ES River and Mercantile UK Dynamic Equity Fund

Quarterly Report to 30 September 2020

RIVER AND MERCANTILE
ASSET MANAGEMENT

For unitholders only

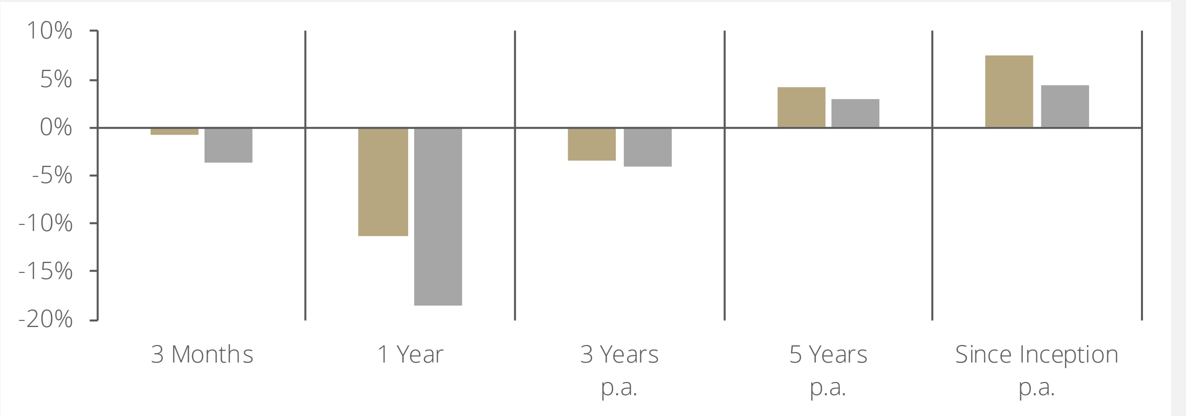
ES R&M UK Dynamic Equity Fund
Quarter 3, 2020

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 United Kingdom Investable Market Index (IMI) Net Total Return (the "Benchmark") over a rolling 5 year period, after the deduction of fees.

Performance

B share class	Fund	Benchmark	Difference
3 months	-0.7%	-3.6%	2.9%
1 year	-11.2%	-18.5%	7.3%
3 years (p.a.)	-3.5%	-4.1%	0.6%
5 years (p.a.)	4.2%	3.0%	1.2%
Since Inception (p.a.)	7.5%	4.3%	3.2%



	Fund	Benchmark	Difference
3 years (cumulative)	-10.2%	-11.8%	1.6%
5 years (cumulative)	22.7%	15.7%	7.0%
Since inception (cumulative)	77.2%	39.3%	37.9%

Source: River and Mercantile Asset Management LLP. Benchmark is the MSCI UK Investable Market Index, net GBP.
Fund performance shown is of B share class (accumulation units) and is calculated using the midday published price, net of an annual management charge of 0.75% per annum. 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	£54m	Tracking Error	4.93 %
Strategy Capacity	£2bn	Active Money	76.98 %
Number of stocks	54		
Largest Holding	Unilever 5 %		

Lower risk						Higher risk
1	2	3	4	**5**	6	7
Typically lower rewards						Typically higher rewards

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.

Investment commentary

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 UK Dynamic Equity 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.

Market Background

Global equity markets rose strongly in the third quarter (MSCI ACWI +8.2% total return) despite falling in September (-3.2%), which lived up to its reputation as a seasonally weak month for investors. Low bond yields, continuing central bank support and a nascent earnings recovery have sustained relatively positive sentiment for equities overall. During July and August, we started to see pockets of over-exuberance in areas of the equity market, notably in more speculative, often loss-making, US-listed companies where trading flow is being driven by 'retail bros' on the Robinhood platform. US dollar weakness was a feature of the quarter (DXY index -3.6%). We have evidence that excess dollar liquidity is making its way 'offshore' into the global economy with sustained rises in overseas FX reserves. This has provided support for commodities (copper +11.8% and the CRB (Commodity Research Bureau) measure of raw material inputs +9.8%). During September, uncertainty regarding US elections, fiscal stimulus and COVID-19 disrupted the positive risk sentiment seen earlier in the quarter with the US dollar making a comeback, while inflation expectations in major economies softened.

How did we perform and why?

(Fund performance references the B share class and is calculated net of a 0.75% p.a. annual management charge)

The Fund returned -0.7% over the 3rd quarter versus a total return of -3.6% by its comparator benchmark, the MSCI United Kingdom IMI index[1]. The Fund fell -2.4%[2] in September compared to -1.7% from the benchmark. Stock selection and sector allocation contributed roughly equally to positive relative performance over the quarter.

888 (+0.7% relative contribution) was the quarter's primary positive contributor. Shares rose +44%, initially on read-across to a bid for peer William Hill and subsequently following an outstanding set of interim results, with earnings per share +82% year-on-year. Strong current trading led management to materially upgrade their profit guidance. SDL (+0.4% relative contribution) rose 36%. Having responded well to better than expected interim results, which led to large analyst forecast upgrades, it was subsequently bid for by fellow UK-listed language translation specialist RWS at a material premium to the spot share price. Gold producer Centamin (+0.4% relative contribution) continued to benefit from a higher gold price. Discount retailer B&M (+0.4%) released an unscheduled trading statement which raised profit guidance, as like-for-like sales growth has continued to be stronger than expected.

TP Icap (-0.5% relative contribution) was the biggest detractor from performance. It fell 35%, with most of the move coming after announcing the acquisition of electronic crossing network Liquidnet. Investors appear to be more focused on the potential dilution from the equity raise to fund the deal or the re-based dividend (to reduce the equity component) rather than its strategic merit and a sensible price. I topped up the Fund's position into the weakness. Insurer Lancashire (-0.4%) retraced some of its summer share price increase. The longer-term implication of current headline losses for the industry (California wildfires, active hurricane season), which have likely been driving near-term share price movements, is an attractive pricing environment into which Lancashire can deploy its strong balance sheet.

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[1] Close-of-business to close-of-business pricing.

[2] B share class (GBP), mid-day to mid-day pricing.

Portfolio Activity

Tyman has market leading positions in engineered window and door components, offering a "one-stop shop" solution which is predominantly sold into the US (two-thirds of sales). Its high average cash flow return on assets (CFROA) over the last 5 years is evidence of a competitively advantaged franchise. Cyclical end markets and some operational issues have conspired to hide the true quality of the franchise and created a mispricing opportunity. Despite the slip-ups, in 2019 Tyman still managed to deliver 17% CFROA and this provides an indication of what they can earn with a mid-cycle housing demand backdrop (versus 12% forecast in 2020). We bought at an attractive free cash flow yield of 12% based on forecasts we consider conservative because they imply a significant slowdown in second half of the year relative to the growth run-rate in July. Our differentiated view on this, which supports the timing of our investment, is underpinned by read-across to a range of signals of strength in the US residential property market, including the strength of US-facing homebuilder and building materials companies' share prices, and improving lead indicators of activity such as mortgage applications.

We bought shares in small-cap miner Central Asia Metals which owns two sustainably low-cost operations in Kazakhstan and North Macedonia producing primarily copper, zinc and lead. The Kazakh copper production, which extracts copper from in-situ dump leach, has one of the lowest costs of production in the world and a strong track record of consistent production volumes, which are both attributes which help increase our margin of safety. We see the copper price as well supported by a falling dollar, increased Chinese stimulus, low inventories of the metal, and risk to supply both in the short-term (coronavirus-related disruption in Chile, particularly) and longer-term due to reduced spend on mine development and exploration. We bought our position at a free cash flow yield of 17-20%, depending on commodity price assumptions.

Drax is a predominantly biomass fuelled, vertically integrated power generator of strategic importance in the UK as it helps meet legally binding carbon reduction targets whilst ensuring security of supply. It is increasingly likely that biomass generation is economically viable after the current subsidy period ends in 2027, due to cost savings, which is key to terminal value assumptions. There is also highly material value inherent in its carbon capture and storage activities. The latter is only in pilot phase today, but we assess that should it achieve a 10% margin on scaled up activities then the shares have scope to double. We believe the market is underestimating Drax's strategic value, which could get recognised by a trade buyer should it not be by public markets.

Spirent Communications has an important role in the global rollout of 5G technology via its position in the relatively consolidated testing market. This niche specialism allows them to recoup high R&D costs with high margins and cash flow during the growth phase of each new technology deployment cycle. Spirent has historically been under-managed (cost discipline and capital allocation) but has a newish management team in place who have demonstrated good discipline on both costs and its guidance to the market. We are currently in the upcycle phase for ethernet technology and in the foothills for 5G and with a large net cash position on the balance sheet, bolt-on acquisitions could support further earnings upgrades. We see an attractive margin of safety assuming the 5G cycle lasts a similar period to previous cycles (3-5 years), with more material upside should peer Keysight Technology's assessment that the 5G cycle could last a decade be accurate.

I bought back into Intertek after its resilient performance through the worst of the crisis highlighted its strengths. Its leadership position within Products testing & assurance gives them access to structural mega-trends such as product traceability and ethical sourcing, or global uniformity of quality in increasingly complex supply chains and distribution networks. I believe that COVID-19 will, if anything, make these tailwinds stronger. This long duration growth is valuable because it comes at high incremental return on capital (due to low capital intensity and attractive margins), so I am comfortable paying a higher starting multiple than the average within the portfolio. In addition, the balance sheet is currently under-leveraged versus the targeted 1.5-2.0x net debt / EBITDA and as it deploys this on sensible acquisitions the valuation multiple will come down.

These new positions were funded in large part by exiting mega-cap holdings British American Tobacco (BAT) and BP. Both were reduced early in the year due to lower conviction. A re-assessment under our sustainable investing framework of People, Innovation and Environment played an important role. Although in both cases there is an optically cheap starting valuation, the rise of 'ESG' awareness within financial markets has almost certainly permanently raised the cost of capital of these businesses, lowering the multiple that investors will be willing to pay. We are lacking evidence of BAT's innovation credentials, and BP's strategy carries an increasing risk of over-paying for 'clean energy' assets to meet environmental targets on the one hand and selling traditional oil assets at low prices to fund this on the other. I progressively struggled to see the path to realising any value gap, and there is opportunity cost to holding capital in these names while we are finding others with evidence that their prospects are already improving.

I exited our remaining small position in Vistry Group. While we continue to believe the Partnerships division is a particularly attractive franchise, the challenges of integrating the Bovis and Linden Homes businesses amidst a still uncertain economic backdrop and additional leverage resulting from this acquisition make the margin of safety in this investment case less clear than for our other housebuilder, Persimmon. When combined with a low score in our quant screen, I executed our sell discipline. We also exited Associated British Foods, as Primark's economic model is likely to come under pressure via reduced sales densities. The rollout of Primark stores was a key pillar of our original *Growth* thesis and the facts have materially changed.

We sold JD Sports, having made an attractive return during our brief holding period. The Fund also sold 'freemium' cyber-security software provider Avast. The share price had risen to our estimate of fair value and there is a risk that over the next 12 months growth rates fade more aggressively than analysts currently model as activity normalises. In both cases capital was re-allocated to holdings with larger valuation anomalies elsewhere in the portfolio.

Outlook

Global equities made new highs in August and, like many other financial assets, are relatively expensive by many standard metrics, at least at the headline level. Combined with narrow market leadership – which is most clear in the US but matched to some extent in most regions – this increases the fragility of the status quo at a time when many appear to be betting on its continuation, based on the 'crowding' across asset classes in securities with a 'disinflationary' or deflationary bias. Broad equity indices could feasibly sell off if the shape of the economic recovery fails to match the V-shape in asset prices *or* if the rising longer-dated inflation expectations lead investors to rotate out of the long duration stocks which have large weights in many indices. September gave a glimpse of this. Entering a final quarter of the year that brings the US presidential election, the denouement of post-Brexit trade deal negotiations, likely news on vaccine progress and more concrete information around what follows on from the current rounds of monetary and fiscal support, I see little reason to believe that volatility (upwards or downwards) will dampen in the near term. While these are 'known unknowns', a balanced approach to risk continues to make sense in this context.

The UK equity market continues to exhibit little exuberance – it was recently flagged in the 'max despair' corner within the well-followed Bank of America Global Fund Manager survey! – and still offers the appealing combination of low starting valuations at a market aggregate level plus wide dispersion of valuations intra-market. Historically, this has implied a higher probability of attractive future returns, as well as an attractive environment for active managers employing valuation discipline to add alpha. A good proportion of our highest conviction ideas are currently strong cyclical franchises and smaller companies where there is a noticeable gap between perceived and actual business quality, and a disconnect between improving prospects and conservatism embedded in analyst forecasts and market valuations.

Thank you – as ever – for your patience, ongoing support and partnership.

William Lough
Portfolio Manager
October 2020

Fund Information

Launch date	22 March 2007[1]
Fund manager:	William Lough (from 3 April 2018)
IA sector:	UK All Companies
Benchmark:	MSCI UK IMI (Total Return, net GBP)
Tracking error range:	N/A
Strategy capacity:	£2bn (pooled & segregated)
XD dates:	1 April & 1 October
Dividend/Accumulation payment date:	31 May and 30 Nov

Share class:	A	B	Z
Launch price (shares):	100.00p	250.00p	500.00p
Share classification:	Retail	Retail/Institutional	Institutional
Type of shares:	Income	Accumulation	Accumulation
Fund charges:			
Annual	1.50%	0.75%	As agreed*
Initial (up to)	5.25%	5.25%	5.25%
Ongoing Charge Figure (OCF) (incl. AMC)	1.68%	0.93%	AMC* + 0.18%
*Z class AMC is charged outside the Fund			
Minimum investment			
Initial	£1,000	£2.5 million	£5 million
Subsequent	£500	£25,000	£50,000
Sedol	B1NG829	B7H1R58	B1NGCT4
ISIN	GB00B1NG8296	GB00B7H1R583	GB00B1NGCT49
Bloomberg	RIVMERALN	RIVMERB LN	RIVMERZ LN

[1] B share class launched 21 November 2012

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