- **2015 was a challenging year for price-sensitive equity managers like ourselves.**
- **The average stock on global markets performed poorly.**
- **Cyclical and emerging market stocks were hit particularly hard.**
- **A narrow group of expensive growth stocks held up global equity indices.**
- **We had strong performers in our portfolios but were let down by heavy losses in some of our more cyclical portfolio holdings.**
- **Unloved stocks have become very cheap.**
- **The stocks in our portfolio offer very attractive return profiles at current share price levels.**
- **A long term contrarian approach is required.**

2015 in review

Coming on the heels of five very strong years in global equity markets, 2015 proved to be a challenging year for market participants, especially price-sensitive equity managers like ourselves. Stock markets around the world witnessed higher levels of volatility and were characterized by:

- Very divergent performance between various sectors, regions and currencies;
- A rout in cyclical shares, especially in energy and raw materials;
- Weak emerging market stocks (MSCI EM index declined 14.6% versus the MSCI World Index's -0.3% return);
- Strong performance from a narrow group of popular large cap growth stocks that flattered returns at an index level;
- Material underperformance by cheap stocks.

The South African stock market specifically was impacted by:

- The lack of growth in the SA economy with certain sectors undergoing sharp contraction which resulted in weak performance by domestic businesses exposed to these sectors;
- The weak rand which boosted the share prices of companies that earn their profits in hard currencies.

The Portfolio had some strong positive contributors in 2015, such as Capitec, Old Mutual, Steinhoff and Discovery, but their positive impact was outweighed by large losses in mining shares (primarily Glencore and Anglo American) and domestic cyclical stocks like Imperial.

We have an investment process that is disposed towards thinking independently and assessing each investment opportunity on its merit. And, where we seem to differ from many market participants is that we pay careful attention to the price paid. As a result, we avoid overpriced securities and are willing buyers of out-of-favour stocks trading at what we think are attractive prices that offer a wide margin of safety. The long term track records of our funds demonstrate our ability to exploit these types of opportunities for our clients. We are, however, not market timers and tend to be early into positions. And, if we assess what detracted from fund performance in 2015 we would argue that in some cases we were early: we bought stocks at an attractive margin of safety but cyclical pressures have weighed on earnings and sentiment over the short term. These cyclical pressures do not impact the long-term intrinsic value of the business. We always take a long term view and are confident that if we back strong management teams they can actually use tough conditions to their shareholders' benefit – taking advantage of weak competitors, making smart acquisitions or buying back cheap shares.

What is always disappointing is where we assess that we have made errors of judgement, particularly when it comes to margin of safety. We think we made mistakes in 2015 and these were primarily a miscalculation of a company's ability to weather tough conditions without diluting shareholders. Anglo and Glencore last year both found their balance sheets excessively leveraged in the environment of very low commodity prices and have been forced into asset sales and, in Glencore's case, an equity issuance that have permanently impaired shareholder value. We think that learning from mistakes like these is an important part of an investment process.

Portfolio positioning and outlook

If there is a positive side to weak recent price performance by some of the individual stocks in the portfolio it is that if value is not permanently impaired the margin of safety widens. As a result we think clients should expect very attractive future returns at lower levels of risk from a number of our higher conviction holdings.

We select stocks in a bottom up fashion. We have a bias for quality and generally found higher quality businesses to be overpriced in recent years. The recent correction in equity markets has enhanced the opportunity within some of the domestically focused shares of above-average quality. Here we consider businesses like Imperial, Old Mutual, Super Group, Discovery, First Rand and Reunert to be attractively priced.

We are almost five years into a commodity bear market that has primarily been characterized by excess supply. The mining shares are largely priced for disaster which is possibly appropriate in some cases, but almost certainly a gross mispricing in others. We think that the return profiles of the mining stocks we own are very attractive: they trade at a very wide discount to conservative estimate of value based on sustainable commodity prices. Mining shares constitute (13.6%) of portfolio value and consist of Glencore, Anglo American, BHP Billiton and AngloPlatinum.

We run a global equity process and our higher conviction offshore stock holdings have generated strong returns for the portfolio over the past four years. Picking stocks within a global universe offers a broader universe and diversification benefits. We continue to find good opportunities to buy higher quality global businesses at attractive prices but don't expect the portfolio to benefit as much from rand weakness in the future as has been the case over this four year period.
We are excited about the outlook for returns from our equity holdings:

- They are attractively priced relative to history and the market in general;
- They are generally on low levels of earnings;
- Many are on high sustainable dividend yields;
- They are generally of above-average quality.

Sentiment is very poor in several areas of the market and it is possible to buy stocks at similar valuation levels to those during the global financial crisis of 2008. These are circumstances in which we consider it appropriate to adopt a contrarian approach and invest in unloved cheap stocks on behalf of our clients. Investors should enjoy good long term returns from these stock price levels.

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JSE Christmas sale

On 27 May 2015 the cash holding in the PSG Flexible Fund was 42.3%, the highest it has been since present management took over. The cash holding had increased to this high level as we were unable to find undervalued equity investment opportunities. On that date, 24.9% of the fund was invested offshore and the exchange rate of the Rand to the US Dollar was R12.08. The remaining 32.8% of the fund was invested in JSE-listed shares.

Subsequent to 27 May 2015, there has been some panic on the JSE with many share prices declining sharply towards the end of the year. During December 2015 we were presented with a "JSE Christmas sale" on quite a scale. On the night of Wednesday 9 December, South Africa's Minister of Finance, Nhlanhla Nene, was unexpectedly fired which set South African markets into a tailspin. The Rand depreciated sharply against the US Dollar, government bonds lost value and the JSE Banks Index dropped 18.5% over the subsequent two days.

The fund held record cash going into this "JSE Christmas sale" and we therefore had the ability to buy selective bargains. We like discounted prices so the fund bought aggressively. As at 31 December 2015 the cash holding in the fund had reduced to 30.6%. This leaves us with further firepower should the fire sale on the JSE continue into 2016.

The table below shows 28 JSE listed shares that the PSG Flexible Fund focussed on that had been subject to the JSE Christmas sale. The average Christmas discount was a massive 32% as measured by the share price fall from 27 May 2015 to 31 December 2015. The largest falls were in resources, Aveng and Arcelormittal. Even some top quality shares were on sale such as Coronation, Shoprite, Firstrand, EOH and AVI. Looking back it was a good decision to hold record high cash levels seven months ago. We believe that it is now the right long-term strategy to gradually use the cash when substantial discounts are offered. Even though it is difficult to buy when the press is full of negative headlines, we put emotion aside, focus on the long-term prospects of a business and buy when the odds are in our favour.

JSE Christmas sale: Discounts offered as at 31 December 2015 relative to 27 May 2015

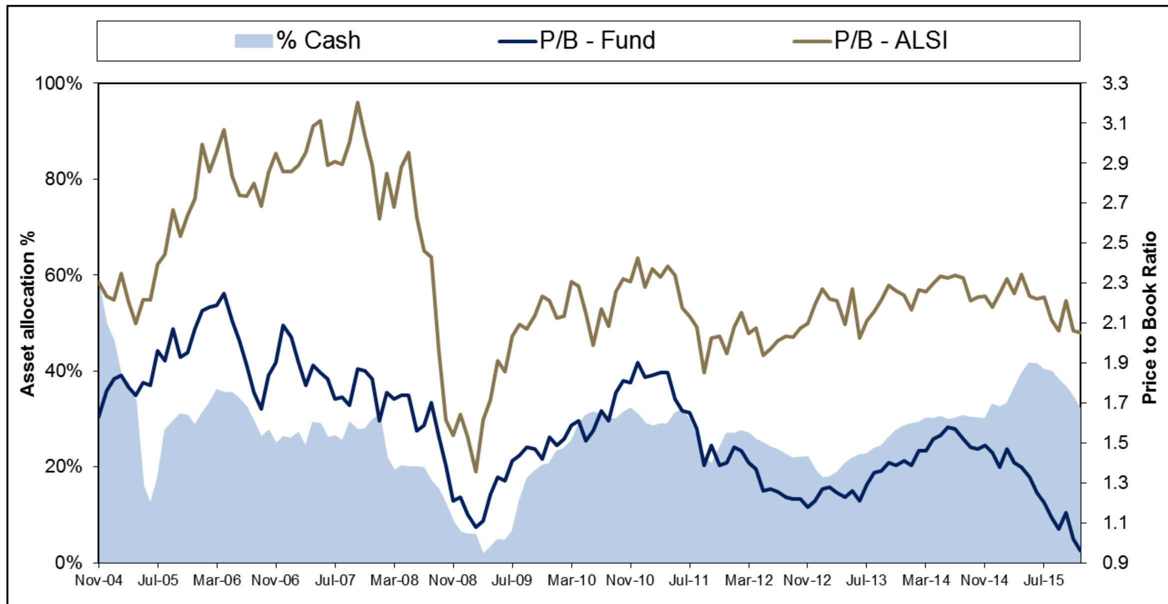
	Share price		
	27-May-15	31-Dec-15	Discount
Aveng Ltd	880	226	-74%
Arcelormittal SA Ltd	1 700	450	-74%
Kumba Iron Ore Ltd	15 500	4 120	-73%
Anglo American Plc	19 259	6 899	-64%
Glencore Plc	5 318	2 081	-61%
Allied Electronics Corp Ltd N	1 305	550	-58%
Stefanutti Stocks Holdings Ltd	680	347	-49%
Coronation Fund Managers Ltd	8 930	5 290	-41%
Eqstra Holdings Ltd	370	221	-40%
Adcorp Holdings Ltd	3 200	1 963	-39%
Barloworld Ltd	9 999	6 197	-38%
Imperial Holdings Ltd	18 300	11 936	-35%
Nampak Ltd	3 700	2 485	-33%
Group Five Ltd	2 918	1 998	-32%
Grindrod Ltd	1 580	1 129	-29%
Hudaco Industries Ltd	12 700	9 495	-25%
Nedbank Group Ltd	24 624	18 861	-23%
Brimstone Investment Corp Ltd N	1 650	1 270	-23%
Firstrand Ltd	5 343	4 237	-21%
Taste Holdings Ltd	354	295	-17%
Eoh Holdings Ltd	15 783	13 500	-14%
Shoprite Holdings Ltd	16 105	14 326	-11%
Tsogo Sun Holdings Ltd	2 605	2 420	-7%
AVI Ltd	8 223	7 738	-6%
Sasol Ltd	43 778	41 940	-4%
Basil Read Holdings Ltd	368	354	-4%
Old Mutual Plc	4 248	4 145	-2%
Wilson Bayly Holmes-Ovcon Ltd	11 400	11 326	-1%
Average discount			**-32%**

Source: TimBukOne

Seven of the PSG Flexible Fund's JSE-listed holdings have increased in price from 27 May 2015 to 31 December 2015 supporting the fund's returns. These shares were: Reunert, Capitec, Holdsport, Steinhoff, PSG Group, Discovery and Super Group. Furthermore, Rand depreciation of around 28.0% against the US Dollar from R12.08 to the current R15.46 has grown the quarter of the fund that was invested offshore.

The graph below plots the weighted average price-to-book ratio ("P/B") of the underlying equities held by the PSG Flexible Fund. The P/B ratio is calculated by dividing the share price by the net asset value of a share. Net asset value is a balance sheet metric calculated by taking shareholders' equity (or assets less liabilities) divided by the number of shares in issue. The lower the P/B ratio, the more the share price is backed up by net assets on the balance sheet of the company. If the P/B ratio is less than 1 you are buying the share for less than the net assets. What we try do to at PSG Asset Management is to buy good quality companies (strong moat and management) at low valuations (margin of safety). A low P/B ratio is one of the indicators of a potential low valuation.

Source: Bloomberg & PSG Asset Management Research



On 31 December 2015 the weighted average P/B ratio had decreased to a record low of 0.96 giving us comfort that the shares our clients hold through the PSG Flexible Fund are attractively valued. 30.6% of the fund is still in cash. If the JSE Christmas sale continues, as it has for the first days of 2016, we can still continue to buy bargains for a long time. Eventually the rest of the market will have the fund's cash and we will have their undervalued equities.

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This is the last fund manager commentary that I will be writing. I started managing the PSG Flexible Fund on 1 November 2004 and after more than 11 years as manager it is time for me to focus on different priorities and opportunities. As of 1 March 2016, I will hand over management of the PSG Flexible Fund to Shaun le Roux with Paul Bosman as co-manager. The fund will continue to be managed as it has been since November 2004. My new role at PSG Asset Management will be that of non-executive chairman of the Equity Investment Committee.

Jan Mouton – Fund manager

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- Benjamin Graham, The Intelligent Investor

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- Continuous decline in the price of commodities;
- A rout in cyclical shares, especially in energy and raw materials;
- Weak emerging market stocks;
- Deflation risks in a number of the developed markets;
- US interest rates starting to rise;
- A drastic weakening of the rand;
- Limited growth in the South African economy

Worrisome news flow of this nature resulted in large drawdowns in the prices of numerous commodities, equities, bonds and currencies. Should you be concerned about your investment in the PSG Balanced Fund?

As co-investors we are more excited than concerned. Sharp drawdowns offer opportunities to buy those assets which we have been eyeing through the window for a long period of time. When the prices of assets move significantly lower than their underlying value, you have the opportunity to get more than you are paying for.

We however don't rush out and blindly deploy cash. We wait for the prices of securities which meet our quality criteria to reach the levels which we regard as attractive. Here we are referring to the prices of shares, bonds, credit and listed property. Such buying opportunities arose in all these asset classes over the last couple of months and we have been drawing down on the Fund's very large cash war chest. When the JSE All Share index peaked at the end of April 2015 the Fund was 24.7% invested in cash. By the end of December 2015 this number had reduced to 17.3% and has continued to reduce during January 2016.

2015 will be remembered especially for the first two bullet points above, a collapse in commodity and resource company prices. In this commentary we would like to share with you some precious lessons we have learnt over the last months about investing in resource companies. Our aggregate investment in this sector was never very large as we were aware of the wide range of outcomes this industry could experience. The range of outcome proved to be even larger than our most pessimistic estimates and this resulted in value destruction. As an investor you will make mistakes, the unforgivable blunder is not learning from your mistakes. Here is a brief summary of our introspection.

How do we determine whether we have made good or bad investment decisions?

The movement of share prices in the short- and medium-term are driven more by sentiment than by fact and therefore significant drops in share prices are not a good measure of how well our process is working.

A good decision is rather when the cash flow generated by the relevant company transpires as or better than expected. It is very likely that we then paid a good price for the stake of the business as our estimate of underlying value was approximately correct.
A bad decision is when the free cash flow generated by the relevant company transpires lower than we expected. It is very likely that we overpaid for the stake as our estimate of underlying value was too high.

It is important to highlight that we are investing for the long-term so we are talking about sustainable through the cycle free cash flow levels. We are not in the business of guessing what companies are going to earn 12 months from now.

It is clear now that we over estimated even the medium- to long-term free cash flow which our resource holdings will generate. An important part of our investment decision regarding each of Glencore, Anglo American, BHP Billiton, Anglo American Platinum and Kumba was their positioning on the respective cost curves. By far the majority of the mines owned by these companies are in the lower half of the cost curve (in aggregate). This provides comfort because should commodity demand drop by for example 20%, the 20% most expensive mining operations would go out of business and the commodity price would enjoy support at the 80th percentile of cost of production.

The theory and the practice turned out to be very different:

- The industry took significant costs out of their mining processes at a rapid rate. It is clear that conditions were so prosperous in this industry for so long that huge amounts of fat crept into the cost bases. Weakening of the currencies in many of the mining geographies assisted with cost reduction. The result was that the cost curve dropped significantly.

- The low cost mines in many cases grew production rapidly and partially negated the effect of closing expensive mines. This flattened the cost curve.
- Supply response came with a long lag as shareholders and debt providers continued funding operations longer than one would think. Often providers of capital find themselves between a rock and a hard place – lose everything or fund for a bit longer and hope the prices recover.

The result is that the commodity prices fell significantly further than the theory dictated. Due to the change in the level and shape of the cost curve mining companies will generate lower levels of free cash flows for many years to come.

Each of the above three bullet points will be incorporated into our thinking when assessing investment opportunities in the future. Very importantly we did no draw a dogmatic conclusion, this would be to shun commodity companies from our process. We rather improved our process.

The tremendous drop in the commodity prices has now resulted in a full blown panic in the prices of commodity companies. Incorporating our improved process, we believe that the share prices of Anglo American, Glencore and BHP Billiton are now pricing in supply demand dynamics which seem all but impossible. There is a limit to how much the cost curve can shift and capital will not fund loss making mining operations into perpetuity.

So this is one of those strange but very rational conclusions, we made a mistake by investing in resource companies but not investing in resource companies now would be a mistake. We are avoiding extrapolating the recent past many years into the future and rather rationally assessing the status quo.

We are convinced that the market is now mistaking mining companies for an electronic blip and ignoring the fact the world will need steel, copper, coal and oil for decades to come.

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2015 will be remembered especially for the first two bullet points above, a collapse in commodity and resource company prices. In this commentary we would like to share with you some precious lessons we have learnt over the last months about investing in resource companies. Our aggregate investment in this sector was never very large as we were aware of the wide range of outcomes this industry could experience. The range of outcome proved to be even larger than our most pessimistic estimates and this resulted in value destruction. As an investor you will make mistakes, the unforgivable blunder is not learning from your mistakes. Here is a brief summary of our introspection.

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It is important to highlight that we are investing for the long-term so we are talking about sustainable through the cycle free cash flow levels. We are not in the business of guessing what companies are going to earn 12 months from now.

It is clear now that we over estimated even the medium- to long-term free cash flow which our resource holdings will generate. An important part of our investment decision regarding each of Glencore, Anglo American, BHP Billiton, Anglo American Platinum and Kumba was their positioning on the respective cost curves. By far the majority of the mines owned by these companies are in the lower half of the cost curve (in aggregate). This provides comfort because should commodity demand drop by for example 20%, the 20% most expensive mining operations would go out of business and the commodity price would enjoy support at the 80th percentile of cost of production.

The theory and the practice turned out to be very different:

- The industry took significant costs out of their mining processes at a rapid rate. It is clear that conditions were so prosperous in this industry for so long that huge amounts of fat crept into the cost bases. Weakening of the currencies in many of the mining geographies assisted with cost reduction. The result was that the cost curve dropped significantly.

- The low cost mines in many cases grew production rapidly and partially negated the effect of closing expensive mines. This flattened the cost curve.
- Supply response came with a long lag as shareholders and debt providers continued funding operations longer than one would think. Often providers of capital find themselves between a rock and a hard place – lose everything or fund for a bit longer and hope the prices recover.

The result is that the commodity prices fell significantly further than the theory dictated. Due to the change in the level and shape of the cost curve mining companies will generate lower levels of free cash flows for many years to come.

Each of the above three bullet points will be incorporated into our thinking when assessing investment opportunities in the future. Very importantly we did no draw a dogmatic conclusion, this would be to shun commodity companies from our process. We rather improved our process.

The tremendous drop in the commodity prices has now resulted in a full blown panic in the prices of commodity companies. Incorporating our improved process, we believe that the share prices of Anglo American, Glencore and BHP Billiton are now pricing in supply demand dynamics which seem all but impossible. There is a limit to how much the cost curve can shift and capital will not fund loss making mining operations into perpetuity.

So this is one of those strange but very rational conclusions, we made a mistake by investing in resource companies but not investing in resource companies now would be a mistake. We are avoiding extrapolating the recent past many years into the future and rather rationally assessing the status quo.

We are convinced that the market is now mistaking mining companies for an electronic blip and ignoring the fact the world will need steel, copper, coal and oil for decades to come.

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As mentioned in our September fund commentary, the stability of bond markets was surprising in the face of increased volatility in currency and equity markets. This calm, however, unwound in the last quarter of 2015 as global events and local political decisions significantly increased the risks associated with investing in fixed income markets.

What we have witnessed during 2015 was a slow upward grind in bond yields, but nothing in comparison with the volatility witnessed in the Rand market and commodity prices. Inflation, especially core inflation, remained fairly muted. GDP growth remained well below potential. All these factors combined lead to a very benign environment for bonds in the first part of the year.

Actions from the SARB MPC were also fairly restrained in 2015, with only 50 basis points of interest rate hikes seen in the face of a weak currency raising the concerns of inflation pass through or so called second round inflation impact. Drought conditions in the major parts of the crop growing areas are pushing maize and wheat prices to new highs on the local commodity exchanges, increasing the risk of food price spikes on the inflation basket.

With all these uncertainties building in the market, bond yields behaved very calmly until a series of events unfolded in the last part of the year that increased the risk premiums in fixed income markets.

Firstly, the outlook downgrade by S&P from stable to negative on the SA sovereign rating was a surprise to the bond market. This increased the possibility of a further downgrade to sub investment grade over the next year to 18 months. Being downgraded to sub investment grade will have serious negative consequences for SA in terms of future borrowing costs and ability to attract foreign capital to fund the current account deficit.

Secondly, there were the political announcements of the changes of the finance minister which took the bond market by surprise and risk premiums climbed to highs not seen since the financial crises of 2008. The SA 10 year yield traded to a high of 10.4% from around a level of 8.6% prior to the announcement, effectively changing the cost of borrowing in fixed income markets.

Thirdly, there was the long anticipated first interest rate increase by the US Federal reserve of 25 basis points. Why is this so important? Because the US Fed set the base rate for world markets to borrow in Dollars. Most governments, semi government entities and corporates borrow in Dollars. This is causing major divergence in developed markets and currencies as the FED is withdrawing Dollar liquidity from markets, while most other developed market central banks, are adding more liquidity to their own markets like the ECB and BOJ.

What this all means in a nutshell for out portfolios is that the margin of safety in government bonds has been significantly repriced. Over the last few years, notwithstanding the fact that the SARB has been increasing interest rates and that inflation has remained within the target band, the margin of safety in bonds remained at a low level. We define margin of safety in bonds as the real yield above inflation given the level of duration or term risk of the particular bond. We have clearly seen the risk premium widen or margin of safety of bonds increase over the last part of 2015. While this does not mean that all bonds on the curve have an equally attractive margin of safety, there are definite areas of opportunity on the yield curve.

We have added to the bond position on specific points of the nominal curve where the real yield has become more attractive given the duration risk. Longer dated bank NCD's remain attractive on a real yield basis given the level of risk and the expected path of inflation and interest rates. A small allocation to property has been added to the portfolio where the valuation became attractive. We will continue to search for real yields that are attractive at the appropriate level of risk.

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Interest rates have risen steadily over the 2015 year as South Africa continued on its rate hiking cycle. The key focus for previous rate hikes by the Reserve Bank was to curb inflationary pressures in the economy without specific focus on the volatility of the rand/dollar exchange rate. As highlighted throughout previous commentaries, the pressure seen on the currency remained one of the biggest stumbling blocks for South Africa in 2015. The final quarter proved too much as the Reserve Bank who could no longer ignore the excessive weakness in the currency, thus hiking the repo rate in November 2015 by 25 basis points to 6.25%. The rand/dollar exchange rate had weakened from a Q3 close of approximately R13.412/$ to R15.46/$ at the end 31 December 2015, approximately 15% down over the quarter. As a nation reliant on high imports, higher inflation should be expected as the cost of imported goods has increased.

Local interest rates in money markets and government bond yields have risen over the 2015 year reflecting growing concerns over the economic outlook in South Africa. The final quarter evidenced the markets perception of the state of the economy with rating agencies Moody's, Fitch and S&P, downgrading their outlook or rating on South Africa, leaving us on the edge of junk investment status. Key areas of concern were the low growth outlook, high public spending and a rising debt burden over the medium term. National Treasury delivered the Medium Term Budget speech in early October, emphasizing the willingness to remedy this situation with the rising debt burden, expected to reach approximately 49% of GDP by 2017, the focus of the budget speech. The market accepted this as a fairly positive delivery of government finances and policy. However, early in December, the unexpected firing of Finance Minister Nene, his replacement with a relatively unknown official in David van Rooyen and subsequent swift replacement with former Finance Minister Gordhan, created turmoil in SA markets as investor confidence, both local and foreign understandably deteriorated. On the back of the sovereign downgrade and upheaval in government finances, asset classes in SA suffered significantly, with fixed income and longer money market yields rising close on 2 percent almost instantly.

Over the latter half of 2015, the US continued to deliver more positive data, indicating that they would be closer to lifting the federal funds rate off a zero base, initiating the first interest rate hike in the US in over 10 years. Nonfarm payrolls, a key US indicator for labour market strength continued to exceed expectations. The result was increased volatility in South African markets, with fixed income yields rising over the quarter. The US lifted the federal funds rate by 25 basis points in December 2015, on what looks to be a slow rate hiking cycle.

It was evident that while not all events can be predicted, it has been more important than ever to focus on the risks facing our markets, something inherently based into our investment thinking. As interest rates have risen throughout the year, the margin of safety and interest rate risk protection for our funds has increased and the volatility noted above, has created opportunity to earn higher real yields for our clients. We remain cognisant that the events of the last quarter are likely to have long lasting effects on our local markets, and therefore we are focusing effort on not getting comfortable with the risks and levels of current interest rate markets. We continue to find good value in the longer end of the NCD curve where 12 month NCD's can be bought for approximately 8.40%.

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- **2015 was a challenging year for price-sensitive equity managers like ourselves.**
- **The average stock on global markets performed poorly.**
- **Cyclical and emerging market stocks were hit particularly hard.**
- **A narrow group of expensive growth stocks held up global equity indices.**
- **We had strong performers in our portfolios but were let down by heavy losses in some of our more cyclical portfolio holdings.**
- **Unloved stocks have become very cheap.**
- **The stocks in our portfolio offer very attractive return profiles at current share price levels.**
- **A long term contrarian approach is required.**

2015 in review

Coming on the heels of five very strong years in global equity markets, 2015 proved to be a challenging year for market participants, especially price-sensitive equity managers like ourselves. Stock markets around the world witnessed higher levels of volatility and were characterized by:

- Very divergent performance between various sectors, regions and currencies;
- A rout in cyclical shares, especially in energy and raw materials;
- Weak emerging market stocks; (MSCI EM Index declined 14.6% vs the MSCI World Index's -0.3% return)
- Strong performance from a narrow group of popular large cap growth stocks that flattered returns at an index level;
- Material underperformance by cheap stocks.

The PSG Global Equity Fund had some strong performers within the portfolio in 2015, such as Markel, Microsoft, Brookfield Asset Management, Steinhoff, eBay, Heidelberg Cement and Stanley Black & Decker but their positive impact was outweighed by large losses in mining shares (primarily Glencore, Anglo American and Arcelor Mittal), Volkswagen's emission scandal (the fund had an investment in Porsche) and cyclical stocks like Colfax Corporation and Weir Group.

We have an investment process that is disposed towards thinking independently and assessing each investment opportunity on its merit. And, where we seem to differ from many market participants is that we pay careful attention to the price paid. As a result, we avoid overpriced securities and are willing buyers of out-of-favour stocks trading at what we think are attractive prices that offer a wide margin of safety. The long term track records of our funds demonstrate our ability to exploit these types of opportunities for our clients. We are, however, not market timers and tend to be early into positions. And, if we assess what detracted from fund performance in 2015 we would argue that in some cases we were early: we bought stocks at an attractive margin of safety but cyclical pressures have weighed on earnings and sentiment over the short term. These cyclical pressures do not impact the intrinsic value of the business. We always take a long term view and are confident that if we back strong management teams they can actually use tough conditions to their shareholders' benefit – taking advantage of weak competitors, making smart acquisitions or buying back cheap shares.

What is always disappointing is where we assess that we have made errors of judgement, particularly when it comes to margin of safety. We think we made mistakes in 2015 and these were primarily a miscalculation of a company's ability to weather tough conditions without diluting shareholders. Anglo and Glencore last year both found their balance sheets excessively leveraged in the environment of very low commodity prices and have been forced into asset sales and, in Glencore's case, equity issuances that have permanently impaired shareholder value. We think that learning from mistakes like these is an important part of an investment process.

Portfolio positioning and outlook

If there is a positive side to weak recent performance by some of the individual stocks in the portfolio it is that if value is not permanently impaired the margin of safety widens. As a result we think clients should expect very attractive future returns at lower levels of risk from a number of our higher conviction holdings.

We select stocks in a bottom up fashion. We have a bias for quality and generally found higher quality businesses to be overpriced in recent years. The recent correction in equity markets has enhanced the opportunity within some of these better quality companies and in good quality cyclical stocks specifically. Here we consider businesses like United Technologies, Union Pacific, Colfax Corporation and the portfolio's global banks holdings to be attractively priced. Also, after a material share price decline in the 2nd half of 2015 we have significantly increased our conviction in Berkshire Hathaway, now the fund's largest holding.

We are almost five years into a commodity bear market that has primarily been characterized by excess supply. The mining shares are largely priced for disaster which is possibly appropriate in some cases but almost certainly a gross mispricing in other. We think that the return profiles of the mining stocks we own are very attractive: they trade at a very wide discount to conservative estimate of value based on sustainable commodity prices. Mining shares constitute (5.65%) of portfolio value and consist of Glencore, Anglo American and Arcelor Mittal.

We are excited about the outlook for returns from our equity holdings:

- They are attractively priced relative to history and the market in general;
- They are generally on low levels of earnings;
- Many are on high sustainable dividend or total payout yields;
- They are generally of above-average quality.

Sentiment is very poor in several areas of the market and it is possible to buy stocks at similar valuation levels to those during the global financial crisis in 2008. These are circumstances in which we consider it appropriate to adopt a contrarian approach and invest in unloved cheap stocks on behalf of our clients. Patient investors should enjoy good long term returns from these stock price levels.

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- **2015 was a challenging year for price-sensitive equity managers like ourselves.**
- **The average stock on global markets performed poorly.**
- **Cyclical and emerging market stocks were hit particularly hard.**
- **A narrow group of expensive growth stocks held up global equity indices.**
- **We had strong performers in our portfolios but were let down by heavy losses in some of our more cyclical portfolio holdings.**
- **Unloved stocks have become very cheap.**
- **The stocks in our portfolio offer very attractive return profiles at current share price levels.**
- **A long term contrarian approach is required.**

2015 in review

Coming on the heels of five very strong years in global equity markets, 2015 proved to be a challenging year for market participants, especially price-sensitive equity managers like ourselves. Stock markets around the world witnessed higher levels of volatility and were characterized by:

- Very divergent performance between various sectors, regions and currencies;
- A rout in cyclical shares, especially in energy and raw materials;
- Weak emerging market stocks; (MSCI EM Index declined 14.6% vs the MSCI World Index's -0.3% return)
- Strong performance from a narrow group of popular large cap growth stocks that flattered returns at an index level;
- Material underperformance by cheap stocks.

The PSG Global Flexible Fund had some strong performers within the portfolio in 2015, such as Markel, Microsoft, Brookfield Asset Management, Steinhoff, eBay, Heidelberg Cement and Stanley Black & Decker but their positive impact was outweighed by large losses in mining shares (primarily Glencore, Anglo American and Arcelor Mittal), Volkswagen's emission scandal (the fund had an investment in Porsche) and cyclical stocks like Colfax Corporation and Weir Group.

We have an investment process that is disposed towards thinking independently and assessing each investment opportunity on its merit. And, where we seem to differ from many market participants is that we pay careful attention to the price paid. As a result, we avoid overpriced securities and are willing buyers of out-of-favour stocks trading at what we think are attractive prices that offer a wide margin of safety. The long term track records of our funds demonstrate our ability to exploit these types of opportunities for our clients. We are, however, not market timers and tend to be early into positions. And, if we assess what detracted from fund performance in 2015 we would argue that in some cases we were early: we bought stocks at an attractive margin of safety but cyclical pressures have weighed on earnings and sentiment over the short term. These cyclical pressures do not impact the intrinsic value of the business. We always take a long term view and are confident that if we back strong management teams they can actually use tough condition

What is always disappointing is where we assess that we have made errors of judgement, particularly when it comes to margin of safety. We think we made mistakes in 2015 and these were primarily a miscalculation of a company's ability to weather tough conditions without diluting shareholders. Anglo and Glencore last year both found their balance sheets excessively leveraged in the environment of very low commodity prices and have been forced into asset sales and, in Glencore's case, equity issuances that have permanently impaired shareholder value. We think that learning from mistakes like these is an important part of an investment process.

Portfolio positioning and outlook

If there is a positive side to weak recent performance by some of the individual stocks in the portfolio it is that if value is not permanently impaired the margin of safety widens. As a result we think clients should expect very attractive future returns at lower levels of risk from a number of our higher conviction holdings.

We select stocks in a bottom up fashion. We have a bias for quality and generally found higher quality businesses to be overpriced in recent years. The recent correction in equity markets has enhanced the opportunity within some of these better quality companies and in good quality cyclical stocks specifically. Here we consider businesses like United Technologies, Union Pacific, Colfax Corporation and the portfolio's global banks holdings to be attractively priced. Also, after a material share price decline in the 2nd half of 2015 we have significantly increased our conviction in Berkshire Hathaway, now the fund's largest holding.

We are almost five years into a commodity bear market that has primarily been characterized by excess supply. The mining shares are largely priced for disaster which is possibly appropriate in some cases but almost certainly a gross mispricing in other. We think that the return profiles of the mining stocks we own are very attractive: they trade at a very wide discount to conservative estimate of value based on sustainable commodity prices. Mining shares constitute (4.41%) of portfolio value and consist of Glencore, Anglo American and Arcelor Mittal.

The PSG Global Flexible Fund has a flexible asset allocation mandate and we allocate capital dependent on opportunities available in various asset classes. We took advantage of falling asset prices in the 2nd half of 2015 and employed a significant portion of the fund's cash holding during the period. At the end of December 2015, the fund had 85% of its value invested in equities with the balance in cash.

We are excited about the outlook for returns from our equity holdings:

- They are attractively priced relative to history and the market in general;
- They are generally on low levels of earnings;
- Many are on high sustainable dividend or total payout yields;
- They are generally of above-average quality.

Sentiment is very poor in several areas of the market and it is possible to buy stocks at similar valuation levels to those during the global financial crisis in 2008. These are circumstances in which we consider it appropriate to adopt a contrarian approach and invest in unloved cheap stocks on behalf of our clients. Patient investors should enjoy good long term returns from these stock price levels.

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