

RIVER AND MERCANTILE  
ASSET MANAGEMENT

UK Equity Fund I Quarterly Report  
June 2009

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# River and Mercantile

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## UK Equity Fund – Quarterly Report

### Fund Aim

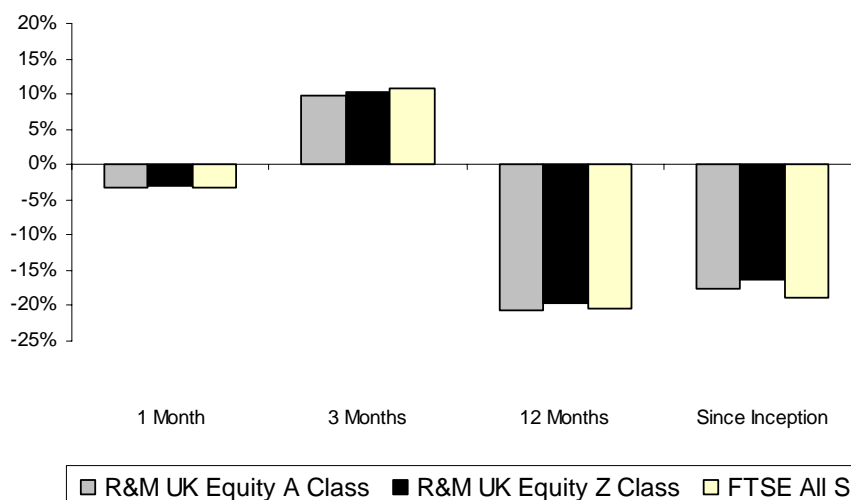
The investment objective of the Fund is to achieve capital growth by investing in a portfolio of investments which shall primarily consist of UK equities capitalised in the FTSE 350 index which offer the prospect of superior long term growth.

Portfolio Summary		Risk Analysis Summary	
Strategy AUM	£189.0m	Portfolio Volatility	14.56%
Strategy Capacity	£2bn	Benchmark Volatility	14.83%
Number of stocks	77	Tracking Error	2.37%
Largest Holding	HSBC 7.10%	Portfolio Beta	0.97
		Active Money	41.20%

### Performance as at 30 June 2009

Retail "A" Class Shares	Fund <sup>1</sup>	Index *	Difference
1 Month	-3.19%	-3.21%	0.02%
3 Months	9.86%	10.88%	-1.02%
12 Months	-20.74%	-20.49%	-0.25%
Since Inception <sup>3</sup> (%p.a.)	-17.50%	-18.87%	1.37%

Institutional "Z" Class Shares	Fund <sup>2</sup>	Index*	Difference
1 Month	-3.03%	-3.21%	0.18%
3 Months	10.27%	10.88%	-0.61%
12 Months	-19.55%	-20.49%	0.94%
Since Inception <sup>3</sup> (%p.a.)	-16.26%	-18.87%	2.61%



Source: River and Mercantile Asset Management LLP

\*Index: FTSE All Share (Total Return)

<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 date 25th February 2008

## **Investment Commentary**

### **Key Observation**

Financial markets around the world have rallied strongly off the lows in March but are still down heavily from this time last year. The outlook remains very difficult and market rotation remains extreme. However, history suggests that the current rally is more sustainable than may appear. We are at the stage in the cycle where industrial confidence and consumer confidence have troughed, but capacity utilisation and unemployment are still deteriorating. There are similarities and differences with every cycle, so whilst we have grave concerns over the ability of the western economies to deleverage smoothly during the next 4-5yrs (longer term the credit bubble has still to deflate or be inflated away) there is enough evidence to suggest that an economic recovery of sorts is likely to continue taking hold through the remainder of 2009 and into 2010.

### **Market background**

The 2<sup>nd</sup> quarter delivered the best quarterly return for the FTSE All-Share Index since Q2 of 2003, at 10.9%. The FTSE 100 was up 8.2%, behind the Mid 250's 16% and 30% from the Small Cap Index. Financials edged out Technology as the best performing FTSE industry group, and cyclicals beat defensives. Telecoms was the only group to show an absolute decline in the quarter. In terms of valuations, mid caps are now rated on a par with large caps (excluding Financials) for 2009E and at a discount in 2010E. This reflects the relative move in earnings, especially in the large caps. If we exclude commodity earnings, the remaining large caps still trade at a discount to mid caps.

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

The portfolio returned 10.3% vs. 10.9% for the benchmark. Despite the positive return the underperformance was a disappointing end to a poor 6 months for the UK Equity fund. It has been a period where most screen-based approaches to stock idea generation have had a more difficult time than usual, and ours was no exception due to the volatile factor rotation (Value to Momentum and back to Value again). During my decade as a fund manager, I have suffered a few bad quarters prior to this year, the two worst being at sharp turning points in the market (Q4 2001 and Q2 2003 near market bottoms). I have tended to underperform when the market moves from risk aversion to risk appetite, from Momentum to Value, from defensive to recovery and from low beta to high beta. In both periods, I subsequently went on to deliver strong performance for every 12 month rolling period over the next 5+ years. Whilst I cannot, of course, promise that again – the experience gives me some comfort as I reposition the fund to leave us better set for future years.

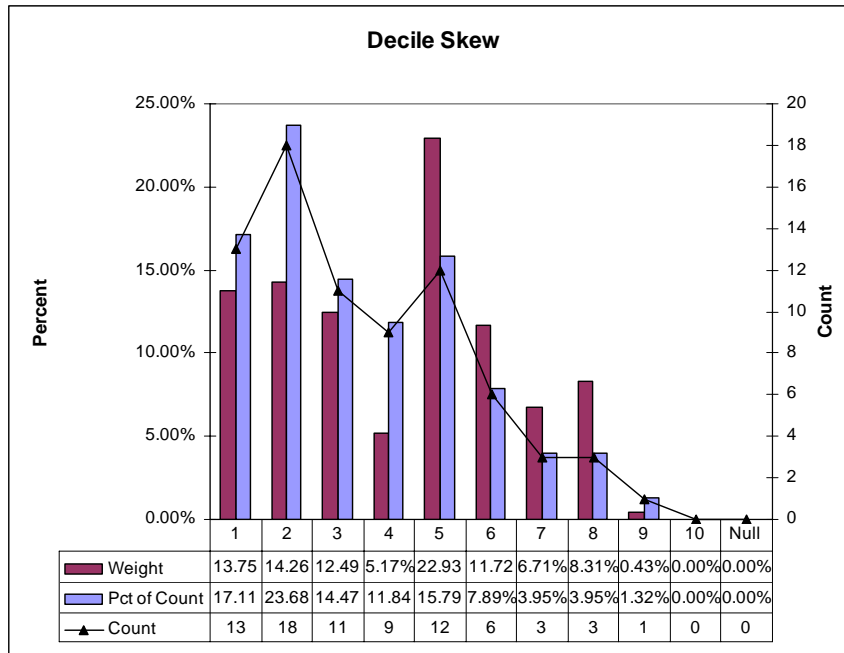
During the second quarter, relative performance was helped by our underweight allocation to the Oil sector despite the rising oil price. This was more than offset by poor performance in Financials. Performance was also undermined by a profit warning at road building consultant Mouchel. The strong performance of Pace Micro Technology, a global leader in set-top box assembly, whose share price almost doubled during the quarter, was not enough to offset negative contributions elsewhere.

### **Key performance contributors for the quarter:**

Positive stock contributions from overweight positions in Pace Micro Technology, ITE and Debenhams. Negative contributions arose from Mouchel, Thomas Cook and HMV. The zero weight in Standard Chartered also hurt relative performance during the quarter. At a factor level the continuing poor performance of Momentum factors detracted from returns despite Value factors working very well.

## Does the portfolio reflect our philosophy and process?

The chart below shows that our strategy continues to have a significant skew towards high scoring stocks. Our category exposure has continued to evolve over the last three months, with 60.3% in Quality, 20.4% in Recovery, 12.9% in Growth and two positions in Asset backed (2.2%) shares.

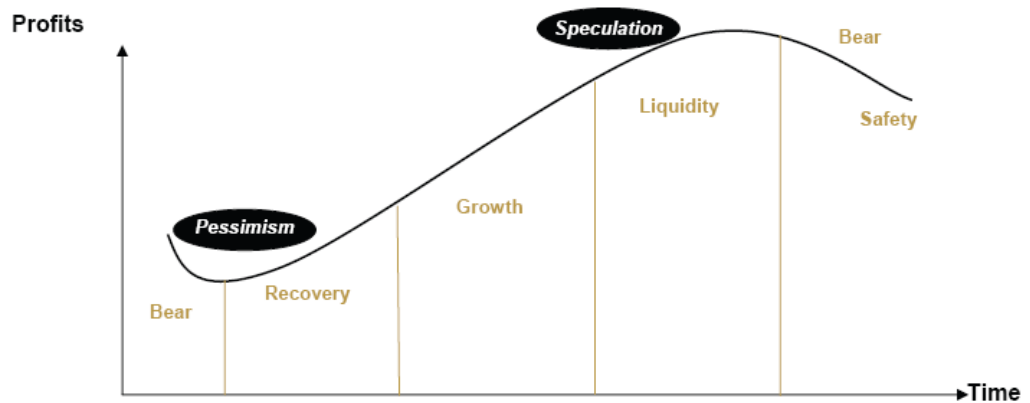


Source: River and Mercantile Asset Management LLP

## What themes occupy us at the moment?

### The Stockmarket Cycle

It is useful to think about the current environment in the context of the stock market cycle.



	STAGE 1 2003/4 1992/3 2009/10?	STAGE 2 2004/6 1994/8	STAGE 3 2006/7 1999/0	STAGE 4 2001/2 1991/2 2007/8
ECONOMIC GROWTH	Below Trend	Trend	Above Trend	Decelerating
MONETARY POLICY?	Loose	Neutral	Tightening	Loosening
CAPITAL?	Rationed	Sustainable	Mis-allocation	Withdrawal
RISK APPETITE?	Low	Neutral	High	Falling
VALUE SPREADS	High	Reducing	Low	Increasing
STYLE?	Value/Recovery	Growth	Momentum	Value/Quality
BUY?	Turnarounds	Where is growth?	Momentum	Earnings sustainability

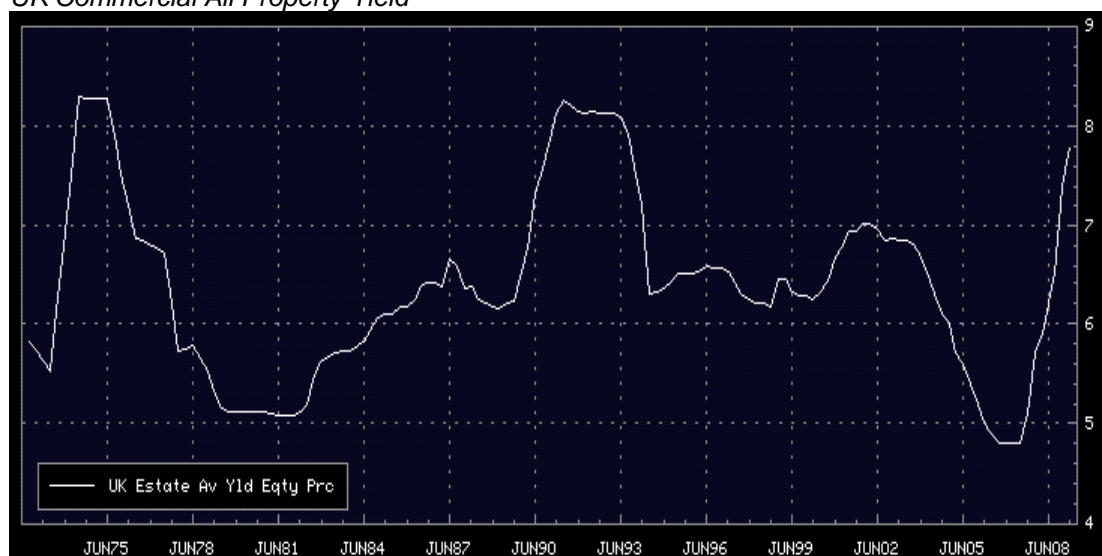
Source: River and Mercantile Asset Management LLP

There is a sound body of evidence to suggest that we have moved into the recovery phase of the stock market cycle. Economies are bottoming out in response to very loose monetary conditions, costs have been cut aggressively by companies to protect profits and enable margins to be rebuilt when demand starts to recover, and capital is now available but only where risk premiums are compelling. Value spreads have come in from their first quarter peak, but remain attractive.

### Asset Backed and Real Estate Stocks

The Asset Backed 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, and 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, notably Government bonds, the yield available on property is now very attractive, a number of standard deviations higher than normal.

So the valuation case for asset backed situations, and Real Estate in particular, looks compelling. Until recently we have been reluctant to commit significant 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 sufficient 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. 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 around 4% and may look to add further to this.

### Financials

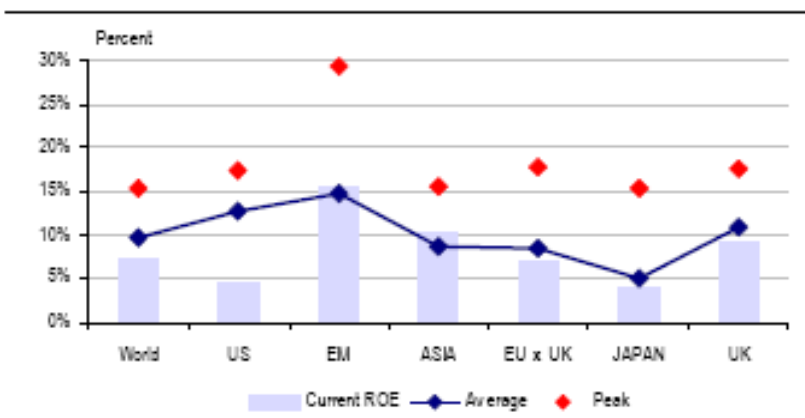
We have been increasing our financial sector exposure this year, buying Banks, Life Insurance, Non-Life Insurance and General Financials. This has included supporting a number of fund-raising, at HSBC in particular. The banking sector is now scoring highly in the recovery and asset backed categories, with low valuations and improving timing.

The key to the thesis on UK banks is that their balance sheets have been somewhat repaired and insured by the UK Government, that whilst write-offs will be very large

they will likely peak this year, that underlying profitability will be rebuilt due to the exit of many competitors and whilst share prices have bounced from the 'end is nigh' lows, valuations remain at the bottom-end of long term ranges.

The chart below, showing Return on Equity for banks across regions, shows what has happened during the credit crunch and the medium term profit recovery opportunity across global markets.

Chart 1: Financial ROE across regions



Source: Datastream, UBS Note: Current RoE calculated as trailing 12 months through May 2009

ROE's ranged between 15% and 20% at the pre-credit crunch peak and have on average at least halved over the last two years. Most regions show returns well below 10%, below the cost of capital. Whilst a return to peak returns is unlikely as economies seek to deleverage there is still substantial recovery potential, with banking management focused on loan re-pricing, cost-cutting, strategic disposals and reducing funding costs. These initiatives are not a quick fix, with full recovery likely to take three to five years. However the more attractive risk and reward profile of the sector means we are comfortable investing there, with significant positions in **HSBC**, **Barclays** and **Lloyds**.

### Portfolio Activity

Considerable activity last quarter was somewhat more biased towards buying new positions in the recovery category funded by sales of relatively expensive defensives.

Purchases included adding to positions in both banks and real estate stocks, the first of which was **HSBC**. Following the recapitalisation in March/April (one of the largest rights issues in UK corporate history) we began to rebuild positions in the banking sector. **HSBC** is a global banking franchise with conservative lending practices and we were able to buy it on a price/book of 1x. Historically, buying banks on these kind of trough multiples has led to significant capital appreciation over the next 3-5yrs.

Later in the quarter, following the announcement that **BGI** was to be sold to **BOA Merrill Lynch**, **Barclays** shares underperformed for a while due to the apparent dilution of the asset sale and following a strong run up in the price from the lows in March. We focused on the improving B/S, expanding lending margins and the potential for **Barclays** to become a top tier investment bank in future through **Barclays Capital** and so took the opportunity to augment our banking exposure via a further purchase.

We added positions in **3i**, a leading venture capitalist investing in smaller companies, following its successful rights issue, **Computacenter** where management continue to improve returns on capital through shifting the business model from box building to software services and finally to **Regus**, a global leader in office outsourcing, which has a huge pile of cash on the balance sheet. We also added **Land Securities** as we became more confident in the value case for commercial real estate, and the chances of yield compression as we move into the second half of 2009. As with **British Land**, the catalyst for buying **Land Securities** was a successful fund raising to repair its overstretched balance sheet.

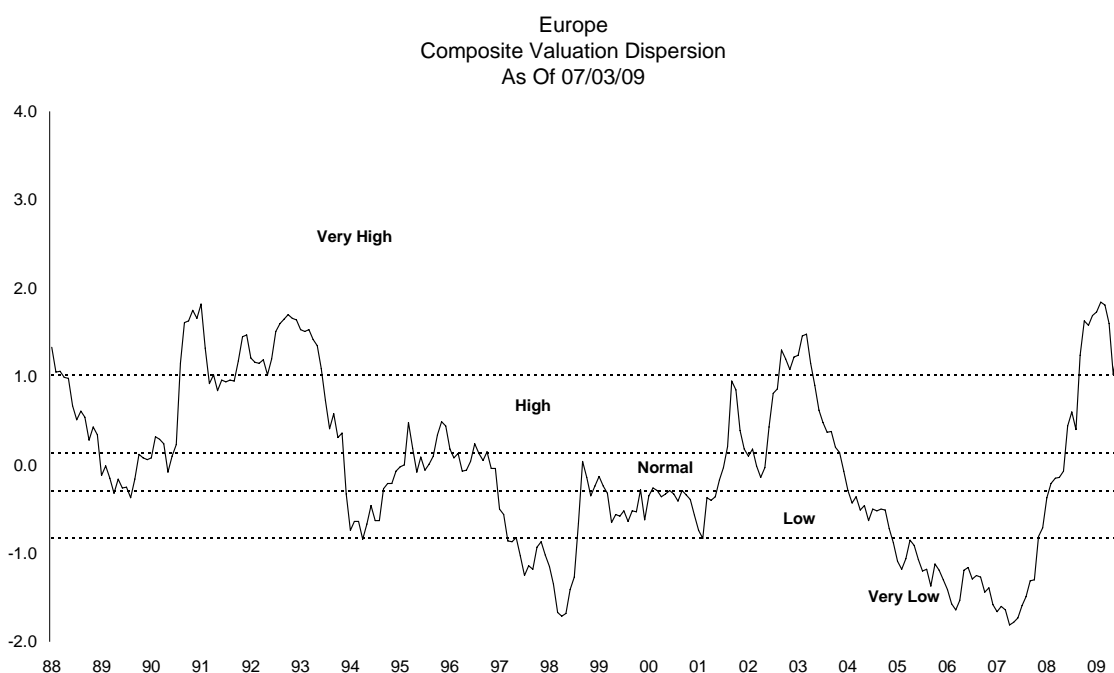
Towards the end of the quarter we also began building recovery positions in both **Inchcape**, a global car distributor and **Booker**, a food wholesaler whose competition is falling by the wayside under a burden of indebtedness.

## Sales

In order to fund the new purchases we sold a number of high quality stocks – most of which had served us well in recent years but whose value case was no longer as compelling on a Graham & Dodds type cyclically adjusted PE basis. **Bunzl**, **Mothercare** and **Connaught** were sold and a reduction in our holdings in **BAE**, **Unilever**, **National Grid**, **Scottish and Southern Energy** and **Cable & Wireless** were also made.

## Outlook

Despite the strong performance for value investors over the past quarter, the Value Gap (the spread between highly rated stocks and lowly rated stocks) remains significantly higher than normal. The chart below is a European measure (4 blended ratios) from Bernstein, updated to the beginning of July, showing that the investment opportunity for a value oriented portfolio is as high as it was coming out of the early nineties and post-TMT bubble recessions.



Source : Bernstein

Of course, as it is often said, no investments go up in a straight line. No doubt risk assets around the world will pause for breath through the summer, needing an actual return to economic growth rather than just an improving trend to continue their recovery. Valuations look reasonable in general, the cheapest part of the market remains more anomalous than usual, and the fundamentals, both in terms of economic growth and company profits, are improving. As we continue through the year, the returns to the UK Equity strategy should improve as the focus shifts back from volatile macro-driven sector rotation to greater performance differentiation at the stock level. *"A diamond is a piece of coal that stuck to the job"* Thomas Edison.

**Dan Hanbury**  
Portfolio Manager

## Fund Facts

Launch date	25 February 2008
Fund manager:	Dan Hanbury
IMA sector:	UK All Companies
Benchmark:	FTSE All-Share (Total Return)
XD dates:	1 April & 1 October
Dividend/Accumulation payment date:	31 May and 30 Nov
Tracking error range:	2-6%
Product capacity:	£2 bn (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	B1NG777	B1NG7KO
ISIN	GB00B1NG7777	GB00B1NG7K01
Bloomberg	RVMUKEA LN	RVMUKEZ LN

### Important Disclosure:

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