PSG Asset Management

ANGLES & PERSPECTIVES

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Contents

Rationally, we know it's important to take a long-term view, but as emotional beings this is usually harder than we think when market conditions are tough. To have a successful investment journey requires us to stay calm, and remain on track with investing despite the temptation to wait on the sidelines for the panic to be over.

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.

Tough market conditions can make for difficult investment decisions

A prolonged period of poor performance from the local market – which, in some cases, has affected short-term returns from fund managers – has left many investors anxious and frustrated. While most of us understand the importance of taking a long-term view, it's usually more difficult than we anticipate to put this into practice. When the value of the stocks we own or the unit trusts we're invested in falls, our gut instinct is to try and put a stop to it. The easiest way to do this often appears to be switching to an investment that's performing better at the time, or to exit the market completely and wait for a turnaround. While there are instances when selling your investment is the right decision, all investors should guard against the behavioural biases that may prompt this decision for the wrong reasons.

Fund managers face the same difficult decisions as individual investors

Few things are more uncomfortable than having bleeding stocks in your portfolio. So, just as clients may start to question their choice of fund manager after a period of poor relative performance, fund managers may start to question whether the market knows something they're missing when portfolio holdings decline. In the first article of this edition, Shaun le Roux explains why we believe the principles behind when to buy or sell a stock and when to buy or sell a fund are similar. Both require the same framework for making good decisions that get the odds in the investor's favour: understanding the impact of emotions on your investment behaviour, considering where you are in the investment cycle, and sticking to a clearly defined philosophy and process that ensures rational decision-making.

The disciplined application of our process helps us evaluate market narratives critically

Our 3 M (Moat, Management and Margin of Safety) process seeks out above-quality investments at below-average prices, which means that we tend to invest counter-cyclically: we will usually be buying when security prices are falling and selling when prices are rising (and margins of safety are declining). As we are often early in our positioning, the prices of the securities our funds invest in may continue to decline before they start contributing to returns. We guard against an emotional response – just as we resist the 'fear of missing out' when choosing not to invest in rising markets – through the checks and balances we've built into our process, and an active culture of self-awareness.

So why have our funds' global equity exposures increased, when several major stock markets around the world are trading at near record levels?

In his article, Philipp Wörz considers the strong performance of US markets and global growth stocks in recent years, and sets out why long-term returns from such high starting valuations may well disappoint. However, he notes that the valuation divergences across and within markets that we've been highlighting for some time persist. Judging the current opportunity set in markets by looking at overall market levels is like assessing someone's happiness by looking at their social media profile – you get a very narrow picture indeed. In fact, the clear majority of the world's equities are already in their own bear market, with their prices having fallen by more than 20% from their highs. Within these geographies and sectors characterised by negative sentiment, we believe we have found several mispriced securities that present the potential for significant upside.

The contrast between China and Japan illustrates our preference for uncrowded markets

We are often asked why our funds are not investing in China, but rather have substantial exposure to Japan. Many clients have read about China's strong growth in GDP over the past 20 years, and a natural assumption is that growth is likely to be sustained in future. This, in turn, is expected to lead to high returns for equity investors. In the final article of this edition, Kevin Cousins explains why we question both these assumptions. He also sets out our investment case for Japan, despite the consensual bear case based on poor growth prospects from aging demographics, persistent deflation, and corporate governance that historically failed to prioritise shareholders. We believe that a combination of low valuations and improving corporate governance makes Japan a rich hunting ground for bottom-up stock selectors.

We hope that you enjoy the read.

How do you know when to sell an underperforming stock (or unit trust)?

Shaun le Roux

Shaun has managed the PSG Equity Fund since 2002 and the PSG Flexible Fund since 2016. He has more than two decades' investment experience and is a CA(SA) as well as a CFA charterholder.

Periods of discomfort can give rise to the desire to sell out of investments

Few things are more uncomfortable than having bleeding stocks or poor-performing managers in your portfolio. When a stock you own is falling, the standard emotional response is that the market knows something you don't, and that it is safer to sell. Where funds are concerned, it is not unusual for investors to lose confidence in a fund manager's ability to deliver after a period of poor relative performance. In both cases, our instinct is to feel more comfortable with recent winners that appear to be better positioned for the current economic circumstances.

During such times, advisers and asset managers have an important role to play in helping clients manage their emotions, ensuring they do not behave irrationally and to the detriment of their long-term investment returns.

Discomfort is more prevalent in tough conditions

As South African investors are acutely aware, things have been very tough for the past five years. In fact, we estimate that more than 80% of the shares in the FTSE/JSE All Share Index are in a bear market. Despite their good long-term returns, the short-term performance of our funds has also been poor. When this happens, it is to be expected that some end clients will start asking whether they should keep holding on to our funds. Similarly, our clients may ask why we continue to own a stock if its share price has declined significantly.

In many ways, investment decisions by fund managers and stock investors are similar

We believe that the principles behind when to buy or sell a stock and when to buy or sell a fund are similar, requiring the same framework for making good decisions that put the odds in the investor's favour. In both instances, the objective is rational decision-making. This requires carefully considering the impact of emotions on our behaviour as investors.

Any urge to sell should be carefully evaluated

Selling a poorly performing stock or fund may be the appropriate action, but you should consider your decision carefully and make sure it's aligned with your predetermined investment process. Indeed, most traders and market timers make use of a stop loss (an automatic sale instruction if a share price falls below a specified minimum) as a disciplined way of exiting stocks when share prices reverse. This can be an appropriate strategy if your primary objective is profiting from a trend. If, however, you are not a trader or market timer and are invested for the long term, it is important to be aware of the potential pitfalls when you have the urge to sell the 'dogs' in your portfolio.

Empirical evidence shows that the average investor always underperforms over the long run[1]

This is largely because of emotional decisions that arise from our behavioural biases. Our predisposition to hate losses more than we love gains (loss aversion) results in a stronger emotional attachment to losers than winners. Furthermore, we are inclined to upweight and extrapolate recent experience (known as recency bias). These biases make us want to act to take the pain away.

It is also important to consider where we are in the investment cycle

The average investor will most likely repeat the pattern of buying high and selling low. These investors will not only want to sell losers but will also be inclined to buy what is winning. The feedback loop between prices and confidence creates more complacency when prices are high, and things appear to be going well. Conversely, in tough times, when low confidence levels are reflected in prices, it is easy to fall into emotional bias traps and to throw in the towel.

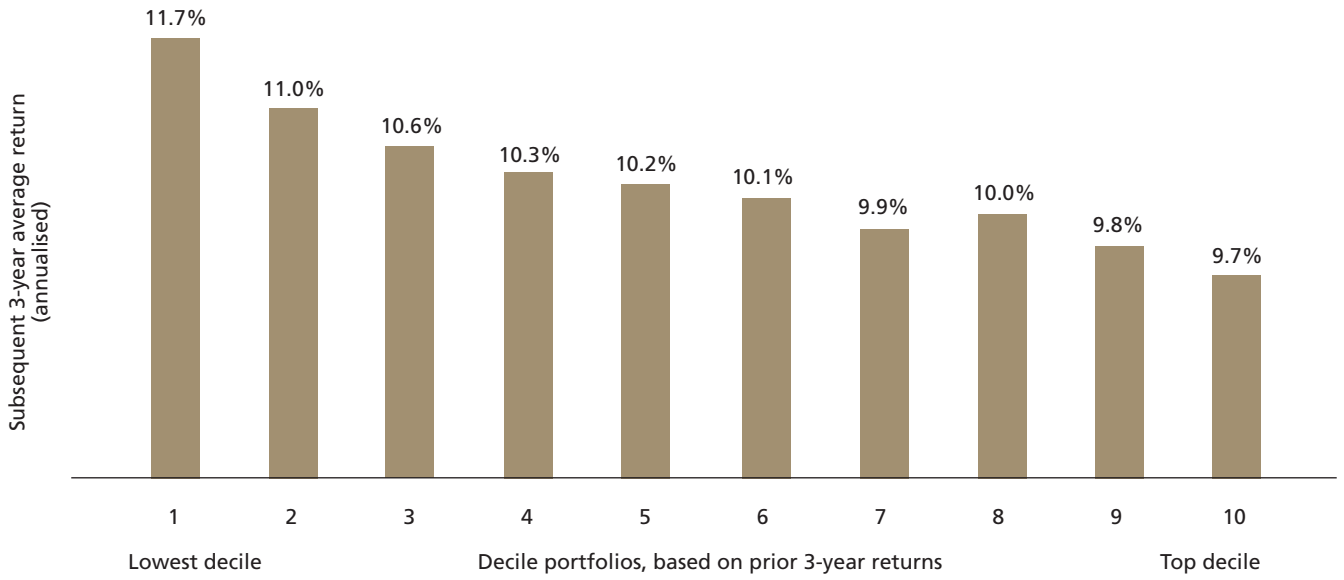
Over long periods, the tendency to capitulate and reduce exposure to risk assets at low points in the investment cycle – or to buy recent winners at high points in the cycle – can seriously erode investment returns. This is illustrated by Graph 1, which shows the average three-year annualised returns for US equity funds after being ranked based on prior three-year returns. The evidence is clear: investors are better served by selling the top-performing funds over three years and investing in the worst performers. Yet their tendency is to do the opposite.

At PSG, we rely on our process to determine whether to sell underperforming stocks in our portfolios

We invest in a disciplined and counter-cyclical way, preferring to buy when others are selling and vice versa. We are happy to use falling share prices to build positions and will typically reduce positions as prices rise and margins of safety narrow.

We always pay attention to falling stock prices, usually as an opportunity to raise conviction but in some cases to reconsider whether our investment case holds. When reviewing our investment case, we rely strongly on our investment process to ensure that we are not allowing emotion to cloud our judgement. In fact, we have actively built a culture of self-awareness that helps us understand our own behavioural biases and build the appropriate checks and balances into our process. These should consistently make us more rational investors – a valuable attribute, as we consider temperament to be a key differentiator between asset managers over long periods. In fact, it is the emotional biases of investors that drive the massive swings in market sentiment, providing opportunities for contrarian investors like ourselves to buy low and extract attractive long-term returns at lower levels of risk.

Graph 1: Weak three-year returns are often a precursor to outperformance in the subsequent three years*



*Data for US long-only equity funds, January 1990 to December 2016
Source: Research Affiliates, LLC, based on data from Morningstar Direct

Being willing to reassess and change your mind is critical
Good investors must have the ability to change their minds; a case of having strong opinions, weakly held. Investing, after all, is a very imprecise science, and valuations need to allow for unforeseeable future outcomes. Mistakes will always be made. At PSG, we have a track record of changing our minds on investments and selling at a loss when information comes to light that indicates it's appropriate to reassess our valuation. There will also be times when we assess risk to be too high to warrant investment, and we will sell a company that is optically cheap if its value is at risk of diminishing because of factors like a weak balance sheet, regulatory changes, or an economic recession.

Deciding when to sell a fund is based on similar principles
While we are not in the business of buying and selling funds or of offering financial advice, we would argue that when deciding whether to exit a fund, the principles should be similar to stock investing. Investors would be well served by:

- a clear philosophy that outlines factors such as whether you are a long-term investor or not
- a research process focused on understanding the philosophy and process of funds considered for investment
- a portfolio implementation strategy that considers the optimum number of funds to invest in and how they are blended to achieve a desired risk-return profile

As with stocks, it is appropriate to consider whether an underperforming fund remains a good investment – while remembering that selling at the wrong time or for the wrong reasons can be detrimental to long-term returns. Considering where we are in the investment cycle and whether there is a danger of selling low or buying high is important. A healthy dose of self-awareness – being conscious of behavioural shortcomings – will also stand you in good stead.

However, just like with shares, there are times when it is appropriate to cut and run from a unit trust. With funds, we would suggest that this entails a loss of confidence in the manager's ability to deliver in accordance with the portfolio strategy. Short-term underperformance is typically a poor indicator of future outcomes. Instead, you should consider whether the portfolios of your underlying managers are constructed – and hence performing – in line with your expectations. Red flags should be raised if there have been any changes in philosophy or process at the underlying manager that suggest a deviation from expectations.

Financial advisers have a very important role to play
Their assistance can be invaluable in avoiding emotional decision-making and poorly considered market timing. The initial structuring of a client's portfolio, with a selection of underlying funds that are clearly differentiated from one another, is another important aspect of fostering rational decision-making.

Emotional decisions in the current conditions can hurt investment returns

Recent feedback from advisers is that many clients are panicking and wanting to switch to cash. However, this holds a high risk of impeding investment outcomes. Indeed, we believe that current conditions warrant the reduction of cash in our funds by buying attractively priced equities. As we discuss in other articles in this publication, there are exciting opportunities for long-term returns across the world, with South Africa looking particularly attractive given the current valuations.

Clear thinking and good guidance are critical in tough times

Tough market conditions such as those we are currently experiencing are when asset managers and advisers earn their paycheques. Both need to make rational decisions during times of heightened emotion. The asset manager needs to capitalise on opportunities that become available while carefully managing the risk taken. The financial adviser needs to advise a course of action that runs contrary to the client's emotions and instinct. This is when clients need both asset managers and advisers most, as how they respond will have a big bearing on long-term investment outcomes.

[1]Dalbar research shows that over the past 25 years, the average investor (determined by restating the mutual fund universe to represent a single investor) has earned below-average returns. Indeed, the average investor materially lags the market over all time periods and across all asset classes. For example, the average investor in an equity unit trust underperformed the S&P 500 by 3.6% over the 10 years to December 2017. Dalbar ascribes the difference primarily to investor behaviour, especially trying to time the market and having a short-term focus.

Philipp Wörz

Why we are deploying cash into a 'bull market'

Philipp joined PSG Asset Management in 2007 and has managed the PSG Global Equity and PSG Global Flexible sub-funds since 2015. He is a CFA charterholder and has 13 years' investment experience.

Our funds' global equity exposures have increased, despite high overall market valuations

In early 2018, we raised the cash holdings in our global funds to record levels after we became increasingly cautious about the available opportunities at the time. We have since increased equity exposures significantly, allocating money to what we deem to be attractive opportunities.

With several major stock markets around the world trading near record levels, clients may rightly ask why. After all, don't we follow a counter-cyclical investment approach? To answer this, we consider current market conditions and how they play into our process.

The US and global growth stocks have been standout performers in recent years

The US market has been the clear winner over the past few years, with the S&P 500 significantly outperforming the rest of the world, and emerging markets in particular. In addition, it is interesting to note the strong performance of global growth stocks, while European, UK, South African and value stocks generally underperformed (as shown in Graph 1).

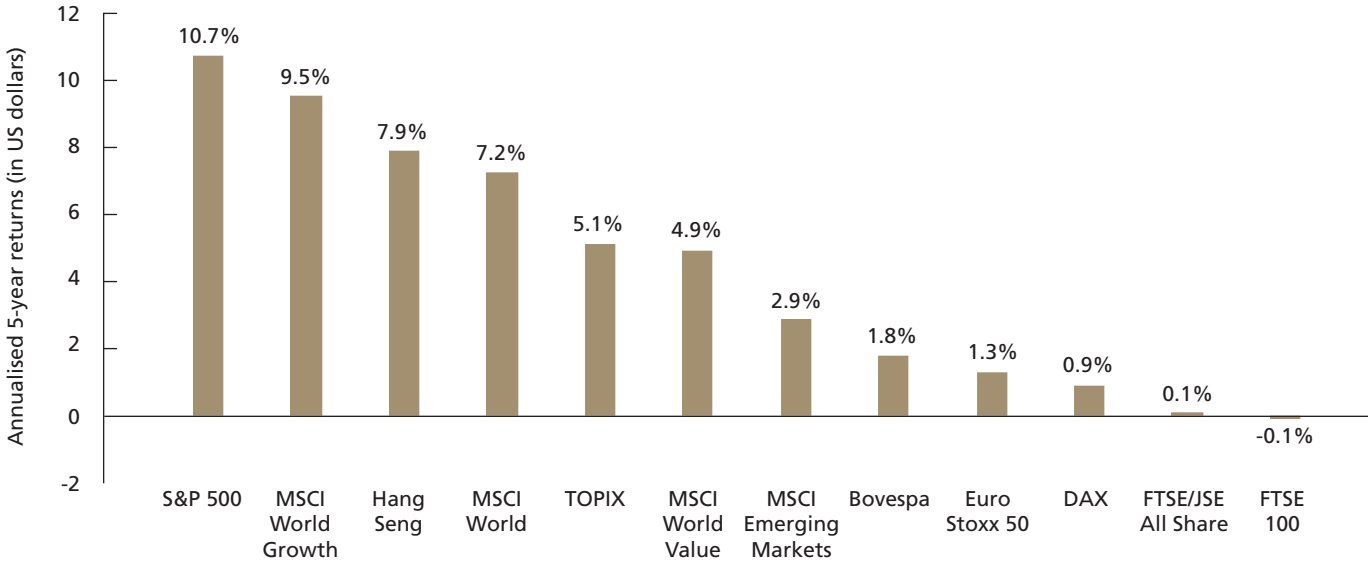
Given this backdrop, it is no surprise that the current consensus appears to be to invest in an S&P 500 index fund. On the other hand, it would seemingly be foolish to invest in South African or UK stocks, not to mention investing with a value manager.

Starting valuations matter, and may mean weak long-term returns from the US

US valuations have been elevated for some time. Despite the length of the current economic expansion and the threat of trade and actual wars, the market keeps grinding higher. However, it is important to remember that over shorter periods, valuation levels are poor indicators of future returns. In contrast, starting valuations matter a whole lot when taking a longer-term view.

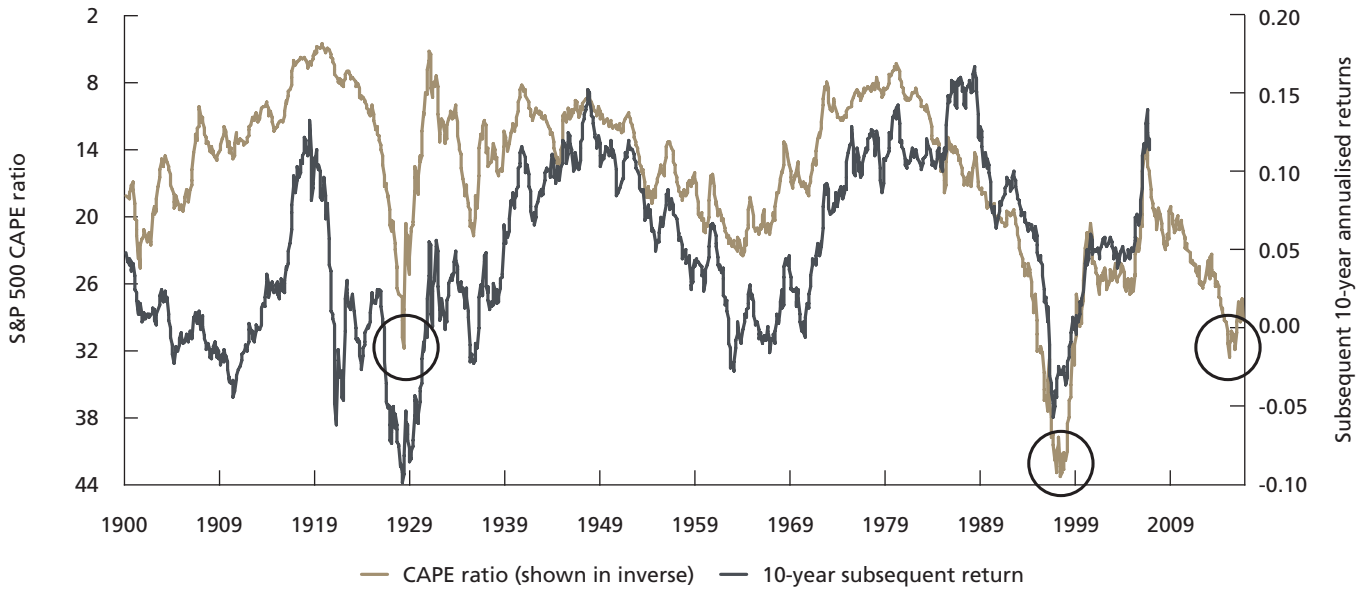
Graph 2 shows the correlation of the starting cyclically adjusted price/earnings (CAPE) ratio to subsequent 10-year returns for the S&P 500. The evidence (for the S&P 500 as well as other global markets) suggests a significant negative correlation: the higher the starting CAPE ratio, the lower the subsequent 10-year return. This also holds true for individual companies, where we would argue that starting valuations have an even bigger impact on longer-term returns.

Graph 1: The S&P 500 and MSCI World Growth indices have outperformed over the five years to 30 June 2019



Sources: PSG Asset Management, Bloomberg

Graph 2: Starting CAPE ratios and subsequent 10-year returns are negatively correlated



Sources: PSG Asset Management, multpl.com

Aside from the last two years, the S&P 500's CAPE ratio of 29.99 times on 30 June has only been higher on two occasions: during the dotcom bubble around the turn of the millennium, and right before Black Tuesday in October 1929. This suggests that future long-term returns from the index may well disappoint.

We do not try to predict whether or when lofty valuations may normalise

As of writing, the MSCI World Index is trading within 4% of its all-time high and the S&P 500 is near record levels. Our bottom-up, counter-cyclical approach means that we buy equities when they are available at significant discounts to intrinsic value (usually during times of falling share prices). Conversely, we sell equity holdings when securities no longer offer a margin of safety (which tends to coincide with rising share prices). So, shouldn't we be reducing equity exposures and waiting in cash for the market to turn?

Many people are trying to predict when the US and global economy will enter a recession and trigger the next bear market. After all, July 2019 will likely mark the longest-ever US economic expansion at 121 months (surpassing the 1991 to 2001 expansion of 120 months). Since 1945, the average bear market has resulted in a drawdown in the S&P 500 of 29%. Timing the next one would appear to be a profitable endeavour.

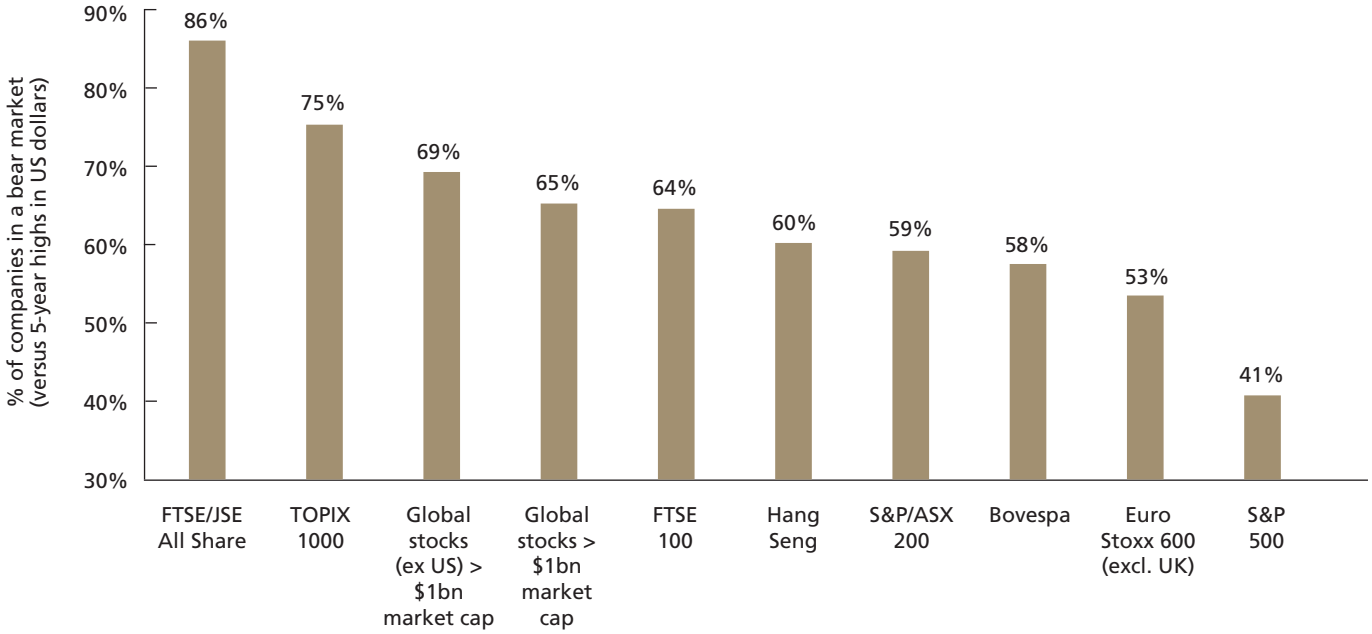
However, we do not believe there is much value in trying to predict uncertain future economic outcomes. For example, while the current US expansion may be the longest on record, many argue it has also been the shallowest, with fewer pockets of excess. More importantly, we believe there is far more to be gained from understanding what individual share prices are implying.

Markets continue to be characterised by widespread valuation divergences

It is interesting to note persistent valuation divergences across and within markets (which we have highlighted for some time). Significantly, the clear majority of the world's equities are already in their own bear market, i.e. their prices have fallen by more than 20% from their highs amid widespread negative sentiment and fear. Graph 3 shows the percentage of shares across several global markets for which this is true (relative to five-year highs, in US dollars). It is interesting to note that except for the S&P 500, this applies to more than 50% of each individual market's companies.

Just over 75% of the Tokyo Stock Price Index (TOPIX) 1000, a little more than 64% of the FTSE 100 and a whopping 86% of FTSE/JSE All Share Index (ALSI) companies are trading in their own bear market (or, when expressed in the local currencies, 81% of the TOPIX 1000, 48% of the FTSE 100 and 73% of the ALSI). The average 'bear market stock' in each index has declined by 41.6% (TOPIX), 41% (FTSE) and 52.4% (ALSI) respectively.

Graph 3: Most shares in global markets are in their own bear market



Sources: PSG Asset Management, Bloomberg (prices as at 24 June 2019)

Market divergences give rise to complacency

Investors tend to gravitate towards what has worked well in the recent past, while shunning what hasn't. While this may have been a profitable strategy until now, we believe that some market participants are living with a false sense of security, focusing solely on the qualitative narrative while ignoring valuations.

In our view, there are several areas in global markets in which investors are currently too complacent and taking on too much risk. These include:

- **US equities:** While expected long-term returns from the S&P 500 may well be low, the US market remains the default choice for many investors.
- **Visible growth:** Having outperformed value investing for over a decade, many believe growth investing will remain the dominant style into perpetuity. But even a great company can be a poor investment if you overpay for it.
- **Tech stocks:** Many new listings (such as Uber, Lyft, Slack and Beyond Meat) do not currently generate profits – and some may never. Yet markets are willing to pay over the odds for them.

The same divergences create pockets of opportunity

In contrast, there are parts of markets that have performed extremely poorly, where pervasive fear has become the norm. We believe that this reduces risk and improves your odds when allocating fresh capital, so it should come as no surprise that these have been our happy hunting grounds over the past year. Examples include:

- **Japan:** Japanese financial companies are one of the least-crowded sectors globally, as many stocks are priced for the zero interest-rate policy to prevail forever. Cheap valuations, strong balance sheets and improving corporate governance bode well for future returns. (Read more about this theme in Kevin Cousins' article on page 9.)
- **Emerging markets, especially South Africa:** After many years of lacklustre returns, domestically focused South African stocks are one of the standout opportunities globally. They offer cheap starting valuations and low-cost optionality to a stabilising economy.
- **The UK:** A prolonged Brexit has taken its toll on investor confidence and valuations.
- **Retail:** At the centre of online disruption, this sector is highly out of fashion. However, carefully selected retailers and property players offer the potential for outsized returns.
- **Agriculture:** A perfect storm of trade wars, US floods and swine fever has taken its toll on global fertilizer stocks. Available land for agricultural production is increasingly limited, which means production growth will primarily need to be achieved through productivity and crop yield improvements. Agriculture remains a compelling long-term structural opportunity.

We are excited by the opportunities we're finding, but are often early in our positioning

While lower share prices in isolation do not determine value, they do indicate that the current environment is conducive to finding mispriced opportunities in unloved parts of the markets. We believe we have found several such opportunities.

However, we tend to be early in our positioning. Buying into falling share prices across several of these 'bear markets' has contributed to our global funds significantly underperforming over the past year. After strong returns in 2016 and 2017 – when they meaningfully outperformed global markets – the PSG Global Equity Fund and PSG Global Flexible Fund have declined by 6.9% and 5.2% respectively since the end of June 2018. This compares to a total return of 7.3% from the MSCI World Index over the same period.

While this short-term underperformance is extremely disappointing, we are encouraged by the valuation opportunity across our portfolios. The funds' global equity holdings are among the cheapest they have been since inception, and at similar levels to early 2016 – a period after which we delivered strong subsequent outperformance. These valuations and the significant upside potential they present inform our confidence in our global opportunity set going forward.

Kevin Cousins

China versus Japan: historic growth or future returns?

Kevin is Head of Research at PSG Asset Management and has 26 years' experience in investment management. After working at BoE Asset Management from 1993 to 2002, he co-founded Lauriston Capital, a specialist hedge fund manager. He then worked as part of the hedge fund management team at Brait (now called Matrix Fund Managers). Kevin joined PSG Asset Management in 2015.

Strong historic growth in GDP can be misleading for investors

We are often asked why we are not investing in China: our funds have little direct exposure to the Chinese economy but in contrast, substantial exposure to Japan. Many clients have read about China's strong growth in GDP over the past 20 years. A natural assumption is that growth is likely to be sustained in future. This, in turn, is expected to lead to high returns for equity investors. We question both these assumptions.

The past may not be a reliable indication of what lies ahead for the Chinese economy

George Magnus (former Chief Economist at UBS and currently an academic at Oxford University) believes China's impressive performance over the past two decades is unlikely to be repeated. In his recent book, *Red Flags: Why Xi's China is in Jeopardy*, he cites the following reasons:

- **Demographic headwinds:** China's working-age population has already peaked and will decline at a faster rate than in Japan and Europe.
- **Debt:** China has accumulated a huge debt burden since 2007, effectively borrowing from the future to boost current growth. The necessary debt service and deleveraging will slow future growth.
- **Exchange control:** China closely controls the renminbi exchange rate, resulting in many pressures and risks as the flow of capital into and out of the country increases.
- **Environmental concerns:** The Chinese environment – particularly its water resource – is hugely degraded and cannot sustain the current economic model.
- **Rising inequality:** Many Chinese have little protection from labour regulations and no social safety net. A more inclusive economy appears politically essential but can only come at the expense of growth.

Each of these impediments to growth is formidable in isolation. In combination, they present a uniquely difficult challenge. Even a well-orchestrated realignment of the economy will slow future GDP growth sharply.

GDP growth and equity returns are not correlated

Furthermore, a recent *Financial Analysts Journal* article[1] argues that high growth in GDP has little correlation with good equity returns. The study evaluated 43 global markets over the 20 years from 1997 to 2017. The most striking growth was in Chinese real GDP per capita, which grew by 8.2% per year. Yet the real return on Chinese equities was only 0.7% per year. In contrast, South African real GDP per capita grew by a paltry 1.3% per year, yet the real return on South African equities was 6.1% per year. The study concluded that what mattered most for total equity returns was firstly real growth in dividends per share (2.8% per year in South Africa, compared to -3.0% in China), and secondly net share buybacks or issuance (the 'supply' of new equity). The MSCI China Index grew its market capitalisation by an incredible 27.5% per year over the 20-year period, but if you adjust for the net new issuance of equity, the annual price return was only 0.9%!

This can be well illustrated by comparing cumulative total returns for high-GDP-growth China against low-GDP-growth South Africa. Over the 20 years under review, total returns from the FTSE/JSE All Share Index were 2.3 times those delivered by the Shanghai A-Share Index (both expressed in US dollars), as shown in Graph 1.

That said, we spend little time evaluating macro conditions when researching equity opportunities. In our experience, within different growth backdrops, demographics and geographies, there will be businesses that create value for shareholders and others that destroy value, regardless of the macro environment.

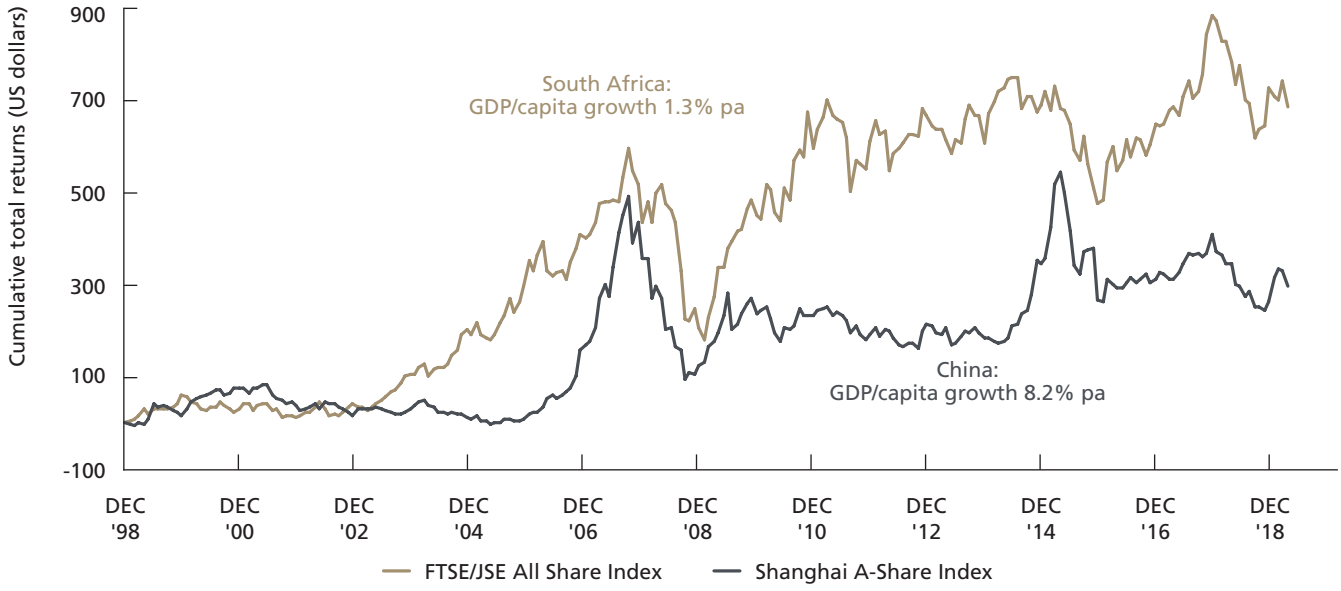
If high GDP growth does not guarantee good equity returns, what other factors can we consider?

1. **Uncrowded markets offer greater potential for attractive entry valuations**

   Study after study has shown that long-term equity returns primarily depend on the initial valuation. We love buying companies at prices we believe are substantially below their intrinsic value (i.e. at wide margins of safety). However, to find attractively priced opportunities in our competitive world requires us to hunt in uncrowded waters.

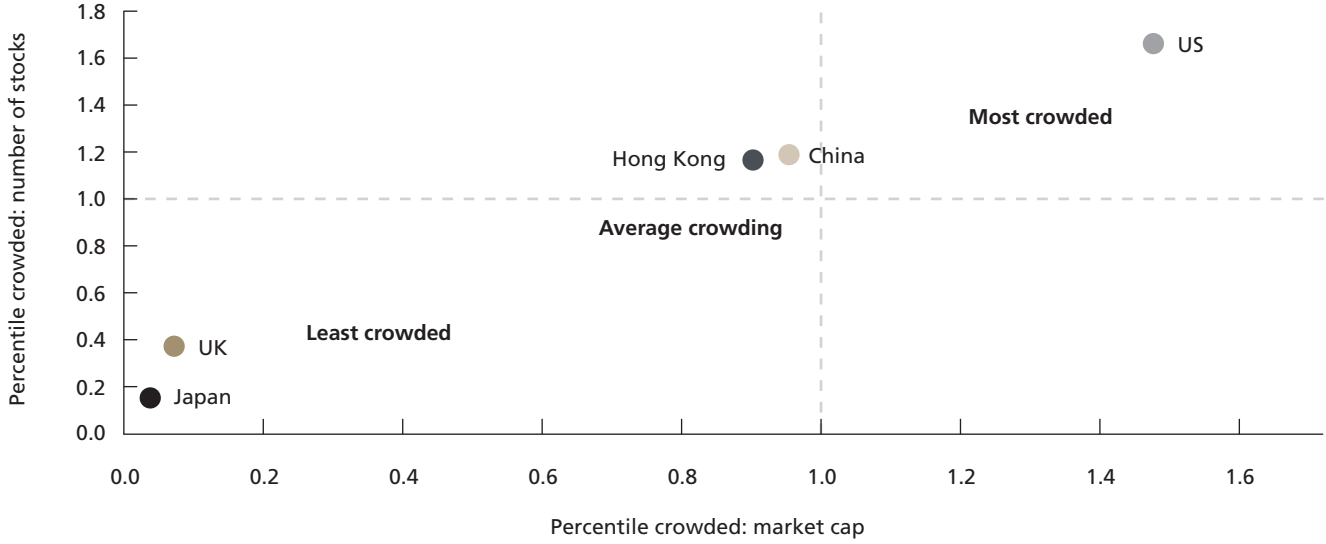
   Research broking house Bernstein's crowding measure is based on institutional ownership (active bets), sentiment from sell-side analysts' ratings and price momentum, and expectations from earnings forecasts and valuations. Its June report[2] indicates Japan as the least crowded global market, with the most crowded being North America (as shown in Graph 2).

Graph 1: The FTSE/JSE All Share Index outperformed the Shanghai A-Share Index from 1997 to 2017



Sources: PSG Asset Management, Bloomberg

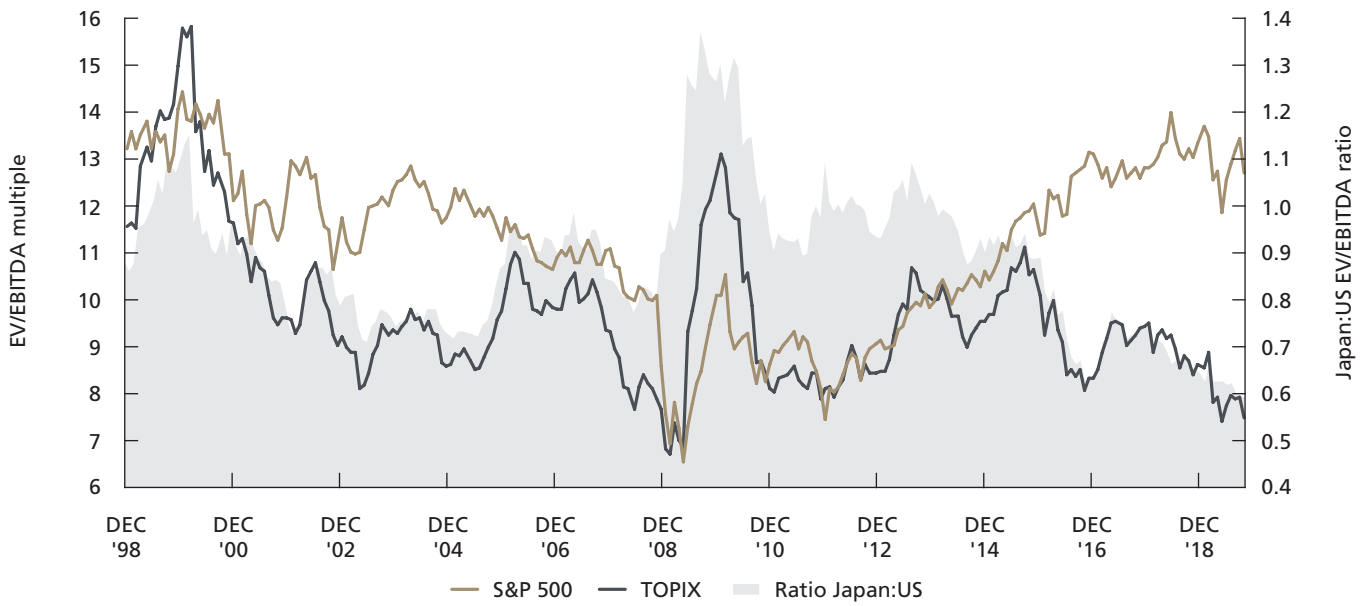
Graph 2: Bernstein's Crowding Index (June 2019) shows that Japan is the least crowded market



Sources: PSG Asset Management, Bernstein

Given that Japan is so uncrowded, we would expect attractive valuations, especially relative to the US. This is indeed the case – the Tokyo Stock Price Index (TOPIX) is back at global financial crisis-level ratings. Its relative rating to the S&P 500 is currently the cheapest it has been in at least 30 years. Graph 3 compares this rating, based on the ratio of enterprise value (EV) to earnings before interest, tax, depreciation and amortisation (EBITDA). (While this is not a rating method we generally like, it is a useful basis for comparing indices that may have loss-making components.) It shows that the US is trading at 12.6 times, close to the peak levels reached in 1999/2000. In stark contrast, Japan is trading at 7.5 times, a level last seen during the 2008/2009 crisis.

Graph 3: The TOPIX is currently trading at attractive ratings relative to the S&P 500



Current ratings

Index		P/E ratio	P/B ratio	Price: TBV	EV/EBITDA
S&P 500	US	18.0	3.2	10.4	12.6
TOPIX	Japan	13.2	1.1	1.3	7.5

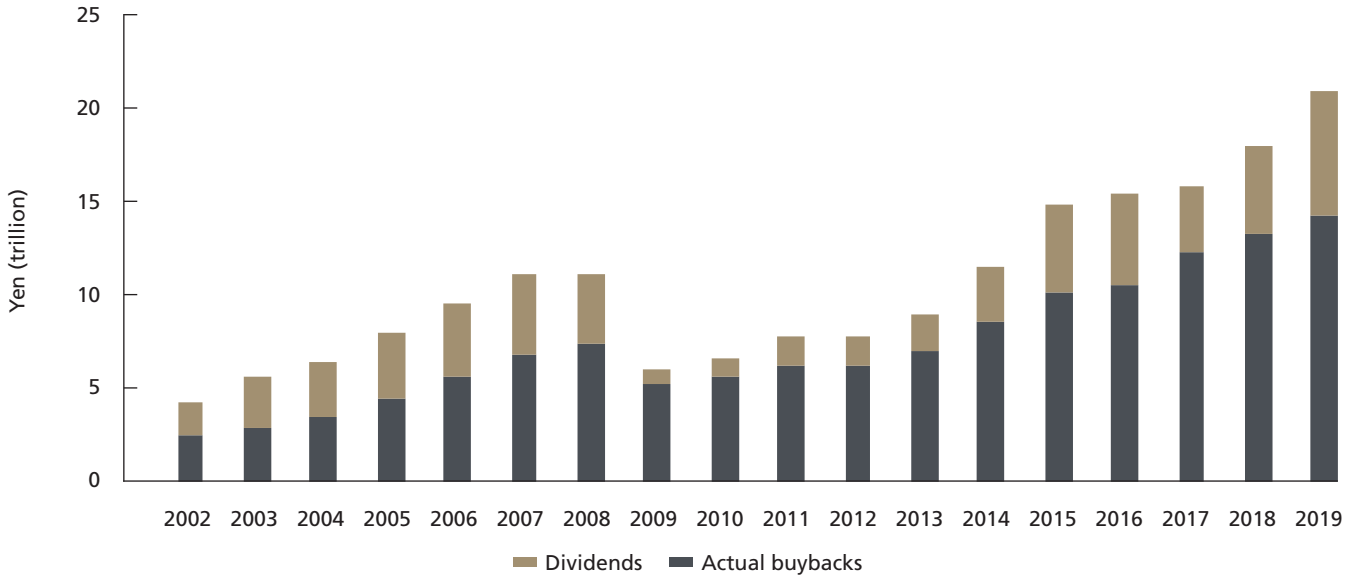
Sources: PSG Asset Management, Bloomberg

2. Corporate governance that prioritises shareholder returns

Why is Japan ignored? There is a consensual bear case stuck on poor growth prospects from aging demographics and persistent deflation. However, we have already shown that overall GDP growth has little bearing on equity returns.

In addition, Japanese companies are seen as value traps that ignore shareholders. The reality is that corporate Japan is changing, with a focus on improving governance that prioritises shareholder returns for the first time. This can be seen from growing dividend distributions and increasing share buybacks. It is also evidenced by the removal of anti-takeover clauses ('poison pills'), the sale of cross holdings, and the gradual improvement of returns on equity, as huge cash balances are reduced or debt markets exploited to lower surplus capital. Morgan Stanley estimates that total capital returns to shareholders in 2019 will amount to ¥22 trillion; some 3.7% of market capitalisation (as shown in Graph 4).

Graph 4: Capital returns to Japanese shareholders are estimated to total ¥22 trillion in 2019



Sources: PSG Asset Management, Morgan Stanley

The combination of low valuations and improving corporate governance makes Japan a rich hunting ground for bottom-up stock selectors

One of several Japanese holdings in our portfolios is the recently privatised life insurer Japan Post Insurance, also known as Kampo. Despite selling by far the largest value of insurance policies in Japan, Kampo only constitutes three basis points in the TOPIX and is not in the Nikkei. (It has historically had a low free float.) However, it is generating good returns on embedded value – an average of 8% per year over the past six years, underpinned by strong growth in new business. These returns have been achieved despite the negative risk-free rate resulting from the Bank of Japan's yield curve control policy, while shareholders will benefit substantially in the event of future policy normalisation. Japan's protection gap is likely to continue growing for at least another decade, indicating a growing life insurance market despite the aging population.

Kampo returned nearly 10% of its market capitalisation to shareholders this year

Kampo's indicated dividend yield is 3.8%, with its dividend having grown at 8% per year since its listing. It has plenty of surplus capital, and in 2019 it repurchased and cancelled 6% of shares in issue. Further share repurchases are likely. Despite this, Kampo trades at 0.3 times embedded value per share and is on an embedded value operating earnings per share multiple of only 3.8 times. While we have no idea when the market will correct such obvious mispricing, we have high conviction that this portfolio holding – and others like it – holds the potential for significant long-term value creation.

References:

[1] 'Net Buybacks and the Seven Dwarfs', (J. L'Her, T. Masmoudi, R.K. Krishnamoorthy), Financial Analysts Journal, https://doi.org/10.2469/faj.v74.n4.4, 2018

[2] 'Bernstein Crowd Control: How crowded is your portfolio?', (A. Larson), Sanford C. Bernstein, 2019

Notes

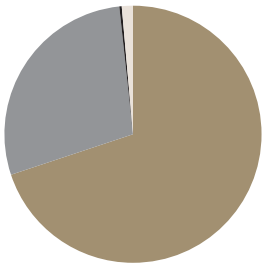
Portfolio holdings as at 30 June 2019

PSG Equity Fund

Top 10 equities

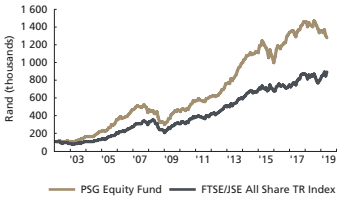
Old Mutual Ltd
Discovery Ltd
Brookfield Asset Management Inc
Japan Post Insurance Co Ltd
Glencore plc
AECI Ltd
Nedbank Ltd
Super Group Ltd
Reunert Ltd
JSE Ltd

Asset allocation



Domestic equity	69.9%
Foreign equity	28.4%
Foreign cash	0.3%
Foreign property	1.4%
Total	**100%**

Performance

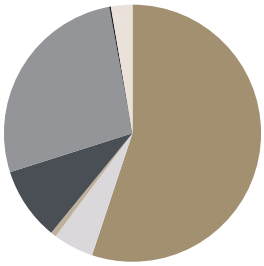


PSG Flexible Fund

Top 10 equities

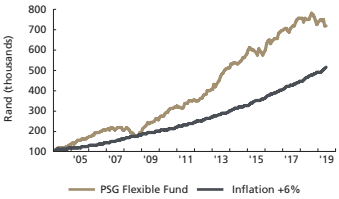
Brookfield Asset Management Inc
Old Mutual Ltd
Discovery Ltd
Japan Post Insurance Co Ltd
Glencore plc
Nedbank Ltd
AECI Ltd
Super Group Ltd
Anheuser-Busch InBev
Reunert Ltd

Asset allocation



Domestic equity	55.1%
Domestic cash	5.1%
Domestic gold	0.7%
Domestic bonds	9.2%
Foreign equity	27.0%
Foreign cash	0.2%
Foreign property	2.7%
Total	**100%**

Performance

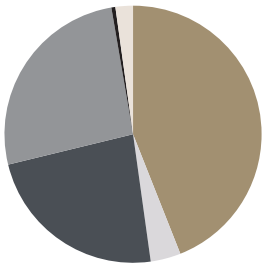


PSG Balanced Fund

Top 10 equities

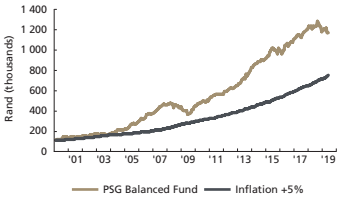
Japan Post Insurance Co Ltd
Brookfield Asset Management Inc
Discovery Ltd
Old Mutual Ltd
L Brands Inc
Nedbank Ltd
AECI Ltd
RMB Holdings Ltd
JSE Ltd
Super Group Ltd

Asset allocation



Domestic equity	44.0%
Domestic cash and NCDs	3.8%
Domestic bonds	23.4%
Foreign equity	26.1%
Foreign cash	0.5%
Foreign property	2.2%
Total	**100%**

Performance



PSG Stable Fund

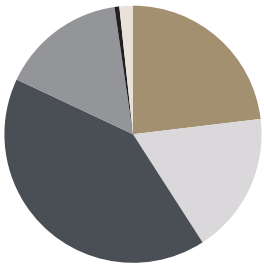
Top 5 equities

Japan Post Insurance Co Ltd
Brookfield Asset Management Inc
Discovery Ltd
L Brands Inc
Old Mutual Ltd

Top 5 issuer exposures

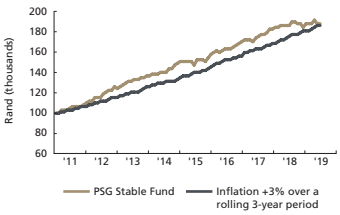
The Republic of South Africa
FirstRand Bank Ltd
Standard Bank of SA Ltd
PSG Money Market Fund
Eskom Holdings SOC Ltd

Asset allocation



Domestic equity	23.1%
Domestic cash and NCDs	17.8%
Domestic bonds	41.1%
Foreign equity	15.7%
Foreign cash	0.6%
Foreign property	1.7%
Total	**100%**

Performance



PSG Diversified Income Fund

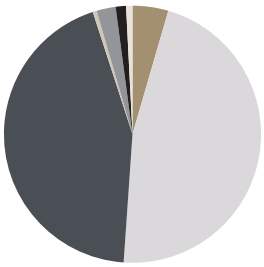
Top 5 equities

Brookfield Asset Management Inc
Japan Post Insurance Co Ltd
JSE Ltd
Simon Property Group Inc
Old Mutual Ltd

Top 5 issuer exposures

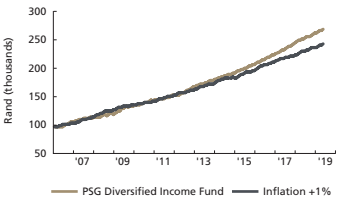
FirstRand Bank Ltd
The Republic of South Africa
Absa Bank Ltd
Standard Bank of SA Ltd
Nedbank Ltd

Asset allocation



Domestic equity	4.5%
Domestic cash and NCDs	46.6%
Domestic bonds	43.9%
Domestic preference shares	0.5%
Foreign equity	2.4%
Foreign cash	1.3%
Foreign property	0.8%
Total	**100%**

Performance

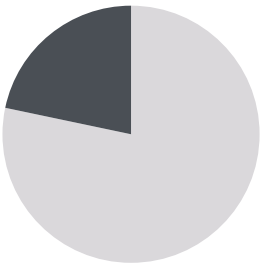


PSG Income Fund

Top 10 issuer exposures

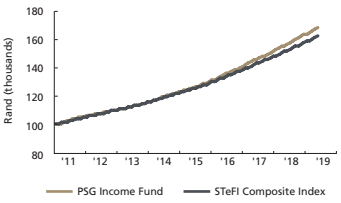
Absa Bank Ltd
Standard Bank of SA Ltd
Nedbank Ltd
FirstRand Bank Ltd
PSG Money Market Fund
The Republic of South Africa
Land and Agricultural Development Bank of SA
Eskom Holdings SOC Ltd
Bidvest Group Ltd
MMI Group Ltd

Asset allocation



Domestic cash and NCDs	78.3%
Domestic bonds	21.7%
Total	**100%**

Performance

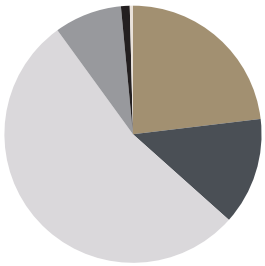


PSG Money Market Fund

Issuer exposures

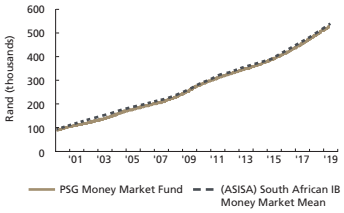
Absa Bank Ltd
Nedbank Ltd
Standard Bank of SA Ltd
FirstRand Bank Ltd
The Republic of South Africa
Investec Bank Ltd
Capitec Bank Ltd

Asset allocation



Linked NCDs/Floating-rate notes	23.1%
Step-rate notes	13.5%
NCDs	53.4%
Treasury Bill	8.5%
Corporate bonds	1.1%
Call	0.4%
Total	**100%**

Performance

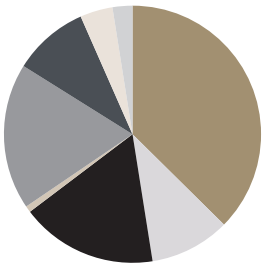


PSG Global Equity Sub-Fund

Top 10 equities

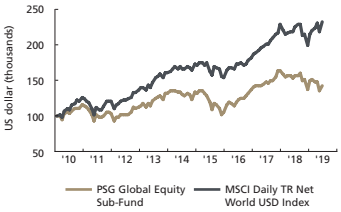
Brookfield Asset Management Inc
Japan Post Insurance Co Ltd
L Brands Inc
The Mosaic Co
Liberty Global Inc
Asahi Group Holdings Ltd
Prudential plc
Babcock International Group plc
Glencore plc
Resona Holdings Inc

Regional allocation



US	37.4%
Europe	10.1%
UK	17.2%
Asia ex Japan	0.8%
Japan	18.4%
Canada	9.5%
Africa	4.1%
Cash	2.5%
Total	**100%**

Performance



PSG Global Flexible Sub-Fund

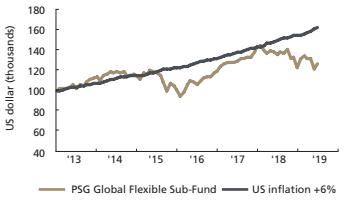
Top 10 equities

Brookfield Asset Management Inc
Japan Post Insurance Co Ltd
Liberty Global Inc
L Brands Inc
The Mosaic Co
Asahi Group Holdings Ltd
Prudential plc
Babcock International Group plc
Wheaton Precious Metals Corp
Glencore plc

Regional allocation

US	32.2%
Europe	8.2%
UK	14.2%
Asia ex Japan	0.8%
Japan	15.9%
Canada	8.9%
Africa	3.2%
Cash	16.6%
Total	**100%**

Performance



Percentage annualised performance to 30 June 2019 (net of fees)

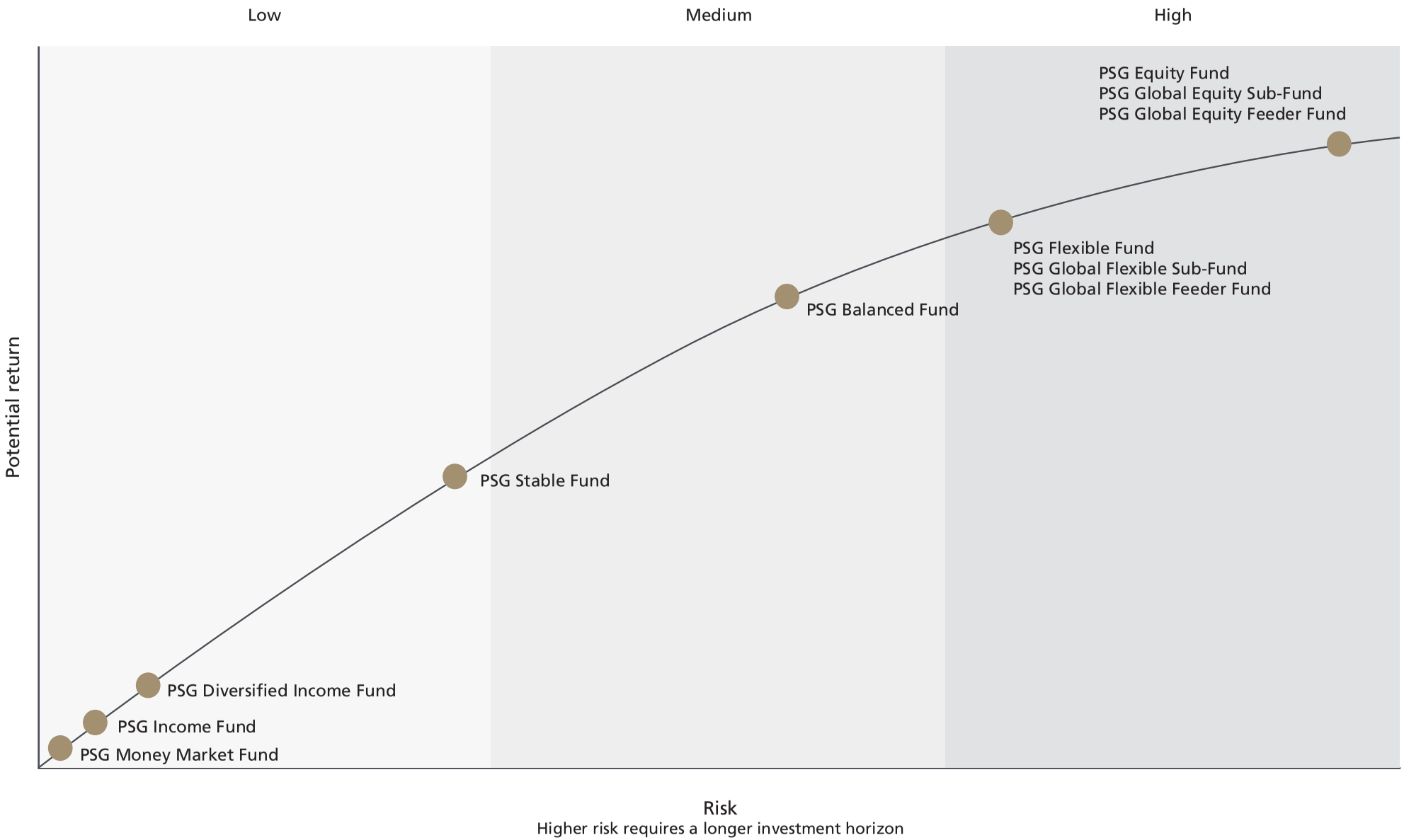
Local funds	1 Year	3 Years	5 Years	10 Years	Inception	Fund inception date
PSG Equity Fund A	-8.90	3.66	3.31	13.28	15.90*	31/12/1997
FTSE/JSE All Share Total Return Index	4.42	6.90	5.85	13.47	13.55	
PSG Flexible Fund A	-4.38	4.64	6.19	14.38	14.43**	02/11/1998
Inflation +6%	10.40	10.76	11.00	11.20	11.75	
PSG Balanced Fund A	-5.11	4.08	5.43	11.20	13.03	01/06/1999
Inflation +5%	9.49	9.79	10.01	10.20	10.52	
PSG Stable Fund A	1.01	5.58	6.33		8.41	13/09/2011
Inflation +3% over a rolling 3-year period	7.49	7.79	8.01	8.20	8.34	
PSG Diversified Income Fund A	6.86	7.80	7.69	7.74	7.83	10/04/2006
Inflation +1%	5.48	5.79	6.01	6.20	6.99	
PSG Income Fund A	8.34	8.41	7.88		7.03	01/09/2011
STeFI Composite Index	7.31	7.44	7.09		6.49	
PSG Money Market Fund A	7.30	7.45	7.10	6.46	8.46	19/10/1998
South African Interest Bearing Money Market Mean	7.51	7.62	7.18	6.54	8.53	
PSG Global Equity Feeder Fund A	-5.69	6.68	6.32		11.20	03/05/2011
MSCI Daily Total Return Net World USD Index (in ZAR)	9.40	10.37	12.78		18.38	
PSG Global Flexible Feeder Fund A	-4.14	5.38	6.90		10.85	11/04/2013
US inflation +6% (in ZAR)	10.91	6.81	13.72		15.93	

International funds	1 Year	3 Years	5 Years	10 Years	Inception	Fund inception date
PSG Global Equity Sub-Fund A	-7.42	7.59	0.93		3.97	23/07/2010
MSCI Daily Total Return Net World USD Index (in USD)	6.34	11.77	6.60		9.98	
PSG Global Flexible Sub-Fund A	-6.25	6.32	1.29		3.72	02/01/2013
US inflation +6% (in USD)	7.80	8.16	7.49		7.67	

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

Source: 2019 Morningstar Inc. All rights reserved as at end of June 2019.
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

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Trustee: The Standard Bank of South Africa Limited, Main Tower, Standard Bank Centre, 2 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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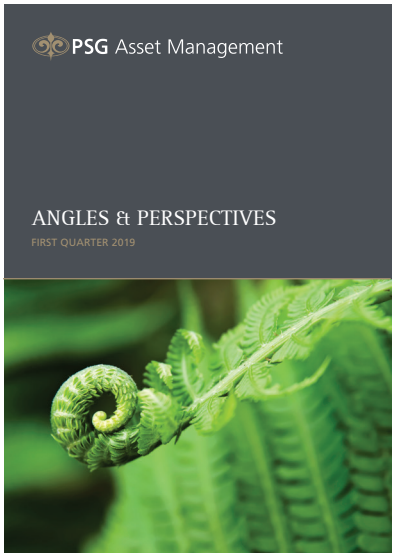
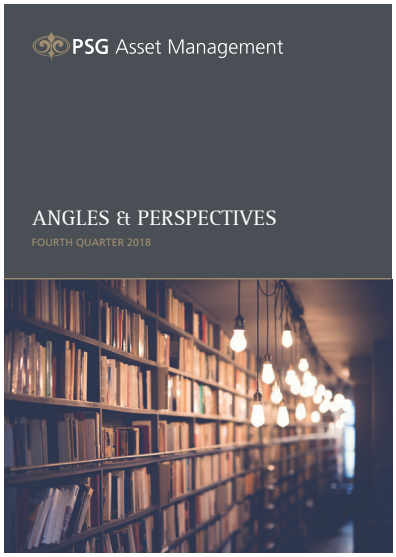
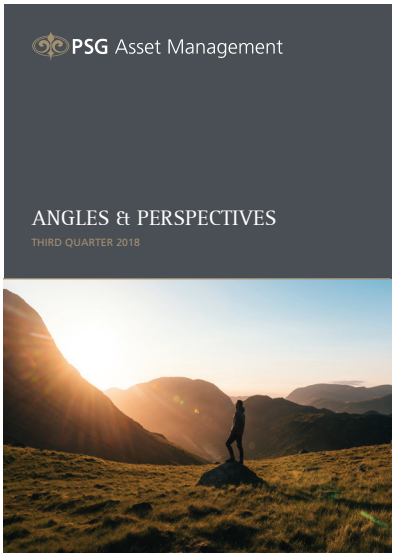


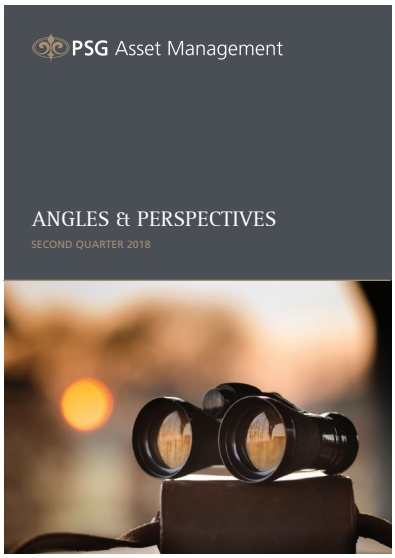
First quarter 2019



Fourth quarter 2018



Third quarter 2018



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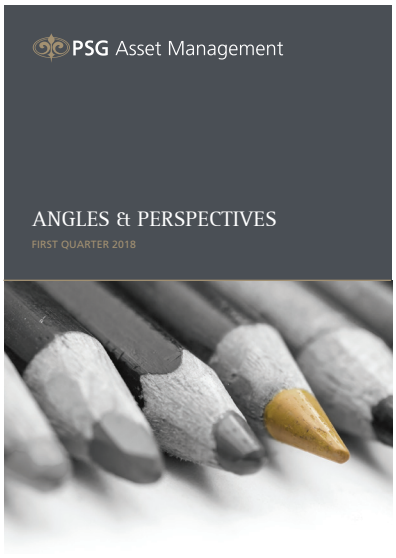
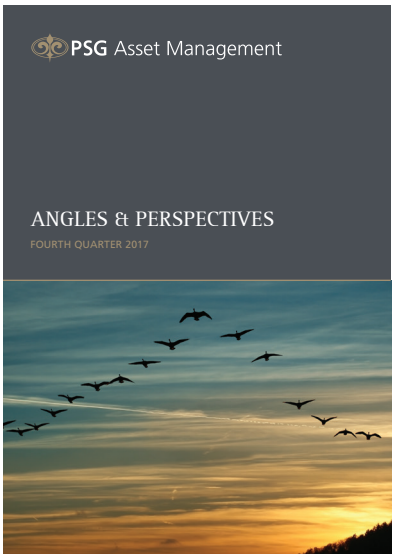


First quarter 2018



Fourth quarter 2017

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