

RIVER AND MERCANTILE  
ASSET MANAGEMENT

UK Equity Smaller Companies Fund I Quarterly Report  
September 2008

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# River and Mercantile

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## UK Equity Smaller Companies Fund – Monthly Report

### Fund Aim

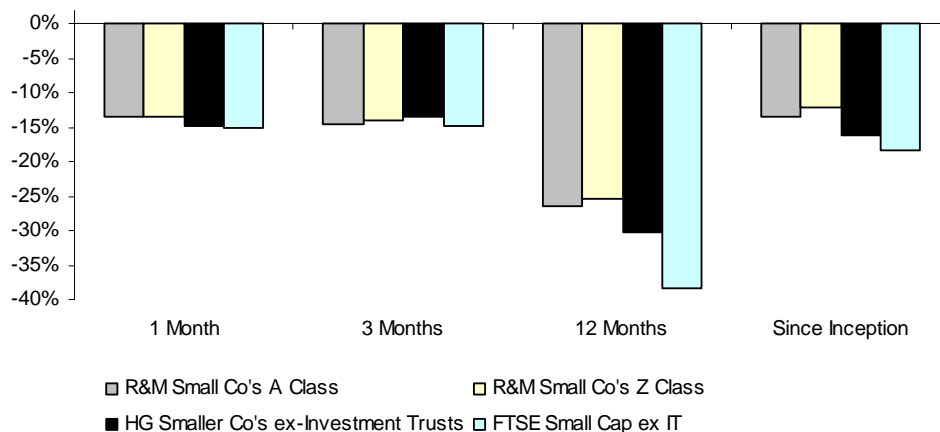
The investment objective of the Fund is to achieve capital growth by investing in a portfolio of investments which shall primarily consist of UK equities which reside in the bottom 10% of the UK stock market in terms of market capitalisation.

Portfolio Summary		Risk Analysis Summary	
Strategy AUM	£32,437,413	Portfolio Volatility	13.75%
Strategy Capacity	£400m	Benchmark Volatility	14.27%
Number of stocks	94	Tracking Error	3.91%
Largest Holding	Babcock 3.01%	Portfolio Beta	0.93
		Active Money	83.71%

### Performance as at 30 September 2008

Retail "A" Class Shares	Fund <sup>1</sup> (%)	HG Index* (%)	Difference (%)	FTSE Small Cap (%)
1 Month	-13.49%	-14.80%	1.31%	-14.99%
3 Months	-14.44%	-13.43%	-1.01%	-14.85%
12 Months	-26.35%	-30.15%	3.80%	-38.36%
Since Inception (%p.a.)	-13.47%	-16.08%	2.61%	-18.37%

Institutional "Z" Class Shares	Fund <sup>2</sup> (%)	HG Index* (%)	Difference (%)	FTSE Small Cap (%)
1 Month	-13.37%	-14.80%	1.43%	-14.99%
3 Months	-14.12%	-13.43%	-0.69%	-14.85%
12 Months	-25.27%	-30.15%	4.88%	-38.36%
Since Inception (%p.a.)	-12.22%	-16.08%	3.86%	-18.37%



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

## **Quarterly Report**

### **Market Background**

The third quarter of 2008 provided a market backdrop of significant volatility, financial crisis and deteriorating global economic growth assumptions. Specific volatility included the biggest one day moves in the oil price and the gold price, whilst equity markets across the globe experienced significant declines. China has not de-coupled from the developed world and therefore its weakening demand for commodities has had a downward effect on spot prices which has been amplified in equities as investor sentiment reversed in this popular momentum investment of recent years.

Serious fears about the robustness of the financial system prior to this quarter had worsened with the forced US government intervention at AIG, Fannie Mae and Freddie Mac whilst Lehman Bros demise highlighted counter-party risk in the system for derivatives markets, and hedge fund prime brokerage. Banks are acting swiftly in the US now to either secure funding from well capitalised third parties (e.g. Buffett's investment into Goldmans) or merge, before its too late, with the few relatively better capitalised banks remaining (e.g. Merrill Lynch & Bank of America). Fear over who will survive has frozen inter-bank lending markets causing governments and Central Banks to both provide emergency liquidity injections and help re-capitalise banks across the globe. Lingering fears over inflation and possibly pragmatic concerns over the effectiveness of the transmission mechanism has meant UK and European interest rates have remained steady until the very recent globally co-ordinated rate cut.

In summary the backdrop has been a rapidly unfolding and deteriorating global banking system as all participants whether they are governments, businesses or investors alike have been adjusting to the real world effects of the necessary de-leveraging of the system, and the negative impact on economic growth. Since markets began there have been two basic emotions which have dominated their progress; fear and greed. Fear clearly has the upper hand at the moment.

### **How did we perform and why?**

We performed broadly in line with the benchmark during the quarter and were a little disappointed with this result. Our portfolio strategy had been broadly correct having positioned ourselves in defensive growth companies and modest positions in resources and a number of classic value stocks, however in trying to increase the value component of the portfolio and reducing momentum we inadvertently sold out of some of our better defensive names, when with hindsight simply reducing our resources exposure would have been more effective.

### **Resources Collapse**

Negative stock selection offset some of the benefits of underweighting the sector. Aquarius Platinum and International Ferro Metals, which we held, underperformed sharply during the period. Furthermore, having boosted performance in the previous 9 months, our Oil Services stocks (Lamprell) underperformed reacting to the falling oil price.

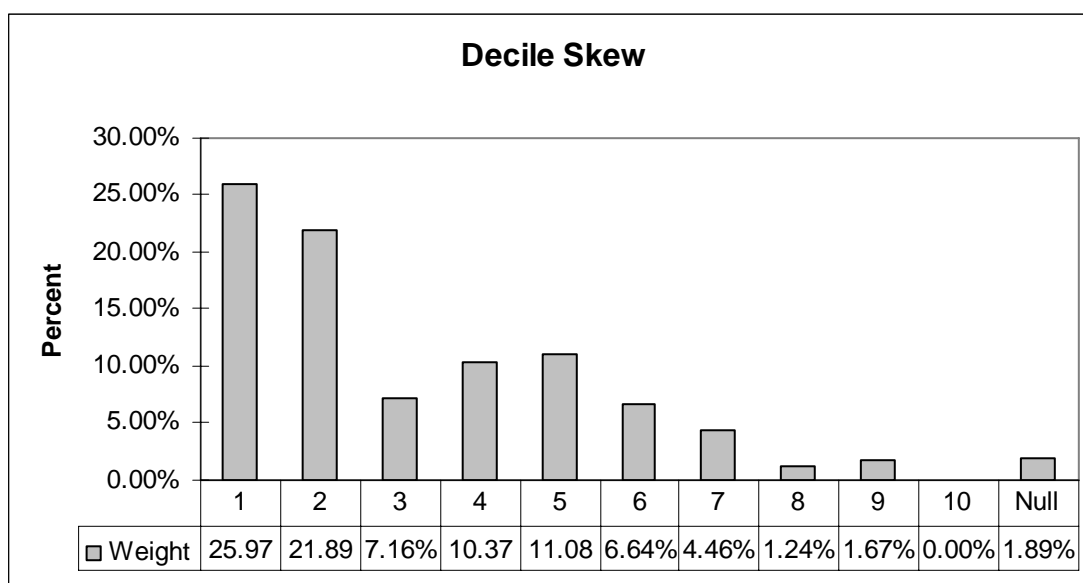
### **Stock Specifics**

Strong performances were seen from some of our specialist retail holdings like Dignity (funeral services) and H&T (pawn-broking) as well as from the food stocks Cranswick (pork supplier) and Finsbury Foods (cakes supplier). A bid for Axon Group, a software services business, gave strong returns. McBride performed strongly (a leading own label household goods provider to the supermarkets) as the market anticipates customers trading down from more expensive brands and the oil price easing will feed through to lower input costs.

Despite holding a relatively small number of high quality resource names it was these that did the real damage last quarter, unwinding the outperformance from Q2. Lamprell, JKX, Salamander Energy and Aquarius Platinum all got sold off aggressively as the market came to terms with the fact a global recession was a real possibility and that China could not simply decouple from the Western World. It is fair to say that some of these better names had become crowded trades and momentum managers and the like tend to exit at any price if momentum turns negative.

## Does the portfolio reflect our Philosophy and Process?

The portfolio maintains a significant weighting to high scoring PVT investments, which reflect our best ideas from the team. We retain the greatest proportion of capital in the Quality category, with less in Recovery and Growth. The core of the portfolio retains a 'defensive growth' bias with some investment in selective value cyclicals.



## What themes occupy us?

### Banking Crisis

"This is a crisis, a large crisis. In fact, if you've got a moment, it's a twelve-story crisis with a magnificent entrance hall, carpeting throughout, 24-hour portage, and an enormous sign on the roof, saying 'This Is a Large Crisis'. A large crisis requires a large plan. Get me two pencils and a pair of underpants." Edmund Blackadder (Blackadder Goes Forth)

Blackadder's comments related to impending orders to go "over the top" to almost certain death during the trench warfare of the First World War. Whilst stock-market conditions may, for some, appear similar, our interest is in his proposed solution, which is far more relevant to the current financial crisis. The US governmental and monetary authorities have until recently proposed poorly thought through and ineffectual piecemeal plans to deal with a rapidly evolving crisis.

Blackadder's plan was based on past experience (in the Sudan) and indeed numerous commentators are haggling over the pros and cons of previous methods of dealing with banking crises in Japan, Scandinavia and the US. The main problem with this approach is that it inadequately updates thinking to the current environment, which is in almost everyway different than the past. What's different on this occasion is the more integrated network of financial markets and hugely increased global interdependency across investment assets, massive leverage and counterparties combined with significant financial complexity which has truly never been tested in modern times. Until the UK galvanised the Europeans into action only piecemeal action had occurred, and even a more meaningful US plan in TARP has been watered down and compromised due to political point scoring in an election year.

We have referred to Warren Buffets description of derivatives as "weapons of mass destruction" in previous reports. With the benefit of hindsight it appears US attempts to locate actual ones at the vast costs of increased defence spending, tight oil markets and human life in Iraq should have been spent at home seeking out imprudent and reckless behaviours in financial markets and saving tax dollars to resolve the outcome.

We see the key requirements to recovery as being; the willingness of banking counterparties to lend with each other, a subsequent improved willingness of banks to provide credit to their customers on more normalised terms and a stabilised impairment environment. Unfortunately, these deliverables are going to take many years to achieve. To reduce counterparty risk, banks need to provide confidence in clear, strong capital positions. This

injections. The latest UK-led steps to re-capitalise key banks is therefore positive but by no means the final solution. It will also require transparency over derivative and counterparty exposures, an improved regulatory environment and visibility on provisioning levels against actual rising consumer arrears and corporate insolvencies. These actions should lead to the long process of re-building confidence by lenders and borrowers alike.

From a bottom-up perspective our main concern is for companies whose strategy and balance sheet require additional or significant on-going debt financing. In this respect we would highlight the excellent balance sheet positions of large holdings like Celsis, BATM, Diploma, E2V, Lamprell and Connaught. We continue to monitor carefully holdings where they have above average leverage, such as Dignity, Finsbury Foods, H&T, and Holidaybreak.

At a sector level we remain wary of those exposed directly to the over-leveraged UK consumer and to the resource complex. We are also conscious, but relatively less concerned, that the fiscal implications of government intervention in markets will ensure a moderating and tight stance for public expenditure for some time to come. It is inevitable, in our view that taxation will rise to offset this unexpected burden.

### **Resources**

We have been cautious on resources for sometime, wary of over-bullish global GDP growth estimates based on de-coupling theories; however this was scant comfort as our holdings have been aggressively marked down along with the entire sector this quarter. We have acted, though, reducing position sizes.

Clearly Chinese growth rates have fallen and, rather than a high "absolute rate" of growth keeping the bull's demand argument going, the change in the marginal rate of growth has caused both an amplified impact on commodity prices themselves and subsequently investors' attitudes to the sector. The backdrop has been one of financial crisis which has fuelled the pace of the sector's collapse (due to specialist resource hedge fund collapses, leverage investors un-winding positions in a popular trade and a reversal of hot-money flows and the Japanese carry trade). However, for us the PVT credentials have clearly deteriorated in many cases. This is because Growth (in profits and sales) has stalled, earnings based valuations ostensibly appear low, but fail to reflect (like the banks a year ago) that earnings estimates are falling as highlighted by Moneypenny due to earnings downgrades as analyst spot price assumptions are overly optimistic. This has combined to break technical support levels and momentum has reversed.

Commodity prices remain above long-term averages, global GDP growth is clearly trending down whilst cost pressures, for now, remain in the system.

### **Time frames for investment**

In times of crisis, and particularly investment bear markets it is easy to be drawn to the headlines like a night-fly to the illumination of a UV Lamp. The psychological pull of newsworthy events as they unfold feeds on emotional biases such as confirmatory bias, myopia and saliency. It is at these times that one requires a systematic and repeatable investment process that helps insulate from 'noise' and 'information overload'.

What we feel is critical is devoting the right proportion of our thinking time to future events and not developing additional overly detailed sector specific knowledge after a period of strong or weak performance. Everyone seems to know what a SIV Lite is now. How useful is this actually now for future investment performance? Many investors know significantly more about mining geology now than before the resources bull-run. How useful is this actually now? The same applied to TMT. The gaining of specialist knowledge often obscures the true and usually simple drivers of investment performance. In our view these are Potential, Valuation and Timing.

This financial crisis moves forward apace. It is by no means over, but does the credit crunch in itself change the key drivers of our investment philosophy for our medium term investments? For some stocks it has, like the banks or Cattles which has been a leading sub-prime lender in the UK since the 1960s. Its business model relies on wholesale funding over the medium-term. Its Potential has hence deteriorated as these wholesale markets are likely to remain constrained over the medium-term.

It is worth thinking back to Captain Blackadders' predicament. Many young men signed up and governments conscripted men to war (not without knowledge that war was an awful thing). What was their medium-term projection? Home by Christmas? Berlin by Friday? Victory within three years. A number of years later, say immediately prior to the entry of the US into the war, what was the outlook then? Another 3 years? Ongoing conflict forever? Certain doom? Defeat by Christmas? We cannot claim to know when crisis conditions will alleviate, but are minded to believe they will eventually. What we can be confident upon is that our best ideas from our PVT Philosophy and process have been selected for this portfolio and that we are patiently reviewing our holdings and seeking out better ones in a systematic and measured fashion.

The portfolio is invested in predominantly a range of businesses which we feel have 'defensive growth' characteristics that we believe will deliver positive profit and shareholder value creation over the medium term. The valuations on some of our holdings have never been cheaper (e.g. Lookers, Next 15 and Celsis). Many of our holdings have recently beaten market expectations (e.g. Chemring, Lamprell, Spirent, Cohort and Tenon)

### **Portfolio Activity**

During the quarter we have continued to add to holdings in the fund which are high scoring PVT ideas. We have written in our monthly reports on significant purchases such as Brewin Dolphin and Management Consulting. We purchased a small position in Delta (galvanising services) in September whilst reducing our weighting in Kier (construction) after a strong bounce and exited Britvic completely on the back of fears over a deteriorating trading environment in conjunction with high debt levels. Proceeds from sales were re-invested in existing holdings.

### **Outlook**

For the UK economy, the outlook is grim. We expect, like most commentators, rising unemployment, further house price falls, weak currency, slowing to negative GDP growth and a painful extended period of de-leveraging at the consumer and corporate level. There has been much data highlighting the relative strong positions of corporate balance sheets. This is clearly true on average at the UK quoted Plc level, but this average hides a huge dispersion and a number of high profile listed businesses will go into administration in the next few years. Our concern remains with the many private equity backed businesses in the UK which are almost certainly overleveraged.

The 'Lie-to-bet' activity has yet to fully blow up, as arrears at the banks are still low, whilst the asset prices have collapsed. There were 1.1m Lie-to-Bet mortgages at the end of June 2008. In 1998 there were 28,700. In the last 4 years an average of 46% of total new housing built has been flats or maisonettes; in 1998 it was 17%. At the end of December 2007 the £ per sq ft of residential property (Knight Frank) for Surrey was £560. Barbados was £562; London was £3,025 ahead of Monaco, 50% more than Manhattan, 200% more than Paris. Errol Flynn once said "my problem lies in reconciling my gross habits with my net income". It seems he's not the only one. August's UK mortgage lending data at 2% of 2007 levels suggests the market is starting to come to terms with this situation, and that we have clearly not yet reached a clearing price for houses and a lending market to accommodate it.

However, within the UK market we have found many well financed businesses which are insulated from UK cyclicity, have self-help to mitigate pressures to profitability and have significant overseas earnings and medium-term growth prospects. Valuations have not tested 1930s lows or indeed, the PE relative to trend earnings during the 1960s and 1970s. However, they are the lowest for over 25 years. We are under no illusions as this financial crisis is the greatest for a generation and its effect on the real economy will be long-lasting. Whilst CERN have been trying to create black holes deep under the ground in Switzerland, banks around the world have been successfully achieving the same outcome. We found pre-CERN tabloid worries about the end of the world mildly ironic. As has been Lehman's Brothers' CEO bemoaning short-sellers despite being one of the world's leading prime brokers. We await Baldrick's "cunning plan" and in the meantime stick to picking our best PVT ideas.

**Daniel Hanbury & Richard Staveley**  
**Portfolio Managers**

## 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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### River and Mercantile Asset Management LLP

30 Coleman Street

London

EC2R 5AL

Telephone: +44 (0)20 7601 6262

Facsimile: +44 (0)20 7600 2462

Email: [enquiries@riverandmercantile.com](mailto:enquiries@riverandmercantile.com)

[www.riverandmercantile.com](http://www.riverandmercantile.com)