PSG Asset Management

ANGLES & PERSPECTIVES

SECOND QUARTER 2020

Contents

PSG Asset Management follows its 3M process to uncover investment opportunities and help investors grow their wealth in the long term.

Introduction

Anet Ahern

Anet has over 30 years' experience in investment and business management. After starting her career at Allan Gray in 1986, where she fulfilled various roles in trading and investment management, she worked as a portfolio manager at Syfrets, and later BoE Asset Management, where she was CIO and CEO. She also spent six years at Sanlam, where she was the CEO of Sanlam Multi Manager International. Anet joined PSG Asset Management as CEO in 2013.

All quality is not created equal

Some investors believe that if you buy quality companies and hold on to them for a long time, you are bound to make money. This is not entirely true, as this simplification ignores a cardinal piece of the puzzle – the starting price of the investment. We believe investors are far more likely to achieve investment success when they combine the quality consideration (as enshrined as **moat** and **management** in our 3M process) with the final critical component of the equation: **margin of safety**.

It may be true that great ideas and great management make great companies, but we have argued time and again that the starting price investors pay has a material impact on the long-term return they achieve. The availability of the first two Ms may be relatively evenly distributed through time – we must always be discerning, but someone always has a good idea and you can almost always find good management teams. However, the final M, margin, is not always equally abundant.

There are times when the market offers us the opportunity to invest in companies at exceptionally attractive valuations, like now. The last M – margin – is the true scarce commodity. The first two Ms (moat and management) for many companies have stayed largely the same, despite a weak post-pandemic economy. Yet it is most often movement in the final M (margin) that typically sends investors running for the hills. However, we would argue that investors are running in the wrong direction. If all other factors have been accounted for and if you remain convinced of your assessment of above-average quality, then an increase in the margin of safety (typically via falling share prices) signals an opportunity to buy. So why do investors not view it as such?

Markets follow their own logic. They diverge from both rational expectations and tangible economic outcomes in the real world for extended periods of time. This causes many investors to capitulate at precisely the wrong time, when their expectations have been dashed yet again and the market persists on its course to exacerbate this. The level of discomfort this causes simply becomes unbearable for many investors.

The courage of conviction is hard won through bitter experience, and by the disciplined setting-aside of emotion through a proven investment philosophy and process. As custodians of our clients' capital we keep our eyes firmly fixed on the third M. When all the indicators align for us in terms of our process, we know that we must act to secure the best long-term outcomes for our clients – even when a pandemic has much of the world in a tailspin and discomfort levels are high. Because above all else, we know great returns are often made in times of great discomfort, by those who have the courage to act when others fall prey to their emotions.

In the first article Looking beyond the corona crisis, Fund Manager Justin Floor outlines developments over the past six months and the extent to which the combination of monetary and fiscal stimulus has driven the recovery of risk assets. In our outlook on asset classes, he explains why we remain positive on the outlook for South African equities despite the extreme negativity that surrounds this asset class.

Fund Manager Shaun le Roux outlines Why it is a bad time to give up on contrarian investing in the second article. He delves into the extraordinary market conditions that have seen investors crowding into a narrow selection of shares, both here and abroad. With investors focusing on earnings growth almost at the exclusion of valuations, we have to ask if the market has completely forgotten the importance of the third M.

Lastly, Fund Manager Philipp Wörz explains why we believe the markets are offering great opportunities in Obscured quality – the market is pitching classic 3M opportunities. He offers three case studies that help to explain why we argue that the current market conditions are heavily stacked in favour of building a classic PSG portfolio.

We trust that you will find these articles insightful, and that they offer you some guidance in these turbulent times.

Looking beyond the corona crisis

Justin Floor

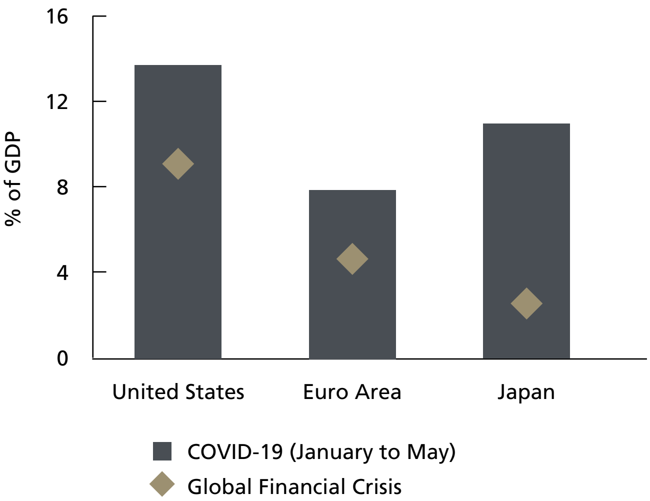
Justin joined PSG Asset Management as a Fund Manager on the PSG Balanced Fund in 2019. He is a qualified actuary and a CFA charterholder, and has over 10 years' investment experience.

Over the past few months, the epicentre of the COVID-19 outbreak has shifted. Perhaps early on the hopes were that the outbreak could be put behind us swiftly. This has not proven to be the case and the disease has shown itself to be a truly global pandemic. Countries that were affected first like China and the developed economies, have largely seen their cases level off, while the epicentre of the pandemic has now moved to the US and emerging market economies.

The policy responses by governments have had profound economic impacts. Shelter-in-place and lockdown measures aimed at containment have decimated economic activity and the ensuing global recession has been faster and deeper than that experienced in the 2008/2009 Global Financial Crisis (GFC). Meanwhile, we have also seen unprecedented monetary and fiscal stimulus measures introduced by policymakers around the world to counteract the impact on economies.

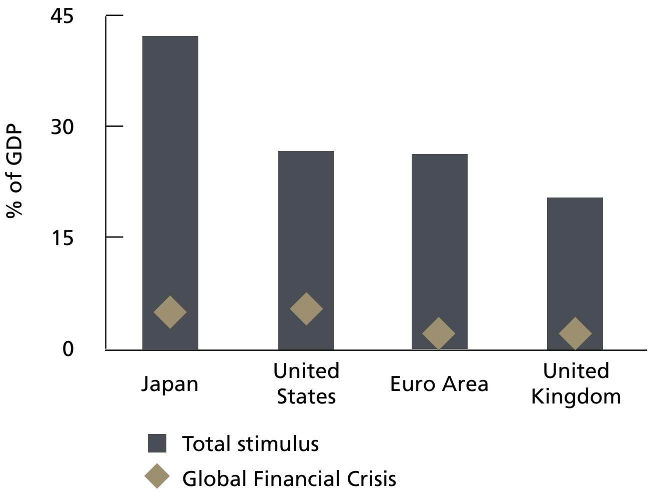
As shown in the charts below, interventions announced by the US, the Euro area and Japan are substantially higher than during previous crises. Fiscal support measures are especially noteworthy as they have been significantly larger than over the last decade. In combination, these measures have the potential to be highly inflationary once the demand and oil price shocks have made their way through the global system. While much remains uncertain, we are increasingly intrigued by the possibility that the future could look very different to the most recent experience.

Graph 1: Unconventional monetary policy measures



Sources: Haver Analytics and World Bank

Graph 2: Fiscal support measures



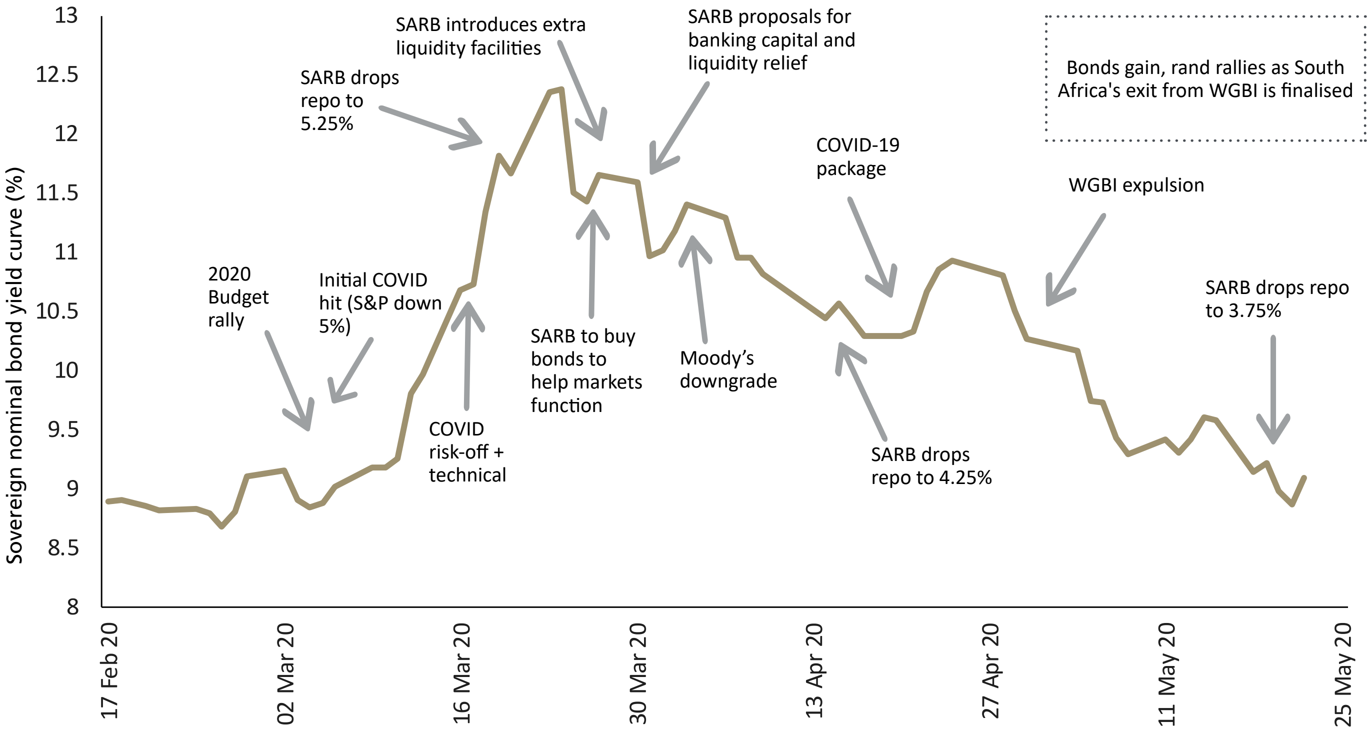
Sources: Haver Analytics and World Bank

The combination of monetary and fiscal stimulus has driven the recovery of risk assets

The immediate response to the pandemic was a widespread fall in virtually all mainstream asset classes. Uncharacteristically, even gold plummeted as investors rushed to liquidate positions and move into cash. Broad market indices have subsequently largely recovered, although mostly due to a strong recovery in a fairly narrow grouping of global shares. While volatility is typically expected from equity markets, the local bond market experienced its own roller-coaster ride over the lockdown period.

It is interesting that the long-awaited Moody's downgrade and subsequent exclusion of South African government bonds from the FTSE World Government Bond Index (WGBI) barely moved the market, and that bonds went on to strengthen over the rest of the lockdown period. With 10-year bonds broadly back to where they were at the beginning of the year, it appears that this event had been adequately priced in.

Graph 3: SA 10-year bond yields swung wildly, but 'big' events were effectively ignored



Sources: Bloomberg and PSG Asset Management

The performance environment has been exceptionally tough over the past 18 months

More recently, the performances of our equity and multi-asset funds have lagged our benchmark and peer group.

The current underperformance can be attributed to three broad areas:

- We do not own Naspers, Richemont and British American Tobacco, which are widely owned, large constituents in the index and that have generally performed well over the past 18 months.
- Many of the undervalued local shares that we own continue to be marked down and are still deeply out of favour.
- Our foreign holdings underperform the market leaders, which include many of the large-cap internet companies. We own excellent companies with good prospects, but so far they haven't kept up with the market leaders.

Generally, it has been a challenging market for valuation-oriented investors seeking mispriced shares in areas that are out of favour. Our article Why it is a bad time to give up on contrarian investing highlights why we believe our approach remains on track.

While the most recent journey has been painful, it must be said that we consider the outlook to be promising. We believe the opportunity from this point is immense for disciplined investors willing to retain a long-term, patient mindset and allocate capital to good, but undervalued, securities. It is rare that all components of a balanced portfolio (local and foreign equities and bonds) are simultaneously priced as attractively as they are right now.

Our current perspective on asset classes

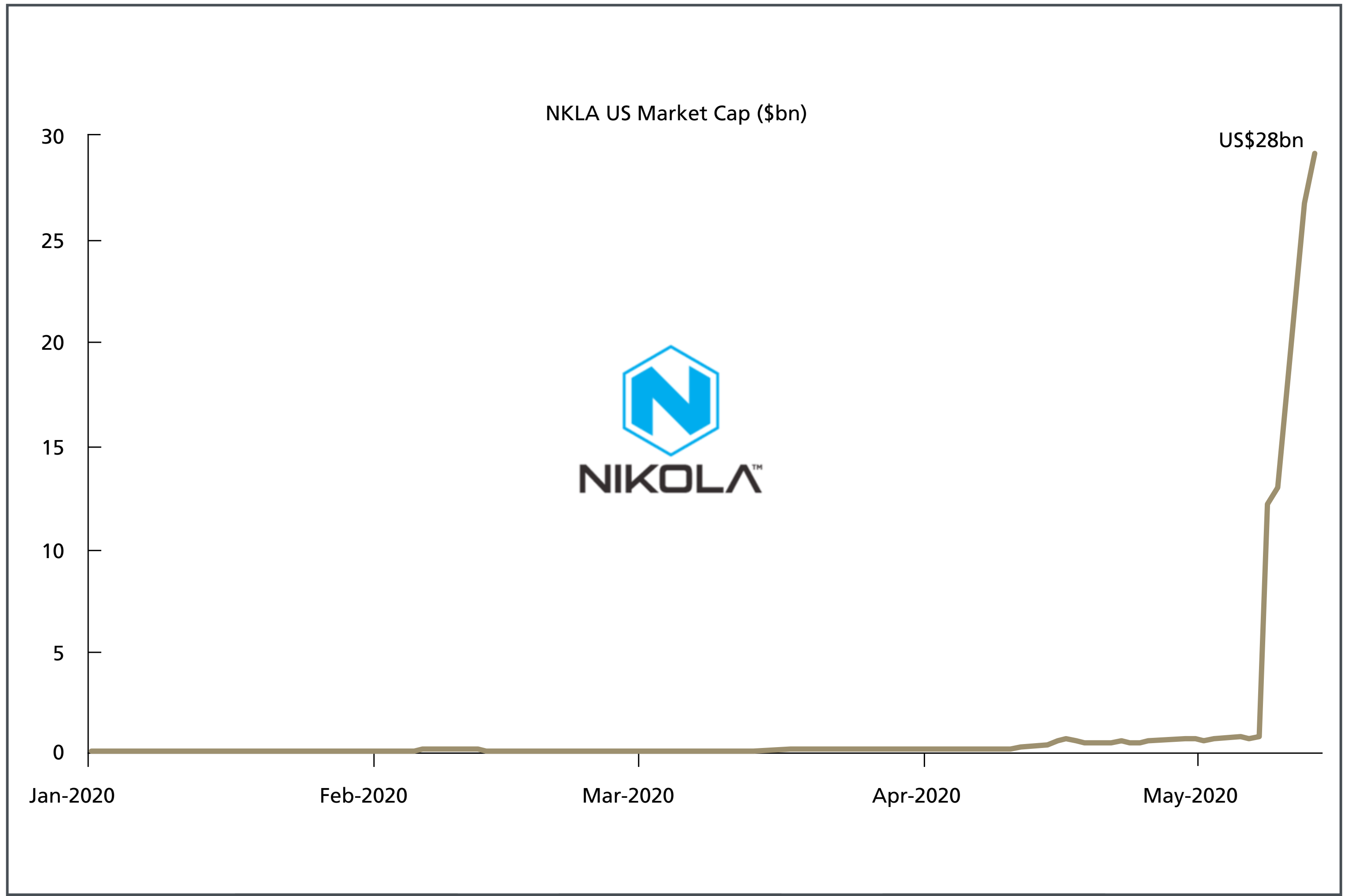
Local equities – not merely a homogenous macro play

The investment case for South African equities is often met with extreme pessimism. With glaringly obvious challenges such as deep structural impediments to growth, unemployment, and depressed aggregate demand, this view is somewhat justified. However, there are some positive macro fundamentals that must be considered as well. Interest rates and inflation rates are at historic lows, creating a stimulatory backdrop. Furthermore, it should be remembered that the country has a vibrant private sector, a highly developed and well-capitalised financial sector, and strong institutions. Headwinds are undoubtedly large and enduring, but this does not mean that there is not an investment opportunity in selective cases. Indeed, history suggests that pervasive gloom is often a necessary pre-condition for being able to buy attractive franchises at attractive prices.

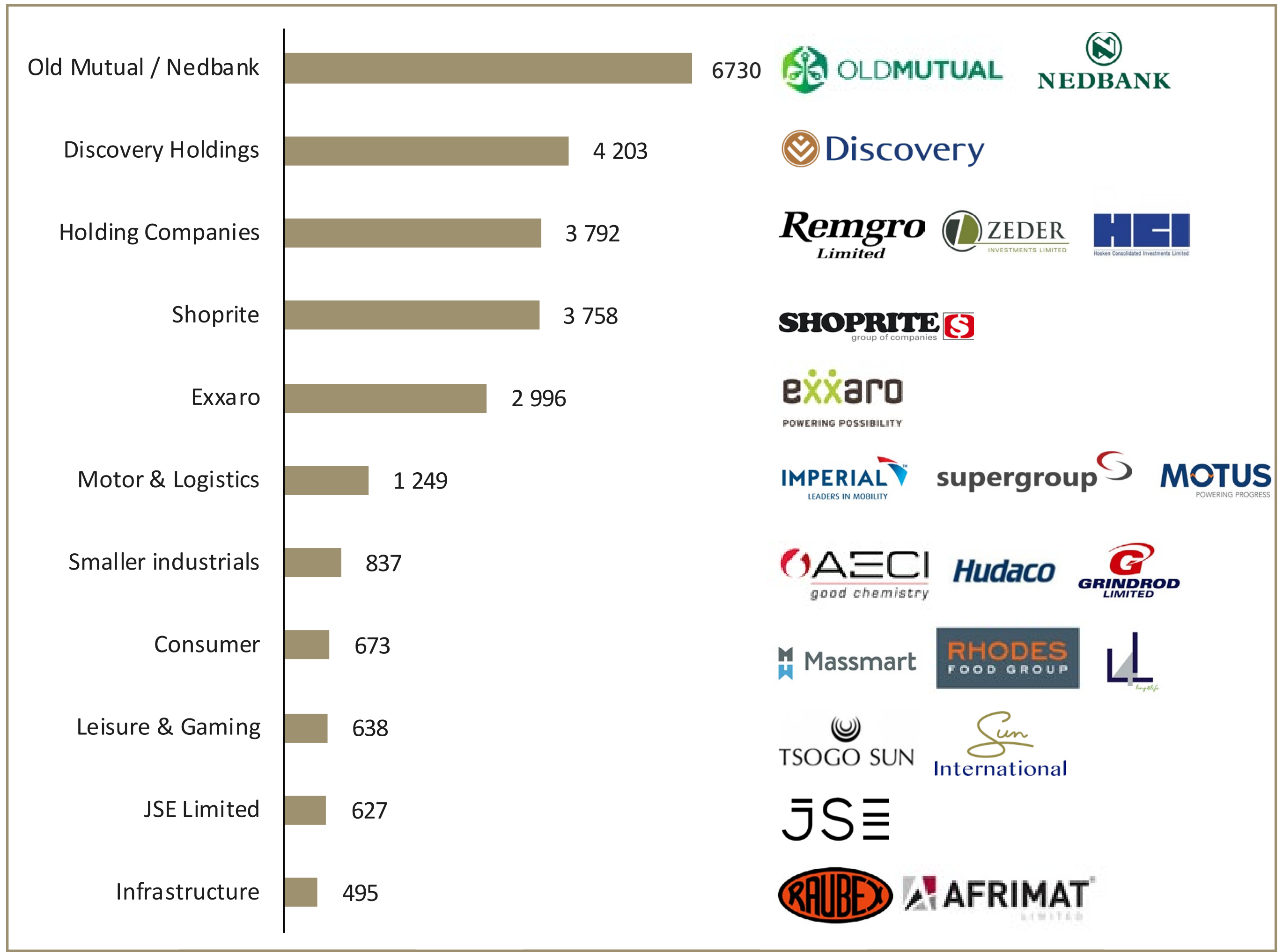
In the race to the bottom, our sense is that the market is overlooking the substantial differentiation and quality that exist in the local share investment universe. Some of these companies with particularly noteworthy attributes include portfolio holdings such as AB Inbev (global brewer with temporary headwinds, yet listed on the JSE), Discovery (highly defensive cash flows from core health and life operations and temporarily obscured growth) and the JSE Limited (cash-flush exchange with revenues benefiting from elevated volatility). Smaller companies such as Raubex, WBHO and Afrimat stand to benefit from reduced local competition as competitors fall by the wayside due to tough local conditions. Many shares are now pricing in exceptionally low expectations far into the future.

To put this in perspective, the entire market cap of most of our local JSE holdings can now be bought for less than US$27 billion, which is the market value of a Nasdaq-listed technology start-up called Nikola Motor Company, the hydrogen truck-builder. At the point of writing, the company had zero revenues, deeply negative earnings and plenty of euphoria. In contrast, the companies listed on the JSE are established businesses with proven business models and earnings power. This extreme divergence in valuations accurately reflects current market sentiment, one that we believe creates fertile ground for outsized outperformance in the future.

Graph 4: Extreme valuation anomalies



Market Cap: US$27bn | Revenues: US$nil | Large losses



Market Cap: US$26bn | Revenues: US$67bn | Net profit: US$4bn

Sources: Bloomberg and PSG Asset Management as at 30 June 2020.

While generally we have high expectations for local shares to deliver significantly above-average returns from here, we do not believe the opportunities will be equally distributed. Not all SA Inc. companies are equally strong, and the environment is likely to be further clouded by elevated share issuance as companies need to recapitalise in light of the strains the COVID-19 pandemic is placing on them. A rigorous and evidence-based investment process, coupled with a healthy dose of scepticism, will prove vital.

Foreign equities: a chasm between high and low expectations

Globally, the market is presenting a very large opportunity to invest in above-average companies at below average prices in certain areas outside the current market favourites. Our portfolio reflects this, with exposures to high-quality companies with unique and coveted assets such as Prudential and Liberty Global. Good companies in geographies that are currently out of favour, such as the UK and Japan, are presenting substantial opportunities as well. The gap between highly rated sectors and companies and the rest is at extreme levels: this chasm in expectations will reward patient investors, much like they have in similar episodes in the past. We delve further into the opportunities in the international market in our article Obscured quality – the market is pitching classic 3M opportunities.

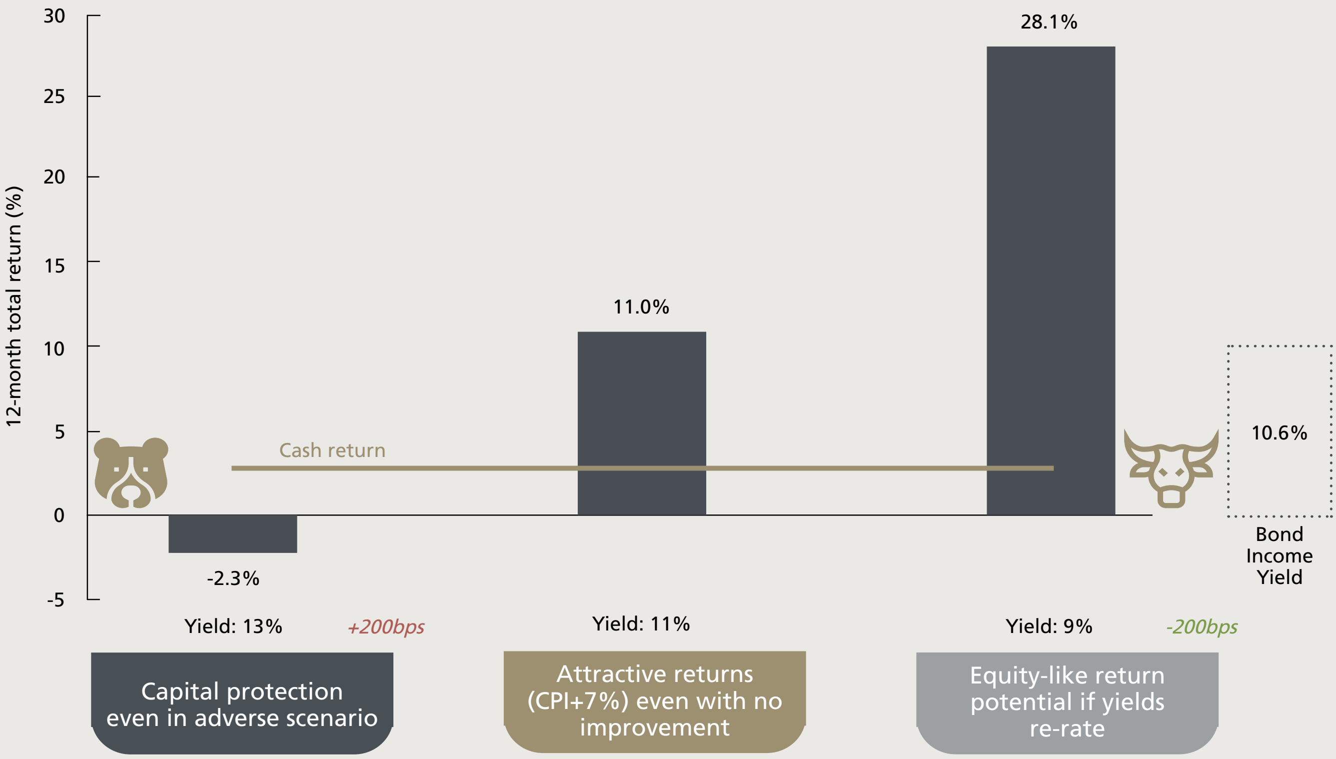
Listed property: challenged, with early signs of some opportunities emerging

We have recently begun to see value in the local listed property sector again for the first time in a long time and have started to selectively allocate capital to certain counters. We continue to favour foreign real estate, and believe the local listed property companies will continue to face a challenging period. This is due to a need to reduce debt, and abide by minimum REIT payout levels against a backdrop of a challenging leasing environment and falling property valuations. We see elevated share count risk for many companies.

We continue to favour SA government bonds over corporate credit and cash

While we acknowledge that there are risks to SA government bonds, we believe they are less risky than the narrative suggests. The exceptionally high income yields they offer have resulted in an asymmetric risk profile that is likely to offer investors equity-like returns over the next few years. By contrast, the corporate credit sector is thinly traded and illiquid, and remains vulnerable to a repricing if liquidity starts to dry up.

Graph 5: Exceptionally high income yield results in valuable asymmetry



Sources: Bloomberg and PSG Asset Management
References the R2037 as at 22 June 2020

A consistent investment process is serving us well in navigating the current uncertainty and noise

We have not experienced a pandemic like the current one in living memory, and it has brought about an exceptional amount of uncertainty and noise. It is important to acknowledge that the environment is fluid and to focus on what we know is certain, rather than falling prey to emotional decision-making. We also know that normality will return to both our lives and markets at some point in time: no crisis lasts forever.

We therefore continue to apply our 3M process and allocate our capital to our best ideas, and that we believe will offer our clients the best opportunities for future returns.

While the recent experience has been disappointing, we expect this will prove to be temporary and believe our funds are set up for excellent, differentiated performance going forward.

Shaun le Roux

Why it is a bad time to give up on contrarian investing

Shaun has managed the PSG Equity Fund since 2002 and the PSG Flexible Fund since 2016. He is a CA(SA) and a CFA charterholder.

Investors around the world have been scrambling to increase their bets in popular stocks. It looks like they are giving up on the cheap underperformers.

A high-conviction view of the next three years

Any review of the holdings of global pension funds, unit trusts, hedge funds, passive exchange traded funds (ETFs) and retail investor portfolios, clearly shows that almost all are heavily exposed to a relatively narrow group of securities. Today, few global portfolios are not dominated by stocks that represent the winners of the past three years: US large caps, technology, growth and quality. At the same time, we are witnessing a global capitulation out of what has not worked in recent times – especially cheap stocks, value funds, emerging markets and contrarian investment strategies. Chasing what has worked in the past, at the expense of what has suffered, is a predictable feature of investment markets. Yet, it is rare that consensus and the market are positioned in such a narrow range of stocks and themes. This seems to be a high-conviction view that the next three years will replicate the experience of the past three years.

Unfortunately, the consequences are also predictable: individual investors are selling low and buying high. This will have a detrimental impact on long-term returns, as we believe the prospects for contrarian investing have been enhanced. Most investors have thrown in the towel on contrarian style at just the time that portfolios need them most.

We have seen the rise of a narrow group of winners and a wide universe of underperformers

It is small wonder that there is immense pressure to invest in what has worked well in the immediate past: the performance gap between the narrow group of winners and the broad universe of underperformers has been extraordinarily wide. Table 1 shows that the ten largest constituents of the FTSE/JSE All Share Index (comprising 62% of the weighting) returned 49% (on average) over three years. The other 127 shares in the index – comprising only 38% of the weighting of the index, but representing 93% of the number of stocks in the index – declined by 29% on average over the same period. This discrepancy in performance has been replicated in markets around the world, although the JSE is more distorted by the relative size of Naspers/Prosus in our market, which masks the fact that the average South African stock has been amongst the poorer global performers.

Table 1: Three-year returns: Top ten versus balance of ALSI

	3-year return	% of index	Number of stocks
FTSE/JSE All Share Index	-6%		
Top ten constituents	49%	62%	10
Other constituents	-29%	38%	127

Sources: Bloomberg and PSG Asset Management (data as at 31 March 2020)

Analysis of the top holdings of the largest unit trust funds in South Africa reveals high levels of overlap and substantial exposure to the ten largest local stocks, the recent winners. Similarly, the largest holdings in actively managed US funds are Microsoft, Amazon, Alphabet, Facebook and Apple. Most managers are hence making an explicit assumption that the experience of the recent past persists. On the JSE, this assumes that most companies never recover from their deep bear markets.

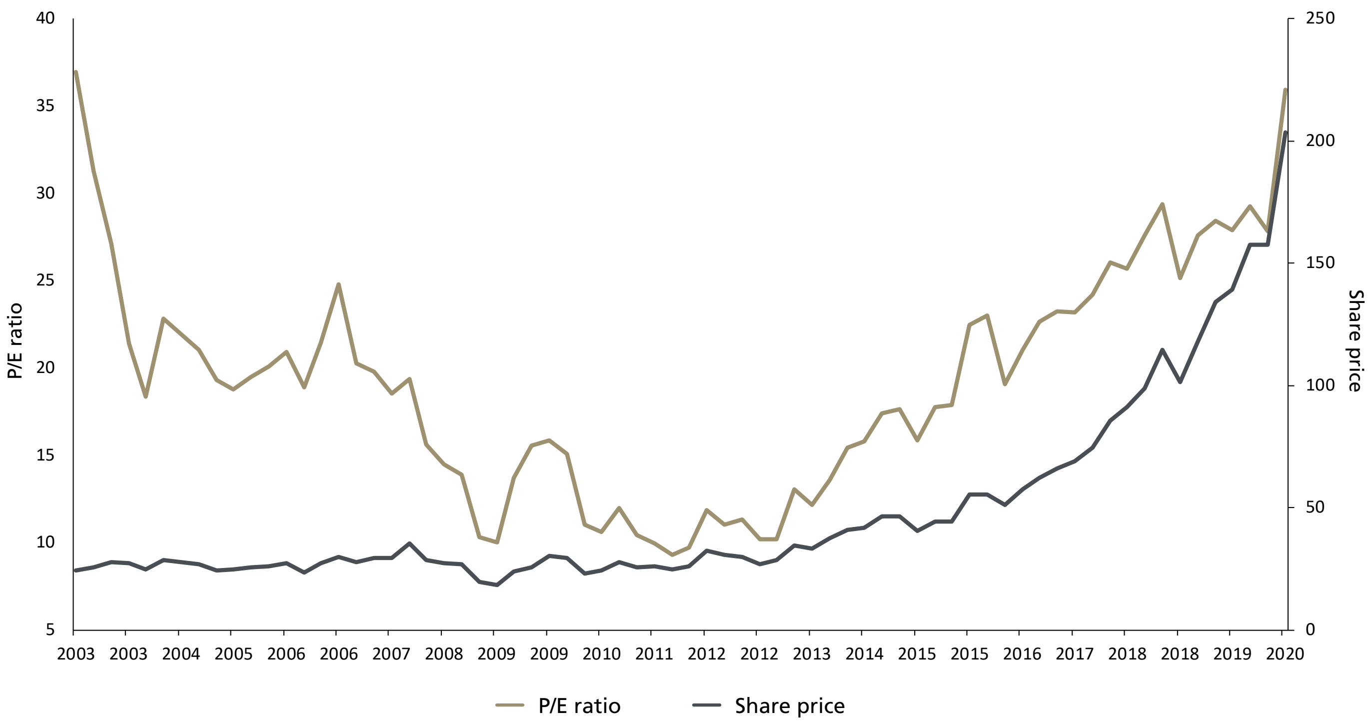
A focus on relative earnings growth but not valuations

This discrepancy in recent performance by popular mega-caps can be explained by two factors: superior earnings growth (which gets all the attention) but also a widening gap in valuations between the mega caps and the balance of the market. To be fair, we have written a lot about this discrepancy in valuations over recent years and discussed our conscious decision to rotate our portfolios towards cheaper stocks that were out of favour. The impact of the latest coronavirus pandemic on cheaper, more cyclical stocks has been severe, having a negative effect on the relative performance of value managers such as PSG. Conversely, the lockdown measures have enhanced the relative profit performance of higher-quality businesses, especially the tech stocks that benefit from the accelerated move to digitisation.

Tech stocks have driven the recovery in index performance

The past few months have seen a dramatic increase in the share prices of the secular growth stocks like Amazon, Microsoft and Tencent as investors rushed back into equities after the March sell-off. As a result, we have seen tech-heavy indices like the Nasdaq, the S&P 500 and the All Share Index staging remarkable recoveries – the S&P 500 recouped all its 2020 losses in June, at the same time that the Nasdaq was making all-time highs. While tech stocks are rare beacons of growth in 2020, the rise in their share prices is almost entirely attributable to shareholders paying more per dollar of earnings. Secular growth stocks are long duration assets – investors take a view that long-term growth compensates for higher valuations – and hence compete for capital with bonds. In a world of ultra-low global bond yields, this has had a dramatic impact on equity valuations. A company like Microsoft – a business that we have owned in the past – currently trades on 36 times earnings. It is a fabulous business, but if you bought it the last time it traded at this kind of valuation level (in 2003), you had to wait a decade for the share price to start appreciating.

Graph 1: Microsoft share price and price-earnings (P/E) ratio



Sources: Bloomberg and PSG Asset Management

What is particularly alarming to observe is how the most expensive stocks on the market, the tech stocks, have become 'safe havens'. In recent times, bad macro headlines – such as a rise in COVID-19 infections in the US – have seen the Nasdaq rise when 'risky' assets like cyclical equities decline. We argue that buying overpriced assets such as developed market bonds and expensive equities is a very poor way to insure your portfolio against adverse economic developments.

Locally, Naspers and Prosus dominate portfolios

Closer to home, it is difficult to find a domestic manager that doesn't gush about the investment merits of Naspers and/or Prosus. In fact, the combination has become such a consensus holding that most managers seem to view a holding of below 20% of portfolio value – in effectively one stock – as overly conservative. This is a function of the extraordinary distortion that has been allowed to manifest in the JSE indices, with

Naspers/Prosus comprising 26% of the Top 40. With an ever-growing proportion of capital being allocated to benchmark-heavy investment styles, Naspers has become a victim of its own success, or, more specifically, Tencent's success. Because, whichever way you slice it, an investment in Naspers/Prosus is primarily an investment in Tencent as the balance of investments are currently loss making. Just like the tech stocks on the Nasdaq, most market participants are positioned in a way that assumes the future will mimic the past. With the current Tencent rating – at 45 times earnings – close to the highs of the past decade, having 20% of your portfolio in one stock is a high-conviction view that not much can go wrong from here. This kind of conviction and concentration is playing out in portfolios around the world.

A fantastic business – what could go wrong?

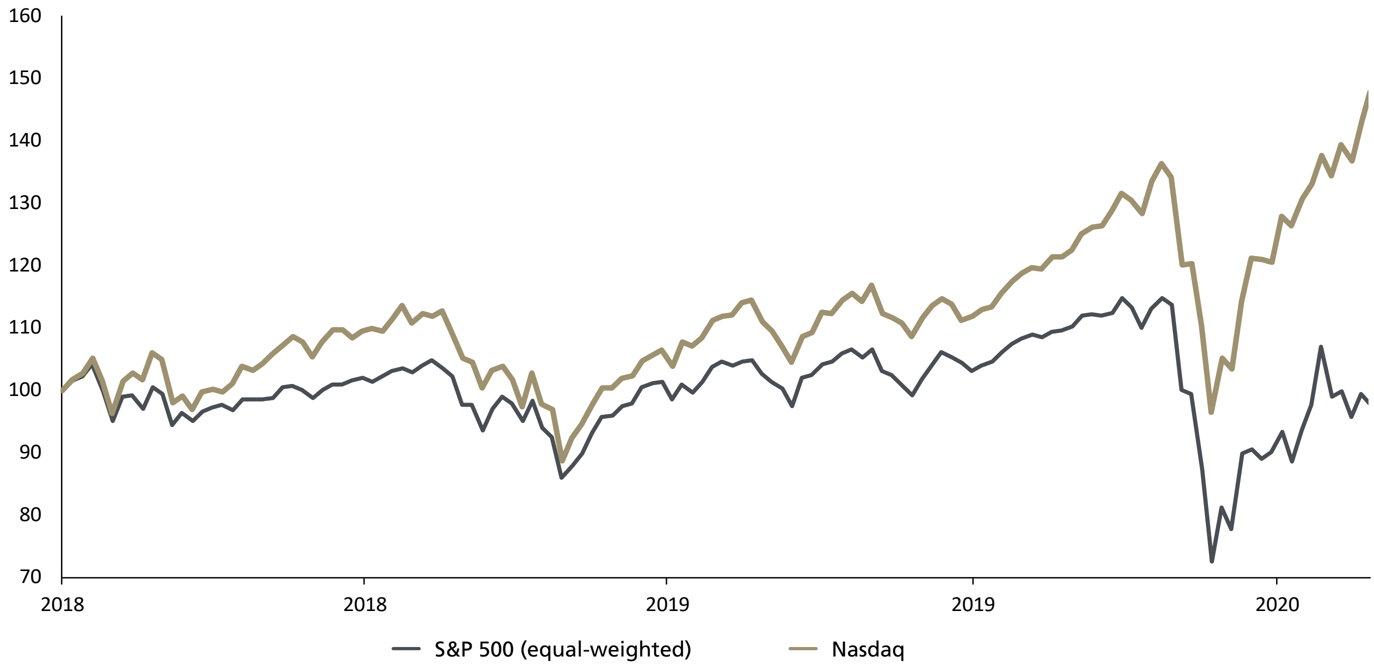
A discussion with fund managers that are long tech stocks will typically focus on the fantastic economics of these businesses and superior long-term earnings power. Here you will find little disagreement from ourselves. What is less frequently discussed are: the price paid, the expectations that are embedded into that price, and what could go wrong. A lot could go wrong with an investment in tech. When expectations and valuations are this high, they do not allow for any disruption to the current status quo. Possible disruptions include: regulatory intervention (likely), higher bond yields and lower P/E ratios, a rotation in fund positioning, unforeseen future competition, and declining returns on invested capital as a result of the law of large numbers. In addition, an investor in Tencent also needs to consider the very real risks associated with Chinese corporate governance. This combination of aggressive positioning, very high expectations and very little attention being paid to what could go wrong is a clear indicator of how investment markets are currently perceiving risk. There is material complacency as far as expensive stocks are concerned.

Many securities are discounting long-term outcomes that are overly pessimistic

At the same time, investors have capitulated out of cheap underperformers where risk is perceived to be high. They are concerned about the lack of visibility around near-term earnings in a COVID-19 ravaged world. This fear is being most acutely felt in emerging markets, like South Africa, which lack the capacity to use stimulus to counter the effects of the lockdown. As with expensive 'safe havens', little reference is made to the price paid for cheap stocks. We would argue that many securities are discounting long-term outcomes that are overly pessimistic. Economies will eventually recover from the very visible COVID-19 shocks, even if the recovery is stop-start and if it takes many sectors a few years to reach 2019 levels of activity. We view this as very fertile ground for long-term contrarian investors. As our article Obscured quality – the market is pitching classic 3M opportunities discusses, we have invested in a number of out-of-favour businesses at incredibly attractive prices. These companies are of above-average quality and the long-term returns look compelling.

There is a growing consensus that global equity markets have moved too fast and are pricing in an aggressive 'V-shaped' recovery that is unlikely to materialise. While time will tell whether this is the case, we think this narrative is overly simplistic. It fails to appreciate that share price recovery has primarily taken place in stocks (like tech) that outperform in a low growth environment. In fact, cheap cyclical stocks that are more dependent on global growth have languished and have incurred sharp losses in 2020. As graph 2 shows, while the tech-heavy Nasdaq is making fresh highs, the average stock on the S&P 500 is lower than where it was at the end of 2017. This discrepancy is even more pronounced in a comparison between the Nasdaq and more out-of-favour parts of global markets like small caps, emerging markets, financials and energy. Again, most market participants are positioned in a way that assumes that this relative price performance persists.

Graph 2: Nasdaq versus equal-weighted S&P 500 (December 2017 to July 2020)



Sources: Bloomberg and PSG Asset Management

Sharp profit growth off low valuations could set the stage for excellent returns to come

We often get asked what would result in outperformance by the contrarian investments that we currently favour: the cheap unloved stocks. Our non-consensual view is that the environment is conducive to the next three years being very different to the prior three: the extent of the crowding in popular sectors sets the scene for aggressive future rotation. 2020 earnings are going to decline sharply for most companies, but this sets the scene for a sharp recovery in 2021. Sharp profit growth and very low starting valuations tend to give rise to excellent returns as stocks emerge from a deep bear market. A stimulatory environment, which the COVID-19 pandemic has induced, has also typically been kind to cyclical industries, commodities and emerging markets and less favourable for developed market bonds and 'bond proxy' stocks like defensives and tech.

These factors favour increased exposure to cheap contrarian investments at a time when most investors are reducing their exposure to these counters. As contrarian investing becomes scarcer its value rises, particularly as a hedge in portfolios that are heavily weighted in crowded expensive assets.

Obscured quality – the market is pitching classic 3M opportunities

Philipp Wörz

Philipp joined PSG Asset Management in 2007 and has been a fund manager on the PSG Global Equity and PSG Global Flexible sub-funds since 2015. He is a CFA charterholder and has over 13 years' investment experience.

Investment markets move in cycles. Sometimes, opportunities abound to acquire the businesses we love to own: higher quality companies that are out of favour and hence cheap. Now is such a time.

Our process is orientated to finding cheap, unloved quality

Our 3M process is inherently designed to capture contrarian investment ideas. This investment philosophy seeks out mispriced quality assets in uncrowded areas and allows us to buy above-average quality companies at below-average valuations over time. One common characteristic of our holdings when compared to many of the popular stocks in global markets today, is that they have strong inherent qualities that are obscured by temporary issues. This requires the investor to scratch below the surface to form an informed opinion.

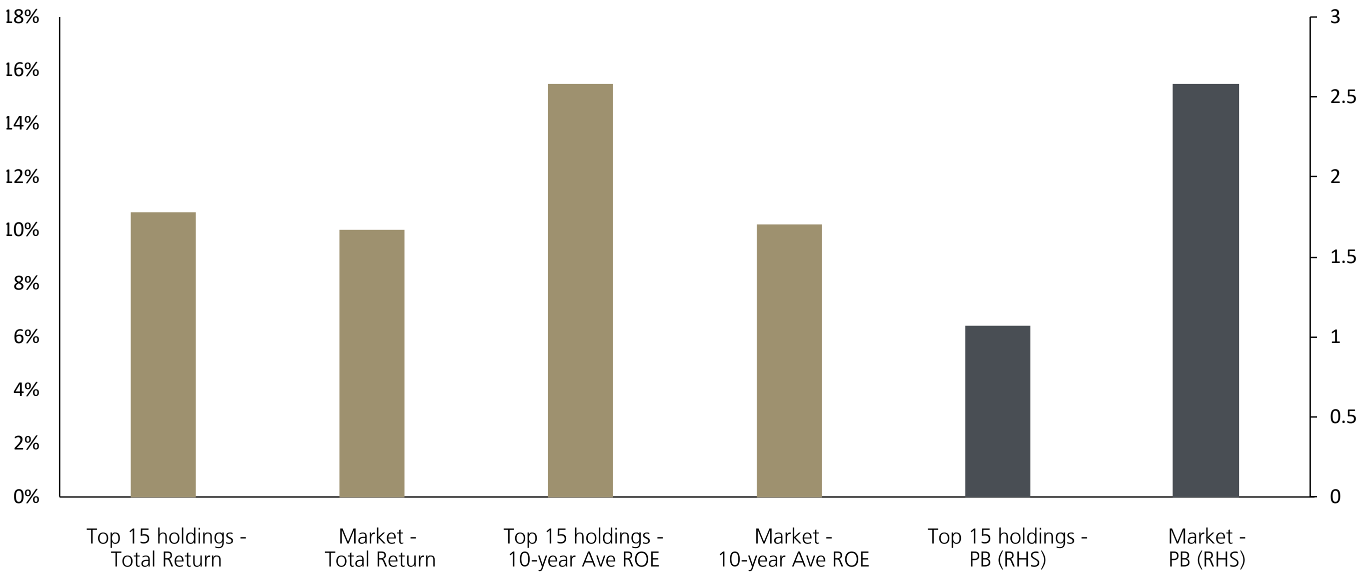
We are of the view that the odds are firmly placed in our clients' favour by allocating capital to companies with 'hidden qualities', as they come with vastly different price tags relative to those where quality and growth attributes are visible to all. Additionally, once these hidden attributes become more visible to everyone, the potential to unlock value can be immense.

Current market conditions favour building a classic PSG portfolio

A classic PSG portfolio has a high conviction in a number of great businesses where the market is currently under-appreciating the strength of their franchises. We have continued to highlight the crowded nature of popular investments and the opportunity set within out-of-favour sectors and geographies (read our article Why it is a bad time to give up on contrarian investing). We believe that the massive COVID-19 disruption has amplified this state of affairs. We have even spoken about COVID-19 as an 'opportunity' to long-term contrarian investors. If you are prepared to expand your investment universe and invest in what is not popular, you can buy companies that are trading at big discounts to what we think they are worth because expectations are very low. By contrast, visible quality and secular growth stocks are attracting a very high rating that carries a lower likelihood of meeting expectations, and hence long-term returns are likely to disappoint.

Our highest-conviction holdings over time have been dominated by businesses where there is clear evidence that they are of above-average quality. Typically, they have generated long-run returns on capital that exceed the market. An analysis of our 15 largest equity investments across all our funds in graph 1 below is insightful. These businesses have, on average, generated returns on equity well in excess of the market and investors have enjoyed superior long-term returns as a result. Yet, for the reasons described above, we can buy such companies at a material discount to the average stock.

Graph 1: Analysis of top 15 equity investments



Sources: Bloomberg, PSG Asset Management, company filings

We have always favoured large shareholdings in companies that have a strong alignment with the management team. This is because we take comfort that they are more likely to think and act like owners, taking a long-term view on value creation. It is noteworthy that our top 15 holdings have median inside ownership of R5.9 billion and in aggregate own R2 trillion of stock in the underlying companies. In particular, we reference the very large inside ownership in companies like Berkshire Hathaway, Simon Property Group, Glencore, Discovery and Liberty Global. Excluding Berkshire's arguably outsized R1.5 trillion inside ownership, the median and aggregate shareholdings are R3.6 billion and R500 billion respectively. A partnership with a competent and an aligned management team is especially important in navigating a crisis.

Opportunity exists where fear abounds

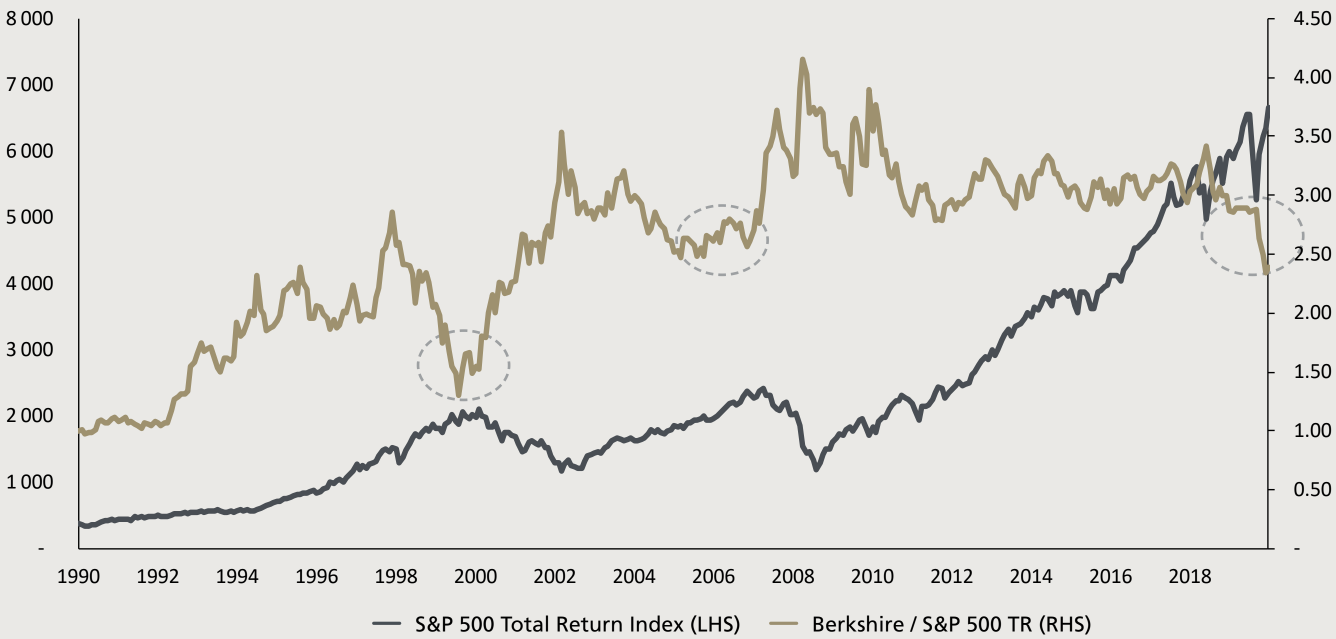
As discussed in the article Why it is a bad time to give up on contrarian investing, the performance of global stock indices have been flattered by expensive large caps. A large proportion of global stocks are in deep bear markets – we calculate that 84% of SA stocks are in a bear market. Emerging markets and cyclical companies are more vulnerable to the deep global recession and hence find themselves deeply out of favour. The market in 2020 has treated cyclical companies with operating leverage harshly, and has been particularly brutal for businesses with financial leverage. We have observed many examples where limited recognition was given to out-of-favour companies that have strong business models and which should recover swiftly. In many cases, stocks that have the capacity to carry higher levels of debt were unduly punished. This opened up the opportunity to buy more resilient companies that are temporarily impacted by the recession. Local examples include Discovery and the JSE. Offshore we have been buyers of AB InBev, Liberty Global, Prudential and Berkshire Hathaway. We also favour cyclical companies that can be acquired on very low valuations such as AECI, Imperial and Exxaro (domestically) and Glencore, Mosaic and Simon Property (globally).

The current opportunity to acquire classic 3M stocks is best illustrated by a few case studies.

Case study 1: Berkshire Hathaway

Berkshire has an outstanding track record of compounding shareholder returns over the long run and it has been an important contributor to our client returns over the past two decades. It is a business with superior qualities, but it tends to fall out of favour at stages of the investment cycle. In recent months, it has underperformed the S&P 500 Index by the widest margin since the Global Financial Crisis (GFC). It typically underperforms when the S&P 500 is in the later stages of a bull market, which is when investors are attracted to the higher rates of growth elsewhere. As the chart below shows, it was a material underperformer in the late 1990s dot-com era, in 2007 and again in 2020. In the two prior periods subsequent outperformance was substantial.

Graph 2: Berkshire Hathaway vs S&P 500 Index

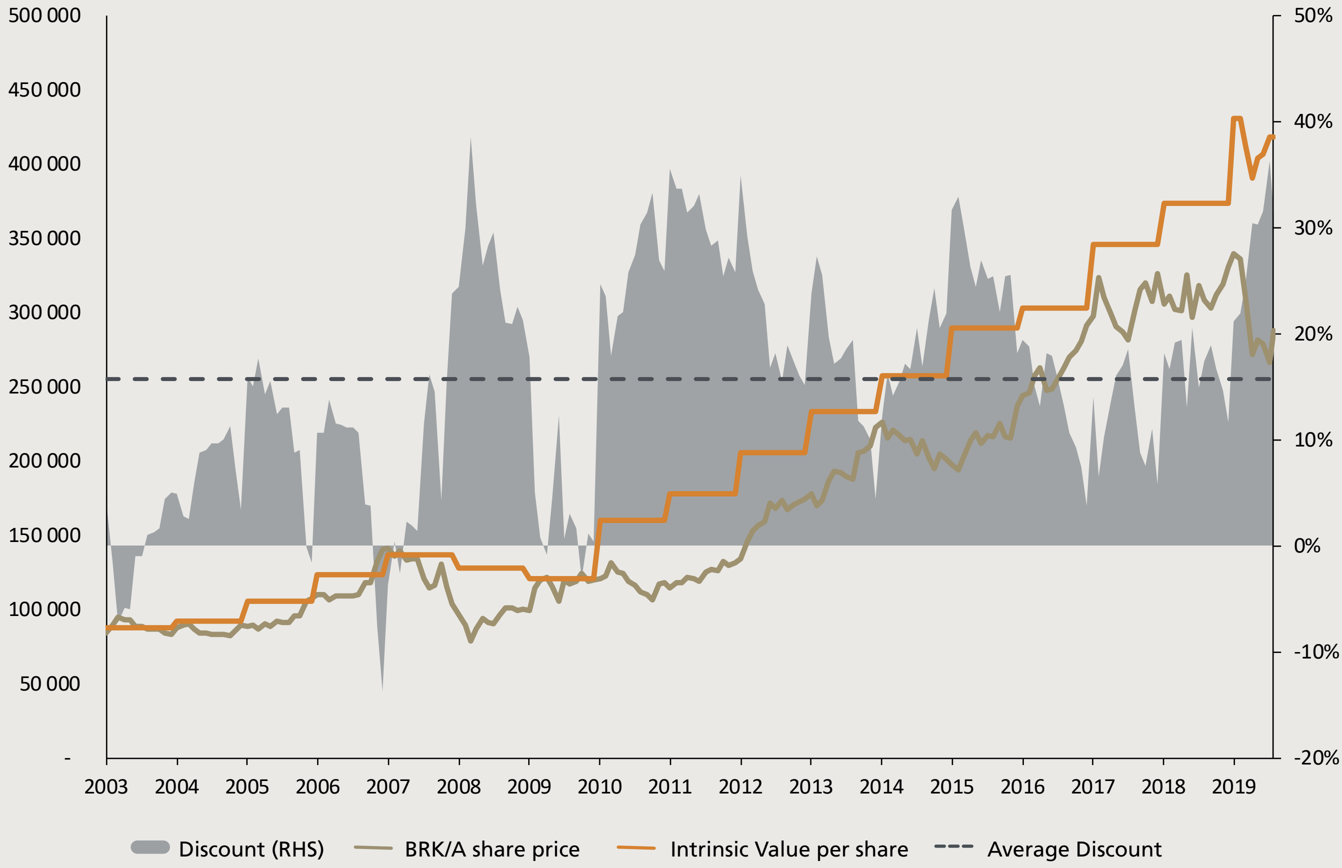


Sources: Bloomberg and PSG Asset Management

Why is Berkshire currently so out of favour?

For the reasons discussed elsewhere, the market is currently obsessed with new economy growth stocks. The Berkshire portfolio, except for its large holding in Apple, is dominated by old economy investments: financials, energy and utilities. Also, its current size makes it difficult to match the exceptional growth rates of the past and increasingly, commentators are viewing it as conglomerate. In a market where momentum investors are winning, it has become popular to refer to Warren Buffett as a 'has-been'. As a result of these and other factors such as the US recession, Berkshire is currently trading at similar valuation levels to the more recent excellent buying opportunities in 2008, 2011 and 2015.

Graph 3: Berkshire Hathaway Class A Price and Intrinsic Value History (monthly)



Sources: Bloomberg, company filings, PSG Asset Management

We think the 'old economy conglomerate run by a has-been' narrative is far from the mark. What is missed by this narrative is the quality of the business and its investments, especially its insurance operations, and the price paid for a superior company. The long-term track record of this business bears testimony to the inherent quality of its operations and the competence of the capital allocation. Its insurance businesses are the jewels that sit at the centre.

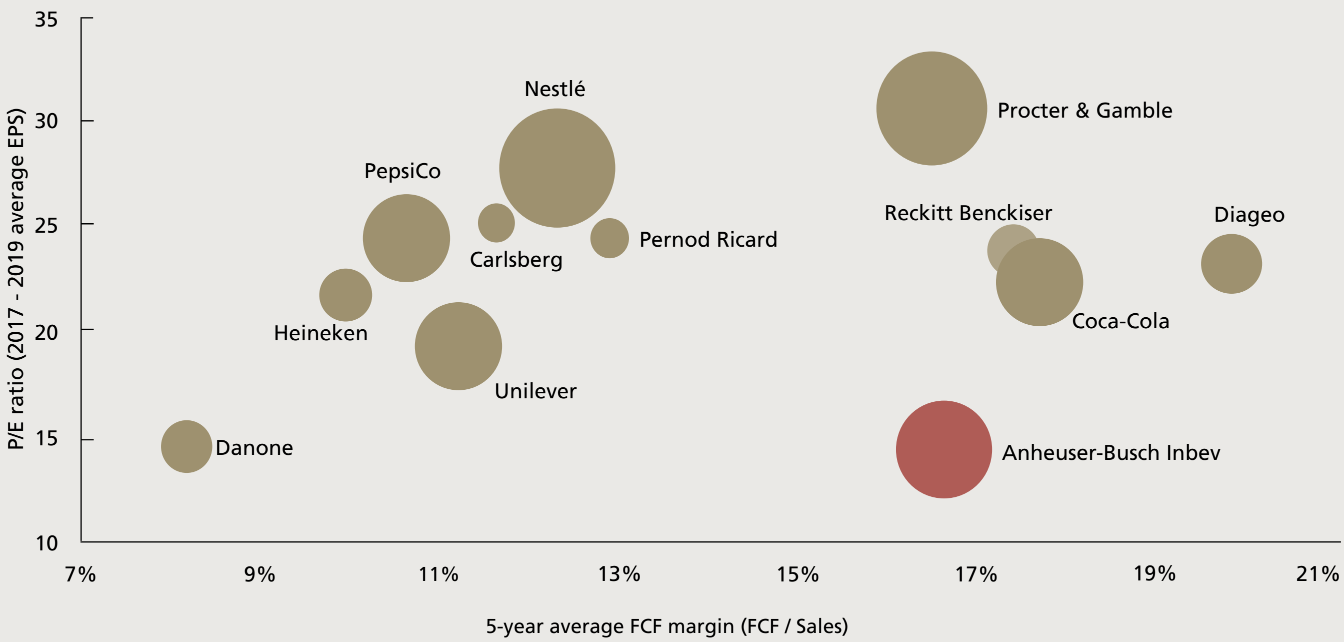
Not only are they uniquely consistent generators of underwriting profits – they also provide permanent capital in the form of a massive float. Berkshire also sits with a remarkable US$130 billion war chest that is ready to be deployed if opportunity arises. This fortress-like balance sheet and willingness to provide capital in times of distress has been one of the key factors behind strong relative performance in tough times in the past.

Case study 2: Anheuser-Busch Inbev (ABI)

ABI also finds itself out of favour: the share price dropped from US$102 in 2019 to as low as US$33 in March 2020. It has a large emerging market business, a lot of debt and has seen end markets severely impacted by lockdowns. ABI has also spent the last few years digesting the SAB-Miller acquisition and preparing the platform for growth. As it is the world's largest brewer, with seven of the world's top ten beer brands, we expect these headwinds to prove to be temporary.

The quality of the franchise is demonstrated by superior margin and cash flow metrics that compare well with the best consumer staple businesses in the world, as seen in the chart below. Free cash flow margins of global consumer staples companies are shown on the x-axis, while the bubble size depicts average annual free cash flows generated (in US$) over the past five years. The y-axis shows price to earnings ratios and given its underlying fundamentals, ABI's current valuation is clearly an outlier.

Graph 4: Global consumer staples - Cash efficiency and valuation



Sources: Bloomberg and PSG Asset Management
Note: bubble size shows relative 5-year average Free Cash Flows (FCF) in USD million

ABI's insiders and management team, led by CEO Carlos Brito, collectively own US$21 billion of the company stock. Their track record suggests they think and act like owners, more recently demonstrated by their decisions to reduce dividend payouts in favour of repaying debt, further ensuring long-term balance sheet and business sustainability.

We believe the current set of circumstances has provided the opportunity to buy a well-managed business with excellent long-term growth prospects at a very reasonable price.

Case study 3: Prudential Plc
Prudential owns a portfolio of high-quality insurance and financial services assets in Asia and the United States. The company has a strong long-term track record, compounding its embedded value per share by 15% annually over the past 15 years and performing solidly throughout the financial crisis of 2007-2008.

Prudential's share price was hit hard in the March sell-off, trading as low as £7, down from its recent February 2020 high of £15 (current share price £12). While investors have been focused on lockdown-induced market gyrations, especially lower interest rates and potential credit market issues in its US Jackson National business, it is easy to overlook the gem within Prudential: its Asian franchise.

Prudential Corporation Asia (PCA), founded in 1923, is arguably one of the world's best insurance franchises in one of the most attractive insurance regions globally. Rising per capita income levels and a still underpenetrated insurance market, coupled with PCA's attractive business mix of high margin, recurring premium risk (life and healthcare) products, afford it the rare ability to compound value over time by reinvesting large and growing cash flows into new business with high incremental returns on capital. The Asian business accounts for 70% of Prudential's embedded value. However, given its materially higher return profile relative to its US business, it contributes a significantly larger portion of intrinsic value.

Jackson National, founded in 1961, is the leader in the United States variable annuity market. Our work suggests Jackson National has sufficient capital to withstand shocks many times worse than the 2008 default experience or a repeat of the Great Depression. This view was also recently reinforced by a transaction with Apollo Global, where its insurance investment arm took an 11% stake in Jackson, further underpinning value.

Prudential's management team, which has been on a journey of slimming down the business when they spun off M&G Plc last October (also listed in London), is on track to further crystallise value by likely listing or selling Jackson in the not too distant future, placing PCA firmly in the spotlight.

We harness the opportunities we identify for our clients
Investment markets will always move in cycles. There will always be reasons for companies falling into and out of favour. The current circumstances have given rise to a number of exceptional companies falling from grace.

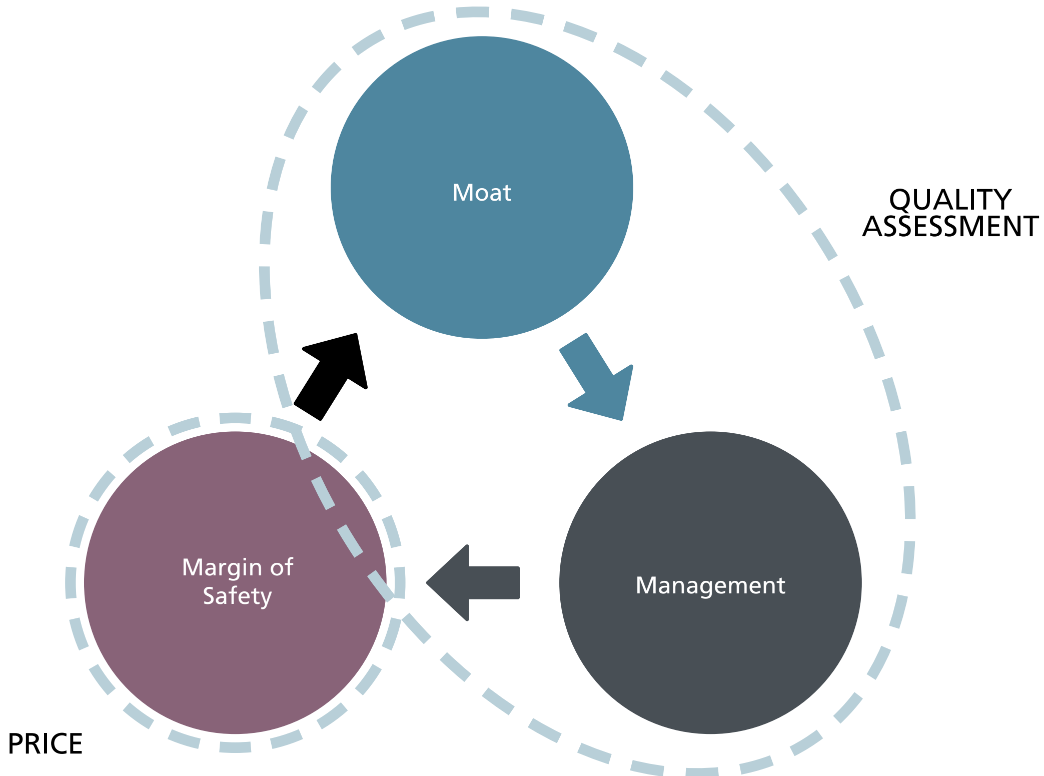
Our long-term investment track records have always been built on harnessing such opportunities for our clients, and we will continue to do so.

A quick reminder of our 3M process

As investment professionals, we seek to generate consistent long-term returns for our clients. A robust and proven investment process is at the heart of our ability to do so consistently over time, even as market cycles come and go and stocks fall in and out of favour. We understand that generating strong long-term returns for our clients rests on the ability to buy low, invest for the long run and sell high.

To find the most attractive opportunities, we look in the uncrowded areas of the market that offer the best chance of mispricing (generally those characterised by fear, uncertainty or neglect). We further improve our chances of success by applying our 3M process.

The first two M's help us evaluate the quality of companies. These are the strength of **'management'** and evidence of a competitive advantage that serves as a **'moat'**, setting the company apart from its peers. Our third M is the **'margin of safety'**, reflected in how far a security is trading from its fair value (or, viewed differently, whether its current price is setting us up to 'buy low'). Essentially, we are looking for some inherent quality that the market might be missing. As a result, we tend to invest in companies that are as good as the market or better, but trading at a discount. We believe that if we apply this methodology consistently, we will tend to buy quality companies at affordable valuations, helping our clients in growing their investments over time.



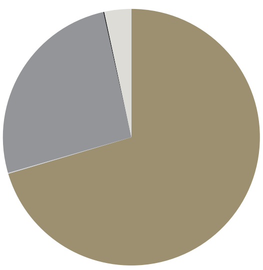
Portfolio holdings as at 30 June 2020

PSG Equity Fund

Top 10 equities

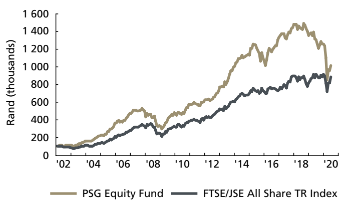
Anheuser-Busch InBev
Discovery Ltd
Liberty Global Inc
Glencore plc
Prudential plc
Imperial Logistics Ltd
AECI Ltd
JSE Ltd
Exxaro Resources Ltd
Remgro Ltd

Asset allocation



Domestic equity	70.4%
Domestic cash	0.1%
Foreign equity	26.0%
Foreign cash	0.1%
Foreign property	3.4%
Total	**100%**

Performance

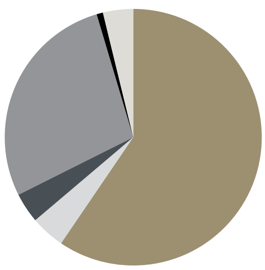


PSG Flexible Fund

Top 10 equities

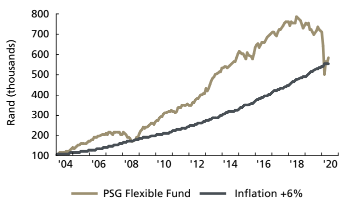
Anheuser-Busch InBev
Discovery Ltd
Liberty Global Inc
Prudential plc
Glencore plc
JSE Ltd
The Mosaic Co
Remgro Ltd
AECI Ltd
Imperial Logistics Ltd

Asset allocation



Domestic equity	59.5%
Domestic cash	4.3%
Domestic bonds	3.8%
Foreign equity	27.8%
Foreign cash	0.8%
Foreign property	3.8%
Total	**100%**

Performance

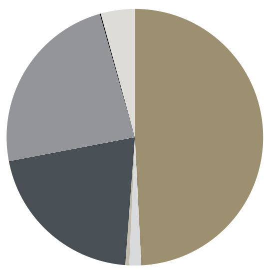


PSG Balanced Fund

Top 10 equities

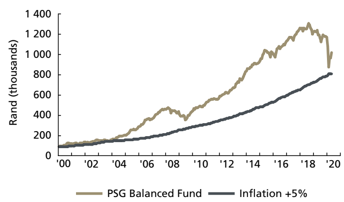
Discovery Ltd
Anheuser-Busch InBev
Liberty Global Inc
Prudential plc
JSE Ltd
Glencore plc
The Mosaic Co
Japan Post Insurance Co Ltd
AECI Ltd
Tanger Factory Outlet Centers Inc

Asset allocation



Domestic equity	49.2%
Domestic cash and NCDs	1.5%
Domestic property	0.5%
Domestic bonds	20.8%
Foreign equity	23.6%
Foreign cash	0.1%
Foreign property	4.3%
Total	**100%**

Performance



PSG Stable Fund

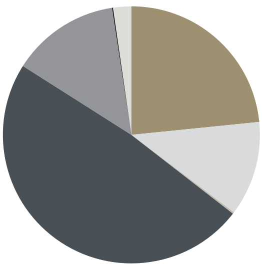
Top 5 equities

Anheuser-Busch InBev
Discovery Ltd
Prudential plc
Liberty Global Inc
JSE Ltd

Top 5 issuer exposures

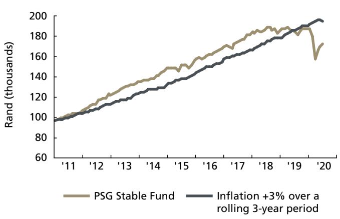
The Republic of South Africa
FirstRand Bank Ltd
Eskom Holdings SOC Ltd
PSG Money Market Fund
Standard Bank of SA Ltd

Asset allocation



Domestic equity	23.4%
Domestic cash and NCDs	11.9%
Domestic property	0.2%
Domestic bonds	48.5%
Foreign equity	13.6%
Foreign cash	0.1%
Foreign property	2.3%
Total	**100%**

Performance



PSG Diversified Income Fund

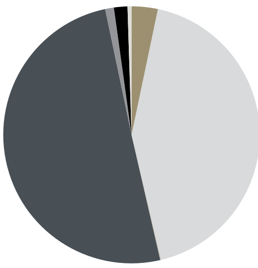
Top 5 equities

JSE Ltd
Anheuser-Busch InBev
AECI Ltd
Simon Property Group Inc
Shoprite Holdings Ltd

Top 5 issuer exposures

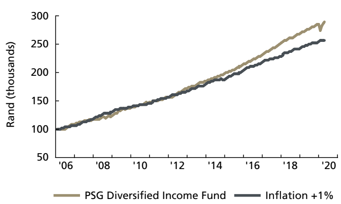
The Republic of South Africa
PSG Money Market Fund
FirstRand Bank Ltd
Standard Bank of SA Ltd
Absa Bank Ltd

Asset allocation



Domestic equity	3.3%
Domestic cash and NCDs	43.0%
Domestic property	0.1%
Domestic bonds	50.3%
Foreign equity	1.1%
Foreign cash	1.7%
Foreign property	0.5%
Total	**100%**

Performance

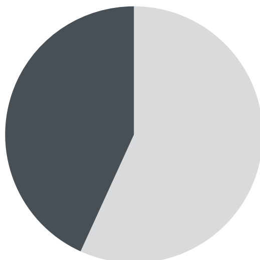


PSG Income Fund

Top 10 issuer exposures

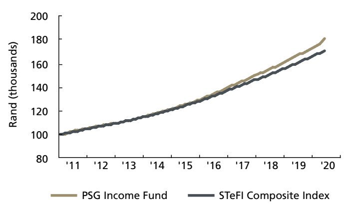
The Republic of South Africa
FirstRand Bank Ltd
PSG Money Market Fund
Standard Bank of SA Ltd
Nedbank Ltd
Absa Bank Ltd
Eskom Holdings SOC Ltd
The Thekwini Fund 14 (RF) Ltd
The Thekwini Fund 15 (RF) Ltd
Capitec Bank Ltd

Asset allocation



Domestic cash and NCDs	56.8%
Domestic bonds	43.2%
Total	**100%**

Performance

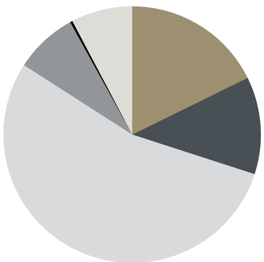


PSG Money Market Fund

Issuer exposures

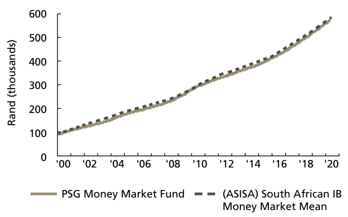
Nedbank Ltd
Absa Bank Ltd
FirstRand Bank Ltd
Standard Bank of SA Ltd
The Republic of South Africa
Investec Bank Ltd
The Thekwini Fund 15 (RF) Ltd

Asset allocation



Linked NCDs/Floating-rate notes	17.7%
Step-rate notes	12.3%
NCDs	54.1%
Treasury Bill	7.9%
Corporate bonds	0.3%
Call	7.7%
Total	**100%**

Performance

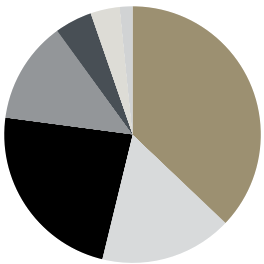


PSG Global Equity Sub-Fund

Top 10 equities

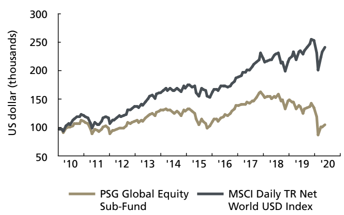
Prudential plc
Anheuser-Busch InBev
Liberty Global Inc
The Mosaic Co
Simon Property Group Inc
Brookfield Asset Management Inc
Resona Holdings Inc
Glencore plc
Japan Post Insurance Co Ltd
Asahi Group Holdings Ltd

Regional allocation



US	37.1%
Europe	16.7%
UK	23.3%
Japan	12.9%
Canada	4.7%
Africa	3.7%
Cash	1.6%
Total	**100%**

Performance

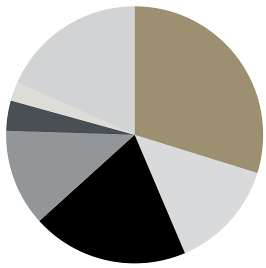


PSG Global Flexible Sub-Fund

Top 10 equities

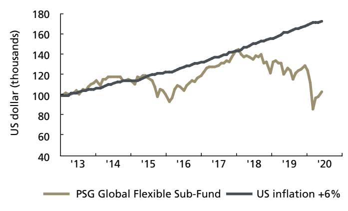
Prudential plc
Liberty Global Inc
Anheuser-Busch InBev
The Mosaic Co
Resona Holdings Inc
Japan Post Insurance Co Ltd
Asahi Group Holdings Ltd
Simon Property Group Inc
Brookfield Asset Management Inc
Wheaton Precious Metals Corp

Regional allocation



US	29.8%
Europe	13.8%
UK	19.7%
Japan	12.2%
Canada	3.8%
Africa	2.4%
Cash and bonds	18.3%
Total	**100%**

Performance



Percentage annualised performance to 30 June 2020 (net of fees)

Local funds						
	1 Year	3 Years	5 Years	10 Years	Inception	Fund inception date
PSG Equity Fund A	-22.14	-8.27	-3.50	8.24	13.41*	31/12/1997
FTSE/JSE All Share Total Return Index	-3.29	5.11	4.16	10.88	12.55	
PSG Flexible Fund A	-19.10	-5.45	-0.58	8.45	11.92**	02/11/1998
SA Inflation + 6%	8.19	9.65	10.51	10.95	11.52	
PSG Balanced Fund A	-14.10	-3.68	0.03	7.54	11.56	01/06/1999
SA Inflation + 5%	7.19	8.68	9.53	9.96	10.36	
PSG Stable Fund A	-7.05	0.79	3.05		6.53	13/09/2011
SA Inflation + 3% over a rolling 3-year period	5.19	6.68	7.52		7.98	
PSG Diversified Income Fund A	4.95	6.71	7.27	7.34	7.63	07/04/2006
SA Inflation + 1%	3.19	4.68	5.52	5.96	6.72	
PSG Income Fund A	9.55	8.75	8.47		7.31	01/09/2011
STeFI Composite Index	6.85	7.17	7.20		6.53	
PSG Money Market Fund A	6.74	7.15	7.19	6.39	8.38	19/10/1998
South African - Interest Bearing - Money Market Mean	6.94	7.32	7.34	6.49	8.46	
PSG Global Equity Feeder Fund A ^	-6.48	-0.41	2.38		9.12	03/05/2011
MSCI Daily Total Return Net World USD Index (in ZAR)	26.66	17.22	14.84		19.26	
PSG Global Flexible Feeder Fund A ^^	1.34	2.21	4.18		9.48	11/04/2013
US inflation + 6% (in ZAR)	30.69	18.17	15.51		17.87	

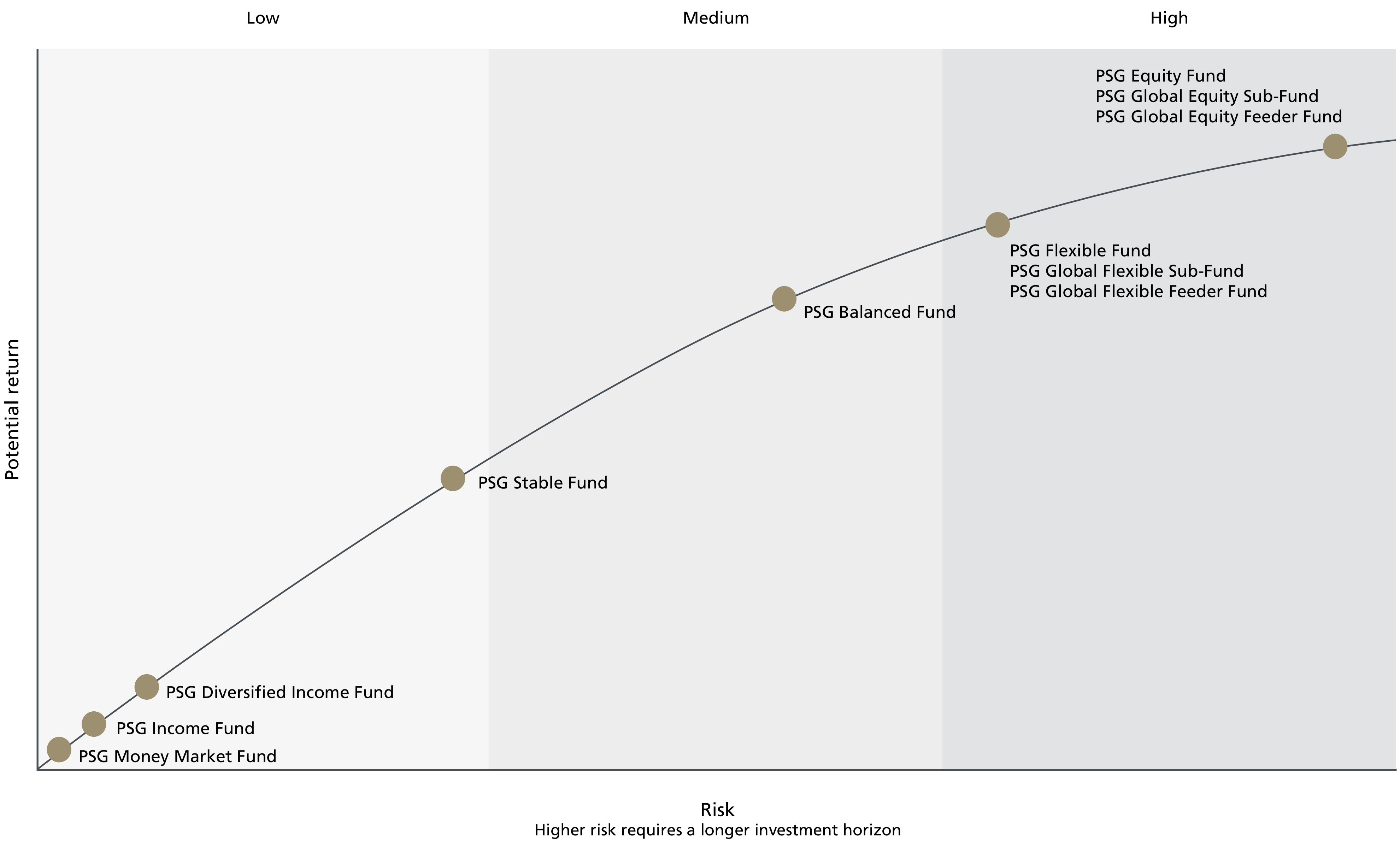
International funds						
	1 Year	3 Years	5 Years	10 Years	Inception	Fund inception date
PSG Global Equity Sub-Fund A	-23.00	-8.67	-3.62		0.87	23/07/2010
MSCI Daily Total Return Net World USD Index (in USD)	2.84	6.70	6.90		9.23	
PSG Global Flexible Sub-Fund A	-17.96	-6.93	-2.34		0.52	02/01/2013
US inflation + 6% (in USD)	6.11	7.56	7.52		7.46	

* Fund manager inception date 01/03/2002
** Current benchmark inception date 01/11/2004

^ The PSG Global Equity Feeder Fund feeds into the PSG Global Equity Sub-Fund
^^ The PSG Global Flexible Feeder Fund feeds into the PSG Global Flexible Sub-Fund

Source: 2020 Morningstar Inc. All rights reserved as at end of June 2020.
Annualised performances show longer-term performance rescaled over a 12-month period.
Annualised performance is the average return per year over the period.
Past performance is not necessarily a guide to future performance.

Risk/reward profile



Unit trust summary

	South African portfolios							Rand-denominated offshore	
	PSG Equity Fund	PSG Flexible Fund	PSG Balanced Fund	PSG Stable Fund	PSG Diversified Income Fund	PSG Income Fund	PSG Money Market Fund	PSG Global Equity Feeder Fund	PSG Global Flexible Feeder Fund
Fund category (ASISA classification)	South African - Equity - General	South African - Multi Asset - Flexible	South African - Multi Asset - High Equity	South African - Multi Asset - Low Equity	South African - Multi Asset - Income	South African - Interest Bearing - Short-term	South African - Interest Bearing - Money Market	Global - Equity - General	Global - Multi Asset - Flexible
Investment objective	Aims to offer investors long-term capital growth without assuming a greater risk, and earn a higher rate of return than that of the South African equity market as presented by the FTSE/ JSE All Share Index (including income).	Aims to achieve superior medium- to long-term capital growth by investing in selected sectors of the equity, gilt and money markets, both locally and abroad. The fund has a flexible asset allocation mandate and equity exposure will vary based on opportunity.	Aims to achieve long-term capital growth and a reasonable level of income for investors. The investment policy provides for the active management of the portfolio assets that include equities, bonds, property and cash, both domestically and in foreign markets.	Aims to achieve capital appreciation and generate a return of CPI+3% over a rolling three-year period with low volatility and low correlation to equity markets through all market cycles.	Aims to preserve capital while maximising income returns for investors. The portfolio comprises of a mix of high-yielding securities, property, bonds, preference shares and assets in liquid form (both local and foreign).	Aims to maximise income while achieving as much long-term capital appreciation as interest rate cycles allow.	Aims to provide capital security, a steady income and easy access to your money.	Aims to achieve capital growth over the long term with the generation of income not being the main objective of the portfolio. It is a rand-denominated equity feeder fund whose investment policy provides for it to invest solely in the PSG Global Equity Sub-Fund.	Aims to achieve superior medium- to long-term capital growth through exposure to selected sectors of the global equity, bond and money markets. It is a rand-denominated feeder fund whose investment policy provides for it to invest solely in the PSG Global Flexible Sub-Fund.
Benchmark	FTSE/JSE All Share Total Return Index	SA Inflation + 6%	SA Inflation + 5%	SA Inflation + 3% over a rolling 3-year period	SA Inflation + 1%	STeFI Composite Index	South African - Interest Bearing - Money Market Mean	MSCI Daily Total Return Net World USD Index (in ZAR)	US inflation + 6% (in ZAR)
Risk rating	High	Moderate - High	Moderate - High	Moderate	Low - Moderate	Low - Moderate	Low	High	Moderate - High
Time horizon	7 years and longer	5 years and longer	5 years and longer	3 years and longer	2 years and longer	1 year and longer	Minimum of 1 day	7 years and longer	5 years and longer
The fund is suitable for investors who:	• want an equity focused portfolio that should produce high real returns above inflation and capital appreciation over the long term • are comfortable with significant stock market fluctuations • are willing to accept potential capital loss • have a long-term investment horizon of seven years and longer	• want exposure to the equity market, but with managed risk levels • aim to build wealth • are willing to accept potential capital loss • have a medium- to long-term investment horizon of five years and longer	• aim to build wealth with a balanced portfolio that diversifies the risk over the various asset classes • are comfortable with market fluctuation risk • are willing to accept potential capital loss • would prefer the fund manager to make the asset allocation decisions • have an investment horizon of five years and longer	• have a low risk appetite but require capital growth in real terms • have a medium-term investment horizon of three years and longer	• have a low risk appetite • want to earn an income, but need to try and beat inflation • have a short- to medium-term investment horizon of two years and longer	• have a low risk appetite • require an income • have an investment horizon of one year and longer	• seek capital stability, interest income and easy access to their money through a low risk investment • need an interim investment vehicle or 'parking bay' for surplus money • have a short-term investment horizon	• want exposure to global equities without personally expatriating rands • are comfortable with international equity market and currency fluctuations • have a long-term investment horizon of seven years and longer	• want exposure to global equities without personally expatriating rands • are comfortable with international equity market and currency fluctuations • have a long-term investment horizon of five years and longer
Net equity exposure	80% - 100%	0% - 100%	0% - 75%	0% - 40%	0% - 10%	0%	0%	80% - 100%	0% - 100%
Income distribution	Bi-annually	Bi-annually	Bi-annually	Bi-annually	Quarterly	Quarterly	Monthly	Annually	Annually
Minimum investment	As per the platform minimum	As per the platform minimum	As per the platform minimum	As per the platform minimum	As per the platform minimum	As per the platform minimum	R25 000 lump sum	As per the platform minimum	As per the platform minimum
Fees (excl. VAT)	Annual management fee: Class A: 1.50%	Annual management fee: Class A: 1.00% + 7.00% of outperformance of high watermark	Annual management fee: Class A: 1.50%	Annual management fee: Class A: 1.50%	Annual management fee: Class A: 1.00%	Annual management fee: Class A: 0.65%	Annual management fee: Class A: 0.50%	Annual management fee: Class A: 0.75%	Annual management fee: Class A: 0.75%
Compliance with Prudential Investment Guidelines (Regulation 28)	No	No	Yes	Yes	Yes	No	Yes	No	No

For full disclosure on all risks, costs and fees, as well as performance fees FAQ, refer to the fund fact sheets on our website: www.psg.co.za/asset-management

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The portfolio is valued at 15h00 daily. **Additional information:** Additional information is available free of charge on the website and may include publications, brochures, application forms and annual reports. **Company details:** PSG Collective Investments (RF) Limited is registered as a CIS Manager with the Financial Sector Conduct Authority, and a member of the Association of Savings and Investments South Africa (ASISA) through its holding company PSG Konsult Limited. The management of the portfolios is delegated to PSG Asset Management (Pty) Limited, an authorised Financial Services Provider under the Financial Advisory and Intermediary Services Act 2002, FSP no 29524. PSG Asset Management (Pty) Limited and PSG Collective Investments (RF) Limited are subsidiaries of PSG Konsult Limited. **Money Market:** The PSG Money Market Fund maintains a constant price and is targeted at a constant value. The quoted yield is calculated by annualising the average 7-day yield. 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Trustee: The Standard Bank of South Africa Limited, The Towers, 2 Heerengracht Street, Cnr Hertzog Boulevard, Cape Town, 8001. Tel: +27 (21) 401 2443. Email: Compliance-PSG@standardbank.co.za. **Conflict of Interest Disclosure:** The funds may from time to time invest in a portfolio managed by a related party. PSG Collective Investments (RF) Limited or the Fund Manager may negotiate a discount in fees charged by the underlying portfolio. All discounts negotiated are re-invested in the fund for the benefit of the investor. Neither PSG Collective Investments (RF) Limited nor PSG Asset Management (Pty) Limited retains any portion of such discount for their own accounts. The Fund Manager may use the brokerage services of a related party, PSG Securities Limited.

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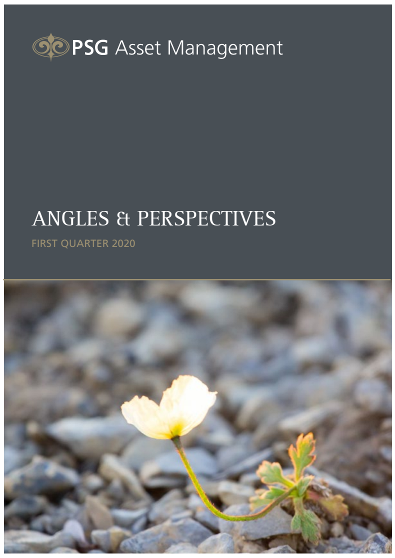
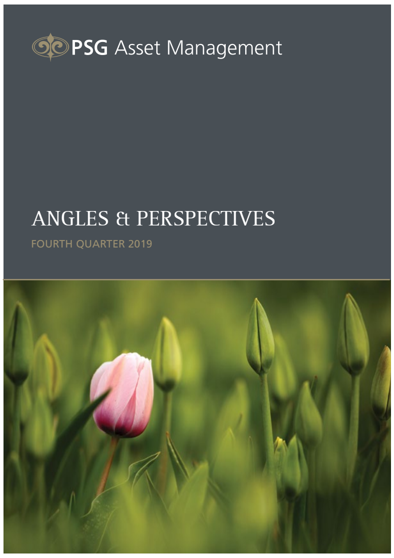
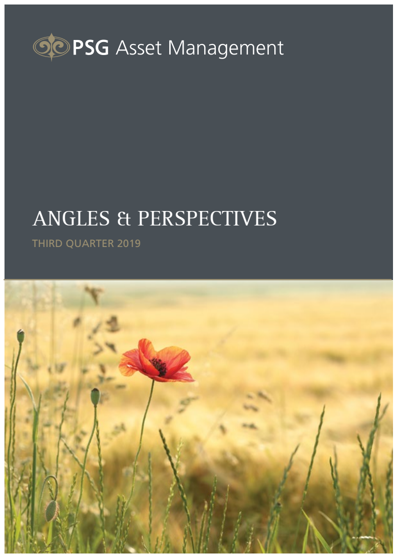


First quarter 2020



Fourth quarter 2019



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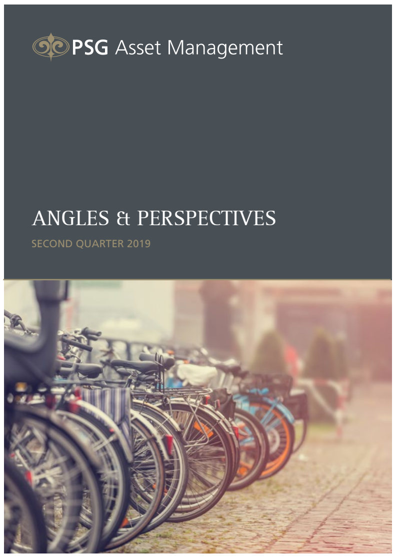

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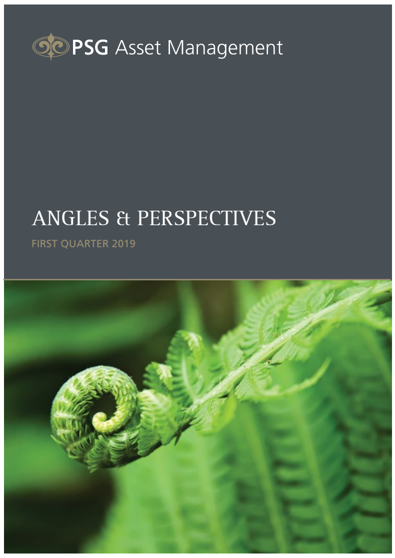

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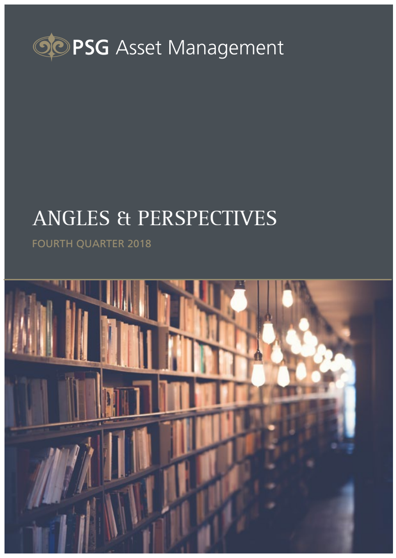

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PSG Asset Management