Fund Aim
The investment objective of the Fund is to generate a rising level of income combined with the potential for capital growth through investing in a portfolio which will primarily consist of UK equities.

Portfolio Summary

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<tr>
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<td>£1bn</td>
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<td>Number of stocks</td>
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<td>81</td>
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<table>
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<th>Largest Holding</th>
<th>Historic Yield¹</th>
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Performance to 30 September 2013

Retail “A” Class Shares

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<tr>
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<th>Index*</th>
<th>Difference</th>
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<td>Month</td>
<td>1.16%</td>
<td>1.12%</td>
</tr>
<tr>
<td>Quarter</td>
<td>7.27%</td>
<td>5.58%</td>
</tr>
<tr>
<td>Year</td>
<td>27.13%</td>
<td>18.93%</td>
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<tr>
<td>3 Years (pa)</td>
<td>12.56%</td>
<td>10.07%</td>
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<tr>
<td>Since Launch¹ (pa)</td>
<td>17.63%</td>
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Asset Manager “B” Class Shares

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<td>1.23%</td>
<td>1.12%</td>
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<tr>
<td>Quarter</td>
<td>7.48%</td>
<td>5.58%</td>
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<tr>
<td>Year</td>
<td>28.10%</td>
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<tr>
<td>3 Years (pa)</td>
<td>13.40%</td>
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<tr>
<td>Since Launch¹ (pa)</td>
<td>18.50%</td>
<td>16.17%</td>
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Source: River and Mercantile Asset Management LLP

¹Index: FTSE All Share (Total Return)
²Performance calculated on a mid to mid basis at close of business, net of annual management charge
³Inception date 3 February 2009
⁴Yield based on the dividends paid in the preceding 12 months as a % of current price
Investment Commentary

Quote for the Quarter

“Change is inevitable, success is optional” – John C. Maxwell

Key observations

Value stocks and smaller companies performed very well during the third quarter of 2013. Large cap global growth stocks did less well. There was a stampede into domestic consumer recovery stocks early in the quarter, a continuation of the trend of the past year or so. We chose to sell into that stampede and recycle capital into cheaper, more attractive areas of the market.

In response to client feedback we have deliberately slightly shortened the quarterly report somewhat relative to recent quarters. We shall continue to provide all the key information and views with regard to the portfolio and its positioning. Hopefully this will have the dual benefit of it being more quickly digestible for you and ensuring your portfolio manager spends more time on PVT stock picking. Please feed back any thoughts on anything that is more or less helpful with the updated format.

Market Background

Quarter

Equity markets gradually got used to the idea of QE tapering during the quarter; indeed the Fed’s decision not to taper towards the end of the period actually backfired, creating a short-term increase in volatility. Despite this late uncertainty, equities around the world did well, supported by stronger signs of developed world economic recovery. The FTSE All Share Index gained 5.6% with the mid cap FTSE 250 and the FTSE Small Cap indices performing best of all (+16% ex-ITs). UK Equities outperformed global equities, gilts, UK corporate bonds and cash over the quarter (in sterling terms). Political events were in focus through much of the period, particularly over the last few weeks. Whilst US tapering has been put on hold (for now) and international military intervention risk in Syria has subsided (for now), heightened political risk in the eurozone and worries of a US shutdown/slowdown have had a moderate impact. Towards the end of the quarter the global equity markets had their fourth best September since records began and the best performing "asset" in the month of September was the stock market of Greece. The press focused on the "shutdown" in Washington with, until lately, investors appearing unmoved by the doomsayers. However, PIMCO founder Bill Gross tweeted “Don't run for the hills [because] of the shutdown or ceiling – run [because] the economy is slowing by itself”.

Miners were the biggest positive contribution to overall market performance during the quarter after being the worst performer over the previous three months. Telecoms (with Vodafone as a top contributor), Media, General Retail and Life Insurance were also strong. Negative contributions came from Oil & Gas, Pharmaceuticals, Tobacco, Banks (mainly from HSBC missing expectations in August) and Food Producers.

How did we perform and why?

Quarter

During the third quarter we returned 7.5% versus the benchmark FTSE All-Share Index return of 5.6%, outperforming the market by 1.8%. Year to date we have returned 20.5% which is c.5% ahead of the market contributing to a c.3% p.a. outperformance of the benchmark over the past three years. As at the close of the quarter, the fund has an increased prospective dividend yield of over 4% (109% of the FTSE All-Share excluding any special dividends we may pick up). We have just paid an interim dividend commensurate with a run rate 3.7% yield during the previous six months which should now grow in future periods.
Positive contributions were made over the quarter from a range of holdings, including several of the smaller company Recovery and Growth holdings. Two of our Recovery positions found themselves on the end of corporate activity - Fiberweb, a construction recovery play, and Invensys, a global leader in process automation – and both were held across all of the team’s diversified portfolios.

Playtech (online gaming software platforms) delivered strong price appreciation as investors continued to warm to its structural growth markets. It is a high quality Growth developer of unified software platforms and content for the online, mobile and land based gaming industry. The company’s gaming applications include poker, casino, sports betting, live gaming and they are currently pushing into social gaming. They developed William Hill online, work with Paddy Power and are now central to the Ladbrokes digital turnaround strategy. Playtech is also held in all of R&M’s UK portfolios.

Staying with the Growth category our engineering consultant, Atkins, performed well as the market re-awakened to the prospect of the government beginning to increase infrastructure spend again and private sector investment also recovering.

Recently purchased emerging market debt specialist Ashmore, which is in our Quality bucket, had been understandably sold off due to money flowing from emerging market currencies after Bernanke indicated that QE will be reduced going forward ($80bn per month to something somewhat less). This created a value gap in the stock which we took advantage of and, with a dividend yield of 5% at purchase, will make a useful contribution to our income requirements. Also within Financials, conviction positions Lloyds Banking and Aviva provided strong returns. Lloyds saw the first 6% of the government stake successfully placed with investors and Aviva continued its restructuring, making several disposals which improved both the capital position and prospects for future growth.

Defence contractor BAE Systems, Shanks (waste recycling) and Halfords also made meaningful contributions over the quarter. It was encouraging to see stocks from all of our main categories (Quality, Growth and Recovery) contributing to the quarter, although Recovery stocks clearly added the most value collectively.

Detractors to performance mainly included the more defensive names which you would expect as the market bought into economic recovery. Tate & Lyle, GlaxoSmithKline and BP all struggled to keep pace with the rising market during the period. Salamander Energy was disposed of mid-quarter in line with a broader reduction of Oil & Gas exploration companies. Early underperformance detracted from the fund but selling off this low scoring, zero yielding, long duration stock provided damage limitation as it has since fallen by another 20%. Elsewhere negative contributions came simply as a result of being underweight three of the four Mining majors, as well as from lacking exposure to Shire and BT.

Does the portfolio reflect our Philosophy & Process?

We continue to have a balance of investments across our four categories of Potential with the dynamics of this cycle currently favouring a diverse allocation of capital to Quality (53%), Recovery (29%), Growth (9%) and Asset-backed (8%). We believe our portfolio has a strong chance of outperforming whatever the global economic growth outlook. We continue to look for those cheap stocks where they are high quality or where they have margin recovery potential and where we feel growth and earnings momentum will remain positive despite the various global risks. We have recently added to globally exposed stocks at the expense of domestic recovery stocks where we see high quality franchises on relatively low valuations given their potential growth prospects – for example Ashmore, Reed, Ultra Electronics and DS Smith. In all cases we continue to rotate the portfolio into strong high scoring PVT ideas where we see medium-term potential for companies to create significant shareholder value, on low valuations, with conservative growth expectations, and where earnings upgrades are more likely to occur in future.
Portability Strategy

Value Dispersion

Value dispersion remains within the normal range so we continue to focus on our balanced PVT multi-factor approach with a reasonable balance of undervalued stocks. We have stayed underweight many of the relatively safe defensives as well as mining stocks where cyclically high margins and poor capital allocation have, until recently, given cause for concern. However, we also maintain a proportion of the portfolio in a focused group of high conviction large caps. BSkyB, GlaxoSmithKline, Reed Elsevier, Lloyds Banking, Aviva, Rio Tinto, Inmarsat, Tesco, ITV, Imperial Tobacco and Unilever would be good examples of such names. These are complemented with a decent exposure to high conviction small and mid cap names which have performed strongly in recent quarters. It is fair to say that small and mid cap managers have had a relatively good time of it in recent quarters so we remain vigilant towards any emerging new trends.
What themes occupy us?

Investment process productivity and contrarian stock picking. We are trying to avoid generic quarter-end macroeconomic and stock market commentary concerning what is currently influencing financial markets where possible.

Investment Process

The McKinsey Global Institute discovered that the average person dedicates 13 hours per week, (28% of the working week) to reading, deleting, sorting and sending emails. In fact, an email is actually just another person's to-do list which has been assigned to you more often than not. So, it should be an item on your list, but not at the top. As investors and market participants, many of us also fall into the same trap of checking our Bloomberg or price screens for many hours during the week. It is like a drug – a shot of adrenaline – watching prices move and seeing the news flow come through.

We have written on the combination of news and noise in the past and it is useful to be reminded of the key points again here. News is costly because it wastes time exacting exorbitant costs. It taxes productivity in three ways: firstly, through consumption time which is the time you actually waste reading, listening to or watching the news; secondly, refocusing time in getting back to what you were doing before you were interrupted; thirdly, news distracts us even hours after we have digested it with images and emotions popping up in our minds hours or even days later. If you read the newspaper for fifteen minutes each morning, then check the news for fifteen minutes during lunch and a further fifteen minutes before you go to bed, you're eating into a substantial amount of time. Add a further five minutes here and there when you're at work, plus distraction and refocusing time, and you will lose productive hours totalling at least half a day every week. Half a day – and for what?

News also massively increases cognitive errors, the most serious of which is 'confirmation bias'. This is when we automatically systematically filter out evidence that contradicts our preconceptions in favour of evidence that confirms our beliefs. In the words of Warren Buffett: “What the human being is best at doing is interpreting all new information so that their prior conclusions remain intact.” That is confirmation bias. News consumption, especially customised news intake, exacerbates this human flaw. The result is that we walk around in a cloud of seemingly confirmational data – even when our theories about the world and about ourselves may be wrong. We become prone to overconfidence, take stupid risks and misjudge opportunities. News not only feeds the confirmation bias, it exacerbates another cognitive error: the story bias. Our brains crave stories that “make sense” – even if they don’t correspond to reality. And news organisations are happy to deliver those stories.
At R&M we attempt to process data and empirical evidence using our MoneyPenny screens and research process in order to minimise noise and news flow. An investment process is never going to deliver all of the time and will always suffer periods of underperformance, but stock correlations in the market are currently quite low giving plenty of opportunity for stock pickers. We are continuing to strive for better processing of the explosion in data facing investors in today’s technology rich world. Continuous improvement is part of the investment culture at R&M in order to deliver market leading alpha to our clients now and in the future. Global MoneyPenny has now been rolled out, giving us valuable new insight into PVT trends around the world which will add depth to the analysis of companies already highlighted in UK MoneyPenny – our multi-faceted R&M UK equity screening tool.

"Knowledge is a process of piling up facts; wisdom lies in their simplification" – Martin H Fischer

UK Housing and Economic Growth

Only eighteen months ago the market was assuming the worst for the UK economy - indeed we commented on the impact of split credit markets on the consumption patterns of consumers, as well as spending by SMEs. It is fair to say that since then there has been a considerable improvement in the outlook, not least due to the government’s boost to the housing market through increasing mortgage supply to first time buyers and the positive impact on housing confidence it has created.

One thing we constantly seek to try and achieve within the framework of our PVT investment screens is to remain contrarian and to challenge conventional wisdom. Red lights start to flash when we see a large proportion of market research and commentary pointing in the same direction and momentum factors overtaking all others. One area we had already grown more cautious of through the spring and summer was the consensual view on UK housing related stocks following the government intervention. The PVT scores were no longer looking attractive so we had removed our exposures. Experience tells us that “the helium goes out of the balloon faster than it goes IN”. We shall no doubt re-visit these stocks in future at a more attractive entry points.

More broadly, UK consumer-exposed stocks have performed very well in the past eighteen months, valuations are significantly higher than they were and, as a result, we have continued to take profits in names such as Cineworld and Moneysupermarket.com although we do own a few of the cheaper consumer-exposed stocks where we perceive the valuations to still be attractive, for example Home Retail Group. We believe there is currently greater opportunity in mid-cycle companies exposed to a pickup in corporate spend, and we have typically turned our attentions back overseas to some of the global leaders which have been ignored during the stampede back into UK domestic stocks.

Portfolio Income

The prospective yield of the fund is currently estimated at just over 4%. Some 35 stocks went ex-dividend over the quarter of which 26 increased their payout above Q3 last year, 3 decreased their dividend (Halfords, Chemring and RSA) and 6 were flat. Of those providing no growth year on year, we expect Shanks and Segro to resume dividend growth over the next 18-24 months.

Twenty five of the stocks that went XD in the quarter grew their dividends faster than inflation. Of particular note are: 888 Holdings, up 23.6%; Unilever, up 22.2%; Kentz, up 20.1%; Serco, up 17.0%; Rio Tinto, up 16.9%; BP, up 14.9%; HSBC, up 11.2%; Vedanta, up 11.0% and Imperial Tobacco also up 11.0%.

The Fund adopts a Total Return approach to stock selection and the portfolio therefore contains a range of yields at the stock level. Eight companies, amounting to less than 5% of the portfolio by value, do not pay a dividend at all. Half of those are Oil & Gas exploration companies where the capital return prospects are more material.
The fund’s current consensus-based prospective yield of about 4% is approximately 110% of the prospective market yield and remains significantly higher than the non-inflation linked yield from 10 year UK Gilts. The recovering profitability of companies, their low payout ratios, strong balance sheets and robust cash generation support ongoing dividend growth as well as the prospect of special dividends which may boost income still further.

Portfolio Activity

In the main we used any weakness in high conviction stocks over the summer to add them to the portfolio across the four categories whilst taking profits in some of the strong performers, stocks where we feel the fundamentals are weaker or where we have lower conviction. I shifted the allocation towards high yielding, high quality and, of course, high scoring stocks. This has been at the expense of low scoring and/or low yielding stocks where I have lower conviction. At this point in time we have turned over c. 12.5% of the fund [((Purchases + Sales)/2 – cash flows)/Average AUM]. Think of this as 7.5% due to the change of portfolio manager and 5% as just catch up on the ongoing rebalancing of any portfolio. The reality is that the portfolio positioning has changed a little more than this as we have used new cash inflows to adjust the portfolio. We saw net inflows of c. £5m during August and September. In terms of size and sectors, FTSE exposure remained similar at c. 58%, FTSE 250 exposure increased to 30% and FTSE SmallCap decreased to c.11%, primarily as a result of a reduction in the small cap E&Ps. I anticipate small cap to remain in the 10-15% range going forward as before. At a sector level we reduced the Oil & Gas and Banks exposures (although retaining the aggregate Financials overweight) to re-distribute elsewhere.

For your interest, I have grouped stocks into their regional focus and category allocation (with key drivers over and above self-help). We have taken profits in UK consumer domestic recovery plays and have deliberately traded back into some high quality unloved EM plays in the past couple of weeks. In future quarters we shall only highlight a number of the key purchases and sales in more detail but for this quarter we are including a summary of all trades of reasonable size grouped by geographic exposure and category for your additional information.

Key purchases by geography with approximate yield and category (Growth, Quality, Recovery, Asset-backed)

Europe

DS Smith, 4% yield (Growth)
Cardboard packaging into FMCG and Industrials (European recovery, environmental legislation, global FMCG, EM customers).

Hansteen, 6% (Asset-backed)
European (German) and UK industrial property.

Global

Inmarsat, 4.5% (Growth)
Global satellite services, long term contracts.

Ultra Electronics 2% (Quality)
Defence electronics, cyber security, Middle Eastern airport infrastructure.

Kentz, 2.5% (Growth)
Oil services - already owned and was buying for the portfolio before the bid approach.

Sage, 3.5% (Quality)
Global software services.

Rentokil, 3.5% (Recovery)
Self-help.
Amlin, 6% (Quality)
Insurance underwriting.

Tesco, 4% (Recovery)
Top up, improved capital allocation globally.

Reed, 3.5% (Quality)
Repurchase (highest scoring FTSE 100 Quality stock with at least a market yield)

Emerging Markets

Unilever, 3.5% (Quality)
Moved back overweight after sharp falls at the end of the quarter – our favoured FMCG (Note that we are still zero weight British American Tobacco, Diageo and SABMiller, not to mention Prudential and Standard Chartered).

Bank of Georgia, 4% (Quality)
EM Bank with strong fundamentals, 20% Tier 1 capital, 20% ROE, 20% Growth on 1.4x Book

Cable & Wireless Communications, 6.5% (Quality)
EM Telecoms, convergence, special sit, US Recovery

Ashmore, 5% (Quality)
Global market leader in EM debt

Braemar Shipping, 5% (Recovery)
Exposed to a reduction in shipping overcapacity and stronger global trade

UK

BSkyB, 3.5% (Quality)
Installed base, dividend growth

Utilitywise, 4% (Growth)
Outstanding growth opportunity in supplying corporate energy dashboard technology

Hargreaves Services, 3% (Quality)
Coal distribution and asset backed with the best of the UK’s coal assets

Sales (all E&Ps sold were high risk, low scoring, zero yield and long duration)

Cineworld – valuation; Moneysupermarket.com – Google algorithmic change and director selling; Salamander Energy - E&P; Rockhopper - E&P; Genel - E&P; Cape – Energy Services; Daily Mail – valuation; RBS - valuation no longer on a deserved discount; Chemring - defence recovery stock with high forecast risk switched into Ultra Electronics.

Profit taking and *reductions

3i, 4imprint, Atkins, St. Ives, Cobham, Vedanta, Lloyds Banking, ITV, Petroceltic*

Key Purchases

Rentokil is a top scoring Recovery and, indeed, Growth stock which has had several tough years but there have recently been signs of light. A first class management team were parachuted into Rentokil several years ago after restructuring ICI and selling it on. Unfortunately a poor market position and very difficult market conditions led to their parcels business consistently underperforming and undermining the good work being done elsewhere in the much larger facilities management and pest control divisions of the company. Now parcels has been sold off (like the Royal Mail which we have applied for)
and the management are focused back on the businesses where they can really make a difference. Ten years ago they made 18% operating margins and last year they made 9% so there is significant margin recovery potential valued on just over 1x EV/Sales and an 11x PE. With recent trading robust, and the sale of the parcels business as a catalyst, all the pieces are in place for an improving business and share price.

**DS Smith** is a high scoring cyclical Growth European industrial leader in cardboard packaging. They have consolidated the market through the acquisition of their largest competitor, SCA, and are realising significant synergies. Their end markets are driven by structural drivers like internet shopping delivery and FMCG (Fast Moving Consumer Goods) companies focusing on environmental and sustainable growth. They are also exposed to European economic recovery but through a defensive blue chip customer base giving downside protection. Forecasts and the valuation are conservatively set as synergies and improving growth should see positive operating momentum and growth continue.

**Ashmore** is a specialist emerging markets investment manager with $77bn AuM in a range of themed strategies: external debt ($ denominated), local currency debt, corporate high yield and equity, special situations and alternatives. A high margin, high returning *Quality* company whose success is built on being in a still niche market (EM debt) and from first rate long-term performance. This base puts them in the best position to benefit from clear structural drivers in EM debt for the medium-term, as this is a relatively uninvested asset class whose attractions include strong balance sheets and strong growth relative to the developed world. The loss of confidence in emerging markets over the summer provided a great entry point for this high quality franchise trading back in line with the market and yielding 5%.

**Kentz** is a global engineering & construction contractor predominantly in Oil & Gas, Mining and Petrochems. It is a Growth stock which has 85% revenue visibility in any one year and a very strong order backlog which is growing rapidly. During the quarter their material undervaluation relative to both the oil services sector and the market was highlighted by a takeover approach from Amec. Like other shareholders we rejected the bid price as inadequately reflecting the attractive prospects for the business. We continue to hold the stock for its growth potential and prospects of a re-rating.

**Utilitywise** is an energy and water consultancy business which provides energy procurement and an advanced software platform to help lower energy consumption for a range of UK Corporates. Utilitywise has strong trading relationships with the large UK energy suppliers and they assist customers in reducing their consumption as well as lowering their carbon footprint. The business is in one of the sweet spots for a pick up in future corporate spending and they are growing very rapidly. We met the management team in the late spring on two occasions and concluded that analyst forecasts were materially too low for the next couple of years. The company has a strong market position with rising gross margins, a robust balance sheet and we added this high conviction *Growth* stock to the portfolio.

**Sales and reductions**

Oil explorers **Genel**, **Rockhopper** and **Salamander** were all sold. **Petroceltic** and **Sterling Energy** were reduced. Whilst there is a chance that one or more of these companies may well find and exploit material oil or gas discoveries I, unlike the previous manager, have very little information advantage over other market participants in identifying which of the myriad of companies in this sector are likely to be the winners. Due to the fact there are always far more exploration losers than winners, with low PVT scores, zero yields and the fact they are long duration in a rising bond yield environment, it was an obvious starting point for recycling capital in to some of my better, high yielding stock picks held in other funds. We also sold oil services recovery stock **Cape** due to its poor track record of shareholder value destruction and switched it into the higher quality Kentz in line with our other strategies.

We sold recovery stock **Chemring** as, after further work on the model, we felt that analysts’ forecasts were too high and the risk of a profit warning looms large. It was a relative switch into top decile **Ultra Electronics** in the same sector. **Cineworld** was sold early in August after good performance over the past six months, responding to perceptions of the improving UK economy. We had bought the stock on sub 1x and with it trading at over 18x we felt the valuation was much too rich given the returns profile and growth prospects. Our timing was good as the stock immediately began to fall sharply and has continued to fall since. **Moneysupermarket.com** and **Daily Mail** were sold as both online B2C and B2B models had re-rated to relatively high valuations. With barriers to entry sometimes questionable and with the margin of safety gone, all of the shares were sold. In particular, **Moneysupermarket.com** was
sold in line with my other portfolios on concerns over their ability to stay at the top of Google search following changes to Google’s search engine algorithms and significant director selling. Since then, comparison websites have come under the regulatory spotlight and the shares have fallen sharply.

Some position size reduction in low scoring large caps like AstraZeneca, BP, HSBC, SSE and Sainsbury also occurred. These were mainly being held for both yield and risk management reasons but, with a reduction in zero yielding small and mid cap names, there is not the necessity to hold so much capital in these names. Indian resource conglomerate Vedanta was reduced in favour of higher conviction name Rio Tinto. We also took some profits in a number of strongly performing mid caps like Atkins, SIG, Cobham and 3i.

The most challenging decision to make in the period was in the Banks sector where the portfolio had been positioned overweight for the past quarter. We have maintained overweights in our favoured banks Lloyds and Barclays but we elected to reduce exposure to HSBC and to sell Royal Bank of Scotland in its entirety despite its recovery prospects. We added the new position in Bank of Georgia but, in aggregate, the Banks weighting was reduced to a neutral weighting versus the benchmark. The reasons for the sales were poor operating momentum at HSBC and a disproportionate allocation of capital to this name because of its index weight despite our low conviction. RBS was sold in preference to keeping Barclays, in line with my other strategies, due to investment banking risk, the loss of the CEO and the fact it was no longer trading at a deserved valuation discount to the other banks.

**Outlook**

Our view, consistent with previous periods, is that rather than trying to second guess the decision making of central banks and governments who, like investors, are prone to errors, we continue to apply our bottom-up PVT stock selection investment process to plot a sensible course to make money for our clients. We hold a concentrated portfolio of best investment ideas, which are exposed to multiple geographies, styles and themes, all of which have strong Potential for shareholder value creation, are attractively priced and where we believe the Timing offers a strong chance of operational improvement and share price appreciation in future. It is tempting to build an entertaining ‘story’ around bond yields, slowdowns, recoveries and sector rotation, but with the market always changing we stay focussed on evidence based PVT stock picking for building our future success.

Your support through this busy period has been very much appreciated. Thank you.

**Dan Hanbury**
Portfolio Manager
**Fund Facts**

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