

RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Fund I Quarterly Report
September 2008

River and Mercantile

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UK Equity Fund – Quarterly Report

Fund Aim

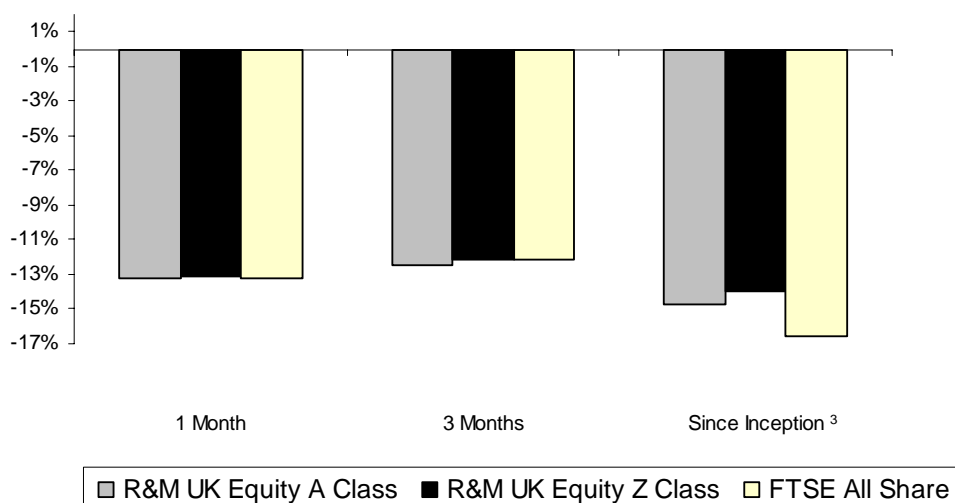
The investment objective of the Fund is to achieve capital growth by investing in a portfolio of investments which shall primarily consist of UK equities capitalised in the FTSE 350 index which offer the prospect of superior long term growth.

Portfolio Summary		Risk Analysis Summary	
Strategy AUM	£6,458,347	Portfolio Volatility	11.93%
Strategy Capacity	£2bn	Benchmark Volatility	12.06%
Number of stocks	70	Tracking Error	1.76%
Largest Holding	HSBC 7.19%	Portfolio Beta	0.98
		Active Money	44.95%

Performance as at 30 September 2008

Retail "A" Class Shares	Fund ¹	Index *	Difference
1 Month	-13.20%	-13.24%	0.04%
3 Months	-12.50%	-12.18%	-0.32%
12 Months	-	-	-
Since Inception ³	-14.69%	-16.54%	1.85%

Institutional "Z" Class Shares	Fund ²	Index*	Difference
1 Month	-13.09%	-13.24%	0.15%
3 Months	-12.18%	-12.18%	0.00%
12 Months	-	-	-
Since Inception ³	-13.93%	-16.54%	2.61%



Source: River and Mercantile Asset Management LLP

*Index: FTSE All Share (Total Return)

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

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

³Inception date 25th February 2008

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 have 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 this quarter and were a little disappointed with this result. Our portfolio strategy had appeared correct having positioned ourselves in defensive growth companies and modest positions in resources and financials, 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 most effective.

Having had an underweight position in Banks from launch in March 2008, we had modestly increased our exposure to domestic banks on the basis that low valuations made them a high risk short. However, HBOS and LloydsTSB underperformed both the market and the sector whilst index-heavyweight and perceived 'safe haven' HSBC was extremely strong versus both the market and sector. We were overweight the former and underweight the latter but have since exited HBOS. We do not believe that HSBC will escape the banking crisis as easily as the market would have us believe and the slowdown in Hong Kong and China represents a significant risk. We own no shares in Standard Chartered for the same reason.

Resources Collapse

Negative stock selection offset some of the benefits of underweighting the sector. Xstrata and Anglo American, which we held, underperformed the majors Rio Tinto and BHP Billiton where we were more underweight. Furthermore, having boosted performance in the previous 9 months, our Oil Services stocks (John Wood and Lamprell) underperformed the majors against a falling oil price.

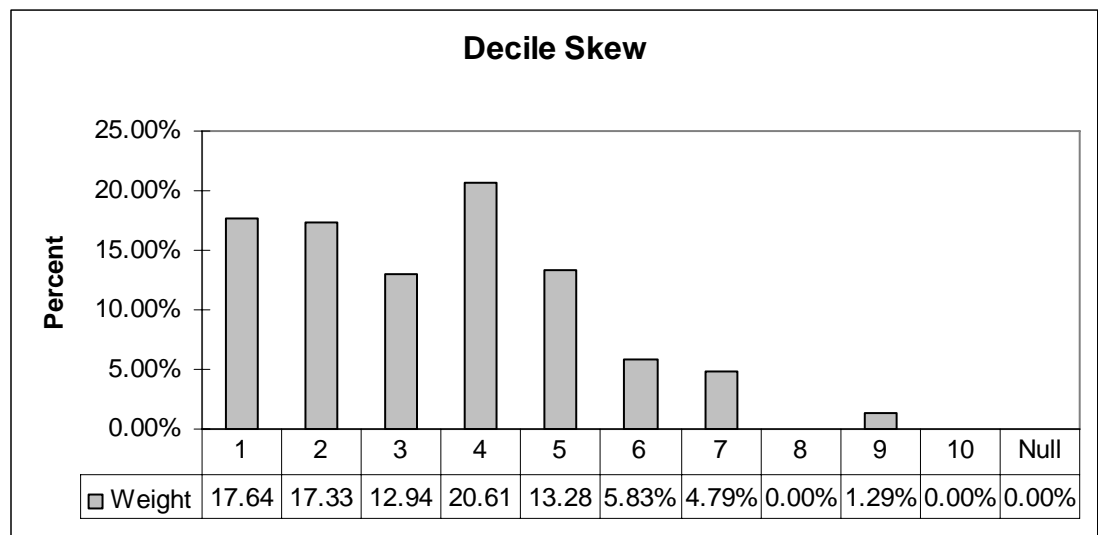
Stock Specifics

Some of our defensive growth holdings have performed weakly during the quarter. Holdings such as Balfour Beatty, WS Atkins and Mouchel have been trading on premium valuation multiples but concerns have surfaced over public sector financing as well as pension fund deficits. Value factors have come to the fore alongside quality at the expense of momentum. Rentokil Initial (a Recovery stock) disappointed and has since been disposed of. Fortunately

there were numerous successful investments during the quarter which included the tobaccos, retailers and insurance companies to limit the downside.

Does the portfolio reflect our Philosophy and Process?

The portfolio maintains a significant weighting to high scoring PVT investments, which reflect are 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 financials and resources. The skew is not as pronounced as would normally be observed due to the sharp reversal in momentum which negatively impacted timing scores.



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 and are proposing 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. 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 will require a mix of government guarantees, equity recapitalisations and Central Bank liquidity injections. The latest UK-led steps to re-capitalise key banks is therefore positive. 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 Bae Systems, Unilever, Cable & Wireless, BP, GlaxoSmithkline and British American Tobacco. We continue to monitor carefully holdings where they have above average leverage, such as First Group and Imperial Tobacco.

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 it has. Cattles 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 PVT thesis deteriorated as these wholesale markets are likely to remain constrained over the medium-term and we sold.

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. Kingfisher, BT and Daily Mail). Many of our holdings have recently beaten market expectations (e.g. Chemring, Bae Systems, Reed Elsevier, Glaxo, and BAT.)

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 Kingfisher and First Group. There were no new purchases during September but we continued to add to our pharmaceutical holdings, Astrazeneca and Glaxo. Later in the quarter we sold out of a number of our more cyclical names such as Kier Group (construction), Hays (recruitment) and Cattles (lending). Proceeds from sales were re-invested in existing holdings. Given that a lot has happened since our monthlies we will just remind you of one example of the type of PVT opportunities we have found.

Kingfisher – Kingfisher is the world's largest DIY retailer outside the US. It's potential is dominated by the recovery possibilities within its UK business where their market dominance and new management team have an opportunity to significantly improve margins over the medium-term, despite a weak consumer environment. Kingfisher, though, also has attractive growth potential given their overseas business where they have market leading positions in countries such as France, Poland, Turkey, Russia and China. Over the long-term these businesses have considerable roll-out potential and Poland itself is now generating almost the same profit as the UK business. A significant valuation anomaly exists, with the business trading at a large discount to its book value despite a recent re-valuation of its large freehold estate and a low recovery PE. This anomaly was highlighted just prior to our purchase by the sale of their Italian business at a premium to book value for cash paying down debt. MoneyPenny highlighted they (unlike many retailers) have in fact been getting upgrades in recent months as analysts have already factored in difficulty on the high street in their forecasts.

Selling Discipline:

Early in the quarter we exited International Power whose valuation upside had significantly unwound due to positive momentum towards energy related companies and their emerging market exposure. As Timing characteristics deteriorated we exited gold miner Peter Hambro. Equally, Sibir Energy's Russian risk has been brought into full view by the South Ossetia conflict and we reduced our holding.

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 relatively 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 £3025 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 cyclicalities, 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. The market's dividend yield (which we accept will be cut) is now above government bonds, also a very rare occurrence in modern times. This financial crisis remains unique 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
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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