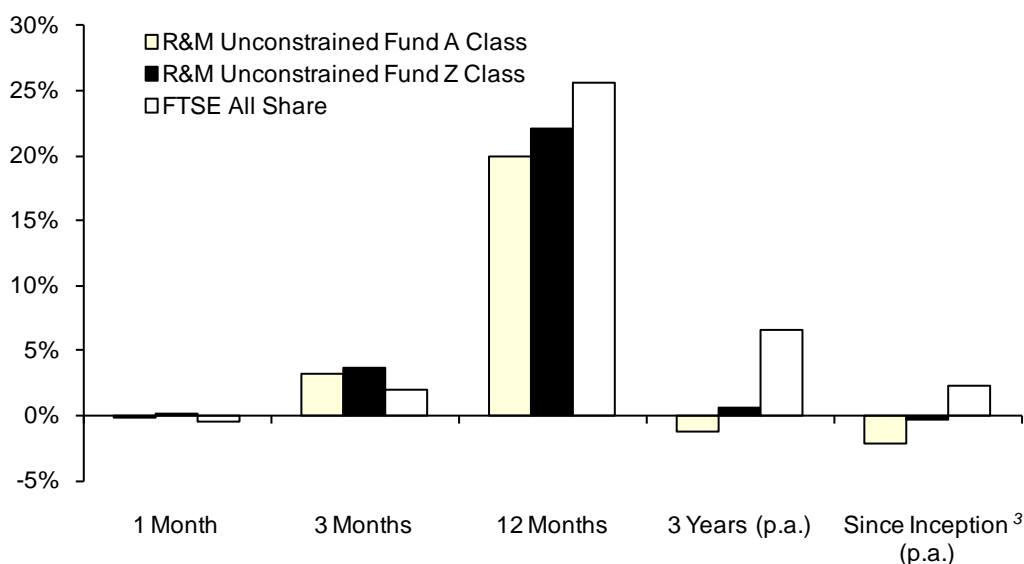
Risk Analysis Summary

Portfolio Volatility	9.80 %
Benchmark Volatility	15.19 %
Tracking Error	6.32 %
Active Money	60.60 %

Performance to 30 June 2011

Retail "A" Class Shares	Fund ¹	Index *	Difference
1 Month	-0.06%	-0.45%	0.39%
3 Months	3.15%	1.91%	1.24%
12 Months	19.90%	25.63%	-5.73%
3 Years (p.a.)	-1.18%	6.55%	-7.73%
Since Inception ³ (p.a.)	-2.11%	2.30%	-4.41%

Institutional "Z" Class Shares	Fund ²	Index *	Difference
1 Month	0.08%	-0.45%	0.53%
3 Months	3.62%	1.91%	1.71%
12 Months	22.05%	25.63%	-3.58%
3 Years (p.a.)	0.57%	6.55%	-5.98%
Since Inception ³ (p.a.)	-0.39%	2.30%	-2.69%



Source: River and Mercantile Asset Management LLP, FactSet

*Index: FTSE All Share (Total Return)

¹Performance calculated on a mid to mid basis at close of business, net of annual management charge

²Performance calculated on a mid to mid basis at close of business, gross of annual management charge

³Inception date 22 March 2007

Key observation

The Economic Cycle Research Institute lead indicator is broad based and is my preferred economic lead indicator. ECRI's Lakshman Achuthan was well ahead of last week's apparent "surprise" weak US jobs data; noting last month that "You're not going to see the normal quarter of a million new jobs on average anytime soon". Unlike the emergent weakness we saw in 2010, the recent weakening in leading measures of economic growth have been more in line with what he calls the "Three Ps". Achuthan argues that the oncoming global economic slowdown is likely to be *pronounced, persistent, and pervasive* - "not a one or two month affair" - though the data is not sufficiently discouraging to warn of an outright recession at this point. ECRI suggests that "the broad economy is going to slow alongside the industrial sector.. it's all going to be synchronized."

Market background

Overall, the FTSE All Share Index managed to rise 1.9% in the second quarter of 2011, thanks to a strong last minute rally following news that the Greek parliament approved another austerity round. Disappointing macroeconomic data proved a drag on equities in the past month or so, starting with a slowdown in US manufacturing activity, disappointing US employment figures, and disappointing PMI manufacturing activity released in early June. Persistent concerns over European sovereign debt also weighed throughout the quarter. Indeed, in June alone, the peak to trough move in the FTSE All Share Index was 5%. April was the most resilient month, and the only month in the quarter to register positive returns (up 3%).

Within the UK equity market, all market cap groupings managed positive returns during the quarter. Overall the mid-caps were strongest, up 2.1% relative to the market; however the small caps proved most resilient during the period of weakness in June.

Commodities and Financials were amongst the worst sectors during the quarter. For Basic Materials this was the second consecutive quarter of weakness. In general, however, most groups saw a reversal of fortunes. Health Care, driven by Pharmaceuticals, was amongst the strongest, thanks largely to double-digit relative returns from **GlaxoSmithKline** (up 11% relative) and strong returns from **AstraZeneca** (up 7% relative).

Factor returns were not significant, with growth underperforming for the first time in a while and positive profit momentum continuing to do well. Traditional value metrics have yet to see any meaningful signs of success this year, but cheap quality stocks, based on our cash flow return valuation model, did generate positive returns.

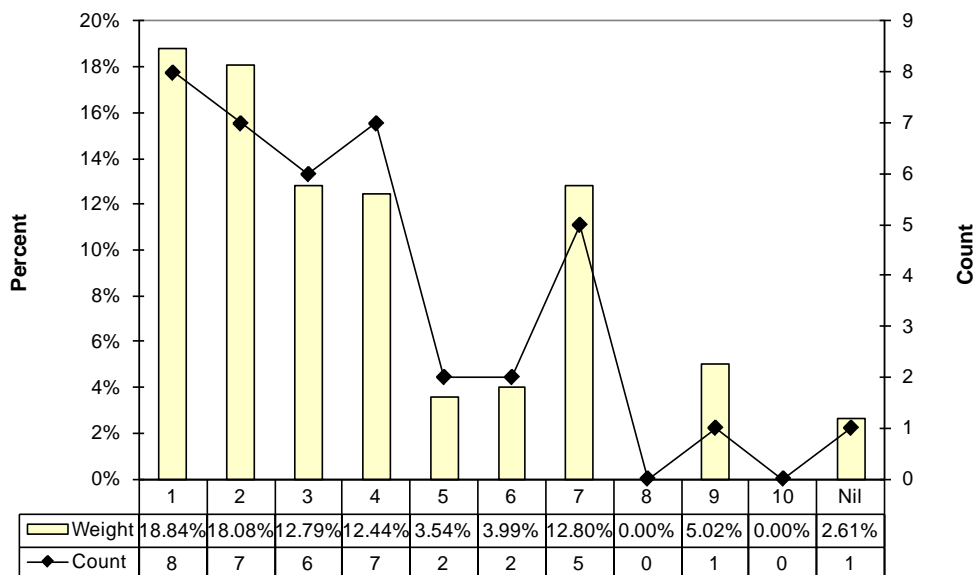
How did we perform and why?

Second Quarter

We returned 3.6%, outperforming the benchmark FTSE All Share Index by 1.7%. Positive contributions arose primarily from the large cap defensive positions. **GlaxoSmithKline** and **AstraZeneca** (Pharmaceuticals), **British American Tobacco** and **Imperial Tobacco**, **Tesco** and **Unilever** (Food) all contributed positively during the quarter. The cyclical areas of the market, in particular Financials and Resources, were a source of weakness. Overweights in our preferred resource stocks **BG Group** and **Anglo American** were weak. Positive stock returns also came from insurance underwriter **Hiscox** and **Iomart**, our beneficiary of the trend towards cloud computing.

Does the portfolio reflect our Philosophy & Process?

The portfolio is currently tilted towards high quality companies which have a strong chance of outperforming through a decelerating global economic growth outlook. We have limited Recovery and Asset Backed exposure at this stage of the cycle. In all cases we continue to rotate the portfolio in to strong PVT ideas, where we see medium term potential for companies to create significant shareholder value, on low valuations and where earnings upgrades are more likely to occur in future.



Source: River and Mercantile Asset Management LLP

What themes occupy us?

Commentary during the quarter was to some degree focused on Greece, and its impending sovereign debt default, as well as the abrupt slow down in China's growth rate. What will be the issues over the next quarter? One issue sure to be making headlines will be the US Debt Ceiling, after ratings agencies said that the US could lose its AAA rating on its sovereign debt as its total debt breached some \$14 trillion. Rather than fearing the outcome of this important debate, we ask where the investment opportunity is.

The US Debt Ceiling – an investment opportunity?

The Administration and Congressional leadership are still battling over a rapidly approaching Debt Ceiling deadline that threatens to throw the country into arrears. The key to the 'Grand Old Party' (Republicans) agreeing to raise the Debt Ceiling is some promise of long term spending cuts, embodied in a new budget blueprint, that achieves "meaningful" deficit reduction. The opening salvos in this fight were fired in April, when the GOP (via Paul Ryan's House Budget Committee) and then the White House (via President Obama's 13 April speech) staked out their respective positions on cutting the deficit. While the President offered less detail than Republican Ryan, he criticized Ryan's attack on Medicare and Medicaid as undermining the middle class and senior citizens.

After a widely reported "secret" meeting between the President and Speaker Boehner (representing the GOP) last weekend, the sides seem to be putting "sacred cows" on the table: Social Security for the President (to the dismay of Congressional Democrats), and Tax Reform for the GOP (to the dismay of other Congressional Republicans). It's no surprise that someone was going to get their feelings hurt as a result of this process, but such is political compromise. We now find each side doing what politicians do best: horse trading "sacred cows", and positioning themselves to emerge the winner of what promises to be a tough fight. The fight can't go on too long though, as the country supposedly runs up against the debt ceiling come 2 August, which some say implies a final deal must be reached by 22 July in order to get it

officially enacted in time. The deadline can probably come and go without a technical default, although this would force the US to prioritise how it spends its tax receipts. In such an environment, debt service gets done first while defence contractors and civilian employees probably get paid last.

Defence Proposals

This brings us to the defence contractors, and US defence spending which accounts for 50% of global defence expenditure. Republican Ryan's original plan left security spending relatively untouched, while the President's speech proposed \$400bn in cuts over 12 years. More recently, the GOP's typical support for defence spending is fracturing over the party's greater interest in keeping taxes low, resulting in the likelihood that the eventual deal includes security cuts in the order of \$400-700bn over 10-12 years. However, timing and distribution of these savings will be left to the Department of Defence (DoD). They are currently conducting a comprehensive strategic review (to be completed early autumn) that is meant to define what different levels of saving imply for different levels of capability.

The 2012 budget process and long-term deficit reduction plans are subject to ongoing negotiations between the White House and Congressional Leaders. Lacking a deal before 2 August, the Treasury could be forced to prioritise payments. In this environment, defence contractors could fall to the back of the line and see cash flow disruptions.

Defence Cuts in Context

There is the notion that one can claim "savings" simply by slowing the projected growth rate. This is no different for defence, where Bank of America analysts have calculated that one can claim \$400bn of savings over 12 years, simply by slowing the projected growth rate by 0.5% annually, allowing for a nominal CAGR of 2% in FY12-16E. While many defence stocks seem to be pricing in perpetual declines in defence spending, even the most onerous of proposals still allow room for growth. Overreaction to headlines is a common phenomenon. It dominated last summer amidst an election campaign preoccupied with the Tea Party and amidst bad press on the F-35. The FY12 budget submission in February provided a relief rally, as defence budgets looked like they would be more robust than feared.

Now that summer has returned, the market is again focused on politics (lacking any details to latch on to). Various frameworks, laying out anywhere from \$400-\$700bn over 10-12 years, are expected outcomes given the current political climate that sees each party trying to out-cut the other while protecting programs dear to their constituencies, all the while gearing up for campaign season. However, do not expect the US to step completely away from being able to project power and, regardless of outcome, expect the changes to come slowly. The market's knee-jerk reactions to political posturing are, in my view, done without a thorough appreciation for the stickiness of defence spending.

Defence Company Valuations

On a global basis defence companies are trading at a 30%+ discount to the broader market (vs. the 20%+ discount at which they traded during historic periods of similar demand and industry structure). As mentioned previously, shares appear to be pricing in permanent ongoing declines in defence spending. Given my less draconian view, I believe shares are likely to re-rate to historic levels over time, once investor concern about the future trajectory of defence spending abates. The end of the Debt Ceiling negotiations in the US, the completion of the US' Comprehensive (Defence) Strategic Review, and the delivery of the 2013 DoD budget, should act as the primary catalysts for this re-rating process during the second half of 2011. The key risks to this view are a greater than expected deceleration of defence spending growth by governments globally.

In summary, defence stocks are pricing in too much bad news. At current levels, defence stocks appear to be pricing in negative defence spending growth in perpetuity. This outlook is misplaced given the persistent threat environment, and the sticky nature of defence spending, particularly in the United States. In fact, even the most draconian proposal to date from leaders

in Washington suggests that nominal defence spending growth might decelerate 50bps to 1.5% annually, but not actually turn negative. As such, we hold **BAE Systems** (yield and Valuation) and are actively considering adding further names in the space.

Portfolio Strategy

Our stock market lifecycle work suggests that, while we are in the trend stage of the stock market lifecycle, there are enough deteriorating data points to imply that a tilt to a large cap quality bias will provide outperformance from here. This work is supported by Merrill Lynch's Quant Strategist Nigel Tupper who has taken the view that his 'Global Wave' has peaked (driven by 5 of its 7 components deteriorating, namely: falling earnings revisions ratio, falling industrial confidence, widening credit spreads, falling consumer confidence and a deteriorating labour market. Better capacity utilisation and rising producer prices were not enough to offset this). Historically equity markets have made limited progress in such an environment, and more defensive sectors like Pharmaceuticals have done best at the expense of cyclicals. Consensus estimate downgrades across the market continue to increase as we move into the third quarter of 2011. Earnings growth expectations are priced to be significant, so a focus on achievability of earnings estimates remains a priority. We now have a large proportion of the portfolio in large caps, with much of that in the defensive mega caps, such as **GlaxoSmithKline** and **AstraZeneca** in the Pharmaceuticals sector, and **BAE Systems** in the Defence sector. They are two of the few areas of the market where we observe genuine value.

The above analysis suggests we shall get increased efficacy from our Quality biased PVT strategy. High scoring PVT stocks with overweights in defensives, as well as limited exposure to deep cyclicals (energy and miners) is how we are positioned. We remain underweight Banks, as we believe that earnings improvement will disappoint relative to previous recoveries. After a recovery in the share prices of many domestically orientated UK stocks during the first half of 2011, we are focused on maintaining mainly international exposure in the portfolio. We still believe that economic growth will be structurally challenged in the UK for many years to come.

Quarter Two Portfolio Activity

Key Purchases

Victrex is a high Quality company, which is the only producer in the world of polyaryletheretherketone (PEEK), a high performance thermoplastic. The global PEEK market grows at 2-2.5x global GDP, with historic track record of 2.8x. Victrex has a growing pipeline for PEEK applications, so their long-term growth profile remains strong. Invibio is growing fast and this high-margin medical applications business, continues to deliver double-digit underlying growth ahead of forecasts. The company generates very strong return on capital and has excellent pricing power, as well as high barriers to entry. A growing pipeline for PEEK leaves growth potential high and, with oil and gas demand being one of the main drivers, growth prospects remain solid. High returns look sustainable, due to an improving mix in their business model, with strong growth drivers for PEEK applications, and backward integration into key raw materials, minimising input costs and improving efficiency.

Growth stock **Immunodiagnosics** (IDH) designs manufactures and sells immunoassay kits for use in the laboratory-based in-vitro diagnostics (IVD) market. IDH specialises in Vitamin D testing, which has increasingly been linked to a number of conditions. The IVD market was worth \$43bn in 2010 growing at 8% for the last decade. Within this Vitamin D market was £0.2bn in 2009, growing at 80% per annum. Having historically served the manual testing market there is now material Growth potential in the rollout of their automated machine razor-blade business model. The analyser is largely placed, and relatively expensive to produce, but tests are cheap and have a high sales price, due to Intellectual Property in the biomarkers. They have a good track record of Growth with three year earnings CAGR of 38%. The caution surrounding the future roll out, where forecasts are based on 150-170 machine placements per year versus a current run-rate of 200, provides the opportunity. We believe the target market, and expanding niche test menu, should insulate them from mainstream competition to some

extent, and provide another leg of growth in returns as placements slow. The 14x P/E valuation (0.5x PEG) for this growth was cheap, and with Timing factors improving we built a position.

Additions

During the quarter we added to our **HSBC** and **BAE Systems** holdings. We also added to our high conviction position, credit services business **Experian** as well as, **Jardine Lloyd Thompson** where we continued to add to our position in Insurance.

Sales and reductions

We sold packaging firm **RPC** after it delivered the anticipated improvement in Growth and Return on capital which, in turn, led to a strong share price appreciation. **International Power** was sold completely, having been previously reduced following its merger. Finally, after a meeting with management, at the solar power wafer manufacturer **PV Crystalox** we did not feel they were not on top of the structural challenge they were facing and, therefore, we sold our position. Timing was fortuitous as the company have subsequently had a huge profit warning, and the shares have more than halved. We also sold long term holding **Chemring**, a defence stock that had managed to buck the weak defence sector trend in the past two years, but is increasingly relying on acquisitions to sustain high growth expectations and, in doing so, was raising the risk profile.

British American Tobacco, **Iomart** and **Shire** (all taking profits), as well as **Smiths Group** (weaker trading), were reduced during the period.

A note on BSkyB

An analyst at Collins Stewart recently encapsulated my view of BSkyB, and the following is based closely on his analysis which explains why I continue to hold the stock - bid or no bid from News Corp. With Murdoch's takeover of BSkyB at best delayed (at worst ... well, he'll have to divest his entire BSkyB stake), it's easy to forget just why News Corp was interested in BSkyB in the first place.

A market-leading position in the UK, innovative programming, leadership in sport/entertainment, and a loyal customer base has helped it develop as a classic cash flow return on investment compounder – generating good returns and reinvesting them in the business. Returns have outstripped the cost of capital for the past eight years, during which time the capital base has grown by over 6% p.a. Strong cash flow generation has not come at the expense of capital expenditure, which rose to around 7.5% of sales in 2007-10 and in the last financial year was 6.2% and amounted to £400m. It is likely that capex-to-sales will come back in the next few years, further benefiting free cash flow.

At the same time, debt/EBITDA has been steadily shrinking and the company is forecast to have net cash at June 2013. Working capital-to-sales has been best in class for years. Supported by strong operational momentum, the company's value is forecast to grow by an eye-watering 27% in the year to June 2012, and by c.20% in the year to June 2013, on our standard cash flow return models. While the stock has looked expensive against the default model for the past four years, at 700p that gap is down to 4% expensive. Using sensitivity analysis to update the model for 2012 and 2013 forecasts, the valuation rises to 780p – 12% above the share price and well above the initial approach of 700p. At 840p a few weeks ago there was some bid premium in the price, but the valuation on fundamental grounds was more than justified. With a healthy set of results expected on 29 July, the recent 20% retracement presents an excellent buying opportunity. If at some point News Corp gets the go-ahead that would only be good for the shares. BSkyB certainly doesn't need takeover chat to get investors interested at these levels. A quality Growth holding if there is no bid.

Outlook

Earnings expectations remain high with most predicting another year of double digit returns, but conditions in markets continue to look similar to late 2007. A deflationary shock is a risk for markets with consensus inflation expectations having risen considerably. Markets appear to be pricing in a benign scenario and it suggests that the market will continue to pay a higher premium for quality as we move through the second half of the year. Risk has moved from investment banks to central banks, but the result has been the same – to drive risk assets and high beta cyclical growth stocks up sharply over the past couple of years. This has left many high quality large cap names on very attractive multiples, which is where our Fund is currently positioned. Pharmaceuticals, Oil & Gas, Defence, Food Retail, and Insurance stocks all provide attractive Growth but where expectations are low.

The UK Unconstrained portfolio continues to have attractive PVT characteristics and we own a portfolio of companies with strong prospects. In particular, Quality stocks with Valuation support and earnings visibility should outperform as we move through the year. The focus is firmly on Quality stocks, capable of growing on good valuations. I continue to have high conviction on Pharmaceutical and Healthcare stocks (**GlaxoSmithKline, AstraZeneca, Smith & Nephew** and **Shire**), Non Life (**JLT & Hiscox**), as well as, high Quality stocks on low valuations that have lagged the 2009 rally such as **BAE Systems**. Thank you for your support.

Dan Hanbury
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	22 March 2007	
Fund manager:	Dan Hanbury	
IMA sector:	UK All Companies	
Benchmark:	FTSE All-Share (Total Return)	
Tracking error range:	N/A	
Product capacity:	£1bn (pooled & segregated)	
XD dates:	1 April & 1 October	
Dividend/Accumulation payment date:	31 May and 30 Nov	
Share class:	A	Z
Launch price (shares):	100.00p	500.00p
Share classification:	Retail	Institutional
Type of shares:	Income	Accumulation
Fund charges:		
Annual	1.75%	0.00%*
Initial (up to)	5.25%	5.25%
*AMC charged outside the Fund		
Minimum investment		
Initial	£1,000	£5 million
Subsequent	£500	£50,000
Sedol	B1NG829	B1NGCT4
ISIN	GB00B1NG8296	GB00B1NGCT49
Bloomberg	RIVMERA LN	RIVMERZ LN

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