

RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Smaller Companies Fund I Quarterly Report
September 2011

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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

Strategy AUM	£29.8m
Strategy Capacity	£400m
Number of stocks	83
Largest Holding	RPC Group 2.31 %

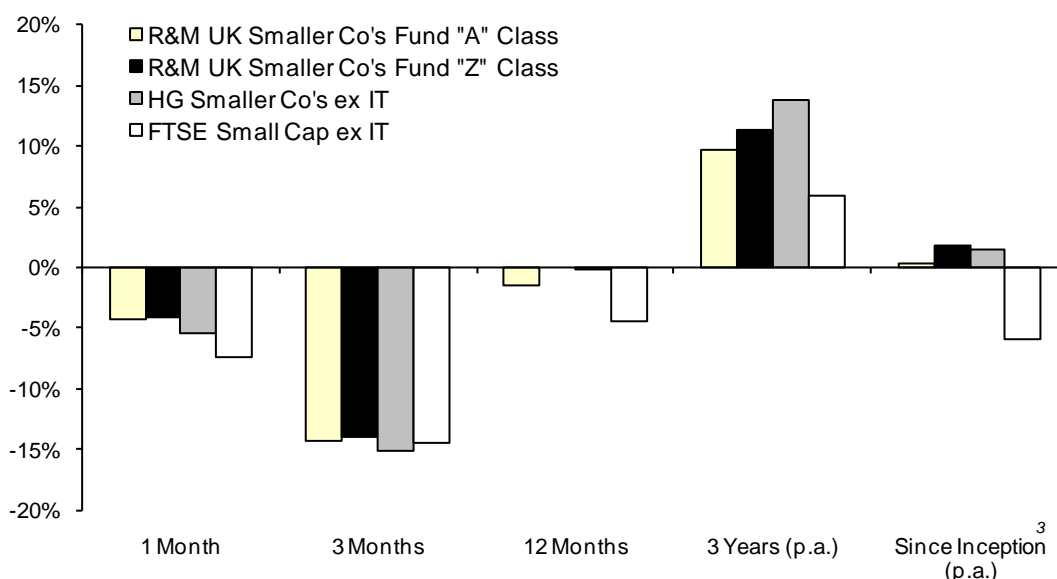
Risk Analysis Summary

Portfolio Beta	0.84
Tracking Error	5.75 %
Active Money	81.99 %

Performance to 30 September 2011

Retail "A" Class Shares	Fund ¹	HG Index*	Difference	FTSE Small Cap (ex IT)
1 Month	-4.28%	-5.48%	1.20%	-7.36%
3 Months	-14.28%	-15.10%	0.82%	-14.42%
12 Months	-1.49%	-0.15%	-1.34%	-4.52%
3 Years (p.a.)	9.71%	13.89%	-4.18%	6.00%
Since Inception ³ (p.a.)	0.28%	1.46%	-1.18%	-5.89%

Inst'l "Z" Class Shares	Fund ²	HG Index*	Difference	FTSE Small Cap (ex IT)
1 Month	-4.16%	-5.48%	1.32%	-7.36%
3 Months	-13.95%	-15.10%	1.15%	-14.42%
12 Months	0.00%	-0.15%	0.15%	-4.52%
3 Years (p.a.)	11.31%	13.89%	-2.58%	6.00%
Since Inception ³ (p.a.)	1.74%	1.46%	0.28%	-5.89%



Source: River and Mercantile Asset Management LLP

*Index: Hoare Govett Smaller Companies ex IT

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 30 November 2006

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 24th (2nd Warwickshire) Regiment of Foot, seeking 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 thus far. Defensives and 'safe' havens outperformed. The fund finally started to benefit from the decision to sell Industrial holdings earlier in the year.

The FTSE All-share finished the quarter down -14.3%, a very significant move with an even worse performance of -17.7% from the FTSE 250 and -18.4% in the AIM. The Hoare-Govett Index fell -15.1% with the FTSE Small Cap Index slightly better at -14.4%.

I remain positive on the outlook for the portfolio with holdings exhibiting strong balance sheets, improving profitability and very low valuations. Sector positioning has started to produce better returns and stock selection attribution is improving.



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 outperformed the Hoare Govett by +1.15%, and the FTSE Small Cap by 0.5%.

Sector positioning overall vs. the benchmark was slightly positive during the quarter, however I would highlight that the earlier decision to sell Industrial Engineering and Electronic & Electricals was finally rewarded as these sectors were very weak. Almost all outperformance was due to stock selection. AIM listed Growth companies performed very well such as wound care manufacturer Advanced Medical Solutions (+16%), video-search company Blinkx (+20%), Identity Verification specialist GB Group (+10%) in addition to the high Quality patent translation expert RWS and the fast-growing Moneysupermarket.com. Whilst Heritage Oil provided some welcome relative outperformance, other resource holdings were mainly a drag on greater outperformance such as Salamander Energy and Ferrum Crescent. Falling economic growth expectations impacted sentiment to SIG, despite delivering a robust set of interims, driven mainly by self-help. However, Psion and Topps Tiles issued weak trading statements and were punished accordingly; both positions have been materially reduced.

Philosophy & Process

There remains good diversification between Category weightings in the portfolio. Quality has grown further to 32% of the fund (largest allocation) with capital in Growth increasing more to 30.6%, through both existing holdings' outperformance and new positions. Recovery reduced further to 23.1%, as indicated was likely in the Q2 report due to the weakening economic lead indicators. 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.

The skew to high scoring stocks, as quantitatively measured by Moneypenny, our proprietary screening tool, has improved further during the quarter with an increase to 73% in the top 4 deciles.

The Value factor, a key component of our Philosophy continues to remain out of synchronisation with the longer term outperformance of the factor. 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 greater relative outperformance recently, indeed our Recovery screen/approach specifically biases to the particularly poorly performing EV/Sales ratio. (Qwest valuation is a proxy DCF, Market to Book is an adjusted Price/Book ratio).

w/c 3 Oct 2011

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

Source: Collins Stewart Quest

I remain focused on ensuring the portfolio benefits strongly when this reverts back to trend.

Quarterly Portfolio Activity

Purchases

Whilst I imagine it is very tempting for investors to be in-active during periods of heightened volatility and changing/cloudy macroeconomic outlooks, until a more obvious consensus emerges, with our systematic process and clear Philosophy we continue to unearth and research a range of PVT opportunities and have acted upon a number during the quarter.

Quality

Paypoint is a high returning, stable business which owns a mature network of payments terminals across a range of independent retailers across the UK addressing the 'cash' economy and the need of many to pay for their utility bills upfront, top up their mobile phones and transact other activities. The terminals have had their functionality upgraded in recent years, and the company is in exciting talks with the Dept of Work regarding the outsourcing of the collection of the Giro. Highly cash generative and supported by an excellent balance sheet, the entrepreneurial management team are pursuing a number of growth opportunities such as a recently completed terminal roll-out in Romania, growing the international Pay-by-Phone mobile ticketing system (e.g. Westminster), providing internet payment solutions and developing parcel delivery solutions via their network with Yodel. The shares yield 5.1% and have been beating market expectations.

Mears is the leading social housing maintenance services business with significant long-term contracts with a range of local authorities and other organisations. This cash generative business provides essential services and offers cheaper outsourced solutions than in-house provision. The company has also developed a domiciliary care offering in recent years. The company is experiencing "unprecedented" public sector opportunities given the 'austerity' demands to reduce costs with a huge bidding pipeline and benefits from its existing market leadership position, and strong balance sheet. The shares are valued on a 2012 PE of 8.5x, with high visibility of profitability and has also recently beat market expectations.

Growth

Alongside the high conviction investment in Anite, another telecommunications network testing company **Spirent** has been acquired for the portfolio. A world leader in testing solutions, like Anite, the business is benefiting from robust demand due to the pressures upon existing telecommunications networks to ensure robust services and the required inter-operability with new technology developments such as '4G'. The business retains a huge cash balance and acquisitions should be expected to improve their offering. The valuation is at a premium to the UK market, however on 2x EV/Sales decent upside is likely given the above-average growth rate, margins of 24%, its discount to the US peer group and from the likely improved returns by investing the cash.

RPS provides a range of consulting services in environmental, energy, health and safety and other markets across the globe. The business, clearly has some cyclicality in its end markets, but has proven over the long-term to provide an outstanding above average growth in profits through a combination of organic drivers and acquisitions. Recent concerns over energy markets, where the Fund has limited exposure, have led to weakness in the shares, and a rare opportunity to invest in the company on a sub-10x PE. The business retains a strong balance sheet.

Cupid is a fast-growing international internet dating company. The business continues to generate exceptional growth, beating market expectations in August with a 189% revenue growth rate, alongside non-UK revenues growing to over 50% of the group. With net cash, critical mass in key territories and clearly winning against competitors in this structural growth market, its relative growth rate and outlook has driven a premium rating. However, a revenue multiple of 3x in the current year falling rapidly in 2012 to nearer 2x appears to offer considerable upside to the shares if the growth rates continue into the medium-term. As the business is already profitable, the PE multiple estimated for 2012 is only 15x with forecasts being recently upgraded.

Recovery

As previously mentioned, I have not been seeking to add to the Recovery category (weighting fell this quarter), however one new opportunity emerged and an initial position has been established in top decile F&C Asset Management. Currently subject to activism, by the now c.20% shareholder Sherborn, the business clearly has scope for improved growth, profit margins, further cost-cutting and should benefit greatly from the efforts of Ed Bramson who has installed himself as Executive Chairman. Bramson's record for turning-round companies and creating shareholder value is excellent and with F&C now valued at <1% of funds under management, yielding 5% and offering a PE of c.10x, the potential upside appears undervalued by the market.

Asset Backed

Leading housebuilder Persimmon was added to the portfolio (alongside Barratt Developments). The UK market appears to have broadly stabilised, and while I still remain underweight the benchmark in terms of Housebuilding exposure, recent results indicated improving margins which were ahead of expectations and caused a re-evaluation of the prospects. The shares trade at a deep discount (+20%) to Book Value and the existence of a large strategic land-bank, and strong operating metrics has led me to moderate this sector stance.

Sales

Two companies were involved in takeover activity during the quarter, namely **Holidaybreak** and **Laird**, both were exited.

A number of holdings experienced deteriorating **Timing** credentials during the quarter and have been sold:

Atkins, the engineering consultant, lost its long-standing CEO during the quarter. 'Later-cycle' construction markets appear challenged with the reduction in global growth expectations, and the business carries a large pension fund deficit. Revised work on market expectations has led to a sale.

Enquest, the oil company, has been performing poorly as the difficulties of growing production (both organically, in-line with expectations and via acquisition) have become evident. A falling moneypenny score, new North Sea taxation and weakening resource prices prompted a cut of this position, as the business lacks a significant reserve base, or material exploration potential and has mature fields.

Recovery holdings **Northgate**, the commercial vehicle hire company and **Howdens**, the kitchen supply business, have been highly successful investments. The scope for market expectations to be beaten now appears stretched given the economic backdrop and mature stage of self-help progress both companies have reached after a number of years/actions. Their valuation anomalies appear almost fully unwound and are relatively unattractive when compared with the stocks purchased above.

Sector and size positioning

The fund remains significantly underweight FTSE 250 stocks in relation to the make-up of the Hoare Govett Index, with 35.2% of portfolio capital in mid-caps vs 73% of the benchmark. Aim holdings represent 23% of the fund represented by a wide range of Healthcare, Technology, Telecommunications and Service company investments. This has had a very material bearing on the performance of the strategy over the last few years vs. the stated benchmark, with the Hoare Govett up 47.7% over the last 3 years and the FTSE Small Cap up only 19%. Clearly mid-caps have done exceptional well relative, to smaller, less liquid equities, however our fund approach has always been to provide a 'core' *small* cap fund. There is currently considerable relative value to be found smaller down the market cap spectrum rather than the £800-£1bn market cap companies that pepper the top of the Hoare Govett Index.

There were some small changes to sector positioning during the quarter, the largest overweight remains the diverse Support Services sector, however this has grown due to the purchases detailed above to +8.1%, 19.3% of the portfolio. Technology is +6% at 14.3% of the portfolio and overall the Fund is +12.9% overweight TMT sectors.

Reducing risk early in the quarter I cut the size of the oil & gas overweight and moved more aggressively underweight Financial services (-1.5%). Key underweight sectors remain the same, (namely Industrial and Consumer sectors) however I have started to narrow the consumer underweight positions adding to Travel & Leisure, Retail and House builders. Mining shares remain a small (3.3%) part of the portfolio.

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. According to Factset the portfolio's 2012 PE is 8.2x and should benefit greatly from a return to the 'value' factor. The UK Small Cap market has a significant number of domestically focused businesses and is underweight (apart from AIM) the Resources sectors relative to the FTSE 100. 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

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

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