RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Long Term Recovery Fund I Quarterly Report
September 2011

River and Mercantile

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UK Equity Long Term Recovery Fund – Quarterly Report

Fund Aim

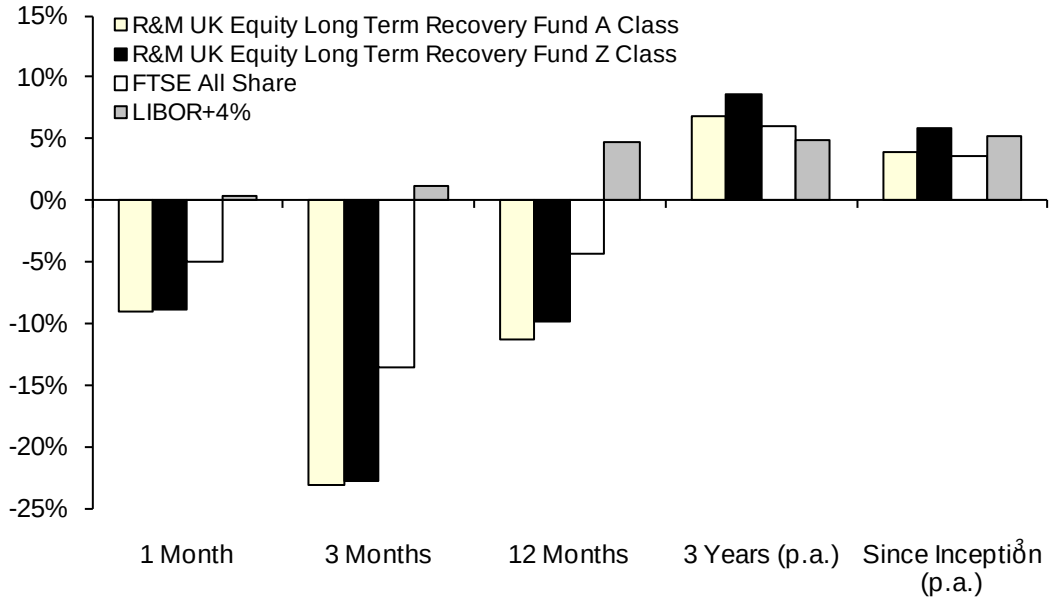
The investment objective of the Fund is to achieve capital growth through investing in a portfolio which will primarily consist of UK equities that meet the manager's recovery criteria of a turnaround in company profitability over the longer term. The Fund will not be restricted by reference to a benchmark,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

Portfolio Summary			Risk Analysis Summary	
Strategy AUM		£67.9m	Earnings Yield	16.60
Strategy Capacity		£200m	Dividend Yield	2.22
Number of stocks		169	Price to Sales	0.70
Largest Holding	BP	3.96 %	Price to Book	1.02

Performance to 30 September 2011

Retail "A" Class Shares	Fund[1]	FTSE All Share	Difference	*LIBOR+4*
1 Month	-8.97%	-5.01%	-3.96%	*0.38%*
3 Months	-23.11%	-13.50%	-9.61%	*1.16%*
12 Months	-11.36%	-4.36%	-7.00%	*4.67%*
3 Years (p.a.)	6.78%	6.04%	0.74%	*4.96%*
Since Inception[3] (p.a.)	3.98%	3.59%	0.39%	*5.26%*

Inst'l "Z" Class Shares	Fund[2]	FTSE All Share	Difference	*LIBOR+4*
1 Month	-8.84%	-5.01%	-3.83%	*0.38%*
3 Months	-22.77%	-13.50%	-9.27%	*1.16%*
12 Months	-9.80%	-4.36%	-5.44%	*4.67%*
3 Years (p.a.)	8.66%	6.04%	2.62%	*4.96%*
Since Inception[3] (p.a.)	5.81%	3.59%	2.22%	*5.26%*



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

"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

Key Observation

This report will be shorter than normal because there is only one thing that is driving markets at the moment and that is risk appetite. If you are perceived as a risky asset, your price is marked down; if you are perceived as a low risk asset your price is marked up. There is **no** regard to valuation, indeed "cheap" is bad (must be riskier) and "expensive" is good (must be safe). This is an Anti-Value bubble.

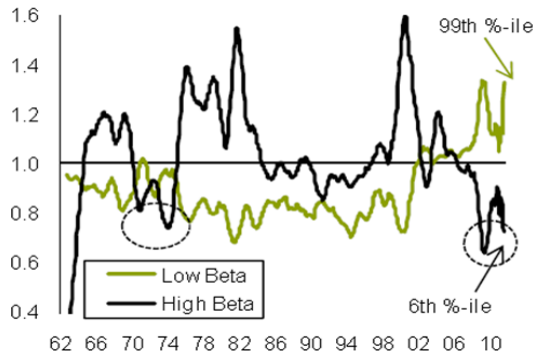
We have, with profuse apologies, performed poorly in this type of market. We have much more Value than the market and a greater desire than the average investor to hunt for longer term anomalies (perceived as risky, I'm sorry to say). Our portfolio has suffered as a result.

Of course low risk can't keep getting more expensive, and higher risk can't keep getting cheaper. This is, as Sir John Templeton suggests, an immutable law of investment. This law worked in 2008/9, the last time we had a 'once in a lifetime' event, and will work again. The anomalies in many, many cases are as large as they were at that last, depressingly recent nadir. The returns will, for those who can hold their nerve at these difficult times, be substantial.

One fact

According to Bernstein low risk stocks (low Beta) have only been this expensive relative to the market 1% of the time since 1960.

Relative Price-to-Book Valuation for High vs. Low Beta Stocks



Source: FactSet, Bernstein analysis

Market background

Quarter:

Asset prices fell, in direct proportion to short-term perceptions of risk (volatility, earnings risk, regulatory risk, balance sheet risk). The FTSE All-Share Index returned -13.5%. Defensive sectors did very well, relatively – indeed, the top ten sectors were all defensive, led by Tobacco which actually saw a positive return. Higher earnings volatility sectors led the market down, with Financials and Mining particularly weak. Value did poorly, with cheap shares just getting cheaper. Quality did well. Recovery, Asset Backed and Growth struggled. The size effect was modest.

How did we perform and why?

Quarter:

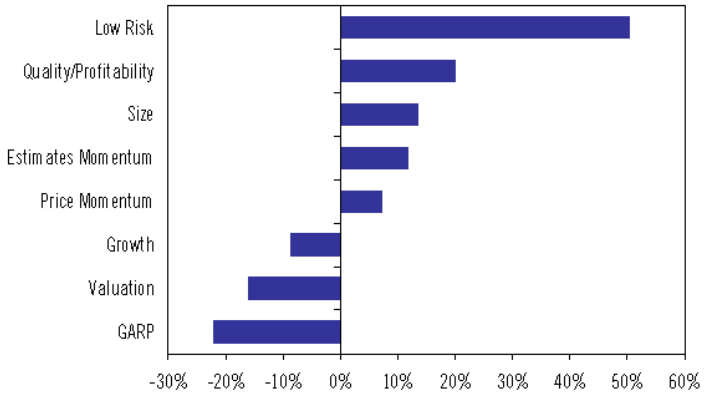
I'm sorry. I performed poorly, with a return of -22.7%. I did not have enough low risk, defensive stocks (half of the underperformance) and I had too many lowly valued but more volatile shares (the balance). It is not that I stuck religiously to the same portfolio after a strong period of performance, indeed I did take quite a lot of profit in the best performing shares (smaller companies in particular) and I diversified the portfolio by category, just that I did not buy the large cap defensives that have driven recent returns because they seemed too expensive and do not fit easily with the remit of this strategy which looks to invest in significantly under-priced assets. Of course we will buy more defensive assets to protect capital when we are at the top of the stockmarket cycle, but our analysis indicated we were far from this point.

The one reassurance I would gain from last quarter's return is that very little of the underperformance was due to stock specific profit disappointments or PVT thesis violations; during the quarter there were just three stocks, **Topps Tiles**, **RM** and **Camelot Information Systems**, that fell on poor profit updates, accounting in aggregate for 75 basis points of negative performance. These stock specific negatives were offset by positive updates from the likes of **Blinkx** and **Monitise**.

Calendar Year:

As a result of the difficult last quarter, the return over 2011 to date has been well behind the market (-18.9% for the Fund, -10.9% for the FTSE All-Share Index). Below, I show the returns to different styles over the year to date confirming an extreme move to low risk stocks, and away from Value (and also Growth at an attractive price). When the relationship between these styles normalises our performance will be strong.

Style Performance Across Market, 2011 YTD



Source: Citi Investment Research and Analysis, IBES, Worldscope, FTSE and MSCI

Longer Term Performance

Three year returns remain strong, as do returns from the Fund's inception.

Key performance contributors

Quarter:

Positive: Stock contributions (B**linkx, Monitise**), underweight mining (**BHP Billiton**), take-over activity (**Axis Shield**).

Negative: Underweight defensives (**Vodafone**, **BAT, Diageo, National Grid**), exposure to more unpredictable earnings streams (**Vedanta, Sky Deutschland**), overweight UK banks (**RBS Group**, **Lloyds**), disappointing profit updates (**Camelot**).

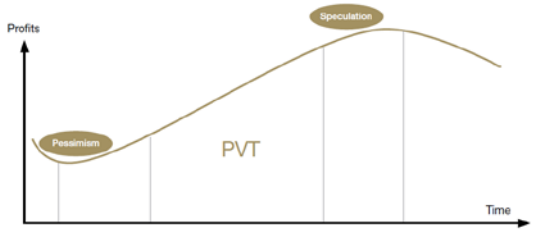
Performance Outlook

When the market switches away from 'safety at any price' to anomalies at record low prices our portfolio will do very well indeed and, as we have done in the past, more than make up for any short term underperformance.

It is of course our objective to generate consistent alpha, rather than the more volatile returns of the last few years. The issue for us is that our key value factor has (no doubt because of the impact of the credit crunch) been much more inconsistent than it has been in the past. We discuss this later in this report but our view is that, as we move beyond the aftershocks of the credit crunch, investors will become more relaxed about buying cheap shares and, as a result, there will be consistent alpha to be generated from exposure to this factor.

What themes occupy us at the moment?

The Stock Market Cycle



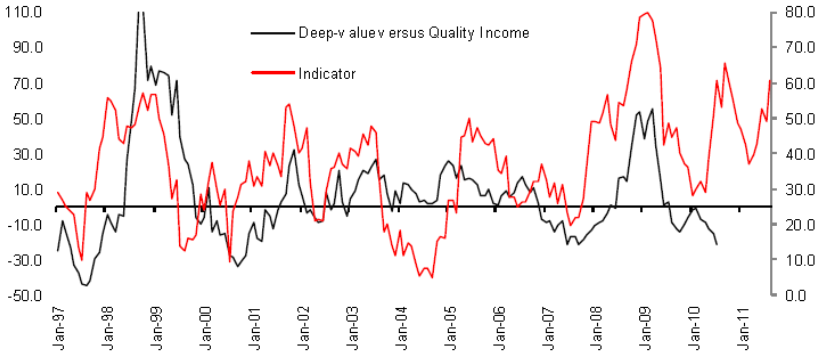
	RECOVERY	TREND	LIQUIDITY	DECLINE
ECONOMY / MONETARY POLICY	Below Trend	Trend	Above Trend	Decelerating
PROFIT CYCLE	RoE Depressed	Rising	RoE Peak	Decreasing
RISK APPETITE?	Low	Normalised	High	Falling
VALUE SPREADS	High	Reducing	Low	Increasing
PORTFOLIO RISK & STYLE?	Risk Increase / Value & Recovery	PVT	Risk Reduction / Quality	Quality

Last quarter our analysis pointed to us being in the trend phase of the cycle; whilst economic growth was moving through a dull patch, monetary policy remained highly accommodative and not suggestive of a move back into recession; risk appetite remained muted; and return on equity was mid-cycle.

However, during the current quarter the trend phase of the cycle has been interrupted by a flight from risk, the main cause of which has been an escalation of the European sovereign debt crisis. This seems to have interrupted demand growth (as consumers and corporates return to conserving cash) and is likely to cause a modest mid-cycle reduction in corporate profitability.

Share prices have moved to discount this interruption in the cycle with equity risk premiums back to historically very high levels. The majority of style models we follow suggest that the stock market is now discounting the type of environment that surrounded the failure of Lehman Brothers at the height of the 2008/9 credit crunch – this as we know presented an attractive point at which to back both equities and the value style.

Annualised 12 relative returns lagged 12 months (%)



Source: SG Cross Asset Management Research

The above analysis has recently been developed by the Quant Team at Sociéte Générale to help allocate between Quality and Value. When the red line is high then Value is attractive and should be overweighted; currently this is suggesting a 73% Value / 27% Quality split, not far off the Value allocation suggested during the last credit crunch. We will be incorporating this sensible analysis into our stock market cycle reviews.

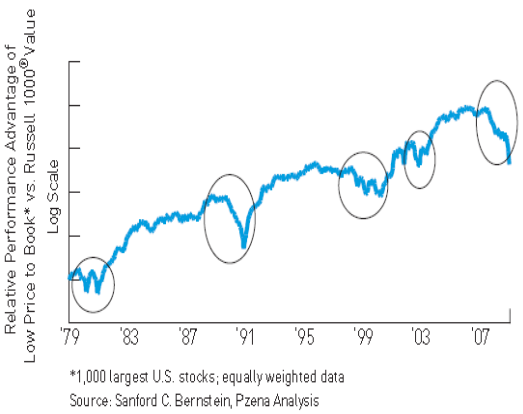
The Value Cycle

The work we did last year on the stock market cycle included outlining one aspect of this, the Value cycle.

After a quarter when cheap stocks all around the world got cheaper I thought it would be useful to do a bit more work on the Value style cycle.

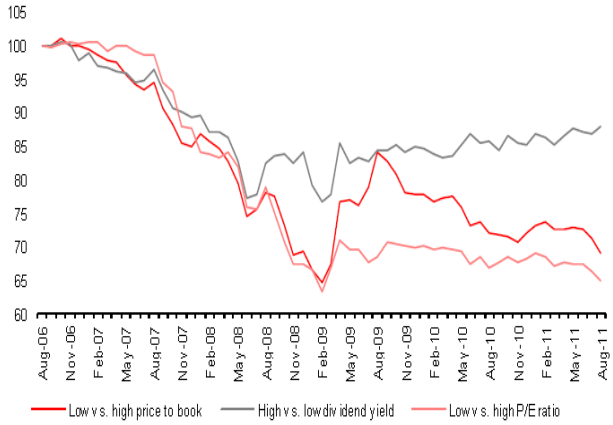
Here are two charts that show first the longer term cycle for Value and also the shorter term returns:

Long Term Return to Value



Source: Sanford C.Bernstein, Pezena Analysis

UK Value Styles



Source: SG Cross Asset Management Research

The first chart confirms that the Value approach (in this case price to book) performs well over the longer term. It also confirms that there are periods when Value struggles. In this thirty year period there have been four periods of outperformance and five (typically much shorter periods) of underperformance.

What were the characteristics associated with Value performing?

Four up-cycles: 1981-89, 1991-98, 2000-06, 2009

Profits started low (1981, 1991, 2009), Value spreads started high (1981, 1991, 2000, 2009), risk appetite started low (1981, 1991, 2009), risk appetite and profits started high (2000). So Value spreads started high at the beginning of each return to Value, and it is more normal than not for profitability and risk appetite to start low. The exception to this rule was at the end of the TMT bubble – here Value protected capital from a peak level of profits and risk appetite. So V is best at the beginning of a profit and risk cycle, and also great at the end of a bubble.

What were the characteristics of Value underperforming?

Five anti-value cycles: 1979/81, 1989/91, 1998/2000, 2007/8, 2010/11

Profit started high (1979/81, 1989/91, 2007/8); Value spreads started low (1979/81, 1989/91, 1998/2000, 2007/8); risk appetite started high (1979/81, 1989/91, 2007/8); risk appetite and profits started low (2010/11).

Of these, three of the five anti-value periods (1979-81, 1989-91, and 2007-8) were associated with profit and risk falls during economic downturns. The 1998/00 period was the run into the TMT bubble, when the culmination of the bull market encouraged a momentum, non-Value

trade into technology related companies. The final anti-Value period is the most recent and is the exception because it was not preceded by a peak in profits, risk appetite or Value dispersion.

In every case, apart from one, the anti-Value trade has been followed by a strong subsequent return to Value, with the Value factor moving to new relative highs. Again the exception is the most recent period, where Value did well from the bottom in 2009 but then tailed off. This exception no doubt reflects the deleveraging impacted nature of this recent recovery phase and the heightened level of risk aversion associated with debt related uncertainty. Perhaps it also suggests a significant opportunity.

Portfolio Valuation Metrics

This is a very lowly valued portfolio of stocks: a current year PE of 8.8, price to cash flow of 4.4, price to book of only 0.85, and price to sales of 0.6. The lower than market earnings multiple is despite the presence of a large number of Recovery shares where profits are below normal levels, most notably the banks.

Recovery Shares

Our Recovery stocks have been hit the hardest over the last three months. In most cases companies have not done anything wrong and have been delivering in line with our PVT thesis and management objectives; the crime they have committed in the mind of the market is having had a volatile history of profits. For this they have been marked down aggressively, often towards the lows they got to in 2008/9.

Wolseley is a classic example of this, a company that has remained a high scoring *MoneyPenny* Recovery stock throughout this recent period of volatility:

Wolseley Share Price

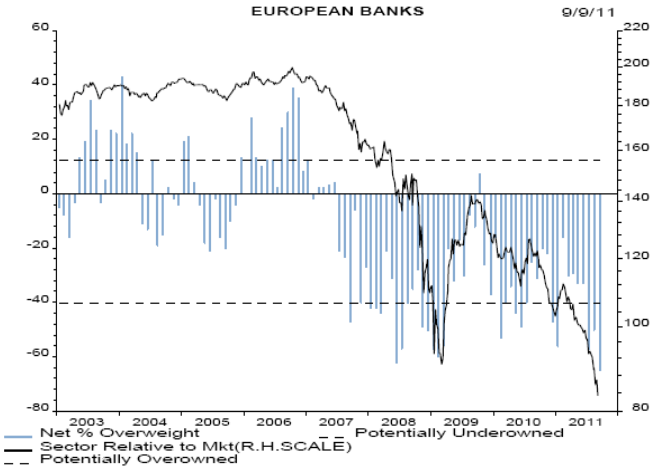
Source: Bloomberg

We do not think its recent fall is justified – it is a much stronger business than it was in 2008/9, with a new management team, a rationalised business structure far more focused on its areas of competitive advantage, and a very robust balance sheet and high levels of cash conversion. Despite these strengths the shares are trading on the same multi-decade low of EV/Sales reached at the peak of the post Lehman credit crunch. A clear buying opportunity for this global leading distributor of building products.

Banks

Global investors have given up on banks; they are actually more unpopular today than they were in the credit crunch:

Fund Managers: Net Percentage Overweight



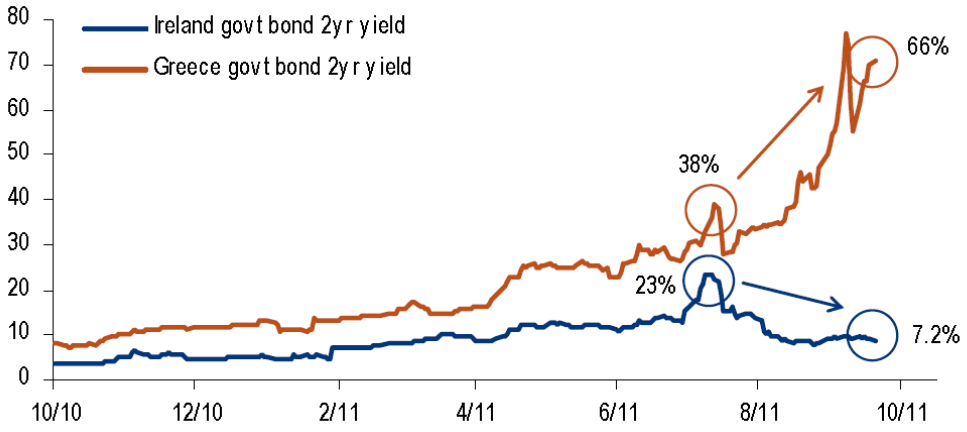
Source: Bank of America Merrill Lynch & Bloomberg

However, I have not given up on the sector. Indeed, despite the huge level of negativity, we think that the UK banks are much stronger than they were three years ago. Lloyds in particular has a far stronger balance sheet, a completely new and well respected management team, falling and more actively managed levels of bad debts, and a regulatory environment that, whilst it will reduce the recovery ROE, is at least now a known quantity. The shares trade at half tangible book value and two times pre-provision profits.

Catalysts – European Sovereign Debt and Double Dips

There is nothing that I can add to all the extensive coverage of the key macro issues at the moment. What I can recognise is that for my portfolio to do well I need two catalysts: firstly the European Sovereign Debt crisis needs to be resolved in line with current expectations, i.e. it will take a long time but eventually a combination of a Greek debt restructuring, Euro bank recapitalisation and an increase in size of the European Financial Stability Facility will bring some stability back to the European sovereign debt market. Looking at what has happened to Irish bond yields recently suggests that the right policy can deliver results:

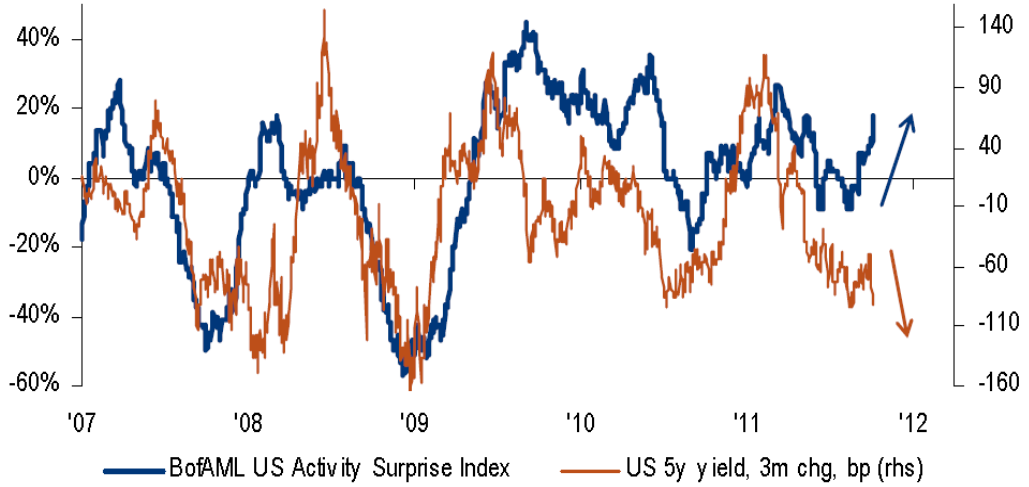
Ireland is no Greece



Source: BofA Merrill Lynch Global Equity Strategy, Bloomberg

Secondly I need the expected 'double dip' to be modest. Here the omens look reasonable, with a clear economic slowdown around the world but not significant contraction. Indeed in the US recent activity releases have been ahead of what are now modest expectations:

US Activity Surprise Index suggests US economy holding up…



Source: BofA Merrill Lynch Global Equity Strategy, Bloomberg, Datastream

Portfolio Activity

Our activity this quarter has focused on responding to the huge moves in risk premiums; the bigger the move the more likely we were to respond. The dominant theme was the risk off trade amongst larger companies – the swing to earnings certainty at any price. This drove stocks with more volatile profit profiles to unsustainably low valuation levels. We added to many of these, across a wide range of UK sectors including **Prudential**, **Standard Chartered**, **Lloyds**, **Rio Tinto**, **BAE Systems**, **Wolseley**, **BP**, **Lonmin,** and **Carnival** and on a similar theme we added to International stocks such as **GE**, **ING, Renault, Cameco** and **Maersk.**

These purchases were funded from smaller companies that held up well during the summer bear market (**Avon Rubber**, **Hogg Robinson, Wacker Neuson**), from taking profits in some defensive shares (**Vodafone, Tate & Lyle**), and from take-over activity (**Dealogic**, **Axis Shield** and **Charter**).

New Investments (purchases)

We made few new investments, preferring to focus capital on adding to existing high conviction positions.

One exception to this was the purchase of **3i,** a top-decile scoring Asset Backed stock. The thesis here is simple – part asset backed, with the shares trading at a 40% discount to assets (with no value put on their substantial fund management business), part recovery with a refocused management team having cut costs and strengthened the balance sheet so that it is in a much better position to weather a possible downturn in the profitability and valuation of its investment portfolio.

Outside of the UK we focused on Global Leaders that had been excessively beaten-up in the summer, including **JPMorgan**, **Siemens** and **Arcelor Mittal**.

Stocks that have delivered versus our PVT thesis (sale)

We took profits in a number of our holdings that were subject to bid activity, including **Charter** which had competing bids from two parties including Melrose, who decided to walk away from the bid and could now be interested in another of our very lowly valued industrial stocks (Cookson or Bodycote).

Outlook

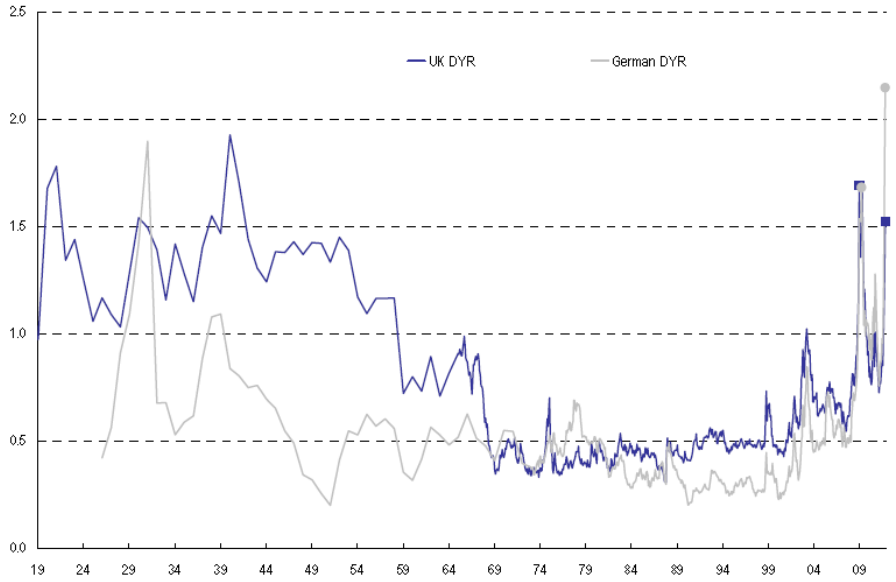
If you're not a tobacco stock or, if push comes to shove, a food producer or utility, you aren't worth owning. Global leading oil company? *Who needs oil when Greece is bust!* Asia's leading Life Assurance Company? *Come off it, don't they own lots of equities and sovereign debt!* An oligopolistic global producer of iron ore? *Why on Earth, the Chinese have stopped buying!* The world's dominant producer of CVJs? *Who is mad enough to buy a new car?!* The UK's leading retail bank? *Oh my God, are you mad, banks will never make money again (and of course they shouldn't be allowed to should they)?!* The point I make is that the market, in its flight to safety, has become so dismissive of so many market leading businesses that there are a great number of fantastic investment opportunities.

Whilst I apologise sincerely for the last quarter's poor performance I will not follow the herd and flee to safety. Instead I have been adding to all these strong businesses in the knowledge that, at some point, we will get through the sovereign debt crisis and buying these lowly valued companies will generate strong medium term returns.

The Long Term Recovery Strategy PE is 8.8x; the average return over the last forty years of buying a portfolio on such a PE is a three year return of over 15% per annum. I have been adding to my personal holding.

And finally, did you ever think we would see equities yielding twice as much as government bonds? Well they do.

Equity Valuations back to pre-1950's: Equity Yield vs. Government Bond Yield



Source: Global Finacial Data and DataStream

Another reason to follow Sir John Templeton's advice and "*buy when others are despondently selling* ..."

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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