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. The *annual* total expense ratio (TER) for 2007 in respect of class B2 was 2.14%.

FUND SIZE: R22 230 557

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

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

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

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Maestro Investment Consulting
Box 1289
CAPE TOWN
8000

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The Maestro Equity Fund

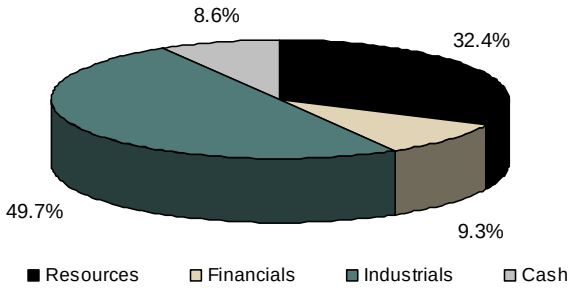
Quarterly report for the period ended

31 March 2008

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 sent to investors.

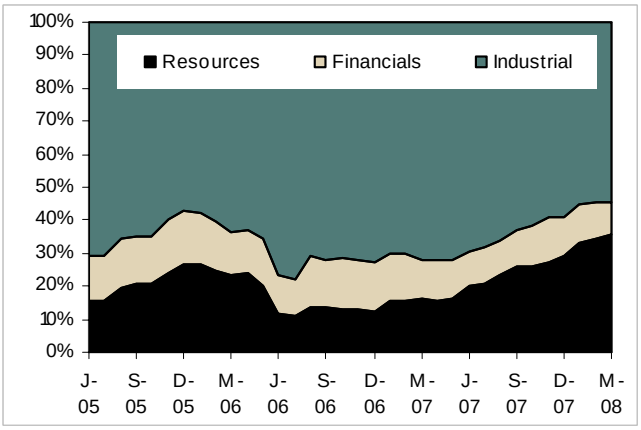
Chart 1: Asset allocation at 31 March 2008



2. The investment position of your portfolio

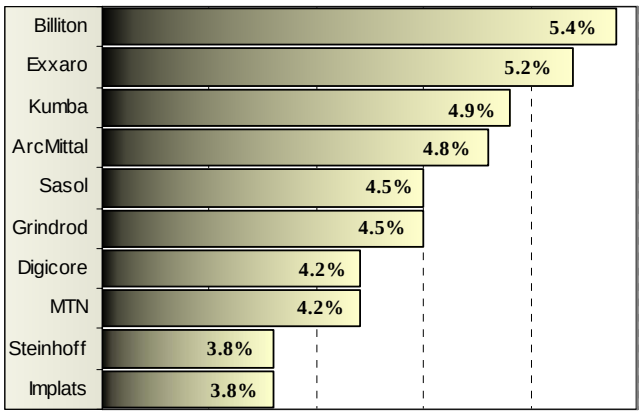
Chart 1 depicts the Fund's sector allocation at the end of March. Exposure to the resource sector totalled 32.4% of the Fund, from 26.4% in December. Financial exposure declined from 10.9% to 9.3% and industrial exposure declined from 53.4% to 49.7%. Cash represented 8.6% of the Fund, up from 9.3% at 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 2: Historic equity sector allocation



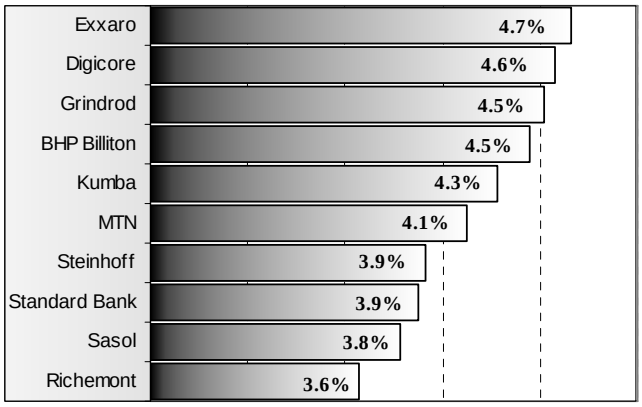
3. **The largest equity holdings**
The Fund's largest holdings at 31 December are listed in Chart 3, expressed as a percentage of the total Fund.

Chart 3: The largest holdings at 31 March 2008



Those at the end of December are listed in Chart 4 for reference purposes. Arcelor Mittal and Implats displaced Standard Bank and Richemont in the "top ten" during the quarter. There were 31 counters in the Fund at quarter-end, unchanged from December, the ten largest of which constituted 45.3% of Fund, up from 41.7% in December.

Chart 4: The largest holdings at 31 December 2007



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.

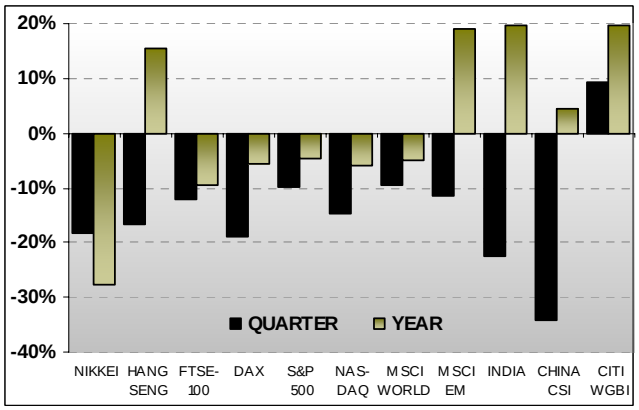
There were no major changes to the Fund during the quarter with the exception of the obligatory participation in the schemes of arrangement in Aveng and Standard Bank, the net results of which was to reduce both holdings marginally.

5. **A review of the recent investment environment**
We have written a lot in *Intermezzo* and the monthly letters about the tumultuous March 2008 quarter, which will go down in history as one of the worst and most volatile. Although some of the quarterly returns may not look that bad at first glance – particularly in the SA market – they hide a "multitude of sins." From the largest trading loss in history (at SocGen) to the collapse of the world's fifth largest investment bank (Bear Sterns), from collapsing currencies (the rand and Iceland krona for example) and hedge funds (too numerous to mention but largely contained to the fixed income environment) to surging commodity and food prices, the past quarter had it all. I cannot begin to describe how traumatic it has been –certainly one of the most stressful and difficult quarters I have ever experienced. Although there were few places to hide investors seemed to take refuge in global bonds and commodities, which were the two asset classes that delivered positive returns during the quarter.

For time's sake, I will keep this Report short. However, the following represent some, but certainly not all, of the most influential factors during the past three months:

- *Price weakness and massive volatility:* although it is self-evident, it is worth pointing out that equity market returns were universally negative. Chart 5 depicts the returns from global markets for the quarter and year to end-March. Apart from a few emerging markets and Hong Kong, which is influenced by the largest emerging market of all, China, the *annual* returns to March are all negative, as were the *quarterly* returns from *all* equity markets. However the returns don't adequately depict the unprecedented volatility, which was far and away the most frightening feature of the market behaviour during the quarter. Chart 6 depicts the quarterly and annual returns to March in respect of local markets.

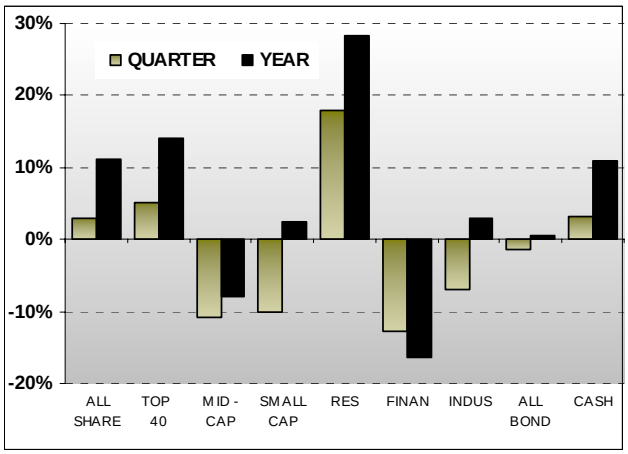
Chart 5: Global market returns to 31 March 2008



- *An ongoing global credit crisis:* the World Bank estimates that the financial sector faces losses on prime mortgages, commercial real estate, leveraged loans and consumer finance of $1 000bn. At the time of writing global banks had written down more than

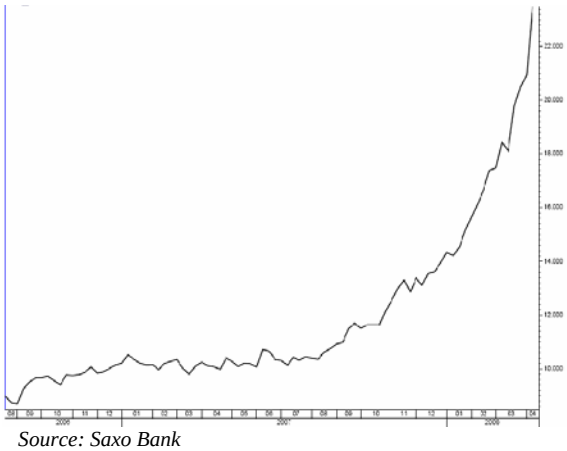
$245bn in bad loans but there is a real concern that we are only at the beginning of this crisis. There is more bad news to come. The losses have forced banks to restore their battered balance sheets with very expensive equity. It has called into question the role and credibility of ratings agencies to the extent that their functions and business models will never be the same. It has resurrected the debate surrounding the merits of the changes in accounting conventions, enacted earlier this century and encapsulated in the International Financial Reporting Standards (IFRS), particularly the mark-to-marking of investments. The net result of these changes on the global economy has been massive and will not go uncontested by policy makers and regulators.

Chart 6: SA market returns to 31 March 2008



- *An ongoing liquidity crisis:* this crisis has been less widely reported but it is arguably more important to the effective functioning of the global financial system. It has to do with the degree of liquidity in the bank system and the extent to which banks can fund their ongoing lending operations. Their traditional sources of funding are being tested: the price of funds has escalated dramatically due to the increase in the price of risk – a function of the credit crisis – which has closed the traditional source of funding, namely the wholesale money market. Moreover, with so much risk around, banks have just about stopped lending money to each other, thereby bringing the inter-bank lending market to a grinding halt. This has left central banks as the only "lender of last resort", which explains why the US Fed, the Bank of England (BoE) and the European Central Bank (ECB) have flushed trillions of dollars and euros into global money markets in a desperate attempt to "reliquify" the financial system.
- *Surging commodity prices:* we have covered this topic in a number of editions in *Intermezzo* so you should be very familiar with it by now. In addition to the record metal and energy prices, soft commodities such as rice, wheat, corn and soyabeans have risen dramatically in recent weeks, spawning riots around the world and government action to curb food exports and secure supply for its citizens. This is an important development; it feeds inflation pressures which are already heading upwards at a disconcerting rate, particularly in the poorer counties, including South Africa. Chart 7 depicts the price of rice over the past 18 months. I apologize for the poor quality of the chart but I thought it was worth including to convey the huge rise in recent months. The price was around $8.8 in June 2006 and at the time of writing is $23.7 a hundredweight (about $1 000 per tonne). It has risen 70% this year so far!

Chart 7: The rice price – staple food for half the world

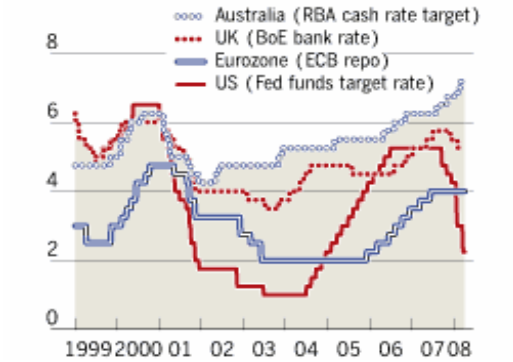


Source: Saxo Bank

- *Disparate interest rates developments:* Ironically, as fast as some interest rates are declining, such as the US, that's how fast they are rising in other countries such as South Africa, Iceland and Australia. The Fed has cut rates aggressively (refer to Chart 8) sparking a rally in US bonds and placing money funds there under pressure – yields on US money funds are now barely positive. Elsewhere the ECB has kept rates at their prevailing (high) levels despite enormous political pressure to reduce them. In South Africa interest rates have risen 4.5% since June 2006, even though the authorities openly acknowledge that higher rates won't reduce inflation in the medium term. The effect of these large movements in interest rates has been to shatter the enjoyable world of "global synchronized growth" that investors enjoyed between 2002 and 2007. It has placed all sorts of pressure on investment markets, in both directions, exacerbating the volatility that characterized the markets in recent months.
- *Large currency "swings":* closely related to developments on the interest front have been the gyrations in currency markets. The euro is at an all-time high against all other currencies while the dollar – ironically the "global reserve currency" - has declined in value against most other currencies,

the rand being the exception of course. The dollar fell 7.6% and 15.9% against the euro during the quarter and year ended 31 March respectively. It declined 11.1% and 15.9% against the yen over the same periods. Despite the dollar's weakness the rand declined against the dollar, registering a fall of 15.9% and 10.6% over the quarter and year to March respectively. Of even greater significance and impact on the SA economy, given that the Eurozone is our major trading partner, the rand declined a shocking 22.4% and 25.0% against the euro during the past quarter and year to end-March! This demonstrates the collapse of the rand against a strong currency and underlines just how dramatic the rand's movements have been as well as the sea-change in perception towards the country on the part of foreign investors. One can only speculate as to the reasons behind the rand's dramatic collapse; the recent change in the political climate and power struggle that lies behind it, the failure of Eskom to provide a reliable supply of electricity, the events in Zimbabwe and the SA government's attitude towards it, the threat of the current account deficit getting out of control and the expected decline in the country's growth rate have all played a part in the rand's demise.

Chart 8: Selected global interest rates (%)



Source: FT.com

- *A weakening global economy:* we have long been proponents of the "decoupling" theme. By this we mean that the global economy will not be affected by the slowdown in the US economy *as much* as during previous slow downs, due to the growth in Asia and emerging markets in general and China and India in particular. That said we also hold the view that the US recession will be longer and deeper than most anticipate. In particular we think the US consumer is in deeper "trouble" than most believe – we will return to this point later in this Report. For what it is worth, the IMF sees the US economy contracting by 0.7% in 2008 and growing 1.6% in 2009. Merrill Lynch forecasts US growth for this year and the next of 0.9% and .6%. The IMF has forecast growth for the Eurozone of 1.4% and 1.2% in 2008 and 2009 respectively. It sees the global economy growing at 3.7% this year, down from its previous forecast, made in January, of 4.1%.
- *Increasing power outages in SA:* we are all fed-up and angry with Eskom and are even more incredulous of the fact that, after having failed so dismally in their *raison d'etre*, they have the gall and arrogance to penalize us for using their product! Sadly there is little anyone can do about the current predicament in the short term, so our thoughts have focused on the effects of the power outages. In short, the news is not good: *the costs to the SA economy and the consumer will be enormous*. Moreover Eskom has cost the global economy something, given that platinum group metals, coal and iron ore prices have risen sharply due to the supply constraints caused by Eskom's failure.
- *Political mayhem in Southern and South Africa:* apart from the Eskom debacle, which has stoked the worst fears in many South Africans, the continued "fallout" from the ANC's Polokwane conference in December last year - by that I mean the resultant "lame duck" parliament, the horse-trading and back-stabbing behind the scenes and the fact no one is sure who is running SA at present - and the ongoing tragedy in Zimbabwe (and Kenya) have all combined to produce *a palpable deterioration in the general climate in South Africa*. There is another wave of emigration taking place as the country starts to feel the effects of the brain drain and depleted skills base, the continuing violent crime, the collapsing infrastructure and the effects of yet another bout of rand-specific currency weakness. While these may not have a *direct* influence on the level of the stock market, their effect is no less real; it has been a major influence on the market and has been an ever-present topic of discussion in all our contact with client this quarter.

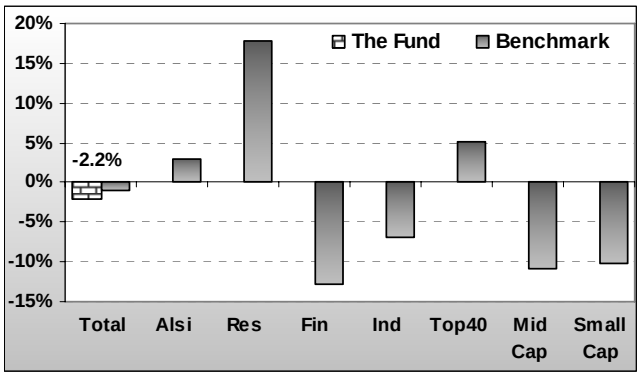
These, then, are but some of the factors we have had to contend with in the daily management of your assets. Let's now turn to how those assets have fared through these turbulent times.

6. The performance of the Fund

The Fund's un-annualised return during the quarter was -2.2%, which can be measured against the return of the Maestro equity benchmark of -1.0%, shown along-side the Fund's return in the "Total" column in Chart 9, and All share index return of 2.9%. As you are aware by now the resource sector dominated the quarter with a return of 17.9% during the period. This is in stark contrast to the quarterly *declines* of 12.8% and 6.9% in the financial and industrial sectors respectively. Yes, that's correct; *there was a 30.7% difference in returns between the resource and financial sector* - quite extraordinary when you consider that this occurred during a period of only three months. In addition, the

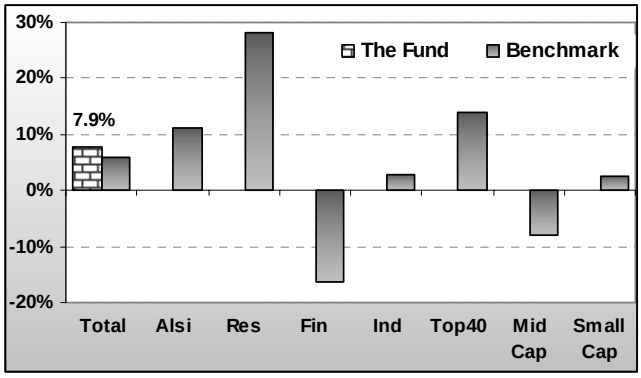
substantial weighting of resource shares in the Top40 index – most mining companies are very large – drove this (large cap) index up 5.1%. The mid and small cap indices on the other hand posted quarterly *declines* of 10.8% and 10.2% respectively. Bearing these disparate sector returns in mind and juxtaposing them against the industrial and mid- and small cap bias of your portfolio, you will understand why your Fund lagged the All share index during the quarter. The quarterly returns of the largest holdings were Billiton 15.1 % (down 14.8% last quarter), Exxaro 6.7% (18.9%), Kumba 8.6% (26.1%), Arcelor Mittal 44.3% (-0.4%) and Sasol 14.6% (14.5%).

Chart 9: Quarterly returns to 31 March 2008



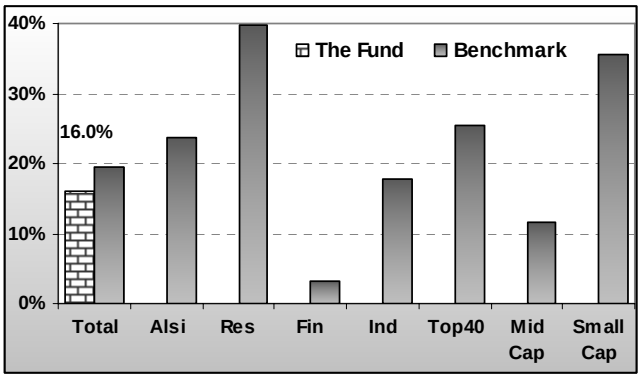
The annual returns are shown in Chart 10. ***The return of the Fund for the year to 31 March was 7.9%.*** The inflation rate rose 9.8% during this period and the All bond index 0.6%. The Fund's return can be compared to the Maestro equity benchmark return of 5.8% and All Share Index of 11.1%. The returns of the other indices are shown in the chart, including the two extremes: the 28.2% return of the resource sector and the 16.3% *decline* in the financial sector - a difference of 44.5% in one year! The mid cap index declined 7.8% and the small cap index rose 2.5%. The main detractors from the Fund's returns during the year were Mr Price down 38.9%, Firstrand 35.0%, Iliad 34.5% and Steinhoff 22.5%. The main contributors were Kumba up 107.7%, Exxaro 68.5%, Arcelor Mittal 67.0%, Sasol 60.5% and Digicore 48.7%.

Chart 10: Annual returns to 31 March 2008



As you may be aware if you have been invested in the Fund for more than a year, the Fund struggled to keep up with the rampant market when it was first launched in June 2005. It then had a disappointing June 2006 quarter, when we adopted too conservative a view following the correction in equity markets at that time. The disappointing historic returns are embedded in the annual returns for the 2-year period to 31 March 2008, shown in Chart 11. Despite this fact, the Fund's 16.0% annual return over the two year period to end-March is not far off the 19.4% return of the Maestro equity benchmark. However it still lags the All Share index return of 23.7%.

Chart 11: Annual return: 2-year period to 31 Mar 2008



7. <u>What lies in store for investors in the months ahead?</u>

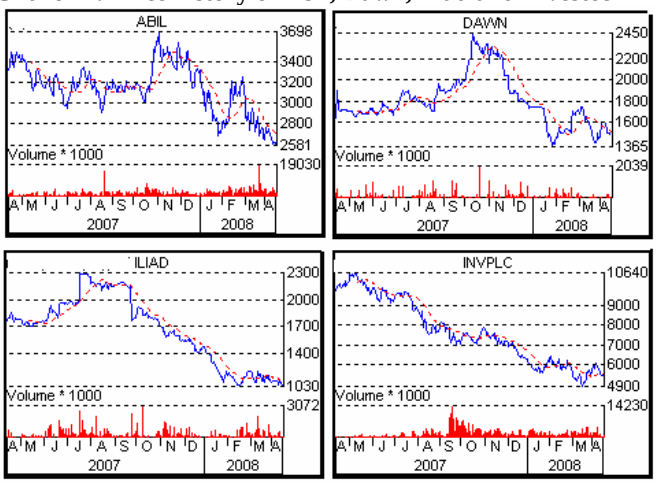
It seems almost futile to think of forecasts when markets are so volatile and beset by such unprecedented events. However you would know by now that we are less focused on "predictions" than on *trying to identify the potential and greatest risk factors we are likely to encounter in the foreseeable future.* I draw your attention to the comments made in the December Quarterly Report, where we went into more detail on our outlook. It is useful to reconcile "what we said" with "what actually happened" but in case you don't have sufficient time for this, I list below what we identified as some of the major risks to the market:

- Rising inflation, particularly food prices
- A US recession - deeper and longer than expected
- Slower emerging market growth
- Corporate earnings
- Political uncertainty in SA
- The rand
- Eskom

It is also worth comparing the above factors to the events as we reported them in an earlier section of this Report. But where do we go from here? I humbly offer some of what is currently on our radar screen. The list is by no means comprehensive but we hope it is thought provoking and informative. For time sake I will not go into much detail but you are welcome to contact me directly to discuss these and other points in more detail.

- *SA equity valuations are very cheap*: many of the financial and industrial companies in which you are invested *offer incredible value at current levels*. Many of them have continued to deliver solid earnings and dividend growth but their prices have declined sharply since October. Notwithstanding attractive prospects for sustainable earnings growth into the future and in many cases despite strong balance sheets and cash flows their prices continue to decline or bump along at very low levels. To describe this as frustrating is a gross under-statement.

Chart 12: Price history of Abil, Dawn, Iliad and Investec

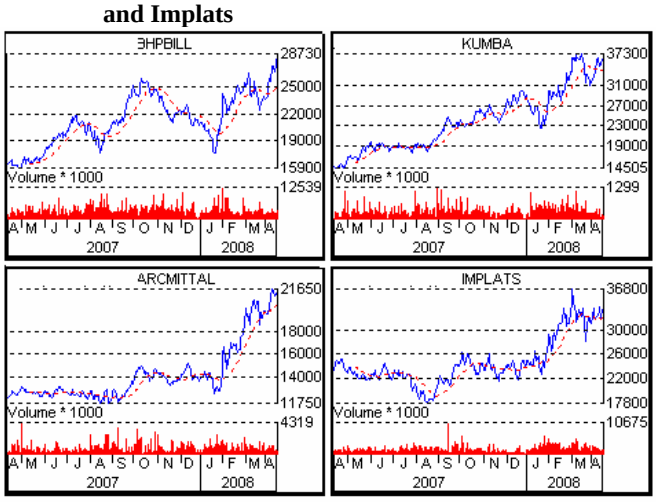


Source: PSG Konsult

Allow me one example: Iliad traded at a 2300c last July (admittedly after having received a tentative offer, subsequently withdrawn, from Absa Capital). At the time of writing it is wallowing around 1030c – a decline of 55.2%. Yet the company recently posted its tenth consecutive year of earnings growth – its compound *annual* growth rates in earnings and dividends over the past seven years are 27.7% and 33.2% respectively. During this time it increased its turnover from R519m to R4.2bn. In the year to December 2007 it increased earnings by 23% and its distribution (the equivalent of a dividend) by 30%. It had virtually no debt and held R96m in cash. We think their business model is robust; after all, it has withstood many challenges in the past ten years. We rate the management team highly; they are a very experienced and stable team and have a meaningful stake in the business. But the share currently trades on an historic PE ratio of 6.4 times and a dividend yield of 5.1%; we think the company will increase its earnings by at least 15% in 2008, making the latter valuations even more attractive. Chart 12 depicts a few more examples of similar situations, such as Abil, which has a forward dividend yield of 10.0%, Cashbuild, Dawn, Grindrod and Investec. We acknowledge that the environment is more challenging but we find the valuations of many of these companies compelling, particularly when taking a longer-term view. As such we remain committed to them and believe they will deliver above-average long-term returns in due course. However, we understand that this is no guarantee that their prices will rise in the short-term; in fact they may continue to offer value, and possibly even decrease, for some time to come.

- *Tale of two markets*: a couple of times in the past we have experienced dichotomous markets, although extremes such as the current one are hard to find. I refer to the fact that although the SA equity market rose 2.9% during the March quarter, there really are two markets at present – one for the resource sector, which rose 17.9% during the quarter, and the other being the financial and industrial sectors, which declined 12.8% and 6.9% respectively during the same period. The rand, which declined 15.9% during the quarter, combined with the surge in commodity prices to propel the resource sector higher. Ironically, the same factors, combined with a couple of others, sent the rest of the market south. Looking ahead into the medium term it is hard to see this situation changing. We believe commodity prices will remain elevated for some time and the rand to remain under pressure.

Chart 13: Price history of Billiton, Kumba, Arcelor Mittal and Implats



Source: PSG Konsult

The question needs to be asked: why don't we then commit more funds to the resource sector? Two immediate answers spring to mind. *Firstly*, many of these shares have risen dramatically in a very short space of time and offer little value at present – which of course doesn't mean they won't move higher; it just means you may not make much money in the long-term if you buy them at these levels. Chart 13 depicts four such examples; if the charts do not impress you, consider the gains in these shares since 21 January, that fateful day when the JSE moved in a

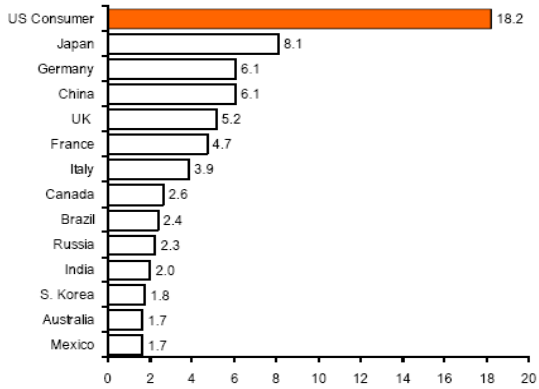
9% range (but closed virtually unchanged) the rand fell over 4% at one stage, the Fed cut rates by 0.75% without having a formal meeting, and Societe Generale booked a $7bn loss. Since 21 January Billiton has risen 62%, Kumba 50%, Arcelor Mittal 76% and Implats 38%. Just to remind you, these gains took place in less than three months, during a time when global equity markets posted *substantial* declines. No matter how strongly you feel about these shares, I'm sure you will agree that buying into them now or increasing existing exposure substantially at these levels is too late and simply doesn't make sense.

Secondly and more importantly, the issue boils down to one of risk. We are of the humble opinion that it is just too risky to invest too much of one's capital in commodity shares. History has shown them to be very risky; their earnings are cyclical and volatile. Experienced investors have learnt the hard way what happens when "the cycle turns".

To put this into context, the dominance of Anglo and Billiton in the SA equity market skew the returns of the All share and Top40 indices very badly. For example, if you wanted to "match" your Fund to the All Share index weightings of these two companies you would have to invest 16.0% and 14.0% of your assets in Anglo and Billiton respectively, or a total of 30.0%. Would you feel comfortable with such a weighting in only two (cyclical) companies? And then we aren't even talking about other attractive commodity plays such as Kumba, Exxaro, Arcelor Mittal and Sasol. We wouldn't feel comfortable investing such a large proportion of your Fund in these shares; we thus remain of the humble opinion that in the long-term your best interests are served by being under-weight the resource sector in general and these two companies in particular. Of course, by definition, this means for as long as resource shares continue to scale new peaks your Fund will underperform the All share index to some extent. In the longer-term though – and here I refer you to the returns of your Fund as discussed above - the equity component of your Fund has at least kept up with the All share index, if not exceeded it over periods of three or more years. Our view is, therefore, less dire than it seems, given the current rampant resource market.

- *The worst may yet lie ahead*: we are of the opinion that the US consumer is in more dire straits than most believe and that the US recession will be deeper and last a bit longer than is generally expected. In addition the global financial system has experienced a significant double "body blow" in the form of the credit and liquidity crises; it would be naïve to think there won't be longer-term and far-reaching consequences, none of which would take only six or nine months to resolve.

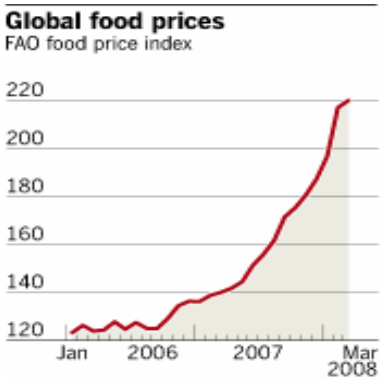
Chart 15: The US consumer as % of global economy



Source: Merrill Lynch

Why such emphasis on the US consumer? Consider the following: the expansion in consumer spending, which lasted for an unprecedented 64 consecutive quarters, has just ended. We have seen the damage the US housing bubble caused - it lasted a record 16 consecutive quarters. But housing only constitutes 5% of US GDP. The US consumer on the other hand makes up 70% of US GDP or 18.2% of global GDP as can be seen from Chart 15. Merrill Lynch points out that "if the US consumer was a country, it would be more than twice the size of the entire Japanese economy, triple the size of Germany and China, and four times the size of the UK and France". Heading into the last two consumer-led US downturns in 1980 and 1990, US households' share of GDP was 14.9% and 16.8% respectively, not 18.2% as it is today. Moreover, there was less leverage (debt) in the system; hence our belief that the process of US consumer de-leveraging is likely to last longer than expected.

Chart 16: Global inflation – watch closely now …



Source: FT.com

- *Higher inflation is on the way*: we alluded to this earlier in the Report. One cannot underestimate the damage done to the integrity of the global economy by rising inflation, and this is before taking into account social unrest and political turmoil that is traditionally sparked by food crises. History is

littered by global crises and political upheavals caused by that "hopelessly human" need – hunger. Apart from food price pressures, the prices of oil and other infrastructure-related commodities, such as steel and iron ore, are all at record levels. We don't think there is reason to panic yet, but we would suggest that central bankers are less in control of rising inflation than they would have us believe, which is of great concern to us. In our opinion, rising global inflation remains close to the top of the list of risk factors for 2008 and beyond.

- *More price weakness and volatility to come*: I hope that the above discussion points, of which there are more, will lead you to the same conclusion that we arrived at: that there will in all likelihood be more price weakness and volatility in global investment markets. A lot of bad news *is* priced into the global and local markets, but one should remember that this doom and gloom is now shifting from "Wall Street" to "Main Street" i.e. from the investment environment into the consumer market. Although we suspect economic conditions are deteriorating, particularly in the US, we have yet to see *how bad* they really are. Remember that data is often released some time after the actual event – in some cases a couple of weeks or months later - so we only find out about things *after* they have occurred. Even if we are only half right in our assessment of the current environment we are likely to see continued volatility in the markets for some time to come. At this stage, although *we would like to think the worst is behind us* – and let's face it, the past quarter had more than its fair share of nail-biting days and, with the exception of commodity-related stocks, prices *have* declined sharply – *we reserve judgment on whether this is indeed the case.*

8. <u>Closing remarks</u>

This time last quarter, as we finalized and dispatched the Quarterly Report, we were literally in the middle of what turned out to be the largest ($7bn) corporate trading loss ever in history, as Societe Generale unwound a $70bn equity derivative position in only a few days and at a time when some major equity markets were closed. This time as we dispatch this Report, markets are a bit calmer, but there is still a lot of risk and uncertainty in the air.

We are thus more conscious than ever of your support and ongoing trust in our ability to "weather this storm". Together we have seen much better times and I am convinced such times will, in due course, return. Right now, though, we are actively engaging the markets with the primary intention of *preserving capital* as opposed to seeking the maximum return. This is part and parcel of the investment cycle; it is implicit in its very nature. Investors must be prepared to take the "bad" with the good. It is at times such as this that we learn a great deal, particularly about risk management.

We will continue to be conservative in our management of your Fund and will seek out and retain investments we believe offer unusual value right now and which will lead to decent long-term returns in the years to come.

Please feel free at any stage to contact either David or I about your portfolio. We remain at your disposal at all times. We look forward to being of further service to you throughout the remainder of the year.

<u>Andre Joubert</u>
18 April 2008