

RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Unconstrained Fund I Quarterly Report
December 2011

River and Mercantile

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UK Equity Unconstrained Fund – Quarterly Report

Fund Aim

The investment objective of the Fund is to achieve capital growth through investing in a concentrated portfolio which will primarily consist of UK equities. The Fund will not be restricted by reference to a benchmark, sector constraints or company size.

Portfolio Summary

Strategy AUM	£12.6m
Strategy Capacity	£1bn
Number of stocks	40
Largest Holding	BP 5.54 %

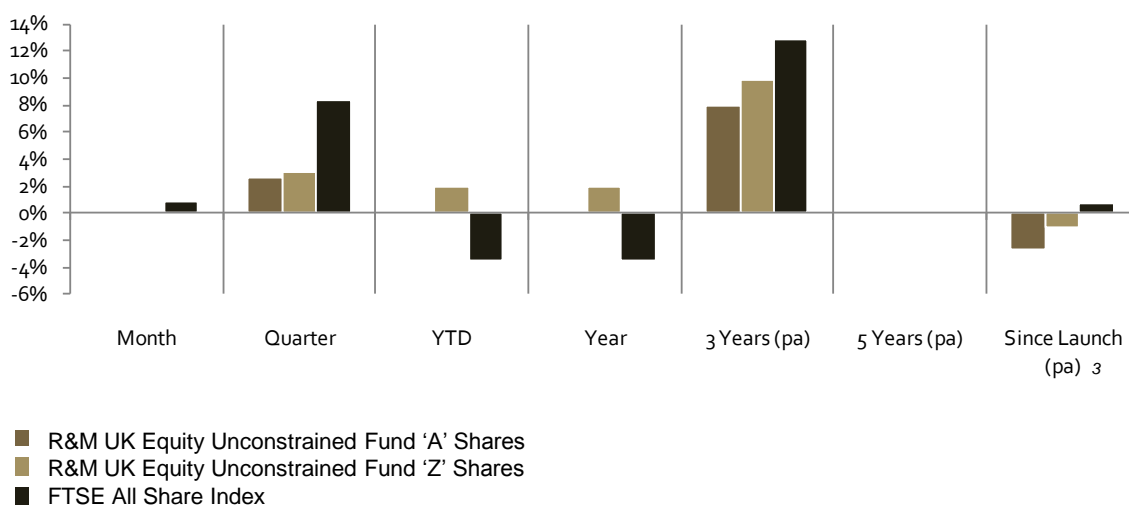
Risk Analysis Summary

Tracking Error	4.97 %
Active Money	63.90 %

Performance to 31 December 2011

Retail "A" Class Shares	Fund ¹	Index *	Difference
Month	-0.10%	0.84%	-0.94%
Quarter	2.62%	8.39%	-5.77%
Year	0.18%	-3.46%	3.64%
3 Years (pa)	7.96%	12.88%	-4.92%
Since Launch ³ (pa)	-2.68%	0.68%	-3.36%

Institutional "Z" Class Shares	Fund ²	Index *	Difference
Month	0.04%	0.84%	-0.80%
Quarter	3.07%	8.39%	-5.32%
Year	1.96%	-3.46%	5.42%
3 Years (pa)	9.88%	12.88%	-3.00%
Since Launch ³ (pa)	-0.97%	0.68%	-1.65%



Source: River and Mercantile Asset Management LLP, FactSet

*Index: FTSE All Share (Total Return)

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 22 March 2007

Quote for the Quarter

“Good judgment comes from experience, and experience comes from bad judgment.”

- Barry LePatner.

Key observation

Ivan Pavlov used to ring a bell before feeding his dogs. Then one day he rang the bell but delivered no food. The dogs still salivated in anticipation; they had developed a “conditioned reflex”. Alan Greenspan always brought investors meat, in the form of easy money to prop up private sector asset prices, but Ben Bernanke’s Fed has none left. And, despite a quarter century of investor conditioning, his ringing of the zero-interest-rate policy bell produced only a tiny response. What will happen the next time the bell rings?

Market Background

The Quarter

The market rallied hard off a low at the beginning of the quarter when there was a maximum pessimism about the prospects for the eurozone and the impact it would have on global growth. The index returned 8.4% in a narrow rally led by the FTSE 100, with mid caps and small caps again lagging the market, returning 3.5% and -1% respectively. At a sector level, the best performances were seen in the large cap defensives Oil & Gas, Tobacco, Beverages, Aerospace and Defence, while the laggards were Financials, Real Estate, General Retail and Utilities.

The Year

The FTSE All-Share Index touched the year’s lows early in the fourth quarter; peak to trough the market fell 18% in 2011. However, with an 8.4% rally late in the quarter, overall the market finished only just in negative territory (-3.5%) in 2011. The UK equity market outperformed global equities through most of the year. The global equity market, as measured by the MSCI Developed World index, fell 7.8%. Compared to a 40% drop in 2008 and the double-digit declines seen post the TMT crash, this single digit decline is perhaps not a bad result considering the underlying economic woes. Of the major equity markets, only the US was better than the UK in 2011. All size groupings finished the year in negative territory. The FTSE 100 Index was the most resilient in this falling market, down only 2.2% in 2011. Both the FTSE 250 and Small cap indices had a tough time, falling 10% and 12.5% respectively. In contribution terms, defensives led in 2011. Large cap Oil & Gas Producers, Pharmaceuticals, Tobacco, Mobile Telecoms and Beverages were the best five. Cyclical laggards — Miners, Travel & Leisure and Financials were the worst sectors in relative contribution terms.

How did we perform and why?

During the quarter we returned 3.1%, versus the benchmark FTSE All-Share Index return of 8.4%, a disappointing finish to what had otherwise been a good year of relative performance. Despite lagging the year end rally we delivered a relatively strong result during the course of 2011, with a positive 2% portfolio return versus a benchmark loss of 3.5%. It was in a year that, due to the underperformance of small and mid cap companies, we relied on our large cap strategy to deliver the alpha. Our small caps did very well until Q4 but we then got hit by some disappointing news from a couple of our small cap holdings and were also caught in the general downdraft of small cap fund redemptions (in November there was the biggest monthly outflow in five years from small cap funds which, in turn, hit many small cap companies).

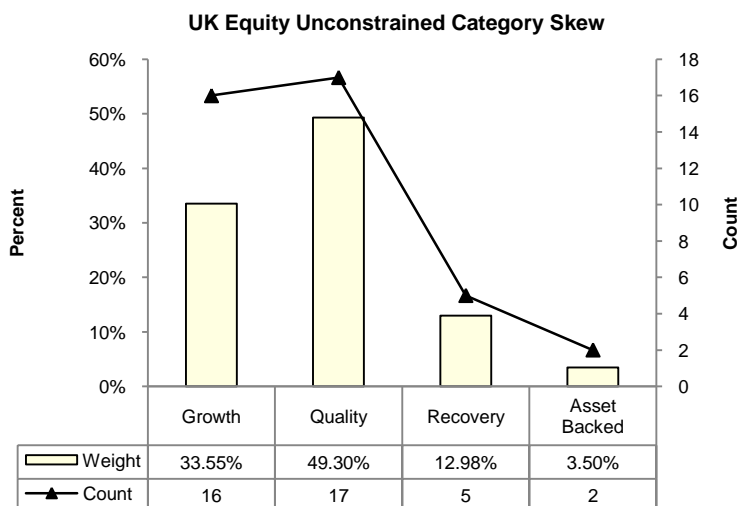
Positive contributions were made during the quarter from new additions in undervalued Industrials. Both Lamprell (Oil Services) and CRH (Construction) performed well shortly after inclusion in the Fund. For a change the highly cyclical large cap sectors of Banks and Mining had very little impact on the quarter at either a stock or aggregate level.

Our conviction small cap position Iomart delivered a solid performance as the market responded to further earnings upgrades and the significant growth potential within cloud services companies. Our quarter was heavily undermined by a very poor showing in a number of our other small cap holdings. Over the past eighteen months or so we have added plenty of outperformance in the small cap space but risk aversion and low liquidity caused a sizeable de-rating of the small cap universe. In particular, our Healthcare growth stocks, Immunodiagnosics and Vectura, both profit warned, and Blinkx, our video search technology investment, made a dubious acquisition which, in turn, undermined the growth case for the core business. We chose to sell Blinkx in its entirety. A number of our other small caps did not have any bad news but simply drifted off and failed to keep pace with the market during the quarter. I expect them to perform better going forward. Finally, it is worth mentioning a stock we do not own: the very strong performance of Royal Dutch Shell continued, reaching over 9% of the index. We are zero weight the stock as we enter 2012 and feel very comfortable with that position. The market has treated the stock as the perfect safe haven due to its size, balance sheet and dividends. However, lack of growth and high break-even rates on their new and existing oil projects make this stock much more risky and high beta than investors realise as we go forward. Over twelve months Royal Dutch Shell alone cost us nearly 2% of performance against the index.

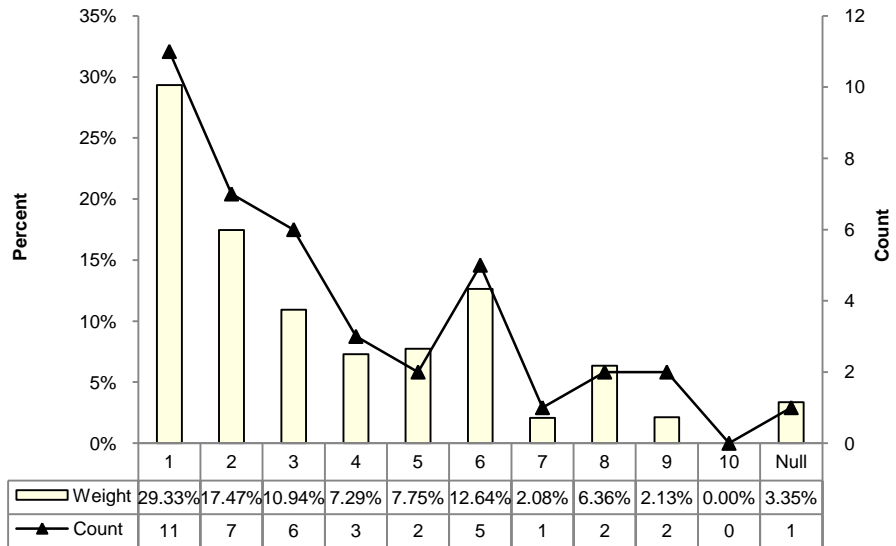
After outperforming markets each year for the best part of nine years between 2000 and 2008, my underperformance through 2009 and 2010 was almost as unpleasant for me as it was for my clients. As a fund manager I know that, in applying my investment process, I shall underperform some of the time, but it is no less unpleasant when it happens. The one positive I took out of that period of poor judgement was that I gained considerable experience as well as making valuable enhancements to our investment process without altering in anyway our core approach. I hope that the return to outperformance during 2011 is the beginning of the good judgement which comes out of that experience.

Does the portfolio reflect our Philosophy & Process?

The portfolio is currently tilted towards a range of high Quality, Growth and Recovery companies. The core Quality names have a strong chance of outperforming, whatever the global economic growth outlook. We were particularly focused on buying cheap stocks early in the last quarter. We have maintained our increased Recovery and Asset Backed exposure due to value dispersion within the market remaining at high levels. This has resulted in us having a slight value bias as we enter 2012 and unusually a slight negative bias towards high ROE stocks and momentum. In all cases, we continue to rotate the portfolio in to strong high scoring PVT ideas where we see medium-term potential for companies to create significant shareholder value, on low valuations, with conservative growth expectations, and therefore where earnings upgrades are more likely to occur in future.



UK Equity Unconstrained Decile Skew



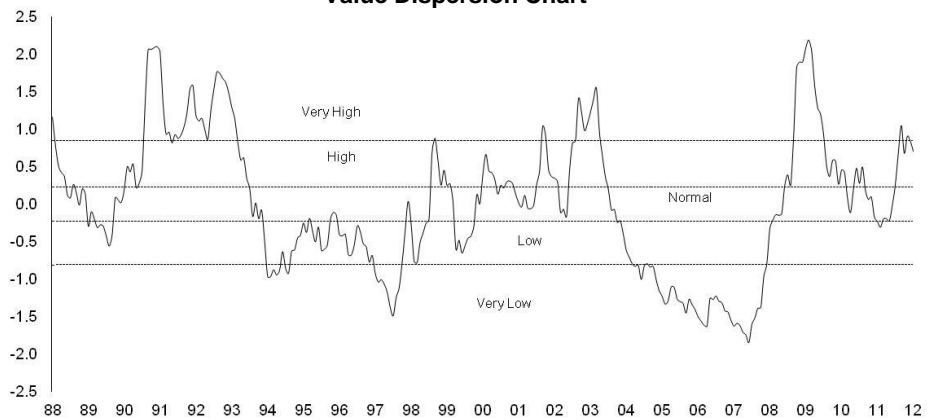
Source: River and Mercantile Asset Management LLP

What themes occupy us?

Value Dispersion

With fear of an economic meltdown in the eurozone - dispersion continues to remain high despite the market rally in the last quarter - as we head into 2012 which, in isolation, implies value strategies should work better. Note that the value dispersion line is a composite measure of price/book, price/sales, cashflow yield and dividend yield. It illustrates the spread of valuations in the market between the cheapest stocks and most expensive stocks. Our premise is that this line cycles and mean reverts regularly. If value dispersion is high it pays us to bias our portfolios to the cheapest stocks.

Value Dispersion Chart



Source: Bernstein

In the last quarterly report we focused on technology as a growth sector where we still felt there were a number of undervalued stocks. This quarter I wanted to highlight outsourcing from the public to private sector. We hold a number of stocks that benefit from this trend, namely Serco, Mears and FirstGroup, and they all trade on historically low valuations due to the austerity measures introduced over the past three years and the perception that all companies exposed to government spend will be losers. This is an opportunity to buy high quality stocks on value multiples (Serco trades on 10x, Mears and FirstGroup closer to 7x).

Outsourcing

Do austerity and tough times – whether at government or corporate level – lead to more or less outsourcing of services? The combination of efficiency gains and service improvements is an intoxicating combination for both public and private sector organisations. Financial controllers have needed little persuasion to take costs out even in the best of times, let alone when pressure on margins is coming from all directions. The pace of outsourcing slowed significantly in 2009 as the perfect storm of elections and the comprehensive spending review conspired to extend the tendering process. There were delays awarding contracts as pending budgets were cut at central and local government level. The complexities of central government processes and spending meant there was a greater impact here, but the pain was shared across the board. However, two years on, the growth rates of outsourcers are rising again.

We believe that one of the few winners within the cash strapped developed world over the next decade will be the outsourcers. Take **Serco**, for example. Its order book had been steadily rising in the past decade – peaking at £17.1bn at the end of 2009 before falling to £16.6bn during 2010 – and is now on the rise with a small half year improvement to £16.7bn. The company also reported a record pipeline of opportunities estimated at £29bn in the middle of 2011. In the second half of the year Serco won contracts on a regular basis. Wins at the November IMS totalled £4.4bn. Since that date, we estimate Serco has won further contracts with a value in excess of £400m. The year-end order book is likely to be slightly higher again. Looking into 2012 we estimate visibility at more than 90% for 2012 – pretty impressive.

The shares are trading on a 2012 10.6x P/E, and a 6.7x EV/EBITDA – against a low-teens EPS CAGR between 2010 and 2013. Serco has rightly been de-rated by the market on growth concerns, but we have now passed the inflection point and growth is just beginning to accelerate. A rating just above the market is a long way below the 50% premium it historically traded on, yet we believe that Serco will deliver significantly better than market growth returns during the next few years.

Macroeconomics and Markets

A tricky cocktail of deflationary deleveraging and reflationary central bank policies continues to challenge even the most seasoned investor as to whether equity markets are pricing in the right level of earnings and dividend growth correctly. It is tempting to gloss over the problems and suggest that the markets are pricing in all the bad macroeconomic news, that this is a cyclical issue and we can muddle through the structural headwinds. While I would like to highlight why I remain cautious on markets in the medium term, I am more optimistic in the shorter term with some lead indicators turning positive and a large liquidity injection expected in the eurozone. There is cause for some optimism in markets with scope for some positive surprises but, unfortunately, I expect these may be short-lived as we progress through 2012.

In summary my latest observations are as follows:

The major rally in Treasuries and the collapse in bank prices suggest a significant deflation threat. Despite this we expect a relief rally in many of the European financial stocks taking the lead from their US equivalents and reacting to the fact that an implosion of the eurozone has been avoided for the time being. This has already started as I write this.

In the medium-term there will be reduced appetite for central banks to print money and buy Treasuries, in the Fed's case, or European Sovereign bonds, in the ECB's case, which has increased the medium-term deflation risk. Again, shorter term, the significant infusion of liquidity at the end of the last quarter in Europe and an ongoing QE programme in the UK has enabled some short-term relative traction in our unloved part of the world. Consensus is that the US is recovering fine, China will avoid a hard landing, but Europe is in trouble - destined to be in an extended recession. Expectation of any outcome in Europe more positive than this scenario is being taken well, particularly by European financial stocks.

Deflation risks weigh most on those assets which are most inflated – namely commodities. We are very cautious of commodity related stocks in general as commodity prices remain high and return on capital has already peaked in the sector as costs continue to rise. Analysts continue to forecast record profit margins which look simply unsustainable next year and beyond.

The last time national debt burdens were this high was WW2 and the private sector collapsed during that period. This time the private sector is going to be crowded out by private savings having to be redirected to fund government, and this will produce a period of extended recessionary conditions in many of the developed economies. We are seeing a classic case of this in Europe now as Banks borrow cheaply from the ECB via the LTRO lending facility and are then effectively forced to buy sovereign bonds from the likes of Italy and Spain.

Corporate profits are at all time highs relative to GDP. From previous peaks in corporate profitability, long term equity returns have always been poor. A sting in the tail is that corporate tax rates are at a level which is typical of the average over the past thirty years or so. However, national debt to GDP ratios have, on average, trebled. Expect corporate tax rates to rise, creating a drag on corporate profits growth as politicians ignore the logic of keeping them low to stimulate growth. Corporate cash balances are high and this may be too much of a temptation for politicians. We have already seen additional taxes in the mining, oil and gaming sectors.

Monetary policy is reaching practical, if not theoretical, limits. The ECB cannot accept the monetary consequences of solving a fiscal crisis; this has created another banking crisis that is restricting private sector credit growth. While the latest market intelligence is that the ECB appear ready to unleash another wave of liquidity towards the end of February, postponing the required deleveraging process, I fear it will ultimately disappoint. The problem is that the ECB might help to address immediate *liquidity* issues of distressed European countries, but it will not address long-term *solvency* issues, and will, in fact, make them worse. The second problem is that the ECB, under existing European treaties, has no authority to buy government debt, and the prohibitions against it are very explicit. Changing that is far more difficult than many market participants seem to believe, because it would require an explicit and unanimous change in the EU Treaties that AAA-rated countries, such as Germany and Finland, vehemently oppose. The ECB are circumventing this problem, as far as I understand, with the use of the LTRO facility to enable European banks to borrow cheaply and then buy and hold the sovereign debt from countries like Italy and Spain as it is issued. The third difficulty is that even if the ECB was to buy the debt of distressed European countries with printed money, via the banks or otherwise, the inflationary effects would likely be far more swift than anything we've seen in the United States. This would not "save" the euro, but would simply destroy it by other means. Also across the pond, internal and external politics are now working to prevent the Fed from firing any meaningful QE3. US foreign creditors' credulity has already been stretched by QE1 and QE2. At least domestically, there does appear scope for the Bank of England to continue buying in Gilts and extending its own QE programme – made possible by our floating currency and AAA-rating. This, at least, will ensure low interests rates for the duration of 2012 and probably well beyond. However, on a five to ten year view, maybe less, Gilts look like an awful investment!

Politicians tend to change the rules to get the prices they want when all else fails. A proposed financial transaction tax is another shot across the bows that politicians are prepared to force capital to go where they want it to go. In the long term this development is negative for markets as governments continue to intervene more and more, despite David Cameron's best efforts to do the opposite in the UK.

The Cyclically adjusted Schiller PE (CAPE) on the US market remains expensive versus history. While it is somewhat cheaper in Europe this points to reduced long term equity returns. If one assumes flat markets through 2012 and earnings are delivered in line with

consensus, this measure will fall on the S&P 500 from the current lofty 20x but still be at close to 17x earnings by year end as the depressed profits of 2001 and 2002 fall out of the ten year rolling measure. Markets are no longer expensive but neither are they cheap on this basis. The long run average is 14x.

In the shorter term, as previously alluded, we can be more hopeful during the first half of this year as we stumble through the European economic doom and gloom. The pessimistic crescendo around the eurozone was deafening through the last quarter. I do not expect the euro to fail this year – it may well do one day – but in the short-term there should be some relatively better news around Fiscal Union and ECB intervention. However, as part of this process, I do expect a number of weak European banks to be nationalised or part nationalised during 2012 and the subsequent years. This, ironically, will not be a net negative at this point relative to market expectations!

Secondly, the economic surprise indicators from the US have been on steadily improving trend through the past quarter which is helping markets but lead indicators are mixed. Equity markets respond positively to positive surprises but both the ECRI and OECD lead indicators point to a continuing slowdown, whilst the ISM in the US and IFO survey in Europe point to some steady improvement over recent months, contrary to the pessimistic headlines.

The spread in valuations between high quality mega caps and anything resembling a risk asset has, again, become pretty extreme shorter term, suggesting it is appropriate to take a modicum of risk at this juncture. We have added a number of cheaper, more cyclical stocks to the portfolio in response to this observation.

Portfolio Strategy

As previously commented, our stockmarket lifecycle work suggests that value dispersion remains high. This requires a greater bias towards value stocks at the expense of either the expensive defensives or mining stocks where cyclically high margins look unsustainable. We have maintained a large proportion of the portfolio in large caps, with much of that in defensive mega caps where we still perceive there is Value (despite this, the small cap element of our portfolio was very detrimental to returns during Q4). **GlaxoSmithKline** and **AstraZeneca** in the Pharmaceuticals sector, **BAE Systems** in the Defence sector and **Unilever** in Food would be good examples we mentioned last quarter. We can add **Serco** to that quality list this quarter.

Due to the high value dispersion in the market we have rotated a significant portion of the portfolio out of the more expensive defensive and growth stocks into areas of the market where we feel prospects are improving and the stocks trade on very low multiples. The Travel & Leisure sector, in particular, is one where we feel there are a number of strong companies trading very cheaply where they have strong prospects for improved return on capital and accelerating growth, despite the difficult economic environment. **Firstgroup** is a bus and rail company whose largest business is running student buses in the US. They have deleveraged since the credit crunch and are benefiting from schools' outsourcing their transport provision. They now trade on a PE of 7x which is equal to their 7% yield. **Easyjet** is Europe's leading low cost airline, growing strongly through taking market share. We bought it with depressed earnings forecasts and yet trading on a lowly PE of 8x. They have net cash on the balance sheet and no pension deficit, unlike many of their competitors. They have scope to double profitability in the coming years. In addition, we have bought what we think will be national winners trading on depressed valuations in rather more cyclical industries like **CRH** in the global construction market.

We remain underweight in Banks although less so as we believe that earnings improvement will disappoint relative to previous recoveries. We have added to our domestic cyclical exposure as emerging markets slow, causing international cyclical growth companies to de-rate. We still believe that economic growth will be challenging for a number of years to come. We intend to rebuild a decent exposure to stocks that benefit from a stronger dollar which is a trend we expect to start seeing through 2012 and beyond. Technology, Healthcare and Non-life Insurance companies are, on average, all net beneficiaries of this driver.

Q4 Portfolio Activity

Key Purchases (mainly recovery stocks)

CRH is a global construction company supplying both aggregates and other building materials to the industry. It operates in very depressed markets. Prior to the last three years CRH had a consistently high return on capital and strong growth. The Potential is that in the developed world, and the US in particular, we have just been through the deepest building recession since the 1930s (US housing starts down 75%, cement consumption down 45%) and, as a result, CRH's sales have fallen 27% from the peak, margins have gone from 9.9% to 3.7%, and the share price has halved. With costs cut, even a modest return to volume growth will produce a strong recovery in shareholder value. The valuation is attractive on the basis of normalised returns, with a net margin of 8% (15% below the last peak) and put on 12x (discount to historic multiples) this equates to over 50% upside. The PB is 1x, EV/S low versus history, and DY 4.1%. Earnings momentum has been stabilising and the share price has picked up from the bottom; news flow out of the US building market is choppy, but points towards a market that is stabilising at very low levels rather than deteriorating further. Last quarter was a good entry point as nervous markets caused a setback in what is a long-term recovery idea.

JD Wetherspoon has longer term attractions of a stock led by a management with a track record of focusing on cash plus shareholder returns (the chairman holds a 25% stake). The 12% FCF yield suggests the 50 p.a. rollout plus 3% dividend yield are well covered, with possible incremental benefits from improving consumer cash flow and a more benign leasing environment to help drive 10% EPS growth. To be clear, the outlook remains tough for trading - JDW are heavily exposed to the high street - and the cost line. However, forecasts look cautious, the share price has begun to trend more positively and the valuation is attractive relative to its peers. A return to 1x sales gives a target price 30% above current levels, equivalent to 7x EV/EBITDA and in line with its ten year average.

Lamprell is the only growth stock to be added during the period. They provide construction and engineering services for oil and gas rigs and are based in the Middle East. They are benefiting from strong end markets in the upgrade and refurbishment market for land based and offshore drilling rigs. They have a strong track record of project execution with virtually all of the US drilling contractors, and 80% market share gives them excellent pricing power. They have relatively high margins and low capital intensity for an oil services company, giving them strong return on capital characteristics. We took advantage of some short term weakness in the share price after the announcement of a contract loss. Our analysis suggested it was a one-off and that order book momentum was set to remain strong. Lamprell is late cycle, at a material discount to the peer group, and looks likely to get earnings upgrades.

JKX is the largest non-state Oil & Gas company in the Ukraine (through its wholly owned subsidiary Poltava Petroleum Co.) and has been successfully operating there for 17 years. It is a highly profitable and cash generative business due to its large producing gas fields in the Ukraine. The key share price driver was, historically, the gas price convergence between Eastern Europe and Western Europe, with Ukrainian gas prices rising to converge with Western European gas prices. Price rises drop straight through to the bottom line. After a significant investment in south west Russia a few years ago there is now a similar driver in expecting Russian gas prices to slowly converge with European gas prices. This is not a stock for widows and orphans but the valuation is compelling provided the current Ukraine/Russian gas price agreement holds.

Sales and reductions

After being overweight **British American Tobacco** ever since I have managed large cap money in 2004 I finally sold the stock from the portfolio. After a decade of stellar returns and share price performance, the growth forecasts and valuation have begun to look unattractive versus other cash generative businesses as investors have poured money into the safe haven of the tobacco sector. At this valuation there is no room for disappointment and so with the margin of safety gone we elected to move on.

Experian is a high quality global growth stock providing credit services where, again, we have seen very decent returns over the past couple of years but where the valuation had become too stretched to justify holding it any longer.

Defence supplier **Cobham** was sold after further analysis suggested that margin forecasts of 18% were too rosy in an environment of defence spending cuts. We have maintained a high conviction position in **BAE Systems** where margins are at a more sustainable level of 10% and where market expectations are somewhat lower.

We sold video search technology leader **Blinkx** after the latest acquisition, and their subsequent broker guidance, threw into doubt the growth rates of the underlying business. **BSkyB** was sold on valuation grounds and we finally took some profits in **Tate & Lyle** after good performance.

Outlook

"Those who have knowledge don't predict. Those who predict don't have knowledge".

- Lau Tzu.

It would be nice to leave it at a Chinese proverb but ultimately, as a fund manager, we are paid to take a view using what resources we have at our disposal. With data so mixed, rather than tackling the big picture to any great extent we are using our value dispersion tools at a risk management level to determine how much quality (e.g. safe defensive stocks, like GlaxoSmithKline or AstraZeneca) versus deep value (e.g. Easyjet and CRH) we have in the portfolio. Our tools are pointing us to an increased value bias at present. Other than that, it is imperative, with so much economic uncertainty, that we remain focused on delivering our PVT stock selection strategy, focusing on finding strong companies on low valuations. By adding some value stocks to the portfolio in the last quarter we hope to benefit from any progress in markets in the coming months. However, a core of the portfolio remains in a number of high quality companies or stocks where growth will not be undermined by further economic weakness. Thank you for your support and best wishes for 2012.

Dan Hanbury
Portfolio Manager

Fund Facts

Launch date	22 March 2007	
Fund manager:	Dan Hanbury	
IMA sector:	UK All Companies	
Benchmark:	FTSE All-Share (Total Return)	
Tracking error range:	N/A	
Product capacity:	£1bn (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	1.75%	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	B1NG829	B1NGCT4
ISIN	GB00B1NG8296	GB00B1NGCT49
Bloomberg	RIVMERA LN	RIVMERZ LN

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