MAESTRO
Equity Fund

PRESCIENT
MANAGEMENT COMPANY

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

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

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

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

FUND SIZE - R16 474 854

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

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

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

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The Maestro Equity Fund

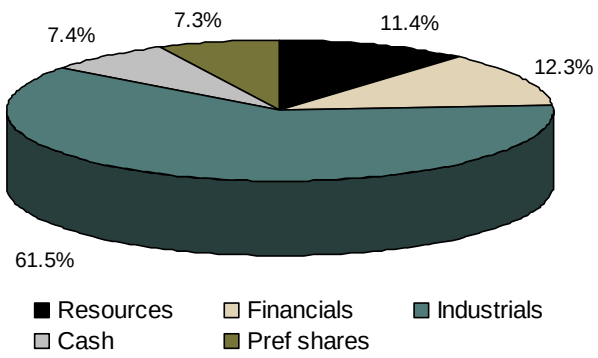
Quarterly report for the period ended

30 September 2006

1. **Introduction**
This report focuses on the investment activities of the Maestro Equity Fund during the past quarter and should be read together with Maestro's monthly investment letter, *Intermezzo*, as well as the monthly Fund Summaries sent to all unit holders.

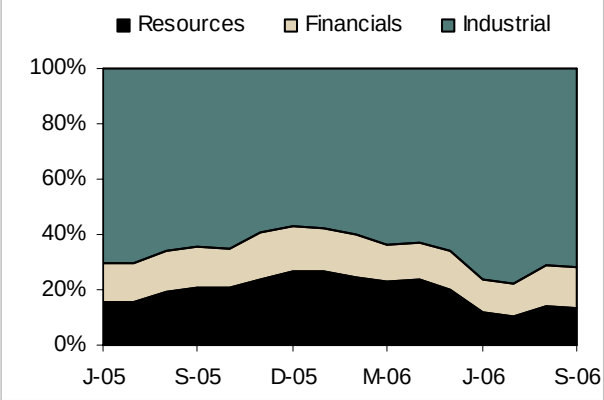
2. **The investment position of your portfolio**
The Fund's sector allocation is shown in Chart 1. At the end of September the Fund's resource exposure amounted to 11% of the Fund, up from 9% in June. Financials increased to 12% of the Fund, up from 9% in June, as did industrial exposure which increased from 56% to 61% of the Fund. Cash represented 7% of the Fund at quarter-end, down from 15% in June, while preference shares comprised the remaining 7%.

Chart 1: Asset allocation at 30 September 2006



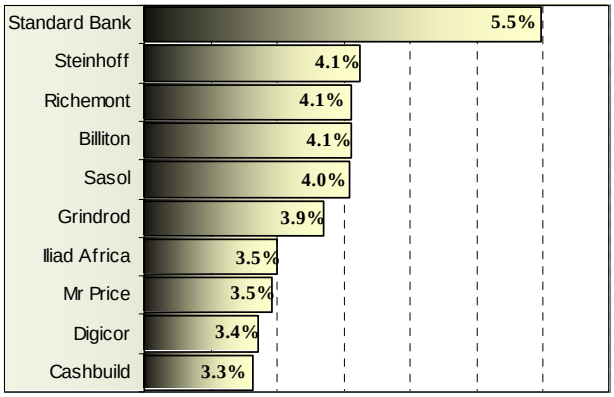
Following the dramatic June quarter when a rapid reassessment of risk caused global equity markets to decline sharply, only to recover most of their losses, the September quarter seemed almost sedate in comparison. However, that would be an incorrect assessment of the market's recent behaviour. Despite a sharp decline in the rand – it declined 8.2% during the quarter - the resource sector rose only marginally due to a general decline in commodity prices. Financials and industrials posted reasonable gains, which suited the Fund, given its bias in favour of the latter two sectors. Exposure to the resource sector increased by 1% ending the quarter at 13% of equity, as shown in Chart 2. Industrial exposure declined from 76% to 72% and financial exposure rose from 12% to 15%.

Chart 2: Historic equity sector allocation



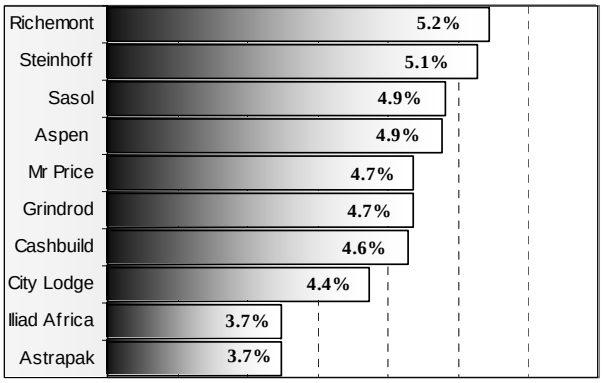
3. **<u>The largest equity holdings</u>**
The Fund's largest holdings at 30 September are listed in Chart 3, expressed as a percentage of the equity portfolio excluding pref shares. Those at the end of June are listed in Chart 4 for reference purposes.

Chart 3: The largest holdings at 30 September 2006



Standard Bank, Billiton and Digicore displaced Aspen, Astrapak and City Lodge in the largest holdings. There were 31 counters in the Fund at quarter-end, as opposed to 29 in June, the ten largest of which constituted 39% of the equity portfolio, from 46% in June.

Chart 4: The largest holdings at 30 June 2006

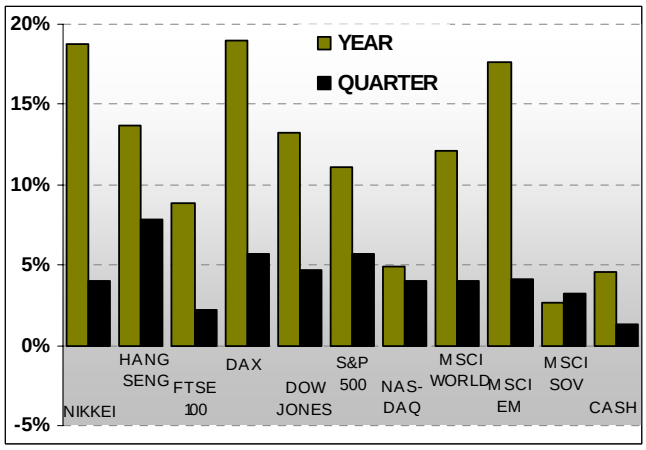


4. **<u>Recent activity on the portfolio</u>**
The investment objective on the Fund is to *achieve long-term growth through the assumption of moderate risk.* It is against this objective that the Fund's activities and performance should be assessed.

During the quarter the holdings in Abil, Billiton, Ellerines, Iliad Africa, Sasol and Standard Bank were increased. New holdings in Anglos and Naspers were introduced into the Fund while the holding in Firstrand preference shares was eliminated.

5. **<u>A review of the September investment environment</u>**
The past quarter provided a good example of how fickle and at times irrational **global** investors can be. The June quarter saw markets decline sharply due to renewed fears of further US interest rate increases on the back of higher inflation. In contrast during the September quarter equity markets posted strong returns despite evidence of an economic slowdown, concern about the rise of Iran as a nuclear power and a test by North Korea of their nuclear prowess. *Bad* news on the US economic front, specifically regarding falling housing and retail sales, was interpreted as *good* news in that the Fed would not have to increase rates further. Of course, that is totally irrational. The US economy is slowing, with more bad news to come which *will* have an effect of corporate earnings. But for now at least, investors seem to be selecting only what they would like to hear. Chart 5 depicts the returns for the past quarter and year. Not only did the markets post positive returns during the quarter, many ended near five-year highs, which subsequent to the quarter-end, they have surpassed.

Chart 5: Global market returns to 30 September 2006

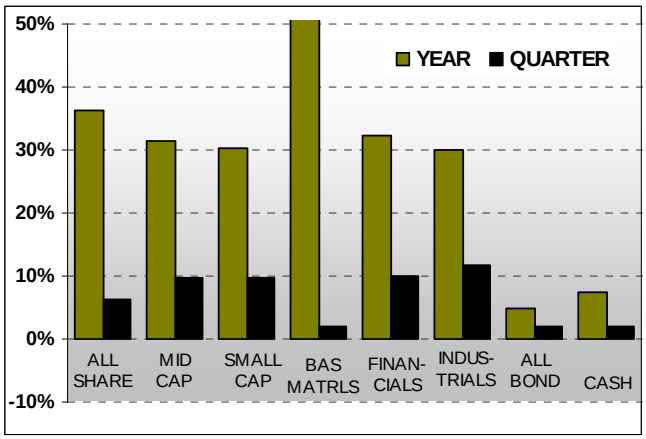


During the past year the fear of rising inflation and the consequent increase in US interest rates dominated investment markets. In contrast, the perception that inflation is *no longer a risk* provided support for equity markets during the past quarter. A major influence in this regard has been the dramatic decline in the oil price.

It peaked in August and is currently nearly 30% off its peak. Commodity prices also posted substantial declines. Both there factors are very significant, as they provided much of the upward pressure on inflation. The decline in their prices thus provides investors with good reason to expect the increase in inflation to abate thereby removing at least some upward pressure on interest rates. In that regard the strong rise in equity markets during the September quarter is understandable. The current subdued oil price bodes well for the future. Global bond markets will continue to derive benefit from this lower interest rate outlook.

Another factor worth mentioning has been the ongoing and unprecedented merger and acquisition (M&A) activity around the world. Never before have private equity investors and corporate raiders been so active. At the time of writing, for example, in the last ten days alone more than $50bn of M&A activity has been announced. More than $1 trillion worth of deals have already been consummated this year, more than the whole of last year, which in itself was a record year for M&A activity. It remains to be seen what returns will be made by the acquirers in these deals, but two things are certain: corporate banks are having a field day and the ongoing activity is having a very positive, yet distorting effect on global equity markets.

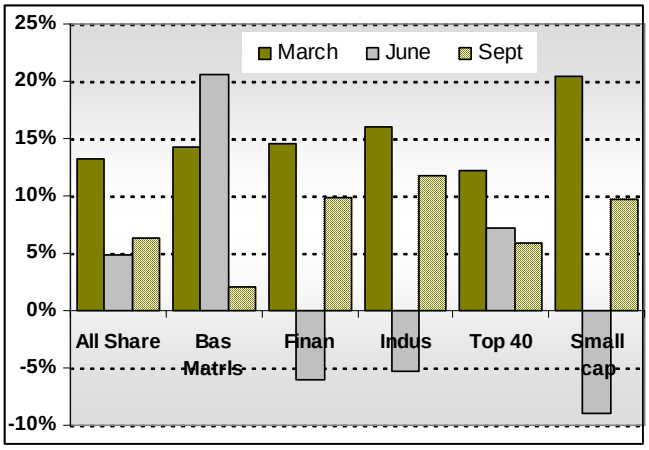
Chart 6: SA market returns to 30 September 2006



Turning to the **local** markets, shown in Chart 6, the dominant feature during the quarter was the rand, which declined 8.2%. The main catalyst for its weakness was the record current account deficit, which at 6.1% of GDP is close to a 24-year high. Of greater concern is the very real possibility of this increasing into the future as government accelerates infrastructural spending and the country prepares to host the 2010 World Cup. In an effort to curb higher spending levels the SA Reserve Bank has begun increasing interest rates, which in turn weighed on some companies in the consumer and financial sectors. Nevertheless, the SA corporate sector remains in "rude health", with solid earnings being reported by most companies. Moreover, there are no real signs of any let up in economic activity and the outlook continues to be favourable if what company management say is to be believed. To be frank, there is little reason not to agree with them.

An aspect of equity market behaviour worth highlighting was the large divergence between the different sectors. Similar to global equity market, the June and September quarterly returns differ substantially across the major sectors, as can be seen from Chart 7. Despite the weak rand the effects of lower commodity prices can be seen on the lowly 2.2% return from the basic materials index. Then again it rose 20.6% in the June quarter, when the financial and industrial sectors declined about 6%. I have often commented in letters accompanying your statements and *Intermezzo*, on the "frustrating" markets. Chart 7 provides insight into my comments – it is very difficult to make money *consistently* when such large divergences exist between the quarterly returns from the three major sectors. Good luck to the individual who thinks they can "time" such large swings in sector returns correctly!

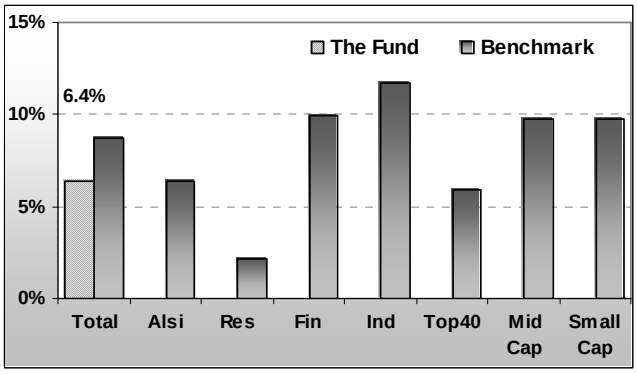
Chart 7: SA equity market quarterly returns for 2006



6. The performance of the Fund

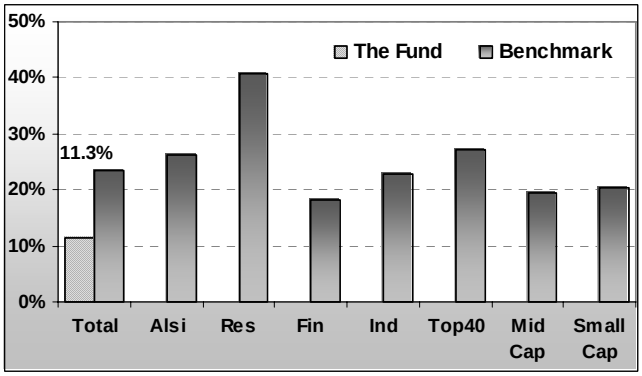
Turning to the Fund's performance Chart 8 shows the returns for the June quarter as well as those of the major JSE indices. ***The total, un-annualised return on the Fund during the September quarter was 6.4%*** which can be measured against the return of the Maestro equity benchmark of 8.7% and All Share Index of 6.3%. The return was higher than that generated by the basic materials (resources) index, but lower than the financial and industrial index returns. This situation should be seen in light of the June quarter when the Fund's returns lagged those of the materials index but exceeded the financial and industrial index returns.

Chart 8: Quarterly returns to 30 September 2006



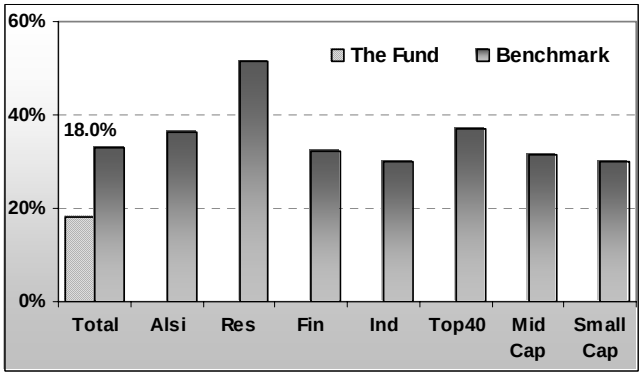
I draw your attention again to the fact that the Fund is conservatively positioned, being underweight in resource shares with a bias in favour of mid and small cap shares. While this position cost the portfolio some returns in the June quarter, it has paid dividends in the September quarter. Although the portfolio has a relatively low weighting to resource shares this has not deprived it of rand hedge exposure. Many of the largest equity holdings derive a substantial portion of their revenue from non-rand sources and as such should and indeed during the September quarter *did* protect the investments against rand weakness. The returns of the largest holdings during the quarter were Standard Bank 1.1% (down 9.2% last quarter), Steinhoff 17.6% (-3.8%), Richemont 14.3% (11.1%), Billiton -3.7% (23.3%) and Sasol -6.9 % (18.0%).

Chart 9: Nine month returns to 30 September 2006



The nine month or "year-to-date" returns are shown in Chart 9. ***The Fund's total return for the year-to-date was 11.3%.*** The year-to-date return can be compared with those of the Maestro equity benchmark of 23.5% and All Share Index of 26.3%. You will remember that the Fund had a disappointing June quarter, which explains a lot of the underperformance of the All Share index for the period. The dominance of the resource index as a source of returns during the year so far is apparent from Chart 9. The mid and small cap indices generated returns over this period of 19.5% and 20.4% respectively.

Chart 10: Annual returns to 30 September 2006



The annual returns are shown in Chart 10. ***The total return of the Fund for the year to September 2006 was 18.0%,*** significantly above the inflation rate over this period of 5.4%. The return can be compared with those of the Maestro equity benchmark of 33.2% and All Share Index of 36.3%. The 51.4% return of the resource sector over the past year was by far the largest, although returns from the financial and industrial indices were nevertheless still impressive. The mid and small cap indices gained 31.5% and 30.2% respectively.

7. **<u>What lies in store for investors in the months ahead?</u>**
It may be interesting to see what Maestro said last quarter and to measure it against what actually happened. With regard to the **global environment**, we noted the following:

- *The threat of inflation getting out of control is remote*. I was right in terms of my view on inflation, although I never thought the oil price would decline as much as it has. The latter continues to be a positive influence on the investment environment.
- *The global economy looks set to slow, but a recession in the US looks unlikely. Emerging market economic growth will continue*. I was right in this regard, too, but more on this a bit later.
- *Corporate earnings will slow and equity prices will move lower in the coming months*. It is too early to assess the extent to which corporate earnings will be affected by the rise in interest rates, both in the US and other parts of the developed world. However, it is fair to say that corporate earnings have remained more resilient than most (including myself) imagined. The bad news, however, may be "just over the hill". Of course, with regard to my expectation that equity prices would decline, I was totally wrong, as can be seen from Chart 5. The bad news may yet be on the way, but one cannot ignore the resilience of equity markets during the past quarter. There is clearly a lot of liquidity (money) out there, and much of it still has to find a home. M&A activity seems to have some

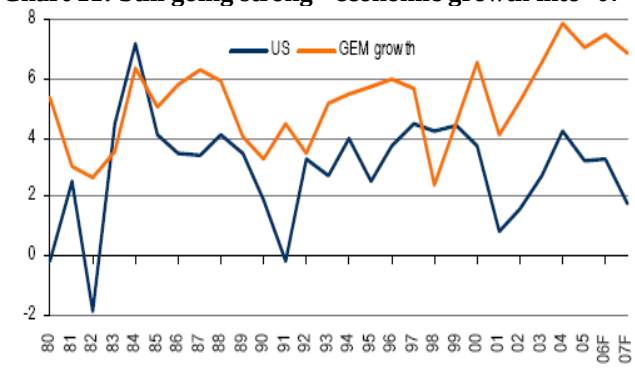
way to go yet, which will lend strength to selected areas of the market.

- *Investors need to adopt a cautious stance for the balance of the year*. If anything, one could have relaxed one's risk profile in the past quarter, but it remains Maestro's view that a fair dose of caution is required when investing in global equity markets in particular.

Of course, this "exercise" is not about Maestro, or any other firm for that matter, being right or wrong. It is about being able to correctly assess the underlying risks in the investment environment and adapting one's investment strategy accordingly. So having seen the September quarter come and go, what lies in store in the coming months? In a nutshell, more of the same:

- *Global growth is likely to slow, but emerging markets will continue to grow at rates higher then developed markets*. The US economy should be able to avoid a recession. The decline in oil and commodity prices in general should keep inflationary fears at bay and enable the work done by central banks to take effect without killing the proverbial goose that laid the golden egg i.e. the consumer. Chart 11 depicts the rate of emerging market (GEM) growth against that of the US. One can see quite clearly that emerging markets are expected to support global growth. The IMF is still forecasting global economic growth at 5.0% in 2007, still significantly above the long-term average, albeit lower than in 2005.

Chart 11: Still going strong - economic growth into '07



Source: Merrill Lynch

- *Corporate earnings growth should continue at reasonable levels*, although certain sectors are likely to feel some headwind – notably those that are directly exposed to the consumer. While equity markets are currently rather overheated in the short-term, they are not excessively valued, which provides a measure of comfort.
- *Investors should remain cautious* given that markets are trading at record levels and the full effects of US interest rate increases are yet to be felt.

Turning to the **local markets**, this is what was said last quarter:

- *The SA economy remains in good shap*e. In this respect I was correct. Despite the rising current account deficit, which has always been the Achilles heel of the country, the SA economy is likely to retain its current momentum. The large (R372bn) commitment by government to renew some of the country's infrastructure as well as the increasing focus on "2010" will provide more than sufficient impetus for our economy. The underlying structural changes, particularly the changing profile within the consumer environment, should not be under-estimated. They, too, will support the economy, although we may well see the level of inflation rise over the next couple of years due largely to a lack of capacity, the requisite skills and a declining rand.
- *The rise in interest rates was misplaced and inappropriate*. I was sincere in my comments last quarter, and still retain my underlying thesis that the changes to the economy are not being properly assessed by the monetary authorities. However I underestimated the momentum of the underlying inflation pressures (I also didn't expect the rand to decline so sharply) so must concede that the "Governor" was correct in raising rates. Of course, rates have just been increased again and are likely to rise further in the coming months. However the decline in the oil price will provide some relief and the higher level of rates should provide support for the rand, which in turn will act as a buffer against further inflationary pressures. That's the good news. The bad news comes in the form of the current deficit and of course any change in the global risk environment. The deficit will in all likelihood deteriorate further, undermining the rand, while deterioration in the global appetite for risk will exacerbate the rand's vulnerability.
- *The rand will remain relatively stable, although it is likely to depreciate gradually against major currencies. The best is behind us*. It is clear I got this one wrong last quarter, although the rand has a history of "spiking". We may well see the rand recover some of the lost ground (it declined to nearly R8.00 shortly after the quarter end) but we must take cognisance of its vulnerability. South Africa does not have the advantage of size such as China or India do, or a very high growth rate to attract foreign capital. This leaves the economy, the

currency and the investment markets vulnerable when "the going gets tough". Maestro will be alert to these vulnerabilities as the global environment stretches itself to the limit in terms of record equity market levels and fragile earnings prospects yet to feel the full wrath of higher rates.

- *The weaker rand will support the equity market, especially resource shares, which despite healthy past gains is not excessively valued*. I have commented sufficiently on the markets and the rand. Suffice is to reiterate Maestro's belief that although markets may continue rising, one cannot lose sight of how far they have risen in the past couple of years. Nothing goes on forever. Let's be alert to the downside risks, while we enjoy what upside comes our way.

8. <u>Closing remarks</u>

The Fund has recovered well from the disappointing June quarter. However, more than a fair share of vigilance should be maintained in the coming months. You can rest in the knowledge that the Fund's equity portfolio comprises companies that have either one or more of the following attributes:

- they are well managed
- have strong cash flows
- a large portion of their revenues is represented by annuity income
- they are not excessively valued
- and will derive some benefit from my expectation of a gradually declining currency.

As such the Fund is well placed to continue delivering decent returns in the coming months, although the rate of return is unlikely to match the unprecedented returns that have characterised SA equity markets over the past few years.

All that remains is for me to thank you for your support in the past quarter. I look forward to continue being of service to you into the future.

Andre Joubert
19 October 2006