PSG | Asset Management

1ST Quarter 2012

ANGLES &
PERSPECTIVES

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Cover photo by: Eric Pearson

A word from the Chief Operating Officer

Welcome to our first newsletter of 2012.

On behalf of all the shareholders, directors and staff of PSG Asset Management, I would like to thank you for your loyal support last year. The combination of this support and our exciting plans for the year ahead bode well for investors.

PSG Asset Management's solid performance in 2011 has enhanced our reputation

During 2011, flows into almost all our unit trusts were very strong. This indicates that the investing community was impressed with the performance of the consolidated PSG Asset Management team. Both existing and newly supporting financial advisors have affirmed that PSG Asset Management's consolidations during 2010 and 2011 have contributed to a company that:

- Is easier to understand;
- Has a solid and concise range of funds that perform exceptionally well; and
- Delivers innovative products and services that are starting to make some of our larger, more established peers sit up and take note.

A notable aspect of the activities of the PSG Asset Management portfolio managers and the Investment Team in 2011 was their single-minded focus on performance and the management of their portfolios. Despite the merger of the asset management teams and a re-arrangement of offices, the team remained focussed on generating high-conviction investment ideas.

We all live and breathe investing and are passionate about what we do. The portfolio managers in particular operate as a strong unit with a powerful research culture. We will continue to enhance and strengthen this during 2012.

Major administrative developments in 2011 have paved the way for enhancing our investment platform

We achieved several significant administrative milestones in 2011. Amongst others we:

- Consolidated a number of legacy retirement funds (from 18 to three);
- Streamlined our offshore operations and structures;
- Invested in extensive staff training for both front and back office staff;
- Acquired Equinox/Intervest and made substantial progress towards integrating the business with our business, including PSG online; and, last but definitely not least,
- We secured a LISP licence, which is a significant step forward to the development and implementation of South Africa's first next generation investment platform.

At the end of 2011, Lizé Visser, PSG Asset Management's Head of Distribution, went to the UK where she spent time with one of the fastest growing next generation investment platforms. She returned brimming with ideas. Using her expertise, we will focus on bedding down and enhancing our administration systems and processes and expanding our investment platform's functionality for financial advisors this year.

In addition, while many of us were taking a breather over the 2011 year-end, the PSG team responsible for the development and maintenance of our investment platform has been hard at work to enhance this platform. We anticipate further exciting developments in the year ahead.

We also made some appointments to the PSG Asset Management Distribution Team during 2011. We did this to increase both the footprint of advisors that we can service in a sustainable and structured way and to increase the quality of our service to you.

We have exciting plans for 2012

Firstly, we are strengthening our Fixed Interest Team with several PSG Absolute Investments team members joining PSG Asset Management. The people who are moving across have a PSG background and their skills and experience will enable them to settle in quickly.

Secondly, we will be extending our services into the institutional market. Historically, PSG Asset Management has focused on managing retail investor money, but more and more asset consultants, pension funds and other institutional investors have asked us to consider managing mandates for their clients. We are pleased to confirm that we have recruited an experienced and highly skilled person to head up this new initiative, and will be able to share who this is soon.

Please join us for the PSG Outlook 2012

Lastly, our portfolio managers have been keeping a close eye on the markets and will be sharing their views of what 2012 may have in store from 31 January to mid-February as they take the PSG Outlook 2012 presentation on the road. We invite you to attend these, so please watch your inbox for the invitation.

Let's embrace the challenges of 2012!

We look forward to the challenges ahead. We remain committed to ensuring that PSG Asset Management is a trusted and preferred investment partner to financial advisors in South Africa and abroad. I wish you a rewarding and fruitful 2012.

Mike Smith
Chief Operating Officer
PSG Asset Management Group

What to do in 2012? Keep your head down and focus on valuations

By Neels van Schaik

Neels van Schaik obtained a BComm Economics from the University of Stellenbosch and joined PSG in 1998. Throughout his time at PSG Neels has been involved in portfolio management and in 2005 he became a CFA charterholder. Neels is an integral part of the PSG Asset Management Equity team, where he analyses stocks and co-manages the PSG Balanced Fund.

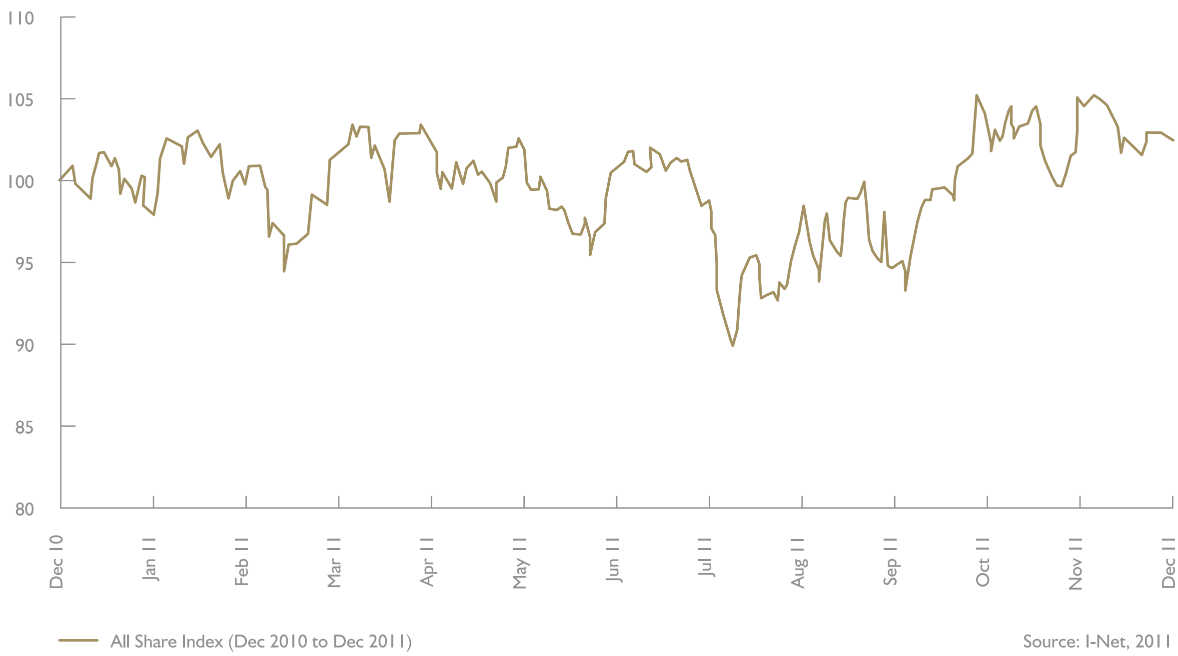
Investors across the globe appear to be entering 2012 with trepidation after a particularly volatile and at times brutal 2011. We believe that a sound investment process is essential for coping with volatile and uncertain times.

Volatility of both stock prices and market sentiment was the main trait of 2011

The market in 2011 was characterised by exceptionally wild swings in stock price returns on a daily and weekly basis. Measured over the full year, we went nowhere, with a total return of 2.6% for the FTSE JSE All Share Index, as seen in Graph 1.

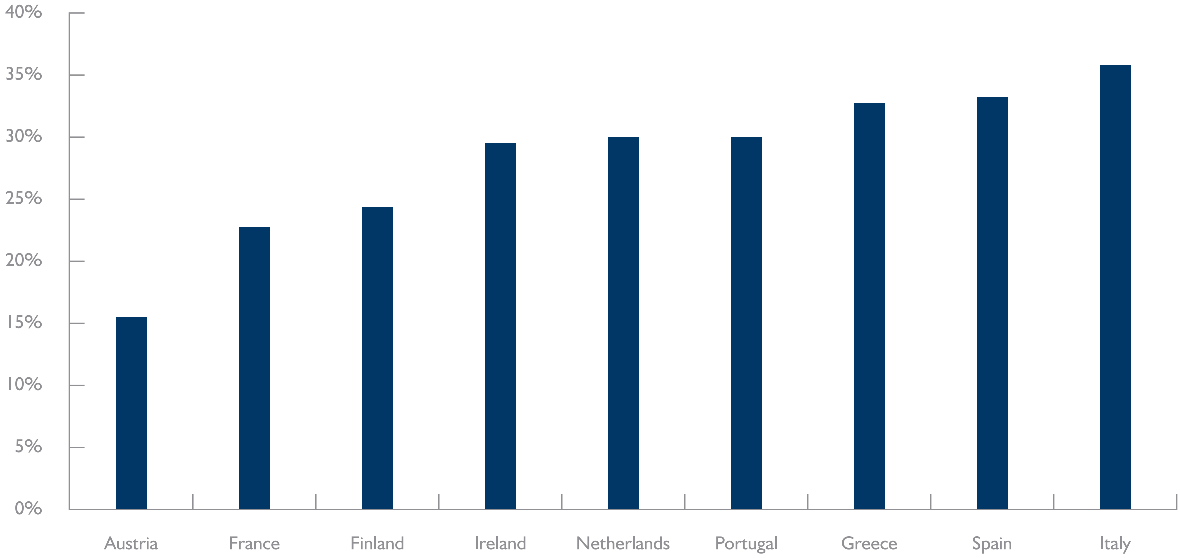
Speculators that thrive on macro noise had a lot of news to chew on. Sentiment swung between extreme pessimism, emanating from talks of a Eurozone break-up and Chinese growth deceleration, and extreme optimism (typically fuelled by empty promises after each of the Eurozone summits held during 2011). It was however one of those years where doing less generally added more value to portfolio returns.

Graph 1: The FTSE JSE All Share Index (total return) for 2011



Source: I-Net, 2011

Graph 2: Change in the real effective exchange rate of Eurozone members vs. Germany since 1999



Source: Deutsche Bank

Why do we expect further ructions in Europe in 2012?

The battle of reconciling a political ideal with an economic reality rages on in the Eurozone. How can an entity survive when it is uncompetitive but is not allowed to lower its prices? This is the fundamental problem with Portugal, Ireland, Italy, Greece and Spain (the PIIGS). In a recent Deutsche Bank study it was estimated that the five 'peripheral' countries in the Eurozone have lost between 25% and 35% of their competitiveness against a country like Germany since 1999, mainly through the faster appreciation of unit labour costs (refer to Graph 2). As there is no release valve for the pressure of rising labour costs in the shape of individual currency devaluation, the only way to improve competiveness is through lower wages, which result in lower living standards.

It's not clear what the political appetite is for the inevitably painful solutions to the Eurozone crisis. There are numerous unanswered questions:

- Will the PIIGS be satisfied with sacrificing sovereignty and enforcing severe austerity in order to remain in the club?
- Does Germany have popular support for stopping the contagion?
- How will Greece leave the Eurozone?
- To what extent will European banks need to be recapitalised?
- What will be the impact of European debt default and restructuring?

While the crisis could well intensify, we expect to continue taking advantage of the opportunity to acquire quality assets, including European equities, at very attractive prices.

What do China's prospects for recovery look like and what are the consequences thereof?

The other pressing issue is China, which is a material contributor to global growth. China is slowing and it is not clear whether relaxing monetary policy will enable the Chinese to engineer a 'soft landing' (slower but still robust growth). The overhang of a significant credit bubble and the related property boom leads many to suggest that a 'hard landing' is on the cards. This would have dire consequences for commodity prices, and consequently the South African economy. We are unclear on the immediate outlook for China and prefer to focus on two long-term impacts it will have on the global economy:

1. Their significant demand for natural resources; and
2. The shifts in economic growth drivers from investment towards consumer spending.

Debt is still a core cause of the global economic problems and is detrimental to growth

Excessive debt lies at the root of the global economy's challenges. In recent years, debt has been shifted from banks to households and governments. Consumers and governments will be forced to spend less, pay off debt and increase savings in the years ahead. This will result in lower economic growth in the West. The global economy faces a wider range of potential outcomes than usual. While global growth will continue to be powered by developing economies, these economies will be impacted by a likely recession in Europe. Medium-term growth will be underpinned by the significant shift of growth, driven by fixed investments, to growth driven by private consumption in the developing world.

While we will have to suffer the deflationary consequences of continued austerity and fiscal tightening in Europe and the US on the one hand, the massive expansion in the monetary base may eventually result in higher inflation.

We try to make rational investment decisions in an uncertain environment

As fundamental investors, we spend more time trying to understand the businesses models of the companies we invest in than speculating about the possible outcome of the latest Eurozone or G20 summit. While we are mindful of the global risks and the possible impact of these risks on financial markets, we are also aware that any investment in the market has inherent risk. As long as you don't overpay for the risk, your returns should be reasonable when measured over time.

The term value investor means different things to different people. For us, value investing means buying one rand of value for sixty or seventy cents. The process of conservatively estimating the value of the asset you want to purchase should lead to rational investment decisions. We take comfort in the fact that fantastic investment opportunities generally arise when the outlook is as uncertain as it currently is. For this reason we are happy to have some dry powder in our portfolios in the form of cash.

Long-term investors do not have to fear price fluctuations if they've done their homework

Only speculators should be concerned about the month-to-month stock market swings. Their transacting has got little to do with the underlying economics of the businesses they are buying or selling. It is instead based on guessing the direction of the market over very short periods.

The liquidity that a stockmarket provides can often lead to subjective and over optimistic decision-making. As it is fairly easy for an investor to sell a stock that does not deliver the expected returns over the anticipated time horizon, the research process inherent in buying listed companies is often not as thorough as it would have been if an investment for example had higher transaction costs or a lock-in period. Consider how carefully you would assess an investment in a private business or even your own residence, relative to a recent stockmarket investment.

At PSG Asset Management our goal is to focus on objective and conservative assessments and valuations of companies in order to avoid sleepless nights when macroeconomic conditions fluctuate. If the return expectations of an investment rely on a continuing economic boom or a specific economic factor, you have to question the objectivity of your assessment.

One pitfall that investors must be wary of, is that assumptions about an investment often become more optimistic as economic conditions improve. This normally results in overpaying for average businesses in economic boom times. But investors also need to guard against being too conservative and pessimistic when assessing a business in poor economic conditions.

JSE-listed equities mainly fall into two groups

Given the uncertain economic environment, there is a wide range of possible outcomes for corporate profits in the future. While global yields are suppressed, there has been a flight to equities that have a more visible profit outlook.

The South African stockmarket generally comprises two distinct areas that are driven by two completely different sets of factors:

1. *Companies that are exposed to the global economic cycle*
   Commodity producers make up a significant portion of this category, which has been badly impacted by Europe's sovereign crisis and China's slowdown. After a slump in stock prices in 2011, the resource sector looks cheap relative to the rest of the market after de-rating significantly. It is currently the most attractive area to find investment opportunities. However, one must carefully assess the margin of safety for resource stocks, as margins and profit levels are likely to decline for some stocks. We prefer low cost producers and favour miners with a diversified portfolio. We currently own Anglo American (see article on page 8), Sasol and BHP Billiton.

2. *Local industrial companies that are exposed to the South African economy*
   Domestic stocks have enjoyed strong tailwinds over recent years due to strong demand from foreign investors, low interest rates and a relatively strong rand. High quality domestic stocks have enjoyed exceptional returns and have seen a significant rerating in multiples, despite all the economic chaos in the developed world. Although profit growth of these companies has been strong over recent years, the re-rating in price-to-earnings (P:E) ratios and price-to-book (P:B) ratios has made up an important part of the capital return from these stocks.

Graph 3 illustrates the extreme difference in valuation between one of the strongly performing domestic sectors, general retailers, and the resource index, on a P:B basis. The obvious conclusion is that expectations are very low for resources and very high for retailers.

Graph 3: Price-to-book ratios of general retailers versus resources (2002-2011)

Source: Bloomberg, PSG Asset Management, 2011

We have limited exposure to expensive domestic stocks for three reasons:

1. Valuations are high;
2. Interest rates are low and the ratings of stocks deteriorate in a rising interest rate environment; and
3. Profit levels and margins are generally high.

This is not supportive of future returns and the risk of losing capital is significant.

The rand will continue to be an important influence on whether interest rates stay lower for longer

The rand lost roughly 20% of its purchasing power against the dollar during 2011, with most of the depreciation occurring during the second half of the year. This has been mainly a function of dollar strength as investors ironically opted for the US dollar as a safe haven currency. We had been of the view that the rand was overvalued at an exchange rate of more than R7 to the US dollar. After the recent sharp adjustment to above R8 to the dollar, the urgency to convert rands to dollars has dissipated, and our focus is on the valuation of the assets that can still be acquired in dollars and euros. Because we can find attractively valued stocks in the US, Europe and the UK, we have maintained a maximum offshore exposure in our multi-asset funds.

Further deterioration in economic conditions abroad and increased risk aversion will likely result in continued rand depreciation. This will have negative ramifications for inflation, which is already breaching the upper band of the inflation target and is likely to sustain these elevated levels in the short- to medium-term. Accordingly, the risk to inflation remains on the upside.

While current indications are that interest rates will stay lower for longer than previously thought, we find bonds relatively unattractive. It is likely that we are at the bottom of the rate cycle and there are upside risks to interest rates on a medium-term view. We do not view the spread above cash and inflation to be attractive enough to warrant large exposure to conventional government bonds.

We are optimistic about developed market stock returns relative to opportunities in local markets

We go into 2012 unexcited about the investment opportunities in the domestic stockmarket, but very optimistic about the opportunities available offshore, specifically in developed markets. The stocks we own offshore are all companies that have proven themselves over many decades as very strong franchises with excellent dividend track records. Most of them are cheaper than their South African peers and are offering higher dividend yields.

Most of our selected South African listed stocks are companies that have strong moats or sustainable competitive advantages over their competitors. We tend to hold these businesses for very long periods of time and allow the management team to exploit their competitive advantages to our benefit by compounding the high returns they generate on capital. Typical characteristics of these companies are:

1. They generate high returns on each rand that is reinvested in the business. This reinvestment of profits entrenches the moat even further and long-term shareholders benefit from the power of compounding.
2. These businesses tend to generate strong cash flow and if managed by shareholder-centric management will consistently pay out a portion of the cash as dividends.
3. The share prices of these businesses tend to be more stable than the average market, albeit not immune to economic downturns and bear markets.
4. The valuations are still reasonable and growth in profits over the next few years off current levels should still translate into similar types of capital returns.

We do also own some cyclical companies such as resource producers, which are trading at attractive valuations where the market is underestimating the long-term sustainable levels of profitability of these companies. Given the wide range of global economic scenarios that could potentially unfold (with none offering exciting growth potential) and the limited number of opportunities in the domestic market, we are sitting with sufficiently liquid portfolios to enable us to use any significant weakness in stock prices to add to new or existing positions of high quality businesses at more attractive prices.

We expect lower returns to continue but anticipate that volatility will provide buying opportunities

During a road show in February 2010, we expressed expectations of low real returns from stocks for several years as the world makes the necessary adjustments to excessive debt levels and general fiscal mismanagement by developed nations. The low real returns that we have experienced over the past two years, therefore, do not surprise us and we expect this pattern to continue for the near future.

We expect to bolster asset allocation-portfolio real returns through maintaining, and potentially increasing, exposure to inflation-linked bonds, and through maintaining exposure to companies with reasonable pricing power, or businesses with moats.

2012 is likely to deliver some more global dramas on the economic and political front with sharp stock price fluctuations a likely result. These fluctuations are an astute investor's best friend as they provide excellent buying opportunities that can deliver superior long-term returns.

Does Anglo have the resources to outperform?

By Shaun le Roux

Shaun is a CA(SA) and a CFA charterholder. He has been managing the PSG Equity Fund since 2002.

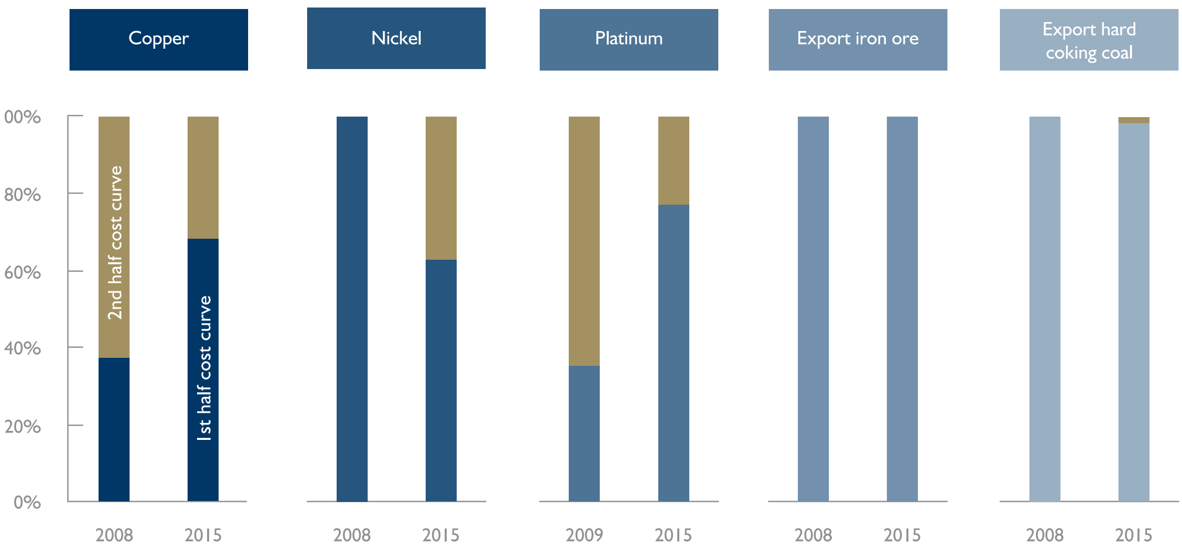
2011 was a year to forget for Anglo shareholders, but attractive value is starting to emerge

In 2011, the market was characterised by the under-performance of companies with an uncertain profit outlook. This was particularly relevant to those earning profits in Europe or where profits could be impacted by a slowdown in China. For example, Anglo's share price declined by 14% in 2011. The share prices of companies with a more positive and stable outlook for earnings had a fantastic year. British American Tobacco's share price rose by 49% and Woolworths rose by 45%. We view many of the resource companies, and Anglo in particular, as being among the more exciting investment opportunities on the JSE at the start of 2012.

High quality companies with pricing power – our first choice for investing – appear to be overpriced

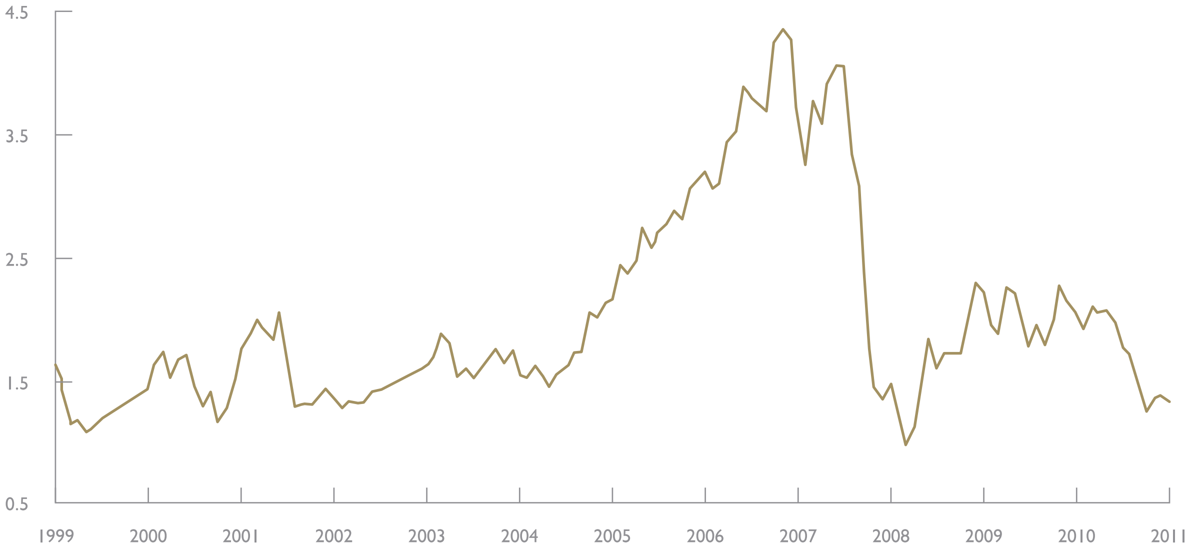
According to our investment process, we favour high quality companies with strong pricing power that comes from having a sustainable competitive advantage or moat. Such companies can reinvest in their businesses and earn high returns on their capital. Patient investors consequently enjoy the benefits of the compounding effect of reinvestment. Unfortunately, the market appears to be overpricing the JSE-listed companies that we would classify as higher quality compounding stocks.

Graph 1: Anglo American's clear-cut strategy to move into the lower half of the production cost curve



Source: Company reports

Graph 2: Anglo American's price-to-book ratio



Source: Bloomberg, PSG Asset Management

Resource producers with low production costs, like Anglo, offer attractive opportunities

We generally believe that resource companies, as producers of commodities, have little opportunity to differentiate their product and have no pricing power. In fact, a resource producer's possibly only competitive advantage lies in their ability to produce at sustainably lower costs than their competitors.

When we analyse mining companies, we particularly pay attention to where they lie on the cost curve for the metals that they produce. Producing at a low cost has several advantages. Such businesses:

- Are less susceptible to price fluctuations;
- Can remain profitable even in the toughest of times; and
- Enjoy the benefits of margin expansion in good times.

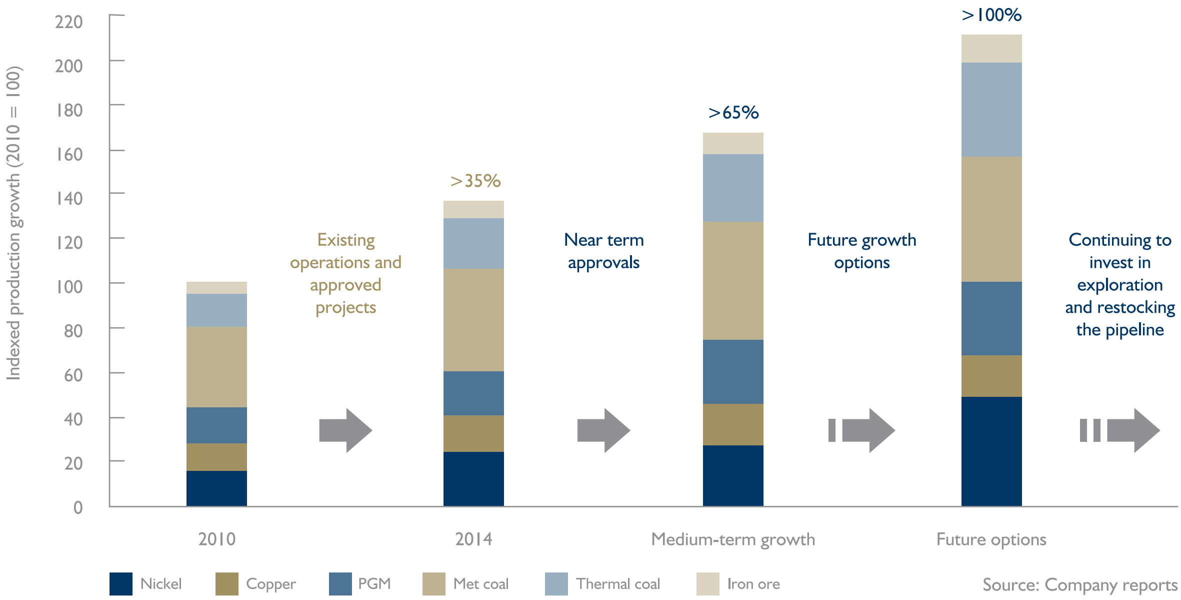
The world's largest mining companies, including Anglo and BHP Billiton, typically focus their capital expansion on 'tier 1 resources' or put differently, on very large low risk/high return opportunities. Although these projects require enormous capital commitment, the quality and grade of the ore body means that resources can be mined at a relatively low cost and the life of the mine is long. As Graph 1 shows, Anglo is placing a high priority on becoming a low cost producer in all of their key commodities.

Strategic and operational improvements by Anglo's Management are encouraging

Assessing a business's management is an important component of our investment process. We pay special attention to whether strategy, track records and remuneration indicate that management are effectively aligned with shareholders. Anglo Management's track record was tarnished when they entered the financial crisis with a highly leveraged balance sheet after concluding acquisitions at boom-time multiples. They were forced to halt dividend payments in 2009, which disappointed many investors.

Since then, Anglo has made significant strides in improving efficiency across the Group and has sold off most of its non-core assets. The balance sheet should be in a net cash position by December 2012, contrary to a net debt position of more than 50% in 2008. We believe that the Anglo Board has taken tremendous effort to improve Management's effectiveness in recent years. The long-term strategy is now clearly communicated as described in their annual reports and we can identify with the decision to focus on 'seven key commodities, driving cost reductions, safe operations and pursuing leading industry performance'. Improvements to date have been encouraging.

Graph 3: Anglo American: Anticipated material production growth



Source: Company reports

The margin of safety is attractive

When we think about investing in a company like Anglo, our primary focus is on the margin of safety. Given the lack of pricing power, we prefer to buy the assets at a significant discount to their estimated value. At the time of writing, Anglo was trading at the lower end of its valuation levels of the past 12 years. Ten years ago financial markets were largely unaware of the huge demand for natural resources from developing economies, China in particular.

As shown in Graph 2, the current price-to-book ratio of 1.3 times indicates that the market has a very poor outlook for the sustainability of the current earnings level. It also implies that Anglo will struggle to exceed its cost of capital once profits normalise. While most industrial commodities look like they reached a cyclical peak in the first half of 2011 on the back of diminishing demand, we do not foresee a 2008-type collapse. On the contrary, we anticipate Anglo producing returns on invested capital that are comfortably in excess of its cost of capital on a long-term view.

Future growth plans and cost control will have a positive impact on Anglo's earnings

Graph 3 shows that Anglo is planning exciting projects for the future and is targeting organic volume growth of 35% by 2014, using 2010 as a base. Volume growth, together with better cost control, should mitigate further commodity price weakness. Anglo is currently trading on about 7.5 times their estimated earnings for 2011. While Anglo has entered a difficult stand-off with Codelco over their entitlement regarding Anglo's Sur assets, the price Anglo got from the sale of a 24.5% stake to Mitsubishi indicates the under-appreciated value inherent in its copper and other assets.

Anglo's current positive trends indicate possible favourable returns in future

We currently prefer Anglo to BHP Billiton, which we also own, largely on the basis of valuations. BHP has been able to generate much higher returns on capital than Anglo and the relative premium rating is therefore understandable. In the light of Anglo's recent operational improvements and some of Anglo's key assets currently yielding historically low margins and returns, we see better returns for Anglo in the future.

Despite uncertainty about China we have a positive outlook for returns from commodity producers

Commodity producers are highly leveraged to Chinese demand. As discussed in the previous article, the outlook for economic growth in China is uncertain. While the long-term demand for raw materials cannot be questioned, China could possibly face a sharper than expected slowdown that affects the demand for industrial metals. If this happens, we will likely see further downside for commodity prices and commodity shares like Anglo. But, based on current valuations, we believe the return versus risk equation is firmly balanced in favour of good future returns.

Is Buffet's Berkshire a buy?

By Jan Mouton

Jan Mouton obtained an M.Phil Finance (2002) from the University of Cambridge and also holds a B.Acc cum laude (1996) and Hons B.Acc (1997) from the University of Stellenbosch. He qualified as a Chartered Accountant (South Africa) in 2000. He completed his articles with PricewaterhouseCoopers in 2000. After a further six months at PricewaterhouseCoopers in Amsterdam, he read an M.Phil Finance at the University of Cambridge on a Cambridge Commonwealth Trust Scholarship. On 1 July 2002 he joined PSG where he assisted the corporate finance team in making investment decisions. He has managed the PSG Flexible Fund since 1 November 2004. The PSG Flexible Fund won two Raging Bull Awards in 2011.

Jan is the Chief Investment Officer at PSG Asset Management.

Berkshire Hathaway is currently the third largest holding in the PSG Flexible Fund. We also hold this widely across our other portfolios. Berkshire is an investment holding company with significant exposure to the following industries: insurance, railroads, energy, manufacturing, retail and service businesses. Berkshire also owns an investment portfolio of high quality equities, including Coca-Cola, Wells Fargo, American Express, IBM and Procter & Gamble.

Berkshire's CEO is, of course, the investment icon Warren Buffett. He is admired for his exceptional ability to make the right investment decisions. We like to believe that, by owning shares in Berkshire, our clients have one of the world's greatest investors working for them.

The three M's form the cornerstone of our philosophy – how does Berkshire stack up?

At PSG Asset Management, our investment philosophy is to invest in companies that:

1. Have good management;
2. Have a strong moat; and
3. Are trading at a margin of safety to our estimated intrinsic value.

We will now investigate how Berkshire fares in these categories, which we refer to as the three M's.

Management

Berkshire has achieved consistently high returns since inception. Buffett's track record since he started managing Berkshire in 1965 is exceptional. Over the 46 years to 2010, the net asset value per Berkshire share has grown by 20.2% per year. This is more than double the total return of the S&P500, which has been 9.4% per year. A growth rate of 20.2% per year may not sound extravagant, but the effect of compounding these returns over 46 years means that $1,000 invested at inception would have been worth a whopping $4,738,114 at the end of the period!

The consistency of the returns is also worth noting. Only the 2001 and 2008 financial years produced negative returns and even these were limited to single digits.

- In 2001 Berkshire was affected by the September 11 incident through its reinsurance business.
- In 2008, Berkshire's investment portfolio was negatively affected by the global financial crisis.

Investors all over the world have been having a tough time ever since the start of the financial crisis in 2008. Berkshire went into the crisis holding a lot of cash, which gave them the opportunity to make good investments at bargain prices when panic struck.

'Our flexibility in respect to capital allocation has accounted for much of our progress to date... Having loads of liquidity, though, lets us sleep well. Moreover, during the episodes of financial chaos that occasionally erupt in our economy, we will be equipped both financially and emotionally to play offensive while others scramble for survival. That's what allowed us to invest $15.6 billion in 25 days of panic following the Lehman bankruptcy in 2008.'

Warren Buffett, Letter to Berkshire shareholders, February 2011

This quote illustrates Buffett's flexible approach to asset allocation and how he patiently waits for the right opportunities. When these opportunities arise, usually when everyone else is in a state of panic, he is not afraid to go on a major shopping spree. He did exactly this during the mayhem after the Lehman bankruptcy. In PSG Asset Management's funds, we also follow such a flexible approach to asset allocation and we patiently wait in cash for the right opportunities.

Another example of Buffett investing when everyone else is panicking was Berkshire's $5 billion investment in Bank of America in August 2011. Between the start of 2011 and mid-August of that year, the share price of Bank of America fell by 48% to around $7. Buffett then made a very clever move. He invested $5 billion in Bank of America preference shares that offered a yield of 6% – a very good yield considering that 10-year US Government Bonds were offering a yield of about 2.1% at the time. He also negotiated options to purchase 700 million Bank of America shares at $7.14 per share exercisable over the next 10 years.

At that stage Bank of America's tangible net asset value was $12.65 per share. At an option strike price of $7.14, Berkshire would therefore be buying at a 44% discount to tangible net asset value. As Berkshire only has to pay the $7.14 in 10 years' time, discounting the $7.14 at 6% (the rate Berkshire is getting paid on the preference shares) would mean that the present value that Berkshire has to pay is $3.99, a 68% discount to tangible net asset value. The beauty of this deal is that Berkshire has all the upside if things turn out well for Bank of America as the options will become very valuable, but limited downside as Berkshire owns less risky preference shares.

Buffett is currently 81 years old and it is valid to question whether Berkshire's exceptional management practices will continue once he steps aside. In our opinion the risk of Buffett's retirement is mitigated by the fact that each operating subsidiary has good management. If you read Buffett's letters to shareholders carefully, you will realise that there are others at Berkshire doing the heavy lifting. Furthermore, Berkshire has a rare and hard to replicate management structure in that most Berkshire managers have exactly the job that they want for the rest of their working years. This creates stability and leads to long-term decision-making.

Moat

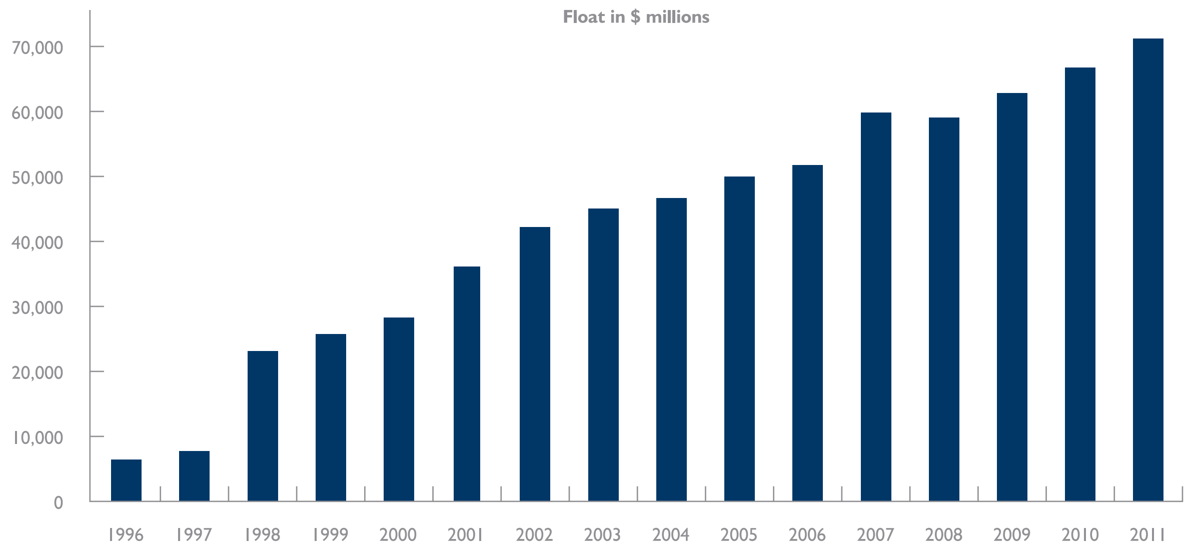
'A truly great business must have an enduring "moat" that protects excellent returns on invested capital. Our criterion of "enduring" causes us to rule out companies in industries prone to rapid and continuous change.'

Warren Buffett, Letter to Berkshire shareholders, February 2008

From the above quote it is clear that Buffett wants a moat when he invests Berkshire's capital. We also want a moat or sustainable competitive advantage when we invest. In the case of Berkshire its extraordinary capital strength creates a moat for the reinsurance business. Insurance companies buy reinsurance for catastrophes that are too large for them to handle on their own, for example an earthquake, hurricane, etc. When the catastrophes strike you want your reinsurer to have the ability to pay up. Berkshire has this ability and this is an excellent marketing tool.

Berkshire's railroad and energy utility businesses are in many cases the sole suppliers in certain markets and to a certain extent have a monopoly – a very strong moat. The rates that

Graph 1: Growth of Berkshire Hathaway's insurance float (1996-2011)



these businesses charge are however subject to regulatory approval. Rates are largely based on the costs of business operations, including a return on capital. If these businesses are well managed, the returns on capital are attractive.

Margin of safety

We prefer to invest in companies where the price we pay for the stock is lower than our evaluation of the company's intrinsic value. The higher the difference between these two values, the greater the margin of safety. We believe Berkshire has such a margin of safety. This margin of safety was confirmend by Buffett himself on 26 September 2011 when he announced a share repurchase program for the first time in Berkshire's history:

'Our Board of Directors has authorised Berkshire Hathaway to repurchase Class A and Class B Berkshire at prices no higher than a 10% premium over the then-current book value of the shares. In the opinion of our Board and Management, the underlying businesses of Berkshire are worth considerably more than this amount, though any such estimate is necessarily imprecise. If we are correct in our opinion, repurchases will enhance the per-share intrinsic value of Berkshire shares, benefiting shareholders who retain their interest… The repurchase programme is expected to continue indefinitely and the amount of purchases will depend entirely upon the levels of cash available, the attractiveness of investment and business opportunities either at hand or on the horizon, and the degree of discount from management's estimate of intrinsic value.'

Berkshire Hathaway news release, 26 September 2011

The book value or net asset value per Berkshire Class A share was $96,876 at 30 September 2011. Adding a 10% premium gives $106,564 per share. As a result of the announced repurchase programme and Berkshire's fortress-like balance sheet, the downside for a Berkshire shareholder from the current share price is limited and the upside enhanced.

Due to the nature of an insurance business it receives insurance premiums in cash in advance and pays claims at a later stage, resulting in a cash float. For Berkshire, as at 30 September 2011, this float amounted to $70 billion! Another positive aspect is that Berkshire generally makes an underwriting profit as the claims paid are less than the premiums received. As a result of the underwriting profit, there is no cost to the $70 billion float and Berkshire shareholders get the investment return on this amount. This float together with the surplus capital in the insurance businesses is invested in an investment portfolio that includes cash, bonds and equities.

In terms of accounting standards, to calculate the net asset value per share of $96,876, the float of $70 billion is deducted as a liability. As discussed above this float costs nothing and is invested in an investment portfolio that generates interest, dividends and investment gains for Berkshire shareholders. The availability of the float is also of a permanent and growing nature and has increased from $6 billion in 1996 to $70 billion in 2011 – see Graph 1. The present value over time of the interest and dividends that Berkshire shareholders will receive on $70 billion will most likely exceed $70 billion.

The float of $70 billion represents an amount of $42,395 per share, if we add the net asset value of $96,876 we calculate a conservatively estimated intrinsic value of $139,271. The share was trading at $114,755 as at 31 December 2011, implying a margin of safety of 18%.

We are confident that Buffett will guide Berkshire through the current turmoil in the market and that our clients will be well rewarded over time.

Meet the Manager: PSG Global Equity Fund

Greg Hopkins

Greg graduated from University of Cape Town in 1993, and qualified as a Chartered Accountant after completing his articles at Ernst Young in 1996. He joined Merrill Lynch Investment Managers (now Blackrock) in London in 1997. On his return to SA in 2006, Greg joined Sanlam Investment Management, where he worked on the Best Ideas Fund product until 2009. Greg joined the PSG Asset Management team in 2010. Greg is Head of Global Equities and manages the PSG Global Equity Fund.

What principles are crucial to successful global investment?

The true essence of a fund manager's job is to try and keep things as simple as possible, as advocated by the forefather of investing, Ben Graham. Five basic investment principles he prescribes are:

1. Be contrarian – buy when others are selling and sell when others are buying.
2. Follow a thorough and patient value-based approach. That is, invest with a margin of safety.
3. Understand what you are investing in.
4. Have an open mind and read widely – keep challenging your thesis.
5. Learn from the past. We all made some mistakes in 2008 and 2009, but the important thing is to go back and analyse these missteps to try to avoid them in the future.

We believe that similar to 'less is more', 'keeping it simple' is a winning investment principle. But most of all, we believe fund managers should be truly passionate about investing. Investing can often become overcomplicated, but the principles that managers need to embrace to be successful are not country- or region-specific. At PSG, we follow the same principles when we invest globally as we do locally.

You're a qualified Chartered Accountant who spent ten years picking stocks in London. What did that teach you?

I was very fortunate to have worked for a leading global asset manager. Initially the company allowed me to move around within the organisation to build a foundation in the various areas of fund management. For example, I spent time with the fixed income team who were investing in government and corporate bonds and currencies.

I also had the privilege to spend time with one of the top US academics in the field of quantitative analysis. Building one of the first stock selection models focusing on emerging markets with him was an enriching learning experience. I then spent the majority of my time on the European equity team as a fund manager in the value team.

Working abroad enabled me to develop a good understanding of some of the best companies in the world. Meeting with their management and studying these companies helped me to accumulate valuable knowledge of both them and the industries within which they operate. This knowledge enables me to put a company that I am analysing and its key drivers in context. We believe the ability to do this is a big advantage if you invest in global stock markets from South Africa.

The time spent learning how to build emerging markets stock-screening models has helped us to develop screens for the ideas we generate. We can now sift through the data of thousands of companies all over the world and filter the best ideas, ignoring companies that don't meet our investment criteria and focusing on those that do.

Having worked overseas for many years, I can honestly say that South Africa has a world-class investment management industry that can hold its own with any of the top global institutions. I am privileged to be a part of the PSG Asset Management team.

What is the PSG Asset Management team's approach to delivering great returns in offshore markets?

We follow a team-based approach. Our rigorous research process feeds directly into both our offshore and domestic portfolios. When we analyse a stock that our screens have identified as one that warrants attention, the stock is allocated to a team of portfolio managers and analysts irrespective of whether it is a global or local stock. We therefore follow the same approach that has delivered great returns for our investors over the last decade in our domestic markets for offshore markets. And we slavishly stick to measuring stocks against our three M's – moat, management and margin of safety.

In addition, we all roll up our sleeves and do primary research – there is no substitute for turning over the stones and understanding the company and its industry. Over the past few months we have spent more time analysing global companies as we are finding promising opportunities beyond our shores.

Why invest in global stockmarkets when South Africa has been such a stellar performer over the last decade?

Many investors ask this valid question. The last decade has seen almost unprecedented wealth creation in South Africa, and rightly so. We entered the previous decade with hugely undervalued stocks and housing markets and a very weak currency.

At PSG Asset Management we believe that the pendulum has swung back somewhat and there are currently great opportunities abroad in household-name companies like Berkshire Hathaway (see article on page 11), the UK food retailer Tesco, Imperial Tobacco (who manufactures Gauloises cigarettes and Cohiba cigars amongst others) and Heineken.

In addition, the deleveraging cycle in the US and Europe has unearthed some great asymmetrical and contrarian opportunities in these markets. For example, when we launched the PSG Global Equity Fund in August 2010, we often spoke about the global spirits company, Diageo, the maker of Johnny Walker whiskey and Smirnoff vodka, amongst other brands. Since then the stock has gone up over 50% in rand terms. We continue to see Diageo as a low-risk company given its strong moat, stable cash flows and significant pricing power. These are the types of opportunities that we seek – low risk and potential for good long-term returns. Although Diageo is a UK-listed company, almost 40% of its revenues come from fast-growing emerging markets.

We don't develop forward-looking views on currencies, though the recent significant sell-off of the rand highlighted the opportunity to diversify one's currency base.

Tell us about the PSG Global Equity Fund that you manage.

We have a great opportunity to invest in the best global equity ideas that come from our research process. We are unconstrained, which means that our investment mandate does not limit us geographically or to a specific industry. The Fund is reasonably concentrated and we typically hold between 30-35 stocks. In the words of Warren Buffett: 'If you understand the business, you don't have to own very many of them.' We believe owning fewer than 30 stocks won't give us sufficient diversification, leading to inevitable errors that impact returns disproportionately. The best fund managers make mistakes. The challenge is to minimise the impact of these mistakes on our clients' portfolios.

What opportunities are you finding out there?

Despite the recent solid performance, global large-cap 'blue-chips' are still providing good opportunities. The question we are asking is: where is the market acting fearfully? US healthcare is an example of where the market fears the regulatory outlook. Global banking stocks, European industrials, and Japan are also good areas to investigate. The biggest danger is that the value-starved fund manager steps up and buys too early and the apparent margin of safety proves to be short lived. Expectations in these areas have been crushed.

Every time we watch or read the news we see crises abroad – in Europe and the US specifically. Should we stay away from these areas?

We wrestle with this question on a daily basis. History has shown that crises offer promising investing opportunities as forced or fearful sellers bring down prices of good companies. When it comes to our knowledge of global stocks, we have to be honest about our limitations as there are a lot of moving parts and possible outcomes. We therefore focus on those companies we know and understand. In addition, there is a possibility that the situation develops into a fully fledged credit and banking crisis, which will push stock prices down further. Our investment process therefore always takes the margin of safety into account.

What do you do when you are not working?

I am an insatiable reader and have been known to get into trouble at home, as I am always escaping with a good book. I spend as much time as possible in the bush or travelling. My lovely wife recently did a month-long field guide course near the Kruger Park. Ever competitive, I have been trying to keep up with her knowledge so I am not shown up in front of my friends.

What is 'RA season'?

by Lizé Visser

Lizé obtained a BComm (1994) from the University of Johannesburg. She joined the industry in 1994 at RMB Unit Trusts. Lizé has held senior management positions at RMB Unit Trusts, Plexus Asset Management, Absa Investments and Investec Asset Management where her duties have always been to focus on the distribution strategy, delivery and support thereof. She joined PSG Asset Management in March 2011 as Head of the LISP. Her responsibilities included managing client services, marketing and sales distribution.

'RA season' is upon us, which means it's time for investors to review their retirement contributions

The South African tax year closes at the end of February each year. This period is often referred to as 'RA season' – short for 'retirement annuity season'.

Currently, taxpayers are allowed certain deductions from their taxable income. These deductions aim to incentivise and promote saving for retirement. At the start of a tax year, most taxpayers cannot tell exactly how much they will earn that year. That is why they must make this calculation close to the end of the year so that they can maximise their retirement contributions and minimise their tax. The most common and easiest way of 'topping up' retirement contributions at the end of the tax year is to make an additional contribution to an existing retirement annuity. You may also purchase a single premium retirement annuity to make up the difference.

How much can a taxpayer contribute to retirement products during the year?

A taxpayer may deduct from their taxable income an amount equal to or greater than:

- 15% of their non-retirement funded income for the year;
- R3,500 less their allowable pension fund contributions; or
- R1,750.

When the end of February draws closer, those taxpayers who have not yet paid up to 15% of their non-retirement funded income must calculate their probable income (as accurately as possible) and then ensure that they pay this over to a retirement fund in time.

What are the characteristics of a retirement annuity?

A retirement annuity allows investors to save before they retire. The annuity provides the investor with income-producing investments during their retirement according to their needs. An investor can have more than one annuity as each annuity has a separate contract with the fund. The investor must nominate one or more beneficiaries of the retirement annuity contract to whom the contracts' benefits should be paid should the investor die before retiring from the fund.

What does a retirement annuity invest in?

At PSG Asset Management, independent financial advisors and their clients have access to a wide range of unit trust funds (local and international funds managed by both PSG Asset Management as well as other managers), hedge funds and other specialist portfolios in which to invest. The only requirement is that the holdings in the portfolios must comply with Regulation 28 of the Pension Funds Act. Regulation 28 essentially aims to ensure that the risks of these portfolios are kept at 'acceptable' levels and in appropriate assets.

How can an investor contribute to a retirement annuity?

Investors can have a number of membership contracts with a retirement annuity fund. They can choose between:

1. A contract with a fixed monthly amount, called a recurring premium retirement annuity, to which investors can add once-off or top-up payments; or
2. A once-off contract with a fixed contribution, called a single premium retirement annuity.

What are some of the benefits of contributing to a retirement annuity?

- Subject to certain limits, retirement annuity contributions are tax-deductible and when the funds eventually pay out, they are either tax-exempt or favourably taxed in the hands of the taxpayer.
- Growth within a retirement annuity fund is not taxed, which means these funds offer potentially higher returns.

- The Income Tax Act permits an employer to reduce the amount of Pay-As-You-Earn (PAYE) tax deductible against an employee's remuneration by the amount of the employee's retirement annuity contributions. This practice enhances an investor's retirement savings. If, for example, a taxpayer has a marginal tax rate of 30% and would like to contribute R1,000 per month, he/she would be able to save R1,429 per month as opposed R1,000 if the monthly PAYE deduction wasn't allowed.
- A retirement annuity fund does not form part of one's estate for estate duty purposes. It's therefore not subject to estate duties, which currently are 20%.
- A retirement annuity fund is also not subject to executors fees, which currently are 3% plus VAT.
- A retirement annuity fund cannot be attached by creditors and is therefore protected against insolvency. This makes these funds especially attractive to taxpayers involved in high risk business ventures and safeguards their income for retirement.

What retirement funds does PSG Asset Management offer?

PSG Asset Management has a complete range of pre- and post-retirement funds to provide for the full range of needs of independent financial advisors and their clients. These include:

- PSG Retirement Annuity;
- PSG Pension and Provident Preservation Funds; and
- PSG Living Annuity.

Each of these funds gives advisors and their clients access to a wide range of underlying unit trusts, hedge funds and other portfolios, which enables them to tailor appropriate solutions fulfil all their retirement needs.

How can independent financial advisors use the PSG Retirement Annuity to assist their clients?

Independent financial advisors will be attracted to a PSG Retirement Annuity firstly due to the trust that their clients will feel from investing with a company as established, solid and stable as PSG. Investing in a PSG Retirement Annuity is easy. Simply go to our website at www.psgam.co.za, click on 'Funds', select 'PSG Local Funds' from the dropdown list and click on 'Retirement Annuity'. All the required information will be at your fingertips.

Our 'Portfolio Selection List' (under 'Invest in a Retirement Annuity' on our website) shows the broad range of underlying investment options. This list of carefully selected funds and portfolios enables independent financial advisors to truly tailor the appropriate solution for their clients. Advisors and investors can view the retirement annuity investment details in the secure online portal at any time.

We look forward to welcoming more clients

As 'RA season' draws closer, we at PSG Asset Management are ready and excited to process new applications and top-ups. The PSG Retirement Annuity is an excellent investment option for making year-end contributions safely, quickly and efficiently, enabling investors to take advantage of tax breaks.

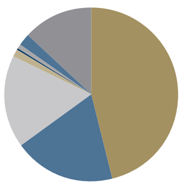
Portfolio holdings and performance as at 31 December 2011

PSG Global Equity Fund

Top 10 equities

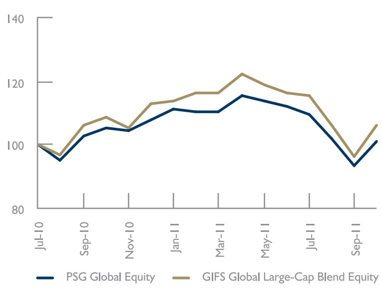
Tesco Plc
Microsoft Corp
Unilever
Berkshire Hathaway Inc
Imperical Tobacco Plc
Heineken Ord
Diageo Plc
Alstom
Exelon Corp
BP Plc

Regional allocation



US	46.3%
UK	18.9%
Europe ex UK	17.1%
Japan	1.5%
China	0.2%
Brazil	0.8%
Africa	2.2%
Foreign equity	**87.0%**
Cash	**13.0%**
Total	**100.0%**

Performance

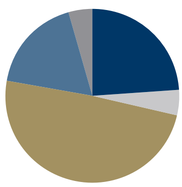


PSG Equity Fund

Top 10 equities

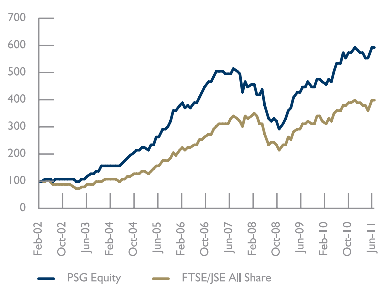
MTN Group Limited
BHP Billiton Plc
Anglo American Plc
Tongaat-Hulett Limited
Sasol Limited
EOH Holdings Limited
Steinhoff International Holdings Limited
Nampak Limited
Grindrod Limited
Laboratory Corp of America

Asset allocation



Resources	23.9%
Financials	4.8%
Industrials	49.3%
Domestic Equity	**78.0%**
Foreign equity	**17.7%**
Domestic cash	**4.3%**
Total	**100.0%**

Performance

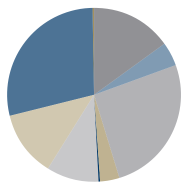


PSG Flexible Fund

Top 10 equities

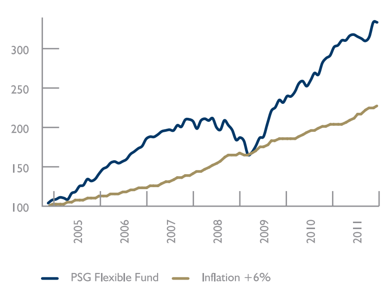
Steinhoff International Holdings Limited
Sasol Limited
Berkshire Hathaway Inc
Anglo American Plc
Capital Shopping Centres Group Plc
EOH Holdings Limited
Tesco Plc
ING Group NV
Grindrod Limited
BHP Billiton Plc

Asset and sector allocation



Resources	15.0%
Financials	4.5%
Industrials	25.8%
Property	3.6%
Domestic equity	**48.9%**
Resources	0.5%
Financials	9.6%
Industrials	12.3%
Foreign equity	**22.4%**
Domestic cash	**28.6%**
Foreign cash	**0.1%**
Total	**100.0%**

Performance

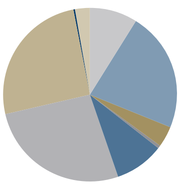


PSG Balanced Fund

Top 10 equities

Steinhoff International Holdings Limited
Anglo American Plc
Sasol Limited
EOH Holdings Limited
Kagiso Media Limited
Tesco Plc
Microsoft Corp
Reunert Limited
Tongaat-Hulett Limited
Grindrod Limited

Asset and sector allocation



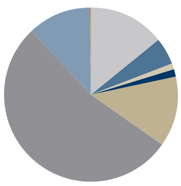
Resources	8.9%
Financials	22.4%
Industrials	3.8%
Property	0.6%
Domestic equity	**35.7%**
Domestic bonds	**9.0%**
Domestic cash	**26.90%**
Foreign equity	**25.6%**
Foreign bonds	**0.2%**
Foreign cash	**2.6%**
Total	**100.0%**

PSG Stable Fund

Top 10 equities

Steinhoff International Holdings Limited
Berkshire Hathaway Inc
Sasol Limited
Anglo American Plc
Oceana Group Limited
EOH Holdings Limited
Tesco Plc
Diageo Plc
Capevin Invest Limited
Capital Shopping Centres Group Plc

Asset and sector allocation



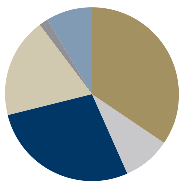
Resources	14.4%
Financials	4.9%
Industrials	1.1%
Property	1.4%
Domestic equity	**21.8%**
Domestic bonds	**13.2%**
Domestic cash	**53.2%**
Foreign equity	**11.7%**
- **Foreign bonds**	**0.0%**
Foreign cash	**0.1%**
Total	**100.0%**

PSG Income Fund

Top 10 FI assets

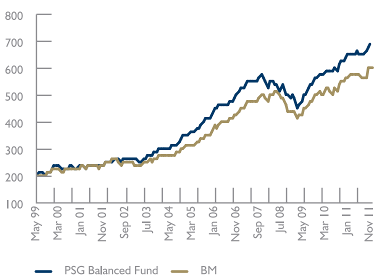
RSA Government Bonds
Nedbank
FirstRand
ABSA
Standard Bank
Capitec Bank
Growthpoint
Eqstra
Steinhoff International
Bidvest

Asset allocation



Listed bonds	34.6%
Promissory notes	9.0%
Floating rate notes	27.7%
NCDs	18.5%
Preference shares	1.8%
Call and cash	8.4%
Total	**100.0%**

Performance



*Performance may only be stated once a fund has a 12-month track record

*Performance may only be stated once a fund has a 12-month track record

Performance to 31 December 2011

FUND PERFORMANCE		1 Year			2 Years**		
Fund	Fund Size	Return	Sector Rank	Sector Count	Return	Sector Rank	Sector Count
CORE FUNDS							
PSG Equity A	R 738 473 383.93	5.59	17	79	12.92	13	77
FTSE/JSE All Share TR ZAR		2.57			10.47		
Domestic EQ General		3.16			10.37		
PSG Flexible	R 1 801 424 723.50	10.48	9	60	17.99	4	57
Domestic AA Flexible		5.78			9.70		
PSG Balanced A	R 1 080 844 700.73	8.21	8	70	11.53	5	60
Domestic AA Pru Variable Equity		5.51			8.15		
PSG Stable ***	R 29 637 975.00						
Domestic AA Pru Low Equity							
PSG Income***	R 43 579 312.53						
STeFI Call Deposit ZAR							
PSG Money Market A	R 1 969 612 045.00	5.45	15	25	6.15	15	24
Domestic FI Money Market		5.48			6.18		
PSG Global Equity	$ 28,521,569.00	-9.29	310	581			
MSCI World Free GR USD		-5.02					
GIFS Global Large-Cap Blend Equity		-11.16					
PSG Global Equity Feeder***	R 29 744 707.74						
Foreign EQ General							
SPECIALIST FUNDS							
PSG Preferred Dividend	R 57 595 917.77	6.89			10.47		
STeFI Call Deposit ZAR		5.29			5.77		
PSG Optimal Income	R 133 132 768.60	4.97			6.00		
STeFI Call Deposit ZAR		5.29			5.77		

* Manager inception dates
** Annualised
*** Performance data may only be published after 12 months
All the performance data is net of fees, for a lump sum, includes income, and assumes reinvestment of income on a NAV to BAV basis.
Source: © 2011 Morningstar, Inc. All Rights Reserved as at 30 December 2011.

										VOLATILITY		
3 Years**			5 Years**			Inception**				3 Years**		
Return	Sector Rank	Sector Count	Return	Sector Rank	Sector Count	Inception Date	Return	Sector Rank	Sector Count	Std. Dev.	Sector Reverse Rank	Sector Count
22.31	1	73	6.26	36	57	01/03/2002*	19.99	3	34	14.87	44	73
17.27			8.09				14.93			17.49		
15.31			6.70				16.01			13.71		
21.25	4	51	12.48	2	40	01/11/2004*	18.32	3	18	11.40	37	51
12.27			7.04				13.94			8.74		
13.98	5	54	7.29	16	40	1999/06/01	15.16	3	10	9.16	38	54
10.30			6.75				13.56			7.11		
						2011/09/13	3.17					
							3.64					
						2011/09/01	1.33					
							1.74					
7.12	14	23	8.53	11	19	1998/10/31	9.57	5	7	0.49	13	23
7.13			8.53				9.55			0.49		
						2010/07/23	-2.09	426	558			
							7.22					
							1.42					
						2011/05/04	0.47	21	27			
							-0.69					
12.68			7.60			2006/11/01	7.13			4.60		
6.63			8.06				8.06			0.44		
7.51			7.61			2006/04/10	7.77			2.46		
6.63			8.06				7.96			0.44		

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Retirement Annuities
Endowments
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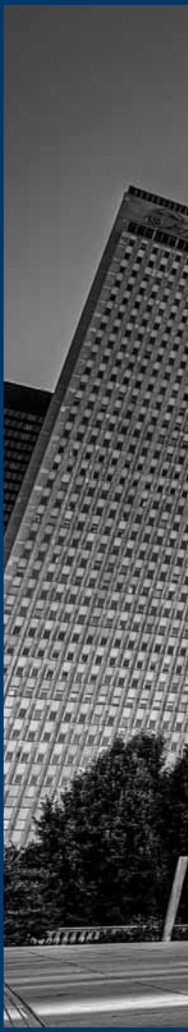
PSG | Asset Management



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