MAESTRO
Equity Fund

PRESCIENT
MANAGEMENT COMPANY

INVESTMENT OBJECTIVE
The Fund's objective is to produce above average long-term returns by investing in the South African equity market. It will simultaneously aim to assume less risk than the risk inherent in the market itself. The Fund adopts a conservative investment philosophy.

FUND BENCHMARK (BMK)
The Fund will measure itself against the FTSE-JSE All Share Index. It will also use an internal benchmark, the Maestro Equity Benchmark, which consists of an equal weighting of the FTSE-JSE Top40 and Findi30 indices which effectively yields an index that is roughly equally weighted between the resource, financial and industrial sectors.

LEGAL STRUCTURE
The Fund is a scheme in the nature of a trust known as a collective investment scheme. The portfolio manager is Maestro Investment Consulting, an approved Financial Services Provider in terms of the Financial Services and Intermediary Act, operating under licence number 739, and the Financial Institutions (Protection of Fund) Act. This portfolio operates as a white label fund under the Prescient Unit Trust Scheme, which is governed by the Collective Investment Schemes Control Act.

FEE STRUCTURE
The maximum initial fee is 2.0%. The investment management fee is 1.75% per annum.

FUND SIZE: R21 027 644

MANAGEMENT COMPANY
Prescient Management Company Ltd
PO Box 31142, Tokai, 7945

TRUSTEE AND AUDITOR
Trustee: Nedbank Limited
Auditor: KPMG Inc.

PORTFOLIO MANAGER
Capstone 96 (Pty) Ltd t/a Maestro Investment Consulting

ENQUIRIES
Maestro Investment Consulting
Box 1289
CAPE TOWN
8000
Fax: 021 674 3209
Email: equityfund@maestroinvestment.co.za

The Maestro Equity Fund

Quarterly report for the period ended

31 March 2007

1. **Introduction**
This report focuses on the investment activities of the Maestro Equity Fund during the past quarter. It should be read in conjunction with Maestro's monthly investment letter, *Intermezzo* and the monthly Fund Summaries which are sent to all investors.

2. **The investment position of your portfolio**
Despite the strong gains during 2006, when the JSE All share index rose 41.2%, the SA equity market continued to rise on the back of a strong local economy and a benign global economic backdrop. Consequently there was little to do during the quarter other than, at the risk of sounding flippant, to "sit back and enjoy the ride".

Chart 1 depicts the Fund's sector allocation at the end of March. Exposure to the resource sector totalled 14.5% of the Fund, from 10% in December. Financial exposure declined 2% to 11.0% but industrial exposure rose from 62% to 65.3% of the Fund. Cash represented 9.2% up from 8% at the end of December. Chart 2 depicts the historical allocation to the three major sectors of the equity market, expressed as a percentage of the equity portion of the Fund.

Chart 1: Asset allocation at 31 March 2007

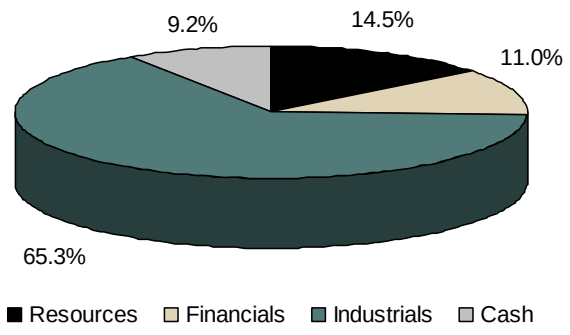
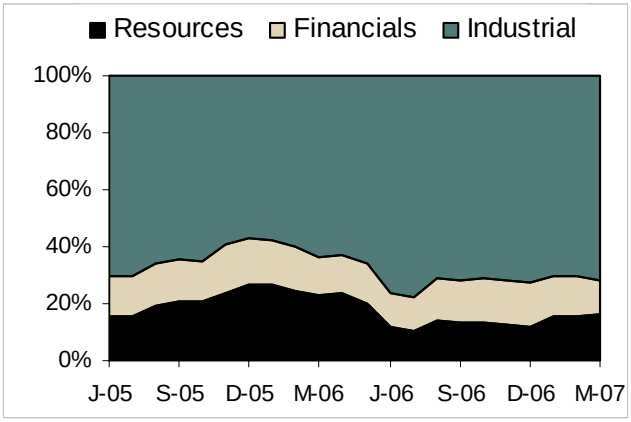
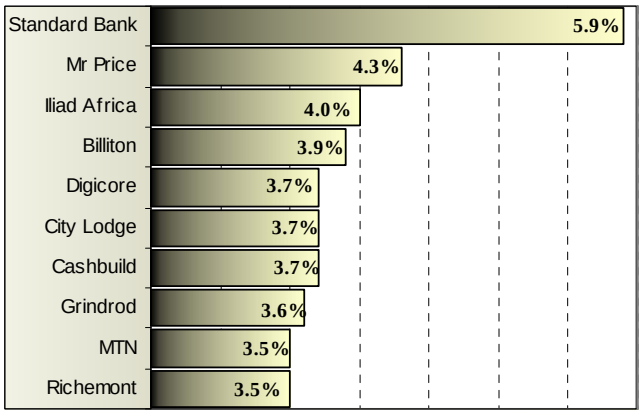


Chart 2: Historic equity sector allocation



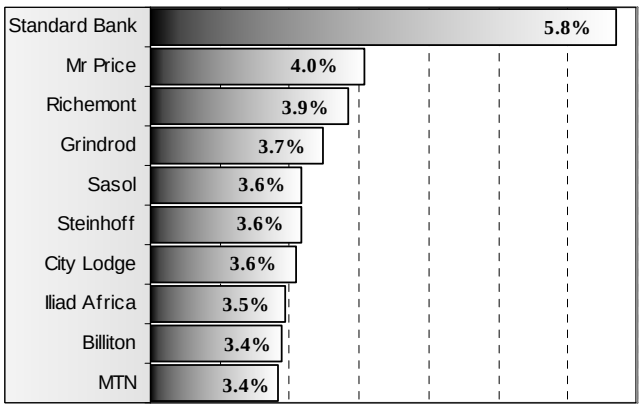
3. **The largest equity holdings**
The Fund's largest holdings at 31 March are listed in Chart 3, expressed as a percentage of the total Fund.

Chart 3: The largest holdings at 31 March 2007



Those at the end of December are listed in Chart 4 for reference purposes. Cashbuild and Digicore displaced Sasol and Steinhoff in the "top ten" during the quarter. There were 34 counters in the Fund at quarter-end versus 31 in December, the ten largest of which constituted 40% of the equity portfolio, up from 38% in December.

Chart 4: The largest holdings at 31 December 2006



4. **Recent activity on the portfolio**
The investment objective on the Fund is to *achieve long-term growth through the assumption of moderate risk.* It is against this objective that the Fund's activities and performance should be assessed. During the quarter the holdings in Naspers and Implats were increased, and holdings in Exxaro, Kumba and Mittal introduced into the Fund. The remaining pref shares were also sold.

5. **A review of the recent investment environment**
The first quarter turned out to be a very interesting quarter on global equity markets. It was also a profitable quarter, particularly on the SA equity market, as you will see in a moment. Developments during the quarter were dealt with in some detail in the March and April editions of *Intermezzo* (just click on the respective months to view the editions of *Intermezzo*).

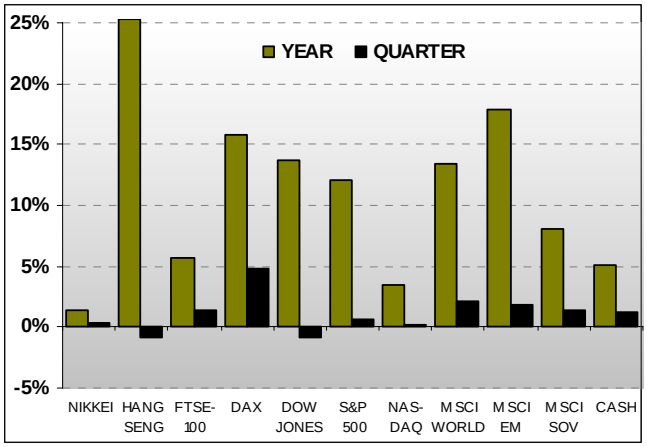
In short the quarter began well. The strong momentum of the final quarter of 2006 continued into 2007. All was going according to plan until February 27, when three events raised the perceived degree of risk in the markets. *Firstly*, the Bank of Japan's mid-February interest rate increase raised a question mark over the extent to which the "carry trade" would unwind. The carry trade involves borrowing in low-yielding currencies such as the yen and Swiss franc, for investment into high-yielding ones such as the rand and to a lesser extent the dollar. *Secondly*, the Chinese equity market fell 9% on that day, reflecting in part the extraordinary gains (+131%) during 2006 and the fact that the Chinese central bank, the People's Bank of China, tightened monetary policy during February. *Finally* the quality of credit, particularly credit relating to the US housing market, was called into question. New evidence emerged regarding weakness in the US "sub-prime" market i.e. where mortgages had been extended to borrowers whose ability to service the debt was questionable.

In the event the first two threats receded: the Chinese market not only erased its loss but ended the quarter at record levels. The yen weakened again after only a few days of strength against higher-yielding currencies. The same could not be said of the US sub-prime market. Market watchers remain concerned about this sector of financial markets, particularly its ability to affect US consumer spending and consequently also the global economy. I will return to this aspect later in this Report, when commenting on the outlook for the remainder of this year. Notwithstanding the three major events described above, some of the highlights during the March 2007 quarter were as follows:

- Unlike the December 2006 quarter *the oil price resumed an upward trend.* Brent oil rose 14.3% during the quarter.

- *Commodity prices continued to rise strongly*. Copper, nickel and tin all rose strongly on the back of continued strong demand, particularly from China.
- *The global economy continued to show strength.* There was evidence of stronger economic growth in Asia, Japan and Europe. Even data from the US, which is widely regarded as the weakest link at present, proved stronger than expected, despite the problems in their housing market.
- *Record levels of M&A and private equity activity* remained the order of the day, despite rising risk levels and interest rates around the world.

Chart 5: Global market returns to 31 March 2007

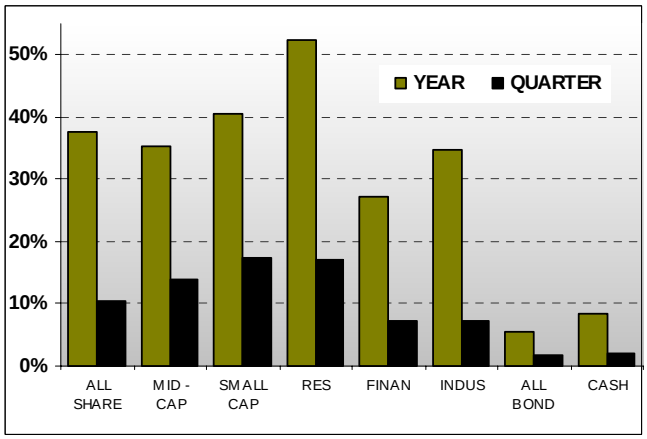


These and other factors combined to push many **global equity markets** to their highest levels in six-and-a-half years. Chart 5 depicts the returns for the quarter and year. One can see from the Chart that, while the returns were positive, the absolute quantum of those returns was not large, other than in Germany. What is less evident from the Chart is the resilience in certain emerging markets; the MSCI emerging market index rose 1.8% during the quarter (the MSCI world index rose 2.1%) despite the market "wobbles" at the end of February that affected emerging markets more than developed ones.

With regard to **the South African economy and equity market**, the latter was also affected by the decreasing appetite for risk towards the end of February. The rand weakened sharply during this period, rising to R7.54 to the dollar. However, more so than many other emerging markets, the rand recovered (although over the quarter it declined 3.0%) and the equity market went on to end the quarter at an all-time record. A supportive economic background provided the grounds for excellent corporate results and hence higher share prices, as did continued favourable international sentiment towards emerging markets and renewed strength in commodity prices.

The local market returns are shown in Chart 6. Note the contrast between Charts 5 and 6 in terms of the quantum of returns. The astonishing (rand) returns over the past few years from the SA equity market show no sign of abating. Most of the major equity indices rose more than 30% in the year to March, while cash and bonds rose less than 10% during the same period.

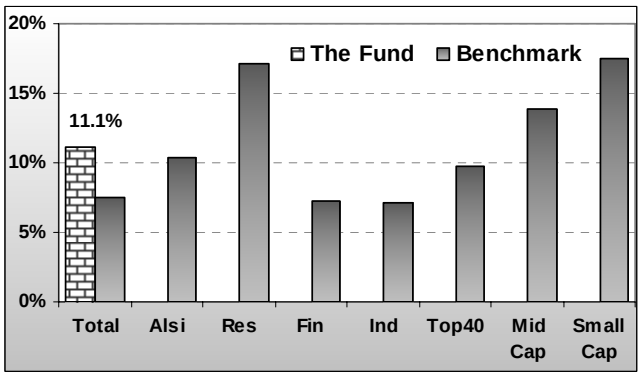
Chart 6: SA market returns to 31 March 2007



6. The performance of the Fund

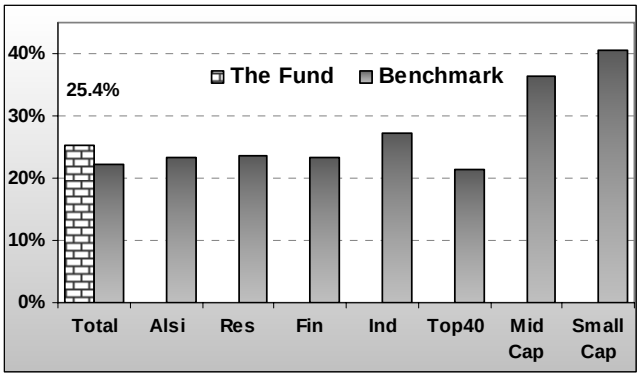
Chart 7 shows the returns for the March quarter; ***the un-annualised return on the Fund was 11.1%***. This can be measured against the 7.5% Maestro equity benchmark return and the 10.4% of All Share Index. It is clear from Chart 7 that the resource index rose the most – 17.2% during the quarter. With the benefit of hindsight it would have been better if the Fund had had greater exposure to resource shares. However, strong results from financial and industrial companies in which the Fund is invested assisted the return. Many of these companies are to be found in the mid and small cap universe. These two indices produced quarterly returns of 13.9% and 17.4% respectively. The returns of the largest holdings during the quarter were Standard Bank 13.0% (up 21.4% last quarter), Mr Price 18.1 % (32.8%), Iliad 28.9% (12.8%), Billiton 26.0% (-3.5%) and Digicore 34.2% (6.6%).

Chart 7: Quarterly returns to 31 March 2007



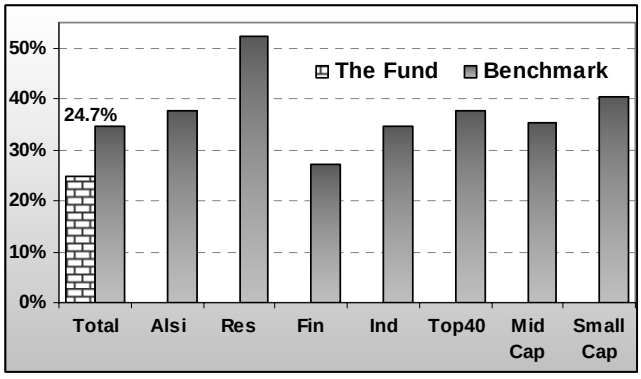
The *un-annualised* returns for the six months to 31 March are shown in Chart 8. ***During this period the Fund rose 25.4%,*** marginally above the major indices other than the mid and small cap indices. This is an improvement over the previous six months, during which time the Fund's performance relative to the overall equity market and other general equity funds was disappointing.

Chart 8 Six-month returns to 31 March 2007 2006



The annual returns are shown in Chart 9. ***The annual return of the Fund for the year to 31 March was 25.4%,*** significantly above the inflation rate over this period of 5.8%. This return can be compared with those of the Maestro equity benchmark of 34.8% and All Share Index of 37.7%. The resource, financial and industrial sectors produced annual returns of 52.3%, 27.3% and 34.7% respectively. The large, mid and small cap indices gained 37.8%, 35.4% and 40.5% respectively. The SA equity market continues to reflect the structural changes underway in the economy and the positive and profitable earnings environment. Barring an external i.e. foreign-based shock to financial markets my humble opinion is that this situation is likely to continue for a while.

Chart 9 Annual returns to 31 March 2007 2006

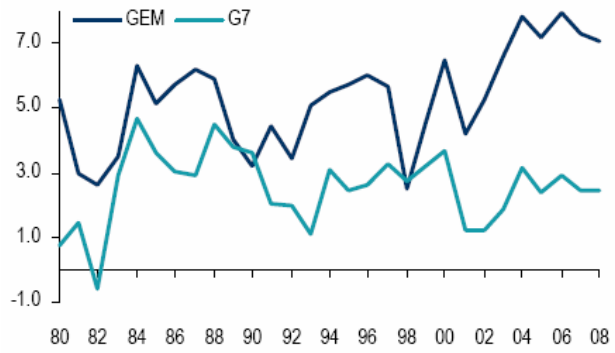


Although there is still a degree of underperformance by the Fund of the Maestro equity benchmark and the All Share index during the year to end-March, it is gratifying to see that the Fund has performed better in the past six months – refer again to Chart 8 in this regard. You may remember that the Fund had a terrible second quarter in 2006, which is still included in the annual returns to end-March.

7. **<u>What lies in store for investors in the months ahead?</u>**
In the December Quarterly Report a great deal of time and space was devoted to the outlook for 2007. Please refer back to that Report because, with the odd exception the view we put forward in that Report remains the same today. If you do not have a copy of that Report please contact me on andre@maestroinvestment.co.za and I will send it to you. Some points we touched on are listed below with updated comments where appropriate.

- *The global economy* continues to grow at a reasonable pace. Europe is growing more rapidly than expected, Asia is growing in line with expectations and the US is still growing but at a slower rate than last year. All eyes are focussed on the US to gauge the extent of any slowdown and to see how it will affect the rest of the world's growth. Note from Chart 10 the divergence between growth in emerging markets (EM) and major developed countries (G7).
- *Global inflation* remains under control, largely within the comfort levels of most central banks. We are watching closely to see the inflationary effects of the rise in the oil price during the March quarter.

Chart 10: Economic growth: EM leading the pack (%)



Source: Merrill Lynch

- *Interest rates:* our expectations of the level and direction of global interest rates remains the same. Monetary policy remains in a "tightening mode", especially in Europe and Asia (the Chinese central bank has raised interest rates three times in the past year and has increased the reserve requirements for banks five times during this period). The future direction of US rates will depend on their inflation rate and the extent to which the fallout in the sub-prime housing market will slow the economy down.
- *Currencies:* we still expect the dollar to weaken gradually against other major currencies during the remainder of this year, although we do not expect a

dollar collapse. The events of the past six weeks have forced us to be more aware of the "carry trade", specifically its effect on the yen and Swiss franc.

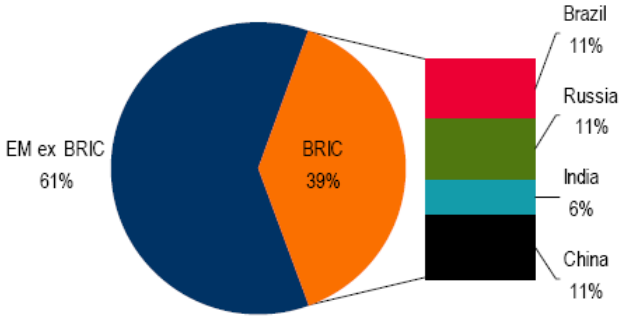
Chart 11: Emerging markets: not over-valued

Source: Merrill Lynch

- *Valuation and corporate earnings:* Global equity returns during the first quarter of 2007 were positive but not spectacular. Similarly, corporate earnings were positive but not sufficiently so to bring about a material improvement in the valuation levels of the markets. But there has also not been a substantial deterioration, leaving markets in another "Goldilocks scenario" i.e. not too cheap and not too expensive. Chart 11 shows the forward price earnings (PE) ratio of emerging markets (EM) relative to developed markets. Over the past 20 years EM have on average traded at a 20% discount to developed markets – depicted by the horizontal line. They current trade just below their average, showing that, despite their strong outperformance of developed markets since 2001, they are not as expensive as you would think.
- *Corporate activity*: M&A and private equity-driven activity remains the order of the day. This factor remains a supportive one for equity markets.
- *Commodity prices:* we have two additional comments on commodity prices since the December Report; *firstly* we are encouraged to see that commodity prices have continued to rise during the quarter. This provides demonstrable evidence of strong economic activity (which is important, as this will sustain the current ratings of equity markets) and of course provides a profitable environment for commodity company earnings, to which SA equity investors are exposed. Our *second* comment – more a concern at this stage – is that the ongoing rise in commodity prices bodes ill for future rates of inflation. Much higher inflation levels are not factored into investors' expectations at present. If commodity prices continue to rise at their current rate, investors will begin to fret – and rightly so – about higher inflation, higher interest rates and consequently more shocks to the financial system.
- *Emerging markets:* we continue to believe that we are experiencing something, well … very special, in emerging markets, specifically the manner in which they are asserting their ascendancy in the global economic pecking order. Emerging economies are becoming increasingly influential in the global order. You would be familiar by now with our positive view on emerging markets but we are watching current events closely for the following reason: we may be overly optimistic or plain unrealistic, but we think the magnitude of their economic momentum and appetite for resources (be it human capital or commodities) *may* result in global investors ignoring the troubles in the US sub-prime housing market and focussing instead on the strong growth and investment opportunities in emerging markets. It has always been said that "if the US sneezes the rest of the world will catch a cold". While that still holds true in the broader sense, we think that notion will be tested this year. If the US economy continues to slow (we think it will grow by about 2.0% this year, perhaps a bit less) investors may be undeterred and focus instead on the 8% or 10% growth rates emanating from the likes of India and China – refer to Chart 10 again in this regard. If our expectations /thesis is correct global equity investors will continue to be rewarded; if we are wrong equity markets could decline during the course of the remainder of the year. Either way, emerging markets hold the key.

As an aside, you may have heard the term "BRIC" being used more frequently these days. Coined by Goldman Sachs a couple of years ago, it refers to the emerging markets of Brazil, Russia, India and China, which together constitute 39% of the emerging market universe, based on the MSCI indices. Chart 12 shows a breakdown of their relative contribution to the MSCI emerging market "pie".

Chart 12: MSCI Emerging market components



Source: Merrill Lynch

In summary then, it is Maestro's humble but considered view that a supportive environment for **global equity markets** exists. Consequently, equities remain our preferred asset class. Although the returns are likely to be more modest than those of 2006, in the absence of any unforeseen shocks global equity investors can look forward to more positive returns.

Let's turn our attention to the **local investment environment.** Without going into much detail we retain the views tabled in the December Quarterly Report. Everything is still going according to plan; the positive start to the year on the equity market confirms as much. There is no room for complacency though, and we are mindful of the "great heights" that the market currently occupies. But we think the story is a good one, structurally sound, with has a shelf life longer than most people think. If there are any risks, they will in all likelihood emanate from across the waters, which is why we focus so much on the global economy and markets. Consequently equities remain Maestro's asset class of choice for local portfolios.

8. <u>Closing remarks</u>

The year has begun well and the Fund is off to a good start. The returns have been positive, in absolute and relative (to the benchmark and All share index) terms.

However, despite our positive view we have been around long enough to know that **the current rate of annual returns of between 30% and 50% is unsustainable**. Consequently we urge you to reduce any *excessive* expectations you may have regarding similar returns in the future. Without wanting to be the bearer of bad news, we think average equity returns of around 20% are still very good, and therefore expect the prevailing, profitable equity market environment to return to more modest levels in the coming quarters. Whether this takes the form of an external shock or whether markets simply "go nowhere" for a while, is beyond our ability to predict right now. But we would be failing in our duty if we did not point out that current equity market returns are high and unsustainable.

Finally, you may have detected a renewed sense of excitement within the "Maestro family". David Pfaff joined our team at the beginning of March and as you will read in the May edition of *Intermezzo* we are taking another new team member on board. Otto Dreyer will join our team in the latter half of April, thereby providing us with sufficient capacity to continue building Maestro into the organization we would like it to be. David and I are working hard to establish a hedge fund, focussed on the local equity market, by the end of June. Tracy remains a critical member of our team, as does Sue – both of them providing the necessary and so easily under-appreciated support without which I would simply not be able to function.

We remain true to my founding vision of *building an investment boutique focussed on the needs of its clients* and in that respect, given the recent additions to the team, we feel more confident and excited about serving you than ever before.

We remain grateful to you for your continued support and confidence in allowing Maestro to take care of some of your assets. Thank you very much - we look forward to being of further service to you throughout the remainder of the year.

Andre Joubert
16 April 2007