

RIVER AND MERCANTILE  
ASSET MANAGEMENT

UK Equity Fund I Quarterly Report  
June 2008

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# River and Mercantile

June 2008

## UK Equity 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 capitalised in the FTSE 350 index which offer the prospect of superior long term growth.

Portfolio Summary			Risk Analysis Summary	
Strategy AUM (GBP)	£	4,857,616	Portfolio Volatility	9.89%
Strategy Capacity (GBP)		£2bn	Benchmark Volatility	10.77%
Number of stocks		69	Tracking Error	2.11%
Largest Holding	Shell	6.11%	Portfolio Beta	0.92
			Active Money	47.00%

### Performance as at 30 June 2008

“A” Class Shares	Fund (%)	Index * (%)	Difference (%)
1 month	-4.86	-7.06	2.21
3 month	1.03	-1.45	2.48
Since inception	1.03	-1.45	2.48

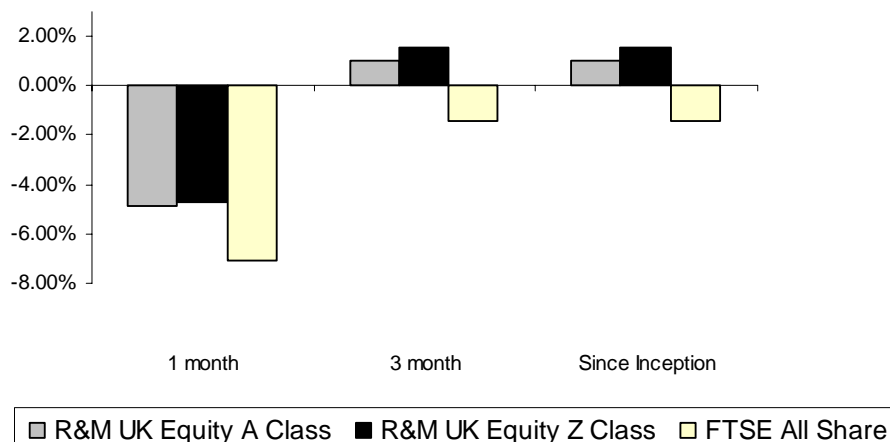
\*Index: FTSE All Share (Total Return)

Performance calculated on a mid to mid basis at close of business, net of annual management charge

“Z” Class Shares	Fund (%)	Index (%)	Difference (%)
1 month	-4.73	-7.06	2.34
3 month	1.53	-1.45	2.98
Since inception	1.53	-1.45	2.98

\*Index: FTSE All Share (Total Return)

Performance calculated on a mid to mid basis at close of business, gross of annual management charge



## Investment Commentary

### Market Background

The UK equity market put in a poor performance in June, declining by 7.4% (capital returns) capping another difficult quarter for UK Equity investors. The market remained preoccupied with rising inflation (as the oil price breached US\$140 per barrel), speculation that the slowdown in the UK economy will deepen, and continued concern over financial companies, all of which were a drag on the market over the quarter. Against this backdrop, the large-cap FTSE 100 index fell by 0.4%, while stocks lower down the market-cap scale fared worse, with the FTSE 250 and the FTSE SmallCap indices falling by 8.2% and 7%, respectively.

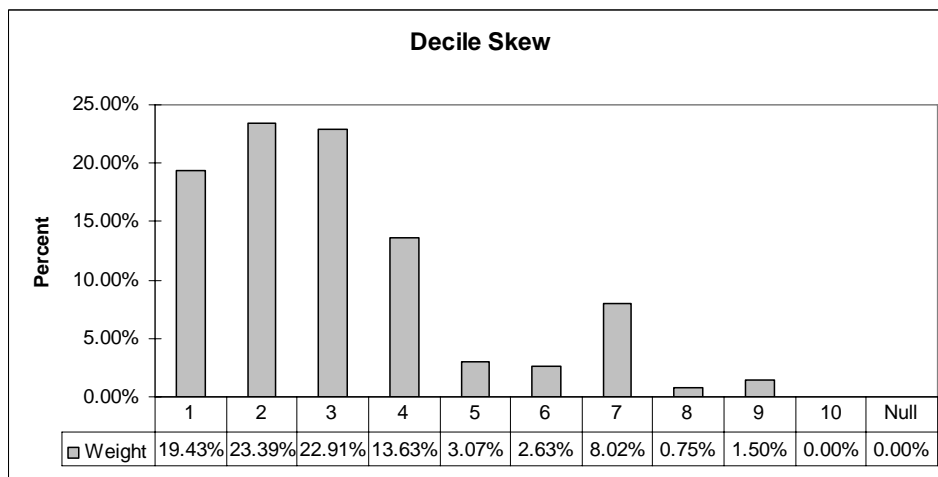
As widely expected, the Bank of England's Monetary Policy Committee (MPC) kept interest rates on hold at 5.0% in June. The decision was made amid growing concerns over UK inflation, with price pressures continuing to gain momentum, allied with mounting evidence of an imminent economic slowdown. In terms of the housing market, data continued to point to deteriorating conditions. At the stock level, the best-performing companies in the market were energy stocks such as John Wood and Sibir Energy. Electricity companies also performed well, benefiting from higher prices. At the other end of the spectrum building materials companies and financial sector companies underperformed sharply.

### How did we perform and why?

The UK Equity Fund performed relatively strongly in its first full quarter returning 1.5% against the FTSE All Share return of -1.5%. Best performing stocks were the oils unsurprisingly with Wood Group and Sibir the stand out performers. Poorly performing stocks included Meggitt due to concerns over its geared balance sheet and the prospect of a severe downturn in the civil aerospace industry, and Cattles, a small position we have maintained in a well capitalised unsecured lender in the UK.

### Does the portfolio reflect our Philosophy & Process?

The portfolio is currently tilted towards both high quality and defensive growth companies which have the best chance of outperforming in a slowing global economy and a UK economy in recession. During the quarter we continued to minimise our exposure to recovery stocks and asset backed stocks. In all cases we continue to rotate the portfolio in to strong PVT ideas where we see medium term potential for companies to create significant shareholder value, on low valuations and where earnings risk is reduced.



## **What themes occupy us?**

In our quarterly reports we attempt to highlight themes that are perhaps non-consensual or at least insightful in helping clients understand our portfolio construction. Earlier fund reports have been cautioning that both UK and global growth looked likely to disappoint, including emerging markets, and that a core of defensive or defensive growth stocks, augmented with a reasonable allocation to resources stocks and a small handful of value stocks (with few financials), has been the right strategy. In hindsight, whilst outperforming, having a larger allocation to resources would have been more helpful in protecting our clients capital to date. We now find ourselves in the position that markets are down around 20% since mid-May, that newspapers are full of doom and gloom and the concerns over whether we are facing inflation or deflation are being comprehensively discussed and documented. It is worth noting that the reasons for understanding the inflation/deflation debate are not just around bond/equity market calls, or whether to be long or short resources, but also that investing in companies with pricing power (i.e. companies able to pass on price rises to customers) has been proven to be a good investment strategy in most market environments.

This quarter we shall continue the debate over inflation/deflation but in the context of the currency markets. We shall also comment on the extreme factor returns in the market (as well as sentiment indicators) to gauge whether or not our strategy remains sound.

## **Sterling and the Dollar**

In early 1985, Sterling flirted with parity against the US dollar. This marked the low point in fortunes that had begun eighteen years earlier with the devaluation against the US dollar. For the subsequent twenty two years, the currency enjoyed broad stability on a trade weighted basis, punctuated briefly by the withdrawal from the ERM in 1992. The Pound became a major beneficiary of a more concerted fight in the U.K. against inflation, aggressive reform of the labour markets and the worldwide shift towards financial deregulation. Unfortunately, these structural positives for the economy are now unwinding and along with mounting cyclical stresses threaten to substantially prolong the currency weakness that began in mid-2007. The Bank of England (BoE) may succeed in regaining the confidence of the public. But the broader policy backdrop is not promising.

Internationally, the price of a banking bailout will lead to further pressure to re-regulate the financial system. The UK economy's heavy exposure to finance and business services at 30% of GDP makes it a warrant on these developments, as the era of supernormal profits in the financial services sector ends.

Without the cyclical momentum that masked these structural frailties and policy errors, confidence in the economy will take a sharp knock. Sterling is about to enter the second and most surprising phase of its depreciation for a number of reasons:

1. There is a high degree of complacency about the positive interest rate differential propping the currency up.
2. For now, there is little scope for policy ease in the wake of intense short-term inflationary pressures and strained fiscal finances.
3. The political environment is the most uncertain in over a decade and the fragility of the banking system among the worst in Europe.
4. The U.K. economy is heading for recession and the only way it will escape outright deflation is via further erosion in Sterling.

The pressures on the European economies from a hawkish ECB and strong Euro might be intense, but they pale into insignificance beside the damage that the deadweight of a highly indebted UK consumer will do. The personal savings ratio is still barely positive and must surely rise, and the unemployment rate has only just started to go up. Whilst

consensus has probably shifted to expecting a mild recession within the UK, we believe that the duration of the downturn will surprise. Housing in particular looks fragile as we move through a multi-year period of credit contraction. To lend some balance to the argument, in its introduction to the latest Financial Stability Report, the BoE observed that "The unavoidable correction after the credit boom is proving protracted and difficult. However, the pricing of risk in credit markets seems to have swung from being unsustainably low last summer to being temporarily too high relative to fundamentals. So, while there remain downside risks, the most likely path ahead is that confidence and risk appetite will return gradually in the coming months." This could be a classic case of our business leaders trying to keep hopes up but may ultimately result in disappointment. The risk of our view of Sterling being wrong is that the financial system improves more quickly than we anticipate but we see relatively little chance of this occurring on a 6-12month view due to the negative economic fundamentals.

In the UK, we are not alone! The fundamentals for the **Dollar** look equally weak. Fannie Mae and Freddie Mac are government-sponsored enterprises that help the mortgage market function by purchasing pools of loans and packaging them into securities. These two financials have originated almost 75% of US mortgages – a \$12 trillion market. At the end of last year, Fannie alone had packaged and guaranteed about \$2.8 trillion worth of mortgages, approximately 23% of all outstanding U.S. mortgage debt. These securities are highly rated and sold to investors all over the world. Clearly investors are concerned. Credit default swaps - a type of insurance against the possibility of Fannie and Freddie defaulting on their corporate bonds are at their most expensive levels in months; both companies are expected to report steep losses for the second quarter; and their main business, mortgage securitization, is under pressure as home price values decline and foreclosure numbers rise. The major issue is that these are very leveraged financial institutions, leveraged much more than any other bank, and they have lots of US mortgage assets. As real estate values decline every day, the value of [the mortgages that it bundles, guarantees, and sells] are called into question. The possibility of government aid looms because it's hard to see how the private market can help the companies. Their stock market values have dropped so low that it would be difficult for them to raise money.

### **The disaster scenarios**

The Federal Reserve and the Treasury have taken great pains to point out that the government is not obliged to bail out either Fannie or Freddie if they face insolvency.

It's debatable where the legal obligations lie, but as a practical matter, the government can not let these institutions fail because of the reliance on them to help fix the mortgage mess. If Fannie and Freddie were unable to buy and back loans, banks would stop originating them and the pool of homebuyers would shrink, causing home prices to fall even further. A 'debt bust' deflationary outcome is unacceptable to the authorities but one they are struggling to get to grips with.

So what would force the Treasury and Fed to step in? Fannie and Freddie are among the most highly-leveraged companies around, meaning the amount of capital they have on hand is nowhere close to the level of assets they control. Fannie and Freddie must constantly borrow money in order to operate; if for any reason borrowing costs rose sharply they would not be able to make good on their guarantees or even fund their day to day operations. This is when the government would feel intense pressure to step in and, at the very least, pay contracts in a timely manner. In an April report, Standard & Poor's said a scenario whereby Fannie and Freddie are insolvent is unlikely, but that the mere possibility of failure at either is a greater threat to the economy than the actual collapse of any investment bank.

## **The bailout scenarios**

So what might it look like if the government is to lend a hand? Outright nationalization is an unlikely option given that neither the current administration nor the presidential candidates could afford to support such a move in an election year. So far, the Treasury Department or the Federal Reserve have come in and provided a liquidity backstop of sorts through extending a discount window to both. Fannie and Freddie could even do a preferred stock deal with the government, much like the deal forged by Citigroup with the Abu Dhabi Investment Authority. That would give officials the ability to argue that they weren't bailing out the companies, but rather making an investment that would pay off in the long run. The doomsday scenario could cost taxpayers more than \$1 trillion, says the S&P report. The report went so far as to say that a government bailout of Fannie or Freddie could force the agency to lower its rating on the creditworthiness of the United States. Either way these developments are clearly very negative for the US Dollar and it has begun to weaken once again.

So the prognosis for Sterling and the Dollar is not great and weakness in either currency clearly has implications for the PVT companies we own in the portfolio. Fortunately the UK market is full of excellent international companies and a weak Sterling suggests we should continue to hold companies where the bulk of their earnings are from overseas.

**Factor returns** – In the past quarter we have again seen extremes in terms of the divergence in returns between growth / momentum and value factors. It has been quite logical because the consumption bubble within the US and UK has burst and we are witnessing a collapse in UK consumer related earnings. The dispersion of PE ratings had narrowed far too much going into 2007. This was because a focus by the market for companies on cheap free cashflow yields, driven to some extent by the private equity M&A bubble, ensured that relatively poor quality cyclicals were trading on similar multiples to the highest quality growth stocks. That was unsustainable, particularly with the economy heading into an environment of contracting credit. In the past year we have seen a rapid re-rating of perceived growth earnings and devaluation of more domestic cyclical earnings. In fact, in the past 9 months we have seen extremely negative returns to value. This leads us to believe that right now it seems logical to assume that some form of rotation in to value may well be very close.

**Market sentiment** – Global investor surveys are useful addition to understanding market sentiment and understanding if trends have overextended. Extreme readings in surveys are often but not always good contrarian indicators. The latest results from the Merrill Lynch Global Fund Manager survey suggest that regional allocation to UK Equities is very low versus other regions. This might suggest that UK Equities are looking attractive versus global alternatives within the equity space. Looking inside the market, the majority of managers continue to shun small caps (a net 74% prefer large caps) as evidenced by stocks held in our portfolio on PEs of less than 3x. These kind of extreme readings can go on for sometime but is beginning to look supportive of small cap performance sometime in the near future. The other interesting reading is that globally a net 82% of respondents expected consensus earnings estimates to fall further next year. Whilst this is of course highly likely and we would agree with this assessment it does tend to suggest that in the short term this is priced in and is conducive to a value rally versus the earnings momentum of the past year or so – particularly when one considers the factor return extremes in the previous paragraph.

## **Portfolio Strategy**

Commodities like oil continue to rise, driven by low real interest rates (negative in places like the US), continued accommodative US central banks (must try and avoid the deflationary bust at all costs) and a still strong Chinese economy. Whilst putting all your eggs in one basket would be wrong as the commodities mania unfolds, it is equally dangerous to bet against a powerful trend. Therefore we continue to prudently allocate capital to resource related companies, albeit underweight the benchmark. What will

undoubtedly put an end to these entrenched trends is the oil price itself finally retreating significantly... but knowing exactly when that is going to happen is extremely difficult. What we do know is the oil price has doubled in the past 12 months and is now 30% above its 200 day Moving Average, leaving it vulnerable to a significant correction even if you believe the longer trend is still upwards. We believe a 30% correction in the oil price would likely be the catalyst for significant factor and sector rotation within the market. As oil falls, inflation worries begin to dissipate and the markets then start pricing in a greater probability of rate cuts in the UK to offset domestic housing deflation. The result will be a vicious rotation out of resource/industrial momentum stocks into the cheap domestic cyclicals. Unfortunately we do not reside in the bullish camp that believes a fall in oil will see the beginning of a new rampant bull market in equities (remember oil has been positively correlated with equity markets for 4 of the past 5 years). If that was the case the fund would need to be to have higher weightings in domestic cyclical value and financials. We have kept our defensive core whilst simply titling some of the resource momentum into cheap cyclicals at the margin.

Our strategy continues to be as follows:

- PVT Process discipline
- Remain in quality but increasingly picking up value recovery stocks at the expense of expensive growth stocks which have enjoyed strong momentum
- Maintain a defensive growth core
- Maintain a resources / hard asset hedge.
- Ensure stock liquidity

### **Portfolio Activity**

As detailed in our Monthly reports new holdings purchased during the quarter included support service businesses **Atkins**, **Rentokil** and **Mouchel**. More recent purchases have been **Salamander Energy** and **Spectris**.

**Spectris** is a cheap high quality late cycle engineering company whose expertise really lies in providing products and services to ensure quality control and productivity gains within a wide range of process industries. They develop and market precision instrumentation and controls with a focus on providing niche applications which have a direct impact on user customers' process performance. They have a history of generating high return on capital and returns in the business are continuing to improve. Recent updates with the company have confirmed they are trading strongly with positive operational gearing allowing profits to expand as the sales grow. This in combination with benefits from recent currency moves (a beneficiary of weak Sterling) is resulting in analysts ratcheting up their profit forecasts for the company. Their strong balance sheet is allowing them to undertake earnings enhancing share buybacks but despite their quality and positive momentum they continue to be valued at a discount to the wider industrials sector. Their superior cashflow generation and improved business organisation should generate a premium valuation in time.

**Salamander** is a top decile medium-sized Growth company developing an Asian focused gas and oil production and exploration business. Localised gas markets ensure that Salamanders gas contracts are relatively resistant to oil price fluctuations whilst new field developments are adding materially to production volumes. They are financing out of cashflows an aggressive exploration programme over the next eighteen months whose possible success is not reflected in the current valuation, in our opinion, unlike a number of other E&P businesses where there appears to be significantly more 'hope' reflected in the share prices.

## **Outlook**

The reason for focusing on currency this quarter is quite simple. It is the abuse of fiat (paper) currencies globally, in particular the reserve currency of the world (US Dollar) which has resulted in an enormous debt bubble developing over the past couple of decades. It was bound to burst and the credit contraction we are now experiencing, and will continue to experience for some time, is the outcome. It is at times like this when it is worth listening to the likes of George Soros, investors who have a proper understanding of both the shortfalls within the global financial system and the weaknesses inherent in a global fiat monetary system.

Like Soros, we believe we have now got towards the end of stage 1 of the financial system problems. They are being well documented currently. Stage 2 is the impact on the real economy and a recession is all but inevitable. Central banks have done what they can to help the banking crisis which started last year. Arguably where they failed is allowing markets to dominate and regulators to abandon their role. Take the credit swaps market for example. There are currently \$45 trillion of outstanding contracts – equivalent to half of US household debt and 5x their national debt. Buffett described these instruments as “weapons of mass destruction” for the financial system a few years ago. This is why the US Federal Reserve was forced to step in and engineer a rescue of Bear Sterns, as both they and JP Morgan were 2 of the largest counter-parties in this market. The problem is the opacity of risk transfer within the system and arguably some kind of regulated exchange is required so that counterparties in the market can deal in confidence with each other and thus avoid the large scale liquidity problems seen in the past year.

So the Fed will in all likelihood prevent a systemic failure within the banking system but they are unlikely to be able to prevent a recession. In addition, holders of US IOUs (US Treasury Bonds) are increasingly reluctant to hold dollars. They are therefore diversifying from the dollar, for example Sovereign Wealth Funds buying commodities which is in part behind the current resources boom. It is likely that the commodities markets are also in the grips of a bubble and it is important for international regulators to ensure excess credit does not fuel this boom to damaging levels in the future.

The UK economy is at least as vulnerable as the US due to the large financial services sector, higher house prices and more consumer debt. The main difference is that for obvious reasons (land, planning etc) there has not been the supply seen in the US coming on here. This all been said, we are in a period where arguably it feels as important to be considering wealth preservation to wealth creation. In the UK market we have a fantastically diverse universe of high scoring PVT investments to choose from. There are sectors where earnings are likely to prove resilient and where dividend growth will remain strong. In fact in a world where property values fall, cash and bonds returns risk being inflated away, currency volatility and commodity bubbles – we believe buying shares in high quality world class PVT companies is an attractive opportunity on any medium term view.

**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

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