

RIVER AND MERCANTILE  
ASSET MANAGEMENT

UK Equity Income Fund | Quarterly Report  
September 2011

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# River and Mercantile

September 2011

## UK Equity Income Fund – Quarterly Report

### Fund Aim

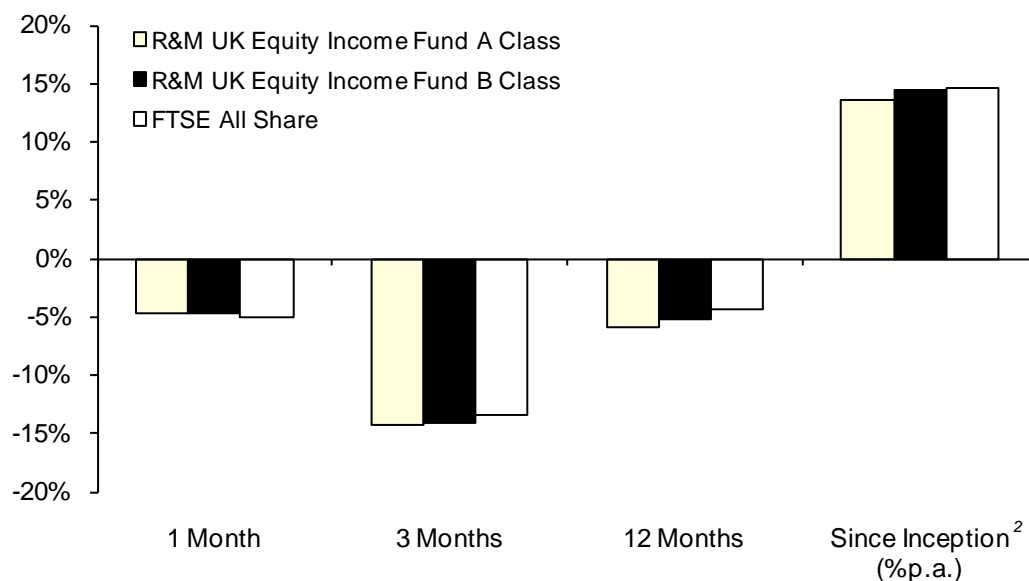
The investment objective of the Fund is to generate a rising level of income combined with the potential for capital growth through investing in a portfolio which will primarily consist of UK equities.

Portfolio Summary		Risk Analysis Summary	
Strategy AUM	£56.6m	Tracking Error	4.02 %
Strategy Capacity	£1bn	Portfolio Beta	0.89
Number of stocks	68		
Largest Holding	Vodafone	6.75 %	
Historic Yield <sup>3</sup>		4.91 %	

### Performance to 30 September 2011

Retail "A" Class Shares	Fund <sup>1</sup>	Index*	Difference
1 Month	-4.78%	-5.01%	0.23%
3 Months	-14.26%	-13.50%	-0.76%
12 Months	-5.84%	-4.36%	-1.48%
Since Inception <sup>2</sup> (%p.a.)	13.62%	14.69%	-1.07%

Asset Manager "B" Class Shares	Fund <sup>1</sup>	Index*	Difference
1 Month	-4.72%	-5.01%	0.29%
3 Months	-14.10%	-13.50%	-0.60%
12 Months	-5.13%	-4.36%	-0.77%
Since Inception <sup>2</sup> (%p.a.)	14.47%	14.69%	-0.22%



Source: River and Mercantile Asset Management LLP

\*Index: FTSE All Share (Total Return)

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

<sup>2</sup>Inception date 3 February 2009

<sup>3</sup>Yield based on the dividends paid in the preceding 12 months as a % of current price

<sup>4</sup>Yield based on current yield of the portfolio holdings

### Market Overview

The great British composer, John Barry, died earlier this year and, whilst many will remember him for his most acclaimed works, such as the James Bond theme (as well as scores to eleven Bond movies) and Born Free (he won five Academy Awards), for me one of his best pieces was the music he wrote for Zulu in 1964.

This great film, depicting the Battle of Rorke's Drift between the British Army and the Zulus in 1879, appears to have many similarities with the current state of the UK equity market in Q3 2011. There is a huge weight of numbers aligned against us. There is no obvious escape route. We are in foreign territory. The odds point to certain death.

However, courage, technology advantage (the Martini-Henry bolt-action rifle), sure defences and a clear military process led to the award of eleven Victoria Crosses, the most ever for a single regiment in a single battle in British military history.

I have the courage of my convictions, am utilising our technology-rich *MoneyPenny* screening tool (Barry would be proud), have significant capital invested in resilient businesses and continue to focus on our Philosophy and Process to drive improved future returns. I won't be singing "Men of Harlech" though.

Interestingly, the loss of c.1300 men at the much larger and disastrous Battle of Isandlwana, shortly before Rorke's Drift, must surely have been on the minds of those soldiers of the 24<sup>th</sup> (2<sup>nd</sup> Warwickshire) Regiment of Foot, when they need to seek courage, possibly akin to current market memories of the credit-crunch episode of 2008/9 which are still clearly on the minds of many.

*"To buy when others are despondently selling and to sell when others are avidly buying requires the greatest fortitude and pays the greatest ultimate reward."* Sir John Templeton.

This quarter was a 'risk-off', shoot first, ask questions later' environment. Economic indicators have deteriorated and US and UK monetary authorities have responded with further quantitative easing. The European policy response appears insufficient, un-coordinated, unclear and slow. Defensives and 'safe' havens outperformed.

For this portfolio, based on the current market consensus dividend forecasts, the prospective yield is c.4.9%. This is attractive relative to other asset classes, the current UK equity market and its history, and 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.



**Lt Gonville Bromhead and Lt John Chard both awarded the Victorian Cross for their role in the defence of Rorke's Drift in 1879**

## Performance

The Fund slightly underperformed during the quarter falling 60 basis points more than the FTSE All-Share Index which dropped -13.5%. Relative underperformance was focused in August, with the Fund outperforming in September.

The Fund's risk framework had the portfolio positioned for a mid-cycle slowdown and not a significant change in risk appetite or recession. In this context relative underperformance was not unsurprising; indeed zero exposure to defensives Imperial Tobacco, Reckitt Benckiser and takeover target Autonomy accounted for 0.60% of underperformance cumulatively. In this "risk-off" environment, economically sensitive midcaps contributed the most to negative attribution; Recovery stocks Tui Travel, Inchcape, and Hays were hard hit despite meeting market expectations and having significant valuation support, whilst resource holdings Afren and Salamander were also out of favour. All of the above holdings fell more than 30% in absolute terms during the quarter. This combined effect outweighed positive contributions from midcap Quality holdings such as Moneysupermarket.com, RPC, IG Group and Tate & Lyle. Top active overweights such as GlaxoSmithKline, Unilever and Vodafone produced excellent relative performances, and the zero exposure to miners, Xstrata and Anglo American, and Banks, Barclays and Standard Chartered, were also beneficial. However, overall, the tilt within the portfolio was not defensive enough for market sentiments during the period.

Sector positioning overall vs. the benchmark was again positive for the third quarter in a row this year. The largest sector underweight, Mining, was particularly beneficial, and is pleasing in the context of the Fund's risk framework of a maximum -8% limit index-relative weighting. However, the underweight in Oil & Gas was offset by weak stock selection as the dispersion in performance between Royal Dutch Shell and BP was stark, I remain underweight the former and overweight the latter. I believe that style factor effects are highlighted by this situation well, with 'Value' receiving little interest in the quarter as all eyes turned to 'safety'. Positioning was positive in almost all other sectors, such as overweights in Healthcare, Telecommunications, Food Producers and Retail. The decision to move overweight Utilities early in August has been rewarded rapidly; however, the Fund remains underweight Tobacco and Beverages which posted strong gains. Encouragingly, unlike Q2, the benefits of being underweight Financials were, this quarter, compounded by good stock selection within the sector during the period.

At a stock level, price moves appeared to have more to do with perceived or actual cyclicality and the possibility of downward earnings revisions rather than company updates on market expectations or underlying valuations. So, whilst a number of the share price moves were disappointing, for almost all current holdings their investment theses remain very much intact. Style factor analysis will show the Fund is materially underweight the average margins in the benchmark which, in part, relates to the portfolio's Recovery holdings where profitability and valuations are still well below 'normalised' levels. This provides comfort when average companies' margins are now very high, or at a peak; which has the greater earnings risk? "Later-cycle" exposures which, in the Fund, have been largely construction related, appear under pressure and action has been taken as detailed below. However, the main specific disappointment during the period relates to the ongoing realisation process at Trading Emissions which has been both delayed and impacted by the current market conditions. The wind-up and return of capital should deliver well in excess of the current share price (54p); activists on the register may improve the eventual outcome.

The portfolio maintains its Value bias, despite little evidence recently of an improvement in this style factor (Factset estimates the Fund's 2012 PE to be 7.9x). The Fund is overweight Financials and therefore any alleviation in concerns or reduction of investor aversion to this area should be rewarded. However, the Fund remains underweight Industrial Cyclical and Resources and therefore a commodities-led rally would lead to relative underperformance, if the portfolio remains as it is currently positioned. Downside protection with excellent income is being sourced from overweights in Telecommunications, Utilities, Food Producers and Healthcare, whilst a stock selection focus, targeting our top PVT ideas, remains the main priority for generating outperformance in the quarters and years to come.

## Philosophy & Process

During the quarter, stock selection decisions influenced the Category weightings which, when combined with Quality outperformance, led to a 3% increase to 64.4% in this category's capital allocation, the largest part of the portfolio. The Recovery category weighting was steady at 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 reduced to 8.8%.

As detailed in our Philosophy & Process document, our approach focuses on different 'value' measures depending upon where a company is in its 'life-cycle'. Dividend yield is a robust measure of determining the value of a share; however, it can be inaccurate in identifying undervalued equities in the Growth phase or Recovery phase. As such our approach lends itself to a mix of yields in the portfolio which, on average, are weighted in order to deliver at least 110% of the FTSE All-Share Index prospective yield. During the quarter, 'value' factors, as quantitatively measured by Collins Stewart, below, performed poorly, apart from dividend yield. This, in part, explains the headwinds to relative outperformance recently, indeed our Recovery screen/approach specifically biases to the particularly poorly performing EV/Sales ratio. (Quest valuation is a proxy DCF, Market to Book is an adjusted Price/Book ratio).

w/c 3 Oct 2011

### QUINTILES

	3 months
<b>VALUE</b>	<b>-7%</b>
QUEST™ Valuation	-3%
QUEST™ Mkt-To-Bk	-9%
EV/ Sales	-11%
Dividend Yield	6%
P/E	-9%

Source: Collins Stewart Quest

The long-term quantitative evidence supporting a Value bias is very strong. However, in recent years, apart from a brief spell in 2009, key Value measures have been ineffective in determining subsequent stock outperformance. Fortunately our Philosophy is not solely focused upon Value alone but incorporates Timing measures such as earnings revisions and technicals. However, I wait with some frustration, if not latent excitement, about future returns, when the benefits of a Value discipline are eventually rewarded.

The skew to high scoring stocks, as quantitatively measured by *MoneyPenny*, our proprietary screening tool, increased during the period with 79% of the Fund in the top four deciles. In times of volatile markets, considerable 'risk' aversion and heightened market 'noise', the foundations of our PVT philosophy and systematic process are a great source of strength for effective decision making. 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 over the medium-term, hence the current diversification.

## Quarterly Portfolio Activity

### PVT opportunities:

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

FTSE 100 constituent **Scottish & Southern Electricity** is a UK electricity company which currently has the rare honour of scoring highly in *MoneyPenny*, in all three screens of Quality, Recovery and Growth. As a Utility, since purchase in July, its bond-like (inflation-linked) stable returns have continued to be re-rated by the market, yet its high dividend yield of c. 5.9% is still considerably more than that offered by Gilts or the average UK equity.

FTSE 250 constituent **Go-Ahead** is a high Quality, UK focused, bus and rail operator. They have regulated positions in a range of profitable franchises from London Bus routes (21% market share) to the key rail franchises Southern (including Gatwick Express), Southeastern and London Midland. Its balance sheet is very strong, and the new contract terms for the latest rail franchises under review by the new Government should improve the visibility and returns of the business further. The shares yield 6%.

FTSE Small Cap constituent **Paypoint** is a unique high-returning business with a well invested network of payment terminals supporting the cash economy in shops and newsagents across the UK. Whilst pre-payments of utility bills and mobile phone top-ups contribute a substantial part of ongoing stable cash flows, management have reinvested in a number of growth engines for the future, such as a terminal network in Romania; Pay-by-Phone, an international mobile-phone parking-ticket service (e.g. Westminster); parcel collection (via Yodel) and online payments (mainly e-gaming). They are currently in talks with the Department of Work & Pensions regarding the outsourcing of the collection of the Giro. The shares yield 5.2% and are net cash.

Near the very end of the quarter, after considerable price weakness, I repurchased **Wolseley** Group, the International Building materials company. The management team continue to drive a steady self-help **Recovery** in profitability whilst end-markets remain depressed but broadly stable. High cash generation has continued to de-lever the balance sheet leading to the reinstatement of the dividend this year. However, profits have not yet normalised. Recent reappraisal of US economic growth outlook led to an excessive negative reaction in the shares, whilst final results post quarter-end told a different fundamental story.

#### **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 involved the sale of large cap **BSkyB**, mid cap bookmaker **William Hill**, small cap **Hogg Robinson** and industrial cyclicals **Melrose** and **Laird**. All have delivered high returns for the Fund, however stronger ideas going forward have been found elsewhere. Both **BSkyB** and **Laird** were sold before the unravelling of their bid approaches which was pleasing. Continuing on from similar Q2 activity, with economic data now weaker rather than mixed, and after a significant profit recovery and re-rating, I further de-risked some highly profitable cyclical investments such as **Melrose** (post the special dividend) and **Hogg Robinson**.

**Kingfisher** was also exited during the quarter. Having outperformed other retailers by a considerable margin since purchase, the yield attractions have fallen relatively. The company has a significant exposure in France (**Castorama** and **Brico Depot**) and for now I have chosen to monitor developments until further clarity on European consumer spending behaviour emerges.

#### **De-risking within financials (but not reducing weighting)**

During the quarter, the handling of the European sovereign debt crisis by monetary authorities and European leaders was not confidence-inducing. Debt-market spreads widened and Bank shares were aggressively sold down, despite hastily applied short-sale bans. Mid cap specialist financial holdings **Intermediate Capital**, which provides mezzanine financing to European companies, and **Close Brothers** (pan-European SME lending) are too close to the heart of the problems, given the lack of clarity in Europe currently. I therefore switched capital to the more Asian exposed life insurer, **Prudential**, and asset manager **Aberdeen**, whose shares were equally, if not more, weak, but where I have greater confidence in the end-market exposures and also believe they offer attractive valuations. Both are scoring top decile Quality and currently yield 4.7% and 5.1% respectively.

## Purchase of selected UK Domestic Recovery exposed businesses

I copy verbatim from my last quarterly report:

*“Overseas corporate earnings, for good reason, have been keenly sought after by investors since the financial crisis as demand has bounce-backed 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.”*

Recent macroeconomic data from China in particular has given further support for this emerging thesis for the Fund over the last twelve months. The most recent ‘recruits’, in addition to Paypoint and Go-ahead detailed above, are:

The **Asset-backed, London & Stamford**, a young company run by old heads. Proven industry investors Raymond Mould and Patrick Vaughan raised money in late 2007 to exploit the bedlam that they expected to proceed. Under some short-sighted duress to ‘get-going’ they kept seed capital mainly dry and were able to exploit the carnage that has ensued in UK commercial property (and residential to a far lesser extent) since 2008. Some outstanding transactions to date have also reconfirmed their skill set and, having internalised the management company within the plc, interests are fully aligned with shareholders to ensure that the considerable leverage still available to the company is applied prudently and profitably over the coming years. Existing rental flows already support a dividend yield of 5.9%.

**Recovery**, and clearly deep value, **Trinity Mirror** is used as a swear-word by some fund managers. I believe that few are paying attention to the fundamentals of the business in 2011. Firstly, the Sunday Mirror is trading well above expectations due to the closure of the News of the World; secondly, cost savings targets were recently upgraded from £15m to £25m annualised; and thirdly, continuing difficult advertising markets already appear to be reflected in expectations causing slight upgrades at the interims. Fourthly, the pension deficit fell from £74m to £44m and net debt fell due to continued cash-generation focus. Fifthly, there remains a large synergistic industry opportunity in UK regional press consolidation which I believe is inevitable. And finally, the valuation is beyond extreme, and whilst I accept the structural concerns have considerable validity and, thus, justify a low valuation, they cannot justify the current PE of 1.8x or EV/Ebitda 2.7x or Price to Book of 0.17x. Whilst a dividend is not currently forecast by the market, I expect the board to highlight the progress they have made and underlying cash generation by reinstating one soon.

### The sale of investments due to weakening theses:

Risks that current economic weakness develops into something more than just a ‘soft-patch’ have risen since my last report. In reaction to deteriorating data points, and mindful of risk management, I chose to exit some ‘later-cycle’ exposures, specifically WS Atkins and Balfour Beatty. Both stocks suffer from large pension fund schemes with deficits and, whilst cash-generative, are finding it increasingly difficult to maintain order books in the face of slowing infrastructure and public sector capital works project volumes (despite what some political rhetoric would have you believe). WS Atkins also lost its long standing CEO during the quarter and with both companies having to deliver on relatively recent US acquisitions, the pressure appears to be mounting, rather than receding, in line with the original thesis that a gradual improvement in economic activity would be manageable by both businesses.

Far more stock specifically, the original theses in Home Retail, Psion and Premier Oil appear challenged. All three have disappointed and the positions cut. Current trading at

Argos suggests that the format is struggling more than average and questions clearly arise over whether this is structural and not cyclical. The self-help Recovery plan at Psion has been slow and behind target, the economic environment must be making this even harder, and I have chosen to focus capital in Recovery theses where progress is much more evident. Finally, Premier Oil, having shown modest (but not exciting) exploration success, has started to miss production growth forecasts, a key part of this growth thesis.

### **Sector and size positioning**

The FTSE 100 weighting has increased by 5% to 68.4%. Exposure to the FTSE 250 has reduced by 2% and exposure to Small Companies has fallen to 13%. This is partly related to the promotion of Kcom and RPC to the FTSE 250.

In relation to the 'Mega-caps' (the top twenty stocks in the UK market by capitalisation) the Fund weighting increased to 46.5% by the end of the quarter, a reduced underweight of -10.6% (4% of which is the underweight in Royal Dutch Shell). The Fund has no exposure to seven of these twenty companies. The main change within these holdings during the quarter was the purchase of National Grid, whose obvious defensive characteristics have been subsequently re-rated by the market, and where I have gained confidence that, under the new Chairman, ownership of their poorly performing US assets will be thoroughly reviewed with potentially significant benefits to the balance sheet on disposal. The other noteworthy changes have been an increase in the active positions in BP, Vodafone, GlaxoSmithKline, AstraZeneca, Unilever and a trimmed overweight in HSBC.

The strategy continues to pursue limited sector risk vs. the market with the largest overweights at +3.1% and +2.5% still Media and Financial Services respectively. There has been some movement of sector rankings, though, with a +2.6% swing into Utilities moving to a 1% overweight. The other main positive increase was in Real Estate following the purchase of London & Stamford. During September I also moved back overweight Life Insurance on sector weakness. Key economically resilient sector overweights are maintained such as Non-life Insurance, Pharmaceuticals (both increased in Q2) in addition to Food Producers, Telecommunications and Healthcare. I remain overweight Technology stocks +1% (the portfolio has a TMT bias). The top six underweight sector stances remain identical, led by Resource sectors and Banks, however the size of the Mining underweight has narrowed to -6.7%. In smaller sectors it is worth noting I moved underweight Industrial Engineering and Construction during the quarter (alongside other existing cyclical sectors underweights in Electronics & Electricals, Chemicals and Oil Services).

### **Portfolio Income**

38 stocks went ex-dividend during the quarter including 36 increases on Q3 2010, 2 falls (Shell and Fiberweb), two returns (Inchcape and BP) and two additional special dividends, from Moneysupermarket.com and Melrose. The Fund's current consensus based prospective yield of 4.9% is 116% of the market yield and is greater than the yield from non inflation-linked income offered by 10 year UK Gilts. Our analysis suggests that the Fund's underlying holdings are growing their distributions at c. 8.9% 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. Indeed, when one reviews the percentage dividend growth rates during the quarter at key holdings such as Centrica (11.7%), HSBC (14%), Unilever (13.7%) Rio Tinto (17.5%) and AstraZeneca (21.4%) I am highly encouraged. The Fund will shortly payout its interim dividend of 3p (A-shares). This follows the 2.75p payment in 2010 and 2.5p in 2009.

## Market & Fund Outlook



In Q2 I wrote “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”. 60 basis points of underperformance over the subsequent quarter, whilst disappointing, should not be entirely unsurprising given this view.

Since then, economic indicators have weakened further, banking market stresses have increased (as measured by spreads), market earnings revisions have moved into negative territory, stockmarkets have fallen markedly and the Bank of England and Federal Reserve have announced further Quantitative Easing. Europe is making hard work of progress towards the type of mechanisms, policy actions, clarity and effort that market participants require to address the Sovereign debt and related banking undercapitalisation issues. Europe seems hamstrung by cultural biases, peppered by conflicting approaches, abundant with painful historical memories, characterised by a genuine misunderstanding of the problem (both politicians and electorates) and led by weak, misaligned institutions and re-election focused politicians. It was ever thus. I suspect that the US situation (economic & political) is far better, and that their aggressive bank recapitalisations, huge monetary loosening and un-bureaucratic capitalistic approach will begin to shine through sooner rather than later in their economic growth trajectory, expectations of which now being rather depressed.

I would encourage clients to view the Fund through the ‘lens’ of our Philosophy via 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 vs. 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, however the high returns less lauded.

A number of portfolio’s consumer-facing global franchises such as Unilever, British American Tobacco and Diageo, have had excellent recent share price performances. I highlighted in Q2 that a number of the Fund’s ‘low risk’ steady investments had yet to deliver ‘defensive’ relative performance in 2011 and, as a result, I expected strong returns in the future. Some of these have now come through such as Vodafone and Centrica, however others remain significant ‘defensive/resilient’ laggards such as BAE Systems, yielding 7.1%, Sainsbury’s, yielding 5.5% (both of these have grown EPS each year from 2005-2010), and Reed Elsevier, 4.4%. The risk to the cashflows 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 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 enjoyed material success in this area and has been reducing exposure all year; however, during July I sold the remaining engineering and electronics holdings.

I have been encouraged by the relative performances of the first few conviction positions in consumer areas such as Kingfisher, William Hill, Inchcape, Moneysupermarket.com and Morrisons, and have added new positions as detailed above. I am now slightly overweight Food and General Retail sectors in addition to Travel & Leisure. The Fund's media holdings also have a distinctly domestic bias. Earnings revisions in Industrial sectors have now rolled over and expectations appear too high for 2012 in my view. The UK economic outlook is clearly not great; however I am focused on the changing relative attractions, expectations and valuations.

## 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 '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, 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 with, dare I write it, 'manageable' exposures to Euro default-risk assets. 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 the Bank sector, however, at this point, cannot justify an extreme underweight position given the low valuations, huge profit and dividend recovery prospects and management changes experienced.

During the quarter I moved overweight Life Insurance following the significant weakness in the sector (due to worries over balance sheet exposures to a range of sovereign and banking debt in Europe). Cash generation in the sector continues to improve and dividends are growing fast. This was mainly achieved via the purchase of Prudential, scoring top decile Quality, with its excellent Asian franchise which, in more 'normal' market risk regimes, is highly valued, thus providing an opportunity. I also added to Aviva, whose specific risks are higher, particularly if Italy defaults, but where stress-testing analysis and further research work indicates concerns are over-played at the current share price.

Separately, the future for returns, growth, profits and dividends at IG Group, Aberdeen Asset Management and Collins Stewart Hawkpoint look attractive and the valuations even more so.

## Resources

I have further increased the overweight in BP, as the valuation appears to reflect a reasonable probability of 'gross negligence' on the Macondo incident. Recent settlements with BP by Mitsui and Weatherford suggest this is not the case. Resolution on this is likely in the next 6-9 months. Recent asset disposals underline my thesis that the sum-of-the-parts value is materially higher than the current share price implies, however management change and a

strategy review (more likely post the Russian debacle) are required to achieve this. I am underweight the other mega-caps, BG Group and Royal Dutch Shell, but very pleased with the purchase of BG Group in Q2 as this share actually outperformed the market despite a general resources sell-off. The dispersion in valuations between Royal Dutch Shell and BP is now extreme (see below graphs). 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. However, they are perceived as considerably more risky by the market (geography, immaturity, size) and underperformed BG Group considerably during the quarter. I expect triple-digit returns from these holdings over the next few years.

**BP Trend PE Relative: 1990 - 2011** Green line – Average, Red/Blue line: +/- 1 standard deviation



Source: Mirabaud Securities

**Royal Dutch Shell Trend PE Relative: 1990 - 2011**



Source: Mirabaud Securities

In Mining, I am biased to iron-ore and strong balance sheets; I have a large sector underweight overall and only own Rio Tinto, BHP Billiton and small holdings London Mining and Ferrum Crescent. Mining shares are now experiencing earnings downgrades at a pace greater than the overall market and their technicals have rolled over, most are in 200 day moving average relative downtrends. Trading opportunities may emerge, but the evidence is building that the Fund's large underweight is appropriate.



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**

## 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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