MAESTRO
Equity Prescient 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.

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 Management, 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 Fund 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% and the annual investment management fee is 1.75%. The *annual* total expense ratio (TER) for the past year in respect of class A was 2.05%.

Income Distribution (annually)
23.78 cents per unit
31 March 2014

FUND SIZE: R128 206 721

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

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

PORTFOLIO MANAGER
Maestro Investment Management (Pty) Ltd

ENQUIRIES
Maestro Investment Management
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CAPE TOWN
8000
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The Maestro Equity Prescient Fund

Quarterly report for the period ended

31 March 2014

1. Introduction

This Report focuses on the investment activities of the Maestro Equity Prescient Fund during the past quarter although it should be read in conjunction with previous editions of *Intermezzo*, wherein we documented some of the salient events in recent months. I also refer you to the Market commentary – March 2014 report, wherein we discuss the markets' behaviour during the quarter. It is at the bottom of this report.

2. The investment position of the Fund

The Fund's sector allocation is shown in Chart 1. Exposure to the resource sector totalled 17.5% of the Fund, up from 14.5% in December. Financial exposure rose 4.9% to 19.4% and industrial exposure declined 3.0% to 57.9%. Cash represented 5.2% of the Fund, down from the 7.9% at the end of December.

Chart 1: Asset allocation at 31 March 2014

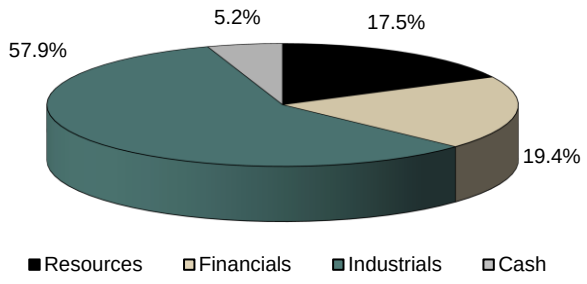
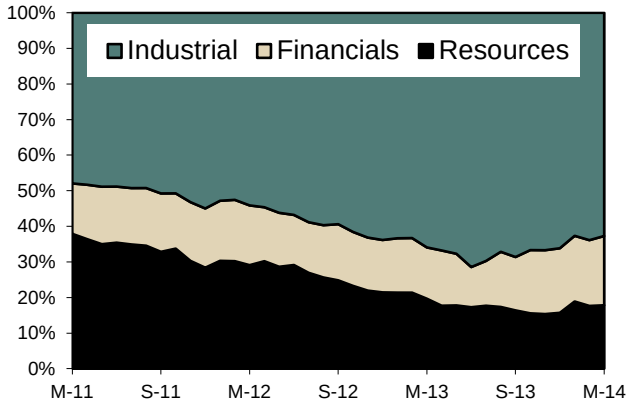


Chart 2 depicts the historical allocation to the three major sectors of the equity market, expressed as a percentage of the equity portion of the Fund.

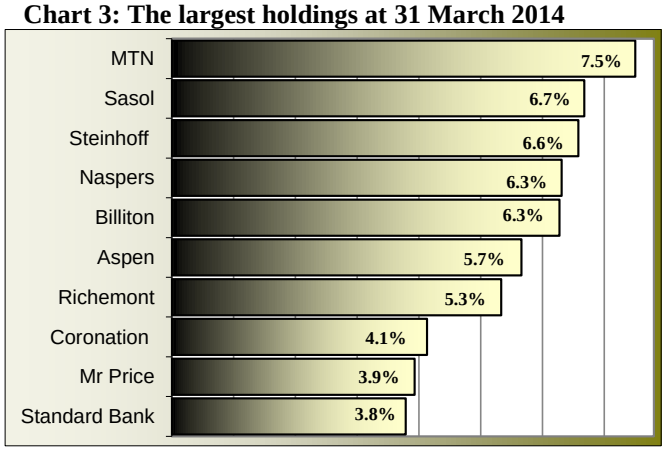
Chart 2: Sector exposure at 31 March 2014



3. The largest equity holdings

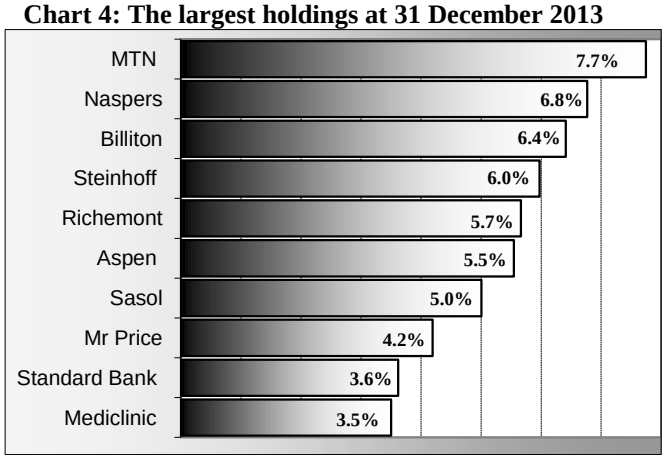
The largest holdings at 31 March are listed in Chart 3, expressed as a percentage of the equity portfolio.

Chart 3: The largest holdings at 31 March 2014



The largest holdings at the end of December are listed in Chart 4. During the quarter Coronation Fund Managers replaced Mediclinic in the top 10 holdings of the Fund. At the end of March there were 32 counters in the Fund, unchanged from the end of December. The ten largest holdings constituted 56.1% of the Fund up from 54.4% in December.

Chart 4: The largest holdings at 31 December 2013



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.

There was a fair amount of activity within the Fund during the quarter.

Within the resource space, the Fund's holding in Sasol was increased during the quarter. New holdings in Anglo American, Glencore and Implats were introduced into the Fund. A more bearish view was taken on the outlook of the iron ore price and hence the prospects of the single commodity producer, Kumba Iron Ore. This led to the sale of the holding out of the Fund during the quarter.

Within the financial and property holdings of the portfolio, the small holding in Prescient was reduced. The holding in the Atterbury Property Fund, Attacq was increased during the quarter.

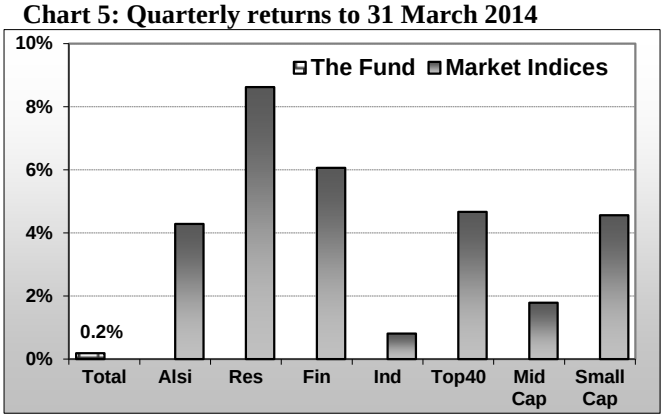
A large part of the Fund's activity was within the industrial space. The Fund has been building up a holding in OneLogix over the past few quarters and continued to add to it during the March quarter. The Fund's core holding in MTN was also increased as were the holdings in WBHO and Woolworths. The small holdings in the construction companies, Esor and Protech were sold during the quarter. The holding in Blue Label Telecoms was also reduced.

A new holding in the form of the IT company, AdaptIT was introduced into the Fund during the quarter.

5. The performance of the Fund

Turning to 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 March quarter was 0.2%***.

Chart 5: Quarterly returns to 31 March 2014



The Fund's return can be compared to the All share index return of 4.3%. We commented extensively in recent Fund Summaries 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 encourage you to read the commentary on the market movements during the quarter in the document entitled *Market commentary –March 2014.*

After stuttering at the start of the year, the local market picked up momentum towards the later part of the March quarter. Concerns on the effects of the US Federal

Reserve's (Fed) tapering (reduction in asset purchases) clouded the outlook for emerging markets for the better part of the quarter. As the quarter progressed, investors began to focus more on the prospects of a faster growing US economy, which caused some of the taper concerns to abate. The 4.3% gain in the aggregate local index conceals the volatility investors had to contend with during the first quarter. Concerns about a slowing Chinese economy, overvalued technology shares and an escalating crisis in Ukraine, all contributed to the share price swings during the quarter.

During the quarter, we witnessed somewhat of a switch in investors' sector preference relative to 2013. Whereas industrials were the best performing sector throughout 2013, basic materials had an impressive showing in the March quarter, as they rose 8.6%. Financials were a close second with gains of 6.1%, and industrials rose a pedestrian 0.8%. The strength in resources was led by gold miners, that returned a staggering 42.6%, although they declined 54.6% in 2013. What played a large role in the underperformance of the Fund relative to the Alsi is fact that the Fund did not have enough resource exposure during the quarter and absolutely no gold miner exposure. We have often commented on our aversion to investing in gold shares and we believe that despite the strong quarterly return, the past 5 quarters provide ample evidence to support our view. Over the past 5 quarters, the gold index's returns read as follows: 42.6%, -16.6%, -0.4%, -33.5% and -17.9%. No matter which way one looks at it, those quarterly returns are the quintessential definition of volatile (read: risky). As if that volatility was not bad enough, over that 5 quarter period, an investor into the gold index would have lost 35.3% of their capital; not only has one endured high risk by investing in gold stocks, but they have also suffered lower returns.

What is not evident from Chart 5 is the performance of companies based on their size. The small-cap index kept up with the large cap index and the midcap index continued to be the laggard on the size spectrum. The mid-cap index rose 1.8%, while the small-cap index gained 4.6%. The large-caps also rose strongly as the Top40 index gained 4.7% during the quarter.

Let us look at the March quarterly returns of some of the Fund's investments. The quarterly returns, excluding dividends, of the largest holdings in the portfolio, were as follows: MTN fell 0.7% (it rose 10.7% in the December quarter), Sasol 14.6% (7.4%), Steinhoff 3.1% (26.2%), Naspers rose 6.0% (18.0%), Billiton 0.4% (8.9%), Aspen 4.7% (2.3%), Richemont 3.4% (3.6%), Coronation 23.8% (16.0%), Mr Price -3.9% (17.8%) and Standard Bank 7.2% (8.0%).

As material as some of the share moves above are, we tend not to read too much into the short-term returns of the Fund's portfolio. We tend to focus more on the longer term returns and I would encourage you to do the same as you draw conclusions on the Fund's performance.

The annual returns to March are shown in Chart 6. ***The annual return of the Fund for the 12 months to March was 23.6%*** which is in line with the All share index return of 23.6%. Inflation rose 6.0% over the past year and the All bond index rose a meagre 0.6%.

Chart 6: Annual return to 31 March 2014

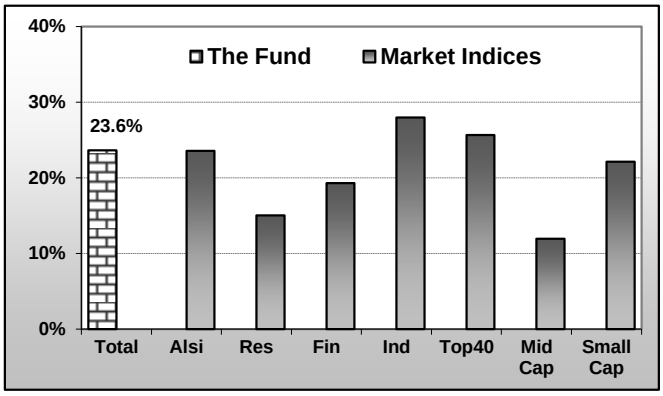
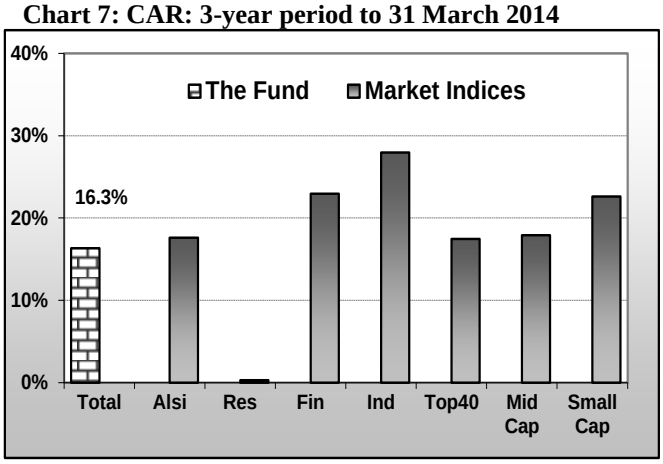


Chart 6 shows the strong outperformance of the industrials index over the past year, despite underperforming in the March quarter. It is probably worth highlighting that despite our preference for industrials and financials over resources, and the fact that they have outperformed over the long-term, that is not to say there won't be periods when resources are strong, which will likely lead to us underperforming. We remain comfortable with our overweight industrial position for now. During the past year, the shares that drove the Fund's returns include Coronation, which rose 106.3%, Steinhoff 103.9%, Naspers 102.7%, EOH 66.1%, Aspen 47.3%, Sasol 44.7% and Richemont 39.3%.

Chart 7: CAR: 3-year period to 31 March 2014

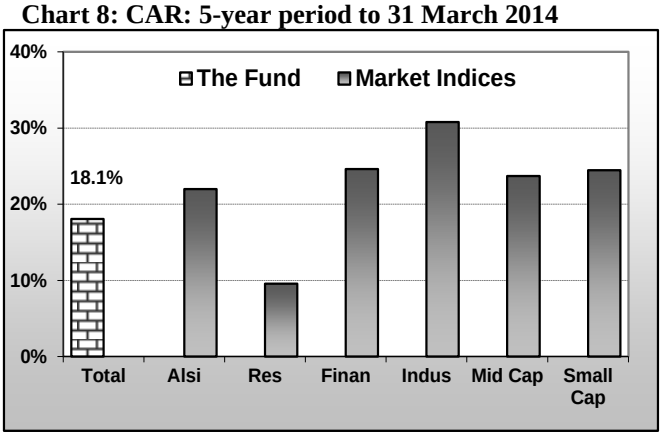


The compound annual return (CAR) of the Fund, shown in Chart 7, ***over the three-year period to March 2014 was 16.3%*** which can be compared to the All share index return of 17.6%.

Again, it is clear from Chart 7 which sectors drove the market higher over the past three years, and it is quite remarkable that the resource sector rose a menial 0.3% *per annum* over this period. Across the market cap spectrum, the large-cap index managed to maintain pace with the mid and small-cap indices, largely thanks to the industrial shares. The three-year compound annual returns of the large, mid and small-cap indices are 17.5%, 17.8% and 22.3% respectively. The respective compound annual returns for the All Bond index and cash over this period were 9.2% and 5.5% respectively.

The CAR of the total Fund return over the five-year period to March 2014, shown in Chart 8, ***was 18.1% per annum*** which can be compared to the All share index return of 22.0%. Over this period, South African inflation rose at 5.3% per annum, while the All bond index compound annual return was 9.0%. The annual return on cash was 6.2%. At the risk of stating the obvious, the base from which these returns are being measured is end-March i.e. in the depths of the financial crisis, which explains the remarkable returns that investors have enjoyed over the past 5 years. It is highly improbable that the next 5 years will be generally as profitable as the previous 5 years, which increases the need for us to ensure that we select that correct sectors and shares for the Fund.

Chart 8: CAR: 5-year period to 31 March 2014



The industrial index compound *annual* return over the five-year period was 30.8%, while financials and resources returned 24.6% and 9.6% respectively over the same period. The 5-year compound annual returns (CARs) for the large, mid and small-cap indices were 21.6%, 23.6% and 24.09% respectively, while the respective CARs for the All Bond index and cash were 9.0% and 6.2% .

Chart 9: CAR: 7-year period to 31 March 2014

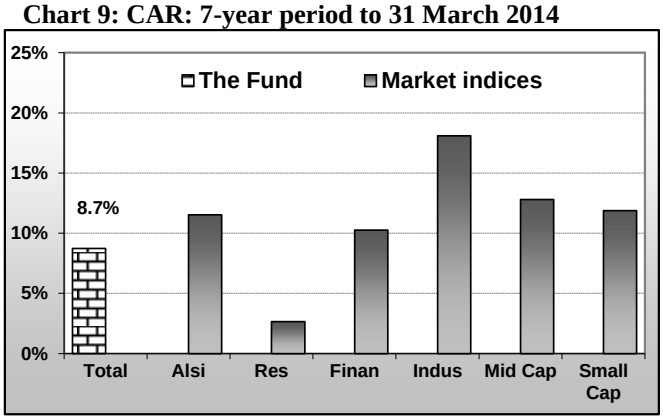


Chart 9 lists the returns over a seven-year period. ***The CAR of the Fund over the seven-year period to March was 8.7%*** versus the return over the same period of the All Share Index of 11.5%. Over this period, South African inflation rose at 6.6% per annum, while the All bond index compound annual return was 8.3%. The annual return on cash was 7.7%.

Once again, the stand out feature in the chart above is the outperformance of the industrial sector relative to the financial and resource sectors over the last seven years. The industrials index has risen 18.1% per annum versus the 10.3% for the financials index and 2.7% for the resource index.

6. Closing remarks

Although the Fund earned a positive return for the March quarter, you will have seen that we lagged the market. While we are obviously not happy with this, we realise why this has happened and continuously work to see if any remedial action is required. Apart from that, you are probably aware that there are times when shares, and indeed portfolios, pause for a breather, which is all part and parcel of equity investing.

Our outlook for 2014 remains the same as it was at the beginning of the year; we expect a continued improvement of the global economy, which should remain supportive of equity markets and negative for bonds and cash. Having said that, company and market valuations are not cheap and earnings growth is essential for investors to enjoy another year of good returns.

There remain several risks to our view, namely, the continued slowing down of the Fed's monetary easing policy and its effects on emerging markets. Geopolitical risks also remain a key concern, with the developments in Russia and Ukraine threatening to escalate, and a slowing Chinese economy that is dampening commodity demand. Although these all represent meaningful risks, it is worth highlighting again that it is all part and parcel of investing. Rather than spending an inordinate amount

of time worrying about the risks that exist in the market, we spend more time looking for companies that we believe are better able to navigate the challenges that invariably occur in all economies. This strategy has worked well for us and we believe that over time, it will continue to generate higher risk adjusted returns for our clients.

As usual, we are here to be of assistance to you, so please, do not hesitate to call on me if ever you wish to discuss anything about the Fund in further detail.

Luke Sparks
On behalf of the Maestro team
14 May 2014

MAESTRO

Market commentary – the March 2014 quarter

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

Table 1: Selected returns: equity markets

	Mar Quarter (%)	Dec Quarter (%)	Annual Returns (%)	2013 (%)
Japan	-9.0	12.7	20.0	56.7
Hong Kong	-5.0	2.0	-0.7	2.9
Germany	0.0	11.1	22.6	25.5
UK	-2.2	4.4	2.9	14.4
US (S&P500) and large cap	1.3	10.6	22.2	32.8
S&P Mid cap	2.7	7.9	19.5	31.6
S&P Small cap	0.8	9.5	26.3	42.4
MSCI World index	***0.8***	***7.6***	***16.7***	***24.1***
Brazil	-2.1	-1.6	-10.5	-15.5
Russia	-17.8	1.4	-18.5	-5.5
India	5.5	9.2	18.6	9.0
China	0.6	-2.7	-4.8	-5.3
MSCI Emerging market index	***-0.8***	***1.5***	***3.9***	***-5.0***
JSE All share	***4.3***	***5.5***	***23.6***	***21.4***
JSE All share ($)	***3.8***	***1.4***	***7.8***	***-1.6***
Basic materials	8.6	1.0	15.0	-1.8
Financial	6.1	6.9	19.3	19.1
Industrial	0.8	6.7	28.0	35.0
Gold mining	42.6	-16.6	-21.1	-54.6
Large cap (Top40)	4.7	5.6	25.7	22.8
Mid cap index	1.8	5.7	12.0	13.0
Small cap index	4.6	3.9	22.1	26.3

Introduction

Having put behind us what was generally a very profitable year for most markets in 2013, the first quarter of 2014 started on the back foot. Most markets that were successful in 2013 struggled to keep up the momentum, with some like the Japanese Nikkei, seeing significant declines during the first quarter.

Similar to the end of 2013, the first part of the March quarter was dominated by concerns of how the Fed's tapering or decrease in bond purchases would affect markets. Having marked the five year anniversary of the bottom of the crisis during the March quarter, it is remarkable to think that many of today's economic policies are still in response to the crisis. The most obvious of such policies is the Fed's quantitative easing (QE) policy that the Fed finally committed to ending later this year. Having 'threatened' to withdraw stimulus since the middle of 2013, the Fed finally took action and started winding down their asset purchases by $10 billion less every month.

During the quarter, the Fed repeatedly indicated to the market that as long as the growth trajectory seen in the US economy continues, they will gradually reduce their asset purchases with the view to complete the program in October of 2014. Later in the quarter, the Fed also hinted at their intention to start increasing US interest rates towards the middle of next year. Considering how some risk assets have benefitted from the profligacy of the Fed, it would come as no surprise that those very assets that have performed best since the crisis saw huge sell offs at the beginning of the quarter, although some of them recovered as the quarter progressed.

Another key feature during the quarter was the severe US weather that distorted most economic data readings. At a time when policy makers and investors were eager to get a good read on the US economy, the weather threw the proverbial spanner in the works and left most economists speculating on whether the weak data emanating from the US was because the underlying economy was indeed weak, or it was all because of the dire US winter. Similar concerns plagued Chinese economic data, but this was a result of the Lunar holidays, that always make the country's first quarter economic data difficult to forecast and interpret.

Table 2: Selected returns: bonds, commodities, currencies

	Mar Quarter (%)	Dec Quarter (%)	Annual Returns (%)	2013 (%)
SA All Bond index	0.9	0.1	0.6	0.6
SA Cash	1.3	1.3	5.3	5.2
Barcap Global Agg. Bond index	2.4	-0.4	1.7	-2.6
Emerging market bonds	3.4	1.7	2.2	-3.3
US 10-year bond	3.4	-2.5	-4.4	-7.8
US Corporate bond	3.0	1.0	1.4	-1.5
US High yield bond	3.0	3.5	7.5	7.4
Cash (US dollar)	0.0	0.0	0.0	0.1
DJCS Hedge index	0.9	2.9	7.0	8.4
Brent (Oil)	-2.7	2.2	-2.1	-0.3
Gold	7.5	-9.4	-19.2	-27.8
Silver	2.4	-10.1	-30.3	-34.9
Platinum	4.5	-3.8	-10.0	-11.1
Palladium	8.7	-1.4	1.0	1.7
Copper	-10.1	1.0	-13.0	-7.1
Nickel	12.7	0.4	-5.6	-18.5
Baltic Dry index	-39.7	13.7	50.9	225.8
CRB Commodity index	-14.2	-1.5	-9.9	-4.1
S&P GS Commodity index	2.3	-0.1	-1.1	-1.3
Euro dollar	0.0	1.8	7.3	4.5
Sterling dollar	0.7	2.3	9.8	1.9
Swiss franc dollar	-0.7	-1.7	-6.7	-2.8
Rand dollar	-0.4	-3.9	2.1	-19.0
Yen dollar	-2.0	7.1	9.5	21.6

The global economy

When one considers the extraordinary lengths that policy makers in developed economies have gone to stimulate their economies over the past five years, we should be concerned that economic growth rates are not higher. As Table 3 shows, after the slowing down in 2013, the world economy is expected to pick up again in 2014 from growth of 2.8% to 3.7%. The economies that are expected to add the most to world GDP during 2014, relative to their contribution in 2013, are the US and the Eurozone group. It is important to highlight that this is in stark contrast to what we have seen since the crisis, when emerging markets were the bright spots in terms of contribution to world GDP, with developed markets limping along. This change in growth outlook between developed and emerging markets is one of the reasons why emerging market equities and currencies have struggled to keep up with their developed market counterparts over the last year. As we have often highlighted, growth occurs at the margin, so economists and investors tend to focus more on the fact that the growth in developed markets is increasing, rather than the fact that the absolute growth rate in emerging markets is higher.

Table 3: Global economic growth rates (%)

GDP growth (%)

	2012	2013F	2014F	2015F
Global	3.0	2.8	3.7	4.0
US	2.8	1.9	3.3	3.8
Eurozone	-0.6	-0.4	1.0	1.4
Germany	0.7	0.4	1.5	1.4
Japan	1.4	1.5	0.7	1.3
UK	0.3	1.9	2.7	2.0
China	7.8	7.7	8.6	8.2
India	4.1	4.3	5.5	6.0
EM (Asia)	6.0	5.9	6.9	6.8
EM (Lat Am)	2.8	2.3	2.7	3.1
EM (CEEMEA)	2.7	2.3	2.8	3.4
EM	4.7	4.5	5.3	5.4
DM	1.4	1.2	2.2	2.6

Source: Deutsche Bank

The optimistic view of the US economy that is illustrated in the 2014 and 2015 forecasts above, largely explains the Fed's current policy of tapering and higher US interest rates in 2015. Of course, the key risk to that policy, and to some extent the strength we have seen in risk assets, is that for some reason the growth does not actually come through. Markets, whether they are for currencies, equities or bonds tend to discount future expectations into current prices, which is the reason commentators often say that 'markets are forward looking'. This is why, when historical data such as GDP and inflation is announced, there is often little movement in various markets, because the 'news' is often already in the price. In the current economic environment, where policy is closely aligned to economic data more than usually, it becomes a key risk that should the markets be pricing in better than expected data, which fails to materialise, we will likely see heightened volatility in the markets. We have no doubt that though the US Fed has committed to start the process of getting back to 'normal' policy towards the end of this year. Should the demanding expectations of US GDP growth of 3.7% not be achieved, we will see a continuation of the unconventional policies that have plagued markets for the last few years.

Over the last two or three years, emerging markets have changed from being the 'darlings' of global investors to the most unloved sector that investors are significantly underweight. An accurate assessment of emerging economies is probably somewhere in between these two extreme views, although that matters little at the moment with sentiment heavily in favour of developed markets. We have commented on the improving growth outlook for developed markets, which has made the search for yield that brought global investors to emerging markets in the first place, less attractive. What is also concerning about emerging markets, and that became more apparent during the March quarter, are the structural challenges that they face, which were laid bare by the developments in Turkey, Thailand, Ukraine, Russia and Argentina. While the political turbulences each of these countries went through during the March quarter were different, we are of the view that to some extent, the underlying drivers are similar, namely, the failings of state capitalism and the murky boundaries between the state and private sectors, which exists across most emerging countries. This is not a new development, neither is it likely to be resolved in a short space of time. However, with large foreign outflows out of emerging markets as a result of Fed tapering, and the resultant weak currencies and higher inflation, the structural issues that were once seen as 'minor' risks have become more apparent and show that emerging markets are indeed a riskier place to invest.

Table 4: Annual rates of inflation (%)

CPI inflation, YoY* (%)

	2012	2013F	2014F	2015F
US	2.1	1.5	2.3	2.3
Eurozone	2.5	1.3	1.0	1.4
Japan	0.0	0.4	2.8	1.6
UK	2.8	2.6	1.8	1.7
China	2.6	2.6	3.5	3.2
India	7.5	6.3	4.3	6.0

Source: Deutsche Bank

Chart 4 shows another notable feature that separates developed and emerging economies i.e. the inflation outlook. While developed markets have very little to concern them as far as inflation is concerned, emerging nations are beginning to see the effects of weak currencies translating into higher inflation. This creates a real conundrum for policy makers in emerging economies, as their conventional tool for high inflation, which is to raise interest rates, will have the unintended consequence of exacerbating the already slowing economies. Rightly so, in our view, many emerging market central banks have decided to take the hard medicine and increase interest rates despite the weak growth outlook, to nip

inflation in the bud. This has had the positive effect of slowing foreign outflows and stabilising emerging market currencies. It remains to be seen how sustainable this policy action will be, but for now, it has worked as an effective band aid solution. In our view, the key will be to balance the interest rate hikes in such as a way that they do not choke off growth. It's no easy task, but one that will be both painful for the short to medium term, but appropriate for the long term.

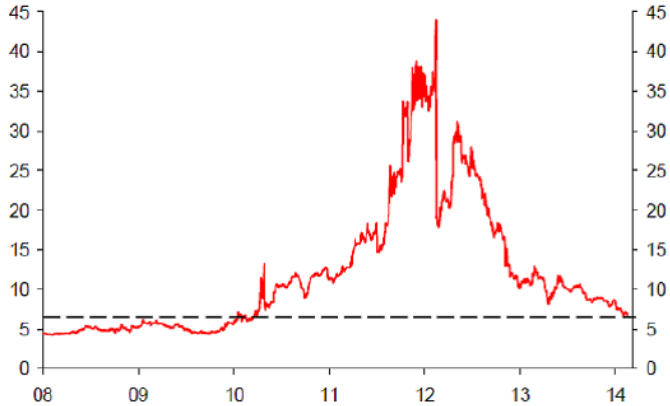
Perversely, while the emerging market complex tries to figure out how to deal with rising inflation, the Eurozone is beginning to face up to the reality that deflation is a real possibility in the region. The strong Euro, weak demand, limited bank lending and declining energy prices, all contributed to the current deflation concerns in the Euro bloc. Policy makers in the region are adamant that talk of deflation is misguided, which is what one would expect them to say; admitting that deflation concerns are justified will only intensify the discussion until it becomes a self-fulfilling prophecy. Either way, that remains an important variable to watch during the course of the year.

Global bond markets

Many investors, ourselves included, have been surprised by the performance of bonds during the March quarter. Few would have envisaged sovereign bonds outperforming equities at the beginning of the year. There are several reasons for this movement in bond prices, despite them being at already low yields at the turn of the year. To understand or forecast the movement in bond yields, particularly US bonds, one has to appreciate the extent to which the bond market has been distorted by Fed policy (QE) over the past few years. At present, the Fed holds almost 40% of all US treasuries that have a duration longer than 10 years. This accumulation of bonds by the Fed has played a massive role in determining US bond yields. The concern in the market is that with the Fed buying $10 billion worth of bonds less every month, who is going to buy treasuries once the Fed stops buying? Now, this is somewhat of a rhetorical question, as there will obviously be a buyer, the question is at what price? With the US economy expecting to pick up later this year and the Fed's QE policy coming to end, we believe it is only a matter of time until bond yields reflect this better economic outlook. We do not expect the move to higher yields to be drastic, mainly because we do not believe the Fed will let that happen, but high interest rates are certainly coming. Due to the fact that most of the world prices their bonds relative to US bonds, we generally expect higher global interest rates into the future. This is not to say that we will not have quarters such as the March quarter, where bonds outperform equities, but what we do believe is that barring an unforeseen economic collapse, the outlook for bonds is negative.

A development in the bond market that has gone on without as many headlines as we would have expected, is the appreciation in the periphery bond markets. Less than two years ago, headlines were filled with calamitous outlooks for Ireland, Greece, Portugal, Italy and Spain, collectively known as the PIIGS. Since then, the bond markets in those nations have recovered, with Greece recently issuing bonds to the market. Chart 1 below shows how the Greek 10 year government bond has rallied since the crisis in 2011/2. Remember that when bond yields decline, as they have recently, prices rise i.e. there is an inverse relationship between bond yields and prices.

Chart 1: Greek 10-year government bond yields (%)

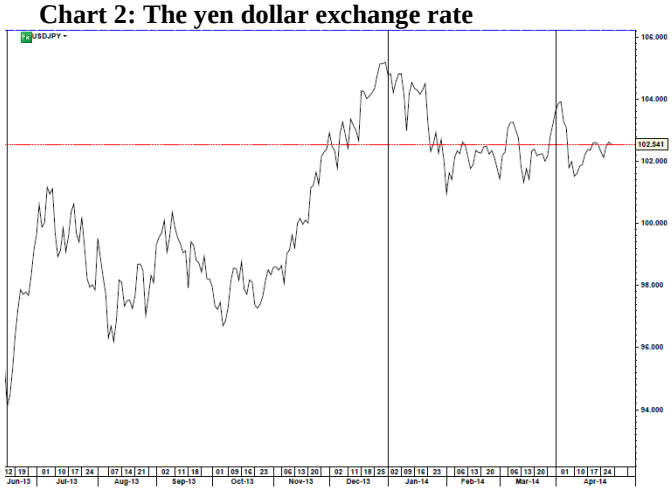


Source: Financial Times

Currency markets

Despite the decline in US bond rates during the quarter, the dollar was weak against other developed market currencies, although it was stronger versus emerging market currencies. The dollar rose 0.2% against the euro and 0.7% against sterling. As far as developed market currencies are concerned, the notable move during the quarter was the strength in the yen, which was a clear reversal of the trend we saw in 2013.

Chart 2: The yen dollar exchange rate



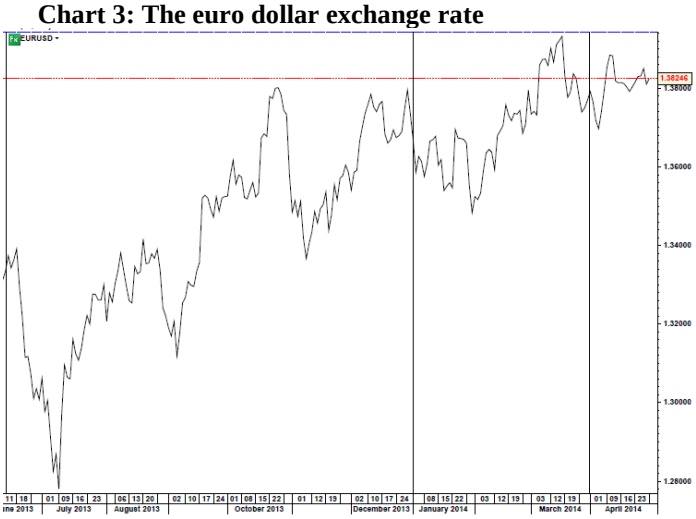
Source: Saxo Bank

The yen dramatically fell 21.6% during 2013, as the BoJ flushed trillions of yen into the market in an effort to weaken the currency and inflate prices i.e. create inflation. In so doing, it provided substantial support to their ailing export

sector and indirectly also to the Japanese stock market. The Japanese stock market rose 56.7% in 2013, but by a lot less in dollar terms. This year, question marks have begun to be raised about the efficacy of this policy. With economic data yet to vindicate Japanese policy makers, it comes as no surprise that the Japanese market has been the worst performing developed market for the quarter. Our view has always been, if problems of over indebtedness, low growth and deflation, that have characterised the Japanese economy for over two decades, can be easily resolved by printing money, why hasn't everyone else done it? Surely it cannot be that easy?

The relative strength of the euro continues to surprise many, confounding many who were expecting its demise in the midst of the 2007/9 crisis. Given the over-indebtedness of the peripheral European countries, it remained a unitary currency and firmed throughout 2013 and has remained steady during the March quarter. Although most forecasters see a weaker euro at the end of this year, we sense that many undermine the region's prospects and barring a massive European QE program in response to deflation concerns, we could see continued strength in the Euro bloc's currency.

Chart 3: The euro dollar exchange rate



Source: Saxo Bank

A notable feature of the March quarter, particularly at the beginning of the year, was the weakness in emerging market currencies. We have already alluded to the *Fragile Five* in our other publications i.e. the currencies of Brazil, India, Indonesia, Turkey and South Africa. These countries have a few undesirable similarities; they all are experiencing weakening growth, high inflation, and have large current account deficits, which in most cases rely on foreign portfolio inflows to fund them. This makes them particularly vulnerable when sentiment turns against the country or when the general level of risk and uncertainty increases. This proved to be the case during the second half of 2013, a trend that continued into the first part of 2014 as investors intensified their fretting about the effects of QE tapering on emerging markets and the Fragile Five in particular. With US interest rates likely to start edging up, the differentials in real interest rates between the Fragile Five and their more developed peers will start to narrow, which compels investors to resort to safer assets, namely, developed market bonds. The story above started playing out in the second half of last year and our sense is that we have not seen the end of it. By raising interest rates, developing economy central bankers have stemmed the tide – but it is just that, a stemming of the tide that is likely to continue for a few more quarters.

Global equity markets

With a very profitable 2013 as the backdrop to the start of the March quarter, it comes as no surprise that many markets that were profitable in 2013 took somewhat of a breather in the first quarter. When one considers that most of the price gains last year came as a result of markets re-rating, as opposed to material increase in the companies underlying earnings, you can understand why markets paused as though to wait for earnings to catch up.

Chart 3: Global returns to 31 March 2014

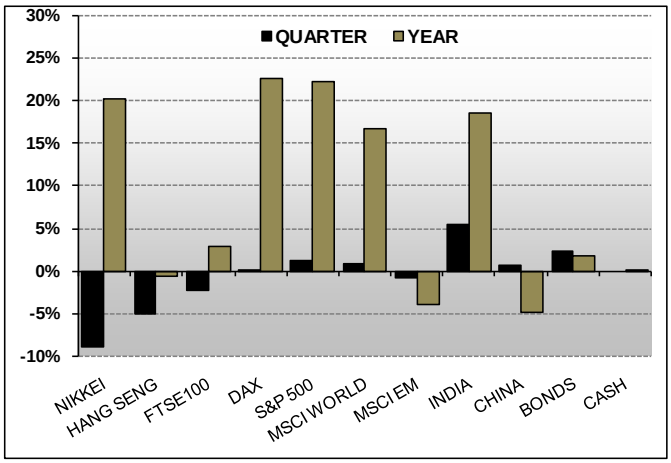
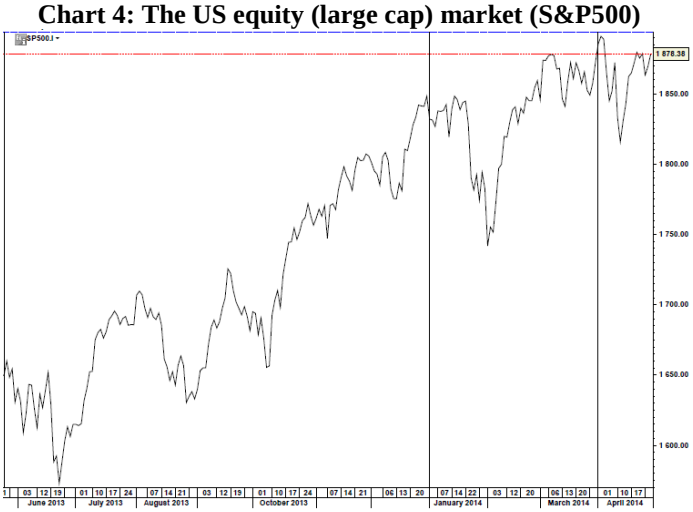


Table 1and Chart 3 depict the returns from major developed and emerging markets. The impressive returns from last year still stand out and speak of investor willingness to take on risk. During the quarter, the Japanese Nikkei, was the worst performer as it declined 9.0%. The Hang Seng was a close second with a fall of 5.0% and the UK declined 2.2%. The rest of the markets were either flat or rose marginally. The best performing market among those we track closely was the Indian BSE, which rose 5.5%.

Looking at the annual returns, developed markets continue to dominate the list of best performers. The German Dax has led the gainers, it is up 22.6% over the past year, which is in line with other European equity indices that have been strong over the past year. The Greek, Portuguese, Italian and Irish stock markets were up 14.9%, 14.9%, 14.4% and 10.7% respectively, during the quarter.

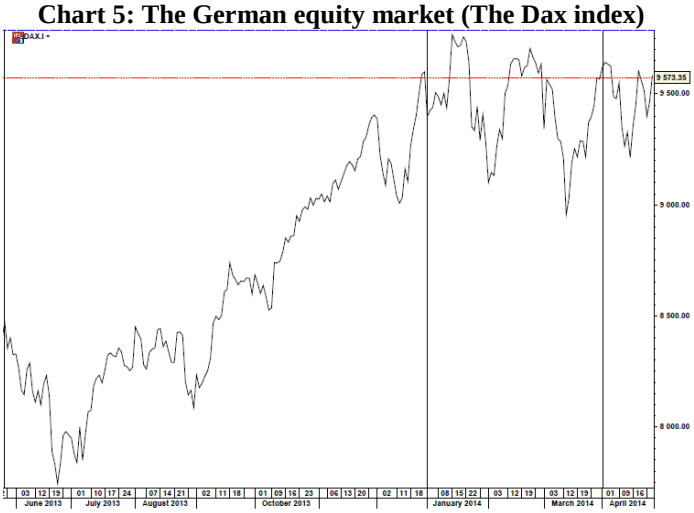
Chart 4: The US equity (large cap) market (S&P500)



Source: Saxo Bank

In the March quarter, the US equity market reached an all time high, as seen in Chart 4. Having reached that level, the market went sideways as news on the growing conflict in Russia concerned investors. When one looks at the longer term returns in the US, then one can clearly see that the market has been on a strong upward surge for over two years. Seeing charts such as the one above makes us cautious, as we know that markets do not go up in a 'straight line'. We would go as far as to say it is healthy for the market to correct every now and again as this makes investors more comfortable to enter the market. The German market (Chart 5) was flat for the quarter, but rose 22.6% for the year.

Chart 5: The German equity market (The Dax index)



Source: Saxo Bank

At this point we view developed markets as 'not expensive, but also not cheap'. This means that there are certain areas in that market where we believe there will be earnings growth to support the higher valuations, while there are sectors that are starting to look concerning. Having said that, even within specific sectors, there are shares that look expensive, but that we feel the valuation is justified. Technology shares for example have received a lot of publicity for their lofty valuations. Some of them are certainly overpriced, like social media stocks that have no earnings to report, but numbers of users. However, some tech shares have been generating earnings and good cash flow, which we believe is critical differentiator between the 'good and bad' tech shares.

Commodity markets

Having mostly declined during 2013, commodities were a mixed bag in the March quarter. Precious metals, which include gold, platinum, palladium and silver, had a strong quarter, where the outperformer was Palladium, rising 8.7%. Much of the strength in precious metals was because of concerns over the volatile political situation in Russia, and to a minor extent some rumours that the Chinese central bank was starting to increase its gold holdings. The on-going platinum miners' strike in South Africa, which is the largest producer of the metal, helped the metal's price rise to 4.5% during the quarter. One would have expected a much larger increase considering how long the strike has been going on for, but the amount of stock piles that the platinum miners have above ground has cushioned the metal's price.

The local economy…

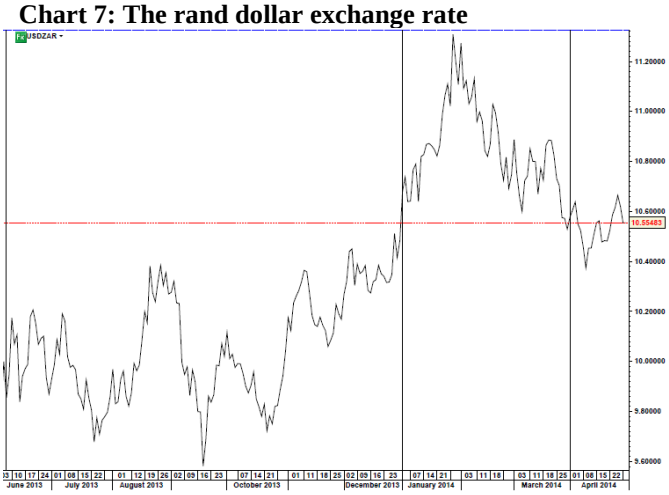
We have touched on a number of features such as commodity prices and the dollar, which have a material impact on the South African (SA) economy. One additional external factor that had a huge bearing on the SA economy during the quarter was the weakness in the Chinese economy. As a country that is largely reliant on exporting commodities, SA's success is inextricably linked to the health of the Chinese economy. Concerns about a slowing Chinese economy in the earlier part of the quarter had a negative impact on the outlook for the SA economy. As stated earlier, it is difficult to be precise about Chinese data at the best of times, so with the Lunar holiday interruptions, the market was overly concerned about the outlook for commodity exporters. We saw this play out by way of weaker commodity prices. Coal fell 14.2% during the month, iron ore fell 14.0% and copper 10.1%. To some extent the concerns on China were eased by the Q1 GDP reading of 7.4%, which though below the target of 7.5%, was enough to ease market concerns for a while. It remains to be seen what policy actions Chinese authorities will make, given that they would probably want their growth to quicken, but at the same time, it isn't weak enough to warrant material assistance from authorities.

Given the above, it will come as no surprise that the SA economy was fragile in the March quarter. In addition to challenging external factors, production at local mines was interrupted by either heavy rains or strike action. The ongoing strike on the platinum mines has received a lot of publicity, the sad reality is that everyone is currently losing; the producers have lost in excess of R14 billion in revenue, the miners have lost close to R6 billion in wages and the

government has lost several hundreds of millions from lost taxes – and these are only the direct loses.

As expected, the spending side of the economy has started to feel the strain, which is compounded by the decline in lending by institutions. Retail and vehicle sales have both slowed, with some sectors of the retail market holding up better than others. Over the next few months, economists continue to forecast a weakening economy, with the consumer under more pressure as inflation continues to creep up, having just reached the 6% level, the upper band of the SA Reserve Bank (SARB). With inflation rising and the rand vulnerable, we are likely to see more interest rate hikes in this year - economists seem to think two more 50bps this year are on the horizon. Given all of the above, we are of the view that the official estimates for growth this year are too high and we note that the SA Reserve Bank (SARB) decreased its growth rate forecast after its recent meeting. We are of the humble view that the SA economy will do well to grow at 2.5% this year, barring any further external shocks.

Chart 7: The rand dollar exchange rate

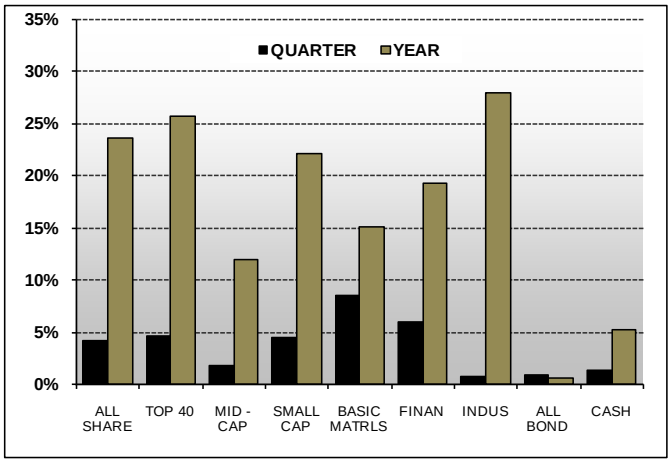


Source: Saxo Bank

<u>… and the local investment markets</u>

Despite the slowing economy, the SA equity market still managed to post respectable returns in the March quarter. Unlike last year, where returns were boosted by the industrial and financial index, the March quarter saw a reversal of this trend, where resources lifted the market. The 8.6% gain in the resource index was ahead of the 6.1% gain in financials and 0.8% gain in industrials. A lot of the gains in the resources should be attributed to the gold index, which rose a remarkable 42.6% in the March quarter after tumbling 54.6% in 2013. As you are probably aware, Maestro has never invested in gold shares, and one of the reasons for this stance is the extent that gold miners are leveraged to the gold price. We regard this as a major risk to investing in South African gold miners. Perversely, this leverage to the gold price is actually the reason why gold miners performed as well as they did in the March quarter. Having cut costs over the past few years in a bid to operate profitably at lower dollar gold prices, the spike in the gold price and the weakness in the rand during the earlier part of the quarter had a massive impact on gold shares. The overly negative pessimism during the course of last year aided the bounce seen during the quarter. It is worth highlighting that despite the huge share gains, we remain unconvinced on the merits of investing in SA gold mines. We are loathed to invest clients' assets in a sector whose fortunes are beyond anyone's control, where factors like the rand exchange rate, the gold price, labour environment and political and regulatory interference are the determinants of one's returns. We favour industrial and financial shares that are less risky and over time, have performed well ahead of resources.

Chart 8: Local returns to 31 March 2014



What makes the returns from the industrial sector so remarkable is that the outperformance over the last year was not a one-year wonder. No; the annual returns for 2009 through to 2012 were 31.0%, 27.4%, 9.2% and 40.8% respectively, showing just how strong industrial shares have been over the years, and at the same time vindicating our long-held preference for them. Also interesting to point out, was the strong showing of the small cap index's annual return, which rose 22.1%, following annual returns of 28.3%, 24.7%, 1.1% and 29.0% between 2009 and 2012. The phenomenon of small caps outperforming large caps is consistent with a similar trend in developed markets, and highlights investor appetite for additional risk in equity markets over the years. Risk, that is, with the expectation of reasonable visibility of returns and the factors influencing them.

Turning to the local bond market, you should not be surprised at the poor returns from this sector, given the deterioration in the rand. The primary local beneficiaries of the Fed's QE policy have been the currency and bond market, which is why the tapering process continues to have negative impact of the bond market. The All bond index rose only 0.9% for the quarter and 0.6% for the year, behind cash which had an annual return of 5.3%.

In closing

At the end of a very profitable 2013, we sensed that markets had taken some of this year's returns into last year and that has since proved to be the case. This view is further evidenced by the number of sectors that performed well in 2013, yet have struggled to keep their momentum into 2014, and in some cases, have sold off meaningfully. Much of the gains in equity markets during 2013 came about as a result of a re-rating in various markets. We believe that for this rating to be maintained, or expanded, we will have to see better earnings growth coming through from equities. Considering the pickup that is expected in the global economy in 2014, we believe that we will see some reasonable earnings growth this year, albeit in certain sectors of the market. The move to 'normal' economic policy in developed economies remains a key risk this year, as investors wean themselves from the cheap money that they have become used to over the past few years.

As far as South Africa is concerned, there are a few challenges that the country has to navigate over the next few months. There is the upcoming election, rising inflation, higher interest rates and the Fed's continued tapering. Similar to other Fragile Five peer currencies, the outlook for the rand remains uncertain and we are likely to see renewed pressure on the currency as the economy slows and the Fed continues to decrease their asset purchases. The risk aversion towards emerging markets is likely to continue, although there have been signs that global investors are willing to differentiate between emerging economies that have better fundamentals than the rest.

Despite our cautious tone above, it is worth remembering that the world economy and South Africa in particular, have successfully negotiated their way out of worse crises in the past. We remain convinced that the best way to approach markets and specific companies that we look to invest in, is by looking for good management who create value for shareholders, reasonable earnings growth and good cash generation, which overtime results in higher share prices.

The Maestro Investment Team
30 April 2014