MAESTRO

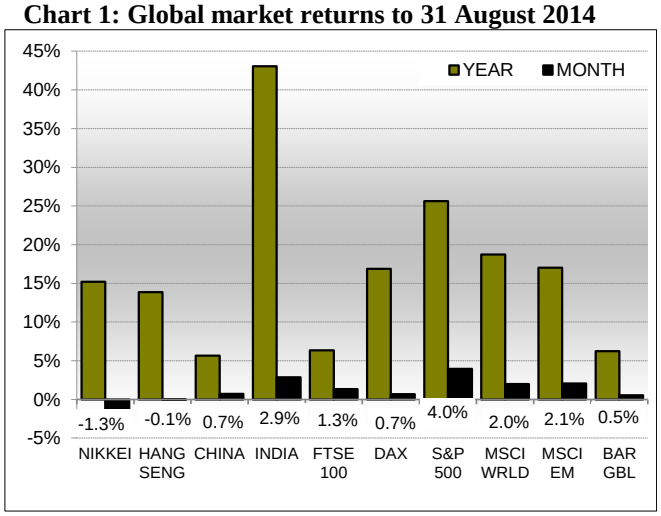
INTERMEZZO

Investment Letter | 14th Edition | September 2014

August in perspective – global markets

August proved to be a very interesting month indeed and was, by and large, profitable for investors almost irrespective of where they were invested. If one had to isolate two themes that dominated markets in August it was, firstly, evidence that the US economic recovery was gaining traction and secondly that the Eurozone was struggling to lift its head above water – and that's putting it kindly. These two themes translated into all-time record highs on the US equity markets and record highs for Eurozone bond prices (record lows for yields) as investors started front-running action they regard the European Central Bank (ECB) now has to take to stem the economic slowdown. The general expectation is that the ECB will enact a round of Quantitative Easing (QE) although the exact timing thereof remains open to debate.

Chart 1: Global market returns to 31 August 2014



Moving to the equity market returns for August, shown in Chart 1, the MSCI World index rose 2.0% while the MSCI Emerging market index rose by slightly more, up 2.1%. Their respective year-to-date returns are now 5.3% and 8.5% respectively, proving that 2014 is heading towards another profitable one for investors. The US market was the strongest amongst developed markets, rising 4.0%. The tech-heavy Nasdaq rose 4.8% while the S&P mid and small indices rose 4.9% and 4.2%, testimony to the appetite for risk that prevailed for most of the month. European equity markets were retarded by the geopolitical concerns surrounding the Ukrainian mess and the effects of further sanctions against Russia; Germany rose only 0.7% while the UK managed a 1.3% gain. The Japanese equity market declined 1.3%. Within the emerging market space, Brazil was the standout feature, posting a gain of 8.8%. India rose 2.9% bringing its annual gain to 43.0% but China posted a modest 0.7% gain. The Russian equity market slid 2.6%.

Global bond markets were also strong, particularly those is Europe, for the reasons already mentioned. The German 10-year bond yield slid through the 1.0% mark and closed the month at 0.89%; yes, that's right, you can now lend money to the German government for 10 years and receive only 0.9% *per annum* for the next ten years! Spanish 10-year yields ended the month at 2.2%, Italy at 2.4%, the UK at 2.37%, France at 1.25% and Switzerland at 0.44%.

Against the backdrop of slowing Eurozone growth and absent any inflation of note, the euro declined sharply against the dollar, losing 1.6% against it on the month. Sterling was also weak; it lost 1.6% against the dollar. The strong dollar took its toll on commodities; gold ended the month virtually flat but platinum and silver declined 2.6% and 5.9% respectively. Iron ore was particularly weak, falling about 8.0%. The price of oil fell 3.4%.

What's on our radar screen?

Here are a couple of items we are keeping a close eye on:

- *The SA economy:* During the past month the second quarter (Q2) economic growth rate was announced. It came in below expectations, with particular weakness in the mining sector, which was hardly a surprise, as well as the manufacturing sector, also not a surprise but still rather alarming. All in all the economy grew at an annual rate of just 0.6% in Q2, which, although an improvement on the -0.6% in Q1, is still nevertheless way below par. A breakdown of the constituents that make up the SA economic pie are shown in Table 1.

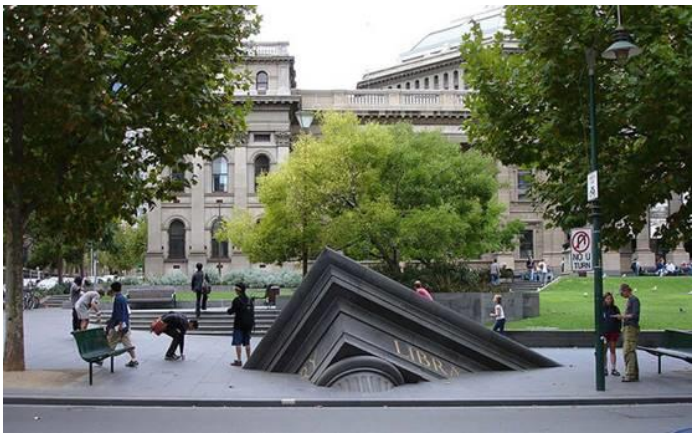
Table 1: SA GDP breakdown: 2014 Q1 and Q2

	2013	2014	
	ann. ave	Q1	Q2
Agriculture	2.3	2.5	4.9
Mining	3.1	-24.7	-9.4
Manufacturing	0.8	-4.4	-2.1
Electricity	-0.4	0.1	-0.6
Construction	2.8	4.9	5.0
Trade	2.2	2.1	-0.2
Transport & comms	1.9	1.7	4.0
Finance & business	2.4	2.0	1.5
Government	1.5	1.7	2.9
Personal services	1.8	1.0	1.2
GDP at basic prices	*1.9*	*-0.9*	*0.7*
Taxes less subsidies	2.1	1.3	0.2
Total GDP	**1.9**	**-0.6**	**0.6**

Source: Deutsche Bank

We have always highlighted South Africa's current account deficit as one of the country's Achilles heels, so it was with some concern that we noticed that the Q2 deficit rose to 6.2% of GDP, from the first quarter Q1's 4.5%. Hopefully this is an anomaly and it will improve in the third quarter, although a lot of the factors that led to the deterioration in the deficit are beyond government control, such as slowing demand for exports from Asia

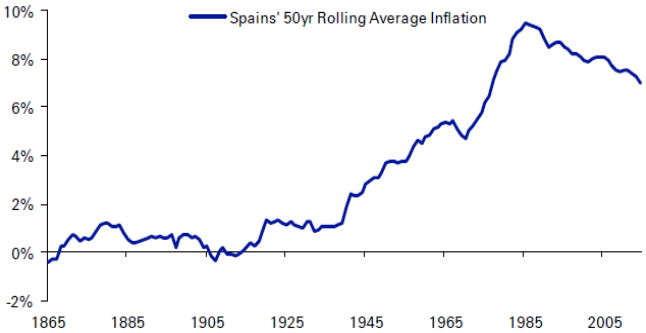
- *The US economy:* In the main, US economic data released during the past month provided evidence that the recovery is continuing. Inflation remains benign, consumer confidence remains reasonable, growth is good Q2 GDP was revised from 3.9% to 4.2%) and general economic activity, as measured by the ISM indices, continues to increase. There were some disappointments, including lower than expected retail sales, and the labour market remains problematic. While the unemployment rate continues to decline, the number of employable people now opting out of the labour pool, as measured by the labour force participation rate (LFPR) continues to grow – the LFPR is now at its lowest level since 1978 - providing substance to the views of many analysts who believe the structural changes in the US labour force in the past decade are largely misunderstood and poorly appreciated.
- *Developed economies:* One of the features of the month was the increasing evidence of an economic slowdown in Europe. Annual inflation in the **Eurozone** declined to just 0.3%, a five-year low. Worse still, unemployment across the Eurozone, at 11.5%, remains stubbornly high. **German** August unemployment remained unchanged at 6.7%. The ECB announced measures to combat the weakness, including a reduction in official bank deposit rates from -0.1% to -0.2%. In **Japan** increased questions are being asked of the effectiveness of Abenomics, as Q2 economic "growth" was revised from -6.8% to -7.1%, although in fairness Q1 growth was boosted prior to the imposition of increased sales tax in April.
- *Emerging market economies:* The **Indian** economy grew 5.7% during Q2 versus Q1's 4.6% growth. Inflation remains stubbornly high at 8.0%, up from June's 7.5%.



Charts of the month

In the June and July editions of *Intermezzo* we drew your attention to some of the anomalies that are currently found in global bond markets, being brought about by the trillions of dollars central banks have pumped into the global financial system to keep interest rates low and markets liquid.

Chart 2: Spain's 50-year rolling average inflation



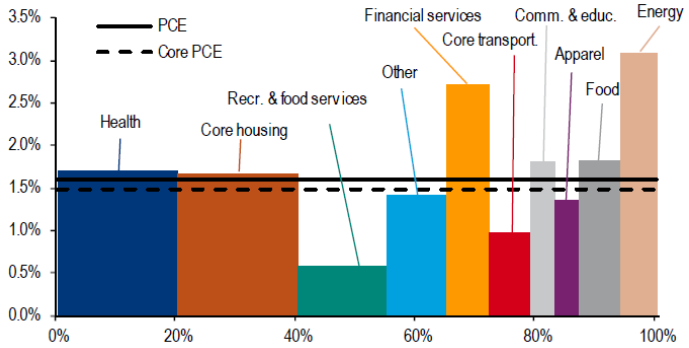
Source: Deutsche Bank

This month we saw yet another interesting anomaly: Spain issued a 50-year bond bearing a coupon of 4.0%. While this yield may look attractive when viewed against the prevailing European and US bond rates – it was issued on the day that French 2-year bond yields traded below 0.0% - Deutsche Bank points out that the average Spanish inflation rate over

the past 50 years is 7.5% (refer to Chart 2) i.e. some 3.5% higher than the rate at which this bond was issued. Strange how investors would ignore the past 50 years of economic data, presumably on the (naive?) belief that Spanish inflation in this case is simply going to improve in the coming decades. History is not on their side.

I would like to share another chart with you briefly, in order to shed some light on an often misunderstood concept of economists and econometricians. It has to do with the notion of *headline* inflation and *core* inflation, where the latter refers to inflation excluding food and energy price increases. The cynical retort from many observers is usually "don't economists eat or drive anywhere?" ☺ While I will refrain from answering that question, for fear of offending my economist friends, Chart 3 depicts the composition of June headline inflation in the US. Forgetting for a moment the actual values, the broadness of the histograms depicts their relative weighting in the basket that measures US inflation. Each country would have its own basket, but the chart is fairly typical of a developed country's inflation basket. You will notice that food and energy i.e. the two components that are excluded in the measurement of core inflation, listed on the right-hand side of the chart, actually comprise only a small component of the overall inflation basket i.e. core inflation as a measure of rising prices, covers by far the majority (nearly 85%) of price increases of goods. Econometric testing has also shown that core inflation is a more accurate long-term indicator of inflation than headline inflation. Bear in mind that food and energy prices are often volatile, which is one of the reasons they are excluded in the "core" basket. Hopefully this removes some of the scepticism regarding the measurement of core inflation.

Chart 3: The composition of US June headline PCE inflation
Vertical axis measures component inflation; horizontal axis measures weight in PCE



Source: Merrill Lynch

August in perspective – local investment markets

Turning to local investment markets, aided by a supportive global bond environment and a marginally firmer rand, the bond market produced a surprising monthly return of 2.8%, bringing its year-to-date return to 7.4%. The equity market was under some pressure, due to declining commodity prices; the basic material sector declined 6.1% while the financial and industrial sectors rose 0.4% and 1.7% respectively. Not surprisingly, large cap shares led markets lower – the Top40 index declined 0.8% while the mid and small cap indices each rose 1.6%. The best performing sectors were fixed line telecoms (Telkom), which rose 15.1%, non-life insurance (Santam), which rose 10.2% and mobile telecoms, up 9.6% (MTN rose 8.4%). The worst performing sectors were general mining, down 8.0%; the industrial metals sector declined 7.9% (Kumba fell 15.1%) and platinum mining 6.5% (Implats and Amplats down 9.5% and 6.0% respectively).

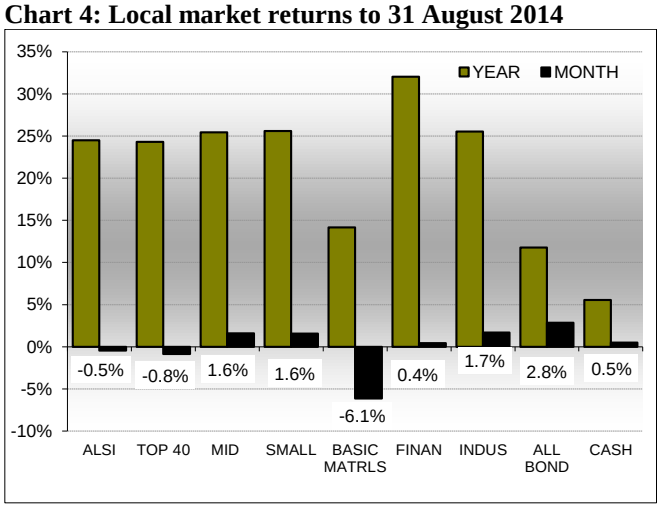
This might be an appropriate place to share something with you that is weighing on the collective mind of the Maestro investment team. We have noticed an increasing degree of volatility at an intra-market level, by which I mean that, although the market itself has not been too volatile, many share prices of specific companies are becoming increasingly volatile. In addition, there have a few major casualties in the market of late, Abil being an obvious example. Both of these factors have caused small – only small at this stage – alarm bells to start ringing within our mindset.

We are worried about the SA economy slowing more than most people believe; we are very worried about the fact that government has "lost control" of the economy and perhaps even more worryingly that they have no idea of how it actually works and consequently no idea of how to "fix it". The parlous state of the majority of parastatals – Eskom

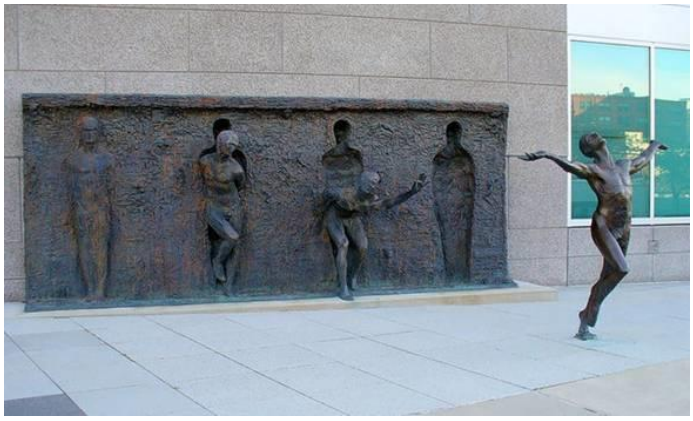
MAESTRO
INTERMEZZO
Investment Letter | 14th Edition | September 2014

being the most obvious example – provides ample evidence that most policy and decision makers in government are simply unable and unqualified to do their job. The consequences are an increasing morass of unnecessary regulation as government tries to "reign in" the unruly corporate sector when, at least in our view, they should be freeing up the sector to create jobs and get the economy going. But in the absence of a supportive policy framework, the future of the SA economy, and indeed all of SA, is getting increasingly bleak.

Chart 4: Local market returns to 31 August 2014



The increasingly volatile company-specific movements are testimony that "it is getting tougher out there" and that the external environment is fraught with new and heightened risks. For now, we see no real catalyst for change.



For the record

Table 2 below lists the latest returns of the mutual and retirement funds under Maestro's care. You can find more detail on our website at www.maestroinvestment.co.za. Returns include income and are presented *after* fees have been charged. Fund Summaries for each respective fund listed in the table are available on our website.

Table 2: The returns of funds under Maestro's care

	Period ended	Month	Year to date	Year
Maestro Equity				
Prescient Fund	**Aug**	**0.4%**	**7.4%**	**21.4%**
JSE All Share Index	*Aug*	*-0.5%*	*12.3%*	*24.5%*
Retirement Funds				
Maestro Growth Fund	**Aug**	**0.4%**	**7.0%**	**18.3%**
Fund Benchmark	*Aug*	*0.4%*	*9.8%*	*19.0%*
Maestro Balanced Fund	**Aug**	**0.5%**	**6.7%**	**16.8%**
Fund Benchmark	*Aug*	*0.5%*	*9.0%*	*17.1%*
Maestro Cautious Fund	**Aug**	**1.1%**	**7.9%**	**15.6%**
Fund Benchmark	*Aug*	*0.9%*	*7.5%*	*13.0%*
Central Park Global				
Balanced Fund ($)	**Jul**	**-2.8%**	**1.9%**	**11.9%**
*Benchmark**	*Jul*	*-0.9%*	*2.6%*	*8.0%*
*Sector average **	*Jul*	*-0.4%*	*2.9%*	*7.9%*

* 40% MSCI World Index, 20% each in Barclays US Aggregate Bond Index, Credit Suisse Tremont Hedge Index and 3-month US Treasury Bills
** Lipper Global Mixed Asset Balanced sector ($)

As is our habit, we list below the returns Maestro generated for our clients on the equity component of their portfolios for the periods to end-June 2014. Just to remind you, these returns represent the actual average returns, after the deduction of fees i.e. the net returns, across the discretionary equity portfolios under our management. There is very little dispersion around this average, which renders the returns a reliable indicator of our clients' experience. Chart 5 depicts the same return data, just in graphic format.

Table 3: Maestro annual returns to 30 June 2014 (%)

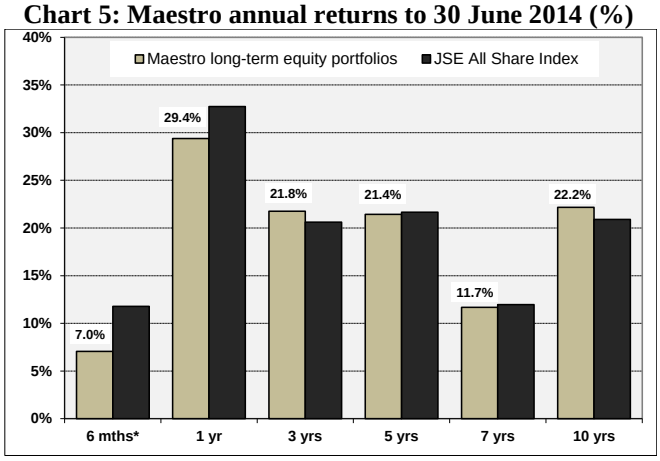
SA equity returns	6m *	1 yr	3 yrs	5 yrs	7 yrs	10 yrs
Maestro local equity returns	*7.0*	*29.4*	*21.8*	*21.4*	*11.7*	*22.2*
JSE All Share Index	11.8	32.7	20.6	21.7	12.0	20.9

* 6-month returns are un-annualized

Our clients will be aware that we had a relatively poor first quarter (Q1) in terms of returns relative to the All share index. The underperformance was largely attributable to the nature of the equity portfolios in our care, which have less resource shares than the weighting of resource shares in the All share index (the basic materials index rose 8.6% in Q1 versus a rise of 0.8% in the industrial index during the same period). This is a conscious decision about which we feel comfortable (we obviously don't like to underperform the market, though), which has also led to our returns, over the years, being significantly less volatile than those of the overall SA equity market. The outperformance by the resource sector has abated (basic materials rose 1.8% versus the 9.1% increase in the industrial index during Q2), which has enabled our relative returns to claw back some lost ground. This trend continued during July and into August.

MAESTRO
INTERMEZZO
Investment Letter | 14th Edition | September 2014

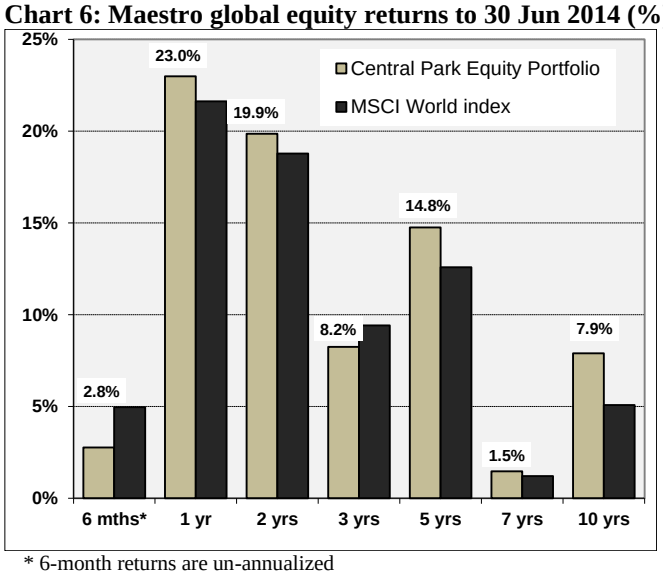
Chart 5: Maestro annual returns to 30 June 2014 (%)



* 6-month returns are un-annualized

Maestro has begun offering, on a very selective basis, to manage global equity portfolios. We have been active in the global equity market, by virtue of us managing our offshore unit trust, Central Park Global Balanced fund, for the past ten years. We list, for interest sake, the returns of the equity component of the Central Park portfolio, in Chart 6 and Table 4. This is the first time we have been able to show a 10-year record of global equity returns, which as you can imagine, represents a milestone for the team.

Chart 6: Maestro global equity returns to 30 Jun 2014 (%)



* 6-month returns are un-annualized

Table 4: Maestro global equity returns to 30 Jun 2014 (%)

SA equity returns	6m *	1 yr	3 yrs	5 yrs	7 yrs	10 yrs
Maestro global equity returns	*2.8*	*23.0*	*8.2*	*14.8*	*1.5*	*7.9*
MSCI World index	5.0	21.6	9.4	12.6	1.2	5.1

* 6-month returns are un-annualized

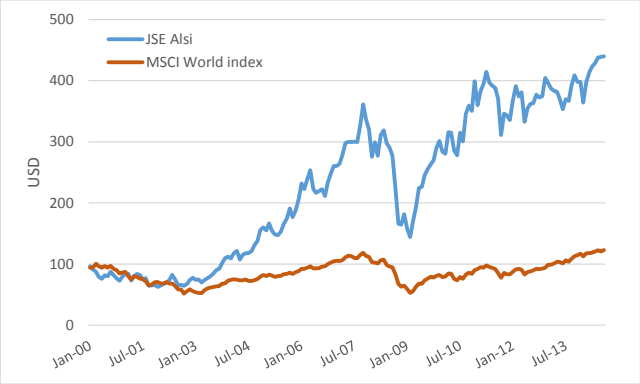
The "offshore versus onshore" debate - by Victor Mupunga

Whilst flicking through TV channels before calling it a night a few days back, I caught the end of what seemed like a routine interview on a local business channel. Judging from the respondent's remarks, the interviewer must have asked him to explain what they (the company that the interviewee represented) were doing with their clients' cash at that time. When I tuned in, the respondent was explaining that his company had used up their maximum offshore allocation. What caught my attention was what the gentleman said next: he said something to the effect that if there was no regulation limiting the amount of funds they could invest offshore for their clients, they would have over 40% offshore compared to the 25% that is currently permissible. That statement got me thinking, what offshore allocation would we at Maestro allocate to our regulation 28 funds if we had free rein? Judging by our discretionary mandates, I reckon we would allocate just short of 30% offshore in the current environment. Interestingly, I believe if we left that decision to some of our clients, the allocation would be significantly more than 30%.

The call of whether to invest in the SA equity market or offshore is never an easy one – it often elicits spirited debates at our quarterly investment meetings and I suspect in your social and business circles too? The reason it is a hotly contested topic in many spheres is because of the rand, which is notoriously hard to predict, and of course the barrage of news on the country, which is usually negative. Our task entails sifting through the 'noise' in an attempt to isolate what we regard as the important information that we believe will affect the currency and ultimately offshore returns for local investors, over the long-term. As difficult a task as that is, we have seen that history contains a lot of lessons on how we can best manage such uncertain variables as the rand, to the point where we are comfortable in making this call on behalf of our clients. Chart 7 is a graph that we

particularly enjoy as it gives a long-term perspective on the "offshore versus local" call – the chart shows the dollar return on the local JSE market versus the MSCI world index.

Chart 7: Global versus local US dollar returns

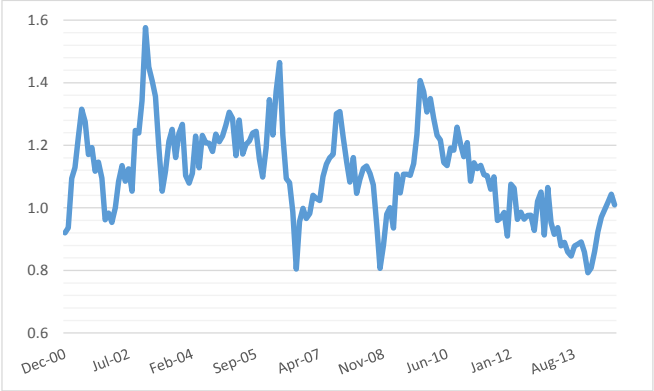


Source: Maestro

What is clear from Chart 7 is that the local market has been a very profitable investment destination since the turn of the century. In numbers, a $100 000 investment in the local market would have grown to $440 050, while $100 000 invested offshore, using the MSCI World index as a proxy, would be worth only $123 070. Many will recall the sentiment towards South Africa (SA) and other emerging markets in the early 2000s. The rand was even weaker than it is today; in the four years leading up to December 2001 it lost more than half its value. In hindsight, we now know that this was in fact the beginning of a very profitable period for both the SA bond and equity markets. The same can be said of the period around the 2007/9 crisis, when investors fled emerging markets, SA included, and were left to rue missing out on the ensuing profitable years.

Notwithstanding the above, there have been periods where global equities have outperformed local equities. Chart 8 below highlights those periods – the chart measures the relative performance of local to global equities. The chart should be read as follows, whenever the line graph is above one (1.0) on the vertical axis, the local market outperformed global markets on a rolling annual basis. As seen in Chart 8, there have been few (and brief) periods where the local market has lagged global markets. This is, unsurprisingly, during bouts of risk aversion, when the local market tends to decline more than its global peers.

Chart 8: JSE performance relative to the MSCI World



Source: Maestro

Apart from those incidences, global and local equity markets tend to move in tandem. Indeed, the correlation coefficient of the two, which is a statistical measure of how the two move in relation to each other, is 0.7, which indicates that the two are very closely related. The magnitude of outperformance (or underperformance) of the two markets relative to each other has also been decreasing over the past two decades.

The reason why I highlight this topic is to debunk another comment I have come across in the media, namely the notion that we could soon see a significant decline in the local market when global markets are rising. While there will undoubtedly be periods of divergence, we hold the view that in the increasingly open global economy in which we live and invest, where the country in which a company is listed and where it does business are not necessarily the same, global and local markets will continue to move with a high degree of correlation. The aforementioned is one of the main reasons why we at Maestro spend a disproportionate amount of our time looking at global economies and companies. In fact, it is estimated that up to 40% of JSE listed earnings are non-rand denominated, a number that we see increasing over time.

MAESTRO

INTERMEZZO

Investment Letter | 14th Edition | September 2014

File 13. – Things almost worth remembering

Setting the record straight

I am deeply embarrassed to have to report that I made a terrible error in last month's edition of *Intermezzo*. In bemoaning the state of education in South Africa, I incorrectly arrived at the amount of R18m that government spends per year on every SA scholar. The correct number is actually closer to R18 000. I do apologize for my error and am grateful to those of you who pointed it out to me.

A few observations about the US Q2 reporting season

For obvious reasons, investors and analysts watch the US corporate reporting season very closely. Now that it is just about over, it is worth highlighting some of the salient features of this regular period in market life. Total Q2 earnings of the 500 companies that constitute the S&P500 index rose 7.9% on an annual basis. This consisted of 4.7% sales growth, a 1.3% increase in net operating margin and a reduction of 1.8% in the number of shares on which the data is calculated. Excluding the results of financial companies (their earnings tend to distort traditional measures of growth) the annual increase in earnings was 12.4% , derived from a 5.0% increase in sales, 5.0% margin expansion and a 2% shrinkage in shares.

Speaking of the "share shrink" buybacks i.e. where companies buy back their own shares and usually cancel them, these have been a major feature of the markets in recent years (refer to Chart 4 in the August edition of *Intermezzo*). During Q2, S&P companies announced buybacks of $106bn and completed net buybacks of about $90bn, which was smaller than the prior four-quarter average of $145bn and $109bn respectively. Current expectations are for the share buyback rate to continue around $100bn per quarter, which will naturally boost S&P earnings by around 1.0%.

So what's with the pics?

A reader recently sent me a number of pictures of unusual sculptures. I thought I would share some of them with you. I apologize for not being able to identify the sources of each picture, nor each respective location. Nothing quite like a creative mind, is there? Enjoy.

Table 5: MSCI returns to 31 August 2014 (%)

29-Aug-2014	Mkt cap	US$ perf (%)		
Region/Country (# Co)	U$bn	2013	1M	YTD
North America (711)	20,321	27.6	3.7	8.7
Canada (95)	1,485	3.3	2.1	12.4
US (616)	18,836	29.9	3.8	8.4
Europe (437)	8,876	21.7	0.2	-0.4
Austria (8)	30.5	10.9	-2.2	-17.7
Belgium (11)	164	24.6	2.5	4.2
Denmark (13)	198	23.4	-1.4	13.7
Finland (12)	117	41.6	0.4	0.4
France (73)	1,320	23.3	1.1	-2.4
Germany (54)	1,182	28.2	-0.9	-8.0
Ireland (4)	40.3	38.9	2.9	2.0
Italy (26)	331	16.9	-2.3	4.2
Netherlands (24)	356	28.5	1.7	-3.2
Norway (10)	117	5.3	1.6	6.2
Portugal (5)	26.3	7.5	-1.5	-13.4
Spain (22)	480	27.7	-1.3	6.1
Sweden (30)	403	21.4	-0.2	-4.2
Switzerland (38)	1,217	23.8	2.2	2.6
UK (107)	2,895	16.2	-0.3	1.3
Israel (9)	70.0	8.0	-3.1	17.1
Asia Pac (989)	7,112	9.3	-0.6	4.6
Japan (311)	2,735	24.9	-2.2	-1.9
Australia (69)	1,095	-0.3	0.3	9.9
New Zealand (6)	18.3	6.2	-1.1	9.0
Asia Pac ex-Japan (678)	4,377	0.5	0.4	9.2
Asia ex-Japan (603)	3,264	0.7	0.4	9.0
China (141)	811	0.4	0.2	4.8
Hong Kong (39)	406	8.1	-1.2	7.5
India (68)	285	-5.3	2.4	24.8
Indonesia (30)	107.8	-25.0	-1.4	27.6
Korea (103)	645	3.1	-0.8	4.2
Malaysia (43)	162	4.2	0.9	2.4
Philippines (20)	41.7	-4.3	2.5	22.5
Singapore (29)	202	-1.8	-2.2	4.7
Taiwan (101)	508	6.6	2.9	13.1
Thailand (29)	96.5	-16.9	4.9	21.0
EMEA (159)	746	-8.0	0.3	-1.0
Czech Republic (3)	9.3	-14.9	4.6	5.9
Egypt (4)	9.7	6.2	8.6	30.7
Greece (10)	29.4	46.2	-0.2	-3.8
Hungary (3)	8.2	-9.0	-0.2	-17.9
Poland (23)	64.9	-1.7	1.6	-3.7
Qatar (10)	19.1	23.9	1.1	18.5
Russia (22)	194.5	-2.6	-1.5	-17.5
South Africa (50)	318.1	-8.8	1.7	10.8
Turkey (25)	69.9	-28.1	-3.4	19.1
UAE (9)	22.8	84.7	-0.1	35.2
Latin America (140)	848	-15.7	7.8	14.5
Brazil (73)	503	-18.7	10.8	21.4
Chile (20)	59.1	-23.0	-0.5	-7.0
Colombia (14)	43.1	-23.7	2.1	12.9
Mexico (30)	223	-2.0	5.0	7.1
Peru (3)	18.8	-31.0	5.7	17.8
Developed Markets (1611)	33,723	24.1	2.0	5.3
Emerging Markets (834)	4,249	-5.0	2.1	8.5
World (2445)	37,973	20.3	2.0	5.6

Source: Merrill Lynch