PSG Asset Management

2ND Quarter 2014

ANGLES & PERSPECTIVES

CONTENTS

REAL RETURNS AND MARGIN OF SAFETY

By Greg Hopkins

Greg is a CA (SA) and a CFA Charterholder. Greg is PSG Asset Management's Chief Investment Officer.

This edition focuses on our primary goal with our investors' wealth

This edition of Angles & Perspectives will be a little more technical than some of our previous editions. It carries what we believe is an important theme. This theme is that our primary goal is to preserve and grow our investors' wealth in real terms – above inflation and with returns commensurate with the risks associated with the different asset classes we invest in.

Inflation is key when aiming for real returns

Now for the technical part: real returns are a function of the realised return from an investment less the inflation rate over the holding period of that investment. The difficult part in this exercise is estimating what inflation is going to be over the next 5-10 years. Buying an investment and then realising in the fullness of time that it did not keep up with inflation when adjusted for the underlying riskiness of the investment is something that we aim to avoid at all costs.

To this end, the recent actions of the Monetary Policy Committee (MPC) of the South African Reserve Bank (SARB) are very instructive. The MPC under SARB Governor Gill Marcus is believed to be more tolerant on inflation than previous committees. On our estimates, monetary policy as measured by real repo interest rates has been accommodative for the last three years, the longest period since the new South African regime in 1994. However, the MPC's willingness to raise rates in the face of weak domestic demand has suggested that they are drawing a line in the sand when inflation expectations start creeping above the upper limit of their 3-6% target band.

Anchored inflation enables us to measure the potential margin of safety

A credible SARB plays an important role in anchoring inflation expectations. We therefore believe that the MPC's actions give us greater confidence that inflation will not exceed 6% over the medium term. This simple assertion gives us more confidence in measuring the potential margin of safety, which we can derive when investing in long-term assets that don't have pricing power, such as government bonds. Our Head of Fixed Income, Ian Scott, will spend more time unpacking this in the first article.

Tyron Green delves into the world of credit and explains why we believe that structural forces are potentially driving credit spreads to unsustainably low levels, and Henno Vermaak writes about an exciting new global opportunity that we have been adding to our funds. We also give readers an insight into the US Fed's actions, which impact markets around the globe.

There are opportunities amidst the environment of reduced yields

Throughout this edition, we continue to question the risk-seeking behaviour of market participants. This behaviour has compressed investment yields across all asset classes, particularly in the fixed income markets. However, we continually keep turning over the stones to find hidden gems and to identify opportunities where fear and uncertainty have driven prices down to levels where the margin of safety becomes attractive.

We trust that our insights will provide you with a deeper level of understanding of the positioning of our funds and that you will enjoy reading this edition.

THE BENEFIT OF BEING CAUTIOUS WHEN OTHERS ARE GREEDY

By Ian Scott

Ian 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.

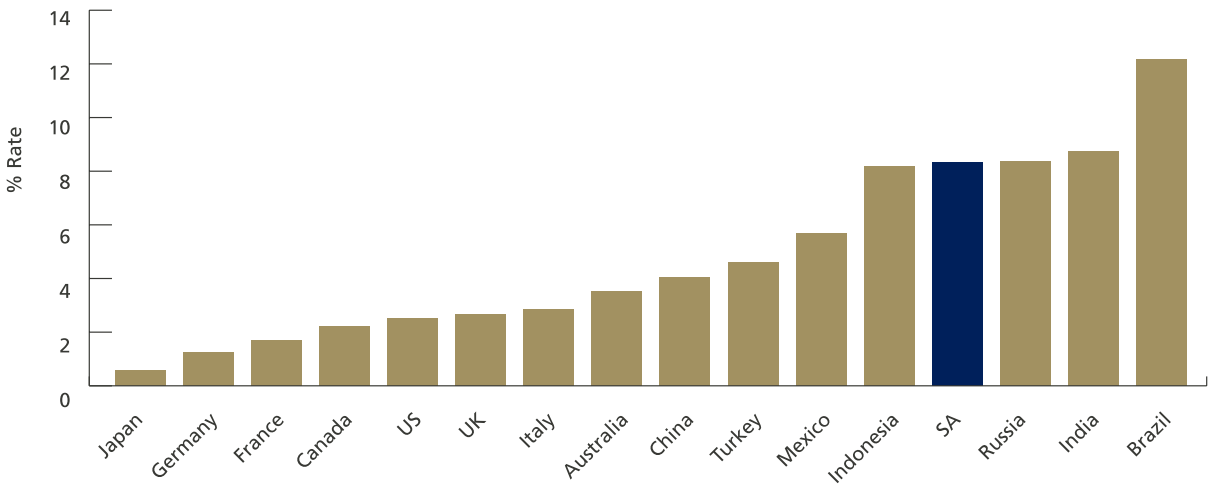
Emerging market bonds still the investment of choice

The risk-seeking behaviour of developed market investors whereby they invest in emerging market bond markets continues unabated. For the past five years, central banks in developed markets have successfully encouraged investors to buy assets at inflated prices. These policies continue as the US Federal Reserve (the Fed) remains dovish on its interest rate policy stance, irrespective of the fact that consumer inflation is close to the Fed's target rate. In Europe, the European Central Bank cut interest rates down to zero and added further stimulus to the European banking system. The question is: why do investors keep on buying emerging market debt even though emerging market fundamentals, like South Africa's fundamentals, are a lot less attractive than those of developed markets?

The hunt for yield

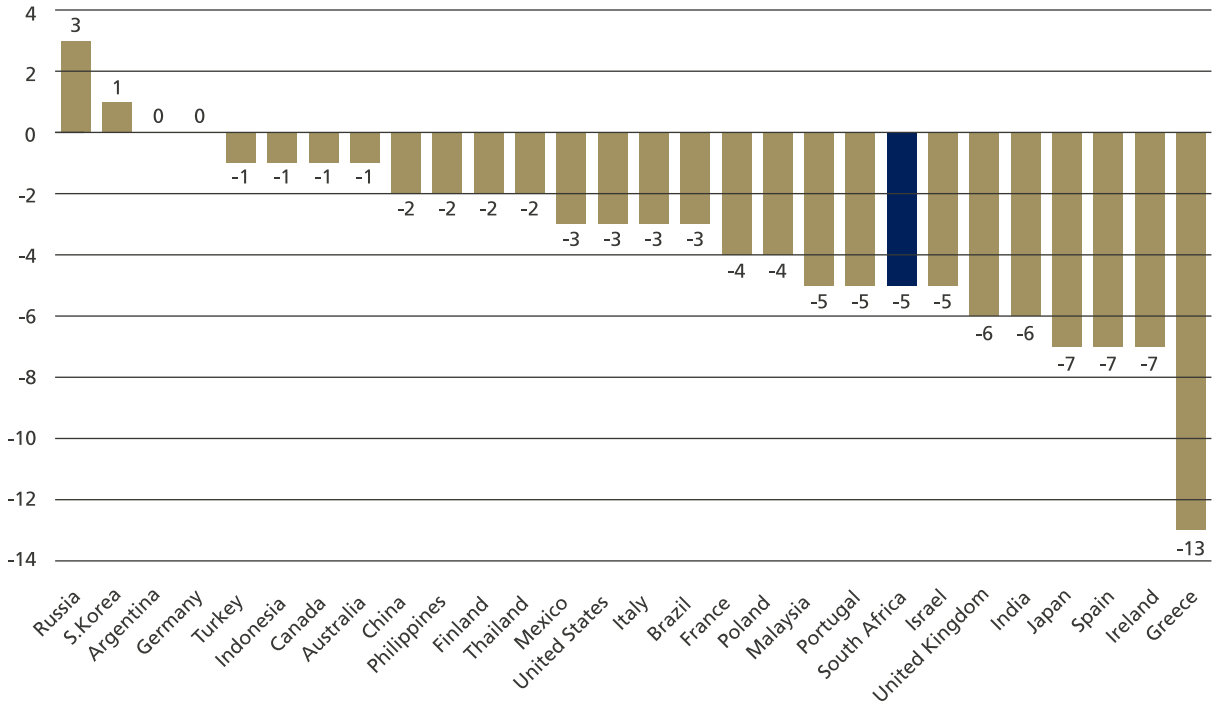
Let's place ourselves in the shoes of these developed market investors for a moment. A central bank lends you cash at near to zero percent, inflation is low and your currency is stable. How do you make a real return for your investors? Interest rates in developed markets are at generational lows and asset prices seem stretched. Then, emerging markets come onto your radar. Depending on the fundamentals of the specific country, these markets offer yields of between 3% and 12%. South Africa specifically stands out in our emerging market time zone due to the high nominal yields and the liquidity of the markets on which to trade these yields, as shown in Chart 1.

Chart 1: Developed versus emerging markets – 10-year nominal yields



Source: Bloomberg

Chart 2: Budget deficits (June 2013 to June 2014)



Source: Bloomberg

It seems investors have forgotten bond fundamentals in this hunt for yield

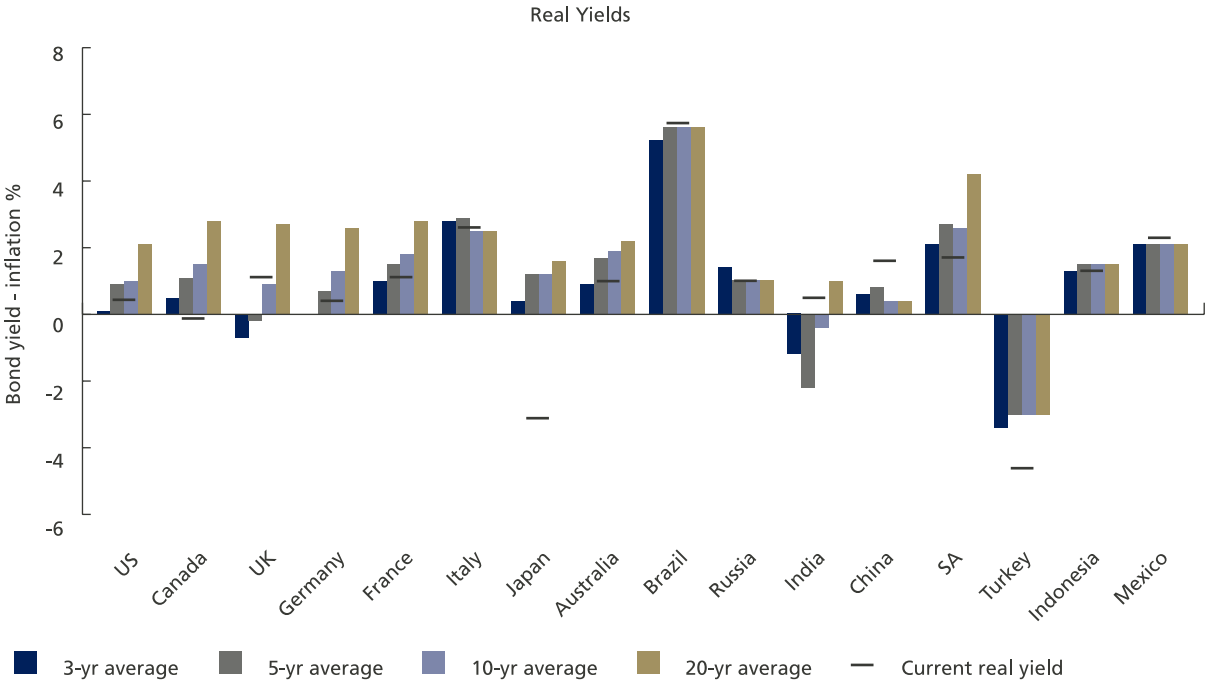
Governments globally are spending and borrowing more to stimulate growth in their respective economies. Currently, budget deficits in most economies are either stable at best or rising, as shown in Chart 2. If governments are borrowing more than ever, why are investors willing to accept to buy this debt at low yields and high prices? In addition, governments are extending the maturity profile of their debt, and yet investors are still willing to accept this longer-dated debt at high prices. The bulk of government issuance in South Africa is for maturity dates between 2020 and 2048. Another problem is that the government uses these long-term borrowings for current expenditure, not infrastructure development. The duration risk (interest rate sensitivity) of investors' portfolios is rising. Demand and supply dynamics in bond markets seem totally out of balance. For us, this scenario represents a margin of safety risk. We feel that we do not have to buy government debt with long duration risk if the current trend is for government to issue a substantial amount of paper into the market over the foreseeable future.

With central banks encouraging this risk-seeking behaviour, investors seem to have forgotten the true fundamentals of bonds. The fact that more bonds than ever are being issued into markets, as mentioned above, does not seem to matter. It also does not seem to matter at what level the bonds trade as long as it is at some level above cash returns. Bond investors are comfortable to buy bonds as long as they know central banks will just keep the printing press going. Is this irrational behaviour reason enough to expose investors' money to this type of long duration risk?

Do real yields matter?

Very few market commentators are talking about the real returns earned on bonds, since inflation in developed markets is low, as shown in Chart 3. It seems like the focus is on comparing bonds with cash, with no real regard for risk-adjusted returns in fixed income markets. Valuations mean little when the printing presses roll on. Over time, long-dated bonds have to yield a fair margin above inflation to compensate the investor for the term risk inherent to these bonds. Long-dated bonds in South Africa currently yield a positive return above inflation but it is low, at about 1.6%. The long run (or what we call through-the-cycle) 10-year nominal yield above inflation is between 2% and 2.5%. This is why we feel the margin of safety in nominal bonds is currently too low. Only when this margin returns to more normalised levels would we invest in longer-dated bonds.

Chart 3: Real bond yields (1994 to 2014)



Source: Bloomberg

Cautious when others are greedy

In the current environment, where risk-seeking behaviour from foreign bond investors is keeping long bond yields at low levels, we choose not to be greedy. Eventually, there will be a return to bond fundamentals, and this will be reflected in higher yields. The return to more normalised real returns on bonds will be a buy signal for us. Initially, real returns in fixed income markets may not be reflected in official rates, but markets will start pricing for the event. Investors will start demanding higher real returns on bonds as the growth dynamic gathers more momentum.

MARKEL – THE VALUE OF THE IMITATOR

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.

'To improve their odds, imitators need to understand "true" imitation, develop the capabilities that enable its effective use, and learn to deploy imitation strategies.'

Interview with Professor Oded Shenkar, Harvard Business Review, April 2010

The power of imitation over innovation

In his book 'Copycats: How smart companies use imitation to gain a strategic edge', published in 2010, Professor Oded Shenkar gives an astonishing statistic: up to 97.8% of the value of innovation goes to those who imitate an original design. According to him, 'good imitators actively search for ideas worth copying'. If that is anywhere close to the truth, then the rational thing to do is to identify the most successful businesses, determine why they are successful, and imitate what they do as best you can. For example, at PSG Asset Management we unapologetically adopt the tried and tested value investing principles of some of the world's most successful investors.

Markel Corporation uses the principle of imitation very successfully

Markel is the latest addition to the top 10 holdings of our global funds. The business is built on the principles of Berkshire Hathaway, one of the stand-out investment successes of the twentieth century.

Similar to Berkshire Hathaway, Markel is an insurance business that uses the cash flow generated by the underwriting of risk to invest in other financial assets to earn an enhanced return on shareholder capital. However, unlike Berkshire Hathaway with its fortress-like balance sheet, Markel is a much smaller business. Yet it still managed to deliver 20% annualised growth in net asset value (NAV) per share for a number of decades.

The investment function is headed by Tom Gaynor, a highly respected value investor. He has been with the company since 1990 and has consistently delivered impressive returns on the portfolio. Over the past 20 years, the Markel Equity Portfolio returned 13.7% per year, significantly outperforming the S&P500 Index, which delivered 9.1%.

The company expanded by growing its net asset value per share

Markel's history starts almost a century ago. Samuel Markel started out as an insurance agent in the 1920s. When he couldn't find sufficient backing to write the compulsory insurance policies on share taxis, he clubbed together with the owners of these share taxis to create a mutual insurance company. He also started a separate company, Markel Services, to write direct and reinsurance business. His sons joined him and through the decades, Markel Services grew as an insurance business in the US.

In 1986, Markel Corporation listed on the stock exchange with a market capitalisation of $15 million. Since listing, the company has grown both organically and through corporate action to a market capitalisation of over $9 billion. More importantly, it has achieved this by growing its NAV per share at a compound growth rate of around 20% per year. Value was created on a per share basis, meaning that every investor benefitted. This was not just a case of empire building.

'Several years ago we discussed our "model for profit". This model helps one understand how we believe we can compound book value at a 20% rate. Simplistically, if we do not lose anything on the underwriting operation, and maintain $4 in investments for every $1 in equity, earning a 5% after tax total return, then we will grow book value at a 20% rate… Our primary financial goal is to increase book value over the long term on a per share basis… Our goal is to compound book value at a 20% annual rate.'

Markel shareholder letter, 1998

So what makes Markel so successful?

We can identify the key contributors to Markel's success by looking at how the company matches up the core elements of our investment philosophy – the three Ms (Moat, Management and Margin of Safety).

1. Moat – Niche, specialised insurance

It is usually difficult to make the case for a moat – or a sustainable competitive advantage – in the insurance business. It is a cyclical industry characterised by many new entrants in good times and many failures in bad times. Anyone with the capital, licencing and distribution to compete with insurance businesses can copy their policies. Most insurance companies do not write profitable business through the cycle.

In certain lines of business, even the rating methodology has to be made public. As a result, a large area of the insurance business is a true commodity market. The only moat is to be the lowest cost operator. Warren Buffett understood that when he bought GEICO, the direct personal lines insurer within Berkshire Hathaway. GEICO had a structural cost advantage and has grown into one of the largest insurers in America. In fact, it is still growing, thanks to its cost advantages.

In Markel's case, the imitator has focused on niche, specialised insurance – areas of the insurance world where standardised policies are less prevalent, where competition is less ruthless, and where service and the skill to underwrite the risks are more important than being the cheapest insurer. These lines of business are called surplus excess lines and offer a form of a moat to a business with the required skill and scale to write these policies. It generates enormous levels of insurance liabilities, which create the float that Markel invests for shareholders' benefit.

'Our strategy for the future is to continue applying the principles that have proven successful for us in the past. We are a marketing oriented insurance organisation. We focus on customer needs and solving customer problems. To do this effectively, we specialise in unique market niches where our expertise enables us to be the very best.'

Markel shareholder letter, 1986

Markel is a large player in this niche, specialised insurance market. It is large enough to offer these niche products nationally, but small enough so that these attractive markets remain a large part of their business. For the large competitors, these lines of business are often marginal businesses that do not form part of the core of the enterprise. On the other hand, regional competitors often do not have the benefit of geographical diversification and need to reinsure large parts of the business, often back to Markel.

In 2000, Markel purchased Terra Nova, which gave it international presence. In 2013 it completed the purchase of Alterra, further expanding its business into South America and globally. Today Markel is an international insurance and reinsurance operation, focused on select lines of business that generate attractive returns on capital. We see evidence of this moat when we analyse Markel's operational performance.

'We are committed to sound business practices and we try to provide complete disclosure so that our partners can fully understand the value of the company. The objective of our shareholder relations program is to attract and retain investors who share our long-term goals.'

Markel shareholder letter, 1993

2. Management – Alignment of interest

Markel is managed by descendants of the founding family. The three leaders who took the company public in 1986 are still at the head of the company, which ensures a particular alignment of interest.

Management are material investors in the business and shareholding across the company is encouraged and facilitated. There are no share option schemes – real cash and bonuses are invested in the organisation. Executive bonuses are paid according to the five-year NAV per share growth and underwriters are compensated on underwriting performance and not business volume.

Executives must have at least five times their annual salary invested in the company and senior managers at least two times their salary. We really like this form of incentive scheme. The Markel managers operate as a team and the risk of key individuals leaving is low.

'Markel functions as a team. We've got a deep and growing roster of skilled players. We know that on a team different players assume different roles and responsibilities. Sometimes it means scoring points, sometimes it means passing the ball to someone else, sometimes it means teaching a new player how to do something, and sometimes it means driving the van to the next game. Those roles can and do change over time. We believe that teams last longer and produce better, more durable results than the "genius with a thousand helpers" model.'

Markel shareholder letter, 2013

3. Margin of Safety – Successful risk management

Insurance companies act like geared entities and the final financial results are often very different from the reported financial statements. As always, we therefore require a margin of safety before we invest.

The principles of maintaining a sufficient margin of safety are ingrained in Markel's business process, particularly to the thinking around underwriting, reserving, investing and accounting philosophy. Most importantly, this thinking is applied in practice. As a result, Markel has, over many years, delivered:

- profitable through-the-cycle underwriting margins
- reserves that ultimately prove to be conservative
- attractive risk-adjusted investment returns
- understandable and prudent accounting

'It is unfortunate that in the world of financial reporting and security analysis that current earnings receive more attention than quality of loss reserves. That does not make it right. We would much prefer to be pessimistic when setting loss reserves than optimistic about current earnings. This philosophy benefits every aspect of our business: it supports our underwriting profit orientation, it supports our investment activity, and it helps build our margin of safety.'

Markel shareholder letter, 1996

One of the reasons why Markel is able to manage risk is that the company is willing to walk away from business if they cannot charge appropriate premiums.

'We fully expect that premium volume (at Markel Southwest) will fall this year, and will fall significantly. We not only expect it; it's OK! When we look at our numbers at the end of this year, the only meaningful barometer will be the combined ratio, not the top line. No one should ever be concerned about market share. Our focus needs to be on underwriting profits.'

Markel shareholder letter, 1999

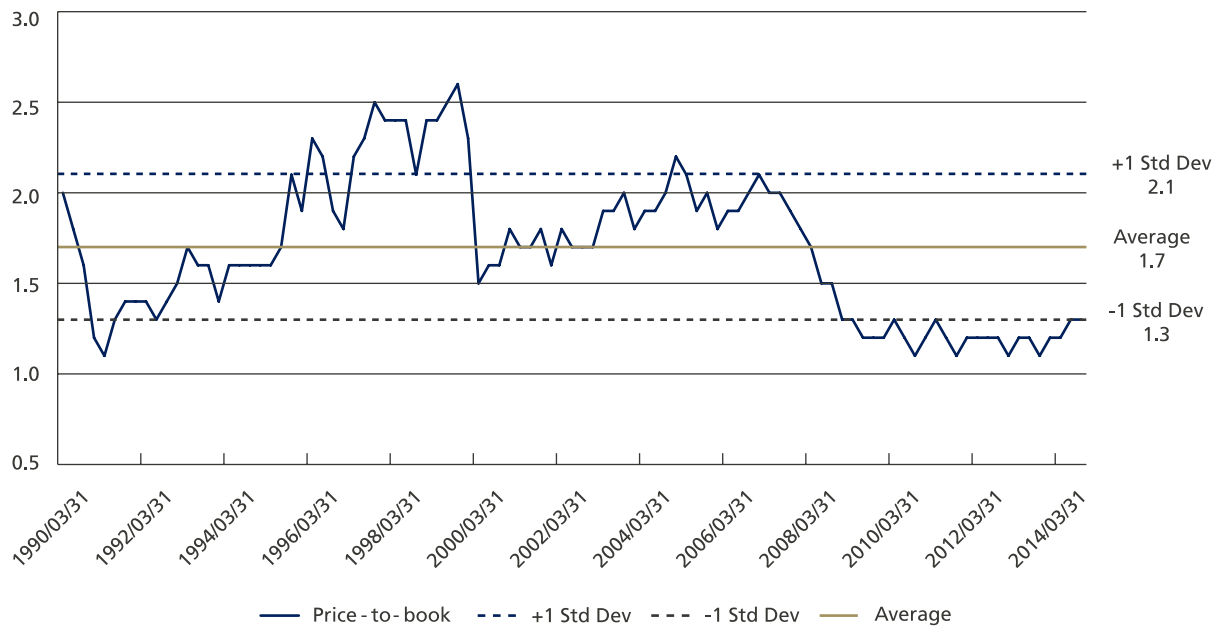
Insurance markets in general have been weak since the mid-2000s. This means that the current profits available from underwriting of risk are not at an elevated level. We expect this to improve into the future. Apart from the weak underwriting cycle, low interest rates further depress overall profitability. As with most insurance companies, a large portion of Markel's investment portfolio is invested in fixed income markets. The current interest rates do not deliver stellar investment returns and as a result, the contribution from the investment book is below what we would regard as sustainable for this business.

For Markel, the current asset allocation is not optimal following the integration of the Alterra acquisition in 2013. However, management is quite clear on their strategy going forward:

'We continue to methodically and systematically add to our equity holdings. Equity investments now comprise 49% of our shareholders' equity, up from the roughly 40% level immediately following the Alterra acquisition. We continue to find reasonable and productive investment ideas, but we also can be accused of driving the car with one foot on the brakes. So be it. We think it is far more important, to know that we can handle any upcoming curves in the road rather than trying to race ahead too fast. Over time, and with good ideas, we will approach a more normal equity allocation of roughly 80% of our shareholders' equity and equity investments. We will move when faster markets give us the opportunity to do so, but we won't be rushed by artificial targets.'

Markel conference call, first quarter 2014

Graph 1: Markel's price-to-book ratio



Source: Bloomberg

Markel is trading at attractive valuation levels, both in absolute terms and relative to its history, as shown in Graph 1.

Markel offers favourable prospects to long-term shareholders

In Markel, we see an imitation of nearly everything we like in Berkshire Hathaway. What's more – the company is trading at an attractive discount to our estimate of intrinsic value. It is a much smaller business and not on the radar screens of most institutional investors. We believe the share offers significant potential to long-term shareholders.

We recommend reading Markel's annual letters to shareholders

This will give you even deeper insights into the company's strategy. Every letter since 1986 is available on the company's website – www.markelcorp.com

UNDERSTANDING THE CREDIT RISK/RETURN TRADE-OFF

By Tyron Green

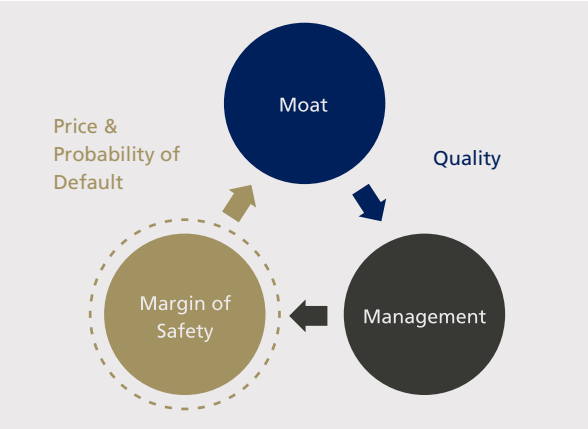
Tyron is a CA (SA) and has an MBA from the University of Cape Town. He has seven years' experience in the investment industry. He joined the Fixed Income team as a Credit Analyst in 2013 and serves on the PSG Asset Management Credit Investment Committee.

We apply our core philosophy when we make credit investment decisions

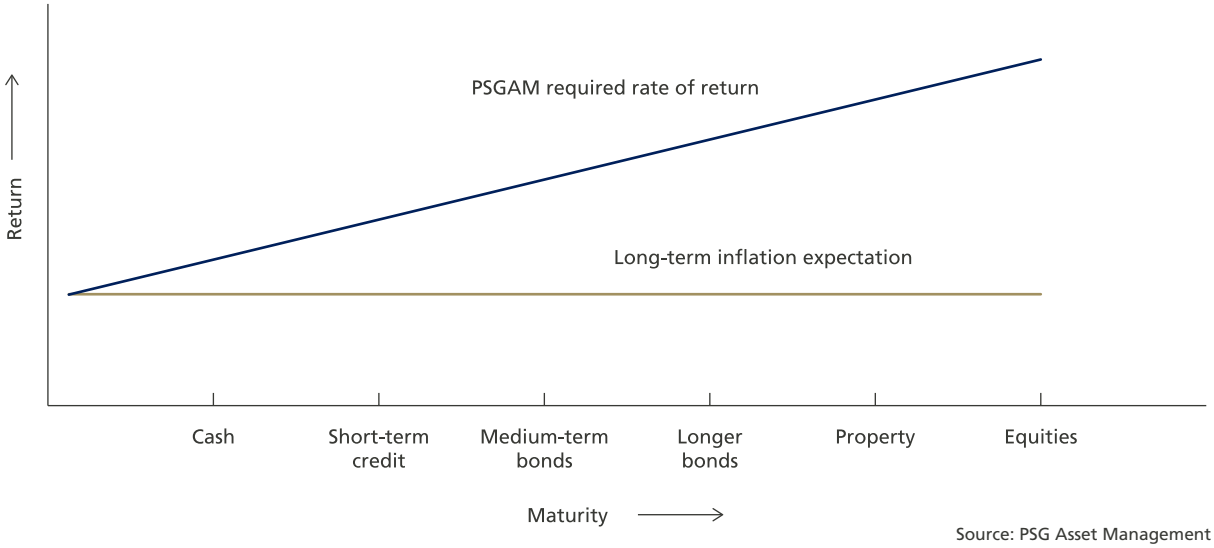
In previous editions of Angles & Perspectives, we wrote about our core investment philosophy, the 3Ms (Moat, Management and Margin of Safety). We apply a similar investment philosophy to our credit investment decisions with an additional focus on the ability to service debt and the legal structure.

We believe our process ensures that we make investment decisions with a low probability of default to mitigate a default senario and capital losses. As demand increases and the search for yield continues, investors seem to either disregard the risks associated with credit or they do not appropriately price in the risk-adjusted fair spread required for the investment. Our process aims to ensure that we are compensated with a fair spread for the risk associated with our credit investments so that we achieve our required real return.

Figure 1: The 3Ms of the PSG investment philosophy

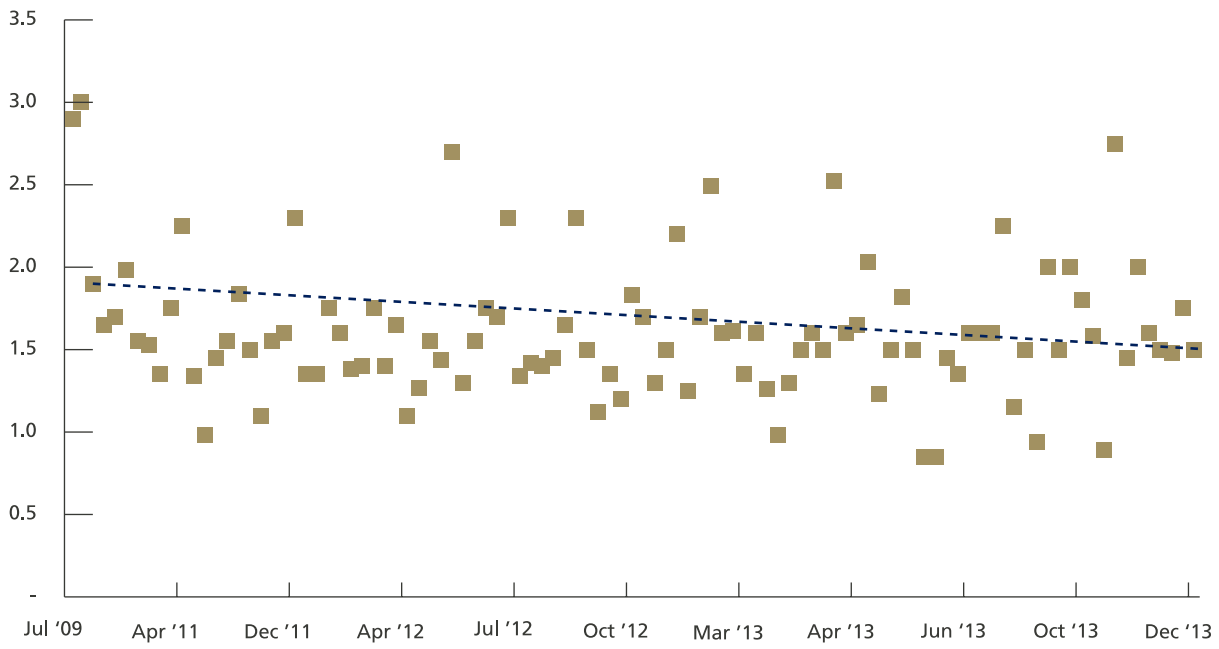


Graph 1: Required rate of return versus long-term inflation expectations



Source: PSG Asset Management

Graph 2: Issue spreads for three- and five-year floating rate notes since 2009



Sources: PSG Asset Management Research and JSE

Graph 1 shows our required return compared to the long-term inflation expectation, with cash and medium-term bonds as the focus of our corporate credit process. The graph shows that the longer the term, the higher the required return. Likewise the higher the risk, the higher the required return.

We aim to achieve our required returns on our credit investments at a fair spread that reflects the risk attached to the investment. However, in many cases we don't believe fair spreads are reflected in new issues.

Lower spreads are driven by high demand

One of the trends we have noticed in the market is the gradual shift to lower issue spreads. Graph 2 shows the decline in spreads for three- and five-year corporate floating rate notes issued since 2009.

Graph 3 shows the decline in the five-year floating rate notes issue spread for an issuer since their first issue in 2009.

New issuers usually issue bonds to the market at a premium. As investors become more familiar with the issuer, the spreads narrow marginally. The narrowing of spreads shown in Graph 3 can be explained by two key factors. The first factor is improved credit metrics. This makes it less risky to lend money to the issuer, which will result in investors demanding a lower required spread for the lower risk.

The second factor that explains narrowing spreads in the bond market is high demand. Graph 4 shows the significant increase in collective investment schemes with assets under management that can be invested in longer-term bonds. The surviving ASISA SA Multi Asset Income Funds, ASISA SA Multi Asset Low Equity Funds and ASISA SA Interest-Bearing Short-Term Funds have increased their assets under management from R128 billion at December 2008 to R428 billion at December 2013.

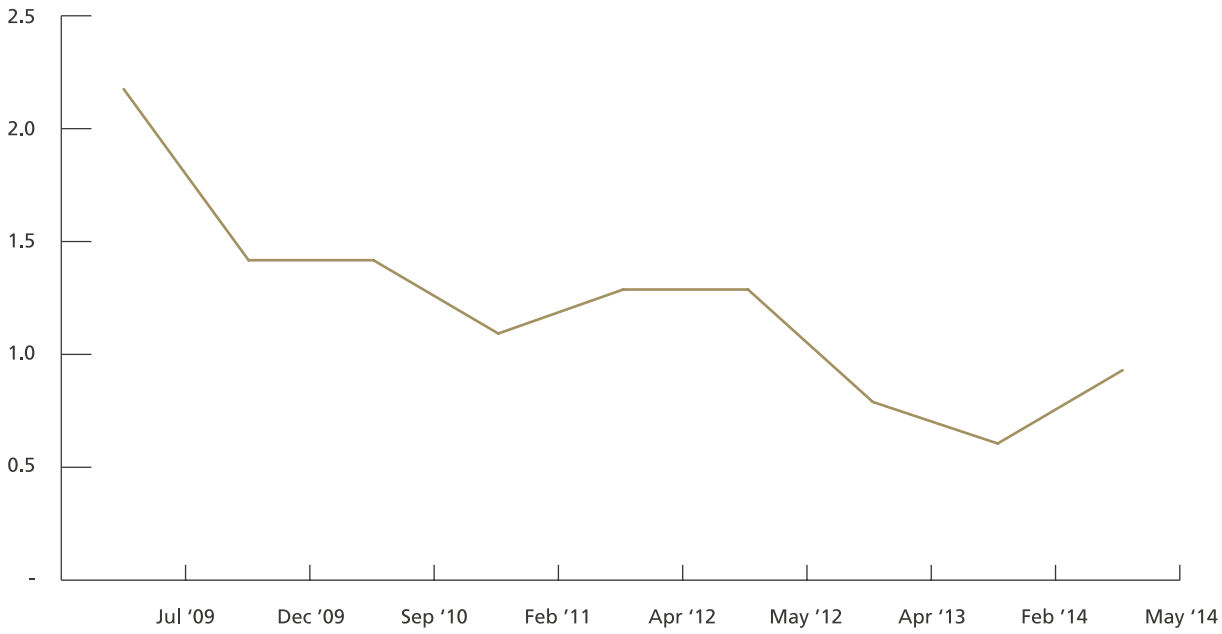
During the same period, the South African gross bond issuance (the supply of bonds) increased from R79 billion in 2008 to R110 billion in 2013 (excluding credit-linked notes, asset-backed securities and structured notes). As a result, demand for credit instruments outstripped the supply.

Many corporates are issuing bonds in the market on the back of the lower spreads trend. This is because investors have demanded lower covenant protections than seen in bank lending, resulting in a more beneficial funding structure for the corporates at a lower cost. The question is: at what point will the markets normalise and the spreads return to fair spreads?

Now is not the time to be greedy for yields

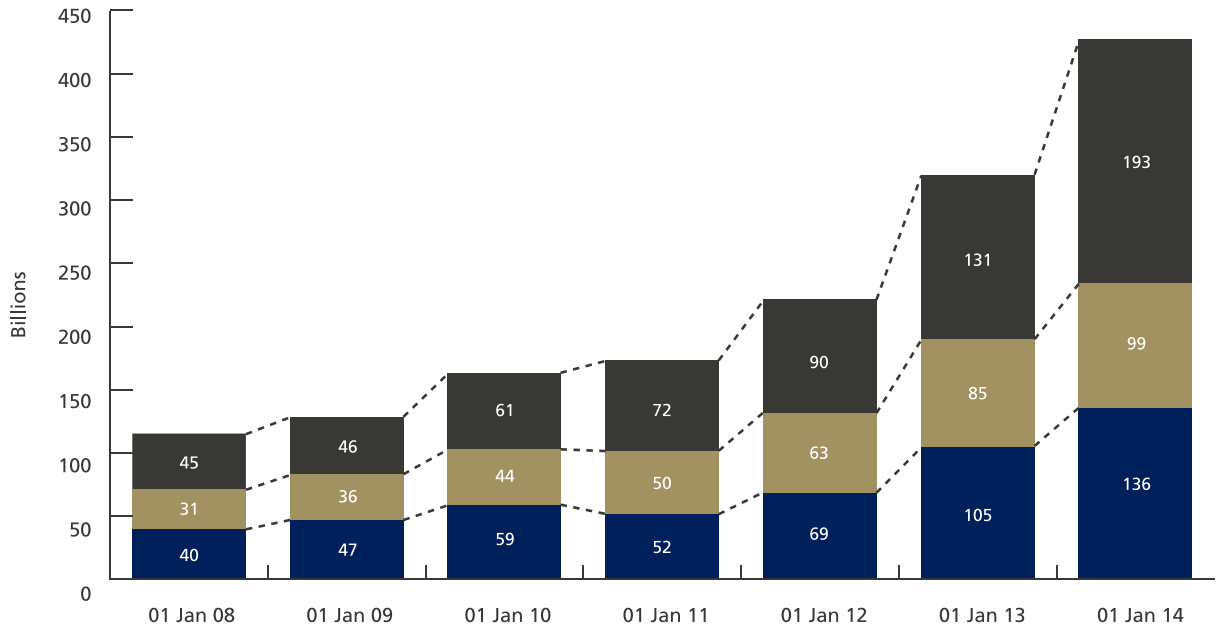
Given the trend of spread narrowing, it is important to remember to not blindly chase higher spreads. Higher spreads come with a higher risk level, which in many cases has not been fairly reflected in the spreads.

Graph 3: Issue spread of five-year floating rate notes since 2009 for a specific issuer



Sources: PSG Asset Management research and JSE

Graph 4: Increase in collective investment schemes (January 2008 to January 2014)



Source: ASISA

Corporate bonds can provide a stable investment at a relatively low risk if the credit process behind the investment is thorough. The last thing any credit investor wants is to be in a default position. Nonetheless, a default could occur, so it is imperative for us, as part of our credit investment process, to understand where the bonds we invest in will rank and what the potential loss could be under a default scenario.

To provide a better understanding of the risk under a default scenario, we provide a high-level overview of the process post default. Following a default, a company will normally go into business rescue where all stakeholders will try to revive the company. If this fails, the company will be liquidated and the assets sold for their best realisable value. The employees and preferential creditors will be paid first, then the secured debt, the senior unsecured debt (the category under which most corporate bonds fall into) and the subordinated debt. The last thing you want under a liquidation is to realise that you took a significant risk, at a low relative risk-adjusted spread and have little or no assets to preserve your capital investment. Higher spread investments can be profitable, if the risk is understood and priced for correctly.

By following our risk-first approach and 3Ms process, we would only invest in higher yield investments where we believe the risk has been priced into the spread and where we are confident and comfortable about the Moat, Management and Margin of Safety.

We have conviction in our process and philosophy for delivering favourable long-term returns

At PSG Asset Management, our credit process is rigorous. We aim to preserve capital by putting risk first and mitigating the potential loss from a default, as well as lower the risk of spread widening on our investments. We believe our process and investment philosophy will enable us to continue to achieve stable returns that are above our required rate of return over the long term.

FUND FOCUS: THE PSG FLEXIBLE FUND

Manager: Jan Mouton

Introduction

The PSG Flexible Fund has been under the stewardship of Jan Mouton since 1 November 2004. Before taking over the management of this Fund, he managed a hedge fund based on principles identified during his M.Phil in Finance that he completed at Cambridge University. Previously known as the PSG Tanzanite Flexible Fund, the PSG Flexible Fund was launched with a specific objective in mind: to provide its investors with equity-type returns, but at significantly lower levels of risk. Why is this important?

'Equities give investors high returns over time, but also potentially expose investors to substantial losses', says Jan Mouton. 'For example, during the 2008 financial crisis, the FTSE/JSE All Share Index (ALSI) fell 45.4%. Many investors cannot stomach such a large loss and then act in panic at the wrong time. The flexible mandate of the PSG Flexible Fund attempts to limit the downside and risks that our clients are exposed to but still provide high returns.'

How we achieve the Fund's objectives

The PSG Flexible Fund has two areas of focus: returns and risk management. To achieve and exceed the benchmark of inflation plus 6%, the Fund needs a significant allocation to equities – on average 75% since Jan Mouton took over management of the Fund. The manager is beholden to our Equity Investment Committee to search for companies that meet our stringent investment criteria (the 3 Ms): companies with a Moat (sustainable competitive advantage), good Management, and that are trading at an acceptable Margin of Safety so that the possibility of a permanent capital loss is lower.

Fundamental bottom-up analysis of the companies is crucial and each fund manager and analyst must really understand the investments that they analyse before making a recommendation to the Equity Investment Committee. 'Not only are we looking at the companies on a nominal basis to see what their return prospects are, but we also look at them in relation to what we can get from cash. We focus on reducing the probability of loss, while still retaining good growth potential, that is, we get the odds in our favour,' says Jan Mouton.

At PSG Asset Management, we are always looking to own high conviction ideas. We are therefore constantly reviewing all our options although we do not easily or frequently make changes. If you look at the PSG Flexible Fund from quarter to quarter – or even over years sometimes – you will see a high degree of consistency in the companies in the Fund.

In 'The general theory of employment, interest and money' (1936), John Maynard Keynes said: 'The spectacle of modern investment markets has sometimes moved me towards the conclusion that to make the purchase of an investment permanent and indissoluble, like marriage, except by reason of death or other grave cause, might be a useful remedy for our contemporary evils. For this will focus the investor to direct his mind to the long-term prospects and to those only.'

It would follow that if, in the Fund, patience and discipline are required for us to achieve the returns that we have and want to continue to generate for our investors, then too investors in the Fund should follow the same approach.

The important role of cash in the PSG Flexible Fund

In the PSG Flexible Fund, cash is used both as a shield, and as a sword. If you cast your mind back to the last part of 2007 into 2008, you will recall that both local and global markets had run hard and valuations became stretched across the board. During this time we found fewer and fewer companies that met our investment criteria. As a consequence of that, our cash holdings began to grow as the companies in the Fund began to reach and exceed their intrinsic values and there were no attractive replacements.

At the end of May 2008, the price-earnings (PE) ratio of the ALSI sat at 15.87 times and the cash holdings of the PSG Flexible Fund were averaging 20% of the Fund. A short nine months later, at the end of March 2009, the PE of the ALSI had fallen by just over 48% and the average cash holdings in the Fund had fallen to less than 6%.

From its high in May 2008, the ALSI fell by 45.4%, while the PSG Flexible Fund only fell by 27.3% from its high. This significantly smaller decline was, in part, because the Fund owned quality stocks that declined less than the market. However, more significantly, it was because when the average stock was plummeting, the investors in the Fund were getting a positive return from cash, which was acting like a shield against the decline in equity values.

As the market fell and company valuations reached attractive levels, we purchased some great companies at exceptional valuations. We deployed the cash that had been serving as protection into companies, which, as the dust settled, produced strong returns for our investors. Between the end of February 2009 and the end of August 2009, the holdings in the PSG Flexible Fund performed strongly and the Fund reached a new high after 15 months. It took the ALSI 30 months to reach its pre-correction high. This proves that cash can have attacking or sword-like characteristics when it is used to buy companies at low valuations that, in the fullness of time, produce handsome returns.

The Fund's holdings are generally quite different to the ALSI and most other local managers

In the PSG Flexible Fund, the application of our investment process has the outcome that we build our portfolios from the bottom up – basing our investment decisions purely on our 3 M investment philosophy. We do not take a share's weighting in an index into consideration when we invest.

South Africa does not have a large number of companies from which managers can choose and if one looks at the large cap companies, this is an even smaller group. Those domestic managers – particularly those who are managing large sums of local equities – have a significantly more difficult set of choices than we have at PSG Asset Management, as the number of shares they can easily and quickly invest in and disinvest from is so limited. By being able to invest outside the top 40 largest companies in South Africa, we are able to give our investors access to companies that many of our peers cannot.

By design, we have chosen to look not only at South Africa-listed companies, but also companies listed on global exchanges. This means that we can give the Fund's investors geographical diversification as well as diversification into sectors that are not represented on the JSE. In addition, there have been times – and we probably find ourselves in a scenario like this right now – where the average local share is quite expensive, but we are able to find foreign companies that are trading on attractive multiples and meet our 3 Ms.

Advice to investors in the PSG Flexible Fund and those considering investing in it

Firstly, invest for the long term. This Fund is not a fund for trying to make a quick buck. Just as we take a long-term view on all our investments that we make in the Fund, so too should investors take a long-term (three to five years) view when investing in it.

Secondly, investing requires patience and discipline. Just as we are required to stick to our investment process in a disciplined way and to have the patience to allow the companies in which we have invested to produce the returns we expect from them, so should investors follow a patient and disciplined approach to their fund selections. For example, when markets are falling and company valuations are becoming cheaper, we tend to buy these companies, allocating our cash to them, not pulling our investments from them. So should disciplined and patient investors ensure that if markets are falling they do not disinvest from the Fund and pull their cash. They should realise that these corrections are the times when future returns will be acquired and they should remain resolute and invested.

Thirdly, investors should consider the PSG Flexible Fund as a way to co-invest with a manager who is personally invested in the Fund.

In turn, we take the cash in the Fund and allocate it to companies that we believe have good management, a sustainable business model and where the price of the company is trading at an attractive margin of safety. We are particularly attracted to those companies in which their management have significant equity holdings themselves as that is also a strong indicator of an appropriate alignment of interests in the long-term success of the company.

Summary

Be disciplined in your investment approach and take a long-term view. Appreciate that, as an investor in the PSG Flexible Fund and therefore in the companies that the Fund owns, there is a strong alignment between the future success of the companies and your own prospects.

Lessons learned

Jan Mouton has been managing the PSG Flexible Fund for a significant period of nearly 10 years and through many different market conditions. He shared 10 lessons that he has learned from managing the Fund over the last decade:

1. You need an investment philosophy.
2. You need a flexible approach to asset allocation – wait for the right opportunities.
3. Stick with your investment philosophy, even when it is not working.
4. Follow a bottom-up approach: focus on companies, not the economy.
5. Invest in companies where management are large shareholders.
6. Reduce risk through global diversification in undervalued shares.
7. Focus on shares with a low PE ratio.
8. Focus on shares with a low price-to-book ratio.
9. Avoid large losses.
10. Invest for the long term.

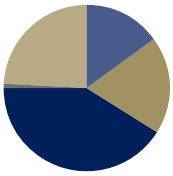
PORTFOLIO HOLDINGS AS AT 30 JUNE 2014

PSG Equity Fund

Top 10 equities

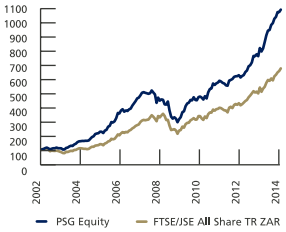
Steinhoff International Holdings Ltd
Glencore Xstrata Plc
Anglo American Plc
Capitec Bank Holdings Ltd
Old Mutual
International Business Machine Corp
Adcorp Holdings Ltd
Markel Corp
Super Group Ltd
JP Morgan Chase & Co

Asset allocation



Resources	15.0%
Financials	19.0%
Industrials	41.0%
Domestic equity	**75.0%**
Domestic Cash	1.0%
Foreign equity	24.0%
Total	**100%**

Performance

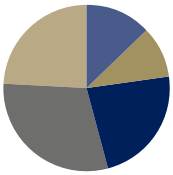


PSG Flexible Fund

Top 10 equities

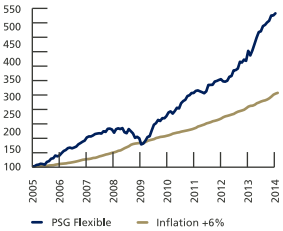
Steinhoff International Holdings Ltd
Capitec Bank Holdings Ltd
Berkshire Hathaway Inc
Anglo American Plc
J Sainsbury Plc
Sasol Limited
Super Group Ltd
EOH Holdings Ltd
Microsoft Corp
International Business Machine Corp

Asset allocation



Resources	13.0%
Financials	10.0%
Industrials	23.0%
Domestic equity	**46.0%**
Domestic cash	30.0%
Foreign equity	24.0%
Total	**100%**

Performance

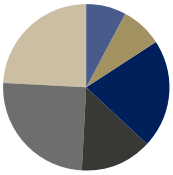


PSG Balanced Fund

Top 10 equities

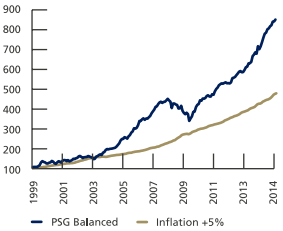
Steinhoff International Holdings Ltd
Capitec Bank Holdings Ltd
Anglo American Plc
Super Group Ltd
Berkshire Hathaway Inc
J Sainsbury Plc
Microsoft Corp
Sasol Ltd
Adcorp Holdings Ltd
International Business Machine Corp

Asset allocation



Resources	8.0%
Financials	8.0%
Industrials	21.0%
Domestic equity	**37.0%**
Domestic bonds	14.0%
Domestic cash	25.0%
Foreign equity	24.0%
Total	**100%**

Performance



PSG Stable Fund

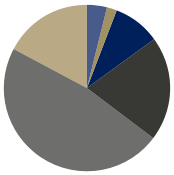
Top 5 equities

Steinhoff International Holdings Ltd
Capitec Bank Holdings Ltd
Berkshire Hathaway Inc
J Sainsbury Plc
Microsoft Corp

Top 5 bond issuer exposures

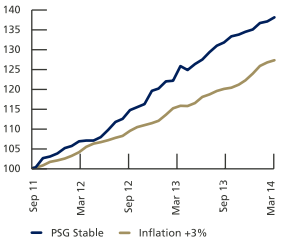
Standard Bank Ltd
FirstRand Bank Ltd
Landbank Ltd
Netcare Investments (Pty) Ltd
Transnet Soc Ltd

Asset allocation



Resources	4.0%
Financials	3.0%
Industrials	9.0%
Domestic equity	**16.0%**
Domestic bonds	20.0%
Domestic cash	47.0%
Foreign equity	17.0%
Total	**100%**

Performance



PSG Optimal Income Fund

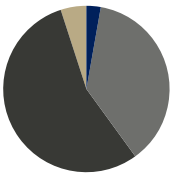
Top 5 equities

Berkshire Hathaway Inc
Steinhoff International Holdings Ltd
Capitec Bank Holdings Ltd
J Sainsbury Plc
International Business Machine Corp

Top 5 bond issuer exposures

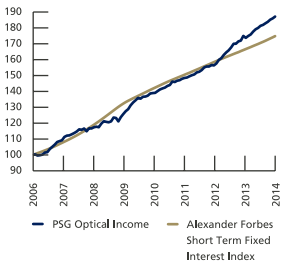
Nedbank Ltd
Standard Bank Ltd
FirstRand Bank Ltd
Mercedes-Benz South Africa Ltd
Absa Bank Ltd

Asset allocation



Domestic equity	3.0%
Domestic cash	37.0%
Domestic bonds	55.0%
Foreign equity	5.0%
Total	**100%**

Performance

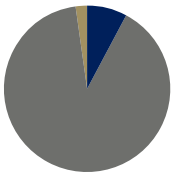


PSG Income Fund

Top 10 bond issuer exposures

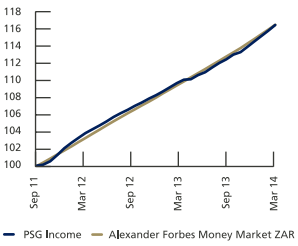
Absa Bank Ltd
Nedbank Ltd
Capitec Bank
Standard Bank
Bidvestco Ltd
Barloworld Ltd
FirstRand Bank Ltd
Landbank
Netcare (Pty) Ltd
The Thekwini Fund Ltd

Asset allocation



Fixed rate notes	8.0%
Floating rate notes	90.0%
Cash	2.0%
Total	**100%**

Performance

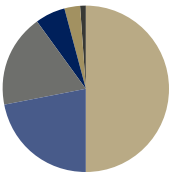


PSG Global Equity Fund IC Limited

Top 10 equities

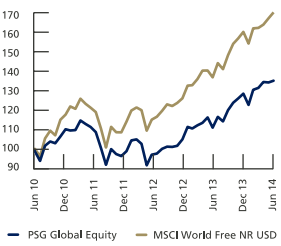
Berkshire Hathaway Inc
International Business Machines Corp
Steinhoff International Holdings Ltd
J Sainsbury Plc
Capital One Financial Corp
JP Morgan Chase & Co
Markel Corp
Porsche Automobil Holdings - Preferred
Microsoft Corp
Cisco Systems Inc

Regional allocation



US	50.0%
Europe	22.0%
UK	18.0%
Africa	6.0%
Cash	3.0%
Asia	1.0%
Total	**100%**

Performance

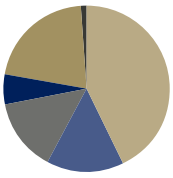


PSG Global Flexible Fund IC Limited

Top 10 equities

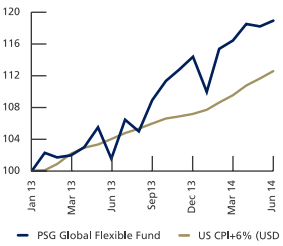
International Business Machines Corp
Berkshire Hathaway Inc
Steinhoff International Holdings Ltd
JP Morgan Chase & Co
J Sainsbury Plc
Capital One Financial Corp
Markel Corp
Porsche Automobil Holdings - Preferred
Cisco Systems Inc
Microsoft Corp

Regional allocation



US	43.0%
Europe	15.0%
UK	14.0%
Africa	6.0%
Cash	21.0%
Asia	1.0%
Total	**100%**

Performance



PERFORMANCE TO 30 JUNE 2014

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 1 808 434 087	37,48	5	124	32,72	1	111
PSG Equity A BM (JSE All Share TR)		32,76	25	125	26,76	17	112
PSG Flexible	R 5 083 592 044	28,54	9	73	25,02	11	65
PSG Flexible BM: CPI +6%		12,66	60	74	12,10	50	66
PSG Balanced A	R 3 333 538 972	21,51	35	105	20,68	26	94
PSG Balanced BM: CPI +5%		11,64	105	106	11,08	94	95
PSG Stable	R 1 698 330 172	10,60	75	92	13,08	43	86
PSG Stable BM: CPI+3%		9,64	80	93	9,08	77	87
PSG Optimal Income	R 643 942 428	7,75	13	57	9,01	6	51
Alexander Forbes Short Term Fixed Interest Index		5,42	53	58	5,35	48	52
PSG Income	R 49 932 441	5,73	20	29	5,20	26	28
Alexander Forbes Money Market Index		5,42	25	30	5,35	25	29
PSG Money Market A	R 2 615 272 446	5,28	20	28	5,17	23	27
South African IB Money Market Mean		5,37	11	29	5,28	11	28
PSG Global Equity Feeder Fund	R 109 584 337	26,59	14	28	33,23	18	23
MSCI World NR USD		32,97	3	29	38,36	6	24
PSG Global Flexible Feeder Fund A	R 404 722 633	22,13	8	17			
PSG Global Flexible BM: US Inflation +6%		15,89	18	18			
OFFSHORE FUNDS							
PSG Global Equity	$ 31 328 152	21,38	107	545	17,65	164	487
MSCI World NR USD		24,07	41	546	21,30	50	488
PSG Global Flexible Fund	$ 91 419 745	16,92	15	89			
US CPI +6%		8,14	63	90			

* 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.

	3 Years**			5 Years**			10 Years**			Inception*			
	Return	Sector Rank	Sector Count	Return	Sector Rank	Sector Count	Return	Sector Rank	Sector Count	Inception Date	Return	Sector Rank	Sector Count
	24,08	4	97	24,20	2	85	21,16	11	47	01/03/2002	21,43	4	41
	20,61	27	98	21,65	13	86	20,95	13	48		16,82	31	42
	19,27	17	62	23,21	5	55	19,11	2	14	01/11/2004	18,95	3	15
	11,95	45	63	11,42	41	56	12,03	13	15		12,18	12	16
	17,29	19	81	17,28	10	61	15,68	14	24	01/06/1999	15,67	4	13
	10,93	77	82	10,40	59	62	10,98	24	25		10,69	12	14
										13/09/2011	12,25	48	78
											8,94	70	79
	7,98	15	43	7,79	20	37				10/04/2006	7,93	13	22
	5,45	40	44	6,02	35	38					7,50	16	23
										01/09/2011	5,54	21	24
											5,44	22	25
	5,24	23	27	5,83	15	25	7,36	8	17	19/10/1998	8,87	4	6
	5,34	11	28	5,90	9	26	7,38	6	18		8,87	5	7
	22,38	19	21							03/05/2011	19,43	20	21
	29,92	3	22								28,01	3	22
										10/04/2013	28,56	5	16
											25,13	13	17
	6,56	336	444							23/07/2010	7,97	269	402
	11,80	76	445								14,41	26	403
										01/01/2013	12,30	12	81
											8,28	32	82

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