RIVER AND MERCANTILE

ES RIVER AND MERCANTILE DYNAMIC ASSET ALLOCATION FUND

Quarterly report to 31 December 2020

For unitholders only

ES River and Mercantile
DYNAMIC ASSET ALLOCATION FUND

Quarter 4, 2020

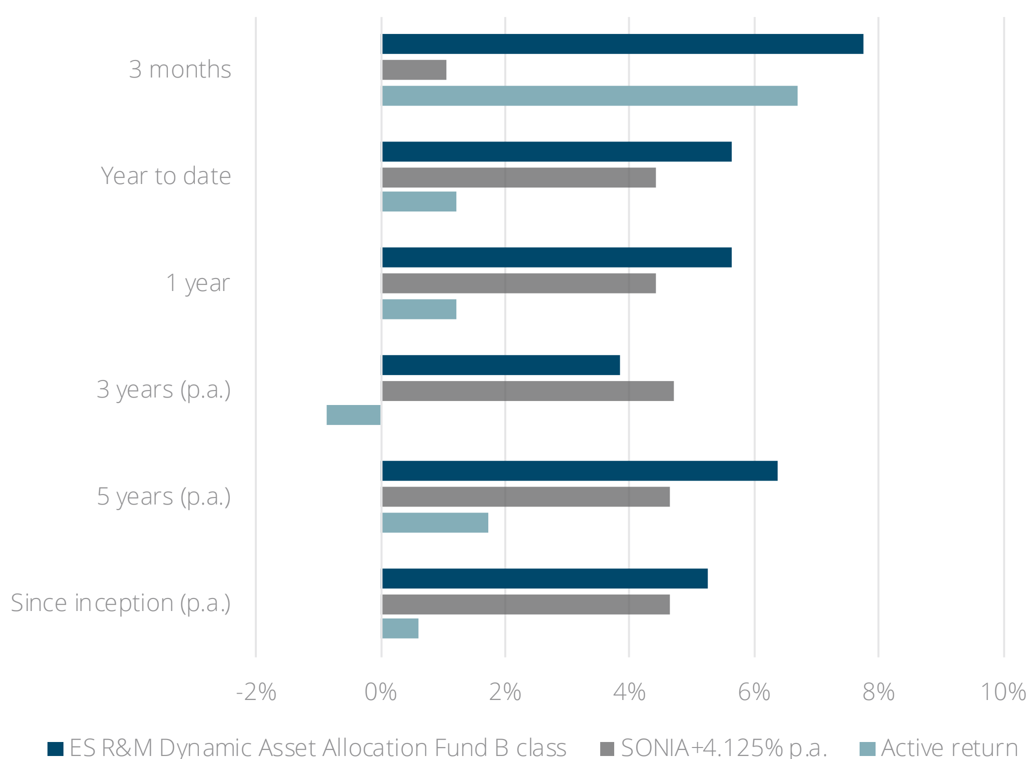
RIVER AND MERCANTILE

INVESTMENT OBJECTIVE

The objective of the strategy is to achieve an average return (income and growth in the value of your investment (known as "capital growth")) of 4.25% per year above cash (based on the SONIA interest rate) (the "Benchmark") over a rolling 3-year period, after the deduction of all fees.

PERFORMANCE

	Fund	Benchmark	Difference
3 months	7.8%	1.1%	6.7%
Year to date	5.6%	4.4%	1.2%
1 year	5.6%	4.4%	1.2%
3 years (p.a.)	3.9%	4.7%	-0.9%
5 years (p.a.)	6.4%	4.6%	1.7%
Since inception (p.a.)	5.3%	4.7%	0.6%



	Fund	Benchmark	Difference
3 years (cumulative)	12.0%	14.8%	-2.8%
5 years (cumulative)	36.2%	25.5%	10.7%
Since inception (cumulative)	38.4%	33.4%	5.0%

Source: River and Mercantile Group PLC. 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 0.55% per annum. Other share classes may be available. ***Past performance is not a reliable indicator of future results.***

PORTFOLIO SUMMARY

AUM	£235.1m
Benchmark	3 month SONIA + 4.25% p.a.
Inception date	2 September 2014
IA Sector	Mixed Investment 20%-60%

SYNTHETIC RISK AND REWARD INDICATOR

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.

Snapshot of views

2020 was an extraordinary year in many ways and leaves us with a much-changed economic outlook heading into 2021. With bond yields close to zero and borrowing costs low, we are currently in a great environment for listed equities. The largest companies are skewing valuations at an index level, hence asset allocation within equities becomes the primary driver of returns. We expect cyclicals (companies more sensitive to the economic cycle) to outperform defensives (companies with less economic sensitivity), and emerging markets to outperform the US, although temporary reversions of this are possible in market corrections which is a factor in our preference for high quality cyclicals. Inflation is a risk considering record stimulus, but whether it materialises is a difficult question. With technology driving efficiencies and lowering prices, it may be that policymakers are unable to manufacture inflation despite heightened spending. The result is lower interest rates for longer, and a tailwind for reasonably priced growing companies. Nevertheless, tactically using assets such as gold is valuable in an environment of falling real interest rates.

An extraordinary 2020, but where next?

In this commentary, we will focus mainly on where we might be going in markets, but to do so we need to consider where we've been.

The last two months of 2020 were extraordinary in market terms, both in terms of the magnitude of the reversal into cyclical stocks within equity markets, and strength of the rally that followed. To illustrate, the Russell 2000 index rallied 29% in the last two months of the year.

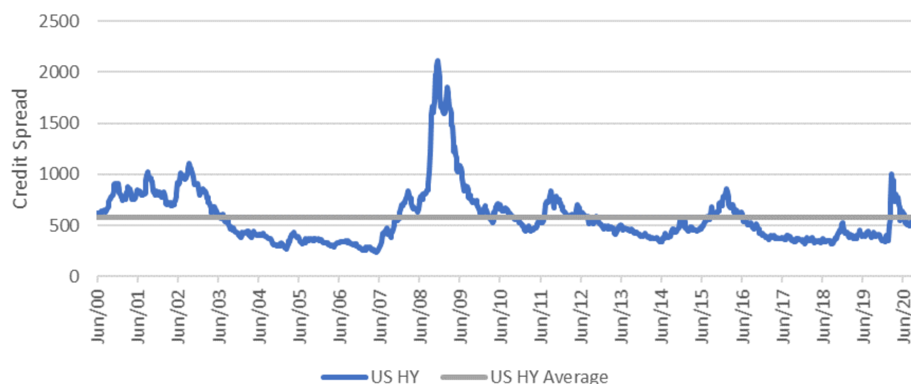
We have been advocating equity exposure in general for some time, and higher cyclical exposure since October, so have been able to benefit from this end of year rally. But the strength of these moves does beg the question, how long can it continue? And how does this influence our approach to investment strategy going forward?

A great environment for listed equities

As we stand today, our best guess is that we ought to see a correction (downwards) or at least a pause in equity markets. How long that takes if it happens is anyone's guess, but markets are often completing these moves relatively quickly (within a month or two).

Our underlying thesis – that this is a great environment for listed equities – remains. Government bond yields are still very low and, in several cases, negative. Credit spreads are back to levels consistent with a "things are pretty decent" economic environment, which the chart below illustrates.

US high yield credit spreads have retreated to below long-term averages, consistent with a stronger economic environment



Source: Bloomberg, 6 January 2021

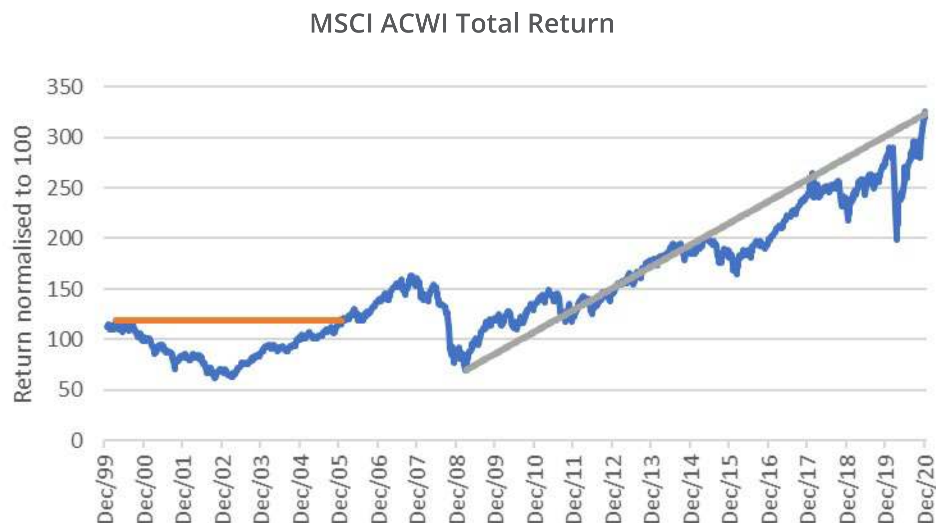
Real estate has significant supply issues because the change in working practices in a post COVID world means that less space is needed than before. Couple this with the question "what do we do with all those redundant shopping malls?" and we've got a supply issue that will take some time to work through.

All of this is great for companies themselves. The cost of borrowing is very low by any standard, which means projects need a lower return threshold to be viable. The benefits of more projects being viable flows to the equity holders. Depressed real estate rents given the supply issues will also benefit companies.

All of this leads back to listed equities being the engine of returns going forward. If volatility and cashflow weren't issues, it's conceivable that portfolios might be dominated by equities in this kind of environment.

Does price matter?

There is no question that historically the highest returns on equities have come from points of lowest prices, and vice versa. Simplistically, if you bought the equity market at the peak in 2000, it took you a long time to achieve a positive return. If you bought at the bottom in 2009, you've done incredibly well.



Source: Bloomberg, River and Mercantile, 6 January 2021

So, the question we wrestle within an equity dominated strategy is, are our portfolios currently expensive and positioned where we'll potentially lose money, or are we in a new normal where valuations are higher, and therefore we need to stay invested? Here we explain what we think is happening.

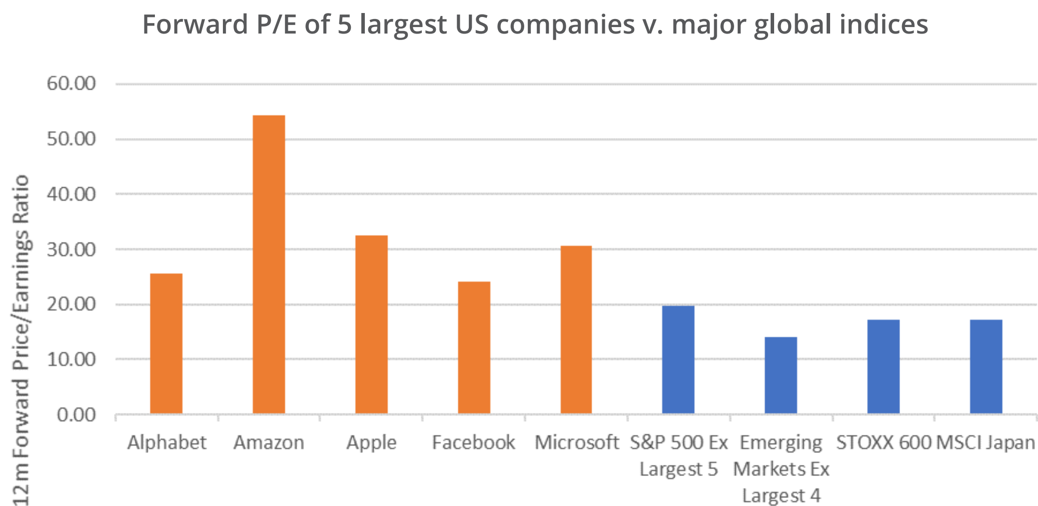
Price matters. But equity price moves in the medium term can be influenced by more than just earnings expectations – for example, discount rates in the form of bond yields. Logically, companies that have very stable profit margins and low debt would see their share prices rise simply because bond prices rise (yields fall). The company itself has bond-like attributes. So when commentators say "this move was just a P/E (price-to-earnings ratio) expansion and not earnings-led, and therefore can't continue", they ignore the bond yield effect. It can continue if bond yields keep falling.

With bond yields falling dramatically in 2020, this is precisely what we've seen. The difference this time compared to prior periods of falling yields is that the very largest companies have been the beneficiaries, and it has skewed the pricing on the whole index. Apple, Microsoft, Amazon, Alphabet and Facebook together make up more than 10% of the MSCI World ACWI IMI index, which is intended to broadly represent global investible equities.

What we believe has happened in the last few years is that the attractiveness of these companies as relatively stable earning, low debt businesses has led investors to up-rate them because of falling bond prices. That in itself is not unusual - historically we have tended to see this in other companies with these characteristics. What is different this time is the size of these companies and their effect on the apparent valuation of indices. Together these companies have an average P/E ratio of close to 35. The long-term average P/E on the S&P index is around 16. So, are these companies worth that? We think they're great companies, albeit several them have some significant anti-trust problems ahead. They are decent growers. But does that growth rate justify these valuations? We think it's far more likely that the valuation is justified by low bond yields.

If we look at the market excluding these companies, the multiples are quite different. The chart below shows forward P/Es for these companies, against the S&P 500 excluding these companies, other developed markets, and emerging markets. For emerging markets, we have removed the top four companies as the same issue applies – Alibaba, Tencent, Taiwan Semiconductor and Samsung are around 20% of the entire emerging market index between them.

Forward P/E of 5 largest US companies v. major global indices



Source: Bloomberg, 6 January 2021

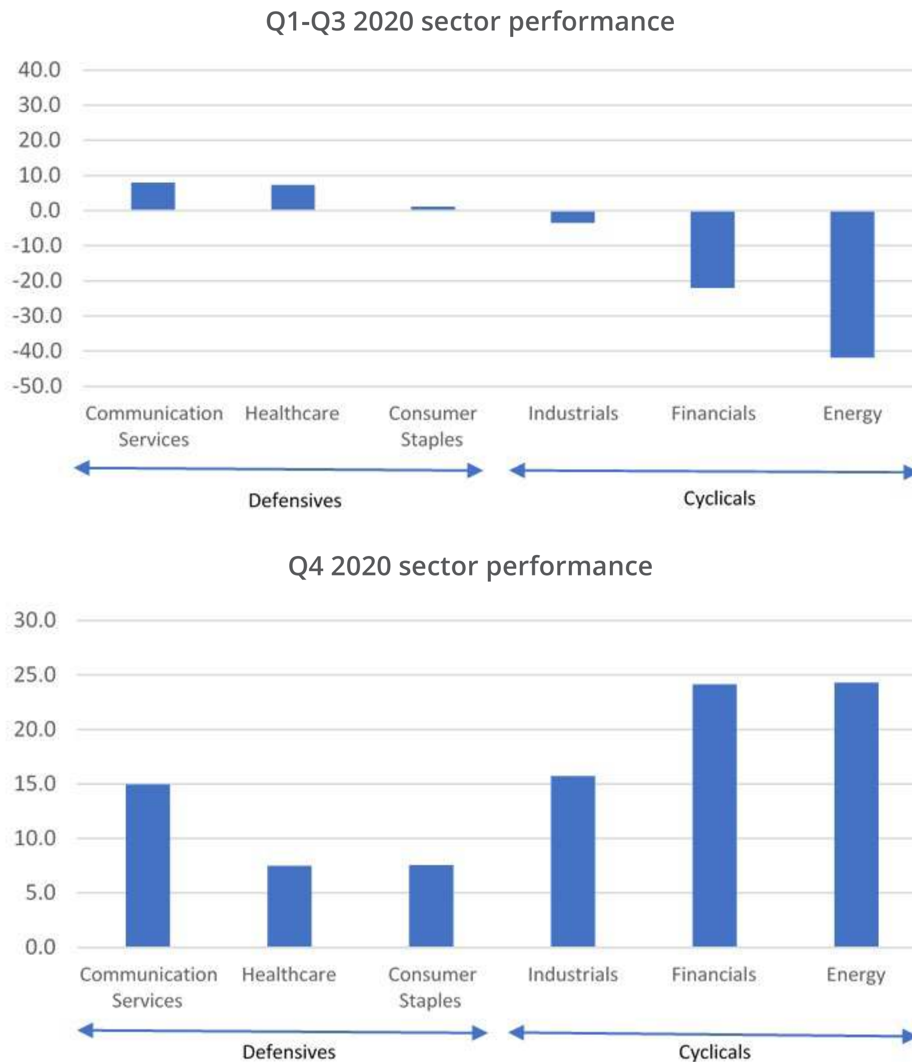
What we believe we have, in this market environment, is a relatively significant segment of the market that is essentially a view, not so much on the company, but on the direction of bond yields. If bond yields in the US drop to 0%, we believe we'll see significant rises in those large companies. But if they rise to 2% from here, it will create headwinds for them (however good companies they are) while being a tailwind for a range of other equities that will benefit from this environment.

What does all this mean? Simply we think there are dangers in implementing a strategy focused on listed equities through a passive strategy or something that looks a lot like the index. The real benefits will come in being more selective about the nature of the exposure you have. This may mean a portfolio that looks meaningfully different to the index. If you believe bond yields are headed down, maybe hold more in these large companies than the index. If you believe the alternative, then perhaps limit your exposure. But we don't think the index structure ought to dictate that view.

This issue is particularly acute because it seems more likely that there may be upward pressure on bond yields in the next 12 months or so.

Dynamism within equities proves its value

The wide disparity between different segments of the equity market will likely continue. See the charts below showing performance of cyclicals versus defensives in the first 3 quarters of 2020, as well as in Q4 2020.



Source: Bloomberg, 6 January 2021

Allocating to the right segments of the equity market has a meaningful effect on overall performance. Drilling down even further into industry sectors, small versus large-cap and regions also shows significant disparities.

We believe that in an environment where listed equities will be the primary driver of returns, allocation within equities essentially becomes the new asset allocation. Real value can be generated by making decisions to allocate to different segments. We have done this throughout the last year and particularly in the last quarter, and expect these sorts of decisions to form an increasing part of how we add value.

In the coming 12 months or so, we continue to expect cyclicals to outperform defensives, and the rest of the world (particularly emerging markets) to outperform the US. However, the opposite may well happen in the short run if we see a correction in Q1, and that is an influence on our current positioning.

The migration of capital out of the US to the rest of the world, as the world reflates, raises an interesting question around inflation, to which we want to turn next.

Are policymakers able to manufacture inflation?

There is lots of talk now about inflation and the inflation trade. We are seeing increasing amounts of inflation scaremongering going on, usually to persuade people to buy cryptocurrencies or gold. We have no problem with either asset, but the question about whether we will actually get inflation is a more involved one.

We have been making the argument for some time now that inflation is an increased risk, not least because governments and central bankers want it. There is plenty of stimulus in the system, and historically money printing has tended to lead to inflation, except post 2008/9.

The problem with this assumption as an automatic transmission mechanism is that it ignores another force. Left unchecked, one could argue that we are in a deflationary environment because the rate of technological improvement is very high. Technology, all else being equal, tends to be deflationary.

We want to use an example from history as a thought experiment. In the industrial revolution (in the period post-1870) the US economy grew dramatically. But it did that during a period of deflation. Perhaps this is not surprising, because the cost of "stuff" fell as production became more efficient (technological improvement). The market naturally cleared at lower prices, and the economy multiplied. At the time there was no central bank dictating monetary policy or stimulus.

But how would this play out today? In theory, an inflation-targeting central bank would look at the deflation level, determine that it was inappropriate, and stimulate. The net result would be a lot of money printing, but a relatively low level of inflation because the stimulus was simply offsetting a deflationary force.

We do think it is conceivable we could see genuine inflation if enough money is printed, but we are doubtful it will be high levels of inflation unless we have a tight labour market. That's hard to see in the near future with the degree of technological improvement going on. Commodity prices, especially in some of the metals, seems like the most likely source of inflation but whether that's enough is an open question.

Our point is that, while there is reason to worry about the resurgence of inflation, thought should also be given to the possibility that governments and central banks are unable to manufacture it. What does this mean? If inflation doesn't arrive, short rates will stay lower for even longer than people think. Ordinarily, that would argue for lower bond yields, but they're already low. But the place this should show up is in reasonably priced growth companies, where the benefit of lower yields for longer will be felt in the discount rate effect we described for the mega-cap stocks above. Therefore, we will likely prefer a strategy that emphasises cyclicals and growth, with an increasing emphasis towards emerging markets, as a means of balancing these issues.

The possibility of inflation does raise the question of the value of monetary assets, such as precious metals and cryptocurrencies. We have favoured gold and silver for this reason. We do believe that there is value in these types of assets in an environment where the interest rate is running below the inflation rate (i.e. there is a negative real interest rate). But we advocate treating the asset more tactically because it doesn't produce a yield and therefore if it goes nowhere it is essentially dead capital. As a result, where we are able, these positions should be managed quite actively to avoid this issue.

Portfolio changes

Throughout the quarter we increased our equity allocation, predominantly funded by credit as yields continued to fall. We also restructured our equity allocation, increasing exposure to certain segments: in particular high quality companies in cyclical sectors, and US technology companies. In both cases we focused on companies with strong ESG characteristics. Towards quarter end, we started to increase exposure to emerging market equity at the expense of developed markets. We continued to tactically trade precious metals throughout the quarter, taking profits in November before using weakness in December to reallocate. Towards the end of the quarter US Dollar exposure was removed from the portfolio.

Mike Faulkner & Joe Andrews
Portfolio Managers

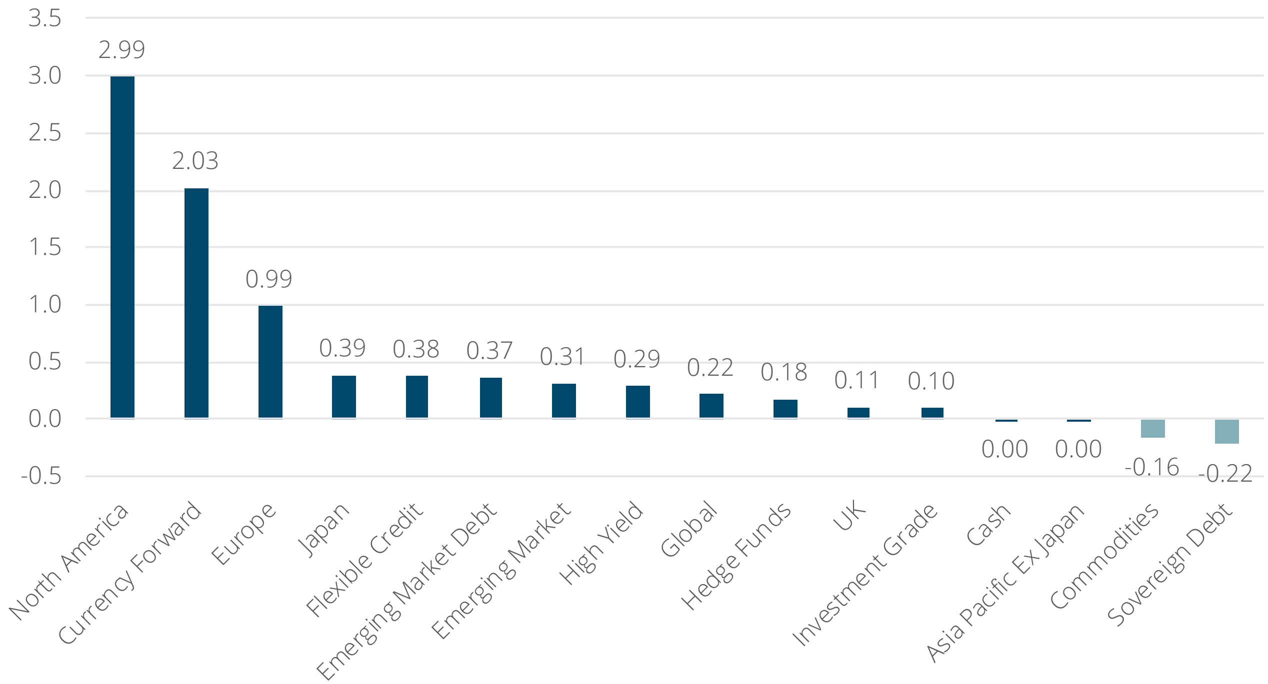
January 2021

**Please note the ES R&M Dynamic Asset Allocation Fund will be changing from the IA Mixed 20-60 sector back to the IA Flexible sector. No changes have been made to the approach or prospectus of the fund*

Asset Class	Rating	Comments
Portfolio Risk View	**3**	**At a portfolio level we have a neutral risk view, but with a preference for equities over credit. Where credit risk is taken, it should be selective.**
Equity	5	**We increasingly favour equities over other on-risk asset classes. Low rates and stimulus are leading to compressed credit spreads and cheaper borrowing costs meaning more corporate projects are viable, a benefit which accrues to shareholders.**
Developed Market	3	At present we are not expressing regional preferences within developed market equities.
Emerging Market	3	Following strong performance from our China overweight position, we no longer have specific EM biases.
Style	5	Current economic conditions favour companies with strong balance sheets and growth characteristics. Cyclical sectors with these characteristics are set to benefit from an improving economic environment. We favour Industrials, Materials, Consumer Discretionary, Tech and Financials.
Credit	2	**We are underweight credit given current spread levels and the minimal compensation for potential defaults and downgrades.**
Investment Grade	3	Stimulus has reduced the possibility of an extreme downside scenario, but current spread levels mean broad based returns are likely to be muted. We favour a selective approach.
High Yield	3	We favour selective credit in the higher quality part of the High Yield market, where there is also explicit policy support.
Emerging Market Debt	2	Weaker economic conditions present headwinds.
Property	1	**We expect stresses to form in office and retail sectors. We favour a bias to assets supported by the trend to online shopping accelerated by COVID.**
Alternatives	**3**	**Alternatives are a good diversifier in the current environment with likely ongoing volatility supportive for many Alts strategies**
Hedge Funds	3	We favour liquid hedge funds with low net exposure. Sacrificing some return in favour of liquid strategies which can be used to redeploy into equity and credit is valuable in an environment where volatility is likely to lead to short term selloffs.
Precious Metals	4	Gold and silver are considered attractive diversifiers in an environment where money supply is expanding. Silver also has the benefit of being used in manufacturing processes.
Defensives	**3**	
Cash	3	
Off-Risk Bonds	2 Downgrade	Downgraded to slightly underweight given current level of rates and relative attractiveness of other assets.
Anti-Beta Strategies	5	Lower yields mean that the diversification benefits of government bonds are more limited. Strategies that deliver positive returns in weaker periods for equity and credit while preserving capital in strong periods are valuable.

RELATIVE CONTRIBUTION TO RETURN OVER THE QUARTER

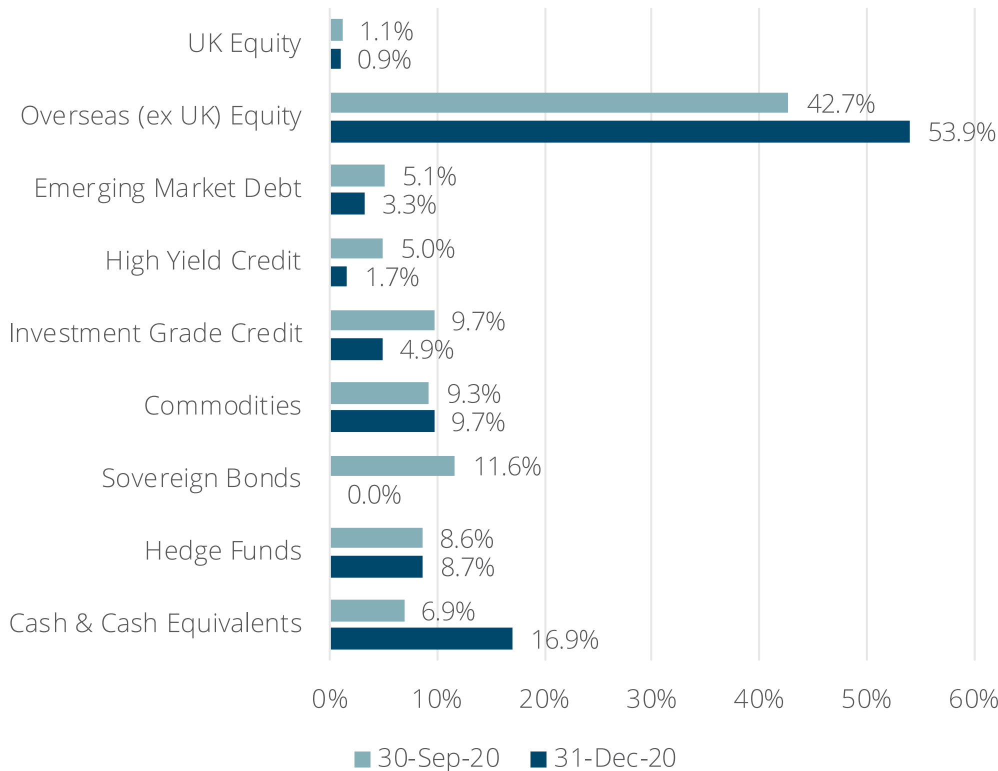
This chart shows the weighting of the fund's holdings across the four categories of Potential, related to the stages of a company's life cycle, as defined within the R&M investment philosophy known as 'PVT' – Potential, Valuation, Timing.



Source: FactSet, based on close of business valuation, gross of fees

ASSET ALLOCATION

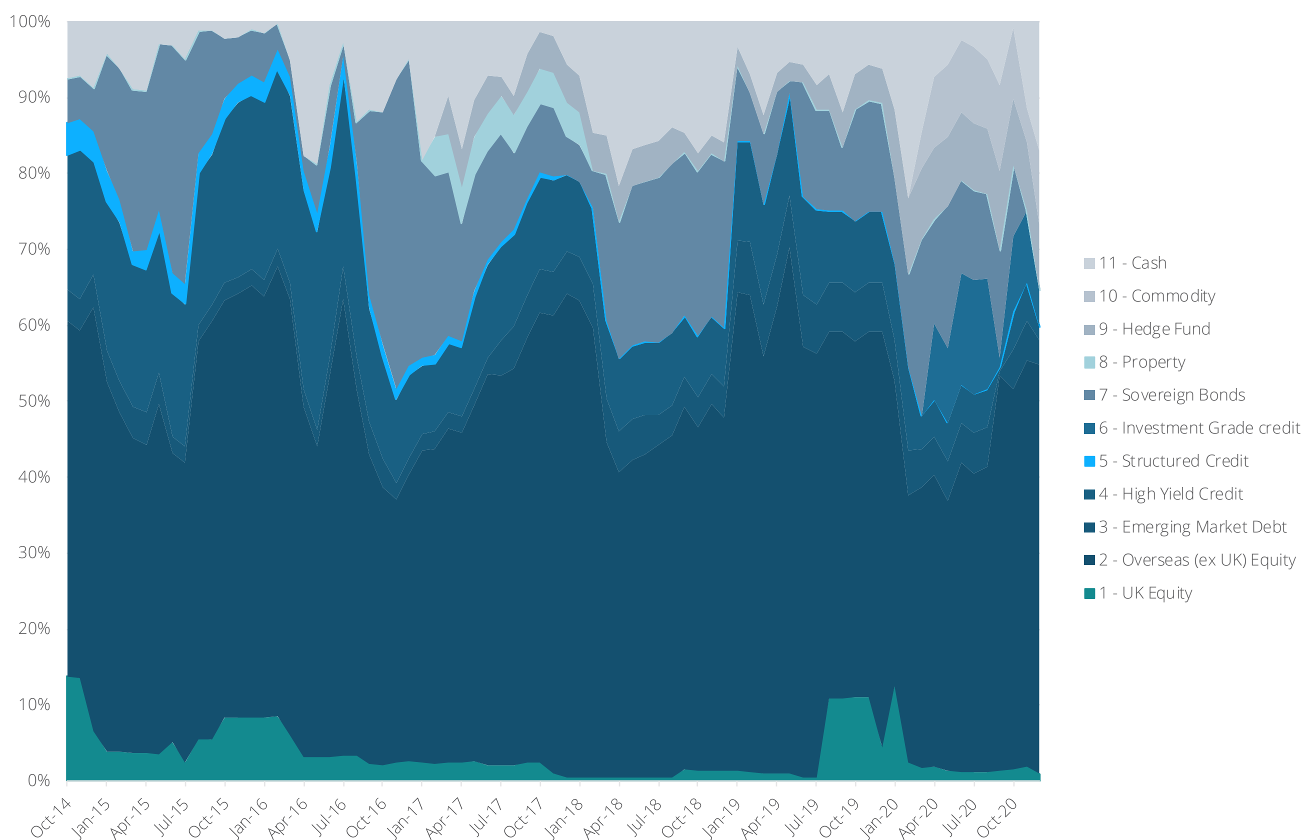
This chart shows the fund's allocation to different asset classes by portfolio weight, at the most recent quarter-end versus the previous quarter-end position.



Source: River and Mercantile Group

ASSET ALLOCATION EVOLUTION SINCE INCEPTION

This chart shows the evolution of the portfolio's weighting to different asset classes over time, since its inception in September 2014.



Source: River and Mercantile Group

TOP 10 HOLDINGS

This table shows the fund's ten largest holdings by weight.

	Weight (%)
Vanguard FTSE Emerging Markets UCITS ETF	9.9
Insight GBP Liquidity Fd	6.7
River and Mercantile Global Macro Z GBP Acc	6.1
Neuberger Berman Global Flexible Credit Fund	4.9
Vanguard S&P 500 ETF	4.8
BlackRock ISC Sterling Liquidity Fund	4.6
iShares Physical Gold ETC	4.5
Vanguard S&P 500 UCITS ETF	3.4
T Rowe Price Funds SICAV - Global High Income	3.3
iShares Physical Silver ETC	3.1

Source: River and Mercantile Group

BROKER COMMISSIONS ANALYSIS

Counterparty	Total (£)	Commission Paid (£)
		Execution Only
ABG SUNDAL COLLIER	0.00	0.00
ATLANTIC SECURITIES	0.00	0.00
BANCO ITAU	0.00	0.00
BARCAP	11,169,416.93	0.00
BERENBERG	0.00	0.00
BMO	0.00	0.00
BTG PACTUAL	0.00	0.00
CANACCORD ALGO	0.00	0.00
CANACCORD GENUITY	0.00	0.00
CENKOS	0.00	0.00
CITI PROG	0.00	0.00
CITIGROUP	8,726,702.77	0.00
CLSA	0.00	0.00
CREDIT SUISSE	0.00	0.00
EXANE	0.00	0.00
FINNCAP	0.00	0.00
GBM	0.00	0.00
GOODBODY	0.00	0.00
HSBC	0.00	0.00
ING	0.00	0.00
INSTINET	0.00	0.00
INVESTEC	0.00	0.00
ITG	0.00	0.00
ITG ALGO	0.00	0.00
ITG EURO	0.00	0.00
J&E DAVY	0.00	0.00
JANE STREET	29,025,512.44	0.00
JEFFERIES	0.00	0.00
JEFFERIES ALGO	0.00	0.00
JPMORGAN CHASE	13,640,940.80	0.00
KEPLER CHEUVREUX	0.00	0.00
LIBERUM	0.00	0.00
LIQUIDNET	0.00	0.00
MEDIOBANCA	0.00	0.00
MIZUHO	0.00	0.00
MORGAN STANLEY	0.00	0.00
NPLUS1 SINGER	0.00	0.00
NUMIS	0.00	0.00
PANMURE GORDON	0.00	0.00
PEEL HUNT	0.00	0.00
RAYMOND JAMES	0.00	0.00
RBC	0.00	0.00
RBC ALGO	0.00	0.00
REDBURN	0.00	0.00
SANFORD BERNSTEIN	0.00	0.00
SANTANDER	0.00	0.00
SHORE CAPITAL	0.00	0.00
SOCIETE GENERALE	7,517,988.36	0.00
STIFEL EUROPE	0.00	0.00
STIFEL NICOLAUS	0.00	0.00
SUSQUEHANNA INTERNATIONAL GROUP	1,182,473.08	0.00
UBS	0.00	0.00
UBS PROG	0.00	0.00
WINTERFLOOD	0.00	0.00
FLOWTRADERS	48,020,024.67	0.00
CONFIRMED FUND PRICE	83,251,214.74	0.00
OPTIVER	29,620,085.63	0.00
BANK OF MONTREAL	0.00	0.00
BTIG	0.00	0.00
CITADEL INVESTMENT GROUP L.L.C.	4,074,902.80	0.00
BANQUE NATIONALE DE PARIS	8,732,546.93	0.00
STIFEL FINANCIAL CORP	0.00	0.00
	£ 244,961,809.14	£ -

Firm Wide Comparators

All Equity Trading	**£ 2,057,106,036.35**	**£999,680.60**
Trades:	**£ 244,961,809.14**	**£0.00**
Average Firm-Wide Commission Rate (%)		0.05%
: **Average Commission Rate (%)**		0.00%

Source: River and Mercantile Asset Management LLP

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