MAESTRO
Equity Prescient Fund

PRESCIENT
MANAGEMENT COMPANY

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

FUND BENCHMARK (BMK)
The Fund will measure itself against the FTSE-JSE All Share Index.

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

FEE STRUCTURE
The maximum initial fee is 2.0% and the annual investment management fee is 1.75%. The *annual* total expense ratio (TER) for the past year in respect of class A was 2.07%.

Income Distribution (annually)
17.76 cents per unit
30 September 2013

FUND SIZE: R 117 334 666

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

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

PORTFOLIO MANAGER
Maestro Investment Management (Pty) Ltd

ENQUIRIES
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The Maestro Equity Prescient Fund

Quarterly report for the period ended

30 September 2013

1. Introduction

This Report focuses on the investment activities of the Maestro Equity Prescient Fund during the past quarter although it should be read in conjunction with previous editions of *Intermezzo*, wherein we documented some of the salient events in recent months. I also refer you to the Market commentary – September 2013 report, wherein we discuss the markets' behaviour during the quarter. It is at the bottom of this report.

2. The investment position of the Fund

The Fund's sector allocation is shown in Chart 1. Exposure to the resource sector totalled 15.1% of the Fund, down from 15.9% in June. Financial exposure rose 3.5% to 13.9% and industrial exposure declined 2.6% to 63.4%. Cash represented 7.6% of the Fund, down from the 7.7% at the end of June.

Chart 1: Asset allocation at 30 September 2013

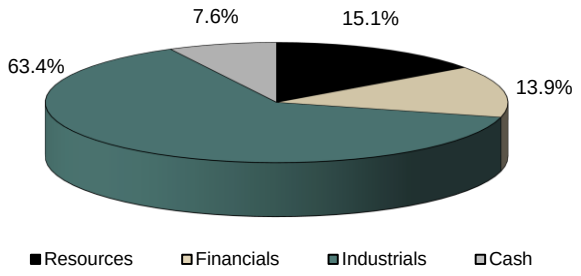
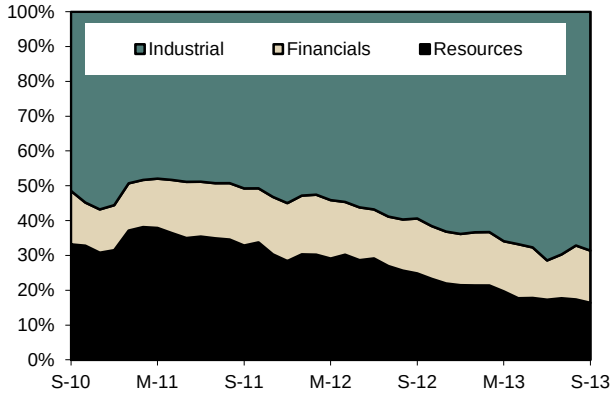


Chart 2 depicts the historical allocation to the three major sectors of the equity market, expressed as a percentage of the equity portion of the Fund.

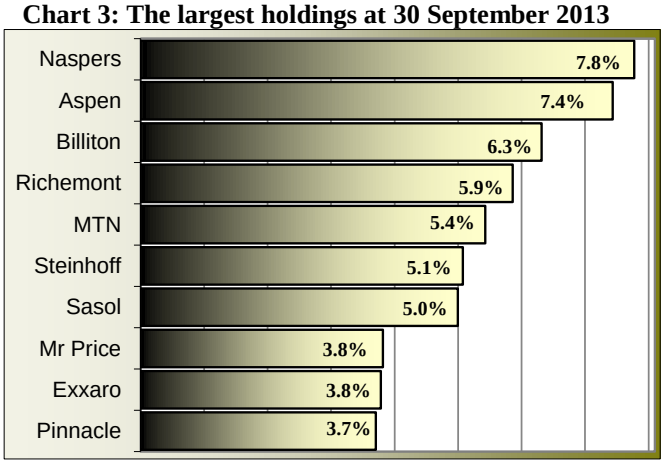
Chart 2: Sector exposure at 30 September 2013



3. The largest equity holdings

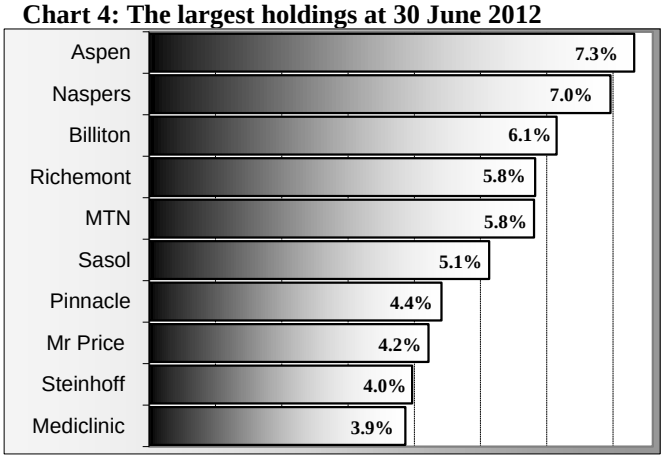
The largest holdings at 30 September are listed in Chart 3, expressed as a percentage of the equity portfolio.

Chart 3: The largest holdings at 30 September 2013



The largest holdings at the end of June are listed in Chart 4. During the quarter Exxaro replaced Mediclinic in the top 10 holdings of the Fund. At the end of September there were 31 counters in the Fund, one less than at the end of June. The ten largest holdings constituted 54.2% of the Fund up from 53.6% in June.

Chart 4: The largest holdings at 30 June 2012



4. Recent activity on the Fund

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

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

During the quarter a view was taken to further increase the financials exposure on the Fund as this is one sector of the market where reasonably attractive valuations and dividend yields are currently more prevalent. The Fund thus increased its holding in Standard Bank and introduced two new holdings in the form of Old Mutual and Discovery. After some extensive analysis of the investment prospects of the unsecured lenders a view was taken to sell out the Fund's small remaining holding in African Bank and add to the holding in Capitec.

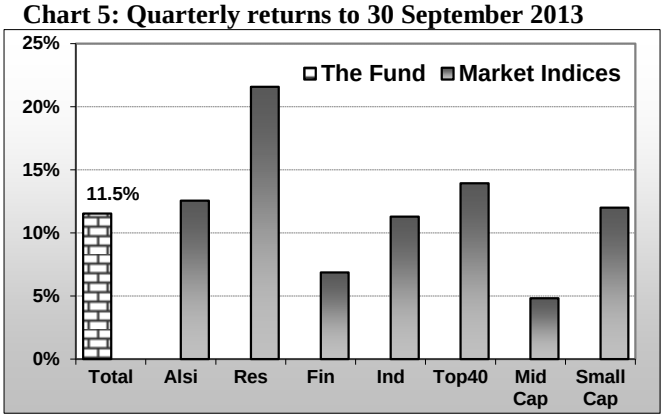
The Fund reintroduced a small holding in City Lodge on the improving growth prospects for the hotel group. The holding in OneLogix was also increased marginally.

Over the quarter the Fund sold out entirely of its small holdings in B&W Instrumentation and Metmar as prospects for both of these companies continue to remain downbeat and a catalyst for a turnaround is elusive. Due to growing headwinds in the consumer space the small holding in Shoprite was also sold out of the Fund. The holding in Hudaco was also reduced.

5. The performance of the Fund

Turning to the performance of the Fund, Chart 5 depicts the returns for the quarter against the major indices. ***The un-annualised return on the Fund during the September quarter was 11.5%***.

Chart 5: Quarterly returns to 30 September 2013



The Fund's return can be compared to the All share index return of 12.5%. We commented extensively in recent letters and *Intermezzo* about the state of the markets during the past few months and refer you to those publications to refresh your memory about the salient features of this period. You can find back copies of *Intermezzo* by clicking here. I encourage you to read the commentary on the market movements during the quarter in the document (at the end of this report) entitled *Market commentary – September 2013.*

The third quarter of 2013 was very different from the previous two quarters. Markets, in general, were strong and moved higher with the news from the US Federal

Reserve (the Fed) that tapering of Quantitative Easing (QE) would only take place if the macroeconomic environment was sufficiently conducive. This news drove markets strongly higher in the first month of the third quarter. They then subsequently took a breather in August but continued upwards in September. The momentum into the latter part of the quarter was supported by the Fed announcing no change to monetary policy i.e. QE.

Basic materials experienced two weak quarters at the beginning of 2013, but rose strongly during the third quarter of the year. Reflecting back briefly, the June quarter was similar to the March one, in that the basic materials sector was very weak and the financial and industrial indices stronger. For the record, basic materials had declined 7.3% in the March quarter, and by 13.8% in the June quarter. At that point in time the sector had *declined* 20.1% year-to-date. The third quarter of the year saw resources rise 21.6%, bringing the year-to-date return to -2.8% and the annual return to 5.6%. It remains to be seen if these recent gains can be maintained.

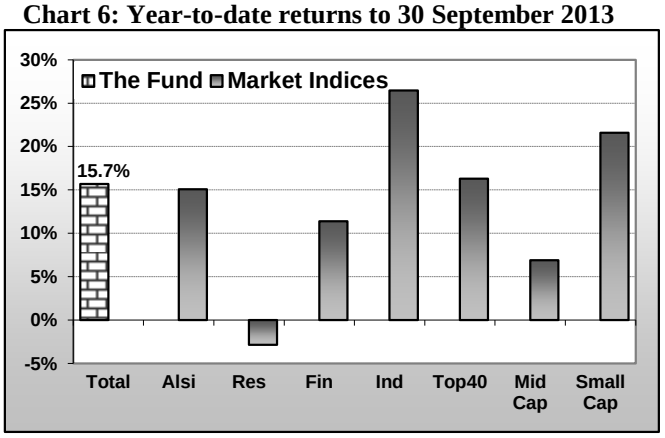
In contrast, the industrial and financial index "only" rose 11.3% and 6.9% respectively during the September quarter. However, this needs to be seen in the context of the year-to-date returns of 26.5% and 11.4%. What is not evident from Chart 5 is the performance of companies based on their size. Small cap companies comfortably outperformed their mid-cap counterparts for the second quarter in a row. The mid cap index rose 4.8% while the small cap index gained 12.0%.

We are still of the view that the basic material sector will remain vulnerable for some time to come. Despite its spectacular rise this quarter it is still plagued by slow global economic growth and the continued mayhem in the SA mining industry.

The quarterly returns, excluding dividends, of the Fund's largest holdings were as follows: Aspen rose 15.7% (it rose 18.9% in the June quarter), Naspers 27.2% (27.4%), Billiton 17.0% (-5.8%), MTN 6.5% (13.9%), Sasol 11.0% (5.9%), Steinhoff 45.8% (-2.0%) and Richemont 14.7% (21.5%). Pinnacle declined 4.2% after having risen 8.6% during the June quarter, Mr Price rose 3.2% (15.1%) and OneLogix 25.4% (-3.3%).

The year-to-date return of the Fund to September was 15.7% compared to the market which gained 15.1%. Note the large discrepancy between the year-to-date returns of the basic material sector and the industrial sector. It's worth pausing for a second and taking a look at Chart 6 above to view this graphically.

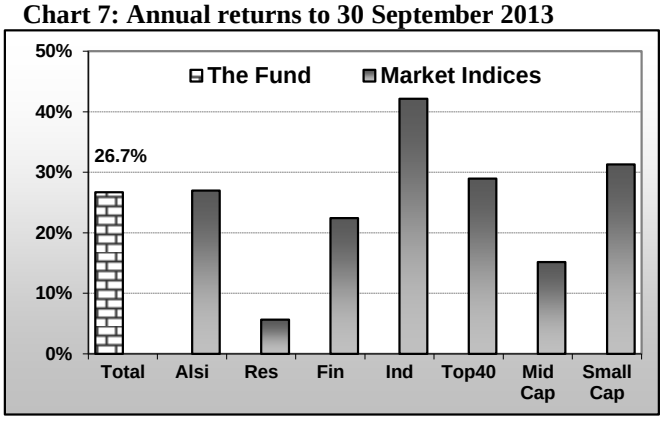
Chart 6: Year-to-date returns to 30 September 2013



Some of the shares that have been responsible for the strong returns in the industrial sector since the start of the year are; Naspers, which rose 70.9%, Grindrod 57.2%, Aspen 55.5%, Richemont 51.8% and Medi-Clinic 35.4%. The shares that are partly responsible for the basic materials underperforming are as follows: Harmony and Anglogold declined 53.2% and 48.8% respectively. Implats fell 26.1% and Kumba Iron Ore 18.4%.

The annual returns to September are shown in Chart 7. ***The annual return of the total Fund for the 12 months to September was 26.7%*** versus the All share index return of 27.0%. The underweight position in basic materials, relative to the All share index, assisted the Fund's returns over the past year. Inflation rose 6.0% over the year and the All bond index rose 3.2%.

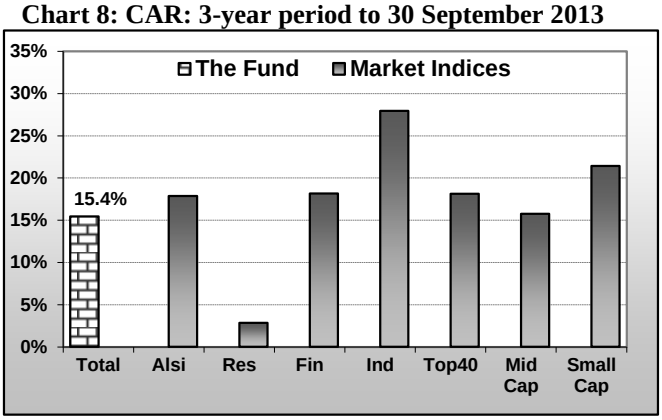
Chart 7: Annual returns to 30 September 2013



The drivers of our local industrial index have been Richemont, which rose 101.6% during the past year, Naspers 80.3%, SABMiller 41.9% and MTN 22.3%. When one considers the extent of their annual returns it is easy to understand why the industrial index has performed the way it has. What is even more remarkable is that these companies are amongst the six largest companies on the market. Fortunately we held all of these shares in the Fund. Not shown in the chart are the annual returns of large, mid and small cap indices, which rose 29.0%, 15.2% and 31.3% respectively.

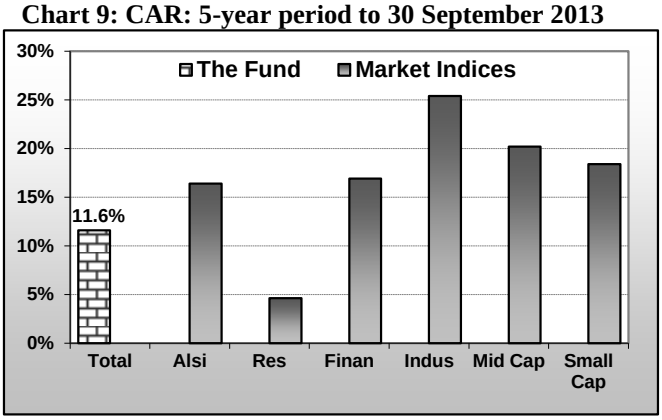
The compound annual return (CAR) of the Fund, shown in Chart 8, ***over the three-year period to September 2013 was 15.4%*** which can be compared to the All Share Index return over the same period of 17.9%. It is clear from Chart 8 which sectors drove the market higher over the past three years and it is quite remarkable that the basic material sector only registered a return of 2.8% per annum over this period. Across the market cap spectrum, the large cap index managed to maintain pace with the mid and small cap indices, largely thanks to the industrial shares. The three-year compound annual returns of the large, mid and small cap indices are 18.1%, 15.8% and 21.4% respectively. The respective compound annual returns for the All Bond index and cash over this period were 8.5% and 5.6% respectively.

Chart 8: CAR: 3-year period to 30 September 2013



The CAR of the total Fund return over the five-year period to September 2013, shown in Chart 9, ***was 11.6% per annum*** which can be compared to the All share index return of 16.4%.

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



Over this period South African inflation rose at 5.0% per annum while the All bond index compound annual return was 10.0%. The annual return on cash was 6.7%. At the risk of stating the obvious, the base from which these returns are being measured is end-September 2008 i.e. in the depths of the financial crisis. The industrial index compound annual return over the five-year period was 25.4% while financials and resources returned 16.9% and 4.6% respectively over the same period. The 5-year CARs for the large, mid and small cap indices are 15.8%, 20.2% and 18.4% respectively, while the respective CARs for the All Bond index and cash were 10.0% and 6.7% .

What is not evident from the graphs is a trend we have brought to your attention in the market commentary, namely the outperformance of the SA equity market relative to developed markets. Whereas the All share index rose 16.4% per annum over the past five years (but only 3.7% in dollar terms), the MSCI World index rose only 5.6% in dollar terms per annum. When you consider how low global equity returns have been for a number of years now, you realise that the SA equity market has been a profitable investment destination relative to the rest of the world.

We have been highlighting a recent trend that has developed over the past year i.e. the outperformance of developed markets versus emerging ones. This is evidenced by the compounded annual returns of the MSCI World index and the MSCI emerging market index, for the past four and five years. The MSCI World index had returned 2.6% per annum over the past 4 years ending September 2012, while the MSCI Emerging markets had returned 6.2%. If one includes the past year and measures the five-year returns to end-September 2013, we see that the CARs for MSCI World index increases to 5.6% while the MSCI Emerging markets decline to 4.6% per annum. The magnitude of this change should not be underestimated. To put this in perspective, the absolute differential between these two markets over the past year has been 19.2% in dollars and far more in local currency terms.

Over the past five years, Central Banks have adopted very accommodative monetary policies. One of the primary beneficiaries of these policies has been emerging markets. The Fed has been very vocal about its stance on tapering its bond buying program (QE), which has resulted in emerging market currencies devaluing.

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

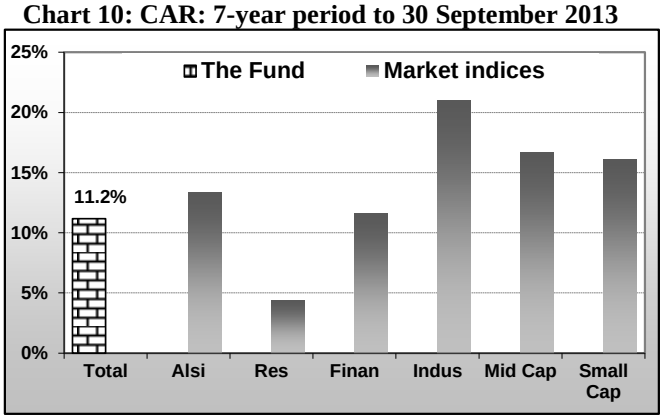


Chart 10 lists the returns over a seven-year period. ***The CAR of the Fund over the seven-year period to September was 11.2%*** versus the return over the same period of the All Share Index of 13.4%. Over this period South African inflation rose at 6.5% per annum while the All bond index compound annual return was 9.3%. The annual return on cash was 7.9%. The outperformance of the industrial sector is again evident and I point out that we measured returns over a seven-year period here i.e. the outperformance by industrial shares is not an overnight wonder; it is a well-established trend that has been in place for more than a decade now and it is this fact that underlines the key component of our investment philosophy, namely a bias in favour of industrial shares. The same could be said for mid and small cap companies. Of course I am dwelling on returns only here and not presenting any data on risk i.e. the volatility or variability of returns, but rest assured that the risk underlying the returns from both the industrial, mid and small cap indices on the one hand, and the Fund on the other, has all been lower than that which prevailed in the equity market as a whole over this period.

6. <u>Closing remarks</u>

Many developed markets are at all-time record levels, but this does not necessarily mean that all is well in the global economy.

We remain of the opinion that the US economy will slow and there is a real risk that the Chinese economy will not grow as strongly as many think. We continue to be conscious of the many potential pitfalls that we may need to negotiate and while we cannot prevent or avoid them, we will continue to manage the Fund with them in mind.

We will once again reiterate our thoughts on bonds, which are less relevant to individual investors than to retirement funds. The US Federal Reserve has signaled the end of "easy and cheap money" and the 30-year bull market in US bonds is now past. Buying into the prevailing low yields of developed bond markets is a very risky strategy. What is also of concern is that it remains highly likely over time that China and Japan will naturally diversify out of US government bonds in favour of other sovereign debt. Not to alarm you, but keep in mind that 43% of all US debt is owned by China and Japan. It cannot be comfortable being in their position and watching your creditors debate whether they will raise the debt ceiling in order for you to get repaid. Rising bond yields will ultimately put pressure on countries' borrowing costs, which will eventually feed through into the real economy. This will then affect the prospects and outlook for equities. We are, however, of the view that this is still some way off. For the time being we continue to be cautiously optimistic in our outlook for equities.

All that remains is for me to thank you, on behalf of the whole Maestro team, for your ongoing support and the confidence you have displayed in our abilities.

<u>Luke Sparks</u>
On behalf of the Maestro team
30 October 2013

Market commentary – the 2013 September quarter

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

Table 1: Selected returns – equity markets

	Sep quarter (%)	Jun quarter (%)	2013 Year to date	Annual returns to Sep (%)
Japan	5.7	10.9	39.1	63.0
Hong Kong	9.9	-6.7	0.9	9.7
Germany	8.0	2.1	12.9	19.1
UK	4.0	-3.1	9.6	12.5
US (S&P500) and large cap	4.7	2.4	17.9	19.6
S&P Mid cap	7.2	0.6	21.9	25.8
S&P Small cap	10.4	3.6	30.0	29.9
MSCI World index	***7.7***	***-0.1***	***15.3***	***17.7***
Brazil	10.3	-15.8	-14.1	-11.6
Russia	11.5	-12.3	-6.8	-3.6
India	-0.1	3.0	-0.2	3.3
China	9.9	-11.5	-2.6	4.2
MSCI Emerging market index	***5.0***	***-9.1***	***-6.4***	***-1.5***
JSE All share	***12.5***	***-0.2***	***15.1***	***27.0***
JSE All share ($)	***11.0***	***-7.8***	***-3.0***	***4.1***
Basic materials	21.6	-13.8	-2.8	5.6
Financial	6.9	-1.6	11.4	22.4
Industrial	11.3	6.9	26.5	42.2
Gold mining	-0.4	-33.5	-45.6	-48.3
Large cap (Top40)	13.9	-0.2	16.3	29.0
Mid cap index	4.8	-0.7	6.9	15.2
Small cap index	12.0	0.4	21.6	31.3

The end of the second quarter of 2013 was characterised by extreme volatility as Bernanke's infamous speech on the US Federal Reserve (the Fed) stance on tightening monetary policy sent markets into a tail spin. This led the chairman to backtrack on his comments, which ultimately calmed down the markets and set a platform off which decent returns were to be generated during the third quarter of the year.

Markets are affected by unknown events and do not like uncertainty. Central Banks around the world have done their very best to ensure that they provide clear guidance to the market in terms of both interest rate expectations and forecasted inflation rates. In an unprecedented move the European Central Bank (ECB) broke 14 years of protocol and decided to give markets forward guidance.

What has become crystal clear of late is that Central Banks will do whatever it takes to ensure that a sustainable recovery is in place, but this does not rule out the possibility that politicians may make mistakes along the way. There is always the risk of one-upmanship for self gain at the expense of global financial markets, as we saw with the recent US Government shutdown of non-essential services. Although the parties reached a last minute deal it merely served to delay the decision into early next year. Despite the precarious situation in the US global equity markets continue to trend higher.

Table 2: Selected returns - bonds, commodities, currencies

	Sep Quarter (%)	Jun Quarter (%)	2013 Year to date	Annual returns to Sep (%)
SA All Bond index	1.9	-2.3	0.5	3.2
SA Cash	1.3	1.3	3.8	5.2
Barcap Global Agg. Bond index	2.8	-2.9	-2.2	-2.6
Emerging market bonds	1.7	-4.4	-4.9	-1.6
US 10-year bond	-0.7	-4.6	-5.5	-5.7
US Corporate bond	0.9	-3.4	-2.5	-1.3
US High yield bond	2.3	-1.4	3.8	7.1
Cash (US dollar)	0.0	0.0	0.1	0.1
DJCS Hedge index	1.6	0.1	5.4	7.4
Brent (Oil)	6.1	-7.1	-2.5	-3.6
Gold	11.3	-25.4	-20.3	-25.3
Silver	15.0	-34.2	-27.6	-37.4
Platinum	7.1	-16.4	-7.6	15.4
Palladium	12.9	-16.5	3.1	13.1
Copper	7.7	-11.0	-8.0	-11.5
Nickel	1.6	-17.9	-18.8	-24.9
Baltic Dry index	71.1	28.7	186.6	161.5
CRB Commodity index	3.5	-7.0	-2.6	-7.2
S&P GS Commodity index	3.3	-6.4	-1.3	-4.4
Euro dollar	4.1	1.2	2.7	5.2
Sterling dollar	6.8	-0.1	-0.4	0.3
Swiss franc dollar	-4.4	-0.1	-1.2	-3.8
Rand dollar	-1.4	-7.6	-15.7	-18.0
Yen dollar	-1.2	5.7	13.5	26.1

The most dramatic movements in the markets over the third quarter can be isolated to commodity and currency prices.

The June and September quarterly returns shown in Table 2 highlight the dramatic turnaround in commodity prices. This has been fuelled by Central Bank stimulus and their support for the continued use of loose monetary policy. The feature of the year thus far has been the underperformance of emerging markets versus developed ones. This has been characterised by an outflow of money, or repatriation of investments, from emerging markets back to developed ones. One of the primary fears of investors is that the demand for emerging market assets will decline, and in turn their currencies will devalue,

as Quantitative Easing (QE) is scaled back. This has been evidenced by the recent devaluation in some developing markets' currencies, some of which were recently labelled the *Fragile Five*.

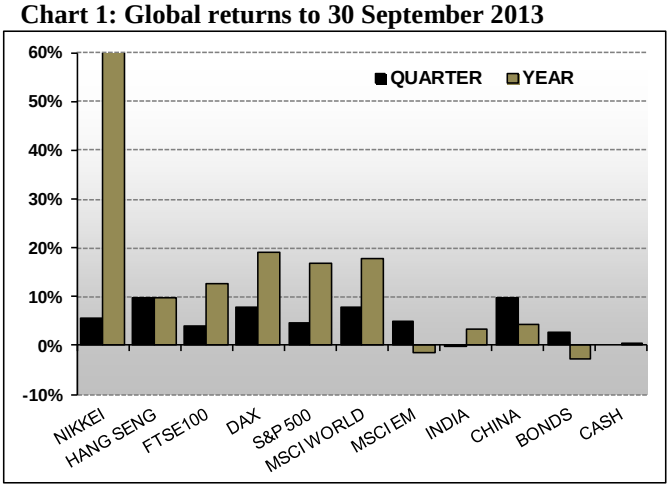
The *Fragile Five* includes the Brazilian real, the Indian rupee, the Indonesian rupiah, the South African rand and the Turkish lira. The common denominator across all these countries is that they run substantial current account deficits that rely on foreign inflows to sustain them. In the vast majority of cases these inflows are portfolio flows as opposed to fixed direct investments (FDI). Portfolio flows are fickle and easy to withdraw while FDI is more permanent and not easily withdrawn. What's important to note is that the rand does not move in isolation; the general public's perception of why the rand has weakened is more related to internal politics than global economics. We are not suggesting that political events don't affect our currency, but rather pointing out that the other four members of the *Fragile Five* have seen similar declines in their currencies.

When global investors decide to either slow down their purchasing of emerging market assets (equities and government bonds), or, heaven forbid, begin redeeming investments, then the future of the underlying country's currencies comes into question. It is far less problematic if the countries run current account surpluses; when they rely on portfolio flows to finance their deficits problems are bound to arise. This normally results in a decline in the country's currency. This devaluation often rears its head in the form of imported inflation which provides Central Banks with reasons to raise interest rates. By raising rates, they hope to attract global capital into markets which will in turn stem the currency weakness and curb rising inflation. We have already seen evidence of this with Brazil, India and Indonesia raising rates during the past quarter. During this process the countries still need to fund their current account deficits, which now need to be done through capital raising. The above factors result in capital being raised at punitive rates, which then leads to a host of new problems.

Global developed investment markets

Chart 1 summarises the quarterly and annual returns of the major global equity, bond and cash markets. You can see clearly from this chart that most risk assets have performed exceptionally well in the recent quarter. The US and German stock markets have risen 16.7% and 19.1% respectively over the last year, whereas the Japanese market has risen 63.0% over the same period, an even more astonishing rise but which needs to be seen in context of the massive QE program the Bank of Japan has embarked on. This has all taken place while China and Hong Kong could only muster annual returns of 4.2% and 9.7% respectively. Even though there is a general consensus in the market that the majority of the world's economic growth is going to come from certain BRIC countries (Brazil, Russia India and China) their equity markets have substantially underperformed their developed market counterparts over the last year, returning only -11.6%, -3.6%, 3.3% and 4.2% respectively. The MSCI emerging market index has returned -1.5% as compared with the MSCI World index return of 17.7%. These indices can be used as proxies for the emerging and developed markets. This again speaks to our point about the uncertainty of the Fed's action in terms of QE tapering. In terms of capital flows globalisation is well and alive and money will find a home where it has the greatest chance of generating *real returns* in US dollar terms.

Chart 1: Global returns to 30 September 2013



QE was designed to reduce interest rates and increase liquidity in financial markets. Its primary goal was to boost asset prices (equities and property) while helping the economy recover. The threat of the Fed tapering, i.e. withdrawal of liquidity, was responsible for the rise in US government bond yields over the quarter. Any further rises could destabilise equity markets, but we believe this threat will remain low over the next quarter. If you were ever in doubt about the importance of QE in the bond market, keep in mind that the holders of a 30-year US Treasury bond are enduring a stunning annualised loss of over 20.0%!

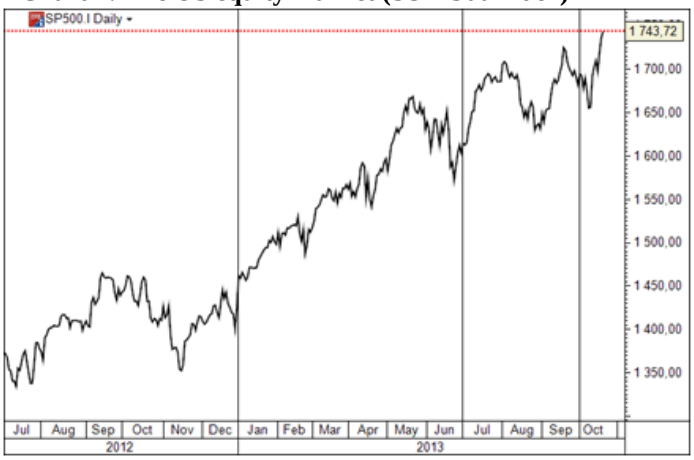
The current chairman of the Fed, Ben Bernanke, is set to step down from his position early in 2014 and markets have been fixated on who will replace him. Two candidates looked to be going head to head for the post; Larry Summers and Janet Yellen, the former being more opposed to QE while the latter being "pro-QE". Markets breathed a sigh of relief as Summers withdrew from the race and with him went any chance of a radical change in policy.

The biggest surprise of the quarter was the fact that the Fed decided not to reduce its $85bn per month of QE stimulus. There is a belief in the market that the Fed will not taper QE until a rise in bond yields coincides with a rise in mortgage applications. The reversal in housing activity in the US during the past quarter could be a likely signal to the Fed that

the macroeconomic environment is still too fragile to withstand even a small tapering.

Chart 2 highlights just how strong the US equity market has been. It is clearly evident from the chart that when, during the third quarter of the year, markets obtained clarity on the Fed position on QE, they rose strongly from September onwards.

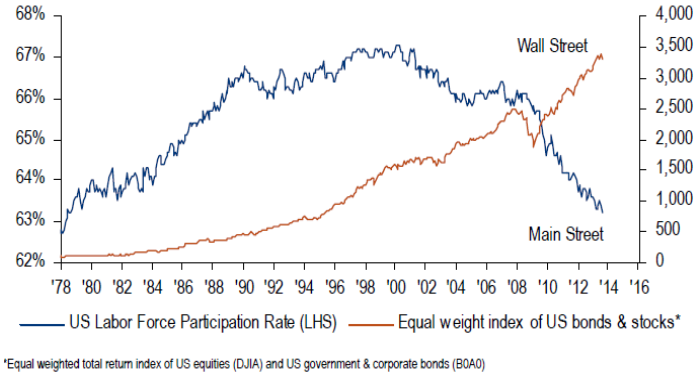
Chart 2: The US equity market (S&P 500 index)



Source: Saxo Bank

The second estimate for growth in the **US economy** during the second quarter (Q2) was released during the third quarter; the initial estimate of 0.8% was revised up to 1.7% although the Q1 growth rate of 1.8% was revised down to 1.1%. Although this is a mixed bag, on a positive note the final 2012 growth rate was revised up from 2.2% to 2.8%. The data releases over the third quarter were both above and below expectations, with no clear trend emerging. The US economy is inching forward but not at the rate investors and policy makers would like.

Chart 3: Wall Street Boom, Main Street Bust

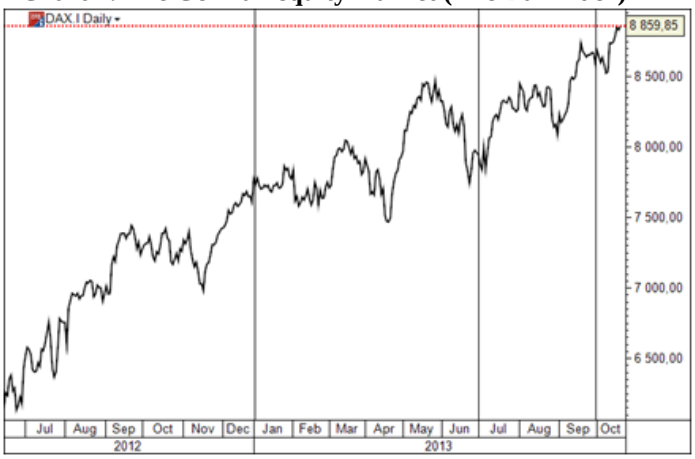


Source: BofA Merrill Lynch

A lot has been written about the "jobless recovery" underway in the US. The US consumer makes up close to 70.0% of GDP. It is therefore critical that the consumer's financial health is repaired before the Fed can tighten their monetary policy stance. It is worth keeping in mind that the longer Main Street takes to recover, the greater the risk of asset bubbles.

For the time being, the situation engineered by generous Central Banks and tightly run corporations has been great for owners of capital, but bad for labour (refer to Chart 3).
The Germany equity market (Dax) continues to power ahead (Chart 4) rising 8.0% this quarter, ahead of its developed market peers. The Dax performance was driven by the value of the Euro (it is an export driven economy), the recovery in the Eurozone periphery and a rebound in Chinese growth.

Chart 4: The German equity market (The Dax index)



Source: Saxo Bank

The German economy is very important to the Eurozone region as a whole. Germany grew faster than expected in the second quarter, rising by 0.7% (quarter-on-quarter, annualised) supported by France, which rose 0.5%. This pushed the Eurozone region higher by 0.3%, thereby breaking six consecutive quarters of negative growth.

Chart 5: The Japanese equity market (Nikkei 225)

Source: Saxo Bank

A lot has been written about both the Japanese economy and its equity market (the Nikkei index – Chart 5). The government's recent experiment with a massive QE program has resulted in a sharp rise in local equities; up 5.7% this quarter, 10.9% in Q2 and 39.1% year-to-date. In a bid to shore up inflation the government has embarked on an extremely loose monetary policy that, dare we say it, makes

the US look like they're in the minor leagues. The effect of this QE program has been a devaluation of the yen, declining 13.5% against the US dollar year-to-date and 26.1% over the year. The world holds its breath to see if this experiment works as it seems as if Japan has one remaining shot at getting it right. They remain the most indebted nation in the world, the second largest holders of US government bonds and with demographics heavily stacked against them; we hope they get it right.

Global developing investment markets

The MSCI World Index continues to outperform the MSCI Emerging market index over the past year. It rose 7.7% this quarter which compares favourably to that of the emerging market index which returned 5.0%. To understand the extent of the recent weakness in emerging markets it is worth taking a step back and reviewing the comparative returns for the year-to-date. Developed markets have risen 15.3% year-to-date and by 17.7% over the past year while emerging markets have declined 6.4% this year so far and by 1.5% over the past year.

The trend that has developed over the long-term is that when the US dollar is strong, developed equity markets tend to outperform emerging markets. We believe the US economy will continue to recover and US bond yields will continue to increase, leading the US dollar to strengthen against a "basket" of currencies. It remains to be seen if the emerging markets can get their house in order and continue to be attractive destinations for foreign capital.

Chart 6: Developed vs. Emerging markets

iShares MSCI World (9BGIIXWD) & Emerging Market (EEM) ETFs (100 = 1 October 2012)

Source: MSN Money

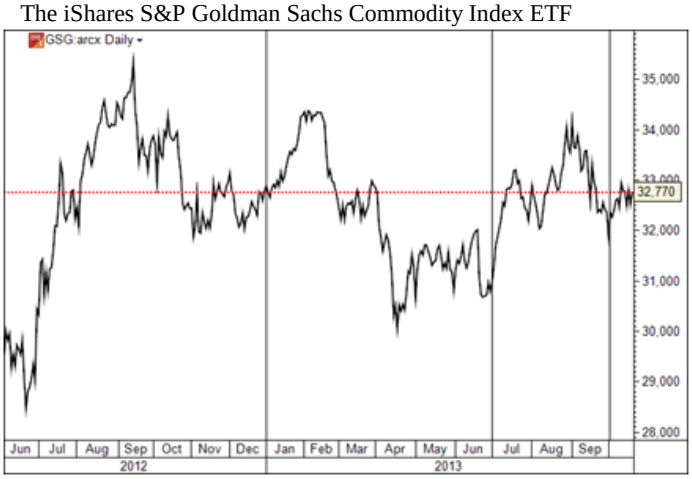
Emerging markets face many obstacles, such as current account deficits, high unemployment, high inflation and poor policy decisions. In addition they have also been faced with declining commodity prices over the last few quarters. A number of emerging markets are faced with the fact that their currencies are considered "commodity-based currencies" which means that declining commodity prices normally translate into a weaker local currency.

What has become clear over the last two years is that commodity prices have a higher correlation to Chinese GDP growth that global GDP growth. In order to see a sustained rise in commodity prices we need to see a sustainable recovery in Chinese growth. The Chinese are the largest consumers of commodities and ultimately determine the underlying demand for most base metals. This will remain the case despite the fact that the Chinese government is attempting to convert the economy from an export driven one to a consumption based one.

When one considers the declines of the following commodities it is easy to see why resource shares have performed the way they have. Amongst the basic materials we have seen the following declines; gold -25.3% over the last year, platinum -15.4%, silver -37.4%, copper -11.5%, nickel -24.6%, aluminium -13.0% and coal -9.3%. Due to the fact that resource companies are price takers, they are ultimately at the mercy of the health of the global economy and more specifically China. This also gives you an idea of one of the reasons why currencies of developing countries have been so weak over the last two years.

Chart 7: The S&P Goldman Sachs Commodity Index

The iShares S&P Goldman Sachs Commodity Index ETF



Source: Saxo Bank

It's no coincidence that the Fed's announcement to hold off on QE tapering dovetailed with improving returns in emerging markets and a strong rise in commodity prices. It would be naive to believe that global capital does not influence the fortunes of where it is allocated and that the actions taken by the largest economies will not ultimately affect what happens in the smaller developing ones.

Encouragingly, South African equities have been the stand-out performer amongst our emerging market peers. Chart 10 highlights the performance of a number of underlying emerging markets and their respective returns in US dollars. The JSE All share has risen 4.1% over the past year in dollar terms, which compares favourably to the MSCI emerging market index, which declined 1.5% over the same period.

Chart 8: SA outperforms BRIC nations so far this year

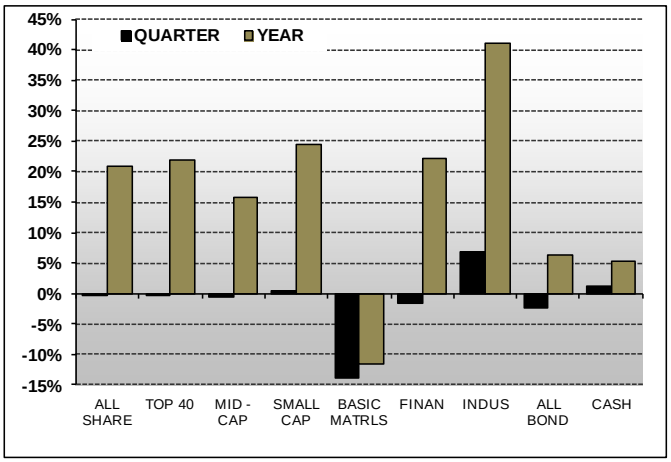
Source: Bloomberg, Nedbank.

Local investment markets

Staying with the South African (SA) investment markets, Chart 9 depicts the returns to the end of June 2013 and Chart 10 the returns to the end of September 2013. These two charts provide a good back drop from which to analyse returns of the past quarter.

Last quarter we brought to your attention the disparity of returns that had been generated by basic material and industrial shares over the past year. The difference in absolute annual returns peaked at the end of June at 52.7%!

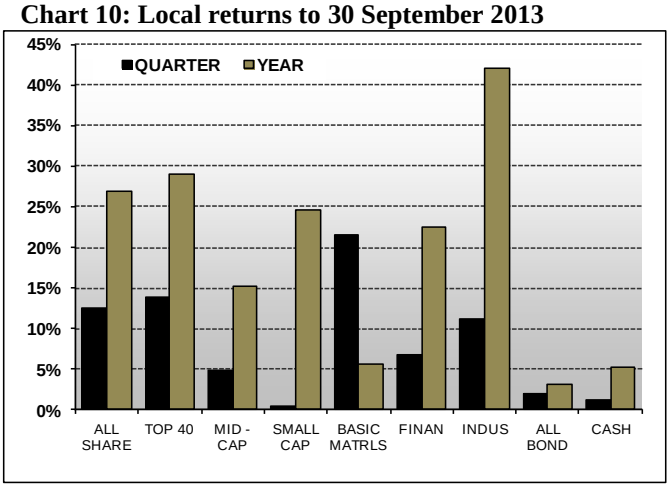
Chart 9: Local returns to 30 June 2013



The third quarter of 2013 provided a fairly healthy environment for basic materials, with the US dollar declining in value, the South African rand continuing to devalue, economic data out of the Eurozone improving and the Fed deciding not to tighten monetary policy. In fact, the Eurozone improved to a point where they are now technically coming out of recession. If the US can continue to gain traction, with the support of Europe and Asia, we could see a synchronised recovery across the globe. This scenario is still some way off and there are many bridges that need to be crossed before we can comfortably say that we are out of the woods. But it's safe to say basic materials were the star performer during the quarter (especially given its performance in the second quarter), rising 21.6%. The industrial and financial sector rose 11.3% and 6.9% respectively. Over the past year basic materials managed to narrow the gap on industrials, taking the differential from 52.7% to 36.5%.

The All share index rose 12.5% during the quarter, with a further surprising feature being the outperformance of large cap shares (13.9%) compared to the mid and small cap companies which returned 4.8% and 12.0% respectively.

Chart 10: Local returns to 30 September 2013

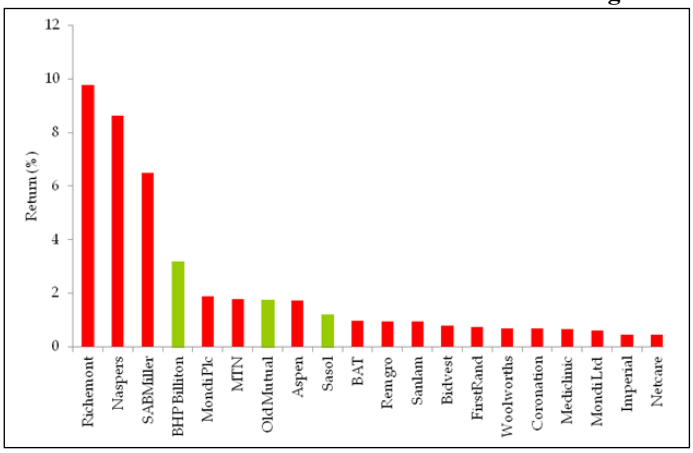


Turning our attention to the annual returns to the end of September, we are able to report returns that are nothing short of spectacular. The All share index has risen 27.0% this past year, driven higher primarily by the industrial sector which is up 42.2%. This needs to be seen in context as financials and basic materials have "only" risen 22.4% and 5.6% respectively. What is not immediately evident from the total return is which underlying shares are actually driving the market and more specifically the industrial index. Before we focus on actual individual shares it is worth noting that the rand has, not surprisingly, lost ground against the dollar, pound and euro over this past year, declining 18.0%, 22.2% and 28.3% respectively.

The weaker currency did, however, provide support for the rand hedges which are typically the larger industrial companies. By way of example, Richemont rose 101.6% during the past year (and 14.7% this quarter), Aspen 83.7% (15.7%), Medi-Clinic 81.2% (8.2%), Naspers 80.3% (27.2%), SABMiller 41.9% (7.0%). More recently Steinhoff came to the party, gaining 37.1% (45.8%).

Chart 11 helps to contextualise how relevant some of the large industrial shares have been in terms of market gains over the past 12 months. Almost two thirds of the All Share gain over the past 21 months has come from three stocks, namely SABMiller, Richemont and Naspers. All of these companies generate significant portions of their revenue outside of the borders of South Africa.

Chart 11: Contribution to Alsi return Jan '12 to Aug '13



Source: PSG Konsult.

We are well aware of the risk this imposes on our portfolios and continue to monitor the relative size of these particular shares within our domestic portfolios.

In closing

Markets have extended their impressive year-to-date returns with a steady grind higher during the third quarter. With one more quarter to go in the 2013 calendar year and headwinds which include the much talked about US debt ceiling debate, it is highly likely that most of the major gains of 2013 are behind us already. We remain focussed on any global macro events that may affect the fortunes of the different asset classes in which we invest.

By now you will be familiar with the fact that Maestro's investment philosophy is style agnostic i.e. we are not purists in our view. This allows us the opportunity to include both value and growth shares in client portfolios during different economic cycles. We believe it is important to remain flexible in one's investment view and we will use all the tools available to achieve sound returns with less risk. It is our experience that it can be very costly adopting a purist view in the investment world, especially when one considers that the only constant seems to be a changing landscape.

David Pfaff on behalf of
The Maestro Investment Team
25 October 2013