PSG Asset Management

THE PSG OUTLOOK 2018

Executive Summary

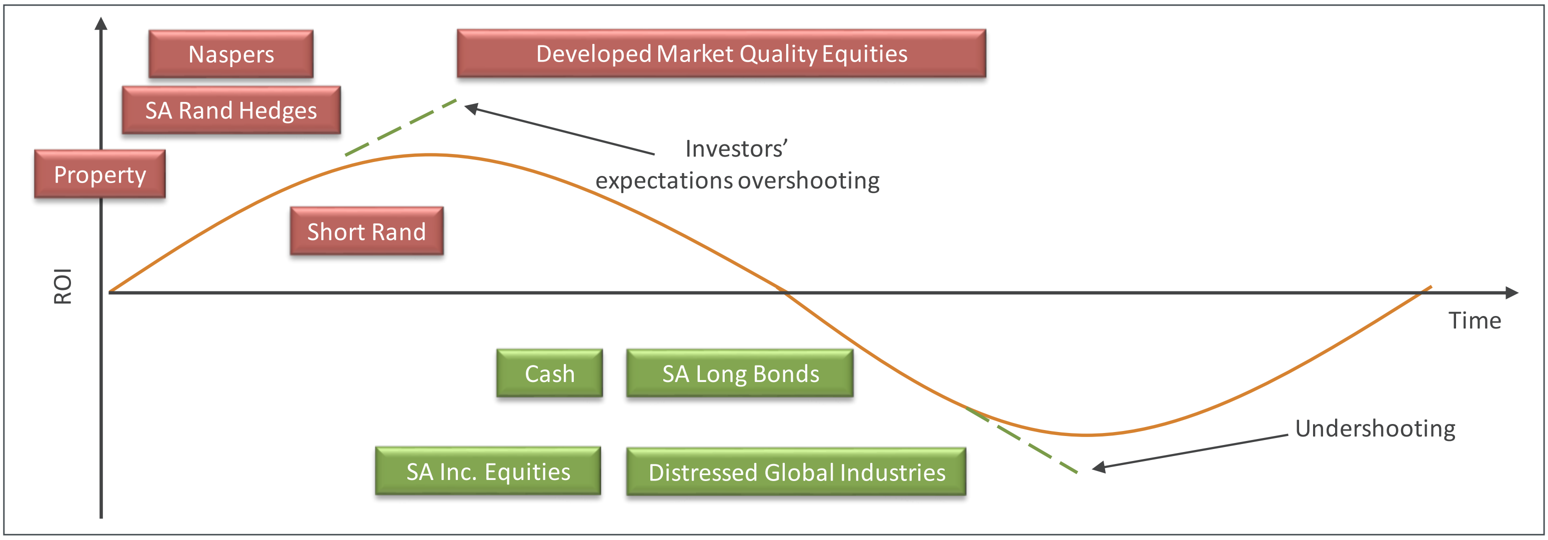
Markets go through big cycles as sentiment shifts between optimism and pessimism

When news flow is good and sentiment positive, investors rush to buy popular securities at any price. When news is bad and share prices fall, fear of loss makes investors retreat – even from risks that are unfounded or overstated. This presents opportunities to buy quality, temporarily out-of-favour securities at attractive prices.

The key is to invest counter-cyclically, in uncrowded parts of the market

These are often areas in which there is fear and uncertainty, and prices and expectations are low. They therefore present the greatest potential for mispricing. Taking a long-term view, we look to find mispriced securities based on our quality (Moat and Management) and price (Margin of Safety) criteria. We apply checklists we've distilled from our collective experience as a further risk overlay, to identify any red flags that may indicate our estimates of intrinsic value could be materially impaired.

PSG ASSET MANAGEMENT'S VIEW: THE MOST AND LEAST CROWDED AREAS OF THE MARKET



Sources: Marathon Asset Management, PSG Asset Management

Post the ANC elective conference: South African equities

Due in most part to local politics, South Africa has largely missed out on a strong emerging markets cycle. While other emerging markets have recently enjoyed healthy inflows, foreign investors aggressively sold South African equities and most domestic asset managers held a bearish view on local assets.

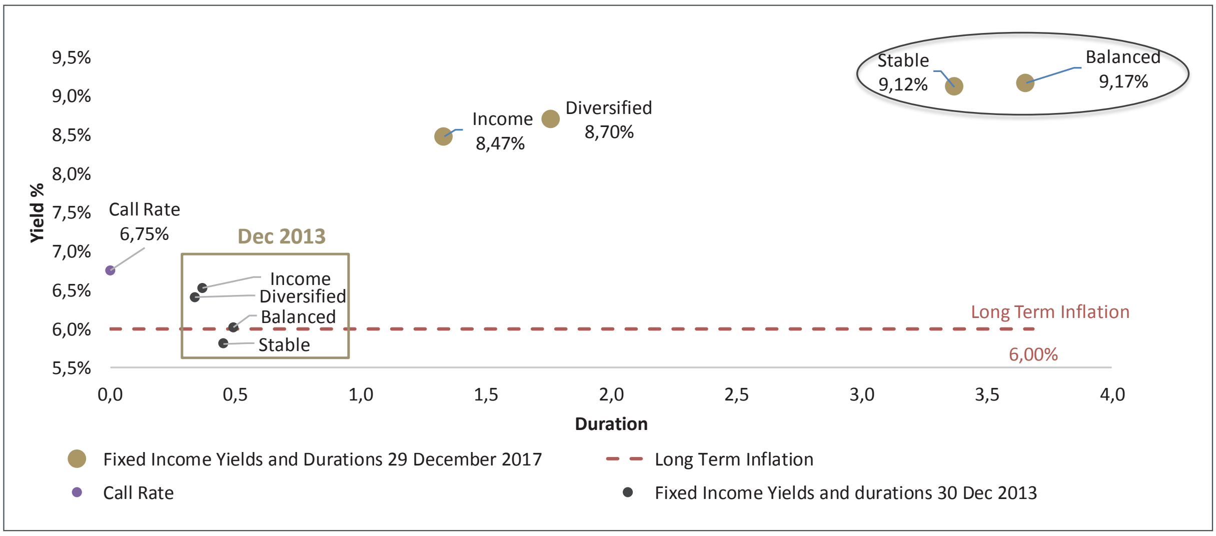
Securities exposed to the local economy were very much out of favour over the past two years – and these parts of the market were very uncrowded. We used the opportunity to invest in high-quality companies that were trading at exceptional valuations. The market reacted favourably to the outcome of the ANC's elective conference. The rand has strengthened substantially and domestic bonds and equities have repriced aggressively.

However, the equity rally has predominantly been restricted to the most liquid counters and we believe that many stocks remain very cheap. Notably, several of these opportunities come from outside the Top 40. Broadly speaking, we think the best opportunity lies in mid- and small-cap stocks.

Post the ANC elective conference: South African fixed income

Yields on long-dated government bonds remain attractive. In fact, when measured over the past 15 years, yields on 20-year government bonds are higher now than they have been 93% of the time. Given a downward inflation trajectory and the credibility the South African Reserve Bank has built in inflation targeting (inflation has averaged 5.8% since the introduction of inflation targeting in 2000), this has presented the opportunity to lock in high real yields for investors. We have also extended the maturity profile of fixed income exposures, which lowers reinvestment risk.

PSG ASSET MANAGEMENT FUNDS: FIXED INTEREST SEGMENT YIELDS



Source: PSG Asset Management

Global: Now is not the time to be bold

While strong global markets may encourage a bullish view, we believe investors should be dialing back risk. If we consider cyclically adjusted price/earnings ratios as a measure, the US market has only been more expensive twice in the past century: just before the 1929 crash and during the Dotcom bubble. In addition, average annualised volatility in 2017 was the lowest on record. This backdrop suggests complacency and very high valuation levels – a dangerous combination.

As a result, we have been finding fewer opportunities in global markets, and the gaps between the share prices of the companies we own and our assessments of intrinsic value have narrowed. However, valuation differences within equity markets remain extraordinarily wide. We are still of the view that if we choose wisely from uncrowded parts of the market, it will bode well for long-term returns at acceptable levels of risk.

Areas of potential mispricing

We continue to find attractive opportunities in South African bonds and locally focused domestic equities. Cash is also still offering good returns. However, while we continue to find selected opportunities in global markets, current valuation levels generally offer limited value.

	2017 (Jan)	2018 (Jan)
High-quality/blue chip SA equities		
Local cyclical equitites		
Government bonds		
Property		
Offshore equities		
Cash		

Source: PSG Asset Management

To invest or if you have any queries: Phone us on +27 (21) 799 8000, Email us at assetmanagement@psg.co.za, Visit our website www.psg.co.za/asset-management

Date of issue: 30 January 2018