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 2.08%.

Income Distribution (annually)
17.76 cents per unit
31 March 2013

FUND SIZE: R 101 306 744

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

The Maestro Equity Prescient Fund

Quarterly report for the period ended

30 June 2013

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 –June 2013 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 15.9% of the Fund, down from 18.1% in March. Financial exposure declined 2.9% to 10.4% and industrial exposure rose 5.2% to 66.0. Cash represented 7.7% of the Fund, down from the 7.7% at the end of March.

Chart 1: Asset allocation at 30 June 2013

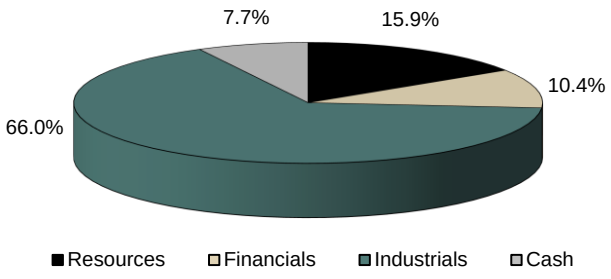
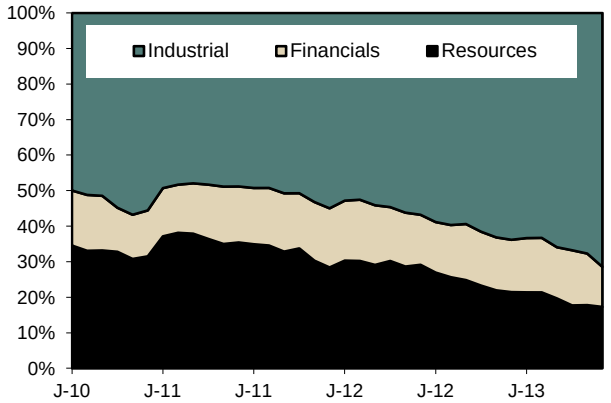


Chart 2 depicts the historical allocation to the three major sectors of the equity market, expressed as a percentage of the equity portion of the Fund.

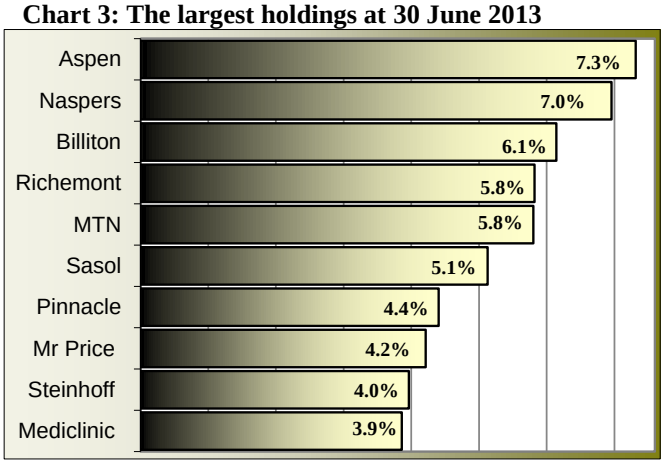
Chart 2: Sector exposure at 30 June 2013



3. The largest equity holdings

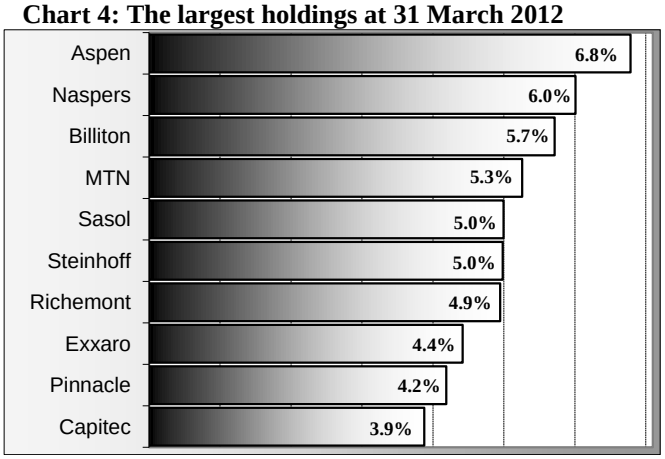
The largest holdings at 30 June are listed in Chart 3, expressed as a percentage of the equity portfolio.

Chart 3: The largest holdings at 30 June 2013



The largest holdings at the end of March are listed in Chart 4. During the quarter Mediclinic and Mr Price replaced Capitec and Exxaro in the top 10 holdings of the Fund. At the end of June there were 32 counters in the Fund, one less than at the end of March. The ten largest holdings constituted 53.6% of the Fund up from 51.2% in March.

Chart 4: The largest holdings at 31 March 2012



4. Recent activity on the Fund

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

There was a fair amount of activity within the Fund during the quarter as some of the new holdings added to the Fund during the first quarter were built on and other smaller holdings were reduced.

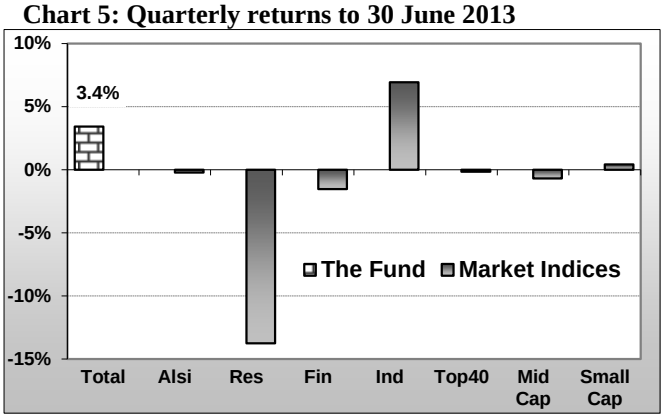
The Fund added to its newer holdings in the form of Standard Bank, SABMiller and Shoprite. The Fund also increased its holding in the niche logistic provider, One Logix. Two of the Funds core holdings, Mr Price and Billiton were also increased.

The Fund sold out entirely of its small Anglos holding as preference has remained for the more conservative diversified miner, Billiton. Over the quarter the Fund has been reducing its small holdings in B&W Instrumentation and Metmar as prospects for both of these companies continue to remain tough and a catalyst for a turnaround is elusive. The Fund also reduced its exposure to the unsecured lending market by lightening its holdings in Abil and Capitec. There were small sales of Coronation and Steinhoff during the quarter as well.

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 June quarter was 3.4%***.

Chart 5: Quarterly returns to 30 June 2013



The Fund's return can be compared to the All share index return of -0.2%. We commented extensively in recent letters and *Intermezzo* about the state of the markets during the past few months and refer you to those publications to refresh your memory about the salient features of this period; you can find back copies of *Intermezzo* by clicking here. I also encourage you to read the commentary on the market movements during the quarter in the document entitled *Market commentary –June 2013.*

The June quarter was similar to the March one, in that the basic materials sector was very weak and the financial and industrial indices stronger. For the second quarter in a row basic material shares led the market lower. Having declined 7.3% in the March quarter, they declined by an even greater margin, 13.4%, during the June quarter, bringing their year-to-date decline to 20.1%. In contrast, the financial index declined only 1.6% during the June quarter bringing its year-to-date

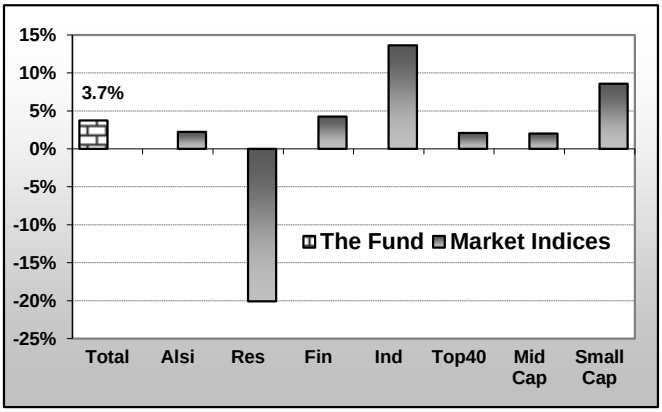
return to 4.3%. The industrial index continued its strong performance, rising 6.9% in the June quarter (it rose 6.3% during the March quarter), bringing its year-to-date return to 13.7%.

What is not evident from Chart 5 is the performance of companies based on their size. Small cap companies comfortably outperformed large and mid-cap companies; the mid cap index declined 0.7% during the quarter and the small cap index rose 0.4%. So not only were the returns from the mid and small cap companies more profitable, they were significantly less volatile.

Turning to the returns of the Fund, you may recall that it had a disappointing quarter in March. There were two main reasons for this; firstly the Fund had a relatively large weighting (relative to the All share index that is) in retail companies, which were severely sold down after their scintillating 2012 returns. Secondly due to the fact that the Fund never held companies like BAT and Old Mutual, large cap rand hedge companies which performed very well on the back of the collapsing rand, the Fund struggled to keep up the with All share index.

All of that changed during the June quarter. You would have seen the activity on the Fund during the quarter already. Despite their significant underperformance in recent quarters, we took the view that the basic material sector was still vulnerable to declines, partly due to a deteriorating global economic outlook and partly due to the mayhem in the SA mining industry. Our continued underweight position in this sector proved decisive in providing for a material outperformance of the market by the Fund – refer again to Chart 5 for the quarterly returns relative to those of the market and major indices. Not only did the Fund outperform the market during the quarter, it made up for the lost ground in the first quarter, as the year-to-date returns in Chart 6 show. Note from this chart just how large the difference is between the year-to-date returns from the basic material and industrial indices.

Chart 6: Year-to-date returns to 30 June 2013



I refer you to the *Market Commentary – June 2013* document again. In it we have devoted a large section to analysing the remarkable quarter and year-to-date behaviour of the SA equity market. We are living in remarkable times, indeed – you will appreciate just how remarkable when you consider these returns in more detail, as set out in the *Market Commentary*.

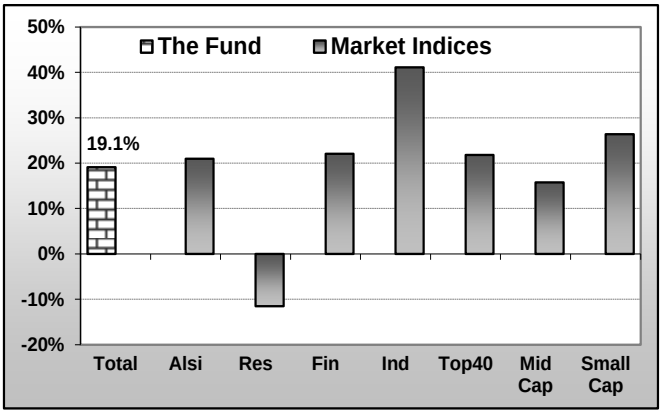
Let us look at specific June quarterly returns of some of the Fund's investments. The quarterly returns, excluding dividends, of the largest holdings in the portfolio were as follows: Aspen rose 18.9% (it rose 13.0% in the March quarter), Naspers 27.4% (5.5%), Billiton -5.8% (-4.7%), Richemont 21.5% (9.0%), MTN 13.9% (-9.1%), Sasol -4.7% (6.1%), Pinnacle 8.6% (19.8%), Mr Price 15.1% (16.4%), Steinhoff -2.0% (-8.8%) and Mediclinic 6.9% (17.0%).

Having considered the returns of the companies into which the bulk of the Fund's capital is deployed you might be interested in other quarterly returns. Anglo, which we have never liked (we have always favoured Billiton over it), declined 19.8% during the quarter (Billiton fell 5.8%). We sold the platinum exposure early last year already but for the record Amplats and Implats declined 22.8% and 31.4% respectively during the quarter. You would also be aware that we have never held a gold share in the Fund; that stood the Fund in good stead when you consider the quarterly returns of Anglogold were -34.9% and of Harmony -39.5% (and these are the better performing gold mines!) Their respective annual declines to June are 49.8% and 53.3%.

We did hold Abil though, and it declined 46.1% in the quarter after the release of awful results and a cutting of their high dividend. We are in the process of selling the entire holding. Capitec declined 9.9% in sympathy and Prescient 8.7%. On a more positive note, other holdings in the Fund also did well despite the negative return from the All share index; Coronation rose 30.7% during the quarter and EOH 6.7%.

The annual returns to June are shown in Chart 7. ***The annual return of the total Fund for the year to June was 19.1%*** versus the All share index returns of 21.0%. Inflation rose 5.6% over the year and the All bond index rose 6.3%. The dramatic underperformance of the basic materials sector relative to the industrial and financial sectors is again a feature of these returns – refer to the chart to see how dramatic it was. The underweight position of the resource sector, relative to the All share index, assisted the portfolio's returns over the past year. Not shown in the chart are the annual returns of large, mid and small cap index, which rose 21.8%, 15.8% and 24.6% respectively.

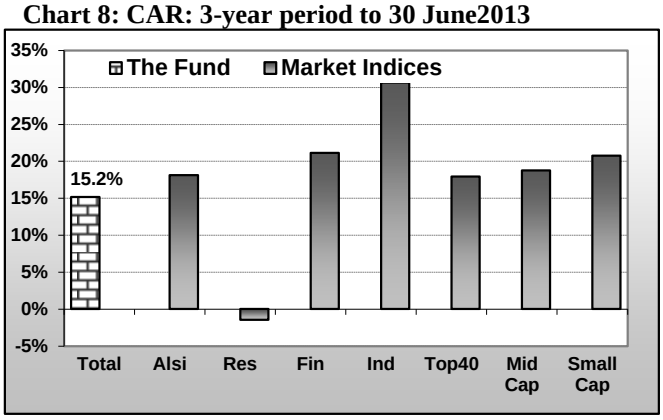
Chart 7: Annual returns to 30 June 2013



I have already drawn your attention to some of the remarkable returns, mainly negative ones, from certain shares in the SA equity market during the past year. If I may generalize for a moment, the Fund's holdings have had mixed fortunes but have mostly delivered positive returns. Amongst those which didn't, Abil declined 55.1%, B&W 46.2% and Hudaco 20.6%. All of these investments have company-specific issues which account for their declines, but we are still very disappointed by their performance. Amongst the resource shares in our portfolios Metmar declined 56.7% in the year to June, Exxaro 23.4% and Kumba 16.4% - the basic materials sector declined 11.5% during this period. With the All share index rising 21.0% in the year to June, companies in the Fund which exceeded our expectations as far as returns are concerned included MTN, which rose 30.6%, Blue Label Technologies 31.1%, Pinnacle 51.0%, Grindrod 55.6%, Naspers 67.8%, Richemont 96.3%, Aspen 80.4% and Coronation 126.8%. This list confirms that despite all the "doom and gloom" we have to wade through daily in the media, and despite the doomsday prophets that write South Africa off at every opportunity, the SA equity market still holds numerous and wonderful opportunities for investors, provided their assets are carefully nurtured and cautiously managed by investment professionals. While it is becoming increasingly difficult to find them and the investment landscape is growing increasingly dark, we remain convinced that there are opportunities out there for us to seek and we are fully committed to doing so.

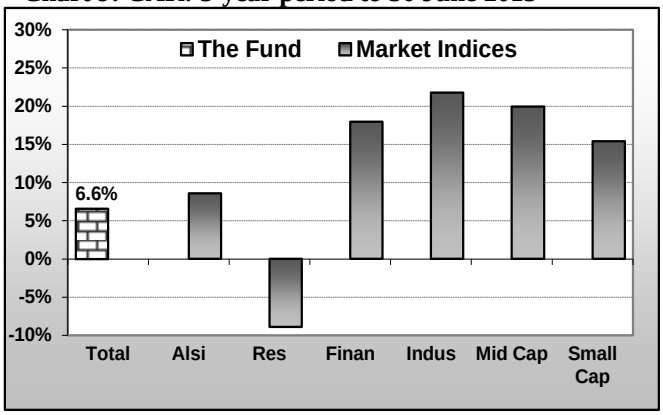
The compound annual return (CAR) of the Fund, shown in Chart 8, ***over the three-year period to June 2013 was 15.2%*** which can be compared to the All Share Index return over the same period of 18.1%. It is clear from the Chart which sectors drove the market higher over the past three years and it is quite remarkable that the basic material sector actually registered a negative return of 1.5% *per annum* over this period. Across the market cap spectrum, it will come as no surprise that the large cap index lagged the mid and small cap indices with returns of 17.9%, 18.8% and 20.8% respectively. The respective CARs for the All Bond index and cash over this period were 10.7% and 5.7%.

Chart 8: CAR: 3-year period to 30 June2013



The CAR of the total Fund return over the five-year period to June 2013, shown in Chart 9, ***was 6.6% per annum*** which can be compared to the All share index return of 8.6%. At the risk of stating the obvious – remember the base off which these returns are being measured is end-June 2008 i.e. in the depths of the financial crisis - I again point out how the industrial index has outperformed all other sectors. The industrials index's compound *annual* return over the five-year period was 21.7% while financials and resources returned 18.0% and -8.9% respectively over the same period. The 5-year CARs for the large, mid and small cap indices are 7.0%, 19.9% and 15.4% respectively. The respective CARs for the All Bond index and cash were 12.2% and 7.1% over this period.

Chart 9: CAR: 5-year period to 30 June 2013



What is not evident from the previous graphs is a trend we have brought to your attention previously, namely the outperformance of the SA equity market relative to developed markets. Whereas the All share index rose 8.6% *per annum* over the past five years, the MSCI World index rose only 5.3% in rand terms (0.4% in dollar terms) per annum. When you consider how low global equity returns have been for a number of years now, you realise that the SA equity market has been a

very profitable investment destination relative to the rest of the world.

Chart 10: CAR: 7-year period to 30 June 2013

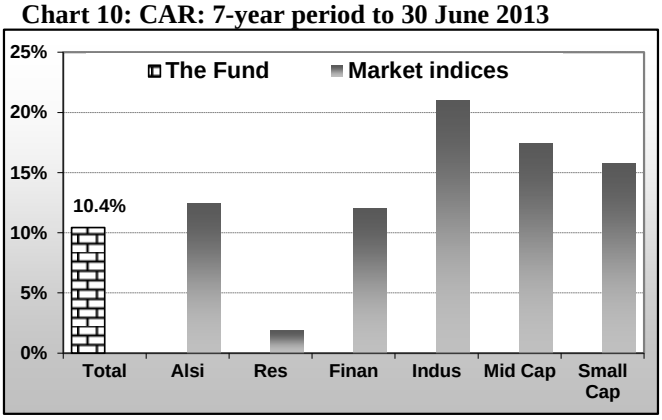


Chart 10 lists the returns over a seven-year period. ***The CAR of the Fund over the seven-year period to June was 10.4%*** versus the return over the same period of the All Share Index of 12.5%. The outperformance of the industrial sector is again evident and I point out that we measured returns over a seven-year period here i.e. the outperformance by industrial shares is not an overnight wonder; it is a well-established trend that has been in place for more than a decade now and it is this fact that underlines the key component of our investment philosophy, namely a bias in favour of industrial shares. The same could be said for mid and small cap companies. Of course I am dwelling on returns only here; I am not presenting any data on risk i.e. the volatility or variability of returns. But you can take my word that the risk underlying the returns from both the industrial, mid and small cap indices on the one hand, and Maestro equity portfolios on the other, has all been lower than that which prevailed in the equity market in this period.

In order to place these long-term returns in perspective, as well as those of the SA equity market, consider the CARs of other markets over the past seven years to June: the MSCI World index, which incorporates developed equity markets, rose 6.1% in rand terms and only 1.2% *per annum* in dollar terms. Over the past year developed equity markets have outperformed emerging markets dramatically, so this underperformance by them over a number of years is going to come to an end. But for now SA equity investors have still been better off investing in their local market.

6. Closing remarks

"*From the specific remarks relating to the returns during the March quarter, you will see that our returns have been below-market. Clearly we are not happy about this and are working hard to rectify it. However, as you are aware, there are times when shares and indeed portfolios pause for a breather, which is all part and parcel of equity investing. While the portfolio "pauses" we work hard to isolate the reasons for the pause, see if any remedial action is required, and then act accordingly.*" These were the words with which we began this section in the March quarterly report. I am pleased to say that we have delivered on our undertaking but we will not rest on our laurels. The investment environment is growing less certain as we head into the second half of the year. While many developed markets are at all-time record levels, we do not for one minute take that as a sign that all is well. On the contrary, we are now more vigilant than ever. Our experience has taught us that when everything seems to be going well (I am thinking more of the global environment here than the SA economy and political landscape) that is exactly when we need to be more cautious and alert than ever.

We think the US economy will slow and there is a real risk that the Chinese economy will not grow as strongly as many think. So the chances that there will be some disappointments during the second half of this year are quite good. With developed equity markets priced to perfection there is more than sufficient chance of a nasty surprise along the way. We are mindful of this and while we cannot prevent or avoid it, we will fashion the portfolio accordingly, CGT permitting of course.

Although it may be less relevant to individual investors than to retirement funds, it is worth placing our view on record here as far as the bond market is concerned. We are of the view that we have seen the best returns from the bond market for many years to come. The US Federal Reserve has signalled the end of "easy and plentiful money" and the 30-year bull market in US bonds is now past. Buying into the prevailing low yields of developed bond markets (at the time of writing US and German 10-year yields are at 2.5% and 1.5% respectively) makes no sense whatsoever. Owning low yielding bonds now that the Fed has signalled the end of quantitative easing is a losing proposition. This was even more relevant during the first half of the year, but yields are still low and decidedly unattractive. We will therefore avoid bond markets, especially sovereign ones, for the foreseeable future.

All that remains is for me to thank you, on behalf of the whole Maestro team, for your ongoing support and the confidence you have displayed in our abilities. We are very grateful for it and do not take it for granted. As usual, we are here to serve and be of assistance to you, so please do not hesitate to call on me if ever you wish to discuss anything about your portfolio in particular or your financial affairs in general.

Luke Sparks
On behalf of the Maestro team
25 July 2013

Collective Investment Schemes in Securities (CIS) should be considered as medium to long-term investments. The value may go up as well as down and past performance is not necessarily a guide to future performance. CIS are traded at the ruling price and can engage scrip lending and borrowing up to 10% of the market value of the portfolio to bridge insufficient liquidity. A schedule of fees, charges and maximum commissions is available on request. Commission and incentives may be paid and if so, would be included in the overall costs. Different classes of units may apply in a portfolio and are subject to different fees and charges. A fund of funds is a portfolio that invests in portfolios of collective investment schemes, which levy their own charges, which could result in a higher fee structure for these portfolios. A Feeder Fund is a portfolio that, apart from assets in liquid form, consists solely of participatory interests in a single portfolio of a collective investment scheme. Forward pricing is used. Fluctuations or movements in exchange rates may cause the value of any underlying international investments to go up and down. CIS prices are calculated on a net asset basis, which is the total value of all the assets in the portfolio including any income accruals and less any permissible deductions (Brokerage, STT, VAT, Auditor's fees, Bank Charges, Trustee and Custodian fees and the annual Management fee) from the portfolio divided by the number of participatory interests (units) in issue. The Fund's Total Expense Ratio (TER) reflects the percentage of the average Net Asset Value of the portfolio that was incurred as charges, levies and fees related to the management of the portfolio. A higher TER does not necessarily imply a poor return, nor does a low TER imply a good return. The current TER cannot be regarded as an indication of future TER's. During the phase in period TER's do not include information gathered over a full year. Maestro is a member of the Association of Savings and Investments.

MAESTRO

Market commentary – the first semester of 2013

Introduction

It is hard to believe that when we penned the last Market Commentary in January this year, we were breathing a sigh of relief that the "fiscal cliff" had been avoided – albeit narrowly. We had been granted a reprieve - at least for a few months. So much water has passed under the bridge since then that it feels as though we have been living in another world for some time already. Be that as it may, this Commentary will summarise the major features of the first half of 2013. It has been an eventful time, with sufficient positive and negative surprises to keep everyone busy. It has also been a relatively profitable period – at least for some investors, and I am happy to say for Maestro clients, too.

Table 1: Selected returns – equity markets

	Mar quarter (%)	Jun quarter (%)	Annual returns to Jun (%)	2012 returns (%)
Japan	18.7	10.9	51.9	22.9
Hong Kong	-1.6	-6.7	7.0	22.9
Germany	2.4	2.1	24.1	29.1
UK	8.7	-3.1	11.6	5.8
US (S&P500) and large cap	10.7	3.0	20.9	16.3
S&P Mid cap	13.1	0.6	23.3	16.1
S&P Small cap	13.7	3.6	23.6	12.6
MSCI World index	***7.2***	***-0.1***	***16.0***	***11.4***
Brazil	-7.6	-15.8	-12.7	7.4
Russia	-4.7	-12.3	-5.6	10.5
India	-3.0	3.0	11.3	25.7
China	0.1	-11.5	-11.1	1.5
MSCI Emerging market index	***-1.9***	***-9.1***	***0.3***	***15.2***
JSE All share	***2.5***	***-0.2***	***21.0***	***26.7***
JSE All share ($)	***-5.2***	***-7.8***	***-0.3***	***20.6***
Basic materials	-7.3	-13.8	-11.5	5.4
Financial	5.9	-1.6	22.1	38.1
Industrial	6.3	6.9	41.1	40.8
Gold mining	-17.9	-33.5	-46.5	-18.5
Large cap (Top40)	2.3	-0.2	21.8	26.1
Mid cap index	2.7	-0.7	15.8	29.6
Small cap index	8.1	0.4	24.6	29.0

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

Global investment markets

There is such a vast quantity of developments to consider; it is impossible to do justice to it all in one report. I will therefore confine myself to a few of the main events during the period, which can be summarized as follows:

Table 2: Selected returns – bonds, commodities, currencies

	Mar Quarter (%)	Jun Quarter (%)	Annual returns to Jun (%)	2012 returns (%)
SA All Bond index	0.9	-2.3	6.3	16.0
SA Cash	1.3	1.3	5.3	5.6
Barcap Global Agg. Bond index	-2.0	-2.9	-2.2	2.1
Emerging market bonds	-2.2	-4.4	2.9	15.8
US 10-year bond	-0.3	-4.6	-4.2	-0.4
US Corporate bond	0.1	-3.4	1.8	10.3
US High yield bond	2.9	-1.4	9.6	15.6
Cash (US dollar)	0.0	0.0	0.1	0.1
DJCS Hedge index	2.3	-0.2	8.9	5.9
Brent (Oil)	-1.0	-7.1	4.5	3.5
Gold	-4.0	-25.4	-25.4	5.7
Silver	-4.4	-34.2	-30.4	6.3
Platinum	3.2	-16.4	-7.8	12.8
Palladium	9.4	-16.5	9.5	11.8
Copper	-4.0	-11.0	-10.7	4.8
Nickel	-2.7	-17.9	-16.7	-6.0
Baltic Dry index	30.2	28.7	16.6	-59.8
CRB Commodity index	0.5	-7.0	-3.0	-3.4
S&P GS Commodity index	2.1	-6.4	8.5	-0.2
Euro dollar	-2.6	1.2	2.4	1.6
Sterling dollar	-6.6	-0.1	-3.3	4.6
Swiss franc dollar	3.5	-0.1	-0.0	-2.1
Rand dollar	-7.5	-7.6	-17.6	-4.8

- **The global economy has continued to grow**, albeit at a slower rate than in the past.
- Apart from a few major setbacks during the first half of 2013 **developed equity markets have risen solidly** throughout the period.
- One of the most noticeable developments during the past six months has been the large difference between the returns of developed markets on the one hand and emerging markets on the other. This extends across all asset classes i.e. **emerging equity, currency and bond markets have all significantly under-performed their developed counterparts**.
- The **dollar firmed against most other currencies**, especially during the second quarter and against emerging currencies.
- **This placed commodity prices under pressure**, with the exception of the oil price.
- But the event by which the June quarter will be remembered is the announcement that the US Federal Reserve **(the Fed) has begun to plan for a reduction in its stimulatory monetary policy, otherwise known as Quantitative Easing (QE)** that it has deployed since the Great Financial Crisis of 2008/9.

Continued global economic growth

At times it is hard to believe, given the policy uncertainty and the negative news flow from regions like Europe and certain emerging markets (Brazil for example), but the global economy has continued to grow at a reasonable pace, at least relative to its historical trend. Most forecasts indicate that the global economy will grow between 3.0% and 3.5% this year and the next, the main impetus of growth emanating from Asia, China and India. We expect the US economy to grow between 1.5% and 2.0% in 2013, although the risk is that this growth could slow. Inflation remains virtually non-existent in developed countries, which removes at least one economic threat.

Table 3: Expected growth and inflation rates (%)

	Real GDP growth			Inflation		
	2012	*F2013*	*F2014*	*2012*	*F2013*	*F2014*
Global	3.1	3.0	3.7	3.1	2.9	3.3
Euro area	-0.5	-0.6	0.5	2.5	1.4	1.3
G7	1.4	1.3	2.2	1.9	1.5	2.1
Emerging EMEA*	2.9	2.3	3.1	4.7	4.5	4.6
Emerging Asia	6.2	6.3	6.7	3.7	3.4	4.1
Latin America	2.9	2.7	3.6	6.1	7.2	7.2
US	2.2	1.7	2.7	2.1	1.6	1.6
Germany	0.7	0.1	1.5	2.1	1.7	1.8
UK	0.3	1.1	2.1	2.8	2.7	2.3
China	7.8	7.6	7.6	2.6	2.5	3.5
India	5.1	5.5	6.5	7.5	5.4	5.7
Brazil	0.9	2.4	3.1	5.4	6.4	5.6

Source: Merrill Lynch, Deutsche Bank
* Emerging Europe, Middle East and Africa

Equity markets scale new heights…

Table 1 contains the return data on various equity markets. Space precludes the listing of the year-to-date returns but they have been impressive despite hiccups in May and June. The year-to-date (to end-June that is) returns for the MSCI World index are 7.1%. The US equity market rose 14.0%, Germany 4.6% and Japan 31.6%. By any measure these are impressive returns and should be seen in the context of an already high base – refer to the last column in Table 1, which depicts the 2012 returns.

Chart 1: Global returns to 31 March 2013

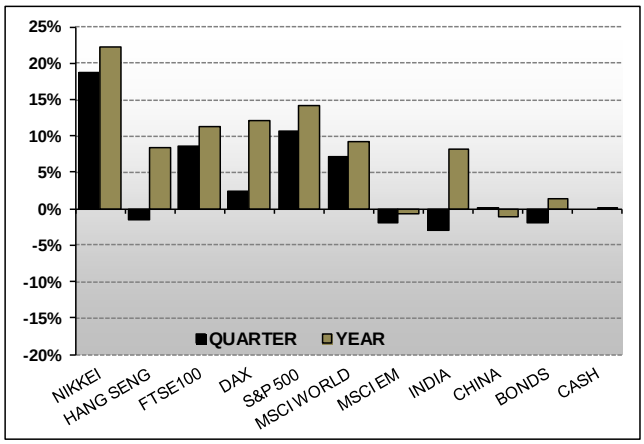
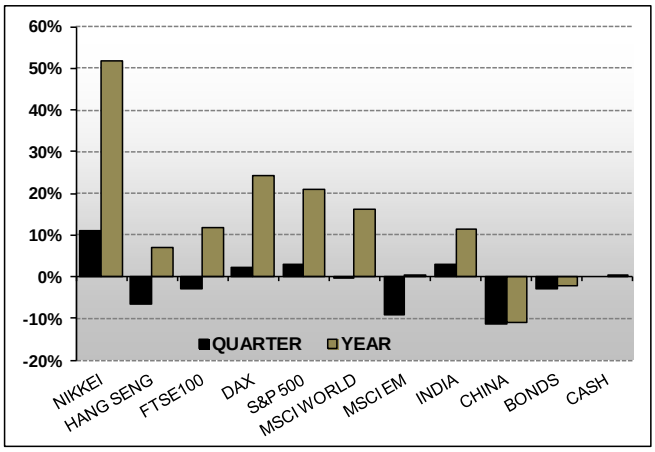


Chart 1 summarises the quarterly and annual returns of the major global equity, bond and cash markets for the March quarter, while Chart 2 depicts the returns for the June quarter.

Chart 2: Global returns to 30 June 2013



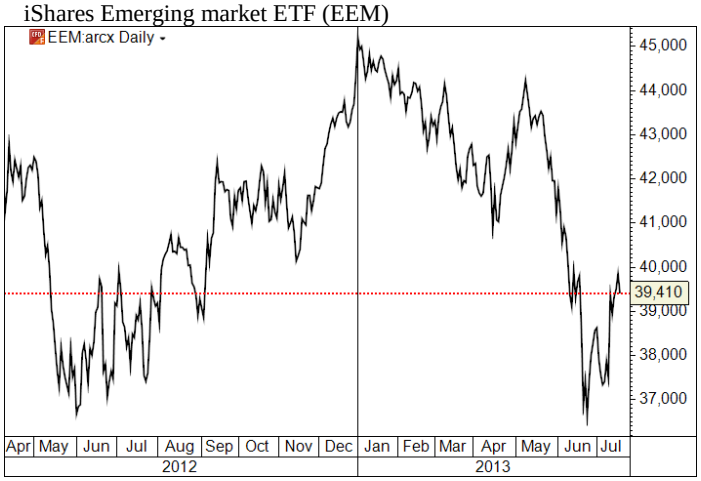
Note from both charts the extent to which developed equity markets have outperformed emerging markets. A feature of this year so far has been the dramatic turnaround in emerging markets' fortunes. Many of last years' "heroes" such as India and Russia have suffered ignominious reversals in fortune as their economies slowed down, often in the face of significant inflationary or current account pressures, and their markets declined sharply. Most emerging markets, with the exception of a few Asian ones, now seem a distant reflection of what they used to be less than two years ago. It is sad to see how many governments in emerging countries failed to capitalize on their good fortunes immediately after the 2009 market and crisis trough. That would have been the time to bring about sustainable economic improvements through appropriate policy implementation, but they failed to do so. It could be a very long time before they receive another opportunity such as that which prevailed during the past five years. Emerging economies and markets, and indeed all the citizens of these economies, are now paying the price for this lost opportunity. Let us now consider selected returns from emerging markets.

… But that doesn't extend to emerging markets

Whereas the MSCI World index rose 7.1% during the first half of the year, the MSCI Emerging market index *declined* 10.9%. Chart 3 depicts emerging markets' fortunes using the iShares emerging market exchange traded fund (ETF) as a proxy. After reaching a peak on the last day of 2012 emerging markets suffered a big decline - 17.2% to be exact - between early May and 19 June, the date of the Fed's announcement about plans to end QE. Investors fear that emerging markets, which were the destination for a large part of the liquidity fuelled by the Fed and other central bankers' largesse, would experience large withdrawals of foreign capital, to the detriment of those countries economic well-being. Countries with large current account deficits are particularly vulnerable and their markets and currencies were adversely affected. Similarly, countries dependent on commodity exports for a

large part of their funding are also vulnerable. Sadly, South Africa fits neatly into all three categories, which explains some of the weakness in the rand and basic materials sector – but more about that later.

Chart 3: Emerging equity markets take a tumble
iShares Emerging market ETF (EEM)



Source: Saxo Bank

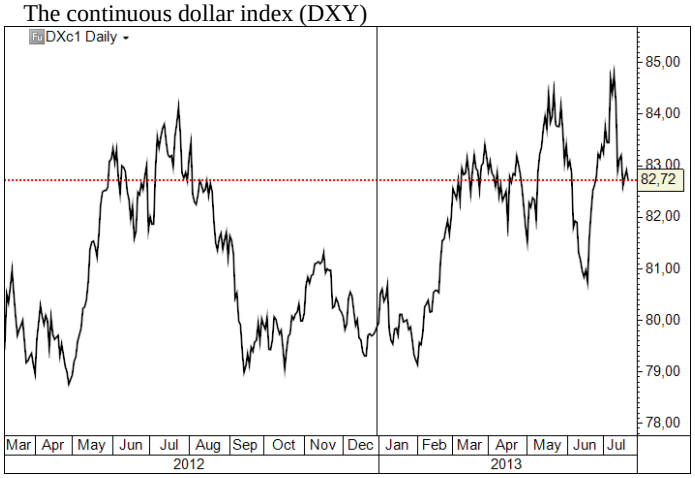
The respective March and June quarterly returns are listed in Table 1. It is worth highlighting that during the first half of this year, the Brazilian, Russian, Indian and Chinese equity markets *declined* 22.1%, 16.5%, 0.2% and 11.4% respectively. The losses were not confined to equity markets though. Emerging market currencies and bond markets were also adversely affected.

A resurgent US dollar

At the time of writing the Indian rupee is at an all-time low against the dollar. Many emerging market governments are hastily unwinding measures put in place only three or four years ago to stop the huge inflow of foreign capital into their countries. How the times have changed – and in such a short space of time! Even some "respectable" currencies have suffered – the Australian dollar has declined 11.8% against the US dollar so far this year, all of that coming in May and June. It puts the rand's 10.7% decline in May into perspective. In fact, although you might find it hard to believe, the rand has performed relatively well in recent months when compared to other emerging market currencies; it has declined 14.5% so far this year, with the bulk of the decline occurring in January and May.

The short-term movements of different currencies hides the fact that the US dollar has slowly but surely been rising against all other currencies. The dollar index, or "DXY" as we call it in the profession, allows us to measure the dollar against a basket of currencies; its recent history is plotted in Chart 4, from which it can be seen that the dollar has been firm for some time, albeit with a lot of volatility. Indeed, currency volatility has increased dramatically this year as investors position themselves ahead of the expected US economic recovery and, of course, a tapering of QE. Note how sharply the dollar (DXY) declined ahead of the Fed meeting on 19 June, when it announced its QE plans, and how dramatically it rose thereafter (although it has subsequently retreated a bit). So for the record, the dollar maintained its recent strength in the past few months, rising 1.4%, 7.2% and 14.9% against the euro, sterling and yen respectively in the first half of the year.

Chart 4: The US dollar – from strength to strength
The continuous dollar index (DXY)



Source: Saxo Bank

With concerns about the rate of global growth, particularly in China, and a strong dollar, commodity prices were always going to find the going tough. They declined across the board – refer again to Chart 2 for the actual returns – with gold leading the decline; refer to Chart 5 for the recent gold price behaviour. Rising US interest rates increase the opportunity cost of holding gold, remembering that gold produces no income but has costs associated with holding it. We will review the effect of the declining gold price on SA gold mine share prices in a later section of this report. Precious metals i.e. gold, silver, platinum and palladium, *declined* 28.4%, 37.0%, 13.8% and 8.7% respectively during the first half of the year. Base metals didn't fare much better; the price of copper, nickel and iron ore declined 14.6 %, 20.1%, 14.3% and 17.0% respectively while coal prices are down 17.7% over the same period. It is no wonder the returns from commodity shares have been so poor this year! Bear these price declines in mind when we consider the returns of the SA equity market in a short while. A noteworthy feature of the commodity complex over the period has been the oil price, which has clung resolutely to its levels above $100; the (Brent) oil price declined only 8.1% in the first semester, 7.0% of that occurring in April. Soft (food) commodities were less weak but they are influenced primarily by climatic and supply conditions rather than global economic growth.

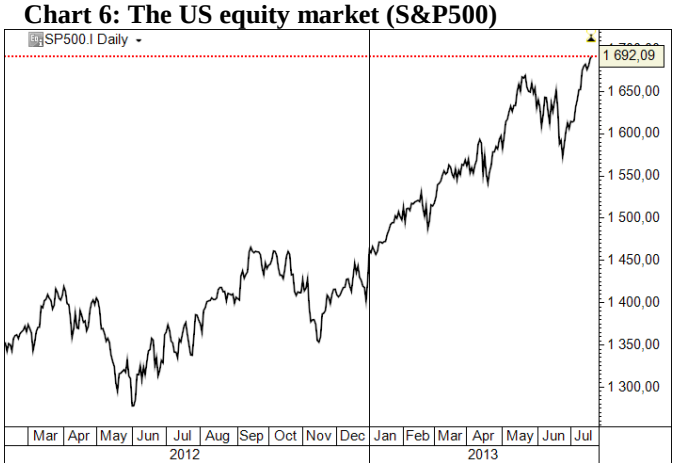
Chart 5: The gold price – not quite what it used to be

Source: Saxo Bank

The 30-year bull market in bonds comes to an end

We have already alluded to the over-riding feature of the June quarter, namely the announcement by the Fed of a provisional timetable for a reduction in its QE program. Market reaction across the world was swift and decisive – global equity and bond markets declined sharply, although most developed equity markets have since risen to post new peaks or have at least resumed their uptrend. Chart 6 depicts the US equity market which, at the time of writing, is at an all-time high. Chart 7 depicts the German equity market.

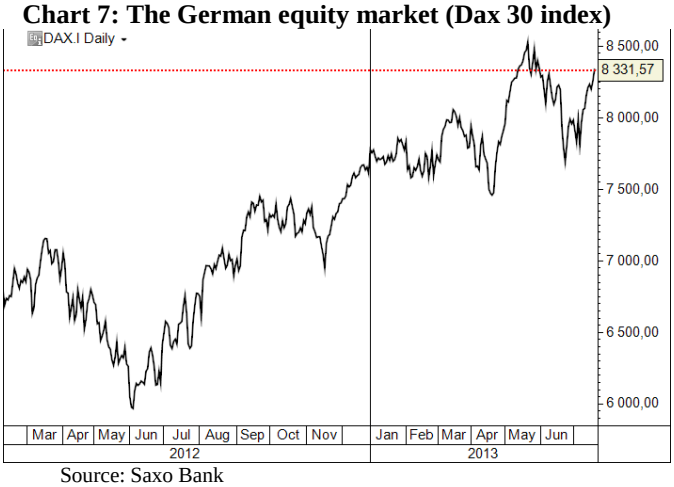
Chart 6: The US equity market (S&P500)



Source: Saxo Bank

The same can't be said for the bond market, but then again the equity markets have not enjoyed a virtually unbroken bull market over the past 30 years. Unlike equity markets, many short-term bond market yields are effectively close to zero – the US and German 10-year bond yields bottomed close to 1.5% - and would be hard pressed to decline further. Remember that as bond yields (the level of interest rates) decline, their prices rise i.e. there is an inverse relationship between bond yields and prices. One of the major objectives of QE was to artificially force interest rates (yields) lower by flooding the markets with cheap money. In this respect central banks have been successful; yields have continued to decline dramatically in response to the central bank stimulation following the 2008/9 financial crisis. It so happened that equity markets have became addicted to QE and the "free money" environment and they, too, have benefitted enormously from QE. That explains the adverse response by both bond and equity markets to the Fed's announcement on 19 June. However, a return to "normal" i.e. an environment without central bank stimulation may be good for equity markets but it is a bad omen for bond markets. Many borrowers, which include municipalities, governments and consumers, simply cannot afford higher interest rates. It is no coincidence that less than a month after the Fed's announcement, the first US municipality, that of Detroit, filed for bankruptcy; there will surely be many more to come.

Chart 7: The German equity market (Dax 30 index)

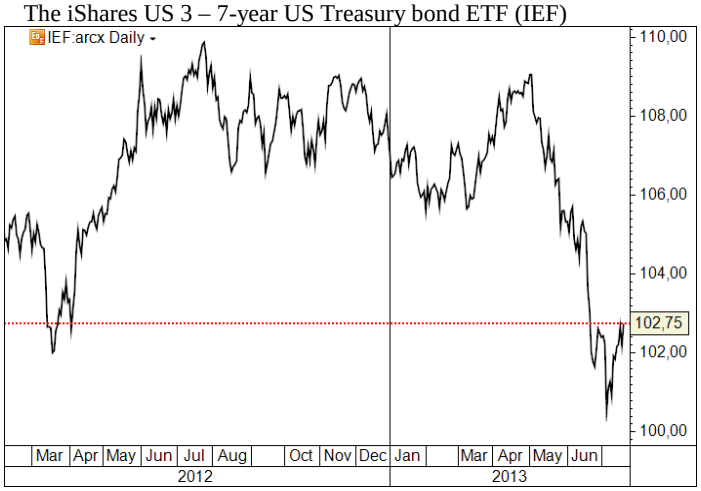


Source: Saxo Bank

With that by way of background, one can understand the equity markets continuing to rise after 19 June. If the Fed is sufficiently confident to withdraw their stimulus, the inference must be that the US economy is strong enough and has sufficient recovery potential to stand on its own feet, which is good news for companies and their profitability. It is also perfectly rational to expect interest rates to start and continue rising in such an environment; which can only spell one thing for bond investors – losses. As it is, bond investors have already lost money during the first half of this year and this is likely to continue for many months, perhaps years, to come. That is what happens when you buy a long-term bond at very low yield levels; there is very little chance of making money from such an investment. This has shaped our view on global bond holdings in the recent past and we continue to be very wary of this asset class.

Chart 8: US 3 – 7-year bond prices

The iShares US 3 – 7-year US Treasury bond ETF (IEF)

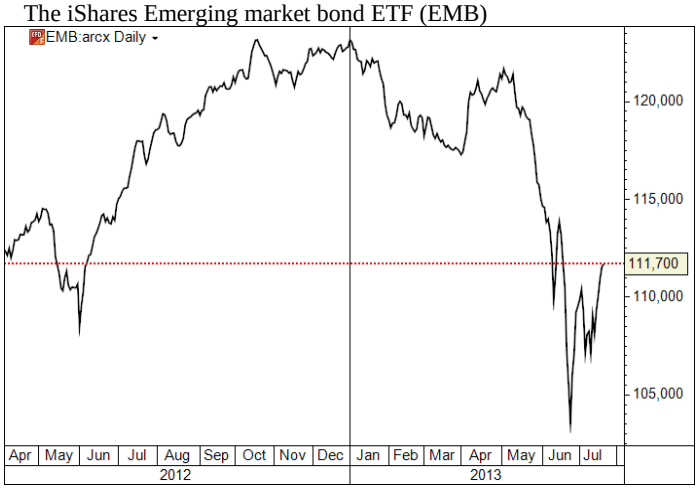


Source: Saxo Bank

Just as with equities, emerging bonds have suffered more than developed market bonds, particularly in dollar terms. Not only have their yields risen but their currencies have also declined. In dollar terms, therefore, their returns have been dismal. Chart 8 depicts the 7 – 10-year (price) return of US bonds. Chart 9 depicts the (price) return of emerging market bonds.

Chart 9: Emerging Market bond prices

The iShares Emerging market bond ETF (EMB)



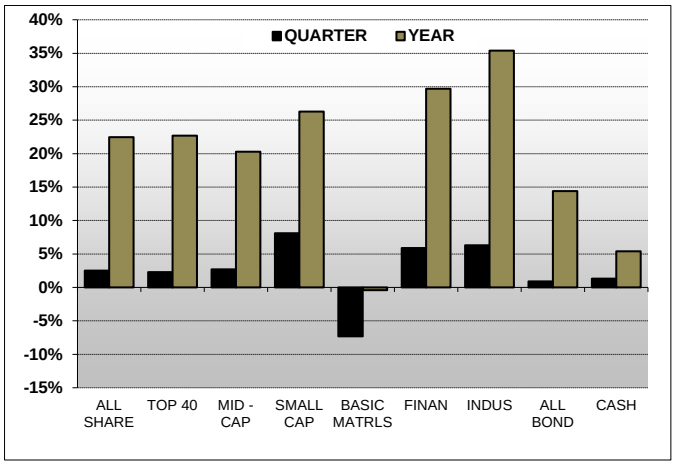
Source: Saxo Bank

Local investment markets

Turning to South African (SA) investment markets, Chart 10 depicts the returns of the major indices to the end of March 2013 and Chart 11 the returns to the end of June 2013.

Although some time has passed since the March quarter, you may recall that the basic materials (resource) index declined 7.3% while the financial and industrial indices rose 5.9% and 6.3% during the quarter. Their respective returns for the year to end-March were -0.4%, 29.7% and 35.4%. It has been a long time since such a disparity prevailed between the resource and other sectors, although when we consider the decline in commodity prices so far this year, the labour trouble on the mines and the total absence of any leadership on the part of government, we should not be surprised. The rand declined 7.5% during the March quarter, but it lent no support to the mining sectors' returns whatsoever. We should learn from that event: the rand does not always support "rand hedges", especially not when the other influential issues are bigger and more complex than those at work undermining the currency. For the record, the All share index rose 2.5% during the March quarter and the All bond index 0.9%. Their respective annual returns were 22.5% and 14.4%.

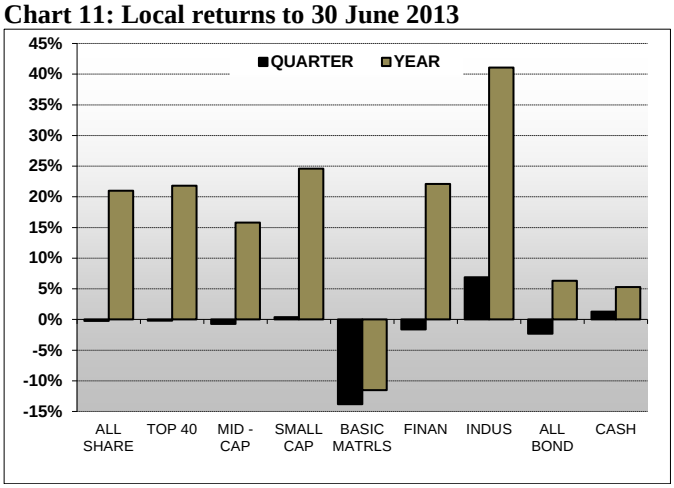
Chart 10: Local returns to 31 March 2013



If the March quarter returns from the basic material index made for sobering reading and were considered to be a "once-off" event, like many local investment managers believed, the June quarter was even more sobering. I have read numerous reports from local managers, penned at the end of last year and the March quarter, proclaiming their belief that the mining sector represented great value and that the disparity between the basic material and industrial indices was simply unsustainable and had to reverse. After all, at the end of December the differential between these two indices was no less than 35.4%. The bad news for them is that it widened further at the end of March to 35.8%. As though that wasn't bad enough it increased to an astonishing 52.7% at the end of June. Now there can be no doubt that the extent of this differential is remarkable, close to unprecedented, but it is also indicative of firstly, the extent to which the SA mining industry has self-destructed and secondly, the extent to which global investors have fled mining shares in favour of financial and industrial companies in developed markets, particularly those in the US. The collapse of the mining sector is also a function of global concerns about the economic slowdown in China, which is a country whose demand for commodities used to know no end. That may well be changing and the performance of commodity prices and mining companies are telling us that.

Let us then consider the returns to end-June: the basic material, financial and industrial indices produced returns of -13.8%, -1.6% and 6.9%. The extraordinary outperformance of industrial shares was again a feature of the quarter. Large companies, which are more global in nature than local, such as British American Tobacco (BAT), Naspers, Richemont and SAB Miller, dominate the industrial index, which explains the large differential between the mining and industrial sectors. The annual returns to June of the three respective indices were -11.5%, 22.1% and 41.1%, showing just how costly it has been to invest in the mining sector when one could have invested a large part of one's portfolio in financials and industrials. The All share index rose 21.0% in the year to June although it declined 0.2% during the June quarter. The All bond index experienced a torrid time. It was buffeted by a weak rand and negative sentiment towards bonds on the part of global investors – remember the returns of the global bond market, discussed above? Under the circumstances it held up quite well; things could have been a lot nastier. All the respective returns are shown in the chart below.

Chart 11: Local returns to 30 June 2013



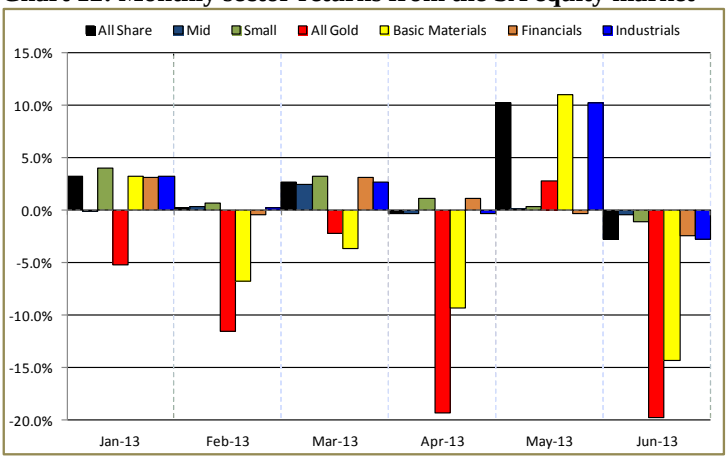
If you thought the returns from the basic material sector were bad (which they are) then consider the returns of the gold mining index. Why would anyone even consider investing in this sector, given all the risk? In the March quarter the gold index lost 17.9%. It followed this up with a 33.5% loss in the June quarter, bringing its year-to-date returns for 2013 to 45.4%. It is hard to believe, but there are still many SA equity unit trusts in that have more than one gold mine in their five largest holdings – that is simply astonishing!

Clients would hopefully have realised by now that equity portfolios in Maestro's care had an excellent June quarter. The average return across our equity portfolio for the quarter was 5.0% versus the All share index return of -0.2%.While we do not often list quarterly returns and will be the first to admit that such a time frame is far too short to deduct any meaningful conclusions about our ability to manage money, I list it here because it illustrates the benefits of our inherent bias in favour of industrial shares. There is currently a large disparity of returns across SA investment managers and it can be ascribed largely to their respective views on and hence exposure to basic materials and industrials. Maestro's recent above-average returns are a function of our underweight exposure to the mining sector and the fact that we have not held any platinum shares for more than a year now and have never, since our inception, bought any gold shares for any client.

In addition we have a fair share of mid and small cap shares in our portfolios, which have assisted in stabilizing our returns i.e. the returns from a Maestro equity portfolio are less volatile than those of the All share index. In the past we have frequently struggled to convince existing and prospective clients that, over time, the returns from mid and small caps are not only greater than those from large caps but are also less volatile. They still don't believe us, even when the facts are there to substantiate our views. The past two quarters once again provided more than sufficient evidence that mid and small cap companies have a valuable role to play in any long-term equity portfolio.

To illustrate this point and also to show you just how volatile market conditions have been so far this year, consider Chart 12. I apologize for it being so small and difficult to read but I wanted to include all the information on it. The chart depicts the monthly returns from the All share, mid and small cap indices from January to June. They are followed by the returns from the gold index (shown in red, for obvious reasons ☺), then the three major sectors being basic materials, financials and industrials. Take time to consider these returns and the risk implicit in holding shares in these sectors.

Chart 12: Monthly sector returns from the SA equity market



A couple of features of this chart and hence market behaviour so far this year are worth highlighting:

- Note how stable and mostly positive (although it is hard to see on the chart) the returns of the mid and small cap sectors have been. The mid and small cap indices respective returns for the year-to-date are 2.0%

and 8.6% (yes, that's 8.6%, showing that there is money to be made in a declining overall market, although it is not easy)

- Notice how different the returns have been each month, showing how difficult it has been to make money in this year's equity market
- And note, too, the wide range of returns, even excluding the gold sector returns. The easiest way to see this is to look at the extent of the scale of the left hand side of the chart; excluding the gold index for a moment, the range of returns falls between about 10.0% and -15.0%, or just more than 25%. This is extraordinary when one considers that these are *monthly* returns, and not annual ones, that all took place on the same stock exchange and thus to a large extent, representative of the same economy. This "amplitude" of returns, or their volatility, is the typical and classic description, or in this case depiction, of risk. In other words, the SA equity market has been full of risk i.e. the returns have been very volatile so far this year, which makes the recent positive and above-average returns on the equity portfolios under Maestro's management that much more gratifying. Not that we would boast; no, we are using our past experience to illustrate some of the key tenets of successful investing.
- Finally, don't ever underestimate the cumulative effects of consistently positive or negative returns. Taking a look again at the chart, it is not easy to see that the cumulative returns for the year to date of the various indices have been vastly different. For the record, the year-to-date returns for the All share index are 2.3%, mid caps 2.0%, small caps 8.6%, the gold index -45.4%, basic materials -20.1 %, financials 4.3% and industrials 13.7%. In any language and in any seasoned investment professional's life, the year so far has been an extraordinary one, despite the modest All share index returns during this period. Without wanting to scare you, it is our considered view that this environment is likely to continue for some time, although we still regard the equity market, local and abroad, as the asset class of choice under the current and expected investment circumstances.

In closing

We are always reluctant to table our investment predictions in writing, partly because we do not always have the opportunity to share them with you in a report like this when they change and partly for the simple fact that they do and will change as the year grows old. This is not a major concern to us, given that our clients have entrusted us to look after their assets in the first place and have thus presumably left the difficult task of managing an uncertain and dynamic future to us. We do share a lot of our views in *Intermezzo*, so please keep reading it to stay abreast of our views and thoughts.

That said, it is fair to say that as far as developed equity markets are concerned, the "easy money" (if there is such a thing) has probably already been made. We expect that the US economy may well slow more than expected and with the eurozone still in a pickle, the world continues to be reliant on China and to a lesser extent fast-growing Asian countries to provide the economic impetus on which all markets depend. Given that the Fed has also earmarked future data releases on the US economy as a trigger for their action, investors will be watching more closely than ever, the most up to date news on the US economy in particular. This will heighten the market volatility and in all likelihood put a few extra years onto the lives of the Maestro team. But we remain firm in our view that equity markets, both local and global, remain the area of greatest possible returns and so our attention will be focussed on them.

We have already indicated that we are very wary of bond markets, particularly global ones which are trading at such low yields (levels of interest rates), so we will be staying well clear of them. Unfortunately, we expect global interest rates on cash to remain very low (many are trading at zero) for a considerable time to come – perhaps even as long as into 2016. Consequently, conservative investors will have to look primarily to equity markets for positive real returns, thereby providing a level of support for equity markets and providing an explanation for their slow but steady march to new peaks. In addition, bond investors will surely be heading for the exits in droves when it becomes clear that interest rates have turned upwards decisively. With some weak US economic data still ahead of us this year, this stampede for the exit may not materialize just yet, but it is already a factor in the flows of money across the world. We will be covering this aspect in more detail in forthcoming editions of *Intermezzo* as we are watching it very closely.

In summary, we remain grateful for the support we continue to receive from our clients. Despite the prevailing uncertainty and expected volatility ahead, we actually love and are passionate about what we do, which does compensate for the nerve-wracking times we experience from time to time. But we are also very aware of the profitable returns equity investors, which include all Maestro clients, have enjoyed over many years – decades in fact – despite all the uncertainty and doom and gloom and are therefore confident in our investment decision making and activity.

Thank for your taking time to read this report – I hope you have found it useful and informative? Please feel free at any stage to engage any member of the Maestro on our market views and how we can use them for your benefit.

Andre Joubert on behalf of
The Maestro Investment Team
19 July 2013