

RIVER AND MERCANTILE
ASSET MANAGEMENT

UK Equity High Alpha Fund I Quarterly Report
September 2008

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	£192,558,065
Strategy Capacity	£1.1bn
Number of stocks	99
Largest Holding	BP 6.73%

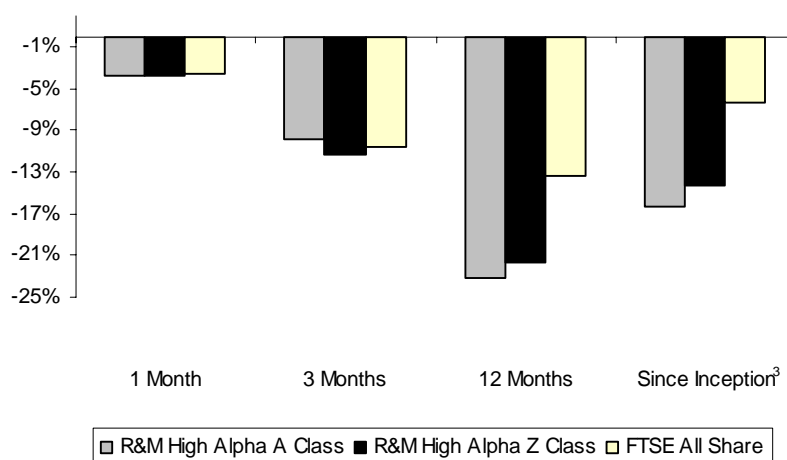
Risk Analysis Summary

Portfolio Volatility	12.58
Benchmark Volatility	12.06%
Tracking Error	3.59%
Portfolio Beta	1.00
Active Money	58.24%

Performance as at 30 September 2008

Retail "A" Class Shares	Fund ¹	Index*	Difference
1 Month	-15.02%	-13.24%	-1.78%
3 Months	-13.12%	-12.18%	-0.94%
12 Months	-28.68%	-22.25%	-6.43%
Since Inception ³ (%p.a.)	-14.14%	-8.33%	-5.81%

Institutional "Z" Class Shares	Fund ²	Index*	Difference
1 Month	-14.93%	-13.24%	-1.69%
3 Months	-12.82%	-12.18%	-0.64%
12 Months	-27.68%	-22.25%	-5.43%
Since Inception ³ (%p.a.)	-12.90%	-8.33%	-4.57%



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 2008

Quote for the Quarter

"To buy when others are despondently selling and to sell when others are avidly buying requires the greatest fortitude and pays the greatest ultimate rewards." Sir John Templeton

Key Observation

Financial markets around the world are in turmoil. Share prices have been battered. The short-term outlook is 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 generational low price. Fortitude is indeed required at this point in the stock market cycle, as is a historical perspective. The capitalist system will survive, sensibly funded enterprises will emerge from this downturn as strong as ever, and PVT stocks that we buy today will prove to be bargains.

Market Background

Equity markets around the world had a very difficult time last quarter as the escalating credit crunch caused a flight from all 'risk' assets. Forced and panic selling was the order of the day. The UK equity market fared as badly as others, delivering a negative return of -12.2%. The winners and losers during the quarter related to fear and greed. Defensives dominated the list of winners, and the defensive characteristics of mega cap companies helped them outperform; mining shares were at last weak, as the slowdown in global growth finally caught-up with the Resources bubble. Other cyclicals also came under pressure. Surprisingly banks did not underperform. HSBC, the dominant constituent of the UK banking sector, is seen as a safe haven due to its strong balance sheet. Quality styles did better than Value; Growth and Momentum started to underperform.

All the excesses of the last few years are unwinding rapidly, and in the process impacting a lot of bystanders. Credit was the first standard deviation (abnormal) event to start to unwind; this swiftly moved on to real estate, starting in the USA but spreading around the world. More recently the twinned dominoes of commodities and emerging markets have fallen. Of these casualties, credit is clearly the most serious because of its role in oiling the wheels of the global economy. A necessary process of deleveraging is happening, but lenders are trying to do this too quickly (almost as irresponsible on the way down as they were on the way up!) causing liquidity to disappear from the world of credit, the weaker banks to collapse and the stronger ones to stop lending to each other. Governments and Central Banks around the world have stepped in to provide liquidity and act as the buyer of last resort of assets from failing institutions. These have been reactive actions, but in recent weeks authorities have tried to get on the front foot. The Troubled Assets Relief Program (TARP) was the start, and will be followed by globally co-ordinated interest rate cuts, and state financed injections of capital into banks as just announced by the UK Government.

How did we perform and why?

The portfolio returned -12.8% vs. -12.2% for the benchmark. Relative performance benefited from the beginning of the flight from Resources, but suffered from the ever increasing risk aversion of investors. The latter caused defensives to perform very well, and we are underweight the expensive defensives. It also caused an improving performance from the Value factor to drift off late in the quarter.

It is disappointing to underperform during a period when one of our key views (bearish Resources) came right. That said, our relative performance trend has improved since earlier in the year; the Value factor is at least bottoming out and both absolute value and value spreads are hugely supportive. Meanwhile the Resources underweight should stand us in good stead for some time. We remain resolutely of the view that our portfolio of investments will produce very strong performance over the medium term.

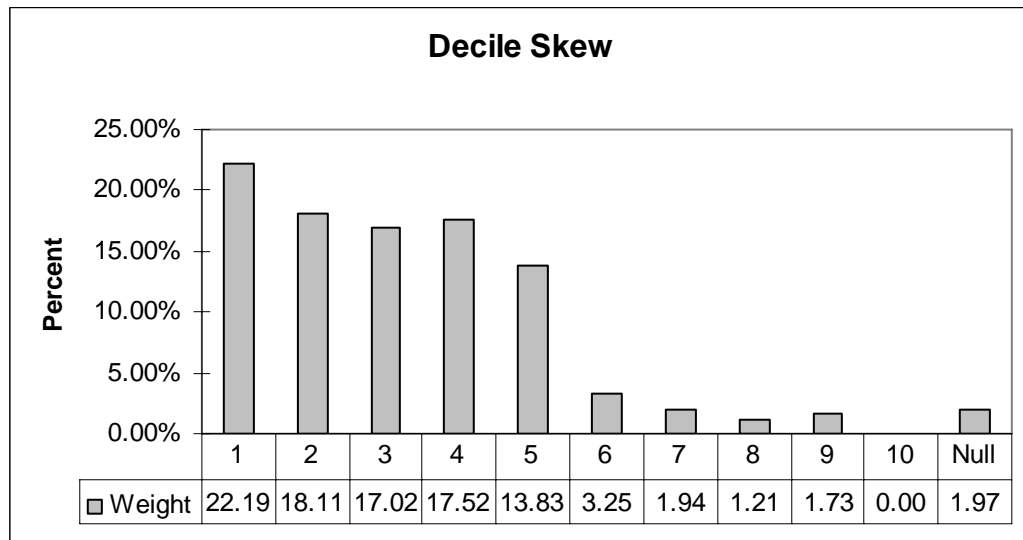
Key performance contributors

Positive: Resources underweight, in particular Rio Tinto and BHP Billiton; take-overs (including nCipher); GlaxoSmithKline overweight.

Negative: Defensives underweight, including Tesco and British American Tobacco; stock selection in banks, namely overweight HBOS, underweight HSBC.

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. Of these high scoring stocks we maintain a 50% exposure to Quality companies, and have continued to increase the Recovery exposure so that this accounts for 38% of the strategy.



What themes occupy us at the moment?

Resources

We have been bearish on commodity prices and related stocks for some time now. This was as much a bubble as credit ever was, and the unwinding of this excess has only just begun. The fundamentals of commodity prices have been undermined by falling global growth, and at the same time speculative hedge fund and investment banking capital is being withdrawn, to be followed by tail-end Charlie money. Prices will return to close to their long term averages, and could even overshoot on the downside. On this basis, oil is still well overbought and this is now our most underweight sector, following the more rapid demise of the mining sector. There is of course a big positive in all this, namely the slaying of global inflation. Global GDP is heading below trend, credit is very tight, and unemployment will be feared the world over. So inflation is dead for now and surely the Bank of England will be prepared to recognise this by cutting interest rates aggressively.

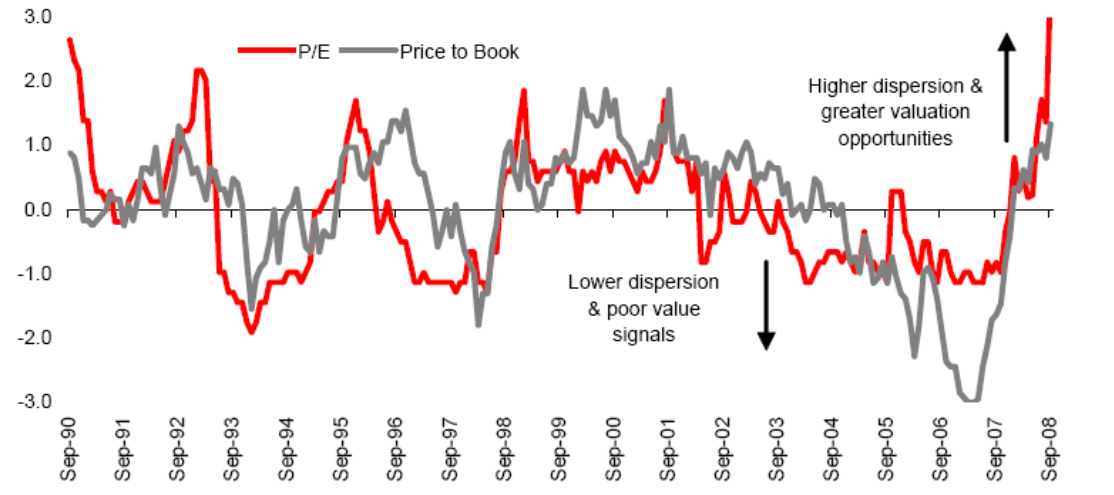
Asset Prices and Monetary Policy

Much of the world's ills can be traced back to the inability of monetary policy to factor in asset price inflation. As a result, interest rates were held too low around the globe (in the US and UK in particular) for much of this decade, fuelling the real estate and credit bubbles. Now the Bank of England has been far too slow to reduce rates, being focused on end-cycle, commodity-driven inflation rather than the far more important real estate and credit implosion. Asset inflation must be targeted from now on so that potentially destabilising bubbles are addressed earlier than they have been over the last couple of decades.

The 'Great Sale' and Valuation extremes

The 'Great Sale' that I have talked about already this year is now becoming the 'Sale of the Century'. Men from Mars, backed by soundly financed banks, would be snapping up whole tranches of the consumer facing economy for fractions of their true worth. The whole market is cheap, but within markets the value spread from high to low is as high as previous peaks over the last couple of decades.

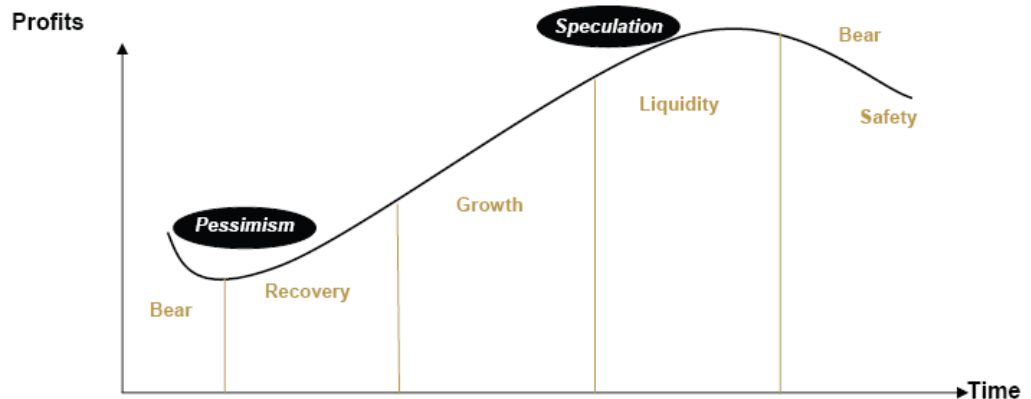
Value dispersion in Europe, measured in standard deviations away from average (i.e. Z-score)



Source: SG Quantitative Research

The result of this is that the 'most attractively valued portfolio I have ever had the pleasure of managing' (mentioned in previous reports) has just become even cheaper. According to the Style Research report at the end of September, the earnings yield of the High Alpha strategy is now an amazing (even more amazing than last time!) 14.3% (or an average PE of 7 times), or 3 times ten year gilts. If this isn't give away territory I don't know what is. After all Ben Graham remains happy with a multiple of only 2 times Government bonds.

The Stockmarket 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 Bear phase of this stock market is clearly a particularly acute one, with the FTSE All-Share Index down almost a third from the peak and Smaller Companies having halved.

However the catalysts for the Recovery phase are being put in place – loosening monetary policy, Central Bank support, capital rationing and a capitulation from investors as risk premiums go through the roof. We will come out of this, as we have done in all other cycles, and we will generate strong absolute and relative returns for you as we move into the Recovery phase.

Portfolio Activity

Existing investments we have become more confident about (purchases)

We added to our position in a number of high Quality, relatively economically defensive companies. These included increasing our Pharmaceutical exposure through topping-up AstraZeneca, adding to the position in BAE Systems, and also increasing our position in Unilever where a very high quality new Chief Executive was appointed.

We continue to like self-help stories within Recovery sectors, in particular where in-market mergers are providing cost saving and pricing power opportunities. Along this line we have added to our position in the traditional travel companies, TUI and Thomas Cook, as their oligopoly position will allow them to come through this consumer downturn in an even stronger position. We have become higher conviction regarding British Airways, following its announced merger with Iberia, and proposed merger with American Airlines' North Atlantic routes. The cost cutting opportunities are significant and the market position at Heathrow becomes even more dominant. The shares are on a recovery PE of only 4 times.

We also like the proposed LloydsTSB merger with HBOS. Here we seem to be alone, but in my admittedly limited experience of credit crises, buying a key competitor for a low price, close to the bottom of the cycle is good for shareholders especially when the deal is implicitly backed by the Government. HSBC made its name, and made a lot of money for its investors, buying Midland bank at the bottom of the last real estate crash and I am prepared to back LloydsTSB's management to achieve the same for shareholders this time round.

New investments (purchases)

Smaller company share prices continued to come under pressure, and have now fallen over 50% from their peak eighteen months ago. This indiscriminate fall has continued to produce some amazing buying opportunities. One example of this is Centaur Media, a high quality publisher and conference organiser for titles such as The Lawyer and Fund Strategy. They have strong market positions, generate lots of cash and have limited gearing. Profits will be impacted somewhat by a UK recession but this is more than discounted in an earnings multiple of less than 7.

Stocks we have cut (sale)

We sold our entire holding in JJB Sports following a profits warning. New management have struggled to turn the company around against the background of a retrenching consumer.

Stocks that have delivered versus our PVT thesis (sale)

We continued to benefit from bid activity, and again looked to realise our investments in bid situations pretty early on in the process due to bids potentially failing because of financing risk. We sold out of a number of holding that received bids, the most successful being nCipher where the bid premium was almost 100%.

We also took profits in our E&P and Oil Services stocks. With the oil price starting to come under pressure we felt that the Potential in these investments was reducing. Sales included Lamprell and JKC Oil & Gas.

Outlook

The credit crunch is in full flight, impacting on risk premiums of all investments and having a serious knock-on effect on the real economy with the UK clearly now in recession. However policy measures are being taken to see us through the credit crunch and allow economies to bottom-out over the next year. Risk appetite has collapsed, the reason for the huge valuation anomalies that have opened up, and the reason for UK equities now yielding more than government bonds.



Source: DataStream, (as at 26/09/2008)

The cross-over shown above is rarely sustainable and was last seen in early 2003 before a significant rally. What is completely absent at the moment though is confidence, with extreme fear and suspicion dominating the actions of bankers and investors. It is very difficult to say what brings fear to an end? Perhaps the activity of Governments and Central Banks starts to get ahead of the curve, perhaps valuations get to such a low point that some of the cash that is parked by institutions is put to work, or perhaps we just wake up one morning and think enough is enough. Until that moment we are working day-and-night on investment, managing the risk in the portfolio on one hand but also being very focused on the huge PVT opportunities that are out there. Through the depths of this bear market I am still happy to refer to the great investors who have seen much of this before:

"To buy when others are despondently selling and to sell when others are avidly buying requires the greatest fortitude and pays the greatest ultimate rewards." Sir John Templeton.

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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River and Mercantile Asset Management LLP
30 Coleman Street
London
EC2R 5AL
Telephone: +44 (0)20 7601 6262
Facsimile: +44 (0)20 7600 2462
Email: enquiries@riverandmercantile.com
www.riverandmercantile.com