

RIVER AND MERCANTILE  
ASSET MANAGEMENT

UK Equity Long Term Recovery Fund | Quarterly Report  
September 2008

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# River and Mercantile

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## UK Equity Long Term Recovery Fund – Quarterly Report

### Fund Aim

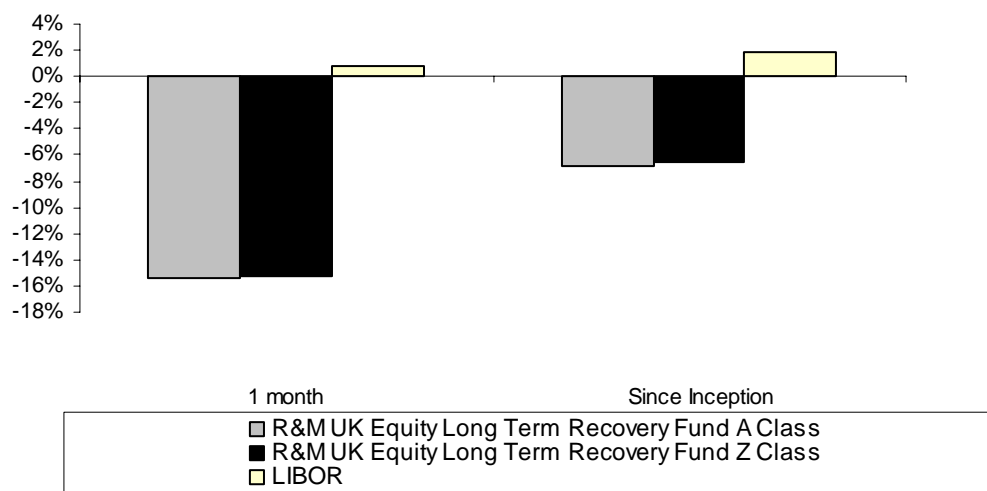
The investment objective of the Fund is to achieve capital growth through investing in a portfolio which will primarily consist of UK equities that meet the manager's recovery criteria of a turnaround in company profitability over the longer term. The Fund will not be restricted by reference to a benchmark, sector constraints or company size.

Portfolio Summary		Risk Analysis Summary	
Strategy AUM	£73,284,878	Portfolio Volatility	9.89%
Strategy Capacity	£200m	Active Money	83.50%
Number of stocks	74	Earnings Yield	14.06%
Largest Holding	Vodafone 3.41%	Dividend Yield	5.22%
Average return to Medium		Price to Sales	0.4
Term Recovery Value	78%	Price to Book	1.0

### Performance as at 30 September 2008

Retail "A" Class Shares	Fund <sup>1</sup>	LIBOR	Difference
1 Month	-15.36%	0.75%	-16.11%
3 Months	-	-	-
12 Months	-	-	-
Since Inception	-6.92%	1.91%	-8.83%

Institutional "Z" Class Shares	Fund <sup>2</sup>	LIBOR	Difference
1 Month	-15.23%	0.75%	-15.98%
3 Months	-	-	-
12 Months	-	-	-
Since Inception	-6.60%	1.91%	-8.51%



Source: River and Mercantile Asset Management LLP

<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

### **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.*

### **The Strategy**

This is our first quarterly report since the launch of the Long Term Recovery Fund in July. The Strategy is a recovery based investment approach that is 100% focused on long-term wealth creation, with no consideration of day-to-day market noise. It only invests in significantly under-priced assets, holds them for the longer term (3-5 years), and should be measured over a similar time period. It has minimal commonality with index constituents, very restricted capacity levels and significant personal investment by the portfolio manager.

The market environment today is an ideal time to launch this approach. The huge levels of volatility and extreme risk aversion will impact the very short term returns of this approach but provide the opportunity to buy into great business franchises, with significant recovery potential at the bottom of the stock market cycle.

### **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 -6.62% from its launch date of 17th July 2008, against 1.91% for Libor and -6.60% for the FTSE All-Share Index. Initial returns from our Recovery strategy will inevitably reflect the risk averse and volatile nature of equity markets; our focus remains on maximising medium term capital appreciation.

## Key performance contributors

Positive: Positive PVT Recovery stock picks included Fiberweb, Kingfisher, Thomas Cook, Wetherspoon; take-overs (including Augean); no Resources exposure

Negative: Profit disappointments from Innovation and JJB; UK banking exposure, in particular HBOS

## 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. 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.

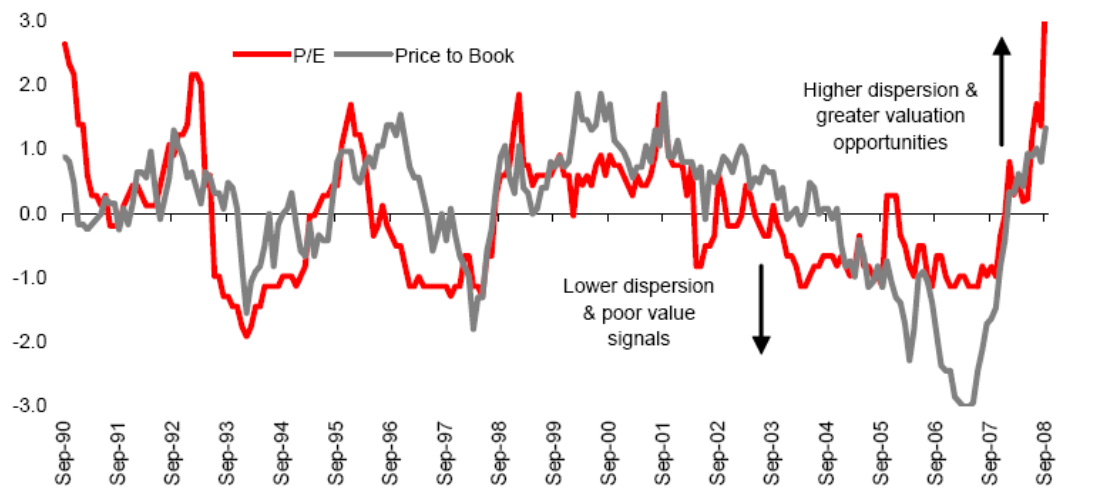
### Asset Prices and Monetary Policy

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)



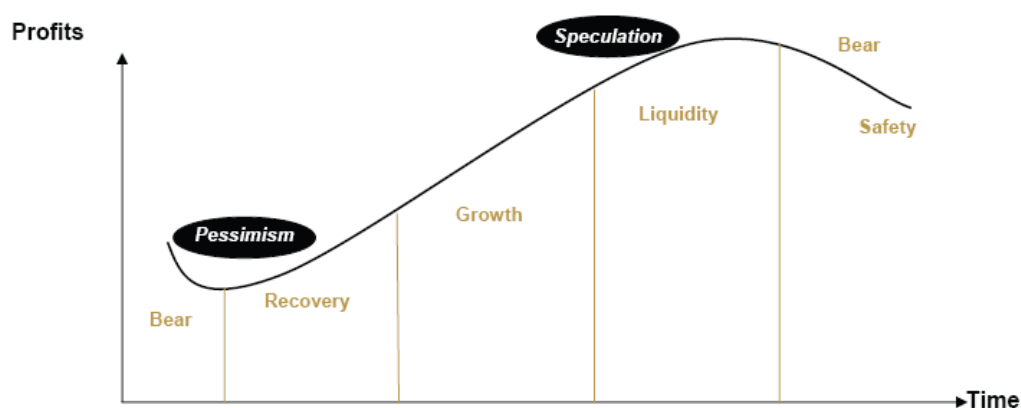
Source: SG Quantitative Research

The result of this is that the Long Term Recovery portfolio has huge Value support as well as being exposed to more than twice the level of sales as the market overall. According to the Style Research report at the end of September, the earnings yield of the LTR strategy is an amazing 14.1% (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 was happy with a multiple of only 2 times Government bonds.

## The Stockmarket Cycle

The Long Term Recovery approach was launched to try and coincide (give or take a couple of quarters!) with the low point of the Stockmarket cycle, as shown in the graph below. The extent of the credit crunch and spill-over into the real world is making the bear phase of this stock market 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.



	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

## Portfolio Activity

### Launch

Timing the launch of this type of strategy is more an art than a science, but we would hope that on a long term view the third quarter of 2008 will be seen as an appropriate time to allocate capital to a recovery type approach. The post-credit crunch bear market has been brutal with the stock market down over 30% and smaller companies down 50%. As a result the universe of recovery shares is a large and very lowly valued one and we have had little difficulty in finding companies whose share prices will we believe, at least double over the next few years.

Our original intention was to keep up to 30% of the portfolio liquid in anticipation of even better buying opportunities; in the event, the opportunities today are so large, and all indicators of sentiment and valuation so depressed that we are now already 90% invested. Market coverage is at 17%, somewhat more than I would have anticipated, but the bear

market and the impact of panic and crowded shorts has provided 100% upside potential in some large companies. The number of stocks is also larger than the original model I put together, reflecting the significant number of opportunities and also a desire to have a bit more diversification during a period of extreme volatility. The portfolio has no exposure to resource related companies, and significant capital committed to consumer service and technology stocks. There is a sensible range of maturity of individual recovery names, with significant exposure to a stock like Compass Group that is eighteen months into its recovery cycle as well as a large investment in Kingfisher where the turn around process has just started.

Our highest conviction investments are self-help stories, in particular those where in-market mergers are providing cost saving and pricing power opportunities. Along this line we have a significant 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.

Smaller company share prices have continued to come under pressure, and have now fallen over 50% from their peak eighteen months ago. This indiscriminate fall has produced 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.

We have some exposure (about 6% of capital) to non-UK investments. These are focused on recovery themes that can be better accessed outside of the UK. We only buy non-UK companies which have market leadership positions. For example we have purchased shares in DR Horton, the US's largest house builder. We think that the US housing market, which we all know has been in recession since 2006, will be the first to show signs of recovery.

## **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	17 July 2008	
Fund manager:	Hugh Sergeant	
IMA sector:	UK All Companies	
Benchmark:	LIBOR Overnight Cash Rate	
XD dates:	1 April & 1 October	
Tracking error range:	N/A	
Product capacity:	£200m (pooled & segregated)	
Dividend/Accumulation payment date:	31 May and 30 Nov	
Share class:	A	Z
Launch price (shares):	100.00p	500.00p
Share classification:	Retail	Institutional
Type of shares:	Income	Accumulation
Fund charges:		
Annual	1.75%	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	B1YHLP5	B1YJFW6
ISIN	GB00B1YHLP55	GB00B1YJFW60

### Important Disclosure:

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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)