

RIVER AND MERCANTILE  
ASSET MANAGEMENT

UK Equity High Alpha Fund I Quarterly Report  
June 2008

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# 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 (GBP)	£ 232,175,008
Strategy Capacity (GBP)	£1.1bn
Number of stocks	108
Largest Holding	BP 7.04%

#### Risk Analysis Summary

Portfolio Volatility	10.87%
Benchmark Volatility	10.77%
Tracking Error	3.60%
Portfolio Beta	0.95
Active Money	56.26%

### Performance as at 30 June 2008

Retail "A" Class Shares	Fund (%)	Index* (%)	Difference (%)
1 month	-7.32	-7.06	-0.26
3 month	-6.23	-1.45	-4.78
Since inception	-12.97	-2.90	-10.06

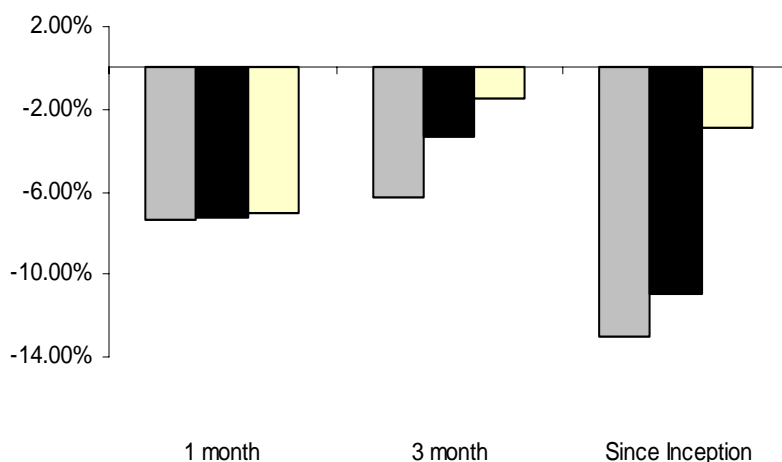
\*Index: FTSE All Share (Total Return)

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

Institutional "Z" Class Shares	Fund (%)	Index* (%)	Difference (%)
1 month	-7.22	-7.06	-0.15
3 month	-3.31	-1.45	-1.86
Since inception	-10.97	-2.90	-8.06

\*Index: FTSE All Share (Total Return)

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



R&M High Alpha A Class
  R&M High Alpha Z Class
  FTSE All Share

Source: River and Mercantile Asset Management LLP

## Investment Commentary

### Quotes for the Quarter

*"Looking for a good investment is nothing more than looking for a good bargain".* John Templeton, who sadly has just passed away.

*"While neither I nor anyone else knows if our period of underperformance is over, it ought to be, if valuation begins to matter more and momentum less in how the market behaves".* Bill Miller, Fund Manager May 2008.

### Market background

The UK equity market fell 1.5% during the quarter. A rally early in the quarter was followed by a sharp pull back in June. Global equity markets were undermined by ever increasing oil prices, stagflationary fears and renewed signs of credit distress. The UK economy deteriorated as house prices fell and cash flows were squeezed by price rises. Resource related companies dominated positive returns, the big fallers were financials and domestic cyclicals. The market was narrow with the majority of shares underperforming the benchmark; mid cap companies fell 7.5% and small cap 5.2%. Value shares have continued to do poorly, quality and momentum did well. A bear market is the reality for most of the stock market, that which excludes the resources complex. For example smaller companies excluding Investment Trusts have fallen 43% from their peak early last year.

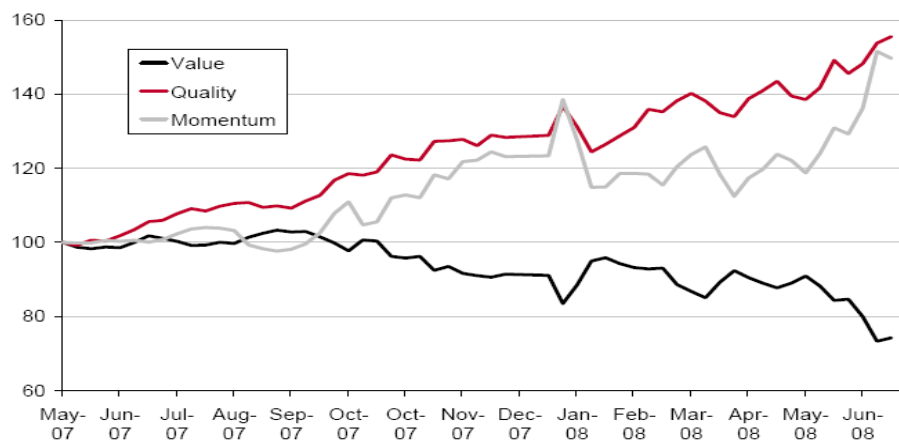
Increasing global inflationary pressure was the most significant macro theme during the quarter. Over 3 billion consumers in the world are now exposed to retail price increases of 10% or more. There are some quite different interpretations of the issues; mine is that this is an end cycle phenomenon, dominated by excess demand in developing economies caused by loose monetary policy at the end of a ten year bull run, and by the last speculative run up in the resources complex driven by a desperate hunt for non-credit related assets. The global economy and rapid build up in manufacturing and service capacity in developing economies has been a source of deflation for the last ten years; this benign environment is no more, China and its fellow developing countries are for now a source of inflationary pressure. However the developed world's exposure to the credit crunch and falling asset prices is an equal and opposite force, such that it is unlikely that inflation in developed economies gets out of hand.

### How did we perform and why?

Against the background outlined above we underperformed, returning -3.3% compared to the benchmark return of -1.5%. The return for 2008 to date is -11.8% versus the index return of -11.2%. This is a disappointing return, especially following a difficult 2007. However the market has favoured stock characteristics that have not historically been my source of alpha, namely end-cycle momentum. When the market returns to looking for fundamental anomalies across all sizes of company, and the bear market in value shares and small cap comes to an end, we will do very well indeed. I appreciate that our clients in the High Alpha strategy are having to be very patient but I do think you will be rewarded. Whilst blue chip companies such as Daily Mail have 100% upside then I am sure the waiting game will be worth it.

The chart below shows the returns to different factors over the last year:

**Figure 1: Style performance over the last year: UK Large cap**



Source: UK Large cap universe: Top quintile – bottom quintile: Non-financials: May 2007 = 100

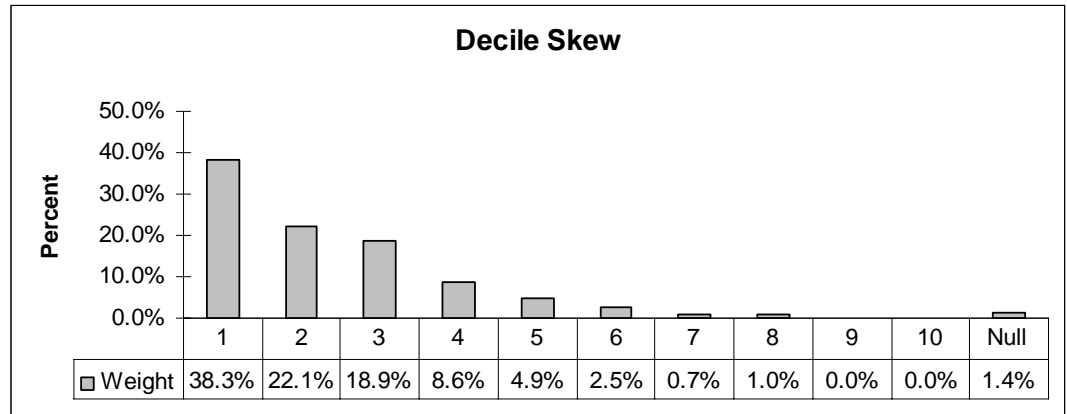
## Key performance contributors

Positive: Stock selection (BATM, Sibir), M&A (Thus)

Negative: Underweight resources (Royal Dutch, BHP, Rio), value overweight, small cap overweight

## 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. Over 60% of the fund is in the top two deciles of PVT stocks, 80% in the top three, only 1% in stocks that do not score.



Source: River and Mercantile Asset Management LLP

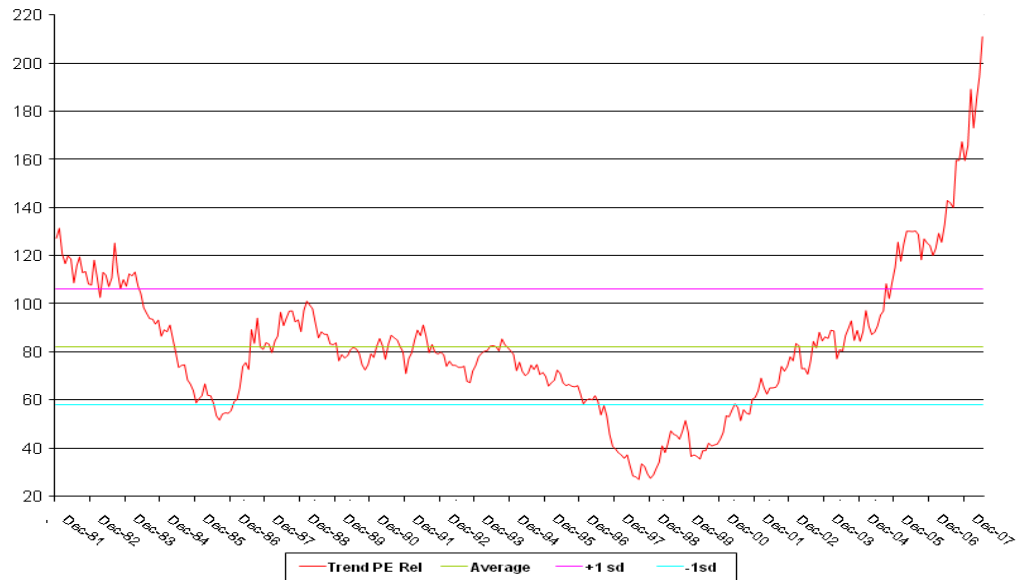
## What themes occupy us at the moment?

*Are long term investors facing extinction?* For various reasons the stock market has become imbalanced. The weight of money is with short term operators not long term ones, with long short mandates not traditional long only, with tomorrow's earnings revisions not the five year fundamental potential of a business model, with "will I make (or not lose) money tomorrow?" not "what is the difference between the current share price and the medium term worth and potential of the business?". The result is huge volatility, share prices that often bear little relationship with medium term worth, the 'forced' withdrawal of long term money due to underperformance or the fear of it, and as a result an inefficient and increasingly expensive market for raising new capital. Traditional money has tried to support bank capital raising at a time of need, as it supported share buy backs when capital was less scarce, but this avenue is now closed. Instead banks are having to seek long term investors from Sovereign Funds, many of which are the beneficiaries of cash flow from the most short term, and momentum driven market one can remember for some time, namely the market for crude oil. The question you will ask me is whether this new world is permanent and therefore traditional managers like myself need to adjust what we do? The answer to this is that I do not know, and that all we can do is have a balanced approach, to be conscious of how Mr. So (short-term operator) might look at one of our potential investments and balance this thought with the medium term potential and value gap.

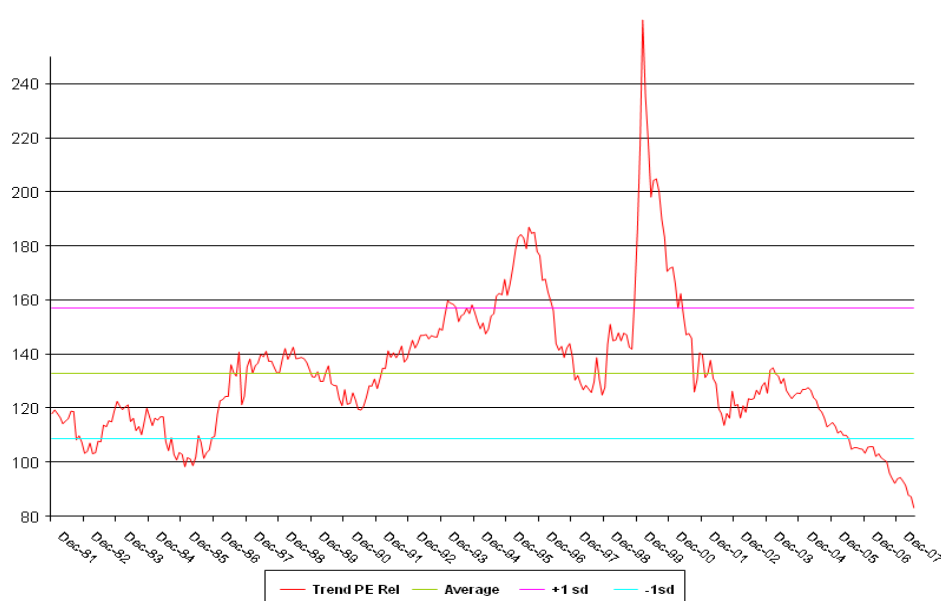
*Is any price too low for a share?* The majority of the stock market (the part that excludes resources) is in a bear market. Share prices fall in anticipation of bad news, and then fall again if the anticipated bad news is delivered, and then fall again when a competitor announces bad news, and then fall again when the oil price goes up (again). As a result the psychology of the market is that no price is too low and that medium term valuations can be ignored. Take Daily Mail as an example. This is a company that has been around for a reasonable period of time, is controlled by the Rothermere family who have run it sensibly for the long term, that has the strongest traditional newspaper franchise in the UK but that has successfully diversified into less mature and less advertising sensitive parts of media such as business to business information provision, that has a strong balance sheet and generates lots of cash. What value is put on this 2nd decile PVT scoring business? A frighteningly high earnings multiple of 5.5 times! Profits could halve and it would still look cheap. This is mad, mad, mad but in this type of market who knows where prices will go in the short term as a market dominated by Mr. So has little time for medium term worth.

*Extremes.* I think that we are close to the extreme spread of valuations and sentiment that was witnessed at the end of the TMT bubble and during the early nineties recession. Below I show a couple of Mirabaud normalised earnings charts that make this very point – Mining off the chart in an expensive direction, Media off the chart in a cheap direction. Most sectors are either at the top (Oil, Chemicals, Industrial Metals, Tobacco, Utilities) or bottom (have a guess....Banks, Life Assurance, Leisure, Retail, Technology and Pharma) of these normalised earnings multiples. When we inflect it will be big.

### Mining



### Media



Source: Mirabaud Group

*When?* I have been too early to buy anomalies. However our Timing criteria has saved the High Alpha strategy from a repeat of the last few months of 2007, but I have still been too early. When will the inflection happen? It does feel like we need an end to the upward momentum in the oil price, a moderation in inflationary pressures and therefore more flexibility in UK monetary policy before we get a swing back in favour of the types of anomalies that I like most and would like to buy more of.

*Oil?* There has been lots of learned commentary on the oil price over the last few months. Here is a technical observation from Bloomberg in mid-June which is probably as valid as any, as the oil price seems to be more about what the marginal buyer is prepared to pay than fundamentals: 'The rally that drove oil to a record level last week surpassed the gains in Internet stocks that preceded the dot-com crash. Crude rose

697% since trading at \$17 a barrel in November 2001, greater than the 640% increase in the Nasdaq index'. We all know what happened next, and we can all see around us the demand destruction that is happening in the oil complex. We are driving less, flying less, buying smaller cars, taking subsidies off oil, putting subsidies on alternative fuels. The demand fundamentals for crude are deteriorating rapidly but still the price goes up? This can't be sustainable, can it?

*Marginal buyers / sellers.* This is how I think we can square the circle, explain why prices can get so far away from medium term worth. It is because marginal buyers and sellers seem to dominate pricing. I remember not that long ago being told that the reason that UK house prices would carry on going up (despite clearly being too expensive) was that new supply was very tight in relationship to ever increasing demand (sounds familiar). But in reality house prices were driven up by what the marginal buyer was prepared to pay, and this kept on going up because dinner party consensus told one So. And then along came the credit crunch. The same is happening in oil...prices are clearly too high (that is why demand is falling), but the marginal buyer is prepared to pay more because oil is NOT a house, or a corporate bond, or a cyclical share. And as for Iron Ore, how can a 100% increase in price over a year be justifiable or sustainable, but for now Chinese steel manufacturers think they can afford it or pass it on. But at some point they won't be able to, and Mr So goes from marginal buyer to marginal seller and dinner party conversation moves on. And as for marginal sellers, they are in panic mode especially when it comes to smaller quoted companies or cyclicals. No price is too low, such as Harvey Nash: Market Cap £21m, net cash £4m, profits after tax £5.4m, or under 4 times earnings!

### **Portfolio activity**

We continue to take a balanced approach to portfolio construction, making sure that we combine high quality, non-cyclical PVT investments alongside the valuation anomalies presented by some of the most depressed domestic consumer companies. The PE on the portfolio is a very low 8 times, the yield 4.3% with lots of sales and asset backing. The return on equity on the portfolio remains well above the cost of capital.

### **Existing investments we have become more confident about (purchases)**

Quality category companies remain the largest part of the portfolio at 50% of capital. We added to our Pharmaceutical exposure, where PVT scores were improving, where newsflow regarding both new drugs and the patent threat to existing therapies has improved, and which just look too lowly valued during this period of profits uncertainty. Purchases included **Glaxo** and **AstraZeneca**. We also added to our Defence exposure, buying **BAE Systems** after a period of weakness. **BAE** is a top decile scoring PVT stock where a strong order book and profits outlook combines with a supportive valuation. Within smaller companies we added to our investment in **Celsis**, a high scoring producer of microbial detection kits for the pharmaceutical and food industries. The company has grown at over 10% p.a. over the last five years, earns a high return on investment and is not cyclical. Despite these attractive attributes it is valued at less than 10 times earnings.

We have added to our recovery category shares so that they now constitute 32% of the portfolio – the focus was on existing investments where we have high conviction in our PVT thesis such as **BP**, **Rentokil**, **JD Wetherspoon** and **Galiform**. This category has been a difficult one over the last year but now is not the time to give up on it given the extremely low valuations put on businesses with great franchises. For example **Galiform** is the dominant supplier of kitchens to the jobbing builder; demand will undoubtedly be weak over this year and next but, given the strength of their balance sheet and relationship with their customers, they will grow market share allowing them to generate at least 10p of EPS in 2011, attractive in relationship to a current share price of 37p.

The Growth category is currently dominated by resource related stocks. We have a more modest exposure to this area at 12% of capital. Within this category **BATM** (telecom software) and **Sibir** (Russian diversified oil company) had strong updates, we bought more and they are both top ten active positions.

We continue to have a modest exposure to asset backed stocks (3.5% capital) judging that it is not yet time to have significant exposure to this under-performing area. However some banks are starting to appear in this category and it is probably from here that they will prove reasonable investments. Once lenders are trading at discounts to book value (post-possible writedowns) then good returns can be achieved. Regarding

banks we did reduce our underweight position, supporting the **RBOS** rights issue and buying **Lloyds TSB**.

#### **New investments (purchases)**

We purchased **Spectris**, a MoneyPenny top decile scoring Quality engineering company. They develop and market precision instrumentation and controls with a focus on providing niche applications directly impacting on user customers' process performance. They have a history of generating a high return on capital and the 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 sales grow. This in combination with benefits from recent currency moves 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 cash flow generation and improved business organisation provide the potential to regain a premium valuation in time.

We also purchased a new position in **Drax**. It is a top decile scoring Quality stock, that operates the Drax coal fired power station, the largest in Europe. Returns from the company are on a strongly improving trend as they benefit from the increasing electricity price; the valuation is low compared to other utilities and low in relationship to its strategic value in a consolidating industry; timing is supported by positive earnings revisions and a strengthening share price.

#### **Stocks that have delivered versus our PVT thesis (sale)**

We continued to benefit from bid activity. This quarter **Thus** was bid for by Cable & Wireless at a 50% premium to its pre-bid price; we sold part of our holding. We reduced our exposure to **International Personal Finance** which has performed extremely well relative to other lenders.

#### **Stocks we have cut (sale)**

We took modest profits from our position in **Schroders** following the April rally in financials, selling the whole position. We have remained underweight financials – whilst the value case is strong, there remains too much uncertainty regarding the profits outlook. We also sold out of **Northern Foods**. Whilst the management are doing a very good strategic job, rationalising the portfolio and reducing costs we felt that in the short-term pressures from raw material price increases and falling sales into M&S would impact the delivery of recovery profits.

#### **Outlook**

*Waiting for the bell to ring.* The key theme over the next few months could well be listening out for the ringing of the bell at the top of the oil price boom and any other commodity price which has yet to reflect the slowing world economy. Only then will the pressure start to come off inflation and interest rates and sponsor a stronger equity market and a swing towards our favoured PVT anomalies.

The UK economic outlook remains difficult with a sustained period of below trend growth seemingly inevitable, as consumers and the public sector rebuild cash flows. However the equity market is discounting much doom and gloom, with single figure PE's on the majority of the market seemingly anticipating a fall in corporate profits.

For the developing world the outlook is far less attractive than resource prices discount, indeed weak stock markets in India and China suggest a high degree of worry. Inflation is too high in most of the developing world, interest rates need to continue to go up and economic growth will moderate as a result.

The High Alpha strategy is exposed to high scoring MoneyPenny stocks, with lots of medium term potential and huge valuation gaps. Macro issues, short termism and fear are dominating share price movements at the moment, but when we see a reversion to medium term fundamentals we will return to generating positive absolute and relative returns for our clients

**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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