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: R24 946 993

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

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

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

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CAPE TOWN
8000

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The Maestro Equity Fund

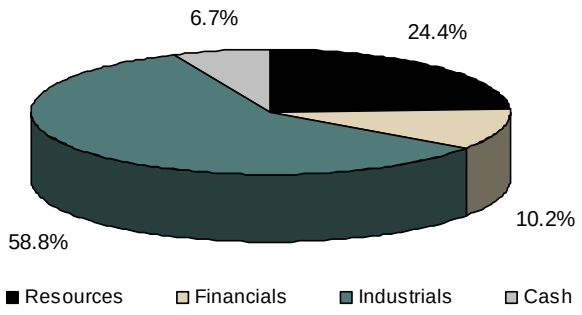
Quarterly report for the period ended

30 September 2007

1. Introduction

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

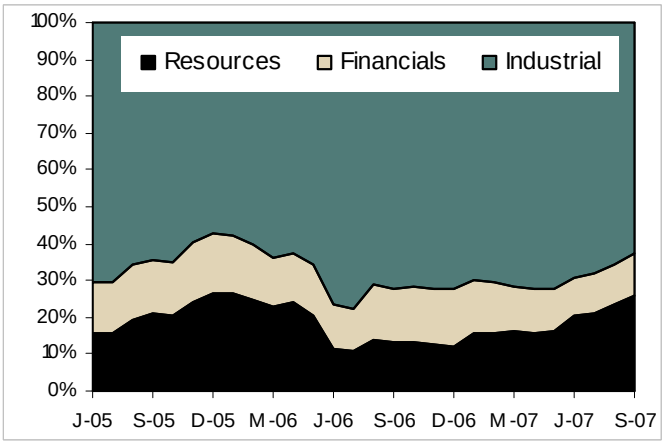
Chart 1: Asset allocation at 30 September 2007



2. The investment position of your portfolio

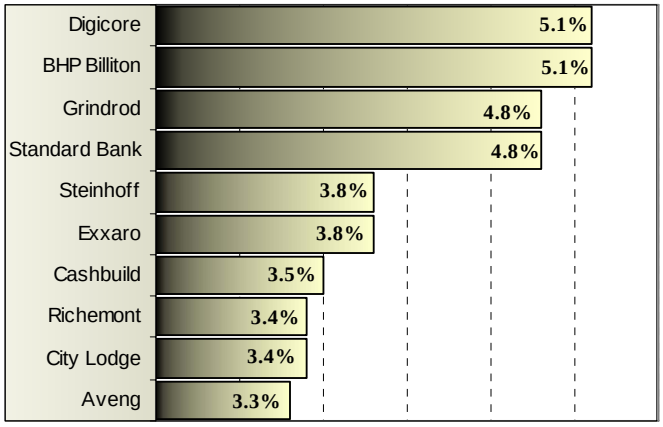
Chart 1 depicts the Fund's sector allocation at the end of September. Exposure to the resource sector totalled 24.4% of the Fund, from 18.7% in June. Financial exposure rose from 9.6% to 10.2% while industrial exposure declined from 63.5% to 58.8% of the Fund. Cash represented 6.7%, down from 8.2% at the end of June. Chart 2 depicts the historical allocation to the three major sectors of the equity market, expressed as a percentage of the equity portion of the Fund.

Chart 2: Historic equity sector allocation



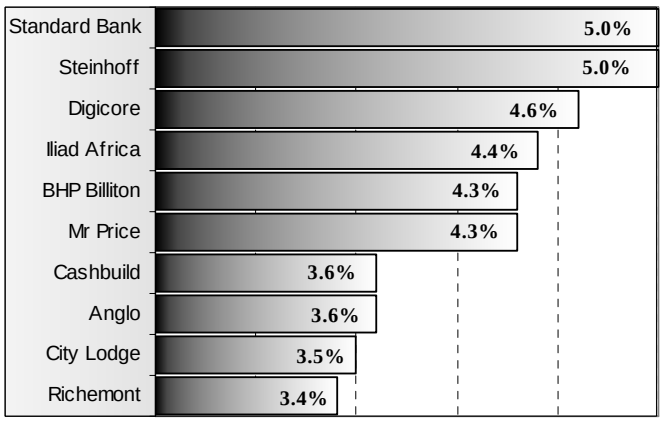
3. **The largest equity holdings**
The Fund's largest holdings at 30 September are listed in Chart 3, expressed as a percentage of the total Fund.

Chart 3: The largest holdings at 30 September 2007



Those at the end of June are listed in Chart 4 for reference purposes. Aveng, Exxaro and Grindrod displaced Anglo, Iliad and Mr Price in the "top ten" during the quarter. There were 33 counters in the Fund at quarter-end versus 32 in June, the ten largest of which constituted 41.0% of Fund, down from 41.7% in June.

Chart 4: The largest holdings at 30 June 2007



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

During the quarter the holdings in Anglo, Exxaro, Implats, Jasco and Mittal were increased. The holding in Ellerine was sold and the Iliad holding reduced. New holdings in Dawn, Investec and Metmar were introduced into the Fund.

5. **A review of the recent investment environment**
We began this section last quarter as follows: "*The second quarter of 2007 proved to a trying one; few would have said during the quarter that the markets would end the quarter with such robust returns*". If ever such as statement was true, it was during the September quarter! We drew attention to the following influential factors:

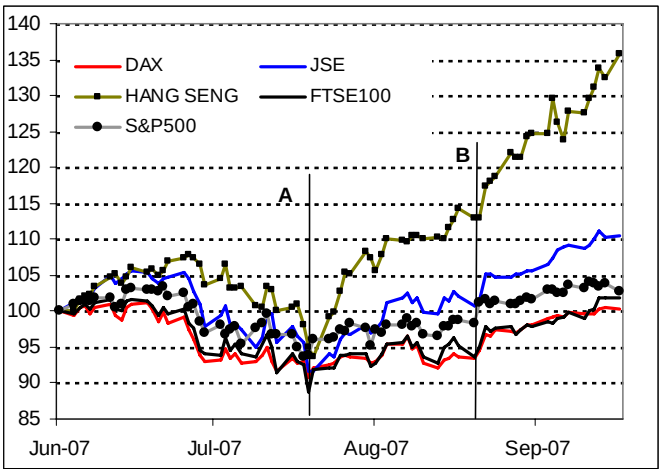
- *A rising oil price*
- *Strong commodity prices*
- *Rising inflation expectations*
- *A Chinese equity market bubble*
- *US sub-prime woes*
- *A weak dollar*
- *Corporate activity*
- *Increased volatility*

If we had but stuck to this script, we would have saved ourselves a lot of stress and ageing, for almost all of these factors contributed to the in global market turmoil midway through the quarter. No one could have foreseen the ferocity of the downturn, yet even more extraordinary was the remarkable recovery that *equity* markets in particular experienced during the second half of the quarter. The events surrounding the turmoil have been well documented in the financial media and *Intermezzo* but it is worth reviewing them with the help of Chart 5.

As the effects of the fallout in the US housing market became apparent, largely as a result of revelations by global banks and large hedge funds of their exposure to, and losses arising from, their activities in this area, so the fallout snowballed and sent global equity markets lower. This in turn led to a virtual collapse in the market for sub-standard bonds (debt) and asset backed securities (ABS). Although the effects of the resultant drying up of liquidity (tradability) were felt in all markets, its impact was initially most painfully felt in the *credit (bond)* market. However it soon spread to global *money* markets and the inter-bank market in particular; even banks started distrusting each other's ability to repay loans extended between them. This forced central banks to pump over $500bn into the financial system in order to keep it liquid i.e. to ensure that it kept functioning properly. At the time of writing this central bank market "facilitation" is continuing, albeit on a smaller scale.

In reaction to this mayhem the US Federal Reserve (the Fed) lowered its discount rate i.e. the rate at which it extends additional facilities to the banks on 17 August – depicted by line "A" on Chart 5. This lent some stability to equity markets, but hedge funds in particular were in a full-blown crisis by now and global credit and money markets continued to swoon in disarray. As concern grew about the effects of the massive rise in the price of credit in general and risk in particular, it was clear that not only the banks but US consumers too, needed relief.

Chart 5: Recent movements in selected indices



With the next Fed meeting only midway through September *developed* (as opposed to *emerging*) equity markets went into limbo, hoping that Fed Chairman Bernanke would come to the rescue. In the event, he did and in emphatic style. The Fed cut the Fed Fund rate by 0.5% - depicted by line "B" in Chart 5. This was the first cut since 2003 and greater than the 0.25% cut the market was expecting. Global equity investors took heart and immediately sent markets soaring. They had seen this movie before – but more about that in a moment. Credit markets reacted cautiously, but the money market and the intra-bank one in particular continued to convulse, leading to the near collapse of at least one UK bank, Northern Rock, and seriously testing the resilience of other banks active in the ABS market.

Of course, throughout this malaise, other markets reacted too. In recent years many investors borrowed capital in cheap currencies such as the yen and Swiss franc, for investment into high-yielding currencies such as the rand and Australian and New Zealand dollars. They also bought high-yielding assets, which were typically to be found in the ABS arena – hedge funds in particular were active in this space. And so the crisis swept across the globe, translated via the *currency market*. The Yen strengthened and the dollar weakened as investors realised that these events would in all likelihood spell the end of this US interest rate tightening cycle. *Commodity markets* also strengthened in the process, supported by sustained demand and a shortage in many metals. The weaker dollar merely compounded the strength of the energy and commodity markets.

With this as background you can understand why, halfway through the quarter, many investors thought the end of the world was in sight. Global money markets, credit and equity markets, and currency and commodity markets were all gyrating in unprecedented fashion. Uncertainty was the order of the day. But as if that wasn't enough, global equity markets staged an extraordinary comeback, in similar fashion to their recovery in June 2006. Most indices ended September higher and went on to post positive returns for the quarter – refer to Chart 6 in this regard.

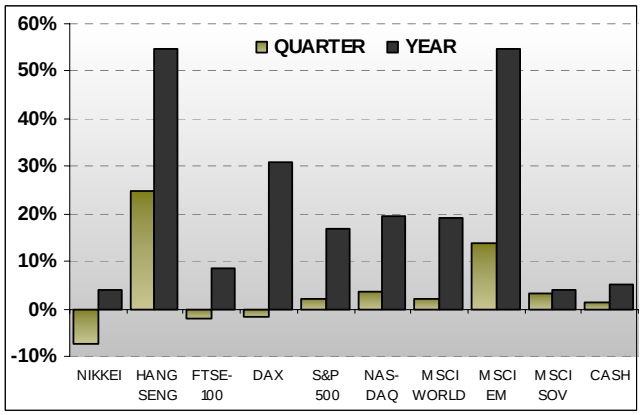
But it was emerging markets that stole the limelight and led the charge, and Hong Kong in particular, as you can see from Chart 5. We will explore the reasons behind this phenomenon later, but stronger growth prospects, higher commodity prices, a weak dollar and stronger earnings prospects all contributed to money flowing into emerging markets.

Some interesting facts about the September quarter are:

- The MSCI World index rose 2.0%
- The MSCI Emerging market index rose 13.7%
- The Hang Seng (Hong Kong) index rose 24.7% and the Indian market 18.0%. The Shanghai A index in China rose 45.3%, bringing its annual gain to 216.7%.
- The Tremont Hedge Fund index rose 1.1%
- The gold price rose 14.2% and the platinum price 8.2%
- The price of oil rose 11.0%
- The dollar weakened 5.0% against the euro

When reviewing the above returns it is hard to understand how volatile, stressful and difficult investment markets were during the past quarter. But there is sufficient "collateral damage" around by way of failed hedge funds, banks in crisis, consumers in even greater crisis, regulators scrambling to put new measures in place, and terrible returns that bear testimony to how difficult the September quarter was.

Chart 6: Global market returns to 30 September 2007

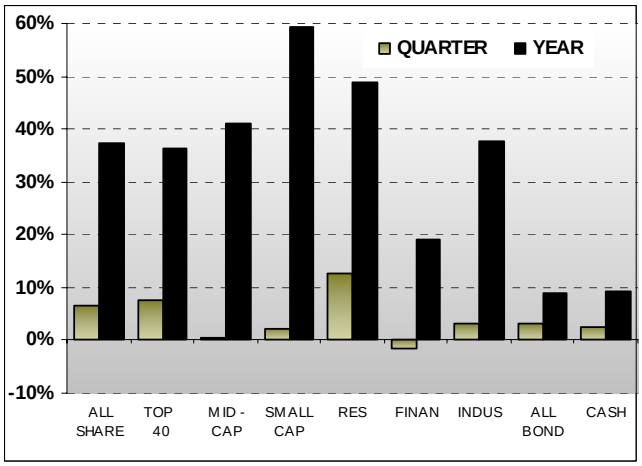


What about the local markets? You will by now be very aware that South Africa is virtually fully integrated into the global financial community, so the global events described above were unavoidable. But there were at least two mitigating factors that prevented our markets from reacting more severely. *Firstly*, the SA financial

sector is not only conservatively but also relatively well managed. SA banks' behaviour in recent years has been fairly responsible; banks have not ventured into the "sub-prime" market in any way. There was thus little fallout from the events that have tarnished the US banking sector. Neither does SA have a hedge fund community that operates aggressively in the credit markets or in areas involving sub-par debt.

Secondly, SA is firmly entrenched in the global emerging market universe, although in this respect we are not in the "first tier" category which includes Brazil, Russian, India and China – the so-called BRIC countries. We are though in the front line when it comes to an orientation in favour of commodities, which we have noted were in great demand during the quarter. Consequently, although the rand was initially on the receiving end in the first half of the quarter – it declined to R7.60 to the dollar at one stage – it actually firmed after the Fed's discount rate cut, to end the quarter at R6.90, some 2.2% higher than where it started. This assisted in supporting our market, which, not surprisingly was led by strong gains in the basic materials (resource) sector. The latter rose 12.8%, in stark contrast to the financial index, which declined 1.6%. This return is symptomatic of the stress in that sector, although this had more to do with perceptions by global investors than what was actually happening on the ground. When all was said and done the All Share index ended 6.7% higher, bringing to an end a remarkably volatile but nevertheless profitable quarter, as shown in Chart 7.

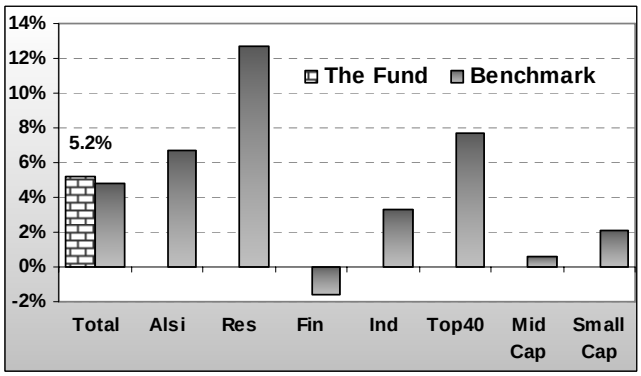
Chart 7: SA market returns to 30 September 2007



6. The performance of the Fund

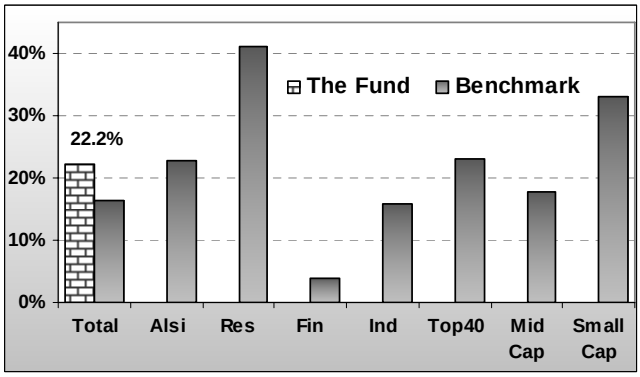
The Fund's un-annualised return during the quarter was 5.2%, which can be measured against the return of the Maestro equity benchmark of 4.8%, shown alongside the Fund's return in the "Total" column in Chart 8, and All share index of 6.7%. The resource sector dominated returns during the quarter, which is very evident from the Chart. On the other hand, the financial sector was weak, in line with the global trend as banks took strain in the face of the money and credit market crisis. It is not every day you see a 14.3% difference between two sectors, which will lend substance to our assertion that the quarter was a particularly volatile and difficult one in which to manage money. Bear in mind, too, that the rand firmed 2.3% during the period, which traditionally would have supported financials and retarded resources – not so this time! Bearing in mind the Fund's bias in favour of mid and small caps and its underweight resource exposure, in our opinion it did rather well under the circumstances during the quarter. The returns of the largest holdings during the quarter were Digicore 19.6% (up 30.3% last quarter), Billiton 24.5 % (20.0%), Grindrod 16.9% (29.7%), Standard Bank 1.2% (-8.0%) and Steinhoff -19.5% (3.7%).

Chart 8: Quarterly returns to 30 September 2007



The *un-annualised* returns for the nine months to 30 September are shown in Chart 9. ***During this period the Fund rose 22.2%,*** ahead of the major indices with the exception of the resource and small cap indices. During this period the Maestro equity benchmark and the All Share index rose 16.3% and 22.9% respectively.

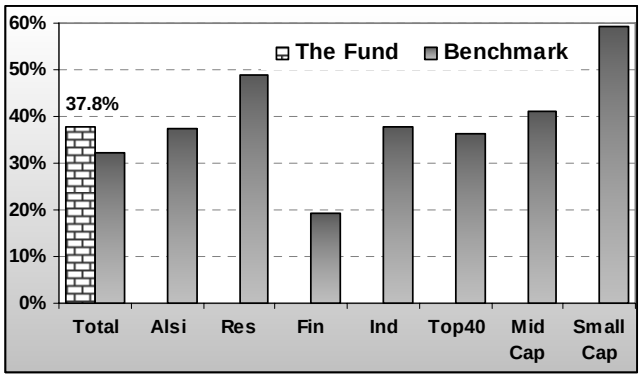
Chart 9 Nine-month returns to 30 September 2007



The annual returns are shown in Chart 10. ***The return of the Fund for the year to 30 September was 37.8%,*** way above the inflation rate over this period of 6.7%. This return can be compared with those of the Maestro equity benchmark of 32.2% and All Share Index of 37.4%. The returns of the other major indices are shown in the Chart – again it is worth pointing out that despite being

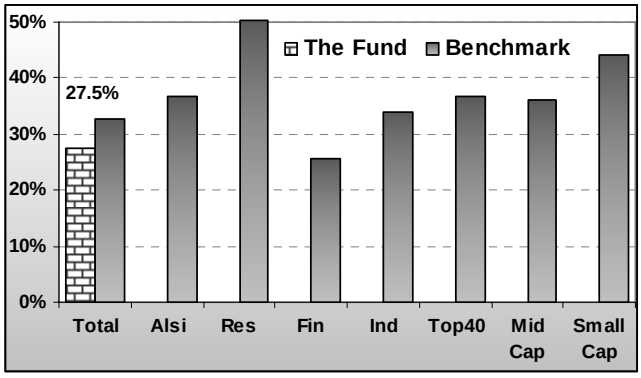
underweight resource shares the Fund managed to outperform the indices, with the exception of the resource and small cap indices, whose returns were extraordinary, to say the least.

Chart 10: Annual returns to 30 September 2007



The improvement in the *relative* performance of the Fund continued during the September quarter - relative to other similar unit trusts, that is. The Fund ended the quarter with above-average returns amongst other general equity unit trusts, comfortably occupying a place in the top quartile. As you may be aware if you have been invested in the Fund for more than a year, the Fund struggled to keep up with the rampant market when it was first launched in June 2005. It then had a disappointing June 2006 quarter, when we adopted too conservative a view following the correction in equity markets at that time. The disappointing historic returns are embedded in the annual returns for the 2-year period to 30 September 2007, shown in Chart 11. Despite this fact the Fund's 27.5% annual return over the two year period to end-September is not that far off the 32.7% and 36.8% respective returns of the Maestro equity benchmark and All Share index.

Chart 11: Annual return: 2-year period to 30 Sept 2007



7. **<u>What lies in store for investors in the months ahead?</u>**
Before sharing our view on the prospects for investment markets, consider these examples of the extraordinary times we are living in: within a day or two of this report being written, the following characterise the prevailing investment environment:

- The SA, Indian, Chinese and Hong Kong equity markets are at all-time record levels. The MSCI Emerging Market index has never been higher than it currently is
- The German, UK and US equity markets are close to all-time highs
- The price of gold is at a 28-year high and platinum is at an all-time high
- The oil price is at a record level with a prospect of it exceeding $100 per barrel now very real
- The prices of most base metals, with the exception of aluminium, are close to or at record levels
- The prices of wheat and corn are flirting with record levels. The price of coffee is at a 10-year high
- The Baltic Dry index, a measure of global shipping rates and which is strongly correlated to global economic growth, is at an all-time high
- The dollar is at an all-time low relative to the euro; the trade-weighted dollar is at a 15-year low
- Sterling is close to a multi-year high relative to the dollar
- The Northwest Passage above Canada is now fully navigable for the first time since satellite records began and icebergs have been spotted off Cape St Francis on the Eastern Cape coast.

At the same time there is talk of a US recession, the banking sector remains under pressure in certain regions, central banks continue to support liquidity in the global financial system and there is much talk of systemic risk. *What on earth is going on?!*

It is impossible to answer this question in a couple of pages but I will do my best to share Maestro's view of the coming months. Once again I would stress that the objective of our mandate is not to "get the view right", for that is impossible to do on a consistent basis. Rather, it is to ensure that we manage the funds that have been entrusted into our care in such a way that they can withstand, as best possible, whatever the markets "throw at us" and to achieve respectable returns during those circumstances. This task involves risk, for which there eventually should be some return. We make no claim to possess any crystal ball and there is no guarantee that

investors will not lose money if the investment environment turns out to be very different from what we expected. With that by way of a health warning, let's take a look at what we think will happen as we move into next year and beyond. We will begin with the global economy, and then move through a review of the US economy, confirm the case for investment into emerging markets and "come in to land" back in South Africa.

Notwithstanding the slowdown in the US economy, we retain the view that **the global economy** is in good health. Global economic growth is likely to be in the order of 5.0% in 2007 and not much less in 2008. Strong emerging market growth, a resilient Euroland (2.1% growth in 2008) and structural changes to the make-up of the global economy support this view. We are advocates of the "de-coupling school", which believes that the structural changes and the strength of emerging markets as a whole will be sufficient to withstand, or de-couple from, a slowdown in the world's largest economy, the US. This theme has become an important one for us throughout the year – we formally identified it as a dominant theme in the May 2007 edition of *Intermezzo*, although regular readers of our output will be aware that we have been trumpeting the "China story" – recall how many times you have seen the Panda - and that of emerging markets for as long as I can remember. A quick glance at Chart 12 and you will see that the de-coupling story has been a *de facto* event since 2005, when US growth started slowing and Asian growth began accelerating. Note that the chart's scales are different – Asian growth is growing at 9%; the US is plodding along at only 2.0%.

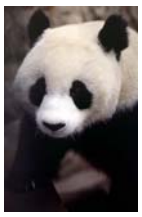
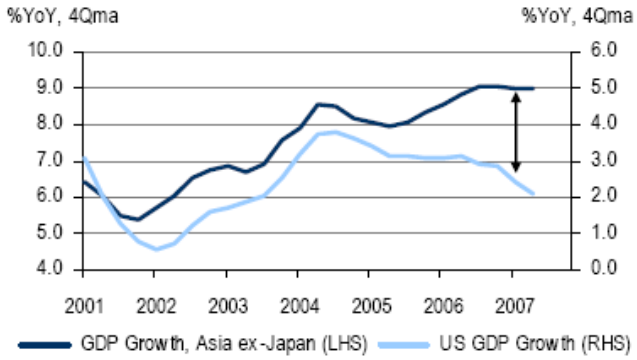


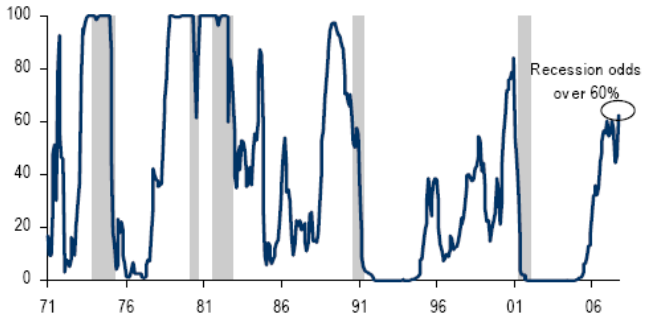
Chart 12: The de-coupling story is already 2 years old



Having established that the global economy is still in good health, I would like to spend more time on **the US economy**. We have been referring to the slowdown in the US for some time now. However, events during the September quarter, specifically the effects of the sub-prime crisis and the upward re-pricing of credit on the US consumer and the housing sector, have given us reason to believe that the US may well be heading for a recession, if it is not in one already. While the technical definition of a recession has suddenly become a hot debating point - that in itself should tell us something – it is pointless getting dragged into that debate. The real issue is the extent of the slowdown in US economic growth and its effect of the US consumer, who has been the main engine of global growth for many years – we are into the 62nd *successive* quarter of growth in US real consumer spending. Without belabouring the point it is useful to share some charts with you, courtesy of Merrill Lynch, which show that the US may be heading for a recession, even if the Fed continues to cut rates, which is by no means a certainty at this stage. For space sake, I will spare you a detailed explanation of each chart, but they are credible and the source impeccable. In the graphs the shaded areas represent periods of US recession.

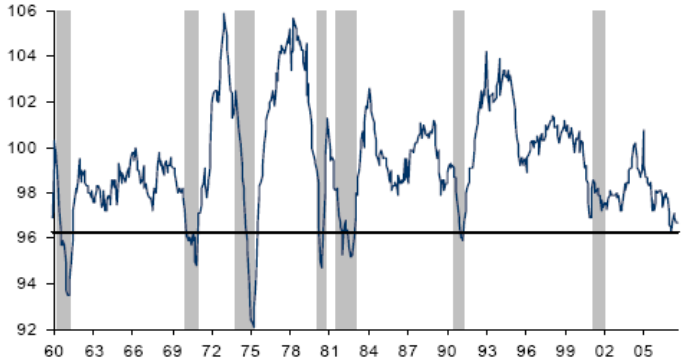
Let's start with Chart 13, which shows a probability model compiled to forecast a recession. It shows that the odds are now more than 60% of a recession taking place. Note just how accurate the model has been predicting previous recessions.

Chart 13: Recession risks are rising – now over 60%



Another warning light is the manner in which traditional economic indicators are pointing to a further slowdown in growth. The ratio of the coincident (current) to the lagging (historic) composite index of economic indicators, depicted in Chart 14, shows that the ratio has never fallen to its current level without an ensuing recession.

Chart 14: Ratio of coincident to lagging indices



One of the major factors behind the slowdown is, of course, the unfolding events in the US housing market. Exactly how bad it is is apparent from Charts 15 and 16. The left hand chart in Chart 15 below depicts the National Association of Home Builders (NAHB) housing market index, which is at an all-time low; the right hand chart shows single-family building permits, now at a 12½-year low. Although this looks pretty dire, due to the drop off in sale of homes there is now a huge overhang in the supply of houses on the market. In fact this inventory is the largest ever during the past 20 years. To take the housing market back to a "normal" level would require another 10% decline in house prices nationwide and a 20% decline in the current inventory – not at all encouraging. The message is clear – the US housing market and thus also the consumer – is not out of the woods yet.

Chart 15: US housing market – the bubble has burst

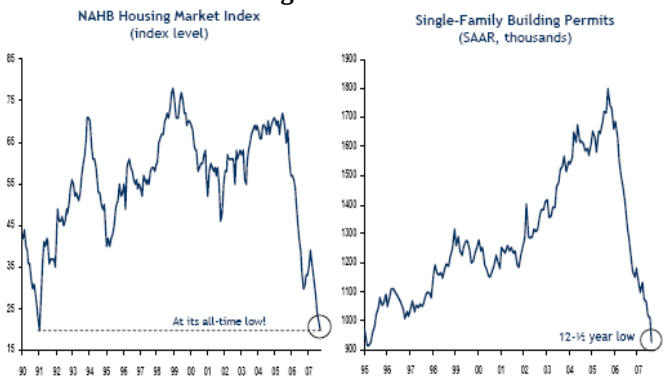
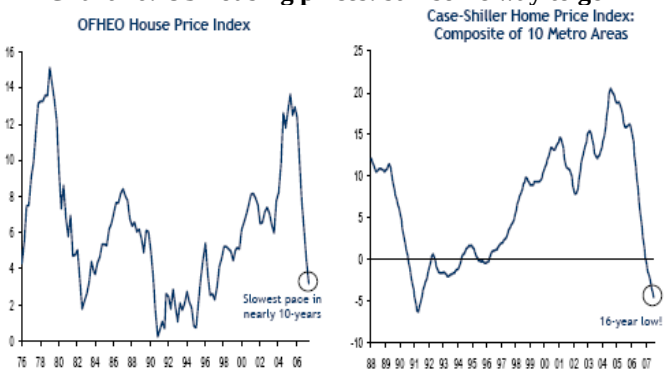


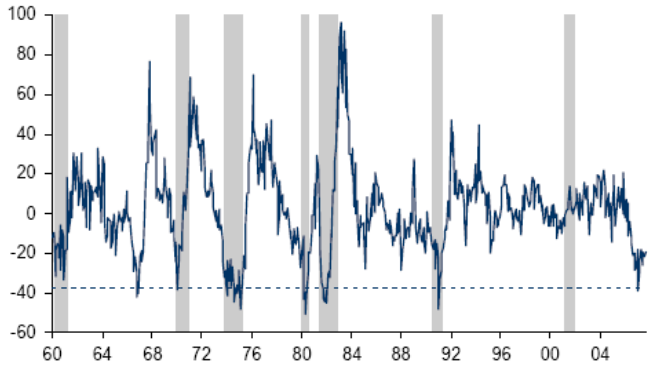
Chart 16 depicts recent developments with respect to US house prices. With price declines and respective indices at multi-year lows the outlook for the US consumer and their economy is bleak.

Chart 16: US housing prices: still some way to go



Returning to my earlier point about how close the US may be to recession, Chart 17 depicts the annual change in the sale of new homes; it shows that recessions occurred in 6 of the previous 7 housing cycles once "housing starts" declined more than 35%. At the risk of flogging a dead horse, Fed Chairman said in a recent speech that "the housing market will continue to be a drain on the economy through next year". He went to say that "although conditions in financial markets have shown some improvement since August, a full recovery of market functioning is likely to take some time". Strong words, which provide much food for thought.

Chart 17: More signs of an impending recession?
Housing starts – annual percentage change



One of the ironies about the investment "game" is that we get it wrong quite often. While some commentators are talking openly about a US recession, it is certainly not the consensus view right now. Table 1 shows the history of what the consensus view was just prior to a recession – economists and analysts don't exactly cover themselves in glory if their record in calling recessions is anything to go by. The only certainty in this regard is that pending recessions are virtually never forecast timeously.

Table 1: Recessions: too hard to call

Recession Dates			Consensus GDP forecast just prior to a recession*	GDP growth in recession year	The "miss"
			(%)	%	bps
Nov-73	to	Mar-75	3.1	-0.4	-347
Jan-80	to	Jul-80	1.4	-1.1	-254
Jul-81	to	Nov-82	3.2	-1.9	-505
Jul-90	to	Mar-91	2.3	-0.2	-249
Mar-01	to	Nov-01	3.1	0.8	-232
Average			**2.6**	**-0.6**	**-318**
Now			2.0	?	?

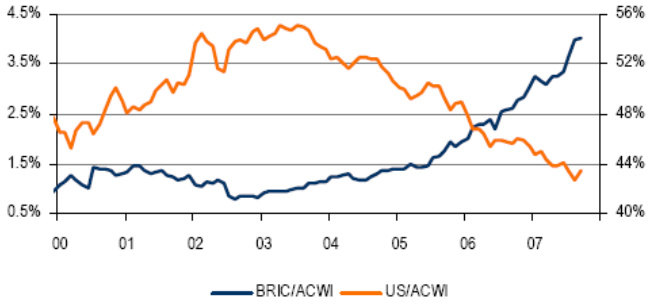
Hopefully I have managed to highlight some of the risks to the US economy in the coming year. But it is not all bad news. Recall that we also believe that the rest of the world has "de-coupled", albeit not altogether, from the US economy. More specifically, **emerging markets and economies** seem to be on their own trajectory. Strong domestic demand and burgeoning demographics are working in favour or emerging markets and supporting further growth in the years ahead.

We comment extensively on emerging markets in *Intermezzo*. For that reason I will refrain from spending too much time on the reasons for our positive view on them in this report, but I would encourage you to follow our thoughts and comments in detail, as documented in *Intermezzo*. We are living in remarkable times, where emerging markets contribute 75% of all the growth in

the global economy. Whereas only ten years ago they were seen as the "underdogs" they now lead the world in terms of growth, fiscal management and trade balances.

The relative importance of emerging markets is growing. Although not necessarily the full story - the size of a share market is not the most important consideration in an economy - see from Chart 18 how the BRIC market cap i.e. the combined value of all the shares listed on those markets has grown from about 1% of the world market cap in 2000 to its current level of 4%. Since 2003, when the current equity bull market began, the US's proportion of the world market cap has declined from 55% to less than 44%.

Chart 18: BRIC markets are increasingly important



Did you know that on 10 October the emerging market bull market celebrated its fifth anniversary? The significance of this event begs a moment to pause and consider some of the metrics surrounding the markets' movements during this period. Take a while to reflect on Table 2, which depicts some of the extraordinary movements in emerging markets and their sectors during the past five years. To place them in perspective, consider that at its low point on 10October 2002 the MSCI Emerging market index stood at 225 with a combined market cap (size) of $450bn. Today the same index is around the 1200 mark with a market cap of $3.3 trillion. What is less clear is that there has been strong leadership from certain sectors and emerging markets; the BRIC markets have led all emerging markets, and within the sectors clear leadership has emanated from infrastructure (via the industrial sector), consumer (via financials) and commodities (via the energy and material sectors).

Although we will deal with the SA context in more detail later in this Report, it is worth noting that the SA experience has been similar; these sectors have all been strong during this period, confirming once again that SA can be accurately categorized as an emerging market.

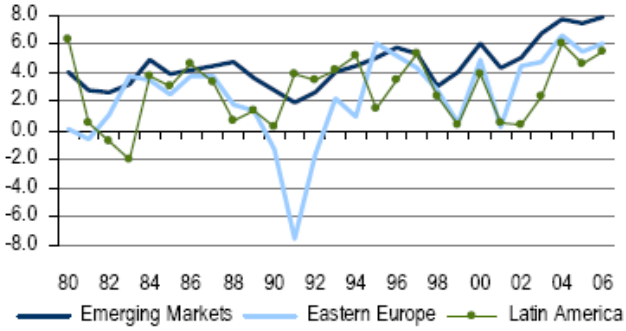
Table 2: MSCI Emerging Market market cap ($bn)

	10/10/2002	9/24/2007	% change
EM Regions			
BRIC	103.2	1,434.0	1290%
Latin America	77.5	645.3	732%
EM	454.3	3,270.7	620%
Asia	253.8	1,822.5	618%
EMEA	123.0	802.9	553%
EM Countries			
China	31.7	524.0	1554%
Brazil	26.1	384.1	1369%
Russia	23.8	299.3	1158%
India	21.6	226.7	951%
Indonesia	5.1	51.5	919%
Poland	5.7	56.2	883%
Turkey	5.9	55.1	835%
Taiwan	57.2	365.9	540%
Chile	7.2	44.9	525%
Thailand	7.9	44.9	470%
Korea	97.6	507.6	420%
Israel	16.5	72.4	338%
Mexico	39.3	165.0	320%
South Africa	60.0	227.6	279%
Malaysia	28.8	78.7	173%
EM Sectors			
Industrials	26.3	314.7	1099%
Energy	49.3	519.8	955%
Financials	78.9	700.6	787%
Materials	71.3	512.9	620%
Utilities	16.4	112.0	581%
Staples	26.2	154.4	488%
Telecom	60.8	357.1	488%
Discretionary	35.5	174.7	392%
Health Care	11.5	54.6	377%
Technology	78.1	369.9	374%

Although it is tempting to think of emerging markets as just those in Asia, remember that Africa, Eastern Europe and Latin America constitute a large portion of the emerging market universe, and have not been lagging in the metrics. Chart 19 depicts regional emerging market growth – it is clear that growth in non-Asian regions is still superior to that of the developed world.

Chart 19: Boom time for emerging markets

Real annual economic growth (%)



Let's return to the aspect of de-coupling and consider one of the main tenets underlying the fact that emerging markets are now less reliant on the US economy. Domestic demand is growing in emerging markets, and in many instances usurping the role once held by exports to the US. Table 3 provides evidence of how Asian growth is increasingly being driven by local needs and less and less by exports to the US in particular.

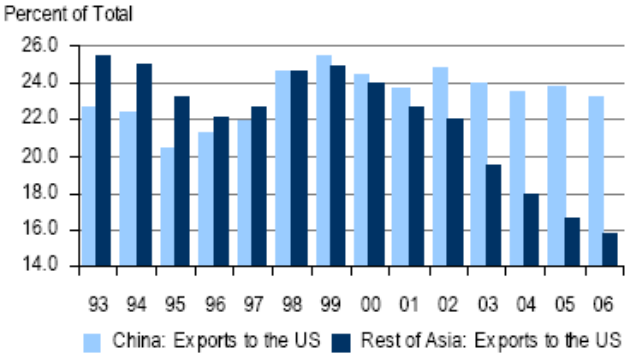
Table 3: Drivers of Asian's economic growth
Figures exclude Australia and China

	US$bn		Percent	Share of	Contribution to 1H07 GDP Growth
	1H06	1H07	Growth	GDP	(Percent of Total)
Nominal GDP	**1,536**	**1,758**	**14.4**	**100.0**	**100.0**
Total Exports	**606**	**671**	**10.7**	**38.2**	**28.3**
To China	85	99	16.2	5.6	6.3
To the EU	84	92	9.6	5.3	3.5
To Japan	55	58	4.4	3.3	1.0
To the US	89	91	2.7	5.2	1.0

Exports to the US constituted only 1% of Asian GDP (economic) growth in the first half of 2007. China and the EU are far more important to the rest of Asia in terms of growth. Exports to the US grew 2.7% in the first half of this year, whereas exports to China grew 16.2%, and to the EU 9.6%.

This is clearly depicted in Chart 20, which depicts both China and the rest of Asia's exports to the US. The trend is clear – less and less exports are flowing to the US; the latter is becoming less relevant to Asia as a source of economic activity and growth. That is not to say the US is unimportant – 22% of China's exports still go to the US. But the primary engine of growth is increasingly domestic orientated. What happens in the US is thus less and less influential on Asian and general emerging market growth.

Chart 20: Asian exports to the US continue to decline



Space precludes a more presentation of the detailed case for investment into emerging markets, but hopefully by now you are getting the picture? A final point that I draw your attention to and which is very relevant in the light of recent economic developments, is what is frequently referred to as "**the reflation trade**". For the record, we tend to go along with this view. The thinking underlying this view goes something like this: the consequence, albeit unintended, of monetary easing (the decline in interest rates) during previous credit crises in the late eighties and nineties was inflation rather than recession, and asset bubbles – Japanese equities in the late eighties and tech shares in the late nineties.

Fast forward to today: we have just experienced a (US) housing bubble on the back of easy monetary policy (a long period of low interest rates). That ended in the sub-prime mess we are now familiar with, thanks to the rise in US interest rates since 2005. However we are quite possibly entering another period of aggressive US interest rate cuts as the Fed struggles to reflate the US economy, stave off a recession and support the reeling US housing and credit markets. If that is the case, where is the next "bubble" going to be? It is not inconceivable, given the reasons listed above, that the "reflation trade" will find its way into emerging markets, leading to a final leg in the most spectacular emerging market bull market in our lifetime. As Merrill Lynch so succinctly point out, "its essentially 1998 in reverse: the credit problem is now in the US rather than emerging markets. Liquidity to ease the US credit problem will be redirected toward emerging markets just as liquidity to ease the Asia/Russia/ Long Term Capital Management problem was redirected toward tech". They go on to point out that, despite the huge rise in emerging markets in recent years, when measured against the historic norms of the end of bubbles, emerging markets still have a long way to rise before they enter the final stages and take on the typical characteristics of a full-blown bubble.

The above thinking explains very clearly why emerging markets rose so strongly after the Fed's rate cut on 18 September – they haven't really stopped rising since then. And if emerging markets are going to continue growing as they have done in the recent past – and there are practical and compelling reasons to expect their recent growth to continue – then commodities are going to be in great demand; all of which brings us full circle, back to **South Africa and its investment markets**.

It might seem rather irresponsible to focus so much on the global economy and relatively less on the SA economy. However, one of Maestro's core values is to focus on the *global* economy and recognise its importance as a determinant of returns on SA investment markets. I am sure you no longer need convincing that this value is an imperative for successful investment on the SA equity market. Just as we did during the second quarter last year, we have again, this very quarter, experienced significant turmoil on the SA equity market, the origins of which had nothing to do with local conditions and the causes of which were far removed from our shores. As a logical extension to this fact

comes the vital requirement of understanding the global economy and its future drivers when arriving at a view on the future of the SA equity market. And in that respect, the news is relatively good – at least from our vantage point.

In similar vein to other emerging markets, although to a lesser extent, the SA economy finds itself squeezed by rising consumer demand and a chronic shortage of proper infrastructure. Consequently, the SA government has embarked on an ambitious plan to spend around R400bn on infrastructure in the next three years. We have already seen the effects of this on sectors such as the construction sector. This plan is irreversible – hence my comment above about their being "compelling reasons" to expect growth in emerging markets to continue. And it does not take into account spending by the *private sector*, which will ultimately *far exceed* the spending by government. Already Transnet, SAA and Eskom, to mention but a few, have announced aggressively plans to expand capacity. Eskom alone plans to spend R150bn in the next five years installing new capacity. I recently read a research report that estimated Eskom would need to spend R1.2 trillion between 2007 and 2025 to fulfil their plans – and even then there would still be insufficient electricity capacity to meet demand! The point I would make is that much of this capacity is not optional. As we all know, having experienced daily traffic jams and power outages, installing the capacity is not an option – it is an economic imperative in order for our country to just keep up – let alone move ahead of – the rest of the world.

Sure, there are risks. What would the activity of investment be without having to take risks? Many of the major risks, however, have been reduced by the "emerging market era" we currently find ourselves in and for which all South Africans should be extremely grateful! Maestro sees it as our part of our mandate to monitor these risks, to the best of our abilities, in an effort to protect your investments and increase their value.

With that in mind we list below some of the immediate risks to the market as we see them. We will be monitoring them in the coming months as they could in one way or another de-rail what we still believe to be a supportive economic backdrop to further gains in the SA equity markets. We will focus here on the local risks, rather than try to list all the risks in the global environment:

- *Political instability* ahead of and surrounding the ANC's elections in December
- This may lead to *a weaker rand*, if only in the short-term, which will only add to inflation pressures in the short term although it will provide some relief for the export sector
- *An over-enthusiastic Reserve Bank governor* who may, in seeking to curb consumer demand, kill the proverbial goose that has laid a couple of "black diamonds". While we are sympathetic to his mandate to keep inflation within a pre-determined range, the two leading constituents driving prices higher, food and oil, are beyond his control and are not a function of excessive consumer demand. The current inflationary pressures are "supply-side" driven, as opposed to being "demand-led" – raising rates is hardly going to bring the price of oil and food down. It may well be that we need to endure slightly higher inflation for the time being, if that is the price we have to pay for ongoing job creation, economic growth and social stability
- *Another unexpected external shock*, more than likely from abroad. This is the hardest risk factor of all; such events are by their nature unpredictable and hard to quantify at the time of the event.
- *A rampant oil price*; as we have indicated earlier in this report, a $100 a barrel oil price before the end of the year looks increasingly possible
- *A setback in the global attitude towards emerging markets*. No, this is not a contradiction of what we said earlier about emerging markets, it is an indication that we *do* have our feet on the ground and are not unaware of how much emerging markets have risen in recent years and weeks. Their huge gains since the September Fed rate cut render them vulnerable to a short-term correction, which these days seem to happen with lightning speed and devastating consequences if you misread the event, no matter how good your intentions.

These are by no means all the risks, but they are some of those that are on Maestro's radar screen. On a more positive note, the favourable structural changes to the economy and the supportive earnings environment, coupled with the fact that the majority of our market is not expensive in historic terms, underscores our continued preference for equities as the asset class we believe will deliver the best returns during the year ahead.

It would be naïve to expect a repeat of the mouth-watering returns investors have experienced in the past few years. As we have been doing for some time, so far in a rather misplaced fashion, we continue to tone down *unreasonable expectations* for excessive equity returns. However, we do believe that equities will generate respectable and real i.e. in excess of inflation, returns for some time to come.

8. Closing remarks

The past quarter has been a significant one in many ways. Apart from the challenges the markets have thrown at us, we also had Otto and Tracy leave and Vicki join the team. We launched the Maestro Long Short Equity Fund in the most trying of market conditions – it nevertheless delivered a positive return during the September quarter – which brought with it a reasonable amount of once-off "set-up" work, which is now behind us.

Despite all of the above, we find the developments within the global economy and the current state of the investment environment absolutely fascinating. We are learning a lot each day and are having lots of fun in the process. It is gratifying to report that all of the funds under Maestro's management are performing well. It is also fitting to note that without your ongoing friendship and confidence in us, none of this would be possible. Consequently, on behalf of the whole Maestro team, I thank you for support and loyalty. We don't take it lightly or for granted, and we look forward to being of further service to you throughout the remainder of the year.

Andre Joubert
19 October 2007

20th Anniversary of the 1987 stock market crash