

RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Smaller Companies Fund I Quarterly Report
December 2011

River and Mercantile

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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	£28.1m
Strategy Capacity	£400m
Number of stocks	87
Largest Holding	Anite 2.58 %

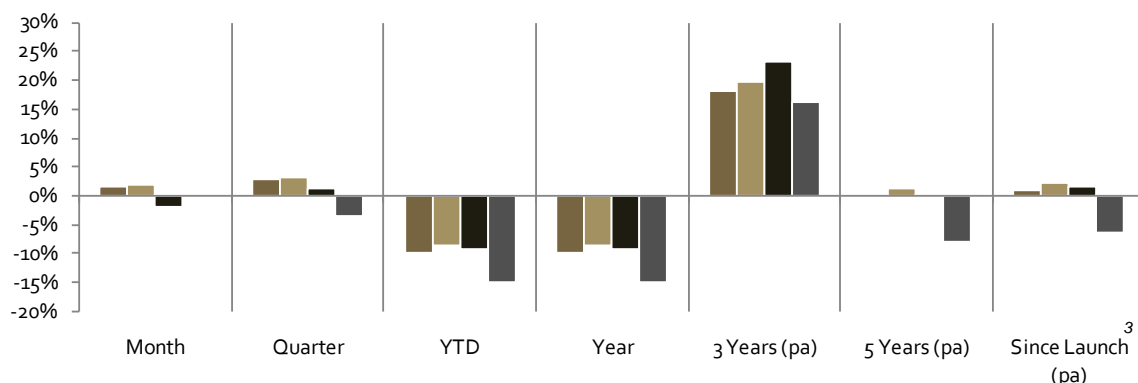
Risk Analysis Summary

Portfolio Beta	0.76
Tracking Error	6.95 %
Active Money	81.88 %

Performance to 31 December 2011

Retail "A" Class Shares	Fund ¹	HG Index*	Difference	FTSE Small Cap (ex IT)
Month	1.65%	-1.84%	3.49%	0.17%
Quarter	2.70%	1.25%	1.45%	-3.53%
Year	-9.93%	-9.13%	-0.80%	-15.16%
3 Years (pa)	18.06%	23.35%	-5.29%	16.12%
5 Years (pa)	-0.35%	0.36%	-0.71%	-7.89%
Since Launch ³ (pa)	0.76%	1.64%	-0.88%	-6.27%

Inst'l "Z" Class Shares	Fund ²	HG Index*	Difference	FTSE Small Cap (ex IT)
Month	1.77%	-1.84%	3.61%	0.17%
Quarter	3.09%	1.25%	1.84%	-3.53%
Year	-8.57%	-9.13%	0.56%	-15.16%
3 Years (pa)	19.84%	23.35%	-3.51%	16.12%
5 Years (pa)	1.14%	0.36%	0.78%	-7.89%
Since Launch ³ (pa)	2.26%	1.64%	0.62%	-6.27%



- R&M UK Equity Smaller Companies Fund 'A' Shares
- R&M UK Equity Smaller Companies Fund 'Z' Shares
- Hoare-Govett Smaller Companies (Ex IT)
- FTSE Small Cap

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 FTSE All-Share Index finished the quarter up 8.39%, however this was FTSE 100 driven as smaller capitalisations failed to participate. The FTSE 250 Index rose 3.5% whilst the Hoare Govett Small Companies (ex IT) Index managed only 1.25%. Smaller cap shares actually fell with the FTSE Small Cap Index down -3.53%, Fledgling Index down -4.49% and AIM All-share down -0.82%.

"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, though 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 a 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 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 a 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, in particular 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 3.3%, 165% of the sub 2% 10 year Gilt yield, with all the growth potential that small companies offer. According to Factset the Fund is less leveraged than the average company and offers a prospective price earnings ratio of 8.3x.

"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.

I remain positive on the outlook for the portfolio with holdings exhibiting strong balance sheets, improving profitability and very low valuations. Sector positioning has produced another quarter of outperformance and stock selection attribution has improved further.

Performance

The Fund outperformed the Hoare Govett by 1.84%, and the FTSE Small Cap by 6.62%. Sector and stock attribution were evenly split during the period. Sector positioning added value across the market.

A takeover approach for the Fund's key financial services holding, **Collins Stewart**, aided performance materially, as Cannacord Financial acted upon the gross undervaluation of the franchise, offering a material premium to shareholders. Top five active position **Anite** had its profit expectations materially upgraded again during the quarter generating a 45% return in the stock. De-merger activity was highly accretive to performance during the period: **Fiberweb** announced the value-accretive disposal of their hygiene division, causing a 24% increase in the share price, and **Mecom** agreed the sale of their Nordic businesses, also transforming their stretched balance sheet position, with the market rewarding the shares with a 34% gain. Recovery stock **Trinity Mirror** continued to outperform pessimistic expectations generating a 17% gain whilst the high quality **Paypoint** provided further progress in their growth businesses rising 19%.

Disappointments included Growth stocks **Blinkx**, **Immunodiagnostic Systems** and **Software Radio Technology**, where organic growth forecasts were all downgraded. I have sold the former and reduced materially the positions in the latter two holdings. The Fund's only pre-production resources stock, **Ferrum Crescent**, had a very weak quarter with a lack of news flow, a deteriorating financing environment and weakening iron-ore prices.

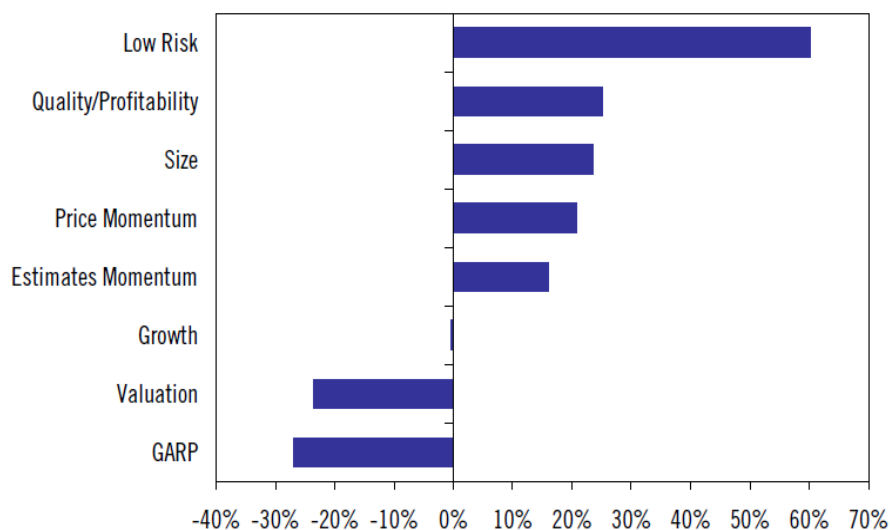
Philosophy & Process

There remains good diversification between Category weightings in the portfolio. **Quality** is 30% of the Fund (largest allocation) with capital invested in **Growth** at 28.8%. Market fears and price weakness allowed the **Recovery** weighting to commence building again, after two quarters of reductions, increasing 5.5% to 28.6%. **Asset-backed** situations represent 12.2% 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 even further during the quarter with an 8% increase to 81% in the top four deciles.

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

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

Quarterly Portfolio Activity

Purchases

Within **Quality**, two new companies were identified. Firstly **Consort Medical** which is a leading manufacturer of drug-delivery devices to pharmaceutical companies. The company has leading-edge metered dose inhalers for companies such as GlaxoSmithKline and has developed world-class service and quality credentials. The business has been low growth for a number of years, however new products are starting to accelerate sales and operational gearing to profits is likely. The shares are lowly rated, highly cash generative and only mildly impacted by the economic environment. Secondly **Go-Ahead** is the leading Bus Company in London and run rail franchises and de-regulated bus services around the UK. A very strong balance sheet and steady growth, underpinned by 'modal' shift from more expensive means of transport, help support the case for strategic value in a consolidating industry.

Three **Growth** companies were purchased, namely **Lamprell**, **ITE** and **Afren**. **Lamprell** has recovered from the prior collapse in oil rig refurbishment activity and has announced a number of new contracts building a pipeline of business which de-risks market forecasts considerably. The company is valued on a sub 10x PE, offering significant scope for upward re-rating as Growth comes through. **ITE**, the Russian focused B2B event organiser has a long history of high returns, steady growth and strong cash generation, and a rare opportunity has emerged to buy this business again on a low valuation multiple with a recovering Russian economy. **Afren** has one of the fastest production growth outlooks of any mid cap oil and gas company. Yet the company also has a fantastic exploration portfolio which could add material reserves over the next few years.

Within **Recovery**, long-suffering **Rentokil** has been added to the Fund. A mix of leading service businesses have been successfully restructured by the new management team over the last few years, apart from the problematic Citilink parcel delivery division. Ongoing difficulties here are dominating market sentiment and a solution (sale, closure, turnaround) will be evident in the very near-term in my view, leading to a revaluation of the group. A gradualist approach has been adopted over the last 12 months to adding UK domestic businesses. During the quarter this accelerated as sentiment and, indeed, conditions appear rock-bottom, whilst the outlook for household cashflows is for improvement in 2012. Positions have been established in **Debenhams**, now materially de-gearred on a PE of 6x, **Lookers**, the car retailer and service company valued on a material discount to the book value of its freehold assets, **Marshalls**, the market leading building materials group yielding 5.8%, and a small position in **Home Retail** on 2x EV/EBITDA.

Sales

Successful exits

William Hill was sold after an excellent year of operational performance, rewarded by the stockmarket but taking the market cap to c. £1.5bn, small no longer. Profits were also taken in **Persimmon**, the house builder, after a strong rally on decent results, but also achieving a market cap of £1.5bn. **Collins Stewart** has also been sold following the shares and cash takeover approach from 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". Finally **May Gurney** was sold, again booking a decent profit. This decision was difficult as the business retains decent organic growth prospects and is well run. However, I am deeply sceptical regarding the potential value accretion from a large capital intensive acquisition made during the period by this services company and therefore I have decided to observe progress from the sidelines for now.

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

During the quarter two thorns in the side of the Fund were finally removed. Both should have been sold some time ago. I succumbed to the investor's psychology hurdle of 'loss aversion' and had poorly analysed the fundamentals underestimating the scale and materiality/speed of change in both companies end-markets. The stocks are **Blacks Leisure** and **CSR**. It is only a very small crumb of comfort that the exit from Blacks was early in the period and, since sale, the stock has fallen a further 95%. I will endeavour to learn from these mistakes.

Sector and size positioning

The Fund remains significantly underweight FTSE 250 stocks in relation to the make-up of the Hoare Govett Index, with 37.8% of portfolio capital in mid-caps vs. 76.1% of the benchmark. AIM holdings represent 20.4% 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 87.7% over the last three years and the FTSE Small Cap up only 56.4%. Clearly mid-caps have done exceptionally 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 £1bn+ market cap companies that pepper the top of the Hoare Govett Index.

There were some changes to sector positioning during the quarter. The four largest overweights remains the diverse Support Services sector, the Media sector, Software & Services and Healthcare. These four represent 44% of the portfolio. However, index changes at the year-end have now moved Mining into the largest underweight at -5.2%, whilst the exit of Collins Stewart has moved Financial Services to the second largest underweight. Whilst Travel & Leisure remains a large underweight position, I have moved slightly overweight the other key consumer sector, General Retail, for the first time in years. Technology is +6.5% at 14% of the portfolio and overall the Fund is +13.5% overweight TMT sectors. The Fund has almost no industrials (Engineering, Electronics) exposure.

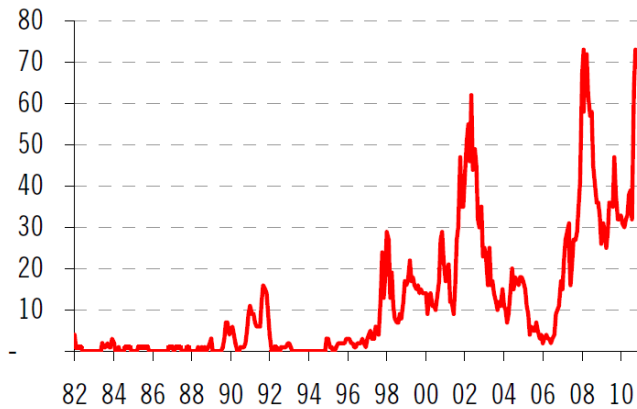
Market Outlook

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 appears to be rife, however the performance of US house building shares from their recent lows in Q3 suggests a 'bunker' mentality is not entirely dominant.

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 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 and smaller company shares great 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 crises 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. The 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 new major 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. In 2011 current 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. This is potentially 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.

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 8.3x 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 Base metals and Bulk Commodity stocks 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. Sentiment, expectations and consequently relative valuations for domestic stocks appears to be rock-bottom. In addition, the improvement in risk appetite that would accompany a rally in the large cap Banks sector would benefit small caps generally despite having no specific Bank exposure.

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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River and Mercantile Asset Management LLP

30 Coleman Street
 London EC2R 5AL
 Telephone: +44 (0)20 7601 6262
 Facsimile: +44 (0)20 7600 2426
 Email: enquiries@riverandmercantile.com
 www.riverandmercantile.com