

RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Income Fund I Quarterly Report
December 2011

River and Mercantile

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UK Equity Income Fund – Quarterly Report

Fund Aim

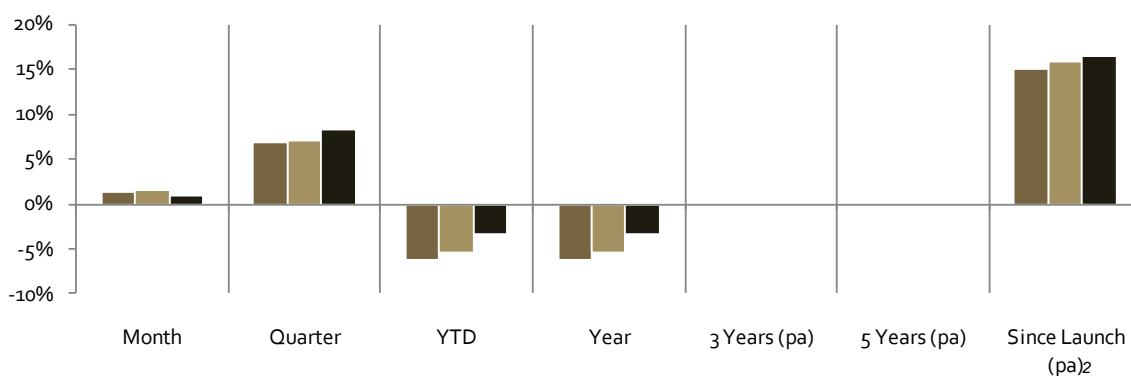
The investment objective of the Fund is to generate a rising level of income combined with the potential for capital growth through investing in a portfolio which will primarily consist of UK equities.

Portfolio Summary		Risk Analysis Summary	
Strategy AUM	£46.9m	Tracking Error	3.67 %
Strategy Capacity	£1bn	Portfolio Beta	0.92
Number of stocks	62		
Largest Holding	Vodafone	6.67 %	
Historic Yield ³	4.23 %		

Performance to 31 December 2011

Retail "A" Class Shares	Fund ¹	Index*	Difference
Month	1.39%	0.84%	0.55%
Quarter	6.87%	8.39%	-1.52%
Year	-6.17%	-3.46%	-2.71%
Since Launch ² (pa)	15.00%	16.54%	-1.54%

Asset Manager "B" Class Shares	Fund ¹	Index*	Difference
Month	1.45%	0.84%	0.61%
Quarter	7.07%	8.39%	-1.32%
Year	-5.47%	-3.46%	-2.01%
Since Launch ² (pa)	15.84%	16.54%	-0.70%



- R&M UK Equity Income Fund 'A' Shares
- R&M UK Equity Income Fund 'B' Shares
- FTSE All Share Index

Source: River and Mercantile Asset Management LLP

*Index: FTSE All Share (Total Return)

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

²Inception date 3 February 2009

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

⁴Yield based on current yield of the portfolio holdings

Market Overview

"Think big, think positive, never show any sign of weakness. Always go for the throat. Buy low, sell high. Fear? That's the other guy's problem. Nothing you have ever experienced will prepare you for the absolute carnage you are about to witness. Super Bowl, World Series - they don't know what pressure is. In this building, it's either kill or be killed. You make no friends in the pits and you take no prisoners. One minute you're up half a million in soybeans and the next, boom, your kids don't go to college and they've repossessed your Bentley. Are you with me?" Louis Winthorpe III, played by Dan Ackroyd, *Trading Places*, 1983.



The highs and lows of the fortunes of Louis Winthorpe III in the comic masterpiece *Trading Places* appear similar to the travails of 2011's stock market. A range of challenges face us: investors are struggling to construct a *clear* macroeconomic, political or market outlook. 'Politics' appear to be dominating, when 'policy' is actually required. *Global* risks are evident, yet they are being addressed by *nationalistic* institutions. Public expectations appear disjointed from economic reality. The polarisation of demographics and the divergent agendas of age across the world are great. The divergence of living standards between the 'haves' and the 'have-nots' has become wider than perhaps society can stand, whilst friction is building between 'citizens' and 'elites'. Action is being driven by a 'make do and mend' approach rather than a reformist approach. Populism, over-regulation, piecemeal policy iteration and high personal taxation are endemic.

2012 offers the possibility of change with elections in key countries such as the US (Q4), France (Q2) and Russia (Q1), and a leadership change in China due (Q3). 2011 was also clearly rife with political leadership change, however most was unscheduled, such as in Italy or the authoritarian regimes of North Africa and North Korea. Considerable instability still resides in other nations such as Syria, Saudi Arabia and Iran, and in a fragile UK coalition government. Recent events suggest attempting to predict political outcomes is foolhardy and probably of limited value. One trend, though, making few headlines has been the quiet rise in extremist popular electoral support in a number of countries such as Finland, the Netherlands, and Hungary. This could spread and would not be unsurprising given high unemployment and food price inflation. How the French vote will be interesting in this regard. The percentage of the population below the age of 25 in Syria, Egypt and Libya is c.55%, 52% and 47% respectively. Spanish unemployment is now over 5.4m, at 23% of the workforce, and is even higher for young people. Despite an unpredictable political landscape, this should act as no impediment to proactively investing. 'Certainty' is premium priced at present.

"We have two classes of forecasters: those who don't know and those who don't know they don't know" John Kenneth Galbraith

Political uncertainty coupled with macroeconomic uncertainty is providing huge opportunity for equity investors. There are obviously times when investors believe, but never *actually* know, the future is clear, and now is not one of those times. However, uncertainty in the equity market has become pervasive, feeding on itself, particularly within the advisory community and press who are actually less concerned with market levels and more with transaction volumes (that is volumes of newspapers and shares sold, the picture above is how stockbrokers feel at the moment). The environment has therefore become rich with investment opportunities where, in reality, the macro or political outcome is likely to be a small factor in determining a stock's medium-term return. This portfolio now has a diversified range of companies providing leading products or services, often with significant market share, profitably positioned with strong capital positions. Decent cash flows are being returned to shareholders as a result and the price to secure this growing stream of dividends is very low, especially when compared to UK Gilts.

The market has become far more obsessed than normal with trying to identify the macro outlook, despite considerable evidence that it's not been very good at doing it in the past. The valuation of a share appears to have become a low priority factor for market participants, when it should be paramount. I remain primarily focused on PVT stock selection which biases towards style factors such as company fundamentals, valuation and price/earnings momentum, all of which have considerably less uncertainty than the main market issue; the outlook for the European sovereign debt crisis. Stock level focus is then combined with a careful portfolio risk management framework. At year-end the portfolio's prospective yield was 4.5%, 118% of the FTSE All-Share Index yield and a whopping 229% of the sub 2% 10 year Gilt yield. According to Factset the Fund is less leveraged than the average company and offers a prospective price earnings ratio of 9.5x.

"Isn't that a £10 note lying on the ground?" asks the graduate.

"No, it can't be a £10 note", answers the Professor of Finance. "If it were, someone would have picked it up by now". The professor walks away and the student picks it up and buys himself lunch.

For those wishing to put the children through college, or eventually own a Bentley, the potential capital appreciation, compounding effects and dividend stream offered by the Fund might be a good place to start.

Performance

"The market is not a very accommodating machine; it won't provide high returns just because you need them" Peter Bernstein.

The Fund rose during the quarter, increasing 7.1% but lagging the FTSE All-Share Index which was up 8.4%. Pleasingly the Fund outperformed the rising market in December. Overall, there was a strong size bias of market performance to large caps (and mega-cap within large) during the period with Small, Fledgling and AIM company Indices actually all falling and the FTSE 100 outperforming the FTSE 250 by 5.9%. The Fund is underweight the FTSE 100 by 20%. Over the medium-term our mid and small cap holdings should generate significant alpha.

A combination of high conviction large cap holdings such as **Vodafone**, **BP**, **Prudential** and **GlaxoSmithKline** were strong contributors to relative performance, in addition to US housing exposed **Wolseley** which responded well to company self-help and improving US data points, up 35%.

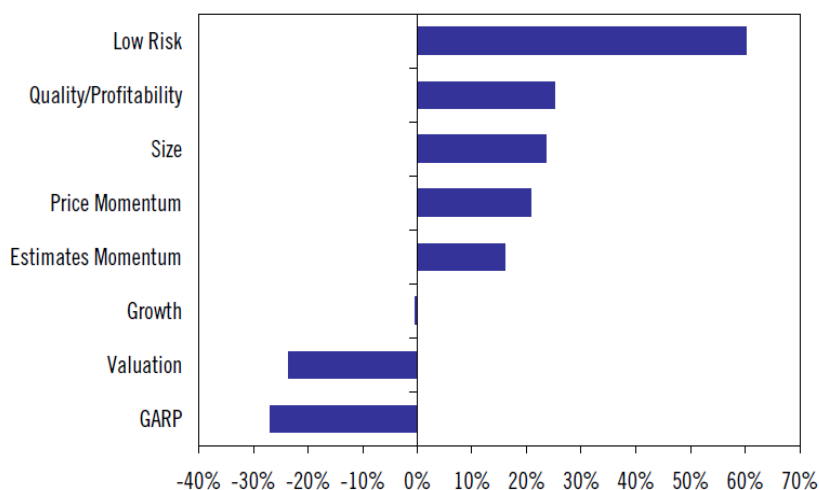
In a difficult quarter for small caps generally, the Fund's holdings generated some excellent results. A takeover approach for small cap holding **Collins Stewart** aided performance, as Cannacord Financial acted upon the gross undervaluation of the franchise offering a material premium to shareholders. **Anite's** profit expectations were materially upgraded again during the quarter generating a 45% return in the stock, whilst **Fiberweb** announced the value-accretive disposal of their hygiene division causing a 24% increase in the share price. **Trinity Mirror** continued to outperform pessimistic expectations generating a 17% gain. Within mid-caps **Aberdeen Asset Management** generated a strong return with solid results and a 25%³

return and **ITV** began to markedly reverse its weakness of the previous quarter. Three of the portfolio's mid caps, namely **RPC**, **Interserve** and **Moneysupermarket.com** were amongst the top ten mid-cap stocks in the market in 2011.

Disappointing, however, were the issues facing **Trading Emissions** which went from bad to worse and significant share price weakness was experienced. I can only apologise for this awful investment which I should have cut much earlier. I have now sold given the continued lack of clarity over value. This caused nearly 0.5% of the relative underperformance during the period. The large underweight in Tobacco stocks and **Royal Dutch Shell** hindered relative performance as did the lack of exposure to **Xstrata** and **Rolls Royce**. The other noteworthy negative was **Lloyds Bank**, which suffered following the sudden illness of the new CEO and ongoing fears over the European Banking system. Quarterly results from Lloyds announced during the period were actually good in my view and the reality of Lloyds's exposure is actually low European lending-default risk.

The following table illustrates the key style factors performance during the year, highlighting (again) how the V or Valuation factor in our multi-factor philosophy (PVT) has been a considerable headwind to better relative performance. I expect this to reverse in short order given the high dispersion of valuations across the market, the material valuation premium low volatility defensive companies have reached, relative to those companies less certain of their near term earnings profile. I also retain my ongoing belief that the long-term evidence suggests the best approach for generating above average, positive investment returns is to select companies whose stock price is at a considerable discount to their intrinsic worth.

Style Performance Across Market, 2011 YTD



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

Philosophy & Process

During the quarter there was little change to Category weightings where stock selection decisions were the key influence. **Quality** remained steady at 63.4% of the portfolio, the largest part of the portfolio. The **Recovery** category weighting increased by c.2.5% to 24.1% 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 7.1%.

As documented 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 the strategy weights in order to deliver at least 110% of the FTSE All-Share Index prospective yield.

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 and incorporates Timing measures such as earnings revisions and technicals. However, I wait with some frustration, if not latent excitement, about future returns, until 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, remains high with 77% of holdings 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 PVT Opportunities were identified during the quarter:

RPS provides world-leading environmental and energy consultancy services around the globe. The company's long-term organic and carefully executed acquisition-driven growth record are exemplary and have translated into excellent, consistently growing dividends. Knocked in recent years by a meaningful operation in Ireland, this has now been restructured, leaving RPS at the forefront of consulting into end-markets such as unconventional fuels (e.g. shale), water (AMP process) and oil & gas reservoir audits.

Carphone Warehouse has always been entrepreneurially run by founder Charles Dunstone. A failed attempt to build a new format European retail business with BestBuy has been aborted, at some cost, yet has opened up an opportunity to invest in the remaining businesses at a highly attractive valuation. The leading independent provider of phones and related advice in Europe and with complexity a permanent function of this market (whether it be product, tariffs, technology compatibility etc), the business has a unique position to grow in this key consumer area. A stake in Virgin Mobile France, surplus property and an emerging markets JV with BestBuy add both complexity to the investment case, yet underline a highly attractive sum-of-the-parts thesis.

Petropavlovsk also returns to the portfolio after a period of underperformance. One cannot escape the fact that the company is a material Gold producer and, through its Hong Kong listed subsidiary, a meaningful iron-ore producer also, thus the direction of gold prices in particular is critical to the investment outcome. However, the main reason for investing has been the marked improvement over the last three company statements against market expectations. The company appears to have realised that the 'under-promise and over-deliver' approach may be the best route towards achieving the valuation that the excellent assets deserve. Recent Gold price weakness provided an opportune moment to re-enter the shares.

Invensys returns to the portfolio after a period of significant underperformance (-36% relative in 2011). The company has had a disappointing year but the medium-term outlook is strong. Its Rail business is a world-leader in signalling and related products and is winning significant orders as developing nations build out their transport networks and developed countries modernise and improve their existing infrastructure. Their Industrial Process systems business also has a diversified global client base with strong profitability. The smaller Controls business should be disposed of as soon as possible generating more headlines than its materiality deserves. Burdened with a huge legacy pension fund, management have made meaningful strides to reduce the deficit, a well-rehearsed investor concern. However, a breakup or sale of the group is inevitable in my view. With a very strong balance sheet, corporate activity of some form or another should expose the gross undervaluation of the shares.

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 **BG** whose valuation has now become stretched again after a robust period of outperformance.

Secondly, **Collins Stewart** has been sold following a cash and shares bid approach by Cannacord Financial. Priced at 50.5p the day before the approach, the shares rose 75%. For me this encapsulates the opportunity set currently within the UK stockmarket. Collins Stewart was cash rich under no financial pressure or distress and has been consistently profitable. However, it is a stockbroker (and wealth manager) and is therefore overtly exposed to market conditions. "It's so undervalued" I cry. "Who cares," comes the response, "We'd rather own Tobacco stocks". Cannacord cared and a quoted stock price is proven to be materially underpriced. The Fund has a range of other small cap holdings where similar events could unfold due to their material undervaluation such as, in no particular order, **Innovation Group, London Mining, Wolfson, Fiberweb, Anite, 4imprint, Wilmington, and Novae**. A number of other holdings in my view have clear strategic value or have public-to-private attractions; however the current upside is not quite as much as 75%. During 2012, hopefully, but not necessarily, when a whiff of confidence returns to corporations, their large cash piles are going to be deployed. The opportunity is to buy now.

Sales

Small cap

I remain pragmatic regarding small-cap positions and during the quarter exited four holdings where Timing attributes had been weak and where conviction was higher elsewhere. These were **Clarkson**, the shipping-broker, **Beazley**, the Lloyds Underwriter, **Globeop**, the hedge-fund outsourcer and **Trading Emissions**.

Midcap

Two holdings were exited after their *MoneyPenny* scores dropped materially and were re-verified. Despite my continued belief in the medium-term recovery prospects in **Hays**, the near-term outlook appears to be worsening rather than improving. Further analysis of cashflows has led me to reassess the dividend outlook and, expecting a cut, have therefore exited the stock for now. **Inmarsat** recovered most of its earlier relative underperformance during the quarter, offering up an unexpected opportunity to cut the position for limited pain. Ongoing challenges around pricing and usage in the core business have become a concern whilst their US 'Light-Squared' venture appears to have growing regulatory hurdles, in addition to considerable operational and other risks.

Sector and size positioning

"Risk means more things can happen than will happen" Elroy Dimson.

The FTSE 100 weighting has fallen by 2.8% to 65.6%. Exposure to the FTSE 250 has increased by 3.5% to 21.5% and exposure to Small Companies has fallen to 11.7%.

In relation to the 'Mega-caps' (the top 20 stocks in the UK market by capitalisation) the Fund weighting was flat at 46.2%, an underweight of -13% (4% of which is the underweight in Royal Dutch Shell). The Fund has no exposure to 8 of these 20 companies. The main changes within these holdings during the quarter was the exit from low scoring **BG**, following a strong stretch of performance and more attractive oil exploration and production opportunities appearing elsewhere, and a move underweight in **British American Tobacco** (1.6% position). These sales represented nearly c. 3.7% of the Fund. The capital was mainly invested during the period into **BHP Biliton** and **Rio Tinto**, moving from underweight to overweight these two preferred large cap mining holdings. There were mild downward adjustments to the active weights in **HSBC** (poor quarterly results), **AstraZeneca** and **Unilever** and a further increase in the overweight to **BP** (recommenced exploration in the Gulf of Mexico, further favourable settlements on Macondo).

The strategy continues to pursue limited sector risk vs. the market with the largest overweights at +3.8% and +3.5% in Media and Software & Services respectively.

There has therefore been some movements of sector rankings with the +4.1% increase in Mining to 7.5%, a -2.9% sector underweight. The reasoning behind this decision to reduce the large underweight was primarily threefold: firstly, the prior stance has been successful and generated good relative performance, however the underweight was well outside the size of normal sector weightings, necessitating a high conviction view, and prices have fallen considerably since the position was taken earlier in 2011. Secondly, my concerns over a possible hard landing in China, potentially caused by the government focus on controlling inflation and over harsh tightening measures, have abated. The Chinese authorities have indeed managed to reduce inflation, with the economy slowing as expected and property prices rolling over. Given ongoing strength in government and consumer finances, China can now start an easing process ensuring continued economic progress. Property prices have further to fall and many property loans require impairment, however, as inflation appears under control, measures will now be taken to ensure output and growth continue (GDP +8%). China's growth will remain resource intensive and bulk commodity supply has continued to lag demand despite poor global economic momentum. Finally, both **BHP Billiton** and **Rio Tinto** have impressive fundamentals, with solid balance sheets, rapidly rising dividend payments and their equity yields appear attractive for the first time this cycle. At year-end **BHP Billiton** yields 3.9%, more than the FTSE All-Share Index.

The other main sector increase was to Software & Services due to the purchase of **Invensys** and the strong performances of **Anite** and **Innovation**. The other notable increase was to General Retail, now +1.9% due to the purchase of **Carphone Warehouse** and a larger position in **Inchcape**. Key economically resilient sector overweights are maintained such as Non-life Insurance, Pharmaceuticals, Food Producers, Telecommunications, Healthcare and Utilities.

Portfolio Income

28 stocks went ex-dividend during the quarter including 22 increases on Q4 2010, no payouts were reduced, 3 were held flat, 3 holdings returned to the dividend list (**SIG**, **Wolseley** and **ITV**) and **Vodafone** delivered a special dividend. I believe that special dividends will now become a recurring annual event for **Vodafone** shareholders until any corporate restructuring of Verizon Wireless occurs. The Fund's current consensus based prospective yield of 4.5% is 118% of the market yield and is greater than the yield from non inflation-linked income offered by 10 year UK Gilts. Our analysis suggests the Fund's underlying holdings are growing their distributions at c. 10% per annum on average; however I suspect this could 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 **HSBC** (12.5%) or mid-cap positions such as **Kcom** (20.9%) and **RPC** (23.5%) I am highly encouraged. At year-end 6 holdings were not forecast to pay dividends in 2012 and 15 were forecast to generate below-market yields. The Fund targets an above average equity yield with a growing income distribution over time, combined with capital growth ahead of the FTSE All-Share Index.

Market & Fund Outlook

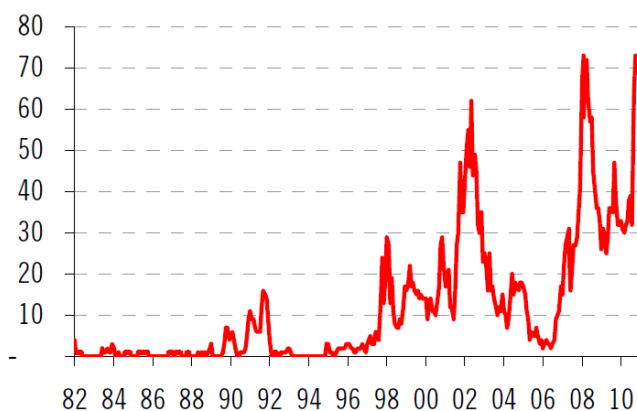
During December a number of US economic data points and surveys began indicating more positive conditions. Scepticism over sustainability and concerns over a derailment by Europe appear to be rife, however **Wolseley's** performance from its recent lows in Q3 suggests a 'bunker' mentality is not entirely dominant.

As a brief reminder, whilst this portfolio is a UK Equities portfolio, the current make-up (source UBS, and likely to be rather crude) of FTSE 100 company revenues are UK 28%, Europe 18%, North America 22% and Rest of the World 32%. The outlook for the UK economy will

affect earnings for the UK market but it is what's happening *outside* the UK which determines the overall result. I have written before at length about the lack of correlation or linkage of GDP growth to stockmarket returns, so I won't go into detail again, suffice to reiterate that it is the starting valuation which is the greatest determinant of medium-term returns from any specific equity market.

As always market participants are arguing about whether equities are 'cheap' or not. The bears appear to be focusing their attention on the Shiller PE, which measures the rolling prices over ten years worth of earnings. On this measure the market appears expensive, although this depends whether you take the median back to 1926, including WW2 and the depression, or use the last 55 years. Whilst one cannot refute the data, or rule out even cheaper markets, one can question the relevance of using a longer time series. Just being longer and with more data points does not mean it's necessarily of greater efficacy of determining current value. The Shiller PE uses 10 years of trailing earnings which currently incorporates the two deepest earnings downturns of the post WW2 period and 2000-2002 is shortly dropping out. With "un-inflation" protected Gilts offering a 2% return on investment and the equity of great business models, market leaders and brands valued at the total of a handful of years' cashflows, I can't help but believe that equities are good value.

Number of FTSE 100 Stocks Yielding more than Gilts



Source: CIRA

Nevertheless, "green shoots" in the US may be appearing. The importance of this dynamic cannot be understated. US GDP according to the CEBR World Economic League Table for 2011 is \$15 trillion. The UK is a mere \$2.4 trillion, for the first time less than Brazil and now considerably less than China at \$7 trillion, growing at c.8% per annum.

The US economy is fairly resilient because the cyclical sectors which usually decline the most in recessions are already so beaten up that they would be hard-pressed to weaken much from current levels. For example, while sales of new cars have rebounded strongly in the past couple of years they are still 15% below pre-recession levels. Sales are actually running below the number of cars being scrapped because of old age or accidents. Similar to the UK, US housing starts are at very depressed levels, arguably below the level necessary for growth in household formation. Clearly most investors will, quite rightly, lay the blame for the current economic predicament on the availability of excessive credit (rather than human greed), however the origins of bank recapitalisations and accelerated sovereign fiscal crisis were primarily manifested in the bubble and collapse of US housing prices. If US housing is stabilising and beginning to grind higher are we more likely to be at the beginning of the end, or the end of the beginning? US housing stock and services at current market prices are equivalent to 17% of US GDP which is roughly the same value as the GDP of France. (Source: Aviate). This is material.

The US is a fairly closed economy with exports accounting for only 14% of GDP and imports 18%. Domestic demand has historically been the prime driver of growth. Even if a severe European recession transpires (German GDP grew 3% last year, but has slowed markedly), the impact will be far, far worse for the UK. US banks, have mostly materially reduced their European loan exposures, have recapitalised to far better capital ratios than their European counterparts and are well-set for Recovery. In no way am I belittling the current challenging

state of affairs. US household debt-to-income ratio remains elevated against history despite decent improvement from the peak pre-crisis. Vacant properties are still at high levels and over 10m mortgages are in foreclosure or +60 days delinquent. Home prices do remain under pressure but are now very affordable on key measures. It is now cheaper to own than rent in many areas and recent mortgage data was encouraging.

For those that believe 'history rarely repeats itself but often rhymes', I find it fascinating that it is just over two decades since October 1991, when UK Chancellor Norman Lamont, based on CBI and Institute of Directors business surveys, said "the green shoots of economic spring are appearing once again." Early in 1992 one of the Sunday newspapers ran a "Green Shoots Index" of signs of recovery, only to have to drop it when few such signs could be found causing all-round lampooning. However, Gavyn Davies, then chief economist at Goldman Sachs, wrote in a newspaper article at the time of Lamont's removal from the Treasury that the famous "Green Shoots" speech had turned out to be "remarkably prescient. From that moment onwards, output stopped declining, and within a few months, it started to rise. Estimates of GDP show the trough of the recession occurring in the fourth quarter of 1991, with sustained growth resuming in the third quarter of 1992, when GDP grew 0.4% compared to the second quarter". The clarity that Recovery has begun is always weakest at the outset when it is actually occurring and only much more obvious looking backwards with the benefit of knowing what actually transpired.

Finally, I would highlight a major new dynamic which currently has limited economic impact but which could have profound economic and geopolitical effects over time. The development of the shale gas industry has received increasing media coverage during 2011 as production levels have grown materially and new resources identified and proven up. US Shale production was c.500k barrels per day equivalent in 2009, and in 2011 market forecasts were for 6,000k. North Sea oil and gas production is c.7,000k. US natural gas prices are more depressed than US housing prices. Potentially, this is a major economic cost benefit to the US economy and clearly will influence 'oil politics' if the US is not as dependent upon Middle Eastern supplies to meet its energy requirements. Note that, in addition to shale, the Canadian 'Tar sands' projects are also moving into a strong growth phase with industry forecasts expecting production to double from 1,000k barrels per day in 2008 to 2,000k by 2014. At this stage I have not drawn firm conclusions about the likely consequences of this emergent factor in US resource dynamics but if production continues to take-off this will be a trend worth following. Internet users grew from 4% to 83% in the UK between 1996 and 2009 and this has completely changed the way we live. Oil accounts for 96% of the US trade deficit. The increasing use of these plentiful, low cost, previously un-extractable domestic gas energy reserves may do the same, and resource related conflict risk might hopefully reduce.

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, Domestic Exposures, 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. **Vodafone** is a key holding, as is **RPC**. 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 mergers and acquisitions 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.

In addition, a range of consumer-facing franchises also offer Potential such as **Unilever**, **Inchcape**, **Moneysupermarket**, **Paypoint** and **Tui Travel**. Recent share price performances have been excellent in the largest consumer staples stocks such as **British American Tobacco** and **Diageo**, these holdings are starting to become expensive relative to the market and I have been reducing weightings. Frustratingly some of the Fund's 'low risk' steady investments have yet to deliver 'defensive' relative performance in these difficult markets and,

as a result, I expect strong returns in the future. These 'defensive/resilient' laggards include **Centrica**, yielding 5.6%, **Bae Systems**, yielding 6.7%, **Sainsbury's**, yielding 5.5%, and **Reed Elsevier**, yielding 4.4%. The risks to the cashflows and dividend streams of all of the above companies appear materially exaggerated and undervalued (especially when compared to Gilts), given their likely growth rates.

Domestic Exposure

From a FTSE All-Share perspective the main sectors dependent upon the UK, such as Retailers, Housebuilders and Leisure, are relatively small and that remains the case with the Fund.

Clients will be aware that for a number of quarters I have been gradually increasing exposure, where prudent, to the UK economy. In addition to Travel & Leisure the portfolio moved overweight Food and General Retail sectors in Q3. General Retail (via **Carphone Warehouse**) has now moved into the top 5 overweights. The Fund's media holdings also have a distinctly domestic bias. Earnings revisions in Industrial sectors have rolled over and expectations still 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 and the evidently low investor expectations for domestic exposed companies.

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 undercapitalised 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 sector, 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. I am overweight Life Insurance.

During the quarter the weighting in Financial Services fell due to the exit of specialist **Globeop**, the dog **Trading Emissions** and the star **Collins Stewart**. Additionally, following strong performances after excellent trading updates at **IG Group** and **Aberdeen Asset Management**, I mildly reduced weightings. I continue with some urgency to search out undervalued de-risked financial investments.

Resources

The overweight in **BP** is now a top ten position, as the valuation appears to reflect a reasonable probability of 'gross negligence' on the Macondo incident. Recent settlements with BP by a range of other parties involved with the disaster suggest this is not the case with multiple-contributing factors. Resolution on this is likely in 2012. 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. The relative underperformance vs. **Royal Dutch Shell** offers a considerable opportunity. **BG's** high production growth rate is fully valued

by the market, however 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. They are perceived as considerably more risky by the market (geography, immaturity, size) and consequently I expect high returns from these holdings over the next few years. In January 2012 I am adding further oil exploration and production investments (to ensure adequate stock diversification) as this whole sub-sector has been overly de-rated.

Mining has been discussed earlier in this report. I am underweight the sector but markedly less so than nine months previously.

“The key during a crisis is for an investor to have the following things: a staunch reliance on value, little or no use of leverage, long-term capital and a strong stomach. Patient opportunism buttressed by a contrarian attitude and a strong balance sheet can yield amazing profits during meltdowns”. Howard Marks (Founder Oaktree Capital)

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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