# ES River and Mercantile UK Equity High Alpha Fund

## Quarterly Report to 30 June 2020

RIVER AND MERCANTILE
ASSET MANAGEMENT

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RIVER AND MERCANTILE
ASSET MANAGEMENT

# ES R&M UK Equity High Alpha Fund

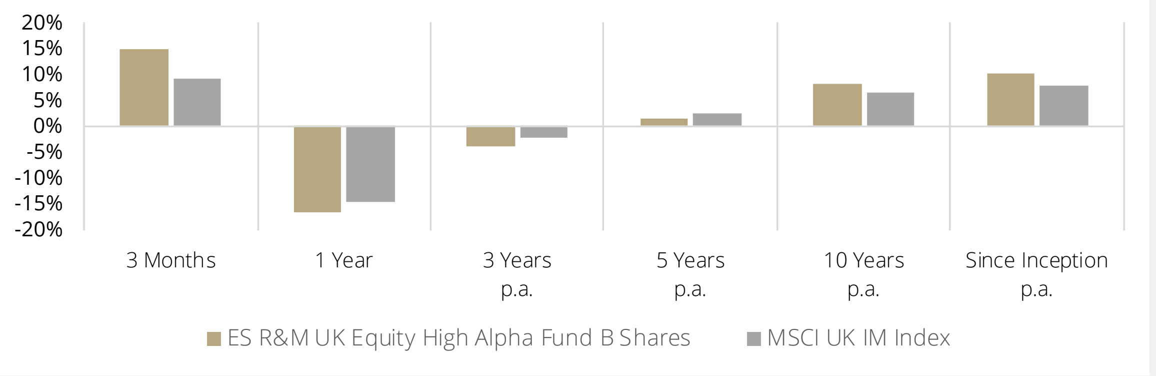
## Quarter 2, 2020

## Fund objective

The investment objective of the Fund is to achieve capital growth by investing in a focused portfolio of investments which shall primarily consist of UK equities which offer the prospect of superior long term growth.

## Performance (net of fees)

| | B share class | Benchmark | Difference |
|---|---|---|---|
| 3 months | 15.0% | 9.2% | 5.8% |
| 1 year | -16.6% | -14.7% | -1.9% |
| 3 years (p.a.) | -3.9% | -2.2% | -1.8% |
| 5 years (p.a.) | 1.5% | 2.4% | -1.0% |
| 10 years (p.a.) | 8.3% | 6.4% | 1.9% |
| Since inception (p.a.) | 10.2% | 8.0% | 2.2% |




## Performance (gross of fees)

| | Z share class | Benchmark | Difference |
|---|---|---|---|
| 3 months | 15.2% | 9.2% | 6.0% |
| 1 year | -16.0% | -14.7% | -1.3% |
| 3 years (p.a.) | -3.2% | -2.2% | -1.0% |
| 5 years (p.a.) | 2.2% | 2.4% | -0.2% |
| 10 years (p.a.) | 9.1% | 6.4% | 2.7% |
| Since inception (p.a.) | 6.0% | 4.1% | 1.9% |

Source: River and Mercantile Asset Management LLP. Benchmark is the MSCI UK Investable Market Index, net GBP. Fund performance shows the B share class (accumulation units) which is net of an annual management charge of 0.75% per annum, and the Z share class (accumulation units) which reflects the fund's gross performance before any fees are deducted. Inception date of the B share class is 20 October 2008 and inception date of Z share class is 28 November 2006. Fund performance is calculated using the midday published price. Note that the benchmark performance is calculated using close of business mid-market prices. Other share classes may be available. **Past performance is not indicative of future results.**

## Portfolio Summary & Key Risk Characteristics

| | | | |
|---|---|---|---|
| Fund AUM | £68.8m | Tracking error | 4.8 % |
| Strategy capacity | £800m | Active money | 55.3 % |
| Inception date | 28 November 2006 | Portfolio beta | 1.08 |
| Number of stocks | 229 | | |
| Largest holding | GlaxoSmithKline 4 % | | |

| 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 High Alpha 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.*

'When you walk through a storm, hold your head up high, and don't be afraid of the dark…' – ***'You'll Never Walk Alone' by Gerry and the Pacemakers*** *(Liverpool football club anthem)*


*Source: Bloomberg*

### Our reports and communication to you

The way the world and you, our clients, consume information has clearly changed over the last few years. Whilst our quarterly reports have always been held in high regard because of the richness of their content and their consistent reference to our PVT philosophy and process, they have perhaps become too long for current day requirements. As a result, I intend to provide a deeper Executive Summary going forward, providing a more distilled, punchy articulation of key events, observations and portfolio activity during the quarter. A more in-depth commentary, which will incorporate my usual thought pieces and examinations of subject matter that demand greater explanation, will be made available separately from the quarter-end reporting cycle, which also allows us to get the more time-sensitive information to you more quickly. In addition, we will be continuing with our regular webinars, adding a little bit more depth to our monthly updates and providing links to short video clips if we are particularly excited by a topic.

### Executive Summary

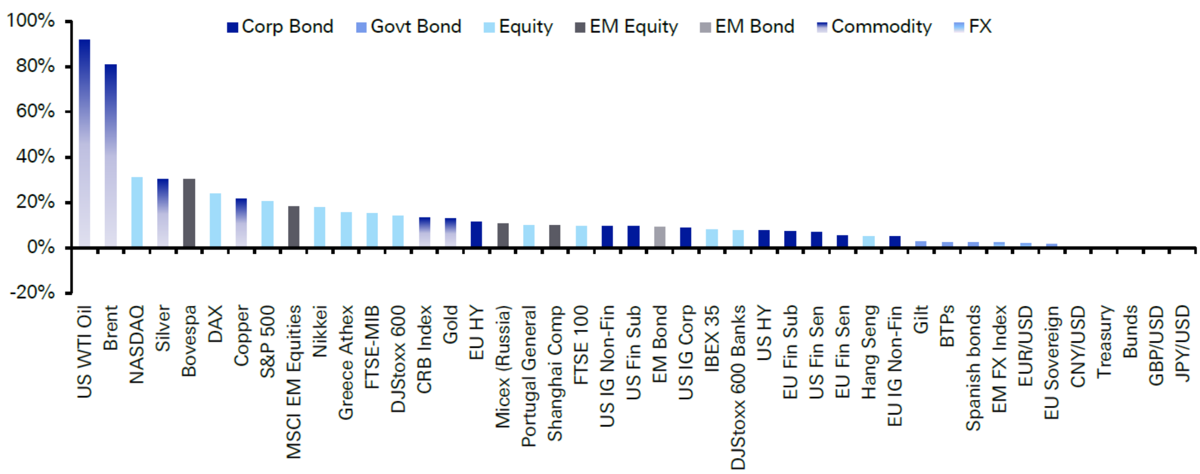
- Covid-19 cases declined in areas where strict social distancing was implemented.
- Perhaps more importantly, rates of hospitalisation and death appeared to fall throughout the period, including in countries where cases were still increasing. Healthcare infrastructure has been able to cope.

- Economies around the world bottomed-out in April, with the recovery starting to come through in May and June, relatively V-shaped so far.
- Equity markets rallied robustly as the threat of Covid-19 peaked, as economies and corporate profits bottomed-out and as very supportive monetary and fiscal policy kicked in.
- Our key investment factor, value, had another difficult quarter. It is highly unusual for value to underperform during economic recovery periods, so this is a very significant anomaly that needs some explaining. Suffice it to say that growth and quality have benefited from falling interest rates, relatively strong corporate fundamentals through the Global Covid Crisis (GCC) and crisis-related flows of liquidity. Value has not benefited from these.
- As a result of this further weak period for value the anecdotal evidence of investors 'giving-up' on this time-honoured approach has become marked; some very high-profile value managers have left the marketplace.
- However, value will be back. As I just mentioned, value nearly always does well in an economic recovery period, especially if that recovery happens at a time when value is relatively attractively priced, which it most definitely is today. What is likely to happen at some point over the next few quarters is this: global economies will continue to recover; the massive monetary and fiscal stimulus will continue to positively impact; deflation will turn to reflation; bond yields will bottom-out; growth and quality stocks' relative fundamentals will peak as more cyclical value stocks start to see profits recover and brought forward digital spending struggles to preserve the momentum embedded in many growth and quality stock share prices; and finally, liquidity and passive based investing may change direction as momentum shifts from deflation to reflation beneficiaries.
- I, like fellow Liverpool FC fans, have continued to believe during the dark times for the club, as well-articulated in this article by Research Affiliates:
- Indeed if you were a visitor to Earth from Mars, and all you had was a deep set of data on factor returns and economic and profit cycles over the last 100 years (since proper equity markets began) and you set yourself the ten key tests on whether now was the time to invest in value, recovery and multi-cap stocks then the answer to all those key tests would be very supportive. Now is, at least according to the data, the best time to invest in value, recovery and multi-cap that I have seen in my career.

## Market returns and our performance

- Equity markets rebounded strongly, led by the safety first and liquid US market and followed by others to varying degrees depending on perceived ongoing risks. The UK market was strong, though handicapped by an underwhelming management of the Covid crisis and returning Brexit worries. The MSCI UK IMI returned +8.8%, the MSCI ACWI +19.2%, the MSCI World +19.4% and MSCI EM +18.1%. The MSCI UK Enhanced Value index returned 10.0% and the MSCI ACWI Enhanced Value index 10.9%.

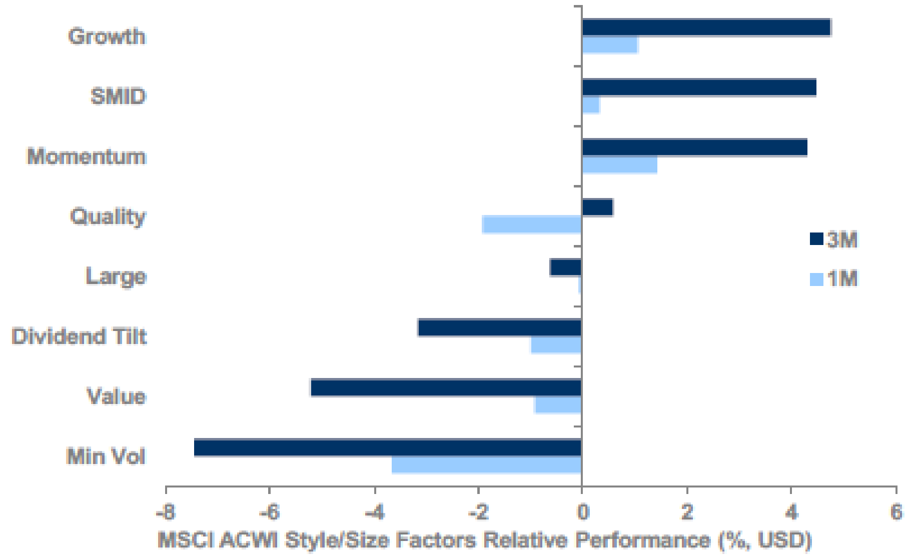
**Total Return performance of major global financial assets in Q2 (in local currency)**




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

- Value factors were weak, growth and momentum particularly strong

ACWI Style/Size Relative Performance




*Source: MSCI, Morgan Stanley Research*

- Our other key factors were, on balance, more supportive: smaller companies started to outperform again, reasonably in the UK (MSCI UK Small Cap index +12.1%) but not in the tech-mega-cap heavy US index. Recovery stocks were somewhat mixed, though some rallied pretty hard, while others like interest rate sensitive stocks (banks) were poor. Regional equity performance was more nuanced, led by the US but also well supported by Europe (Dax) and some emerging markets.
- Despite the value headwind we had a pretty strong quarter, clearly with strong absolute returns (recovering somewhat from a very weak Q1) and robust relative returns. As for much of the anti-value period since the Global Financial Crisis (GFC) (until 2018), we managed to offset value headwinds with robust multi-cap investing and exposure to companies that were clearly going to increase shareholder value, either from a low point for recovery stocks or through ongoing structural growth delivered by the good value growth stocks in the portfolio, including digital economy exposure.
- The ES River and Mercantile UK Equity High Alpha Fund returned +15.2% (gross, Z shares) and +15.0% (net, B shares), an outperformance over its benchmark of 6%.
- During the relatively short-lived periods when value did well during the quarter, often when bond yields moved up a few basis points and other investors were prepared to look beyond the most reliable stocks, we performed very strongly indeed.
- Our medium-term returns have been negatively impacted by the post-2017 period, during which all our factors have struggled at the same time: namely value, recovery, multi-cap and regional diversification. This has been a difficult period of performance for which I remain very sorry.
- Our long term, and since PVT-inception returns are strong, especially versus value benchmarks and peers. My 25-year track record continues to annualise at almost 4% p.a. ahead of benchmark.

## Activity and positioning

- The portfolio continues to have a very clear value bias, with strong absolute valuation support including a 1.1x price to book valuation and double-digit earnings and cashflow yields (despite the fall in corporate profits).
- We combine stocks with traditional value characteristics (such as banks and specialist financials), with attractively valued and currently out of favour quality and growth franchises (such as ASOS, AB Foods, JD Sports, Boku, Unilever and GVC), many top decile *MoneyPenny* recovery stocks (888, Capita, Playtech, John Wood, Hunting, Senior), classic global cyclicals but with a focus on those with leading franchises (RHI Magnesita, Meggitt, Hunting, Anglo American) and UK domestic stocks that are temporarily disliked (Capital & Counties, Persimmon, Premier Miton, JD Wetherspoon).

- Our activity over the last quarter has focused on adding to the above, with significant purchases of Unilever, Lloyds, JD Sports, Hunting, Bank of Ireland, Senior, Meggitt, Capital & Counties and Fresnillo. Sales have included taking full profits where our PVT thesis has been delivered, including CMC and Sabre Insurance, top-slicing into relative strength (Helios Towers, Impax, Reckitt) or re-focusing capital towards higher conviction ideas (Kaz Minerals, XPS Pensions).

## Are we following our PVT philosophy and process and a consistently articulated style and factor bias?

- Yes. The portfolio remains clearly skewed towards high scoring *MoneyPenny* stocks; it has a clear value bias; it has exposure to all four of our categories of potential but with a greater tilt to recovery and asset-backed due to the richer anomaly set in this part of the market; it is a multi-cap portfolio.

## Team and investment philosophy updates

- In previous reports, we have mentioned continued investment in the PVT team despite the value headwinds. This is now very much in place, with James Sym (to launch our European Equity strategies and support our global franchise), Alexander Stout (Global Analyst) and Laura Corbetta (Quantitative Analyst) all having started (from home sadly) in June.
- As a team, we have, led by Gary Dowsett, spent a considerable amount of time formalising our own core sustainability beliefs to act as a long-term foundation for this now key part of investing. The key pillars of Sustainable PVT are People, Innovation and Environment which better reflects our beliefs than ESG.

## Outlook

- Equity markets have perhaps recovered ahead of many people's expectations and, given the many Covid-19 related uncertainties, will remain volatile.
- However, the global economic and profit cycle has now bottomed-out.
- Medium-term valuation metrics in most equity markets, outside of the momentum-driven US market, remain supportive, most notably in the UK.
- This portfolio is very modestly valued and has a well-diversified exposure to companies that will be able to grow profits and cash flow robustly from this current low point. This should allow for attractive absolute and relative returns.

Thank you for your continued support and patience.

**Hugh Sergeant**

Head of Value and Recovery Strategies, PVT Equities

July 2020

# Fund information

| | |
|---|---|
| Inception date: | 28 Nov 2006 |
| Fund manager: | Hugh Sergeant |
| IA sector: | UK All Companies |
| Benchmark: | MSCI UK IMI (Total Return, net GBP) |
| Tracking error range: | 4-8% |
| Strategy capacity: | £800m (pooled & segregated) |
| Ex-dividend dates: | 1 April & 1 October |
| Dividend/Accumulation payment date: | 31 May and 30 Nov |

| Share class: | B | Z |
|---|---|---|
| Launch price (shares): | 250.00p | 500.00p |
| Share classification: | Standard | Institutional |
| Share class: | Accumulation | Accumulation |
| Fund charges: | | |
| Annual management charge | 0.75% | As agreed* |
| Maximum initial fee for direct investments | 5.25% | 5.25% |
| Ongoing Charge Figure (OCF) (incl. AMC) | 0.90% | AMC* + 0.15% |
| *Z class AMC is charged outside of the Fund | | |
| Minimum direct investment: | | |
| Initial investment | £2.5 million | £5 million |
| Subsequent investments | £25,000 | £50,000 |
| Sedol | B3D79W3 | B1DSZP7 |
| ISIN | GB00B3D79W34 | GB00B1DSZP77 |
| Bloomberg | RMUKEHG | RMUKEAA LN |

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