Current context

At an index level (FTSE/JSE All Share Index), the JSE has gained 3.4% this year. However, all of this can be attributed to one share: Naspers (up 26%). Most shares on the JSE have declined in 2017. High levels of political uncertainty and weak economic conditions in South Africa have seen widespread selling of domestic equities, particularly by foreigners. South African banks are down 5%, the general retail sector is down 8% and the broad mid-cap sector is down 7%. Generally, confidence levels are very low and the sentiment around local equities is very poor. In contrast, global equity markets have generally enjoyed a strong year – South Africa is a stand-out underperformer.

Our perspective

The current market environment is a difficult one in which to make short-term investment decisions. This is an unpredictable time, and can result in portfolios being positioned around binary potential outcomes. We position our portfolios based on a consistent process that ensures inherent quality and sufficient margin of safety in all instruments we buy. We also avoid building binary portfolios that are skewed towards any particular outcome. Although this may result in short-term underperformance, we believe it increases the number of outcomes in which we will achieve the benchmarks set by our funds over the relevant time horizons.

Large parts of the South African market are currently deeply out of favour due to the political backdrop, recessionary conditions and aggressive foreign selling. As a result, we can buy quality companies at a widening margin of safety. We believe that this environment – where there are very diverse valuations on equity markets – is good for making long-term investment decisions.

The broad perception of the market is that risk is low when share prices are high, and have been rising. Contrary to this view, we think that risk is in fact lower when share prices are low (as is currently the case with out-of-favour domestic counters). We do not consider very expensive stocks that are deemed to be defensive as low-risk investment opportunities, and we expect muted long-term performance from such stocks. We believe the market is missing the fact that earnings are depressed for many South African companies, and we expect earnings to improve for most of our local investments despite the recessionary conditions. The combination of low earnings and low valuations supports strong long-term investment returns.

Portfolio positioning

We have taken full advantage of our offshore allocation (25%) to invest in high-conviction global ideas. While we anticipate superior returns from some of our domestic opportunities after the recent price declines, we continue to believe that our offshore holdings offer important diversification benefits as well as attractive long-term returns.

We think it is a good environment for long-term stock picking, and have a track record of generating good returns for our clients in tough times when sentiment is poor. Typically, we have enjoyed strong subsequent medium-term outperformance when fear is prevalent.

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Portfolio positioning
The PSG Flexible Fund remains conservatively positioned. We are happy to sit in cash while we wait for opportunity to invest in businesses that meet our required standards of quality (moat and management) at the appropriate margin of safety. Given the generally high levels of valuations on the JSE and other stock markets, we had been running at well above average cash levels earlier in 2017. We have, however, taken advantage of the sell-off in domestic counters to employ capital. Cash levels were 32% at the end of March and are currently 26%. Included in this cash classification is a 1.5% offshore gold holding. Our domestic cash is primarily invested in short-dated liquid bank negotiable certificates of deposit, yielding 8.3% on average.

We have taken near full advantage of our offshore allocation (22%) to invest in high-conviction global equity opportunities. While we anticipate superior returns from some of our domestic opportunities after the recent price declines, we continue to believe that our offshore holdings offer important diversification benefits as well as attractive long-term returns.

We think it is a good environment for long-term stock picking, and have a track record of generating good returns for our clients in tough times when sentiment is poor. Typically, we have enjoyed strong subsequent medium-term outperformance when fear is prevalent.

We retain a healthy cash buffer that we will aggressively employ in times of panic when a broader selection of quality shares can be bought at a wide margin of safety.

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by Paul Bosman and Greg Hopkins

Current context
Headlines around issues like land expropriation, the new mining charter and the independence of the South African Reserve Bank (SARB) – accompanied by a continuous stream of leaked Gupta-related emails – do not make for peaceful bedtime reading. Investors are understandably concerned.

Our perspective
"Be fearful when others are greedy and greedy when others are fearful." – Warren Buffett

Have you spoken to any South Africans recently who are fearful? One of the world's greatest investors says this is the time to be greedy.

In investments, 'being greedy' means that you should be a buyer when fear is driving the prices of securities (shares and bonds) lower. There are various human biases that cause irrational selling. One of these is confirmation bias: once we reach a certain conclusion or develop a specific narrative, we search for or interpret information in a way that confirms our preconception. For example, once someone has decided South Africa is going the route of Zimbabwe, they will only see information that confirms this theory. Such a person would be a hasty seller. We would like to point out three possible reasons why we believe that 'greedy' investors currently have better odds:

1. *Plenty of bad news has already been discounted in to the prices of securities.*
   We can currently buy quality companies on the JSE at price-earnings (P:E) ratios in the high single-digit to low double-digit range, which is a standout opportunity. The weighted average P:E ratio of the JSE-listed companies in the PSG Balanced Fund is currently 13.4. These are all companies that have some form of competitive advantage and are managed by very capable teams. There are many future scenarios under which these companies fare well and will reward brave investors handsomely.

2. *Uncertainty and daunting prospects reduce competition, which is the most important driver of profits.*
   If in the year 1900 you knew which political developments would take place in South Africa over the next 117 years, would it be your investment destination of choice? Probably not. However, a recent study by Credit Suisse found that since 1900, South African stocks have generated higher US dollar returns than any other geography. Similarly, consider the tremendous social and regulatory pressure the tobacco industry has faced over the last 20 years. Despite this, an index of listed US tobacco companies has returned an annualised total return of 15.4% over this period – significantly more than the S&P 500 Index, which has returned 7.1% when measured on the same basis.

   Why these unlikely outcomes? We believe that lack of competition was a significant contributor in both cases. In South Africa, sanctions and generally daunting political conditions kept new entrants at bay. In the tobacco industry, banned advertising made it impossible to enter the market.

   Current domestic uncertainty is scaring off competition – both from outside investors and from many South African companies that are allocating capital offshore rather than competing locally. According to SARB figures, South African companies invested R300 billion outside our borders over the past five years.

3. *There are numerous facts that don't support the failed state thesis.*
   If you live in a country with extreme income inequality and unemployment of close to 30%, should you be surprised to hear populist rhetoric from time to time? However, the process of moving from rhetoric to legislation is long and rigorous – and significantly easier said than done. Over and above parliamentary processes, we also have an independent judiciary and a constitution that is widely regarded as one of the most progressive in the world. And ultimately, we have a functioning democracy that gives the public the ability to hold politicians to account. The change of power in key metropoles in 2016 serves as an example.

We don't know the future for a fact, but we do believe that odds are currently better for buyers of undervalued South African equities than for sellers. We remind existing investors in our unit trusts that to enjoy the benefits of our process, you need to invest for the long term – even when it is very hard.

Portfolio positioning

We continue to have a large portion of the portfolio invested offshore (23%) in high-conviction global ideas. We have also actively been allocating capital to our higher-conviction domestic ideas, which continue to offer compelling value. The real yields offered by South African government bonds are above our required rate and the portfolio currently has an aggregate exposure of 10 percent to these instruments. Cash levels remain high and we are able to deploy 13% of the fund if new opportunities arise. We think it is a good environment for long-term stock picking, and have a track record of generating good returns for our clients in tough times when fear is prevalent (such as in 2003, 2009, 2011 and 2015). Subsequent average five-year outperformance for our funds over these periods (including 2015 to date) was 6.6% a year (5.4% excluding 2015).

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Portfolio positioning

We continue to have a large portion of the portfolio invested offshore (17%) in high-conviction global ideas, along with a small hard currency holding. We have also actively been allocating capital to our higher-conviction domestic ideas, which continue to offer compelling value. The real yields offered by South African government bonds are above our required rate and the portfolio currently has an aggregate exposure of 15% to these instruments. Cash levels remain high and we are able to deploy 29% of the fund if new opportunities arise. We think it is a good environment for long-term stock picking, and have a track record of generating good returns for our clients in tough times when fear is prevalent (such as in 2003, 2009, 2011 and 2015). Subsequent average five-year outperformance for our funds over these periods (including 2015 to date) was 6.6% a year (5.4% excluding 2015).

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Date issued: 14 July 2017

Ian Scott and Paul Bosman

Current context

Over the last year, most fixed income asset classes have rewarded investors with above-inflation returns. Cash returned 7.6% and government bonds returned 7.9%, while inflation over this period was 5.4%. The global environment is very supportive of local currency bonds and we have seen foreigners enter the local market as substantial buyers. In addition, credit spreads for large banks are falling, indicating good demand for credit in quality names. Not all fixed income asset classes have performed well, however. As a case in point, inflation-linked bonds returned -0.1% over the last year, due to the current downward phase of the inflation cycle.

Our perspective

The environment for fixed income investors is positive, despite the political noise we witness nearly daily and the fact that South Africa is in recession. While this is negative for the economy, it means that there is a low probability of rising inflation and hikes in short-term interest rates – which are negative for fixed income assets. In fact, consumer inflation has surprised on the low side in 2017, prompting short-term interest rate markets to price for interest rate cuts over the next year. Despite the negative growth environment and falling inflation, the South African Reserve Bank's (SARB) Monetary Policy Committee has been erring on the side of caution by not reducing interest rates. We believe this creates good opportunity for our investors to invest in instruments offering high real yields at low levels of risk. The market is giving us a window of opportunity that may change soon.

We are still finding good opportunities in cash markets. In particular, banks are paying high yields in the front end of the curve to comply with banking regulations. We also continue to find opportunities for high real yields in the one-year and longer parts of the negotiable certificate of deposit market. We deem selective credit names attractive. However, the recent increase in demand for bank credit has seen spreads narrow and we believe the opportunities in that sector are fewer than a year ago. As such, we are searching for opportunities in other areas of credit issuance.

Government bond yields are still attractive in the medium- to longer-dated area of the yield curve, despite current political noise. We believe that building a portfolio around a single negative narrative in bonds would expose our investors to binary outcome risks, which we aim to avoid. In addition, the valuations of long-dated bonds are not merely dependent on macro drivers. Factors like the strength of South Africa's institutions, fiscal policy and term premium play a significant role as well. We believe a lot of negative news is already reflected in the yields of longer-dated bonds. If the SARB and National Treasury maintain the current policy framework, real yields of more than 3% on these bonds are attractive in a low growth and inflation environment.

Portfolio positioning

We have been allocating capital over the various interest rate curves where they have presented high real yield opportunities. Firstly, the long end of the cash curve – where banks are willing to pay higher yields for longer-term funding – remains attractive. We have also selectively added to our government bond position in the medium-end of the curve. In addition, we participated in credit issues where credit spreads met our fair value criteria. To reduce the correlated nature of positions in the portfolio, we decided to switch a portion of the local equity position into offshore equities. We believe that the fund is well positioned for investors and savers looking for high real yields at low levels of risk.

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Date issued: 14 July 2017

PSG Income Fund

Quarterly Portfolio Commentary as at 30 June 2017

Ian Scott and Tyron Green

Current context

Over the last year, most fixed income asset classes have rewarded investors with above-inflation returns. Cash returned 7.6% and government bonds returned 7.9%, while inflation over this period was 5.4%. The global environment is very supportive of local currency bonds and we have seen foreigners enter the local market as substantial buyers. In addition, credit spreads for large banks are falling, indicating good demand for credit in quality names. Not all fixed income asset classes have performed well, however. As a case in point, inflation-linked bonds returned -0.1% over the last year, due to the current downward phase of the inflation cycle.

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The environment for fixed income investors is positive, despite the political noise we witness nearly daily and the fact that South Africa is in recession. While this is negative for the economy, it means that there is a low probability of rising inflation and hikes in short-term interest rates – which are negative for fixed income assets. In fact, consumer inflation has surprised on the low side in 2017, prompting short-term interest rate markets to price for interest rate cuts over the next year. Despite the negative growth environment and falling inflation, the South African Reserve Bank's (SARB) Monetary Policy Committee has been erring on the side of caution by not reducing interest rates. We believe this creates good opportunity for our investors to invest in instruments offering high real yields at low levels of risk. The market is giving us a window of opportunity that may change soon.

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Current context

Lately, the macroeconomic environment in South Africa has been relatively tricky to navigate. On the one side, we have falling inflation, which should be positive for the real disposable incomes of South African consumers. Lower food price inflation will relieve pressure on lower income earners in particular, given the higher weighting of food in average monthly household spend. Optimistically, we could expect this to spur consumption and demand – and therefore GDP. However, the other side of the coin is that South Africa entered a technical recession (two consecutive quarters of negative real GDP growth) at the end of the first quarter. This followed a protracted decline in the automotive, manufacturing and mining industries; all key sectors to economic growth in South Africa. As a result – and added to unemployment of 27.7% and low levels of credit extension – the average consumer will likely be unable to take advantage of falling prices.

This is the South Africa Reserve Bank's dilemma, with it having held the repo rate at 7% since March 2017. Clouded by political and rating downgrade narratives, it's also a question on most investors' minds: should the repo rate be cut to support real GDP growth, or is it appropriate to remain at 7% to protect the rand? We believe that this uncertainty has kept money market rates elevated at attractive levels for our investors.

Our perspective

Core to our fixed income philosophy is that our investment process focuses on the information we have available, avoiding the tendency to forecast. While political and economic uncertainty remains entrenched in investors' minds, our portfolio positioning reflects that we do not know how specific events will turn out, or what the subsequent market reaction will be. This drives the need to ensure we diversify the fund appropriately, and position it to benefit from a range of possible outcomes.

While we do believe that recent data point to lower inflation and steadier interest rates going forward, we are also aware that event risk is considered higher. We therefore believe that it is important to maintain a sufficient weighting in floating rate instruments (roughly 40% of the fund as at quarter end). This gives us comfort that we are positioned to take advantage of a potential turn in the interest rate cycle, but also have insurance against a sudden increase in interest rates.

Portfolio positioning

As mentioned in previous commentaries, we look to extend fund duration through a bigger position in fixed rate instruments. These instruments are expected to perform better over the near term, with the interest rate cycle largely understood to be at a peak of 7%. We have favoured the longer end of the negotiable certificate of deposit curve, as we believe that rates of greater than 8% for a one-year term are attractive, offering a potential real yield of more than 2%. Despite the shortage in issuance of commercial paper (corporate lending in the money market space), we have been able to add exposure where we have found mispricing in issuers we are comfortable with. The fund continues to have exposures diversified across the South African banks, with an allocation to treasury bills. This ensures that we are comfortable with overall fund liquidity.

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Current context

Given the backdrop of elevated market valuations, global stocks continued their strong performance during the second quarter, with the MSCI World Index delivering a positive return of 9.43% (11.01% including dividends) year to date. The tech-heavy Nasdaq index outperformed comfortably (+14.67%), while an acceleration in European growth, coupled with a market-friendly election outcome in France and dollar weakness, drove European stocks 15.91% higher. Emerging markets also ended two years of underperformance and returned 18.55% year to date. (All returns quoted in US dollars.)

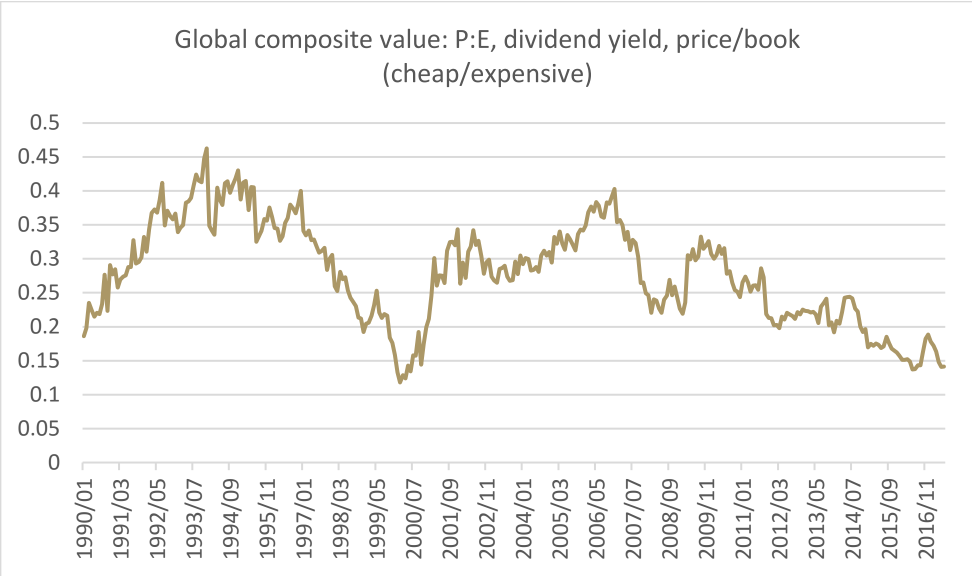
This does not necessarily mean that all markets and all market sectors had an easy year. Value stocks, which outperformed last year on the back of higher growth, inflation and interest rate expectations post Donald Trump's election, underperformed the broader market as the likelihood of effective policies to drive US growth diminished significantly. Continued threats of disruption (both perceived and real) by online retailers and lower-cost competitors have also driven the prices of US retailers down by 7% at an index level. In addition, while most emerging markets have seen their currencies and stock markets appreciate considerably this year, countries such as Brazil and South Africa continue to excel at scoring political own goals. Markets in both these countries have underperformed both emerging and global market peers.

Our perspective

We inherently like to buy high-quality companies with attractive growth prospects, at attractive valuations. We do not consider very expensive stocks that are deemed to be defensive as low-risk investment opportunities, and we expect muted long-term performance from such stocks. Rather, we think the risk is lower (and the opportunity better) in quality assets that are currently out of favour, yet offer excellent long-term prospects. This is reflected in the construction of the portfolio.

In fact, the divergence in valuations between the most expensive parts of the markets relative to the cheapest is still as extreme as it was during the dot-com bubble (as shown in the charts below). This warrants caution, but also presents stock-picking opportunities away from the popular crowd.

Source: Bernstein Research, PSG Asset Management



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Portfolio positioning

Our portfolios are constructed from the bottom up and are diversified across regions, industries and currencies. We continue to have strong conviction in our large portfolio holdings, namely Brookfield Asset Management, Cisco Systems, Yahoo Japan and AIA Group. We are also well exposed to some high-quality cyclical companies on low levels of earnings. Finally, while cognisant of the risks, we are finding great opportunities in the United Kingdom, emerging markets and areas such as agricultural commodity producers.

Complacency and significant amounts of greed in some parts of the market have allowed us to reallocate capital out of securities where valuations have approached or exceeded our estimates of intrinsic value, into investment opportunities where fear and uncertainty have driven prices to attractive valuation levels. We have exited or significantly reduced our positions in Apple, Mastercard, Microsoft, Sainsbury's and J.P. Morgan, while allocating capital to companies such as Discovery (an outstanding global opportunity in our view), The Mosaic Company (the world's largest potash and phosphate producer) and Babcock International (the UK's leading defence and engineering outsourcer).

A backdrop of rising asset prices and expensive valuations for the world's best companies informs the fund's current cash holding.

The world remains an uncertain place, with the impacts of US policy changes, balance sheet normalisation by central banks, geopolitical tensions and many other factors, yet unknown. The securities in the fund are trading at a significant margin of safety and we are ready to deploy additional firepower once further high-conviction investment opportunities become available.

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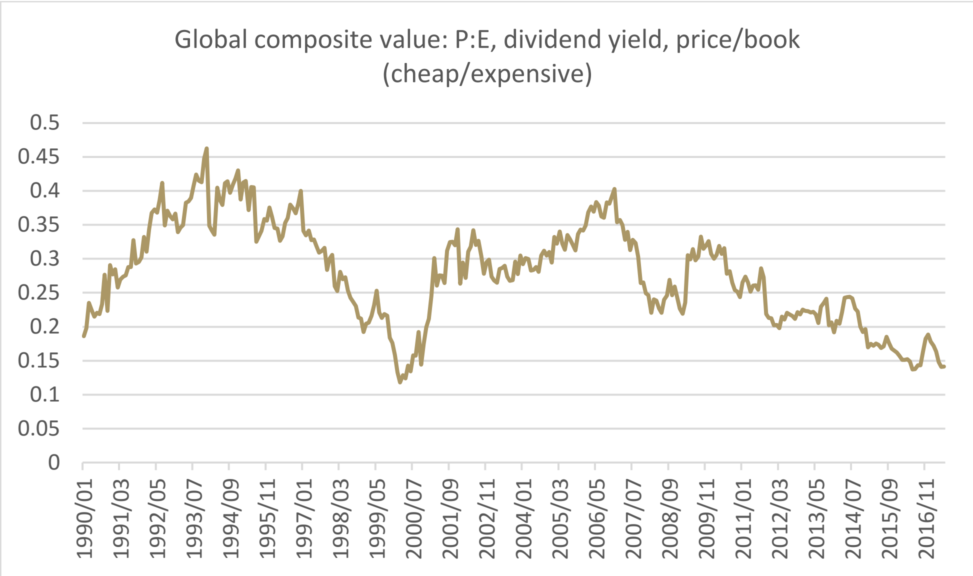

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Our portfolios are constructed from the bottom up and are diversified across regions, industries and currencies. We continue to have strong conviction in our large portfolio holdings, namely Brookfield Asset Management, Cisco Systems, Yahoo Japan and AIA Group. We are also well exposed to some high-quality cyclical companies on low levels of earnings. Finally, while cognisant of the risks, we are finding great opportunities in the United Kingdom, emerging markets and areas such as agricultural commodity producers.

Complacency and significant amounts of greed in some parts of the market have allowed us to reallocate capital out of securities where valuations have approached or exceeded our estimates of intrinsic value, into investment opportunities where fear and uncertainty have driven prices to attractive valuation levels. We have exited or significantly reduced our positions in Apple, Mastercard, Microsoft, Sainsbury's and J.P. Morgan, while allocating capital to companies such as Discovery (an outstanding global opportunity in our view), The Mosaic Company (the world's largest potash and phosphate producer) and Babcock International (the UK's leading defence and engineering outsourcer).

A backdrop of rising asset prices and expensive valuations for the world's best companies informs our relatively high levels of cash. At the end of June, the PSG Global Flexible Fund had 29% of the fund in cash.

The world remains an uncertain place, with the impacts of US policy changes, balance sheet normalisation by central banks, geopolitical tensions and many other factors, yet unknown. The securities in the fund are trading at a significant margin of safety and we are ready to deploy large amounts of firepower once further investment opportunities that satisfy our strict criteria become available.

The information and content of this publication is provided by PSG as general information about its products. The information does not constitute any advice and we recommend that you consult with a qualified financial adviser before making investment decisions. For further information on the funds and full disclosure of costs and fees please refer to the Minimum Disclosure Documents on our website.

Disclaimer: Collective Investment Schemes in Securities (CIS) are generally medium- to long-term investments. The value of participatory interests (units) or the investment may go down as well as up and past performance is not a guide to future performance. CIS are traded at ruling prices and can engage in borrowing and script lending. The Funds may borrow up to 10% of the market value to bridge insufficient liquidity. Fluctuations or movements in the exchange rates may cause the value of underlying international investments to go up or down. Where foreign securities are included in a portfolio, the portfolio is exposed to risks such as potential constraints on liquidity and the repatriation of funds, macroeconomic, political, foreign exchange, tax, settlement and potential limitations on the availability of market information. The portfolios may be capped at any time in order for them to be managed in accordance with their mandate. Excessive withdrawals from the fund may place the portfolio under liquidity pressures and, in certain circumstances a process of ring-fencing withdrawal instructions may be followed. PSG Collective Investments (RF) Limited does not provide any guarantee either with respect to the capital or the return of the portfolio.

Fees and performance:
Prices are published daily and available on the website www.psg.co.za and in the daily newspapers. A schedule of fees and charges and maximum commissions is available on request from PSG Collective Investments (RF) Limited. Commission and incentives may be paid and, if so, are included in the overall costs. Forward pricing is used. Different classes of Participatory Interest can apply to these portfolios and are subject to different fees, charges and possibly dividend withholding tax and will thus have differing performances. Performance is calculated for the portfolio and individual investor performance may differ as a result thereof. All performance data for a lump sum, net of fees, include income and assumes reinvestment of income on a NAV-NAV basis. Income distributions are net of any applicable taxes. Annualised performance show longer term performance rescaled over a 12 month period. Individual investor performance may differ as a result of initial fees, the actual investment date, the date of reinvestment and dividend withholding tax. . Unit Trust prices are calculated on a net asset value (NAV) basis, which is the market value of all asses in the fund including income accruals less permissible deductions divided by the number of units in issue. Actual Annual Figures are available to the investor on request.

Source of performance: Figures quoted are from Morningstar Inc.

Cut-off times: The cut-off time for processing investment transactions is 14h30 daily, with the exception of the PSG Money Market Fund, which is 11h00. The portfolio is valued at 15h00 daily.

Additional information: Additional information is available free of charge on the website and may include publications, brochures, application forms and annual reports.

Company details: PSG Collective Investments (RF) Limited is registered as a CIS Manager with the Financial Services Board, and a member of the Association of Savings and Investments South Africa (ASISA) through its holding company PSG Konsult Limited. The management of the portfolios is delegated to PSG Asset Management (Pty) Limited, an authorised Financial Services Provider under the Financial Advisory and Intermediary Services Act 2002, FSP no 29524. PSG Asset Management (Pty) Limited and PSG Collective Investments (RF) Limited are subsidiaries of PSG Konsult Limited.

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Conflict of Interest Disclosure: The Fund may from time to time invest in a portfolio managed by a related party. PSG Collective Investments (RF) Limited or the Fund Manager may negotiate a discount in fees charged by the underlying portfolio. All discounts negotiated are re-invested in the Fund for the benefit of the investor. Neither PSG Collective Investments (RF) Limited nor PSG Asset Management (Pty) Limited retains any portion of such discount for their own accounts. The Fund Manager may use the brokerage services of a related party, PSG Securities Ltd.

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