PSG Asset Management

4th Quarter 2013

ANGLES & PERSPECTIVES

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INTRODUCTION

By Anet Ahern

Anet Ahern has over 25 years' experience in investment and business management. After starting her career at Allan Gray in 1986, where she fulfilled various roles in trading and investment management, she worked as a portfolio manager at Syfrets, and later BoE Asset Management, where she was CIO and CEO. She also spent six years at Sanlam, where she was the CEO of Sanlam Multi Manager International, with assets totalling R100 billion in local and global mandates. Anet joined PSG Asset Management as CEO in 2013.

2013 was a successful year for us and our supporters

As the New Year takes off with all its challenges, 2013 is fading as fast as our summer tan. However, for the PSG Asset Management team and our loyal supporters and investors, we achieved a few notable milestones that will stay with us a bit longer:

- The PSG Flexible, Equity and Balanced funds achieved first quartile returns over 1, 3 and 5 years, with the Optimal Income Fund also in the first quartile over the last year.
- The PSG Equity Fund is the top performing South African Equity Unit Trust over 1 and 5 years.
- Thanks to your support, one fund passed the R3 billion mark, three are larger than R2 billion and five are over R1 billion in size.
- Our assets under management exceeded R39 billion for the first time, and our single manager funds exceeded R13 billion.
- We have also seen a significant increase in the number of new investors as more and more advisors are recommending that their clients invest in our funds.

Our long-term views don't change very often

At our PSG Outlook presentations earlier this month we shared our investment views and for those of you who attended these or read our views in this edition and feel a sense of deja vu, it is not your imagination. We tend to formulate long-term views, in a considered way, by doing our own research and thinking. This means our views don't change too often.

This edition seeks to answer three common client questions

1. What do I do with investors who need income if there is a risk of rising interest rates?
2. I am concerned about the equity market – do you still see opportunities?
3. What about international or offshore investing – are there still opportunities?

Income funds and the risk of rising interest rates

We start with an in-depth discussion of the interest rate market, sharing how we assess and address interest and inflation risk in our suite of fixed income funds. This is followed by a section addressing our credit process, a crucial part of managing risk in a portfolio. We attempt to simplify some of the technical and complex issues around credit ratings, and get back to the basic factors we consider when lending someone money.

Meet the manager of the multi-award-winning PSG Equity Fund

Our Meet the Manager section features Shaun le Roux, the award-winning manager of the PSG Equity Fund. While it is always interesting to understand the people behind our process and philosophy, this is where we also share our views about the level of the equity market and how our approach attempts to set our investors up for success throughout market cycles.

Are there still opportunities offshore?

We hope that the next section in this edition gives you food for thought as we look at a case study of one of our preferred global stocks. We illustrate how our globally integrated bottom up process helps us find stock opportunities without having to time the shorter-term movements in the market.

Our philosophy remains consistent and a source of comfort irrespective of market changes

In closing, we reiterate our investment philosophy and beliefs, specifically highlighting the importance of having a margin of safety in all asset classes.

We hope that you enjoy this virtual tour of what is top of mind for us as we embark on 2014. Thank you for your support, we hope you enjoy the read and wish you a year of successful investing.

THE FIXED INCOME OUTLOOK FOR 2014

By Ian Scott

Ian Scott joined Sasol Oil as a forex trader in 1996, trading crude oil and petroleum products, foreign exchange exposures, and hedging various market risks. In 1999 he joined SCMB Asset Management as a money market dealer. He was also involved in the portfolio management of various cash funds. In 2003 he moved from the money market desk to join the capital market desk of the fixed interest team and in 2007 he was promoted to senior portfolio manager. Ian joined PSG Asset Management in June 2013 as Head of Fixed Income.

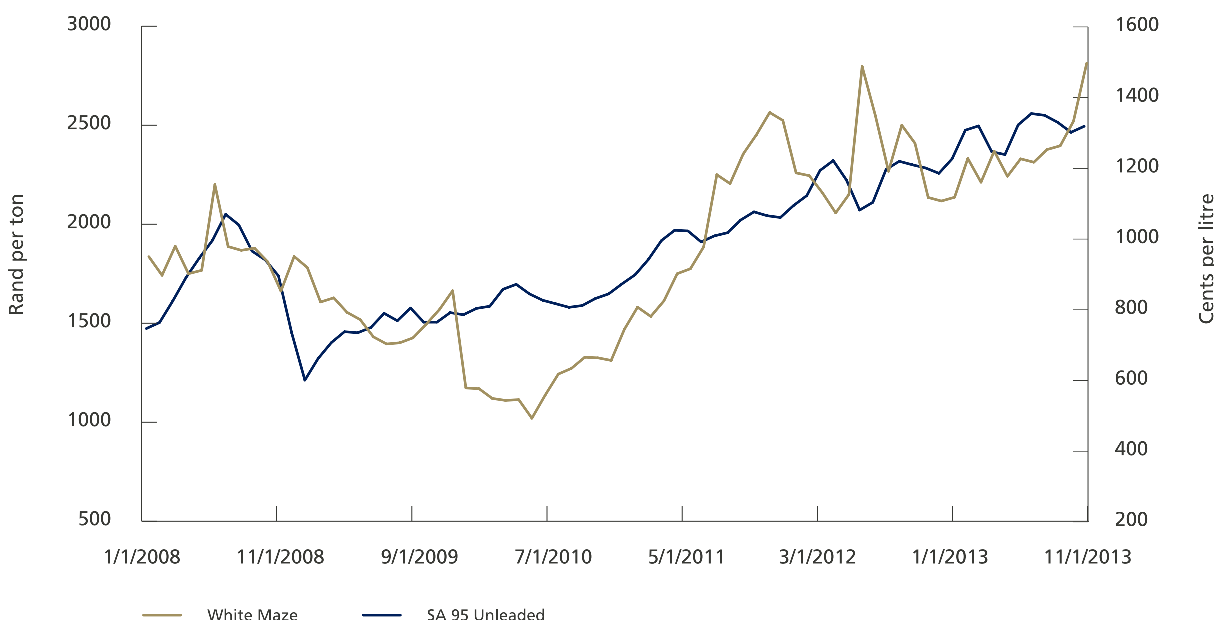
The prices and margin of safety of fixed income assets have changed since mid-2013

Each new year starts with the promise of better things to come. In 2013, the fixed income world was turned on its head by the US Federal Reserve's (the Fed's) changes in monetary stance. It literally was the tale of two halves in 2013 and we believe that this set the tone for what to expect from fixed income markets in 2014. The key to investing in fixed income in 2014 is the same as in the latter part of 2013: what to avoid (and not own) is much more important than what to own. The quality of fixed income assets has not deteriorated (investment ratings have not been materially downgraded), but their pricing and margin of safety have changed dramatically since the middle part of 2013.

In 2013, cash and income funds were the winners

As shown in Graph 2, the winners last year were cash and all types of income funds. The losers were long-dated nominal bonds and inflation-linked bonds. This was in an environment where inflation wasn't a threat and the market wasn't pricing in any changes to monetary policy until the second quarter of 2014. The second round effects of the rand weakness

Graph 1: Inflation risks are rising in South Africa



Source: Bloomberg

on inflation were muted and on GDP growth were benign, enabling the South African Reserve Bank (SARB) Monetary Policy Committee (MPC) to hold interest rates steady.

We expect more of the same in 2014, but the inflation outlook is deteriorating

Fundamentals that affect the inflation outlook are getting worse. As shown in Graph 1, the large depreciation in the rand in the beginning of this year and the sharp increase in maize and petrol prices are very likely to affect inflation expectations for the year. Retailers have already said that they will have to pass price increases on to consumers this year. Real wage growth and escalating administered prices will add to inflation momentum.

Continued rand weakness off a low base could force the MPC to adjust their inflation policy

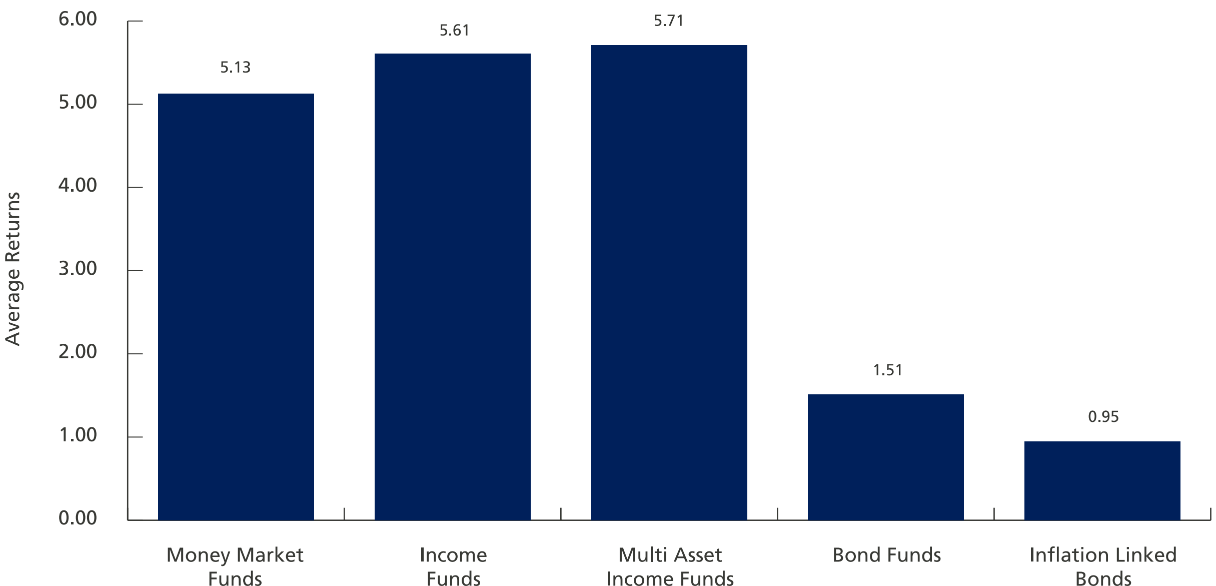
The money markets were already pricing in a high probability that the SARB MPC would have to increase rates sooner in 2014, due to higher inflation expectations. Inflation is rising, growth remains muted and we have a national election in the middle of the year. How will the SARB MPC react through monetary policy? A common view was that the SARB would probably want to keep rates constant at the current level for as long as possible. However, continued weakness from an already weak rand has forced the MPC to adjust policy to curb rising inflationary expectations.

How do we invest wisely in fixed income markets in the current environment?

1. Move surplus stable cash away from call and current accounts. Cash currently has a negative return relative to inflation. The smart trade would be to invest the cash in a low-risk alternative like an income fund, where the return is more in line with inflation, or a multi-asset income fund that offers an above-inflation return.
2. Stay away from long-dated nominal bonds. There is a lot of upside yield risk (lower prices) currently in the bond market. Globally, long-bond yields are rising because the Fed is withdrawing liquidity from the US bond market. This is very negative for emerging bond markets with poor fundaments like South Africa. There will be a time to buy long bonds, but not at current valuations. The margin of safety is not high (enough) for long-dated bonds.
3. Be wary of investing in inflation-linked bonds now. They do protect investors against inflation, but the valuations of inflation-linked bonds are currently high. The margin of safety for inflation-linked bonds is therefore very low. Remember, inflation-linked bonds carry a very high interest rate risk due to their index nature, long maturity dates and lack of liquidity.

We believe that the smart trade in the fixed income markets in 2014 is to invest in income and multi-asset income funds that have a high exposure to floating rate notes and a low allocation to long-dated nominal and inflation-linked bonds.

Graph 2: Fixed income winners in 2013



Source: Morningstar

HOW DO WE THINK ABOUT BONDS?

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 Balanced Fund and PSG Stable Fund.

To achieve consistent above-average investment returns requires independent thinking. We believe that independent research is key to independent thinking. We therefore prepare our own research views and notes when it comes to bonds. We aim to avoid mistakes by starting with and sticking to the basic principles, thinking about every step as we go.

What are the basic principles when it comes to bonds?

Our view is that we are lending our clients' money to an outside party and we need to:

- Be sure that we get all the money back (preserve capital).
- Earn a good interest rate (optimise returns).

Capital preservation: How do we make sure we get all the money back?

In general, the market relies heavily on rating agencies who churn out credit ratings on bond issuers. The credit ratings would then be an indication of the probability of getting your money back. Credit ratings would typically be expressed in formats such as Aaa, Baa1, Ba1, Caa, A-1+ and BB-. Surprisingly enough, the market prices bonds based on these combinations of letters and numbers. We find relying on these ratings a poor basis for investment decisions.

We focus on three questions

1. What is the true and sustainable cash flow of the borrower?
2. What is a realistic value of the assets held by the borrower?
3. What is our access to the assets if the borrower fails to pay?

The three considerations above are the foundation of our process, so we will explain them in a little bit more detail.

1. What is the true and sustainable cash flow of the borrower?

It is important to understand how much free cash flow the bond issuer truly generates and how sustainable it is. Many analysts would look at a company's EBITDA (earnings before interest, tax, depreciation and amortisation) as representing the company's 'free cash flow' and consider that in relation to the amount of interest that the company has to pay. The higher the ratio is of EBITDA to interest, the better the situation.

However, at PSG Asset Management, we believe that EBITDA fails to take into account the borrower's capital expenditure (capex), and how much of that capex is being used just to maintain production.

Graph 1 shows the Production and Capex/Revenue of Impala Platinum between 2000 and 2013.

The company's capex has not resulted in production growth. This tells us that the capex is necessary to maintain production. We would therefore deduct all capex from EBITDA in order to determine the company's true free cash flow.

In Table 1 we do just that. We can see Impala Platinum's capex and the resulting true free cash flow. When capex is deducted, it results in a negative true free cash flow for 2013. Impala Platinum's ability to service debt is therefore significantly poorer than suggested by EBITDA.

Table 1: Impala Platinum true free cash flow

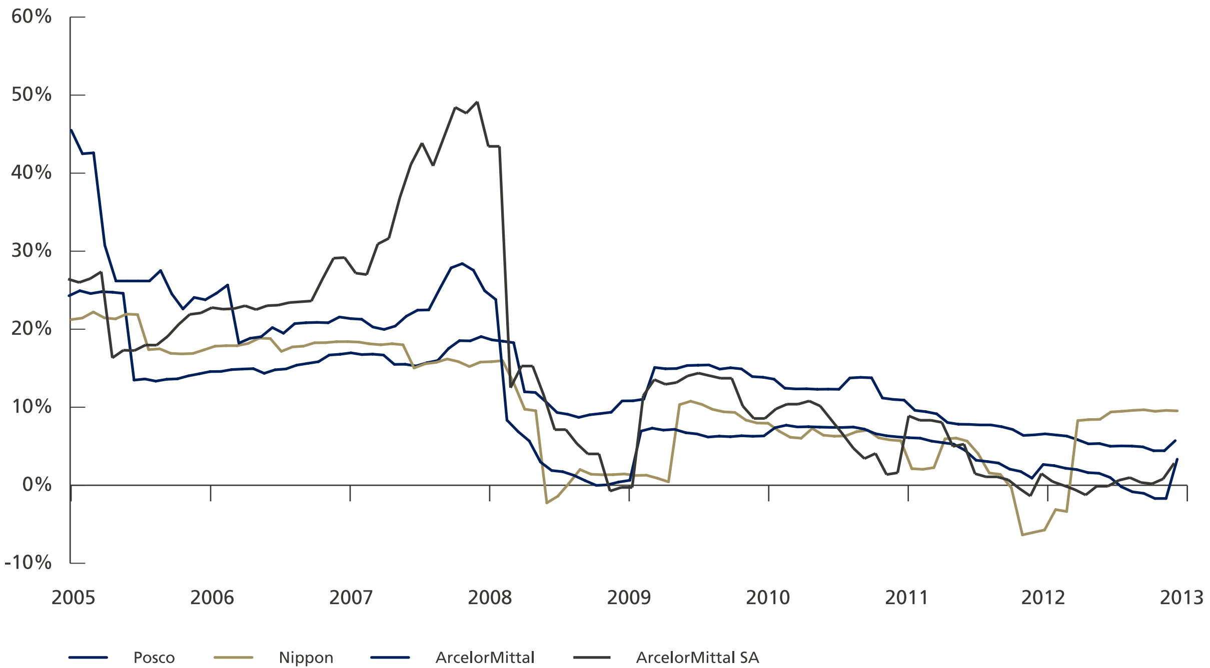
Impala Platinum	2013	2012
EBITDA	5,205	7,949
Total Capital Expediture	(6,360)	(7,284)
Free Cash Flow	(1,155)	665

Source: Impala Platinum Holdings Ltd Company Report

Graph 1: Capital expenditure doesn't always result in production growth

Source: Impala Platinum Holdings Ltd Company Report

Graph 2: Return on equity generated by four steel companies



Source: Bloomberg

How sustainable is the current cash flow?

It is very important to consider whether current earnings reflect a 'normal' state of the world. We would typically consider how many variables are within management's control and the strength of the company's competitive advantage. In the steel industry both of these factors deliver low scores.

Graph 2 shows the return on equity generated by four steel companies between 2005 and 2013. Between 2005 and 2008 they all generated high returns on equity which, if extrapolated forward, would have would have proven to be a big mistake. Creditors would have been prepared to lend these steel companies significantly more in 2008 than they would be to today.

2. What is a realistic value of the assets held by the borrower?

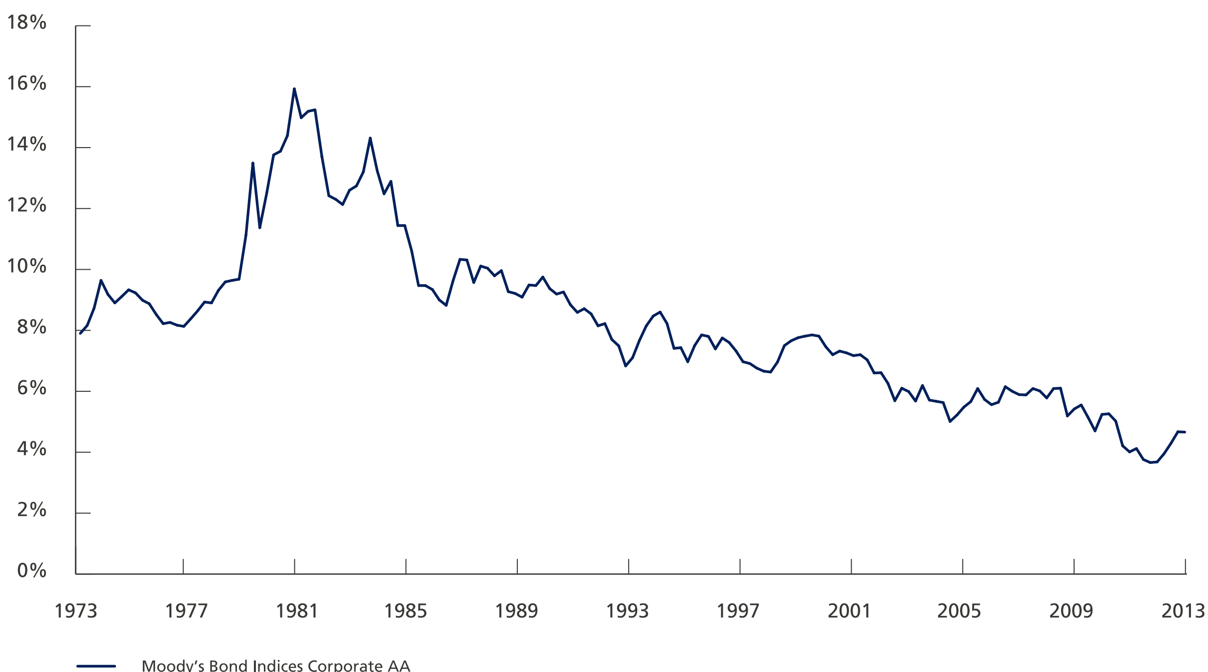
   The fact that auditors have signed off on the value of assets on a balance sheet does not mean that it is the correct market value. It only means that the company has correctly applied the accounting standards it chose to follow. We consider the reported balance sheet values and make adjustments where necessary. These adjustments are not second decimal numbers but we would still prefer to be more right than most certainly wrong.

   As an example, let us consider why we are prepared to lend money to Capitec but not to African Bank (Abil). In both cases, the companies are borrowing against their debtors books. The reported value of the debtors books is therefore the crux of the matter. On examination, we found that the values are hardly comparable. Capitec applies more conservative definitions and provisions than Abil when valuing outstanding loans. For example Capitec writes off a loan after three months of non-payment, Abil only does so after 12 months. Capitec currently provides for 177% of its arrears, Abil provides for only 64%. If we apply Capitec's definitions and provisioning policies to Abil's debtors book it would knock 84% off Abil's post rights issue reported tangible capital. This is a rather significant adjustment to the auditor approved figures.

3. What is our access to the assets if the borrower fails to pay?

   It is insufficient to focus only on the true value of the assets. It doesn't mean much if they belong to somebody else. It is very important to scrutinise the legal terms of the specific debt programme in which you are investing. When you add up all the assets already encumbered, you may find that there are no unencumbered assets backing your bond. If there are in fact unencumbered assets, you need to determine whether the bond issuer is allowed to encumber those assets to somebody else without your permission. The banks are typically sharper on scrutinising these terms than the market and bond issuers sometimes get away with murder. Once again, we would roll up our sleeves and do a thorough analysis.

Graph 3: Don't lend out money at a rate today which you might be sorry about tomorrow



Source: Bloomberg

How do we make sure we earn a good interest rate?

Once we have established that we are comfortable that the bond issuer will be able to repay us, we need to make sure that we are extending the loan at an interest rate that is favourable for our clients.

Once again, the best way to avoid mistakes is to start with the basics. We follow two principles:

1. The rate earned should be at least in line with prevailing market rates.
2. Don't lend out money at a rate today which you might be sorry about tomorrow.

The rate should at least be in line with prevailing market rates

We would consider the rates at which governments, banks and other bond issuers (which we consider of a similar quality) are borrowing. This would be a spot comparison, so at a specific time.

Don't lend out money at a rate today which you might be sorry about tomorrow

However, only doing a spot comparison is not good enough. We must also consider interest rates over time. Graph 3 illustrates the extent to which the yields on corporate bonds can vary over time. We are careful not to extend loans at rates that are significantly below the longer term average level.

Our approach to investing in bonds is not complicated, it is just common sense combined with old fashioned hard work.

MEET THE MANAGER

Shaun le Roux

Since Shaun began managing the PSG Equity Fund in 2002, it has delivered an annualised return of 21.32% per year, which compares very favourably with the FTSE/JSE All-Share Index's (ALSI) return of 16.42% per year and the average fund's return in the sector of 17.69%. R100,000 invested in the ALSI on 1 March 2002 would have been worth a tidy R604,635 at the end of December 2013. The same sum invested in the PSG Equity Fund on the other hand would have been worth an impressive R984,938, 63% more than the ALSI!*

Shaun, you have been managing the PSG Equity Fund for nearly 12 years now and the Fund's track record over all periods is exceptional. To what do you attribute this success?

PSG Asset Management has a stong investment team staffed by highly competent and passionate people. Combine this with a robust process and you have the ingredients for long-term success. The PSG Equity Fund has successfully leveraged the quality research produced by the broader team over the years.

How big a role does the opportunity set play in delivering better returns than some larger peers and those managers who have chosen to limit themselves to domestic stocks?

A larger investment universe is unquestionably an advantage by sheer virtue of the fact that you have more opportunities to exploit. I am of the view that this advantage has been masked by the dominance of large cap industrials in the ALSI performance over the past few years. The Fund performed well last year despite no exposure to the large rand-hedge industrial stocks – which we think are overpriced. We achieved this because we had the ability to cast our net wide and invest in quality companies trading at great prices, many of which came from offshore and outside the Top 40.

How have you found equity markets over the last year or so?

Our philosophy of bottom-up investing and not trying to predict market movements or macro-economic events has served us well. The very uncertain economic environment of recent years is what gave rise to the opportunity to buy stocks for a lot less than what we thought they were worth. Most stocks have re-rated substantially, returns have been strong and there are definitely pockets of overvalued shares. We think that we saw stock picking being rewarded in 2013 and we believe that we can still find good value within equity markets. Given the huge variance in the valuation levels of different sectors and stocks we expect stock pickers to continue being rewarded.

Are you optimistic that the Fund will continue to be able to deliver excellent returns?

We select stocks for inclusion in our portfolios on a minimum 3 to 5 year view. On this basis, the stocks in the Funds are still attractively priced and meet our criteria for investment. Accordingly, we expect good returns but must concede that the returns we expect from the stocks in the Funds are lower than they were a year or two ago.

What are some of the biggest mistakes you have seen many investors making when it comes to investing? And investing in equities in particular?

It is human nature to extrapolate recent experiences into the future. Investors therefore have a tendency to struggle to separate the story from the investment opportunity. Good examples include overlooking extraordinarily low valuations in 2008/9; failing to recognise the opportunity in global equities relative to the JSE three years ago; and the very high expectations that are currently embedded in the popular growth stocks.

Rumour has it that, when you are not managing funds, you are a bit of an artist and enjoy racing mountain bikes. When you are away from the office, do you shut off completely or are your hobbies merely spaces and places to think differently?

I am extremely fortunate to have a job that is also my passion. This means that I never really switch off. But, I do recognise the need to recharge the batteries and stay focused. Living in beautiful Noordhoek, spending time with the family, riding my bike and playing with my oil paints help keep me sane.

* Source: Morningstar

EQUITIES: HOW WE TRY TO GET THE ODDS IN OUR FAVOUR

By Shaun le Roux

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

The trade-off between quality and price

Assessing the quality of a business is at the forefront of our investment process. Specifically, we like to determine whether a company has a sustainable competitive advantage (or moat) and a strong management team to act as custodians of shareholder capital. At the same time, we prefer to buy businesses that are trading at less than what we think they are worth. This approach ensures that we have an adequate margin of safety.

The three Ms aim to help us preserve client capital and improve potential returns

Combining this strong focus on quality (moats and management) with what we think a company is really worth (margin of safety) is what we refer to as our three Ms. These elements of our process help us preserve client capital and increase our ability to improve potential returns.

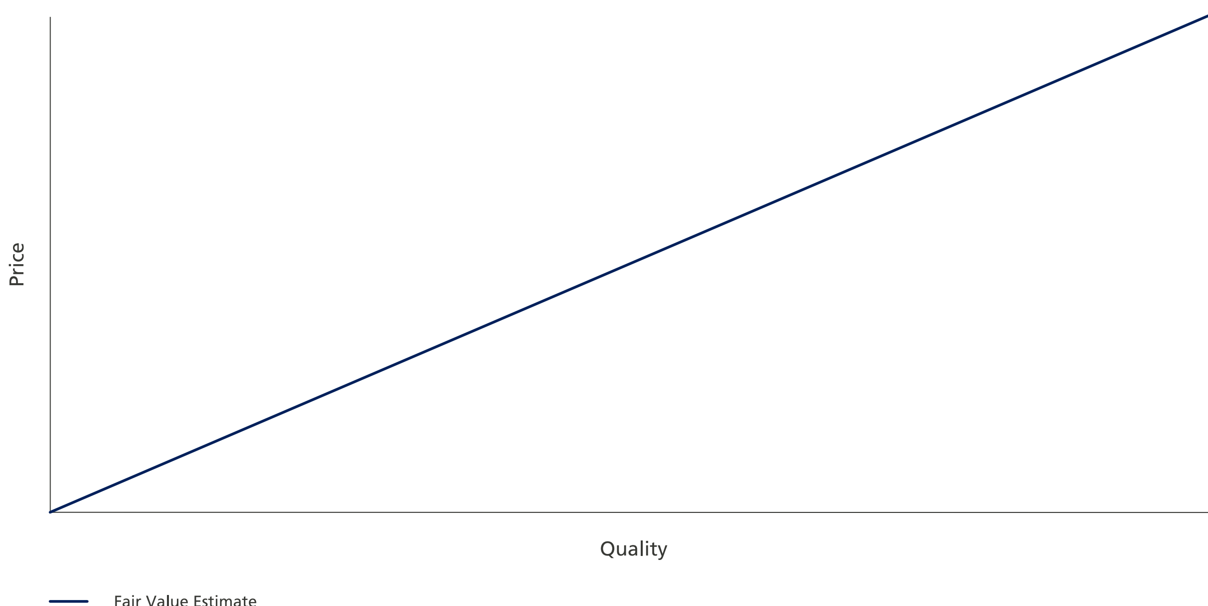
Quality is determined by how predictable future cash flows are

We believe that the quality of a business is determined by how predictable future cash flows are. The highest quality businesses have an edge that allows them to consistently grow future cash flows. Investment markets reward certainty and higher quality companies tend to be more expensive. Companies with weaker business models tend to be cheaper. If there is a wide range of possible outcomes for future cash flows, the market requires a higher return to compensate for this risk: Price to earnings (PE) ratios will be lower and dividend yields will be higher over time.

We improve our odds by buying above average quality companies for below average prices

Part of our analysis of a potential investment opportunity is to estimate the company's intrinsic or fair value. The fair value of an investment equates to the value of future cash flows

Graph 1: The 'Fair Value Estimate' line



Source: PSG Asset Management

reflected in today's terms after accounting for the risks. Our estimation of intrinsic value takes into account how reliably we can forecast future cash flows and the growth rates that we are confident to be able to predict based on the strength of the company's moat and the quality of its management team.

One of the easiest ways for equity investors to get the odds in their favour is to buy an above average quality company for a below average price. We spend a lot of time analysing companies that have a track record (or market positioning) that indicates that they are superior, but where this positioning is not reflected in the current price.

Why does a quality business become 'cheap'?

There may be short-term perceptions and concerns about the company's earnings. We have a record of exploiting opportunities to buy quality companies at attractive prices because they have a fixable or temporary problem. Our desire to avoid future capital loss means that we aim to avoid companies that trade above what we estimate they are worth or lie above the fair value line in Graph 1.

We are very careful not to overpay

We currently believe that many of the more popular industrial and financial stocks are overpriced and therefore risky. These would include some of the strongest performers of recent years such as Naspers, Richemont, SAB Miller and Aspen. They may be high quality companies, but we believe that current share prices incorporate overly optimistic expectations and that there is a real risk of capital loss.

We demand a higher margin of safety for lower quality companies with unpredictable earnings

We are happy to own lower quality companies with more unpredictable future earnings streams but need to be compensated for this with a higher margin of safety. We buy such companies on the basis of an expectation of a mean reversion to our conservatively estimated fair value. Hence, we refer to them as 'mean reverters'. As shown in Graph 2, it is our view that Anglo American currently provides such an investment opportunity. We see a very low probability of permanent capital loss from current price levels and the stock trades at a material discount to our conservatively-calculated intrinsic value.

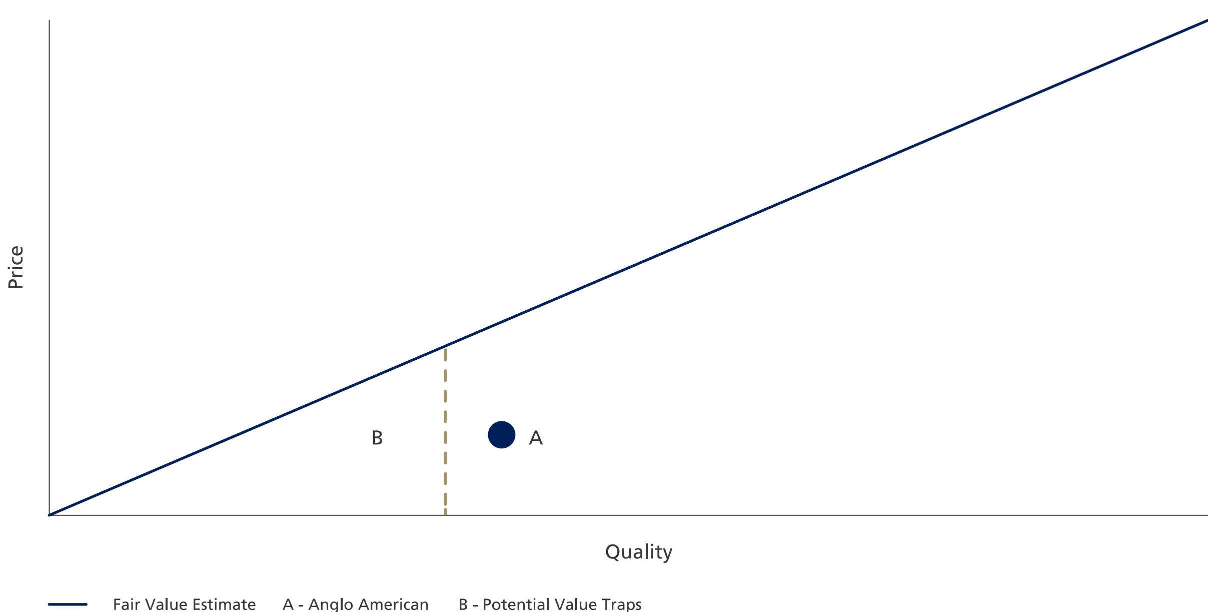
We are careful to avoid potential value traps and permanent capital losses

There are currently a number of stocks that are visibly cheap but we prefer to avoid them on the basis that we cannot satisfy our requirement that permanent capital loss is highly unlikely.

These tend to be stocks that have fallen out of favour (this is a characteristic that we would normally like), but we feel that we are not being adequately compensated for the risks. This may be business or industry specific such as:

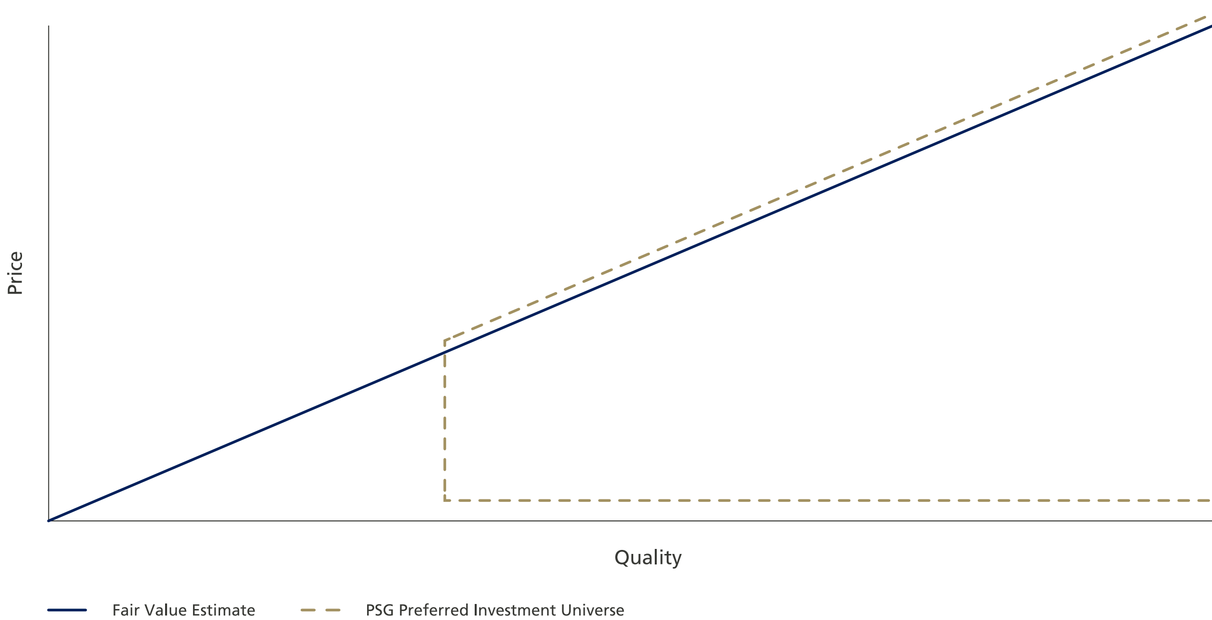
- The business being adequately capitalised (such as Abil);
- Future commodity price rises compensating for structural cost challenges (such as gold and platinum stocks);
- It being unlikely that the business will be run for shareholders on a sustainable basis (such as Telkom); or
- The share not being cheap enough to compensate for the company-specific risks but trading at a low multiple.

Graph 2: Mean reverters versus potential value traps



Source: PSG Asset Management.

Graph 3: Our preferred equity investment universes



Source: PSG Asset Management.

We avoid such stocks on the basis that they are potential value traps. A value trap is a company that appears cheap and trades at low multiples relative to history, but it stays cheap or gets cheaper still because of an inherent problem with the company or industry. This can result in good returns when company fundamentals improve, but we don't consider it worthy of the risk.

Our preferred equity universe is valuation-based and driven by quality, price and risk

Graph 3 shows our preferred equity investment universe. We have a strong focus on value, but our quality overlay sees us actively seeking out mispriced superior companies. We are, however, careful about overpaying. We also tread very cautiously with lower quality opportunities and walk away from potential value traps where we can't conclude with great confidence that we are being adequately compensated for the risk. We believe that such a process improves our odds of achieving consistent performance.

CAPITAL ONE

By Henno Vermaak

Henno started as an analyst with PSG Asset Management in 2008. He is a qualified actuary and CFA Charterholder and manages the PSG Global Flexible and PSG Global Equity Funds.

Our sector holdings are a consequence of our stock selection process

At PSG Asset Management, we follow a bottom-up investment process to identify undervalued investment opportunities on a global basis. As regular readers would know, this means that we do not attempt to predict which industries or sectors will become more or less popular in the market but rather focus on the specific attributes and valuations of the companies. Consequently, a fund's sector allocation is purely the result of our process of individual stock selection, not the driver of decisions.

The PSG Global Funds' exposure to the financial stocks increased steadily during 2013

It is, however, interesting to consider the movements in the sector allocations of our funds over time as an indication of where our research identifies the attractively priced businesses. At the end of 2013, the largest allocation in our global funds was to the financial sector – possibly an indication that the market's nerves are still suffering from the financial crisis. In Graph 1 we show that the proportion of the PSG Global Equity Fund and PSG Global Flexible Fund invested in financial companies steadily increased throughout 2013.

Capital One, a US diversified financial services firm, is one of our top ten holdings

In the past we have written about Berkshire Hathaway, our largest financial holding in the global funds. In this edition, we will discuss Capital One, which has entered the Top 10 holdings of both the PSG Global Funds over the past quarter.

Capital One is a New York-listed bank with operations in the US, Canada and the UK. It was founded in 1988 and, through a series of acquisitions, grew from a pure credit card business into a diversified financial services firm with three core businesses: credit cards, consumer banking and commercial banking.

The transformation of their total loan book is shown in Graph 2. Credit cards remain a dominant part of the business and the business is currently the 4th largest issuer of Visa and Mastercard credit cards in the US. However, the exposure of the loan book also extends into vehicle finance, mortgages and commercial loans.

Why do we like Capital One?

Banks are generally geared entities and small operating mishaps can quickly destroy value. We therefore do our work very thoroughly and make conservative assumptions when we analyse such institutions. In the case of Capital One, there is much to like about the business.

1. Management is aligned because senior management are significant shareholders

   The business is owner-managed. The founder is still the CEO and has significant personal wealth invested in the business. In fact, the CEO does not receive any basic cash salary. His remuneration comes only in the form of deferred bonuses and stock-based compensation.

   All senior managers are also required to hold shares in the company to the value of at least three times their salary. Combined, they own more than 2% of the shares in the company. This implies an aggregate exposure of management of nearly $1 billion. We don't find this level of alignment very often at large banks.

   Our analysis indicates that this alignment translates into a business that is exceptionally well-managed with diligent expense control and thoughtful capital allocation. Management follows an information-based strategy with rigorous testing and net present value-based decision-making. As such, the aim is not to build an empire, but to increase the profits of the operation for shareholders.

2. The business follows a sensible diversification strategy

   This is clear in the transformation management accomplished over the past two decades. They succeeded in diversifying the balance sheet, both on the asset (away from purely credit cards) and on the liability side. It is on the liability side where the approach added particular value. From being debt-funded in the early 90's the balance sheet currently shows that more than 80% of their funding is from deposits.

   Compared to funding only with debt, the ability to fund with customer deposits adds two key benefits. Firstly, it lowers the cost of funding because deposits are generally cheaper than debt. Lower funding costs enable a bank to earn higher net interest margins and, ultimately, higher profits. Secondly, it reduces risk as a deposit-funded institution is less exposed to the vicissitudes of the capital markets.

   The improved stability of the balance sheet meant that Capital One survived the global financial crisis. It was able to acquire the US banking operations of ING, the Dutch bank, when it was forced to sell its international operations. Through this acquisition, Capital One became the largest direct bank in America and made it the market leader in this fast growing segment of US banking.

   Direct banking can be a very attractive business. As the bank saves on the significant costs of maintaining a branch network, it can afford to pay higher rates on deposits and/or charge lower rates on loans. A low cost base, combined with the subsequent ability to attract high quality deposits is a competitive advantage in the world of banking. Capital One has proven this and now ranks as one of the ten largest deposit holders in the US.

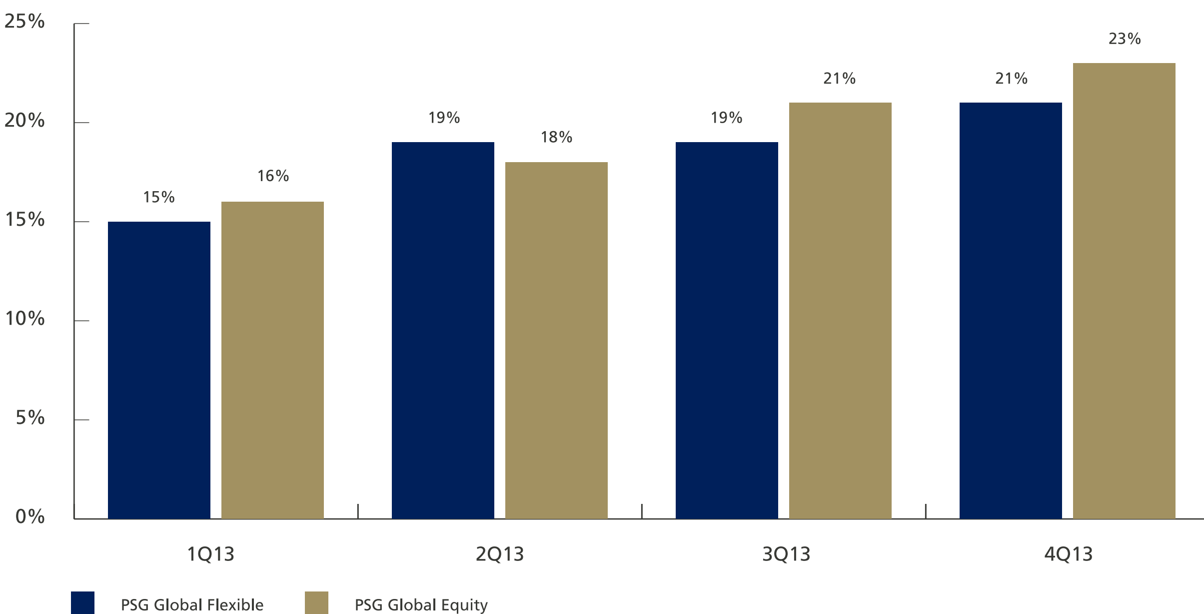
3. They have a focused offering that delivers high returns on equity

   Capital One remains highly focused. The bank competes in segments of the market where it sees the ability to develop an edge over competitors. It has grown in areas where returns are superior and the industry structure is attractive (credit cards, auto loans, direct banking), while running down areas where it is not the case (such as mortgage lending). This has led to positions of scale with much lower complexity than is the case at many larger banks.

   The business delivers high returns on equity without undue leverage and has started to return capital to shareholders. Capital One increased its dividend six-fold in 2013 and has indicated that more capital will be returned to shareholders over the coming years. This is made possible by the fact that the bank has a strong capital base and is generating capital in excess of its organic growth requirements which, combined with the run-off of non-core lines of business, releases further capital.

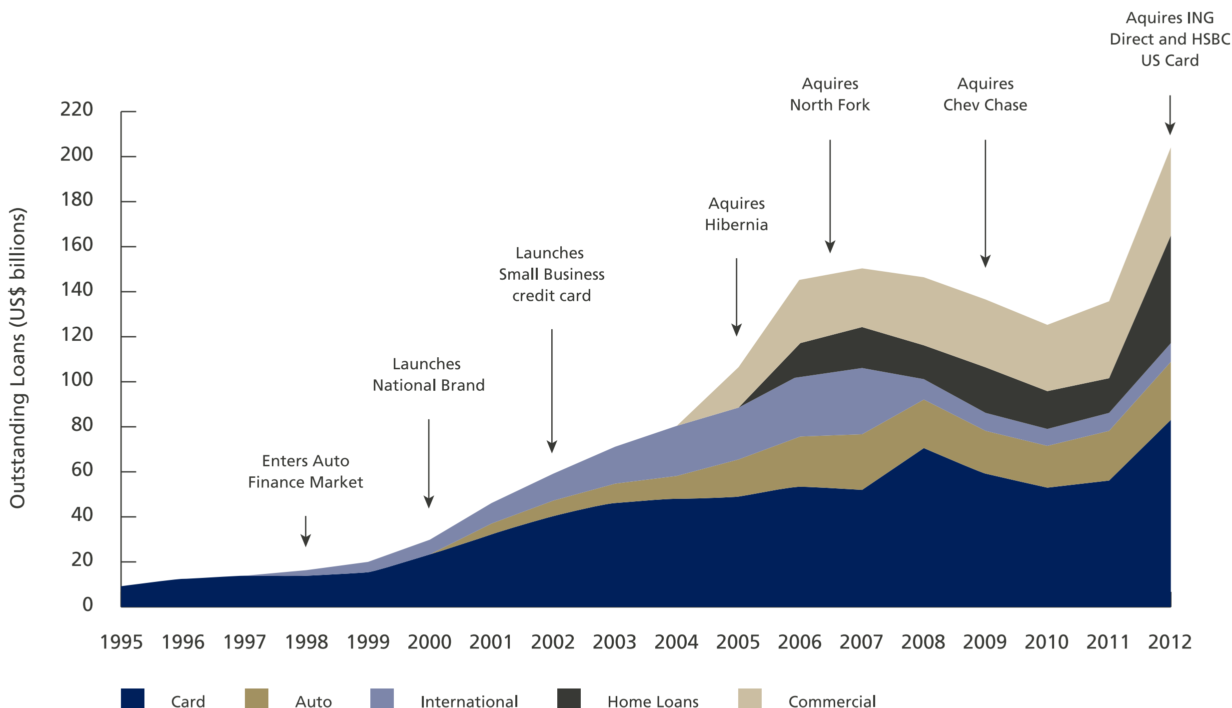
   In addition, the bank is very well geared towards an economic recovery in the US. Credit card loan growth

Graph 1: PSG Global Funds exposure to financial sector



Source: PSG Asset Management

Graph 2: The transformation of the Capital One loan book



Source: Capital One company presentation

has lagged other forms of credit leading into the global financial crisis. One of the main reasons was the growth in home equity credit lines - essentially US consumers using their mortgages as ATMs in the booming housing market before 2008. We do not expect a repeat of this trend and should see the loan extension mix swing in the favour of credit cards as consumer spending continues to grow.

The bank provides compounding potential

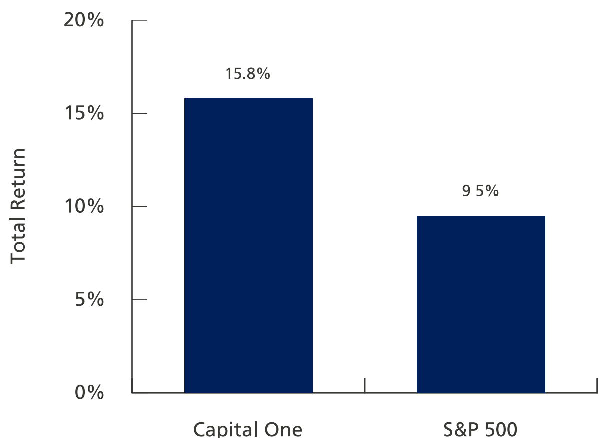
Since 1994, Capital One has outperformed the US market. It has delivered a total return (including dividends) of 15.8% p.a. This comfortably outperformed the S&P 500 Index at 9.5% p.a, as shown in Graph 3.

Capital One is a focused bank with sustainable competitive advantages over their competitors

In our opinion, the share price does not reflect the strong management team combined with the business' inherent competitive advantages. Capital One trades at an attractive multiple of less than 10 times historic earnings and at net asset value.

Capital One ticks the requirements of all of our three Ms: Moat, Management and Margin of Safety and is currently unloved by the market.

Graph 3: Capital One has comfortably outperformed the S&P 500 Index since 1994



Source: Bloomberg

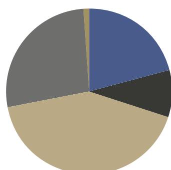
PORTFOLIO HOLDINGS AS AT 31 DECEMBER 2013

PSG Equity Fund

Top 10 equities

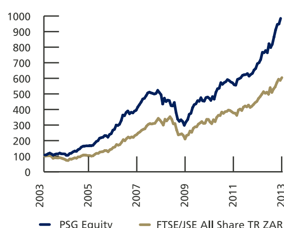
Anglo American Plc
Steinhoff International Holdings Ltd
Microsoft Corporation
Capitec Bank Holdings Ltd
Adcorp Holdings Ltd
Clover Industries Ltd
Exxaro Resources Ltd
Sasol Ltd
Omnia Holdings Ltd
Glencore Xstrata Plc

Asset allocation



Resources	21.0%
Financials	9.0%
Industrials	42.0%
Foreign equity	27.0%
Domestic cash	1.0%
Total	**100%**

Performance

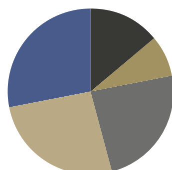


PSG Flexible Fund

Top 10 equities

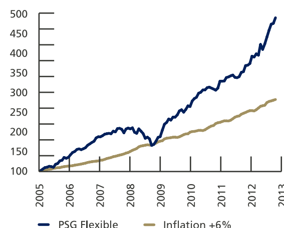
Steinhoff International Holdings Ltd
Anglo American Plc
Berkshire Hathaway Inc
Capitec Bank Holdings Ltd
Sasol Limited
Tesco Plc
Super Group Ltd
ING Groep NV
Porsche Automobile Holdings
Eqstra Holdings Ltd

Asset & sector allocation



Resources	14.0%
Financials	8.0%
Industrials	24.0%
Domestic equity	**46.0%**
Foreign equity	**26.0%**
Domestic cash	28.0%
Total	**100%**

Performance

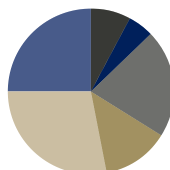


PSG Balanced Fund

Top 10 equities

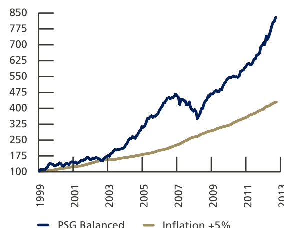
Steinhoff International Holdings Ltd
Anglo American Plc
Super Group Ltd
Berkshire Hathaway Inc
Capitec Bank Holdings Ltd
Adcorp Holdings Ltd
Microsoft Corporation
Tesco Plc
Sasol Ltd
International Business Machine Corp

Asset & sector allocation



Resources	8.0%
Financials	5.0%
Industrials	21.0%
Domestic equity	**34.0%**
Domestic bonds	**13.0%**
Domestic cash	**28.0%**
Foreign equity	**25.0%**
Total	**100%**

Performance



PSG Stable Fund

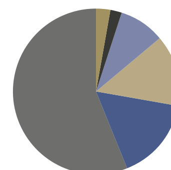
Top 5 equities

Steinhoff International Holdings Ltd
Microsoft Corporation
Berkshire Hathaway Inc
Tesco Plc
Capitec Bank Holdings Ltd

Top 5 bond issuer exposures

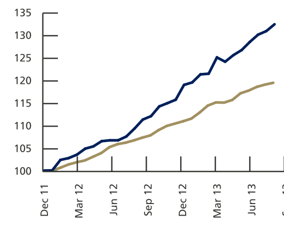
Transnet Soc Ltd
Absa Bank Ltd
Landbank
FirstRand Bank Ltd
Toyota Financial Services (SA) (Pty) Ltd

Asset & sector allocation



Resources	3.0%
Financials	2.0%
Industrials	9.0%
Domestic equity	**14.0%**
Domestic bonds	**14.0%**
Foreign equity	**16.0%**
Domestic cash	**56.0%**
Total	**100%**

Performance



PSG Optimal Income Fund

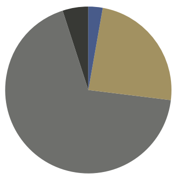
Top 5 equities

Berkshire Hathaway Inc
Steinhoff International Holdings Ltd
International Business Machine Corp
Microsoft Corp
Capitec Bank Holdings Ltd

Top 5 bond issuer exposures

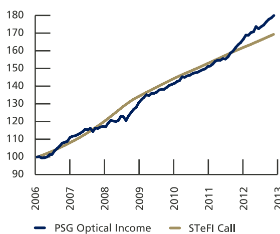
Nedbank Ltd
Capitec Bank Holdings Ltd
Barloworld Ltd
Transnet Soc Ltd
ABSA Bank Ltd

Asset allocation



Local Equity	3.0%
Local Cash	24.0%
Local Bonds	68.0%
Offshore Equity	5.0%
Total	**100%**

Performance

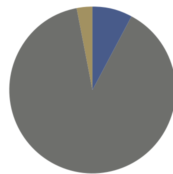


PSG Income Fund

Top 10 bond issuer exposures

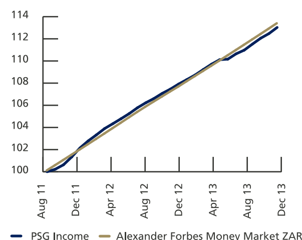
Nedbank
Barloworld Ltd
Capitec Bank
Absa Bank Ltd
Firstrand Bank Ltd
Eqstra Corporation
Bidvestco Ltd
Landbank
Transnet Soc Ltd
Toyota Financial Services (Pty)(SA)Ltd

Asset allocation



Fixed rate notes	8.0%
Floating rate notes	89.0%
Cash and NCDs	3.0%
Total	**100%**

Performance

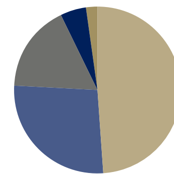


PSG Global Equity Fund

Top 10 equities

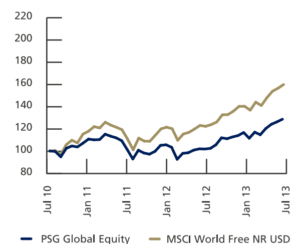
Berkshire Hathaway Inc
International Business Machines Corp
Microsoft Corporation
Steinhoff International Holdings Ltd
JP Morgan Chase & Co
Capital One Fin Corp
Cisco Systems Inc
Tesco Plc
Porsche Automobile Holdings
Target Group

Regional allocation



US	49.0%
Europe	27.0%
UK	17.0%
Africa	5.0%
China	2.0%
Total	**100%**

Performance



PERFORMANCE TO 31 DECEMBER 2013

FUND PERFORMANCE							
		1 Year			2 Years**		
Fund	Fund Size	Return	Sector Rank	Sector Count	Return	Sector Rank	Sector Count
LOCAL FUNDS							
PSG Equity A	R 1 316 488 683	37.08	1	116	28.09	5	107
FTSE/JSE All Share TR ZAR		21.43			24.03		
(ASISA) South African EQ General		19.28			19.63		
PSG Flexible	R 3 869 255 074	31.55	4	68	22.30	22	63
PSG Flexible BM: CPI +6%		11.38			11.50		
(ASISA) South African MA Flexible		17.59			17.69		
PSG Balanced A	R 2 432 726 017	26.03	3	104	19.68	24	94
PSG Balanced BM: CPI +5%		10.36			10.48		
(ASISA) South African MA High Equity		17.89			17.08		
PSG Stable	R 1 158 405 172	14.62	27	89	13.27	37	81
PSG Stable BM: CPI+3%		8.35			8.48		
(ASISA) South African MA Low Equity		12.07			12.59		
PSG Optimal Income	R 266 465 487	8.14	5	54	8.74	3	47
STeFI Call Deposit ZAR		4.68			4.88		
PSG Income A	R 102 406 388	4.74	28	30	5.19	27	28
Alexander Forbes Money Market ZAR		5.32	21	31	5.45	26	29
PSG Money Market A	R 2 573 570 889	4.99	25	28	5.15	25	27
(ASISA) South African IB Money Market		5.10			5.05		
PSG Global Equity Feeder Fund	R 73 758 918	48.83	18	25	28.38	20	23
MSCI World NR USD		56.38			37.97		
(ASISA) Global EQ General		52.00			34.26		
OFFSHORE FUNDS							
PSG Global Equity	$ 28 546 937	21.96	268	504	15.17	334	459
MSCI World NR USD		26.68			21.13		
GIFS Global Large-Cap Blend Equity		20.69			16.92		

* Manager inception dates
** Annualised (for periods greater than 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 NAV basis.
Source: © 2014 Morningstar, Inc. All Rights Reserved.

										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
20.10	7	93	24.59	1	84	01/03/2002*	21.32	2	42	9.42	27	93
16.42			19.93				16.42			11.53		
13.91			17.38				17.69			9.17		
18.22	14	60	21.67	4	53	01/11/2004*	19.17	3	15	7.73	39	60
11.71			11.32				12.11			2.49		
13.44			14.04				15.48			5.83		
15.73	17	83	16.23	10	64	01/06/1999	15.77	4	13	5.63	21	83
10.69			10.30				10.60			1.15		
13.00			13.05				13.96			5.79		
						13/09/2011	13.45	36	77			
							8.40					
							12.40					
7.47	16	40	8.00	13	32	10/04/2006	8.05	13	22	1.71	24	40
5.02			5.93				7.16			0.10		
							5.39	22	24			
							5.49	21	25			
5.25	23	27	6.33	15	24	31/10/1998	8.98	4	6	0.08	15	27
5.30			6.40				8.98			0.25		
						05/04/2011	23.18	20	21			
							30.46					
							27.16					
6.36	265	420				23/07/2010	7.84	331	401	14.04	132	420
11.49							14.50			13.73		
6.69							9.72			-		

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PSG Asset Management Administration Services (Pty) Limited is an Authorised Financial Services Provider, Registration Number 1999/014522/07, FSP Number 563. PSG Asset Management Administration Services (Pty) Limited administers the PSG Voluntary Investment Plan. PSG Asset Management Nominees (Pty) Limited is the entity that holds investments in the PSG Voluntary Investment Plan in safe custody for your benefit exclusively. PSG Asset Management Life Limited is an Authorised Financial Services Provider, Registration Number 1999/010087/06, FSP Number 22557. PSG Asset Management Life Limited is the underwriter of the PSG Asset Management Retirement Annuity, PSG Asset Management Preservation Funds, the PSG Asset Management Equity Linked Living Annuity and the PSG Asset Management Endowment Investment.

PSG Fund Management (CI) Limited as Manager of the PSG Global Equity Fund is licensed by the Guernsey Financial Services Commission (“GFSC”). The PSG Global Equity Fund is a Class B open-ended collective investment scheme authorised by the GFSC.

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