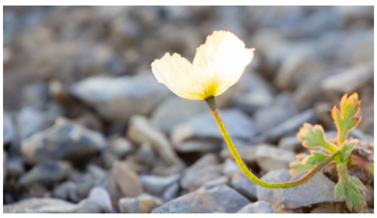
PSG Asset Management

ANGLES & PERSPECTIVES

FIRST QUARTER 2020

Contents



At PSG Asset Management we follow our proven 3M process consistently to uncover the most promising investment opportunities for our investors.

Anet Ahern

Introduction

Anet has over 30 years' experience in investment and business management. After starting her career at Allan Gray in 1986, where she fulfilled various roles in trading and investment management, she worked as a portfolio manager at Syfrets, and later BoE Asset Management, where she was CIO and CEO. She also spent six years at Sanlam, where she was the CEO of Sanlam Multi Manager International. Anet joined PSG Asset Management as CEO in 2013.

There are always opportunities for patient investors
2020 will undoubtedly be remembered as a watershed year in the history books. The COVID-19 pandemic has derailed markets across the board. Moreover, the pandemic itself is raising questions about the viability of many industries and business models which have in the past been part of our everyday lives. The mayhem has left investors with precious few places to hide, and the impact on investor portfolios has been severe. How do we chart a path forward, if we cannot be sure what the future will look like?

More than ever, following a trusted process matters
Investor capitulation remains our biggest concern. Switching to sectors or stocks that are perceived to be doing better (even at these low levels), comes at the risk of crystallising paper losses. We acknowledge that COVID-19 has had, and will continue to have, profound impacts on many businesses and industries. Some sectors will be more affected than others, and some management teams will fare better than others. We cannot predict when and how the market will reward specific shares or sectors. But we know that in the long run, well-managed companies will continue to do business and grow over time, rewarding their shareholders, whatever the short-run challenges.

Our challenge as investment professionals and stewards of our clients' capital, is to sift through the available choices, and identify those companies best poised to reward their investors handsomely at acceptable levels of risk. Our commitment to this objective has never changed, and we remain as focused as ever on unlocking future opportunities.

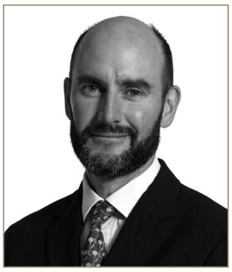
PSG Asset Management has always been committed to open engagement with the advisers and clients who support us. As a value manager, we understand that there will be times when the market does not reward our approach. In the long run, however, we remain confident that the key to long-term returns lies in buying low and selling high. In our lead article, Chief Investment Officer Greg Hopkins and Fund Manager Shaun le Roux address some of our investors' most pressing questions.

In the second article in this edition, Our Head of Research, Kevin Cousins, outlines the opportunities we are seeing in the midst of the COVID-19 gloom. We have revisited our estimates of intrinsic value given the implications of COVID-19, and have made changes to our portfolios where we believed our clients' capital could be better employed elsewhere. Nonetheless, we have found many instances where intrinsic values have only been impacted slightly, while share prices have declined sharply. We aim to use these opportunities with care and to our clients' advantage.

Finally, Fund Manager Lyle Sankar offers his insights into Navigating the storm in fixed income markets. The bond market has also suffered from the COVID-19 fallout, with investors withdrawing large amounts from emerging market countries. Our portfolios were negatively impacted during March, as our preferred asset holding, sovereign bonds, came under pressure. Despite the negativity around South African government bonds, we believe the sell-off to date has been mostly technical in nature, and that this asset class will continue to offer investors equity-like returns in the near term.

We trust that you will find these articles insightful, and that they offer you some guidance in these turbulent times.

COVID–19: Answering our clients' questions in the world of elevated uncertainty and poor returns



Greg Hopkins

Shaun le Roux

Greg is the Chief Investment Officer at PSG Asset Management and a fund manager on several of our funds. He has over 20 years' investment experience and is a CA(SA) as well as a CFA charterholder.

Shaun has managed the PSG Equity Fund since 2002 and the PSG Flexible Fund since 2016. He is a CA(SA) and a CFA charterholder.

The impact of the COVID-19 outbreak on the global economy and financial markets has been severe. The scale of the sell-off, spike in volatility and subsequent rally illustrate just how challenging the environment is as investors grapple with a very wide range of potential outcomes. Our investment team has diligently been working its way through the risks and opportunities the COVID-19 outbreak presents (for more detail on the opportunities we see, read Head of Research Kevin Cousin's and Fund Manager Lyle Sankar's articles).

We acknowledge that analysing company fundamentals is a continuous and challenging process with many unknowns. Our process is, however, identifying a number of companies (both in South Africa and abroad) where the sell-off looks materially overdone. If the COVID-19-related knock to what these businesses are worth is relatively small, the opportunity for returns is staggering. It may well be a case of companies that were cheap becoming even cheaper. Good things lie ahead if we can accurately separate risk from opportunity in this environment and be brave where appropriate.

We think it best to communicate with our clients by answering the main questions that are being raised.

Q: What is your message to investors?
We acknowledge that this is a very difficult time to be making investment decisions, as there are a lot of unknowables and the implications of making the wrong decisions are amplified. If you sell stocks worth a rand for 20c to buy stocks that are also worth a rand but are trading at 120c, the long-term impact on your portfolio could be severe. Obviously, the challenge will be to identify which are the 20c stocks and which are the 120c stocks. This is why an investment process is so important – it removes the emotion and weighs the evidence, focusing on the process and not the outcome. If you are trying to predict outcomes and back-engineer a portfolio, the likelihood of error is high. In times like these we always encourage investors to try take emotion out of the picture, fall back on the process and manage the risks. However, investors should also be prepared to be brave where it is appropriate and make decisions that will reward them over the long run.

Q: PSG's performance was poor in 2019 and continued to lag benchmarks over the past quarter. Please can you help us understand this?
We are acutely aware that it has been a very disappointing and challenging time for our clients. They had endured poor short-term performance by our funds and the additional pain of the March COVID-19 sell-off has naturally caused a lot of concern. Many of the cheap stocks our clients owned performed poorly in 2019 and, despite wide margins of safety, were hit hard in March. Under the circumstances, it is entirely appropriate to be questioning whether this is indicative of flaws in our investment process. In order to understand our recent performance, is it important to delve into both the reasons for poor returns in 2019 and the March drawdown.

Our performance in context
PSG's 3M process focuses on identifying cheaper securities, typically in uncrowded areas. We look for stocks that have an inherent quality that the market is missing. This style of investing has worked very well over long periods of time and is suitable for clients with a longer investment time horizon. Over the past few years, we have identified attractive domestic opportunities on the JSE as well as in less popular and cheap global stocks. The reasons for the pre-COVID underperformance by the stocks in our portfolio can broadly be attributed to two factors: the low levels of confidence in South Africa that depressed local stock performance, and the widening divergence in global valuations between cheap, out-of-favour stocks and their expensive widely owned counterparts. Clients will recall that the JSE's performance at an index level in 2019 was driven by a handful of resources stocks and Naspers, with the vast majority of shares continuing their multi-year bear markets. It is very important to note that the COVID-19 pandemic has not changed the rationale for owning the businesses that our clients do. Instead, future returns have been delayed and potentially improved. If fear results in the opportunity to invest in good companies at very low prices, given low expectations about their future prospects, then COVID-19 has enhanced the opportunity to execute on our investment philosophy.

Market developments in March

Other than cash and developed market bonds, there were few places to hide in the March sell-off. Despite underperforming before the crisis, cheap stocks were hit particularly hard in March (both locally and overseas). While the selling was broad-based, stocks that were economically sensitive, leveraged or in emerging markets were hit hardest. This weighed very heavily on some of our global holdings as well as many companies on the JSE, hence the losses we incurred in our portfolios. However, for the reasons that Head of Research Kevin Cousins expands on in The opportunity in the COVID-19 storm, panic selling has the tendency to be irrational and prices can be expected to reverse quickly if they have overreacted. It can also create tremendous opportunities and we have pounced on a number of COVID-19 opportunities as discussed in that article.

Our recent analysis has been focused on determining the extent of the COVID-19 impairment to intrinsic value. We have concluded that while the prices of the securities in our portfolios have fallen sharply, their fundamental values are still intact. That is why we expect the vast majority of the loss in capital to be temporary. We also believe that the current environment of low confidence, temporarily weak economic conditions and abundant liquidity sows the seeds for the next bull market. Our research indicates very sizeable upside for a number of securities when conditions stabilise.

Q: One of the characteristics of your process is investing with a margin of safety – yet this has not prevented your shares from falling further. Why?

It is true that buying at a margin of safety is our main tool for protecting our clients against permanent capital loss. We should, however, remember that share prices can move in a very wide range around your assessment of intrinsic value, and during extreme environments prices can over- and undershoot by a large degree. We are currently witnessing such an environment and we believe that share prices have moved to very extreme levels relative to fundamental value. In many cases, SA stocks are much cheaper than they were during the Global Financial Crisis (GFC).

Fundamental value must be considered alongside share prices

We also think it is important to distinguish between permanent and temporary capital loss. We expect that the majority of the losses incurred recently will prove to be temporary in nature. An economic contraction as severe as the current one does, however, result in some impairment of shareholder value for many companies: they will make less profit or incur losses and/or take on more debt. In some cases, equity value will be wiped out. Viewed through this lens, some reduction in fundamental value has been incurred by most global equity investors, but this reduction in shareholder value cannot be looked at in isolation – it needs to be considered in conjunction with much lower share prices. The surest way to crystallise permanent capital loss is to sell at very depressed prices.

The margins of safety in our portfolios are substantial

Most businesses grow their intrinsic value over time and will not take long to restore any value lost. This is especially the case in industries where weaker competitors fall by the wayside, enabling survivors to grow market share and extract more pricing power. In this way, a deep recession can be very cathartic, enable the strong to get stronger and result in higher long-term returns on capital for market leaders. While it is still unclear what the ultimate impact of the COVID-19 outbreak will be and when a recovery is likely to take place, it is clear that our stocks and bonds were cheap going into the recent COVID-19 crisis, i.e. they had large margins of safety when viewed over a longer period. We estimate our local and global buy lists were on a price to intrinsic value of 0.55 (an 81% margin of safety) and 0.64 (a 56% margin of safety) respectively. This value is still apparent today in the midst of the crisis.

Q: What have you concluded on the COVID-19 impacts on your portfolios and what changes have you made?

Our portfolios underperformed in March, as outlined above. However, we consider these losses as temporary, for two reasons. Firstly, the reductions in intrinsic value have been relatively small at a portfolio level. Secondly, we have been able to harness the COVID-19 driven opportunity to acquire very good businesses at exceptional prices. We expand on the dislocation between prices and value in more detail in Navigating the storm in fixed income markets and The opportunity in the COVID-19 storm.

Broadly speaking, we have retained the shape of our portfolios. Our highest conviction is reflected in domestic sovereign bonds – from which we expect equity-like returns – and more resilient companies (domestic and global) trading at wide margins of safety. Our largest current stock holdings (AB Inbev, Liberty Global, Discovery and Japan Post Insurance) are representative of this opportunity to own higher-quality resilient and cheap businesses. Our clients also own a number of very cheap companies exposed to parts of the economy that are experiencing a drop in demand. These include local financials, mid-cap industrials and US retail REITs.

Although the nearer-term earnings profile of these companies has been impacted by COVID-19, their low earnings at the start of the COVID-19 crisis bode well for their longer-term earnings growth potential. Our analysis of balance sheets and valuations indicates a very wide disconnect between the share price and a conservative value that factors in sustained suppression of economic activity as a result of the lockdown.

Q: What does COVID-19 mean for emerging markets like South Africa and your SA Inc. investments?

It is quite easy to paint a dire picture for most emerging markets, given the impact of the collapse in demand on their economies and their fragile fiscal status. There is no question that significant challenges lie ahead and the exiting of the COVID-19 lockdown is likely to be a stop-start affair. Emerging market economies also lack the firepower for stimulus to compensate for the collapse in demand. But, in the rush to reduce investment risk, global investors have fled emerging markets at an unprecedented rate, extracting US$100 billion in three months. This has had a very severe impact on currencies and asset prices in South Africa and other emerging markets, and it can be argued that the extreme price movements provide an opportunity to generate long-term returns that will handsomely exceed those available in developed markets like the US. Fund Manager Lyle Sankar unpacks the extremity of the pricing of SA sovereign bonds in Navigating the storm in fixed income markets and offers a number of reasons to substantiate our view that yields are likely unsustainably high (and prices unsustainably low).

The impact of a change in sentiment could be pronounced

Similarly, equity markets tend to recover well before the economic data and if the point of maximum global investor pessimism lies behind us (even if the economic woes lie ahead) it is possible for the wave of outflows to turn the other way. Historically, an environment of massive global monetary and fiscal stimulus creates liquidity that finds its way into the cheap growth assets and high-yielding securities that are abundant in emerging markets. Given the high yields and very low prices in emerging markets, the impact of a change in sentiment and direction of flows on domestic security prices could be very pronounced. Our clients still have material exposure to domestic companies and bonds that we think will produce exceptional long-term returns.

The opportunity in the COVID–19 storm

Kevin Cousins

Kevin is Head of Research at PSG Asset Management and has 26 years' experience in investment management.

The COVID-19 outbreak has plunged the globe into chaos. We are in uncharted territory, from both a societal and a financial market perspective. The policy response to the virus has come at a severe economic cost, with a collapse in demand and extensive disruption to supply chains. Whole sectors have ground to a halt, including crucial employers in industries such as hospitality and tourism, non-essential manufacturing and retail. The current uncertainty and fear about potential outcomes feel unprecedented. As stewards of our clients' capital, we have applied our minds to find the opportunity for our clients in the midst of the COVID-19 storm.

Our response to uncertainty

We set up a task team to monitor the COVID-19 outbreak. The team updates a dashboard showing key metrics across important countries and curates the massive volume of research for circulation within the broader investment team, with a focus on issues that can dramatically impact the COVID-19 outcomes, such as infection rates and death rates, and vaccine and treatment trials.

Forecasts by various experts about the possible outcomes of the COVID-19 outbreak show a huge range of outcomes and have changed dramatically in a matter of weeks. It is clear that very small changes to assumptions have enormous impacts on modelled outcomes, and given the many variables, even highly qualified and experienced epidemiologists do not actually know how COVID-19 will develop in the months ahead.

We don't aim to predict outcomes, but rather remain focused on managing our clients' investments

Our goal is staying abreast of COVID-19 developments as they unfold, rather than trying to predict outcomes. We acknowledge that we don't know what will happen, and believe it is dangerous to make explicit top-down forecasts for the economy or try to predict the impact on financial markets.

What we have done is to focus on stocks, answering two key questions:

- Do our buy list companies have the resilience to weather the COVID-19 storm?
- Has the general collapse in stock market prices surfaced attractive new opportunities for our clients?

Have intrinsic values changed?

We have re-evaluated our existing holdings given the COVID-19 uncertainty, using appropriately conservative assumptions. Our process was to stress-test our holdings for a severe demand disruption, and evaluate available liquidity in the light of this and our earlier work on balance sheet resilience. We have also engaged with management to understand what a prolonged shutdown would look like.

The most vulnerable companies are those in sectors where revenue has shown a dramatic decline or come to a complete halt, while costs are still being incurred. Should those companies have significant gearing, the risk of a wholesale transfer of value from equity holders to debt holders becomes acute. Where our work has highlighted companies that have suffered a permanent impairment of value, we have acknowledged this new reality and changed our portfolios even at the prevailing low prices. Given that our portfolio companies entered the COVID-19 crisis with resilient balance sheets, low earnings and cheap valuations, i.e. large margins of safety, the impact of these portfolio changes was largely insignificant.

Selling, even at depressed prices, offers the prospect of applying cash better elsewhere

Some examples include brick-and-mortar retail exposure such as L Brands and Washington Prime. While it always feels terrible to sell a stock at a depressed price, the upside of the general price decline is the rare opportunity to use the resulting cash to acquire great companies at attractive prices.

A wealth of quality on sale

Every extreme market disruption feels unique at the time. Consider the Global Financial Crisis (GFC) following on the unprecedented US housing and mortgage market collapse, and 9/11 when global terror was unleashed. With the benefit of hindsight, we can say that these periods of extreme uncertainty enabled us to build portfolios of exceptional businesses that set up our clients' funds for the next cycle. We believe the COVID-19 disruption could provide a similar opportunity.

Three areas where we believe the market sell-off has created opportunity

The sell-off of geared companies

One parallel to the GFC is that as credit spreads widened, companies carrying leverage have been aggressively sold off. This is a rational response given the stress-testing work we mentioned earlier. However, some companies are better suited to leverage than others. This includes those with resilient revenues, long-life assets, wide cash operating margins and management teams that conservatively structure debt and keep ample liquidity available. These companies should not be tarred with the same brush as other leveraged businesses.

The scramble to get out of emerging markets

Emerging markets, including South Africa, have suffered enormous outflows of capital as foreign investors sold investments and repatriated their funds. Emerging markets were already looking cheap, with low earnings and ratings near cyclical lows. This latest move down provides fantastic value across even very high-quality emerging market companies.

An aversion to financials

Finally, the financial sector has displayed a very high 'beta', falling much more than the broader market. We think much of this is due to 'muscle memory' from the GFC, when financials were the epicentre of the crisis and their highly leveraged balance sheets and high valuations provided a catalyst for dramatic drops in prices. However, the situation preceding the COVID-19 sell-off was very different, with strong capital levels (lower leverage) and attractively low multiples of book or embedded value.

In particular, life assurers focused on protection products have been severely devalued, despite a resilient business model that carries little systemic risk and stable contractual revenues through the economic shutdown. Mortality stress tests have little impact on embedded values, given the high average age of COVID-19 related deaths, offset from products such as annuities and the finite period over which the pandemic is likely to play out.

Seeing the opportunity in the crisis

We have been buyers of companies like AB Inbev, Shoprite, Liberty Global, Prudential, Discovery and Brookfield Asset Management. In many cases these are '3M' stocks we know well and like, but had historically chosen to sell or reduce our positions as prices rose and the margin of safety diminished. Thus, while COVID-19 has produced much hardship and loss, it has also afforded us an opportunity to buy shares in these quality companies at remarkably wide margins of safety.

Case study one: AB Inbev

AB Inbev, the world's biggest brewer, has suffered a share price decline of over 50% in USD. It represents 'the sum of all fears' for investors given its high emerging market exposure (about 60% of revenue) and leveraged balance sheet. In addition, as investor fear rises, time frames become shorter and shorter. Near term, a substantial earnings decline is expected for AB Inbev. Many of its 'on-premise' channels (bars, restaurants and hotels) are closed across much of the world and, in a few markets like SA, Mexico and Nigeria, even off-premise sales of alcohol have been banned. This means 2020 earnings will show a sharp decline.

Will AB Inbev make it through the crisis? While leveraged, its balance sheet is conservatively structured and well managed. They have an incredible US$26 billion of available cash, which will rise to US$37 billion on completing the sale of their Australian business to Asahi (just approved by the Australian competition authorities).

We believe AB Inbev is one of the widest moat businesses in the world, and has a management team that thinks and acts like owners. We have been able to buy AB Inbev at about 10 times normalised earnings which, given the ratings of its listed subsidiaries, implies a 4 times P/E for the rump of the business (which includes markets like Mexico, Columbia, North America, Western Europe and Africa). The COVID-19 crisis has effectively gifted us this opportunity to increase our holding and we upgraded our conviction levels. We are confident that the growth prospects of emerging markets will once again find favour with investors in the future, and quality businesses like AB Inbev will once again be accorded the premium ratings they deserve.

Case study two: AECI

AECI has been a long-term client holding. This mid-cap diversified industrial company is primarily focused on mining explosives and mining and industrial chemicals. AECI has an excellent long-term track record generating market-beating compound returns of 20% for the two decades prior to us acquiring shares in the business. Its inherent quality was once again demonstrated in its ability to grow headline earnings by 10% during a tough 2019. As with most SA businesses, the lockdown has forced closures at some of its operations, representing approximately 25% of revenues (according to our calculations). Some of these operations are currently in the process of reopening, together with the mines they service. Although revenue will probably take a knock in 2020, it will be much smaller than that suffered by other domestic businesses in more sensitive sectors like hospitality, travel or consumer-related industries.

We conservatively modelled the impact of an extended lockdown on this business and made a small downward adjustment to our intrinsic value. By contrast, the share price fell by over 30% in March. After this adjustment, AECI trades at 43% of our assessment of fair value. If it were to close this gap, the upside is 134% (before dividends)! It trades on 6.3 times 2019 earnings (it entered the COVID-19 crisis on an attractive 9 times 2019 earnings) and on a 15% free cash flow yield. We see no reason why 2019 levels of earnings cannot be recovered in 2021.

While we expect COVID-19 to knock 2020 profits (relative to the prior year), we expect this business to prove relatively resilient. It is a good example of the opportunity to acquire good local businesses at extremely attractive valuations at a time when profits will be depressed.

Low markets provide the starting point for excellent long-term returns

Our ongoing research is focused on adding more 'quality on sale' stocks to our portfolios. We are finding these both among our historic holdings that we know well and can convert quickly, and in new opportunities. While we don't know how long the COVID-19 disruption will last, we do know that buying resilient businesses priced at financial crisis ratings offers a fantastic starting point for excellent long-term returns.

Navigating the storm in fixed income markets

Lyle Sankar

Lyle joined PSG Asset Management in 2014 and currently manages the PSG Money Market Fund, PSG Income Fund and PSG Diversified Income Fund. He is responsible for credit and fixed income analysis, and serves as a fixed income trader on the funds.

The COVID-19 outbreak translated into broad-based weakness in emerging market assets as the outlook for global growth and the appetite for risk assets swiftly deteriorated. This resulted in a tough period for our clients, as we have favoured hard-hit nominal government bonds over other areas of the fixed income market. We, however, remain confident that bonds offer an attractive opportunity for our clients, and continue to position our funds to achieve acceptable client outcomes in the best risk-adjusted manner.

PSG Asset Management has favoured the real yields in sovereign bonds

We have favoured nominal government bonds over other areas of the fixed income market. We believe headline inflation will remain anchored over the longer term, due to the credible monetary policy approach of the South African Reserve Bank (SARB). Our positioning was therefore focused on the significant real yield opportunity these bonds offered investors. These instruments, in our view, offered a margin of safety with real yields close to all-time highs and disproportionately high relative to global developed and emerging market bond yields. This implied that yields were compensating for idiosyncratic South Africa-specific structural risks. Our funds were therefore relatively overweight in exposure to sovereign bonds while underweight in corporate bonds and local listed property exposure, which offered poorer valuations, low absolute and real yields and significant inherent credit (default) risk.

The recent upward movement in bond yields has marginally impacted our assessment of intrinsic value and as such offers significantly wider margin of safety to our view that these bonds will continue to deliver attractive returns for clients. In graph 1 on the following page, we illustrate the real yields available in these bonds pre and post the impact of COVID-19 (using a conservative 4.5% inflation rate).

We have carefully considered the risks and opportunities in the domestic sovereign bond market

We recently reassessed our views on the sovereign and macro environment to ensure our clients are compensated with a fair real yield considering the changed global environment. Our conclusion is that the current sovereign curve still provides attractive opportunities relative to other areas of the fixed income market. These bonds now offer an additional 1% to 2% real yield to compensate for the near-term economic shock and its impact on South Africa's fiscal position.

Evaluating the impact of an economic recession on domestic bonds

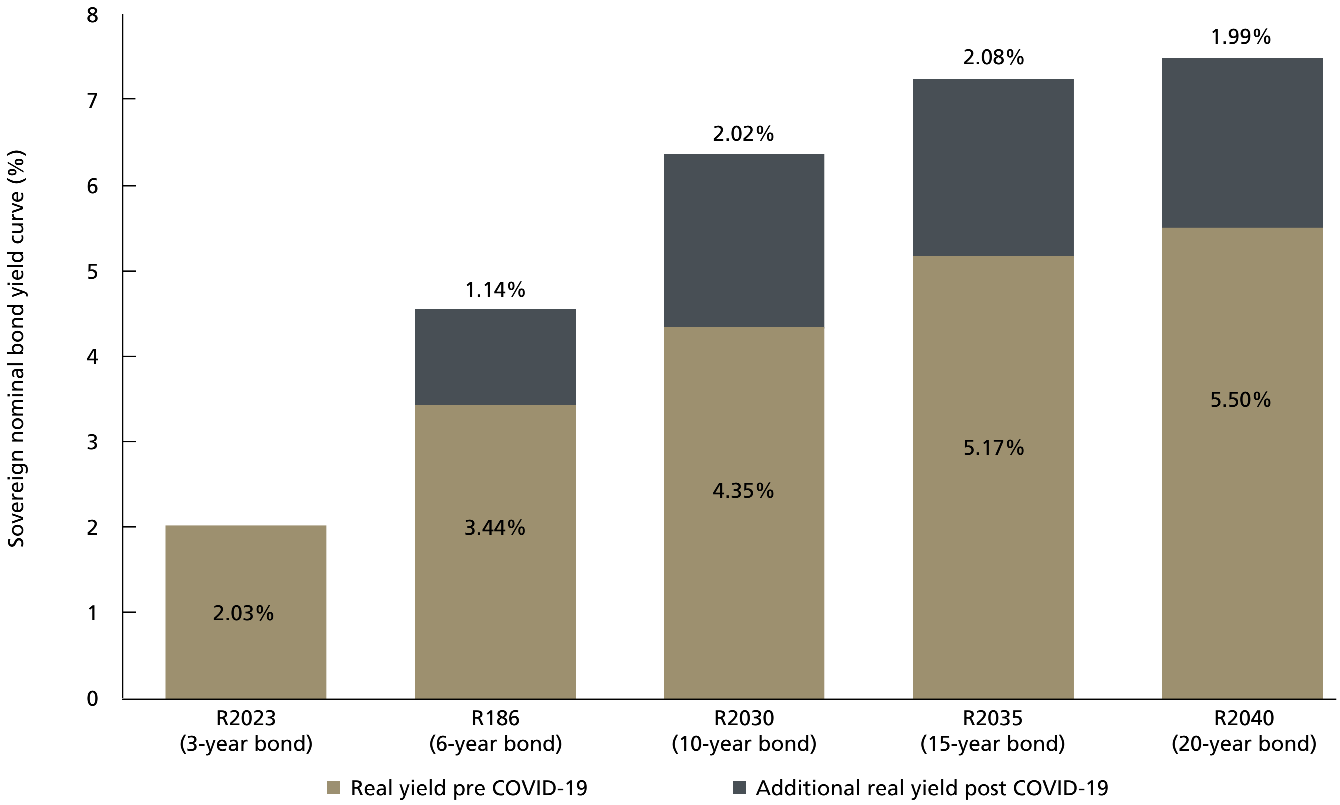
The outlook for the South African economy over the rest of 2020 is dire. It is therefore appropriate to consider the impact this is likely to have on the country's fiscal position. There is a prevailing bear theory that many emerging markets, including South Africa, stand on the edge of a balance of payments crisis and that bond yields could rise substantially. What gives us the confidence that bonds remain an attractive opportunity under the circumstances?

South Africa entered this period in a weak fiscal position with the outlook for debt to GDP and the weight of debt service costs already a concern for investors. Interestingly, it is only two months ago that National Treasury embarked on a more determined approach to fiscal reform, earmarking R150 billion in cuts to Government's wage bill with a view to restoring the credibility of our budgetary framework. The outlook, however, has now deteriorated significantly with South Africa's real GDP growth expected to be anywhere between -5% and -10% for 2020 and the main budget deficit to be worse than -10% of GDP. These factors contributed to the rise in domestic bond yields in March 2020 – which saw the 10-year bond yield hitting 13%, 4% higher than the levels of early March 2020!

Understanding the true drivers of the sell-off

Contrary to the narrative, we believe other technical factors were the primary drivers of higher yields in emerging market debt. The biggest driver was the unprecedented wave of foreign selling of perceived risky assets (especially liquid assets such as emerging market debt). Other drivers included liquidity constraints in the asset management industry, margin calls on derivative instruments used in bond funds, and domestic asset class rotations into lower risk products. The sell-off was probably so extreme because these factors occurred simultaneously. Therefore, we believe it was more technical than fundamental in nature.

Graph 1: Change in real yields during the COVID-19 outbreak



Sources: PSG Asset Management, Bloomberg

Reassessing the case for South African sovereign bonds: several positive developments are being overlooked in a time of fear

Given the very visible bear cases for South Africa and other emerging markets, driven by the GDP shock to their finances, it is important to reassess the appropriateness of our views and the likelihood of these tail risks negatively impacting portfolios in the future. Specifically, does the additional real yield compensate investors for these risks, and what mitigants are in place to soften the impact on the fiscus?

South Africa's institutions have implemented a co-ordinated and largely coherent COVID-19 plan

- **Healthcare initiatives:** To date, South Africa's healthcare plan to combat COVID-19 has been viewed as a positive surprise relative to our history of poor policy implementation, even garnering praise from the World Health Organisation (WHO). The plan appears to have been operationally sound with additional emergency funds allocated towards healthcare, achieving positive results and flattening the infection rate curve.
- **Monetary policy:** The South African Reserve Bank (SARB) acted quickly and decisively in an environment characterised by increased uncertainty and fluid information flow. The SARB has cut the repo rate by 2%, which is expected to deliver R80 billion in stimulus to the real economy. The Bank further reduced the capital and liquidity regulatory requirements of banks, enabling them to extend credit to business and individuals requiring support during this period. The SARB has provided additional liquidity to the market, by increasing the number of auctions through which the banks can access cash, as well as lowering the cost and extending the term of these loans. Our banks have also built up capital reserves over the years, as South Africa did not experience cyclical credit extension, entering this period relatively well capitalised on a global scale. Monetary policy appears to have been effective to date in easing liquidity concerns in the market, reducing the risk of another liquidity induced sell-off. Importantly, both the SARB and the banks are now fully able to act countercyclically due to years of prudent policy action and balance sheet management. This is an important consideration when thinking back to previous crises where the SARB was forced to increase rates during a crisis.

- **Fiscal policy:** Government released a fiscal plan indicating a R500 billion package to underpin the economy. The detail has been widely written about with the scepticism that usually accompanies actions by Government. The R500 billion package appears to be in line with some of the larger support packages we have seen globally, at around 10% of GDP, surprising many. It does appear that Government used some manoeuvring within the budget by reprioritising expenditure, delaying tax receipts from corporates and allowing access to R100 billion within the Unemployment Insurance Fund (UIF)'s positive net position. The remaining R200 billion relates to a guarantee scheme enabling the banks to extend credit, with Government expected to guarantee roughly R32 billion of potential losses. Putting these numbers together, it appears the actual outlay for Government is a lot less than R500 billion, which indicates potential multiplier benefits of the schemes introduced.

There should be sufficient domestic demand for further government issuance

We have spent significant time modelling the potential impact of a lower GDP base for the year, and the impact on tax revenue will undoubtedly require additional borrowing by Government. The broad assumption is that the additional funding requirement places too much pressure on the local fund management industry and banks, given the lack of support from foreign investors in our local bond auctions. Graph 2 indicates the take-up of bonds issued by National Treasury in recent years.

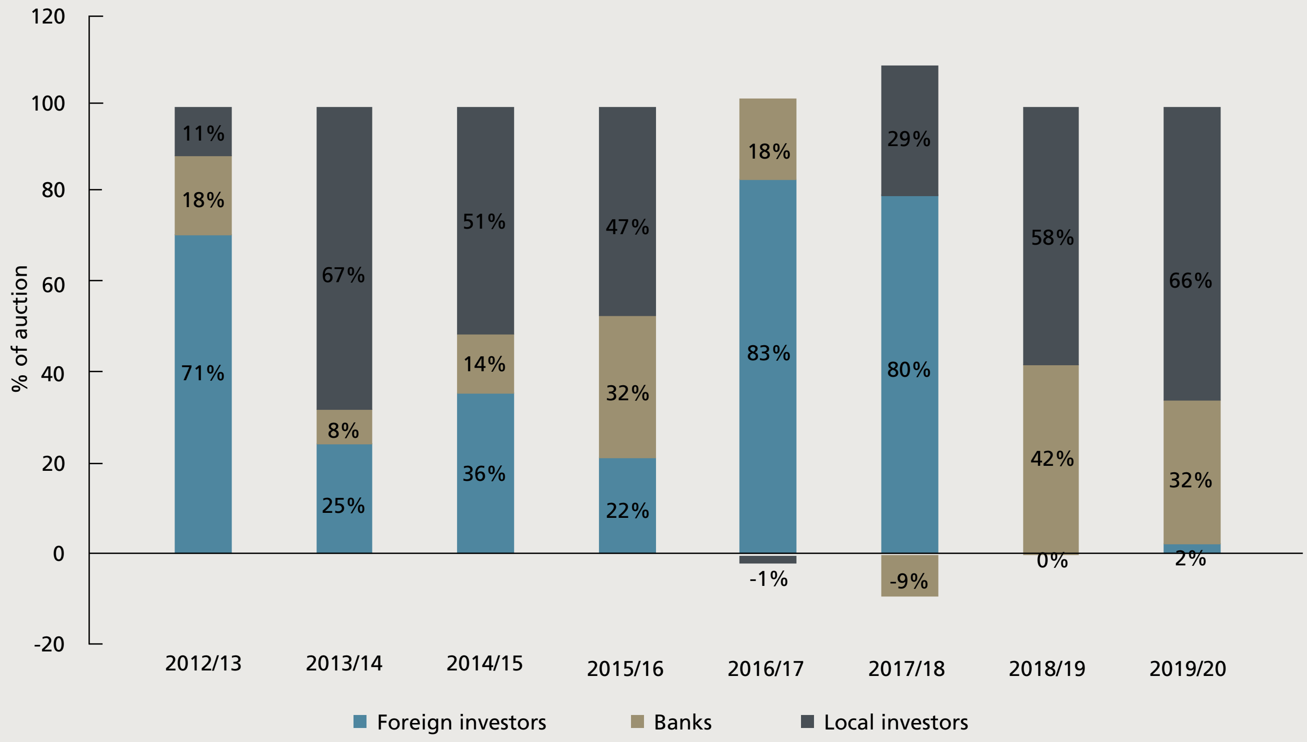
Foreigners have not participated actively in our auctions for close to two years, after a period of averaging around 40% of auction issuance since 2012/13 and taking up more than 80% in the preceding two years. It is difficult to predict whether foreign investors will continue to shun our auctions. However, there are a few aspects that need to be considered. Firstly, real yields are substantially higher, and it is not a given that foreign buyers will stay on the sidelines given the depressed yields of developed market bonds. The most crucial variable in assessing whether the additional supply will fall fully on the local market, is whether Government will restore the credibility of our budgetary framework. Indications from the budget before COVID-19 was documented in South Africa, are that Government was committed to doing so. This notion is further supported by recent indications that the stimulus package will need to be offset with austerity measures. Secondly, we also believe Government has the option to reduce the supply of longer-dated bonds by increasing the issuance of treasury bills at significantly lower rates, where demand consistently exceeds issuance levels at the weekly auctions. Government can access this benefit due to the favourable long-term debt structure that is currently in place. Thirdly, whether through multilateral funding or additional offshore bond issuance, South Africa can access funding other than in the local markets, as noted in the release of the R500 billion stimulus package.

Emerging market outflows should reverse when the panic subsides

Foreign flows are inherently extremely unpredictable. There is a widely held view that emerging market outflows will continue for South Africa, even in the event of an easing in global risk sentiment. It is important to assess the outflows we have already seen, as these impact valuations of our local assets. As of April 2020, foreigners have sold roughly R176 billion in government bonds since 2018. This has had a significant impact on the valuation of our local assets with the yields on our 10-year bond trading at close to 11%, our credit default swap spread now trading at 4.6% from a low of 1.6% at the end of 2019, and the rand losing the most against the US dollar in the emerging market currency basket, close to 35% down since the start of the year. In conjunction with these depressed valuations, it is important to consider some of the mitigants for South Africa relative to other emerging markets:

- South Africa has a floating rate currency which tends to react to stabilise the current account, as rand weakness translates into greater exports. Importantly, the SARB does not seek to intervene in foreign exchange markets to protect the value of the rand, increasing the value of this buffer. While the rand has weakened the most out of our peer comparisons, this is counterintuitively a potential positive as other central banks have utilised limited foreign reserves to buffer the devaluation of their currencies.
- Regulation 28 limits the offshore allocation of local funds to 30%, with a 12-month grace period to correct should this limit be exceeded. In previous periods of rand weakness, this acted as a self-correcting mechanism for the rand as capital is eventually repatriated back into the local market. We estimate that the current period of weakness could result in close to US$20 billion being repatriated over the course of the next 12 months – inevitably offering potential strength for the rand.
- South Africa's low levels of expiring sovereign debt in 2020 and 2021 provide us with increased room to act fiscally. Further, South Africa can leverage off a strong debt structure (long dated with low foreign currency denominated debt) to issue debt that could potentially be extremely attractive to various investors, with real yields close to the highest on offer globally, and well in excess of yields on developed market bonds. South Africa continues to have a deep and liquid market for investors to access and has a track record of honouring debt repayments.

Graph 2: National Treasury auction allocations



Source: Absa CIB research

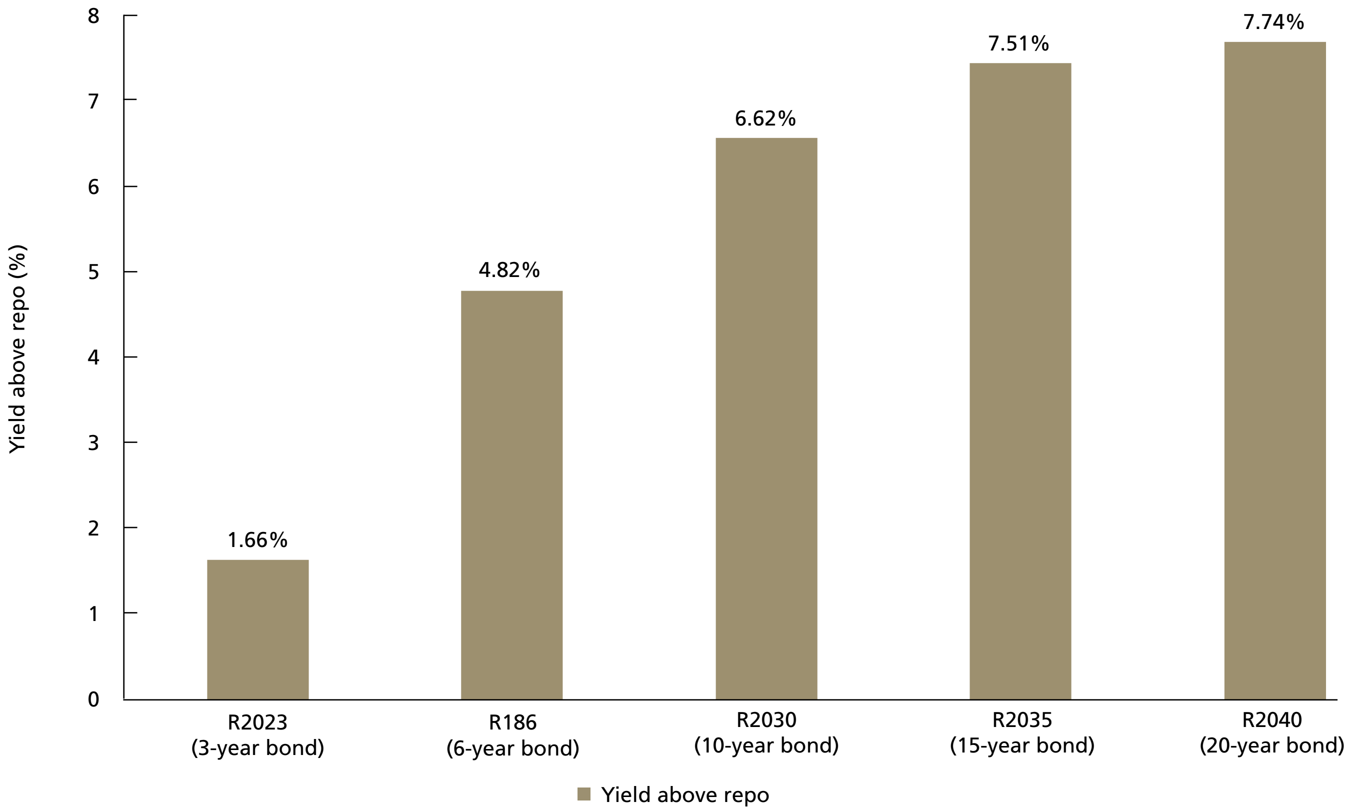
How have we managed positioning?

We are continuously looking to position our funds to achieve acceptable client outcomes in the best risk-adjusted manner. A key change to our positioning has been a shift of some of the allocation from longer-dated bonds into the R186, which looks to be one of the most mispriced areas of our bonds curve. Short-term rates are currently at all-time lows with the repo rate cut to 4.25%. The R186, now being a bond with six years to maturity, is therefore more exposed to the anchoring effect of a low repo rate and also provides the benefit of an extremely steep rolldown for the remaining term of the bond, with close to 5% yield compensation above the current repo rate. Graph 3 highlights the extreme steepness of our yield curve.

Corporate credit in light of the distress in sovereign bonds

We have been reducing corporate bond holdings in all our funds since early 2019, with our corporate bond holdings currently at long-term lows. The corporate bonds that we do hold, have also been focused on shorter-dated, floating rate bank instruments (senior, subordinated debt and negotiable certificates of deposit (NCDs)) which we believe still provide appropriate risk-adjusted returns and balance in a portfolio context. With the recent flows into income funds, the risks in this area of the market have grown due to poor pricing, poor liquidity outside of bank instruments and a weak economic backdrop. This has now been heightened by the impact of COVID-19. However, we have not yet seen the comparative price weakness we have witnessed in sovereign bonds which carry no credit risk.

Graph 3: Excess yield above the repo rate

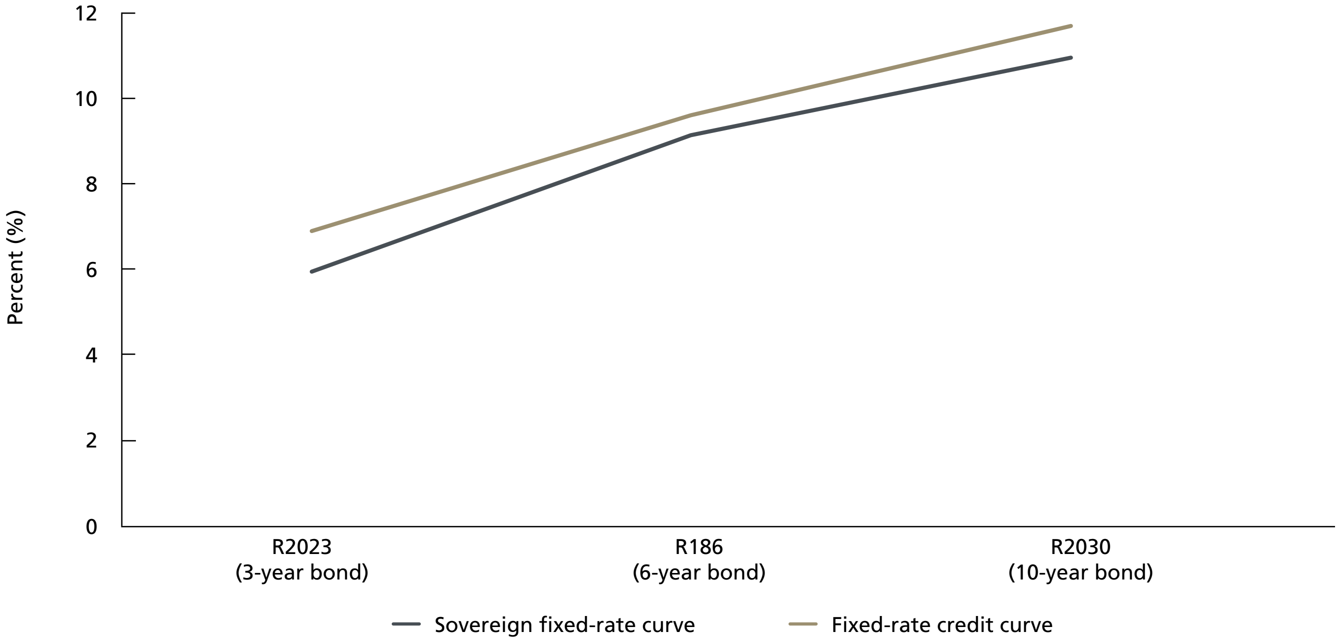


Sources: PSG Asset Management, Bloomberg

When comparing the spreads corporate bonds offer in excess of those offered by the fixed-rate sovereign curve, we believe that investors are not being adequately compensated for the increased risks. Graph 4 on the following page illustrates the thin premium investors are being offered by fixed-rate corporate credit, an average spread of 0.7% above the sovereign curve, which carries no inherent credit risk.

With a deteriorating outlook, we believe that corporate credit is still in the initial stages of repricing and we are selectively looking for opportunities. On a relative basis, we continue to favour sovereign bonds in our funds.

Graph 4: Fixed-rate credit curve



Sources: PSG Asset Management, JSE MTM

Listed property

This is an area of the market we have avoided for some time due to poor fundamentals, unsustainable dividend payouts and significant gearing. We have highlighted to clients before that we believed starting valuations, both at an underlying property valuation and a share price level, were not attractive on a risk-adjusted basis. The impact of COVID-19 has hastened the devaluation in the sector, with the index falling close to 50% for the year to date. We expect that, eventually, underlying property valuations should begin to reflect the fundamentals of increased rental pressure and normalised loan-to-value assessments. This process will highlight those that have not managed their businesses sustainably enough to survive the impact of COVID-19, but also the more resilient companies in this sector. We are confident that during this crisis, our process will identify the stand-out opportunity for clients to gain exposure to listed property.

Tough conditions signal opportunities ahead

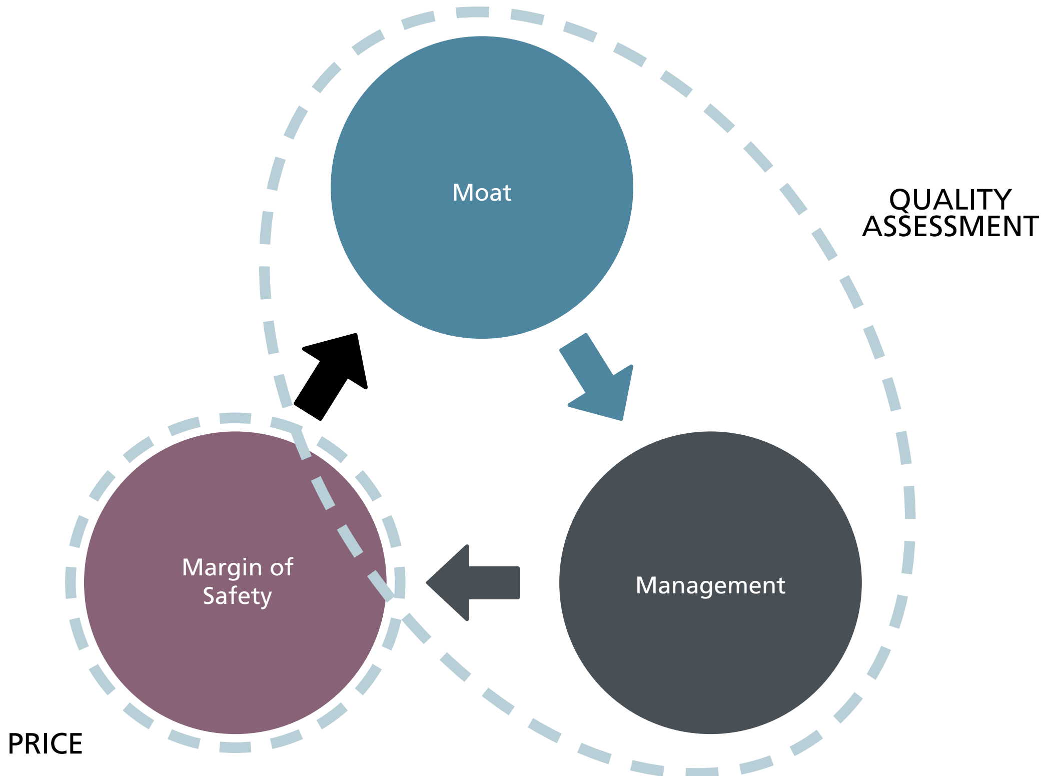
The COVID-19 crisis has caused dislocation in prices within financial markets. In the case of domestic sovereign bonds, we view the sell-off as mostly technical in nature and believe that the opportunity has been enhanced. In fact, our fair value analysis suggests that equity-like returns could be expected from this element of our portfolios. We expect volatility to remain high given the uncertainty around the exit of the lockdown and impact on the economy and fiscus. Accordingly, we have retained cash to deploy into further weakness or into opportunities that arise within the corporate credit or property markets.

A quick reminder of our 3M process

As investment professionals, we seek to generate consistent long-term returns for our clients. A robust and proven investment process is at the heart of our ability to do so consistently over time, even as market cycles come and go and stocks fall in and out of favour. We understand that generating strong long-term returns for our clients rests on the ability to buy low, invest for the long run and sell high.

To find the most attractive opportunities, we look in the uncrowded areas of the market that offer the best chance of mispricing (generally those characterised by fear, uncertainty or neglect). We further improve our chances of success by applying our 3M process.

The first two M's help us evaluate the quality of companies. These are the strength of **'management'** and evidence of a competitive advantage that serves as a **'moat'**, setting the company apart from its peers. Our third M is the **'margin of safety'**, reflected in how far a security is trading from its fair value (or, viewed differently, whether its current price is setting us up to 'buy low'). Essentially, we are looking for some inherent quality that the market might be missing. As a result, we tend to invest in companies that are as good as the market or better, but trading at a discount. We believe that if we apply this methodology consistently, we will tend to buy quality companies at affordable valuations, helping our clients in growing their investments over time.



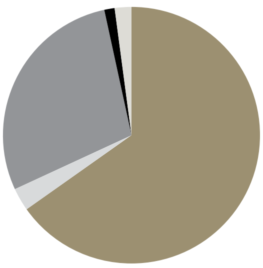
Portfolio holdings as at 31 March 2020

PSG Equity Fund

Top 10 equities

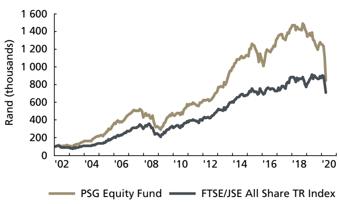
Discovery Ltd
Japan Post Insurance Co Ltd
Liberty Global Inc
Anheuser-Busch InBev
Glencore plc
AECI Ltd
Shoprite Holdings Ltd
JSE Ltd
Old Mutual Ltd
Prudential plc

Asset allocation



Domestic equity	65.2%
Domestic cash	2.9%
Foreign equity	28.5%
Foreign cash	1.3%
Foreign property	2.1%
Total	**100%**

Performance

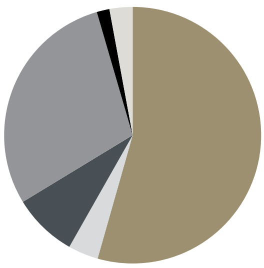


PSG Flexible Fund

Top 10 equities

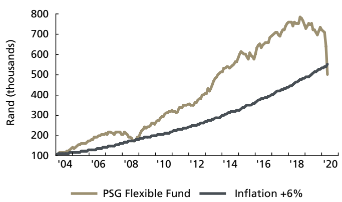
Discovery Ltd
Japan Post Insurance Co Ltd
Liberty Global Inc
Anheuser-Busch InBev
Glencore plc
Prudential plc
Shoprite Holding Ltd
AECI Ltd
Remgro Ltd
Old Mutual Ltd

Asset allocation



Domestic equity	54.4%
Domestic cash	3.8%
Domestic bonds	8.1%
Foreign equity	29.2%
Foreign cash	1.6%
Foreign property	2.9%
Total	**100%**

Performance

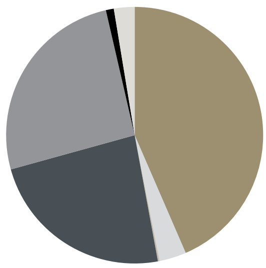


PSG Balanced Fund

Top 10 equities

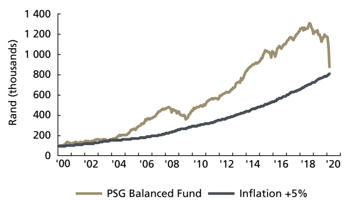
Discovery Ltd
Japan Post Insurance Co Ltd
Anheuser-Busch InBev
Prudential plc
Liberty Global Inc
JSE Ltd
AECI Ltd
Babcock International Group plc
The Mosaic Co
Shoprite Holdings Ltd

Asset allocation



Domestic equity	43.5%
Domestic cash and NCDs	3.4%
Domestic property	0.2%
Domestic bonds	23.6%
Foreign equity	25.7%
Foreign cash	1.0%
Foreign property	2.6%
Total	**100%**

Performance

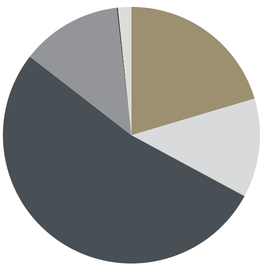


PSG Stable Fund

Top 5 equities
Anheuser-Busch InBev
Prudential plc
Discovery Ltd
Japan Post Insurance Co Ltd
JSE Ltd

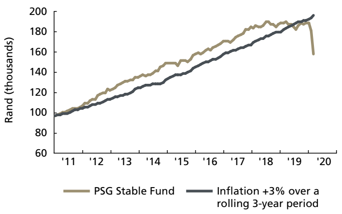
Top 5 issuer exposures
The Republic of South Africa
FirstRand Bank Ltd
Eskom Holdings SOC Ltd
Standard Bank of SA Ltd
Nedbank Ltd

Asset allocation



Domestic equity	20.4%
Domestic cash and NCDs	12.4%
Domestic property	0.1%
Domestic bonds	52.6%
Foreign equity	12.7%
Foreign cash	0.1%
Foreign property	1.7%
Total	**100%**

Performance

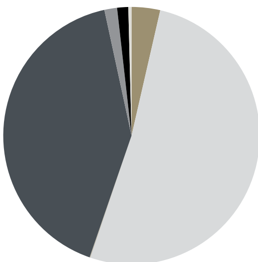


PSG Diversified Income Fund

Top 5 equities
Japan Post Insurance Co Ltd
JSE Ltd
Anheuser-Busch InBev
Prudential plc
AECI Ltd

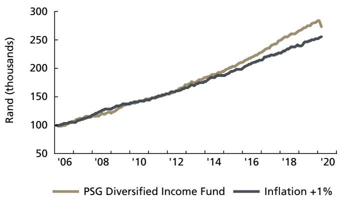
Top 5 issuer exposures
The Republic of South Africa
FirstRand Bank Ltd
Standard Bank Group Ltd
PSG Money Market Fund
Absa Bank Ltd

Asset allocation



Domestic equity	3.6%
Domestic cash and NCDs	51.6%
Domestic property	0.1%
Domestic bonds	41.3%
Foreign equity	1.6%
Foreign cash	1.4%
Foreign property	0.4%
Total	**100%**

Performance



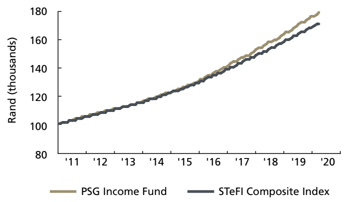
PSG Income Fund

Top 10 issuer exposures
Standard Bank of SA Ltd
FirstRand Bank Ltd
PSG Money Market Fund
Absa Bank Ltd
The Republic of South Africa
Nedbank Ltd
Capitec Bank Ltd
Eskom Holdings SOC Ltd
The Thekwini Fund 14 (RF) Ltd
The Thekwini Fund 15 (RF) Ltd

Asset allocation

Domestic cash and NCDs	73.6%
Domestic bonds	26.4%
Total	**100%**

Performance



PSG Money Market Fund

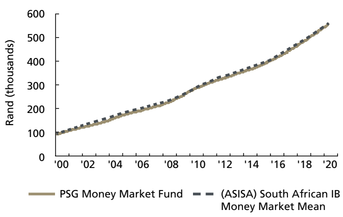
Issuer exposures

FirstRand Bank Ltd
Nedbank Ltd
Standard Bank of SA Ltd
Absa Bank Ltd
The Republic of South Africa
Investec Bank Ltd
Capitec Bank Ltd
The Thekwini Fund 14 (RF) Ltd

Asset allocation

Linked NCDs/Floating-rate notes	18.9%
Step-rate notes	22.0%
NCDs	23.7%
Treasury Bill	10.8%
Corporate bonds	8.3%
Call	16.3%
Total	**100%**

Performance

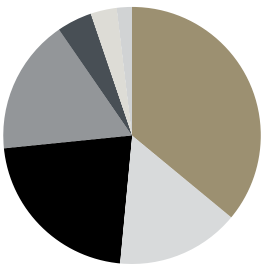


PSG Global Equity Sub-Fund

Top 10 equities

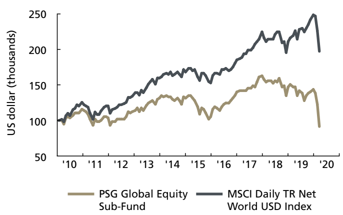
Japan Post Insurance Co Ltd
The Mosaic Co
Brookfield Asset Management Inc
Liberty Global Inc
Prudential plc
Resona Holdings Inc
L Brands Inc
Asahi Group Holdings Ltd
Glencore plc
Simon Property Group Inc

Regional allocation



US	36.0%
Europe	15.5%
UK	21.9%
Japan	17.0%
Canada	4.4%
Africa	3.3%
Cash	1.9%
Total	**100%**

Performance

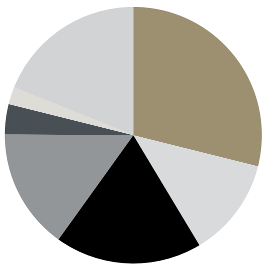


PSG Global Flexible Sub-Fund

Top 10 equities

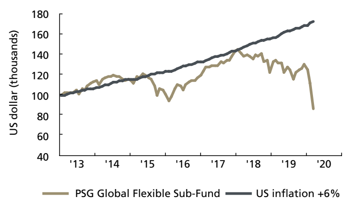
Japan Post Insurance Co Ltd
Brookfield Asset Management Inc
The Mosaic Co
Liberty Global Inc
Prudential plc
Asahi Group Holdings Ltd
L Brands Inc
Resona Holdings Inc
Glencore plc
Simon Property Group Inc

Regional allocation



US	28.9%
Europe	12.5%
UK	18.5%
Japan	15.2%
Canada	3.8%
Africa	2.2%
Cash and bonds	18.9%
Total	**100%**

Performance



Percentage annualised performance to 31 March 2020 (net of fees)

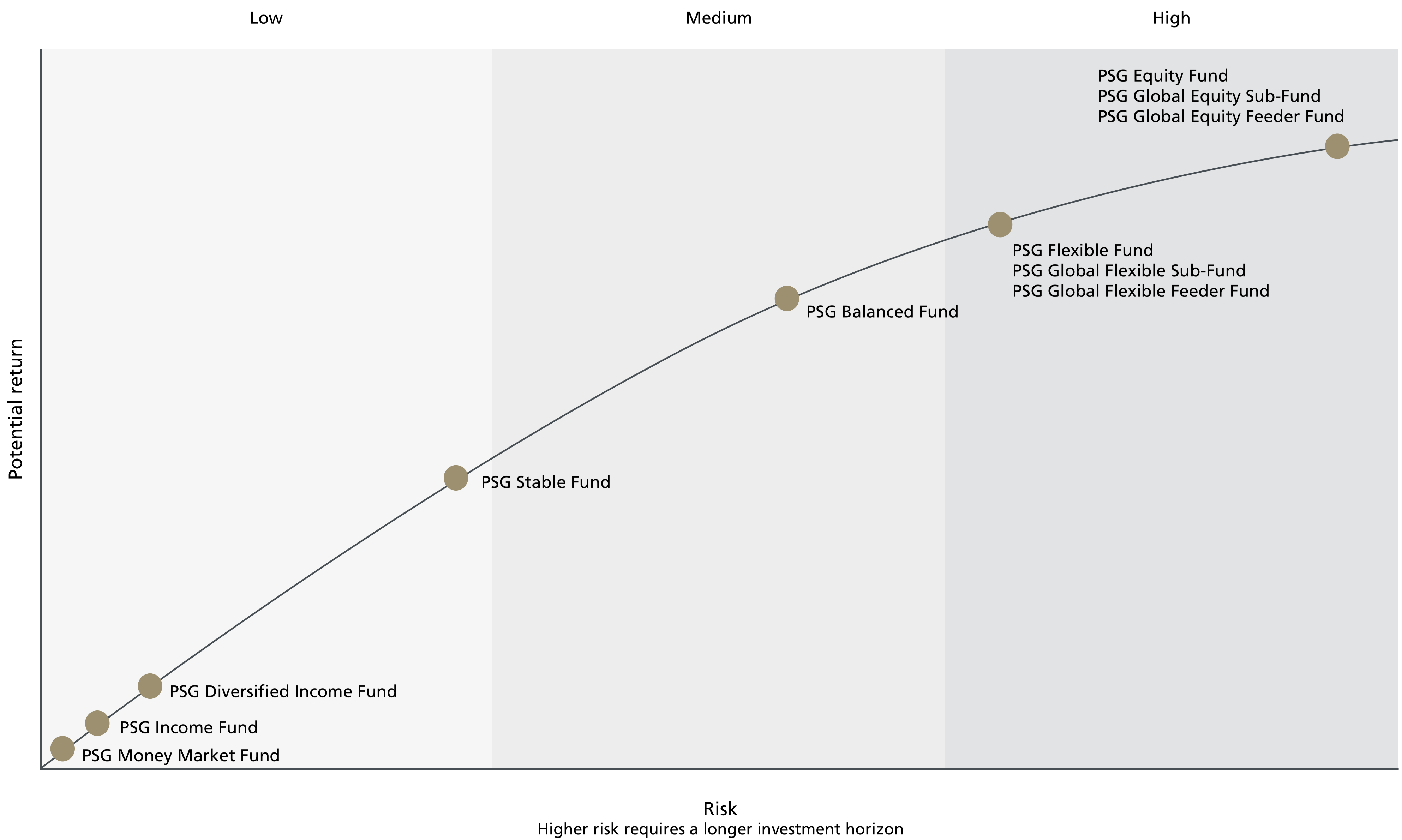
Local funds						
	1 Year	3 Years	5 Years	10 Years	Inception	Fund inception date
PSG Equity Fund A	-37.52	-14.97	-6.79	5.93	12.49*	31/12/1997
FTSE/JSE All Share Total Return Index	-18.38	-2.07	-0.13	7.67	11.45	
PSG Flexible Fund A	-32.87	-10.95	-3.51	6.93	11.00**	02/11/1998
Inflation +6%	10.61	10.21	11.18	11.14	11.65	
PSG Balanced Fund A	-28.02	-9.13	-2.86	5.85	10.90	01/06/1999
Inflation +5%	9.61	9.24	10.20	10.15	10.46	
PSG Stable Fund A	-15.56	-2.41	1.43		5.59	13/09/2011
Inflation +3% over a rolling 3-year period	7.62	7.24	8.20		8.21	
PSG Diversified Income Fund A	1.69	5.49	6.50	6.91	7.38	10/04/2006
Inflation +1%	5.62	5.24	6.20	6.15	6.87	
PSG Income Fund A	7.85	8.17	8.03		7.08	01/09/2011
STeFI Composite Index	7.20	7.31	7.22		6.54	
PSG Money Market Fund A	6.54	7.11	7.10	6.37	8.38	19/10/1998
South African Interest Bearing Money Market Mean	6.79	7.29	7.24	6.46	8.46	
PSG Global Equity Feeder Fund A	-26.76	-6.52	-0.67		7.25	03/05/2011
MSCI Daily Total Return Net World USD Index (in ZAR)	10.95	12.14	11.57		17.86	
PSG Global Flexible Feeder Fund A	-18.23	-3.24	1.49		7.44	11/04/2013
US inflation +6% (in ZAR)	34.09	18.85	16.67		18.93	

International funds						
	1 Year	3 Years	5 Years	10 Years	Inception	Fund inception date
PSG Global Equity Sub-Fund A	-38.94	-14.11	-7.21		-1.06	23/07/2010
MSCI Daily Total Return Net World USD Index (in USD)	-10.37	1.92	3.24		7.50	
PSG Global Flexible Sub-Fund A	-33.67	-11.95	-5.66		-1.89	02/01/2013
US inflation +6% (in USD)	8.32	8.02	7.96		7.63	

* Fund manager inception date 01/03/2002
** Current benchmark inception date 01/11/2004

Source: 2020 Morningstar Inc. All rights reserved as at end of March 2020.
Annualised performances show longer-term performance rescaled over a 12-month period.
Annualised performance is the average return per year over the period.
Past performance is not necessarily a guide to future performance.

Risk/reward profile



Unit trust summary

	South African portfolios							Rand-denominated offshore	
	PSG Equity Fund	PSG Flexible Fund	PSG Balanced Fund	PSG Stable Fund	PSG Diversified Income Fund	PSG Income Fund	PSG Money Market Fund	PSG Global Equity Feeder Fund	PSG Global Flexible Feeder Fund
Fund category (ASISA classification)	South African - Equity - General	South African - Multi Asset - Flexible	South African - Multi Asset - High Equity	South African - Multi Asset - Low Equity	South African - Multi Asset - Income	South African - Interest Bearing - Short-term	South African - Interest Bearing - Money Market	Global - Equity - General	Global - Multi Asset - Flexible
Investment objective	Aims to offer investors long-term capital growth without assuming a greater risk, and earn a higher rate of return than that of the South African equity market as presented by the FTSE/JSE All Share Index (including income).	Aims to achieve superior medium- to long-term capital growth by investing in selected sectors of the equity, gilt and money markets, both locally and abroad. The fund has a flexible asset allocation mandate and equity exposure will vary based on opportunity.	Aims to achieve long-term capital growth and a reasonable level of income for investors. The investment policy provides for the active management of the portfolio assets that include equities, bonds, property and cash, both domestically and in foreign markets.	Aims to achieve capital appreciation and generate a return of CPI+3% over a rolling three-year period with low volatility and low correlation to equity markets through all market cycles.	Aims to preserve capital while maximising income returns for investors. The portfolio comprises of a mix of high-yielding securities, property, bonds, preference shares and assets in liquid form (both local and foreign).	Aims to maximise income while achieving as much long-term capital appreciation as interest rate cycles allow.	Aims to provide capital security, a steady income and easy access to your money.	Aims to achieve capital growth over the long term with the generation of income not being the main objective of the portfolio. It is a rand-denominated equity feeder fund whose investment policy provides for it to invest solely in the PSG Global Equity Sub-Fund.	Aims to achieve superior medium- to long-term capital growth through exposure to selected sectors of the global equity, bond and money markets. It is a rand-denominated feeder fund whose investment policy provides for it to invest solely in the PSG Global Flexible Sub-Fund.
Benchmark	FTSE/JSE All Share Total Return Index	Inflation +6%	Inflation +5%	Inflation +3% over a rolling 3-year period	Inflation +1%	STeFI Composite Index	South African - Interest Bearing - Money Market Mean	MSCI Daily Total Return Net World USD Index (in ZAR)	US inflation +6% (in ZAR)
Risk rating	High	Moderate - High	Moderate - High	Moderate	Low - Moderate	Low - Moderate	Low	High	Moderate - High
Time horizon	7 years and longer	5 years and longer	5 years and longer	3 years and longer	2 years and longer	1 year and longer	Minimum of 1 day	7 years and longer	5 years and longer
The fund is suitable for investors who:	• want an equity focused portfolio that should produce high real returns above inflation and capital appreciation over the long term • are comfortable with significant stock market fluctuations • are willing to accept potential capital loss • have a long-term investment horizon of seven years and longer	• want exposure to the equity market, but with managed risk levels • aim to build wealth • are willing to accept potential capital loss • have a medium- to long-term investment horizon of five years and longer	• aim to build wealth with a balanced portfolio that diversifies the risk over the various asset classes • are comfortable with market fluctuation risk • are willing to accept potential capital loss • would prefer the fund manager to make the asset allocation decisions • have an investment horizon of five years and longer	• have a low risk appetite but require capital growth in real terms • have a medium-term investment horizon of three years and longer	• have a low risk appetite • want to earn an income, but need to try and beat inflation • have a short- to medium-term investment horizon of two years and longer	• have a low risk appetite • require an income • have an investment horizon of one year and longer	• seek capital stability, interest income and easy access to their money through a low risk investment • need an interim investment vehicle or 'parking bay' for surplus money • have a short-term investment horizon	• want exposure to global equities without personally expatriating rands • are comfortable with international equity market and currency fluctuations • have a long-term investment horizon of seven years and longer	• want exposure to global equities without personally expatriating rands • are comfortable with international equity market and currency fluctuations • have a long-term investment horizon of five years and longer
Net equity exposure	80% - 100%	0% - 100%	0% - 75%	0% - 40%	0% - 10%	0%	0%	80% - 100%	0% - 100%
Income distribution	Bi-annually	Bi-annually	Bi-annually	Bi-annually	Quarterly	Quarterly	Monthly	Annually	Annually
Minimum investment	As per the platform minimum	As per the platform minimum	As per the platform minimum	As per the platform minimum	As per the platform minimum	As per the platform minimum	R25 000 lump sum	As per the platform minimum	As per the platform minimum
Fees (excl. VAT)	Annual management fee: Class A: 1.50%	Annual management fee: Class A: 1.00% + 7.00% of outperformance of high watermark	Annual management fee: Class A: 1.50%	Annual management fee: Class A: 1.50%	Annual management fee: Class A: 1.00%	Annual management fee: Class A: 0.65%	Annual management fee: Class A: 0.50%	Annual management fee: Class A: 0.75%	Annual management fee: Class A: 0.75%
Compliance with Prudential Investment Guidelines (Regulation 28)	No	No	Yes	Yes	Yes	No	Yes	No	No

For full disclosure on all risks, costs and fees, as well as performance fees FAQ, refer to the fund fact sheets on our website: www.psg.co.za/asset-management

Contact information

Local unit trusts
0800 600 168
local.instructions@psgadmin.co.za

Offshore unit trusts
0800 600 168
offshore.instructions@psgadmin.co.za

General enquiries
+27 (21) 799 8000
assetmanagement@psg.co.za

Websites
www.psg.co.za/asset-management
www.psgkglobal.com

Cape Town office

Physical address
First Floor, PSG House
Alphen Park
Constantia Main Road
Constantia
Western Cape
7806

Postal address
Private Bag X3
Constantia
7848

Switchboard
+27 (21) 799 8000

Guernsey office

Address
11 New Street
St Peter Port
Guernsey
GY1 2PF

Switchboard
+44 (1481) 726034

Malta office

Address
Unit G02
Ground floor
SmartCity Malta
SCM 01
Ricasoli
Kalkara
SCM 1001

Switchboard
+356 (2180) 7586

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Trustee: The Standard Bank of South Africa Limited, The Towers, 2 Heerengracht Street, Cnr Hertzog Boulevard, Cape Town, 8001. Tel: +27 (21) 401 2443. Email: Compliance-PSG@standardbank.co.za. **Conflict of Interest Disclosure:** The funds may from time to time invest in a portfolio managed by a related party. PSG Collective Investments (RF) Limited or the Fund Manager may negotiate a discount in fees charged by the underlying portfolio. All discounts negotiated are re-invested in the fund for the benefit of the investor. Neither PSG Collective Investments (RF) Limited nor PSG Asset Management (Pty) Limited retains any portion of such discount for their own accounts. The Fund Manager may use the brokerage services of a related party, PSG Securities Limited.

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Date issued: 11 May 2020

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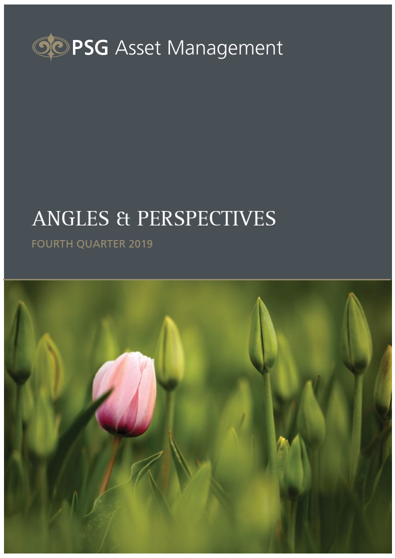

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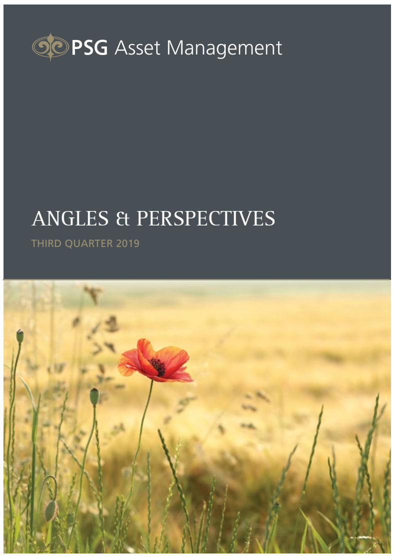

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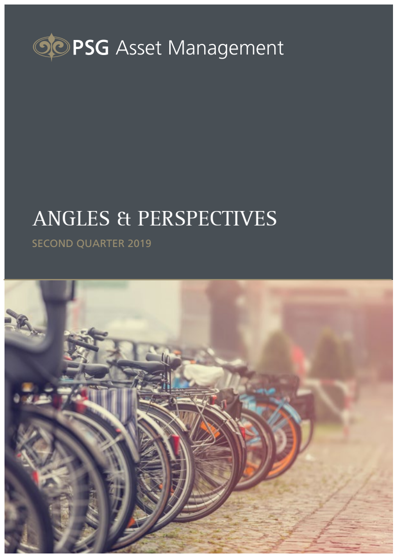

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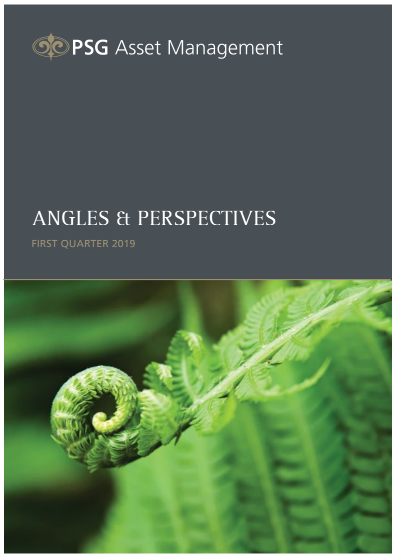

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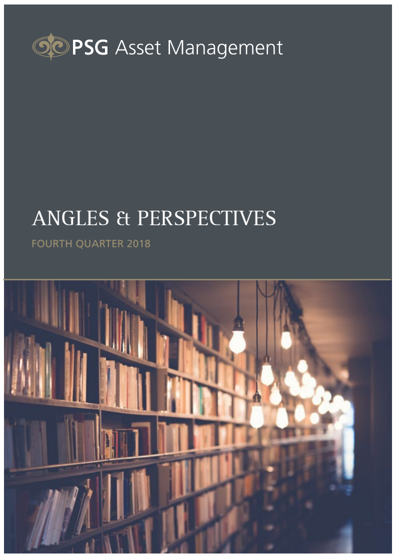

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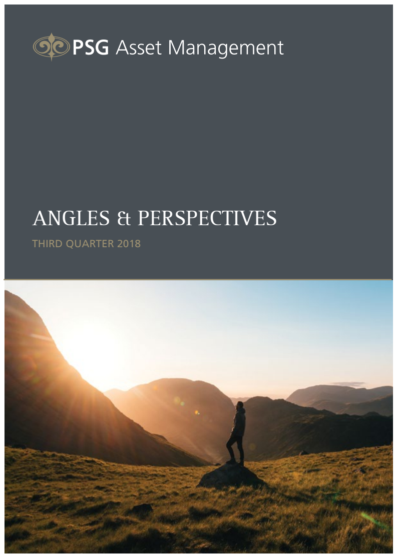

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