ES River and Mercantile UK Recovery Fund

Quarterly Report to 30 September 2020

RIVER AND MERCANTILE
ASSET MANAGEMENT

For unitholders only

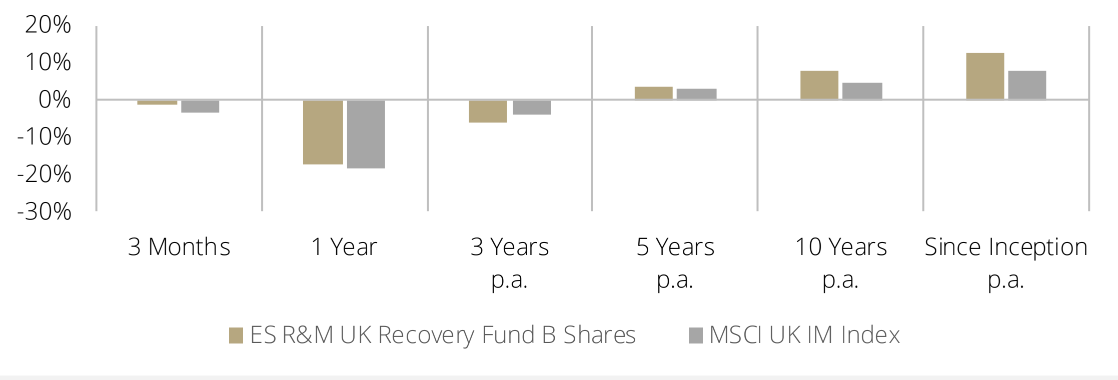
ES R&M UK Recovery Fund
Quarter 3, 2020

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 (net of fees)

	B share class	Benchmark	Difference
3 Months	-1.4%	-3.6%	2.2%
1 Year	-17.1%	-18.5%	1.4%
3 Years p.a.	-5.9%	-4.1%	-1.8%
5 Years p.a.	3.8%	3.0%	0.8%
10 Years p.a.	7.8%	4.6%	3.1%
Since Inception p.a.	12.6%	7.9%	4.7%



Performance (gross of fees)

Z class

	Z share class	Benchmark	Difference
3 Months	-1.2%	-3.6%	2.4%
1 Year	-16.2%	-18.5%	2.3%
3 Years p.a.	-5.0%	-4.1%	-0.9%
5 Years p.a.	4.8%	3.0%	1.9%
10 Years p.a.	8.9%	4.6%	4.2%

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 (income units) which is net of an annual management charge of 1.00% 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 1 April 2009 and inception date of the Z share class is 17 July 2008. Fund performance is calculated using the midday published price. 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	£139.3m	P/E FY1	17.0
Strategy capacity	£500m	Dividend yield	2.7 %
Inception date	17 July 2008	EV to Sales	1.17
Holdings (UK/Non-UK)	232/58	Price to Book	1.01
Largest holding	Prudential 2.1 %		

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 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.

Following positive feedback from our clients we continue with our more condensed quarterly reports which will be supplemented from time to time by deeper thought pieces and more specific areas of communication, such as our Sustainable PVT white paper that will be distributed shortly.

Executive Summary

- There remain numerous extraordinarily undervalued companies in a world where many assets are clearly very expensive. A yield of close to zero for government bonds versus an earnings yield of c10% for the UK Recovery portfolio and a price to book (PB) of just over 1 times, and exposure to a group of companies that have historically grown profits by no less than the overall market and should be able to do better than that from here as economies recover. Decent companies, on very low valuations should, at some point, equal very strong returns, especially at a time when return expectations for many other assets are low.
- It has remained painful being a value or contrarian investor for much of this year as other investors have continued to focus on what has already been successful (Growth, Quality, Momentum) and companies that have been beneficiaries of social distancing measures. Well known UK based value investors continue to withdraw from the market, most recently Tom Dobell who put in 10 consecutive years of outperformance during the last pro-value cycle whilst managing the original Recovery focused fund.
- The thing is everyone is positioned in the same way, so what happens when they decide that this is no longer quite the right way to be positioned? What we get is a charge into all those stocks that they have been happy to dismiss as un-investable; just imagine the huge amount of capital looking to purchase all those unloved value stocks, most of which are now quite small in market cap terms!
- Economies around the world have been recovering strongly from the lockdown induced low earlier in the year. However, a second wave of Covid-19 cases has hit most countries, stalling re-openings and leading to the recovery in some segments of economies being put on hold and market sentiment becoming more cautious.
- However, to date the increase in cases has not led to a significant absolute increase in rates of hospitalisation, suggesting that this wave is more manageable than the first. Healthcare infrastructure has been able to cope.

This graph shows hospital admissions in Spain, the country that has seen the most dramatic 2nd wave

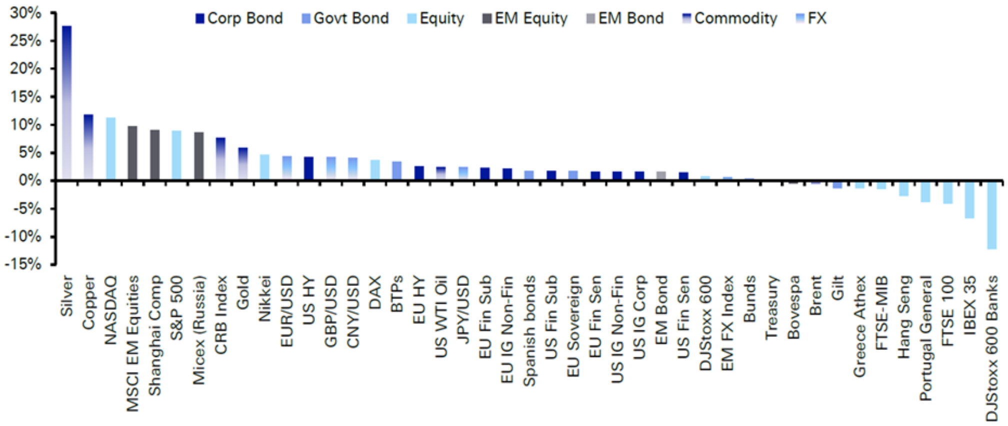
Source: Bank of America

- Equity markets continued to rally early in the third quarter, but this faded later in the period, with September quite weak. This coincided with the economic uncertainty associated with the 2nd wave of the virus and increased focus on an uncertain US Presidential election. The latter is likely to be closer than polls, which put Biden ahead. A victory for the Democrats is likely to be more inflationary and supportive of value stocks.
- Our key investment factor, Value had another muted quarter. It is highly unusual for Value to underperform during economic recovery periods, so this remains a very significant anomaly that needs some explaining. Suffice to say that Growth and Quality have benefitted from falling interest rates, relatively strong corporate fundamentals through the Covid crisis and better positioning regarding sustainability and flows of liquidity. Value has not benefitted from these.
- 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 through 2021, especially if there is confidence that we are finally through the worst of the virus, perhaps catalysed by a vaccine or just post 2nd wave maturation of the pandemic; 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 investing may change direction as momentum shifts from deflation to reflation beneficiaries.
- Indeed repeating my person from Mars test, if 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 ask 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 questions would be very supportive. It remains, at least according to the data, the best time to invest in Value, Recovery and Multi-Cap that I have seen in my career.
- Previous economic recovery periods during my career (1992/3, 2002/3, 2009/10, 2012/13) saw my funds produce very strong absolute and relative returns. I believe that this is still to come in this cycle.

Market returns and performance

- Equity Markets were strong early in the quarter but gave some of this back in September. Technology (Nasdaq +11.2%) continued to lead the way and banks (DJStoxx 600 Banks -12.1%) remained the laggards. Emerging markets outperformed, supported by a weak USD. US equities remained robust, led by their growth stocks. European equities were lacklustre, perhaps held back by a strong Euro. Commodities continued to be quite strong, but not oil; the reflation trade seems to be benefitting the scarcer commodities in particular, led by precious metals. Government bonds produced a modest positive total return. The UK equity market was a notable laggard, with risk premiums moving up as the possibility of a hard Brexit increased and the UK Government continued to be lacklustre in its handling of the pandemic; in addition the UK is underweight large cap tech and overweight value sectors, such as banks and energy. However, going against the above sterling did manage to rally during the quarter though much of this was USD weakness. The MSCI UK IMI (GBP) returned -3.6%, the MSCI ACWI (GBP) +3.4%, the MSCI World (GBP) +3.2% and MSCI EM (GBP) +4.9%. The MSCI UK Enhanced Value Index returned -8.9% and the MSCI ACWI Enhanced Value Index (USD) only +0.1% compared to the MSCI World (USD) return of +7.9%.

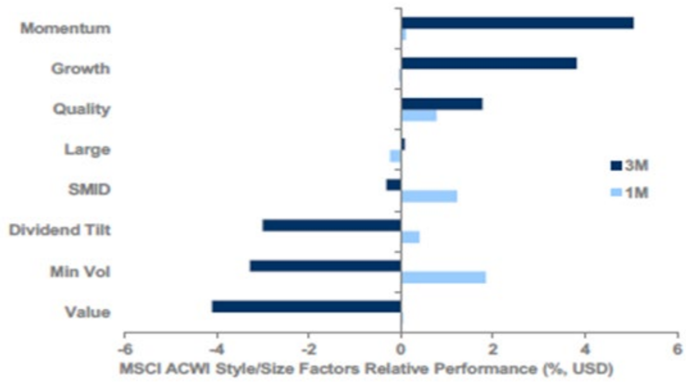
Total Return Performance of Major Global Financial Assets in Q3 (in local currency)



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

- Value Factors were weak, Momentum, Growth and Quality particularly strong:

ACWI Style Factors Relative Performance



Source: MSCI, Morgan Stanley Research

- Our other key factors were broadly neutral: smaller companies in the UK outperformed, led by growth small cap (MSCI UK Small +1.8%) but not in the tech mega-cap heavy US index. Recovery stocks were mixed, some rallied pretty hard as they started to beat earnings expectations, while others, like interest rate sensitive stocks (Banks) and those negatively impacted by the extension of social distancing measures, were poor. Regional equity performance was more nuanced, led by the US but also well supported by some Emerging Markets.
- Despite the Value headwind we had a reasonable quarter for relative performance, as for much of the anti-value period since the GFC (until 2018) we managed to offset value headwinds with some robust multi-cap investing and exposure to companies that were demonstrably going to increase shareholder value, either from a low point for recovery stocks or through on-going structural growth delivered by the good value growth stocks in the portfolio.
- The UK Recovery Fund returned -1.2% (gross, Z shares) and -1.4% (net, B shares), an outperformance of +2.4%
- 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. Over the last 10 years and since inception the Fund has been over 4% p.a. ahead of the

benchmark. My 25-year track record continues to annualise at almost 4% p.a. ahead of peers and the benchmark.

Key performance contributors

- Positive: PVT stock picks, smaller companies in particular (MPAC, ASOS, 888); some recovery stocks start to bounce (William Hill, including a bid, Xaar), underweight oil majors (Royal Dutch Shell), underweight HSBC.
- Negative: Growth and Quality stocks continue to outperform Value (AstraZeneca, LSE and Ocado underweights); individual stock disappointments (Premier).

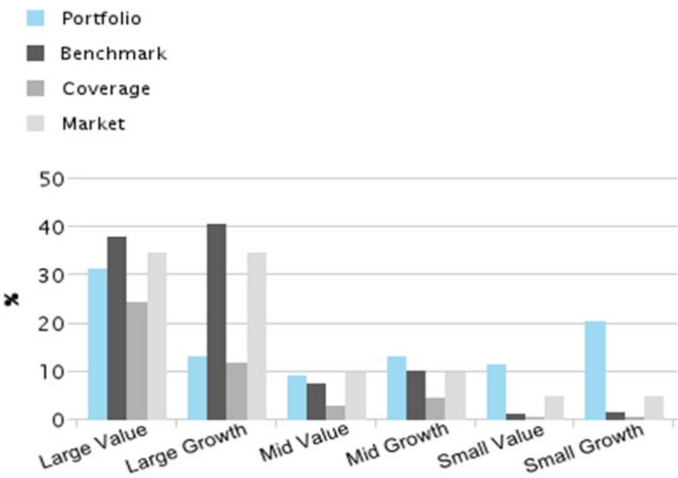
Activity and positioning

- The portfolio continues to have a very clear value bias, with strong absolute valuation support including a 1x price to book valuation and double-digit normalised earnings and cashflow yields. Historic growth is not less than the market. There is a robust multi-cap bias, including an overweight position in undiscovered smaller growth stocks.

Style Skyline

Source: StyleAnalytics

Portfolio allocation to Value and Growth stocks by size and versus benchmark



Source: StyleAnalytics

- 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 Glaxo, Sage, Booking, AB Foods, Walt Disney, Boku, Unilever and GVC), many high scoring *MoneyPenny* recovery stocks (Card Factory, Indivior, Playtech, Baidu, G4S, John Wood, Hunting, Senior), classic global cyclicals but with a focus on those with leading franchises (Owens Corning, RHI Magnesita, Johnson Controls, Meggitt, Hunting, Anglo American) and UK domestic stocks that are temporarily disliked (Capital & Counties, Wimpey, Premier Miton, JD Wetherspoon). We are overweight stocks that would benefit from a vaccine discovery i.e. those that have been negatively impacted by social distancing requirements

(Restaurant Group, SSP); the survivors here will be able to strengthen their market positions and medium term economics.

- Our activity over the last quarter has focused on adding to the above, with significant purchases of Johnson Controls, Glaxo, Card Factory, Owens Corning, Indivior, IP Group, IMI, GVC, Tyman, Hunting, Boohoo, Naked Wines and Fidelity China Special Situations. In addition, we are aggressively rebuilding our position in Somero, lowly valued again and with its order book bottoming out.
- Sales have included taking full profits where our PVT thesis has been delivered, including JD Sports and Sunrise Communications, top slicing into relative strength (ASOS, Reckitt Benckiser, Antofagasta) or re-focusing capital towards higher conviction ideas (Morrison, TI Fluid).

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 (we have now launched our European Equity Strategy to support our Global franchise), Alexander Stout (Global Analyst) and Laura Corbetta (Quantitative Analyst) all having started in June.
- As a team (led by Gary Dowsett), we have 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 our sustainability Philosophy are People, Innovation and Environment. Sustainable PVT, as we call it, is now fully incorporated into all our company research and investment decision making. Please do ask if more detail is required (we will be sending out a white paper detailing this approach later in the quarter).

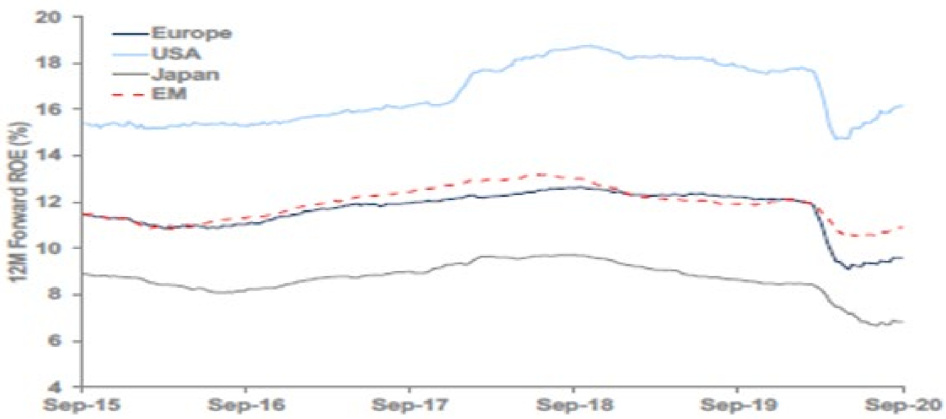
Outlook

Looking at equity markets from a PVT perspective:

- Potential:

The profit cycle has now moved early cycle, with return on equity (shown below) around the world quite depressed. This provides a base for attractive levels of profits growth from here as returns normalise. Recovery stocks, in particular, should see strong profits growth. UK returns are at a cycle low.

Global Return on Equity



Source: Morgan Stanley Research

UK Returns over time (ROA, ROE, ROI)

Source: Morgan Stanley Research

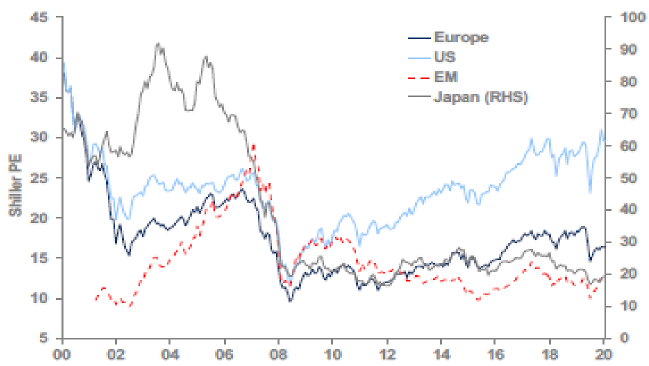
- Valuation:

Equities remain attractively valued versus other assets, government bonds, in particular. Within equity markets there are quite a few that look attractively valued from an absolute, as well as relative perspective – this would clearly include the UK, and also much of Europe and Asia. US equities continue to look expensive in absolute terms, and trade at significant premium to other regions but are supported by low government bond yields.

Global Price to Book

Source: MSCI, IBES, Morgan Stanley Research

Global Shiller PE



Source: MSCI, Haver, Morgan Stanley Research

The UK market is valued on a very modest Shiller PE of 12.8 times, right at the bottom of the last 30-year range, and half that of the US equity market (for example).

FTSE All-Share – Shiller Price to Earnings (Latest = 12.8)

Source: FTSE, Global Financial Data, Morgan Stanley Research
Notes: Shiller PE defined as inflation adjusted price to 10Y average EPS. Shiller DY defined as inflation adjusted average DPS to price.

- Timing:

Positive Timing indicators would include very supportive monetary and fiscal policy, positive cycle indicators such as PMIs, the economic and profit cycles moving into a recovery phase, unemployment above mid-cycle levels and house prices picking up (positive animal spirits). Regarding a move from deflation to reflation some indicators have turned positive, such as breakeven inflation expectations (shown below):

Breakeven Inflation expectations (Europe and US)

Source: Bloomberg, Morgan Stanley Research

Negative Timing indicators would focus on recovery being disrupted by the 2nd wave of Covid cases and geo-political uncertainties, notably the US Presidential election. The former is probably the key: the market needs a vaccine type event to provide the certainty that we can move to a post-Covid world.

- In conclusion, 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.
- Previous economic recovery periods during my career (1992/3, 2002/3, 2009/10, 2012/13) saw my funds produce very strong absolute and relative returns, particularly our recovery strategies. I believe that this is still to come in this cycle.

Thank you for your continued support and patience.

Hugh Sergeant
Head of Value and Recovery Strategies, PVT Equities
October 2020

Fund Information

Launch date	17 July 2008
Fund manager:	Hugh Sergeant
IA sector:	UK All Companies
Benchmark:	MSCI UK IM Index (Total Return)
Tracking error range:	N/A
Strategy capacity:	£500m (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:	Asset Manager	Asset Manager	Institutional
Type of shares:	Income	Income	Accumulation
Fund charges:			
Annual Management (AMC)	1.00%	0.75%	As agreed*
Initial (up to)	5.25%	5.25%	5.25%
Ongoing Charge Figure (OCF) (incl. AMC)	1.11%	0.86%	AMC* + 0.11%
*AMC charged outside the Fund			
Minimum investment			
Initial	£2.5 million	£50 million	£5 million
Subsequent	£25,000	£50,000	£50,000
Sedol	B614J05	BG21HH8	B1YJFW6
ISIN	GB00B614J053	GB00BG21HH88	GB00B1YJFW60
Bloomberg	RMUKEBB LN	RMUKELS LN	RMUKELB LN

Note:

This fund was known as the River and Mercantile UK Equity Long Term Recovery Fund until 1 July 2018 when its name was changed to the River and Mercantile UK Recovery Fund.

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