

RIVER AND MERCANTILE  
ASSET MANAGEMENT

UK Equity Smaller Companies Fund I Quarterly Report  
June 2009

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# River and Mercantile

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## UK Equity Smaller Companies Fund – Quarterly Report

### Fund Aim

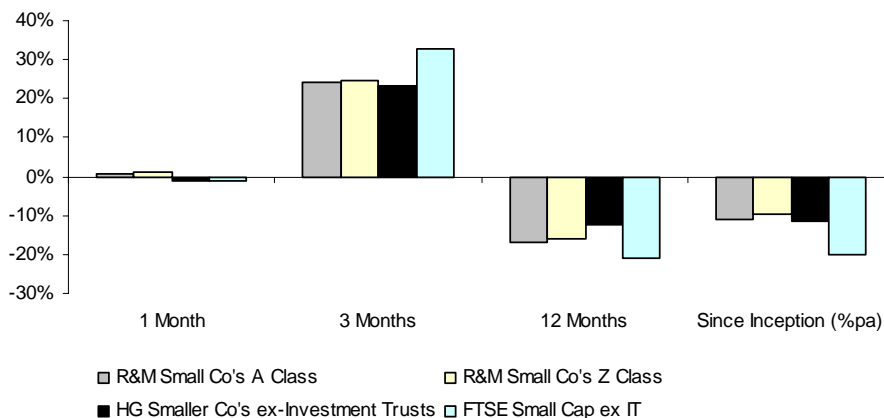
The investment objective of the Fund is to achieve capital growth by investing in a portfolio of investments which shall primarily consist of UK equities which reside in the bottom 10% of the UK stock market in terms of market capitalisation.

Portfolio Summary		Risk Analysis Summary	
Strategy AUM	£31.9m	Portfolio Volatility	19.23%
Strategy Capacity	£400m	Benchmark Volatility	18.63%
Number of stocks	94	Tracking Error	5.17%
Largest Holding	RPC 2.09%	Portfolio Beta	0.99
		Active Money	79.38%

### Performance as at 30 June 2009

Retail "A" Class Shares	Fund <sup>1</sup> (%)	HG Index* (%)	Difference (%)	FTSE Small Cap (%)
1 Month	0.84%	-1.21%	2.05%	-1.11%
3 Months	24.10%	23.17%	0.93%	32.74%
12 Months	-17.04%	-12.37%	-4.67%	-20.97%
Since Inception <sup>3</sup> (%p.a.)	-10.85%	-11.29%	0.44%	-20.05%

Institutional "Z" Class Shares	Fund <sup>2</sup> (%)	HG Index* (%)	Difference (%)	FTSE Small Cap (%)
1 Month	0.97%	-1.21%	2.18%	-1.11%
3 Months	24.57%	23.17%	1.40%	32.74%
12 Months	-15.78%	-12.37%	-3.41%	-20.97%
Since Inception <sup>3</sup> (%p.a.)	-9.54%	-11.29%	1.75%	-20.05%



Source: River and Mercantile Asset Management LLP

\*Index: Hoare Govett Smaller Companies ex IT

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

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

<sup>3</sup>Inception 30 November 2006

## **Investment Commentary**

### **Market Overview**

During the second quarter of 2009 the MSCI world index delivered the best quarterly returns since the first quarter of 1986 up 19.7%. The FTSE All-share delivered 10.9%, a material gain relatively held back by currency swings and the UK market's bias to defensive sectors such as Pharmaceuticals (+3.2%), Tobacco (+3.2%) and the Oil majors (+1.7%). However, strong performances were delivered by Financials, Technology, and Mining. Mid and small capitalisation shares did extremely well rising 17.5% and 28.8% respectively, as investors' risk appetite improved. A raft of macro-economic and market related data supported this sentiment shift, the least important being the fertility rate hitting a 35 year high in England and Wales, the rest we will discuss later, but the former aiding the fund's holding in Mothercare to reach a 5 year relative high.

1986 was when the film Topgun was released. We doubt the market's move to small cap is a salutation to Tom Cruise's impressive 5ft 7 inches. However, consensus for far too long has been that his naval aviator call sign "Maverick" was the only suitable description of smaller company investments. The F14 Tomcat, flown in the movie was withdrawn from service in September 2006 having been actively engaged since 1974. Just before they pulled it from service the US sold a huge batch to The Islamic Republic of Iran Air Force, who are still the only active users of the plane, and whose disputed election during the quarter was the main geo-political event. In tighter commodity price conditions events may have created material oil-price action, but US inventories remain stubbornly high.

The main corporate news of the quarter was the bankruptcy of General Motors, for many years America's largest company and a fully underwritten rights issue at Rio Tinto, highlighting which industries and outlooks shareholders are willing to support post the bursting of the credit bubble.

### **Performance**

The Fund delivered 24.6% during the quarter beating the benchmark return of 23.2%. Overall the portfolio was overweight defensive shares as the market turned which impacted performance initially, however we made material changes to the fund holdings during the quarter allowing a re-balancing towards Recovery and Value. A number of highly indebted 'fallen-angels' rallied significantly during the quarter. We still perceive many of these to be extremely risky investments and have used Moneypenny's Recovery and Asset-backed screen followed by fundamental analysis of balance sheet strength to select only the best investment opportunities to deliver a sustainable recovery over the medium-term without massive equity dilution. Pace Micro Technology, Intec Telecom Systems and a recovering Innovation Group all helped towards a strong contribution from the Technology sector. Fiberweb and RPC delivered strong Recovery performances with industrials. Mouchel, Babcock, and Management Consulting were disappointing within Support Services and Alternative Networks was weak after profit expectations were lowered. Stock selection in General Retail has been positive. The Value factor helped during the period whilst momentum measures were less effective.

### **Philosophy & process**

The largest proportion of capital within the fund is invested in the *Quality* category. These companies have strong franchises, and high, generally improving returns. Examples include Halfords, William Hill, Rensburg Sheppards, RM Group, Spirent and Pace Micro. The portfolio remains biased to businesses with robust balance sheets, critical in enabling the exploitation of others weaknesses during a time of depressed profits and valuations. The dangers of leverage remain and from an investment style perspective, we are seeking 'Iron Maiden' *Quality*, an essentially niche band which formed in 1975 and has now sold over 70 million albums and yet still won the Brit Award in 2009 for the Best Live Act. This is preferable to the larger *Quality* Michael Jackson franchise which has been in decline, was clearly over-leveraged financially and certainly won't win that award (being American). The exposure to *Recovery* has been increased; a category musically most akin to 'Take

That', who written off 5 years ago, reformed in 2006 (with a new strategy and changed management; less dancing, no Williams) which has just sold over a million tickets for their Summer Tour. Examples include Charter, CSR, Holidaybreak, Inchcape and RPC. The *Growth* category often has too much of the 'Susan Boyle' to it in small cap: A short track-record, high expectations, achieving too much, too fast with potentially serious repercussions. Genuine growth examples we have invested in include CVS, H&T, Caretech and Peter Hambro Mining.

74% holdings are currently in the top 3 deciles indicating an improved skew to high scoring stocks. Style research now highlights a Value bias within the fund, which has been helpful as this style factor has been more positive for performance during the quarter in addition to positive earnings and price momentum combined with low leverage.

### Portfolio Activity

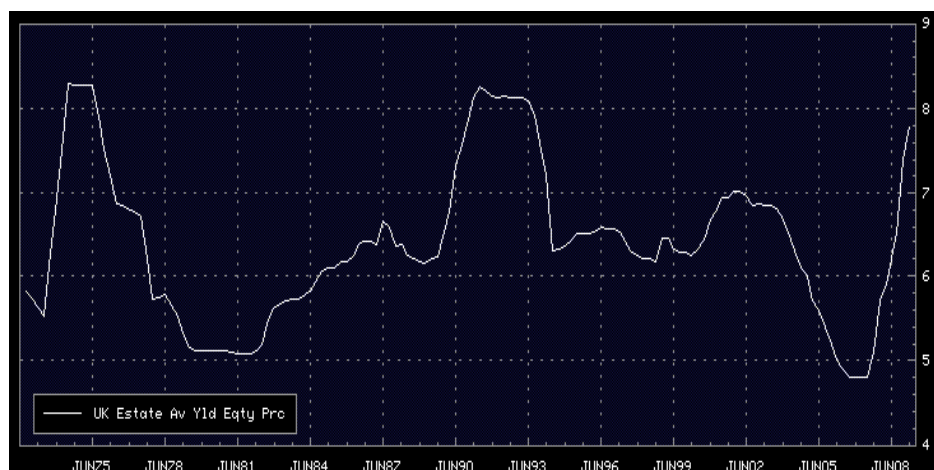
#### Increased Recovery exposure

We acted early in the quarter to introduce high scoring well financed Recovery shares as numerous macro-economic and market indicators suggested the low valuations in this Category should be increasingly exploited and a more aggressive stance was justified. Purchases included some Industrials, where current trading is very difficult but the medium-term investment case is attractive, such as Ashtead, Charter, Domino Printing, and Bodycote, some Consumer exposed businesses such as Halfords, Topps Tiles, Inchcape, William Hill and Persimmon and some financials geared to market recovery such as Rensburg Shepphards, Evolution and Close Brothers. Within the Growth Category we rotated 'defensive growth' names into mainly healthcare related growth companies such as Goldshield, CVS Group and Caretech, but also a new position in Homeserve, the fast-growing international home emergency repair business. We also added within Resources to the fast-growing Salamander Energy, Anglo Pacific and Peter Hambro Mining. We continue to find specific 'self-help' recovery situations which are less reliant on a positive economic outcome such as Psion and Blacks Leisure. The fund, however, despite our increased exposure, remains underweight at a sector level in these key recovery areas, such as Oil & Gas, Industrial Engineering, Consumer Services and General Financials.

#### Increased Asset-Backed exposure

The category has been a poor performer during the credit crunch years. This follows a typical Life Cycle, with many years of good returns to asset backed investments (real estate in particular) leading to complacency and as a result an overly financially geared model going into a cyclical downturn. This excess gearing, and the bank debt associated with it has exaggerated the bear market as forced selling has taken values below their likely medium-term fundamental worth. With asset prices now very low the implied yields are high, indeed as the chart below shows they have in absolute terms returned to the peaks last achieved after previous property crashes in the mid-seventies and early nineties:

*UK Commercial All Property Yield*



(Source Bloomberg, CBRE)

In addition relative to other income producing assets, Government Bonds in particular, the yield available on property is now very attractive, indeed a number of standard deviations higher than normal.

So the valuation case for asset backed situations, and real estate in particular looks compelling. However until recently we have been reluctant to commit any capital to this category due to an absence of Timing support. However this is now changing with a number of catalysts for recovery now in place. Real estate companies have re-financed, ensuring that they have the balance sheet strength to survive and then prosper; smart money is being raised, by seasoned property investors who astutely exited when the market became over-heated and will be put to work over the next year; and the financial investors, such as banks are now better capitalised and therefore less inclined to fire sale their property exposures. Transaction activity is just starting to pick-up, yields at the prime end have stopped falling and analyst estimates for net asset values at many of the property companies will now prove too cautious. We have increased our allocation to the asset backed category to more than 8% via companies such as Derwent London, Hansteen Holdings, London & Stamford, Mucklow and St Modwen Properties.

### **Market Outlook**

"The charm of history and its enigmatic lesson consists in the fact that, from age to age nothing changes and yet everything is completely different". Aldous Huxley.

The Banking crisis and resultant world slowdown has caused some commentators to question the role or nature of capitalism going forward. It is understandable to search for blame and question the fabric of the system, given that almost everyone around hasn't experienced anything quite as terrifying economically as the last 12 months. Capitalism has helped produce a massive rise in world living standards over the last 100 years (the greatest rise being to early adopters) and the current downturn looks unlikely to materially damage the increase in living standards achieved through that period. The main issue is that some have confused Capitalism with the Economic Cycle, forgetting that Capitalism isn't a free pass to riches, a 'license to leverage' and an asymmetrical risk-reward payoff strategy. Fortunately, as the FT concluded "Capitalism's worst crisis in 70 years has not prompted a serious alternative vision of society". Indeed the story of modern capitalism appears very much to be a rhythmic repetition of cycles harmonised by eerily similar crises. Although the details differ they are usually variations on the credit induced asset price inflating theme with a rapid build of euphoric, speculative behaviour ending in inevitable bust.

However, the tool-kit of capitalism has changed during the last century in particular through the broadly unchecked development of derivatives. The oversight function of markets and practitioners has morphed and lost its sense of purpose and direction. Greed has allowed credit yet again to fan the flames of the fire. It does seem recent developments principally started following the embracing of pro-market ideology by Reagan, Thatcher and Paul Volcker, then Chairman of the Federal Reserve in 1980, all critical in moving on from a mixed, Keynesian approach. However, other geo-political changes occurring at the same time were as important and are even more now for the development of Capitalism. Highly material was the collapse of Soviet communism and the shift in China from planned economy to market, allowing globalisation to accelerate and the benefits of trade to increase. Regarding credit this ideological shift helped fuel an unchecked explosion in debt with aggregate debt of the financial sector jumping from 22% of US GDP in 1981 to 117% in the Q3 '08 . In the UK the number exceeds 250%. Capitalism must develop the ability to allow non-political, objective oversight to restrict unchecked credit-expansion. This should be partly external via an enlightened, emboldened unified regulatory authority and should be partly mitigated by the improved standing of internal risk management functions and front-office incentive structures.

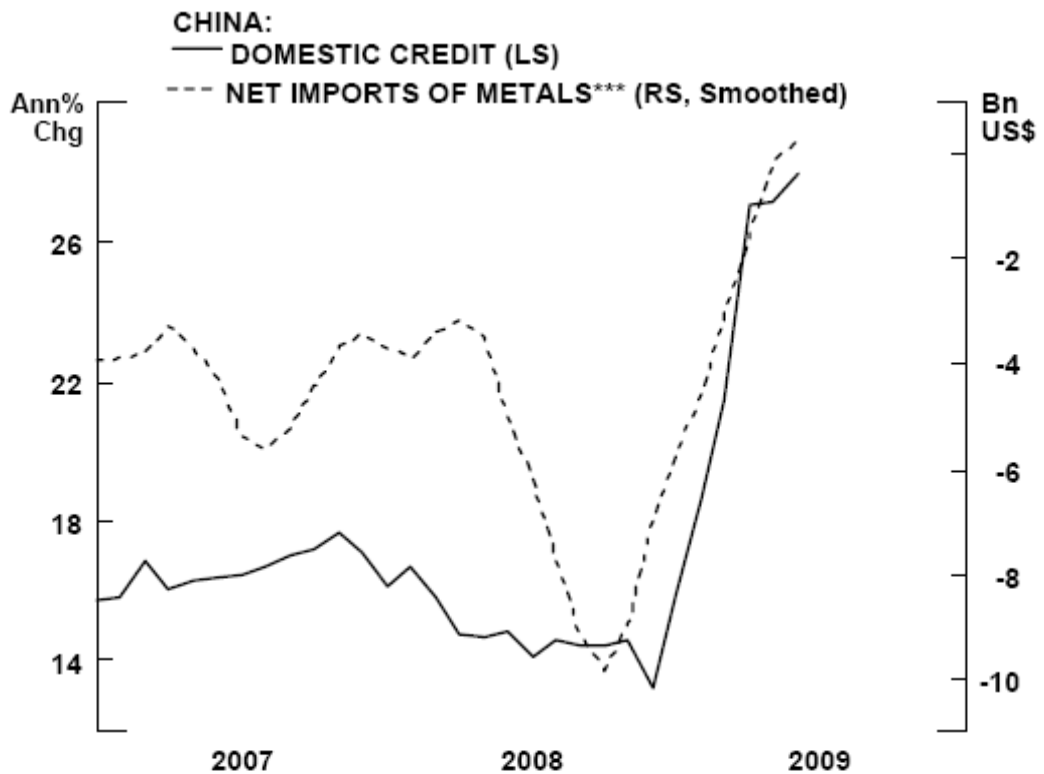
We are convinced meaningful progress should be possible without significant incremental regulation or new oversight bodies, and the simplification of responsibilities should improve outcomes. The goal should be to tame, not abolish, the cycle, executed in the context of the known limits of the market economy. Until

truly addressed the weakest parts of the system will routinely clamour for economically unjustified support for their dying industries and business models under the cover of "failed capitalism". Bankruptcy is part of capitalism; it makes the system bear the costs of the risks taken on and helps price risk effectively. Economic support can then be channelled into genuine areas for the future where real comparative advantage can be built.

The backdrop to this regulatory challenge is the current economic cycle, historically high levels of western world private and public debt and China.

The economic cycle is very much here to stay; its amplitude and length will continue to vary greatly. Nigel Lawson from one ex-chancellor to another in a hotter seat at present wrote "the economic cycle is endemic and inescapable and everyone (with the exception of Brown) has always known this". Identifying where we are currently in this cycle will aid portfolio construction and mitigate risk in the second half of the year: Economic Surveys have picked up, including the ISM and IFO surveys. The yield curve has steepened, implying a pick up in inflationary expectations and a renewed confidence in monetary authority actions. Risk appetite has returned as highlighted by small cap performance, falling credit spreads and lower levels of volatility. Economies continue to contract, albeit at a slower pace, but still below trend, suggesting actual recovery is still ahead rather than behind us. Markets may have also bottomed with consensus profit and dividend expectations picking up (see chart above), technical indicators turning positive (such as the Coppock) and cyclical adjusted trend PE ratios still remaining low. The de-leveraging effect, though, should take the shine off the extent and pace of any economic recovery.

Strong Chinese data, in particular the PMI has been coincidental with rising commodity prices suggesting sentiment on global growth is improving. However, we remain very wary of extrapolating Chinese data points into a thesis that commodity demand-supply is back in equilibrium, or that China has decoupled. China is in a better relative position than the US with the financial strength to afford its stimulus packages and robust urbanisation trends supporting the outlook for domestic demand, and many family-run businesses have the ability to take longer-term decisions. However, authorities are clearly buying commodities because the price is low relative to recent levels and in the anticipation of future demand. This is a very different dynamic to achieving equilibrium from order-backed demand-led buying. In fact Shanghai and Shenzhen handled 2m and 1.4m container boxes in June (-18%, -20% year-on-year), weaker than (-12% and -16%) in May. The Wall Street Journal reported China exports down 21.7% in H109. This translates to 21.2% slump in June (vs. -26% in May) and a worse 2Q (-23%) than 1Q (-20%). Thankfully they continue to buy US treasuries and the Dollar, but they have not decoupled.



Source: BCA Research

### Summary

Western Capitalism needs to adapt in order to ensure smoother, continued economic progress. The risks are higher than in the past because of the size of the financial sector and the levels of debt outstanding. Radical change is not required but acceptance of the economic cycle is a necessity. Regulatory reform is also necessary, but mainly of its nature and a reduction in its amount. Incentive structures must become more risk-based, time driven and intelligent. China's economic relevance has never been greater, but its current 'recovery' questioned. The Recovery phase in the UK market is nascent and mid and small cap companies should continue to perform, albeit at a slower pace than this quarter. The market remains cheap and your portfolio cheaper. We continue to seek the best Growth, Recovery, Quality and asset-backed opportunities in the small cap arena with positive Timing characteristics. "A diamond is a piece of coal that stuck to the job". Thomas Edison.

**Dan Hanbury & Richard Staveley**  
**Portfolio Manager's**

## Fund Facts

Launch date	30 Nov 2006
Fund manager:	Dan Hanbury & Richard Staveley
IMA sector:	UK Smaller Companies
Benchmark:	HG Smaller Companies ex-IT
XD dates:	1 April & 1 October
Dividend/Accumulation payment date:	31 May and 30 Nov
Tracking error range:	4-10%
Product capacity:	£400m (pooled & segregated)

Share class:	A	Z
Launch price (shares):	100.00p	500.00p
Share classification:	Retail	Institutional
Type of shares:	Income	Accumulation
Fund charges:		
Annual	1.50%	0.00%*
Initial (up to)	5.25%	5.25%
*AMC charged outside the Fund		
Minimum investment		
Initial	£1,000	£5 million
Subsequent	£500	£50,000
Sedol	B1DSZR9	B1DSZS0
ISIN	GB00B1DSZR91	GB00B1DSZS09
Bloomberg	RMUKSAI LN	RMUKSEA LN

### Important Disclosure:

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