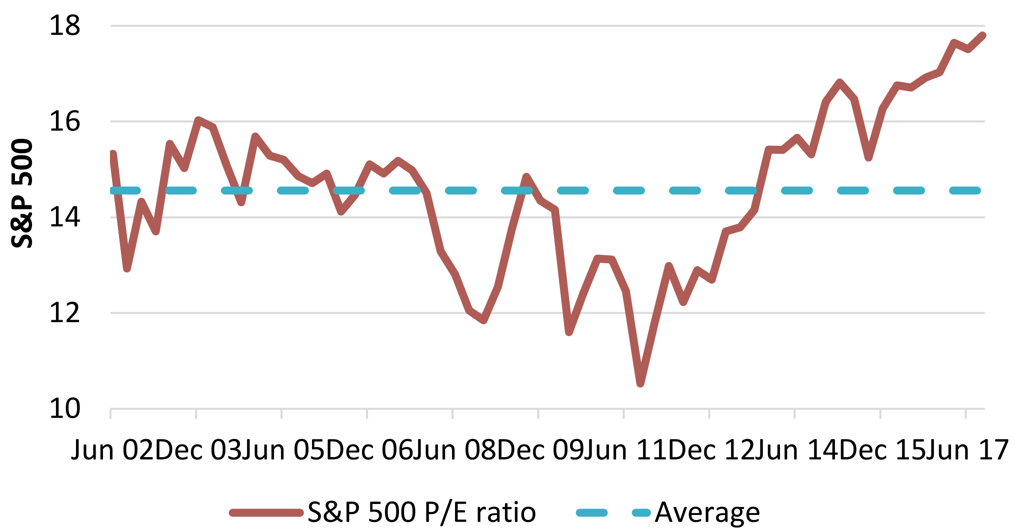
Shaun le Roux and Greg Hopkins

Current context

Global asset prices are mostly trading at elevated valuation levels: bond yields are at exceptionally low levels while equity markets are expensive. The US market, for example, is at its most expensive level in 15 years (based on 12-month forward price-earnings ratios).

S&P 500 Index – 12-month forward price-earnings ratio



Source: Bloomberg, PSG Asset Management

While valuations appear high at index levels, it is notable that there is a very wide divergence of valuations within stock markets. We have observed that out-of-favour sectors and stocks are extraordinarily cheap relative to popular stocks (which are the beneficiaries of passive flows and have been competing with bonds for capital).

Amid political instability, South Africa has been a notable underperformer within emerging market equities and has been subject to heavy selling by foreign investors. The economy is doing poorly and domestic sentiment is fast approaching levels associated with deep economic crises.

Our perspective

While we have been finding fewer high-conviction equity ideas across the broader global universe, there are still very attractive isolated opportunities. This is particularly true for the domestic stock market, where very poor sentiment is likely to have given rise to mispricings that will provide good long-term returns at acceptable levels of risk. We have relatively high conviction in a number of higher-quality domestic businesses that we have been able to buy at very wide margins of safety. It is our view that the valuation levels of these stocks more than compensate for the high levels of political risk in South Africa, and are at levels last seen during the global financial crisis. They are attractive on all valuation metrics – especially free cash flow yields, where double-digit yields are the order of the day. It is also important to remember that these cash flows are largely being generated in tough economic conditions.

Unpredictable political events are having a heightened impact on financial markets. We do not try to base portfolios on our prediction of any outcomes or try to time markets. Our focus is on finding investment ideas that are likely to help our clients achieve their investment objectives over the long run. Uncertainty around the outcome of political events has the tendency to create such opportunities. We think that carefully selected South African stocks should help clients grow their capital over the long term. Conversely, we do not think that buying expensive dual-listed rand hedges on a view that the rand will weaken is an appropriate strategy for reducing portfolio risk.

Portfolio positioning

The Fund has 24.5% invested in direct offshore equities. We have been reducing exposure to US stocks as prices rose in recent months. Our domestic equity exposure is indicative of our relatively high conviction in the long-term returns we expect from our local stock picks. We have identified excellent individual opportunities, many of which come from outside the Top 40.

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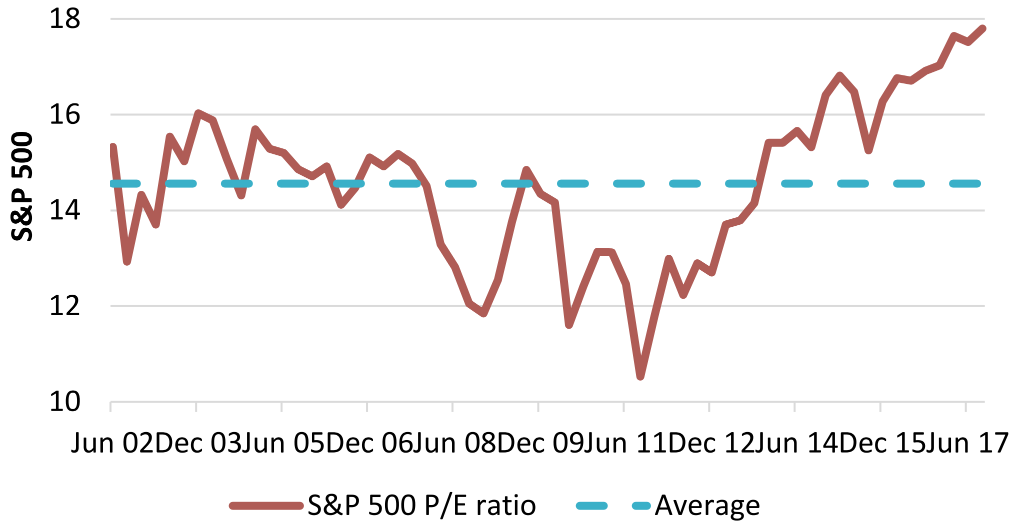
Date issued: 13 October 2017

Current context

Global asset prices are mostly trading at elevated valuation levels: bond yields are at exceptionally low levels while equity markets are expensive. The US market, for example, is at its most expensive level in 15 years (based on 12-month forward price-earnings ratios).

S&P 500 Index – 12-month forward price-earnings ratio



Source: Bloomberg, PSG Asset Management

While valuations appear high at index levels, it is notable that there is a very wide divergence of valuations within stock markets. We have observed that out-of-favour sectors and stocks are extraordinarily cheap relative to popular stocks (which are the beneficiaries of passive flows and have been competing with bonds for capital).

Locally, unpredictable political events are having a heightened impact on financial markets. Amid this political instability, South Africa has been a notable underperformer within emerging market equities and has been subject to heavy selling by foreign investors. The economy is doing poorly and domestic sentiment is fast approaching levels associated with deep economic crises.

Our perspective: Why disciplined, flexible investing is appropriate for many clients

Experience has taught us that the combination of a flexible strategy and a disciplined investment process is appropriate for many clients. We have learnt that, on average, investors have a lower tolerance for risk than they think. This is particularly the case eight-and-a-half years into a bull market, as low yields have resulted in clients being incentivised to increase risk to extract returns. In practice, many investors find a material market correction very challenging, and are prone to panic and want to sell at the worst possible time.

We do not try to base portfolios on our prediction of any outcomes or try to time markets. Our focus is on finding investment ideas that are likely to help our clients achieve their investment objectives over the long run. Our Flexible funds will be building cash as share prices rise and opportunities become fewer and less rewarding. As a result, we expect to better preserve capital in the event of a downturn and will have cash to employ when the market panics. Investors' emotions will see them doing the opposite – and in reality, we are often buying from panicking investors.

The Fund's primary objective is to deliver equity-like returns at lower levels of risk. We have found that if we are patient and wait for the market to pitch opportunities to buy quality businesses at wide margins of safety, it is possible to match (or beat) the market's returns despite a relatively conservative allocation to risky assets (equities). The Fund has had an average cash level of 26.6% since inception (2004).

Portfolio positioning

While we have been finding fewer high-conviction equity ideas across the broader global universe, there are still very attractive isolated opportunities, particularly in the domestic stock market. High global asset prices suggest that investors should expect more muted long-term returns from most securities and a more cautious positioning is warranted. Accordingly, the Fund remains cautiously positioned, with cash comprising 27.3% of the portfolio (25.2% domestic cash and 2.1% offshore cash).

The reason that cash levels aren't higher is that poor domestic sentiment is likely to have given rise to mispricings, which will provide good long-term returns at acceptable levels of risk. We have been adding to our exposure to higher-quality domestic businesses at very wide margins of safety. It is our view that the valuation levels of these stocks more than compensate for the high levels of political risk in South Africa, and are at levels last seen during the global financial crisis. They are attractive on all valuation metrics – especially free cash flow yields, where double-digit yields are the order of the day. It is also important to remember that these cash flows are largely being generated in tough economic conditions. Our domestic equity exposure (51.5% of Fund value) is indicative of our relatively high conviction in the long-term returns we expect from our local stock picks. We have identified excellent individual opportunities, many of which come from outside the Top 40.

The Fund also has 21.3% invested in direct offshore equities. We have been reducing exposure to US stocks as prices rose in recent months.

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Date issued: 13 October 2017

Current context
Many investors are concerned about where future returns will come from. Locally, political uncertainty, financially depleted state-owned enterprises and weak GDP growth remain top of mind. Globally, the dominant narrative is that the prolonged era of accommodative monetary policy in developed markets is gradually coming to an end. The result will see the normalisation of bond yields (i.e. capital losses for bond investors) and the end of the steamy equity bull market. Or so the story goes.

Although we understand these concerns (especially those around global bond markets), we don't prescribe to any single market view – and we certainly don't try to time market movements. A number of our global holdings are indeed approaching fair value, but we are continually finding new opportunities for inclusion in our funds.

Our perspective
"A little knowledge is a dangerous thing. So is a lot." – Albert Einstein

How will we generate satisfactory returns for our clients in such trying times?

Not by knowing a lot…
Trying to understand each and every possible market driver and building multivariate regression models to predict security prices would be one way to approach the problem. However, we believe this is dangerous. It is very hard to predict the future, and equally as hard to predict the impact of future events on security prices. Probability theory teaches us that multiplying two unlikely success rates results in an even lower hit rate.

… but also not by knowing only a little.
Another approach would be to buy an index or a basket of stocks that seem to be running and are widely held by peers. In this case, we could hedge our bets in terms of relative performance. This would mean lower risk for us but higher investment risk for our clients. However, we believe that this approach is dangerous too. In the long run, markets don't have mercy for the lazy.

We believe the answer is to know a lot about investments that match our very specific criteria.
These investments are the equities or bonds of companies that are managed by capable individuals and have some kind of protection from ruthless free market forces. When we find such opportunities, we do very rigorous research and estimate an intrinsic value for the security (share or bond) we are considering. If its price is below our intrinsic value it qualifies for inclusion in our funds.

Drivers of future investment returns can therefore be broken down into the following:
- savvy management teams allocating capital to opportunities that deliver good returns and drive profit growth
- the leveraging of economic moats (competitive advantages) that allow companies to increase revenue by more than costs and thereby grow profits faster than GDP
- the rerating of security prices towards intrinsic value

(Share prices are driven higher by greater profits and/or movements towards fair value, while bond returns are obtained from regular coupons and/or movements of bond prices towards fair value.)

There is also a fourth driver: our process of rotating into cash when securities become fairly or marginally overvalued, so that we can rotate back into undervalued securities when they become available. If markets do contract in the near term, it would give us an opportunity to switch on this fourth engine and rotate into undervalued investments.

Remember that we follow a long-term investment approach. Our clients should do the same to enjoy the benefits of our process.

Portfolio positioning

We continue to have a large portion of the Fund invested offshore (24%). Our largest offshore holding, Brookfield Asset Management, continues to offer terrific value. However, we have been rotating out of global stocks that are approaching their fair values into more attractively priced new ideas. Numerous domestic companies continue to offer good value and we have been adding a few new names.

The real yields offered by South African government bonds are above our required rate and the Fund currently has an aggregate exposure of 11% to these instruments. Cash levels remain high and we are able to deploy 11% of the Fund if new opportunities arise. We think that this is a good environment for long-term stock picking and have a track record of generating good returns for our clients by investing in companies and fixed income instruments with market prices that don’t represent true value.

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by Paul Bosman and Ian Scott

Current context

Many investors are concerned about where future returns will come from. Locally, political uncertainty, financially depleted state-owned enterprises and weak GDP growth remain top of mind. Globally, the dominant narrative is that the prolonged era of accommodative monetary policy in developed markets is gradually coming to an end. The result will see the normalisation of bond yields (i.e. capital losses for bond investors) and the end of the steamy equity bull market. Or so the story goes.

Although we understand these concerns (especially those around global bond markets), we don't prescribe to any single market view – and we certainly don't try to time market movements. A number of our global holdings are indeed approaching fair value, but we are continually finding new opportunities for inclusion in our funds.

Our perspective

"A little knowledge is a dangerous thing. So is a lot." – Albert Einstein

How will we generate satisfactory returns for our clients in such trying times?

Not by knowing a lot…

Trying to understand each and every possible market driver and building multivariate regression models to predict security prices would be one way to approach the problem. However, we believe this is dangerous. It is very hard to predict the future, and equally as hard to predict the impact of future events on security prices. Probability theory teaches us that multiplying two unlikely success rates results in an even lower hit rate.

… but also not by knowing only a little.

Another approach would be to buy an index or a basket of stocks that seem to be running and are widely held by peers. In this case, we could hedge our bets in terms of relative performance. This would mean lower risk for us but higher investment risk for our clients. However, we believe that this approach is dangerous too. In the long run, markets don't have mercy for the lazy.

We believe the answer is to know a lot about investments that match our very specific criteria.

These investments are the equities or bonds of companies that are managed by capable individuals and have some kind of protection from ruthless free market forces. When we find such opportunities, we do very rigorous research and estimate an intrinsic value for the security (share or bond) we are considering. If its price is below our intrinsic value it qualifies for inclusion in our funds.

Drivers of future investment returns can therefore be broken down into the following:

- savvy management teams allocating capital to opportunities that deliver good returns and drive profit growth
- the leveraging of economic moats (competitive advantages) that allow companies to increase revenue by more than costs and thereby grow profits faster than GDP
- the rerating of security prices towards intrinsic value

(Share prices are driven higher by greater profits and/or movements towards fair value, while bond returns are obtained from regular coupons and/or movements of bond prices towards fair value.)

There is also a fourth driver: our process of rotating into cash when securities become fairly or marginally overvalued, so that we can rotate back into undervalued securities when they become available. If markets do contract in the near term, it would give us an opportunity to switch on this fourth engine and rotate into undervalued investments.

Remember that we follow a long-term investment approach. Our clients should do the same to enjoy the benefits of our process.

Portfolio positioning

We continue to have a large portion of the Fund invested offshore (16%). Our largest offshore holding, Brookfield Asset Management, continues to offer terrific value. However, we have been rotating out of global stocks that are approaching their fair values into more attractively priced new ideas. Numerous domestic companies continue to offer good value and we have been adding a few new names.

The real yields offered by South African government bonds are above our required rate and the Fund currently has an aggregate exposure of 15% to these instruments. Cash levels remain high and we are able to deploy 24% of the Fund if new opportunities arise. We think that this is a good environment for long-term stock picking and have a track record of generating good returns for our clients by investing in companies and fixed income instruments with market prices that don’t represent true value.

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Ian Scott and Paul Bosman

Current context

The local and global environment remains supportive of local fixed income assets, despite the political uncertainty South Africa has experienced over the last year or two. Most fixed income sectors have delivered above-inflation (real) returns, rewarding investors who were willing to look through the noise. Over the last year, cash returned 7.6%, credit around 12% and government bonds 8.3%. Currently, inflation-linked bonds are the only underperformers, due to high demand keeping real yields on these instruments lower.

Our perspective

Over longer timeframes, the US dollar cycle tends to be negatively correlated with the performance of emerging market economies and financial assets. Currently, the dollar is weak and supportive of commodity prices and emerging market currencies. Inflation in emerging markets is also falling, which is driving real yields higher. With global markets still characterised by low yields and investors in developed markets left yield-hungry, we should not be surprised that these investors are currently the largest buyers of South African local currency bonds.

South Africa has high real yields, falling inflation, a credible central bank and a liquid bond market: all the characteristics foreign investors are looking for. As South Africans, we live close to our own micro issues and are sensitive to any political disruptions. For investors sitting in London, New York or Tokyo, however, South African politics look quite similar to many of our emerging market peers. The local backdrop is still positive for fixed income, given that inflation remains on a downward trajectory. And as growth is very low, the risk of demand-side inflation surprising on the upside is also low. The Monetary Policy Committee of the South African Reserve Bank (SARB) remains cautious by not reducing interest rates too aggressively, citing concerns over the rand, inflation expectations and policy uncertainty. This means that real rates will remain higher for longer. This gives our funds the opportunity to lock in attractive yields on fixed-rate instruments to the benefit of our investors.

While the SARB has extended this window of opportunity, it may not last for long. For example, we are finding less opportunities in cash than over the last year or so, mainly due to the rate-cutting cycle that has started and banks flattening their funding curves (due to the large amount they have already issued and slow growth in their asset books). However, there is still opportunity to lock in real rates in the one-year area of the curve. We have seen similar developments in the credit market, with the high credit spreads that were on offer over the last year or more starting to fall. Participants in the local credit market have become very positive on credit spreads, bidding spreads lower in auctions and aggressively hunting for credit names at lower spread levels in the secondary market. We are finding less opportunity in this market and, as always, participate selectively only where we find value at the appropriate risk level.

Government bond yields remain attractive in the medium- to longer-dated area of the yield curve, despite the current narratives around politics and a further sovereign downgrade. There are many moving parts to a possible downgrade that we cannot predict, and building portfolios around any possible binary outcome is a risk we avoid. We believe a lot of negative news is already reflected in the yields of longer-dated bonds. If the SARB and National Treasury maintain historical credibility, real yields of more than 3% on long-dated bonds are attractive in the current economic environment.

Portfolio positioning

We have been allocating funds over the various interest rate curves that have presented us with high real yield opportunities. We have allocated from our cash to credit and government bonds. We still find value in the one-year area of the cash curve and have selectively added to our government bond position in the medium end of the curve. We also 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 have maintained the balance between local and offshore equities to reduce the risk of correlation in the fund. We believe the Fund remains well positioned for investors and savers looking for high real yields and diversification at low level of risk.

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Ian Scott and Tyron Green

Current context

The local and global environment remains supportive of local fixed income assets, despite the political uncertainty South Africa has experienced over the last year or two. Most fixed income sectors have delivered above-inflation (real) returns, rewarding investors who were willing to look through the noise. Over the last year, cash returned 7.6%, credit around 12% and government bonds 8.3%. Currently, inflation-linked bonds are the only underperformers, due to high demand keeping real yields on these instruments lower.

Our perspective

Over longer timeframes, the US dollar cycle tends to be negatively correlated with the performance of emerging market economies and financial assets. Currently, the dollar is weak and supportive of commodity prices and emerging market currencies. Inflation in emerging markets is also falling, which is driving real yields higher. With global markets still characterised by low yields and investors in developed markets left yield-hungry, we should not be surprised that these investors are currently the largest buyers of South African local currency bonds.

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Portfolio positioning

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Current context

Interest rates declined over recent quarters, with the local environment becoming more supportive of fixed income markets as inflation expectations moderated over the medium term. The global backdrop has also supported a more stable rates market by encouraging inflows into emerging market assets. As a case in point, we have seen roughly R70 billion in foreign flows into South African bonds for the year to end September – R13 billion of which occurred in September alone. We believe that this has underpinned South African interest rates by providing significant support to the rand amid political and economic uncertainty.

The South African Reserve Bank (SARB) cut the repo rate by 25 basis points at its July Monetary Policy Committee meeting, the first interest rate cut since July 2012. The SARB's current expectation is for headline inflation to reach a low of 4.6% in the first quarter of 2018, and to average 5.0% and 5.3% in 2018 and 2019 respectively. Its real GDP forecast has improved slightly, but it still expects meagre growth of 1.5% in 2019. The environment was therefore supportive of an interest rate cut, but we do not believe it will necessarily do much in spurring real economic growth, given high levels of policy uncertainty and lack of policy implementation.

Our perspective

Over the quarter, the market once again reminded us how important key principles behind our investment process are. We are happy to buy when we feel others are pricing in too much risk (or conversely to sell or sit in cash when we feel risks are overlooked or securities are overvalued). This has been the case over the past year. Market noise and political uncertainty has created an environment of high interest rate expectations, despite inflation and growth fundamentals supporting lower interest rates. This has allowed us to buy NCDs and certain high-quality corporate credit at wider margins of safety (higher yields and higher spreads), which makes us comfortable that we have locked in attractive real yields to the benefit of our investors.

We also do not look to time markets (i.e. forecasting interest rate movements or specific events). Rather, we buy with a through-the-cycle view of inflation over the term of the instrument under consideration. When the SARB did not announce another rate cut at its September meeting, NCDs (which were strongly bought after the July meeting) sold off roughly 20 basis points higher. This would have been uncomfortable for investors trying to time interest rate tops and bottoms.

Portfolio positioning

Our view remains that in combination, the local and global environment will continue to support lower rates in South Africa. As such, we continue to allocate to fixed-rate instruments where duration limits allow. Given the likely noisy period ahead (as ratings decisions and the ANC elective conference approach), we also look to hold floating-rate instruments, where we can buy at wider spreads as protection against any sudden rate actions. We are therefore managing the Fund closer to maximum duration but are also looking to maintain liquidity for attractive opportunities that may arise in any market sell-offs.

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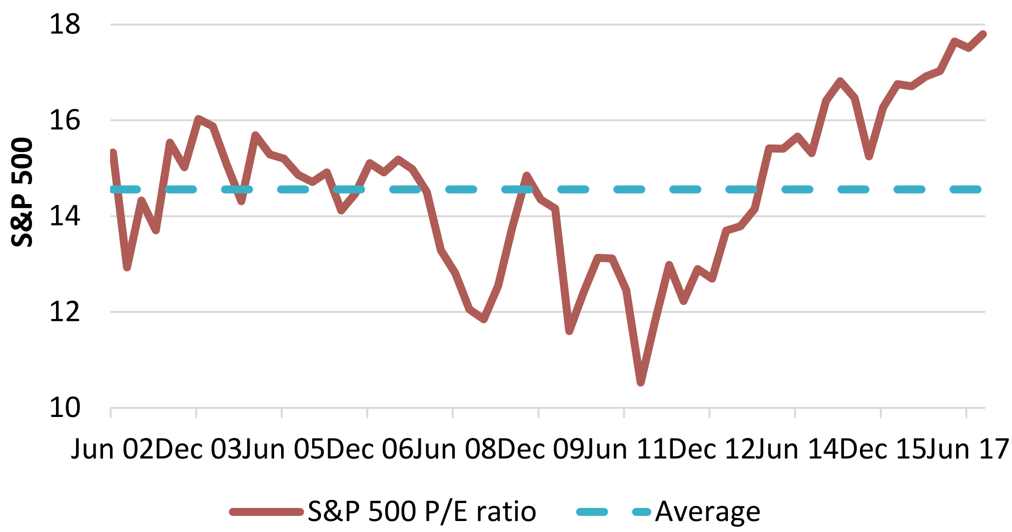
Current context

Global asset prices are mostly trading at elevated valuation levels: bond yields are at exceptionally low levels while equity markets are remarkably expensive. The US market, for example, is at its most expensive level in 15 years (based on 12-month forward price-earnings ratios).

S&P 500 Index – 12-month forward price-earnings ratio



Source: Bloomberg, PSG Asset Management

While valuations appear high at index levels, it is notable that there is a very wide divergence of valuations within stock markets. We have observed that out-of-favour sectors and stocks are extraordinarily cheap relative to popular stocks (which are the beneficiaries of passive flows and have been competing with bonds for capital).

Our perspective

While we have been finding fewer high-conviction equity ideas across the broader global universe, there are still very attractive isolated opportunities. However, these tend to be in some of the less popular parts of the market.

Historically, we have found that some of the best investments are made in times of fear and uncertainty, when overall sentiment towards an area of the market is particularly poor. For example, it wasn't long ago that the predicted 'death of the PC' would render legacy tech companies redundant. While this was a legitimate concern at the time, these fears were necessary for us to be able to buy a company like Microsoft at under ten times earnings in 2013. Currently, we are witnessing particularly negative narratives around Brexit and US retailers (in the shadow of Amazon), which present opportunities for mispricing in domestically focused UK companies and the US retail sector. Consequently, we have been buyers of UK engineering support firm Babcock and US retailer L Brands in recent months.

Portfolio positioning

Our portfolios are constructed from the bottom up and are diversified across regions, industries and currencies. We continue to have strong conviction in our large portfolio holdings, namely Brookfield Asset Management, Yahoo Japan and AIA Group.

Rising asset prices have allowed us to reallocate capital out of securities where valuations have approached or exceeded our estimates of intrinsic value, into investment opportunities where fear and uncertainty have driven prices to attractive valuation levels. During the quarter, the Fund sold out of Microsoft, Stanley Black & Decker, Apple, Mastercard and Markel Corp.

A backdrop of expensive valuations for the world's best companies informs the Fund's current cash holding, which we are ready to deploy once further high-conviction investment opportunities become available.

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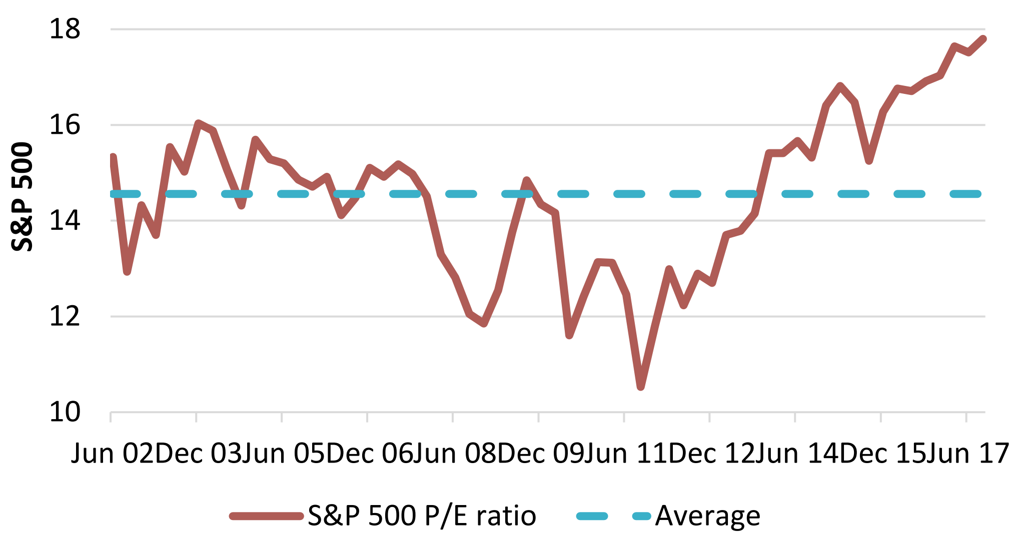

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Our perspective: Why disciplined, flexible investing is appropriate for many clients

Experience has taught us that the combination of a flexible strategy and a disciplined investment process is appropriate for many clients. We have learnt that, on average, investors have a lower tolerance for risk than they think. This is particularly the case eight-and-a-half years into a bull market, as low yields have resulted in clients being incentivised to increase risk to extract returns. In practice, many investors find a material market correction very challenging, and are prone to panic and want to sell at the worst possible time.

Our Flexible funds will be building cash as share prices rise and opportunities become fewer and less rewarding. As a result, we expect to better preserve capital in the event of a downturn and will have cash to employ when the market panics. Investors' emotions will see them doing the opposite – and in reality, we are often buying from panicking investors.

The Fund's primary objective is to deliver equity-like returns at lower levels of risk. We have found that if we are patient and wait for the market to pitch opportunities to buy quality businesses at wide margins of safety, it is possible to match (or beat) the market's returns despite a relatively conservative allocation to risky assets (equities).

Portfolio positioning

Markets continued to be strong over the quarter, with the MSCI World Index rising 5%. While we allocated fresh capital to some excellent long-term ideas, several of our existing holdings continued to appreciate towards their intrinsic values, which resulted in a slight rise in cash levels. During the quarter, the Fund sold out of Microsoft, Stanley Black & Decker and Markel Corp. However, we continue to have strong conviction in our large portfolio holdings, namely Brookfield Asset Management, Yahoo Japan and AIA Group.

While we have been finding fewer high-conviction equity ideas across the broader global universe, there are still very attractive isolated opportunities. High global asset prices suggest that investors should expect more muted long-term returns from most securities. Accordingly, the Fund remains cautiously positioned, with cash comprising 31% of the portfolio. The reason that cash is not higher is that we continue to find good opportunities that satisfy our criteria for investment, generally in some of the less popular parts of the market.

We believe that our disciplined, flexible approach of preserving and growing capital should continue to serve investors well.

The information and content of this publication is provided by PSG as general information about its products. The information does not constitute any advice and we recommend that you consult with a qualified financial adviser before making investment decisions. For further information on the funds and full disclosure of costs and fees please refer to the Minimum Disclosure Documents on our website.

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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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