MAESTRO
Equity Fund

PRESCIENT
MANAGEMENT COMPANY

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

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

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

FEE STRUCTURE
The maximum initial fee is 2.0%. The investment management fee is 1.75% per annum. The *annual* total expense ratio (TER) for 2008 in respect of class A was 2.17%.

FUND SIZE: R19 843 169

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

ENQUIRIES
Maestro Investment Consulting
Box 1289
CAPE TOWN
8000

Fax: 021 674 3209
Email: equityfund@maestroinvestment.co.za

The Maestro Equity Fund

Quarterly report for the period ended

30 September 2008

1. Introduction

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

2. The investment position of your portfolio

The Fund's sector allocation is shown in Chart 1. Exposure to the resource sector totalled 27.7% of the Fund, down from 37.0% in June. Financial exposure rose 4.1% to 12.1% and industrial exposure rose from 46.6% to 50.0%. Cash represented 10.2% of the Fund, up from 8.5% at the end of June.

Chart 1: Asset allocation at 30 September 2008

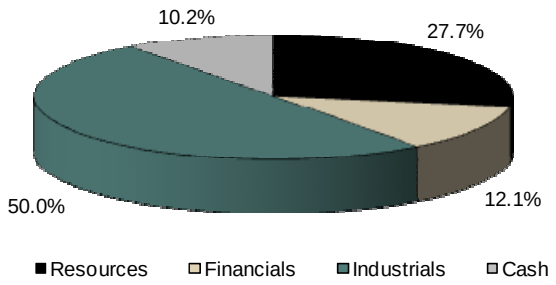
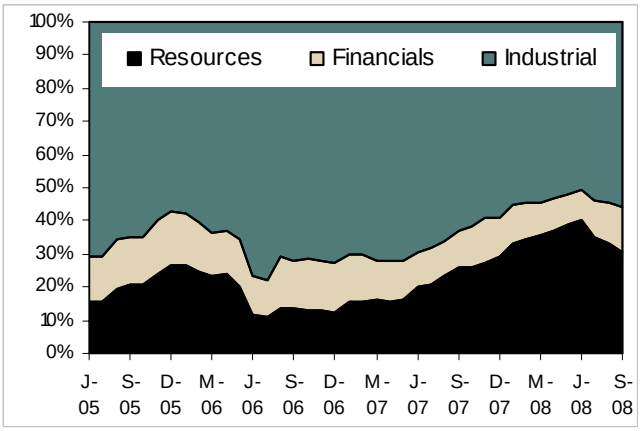


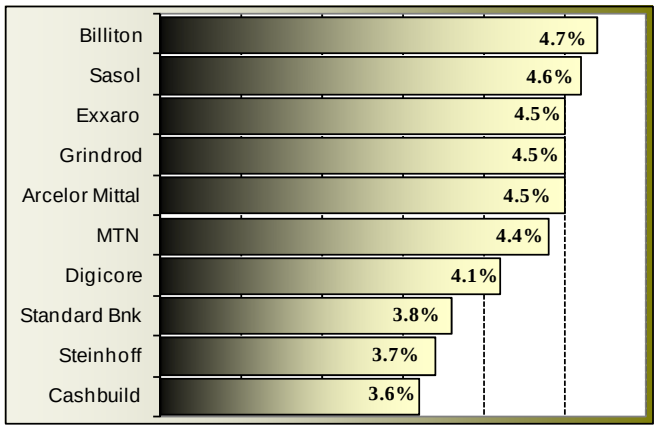
Chart 2 depicts the historical allocation to the three major sectors of the equity market, expressed as a percentage of the equity portion of the Fund.

Chart 2: Sector exposure at 30 September 2008



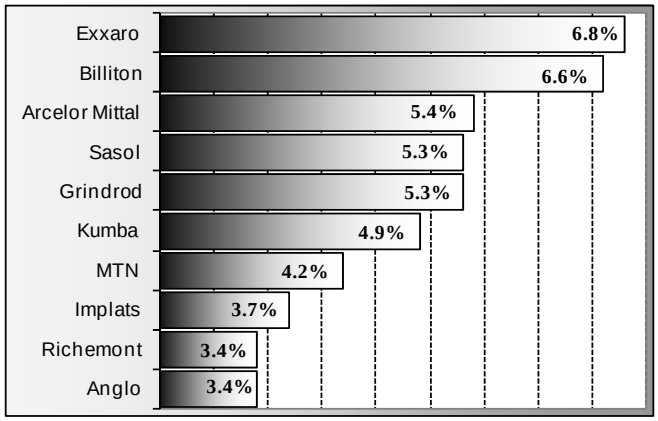
3. **The largest equity holdings**
The largest holdings at 30 September are listed in Chart 3, expressed as a percentage of the equity portfolio.

Chart 3: The largest holdings at 30 September 2008



The largest holdings at the end of June are listed in Chart 4. During the quarter Digicore, Steinhoff, Standard Bank and Cashbuild displaced Anglo, Kumba, Implats and Richemont in the largest holdings. At the end of September there were 29 counters in the Fund, down from 31 in June, the ten largest of which constituted 42.4% of the equity portfolio, down from 49.0% in June.

Chart 4: The largest holdings at 30 June 2008

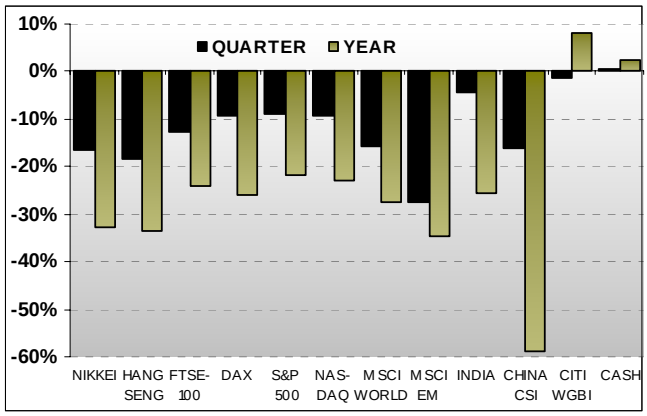


4. **Recent activity on the portfolio**
The investment objective on this portfolio is to *achieve long-term growth through the assumption of moderate risk.* It is against this objective that the activities and performance of the portfolio should be assessed.

During the quarter the Amaps, Richemont and Telkom were sold out of the Fund. Merafe Resources was introduced into the Fund and the holdings in Dawn, Digicore, Firstrand, Grindrod, Metmar, Iliad and Investec were increased.

5. **A review of the recent investment environment**
I refer you to the past few editions of *Intermezzo*, specifically the October edition wherein we covered recent events in investment markets in some detail. I don't want to repeat what we have said but would like to use this Report to document a synoptic review of events, using charts to share the drama that has plagued and characterized markets during the past nine months. Let's first consider the returns of the past quarter and year, some of which are listed in the Chart below.

Chart 5: Global market returns to 30 September 2008



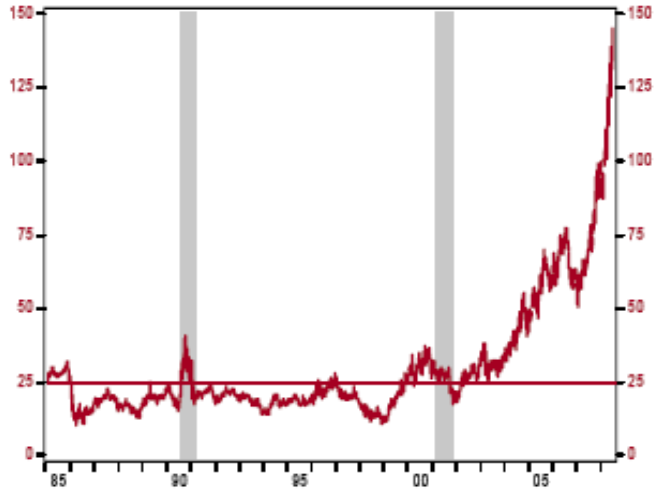
With the exception of bonds, which rose 8.0% in the past year, *all global asset classes declined during the quarter and year*. Despite its terrible contents, the chart hides even greater trauma on individual markets, particularly emerging ones. Markets have declined much further in October and I refer you to the usual table at the end of *Intermezzo* each month, which lists the MSCI emerging market indices. **Be warned: the annual returns to end-October are going to look *very ugly*!**

Let us review some of the events and characteristics of the past quarter. I will keep it brief but of course you are more than welcome to contact any of us in the office to discuss these matters in more detail.

The initial "trip wire" for the credit crisis started in July 2007 with the sub-prime mess in the US; banks and other financial institutions lent money to borrowers who had no hope of repaying the debt. Worse still, the debt was extended on the basis of inflated property prices (house prices in particular) and this debt, which was clearly of suspect quality, was then sold on to investors in highly leveraged structures. As house prices began to fall, so sub-prime borrowers started defaulting. This started a domino effect which culminated, after much pain and loss, in banks suspending their lending to each other and forcing government intervention across the world on an unprecedented scale. The rest, as they say in the classics, "is history."

In the turmoil leading up to the mayhem in the third quarter and into October, you will recall from the June Quarterly Report that, as though there was not enough to be concerned about, a new, ***second***, crisis arose in the form of a surge in the oil price. It rose 39.4% during the June quarter, touching $147 at one stage. Chart 6 shows the extent of the rise at that time.

Chart 6: The oil price rise to June 2008

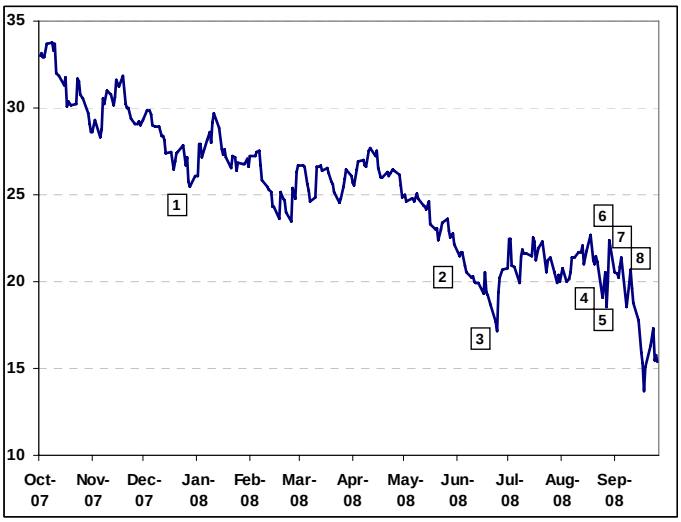


Source: Merrill Lynch

Why this crisis was so destructive was that the higher oil price caused food and energy prices to soar, pushing up inflation around the world and forcing central banks to keep interest rates at their prevailing high levels or increase them even further. Naturally, this was exactly the *opposite* of what was required to quell the first crisis, being the credit crunch and the seizure of liquidity.

The first sign of a breakdown in the financial system, and here I am not referring to the sub-prime crisis but the ***third*** crisis of systemic global financial failure, became apparent in July and August but really came to a head in September. Investment bank Bear Sterns had collapsed in March. But in early September when questions were asked about the health of Freddie Mac and Fannie Mae, investors sat up and took notice of the problem. After all, these two government sponsored enterprises (GSEs) had assets (of unknown quality due to the sub-prime problem) of $6 trillion between the two of them. It was unlikely that the US government would be able to prevent them from going under – the numbers were simply too large. Yet Freddie and Fannie's debt traded at a similar credit rating as that of the US government because it was seen as being backed by the US government. The fact that the bulk of Freddie and Fannie debt (their bonds) are held by foreign (principally Asian) investors simply added to the complexity of the problem. On 15 July the government explicitly stated that they would honour Freddie and Fannie debt, but shares of the two GSEs continued their precipitous decline en route to an eventual collapse. In response, on 7 September the US government injected $100bn into each GSE, much to the shock of the purists. The terms of the deal were such that the remaining equity of the two entities (which was by now very little) was obliterated. Think of the implication of this action: the US government was nationalizing two huge financial entities and simply ignoring the interests of private investors. Is it no wonder that private investors began to fear the worst, knowing that many banks, especially US ones, were in a really bad way? After all, one of the biggest banks in the US, Indy Mac, had collapsed in mid-July – how safe were all the others?

Chart 7: Developing demise of the financial landscape
The S&P Financial exchange traded fund (XLF)

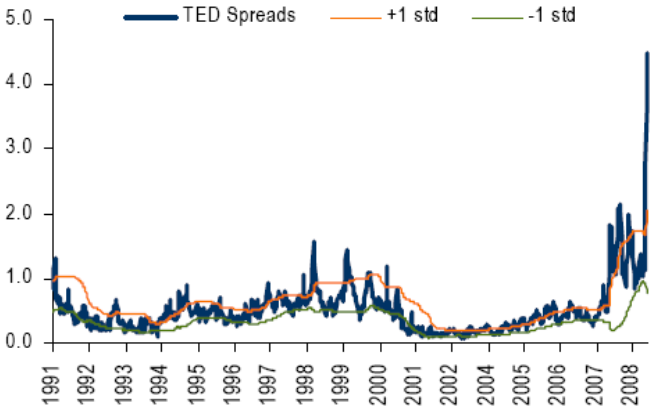


Notes:
1. Bear Sterns collapses
2. Concerns mount about Freddie Mac and Fannie Mae
3. Freddie and Fannie are nationalized
4. Lehman Brothers collapses
5. TARP is mooted
6. AIG is nationalized
7. WaMu collapses
8. Congress fails to ratify TARP

Retail investors began to get edgy too – was their money safe? More importantly, why were they being asked to bail out institutions seen as "fat cats" that had enjoyed years of excess and "good times"? That placed a lot of pressure on the politicians and this may well have had something to do with the fact that, when US investment bank Lehman Brothers ran into serious trouble and was well on the way to bankruptcy, they stood back and let it fail. This is perhaps a bit harsh; the authorities did not let Lehman Brothers fail. It failed due to its reckless trading practices, compounded by the change in sentiment and squeeze on its funding, but history will probably only record the authorities' unwillingness to rescue Lehman. Be that as it may, the collapse of Lehman is already being seen as a massive failure on the part of regulators and

authorities to appreciate how inextricably linked the financial system was and is. Lehman's collapse triggered shockwaves through the global banking system, trapping billions of dollars in the organization - Lehman was one of the world's biggest prime brokers and clearers for the derivative industry. This spread panic in banking circles, which effectively led to the suspension of what little interbank lending was still taking place. Banks simply stopped trusting each other.

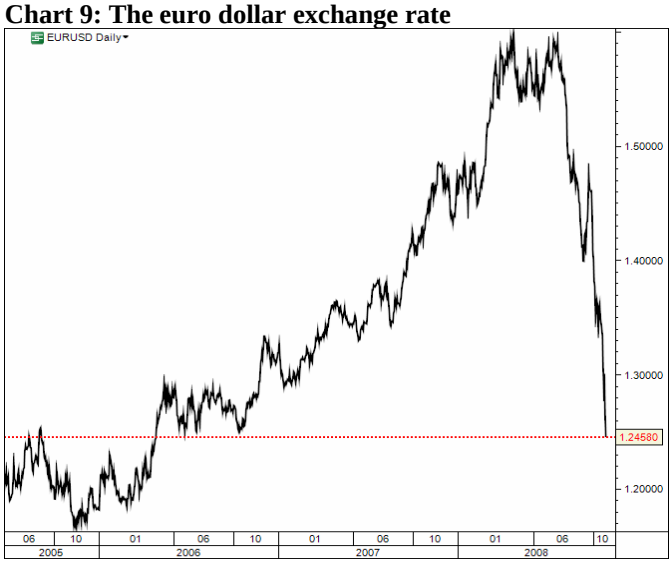
Chart 8: The "TED spread" – interbank lending soars



Source: Merrill Lynch

Without going into detail (the detail is contained in the October edition of *Intermezzo*) suffice is to say that the cost of interbank lending soared – refer to Chart 8, which depicts the "TED spread" being the difference between Libor and 3-month US Treasury bills and is an indication of the cost of interbank lending. The dramatic rise in the cost of this lending hastened the systemic seizure of all money markets in September. This led directly to bank failures around the world, government bale-outs, nationalizations and other actions, symptoms and casualties which we will most surely read about in history books for years to come.

Chart 9: The euro dollar exchange rate



Source: Saxo Bank

It is important to point out that the financial crisis had a profound impact on all other assets classes – hence our frequent comment that there has been "no place to hide." Let me list a sample of these. *Firstly*, although we find it hard to understand, apart from the superficial explanation of a "flight to quality," the dollar has surged against all currencies. The rand, euro and pound declined 5.5%, 10.9% and 10.4% respectively against the dollar during the quarter. They have declined significantly more during October. (At the time of writing these three currencies had weakened 26.3%, 8.5% and 8.8% in the first three weeks of October). Chart 9 depicts how sharply the euro has fallen against the dollar – back to April 2006 levels.

Chart 10: The rand dollar exchange rate

Source: Saxo Bank

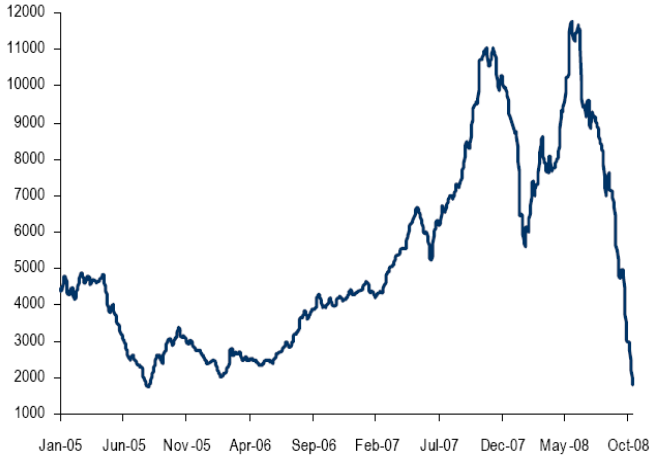
Chart 10 shows how the rand has fallen (the higher the line, the more rand one needs to buy a dollar). Chart 11 shows sterling versus the dollar; sterling has declined more than most "hard" currencies on the back of the evidence that the UK is already in recession and is set to lower interest rates substantially.

Chart 11: The sterling dollar exchange rate

Source: Saxo Bank

Secondly, the strong dollar and the fear of a global recession weighed heavily on the prices of commodities across the board. From soft commodities (food and grains) to hard commodities (metals), from related prices such as shipping rates to "new age" commodities such as DRAM and microchips, prices have collapsed. As a generalization, commodity prices have fallen about 50% on average from their peak levels in the past year. Some declines have been more severe, such as the Baltic Dry index, which depicts shipping rates for to dry goods (iron ore, coal, etc), shown in Chart 12. In case you don't fully appreciate the extent of the decline, the index has fallen about 91% from its peak reached only five months ago. This will give you an indication of just how severe and ferocious *the speed of change* has been – we have never experienced anything quite like it!

Chart 12: The Baltic Dry index



Source: Merrill Lynch

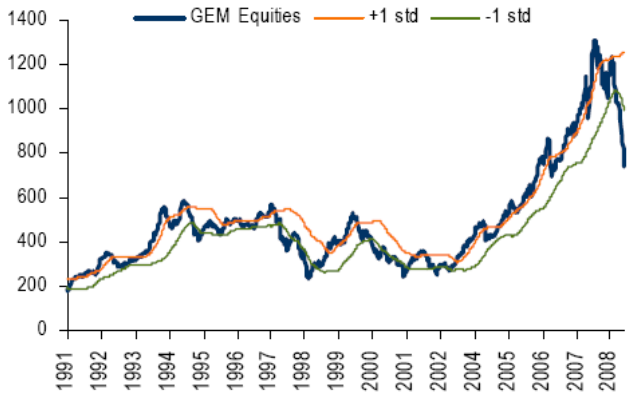
Of course, the price of oil has also declined sharply – at the time of writing it is off 58% from its peak of $147. Consequently, the second crisis to befall the world this year, namely the energy crisis of the second quarter, has neatly been dispatched to the history books – at least for the time being.

Thirdly, a combination of the currency and commodity price declines has brought problems of their own, specifically to some nations. The October edition of *Intermezzo* highlighted the plight of Russia and Iceland. Other countries have suffered similar fates, including Hungary, Malaysia and Ukraine. At the time of writing Argentina seems set to default on its debt, despite having just seized $29bn of private pension funds in an effort to preserve foreign currency and secure cheap funding. It is easy to document these events, but we should bear in mind that each situation means a lot of hardship for millions of people in their daily lives, people who had very little to do with the excesses of Wall Street or the US consumers. Consequently it is not unrealistic to expect a complete reassessment of "free market Capitalism" as we knew it only last year. The crises we are living through will change the world and its ideology and will accelerate the shift in power from the West to the East. We don't quite know what that means right now, but it will surely become apparent in the next few years and will result in a very different world from the one we grew familiar with and benefited from in the first seven years of the New Millennium.

But I digress; back to the September quarter and some of the effects of the financial crisis. *Fourthly*, to state the obvious, the global financial crisis had a profound effect of the world's equity markets, all of which declined sharply across every sector and industry. We expected emerging markets to survive the global economic slowdown better than developed markets, but we did not contemplate the effect on them of a full blown systemic meltdown. The effect has been severe, as can be seen from Chart 13, which shows how sharp the declines in the MSCI Emerging market index have been. Chart 5 showed the quarterly markets declines, but please remember that during the first three weeks of October alone all equity markets have declined *by much greater amounts*. This much will be evident in future correspondence from us.

Chart 13: Not much emergence here of late

The MSCI Emerging market index

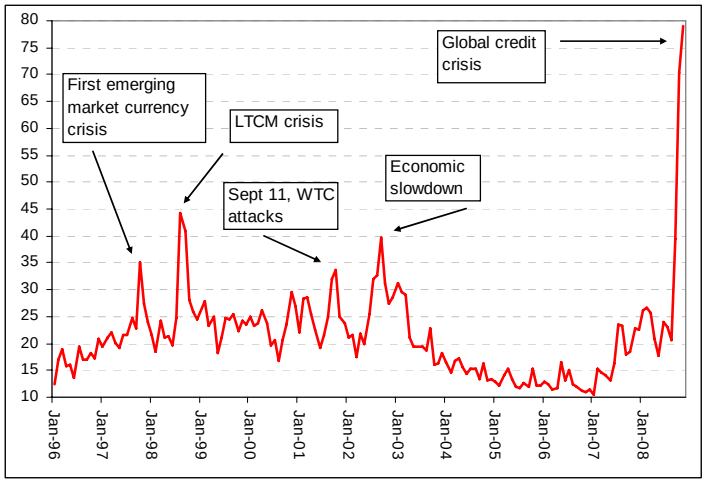


Source: Merrill Lynch

We would still argue that many, though not all, emerging economies are weathering the crisis better than developed one. After all, China and India are forecast to grow 9% and 7% in the coming year, whereas the UK, EU and US are likely to be in recession for most of 2009. What we failed to appreciate though, was that although *economic* de-coupling has occurred, *financial* de-coupling has not. The respective emerging market *economies* are doing better but their *stock markets* are not. A feature of the declines has been a "flight to quality." Investors have fled from anything emerging market-related, into the dollar and yen. The risk aversion has extended to currency markets as well, which goes some way to explaining the sharp declines in emerging currencies, including the rand. In the past we have referred you to the Vix index, which is the implied volatility on the S&P500 future contract - in layman's terms it is a measure of volatility in the US

equity market. It is often called the "fear gauge" due to its close correlation with investor sentiment, particularly during times of crisis. Chart 14 depicts the behaviour of the Vix index over the past decade. You can see that in the current crisis the index has risen significantly higher than it went during any previous dislocations in the market, including the Long Term Capital Management (LTCM) and emerging market currency crisis of August 1998, the September 11 World Trade Centre (WTC) attacks and the 2002 economic slowdown. The chart shows the extent of the unprecedented turmoil of the current financial crisis and the systemic risk to which the world has succumbed.

Chart 14: The Vix index - levels never seen before

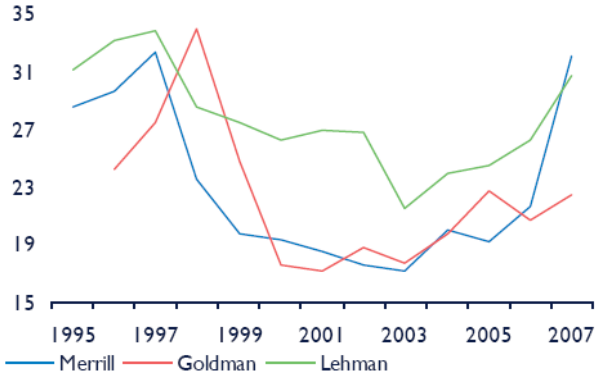


As a *final* comment on the past quarter's unique events, remember that the crisis has been compounded by two other factors, namely the prospects of a sharp slowdown in the global economy and the US in particular, and the fact that, to start off with, financial markets and many of their participants were characterized by massive leverage. The leverage of at least three agents contributed to the base off which the credit crisis imploded. What was already a bad situation was made significantly worse by the amount of times existing capital had been multiplied by banks (on their balance sheets), hedge funds (in their day-to-day operations) and US consumers (in the lifestyles they had grown accustom to in the past decade or more). When the credit crisis started gaining traction in the second half of 2007, following the first cracks in the sub-prime markets, these agents started de-leveraging i.e. selling down their debt, which contributed to the momentum and ferocity of the price declines across all asset classes, from commodities to equities to US and UK house prices.

A couple of charts on the extent of this leverage follow: we begin with an example of the leverage (gearing) of US investment banks, who have been one of the main culprits in recent years. The de-leveraging process after the bursting of the Tech Bubble in 2000 is apparent from Chart 15, as is the extent to which their leverage increased again in the past seven or so years. By the end of 2007 Merrill Lynch and Lehman Brothers had multiplied their equity by about 31 times; for every $1m of share capital they had, the lent out $31m. Is it any wonder that we have seen the demise of investment banks in the past year?

Chart 15: US investment bank leverage

Ratio of assets to equity (times)

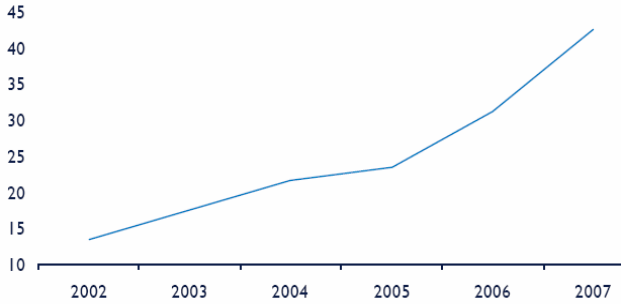


Source: Investec Securities

Another chart worth showing is that of the outstanding over-the-counter (OTC) derivatives i.e. derivatives that are not traded on major exchanges, expressed as a multiple of the US economy. The chart is based on data provided by the Bank of International Settlements (BIS).

Chart 16: Total outstanding OTC derivatives contracts

Multiple of US GDP (times)



Source: Investec Securities

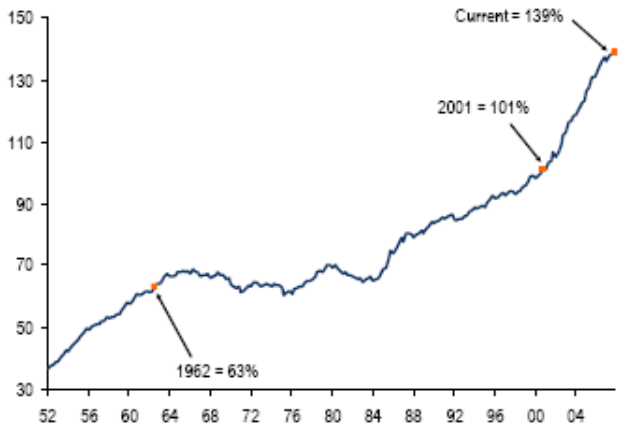
The next chart shows the US consumer, who has steadily increased his spending in the past decades. Chart 17 shows this spending as a portion of the US economy – it has been on a steady trend since 1966 and has never been higher than it is at present.

Chart 17: US consumer spending as a share of GDP

Source: Merrill Lynch

We included the next chart in the April's *Intermezzo* but it is worth revisiting here – see firstly how US household debt has grown since the mid-1950s and secondly how the *rate of growth* has accelerated i.e. see how steep the line gets from the beginning of the 21st century.

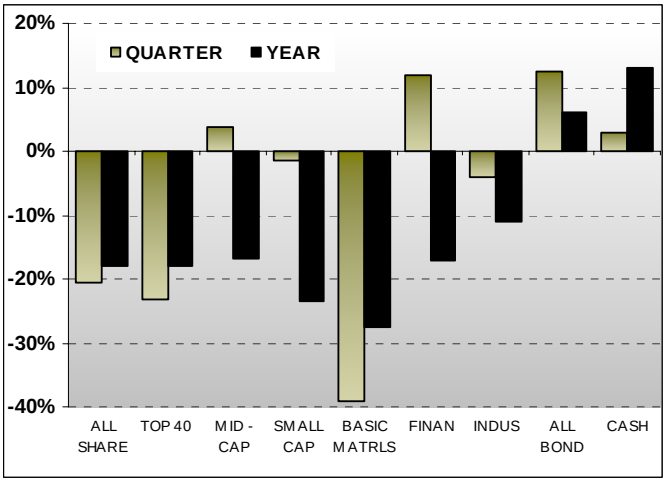
Chart 18: US household debt-to-income ratio (%)



Source: Merrill Lynch

The last chart we need to review in this section is one that depicts the returns of the SA markets. It is worth pointing out that despite the recent trauma, the financial and mid-cap sectors posted positive returns during the quarter. Unfortunately, these have been more than reversed in October. Note how weak the basic materials sector has been – it declined 39.2% during the quarter - despite the weak rand, which declined 5.5% during the quarter.

Chart 19: SA market returns to 30 September 2008

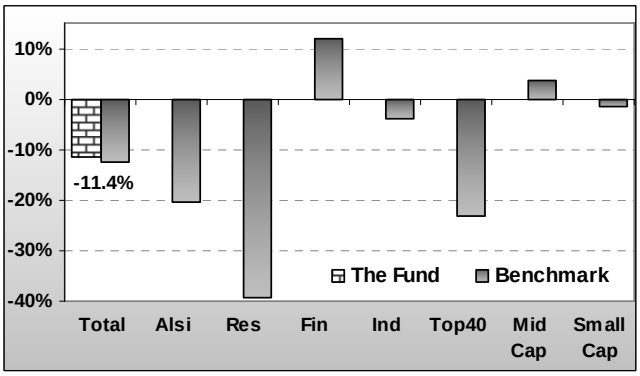


In summary, the past quarter and into October has been one of the most dramatic and volatile periods in living memory. It has seen history being re-written on a daily basis and the global financial landscape as we knew it changed in unprecedented fashion and in lightening speed. It is against this background that you should evaluate the investment returns of your portfolio.

6. The performance of the Fund

Turning to the performance of the Fund Chart 20 depicts the returns for the quarter as well as those of the major indices.

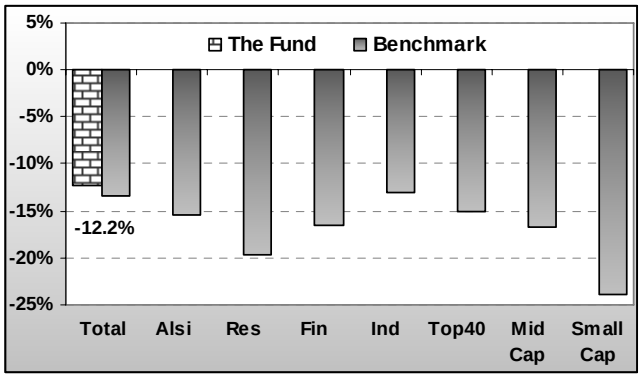
Chart 20: Quarterly returns to 30 September 2008



The un-annualised return on the total Fund during the September quarter was -11.4% which can be measured against the returns of the Maestro equity benchmark and All share index of -12.5% and -20.5% respectively. Despite the weak rand the basic materials sector was severely impacted by the events described above. Concerns about the effects of a global economic slowdown translated into a speedy and severe decline in commodity prices, which had a very negative effect on material shares. The decline should be seen in the context of the previous quarterly returns from this sector of 17.9% in March and 12.1% in June. Compare this to the quarter returns of the financial sector of -12.8% to March

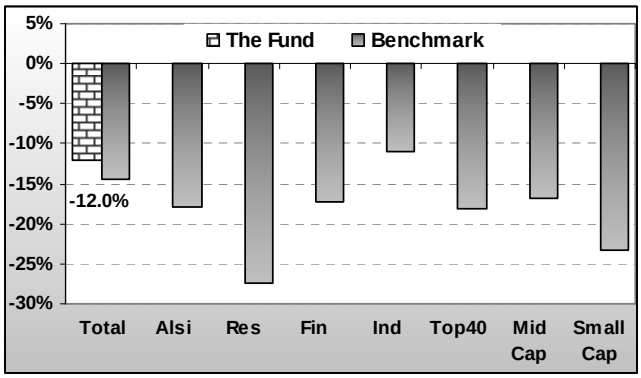
and -14.5% for the June quarter, and you will understand why the September quarterly return for financials was positive at 11.8%. For the record, the September quarterly returns for the mid and small cap sector were 3.6% and -1.5% respectively. The returns of some of the largest holdings during the quarter were Billiton -36.6% (up 24.0% last quarter), Sasol -24.1% (18.6%), Exxaro -50.0% (30.9%), Grindrod -32.2% (19.1%) and Arcelor Mittal -26.5% (13.2%).

Chart 21: Year-to-date returns to 30 September 2008



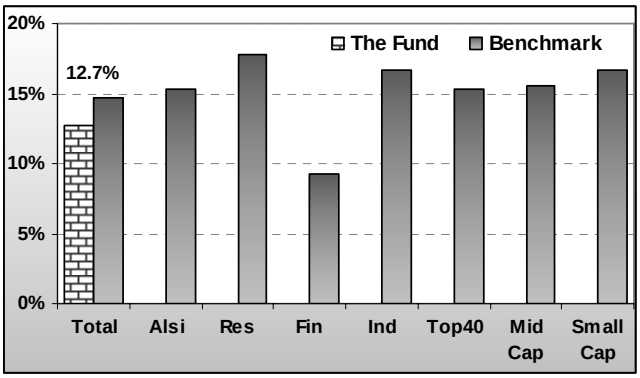
The un-annualised year-to-date returns for the nine months to end-September are shown in Chart 21. ***The return of the total Fund was 12.2*** which can be measured against the respective returns of the Maestro equity benchmark and All share index of -13.4% and -15.5%. It is clear that the period has been a negative one on the SA equity market, with all indices firmly in negative territory. The basic materials sector declined 19.7% over the period and the financial and industrial indices 16.6% and 13.1% respectively over this period. The mid and small cap indices declined 16.7% and 23.9%.

Chart 21: Annual return to 30 September 2008



The annual returns are shown in Chart 22. ***The return of the total Fund for the year to 30 September was -12.0%.*** Inflation rose 13.7% during this period and the All bond index 6.0%. This can be compared to the Maestro equity benchmark return of -14.4% as well as the All Share Index of -18.0%. The following example will give you an idea of how rapidly the sectors in the market have changed as well as the extent of that change: in the June Quarterly Report, only three months ago, I reported that the annual return of the basic materials sector was 34.5% and that of the financial index -27.2%. I highlighted the extreme nature of this dichotomy – a difference of 61.7% between the two sectors in only one year. Well, consider the returns only three months later: the basic material sector lost 27.5% and financials 17.3% i.e. the former index experienced an annual turnaround of 62% in just three months – and this in the face of a weak rand. For the record the mid cap index, not shown in the chart, declined 16.8% during the period and the small cap index 23.4%. The main detractors from the Fund's returns during the year were Iliad *down* 52.5%, Anglo 39.2%, Jasco 35.9% and Investec 35.8%. The main contributors were Aspen 26.8%, Arcelor Mittal 19.7%, Sasol 18.2% and MTN 10.0%.

Chart 23: CAR: 3-year period to 30 September 2008



The compound annual return (CAR) of the Fund over the three-year period ended 30 September, shown in Chart 23 ***was 12.7% per annum***; it can be compared to the returns over the same period of the Maestro equity benchmark of 14.7% and the All Share Index's 15.4%. Unlike markets offshore, the SA equity market's returns over the three-year period are still positive, although this is likely to change by the end of this year. The CARs for the large (Top40), mid and small cap indices to September, not shown in the chart, are 15.3%, 15.6% and 16.7% respectively. Bonds and cash delivered respective returns of 15.4% and 9.9% over the same period.

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

Sadly, *for the third successive quarter* it is necessary to start this section of the Report in the following way: "it seems almost futile to think of forecasts when markets are so volatile and beset by such unprecedented events. Markets tried in vain to overcome the negative factors midway through the June quarter (in this case the September quarter); *at the time of writing markets are again heading sharply lower*."

You don't need me to tell you that we are in the midst of an awful global financial crisis. But it makes Maestro's task of presenting a coherent and accurate

assessment of the near to medium-term future extremely difficult. One of the most challenging aspects of the investment profession is that we can be accurately measured and our views and forecasts measured against subsequent events to test their accuracy and our understanding of the investment environment. All of this takes place in a world of rapid change, great uncertainty and utter dependence of outside factors to "make it all happen" i.e. we have no control over the environment. Moreover, when the environment is particularly difficult, as it has been throughout the past year and is likely to continue for the year ahead, it is easy to abrogate responsibility for our actions. Yet we also are quick to claim our successes as the result of our ability, when in most cases it is the result of market conditions. As a fund manager recently said "we confuse the trend with skill."

Why all this philosophizing? Because it is at this stage that we need to look forward in order to best position your investments for the future; that is the task we have been mandated to achieve for you. The problem is that, right now, we really don't know what the immediate future holds. This might seem a terrible admission, but Maestro is completely committed to honesty and is very wary of being seen as arrogant and haughty, particularly in times such as this. Don't be mistaken, we have views on what we think will happen – it's just that we are not sure how valuable those views are right now. As I said earlier, it is only in the future that we will know how valuable those views are, but we continue to believe, based on the 65 years of cumulative experience in the Maestro team and on the returns that we have generated in the past few years on your portfolio, that we can add value to your portfolio and justify our role – even if this role is only apparent over the medium to long term.

The purpose of this Report is to look backwards, with crystallized accuracy and also to look forwards, albeit it through a murky, dark mirror. As you can imagine the past few months have been accompanied by a deep questioning of our views, of the ways in which markets are working i.e. are they efficient at present, and what the future holds. Of course, there has also been much stress and very long hours in the Maestro office. The turbulent and unique environment has resulted in many traditional relationships that could be relied on with great certainty, either not working properly or simply being blown apart. The past is now, quite literally, not what it used to be. For example, one particular global hedge fund we follow (we have not invested any assets in it though) is based on a quantitative model which relies on the "proven" historic relationship between the estimates of corporate earnings and subsequent share price performance (that's my simple explanation of what is a rather complicated process). Historically the Fund's performance has been average and relatively stable, proof surely, that the "model" works. Well, that Fund simply imploded in September, delivering a *monthly* return of -21.8%; indication, I would suggest, of the dislocation in the market at present due to the financial crisis. Gold has declined sharply despite its reputation (though not regarded as such by Maestro) as a store of value. Valuation is being totally disregarded: the Russian oil giant, Gazprom, until recently one of the largest companies in the world, last week reported a 32% increase in quarterly profits to $10.8bn, yet its share price is 76.4% off its May peak and the company trades on a PE ratio of only 2.5 times next year's earnings. Only three months ago, investors couldn't buy enough Gazprom shares. Despite a huge increase in debt and an unprecedented looming budget deficit in the next few years, the dollar has surged instead of weakened. SA's resource share prices have collapsed despite a simultaneous collapse in the rand – these are just some of the anomalies present in the market which render any attempt to forecast future market behaviour rather futile.

With that in mind, last quarter we were brave or perhaps foolish enough to share some of our expectations. Let's review them very briefly, before we review what we listed as possible catalysts for an end to the then-prevailing market mayhem (which of course has only got worse).

- *Continuation of the credit crisis*: we suggested the crisis would continue, which it has, but we totally underestimated the systemic failure that has occurred since September and the enormous destruction of value that accompanied it.
- *Continuation of the energy crisis*: we suggested that high oil prices would continue and in this respect we were totally wrong. Such has been the force of demand destruction wrought by the financial meltdown that the oil price has declined more than 40% from its May peak, exacerbating the declines of major equity indices.
- *Rising inflation*: we suggested that pricing pressure would continue although noted that governments had taken substantial action to arrest the sharp price increases. In this regard, we were correct although we didn't anticipate the severe price declines across the commodity complex.
- *US inflation*: we noted in particular that inflation was not a problem in the US. If anything deflation was soon to become an even greater problem. In this respect we were correct: US inflation has registered three consecutive monthly declines and we suspect that is only the beginning. *We think deflation in the US is in the process of becoming one of the next major problems in the global economy*.

- *Global currencies*: partly based on our view of US deflation and a rising budget deficit, we suggested that the dollar would remain inherently weak. To be honest we still believe this to be the case, but in the short-term we have been horribly wrong. The dollar rose 12.2% and 11.7% against the euro and sterling in the September quarter and has gained another 10.2% and 10.7% respectively so far in October; these are extreme moves in the currency market. For the immediate future and as a function of the current crisis we now expect the dollar to remain firm, although this doesn't detract from our humble view that in due course the dollar will resume it weak trend.
- *Global interest rate developments*: we suspected that the ECB would retain a firm bias and that the BoE would lower UK rates. Both of these happened although in the face of enormous political pressure and collapsing markets interest rates have been cut across the globe. We suspect they will continue to be reduced in the coming months.

Table 1: Selected growth and inflation forecasts

	Real GDP % growth[b]			Consumer Prices % growth[c]		
	2007	2008F	2009F	2007	2008F	2009F
US	2.0	1.1	-1.0	2.9	4.6	2.3
Japan	2.0	0.1	-1.2	0.0	1.5	0.1
Euroland	2.6	0.9	-1.4	2.1	3.4	1.4
Germany	2.6	1.4	-1.5	2.3	3.0	1.0
France	2.1	0.7	-1.2	1.6	3.3	1.0
Italy	1.4	-0.1	-1.0	2.0	3.5	1.6
Spain	3.7	1.2	-2.0	2.8	4.3	2.0
UK	3.0	0.9	-1.7	2.3	3.8	2.8
Sweden	2.9	0.7	-0.8	2.2	3.7	2.2
Denmark	1.7	-0.2	-1.4	1.7	3.3	1.0
Norway	3.7	2.0	-1.4	0.7	3.8	2.6

Source: Deutsche Bank

- *US recession:* for a long time - since the beginning of this year if my memory serves me correctly – we have held the view that the US economy is heading for a recession; it probably started at the beginning of this year. This view is now widely shared, the only disagreement being the extent and duration of the recession – we suspect it will be deeper and longer than most investors believe. Table 1, for example, lists a selection of forecasts. Note the 2009 forecasts – they have been revised lower and *are now all negative*. Of course, that's not the full story, as Table 2 shows. Asian and other countries should help to keep the global economy out of recession. Note the G7's expected growth for 2008 and 2009 or 0.8% and -1.1% respectively versus the total global (world) growth of 3.2% and 1.2%. Thank heavens for emerging markets!

Table 2: Selected growth and inflation forecasts

	Real GDP % growth			Consumer Prices % growth		
	2007	2008F	2009F	2007	2008F	2009F
Asia (ex Japan)	9.4	7.6	5.7	4.4	7.3	4.1
India	9.3	7.7	6.0	4.6	9.6	5.3
China	11.9	9.8	8.0	4.8	6.3	2.8
Latin America	5.4	4.3	2.3	6.2	8.7	6.9
Brazil	5.4	5.2	2.9	4.5	6.2	5.0
EMEA	6.6	5.4	3.2	9.5	11.8	9.3
Russia	8.1	6.9	3.4	11.9	14.1	10.5
G7	2.1	0.8	-1.1	2.2	3.6	1.7
World	4.7	3.2	1.2	3.6	5.6	3.1

Source: Deutsche Bank

- *The state of the US consumer*: we have also long held the view that not only is the "master of excess," the US consumer, at the end of his shelf-life but also that as his fate and financial position become increasingly precarious, so the economic effects will become apparent, with very negative consequences. We hit the proverbial "nail on the head" with respect to this view. However, it should have been at the top of our priority list and should have occupied position one, two and three, so important has it proved to be. This factor more than any other, is behind the systemic failure we are now experiencing and is the root cause of the problems in investment markets today. More to the point, we think the state of the US consumer holds the key to the recovery from the current turmoil and we will be monitoring his position closely for any sign of improvement – it is a long way off, though.
- *The SA economy*: we retain our view that the SA economy will not move into recession although its rate of growth will slow. Trevor Manuel recently reduced his forecast for SA economic growth to 3.7% in 2008 and 3.0% in 2009. We are watching the trade deficit closely i.e. the extent to which SA imports more than it exports. This is the Achilles heel and is a large factor behind the rand's weakness. Manuel expects the deficit to widen to 8.9% of GDP, which is very high by world standards, by 2011/12.
- *Valuation levels in the SA equity market*: we went to some length to justify a positive view towards the SA equity market on the basis of its relative value. Shares were cheaper than they had been for a long while and were likely to get even cheaper as corporate earnings growth continued. Well, this logical view has been blown out of the water by a combination of forced selling (by unit trusts having to raise cash for redemptions), flight out of the country by foreign investors, a substantial increase in the risk premium demanded by foreign investors, and wave after wave of risk aversion that has

washed through the markets. It remains true that now more than ever, shares are being priced at very attractive levels i.e. shares are very cheap, but that is no guarantee they won't be cheaper tomorrow and the day thereafter. The investment road is now littered with investors who have been badly burnt committing cash to a "cheap" market only to have lost a substantial amount shortly thereafter. *It will take a long time before confidence returns to equity markets, both here and abroad*.

Having reviewed what we said last time, we went on to suggest some possible catalysts for a turnaround. We did however prefix our thoughts with the health warning that such speculation was risky and should be treated with a great deal of caution. We stated that *markets would remain weak and volatile for some time to come* although we never for a moment imagined the speed and extent of the destruction we have witnessed before our very eyes *each day* during the past two months. With the benefit of hindsight let's see why we said that and how we fared:

- *Valuation levels:* we noted the attractive levels of valuation in the SA equity market, but also pointed out that it is unlikely to play a major role as long as it continued to "rain pianos" which of course it has, with vengeance. Chart 24 for example, shows the forward PE ratio of emerging markets. They are cheaper now than after the 1998 LTCM crisis and the September 11-induced economic slowdown in 2002. In addition, emerging markets are in much better shape economically now than then, yet it has not prevented them from posting huge declines.

Chart 24: How long can you go? Fwd PE of MSCI EM

Source: Merrill Lynch

- *Certainty within the global financial crisis*: we noted that markets are unlikely to stop declining until some form of certainty returned. What transpired was the most unprecedented degree of uncertainty at all levels – amongst investors, regulators, policy-makers and market participants (banks, etc). Not only will it be a long time before certainty returns but when it returns it will bring with it massive change to the environment we once knew in the form of greater regulation, more government interference and increased oversight and supervision.
- *A stable or rising dollar*: we looked to a firmer dollar, or at least for the dollar to arrest its decline against other currencies, as a precursor for a healthier market. Here is another instance where a traditional relationship has broken down. We certainly now have a firm – rampant is a better description – dollar, but it has not helped the markets at all. Rather the ferocity of its rise has destabilized a number of other markets. This situation will probably prove temporary; we see it more as a symptom of the current chaos (the dollar is the only real beneficiary of a "flight to safety" mentality) than a solution for it.
- *A cessation in the rise of the oil price*: the sharp oil price decline has now happened and should be welcomed; for the time being markets have largely ignored it in the mad scramble for capital preservation.
- *The arrest of rising food prices*: the surge in food prices has been arrested although emerging countries, including South Africa, are unlikely to feel the benefit; their currencies have weakened dramatically against the dollar, thereby annulling any benefit from the sharp decline in commodity and food prices.

You have been very patient in getting this far in the Report. We appreciate you taking the time and effort to read it. We are "coming in to land" so will end with a few more thoughts.

Firstly, in the current chaotic market conditions it is virtually pointless making bold forecasts as to when the markets will turn. Right now the only certainty is their direction: they are heading lower. To be brutally honest, the markets "aren't working" right now. There is simply no reason or rationality behind the precipitous declines in the underlying companies. *Daily* changes in the prices of Anglo, Billiton, Arcelor Mittal and others of between 10% and 20% defy any logic. **We consequently believe the most appropriate action right now is to sit on the sidelines and wait until some form of normality returns to global equity markets.** Exactly where markets will end up i.e. at what level or when this process will occur, is hard to say. However, on the basis of our best estimate we think the US equity market will continue to struggle to find a bottom during the next six months. Only after that will the true extent of the recession become apparent, giving investors an indication of the damage inflected by the present crisis and an opportunity to reassess the prospects for corporate earnings and the state of the US consumer. And only once the US economy and markets have stabilized will the rest of the world's markets settle down. We are not saying that markets will continue to

decline for the next six months, but **we are saying that the markets are likely to remain volatile and unsettled for some time to come.** We don't for a moment think the markets are about to set off on a sustainable uptrend in a hurry, although there could be a number of "bear market rallies" in the interim. It is truly a "buyer's market" and we would be in no hurry to rush in and commit new capital to the market. On a selective basis some investment opportunities might arise but equities are likely to remain nervous and their subsequent returns subdued in the coming months.

Secondly, we would hasten to point out that now more than ever equity markets are generating a high, reliable and rising income stream (yield). So for those who are dependent on their equity portfolios for income generation, there is no need to worry about future income levels. The capital value of the portfolio is likely to decline further in the coming months but the income from the portfolio is, in our humble opinion, relatively secure. We would go further to say that now is not a bad time to commit more money to the equity market, *on a very cautious and selective basis*, if your long-term objective is to live off the income from your equity portfolio. It is quite possible to generate between 5% and 6% tax-free from a quality portfolio of South African equities, with the added benefit that this income stream will grow consistently in the future and will eventually be accompanies by a degree of capital growth. That, in our opinion, represents a valuable, once in a decade, opportunity.

8. Closing remarks

We head into a new year, just more than a month away, with a lot of caution, and some trepidation given the severe bruising the past two months (September and October) have inflicted on equity investors. We are not entirely certain what the future holds but we do know that the SA equity market represents good value at these levels. Selling out of one's equity investments at this stage therefore makes little sense. However, given the amount of demand destruction in recent months, whereby consumers' appetite for goods and investors' appetite for risk has been fundamentally reduced, together with a deflationary and recessionary environment in most developed economies, we will proceed with extreme caution and will exercise our responsibilities and mandate with the utmost diligence and care.

The longer-term returns reflected in this Report provide sufficient evidence of the merits of long-term investment, despite temporary and unenjoyable periods of equity weakness. As much as we find the current markets uncomfortable we will continue to be conservative in our management of your Fund and will seek out and retain investments we believe offer unusual value right now and which will lead to respectable long-term returns in the years to come.

Please feel free at any stage to contact either myself or any other member of the Maestro team about your portfolio. We remain at your disposal at all times and look forward to being of further service to you throughout the remainder of the year.

Andre Joubert
27 October 2008