MAESTRO EQUITY PRESCIENT FUND

QUARTERLY REPORT

Orchestrating Your Wealth

MAESTRO
Masters of Investment

PRESCIENT
MANAGEMENT COMPANY

For the period ended 30 September 2014

Investment objective
The Maestro Equity Prescient 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.

The Fund benchmark
The Fund will measure itself against the FTSE-JSE All Share Index.

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

Fee structure
The maximum initial fee is 2.0%. The annual investment management fee is 1.75%. The annual total expense ratio (TER) for period ended 30 June 2014, in respect of class A was 2.06%.

Income declaration (annually)
23.78 cents per unit
31 March 2014

Fund size
R128 174 272

Management company
Prescient Management Company (RF) Ltd
PO Box 31142, Tokai, 7945

Trustee and auditor
Trustee: Nedbank Limited
Auditor: KPMG Inc.

Investment manager
Maestro Investment Management (Pty) Ltd

Enquiries
Maestro Investment Management
Box 1289
CAPE TOWN, 8000
Tel: 021 674 9220
Email: luke@maestroinvestment.co.za

Introduction

This Report focuses on the investment activities of the Maestro Equity Prescient Fund during the September quarter. It should be read in conjunction with recent editions of Intermezzo and the monthly fund summaries, wherein we documented some of the salient features of the recent market behaviour. I also refer you to the Market Commentary – September 2014 report, wherein we discuss the markets' behaviour during the quarter. It will be sent together with this report.

The investment position of the Fund

The Fund's asset allocation is shown in Chart 1. Exposure to the resource sector totalled 17.1% of the Fund, down from 17.9% in June. Financial exposure fell to 16.4% from 18.6% and industrial exposure rose from 58.9% to 60.5%. Cash represented 6.1%, up from 4.8% at the end of June.

Chart 1: Asset allocation at 30 Sep 2014

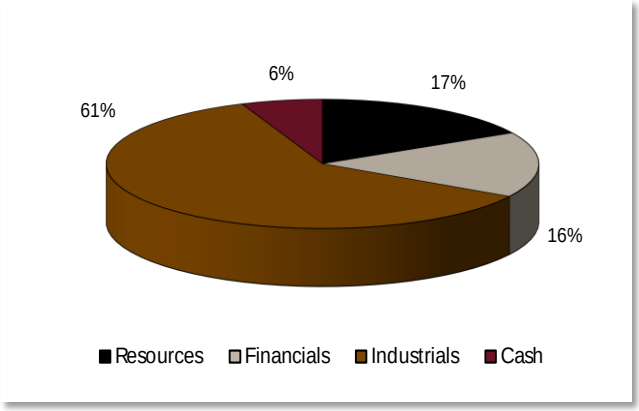
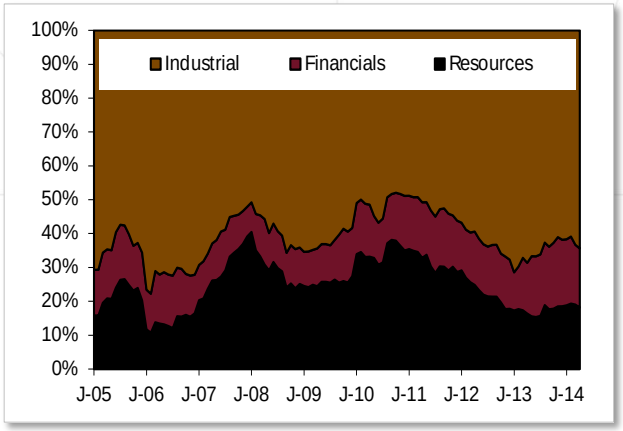


Chart 2 depicts the historical allocation to the three major sectors of the equity market, expressed as a percentage of the equity portion of the Fund.

"To achieve great things, two things are needed; a plan, and not quite enough time."
- Leonard Bernstein

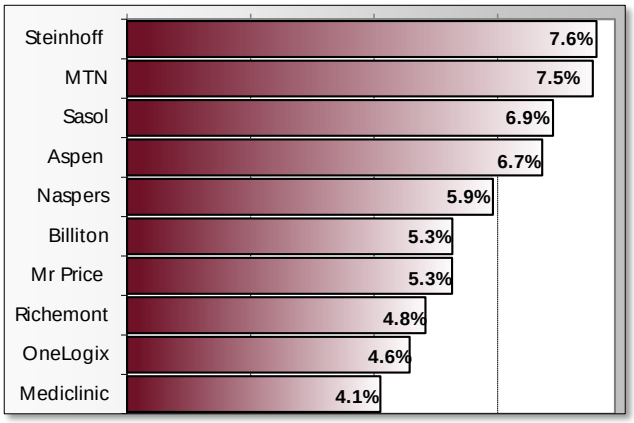
Chart 2: Sector exposure at 30 Sep 2014



The largest equity holdings

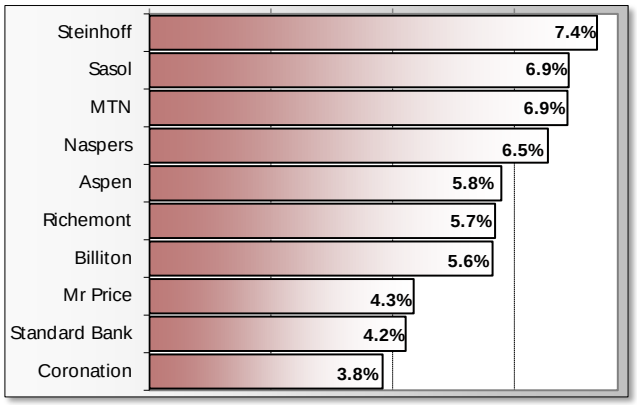
The largest holdings at 30 September are listed in Chart 3, expressed as a percentage of the equity portfolio.

Chart 3: The largest holdings at 30 Sep '14



The largest holdings at the end of June are listed in Chart 4. During the quarter, OneLogix and Mediclinic replaced Standard Bank and Coronation in the top 10 holdings of the Fund. At the end of September there were 28 counters in the Fund, one less than at the end of June. The ten largest holdings constituted 58.7% of the Fund up from 57.2% in June.

Chart 4: The largest holdings at 30 Jun '14



Recent activity on the portfolio

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.

During the quarter the Fund reduced its holdings in Coronation and Naspers. The Fund also sold out its relatively small position in Capitec.

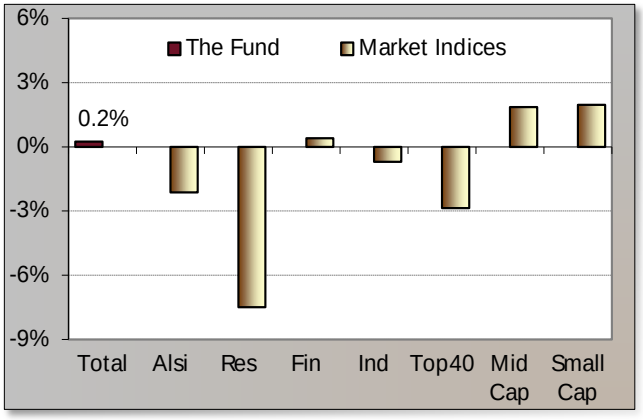
The performance of the Fund

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 0.2%.**

The Fund's quarterly equity return of 0.2% can be compared to the All share index return of -2.1%.
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 – September 2014.

Chart 5: Quarterly returns to 30 Sep 2014

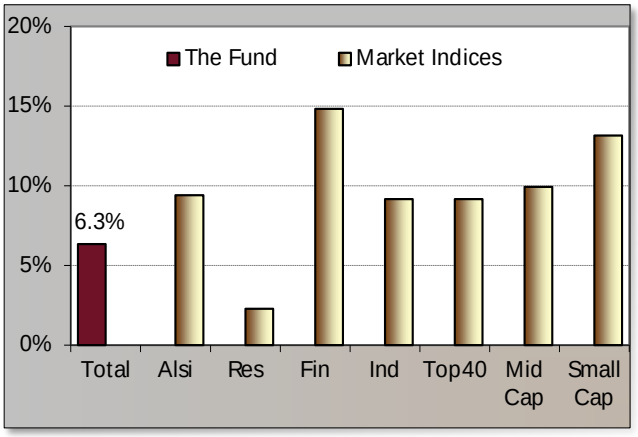


Locally, the main theme of the September quarter was a similar one to June quarter, where resources significantly lagged the industrial and financial indices. The weakness in the rand over the quarter was not enough to compensate for the dramatic declines seen in commodity prices over the quarter (refer to the Market Commentary for more information). After a strong June quarter, Industrials were marginally down in the September quarter, declining 0.7%. Financials were surprisingly resilient in the weak rand environment, gaining 0.4% over the quarter. Gold shares were weak over the quarter on the back of a weak gold price, as the gold index declined 12.4%.

What is not evident from Chart 5 is the performance of companies based on their sizes. The small and mid-cap indices significantly outperformed their large-cap peers over the quarter. The mid-cap index rose 1.9% and the small-cap index gained 2.0%, while large-caps were relatively weak, as the Top40 index declined 2.9% during the quarter.

Let us look at the September quarterly returns of some of the Fund's investments. The quarterly returns, excluding dividends, of the largest holdings in the portfolio, were as follows: Aspen rose 12.6% (it rose 6.3% in the June quarter), Mr Price 17.4% (14.9%), Steinhoff -8.7% (16.2%), Naspers -0.6% (7.8%), MTN 6.4% (3.9%), Billiton -9.5% (6.3%), Sasol -3.0% (7.3%), Richemont -17.6% (10.8%), Mediclinic 12.6% (9.2%) and OneLogix 19.5% (17 .1%).

Chart 6: Year-to-date returns to 30 Sep '14

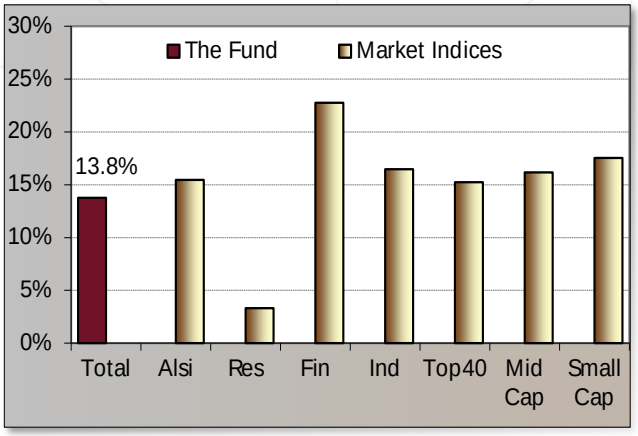


The un-annualised return on the total Fund for the year-to-date was 6.3%, shown in Chart 6. The Alsi rose 10.0% for the year-to-date. The underperformance during that period is as a result of the strength in gold shares in the first quarter, which we commented on extensively in the June quarterly report. Interestingly, financials have been the standout performer for the year-to-date, despite the marginal weakness in the rand.

The annual returns to 30 September are shown in

Chart 7. The annual return of the Fund was 13.8%. Inflation rose 6.4% over the past year and the All bond index rose 5.8%.

Chart 7: Annual returns to 30 Sep 2014



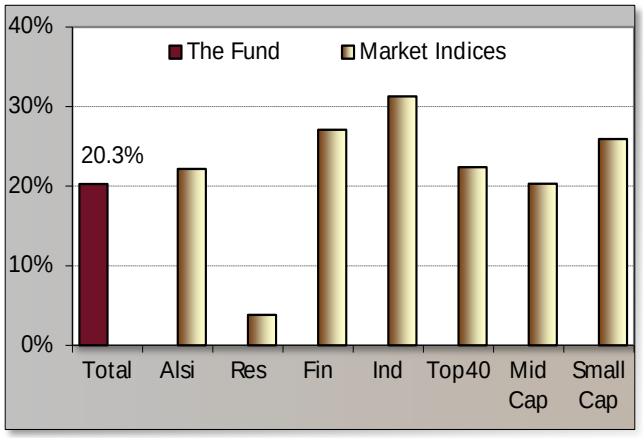
The overweight position in industrials relative to the All share index and the underweight position in resource shares assisted the returns over the past year. Not shown in the chart are the annual returns of large, mid and small-cap indices, which rose 15.2%, 16.2% and 17.5% respectively.

During the past year, the shares that drove the Fund's returns include Mr Price, which rose 52.7%, Steinhoff 51.3%, Coronation 40.9%, Naspers 34.1%, EOH 32.7%, OneLogix 32.4% and Aspen 28.1%.

The compound annual return (CAR) of the Fund, shown in Chart 8, over the three-year period to September 2014 was 20.3%, which can be compared to the All share index return of 22.2%.

It is probably worth highlighting that despite our preference for industrials and financials over resources, and the fact that they have outperformed over the long-term, that is not to say there won't be periods when resources are strong, which will likely lead to us underperforming. We remain comfortable with our overweight industrial position and we continue to believe that over the long-term, it will remain a major contributing factor to our outperformance.

Chart 8: CAR: 3-year period to 30 Sep 2014



Across the market cap spectrum, the small-cap index had the strongest performance, followed by the large-cap and small-cap indices. The three-year compound annual returns of the large, mid and small-cap indices are 22.4%, 20.3% and 25.6% respectively. The respective compound annual returns for the All Bond index and cash over this period were 8.4% and 5.5% respectively.

The CAR of the total Fund over the five-year period to September, shown in Chart 9, was 13.8% per annum. This return can be compared to the All share index return of 18.0%.

The industrial index compound annual return over the five-year period was 25.6%, while financials and resources returned 20.3% and 4.9% respectively over the same period. The 5-year CARs for the

large, mid and small-cap indices were 17.9%, 18.4% and 20.2% respectively, while the respective CARs for the All Bond index and cash were 9.3% and 5.9%.

Chart 9: CAR: 5-year period to 30 Sep 2014

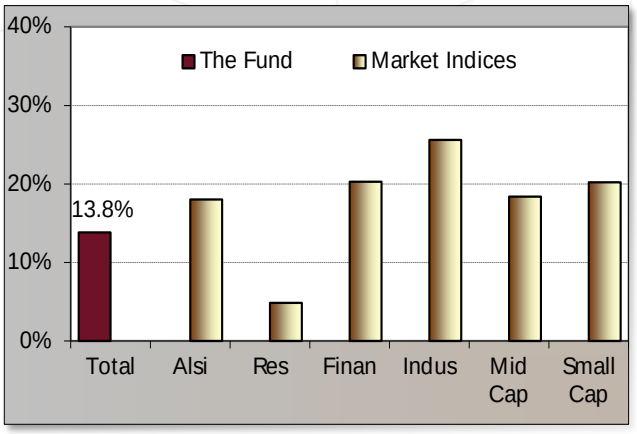
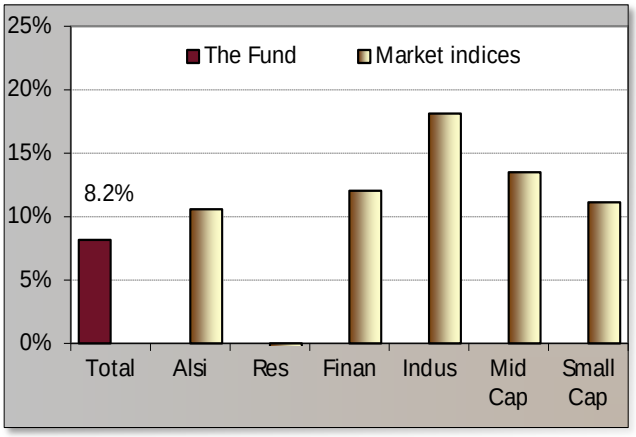


Chart 10 lists the returns over a seven-year period. **The CAR of the Fund over the seven-year period to September was 8.2%** versus the return over the same period of the All Share Index of 10.6%.

Over this period, South African inflation rose at 6.3% per annum, while the All bond index compound annual return was 8.8%. The annual return on cash was 7.4%.

Once again, the stand out feature in the chart below is the outperformance of the industrial sector relative to the financial and resource sectors over the last seven years. The industrials index has risen 18.1% per annum versus the 12.0% for the financials index and decline of 0.9% for the resource index. the last seven years. The industrials index has risen 18.1% per annum versus the 12.0% for the financials index and decline of 0.9% for the resource index.

Chart 10: CAR: 7-year period to 30 Sep '14



Closing remarks

Markets had a lot to digest during the quarter, with slowing eurozone and China economies, as well as clear signs that the Fed's third quantitative easing (QE) program is coming to an end (refer to the Market Commentary for more on these topics). These events did not affect equity markets as much as they did commodity prices, which were hard hit over the quarter. The reasonable economic growth in the US has been encouraging, however, we would argue that in order for equity markets to be sustained at these levels and to move higher, we need to see a continuation of this growth.

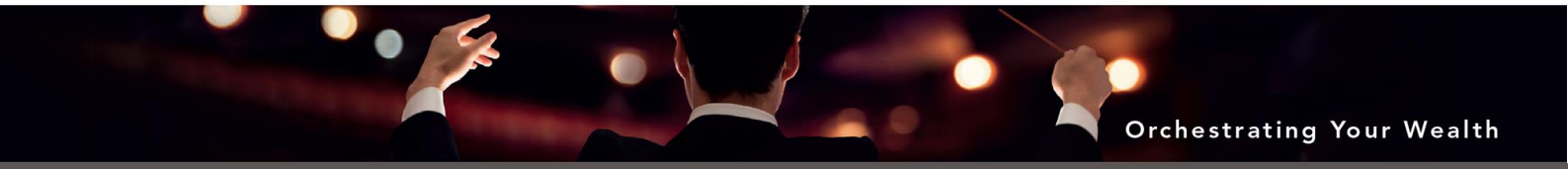
With the end of the Fed's QE program in sight and with other major central banks adopting different approaches to monetary policy, it is likely that we will see an increase in the levels of volatility across equity, bond, currency and commodity markets over the next year. We would thus caution against expectations that the relatively smooth ride in markets over the past couple years will continue without some bumps ahead.

Saying this, volatility and investor nervousness more often than not present opportunities for long term investors to invest in great companies at reasonable or cheap prices.

We thus continue to make it out goal to search out these companies despite the prevailing market conditions and sentiment for the benefit of our clients.

As usual, we are here to be of assistance to you, so please, do not hesitate to call on me if ever you wish to discuss anything about the Fund in further detail.

Kind regards
Luke Sparks



Market Commentary: The September 2014 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 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 (%)	June Quarter (%)	Annual Returns (%)	2013 (%)
Japan	6.7	2.3	11.9	56.7
Hong Kong	-1.1	4.7	0.3	2.9
Germany	-3.7	2.9	10.2	25.5
UK	-1.8	2.2	2.5	14.4
US (S&P500) and large cap	1.2	4.7	20.1	32.8
S&P Mid cap	-4.3	4.0	10.2	31.6
S&P Small cap	-7.0	1.8	4.5	42.4
MSCI World index	*-2.6*	*4.2*	*10.0*	*24.1*
Brazil	1.8	5.5	3.4	-15.5
Russia	-18.4	16.3	-20.8	-5.5
India	4.8	13.8	37.4	9.0
China	15.4	0.7	8.7	-5.3
MSCI Emerging market index	*-4.3*	*5.6*	*1.8*	*-5.0*
JSE All share	*-2.1*	*7.2*	*15.5*	*21.4*
JSE All share ($)	*-7.8*	*6.0*	*2.8*	*-1.6*
Basic materials	-7.5	1.8	3.3	-1.8
Financial	0.4	7.8	22.8	19.1
Industrial	-0.7	9.1	16.5	35.0
Gold mining	-12.4	0.1	4.4	-54.6
Large cap (Top40)	-2.9	7.4	15.2	22.8
Mid cap index	1.9	6.0	16.2	13.0
Small cap index	2.0	6.1	17.5	26.3

Table 2: Selected Returns: Bonds, commodities and currencies

	Sep Quarter (%)	Jun Quarter (%)	Annual Returns (%)	2013 (%)
SA All Bond index	2.2	2.5	5.8	0.6
SA Cash	1.5	1.5	5.6	5.2
Barcap Global Agg. Bond index	-3.1	2.0	4.4	-2.6
Emerging market bonds	-2.2	4.8	7.8	-3.3
US 10-year bond	0.7	2.7	3.6	-7.8
US Corporate bond	0.0	2.9	7.1	-1.5
US High yield bond	-1.9	2.6	7.2	7.4
Cash (US dollar)	0.0	0.0	0.1	0.1
DJCS Hedge index	0.6	1.9	7.7	8.4
Brent (Oil)	-15.7	4.3	-12.6	-0.3
Gold	-7.5	1.8	-8.3	-27.8
Silver	-18.0	4.5	-21.1	-34.9
Platinum	-10.8	2.7	-7.9	-11.1
Palladium	-10.3	11.0	6.7	1.7
Copper	-3.6	4.6	-8.4	-7.1
Nickel	-11.7	19.3	19.1	-18.5
Baltic Dry index	27.8	-39.5	-47.0	225.8
CRB Commodity index	-8.1	1.8	-1.3	-4.1
S&P GS Commodity index	-10.9	2.0	-7.8	-1.3
Euro dollar	-7.7	-0.7	-6.7	4.5
Sterling dollar	-5.2	2.6	0.1	1.9
Swiss franc dollar	7.8	0.4	5.7	-6.7
Rand dollar	-5.8	1.2	-10.9	-19.0

Introduction

The third quarter of 2014 saw volatility increase in global equity markets as fears around a significant slowdown in eurozone economic growth, a continuation of geopolitical risks and fears around a

MAESTRO INVESTMENT MANAGEMENT
PO Box 1289, Cape Town 8000 ♪ Third Floor, Letterstedt House, Newlands on Main, Main Road, Newlands 7700 ♪
Tel: 021 674 9220 ♪ Fax: 021 674 3209 ♪ E-mail: info@maestroinvestment.co.za ♪ www.maestroinvestment.co.za ♪
Directors: André Joubert, Sue Joubert, Anthony Coombe, Ronny Miyambo. Reg no. 2000/028796/07

global spread of Ebola all plaguing investors' minds.

As shown in Tables 1 and 2, apart from a few standout performers, equities were weaker over the quarter, both internationally and locally. Bond performances were mixed, as locally the asset class was strong with the All Bond index gaining 2.2% despite the weak rand. Internationally, bonds were weak with the Barcap Global Aggregate Bond index falling 3.1% over the quarter.

The most dramatic moves in global markets were observed in the commodity space. The US dollar was particularly strong over the quarter, as the US economy showed encouraging signs of growth and the Federal Reserve (Fed) gave indications that they would be ending their quantitative easing (QE) program. The strong dollar, coupled with nervousness around the pace of China's economic growth, weighed heavily on commodity prices.

The Global Economy

The US Economy

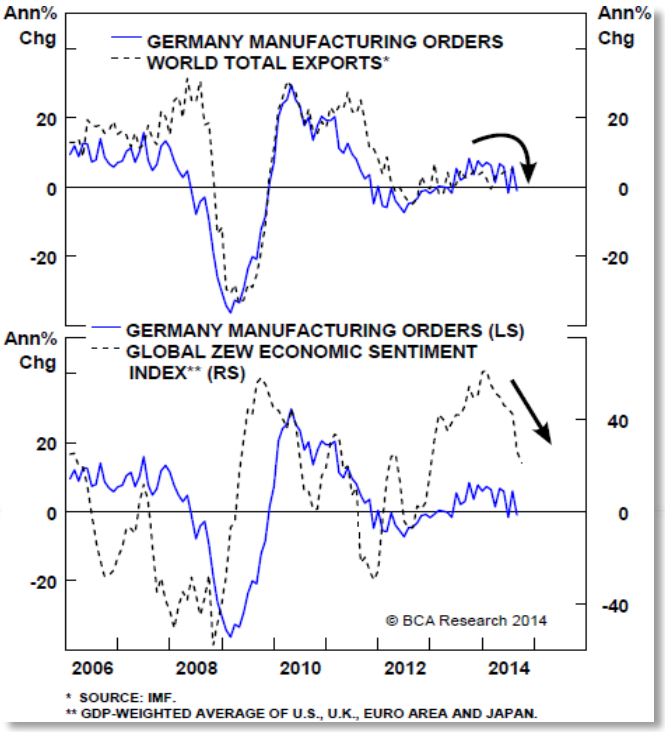
Over the past few years there has been much spoken about US economic growth being "sub-trend" since the global financial crisis. Although this has been the case, it is interesting to note that the US private sector GDP has actually been growing at an average annual rate of 3.1% since 2008. Fiscal austerity measures by the government have weighed on the headline GDP number, however, these measures are largely coming to an end. This fiscal austerity, or as some call it "public sector retrenchment", weighed 2.2% on US GDP last year and should reduce to around 0.4% this year. This bodes relatively well for overall economic growth in the US, which should continue to gravitate toward the speed set by the private sector, which is around 2.5% over the next year or so.

The Eurozone Economy

The third quarter saw more setbacks for the eurozone economy, as it became evident that the recovery stalled in the second quarter from a reasonably robust first quarter. Germany's GDP contracted in the second quarter by 0.2%, with weak exports being flagged as the main culprit. This can partly be attributed to the tit for tat sanctions imposed by both the EU and Russia in response to the crisis in the Ukraine. Other large eurozone economies also showed signs of struggle, with the Italian economy shrinking 0.2%, dipping back into recession, while the French economy stagnated. The regions Purchasing Manager's Index (PMI), which is a key leading economic indicator, dropped to just above 50 in August, which was its lowest level in just over a year. The contraction in German industrial production and orders in August is an ominous sign, given that German industrial complex is highly geared to global growth. It is becoming more and more evident that the ongoing lack of credit demand in the eurozone is muting the effects of the ECB's efforts to quantitatively ease monetary policy and increasing the very real risk of deflation. With inflation expectations declining, business and consumer confidence have been weakening too. With European governments still aiming at balancing budgets and thus not keen on spending their way out of a low growth scenario, the burden of stimulating growth is falling on the shoulders on the ECB.

The eurozone recovery is likely to be both weak and uneven over the coming quarters, and in particular the recent weakness in the German economy is a worry to us.

Chart 1: German economy slowing



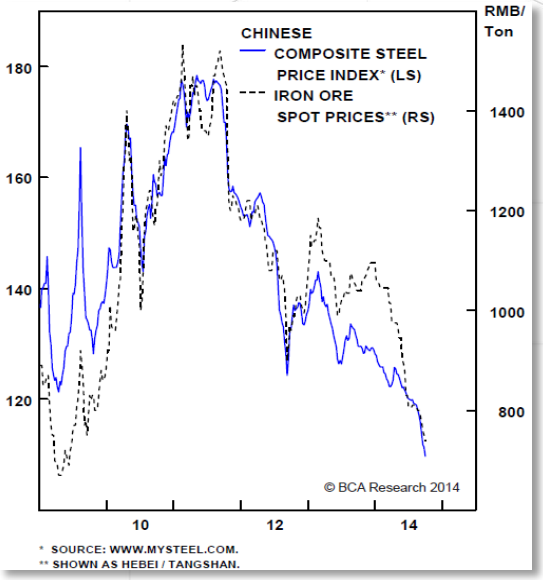
Source: IMF and BCA

The Chinese economy

China's economic growth has been lukewarm over the last quarter, with both consumer confidence and manufacturing PMIs declining of late. The housing market, a key contributor to economic growth over the past few years, showed more signs of weakening too.

Overall it has become clear that double digit Chinese economic growth rates are likely a thing of the past. The new question is whether China can sustain the government-stated growth target of 7.5%. China's economy has a savings rate of around 50% of GDP, which is higher than any other economy, and which has financed the prolonged investment boom over the past two decades. The economy is now going through a period of oversupply or inadequate demand, as a result of the investment boom and a prolonged slump in global trade since 2008. Concerns over the oversupply and sustainability of the high levels of investment in infrastructure in China has resulted in a sharp decline in commodity prices so far this year. As can be seen in Chart 2, the prices of steel and its key input, iron ore, have both been almost in free fall so far this year.

Chart 2: Steel and Iron Ore prices



Source: www.mysteel.com and BCA

The slowdown of the economy is being closely watched by the Chinese authorities. Although they have explicitly stated that they are not going to adopt large scale monetary easing, which they view as "irresponsible", they recognise the need for what they call "targeted easing" and "precision fine tuning" to ensure that economic growth stays within their target range.

Table 3: Global growth expectations (%)

	2013	2014F	2015F	2016F
Global	3.0	3.3	3.9	4.0
US	2.2	2.4	3.6	3.1
Eurozone	-0.4	0.7	1.0	1.4
Germany	0.1	1.5	1.5	1.4
Japan	1.5	1.0	1.3	1.4
UK	1.7	3.1	2.5	2.3
China	7.7	7.8	8.0	8.0
India	4.4	5.5	6.5	6.5
EM (Asia)	6.1	6.4	6.9	6.8
EM (Lat Am)	2.5	1.0	1.9	3.0
EM (CEEMEA)	2.4	1.9	2.7	3.0
EM	4.7	4.6	5.2	5.5
DM	1.3	1.8	2.4	2.4

Source: Deutsche Bank

Overall, what has been confirmed over the past quarter is that the US economy has re-emerged as the leader in global growth, with GDP likely to be around 2.4% for 2014, provided there isn't a dramatic slowdown in European and Chinese growth. The eurozone economy is weak and weakening at the core (i.e. Germany and France); without significant intervention from policy makers this trend is likely to continue. The eurozone economy will likely grow at 0.7% for 2014. The Chinese government has recognised the need to continue to ease monetary policy, albeit incrementally, which means that economic growth will likely be "managed" around the 7% to 7.5% mark.

Central bank activity

As we have mentioned in previous Market Commentaries, global central banks have had a huge impact on the performance of markets via their loose monetary policy since the Great Financial Crisis of 2007/9. It is thus important to maintain a watchful eye on their behaviour and actions as they will likely continue to impact both the direction and levels of volatility in global markets.

Over the quarter the European Central Bank (ECB) acted in response to a slowdown in growth and subdued inflation by reducing its policy interest rates further. It launched purchases of investment grade asset-backed securities, issued by the non-financial private sector, as well as covered bonds of the financial sector. Although we have not seen any significant and outright QE from the ECB yet, the very scary prospect of falling into deflation may just be the catalyst for this type of announcement.

Despite the relatively strong employment data seen in the US, where unemployment is now at 5.9% (the lowest level since July 2008), the Fed remained cautious in its comments on the outlook for economic growth. Its plan to end QE this year is still on track, however, the outlook for the first interest rate increase is being pushed out to the latter part of 2015.

The Bank of Japan (BoJ) maintained its monetary expansion programme at ¥60 to ¥70 trillion per year. There were also interest rate cuts by central banks in Israel, Korea, Chile, Turkey, Romania, Hungry and Peru.

Consumer Price Inflation

With the global economy slowing, it is not surprising that inflation expectations have been steadily declining over the last few quarters. Key to this has been downward pressure seen in commodity prices and the economic growth worries in the eurozone and China, which have weighed on inflation expectations.

Table 4: Annual rates of inflation (%)

	2013	2014F	2015F	2016F
US	1.5	1.8	2.2	2.4
Eurozone	1.3	0.5	1.1	1.5
Japan	0.4	2.9	1.7	1.8
UK	2.6	1.7	1.9	2.0
China	2.6	2.2	3.0	3.0
India	10.1	7.7	7.1	7.0

Source: Deutsche Bank

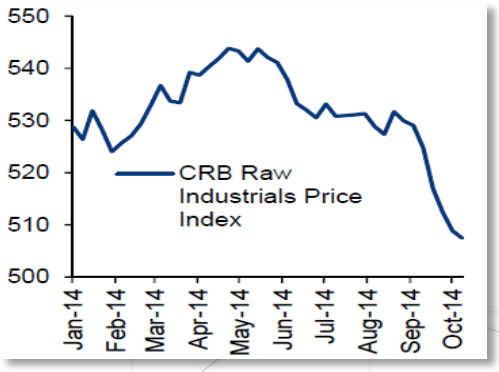
Over the recent quarter there have been significant reductions in inflation expectations, with both the US and eurozone inflation expectations reducing by 0.2% for 2014. The most recent inflation expectations are now show in Table 4 above.

Commodity markets

As mentioned above, one of the key drivers of the reduction in inflation expectations has been the weakness in commodity prices. Almost every major global commodity price declined significantly over the quarter, indicating the very real concern of a slowing global economy.

As commodity prices are denominated in US dollars, the strength in the dollar can also be partly to blame for the declines in the prices. The oil price fell 15.7% over the quarter and is down 14.6% for the year so far. Within the precious metals universe, we saw gold decline 7.5%, platinum 10.3% and silver an astonishing 18.0% over the quarter. Amongst the base metals, copper declined 3.6% and nickel 11.7%, while aluminium actually rose 4.5%. Iron ore had another disappointing quarter as it plunged 17.4% on the back of slower imports into China. Soft commodities had another weak quarter on the back of good US crop weather and a stronger dollar. Corn fell 24.4%, cotton 21.8%, sugar 6.9% and soybeans 34.8%.

Chart 3: Falling commodity prices



Source: Bloomberg

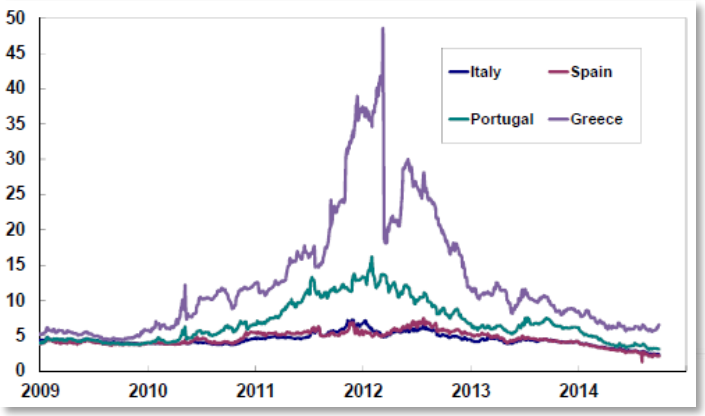
Global bond markets

Very few market pundits predicted the phenomenal moves in the bond yields of the peripheral eurozone sovereigns since they spiked in 2011/2012. Since the market fears and some calls for sovereigns to leave the common currency union only three years ago, we have seen a massive return of the appetite for their bonds.

The sovereign bond yields in these highly indebted countries fell to record lows in the quarter, as the ECB continued to adopt measures to revive lending and counter the prospect of deflation. Yields on 10-year government bonds in Italy, Spain and Portugal declined to 2.29%, 2.05% and 3.08% respectively at

the end of the quarter, which were all around 0.6% lower than in late June. The dramatic moves over that last five years can be seen in the chart below. Economic conditions in the highly indebted eurozone economies have to a large extent stabilised, albeit at weak levels, but the risk of renewed weakness remains elevated, mainly due to persistent troubles in their banking sectors.

Chart 4: Eurozone 10-yr bond yield collapse

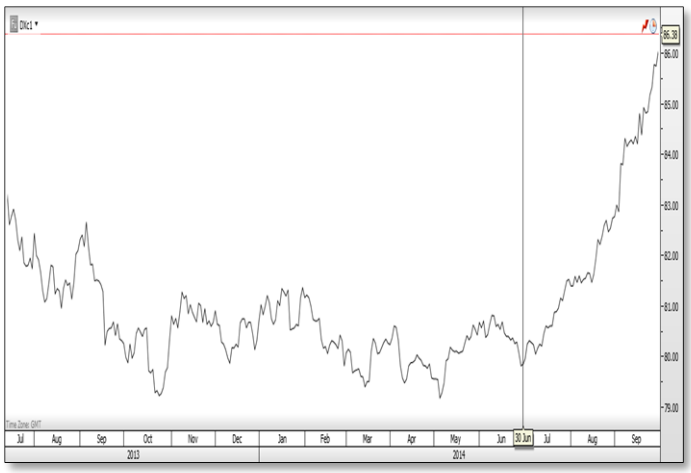


Source: Datastream

Currency markets

With QE in the US coming to an end and the US economy seeming to be in reasonable shape, the fact that the US dollar was strong in the third quarter did not come as a major surprise. The extent to which it strengthened did take us a little by surprise though. The chart below shows the trade weighted dollar index, which measures a "US trading partner" weighted basket of currencies against the dollar. This chart shows that, since the end of the second quarter, the dollar has been strengthening significantly as the Fed's "debasement" of the dollar comes to an end with QE finishing up. Virtually all major currencies were weaker against the dollar over the quarter.

Chart 5: The US dollar index



Source: Saxo Bank

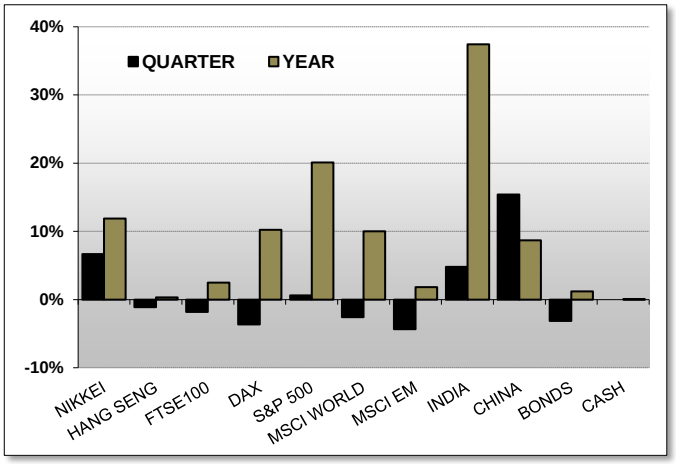
Global equity markets

With QE coming to an end in the US and European growth showing signs of faltering, it is no surprise that most equity markets came under pressure over the quarter. Emerging markets underperformed developed markets, as the MSCI Emerging Market Index declined 4.3% versus the 2.6% decline in the MSCI World Index. It is important to point out that the MSCI indices measure the performance of underlying indices in US dollars, so the strength of the dollar over the quarter accentuates the declines in the MSCI indices.

The chart below shows that the standout performers for the quarter were the Chinese, Japanese and Indian markets, which rose 15.4%, 6.7% and 4.8% respectively. Not shown in the chart below are the performances of the Brazilian and Russian markets, which lagged their BRIC counterparts. The Brazilian market rose by 1.8% while the Russian market declined a dramatic 18.4%. The performance of the

Russian market is understandable, given that it is heavily influenced by the oil price, which was very weak over the quarter. The sanctions imposed by the West on Russia were also partly to blame for the market's weakness.

Chart 6: Global returns to 30 Sept 2014

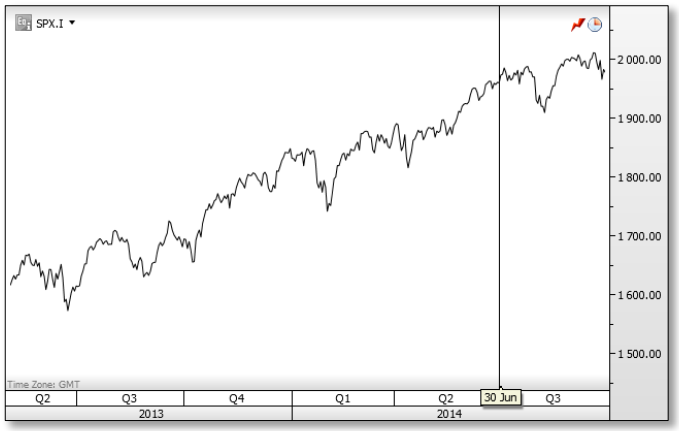


Source: Maestro

Within developed markets, the weakness in European equities is understandable, particularly with the very real threat of weak economic growth and deflation hanging over the common monetary union. Amongst the major developed market indices the German market was hardest hit, declining 3.7% on the quarter. The UK market fell 1.8%.

US large cap equities performed relatively well under the circumstances, with the S&P 500 large cap index gaining 0.6% for the quarter. It is interesting to note that the US small and mid-cap equities significantly underperformed their large cap counterparts, with the S&P mid and small cap indices declining 4.3% and 7.0% respectively.

Chart 7: The US equity (large cap) market (S&P500)

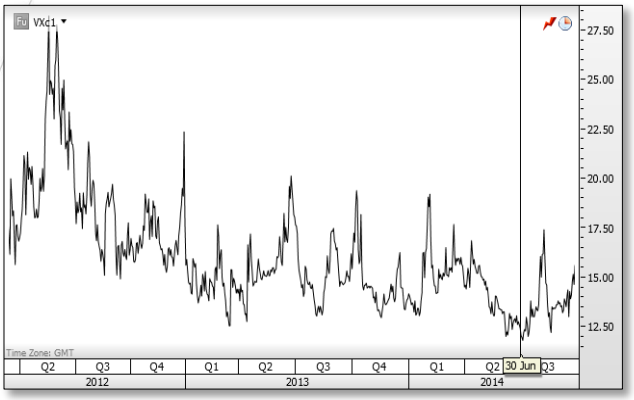


Source: Saxo Bank

With QE coming to an end in the US, and uncertainty and speculation as to when the Fed will start to increase interest rates, we have seen a marked increase in the levels of volatility in equity markets. Over the quarter we saw the Vix (see chart below), which is a measure of equity market volatility in the US, decline to a multi-year low and then increase significantly as weaker economic data started emanating from the Eurozone, and fears around Ebola spreading increased.

The levels of volatility have increased further into the fourth quarter, with the Vix spiking up to a level of 23 during October - the highest level in almost two years. It is our view that volatility is here to stay, as the Fed exits its QE program and the reliance on "good economic data" from the major world economies to support markets increases.

Chart 8: Volatility index (Vix) in the US



Source: Saxo Bank

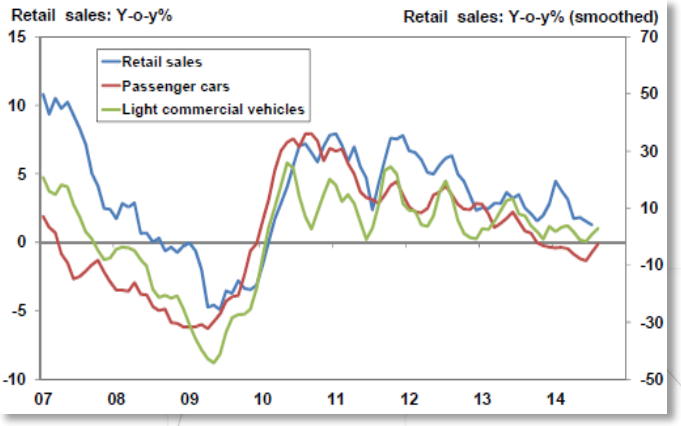
The local economy

Economic growth in the South African (SA) economy continues to disappoint following the strikes that plagued the first half of the year. The SA economy grew at a pedestrian 0.6% quarter-on-quarter, seasonally adjusted basis in the second quarter, after a 0.6% decline in the first quarter of the year. The growth in the second quarter stemmed mainly from increased value added by general government services, which most likely was boosted by spending related to May's general elections.

On the expenditure side of the economy, it is very evident that household consumption expenditure (HCE) continues to struggle, slowing to 1.5% in the second quarter from 1.8% in the first quarter. The consumer is most certainly under significant pressure, however, the recent and expected declines in the price of fuel is likely to provide some relief to the consumers' pocket. The slower expansion in HCE was also in line with household disposable income growth, which slowed from an increase of 1.7% in the first quarter to 1.3% in the second quarter. The HCE growth trend is likely to continue in the third quarter, as we have not yet seen compelling signs that there has been an improvement in household finances and confidence.

The chart below shows the trend over the past couple of years for retail sales and vehicle sales has been downward, which clearly indicates a consumer under pressure.

Chart 9: Consumer spending slowed further

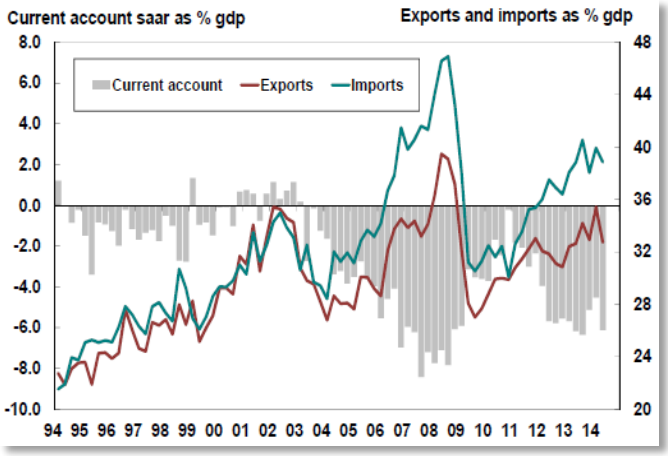


Source: NAAMSA and Stats SA

Growth in gross fixed capital formation (GFCF) disappointed in the second quarter as well, slowing to 0.5% from 2.6% in the first quarter. This is the slowest growth since 2009 and reflects a contraction in investment spend by both the private sector and public companies.

Economic indicators which have been released so far suggest that the lacklustre economic growth seen in the second quarter persisted into the third quarter.

Chart 10: SA current account deficit widened

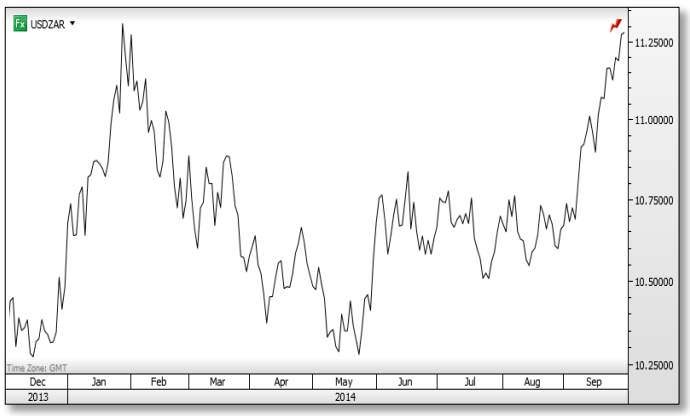


Source: SARB

The economy's trade deficit deteriorated over the second quarter, with the current account deficit rising from 4.5% to 6.2% of GDP. The graph above shows that imports have increased at a faster rate than exports, particularly since 2011, which is when the rand began its recent major weakening trend. The further expansion in the trade deficit put pressure on the rand, which weakened 5.8% against the dollar over the third quarter. It is expected that the current account deficit may narrow towards the end of the year, helped by stronger global demand, weak domestic demand and a weaker rand. The deficit should be watched closely as it is a key driver of the performance of the local currency.

The rand's decline against the dollar over the quarter, shown in the chart below, needs to be seen in the light of a strong dollar across the board. The rand only weakened marginally against the pound and actually strengthened 2.0% against the euro. The euro was particularly weak over the quarter, declining 7.7% against the dollar.

Chart 11: The rand dollar exchange rate



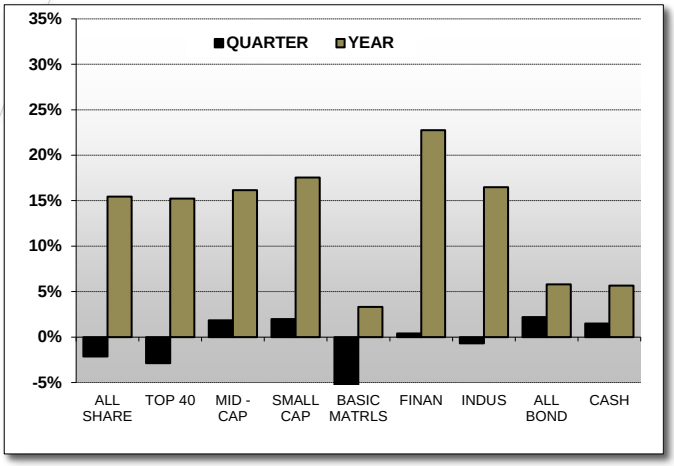
Source: Saxo Bank

Local investment markets

The All Share Index (Alsi) reached an all-time high during the quarter when it touched 52 242 points in July. This was, however, short lived, as problems in the Ukraine and Russia continued, as well as protests in Hong Kong added to investor pessimism towards emerging markets. Weaker global economic data in the eurozone and China also added to the local market woes. As a result the Alsi declined 2.1% over the quarter.

Taking a closer look at the drivers of the Alsi's performance over the quarter, it is interesting to note that although the rand was weak against the dollar, the basic materials index (resources) was the hardest hit amongst the three major indices. Not shown in the chart below was the performance of the gold index which fell 12.4% over the quarter, as the gold price ran into some significant headwinds.

Chart 12: Local returns to 30 Sept 2014



Source: Maestro

With the industrials index dominated by shares with rand hedge characteristics, it is understandable that the index performed relatively well, declining only 0.7% over the quarter. What did catch us by surprise was the resilience of financial shares, with the financials index actually gaining 0.4% over the quarter. Typically, when the rand weakens, financial shares come under pressure, however, this was not the case over the quarter.

In previous Market Commentaries we have alluded to the reasonably close correlation between the South African mid and small cap indices moving in line with the US mid and small cap indices, however, this quarter we saw the opposite happen. In the US, the S&P mid and small cap indices declined 4.3% and 7.0% respectively, underperforming the S&P 500 large cap index, which rose 0.6%. The opposite happened in the local market, whereby the mid and small cap indices rose 1.9% and 2.0% respectively, outperforming the Top40 large cap index, which fell 2.9%.

Turning to the local bond market, the third quarter built on the gains from the second quarter, as the All bond index posted a gain of 2.2%, which brought its annual return to 5.8%. This return was fairly surprising given the fact that bonds normally perform poorly when the rand weakens.

In closing

With clear indications from the Fed that they are stopping their monetary stimulus by ending their quantitative easing program, it is becoming increasingly important for economic growth, particularly in the US, to come through to justify current equity market levels. It is no secret that the major support for markets over the past five years has been easy monetary policy. It is our view that without a steady improvement in global economic growth (particularly the US), current equity market levels are under threat.

It is widely accepted that the eurozone is slowing, which continues to be a concern to us, however, we will get very nervous if deflation starts becoming widespread across the continent, and the policy makers are seen to be helpless in fighting it off.

As far as South Africa is concerned, there are a number of challenges that the economy is still navigating, namely rising inflation, increasing electricity costs, labour unrest and fragile economic growth of its major trading partner, namely the eurozone. The outlook for the rand continues to be uncertain and we are likely to see increased levels of volatility in the currency as the economy slows and the Fed exits its QE program.

MAESTRO INVESTMENT MANAGEMENT
PO Box 1289, Cape Town 8000 ♪ Third Floor, Letterstedt House, Newlands on Main, Main Road, Newlands 7700 ♪
Tel: 021 674 9220 ♪ Fax: 021 674 3209 ♪ E-mail: info@maestroinvestment.co.za ♪ www.maestroinvestment.co.za ♪
Directors: André Joubert, Sue Joubert, Anthony Coombe, Ronny Miyambo. Reg no. 2000/028796/07

Despite our expectations for volatility to increase across markets for reasons alluded to above, we remain convinced that the best way to approach markets and specific companies that we look to invest in, is by looking for good management who create value for shareholders, reasonable earnings growth and good cash generation, which over time results in higher share prices.

Luke Sparks
On behalf of the Maestro Investment Team

31 October 2014

MAESTRO INVESTMENT MANAGEMENT
PO Box 1289, Cape Town 8000 ♪ Third Floor, Letterstedt House, Newlands on Main, Main Road, Newlands 7700 ♪
Tel: 021 674 9220 ♪ Fax: 021 674 3209 ♪ E-mail: info@maestroinvestment.co.za ♪ www.maestroinvestment.co.za ♪
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