PSG | Asset Management

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ANGLES & PERSPECTIVES

CONTENTS

Welcome to the global edition

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Mark Cliff is a senior investment specialist with PSG Asset Management and the company's Head of Communication. He is a Certified Financial Planner®.

Paris – a dynamic city with a rich history

Have you ever been to Paris? Paris is a very old city with archaeological signs of settlement going back to 4,200BC. When the Black Death hit Europe in 1348, Paris had a population of about 200,000 people. The great cholera epidemic of 1832 killed nearly 20,000 of the 650,000 people living in the city at the time.

The Industrial Revolution brought a network of railways to Paris, which led to a massive wave of migration to the city in the 1840s. The first Paris Metro (underground train) opened in 1900. The Metro and other rail services in the city are integral in transporting the more than 2 million people who live within the city and the 12 million inhabitants of the greater Paris district. There are a lot of people in Paris!

If you take one of the popular bus tours around Paris you may be struck – as I was – by the amount of change the city has been subjected to over centuries and yet how, despite wars and revolutions, pestilence invasions and occupations, the city of Paris has always survived, adapted and grown. Today Paris is the largest city in France and the largest metropolitan area in Europe, and contributes more than 30% of France's GDP. It is the most visited city in the world by tourists and still has a strongly growing population.

Despite the turbulence in Europe, we believe the cloud has a silver lining

Paris has clearly seen trouble in the past and has always overcome its adversities. As one of the leading cities in Europe, the prospects of this area and its inhabitants are important for the prospects of the many companies around the world that are dependent on the Parisians (together with other Europeans) for the consumption of their goods and services. Right now, company share prices are reflecting a somber to bleak outlook for the region. However, Paris's (very apt) motto is 'fluctuat nec megitur', which means 'it is tossed by the waves, but does not sink'. We believe that Paris will survive the current turbulence and so will Europe.

In this edition we focus on the value of a global investment perspective

Against this background, we have decided to focus solely on the importance of South African investors having a global perspective in this edition of Angles & Perspectives.

Neels van Schaik starts this edition with a broad look at the global investment landscape as we see it – focusing on Europe in particular – and explains how we are approaching the markets via the structured application of our investment process.

Paul Bosman writes about how important it is for true value investors to look for opportunities in the unwanted, dark spaces and illustrates this approach with a few examples.

Greg Hopkins, who spent a significant period of time managing a European Equity fund from London before he joined PSG, looks at the risks and opportunities of currently investing in Europe, and how these risks should be measured and managed.

Finally, Shaun le Roux writes about the benefits of holding global stocks in your local portfolio and how, over the years, we have developed a process that allows us to evaluate these stocks not in isolation, but in a holistic way that has been shown to add value to our portfolios.

We trust that you will find this edition interesting. For now, I'm going to take a quiet walk up the Champs Elysees.

It is in chaos that you find opportunity

By Neels van Schaik

Neels van Schaik holds a BComm 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.

"A diamond is a chunk of coal that is made good under pressure."
– Henry Kissinger

Is the investment environment abnormal?

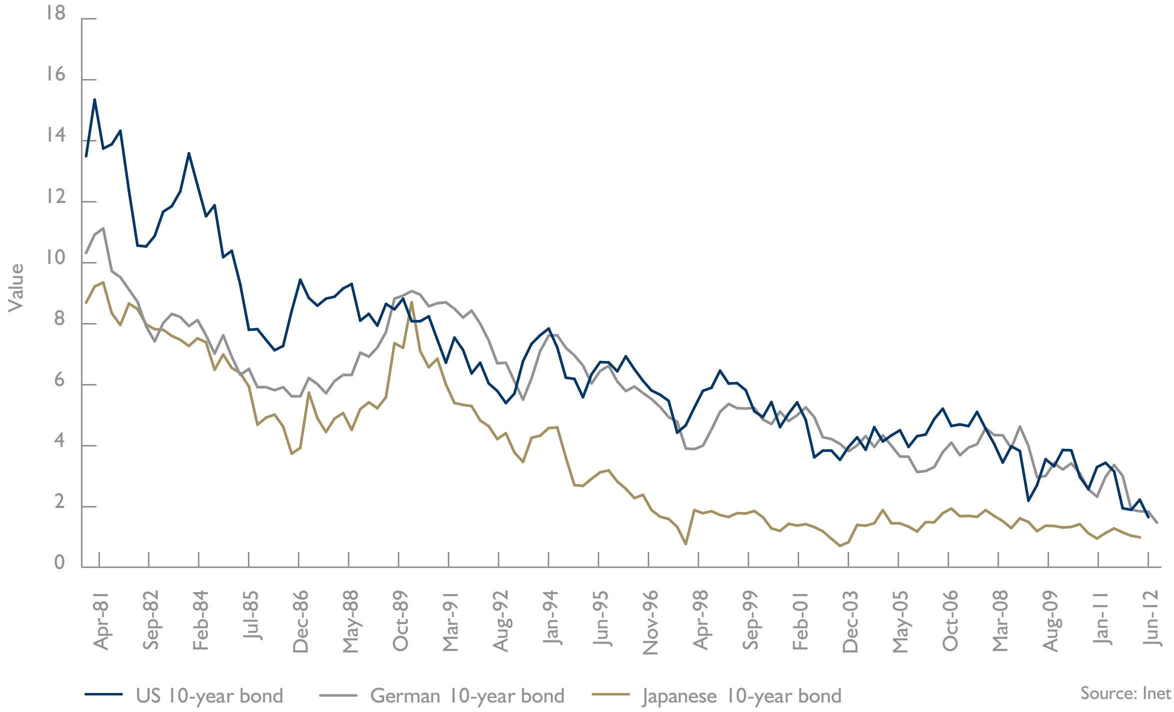
If you are wondering whether we are facing an abnormal investment environment, you need look no further than the yields at which investors are currently lending money to developed market governments.

US 10-year treasury yields are trading at just 1.48%, the lowest level since the sixties. On the other side of the Atlantic, the German 10-year bund is trading at a Euro-era low of 1.25%. It is worth noting that bond yields in both these mature economies have been following the same trajectory as the Japanese bond market since the peak in Japan's economic boom in the late eighties.

Japanese bonds tell the tale

The Japanese bond market has been fairly accurate in its assessment of the Japanese economy. During the last 10-15 years we have witnessed low to negative growth rates and the Japanese Central Bank fighting deflationary pressures.

Graph 1: US, German and Japanese 10-year bond yields



Source: Inet

The current trend in both the US and German bond market is telling a similar tale of deflationary risks and economic stagnation.

Only a couple of months ago, some market commentators were still arguing the decoupling thesis that will see Chinese economic growth maintain its 30-year long growth trajectory, while growth in the West will falter. Given how interlinked the world economy has become, this thesis has always been built more on hope (and fear of the alternative) than simple logic.

This is becoming more evident as growth in many Southeast Asian countries slows down with the rest of the world as the Eurozone's battle for survival reins in growth across the globe.

Eurozone fragmentation?

Bond yields in some developed markets are sending out a clear signal that the policy solutions implemented by European policy makers are not enough to stop the Eurozone from disintegrating. This is very well illustrated when comparing 10-year bond yields of peripheral European economies to that of Germany.

The 10-year bond yields of countries like Greece, Portugal and Spain are currently trading at 24%, 10.1% and 6.8% respectively – levels that make new debt repayments unaffordable. It has become a vicious circle that has essentially squeezed some of these peripheral countries out of global capital markets and they need to look elsewhere for financing to plug the holes, let alone to fund growth policies. It is too late for countries like Greece or Portugal to save themselves from recession. These peripheral countries need to either grow themselves out of debt or inflate their way out of it; or potentially both.

The best way of extricating themselves would be to exit the European currency zone, default on the sovereign debt and start with a fresh balance sheet. It will certainly be extremely painful in the short term, but rather short-term pain than being the lab rat in the grand experiment to see whether a currency union can actually work.

Currency devaluation is not an option within the Eurozone

Currency devaluation has been an important policy tool that many countries have used historically to inflate their debt away. Peripheral Eurozone countries however owe debt in a currency that they can't devalue or print, and they are dependent on the European Central Bank to set monetary policy. This policy might be effective for the core European countries, but it is totally inadequate to solve the problems at the periphery.

Current debt levels will be financed at ever increasing interest rates if the recent rise in the PIIGS' bond yields is sustained despite falling economic activity and income. Without the growth policies that some of the newly elected European leaders are pushing for, some countries that have been facing a liquidity crunch, will end up becoming insolvent.

For peripheral countries to grow, they must become more competitive again. They will struggle to achieve that if their unit labour cost is 20% more expensive than the Northern European countries. In a very detailed analysis of the current state of the Eurozone entitled "A primer on the Euro breakup: default, exit and devaluation as the optimal solution", author, portfolio manager and analyst Jonathan Tepper highlights the fact that the divergences between some of the intra-Euro effective exchange rates are as wide as 35%. Normally these divergences in competitiveness between countries rebalance through currency de- or ap-preciation. In the absence of such a mechanism, the burden of adjustment will have to fall on wages and prices.

It is quite clear what the herd is thinking...

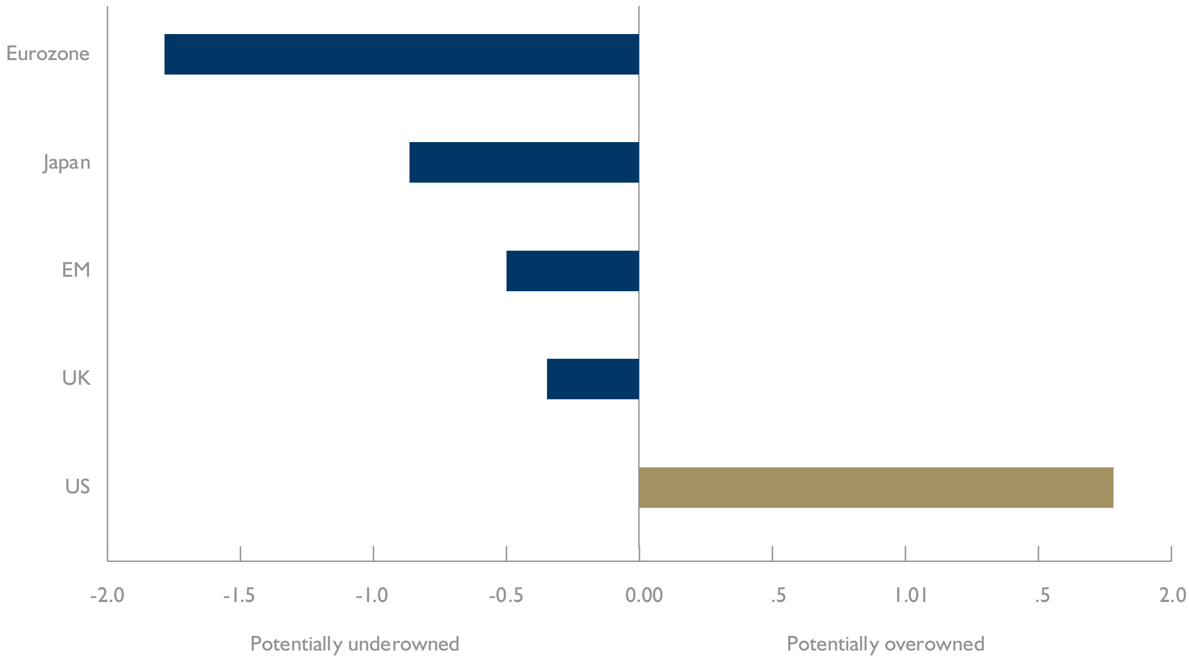
Ultimately there is a very high probability that one or two of the peripheral European countries will have to exit the European currency zone. It might not happen in the next month, but there is a very big chance that it will happen eventually. The implications that this will have for economic growth in the region and for the rest of the globe is very uncertain. As a result, many offshore stocks have sold off significantly and professional money managers have been exiting the region aggressively as shown in a recent global fund manager survey conducted by Bank of America Merrill Lynch. (See Graph 2.)

...but that is where the opportunity lies

The current dire economic conditions in Europe and the herd mentality that normally prevails in the investment industry are creating the ideal hunting ground for contrarian investors that are willing to roll up their sleeves and get their hands dirty. By nature, we gravitate towards opportunities where the stock prices of good quality businesses are sharing the same fate as those of a much lower quality. In an environment where investment horizons can now be measured in days, we believe patient investors will reap significant rewards over the next few years.

The most important tool that investors need in the current environment, is a sound investment process that takes emotion out of investment decisions. Such a process is, and should never be static. Like all investors, we have made mistakes in the past. But we have rigorously worked at adjusting our process to accommodate the lessons we have learned from such mistakes and we are well positioned and equipped to benefit from any opportunities that will arrive from the current crisis.

Graph 2: Global region positioning relative to history (z-score)



Source: Bank of America Merrill Lynch

US stocks are over-owned at 1.8 standard deviations above the historical norm and Eurozone stocks are under-owned at 1.8 standard deviations below the historical norm.

Having set the scene, in the articles that follow, we will try to illustrate with a few examples where we currently see value in the global investment arena. More importantly, we will discuss how our investment process is guiding us towards these opportunities and helping us to understand the risks inherent in these opportunities.

Contrarian: Finding gems in the darkest places

By Paul Bosman

Paul joined PSG in 2004 when he began working for PSG Capital as an equity analyst. In November 2004 he joined the PSG Tanzanite team as an equity analyst. With the incorporation of PSG Tanzanite into PSG Asset Management, Paul continued as an equity analyst, specialising in both local and offshore listed companies. On 1 September 2011 Paul became a Portfolio Manager at PSG Asset Management and is responsible for the management of the PSG Stable Fund.

Our investment philosophy – the three c's

Regular followers of PSG Asset Management will know that we hunt tirelessly for companies that have wide moats, are run by strong management teams and are trading at an enticing margin of safety. Until now, we have however not written much about our investment philosophy.

The term 'investment philosophy' frequently appears in marketing material, possibly because it creates an impression of a mysterious wealth of investment knowledge that has been carefully distilled into the Holy Grail of capital allocations.

At PSG Asset Management, we see our investment philosophy more practically as though it were the direction provided by a non-executive board of directors. We summarise our philosophy into just three words: consistent, conservative and contrarian.

Consistent and conservative: important and comfortable

Consistent refers to the way in which we apply our philosophy and process across our full range of funds and how this application has remained the same over a long period of time and through different market conditions. Regardless of what the markets throw at us, we apply our methodology consistently.

Conservative refers to our approach to valuing assets. In valuation assumptions we remain cognisant of the fact that spring doesn't last forever. We provide for the dark clouds that stifle growth.

These two c's, consistent and conservative, instil discipline in our thinking and methodologies.

Contrarian: crucial and very uncomfortable

Contrarianism is at the heart of true value investing and shows us where and when to look for opportunities. Being consistent and conservative is relatively easy. Being contrarian is not. It means having to go against popular and widely-held views. It demands courage and guts.

Let's delve a bit deeper into two of our more contrarian holdings.

The construction industry: Buying the right builder at the 'wrong' time

Despite all the anxiety in Europe, South African equities in general remain stubbornly expensive. We hold a number of high quality South African industrial companies that we believe still offer value, but the contrarian opportunities are more limited.

In our opinion, the only two local industries where the market is pricing in overly pessimistic prospects are resources and construction. Our funds have reasonably large exposure to resource companies, but we have also found one opportunity in the construction sector.

Consider Graph 1 on the next page as a gauge of the market's lack of excitement about the anticipated future profits to be generated by the construction industry in South Africa.

It is important to point out that at PSG Asset Management we focus on buying high quality companies, which means an undervalued sector does not necessarily imply opportunities. We look for a company that we really want our clients to own. Fortunately for our investors, a company called Stefanutti Stocks listed in the construction heydays and, as fortunately, we did not buy it for our funds on listing.

Graph 1: FTSE/JSE Africa Construction and Materials Index

Source: Bloomberg

Graph 2 on page 7 illustrates how the company's price earnings (P:E) ratio has compressed over the last number of years.

The management team at Stefanutti Stocks has a very strong operational track record and, very importantly, are shareholders in the business. The company is well diversified across construction disciplines, with a favourable mix towards the higher margin, more specialised subsectors. We are not able to build enough conviction around the moats in this industry to justify a large exposure to this company. However, at a seven multiple on low profits, the margin of safety is sufficient for inclusion in our portfolios, albeit a smaller holding.

European banks not selling like hotcakes

Another example of the execution of our contrarian approach is acquiring ING Group when the very existence of the European Monetary Union is uncertain.

The Group is listed in Amsterdam and, with most of its assets being European, it currently finds itself in the teeth of the gale. The share price, as illustrated in Graph 3, tells the tale.

Are we being brave or ignorant?

ING Group has total assets of €1.2 trillion. The Group generates approximately 70% of profits from banking activities and the remainder from insurance services. Roughly 80% of banking profits are generated in Europe, mostly in the Netherlands, Belgium and Germany. The ING Group's banking subsidiaries include ING Direct, the world's largest direct bank, whose operational efficiency makes it a lethal competitor and it is a valuable asset for the Group. ING Insurance generates approximately 25% of profits in the Asia/Pacific region and the remainder about equally in Europe and North America.

What's the attraction?

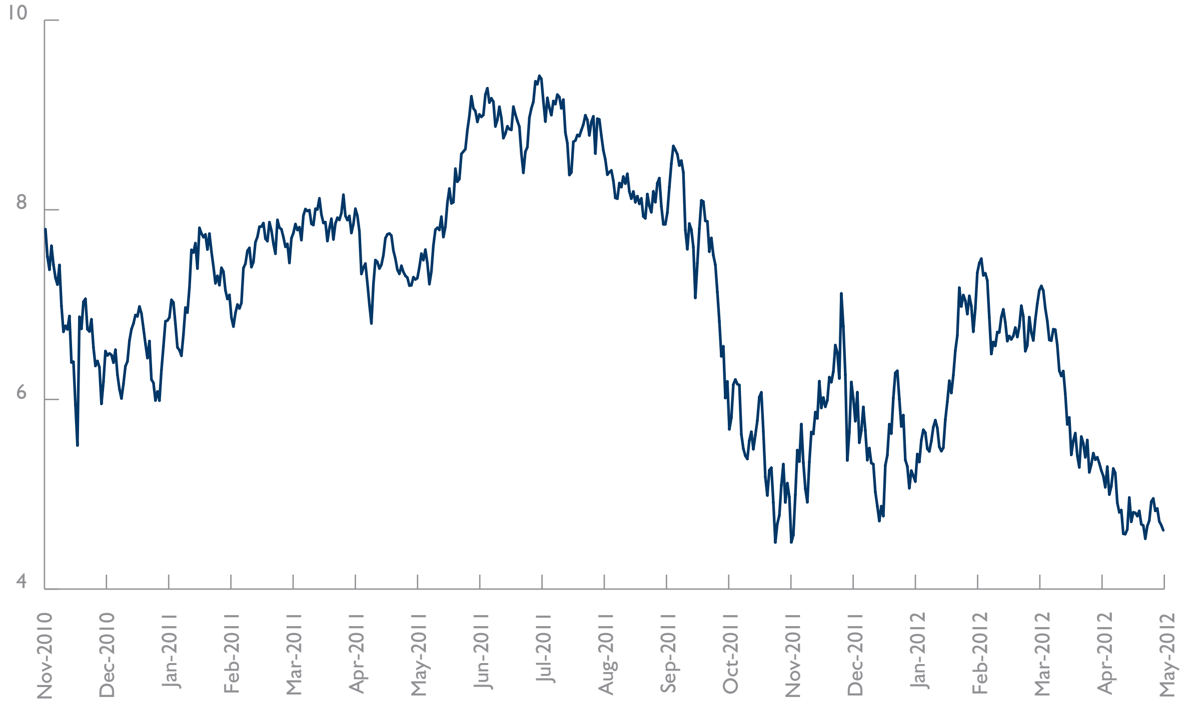
In short, ING is a strong brand with wide distribution and a number of dominant market positions. The bank as well as the insurance business are well capitalised. Despite the tremendous turmoil in Western Europe, ING has been performing well operationally. In 2011 the Group made €4.5 billion profit, up from €3.9 billion in the previous year.

We added the share to our buy list when it was trading at €9.20; the current price is €4.62. Some readers may be wondering how we made such a mistake. When we started to buy, the company was trading at a 4% discount to tangible net asset value (NAV), which is generally an attractive entry point for a profitable business. Since then the tangible NAV has grown by 21%, but the share price has dropped by 50%. As a result the company currently trades at 40% of net tangible assets. Sometimes cheap stocks get cheaper, and sometimes they get much cheaper.

Graph 2: Stefanutti stocks P:E ratio

Source: Bloomberg

Graph 3: ING Group share price



Source: Bloomberg

Naturally we cannot and do not ignore the current uncertainty with regards to the value of European assets. Nobody knows how big the hole is, and neither do we. However, we think we know how big the hole is not.

Table 1: ING Group's total exposure to the PIIGS

	Total exposure in □m (all asset classes)
Portugal	2,926
Italy	24,074
Ireland	3,414
Greece	421
Spain	39,517
Total	**70,352**

What we do know is that the Group's tangible net assets currently exceed its market capitalisation by □28 billion. This is roughly equal to 40% of the total PIIGS assets on ING's balance sheet.

In our view, it is unlikely that ING will only receive 60% of its entitled cash flows from these countries. Naturally there are many other possible risks, like a contagious banking crisis or large losses in other areas where ING operates. Being contrarian is not risk free. We think the margin of safety is wide enough for our clients to have some exposure to this particular financial services group.

If anything but the worst case scenario materialises, our clients should make money.

Our global outlook provides us with more opportunities

According to our investment process, we analyse and research companies on a global basis. This means that we are not restricted to South African-listed stocks. This flexibility puts us in the position of being able to acquire fantastic contrarian opportunities for our investors, instead of being caught in the straight-jacket of having to pick expensive local stocks from 'the best of a bad bunch'.

We believe that the three c's of our investment philosophy – consistent, conservative and contrarian – provide us with a sure compass towards constructing portfolios that have lower levels of risk and higher return prospects.

The risks and opportunities of investing in Europe

By Greg Hopkins

Greg is a CA (SA) and CFA chartholder. After completing his articles at Ernst Young in 1997, he joined Merrill Lynch Investment Managers (now Blackrock) in London. On his return to SA in 2006, Greg joined Sanlam Investment Management, where he worked on the Best Ideas Fund product until 2009. He joined the PSG Asset Management team in 2010. Greg is Head of Global Equities for the PSG Asset Management team and manages the PSG Global Equity Fund.

Is there currently value in Europe?

Paul Bosman's article above highlights the importance of being contrarian in our investment philosophy. He also gives a good example of a stock at the front line of the current pitched battle between the bulls and the bears in Europe.

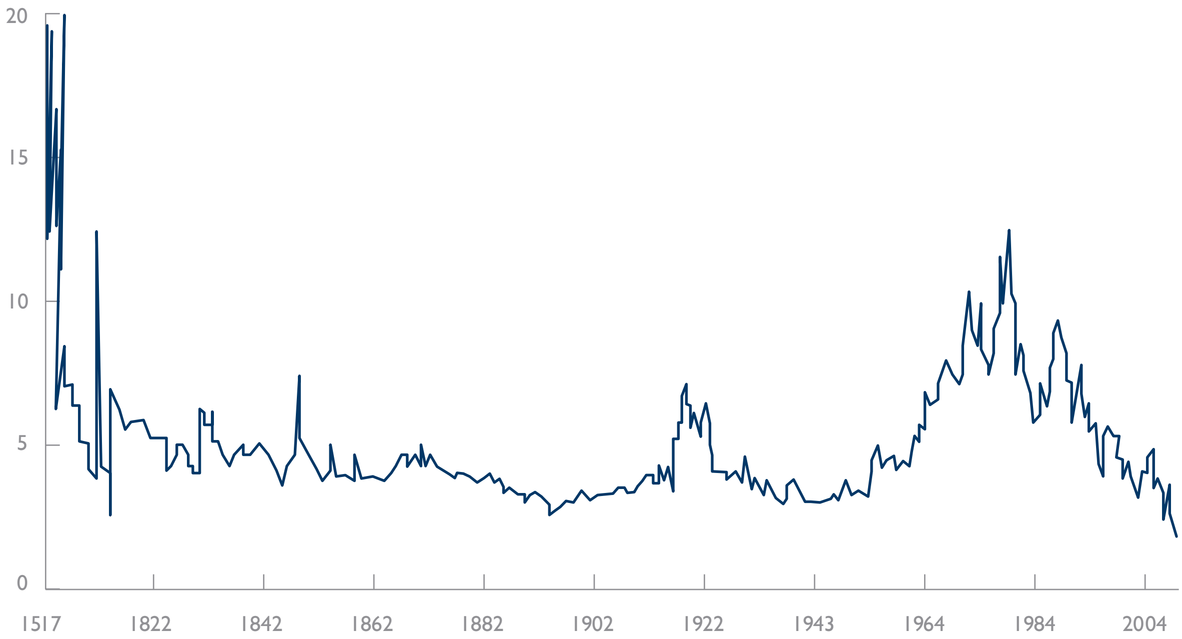
We believe it's worth exploring the European investment theme and, within this context, how we incorporate risk into our overall investment process.

Contrarians are attracted to bad noise

There is a lot of bad noise surrounding Europe right now. When this happens, contrarian value managers start to smell blood in the water. The valuations of many great companies are at near-record low levels, which would normally be an indicator that it's time to buy. Let's take a look at some of the evidence.

A few interesting charts have recently crossed our desks. Graph 1 points out that Dutch bond yields are now at 500-year lows.

Graph 1: Netherlands 10-year Government bond yields



Sources: BotA Merill Lynch Global Equity Strategy, Global Financial Data, Bloomberg

Graph 2 illustrates that Europe has underperformed the US by over three standard deviations over the past 20 years.

The pervasive fear in Europe has created opportunities

Merrill Lynch have highlighted that, as at the end of May, the market capitalisation of all Greek equities was just under $6 billion ('The death of bonds', Hartnett). This happened to be the same as just one South African company – our own Aspen Pharma – which is around the 25th largest in our South African screening universe.

Across the pond, US bond yields have recently made 200-year lows, a record that was previously set in November 1945.

Given the clearly Armageddon-like headlines emanating from the European region, these charts will not be a surprise to most. What they might indicate however, is the extreme pessimism that is currently being reflected in current market valuations.

When the bears get excited, it's probably time to start taking notice

History has taught us that stockmarkets are often very good at pricing the news headlines of the day. As 'perma-bear' Albert Edwards, often points out, the macro environment always looks awful when the market is cheap. CLSA's Russell Napier, another perma bear, has recently become a European bull and in a very interesting video on the FT website ('Uber-bear sees value in Europe') he points out that Europe is now close to the 1982 cyclically adjusted price earnings (CAPE or Shiller P:E) ratio lows, which marked the start of the last great bull market. (See Graph 3.)

Graph 3 was constructed in March of this year. If we update the chart with the recent sell-off, it will show that we are moving even closer to those 30-year lows.

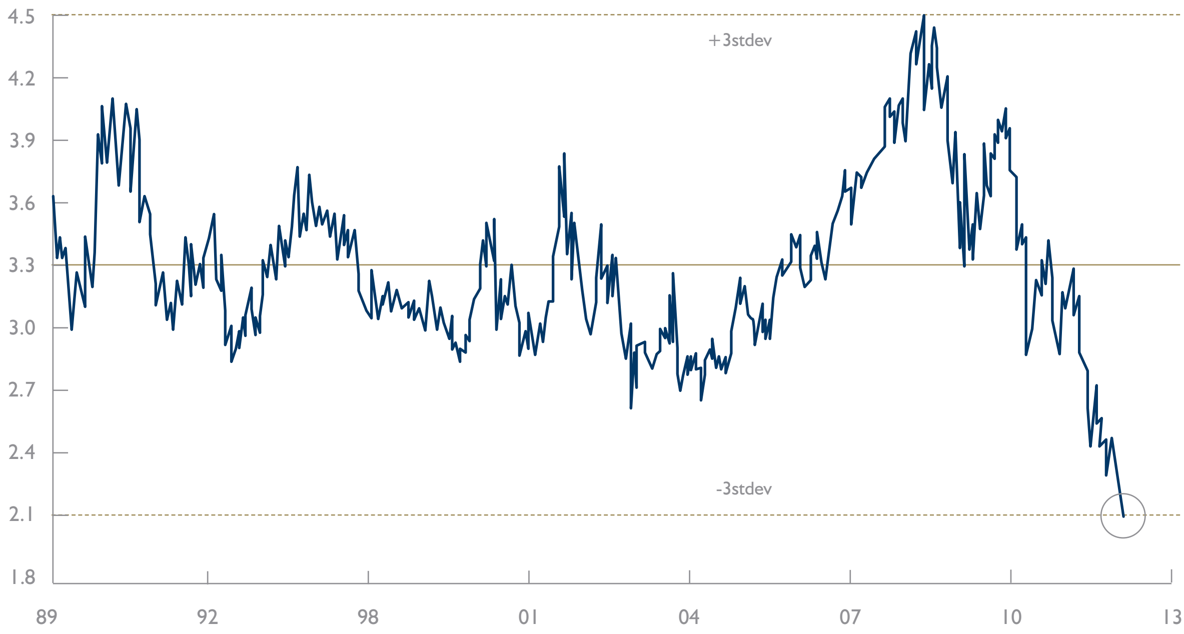
We agree with the view that valuation metrics do not give us an indication of the timing of the bottom of the market, although they do highlight where value might be found for above average future returns. They also highlight areas to look for a potential significant margin of safety.

Do not be blind to the risks

There are clearly risks associated with investing in European or any equity markets, or for that matter investing in global bonds at current valuations. Price moves (volatility) are, in our mind, not one of these risks – unless one has a short-term horizon.

Our assessment of equity risk or the risk that we will suffer a permanent loss of capital, emanates from our bottom-up investment process. Graph 4 is a simple checklist of some of the metrics we use to assess the required return or discount rate that we would build into our intrinsic value calculations.

Graph 2: Eurostoxx 50 relative to the S&P500 Index in dollar terms

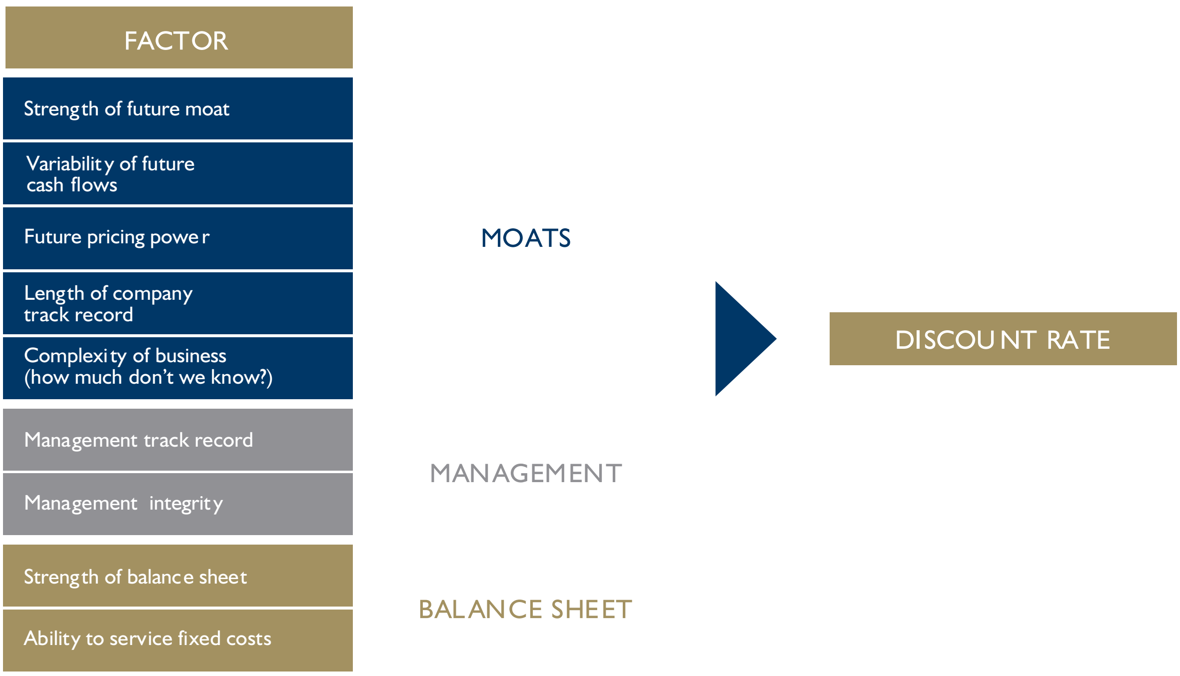


Sources: BotA Merill Lynch Global Equity Strategy, Global Financial Data, Bloomberg

Graph 3: Cyclically adjusted European P:E and equity real return

Source: Datastream, Goldman Sachs Global ECS Research

Graph 4: Metrics checklist to assess the discount rate



Source: PSG Asset Management

In essence, we are asking how wrong we could be in the future or, in another manner of speaking, how much we don't know when we invest in a specific business. Certain factors, such as the length of company and management track records or its strength of pricing power, make it easier to answer these questions.

What we don't know

Using this checklist, potential investments with higher perceived risks will typically demand higher required returns or discount rates. With this in mind, there are many things that we don't know that may impact European business cash flows 5 or 10 years from now, which will mean that we will use a higher hurdle rate when evaluating these cash flows.

One of these may be a financial (or banking) crisis that could hinder a company's ability to operate their business. At PSG we look to invest in great companies with excellent management teams and that are trading at very attractive valuations. Part of that analysis, as highlighted in Graph 4, is an assessment of the company's balance sheet or the probability that it will be around to continue fighting in extremely stressed economic environments. This forms the core of any margin of safety assessment.

Try to avoid terminal paralysis

Think back to the state of global markets at the end of the first quarter of 2009 and the amount of doom and gloom that had enveloped the world. Jeremy Grantham of GMO wrote a great piece back then entitled 'Reinvesting when terrified', which turned out to be prophetic.

Grantham wrote: "Every decline will enhance the beauty of cash until, as some of us experienced in 1974, 'terminal paralysis' sets in. Those who were over invested will be catatonic and just sit and pray. Those few who look brilliant, oozing cash, will not want to easily give up their brilliance. So almost everyone is watching and waiting with their inertia beginning to set like concrete. Typically, those with a lot of cash will miss a very large chunk of the market recovery."

"Remember that you will never catch the low. Sensible value-based investors will always sell too early in bubbles and buy too early in busts. But in return, you may make some important extra money on the roundtrip as well as lowering the average risk exposure… Life is simple: if you invest too much too soon you will regret it … On the other hand, if you invest too little after talking about handsome potential returns and the market rallies, you deserve to be shot… Be aware that the market does not turn when it sees light at the end of the tunnel. It turns when all looks black, but just a subtle shade less black than the day before."

We continue to look for opportunities in Europe

Europe may or may not have finally hit the wall. We don't know, but we are sticking to our battle plan. Five years from now we don't want to wonder how, having sat in the darkness and having carefully measured the risks, we were paralysed in the prevailing extreme conditions and missed a great opportunity to buy a number of top quality companies at exceptional valuations.

Benefits of global stocks in your local portfolio

By Shaun le Roux

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

Exposure to offshore equities will be an important contributor to PSG fund performance

South Africa's unit trusts can invest up to 25% of their net asset value in offshore assets – if their mandate allows them to do so. We believe that sensible application of this leeway can and will significantly enhance risk-adjusted portfolio returns over the long run and that funds like ours that make use of this flexibility will enjoy greater opportunity to both increase returns and decrease risk over time for their investors.

Foreign currency exposure can help preserve capital in times of heightened volatility

It goes without saying that including offshore assets in a portfolio allows it to partly diversify its currency exposure. If all the assets of a fund are rand-denominated, rand volatility can play a major part in relative return. The rand usually depreciates at times when market risk is higher and capital preservation becomes more important. A weaker rand means that the purchasing power of rand assets has declined.

There are times when global bonds are priced attractively enough to offer sufficient returns at reasonable risk and we would then advocate their inclusion in a diversified multi-asset portfolio. Unfortunately this is not one of these times. At current valuation levels global bonds look materially over-priced relative to the risk. Yields are very low while sovereign balance sheets are in a perilous state – not a happy combination for future returns.

The PSG funds have maximum offshore equity exposure

PSG's portfolios are generally all fully invested (to the maximum allowed) in offshore equities. Even the PSG Equity Fund, our domestic general equity fund, has invested 25% of its value in global shares. We currently see tremendous opportunity to generate very good returns over the long run with carefully selected offshore stocks.

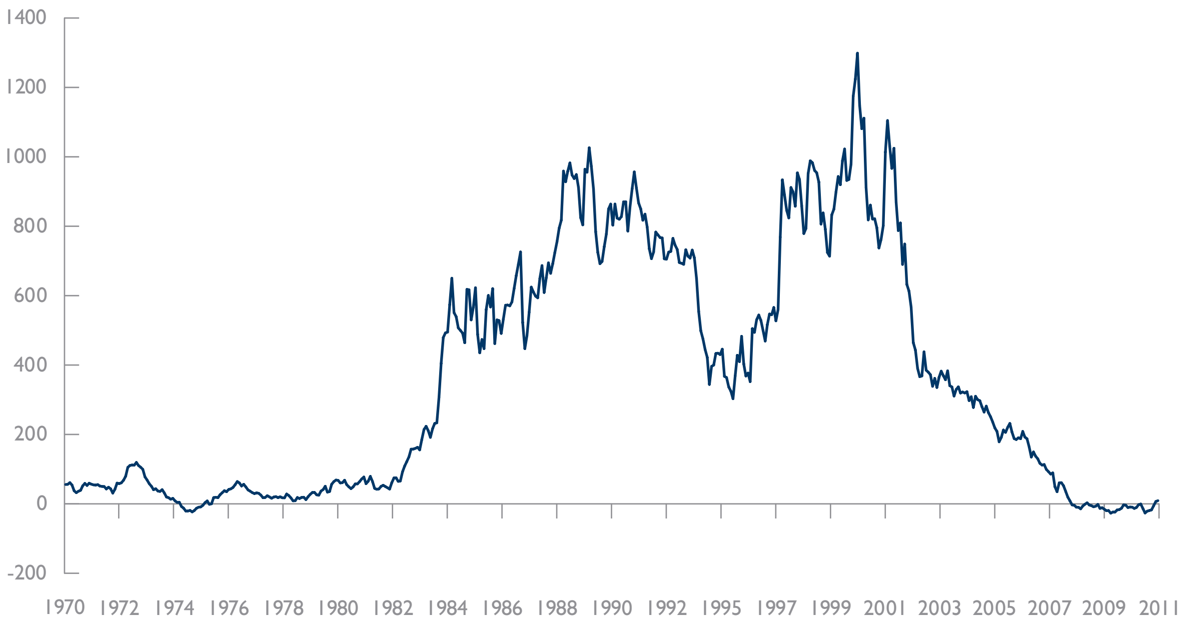
As bottom-up stock pickers, we prefer to select stocks individually and invest directly into global equities. More than two years ago we extended our team-based investment process to incorporate global equities. Our investment team applies the same consistent approach to analysing stocks regardless of where they are listed. The same process and research goes into building conviction stock ideas for inclusion in our direct global equity fund, the PSG Global Equity Fund, as for our domestic unit trusts.

The benefits of holding both local and offshore stocks

Carefully selected offshore stocks serve our portfolios well. Their benefits include:

- *An enhanced investment universe:* The investable opportunities in SA are limited. The JSE All Share Index has 142 companies with a market capitalisation of R2 billion and above. Very large asset managers will find their investable universe is constrained. Holding direct offshore stocks extends the investment universe by several thousand potential opportunities.
- *Access to diversified earnings drivers:* Generally, there are few stocks on the JSE that aren't heavily exposed to the South African economy and/or world commodity markets. By including US, European or emerging market stocks, you can diversify exposure to specific economic drivers.
- *Not needing to invest in 'the best of a bad bunch':* Current valuation levels of many of the larger high-quality JSE companies are excessive. We have identified a number of high-quality global businesses that are attractively priced. By including global equities in our portfolios, we can take advantage of this opportunity and are not forced to include overpriced shares because they are the 'best of a bad bunch'.
- *Exposure to better company-specific opportunities within a sector:* A global mandate allows the fund manager to find better specific opportunities than those available on the

Graph 1: S&P 500 Index in rands (rolling 10-year returns %)



Sources: I-Net, PSGAM

JSE, even if they operate in similar sectors. For example, we have a preference for Heineken over SAB Miller, eBay over Naspers, ING over Standard Bank and Tesco over Shoprite.

As Graph 1 shows, investing in global equities is not all plain sailing. Rolling 10-year returns in rands at an S&P 500 index level have been flat to negative for more than three years. However, rand returns on investments made between the mid-1970s and mid-1990s were very good. Based on current valuation levels, we believe that it is unlikely that extreme under-performance of the JSE by developed market equities will persist.

Investing offshore is challenging and requires a proven philosophy, disciplined process and a team with appropriate skills

Investing offshore is a difficult business. The universe is massive and most South Africans are not particularly familiar with these businesses. Currency movements can also wreck returns. Consequently, a disciplined investment process is crucial. We are of the view that an investment process must have the following features to have any chance of being successful:

- *A clearly defined and implemented investing philosophy:* Investors need to be very clear about what type of investments they are looking for offshore. A strategy of chasing areas of high growth or hype does not generally pay off.

- *Robust screening:* A good screening model is necessary to filter and identify opportunities that meet the investment philosophy.

- *Thorough research:* We do not invest before we have done detailed research on and understand a company, the industry in which it operates, its management and its track record. We are happy to walk away from investment ideas where we cannot adequately build such knowledge. We are convinced that a lack of familiarity with offshore businesses requires a greater duty of care in understanding the company and an honest assessment of what we don't know.

- *A value-based approach:* The most important factor in the future contribution of an offshore stock idea is the consistent application of a value-based investment process. This allows the investment team to compare different investment ideas in different countries. The price you pay for an asset plays a huge part in future returns. Take a look at the subsequent returns of an investment into US equities in 2000/2001 when the US market was expensive and the rand was very cheap. Compare that period to the current situation when many US equities are cheap and the rand is on the expensive side.

Including global stocks will benefit your portfolio

We expect our global exposure to be a differentiator for our investors. We believe that well-selected offshore stocks can add tremendous value to a local portfolio. Risk can be reduced and returns may be enhanced.

We think current valuations provide the opportunity for better returns for patient investors. This is because there is tremendous fear in many developed markets and, as a result, we can buy great companies at very attractive prices.

The PSG portfolios include exposure to great global companies. This diversification means that we are not restricted to the 'best of the bad bunch'.

Meet the Manager

Paul Bosman

Paul joined PSG in 2004 when he began working for PSG Capital as an equity analyst. In November 2004 he joined the PSG Tanzanite team as an equity analyst. With the incorporation of PSG Tanzanite into PSG Asset Management, Paul continued as an equity analyst, specialising in both local and offshore listed companies. On 1 September 2011 Paul became a Portfolio Manager at PSG Asset Management and is responsible for the management of the PSG Stable Fund.

Tell us about the PSG Stable Fund. Why did PSG choose to launch this type of fund in September 2011?

At PSG we provide investors with a simple range of funds that covers the risk spectrum. We prefer to think of ourselves as asset managers as opposed to asset accumulators. We don't believe that having a fund in every sector is in the long-term interests of our investors, our managers and our shareholders – all of whom should have their interests aligned.

With the birth of PSG Asset Management in its current form, we then felt that we had a team with the right people and processes in place to expand our existing fund range to include two more conservative funds, the PSG Stable Fund and the PSG Income Fund.

Looking at the risk spectrum, we now have a Money Market Fund as well as funds that, over time, should give investors inflation plus 2% (PSG Income Fund), 3% (PSG Stable Fund), 5% (PSG Balanced Fund), 6% (PSG Flexible Fund) and 7% (PSG Equity Fund and PSG Global Equity Fund).

Looking specifically at the PSG Stable Fund, the Fund's mandate allows it to invest a maximum of 40% in equities, 25% in property and 25% directly offshore. Capital not allocated to equities and property is invested in fixed interest instruments.

So the PSG Stable Fund targets a return of inflation plus 3% over a rolling three-year period. How do you go about constructing a portfolio to achieve this?

We won't outperform inflation by 3% if we spend most of the time hiding in low risk instruments.

On average we will use the lion's share of the Fund's permitted 40% allocation to equities over time. The allocation will however not be dogmatic – it will be the result of our bottom-up equity selection process. If we are able to find many quality companies trading below our estimate of their intrinsic value, the equity allocation could be as high as 40%. If we are not able to find many such opportunities, we will not feel compelled to maintain a large equity exposure. This is integral to the Fund's risk management process. Holding expensive and/or low quality companies can result in permanent capital losses.

With regards to allocating the remainder of the portfolio, we continuously assess various fixed income instruments as well as property and nibble at opportunities. There are many kinds of fixed interest instruments, each with a unique risk return profile. Our approach is to look for those anomalies where the risk-return profile of a particular instrument stands out. This process however happens within a 'risk budgeting' framework, in terms of both credit and yield curve risk. Rather than taking bold calls on the yield curve or single corporate issues, we aim to lock in attractive yields when they unveil themselves. For example, we have managed to lock in some inflation-linked bonds at yields that are in line with the Fund's benchmark.

You worked with Jan Mouton on the PSG Flexible Fund for a long time before being appointed manager of the PSG Stable Fund. How might your equity holdings differ from the other PSG funds from time to time?

The PSG Stable Fund will generally hold the same stocks as the rest of the PSG funds, although the weightings might differ somewhat.

When you aim to preserve clients' money in real terms over a three-year period, you have to be brutally honest about what you do and don't know. To keep us honest we picture a genie offering us a peek at all the future cash flows that the Fund will actually earn from its various investments. The greater the chance that the result will surprise us, the further we are swaying off course.

The PSG Stable Fund has a preference for companies whose range of possible profits is not too wide. Companies with more stable cash flows tend to trade at higher multiples and this is where the PSG Stable Fund might be prepared to pay up a little for quality companies. The Fund will, however, also look at the mean reverting opportunities where the range of potential outcomes is wider. In these cases we will demand a very significant margin of safety and be careful of companies with leveraged balance sheets.

Unlike many of the peers in the Domestic Asset Allocation Low Equity Sector, the PSG Stable Fund has a significant allocation towards companies not listed on the JSE, but listed in Europe and America. How do you think this will enhance your ability to achieve your performance goals and what effect will it likely have on the volatility of the Fund?

To quantify the impact on volatility is tricky, because often the currency counterbalances sharp movements in the offshore share prices. However, it is safe to say that the volatility will differ from funds that do not have an offshore allocation.

From a stable-type fund's perspective, the US and especially Europe offers low hanging fruit, with non-cyclical businesses trading at low double-digit or even single-digit multiples. What makes these offshore opportunities even more compelling is that South African consumer non-cyclicals currently trade at very high multiples. The reality is that, if we weren't able to invest in companies like Tesco, Berkshire Hathaway, IBM, Diageo and Unilever, we would have been forced to hold more cash. The majority of the quality local companies are too expensive for us.

In our view, our allocation to these companies drastically improves the odds of the Fund outperforming inflation plus 3%. The ride might be slightly bumpy though.

Tell us what you enjoy doing when you are not busy researching companies, evaluating yields and managing the PSG Stable Fund.

A perfect Saturday would be an early swim at the Silvermine dam, breakfast at Tasha's, spending a few hours in the Mfuleni township tutoring students maths, followed by quick stop at a wine farm, home in time for kick-off, hoping the doorbell rings five times and lighting the fire.

Nothing riveting, perhaps a bit of a South African cliché, but would you want weirdos managing your money?

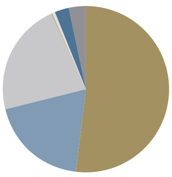
Portfolio holdings and performance as at 30 June 2012

PSG Global Equity Fund

Top 10 equities

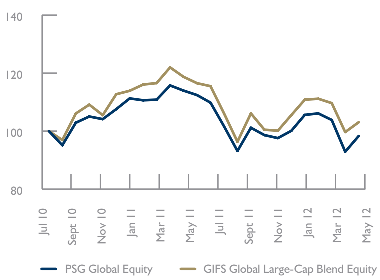
Tesco Plc
Berkshire Hathaway Inc
Unilever
Alstom
Heineken Holding NV
Microsoft Corporation
Bank of New York Mellon Corp
Imperial Tobacco GP Plc
BP Plc
Diageo Plc

Regional allocation



US	52.0%
UK	19.3%
Europe ex UK	22.1%
Japan	0.0%
China	0.2%
South America	0.5%
Africa	2.8%
Foreign equity	**96.9%**
Cash	**3.1%**
Total	**100.0%**

Performance

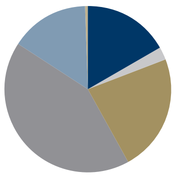


PSG Equity Fund

Top 10 equities

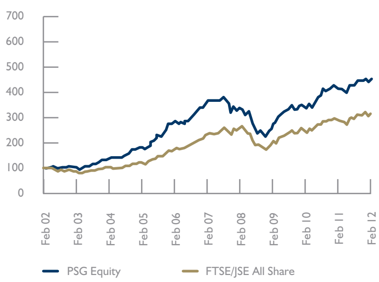
BHP Billiton Plc
Anglo American Plc
Steinhoff International Holdings Ltd
Sasol Ltd
Tesco Plc
Nampak Ltd
Brimstone Investment Corporation Ltd
Laboratory Corporation of America
Berkshire Hathaway
Ebay Incorporated

Asset allocation



Resources	29.0%
Financials	4.4%
Industrials	39.5%
Domestic Equity	**72.9%**
Domestic Cash	**0.6%**
Foreign equity	**26.5%**
Total	**100%**

Performance

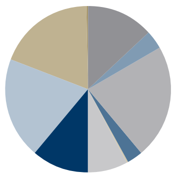


PSG Flexible Fund

Top 10 equities

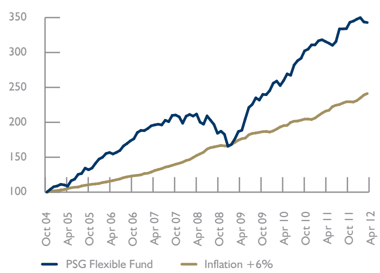
Steinhoff International Holdings Ltd
Sasol Ltd
Berkshire Hathaway Inc
Anglo American Plc
Tesco Plc
Capital Shopping Centres Group Plc
EOH Holdings
Eqstra Holdings Ltd
ING Group NV
Grindrod Limited

Asset allocation



Resources	16.4%
Financials	4.5%
Industrials	27.7%
Property	3.5%
Domestic equity	**52.1%**
Resources	0.4%
Financials	9.7%
Industrials	14.0%
Foreign equity	**24.1%**
Domestic cash	**23.5%**
Foreign cash	**0.3%**
Total	**100%**

Performance

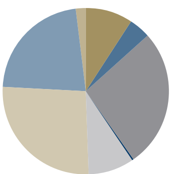


PSG Balanced Fund

Top 10 equities

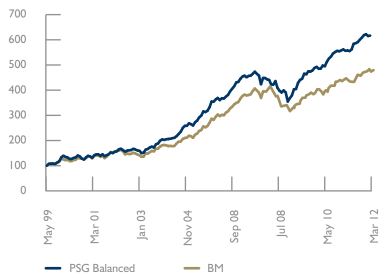
Steinhoff International Holdings Ltd
Anglo American Plc
PSG Global Equity Fund
Sasol Ltd
EOH Holdings
Tesco Plc
Kagiso Media Ltd
Microsoft Corp
Tongaat-Hulett Ltd
Reunert Ltd

Asset allocation



Resources	9.6%
Financials	4.6%
Industrials	26.2%
Domestic equity	**40.4%**
Domestic Property	**0.3%**
Domestic bonds	**8.8%**
Domestic cash	**26.1%**
Foreign equity	**22.5%**
Foreign bonds	**0.0%**
Foreign cash	**1.9%**
Total	**100%**

Performance

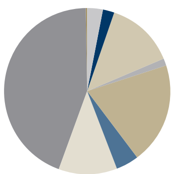


PSG Stable Fund

Top 10 equities

Tesco Plc
Berkshire Hathaway Inc
Steinhoff International Holdings Ltd
Brimstone Investment Corporation Ltd
EOH Holdings Ltd
Capevin Investments Ltd
Kagiso Media Ltd
Anglo American Plc
International Business Machines Corp
Sasol Ltd

Asset allocation



Resources	3.2%
Financials	2.1%
Industrials	13.5%
Domestic equity	**18.8%**
Property	**1.4%**
Domestic bonds	**19.6%**
Resources	0.0%
Financials	4.6%
Industrials	11.4%
Foreign equity	**16.0%**
Domestic cash	**44.0%**
Foreign cash	**0.2%**
Total	**100%**

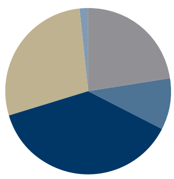
*Performance may only be stated once a fund has a 12-month track record

PSG Income Fund

Top 10 FI assets

FirstRand
Nedbank
Capitec Bank
ABSA
Standard Bank
Steinhoff International Holdings Ltd
Bidvest
Imperial Holdings
Netcare
Growthpoint

Asset allocation



Listed bonds	22.7%
Promissory notes	9.9%
Floating rate notes	37.7%
NCDs	28.1%
Call and cash	1.6%
Total	**100%**

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

Performance to 30 June 2012

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 766 320 034	8.51	50	88	17.00	19	81
FTSE/JSE All Share TR ZAR		9.24			16.69		
Domestic EQ General		9.19			14.68		
PSG Flexible	R 2 200 901 608	8.62	40	62	14.85	16	60
Domestic AA Flexible		10.64			13.06		
PSG Balanced A	R 1 290 742 436	10.83	21	79	12.72	20	68
Domestic AA Pru Variable Equity		9.26			10.75		
PSG Stable ***	R 23 620 729						
Domestic AA Pru Low Equity							
PSG Income***	R 39 963 881						
STeFI Call Deposit ZAR							
PSG Money Market A	R 1 861 736 881	5.40	18	25	5.70	14	24
Domestic FI Money Market		5.47			5.75		
PSG Global Equity	$ 25 872 962	-12.56	512	570			
MSCI World Free GR USD		-4.42					
GIFS Global Large-Cap Blend Equity		-11.57					
PSG Global Equity Feeder***	R 21 512 840	3.31	23	24			
Foreign EQ General		10.26					
SPECIALIST FUNDS							
PSG Preferred Dividend	R 97 777 154	10.10			7.57		
STeFI Call Deposit ZAR		5.30			5.46		
PSG Optimal Income	R 133 540 906	5.99			6.05		
STeFI Call Deposit ZAR		5.30			5.46		

* 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.
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										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
18.84	16	78	4.35	42	61	01/03/2002*	19.34	4	34	12.13	44	78
18.36			6.53				14.92			14.28		
16.22			5.14				15.83			11.24		
22.03	4	55	11.68	2	46	01/11/2004*	17.43	3	20	8.91	32	55
13.92			5.89				13.88			7.34		
15.08	8	60	6.44	20	42	1999/06/01	14.92	3	10	5.72	26	60
11.43			5.83				13.42			5.74		
						2011/09/13	10.19	52	68	-		
							8.75					
						2011/09/01	6.35	44	56	-		
							4.38					
6.27	15	24	8.17	12	19	1998/10/31	9.42	4	6	0.26	11	24
6.32			8.19				9.40			0.26		
						2010/07/23	-1.18	441	525	-		
							8.68					
							2.56					
						2011/05/04	-1.11	24	24			
							7.67					
11.12			8.01			2006/11/01	6.93			4.97		
5.89			7.72				7.81			0.20		
6.98			7.04			2006/04/10	7.59			1.67		
5.89			7.72				7.74			0.20		

NOTES

NOTES

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Retirement Annuities
Endowments
Living Annuities

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