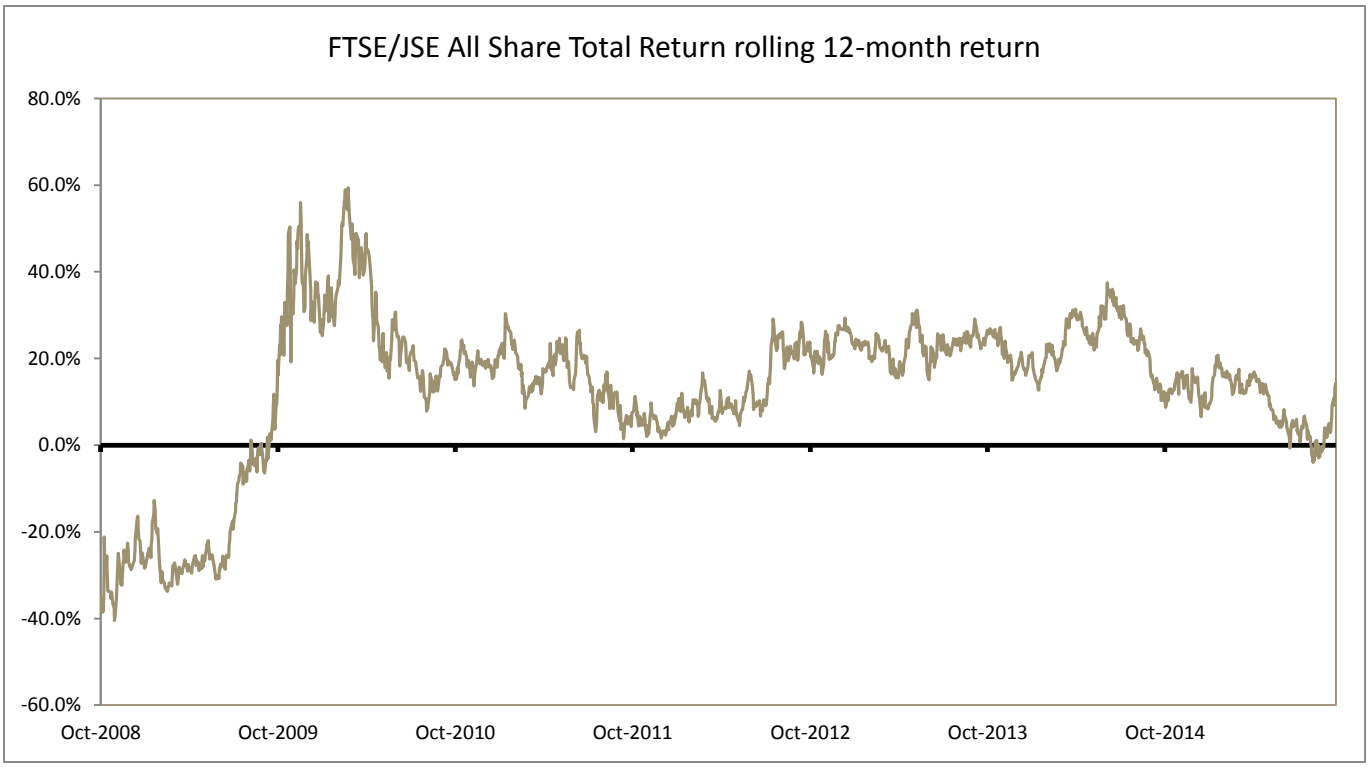
Equity markets have been very kind to investors over the past six years.

Remarkably, until two months, ago investors in the FTSE/JSE All Share had not experienced negative returns over a rolling twelve month period since October 2009. After a 10% drawdown in August this year, one year returns briefly dropped into negative territory but prices have subsequently recovered. It is worth pointing out that the All Share's performance has been very strongly supported by rand weakness and very strong performance by a handful of heavyweights, especially Naspers and SAB Miller.



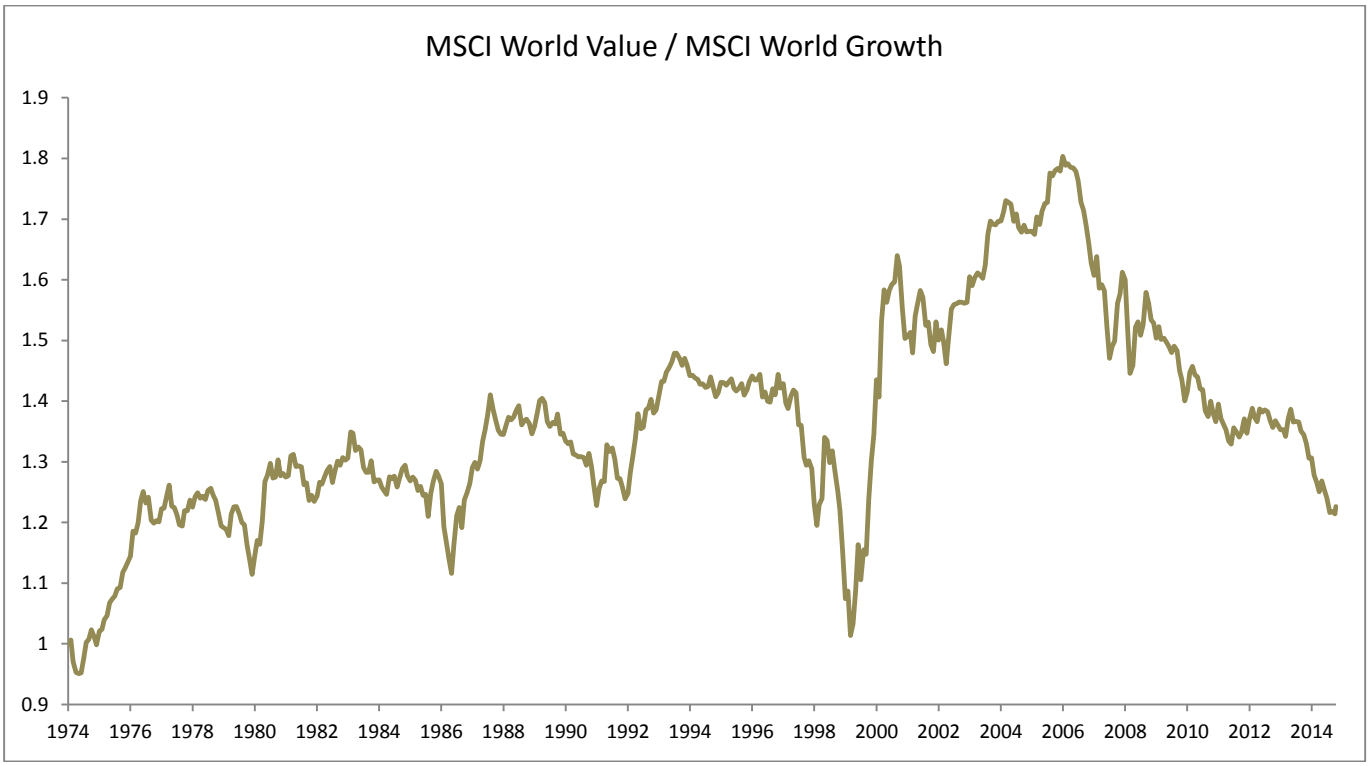
Source: Bloomberg, PSG Asset Management (13.10.2015)

The correction that the market endured in recent months was felt most acutely in the cyclical sectors, particularly the mining stocks. Glencore and Anglo American have been top ten positions in the PSG Equity Fund and the share price declines in 2015 have had a material impact on short-term fund performance. The Glencore share price was particularly volatile in September and the extent of the decline attracted many headlines.

Investors in the fund will be aware that we have taken a view that sentiment around the mining sector is very poor and as a result many stocks are trading at very depressed prices. The range of outcomes for profits from miners, and other heavily cyclical price-takers, is very wide. Hence, we like to buy such assets only when we are happy that the margin of safety is commensurately wide and we think we are insulated against unforeseen events by the difference between what we think a company is worth, and where it is trading. We have been, and remain, of the view that Glencore and Anglo trade at a wide discount to a conservative valuation of their businesses.

September saw panic-selling in the mining sector with indebted companies bearing the brunt of the aggressive moves. We have carefully assessed the investment case for our investments, including a stress test of balance sheets and an assessment of tail risk. We concluded that for a stock like Glencore, the share price moves were almost certainly not driven by fundamentals and that the concerns around the balance sheet were overblown. We bought more Glencore on behalf of our clients into weakness. The share price has recovered sharply in October, but sentiment remains very poor.

At PSG Asset Management we have an unashamed bias for higher quality companies that are not excessively priced. This bias has served our clients very well over longer term investment horizons. Unfortunately, we perceive that current market conditions provide limited opportunity to buy strong businesses at attractive prices. As the chart below illustrates, the outperformance by growth of value on a global basis has been very pronounced and has reached levels last seen in the Nasdaq tech boom. This reflects the unrelenting demand for higher quality growth businesses in a growth-starved world. It also reflects just how out of favour the cheaper more cyclical stocks and sectors are.



Source: Bloomberg, PSG Asset Management (13.10.2015)

We are bottom-up managers and this discrepancy in relative prices between in-demand growth stocks and out-of-favour value stocks shows up in the opportunities we can find to invest our clients' capital. We continue to find fewer opportunities in the quality sectors and think the returns from carefully selected cyclical stocks will be very favourable. Investing in this fashion requires a longer term investment horizon, patience and emotional discipline but our experience has shown us that this is the true path to long-term investment success.

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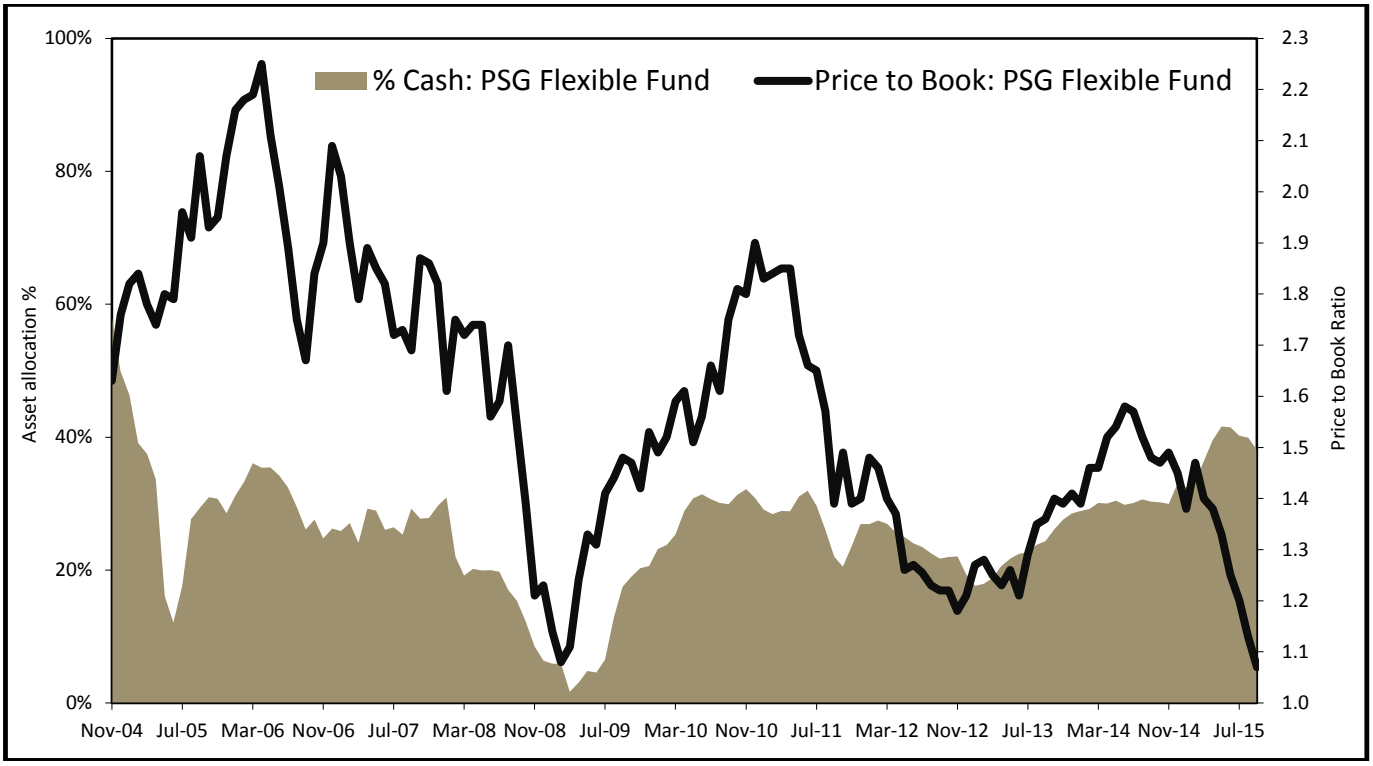
Remarkably, until two months ago, investors in the FTSE/JSE All Share Index had not experienced negative returns over a rolling twelve month period since October 2009. After a 10% drawdown in August this year, one year returns briefly dropped into negative territory but prices have subsequently recovered. It is worth pointing out that the All Share's performance has been very strongly supported by rand weakness and very strong performance by a handful of heavyweights, especially Naspers and SABMiller.

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 potentially low valuation.

Price to book and average cash allocation of the PSG Flexible Fund



Source: PSG Asset Management

The weighted average P/B ratio of the equities held is currently at an all-time low of 1.07, i.e. the equities held by the PSG Flexible Fund has never been more attractively priced based on P/B valuation than now. The current P/B of 1.07 is even lower than the 1.08 reached on 28 February 2009 at the bottom of the global financial crisis.

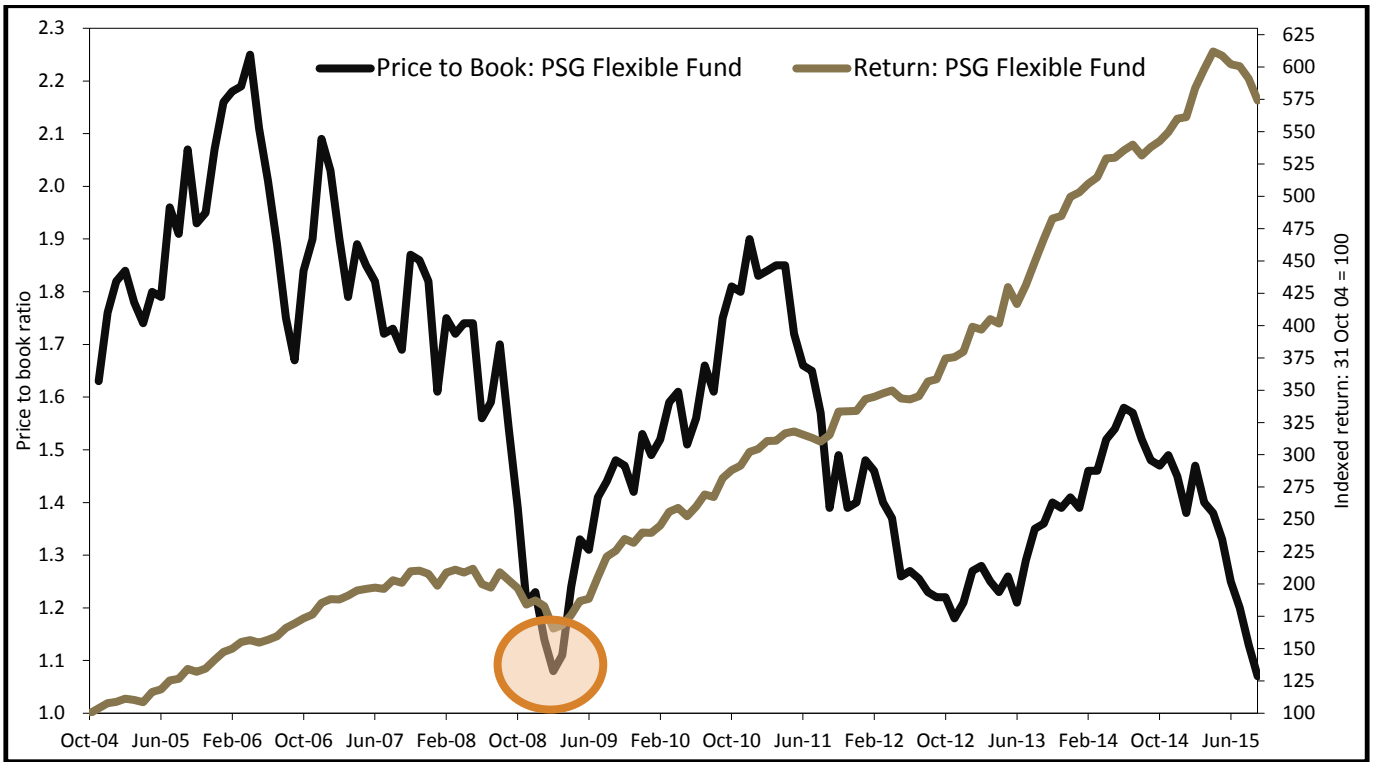
The graph also shows % of the PSG Flexible Fund that was invested in cash since 2004; the remainder of the Fund was invested in equities. In terms of asset allocation just over 40%, on average, of the PSG Flexible Fund was invested in cash over the past six months – our highest average cash level since the present management took over in 2004. This record cash holding has protected investors against the current decline in markets. We are now gradually using this cash as we are finding more opportunities in the market turmoil, especially in certain sectors where extreme fear and pessimism exist.

Our record cash holding gives us the ability to invest where others are divesting in a stampede of panic.

You will notice that our cash holding as at 30 September 2015 of 37% is much higher than the average cash holding during February/March 2009 of around 4% when the P/B ratio was previously at a record low. Current market conditions are different from those that existed during 2009 when almost all share prices were severely affected. In the current market, the share prices of lower quality shares have taken most of the beating and high quality shares are holding up well. We have higher cash holdings relative to 2009 as we are waiting for the share prices of some higher quality companies, which we prefer to own, to decline to more attractive levels.

Historically the P/B ratio of the PSG Flexible Fund was a good indicator of an optimal time to invest. If you had invested in the PSG Flexible Fund in February 2009 when the P/B was at its previous low point, you would have had good subsequent returns as the following graph illustrates.

Price to book and return of the PSG Flexible Fund



Source: Morningstar; PSG Asset Management

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Clients who (despite our cautioning not to) keep an eye on the shorter term performance of our funds might have developed some angst over the last couple of months. What has happened?

As communicated many times in our commentaries and presentations, we have been operating in an investment environment where companies that generate predictable cash flows have been too expensive, while companies that generate more volatile cash flows have been too cheap. (For example, Mr Price has been very expensive and Anglo American has been very cheap). As of late these "too expensive" companies have started moving towards more fair prices. No surprises there. However, the "too cheap" companies became much cheaper - at a rapid rate. The latter had an adverse effect on the unit prices of our funds.

Are falling prices a problem?

Remember that lower share prices are only a problem if you are a forced seller. If you hold cash, you can get more shares for the same amount of money – hardly a problem. Fortunately we hold loads of cash in our asset allocation funds and therefore had the privilege of spending our clients' money on great companies.

We bought two kinds of companies:

1. High quality companies which were in the market at far more reasonable prices.

   We bought more shares of companies already held in the fund, but also bought shares in companies for the first time. Companies which we bought into the PSG Balanced Fund for the first time include:

   Union Pacific: one of North America's largest railroad companies. (Berkshire Hathaway owns the other one.) The business has very compelling long-term economics and is managed exceptionally well. It doesn't go on sale very often so we had to move quickly.

   Softbank: a Japanese holding company which owns stakes in Alibaba, Yahoo Japan and telecommunications companies in both Japan and the USA. The chairman, Masayoshi Son, owns a large chunk of the business and has a long track record of making very smart investments.

   We added to existing holdings of Colfax, Berkshire Hathaway and Capital One.

2. Companies that generate more volatile cash flows which went from cheap to dirt cheap. Very important to note, here we only buy the companies that we believe have competent management teams and strong balance sheets. We bought more shares in Glencore, Anglo American, BHP Billiton, Group Five and WBHO.

Falling share prices generally get us excited because we can buy more shares with the same amount of cash for our clients. What doesn't get us excited is when share prices fall due to dishonesty at a company. Part of our assessment of management is whether the company's culture is one of honesty and transparency. This is not a matter of degree; a company which does not tick this box will not be considered for our funds. Over and above this being integral to protecting clients' capital, the team at PSG Asset Management only want to analyse and invest in companies which we admire. This is why it was a very disappointing day for us when Volkswagen admitted that they had cheated in emission testing on a global basis over the course of six years. The PSG Asset Management funds were invested in the Volkswagen Group via Porsche Automobil Holding (which owns 51% of the Volkswagen Group's voting shares).

So what happens if it transpires that a company in which we are invested proves to have been dishonest?

We exited the position as quickly as possible without putting undue pressure on the share price. Our orders were placed over the course of the three days subsequent to the news breaking. We completely exited all exposure to Porsche Automobil Holding (and therefore VW Group) across the PSG Asset Management funds.

Concluding on a very eventful quarter:

- Out of favour companies became significantly more out of favour - very quickly. We added selectively.
- Patience paid off, we are finally buying great companies at below fair prices.
- Our investment philosophy excludes companies where there is a shred of doubt regarding honesty. We need to get even better at finding such shreds.

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In a world of heightened volatility, nominal bond markets have begun to show a sense of calm and stability.

During the last quarter there have been moments of significant volatility in emerging market currency and equity markets. Despite this global bond markets have remained very composed and our own market has been no exception. The rand weakened against all the major currencies over the quarter and equity markets came under severe pressure. The RSA 10 year government bond traded in a fairly narrow band despite the volatility experienced in related markets. There are a few reasons why bond markets have not been reacting to the global volatility in other markets and why investors have been buying bonds as a counter to the turmoil.

Firstly, inflation remains benign in the developed world. In fact, we are witnessing negative inflation in Europe. Inflation in the US remains below the 2% target set by the US Federal Reserve. Despite the rand (and other emerging market currencies) weakening, inflation is still muted in these emerging markets due to consumers who remain under pressure, which has prevented local companies from passing on significant price increases. Lower oil and commodity prices remain a source of disinflation in the world.

Secondly, robust growth remains elusive in the world and most forecasts are being continually revised downwards. In South Africa, the South African Reserve Bank has revised growth lower at almost every Monetary Policy Committee meeting in 2015. National Treasury has already indicated lower GDP growth numbers than the 2% which was anticipated in the February budget speech and most economists have already scaled back growth forecasts over the next two years.

Thirdly, consumers' disposable income is being eroded through various forms of taxation and higher interest rates. In South Africa we have seen an increase in taxes in the February budget, benchmark interest rates increasing in July and petrol prices on the rise due to rand weakness. These and other factors have all led to consumers having less disposable income and the ability to absorb price increases.

Fourthly, central banks remain largely on the side-lines. As much as global central banks want to adjust monetary policy back to more normalised levels, the factors above are preventing aggressive policy adjustments. A good example has been the fact that despite the US Federal Reserve warning that they would be increasing rates in 2015 and would move rates substantially higher over the next two years, it has not adjusted short rates so far this year and the outlook for substantially higher rates over the next few years seems less obvious.

All these factors paint a picture of a more benign environment for bond yields and fixed income instruments in general. An environment of low inflation, muted GDP growth and a constrained consumer is a world where bond yields could remain muted. If inflation falls further and bond yields remain at current levels there will be an opportunity to participate in higher real yields at a low credit risk level, with the added benefit of being invested in fairly liquid instruments.

Longer dated bank NCDs remain attractive on a real yield basis given the level of risk and expected path of inflation and interest rates. Certain parts of the nominal yield curve have also become more attractive on a real yield basis.

We will continue to deploy cash when real yields are attractive at the appropriate level of risk.

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During the month of September, bond and money market yields settled following the bouts of increased volatility experienced across all asset classes in August. The rand however remains weak with significant swings providing an indication of the risk-off sentiment towards emerging market assets. The rand reached a new low of R14.15 to the US dollar towards the end of September.

Commodity prices remain under pressure, with little prospect of an immediate market turnaround. Fears around a China economic slowdown have further suppressed commodity prices as demand for precious metal is expected to remain low over the near term. A clear example of this was the price of platinum, which fell to a level of around US$905/oz., a price last seen in January 2009. South Africa, being a major commodity exporter, has seen the effects of these reduced prices through a persistent current account deficit, a weak rand and this has led to growth expectations being revised down continuously.

As a result of these circumstances, the outlook for headline inflation is a continuation of an upward trend as base effects work through the cycle. Going forward, inflationary pressures appear mixed as inflation effects caused by a weaker currency are balanced against weak commodity prices, specifically Brent crude oil. It is often questionable how far the weaker currency can influence consumer prices when consumer demand is mute. The wage negotiations which commenced in the coal sector on 30 September 2015 are likely to provide some direction on the outlook over the near term.

An interesting point to note at the end of September was that cash has been the second best performing asset class year to date according to RMB research reports. This speaks to the steepness of the money market curve, where we continue to find value-enhancing opportunities. We see better value in the 6- to 12-month region of the curve and are watching the secondary corporate bond market closely for opportunities.

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Clients who (despite our cautioning not to) keep an eye on the shorter term performance of our funds might have developed some angst over the last couple of months. What has happened?

As communicated many times in our commentaries and presentations, we have been operating in an investment environment where companies that generate predictable cash flows have been too expensive, while companies that generate more volatile cash flows have been too cheap. (For example, Mr Price has been very expensive and Anglo American has been very cheap). As of late these "too expensive" companies have started moving towards more fair prices. No surprises there. However, the "too cheap" companies became much cheaper - at a rapid rate. The latter had an adverse effect on the unit prices of our funds.

Are falling prices a problem?

Remember that lower share prices are only a problem if you are a forced seller. If you hold cash, you can get more shares for the same amount of money – hardly a problem. Fortunately we hold loads of cash in our asset allocation funds and therefore had the privilege of spending our clients' money on great companies.

We bought two kinds of companies:

1. High quality companies which were in the market at far more reasonable prices.

   We bought more shares of companies we already owned but also bought shares in companies for the first time. We shopped among the US industrials especially.

   Companies which we bought into our global portfolios for the first time include:
   Union Pacific: one of North America's largest railroad companies. (Berkshire Hathaway owns the other one.) The business has very compelling long-term economics and is managed exceptionally well. It doesn't go on sale very often so we had to move quickly.

   Yahoo Japan: Japan's largest e-commerce and search portal (think of a blend of eBay and Google dominating the Japanese market). Yahoo Japan's business model enjoys attractive economics and structural growth tailwinds. The $4bn cash holding (20% of market cap) may be used to buy back Yahoo Inc.'s 35% stake.

   Companies where we increased our conviction significantly:
   Softbank: a Japanese holding company which owns stakes in Alibaba, Yahoo Japan and telecommunications companies in both Japan and the USA. The chairman, Masayoshi Son, owns a large chunk of the business and has a long track record of making very smart investments.

   Softbank's share price dropped from ¥7688 to ¥5401 during the quarter.

   We added to our existing holdings of Colfax, United Technologies, Berkshire Hathaway, Wells Fargo and National Grid.

2. Companies that generate more volatile cash flows which went from cheap to dirt cheap. Very important to note, here we only buy the companies that we believe have competent management teams and sufficiently strong balance sheets to sit out the cycle. We bought more shares in Glencore and HSBC.

Falling share prices generally get us excited because we can buy more shares with the same amount of cash. What doesn't get us excited is when share prices fall due to dishonesty at a company. Part of our assessment of management is whether the company's culture is one of honesty and transparency. This is not a matter of degree; a company which does not tick this box will not be considered for our funds. Over and above this being integral to protecting clients' capital, the team at PSG Asset Management only want to analyse and invest in companies which we admire. This is why it was a very disappointing day for us when Volkswagen admitted that they had cheated in emission testing on a global basis over the course of six years. The PSG Asset Management funds were invested in the Volkswagen Group via Porsche Automobil Holding (which owns 51% of the Volkswagen Group's voting shares).

So what happens if it transpires that a company in which we are invested proves to have been dishonest?

We exited the position as quickly as possible without putting undue pressure on the share price. Our orders were placed over the course of the three days subsequent to the news breaking. We completely exited all exposure to Porsche Automobil Holding (and therefore VW Group) across the PSG Asset Management funds.

Concluding on a very eventful quarter:

- Out of favour companies became significantly more out of favour - very quickly. We added selectively.
- Patience paid off, we are finally buying great companies at below fair prices.
- Our investment philosophy excludes companies where there is a shred of doubt regarding honesty. We need to get even better at finding such shreds.

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