River and Mercantile
March 2012
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.

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<tr>
<th>Portfolio Summary</th>
<th>Risk Analysis Summary</th>
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Performance to 31 March 2012

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<td>6.10%</td>
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<td>0.92%</td>
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<td>Year</td>
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<tr>
<td>3 Years (pa)</td>
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<td>18.85%</td>
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<tr>
<td>Since Launch³ (pa)</td>
<td>8.61%</td>
<td>7.07%</td>
<td>1.54%</td>
<td>4.82%</td>
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<th>Inst’l “Z” Class Shares</th>
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<td>-6.12%</td>
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<td>3 Years (pa)</td>
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<td>18.85%</td>
<td>8.44%</td>
<td>4.54%</td>
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<tr>
<td>Since Launch³ (pa)</td>
<td>10.52%</td>
<td>7.07%</td>
<td>3.45%</td>
<td>4.82%</td>
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Source: River and Mercantile Asset Management LLP
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 17 July 2008
Quote for the Quarter

“Walter has diversified enormously, owning well over 100 stocks currently. He knows how to identify securities that sell at considerably less than their value to a private owner. And that’s all he does. He doesn’t worry about whether it’s January, he doesn’t worry about whether it’s Monday, he doesn’t worry about whether it’s an election year. He simply says, if a business is worth a dollar and I can buy it for 40 cents, something good may happen to me. And he does it over and over and over again.”


Key Observation

Last quarter I wrote in reasonable detail about value investing. About how this approach has had a long and successful history; but also about how a traditional valuation-led investment approach has struggled over the credit crunch years as investors sought short-term safety ahead of medium-term opportunity. This “security first” nature of the market has thrown up many, many shares that Walter Schloss would have appreciated, shares where one could pay 40p for a pound worth of profits, cash or assets. It is these types of shares and business franchises that are hugely undervalued that we have focused capital towards, in order to generate superior returns for our investors. There are early signs that 2012 is going to be a better year for this approach.

The Anti-Bubble and Value

The Anti-Bubble (anti-equity, anti-long term, anti-risk, anti-value) might be at the beginning of a multi-year normalisation cycle. Assets that have suffered during the Anti-Bubble (equities, recovery stocks, value) did better last quarter whilst short-term security investments (UK Gilts and US Treasuries, gold, consumer staple stocks) did worse. We are at the early stages of this move back towards investments with higher risk premiums.

At River and Mercantile we look to comprehensively articulate our investment approach and explain our current views. That is why we produced our *Philosophy & Process* document before we launched the business, that is why we updated it with our explanation of the Stockmarket Cycle, and this is why we are in the process of launching a Value sub-site at [www.riverandmercantilevalue.com](http://www.riverandmercantilevalue.com) which will document the recent work we have done on the Value factor as well as providing current insights into this part of the market.

Corporate Fundamentals

Last year equity markets clearly got it wrong regarding the outlook for company fundamentals. The collapse in many share prices in 2011 appeared to discount a severe fall in corporate profitability. This has not materialised. Indeed, the key reporting season that is now coming to an end has confirmed how strong corporate fundamentals are, with robust growth in profits and cash flow. Many cyclical sectors that were particularly badly hit in the 2011 sell-off, such as building stocks and industrials, generated results that were well ahead of market expectations. I am glad that we added to our positions in these stocks at the bargain basement prices that were on offer last year.

Market background

Quarter:

Equity markets have started the year well. Some semblance of normality has returned to the European financial system, supported by a huge provision of liquidity from the ECB and by a completion of the Greek re-financing. Economic indicators suggested that developed world economies were starting to strengthen again. Unlike the rally at the end of last year the best performing investments were the better value ones (those with higher risk premiums). Good
financials (banks and life assurance) outperformed expensive defensives (tobacco). Our Recovery and Growth category stocks did well, Quality lagged. Smaller Companies, which failed to participate in last quarter’s rally, produced a strong return. Cyclical sectors, on average, outperformed (Chemicals and Industrials), though resources were a somewhat surprising laggard, undermined by weaker economic data out of China. UK domestic sectors (General Retailers and Housebuilders) performed surprisingly well as investors looked forward to a more benign period for the UK economy.

How did we perform and why?

We are pleased to report that we have made up quite a lot of the underperformance that resulted from last year’s flight to safety. Improved returns to value and smaller companies, and a strong company reporting season enabled us to perform well in both absolute and relative terms.

Quarter:

We outperformed, as many of the factors that had negatively impacted us last year turned into positive contributors. Value started what we expect to be a long-term period of outperformance, expensive defensives weakened somewhat, smaller companies rallied and our portfolio benefited from stronger earnings revisions than the market.

Longer Term Performance

The three year returns are very strong, with the Long Term Recovery strategy returning 27.3% p.a. versus the FTSE All-Share Index’s 18.9% p.a.

Key performance contributors

Quarter:

Positive: Overweight Financials (Lloyds Bank, International Personal Finance); underweight defensives (Royal Dutch Shell); overweight earnings upgrades (Bodycote) and underweight earnings downgrades (Tesco); broad spread of stock contributions (888, Barratt Development).

Negative: Overweight Pharmaceuticals (GlaxoSmithKline); overweight Carnival (impacted by Costa Concordia incident).

Performance Outlook

We would suggest that we are only at the beginning of the return to value and the un-winding of the anti-bubble trade. As the chart below shows value has recovered only a modest part of its recent underperformance of lower risk (safety first) stocks.

Value vs. Low Risk

Source: Bloomberg
Does the portfolio reflect our philosophy and process?

The chart below shows that our strategy continues to have a strong skew towards high scoring stocks.

![Decile Skew Chart]

Source: River and Mercantile Asset Management LLP. “Null” represents overseas stocks.

We continue to have a balance of investments across our four categories of Potential.

What themes occupy us at the moment?

The Stock Market Cycle

Midway through 2011 the trend phase of the Stockmarket Cycle was prematurely interrupted by a flight from risk, the main cause of which was the escalation of the European sovereign debt crisis. Share prices moved aggressively to discount an interruption in the cycle with equity risk premiums back to historically very high levels.

From the perspective of where we are today, equity prices were wrong to discount a severe economic downturn; global nominal growth has remained decently positive and corporate profits have continued to grow. It would appear that our previous analysis, that suggested we were in the trend phase of the Stockmarket Cycle, remains correct.

Corporate Fundamentals

The recent results season has confirmed that company fundamentals are robust. In 2011 sales grew by almost 10% on average, profits grew by 12% and cash flow generation was robust,
further strengthening strong balance sheets. Add to that falling corporation tax rates and improving earnings revisions and the positive picture is complete.

The US Economy

We are positive on the medium-term outlook for the US economy for five key reasons. The first is the huge latent demand in the housing sector, with housing starts per household back at 1930s Depression.

The recovery in activity back towards long-term averages would provide a substantial boost to the US economy, and current lead indicators (housing transactions, mortgage activity, house builder order books, and reducing supplies of foreclosures) point towards a housing market that is finally bottoming-out.

Secondly, we are in the middle of an energy boom in the US; the technology shock in unconventional oil and gas production has allowed North America to far better exploit its substantial natural reserves, in the process becoming one of the fastest growing energy suppliers in the world, significantly reducing this region’s dependence on Middle Eastern imports.
Thirdly, the economics of where to locate manufacturing around the world is slowly shifting; increasing costs in Asia (high wage inflation and land costs) and falling costs in the US (surplus labour and collapsing land costs) mean that a number of well respected analysts, such as the Boston Consulting Group, are actively talking about the return of manufacturing to the US. This will aid economic recovery.

Fourthly, the US continues to be at the forefront of the digital revolution with global leading franchises such as Apple, Amazon, Facebook and Google providing leadership to a high value added and fast growing ecosystem that services this digital economy.

And finally, and perhaps most importantly, the US banking system is, after six years of crisis, almost back to 'business as usual'. Regulators have signed off on the balance sheets of nearly all the key banks, indeed in some cases (JPMorgan) they are even allowing some capital to be returned to shareholders; as a result, regulatory (and political) pressure has abated and the US banking system has returned to modest levels of lending growth, thus supporting, rather than hindering, economic activity.

Risk free asset bubble – is this about to burst?

“\textit{What the wise man does in the beginning, the fool does in the end}”

During the credit crunch (and its after-shocks) there has been a huge flight to assets that have been perceived as low risk. As a result these assets have taken on bubble-like characteristics, i.e. their valuations have moved standard deviations away from what might be justified by fundamentals and by long term historical relationships. Just look at the two charts below. Both show that today’s valuations are at the extreme end of their long-term norms:

\begin{center}
\textit{UK Gilts are at record lows}
\end{center}

\begin{center}
\textit{British American Tobacco – Trend P/E relative, 1990 -2011}
\end{center}
Other assets in this camp would include gold, the yen and London Prime Real Estate.

In his latest letter to shareholders, Buffett made some interesting observations about gold: “Today the world’s gold stock is about 170,000 metric tons. If all of this gold were melted together, it would form a cube of about 68 feet per side. At $1,750 per ounce – gold’s price as I write this – its value would be $9.6 trillion. Call this cube pile A. Let’s now create a pile B costing an equal amount. For that, we could buy all U.S. cropland (400 million acres with output of about $200 billion annually), plus 16 Exxon Mobils (the world’s most profitable company, one earning more than $40 billion annually). After these purchases, we would have about $1 trillion left over for walking-around money (no sense feeling strapped after this buying binge). Can you imagine an investor with $9.6 trillion selecting pile A over pile B?”

If I could be so bold as to make a similar observation regarding London Prime Real Estate: how many three bedroom houses can be bought in Atlanta, Georgia (second best city in US for jobs growth) for the price of a one bedroom apartment at One Hyde Park? The answer is one thousand, three hundred! Yes, the Candy brothers’ apartments sell for a cool £25m, whilst three bedroom homes in Atlanta can be bought for $30,000 each. If I had £25m I know what I would do with it…

Portfolio Activity and Themes

This quarter I will focus my stock picking and activity comments on describing a number of the key themes within the portfolio.

US Housing

As described above, we are positive on the medium-term outlook for the US economy, and within that are very bullish about the outlook for US housing and building related stocks. Not that we are expecting a big bull market in US housing, just that all metrics that relate to this part of the US economy are so far below trend that any normalisation of this market implies strong growth.

Key beneficiaries of this would include Wolseley (through Ferguson, their market dominant US building products distributor), CRH (market leading building materials and products manufacturer in North America) and Lupus (a smaller company, but nevertheless the largest producer of window fittings into the US fabricators). Whilst Wolseley has been a strong performer since we added to our position during last year’s equity market panic, we remain bullish as Ferguson will be able to drive a multi-year growth in sales and margin improvement. Meanwhile Lupus has just sold its non-core oil coupling business for a good price, giving it significant financial firepower to consolidate further its position in supplying lots of the products that go into the assembly of windows and doors. Wolseley, CRH and Lupus are all top scoring recovery stocks.

Banks

Whilst bank shares rallied during the quarter they remain very depressed.

Bank share prices

Source: Bloomberg
We think that the fundamentals for UK listed banks continue to improve and are waiting patiently for the day when this is better recognised by the equity market. Revenue generating opportunities should bottom-out over the next eighteen months as the regulatory and self-imposed need to deleverage abates and as the pricing of their key mortgage products firm up; meanwhile operating costs at all banks have continued to be reduced, the bad debt line is on an improving trend and funding costs, which spiked again at the time of the European Sovereign debt crisis, are again normalising. Profitability should be on a significantly improving trend as a result. Meanwhile UK banks have robust balance sheets, with no new capital required. We like nearly all the UK listed banks, with overweight positions in Barclays, Lloyds, RBS and now HSBC. Barclays and HSBC were the focus of our buying during the quarter, the former because their Investment Banking business should see good profit recovery this year, the latter because at 1x book value it is just too cheap for a global leading banking franchise (BrandFinance number one global banking brand, ahead of Wells Fargo and American Express) and because its gigantic US$ deposit base (second only to US and Chinese Government bodies) should soon start to earn a better return as sustainable, demand-led US growth replaces liquidity-induced growth spurts negating the need for dramatically negative real interest rates.

On a cyclically adjusted PE basis (CAPE as Citigroup call it, adjusts earnings to take into account peaks and troughs) Financials are the cheapest sector globally, and UK Financials are on the lowest CAPE (6x) within this lowly valued universe.

**Investment Income – only upside from here**

Because short-term and long-term interest rates have been low for a long period of time, modest returns on investment income have been baked into analyst forecasts of companies that have traditionally made a good return of being guardians of their customers ‘float’. Think of insurance premiums or bank deposits - not a business’s own cash but a good source of return when interest rates are at ‘normal’ levels. But, if I’m right and yields on Government bonds have bottomed-out, and if short-term rates slowly trend back to normal, then investment income will have bottomed-out. To gain exposure to this theme we have added to our HSBC position and our investment in Non-life Insurance companies, such as RSA. And the numbers are large – HSBC has $1.2 trillion in dollar deposits; if US interest rates returned to a more normal level of 2.75% then, ceteris paribus, HSBC would see a 45% increase in earnings estimates!

**Digital Economy**

We continue to be ardent fans of the superior growth dynamics that come from participating in the rapid evolution of the digital economy. Currently we have capital invested in a number of pure online business franchises: MoneySupermarket.com, the UK’s largest price comparison site; 888 and BWIN Party, respectively UK and Global leading internet gaming companies; ADVFN, an expanding independent provider of trading information and gossip to the world’s
most active private investors; and Blinkx, a leading provider of online video search. We are also very bullish about mobile banking, the use of devices to replace more traditional methods of paying for things and transferring cash. Our exposure to this market is gained through Monitise, a key provider of the infrastructure ecosystem that lies behind mobile banking. They are Visa’s technology partner, which has provided them with a global platform for their technology; and they have just announced the purchase of a leading competitor in the US, Clairmail, giving them a strong presence in this key market. We also own companies that provide services into the digital economy: GB Group (online ID verification), and Optimal Payments (provides the payments infrastructure for the global gaming community). Last, but not least, we own a number of traditional media companies that have migrated much of their content into the digital world, and are now starting to benefit from this trend rather than suffer at its hands: this would include the Daily Mail, where MailOnLine is now the world’s most visited news (gossip) site, and business to business publishers such as Centaur Group and UBM, which are starting to make more money from digital content than from physical copy.

UK Domestic Businesses

We are becoming more optimistic about the outlook for the UK economy, as we move past the worst of the negative impact on incomes and consumer confidence that came from the combination of an imported increase in the cost of living, fiscal austerity and an increase in public sector related unemployment. Our exposure to UK domestic facing stocks has focused on four areas where MoneyPenny scores are high: the Banks (Lloyds), as described above; the Housebuilders (Barratt and Persimmon), who, as well as seeing their return on assets recover, are also benefiting from a return focused shift in their business model (focus less on quantity of houses sold, more on the profit and cash returns that are made on the sale); the General Retailers, where the survivors (Debenhams) should see profit growth ahead of what have become very depressed expectations; and Support Services stocks, such as Howdens (UK dominant distributor of kitchens to the building trade) and Speedy Hire (UK’s largest provider of small plant hire) which are very lowly valued and would be significant beneficiaries of even a modest pick-up in end demand.

Industrials with a self-help angle

Quite a lot of the bull market in industrial stocks has already played out. However, there remains value away from the stock market darlings, the Weirs and Rotorks of this world. We are focused on companies which are misunderstood by the market due to the current obsession with steady earnings, and where management (often new) are delivering self-help strategies that are accelerating growth in shareholder value. So, for example, we like Bodycote (global number one heat treatment services) where new management have materially increased profitability in the short-term and are focused on permanently improving medium-term return on capital through more efficient use of their heat treatment plants and through allocating new capital to higher returning niches and geographies. And we like DS Smith (European leader corrugated packaging), where management (again new) have transformed their market position through the acquisition of one of their main European competitors; not all acquisitions work, but they have done this deal at an attractive price, at a sensible point in the cycle, and will be able to deliver significant synergy savings at the same time as an enhanced service to their Pan-European customers. And, very recently, we have been buying AZ Electronic Materials (global leading supplier of speciality chemicals), a top scoring Quality category stock which is valued lowly relative to its peers because of its exposure to the cyclical semi-conductor industry. However, AZ has managed its business extremely well through the recent period of economic volatility, and has been able to protect profitability due to its key role in the industry supply chain and its exposure to growing end-markets such as smartphones and tablets. We expect the shares to be re-rated as they prove themselves to be less cyclical than the market thinks.

Sales

In the rally there have inevitably been shares that have become overbought, and where it was sensible for us to take some profits. Sales in this category included BG (benefiting from the strong oil price), which we reduced to 2% of the portfolio, and Xstrata, which initially benefited from a mining sector that was strong early in the quarter and was then the subject of a bid from Glencore.
Complete sales included BBA and Legal and General, both following strong performance and a complete realisation of our original PVT thesis, and International Power, which received a bid from GDF, its majority shareowner.

**Outlook**

We think that the outlook for equity markets is positive. The key reason for this is that starting valuations, the key determinant of medium-term returns, are low. The cyclically adjusted PE for the UK market, at fourteen times, is well below its average of the last forty years and is compatible with a double digit annual return over the next ten years:

![MSCI World 10 Year Annual Return Against Starting CAPE](image1)

*Source: CIRA, Factset, MSCI World data since 1970*

Investment markets cycle and, if history is a good guide (and it is nearly always a better guide than city scribblers), then ten year rolling returns are picking up off a cyclical low point:

![US and UK 10yr Rolling Nominal Returns 1881-2012](image2)

*Source: Global Fiancial Data, DataStream & Haver*

In addition, spot earnings yields, at almost 10% for the UK Equity market, look very compelling versus other assets, of which the so-called ‘low risk’ assets have almost no yield, resulting in a huge yield pick up for equities. This will inevitably attract investors and asset allocators as confidence continues to return to the world’s economy and financial system.
Meanwhile, as already mentioned, corporate fundamentals are strong: profits will increase again in 2012, as global nominal GDP growth will remain positive, allowing for top-line growth, and margins should be boosted by a first year of decent profitability from many banks. Alongside this, the very strong balance sheets of companies will fund value accretive strategies, including higher dividends, increased buy-backs, organic investment and bolt-on acquisitions.

Our portfolio remains significantly biased towards high scoring PVT anomalies and away from low scoring, “safety first” and expensive defensives. Our portfolio will provide material excess returns to medium-term investors.

Buffett on Schloss: “He knows how to identify securities that sell at considerably less than their value to a private owner. And that’s all he does. He doesn’t worry about whether it’s January, he doesn’t worry about whether it’s Monday, he doesn’t worry about whether it’s an election year. He simply says, if a business is worth a dollar and I can buy it for 40 cents, something good may happen to me.”

Thank you for keeping the faith!

Hugh Sergeant
Head of UK Equities
## Fund Facts

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