

RIVER AND MERCANTILE  
ASSET MANAGEMENT

UK Equity High Alpha Fund I Quarterly Report  
December 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	£151m
Strategy Capacity	£1.1bn
Number of stocks	108
Largest Holding	BP 8.04%

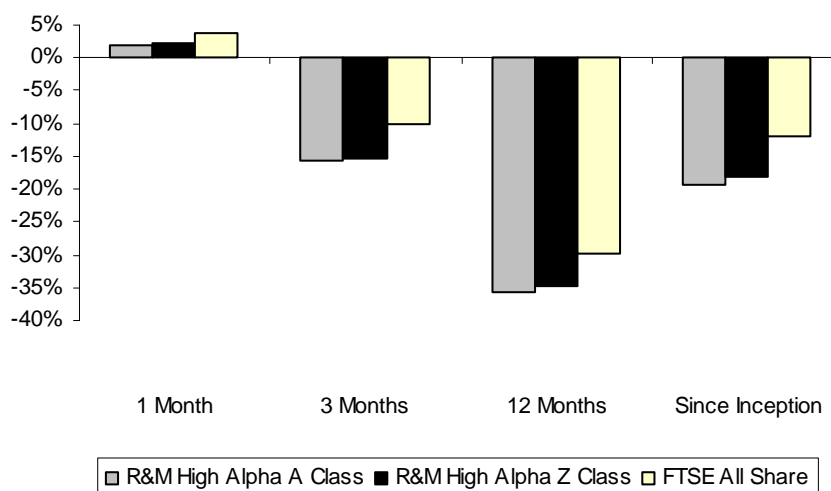
### Risk Analysis Summary

Portfolio Volatility	13.49%
Benchmark Volatility	12.59%
Tracking Error	3.67%
Portfolio Beta	1.03
Active Money	52.07%

### Performance as at 31 December 2008

Retail "A" Class Shares	Fund <sup>1</sup>	Index*	Difference
1 Month	1.88%	3.67%	-1.79%
3 Months	-15.60%	-10.19%	-5.41%
12 Months	-35.77%	-29.93%	-5.84%
Since Inception <sup>3</sup> (%p.a.)	-19.37%	-12.00%	-7.37%

Institutional "Z" Class Shares	Fund <sup>2</sup>	Index*	Difference
1 Month	2.12%	3.67%	-1.55%
3 Months	-15.21%	-10.19%	-5.02%
12 Months	-34.83%	-29.93%	-4.90%
Since Inception <sup>3</sup> (%p.a.)	-18.16%	-12.00%	-6.16%



Source: River and Mercantile Asset Management LLP

\*Index: FTSE All Share (Total Return)

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

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

<sup>3</sup>Inception date 28th November 2006

## Investment Commentary

### 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 short-term 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 generational low price. Fortitude is 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 down-turn as strong as ever, and PVT stocks that we buy today will prove to be bargains.

### Market background

#### 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 low risk counters. The UK equity market, whilst it proved to be more defensive than most 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 outperformed, despite the collapsing oil price. Momentum and Quality styles significantly outperformed Value.

#### Year:

2008 has been the 3<sup>rd</sup> 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 (ex Investment Trusts) fell almost 50%, a real return almost 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 -15.2% vs. -10.2% for the benchmark. This was a disappointing end to the year, with relative performance impacted by a further flight of capital to expensive defensives and the under-performance of smaller companies.

#### Year:

I must apologise for not protecting capital well enough in this downturn, with the High Alpha strategy returning -34.8% in 2008, an under-performance of the index of 4.9%. Whilst correctly cautious of a number of macro trends, including identifying the real estate and commodity bubbles, I failed to sufficiently de-weight the factors that have helped generate my returns over the long-term, namely Value, Recovery and Smaller Companies. All these factors 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 (the 20 highest yielders in the FTSE350 at the beginning of 2008 fell by 70%); perhaps the value spread (difference between highly rated and lowly rated stocks) had narrowed too much going into the credit crunch; without doubt lowly valued financial shares have performed very poorly as their profitability has evaporated; and any over-sold company with a hint of cyclicity or

financial risk just carried on falling throughout 2008. This latter point prevented many Recovery shares from performing well; often management were delivering fundamental improvements at these recovery type businesses, but this was overwhelmed in the short-term by investor fears about the impact of the economic and stock market cycle. I will cover Smaller Companies in detail later in this report, suffice it to say they have had a truly dire last eighteen months, falling almost 2/3rds as investors have sought the relative safety of more liquid investments.

### Key performance contributors

#### Quarter:

Positive: overweight attractively valued defensives (Mobile Telecom and Pharma sectors); underweight mining; UK consumer facing stocks start to out-perform (JD Wetherspoon).

Negative: Expensive defensives underweight (i.e. beverages); Oil underweight; poor performance of smaller companies and value.

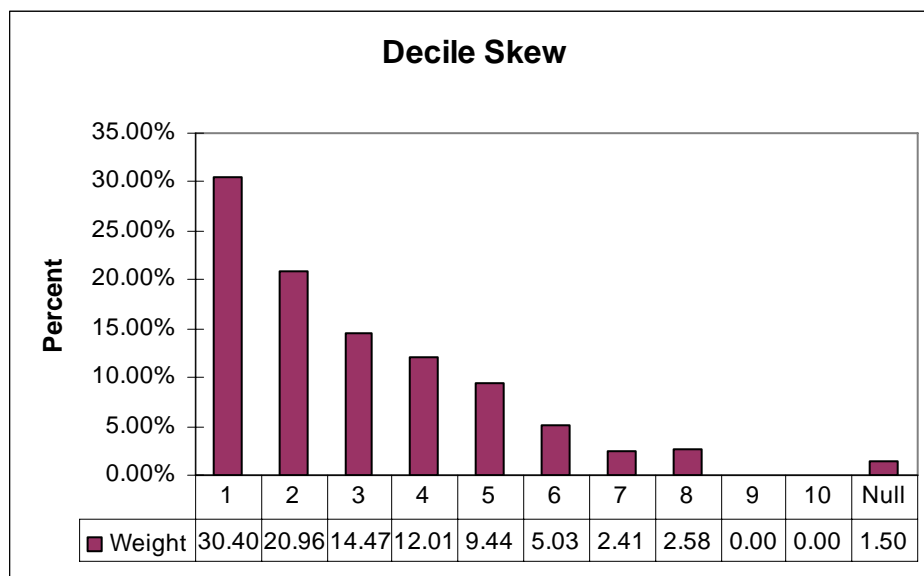
#### Year:

Positive: Mining stocks fall sharply (no exposure to Rio, BHP); Quality stocks perform well (overweight Pharmaceutical sector); Bid activity (GCAP, nCipher).

Negative: Smaller Companies under-perform by 20%; Value factor underperforms by over 20% (SG Global Style Analysis, performance of Low versus High PE); poor stock selection in banks.

### 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 51% in Quality, 37% in Recovery, and more modest exposures to Growth (7%) and Asset backed (3%) shares.



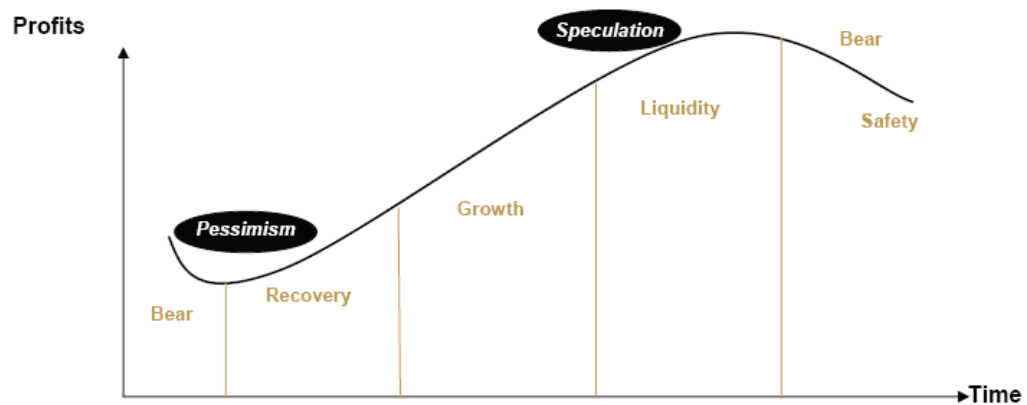
Source: River and Mercantile Asset Management LLP

### What themes occupy us at the moment?

#### The Big Picture

Over the last year we have preferred to frame the current environment in the context of the stock market cycle.

## The Stockmarket Cycle



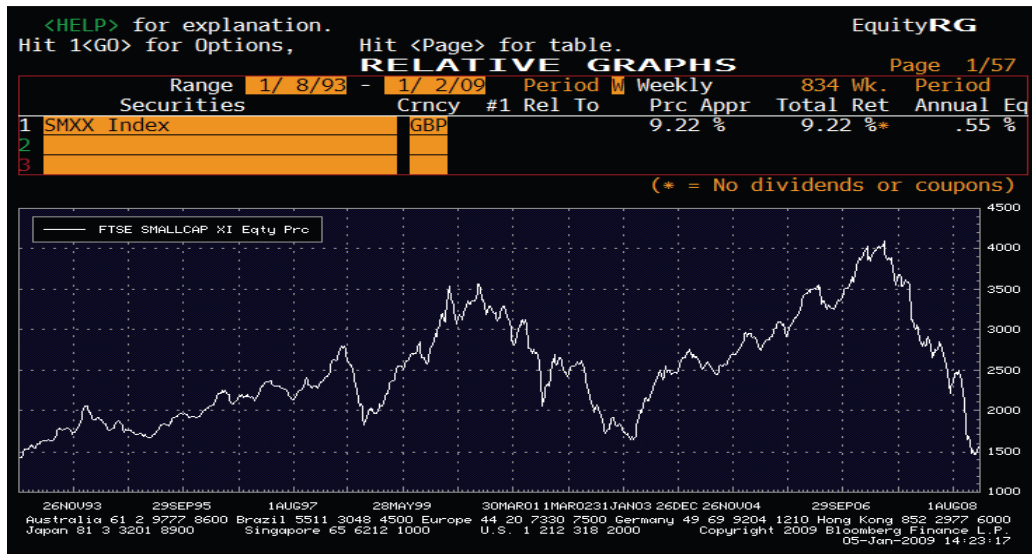
	STAGE 1 2003/4 1992/3 2009/10?	STAGE 2 2004/6 1994/8	STAGE 3 2006/7 1999/0	STAGE 4 2001/2 1991/2 2007/8
ECONOMIC GROWTH	Below Trend	Trend	Above Trend	Decelerating
MONETARY POLICY?	Loose	Neutral	Tightening	Loosening
CAPITAL?	Rationed	Sustainable	Mis-allocation	Withdrawal
RISK APPETITE?	Low	Neutral	High	Falling
VALUE SPREADS	High	Reducing	Low	Increasing
STYLE?	Value/Recovery	Growth	Momentum	Value/Quality
BUY?	Turnarounds	Where is growth?	Momentum	Earnings sustainability

The 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. I underestimated the full impact of the credit crunch and therefore the depth of this stock market cycle, but like Anthony Bolton I believe that the recovery phase of the market will emerge in 2009. 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 my generation. 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, taxpayers' money is keeping the banking industry intact, and falling commodity prices are boosting the spending power of the consumer. All this should at some stage in 2009 be seen to offset the contractionary forces of deleveraging and asset price deflation.

Talking of Anthony Bolton, I do think he makes amazing sense and I am happy to quote from his analysis of where we are in the cycle in the FT on 3<sup>rd</sup> 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 I discuss further in the outlook part of this report are not unlike our stock-market cycle analysis, both suggesting that we should be close to the bottom of this cycle.

## Smaller Companies

The chart below shows how aggressive the bear market in smaller companies has been. A 66% fall from top to bottom (hopefully!) ranks alongside the worst bear markets in history, and has taken the Small Companies Index back to levels last seen in early 1993!



Source: Bloomberg

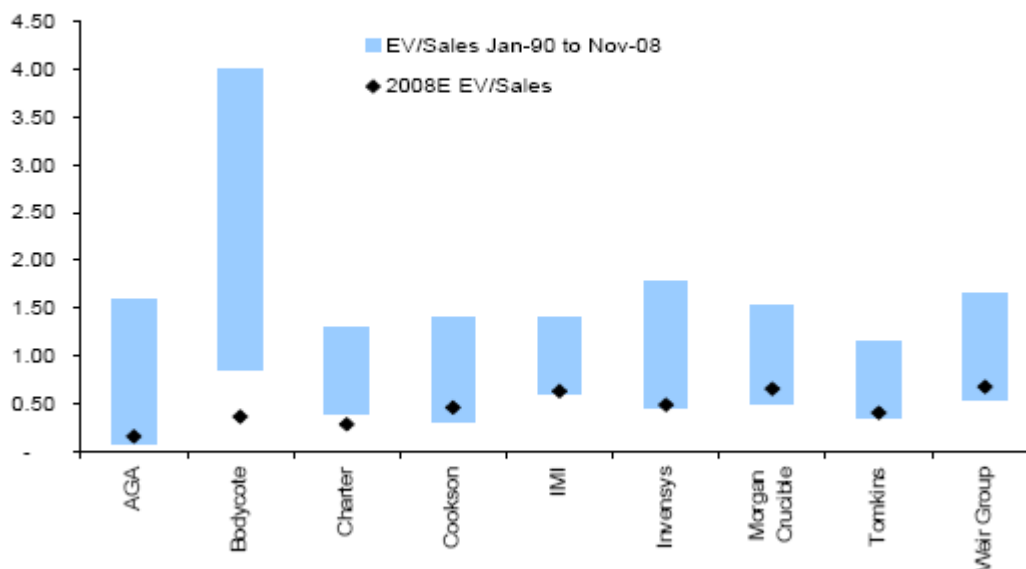
There have been a number of reasons for the fall. Firstly an ever expanding equity risk premium has caused an increasing liquidity premium; the uncertainty about what tomorrow will bring has led investors to fear holding positions in illiquid stocks. Secondly smaller companies are more domestic, and more cyclical; as a result their profits are vulnerable during this economic downturn. And thirdly smaller companies were popular with hedge funds during the last year of the bull market creating something of a 'crowded trade'; the retreat of hedge funds seems to have caused forced selling of this part of the market.

And what of the outlook? One starting point, that of Valuation is clear. Smaller Companies represent outstanding value. The yield of over 7% on the FTSE SmallCap Index (excluding investment trusts) is the same as the prospective PE of 7; the price / book is only 0.6 times, and the sales backing is huge. Meanwhile the technical position within this part of the market should soon improve; much of the forced selling has happened, no new issues are coming to the market, and stockbroker participants in these types of companies are merging reducing over-capacity. Market coverage of many smaller companies is increasingly sparse and sometimes non-existent; this provides significant opportunities for the medium term investor to unearth undiscovered anomalies. And these anomalies are humongous; Quality small companies such as **Centaur Media** (business to business publishing) and **Neovia** (internet money transfer) would at least double in the process of returning to fair value, whilst Recovery Small Cap stocks such as **Cookson** could return over 250% if it returned to a modest 8 times multiple of long term earnings.

### Cyclicals – how low have they gone?

Nearly all companies with a hint of cyclical demand have seen their share prices savaged over the last year. But how much of a potential reduction in profits is discounted in current share prices? This question can be addressed by looking at current valuations for a classic cyclical industry relative to their long term range. Below I show this for UK Industrial stocks, on an Enterprise Value / Sales basis.

Figure 13. EV/Sales Forecast versus Historic Range, 1990-2008E



Source: Company Reports and CIR Estimates

With current valuations all at the bottom-end of their 18 year range (covering two down cycles) then it is clear that a recession at least as deep as the worst industrial downturn of the last two decades is now fully discounted. Whilst this will not prevent further short term falls in the share prices of such cyclical sectors it does suggest that on a medium term basis the odds of making reasonable returns from an investment at this point are high, or in Ben Graham terms the margin of safety at these prices is compelling.

### Enron Debt

As we all know Enron typified the last equity bubble, the heady-days of TMT and playing loose with accounting. But reading Seth Klarman's introduction to the latest edition of Graham and Dodd's Security Analysis it was surprising (even for a recovery oriented investor like me) 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 Enrons, 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 I would suggest that you are provided with a significant margin of safety when buying into these counters.

### Portfolio Activity

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

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

We added to a number of high scoring PVT stocks. In Quality these included **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 bought a more substantial position in **Aegis**. This remains a high quality and strategically valuable business, the largest independent media buyer and media research company in the world. However the shares have been weak due to their exposure to the global advertising downturn. With the shares falling towards a multi-decade low valuation,

management changes suggesting that the board were increasingly focused on shareholder value realisation, and the major strategic shareholder, Vincent Bollore confirming his attraction towards the business we were happy to add to the position.

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

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**, whose share price fell sharply when it announced a rights issue to help fund their purchase of a stake in British Energy. 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.

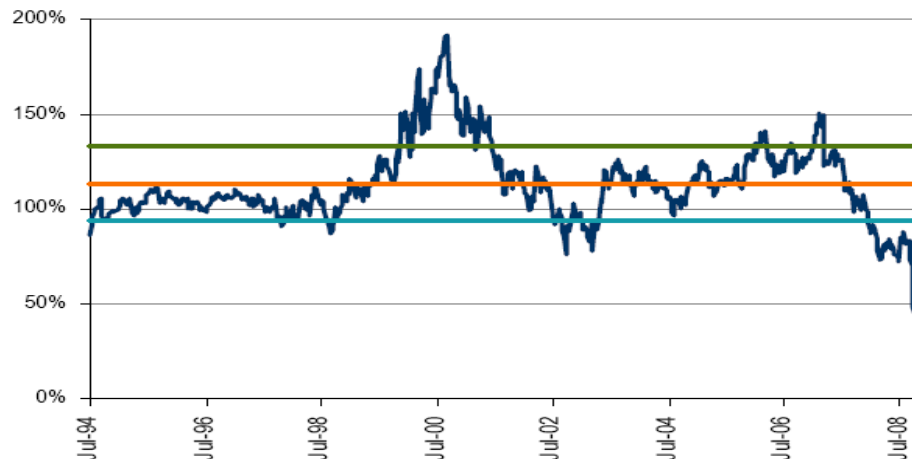
During the quarter we made our first investment in the downtrodden UK housing sector, purchasing **Persimmon**. In the outlook section of this report we provide a brief analysis of the housing market, suggesting we are more than halfway through the mean reversion of house prices; this combined with equity values for housing exposed stocks trading at multi-decade lows has encouraged us to make an investment, with a focus on the high quality management and market position that Persimmon provides. Whilst they do have a reasonably large net debt position, this is more than covered by conservatively valued land and work-in-progress, enabling this debt to be aggressively reduced as the house building market is right-sized.

We reduced our underweight position in the Mining sector, buying **Rio Tinto** for the first time. Whilst the outlook for profits at these companies is very difficult, with return on investment forecast to fall from multi decade peak levels in 2007 to multi decade low levels in 2009, share price falls have in some cases discounted this, with Rio Tinto for example now valued at a significant discount to a medium term value of its assets or cash flow potential.

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.

We do think that at some point this year credit spreads will peak and the outlook for financial services companies will bottom-out. However we are reluctant to commit significant additional capital to banks until their level of credit provisions stabilises, preferring instead other high quality, credit associated businesses where valuations are equally compelling. An example of this is **3i**, the UK's leading quoted private equity investor and a 2<sup>nd</sup> decile Asset Backed stock. Due to worries about private equity returns and gearing levels 3i saw its shares collapse during the second half of last year, falling to a 75% discount to its net asset value:

Chart 4: 3i - Price to Book



Source: DataStream/Merrill Lynch research

Whilst 3i's NAV will fall during this cyclical downturn, and we assume a pessimistic 50% decline in NAV, it is a survivor in this industry, its debt is modest in comparison to the value of its private equity portfolio, and new investments made over the next few years should realize worthwhile returns. We have taken a modest initial position in the stock.

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

We sold out of **Standard Life** during the quarter, following strong relative performance both against the market and the Life Assurance sector partly driven by speculative rumours regarding bid activity. This took the relative valuation to a significant premium versus history, and led to falling MoneyPenny scores. With Standard Life not a notably higher quality business than other sector constituents we decided to focus our Life Assurance positions on Legal & General and Prudential.

We also sold our entire position in **Premier Farnell**. This has been a strongly performing recovery share, delivering in-line with our original thesis of new management improving its market share and return metrics. However as a distributor they remain exposed to the cyclical downturn in industrial production that we are witnessing, and following their strong share price they became highly valued compared to other industrial exposed stocks.

#### Stocks we have cut (sale)

We sold out of our position in **Sibir Energy**. The portfolio has not been negatively impacted by our holding in the company, that said we decided that our original thesis would not be delivered against given the increasing risk associated with doing business in Russia. Subsequent events have confirmed the wisdom of this decision.

#### Outlook

"This, too, shall pass" Abraham Lincoln

"The only thing we have to fear is fear itself." Franklin D. Roosevelt

#### Global Equity Market Valuations:

On nearly every metric equity valuations are at a multi-decade lows. The Graham & Dodd PE sensibly smoothes company profits through the cycle, and puts a PE multiple on these. At a time when profits are coming off a cyclical peak it is a more relevant earnings based valuation than a conventional PE. This multiple is back to the low levels last reached in the early eighties.

**Chart 34: European market – Graham & Dodd PE**

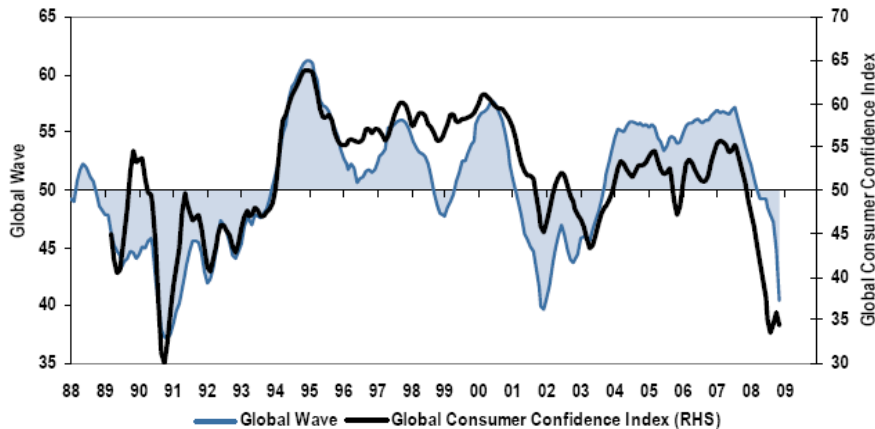


Source: MSCI and European Equity Strategy

### Market Expectations

As Tweedy, Browne identify in our introductory quotation the equity market looks forward not back. So a key to understand where we are going from here is not how difficult things seem today, but what the consensus is expecting. If the consensus is already very depressed then a lot of bad news is in the price:

**Chart 5: Global Consumer Confidence Index**



Source: Merrill Lynch Global Quantitative Strategy, MSCI, IBES, Bloomberg, OECD, IMF

Looking at one key indicator of confidence, that of the global consumer, this is at its lowest point since the recession of the early nineties.

### Risk Appetite

I have not talked about this much so far in this report, but it is clear that under-valued investment anomalies will only mean revert when there is some appetite for risk. As many indicators show, there has been, over the last year, Zero tolerance for risk. That is why US treasury yields have fallen to multi decade low levels, why junk bonds yield 20% and why the VIX index has spiked to an all time high.

As a result the risk appetite play from here is that over the medium term it can only go one way i.e. risk appetite can only go higher if it starts at zero. And there is plenty of cash waiting on the sidelines if some risk appetite returns; according to Barrons "Money stashed in market mutual funds has surpassed that in stock mutual funds for the first time". We will benefit from a return of risk appetite.

### House Prices

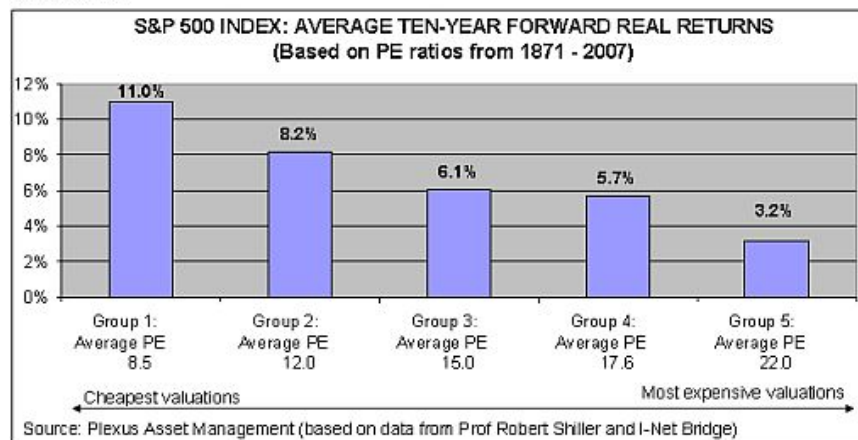
The real estate bubble around the world, and its implosion has been the source of many of today's ills. How far away are we from relative stabilisation of this market? The key here is valuation, or affordability. In this regard most indicators would suggest that we are at least halfway through the correction. In the UK housing market the price to earnings ratio (house prices to income) has fallen to 4.4 times, versus 5.8 at the peak and a long-term average of

4. Assuming an over-shoot a further 12% fall in house prices and a 4% increase in income takes us to a multiple of 3.7 times, a sensible long term ratio, and becoming affordable again for the first time buyer. On this basis we would today be 2/3rds of the way through the fall. Similar analysis for the commercial property market, based on yields for blue chip property again suggests we are now closer to the bottom than the top.

### The Margin of Safety is greater when valuations are low

Over the last eighteen months we have been in a vicious bear market with equities halving in value around the world; at the same time valuation spreads (i.e. the PE spread between the top decile by PE of the market and the bottom decile) have significantly increased so that they are approaching historic highs. One outcome of this is that a portfolio constructed today with a value bias is, based on past experience highly likely to produce attractive medium term returns. This is because low PE portfolios put together when value spreads are high have in the past produced significant alpha. I show below a study of returns achieved from US equities over the long term based on what Price to Earnings ratios were paid for a basket of stocks. If you paid 8.5 times PE you got a 11% p.a. real ten year return; if you paid 22 times PE the real return fell to 3.2% p.a. real.

DIAGRAM A.1



### The High Alpha Strategy – Valuation

So what are the valuation characteristics of the R&M High Alpha strategy at the moment? The PE of the portfolio is only 6.5 times earnings, the yield is 4.9%, the price to book is below parity, and there are also very substantial sales and cash flow backing.

### Summary

Whilst the economic background remains very difficult there are some signs of risk appetite returning to the world of investment, with valuations on all risk assets so low that any stabilisation in the financial background is encouraging marginal buyers of generationally lowly valued assets. The huge risk premiums available, in combination with our stock market cycle indicators becoming increasingly positive continues to encourage us to stay with the key factors that have served us well over the longer term. Value, Recovery and Smaller Companies have hurt your returns over the last two years, and that is very disappointing; however these factors have rarely been more unloved, they will come good and both the absolute and relative returns will be very compelling when other investors return to these types of anomalies.

**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](mailto:enquiries@riverandmercantile.com)**  
**[www.riverandmercantile.com](http://www.riverandmercantile.com)**