PSG Asset Management

Angles & Perspectives

First Quarter 2021

Contents

At PSG Asset Management, part of our commitment to investors is that we remain 'true to the label' of differentiated investing, with a focus on balancing value and quality.

Introduction

Anet Ahern

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.

True to the label

Markets are cyclical by nature. This means no single sector, stock or geography remains in the lead indefinitely. There are also many different approaches to investment and endless debates about the 'best' approach. Market cycles often overlap and intersect, and this can present pitfalls to unwary investors if they lock in losses by switching between strategies at the wrong time.

Part of our commitment to investors, is that we remain 'true to the label' of differentiated investing, with a focus on balancing value and quality. We seek to find great companies that are underappreciated by the market. This enables us to buy companies with robust value propositions and bright future prospects at a discount, enhancing our chances of selling them later at a profit or enjoying the compounding benefits of being long-term holders.

This process might seem simple, but it requires a high degree of commitment to non-emotional decision-making and a fixation on in-depth research. It is our commitment to our proven 3M philosophy that enables us to continue finding great investments, regardless of where the market finds itself. There is no single sector or stock that is always in favour. There is always an opportunity to find mispriced value. This has never been more true than at the current time.

While aggregate index levels may indicate markets are overpriced, we find wide divergences in the markets and ample opportunities to buy quality at deep discounts. We are excited by current conditions, because – despite the many challenges – we understand the immense potential that is hidden beneath the surface, especially for patient, long-term investors.

In the first article, Fund Manager Justin Floor argues that The best years of our investment value proposition lie ahead. As we are differentiated managers, our performance can be out of step with that of the market at times. The most recent drawdown, which culminated in early 2020, lasted longer and was deeper than we would have liked. Looking ahead, however, we remain convinced of the value our approach can add to client portfolios. We are encouraged by the differentiated and attractive positioning our portfolios offer clients and believe this unique outlook will become increasingly valuable to investors looking to navigate markets going forward.

In the second article, Fund Manager Shaun le Roux explains Why our funds remain offensively positioned when equity markets are high. Clients will be familiar with our tendency to hold high levels of cash when markets are expensive and risk appetite is high – a case of being fearful when others are greedy. Yet cash levels in our funds are currently low and our funds remain offensively positioned. Shaun argues this is entirely in keeping with the consistent application of our investment process, which continues to identify very compelling investment prospects.

In our final article, Fund Manager Dirk Jooste explores our portfolio construction process in Blending our best ideas: Lifting the lid on the asset allocation of our multi-asset portfolios. Dirk explains why our asset allocation process always starts by considering the risk-adjusted returns above what can be earned on cash. He then sets out how we aim to allocate capital to our best ideas, balancing risk and potential reward, in line with the client and mandate needs.

We trust that you will find these articles insightful, and their guidance valuable, in these turbulent times.

There is no single sector or stock that is always in favour. There is always an opportunity to find mispriced value.

Justin Floor

Assessing our investment approach

Justin joined PSG Asset Management as a Fund Manager on the PSG Balanced Fund in 2019. He is a qualified actuary and a CFA charterholder, and has over 10 years' investment experience.

The woods are lovely, dark and deep,
But I have promises to keep,
And miles to go before I sleep,
And miles to go before I sleep.

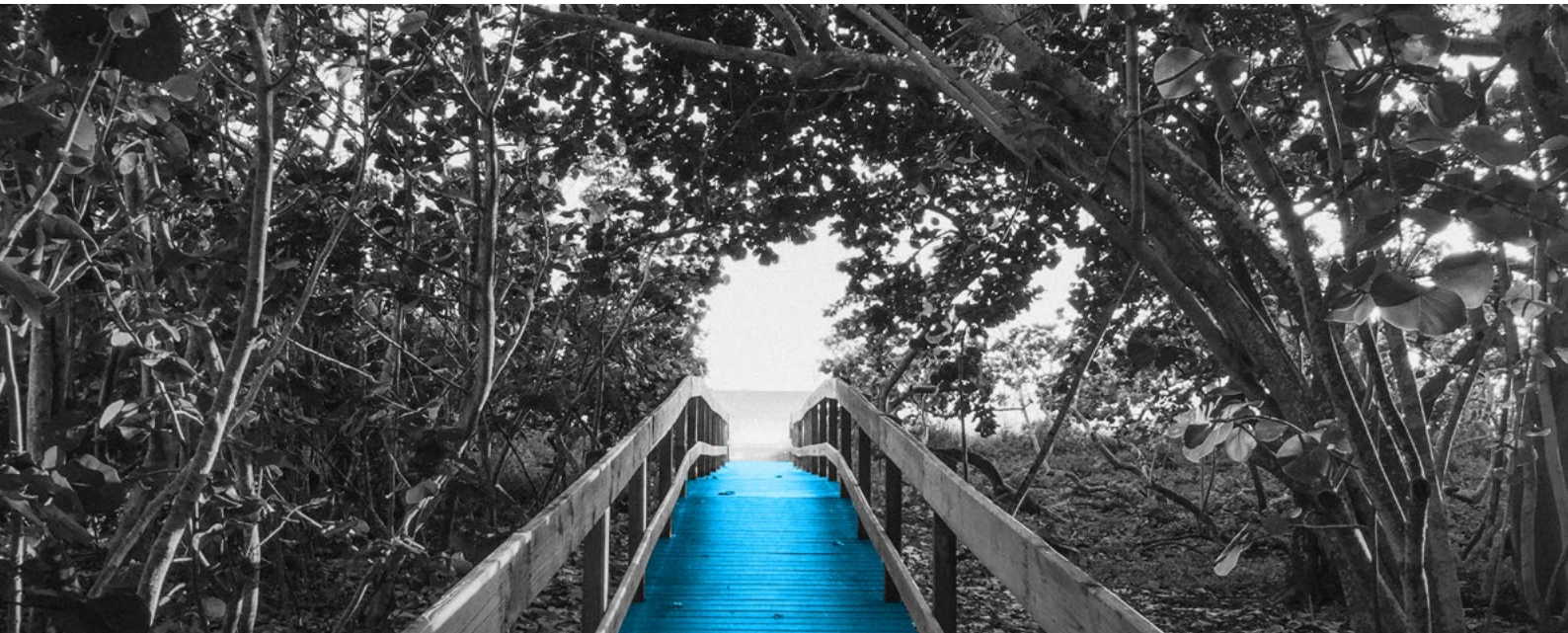
– Robert Frost

The best years of our investment value proposition lie ahead

As we are differentiated managers, our performance can be out of step with that of the market from time to time. The most recent drawdown, which culminated in early 2020, lasted longer and was deeper than we would have liked. Looking ahead, however, we remain convinced of the value our approach can add to client portfolios. We are encouraged by the differentiated and attractive positioning our portfolios offer clients and believe this unique outlook will become increasingly valuable to investors looking to navigate the deep (and sometimes lovely) forests of investment markets going forward.

Buying good businesses for less than they are worth is at the heart of what we do

Our 3M investment philosophy provides a shared basis for the consistent and repeatable approach our investment team employs. The focus of our process is on buying businesses at prices below the value implied by the quality of their cash flow (moat) and the management responsible for stewarding it.



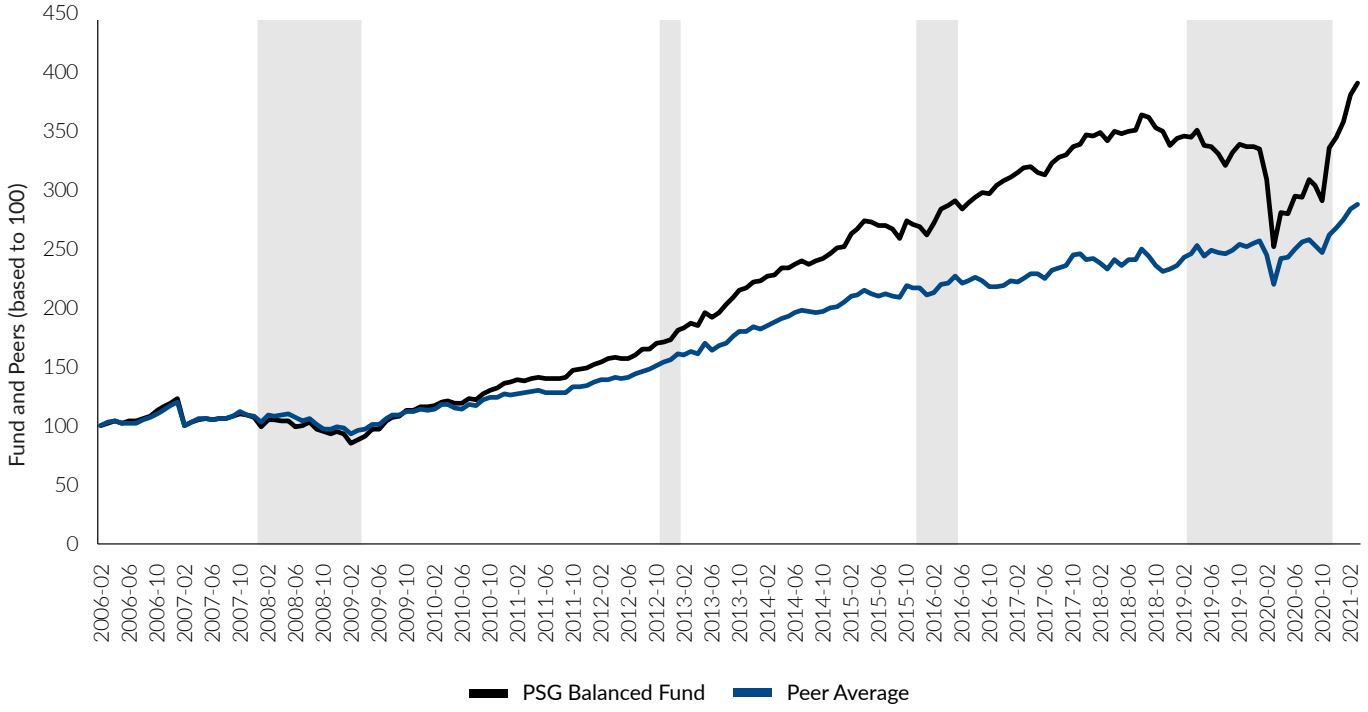
While simple, our approach has some notable characteristics:

- Our focus on margin of safety means that we believe price eventually always matters. As a result, our portfolios can underperform in periods where the market shuns valuation as a pricing mechanism.
- Our focus on price and undervaluation attracts us to situations where fear or uncertainty obscures the underlying quality or growth of cash flows (perhaps due to temporary challenges). As a result, we tend to allocate capital counter-cyclically and can sometimes appear contrarian.
- We don't reference market indices or benchmarks when constructing portfolios and so our portfolios can look very different to others. We believe this benchmark agnostic approach is a necessary, but not sufficient, criterion for the long-term outperformance objectives we set ourselves.
- We employ a long-term approach and patiently wait for underlying attributes to be recognised by the market.
- Our moat and management focus are the bedrock of our environmental, social and governance (ESG) philosophy and we strive to take a balanced and responsible approach to evaluating ESG.

Our multi-asset funds have a cash-first approach to portfolio construction and we believe cash can play a valuable role in portfolios under most conditions (see Dirk Jooste's article Blending our best ideas: Lifting the lid on the asset allocation of our multi-asset portfolios).

Importantly, we do not self-identify as deep value managers. We would describe our approach as a bottom-up focus on buying slices of businesses. Some of our best past and current ideas seek to identify quality and growth before they become visible in the market (and are priced accordingly). This approach has worked well for long periods of time (see chart below). Note the MDD for the PSG Balanced Fund is available here.

PSG Balanced Fund: Performance history



Source: Morningstar, PSG Asset Management. Grey shaded area represents periods where the fund underperformed peers over rolling 12 months.

Our approach impacts the performance of our portfolios

Disciplined and patient application of our investment process has resulted in significant outperformance since inception. Notably, this performance does not come in a straight line, with several notable periods where the fund underperformed (2009, 2012, 2016 and 2020), indicated in grey in the chart above.

While occasional episodes of underperformance are to be expected for a differentiated, high-conviction process such as ours, the most recent period of underperformance was particularly severe, both in extent and duration (it lasted approximately 18 months). It is therefore understandable and appropriate that many of our investors are asking if our investment approach is still relevant or whether it is 'broken'.

Unpacking the recent episode of underperformance

We believe the following factors, which were all manageable in isolation, had an unusually severe impact on our style of investing and our client portfolio performance when combined.

Global and local investment environment:

- An extended period of low global interest rates, driven by a combination of persistently low inflation and sustained monetary accommodation, has contributed to dampening the rewards usually evident in seeking out undervalued securities.
- The rising trend (particularly globally) of passive investing had a profound impact on market structure (including contributing to ongoing momentum in large cap shares).
- The largest divergence in recorded history between expensive (large cap quality and growth equities) and cheaper parts of the market. Price became a lot less relevant as a contributor to future performance.
- The most severe and extended emerging market and SA-specific economic downturn on record.

Our portfolio actions:

- A material contributor to a disappointing outcome in recent years was that we were too early to sell out of some large cap US shares (e.g. Microsoft and Apple were significant holdings a few years ago) and resources companies. The areas where we found value instead (for example, out-of-favour global cyclical shares and SA financials and industrials) were cheap, but continued getting cheaper. While our positioning is now starting to pay off handsomely, we were far too early in our positioning.
- We got a few isolated stock selections wrong (our 2018 and 2019 investments in Tongaat and EOH were notable examples we have written about previously), which was especially disappointing given we had successfully avoided some of the market fall-out from counters such as Steinhoff, Resilient and Aspen prior to that.

Covid-19 itself:

The radical government-mandated lockdowns and suppression of normal human interactions severely impacted some companies, especially those reliant on social and physical operating modes, while it benefited others (typically more digitally enabled ones). This divergence was in many cases made worse by poor liquidity conditions, resulting in abnormal divergences between price and underlying business volatility.

As the stewards responsible for our clients' capital, we were disappointed by the extent of the recent underperformance. We expect portfolio and process enhancements to contribute to a smoother client journey in the future, while jealously guarding the essence of our differentiated approach to generating outperformance.

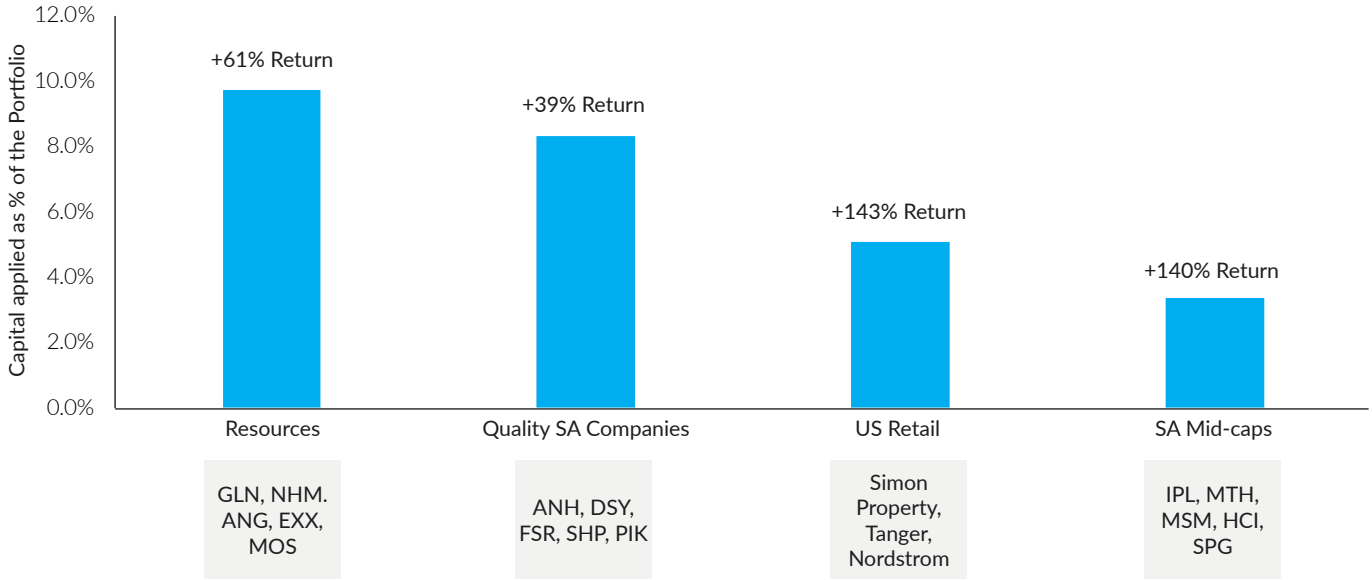
We believe our investment proposition will become increasingly valuable

The market crash of 2020 has been followed by a substantial recovery in asset prices and our investment positioning has started to be rewarded. We have seen encouraging progress over the last year, and we believe our investment approach will become increasingly valuable and relevant for investors in the year ahead as well.

In particular, the following supporting points are worth noting:

- Our investment team has been stable through the challenges of 2019 and 2020, and we have applied our investment philosophy consistently, setting aside emotion to buy undervalued businesses and taking a patient approach.
- Early 2020 offered a once-in-a-generation opportunity to deploy capital into high-quality businesses at exceptional prices. Our investment process is extremely well suited to exploiting such an opportunity. The chart below shows the areas we allocated capital to during 2020, and the returns that followed. Opportunities were ruthlessly and unemotionally assessed, and the portfolios came out of the crisis in much better shape than they went in.

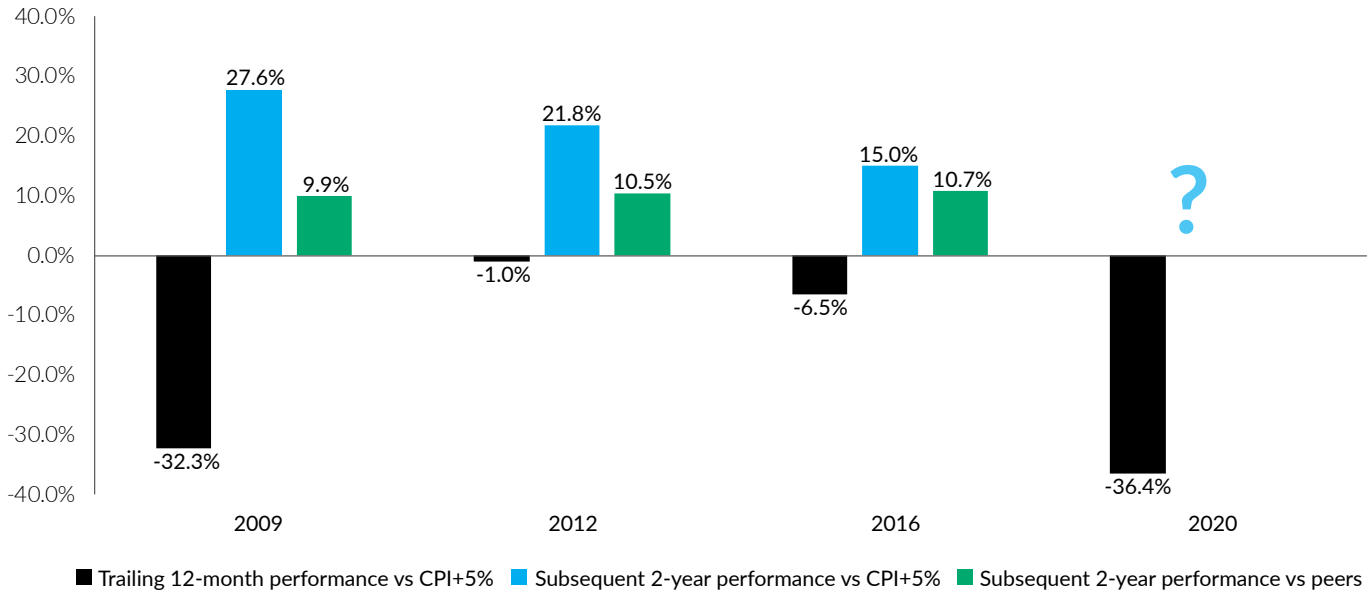
PSG Balanced Fund: Top portfolio purchases and subsequent average returns in 2020



Source: PSG Asset Management

- Our portfolios offer a unique component of differentiation relative to large peers and benchmark indices that are broadly invested in very narrow and crowded areas. Many of our best mid-cap ideas simply cannot be exploited by large managers. We expect our portfolios to play an important role within a well-blended solution.
- Historical experience demonstrates that periods of underperformance are always followed by strong and sustained recoveries in absolute and relative performance (see chart below). A defining feature of our investment process is that our best years typically follow periods of disappointment. We have no reason to believe this time will be any different.

PSG Balanced Fund: performance following periods of underperformance



Source: Morningstar data, PSG Asset Management

Our investment approach makes a powerful addition to client portfolios

2020 was a challenging year with an unusual number of surprises and uncertainties. Throughout this period, it was critical to put emotions aside and make good decisions, guided by a sensible and tested investment approach.

This is exactly what our team aimed to do, and we believe it has enabled us to exploit once-in-a-generation opportunities many other managers may have missed. We believe our investment approach presents a particularly valuable proposition for investors at present.

Why our funds remain offensively positioned when equity markets are high

Shaun le Roux

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.

We anticipate very divergent future returns from stock markets. A strong case can be made for excellent long-term returns from a carefully selected active portfolio.

We recently marked the one-year anniversary of the lows reached during the pandemic-induced panic of March 2020. If you had predicted at the time that the S&P 500 would be 78% higher a year later, psychiatric observation would have been suggested. With markets hitting all-time highs in recent weeks and many prominent examples of the frothiness, manias and bubbles that we associate with late-cycle bull markets on display, caution is justified. There have recently been many examples of very speculative or aggressive market behaviour and the likes of Tesla, Dogecoin, Archegos, special-purpose acquisition vehicles (SPACs), non-fungible tokens (NFTs), Gamestop and ARK have offered telling insights into market temperature. Clients will be familiar with our tendency to hold high levels of cash when markets are expensive and risk appetite is high – a case of being fearful when others are greedy. Yet cash levels in our funds are currently low and our funds remain offensively positioned. However, this is entirely in keeping with consistent application of our investment process, which continues to identify very compelling investment prospects.

If you are prepared to look within markets, you should come to a very different conclusion to the building narrative that all stocks are expensive and defensive positioning is warranted.

We argue that the capital cycle has given rise to extremities and distortions in positioning and prices that provide a very favourable environment for bottom-up stock-pickers like ourselves. We focus on the price paid and take a long-term view. Accordingly, we expect stock portfolios that our clients own to both handsomely beat the market and generate strong returns over the next few years.

The broader South African investor base has become very pessimistic. Poor returns from local assets and high levels of emotional stress continue to make offshore investments popular and an easy sell for banks and some financial advisers. While we strongly support portfolio diversification and favour healthy offshore exposure for high net worth individuals, we question the wisdom of the ongoing panic to reduce cheap domestic equities in favour of expensive global stocks (or domestic cash). Further to the scramble offshore, local investors have also been selling equity-heavy local unit trusts and migrating to cash and fixed income. The Association for Savings and Investment (ASISA) statistics (as at 31 December 2020) show that 2020 was a record-breaking year for the local investment industry, taking R213 billion in net annual inflows. SA interest-bearing portfolios continued to attract the bulk of inflows, while the SA equity sector recorded a second year of net outflows. In their bid to avoid volatility, investors have even started shying away from historically popular multi-asset portfolios: the sector only recorded R3 billion in net inflows for 2020.

Domestic equities have endured a triple whammy: foreigners have been multi-year sellers, institutions have dramatically reduced their weightings to multi-decade lows, and retail investors have fled into cash and offshore. This has given rise to extremely depressed prices, especially during the crisis of last year. What worries us most is that this behaviour is persisting and end-investors are likely truncating future portfolio returns by selling very low and buying very high. What is lost in times of stress and emotion is the fact that investment markets move in cycles, and if capital leaves and prices become depressed, the seeds for high future returns are sown. Conversely, buying expensive assets always reduces the odds of achieving high future returns. At current ultra-low yields, investors may end up paying dearly for the 'comfort' of the perceived safety that cash offers, especially in light of the pitiful protection it offers against future inflation – we believe cash is the most expensive it has been in modern times. Yet, SA investors have aggressively moved out of cheap equities into cash. Similarly, the passive or mega-cap offshore investments currently preferred by pessimistic locals are extremely expensive relative to history, making it difficult to argue for favourable future returns. Let the buyer beware.

As is usually the case, panic selling of stocks by both locals and foreigners during last year's crisis gave rise to a rarely seen buying opportunity. The most acute opportunity arose in the stocks that were already cheap coming into the crisis and which were still dumped during the panic: unloved cyclical industries and out-of-favour geographies like emerging markets, the UK and Japan were severely punished. Market panic within a very unbalanced market has created the most favourable environment for differentiated investing in two decades. We have been able to buy fantastic businesses set for explosive profit growth at depressed prices – a powerful combination. This explains why the PSG Equity Fund is 75% higher than the lows of March 2020.

Despite a strong recovery over the past year, our conviction in the expected long-run returns from the companies that our clients own remains high.

Our 3M process sees us preferring to invest in quality businesses that are being overlooked or under-appreciated by the market. Extreme market conditions of recent years were exacerbated by the turmoil and uncertainty of 2020, dishing up very attractive opportunities to identify cheap stocks where inherent quality was being obscured. Examples include some of our larger fund holdings discussed below. We are confident that these companies will enjoy strong profit growth over the next few years, initially as a result of a post-pandemic recovery and thereafter as a result of their strong market positions. Most importantly, our clients own stocks that are still cheap – particularly when compared to the elevated levels of the well-owned winners of the past few years.

Discovery

2020 was a tough year for life assurers. Discovery put in a strong operational performance and, given the conservative level of Covid-19 provisioning and anticipated decline in investment spend, the company is very well positioned for several years of above-market profit and cash flow growth as its new and emerging businesses begin to reach scale. It is extremely attractively priced, as it appears that the relevance and competitive advantage of its shared-value platform is under-appreciated by the domestic investor base. In short: it's a local fintech champion with a long global runway.

Remgro

2020 provided an excellent opportunity to acquire this quality share with an 'SA Inc.' label. There are several attractive features to this investment case. As an investment company, it trades at a very wide discount (40% plus) to a quality portfolio of underlying investments that are all cheap in their own right: Mediclinic, RMI, Distell, CIVH (the telecoms infrastructure player), RCL Foods, etc. We expect management to take advantage of the opportunity to close the wide discount. The investee companies look well positioned to enjoy strong growth in profits and cash flow from this point in time.

AB InBev

AB InBev is a global brewing champion that owns seven of the world's ten largest beer brands. The company endured strong headwinds in most of its key markets last year, suppressing earnings and drawing attention to the high levels of debt on the balance sheet. We think this situation has obscured the degree to which the company has sensibly locked in extremely low costs of finance and built a platform that will enjoy strong and sustainable growth as it leverages its competitive advantage in both mature and growth markets. The share is very cheap relative to our assessment of earnings power, which we believe will materialise in a few years to come.

Imperial

Imperial is a logistics company that is undergoing a transformation. It has unbundled Motus, sold its European shipping business and streamlined its domestic consumer business. Imperial is intending to sell its remaining European assets and concentrate on two areas: a mature domestic logistics player with high market share and a growing African market access business. The transformation of the group has coincided with severe Covid-19 disruption in 2020, obscuring the earnings power and return potential of the new-look business. We expect the market to recognise the company's inherent quality and earnings potential in time. Covid-19 highlighted the essential nature of a logistics network. This is a deeply relevant business, yet the company trades at an extraordinarily low multiple of sustainable cash flow.

AECI

AECI is a good example of the opportunities that lie outside the Top 40 on the JSE. This mid-cap explosives and chemicals manufacturer has generated well above market returns for most of the past two decades. Yet, the lack of interest in local companies and the extra risk premium afforded to 'lower liquidity' companies saw this business trade at around six times normalised earnings (and a 10% forward dividend yield) in 2020. Operational performance last year was robust, and we are constructive on the path to higher returns on capital, as the underlying businesses are sound and prospects are favourable. It remains extremely cheap.

The stocks discussed above are excellent case studies of the opportunities that the market is currently providing to buy great businesses at wide margins of safety (or discounts to intrinsic value). These stocks are very cheap relative to the cash flows that we expect them to produce over the next few years – PSG Equity Fund clients are invested in domestic and global stocks that trade at 69% of what we think they are worth. This explains the low levels of cash in our funds. We believe patience will be rewarded for those who can look past the manias and extremities of today. Our clients have always been well rewarded by owning good businesses with solid prospects at cheap prices. This is very fertile ground for a differentiated approach.

While we strongly support portfolio diversification and favour healthy offshore exposure for high net worth individuals, we question the wisdom of the ongoing panic to reduce cheap domestic equities in favour of expensive global stocks (or domestic cash).

Blending our best ideas: Lifting the lid on the asset allocation of our multi-asset portfolios

Dirk Jooste

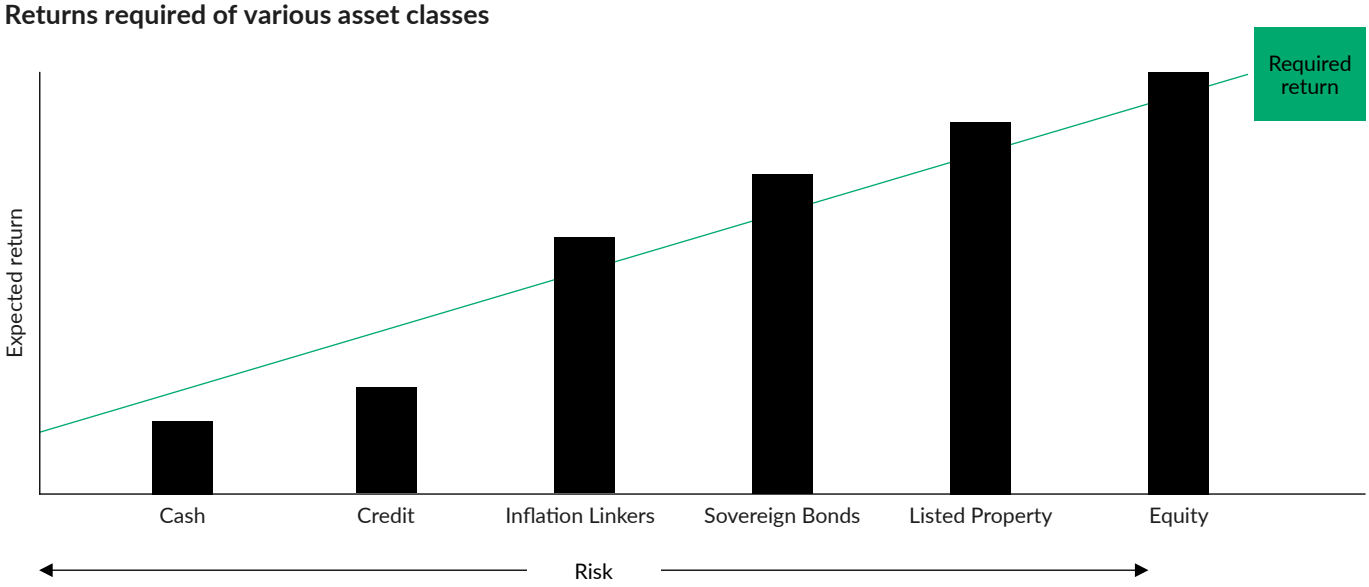
Dirk joined PSG Asset Management in August 2017. He is a CFA charterholder and has 10 years' investment experience.

Our multi-asset process starts by considering cash

Multi-asset funds can invest across multiple asset classes to meet their portfolio objectives. We aim to allocate capital to our best ideas, balancing risk and potential reward, in line with the client and mandate needs.

Our default position is always cash, and we will only allocate to opportunities that offer sufficient risk-adjusted returns above what can be earned on cash. Every security has a return hurdle based on the risks associated with investing in it. We allocate capital on a bottom-up basis, as the expected returns exceed these required return hurdles. The expected return is a function of the current market price.

Returns required of various asset classes



Source: PSG Asset Management

Our clients should be aware that our portfolio construction process has the following characteristics. We:

- Deliberately employ a countercyclical approach, as we tend to allocate capital to securities with high expected future returns. This often happens when prices are depressed and sentiment is weak.
- Follow a cash-first approach and will run with sizeable cash holdings if the alternatives are unattractive.
- Can be positioned very differently to other market participants and do not use strategic asset allocation.
- Are careful not to overpay, even as we actively seek out securities providing insurance or low correlation to our other ideas (therefore improving diversification).
- Take a patient, long-term approach. Sometimes it takes time for undervaluation to translate into higher prices.

In constructing multi-asset class portfolios, we draw the best ideas from across asset classes

Our portfolio construction seeks to blend our team's best ideas for all available asset classes. The objective is to reach an optimal balance of risk and return and to ensure a satisfactory outcome in as many scenarios as possible. While many investors may associate multi-asset funds with the higher-risk balanced funds (which can hold up to 75% in equities, like the PSG Balanced Fund), there are also multi-asset funds with more moderate risk profiles and a lower allocation to equities (like the PSG Stable Fund, with a maximum of 40% in equities, and the PSG Diversified Income Fund, with a maximum of 10% in equities). As the asset allocation changes in line with our process and where we see opportunities emerge, these funds offer a dynamic solution to changing market conditions, while remaining aligned to the stated fund objective.

We believe that, considering the poor expected returns from cash and income assets (as detailed in **Our asset class views** below), income investors who are able to extend their time frames slightly, should consider how low equity multi-asset funds can be used to address their income needs. These funds offer a compelling alternative to more cautious income-seeking investors who are willing to tolerate some additional volatility.

Our asset class views

Cash and credit

The South African Reserve Bank (SARB) benchmark repo rate has been cut by 300 basis points to a 55-year low of 3.5%, in a decisive response to the Covid-19 pandemic. In turn, yields on cash and money market instruments, which are determined by a combination of market forces and the repo rate, have fallen too.

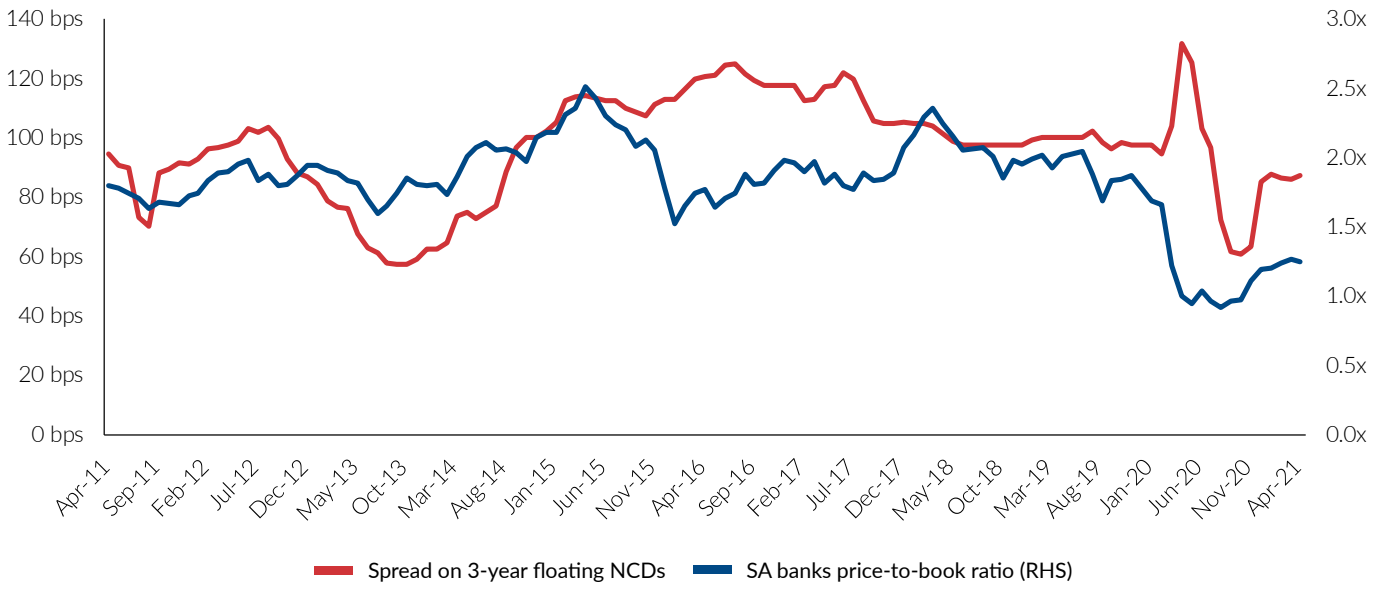
Our sense is that the current cash market is complacent about inflation and it seems likely that cash and money market instruments will deliver very poor (possibly negative) real returns from current levels. Like much of the global fixed income market, in the SA cash space, risk-free return appears to have turned into return-free risk.

The fortunes of the credit and cash markets are inextricably bound together, as most of the credit market issuance occur on a floating-rate note basis, with an additional credit spread over a base rate, such as JIBAR (which floats in line with the repo rate).

Over the last year, we have observed a substantial decline in both components of the return on credit: base rates (as the repo rate has been cut) as well as credit spreads, which have compressed materially.

The compression in credit spreads (most visible in corporate bonds and money market instruments issued by the domestic banking sector) stands at odds with both the current economic environment and other asset prices. The chart below highlights how credit spreads for 3-year bank paper fell to decade lows (approximately 60 basis points above JIBAR) while bank equity valuations (proxied by the price-to-book ratio) are signalling much more fear. It is clear that investors are currently being paid more to take the equity risk, as opposed to the credit risk of the same issuer.

Share valuations reflect fear while credit spreads show complacency



Sources: PSG Asset Management; Bloomberg

We think this disconnect can be explained by classic supply and demand: caution and good historical real returns have resulted in a 'dash to cash', as seen by substantial net flows into income funds in the ASISA statistics. Meanwhile, this demand has not been matched by supply: the issuers (mainly banks) have slowed lending and retail deposits have surged as bank customers fled to safety. The result is that wholesale credit instrument issuance (supply) has fallen at the same time. Consequently, credit spreads have responded by narrowing (i.e. providing smaller additional returns over the JIBAR rate).

These supportive dynamics have a high likelihood of reversing. It is likely that holding cash, which is the traditionally safe asset class, has become significantly more risky. Poor liquidity and thin trading volumes in the secondary market magnify these risks further.

We are still appreciative of cash as a default position and for the intangible benefits it can provide as dry powder. However, we have low allocations to cash and credit compared to our historical holdings and are instead allocating to alternatives such as short-dated inflation-linked bonds and selected defensive and undervalued equities. In some funds, we have opted to use equity hedging instruments rather than cash holdings for defensive purposes.

Government bonds

We continue to favour SA government bonds.

We are well aware of the precarious fiscal position South Africa finds itself in. However, it is important to put the fears around Government's fiscal position into perspective. Our research suggests that the fiscal risk premium and bond supply premium (increased government funding requirements) embedded in SA government bonds are excessive. Curves are therefore steep when comparing the mid- to long parts of the curve to the shorter end. This provides an opportunity to enjoy high levels of yield and, given the elevated shape of the curve, investors will enjoy the benefits of a steep 'rolldown' as time progresses.

One niche area of the sovereign bond market that stands out as being particularly attractive at present, is inflation-linked bonds.

South African Government Inflation-Linked Bonds (ILBs)

First issued: 20 March 2000

national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

South African Government Bonds are issued by the National Treasury

Terms	
Principal:	100 + inflation
Coupon:	Fixed rate on indexed principal
Quoted as:	Real yield (ex. inflation)
Hold to maturity return:	Real yield plus inflation

Example	
Issue date:	March 2021
Maturity date:	March 2022
Years to maturity:	1
Purchase price:	R100
Coupon:	**3.00%**
Coupon frequency:	Annual
CPI level at issuance (A):	118.5
CPI level at maturity (B):	125.6
Change in CPI (A/B-1):	6.00%
Indexation factor (A/B):	1.06
Bondholder receives at maturity:	(R100 + R3) x 1.06 = R109.18
Nominal return:	R109.18/R100.00 = 9.18%
Real return:	R109.18/R106.00 = **3.00%**

Source: PSG Asset Management

"We continue to favour SA government bonds.

Inflation-linked bonds (ILBs or inflation linkers) are particularly attractive right now, for a number of reasons:

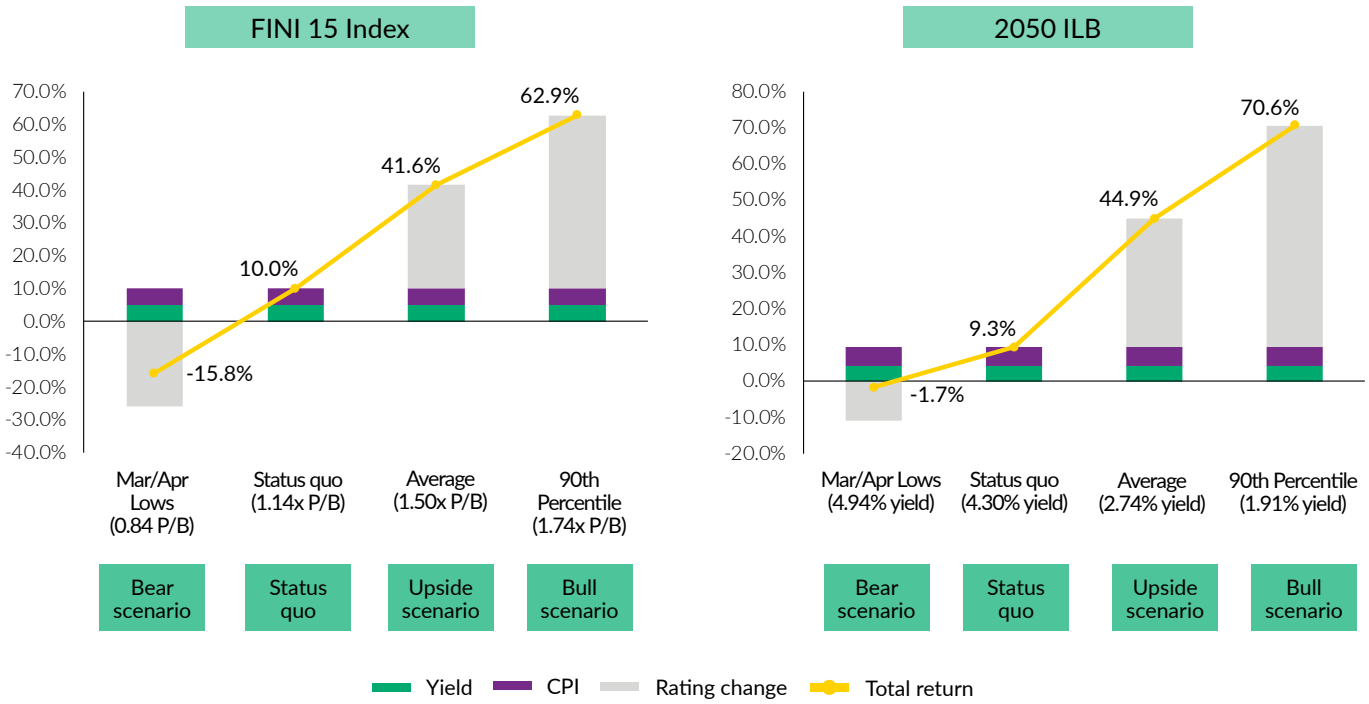
- Real yields above 4% for longer-dated instruments are high by historical standards (above the 98th percentile) and are among the highest in the world.
- Total returns look very compelling relative to cash and fixed nominal bond alternatives, especially after adjusting for risk (no inflation or credit risk).
- Foreigners are not large players in this space.
- They provide valuable portfolio insurance in the seemingly unlikely scenario of a spell of elevated inflation or even the expectation thereof (a scenario that would be very challenging for traditional cash and fixed-rate nominal bond instruments).
- ILBs play a valuable role in the portfolio as they bring a significant all-weather dimension to multi-asset and fixed income portfolios by virtue of having an adjustable base rate mechanism. During periods of unexpected, elevated inflation this provides an invaluable counterbalance to many exposures in a portfolio. In times when other floating alternatives are unattractive, short-dated inflation linkers can be an efficient instrument choice.

While short-dated ILBs are a compelling alternative to cash and floating-rate credit today, we also find significant opportunity in long-dated ILBs.

Long-dated ILBs can be volatile given relatively high duration characteristics (price is more sensitive to changes in yield), but at sufficiently high starting real yields, they can begin to compete against equity alternatives, at much lower levels of risk.

In the chart below we consider the expected range of outcomes for the FINI 15 equity index (a good proxy for SA interest rate sensitive equities) and a long-dated ILB maturing in 2050 looking forward over a one-year horizon. We consider four scenarios below. A bear case, in which we assume a return to the (all-time) low levels reached during March/April of 2020, a status quo scenario where there is no normalisation in rating, an upside scenario where the rating reverts to the 10-year average and, finally, a bull scenario where the 10-year 90th percentile rating levels are reached. Currently, the two investments have similar starting dividend/coupon yields of 5.0% and 4.3% respectively. Assuming no change in rating and that capital grows in line with inflation (assumed at 5%), we arrive at very similar status quo returns. However, considering the range of outcomes on the down- and upside, we see very favourable asymmetry from the long-dated ILB – especially considering the risk-free nature of the investment.

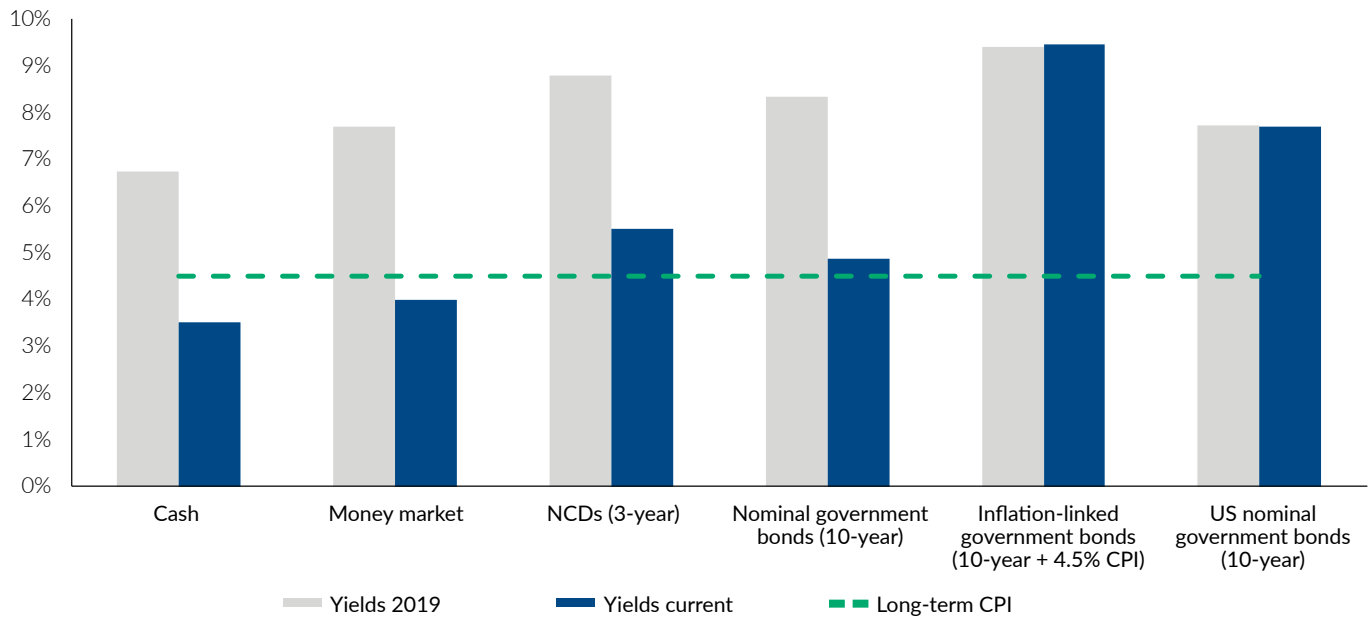
Various scenarios for future returns: 2050 ILB vs FINI 15 Index



Source: PSG Asset Management

The last year has seen a profound recalibration of the fixed income opportunity set (see the chart that follows). We have responded by reducing our cash and credit exposures and adding to nominal and inflation-linked bonds, where short-dated linkers are playing a valuable cash-type role and longer-dated instruments are providing equity-like expected returns at substantially lower risk.

Yields from various fixed income opportunities



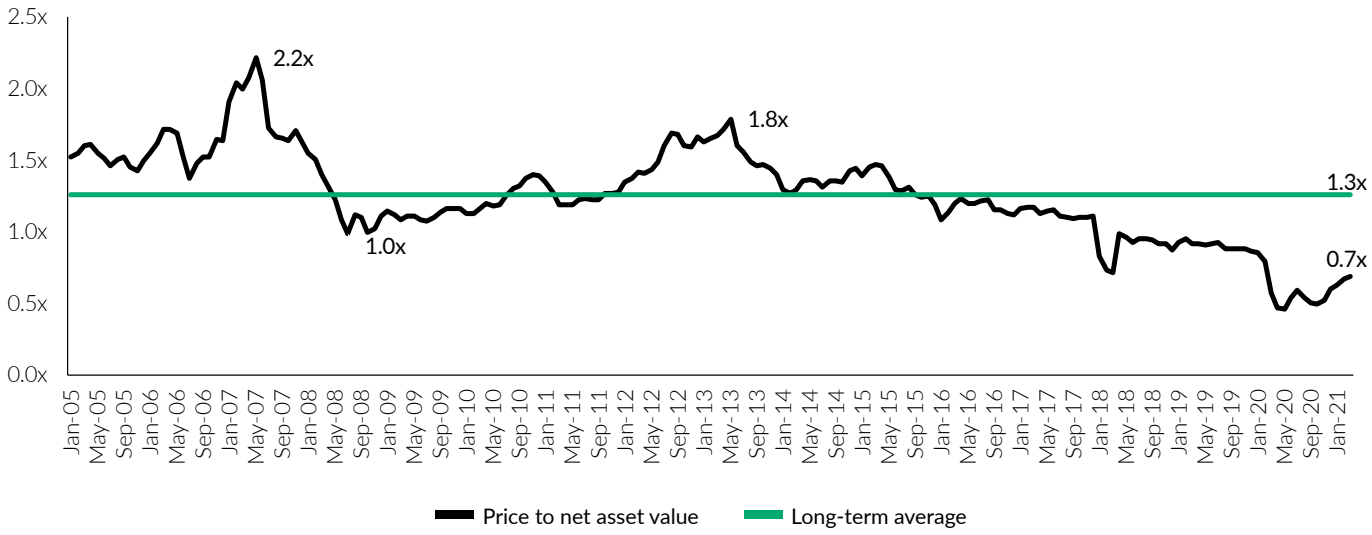
Sources: PSG Asset Management; Bloomberg

South African listed property

The South African listed property sector has had a torrid few years. The sector was facing headwinds even before the onset of the Covid-19 pandemic, and once the pandemic hit, many fundamental concerns were amplified. The negative conditions dogging the listed property sector are very real, and a large part of the reason why we had avoided the sector over the past few years.

However, our interest is piqued when extremely negative narratives become conventionally accepted wisdom, and we are carefully sifting through the train wreckage, and incrementally and selectively adding to opportunities in this space. The chart below illustrates that the South African Property Index is currently trading deeply discounted and at a fraction of long-term average net asset values, as an indication of how negative the sentiment has turned.

Real estate investment trust (REIT) prices to tangible net asset value



Sources: PSG Asset Management; Bloomberg

Equities

As highlighted in Shaun le Roux's article Why our funds remain offensively positioned when equity markets are high, we are taking advantage of some very compelling investment opportunities in high-quality companies.

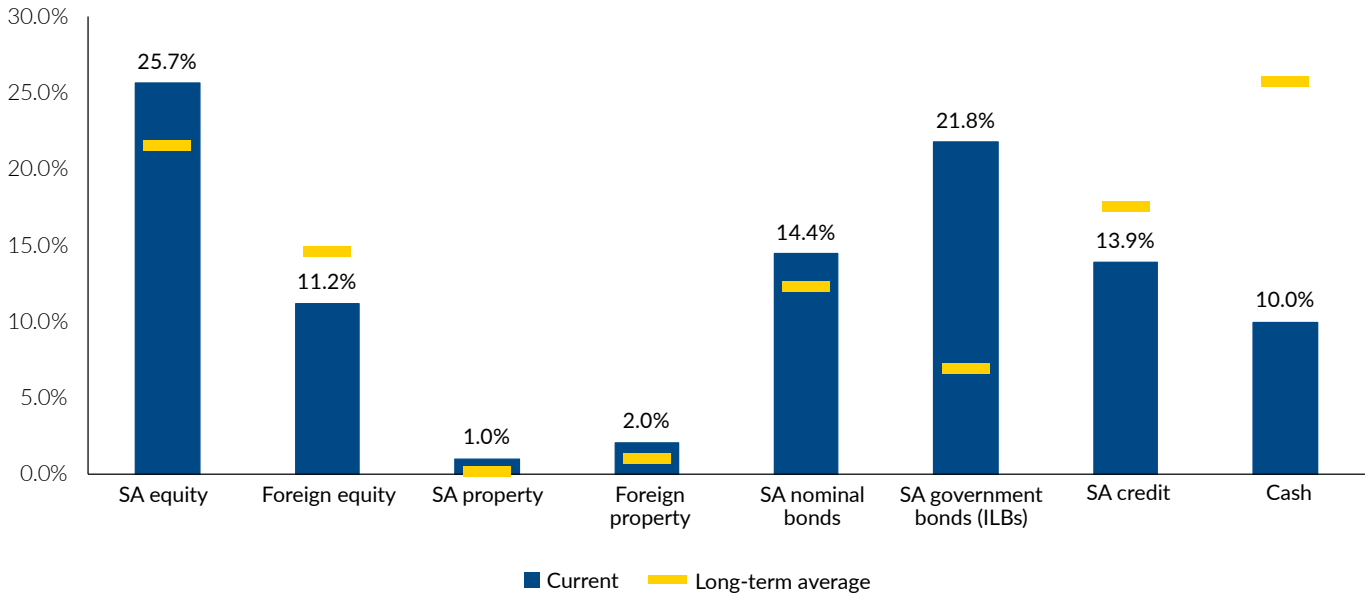
We believe the prospects look excellent for long-term returns from a portfolio that also includes carefully selected contrarian equity opportunities. Our equity buy lists are full relative to history – a reflection of the attractiveness of the current opportunity set.

Case study: How our asset allocation decisions are reflected in the PSG Stable Fund

The PSG Stable Fund aims to achieve capital appreciation and generate a performance return of CPI+3% over a rolling three-year period. The investment policy provides for investment in a mix of debt securities, money market instruments, bonds, inflation-linked securities, listed equities and property, preference shares and other high-yielding securities and derivatives. The fund may have up to 40% in equities and operates within the constraints of Regulation 28 of the Pension Funds Act. View the full MDD here.

Currently, we are finding compelling opportunities in local and foreign equity markets, selective opportunities in local and foreign property, and fixed-rate and inflation-linked sovereign bonds. Given our current concerns about the credit and cash sector, we hold a below-average allocation to these instruments when compared to the long-term average.

PSG Stable Fund asset allocation as at 31 March 2021



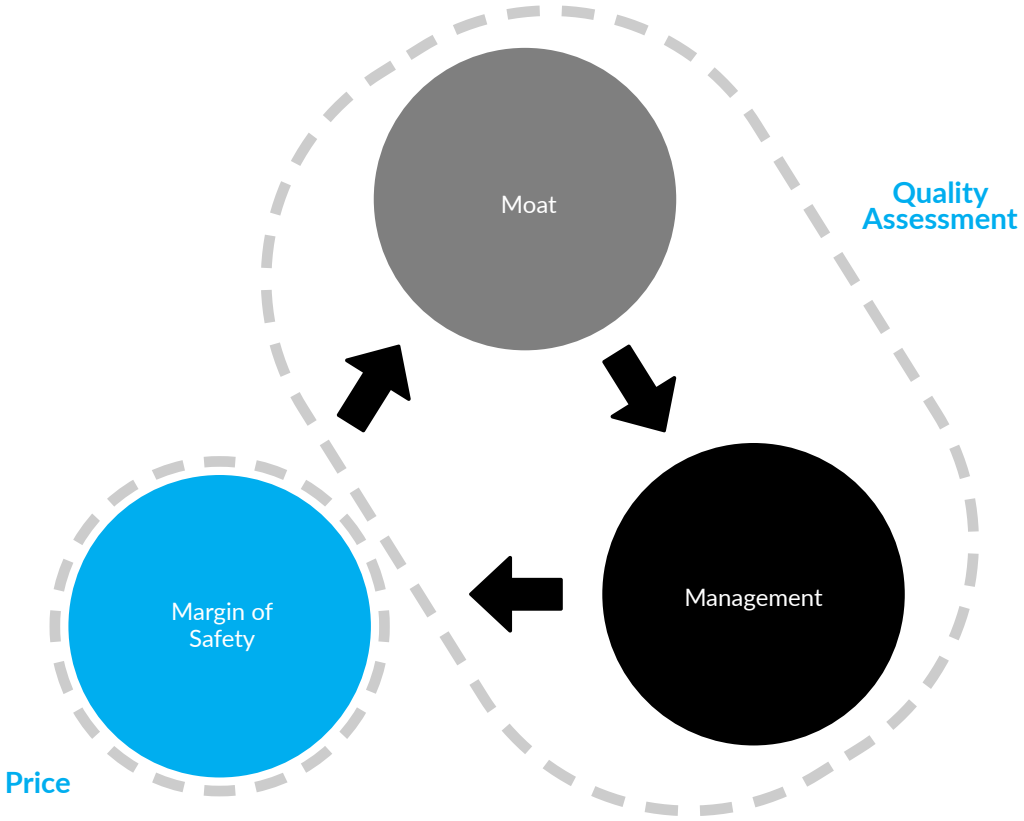
Sources: PSG Asset Management

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.



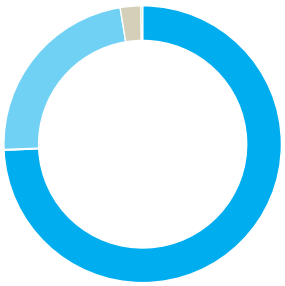
Portfolio holdings as at 31 March 2021

PSG Equity Fund

Top 10 equities

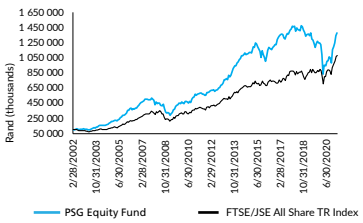
Discovery Ltd
Glencore plc
Anheuser-Busch InBev
Remgro Ltd
Imperial Logistics Ltd
AECI Ltd
JSE Ltd
Super Group Ltd
Old Mutual Ltd
AngloGold Ashanti Ltd

Asset allocation



Domestic equity	74.3%
Domestic cash	0.1%
Foreign equity	23.0%
Foreign property	2.4%
Foreign cash	0.2%
Total	**100%**

Performance

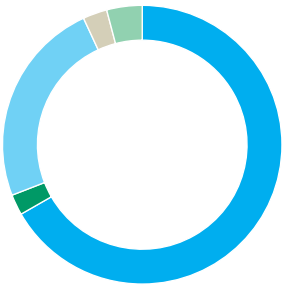


PSG Flexible Fund

Top 10 equities

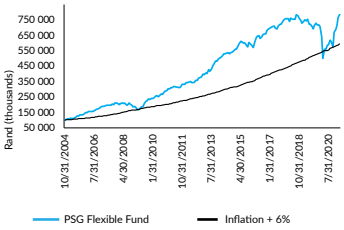
Anheuser-Busch InBev
Discovery Ltd
Glencore plc
Remgro Ltd
AECI Ltd
Imperial Logistics Ltd
Super Group Ltd
Old Mutual Ltd
JSE Ltd
Simon Property Group Inc

Asset allocation



Domestic equity	66.7%
Domestic cash	2.4%
Foreign equity	24.0%
Foreign property	2.8%
Foreign cash	4.1%
Total	**100%**

Performance

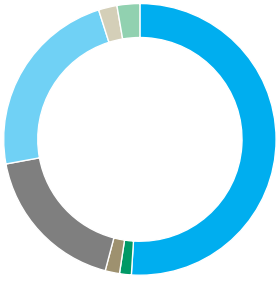


PSG Balanced Fund

Top 10 equities

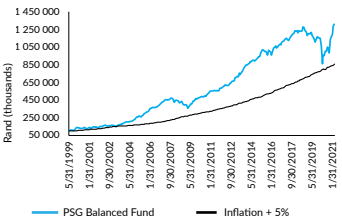
Discovery Ltd
Anheuser-Busch InBev
Glencore plc
Remgro Ltd
Prudential plc
JSE Ltd
Imperial Logistics Ltd
AECI Ltd
Liberty Global Inc
Simon Property Group Inc

Asset allocation



Domestic equity	51.0%
Domestic cash and NCDs	1.4%
Domestic property	1.7%
Domestic bonds	18.0%
Foreign equity	23.0%
Foreign property	2.2%
Foreign cash	2.7%
Total	**100%**

Performance



PSG Stable Fund

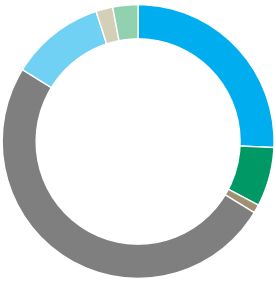
Top 5 equities

Discovery Ltd
Anheuser-Busch InBev
Remgro Ltd
Simon Property Group Inc
AECI Ltd

Top 5 issuer exposures

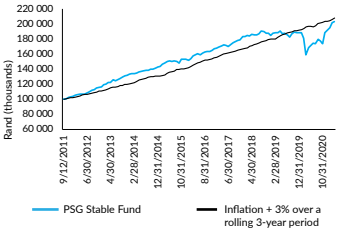
The Republic of South Africa
FirstRand Bank Ltd
Eskom Holdings SOC Ltd
Standard Bank of SA Ltd
Nedbank Ltd

Asset allocation



Domestic equity	25.7%
Domestic cash and NCDs	7.0%
Domestic property	1.0%
Domestic bonds	50.1%
Foreign equity	11.2%
Foreign property	2.0%
Foreign cash	3.0%
Total	**100%**

Performance



PSG Diversified Income Fund

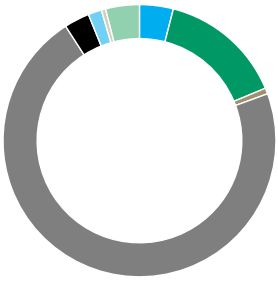
Top 5 equities

PSG Group preference shares
Absa Bank Ltd preference shares
Standard Bank of SA Ltd preference shares
Simon Property Group Inc
Grindrod Shipping Holdings Ltd preference shares

Top 5 issuer exposures

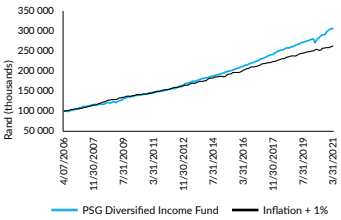
The Republic of South Africa
FirstRand Bank Ltd
PSG Money Market Fund
Standard Bank of SA Ltd
Eskom Holdings SOC Ltd

Asset allocation



Domestic equity	4.0%
Domestic cash and NCDs	14.7%
Domestic property	0.7%
Domestic bonds	71.5%
Preference shares	3.0%
Foreign equity	1.6%
Foreign property	0.5%
Foreign cash	4.0%
Total	**100%**

Performance



PSG Income Fund

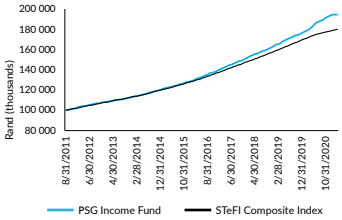
Top 10 issuer exposures

The Republic of South Africa
FirstRand Bank Ltd
PSG Money Market Fund
Standard Bank of SA Ltd
Nedbank Ltd
Absa Bank Ltd
Capitec Bank Ltd
Eskom Holdings SOC Ltd
Old Mutual Ltd
The Thekwini Fund (RF) Ltd

Asset allocation

Domestic cash and NCDs	51.1%
Domestic bonds	48.9%
Total	**100%**

Performance

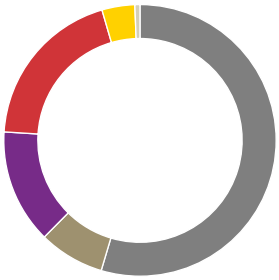


PSG Money Market Fund

Issuer exposures

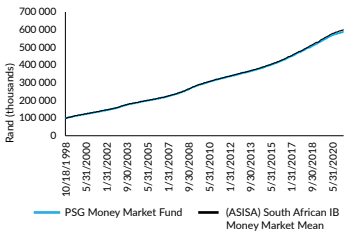
The Republic of South Africa
Nedbank Ltd
FirstRand Bank Ltd
Absa Bank Ltd
Standard Bank of SA Ltd
Investec Bank Ltd

Asset allocation



Treasury Bill	54.6%
Linked NCDs/Floating-rate notes	7.8%
Step rate notes	13.6%
Call	19.5%
NCDs	3.9%
Corporate bonds	0.6%
Total	**100%**

Performance

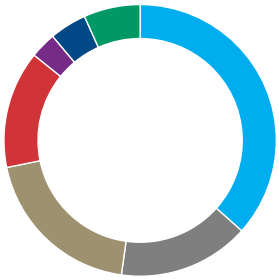


PSG Global Equity Sub-Fund

Top 10 equities

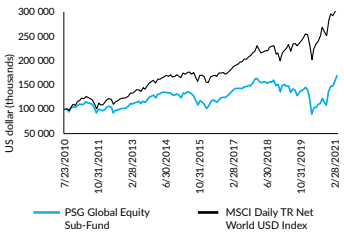
Anheuser-Busch InBev
Asahi Group Holdings Ltd
Prudential plc
Glencore plc
Simon Property Group Inc
Liberty Global Inc
Resona Holdings Inc
Philip Morris International Inc
Japan Post Insurance Co Ltd
Brookfield Asset Management Inc

Regional allocation



US	36.6%
Europe	15.6%
UK	19.6%
Japan	14.0%
Canada	3.1%
Africa	4.4%
Cash	6.7%
Total	**100%**

Performance

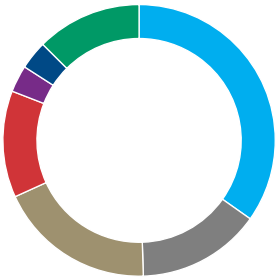


PSG Global Flexible Sub-Fund

Top 10 equities

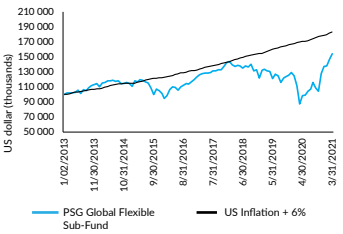
Anheuser-Busch InBev
Simon Property Group Inc
Asahi Group Holdings Ltd
Glencore plc
Prudential plc
Liberty Global Inc
Resona Holdings Inc
Philip Morris International Inc
Japan Post Insurance Co Ltd
Brookfield Asset Management Inc

Regional allocation



US	34.8%
Europe	14.7%
UK	18.7%
Japan	12.7%
Canada	3.2%
Africa	3.4%
Cash and bonds	12.5%
Total	**100%**

Performance



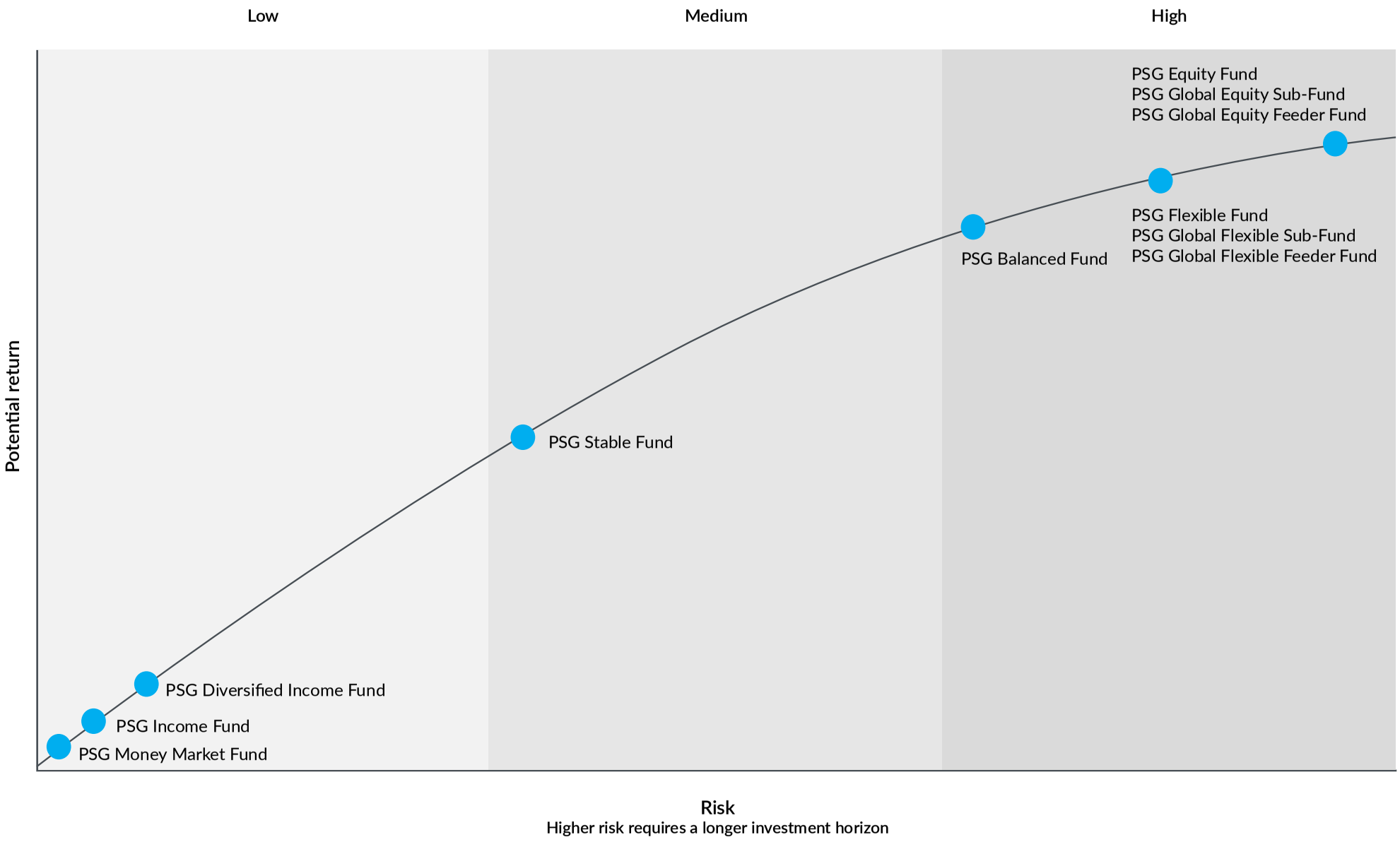
Percentage annualised performance to 31 March 2021 (net of fees)

Local funds						
	1 Year	3 Years	5 Years	10 Years	Inception	Fund inception date
PSG Equity Fund A	64.52	-0.57	3.72	9.15	14.75*	31/12/1997
FTSE/JSE All Share Total Return Index	54.03	9.68	8.20	10.85	13.35	
PSG Flexible Fund A	57.71	2.06	4.47	9.76	13.41**	02/11/1998
SA Inflation + 6%	8.88	9.83	10.36	11.06	11.48	
PSG Balanced Fund A	52.20	2.71	4.72	9.01	12.52	01/06/1999
SA Inflation + 5%	7.88	8.85	9.38	10.06	10.34	
PSG Stable Fund A	27.74	3.32	5.20		7.72	13/09/2011
SA Inflation + 3% over a rolling 3-year period	5.87	6.85	7.38		7.96	
PSG Diversified Income Fund A	13.05	6.89	7.55	7.60	7.75	07/04/2006
SA Inflation + 1%	3.87	4.85	5.37	6.06	6.67	
PSG Income Fund A	8.36	8.05	8.32		7.21	01/09/2011
STeFI Composite Index	4.57	6.34	6.81		6.34	
PSG Money Market Fund A	4.00	6.16	6.71	6.20	8.21	19/10/1998
(ASISA) South African - Interest Bearing - Money Market Mean	4.56	6.45	6.95	6.33	8.31	
PSG Global Equity Feeder Fund A ^	58.70	10.68	7.70		11.57	03/05/2011
MSCI Daily Total Return Net World USD Index (in ZAR)	27.37	21.40	13.45		18.78	
PSG Global Flexible Feeder Fund A ^^	47.27	12.10	7.57		11.77	11/04/2013
US Inflation + 6% (in ZAR)	-10.98	16.05	8.19		14.69	

International funds						
	1 Year	3 Years	5 Years	10 Years	Inception	Fund inception date
PSG Global Equity Sub-Fund A	87.98	3.14	8.09	4.40	5.06	23/07/2010
MSCI Daily Total Return Net World USD Index (in USD)	54.08	12.81	13.36	9.88	11.18	
PSG Global Flexible Sub-Fund A	77.07	3.96	7.68		5.39	02/01/2013
US Inflation + 6% (in USD)	7.69	7.84	8.10		7.64	

* Fund manager inception date 01/03/2002
** Current benchmark inception date 01/11/2004
^ The PSG Global Equity Feeder Fund feeds into the PSG Global Equity Sub-Fund.
^^ The PSG Global Flexible Feeder Fund feeds into the PSG Global Flexible Sub-Fund.
Source: 2021 Morningstar Inc. All rights reserved as at end of March 2021.
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 to 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 to 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 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 with an investment policy providing for investment 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 with an investment policy providing for investment solely in the PSG Global Flexible Sub-Fund.
Benchmark	FTSE/JSE All Share Total Return Index	SA CPI + 6%	SA CPI + 5%	SA CPI + 3% over a rolling 3-year period	SA CPI + 1%	STeFI Composite Index	South African - Interest-bearing - Money Market Mean	MSCI Daily Total Return Net World USD Index (in ZAR)	US CPI + 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 moderate risk appetite but require capital growth in real terms • have a medium-term investment horizon of three years and longer • are comfortable with fluctuations in markets	• 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% Class E: 0.75% + 20.00% performance fee on outperformance of the benchmark	Annual management fee: Class A: 1.00% + 7.00% performance fee on outperformance of the high-water mark Class E: 0.75% + 7.00% performance fee on outperformance of the high-water mark	Annual management fee: Class A: 1.50% Class E: 1.00%	Annual management fee: Class A: 1.50% Class E: 1.00%	Annual management fee: Class A: 1.00% Class E: 0.60%	Annual management fee: Class A: 0.65% Class E: 0.40%	Annual management fee: Class A: 0.50% Class F: 0.30%	Annual management fee: Class A: 0.75% Class E: 0.25%	Annual management fee: Class A: 0.75% Class B: 0.25%
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: https://www.psg.co.za/about-us/psg-asset-management. The A classes have been closed to new investors.

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The portfolio is valued at 15h00 daily. **Additional information:** Additional information is available free of charge on the website and may include publications, brochures, application forms and annual reports. **Company details:** PSG Collective Investments (RF) Limited is registered as a CIS Manager with the Financial Sector Conduct Authority (FSCA), and is a member of the Association for Savings and Investment South Africa (ASISA) through its holding company PSG Konsult Limited. The management of the portfolios is delegated to PSG Asset Management (Pty) Limited, an authorised Financial Services Provider under the Financial Advisory and Intermediary Services Act 2002, FSP no. 29524. PSG Asset Management (Pty) Limited and PSG Collective Investments (RF) Limited are subsidiaries of PSG Konsult Limited. **Money Market:** The PSG Money Market Fund maintains a constant price and is targeted at a constant value. The quoted yield is calculated by annualising the average 7-day yield. 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In most cases the return will merely have the effect of increasing or decreasing the daily yield but in the case of abnormal losses it can have the effect of reducing the capital value of the portfolio. **Fund of funds:** A fund of funds portfolio only invests in portfolios of CIS, which levy their own charges, which could result in a higher fee structure for fund of funds portfolios. **Feeder funds:** A feeder fund is a portfolio that, apart from assets in liquid form, invests in a single portfolio of a CIS, which levies its own charges and which could result in a higher fee structure for that feeder fund.

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 reinvested 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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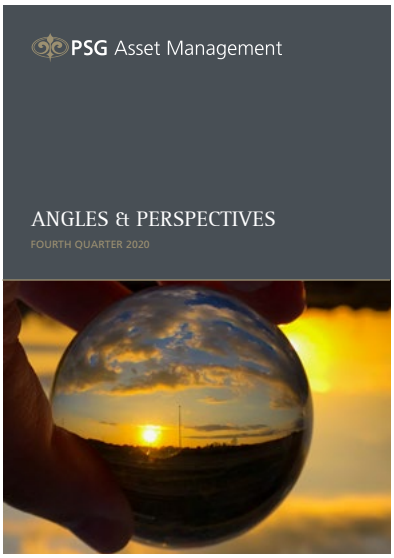
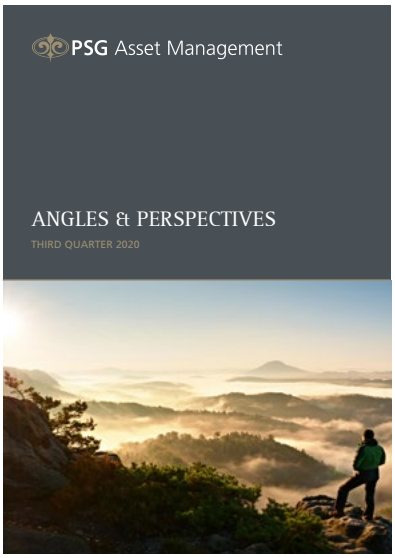


Fourth quarter 2020



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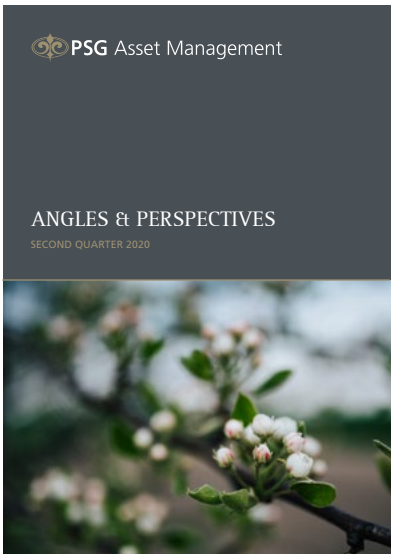

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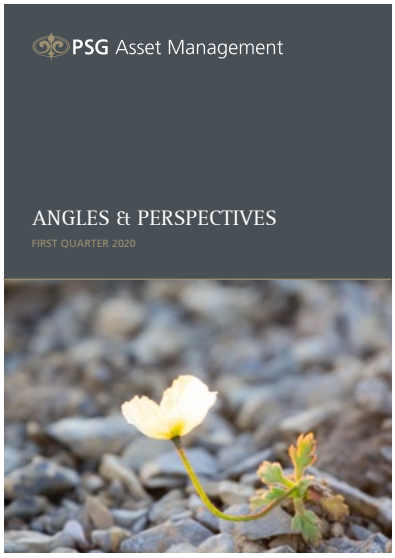

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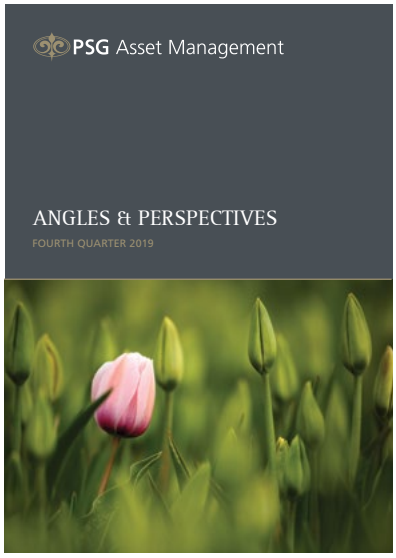

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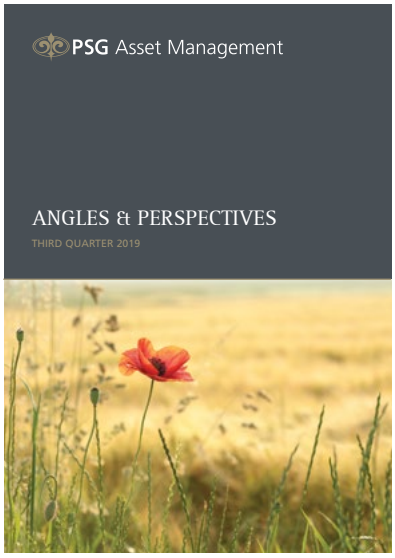

Third quarter 2019

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