ES River and Mercantile Global Recovery Fund

Quarterly Report to 31 December 2019

RIVER AND MERCANTILE
ASSET MANAGEMENT

For unitholders only

RIVER AND MERCANTILE
ASSET MANAGEMENT

ES R&M Global Recovery Fund

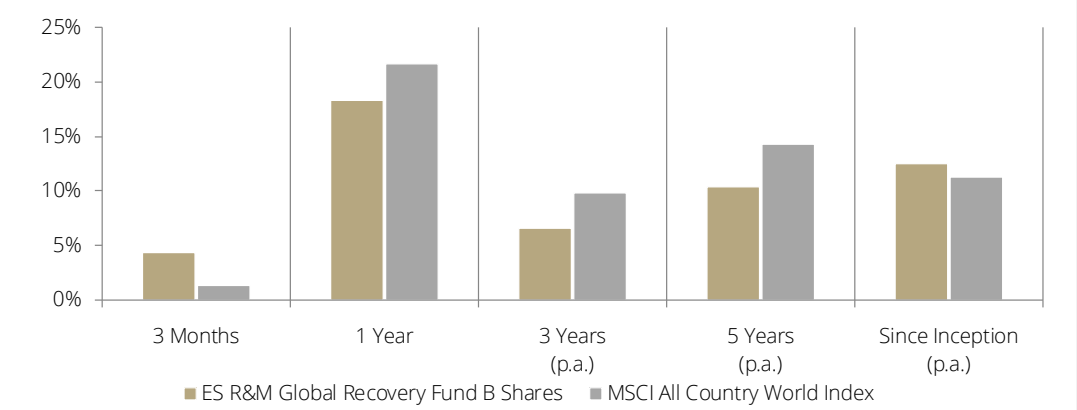
Quarter 4, 2019

Fund Objective

The investment objective of the Fund is to grow the value of your investment (known as "capital growth") in excess of the MSCI All Country World Index (ACWI) Net Total Return (the "Benchmark") over a rolling 5 year period, after the deduction of fees.

Performance (net of fees)

	B share class	Benchmark	Difference
3 months	4.3%	1.3%	2.9%
1 year	18.3%	21.7%	-3.4%
3 years (p.a.)	6.6%	9.9%	-3.3%
5 years (p.a.)	10.4%	12.0%	-1.6%
Since inception (p.a.)	12.6%	11.3%	1.2%



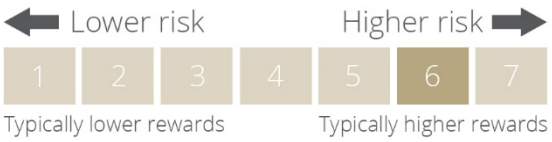
Performance (gross of fees)

	Z share class	Benchmark	Difference
3 months	4.6%	1.3%	3.2%
1 year	19.6%	21.7%	-2.2%
3 years (p.a.)	7.6%	9.9%	-2.2%
5 years (p.a.)	11.5%	12.0%	-0.5%
Since inception (p.a.)	13.7%	11.3%	2.4%

Source: River and Mercantile Asset Management LLP. Benchmark is the MSCI All Country World Index (ACWI), net GBP.
Fund performance shown is of B share class (income units) which is net of an annual management charge of 1.00% per annum, and Z share class (accumulation units) which reflects the fund's gross performance before any fees are deducted. Please note that the benchmark performance is calculated using close of business mid-market prices. Other share classes may be available.
Past performance is not a reliable indicator of future results.

Portfolio Summary & Key Risk Characteristics

Fund AUM	£462.3m	Price to book	1.28
Strategy capacity	£1bn	Price to sales	0.92
Inception date	4 March 2013	Portfolio beta	0.97
Number of stocks	407	Tracking error	4.63 %
Largest holding	Facebook 0.8 %	Active money	86.19 %



The Synthetic Risk and Reward Indicator (SRRI) is based on how much the returns of the shares have varied over the last five years, or since launch (whichever is the shorter period). The higher the rank the greater the potential reward but also the greater the risk of losing money. For more details please refer to the Key Investor Information Document.

The information contained in this report does not constitute as investment advice and should not be treated as a recommendation to invest in any security. The information is based on the historical performance of the ES R&M Global Recovery Fund and may no longer be current. Any references to securities are for illustrative purposes only and these securities may no longer be held. The information should not be used as the basis for any investment decision. Any opinions expressed are opinions of the relevant portfolio manager and are given in good faith as of the date of the report but should not be considered operative at any date thereafter.

With monetary and fiscal policy around the globe being accommodative, trade discussions relatively constructive, greater certainty returning to the UK, and global economic optimism bottoming-out, equity markets were well supported during the quarter and provided strong returns over 2019.

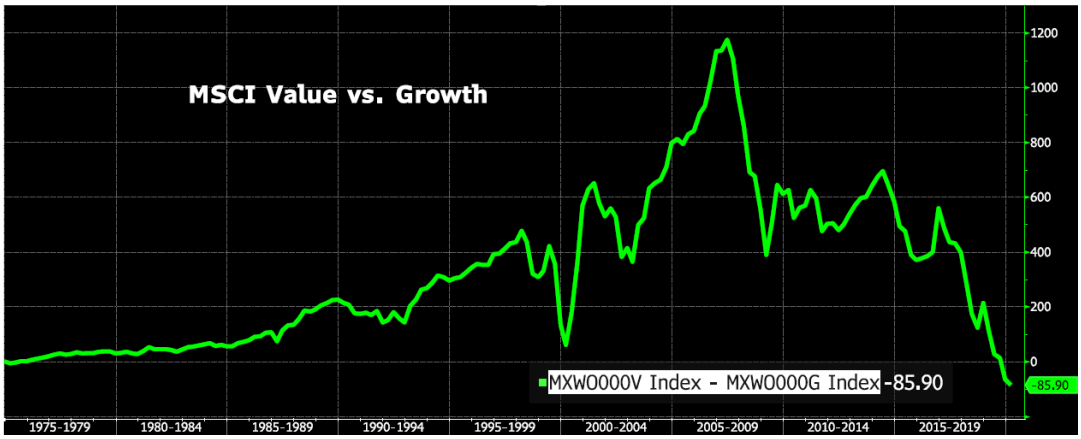
To date the supportive monetary environment has favoured a continued flow of capital (including passive investors) into Growth and Quality type equities, and as a result we have had to work very hard just to keep up with our benchmarks; however, we would expect a recovering global economy over the coming quarters together with bond yields trending upwards to support a broader set of equity investments, in particular our **PVT** stock picks, backed as they are by attractive valuations.

Value

Value had a better quarter but was still down on the year. With the anti-value cycle now having lasted over ten years there have been some notable casualties with several high-profile value managers exiting the market. Given that we have continued to run committed value portfolios throughout this difficult period our performance has been reasonable and has allowed us to "stay in the game", ready to benefit when we get a more sustained interest in buying companies when they are attractively valued.

The anti- value cycle (MSCI Value vs. MSCI Growth) has lasted over ten years – the longest recorded period of value underperforming:

MSCI World Value vs. Growth



Source: Bloomberg

Style returns and our key factors

In 2019 the market's focus (all round the globe) was on Growth stocks, with Quality stocks also robust. Value (buying things cheaply) continued to struggle, though this did improve towards the end of the year. By implication, through the year investors were happy to pay higher and higher prices for Growth and Quality.

Style returns over 2019, by region:

Regional Style performance Spreads, 2019

Due to copyright restrictions we are not permitted to include this chart here.

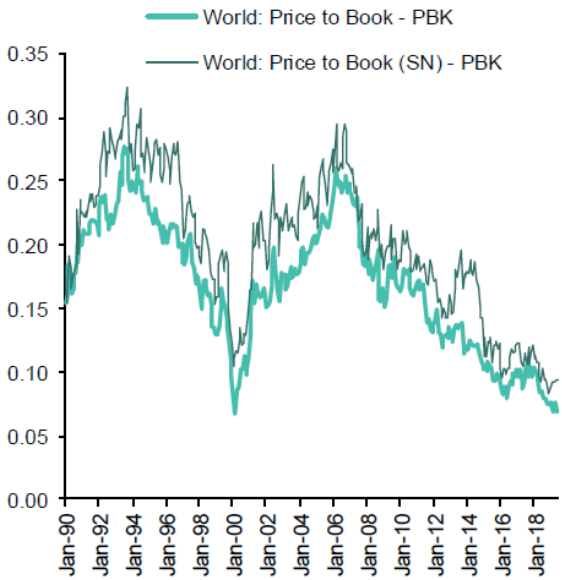
Source: Citi Research, MSCI

Our other key factors - recovery, small cap and looking for regional value around the globe - also struggled during much of 2019 though the last quarter was more supportive, helped by a decisive UK General Election and more confidence in the global economic outlook.

Relative valuations of different styles

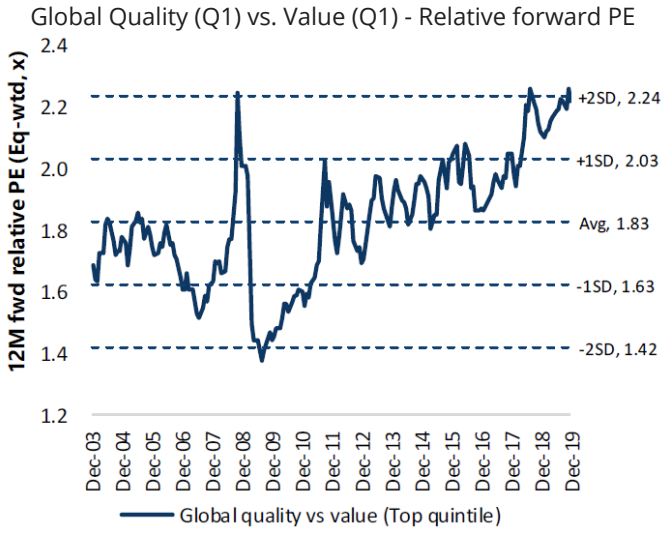
Value stocks continue to trade very cheap versus their history. The chart below shows the relative valuation of value stocks globally (on a price to book (PB) basis, including sector adjusted). We remain at the TMT (technology, media and telecoms) bubble extremes and this is very much a global phenomenon.

Global Price to Book valuation



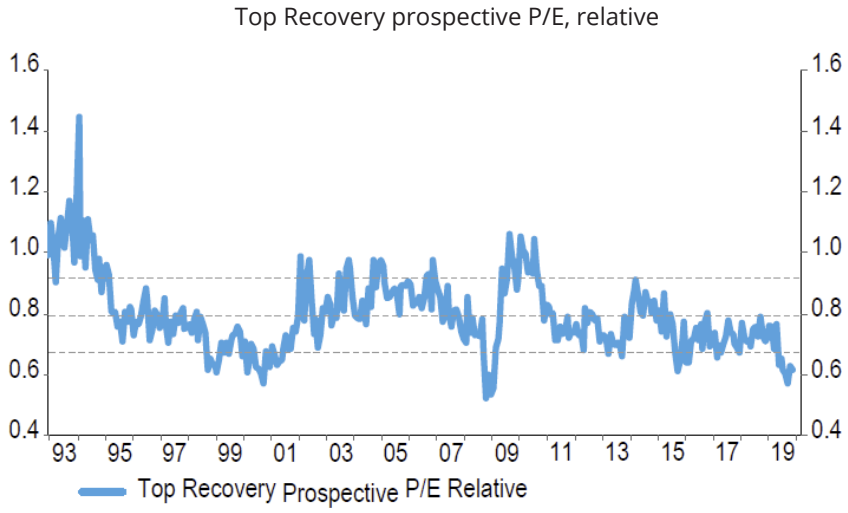
Source: Datastream, MSCI, Bernstein analysis. Data to 19 June 2019

Meanwhile, for example, Quality stocks are valued at relative peaks versus their history. The chart below shows the relative price to earnings (PE) multiple of the top quartile of Global Quality stocks vs. the top quartile of Global Value stocks.



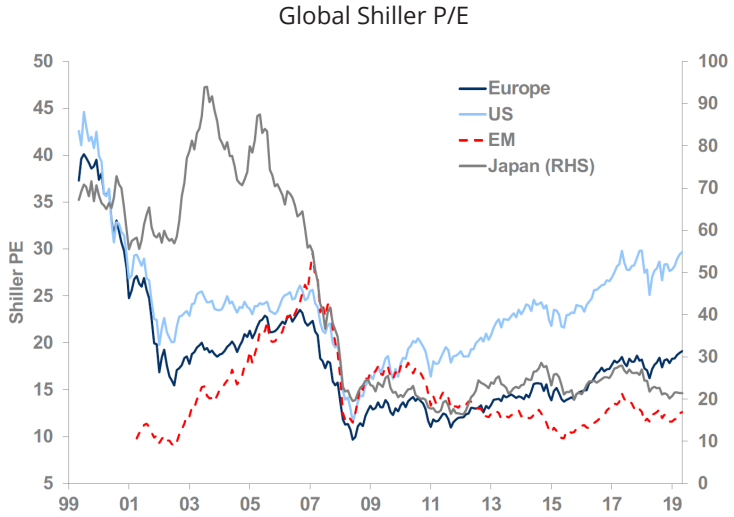
Source: Jefferies, FactSet alpha tester. Note: Bottom-up aggregate PE based on equal weight.

And our favoured Recovery stocks continue to trade relatively cheap, undermined over the last 18 months by the weakening global economy; but here the outlook looks more supportive, suggesting a very apposite time to be adding to recovery type stocks. The graph below shows the relative PE valuation over time of a cohort of recovery stocks (as defined by BofA Merrill Lynch, very similar to our definition of recovery) versus non-recovery stocks.

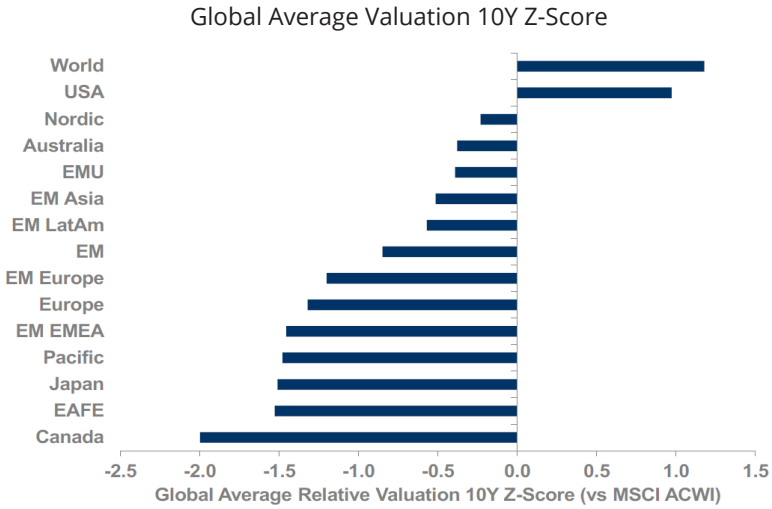


Source: BofA European Equity Quant Strategy. Reprinted by permission. Copyright © 2020 Bank of America Corporation ("BAC"). The use of the above in no way implies that BAC or any of its affiliates endorses the views or interpretation or the use of such information or acts as any endorsement of the use of such information. The information is provided "as is" and none of BAC or any of its affiliates warrants the accuracy or completeness of the information.

In addition to these cycle extremes there are very material regional valuation anomalies, with the US, the momentum market and cheerleader for relatively expensive growth stocks, valued pretty highly versus history while other regional markets are reasonably valued in absolute terms and versus their own histories. The Morgan Stanley graphs below show Shiller PEs over time for the US, Europe, Japan and emerging markets (EM), and a Z score ranking of relative valuations around the world.



Source: Morgan Stanley Research, European Equity Strategy, 2019.



Source: Morgan Stanley Research, European Equity Strategy, 2019.

Not quite as extreme but another opportunity: Small caps

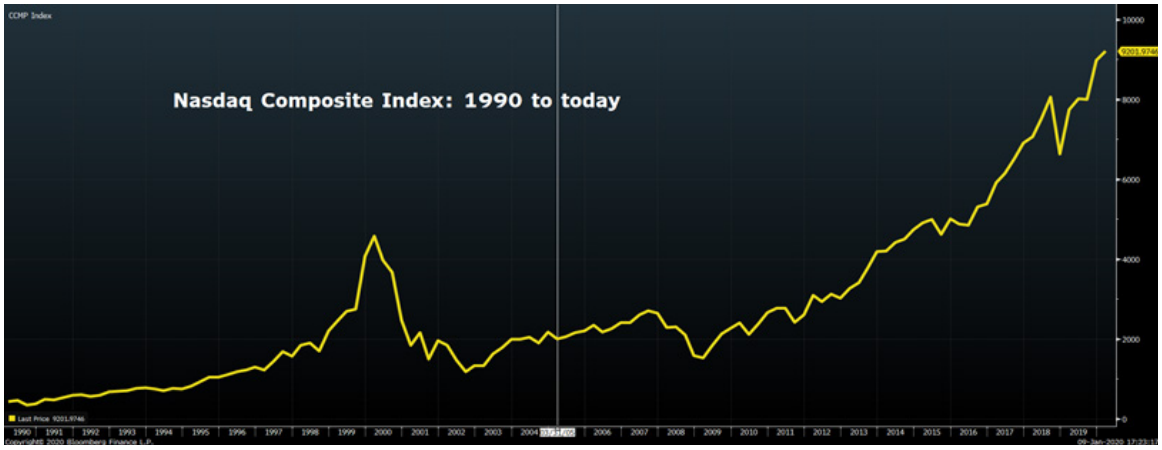
Whilst they had a solid fourth quarter, smaller companies have underperformed around the globe over the last two years, caught up in fears about the economic outlook with less exposure to bond proxy and ETF-able growth characteristics. This has left small caps in the UK, US, Europe and Asia Pacific trading at valuation discounts despite their superior longer-term growth characteristics. We continue to favour this area.

Lots of PVT stock picking opportunities still exist –medium term return potential is no worse than historic returns.

Because of the market's emphasis on paying higher and higher prices for growth and quality stocks there remains a substantial set of stock picking opportunities for us PVT investors. Perhaps not at the rock bottom prices that were available earlier in the year but bottoming-out share price technicals are a positive, reflecting improving fundamentals and emerging investor appetite. We continue to find attractive business franchises on high single-digit (and some on double-digit) earnings yields and attractive free cash flow (FCF) yields where profit growth and intrinsic value potential over the medium-term is substantial – the results are portfolios that should be able to generate the absolute returns that we have seen since the inception of the funds I manage, this theme developed below.

But keeping up with the Nasdaq Index?

This is the very frustrating aspect of investment at the moment. You can put your heart and soul into finding PVT anomalies in the UK and around the world, lots of them have worked really well, but can you keep up with the GROWTH stocks, in particular the Nasdaq Index…?



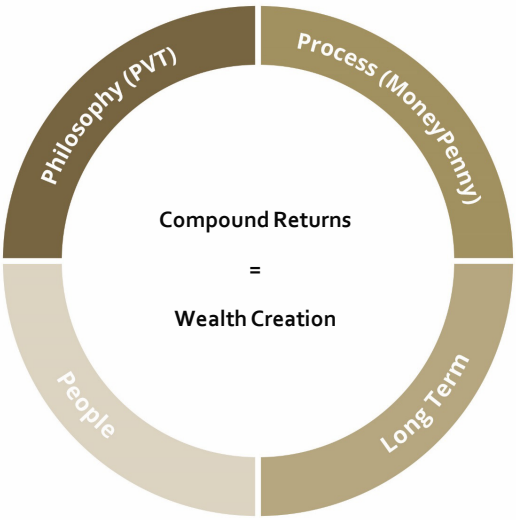
Source: Bloomberg

But do you *want* to keep up with it? If you do, then ETF'ing makes sense… but then you are buying an index that has already gone up A LOT and is on a PE of 34x, PB of 5, and Price to Sales (PS) of 3.3x. This is part of the active vs. passive debate, as I continue below.

Wealth creation

At times like this when the investment industry is under a lot of scrutiny we like to remind ourselves what lies at the heart of what we do; the slide below appears in all my standard presentation packs and is a statement that our key objective (and the very exciting part of what we do) is to create significant wealth for our clients by exploiting what Albert Einstein coined the 8th 'Wonder of the World' – that being compound returns. It is a fact that £1m invested for twenty years, achieving a 12% annualised total return, becomes £11m at the end of the period (if you don't believe me then there are loads of compound interest apps you can download to check).

The aim of our investment approach? Creating wealth for our clients through compound returns:



Source: River and Mercantile Asset Management LLP

If you can compound in double figures? Here is the maths:

After 20 years	At (p.a.)	12%	13%	14%	versus	8.2%[1]
£1m	Becomes	£11m	£13.5m	£16.4m		£5.2m

For illustration purposes only.[1]Source: River and Mercantile Asset Management LLP

And how have we done over the years? Below I show all the strategies I have run over my career, showing the annualised returns since inception, some going back over twenty years, through all sorts of economic and stock market cycles. The range of these returns is 12-14% p.a., behind the fund manager greats but enough of a return to help create significant wealth. And you, the reader, has been kind enough to allow me to help you and your clients become wealthier.

What equity investing should be about: Delivering attractive returns over the long term:

Hugh Sergeant Strategies (GBP)	Inception	Since Inception % (p.a.)	No. of years
UK Equity High Alpha**	1 January 1992	13.7	26
UK Recovery	17 July 2008	13.0	11
Global Recovery	4 March 2013	13.7	6
Global High Alpha***	23 December 2014	12.7	5
Hugh Sergeant Strategy (USD)	**Inception**	**Since Inception % (p.a.)**	**No. of years**
Global Concentrated	1 Feb 2012	14.6	8

Source: River and Mercantile Asset Management LLP. GBP gross of fees performance for all funds and representative accounts. All performance is to 31 December 2019 and is calculated on a mid to mid basis at close of business. **ES R&M UK Equity High Alpha Fund launched on 28.11.2006. Performance since that date is sourced from River and Mercantile Asset Management LLP. Returns for 2006 are from 28.11.06 to 31.12.06; returns for other periods are calendar years. Source for other data: The WM Company, Lipper Hindsight. 1992 to 2001 = segregated account with FTSE All-Share Index +2% target, managed by Hugh during his time at PDFM/UBS. 2003 to 2005 = The SG UK Growth Fund. Performance for 2002 and most of 2006 is not included in the Since Inception Calculation as Hugh was on gardening leave due to moves to SGAM and R&M, respectively. ***Please note, performance for the Global High Alpha Strategy (GBP) is calculated from inception to 12 August 2016 for the ES R&M Global High Alpha sub-advised sleeve of the ES R&M Dynamic Asset Allocation Fund. From 12 August 2016, performance is calculated from the ES R&M Global High Alpha Fund 'share class'. The Global Concentrated Strategy is representative of a segregated account which is based in USD. All performance is to 31 December 2019 and is calculated gross on a mid to mid basis at close of business.

Active investing

Wealth can clearly be created by investing passively, deliberately replicating a market index in order to achieve a return that is consistently a little bit worse than this benchmark (as there are some costs involved). This is a sensible and low risk way of approaching investment, and at times like this when active managers are under scrutiny is, according to some, the only way to do things. But of course, it is not the only way, and the power of compounding explains why. If you look at the compounding example shown above, just a 2% additional return on your £1m invested (14% p.a. return rather than 12% p.a.) creates another £5.4m of wealth after 20 years. Yes, the numbers are big! And are active managers, on average, really that bad? If you look at the median UK equity manager (IA UK All Companies)

over 10 years to the end of December 2019, they have returned 129.7% which compares very favourably to the MSCI UK benchmark return of 113.2%, the Legal & General Tracker Trust return of 109.4%, and the Virgin UK Tracker of 99.4%. Over that same time period the ES River and Mercantile UK Recovery Fund has returned 207%, the ES River and Mercantile UK Equity High Alpha Fund 173.3%, Schroder Recovery (our closest peer) 161% and Liontrust Special Situations (top percentile fund) 314% (all data sourced from FE Analytics).

And here are the relative to benchmark, since inception, returns for all the pooled funds run off our PVT Platform. Given a clear philosophy and process, the right people and the passage of the right amount of time then benchmarks can be bettered and by a wide margin if you let compounding work its magic:

Global Strategies		Since Inception % (p.a.)	Added Value % (p.a.)
Global High Alpha* (GBP)	Inception: 23 Dec 2014	12.7	+0.9
MSCI ACWI		11.8	
Global Recovery (GBP)	Inception: 4 March 2013	13.7	+2.4
MSCI ACWI		11.3	
Global Concentrated Portfolio (USD)	Inception: 1 Feb 2012	14.6	+4.8
MSCI ACWI		9.8	
UK Strategies GBP		**Since Inception % (p.a.)**	**Added Value % (p.a.)**
UK Equity High Alpha	Inception: 28 Nov 2006	8.5	+2.6
MSCI United Kingdom IMI		5.9	
UK Recovery	Inception: 17 July 2008	13.0	+5.1
MSCI United Kingdom IMI		7.9	
UK Dynamic	Inception: 22 March 2007	7.5	+1.9
MSCI United Kingdom IMI		5.6	
UK Equity Smaller Cos.	Inception: 30 Nov 2006	12.1	+5.7
Numis Smaller Cos AIM. ex IT		6.4	
UK Income	Inception: 3 Feb 2009	11.5	+0.9
MSCI United Kingdom IMI		10.6	
*R&M UK Micro Cap**	Inception: 2 December 2014	14.3	+5.4
Numis Smaller Cos AIM. ex IC		8.9	

Source: River and Mercantile Asset Management LLP, MSCI (for further information please refer to the disclaimer at the end of this pack). Z share class (gross of fees) performance for all Funds except ES R&M UK Equity Income and ES River and Mercantile ('R&M') UK Equity Smaller Companies which is B class performance. B share class (income units) performance for the ES R&M UK Equity Income Fund is net of an annual management charge of 0.75% per annum. Performance for The ES R&M Global Recovery Fund is shown in GBP. Performance for ES R&M UK Equity Smaller Companies Fund B share class (accumulation units) is net of an annual management charge of 0.75% per annum. All fund performance is to 31 December 2019. *Please note, performance for the Global High Alpha strategy (GBP) is calculated from inception to 12 August 2016 for the ES R&M Global High Alpha sub-advised sleeve of the ES R&M Dynamic Asset Allocation Fund. From 12 August 2016, performance is calculated from the ES R&M Global High Alpha Fund 'share class'. *The UK Micro Cap Investment Company Limited is a closed ended vehicle with the NAV calculated close of business using data provided by BNP Paribas. PAST PERFORMANCE IS NOT A GUIDE TO FUTURE PERFORMANCE.

The PVT team - organisation and investment

The non-investment demands on fund managers has continued to increase over the last few years – the latest being the introduction of the Senior Managers regime. In order to reflect these demands and to ensure that our key investors can focus on investment we have decided to put in place a new management structure: Charles Benett moves up to become Managing Director of the PVT Team, with a leadership role in non-investment matters; I become Head of Value and Recovery, responsible for investment and strategic leadership for this product set; Dan Hanbury adopts the same role for the Smaller Companies and Income products.

At the same time, we continue to be committed to investing in the team, with two live searches at the moment: firstly an additional analyst who would focus on global equity research; and a number two to Charles on the quantitative research side, to support the existing platform but also to ensure that we enhance our quants capability and potentially extend it into sustainable investing.

Last quarter's market returns - introduction

December saw two important pieces of geopolitical news which reduced a couple of the tail-risks that had roiled both global and UK domestic investors, in the form of a détente in the US-China trade war and a convincing majority for Prime Minister Boris Johnson's Conservative Party in the UK general election. When combined with a bottoming-out in global economic lead indicators and an inventory correction plus accommodative monetary policy around the globe, the current set-up suggests taking a positive view on risk assets like UK equities over the intermediate term.

In the UK, it had become clear from election manifestos that whichever party formed a government there was going to be a period of fiscal stimulus in the UK. However, the clear political swing to the left embodied by Labour's

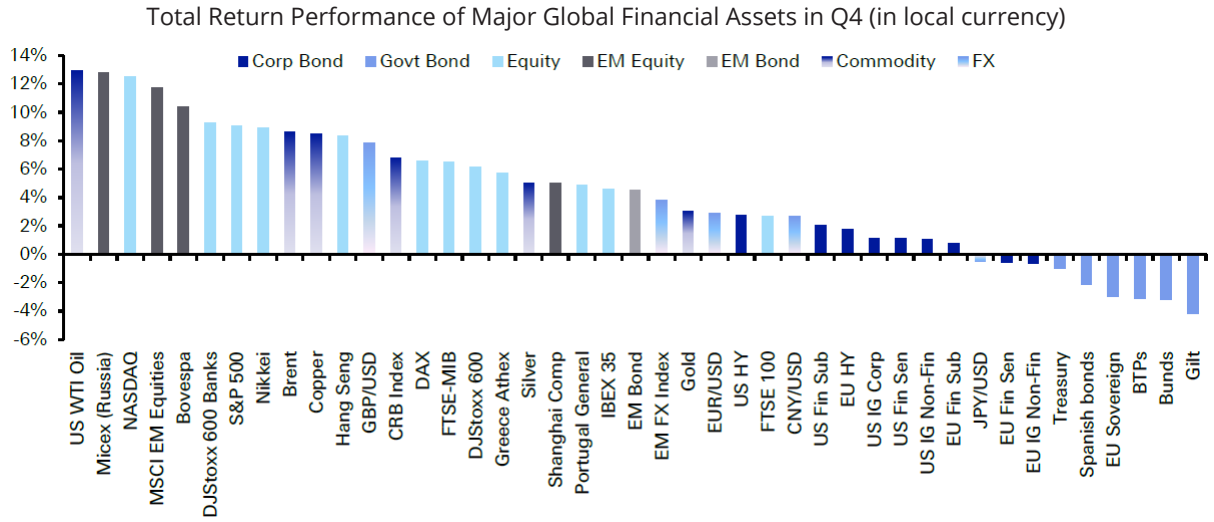
manifesto – with its somewhat troubling moves for investors towards property appropriation – had undoubtedly upped the stakes on the result in the eyes of many investors, regardless of whether some of the more extreme policy elements were deliverable legally or politically. As such, a Conservative majority – and in the end a more convincing one than most had anticipated – is a strong positive for UK businesses and their equity investors. There is a wonderful opportunity here for the government to inject some optimism into an economy that has found itself facing the burden of uncertainty (with impressive levels of resilience) since the EU referendum in June 2016 and to provide a stable platform that allows some of the pent-up demand and investment, from both domestic and foreign sources, to be unleashed.

Investor anxiety over an imminent US recession has reversed as the US de-escalated the China trade and technology war, while the Fed and other global central banks have further loosened monetary policy to offset the souring corporate sentiment, particularly in the manufacturing sector (as indicated by PMIs below 50), that we highlighted last quarter. We see evidence in the data of an inventory correction and improving order trends as supportive of the view that global economic growth will improve. Certainly, the risk of a recession materialising in 2020 under the current conditions appears low, but we should not necessarily conflate this with a sharp inflection or high growth.

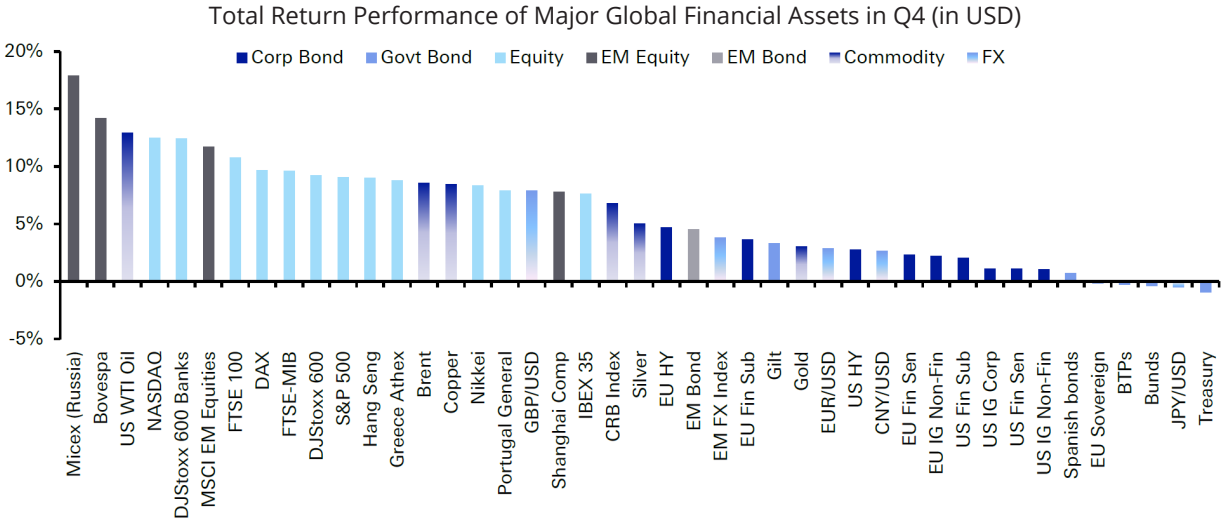
Market returns

The fourth quarter mirrored a strong overall year for major financial assets with 34 out of the 38 non-currency global assets monitored by Deutsche Bank (DB) showing a positive return in US dollar (USD) terms in the quarter and all 38 delivering positive returns for 2019 overall in both local currency and USD terms. Risk assets led the way in Q4, a combination of growth-oriented equities (Nasdaq +12.5%), a strong bounce in emerging market equities (MSCI EM +11.7%), financials and commodities (notably oil and copper) all strong. The best performing currency pair in DB's rankings over Q4 was GBP/USD, with sterling ending the quarter +7.9% against the dollar ensuring a strong USD return for UK equities. Much of sterling's gains came after Prime Minister Johnson and the EU agreed a new Brexit deal in October, and the gains in GBP/USD over the last three months mark the strongest quarterly performance since Q2 2009. Returns from sovereign debt and credit markets were more subdued. The dollar had its first period of weakness for a while.

The total return performance of major financial assets in Q4 (in local currency and USD):



Source: Deutsche Bank Research, Bloomberg Finance LP, Mark-It



Source: Deutsche Bank Research, Bloomberg Finance LP, Mark-It

The MSCI All Country World Index (ACWI) was up robustly in USD terms (+9.1%), as was MSCI World (+8.7%), but was weaker in GBP due to local currency strength (MSCI ACWI GBP +1.4%). MSCI UK Investable Market Index (IMI) (+3.6%) lagged the rest of the world, with share prices undermined by sterling strength. The USD return for UK equities was robust.

Within equity markets the MSCI ACWI Enhanced Value index was modestly ahead of our MSCI ACWI benchmark (returning +10.7%) with a relatively strong conclusion to the year.

How did we perform and why? (Before and after fees, close of business benchmark, mid-day fund price)

Over the quarter

We performed strongly over the quarter, supported by more certainty returning to global economies which seemed to encourage a broader market. None of our key factors were particularly robust - with value having a modestly better quarter, recovery stocks starting to perform and small cap at least no longer acting as a drag – but, in combination, they supported better relative returns, and allowed positive stock picking to come through. A rampant Nasdaq remains a big headwind. Sterling strength dampened the absolute returns for GBP based holders.

The portfolio returned +4.6% (Z shares, gross of fees) and +4.3% (B shares, net of 0.75% p.a. fee) compared with the benchmark MSCI ACWI (+1.3%). Our regional and sector weighting were broadly neutral, with the majority of performance coming from stock selection with an additional contribution from FX (USD weakness).

Longer term performance

Performance for our global funds in 2018 and for the first three quarters of 2019 was difficult as all our key factors (Value, Recovery, Small Cap and a diversified regional exposure) lagged. Performance prior to this period was robust and wealth creation (annualised compounding since inception) has also been strong, especially given the ongoing headwind from the Value factor. . Over 2019 the performance was modestly behind the benchmark with the fund returning +19.6% (+18.3% for the B shares) compared to the benchmark MSCI ACWI return of +21.7% (MSCI ACWI Enhanced Value -7.4% vs benchmark, MSCI ACWI Enhanced Value (USD) +19.2% vs. MSCI ACWI (USD) +26.6%)); over three years the return of +7.6% p.a. (+6.6% p.a. for the B shares) is also behind the benchmark return of +9.9% p.a. (Enhanced Value +2.8% p.a.); the five year return of +11.5% p.a. (+10.4% p.a. for the B shares) versus the benchmark return of +12.0% p.a.; and the since inception return of +13.7% p.a. (+12.6% for the B shares) compares favourably with the benchmark return of +11.3% p.a. over the same period. The cumulative increase in the Z shares since the 2013 launch is over 140%. We await stronger support from all our factors.

Key performance contributors

Positive: **PVT** stock picks (**Prada**, **Wiit**, **Yageo**); recovery stocks bottoming-out (**CGG**); Brazilian stock picking, especially small cap (**Gafisa**, **Eucatex**) ; underweight bond proxies; financials rally.

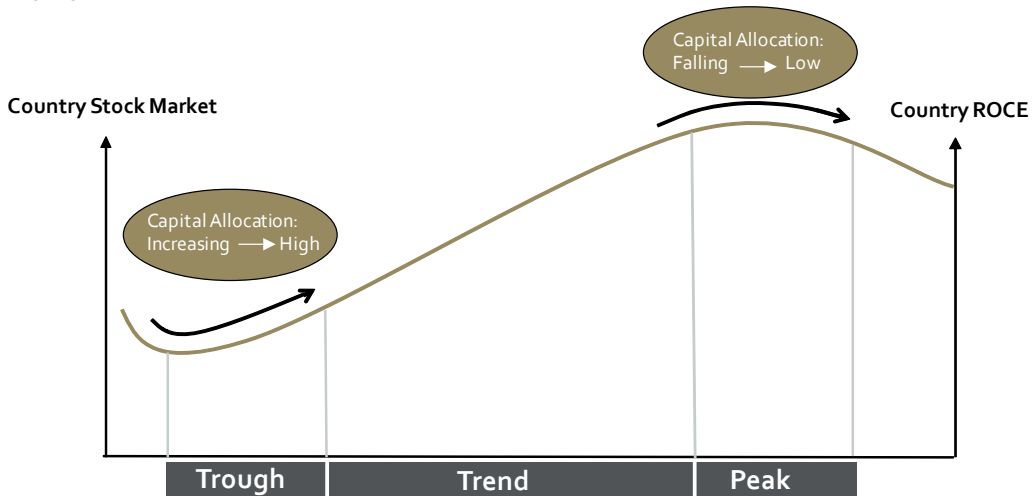
Negative: Nasdaq and global growth stocks power on (**Apple** underweight);, stock disappointments (**Tullow**).

Performance outlook

Despite the short-term rally my funds remain inversely correlated to bond yields at the moment, so sadly the biggest driver of my relative performance at the moment is bond yields; bond yields trending positively as the global economy picks-up is supportive of our factors which remain out-of-favour and mostly still at generational cyclical lows.

Meanwhile, this portfolio remains very good value and will, we believe, show attractive levels of medium-term profits and cash flow growth as we are exposed to many secular growers (but ones that are currently less fashionable) and classic recovery stocks that can significantly enhance shareholder value. The potential for our key factors to help generate strong returns is significant as is our ability to invest in high conviction **PVT** stocks.

The Country Cycle - where are we now?



Countries	P	V	T	Av
Netherlands	90%	94%	82%	89%
Italy	83%	98%	63%	81%
Hungary	77%	92%	68%	79%
New Zealand	92%	85%	51%	76%
US	57%	100%	64%	74%
Austria	81%	71%	65%	72%
Australia	65%	97%	46%	69%
France	54%	97%	57%	69%
Finland	60%	85%	61%	69%
Belgium	83%	59%	56%	66%
Russia	60%	80%	55%	65%
Switzerland	57%	98%	40%	65%
Denmark	57%	87%	49%	65%
Ireland	45%	94%	50%	63%
Canada	72%	42%	73%	62%
Portugal	39%	94%	53%	62%
Brazil	78%	74%	29%	60%
Colombia	80%	33%	57%	56%
Taiwan	21%	97%	50%	56%
Greece	54%	58%	51%	55%
Japan	55%	48%	59%	54%
Germany	54%	51%	51%	52%

Countries	P	V	T	Av
Sweden	31%	62%	51%	48%
UK	46%	42%	52%	47%
Peru	38%	35%	67%	46%
United Arab Emirates	47%	49%	37%	44%
Spain	31%	44%	47%	41%
Singapore	51%	28%	43%	41%
India	5%	53%	58%	39%
Israel	17%	57%	42%	39%
Poland	33%	16%	66%	38%
Saudi Arabia	22%	63%	30%	38%
Mexico	43%	14%	55%	37%
Norway	28%	67%	16%	37%
China	21%	48%	38%	36%
Philippines	44%	10%	52%	35%
Chile	34%	0%	49%	28%
South Africa	33%	2%	47%	28%
Hong Kong	5%	16%	54%	25%
Thailand	19%	12%	44%	25%
Turkey	19%	12%	44%	25%
Indonesia	19%	12%	44%	25%
South Korea	9%	26%	36%	24%
Malaysia	17%	1%	29%	16%

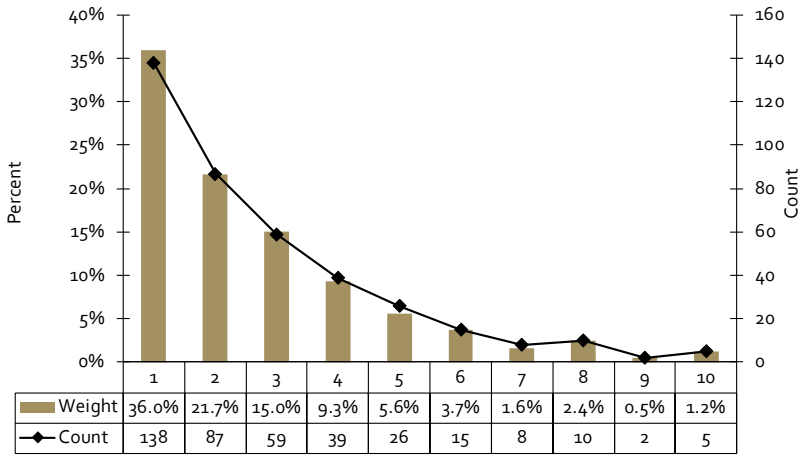
Source: River and Mercantile Asset Management LLP

The above shows our country cycle quantitative scores, with 'high' being bad whilst 'low' is good. US equities remain close to the top of the ranking, meaning they are late cycle and, therefore, continue to have riskier attributes. Core Europe combines supportive valuations with mid-cycle returns on capital and is more attractive than the US as a result, Germany in particular; the UK remains attractive, with still modest equity valuations and a domestic equity profit cycle that will benefit from post-election certainty; emerging market and resources exposed countries (such as Brazil, Colombia, China, Malaysia and Singapore) are scoring very well at the moment, still closer to the bottom of their cycles with very attractive valuations; Hong Kong is now showing early cycle characteristics with very low valuations, as the economy and sentiment have been heavily impacted by the pro-Democracy protests; Japan remains attractive on the basis that it has permanently improved its previously very low return on capital and spot multiples are very low; in addition Japan has lagged other markets but should be geared to an improving China and overall global growth outlook.

We remain committed to a much more diversified and earlier cycle regional exposure for our global portfolios than that offered by the global benchmark, not wanting to put all our (your) eggs in the US equity basket given how mature the US cycle is and finding compelling PVT stock picking opportunities all around the world. In Europe, domestic facing stocks have continued to lag and provide many recovery PVT opportunities and the Quality vs. Value gap is particularly dramatic in this region, something for us to exploit. We continue to like the longer-term growth characteristics of Asia which combine with somewhat depressed but improving returns, attractive valuations and more supportive cyclical stimuli. Whilst we remain cautious of US equities, given how mature the cycle is, substantial increases in valuation spreads during 2018/19 have continued to present a greater set of stock picking opportunities.

Does the portfolio reflect our philosophy and process?

Decile skew as at 31 December 2019



Source: River and Mercantile Asset Management LLP

With more Growth and Quality stocks being de-rated due to fears about their cyclical exposure we have a somewhat more balanced category mix across our four categories of Potential, though the continued anti-value, anti-recovery and anti-risk nature of the market has meant that our high conviction **PVT** stocks remain very different from consensus: *Recovery* (41%), *Asset-backed* (21%), with reasonably priced *Quality* (20%) and *Growth* (18%) steady.

Economic outlook: Improving in the UK and globally

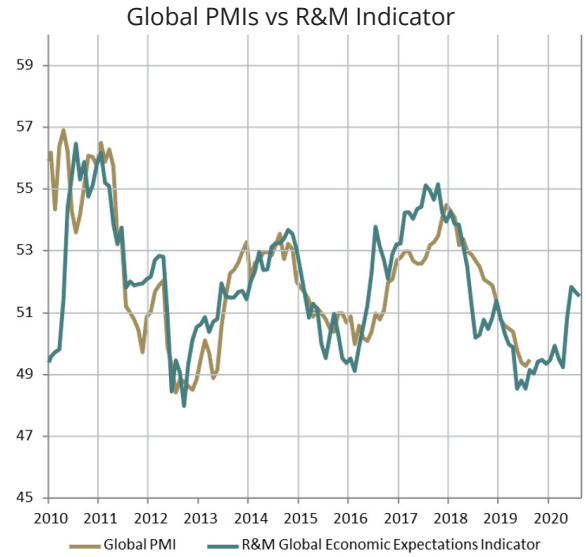
Although the risk of a semi-hard Brexit at the end of 2020 will continue to hang over the UK, the sweeping December election win for BoJo and his Conservative Party has brought much of the damaging uncertainty of recent years to an end. Amid the clearer outlook, we see three positive factors that can underpin an economic rebound.

A recovery in global demand should lift output in export-oriented industries. The latest survey data for production expectations among manufacturers of intermediate and investment goods have bottomed-out, with some tentative signs that a rebound is already underway.

Less UK domestic political uncertainty can lift household confidence and underpin a pickup in real consumption growth. Wages are rising at a decent clip, while households' finances remain solid. Facing fewer risks, consumers should now have the confidence to spend more.

In addition, government spending growth is accelerating. At the September 2019 Spending Round, Chancellor Sajid Javid already set out plans for the fastest growth in day-to-day government spending in 15 years. Expect a further step-up in public sector investment spending at the upcoming budget in March as well as initiatives to support economic development in the North, already a clear ambition of this government and underpinned by the northern electorate's support during the recent election.

Mike Faulkner, our Group CIO, has echoed these sentiments in recent thought pieces that he and his research team have produced: bullish on the 2020 outlook for the global economy, and strongly of the view that this will support a robust return to the value factor:

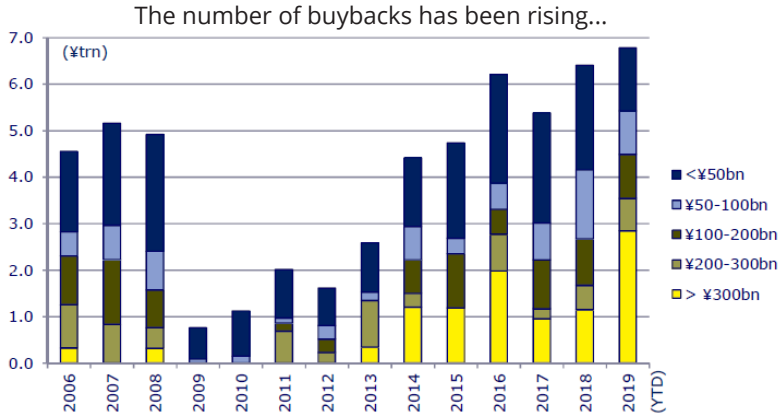


Source: River and Mercantile Solutions, Bloomberg. As at 31 August 2019

Some additional observations regarding the regional equity opportunities around the world:

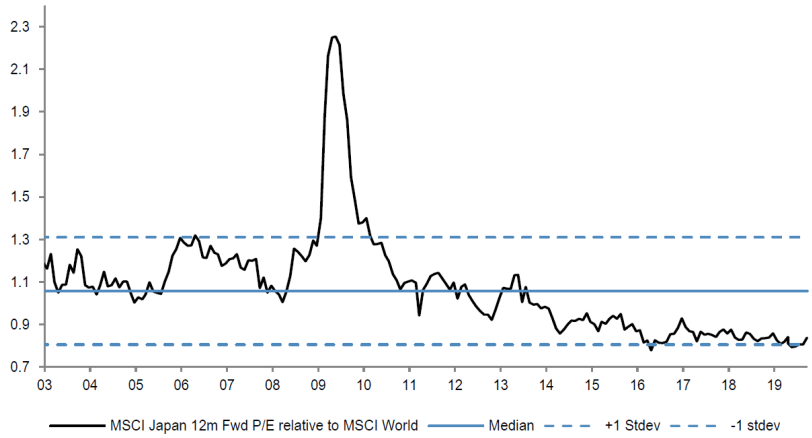
Despite last year's robust performance, **UK** and **European equities** remain comparatively unloved, trading on a high dividend yield premium versus local bond markets, with corporate profits still well below previous peak levels (with domestic profits in Europe remaining subdued), and with valuations relative to the US equity market at a generational low.

Japanese equities are good value, they are some of the most geared to the global industrial production cycle (so will benefit as lead indicators bottom-out) and they have become pretty aggressive at managing shareholder value as shown below with buybacks increasing every year since 2013 and, this year, running at 7% of market cap!



Source: CLSA, Bloomberg

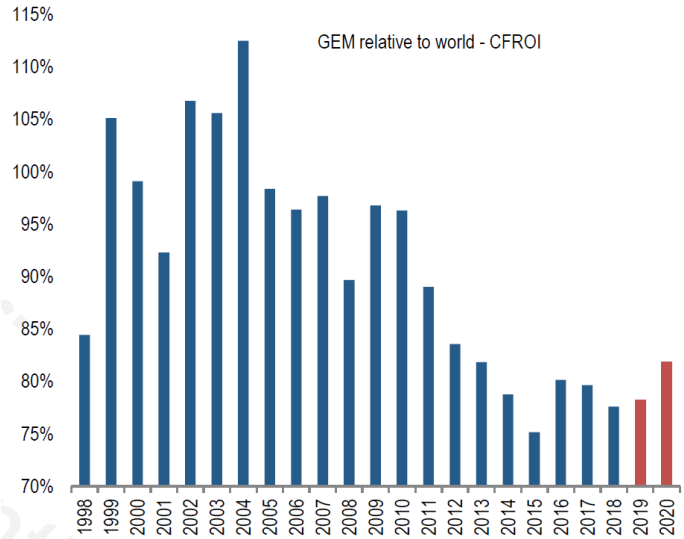
MSCI Japan 12m forward PE relative to MSCI World



Source: IBES, J.P.Morgan Cazenove

Emerging markets are good value and big beneficiaries once some of the well-known short-term uncertainties dissipate and at a company level, like Japan, they are becoming better guardians of shareholder value with the chart below showing that cash flow returns on investment (CFROI) are trending positively whilst at the same time the current spot free cash flow yield is higher than the developed world:

CFROI is improving relative to the world from low levels



Source: Credit Suisse HOLT

The US equity market is clearly more expensive than other equity markets around the world, as shown earlier by the US Shiller PE. However, this premium has been largely justifiably ignored in the context of the superior return on equity (RoE) and shareholder value growth delivered by the US corporate sector over the last few years. However, one can argue that elements of the US equity superiority are peaking – indeed two key components in the high RoE story are one-off in nature and close to their peaks – namely the significantly reduced tax burden and the benefits of leverage which together have accounted for a lot of the RoE vs. history and vs. the RoW (rest of world).

Portfolio positioning – activity, themes and stocks

Style Skyline History Range Jan 2011 - Dec 2019

Source: StyleAnalytics

The portfolio remains very good value with most measures of value commitment in the top quartile of the fund's historic range (Style graph above, the red diamonds show the current positioning): trading on a price to book of 1.3 times (a 50% discount to the market), an earnings yield of 8.7%, a cash flow yield of 13%, a dividend yield of 2.4% and a price to sales of 0.9 times, (a 45% discount, all data sourced from StyleAnalytics).

Activity

We continue to stick with what we have been doing over the last few decades: **PVT** stock picking in the UK and globally, wanting to find good franchises but buy them when they are temporarily out of favour rather than when they have already done really well. Our focus remains on good value stocks, recovery type stocks, small and mid-cap stocks, out-of-favour stocks which are clear **PVT** anomalies, partly because their thesis has some uncertainty associated with it and regional diversification. None of these characteristics are favoured by other investors, active or passive, all of whom seem to favour already highly regarded franchises; ones that have consistently made high returns and whose valuations may be high versus their own histories but not out of court if valued against government debt with a negative yield.

Now continues to be a good time to be buying growth cyclicals as they have de-rated aggressively alongside weakening PMIs and short-term demand; we look for strong market positions, attractive through-the-cycle growth and returns, and valuations that discount a 'normal' (not Global Financial Crisis (GFC)) downturn. Examples of this include **Prudential**, **Cisco**, **Fanuc**, **Las Vegas Sands, Imax** and **Carnival**, the latter now trading at its lowest earnings multiple since the GFC:

Source: Bloomberg

We continued to add to our Japanese small cap exposure, a rich hunting ground for PVT opportunities and a long-term source of compounding. An example was our purchase of **Sansei Technologies** (1st decile *Asset-backed*, 2nd decile *Growth*), the leading independent lift servicing company in Japan. With a history of sensible management plus consistent revenue growth and margins, it was available on a single-digit earnings multiple and discount to book value with an activist investor now on the shareholder list encouraging increased investor communication from this family run business.

We identified a number of new, high conviction recovery stocks during the second half of 2019 and added capital to these during the last quarter, including **GEA** (mentioned below) and **Aryzta** (1st decile *Recovery*), a leading global producer of fresh bakery products.

Sales were again focused on M&A (**Amerisur**, **Bolsas y Mercados Espanol**), taking profits in a number of strong performers where valuations looked less inviting (**Wiit**, **Adevinta**, **Banco BTG**, **Fiserv**, **RWE**) and cutting stocks where the thesis was not playing out or we had worries about the **T**iming aspect of **PVT** (**AMS**, **BEC World**).

Significant stock positions and new ideas:

Carnival (2nd decile *Asset-backed*) is the market leader in the global cruise industry, with unrivalled scale at twice the size of its nearest competitor and close to 50% global market share. The market fears that Carnival cannot sustainably grow earnings as supply growth in excess of demand growth will destroy pricing discipline and return on capital. However, we find no empirical evidence to show a strong relationship between pricing and supply growth in the cruise industry. This is attributable to a number of industry specific factors. Firstly, the cruise industry is deeply underpenetrated at under 4% of leisure demand so capacity additions are inconsequential in context of the wider market, and cruise is taking share from land-based vacations driven by compelling relative value. Secondly, demographic tailwinds in both mature and emerging markets drives structural demand growth that helps compensate for cyclicality. Thirdly, industry supply growth is measured as global ship building capacity is constrained with only three major global shipbuilders and net supply growth is held back by retirement of existing vessels which is being accelerated due to new environmental standards. Recent share price weakness has taken the valuation down towards GFC lows, more than discounting short-term issues; indeed, the latest company update has underpinned current forecasts suggesting that **T**iming is starting to be supportive.

Prudential (2nd decile *Quality*) is a genuine Quality compounder, delivering a 25% return (CFROE) while growing its equity base at 5-10% every year since 2009, and with a track record of ~15% CAGR (compound annual growth rate) in operating earnings since 2004. The engine for sustained growth is its leading Asian franchise, with an agent base that would be impossible for a competitor to replicate from scratch selling into structurally growing demand, propelled by lower insurance penetration, lack of state benefits and favourable demographics. The CEO of Asian operations believes this business can double earnings over the next 5-7 years, i.e. 10-15% CAGR, though growth has been under pressure in the short term from disruption caused by the Hong Kong protests. It also has a market-leading US variable

annuities (VA) business (Jackson National) which can benefit from baby boomers heading into retirement, driving demand for its products. In Q4 2019 it completed the spin-out of M&G, one of the largest UK life insurers and asset management businesses. We see this as a positive step to generate shareholder value, acting to shine a light on the compelling valuation opportunity in the Asian business particularly. The group trades on 10x earnings, which is low considering the growth potential and return profile, but the implied discount on the Asian business versus close peer AIA trading on 19x – even assuming a relatively low multiple for Jackson National – looks stark. We think it is possible that the board looks to sharpen the focus on the Asian franchise further in due course by selling or IPO'ing Jackson, which would materially alter the risk profile by reducing shareholders' exposure to financial assets.

Baidu, the leading internet search engine in China is a top decile scoring Recovery PVT stock within our proprietary global stock screen (MoneyPenny). Baidu has recovery Potential because its share price and return on capital are depressed after a period of significant investment in new areas of growth (such as online video publishing, cloud based services, artificial intelligence and autonomous driving, all of which are establishing strong market positions in China) coincided with a period of weaker performance from its core search business which saw growth reduce due to some loss of market share and a cyclical downturn in advertising spend. Our view is that return on capital has now bottomed-out as its period of investment has peaked, its growth areas will start to be self-funding and its core advertising market will see cyclical improvement as the Chinese market recovers. Meanwhile the Valuation of Baidu is very low; stripping out its large cash pile and stakes in other quoted companies leaves its core business on only two times sales and a recovery free cash flow yield in excess of 10%, both very attractive multiples when compared with the history of Baidu and its global peers. The **T**iming part of our investment thesis is improving, with profits starting to beat expectations, the share price rallying off the low point and the Chinese advertising market starting to improve.

We continue to be high conviction regarding our position in **Capita** (1st decile *Recovery*), the UK's largest Business Process Outsourcing (BPO) company with an estimated market share of 25-30% split broadly equally between public and private sectors. Capita is a 1st decile Recovery stock where the benefits of wide-ranging changes made by the CEO, appointed in December 2017, are starting to come through. Cost reductions of £175m by 2020 are ahead of schedule, with management confident of ultimately earning 10%+ operating margins, compared to an average of ~12.5% over the last 10-15 years, and over £200m free cash flow.

Flutter Entertainment (1st decile *Quality*) operates a highly profitable online gambling model (23-25% EBITDA margins / 30% CFROA average over the last five years), has geographically diversified earnings, a rock-solid balance sheet, strong management team and has a highly desirable early mover strategic position in the US sports betting market offering longer term earning power optionality. 20% market share of US sports betting (vs. 45-50% today in key states) with 25% of the total market opened up would double today's EBITDA. This is the sort of opportunity the market typically finds it hard to price correctly. We believe that the regulation-driven earnings downgrade cycle of the last 12-18 months has bottomed-out; this is reflected by share price performance which has started to trend positively. Solid underlying growth characteristics (+15% YoY in 2019) with low capital requirements and their US positioning underpins a premium multiple in the sector. Based on our assessment of the long-term value of the US, which is currently loss-making, the core business was available on an attractive 10x EBITDA as opposed to the headline 14x, which is more in line with the historic average. In 2020 we expect their merger with The Stars Group to close, which will produce the scale player in the industry and provide multiple synergy opportunities.

We continue to look to build the position in **GEA Group** (2nd decile *Recovery*), a German engineering company specialising in machinery, plant and process technology and components primarily for the food and dairy production chain; its key franchise is milk drying equipment and milking robots. Although equipment ordering cycles have some cyclicality, there are a number of structural trends which should support demand over the long-term and recurring services revenues are ~1/3 of group total (less cyclical than equipment sales). The business is well spread globally, so well positioned to take advantage of structural trends, and has leading market positions in most businesses. The share price has halved since October 2016 due to a number of profit warnings; operating margins are forecast to be <10% in 2019 against a normalised range of 11.5-13.5% (achieved 2011-18). The issues, we believe, are mostly self-inflicted and, therefore, reversible. The business is fundamentally sound (return on capital above cost of capital each year since 2006) and has a strong (nearly net cash) balance sheet. On 1x EV/S the shares are undervalued for the margins they should make (10%+ EBIT margins) but FCF multiples better reflect the shareholder value creation opportunity; FCF has already started to inflect ahead of EPS and, taking into account the capex and working capital targets set out at the recent capital markets day, we believe GEA will generate well in excess of €1bn of FCFF (free cash flow to the firm) over the next three years (building to over 10% yield in 2022e). Combined with restructuring of headcount, procurement savings, footprint rationalisation in Asia Pacific and a shift to low cost manufacturing in Eastern Europe – all being driven by a new CEO and changed management team – there are solid strategic options for both sides of the return on capital equation to improve.

We added to the position in **Oracle** (1st decile *Quality*), a business-to-business (B2B) 'staple' with attractive **P**otential through its high (35-40% excess) cash, improving and defensible CFROI due to its installed-base moat; unlike other staples it trades at a discount to historic multiples and offers an attractive starting FCF yield (7%) as well as being at its widest spread in 15 years to US software peers on an Economic PE basis so is a clear Value anomaly. This is due to i) a growth hiatus, and ii) a perception of declining returns, when in fact a large part of the declining CFROI was due to excess cash build-up – $40bn cash on the balance sheet (vs $170bn market cap) now being used for share buybacks – while organic sales growth is now re-accelerating and about to cycle relatively easy comps in 2018, supporting Timing. The crux of the investment case is that we now have evidence of a multi-year product cycle beginning, on the back of database options launched in November 2017 now becoming generally available across cloud and on-premise, which are material enough to drive mid single-digit revenue growth. This is enough to drive double-digit FCF growth for years; the last similar cycle in the early 2000s lasted for eight years. We see attractive downside protection and attractive upside optionality should its new database product and the superior economics and security features of its Gen 2 Cloud product drive sustainably higher revenue growth than we or consensus currently anticipate.

Outlook

With monetary and fiscal policy around the globe being accommodative, trade discussions relatively constructive, greater certainty returning to the UK, and global economic optimism bottoming-out, equity markets were well supported during the final calendar quarter and provided strong returns over 2019 and a constructive background as we move into 2020.

To date the supportive monetary environment has favoured a continued flow of capital (including passive investors) into growth and quality type equities, and as a result we have had to work very hard just to keep up with our benchmarks; however, we would expect a recovering global economy over the coming quarters together with bond yields trending upwards to support a broader set of equity investments, in particular our PVT stock picks backed as they are by still highly attractive valuations.

Thank you for your continuing support as we head into a new decade.

Hugh Sergeant
Head of Value & Recovery, PVT Equities

January 2020

Fund Information

Launch date	4 March 2013
Fund manager:	Hugh Sergeant
IA sector:	Global
Benchmark:	MSCI All Country World
Tracking error range:	N/A
Strategy capacity:	£1bn (pooled & segregated)
XD dates:	1 April & 1 October
Dividend/Accumulation payment date:	31 May and 30 Nov

Share class:	B	S	Z
Launch price (shares):	250.00p	250.00p	500.00p
Share classification:	Retail/Institutional	Retail/Institutional	Institutional
Type of shares:	Income	Income	Accumulation
Fund charges:			
Annual	1.00%	0.75%	0.00%*
Initial (up to)	5.25%	5.25%	5.25%
*AMC charged outside the Fund			
Minimum investment			
Initial	£2.5 million	£50 million	£5 million
Subsequent	£25,000	£50,000	£50,000
Sedol	B9428D3	BG21HL2	B96FYM1
ISIN	GB00B9428D30	GB00BG21HL25	GB00B96FYM16
Bloomberg	RMEWREB LN	RMEWRES LN	RMEWRLB LN

The information in this document has been prepared and issued by River and Mercantile Asset Management LLP (trading as "River and Mercantile" and "River and Mercantile Asset Management") registered in England and Wales under Company No. OC317647, with its registered office at 30 Coleman Street, London EC2R 5AL. River and Mercantile Asset Management LLP is authorised and regulated by the Financial Conduct Authority (Firm Reference Number 453087), is registered with the U.S. Securities and Exchange Commission as an Investment Adviser under the Investment Advisers Act of 1940.

River and Mercantile Asset Management LLP is a subsidiary of River and Mercantile Group Plc which is registered in England and Wales under Company No. 04035248, with its registered office at 30 Coleman Street, London EC2R 5AL.

This document is directed at professional and retail clients. The information in this document should not be relied on or form the basis of any investment decision. Retail clients requiring any information should seek the advice/assistance of a Financial Advisor. The information contained in this document is strictly confidential and must not be reproduced or further distributed.

The value of investments and any income generated may go down as well as up and is not guaranteed. An investor may not get back the amount originally invested. Past performance is not a reliable guide to future results. Changes in exchange rates may have an adverse effect on the value, price or income of investments. Please refer to the ES River and Mercantile Funds ICVC principal prospectus for further details of the financial commitments and risks involved in connection with an investment in this Fund. The information and opinions contained in this document are subject to updating and verification and may be subject to amendment. The information and opinions do not purport to be full or complete. No representation, warranty, or undertaking, express or limited, is given as to the accuracy or completeness of the information or opinions contained in this document by R&M, its partners or employees. No liability is accepted by such persons for the accuracy or completeness of any such information or opinions. As such, no reliance may be placed for any purpose on the information and opinions contained in this document.

Please note that individual securities named in this report may be held by the Portfolio Manager or persons closely associated with them and/or other members of the Investment Team personally for their own accounts. The interests of clients are protected by operation of a conflicts of interest policy and associated systems and controls which prevent personal dealing in situations which would lead to any detriment to a client.

The Global Industry Classification Standard ("GICS") was developed by and is the exclusive property and a service mark of MSCI Inc ("MSCI") and Standard & Poor's, a division of The McGraw-Hill Companies, Inc. ("S&P") and is licensed for use by River and Mercantile Asset Management LLP. Neither MSCI, S&P nor any third party involved in making or compiling the GICS or any GICS classifications makes any express or implied warranties or representations with respect to such standard or classification (or the results to be obtained by the use thereof), and all such parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability and fitness for a particular purpose with respect to any of such standard or classification. Without limiting any of the foregoing, in no event shall MSCI, S&P, any of their affiliates or any third party involved in making or compiling the GICS or any GICS classifications have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages.

Neither MSCI nor any other party involved in or related to compiling, computing or creating the MSCI data makes any express or implied warranties or representations with respect to such data (or the results to be obtained by the use thereof), and all such parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to any such data. Without limiting any of the foregoing, in no event shall MSCI, any of its affiliates or any third party involved in or related to compiling, computing or creating the data have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages. No further distribution or dissemination of the MSCI data is permitted without MSCI's express written consent.

Although River and Mercantile's information providers, including without limitation, MSCI ESG Research LLC and its affiliates (the "ESG Parties"), obtain information from sources they consider reliable, none of the ESG Parties warrants or guarantees the originality, accuracy and/or completeness of any data herein. None of the ESG Parties makes any express or implied warranties of any kind, and the ESG Parties hereby expressly disclaim all warranties of merchantability and fitness for a particular purpose, with respect to any data herein. None of the ESG Parties shall have any liability for any errors or omissions in connection with any data herein. Further, without limiting any of the foregoing, in no event shall any of the ESG Parties have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages.

River and Mercantile Asset Management LLP
30 Coleman Street, London EC2R 5AL
www.riverandmercantile.com