by Shaun le Roux and Greg Hopkins

Current context
Global stock markets enjoyed strong gains in 2017, which was a year of synchronised global growth and extraordinarily low volatility.

The MSCI World Index rose 23.1% in US dollars. The FTSE/JSE All Share Index also put in a solid performance, adding 21% during the year. But returns at an index level were materially flattered by Naspers, which benefited from significant price appreciation in Tencent. Domestically-focused stocks generally had a tough year amid very poor sentiment, although they did enjoy a sharp December rally after the conclusion of the ANC elective congress.

A significant event on the local stock market was the implosion in the Steinhoff share price. Fortunately, this did not affect our clients, as the share was not held in the funds. Although we had bought Steinhoff in the past, actions taken by the management team over recent years resulted in the company no longer clearing our corporate governance checklist.

The fund returned 11.2% during 2017 and has returned 15.3% per annum over the past five years, ahead of its benchmark (11.9%).

Our perspective
Despite a moderate re-rating in December, we would classify many SA Inc shares as materially undervalued. Investments in domestic companies have not been based on a prediction around political outcomes, but rather a willingness to use poor sentiment to acquire good businesses at a wide margin of safety. The opportunity set within less liquid companies on the JSE is particularly attractive and bodes well for long-term returns.

Given the elevated levels of global stock valuations, we have been finding fewer high-conviction global stock opportunities and have been taking profit in some US stocks that have seen strong price appreciation. However, the valuation gap between crowded and unloved equities remains very wide. We believe that this bodes well for bottom-up stock selection and the portfolio holdings are attractively priced relative to our assessments of intrinsic values.

Portfolio positioning
We retain healthy exposures to domestic businesses that are attractively priced, specifically mid- and small-cap shares that trade at bear market valuations with very healthy free cash flow generation. We are mindful of liquidity and hence have been careful with position sizing in less liquid companies.

Discovery remains our highest-conviction local stock idea. We continue to be of the view that the market is under-appreciating the inherent quality and long-term global growth opportunity for this business.

Brookfield Asset Management is the largest offshore holding. We remain comfortable that the share price is not reflective of the track record, asset base and earnings power of this global manager of real assets.

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Date issued: 15 January 2018

by Shaun le Roux and Greg Hopkins

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A significant event on the local stock market was the implosion in the Steinhoff share price. Fortunately, this did not affect our clients, as the share was not held in the funds. Although we had bought Steinhoff in the past, actions taken by the management team over recent years resulted in the company no longer clearing our corporate governance checklist.

The fund returned 10.0% during 2017 and has returned 14.9% per annum over the past five years, ahead of its benchmark (11.5%).

Our perspective
Despite a moderate re-rating in December, we would classify many SA Inc shares as materially undervalued. Investments in domestic companies have not been based on a prediction around political outcomes, but rather a willingness to use poor sentiment to acquire good businesses at a wide margin of safety. The opportunity set within less liquid companies on the JSE is particularly attractive and bodes well for long-term returns.

Given the elevated levels of global stock valuations, we have been finding fewer high-conviction global stock opportunities and have been taking profit in some US stocks that have seen strong price appreciation. However, the valuation gap between crowded and unloved equities remains very wide. We believe that this bodes well for bottom-up stock selection and portfolio holdings are attractively priced relative to our assessments of intrinsic values.

Portfolio positioning
The fund is conservatively positioned, with 30% of fund value in cash (5% offshore and 25% domestically held). This cash level is higher than historic averages and is reflective of valuation levels within the broader opportunity set. We remain of the view that the value of cash is under-estimated, particularly after a nine-year bull market.

We retain healthy exposures to domestic businesses that are attractively priced, specifically mid- and small-cap shares that trade at bear market valuations with very healthy free cash flow generation. We are mindful of liquidity and hence have been careful with position sizing in less liquid companies.

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Date issued: 15 January 2018

by Paul Bosman and Greg Hopkins

Current context
Two of the most commonly discussed market-related topics during the final quarter of 2017 were the developments in local politics and at Steinhoff International.

Our perspective
Fortunately, the implosion in the Steinhoff share price did not affect our clients, as the share was not held in the funds. Although we had bought Steinhoff in the past, actions taken by the management team over recent years resulted in the company no longer clearing our corporate governance checklist.

On the political front, South African equity and bond markets have taken kindly to how the leadership battle within the ANC unfolded. This has seen upward re-pricings in many of the securities in the funds, which have heavier exposures to the areas that enjoyed the largest re-pricings. This was not due to predicting how events would unfold, but rather the result of our bottom-up process. We have written about the opportunities we are finding in South African-centric companies and South African government bonds over the last number of quarters, as well as our assessment that the prices of these securities were not representing true underlying value. There were numerous contributors to the pessimism that caused this, including the ANC leadership race.

It is important to highlight that we do not build binary portfolios (i.e. bet on single outcomes). The fund's continued significant offshore exposure – despite the large domestic opportunity set – serves as good example. Furthermore, we limit the size of highly correlated exposures. Despite the tremendous value offered by South African banks, aggregate equity exposures to these holdings did not reach double digits. We followed similar aggregate exposure restraint to natural resources companies during their crash of 2015/16. Taking large directional bets is often the portfolio manager's Achilles' heel, and we guard against this.

Current positioning
Although recent events have been beneficial to the performance of the funds, market movements always need to be considered over the longer term. Therefore, the longer-term performance of the funds and our current positioning are more important considerations than recent events. We continue to favour large amounts of cash and equivalents, which will buffer drawdowns and, importantly, enable us to pounce when opportunities arise.

Although many South African financial and industrial stocks have re-rated to higher levels, most of these companies remain undervalued. Similarly, in our view the real yield offered on 20-year South African government bonds remains a standout opportunity. Offshore equity exposure is well diversified across industries and geographies. Despite rallying markets, these securities also continue to trade at a margin of safety. As an investor in the PSG Balanced Fund, you therefore own a basket of underpriced securities and plenty of cash – a good hand for many permutations. We follow a long-term approach to investing, and encourage our clients to do the same to benefit most from our process.

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by Paul Bosman and Ian Scott

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Current context

The fourth quarter of 2017 was always going to be nervous ride due to the political events that played out locally at the end of the year. Fortunately, the global backdrop remained favourable for emerging markets and fixed income. Returns from most fixed income asset classes have been higher than inflation (real returns), rewarding investors who have been willing to wait patiently. Over the last year, cash returned 7.52%, fixed-rate credit 13.48%, floating-rate 11.89% and government bonds 10.36%. Inflation-linked bonds underperformed, due to the high inflation protection cost in the real yield market.

Our perspective

It is of interest to note that the global environment is still supportive of emerging market yields – the yield curves of developed markets flattened substantially in the last quarter. This is especially evident in the US, where we would expect yield curves to steepen due to higher economic growth and the Federal Reserve actively reducing quantitative easing through fewer purchases of government securities. The recent approval of the US tax reform bill is also expected to be negative for long-dated bond yields, as it means that the US Treasury will have to borrow more from the markets over the long term. Yet, the US 30-year bond is trading at a low margin against the US 10-year bond. Low yielding, long-dated US bond yields are positive for the US housing market and emerging markets. Global credit spread markets are still trading at very low levels and the demand for emerging market real yields remains high.

Locally, the South African Reserve Bank (SARB) maintains a hawkish stance on monetary policy, despite the downward trend in consumer inflation. It is still concerned about a rand fallout due to local politics. The inflation trend continues lower and the low tariff increase awarded to Eskom for 2018 bodes well for it to continue into the new year. The window for cutting rates may not be closed if the local negative narrative unwinds. Current GDP growth is below potential. Furthermore, consumer credit demand is still in the low single digits and should not be an inflation concern for the SARB at this point.

Due to the worsening local narrative over the past year or more, banks were willing to pay higher rates to raise funds in the Negotiable Certificate of Deposit (NCD) market. This presented a good opportunity to lock in high real yields at low duration risk into our portfolios. The 12-month and longer-dated part of the NCD curve continues to look attractive against the SARB forecasted path of inflation over the next year or more. The government cash curve is also presenting ad hoc real-yield buying opportunities.

In contrast, the credit market was more muted during the last quarter of 2017, due to a slowdown in corporate and bank issuance in the face of the negative local backdrop. Demand far exceeded supply at the beginning of the quarter and spreads were bid lower in the market. However, due to specific corporate events in the latter part of the quarter, buyers of credit became more circumspect around corporate names and spreads. There are still good opportunities in this market to lock in real yield at low levels of risk.

Fear and uncertainty dominated the view on government bonds. It was easy to look at the narratives of negative political outcomes, a worse-than-expected budget balance and the negative actions from ratings agencies to build a bear case for South African bonds. The tougher question to ask was, "What was already reflected in the price?" From a ratings perspective, South Africa was already priced in line with other high-yield peers. Furthermore, in emerging market countries with worsening fiscal metrics (poor budgets), the integrity of the central bank is key – and we have seen this year that the independence of the SARB is non-negotiable and was successfully defended in court. A fair amount of the negative news has already been reflected in the government bond yield. With inflation falling, we believe this is a good opportunity to lock in real yields with liquidity for investors.

Portfolio positioning

We have been allocating funds over the various interest rate curves that have presented us with high real yield opportunities. We still find value in the one-year and longer-dated areas of the cash curve. We are also finding selective opportunities on the government cash curve. We have selectively added to our government bond position in the front end of the curve and participated in credit issues where credit spreads met our fair value criteria. However, we are turning more cautious on credit names as spreads decline. We continue to believe that the fund is well positioned for investors and savers looking for high real yields at low levels of risk.

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Current context

The fourth quarter of 2017 was always going to be nervous ride due to the political events that played out locally at the end of the year. Fortunately, the global backdrop remained favourable for emerging markets and fixed income. Returns from most fixed income asset classes have been higher than inflation (real returns), rewarding investors who have been willing to wait patiently. Over the last year, cash returned 7.52%, fixed-rate credit 13.48%, floating-rate 11.89% and government bonds 10.36%. Inflation-linked bonds underperformed, due to the high inflation protection cost in the real yield market.

Our perspective

It is of interest to note that the global environment is still supportive of emerging market yields – the yield curves of developed markets flattened substantially in the last quarter. This is especially evident in the US, where we would expect yield curves to steepen due to higher economic growth and the Federal Reserve actively reducing quantitative easing through fewer purchases of government securities. The recent approval of the US tax reform bill is also expected to be negative for long-dated bond yields, as it means that the US Treasury will have to borrow more from the markets over the long term. Yet, the US 30-year bond is trading at a low margin against the US 10-year bond. Low yielding, long-dated US bond yields are positive for the US housing market and emerging markets. Global credit spread markets are still trading at very low levels, and the demand for emerging market real yields remains high.

Locally, the South African Reserve Bank (SARB) maintains a hawkish stance on monetary policy, despite the downward trend in consumer inflation. It is still concerned about a rand fallout due to local politics. The inflation trend continues lower and the low tariff increase awarded to Eskom for 2018 bodes well for it to continue into the new year. The window for cutting rates may not be closed if the local negative narrative unwinds. Current GDP growth is below potential. Furthermore, consumer credit demand is still in the low single digits and should not be an inflation concern for the SARB at this point.

Due to the worsening local narrative over the past year or more, banks were willing to pay higher rates to raise funds in the Negotiable Certificate of Deposit (NCD) market. This presented a good opportunity to lock in high real yields at low duration risk into our portfolios. The 12-month and longer-dated part of the NCD curve continues to look attractive against the SARB forecasted path of inflation over the next year or more. The government cash curve is also presenting ad hoc real-yield buying opportunities.

In contrast, the credit market was more muted during the last quarter of 2017, due to a slowdown in corporate and bank issuance in the face of the negative local backdrop. Demand far exceeded supply at the beginning of the quarter and spreads were bid lower in the market. However, due to specific corporate events in the latter part of the quarter, buyers of credit became more circumspect around corporate names and spreads. There are still good opportunities in this market to lock in real yield at low levels of risk.

Fear and uncertainty dominated the view on government bonds. It was easy to look at the narratives of negative political outcomes, a worse-than-expected budget balance and the negative actions from ratings agencies to build a bear case for South African bonds. The tougher question to ask was, “What was already reflected in the price?” From a ratings perspective, South Africa was already priced in line with other high-yield peers. Furthermore, in emerging market countries with worsening fiscal metrics (poor budgets), the integrity of the central bank is key – and we have seen this year that the independence of the SARB is non-negotiable and was successfully defended in court. A fair amount of the negative news has already been reflected in the government bond yield. With inflation falling, we believe this is a good opportunity to lock in real yields with liquidity for investors.

Portfolio positioning

We have been allocating funds over the various interest rate curves that have presented us with high real yield opportunities. We still find value in the one-year and longer-dated areas of the cash curve. We are also finding selective opportunities on the government cash curve. We have selectively added to our government bond position in the front end of the curve and participated in credit issues where credit spreads met our fair value criteria. However, we are turning more cautious on credit names as spreads decline. We continue to believe that the fund is well positioned for investors and savers looking for high real yields at low levels of risk.

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by Hein Dietzsch

Current context

It was a bumpy final quarter of 2017. Politics continued to drive money market interest rates and the bond market, with significant swings in sentiment. During the quarter, Finance Minister Malusi Gigaba delivered the Medium-Term Budget Policy Statement, which put forward a path that veered from preferred fiscal prudency. This resulted in Standard & Poor's downgrading South Africa's local currency credit rating to below investment grade, and a sharp increase in local interest rates. Post the budget, the market focused purely on the ANC's elective conference, for which a business/investor-friendly outcome – the election of Cyril Ramaphosa as ANC leader – was uncertain. As a result, we saw elevated levels of fear driving short-term rates higher and the rand weaker, followed by a sharp correction mid-December.

The rand, a big driver of interest rate expectations, is currently trading at around R12.30 to the US dollar, falling from a quarterly peak of around R14.45/$ (roughly a 15% gain). Similarly, money market rates (as measured by the one-year bank certificate of deposit) fell from a quarterly peak of around 8.3% to current levels of around 7.8%.

Our perspective

South African politics has dominated local rates markets for quite some time and, understandably, has also dominated news headlines. Often, however, the market impact of politics is centered on specific events (e.g. the ANC elective conference) with unexpected outcomes (positive or negative). For this reason, we do not try to forecast the unknown, political or otherwise. Rather, we focus on independent, evidenced-based research; a key pillar of our investment process. Therefore, we place greater emphasis on the fundamentals driving short-term rates: inflation, growth and the global macroeconomic backdrop.

As at the latest inflation reading (30 November 2017), headline inflation was measured at 4.6%, down from 6.6% the previous year. It is expected to drop even further given the strengthened rand/dollar exchange rate. South Africa is also expected to continue a low growth trajectory until we see significant policy reform, and the global backdrop of a slow and steady increase in developed market rates remains evident. Focusing on these drivers, the market appears to be supportive of a lower interest rate environment in South Africa. Given the real yields available, we believe that the risk in this environment is *not* being invested, in anticipation of higher rates that may result from future events or political narratives.

Portfolio positioning

Average inflation year to date to end November was roughly 5.5% and is expected to draw lower into 2018. We are comfortable that we have been able to express our views by taking advantage of this favourable inflation profile with a bias towards fixed-rate instruments (which benefit as rates fall), looking to be closer to maximum duration. Recent concerns around National Treasury's need to increase funding in the short-term market (Treasury bills) has seen the fund increase exposure to this area of the market (where fear has been apparent). The fund bought these bills at higher rates than Big Four bank paper of similar maturity. The allocation of the fund increased from roughly 13.5% to 23.5% over the quarter given this mispricing, which should provide significant benefit going forward.

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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. A money market portfolio is not a bank deposit account. Excessive withdrawals from the portfolio may place the portfolio under liquidity pressures and in such circumstances a process of ringfencing of withdrawal instructions and managed payouts over time may be followed. The total return to the investor is made up of interest received and any gain or loss made on any particular instrument. In most cases the return will merely have the effect of increasing or decreasing the daily yield but in the case of abnormal losses it can have the effect of reducing the capital value of the portfolio.

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by Philipp Wörz and Greg Hopkins

Current context
The year was remarkable, arguably for the market events that did *not* happen.

Fear in markets (as measured by volatility levels) remained at record lows, which is astounding given the length of the current bull market – almost nine years – and the number of geopolitical uncertainties investors faced.

The fourth quarter of 2017 marked the seventh consecutive quarterly gain for the MSCI World Index (5.6%). In addition, 2017 was the first year since 1996 that the index delivered positive returns in all quarters, bringing its total return for the year to 23.1%. In fact, its largest weekly drawdown was a paltry 1.5%, a muted decline unrivalled in any other year since its inception in 1969. Similarly, the year saw the S&P 500 Index deliver 12 positive months for the first time in its history. It has now risen for 14 consecutive months – its longest run ever.

Following on from a strong 2016, we are pleased to have performed relatively well in this market, which was largely driven by expensive, large-cap stocks that were generally absent in the fund. The PSG Global Equity Feeder Fund returned 9.2% for the quarter and 24.0% for the year. As we have previously noted, the lack of volatility provided active investors with limited, market-specific opportunities to acquire quality assets at cheaper prices. We believe that the fund's performance resulted from selected and significant mispricing we identified.

(All returns quoted in US dollars.)

Our perspective
Given the elevated levels of overall market valuations and low levels of volatility, attractive investment opportunities have become a scarce commodity.

At PSG Asset Management, we select individual securities from the bottom up, and are comfortable to sit on the sidelines if we cannot find investments that satisfy our stringent 3M criteria (Moat, Management and Margin of Safety) – particularly the requirement for a wide margin of safety.

Fortunately, as we have written about extensively, while markets have been trading at lofty valuation levels for some time, the divergence of valuations within markets has been as wide as during the tech bubble of 2000. This has created an ideal environment for mispriced opportunities. Over the past number of years, these have tended to be in some of the less popular areas of the market, such as global (and specifically US) banks, resource and energy-related companies, emerging markets and, more recently, US retail.

While the past two years – and the fourth quarter of 2017 specifically – saw a rotation away from some of the more popular parts of the market to those less crowded, the valuation gap remains wide. We believe that this bodes well for bottom-up stock selectors like ourselves. The fund's holdings remain, on average, attractively priced relative to our assessments of intrinsic value.

Portfolio positioning
Given the rise in asset prices throughout 2017, we have been harvesting many existing holdings as they appreciated towards our estimates of intrinsic value. This discipline continued in the fourth quarter, during which we materially reduced two of our previous higher-conviction holdings, Cisco Systems and Union Pacific, after sharp increases in their share prices.

With US tax reform finally becoming a reality, and following three federal funds rate hikes during the year, US banking stocks continued to be in strong demand. While this sector still offers pockets of value, the fund reduced its exposure to US banks to 4.8% at the end of December 2017. This compares to 15% two years ago, when these stocks were deeply out of favour.

While we have been finding fewer high-conviction equity ideas across the broader global universe, there are still attractive isolated opportunities. We continue to have strong conviction in the fund's top holdings, particularly Brookfield Asset Management, which still trades at a wide margin of safety despite its strong performance in 2017. During the quarter, we were aggressive buyers of Babcock International (with Brexit-related fears continuing to weigh on its share price) and allocated further capital to Pandora A/S and UK-listed Premier Foods.

Overall, against a backdrop of high valuations and the re-rating of many of our existing holdings, the fund's cash level increased. While holding cash when interest rates are generally low and markets are broadly rising may be deemed as a potential drag on performance, we simply view it as increasing the opportunity set available to us in future.

In the prevailing environment, investors should expect more muted long-term performance from most risk assets. However, we believe that our disciplined approach of preserving and growing capital should continue to serve investors well.

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In the prevailing environment, investors should expect more muted long-term performance from most risk assets. However, we believe that our disciplined but flexible approach of preserving and growing capital should continue to serve investors well.

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Disclaimer: Collective Investment Schemes in Securities (CIS) are generally medium- to long-term investments. The value of participatory interests (units) or the investment may go down as well as up and past performance is not a guide to future performance. CIS are traded at ruling prices and can engage in borrowing and scrip lending. The Funds may borrow up to 10% of the market value to bridge insufficient liquidity. Fluctuations or movements in the exchange rates may cause the value of underlying international investments to go up or down. Where foreign securities are included in a portfolio, the portfolio is exposed to risks such as potential constraints on liquidity and the repatriation of funds, macroeconomic, political, foreign exchange, tax, settlement and potential limitations on the availability of market information. The portfolios may be capped at any time in order for them to be managed in accordance with their mandate. Excessive withdrawals from the fund may place the portfolio under liquidity pressures and, in certain circumstances a process of ring-fencing withdrawal instructions may be followed. PSG Collective Investments (RF) Limited does not provide any guarantee either with respect to the capital or the return of the portfolio.

Fees and performance:
Prices are published daily and available on the website www.psg.co.za and in the daily newspapers. A schedule of fees and charges and maximum commissions is available on request from PSG Collective Investments (RF) Limited. Commission and incentives may be paid and, if so, are included in the overall costs. Forward pricing is used. Different classes of Participatory Interest can apply to these portfolios and are subject to different fees, charges and possibly dividend withholding tax and will thus have differing performances. Performance is calculated for the portfolio and individual investor performance may differ as a result thereof. All performance data for a lump sum, net of fees, include income and assumes reinvestment of income on a NAV-NAV basis. Income distributions are net of any applicable taxes. Annualised performance show longer term performance rescaled over a 12 month period. Individual investor performance may differ as a result of initial fees, the actual investment date, the date of reinvestment and dividend withholding tax. . Unit Trust prices are calculated on a net asset value (NAV) basis, which is the market value of all asses in the fund including income accruals less permissible deductions divided by the number of units in issue. Actual Annual Figures are available to the investor on request.

Source of performance: Figures quoted are from Morningstar Inc.

Cut-off times: The cut-off time for processing investment transactions is 14h30 daily, with the exception of the PSG Money Market Fund, which is 11h00. 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 Services Board, 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.

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Conflict of Interest Disclosure: The Fund 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 Ltd.

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