PSG Wealth

INVESTMENT RESEARCH AND STRATEGY REPORT

SPRING 2015

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Economic commentary
Financial market review
Tactical preferences
Domestic unit trust positioning
Offshore mutual fund positioning
Equity research
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Introduction

Welcome to the first edition of the *PSG Wealth Investment Research and Strategy Report*. In an effort to add more value to your PSG Wealth experience, we have compiled a new interactive digital publication which will be distributed to you seasonally.

We hope to provide insightful content and we kick off our Spring edition with in-depth information and commentary from our investment team on everything from our domestic unit trust position and equity research, to preference shares and cash management options.

At PSG we believe that wealth is personal. To really make it count, wealth management should be shaped to the individual. For that reason our new publication is interactive – you do not need to scroll through the whole document to get to the section you want to read, but can simply click on the related tab and jump straight to the piece that's piqued your interest. We will focus on an array of topics every season, looking back over the past three months to interesting events and investment industry developments.

What to expect from our first edition

In this edition, Franco Pretorius, Head of Direct Security Research, takes a closer look at the construction sector and whether investing in this sector is a value play or value trap. Henko Roos and Johan Pyper, senior analysts in our multi-management team, take a look at offshore and domestic unit trusts respectively. I have given my own insights into prevailing economic and financial market conditions, as well as the current position of our funds.

We value your feedback

We hope you enjoy the read, and the new format of our seasonal research report. Please feel free to send us any feedback you might have – we always look forward to hearing from you.

Regards,

Adriaan Pask

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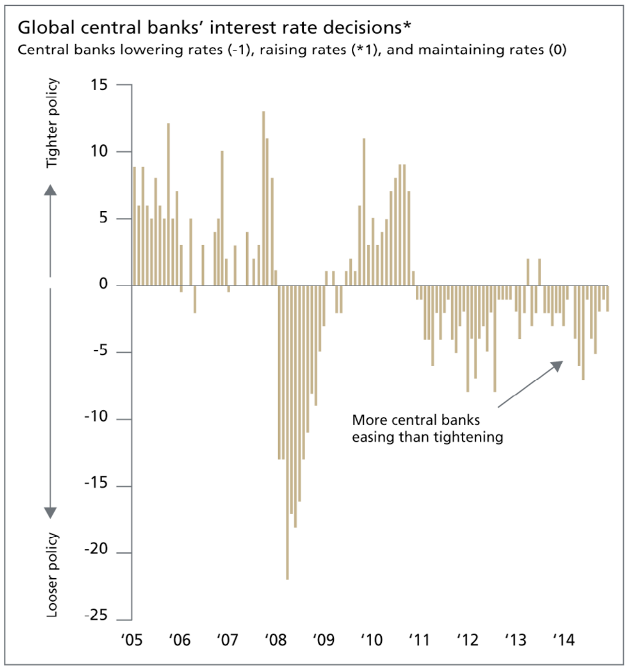
Economic commentary

Macro-economic considerations increasingly important

Over the better part of the last decade we have seen top-down considerations becoming increasingly important in portfolio construction. At the turn of the century investors were far more concerned with bottom-up valuations than top-down valuations based on macro-economic events. Value trumped growth strategies, and forecasting was dubbed a futile and obsolete task of economists.

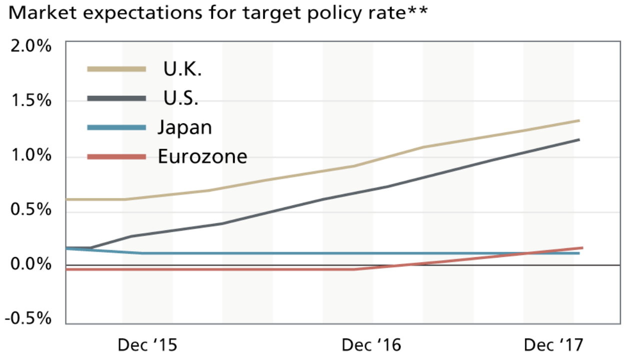
Today however, although 'bottom-up' and 'value' investing has become deeply entrenched in our prevailing investment culture (particularly in South Africa), most professional money managers would concede that macro-economic considerations have become increasingly important in portfolio management and construction over the last decade.

This advent has largely been driven by extensive and widespread monetary and fiscal policy changes globally. These policy changes, and the sheer scale at which they have been implemented, have had (and will continue to have for some time) a longer-term impact on the potential investment returns of all traditional asset classes.



Source: JP Morgan

The first graph shows that monetary policy decisions have been a tailwind for global growth since 2010. Within developed markets, the faster rebound in growth in the US and the UK means that interest rate expectations are much higher relative to Europe and Japan. The European Central Bank and the Bank of Japan are expected to continue expanding their respective balance sheets to maintain growth trajectories and eventually normalise rates.



Source: JP Morgan

We think the most prudent mindset in these market conditions is to remain bottom-up focused, but to incorporate top-down considerations into your process in order to frame those bottom-up decisions. This will also assist investors to avoid pitfalls they may not have picked up by an isolated bottom-up process.

The US Federal Reserve (Fed) taking center stage

On 17 September, the Fed made its most eagerly awaited monetary policy decision in years when it decided to keep interest rates unchanged. Given the recent market volatility and strong dollar, some analysts correctly predicted that the Fed would not raise rates at this meeting, against consensus view.

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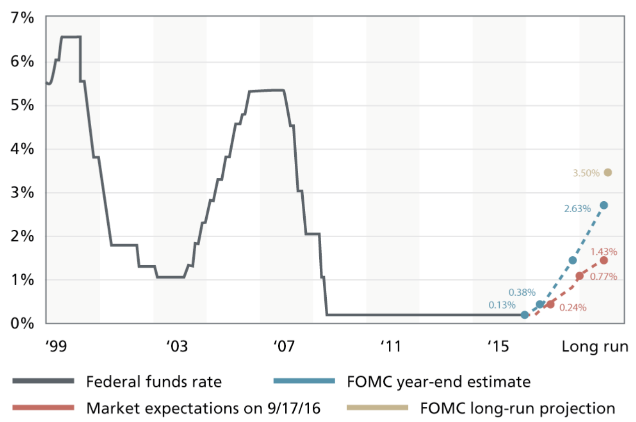
Economic commentary

Federal funds rate expectations
FOMC and market expectations for the fed funds rate



FOMC September 2015 forecasts* Percent				
	2015	2016	2017	Long run
Change in real GDP, Q4 to Q4	2.1	2.3	2.2	2.0
Unemployment rate, Q4	5.0	4.8	4.8	4.9
PCE inflation, Q4 to Q4	0.4	1.7	1.9	2.0

Source: JP Morgan

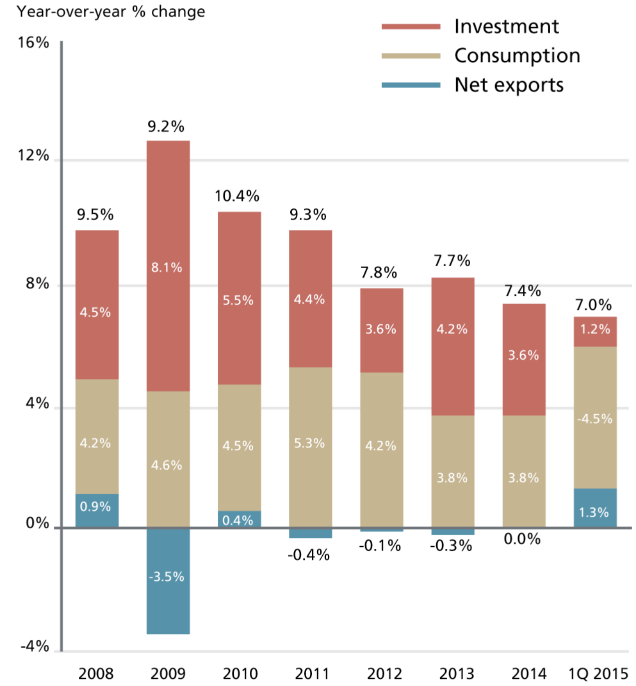
The diagram above shows the differences in rate expectations between the Federal Open Market Committee (FOMC) and market participants. Market participants expect the federal funds rate to be much lower than what is being projected by the FOMC. This means that large and unexpected rate hikes could disrupt the market.

From an asset class valuation perspective however, not much has changed. The expectation remains that the Fed, for the first time since 2006, will raise rates reasonably soon. The Fed's next interest rate decision will be only one event in a continuous series of events that will influence financial markets over the coming months and years. Because opinion is still largely divided on when rates will increase, we expect volatility in the markets to prevail.

Emerging markets crumbling

China's economy is in a major slow down. This was the case even before the recent effects on consumer confidence played out. There has been a material structural change in strategy for the Chinese economy, where the focus has shifted from infrastructure spending (which supported a commodity super-cycle), to developing a sustainable consumer-led economy.

China real GDp contribution
Year-over-year % change



Source: JP Morgan

It is expected that this will result in a lower demand for commodities, which has drastically impacted spot prices, the profitability of resource companies, emerging market economies and, in particular, emerging market currencies.

The chart on the next page shows the sovereign spread over Treasuries for several emerging market countries. Russia and Brazil are two prime examples of countries in which spreads are pricing in significant risks. Russia is facing sanctions and suffering from lower oil and gas prices, while Brazil has been severely impacted by a slowdown in commodity prices.

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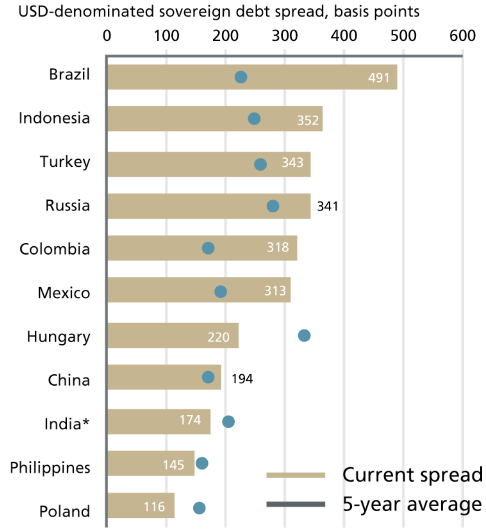
EMD sovereign spreads by country

USD-denominated sovereign debt spread, basis points



Source: JP Morgan

Looking ahead

Presently there are two schools of thought on how the world's economic future will unfold. The first envisages a world with deflation, where the next move in Federal Reserve policy will be another round of US quantitative easing, rather than an interest rate hike. The second school seems to feel that normality is returning to economic conditions, and that the US could therefore lead the world into the next economic upturn.

Our view remains that the Fed will lead the way forward in terms of global economic sentiment, and that it is increasingly important to be cognisant of US economic data releases. Our view is that US GDP growth will continue to fluctuate between 2%-3%, and that core inflation is likely to decline very gradually and settle in a 1.5%-2% range, with US unemployment levels continuing their downward trend. We suspect that this view is likely to coincide with the Fed raising rates to 1% during the course of 2016.

However, given that the Fed has indicated that rate hikes will be 'data dependent', rate hikes may well be accelerated if growth and inflation rates are higher, and employment figures stronger. Conversely, if US macro-economic data disappoints, it becomes increasingly likely that rate hikes will be further delayed.

What are Production Manufacturing Indices (PMIs) implying?

Looking at global PMIs it is clear that growth expansion could be expected in developed markets, including for most members of the European Union. Contracting growth could be expected for many emerging markets, especially for those with significant sovereign spreads, a strong reliance on exports from specific commodities for GDP growth and vulnerable fiscal budgets.

Manufacturing PMI > 50

Country	Last	Previous	Change	Highest	Lowest
Denmark	69.63	61.71	7.92	70.53	24.86
Saudi Arabia	56.50	57.70	-1.20	61.80	56.10
United Arab Emirates	56.50	55.80	0.70	61.20	51.70
Hungary	55.80	51.00	4.80	58.30	37.63
Czech Republic	55.50	56.60	-1.10	57.50	46.00
New Zealand	55.00	53.50	1.50	62.03	35.59
Ireland	53.80	53.60	0.20	57.50	48.00
Sweden	53.30	53.20	0.10	71.40	32.70
United States	53.10	53.00	0.10	57.90	51.00
Netherlands	53.00	53.90	-0.90	57.00	48.00
Italy	52.70	53.80	-1.10	55.30	48.00
Austria	52.50	50.50	2.00	54.30	46.90
Germany	52.30	53.30	-1.00	62.70	32.00
Australia	52.10	51.70	0.40	62.13	30.86
Mexico	52.10	52.40	-0.30	57.10	49.70
Euro Area	52.00	52.30	-0.30	59.00	33.50
Spain	51.70	53.20	-1.50	55.80	41.10
United Kingdom	51.50	51.60	-0.10	61.50	34.40
India	51.20	52.30	-1.10	55.00	48.50
Japan	51.00	51.70	-0.70	56.20	29.60
Poland	50.90	51.10	-0.20	55.90	46.90
France	50.60	48.30	2.30	57.50	42.70
Egypt	50.20	51.20	-1.00	52.50	37.10

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Manufacturing PMI < 50

Country	Last	Previous	Change	Highest	Lowest
Switzerland	49.50	52.20	-2.70	66.90	32.60
Vietnam	49.50	51.30	-1.80	54.80	43.60
South Korea	49.20	47.90	1.30	52.60	45.70
Russia	49.10	47.90	1.20	53.20	47.60
South Africa	49.00	48.90	0.10	64.20	34.20
Turkey	48.80	49.30	-0.50	55.00	48.00
Canada	48.60	49.40	-0.80	56.30	48.60
Singapore	48.60	49.30	-0.70	51.90	48.30
Indonesia	47.40	48.40	-1.00	58.50	46.40
Norway	47.30	43.70	3.60	64.60	34.80
China	47.20	47.30	-0.10	52.30	47.20
Brazil	47.00	45.80	1.20	53.20	45.80
Taiwan	46.90	46.10	0.80	56.10	45.60
Hong Kong	45.70	44.40	1.30	53.30	44.40
Greece	43.30	39.10	4.20	51.30	30.20

Large economies

Members of the EU

BRICS countries

Expectations in a nutshell

Our expectation is for Fed rates to normalise on the back of strong macro-economic data releases. The European Union is largely set for a recovery in an expansive monetary policy climate. We generally expect emerging markets to continue to struggle over the short term, as commodity prices remain low over this period. As recoveries in larger economies start to take place, we expect emerging market PMIs to signal improved growth, and perhaps the potential for higher spot prices on the back of increased demand. However, this is not necessarily imminent and may take some time to unfold. We continue to monitor these events closely and will position our portfolios to reflect our views on potential risks and opportunities.

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Financial market review

Market indicators (as at 30 September 2015)

INDEX	QUARTER-END VALUE	1M	3M	6M	1Y	3Y	5Y
ALSI	50 088.86	0.23%	-3.32%	-4.01%	1.53%	13.36%	14.01%
Industrials	74 745.80	3.73%	-0.15%	1.16%	13.07%	26.11%	29.68%
Resources	17 053.88	-11.99%	-20.23%	-24.14%	-40.34%	-11.89%	-7.21%
Financials	42 683.44	-2.56%	-2.15%	-5.63%	14.59%	19.33%	19.08%
Listed Property	644.58	-0.23%	4.56%	-2.95%	19.27%	10.84%	14.01%
ALBI	493.84	-0.07%	1.11%	-0.31%	7.04%	5.59%	8.95%
VIX	24.50	-13.82%	34.39%	60.24%	50.21%	18.58%	0.68%
S&P 500	1 920.03	-2.64%	-6.94%	-7.15%	-2.65%	11.09%	13.65%
Euro Stoxx	3 100.67	-5.17%	-9.45%	-16.14%	-3.88%	8.78%	2.57%
Nikkei	17 388.15	-7.95%	-14.07%	-9.47%	7.51%	32.01%	17.12%
Hang Seng	20 846.30	-3.80%	-20.59%	-16.28%	-9.10%	0.01%	-1.35%
Dax	885.74	-5.31%	-10.13%	-17.11%	4.87%	13.14%	12.48%
MSCI World	1 581.92	-3.86%	-8.86%	-9.13%	-6.86%	6.87%	6.83%
MSCI World ex US	1 634.95	-5.29%	-11.08%	-11.49%	-12.34%	1.94%	0.59%
FTSE 100	6 061.61	-2.98%	-7.04%	-10.50%	-8.47%	1.85%	1.85%

Source: INET

*Performance reported in base currency. Returns of periods exceeding one year have been annualised.

Sources: I-Net, J.P. Morgan

Domestic assets

Domestic equities experienced a poor quarter, with the FTSE/JSE All Share Index (ALSI) generating a 3.32% loss. This ate into nearly all of the 4.84% returns made during the previous quarter.

Industrials generated a loss of only 15 basis point for the quarter, which compares very favourably with the 20.23% loss generated by the resources sector. Financials delivered a 2.15% loss over the quarter.

On a longer-term assessment, the ALSI has generated an annualised return of 14.01% over the preceding five years. Industrials, which gained 29.68% over the same period, have been the main driver of returns. Resources were a significant detractor of returns, generating a 7.21% annualised loss over the same five-year period.

Listed property experienced exceptional returns over the last five years, matching the ALSI return exactly. We do, however, believe that the asset class is now somewhat overheated and, as a result, we have lightened weightings where appropriate.

We generally expect emerging markets to continue to struggle over the short term as commodity prices remain low over this time. As recoveries in larger economies start to take place, we expect emerging market Purchasing Managers' Indices to signal improved growth, and perhaps the potential for higher spot prices on the back of increased demand. However, these events are not necessarily imminent, and may take some time to unfold.

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It is worth noting that roughly 40% of the earnings of JSE-listed companies are generated abroad, and often in developed markets. Although the macro-economic outlook for emerging markets look grim at the moment, careful stock picking may yield very different results to what the local macro-economic variables may suggest.

Global assets

Global equity returns generally reflect what we have noted in the previous economic commentary, with developed markets outperforming emerging markets. Although the US and UK generated losses over the quarter, these losses were far less severe than in Asia and Europe.

The S&P 500 generated a loss of 6.94% in the previous quarter, and the FTSE 100 a loss of 7.04%. The Hang Seng shed 20.59%, and the Euro Stoxx index 9.45%.

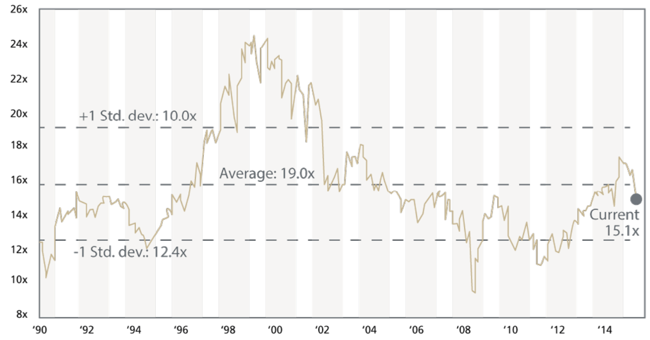
There were some exceptions with regards to the outperformance of developed markets. The German Dax was down 10.13% over the quarter and the Japanese price-weighted Nikkei was down 14.07%.

On a longer-term evaluation, the US generated a strong five-year return number, with the S&P 500 up by an annualised 13.65%. The German Dax also generated strong returns of 12.48% per annum over the last five years, despite extensive controversy regarding monetary support to the rest of the Eurozone.

The final diagram shows various valuation metrics for the S&P 500 in the top right box, while the main chart shows the forward price/earnings ratio over a 25-year history. It is noticeable that although there has been significant price-to-earnings expansion over the preceding seven years, markets still seem fairly valued by most valuations metrics.

Most of the price movement came through from material earnings growth, which increased from the lows of $11 per share in 2008 to the current earnings per share of roughly $25 per share. With positive US labour and manufacturing numbers coming through, we expect earnings per share to edge towards $30 over the next 12 to 18 months, which will provide further price support.

S&P 500 Index: Forward P/E ratio



Valuation measure	Description	Latest	25-year	Std. dev. Over-funder-valued
P/E	Forward P/E	15.1x	15.8x	-0.2
CAPE	Shiller's P/E	24.3	25.5	-0.2
Div. Yield	Dividend Yield	2.5%	2.1%	-0.7
P/B	Price to book	2.4	2.9	-0.7
P/CF	Price to cash flow	10.4	11.4	-0.4
EY Spread	EY minus Baa yield	1.5%	-0.6%	-1.0

Source: JP Morgan

PSG Wealth

Tactical preferences

Domestic assets

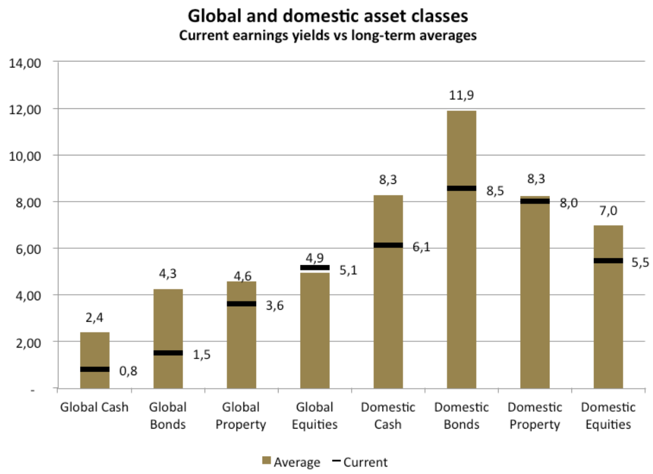
As an asset class, domestic equity remains slightly overvalued relative to its historic yield. There are certainly some expensive pockets in the market, and investors should expect some increased volatility at current levels. Good stockpickers should be able to find value in selected shares. Nimble investors will benefit from more frequent opportunities created by increased volatility.

We are increasingly cognisant of the fact that there are some value traps on the local exchange – some counters are trading at very low price-to-earnings multiples, but earnings are in a cyclical decline. We feel that risks abound for inexperienced investors.

In addition, as the strength of the local economy is waning, we must look at corporate balance sheets and debt structures that will be able to weather the storm.

Interest rate hikes are set to present headwinds for capital growth in the property sector. Broadly speaking, we expect property yields to normalise on the back of capital value pressure.

Selected property shares are experiencing growing yields, which may present some opportunities, but broad-based property exposure is ill-advised at this stage. We favour liquid property companies that have diversified their portfolios offshore.



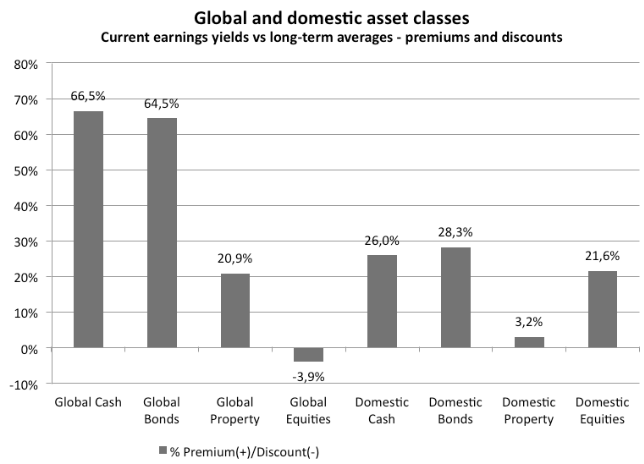
Of all the domestic asset classes, domestic bonds are still the least attractive. The asset class yield is currently at a 28.3% premium relative to its historic average.

Longer duration bonds may be susceptible to capital losses over the short term. Although we have witnessed some new life in the asset class in more recent times, domestic bonds remain overvalued.

Domestic cash may be the asset class with the least risk, but it also offers very little investment potential. The gross real yield on money market assets is negative and on an after-cost, after-tax basis, there is very little to be excited about in this asset class. Although cash plays an important role in a portfolio that requires capital protection and liquidity, growth is severely restricted.

Global assets

Global equity valuations present a mixed picture. Developed economy forward price-earnings (P/E) ratios seem to indicate that developed market equities may be fairly valued to slightly overvalued, while forward P/E ratios for developing economies appear undervalued. That being said, strong economic recoveries in developed economies like the US and UK should support further medium-term earnings growth. Poor economic growth in developing economies is not supportive of any positive outlook on earnings at this stage.



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The one caveat to this assessment is that weaker emerging market currencies have made developing market assets more appealing to foreign investors, which may underpin some demand. Therefore, currency movements are likely to be one of the largest factors influencing the level of success of these markets over the shorter term.

From a valuation perspective, global listed property is currently a better investment than global bonds and global cash. Earnings yields are much closer to their historic averages, although they trade at a premium to their long-term averages.

Investors should, however, be very cautious in this segment of the market. Extreme property price fluctuations in structures with high leverage or limited liquidity can hold severe consequences for investors.

Valuations on global bonds are stretched on the back of unchartered monetary policy stimulus and the subsequent capital flow to credit instruments. In the US, nominal and real 10-year treasury yields have been falling for the past 30 years, leaving both real and nominal yields historically low. Federal Open Market Committee research supports the view that current yields should increase by roughly 3% to normalise.

Global cash remains unattractive apart from its liquidity and nominal capital protection properties. For investors seeking offshore diversification, equities offer the best value over an investment horizon that would be suitable for an offshore investment.

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Initial positioning

Each fund of funds (FoF) in the PSG Wealth Solutions range:

1. has been designed around specific investment needs (required rate of return) and an acceptable level of risk
2. has a set minimum investment horizon to eliminate the risk of a permanent capital loss
3. has potential managers we have identified from the investment universe as suitable building blocks, based on the principles above

The most conservative fund in the PSG Wealth Solutions range is the PSG Wealth Enhanced Interest Fund. It aims to maximise income while also providing maximum stability of capital invested. The fund may only invest in fixed-interest instruments with a maximum outstanding tenor of 36 months (per instrument) and a maximum average weighted duration of 200 days. The fund has a minimum investment horizon of two months.

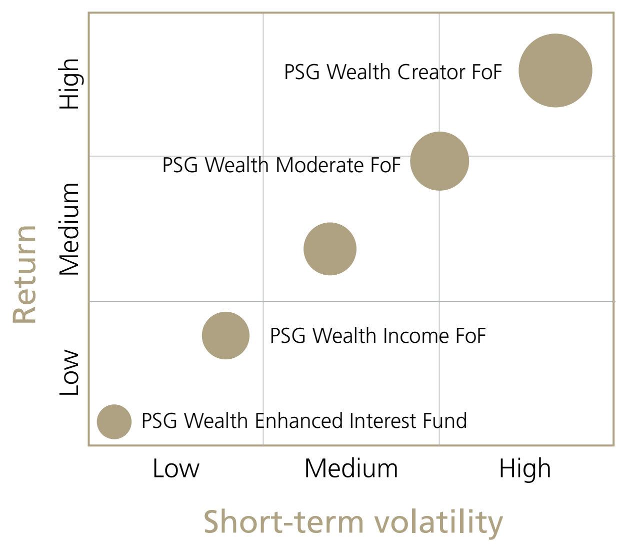
The PSG Wealth Income FoF is a low-risk fund that aims to generate income and some long-term capital appreciation as interest rate cycles allow. The fund may invest in all asset classes, with a maximum exposure of 10% to equities and 25% to property. It has a minimum investment horizon of two years.

The PSG Wealth Preserver FoF is a conservative fund that aims to achieve medium- to longer-term capital growth within an acceptable level of volatility during any market cycle. The fund may invest in all asset classes, with a maximum exposure of 40% to equities. It has a minimum investment horizon of three years.

The PSG Wealth Moderate FoF is a medium-risk fund that aims to achieve medium- to longer-term capital growth within an acceptable level of volatility during any market cycle. The fund may invest in all asset classes, with a maximum exposure of 75% to equities. It has a minimum investment horizon of five years.

The PSG Creator FoF is a high-risk fund that aims to achieve capital growth over the long term. The fund may invest in all asset classes but has to maintain a minimum exposure of 75% to equities. It has a minimum investment horizon of five years.

Initial positioning of the PSG Wealth Solutions according to risk and return characteristics



Detailed positioning

The detailed positioning of each FoF in terms of its exposure to the different asset classes will depend on the combined asset class exposures of all the underlying managers.

PSG Wealth Enhanced Interest Fund

The management of this fund is allocated to five of the most respected short-dated fixed-interest managers in South Africa, namely Atlantic, Nedgroup Investments Core Income, Prescient Yield QuantPlus, PSG Asset Management and STANLIB.

The assets in the fund consist of short-dated instruments of investment grade quality. These instruments are not negatively influenced by rising interest rates, but allow the fund to benefit very quickly from higher interest rates. The fund has a modified duration of 21.6% (or 78.9 days).

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Domestic unit trust positioning

Positioning according to instrument type

PSG Wealth Enhanced Interest Fund	
Instrument type	%
Cash and call	1.4%
Commercial paper	2.0%
Coupon certificates of deposit	1.8%
Fixed deposits	3.9%
Fixed interest bonds	10.6%
Floating rate securities	41.6%
Negotiable certificates of deposit	34.7%
Promissory notes	4.0%
Treasury bills	0.0%
Portfolio total	100.00%

Positioning according to credit ratings

PSG Wealth Enhanced Interest Fund	
Credit rating	%
Cash	0.2%
AAA	6.1%
AA+	2.7%
AA	60.8%
AA-	2.6%
A+	16.9%
A	7.7%
A-	1.6%
BBB+	0.3%
BBB	0.0%
BBB-	0.0%
Other	1.1%
Portfolio total	100.00%

PSG Wealth Income FoF

The management of the fund is allocated to four managers, namely Coronation Strategic Income, Prescient Income Provider, Prudential Enhanced Income Fund and PSG Diversified Income Fund.

The largest exposure of the fund is the 48.37% holding in domestic bonds, which have durations of between one year and seven years. However, these bonds consist mainly of floating rate bonds, where yields adjust every three months to be in line with market rates. This allows the fund to participate in higher yields than money market rates, without a significant increase in price volatility.

The second largest exposure of the fund is a 36.5% holding in cash and money market instruments. Cash has virtually no volatility, its yield increases with rising interest rates and a cash holding increases the manager's ability to participate in new opportunities when they arise.

The rest of the funds exposure consists mainly of a 10.1% holding in global assets, to benefit from offshore diversification; a 2.4% real estate holding, to benefit from the ability to produce inflation-beating returns; and a 2.2% exposure to inflation-linked bonds, to benefit directly from rising inflation.

Look-through positioning

PSG Wealth Income FoF	
Asset allocation	%
Foreign equities	1.42
Foreign property	1.27
Foreign bonds	6.63
Foreign other	0.19
Foreign cash	0.63
Domestic equities	1.25
Domestic property	2.35
Domestic preference shares	1.41
Domestic ILBs	2.22
Domestic bonds 7+ years	9.21
Domestic bonds 3-7 years	14.84
Domestic bonds 1-3 years	22.10
Domestic cash and money market	36.49
Portfolio total	100.00%

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PSG Wealth Preserver FoF

The assets of the fund are divided between five of the most respected conservative asset managers, namely Coronation Balanced Defensive, Investec Cautious Managed, Nedgroup Inv Stable, Prudential Inflation Plus and PSG Stable.

The largest exposure of the fund is its 34.1% holding in equities, which consists of about 16.0% holding in domestic equities and an 18.3% holding in foreign equities. This is lower than the fund's maximum limit of 40%, and reflects both the defensive positioning of the underlying managers and the view that equities have the highest return potential of all asset classes over the medium to long term.

The second largest exposure of the fund is the 27.9% holding in cash and money market instruments. Cash has virtually no volatility, its yield increases with rising interest rates and a cash holding increases the manager's ability to participate in new opportunities when they arise.

The third largest exposure is the 29.68% holding in bonds. These bonds are primarily short-dated and consist mainly of floating rate bonds that participate in higher yields than money market rates, without a significant increase in volatility.

The rest of the fund's exposure consists of a 4.6% holding in global non-equity assets (which brings total offshore exposure to 22.9%); an 8.6% holding in short-term bonds, to participate in higher yields; a 6.9% holding in inflation-linked bonds, to benefit from rising inflation and a 3.2% holding in domestic real estate, to benefit from the ability to produce inflation-beating returns.

Look-through positioning

PSG Wealth Preserver FoF	
Asset allocation	%
Foreign equities	18.26
Foreign property	0.51
Foreign bonds	1.48
Foreign other	0.00
Foreign cash	2.62
Domestic equities	15.85
Domestic property	3.23
Domestic preference shares	0.45
Domestic ILBs	6.89
Domestic bonds 7+ years	9.56
Domestic bonds 3-7 years	4.58
Domestic bonds 1-3 years	8.65
Domestic cash & money market	27.93
Portfolio total	100.00%

The PSG Wealth Preserver FoF is a well-diversified fund positioned to lower volatility and benefit from higher inflation and interest rates.

PSG Wealth Moderate FoF

The fund's assets are divided between six moderate fund managers, namely Coronation Balanced Plus Fund, Foord Balanced Fund, Investec Opportunity Fund, Prudential Balanced Fund, PSG Balanced Fund and SIM Balanced Fund.

The largest exposure of the fund is its 61.5% holding in equities, which consists of a 38.7% holding in domestic equities and a 22.8% holding in foreign equities. This is lower than the fund's maximum limit of 75% and reflects the defensive positioning of the underlying managers.

The 38.7% holding in domestic equities is divided mainly between resources (6.8%), financials (8.4%) and industrials (22.1%).

The second largest exposure of the fund is an 18.0% holding in cash and money market instruments. Cash has

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virtually no volatility, its yield increases with rising interest rates and a cash holding increases the manager's ability to participate in new opportunities when they arise.

The rest of the fund's exposure consists mainly of a 13.4% holding in bonds, a 3.8% holding in property and a 3.3% holding in global non-equity assets (which brings total offshore exposure to 26.1%).

Look-through positioning

PSG Wealth Moderate FoF	
Asset allocation	%
Foreign equities	22.8
Foreign property	0.8
Foreign bonds	0.3
Foreign other	0.3
Foreign cash	1.8
Domestic equities	38.7
Domestic property	3.8
Domestic preference shares	0.1
Domestic ILBs	1.1
Domestic bonds 7+ years	7.4
Domestic bonds 3-7 years	2.4
Domestic bonds 1-3 years	2.5
Domestic cash & money market	18.0
Portfolio total	100.00%

The 10 shares the fund has the largest exposure to are all blue chip companies with very broad investor bases that consist of both local and international investors.

Top 10 holdings

PSG Wealth Moderate FoF	
Top 10 holdings	%
Steinhoff	3.77%
British American Tobacco plc	3.37%
Sasol	3.20%
CF Richemont SA	2.77%
Standard Bank	2.75%
MTN Group Ltd	2.42%
Naspers Ltd	2.39%
Anglo American PLC	2.29%
Aspen	2.13%
BHP Billiton	1.80%
Total	26.89%

PSG Wealth Creator FoF

The assets of the PSG Wealth Creator FoF are divided between five highly respected general equity managers, namely Coronation Equity Fund, Investec Equity Fund, Old Mutual Investors' Fund, Prudential Equity Fund and PSG Equity Fund.

The largest exposure of the fund is its 94.2% holding in equities, which consists of an 86.0% holding in domestic equities and an 8.2% holding in foreign equities. This is well above the fund's minimum equity limit of 75%.

The 86.0% holding in domestic equities is divided between resources (14.0%), financials (23.7%) and industrials (47.9%).

The rest of the fund's exposure consists of a 3.5% holding in cash and money market instruments, a 2.0% holding in property and a 0.1% holding in global non-equity assets (which brings total offshore exposure to 8.3%).

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PSG Wealth Creator FoF	
Asset allocation	%
Foreign equities	8.22
Foreign property	0.00
Foreign bonds	0.00
Foreign other	0.10
Foreign cash	0.02
Domestic equities	85.98
Domestic property	2.02
Domestic preference shares	0.20
Domestic ILBs	0.00
Domestic bonds 7+ years	0.00
Domestic bonds 3-7 years	0.00
Domestic bonds 1-3 years	0.00
Domestic bash & money market	3.45
Portfolio total	100.00%

The 10 shares with the largest exposures in the fund are all blue chip companies with very broad investor bases that consist of both local and international investors.

Top 10 holdings

PSG Wealth Creator FoF	
Top 10 holdings	%
Naspers Ltd	7.70%
Steinhoff	4.69%
Old Mutual	3.72%
Sasol	3.46%
MTN Group Ltd	3.14%
FirstRand Bank Ltd	3.11%
Anglo American PLC	2.84%
Standard Bank	2.63%
British American Tobacco plc	2.20%
Nedbank Group Ltd	1.76%
Total	35.24%

Conclusion

Developed countries lowered interest rates to their lowest levels in recent history to save the world economy from a severe recession. This flooded the financial system with cash, which found parking spaces it was not intended for.

The result of this is that investors are confronted daily with extreme volatility in almost all asset classes and currencies.

The non-equity exposure in all our FoFs consists primarily of cash, money market instruments and short-dated bonds. These assets earn interest directly from current low yields. Although some higher yields are available from longer-dated bonds, these bonds are currently at very high valuations and we expect that a rise in interest rates will see a sell-off in bonds.

The equity exposure in our multi-asset portfolios (PSG Wealth Preserver FoF and PSG Wealth Moderate FoF) are well-diversified in terms of domestic equity sectors and offshore equities, which have benefited from the weaker rand. The offshore exposures of each of these two funds are very close to the maximum exposures allowed.

The PSG Wealth Creator FoF does not have the same level of offshore exposure. This is simply due to the limited number of funds with large offshore exposures in the investment universe of the fund. However, South African blue chip companies have a large rand-hedge component as they derive a large portion of their income from foreign countries.

Investors in the PSG Wealth Solutions may be assured that their investments are in the hands of the best asset managers available to us. Through their research and insight all our funds are well diversified and conservatively positioned to withstand the current uncertainties and coinciding volatility currently experienced in financial markets.

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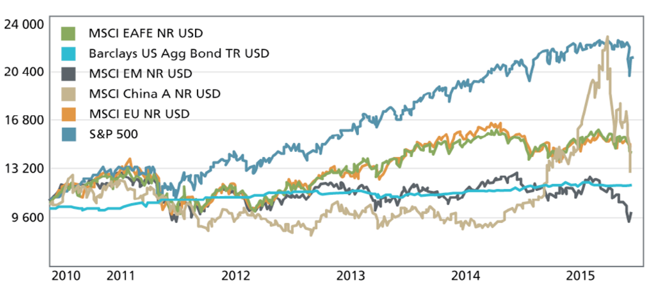
Macro trends in global fund management

2015 has seen a number of key themes playing out in the global financial markets. Current macro themes include developed vs emerging market allocation as well as regional allocation within developed markets, specifically between Europe and the US. Making the right call on these macro-economic factors has played a big part in the relative performance of global funds. Sector specific themes also had an impact on fund performance, but an attribution analysis of the relative performance of funds within our global multi-asset and equity universes, highlighted that security selection have generally contributed most of the alpha (excess returns above benchmark) during Q3 2015.

Regional market performance

The chart below highlights the difference in regional equity performance over the last five years. US markets had an exceptional run, even after the recent market correction, significantly outperforming European and other developed markets. Emerging markets significantly underperformed and has delivered negative growth over the last five years.

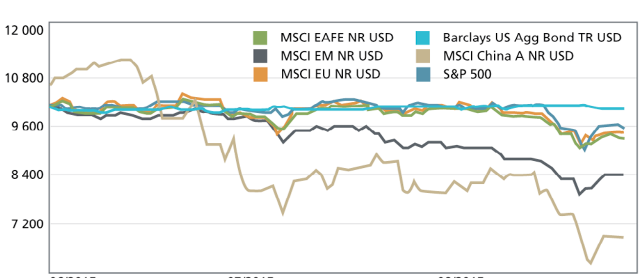
Five-Year Appreciation in Value of $10,000



Source: Morningstar

As illustrated by the chart below the last three months have seen a significant decrease in value of emerging markets, specifically Chinese markets. Developed market stocks were down slightly while US Bonds were flat.

Three-Month Drop in Value of $10,000



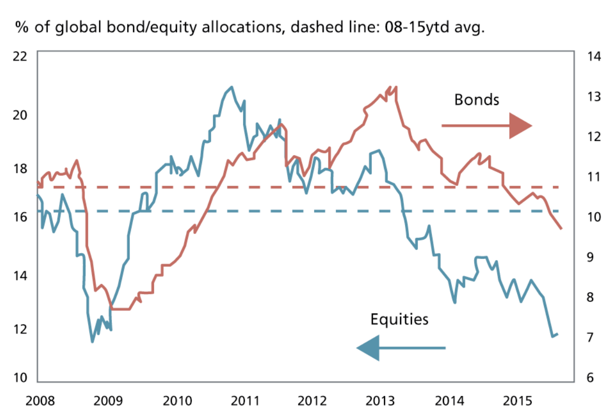
Source: Morningstar

Emerging market (EM) positioning

For at least the last two decades, a key global theme has been the allocation of assets to emerging markets, either through investing in large multi-nationals that generate relatively large parts of their revenue from emerging markets or by investing directly into emerging market instruments. However, recent market volatility, triggered mostly by concerns over a slowing Chinese economy, has seen this trend reverse quite rapidly.

According to the Institute of International Finance (IIF), global funds and ETFs have reduced emerging market "active" exposure to levels last seen in the 2013 "taper tantrum". Fund investors in Europe and the US sold out aggressively, withdrawing more than $50 billion from Emerging Markets in Q3 2015.

Emerging Markets: Fund Allocations



Source: The Institute of International Finance, includes Mutual Funds and ETFs.

The above chart illustrates the change in emerging and developed market allocations since 2008. Over the last quarter Global multi-asset and equity funds have

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aggressively reduced exposure to emerging markets assets, reducing overall emerging market bond and equity allocations to the lowest level since early 2009. Emerging market stocks suffered the most from a significant decline in global investor's appetite, with the average allocation decreasing from 21% in 2010 to just below 12% in 2015.

Developed market positioning

Given the relative performance of US markets over the last five years, combined with the status of the economic recovery within each region, the consensus view among global equity managers are that US stocks are fairly valued and that European stocks are currently offering better opportunities on a valuation basis. Consequently we have seen a steady increase in active allocations to European equities.

Trends in Asset Allocation

A recent fund manager survey by Bank of America Merrill Lynch highlighted that cash balances of global managers have increased to 5.1% on average in September 2015, a level last seen in the 2008 crisis. A total of 178 global managers with over $480 billion in assets under management participated in the survey, and in addition to the increasing cash allocation, the survey also highlighted that:

- the threat of recession in China is considered the biggest tail risk to fund performance
- the concern over a potential emerging market debt crisis have increased
- risk appetite has steadily decreased with the number of active equity overweight's decreasing by 24 percent
- expectations of U.S. Fed rate rise has been postponed to Q4

A survey of US Fund managers has steadily reduced the recommended equity weighting in a model global portfolio, while increasing debt exposure as the Fed has put off raising rates. Discussions with managers within our global multi-asset universe highlighted that Bonds are still not a favoured asset class, many managers without a specific mandate requirement to hold fixed interest instruments, has opted for cash rather than bonds given the high valuations currently found in the offshore bond market.

Our positioning

PSG Wealth currently offers two offshore unit trusts, the PSG Wealth Global Moderate FoF and the PSG Wealth Global Creator FoF. The PSG Wealth Global Moderate FoF is a multi-asset flexible fund with the objective of maximizing capital and income returns, through active management of an internationally diversified portfolio of global allocation funds. The maximum net equity exposure is 75% with an average net equity allocation since inception of 65%.

The PSG Wealth Global Creator FoF is a global general equity fund with the objective of maximising capital returns through active management of an internationally diversified portfolio of global equity funds. The emphasis of the underlying managers' investment approach will be on equities, with a preference for unconstrained mandates.

Detailed positioning

Our investment philosophy and process focusses on fund selection, while leaving the asset allocation and security selection to our underlying managers. Thus the positioning of each Global FoF will depend on the asset class exposure of all the underlying managers.

PSG Wealth Global Moderate FoF

The assets are divided equally between six global multi-asset funds, namely BlackRock Global Allocation, Coronation Global Managed, Foord International Trust, Templeton Global Balanced, Investec Global Strategic Managed and PSG Global Flexible.

The fund currently has 64.25% in offshore equities, this is below the fund maximum of 75% and indicates the current defensive nature of the fund, which ties in with the global trends discussed earlier. The second largest positon in the fund is global cash at 22.5%, our underlying managers have indicated that the relative high cash position provides them with the benefit of participating in raising interest rates and also allows them the flexibility to quickly react to buying opportunities in the market. In volatile markets, as the current experience shows, cash also provides the overall portfolio with some protection against drawdowns.

The balance of the allocation consists of a 10.10% allocation to global bonds – this position is significantly lower than the sector average of 24.85%. This deviation

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is due in part to the negative view on bonds currently held by a number of our underlying managers and part due to the difference between the flexible strategy followed by PSG Wealth and the more traditional (60% Equity / 40% Fixed interest) strategy followed by many US large global multi asset portfolios. Offshore property accounts for 1.6% of the portfolio.

Relative to the category average (USD Moderate Allocation), the fund is overweight by 3.87% in Financial Services and 5.94% to Consumer Cyclicals. The fund is underweight Healthcare by 2.52% and Utilities by 2.29%.

Look-through positioning of the PSG Wealth Global Moderate FoF

PSG Wealth Global Moderate FoF	
Asset Allocation	%
Foreign Equities	64.25
Basic Materials	3.76
Communication Services	2.27
Consumer Cyclical	9.19
Consumer Defensive	6.75
Healthcare	8.02
Industrials	4.81
Technology	7.37
Energy	3.61
Financial Services	17.71
Utilities	0.77
Foreign Property	1.56
Foreign Bonds	10.10
Foreign Other	1.20
Foreign Cash	22.50
Domestic Assets	0.38
Portfolio total	100.00%

Top 10 holdings of the PSG Wealth Global Moderate FoF

The 10 shares with the largest exposure in the fund are a mix of mega-cap multinationals and some emerging market equities held within some of the more concentrated underlying funds.

PSG Wealth Creator FoF	
Top 10 holdings	%
Markel Corp	1.16%
JP Morgan Chase and Co	1.02%
Microsoft	0.91%
Berkshire Hathaway	0.90%
Sainsbury	0.86%
Capital One	0.84%
Brookfield Asset Management	0.81%
Google	0.66%
Tata Motors	0.56%
Daimler	0.55%
Total	8.28%

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Regional allocation of the PSG Wealth Global Moderate FoF

With regards to region and sector allocations, relative to the category average the fund is currently slightly overweight developed markets and underweight emerging markets. Regional active weights includes an overweight in US equities by 11.86% and an underweight in Greater Europe of 11.61%.

PSG Wealth Global Moderate FoF		
Americas	59.38%	47.52%
North America	57.17%	46.75%
Latin America	2.21%	0.77%
Greater Europe	26.31%	37.92%
United Kingdom	9.60%	12.25%
Europe Developed	14.90%	20.09%
Europe Emerging	0.58%	4.75%
Africa/Middle East	1.23%	0.84%
Greater Asia	14.31%	14.56%
Japan	6.07%	5.04%
Australasia	0.53%	2.02%
Asia Developed	3.36%	3.95%
Asia Emerging	4.35%	3.55%
Market Classification	100.00%	100.00%
% Developed Markets	92.23%	90.63%
% Emerging Markets	7.77%	9.37%

PSG Wealth Global Creator FoF

The assets are divided equally between six global equity funds, namely Goldman Sachs Global Equity, Investec Global Franchise, Nedgroup Global Equity, Sanlam World Equity Tracker, Schroders International QEP and Threadneedle Global Select.

The fund currently has 93.82% in offshore equities, 0.26% in offshore property and 5.85% in offshore cash. The cash allocation is in line with global trends discussed earlier. Relative to the category average (USD Global Large-Cap Blend Equity) the fund is currently overweight Healthcare by 2.66%, overweight Consumer Defensive by 4.31% and underweight financial services by 2.95%.

Look-through positioning of the PSG Wealth Global Creator FoF

PSG Wealth Creator FoF	
Asset Allocation	%
Foreign Equities	93.82
Basic Materials	3.27
Communication Services	2.83
Consumer Cyclical	11.00
Consumer Defensive	14.22
Healthcare	16.27
Industrials	11.43
Technology	15.18
Energy	4.05
Financial Services	14.69
Utilities	0.89
Foreign Property	0.26
Foreign Bonds	-
Foreign Other	0.07
Foreign Cash	5.85
Domestic Assets	-
Portfolio total	100.00%

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Top 10 holdings of the PSG Wealth Global Creator FoF

The 10 shares with the largest exposure in the fund are predominately large multinational companies with a global footprint.

PSG Wealth Creator FoF	
Top 10 holdings	%
Microsoft	1.94%
Roche	1.44%
Nestle	1.25%
Apple	1.21%
Anheuser-Busch InBev	1.20%
Wolseley	1.12%
Google	1.01%
Johnson & Johnson	1.01%
Reckitt Benckiser Group	0.97%
Imperial Tobacco Group	0.95%
Total	12.10%

Regional allocation of the PSG Wealth Global Creator FoF

Relative to the category average the fund has not taken any active bets on developed vs emerging markets. With regards to regional allocation the fund is overweight US by 4.56% and underweight Greater Europe by 3.63%.

PSG Wealth Global Moderate FoF		
Americas	55.69%	51.13%
North America	54.84%	50.51%
Latin America	0.85%	0.62%
Greater Europe	31.36%	34.99%
United Kingdom	10.45%	14.06%
Europe Developed	20.27%	20.13%
Europe Emerging	0.16%	0.27%
Africa/Middle East	0.48%	0.52%
Greater Asia	12.96%	13.88%
Japan	7.11%	7.53%
Australasia	1.92%	1.38%
Asia Developed	2.33%	2.94%
Asia Emerging	1.60%	2.03%
Market Classification	100.00%	100.00%
% Developed Markets	97.06%	96.87%
% Emerging Markets	2.94%	3.13%

Conclusion

Recent market volatility has resulted in significant drawdowns in emerging markets, both in performance and fund flows. Global funds have reacted strongly to risks highlighted in emerging markets and it is clear that careful portfolio construction, that pays attention to regional and sector specific risks, remains one of the most important aspects to iron out in order to provide your clients with their required outcomes.

During periods of high volatility, the best managers are able to weather the storms while also identifying the opportunities which naturally present themselves. By focussing on managers with a clearly defined and disciplined investment process, tested through various market conditions, our funds are well positioned to provide the necessary protection while still delivering a strong performance through various market conditions.

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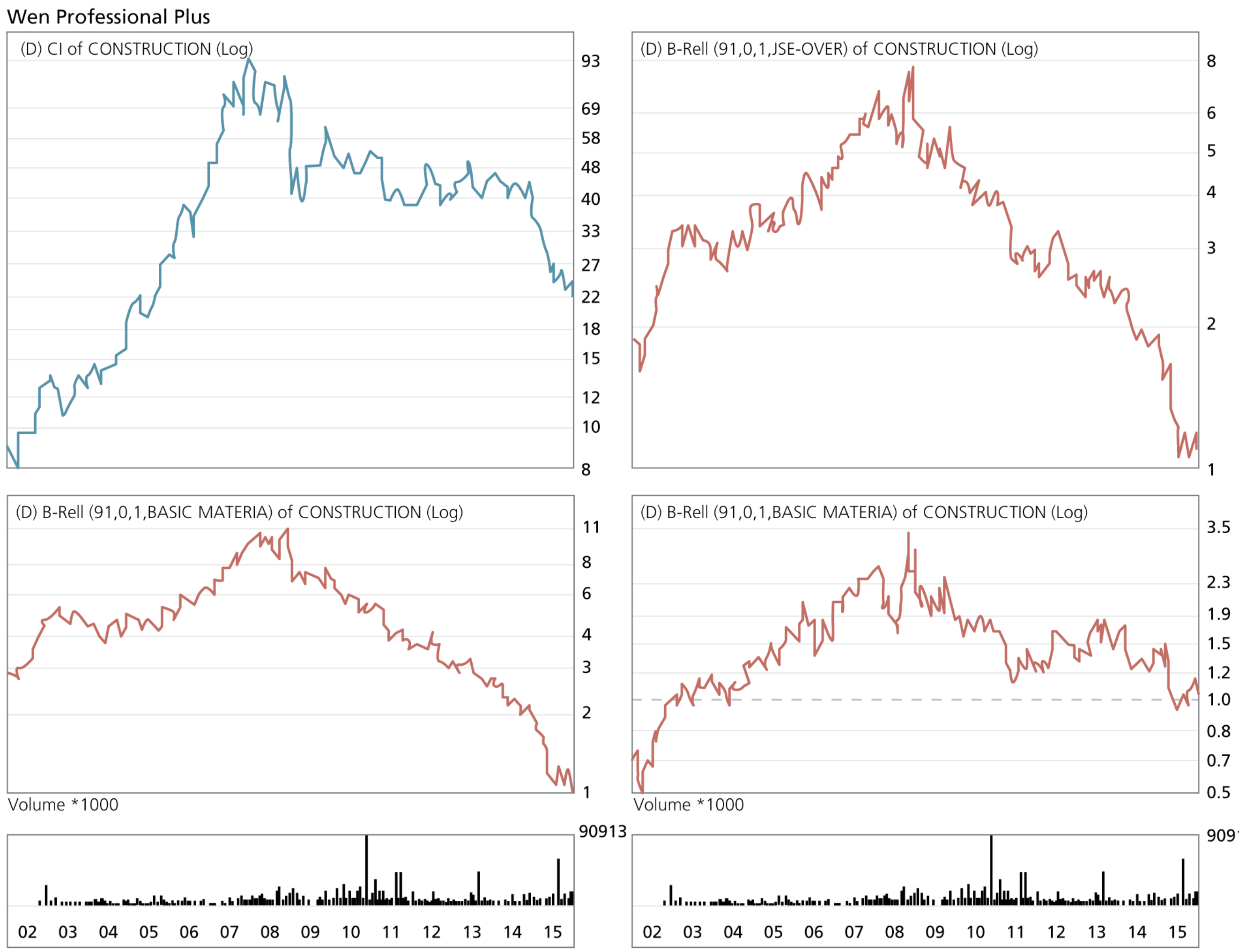
Equity research

The construction sector: value play or value trap?

As value investors, we believe that financial markets are efficient in the long run, but can be inefficient in the short and medium term. The investment process that we employ focuses on identifying mispriced securities to create diversified portfolios that will outperform the market over time. Shares that qualify as value investments are normally out of favour with the investment community and a certain amount of contrarian investing is called for. This is partially confirmed by Warren Buffett who said, "We attempt to be fearful when others are greedy and to be greedy only when others are fearful." Our contrarian DNA has drawn us to one of the weakest sectors of the JSE over the last seven years: the construction sector.



The graphs above reflect the performance of the construction sector as a whole, relative to the All Share Index, Financial and Industrial Index and Basic Materials Index. As indicated, the majority of construction investments have been very poor performers over the last seven years, with the Construction and Materials Index declining by 51%. This underperformance is particularly pronounced given the strong performance of the JSE, and especially the Financial and Industrial Index – over the period. The construction sector even underperformed a very weak basic material sector, which is comprised of poorly performing commodity stocks.

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A substantial portion of the construction sectors' underperformance can be attributed to market factors not under the control of a company's management, such as a weak commodity demand and a decline in government infrastructure spending. However, poor capital allocation and the poor execution of projects, which should be management's core competency, contributed significantly to underperformance. Accordingly, a significant number of investors have abandoned the sector in its entirety after a number of years of underperformance. This has driven prices and valuations to 15-year lows.

Two of our preferred valuation techniques are return on equity (ROE) and Price/NAV levels, as they highlight companies that are effectively utilising their capital. Price/NAV levels have a direct correlation with ROE, as a sustainably high return on equity will lead to high growth in earnings. Companies that have a high ROE will be valued at a high Price/NAV multiples, while companies that produce a sub-par ROE should, deservedly, trade at a discount. Those companies that have the potential to produce above-average ROE, but have far too much capital will dilute their returns, which should result in valuations that are lower than their potential. Any businessperson will tell you that the return or potential return on any project is the major consideration in every business decision. Yet this is very often overlooked when valuing a company, as analysts are normally consumed by earnings and earnings forecasts.

From the table below we can see that the market values most construction stocks on P/E ratios of between 8 and 11 times, and that this remains in line with this sector's long-term trend. This is despite the significant differences in consensus growth rates expected from these stocks, as illustrated by their three-year growth rates.

The fact that so many investors focus on this trend and the outlook of earnings, create opportunities to those interested in value. The ROE and Price/NAV valuation technique has proven successful in relatively stable companies, but we believe it holds value when looking at more cyclical industrial counters as well.

This method is successful because it normalises EPS and therefore the P/E ratio. This means that investors will not get caught up in crowd mania – especially when a company has had a particularly good or bad year. According to the table below, all companies with a PEG ratio below 75 (coloured in green) indicate value.

The valuation produced is less volatile and makes more sense, as it uses the more stable NAV as a base.

Construction and materials

Share code	Share name	Share price	Historical PE	Prev.EPS Date	Actual EPS	*Forecast Year 1	% Growth	*Forecast Year 2	% Growth	*Forecast Year 3	% Growth	3 Year Growth %	PEG
GRF	Group Five Ltd	2000	9.8	2015/06/30	204	346	69.6	404	16.8	331	-18.1	17.5	56
MUR	Murray & Roberts Hidgs	1181	5.9	2015/06/30	201	169	-16	180	7	204	13	0.5	1175
PPC	PPC Ltd	1765	10.5	2015/06/30	168	143	-14.7	162	13.1	170	4.9	0.4	2626
RBX	Raubex Group Ltd	1730	8.4	2015/06/28	206	240	16.7	266	10.6	286	7.5	11.6	72
WBO	Wilson Bayly Hlm-Ovc Ltd	12183	11	2015/06/30	1105	1307	18.3	1465	12.1	1597	9	13.1	84

Source: Inet BFA, PSG Wealth calculations

Construction and materials

Share code	Share name	Price	P/E	HEPS Growth (%) Forecast	PEG (P/E) (%)	ROE (%) Forecast	P/NAV	PEG (NAV) (%)	P/TNAV	P/Cash flow	P/Sales	Div yield (%)	Interest cover	Mngmnt Comment
AEG	Aveng Group Limited	462	EPS Neg	-12	N/A	8	0.1	N/A	0.2	-0.8	0	0	2	Negative
GRF	Group Five Ltd	2000	8.3	15	56	14	0.7	58	0.7	0.7	5.3	0.1	2.8	Postive
MUR	Murray & Roberts Hldgs	1176	6.1	8	76	13	0.8	79	1	-152.4	0.2	4.2	15.2	Negative
RBX	Raubex Group Ltd	1732	7.5	11	69	15	0.9	67	1.2	13.2	0.5	4.1	38.9	38.9
WBO	Wilson Bayly Hlm-Ovc Ltd	12208	10.5	15	70	21	1.7	68	2.2	3.3	0.2	3	No debt	Positive

Source: PSG Wealth estimates

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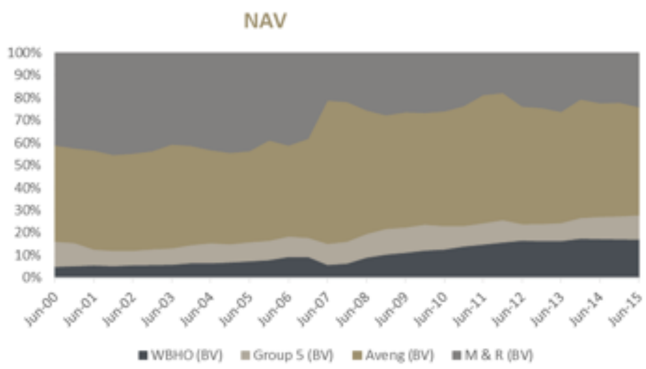

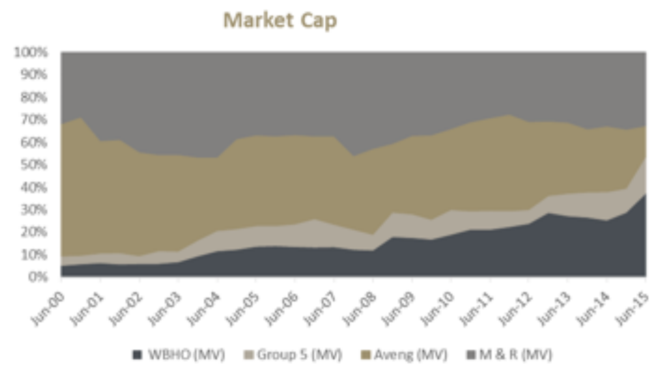

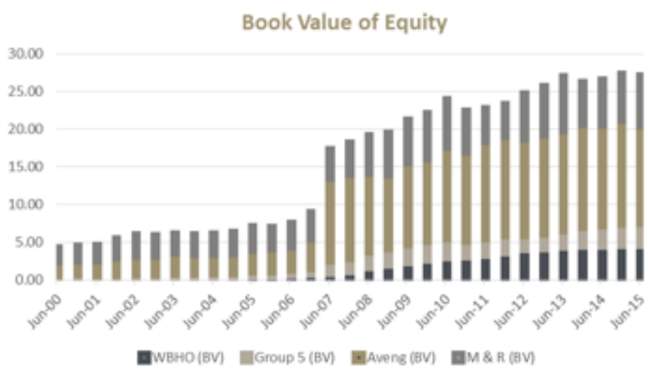

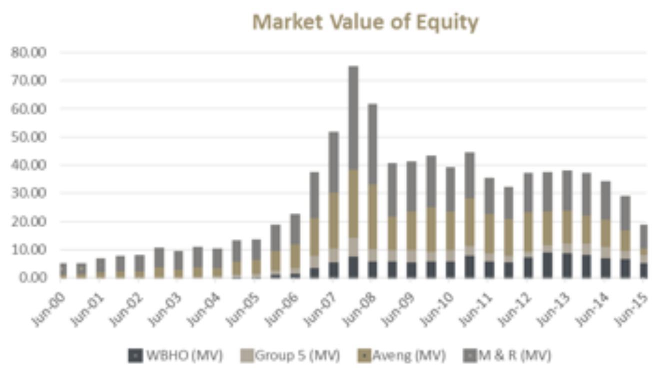

Source: PSG Wealth Calculations

An investigation into four of the most prominent heavy construction counters (equities) reflects that despite the NAV of the combined group largely trending upwards over the long term, the value that the market is prepared to pay for this growth has declined significantly since 2007. This is mostly related to the decline in margins that these companies have experienced over the time period. We can also infer that when the sector was at its frothiest (in 2007), investors were willing to pay R73 billion for R18 billion in combined net assets (a multiple of 4). Today, they are only willing to pay R17 billion for R27 billion in net assets. This translates into 65 cents for every 100 cents in assets. The current combined price paid per rand of net assets is the lowest it has been over our entire review period. As shown in the top part of the graph, WHBO has managed to grow its net assets at a faster pace (indicative of its higher ROE) than its three competitors over this period. In turn, the market has rewarded it with a higher market valuation (market cap). Despite the attractive valuations of these counters on a Price/NAV metric, market pessimism towards them is not unwarranted. While order books have remained firm margins, earnings have shown a downward trend for a number of years and are currently at, or close to, all-time lows. The industry's prospects remain largely reliant on government and mining infrastructure spending. Despite the South African government's large infrastructure plans, we expect the rate of delivery to be low. Mining infrastructure spending is unlikely to come to the rescue, as commodity prices are unlikely to improve. Commodity prices will largely be dictated by Chinese growth, which is expected to moderate, resulting in a weaker demand environment. This will be exaggerated by an increase in supply from recently commissioned mines around the world.

The overcapacity in the construction industry following the completion of the South African FIFA World Cup resulted in weak pricing power, which is illustrated in the table on the following page by the subsequent decline in operating margins. This should improve going forward, given the significant restructuring completed across the whole industry, and especially civil engineering divisions. In this restrained environment, construction companies

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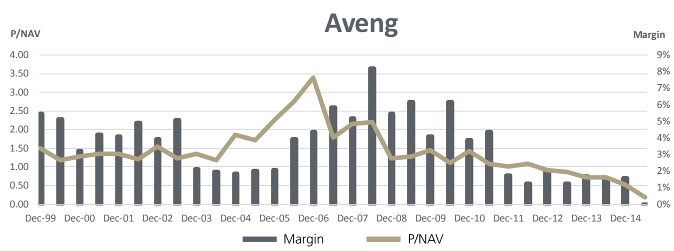
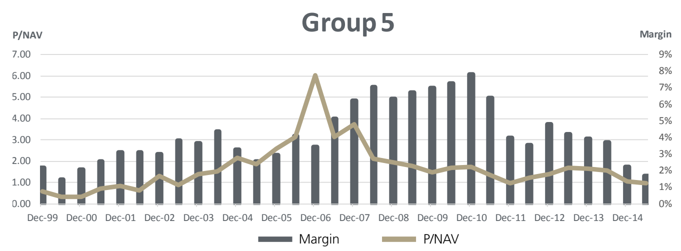
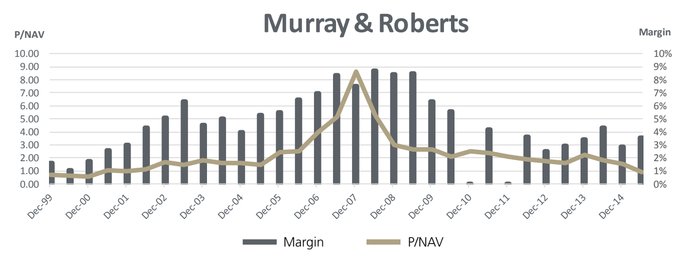
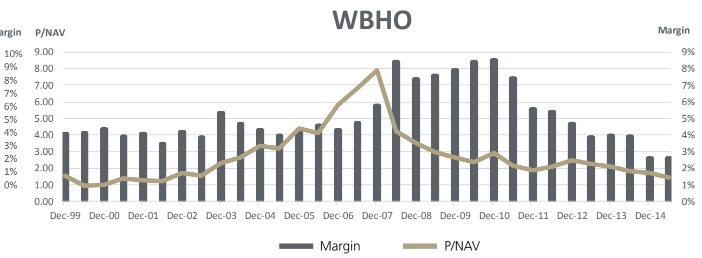
PSG Wealth

Equity research









Source: PSG Wealth calculations

have focused their attention on lower margin building contracts and cross border contracts, with a specific preference for Australia. So, while the short-term outlook is expected to remain depressed, marginally higher order books and an improvement in operating margins off of a very low base should support earnings growth. This could be achieved despite margins remaining below their long-term averages. The table above also demonstrates (based on Price/NAV levels) that share prices normally improve about 18 months prior to the improvement in earnings.

This value investing approach, however, comes with one caveat: it requires a good amount of patience. It is often easier to tell what will happen to the price of a stock than how much time will elapse before it happens. The South African government can't delay infrastructure projects indefinitely – infrastructure spend is core to the National Development Plan, to which it has committed.

In addition, commodity prices will pick up eventually as supply and demand returns to equilibrium. Historically low construction margins will recover as less efficient players are forced to quit the industry and pricing power improves for the survivors. Downside in share prices should be limited, as indicated by the significant discount at which these shares are trading relative to their net assets, while upside potential could be significant. It is, however, essential to select shares with a high probability of remaining solvent for longer than the market can remain irrational as it is likely that the value evident in the construction sector might only be realised over the medium to longer term. Value investments tend not to be recognised as such, and patience is needed until the rest of the market comes to recognise the value.

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Fixed Income

South African Reserve Bank Governor Lesetja Kganyago has telegraphed the Monetary Policy Committee's (MPC's) clear intention to move ahead of the curve and implement small incremental increases in official short-term interest rates ahead of imminent policy normalisation by the US Federal Reserve (Fed). We expect this trend to continue in the months ahead, with a 25bp increase likely at the November MPC meeting to bring prime to 9.75% by the end of 2015.

If the currency rout in emerging markets continues, the probability of rates being hiked by 50bps in November cannot be ruled out, but this is not our core view. We expect a further 150bp increase over the ensuing 18 months, taking prime to 11.25% by Q1 2017. The likelihood of 50bp increments will increase as the base rate moves higher over the next year. The clear and present danger to emerging markets is probably greater now than at any time in the past seven years. With the commodity cycle and growth in China under pressure, the rand continues to be vulnerable, as do our equity and bond markets.

The rand has already breached the R13 level to US dollar, and R15 to the euro. Pass-through effects have been muted thus far and renewed oil price weakness has seen reported inflation contained at around 5%. The delay in Eskom's additional tariff increase has also provided some respite.

The MPC has communicated its intention of gradual policy normalisation and is moving to a position ahead of the curve in the hope that this will suppress further currency depreciation and the consequent impact on inflation. Given the MPC's recent hawkish rhetoric and persistent currency weakness, we could see short-term rates rising faster than the market is anticipating.

Top 10 holdings	PSG recommended weight %	ALBI weight* %	Avg fund weight** %
Cash	70	0	55
1-3	0	7	3
3-7	5	19	9
7-12	25	24	15
12+	0	50	18
Subtotal (bonds)	30	100	45
Total (cash & bonds)	100	100	100
Modified duration (incl cash)	2.0	7.1	3.3
Modified duration (excl cash)	6.0	7.1	6.8
Convexity	12.8	86.5	25.8

*All Bond Index (06.08.2015) **AFLU (30.06.2015)
Source: JSE, PSG, Alexander Forbes

A bear flattener over the next twelve months is the likely outcome. We would therefore avoid the short-dated area of the curve in favour of cash. A barbell of longer-dated bonds and cash would be the preferred risk/reward trade-off given the authorities' willingness to act on inflation. However, upside risks across the entire curve are prevalent.

We have looked at the extent to which movements in yields are correlated with movements in the rand. Although a generally positive relationship has prevailed over the period between 2002 and 2015, intervening periods have shown little or no correlation.

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In fact, the period from January 2000 to date reveals a correlation of zero. However, whenever there are sharp moves in the currency the correlation improves, as was the case in 2008 when the R-squared increased to 86% as the rand depreciated in the initial stages of the crisis. Since long bond yields bottomed at the end of January 2015, the R-squared has been 61% over the period to date.

Although the dollar oil price is once again testing new multi-year lows, the rand has depreciated across a broad spectrum of currencies and the prospect of Fed interest rate normalisation is a lot closer than it was a year ago.

Yields are discounting some bad news, and with high institutional levels of cash the upside should continue to be capped at levels lower than would be the norm. However, the gap between cash and fixed interest has shrunk.

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Property commentary

The SA Listed Property Index (SAPY) recorded a 6.24% total return for the quarter ended September 2015. The All Bond Index (ALBI) appreciated by 1.11% over the quarter, and the FTSE/JSE All Share Index declined by 2.13% over the same period.

Asset class	MTD	QRT	YTD	12 months
Cash (SteFI)	0.52%	1.60%	4.76%	6.38%
Bonds (ALBI)	-0.07%	1.11%	2.67%	7.04%
SA Listed Property (SAPY)	0.83%	6.24%	13.26%	25.82%
Equities (ALSI)	0.95%	-2.13%	3.39%	4.79%

Source: Catalyst Fund Managers, RMB Credit Research

The results season came to a close during the month of September, with the last couple of companies in the South African sector reporting their results. Attacq reported their full-year results for the period ended 30 June 2015, which showed that net asset value per share growth for the period was 15.5%. Attacq also advised shareholders that Coronation Fund Manager's stake in the company increased to 20.05% and that Royal Bafokeng Holdings reduced its stake to 9.96%. Fairvest's reported results indicated distribution per unit growth of 10.1% for the full-year period ended 30 June 2015.

A number of companies raised capital in September, namely Rockcastle (R1 billion), Dipula (R200 million) and Pivotal (R600 million). In addition to raising capital, Rockcastle also announced the acquisition of Platan Shopping Centre in Poland for €52 million. Fortress and Capital issued their respective circulars on the proposed takeover of Capital by Fortress Income Fund.

Stenprop, which has properties in Germany, the UK and Switzerland, announced that they will be moving to the main board of the JSE and will have a dual primary listing on the JSE and Bermuda Stock Exchange.

Growthpoint advised shareholders that 40.5% of its dividend reinvestment alternative was taken up by shareholders, which results in an additional 19 309 956 new ordinary shares.

New Europe Property Investments (NEPI) advised that shareholders on the South African share register will receive their cash dividend in South African rand, converted from euros at an exchange rate of EUR1.00:ZAR15.1835. The cash dividend of 18.17 euro cents per share will be equal to 275.88 ZAR cents per share.

Vukile advised shareholders that Prudential Investment Managers increased their stake in Vukile to 5.08% of Vukile's issued shares.

Real estate fundamentals in South Africa remain challenging, and local listed property players continue to diversify their portfolios offshore in an effort to access stronger real estate fundamentals.

Global listed property

The FTSE EPRAN/NAREIT Developed Rental Index recorded a net total USD return of exactly 2% in September. The best performing listed real estate market (in base currency) was North America, which recorded a return of 2.92% for September.

Concerns about China continue to weigh heavily on capital markets, as the Chinese economic slowdown impacted Asian and Australian property sectors. Catalyst reports that Hong Kong companies such as Hysan and Wharf have seen tenant sales declining at their flagship shopping malls. In addition, investors in Australia seem concerned that their economy could be heading towards a recession.

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Region	Sept 2015 return % (USD)	Sept 2015 return % (rand)	YTD return % (USD)	YTD return % (rand)
Global Investors Index	2.00%	6.60%	-3.81%	15.43%
North America	2.92%	7.56%	-4.59%	14.48%
Europe	0.02%	4.53%	6.60%	27.92%
Asia ex Australia	2.32%	6.93%	-8.66%	9.60%
Australia	-0.41%	4.08%	-4.91%	14.10%
SA Listed Property Index	-3.72%	0.83%	-9.38%	13.26%

Source: Catalyst Fund Managers, FTSE/EPRA NARBT, Bloomberg, I Net Bridge

Positioning

In our view, the interest rate cycle will impact domestic economic strength, affordability and sentiment. In addition, other income-generating assets with positive correlations to interest rates will become increasingly attractive, placing further downward pressure on listed property.

Where we are required by mandate to hold listed property, we prefer to hold counters with the following characteristics:

- low price-to-book values
- low levels of debt/gearing and strong credit ratings
- globally diversified portfolios, or counters that generate earnings abroad (like New European Property Fund, Rockcastle, New Frontier, Capco, IntuProp, Mas, Sirius, Redefine International and Investec Australia)
- utilisation of structures that offer superior liquidity, like REITS
- superior distribution growth track records

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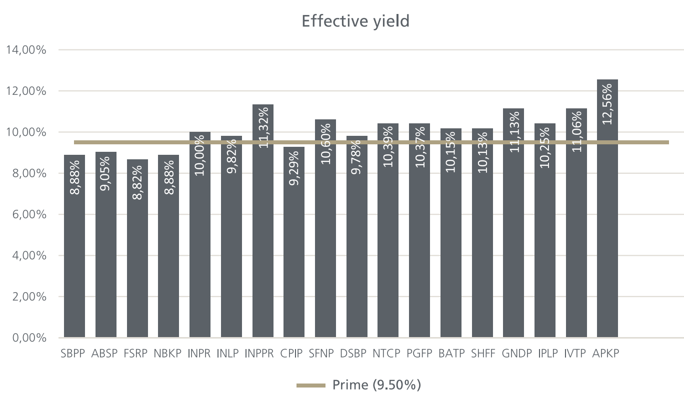
Overview

The preference share market index only generated a gain of 0.7% (total return) during the quarter. The poor performance was largely attributable to weaker South African equities and a softer rand.

Although yields expressed as a percentage of prime are generally below the prime rate, effective yields are currently above prime at 9.5%. This is due to lower market prices.

Some markets capitalisations are well below R1 billion, and some trading volumes remain very low in absolute terms.



A word on banking prefs and BASEL III

Basel III capital adequacy requirements stipulate that banks must hold specified minimum amounts of capital in their tier 1 common equity, as set out by the South African Reserve Bank (SARB). The existing preference share listing documents currently do not satisfy the requirements under Basel III, but the SARB has allowed a 'grandfathering' period during which the preference shares allocated towards tier 1 capital will be reduced by 10% per annum (currently 70%).

It remains to be seen whether the bank will elect to repurchase their preference shares in the open market, or will rather incentivise investors to accommodate any changes to the legal risks in the listing documents.

9/30/2015	STANDARD	ABSA	FIRSTRAND	NEDBANK	INV-LTD	INV-BANK	INV-PREF	CAPITEC	SASFIN	DISCOVERY	NETCARE	PSG	BRAIT	STEINHOFF	GRINDROD	IMPERIAL	INVICTA	ASTRAPAK	AFR. BANK
Prime 9.50%	SBPP	ABSP	FSRP	NBKP	INPR	INLP	INPPR	CPIP	SFNP	DSBP	NTCP	PGFP	BATP	SHFF	GNDP	IPLP	IVTP	APKP	ABLP
Price	R 83.00	R 738.99	R 82.00	R 9.00	R 76.10	R 83.00	R 82.50	R 85.50	R 74.00	R 97.50	R 78.50	R 76.61	R 100.00	R 81.00	R 75.50	R 76.75	R 90.00	R 67.49	R -
Yield as % of Prime	77.00%	70.00%	75.56%	83.33%	77.78%	83.33%	95.00%	83.33%	82.50%	100.00%	82.50%	83.33%	104.00%	82.50%	88.00%	82.50%	102.00%	88.89%	75.90%
Dividends	Non-cum	Non-cum	Non-cum	Non-cum	Non-cum	Non-cum	Non-cum	Non-cum	Non-cum	Non-cum	Cum	Cum	Cum	Cum	Cum	Cum	Cum	Cum	Non-cum
Accrued dividends	R 0.60	R 4.08	R 0.57	R 0.08	R 2.25	R 2.41	R 2.74	R 0.26	R 0.04	R S 0.41	R 3.05	R 0.26	R 2.64	R 3.65	R 0.36	R 0.25	R 2.40	R 0.27	*sus-pended
Clean price	R 82.40	R 734.91	R 81.43	R 8.92	R 73.85	R 80.59	R 79.76	R 85.24	R 73.96	R 97.09	R 75.45	R 76.35	R 97.36	R 77.35	R 75.14	R 76.50	R 87.60	R 67.22	R -
Liquidity	SBPP	ABSP	FSRP	NBKP	INPR	INLP	INPPR	CPIP	SFNP	DSBP	NTCP	PGFP	BATP	SHFF	GNDP	IPLP	IVTP	APKP	ABLP
Market cap (Rm)	R 4,398 m	R 3,654 m	R 3,690 m	R 3,226 m	R 2,452 m	R 1,282 m	R 188 m	R 196 m	R 141 m	R 780 m	R 510 m	R 1,334 m	R 2,000 m	R 1,215 m	R 559 m	R 348 m	R 675 m	R 101 m	R 0 m
Avg monthly trade (Rm)	R 63.32 m	R 36.21 m	R 43.15 m	R 36.81 m	R 30.67 m	R 15.24 m	R 4.22 m	R 5.72 m	R 2.70 m	R 11.29 m	R 12.35 m	R 14.07 m	R 21.98 m	R 12.59 m	R 7.35 m	R 8.17 m	R 18.23 m	R 2.40 m	R 0.00 m
% of market cap traded monthly	1.44%	0.99%	1.17%	1.14%	1.25%	1.19%	2.24%	2.91%	1.92%	1.45%	2.42%	1.05%	1.10%	1.04%	1.32%	2.34%	2.70%	2.37%	
Yield as a % of Prime	93.45%	95.25%	92.79%	93.43%	105.31%	103.40%	119.11%	97.76%	111.55%	102.99%	109.34%	109.15%	106.82%	106.66%	117.11%	107.84%	116.44%	132.24%	0.00%
Effective yield	8.88%	9.05%	8.82%	8.88%	10.00%	9.82%	11.32%	9.29%	10.60%	9.78%	10.39%	10.37%	10.15%	10.13%	11.13%	10.25%	11.06%	12.56%	0.00%

Source: Grindrod Bank

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Current risks for preferences shares

Although preferences shares can be suitable income-generating investments for some high net worth investors, and although prime-linked yields are set to increase as interest rates increase, we feel that there are some significant capital risks in this asset class.

With the domestic economy struggling, further downgrades to any South African sovereign ratings, local banks or state-owned enterprises that are guaranteed by the South African government become increasingly likely. If this happens, large international institutional investors and passive investment funds may be compelled to exit these markets. This will drive yields higher and will put capital values of preference shares under pressure.

In addition, liquidity is an investment characteristic that we easily sacrifice, as it often places an investor in the position of price taker when fundamental asset values are skewed disproportionally to what can be obtained in the open market.

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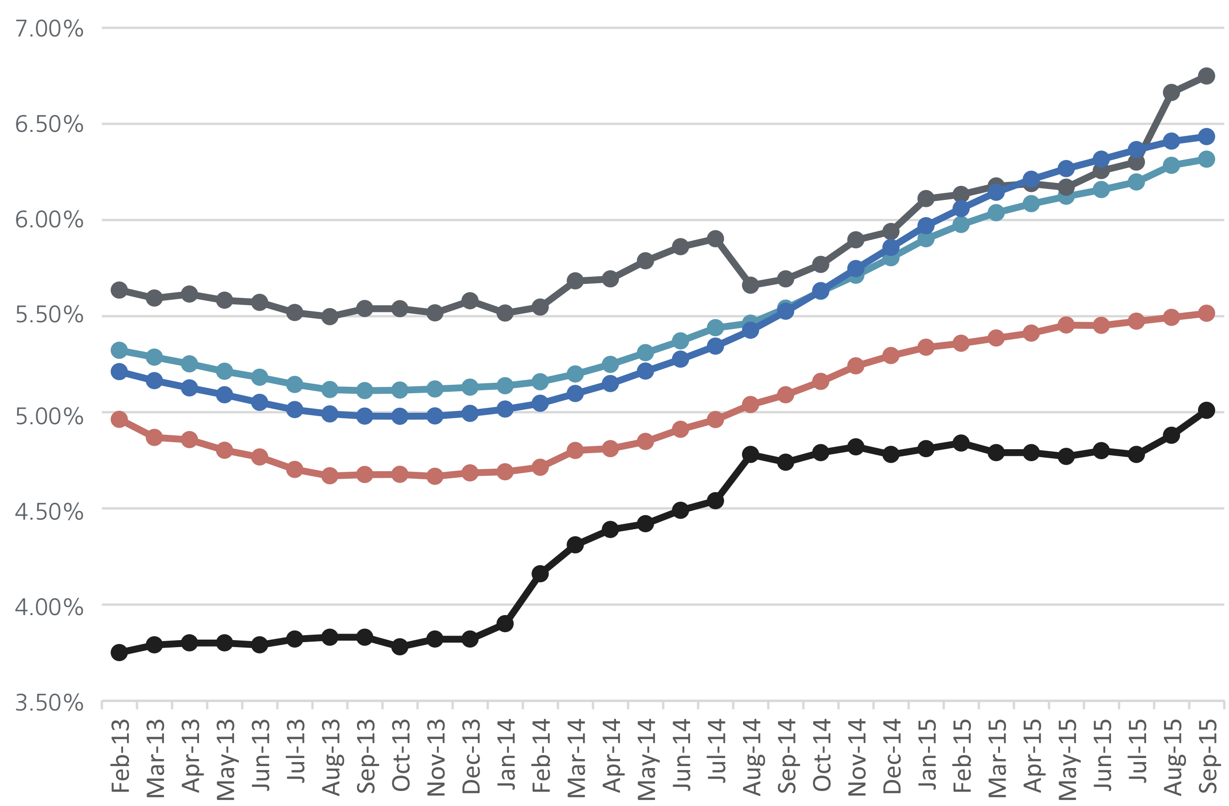
ETF

The effective after-cost yields for both the PSG Wealth Enhanced Interest Fund (6.75%) and the PSG Money Market Fund (6.43%) are currently well above SteFI call rates (5.51%), as well as the average yield of the ASISA Money Market Fund peer group (6.32%).

Both these options invest only in investment grade instruments, and are also Regulation 28 compliant. The PSG Money Market Fund retains a slightly shorter duration as required by its fund classification and mandate. The PSG Wealth Enhanced Interest Fund's mandate maintains a slightly higher duration profile to enhance yield.

The JSE Trustees rate (net 5.01%) offers a reasonable yield for investors who wish to keep cash in their stockbroking accounts to act swiftly if equity investment opportunities present themselves.

Yield comparison (net of fees)



	Feb 13	Mar 13	Apr 13	May 13	Jun 13	Jul 13	Aug 13	Sep 13	Oct 13	Nov 13	Dec 13	Jan 14	Feb 14	Mar 14	Apr 14	May 14
JSE Trustees Rate (Net)	3.75	3.79	3.80	3.80	3.79	3.82	3.83	3.83	3.78	3.82	3.82	3.90	4.16	4.31	4.39	4.42
ASISA MM Avg (Net)	5.32	5.29	5.25	5.21	5.18	5.14	5.12	5.11	5.11	5.12	5.13	5.14	5.16	5.20	5.25	5.31
STeFI Call (Net)	4.96	4.87	4.86	4.80	4.77	4.70	4.67	4.68	4.68	4.67	4.68	4.69	4.71	4.80	4.81	4.85
PSGW EI D (Net)	5.64	5.59	5.61	5.58	5.57	5.52	5.50	5.54	5.54	5.52	5.58	5.52	5.55	5.68	5.69	5.79
PSG Money Market (Net)	5.21	5.16	5.13	5.09	5.05	5.01	4.99	4.98	4.98	4.98	4.99	5.02	5.05	5.10	5.15	5.21

	Jun 14	Jul 14	Aug 14	Sep 14	Oct 14	Nov 14	Dec 14	Jan 15	Feb 15	Mar 15	Apr 15	May 15	Jun 15	Jul 15	Aug 15	Sep 15
JSE Trustees Rate (Net)	4.49	4.54	4.78	4.74	4.79	4.82	4.78	4.81	4.84	4.79	4.79	4.77	4.80	4.78	4.88	5.01
ASISA MM Avg (Net)	5.37	5.44	5.46	5.54	5.63	5.71	5.80	5.90	5.98	6.04	6.08	6.12	6.16	6.20	6.28	6.32
STeFI Call (Net)	4.91	4.96	5.04	5.09	5.16	5.24	5.29	5.34	5.36	5.39	5.41	5.45	5.45	5.47	5.49	5.51
PSGW EI D (Net)	5.86	5.90	5.66	5.96	5.77	5.90	5.94	6.11	6.13	6.18	6.19	6.17	6.26	6.30	6.66	6.75
PSG Money Market (Net)	5.28	5.34	5.43	5.52	5.63	5.75	5.86	5.97	6.06	6.14	6.21	6.27	6.32	6.37	6.41	6.43

Source: PSG Wealth, JSE, Morningstar.

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Traditional value investing in commodities is counterintuitive – An opinion

Does buying stocks with low price-to-earnings (P/E) ratios produce higher returns? A wealth of literature exists on the topic of low P/E stocks within the framework of value investing. The conventional wisdom is that low P/E stocks are cheap and represent good value. This is backed up by empirical evidence which shows that low P/E stocks outperform high P/E stocks over the medium term.

Value investing

Many value investors claim to trace their investment approach to Ben Graham, Warren Buffet's mentor. Traditionally they use Graham's 1934 book *Security Analysis*, co-authored with David Dodd, as their investment bible. Prof. Aswath Damodaran from the Stern School of Business at New York University, who specialises in equity valuation, explains that in this first edition, Graham converted his views on markets to specific screens that could be used to find undervalued stocks.

Ben Graham's screens for undervalued stocks

Prof. Aswath Damodaran from the Stern School of Business at New York University notes that only stocks with low P/E ratios would have had a chance of passing Graham's first screen. He adds that many of the remaining screens are designed to eliminate those stocks that have low P/E ratios for the wrong reasons – low growth and high risk.

Graham's screens are:

1. Earnings to price ratio that is double the AAA bond yield (The price earnings ratio screen)
2. P/E of the stock has to be less than 40% of the average P/E for all stocks over the last 5 years
3. Dividend yield > Two-thirds of the AAA Corporate Bond Yield
4. Price < Two-thirds of tangible book value 5
5. Price < Two-thirds of net-current-asset-value (NCAV), where net current asset value is defined as liquid current assets including cash minus current liabilities
6. Debt-equity Ratio (book value) has to be less than one
7. Current Assets > Twice current liabilities
8. Debt < Twice net current assets
9. Historical growth in EPS (over last 10 years) > 7%
10. No more than two years of declining earnings over the previous ten years.

But how well does Graham's screens work when it comes to picking stocks?

Henry Oppenheimer studied the portfolios obtained from these screens from 1974 to 1981 and concluded that you could have made an annual return well in excess of the market. Academics have tested individual screens - low P/E ratios and high dividend yields, to name two - in recent years, which were found to deliver higher returns. However, Damodaran says an attempt to convert the screens into a mutual fund that would deliver high returns failed. In his lectures Damodaran uses an example from the 1970s, where an investor named James Rea was convinced enough of the value of these screens that he founded a fund called the Rea-Graham Fund. This fund invested in stocks based on Graham's screens. While it had some initial successes, the fund struggled during the 1980s and early 1990s and was ranked in the bottom quartile for performance.

From this example you can see that a strategy of investing in stocks based purely on low P/E ratios can be dangerous, especially when value investors get caught up in the game of rising commodity prices (which lead to rising earnings expectations). The commodity cycle, although difficult to predict, has often been used to decide when to invest or not. Many commodity investors like to find extremes in commodity prices, where a commodity is trading at multi-year lows or highs. Traditionally you would want to buy commodity shares when they trade at the bottom of the cycle. In this scenario the company's earnings would be lower and its P/E ratio higher. In turn, you would want to sell commodity shares when the price is high and it's at the top of the cycle, which means the company's earnings are higher but its P/E ratio is low. Thus going against the grain of conventionally buying shares with low P/E ratios, with commodities you want to sell when the share has a low P/E ratio.

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When the price of a commodity falls to or below the cost of production, it is only a matter of time before supply drops, because producers will stop producing a commodity at a loss. This is how things in the commodities cycle has run for decades, and even centuries. When the price of a commodity rises to an extreme level, there is a good chance that producers around the world will increase production of that commodity to capitalise on high profits. There is an old saying in the commodity markets that high prices cure high prices – production increases and high prices causes demand to drop. But how do you gauge in which part of the commodity cycle we currently are? Or how do you decide to buy into a company when it seems cheap, waiting for the cycle to turn with the hope that the company survives in the long run?

The typical value investor will search for the cheapest P/E ratio, which is the crux of the investment method prescribed by Graham. However, using the P/E ratio on its own will not give you enough information to judge whether it will be worth buying into a company. As explained above, it can be counterintuitive if you use this strategy to invest in commodity companies which are cyclical in nature.

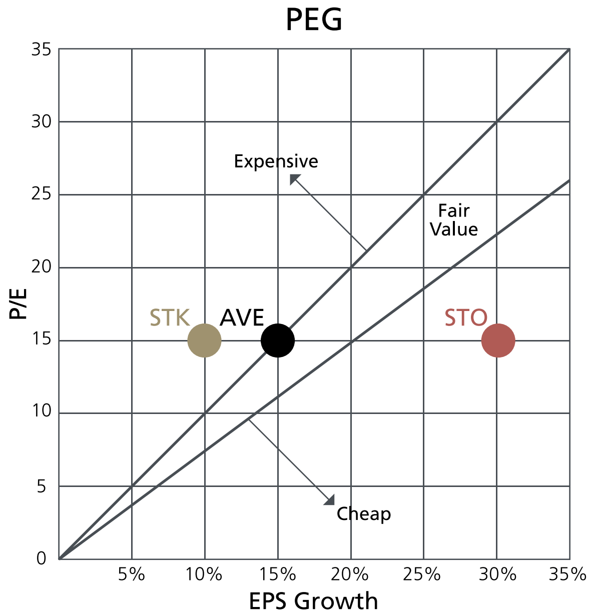
Instead of using the P/E ratio, it might be better to use the price-to-earnings growth (PEG) ratio. The PEG ratio, invented in the 1960s by the stock market investor Jim Slater, attempts to measure the degree of a discount or premium you're paying for growth. The calculation is to divide the P/E ratio by the long-term annualised percentage growth rate of earnings, ideally the next five years' worth. Generally, a lower PEG ratio indicates better value.

If you consider the graph on this page you can see that although both stocks shown have a P/E ratio of 15, their growth rates over the period under review differ. You would therefore not have capitalised on the returns of the high-growth stock if you just used the P/E ratio to choose which stock to buy.

When considering investments in commodity companies, you also need to take the company's assets and debt into account. Even though the price of a share in a commodity company can drop at a specific time in the cycle, this does not necessarily mean that the assets it owns dropped by a similar percentage. Here you can use the price-net-asset-value (P/NAV) ratio, which shows how a share is valued compared to its NAV.

PEG Ratio

Name	Code	Share price	EPS growth	P/E	PEG
Stock 1	STO	100	30%	15	50%
Stock 2	STK	100	10%	15	150%



Source: PSG Data

However, if you want to find cheap stocks that would be good investments, you have to calculate more valuation multiples – just as with P/E ratios you can't simply rely on this one ratio (P/NAV) when making investment decisions.

At PSG Wealth we search for shares that not only trade at low P/E or PEG ratios, but rather those that have low NAVs relative to their normalised return-on-equity (ROE) over a period. You also need to consider a company's debt-to-equity ratio . The debt-equity ratio is a measure of financial leverage, telling you the percentage of a company's assets financed by debt. Lower numbers are generally preferred because high debt loads can turn into big problems in a downturn.

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More than value investors

Value investors are essentially bargain hunters, as they hold undervalued shares in the belief that they have limited downside risk, but strong upside potential. However at PSG Wealth, we apply the value investor style with a bias towards quantitative analysis, as we aim to invest in shares that either trade at low P/E ratios relative to their long-term growth rates, or on low Price/NAV ratios relative to their sustainable ROE. PSG Wealth also considers the financial structure of a company, its dividend policies, its profitability and its cash conversion.

The value approach requires a lot of patience: you have to hold the undervalued share until the rest of the market recognises their worth and causes share prices to rise to fair value. This encourages a long-term focus when applied as part of your investment strategy.

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