PSG Equity Fund

Quarterly Portfolio Commentary as at 31 March 2015

The PSG Equity Fund has enjoyed strong gains over the past year, as it has since the bull market commenced in March of 2009. Pleasingly, the highest contributors to fund performance over the past year have been amongst our higher conviction stock picks: Capitec, Steinhoff, EOH, Markel, Cisco, Old Mutual, Brookfield and AVI each contributed more than 1% in absolute performance terms over the twelve months to end March.

Most of the perceived "higher quality" stocks on the JSE trade at very elevated valuation levels and we believe little attention is being given to the price paid. We continue to avoid stocks that we consider to be overpriced on the basis that we think there is a relatively high probability of losing money. We can still find better opportunities than many of the popular financial and industrial stocks that are so large in the index.

We remain of the view that the best long term returns will come from the unloved parts of the market, if stocks are wisely and prudently selected. The Fund's largest position is Glencore. The resource sector has performed very poorly amidst sharply declining commodity prices. Sentiment is terrible and as a result valuations are at very low levels. Our research suggests that Glencore is materially undervalued relative to a conservative value of the cash it should generate in a normal year. We think that the market is not attributing and appropriate value to its marketing division, which generates superior returns on capital on a sustainable basis. Furthermore, we are confident that management are well-aligned with shareholders and hence will make capital allocation decisions that will grow per share value over the long run.

Our portfolios will often look very different to their benchmarks, as is the case at the moment. We do not own shares just because they are large in the benchmark. In fact, we consider a passive benchmark-hugging strategy to be particularly risky in the current environment, with stock market indices dominated by expensive large caps. We take comfort from the fact that the stocks we own are on average as good as the market but trade at a material discount to the average stock on the JSE.

We continue to focus on investing in superior companies that are not overpriced. Unfortunately, after strong price gains in recent years we are finding fewer domestic opportunities in the current market climate. However, we are well served by having a global process and can still identify many good opportunities within the breadth of the global equity universe. Accordingly, the Fund remains fully invested in direct offshore equities, at the regulatory limit of 25%.

We put risk at the forefront of our investment process and define risk as the possibility of losing money for our investors. We expect the stocks in the funds to deliver good returns for long term investors at acceptable levels of risk.

"I believe the chance of any event causing Berkshire to experience financial problems is essentially zero. We will always be prepared for the thousand-year flood; in fact, if it occurs we will be selling life jackets to the unprepared. Berkshire played an important role as a "first responder" during the 2008-2009 meltdown, and we have since more than doubled the strength of our balance sheet and our earnings potential. Your company is the Gibraltar of American business and will remain so." *

As at 31 March 2015 the second largest investment in the PSG Flexible Fund was Berkshire Hathaway Inc. which represented 6.4% of the Fund. Berkshire Hathaway has been managed by Warren Buffett for the past 50 years and it has been of the largest investments in the PSG Flexible Fund for more than 8 years. The fund owns 160 class A shares that are worth R428.7million or R2 679 203 each. Over the past 8 years we paid on average R886 291 for each of these shares. The investors in the Fund have made good gains on their Berkshire investment. We believe Warren Buffett and his team (340 499 people work for Berkshire) will continue to produce above average returns for investors.

A recent example of how Buffett adds value has been through the Kraft/Heinz merger. On 25 March 2015 it was announced that Heinz, a leading global food company, would merge with Kraft, the 4th largest food and beverage company in the United States. The combined entity will be the 3rd largest food and beverage company in the United States. It will have an attractive portfolio of branded products and the potential for significant cost and revenue synergies. Berkshire acquired 50% of Heinz on 3 Jun 2013 for an amount of USD4.25bn. The other 50% was acquired by 3G Capital, a global investment firm focused on long-term value, with a particular emphasis on maximizing the potential of brands and businesses. Executives from 3G Capital have managed Heinz since acquisition and have transformed Heinz into a food company with industry leading margins. Operating improvements of around USD1 billion have been achieved through implementing zero-based budgeting, simplifying the corporate structure and rationalising the manufacturing footprint of Heinz.

After the merger, Berkshire will own 25.5% of the combined Kraft Heinz and together with 3G Capital they will control 51% of Kraft Heinz. Based on the market price of a Kraft share of USD87.12 as at 31 March 2015 we estimate that Berkshire's 25.5% interest in Kraft Heinz is worth around USD21.5bn. This means that in the 22 months since acquisition Berkshire has made a gain of around USD12.2bn on its Heinz investment.

Berkshire currently trades at a price-earnings ratio (based on our adjusted earnings) of 15.9 times and a price to book ratio of 1.5 times. Berkshire has indicated that they would do share buybacks at a price to book ratio of 1.2 times, therefore shareholders have some form of downside protection. The price-earnings ratio of Berkshire at 15.9 times is also less than that of the S&P 500 Index. In our opinion the average business held by Berkshire is of better quality than the average business included in the S&P 500 Index.

"Today Berkshire possesses:

1. an unmatched collection of businesses, most of them now enjoying favourable economic prospects;
2. a cadre of outstanding managers who, with few exceptions, are unusually devoted to both the subsidiary they operate and to Berkshire;
3. an extraordinary diversity of earnings, premier financial strength and oceans of liquidity that we will maintain under all circumstances;
4. a first-choice ranking among many owners and managers who are contemplating the sale of their businesses and
5. in a point related to the preceding item, a culture, distinctive in many ways from that of most large companies, that we have worked 50 years to develop and that is now rock-solid." *

Warren Buffett is 84 years old. No one lives forever, but you can build a culture that can endure after you leave. We believe Buffett has achieved this. Berkshire's many operating subsidiaries each have its own good CEO – this will continue once Buffett leaves.

"I'm not embarrassed to admit that Heinz is run far better under Alex Behring, Chairman, and Bernardo Hees, CEO, than would be the case if I were in charge. They hold themselves to extraordinarily high performance standards and are never satisfied, even when their results far exceed those of competitors." *

There are 340 499 people that work for Berkshire. They will continue to produce growth for shareholders. Furthermore, a successor to Buffett has been chosen by the board so there is a plan for the inevitable consequence of age. Despite Berkshire being such a large company it has a culture that "fights the ABC's of business decay, which are arrogance, bureaucracy and complacency:" *

"We do, of course, have an active audit function; no sense being a dammed fool. To an unusual degree, however, we trust our managers to run their operations with a keen sense of stewardship. After all, they were doing exactly that before we acquired their businesses. With only occasional exceptions, furthermore, our trust produces better results than would be achieved by streams of directives, endless reviews and layers of bureaucracy. Charlie and I try to interact with our managers in a manner consistent with what we would wish for, if the positions were reversed." *

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Let’s work through a hypothetical scenario to illustrate our decision making process.
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In all other cases, you’ll remain a happy investor.

This, in a nutshell, is what we do.

One of our favourite little laundries is Capitec Bank. The Capitec share prices is up 2 and a half times since August last year and we are understandably getting many questions as to why we are not selling all our shares. Well, if we work our way through our laundry logic illustrated above:

- Management team is intact and superbly aligned with our interests as they are also large shareholders.
- We’re not overly concerned about competitors. Capitec continues to make rapid inroads into the South African banking market with their market share having grown by over 60% over the last 3 years.
- Nobody is offering us a silly amount of money for our shares - yet.(There are however a couple of investors who are now working out how silly they were to sell their shares in August last year.)

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Currency volatility has been rising since the middle of 2014 as we saw the US Dollar embark on a strengthening path against most currencies in the world. The rise of the Dollar had a profound effect on asset classes like commodity prices, emerging market currencies and on the forecasts for global inflation and growth. From a SA perspective the Dollar has made a substantial impact on a few economic fronts. Firstly, there was the impact through a wide range of lower commodity prices. The fall in SA's export commodity prices like iron ore and coal were countered by the lower import price of crude oil which was beneficial to the SA consumer and the likes of large diesel users like Eskom. Secondly, there was the inflation impact. Although the Rand weakened against the Dollar it actually maintained a steady profile on a trade weighted basis against the currencies of our largest trading partners. Thus the inflation impact from Rand weakness will be muted. At the moment it is a Dollar theme driven market sentiment.

Globally inflation and growth remain at muted levels, with various central banks across the globe easing monetary policy further in 2015. The European Central Bank finally implemented a much anticipated quantitative easing programme at the beginning of March. The US Federal Reserve is the only developed market central bank that has opened the door for increasing interest rates for the first time after the financial crises of 2008. This has been the main reason for the volatility and higher risk premiums in emerging markets linked to the US Dollar interest rate cycle. SA is linked to the US interest rate cycle, due to the fact that SA has much more offshore debt in Dollars than in any other currency.

Locally the fundamental drivers for growth have been weakening and the outlook for inflation has changed. Regulatory changes in the form of higher taxes in the budget and expected higher electricity tariffs will lead to higher administered price inflation, coupled with higher food prices, which leads to a change in the expected path of consumer inflation. This sentiment was echoed by the SARB MPC in its last statement, expressing a more negative view on consumer inflation over the next 12 to 18 months.

Fixed income markets have been volatile in the wake of the rising Dollar. The SA 10 year bond traded between 7% and 8% in a short space of time as the fixed income market took its cue from the volatility in the currency markets. Issuance in the long dated bond market is still dominated by government and SOE paper. Issuance of short and medium dated corporate credit remains muted during this quarter and was mainly limited to refinancing transactions from the major banks in SA. Corporates in SA have healthy balance sheets at present and are reluctant to borrow in the markets at elevated spread levels. This situation will unwind over a period of time as corporates need more funding and bank funding becomes more unattractive with the further implementation of bank capital restrictions.

With the implementation of further legislation on bank capital (Basel 3) in January 2015, we see banks willing to increase the duration of their funding books and pay higher yields on their longer dated NCD's. We continue to selectively use this opportunity to lock in higher real yields for the Fund at a low risk of default. Currently longer dated bank NCD's look attractive, given the expected path of inflation and a protracted interest rate hiking cycle. We will continue to deploy cash when real yields are attractive given the level of risk.

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Buffett made money for Berkshire shareholders the difficult way: Compounding growth at 19.4% on average over a 50 year period without taking high risk - that demonstrates skill. In the creation of many other fortunes luck was a big contributor to success, for example some of the internet based fortunes. In ten years' time customers will, however, still be using Berkshire's railway lines, power utilities, eating Kraft & Heinz products and insuring risks with the largest insurance check book in the world. It is, however, difficult to form a proper expectation of who will be the internet winners in ten years' time – you will either be very lucky or very disappointed – a gambler's payoff as opposed to the investor's payoff that Berkshire provides.

"Forget what you know about buying fair businesses at wonderful prices instead, buy wonderful businesses at fair prices" *

* Warren Buffett, Berkshire 2014 Letter to Shareholders

PSG Money Market Fund

Quarterly Portfolio Commentary as at 31 March 2015

The first quarter of 2015 saw markets beginning to grasp the concept that the Reserve Bank could potentially have room to cut the repo rate. This was considered an unlikely event, but given the sharp fall in the Brent crude oil price and continuously declining global food prices, inflation numbers over the coming months were expected to remain on a downward path.

In the buildup to the January MPC meeting, and in light of the above, the markets began to price in a potential rate cut. The NCD curve flattened over the 6 to 12 month area and FRA markets fully priced in the probability of the SARB cutting the repo rate by 25 basis points. The higher and more attractive rates seen on the NCD curve in December 2014 were quickly reversed. The SARB ultimately kept rates on hold at the January 2015 MPC meeting as the path of inflation allowed the SARB to be more accommodative of low SA growth. The SARB remained hawkish in tone, cautioning the market that the current trajectory in inflation was potentially transitory and highly sensitive to oil price fluctuations. The SARB highlighted greater upside risk to the repo rate.

The SARB expectation of Headline Consumer Price inflation was at a low point of 3.8% in the first quarter of 2015. In February, oil prices reverted to levels around $60, and fuelled expectations of petrol price increases. National Treasury delivered its budget speech citing an increase to fuel levies in order to raise the additional revenue required to maintain a stable budget deficit. The petrol price hike in the beginning of April would therefore reverse most of the benefits accrued to consumers of lower oil prices, and result in inflation returning to an upward path. The budget also indicated that ESKOM would be allowed to apply to NERSA for a 25% hike in tariffs. February saw stronger than expected US nonfarm payroll data, which caused the US Dollar to strengthen against most currencies, and the Rand experienced significant weakness as a result. Currency risk on the timing of US Federal Funds rate hikes persists. There is a growing impetus that the Fed is reaching its targets to begin normalising US interest rates. This has seen sustained pressure on global currencies as the dollar remains strong.The March 2015 MPC meeting saw rates unchanged, but the uncertainty and risks regarding these factors point largely to upside risk on the inflation outlook.

While inflation is still expected to remain within the target band for 2015, it is widely expected by the market to significantly breach the 6% upper bound in Q1 2016 as base effects filter through. The market remains cautious as rates have steadily risen to reflect increased expectations of hikes in the latter end of 2015. As such, the money market curve now offers value in longer term NCD’s as well as opportunities to trade the steepness of the curve.

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One of our favourite global laundries is Markel Corp. We wrote about the value of the imitator our Q2 commentary of 2014. We started investing in this business a year ago at share prices below $600. This implied a 20% premium to the accounting valuation of the business, but still significantly below our estimate of intrinsic value. Since then the share prices has appreciated 30% and the business is currently the largest exposure in the global funds.

The question could be askes, why are we not selling this business? Well, if we work our way through our laundry logic illustrated above:

- Management team is intact and superbly aligned with our interests as they are also large shareholders.
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