PSG | Asset Management

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ANGLES & PERSPECTIVES

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The foundations of outperformance

By Greg Hopkins

Greg is a CA (SA) and CFA charterholder. 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 CIO for the PSG Asset Management team.

It's not what you look at that matters, it's what you see

Fund managers often get asked what it is that differentiates them from competitors. The majority of people typically answer that question with the standard response that they are contrarian and that they follow their processes consistently. However, most investment processes are quite generic. Also, most fund managers typically read the same annual reports and market research, talk to the same management teams, read the same newspapers, watch the same business channels, and listen to the same radio stations on the way home from work.

Warren Buffett gave the clearest insight into what differentiates successful investors in Berkshire's 2011 Annual Report. Referring to IBM he wrote: "I have been reading the company's annual report for more than 50 years, but it wasn't until a Saturday in March last year that my thinking crystallised. As Thoreau said, 'It's not what you look at that matters, it's what you see.'" This is quite visionary. He is describing the process of hyper-rational thinking, of sifting through the noise and focusing on the essence of the underlying idea, and of capturing the true asymmetry of the eventual outcome. This asymmetry of outcomes hopefully translates into little downside and significant upside.

Our competitive advantage

We believe that the crystallisation of financial information is our core competitive advantage. We believe that this competitive advantage derives from the people we have and from how we have chosen to organise ourselves.

We choose to follow a team-based approach to reduce risk and improve capital allocation. We encourage a culture of research and an environment of debate, discussion and alternative viewpoints. Our industry is littered with failed investment teams that have shown that this is not an easy path to follow. We have however managed to keep the core of our team together for many years. We have worked hard to distil our investment process into our three Ms: Moat, Management and Margin of Safety. This is a simple checklist that we believe increases the odds of rational thinking. We all buy into our process – we don't spend our time debating on what the best valuation methodology is or whether this is the type of company we should be investing in. We rather spend our time analysing investment ideas using our framework.

We adhere to the key factors that contribute to long-term outperformance

We believe other factors also contribute to a rational outcome. Firstly, getting the right balance between asset size and performance is key, that is, not being so large as to reduce the number of potential investable ideas that your investors might participate in. We believe that having 100 potential ideas to invest in will result in a better outcome for our investors than having 20-30 ideas. That number increases significantly if you have a global perspective and extend the universe to offshore shares, as we do in our process. Secondly, you should focus on a few high quality products. The third factor is to create an environment that optimises individual potential and performance. Lastly, and probably most importantly, you must have the humility to understand that what you know and what you don't know is the foundation of a successful process.

These are all factors that contribute to long-term, sustainable outperformance, and these are all factors that we at PSG Asset Management take very seriously.

We hope you enjoy this first edition of our *Angles & Perspectives* for 2013.

Exploiting opportunity in an artificial world

By Neels van Schaik

Neels van Schaik holds 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.

The global economic scene remains gloomy

The fear and pessimism that dominated investors' minds in 2012 are still a stark reality today. The US sovereign debt levels remains a major growth hurdle and could still push the US economy back into recession over the next few months if not adequately dealt with. Europe's sovereign debt crisis has changed shape and colour since 2008, but is far from being resolved. The austerity measures that have been forced upon Southern European members by the IMF and the European Central Bank as a prerequisite for financial support has lowered the potential long-term growth rate of the entire European Union.

Although there are tentative signs of recovery in the Chinese economy, there are still clear concerns about the sustainability of historical growth rates. Chinese labour costs are rising and as a result competitiveness in certain industries is waning. The development model that China has followed has been tried and tested by many countries in the past, with disastrous consequences.

Low interest rates and taking on more risk are at the order of the day

Despite all these fears persisting throughout the past two to three years, asset prices have defied gravity. The most plausible explanation can be found in the impact that central banks' monetary policy have had on risk-seeking behaviour. The Federal Reserve Bank's actions have kept US interest rates across the yield curve artificially low and real short rates in negative territory for the best part of five years. Chairman Bernanke has indicated on more than one occasion that interest rates are likely to stay exceptionally low until at least 2014.

Investors are therefore forced to adjust their asset allocation if they want to achieve returns that adequately compensate them for the underlying risk. In short, they are forced to choose between an asset class that cannot keep track with inflation and alternatives with an increasing probability of permanent loss of capital.

The Fed has effectively been targeting the reflation of asset prices through its abnormally low interest rates and accommodative monetary policy and, as a result, has encouraged abnormal investor behaviour. What under current circumstances looks like stable and rising asset prices may eventually lead to a monetary policy cliff as and when interest rates adjust upwards.

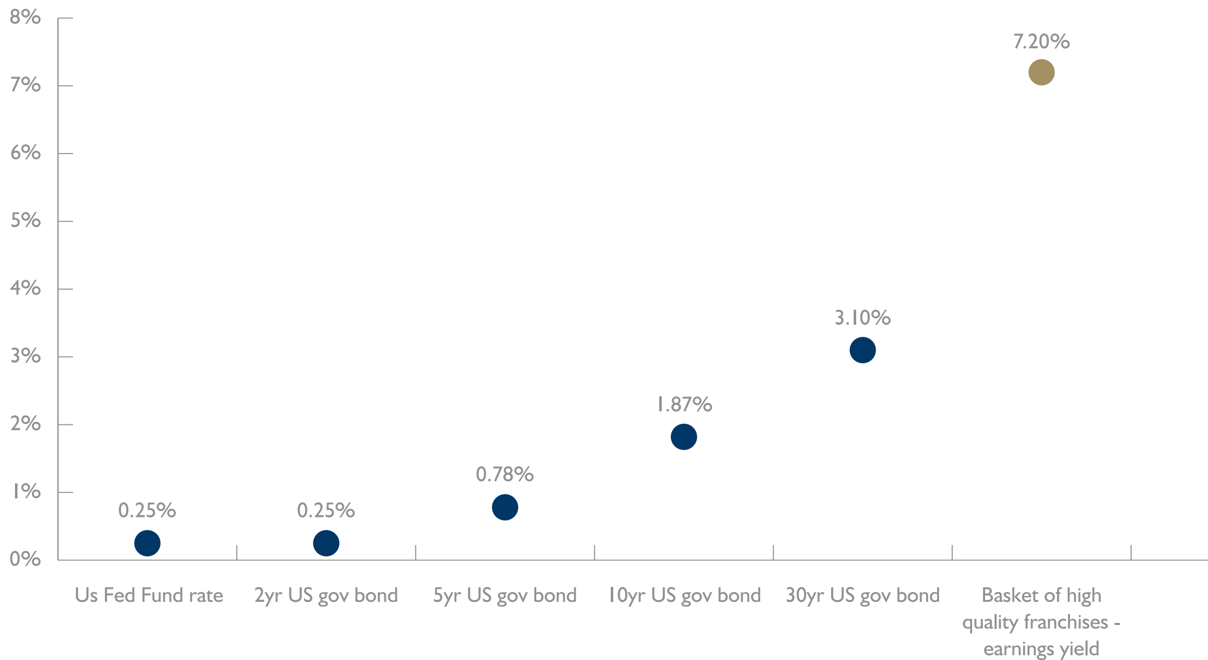
Focus on high quality companies with promising yields

Under circumstances where it's not clear when interest rates will normalise and artificial stimulus will end, we believe it is prudent to focus investment efforts on companies where the cash flow profile is predictable and stable. In the current environment where investors are forced to give stocks the benefit of the doubt, it is encouraging that there are still global opportunities available where the earnings yields (profit per share divided by stock price) are substantially higher than government bond yields. In some instances, the investment ratings of these businesses are the same as that of the US Government, which is evidenced by the low debt levels on these companies' balance sheets.

In Graph 1 below we illustrate the attractiveness of a basket of these high quality companies by comparing them to the US government bond at different maturities. The basket of stocks we have used for this exercise has been equally weighted. The yield that investors get on the basket, measured on an earnings yield basis, is more than double that of a 30-year US government bond. The 5-year Credit Default Swap (CDS) spread of this basket of companies is the same as that of the 5-year US government bond. Putting it differently, investing in 30-year US government bonds carries the same risk as investing in this basket of stocks, but you are earning less than half the yield.

Furthermore, most of the companies included in the basket have delivered uninterrupted growth in dividends over the last

Graph 1: The yield of a basket of high quality companies compared to US government bond yields



Sources: Bloomberg, Company financials, PSGAM basket consists of:
Tesco, Heineken, Microsoft, United Technologies, IBM, Target Corp, Unilever, Coca Cola, Nestlé

15 years. These companies are also generally managed by world class management teams that, in many instances, have been with the companies for decades. This is more than we can say about politicians these days.

Investors in these quality companies can expect good future returns

Although some of these companies have already delivered superb returns since late 2008, we would argue that most of the returns have been a recovery in the ratings, or price-to-earnings (P/E) ratios. Expectations for future returns should be anchored to growth in per share profits and dividends, with very little, if any contribution from a further rerating, although possible in some cases. Given our growth expectations and the inherent quality of these companies, investors can justify paying premium ratings.

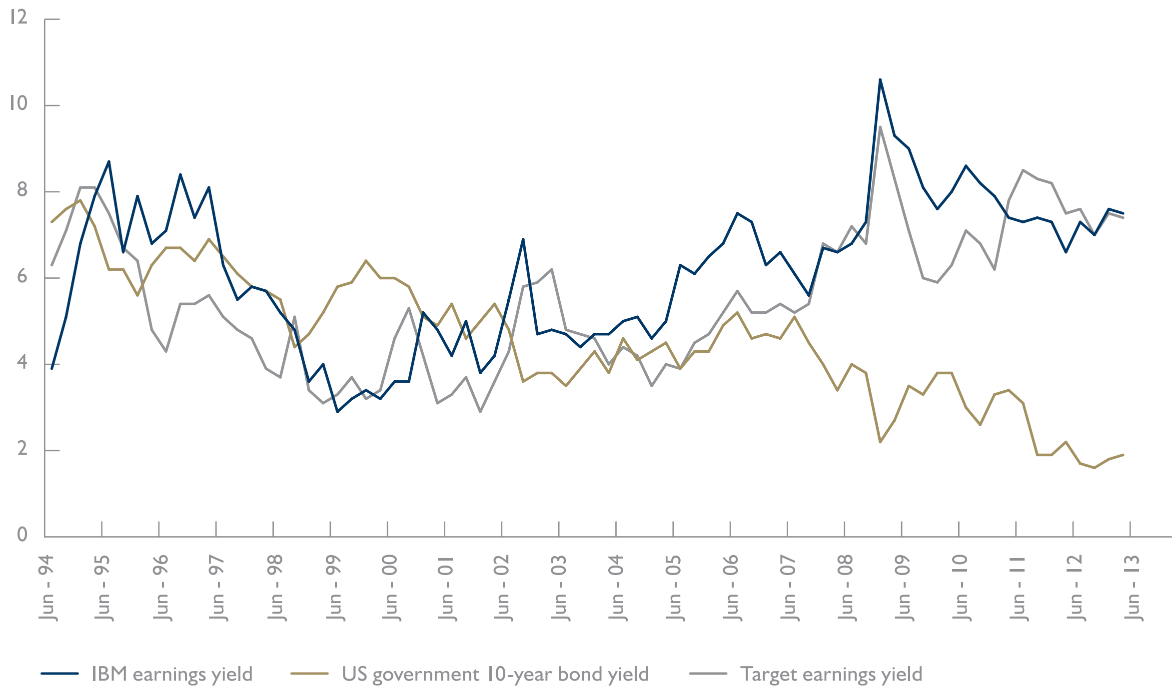
On the basis that US government bonds are overvalued and that yields will have to rise in future to attract new capital, there is a perception that stock ratings could be negatively impacted by this rise in bond yields. Although this is true for some companies, we argue that US bond yields have to rise substantially before it will have any long-term implications for ratings of most businesses in our universe.

The US 10-year bond yield has historically been a good proxy for the rating of some high quality businesses in the US. IBM and Target Corporation are two good examples, with the average earnings yield of both these companies being almost exactly equal to the US long bond yield before the housing market crash in 2007, as shown in Graph 2. Since then there has been a significant divergence between the earnings yield of these companies and the US long bond yield. Assuming that this gap will close again in the long term, but mainly as a result of the derating of US debt (rising yields), it would mean that the US 10-year bond yield – currently at 1.9% – can rise to 6% or 7% before it will negatively impact the rating of these companies. Given that long-term US nominal GDP growth will battle to reach levels sustainably higher than 3% or 4%, it is unlikely that US bond yields will reach an average level of 6% in the near future. The possibility therefore exists that companies like Target and IBM could therefore rerate further, even in an environment of rising US bond yields.

We may live in uncertain times, but there are opportunities

In the world of investing there is always uncertainty. Investors waiting for certainty before committing capital to the market will always be underinvested when stocks are cheap (because of the uncertainty) and overpay for stocks when they are expensive and

Graph 2: The earnings yield of IBM and Target compared to the US long bond yield



Sources: Bloomberg, PSGAM

optimism reigns supreme. We have to acknowledge that there are indeed fewer opportunities, even in the offshore market, compared to three or four years ago. However, there are still enough opportunities that should deliver much better returns than those asset classes that investors are being forced to avoid.

Adcorp and the hidden moat

By Philipp Wörz

Philipp obtained a BComm (Hons) Economics from the University of Stellenbosch and is a CFA charterholder. He has been with the business for over six years, is an analyst and serves on the PSG Asset Management Investment Committee.

Unemployment and bad labour relations still reign in South Africa

South Africa's official unemployment rate of 25.5% is one of the world's highest. Of the economies surveyed by *The Economist*, only Spain and Greece are worse off, with rates of 26.2% and 26% respectively. What is even more frightening is the fact that South Africa is undergoing a period of sustained, albeit slow, economic growth, whereas Greece's and Spain's economies are shrinking. Also, South Africa's rate of 25.5% is based on the narrow definition of unemployment that excludes all supposed jobseekers that have become disillusioned and have therefore given up looking for work. Including this group would ratchet up the rate of joblessness to 37%!

There are many reasons for South Africa's dire employment situation, but our inadequately educated workforce and restrictive labour legislation are top of mind. Research conducted by the World Economic Forum in its 2012-2013 Global Competitiveness Report confirms this. South Africa's education system ranks 140th out of 144 countries, with the quality of maths and science education at position 143. Our country's hiring and firing practices are the world's second most restrictive. To anyone who witnessed the events of Marikana or recent farm workers' strikes, it won't come as a surprise that we are last on the list in the "Cooperation in labour-employer relations" category.

Most readers would be well aware of the dark clouds that have floated above the South African staffing, and in particular temporary staffing industry, over the past three years. The industry's future, after being dealt a body blow from the after effects of the global financial crisis, has been under constant jeopardy due to the calls by left-leaning politicians and COSATU for a ban on labour broking.

Adcorp – an exciting opportunity on the JSE

Poor economic conditions coupled with legislative uncertainty have weighed on the staffing industry and investors have been very reluctant to commit capital to companies in this sector. For us, this has created an exciting investment opportunity.

JSE-listed Adcorp Holdings is directly exposed to the challenges brought on by the difficult South African labour and skills environment. We currently see it as one of the better opportunities on the JSE.

Adcorp, founded in 1975 and listed in 1987 is South Africa's largest multi-brand recruitment and placement agency. The company provides human capital management, business process outsourcing (BPO) and training services in South Africa, large parts of Africa and, after the recent acquisition of Paxus, also in Australia. In the 2012 financial year the company earned around 60% of its profits in the blue collar segment, where it places approximately 80 000 contractors on any given day in South African workplaces. The remainder of the profits were earned in its white collar, BPO and training businesses.

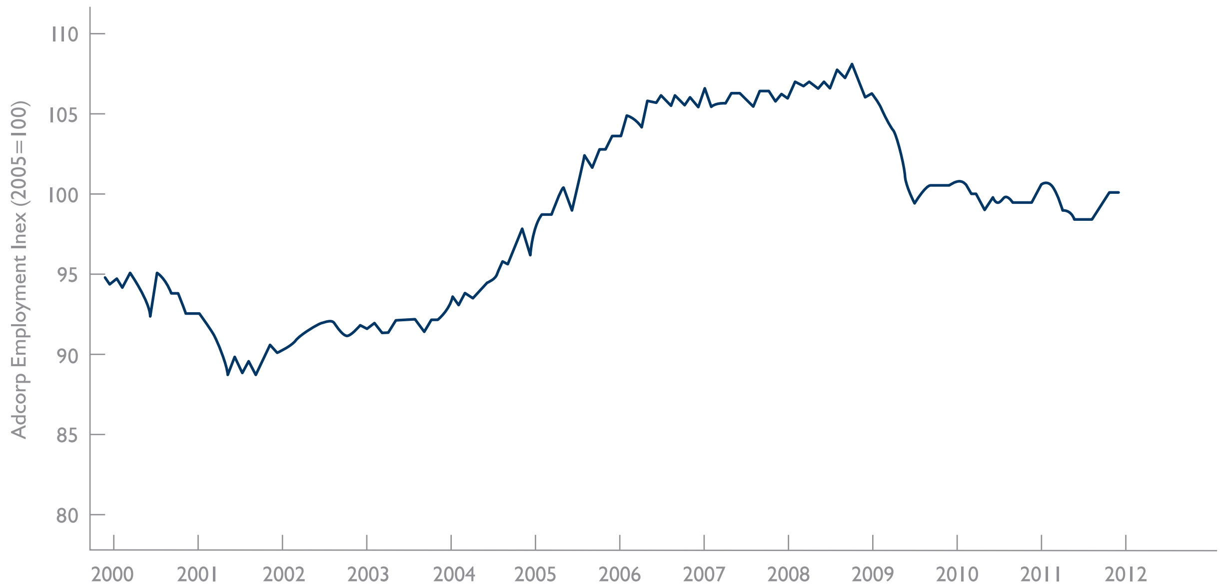
Restrictive labour practices have many adverse effects

One of government's top priorities is large scale job creation. Union leaders would strongly prefer these jobs to be permanent, unionised jobs. Ironically, South Africa's restrictive labour practices have had the opposite effect. While overall employment has been fairly stagnant (Graph 1), temporary employment has grown at the expense of permanent jobs (Graph 2), favouring large players such as Adcorp.

There are many reasons for this diverging trend. Because of rigid labour laws, employers have been reluctant to employ staff on a permanent basis in case economic conditions necessitate redundancies. A regularly striking workforce and overly restrictive hiring and firing practices have only made the problem worse.

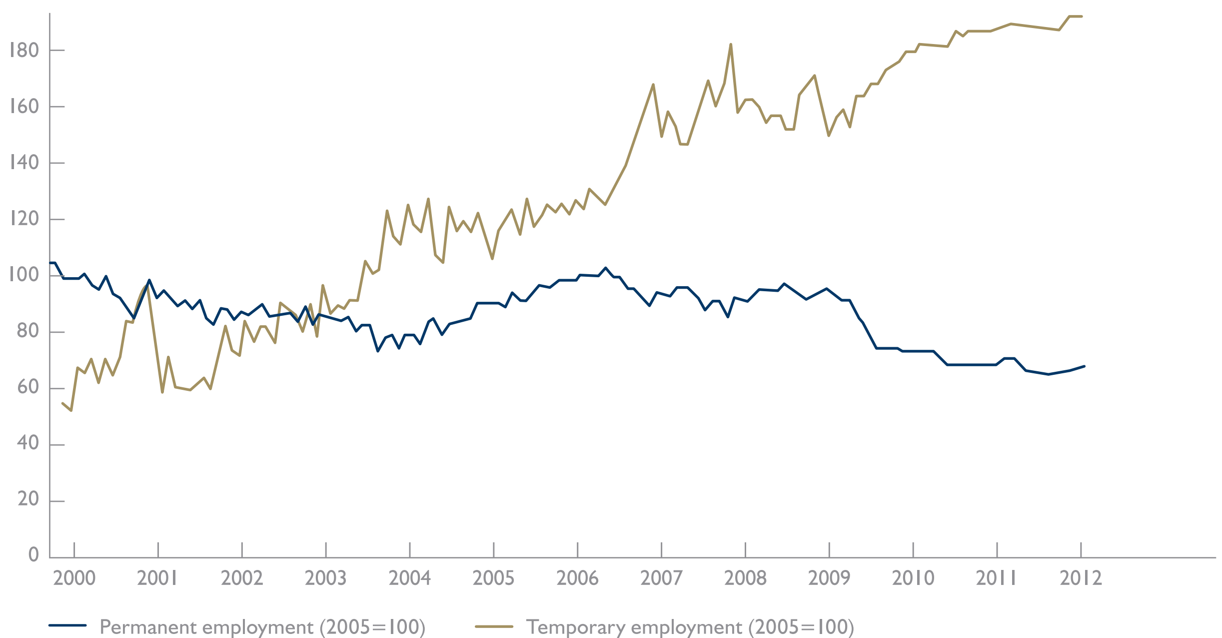
Another by-product has been mechanisation of labour. In industries where mechanisation is impractical or too costly, we struggle to see employers willingly hiring permanent blue collar

Graph 1: Overall employment growth



Sources: Adcorp Analytics, PSGAM

Graph 2: Permanent versus temporary employment growth



Sources: Adcorp Analytics, PSGAM

staff, given the militancy currently displayed in many sectors of South Africa's economy.

Industry structure and changing industry characteristics favour large players

While the staffing industry has previously been characterised by low barriers to entry, recent trends suggest industry consolidation, which should favour large industry players.

Staffing practices have become increasingly sophisticated, with technology playing an ever-expanding role. In these difficult economic times, employers have been centralising procurement departments and rationalising the number of staffing suppliers to save costs and headcount. Additionally, tenders have become more complex and regulations increasingly stringent.

All these trends favour businesses such as Adcorp that has a significant scale advantage over smaller competitors, whether it's investing into technology or dealing with complex tenders and compliance procedures.

A weak economy coupled with some of the abovementioned trends have led to a de-fragmentation of the industry that is set to continue. According to Adcorp, the number of employment agencies have reduced from 3 400 in 2009 to around 2 800 in 2012, a drop of 20%.

Regulatory interference is growing the available pool

While the banning of labour broking is off the agenda, labour bills in front of parliament not only have a bearing on workers employed via labour brokers but seek to regulate all forms of temporary or contract employment. South Africa has a pool of around 3.9 million workers, or 29% of total employment, that fall into this category. This includes around 1 million people employed through traditional labour brokers with the bulk employed by companies directly.

We believe that as legislation makes it increasingly complex and costly for employers to take on staff directly, in particular as it relates to the equal treatment clause, many companies will likely outsource this service to employment specialists. This will expand the available market for employment providers significantly.

Even though we are not particularly excited about growth in general employment levels in South Africa, we believe the long-term opportunity for Adcorp is vast, due to market share gains and the potentially growing market served by labour brokers.

Labour brokers: a source of job creation?

As mentioned, job creation is one of government's top priorities. Placement agencies such as Adcorp that make the majority of their income from placing blue collar candidates into temporary or flexible working arrangements, are well positioned to assist government in this goal. In 2011, the National Planning Commission published its recommendations for job creation. In fact, one of the recommendations was "to promote the positive, job-creating role that labour broking can play in the South African labour market".

In the 2012 financial year, Adcorp facilitated more than 5 700 learnerships, thereby enhancing the employability of South Africa's large unemployed constituency. According to the company, 50% of jobseekers have never worked before and 30% of people placed into temporary positions go onto permanent employment within one year and 42% within three years.

Adcorp benefits from South Africa's skills shortage

The paradox in the local labour landscape is that South Africa has both one of the highest unemployment rates of the major economies and an enormous shortage of skills. According to Adcorp CEO, Richard Pike, there are 800 000 high skilled vacancies in South Africa's labour market. While this is a sad reality facing the country, it can be beneficial to those supplying the skills. Adcorp also operates in this lucrative upper end of the skills spectrum, an offering that was bolstered through the acquisition of Paracon in 2011.

Tapping into opportunities in Africa

Another area of strong growth is Adcorp's focus on the African continent outside of South Africa's borders. Oil, gas, mining and exploration operations are rapidly expanding across Africa, offering Adcorp the opportunity to provide scarce, mainly technical, skills into the region.

Low hanging fruit in the back office

Since listing in 1987, Adcorp has grown both organically and via a string of acquisitions. Operating a plethora of systems and cost structures however prevented the group from benefitting from the economies of scale one would have liked to see. Over the past couple of years, the company has implemented enterprise-wide IT systems and also reorganised its back office. This should render significant scale benefits, driving growth in earnings over the foreseeable future.

Management plays a key role in Adcorp's impressive performance

One of the criteria we thoroughly assess is management's ability to allocate capital in the long-term interests of shareholders. At the time when this newsletter went to print, Adcorp would have concluded the R544.8 million acquisition of Australia-based IT and recruitment business Paxus from New York-listed CSC. This comes on the back of the R637 million acquisition of Paracon in the back end of 2011.

We are generally attracted to staffing businesses as they are cash-generative, high-return and capital-light businesses by nature. In 2012 for example, Adcorp earned a 28% return on assets managed, assisted by an asset turnover of 6.6 times.

However, as 67% of Paxus and 60% of Paracon were funded via the issue of new equity, earning a requisite return on the capital invested is paramount. We rate Adcorp's management team highly and back them to grow shareholder value.

Adcorp offers a significant margin of safety

While the current militant labour environment and rigid labour legislation will likely leave investors' fears elevated for some time, Adcorp's prospects for medium- to long-term profit growth look promising. We believe that the market trends described earlier will strengthen the company's moat and boost its earnings power over time.

At the current share price we are effectively paying nine times earnings, mostly earned in cash, and receiving a dividend return of 5%. We are satisfied that Adcorp trades at a significant discount to our conservative estimate of intrinsic value, even if labour and economic conditions do not improve. The share offers significant long-term optionality if South Africa can improve the quality of its education system and labour relations, which will drive the economy and employment.

In our view, Adcorp is a good example of a contrarian opportunity in an unloved sector. It also illustrates the added benefit of regulatory intervention strengthening the competitive advantage of the strong players.

Tesco: Greedy when others are fearful

By Henno Vermaak

Henno has been an analyst with PSG Asset Management since 2008. He is a qualified actuary and CFA charterholder.

Applying our 3M philosophy is a thorough and on-going process

Reading, thinking and talking about businesses is what our team does at the office. When we actually get down to doing some work, it generally involves analysing some new business according to our 3M philosophy. This is when we aim to answer three fundamental questions:

- Does this business have a sustainable competitive advantage – a moat?
- Will this management team be good stewards of our clients' capital?
- Can we buy this business at an attractive margin of safety?

Our investment committee sits regularly to consider the research done and to discuss whether we should include any particular business in our portfolios. Ideas are discussed, analysis considered and ultimately an assessment of these three questions is made.

Once we have answered these critical questions we can again sit back and read, think and talk about businesses. However, following a deep dive on any business, our daily action takes on an additional angle – on-going maintenance. Are we still correct in our assessment of the three questions above? In other words, the three questions we think about become:

- Is the moat still strong?
- Are the actions by management in our clients' interest?
- Is there still a margin of safety?

Most of the time, the answers to these questions allow us to sit back and look for other opportunities while we wait for our investment thesis to develop. However, every so often something happens that triggers our activity levels to increase dramatically. Our actions around our holdings in Tesco over the past year are one such an example.

Tesco has been a long-term holding in our unit trusts.

Our analysis indicated that Tesco is the type of company we want our clients to own and by the end of 2011, we held just over 2.3 million Tesco shares across the different portfolios. However, during January 2012, Tesco released a very disappointing Christmas trading update that guided the market to lower profits than consensus estimates.

Mr Market didn't like the news at all. In fact, as shown in Graph 1, the share price fell 20% in the days following this announcement. We went back to our analysis of Tesco and confirmed that the investment case was intact. We concluded that the market over-reacted and that the margin of safety had increased. As a result, we added significantly to our holdings, increasing our position to nearly six million shares.

Some people may find it strange that we became buyers when so many others were selling. Below we discuss our thinking following the announcement that shocked the market.

Is the moat still strong?

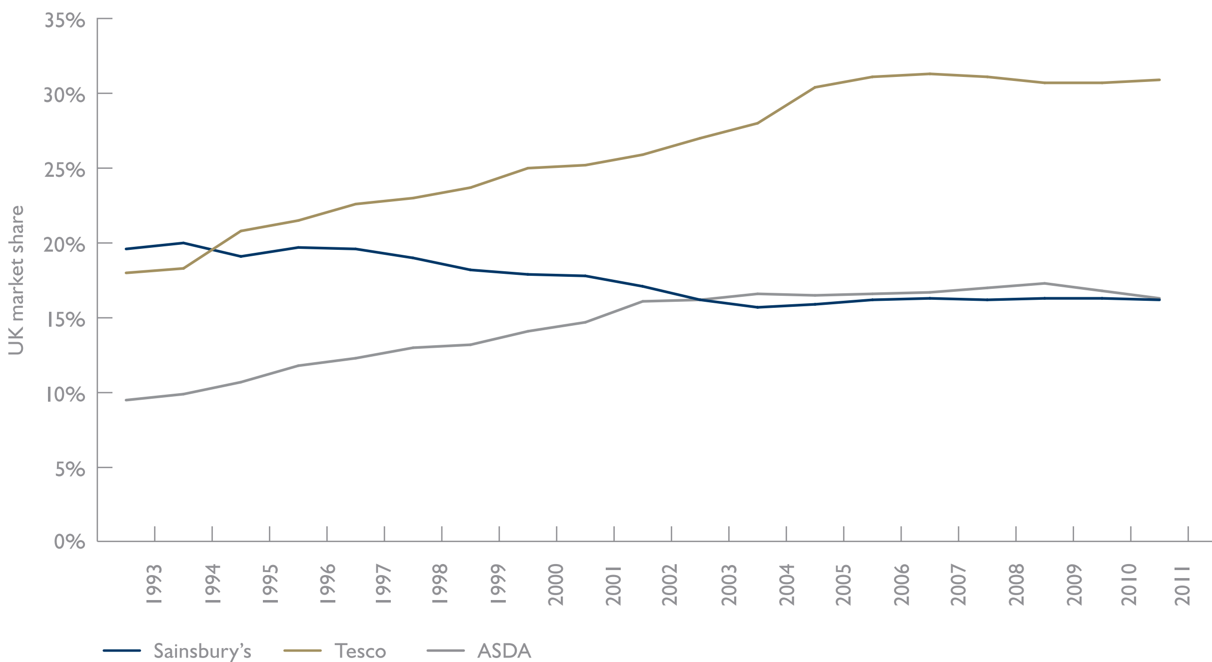
The business still has a moat. Tesco is the largest retailer in the UK and number three globally which ensures that it can leverage the economies of scale that come from its enormous buying power and logistics efficiencies. In Graph 2 below we see that it has grown its market share in the UK from below 20% in 1993 to above 30% in 2005 – no small task considering that Wal-Mart entered the UK in 1999 when it purchased ASDA. Since 2005 it maintained this market share around 30% and continues to do so.

Furthermore, the business historically operated at profit margins in excess of its competitors. The combination of stable/growing market shares with higher profits is often an indication of a strong moat. Our analysis confirmed that while profitability in the near

Graph 1: Tesco share price and the number of shares held by PSG Asset Management unit trusts

Sources: Bloomberg, PSGAM

Graph 2: UK market share for Tesco and its main competitors



Sources: Kantar Worldpanel

term would be under pressure, Tesco remains a very profitable operation and essentially a business with a fixable problem.

Are the actions by management in our clients' interest?

Management is doing the right thing. Tesco has a new CEO, Philip Clarke, who was appointed in March 2011. He has a stellar track record and played a key role in Tesco's growth in Asia and Europe. Together with the new members of his team, he was able to look at the whole business with a fresh pair of eyes. The team realised that management had been running the UK business too hot, not enough had been invested in the brand, store design and shopping experience in recent years. The new management team is committed to investing significantly in the improvement of the UK business.

They also reviewed the likely success of some of the investments made by the company. The expansion into the US came under particular scrutiny and the company has since decided to disinvest from the US operation. This will improve profitability and the return on capital significantly. It will also address one of the main concerns some analysts had for the business.

Is there still a margin of safety?

At the time of our review, we calculated an attractive margin of safety. On the regular metrics, it looked cheap. Tesco was trading at less nine times its earnings, nearly a third of the valuation the market placed on some South African retailers.

Tesco owns around 70% of all the properties it operates from. These properties are a significant asset on the balance sheet, but are reflected at historical cost prices. When we adjusted these properties to market value, we found that the Tesco share price was valuing the whole of the business at the net value of the properties alone. This means that by investing in Tesco, you could invest in a property company and get the whole operating business (the third largest global retailer with very strong brands and lots of customer goodwill) for free. This is the type of asymmetrical pay-off we find particularly attractive.

Also, Tesco generates tremendous amounts of free cash flow and distributes a lenient portion as a dividend to shareholders. Tesco was offering a well-covered dividend yield of 4.5% when we increased our stake. This dividend yield was more than double the yield that was available on UK government bonds at the time. So, on an absolute, relative and asset value basis it made sense to invest in Tesco.

Tesco in today's portfolios

Tesco remains a large holding across our funds.

The outlook for the UK economy is not rosy. Nor is the economic situation in some of the European territories in which Tesco operates. However, people tend to get hungry on a daily basis and the large market shares that Tesco commands in its various territories should ensure robust revenue levels. The current market price reflects the continued global pessimism, but, in the words of Warren Buffett: "Be greedy when others are fearful, and fearful when others are greedy." In this case there is the additional opportunity of being greedy where customers get hungry.

Meet the Manager

Henno Vermaak

Congratulations on your recent appointment as investment advisor on the PSG Global Flexible Fund. Tell us a little about the fund

Thank you, it is quite an honour to share in the responsibility of managing our clients' capital.

The PSG Global Flexible Fund is domiciled in Guernsey and regulated by the Guernsey Financial Services Commission. The PSG Global Flexible Fund has not yet been approved by the Financial Services Board for distribution in South Africa. PSG Asset Management expects to achieve such approval within the first quarter of 2013.

The PSG Global Flexible Fund will do exactly what the name says: utilise the PSG Asset Management process within a flexible mandate across global opportunities. To unpack it further:

- **The PSG Asset Management process:** We focus on businesses with strong moats, proven management teams which offer wide margins of safety irrespective of where they are listed
- **The flexible mandate** allows the fund to vary its exposure to assets according to the opportunities available in the market. The fund has no prescribed limits on asset class or sector exposure. In other words, the fund will never be forced to hold onto overpriced assets just because a mandate says so. If we are unable to find attractive investment opportunities, the fund will patiently wait in cash
- **Global opportunities** are where we find the bulk of our attractive investment ideas at present. The negative headlines worldwide have brought the prices of some of our favourite companies into buying territory and we see great long term opportunities for our investors

The PSG Global Flexible Fund is a Guernsey-based, dollar-denominated unit trust. It is managed by PSG Fund Management (CI) Ltd who has appointed PSG Asset Management to advise and trade on the fund. Jan Mouton is co-advisor with me on the fund.

The benchmark of the fund is US inflation +6% – quite an aggressive benchmark considering that the US stock markets have delivered a six per cent real return since 1900 (before any fees or taxes have been taken into consideration). We aim to deliver equity-like returns at lower levels of risk.

This sounds similar to the local PSG Flexible Fund

Yes. In essence, this fund is a natural progression of the successful strategy that we have followed with the PSG Flexible Fund and I am grateful to benefit from Jan Mouton's input as co-advisor on the new fund.
The funds have similar mandates, benchmarks, fee structures and both benefit from the research done by the whole PSG Asset Management team. The only real difference is that the PSG Flexible Fund is limited to a maximum of 25% offshore exposure, whereas the new PSG Global Flexible Fund is limited to no more than 20% South Africa-listed equities.

What are the benefits of a global unit trust compared to an offshore share portfolio?

We see three main advantages over direct share portfolios:

1. **Oversight:** Investors benefit from all the levels of protection provided by regulated unit trusts, including the safe custody of assets, oversight by regulators and annual independent audits.
2. **Costs:** The fund benefits from institutional brokerage rates and a low annual fee of 0.75% per year. The performance fee is subject to a high watermark and ensures that the interests of investors and management remain aligned.
3. **Tax benefits:** The fund is a roll-up fund, which means that no distributions are made by the fund. This is beneficial as the investor needs only to declare gains when units are sold – not when dividends are received on the underlying investments. All dividends declared by companies in the portfolio are automatically reinvested in the fund. In addition, there are no capital gains events triggered when the manager trades within the fund.

The initial investors in the fund are employees of PSG Asset Management and their families. We believe in this product and will share in the success of the fund.

Tell us a bit about your investment experience

I joined PSG in 2008, working initially as an analyst with the PSG Flexible Fund team. Since the creation of PSG Asset Management in 2011, I have primarily focused on global companies as part of the larger PSG Asset Management investment committee.

I bought my first shares in 2000, so I suppose the market has been teaching me lessons for nearly 13 years now.

A lot of investors in South Africa who have held global assets for the past 10-15 years have seen very poor returns relative to the rich rewards of the JSE. Why should investors be looking abroad?

The JSE has been one of the top-performing investment destinations over the past decade or so, while global developed markets have generally moved sideways. We think the main reason for this difference has been the initial valuations and expectations priced into the start of this particular measurement period.

If we rewind back to the mid-90s, we'll see that investors had very low expectations from South Africa post the changes of 1994. The JSE was priced at a discount to developed markets. In comparison, the US and other developed markets were in a long-term bull market, which started in 1982 and ran all the way to 2000. In our opinion, a number of investors were lured into developed markets by the attractive returns and currency worries of the day.

Today the position is reversed. The JSE, along with other emerging markets have benefited from a relative revaluation and many years of attractive returns. The financial crisis, recessions, fiscal cliff and troubles in Europe have all led to some very attractive opportunities in the out-of-favour regions of the world. We believe that these opportunities in the developed markets offer very attractive investment cases to contrarian investors.

PSG Asset Management positions itself as contrarian investors. What does this mean to you and where do you think the contrarian opportunities may be found in 2013?

Being contrarian means being comfortable to go against the popular or crowd-pleasing trends when you see an opportunity.

Some of our best-performing investment ideas in 2012 were holdings in listed companies where the investment mood was the most negative – in Europe. The concerns around sovereign debt in Europe, economic growth in Britain and the fiscal situation the US are still with us. Our most attractive investment ideas currently are to be found in exactly these markets.

How easy is it to sit at the bottom of Africa and pick stocks in Europe, the USA and across the globe? Are you at a disadvantage when compared to the managers of other funds in your sector who are based in London, New York and Hong Kong?

We have a particular philosophy and process that we can easily apply to any company regardless of where it is listed. We are long-term investors and we do not trade on the "word on the street" but focus on proprietary bottom-up research. As such, being away from the noise might actually be to the benefit of our investment decisions.

I take comfort in the fact that most of my investment idols are, in fact, the people who do not sit in London, New York or Hong Kong.

Tell us a little about yourself

I grew up in Johannesburg and was fortunate to have studied at Stellenbosch University. After graduation I spent some time in London and completed my actuarial qualification while working at a large consulting firm. I returned to South Africa in 2008 when a position opened up at the PSG Flexible Fund. This move finally enabled me to make my investment hobby a full-time pursuit.

Outside of investments, I am passionate about travelling, continued learning and interesting wines. Sometimes I travel purely to learn more about wine.

I am positive about South Africa, warts and all.

Why changes in the UK regulatory environment may affect your business

By Lizé Visser

Lizé is Executive: Distribution, Marketing & Client Services for the PSG Platform.

Staying clued up with industry changes and trends is a challenge

The local investment industry is currently undergoing drastic changes. The full implementation of the revised Regulation 28 is still under way. Also, a number of key areas relating to the implementation of the Treating Customers Fairly (TCF) legislation are being ironed out, with the FSB hoping to start implementing TCF by early 2014. In addition, Treasury has recently published a discussion paper on improving tax incentives for retirement savings, of which the most important point is capping employee contributions for tax purposes. Apart from keeping up to date with all these changes and completing the local FAIS regulatory exams, advisors should take note of the Retail Distribution Review (RDR) implemented in the UK at the end of 2012. The RDR stipulates even more refined guidelines on engaging with investors, fees and commissions. According to the stated aims of the RDR, there has been a lot of inconsistency in terms of the financial advice that consumers are receiving and who was being paid for what, and by whom. As with TCF, this may well find its way to South Africa.

The RDR affects how UK investors engage with financial advisors now and in future

Before the new rules, when an independant financial advisor (IFA) sold a fund to a client, the client would pay an annual management fee each year to the fund company and then some of this money would be sent back from the fund company to the IFA. For example, if an investor paid a 1.5% annual management fee each year on their fund, their IFA may get as much as 0.5% of that fee. That cut of the fee, the trail fee or trail commission, allowed advisors to give advice to clients without charging any significant upfront fees. Some investors may not have been aware of the indirect costs of the advice that they were getting. From a regulatory point of view, one can see how a practice like this could potentially be seen as creating a bias in the industry.

The RDR aims to ensure more transparency and fairness in the investment industry

The ultimate goal of RDR is to ensure there is more transparency and clarity in the investment advice industry. In the words of the UK Financial Services Authority (FSA): "We want to ensure a level playing field where firms can compete upon the basis of the service they provide to their clients; not the deals they have in place with product providers."

Put differently by the FSA, "the Retail Distribution Review is a key part of our consumer protection strategy. It is establishing a resilient, effective and attractive retail investment market that consumers can have confidence in and trust at a time when they need more help and advice than ever with their retirement and investment planning."

One of the principal aims of the RDR is to allow consumers to have confidence that the advice they receive is in their best interests and that advisors are not simply recommending providers which pay the highest commission.

An overview of the main changes:

1. **Independent vs. restricted advisors**

   Financial advisors will be split into two distinct categories: independent and restricted. When consumers speak with any advisor, they will have to tell their clients which category they are in. IFAs will be required to have more qualifications to ensure they are better able to advise clients on investment decisions. They need to consider all different kinds of investment products such as stocks, funds, ETFs, investment trusts, pensions, annuities and more. They must be knowledgeable about all investment products and cannot simply specialise in one area. IFAs have to consider all products before rejecting them as unsuitable.

Restricted advisors will not have to increase their qualifications and will not have to be knowledgeable about all areas of the market. Instead, they have the freedom to pick and choose which investment products and areas to specialise in. For example, they may focus simply on ethical investing or a limited product set. Some restricted advisors will advise clients on nearly all investment opportunities in the market, but if they lack knowledge in just one area or if they lack the proper qualifications, then they will not be able to call themselves "independent". Their ability to advise on all investment products will be limited, hence the name "restricted".

2. **No more commissions from fund companies to IFAs for new fund sales**

   Research has shown that many UK consumers don't realise that IFAs make money through commissions. But the new RDR rules stipulate that IFAs will no longer be able to receive commissions from fund companies for selling new funds to clients. In the UK, IFAs will now have to ensure that they have an upfront, transparent agreement with each of their clients about fees before giving financial advice. The new rules requiring an upfront agreement on client fees instead of commissions aim to make IFAs' charges more transparent for investors and to ensure that investors receive unbiased investment advice.

3. **The changes may imply a new charging structure for many IFAs**

   Different IFAs will charge their clients differently in 2013. For clients who need once-off advice, IFAs may agree to charge a flat fee or an hourly fee. For clients who want more regular contact with their IFA, an annual charge may be arranged where the client pays the IFA a percentage of their portfolio each year.

Clients that may have bought a fund from their advisor before 2013 are likely to still be paying them indirectly through fund commissions into 2013 and beyond. The IFA does not have to advise their client to switch into a non-commission-paying version of the fund unless they conduct a review of the portfolio and recommend changes. Meanwhile, some fund companies are automatically switching clients into new fund share classes, which strip out the IFA portion orcommission. These new fund share classes are being called "clean" share classes.

Choosing a platform for the future

In the context of the above regulatory changes, many UK advisors have been forced to review their platform choices and have spent considerable amounts of time conducting in-depth investigations and evaluations of the varying platforms' capabilities. They are using platforms to restructure their business in readiness for the implementation of the RDR.

Selecting the most suitable platform has the potential to give advisors much greater control over their clients' investments both in terms of the overall costs to the client and the structure of their portfolio(s). In addition, it can also help to lower the costs of running a financial planning practice and increase revenue.

The UK regulator has published guidelines for advisors on how to choose a platform

Choosing the wrong platform can increase cost and may limit an IFA's business. In the context of regulatory changes like the ones that are taking place in the UK, an IFA's platform choice may affect their proposition to their clients regarding cost, complexity of rebate structures and access to technical expertise.

The FSA has published a platform factsheet 'Platforms: using fund supermarkets and wraps', which provides some high level platform due diligence guidance for UK advisors. Within this document the FSA outline nine key areas that advisors should consider when considering the suitability of a platform.

1. The platform provider (for example, their reputation and financial standing);
2. Terms and conditions of using the platform;
3. Charges – including actual cost, charging structure and transparency of charges;
4. Range of funds, tax wrappers and other products available;
5. Range of asset classes;
6. Functionality (for example the ability to switch or re-register off platform or record legacy assets);
7. Accessibility;
8. Additional tools (for example, risk profiling and asset allocation tools); and
9. Support services (for example, help facilities and training).

Although choosing a platform is not an easy process and can be very time consuming, the rewards for choosing the right platform will be significant.

Sources: UK Financial Services Authority: www.fsa.gov.uk
Morningstar and IFAonline.co.uk

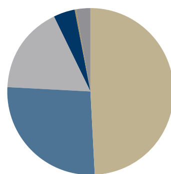
Portfolio holdings as at 31 December 2012

PSG Global Equity Fund

Top 10 equities

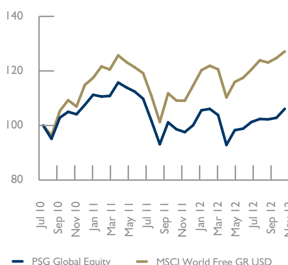
Tesco Plc
Alstom
Berkshire Hathaway
Bank of New York Mellon Corp
Steinhoff Int. Holdings Ltd
Unilever
Heineken Holding NV
Microsoft Corporation
Imperial Tobacco GP Plc
JP Morgan Chase & Co

Regional allocation



US	49.4%
Europe	26.5%
UK	17.1%
Africa	4.1%
China	0.2%
Foreign equity	**97.3%**
Cash	**2.7%**
Total	**100%**

Performance

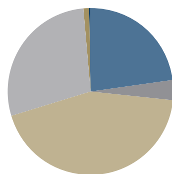


PSG Equity Fund

Top 10 equities

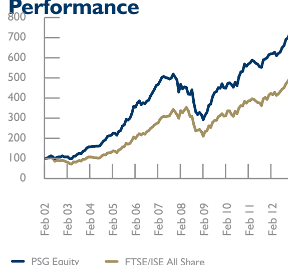
Anglo American Plc
Sasol Ltd
Steinhoff Int. Holdings Ltd
Tesco Plc
EOH Holdings
Alstom
Brimstone Investment Corp. Ltd
Nampak Ltd
Kagiso Media Ltd
Howden African Holdings

Asset allocation



Resources	23.0%
Financials	3.8%
Industrials	43.5%
Domestic equity	**70.3%**
Foreign equity	**28.4%**
Domestic cash	**1.2%**
Foreign cash	**0.1%**
Total	**100%**

Performance

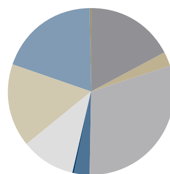


PSG Flexible Fund

Top 10 equities

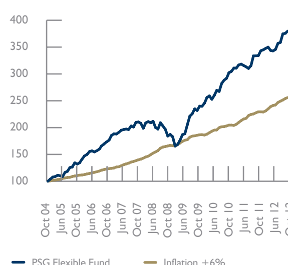
Steinhoff Int. Holdings Ltd
Anglo American Plc
Sasol Ltd
Berkshire Hathaway Inc
Tesco Plc
ING Groep NV
Grindrod Ltd
EOH Holdings
Capital Shopping Centre
Eqstra Holdings Ltd

Asset allocation



Resources	17.3%
Financials	2.8%
Industrials	30.2%
Property	3.1%
Domestic equity	**53.4%**
Resources	0.4%
Financials	10.5%
Industrials	16.0%
Foreign equity	**26.9%**
Domestic cash	**19.6%**
Foreign cash	**0.1%**
Total	**100%**

Performance

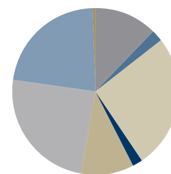


PSG Balanced Fund

Top 10 equities

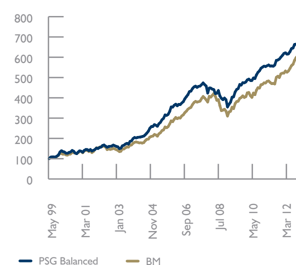
Anglo American Plc
Steinhoff Int. Holdings Ltd
Sasol Ltd
Tesco Plc
EOH Holdings
Super Group Ltd
Kagiso Media Ltd
Microsoft Corporation
Brimstone Investment Corp Ltd
Labcorp of America

Asset allocation



Resources	12.3%
Financials	2.3%
Industrials	26.1%
Domestic equity	**40.7%**
Domestic Property	**1.8%**
Domestic bonds	**10.4%**
Domestic cash	**24.4%**
Foreign equity	**22.2%**
Foreign cash	**0.5%**
Total	**100%**

Performance

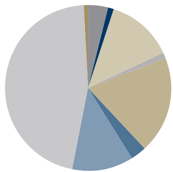


PSG Stable Fund

Top 10 equities

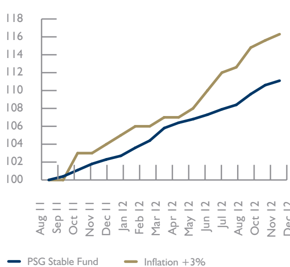
Tesco Plc
Berkshire Hathaway Inc
Sasol Ltd
Anglo American Plc
Super Group Ltd
Capevin Investments Ltd
EOH Holdings
Roche Holding
Adcorp Holdings
Steinhoff Int. Holdings Ltd

Asset allocation



•	Resources	4.0%
•	Financials	1.2%
•	Industrials	12.9%
•	Property	1.2%
	Domestic equity	**19.3%**
•	**Domestic bonds**	**18.9%**
•	Financials	3.0%
•	Industrials	12.1%
	Foreign equity	**15.1%**
•	**Domestic cash**	**46.1%**
•	**Foreign cash**	**0.6%**
	Total	**100%**

Performance

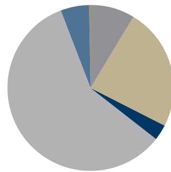


PSG Optimal Income Fund

Top 10 equities and bonds

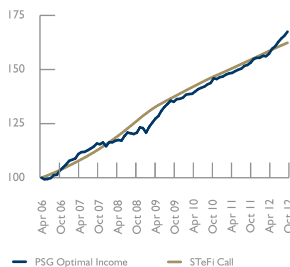
Sasol Ltd
Capital Shopping Centre
Tesco Plc
Steinhoff Int. Holdings Ltd
Capevin Investments Ltd
TN25 - Transnet Soc Ltd
EQS04 - Eqstra Corporation
SBS25 - The Standard Bank of SA
MET01 - Metropolitan Group Ltd
IBL19 - Investec Bank Ltd

Asset allocation



•	Local Equity	8.8%
•	Local Cash	23.9%
•	Local Property	2.9%
•	Local Bonds	58.8%
•	Offshore Equity	5.4%
•	Offshore Cash	0.2%
	Total	**100%**

Performance

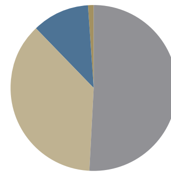


PSG Income Fund

Top 10 FI assets

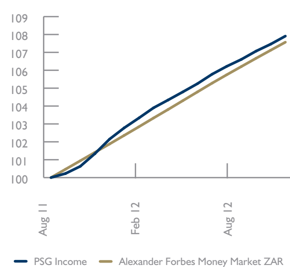
FirstRand
Nedbank
Standard Bank
Capitec Bank
ABSA
Investec Bank Ltd
Steinhoff Int. Holdings Ltd
Eqstra
Sanlam
Imperial Holdings

Asset allocation



•	Listed bonds	51.0%
•	Floating rate notes	37.0%
•	NCDs	11.0%
•	Call and cash	1.0%
	Total	**100%**

Performance



Performance to 31 December 2012

FUND PERFORMANCE

Fund	Fund Size***	1 Year Return	1 Year Sector Rank	1 Year Sector Count	2 Years** Return	2 Years** Sector Rank	2 Years** Sector Count
CORE FUNDS							
PSG Equity A	R 789 852 798	19.68	63	91	12.41	38	80
FTSE/JSE All Share TR ZAR		26.68			13.99		
Domestic EQ General		20.99			11.72		
PSG Flexible	R 2 479 650 999	13.70	46	59	12.08	26	57
Domestic AA Flexible		18.75			12.08		
PSG Balanced A	R 1 587 410 404	13.65	51	84	10.90	33	72
Domestic AA Pru Variable Equity		15.57			10.43		
PSG Stable	R 44 737 042	11.92	49	69			
CPI+3%		8.58					
PSG Optimal Income	R 107 244 918	9.34			7.13		
STeFI Call Deposit ZAR		5.08			5.19		
PSG Income	R 37 949 919	5.65					
Alexander Forbes Money Market		5.58					
PSG Money Market	R 1 770 462 945	5.31	17	26	5.38	17	26
Domestic FI Money Market		5.41			5.45		
PSG Global Equity	$ 27 637 515	8.76	467	568	-0.68	339	522
MSCI World Free GR USD		16.54			5.21		
GIFS Global Large-Cap Blend		13.28			0.31		
PSG Global Equity FF	R 22 120 036	10.74	25	25			
MSCI World Free ZAR		22.47					
SPECIALIST FUNDS							
PSG Preferred Dividend	R 114 996 451	5.76			6.33		
STeFI Call Deposit ZAR		5.08			5.19		

* Manager inception dates
** Annualised (for periods greater than 12 months)
*** Fund Size as at 31 December 2012
All the performance data is net of fees, for a lump sum, includes income, and assumes reinvestment of income on a NAV to NAV basis.
Source: © 2012 Morningstar, Inc. All Rights Reserved.

3 Years**			5 Years**			Inception**				VOLATILITY 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
15.13	23	77	7.92	34	66	01/03/2002*	19.96	4	32	10.69	35	77
15.63			9.41				15.97			13.17		
13.81			7.37				16.46			10.39		
16.54	9	53	12.79	4	44	01/11/2004*	17.74	3	18	6.78	17	53
12.64			7.53				14.38			6.66		
12.23	19	61	7.94	26	50	01/06/1999	15.05	3	10	4.44	16	61
10.57			7.42				13.71			5.12		
						13/09/2011	12.34	50	65			
							8.21					
7.10			7.56			10/04/2006	8.00			1.42		
5.54			7.24				7.53			0.17		
						01/09/2011	5.87	51	56			
							5.62					
5.87	14	25	7.69	12	20	31/10/1998	9.26	4	6	0.22	12	25
5.92			7.72				9.25			0.21		
						23/07/2010	2.22	439	497			
							10.93					
							6.10					
						04/05/2011	6.53	24	24			
							17.08					
8.88			8.84			01/11/2006	6.90			4.59		
5.54			7.24				7.57			0.17		

Contact information

PSG Asset Management Unit Trusts

Local Unit Trusts

0800 600 168
utadmin@psgam.co.za

Offshore Unit Trusts

0800 600 168
utoffshoreadmin@psgam.co.za

PSG Asset Management Administration Services

Voluntary Investment Plan
Preservation Funds
Retirement Annuities
Endowments
Living Annuities

General enquiries

0800 117 180
clientservice@psgam.co.za

Technical Investment Centre

0860 0000 27
tic@psgam.co.za

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Cape Town Office

Physical address
First Floor, PSG House
Alphen Park, Constantia Main Road
Constantia, Western Cape

Postal address
Private Bag X3
Constantia, 7848

Switchboard
+27 21 799 8000

GPS co-ordinates
S 34° 00.863´ E 18° 27.387´

Johannesburg Office

Physical address
First Floor, 28 Fricker Road
Illovo, Johannesburg
Gauteng

Postal address
PO Box 41259
Craighall, 2024

Switchboard
+27 11 772 6600

GPS co-ordinates
S 26°129838´ E 28°047602´

Guernsey Office

Address
11 New Street,
St Peter Port,
Guernsey, GY1 2PF

Switchboard
+44 1481 726034

Client services
SA Toll Free
0800 600 168