The South African economy is facing a raft of challenges: the political landscape is on a knife-edge; a sovereign debt downgrade to "junk" status is a real possibility and a fragile low-growth economy is buckling under the pressures of high rates of inflation and rising interest rates. This is not a "feel-good" scenario and downside risks are elevated as far as economic growth is concerned.

It is therefore not surprising that investment sentiment is very poor and investors are seeking to protect their portfolios against further deterioration in the status quo. The preferred method of portfolio protection seems to be by raising exposure to non-resource rand hedge stocks. While many of these companies are amongst the highest quality and largest businesses listed on the JSE, and investors in them have been handsomely rewarded in recent years, it is worth noting that the ratings of these businesses are very high – we think they are overvalued. And this risk of owning expensive shares is further exacerbated by a high level of earnings when expressed in rands (given material rand weakness over the last year). Accordingly, it is highly possible that owning expensive rand hedge shares may not prove to be such a defensive strategy after all.

PSG Asset Management, on the other hand, has been reducing our exposure to rand hedge and offshore stocks to acquire some of the out-of-favour domestically-focused businesses in SA at what we consider to be a wide margin of safety.

We are often asked why we would be buying SA banks, insurers or interest rate sensitive industrials under the current circumstances. Our answer is simple - it is the very tough economic conditions and very poor sentiment that result in the opportunity to buy good businesses at very attractive valuation levels. In fact, many of the stocks that we have been buying for our clients are trading at price-earnings ratios or dividend yields last seen in 2003 or 2008. To buy above-average quality companies at distressed prices bodes very well for long-term returns for our investors.

The PSG Equity Fund was a buyer of Firstrand, Imperial and Nedbank during the first quarter of 2016. We reduced our exposure to Super Group.

The foreign equity component reduced from 32% to 24% during the quarter.

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PSG Asset Management, on the other hand, has been reducing our exposure to rand hedge and offshore stocks and utilising our very large cash balances to acquire some of the out-of-favour domestically-focused businesses in SA at what we consider to be a wide margin of safety.

We are often asked why we would be buying SA banks, insurers or interest rate sensitive industrials under the current circumstances. Our answer is simple - it is the very tough economic conditions and very poor sentiment that result in the opportunity to buy good businesses at very attractive valuation levels. In fact, many of the stocks that we have been buying for our clients are trading at price-earnings ratios or dividend yields last seen in 2003 or 2008. To buy above-average quality companies at distressed prices bodes very well for long-term returns for our investors.

The PSG Flexible Fund was a buyer of Firstrand, Imperial, Old Mutual, Coronation and Discovery during the first quarter of 2016.

The level of cash in the Fund decreased from 30% to 28% over the quarter. It is worth remembering that cash levels were as high as 42% in May/June of 2015 and we were aggressive buyers of equities as opportunities presented in the latter stages of 2015.

The foreign equity component reduced from 29% to 26% during the quarter.

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Good returns are made in bad times
We buy good companies when they are cheap; this doesn't happen when the world is merry. Therefore our magnifying glass focuses on where there is pessimism or – even better – full-blown panic. The current downturn in the oil and gas industry is just that.

There are opportunities in the oil and gas industry sell-off
Concerns around prolonged lower oil and gas prices have resulted in the shares of many related companies selling off. As invariably happens, some prices fall hopelessly too far. We believe this is the case for Colfax Corporation, a stock we have gradually been introducing into the PSG Balanced Fund over the last number of months. Colfax is currently the fifth largest offshore equity holding in the fund.

Colfax Corporation: a solid, diversified business
Colfax is a US-based engineering company which consists of two distinct segments, Fabrication Technology and Gas & Fluid Handling. The Fabrication Technology business supplies about 12% of global welding equipment and related consumables. The Gas & Fluid Handling business is a supplier of high-tech equipment and parts including fans, pumps and compressors.

We look for robust profits that can grow
At PSG Asset Management we look to buy income streams which are reasonably robust and well-poised for growth. Colfax ticks both these boxes.

Robust profits

- The company's customer base is diversified across many industries, including the oil and gas, power generation, marine, automotive and construction industries.
- Colfax has limited geographical concentration risk, with its largest single market (the US) contributing only 30% of total sales.
- A large portion of the company's sales originate from aftermarket sales – which tend to be of a recurring nature.
- Profits that can grow.
- Just over 40% of Colfax's sales originate from emerging markets.
- Colfax's product range is generally about quality rather than price, which allows for at least nominal revenue growth.
- The company continues to drive significant efficiency improvements.
- The management team has a track record of earnings-enhancing bolt-on acquisitions.

Our 3M yardstick: how does Colfax stack up?

Moat

- The Fabrication Technology segment houses the ESAB brand. ESAB's heritage dates back to 1904 and the invention of the welding process. ESAB is the largest player in a fragmented market, which allows for larger research and development spend (i.e. better product) and lower manufacturing costs. Seven out of ten welders change suppliers every year, but they hardly change away from ESAB.
- The Gas & Fluid Handling segment primarily consists of the Howden brand. Howden was founded over 150 years ago and focuses on being the market and technology leader in its various focus areas, which are mainly non-commoditised, niche industrial end markets.
- Besides its underlying subsidiaries having strong moats in their own right, we believe the real differentiating factor is Colfax Business Systems (CBS). This refers to a set of proprietary operational and management tools which focuses on continuous group-wide improvements. CBS serves as a propeller of growth as new acquisitions are plugged into a super-efficient and cross-selling system.

Management
For us every day is a treasure hunt for those exceptional management teams who have large personal investments in the companies they run. The hunt was called off early the day we found the Rales brothers.

The Rales brothers, who collectively own 19.6% of Colfax, are two of the best industrialists in modern US history. They really made their mark with Danaher, an industrial company which they founded back in 1984. Danaher has been a phenomenal success story which has rewarded long-term shareholders with a compound annual total return in excess of 20% over the last three decades. Danaher is all about astute acquisitions and a culture of continuous efficiency improvements. Colfax, which they founded in 1995, unsurprisingly has the very same foundation.

Margin of safety
We're thankful for the 'industrial recession', which has resulted in a lack of interest in this stock. We were able to add to the Colfax holding at a free cash flow yield of close to 10% during the first quarter, a steal in our view.

Colfax is a thoroughbred selling at half-breed prices, or a good horse bought in bad times.

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It is very easy to be gripped by fear when reading the media or listening to the conversations of people from all walks of life.

The South African investment landscape has become a lot more volatile in recent months. Fear and uncertainty have taken hold and are affecting the way markets are currently pricing assets. We believe it is times like these that present opportunities for us to buy securities that are being been under appreciated due to fear.

As part of our philosophy, we always want to buy instruments into the portfolios that have a margin of safety. We currently believe that with all the fears in the markets due to global, political or economic events, the margin of safety in some fixed income assets has widened. Unfortunately, you cannot have your cake and eat it in markets - attractive real yield opportunities arise when there is fear in markets.

Let's just look at the backdrop of fixed income markets and why we think there are opportunities which were not available over the last few years.

Inflation
Yes, locally inflation is on the rise, but the South African Reserve Bank's (SARB) Monetary Policy Committee is sticking to their inflation targeting mandate and shows that they will increase rates to anchor inflation expectations. Globally, inflation is very low due to low commodity prices and inflation expectations abroad remain anchored.

Growth
Growth in most parts of the world is below expectations. Here in SA we continually see the SARB revise growth lower at every MPC meeting and the output gap remains. Globally, growth remains muted, causing the International Monetary Fund and World Bank to regularly revise these expectations lower.

Central Banks
Most developed market central banks are continuing with or adding more stimulus to global markets. We have seen the European Central Bank and Bank of Japan further reduce short-term interest rates into negative territory, trying to mitigate the unwanted effects of deflation. The most hawkish central bank currently, the US Federal Reserve, also had to turn on their heels and reduce their forecasts for further interest rate increases this year.

Looking at the factors above, this does not seem to be a world where bond yields suddenly rise to historic high levels and expose investors to large capital losses. A lot of bad news is already reflected in our local government bonds and we believe that the possibility of a downgrade and higher inflation is factored in. We think the margin of safety in bonds is wider than where it was three years ago and we are using this as an opportunity in the fund.

A Sovereign bond position is also a way of protecting our portfolios against a deflationary shock in the world, with the added benefit of being a liquid instrument in times of fear. This does not mean that the whole yield curve is an outright buy, but there are selective opportunities on the curve.

We are adding 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 Negotiable Certificates of Deposit remain attractive on a real yield basis given the level of risk and the expected path of inflation and interest rates.

The allocation to property has been sold from to the portfolio when the valuation became unattractive.

We will continue to search for real yields that are attractive at the level of risk.

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It is very easy to be gripped by fear when reading the media or listening to the conversations of people from all walks of life.

The South African investment landscape has become a lot more volatile in recent months. Fear and uncertainty have taken hold and are affecting the way markets are currently pricing assets. We believe it is times like these that present opportunities for us to buy securities that are being under appreciated due to fear.

As part of our philosophy, we always want to buy instruments into the portfolios that have a margin of safety. We currently believe that with all the concerns in the markets due to global, political or economic events, the margin of safety in some fixed income assets has widened. Unfortunately, you cannot have your cake and eat it in markets - attractive real yield opportunities usually arise when there is uncertainty in markets.

Let's just look at the backdrop of fixed income markets and why we think there are opportunities which were not available over the last few years.

Inflation
Local inflation is on the rise, but the South African Reserve Bank's (SARB) Monetary Policy Committee is sticking to their inflation targeting mandate and seem committed to increasing rates to anchor inflation expectations. Globally, inflation is very low due to low commodity prices. Inflationary expectations globally are also benign.

Growth
In SA we continually see the SARB revise growth lower at every MPC meeting and the output gap remains. Globally, growth remains muted, causing the International Monetary Fund and World Bank to regularly revise these expectations lower.

Central Banks
Most developed market central banks are continuing with or adding more stimulus to global markets. We have seen the European Central Bank and Bank of Japan further reduce short-term interest rates into negative territory, trying to mitigate the unwanted effects of deflation. The most hawkish central bank currently, the US Federal Reserve, also turned on their heels and reduced their forecasts for further interest rate increases this year.

Looking at the factors above, this does not seem to be a world where bond yields are likely to suddenly rise to historic high levels and expose investors to large capital losses. A lot of bad news is already reflected in our local government bonds and we believe that the possibility of a downgrade and higher inflation is factored in. We think the margin of safety in bonds is wider than where it was three years ago and we are selectively adding to the position in the fund.

A Sovereign bond position is also a way of protecting our portfolios against a deflationary shock in the world, with the added benefit of being a liquid instrument in times of fear. This does not mean that the whole yield curve is an outright buy, but there are selective opportunities. Longer dated bank Negotiable Certificates of Deposit remain attractive on a real yield basis given the level of risk and the expected path of inflation and interest rates.

We will continue to search for real yields that are attractive at the level of risk.

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2016 began in the grip of fear which took hold in the latter part of 2015, with interest rates significantly higher as a result.

The consensus view in the market, expressed by economists and in the Forward Rate Agreement (FRA) market, was that the South African Reserve Bank (SARB) would have little choice but to raise the repo rate at the January 2016 Monetary Policy Committee (MPC) meeting. Much debate however, was whether a 25 or 50 basis point hike would be more appropriate given the fragile growth outlook for South Africa over the medium-term. The January Monetary Policy Committee (MPC) meeting arrived with the SARB hiking the repo rate by 50 basis points, to 6.75%. The market, as reflected in the reaction of the Rand/Dollar exchange rate and government bond yields, viewed this decision by the SARB as positive and as an indication of credible policy action. The SARB highlighted that the depreciated real exchange rate and higher expected food price inflation as a result of the drought, had placed significant upward pressure on the trajectory of headline inflation over the medium term, a key driver in their decision to hike the repo rate by 50 basis points.

The Budget Speech was delivered in February, as the market laid down expectations of how Minister Pravin Gordhan would steady the fiscal path for South Africa. This was viewed as one of the tougher budget speeches to deliver, with South Africa's investment grade credit rating fragile to say the least. The buildup to the speech was surprisingly positive as the market became more confident that the Minister would not disappoint. In addition, business leaders in SA began to speak more positively and the market came off asset class lows experienced in December 2015. The budget largely delivered on expectations, as the Minister re-emphasised that fiscal consolidation and the debt burden was a priority for National Treasury in light of slowing growth prospects over the medium- term.

Below are a few positive takeouts from the budget that could go a long way to appeasing the credit rating agencies:

- A budget deficit of 2.4% by 2018/2019, improved from the October 2015 figure of 3%.
- A debt to GDP ratio of 46.2% by 2018/2019, improved from the October 2015 figure of 49.4%.
- Emphasis on improving the performance and efficiency of key SOE's such as Eskom and Transnet.
- Increased funding for tertiary education.
- Increased control over government tender processes and,
- A halt in government employee vacancies, easing wage inflationary pressures.

National Treasury opted not to raise VAT in order to raise its required revenue targets, viewed as something of a surprise to the market. This is likely to ease the pressures on the consumer. Overall, the budget was considered satisfactory and possibly able to allay fears of a credit rating downgrade to sub-investment grade status. The implementation of these policies will be telling as the year runs its course.

Amidst significant upward pressure on inflation from food prices, the SARB committed to their mandate of inflation targeting by further hiking the repo rate at the March 2016 MPC meeting, by 25 basis points to 7%. The SARB's forecasts show headline inflation averaging above 6% for 2016 and 2017, falling below the target by the fourth quarter of 2017.

Money Market rates reflect this view on inflation and therefore remain attractive with a steep Negotiable Certificate of Deposit (NCD) curve. One year NCD's are trading at attractive yields of close to and above 8.5%. We remain cautious in ensuring a margin of safety as the South Africa inflation profile remains, as always, susceptible to external shocks.

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Good returns are made in bad times
We buy good companies when they are cheap; this doesn't happen when the world is merry. Therefore our magnifying glass focuses on where there is pessimism or – even better – full-blown panic. The current downturn in the oil and gas industry is just that.

There are opportunities in the oil and gas industry sell-off
Concerns around prolonged lower oil and gas prices have resulted in the shares of many related companies selling off. As invariably happens, some prices fall hopelessly too far. We believe this is the case for Colfax Corporation, a stock we have been introducing into the PSG Global Equity Fund over the last number of months. Colfax is currently the 8th-largest holding in the fund.

Colfax Corporation: a solid, diversified business
Colfax is a US-based engineering company which consists of two distinct segments, Fabrication Technology and Gas & Fluid Handling. The Fabrication Technology business supplies about 12% of global welding equipment and related consumables. The Gas & Fluid Handling business is a supplier of high-tech equipment and parts including fans, pumps and compressors.

We look for robust profits that can grow
At PSG Asset Management we look to buy income streams which are reasonably robust and well-poised for growth. Colfax ticks both these boxes.

Robust profits
- The company's customer base is diversified across many industries, including the oil and gas, power generation, marine, automotive and construction industries.
- Colfax has limited geographical concentration risk, with its largest single market (the US) contributing only 30% of total sales.
- A large portion of the company's sales originate from aftermarket sales – which tend to be of a recurring nature.
- Profits that can grow.
- Just over 40% of Colfax's sales originate from emerging markets.
- Colfax's product range is generally about quality rather than price, which allows for at least nominal revenue growth.
- The company continues to drive significant efficiency improvements.
- The management team has a track record of earnings-enhancing bolt-on acquisitions.

Our 3M yardstick: how does Colfax stack up?

Moat
- The Fabrication Technology segment houses the ESAB brand. ESAB's heritage dates back to 1904 and the invention of the welding process. ESAB is the largest player in a fragmented market, which allows for larger research and development spend (i.e. better product) and lower manufacturing costs. Seven out of ten welders change suppliers every year, but they hardly change away from ESAB.
- The Gas & Fluid Handling segment primarily consists of the Howden brand. Howden was founded over 150 years ago and focuses on being the market and technology leader in its various focus areas, which are mainly non-commoditised, niche industrial end markets.
- Besides its underlying subsidiaries having strong moats in their own right, we believe the real differentiating factor is Colfax Business Systems (CBS). This refers to a set of proprietary operational and management tools which focuses on continuous group-wide improvements. CBS serves as a propeller of growth as new acquisitions are plugged into a super-efficient and cross-selling system.

Management
For us every day is a treasure hunt for those exceptional management teams who have large personal investments in the companies they run. The hunt was called off early the day we found the Rales brothers.

The Rales brothers, who collectively own 19.6% of Colfax, are two of the best industrialists in modern US history. They really made their mark with Danaher, an industrial company which they founded back in 1984. Danaher has been a phenomenal success story which has rewarded long-term shareholders with a compound annual total return in excess of 20% over the last three decades. Danaher is all about astute acquisitions and a culture of continuous efficiency improvements. Colfax, which they founded in 1995, unsurprisingly has the very same foundation.

Margin of safety
We're thankful for the 'industrial recession', which has resulted in a lack of interest in this stock. We were able to add to the Colfax holding at a free cash flow yield of close to 10% during the first quarter, a steal in our view.

Colfax is a thoroughbred selling at half-breed prices, or a good horse bought in bad times.

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