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.

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 2.03%.

Income Distribution (annually)
29.02 cents per unit
31 March 2012

FUND SIZE: R 91 937 989

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

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

PORTFOLIO MANAGER
Maestro Investment Management (Pty) Ltd

ENQUIRIES
Maestro Investment Management
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CAPE TOWN
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The Maestro Equity Fund

Quarterly report for the period ended

31 December 2012

1. Introduction

This Report focuses on the investment activities of the Maestro Equity 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 - the 2012 December quarter* which is included at the bottom of this report whereby we discuss in detail the market activity during the quarter.

2. The investment position of the Fund

The Fund's sector allocation is shown in Chart 1. Exposure to the resource sector totalled 19.5% of the Fund, down from 22.1% in September. Financial exposure declined 0.6% to 13.4% and industrial exposure decreased 0.1% to 58.0%. Cash represented 13.4% of the Fund, up from the 11.0% at the end of September.

Chart 1: Asset allocation at 31 December 2012

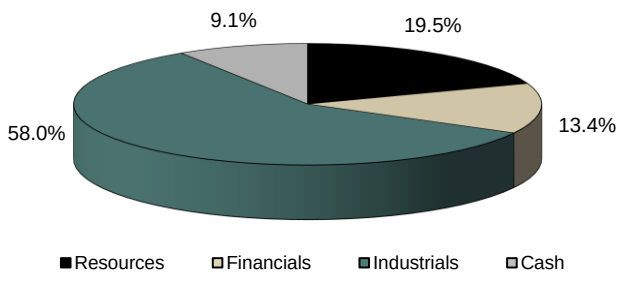
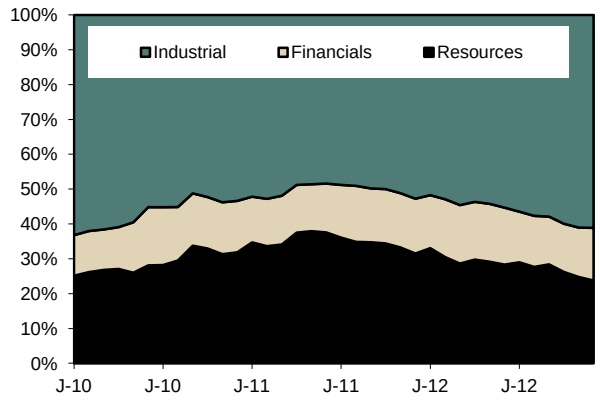


Chart 2 depicts the historical allocation to the three major sectors of the equity market, expressed as a percentage of the equity portion of the Fund.

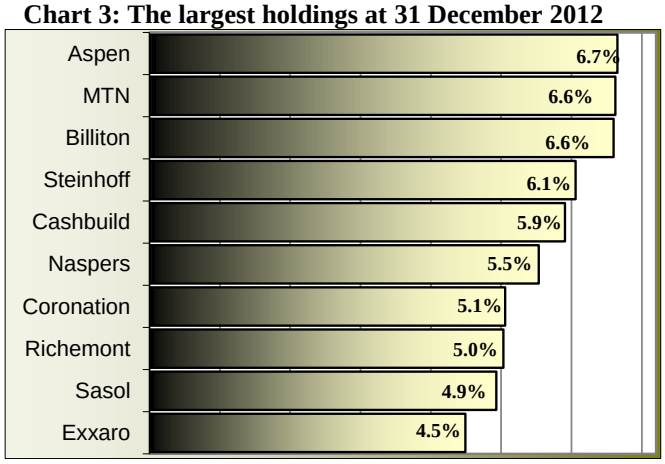
Chart 2: Sector exposure at 31 December 2012



3. The largest equity holdings

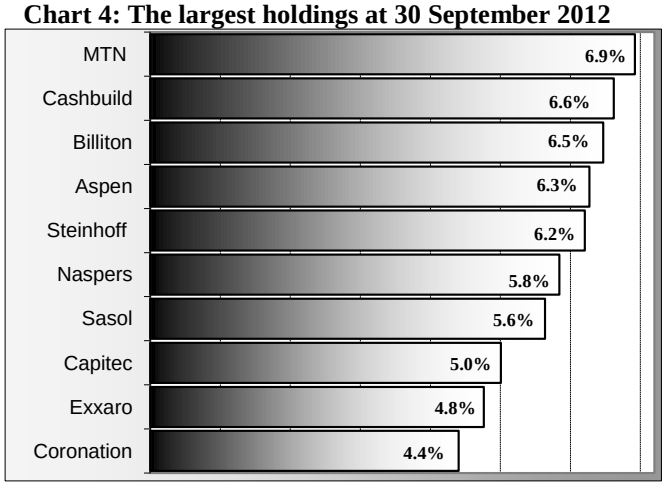
The largest holdings at 31 December are listed in Chart 3, expressed as a percentage of the equity portfolio.

Chart 3: The largest holdings at 31 December 2012



The largest holdings at the end of September are listed in Chart 4. During the quarter Richemont replaced Capitec in the top 10 holdings of the Fund. At the end of December there were 28 counters in the Fund, one less from the end of September. The ten largest holdings constituted 56.9% of the Fund down from 58.2% in September.

Chart 4: The largest holdings at 30 September 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 Fund's largest holdings were trimmed and the newer holdings were added to as well as one holding sold out of.

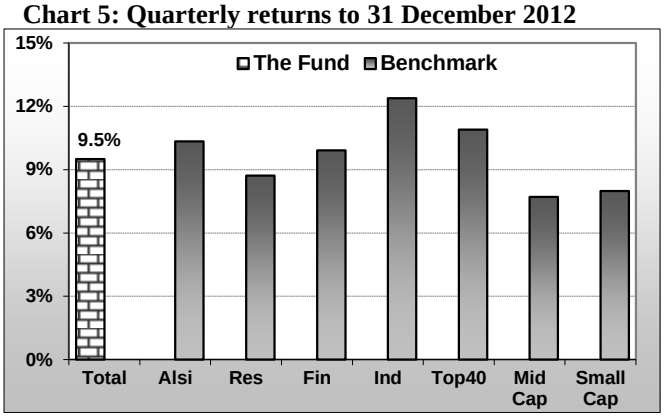
After poor results and with a low likelihood of a quick turnaround, Digicore was sold out of the Fund in the quarter. The Fund further reduced its holdings in MTN, Kumba Iron Ore, Investec plc and Anglo American during the quarter.

Newer holdings which have been introduced into the Fund over the second and third quarters were added to. These include Prescient Limited, Pinnacle Technology Holdings and Mediclinic. The Fund also added to well established holdings in Hudaco, Blue Label Telecoms, Grindrod and B&W.

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 December quarter was 9.5%***.

Chart 5: Quarterly returns to 31 December 2012



The Fund's return can be compared to the All share index (Alsi) return of 10.3%. We commented extensively in recent letters and Intermezzo about the state of the markets during the past few months and refer you to those publications to refresh your memory about the salient features of this period; you can find back copies of Intermezzo by clicking here. I also encourage you to read the extensive commentary on the market movements during the quarter in, *Market commentary - the 2012 December quarter* which is included at the bottom of this report.

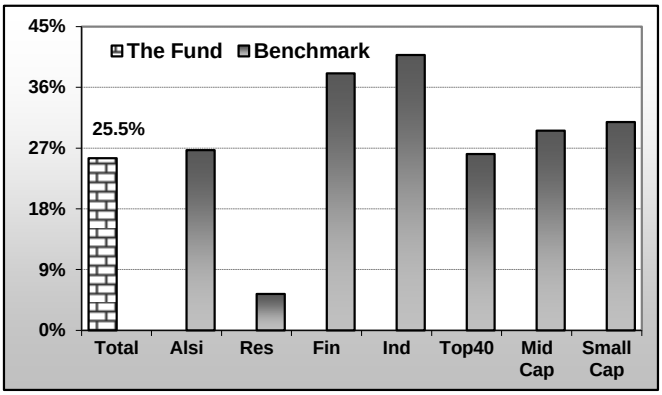
In the market commentary we expound on the key global and local events over the fourth quarter. These events include the US fiscal cliff debacle, the US and Japanese elections, a political handover of power in China as well as further monetary stimulus by the major central banks around the world which all played a role in the respective market performances. Towards the end of the quarter investors started to give US politicians the benefit of the doubt and took a positive view that some sort of deal would be reached on the fiscal cliff which supported many global markets including the local one.

Strong gains were recorded in almost all of the major sub sectors of the local market. The industrial sector (the usual suspect) led the charge by gaining 12.4% followed by the financials 9.9% and resources 8.7% sectors. The gold sector was the notable exception, declining 5.0% over the quarter as a weaker rand was not able to compensate for a declining gold price and continued negative investor sentiment towards gold miners.

What is not seen in Chart 5 is the performance across size spectrum as the large caps (returning 10.9% for the quarter) outperformed their smaller cap peers, the mid-caps (7.7%) and small-caps (8.0%).

The returns excluding dividends of the largest holdings in the Fund during the quarter were as follows: Aspen rose 18.2% (it rose 13.6% last quarter), MTN 10.9% (13.7%), Billiton 13.6% (9.7%), Steinhoff 5.2% (5.8%), Cashbuild -0.6% (13.1%), Naspers 5.5% (18.4%), Coronation 27.9% (12.0%), Richemont 32.8% (11.6%), Sasol -2.5% (8.7%) and Exxaro 5% (-15.3%). Other holdings within the Fund which posted strong quarterly returns included those in Blue Label Telecoms which rose 25.3%, Tiger Brands 19.1%, Wilson Bayly 14.0% and Investec 13.7%. On a negative note, the shares which lagged in the Fund were B&W which declined 10.8% and African Bank which fell 2.6%.

Chart 6: Annual returns to 31 December 2012



The annual returns to December are shown in Chart 6. ***The annual return of the Fund for the year to December was 25.5%***. Inflation rose 5.6% over the year and the All bond index rose 16.0%.

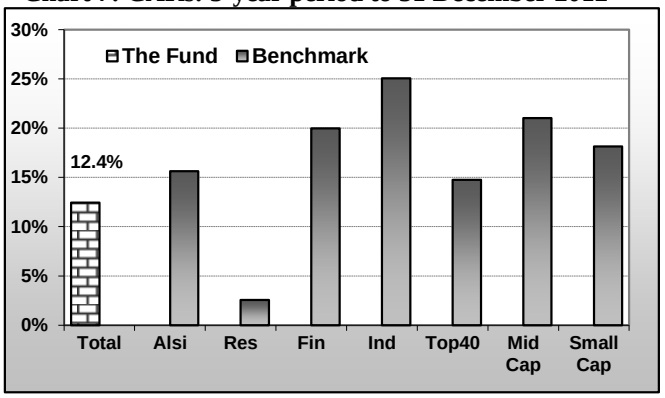
The Fund's annual can be compared to the All share index return of 26.7%. The dramatic underperformance of the resource sector relative to the industrial and financial sectors is very evident in the chart. The Fund's underweight position within the resource sector (relative to the All share's weighting) has assisted the performance of the Fund over the last year. Putting the industrial and financial sectors' amazing outperformance into perspective; over the past year industrials and financials are up 40.8% and 38.0% respectively versus a gain of 5.4% for the resources sector. Not shown in the chart above are the annual returns of large, mid and small cap index, which rose 26.1%, 39.6% and 29.0% respectively.

There has been a lot of comment in the press recently regarding the large divergence in the returns of companies which fall into the "growth" classification as opposed to those falling into the "value" classification. Managers who manage portfolios with a growth mandate have generally outperformed managers with a value mandate over the last few years. I must add here that we at Maestro manage portfolios in a "style agnostic" way. This means that we are not purists and thus inflexible/constrained in our style choice. Rather we take the bigger picture into account (i.e. look at market conditions) as well as many different company specific factors (not just valuation or growth prospects) when making investment decisions.

With the above as background, it should not surprise you that within the Fund, companies which have managed to record good growth in earnings have outperformed those with "cheap" valuations. Taking a closer look at the annual returns for these "growth" companies within the portfolio, Mr Price rose an impressive 75.4%, Aspen 74.8%, Coronation 74.7%, Pinnacle 67.8%, Richemont 63.1%, Naspers 53.8%, Wilson Bayly 49.3% and Cashbuild 30.5%. These returns exclude dividends i.e. the changes reflect only the share price movements. It is also not too much of a surprise that the shares which detracted from the Fund over the past year were those which can be grouped into the "value" classification. These include Anglos which declined 12.3%, African Bank 6.1%, Sasol 5.9% and B&W 3.3%.

The compound annual return (CAR) of the Fund over the three-year period to December 2012, shown in Chart 7, ***was 12.4%*** and can be compared to the return over the same period of the All Share Index's 15.6%.

Chart 7: CARs: 3-year period to 31 December 2012

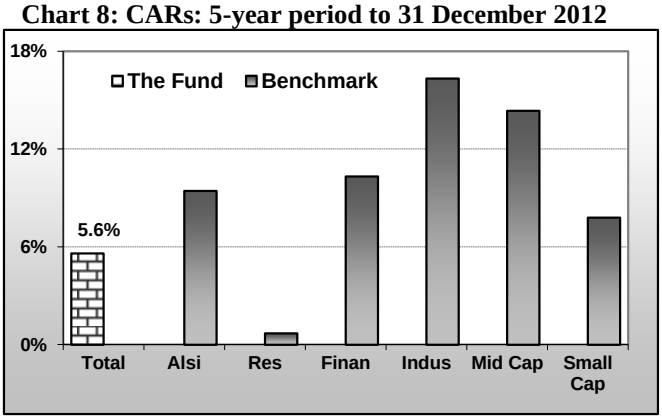


It is clear from Chart 7 which sectors have driven the market higher over the past three years. Across the

market cap spectrum, it will come as no surprise that the large cap index lagged the mid and small cap indices with returns of 14.8%, 21.0% and 18.1% respectively. The respective CARs for the All Bond index and cash over this period were 13.2% and 6.1%.

Chart 8 depicts the Fund's CARs for the five-year period to 31 December 2012. ***The compound annual return*** (CAR) ***of the Fund over the five-year period to December was 5.6% per annum*** compared to the All share index return of 9.4%. At the risk of stating the obvious, we will point out again how the industrial index has outperformed all other sectors. Industrials' compound annual return over the five-year period was 16.3% while financials and resources returned 10.3% and 0.7% respectively over the same period. The 5-year CARs for the large, mid and small cap indices are 8.8%, 14.4% and 7.8% respectively. The respective CARs for the All Bond index and cash were 11.1% and 7.9% over this period.

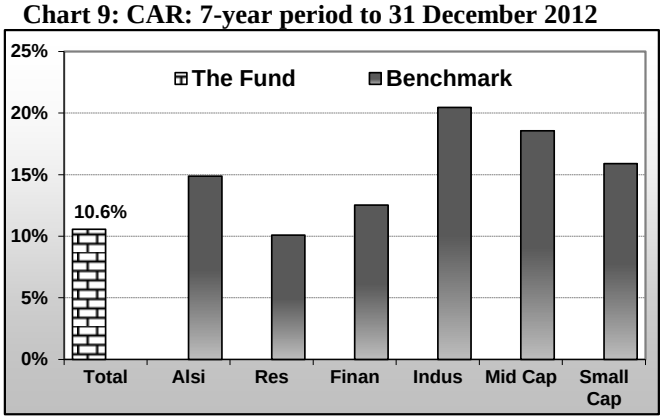
Chart 8: CARs: 5-year period to 31 December 2012



What is not seen in the previous graphs is a trend we have brought to your attention previously, namely the outperformance of the SA equity market relative to developed market returns. Whereas the All share index rose 9.4% *per annum* over the past five years, the MSCI World index rose *only* 0.9% (in rand terms) per annum! When you consider how low the global returns are, you realise that the SA equity market has been a very profitable investment destination relative to the rest of the world.

Chart 9 lists the compound annual returns (CARs) over a seven-year period. ***The compound annual return*** (CAR) ***of the Fund over the seven-year period to December was 10.6% per annum*** versus the return over the same period of the All Share Index of 14.9%. In order to place these long-term returns in perspective, as well as those of the SA equity market, consider the CARs of other markets over the past seven years to December: the MSCI World index, which incorporates developed equity markets, rose only 0.9% *per annum* although the MSCI Emerging market index rose 5.9% per annum.

Chart 9: CAR: 7-year period to 31 December 2012



6. Closing remarks

It is nice to close off the year with another strong quarter of equity markets gain. 2012 turned out to be a very profitable year in the local and in most international markets. Key events such as the US fiscal cliff negotiations, the US elections and the handover of power in Japan and China all had the potential to unsettle markets during the quarter. In effect the opposite happened as the local market, along with most international markets, chugged higher with relatively low levels of volatility. I would encourage you again to read about the key themes which influenced markets during the quarter in the *Market commentary – the 2012 December quarter* document.

While the world managed to avoid the major "tail-risks" over the year, it would be naïve to think that all major risks have been removed from the market. Elections in Italy and the debt ceiling debate in the US in the coming months pose short-term risks to markets and we will be keeping a close eye on these two key events. It must also be noted that many markets around the world have risen sharply of late and are hitting all-time highs; this leads us to be a bit cautious. We would have a greater degree of concern if market valuations were also looking stretched. However in many cases, including that of the local market, markets are not that expensive.

Another important point to raise is that of the major competing asset to equities, namely bonds. Bonds are becoming increasingly "risky" due to extremely low or in many cases negative real yields which they are offering. We believe that investors are being (and we believe will continue to be) enticed away from bonds and into equities due to their relatively high dividend yields. This theme of rotation from "expensive" bonds to "cheap" equities gives us confidence that the equity market will be supported in the medium to longer term.

So after enjoying a good year in equity markets, the base for further substantial gains has been set quite high going into 2013. We are conscious that there are a few hurdles that the market has to deal with in the short-term which pose some threat to substantial short term gains. That said, we are confident in the medium to longer term outlook for equities and will continue the search for attractively valued, quality companies in the market. These are companies with strong balance sheets, good management, strong cash flows and good prospects for earnings growth. We will thus continue our conservative management of the portfolio and will retain holdings in companies we believe will lead to respectable returns in the long-term.

Luke Sparks
On behalf of the Maestro team
28 January 2013

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

MAESTRO

Market commentary – the 2012 December quarter

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

Table 1: Selected returns – equity markets

	Dec quarter (%)	Sep quarter (%)	2012 returns (%)	2011 returns (%)
Japan	17.2	-1.5	22.9	-17.3
Hong Kong	8.7	7.2	22.9	-20.0
Germany	5.5	12.5	29.1	-14.7
UK	2.7	3.1	5.8	-5.5
US (S&P500) and large cap	-0.4	6.5	16.3	2.5
S&P Mid cap	3.2	5.0	16.1	-3.1
S&P Small cap	-0.1	5.1	12.6	-0.2
MSCI World index	***2.1***	***6.1***	***11.4***	***-7.6***
Brazil	3.0	8.9	7.4	-18.1
Russia	3.5	9.3	10.5	-21.9
India	3.5	7.7	25.7	-24.6
China	7.1	-6.3	1.5	-21.7
MSCI Emerging market index	***5.3***	***7.0***	***15.2***	***-20.4***
JSE All share	***10.3***	***7.3***	***26.7***	***2.6***
JSE All share ($)	***7.3***	***6.3***	***20.6***	***-16.0***
Basic materials	8.7	1.8	5.4	-5.7
Financial	9.9	6.5	38.1	7.4
Industrial	12.4	10.5	40.8	9.2
Gold mining	-5.0	3.1	-18.5	6.9
Large cap (Top40)	10.9	7.6	26.1	2.2
Mid cap index	7.7	5.4	29.6	4.7
Small cap index	8.0	6.2	29.0	1.1

The December quarter brought to a close what was in many cases a profitable year in equity markets. Key events such as the US fiscal cliff debacle, the US and Japanese elections, a political handover in China as well as further monetary stimulus by the major central banks around the world, all played a role in the respective market performances. Towards the end of the quarter investors started to give US politicians the benefit of the doubt and took a positive view that some sort of deal would be reached on the fiscal cliff which supported the markets. What added to the positive sentiment was the announcement by the Federal Reserve that interest rates (the fed funds rate) would be kept in an exceptionally low range for "at least as long as the unemployment rate remains above 6.5%". Investors in Asia also took a positive view on the transition of power and planned policy changes in the continent's two largest economies and piled into Asian equity markets. We will expound on these key events later in the report.

On the whole as was the case in the third quarter, emerging markets fared better than developed markets during the quarter. The MSCI emerging market index rose 5.3% compared with the MSCI World index return of 2.1%.

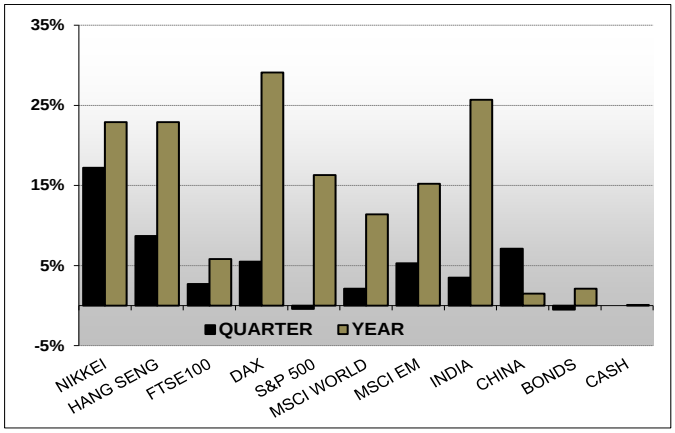
Table 2: Selected returns – bonds, commodities, currencies

	Dec Quarter (%)	Sep Quarter (%)	2012 returns (%)	2011 returns (%)
SA All Bond index	2.6	5.0	16.0	8.9
SA Cash	1.3	1.4	5.6	5.7
Barcap Global Agg. Bond index	-0.5	3.3	2.1	5.6
Emerging market bonds	3.1	6.3	15.8	8.1
US 10-year bond	-0.4	0.9	-0.4	9.4
US Corporate bond	0.7	4.0	10.3	7.5
US High yield bond	3.3	4.6	15.6	4.4
Cash (US dollar)	0.0	0.0	0.1	0.1
DJCS Hedge index	1.5	1.9	5.9	-2.5
Brent (Oil)	-1.1	14.9	3.5	13.3
Gold	-6.3	11.1	5.7	11.7
Silver	-12.6	28.0	6.3	-8.0
Platinum	-8.5	16.8	12.8	-22.9
Palladium	9.7	9.4	11.8	-21.0
Copper	-3.8	8.7	4.8	-21.7
Nickel	-7.5	12.7	-6.0	-26.8
Baltic Dry index	-8.8	-23.7	-59.8	-2.0
CRB Commodity index	-4.7	13.8	-3.4	-5.4
S&P GS Commodity index	-3.2	17.3	-0.2	3.9
Euro dollar	2.5	1.4	1.6	-3.2
Sterling dollar	0.7	3.0	4.6	-0.7
Swiss franc dollar	-2.6	-0.7	-2.1	0.3
Rand dollar	-2.8	-0.9	-4.8	-18.1

Global investment markets

Chart 1 summarises the quarterly and annual returns of the major global equity, bond and cash markets.

Chart 1: Global returns to 31 December 2012



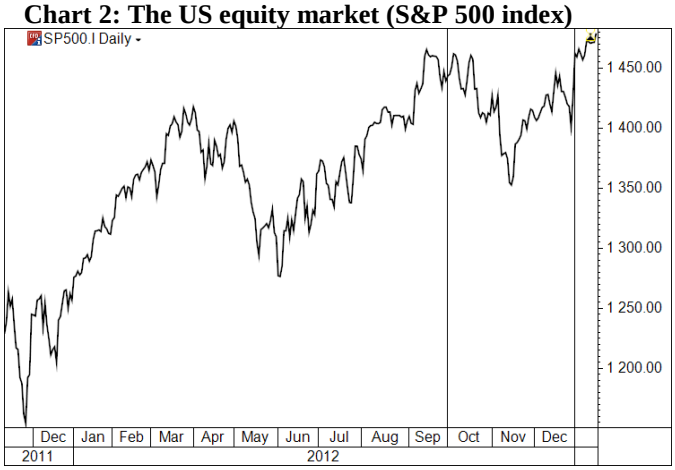
You can see clearly from Chart 1 that the positive quarter which most major equity markets experienced assisted in producing very respectable and in many cases superb annual returns.

While by no means comprehensive, the following were some of the key features of the December quarter which caught our attention and which we would like to expound on further:

- *US fiscal cliff narrowly avoided:* By far, the main feature of the December quarter was the US fiscal cliff debacle. It was widely believed that the consequences of no fiscal cliff deal being reached would likely cause a severe US and possibly even global recession in 2013. The full brunt of the automatic cuts in government spending along with simultaneous increases in various tax rates as a result of no deal being reached was estimated to cut about 4.5% from US 2013 GDP. Investors however took a positive view that some sort of deal would be struck before the 31 December 2012 deadline which caused many equity markets to move higher during the quarter.

  The end result was an 11th hour bill being passed to avoid the fiscal cliff. Some of the key features of the deal include an increase in the maximum tax rate for the highest earners from 35.0% to 39.6%. Top tax rates on capital gains and dividends increasing to 23.8% and a 2% payroll tax cut will be allowed to expire. Expanded unemployment benefits would be extended for a year. The automatic spending cuts of $110bn due to kick-in in January 2013 will now be delayed until February when Congress will again need to negotiate to increase the debt ceiling which is the next hurdle facing financial markets.

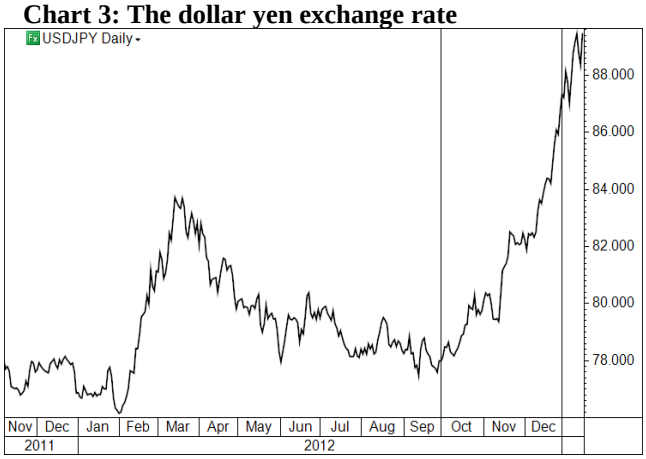
Chart 2: The US equity market (S&P 500 index)



Source: Saxo Bank

- *The US market and elections:* After a strong performance in the third quarter the US equity market (Chart 2) lagged its developed market peers in the final quarter of 2012. Despite a weaker dollar which in theory should have provided support for the market, some of the major index constituents performed poorly (most noticeably Apple) which weighed heavily on the S&P500 index. The fourth quarter also saw the conclusion on the US presidential race with Barak Obama securing a second term in office. We found it remarkable that after spending a record-breaking $6 billion (more than the GDP of Malawi) on the 2012 election, US voters opted for four more years of the same, in terms of senate, congressional and presidential representation. We are of the increasing belief that there are fundamental flaws in the US political machine and however good the president's intentions are he is likely to have limited power to implement a substantial policy change to get the US out of their low growth and high debt mess.

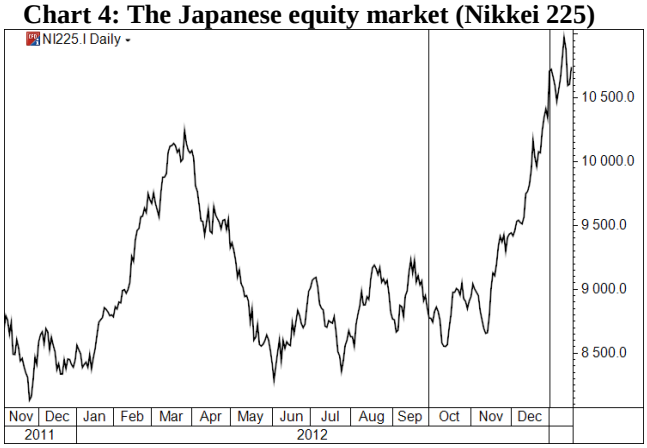
Chart 3: The dollar yen exchange rate



Source: Saxo Bank

- *Policy change in Japan:* There were also significant political and policy shifts in Japan during the fourth quarter. These came about as Shinzo Abe took over the reigns as Prime Minister during December for a second time after being booted out of office in 2007. Abe has subsequently announced that he will "set a policy accord" with the Bank of Japan (BoJ) for a mandatory inflation target of 2% backed by "unlimited monetary stimulus".

Chart 4: The Japanese equity market (Nikkei 225)

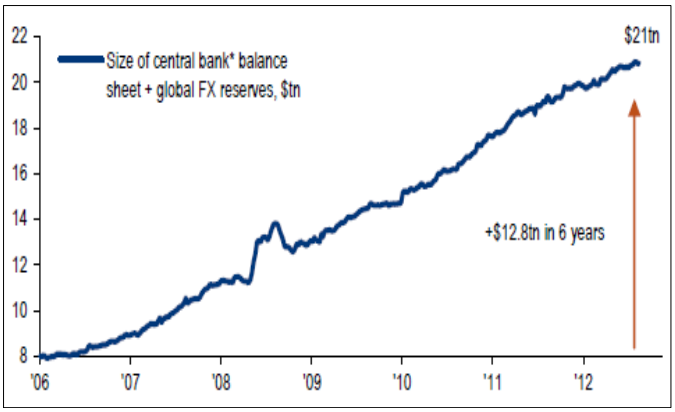


Source: Saxo Bank

The BoJ also expanded its monetary stimulus program by another 10 trillion yen to 76 trillion yen in December. The net effect of the change in political power and the

excessive monetary stimulus by the BoJ was a dramatically weaker yen (Chart 3) which resulted in an astounding 17.2% rally in the Japanese equity market (Chart 4) in the fourth quarter. After a lacklustre first three quarters of 2012 the Nikkei dramatically outperformed all other major equity markets in the final quarter and finished the year up 22.9%.

Chart 5: Cumulative size of ECB, Fed, BoJ, BoE and SNB balance sheets



Source: Merrill Lynch, Bloomberg

- *Monetary stimulus has shown no signs of abating:* Central banks around the world have continued to pump liquidity into the system through quantitative easing and other methods over the last six years. Chart 5 above shows the combined balance sheets of the world's major central banks more than doubling since 2006. During the quarter a significant announcement was made by the US Federal Reserve Chairman, Ben Bernanke, stating that interest rates (the fed funds rate) will be kept in an exceptionally low range for "at least as long as the unemployment rate remains above 6.5%". The significance of this statement is that it is the first time that the Fed's monetary policy has been explicitly aligned to a level of employment in the economy. This highlights the stark difference between the Fed's mandate, which is both aimed at reducing unemployment and also price stability, and the ECB's mandate which remains solely price stability. The Fed's surprise statement was alongside the widely expected move to roll the expiring Operation Twist into outright purchases of longer-term Treasuries at a rate of $45bn per month and of similar average duration.
- *Equity market strength: Most e*quity markets responded favourably to Bernanke's comments in mid-December. Other factors which assisted the strong markets in the last few weeks of the year were promises of ever increasing central bank intervention from various other parts of the world, some recovery momentum in China, and a general optimism around a fiscal cliff compromise. Investors gave authorities the benefit of the doubt and continued to reduce the odds of the worst case scenarios (tail risks) occurring. The performance of the German market (Chart 6) has been a standout amongst developed markets, rising another 5.5% during the quarter, despite the strong euro, to end 2012 with a gain of 29.1%.

Chart 6: The German equity market (The Dax index)

Source: Saxo Bank

- *Volatility mixed depending where you look:* It is fascinating to see from Table 1 and Table 2 above the differences between the volatility in equity markets and commodity prices. The Vix (index measuring the volatility in US equity markets) was pointing to record low volatility in equity markets during the quarter. This can be contrasted in the theme which we have seen throughout the year of large and dramatic swings in many commodity prices.

Chart 7: The Silver price (US¢)

Source: Saxo Bank

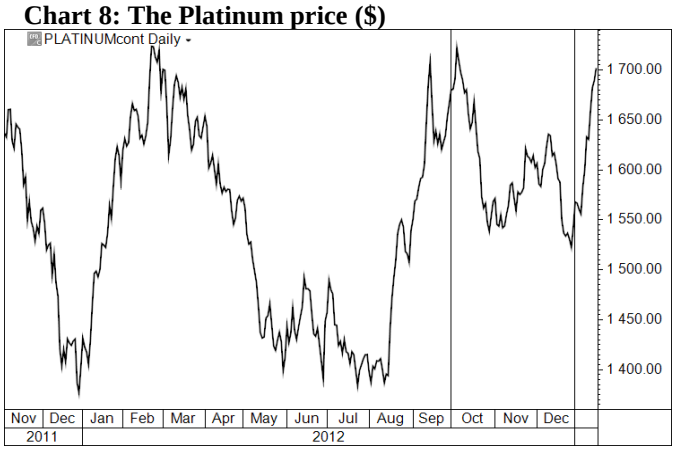
We commented in the third quarter market commentary about the volatility in the price of silver and Chart 7 depicts that this trend continued throughout the final quarter of 2012. Volatility has been the dominant theme in most precious metal markets over the last couple of years. This is best depicted in the price movement of silver over the last two years. From December 2010 to December 2012 the price of silver is virtually unchanged at about $30 per ton. Looking a bit closer at the price action within these 24 months we see the dramatic volatility in the silver price as it traded in a massive $23

range between $26 and $49! It is no surprise that with the fear of currencies "losing their value" as a result of excessive quantitative easing by global central banks, a large speculative interest remains by investors in "hard asset" markets like silver.

Another commodity which was also particularly volatile throughout 2012 was platinum. Chart 8 depicts this volatility in the precious metal which was not only heightened by the macro issues including fears about a slowing global economy and monetary stimulus, but also by significant demand and supply issues. Labour unrest in the world's largest platinum producer (South Africa) during the third and fourth quarter created a significant amount of uncertainty around the current and future supply of the metal. The 8.5% decline in the price during the fourth quarter must be seen in context of the market's knee jerk reaction in the third quarter to the start of the strike action where the price gained 16.8%.

It is worth pointing out that so far in 2013 the price has again risen sharply in response to Anglo Platinum's announcement of their planned significant reduction in production equivalent to about 7.0% of the world's annual demand!

Chart 8: The Platinum price ($)



Source: Saxo Bank

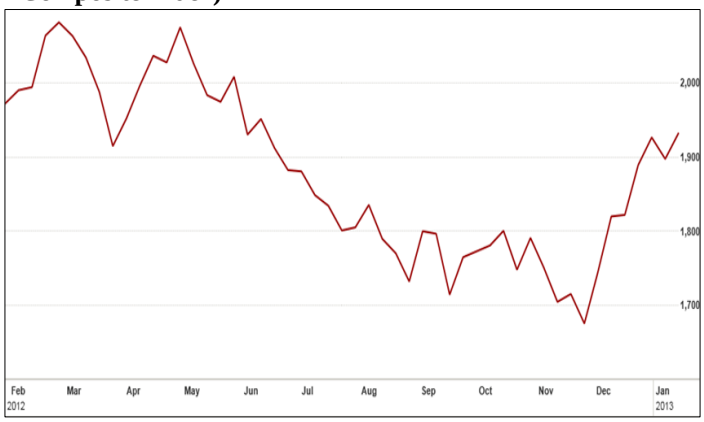
It is also worth commenting on the "surprising" price action of gold during the quarter and in essence, throughout the year. The gold price movement in 2012 continued to confound many pundits who, in a backdrop of large amounts of quantitative easing, were calling for the price to rise well over $2 000 at the end of the year. Yet *even* with very bold moves from many global central banks, particularly from the Fed and the BoJ *and* a weaker dollar during the fourth quarter, the price of gold declined by over $100 in the final three months of 2012.

Chart 9: The Gold price ($)

Source: Saxo Bank

Looking at the annual performances, it was a mixed but generally positive picture for the different commodities. Coffee was the worst performing commodity down by nearly 37% while lumber saw the best returns, gaining 51%. In the precious metals universe, despite the heightened volatility, platinum (12.8%) and silver (6.3%) outpaced the gains seen in gold (5.7%). The broader commodity index CRB index (-3.4%) declined for the second consecutive year in 2012.

Chart 10: The Chinese equity market (Shanghai Composite Index)



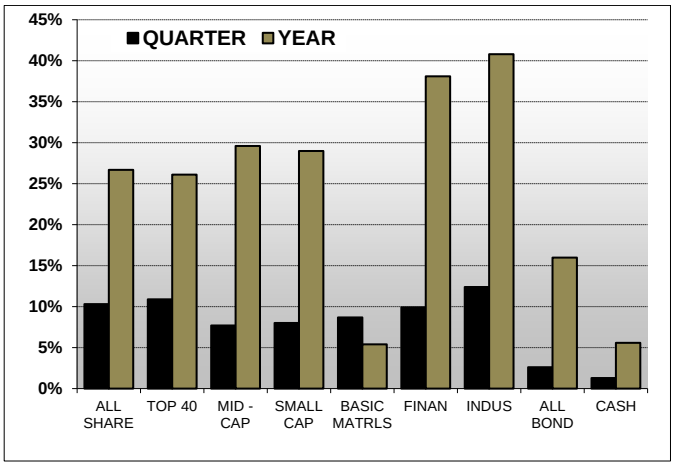
Source: The FT

- *Transition of power in China:* The once in a decade transition of power in China also took place during the quarter which saw Xi Jingpin and Li Keqiang take over the reins of the world's second largest economy. The new leaders have come to power with their stated goals being to transition the Chinese economy from one which has had a heavy reliance on infrastructure development and exports to a more consumption driven economy. The market has taken a positive view on the leadership transition and the Shanghai composite index (Chart 10) staged a dramatic turnaround it the fourth quarter, rising 7.1% to end the year in positive territory.

Local investment markets

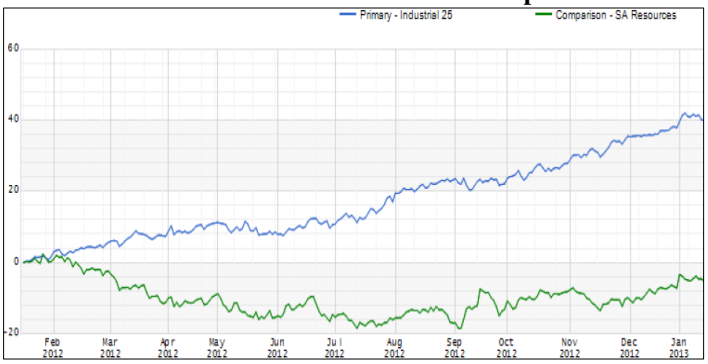
Turning to South African (SA) investment markets, Chart 11 depicts the quarterly and annual gains in the major indices for period ended 31 December 2012.

Chart 11: Local returns to 31 December 2012



The Chart above shows the impressive returns that were enjoyed in almost all sectors of the local market during the quarter. The industrial sector (the usual suspect) led the charge by gaining 12.4% followed by the financial 9.9% and resource 8.7% sectors. The gold sector was the exception, declining 5.0% over the quarter as a weaker rand was not able to compensate for a declining gold price and continued negative investor sentiment towards gold miners. Overall, it was a very profitable year for both local and foreign investors in the SA equity market as the All Share index rose 26.7% in rand terms and 20.6% in dollar terms. Almost all of the major sub sectors of the market, barring the gold sector, enjoyed strong fourth quarter performances.

Chart 12: Industrials and resources relative performance



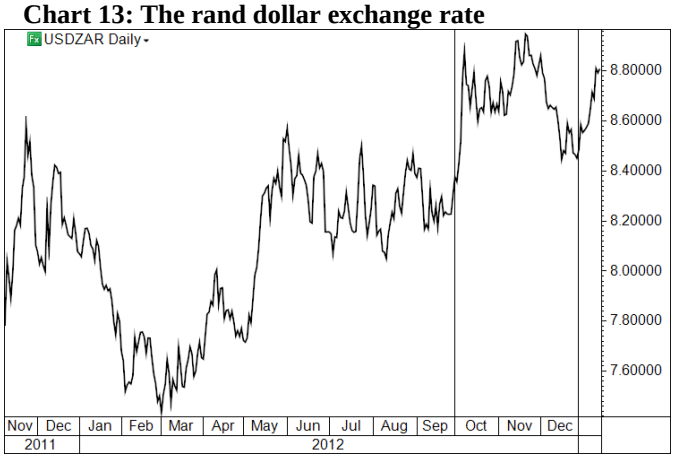
Source: Investec Securities

What took many local investors and managers by surprise during 2012 was the dramatic underperformance of the resource sector. Chart 12 shows the relative performance of the industrial and resource sectors over the last 12 months. Even with the rand weakening 4.8% over the year (which in theory should have boosted resources) the basic materials index underperformed the industrial and financial sectors by 35.4% and 32.7% respectively! With much uncertainty around global growth still plaguing the markets, investors favoured companies with relatively stable earnings growth prospects (i.e. industrials and financials) over their cyclical counterparts (resources). Despite a weaker rand and a couple of downgrades on SA government bonds by ratings agencies, Fitch and S&P, the All Bond index enjoyed a great 16.0% gain during the year. This is a clear indication that international investors are continuing their search for positive real yields (i.e. yields in excess of inflation) – an attractive quality which SA government bonds still offer.

Within the market capitalisation universe, it was a strong quarter for large caps, as the 10.9% increase in the Top40 outpaced the mid and small cap gains of 7.7% and 8.0% respectively. However, mid and small caps have outpaced their large cap peers over the last year, rising 29.6% and 29.0% respectively versus the 26.1% gain for the Top40.

Turning to the local economy, industrial action in the mining and transport sectors weighed heavily on the economy in the third quarter, but conditions continued to worsen in the fourth quarter given the duration of the strikes in the platinum, gold and transport sectors. GDP growth in the third quarter was negatively impacted, coming in at 1.2% quarter on quarter (qoq). The mining sector was the main drag as expected, contracting by 12.7% qoq and subtracting 0.6% points from growth. Overall the growth performance was poor across all sectors except for agriculture which expanded by 7.4% in the third quarter. There were a few other negative prints on the local data front, one of them being the fourth quarter BER business confidence index which declined by one point to 46. This means that more than half of the respondents to the survey (business owners or managers) were downbeat about the business climate over the fourth quarter.

Chart 13: The rand dollar exchange rate



Source: Saxo Bank

One of the more worrying things that we are watching is continued deterioration in the cumulative trade deficit which came in at R112.7 billion in November, from a deficit of R18.4 billion over the same period a year ago. One of the key reasons for the continued deterioration in the cumulative trade

deficit can be explained by the sharp drop in the exports to Europe (SA's biggest trading partner), which dropped by 10.3% compared with a year ago. The deficit was also impacted negatively by the mining and transport strikes which put substantial pressure on the rand for most of the fourth quarter (Chart 13) and remains a key risk to the rand into 2013.

In closing

Markets in general showed their resilience in the fourth quarter. Key events such as the US fiscal cliff negotiations, the US elections and the handover of power in Japan and China all had the potential to unsettle markets. In effect the opposite happened as most markets chugged higher with relatively low levels of volatility. To us this highlights a couple of key "bigger picture" themes which will likely prevail in the market for some time.

One of these themes relates to the important fact that equities remain a relatively under-owned asset class. What we mean by this is that equity weightings in both the retail investor and global fund managers' portfolios have been relatively low. This has been a result of both scepticism and caution in the asset class by investors and managers and hasresulted in them not fully participating in the rally of most equity markets over the last four years. With a substantial amount of cash sitting on the side-lines and waiting for an opportunity to be deployed, there seems to be a strong underpin to the markets.

Another important theme which will likely direct equity markets, albeit over the medium to longer term, is the attractiveness of alternate investment options. The major competing asset class to equities is bonds. As bond yields continue to fall, bonds as an asset class is looking increasingly risky. In many cases the continued purchasing of bonds are in effect almost guaranteeing investors a negative real return due to ultra-low bond yields and rising inflation expectations. Investors are thus being "forced" to notice the attractive dividend yields which many stable and well capitalised shares are offering and increase their allocation to equities. This theme, termed the "Great Rotation" (i.e. investors' rotation out of bonds and into equities), is Merrill Lynch's highest conviction call over the medium term which they say may have already begun in 2012.

The fundamentals for equities are also good with many reasonable valued, well capitalised, strong dividend paying companies with good earnings growth prospects and solid management teams still identifiable in the market. Add to the fundamentals the facts that the "growth" asset class, equities, are under-owned by global investors and the relative attractiveness of bonds fast decreasing, we are positive on equities over the medium to longer term.

All this being said, many global markets have risen substantially in 2012 and thus the base has been set quite high going into 2013. Fortunately the world managed to avoid some of the key tail risks which would have almost certainly unsettled markets during 2012. These key tail risks which seem to have subsided for the moment include this risk of a collapse (economically or politically) of a European nation or a major policy mistake by politicians or policy makers of a large global economy.

Elections in Italy and the debt ceiling debate in the US in the coming months do pose short term risks to markets and we will be keeping a close eye on these two key events. Another important point to mention is the reasonably close correlation of many equity market performances and growth in manufacturing within the underlying economy (measured by the Purchasing managers Index or PMI). Although many equity markets have risen substantially over the year, manufacturing in the underlying economies are lagging substantially. It seems that investors are pricing in a rebound in manufacturing growth, which if we do not see in the coming quarter, could lead to a short term setback in the markets.

Be that as it may, by many accounts the future is by no means certain. While some short term challenges which we have mentioned above still face equity markets, we remain relatively optimistic on the medium prospects for equity markets. If we were to see a near term pull back in equity markets, our bigger picture themes suggest that investors sitting with large cash balances may use such an opportunity to increase their equity holdings. This would no doubt provide an underpin to the markets.

The Maestro Investment Team
23 January 2013