

RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Long Term Recovery Fund | Quarterly Report
December 2011

River and Mercantile

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UK Equity Long Term Recovery Fund – Quarterly Report

Fund Aim

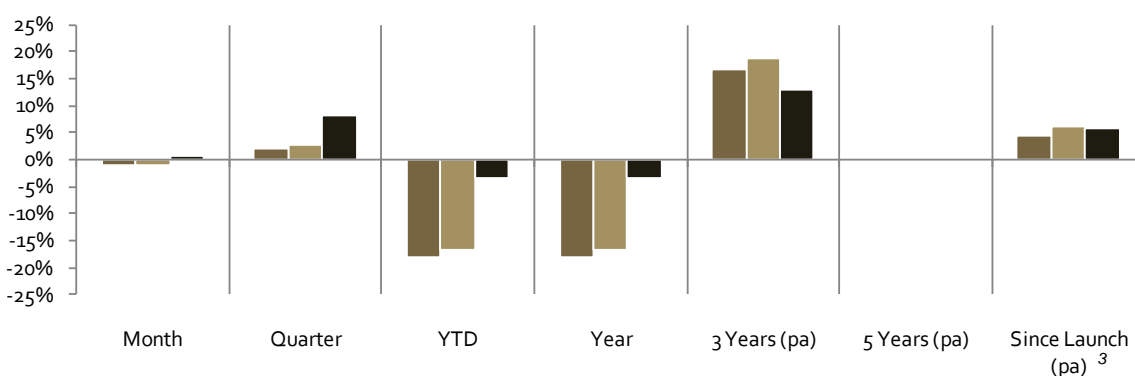
The investment objective of the Fund is to achieve capital growth through investing in a portfolio which will primarily consist of UK equities that meet the manager's recovery criteria of a turnaround in company profitability over the longer term. The Fund will not be restricted by reference to a benchmark,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

Portfolio Summary		Risk Analysis Summary	
Strategy AUM	£78.5m	Earnings Yield	6.74
Strategy Capacity	£200m	Dividend Yield	2.80
Holdings (UK/Non-UK)	111/53	Price to Sales	0.65
Largest Holding	BP 4.89 %	Price to Book	0.91

Performance to 31 December 2011

Retail "A" Class Shares	Fund ¹	FTSE All Share	Difference	LIBOR+4
Month	-1.12%	0.84%	-1.96%	0.37%
Quarter	2.25%	8.39%	-6.14%	1.15%
Year	-18.20%	-3.46%	-14.74%	4.66%
3 Years (pa)	16.71%	12.88%	3.83%	4.75%
Since Launch ³ (pa)	4.35%	5.77%	-1.42%	5.10%

Inst'l "Z" Class Shares	Fund ²	FTSE All Share	Difference	LIBOR+4
Month	-0.98%	0.84%	-1.82%	0.37%
Quarter	2.70%	8.39%	-5.69%	1.15%
Year	-16.76%	-3.46%	-13.30%	4.66%
3 Years (pa)	18.77%	12.88%	5.89%	4.75%
Since Launch ³ (pa)	6.19%	5.77%	0.42%	5.10%



- R&M UK Equity Long Term Recovery Fund 'A' Shares
- R&M UK Equity Long Term Recovery Fund 'Z' Shares
- FTSE All Share Index

Source: River and Mercantile Asset Management LLP

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

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

³Inception Date 17 July 2008

Quote for the Quarter

"You make most of your money in a bear market, you just don't realise it at the time." Shelby Davis

"To get a bargain price, you have to look where the public is most frightened and pessimistic. When you purchase a large amount of future earnings for a low price, you have made a good investment. The only way to accomplish this is to buy when others are selling". Sir John Templeton

Key Observation

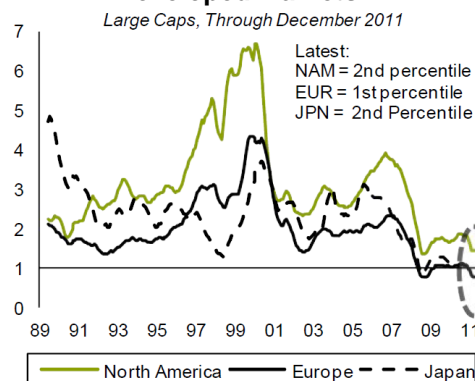
Value investing has had a long and successful history. Countless studies have proven the efficacy of buying shares when they are lowly valued and selling them when they are expensively valued. And many real fortunes (including Sir John's) have been made on the back of applying this philosophy. However, the last five years has seen a period of significant difficulty for a traditional value based approach as investors have sought safety rather than value during a period of uncertainty for the global economy. This anti-value trade has now, however, become so extreme that we describe it as an **anti-bubble**, and by describing it as such we believe that, like all bubbles in the past, it is unsustainable. Expensive shares can't keep on getting relatively more expensive; cheap shares can't keep on getting relatively less expensive; at some point the elastic will have been stretched too far and will snap back.

Later in this report I will focus on providing the detail to back up these observations and explain why the value factor is likely set for a significant and more sustained period of outperformance.

The Anti-Bubble

According to Bernstein, higher risk stocks (higher Beta) have only been this cheap 1% of the time over the last twenty five years. This is the reverse of where we were at the height of the TMT bubble, and adds further support to my concept of the anti-bubble.

Price/Book for Highest Beta Quintile: Developed Markets



Source: MSCI, Bernstein analysis

Market background

The anti-bubble (first explained on our website and covered in a Financial News article in December) is my name for the equity market at the moment. It describes how the UK stockmarket has become the complete opposite of where it was at the height of the TMT bubble in 2000 - black and white, chalk and cheese, matter and anti-matter, bubble and anti-bubble.

Back in 2000 everyone loved equities and, within the equity market, they especially loved anything with more risk, as risk (such as technology growth stocks) meant an 'opportunity to make money'. Greed was commonplace, fear was for wimps, defensive stocks such as Tobacco and Food Producers could be safely ignored, however low they were priced.

Fast forward to today and what do we have? We have a hatred of equities, as reflected in very low valuations and, within the equity market, anything that has a hint of risk (such as cyclical earnings) is considered close to un-investable because risk equals a short-term threat to share prices that no-one has the appetite to bear. Fear is commonplace, greed is for madmen, and investing in stocks that are 100% cheap is considered to be speculation not sensible long-term investing. The only place to be now is those very same Tobacco and Food stocks that were friendless twelve years ago. This is an anti-bubble.

But, of course, anti-bubbles produce significant opportunities for capital gain. Combining a cheap market with a huge number of shares that are considered un-investable (because they are cyclical, or they make money from financial services, or they have some debt, or they operate in Europe....) it becomes easy to construct a portfolio of great businesses on record low valuations. This portfolio is not performing for you at the moment and for this I apologise...but give it time and the rewards for patience will be significant.

Market background

Quarter:

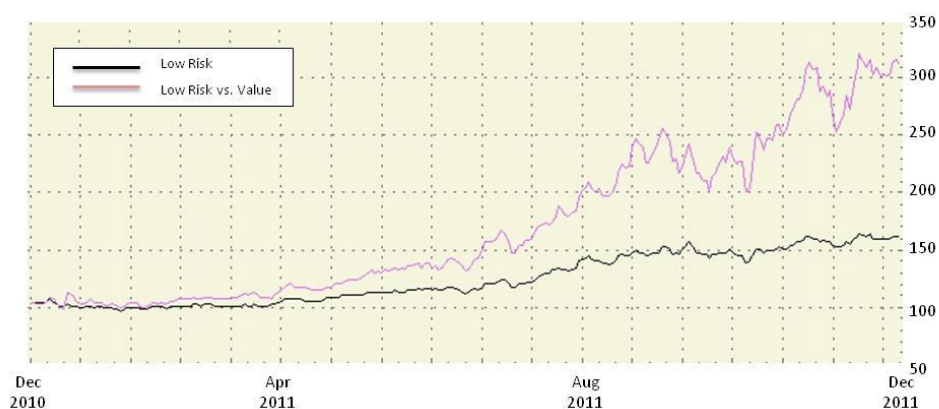
Equity prices did rally over the quarter, helped by reassuring economic activity in the US and the provision of financial liquidity by the ECB in Europe. However, the rally was the very opposite of a risk-led rally; indeed it was led by a combination of big, defensive stocks such as Royal Dutch Shell and British American Tobacco, and companies where profit margins are already very high such as the Industrial Engineers; the laggards were the recovery stocks with the biggest profit potential in more normal markets, and smaller companies. The FTSE All-Share Index returned 8.4% led by the Oil Majors, Tobacco, Engineers and Beverage stocks. Value did poorly, with cheap shares just getting cheaper and the very depressed financial services stocks lagging materially. Quality Potential did well. Recovery, Asset Backed and Growth Potential struggled. Smaller companies significantly underperformed the rally.

How did we perform and why?

The portfolio has performed poorly over the last year and for that I apologise. As you know, we look for shares with above average profit Potential, on attractive Valuations and where the outlook is supported by improving Timing indicators; in other words a hunt for PVT anomalies. In this uncertain world the market is not interested in anomalies, what the market wants is short-term security, profits that may not increase materially over the longer term but that have greater certainty over the immediate future and for this 'safety' the market is prepared to pay a higher and higher price. We struggle in this environment.

The chart below shows how extreme the move from good value stocks to lower risk stocks was in 2011, the latter outperforming the former by over 200%!

Low Risk vs. Value



Source: Bloomberg

This relative performance of low risk versus value was more extreme in 2011 than in either 2007 or 2008, so more extreme than during the credit crunch.

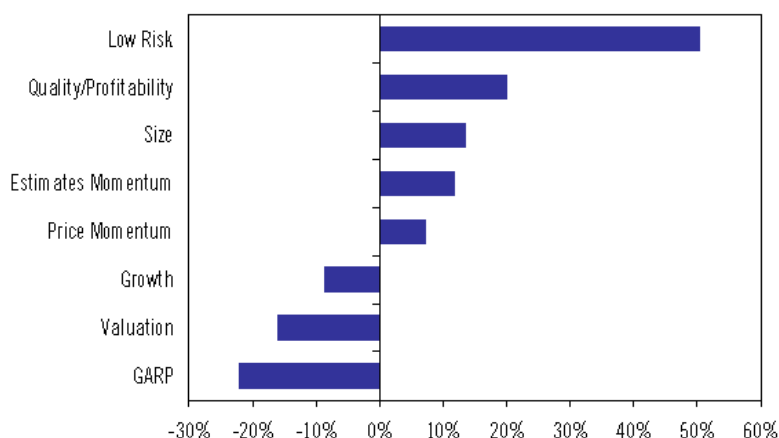
Quarter

We underperformed the rally, returning 2.7% compared with a market return of 8.4%. We had too little in big cap defensives such as Royal Dutch Shell and British American Tobacco, too much in recovery stocks in general and financial services companies in particular. During the summer we had sensibly switched some capital from our strongly performing smaller companies (such as Monitise) into larger company laggards such as the Mining stocks; this proved to have been the right thing to do, but was not enough to protect us from the savage de-rating that smaller companies saw later in the year.

Year

Our key investment strategies, value and smaller companies (and growth at the right price) have had a difficult year. As a result of this our return over 2011 has been well behind the market (-16.7% for the Fund, -3.5% 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.

Style Performance Across Market, 2011



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

Longer Term Performance

The three year returns remain strong, with the Long Term Recovery Strategy returning 67.5% versus the FTSE All-Share Index of 43.8%.

Key performance contributors

Quarter:

Positive: Overweight US recovery (**Wolseley**), Stock contributions (**Rockhopper**, **Anite**, **Bwin**), takeover activity (**Alterian**).

Negative: Underweight large company defensives (**Royal Dutch Shell**, **BAT**), Financial Services exposure (**Lloyds Bank**), disappointing updates (**Blinkx**).

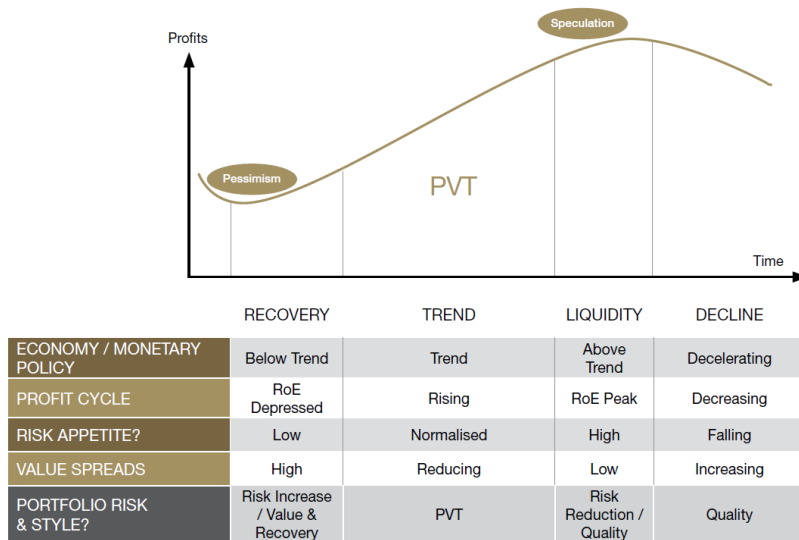
Performance Outlook

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. It is our view 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 Stockmarket Cycle



Midway through 2011, the trend phase of the stockmarket cycle was prematurely interrupted by a flight from risk, the main cause of which was the escalation of the European sovereign debt crisis. This interrupted demand growth (as consumers and corporates returned to conserving cash) and is causing a modest mid-cycle reduction in corporate profitability. Share prices moved aggressively 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 stockmarket 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 and potential styles.

Value Investing

As promised I would like to provide some detailed analysis of the value approach.

Value Investing – does it work?

In the River and Mercantile UK Equity Philosophy and Process document we detailed a number of studies that showed the efficacy of the Value factor. Another significant source of data comes from the Tweedy, Browne document entitled 'What has worked in Investing – Studies of Investment Approaches and Characteristics Associated with Exceptional Returns'. Here they detail **over fifty** studies that relate to the alpha generating ability of value based strategies across global markets, including studies of Low Price in relation to Assets, Low Price in Relation to Earnings and Cash Flow, Significant Declines in Stock Prices and Small Market Capitalisation. These studies form a substantial body of evidence in favour of value and out of favour characteristics.

One of the studies I find most interesting is one by Fama and French which looks at the returns to Price to Book and Market Capitalisation together, over a long period of time (twenty seven years). I detail the results below:

July 1963 – December 1990 Annual Investment Returns for Low Versus High Price/Book Value Stocks According to Market Capitalization within Each Price/Book Value Category for New York Stock Exchange, American Stock Exchange and NASDAQ Listed Stocks

Market Capitalization Decile	Ratio of Price to Book Value Decile									
	(Highest Price/Book Value)					(Lowest Price/Book Value)				
	1	2	3	4	5	6	7	8	9	10
1 (Smallest market capitalization)	8.4%	13.7%	14.4%	17.2%	18.7%	18.1%	20.4%	20.5%	21.8%	23.0%
2	5.2	12.6	11.5	14.3	16.0	14.3	19.0	15.4	17.2	21.5
3	6.7	10.6	14.8	11.4	16.3	15.6	15.6	16.8	18.5	19.2
4	4.7	8.6	12.7	16.3	13.6	14.5	16.1	19.1	18.1	17.6
5	10.6	7.8	13.0	17.6	13.6	17.2	17.3	15.1	18.2	17.9
6	8.4	11.8	13.7	14.8	11.3	15.2	14.3	14.3	14.9	18.0
7	11.4	12.0	11.9	10.0	11.9	13.6	11.9	13.9	13.2	17.6
8	7.9	13.6	10.9	11.4	11.9	12.1	13.8	12.6	15.5	18.6
9	5.3	10.7	11.0	12.0	12.6	11.2	9.8	13.3	12.5	14.6
10 (Largest market capitalization)	11.2	10.6	10.1	8.5	9.5	10.0	9.7	11.5	11.6	14.2
All companies in each price/book value decile	7.7	11.8	12.7	14.0	14.9	15.1	16.7	16.8	18.0	19.6

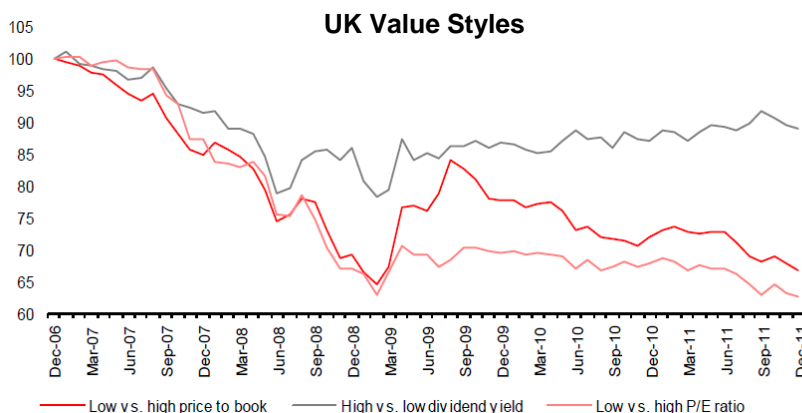
Source: Tweedy, Browne Company LLC

This shows the lowest prices in relation to book value performed relatively very well and, in combination with exposure to smaller capitalisation companies, provided the best returns. So, cheap and small was the most efficacious approach over this long term time frame, which encompassed many cycles.

It is no coincidence that this is how the portfolio is positioned today – much more book value and more small companies than the overall market. Indeed I would suggest that my portfolios have a stronger allocation to these factors than many of the original value investors such as Tweedy, Browne, a number of whom seem to have drifted towards the ‘Quality at the Right Price’ end of the investment philosophy spectrum.

Value Investing – how has it done recently?

In the earlier performance review I provided some detailed analysis of last year’s poor return to the value factor. Below I show Societe Generale’s analysis that shows how the value factor has struggled over the last five years. This is the first time since academic analysis began that value has underperformed over this length of time, this point confirmed by the study I did of the value cycle in my last quarterly report.



Source: SG Cross Asset Management Research

Have hedge funds been able to withstand the valuation rout? No, the average return to Fundamental Value Strategies in 2011 was -23.6%.

Finally one should mention that a number of well known value managers, such as Bill Miller and Anthony Bolton, have publicly struggled to perform in the current environment.

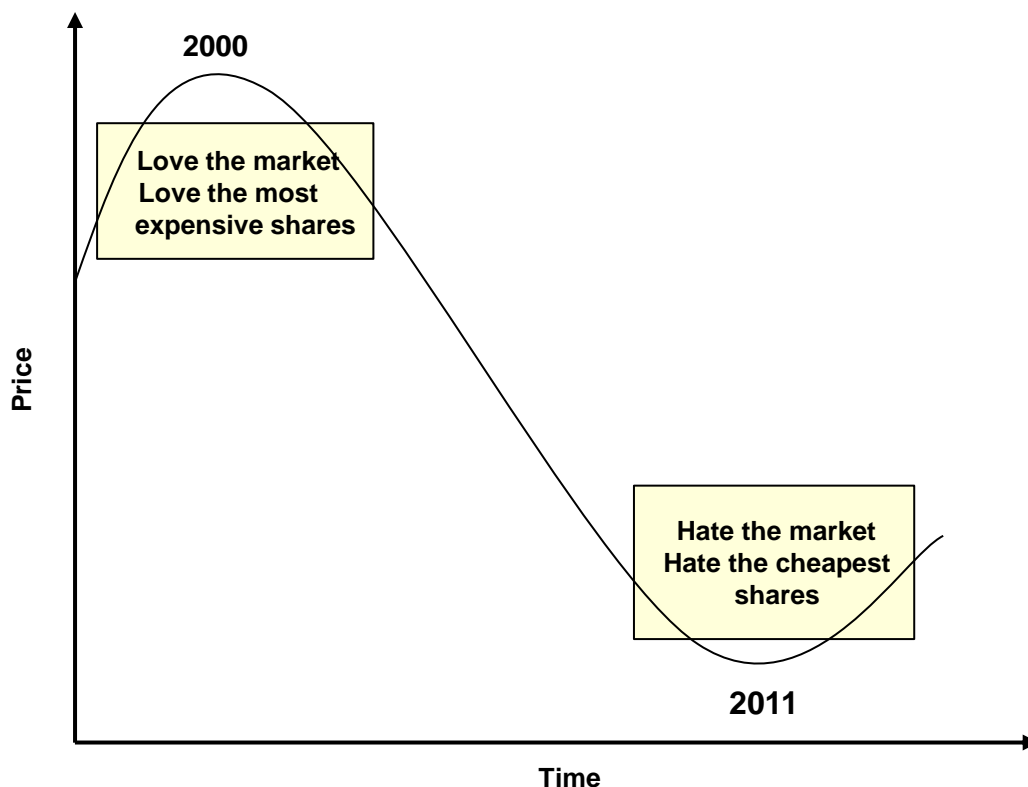
How extreme have recent anti-value moves been?

Very - here are the return spreads in 2011 between the top 20% and bottom 20% of stocks by factor, as provided by Citigroup:

Earnings Yield -19.8%, Price to cash flow -16%, Price to book -22.7%, Price to sales -11.3%, Deviation from fair PE -26.4%, Deviation from fair Price to book -23.6%, Deviation from fair price to sales -19.8%.

The 'Anti Bubble'

I describe this huge move away from cheap shares as the anti-bubble, a cyclical phenomenon which saw a love of risk peaking during the TMT bubble and reaching its nadir during the current credit crunch. The nadir is represented by the average investor giving up on Valuation as an investment tool, the phenomenon that we have witnessed over the last six months.



Source: BofA Merrill Lynch Global Equity Strategy, Bloomberg

This anti-bubble has taken many shares back to the very depressed levels that they fell to in the 2008/9 credit crunch:

3i



Source: Bloomberg

Lloyds



Source: Bloomberg

Invensys



Source: Bloomberg

Segro



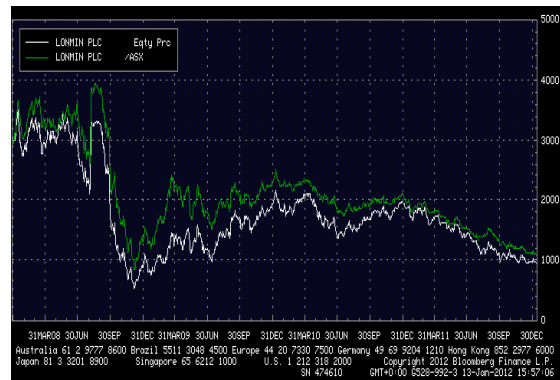
Source: Bloomberg

Centaur



Source: Bloomberg

Lonmin



Source: Bloomberg

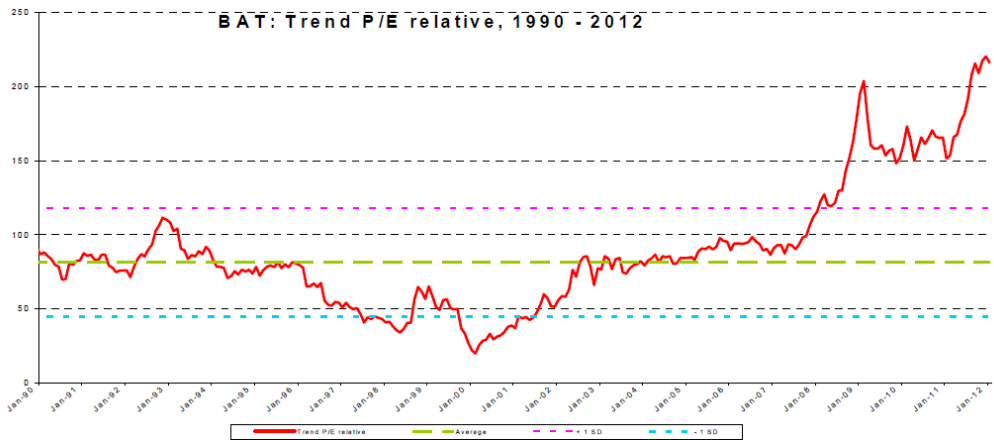
What assets are trading very cheaply?

The following sectors and stocks are a selection of those that are trading at, or close to, their long term (twenty year) relative low valuations:

Banks (UK banks 0.4x PB versus 0.4 to 3.0x PB long term range), Asset Managers (10x PE versus long term range of 9x to 20x), Internet Gaming (5x EBITDA versus 5-10x range), Investment Companies (3i, trading at 0.6x PB versus long term range 0.6x to 1.2x PB), Recruitment (Hays, trading at 0.3x sales versus long term range of 0.3 to 1.0x sales), smaller Mining stocks (Lonmin, trading at 0.85x PB versus 0.7x to 2.0x range), Pharmaceuticals (PE 11x versus long term range 9x to 20x), Media (ITV, PE 9x versus range 8x to 20x), Real Estate (trading at 30% discount to NAV versus 35% to 0% range), Distributors (Electrocomponents, PE 10x versus long term range 8x to 18x), Indian Infrastructure (0.6x PB versus 0.6x to 1.6x range).

What assets are trading relatively expensively?

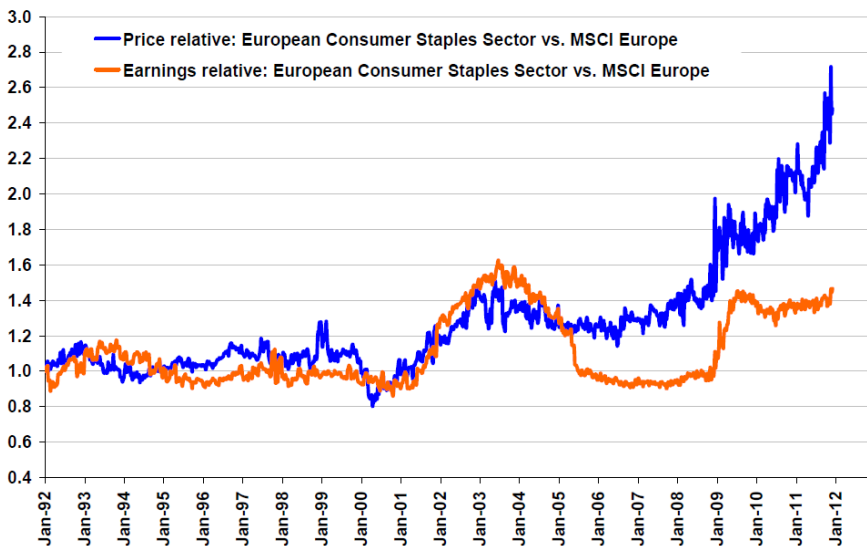
Large company defensives:



Source: Mirabaud

The 'safety before value' nature of the market has resulted in a huge re-rating of the Consumer Staples stocks, with their share prices materially outperforming their earnings. This is not sustainable.

European Consumer Staples price and earnings relative vs. MSCI Europe



Source: DataStream

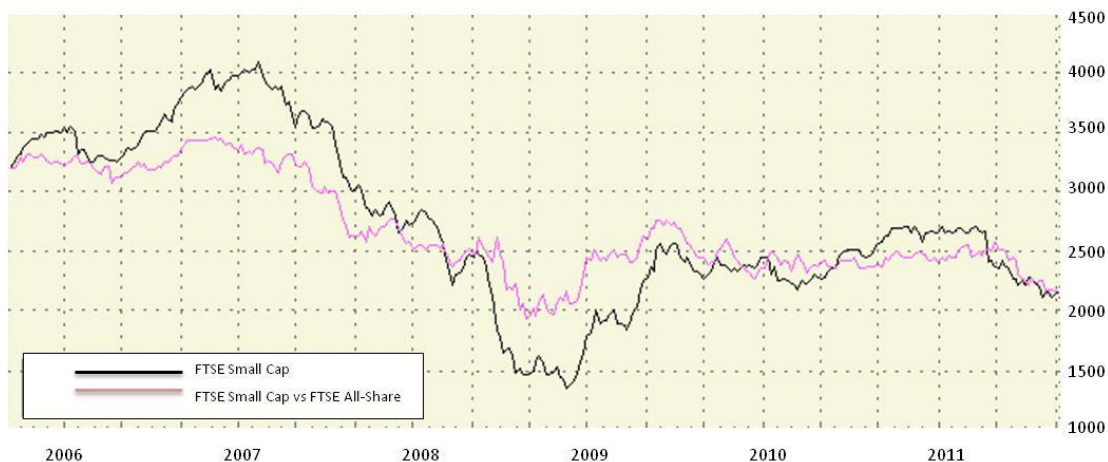
What is the valuation of our portfolio?

This is a very lowly valued portfolio of stocks: a current year PE of 8.8, price to cash flow of 4.9, free cashflow yield of 7.8, price to book of only 0.9, and price to sales of 0.65. 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.

Smaller Companies

Following a difficult end to the year, smaller companies lagged their larger brethren significantly in 2011. As the chart below shows, this leaves them trading only modestly above their 2008/9 nadir (especially if you allow for inflation) and almost 50% below their 2007 peak.

FTSE Small Cap vs FTSE All-Share



Source: Bloomberg

As a result of this de-rating, smaller companies look highly attractive again, trading on only 8 times current year profits, a material discount to the FTSE 100 Index.

What will be the catalyst?

Hopefully it is clear from my analysis that Value works over the long term, that the recent poor return to Value has been an extreme event, that this has resulted in many sectors and shares being valued at very low levels relative to their long term history and that this has enabled us to construct a portfolio with outstanding value and profit potential.

What, of course, is missing is the catalyst – what will this be? The answer to this is confidence. As long as there is limited confidence in the current global economic model then safety first will remain at the forefront of investors' minds and activity. When confidence returns, when we start believing that, whilst the model has flaws, it is still capable of generating significant economic growth and prosperity, then there will be a move from safety first towards the investment anomalies that are so abundant at the moment, and which are well represented in your portfolio. Of course, Europe is the swing factor in this test of confidence – the biggest trading block in the world needs to continue to find its way towards the mechanisms that allow it to move on from this period of acute distress. Our central case is that Europe will get there, if a bit slowly for us impatient Anglo-Saxons.

Portfolio Activity

Our activity this quarter has again focused on adding to existing high conviction PVT stocks where share price weakness was caused by the ongoing move to safety. This included purchases of financial services stocks such as **Intermediate Capital** (single figure PE), adding to investment companies such as **3i** (over 40% discount to assets), topping up Industrials, such as **Bodycote**, that are only half way through their profit recovery programme, and buying classic value bargains such as **Rentokil** that are worth almost twice the current share price on a break up. We also started topping up some smaller companies (such as **Centaur Media** and **Yule Catto**) that underperformed as this part of the market was de-rated.

Our **non-UK** activity focused on adding to what I see as an exceptional list of out-of-favour, but fantastic, businesses, including purchases of **Intel** (global leader, PE of 10x), **Sands China** (best-of-breed casino operator in Macau that suffered a bear raid during the quarter), **Sanofi** (to complement our UK pharmaceutical holdings), **New World Development** (HK Real Estate stock that has fallen to less than half book value) and **Alcoa** (global leading aluminium producer trading at 2009 cyclical low point).

New Investments (purchases)

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

However, we did start to build a position in **Qinetiq**, a top decile scoring quality stock that operates in the area of defence contracting and outsourcing. The company makes an attractive return on investment, and this is being enhanced by action taken by a strong new management team who have cut costs and improved the balance sheet structure through effective working capital management. This will allow the business to return to investing in growth, something that is not discounted in a modest single figure Price to Earnings multiple. Timing is strong, supported by positive earnings revisions, a share price that has started to rally from depressed levels, and fundamental catalysts including the new management team.

We also showed our faith in another willing purchaser of out-of-favour businesses, namely Anthony Bolton. Chinese stocks look very attractively valued now, in particular the smaller companies that Anthony likes to find, so we purchased the **Fidelity China Special Situation Fund** following a 40% fall in its share price.

Existing investments we have become more confident about (purchases)

The equity market risk-off is providing a great opportunity to add to our positions in stocks that are the guardians of the world's increasing propensity to save. We do think that savings and investments are a long-term growth industry, as people in developing countries have more money to save and people in developed economies need to take greater responsibility for funding their retirements. Good growth, high returns on investment and an opportunity to pay low multiples of free cashflow due to their sell-off in these volatile markets. We bought shares in **Schroders** (great global brand), **F&C** (turnaround) and, as we speak, **Blackstone** (global leading Private Equity and alternatives manager).

Stocks we have cut (sale)

We decided to exit from our position in **Conygar**. This is a small UK Real Estate stock where we respect the management but where their ability to follow their stated strategy of buying an attractively valued portfolio of property of financial vendors is being compromised by the banks reluctance to sell. We will wait for a better time to back this approach.

Stocks that have delivered versus our PVT thesis (sale)

We started reducing our exposure to **Anite** during the quarter. This followed a near tripling of the share price over the last eighteen months as our thesis of increased investment in next generation mobile networks came through, buoying demand for the company's handset testing products. This led to strong profit momentum and a material revaluation of the equity. Whilst the **V** part of the thesis is no longer compelling, the **Potential** and **Timing** factors remain strong, encouraging us to keep a position in the stock.

Outlook

I hope that it is clear from my analysis that Value works over the long term, that the recent poor return to Value has been an extreme event, that this has resulted in many sectors and shares being valued at very low levels relative to their long term history and that this has enabled us to construct a portfolio with outstanding value and profit potential.

When more certainty returns to the global economy and financial markets the portfolio will do very well indeed and, with the companies we are invested in having the Potential in more normal times to generate many years of profit growth, we would anticipate that the return to value will this time be enduring.

As Sir John Templeton once said *“To get a bargain price, you have to look where the public is most frightened and pessimistic. When you purchase a large amount of future earnings for a low price, you have made a good investment. The only way to accomplish this is to buy when others are 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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