AJBell Investcentre

Fundamentals with Russ Mould

October 2017

Welcome to the latest edition of Fundamentals. This time around I'm going to look at an actively-managed fund, namely **River and Mercantile UK Equity Smaller Companies**

[CAPTION
River and Mercantile UK Equity Smaller Companies B (Acc)
ISIN - GB00B1DSZS09 SEDOL – B1DSZS0]

The £850 million pound fund's mandate is to generate capital growth for advisers and clients.

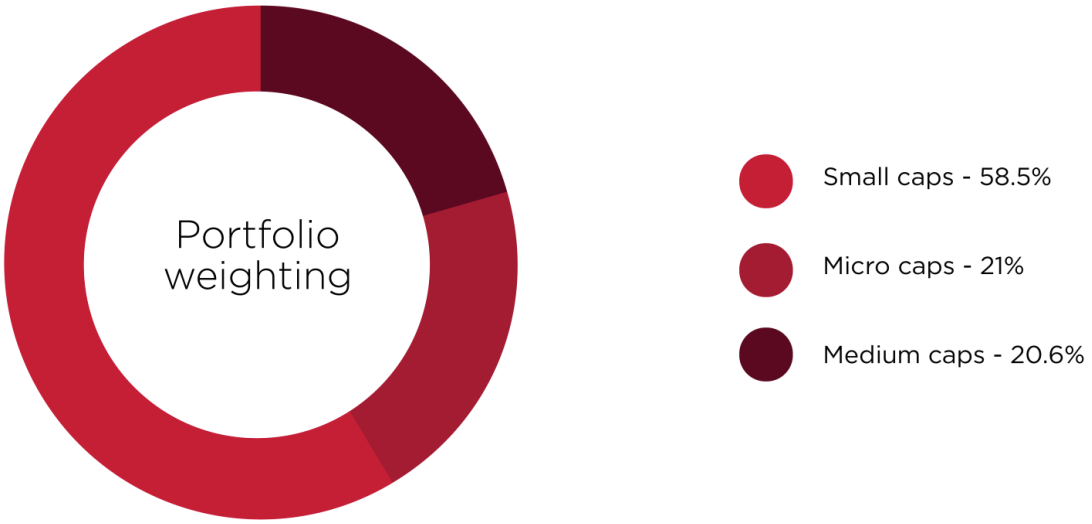
As its name suggests, it seeks to do so by investing in smaller companies. Fund manager Philip Rodrigs and team focus on making their picks from the smallest 10% of the UK stock market, as measured by their market capitalisation.

The fund comes with a very clearly defined investment process, which is underpinned by a quantitatively-based proprietary system, which provides filters and screens to help the fund managers sift for suitable portfolio picks. In general Rodrigs and team like to identify young, rapidly growing businesses that can deliver hefty share price advances.

The portfolio is kept pretty tight. The latest fact sheet reveals it contains 71 holdings although the top 10 represents barely a quarter of the assets so the River & Mercantile team does look to provide diversification to manage the risks that can come with smaller firms.

The biggest positions in the fund as I sit here are premium drinks mixer provider Fevertree, drinks retailer Conviviality, Smart Metering Systems, corporate telecoms and bandwidth provider Gamma and language translation software provider SDL.

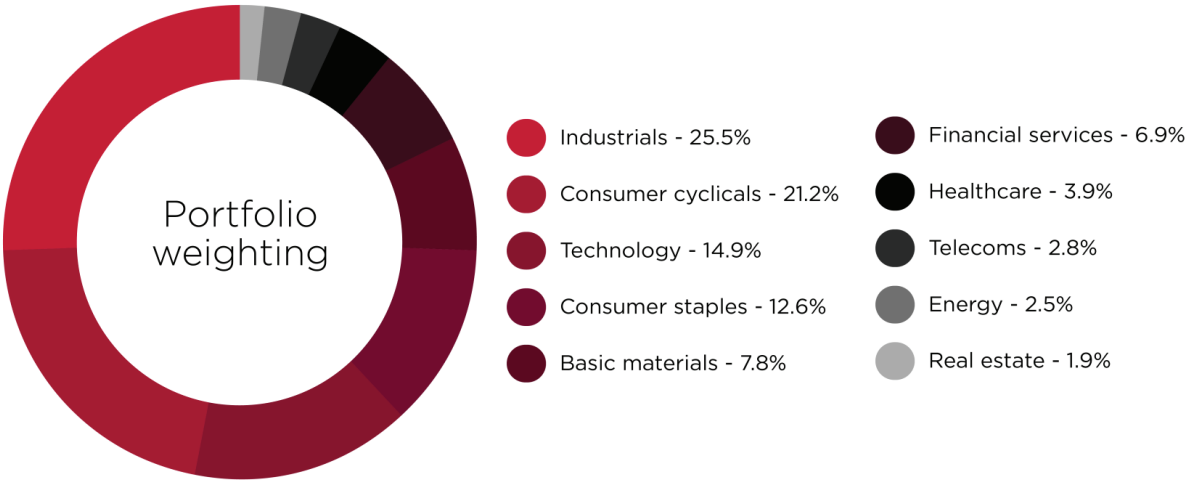
By market cap, just over 20% of the assets are in mid-caps, nearly 60% in small caps and just over 20% in micro-caps. There is no exposure at all to large caps, such as the FTSE 100's members.



Source: Morningstar, River & Mercantile factsheet
Note: Past performance is not a guide for future performance and some investments need to be held for the long term

By sector, industrials, consumer discretionary and technology are the three biggest sector exposures, at 26, 21 and 15% of the portfolio respectively.

Intriguingly just 8% of the assets are in mining stocks and barely 3% in oils, despite the huge number of junior diggers and drillers quoted in London. Any advisers or clients who are looking for defensive stodge are likely to be disappointed, with a zero weighting in utilities, 3% in telecoms and just 4% in healthcare.



Source: Morningstar, River & Mercantile factsheet
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The fund is eligible for SIPPs, ISAs and dealing accounts and the minimum investment is just one share.

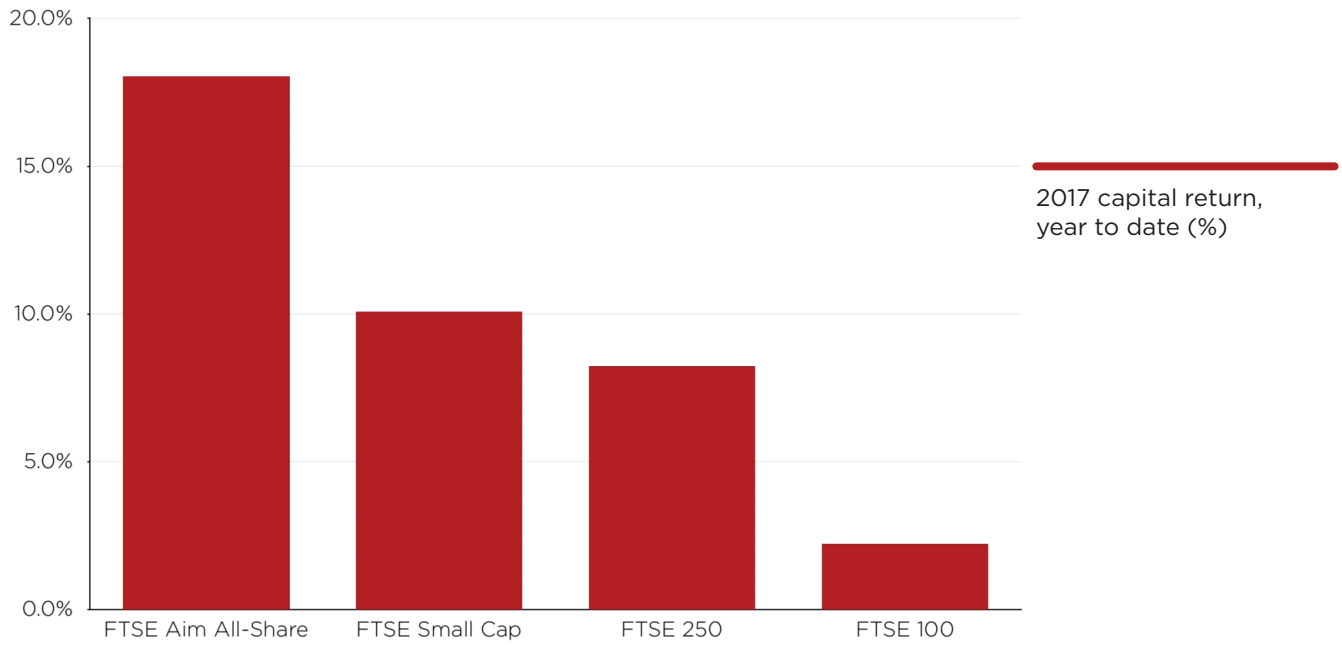
On this occasion we are talking about the accumulation units – where the dividends are automatically reinvested – although River and Mercantile UK Equity Smaller Companies does also come with income units, where dividends are paid out quarterly.

The ongoing charge figure is 0.83% - so advisers and clients do have to pay for the expertise of the fund managers - and for those who set store by such things the fund comes with a five-star ranking from Morningstar.

So - those are the mechanics. The question to address next is why could advisers and clients consider this fund for portfolio inclusion today?

Well, I think there may be three possible reasons:

- First, small caps have done pretty well in the UK this year. The FTSE AIM All-Share index has outperformed the large-cap FTSE 100 and the mid-cap FTSE 250, with an 18% gain against 2% and 8% respectively, while the FTSE Small Cap benchmark is up 10%, in capital terms. Small caps can provide terrific share price gains when things go well and you find a few winners.



(Data from 1 January to 25 September 2017)
Source: Thomson Reuters Datastream.
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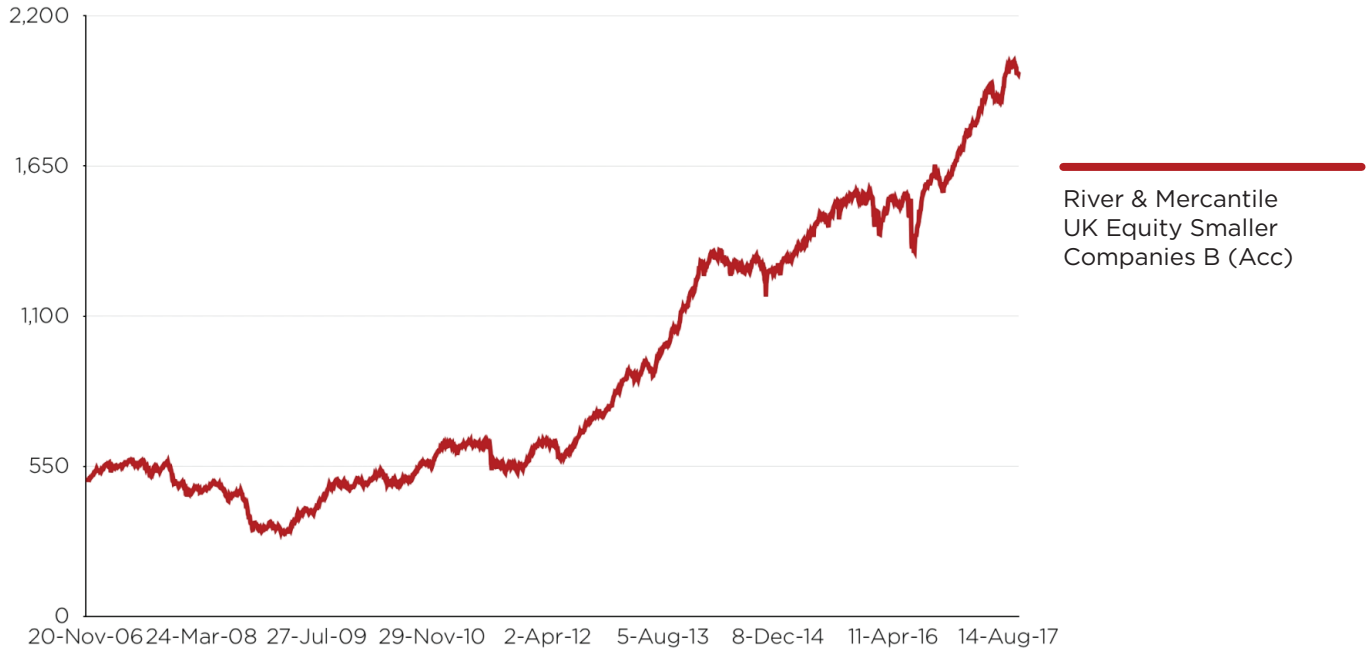
- Second, picking small-caps can be rewarding but it can be downright dangerous too. Smaller firms tend to be more reliant than big ones on a particular executive, a certain product or a key geographic market, so they have a lesser margin for error if something goes wrong. In addition, they are not always as well funded as big caps so in a worse case they can turn into a cash sink or even go broke. A fund with 71 holdings therefore provides some welcome diversification and therefore some management of the downside risks.

- Finally, the fund and its managers have an excellent long-term performance record, to suggest that its screening process is proven. This chart shows how it has done since inception in 2006, although I should stress that Philip Rodrigs has not been there for all of that span – he joined from Investec in 2014.



Source: Thomson Reuters Datastream
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This is not to say River and Mercantile UK Equity Smaller Companies fund will suit every investor, also for three reasons:

- First, those advisers and clients who are seeking income are unlikely to be excited by the 1% yield.
- Second, others may not like the 0.83% ongoing charge figure. There are only a handful of rival, actively-managed small-cap funds that come cheaper and the sole passive, Exchange-Traded Fund is cheaper too, at 0.58%, but no doubt the River and Mercantile team would argue they have provided value for money given their 5- and 10-year performance records in particular.
- Third, small-caps are risky and things can and do go wrong. They tend to outperform when markets are rising and animal spirits are high but can underperform – and get hit hard – when a bear market growls its way into view and investors start to run scared. Advisers and clients need to make sure that they can be patient and sit out any bear downturn and not find that their personal circumstances mean they need the cash in the fund and are forced sellers at a potentially inopportune time.

Advisers and clients must therefore do their research on River and Mercantile UK Equity Smaller Companies to make sure that it fits with their overall strategy, target returns, time horizon and appetite for risk before they put any capital to work.

Thank you for watching and I look forward to seeing you next time.