MAESTRO
Balanced Fund

PRESCIENT
LIFE LIMITED

INVESTMENT OBJECTIVE
The Fund's objective is to produce above-average long-term returns whilst assuming less risk than inherent in the market itself. The Fund is balanced across multiple asset classes and is subject to the restrictions of Regulation 28 of the Pensions Funds. Although the Fund adopts a conservative investment philosophy, the exposure to equities will be less than that of the Maestro Growth Fund and more than the Maestro Cautious Fund.

FUND BENCHMARK (BMK)
The Fund will measure itself against a benchmark consisting of 50% All share Index, 20% All bond Index (ALBI), 20% Short term fixed income (STEFI) index and a 10% global benchmark.

LEGAL STRUCTURE
The Fund is a pooled portfolio on the Prescient Life Limited balance sheet. The appointed portfolio manager of the Fund is Maestro Investment Management (Pty) Limited, an approved Financial Services Provider in terms of the Financial Advisory and Intermediary Services Act, operating under licence number 739. Prescient Life Limited is a linked insurer governed by the Long Term Insurance Act. Prescient Life Limited issues investment linked policies. This Fund operates as a white label under the Prescient Life Licence.

FEE STRUCTURE
The annual investment management fee is 1.5%. The fee is inclusive of all underlying managers' fees, platform and administrative fees. In the case where the Fund is accessed and used as a Preservation Fund or Retirement Annuity an additional fee of 0.2% per annum is charged by Prescient.

FUND SIZE: R 17 595 043

LONG TERM INSURER
Prescient Life Limited
(Reg no: 2004/014436/06)

AUDITOR
KPMG Inc.

PORTFOLIO MANAGER
Maestro Investment Management (Pty) Ltd
(Reg no: 2000/028796/07)

ENQUIRIES
David Pfaff
Maestro Investment Management
Box 1289
CAPE TOWN
8000
Tel: 021 674 9220
Fax: 021 674 3209
Email: david@maestroinvestment.co.za

The Maestro Balanced Fund

Quarterly report for the period ended

30 June 2012

1. Introduction

This Report focuses on the investment activities of the Maestro Balanced Fund during the recent past although it should be read in conjunction with previous editions of *Intermezzo*, wherein we documented some of the salient events in recent months. Appendix A contains a summary of the market activity during the June quarter.

2. The investment position of the Fund

The Fund's asset allocation is shown in Chart 1. Exposure to the equity market totalled 53.1% of the Fund, down from 56.0% at the end of March. Bond exposure increased from 14.1% to 16.5% and offshore exposure fell to 18.7% from 20.5% of the Fund. Cash represented 11.9% of the Fund, up significantly from March's position of 9.4%.

Chart 1: Asset allocation at 30 June 2012

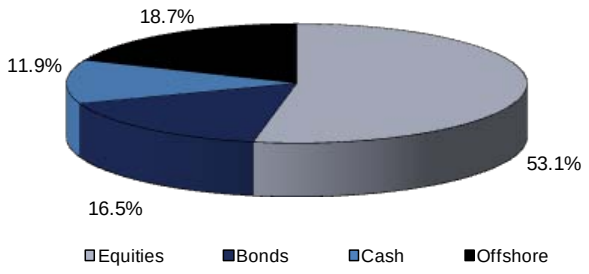
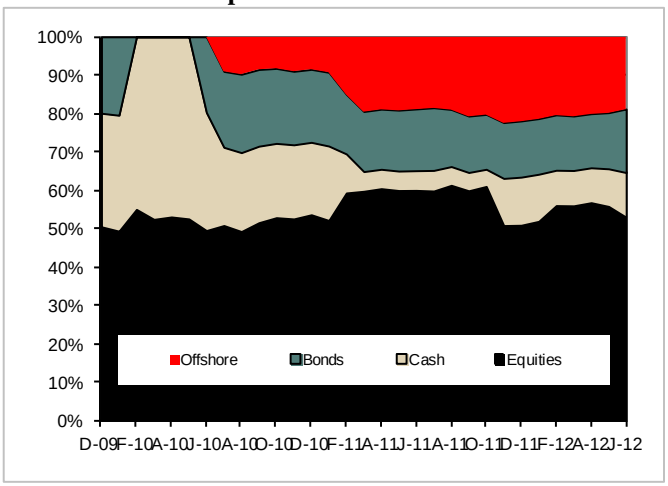


Chart 2 depicts the historical allocation to the major asset classes, expressed as a percentage of the total Fund.

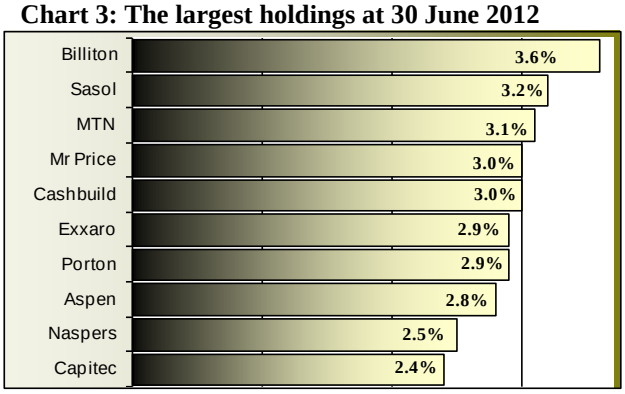
Chart 2: Sector exposure at 30 June 2012



3. The largest equity holdings

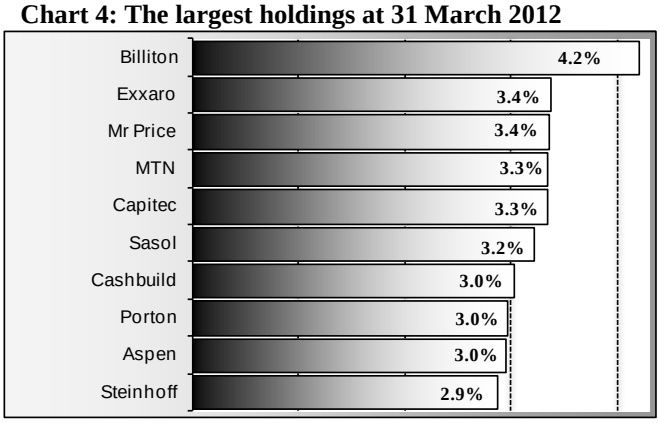
The largest holdings at 30 June are listed in Chart 3 expressed as a percentage of the Fund's equity portfolio.

Chart 3: The largest holdings at 30 June 2012



The largest holdings at the end of March are listed in Chart 4. During the quarter Naspers displaced Steinhoff in the largest holdings. At the end of June there were 29 counters in the equity component of the Fund, compared to 25 at the end of March. The ten largest holdings constituted 29.4% of the Fund down from 32.7% in March.

Chart 4: The largest holdings at 31 March 2012



4. Recent activity on the Fund

The investment objective on this Fund is to *achieve long-term growth through the assumption of moderate risk.* We would emphasise the "long-term" aspect of this objective; we are confident that the companies in which the Fund is invested will deliver long-term capital growth together with a steady increase in dividends over time.

The Fund has been designed in accordance with the rules and regulations that govern Regulation 28 of the Pensions Fund Act. It is not open to the retail public and can only be accessed through a company's Provident/Pension Fund or by individuals who have preservation money or wish to either transfer or purchase a Retirement Annuity (RA). These RA's can then be converted into living annuities when the time arises.

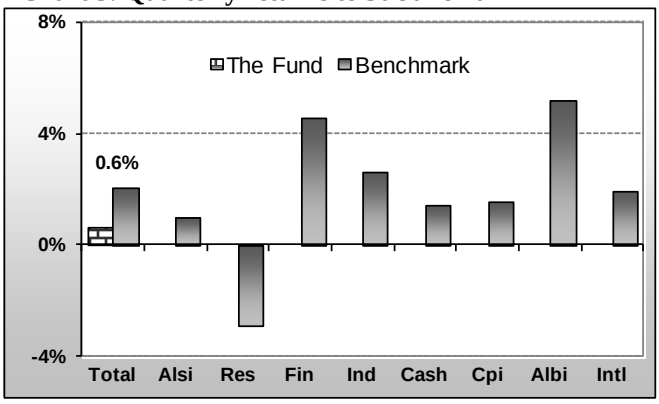
The document focuses on the equity component of the Maestro Balanced Fund both locally and globally, due to these components making up the lion share of the Asset Allocation.

We are still of the opinion that domestic equities are the asset class of choice over the medium to long term. The Balanced Fund's exposure to equities declined 2.9% during the second quarter of 2012. The offshore component declined by 1.8% while the fixed income; namely cash and bonds both rose by approximately 2.5% each.

5. The performance of the Fund

Chart 5 depicts the returns for the quarter against the major indices. ***The un-annualised return on the Fund during the June quarter was 0.6%*** which can be compared to the Maestro Balanced Fund benchmark of 2.1%**.** Appendix A summarizes the major developments during the quarter for your interest.

Chart 5: Quarterly returns to 30 June 2012



The international component produced a rand return of 1.1% versus the 1.9% rise in the benchmark; the rand declined 6.2% during the quarter**.** ***The Fund's quarterly equity return of 3.3%*** can be compared to the Maestro equity benchmark and All share index returns of 1.9% and 1.0% respectively. We commented extensively in recent letters and *Intermezzo* about the state of the markets during the past few months and refer you to those publications to refresh your memory about the salient features of this period; you can find back copies of *Intermezzo* by clicking here. I also refer you to Appendix A, which details the nature of the market movements during the quarter. Like so many other periods in the market during the past years the June quarter was unique and provided the Fund with yet another positive quarterly return.

You will see from Appendix A that, unlike the March quarter when investors enjoyed broad gains across most asset classes, the gains during the June quarter differed across asset classes. Risk assets were generally weak

while assets that are perceived as "safe" had a strong quarter. Considering the impressive returns that riskier assets posted at the start of the year, it did not come as a major surprise that they were out of favour during the June quarter. In local currency, the All Share Index (Alsi) just managed to register a positive return of 1.0%. The rand's 6.2% decline brought the Alsi more in line with international markets when reported in dollar terms. Just about all the negative returns were accumulated in the month of May when uncertainty over the future shape and constituents of the Eurozone resurfaced, causing investors to sell equities in favour of fixed income assets.

As the quarter progressed it became apparent that the prior expectations concerning global economic growth were far too optimistic and, without the assistance of policymakers, the global economy would continue to falter. Unfortunately, no policymakers came to the rescue until literally the final hour of the quarter when an emergency European Union summit conjured up a solution they believed would assist ailing Euro nations. Markets cheered this development and it added some respectability to the quarter's gains.

With that by way of a macro economic backdrop it is not surprising to see that basic material shares were once again the laggards. The resource index was the only index that registered negative returns (-2.9%) while financials and industrials rose by 4.6% and 2.6% respectively. Your Fund's relative outperformance against the benchmark was largely driven by the asset allocation call - overweight industrials and underweight resources. It is extraordinary to see the divergence in the various indices' returns continue to widen.
We attribute this variance to a number of factors; the first being the heightened uncertainty is causing investors to seek the safety of assets with more predictable cash flows. Within the equity sectors, financials (specifically listed property) and industrials have far more predictable earnings and hence dividend distributions than resource shares, which are cyclical in nature. We believe this lack of visibility as far as future cash flows are concerned is counting against resource shares; investors continue to dump them in favour of financials and industrials which provide some income in a low yield global environment. Another facet of resource shares that many seem to forget is that they are ultimately price takers. Regardless of how well a resource mine or oil rig is run, the selling price of its output is determined by the market. Commodities have been among the worst performing asset class for the year-to-date, so it is logical to see resource shares struggle as they have.

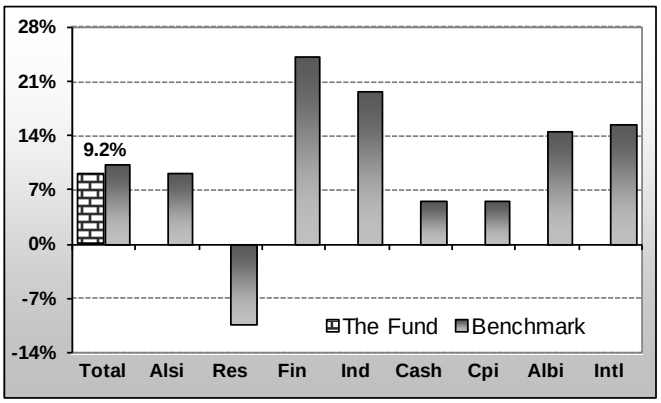
Chart 6 summarizes the net result for the quarter: financials led the indices, gaining 4.6% during the quarter, industrials 2.6% and resources -2.9%. Across the size spectrum, large caps returned 0.6% for the quarter, lagging the mid (up 3.2%) and small cap (1.8%) indices. The preference share component of your Fund posted a disappointing quarterly return of -3.5%.

The returns excluding dividends of the five largest holdings in the Fund during the quarter were as follows: Billiton it rose 0.6% (but declined -0.3% in the March quarter), Sasol -7.6% (-3.9%), MTN 4.4% (-6.1), Mr Price 18.6% (18.2%), and Cashbuild 8.7% (6.8%).

Other holdings across the equity component of the Fund which posted positive quarterly returns included those in Metmar, which rose 15.4% during the quarter, Firstrand 11.5%, Hudaco 8.6% and City Lodge 7.2%. On a negative note, the laggards in the portfolio were B&W which declined 25.3%, Protech 24.7%, Blue Label Telecom 12.8% and Grindrod 10.5%.

The annual returns to end-June are shown in Chart 6. ***The annual return of the total Fund for the year to June was 9.2%***. Inflation rose 5.5% over the year and the All bond index rose 14.6%. ***The Fund's international component produced a rand return of 9.4%*** versus the benchmark increase of 15.5%. The rand declined 17.1% against the dollar during the year.

Chart 6: Annual returns to 30 June 2012



The Fund's annual return to June on its equity component was 9.7% versus the Maestro equity benchmark and All share index returns of 13.9% and 9.6% respectively. Despite the weak rand (-17.1%), the basic material sector declined 10.2% as added concerns about the slowing global economy weighed on the prospects for basic materials. The Maestro equity benchmark apportions a larger weighting to industrials at the expense of resource shares and this explains much of its outperformance relative to the Alsi. Our overweight industrials and underweight resources asset allocation call has proved to be prescient over the past year. Looking forward we believe it is still the right call that will ensure your assets are exposed to as little global shrapnel as possible. Until policymakers provide the

necessary catalysts, we are likely to see resource shares move sideways or downwards for the foreseeable future. To put the industrial sector's outperformance into perspective; over the past year industrials are up 19.7% versus resources' decline of 10.2%, a variance of 29.9%. Financials too have had a profitable year, returning 24.2%, ahead of industrials. Not shown in the chart above are the annual returns of large, mid and small cap index, which rose 7.1%, 21.1% and 17.3%.

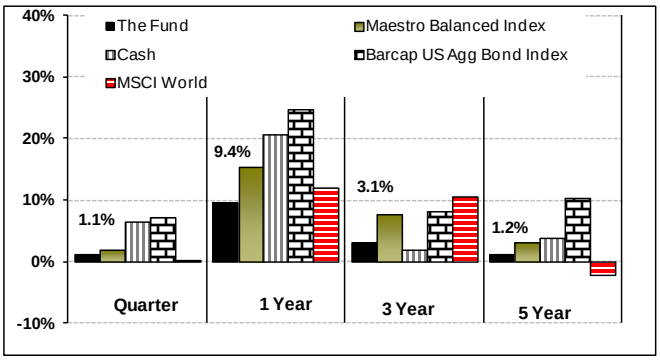
With the above as background, it should not surprise you that across all of the equity portfolios under Maestro's care, resource counters dominated the worst performers while financials and industrials were the best performers. Onto specifics, the main detractors from the portfolios over the past year were Implats, which declined 25.8%, B&W 25.3%, Digicore 22.9%, Anglo 19.0%, Investec 13.9%, Billiton 11.4% and Metmar 6.0%. On a more positive note Mr Price rose 64.1%, Aspen 50.0%, Cashbuild 44.5%, Coronation 43.4% and Hudaco 39.3%. These returns exclude dividends i.e. the changes reflect only the share price movements.

6. International component of the Fund

The activities of Central Park Global Balanced Fund are communicated via monthly Fund Summaries as are the positioning and performance of its portfolio. I suggest you use the Central Park Quarterly Report as the primary document for the evaluation of Central Park's return as it is unaffected by timing and currency distortions. The returns to end-June of the Fund's international component, in rand terms, are listed in Chart 7 and the *same* returns in dollar terms are listed in Chart 8. We have previously pointed out but it is worth repeating here; the benchmark against which Central Park measures itself is a demanding one, as it contains a 20% weighting in a hedge fund index, which most of Central Park's peers do include. Although markets in general have been volatile and weak during the past decade, hedge fund indices have been less volatile and weak which has supported the benchmark returns during most periods. This is worth bearing in mind when analysing the returns shown in the charts.

The June quarter was not a very profitable one for global investors. This is best illustrated by Chart 8 which shows Central Park and its benchmark's return for the period. The weak rand, which declined 6.2% during the quarter, added an air of respectability to the returns. Chart 7 below shows that in rand terms, Central Park rose 1.1% versus the benchmark's return of 1.9% during the June quarter. The trend of weak dollar returns and an even weaker rand can also be seen in the annual returns. Over the past year, Central Park rose 9.4% in rand terms versus the benchmark's 15.5%.

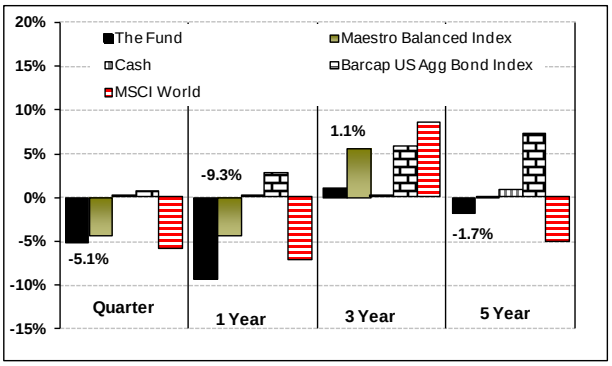
Chart 7: Global rand returns to 30 June 2012



Appendix A summarizes the salient features of the market behaviour during the June quarter. It is best to review the offshore returns in the light of these comments. I also refer you to the June Central Park Quarterly Report, which will be published in a few weeks' time, for a detailed analysis of Central Park Global Balanced Fund's returns.

In short, Central Park gave back in the June quarter some of the impressive gains it accumulated in the March quarter. However, the weakness in the June quarter was not large enough to deter from the reasonable year-to-date number; the Fund is up 2.9% in dollars for the year-to-date ahead of the benchmark's 0.7%. The second quarter had bouts of volatility and irrational market movements that worked against the Fund. You will recall from last year that it is in markets such as these that Central Park struggles. Adverse currency movements and weak emerging markets equity returns led to the -5.1% quarterly return in dollars which can be compared to the benchmark's 4.4% decline. You would be aware that though Central Park is a dollar denominated fund, at the end of the quarter only 50.0% of the Fund was invested in dollar assets, a view taken in light of our concerns regarding the long-term fundamentals of the dollar. Given the above, you would understand why the Fund had a weak quarter on the back of a strong dollar.

Chart 8: Global dollar returns to 30 June 2012



7. Closing remarks

Of late we seem to be describing every quarter as "remarkable" – there really aren't many "dull" days in these markets. There is so much going on globally within the macro and micro investment landscape that many investors, including ourselves, would not mind a "dull" quarter in the markets. This however seems unlikely when you consider the hurdles that markets will have to navigate during the remainder of the year.

On our radar screen we will be closely watching the extent to which the global economy slows. Of great interest to us will be the extent to which policymakers (both governments and central bankers) will go in order to stimulate growth in their respective regions. We expect the Euro debt crises and the US fiscal crisis to continue to "muddle through" in the background. The above is but a hint of the potential risks that could undermine returns for the rest of the year. Indeed investors always operate under conditions of uncertainty, but as we have stressed throughout this report, the current level of uncertainty is certainly higher than usual.

In light of the aforementioned risks, we will be conservative in our management of your assets and will retain holdings in investments that we believe will lead to respectable returns in the long-term. A lot of these companies have already proven themselves over the last five years in the manner in which they coped with the numerous crises; many have recovered to price levels far in excess of those that prevailed before the onset of the crisis in 2007. In fact a number of these holdings are currently trading near all-time highs despite all the "noise" out there. Our task is to remain focused on the Bigger Picture and not get caught up in the hype that often accompanies volatile markets.

David Pfaff
On behalf of the Maestro team
17 August 2012

Appendix A

A summary of market behaviour – June 2012

We comment extensively on market movements from month to month in *Intermezzo* and in the letters accompanying your statements. We therefore provide only a summary here of the salient features of market behaviour during the June quarter. The returns of selected equity, bond, commodity and currency markets are shown in Tables 1 and 2.

Table 1: Selected returns – equity markets

	Jun quarter (%)	Mar quarter (%)	2012 Year to date	Annual returns (%)
Japan	-10.7	19.3	6.5	-8.2
Hong Kong	-5.4	11.5	5.5	-13.2
Germany	-7.6	17.8	8.8	-13.0
UK	-3.4	3.5	0.0	-6.3
US (S&P500) and large cap	-3.4	12.7	9.6	5.8
S&P Mid cap	-5.3	13.1	7.1	-3.8
S&P Small cap	-3.9	11.7	7.3	0.2
MSCI World index	***-5.8***	***10.9***	***4.5***	***-7.6***
Brazil	-15.9	13.9	-4.2	-12.9
Russia	-19.7	18.8	-2.3	-29.2
India	-0.2	12.6	12.8	-7.5
China	-1.7	2.9	1.2	-19.4
MSCI Emerging market index	***-10.0***	***13.7***	***2.3***	***-18.2***
JSE All share	***1.0***	***6.0***	***7.1***	***9.3***
JSE All share ($)	***-5.2***	***11.5***	***5.7***	***-9.5***
Basic materials	-2.9	-2.0	-4.8	-10.2
Financial	4.6	12.8	17.9	24.2
Industrial	2.6	10.5	13.4	19.7
Gold mining	-2.2	-14.9	-16.8	0.2
Large cap (Top40)	0.6	5.1	5.7	7.1
Mid cap index	3.2	10.6	14.2	21.1
Small cap index	1.8	10.4	12.4	17.3

The second quarter of 2012 was just as remarkable as the first, albeit for different reasons. You will recall that for most of the first quarter, markets were "on the charge" and went on to record one of their best starts to a year as far as returns are concerned. As shown by Table 1 above, this all came to a grinding halt during the second quarter. One shouldn't be entirely surprised that markets gave back some of their gains in the June quarter when you consider the extent of the gains in the March quarter. What would have caught many by surprise though was the manner in which the second quarter losses were incurred – virtually all the declines were experienced during the month of May when investors took a grim view to developments in the Eurozone where some were even calling for an imminent collapse of the bloc. The elevated risk aversion persisted up until a favourable election outcome in Greece and an emergency European Union summit towards the end of the quarter added some respectability to the quarter's equity losses.

Despite the June quarter-end rally, a quick glance at Table 1 above provides ample evidence that the second quarter was indeed a difficult one for investors. Take for instance the BRIC equity indices; they suffered an average decline of 9.4% for the quarter. Russia and Brazil were the worst performers in the group, falling by 19.7% and 15.9% respectively. The dire declines in these two indices highlight another theme that played out during the June quarter namely a slowing global economy. As the prices of commodities declined and investors began to factor in the inevitable slowdown in emerging economies (particularly those reliant on commodity exports), their equity markets seemed to bear the brunt of the change in investors' relative views.

On the whole, developed markets fared better than emerging markets, an occurrence one would expect during periods of heightened risk aversion such as we experienced during the quarter. The MSCI World index declined 5.8%, ahead of the MSCI emerging market's 10.0% decline. The best performing developed market index was the UK's FTSE 100 which fell by 3.4%.

Table 2: Selected returns – bonds, commodities, currencies

	Jun Quarter (%)	Mar Quarter (%)	2012 Year to date	Annual returns (%)
SA All Bond index	5.2	2.3	7.6	14.6
SA Cash	1.4	1.4	2.9	5.8
Barcap Global Agg. Bond index	0.6	0.9	1.5	0.4
Emerging market bonds	1.7	5.1	6.8	6.7
US 10-year bond	5.8	-2.2	3.4	17.4
US Corporate bond	2.4	2.4	4.9	9.2
US High yield bond	1.8	5.2	7.1	6.5
Cash (US dollar)	0.0	0.0	0.0	0.0
DJCS Hedge index	-1.8	4.0	2.2	-2.0

Brent (Oil)	-20.4	14.4	-8.9	-13.1
Gold	-3.9	5.6	1.5	6.2
Silver	-16.5	15.1	-3.9	-22.7
Platinum	-12.9	21.1	5.5	-17.1
Palladium	-9.8	3.3	-6.8	-22.9
Copper	-10.1	11.5	0.2	-18.6
Nickel	-5.9	-4.3	-9.9	-28.9
Baltic Dry index	7.5	-46.3	-42.2	-29.0
CRB Commodity index	-11.1	1.0	-10.9	-19.6
S&P GS Commodity index	-17.0	5.9	-12.1	-15.4
Euro dollar	-4.7	2.6	-2.2	-12.5
Sterling dollar	-1.8	-2.8	0.9	-2.3
Swiss franc dollar	4.7	-3.3	1.2	12.4
Rand dollar	-6.2	5.2	-1.3	-17.1

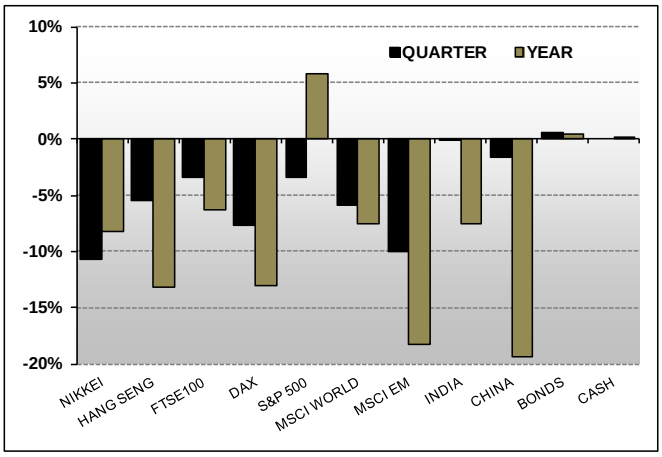
The deterioration of global growth expectations had an immense effect on all commodity prices during the quarter. Even precious metals, which are often perceived as safe havens, were not spared the selloff. The worst performing precious metal was silver which fell 16.5% during the quarter. Gold performed better but still declined 3.5%. Industrial metals too were weak; "Dr Copper" led the way with a decline of 10.1% bringing its annual return to -18.6%. If there were still any lingering doubts on how investors' outlook on the global economy has changed over the past few months, the drastic (20.4%) decline in the oil price provided sufficient evidence that the global economy is indeed slowing down.

Currencies, too, followed the classic "risk-off" pattern; we saw the dollar and yen strengthen against almost every other currency. Currencies such as the rand and Aussie dollar, whose fortunes are closely linked to commodity prices, were the weakest during the quarter. The rand declined by 6.2%, erasing all the gains of the first quarter, bringing the year-to-date return to -1.3%. For the record, the rand declined 17.1% over the past year.

Global investment markets

Chart 1 summarizes the quarterly and annual returns of the major equity, bond and cash markets. You can see clearly from this chart that risk assets have not only had a difficult quarter but a very tough year as lukewarm macroeconomic data and the intensification of the European crisis resulted in market participants selling off risky assets. It is interesting to note that the best performing equity index over the past year is the US market (S&P 500), while the worst performing was the Chinese market. While there are a number of reasons why this anomaly would manifest; we believe one of the reasons is the rapid deterioration in investors' expectations concerning the Chinese economy over the past year relative to the US. Said differently, whilst the US economy has also been weak, it has been less of a surprise than that of China.

Chart 1: Global returns to 30 June 2012



Much of the weakness in the Chinese economy is a result of the restrictive monetary and fiscal policies that the country's authorities implemented in 2010 and 2011 to alleviate concerns of growing asset bubbles. It is fair to say, those fears have now been replaced by anxieties that the economy is slowing rapidly to the extent that growth could fall below the government's target of 7.5% for 2012. The European malaise has not helped Chinese exports either; the country's manufacturing sector has shrunk for the past seven consecutive months, a trend that is likely to continue for the next few months at the very least.

In a low growth, low yield and heightened risk environment, risk assets such as equities, commodities and emerging market currencies tend to struggle. This phenomenon dominated markets during the quarter. While by no means comprehensive, the following were some of the features of the June quarter which caught our attention that we would like to expound more on.

- *Weak equity markets:* Charts 2 and 3 depict the movements of the US and German equity markets over the past year. The thick vertical line in all the ensuing charts depicts the start of the June quarter as a reference point off which to measure the quarterly return. It is clear from the charts how weak global markets were during the June quarter on the back of a very profitable March quarter – refer again to Chart 1 which shows the quarterly and annual returns. It is also evident from these charts just how volatile quarterly returns have been for the past year. The magnitude of quarterly losses and gains has been nothing short of extra-ordinary and it speaks to the amount of uncertainty prevalent in the markets. Though the extent of market gyrations in developed markets was less in

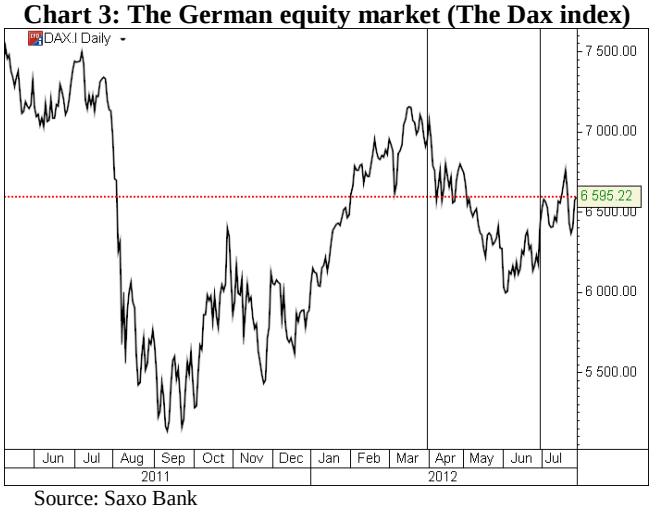
the June quarter, relative to the previous three quarters, it is a trend worth highlighting as it speaks to the current uncertain investment climate.

Chart 2: The US equity market (S&P 500 index)

Source: Saxo Bank

We believe that investors' minds are preoccupied with what is often referred to as event risk - a concern that market prices could move drastically on a low probability but high impact event. This apprehension stems from the lack of investor visibility on what governments and policy makers will do next to circumvent further worsening of their economies and the crisis.

Chart 3: The German equity market (The Dax index)



Source: Saxo Bank

You may recall that in the March quarterly we remarked on the positive effects of some unconventional measures that global central banks have recently undertaken to stimulate growth i.e. the likes of quantitative easing (QE), operation twist and long-term repurchase operations (LTRO). We highlighted that markets "love" such measures because the cheap money from central banks tends to flow into risk assets. Of late, central bankers have indicated that they are ready to step in with additional measures, such as the above, to boost confidence and stimulate growth. We remain sceptical whether these measures are able to rekindle flagging economies; however, we do acknowledge that they are good for risk assets like equities, emerging market bonds and commodities. Investors, including us, are then caught in a "catch-22" situation - where we expect a waning economic outlook and would ordinarily reduce our risk asset holdings, yet on the other hand we are cognisant that co-ordinated efforts by policy makers could send equity prices sharply higher, at least for a period. This, we sense, is the main reason why markets have not collapse over the past few months; global central banks and governments have provided a form of a "put option" on markets. We have previously expressed our doubts on whether developed market central banks still have potent tools to fend off further weaknesses in their respective economies.

With interest rates already at historic lows and central bank balance sheets at record highs, it is certain that developed market monetary policy makers have a limited arsenal at their disposal. Not that they would ever admit it, but the truth is that the best they can do is to *temporarily* improve sentiment and by so doing provide governments with additional time to sort out the mess. This is what is so unusual about the current global situation; the major risks and their potential resolution are primarily dependant on governments and their policy actions.

- *The decline in Japanese equities:* Table 1 and Chart 4 below show that the Nikkei was the laggard among developed market equities. The Nikkei fell 10.7% in the June quarter compared to its 19.3% return in the previous quarter.

Chart 4: The Japanese equity market (Nikkei 225)

Source: Saxo Bank

Having carried out numerous asset purchase (quantitative easing) programs since 2010, the Bank of

Japan (BoJ) surprisingly decided not to add meaningfully to its balance sheet over the June quarter. This tight-fisted act seemed to encourage investors to retain their yen holdings and eased some concerns that the central bank is trying to monetise the country's debt. Interestingly, the BoJ's quantitative easing program has seen it buy up ¥70tn ($860bn) worth of assets and it holds the title of being the central bank with the largest balance sheet as a proportion of gross domestic product – ahead of the European Central Bank, the Federal Reserve and the People's Bank of China. Despite the above, Chart 5 shows how the yen has held up well over the past year as investors continue to regard the Asian currency as a safer holding along with the US dollar – it strengthened 1.2% against the dollar over the past year.

Chart 5: The dollar yen exchange rate

Source: Saxo Bank

- *The stronger dollar, a "risk off" trade:* As we earlier alluded to in this report, the dollar was highly responsive to global risk aversion, particularly against emerging market currencies. It remains something of a mystery to us why the currencies of some of the most indebted nations in the world (read: US and Japan) are still regarded as "safe havens". Logic would suggest that a less indebted nation is more likely to repay its debt compared to one whose debt pile just about covers its eye balls – or in the case of Japan, is twice its "height". As if that were not enough, the budget deficits of the US and Japan for 2012 are projected to be 7.6% and 8.1% respectively – meaning those nations continue to add to their debt mass. Perhaps the greatest paradox of all is that both governments, the US and Japan, are facing stiff resistance in their respective parliaments to pass bills that will allow them to borrow more and avert government shut downs which could result in creditors not being paid; yet investors still clamour for their sovereign bonds and their currencies. For the US, the debt ceiling debate has been put on the back burner for a while but we are likely to see a resumption of that fiasco towards the end of this year as the government will soon bump up against its $16.4tn borrowing limit again. In the case of Japan, a similar drama is unfolding in parliament where the opposition parties are blocking a bill to finance the budget deficit. Japanese officials claim that should this bill not be passed, the government will run out of money by October and not be able to pay creditors. While we recognize that a lot of this "noise" is politicking, you cannot help but wonder if there is anything deserving the term "safe haven" in these current markets filled with uncertainty.

Moving onto emerging market currencies, Chart 6 shows how the rand fared against the dollar.

Chart 6: The rand dollar exchange rate

Source: Saxo Bank

True to the risk off theme, the rand was weaker against the dollar through the June quarter, although most of the damage was done in May. This trend is consistent with other currencies whose performance is correlated to commodity prices; these include the Aussie and Canadian dollar. Chart 7 and 8 below show how the aforementioned currencies have performed over the past year.

Chart 7: The Aussie dollar US dollar exchange rate

Source: Saxo Bank

While the trend in Chart 6, 7 and 8 is similar i.e. dollar strength against commodity currencies, the rand has declined significantly more than its peers. The rand has fallen by 17.1% over the past year, while the Australian and Canadian dollars have weakened by 4.3% and 5.6% respectively. There are several reasons for this occurrence, some which we feel are justified and others, not so much. Starting with the later, rating agencies have been making a lot of negative noise about South Africa since the outlook downgrades earlier this year.

Chart 8: The Canadian dollar US dollar exchange rate

Source: Saxo Bank

You will recall that all three major international rating agencies caused a storm (at least in SA political circles) earlier this year when they downgraded South Africa's sovereign rating outlook from stable to negative, citing concerns about structural economic and social problems. The agencies went on to highlight concerns that reining in public spending will be more difficult now because of pressures being exerted on government. While there is some truth to the issues raised by the ratings agencies, we are of the view that those concerns are not unique to South Africa but are consistent with a global trend where governments are under increasing pressure to cut spending yet are struggling to do so as public discontent becomes more prevalent. Be that as it may, this negative publicity on South Africa, aided by debacles such as the Gauteng toll gates saga and the nationalisation "debate" did not endear the rand to foreign investors.

Of greater concern and relevance to the rand's outlook relative to other emerging market currencies is the poor performance of the mining and manufacturing sectors, which raises concerns about South Africa's balance of payments and puts pressure on the rand. While South Africa's terms of trade have been favourable over the last decade, the declines in mining exports (particularly platinum and coal) have started to put stress on the terms of trade. A continuation of this trend will increase the balance of payment's reliance on foreign security purchases i.e. inflows, to support the rand. We know too well that in the current investment climate investment flows into emerging markets are fickle, which makes the rand even more vulnerable. Furthermore, sentiment over Europe will continue to weigh on the rand in the near to medium term. This certainly was the case in the June quarter as shown by Chart 9 below where the rand tracked the euro's downward movement.

Chart 9: The euro dollar exchange rate

Source: Saxo Bank

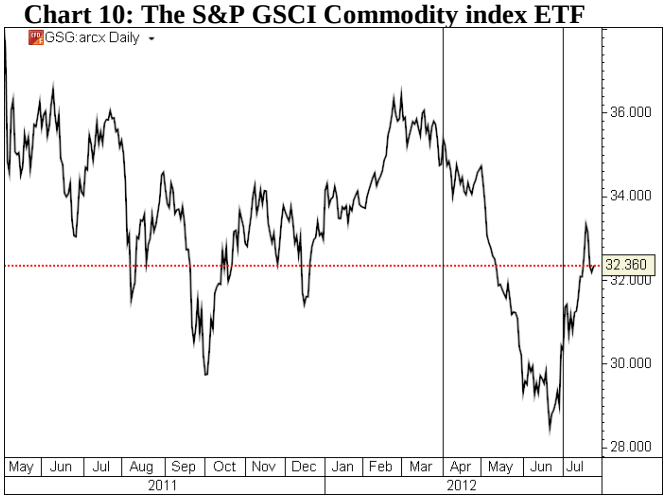
The euro had a difficult quarter which saw it decline by 4.7% bringing its annual return to -12.5%. As can be seen from the chart above, since the end of the quarter the currency has continued to weaken registering levels last seen in the depths of the crises. Indeed there were times during the previous quarter (particularly the month of May) when a structural change in the composition of the bloc seemed imminent. The fears raised by the inconclusive first round of Greek elections and the possible collapse of the Spanish banking system had European investors rushing for the exits. Were it not for a marginal victory for the pro-bailout political party in Greece and another European Union summit at the end of the quarter, the euro would have been much weaker.

The reality that the problems faced by the Euro bloc will be with us for a long time has settled into most people's minds. Much has been said and written about the Euro Union's troubles to the extent that many investors, including us, have somewhat grown weary of the Eurozone crisis. Some, during periods of frustration, have even called for the union to disintegrate, resulting in the worst possible outcome, and then to pick it up from there i.e. starting from scratch as it would seem. Unfortunately, it is not that easy. Like a sequel to a movie, there are always new twists and turns that the role players conjure up to keep you interested enough to keep

coming back. During the past quarter, the emphasis was on a banking union that would result in rescue funds directly recapitalising banks thereby stopping the negative loop where weak government balance sheets affect bank balance sheets and vice versa. The market considered this a step in the right direction and there was a brief cheer on that news. It turned out to be fleeting optimism as details and the time horizon of when this would be achieved were vague. While we are firmly in the camp that believes the Eurozone crisis has no quick fix and it will take years to align every stakeholder's interest, we also maintain that focus on economic growth is probably the most credible solution. In that regard, we saw glimmers of hope during the past quarter as the EU leaders agreed to a €120bn growth package that will be aimed at giving a boost to Europe's flagging economies. Only time will tell if this is more of political rhetoric or it is a step, albeit small, in the right direction.

- *The weakness in commodity markets:* The S&P GS commodity index, a proxy for commodity prices, showed that the second quarter of this year was the worst quarter for commodities since the collapse of Lehman Brothers in 2008. On aggregate, commodities were the worst performing asset class, when measured on a total return basis, in the first six months of this year. Were it not the quarter-end rally, the returns would have been worse. Almost all the declines in the commodity complex should be attributed to the deterioration of the economic activity in China and to a lesser extent the absence of imminent monetary or fiscal intervention from policy makers.

Chart 10: The S&P GSCI Commodity index ETF

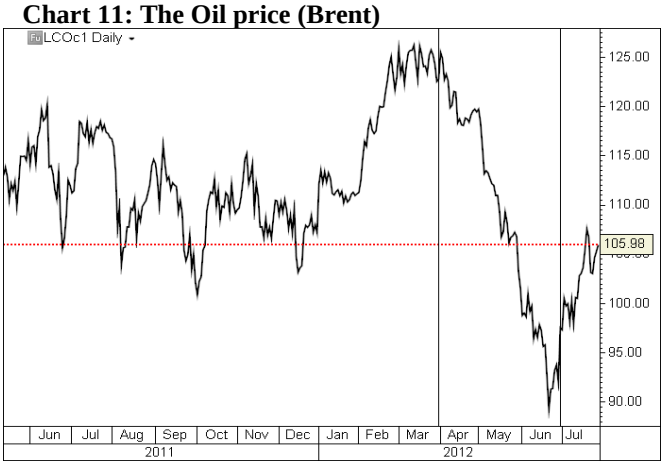


Source: Saxo Bank

As we mentioned in the March quarterly report, commodities historically tend to perform strongly in anticipation and during periods of quantitative easing or similar unconventional monetary stimulus. This characteristic in both hard and soft commodities explains some of the strength in commodities during the March quarter when markets were buoyed by the European Central Bank's long-term repurchases operations. As the effects of central bank's profligacy waned and economic growth declined, commodity prices plunged. The effects were more brutal on energy and industrial commodities as exemplified by the drop in the oil and copper prices respectively.

The oil price's 20.4% decline was the worst quarterly return since the depths of the crisis and reflects investor's concerns about the world economy.

Chart 11: The Oil price (Brent)



Source: Saxo Bank

You will recall that for much of the first quarter the oil price was driven up by supply concerns emanating from the Middle East which saw the price of Brent oil reaching levels last seen before the crisis - how quickly things have changed. In the June quarter market participants shifted their focus to demand side concerns i.e. a slowing world economy which will not require as much oil. The demand-side worries reduced the premium that had been added to the oil price on concerns that supply shocks could materially affect economic growth. A more ample supply outlook also came about due to Saudi Arabia's efforts to boost production. The nation's repeated claims that they stood ready to ramp up production if the need arose aided in easing the lingering concerns. We have previously expressed our concerns on what we thought was a high oil price relative to how the macro picture was shaping up, so we certainly regard it as a positive to have the oil price around the $100 per barrel mark. According to Merrill Lynch's calculations, a $10 per barrel drop in the oil price adds 0.2% to US (and global) growth in the following four quarters. Oil prices are down about $20 per barrel relative to their average of the last year, suggesting a 0.4% boost to growth that would not have occurred with a higher oil price.

Chart 12: The Comex Copper futures ($)

Source: Saxo Bank

Precious metals which are often perceived as safer assets had somewhat of a mixed quarter. Palladium and Silver were the weakest of the lot declining 13.6% and 13.2% respectively. Platinum and gold fared better, but still declined by 9.0% and 3.2% respectively.

Chart 13: The Platinum price ($)

The platinum market has faced numerous headwinds since the start of the financial crisis. The impact of diminishing industrial demand coupled with an apparent shift away from the metal as a safe haven has resulted in a 17.1% decline over the past year. Apart from the macro elements that have affected the platinum market, the supply side has also been hammered by the effects of strike action, safety stoppages and equipment shortages that have increased production costs. The total lost production for the first half of this year has already surpassed the lost production during the whole of 2011. Unfortunately for platinum miners, the price of the commodity is yet to reflect the potential decline in future supply. It is estimated that 40.0% of platinum production in South Africa is running at a loss, which suggests we are likely to see more declines in production (as more mines close) before the platinum price corrects to match supply and demand.

Chart 14: The gold price ($)

Source: Saxo Bank

As shown by Chart 14, the price of gold has been in a consolidation period for almost a year. Having fallen from the highs of over $1 900 per oz. or 20.1%, the gold price has been trading in a narrower range. It would appear as though the gold market is now grappling with a lack of an obvious catalyst that would move it out of that range. The catalyst could come in the form of a third round of quantitative easing by the US Federal Reserve which history shows has been a large driver of the gold price.

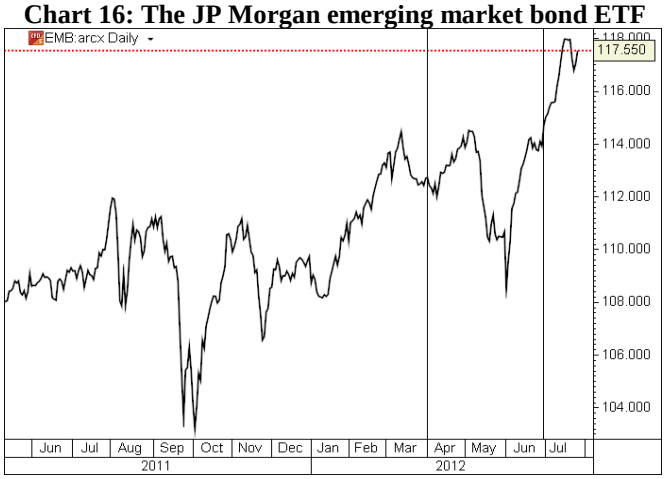
Chart 15: iShares Barclays 10 - 20 year Treasury Bond ETF

Source: Saxo Bank

- *The strength of the Treasury bond market:* Throughout the quarter the US bond market showed remarkable strength. This trend was replicated in other sovereign bond markets that investors regarded as safe. A recent statistic we came across read that seventeen countries currently have 2-year bond yields below 1.0%, while countries such as the Netherlands, France and the US have their 10-year bond yields trading at multi-century

lows. US 10-year treasuries have risen by 17.4% over the past year which is extraordinary considering how low yields were a year ago. How long investors will remain content with negative real returns by piling into the low yielding sovereign bonds remains to be seen.

Chart 16: The JP Morgan emerging market bond ETF



Source: Saxo Bank

Local investment markets

Turning to the South African investment markets, Chart 17 depicts the quarterly and annual gains in the major indices for period ended 30 June 2011.

Chart 17: Local returns to 30 June 2012

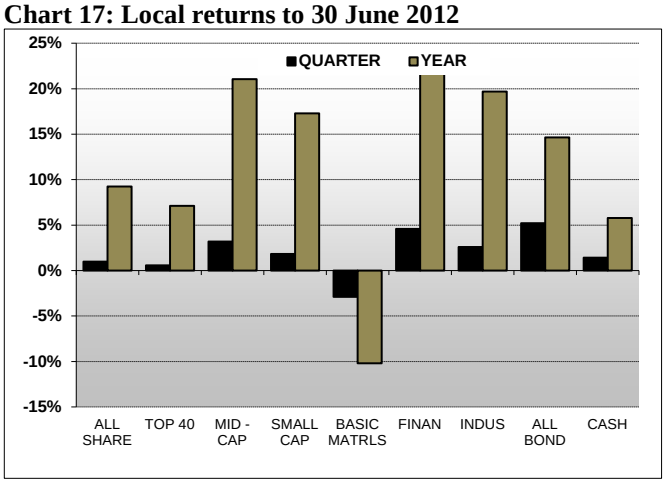


Chart 17 shows that, with the exception of the basic material sector, the local market was resilient relative to global markets. What is critical to consider though when comparing the local market to its global peers is the performance of the rand. What we experienced during the June quarter was that the rand bore the brunt of swings in investor sentiment to South Africa while the equity and bonds markets chugged along. Take for instance the All Share Index which gained 1.0% in rand terms but in dollars declined 5.2% as a result of the rand's 6.2% decline against the dollar. The trend is the same for the annual returns where rand returns were solid, even impressive for some sectors (financials and industrials) but when reported in dollar terms they are barely positive. One should certainly consider themselves to have been in a sweet spot if they were a rand denominated investor over the past year because there were very few places around the world were one could have earned such returns.

Focusing on the specific sectors, resource shares again weighed on the All Share Index and limited the index's quarterly and annual gains to 1.0% and 9.3% respectively. Gold miners, most of which are large cap shares, were one of the worst performing sectors declining 2.2% during the quarter, bringing the gold index's annual return to a measly 0.2%. Of great interest to us is the continued outperformance of the mid (21.1%) and small caps (17.3%) compared to the large caps (7.1%) over the last year. With the amount of risk prevalent in the market over the previous year you may have expected large caps to have performed much better than smaller companies, which are often viewed as risker.

The local bond market has continued to surprise most investors. It outpaced the equity market, rising 5.2% during the quarter and 14.6% for the year as a whole. We largely attribute this to a change in expectations of the South African short-term interest rate outlook. At the start of 2012 economists' consensus view was for an interest rate hike during the course of the year (remember inflation was above the Reserve Bank's target band then). As the year has progressed, weak economic data and a surprise slowdown in inflation (relative to expectations) have seen most economists discard the rate hike expectation and replace it with a strong possibility of a rate cut. Subsequent to the end of the quarter, the South African Reserve Bank cut interest rates by 0.5%. Again, this action was supportive of the bond market which continued its strength into the September quarter.

In closing

The halfway mark of any race or event is always a good point to look back at what has become known and use that "experience" to guide you through what lies ahead. Sadly, in this case, looking at what has transpired during the first half of the year only adds to the blur of the current investment landscape. The first quarter could not have been more different to the second, the former had a firm "risk on" tone while the later was the complete opposite – this leads us to the present moment where we have recorded marginally positive gains for the year-to-date. How the next quarter will map out is a difficult call to make, perhaps graphs such as Chart 18 below will aid in providing some perspective.

Chart 18: SA equity market quarterly returns

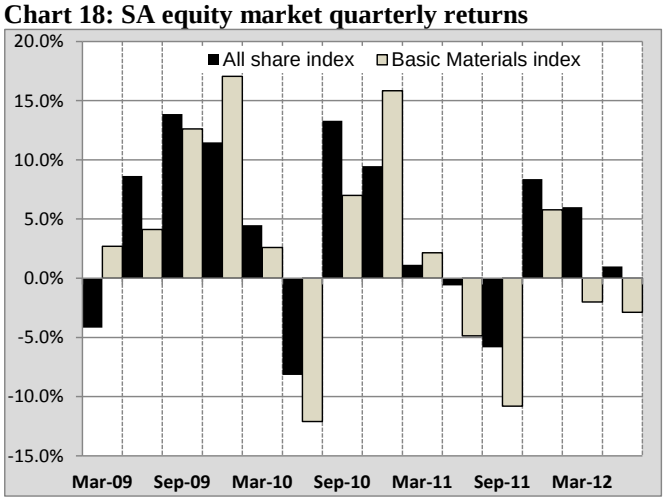


Chart 18 above shows how quarterly returns have gyrated over the quarters since the depths of the crises. Despite the odd non-profitable quarters (such as June) the trend has been firmly up. Over the period shown in Chart 18 above, the market has risen 80.1%. Interestingly, industrial shares have risen 126.8% over the same period, financials 103.3%, resources only 33.8% and gold miners -12.1%.

What is evident from this point onward as far as market returns are concerned is the extent to which policy makers will have a large say on how the rest of the year pans out. Whispers of major policy moves are growing louder and it would appear as though policy makers are taking baby steps in that direction. The number of central banks cutting interest rates is increasing. Most notably, the People's Bank of China recently cut interest rates twice in the space of one month, a clear sign that they realise the risks of a slowing Chinese economy not only to the global landscape but within the republic. The likes of Brazil, Australia and South Korea are well on their way in bringing down interest rates; this is certainly useful in emerging markets where central banks still have the interest rate tool. Developed market central banks are indicating too that they stand ready to ease policy further by carrying out unconventional measures.

While we agree that the above on its own is unlikely to prevent the slowdown in the global economy that we expect for the remainder of the year, we believe it will certainly "cushion" the effects thereof. The improved sentiment and cheaper money that comes with looser monetary policy will go some way to give consumers much needed breathing space.

For the markets, looser monetary policy will surely be viewed as a reprieve that affords governments much needed time to get their houses in order.

There are several other issues that concern us as we enter the second half of the year, not least of which is the state of the US economy. Apart from the anticipated fiscal tightening that is expected in 2013, another reason for our sombre outlook on the US economy is the election towards the end of the year. With the campaigning already underway and the respective parties already entrenched in attacking each other, very little progressive policies will be enacted by both camps as the focus becomes the election date. It is a shame and a sad indictment against political leaders that so much money and time is spent towards this spectacle, rather than dealing with matters of greater concern.

Be that as it may, our concerns and the uncertain future should not detract from attractions of good investments in the market. It is often said that it is in markets such as these one is able to find value and good buying opportunities. There will always be companies that navigate these uncertainties better than their peers. Our task is to search for such companies and invest your assets in them.

The Maestro Investment Team
17 August 2012