

RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity High Alpha Fund I Quarterly Report
June 2009

River and Mercantile

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UK Equity High Alpha Fund – Quarterly Report

Fund Aim

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

Portfolio Summary

Strategy AUM	£198.9m
Strategy Capacity	£1.1bn
Number of stocks	112
Largest Holding	HSBC 7.17%

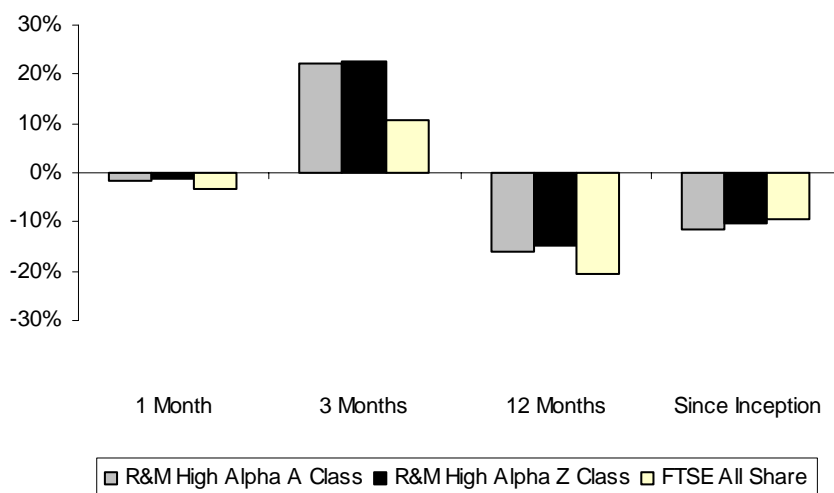
Risk Analysis Summary

Portfolio Volatility	16.88%
Benchmark Volatility	14.83%
Tracking Error	4.82%
Portfolio Beta	1.09
Active Money	52.06%

Performance as at 30 June 2009

Retail "A" Class Shares	Fund ¹	Index*	Difference
1 Month	-1.47%	-3.21%	1.74%
3 Months	22.19%	10.88%	11.31%
12 Months	-16.08%	-20.49%	4.41%
Since Inception ³ (%p.a.)	-11.48%	-9.55%	-1.93%

Institutional "Z" Class Shares	Fund ²	Index*	Difference
1 Month	-1.12%	-3.21%	2.09%
3 Months	22.64%	10.88%	11.76%
12 Months	-14.79%	-20.49%	5.70%
Since Inception ³ (%p.a.)	-10.16%	-9.55%	-0.61%



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 28th November 2006

Quarterly Report: Q2 2009

Quote for the Quarter

President "Bobby": Mr. Gardner, do you agree with Ben, or do you think that we can stimulate growth through temporary incentives?

Chance the Gardener: As long as the roots are not severed, all is well. And all will be well in the garden.

President "Bobby": In the garden.

Chance the Gardener: Yes. In the garden, growth has its seasons. First comes spring and summer, but then we have fall and winter. And then we get spring and summer again.

President "Bobby": Spring and summer.

Chance the Gardener: Yes.

President "Bobby": Then fall and winter.

Chance the Gardener: Yes.

Benjamin Rand: I think what our insightful young friend is saying is that we welcome the inevitable seasons of nature, but we're upset by the seasons of our economy.

Chance the Gardener: Yes! There will be growth in the spring!

Benjamin Rand: Hmm!

Chance the Gardener: Hmm!

President "Bobby": Hm. Well, Mr. Gardner, I must admit that is one of the most refreshing and optimistic statements I've heard in a very, very long time.

President "Bobby": I admire your good, solid sense. That's precisely what we lack on Capitol Hill.

From the Peter Sellers classic, *Being There*.

Key Observation

It has been a good quarter for those who kept the faith, for those value oriented investors who continued to support shares in companies as they fell to levels that reflected extreme fear rather than rational analysis. And this is my main message today: to remind investors that whilst the last three months has been better, we have only just started the recovery from irrational levels and there is a lot more to go for. A share that has gone up 100% will attract comments that it has gone up too far, that it has had its recovery. But if that same share had fallen 90% during the slump, it can double and still be down 80% from the top. And if that same share was valued at only one times recovery profits at the low point, it is only now valued at two times those profits. In other words there is a lot more to go for. The High Alpha strategy has a portfolio of shares in good companies, where the fundamentals are starting to improve, and remain remarkably undervalued on all measures. Spring is in the air.

Market background

Quarter:

Equity markets around the world had a strong quarter, encouraged by an apparent bottoming-out of the global economy. Many leading economic indicators, in many parts of the world became clearly less negative, and indeed some moved to levels that suggest a return to positive economic growth later this year. Credit markets showed material improvement, supported by a willingness of equity investors to inject new capital into companies to make them financially more robust. The capitalist system that had to be underwritten by governments and central banks last year is functioning again, moving capital to parts of the economy where rewards are perceived to be attractive.

The UK equity market delivered a positive return of 10.9%. The winners and losers were clear – cyclicals, bombed-out financials and recovery stocks did very well, defensive shares performed poorly. Smaller companies had a very strong quarter, rallying by 28.8%. Factor performance was clear, with an aggressive rotation from Momentum to Value.

How did we perform and why?

Quarter:

The portfolio returned 22.6% vs. 10.9% for the benchmark, an outperformance of 11.7%. I am glad that our better performance this year has continued, and as we are only just moving into the recovery phase of the stock market cycle I would hope that our stronger returns can be sustained.

Key performance contributors

Quarter:

Positive: overweight smaller companies, recovery category and the value factor all of which performed very well. It should be noted that eight out of my top ten contributors were smaller companies which at least doubled, the 'tail' (i.e. smaller active positions) in the portfolio worked really well. Avis Europe, Topps Tiles, Galiform and an underweight position in Royal Dutch Shell were the biggest individual contributors.

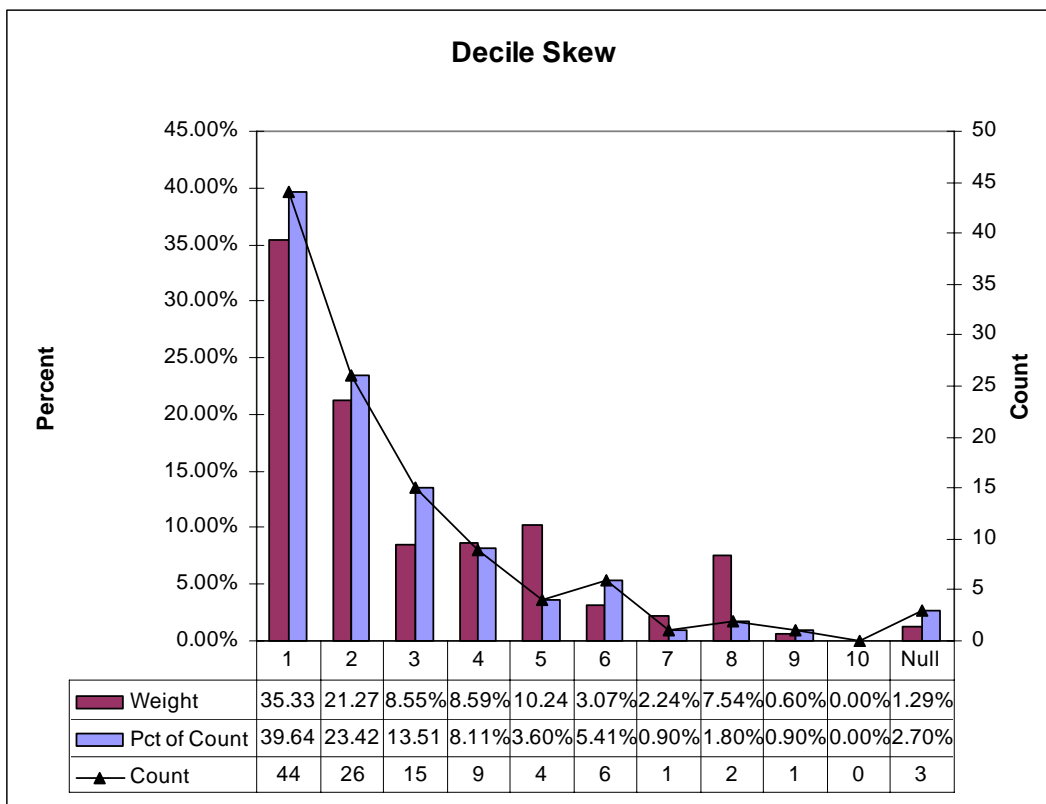
Negative: the only negative contributors to performance were at the stock level, notably not having a position in Standard Chartered which performed strongly as Emerging Markets recovered.

Longer Term Performance

My relative returns are now positive over a number of longer term periods, and since my records began are trending at 4% per annum. Performance since I started managing money at River and Mercantile is still sub-par but I would hope that this will become positive over time. I will regret not being more defensive as we moved into the credit crunch for the rest of my career, and I continue to apologise for that. However with our Stock market Cycle work we should defend better next time whilst not detracting from our ability to exploit the huge investment anomalies that exist at times like this, as we move into the recovery phase of the market.

Does the portfolio reflect our philosophy and process?

The chart below shows that our strategy has a significant skew towards high scoring stocks. Indeed on a stock count basis the skew is as high as it has been for some time, supported by the improved Timing score of many of our investments as their share prices and earnings revisions start to strengthen.



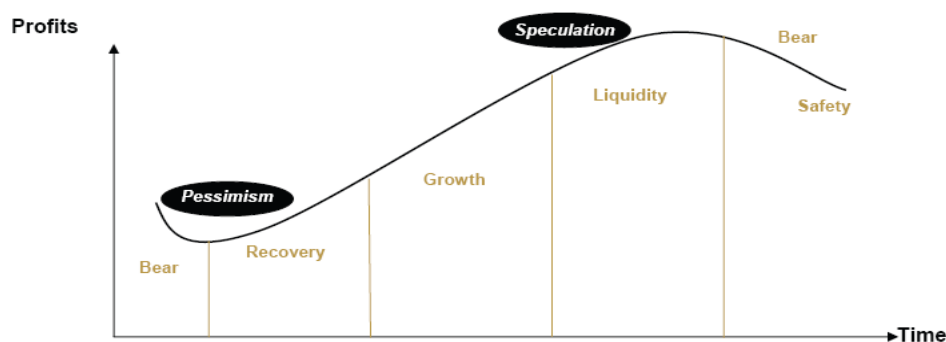
Source: River and Mercantile Asset Management LLP

Our category exposure shows a continued high exposure to Quality and Recovery, and with a notable increase in the Asset Backed exposure (to 6.5%). As we suggested last quarter we are becoming far more attracted to this category, Real Estate in particular, where we think commercial property yields are now too high and as a result attracting new, fundamental investors.

What themes occupy us at the moment?

The Stockmarket Cycle

We continue to frame the current environment in the context of the stock market cycle, and as we do for our sector skews we will report on where we think we are in the cycle on a regular basis.



	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 arrogance 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; 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, Government Bonds in particular, 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 overheated 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 will look to add further to this.

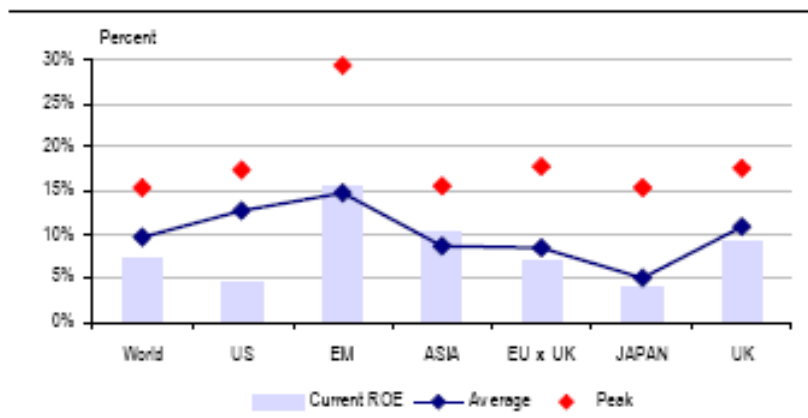
Financials

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 highly unlikely as borrowers and lenders seek to deleverage there is still substantial recovery potential, with banking management focused on loan re-pricing, cost-cutting, strategic disposals and reducing their own 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 being modestly overweight, with significant positions in **HSBC, Barclays, Lloyds and Royal Bank**.

Rights Issues and Shareholder Value

Last quarter we wrote about our backing of a number of capital raisings by companies, seeing this as a good opportunity to invest in good quality companies at the bottom of their Company Life Cycle. This is still our view but, as ever, Investment Banks see this as a fee-generating opportunity and are encouraging both too much and too many companies to raise capital. This reminds us that management need to go back to first principles of shareholder value generation. Issuing shares at a low price is dilutive to returns; when it is done to normalise a balance sheet that is fine, but it must not be done to provide "belt-and-braces" protection as future returns are unnecessarily diluted.

Like the capitalist system as a whole, shareholder value has developed a bad name over the credit crunch years. That is not because it is a silly concept; it is because it was abused at the top of the stock market cycle and became an excuse for financial engineering. Share prices are driven by the underlying value linked to them and management can enhance this through sensible use of cash flow and management of the equity base. In particular share buy backs can be good for shareholder value, but only if they are done when the shares are lowly valued and purchased out of free cash flow. Share buy backs must not be done at the top of the market, as a short term fix to get even higher returns. And if they have to be done at the low point in the market, then it is critical that the amount is sensible, complemented by aggressive cash focused restructuring, and not undertaken to ensure management and bankers keep their jobs.

Portfolio Activity

The bottom of the stock market cycle was largely confirmed during last quarter. As a result of this we continue to have a significant exposure to Recovery stocks, and have been adding to the Asset Backed category.

Refinancing (purchases)

There were a significant number of rights issues during the quarter aimed at strengthening balance sheets and providing capital to grow into the cyclical upturn. We supported a number of these, seeing an opportunity to apply new capital at the bottom of the cycle. We focused on businesses with strong franchises. The biggest recipients of our capital were **HSBC and Rio Tinto**. HSBC remains an attractive global banking franchise, which tapped shareholders rather than the public sector for equity to ensure that it continued to have one of the strongest balance sheets in the sector. Rio Tinto replaced Chinese investors with capital from its own

shareholders as it sought a more appropriate level of balance sheet gearing. We are confident that we will make attractive returns on both these investments.

Other investments (purchases)

Early in the quarter we detected a clear shift in risk appetite, and a preparedness by the market to buy into more illiquid investments. We used this as a signal to top-up a number of our existing high PVT scoring smaller company investments, such as **Topps Tiles** (1st decile recovery), **Trifast** (2nd decile recovery) and **Lavendon** (1st decile Asset Backed).

As regular readers of my Quarterly Reports will know, I like companies that buy-out competitors at the bottom of the market; far more sensible than the norm which is to make acquisitions at the top of the cycle. The current company to fit this theme is **Segro**, with the Slough Estates focused industrial property company bidding for its main competitor Brixton Estates. Because this is a rescue it is looking to pay a fraction of what the company was worth a few years ago, and a material discount to current net asset value. If this deal is completed it will be very accretive for shareholders over the medium term and we have added to our holding in this top decile asset backed stock as a result.

A previous example of in-market mergers, the traditional travel companies have seen their share prices underperform since we took profits last year. The muted demand environment for holidays alongside parent company distractions has led the stock market to re-focus on short-term fears rather than longer-term fundamentals. This is now an oligopolistic market, with well run companies that are focused on margins not volume, and because the shares have become very cheap again we have been buying them back. **Thomas Cook** has been the focus of our activity.

A new stock we purchased was **Computacenter**. This is a top decile scoring Recovery share in one of our favoured sectors, Technology. Over the last few years management have successfully transitioned Computacenter away from its origins as a reseller of Personal Computers towards an outsourcing model where it looks after whole PC networks for major corporates. This shift is now starting to bear fruit, returning the company to growth and enabling it to rebuild margins. As a result profits are starting to beat expectations, and with the valuation reflecting the company's low growth past, there is significant share price upside as the management deliver on their new business model.

Stocks that have delivered versus our PVT thesis (sale)

We sold out of **Rightmove** following a near doubling of the share price since we developed our PVT thesis on the stock. Whilst the business is an attractive one, and the estate agents it is exposed to are starting to see recovery, this became fully reflected in the share price which is now trading at a premium to our estimate of medium term worth.

We sold our position in **Aegis**, the media buyer. This followed strong relative performance, a return to a full valuation and concerns we had about likely late-cycle deterioration in global advertising spend.

We also reduced the fund's exposure to some early cycle consumer cyclicals following robust performance. This included taking some profits in retailers such as **Kingfisher** and **M&S**.

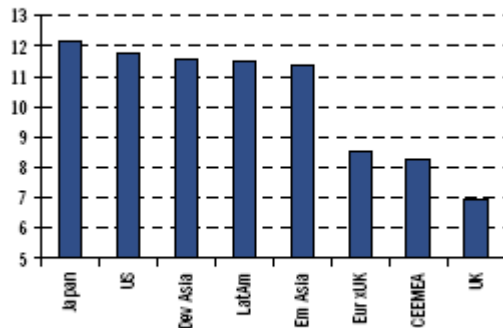
Stocks we have cut (sale)

We sold our position in **Shanks**. Following a disappointing trading update, and an unnecessary fund raising, the MoneyPenny score deteriorated. We decided to switch our capital into higher scoring stocks.

The Valuation of UK Equities

If I could be patriotic for a moment and state that the UK Equity market is very cheap, one of the best value in the world. Seven times trend PE! Buy while stocks last!

Figure 23. PE Based on 10 Year Average E

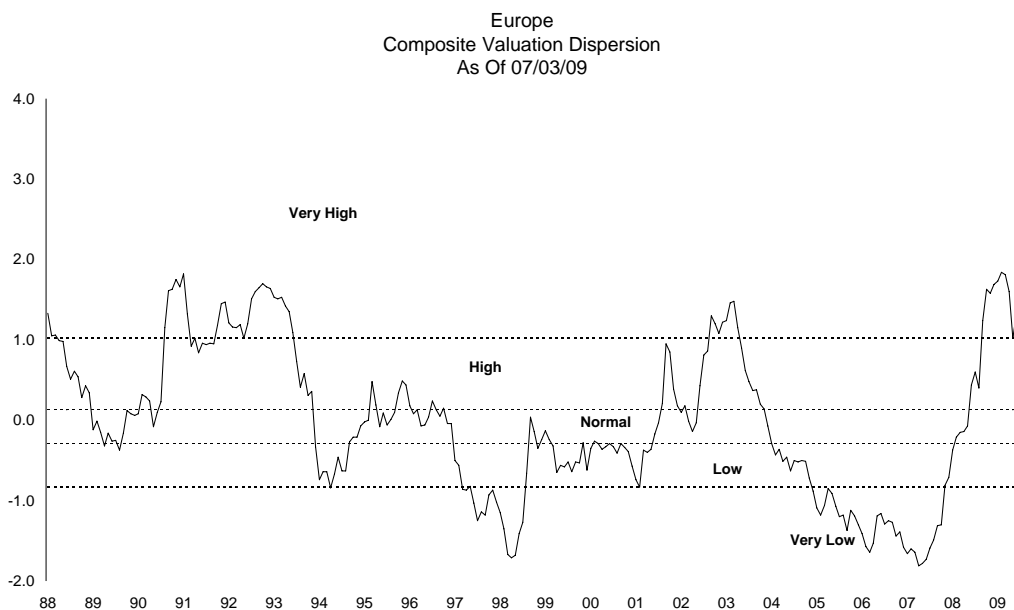


Source: CIRA, Factset

As for the High Alpha Portfolio it continues to offer very compelling value; only 1 x book value, every 100p of investment is backed by 215p of sales, and the earnings multiple is lower than the market.

Outlook

Whilst the Value Gap (the spread between highly rated stocks and lowly rated stocks) that we outlined last quarter has reduced somewhat, it 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. These were strong periods for my approach.



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, probably needing an actual return to economic growth rather than just an improving trend to continue their recovery. But, if we need to wait, the wait will be well worth it. Valuations are low in general, and 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 emerge into springtime for the world's economy the returns to the High Alpha strategy will be high. There is a lot more to go for.

Hugh Sergeant
Head of UK Equities

Fund Facts

Launch date	28th November 2006	
Fund manager:	Hugh Sergeant	
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:	4-8%	
Product capacity:	£1.1bn (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	B1DSZM4	B1DSZP7
ISIN	GB00B1DSZM47	GB00B1DSZP77
Bloomberg	RMUKEHA LN	RMUKEAA LN

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