

RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity Fund I Quarterly Report
December 2008

River and Mercantile

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UK Equity Fund – Quarterly Report

Fund Aim

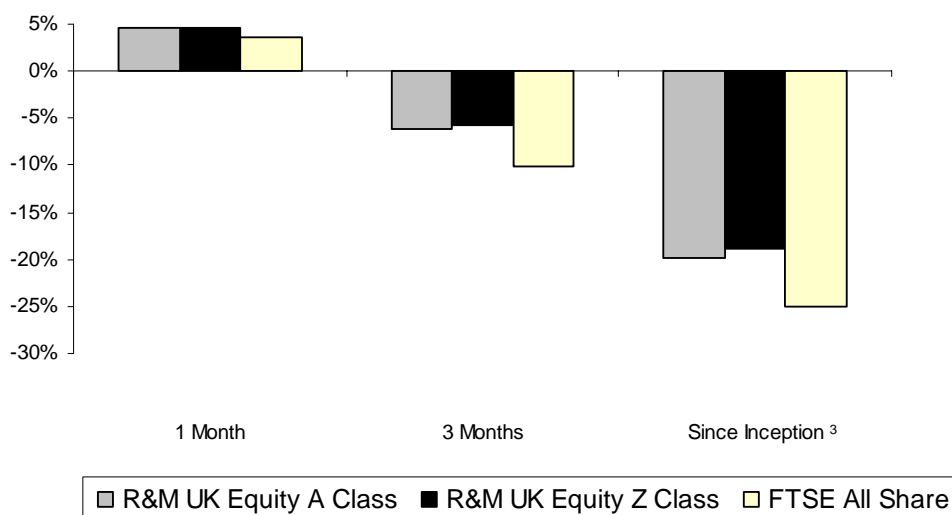
The investment objective of the Fund is to achieve capital growth by investing in a portfolio of investments which shall primarily consist of UK equities capitalised in the FTSE 350 index which offer the prospect of superior long term growth.

Portfolio Summary			Risk Analysis Summary	
Strategy AUM		£63.7	Portfolio Volatility	11.55%
Strategy Capacity		£2bn	Benchmark Volatility	12.59%
Number of stocks		61	Tracking Error	2.46%
Largest Holding	BP	7.15%	Portfolio Beta	0.90
			Active Money	42.45%

Performance as at 31 December 2008

Retail "A" Class Shares	Fund ¹	Index *	Difference
1 Month	4.52%	3.67%	0.85%
3 Months	-6.04%	-10.19%	4.15%
12 Months	-	-	-
Since Inception ³	-19.85%	-25.04%	5.19%

Institutional "Z" Class Shares	Fund ²	Index*	Difference
1 Month	4.66%	3.67%	0.99%
3 Months	-5.69%	-10.19%	4.50%
12 Months	-	-	-
Since Inception ³	-18.83%	-25.04%	6.21%



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

Quote for the Quarter

“Just as hubris and overconfidence drove our debt and equity markets over the last five years, fear is now paralysing investors. If you listen to most market pundits today, you should sell everything and wait. We have been in the investing game long enough to know that trying to time markets is a ruse. The pundits could be right, but they would be lucky. Bull markets do not begin with a starting gun and they generally anticipate the good times to come well in advance. Knowing when to get back in is problematic if not impossible. It has been our observation that the low hanging fruit gets picked early and fast.”

Tweedy, Browne (Guardian of Ben Graham's philosophy) October 2008

Key Observation

Financial markets around the world have been devastated over the last year. The outlook remains very difficult. However as investors we must never forget that we are buying a share in the medium term cash flow of a business and that these cash flows are now available at a very low price. Fortitude is required at this point in the stock market cycle, as is a historical perspective. Sensibly funded enterprises will emerge from this down-turn as strong as ever, and many PVT stocks that we buy today will prove to be bargains.

Market background

4th Quarter :

Despite a modest recovery in December equity markets around the world had a very difficult last quarter of 2008 as risk assets continued to suffer from a flight of capital towards perceived low risk assets. The UK equity market, whilst it proved to be more defensive than most, insulated by a weak currency, still delivered a negative return of -10.2%. The winners during the quarter continued to be defensives, both in terms of sectors such as pharmaceuticals and beverages doing well but also liquid mega-cap stocks performing much better than the average company. Cyclical, financials and smaller sized companies did poorly. Surprisingly, oil producers materially out-performed, despite the collapsing oil price as investors looked for safe dividend yields. Momentum and Quality styles continued to significantly outperform value.

Year :

2008 has been the 3rd worst year for UK equities since proper records began in 1899, with a negative total return of -29.9%. Returns deteriorated as one moved down the size bands. The Small Cap Index fell almost 50%, a real return as bad as the 1974 stock market correction, the worst in our history. During this decade half the annual returns have been negative.

How did we perform and why?

Quarter:

The portfolio returned -5.7% vs. -10.2% for the benchmark. Despite the absolute negative return the outperformance was an encouraging end to a challenging year. Relative performance was helped by overweights in defensives which got more expensive as bond yields cratered factoring in global deflation.

Since Inception :

Despite outperforming, given my cautious view of the world I would still have hoped to protect capital better in this downturn, with the UK Equity strategy returning -18.8% since inception in Feb 2008. Whilst correctly cautious of a number of macro trends including identifying the credit and commodity bubbles I still failed to sufficiently de-weight value factors, which have struggled since the credit crunch began. Value protected portfolios in the last stock market downturn, as the TMT bubble burst. In contrast in this correction lowly valued shares have suffered more than most as the credit driven earnings bubble unwinds.

Key performance contributors

Quarter:

Positive: over-weight attractively valued defensives (Mobile Telecom and Pharma sectors); underweight mining. Biggest stock contributions were Serco, Hiscox and Amlin.

Negative: Oil underweight. Poorest stock contributions were Lamprell and Intermediate Capital.

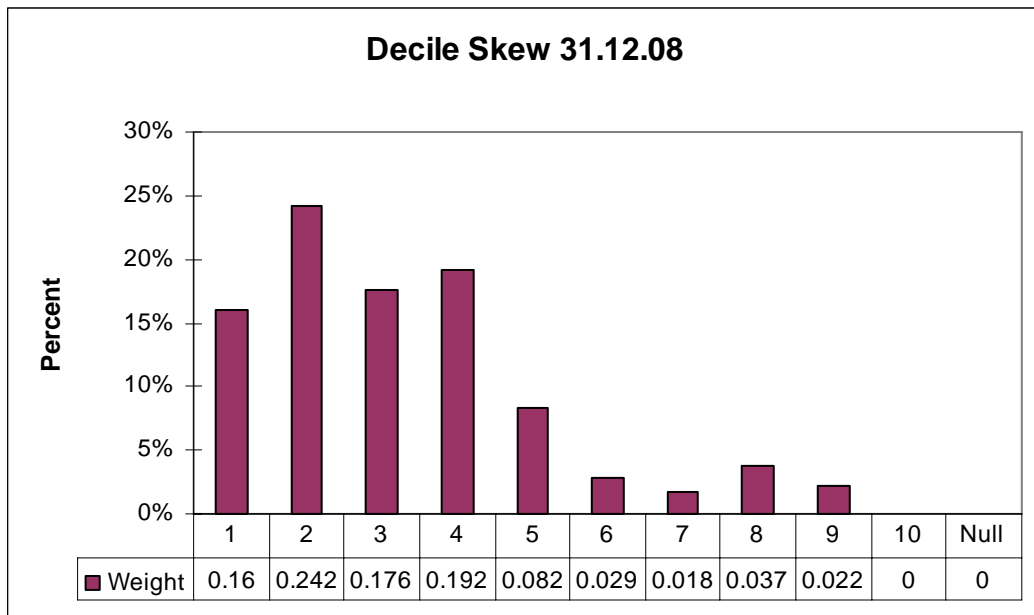
Since Inception:

Positive : Mining stocks fall sharply (no exposure to Rio, BHP); Quality stocks perform well (overweight Pharmaceutical and Tobacco sectors). Biggest stock contributions were British Energy (bid), Amlin, Hiscox and Serco as well as a raised cash position and underweight in Rio Tinto.

Negative : Midcaps under-perform by 11.74%; Value factor underperforms by 20% (SG Global Style Analysis, performance of Low versus High PE). Poorest stock contributions were Lloyds TSB, Cattles, Aquarius Platinum and Peter Hambro Mining.

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 not really changed over the last three months, with 67.9% in Quality, 13.8% in Recovery, 13.4% in Growth and only one position in Asset backed (0.7%) shares.



Source: River and Mercantile Asset Management LLP

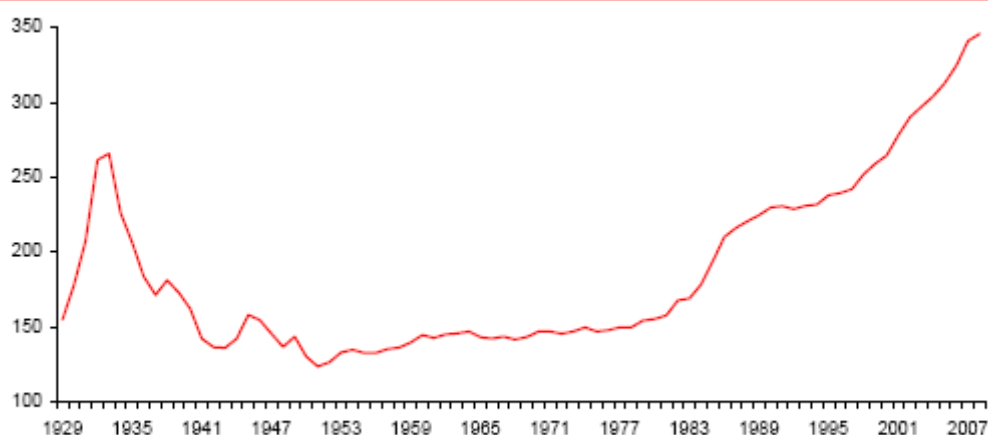
What themes occupy us at the moment?

It is appropriate at this stage to refer both to the economic cycle, the long term credit cycle and the stock market cycle given the dramatic falls into Q4 as well as sentiment extremes.

Economic Cycle - Where are we in the process of the economy deleveraging?

Deleveraging the largest debt bubble in global history has barely begun. We are focused on the US as well as the UK here as it is the US consumer which has been the main driver of global demand. Savings ratios will rise creating an extended recession and a significant drag on growth for some time hitherto.

US total debt as % of GDP De-leveraging hasn't even begun



Source: SG Equity Research

This global debt bubble was not born in the mid-nineties as some would believe but actually in 1970 when Richard Nixon took the US off the gold standard and abolished Bretton Woods. Once again a fiat reserve currency of the world took centre stage and this aided in spectacular deficit spending and the foundations for the greatest credit bubble in history. Ever since then there has been an on-going debate by those who believe either that the American economy is heading for a hyperinflationary breakdown and those who believe that deflationary collapse is inevitable. Every previous credit bubble in history has burst resulting in debt repudiation and an extended economic downturn. This one ultimately will be no different but the path we take will be heavily influenced by the central banks and governments who are currently leveraging the state to offset credit contraction in the household and corporate sectors. This massive adjustment process needed to right the previous excesses leaves authorities treading dangerously between a rock and a hard place – deflation or stagflation. The hope of course is that the authorities have learnt from the experience of the 30's and the Japanese experience – the response so far indicates this but unfortunately the interconnected nature of the world's financial markets and the sheer scale of the debt now makes for a difficult period for investors and governments alike.

In the past couple of months some large stimulus packages have been commented on particularly in the US. To give some context to these very large numbers I have listed a few more very large numbers below (data as of end of 2007 in trillions of dollars) :

Size of US stockmarket : \$19trn

Size of US bond market : \$27trn

Size of US credit derivatives market : \$515trn (estimated)

Size of US housing market : \$21trn

US National Debt (state, business and household) >\$50trn which is > 350% of GDP

Unfunded social security and medicare liabilities account for the same amount again

Announced US fiscal stimulus and rescue packages to Dec 08 : \$1trn - \$1.5trn as well as \$0.5trn of 'quantative easing so far'.

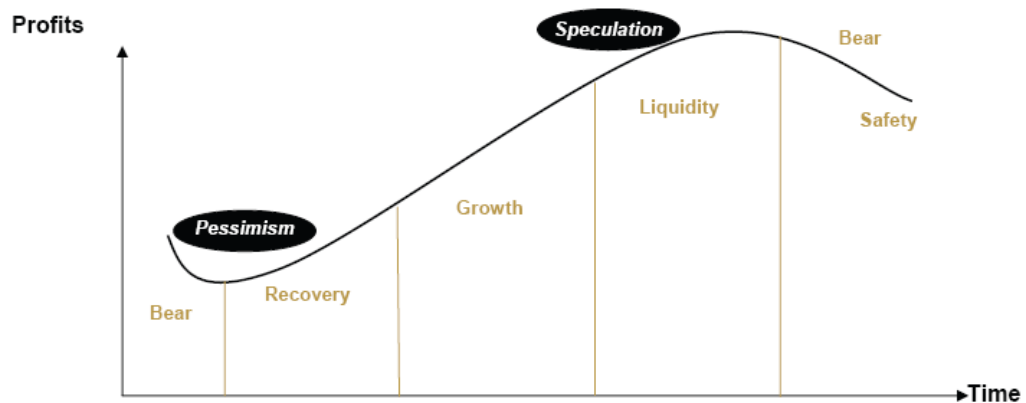
The Long Cycle - Judgement of history

Historians teach us that civilisations go through cycles of birth, growth, decline, and death much like a biological organism. Though some would now have you believe America is somehow immune from this process, history teaches us differently. Historical cycles – the ebb and flow of change – are the primary facts of life on this planet. Currency debasement is a prominent feature of an empire's decline. The examples are numerous. Rome. Greece. Genghis Khan, Napoleonic France and post World War II Britain. Given that the United States is in the midst of a currency debasement of its own we should sit up and take note.

The dollar system, which was imposed on the world at Bretton Woods in 1944 and which became a pure fiat system in August 1970, when President Nixon closed the gold window could now be in the process of failing. The fiat-based dollar system has allowed the US to take unfair advantage of other countries by constantly being in debt to them. This level of indebtedness was always unsustainable. Global competitive currency debasement appears to now be in full swing as interest rates head towards zero. Japan at zero, US almost there, UK & Europe heading there fast, so where is the surprise? Watch out for China, if they are forced to devalue the Yuan in the face of a recession and the resulting unrest, a global trade war could ensue.

The Stockmarket Cycle

These are long term trends, so where are we within the stockmarket today given this backdrop. Over the last year we have found it useful to frame 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

The reason for this is that all phases of the economy and stock market, even the most extreme have a historical context and are cyclical in nature. Bull phases inevitably come to an end, interrupted by tightening monetary policy and by the exhaustion of the marginal buyer; likewise bear phases come to an end, stimulated by expansionary economic policies and by the capitulation of the marginal seller. In terms of the economy it is clear that we are in the middle of a deep recession, but it is also clear that we have seen a massive market and policy response that adds up to the biggest economic stimulus that the UK economy has seen in our generation (it needs to be). The market has led sterling down to hugely competitive levels, the Bank of England is cutting interest rates to levels previously unheard of in its history (dating back to 1694), fiscal policy is expansionary, tax payer's money is keeping the banking industry intact, and falling commodity prices are boosting the spending power of the consumer.

At this stage of the cycle Mr Bolton and my colleague Hugh do make some sense and I am happy to follow Hugh in quoting from Bolton's analysis of where we are in the cycle from the FT on 3rd January: "When evaluating the market outlook, there are three things that I focus on. The first is how the current situation compares with the historical pattern of bull and bear markets....when the time and scale of the rise or fall are both high relative to historical

averages, the odds of a change of trend increase. The second factor is indicators of investment sentiment and behaviour....when these indicate extreme pessimism or optimism, it normally pays to bet against them. The third factor is long-term (30-40 years) market valuations, particularly measures such as price-to-book value. When these move outside their normal range, it can signal opportunity. In my experience, when all three factors confirm each other (such as in the last quarter of 2008), the odds are that you are near a turning point." Bolton's indicators, some of which we discuss further in the outlook part of this report are not unlike our stock-market cycle analysis, both suggesting that we just passed some form of bottom in this cycle, despite the long term fundamentals. The Japanese bear market is a useful precedent as there were 3 or 4 large bear market rallies where investors could make very good returns. As I write this we have just enjoyed another.

Enron Debt

Enron typified the last equity bubble, the heady-days of TMT and playing loose with accounting. But I was interested to hear from Hugh that in reading Seth Klarman's introduction to the latest edition of Graham and Dodd's Security Analysis, he was surprised to read "Enron debt...traded as low as 10 cents on the dollar; ultimate recoveries are expected to be six times that amount". Today investors are treating all cyclicals with any debt as potential Enron's, valuing the equity at the equivalent of 10 pence in the pound; if Enron debt (as toxic as you could find) could be a six bagger from the bottom, what returns could be achieved from the equity in sound but somewhat leveraged businesses that are currently priced for credit Armageddon. Again we would suggest that for now you are provided with a significant margin of safety when buying into sensibly leveraged companies (except banks themselves) now that governments have to a large extent underwritten the banking system.

Portfolio Activity

Activity last quarter was somewhat more biased towards buying new positions, a combination of high scoring quality stocks, and a few footholds in recovery stocks.

Purchases

Rexam is a global packaging company that supplies the relatively defensive end markets of food, beverages and healthcare sectors. It is fundamentally a high quality cash generative business. Rexam has a low rating after 2-3yrs of severe input price pressure (high aluminium price) and relatively high gearing. The high aluminium price has negatively impacted returns in the past few years, ensuring they have been on the end of a series of estimate downgrades through the period. The high gearing has intensified the de-rating. With the aluminium price now falling it is likely that returns should start to improve and upgrades have started and look likely to continue. As EBIT improves interest cover should improve from the current 3.5x to a much healthier looking 5x in the next couple of years which should in turn lead to a relative re-rating of the shares.

Throughout the year we continued to look for Quality defensive shares, but the problem we encountered was that rarely could these be found with attractive valuations. One exception to this last quarter was **Centrica**. Centrica is a high quality utility with a huge customer base, and will benefit from sharply falling wholesale gas prices in the coming year. The valuation at purchase was compelling, 9 times earnings and a 5.5% yield, and the shares had positive timing characteristics including forecast upgrades and an out-performing trend in the share price.

We purchased **Experian**, a top decile scoring stock that leads the world in credit checking. After suffering a steep share price fall earlier in the year when the credit crunch started to impact on their volume growth, the shares have more recently started to out-perform as their market leading position has allowed them to take share and management have been quick to cut costs to maintain profitability.

We also made our first investment in a company exposed to the very depressed global automotive industry, buying **GKN**. Like all our most favoured cyclical investments, GKN has a very strong franchise, being a global leader with a 40% market share in the production of constant velocity joints. The shares are very depressed, the valuation (0.6x book value, recovery PE below 5) very supportive, and the recovery potential over the medium term is significant with margins now forecast to fall to a multi-decade low in 2009. With global

automotive production likely to stabilise towards the end of 2009 now is a reasonable time to make an initial investment in this industry.

Sales

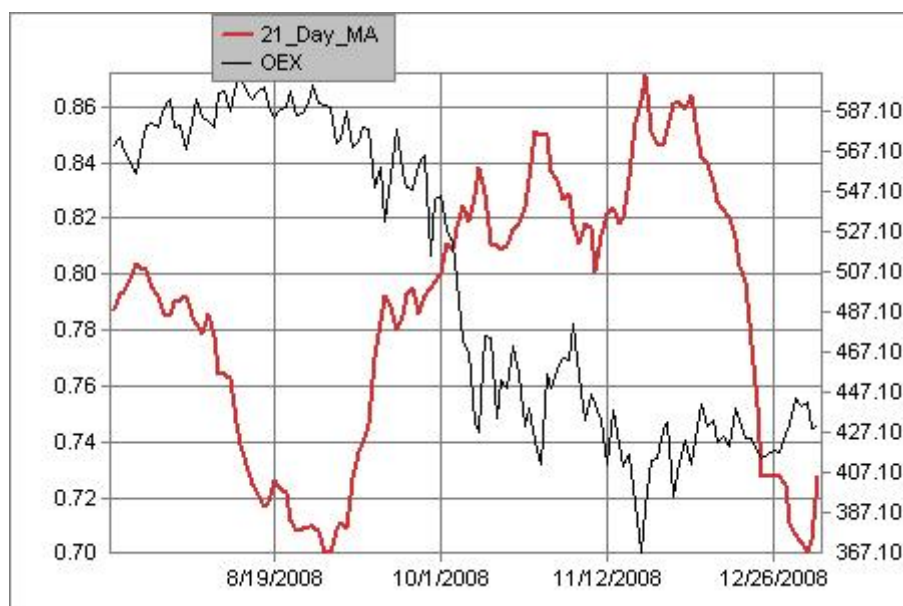
BBA Aviation a supplier of corporate aviation services in the US was sold as the corporate environment continued to deteriorate and an excessive debt burden put future growth at risk. **Senior** who are an automotive and aerospace component supplier was sold shortly before it halved due to fears over end markets slowing. A small position in **ITV** was sold – it remains a special sit with value in its programs but it was the large pension deficit and stretched B/S that raised the biggest questions for future cashflow. **British Airways** was sold for similar reasons. We also took profits in a couple of our larger defensive positions after strong outperformance through the year. Both **British American Tobacco** and **Unilever** had their overweights reduced.

Outlook

So where are we with markets?

“The crowd is usually wrong at extremes”.

I'm not particularly keen to call markets as it is extremely difficult thing to do but given we have just endured the worst year in our investment lifetimes I think it is appropriate to share my view of where I believe we are. Judging by recent observations fund manager consensus appears to have moved in just 2 months to markets put in a bottom in mid/late November, an economic recovery will occur in the second half of 2009, stocks are cheap and are discounting all the bad news. This latest Put/Call ratio below in red suggests that the extreme pessimism of October and November has quickly dissipated and in fact we are already back to confidence levels seen at the end of August 2008. Extreme negative sentiment is already no longer valid as a bull argument.



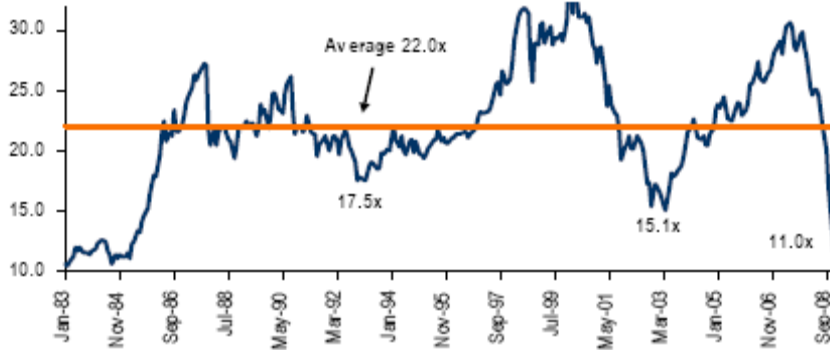
Source: Chicago Board Options Exchange

Whilst we saw a significant low in November, I am not convinced it was THE low for this bear market. This is based on my assumption that central banks and governments remain behind the curve and will be seen to be losing the fight against deflation before we really bottom. The bottom in November was surrounded by fear of the global banking system collapsing. However, now that governments have successfully underwritten their large banks (at the expense of currencies/tax payers/savers etc) THE low of this bear market may well revolve around a broader pensions / savings crisis and concern that the authorities are failing in their fight with deflation.

Global Equity Market Valuations:

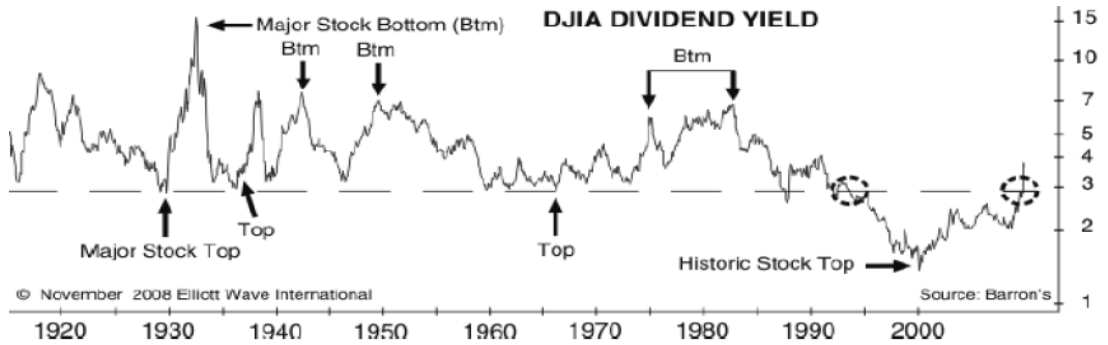
Whilst the fundamentals look poor - on many metrics equity valuations are at a multi-decade lows which is more supportive.

Chart 34: European market – Graham & Dodd PE



Source: MSCI and European Equity Strategy

However over the longer term the case is not clear that markets are so cheap:

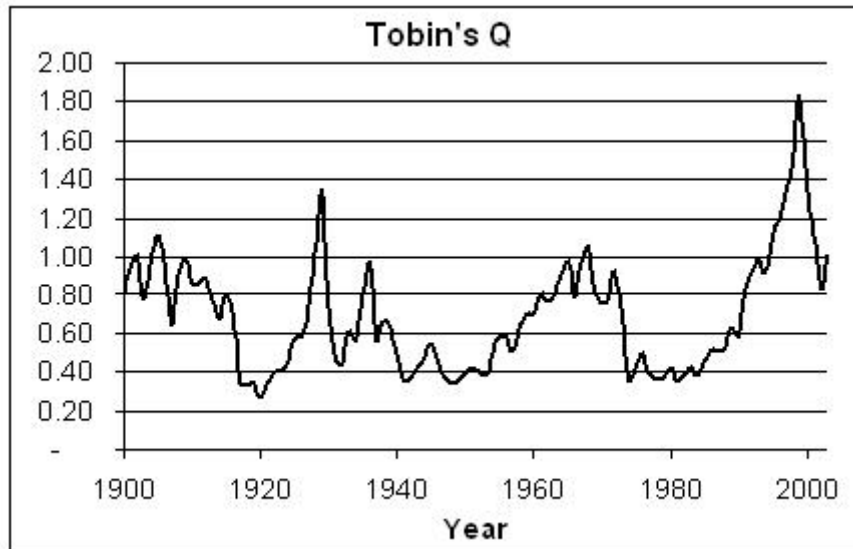


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Source: Barron's

This chart of the Dow Jones Yield in the US suggests that before this longer term bear phase of the market is over, dividend yields may climb somewhat higher.

An alternative approach is Tobin's Q which compares the US market value to the replacement value of the underlying corporate assets. The ratio fell to 0.7 in Dec 08 back to the long run average. For most of the last century the ratio has been between 0.4 and 1 although it did reach 1.9 at the peak of the dotcom boom. It has fallen below 0.4 no less than 3 or 4 times at the bottom of previous bear markets. This suggests that whilst authorities may be able delay the ultimate bottom of the bear market with their printing presses we may still need to go lower.



Source: Wikipedia

The UK Equity Strategy

So what is our strategy for the R&M UK Equity Fund at the moment? We have continued to focus on where we are within company lifecycles, monitoring valuations and factor returns. As a result of the large moves seen in markets during the second half in 2008 we have progressively moved from a Quality, Momentum and Value bias to more Quality and Value. We remain focused predominantly on a portfolio of high quality high scoring PVT companies. Those stocks which have strong pricing power and are less economically sensitive provide the best antidote to a more deflationary environment. Pharmaceuticals, tobacco, food retail and public sector related stocks through either defence or infrastructure spending remain attractive areas to invest. However, we have taken advantage of some very depressed share prices recently to increase exposure to some early cycle recovery stocks such as Travis Perkins, GKN and most recently Persimmon and Thomas Cook where we feel bad news is more than in the price. We continued more generally to increase consumer cyclical services exposure in Q4 increasing weightings in Support Services, Media, General Retailers and Travel & Leisure (we are overweight all of these sectors). We remain bearish of China's slowing economy and global growth for now so stay underweight resources and industrials. Within financials we prefer the outlook for non-life insurance companies to that of banks.

Daniel Hanbury
Portfolio Manager

