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 2.05%.

Income Distribution (annually)
17.76 cents per unit
31 December 2013

FUND SIZE: R126 796 947

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
Box 1289
CAPE TOWN
8000
Phone: 021 674 9220
Fax: 021 674 3209
Email: equityfund@maestroinvestment.co.za

The Maestro Equity Prescient Fund

Quarterly report for the period ended

31 December 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 – December 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 14.5% of the Fund, down from 15.1% in September. Financial exposure rose 0.6% to 14.5% and industrial exposure declined 2.5% to 60.9%. Cash represented 7.9% of the Fund, up from the 7.6% at the end of September.

Chart 1: Asset allocation at 31 December 2013

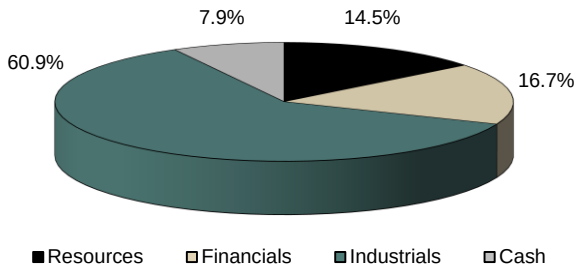
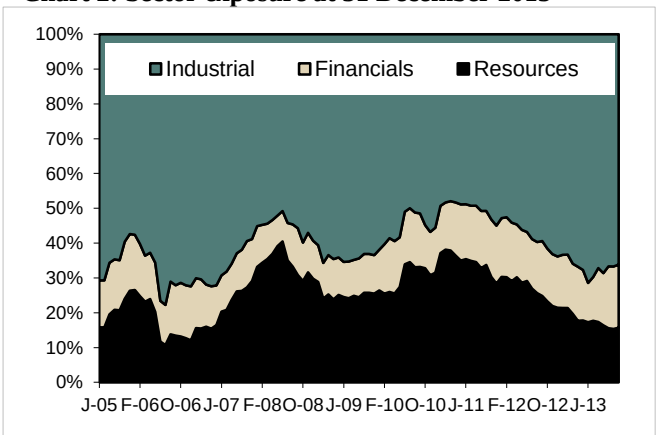


Chart 2 depicts the historical allocation to the three major sectors of the equity market, expressed as a percentage of the equity portion of the Fund.

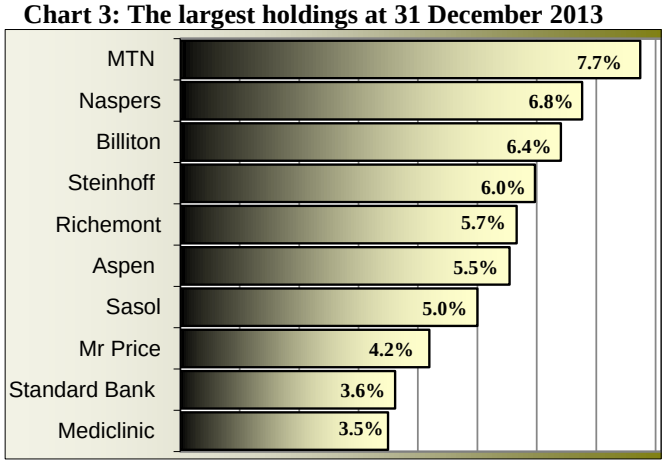
Chart 2: Sector exposure at 31 December 2013



3. The largest equity holdings

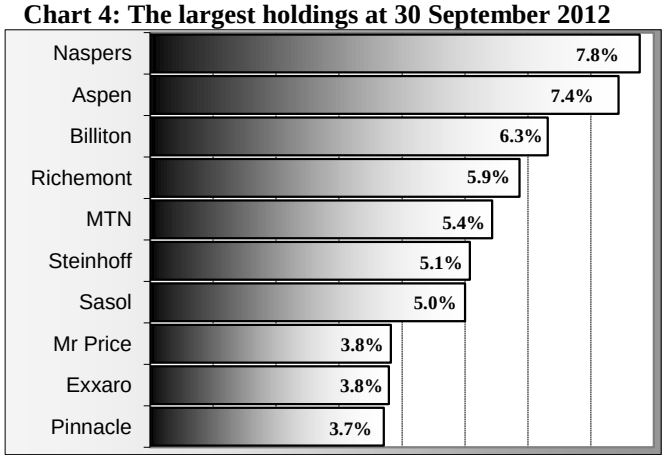
The largest holdings at 31 December are listed in Chart 3, expressed as a percentage of the equity portfolio.

Chart 3: The largest holdings at 31 December 2013



The largest holdings at the end of September are listed in Chart 4. During the quarter Exxaro replaced Mediclinic in the top 10 holdings of the Fund. At the end of December there were 32 counters in the Fund, one more than at the end of September. The ten largest holdings constituted 54.4% of the Fund up from 54.2% 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. After stellar performances in the first part of the year the holdings in Naspers and Aspen were reduced slightly during the fourth quarter. Both of these companies remain core holdings in 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 added to its financial exposure by increasing the Old Mutual, Standard Bank and Discovery holdings.

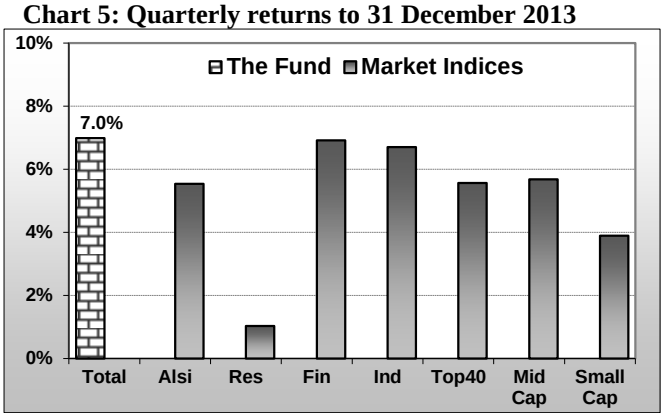
The Fund's holdings in MTN and Woolworths were increased while a small holding in the Atterbury Property Fund, Attacq, was introduced into the Fund.

Post some disappointing results from Tiger Brands, the Fund sold out of its relatively small holding in the company. The Fund also reduced its holding Hudaco.

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 7.0%***.

Chart 5: Quarterly returns to 31 December 2013



The Fund's return can be compared to the All share index return of 5.5%. 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 also encourage you to read the commentary on the market movements during the quarter in the document entitled *Market commentary – December 2013.*

There was little change to the momentum of markets moving from the strong third quarter into the fourth quarter of 2013. Despite the December announcement that the Federal Reserve (the Fed) would start reducing its bond buying program by $10bn per month, developed markets rose strongly. Locally, the All Share index continued to chug upwards, spurred to a large extent by a weaker rand. The rand weakened 3.9%, 5.9% and 6.4% against the US dollar, pound and the euro respectively during the quarter.

Resources remained out of favour amongst investors during the quarter and even the weakening rand was unable to significantly boost the basic materials index, as it rose only 1.0% in the fourth quarter. Financials and industrials on the other hand enjoyed yet another strong quarter rising 6.9% and 6.7% respectively.

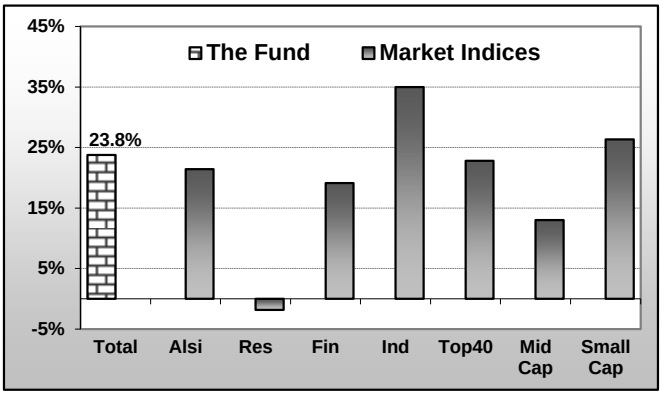
What is not evident from Chart 5 is the performance of companies based on their size. With small-cap companies outperforming their mid-cap counterparts for the previous two quarters, it is not surprising that this trend turned around in the fourth quarter. The mid-cap index rose 5.7%, while the small-cap index gained 3.9%. The large-caps also rose strongly as the Top40 index gained 5.6% during the quarter.

Let us look at the December quarterly returns of some of the Fund's investments. The quarterly returns, excluding dividends, of the largest holdings in the Fund were as follows: MTN rose 10.7% (it rose 6.5% in the September quarter), Naspers 18.0% (27.2%), Billiton 8.9% (17.0%), Steinhoff 26.2% (45.8%), Richemont 3.6% (14.7%), Aspen 2.3% (15.7%), and Sasol 7.4% (11.0%), Mr Price 17.8% (3.2%), Standard Bank 7.3% (7.5%), and Mediclinic 2.3% (8.2%).

It is dangerous to read too much into the short-term returns of the Fund. When selecting investments for the Fund we ensure that the long-term prospects of the companies are sound and that their management has the ability to deliver on their stated objectives. I would therefore encourage you to focus on the longer-dated returns.

The annual returns to December are shown in Chart 6. ***The annual return of the Fund for the 12 months to December was 23.8%*** which compares very favourably with the All share index return of 21.4%. Inflation rose 5.4% over the year and the All bond index rose a meagre 0.6%.

Chart 6: Annual return to 31 December 2013

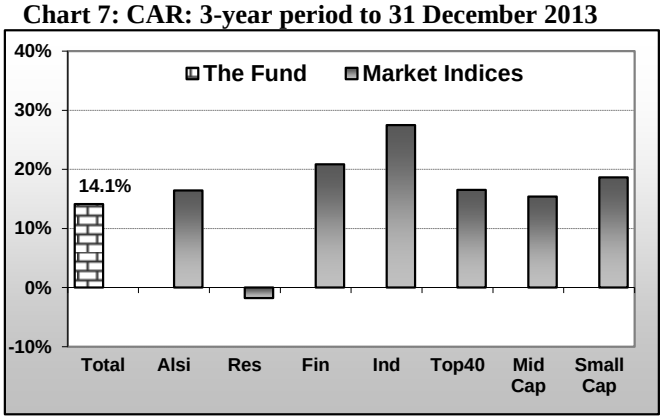


The severe underweight position in basic materials relative to the All share index, and the fact that the Fund held no gold shares (the gold index declined 54.6% for 2013), assisted the returns over the past year. Not shown in the chart are the annual returns of large, mid and small-cap indices, which rose 22.8%, 13.0% and 26.3% respectively.

Chart 6 clearly shows the strong outperformance of the industrials index during the year. With the rand depreciating 19.0% against the US dollar during 2013, it is no surprise that there were strong performances from the companies with significant earnings offshore. These include Naspers which rose 101.8% over the past year, Steinhoff 64.5%, Aspen 59.0%, Richemont 57.3%, Mediclinic 38.6% and MTN 22.2%. Other companies that performed well in 2013 included EOH which rose 112.7%, Coronation 101.6%, OneLogix 79.0%, Grindrod 76.9%, Sasol 41.8% and SABMiller 36.8%. There were a few companies which disappointed, namely Kumba which fell 22.1%, Tiger Brands 17.9%, Exxaro 13.3% and Wilson Bayly Holmes 7.0%.

The compound annual return (CAR) of the Fund, shown in Chart 7, ***over the three-year period to December 2013 was 14.1%*** which can be compared to the All share index return of 16.4%.

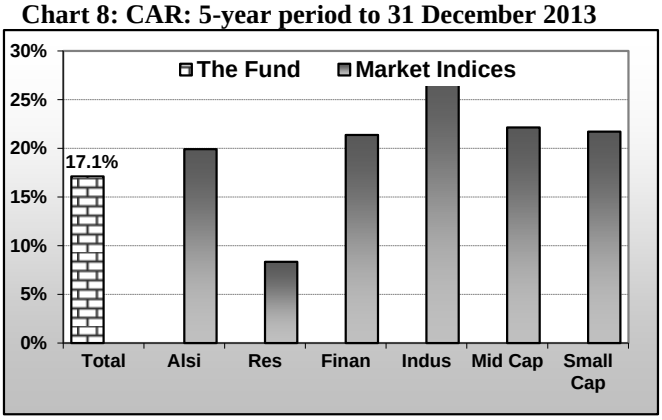
Chart 7: CAR: 3-year period to 31 December 2013



It is clear from Chart 7 which sectors drove the market higher over the past three years and it is quite remarkable that the basic material sector registered a *negative* return of 1.8% *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 16.5%, 15.4% and 18.7% respectively. The respective compound annual returns for the All Bond index and cash over this period were 8.3% and 5.5% respectively.

The CAR of the total Fund return over the five-year period to December 2013, shown in Chart 8, ***was 17.1% per annum*** which can be compared to the All share index return of 19.9%.

Chart 8: CAR: 5-year period to 31 December 2013



Over this period South African inflation rose at 5.3% per annum, while the All bond index compound annual return was 7.7%. The annual return on cash was 6.4%. At the risk of stating the obvious, the base from which these returns are being measured is end-December 2008 i.e. in the depths of the financial crisis. The industrial index compound *annual* return over the five-year period was 28.2%, while financials and resources returned 21.4% and 8.3% respectively over the same period. The 5-year compound annual returns (CARs) for the large, mid and small-cap indices were 19.6%, 22.2% and 21.7% respectively.

Chart 9: CAR: 7-year period to 31 December 2013

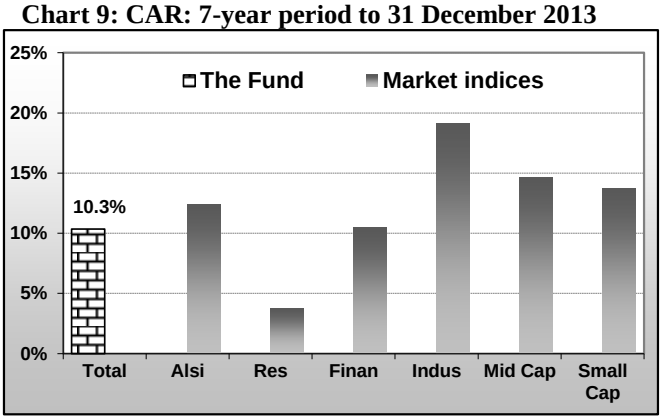


Chart 9 lists the returns over a seven-year period. ***The CAR of the Fund over the seven-year period to December was 10.3%*** versus the return over the same period of the All Share Index of 12.4%. Over this period South African inflation rose at 6.4% per annum while the All bond index compound annual return was 8.4%. The annual return on cash was 7.8%.

Again it is worth highlighting the significant outperformance of the industrial sector relative to the financial and resource sectors over the last seven years. The industrials index has risen an amazing 19.1% per annum versus the 10.3% for the financials index and 3.8% for the resource index.

6. Closing remarks

It is great to have enjoyed yet another year of good returns in the market after the strong performance in 2012. A risk that we at Maestro are keeping a close eye on this year is the slowing down of monetary easing by the Fed. Global markets have been addicted to the profound amounts of monetary stimulus that major central banks have been providing over the last five years. With the largest of them (the Fed) now clearly set on scaling back the stimulus, it is highly likely that both equity and bond markets will experience more volatility in 2014. We do not predict a financial collapse or a major crisis as a result of the reduction in stimulus; however it is highly likely that the relatively smooth ride that we enjoyed in the markets in 2013 will become a bit bumpier in 2014.

Overall, it is our view for the year ahead that the economic environment, namely a continued improvement of the global economy, should remain supportive for markets and hence our conservatively optimistic view for 2014. Saying this, company and market valuations are not cheap and earnings growth is essential for investors to enjoy another year of good returns. We will consequently retain our current strategy and investment view, which has worked well in the past and has generated good risk adjusted returns for our clients.

On behalf of the whole Maestro team, I will end by expressing my thanks to you for your support throughout last year. I am glad that the Fund enjoyed a profitable year in the markets and we will continue to do all we can to ensure that the Fund is positioned to generate substantial risk-adjusted, long term returns.

Luke Sparks
On behalf of the Maestro team
12 February 2014

MAESTRO

Market commentary – the December 2013 quarter

We comment extensively on market movements in *Intermezzo* and in the letters accompanying client statements, so provide only a summary here of the salient features of market behaviour during the December quarter and 2013 as a whole. The returns of selected equity, bond, commodity and currency markets are shown in Tables 1 and 2.

Table 1: Selected returns: equity markets

	2012 (%)	Sep Quarter (%)	Dec Quarter (%)	2013 (%)
Japan	22.9	5.7	12.7	56.7
Hong Kong	22.9	9.9	2.0	2.9
Germany	29.1	8.0	11.1	25.5
UK	5.8	4.0	4.4	14.4
US (S&P500) and large cap	16.3	4.7	10.6	32.8
S&P Mid cap	16.1	7.2	7.9	31.6
S&P Small cap	12.6	10.4	9.5	42.4
MSCI World index	***13.2***	***7.7***	***7.6***	***24.1***
Brazil	7.4	10.3	-1.6	-15.5
Russia	10.5	11.5	1.4	-5.5
India	25.7	-0.1	9.2	9.0
China	1.5	9.9	-2.7	-5.3
MSCI Emerging market index	***15.2***	***5.0***	***1.5***	***-5.0***
JSE All share	***26.7***	***12.5***	***5.5***	***21.4***
JSE All share ($)	***20.6***	***11.0***	***1.4***	***-1.6***
Basic materials	5.4	21.6	1.0	-1.8
Financial	38.1	6.9	6.9	19.1
Industrial	40.8	11.3	6.7	35.0
Gold mining	-18.5	-0.4	-16.6	-54.6
Large cap (Top40)	26.1	13.9	5.6	22.8
Mid cap index	29.6	4.8	5.7	13.0
Small cap index	29.0	12.0	3.9	26.3

Introduction

In many respects 2013 was the year in which the markets cried wolf. Of course, it is easy to see it now, with the benefit of that exact science, hindsight. This time last year we were concerned about the effects of the near-death-experience of the fiscal cliff, the Eurozone was still in apparent danger of disintegrating, the success or otherwise of quantitative easing (QE) was far from clear and certain central banks, the Bank of Japan (BoJ) in particular, had not yet committed themselves to a policy of extravagant monetary expansion. Yet for all those and other risks, global equity markets delivered one of their best years yet in terms of returns. Bond investors were less fortunate and cash investors, at least in the major developed economies, received nothing throughout the year.

Ironically, many of the risks we face in the coming year are similar, although notwithstanding the bumpy start to 2014 (at the time of writing the MSCI Emerging market index has declined 13.0% since December) there is a greater sense of comfort amongst many global investors that we may well have seen the worst of the effects of the Great Financial Crisis of 2007/9.

This market commentary is mostly about the past i.e. the salient features of investment market behaviour last year, rather than what lies ahead in 2014. We will, however, comment briefly about the bearing that last year's returns may have on the returns in 2014.

Table 2: Selected returns: bonds, commodities, currencies

	2012 (%)	Sep Quarter (%)	Dec Quarter (%)	2013 (%)
SA All Bond index	16.0	1.9	0.1	0.6
SA Cash	5.5	1.3	1.3	5.2
Barcap Global Agg. Bond index	4.3	2.8	-0.4	-2.6
Emerging market bonds	17.5	1.7	1.7	-3.3
US 10-year bond	4.2	-0.7	-2.5	-7.8
US Corporate bond	10.4	0.9	1.0	-1.5
US High yield bond	15.6	2.3	3.5	7.4
Cash (US dollar)	0.1	0.0	0.0	0.1
DJCS Hedge index	7.7	1.6	2.9	8.4
Brent (Oil)	3.5	6.1	2.2	-0.3
Gold	5.7	11.3	-9.4	-27.8
Silver	6.3	15.0	-10.1	-34.9
Platinum	12.8	7.1	-3.8	-11.1
Palladium	11.8	12.9	-1.4	1.7
Copper	4.8	7.7	1.0	-7.1
Nickel	-6.0	1.6	0.4	-18.5
Baltic Dry index	-59.8	71.1	13.7	225.8
CRB Commodity index	-3.4	3.5	-1.5	-4.1
S&P GS Commodity index	-0.2	3.3	-0.1	-1.3
Euro dollar	1.6	4.1	1.8	4.5
Sterling dollar	4.6	6.8	2.3	1.9
Swiss franc dollar	-2.1	-4.4	-1.7	-2.8
Rand dollar	-4.8	-1.4	-3.9	-19.0
Yen dollar	12.4	-1.2	7.1	21.6

The global economy

When one considers that the majority of the developed world has been living in a world of zero interest rates for more than three years already, we should perhaps be concerned that economic growth rates are not higher. As Table 3 shows, the world economy slowed in 2013, with the main culprits being the US and China, although the Eurozone continued to act as a drag on global growth. The slowing of these two huge economies had to do with the excessive stimulatory measures that were applied to them in the depths of the 2007/9 crisis and a desire on the part of policy makers to revert back to a more "normal" environment, even if they are unsure of what exactly this means any more. While an estimated growth rate of between 2.8% and 3.0% by the global economy is no mean

feat, growth nevertheless occurs at the margin, so economists and investors focus more on the fact that the growth is slowing than on the absolute level of growth. The headline growth rate also hides a number of economies, such as the bulk of the Eurozone and part of Latin America and Russia, whose growth is slowing significantly, and where the causes of the slowdown have more to do with inappropriate policies than anything else.

Table 3: Global economic growth rates (%)

	2012	2013F	2014F	2015F
Global	3.0	2.8	3.8	4.0
US	2.8	2.0	3.5	3.8
Eurozone	-0.6	-0.4	1.0	1.4
Germany	0.7	0.5	1.5	1.4
Japan	1.4	1.5	0.7	1.3
UK	0.1	1.5	2.7	2.0
China	7.8	7.8	8.6	8.2
India	4.1	4.3	5.5	6.0
EM (Asia)	6.0	6.0	6.9	6.8
EM (Lat Am)	2.8	2.3	2.6	3.1
EM (CEEMEA)	2.7	2.2	2.9	3.5
EM	4.7	4.5	5.3	5.4
DM	1.4	1.1	2.2	2.6

Source: Deutsche Bank

Two important and troublesome features of the past and prevailing global economy need to be highlighted, as they will remain major concerns and risks in the years to come; *firstly*, the growth, albeit at a slower level, has been accompanied by a noticeable lack of job creation across virtually all countries, largely in the category of youth and adult males. An economic recovery of this nature is clearly unsustainable from a socio-economic point of view and it is thus not surprising to have seen pockets of social unrest and voter discontent; we expect this phenomenon to continue this year. Even in the US, where the unemployment has declined steadily, it has only done so as large numbers of unemployed people have dropped out of the labour pool i.e. have stopped looking for work.

Table 4: Annual rates of inflation (%)

	2012	2013F	2014F	2015F
US	2.1	1.6	2.5	2.3
Eurozone	2.5	1.4	1.0	1.4
Japan	0.0	-0.2	2.1	1.3
UK	2.8	2.6	2.1	1.9
China	2.6	2.5	3.5	3.2
India	7.5	6.3	5.5	6.3

Source: Deutsche Bank

The *second* notable feature of the prevailing economic climate is the absence of inflation in the developed world (refer to Table 4). On the face of it one would think this is a good thing, but it is of great concern that corporates have lost all notions of pricing power. Japan stands as a terrible example of what can happen to an economy, not to speak of investment returns, that is doomed to deflation for decades. There is general agreement that a small, but manageable, measure of inflation – let's call that around 2.0% per annum – is preferable to no inflation or worst still, to deflation. It could well be that one of the major policy "battlegrounds" in the coming year will be about inflation and what policies to implement to prevent economies slipping into deflation. There remains little consensus about how to deal with deflation and most central bankers would probably admit in private that they are petrified of it – for good reason. Perversely, many emerging markets are now dealing with rising inflation, which creates the conundrum that the inflationary policies of the developed world could well act as fuel to the fire of the developing world's inflation problems, partly through the mechanism of a strong dollar, which translates into weaker emerging market currencies, which in turn fuels local inflationary pressures.

So we will have to monitor the characteristics surrounding employment levels and inflation as these are two important considerations when assessing the integrity (quality) of the global economic recovery expected to occur in 2014.

Global bond markets

With central bankers in the developed world promising to keep interest rates as low as possible for as long as necessary and promising to "do all that it takes" to provide sufficient liquidity to the monetary system, it is not surprising that the bond market had a tough year least year. Add to that the fact that 2013 started with record low yields (and therefore high prices), one can appreciate that global bond markets were always going to struggle to post decent returns in 2013. As it happens (refer to Table 2 for the bond market returns) only the high yield US bond market (a market that used, more accurately, to be called the junk bond market) posted positive returns during the year as a whole.

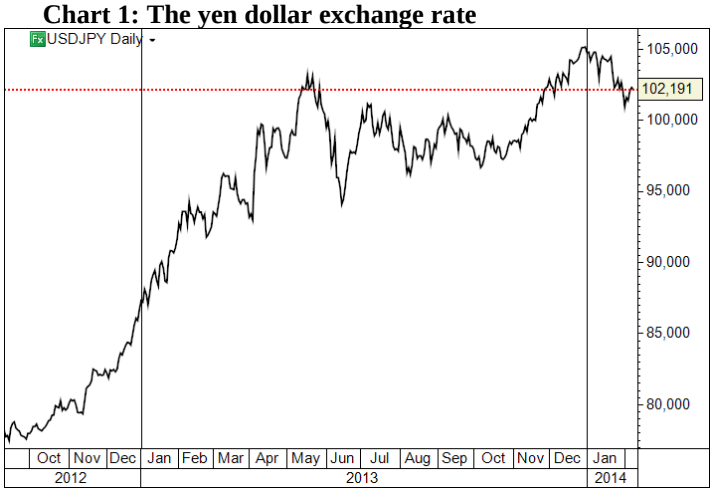
The prospects for the bond market this year hardly look any better. If anything, the headwinds are likely to increase, providing that the global economy does not slow unexpectedly. The US Federal Reserve (the Fed) is focussing on moving to a more normal monetary environment by curtailing some of its support for the bond market. It is doing so by purchasing less bonds every month; it has already decreased its monthly purchases from $85bn to $65bn per month. That said, conditions in the Eurozone and Japan are less conducive to an easing of monetary support, so there will still be some support for global bonds. However, if the global economy does grow at a faster rate as we expect it to, then the pressure on bond yields will be upwards and the pressure on prices downwards, making it hard to imagine the bond market will post any material returns of note this year.

Currency markets

Although US bond rates rose during the course of 2013, the dollar was surprisingly weak, except against emerging market currencies. The dollar declined 4.3% against the euro and 1.9% against sterling. The standout feature during the year in the developed currency markets was the determined effort by the BoJ to weaken their currency; an effort which was spectacularly successful – refer to Chart 1 below. The yen fell 17.7% against the US dollar as the BoJ flushed trillions of yen

into the market in an effort to weaken the currency and inflate prices i.e. create inflation. In so doing, it provided substantial support to their ailing export sector and indirectly also to the Japanese stock market. The Japanese stock market rose 56.7% in 2013, but by a lot less in dollar terms.

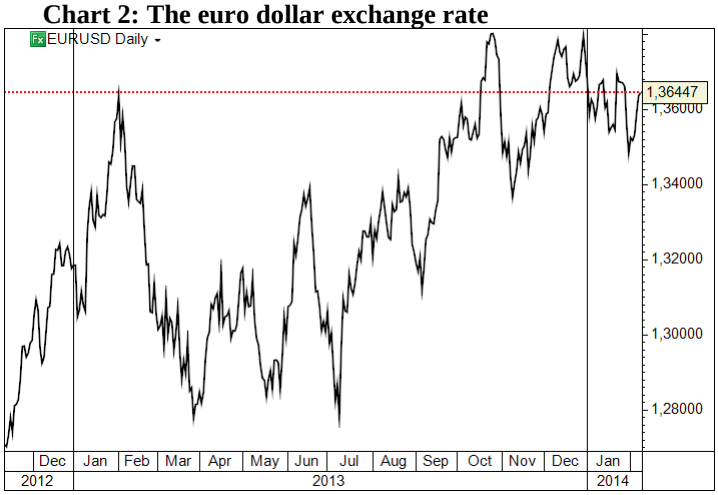
Chart 1: The yen dollar exchange rate



Source: Saxo Bank

The relative strength of the euro continues to surprise many. Confounding many who were expecting its demise in the midst of the 2007/9 crisis, given the over-indebtedness of the peripheral European countries, it remained a unitary currency and firmed throughout the year, even against the "mighty" greenback – refer to Chart 2 below. Although most economists are calling for a euro dollar exchange rate between 1.20 and 1.25 by the end of this year, we suspect it will end the year higher than that.

Chart 2: The euro dollar exchange rate



Source: Saxo Bank

A notable feature of the year, specifically towards the end of the year, was the increasing weakness in certain emerging market currencies. We have already alluded to the *Fragile Five* in our other publications, also called the *BRIITS* i.e. the currencies of Brazil, Russia, India, Indonesia, Turkey and South Africa. These countries bear the common characteristic of having current account deficits, which in most cases rely on foreign portfolio inflows to fund them. This makes them particularly vulnerable when sentiment turns against the country or when the general level of risk and uncertainty increases. This proved to be the case during the second half of the year, particularly as investors began fretting about the effects of QE tapering on emerging markets and the Fragile Five in particular i.e. what would happen if and when the Fed began scaling back its purchases of US bonds. It is widely accepted that much of the money central banks have been flushing into the world has found its way into emerging markets and commodities.

True to form, the BRIITS' currencies ended the year sharply lower across the board. The Russian rouble ended down 7.0% against the dollar, the Indian rupee 11.4%, the Brazilian real 13.2%, the Turkish lira 16.9% and the South African rand 19.0%. You are surely aware that the weakness in these currencies has increased sharply into 2014, so this will be an area of major focus for all investors.

Global equity markets

This is fun part of the commentary, where we get to report on what will go down as one of the more profitable years in equity market history. Despite all the doom and gloom, equity markets in both developed and developing countries posted substantial returns, admittedly for the most part through a re-rating of their price levels as opposed to a material increase in the companies' underlying earnings.

Chart 3: Global returns to 31 December 2013

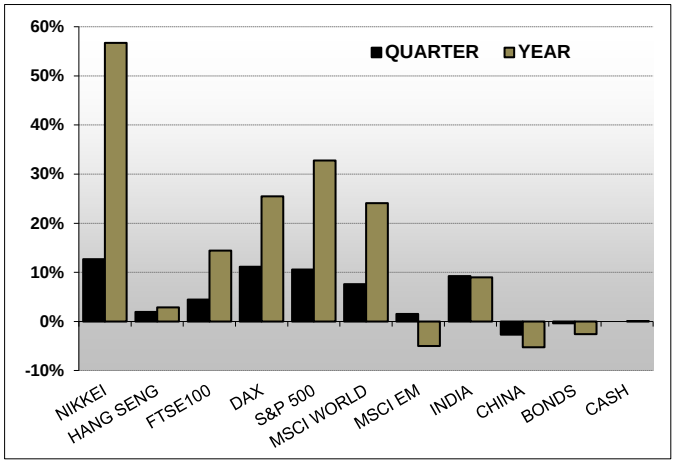
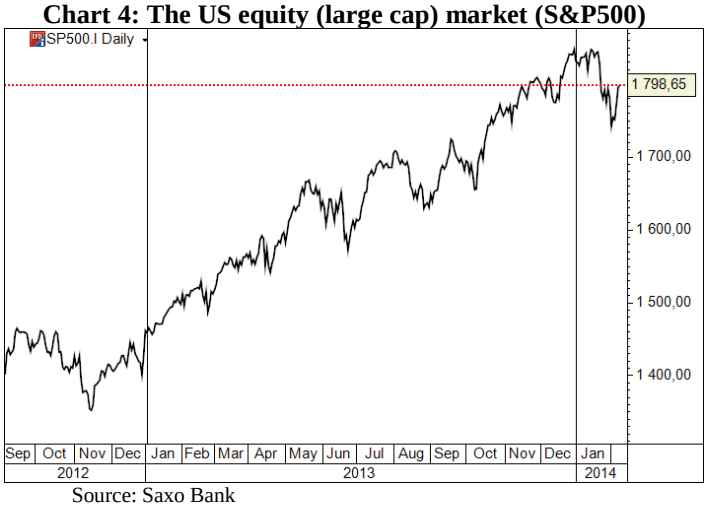


Table 1 and Chart 3 depict the returns from major developed and emerging markets. The sheer size of returns was quite remarkable and speaks of investor willingness to take on risk. One of the better performing markets was that of the US, where large cap index, the S&P500, rose 32.8% after rising 16.3% in 2012. This return was trumped by the tech-heavy Nasdaq index, which rose 38.3% (15.9% in 2012) and the S&P small cap index, which delivered an astonishing 42.4% return (12.6% in 2012). The Japanese market rose 56.7%, but this was heavily influenced by the BoJ's deliberate weakening of the yen; the Japanese market is heavily weighted in favour

of major exporters like Sony and Toyota, who benefit substantially from a weaker yen.

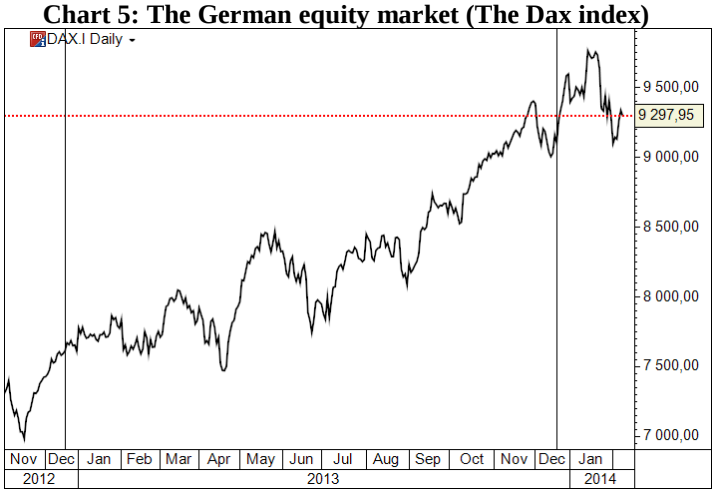
Chart 4: The US equity (large cap) market (S&P500)



Source: Saxo Bank

The German market (Chart 5) was also a profitable place to be, rising 25.5% after a 29.1% return in 2012. The UK market was less profitable, rising only 14.4%, having been pulled lower by a relatively large weighting in mining and financial shares, which did not have a great year. The MSCI World index, a measure of developed equity markets by and large, rose 24.1% after a 13.2% gain in 2012. That stands in stark contrast to the fortunes of emerging markets; the MSCI Emerging market index *declined* 5.0% in 2013, following a rise of 15.2% in 2012. Of the BRIC countries, only India managed a positive return, rising 9.0% in 2013 (all of which came in the last quarter of the year) versus the declines in China, Russian and Brazil of 5.3%, 5.5% and 15.5% respectively.

Chart 5: The German equity market (The Dax index)



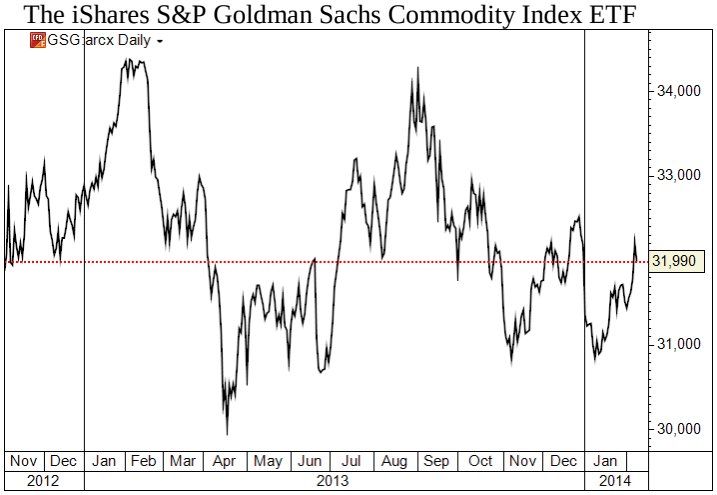
Source: Saxo Bank

Commodity markets

Despite the relatively weak dollar most commodity prices declined during 2013. The most stubborn price was the oil price. It displayed a disheartening degree of stability, declining only 0.3% last year despite the slower growth rate of the global economy and the increasing degree of energy self-reliance of the US, thanks to the shale revolution occurring there. Despite the oil price stability, precious metals were weak; gold declined 27.8% (refer to Chart 9), its poorer cousin, silver, ended the year down 34.9%, platinum ended down 11.1%. Palladium rose marginally, up some 1.7%. Most soft commodities ended lower on the year.

Chart 6: The S&P Goldman Sachs Commodity Index

The iShares S&P Goldman Sachs Commodity Index ETF



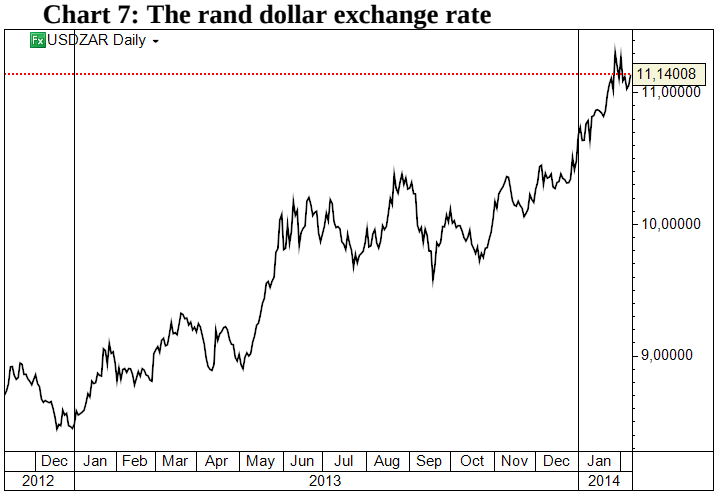
Source: Saxo Bank

The local economy…

We have touched on a number of features such as the gold price and rand, which have a material impact on the South African (SA) economy. It would be a grave mistake to think of the SA economy and investment markets in isolation – an error which political and labour leaders make virtually every day if their actions, policies and utterances are anything to go by. The only reason why we separate them in a document like this is to focus specifically on South Africa; many of you have the bulk of your investments in SA and as such would like to see more detail about, for example, the various sectors of the equity market.

It would not come as a surprise to hear that SA's economic growth is under threat. From a growth rate of 3.6% in 2011, the growth rate declined to 2.5% in 2012 and a likely 1.9% in 2013. Although the economy is holding up better than most expected, given the impact of the weak rand, labour unrest and disruptions, rising inflation and the lack of political leadership, it is hard to see the growth rate being sustained in the face of this enormous onslaught. We are of the view that the official estimates for growth this year are too high and we note that the SA Reserve Bank (SARB) decreased its growth rate forecast after its recent meeting. We are of the humble view that the SA economy will do well to grow at 2.5% this year, barring any further external shocks.

Chart 7: The rand dollar exchange rate



Source: Saxo Bank

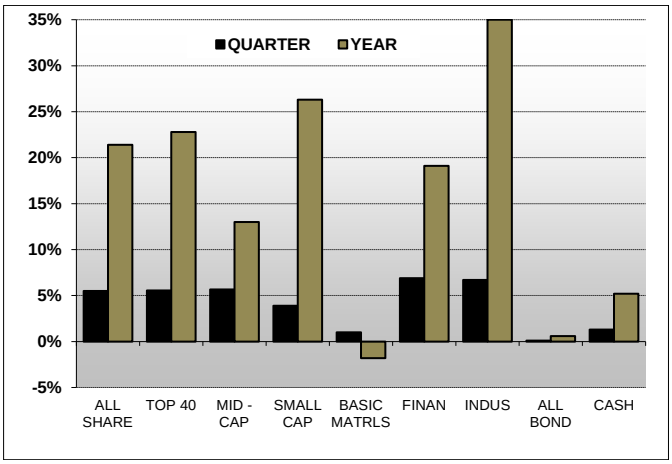
In addition, given the recent weakness of the rand against all other currencies (refer to Chart 7), it is naïve to believe that our inflation rate won't come under renewed pressure from all sorts of effects that pass through, from the higher petrol price, wage settlements significantly higher than inflation, and the like. We are likely to see a breach of the upper 6.0% limit of the target range in the coming months, although the weak growth is likely to limit any ongoing upward pressure in inflation. One can see the SARB is doing their best to curb inflationary expectations, which are threatening to get out of hand. So we hope that, on average, inflation will remain within the 3% to 6% target range for most of the year.

Interest rates remained steady through all of 2013. Weak consumer demand countered rising inflationary pressures from some quarters, but that delicate balance was turned upside down in January this year with the renewed onslaught on the Fragile Five currencies, of which SA is one. This jolted the SARB into action; their 0.5% increase in the official interest rate was a reaction to renewed concern on the part of global investors that the rand was about to spiral out of control. We are tempted to think that the SARB made an error in raising interest rates, but appreciate they wanted to signal to the market they were not unaware of the changing global environment. Although their action did not stem the rand's weakness, it sent a message to the world that the SARB is not impartial to the inflationary pressures that will arise as a result of the weaker rand. On this basis and assuming the rand is likely to remain under pressure – certainly for as long as our current account remains in deficit and under pressure – we think that interest rates will rise again in due course, by around 2.0% to 2.5% in total in the coming year.

<u>… and the local investment markets</u>

Despite the slowing economy and thanks in part to rampant global equity markets, the SA equity market still managed to post respectable returns. However, whereas in previous years when the rand was very weak and boosted basic material shares, last year saw industrial and financial shares leading the charge higher, partly on the back of the weak rand, but also as a result of excellent earnings. Chart 8 lists the respective returns from the major sectors and also those across the size (market cap) spectrum.

Chart 8: Local returns to 31 December 2013



What makes the returns from the industrial sector so remarkable is that last year was not a one-year wonder. No; the annual returns for 2009 through to 2012 were 31.0%, 27.4%, 9.2% and 40.8% respectively, showing just how strong industrial shares have been over the years and at the same time vindicating our long-held preference for them.

Also interesting to point out was the strong showing last year of the small cap index, which rose 26.3%, following annual returns of 28.3%, 24.7%, 1.1% and 29.0% between 2009 and 2012. The phenomenon of small caps outperforming large caps is consistent with a similar trend in developed markets, and highlights investor appetite for additional risk in equity markets over the years. Risk, that is, with the expectation of reasonable visibility of returns and the factors influencing them. This is in contrast to simply taking risk through an investment in SA gold shares, for example, where the sector fortunes are beyond anyone's control, including factors like the rand exchange rate, the gold price, labour environment and political and regulatory interference. That is why for many years now Maestro has shied away from high-risk, volatile mining and gold shares and invested the bulk of client money in the more predictable financial and industrial sectors. We have had exposure to some basic material shares but it has been far less than the exposure implicit in the All share index weightings.

In terms of the companies in which we invested a reasonable portion of our clients' portfolios, we were very disappointed by the returns from B&W and African Bank (Abil) which declined 62.6% during the year, although we did sell both holdings towards the end of last year. Prescient declined 29.2% on the year (it is a very small holding in portfolios), Kumba declined 22.1%, Tiger Brands 17.9% and Exxaro 13.3%. On a more positive note, Richemont rose 57.3%,

Aspen 59.0%, Steinhoff 64.5%, Grindrod 76.9%, OneLogix 79.0%, Coronation 101.6%, Naspers 101.8% and EOH 112.7%. These shares drove the bulk of our outperformance and contributed to another successful year of equity investment for our clients.

Chart 9: The dollar gold price

Source: Saxo Bank

Turning to the local bond market, you should not be surprized at the poor returns from this sector, given the deterioration in the rand and the misfortune of global bond markets. The All bond index rose only 0.6% last year while the return from cash was 5.3%.

Value and growth investing - has the landscape changed?

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. It is our experience that it can be very costly having a purist view in the investment world, especially when one considers that the only constant seems to be a changing landscape. We believe it is important to remain flexible in your investment view and to use all the tools available to achieve sound returns with less risk. We note with some interest the active debate in local circles regarding the merits of value investing; this stems in part from the very poor returns from some high profile value funds over the past five or so years. With the gold, platinum and basic materials index having posted strong returns in the closing months of 2013, these funds have enjoyed something of a return to favour, with their respective managers claiming "victory" for their style of management. We think that misses the point entirely. To have, for example, six or seven of your fund's ten largest holdings in a sector that is typically characterized by large double digit returns (mostly negative returns in the past few years) is a very risky strategy. To be fair, there are investors that enjoy these kinds of high-risk returns, but they are typically not Maestro-type clients and they should not be surprised by the highly volatile nature of their returns. While it is all good and well to highlight very large recent monthly returns as some value managers are currently doing, it says nothing about the *inordinate degree of risk* that was assumed in the generation of those returns. As we pointed out earlier, neither company management nor investment managers could honestly claim to have influenced the factors that led to those large returns having been generated, such as movements in the gold price, rand and sentiment.

Maestro's performance track record over the past thirteen years illustrates that our pragmatic approach to the investment world works for clients and it works for Maestro. We don't believe it is worth hanging on to any purist approach when managing money, such as either extremes of value or growth investing. We believe in buying great companies with top quality management and sound earnings prospects. We try and reduce the degree of risk assumed to the bare minimum, but acknowledge that if nothing else, the very essence of investment management is about managing risk, so the concept of risk can never be totally eradicated; rather it has to be managed properly. With our balanced and pragmatic approach, the Maestro team will continue to manage our clients' money to the best of our abilities, taking careful note of their personal circumstances first and foremost, and then matching that with the levels of risk implicit in the prevailing investment environment.

In closing

We once again thank you for your support throughout the year. A profitable year such as 2013 is always a hard act to follow, particularly when the returns generated were, in one form or another, influenced by and occurred within an abnormal policy environment. That said, we are of the humble view that the global economy is in a reasonable space, with reasonable growth prospects. It's recovery from the Great Financial Crisis and the movement towards a more normal (policy) environment is still fragile though and is likely to include the odd "wobble", compounded by the fact that markets are no longer as cheap as they were in 2009 and 2010. Nevertheless, we are comfortable that the global environment will continue to make progress towards a more normal environment.

As far as South Africa is concerned, there are a number of important features that will arise in the months ahead that are unpredictable and have the potential to be very destabilizing. These include the fact that, at least in our view, government seem to have "lost control of the economy" and many of the forces that bear down on it, such as tax revenue, inflation, the rand, the labour situation and very importantly, government's own ability to implement any of its policies. Add to these the fact that we are heading for an election soon, which means that government will lose complete sight on important longer-term issues like appropriate policy formulation and real economy leadership. These factors – and there are plenty more – will weigh on investment sentiment, both inside and outside the country and combine to make the coming few months in the country very interesting.

Despite all the doom and gloom, South Africa has successfully negotiated its way out of worse crises in the past and we have confidence in corporate South Africa's ability to adapt to meet the changing circumstances and to make the most of the opportunities that come their way. In short, we are looking for another profitable year from the SA equity market, although we would caution that the returns are almost certainly unlikely to be as large as the returns experienced by the bulk of the sectors over the past four to five years.

The Maestro Investment Team
10 February 2014