UK Equity
Philosophy and Process

SECOND EDITION

RIVER AND MERCANTILE
ASSET MANAGEMENT

SECOND EDITION
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To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information. What’s needed is a sound intellectual framework for making decisions and the ability to keep the emotions from corroding that framework.

Warren Buffett
preface to ‘The Intelligent Investor’ (1973)
Introduction

River and Mercantile Asset Management LLP (R&M) was founded in 2006 by a management team led by James Barham and Julian Cripps with backing from Sir John Beckwith and his Pacific Investments team led by Mark Johnson. The business has thrived since its launch and the combined funds under management of the UK Equities and Global Equities Divisions has continued to grow strongly.

Our objectives remain to:

- Establish R&M as a market leader in the provision of UK Equities, Global Equities and other specialist products to the Institutional and Retail markets.
- Produce strong, through the cycle performance for client portfolios.
- Grow funds under management within return-orientated capacity constraints.
- Create a diverse revenue line.
- Maintain a robust operational infrastructure to allow future targeted expansion.
- Provide an operating environment for investment managers (and all employees) that encourages, rather than restricts, personal development.
- Preserve a tangible partnership culture.
- Deliver a business model and investment products that genuinely aligns clients’ interests with those of the partnership.
- Construct a business that has sustainability beyond the involvement of the founding partners.

From an investment perspective our values are simple ones: to ensure we have the right people to deliver a clearly articulated and properly researched investment process that we believe will generate strong outperformance for our clients, as well as exceptional levels of service.
Our UK Equity Team described in detail their PVT investment philosophy and related process before launching their first investment products in November 2006. Some years, and one credit-crunch, later we felt it was an appropriate time to reconfirm the approach, and also to document the stock market cycle enhancement that we have made to our portfolio construction process.

The UK Equity Team offers a PVT investment philosophy that has identified and combined the key sources of investment return, a process that systematically searches for and monitors these PVT stocks, and a stock market cycle based framework for managing portfolio construction risk and opportunities.

This document will explain:

• Our philosophy - how we make money
• Our process - how we will apply our philosophy to build portfolios

This document has been updated from the original that was first published in 2006. It should go without saying there have been very few changes to the section that articulates our philosophy; the additions to the process focus on a thorough documentation of our stock market cycle based approach to the process of top-down risk management.
Executive Summary

We believe that the stock market has ever present opportunities to deliver absolute and relative returns for investors.

Academic studies such as Fama & French (1992), quantitative studies such as ‘What Works on Wall Street’ by James O’Shaughnessy (2005) and investment books such as ‘Investing with Anthony Bolton’ (2004) provide evidence that excess returns can be achieved by applying a consistent approach to exploit opportunities in the stock market.

It is this effective and efficient exploitation of real world opportunities that we attempt to explain in this document, and that we have put in place in the management of UK equities at R&M.

Core Values

The UK team at R&M has five core values:

1. We believe in partnership with our clients.
2. We are practical investors who live and breathe the evaluation of company prospects but who also believe that there are repeatable investment cycles that can be systematically exploited. We consequently marry quantitative and fundamental analysis.
3. We believe in exploiting a combination of investment factors, to maximise returns and minimise risk.
4. We think independently, forming our own conclusions.
5. We are medium term investors, believing that you must have the right time frame to allow opportunities to develop into profitable investments.

Investment Approach

- Our philosophy identifies the three factors that drive share prices higher over the medium term, namely Potential, Valuation and Timing (PVT).
- We believe that companies have life cycles; times of success, times of failure and then change. As a result we categorise the potential investment universe into growth, quality, recovery and asset backed opportunities.
- Our proprietary screening tool (MoneyPenny) systematically scores and ranks all UK companies on PVT within each of the four categories.
- Our investment process ensures we efficiently verify these PVT ideas, whilst our stock market cycle analysis provides a systematic framework for managing top-down portfolio construction opportunities and risks.
- Our process is aimed as much at the sell decision as when to buy, using our PVT discipline to ensure we maximise returns before selling an investment.
• In summary we systematically hunt for the best PVT growth, quality, recovery and asset backed investment anomalies and manage our exposures with reference to the stock market cycle.

This document is comprised of two distinct sections

Part 1 – Investment Philosophy

This articulates our investment beliefs examining the evidence in support of our strategy.

Part 2 - Investment Process

This details how we translate our investment philosophy to client portfolios and how we manage portfolio construction risks and opportunities.
Part 1

Investment Philosophy
1.1 An Introduction to PVT

Our core investment philosophy is called ‘PVT’. PVT stands for Potential, Valuation and Timing. We target these three factors when assessing a stock’s potential to generate absolute and relative returns.

The Three Factors

What makes a share price go up?

1. Potential

“If a company is worth more tomorrow than today the shares will increase in price.”

The potential of a company represents its ability to create economic value for shareholders. Economic value is enhanced by a growth in profits, cash flow or asset backing. We look for companies with above average value creation potential.

Over the years we have found that the companies that can deliver above average potential divide into four categories; these relate to where a company is in its ‘life cycle’:

- **Growth**: The delivery of strong and consistent revenue and profits growth.
- **Quality**: A business franchise that delivers a superior return on investment.
- **Recovery**: The process whereby a company produces a recovery in profits to ‘normal’ levels following a decline.
- **Asset backed**: The delivery of asset-backed growth to a long-term investor.
2. Valuation

“If a company’s shares trade at a discount to fair value they will increase in price.”

This factor represents the pricing anomaly, the gap between the stock market’s valuation of the company (i.e. its current share price) and its underlying economic worth.

We apply the valuation metrics and techniques that are most relevant to the category of stock being analysed to help identify material pricing anomalies.

3. Timing

“If management is focused on delivering a company’s potential, and this is confirmed by improving earnings and a supportive share price, this is a good time to buy.”

Timing addresses the issue of when is the right time to buy and sell. It aims to minimise the risk of being too early into an investment, and to optimise the period of time held and returns generated once an investment has been made.

What are our timing indicators?

We need clear evidence that the value creation dynamic is unfolding as indicated by upward profit revisions and/or share price strength (technicals). We also want management in place who are focused on delivering shareholder value.

To achieve an effective discipline for the sale of stocks we look for the emergence of weakening PVT criteria and, in particular, clear evidence that value creation has peaked. Low PVT scoring companies will be replaced by high ranking ones. We will also sell if our original PVT thesis is proved wrong by new information.
1.2 Linking PVT with the real world - Company Life Cycles

Summary

We combine the real world of companies with empirically backed investment factors. These are linked by our work on company life cycles.

Background

There are two broad schools of active fund management. There are those that have rigid philosophies, or highly systematic quantitative processes, for example value investors that only buy low PE stocks. Alternatively there are the pragmatic stock pickers who are experienced market practitioners and understand what moves share prices but have little by way of an investment formula, who would include a number of well known retail managers.

Having had exposure to both these approaches over the years we have decided that even the best exponents of each have weaknesses. The hard philosophies can produce good returns but often in a volatile and inconsistent fashion. And because they rarely relate closely to the underlying company they sometimes prove to be completely wrong. Meanwhile, because it is so un-formulaic, the pragmatic stock picking model is hugely dependent on the flair of individual fund managers. It is rarely scalable, is difficult to replicate consistently and will often fall foul of behavioural biases.

Our approach

We combine these two schools. We set out to marry the rigour and repeatability of hard philosophies with the realism and broader opportunity set of the pragmatic stock picker.

We call the concept that binds all this together the company life cycle, expressed through share price movements. Like most living things, companies have life cycles; times of great success and times of failure, then change. It is our understanding of these cycles - how they drive share prices and the similarities between companies at certain points in their evolution - that we seek to capture. We integrate this concept into our PVT philosophy.
The Company Life Cycle

Stage 1 – Growth
Stage 2 – Steady State
Stage 3 – Decline
Stage 4 – Consolidation and Change
Stage 5 – Recovery

It is our contention that all quoted companies go through these five stages at some point in their lives. Most new companies exhibit above average growth (stage 1), perhaps because their markets are immature or because they are growing market share. This growth slows as their industry matures or market share becomes harder to grow as new competitors enter a sector. Companies then move into their steady state (stage 2), which can last for many years. However, at this more mature stage, they are increasingly vulnerable to economic cycles, competition or complacent management. Sooner or later, profitability starts to disappoint leading to the decline stage (stage 3). Corporate change is required (stage 4), often led by new management. The focus at this stage is to deliver recovery (stage 5) leading to the return of profits to a normal level.

Identifying these different stages in a company’s life cycle allows us to maximise returns and minimise risk. It enables us to buy growth companies at the beginning of their growth phase and value companies during their recovery stage. It provides a reason to sell or avoid shares as they move into decline. It also ensures that we apply the right valuation metrics to a company. Most importantly, when we screen for companies, it makes sure we compare like-with-like, growth versus growth shares, recovery versus other recovery shares.

References

Company life cycles have largely been the preserve of Management Schools and their Professors. One of the best books on the subject, ‘Corporate Life Cycles: How and Why Corporations Grow and Die’, was written by Ichak Adizes (1988). His analysis relates to an extended cycle of growth,
maturity and then decline or "Infant, Prime, Stable and Bureaucracy". He says that “organisations have lifecycles just as living organisms do; they go through the normal struggles and difficulties accompanying each stage of development”.

**Adizes’ Organisational Life Cycle Model**

Mauboussin (2006) briefly investigates life cycles in the context of company innovation. He compares an analysis of corporate cycles with work done by biologists on evolution – in particular, how a species increases its fitness. “What does a fitness landscape look like? Envision a large grid, with each point representing a different strategy that a species (or a company) can pursue. Further imagine that the height of each point depicts fitness. Peaks represent high fitness, and valleys low fitness. From a company’s perspective, fitness equals value-creation potential. Each company operates in a landscape full of high-return peaks and value-destructive valleys.”

Montier (‘Behavioural Finance’, 2002) talks about the momentum life cycle: “Stocks which experience good news move up the cycle, becoming the stock of the moment... eventually these stocks disappoint the market... and end up suffering general neglect”. This we would see as the sentiment life cycle that will likely exaggerate the share price impact of the company life cycle.

In terms of investment manager philosophies and the company life cycle we can find few references. The closest we have come is the two famous Fidelity investors, Peter Lynch and Anthony Bolton.

Peter Lynch, the manager of the hugely successful Magellan Fund talks about his “Six categories: slow growers, stalwarts, fast growers, cyclicals, asset plays and turnarounds....I’ve found that these six categories cover all of the useful distinctions that any investor has to make” (‘One Up On Wall Street’, 1989).

In Anthony Bolton’s book ‘Investing with Anthony Bolton’ (2004) he describes the following companies his fund would consider: “Companies with recovery potential, companies with strong growth potential, companies with assets whose value has not been recognised, companies with a special product, companies which are possible takeover candidates, companies subject to restructuring, companies which are not widely recognised.”
These investors have recognised the different categories of stocks that can make good returns, but may not have related this directly to an investment philosophy.

We have formalised this strategy with our company life cycle approach, allowing a more systematic approach to exploiting our categories of investment anomalies.

We will now describe how this is integral to our PVT Philosophy.
1.3 PVT Investment Philosophy – The Detail

Overview

This section provides more detail regarding why the three factors can make you money. We will guide you through why they work in the real world and provide you with references and examples that help confirm their effectiveness. We also detail how our theory of company life cycles links the different components of our philosophy together.

The Components
PVT Factor 1 - Potential

The Potential factor within PVT reflects the real world that we have identified with our company life cycle theory; it acknowledges that companies are at different stages in the life cycle and are better analysed on this basis, rather than a ‘one size fits all’ approach.

Our categories match the different phases of the life cycle as follows:

**Company Life Cycles and Categories of Potential**

![Diagram showing the relationship between value and potential categories]

**Stage 1** – Growth / Growth potential
**Stage 2** – Steady State / Quality potential
**Stage 3** – Decline / Avoid
**Stage 4** – Consolidation and Change / Avoid then review
**Stage 5** – Recovery / Recovery potential

Within stage 1 we look for the best Growth companies; in stage 2 we hunt for the highest Quality companies as the best way to rank one ‘steady-state’ company versus another; we seek to avoid stage 3 and normally avoid early stage 4. As stage 4 evolves and changes are made we are on the look-out for the most convincing Recovery stocks. Our Asset Backed category of investment has its own life cycle; the asset intensity of their business models makes them cyclical by nature, with growth followed by recession, and change followed by recovery.

We are only interested in categories of company or stages in a company’s life cycle that have the right dynamics to drive share prices higher and/or where the stock market clearly does not have the right medium term information. Many companies are in a steady state, making average returns, growing close to the average, on an average valuation. These are only of interest from a risk management perspective.
Potential Categories

Our Potential categories divide as follows:

1. Growth

Definition

We define Growth as companies that are growing revenues and profits at a materially faster pace than the average. We would expect our Growth companies to also show medium term consistency of shareholder value enhancement.

Why this works

“If a company is growing significantly faster than the average but is priced in-line with the average then the shares will increase in price.”

Companies that are part of an immature industry or that are taking market share, and those that are benefiting from a cyclical upswing, grow their revenue and profits at a robust pace. As companies are valued off the profits (and therefore cash) they generate this growth will result in a strong share price, assuming a reasonable starting valuation.

Growth investing had earned itself a poor reputation at the start of this century because of its association with the TMT bubble. But bubbles only represent the over-extrapolation of investment themes to the point that prices paid lose touch with economic reality. When Growth is attractively priced it is a hugely powerful economic force, benefiting from the phenomenon of compound returns and the growing willingness of investors to factor them in. For example, if a company grows its profits at 15% p.a. over 10 years it will in economic terms be 304% larger at the end of the period; if it grows by 5% it will only be 63% larger. So, growth is good, though it is critical that it is combined with an attractive starting valuation.

For Growth to really work, one needs to either catch the company early (before the fast growth is reflected in the valuation) or when it is temporarily out of favour due to an external event. Growth investing benefits from identifying themes that will sponsor a period of rapid economic expansion in an industry, as well as the underlying ability of managements to harvest profits from the trend.

References

For evidence of the potential of this approach one needs to look no further than the classic book by Philip Fisher, ‘Common Stocks & Uncommon Profits’ (1958). Peter Lynch in ‘One up on Wall Street’ (1989) also identifies this as an area that can produce very handsome returns. “Fast growers are among my favourite investments,” he says “…if you choose wisely, this is the land of the 10-to 40-baggers...one or two of these can make a career.” Amen.
Jim Slater, in ‘The Zulu Principle’ (1992), says “Earnings are the engine that drives the share price. There can be no doubt that EPS growth and the performance of share prices are umbilically linked... The best bargains are usually found in the 15-25% p.a. bracket”. He adds an observation on the need to combine growth with an acceptable valuation: “The ideal investment is a company in which EPS are growing annually at a high and sustainable rate. If this kind of share can be purchased on a PE ratio below the market average, you have discovered a jewel beyond price. If the PE ratio is above the average of the market but modest in relation to the growth rate you have still found a rare gem”.

James O’Shaughnessy (‘What Works on Wall Street’) confirms that growth has to be married with a value control. “If earnings growth is combined with not paying more than 1.5x sales then returns of 18.3% are achieved compared with 13% for the index.”

**Example – Aggreko**

The expansion of Developing Economies has been a key growth theme during the first decade of the new millennium, and Aggreko has been a great way to obtain exposure to this structural growth. As a global leader in providing rental power generators, specialising in just-in-time response, they have been able to meet the frequent short term power shortages that have appeared across the developing world as industrial and consumer demand for power has grown faster than the ability of the electricity infrastructure in these emerging economies to supply this power. The result has been dramatic growth: over the five years ending in December 2009 sales compounded at 26% per annum and earnings at over 30% per annum, sales per share tripled, earnings per share quadrupled, and the shares rose over 500%.

**Aggreko PLC - Price**

Data Source: Prices / Exshare \( \text{©FactSet Research Systems} \)
2. Quality

Definition

We define Quality as companies that are earning an above average return on invested assets and where these returns are on an improving trend.

Quality is the best way to rank steady-state companies (company life cycle).

We will be cautious where returns are high but trending down.

Why this works

“If better than average companies are priced like an average company then the shares will do well.”

Quality, once it has been identified, is a very reliable and low risk source of returns. Quality describes companies that may have matured so that they are in the steady state part of the company life cycle, but have also built up a strong business franchise in an attractive market allowing them to earn a superior return on investment. By re-investing these returns they generate a sustainable growth rate, thereby creating value for shareholders.

Again, as long as the starting valuation is fair (i.e. little more than the market average), then a high return on investment business will earn you superior returns on your investment and compound your returns over a number of years.

The opportunity to invest in this category of stock at the right price will sometimes be provided by the inability of the market to effectively value the medium term cash flow and high re-investment rate of the business; and sometimes by short-term issues such as big picture worries or a temporary reduction in the level of returns achieved by the company. In the latter case you need to be confident that the company’s franchise is intact.

References

There is a well-read book by Joel Greenblatt called ‘The Little Book That Beats the Market’ (2006). This documents and back tests a ‘quality at the right price’ approach, which Greenblatt calls the “magic formula”. The process involves screening a universe for high return on capital business with an attractive earnings yield, the returns being over 10% p.a. better than the US market.

In a similar vein, Warren Buffett has earned billions with a focus on investing in strong business franchises that have temporarily fallen out-of-favour.

Cash flow return on invested assets (CFROA) models are also based on this approach. The CFROA measure has in recent years become one of the more popular value-based management techniques, which is increasingly used in the investment community. The technique was originally developed in the 1960s and 1970s. Its popularity can be partially attributed to the fact that all the information needed to calculate a CFROA is publicly available in published accounts. Adjustments for inflation allows for the realistic
comparison across time. Using this objective framework allows comparisons to be made between companies.

**Example - Rotork**

Rotork is a classic example of the Quality category. This ‘old economy’ manufacturer of actuator valves and gears has a business franchise that enables it to consistently make high returns on investment, just the sort of ‘Steady State’ business we are looking for. Its cash-flow-return-on-invested-assets has been well above its cost of capital, averaging 20% over the last ten years. These attractive business characteristics were ignored during the TMT bubble stock market resulting in a very compelling valuation and entry point into the shares; and since this period Rotork has opened up new markets in China and other emerging economies, accelerating growth and moved its own manufacturing base and parts sourcing to low-cost countries, thereby improving margins. This combination of high and improving returns has driven a strong share price, which has continued through the decade with hardly a hiccup during the credit crunch.

**Rotork PLC - Price**
3. Recovery

Definition

We define Recovery shares as those that currently have a depressed level of profits and share price but are showing clear signs of recovering those profits to a more normal level, “normal” being defined as the average over the last ten years.

Why this works

“If a company has depressed profits its share price will be depressed. If the profits recover the share price will recover.”

Recovery investing is another mighty investment force. If companies go into decline and their profits fall, the shares can suffer significant weakness. Investors will tend to value these companies off their depressed level of profits, the result being a very lowly share price that has the capacity to multiply if profitability can be returned to more normal levels.

Practically all companies are Recovery stocks at some point in their lives, from the world’s largest such as BP in the early nineties (and in 2010) to smaller companies such as Sheffield Insulation (SIG) today.

At some point, most companies get hit by a downturn in profits; perhaps a cyclical downturn in their industry, a complacent management team that took value destructive decisions, or a secular shift in the economics of an industry. The stock market always reacts the same way, by killing the share price when profits are under pressure.

These companies must then go through a period of renewal to put in place the building blocks for recovery – from management change to disposals and cost-cutting. It is only when expectations of profit are showing strong signs of picking up that the shares can start to do well. At this stage, they can do very well indeed - profits can at least double over a relatively short time frame and the share price can do even better as investor confidence also allows a re-rating of the shares.

The Timing element is especially important for this category because buying too early can be very expensive in the short term. In particular, because low returns make servicing debt difficult we need to be confident that the company has the financial strength to survive the difficult times.

As the recovery takes hold, we need to understand whether this is a purely cyclical pick-up or if there is something more long lasting, or structural, about this period of corporate renewal.

References

The most successful value strategy in O’Shaughnessy’s ‘What Works on Wall Street’ is the price to sales ratio, hence he labels it “the King of the Value factors”. Low price to sales is essentially a Recovery strategy as it is caused by depressed profits - in other words, profits that have a lot of recovery potential. The price to sales ratio is our key recovery screen.
Bolton refers to recovery as a key strategy in ‘Investing with Anthony Bolton’ as does another Fidelity fund manager, Peter Lynch, who describes turnarounds as ‘very exciting and very rewarding overall’. And in his more recent book, ‘Investing Against the Tide’, Bolton has a chapter titled ‘My favourite type of share’, in which he says “At the heart of my approach has been buying recovery or turnaround stocks on attractive valuations. These are normally businesses that have been doing poorly. Many investors don’t like being associated with businesses that are not doing well and can miss when a change for the better occurs. This often involves changes in the management team, a restructuring or even a refinancing”.

Example - BP

In 2006 we wrote “It is easy to forget but BP, over 7% of the UK stock market and one of the largest companies in the world, was once a classic recovery stock. In the late 1980s and early 1990s the shares were unloved; the company was in its decline period with excess costs, poor returns, poor management and financial worries. This all came to a head in 1992, when a further share price collapse precipitated a period of change and renewal. Lord Simon and the young John Browne put in place an aggressive programme of cost cutting and debt reduction, taking the company from making losses in 1992 to top quartile industry performance in four years. John Browne was promoted to Chief Executive in 1995 and the rest is history, the shares climbing six fold during their recovery period, which pre-dated the return to favour of the commodities sector.” Of course this was all before the 2010 Gulf of Mexico disaster, but this just proves the point of the Company Life Cycle, that all companies go through good times and bad times, and BP is now firmly back in the Recovery camp!

BP PLC Price

![BP PLC Price Chart](chart.png)
4. Asset backed

Definition

We define companies with strong asset backing as those whose value is primarily driven by tangible asset backing, not by their earnings power.

This category is distinct from the first three, and will be a significantly smaller part of our portfolios.

Why this works

“If a company’s assets are worth substantially more than the current share price then the shares will do well.”

The majority of shares increase in value due to higher profits and cash flow. However our last Potential category does not. Instead it is driven by asset appreciation. We divide asset backing into two: traditional tangible assets such as property (which we can screen for) and goodwill type assets such as a highly defendable market position (which we include in our verification process).

The key to securing good returns from Asset Backed situations is that there needs to be an element of scarcity associated with the asset. Property is often scarce, and its value will therefore rise at least in line with the overall wealth of an economy. In the case of goodwill, great soccer players will have a high value due to scarcity, while a business asset that has a good market position in a consolidating industry will also attract a high price.

Returns on asset backed situations can often be lumpy. These companies can be unfashionable for periods of time, and returns may only be made as a result of corporate activity seeking to unlock traditional or strategic asset backing.

Like other companies, asset backed enterprises have life cycles. These can fit the pattern already described, or can be more dramatic and largely cyclical in nature. Asset backed stocks tend to do best as the stock market cycle matures, benefiting as they do from good levels of credit availability.

References

One of Ben Graham’s (‘The Intelligent Investor’) key stock-picking criteria was the “net-current-asset” issue, where securities were purchased “at a cost for each of less than their book value in terms of net-current-assets alone” These ‘bargains’ are not often available today (though there were quite a few at the 2009 credit crunch nadir) but the principle still applies.

Many of the world’s richest people have made their money buying asset-backed businesses at the right point in the cycle.

The venture capital model often focuses on these types of businesses.
Example – McCarthy & Stone

Again we wrote in 2006 “McCarthy & Stone is a classic example of an Asset Backed investment, having shown both cyclical recovery and strong asset growth during the last 15 years of its life cycle. In the early 1990s this dominant builder of retirement homes was struggling against the background of a difficult housing market and investor scepticism. The result was a share trading at a huge discount to the accounting book value of its land and work in progress, and an even greater discount to the medium term worth of its market position. New management was required to strengthen the business and its financial position; this, together with a cyclical improvement, and the strength of McCarthy & Stone’s market position allowed a return to attractive returns on a growing asset base. The shares have gone up 45 times from the low point, and are to be taken private in 2006.” It is interesting to note that in the first draft of this document in 2006, I (Hugh Sergeant) wanted to put ‘taken private at the top of the market’ but the editor thought that this was too risky a comment; of course, and as predicted by our Life Cycle work, it was the top: the banks loaded the business up with debt and the inevitable financial restructuring followed. History may not repeat itself but it most certainly rhymes!

McCarthy & Stone PLC Price

Data Source: Prices / Exshare ©FactSet Research Systems
PVT Factor 2 - Valuation

What is a business worth? Can we pay a big discount to fair value?

Our second factor, Valuation, has been comprehensively documented. However, because it often requires going against the stock market consensus, it remains as poorly implemented today as it was in Ben Graham’s day. Investors find it as hard as ever to ignore the noise generated by the prevailing market view of a stock. If you are one of the fortunate few that can, you have the starting advantage of a valuation oriented investor.

We are valuation (value gap) investors not value (low multiple) investors, looking for anomalous prices across the whole market from Growth and Quality to Recovery and Asset Backed stocks.

References

Ben Graham was the father of value investing. In his book ‘The Intelligent Investor’ he defined three key concepts:

1. Companies have an ‘Intrinsic Value’ that the intelligent investor should seek to establish.
2. ‘Mr. Market’ (i.e. the stock market) is a manic depressive entity quoting wildly different prices for the same company depending on its mood. Intelligent investors should exploit this.
3. And, most importantly, the ‘Margin of Safety’ concept where investors should look for a significant margin between their estimate of the value of a company and what Mr. Market is asking them to pay for it.

In his postscript to Ben Graham’s book, Warren Buffett documented the investment performance of “the Superinvestors of Graham-and-Doddsville” (who, like Warren Buffett, were pupils in Ben Graham’s investment classes). For example, the Walter Schloss Partnership returned 16.1% p.a. versus the index of 8.4% between 1956 and 1984.

More recent evidence would include O’Shaughnessy (2005) and other practical applications of value investing, such as Neff (1999) and Brandes (2004). In ‘What Works on Wall Street’ O’Shaughnessy states that “stocks with low price-to-book, low price-to-cash flow, and low price-to-sales ratios dramatically outperform the All Stocks universe”. $10,000 invested in a basket of low price-to-sales stocks in 1951 would have become $22m by December 2003, compared with only $5.7m for All Stocks.

Academic research backs up these publications. Basu (1977) looked at the performance of low price-to-earnings stocks and found that these outperformed. This work was followed up by Fama and French (1998) who also found low valuation to be a good predictor of performance. Lakonishok, Schleifer and Vishny (1994) looked at the different risk characteristics of value strategies and found that differential returns were not accompanied by notable differences in traditional measures of risk, including beta and volatility.
Why it Works

There are three reasons why value-driven investing works.

First, starting yields (a key component of long term returns for investors) are usually high, providing an immediate advantage to the value stock.

Second, the low starting valuations imply low expectations from investors and therefore a low probability of disappointment.

Third, value stocks often get to their low valuations because they have already disappointed the market. Investor sentiment becomes depressed, focused on the short term, and scared about a further loss of value. Indeed loss aversion is a well known concept from behavioural finance (Mauboussin 2006): "For good evolutionary reasons, humans are averse to loss when they make choices between risky outcomes. More specifically, a loss has about two and a half times the impact of a gain of the same size." Hence the desire of investors to avoid stocks that have already disappointed as a way of avoiding future loss. However this loss aversion will over time be replaced by more positive sentiment as evidence of improved delivery from the management team develops, leading to share price recovery.

Academic literature provides further support. Studies in psychology suggest that individuals tend to use simple heuristics (rules of thumb) for decision making, opening up the possibility of judgmental biases in investment behaviour (Kahneman and Riepe, 1998; Schleifer, 2000). In particular, investors may extrapolate past performance too far into the future. Value stocks tend to have a recent history of disappointment; investors tend to ‘anchor’ their thoughts on the stock towards this, the result being an under-pricing of the security.

Our Approach

We strongly believe that stocks can trade at a substantial discount to their medium term worth and have proved this over the years. The causes of these discounts range from City short-termism to a fundamental misunderstanding of the medium term profit potential of a business. The consensus (or ‘Mr. Market’) dictates share prices, but Mr. Market is often wrong over the medium term.

We are not, however, a low PE, high yield type of value investor. We are driven by valuation – in other words, what a business is worth acknowledging that there are different types of businesses and you can not apply a ‘catch-all’ valuation metric across the market. Growth businesses can be as effectively valued as Asset Backed companies, taking account of prospective earnings increases, if one uses the right tools.

We do not want to over-complicate things, by creating bespoke models for every single company in the universe. Although this technique is practiced by many of the world’s largest fund managers, this approach has not been proven and it is not repeatable due to its dependency on the quality of analyst input.
Our approach is to apply our life cycle based segmentation of the market to determine the valuation metrics that we use for companies. So Quality lends itself to the cash flow return on invested assets (CFROA) metric, Growth to an earnings yield basis, Recovery to a sales analysis and Asset Backing to a quantification of book value or take-out multiples.

Using these metrics (on page 41) we can screen for new ideas in the knowledge that we are not trying to rank apples against pears.
PVT Factor 3 - Timing

Is now the right time to buy/sell?

Academic evidence and practical experience shows that there is a right time and a wrong time to buy or sell a stock.

Timing entry and exit points is critical to maximising returns, as without this factor it is very easy to be exposed by momentum trends. Instead we look to gain a competitive advantage from these trends.

Tools can be used to time entry to a stock, significantly reducing the risk of investing in ‘falling knives’, shares that look superficially attractive after a price fall but where economic value and share price have a lot further to fall. The same tools can be used to time an exit from a stock, the aim being to maximise returns from an investment during its uptrend, resisting the temptation to sell during early signs of share price strength. Our tools are based on a combination of behavioural finance theory and real life experience.

General References

A number of studies have shown that, when used in combination with other factors, a timing tool such as momentum is a powerful factor, as well as a risk reducer. In ‘What Works on Wall Street’ O’Shaughnessy’s most successful back test involved companies that exhibited both value and momentum.

Our Approach

We look at three timing tools. Two are quantitative in nature, the third is qualitative.

First, we assess the direction and speed of profits growth (through earnings revisions). Second, we examine the information provided by share price trends (technical analysis). Third, we carry out fundamental analysis, namely identifying the presence of catalysts focused on closing the valuation gap and an accumulation of positive news flow. In particular, we assess the management’s commitment to shareholder value. The first two we use in screening, the last is part of our verification process.

We are not momentum investors – i.e. buying a share just because of the direction in which it is heading – we are Timing investors, using tools to ensure that we maximise our ability to buy and sell a position in an investment at the right time. Our tools are closely linked to the real world, to likely trends in economic value.
Our Timing Tools

1. Earnings forecast momentum

“If a company can improve operating performance above expectations it will be rewarded with a higher share price.”

There are two reasons why profit upgrades and downgrades drive share prices. First, higher profits equates to increased shareholder value creation and so if a company can deliver profits above market expectations the share price will rise. This reflects the basic financial theory that the value of a firm is the present value of future cash flows. Second, profit upgrades (and downgrades) tend to be serially correlated. Once a company has had one positive announcement the chances of another one increase dramatically, sponsoring further share price appreciation. This has been confirmed by academic studies such as that by Mendenhall (1991), ‘Evidence on the Possible Underweighting of Earnings Related Information’. This serial correlation is due to a number of factors.

One reason is that management teams downplay operating improvements because they want to be able to beat expectations. For their part, analysts covering stock markets are anchored in the past, as a result of which they limit their first upgrade, which becomes easy to beat. These analysts also tend to under-react to new information. They suffer from overconfidence in their ability to forecast and adhere to their previous understanding of a company’s prospects. This causes them to change their forecasts gradually and, as a result, share prices do not adjust fully to the new information. This anchoring effect is documented by Bernard and Thomas (1989) in ‘Post Earnings Announcement Drift: Delayed Price Response or Risk Premium’. They showed in this study that stocks that beat expectations outperform by an average of 2% over the next 60 days.

Companies that have been down on their luck take time to come good again. Perhaps the economy takes a while to pick-up or the new management team needs time to make the changes required to drive value. But when their fortunes do start to improve it is nearly always the case that good news compounds. So profit upgrades, like downgrades, rarely come in ones.

However, not all companies are created equal and different profits momentum analysis needs to be applied to our different categories. Quality shares need to be beating expectations to do particularly well, but Recovery shares only need to see the rot stopping or profitability bottoming-out for profit outcomes to start being a supportive factor.

2. Share price (technicals)

The stock market is both a weighing machine and a voting machine. Weighing is based on the pricing of medium term economic information such as profits; voting is based on investors reacting to shorter term events, some economic and some sentimental. The divergence of the two presents the anomaly for medium term investors to exploit. As an investor one can just take a position when the gap opens and over time one will be rewarded
(value investors), or one can understand the voting machine better and benefit from its trends (the T part of PVT).

There is indeed clear evidence that share prices trend over time. These trends are explained by the fact that investors, like analysts, suffer from behavioural bias and are slow to appreciate new information that will affect the share price. They often underreact to the information because they are overconfident in their ability to predict a company’s prospects. The serial correlation of share prices happens for similar reasons as to why earnings revisions serially correlate except that it is investors rather than analysts that are underreacting. Stock prices take a while to adjust correctly for new data and trend as they do so. It is for these reasons that trends are more likely to persist than to change, and so we prefer buying stocks that are already moving into up trends.

There is also a secondary effect when considering share price trends. Over the longer term, investors tend to overreact which often leads to an extension of a trend beyond the point that can be justified by a stock’s fundamentals. This is caused by ‘regret’ as investors who are repeatedly being wrong on a company or sector, finally capitulate and buy the stock even if by then it has become over-valued. One of the best examples of this was the huge number of new investors entering the market in late 1999 and early 2000 as tech stocks appeared to be making other people overnight fortunes. We temper our enthusiasm for those stocks whose trends may have become over-extended by being disciplined in considering other PVT factors such as Valuation. Evidence for share price trending comes from a number of academic studies, including Jegadeesh and Titman (1993), ‘Returns to Buying Winners and Selling Losers’.

Our use of technicals focuses on investing in stocks that have entered up-trends, as indicated by upward share price relatives, and avoiding those stocks that have entered downtrends, as indicated by downward share price relatives. The latter is a very strong tool to ensure that we do not get tempted into ‘falling knives’, shares that have been weak and therefore are starting to look attractively valued but where there is a lot more bad news, both in fundamental and share price terms to come.

3. Catalysts

This is a fundamental tool that is part of our verification process. We ask ourselves:

“Is there a catalyst in place to turn around the performance (and perception) of the company, and return it to creating value for shareholders?”

The most important catalyst by far concerns the corporate management team. Are they focused on delivering value for shareholders; if not, then are pressures on the company such that a change in management is imminent? New management can look at a business with a fresh pair of eyes, and make the changes that are needed. We look for a clear strategy that outlines the steps required to enhance economic value.
Other potential catalysts include the adoption of a new business strategy, the disposal of non-core businesses, cost cutting, financial restructuring, share buy backs and share purchases by company directors. If there is an accumulation of improving newsflow our confidence in the Timing factor will increase.

PVT – The Benefits of a Multi-Factor Approach

Multi-factor screens or models provide higher risk-adjusted returns than single factor models. A combination of factors will also give a more consistent outperformance. At R&M, by combining Potential and Valuation with Timing, we bring together traditional finance theory with behavioural finance. Our back test data suggests that stocks that score well in our multi-factor screens perform strongly in the future, and do so with a lower risk profile than single factor models because of the diversification provided by the three factors. We provide evidence for this in the appendix.

A number of comparative studies have been conducted on multi-factor and single factor models. Most comprehensive amongst these is the work of O’Shaughnessy (2005) which tests a range of models. His conclusion is clear (p 257), “Using multifactor models dramatically enhances returns...you’re much better off using several factors to build your portfolios. Returns are higher and risk is lower”.

For example “Buying those 50 stocks from the All Stocks universe having price-to-sales ratios below one and the best price performance from the previous year actually has a slightly lower standard deviation... yet earns $17m more over 52 years”

He provides an explanation for one of the successful multi-factor approaches: “I believe that adding relative strength to a value portfolio dramatically increases performance because it picks stocks just after investors have recognised that they are bargains and are buying them once again”. We would add that investors have also recognised that the fortunes of the company are improving.

Haugen and Baker (1996) and Fama and French (1993) have both produced work that supports a multi-factor approach, as have recent work by the quant teams at Merrill Lynch, Sanford Bernstein, Dresdner Bank and Collins Stewart (Quest).

This academic evidence is complemented by years of observation by the R&M UK Equity Team. Time after time the best performing shares are not the ones with the highest growth, or best returns, or those that are cheapest, or those that are seeing the best profits revision they are those shares that combine all these: great shareholder value Potential (profit growth), a clear Valuation gap (companies that are worth a lot more than the current share price), and with news flow (Timing indicators) that is clearly improving. This is where we focus our efforts.
Part 2

Investment Process

How we apply our philosophy to portfolios
2.1 An introduction to our process

Our process is focused on finding PVT ideas, verifying and debating these ideas, and constructing portfolios based on combining high conviction PVT stocks with stock market cycle based management of the macro opportunities and risks. We search for Potential, Valuation and Timing (PVT) ideas, we verify the idea through fundamental and financial analysis, and we assess the risk of adding a stock to the portfolio.

We are an ideas-led house, with our research effort focused on a comprehensive analysis of whether our ideas really qualify as PVT stocks.
2.2 Ideas

Background

Potential PVT ideas come from a variety of sources including:

- Our bespoke screening system, which we call MoneyPenny
- The flair of our fund managers and our significant experience of the whole UK market
- Our weekly team meeting.
- External sources such as investment banks and journals.

Why screen?

In today’s technology rich and high speed communication environment it is often the danger of having too much information, rather than too little, that is the greater challenge for investors. Academic studies support this observation (Russo and Schoemaker 2002), showing that accuracy of decision making improves with the first incremental pieces of information, but after a while new information actually detracts from the decision. ‘Blink: The Power of Thinking Without Thinking’, a popular book written by Malcolm Gladwell in 2005, also captured this concept.

Only a few years ago fund managers could gain a significant information advantage over other market participants through access to company management and the research analyst community in the City. Now with the advent of the internet there is a more level playing field for private investors to gain access to the information that had previously only been accessible to professionals. The new challenge for investors is how to deal with information overload at every level. One example of excess information is that every week there are over 20,000 company research reports published globally on companies, each attempting to lend new insight. This is in addition to all of the newspaper reports, economist forecasts and stockbroker recommendations to digest.

It is important that fund managers are as skilful in filtering out this barrage of ‘noise’ as they are in their ability to uncover hidden value, unknown company gems or areas where the market is incorrect in its perceived wisdom. This is critical in order that as investors we constantly stay focused on what the key drivers of shareholder value and share price performance are.

When deluged by large quantities of information investors tend to categorise their thinking through simple rules of thumb, known as heuristics. Heuristics are well documented and lie at the heart of behavioural finance theory. We use them to simplify our lives, but they have unintended investment consequences that do not help in the pursuit of outperformance.

The solution to the problem of information overload and overcoming behavioural bias lies in a disciplined repeatable investment philosophy and process, aided by sensible multi-factor stock screens and a process that
focuses on key information rather than simply acquiring as much information as possible.

**Why we marry traditional fundamental analysis with quantitative screening**

We have built a screen that reflects how we have achieved superior returns in the past. We believe that this is the most efficient, and systematic way of unearthing these anomalies in the future. The screen is, however, just a starting point. Fundamental analysis and fund manager flair are also essential, both for validating the output from our screening tool, and also for discovering the opportunities that are not identified by this approach.

**What a quant screen does and does not provide**

<table>
<thead>
<tr>
<th>Provides</th>
<th>Does not provide</th>
</tr>
</thead>
<tbody>
<tr>
<td>Systematic review of factors</td>
<td>Factor adjustment</td>
</tr>
<tr>
<td>Stock ranking</td>
<td>Stock selection</td>
</tr>
<tr>
<td>Linear thinking</td>
<td>Lateral thinking</td>
</tr>
<tr>
<td>Questions to ask</td>
<td>Answers</td>
</tr>
<tr>
<td>Trend following</td>
<td>Pre-emption of trends</td>
</tr>
</tbody>
</table>

**What a Fund Manager does and does not provide**

<table>
<thead>
<tr>
<th>Provides</th>
<th>Does not provide</th>
</tr>
</thead>
<tbody>
<tr>
<td>Creative insight</td>
<td>The capacity to look at all things constantly</td>
</tr>
<tr>
<td>Interpretation of the data</td>
<td>The ability to assimilate all the data</td>
</tr>
<tr>
<td>The ability to be early &amp; pre-empt trends</td>
<td>The conviction to always execute</td>
</tr>
<tr>
<td>Focused research</td>
<td>Research without behavioural bias</td>
</tr>
<tr>
<td>Common sense</td>
<td>The ability to always be rational</td>
</tr>
</tbody>
</table>
MoneyPenny: Our Bespoke Screening System

For the launch of R&M’s UK Equity offering we developed our MoneyPenny screening capability. It allows efficient sourcing of ideas and consistent application of our philosophy.

*It is not a black box; it is a very efficient tool for finding PVT ideas.*

Our screening process is different to that used by other asset managers because it segments the investment universe into categories of Potential value creation and ranks these stocks against each other. We do not make the common mistake of comparing apples with pears; instead, we find the highest ranked or best Growth, Quality, Recovery and Asset Backed PVT stocks.

**Ultimately, we screen stocks for three factors, divided into four categories:**

<table>
<thead>
<tr>
<th>PVT Screen</th>
<th>Growth</th>
<th>Quality</th>
<th>Recovery</th>
<th>Asset Backed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Potential</td>
<td>Above average 5 year turnover growth</td>
<td>Above average and improving cash flow return on assets (CFROA)</td>
<td>Margins below 10 year average %</td>
<td>Top 25% Asset backed stocks</td>
</tr>
<tr>
<td></td>
<td>Above average 5 year EPS growth</td>
<td>Growth consistency</td>
<td>Share price % below peak</td>
<td></td>
</tr>
<tr>
<td>Valuation</td>
<td>Earnings yield / Growth (PEG)</td>
<td>CFROA valuation gap</td>
<td>Enterprise value/sales vs history</td>
<td>Price/book</td>
</tr>
<tr>
<td></td>
<td>Earnings yield</td>
<td>Earnings yield</td>
<td>Earnings yield</td>
<td>Dividend yield</td>
</tr>
<tr>
<td></td>
<td>Free cash yield</td>
<td>Free cash yield</td>
<td>Enterprise value/invested capital vs history</td>
<td>Gross cash multiple (non-property)</td>
</tr>
<tr>
<td>Timing</td>
<td>Earnings revisions</td>
<td>Earnings revisions</td>
<td>Earnings revisions</td>
<td>NAV revisions</td>
</tr>
<tr>
<td></td>
<td>Share price strength (technicals)</td>
<td>Share price strength (technicals)</td>
<td>Share price strength (technicals)</td>
<td>Share price strength (technicals)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Margin recovery commenced</td>
<td></td>
</tr>
</tbody>
</table>

**Why do we use these metrics for MoneyPenny?**

Our metrics are based on:
1. Quantitative research
2. Practical application, and
3. Simplicity.

**How do we screen for financials?**

For asset-backed financials, such as banks, we focus on equity based returns; for goodwill-based financials, including fund managers, we use the same metrics as non-financials. Where a valuation metric is less relevant to a financial company we use the best alternative. For example, dividend yields can be used rather than free cash yields or price to book versus history rather than enterprise value/sales versus history.
What are the outputs of MoneyPenny?

We rank each category by PVT, with an equal one third weighting across Potential, Valuation and Timing factors. Within the PVT valuation matrix we rank each metric by decile and then apply a fixed weight to the metric in-line with historic observation. The only category where we pre-screen the universe is Asset Backed where we narrow the universe to the bottom quartile of price-to-book stocks (i.e. most asset backing).

The resulting output is the UK equity universe, divided into deciles and ranked by Growth, Quality, Recovery and Asset Backed potential.

Can MoneyPenny be used to provide sector insights and weights?

Yes. MoneyPenny scores are aggregated at a sector level giving an insight into relative sector attractions. These sector scores are used to check that our portfolio positions are consistent with these scores.

Back testing MoneyPenny

In 2006 we back tested our MoneyPenny screen using an industry leading tool, the FactSet Alpha Tester with data from multiple providers including Reuters, Quest, FactSet and FTSE. We updated the back test in 2010.

Methodology

We went as far back as the quality of data would allow us. This took us back nine years to mid-1997. We then used our MoneyPenny criteria to screen each category by decile every month, and tested the performance of these deciles over future periods from 6 to 18 months. Within the deciles we equal weighted (rather than market weighted) stocks, and compared the performance of these deciles against an equally weighted FTSE All-Share Index. The result was an average of almost 100 periods over which we have return information.

This nine year period was a reasonably representative period over which to test our approach, given that amongst others it included a ‘bull’ and ‘bear’ phase and a strong ‘growth’ period followed by an equally strong ‘value’ period.

The results

The details of the 2006 results (and those from the 2010 update) are provided in the appendix. Here we provide a summary:

<table>
<thead>
<tr>
<th>Category</th>
<th>Top decile relative performance</th>
<th>Bottom decile relative performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth</td>
<td>+6.3% p.a.</td>
<td>-8.1% p.a.</td>
</tr>
<tr>
<td>Quality</td>
<td>+7.0% p.a.</td>
<td>-7.8% p.a.</td>
</tr>
<tr>
<td>Recovery</td>
<td>+5.4% p.a.</td>
<td>-3.9% p.a.</td>
</tr>
<tr>
<td>Asset backed</td>
<td>+11.1% p.a.</td>
<td>+4.1% p.a.</td>
</tr>
</tbody>
</table>

These results use the same parameters, apart from holding periods, with Growth assessed over six months, Quality over twelve months, and Recovery and Asset Backed over eighteen months. The Growth category
drives higher returns over a shorter term period, the Recovery and Asset Backed categories take longer to generate returns.

As can be seen in the appendix, the performance by decile is broadly linear, with the top decile outperforming the second which outperforms the third and so on. This provides further support for our approach.

As noted above, the Asset Backed category is the only one where the universe is pre-screened for the top quartile of asset backed stocks. The back test for this category therefore compares the top decile of this top quartile versus the bottom decile of this top quartile. The results suggest that Asset Backed stocks, in general, outperformed (2010 view: aided by credit expansion).

In early 2010 we measured the performance of our screens over the three year period from 2007, through 2008 and 2009 to build on our original back test work and bring our understanding of screen performance during different stages of the stock market cycle up to date. A summary of this analysis, during a period of huge top-down inspired volatility, can be seen on page 75.

Encouragingly the Quality screen continued to perform well during the period.

Whilst the Recovery and Asset Backed screens struggled during the bear market phase of 2007/08 (one catalyst for our work on the stock market cycle) they performed very strongly in 2009 during the first year of recovery. Performance for the Growth screen was modest during the period but as we write has performed well during the trend phase of the stock market cycle in 2010.

Correlation analysis

Our 2006 back testing work allowed us to do some useful work looking at both the correlation between PVT factors, and between our four life cycle categories.

The detail is provided in the appendix, but the summary is that correlations were low between both PVT factors, and between categories, providing evidence that the components of our philosophy produce attractive returns at different points in time, theoretically producing more consistent and higher risk adjusted returns. Our subsequent work on the stock market cycle helps explain why and when the different categories are likely to perform.

Category correlation:

<table>
<thead>
<tr>
<th></th>
<th>Growth</th>
<th>Quality</th>
<th>Recovery</th>
<th>Asset backed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth</td>
<td>1.00</td>
<td>0.22</td>
<td>-0.20</td>
<td>-0.26</td>
</tr>
<tr>
<td>Quality</td>
<td>0.22</td>
<td>1.00</td>
<td>0.03</td>
<td>-0.02</td>
</tr>
<tr>
<td>Recovery</td>
<td>-0.20</td>
<td>0.03</td>
<td>1.00</td>
<td>0.15</td>
</tr>
<tr>
<td>Asset backed</td>
<td>-0.26</td>
<td>-0.02</td>
<td>0.15</td>
<td>1.00</td>
</tr>
</tbody>
</table>
Experience and Flair

The experience and flair of a seasoned and successful investor counts for a lot and our team brings these attributes to R&M. We have each spent a number of years consistently applying our ‘own’ philosophies, during both good and bad times. This has created flair based on our love of stock markets, business and making money. This combination provides us with the ability to identify and highlight potential anomalies missed by managers with less experience and sometimes overlooked by our screen.

Our screen has been designed to mirror our investment approach as closely as possible, but the real world does not allow a perfect match and potential gaps need to be addressed by our own ability to mentally screen for ideas. For example, we can find strategically valuable companies that are attractive to corporate predators at higher valuations than our selected V criteria possibly due to specific ‘acquirer’ based synergies. We can identify global themes, which will produce high conviction in certain stocks featured in our screen and new, emerging companies that do not have the data for effective screening, but have the characteristics to fit our PVT philosophy.

There will also be occasions where a single screen in isolation can give the wrong signal. For example, cyclical businesses can score highly within our Quality category at the top of their cycle, as this is when they earn superior returns. However, experience will tell us that this is not the time to be allocating capital to this part of the market.

Team Meeting (discussing MoneyPenny output)

We run our MoneyPenny screen weekly and discuss the output at our weekly team meetings, with a formal review each fortnight. We look for high scoring stocks that have yet to be verified (new ideas).

Verification (New Ideas) Meeting

We have a Verification meeting every week to present the research done on new ideas. We believe that this meeting strikes the right balance between the need for timely consideration of new ideas and our determination to restrict bureaucracy. A big problem at many fund management houses is that ideas are not followed up in a timely manner due to the attention of analysts and fund managers being distracted by other matters. Larger firms often have committee based processes which can obstruct or delay verification work, often due to the time taken to build a wide consensus. New investment ideas can also be debated on an ad-hoc basis.

At R&M we have a small team where performance will remain the priority. As a result we have an open, fluid system of developing ideas without unnecessarily rigid meeting schedules. We do not seek to build a consensus at this meeting, but improve the verification of a PVT idea through harnessing all the team’s collective knowledge, analytical skills and insights whilst subjecting ideas to a structured debate based on our philosophy. We believe our partnership structure and ideas-led approach, when combined with our passion for performance, ensures an effective debate.
External Sources

No man, team, or screen is an island, or the sole source of all potential PVT ideas. Consequently, we see the outside world as a world of new ideas and input diversity.

This outside world encompasses research analysts, journals and ideas adopted by other fund managers we respect.

Ideas generated externally will be verified in the context of their MoneyPenny score and our PVT philosophy.
2.3 Verification

**Background**

This is the process by which we check the validity of the initial PVT thesis. This is the focus of our research effort, combining an in-depth analysis of the Potential, Valuation and Timing of a company, with financial business analysis, and management interrogation. Investment ideas can easily fail at this stage if, after investigation, they no longer fit the criteria.

We systemise our standard analysis package to ensure that our verification process is as efficient as possible.

Verification, by definition, must include debate, both between members of our team and with the outside world.

**Sequence of Process**

The sequence of our verification process is as follows:

1. MoneyPenny score – new ideas identified at team meeting
2. PVT thesis – verification pack, including PVT summary front sheet and standard analysis
3. Company contact
4. Debate

**1. Screening**

We run our MoneyPenny screen weekly and discuss the output at our weekly team meetings, with a formal review each fortnight. We look for high scoring stocks that have yet to be verified. Once identified a research sponsor is nominated to be responsible for the verification process.

**2. PVT Thesis – in depth verification**

We test the PVT score and thesis through analysing the key drivers of PVT relevant to the stock category; in addition we analyse the key standard value drivers. A copy of our Verification front sheet can be found in the appendix.

**Potential**

We ask what are the key drivers of Potential? First, we divide Potential by category – Growth, Quality, Recovery and Asset Backed.

Then we look at the key components that the fund manager will consider in understanding whether this stock has Potential within its category. These components are tested by interviewing management and discussion with leading analysts and team members.
Growth
Is this business going to show superior growth of turnover and profits over the medium term? Is growth likely to be ahead of expectations, and has growth been consistent in the past?

We consider:
- Market growth
- Market share
- Pricing
- Cyclical effects
- Position in growth life cycle.

Quality
Is this business earning an above average return on invested assets, and is this trending upwards?

We look at:
- A company’s history of CFROA (cash flow return on assets) or ROE, how high are returns and what has been the recent trend.
- Is this sustainable – nature of industry, market position, and pricing power?

Recovery
What is the Recovery potential, in margins and therefore profits?

We consider:
- Level of margin now versus ten year history
- Reason for sub-trend margins
- Recovery drivers, including management initiatives for shareholder value and targets
- Financial position and cost of restructuring.

Asset Backed
Does this business have significant asset backing?

We consider:
- Are the shares trading at a significant discount to tangible assets and/or invested capital?
- What is the rate of growth of assets?
Valuation

We ask is the PVT score correct? Is there really a significant Valuation anomaly? Can this be quantified?

At this stage we provide a broader range of valuation metrics, at least one of these being absolute, such as discounted cash flow, strategic and sum of the parts valuations. These metrics are needed to confirm the valuation anomaly flagged up by MoneyPenny. The valuation work also needs to consider corporate accounting policies and whether or not similar shares are producing strong valuation scores.

Timing

Is now the optimal time to buy/sell?

Our verification process looks for fundamental confirmation that now is the time to buy or sell.

We decide whether or not there are sufficient catalysts in place to turn around the performance of the company and its shares; in particular we consider whether or not the management team is focused on shareholder value, or whether changes in management are needed to deliver this. We analyse recent news flow to see if it has shown a clear improvement. We take account of dealing conditions through a dealer liquidity review and check on the recent actions of leading shareholders and directors. We ask ourselves whether similar shares are displaying strong Timing scores and check the perceived wisdom in the market to understand whether sentiment is, or could be, about to improve.

Standard Value Drivers

In addition to category specific verification, we want to understand the following with regard to all companies:

Business Analysis

What are the strengths, weaknesses, opportunities and threats for the company’s profit drivers?

We consider corporate competition and barriers to entry; suppliers and cost base; customer demand and pricing and macro-economic influences.

Management Analysis

Are management focused on driving shareholder value, and do they have the skills to deliver Potential? For example, a management team may be able to grow a ‘Growth’ business but do they have the specific abilities to drive a Recovery situation? We consider recent and expected management changes; track records; manager motivation and their strategy to deliver shareholder value, corporate governance and compliance with ESG issues.
Cash Flow Analysis

How robust is cash flow and where is the cash generated going?

We assess the financial model of the business, in order to understand issues such as the underlying drivers of cash generation, working capital cycles and capital expenditure requirements; the conversion percentages of stated profits into actual cash and, critically, the CFROA and ROE history.

Financial Strength

Is the company financially sound?

This issue is particularly relevant for recovery and growth categories. We consider levels of gearing; interest and dividend cover by earnings and gross cash flow; off balance sheet leverage; on balance sheet pension scheme issues and known (and hidden) asset support, such as tax losses.

Risk

What are the risk characteristics of the stock and the risks to the PVT thesis?

This would include thesis risk, specifically “what could go wrong?” Which drivers of P, V and T do we have least conviction in or have the highest marginal impact on the strength of the thesis, and macro economic impacts.

3. Company Meetings

Company meetings are an integral part of our process but, like the concept of research ‘coverage’, we do not have meetings simply because the option happens to be there. Instead, we have company meetings when we need answers and we carry out research when there are anomalies.

Company meetings occur either at our offices, at the company’s premises or at third party offices (usually stockbrokers). They can also be as simple as a telephone conference call.

The key verification reasons for having a company meeting are to:

• Develop and test the PVT thesis
• Evaluate management
• Improve understanding of strategy and business
• Discuss issues related to verification analysis.

A key benefit of our PVT screen and its part in our process is that it screens out companies that do not score highly on our key investing success factors. This reduces the number of low added-value or entirely unnecessary company meetings. Meetings like these can do more harm than good if emotional and behavioural biases end up being generated.

We expect to meet a material number of companies during the year. However, we have noted that excessive numbers of company meetings can have a detrimental effect on value added when there is insufficient time for preparation and follow-up. We also believe that the added value
from company meetings increases as the size of the company decreases. This consequently skews our meetings towards medium and smaller sized businesses.

4. Debate and Recommendation

Aim

Our desire is to have accountable rather than consensual portfolios, as the latter tend to underperform. However, we believe that team debate is an important factor in ensuring effective testing of the validity of a stock’s PVT thesis, its strengths and weaknesses.

Format

We are a small team. As a result we can be flexible and adaptable to investment opportunities as they arise. New investment ideas can be debated on an ad-hoc basis. However, to add structure to our process, we have a weekly verification meeting at which new ideas are presented. This comprises a short presentation by the sponsor with reference to our standard documentation. Team members will test the thesis through questioning. If the PVT thesis is incomplete, further work will be required. If the PVT score is low and there is not a valid fundamental case the idea will be ‘rejected’.

Sell discipline

A systematic selling discipline is critical to consistently generate above average investment returns. Our selling process is driven by the inverse of our PVT philosophy. Shares where the Potential is deteriorating, such as falling returns for a Quality stock, where Valuation anomalies have unwound due to out-performance, and where Timing has turned, possibly due to earnings downgrades, will be assessed for sale.

We also systematically monitor the PVT scores of portfolio holdings in MoneyPenny. Where scores fall significantly, or into the bottom four deciles of the key category, the original sponsor of the holding is required to re-verify the PVT thesis and then the holding is debated by the team at the weekly meeting. This function facilitates a rapid overview of the PVT scores across individual portfolios, highlighting any significant changes that may warrant further investigation.

Decision making

We are acutely aware of the perils of consensus building in fund management and believe strongly in the benefits of team work, as long as respect for the individual is maintained. R&M wants to encourage meaningful debate, efficient decision-making and an environment that supports personal responsibility for investment decisions.

Believing strongly in the power of MoneyPenny means that if a company has a low PVT score but a fund manager has built a strong PVT thesis with reasons provided for the ‘erroneous’ low score, a second fund manager must also sign-off the recommendation prior to any action taking place.
What coverage is required for stock purchase?

The documentation required ahead of a stock purchase for portfolios is simple, and focuses on confirming or rejecting a PVT idea.

<table>
<thead>
<tr>
<th>Growth</th>
<th>Responsibility</th>
</tr>
</thead>
<tbody>
<tr>
<td>PVT front sheet*</td>
<td>Fund manager – each stock must have a clear PVT analysis</td>
</tr>
<tr>
<td>Screening score</td>
<td>Automated</td>
</tr>
<tr>
<td>Generic analysis</td>
<td>Automated / fund manager</td>
</tr>
<tr>
<td>Share holder analysis/liquidity review</td>
<td>Automated / dealer</td>
</tr>
<tr>
<td>Additional commentary</td>
<td>Fund manager</td>
</tr>
<tr>
<td>Best ‘broker research note’</td>
<td>‘Sell side’ analysts</td>
</tr>
</tbody>
</table>

*This is a systematic means of collecting information on individual companies. Examples are available on request.

What ongoing coverage is required?

Sector

Our approach to stock coverage is based on identifying new PVT ideas through the process outlined above.

We do not believe our process lends itself to analyst based sector coverage, this would just introduce behavioural biases to the portfolios.

Stock

PVT thesis updates, which may include company meetings; MoneyPenny monitoring (improving or falling rankings), at our weekly team meetings; external reviews (conferences to develop / maintain industry understanding, analysts sector reviews).

Weekly Team Meeting (monitoring existing holdings)

Our verification meetings are the source of verified PVT stocks to put into portfolios. Our other key meeting is our weekly team meeting. At this we monitor all our existing positions in portfolios, the focus of which is significant movements (up and down) in MoneyPenny scores, with a formal response required if a score falls below the fifth decile; we monitor our PVT screens for high scoring stocks by category which we have yet to cover, this being the first source of ideas for the verification process; and we explain recent buying and selling activity in our portfolios.
2.4 Risk, the Stock Market Cycle and portfolio construction

Stock picking is about finding shares that will deliver attractive returns. However, controlling the downside risk and volatility of portfolios is also a key part of investment management. We need to understand what investment risk is and how it can be managed. We then need to marry this with the level of risk our clients are comfortable with and how we can construct portfolios to reflect their risk and return appetite.

Our approach to risk and portfolio construction reflects our overall investment philosophy. We combine traditional risk analytics and controls with real life experience and prior observation of what can impact portfolios negatively.

What do we understand by Investment Risk?

We identify four categories of risk, all of which can be managed.

1 - Investment Thesis Risk

Definition

This is the risk that you have got your original theory on an investment opportunity wrong. Individual mistakes in a portfolio can undermine good work elsewhere.

How do we manage it?

The assumption we make is that whilst our investment philosophy and process should minimise the number of stock selection mistakes we make, they will still occur. We therefore need to regularly test our PVT thesis on stocks and to be able to act if our thesis weakens considerably.

We do this by running our PVT screen weekly and by highlighting and discussing weakening scores (formally at our team meetings). We also carry out frequent fundamental updates on all our holdings, ensuring that news flow from a company is in line with our thesis.

If our original thesis is no longer valid we will sell the investment.

2 - Top Down (Macro) Risk

Definition

This is the risk that portfolio returns are impacted by top-down (or macro) factors, rather than by bottom-up (PVT) factors. A recent example of this (2008) has been the impact of the credit crunch.

Our Stock Market Cycle thesis

Everything in investment has cycles – good times, and bad times. We have learned over the years that one needs to understand these cycles
to effectively manage portfolio construction opportunities and, most importantly, portfolio construction risks. At the bottom of the stock market cycle, when opportunities are well above average, and risk premium are high, then be prepared to construct portfolios to maximise returns. At the top of the stock market cycle, when opportunities are limited and risk premiums modest, then focus on protecting portfolios.

The Stock Market Cycle

“To buy when others are despondently selling and to sell when others are avidly buying requires the greatest fortitude and pays the greatest ultimate rewards.”
Sir John Templeton.

What are the key cyclical components of the stock market that we monitor?

Economic Cycles

The economic cycle needs no introduction. As we all know, economies do not grow at an even pace. They have normal times (when they grow in line with trend), they have periods of over-heating (when Schiller’s ‘animal spirits’ take over, and growth is too fast and inflationary), and then they have periods of contraction (when economies respond to the tightened monetary policy put in place during the periods of excess). These economic cycles have always existed in the past, and will do so in the future. The ups and downs of economies have a noticeable impact on equity markets, on the desire to own and therefore the price of risk assets, and most importantly on the profit cycle.

Profit Cycles

As well as individual companies having an ebb and flow in their profits, there is a cycle in overall corporate profitability as the chart below shows. This is the main instance where the economic cycle has a material impact on the
fortune of investors, and provides a degree of insight into how to manage portfolio construction risk.

**UK PLC Return on Equity**

At the top of the profit cycle (usually co-incidental with the peak of the economic cycle) demand in most areas of the economy is above trend and the majority of companies are achieving peak levels of profitability. But as the cycle starts to trend down, demand weakens and the profits of many companies are vulnerable – the earnings downgrade cycle has started, with the more cyclical and financially geared stocks likely to witness the biggest negative earnings revisions. Share prices always follow profits at this point, so the best place to be invested is in the more defensive, higher quality companies.

Fast forward one to two years and return on equity across the corporate sector is now depressed, with many companies making cyclically low margins. Demand is now stabilising and, with costs having been cut, profitability has bottomed-out and in many cases starts to beat what have become very negative expectations – the earnings upgrade cycle has begun. As demand strengthens, moving back towards trend, it becomes easy for companies to grow profits again, as operational gearing kicks in, and the more cyclical and financially geared corporations will trounce analysts’ expectations. Now is the time for Recovery type stocks, as this is where news flow is at its most positive.

**Style Cycles**

To us the Value factor is critical; like Ben Graham we want to buy things for 50p in the Pound. But we have learned that having a cheap portfolio does not always work, that’s why value focused managers do have some down years. Low price to earnings and low price to book stocks do not protect capital after the profit cycle has peaked – a lowly valued steel stock is only headed in one direction when corporate profits come under
pressure, and that is down. The characteristic that really works at this point is defensiveness, with only modest reference to the price paid for stable earnings. Of course if you can buy defensive stocks on low valuations at the top of the profit cycle then that is fantastic. And of course this is what you could have done at the top of the TMT bubble; you could buy defensive tobacco stocks such as British American Tobacco on earnings multiples of five, a no-brainer; stocks like this actually went up in price when everything else was falling.

The other time to be wary of owning a cheap portfolio is when the difference in valuations between cheap and expensive (high and low PB or PE) stocks is narrow compared to history. As the chart below shows (composite valuation spread, measured in standard deviations between cheap and expensive stocks) value does have a cycle:

**UK Equity Valuation Spreads**

![Graph showing UK Equity Valuation Spreads]

Source: Bernstein

**References**

There is little authoritative academic work on this subject that directly investigates the relationship between business and investment cycles. The best analysis we have read is by Lars Tvede (Business Cycles 2006) because he is first-and-foremost an investor, so his analysis is real world rather than theoretical.

He identifies seven stages of the cycle starting at the low point:

i) the monetary accelerator, when interest rates are below natural rates leading to improved optimism and economic activity

ii) the inventory accelerator, when companies start to re-stock

iii) the capital spending accelerator, as increased demand fills up capacity requiring more investment

iv) the collateral accelerator, as rising asset prices feed into increasing confidence and growth
v) the emotional accelerator, as animal spirits start to take over creating momentum markets and ultimately bubbles

vi) exhaustion, as incremental investment becomes unprofitable and participants start to realise that the game is up

vii) the credit crunch, as unproductive assets need to be destroyed, in the process stranding the credit that helped finance them.

We have now returned to the first stage, as monetary authorities respond to the fall in demand associated with a credit crunch. As Tvede suggests, a full cycle, from beginning to end, lasts 18-20 years, which ties in with our view that periods of excess credit creation are associated with a new generation of bankers that have yet to learn that lending too much will always come back to haunt them.

The recent bestseller by Reinhart and Rogoff, 'This Time Is Different', has at its core the concept that history has regularly repeated itself, that financial and other booms and busts are an inherent part of our economic, financial and behavioural systems. As they say “Our basic message is simple: we have been here before. No matter how different the latest financial frenzy or crisis always appears, there are usually remarkable similarities with past experience from other countries and from history.”

Sensible work on the stock market cycle has also been done by some of the Investment Banks. For example the Merrill Lynch Quantitative Team articulates a concept called the Global Wave that systematically relates portfolio construction to where one is in the economic cycle.

John Train, a seasoned and well respected commentator on investing, says in 'The Craft of Investing' that “You need to get deeply into your bones the sense that the stock market moves in cycles, so that you will infallibly get wonderful bargains every few years, and have a chance to sell at ridiculously high prices a few years later...toward the bottom of a bear market you hear terrifying prophesies about disastrous possibilities that only occur every fifty or a hundred years. You are expected to believe that economic activity will all but stop. Don’t believe it!”

And naturally Anthony Bolton thinks a lot about the cycle without developing a systematic framework. In ‘Investing Against The Tide’ he writes “Always remember that the stock market goes in cycles and never goes up forever...at tops it’s not that the news stops being good, it’s that it stops getting better, with the reverse at lows”.

And finally Adam Smith “You do have to know what time of market it is. Markets go in cycles like all of the other rhythms of life.”

How do we manage Stock Market Cycle risk?

As part of our quarterly risk meeting we systematically monitor where we are in the stock market cycle, quantifying our location in the economic, profit, and style cycles. As well as being an essential exercise for understanding where the big picture risks and opportunities lie, it ensures that we talk about macro issues in a consistent and logical manner, rather than with the random
pattern that is so familiar to watchers of Bloomberg TV or readers of even the best financial newspapers.

We focus on managing portfolio construction risk at the top and bottom of the cycle, in particular looking to accentuate our risk exposure (for example buying recovery stocks and smaller companies) at the bottom of the cycle, and minimise our risk appetite at the top (with a focus on quality and defensive stocks). At all other times, during the trend phase of the stock market cycle, a broad exposure to all our PVT factors, all our categories and all sizes of company will stand us and our clients in good stead.

**Market PVT and the Stock Market Cycle**

A logical extension of this work is to apply our PVT framework to understanding where we are in the market cycle. We ask what is the market PVT?

1. Potential: are market aggregate profits below or above trend?
2. Valuation: are equity markets cheap or expensive versus history?
3. Timing: is corporate news flow improving/positive or deteriorating/negative?

This approach has the added benefit of allowing us to comment (to you) in a consistent fashion on the attractions of equity investment at any point in time.

**Market PVT Analysis**

<table>
<thead>
<tr>
<th>PROFIT POTENTIAL</th>
<th>P</th>
<th>RoE Low, Potential High</th>
<th>RoE High, Potential Low</th>
</tr>
</thead>
<tbody>
<tr>
<td>VALUATION</td>
<td>V</td>
<td>Risk Averse, Valuations Low</td>
<td>Risk Hungry, Valuations High</td>
</tr>
<tr>
<td>TIMING</td>
<td>T</td>
<td>Key Indicators Improving</td>
<td>Key Indicators Deteriorating</td>
</tr>
</tbody>
</table>
3 – Benchmark Risk

Definition

This is the most common risk measure and refers to volatility of returns relative to benchmark. It is particularly applicable to our less aggressive strategies. These risks are well documented.

How do we manage it?

We manage relative risk through traditional means such as tracking error (ex ante and ex post) ranges and stock and sector controls.

4 – Diversification (Concentration Risk)

Definition

This is simply the concept of not putting “all your eggs in one basket”, reducing the volatility and potential for loss by investing in a number of stocks and therefore diversifying ones portfolio. For diversification to work there is a need to not only have a number of investments, but for these stocks to be lowly correlated.

How do we manage it?

Our philosophy and process lends itself to natural diversification; PVT exposes our portfolios to three factors not just a single one such as value; our Company Life Cycle approach acknowledges that there are four categories of company that can make us money; our valuation work puts as much emphasis on absolute valuations as it does on relative, ensuring that we think about the risk of capital loss as well as the relative upside in an investment; and our multi-cap approach means that we look to find PVT anomalies across all sizes of company.
**Risk Meetings**

We have a quarterly risk meeting to review the risk positioning of all portfolios. The agenda covers the following for each UK strategy:

- **Do our portfolios reflect our philosophy and process?**
  
  A key check here is the decile skews to high scoring MoneyPenny stocks (example below, High Alpha portfolio). There should be a strong bias of capital and stock count towards the highest decile stocks. We report on skews to our clients on a quarterly basis.

![Weight and Count](image)

Source: River and Mercantile Asset Management LLP, UK High Alpha Fund, January 2011

- **Thesis risk**

  Have we correctly verified all low scoring (and falling score) stocks? If not then the original sponsor will be mandated to re-verify an investment.

  What are the broad biases in the portfolio? Are they all understood? And are there any unintended bets?

  We analyse the style bias of portfolios, and interrogate portfolios for exposures that have not been planned (i.e. high financial leverage)

- **Liquidity Risk**

  We monitor days to liquidate our strategies and adjust smaller company exposures and capacity constraints in response.

- **Mega-Cap Exposure**

  Do our mega-cap exposures (often a large part of risk budgets) reflect PVT convictions? If not, action will be taken.

- **Are funds compliant?**

  With all hard controls (tracking error, stock and sector, smaller company limits).
Commonality across strategies
Where are the key differences, are they explained by strategy or style differences, if not what action needs to be taken?

Stock Market Cycle analysis
A systematic and scored analysis of where we are in the cycle.

Our approach to portfolio construction
Portfolio construction is the marriage of this understanding of investment risks with the risk and reward appetite, or investment objectives of the client.

How do we define portfolio construction?
It is how a fund manager puts together a portfolio to maximise returns within a clear risk budget.

All our strategies have clear risk parameters. For portfolios that are managed against the FTSE All-Share Index a key risk tool is tracking error. The aim of our portfolio construction is to use this tracking error budget as efficiently as possible, weighting stocks and sectors that are most likely to produce alpha (benchmark outperformance) within this budget.

Using our risk budget efficiently – ranking and weighting positions
Our PVT philosophy and process are focused on producing return generating potential investments but we still need to answer the question, how should we rank and weight them?

Our primary input into ranking and weighting potential investments is PVT conviction and sustainability. This is determined from a combination of our PVT screen score and our verification process. So if a new recovery share screens in the top decile versus the recovery universe and has come through the verification process with ease then it will be a high conviction position within a portfolio.

As a result all our portfolios will rank highly by PVT screen and verification conviction and will skew towards the top deciles.

Can a stock have a low score and still be held?
The occasions will be rare but, yes, they can. However, if the screen score is low there has to be a very clear fundamental verification based argument for investment, with sign-off from two fund managers.

Sector positions and sector ‘Life’ cycles
Sector strategy is an area fraught with tension. To a committed stock picker sector strategy is residual, the by-product of many individual stock views. To some extent this is our view, but we do also manage sector positions for three reasons.
First, we monitor PVT scores at a sector level to give us visibility about the relative attractions of sectors, and to influence our portfolio construction. If sector constituents are bunching together in the top deciles then a sector overweight position would most likely be the result.

Second, we look to actively exploit the significant standard deviation events that happen at a sector level from time to time. By this we mean that macro drivers - such as commodity prices in 2006 or technology demand in 2000 - can deviate materially away from the norm. If this deviation is a significant standard deviation event, and has led to a re-rating (or de-rating) of sectors exposed to this influence then we will want to adjust portfolios to minimise risk exposures, both to benefit from the inevitable return towards trend and to manage the absolute risk in the portfolio.

Third, risk management is clearly the other reason for managing sector positions. We believe portfolios benefit from diversification, and ensure this through diversifying across our potential categories, and across sectors.

Category Allocation

Our potential (PVT) factor is divided into four categories. Allocating parts of a portfolio to these different categories will ensure diversification as they are not highly correlated. Two Recovery shares at the bottom of an economic cycle are likely to move closely together, but they will not be closely correlated with a Quality company.

How do we weight between categories?

The results of our back test in combination with our historical experience point towards a higher strategic weighting in Quality category shares (which produced the highest risk-adjusted returns) with the balance of portfolios split between the other categories depending on where we are in the stock market cycle (higher Recovery weighting at the bottom of the cycle, more Growth during the trend phase). Asset backed stocks are a modest part of the market and therefore our Asset Backed category exposure is always likely to be a small part of portfolios.

Size

Our intellectual capital (with all members of the team having significant smaller company experience) and our MoneyPenny screening process lends itself to adding value across all sizes of company. It is natural for us (subject to strategy) to be overweight smaller companies, but again we manage exposure depending on where we are in the stock market cycle.
2.5 Our products, and Manager styles

We offer a full range of long-only UK Equity products, from a lower risk Core approach to our capital appreciation focused Long Term Recovery fund:

<table>
<thead>
<tr>
<th>Manager(s) – lead</th>
<th>Benchmark Index</th>
<th>Out performance Target</th>
<th>Tracking error range</th>
<th>Stock and sector controls:</th>
<th>Strategic size exposure</th>
<th>Product capacity</th>
<th>Number of Stocks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dan Hanbury</td>
<td>FTSE All Share</td>
<td>Index + 2% p.a.</td>
<td>2-6</td>
<td>Relative to Index:</td>
<td>FTSE 350</td>
<td>£2bn +</td>
<td>50-80</td>
</tr>
<tr>
<td>Hugh Sergeant</td>
<td>FTSE All Share</td>
<td>Index + 3% p.a.</td>
<td>4-8</td>
<td>Relative to Index:</td>
<td>Multi-cap</td>
<td>£1bn</td>
<td>Unconstrained</td>
</tr>
<tr>
<td>Dan Hanbury</td>
<td>FTSE All Share</td>
<td>Index + 4% p.a.</td>
<td>n/a</td>
<td>Absolute:</td>
<td>No limits</td>
<td>£1bn</td>
<td>Unconstrained</td>
</tr>
<tr>
<td>Hugh Sergeant</td>
<td>Maximise Long</td>
<td>LIBOR + 4% p.a.</td>
<td>n/a</td>
<td>Absolute:</td>
<td>Multi-cap</td>
<td>£200m</td>
<td>20-40</td>
</tr>
<tr>
<td></td>
<td>Term Capital</td>
<td>Yield: 110% of All Share</td>
<td>2-8</td>
<td>Relative to Index:</td>
<td>55% min FTSE 100 &amp; 15% max Small Cap</td>
<td>£400m</td>
<td>60-100</td>
</tr>
<tr>
<td></td>
<td>Returns</td>
<td>Index + 3% p.a.</td>
<td>4-10</td>
<td>Relative to Index:</td>
<td>100% small</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Segregated portfolios managed according to the same mandate will be operated on a model basis.

Manager style differences and Manager cycles

All our strategies exhibit a strong commitment to our Philosophy and Process, as evidenced by high skews towards top decile scoring MoneyPenny stocks. However fund manager flair, which we encourage at R&M, does result in portfolios run by Hugh Sergeant and Dan Hanbury having different through the cycle style biases. Hugh is known as a value-led manager, and his portfolios will normally exhibit higher than market exposure to value characteristics. He will also typically have an overweight position in smaller companies. Dan is a lower risk, quality focused manager so his portfolios will on average have higher than market return on investment characteristics and a lower beta. Richard has a more style neutral approach.
All fund managers have a performance cycle. Historic data shows that our managers have outperformed in a significant majority of years (i.e. Hugh Sergeant has outperformed in eight out of the last ten years, and fourteen out of the last eighteen), however there are market backgrounds that might cause individual managers to struggle. For Hugh it would be poor years for Value or smaller companies; for Dan high beta and lower returns for Quality stocks would be a difficult environment for performance.

### Manager Style

<table>
<thead>
<tr>
<th>PVT</th>
<th>FactorBias</th>
<th>Size</th>
<th>Risk Appetite (beta)</th>
<th>Products</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dan Hanbury</td>
<td>✔</td>
<td>Core</td>
<td>&lt;1</td>
<td>UK Equity Core</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Core</td>
<td></td>
<td>UK Unconstrained</td>
</tr>
<tr>
<td>Richard Staveley</td>
<td>✔</td>
<td>Value/Core</td>
<td>Small 1</td>
<td>UK Income</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>UK Small Cos</td>
</tr>
<tr>
<td>Hugh Sergeant</td>
<td>✔</td>
<td>Value</td>
<td>Small &gt;1</td>
<td>UK High Alpha</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>UK LTR</td>
</tr>
</tbody>
</table>

Core Platform | Manager Specific (portfolio construction and style bias)
Conclusion

Our competitive advantage

Our philosophy is designed to answer one question:

“Can we make money by buying this stock?”

• It originates from many years of practical experience and is supported by empirical evidence and academic research

• We focus on the three key factors (PVT) that drive share prices higher over the medium term

• We understand that the shareholder value generation potential of a company depends on its position in the company life cycle

• Our PVT philosophy is simply and systematically implemented through our stock picking process.

• We have a clear and real world based approach to risk management, with a particular understanding of the stock market cycle

• We think independently and will always trust in our approach rather than current fashion

“To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information. What’s needed is a sound intellectual framework for making decisions and the ability to keep the emotions from corroding that framework.”

Warren Buffett
Preface to ‘The Intelligent Investor’ (1973)
1. Biographies

The Team

The portfolio manager team at R&M is made up of Hugh Sergeant, Richard Staveley and Dan Hanbury, the original founder fund managers. Hugh has been active in the UK equity market for over 20 years and has an 18 year record of adding value. Richard and Dan have covered the UK market for over 10 years and have developed strong reputations and performance records. We complement each other, bringing different investment skills to the team.

Hugh Sergeant
Head of UK Equities

Hugh graduated from the London School of Economics with a degree in Economics. He joined Gartmore in 1987 as a UK equity graduate trainee and moved to Phillips & Drew in 1990, managing UK equities throughout his twelve years there. He became Head of Smaller Companies in 1997, establishing a new team and launching the UBS Smaller Companies Fund. In March 2000 Hugh was promoted to Head of UK Equities at UBS Global Asset Management and Chairman of the UK Equity Committee. He joined SGAM in 2002 where he was Head of UK Equities, manager of the Growth strategy and co-manager of the Special Opportunities Fund. Hugh joined R&M in August 2006.

Hugh is Head of the UK Equity team at R&M with overall responsibility for managing and developing the team. As a fund manager he is focused on the UK High Alpha and Long Term Recovery strategies.

Richard Staveley
UK Equity Fund Manager

Richard graduated from Newcastle University with a degree in Politics. He began his career at PriceWaterhouseCoopers in London, qualifying as a Chartered Accountant in 1999, before joining the hedge fund boutique Bradshaw Asset Management as an Assistant Fund Manager. In 2001 he moved to SGAM as part of the UK Small Companies team and in 2002 he became responsible for all UK small company investments. Richard joined R&M in August 2006.

Richard is Research Director and a UK Equity fund manager at R&M with responsibility for the UK Equity team research function. As a fund manager he is focused on the UK Income and Smaller Companies strategies. He holds the CFA designation.
**Daniel Hanbury**  
*UK Equity Fund Manager*

Dan graduated from Loughborough University in 1996 with a 1st Class Honours Degree in Mechanical Engineering. He began his career at Schroder Investment Management on the UK Fund Management desk before joining the research department for two years as an analyst in the UK Research Team. He joined Investec Asset Management in 2000 and was responsible for the UK Small Companies Fund, and the UK Unconstrained Portfolios; he was the alternate manager on the Core portfolios and had specific analyst responsibilities for Industrials and Resources stocks.

Dan is focused on managing our Core and Unconstrained strategies and he also has responsibility for coordinating the quantitative analysis at R&M.

**Charles Benett**  
*Quantitative Analyst*

Graduated from Balliol College, Oxford, with a degree in Philosophy, Psychology and Physiology. He spent five years in the Royal Navy, including active service in the Gulf. After studying for an MBA at Columbia Business School, New York, he worked as a sell-side Equity Research Analyst for Toronto Dominion Securities (USA). Returning to the UK, he worked as a Technical Product Manager at Micromuse, worked on his own technology start-up and studied for an MSc in Computer Science at Imperial College, London. Most recently, he worked at Advanced Portfolio Technologies (APT) in software development and risk consulting.

Charles joined R&M in July 2006. Charles is the Quantitative Analyst at R&M where his primary responsibility is managing the stock screening database and system.
2. Fund Manager Performance pre R&M

How have we done?

Hugh Sergeant

Hugh Sergeant's Long-Term Track Record
Represents an Annualised Outperformance of 5.4% p.a.

Dan Hanbury

Dan Hanbury's Long-Term Track Record
Represents an Annualised Outperformance of 10.1% p.a.

Richard Staveley

Richard Staveley's Long-Term Track Record
Represents an Annualised Outperformance of 3.1% p.a.

Notes

1. Hugh has had positive performance, both relative and absolute in 11 of the past 13 years.
2. CY 2002 is not shown for Hugh or the index due to incomplete data arising from Hugh’s move to SGAM.
3. Source: The WM Company/Lipper, Hindsight, 1992-2001; Segregated account with + 2% outperformance target versus the FTSE All-Share Index (TR), managed prior to joining SGAM, 2003-2005; The SIS UK Growth Fund.
4. All returns are Gross of fees.

Notes

1. Dan has had positive performance in 6 of the past 6 years.
2. Inception is 30/06/00, when Dan became fund manager.
3. Source: Lipper, Hindsight, Bid to Bid, Total Return, Gross of fees.
4. The fund’s performance target was a 4% p.a..

Notes

1. Richard has had positive performance, both relative and absolute in 3 of the past 4 years.
2. Inception is 01/10/02, when Richard had completed rebalancing the portfolio following his appointment as fund manager.
3. Source: Lipper, Hindsight, based on SIS UK Smaller Companies Fund, which had target outperformance of 2% p.a.
4. All returns are Gross of fees.
3. R&M Fund Performance Since Launch

R&M UK High Alpha Fund

Notes
1. Institutional Z Class Shares.
2. FTSE All-Share Index.
4. Source: River and Mercantile Asset Management LLP, close of business mid to mid, Total Return, Gross of Fees.

R&M UK Long Term Recovery Fund

Notes
1. Institutional Z Class Shares.
2. FTSE All-Share Index.
4. Source: River and Mercantile Asset Management LLP, close of business mid to mid, Total Return, Gross of Fees.

R&M UK Equity Fund

Notes
1. Institutional Z Class Shares.
2. FTSE All-Share Index.
4. Source: River and Mercantile Asset Management LLP, close of business mid to mid, Total Return, Gross of Fees.
Notes
1. Institutional Z Class Shares.
2. FTSE All-Share Index.
4. Source: River and Mercantile Asset Management LLP, close of business mid to mid, Total Return, Gross of Fees.

R&M UK Equity Unconstrained Fund

Notes
1. Institutional Z Class Shares.
2. Hoare Govett Smaller Companies (ex IT) Index.
4. Source: River and Mercantile Asset Management LLP, close of business mid to mid, Total Return, Gross of Fees.

R&M UK Smaller Companies Fund

Notes
1. Institutional B Class Shares.
2. FTSE All-Share Index.
4. Source: River and Mercantile Asset Management LLP, close of business mid to mid, Total Return, Net of Fees.

R&M UK Equity Income Fund
4. Back testing the R&M approach

As a further ‘proof of concept statement’ in 2006, before launch we back tested our PVT screen.

**Methodology**

We went as far back as the quality of data would allow us. This took us back nine years to mid-1997. We then used our MoneyPenny criteria to screen each category by decile every month, and tested the performance of these deciles over future periods from 6 to 18 months. Within the deciles we equal weighted (rather than market weighted) stocks, and compared the performance of these deciles against an equally weighted FTSE All-Share Index. We did this to take out any size bias. The result was an average of almost 100 periods over which we produced return information.

This nine year period was a reasonably representative period to test our approach over, given that amongst others it included a ‘bull’ and ‘bear’ phase and a strong ‘growth’ period followed by an equally strong ‘value’ period.

The following results were generated:

**Growth Category – Relative Returns**

**Growth screen – 6 month holding period**

![Bar chart showing relative outperformance](chart.png)

Source: River and Mercantile Asset Management LLP

Growth stock returns, charted above, showed outperformance in the top deciles (bars 1 and 2 on the chart), mirroring underperformance in the lower
deciles (9 and 10). Note that the relative returns were calculated against an equally weighted benchmark, using monthly samples and a holding period of 6 months.

**Correlation Analysis**

Low or negative correlations between PVT factors will produce less volatility in portfolio returns and therefore superior risk-adjusted returns in aggregate. What correlation did the three factors as applied to the growth category exhibit over the back test period?

<table>
<thead>
<tr>
<th></th>
<th>Potential</th>
<th>Valuation</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Potential</td>
<td>1.00</td>
<td>0.71</td>
<td>-0.24</td>
</tr>
<tr>
<td>Valuation</td>
<td>0.71</td>
<td>1.00</td>
<td>-0.22</td>
</tr>
<tr>
<td>Timing</td>
<td>-0.24</td>
<td>-0.22</td>
<td>1.00</td>
</tr>
</tbody>
</table>

The results of the growth back test showed low correlations between the factors demonstrating the advantages of a diversified multi-factor screen.

**Quality Category – Relative Returns**

Quality screen – 12 month holding period

Quality stocks, showed out performance in the top deciles, mirroring underperformance in the lower deciles. The relative returns were again calculated against an equally weighted benchmark, using monthly samples and a holding period of 12 months.
Correlation Analysis

<table>
<thead>
<tr>
<th></th>
<th>Potential</th>
<th>Valuation</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Potential</td>
<td>1.00</td>
<td>0.19</td>
<td>0.54</td>
</tr>
<tr>
<td>Valuation</td>
<td>0.19</td>
<td>1.00</td>
<td>-0.48</td>
</tr>
<tr>
<td>Timing</td>
<td>0.54</td>
<td>-0.48</td>
<td>1.00</td>
</tr>
</tbody>
</table>

The results of the quality back test showed reasonably low correlations between the factors which again demonstrated the advantages of the diversified multi-factor screen.

Recovery Category – Relative Returns

Recovery screen – 18 month holding period

![Graph showing relative outperformance over time]

Source: River and Mercantile Asset Management LLP

The relative returns were again calculated against an equally weighted benchmark, using monthly samples and a holding period of 18 months.

Correlation Analysis

<table>
<thead>
<tr>
<th></th>
<th>Potential</th>
<th>Valuation</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Potential</td>
<td>1.00</td>
<td>0.28</td>
<td>-0.77</td>
</tr>
<tr>
<td>Valuation</td>
<td>0.28</td>
<td>1.00</td>
<td>0.50</td>
</tr>
<tr>
<td>Timing</td>
<td>-0.77</td>
<td>0.50</td>
<td>1.00</td>
</tr>
</tbody>
</table>

The results of the recovery back test showed low correlations between the factors and out performance in the top deciles, mirroring underperformance in the lower deciles.
The relative returns were again calculated against an equally weighted benchmark, using monthly samples and a holding period of 18 months. Note in this case that it was only the cheapest quartile of stocks within the universe plus all real estate stocks which are ranked. The results highlighted that asset-backed companies in general outperformed during this period, with the top deciles again providing the best returns. It should be noted (2010) that asset backed stocks were particular beneficiaries of the expansive credit cycle during these years.

<table>
<thead>
<tr>
<th>Potential</th>
<th>Valuation</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.00</td>
<td>0.44</td>
<td>0.36</td>
</tr>
<tr>
<td>-0.44</td>
<td>1.00</td>
<td>-0.23</td>
</tr>
<tr>
<td>0.36</td>
<td>-0.23</td>
<td>1.00</td>
</tr>
</tbody>
</table>

The results of the Asset-backed back test showed low correlations between the factors.
Cross Category Correlation

In terms of understanding the risk adjusted return potential of our approach one needs to look at the correlations between categories as well as between the PVT factors. This we do below, looking at the pattern of top decile returns by category:

<table>
<thead>
<tr>
<th></th>
<th>Growth</th>
<th>Quality</th>
<th>Recovery</th>
<th>Asset backed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth</td>
<td>1.00</td>
<td>0.22</td>
<td>-0.20</td>
<td>-0.26</td>
</tr>
<tr>
<td>Quality</td>
<td>0.22</td>
<td>1.00</td>
<td>0.03</td>
<td>-0.02</td>
</tr>
<tr>
<td>Recovery</td>
<td>-0.20</td>
<td>0.03</td>
<td>1.00</td>
<td>0.15</td>
</tr>
<tr>
<td>Asset Backed</td>
<td>-0.26</td>
<td>-0.02</td>
<td>0.15</td>
<td>1.00</td>
</tr>
</tbody>
</table>

What this shows is that the categories are lowly, or sometimes negatively correlated. So we have shown that each category produces alpha, but this is produced at different times. This should produce both more consistent returns than single factor or category approaches, and higher risk adjusted returns.

Screen Performance Analysis: 2010 Update

In 2010 we measured the performance of our screens over the three year period from 2007, through 2008 and 2009 to build on our original back test work and also to bring up to date our understanding of screen performance during different stages of the stockmarket cycle. A summary of the analysis is shown below:

Top Quintile of Standard Screens
Eq Wgt vs Eq Wgt All-Share: 12 mth holding periods

Source: River and Mercantile Asset Management LLP
5. Verification Front Sheet

<table>
<thead>
<tr>
<th>Company</th>
<th>SIG</th>
<th>Thesis</th>
<th>Recovery</th>
<th>Score</th>
<th>24</th>
<th>1.3</th>
<th>Decile</th>
<th>1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price (GBP)</td>
<td>140.4</td>
<td>Potential</td>
<td>9.5</td>
<td>Valuation</td>
<td>6</td>
<td>Timing</td>
<td>8.63</td>
<td></td>
</tr>
<tr>
<td>Mkt Cap (£ millions)</td>
<td>829.5</td>
<td>Depressed</td>
<td>Margins</td>
<td>9</td>
<td>EV/Sales or P/FVs</td>
<td>7</td>
<td>Margin Recovery</td>
<td>10</td>
</tr>
<tr>
<td>EV (£ millions)</td>
<td>1,055.8</td>
<td>Depressed</td>
<td>Share Price</td>
<td>10</td>
<td>EV/InvCap or DivYld</td>
<td>8</td>
<td>Earnings Momentum</td>
<td>9</td>
</tr>
<tr>
<td>Date of Thesis</td>
<td>28-Mar-11</td>
<td></td>
<td></td>
<td></td>
<td>Earnings Yield</td>
<td>4</td>
<td>Technical Score</td>
<td>7.75</td>
</tr>
</tbody>
</table>

Summary of PVT Thesis

Potential - Category Specific

Where is the company in its life-cycle? Have category specific factors been considered?

Business Franchise SWOT (Competition, Suppliers, Cost-base, Customers, Pricing)

Management evaluation (Change, track record, motivation, strategy)

Cashflow

Financial Strength (off-BS items, operational gearing, hidden/ hard assets backing)

Valuation

Timing

Are earnings being upgraded? What is the quality of revisions? What are the revision drivers? Fundamental catalyst?

Key risks to PVT thesis:
6. References

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